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ANALYSIS OF A POTENTIAL TRANSFER TAX FOR FINANCING EDUCATION IN TEXAS

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EXECUTIVE SUMMARY

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Expanding an earlier study (Gilliland, November 2004) of the role of a potential transfer tax in the Texas school finance reform, this analysis examined three separate scenarios. First, the study explored the impact of a 1.5 percent transfer tax coupled with a 50 cent property tax reduction. The second scenario saw transfers taxed at 0.75 with property taxes reduced by 10 cents per $100 of assessed value. Finally, the case of a 1.5 percent transfer tax with a 75 cent property tax break indicated the level of relief needed to ensure tax neutrality to all Texas homebuyers. The study indicated the following:

- Both the 0.75 percent transfer tax – 10 cent property tax cut and the 1.5 percent transfer tax - 50 cent property tax cut would result in higher tax burdens for all households studied.

- Concentrating a part of the tax burden on real estate transfers imposes a higher proportionate tax burden on low income households than on high income households.

- The effects of a lower transfer tax and smaller property tax reduction were more negative than those of either of the other scenarios.

- A property tax rate reduction of more than 75 cents would be required to offset a 1.5 percent transfer tax for all income classes studied. That rate would provide substantial net tax reductions to higher income Texans while the lowest income group would still face a net tax increase.

- In the 1.5 percent transfer tax – 50 cent property tax scenario, 77.2 percent of black households, 75.7 percent of Hispanic households and 60.8 percent of non-Hispanic white households face net tax increases ranging from 1.5 to 0.7 percent of income.

- Because 50 percent of Hispanic households and 40 percent black households are likely to buy homes in the next few years while non-Hispanic white households are less likely to buy, the transfer tax will disproportionately impact those minority groups.

- Depending on the rate adopted, the transfer tax alone will likely cost the Texas economy 8,700 to 17,400 jobs.

- The envisioned plans fail to provide revenues sufficient to replace the property tax revenue reduction.

REAL ESTATE TRANSFER TAX FOR SCHOOL TAX RELIEF

A tax on real estate transfers concentrates the resulting tax burden on a narrow and limited segment of the wealth invested in real property. In general, taxes should arise from a broad base at a relatively low rate. That combination limits the wedge between the price paid by buyers and the amount received by sellers that results when a tax is introduced into an economy. To assess the impact of a proposed transfer tax program in Texas, the Center explored the effects of imposing a 1 percent real estate transfer tax coupled with a 50 cent reduction in M&O school tax rates (Gilliland, November 2004).

This analysis expands on that study to consider several alternative plans with varying transfer tax rates and different levels of property tax reductions. Due to income and consumption patterns, the transfer tax option appears to impose greater proportionate burdens on homebuyers with average and below average incomes. A 1.5 percent transfer tax would require a reduction in school taxes ranging higher than 75 cents to offset the tax burden at the lowest income levels studied.

TRANSFER TAX PLANS

The analysis examines the effects of three different plans for substituting the proceeds of a transfer tax on real estate for school property taxes in Texas. Table 1 presents the details of each of these cases. In the first case, buyers of real property would incur a tax of 0.75 percent of the sale price of the property at closing. In return, owners would enjoy a reduction of 10 cents per 100 dollars of assessed value. The combination would generate $487.5 million dollars annually from real estate transfer taxes and reduce school taxes by $1.06 billion (see Gilliland, November 2004 for computation details). That amount of revenue reduction would require added tax revenues from other sources of $ 0.571 billion, as shown in Table 1. Similarly, a 1.5 percent transfer tax coupled

Table 1. Alternative Transfer Tax Proposals for Texas Property Tax Relief

Transfer Tax Rate	Estimated Tax Revenue	Property Tax Rate Reduction	Estimated Tax Shortfall
0.75 percent	$ 487.5 million	10 cents per $100	$ 0.571 billion
1.50 percent	$ 975.0 million	50 cents per $100	$ 4.32 billion
1.50 percent	$ 975.0 million	75 cents per $100	$ 6.97 billion

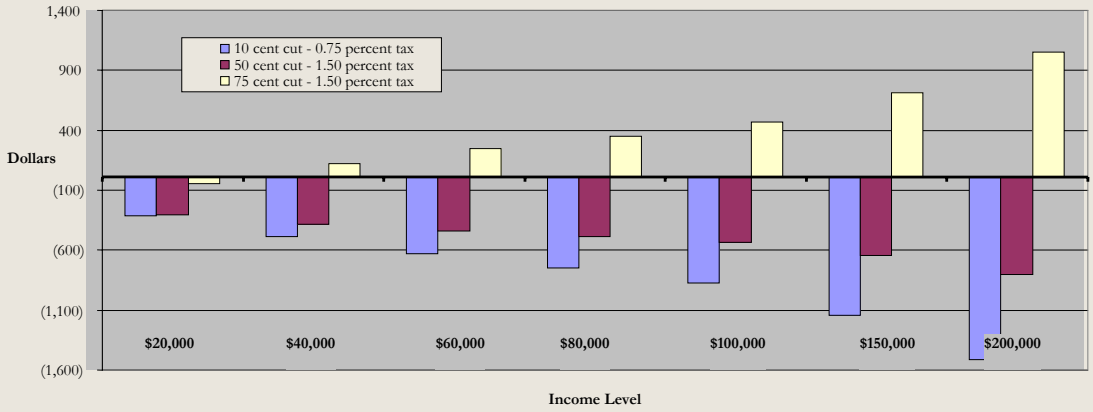
Source: Real Estate Center at
Texas A&M University

with a property tax reduction of 50 cents per $100 of assessed value would lead to a $975 million dollar transfer tax and an added revenue requirement of $4.32 billion. At $22.82 per capita for the 0.75 percent rate and $45.63 per capita for the 1.5 percent rate, the Texas transfer tax would rank 12th or 4th among states that impose transfer or transactions taxes. The final case, a property tax reduction of 75 cents per $100 of value was designed to make the present value of projected property tax savings offset as much of the transfer tax as possible. The goal was to ascertain how much property tax relief was required to ensure that most homebuyers do not face a net tax increase from a 1.5 percent transfer tax levy.

ECONOMIC EFFECTS OF TRANSFER TAX

Figure 1 shows the results of estimating the net impact of the transfer tax on homebuyers with different levels of income after accounting for the present value of tax saving associated with a reduction of property taxes (see Gilliland, November 2004 details of calculations). The 0.75 percent level of transfer tax scenario, represented by the blue bars in the figure, produces the largest net loss

Figure 1. Net Tax Saving From Various Combinations of Projected Property Tax Cuts and Percent Real Estate Transfer Taxes



Note: This analysis assumes school revenues that falls $ 0.6 billion, $ 4.3 billion, or 7.0 billion short of current school funding levels. Property tax reductions assumed to be lost over 10 years and discounted at 8 percent to reflect risk.

because the property tax rate reduction fails to adequately offset the transfer tax with the lowest income homebuyer facing a $313 net increase in net tax liability (see appendix for details). These lowest income homebuyers would face a $308 increase in the 1.5 percent-50 cent reduction scenario and still sustain a $41 net loss in the 1.5 percent-75 cent reduction scenario. This latter result indicates that attaining neutrality for these homebuyers will require a school tax rate reduction of more than 75 cents. That would mean a reduction of more than half of prevailing maintenance and operation school tax rates would be required to ensure tax neutrality for the lowest income homebuyers. Consequently, the highest income homebuyers would enjoy a net reduction in tax burden of $1,050 as shown in Figure 1. The 15 percent-50 cent reduction scenario imposes a lesser burden on homebuyers at all levels compared to the 0.75 percent-10 cent reduction scenario. Clearly, the 10 cent reduction in property tax rates provides inadequate relief compared to the other scenarios. These circumstances arise from the differing relationship between income levels and typical home values. Specifically, for the lowest income group, the value of the typical home is

Table 2. Changes in Tax Liability as a Percent of Income

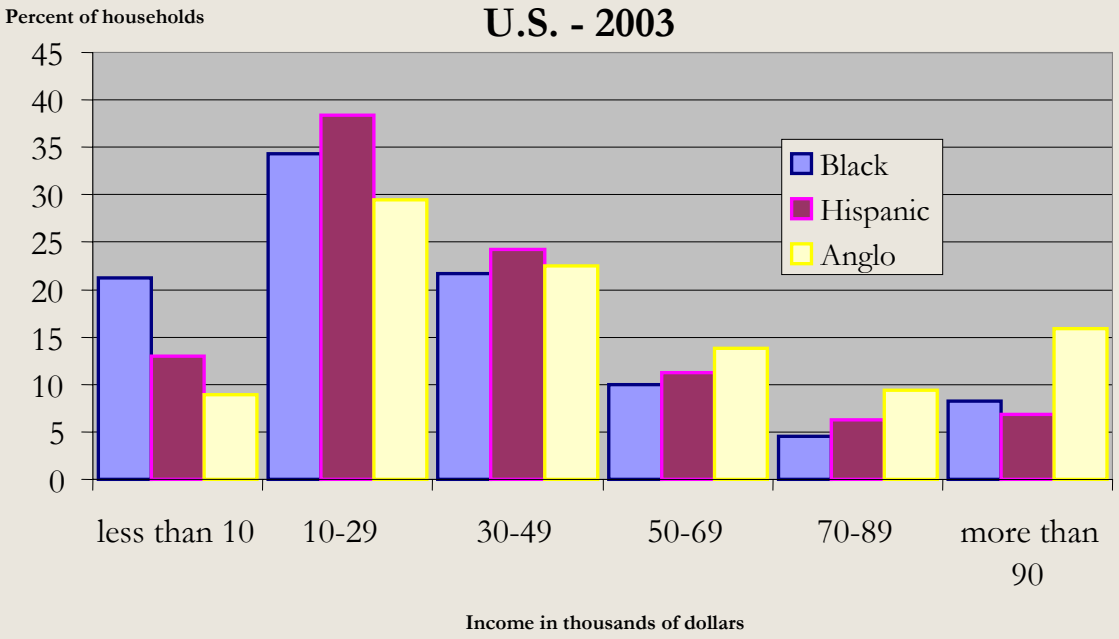
Income Level	Home Value	Net Change in Taxes as a Percent of Household Income		
		0.75 % Transfer Tax 10 Cent Prop. Tax Cut	1.5 % Transfer Tax 50 Cent Prop. Tax Cut	1.5 % Transfer Tax 75 Cent Prop. Tax Cut
20,000	56,000	-1.6	-1.5	-0.2
40,000	92,000	-1.2	-1.0	0.3
60,000	120,000	-1.0	-0.7	0.4
80,000	144,000	-0.9	-0.6	0.4
100,000	170,000	-0.9	-0.5	0.5
150,000	225,000	-0.8	-0.4	0.5
200,000	300,000	-0.8	-0.4	0.5

2.8 times annual income while that for the highest income group is only 1.5 times annual income. This relationship ensures that the transfer tax will be disproportionately burdensome at lower income levels. Table 2 shows the changes in tax liability as a percentage of the associated income levels. The relative impact at the lower income levels remains uniformly greater than those at the higher income levels. In addition to this situation, the requirement for additional cash at the closing will make buying a home more difficult especially for lower income households for which the payment amounts to a larger percentage of income than for higher income households.

Figure 2 shows the distribution of income for each of three ethnic groups for the west south central United States as reported by the U.S. Bureau of the Census and the U.S. Bureau of Labor Statistics. As the figure shows, approximately 21 percent of black households in this region had total money household income of less than $10,000. About 8 percent of black households had incomes of more than $90,000 with 34 percent earning in the $10,000 to $30,000 range. That latter bracket roughly corresponds to the $20,000 income level in this study. The data indicate that 77.2 percent of black households, 75.7 Hispanic households, and 60.8 percent of non-Hispanic white households had incomes of less than $50,000. Linking the information in Figure 2 with the analysis of changes in tax liability for the 1.5 percent-50 cent property tax reduction scenario, suggests that the relative burden of this tax shift would fall most heavily on lower income households. Further, because larger percentages of black and Hispanic households fall into these lower income categories, the tax shift would disproportionately affect these groups.

In addition to this evidence indicating that high numbers of minorities fall in the most heavily impacted income categories, research undertaken by the Real Estate Center indicates that those minorities are more likely than the non-Hispanic white population to be buying a home in the near future. Conducting a survey of 4,080 Texans in 2003, the HarrisInteractive polling organization, acting on behalf of the Real Estate Center, found that approximately half of Hispanics and 40 percent of blacks had plans to purchase a home in the next three years. Non-Hispanic whites were the least likely to be buying a home in the next few years. Although plans don't always result in a purchase, the stated expectations mean that the transfer tax will likely disproportionately impact minority populations because large numbers of those groups are likely to buy homes in the near future.

Figure 2. Distribution of Total Money Household Income by Ethnic Group in the West South Central U.S. - 2003



FINAL IMPACT OF TAX SHIFT

Using the calculations described in Gilliland (November 2004), the anticipated revenue collected via the 1.5 percent transfer tax would result in a loss of 17,363 jobs, absent offsetting tax cuts. The lower 0.75 percent rate would remove enough purchasing power to inflict a loss of 8,682 jobs. Presumably, the large property tax reduction for those not buying real estate could be counted on to counteract this negative influence. However, the system remains short of full funding by the amount of revenue required to fill the gap between the property tax reduction and transfer tax revenues. That funding short-fall will require an infusion of tax revenue from some other sources. The question of the final impact of the proposed transfer tax depends on the source of that revenue.

Taxes impact economies in two distinct ways. First, they tend to change both the apparent prices paid by buyers of taxed items and received by sellers of those items. Second, they extract resources from the taxed industry resulting in a loss of activity. For example a transfer tax would result in fewer real estate sales as marginal buyers would opt not to purchase when faced with the increment in their acquisition cost. Further, in weak housing markets, builders, forced to reduce prices because of slackened demand would build fewer homes. The resulting loss in economic activity reduces the economic vitality of the taxed industry and all of the peripheral affiliated business.

Given the above scenarios, owners of existing homes would experience a substantial reduction in property taxes with the transfer tax concentrated on homebuyers. However, the source of funds needed to provide the remainder of the envisioned property tax cuts suggests that even these homeowners will likely face an added tax liability. Currently, conventional wisdom dictates a broad based business tax will be the main revenue replacement vehicle. In past decades, heavy taxes on oil and gas production probably succeeded in shifting the burden of state government to entities beyond Texas borders. In those circumstances, a tax on that targeted business could have relieved the tax burden of Texas residents. However, studies predict that current economic conditions will cause the burden of state taxes assessed to businesses to remain with Texas citizens in the form of higher prices for taxed items or reduced returns to resource owners. To the extent that the final tax incidence migrates to consumption, the regressive tendencies observed in this and the previous studies would be reinforced.

Table 3. Economic Deadweight Loss of a Texas Real Estate Transfer Tax

Transfer Tax Rate	Estimated Tax Revenue	Indicated Loss to Economy	Estimated Job Loss
0.75 percent	$487.5 million	10 cents per $100	8,682
1.50 percent	$ 975.0 million	50 cents per $100	17,363

Source: Real Estate Center at
Texas A&M University

Finally, reduced affordability implied by the net increase in tax burden for Texas homebuyers points to a reduced number of home sales compared to current levels. This decline would result from an enlargement of that group of potential buyers that simply can no longer afford to buy the home. In addition, some potential buyers may find ways to effect a transfer without participating in a taxable event. For example, would assigning a 99-year lease, qualify as a real estate transfer? If not, leasing may avoid the transfer tax. Structuring such tax-avoidance ownership patterns would undoubtedly inflict added cost to the transaction, but so long as those costs remained smaller than the amount of a transfer tax, they would be a viable option.

All of the influences threaten to impose unintended consequences on those targeted for tax relief. Further, quantifying these deleterious effects remains an uncertain activity because of the nature of available information. First, there is no credible estimate of the volume of real estate transfers in Texas each year. Second, affordability is gauged at the Center in terms of the ability of the median income household to buy a home at the median sale price. Third, the final incidence of this tax change remains unknown because of the revenue shortfall that would be recouped from other sources.

CONCLUSION

The idea of shifting school operating taxes to a real estate transfer tax while reducing property taxes would concentrate the tax on a restricted, narrow base. For the most likely 1.5 percent rate, the per capita levy would be one of the highest per capita transfer taxes in the nation. Ironically, the less extreme 0.75 rate would produce a much lower per capita tax, but the muted property tax relief associated with that rate would result in greater net tax burdens than those following from the higher transfer tax. Property taxes would have to be cut by at least half of most current maintenance and operation tax rates to ensure no net tax increases to all classes of households.

Following from the decline in the amount of income dedicated to purchasing a home, the transfer tax proposals appear to disproportionately impact lower income households. Further, because they are more heavily concentrated in the lower income levels coupled with a much greater likelihood of buying in the near future, Hispanic and black households would be more heavily impacted than would non-Hispanic white households.

By reducing affordability, the transfer tax threatens to negatively impact the housing and development segments of the economy. Because housing construction has often driven economic recoveries, that effect could well inhibit the economic performance of the Texas economy.

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Income Level	Home Value	Transfer Tax at Closing		
		0.75 % Transfer Tax 10 Cent Prop. Tax Cut	1.5 % Transfer Tax 50 Cent Prop. Tax Cut	1.5 % Transfer Tax 75 Cent Prop. Tax Cut
20,000	56,000	420	840	840
40,000	92,000	690	1,380	1,380
60,000	120,000	900	1,800	1,800
80,000	144,000	1,080	2,160	2,160
100,000	170,000	1,275	2,550	2,550
150,000	225,000	1,688	3,375	3,375
200,000	300,000	2,250	4,500	4,500

Income Level	Home Value	Present Value of Projected Property Tax Cut		
		0.75 % Transfer Tax 10 Cent Prop. Tax Cut	1.5 % Transfer Tax 50 Cent Prop. Tax Cut	1.5 % Transfer Tax 75 Cent Prop. Tax Cut
20,000	56,000	107	532	799
40,000	92,000	200	1,000	1,500
60,000	120,000	273	1,363	2,045
80,000	144,000	335	1,675	2,512
100,000	170,000	403	2,012	3,019
150,000	225,000	545	2,726	4,090
200,000	300,000	740	3,700	5,550

Income Level	Home Value	Net Change in Tax Liability		
		0.75 % Transfer Tax 10 Cent Prop. Tax Cut	1.5 % Transfer Tax 50 Cent Prop. Tax Cut	1.5 % Transfer Tax 75 Cent Prop. Tax Cut
20,000	56,000	-313	-308	-41
40,000	92,000	-490	-380	120
60,000	120,000	-627	-437	245
80,000	144,000	-745	-485	352
100,000	170,000	-872	-538	469
150,000	225,000	-1,142	-649	715
200,000	300,000	-1,510	-800	1,050

Income Level	Home Value	Net Change in Taxes as a Percent of Household Income		
		0.75 % Transfer Tax 10 Cent Prop. Tax Cut	1.5 % Transfer Tax 50 Cent Prop. Tax Cut	1.5 % Transfer Tax 75 Cent Prop. Tax Cut
20,000	56,000	-1.6	-1.5	-0.2
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