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## *Revamping State Taxes: Options and Implications*

While state leaders generally have opposed an increase in state taxes this session, many have set as a long-term goal the restructuring of the state tax system. In 1997, then-Gov. George W. Bush sought to revamp state taxes with a goal of enhancing fairness and efficiency. That effort was unsuccessful, and many of the concerns cited at that time remain unresolved. As the once-dependable growth in state revenue has stalled and demands for state services such as education and health care have increased, new pressures have been placed on the state tax system.

Many cite Texas' low rankings in generating revenue (48th in both state tax revenue per capita and state tax revenue as a percentage of personal income) as a positive factor in promoting economic development and limiting the size of government. Others say restricting state revenue prevents the state from meeting essential needs and shifts the spending burden to local governments such as cities and school districts. The February 2003 issue of *Governing* magazine ranked Texas' tax system at the bottom in terms of adequacy and fairness, while giving the state higher marks for tax administration.

Texas is not alone in facing fiscal challenges. Governments at all levels across the nation are tightening their belts and seeking new revenues. Fiscal 2002 marked the first time since 1994 that any state had raised taxes, according to the National Conference of State Legislatures, with higher cigarette and tobacco taxes and fee increases the leading choices.

*This report examines several proposals for restructuring the state tax system that Texas lawmakers may be asked to consider in the future.*

This report examines several proposals for state tax restructuring that lawmakers may be asked to consider in the future. Each proposal is discussed in terms of history and background, administration, revenue projections, and arguments for and against.

## Broadening the Sales Tax

The mainstay of Texas' fiscal system, the sales tax affects all segments of the economy. It is the only tax (other than the tax on motor vehicle sales and rentals) paid directly by individual consumers as well as businesses. The tax actually has two facets: the *sales* tax, levied on retail transactions between parties within the state, and the *use* tax, which applies to usage within the state of taxable items changing hands between parties, one of which is not located within the state.

All but five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) levy sales taxes, but Texas depends more heavily on its sales tax than do most other states. Texas' sales tax generated about \$14.5 billion in fiscal 2002, 55 percent of state tax revenue and more than one-quarter of all state revenue.

Nationally, the sales tax's revenue-generating capacity is diminishing. The National Conference of State Legislatures cites three contributing trends: the transition to a more service-oriented economy, the proliferation of exemptions, and burgeoning interstate sales fueled by the Internet.

As a consumption-based tax, the sales tax generally is considered regressive relative to income. That is, lower-income consumers pay a higher proportion of their incomes in taxes when buying the same taxable items as higher-income consumers buy. For example, families with annual incomes below \$11,172 pay about 7 percent of their incomes in sales taxes, compared to 1 percent for families with annual incomes of more than \$124,699, according to the comptroller.

**Administration.** Texas' state sales-tax rate is 6.25 percent of the purchase price of taxable items. Lawmakers have increased the rate seven times, most recently from 6 percent in 1990. State law caps local sales-tax rates at 2 percent overall, so combined state and local rates may not exceed 8.25 percent. Cities, counties, transit authorities, and special-purpose districts may impose sales taxes at rates up to 1 percent. Many communities and most major urban areas have reached the cap, but the statewide average combined rate was 7.8 percent in 2001, according to the Sales Tax Clearinghouse. Almost all sales-tax monies go into general revenue. Sales taxes on motor oil and other lubricants go into the State Highway Fund; sales taxes on sporting goods benefit parks, wildlife, and recreation.

When enacted in 1961, Texas' sales tax applied only to tangible goods. The tax now applies to final retail sales (not for resale) and leases of goods, to most rentals, and to services listed under Tax Code, sec. 151.0101. Among other items, taxable services include telecommunications, cable television, amusement, insurance, credit reporting, debt collection, and repair and remodeling of certain real and personal property.

Major exemptions include food for home consumption; water; residential natural gas and electricity; manufacturing materials, machinery, and equipment; agricultural feed, seed, chemicals, and supplies; prescription and over-the-counter medicines; and partial exemptions for data processing, information services, and Internet access. Exemptions for necessities such as groceries, residential energy, and medicines are intended to ease the effects of regressivity on poorer Texans. Major exclusions include medical, legal, architectural, engineering, automotive, financial, dental, accounting/auditing, real estate, advertising, and child-care services. For fiscal 2002-03, the comptroller estimated the value of all sales-tax exemptions at \$39.3 billion and the value of all exclusions at more than \$8.8 billion.

Texas is one of several states that allow a sales-tax holiday. During the first weekend in August, shoppers who buy certain apparel pay no state sales tax on items that cost \$100 or less. Local government participation is optional, but no taxing entities opted out of the holiday in 2002. The comptroller estimates that the 2002 holiday exempted purchasers from about \$33.2 million in state taxes and \$8.8 million in local taxes.

Out-of-state vendors who have established a physical connection (nexus) with Texas must collect and remit use taxes from their Texas customers. Texans who buy from out-of-state companies without nexus are obligated to pay use taxes to the state, but few do so, and the law seldom is enforced. The comptroller projected \$370 million in uncollected use-tax revenue attributable to remote sales, primarily mail order and the Internet, in fiscal 2002. The 35 Streamlined Sales Tax Implementing States (SSTIS), including Texas, are attempting to make sales-tax laws more uniform and to create a mechanism for collecting use taxes owed on remote sales. The 78th Legislature is likely to consider one or more bills that would conform parts of Texas' Tax Code to the multistate agreement that SSTIS has adopted. For more background, see *Taxing E-Commerce and Other Remote Sales: Choices for Texas*, HRO Focus Report Number 77-19, April 9, 2002.

## Broadening the Sales-Tax Base

Removing exclusions and exemptions from most nonmedical business and professional services

### Recent major changes:

1999: added exemptions for sales-tax holiday (apparel), over-the-counter medications, timber production items; added partial exemption for information/data processing services, Internet access  
1990: increased state rate from 6 percent to 6.25 percent

	<b>HB 4 as engrossed by House (1997):</b>	<b>Center for Public Policy Priorities (2002):</b>
<b>Base:</b>	Add services including freight hauling, motor vehicle repair, public relations/management consulting, computer programming, various personal and other services	Add services including legal, architectural/engineering, freight hauling, financial, accounting/auditing, advertising, real estate, computer programming, management consulting
<b>Rate:</b>	6.25 percent	6 percent
<b>Biennial revenue projection:</b>	\$1.3 billion (fiscal 2001-02)	\$2.9 billion (fiscal 2004-05)

Most sales taxes are remitted by retailers and other businesses, which are compensated for their collection costs through handling fees (currently, one-half of 1 percent of tax due). The comptroller identified more than 600,000 sales taxpayers in fiscal 2001.

**Proposals for change.** During the 75th Legislature in 1997, the House-approved version of HB 4 by Craddick/Junell would have broadened the sales-tax base to include many additional services, as part of a broad package of tax changes. Given the need to increase state revenues, supporters said, expanding the sales-tax base to include services that had enjoyed tax-free status would be less regressive than increasing the sales-tax rate. Opponents argued that the existing exemptions were valid and that removing them would harm key industries such as oil and gas, construction, and transportation. The House-Senate conference committee on HB 4 eliminated the sales-tax provisions, and the bill as enacted dealt primarily with property taxation and the school finance system.

Recently, the Austin-based Center for Public Policy Priorities (CPPP) has proposed applying the sales tax to most services now excluded or exempt, other than medical (including dental and other health care). Taxing all non-health-care-related services at the current rate would generate \$6.5 billion during fiscal 2004-05, on the basis of comptroller data. The CPPP has discussed lowering the state tax rate to 6 percent across the board and taxing

nonmedical business and professional services. That approach would yield a net increase of \$2.9 billion, according to the CPPP. Business and professional services projected to generate the most sales-tax revenue (in descending order) are legal, architectural/engineering, freight hauling, financial, accounting/auditing, advertising, real estate brokerage, contract computer programming, and management consulting.

Another option discussed recently is raising the sales-tax rate while broadening the base and dedicating all or part of the increased revenue to public education. These changes would coincide with reducing or eliminating school property taxes and/or repealing the revenue-recapture component of the school finance system. A similar proposal in the mid-1980s, called Proposition Zero, would have raised the sales-tax rate by 1 cent and exempted the first \$100,000 of residential property valuation in computing school property taxes. The state would have reimbursed school districts with the offsetting new sales-tax revenue on a per-student basis. Any additional sales-tax revenue generated by the rate hike would have been distributed by formula to help equalize funding between property-rich and -poor school districts. At least 19 House members, mostly from small cities and rural areas, endorsed the effort, but Proposition Zero never gained enough momentum for enactment.

*(See Sales Tax, page 16)*

## Expanding the Franchise Tax

The franchise tax is Texas' primary business tax. The state grants private entities the privilege or franchise of doing business in Texas, entitling those entities to certain rights. The concept underlying the franchise tax is that businesses should bear some of the state's costs of ensuring those rights and of providing services such as law enforcement, regulation, and access to courts.

Texas lawmakers enacted the franchise tax in 1907 as a levy on corporate assets. Over the years, successful legal challenges to the method of calculating taxable capital (assets' net worth) caused massive refunds, leading to sharp revenue declines in the 1980s. In 1991, the 72nd Legislature reduced the capital tax rate from 0.525 percent to 0.25 percent (\$2.50 per \$1,000) and added an income component to the base. Since 1992, companies owing franchise tax have had to pay the higher of the capital levy or an amount generated by a 4.5 percent tax on earned surplus (modified net income). Some argue that the income component of the franchise-tax base makes it tantamount to a corporate income tax.

The Legislature has changed the franchise-tax base and/or rate a dozen times since 1938. Annual net revenues peaked in fiscal 1999 at \$2.1 billion. In fiscal 2002, the tax accounted for about 7 percent of all state tax revenue, generating about \$1.9 billion in general revenue.

**Administration.** The franchise tax now applies to for-profit corporations and limited-liability companies (LLCs) chartered or organized in Texas, as well as to out-of-state corporations and LLCs based or doing business in the state. It applies to professional corporations, banks, savings and loan associations, state limited banking associations, and professional LLCs, but not to limited partnerships or sole proprietorships.

About 475,000 businesses are subject to the franchise tax, but fewer than half actually owe taxes. Insurance and open-end investment companies such as mutual funds, corporations with gross receipts less than \$150,000 or that owe less than \$100 in tax, and most nonprofit corporations are exempted. Major exemptions and exclusions include interest earned on federal securities, business loss carryover, and officer/director compensation paid by companies with 35 or fewer shareholders. The comptroller estimated the value of exemptions and deductions at \$1.2 billion in fiscal 2002.

### Franchise Tax Expansion

Broadening tax liability to include partnerships and sole proprietorships

**Current rate:** higher of 0.25 percent of taxable capital or 4.5 percent of earned surplus

**Recent changes:**

1999: added exemption for small businesses, tax credits for R&D, investment, job creation, child care

1991: added earned surplus to base, reduced capital tax rate by 52 percent

**CSHB 4, 75th Legislature (1997):**

**Base:** add partnerships

**Rate:** no change

**Exemptions:** passive income; repeal some exemptions for nonprofits and small businesses

**Exclusion:** sole proprietorships

**Deduction:** first \$100,000 of compensation for small-business partners/owners

**Biennial revenue projection:** \$763 million (fiscal 1998-99)

Franchise-tax credits enacted in 1999 (SB 441 by Ellis, et al.) apply to expenses incurred for research and development, job creation, capital investment, and child care. For fiscal 2002, businesses claimed credits that reduced their franchise-tax liability by about \$25 million, according to the comptroller.

In recent years, some large Texas-based firms have reorganized as partnerships under state law. As such, they no longer must pay the franchise tax. Examples include Dell Computer of Austin and SBC Communications of San Antonio. Firms accomplish this by forming wholly-owned out-of-state subsidiaries, usually in tax-friendly states like Delaware; hence, the resulting entity has been nicknamed "the Delaware sub." Typically, the subsidiaries enter into limited partnerships wherein the general corporate partner owns 0.1 percent of the operating assets in Texas and the limited partners own 99.9 percent. Under the comptroller's administrative rules, foreign corporations acting as limited partners are not considered to be doing business in Texas for tax purposes and thus are not subject to the franchise tax. The tax liability of the general partner corporation typically is zero because its 0.1 percent interest fails to generate total receipts greater

than the \$150,000 income threshold. The comptroller has estimated that the “Delaware sub” cost the state about \$247 million in lost revenue during fiscal 2002-03, and that requiring these entities to pay the franchise tax could bring in as much as \$360 million in fiscal 2004-05.

**Proposals for change.** During the interim between the 77th and 78th Legislatures, the Joint Select Committee on Public School Finance heard testimony suggesting that the state consider extending the franchise tax to other types of business entities, primarily limited partnerships and sole proprietorships. This would create new classes of taxpayers, namely small businesses and professional service providers such as doctors, lawyers, accountants, and engineers.

In 1997, HB 4 by Craddick/Junell, as introduced, would have abolished the franchise tax in favor of a business activity tax (see pages 6-7). As substituted by a House select committee, CSHB 4 would have subjected partnerships, but not sole proprietorships, to the franchise tax. The bill would have increased the small-business exemption and repealed the exemptions for three categories of nonprofit corporations, including chambers of commerce, as well as for electric and telephone cooperatives, solar energy firms, development corporations, and several others. Exempt businesses still would have had to pay franchise tax on earned surplus income derived from any taxable business interests. The bill’s fiscal note estimated a revenue gain of \$763 million for fiscal 1998-99. However, the House-Senate conference committee removed the franchise tax provisions, and HB 4 as enacted dealt primarily with property taxation and the school finance system.

Conceivably, the comptroller could address the “Delaware sub” issue by changing the pertinent administrative rule. Some contend, however, that any change would require amending the Tax Code. They argue that the Legislature has acquiesced to the administrative rule, in effect since the 1970s, and would have to supersede it statutorily. According to the Comptroller’s Office, a unilateral rule change almost certainly would be challenged in court on those grounds.

**Arguments.** The franchise tax is more efficient than sales, business activity, and personal income taxes, according to economist Ray Perryman, and has high potential for revenue growth, but is relatively inequitable. Critics argue that the franchise-tax base is too narrow and is weighted too heavily toward capital-intensive

industrial and mercantile enterprises. They view the tax as outdated because its revenue stream does not reflect growth in the “information economy,” especially services. They note that companies in manufacturing and trade, which account for 31 percent of Texas’ gross state product (GSP), bore almost half of the franchise-tax burden in fiscal 2002, while finance, insurance, real estate, and other services that account for 35 percent of GSP paid only about one-quarter of franchise taxes. Also, they say, the tax’s capital component is not correlated to the ability to pay.

Proponents maintain that extending the franchise tax to partnerships and/or sole proprietorships would make the tax more equitable. They say that all business entities should have to shoulder a fair share of the tax burden, regardless of their corporate structure. Partners and sole proprietors counter that they are entitled to different tax treatment because they lack the legal advantages enjoyed by corporations. They say subjecting partnerships and sole proprietorships to the franchise tax would amount to a tax on individual partners’ and owners’ personal incomes, rather than on business income, as proponents argue.

Broadening franchise-tax liability could have constitutional implications. Art. 8, sec. 24 of the Texas Constitution requires a binding statewide referendum on any law that imposes a tax on net income, “including a person’s share of partnership and unincorporated association income.” Such a referendum must specify the tax rate. At least two-thirds of any net income-tax revenue must be used for school property-tax relief and the remainder for public education. Some argue that making partnerships and sole proprietorships pay the franchise tax would require voter approval as stipulated in the Constitution. Such a vote might not be necessary, however, if partners’ compensation were made deductible for personal services partnerships, as is corporate officers’ compensation, or if voters amended the Constitution.

Texas is one of the few states that do not tax out-of-state corporations operating as limited partnerships in their states. Supporters defend this policy under the rubric of the state’s interest in encouraging economic growth, while critics view it as a loophole for tax avoidance that should be closed. Advocates note that to be fully effective, any legislative change would have to assess tax liability to the parent corporation to prevent companies from circumventing the tax by forming multiple partnerships, a practice known as “layering.”

## Business Activity Tax

A business activity tax (BAT) is a variation of the value-added tax (VAT) used widely in Europe. In its most basic form, a VAT taxes a product at each stage of production or distribution as its value — defined as gross receipts less expenses — accrues incrementally. Hence, a VAT taxes earnings attributable to an entity's land, labor, management, and owned capital. A BAT essentially taxes the difference between an entity's revenue and its cost of purchased goods. An example is Texas' gas utility tax, levied on natural gas utilities' gross income (taxable gross receipts less the cost of gas sold) at a rate of 0.5 percent. In fiscal 2002, 160 taxpayers remitted \$4.9 million in gas utility taxes.

**BATs in other states.** Michigan and New Hampshire are the only states with broad-based BATs. In the mid-1970s, Michigan replaced about a half dozen business taxes with the Single Business Tax (SBT), which primarily taxes a combination of profits and employee compensation at a rate of 1.9 percent. Many credits and exemptions exist for various businesses. After legal challenges, a full one-year capital investment deduction was replaced with a tax credit. The Michigan Economic Growth Authority can exempt new businesses for up to 10 years. In fiscal 2002, the SBT generated about \$2 billion in revenue. In fiscal 2001, it accounted for about 5 percent of all state revenue and 9 percent of tax revenue.

Part of the rationale for enacting the SBT was the Michigan economy's dependence on the automobile industry, which produced unstable streams of tax revenue because of its cyclical nature. In 1999, the tax rate was reduced from 2.3 percent and a gradual phase-out began. The rate was to fall by 0.1 percentage point per year until it reached zero in 2021. The annual reduction has been halted indefinitely, however, in exchange for accelerating the phase-out to 2010. Instead of dropping to 1.8 percent in January 2003, the rate will remain at 1.9 percent until budget reserves rise. No replacement for the tax has been proposed, according to state fiscal officials.

In 1993, New Hampshire lowered its primary business tax, the Business Profits Tax, from 8 percent to 7 percent and enacted the Business Enterprise Tax (BET), which is levied on business interest, dividends, wages, and other compensation at a rate of 0.25 percent.

### Business Activity Tax

Modified value-added tax levied on all business organizations' revenue

**Number of states:** 2 (Michigan, New Hampshire)

**Original 1997 Bush plan:**

**Base:** net income plus labor costs, employee benefits, depreciation

**Rate:** 1.25 percent

**Exemption:** first \$500,000 of base

**Deduction:** new capital investments

**Biennial revenue projection:** \$6.1 billion (fiscal 2000-01)

Partnerships, proprietorships, corporations, and nonprofit entities other than those federally tax-exempt are subject to the BET. The tax yields about one-fifth of New Hampshire's business tax revenue.

**Texas initiatives.** Although a broad-based BAT has been discussed in previous legislative sessions, Texas never has enacted one. In 1991, when the state faced a \$4.8 billion revenue shortfall, former Gov. John Connally advocated a tax-reform plan that included a modified VAT. Dissenting from recommendations for personal and corporate income taxes put forward by the Governor's Task Force on Revenue, Connally proposed replacing the franchise tax with a Texas Business Tax (TBT) at a rate of 2.35 percent of gross receipts. The first \$75,000 of tax base would have been exempt. Businesses with compensation exceeding 50 percent of their gross tax bases could have adjusted their bases. Capital investment, local property taxes, and in-state research costs would have been fully deductible. Connally claimed that the TBT would be revenue-neutral and would shift some of the state's tax burden from individuals to businesses. Lawmakers eventually omitted this tax from the raft of revenue measures enacted in 1991, which included restructuring the franchise tax, expanding the sales-tax base, increasing motor-fuels taxes, and creating the state lottery.

In 1997, then-Gov. George W. Bush proposed a TBT as part of a package that included repealing the franchise tax and business inventory tax, providing school property-tax relief, and broadening the sales-tax base. Similar to Michigan's SBT, Bush's TBT would

have been based on net income, depreciation, labor costs, and employee benefits. The standard deduction would have been \$500,000, and investment income would have been exempted. Existing franchise-tax exemptions, mostly for nonprofit corporations and insurance companies, would have been “grandfathered.” The proposed rate was 1.25 percent of each taxpayer’s adjusted tax base. According to the comptroller, the TBT would have generated between \$2.8 billion and \$3.3 billion annually from fiscal 1999 through 2002. It would have accounted for between 10.6 percent and 12.5 percent of state tax revenue and for about 6 percent of all revenue. TBT revenues and some sales-tax revenues would have been deposited into a school trust fund created by a proposed constitutional amendment. The fund would have reimbursed school districts for the cost of the bill’s property-tax relief measures.

These measures were referred to the House Select Committee on Revenue and Public Education Funding. After extensive hearings, the committee replaced the TBT provisions and the sales-tax increases with broadened sales and franchise tax bases and other revenue measures. The Senate took a more gradual approach that led to a conference committee stalemate. Eventually, Texas voters amended the Constitution to provide more than \$1 billion in local property-tax relief by raising the mandatory homestead exemption from \$5,000 to \$15,000.

In February 2002, economist Ray Perryman included a generic BAT among the school property-tax alternatives he presented to the Select Joint Committee on Public School Finance. Sponsors included the Equity Center, Texas Association of School Administrators, and 55 West Texas school districts. Perryman specified no tax rate (all of his alternatives presumed levies of \$1 billion each) but assumed an exemption for small businesses.

**Arguments.** Because BATs typically apply to most or all kinds of businesses, economists generally consider them fair and equitable. Low rates spread over virtually all segments of a state’s economy give the BAT stability and potential for revenue growth. Exemptions and targeted incentives can ease the burden on small business and help to attract new or desired industries.

Administration usually is straightforward and efficiency high, according to Perryman. He maintains that a BAT does not alter economic decision-making substantially because firms generally seek to maximize added value regardless of their tax liability. Thus, Perryman projects a smaller loss of private economic activity from a BAT than from other business taxes.

Much of the opposition to the BAT stems from the fact that businesses must pay it even when they are not profitable. Also, because wages are a key component, BATs tend to have a greater impact on labor-intensive industries than on capital-intensive ones. Calculating BAT payments can be complicated because it involves gross receipts. Some contend that BATs impede economic growth because they become a cost of doing business that does not respond readily to market forces. These arguments have contributed to the SBT’s phase-out in Michigan, where exemptions have proliferated to the point that a relatively few companies pay a disproportionate share of the tax.

In 1991, the Governor’s Task Force on Revenue concluded that Connally’s proposed TBT would have exacerbated inequity for middle- and lower-income taxpayers; taxed consumption, in effect, by acting as a tax on gross state product that would be passed on to consumers; and created undue hardships during economic downturns. In 1997, similar concerns arose about Bush’s TBT. Proponents noted that, at the time, the business tax burden was \$5,000 per employee in capital-intensive industries as opposed to \$500 per employee in labor-intensive industries. Bush’s TBT would have brought more noncorporate, service-oriented businesses (professionals, retail/wholesale trades, etc.) into a tax system heavily dependent on oil and gas, utilities, and manufacturing. Though designed to distribute the tax burden in line with a business’s contribution to the economy, the TBT would have resulted in a net tax reduction for some industries and a new tax for others. Although the proceeds would have been dedicated to education, thus ultimately benefiting workforce development, opponents dubbed it a small-business income tax and a “tax on jobs” that would penalize businesses with small profit margins.

## Increasing Motor-Fuels Taxes

Like all other states and the District of Columbia, Texas levies excise taxes on the roadway use of gasoline, diesel fuel, and liquefied petroleum gas (LPG). The state also levies sales tax on motor oil and other lubricants (motor fuels are exempt). Revenue from these motor-fuels taxes (MFTs) is spent primarily on transportation and, to a lesser extent, on public education.

Lawmakers enacted the gasoline tax in 1923 at 1 cent per gallon and have raised the rate seven times. The state added diesel fuel and LPG taxes in 1941 at 8 cents and 4 cents per gallon, respectively. The longest period without a rate change was from 1956 to 1984, at 5 cents for both gasoline and LPG and 6.5 cents for diesel. MFTs typically were the largest source of state tax revenue from 1930 until 1967, when the sales tax surpassed MFTs.

Since 1991, Texas has taxed gasoline and diesel fuel at 20 cents per gallon and LPG at 15 cents per gallon. Texas is one of six states that tax gasoline at the 20-cent rate. State MFT rates range from 7.5 cents per gallon in Georgia to 29 cents per gallon in Rhode Island. The federal rates are 18.4 cents for gasoline and 24.4 cents for diesel; LPG rates range from 4.3 cents to 13.6 cents, depending on the type of gas.

Texas' MFT collections nearly have quintupled since 1983, largely because of rate hikes, and have accounted for 11 to 12 percent of state tax collections since fiscal 1985. MFT revenues are projected at nearly \$5.7 billion in fiscal 2002-03, making MFTs the third largest source of state tax revenue, behind the sales and motor-vehicle sales and rental taxes.

Nationally, MFT rates have lagged behind inflation. In nominal terms, average state gasoline-tax rates have more than doubled since 1970, and the federal rate has more than quadrupled. Adjusted for inflation, however, average state gasoline-tax rates as of 2000 had declined by 2.67 cents per gallon from 1970, while federal tax rates had risen by only 0.15 of a cent, according to the Federal Highway Administration.

In 2002, five states — Connecticut, Indiana, Kansas, Maine, and Rhode Island — raised MFT rates for a net revenue gain of \$190 million, according to a report by the National Conference of State Legislatures.

### Motor-Fuels Tax Increase

Raising per-unit tax rates on gasoline, diesel fuel, and liquefied petroleum gas (LPG)

**Current rates:** 20 cents per gallon for gasoline and diesel fuel, 15 cents per gallon for LPG

**National average (50 states and Washington, D.C.):** 20.3 cents per gallon

**Most recent change:** 5-cent increase in 1991

**HB 3106, 77th Legislature (2001):**

**Base:** no change

**Rate:** 25 cents per gallon for gasoline and diesel fuel, 20 cents per gallon for LPG

**Allocations:** one-fourth of net increase to school employees' health insurance, extra \$17.7 million annually to counties for bridges and state roads

**Biennial revenue projection:** \$240 million per 1-cent increase

**Collection and allocation.** Texas collects gasoline and diesel-fuel taxes from distributors and suppliers monthly and from interstate truckers quarterly on the first taxable sale. This arrangement is considered highly efficient because a relatively small number of taxpayers (fewer than 15,000 in fiscal 2001) generate a large amount of revenue. LPG taxes are collected annually from permitted dealers and prepaid decal holders.

Gov. Rick Perry and the Texas Department of Transportation (TxDOT) have advocated adopting the federal method, used by many states, of collecting MFTs at the terminal level or "rack." Collection would occur earlier in the distribution chain, further reducing the number of tax remitters. Proponents say this procedure would simplify auditing and reduce fraud, thereby increasing revenue. The Governor's Office has estimated that this measure would bring in an additional \$273 million per year in state and federal taxes. The Comptroller's Office has disputed proponents' estimates of revenue gains, however, and petroleum marketers and convenience store operators, who retain 2 percent of the taxes they collect to cover expenses, have opposed the change.

Major MFT exemptions include agricultural, industrial/commercial, marine, off-road, and public school uses of motor fuel. Exemptions are based chiefly



on the notion of MFTs as user fees; that is, fuel consumed for uses not contributing to roadway deterioration is not taxed. That rationale, in turn, raises an equity issue regarding the proportionality of taxes paid by drivers of different classes of vehicles that cause varying degrees of road wear. Some argue that larger, heavier vehicles such as long-haul trucks do more damage, so their operators should pay a greater share of the taxes that support highway maintenance. Texas addresses this issue by requiring fee-based permits for overweight and oversized trucks.

Texas Constitution, Art. 8, sec. 7-a dedicates one-fourth of net MFT revenue to the Available School Fund and three-fourths to highway-related expenditures. The State Highway Fund also receives revenue from federal MFTs, state motor-vehicle registration fees, and sales taxes on lubricants. Fund monies may be spent only on highway improvements, environmental mitigation, and law enforcement. TxDOT shares the fund mainly with the Department of Public Safety.

**Recent proposals.** In 1999, Sen. Bill Ratliff suggested a 5-cent-per-gallon increase in the gasoline tax to address the state's perceived "mobility crisis." The idea attracted little support during a period of rising gasoline prices, when U.S. Sen. Kay Bailey Hutchison and others were calling for suspension of the federal gasoline tax. The Texas Transportation Commission and TxDOT staff also have suggested raising MFT rates, among other revenue options.

HB 3106 by Alexander/Averitt, introduced during the 77th Legislature in 2001, would have increased MFT rates by 5 cents per gallon across the board. The bill would have boosted MFT revenue by more than \$500 million a year, according to the Legislative Budget Board. Additional revenue for the Available School Fund would have been earmarked for health insurance benefits for school employees, contingent on amending the Constitution. An additional \$17.7 million a year would have been allocated from the State Highway Fund to counties for bridge repairs and state road improvements. The House Ways and Means Committee held a hearing on HB 3106 but left it pending.

**Arguments.** Some proponents say an MFT rate increase is long overdue. They note that since the last increase in 1991, the growth in state highway spending has lagged behind growth in population and in vehicle

miles traveled, resulting in greater traffic congestion. Given the need to increase highway spending, they say, motorists should bear the brunt of any revenue-raising measure because they are the chief beneficiaries of the state's roadways, and their vehicle use creates the need to maintain and expand the system. Sponsors of HB 3106 said that a 5-cent-per-gallon rate increase would cost the average Texas motorist less than \$3 a month. Supporters argued that retail competition, better driving habits, and use of public transportation could help lessen the economic impact of a rate increase on low- and moderate-income drivers. They also said that raising fuel costs through tax increases could encourage motorists to conserve fuel by driving less or buying more fuel-efficient vehicles, which would help to reduce harmful hydrocarbon emissions along with U.S. dependence on foreign oil.

Opponents of tax-rate increases note that MFTs are regressive, meaning that they consume a larger share of low- and moderate-income motorists' budgets than of those with higher incomes. In Texas, an expansive state with an underdeveloped mass transit system, many consider a personal vehicle a necessity. Opponents say a 5-cent-per-gallon tax hike would cause an unacceptable increase in the cost of operating a vehicle. Unlike businesses, they say, individual motorists cannot pass on the tax increase to customers.

**Changing the base.** Some TxDOT officials and other transportation professionals dislike relying on MFTs as the primary source of highway funding. They note that road construction costs have outstripped inflation in general and gasoline prices in particular in recent years, while MFT revenue growth has remained static because it is based on consumption rather than price. They fear that if automotive fuel economy improves and gasoline prices remain relatively low, MFT revenue will remain inadequate to meet Texas' transportation needs.

Some have suggested basing the MFT rate on a percentage of fuel prices rather than on a flat rate per unit of consumption. Such a measure, akin to a sales tax on gasoline, would tie MFT revenue more closely to oil and gas prices and consumer spending decisions than to fuel efficiency or driving habits. The fiscal impact, however, is unclear. The state's MFT revenue stream might become less stable, but motorists would have more control over how much tax they paid, depending on where they bought gasoline.

## Increasing “Sin” Taxes

Excise taxes on tobacco products and alcoholic beverages are among the oldest and most widely used levies in the world. Texas has taxed liquor since the days of the republic and cigarettes since the Great Depression. All 50 states and the federal government impose these so-called “sin” taxes.

Texas levies two separate tobacco taxes — one on cigarettes and another on cigars and other tobacco products (OTP: chewing and smoking tobacco and snuff) — and separate taxes on package sales of liquor (distilled spirits), beer, malt liquor (ale), and wine and on by-the-drink sales of mixed drinks and of alcoholic beverages sold on commercial airlines and passenger trains. All tobacco and alcohol tax revenues go into general revenue except for mixed-drink tax collections, of which cities and counties each receive 10.7 percent. In fiscal 2002, combined tobacco and alcohol tax revenues totaled \$1.1 billion, slightly more than 4 percent of all state tax revenue, according to comptroller data.

Wholesale tobacco distributors remit cigar, OTP, and cigarette taxes monthly. Current rates are: cigarettes, 41 cents per 20-count pack; cigars, from one cent per 10 weighing less than three pounds to \$15 per 1,000 weighing more than three pounds; OTP, 35.2 percent of factory price. Major exemptions include Indian tribal and federal sales and importation for personal use. Texas lawmakers have increased the cigarette-tax rate nine times and cigar/OTP tax rates seven times, most recently in 1990. Tobacco also is subject to the sales tax and to federal taxes (39 cents per pack on cigarettes and various rates for cigars and OTP).

The national average rate for state cigarette taxes is 61 cents per pack (68 cents in non-tobacco-producing states), led by Massachusetts at \$1.51 and New York and New Jersey at \$1.50. The lowest rate is Virginia’s 2.5 cents; among non-tobacco-producing states, the lowest rate is 12 cents in Wyoming. Texas’ rate now ranks 28th. In the past year, 21 states increased cigarette taxes by an average of 42 cents per pack, according to the National Conference of State Legislatures.

Manufacturers, distributors, and brew pubs remit beer taxes monthly, and permitted sellers remit mixed-drink taxes. Current rates are: liquor, \$2.40 per gallon; beer, \$6 per 31-gallon barrel; malt liquor, 19.8 cents per

gallon; mixed drinks, 14 percent of gross receipts; wine, from 20.4 cents to 51.6 cents per gallon; and airline/train sales, 5 cents per serving. Liquor, beer, malt liquor, and wine sold at federal military facilities are exempt from state taxes in Texas but are subject to federal taxes. The state’s liquor-tax rate has gone up seven times. In 1984, lawmakers raised the rates of the liquor, beer, malt liquor, mixed drink, and wine taxes. More recently, the mixed-drink tax rate rose by 2 percentage points in 1990.

**Revenue considerations.** Texas’ cigarette tax revenue has been virtually constant since 1991, despite a dip in the past two years. Liquor tax revenues generally have risen at a stable pace. According to the Comptroller’s Office, tobacco and alcohol consumption have declined steadily over the past two decades, largely because of health concerns. Almost all revenue growth in these categories is due to rate increases that have offset erosion of the tax base.

“Sin” tax revenues do not grow in direct proportion to rate increases, according to the Comptroller’s Office, because some consumers curtail or cease their usage of taxed products as prices go up. For example, for every 10 percent rise in the price of cigarettes, including taxes, consumption declines by 3 to 5 percent, according to a 2000 report by the U.S. surgeon general. The inverse relationship between tax revenue growth and overall prices also reflects increases in “black market” activities such as bootlegging.

Because purchases of tobacco and alcohol are largely discretionary (setting aside the factor of addiction), these taxes essentially are self-assessing. Black markets for these products are relatively small, neutralizing the effect of tax increases on price competition. One exception is in border areas; for example, cigarettes and liquor are cheaper in Mexico than in Texas, and all four of Texas’ neighbor states have lower cigarette-tax rates but higher alcohol-tax rates (except Louisiana’s wine tax rate, which is lower).

**Current proposals.** The Senate Finance Committee discussed several options for “sin” tax rate increases during interim hearings in 2002. Two House bills filed for the 78th Legislature would increase the cigarette tax at different rates and for different purposes. As of late February, no bills had yet been filed to increase any other taxes on tobacco or on alcoholic beverages.

## Cigarette Tax Increase

**Current rate:** 41 cents per pack

**Most recent change:** 1990: increased rate from 26 cents to 41 cents per pack

**National average rate (50 states):** 61 cents per pack

	<b>HB 53 (Wolens), 78th Legislature:</b>	<b>HB 267 (Naishtat), 78th Legislature:</b>
<b>Rate:</b>	91 cents per pack	\$1.41 per pack
<b>Allocation:</b>	Police, sheriff's, fire departments	Health-related programs and agencies
<b>Biennial revenue projection:</b>	\$1.0 billion	\$1.5 billion

HB 53 by Wolens would raise the cigarette tax by 50 cents a pack, to 91 cents. Such an increase would bring the combined state/federal tax levy, including state and local sales taxes, to \$1.55 a pack. According to tobacco industry data for 2001, the average total cost per pack sold in Texas would rise from \$3.52 to \$4.02. The author estimates that HB 53 would generate about \$1 billion in additional revenue in fiscal 2004-05, to be dedicated to police, sheriff's, and fire departments. The comptroller would disburse the proceeds from a new County and Municipal Cigarette Tax Fund.

HB 267 by Naishtat would increase the cigarette tax by \$1 per pack, raising the combined total tax to \$2.05 per pack and bringing the average total cost to \$4.52 per pack. The author estimates that HB 267 would generate about \$1.5 billion during fiscal 2004-05, to be allocated among the state-federal Medicaid program, the Texas Department of Health, the Children's Health Insurance Program, trauma care, rural health care, tobacco cessation programs, the Texas Department on Aging, and the Texas Cancer Registry.

**Arguments.** Part of the rationale for "sin" taxes is that they discourage socially damaging behavior and help to recover part of the attendant social costs. However, some call such taxes punitive and regressive in that they affect lower-income people disproportionately.

Polls touted by proponents show Americans favoring increases in cigarette taxes. Antismoking advocates claim that rate increases boost state revenue while reducing smoking. Lower usage of cigarettes, they say, reduces

the number of smoking-related illnesses, resulting in less spending on health care by states and by employers who pay for health insurance. In the long term, supporters say, tax increases benefit adolescents and young adults who quit smoking or who never start, especially if the state spends the additional revenue on antismoking programs; in the short term, additional revenue helps offset associated health costs. The federal government's health agenda, published in *Healthy People 2010*, calls for an average state/federal cigarette-tax rate of \$2 per pack by 2010, about double the current national average. Some proponents of tax increases say that because local governments have limited resources to supplement law enforcement and emergency services, additional revenue from cigarette taxes should be spent where it is needed most, regardless of who pays the tax.

Opponents counter that tax increases reduce smoking only slightly and that government regulation and negative publicity about smoking's side effects already are reducing consumption. They argue that the main impact of tax increases is on the young, who can least afford to pay and whom tobacco companies no longer are allowed to target, rather than on adults, who represent the largest amount of potential health-care costs. Compounding the unfairness, in their view, is the allocation of revenue to general or non-health-care-related purposes. They say smokers already are penalized by high taxes and by restrictions on the use of a legal product and would receive no direct benefit from higher cigarette taxes. Using revenue from a narrow class of taxpayers to pay for general public goods or services amounts to "tax profiling," according to opponents.

## State Property Tax

Property is subject to only local taxation in Texas. The state exerts oversight chiefly through rate limits, exemptions, and exclusions. A state-level property tax existed from the days of the republic until voters abolished it by amending the Constitution in 1982. The statewide tax applied to all property, including intangible assets (documented wealth), but assessment was inconsistent and enforcement was lax.

Since 1979, real and business personal property has been taxed on the basis of appraised value, which cannot exceed the property's fair cash market value (Texas Constitution, Art. 8, sec. 20). Central appraisal districts in each county assign values to taxable property, subject to review, appeal, and litigation. The governing bodies of local taxing entities set property-tax rates.

Property taxes generate more revenue (\$25 billion in 2001) than any other state or local tax. About 60 percent of that revenue goes to school districts, providing the majority of funding for public schools across Texas. Although public education is the largest single expenditure in the state budget, the state's share of funding has fallen in recent years.

Higher tax rates and appraised values have resulted in steadily increasing property-tax collections. According to the comptroller, exemptions and abatements reduced collections by \$3.4 billion in 2002. The largest reduction, \$1.1 billion, was due to appraisal of agricultural land on the basis of productivity value rather than market value. Major exemptions from school property taxes relate to residence homesteads: the state-mandated exemption of \$15,000 of the appraised value of each homestead, plus a \$10,000 exemption for seniors and the disabled; additional local-option exemptions; a ceiling ("freeze") on tax bills for seniors; and a 10 percent cap on increases in the appraised value of homesteads.

**Recapture system.** The concept underlying the state's school finance system is substantially equal revenue for substantially equal tax effort. To compensate for local variations in property wealth, the state guarantees school districts a certain amount of revenue per student (the "guaranteed yield") and redistributes additional funding to lower-wealth districts through property-tax revenue recaptured from higher-wealth districts. The recapture mechanism is based on taxable wealth per

### State Property Tax

Replace local school property taxes with a dedicated state property tax, eliminating revenue recapture for maintenance-and-operations (M&O) spending

**Most recent change:** constitutional amendment in 1982 abolished state tax

**Other states with similar taxes:** 15 (at least five dedicated to education)

**Ratliff proposal highlights:**

**Base:** same (real and business personal property)

**Rate:** \$1.40 per \$100 of valuation for M&O

**Local enrichment option:** up to 10 cents/\$100

**Biennial revenue projection:** neutral (\$6,085 per student, adjusted)

student, and the comptroller's annual study of school property values is used to determine the distribution of state funds.

State law generally caps school property-tax rates for maintenance and operations (M&O) expenditures at \$1.50 per \$100 of valuation. Currently, more than one-third of the state's 1,000-plus school districts are at or near the cap. Some legal and school-finance experts believe that when a majority of districts reach the cap, the school property tax effectively will have become an unconstitutional state property tax.

In 2001, the West Orange-Cove school district filed suit challenging the constitutionality of recapture on the ground that the M&O cap precluded the school board's discretion in setting local tax rates. The trial court dismissed the case, finding that too few districts had reached the cap. State District Judge Scott McCown stated that most capped districts still had revenue options, noting that many of them grant optional homestead exemptions. The Third Court of Appeals in Austin upheld Judge McCown's ruling in April 2002. The Texas Supreme Court has agreed to hear arguments on appeal in March 2003.

**Proposals for a state-level tax.** The concept of reinstating a state-level property tax is not new. In the early 1990s, when the state was struggling to craft court-mandated equity reforms, then-Sen. Carl Parker proposed replacing school taxes with a state property tax of \$1 per

\$100 of valuation. In 1997, then-Rep. Paul Sadler proposed a state property tax on businesses during the debate over Gov. George W. Bush's property-tax relief plan.

In April 2002, Sen. Bill Ratliff, then lieutenant governor, called on the Joint Select Committee on Public School Finance to revamp the revenue redistribution system he had helped to create in 1993. His plan would fund the Foundation School Program (FSP) with a combination of existing state and local revenue streams and a new dedicated state property tax. Voters would be asked to approve a constitutional amendment that would (1) abolish school districts' authority to levy property taxes for M&O expenditures, (2) authorize the Legislature to impose a state property tax for public education, and (3) authorize the Legislature to allow school districts to levy taxes for local enrichment programs at rates up to 10 cents per \$100. Sen. Ratliff suggested a state tax rate of \$1.40 per \$100 for the FSP.

The state would guarantee a yield of \$30 per penny of tax effort per student in weighted average daily attendance (WADA) for all districts' basic allotment and for local enrichment in property-poor districts (those with taxable wealth of less than \$300,000 per WADA). The basic allotment would be \$6,085 per student or \$4,725 per WADA. That amount would be about \$115 more per WADA for M&O than now is available to property-poor districts, according to the committee report. School districts would retain taxing authority for debt financing of facilities. The state would guarantee \$35 per penny of tax effort (up to 30 cents) per ADA for debt service on facilities and would distribute revenue to districts through an ADA-based formula.

The Legislative Budget Board staff determined that the Ratliff plan would be revenue-neutral. The current system raised about \$24 billion for schools in the 2002 tax year.

**Arguments.** Proponents say a state property tax would make the school finance system more equitable. Every taxpayer would pay the same basic rate, and local school boards could raise rates to pay for additional local programs. Abolishing recapture, proponents say, would end the transfer of local property-tax revenue from more than 100 school districts, estimated at \$980 million in the 2002-03 school year. This fairer method, they say, would increase the state share of school funding from

about 44 percent to more than 90 percent. The Legislature could raise education revenue more easily across the board, enabling a more even distribution of the benefits of property wealth.

Proponents say that the resulting limitations on flexibility or growth in response to higher enrollments would be no greater than they are now, assuming that property values keep rising. Rather, school districts would be spared the year-to-year vicissitudes of local real-estate markets and property appraisals. This would aid budget planning without usurping local school boards' spending authority, they say. Overall tax rates for property owners in many districts would not change, and some would decrease, proponents say. Sen. Ratliff said his plan could be refined so that as few as six districts would receive less total funding. Ultimately, proponents say, retooling the existing system is preferable to other alternatives, such as a state income tax.

Critics say a revenue-neutral state property tax would be merely a variation on revenue recapture, another way of redistributing property wealth. The school finance system would remain overly reliant on property taxes, they say, because the measure would introduce no new revenue source. Capital-intensive industries would receive no relief from their increasingly heavy property-tax burden. The unwieldy and controversial appraisal process would remain unchanged, and many homeowners would lose their local-option homestead exemptions. Despite the systemic change, they say, the state would have no more money for education than it has now.

Under the Ratliff plan, opponents say, the state effectively would take more than 93 percent of available property-tax revenue away from districts but would not necessarily return it all to the "donor" districts, leaving them with access to less than 7 percent. By some estimates, at least a dozen and as many as 64 districts would have less money to spend, even if they taxed at the maximum allowable rate. More than 200 districts would see a tax increase, but local boards no longer could set basic rates. That power would be vested in legislators, who could change rates no more often than every two years. Critics say this system would hamper districts' ability to respond to fiscal challenges caused by rapid enrollment growth or other factors beyond their control. In the final analysis, they say, many districts — including most property-rich ones — would be better off with the status quo.

## State Income Tax

Texas never has imposed a personal income tax, though all but six other states — Alaska, Florida, Nevada, South Dakota, Washington, and Wyoming — impose such a tax. (New Hampshire and Tennessee tax interest and dividend income only.) During Texas' fiscal crisis in the early 1990s, then-Lt. Gov. Bob Bullock and others proposed a state income tax. The failure of that effort led to a constitutional amendment, approved by voters in 1993, that delineates how an income tax may be enacted.

Article 8, sec. 24 of the Constitution requires that any law enacted to tax net personal incomes be approved by a majority of voters in a statewide referendum. The ballot must specify the proposed rate applicable to taxable income. Increases in the tax rate or statutory changes that increase all income taxpayers' combined tax liability also must be approved in a statewide referendum. At least two-thirds of net income-tax revenue (after refunds and collection costs) must be used to reduce school property-tax rates for maintenance and operations (M&O). For each cent per \$100 of assessed valuation that local rates are reduced by income-tax revenues, the maximum allowable M&O tax rate (cap) is reduced by an equal amount. Voters in each school district must approve any increase above the new lower maximum rate. The Legislature must appropriate or allocate the remaining income-tax revenue to education.

**Recent proposals.** Only three bills proposing a state income tax have been filed since voters approved Art. 8, sec. 24. In 1995, HB 2718 by Maxey would have imposed a 4 percent tax on all taxable personal incomes exceeding \$89,500, including those of nonresidents earning income in Texas. In 2001, both HB 3293 and HB 3464 by Maxey would have set the taxable income threshold at \$69,000. None of the bills received a committee hearing.

Two of the more prominent state income-tax plans discussed during the interim between the 77th and 78th Legislatures took very different approaches. The Joint Select Committee on Public School Finance heard testimony on both proposals but endorsed neither.

The Center for Public Policy Priorities (CPPP) suggested that Texas impose an individual income tax similar to those in other states, citing Kansas as a typical example. Kansas' tax tracks the federal tax code and

applies both to residents and to nonresidents with in-state income sources. The tax has three income brackets for singles and married people filing separately, ranging from \$15,000 to \$30,000, and three brackets for married couples filing jointly, ranging from less than \$30,000 to more than \$60,000. Personal exemptions are \$2,250 for single taxpayers and children and \$4,500 for married taxpayers. Standard deductions are \$3,000 for singles and married people filing separately, \$4,500 for heads of households, and \$6,000 for married joint filers. Rates range from 3.5 percent to 6.45 percent of federal adjusted gross income (FAGI), with multipliers and add-backs at certain income thresholds.

According to the CPPP, a similar tax levied in Texas would generate about \$36 billion per biennium, of which \$12 billion could be dedicated to public education and \$24 billion used to reduce local property taxes.

Houston attorney David Thompson has proposed a voluntary state personal income tax in exchange for a state sales-tax rebate. Although Art. 8, sec. 24 of the Constitution might not apply to an optional tax, Thompson advised adoption using that procedure. The Alternative Education Tax (AET) would be dedicated to public education. The tax rate would apply to FAGI, and the state would collect the revenue and issue the rebates.

Thompson's hypothetical example assumed that a taxpayer with four dependents and a \$50,000 AGI would pay \$1,031 a year in sales taxes (one-third of AGI spent on items taxable at 6.25 percent). At a rate of 2.5 percent, the AET would cost the taxpayer \$1,250. If paid, the state would net the additional \$219 and would rebate the taxpayer \$1,031. To compensate for varying consumption rates among taxpayers at different income levels, the state would have to create imputed sales-tax tables to calculate rebates. Eventually, in effect, taxpayers would pay either the AET or the sales tax, but not both. According to the Legislative Budget Board, the AET would generate a biennial net gain of \$1.1 billion for the state.

State income taxes, unlike sales taxes, are deductible from federal income taxes. Thompson's plan is predicated on the AET's deductibility, which he believes would encourage more filers to itemize deductions. Ostensibly, the federal deduction would offset any costs not covered by the rebate that were incurred by the approximately 20 percent of Texas filers who itemize their deductions. To encourage itemizing, Thompson suggested making the AET payable any time during the tax year but due on or

## Personal Income Tax

**Other states' personal income-tax rates:** lowest = 0.36 percent (Iowa); highest = 12 percent (Massachusetts)

### Alternative Education Tax:

Voluntary income tax in lieu of state sales tax, dedicated to public education

**Base:** federal adjusted gross income

**Rate:** 2.5 percent

**Biennial revenue projection:** \$1.1 billion (net)

### Kansas-style state income tax:

Revenues would be used to fund public education and reduce local property taxes

federal adjusted gross income

3.5 to 6.45 percent

\$36 billion

before December 31. He advised using the previous tax year's FAGI to compute both the AET payment and the sales-tax rebate.

**Arguments.** In general, proponents argue that a progressive income tax is fairer than other taxes because the levy rises with income, directly linking tax liability to one's ability to pay. That aspect, they say, also provides potential for revenue growth as incomes rise over time. Growth of the tax base tends to track business expansion, according to economist Ray Perryman, and administration is relatively simple.

Opponents counter that income taxes hurt the state economy as well as individuals, especially wage earners. Perryman argues that income taxes divert more private-sector resources from productive uses, such as investment capital and disposable income, than do other major revenue measures. He notes that workers in other states have sought additional compensation from employers to offset the effects of state income taxes. Critics also note that income-tax revenue is susceptible to economic fluctuations.

Income-tax supporters maintain that Texas' tax structure is outmoded — particularly for education funding — because it fails to reflect that most personal wealth now is based on income rather than on property. The CPPP contends that a Kansas-type state income tax would reduce school property taxes by 85 percent, thereby benefitting most Texans.

Opponents claim that Texas enjoys a competitive economic advantage over most other states because it does not tax incomes. The Texas Taxpayers and Research

Association (TTARA) notes that the property-tax relief component of any Texas income tax would lower but not remove the school property-tax rate cap. Businesses' share of school property taxes would decrease, according to TTARA, but senior homeowners would receive less property-tax relief than others because the existing freeze on taxes for those 65 and older is based on the amount of taxes paid, not on taxable value.

The CPPP maintains that the federal deductibility of a state income tax would ease the burden on Texas taxpayers. Thompson acknowledges that without federal deductibility, the AET would be less attractive and its revenue-generating potential would be smaller. Several tax lawyers and fiscal experts believe that a voluntary state income tax would *not* be federally deductible. Some say that if it were, the deduction would be limited to the amount of state income tax paid that exceeded the state sales-tax rebate received. A U.S. Internal Revenue Service official, speaking informally, tended to corroborate that view. The official added that itemizing generally is declining as the federal standard deduction increases.

Linking a state income tax to its federal counterpart, as some have suggested, could have long-term implications. State taxpayers might benefit from new federal tax laws, while state governments might not. For example, because Kansas is required by statute to base its income-tax calculations on FAGI, any base changes to the U.S. tax code (such as accelerated depreciation or a higher standard deduction) directly affect the state's income-tax revenue stream. Some Kansas legislators have suggested that the state consider disconnecting its income tax from the federal system to minimize revenue losses.

**(Sales Tax, from page 3)**

**Arguments.** Proponents of expanding the base argue that the sales tax will become ineffective, if not obsolete, if it continues to apply primarily to goods. Although revenue continues to grow with inflation and demand for goods, it does not reflect growth in the service sector and the new “information economy.” Citing data from the comptroller, the CPPP notes that the sales tax applies to a greater proportion of retail goods (40 percent) than of services (30 percent), yet sales growth in services has outstripped sales growth in goods by more than 50 percent in the past 10 years. Expanding the base to include more services would bring much-needed equity to the sales tax, supporters say.

Others oppose taxing business services in principle as a form of double taxation. Service exemptions and exclusions are predicated on levying the sales tax on final transactions. Not unlike raw materials, which are exempt, many business services represent intermediate steps in manufacturing or production. Opponents view taxing such services as unfairly “pyramiding” taxes. Although sales taxes on services largely would be paid by consumers, opponents argue that businesses that paid those taxes could pass the costs on to consumers in the form of higher prices or else might eliminate some jobs. Job losses

would be more likely in construction, manufacturing, and mining, according to economist Ray Perryman.

Whether expanding the tax base would make the tax more regressive is unclear. The CPPP argues that an accompanying rate reduction might diminish regressivity and that taxing only business and professional services would have less impact on low-income people who use those services less. However, opponents note that taxes on advertising or real estate brokering services could be passed on to poorer consumers through higher grocery prices or rents, and taxing auto repair or child care could hit low- to medium-income workers particularly hard.

The impact of base expansion on consumers’ economic decisions also is uncertain. Whether taxing some services would prompt consumers or businesses to forgo spending on those services in favor of other services depends on such factors as the tax rate, ability to pay, available alternatives, and competition. However, opponents argue that such a tax could put Texas companies that provide business and professional services to multistate clients doing business in Texas at an economic disadvantage relative to competitors in states that do not tax those services.

— by **Patrick K. Graves**

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