



HOW TO REDUCE PROPERTY TAXES

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INTRODUCTION

This is the third in a trilogy of policy briefs discussing education and taxation. In our first brief, we explain the state's need to increase its investment in public education. In our second, we explain how a Texas-style personal income tax is the best way both to adequately support public education and to reduce reliance on the property tax. In that piece, we outline why a new business tax by itself won't raise enough money to significantly cut property taxes and why a higher sales tax would be a move in the wrong direction.

In this brief, we explain alternative ways to cut property taxes, targeting reductions to those who need them the most.

THE PROPERTY TAX IS A DEPENDABLE AND GROWING SOURCE OF REVENUE

The property tax has performed relatively well as a revenue source for Texas school districts, cities, and counties. Over the ten-year period from 1995 to 2004, the value of taxable property statewide grew by 63%, while taxable sales increased by only 52%. Neither tax base kept up with the growth in personal income, which was up 70% during the same period.

The proportion of total property value that is subject to the property tax has stayed relatively constant since the homestead exemption was tripled in 1997; about 80% of total value is taxable, after accounting for exemptions, agricultural valuations, the over-65 tax freeze, and the cap on appraisal growth. In contrast, the sales tax covers a shrinking proportion of total sales. Taxable sales accounted for 27% of all sales in 1995, but only 22% of all sales in 2004, as untaxed services grew in importance in the Texas economy.

The property tax has been less volatile than the sales tax. Taxable property values statewide have increased every year over the past ten years, but taxable sales fell from 2001 to 2002, and remained below 2001 levels in 2003 – the cause of the large state budget shortfall facing the 2003 Legislature.

Raising the sales tax rate to reduce property taxes would thus move Texas in the wrong direction for two reasons:

First, increasing reliance on a regressive tax – the sales tax – while reducing the use of a less regressive tax – the property tax – would increase the unfairness of our state and local tax system.

Second, shifting from a reliable, fast-growing tax – the property tax – to a volatile tax that fails to reflect the changing nature of the state’s economy – the sales tax – would provide a less adequate and less dependable source of revenue to support public education.

SOME WAYS TO REDUCE PROPERTY TAXES ARE BETTER THAN OTHERS

In any event, there are better ways to reduce property taxes than an across-the-board rate cut. Certain mechanisms can target families most heavily affected by high taxes or ensure that all property owners are paying their fair share of taxes.

Any proposed tax changes should be evaluated by a tax equity note. The House rules require that, before the House can consider any tax bill that “creates or impacts a state tax or fee,” the Legislative Budget Board must prepare “a tax equity note that estimates the general effects of the proposal on the distribution of tax and fee burdens among individuals and businesses.” (Rule 4, section 34(b)(5)) The Senate has a similar rule that gives the chair of the Senate Finance Committee the option of requesting an equity note. (Rule 7.09(g)) In addition, the comptroller is required to prepare a biennial report on the overall incidence of the school property tax and any major state tax. These analyses include the effect of these taxes by family income level, between homeowners and renter, and among different industries.

Increased homestead exemption: Texas currently exempts the first \$15,000 of the value of a homestead from school property taxes. Homeowners who are disabled or age 65 or older are entitled to an additional \$10,000 exemption.

Flat-amount homestead exemptions offer the greatest benefit to lower-income homeowners, since the dollar amount represents a larger share of the value of a lower-value home than of a higher-value home. The comptroller’s tax incidence study shows that the general homestead exemption reduces school property taxes by an average of 0.51% of income for the one-fifth of Texas households with annual incomes under \$22,000, but by only 0.11% of income for the one-fifth with the highest incomes – over \$97,000.

To increase the number of eligible homeowners that actually receive the benefits of the exemption, an application for the homestead exemption should be included with the documents at all residential property closings. One bill to accomplish this was reported favorably from committee during the 78th regular session.

Of course, a homestead exemption does not benefit taxpayers who rent their homes, even though they pay those property taxes that are passed through in higher rents. Also, the exemption has not been increased since 1997, when it was raised from \$5,000, although housing values have increased rapidly since then. An exemption indexed to the median statewide price of a home would adjust automatically to preserve the benefit of an exemption.

Property tax deferral: Current law permits homeowners age 65 or older to defer collection of property taxes as long as they own and occupy their home, and for 181 days thereafter. A tax lien is placed on the property and interest of 8% a year accrues until the deferred tax bill is paid. The deferral may be obtained by filing a simple one-page affidavit with the appraisal district.

In other words, an elderly homeowner never has to sell his or her home to pay property taxes. The taxes can be deferred until after the owner moves or dies and the house is sold, and then paid from the proceeds before distribution to any heirs. Unfortunately, this provision is little-known and infrequently used, despite explicit statutory language requiring all chief appraisers to annually publicize this option.

In addition, since 1997 all homeowners have been able to defer property taxes on the portion of the taxable value of their homes that exceeds 105% of the prior year's value, not including new improvements. This protection is in addition to the cap that prevents homestead appraisals from increasing faster than 10% a year. This provision is even lesser known and rarely taken advantage of.

Circuit breaker: Just as an electric circuit breaker protects wiring from an electric overload, a property tax circuit breaker protects a taxpayer from tax overload by reducing property taxes that exceed a certain percentage of a taxpayer's income. Unlike a homestead exemption, the amount of reduction depends on both income and the property tax bill. This allows states to target benefits to homeowners having the greatest difficulty paying property taxes, such as elderly homeowners on a fixed income, not wealthy retirees. A common formula would rebate to taxpayers one-half of their property taxes in excess of 5% of family income, with benefits phased out as income rises.

A total of 33 states and the District of Columbia currently have circuit breaker programs. Many programs are targeted at the elderly, but seven allow all households to participate without regard for age, while five others cover all households but provide more generous benefits to the elderly. Family income limits can be as high as \$82,650 for joint filers, averaging about \$30,000 among participating states, with maximum annual benefits reaching \$1,530, with an average of \$750.

A unique feature of circuit breakers is the ability to benefit renters, who are assumed to pay property taxes indirectly through higher rents rather than directly to local governments. Twenty-six states and the District of Columbia provide relief to both renters and homeowners, while two states have circuit breaker programs for renters only.

These states make some assumptions about how much of a rent payment represents property taxes, which can vary among regions and by local market conditions. Property tax rent equivalents vary from 6% to 35% of rent, with most states in the 15 to 20% range. Benefits can be as high as \$2,100 per year and average nearly \$1,100.

Although benefits are linked to household income, it is not necessary for a state to have a state personal income tax in order to successfully operate a circuit breaker program. Five of the nine states lacking a state income tax – Alaska, Nevada, South Dakota, Washington, and Wyoming – have adopted circuit breakers.

Other benefits for renters: Another approach to directing the benefits of property tax reductions to renters was adopted by the House in its school-finance and tax bill in 1997. The House version of HB 4 would have required landlords who rent four or more residential units to register and report property tax savings to the state comptroller. A landlord would have had to pay a fee to the comptroller equal to the difference between the amount of property taxes paid for each year from 1997 to 1999 and the amount that would have been collected at the property tax rate in effect in 1996. A landlord would, however, have been entitled to a credit against this fee for any rent

reduction given to tenants for each tax year – creating a strong incentive to pass property tax savings through to tenants.

This rebate program was thought to be more administratively efficient than a circuit breaker, since the costs of running the program would be covered by fees paid by the landlords. Renters would have gotten tax savings proportional to the savings on the property they rented, rather than according to their income or family size, as under a circuit breaker.

REQUIRING ALL PROPERTY TAXPAYERS TO PAY THEIR FAIR SHARE CAN KEEP RATES LOW

Taking steps to make sure all property owners pay their fair share of taxes can help keep rates lower across the board. Several ways are available to ensure that taxes are calculated on the full fair market value of property.

Sales price disclosure: Local appraisal districts base valuation of property on the best information available from commercial sources, but the districts lack the comprehensive knowledge of real estate values needed for full accuracy. In particular, price information on high-end homes and on business property is very hard to obtain. To remedy this, the state should require that sales prices in all real estate transactions be reported to the appraisal district. Disclosure is required in 35 states; Texas is the only state so highly dependent on property taxes that tries to function without knowing actual sales prices.

Increasing the amount of taxable property value by ensuring that all property is on the rolls and accurately valued would permit the school districts to collect the same amount of revenue at a lower tax rate. Since the state guarantees that school districts can generate a certain amount of revenue per student for each penny of tax rate, more local revenue could also reduce the need for state aid.

During the 2005 regular session, the Senate passed SB 282, which would have required the purchaser of real property to file a signed report with the chief appraiser disclosing the sales price of the property and other sales and value-related information. The bill failed to reach the House floor.

Improved property value study: Because state school-finance payments are based on the property values within each school district, the state has a financial interest in ensuring the accuracy of local property-tax appraisals to avoid incorrectly low estimates that create an artificially high demand for state aid.

The comptroller each year carries out a “ratio study,” comparing the local appraisal district’s estimate of market value to the comptroller’s own determination. If the locally determined value is within an acceptable range of the state’s estimate, the local value is used in distributing school-finance assistance. If the local value is too low, the state-determined valuation is used (after a two-year grace period). The comptroller also conducts a performance audit of any appraisal district that falls short of the required measures of accuracy.

The state's study does not directly affect the value on which taxes are levied. It does, however, give school districts a strong incentive to ensure accurate valuations by their appraisal district, whose board of directors includes several members appointed by the school districts within the county.

The comptroller does not report statewide median appraisal ratios for industrial real or personal property, noting that too few sample observations are available to produce meaningful ratios, so the state must accept local valuations. However, since industrial property accounts for more than 11% of total taxable value statewide, this is a significant shortcoming in the study.

A study by the International Association of Assessing Officers in 2001 stated that the comptroller lacks sufficient funding, staff, training, computerization, and information support technology to perform such a large study. Additional funding might allow the comptroller to increase the accuracy of the study and expand its coverage to include industrial property.

Enforcement of agricultural valuation: Land devoted to certain farming, ranching, wildlife management, or timber purposes is appraised at its productivity value – the value based solely on the land's capacity to produce agricultural products – rather than on its market value. Although not literally an exemption from taxation, this is commonly known as the “ag exemption.”

There are widespread indications that these provisions are abused. For instance, a developer holding land on the fringe of an urban area can, with minimal investment, reasonably maintain that the acreage is devoted to agricultural use, even though it is intended to soon be subdivided. The best check on this abuse under current law is the requirement that assessors record both the market and productivity valuations. If the land is converted to a nonagricultural use, the owner must pay the taxes that would have been imposed on the land at market value over the preceding five years, plus interest.

In 1997, as part of a much larger school-finance and tax-reform bill (HB 4), the House passed a provision that would have prohibited land from being designated “open-space” land if a contiguous parcel of land owned by the same person was not eligible for the open-space valuation. According to the House Research Organization, this limitation was intended to prevent, for instance, power companies from putting a few cows to graze under power lines in order to obtain a lower valuation, and thus a lower tax bill. Florida attempts to deal with abuse of agricultural exemptions by denying the exemption for land purchased for more than three times its agricultural value.

SOME WAYS TO REDUCE PROPERTY TAXES HAVE HARMFUL SIDE EFFECTS

Lower appraisal cap: In 1997 the voters approved a constitutional amendment to allow the legislature to limit the increase in the taxable value (appraisal) of a residential homestead to 10% a year. A constitutional amendment was required because the cap is an exception to the basic requirement that taxation be equal and uniform (Art. 8, sec. 1-a, of the Texas Constitution) and that all taxable property be taxed in proportion to its value (sec. 1-b).

More than half of the benefit of the current 10-percent cap goes to families with incomes over \$97,000 a year, according to the comptroller's tax incidence study. Higher-income families live in higher-priced homes, and higher-priced homes tend to gain in value more quickly than lower-priced

homes. This tendency is so strong that the one-tenth of Texas families with incomes over \$136,000 reap more than one-third of the benefit of the current cap.

Several bills to lower the cap were debated during the 2005 legislative sessions. HJR 35, which would have permitted the Legislature to reduce the cap to 5%, died on the House floor during the regular session. In the second special session, SJR 4, which would have permitted local taxing units to set a cap as low as 3%, was reported from the Senate Finance Committee, but did not reach the Senate floor.

One problem with the current cap is that, since only the value of homesteads is limited, businesses end up paying a greater share of local property taxes. The one-third of Texas families who rent their homes also have to pick up an additional share of property taxes, since they pay the tax bill of their landlord, who passes it on to them in the form of higher rents. This problem is worst in Houston, Dallas, and Austin, where more than half of households rent their houses or apartments.

But expanding the cap to cover business property just creates other problems. The value of business property is very sensitive to changes in the economy, so tends to rise and fall much more than the value of homes. If business property that was covered by an appraisal cap suffered a sharp fall in market value, even if the value of the property quickly recovered, the cap could hold the taxable value significantly below market value for many years.

An artificial cap creates the “Welcome, Stranger” phenomenon. The taxable value of a homestead would be raised to its true market value when it was sold. Two neighbors living in identical houses would pay the same amount in property taxes, as long as neither moved. But if one sold his home, the newcomer (“the stranger”) would be charged taxes on the full market value of his home, while the person who did not move would pay on only a fraction of the true value. Needless to say, this would provide a real disincentive from moving into a nicer home and might discourage people from coming to Texas. Another odd result of a cap on residential appraisals is a strong incentive for local governments to attract retail business, rather than new homeowners. Retail centers supply local governments with sales tax revenue, which are unaffected by an appraisal cap and could exceed the cost of any additional demand for public services, such as police and fire protection and new roads.

Broader over-65 tax freeze: In addition to the extra \$10,000 homestead exemption, homeowners aged 65 or older are entitled to have their school property tax bill “frozen” at the level they pay the year they turn 65. This tax ceiling can even be transferred to a new home, with the school tax on the new home calculated to give the same percentage tax break as that on the original home.

Under the provisions of a constitutional amendment passed by the voters in 2003, cities, counties, and junior college districts may also freeze the property taxes of homeowners when they turn age 65.

The cost to the state of the school-property-tax freeze is forecast to grow at nearly twice the rate of the general homestead exemption or the over-65 exemption. According to the comptroller’s tax exemption study, the flat-rate exemptions are expected to grow by about 25% between 2005 and 2010, while the cost of the freeze is forecast to increase by almost 50%. As the Baby Boom generation reaches age 65, starting in 2011, the cost of the tax freeze will begin to grow even more quickly, seriously hampering the ability of school districts and other local governments to generate needed property tax revenue.

Continuation of optional percentage homestead exemption: The optional homestead exemption permits a school district to exempt up to 20% of the value of a residential homestead from school property taxes. The exemption was enacted in 1981 as part of the wave of reform that created the current property-tax system. Because the new system required all homes to be taxed at their full market value, rather than at some fraction of the total value, homeowners were facing rapid increases in their values. The optional exemption, along with other statewide mandatory exemptions, was intended to ease the “sticker shock” faced by homeowners.

The optional homestead exemption is currently offered by less than one-quarter of the 1,000-plus school districts in Texas. These districts are clumped in certain areas of the state, probably because the exemptions were adopted in response to competitive pressures within these regions. For instance, none of the school districts in Bexar County offers the exemption, but 9 of the 21 districts in Harris County have the exemption. Houston ISD alone accounts for one-quarter of the exemption’s total cost to the state.

School districts with high property wealth per student are more likely to offer the exemption than other districts, as are districts with little reliance on residential property in their tax base. Under current law, the state replaces one-half of the revenue that school districts lose to the optional homestead exemption as long as the education commissioner certifies that the state has appropriated more than enough to fully fund other school finance formulas.

The optional homestead exemption is one of the most regressive exemptions in the Tax Code. According to the comptroller’s tax incidence study, more than half of the benefit received by Texas homeowners goes to the one-fifth of Texas households with an annual income of more than \$97,000. Only 18% of the benefit of the exemption goes to the one-half of families with an income of less than \$50,000 per year.

Since the optional exemption applies to a percentage of the value of a homestead, it reduces the taxable value of a higher-priced home more than the value of a lower-priced home. In contrast, the mandatory statewide exemption of the first \$15,000 of a homestead’s value is progressive, since it has a greater impact on a low-value home than on a higher-value home.

Of course, families that rent their homes receive no benefit at all from any homestead exemption, which goes only to homeowners. Homestead exemptions also burden business property owners, since a school district must levy a higher tax rate to make up for the value lost to homestead exemptions.

ANY INCREASED REGRESSIVITY CAN BE OFFSET WITH LONE STAR CARD REBATES

Any reduction in the property tax funded by a more regressive tax, such as the sales tax, would increase the regressivity of the Texas system. This shift in tax burden onto the lowest-income families would be exacerbated by the difficulty in directing the benefits of property tax reductions to these families, who are less likely to be property owners. One innovative way to protect the poorest Texans from the worst effects of a tax-burden shift is through Lone Star Card rebates, as proposed by the Senate Finance Committee in recent legislative sessions.

The 800,000 low-income households that use a Lone Star Card for food stamps or cash assistance benefits would have received a cash payment or additional nutritional assistance expected to average roughly \$10 per month. This additional benefit would have almost entirely protected the 10% of Texas families with incomes under \$13,000 from the changes in the tax-swap bills considered in 2005, which included a half-cent increase in the state sales tax.

Most states help mitigate the regressivity of their state and local tax system through income-tax credits, such as the state earned income tax credit that is offered by 18 states. Since the lack of a state personal income tax prevents Texas from simply granting tax credits, the Lone Star Card rebate offers an excellent, administratively efficient alternative method of targeting tax reductions to low-income families.