HOUSE RESEARCH ORGANIZATION session focus

Texas House of Representatives March 24, 1997

The Tax System and Public School Financing in Texas

On January 29, 1997, the House Select Committee on Revenue & Public Education Funding met for the first time to consider Governor George W. Bush's property tax relief proposal. The governor proposed to reduce local property taxes by using state revenue to cover a greater share of public education financing. One month later the committee set aside the governor's plan in order to examine the two issues of taxation and public school financing from a broader perspective. The question facing the committee, chaired by Rep. Paul Sadler, was whether to focus solely on property tax relief or to devise a tax system that would adequately fund public education for the future. While the committee supported property tax reform, it expressed general agreement that this change alone would not be sufficient to satisfy future public funding needs for public education. Gov. Bush has said he would consider the committee's recommendations.

The House select committee is now examining alternative revenue sources with growth potential to fund the $38 billion needed to support public education in the coming biennium and beyond. At present, the state pays less than 47 percent ($17.7 billion) of the total cost of funding public schools, while the local contribution amounts to more than 53 percent ($20.2 billion). The committee has examined various alternative revenue sources. Some would require implementing new taxes, such as the gross receipts tax, a value-added tax like the business activity tax proposed by Gov. Bush, and a personal income tax. Others would revise the current tax system by expanding bases of the sales tax and franchise tax and the local business property tax base to include tangible and intangible property and by imposing a state property tax on business property. The committee also is exploring eliminating exemptions and exclusions to the property tax, motor fuels tax and severance taxes. According to committee data, more than $9 billion could be raised over the next biennium alone by expanding the sales, franchise and motor fuels taxes, allowing the state to assume a much larger share of public education funding.

Although tax bills must originate in the House, Lt. Governor Bob Bullock has appointed a special Senate committee to stay abreast of property tax relief and public school financing in anticipation of House action. The 11-member committee, chaired by Sen. Ken Armbrister, is examining the governor's proposed tax plan. In addition, the Senate Education Committee, chaired by Sen. Teel Bivins, is looking at alternatives to the current school finance system that recaptures and redistributes property tax revenues from the wealthiest school districts to poorer school districts, commonly known as the "Robin Hood" plan.

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State/Local Share of Public School Funding
Fiscal 1998-99

State	$17.7 billion (46.7%)
Local	$20.3 billion (53.3%)
TOTAL	$38.0 billion*

*Does not include federal funds.

On March 14, Rep. Sadler filed legislation (HB 3394, HB 3395, HJR 116 and HJR 117) to be used as legislative vehicles for whatever tax and public education finance proposals the select committee decides upon.

Overview of the Current Tax Structure

Public services in Texas are funded by a mix of local, state and federal funds. State taxes account for about 50 percent of estimated state revenue for fiscal 1996-97; non-tax revenue — such as federal funds, fees, lottery sales, land income and investments and dividend payments — make up the other 50 percent.

Texas has relied on essentially the same structure of state and local taxes since the state first imposed a general sales tax in the early 1960s. The sales tax and the local property tax are the state's primary sources of tax revenue and account for more than three-fourths of local and state tax collections today. Over the years, the Legislature has tinkered some with this structure, dropping a relatively small state property tax in 1982, making changes in calculating the corporate franchise tax in 1991 and expanding the sales tax base several times between 1972 and 1990.

While the basic state-local tax framework has remained relatively constant, tax rates have been increased several times over the past decade to stretch the system to meet changing spending patterns and economic conditions. The proportion of local tax revenue that funds state and local services has increased in recent years to 50 percent, up from about 40 percent in 1982. As a result, some state leaders and economic analysts have questioned the adequacy and fairness of the revenue system and its ability to meet long-term public needs.

State and local shares

In Texas local taxes make up a larger share of the state-local tax burden than in other states. The primary local tax is the property tax, which may be levied by school districts, counties, cities and special districts, such as junior college, hospital, and navigation districts. A state property tax was constitutionally abolished in 1982.

Property taxes accounted for 42 percent of total state and local taxes in Texas in 1995, followed by state general sales taxes (28 percent) and other state taxes (23 percent). Local government sales taxes, which are collected by the comptroller and remitted to local jurisdictions, totaled 7 percent of all state and local taxes in 1995.

Percentage of Local Tax Revenue from Major Tax Sources
Calendar Year 1993

Property Tax	85.5
Local Sales Tax	14.5

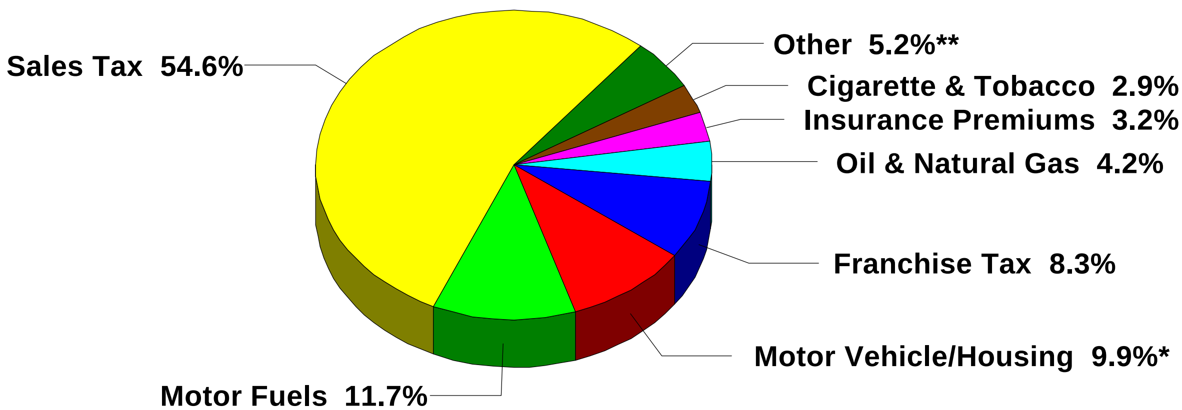
Source: Legislative Budget Board, 1996-97 Fiscal Size Up.

Business and individual shares

Business pays roughly 60 percent of total state and local taxes in Texas; individuals pay the remaining 40 percent. The tax burden on Texas business is higher than in other populous states. Among the 10 largest states, only Florida, which like Texas has no personal income tax, relies as heavily on business to pay a majority of state and local taxes. In 1991 then-Governor Ann Richards' Task Force on Revenue recommended that the tax burden be evenly shared between business and individuals.

Local property taxes make up the primary tax burden on businesses, with sales taxes ranking second and special taxes, such as the corporate franchise tax levied solely on business, third. Property and sales taxes account for about three-fourths of all taxes paid by business. For individual taxpayers, sales taxes are the leading tax, accounting for about 40 percent of the total. Property taxes are second at 33 percent and motor fuels taxes a distant third at 8 percent.

Major Sources of State Tax Revenue



Total tax revenues fiscal year 1996: $19.762 billion

*** Motor vehicle taxes constitute 90 percent of the Motor Vehicle/Housing category.**
**** Other includes: Alcoholic beverages, utilities, inheritance, hotel/motel and other miscellaneous taxes.**
***Source:* Comptroller's Annual Cash Report Fiscal Year 1996.**

Property taxes

The leading single source of state and local tax income in Texas is the property tax. In 1995 local governments in Texas levied nearly $16 billion in property taxes.

Property taxes are generally considered to be proportional taxes, i.e., the amount of the tax as a percentage of income is relatively constant among the vast majority of taxpayers.

According to the Legislative Budget Board (LBB), school districts have been responsible for 69 percent of the property tax growth since 1984. School district property tax revenues increased by 107 percent from 1984 to 1993, swelling from about $4.2 billion to $8.7 billion. The average effective tax rates of school districts increased even faster than overall rates, from 60 cents per $100 property valuation in 1984 to $1.42 in 1996. Recent school district increases are linked in part to the state's efforts to equalize school funding without abandoning what is fundamentally a property tax-based finance system. As state revenue has been shifted away from relatively property-rich to property-poor districts, the property-rich districts have increased tax rates to offset the loss of state aid and redistribution of local revenue. At the same time, a system in which greater local tax effort is rewarded with more state aid has created an incentive for all districts to boost local tax rates.

Percentage of Property Taxes Collected by Taxing District
Calendar Year 1995

Special Districts	10.4
County	14.7
Cities	16.0
School Districts	58.8

***Source:* Comptroller's Annual Property Tax Report, Tax Year 1995.**

Although property taxes create disparities in the value of taxable property among school districts and, thus, inequities among school districts, they do have one advantage over other taxes: they generally are stable during recessions, when revenue from sales and income taxes can drop sharply. Nonetheless, unusually volatile property values in the 1980s caused dislocations in the property tax base. Total school district appraised values dropped from a peak of $761 billion in 1986 to $726 billion in 1992. In 1995 they had risen again to $778 billion.

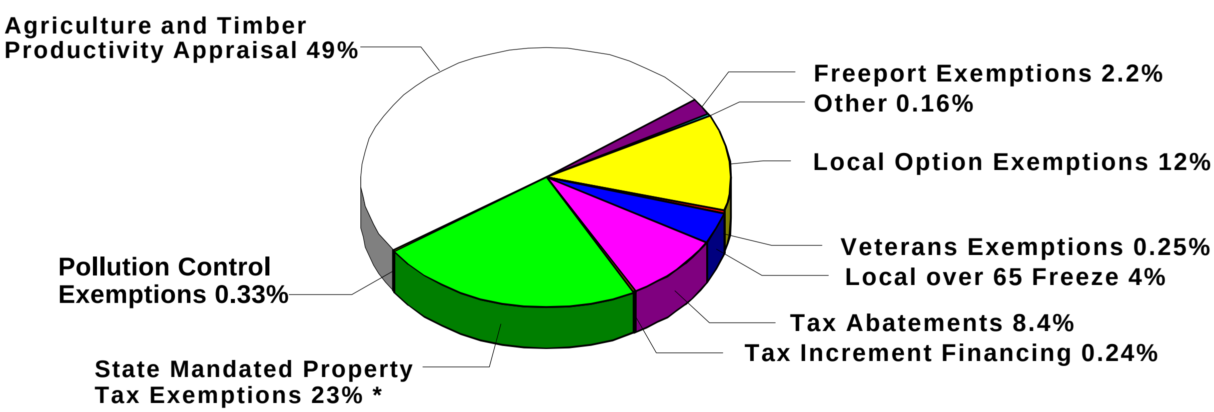
But the new gains in property valuation were not across-the-board. For example, in 1985 single family residences were valued at $224 billion, while oil, gas and mineral valuation stood at $87 billion. By 1995 home valuations had increased to $301 billion, but oil, gas and mineral values had dropped to $32 billion. Furthermore, the amount of property valuation to support each student is lower than it was in 1985 because student enrollment and inflation have increased, while property valuation is now level with what it was in 1985.

The decline in appraised value in the late 1980s was exacerbated by the growth of exemptions and abatements, which removed $36.7 billion in property value from the tax rolls in 1985. In 1995, those exemptions had grown in value to $59.9 billion, a 39 percent increase.

Tax abatements also may exempt from taxation all or part of the value of improvements and personal property, except inventory and supplies, in a designated area. Cities and counties may set up reinvestment zones and abate taxes on new facilities and expansion of existing facilities in the zone. SB 7 by Ratliff, the school finance bill enacted in 1993, required that calculations of total taxable property include property value abated by school districts, causing school districts with tax abatement exemptions to receive less state aid.

In addition to exemptions and abatements, the Legislature allows certain agricultural and timber land to be taxed based on productivity, i.e., the difference between market value and productive value of the land. Over the past 11 years, the average annual property tax valuation loss under this program has amounted to $67.6 billion. Totally exempt properties — churches, federal property and property owned by state or local governments and institutions of higher education — are not included in the total property valuation but can be considerable. For 1995,

Property Tax Exemptions



Total value of land exempted from property taxes in 1995: $117.89 billion

* State mandated property tax exemptions include a $5,000 residential homestead exemption and a residential property tax freeze for those 65 and older.
Source: Comptroller's Annual Property Tax Report, Tax Year 1995

Property Tax Exemptions

Constitutionally mandated

- Basic $5,000 residential homestead exemption

- Tax freeze for persons 65 or older, so long as the person lives in the home and does not add significant improvements

Constitutionally allowed with legislative approval

- Additional homestead exemption for persons over 65 or disabled (Legislature may exercise option to specify the amount and condition of eligibility for additional exemption for such individuals based on economic need)

- $3,000 homestead exemption for disabled veterans

- "Freeport" optional exemption instituted in 1992 waiving tax on certain goods, wares, ores, merchandise and tangible personal property used in the repair and maintenance of aircraft operated by a certified air carrier that are in the state for 175 days or less (oil, natural gas and petroleum products do not qualify)

- Pollution control exemption, begun in 1995, for property used to control pollution

Local option

- Additional exemptions of up to 20 percent of a residence's appraised value

- Additional exemption of at least $3,000 for the disabled or persons 65 or older

the comptroller estimated the value of totally exempt property at $38.4 billion out of a total statewide market value of $816.7 billion.

Sales and use taxes

Sales taxes supplied more than one-third of all state and local tax revenues in Texas in 1995 and 54.6 percent of state taxes in fiscal 1996. The state sales tax is the largest single source of revenue to the state. Sales taxes are especially important in states that do not tax personal income. (In addition to Texas, other states that do not tax personal income are Alaska, Florida, Nevada, South Dakota, Washington and Wyoming. New Hampshire and Tennessee tax only investment income.)

The Texas state sales tax rate at 6.25 percent is one of the highest in the nation; only Mississippi, Nevada, Rhode Island and Washington have higher state sales tax rates. In Wyoming, the sales tax rate can be adjusted annually according to a formula based on balances in the unappropriated general fund and the school foundation fund. The Texas Legislature has raised the sales tax rate four times since 1984 and expanded the tax base repeatedly to embrace a much wider range of goods and services. Cities, counties, transit systems, and certain other districts may impose local sales taxes totaling up to an additional two percent, so that many Texans pay a total sales tax of 8.25 percent.

The sales tax is considered to be a regressive tax because it takes a higher percentage of income from taxpayers with lower incomes. However, Texas has tempered the regressivity by exempting from the sales tax everyday basic needs, such as food, medicine and medical care, and utilities.

State sales tax revenues for fiscal 1996 amounted to nearly $19.8 billion. The Comptroller's Office has estimated that sales tax exemptions, exclusions and discounts will cost Texas $14.6 billion in fiscal 1997, an amount equal to nearly 75 percent of the 1996 sales tax collection. However, about $2.5 billion of that total are items taxed under other laws (crude oil, motor vehicles, motor fuels, mixed drinks, cement and sulphur). The largest sales tax exclusion is $6 billion for materials used in manufacturing, a provision intended to keep Texas manufacturing competitive with other states that exempt manufacturing materials from the sales tax.

Appraisal Districts

Appraisal districts were created in 1982, when Texas voters approved HJR 1, a constitutional amendment to abolish the statewide property tax, and allowed localities to administer property taxes. There are 253 appraisal districts in Texas, one for each of254 counties except Potter and Randall counties, which comprise a single appraisal district.

Appraisal districts do not set or enforce property tax policy but determine what property is taxable and appraise its market value. They administer the laws regarding property tax exemptions and special valuations, including the homestead, over-65, veterans' and disability exemptions. The districts compile and maintain the appraisal rolls and provide this information to local taxing entities, such as cities, school districts, counties, and special districts, which actually collect the taxes. Each appraisal district is governed by a board of directors, appointed to two-year terms by the governing bodies of the districts' various taxing authorities. The board administers the district's budget, provides public information, and appoints and provides oversight for appraisal review boards.

Chief appraisers, the chief executive officers of the appraisal districts, are hired by the boards of directors. The chief appraisers and their staff conduct the appraisal and valuation of property and determine eligibility for exemptions. The chief appraisers act as liaisons between taxpayers and the governing bodies, appraisal review boards and boards of directors.

The appraisal review board hears and evaluates protests from taxpayers regarding property appraisals, responding to protests in public hearings or in writing. Depending on the size of the appraisal district, the board may have from nine to 45 members. Members are not salaried but receive a per diem established by the district as well as reimbursement for expenses incurred in the performance of their duties. Members of both boards of directors and appraisal review boards must have resided within their district for two years.

Appraisal districts are required to appraise property at least once every three years. The property value should reflect market value. Property is generally appraised using three methods: comparable sales, if applicable; income generated by the property; or new replacement cost less depreciation. Appraisals can be done using one method or all three, depending on the appraiser and the amount of information available. Generally, residential property is appraised using comparable sales, commercial property using the income approach, and industrial property using the replacement cost approach.

— by Jenny Staff

Major Sales and Use Tax Exemptions and Exclusions

Estimated State Revenue Gain

Fiscal 1998-99

Exemption	(millions of dollars)
Food for home consumption	$ 1,758.0
Residential gas and electricity	974.2
Prescription medicine and devices	246.5
Health care services (physicians, health practitioners)	497.3
Dental services	104.5
Water	256.0
Gas and electricity used in manufacturing	577.7
Gas and electricity used in mining	72.6
Manufacturing machinery and equipment	638.0
Packaging and wrapping supplies	279.9
Agricultural items	608.0
Agricultural manufacturing machinery and equipment	68.5
Agricultural gas and electricity	23.8
Repair for certain aircraft	18.6
Miscellaneous transportation services	292.5
Legal services	221.6
Accounting and audit services	136.0
Architectural and engineering services	226.9
Brokerage and financial services	202.9
Computer programming services	58.4
Management consulting and public relations services	80.9
Temporary labor supply services	79.5
Real estate commissions	128.3
Construction labor costs	288.3
Barber and beauty services	72.8
Car wash services	20.0
Automotive maintenance and repair	285.3
Newspapers and newspaper inserts	36.0
Magazine subscriptions	42.1
Advertising services	192.3

Source: Comptroller's Office, Revenue Estimating

Motor Fuels Tax

Motor fuels taxes on gasoline and diesel fuel are the second most important source of state tax revenue, accounting for about 12 percent of revenue in fiscal 1996 at $2.321 billion. The tax rate for gasoline or diesel has stood at 20 cents per gallon since 1991. Revenues from these taxes do not rise with inflation because the fuels tax is figured at a flat rate per gallon. The revenue is constitutionally dedicated: 75 percent goes to the State Highway Fund and 25 percent to the Available School Fund. The Comptroller's Office estimates that more than $241.8 million could be collected in fiscal 1998-99 from repealing certain motor fuels tax exemptions and taxing them at a six-cent per gallon tax rate.

Major Motor Fuels Tax Exemptions

Estimated State Revenue Gain

Fiscal 1998-99

Exemption	(millions of dollars*)
Aviation	$180.1
Railway Engine	23.0
Agricultural use	16.4
Industrial and commercial	10.0
Marine	8.6
Construction	3.7

*Computed at a tax rate of six cents per gallon.

A 10-cent increase in current tax rates, from 20 cents to 30 cents per gallon, for gasoline and diesel fuel could pour an additional $550 million into the Available School Fund in fiscal 1998-99, the comptroller estimates. The Highway Fund would realize an additional $1.650 billion.

Motor vehicle sales and rental taxes

The 6.25 percent sales tax on motor vehicles collected $1.765 billion in fiscal 1996 and is the state's third largest source of tax revenue. The tax is levied on the sales price of a motor vehicle less the value of any trade-in. A sales tax of 10 percent also is levied on car rentals, dropping to 6.25 percent after 30 days. The state also imposes a 6.25 percent Texas-apportionment tax on certain motor vehicles, such as buses and trucks, operated interstate by Texas resident carriers or domiciled or doing business in Texas. This tax is scheduled to be repealed September 1, 1997. In fiscal 1996 the tax brought in $20.2 million.

Motor vehicles taxes have consistently provided from 6 to 8 percent of state tax revenue over the past two decades. The sales tax rate increased from 4 percent in the early 1980s to the current level of 6.25 percent. One quarter of the revenue from the motor vehicle sales tax is dedicated by law to public education through the Foundation School Fund.

The Comptroller's Office estimates that $59.3 million could be raised in the next biennium by keeping the 6.25 percent sales tax on interstate motor carriers and imposing a tax of 6.25 percent tax on manufactured housing sales, adjusted to exclude construction labor costs.

Corporate franchise tax

The state's major business tax, the corporate franchise tax, was the fourth largest tax source for Texas in fiscal 1996, bringing in 8.3 percent of all state tax collections. The tax accounts for 16 percent of all taxes paid by business. The corporate franchise tax can be figured based on either taxable capital or "earned surplus." Earned surplus is a firm's federal taxable income, before any net operating loss deductions, with officer and director compensation added back into the base. Taxpayers pay the higher of $2.50 per $1,000 of taxable capital or 4.5 percent of earned surplus. The earned surplus option was designed to provide a more clearly defined tax base, but since corporate profits tend to fluctuate, taxable capital was retained as a more stable alternative base.

The burden of franchise tax liability among the sectors of the Texas economy does not correspond to the contribution each makes to the gross state product. Manufacturing corporations account for a lower percentage of the gross state product than does the service sector, but they pay a larger percent of the tax.

Some say that the corporate franchise tax, first levied in 1907, is an income tax, while others contend that it differs from an income tax by also taxing a firm's net worth.

The franchise tax has been criticized for being inequitable because it favors some business sectors at the expense of others. The franchise tax is paid by corporations, including subchapter S corporations, banks, savings and loan institutions, and limited liability companies doing business in Texas, but exempts partnerships, sole proprietorships and professional associations. The comptroller calculates that 90 percent of the franchise tax is paid by the top 10 percent of firms required to pay the tax, which means the tax burden falls on a few large firms. The comptroller estimates the value of franchise tax exemptions to profit-making and non-profit corporations will amount to $700 million in fiscal year 1997.

A report prepared by the Comptroller's Office in 1996 for the House Ways and Means Subcommittee on Franchise Tax Avoidance indicated the state could increase its franchise tax revenue by $111 million a year by taxing intangible assets based on business' commercial domicile instead of place of incorporation and by taxing certain limited liability entities. However, some tax experts say that extending the franchise tax to noncorporate limited liability entities might run afoul of the Texas Constitution's prohibition against taxing personal income without voter approval. The number of non-corporate forms of business have become more common in Texas in the last 10 years. Texas has about 2,300 limited liability partnerships, compared to 1,125 in New York.

The comptroller estimates the state could collect almost $2.3 billion in fiscal 1998-99 by repealing franchise tax exemptions and deductions for for-profit ($2 billion) and non-profit ($273 million) corporations. The value of the largest single exemption, noncorporate entities, is estimated to be $814 million in 1998-99. The exemption for insurance companies alone is valued at $209 million in the next biennium. However, the more than 2,000 insurance companies operating in Texas paid insurance premium taxes amounting to over $627 million in 1996 alone.

Severance taxes

Oil and natural gas tax collections — called severance taxes — have fluctuated sharply with the ups and downs of the industry. In 1982 severance taxes accounted for 27 percent of state tax revenue: in 1996 they accounted for only 4.2 percent. One-fourth of the revenue collected through severance taxes is constitutionally dedicated to the Foundation School Fund to support public education.

According to comptroller estimates, a new severance tax on lignite coal could bring in $186.4 million in the next biennium.

Tobacco and alcohol taxes

"Sin tax" revenue has dropped steadily since 1972, when it accounted for 13.6 percent of state tax revenue. In fiscal 1996, these taxes represented only 2.9 percent of state tax collections. Just over 1.8 percent of the cigarette tax is statutorily dedicated to the Foundation School Fund. One-fourth of the beer, wine and liquor taxes is allocated by statute to the Available School Fund and the Foundation School Fund.

The House select committee has discussed raising the cigarette tax from 41 cents, a level set in 1990, to 61 cents per pack, which would raise $408.3 million in fiscal 1998-99.

Insurance occupation taxes

In fiscal 1996 the state collected $626.6 million in taxes from the insurance industry in Texas. Most of the revenue came from the tax on insurance premiums. The rate paid on insurance premiums varies: life, accident and health insurers pay a flat rate of 1.75 percent; collections on other insurance lines are based on the insurer's proportion of Texas-based investments and range between 1.3 percent and 2 percent.

In 1947 the federal government exempted the insurance industry from federal regulation, leaving regulation of the industry to the individual states. Insurance regulations — and taxes — in one state track those in other states. New or higher taxes on insurers operating in Texas could have the effect of triggering a retaliatory tax in another state. A state with lower rates can tax Texas insurers doing business in that state at the higher Texas tax rate, putting the Texas insurer at a competitive disadvantage.

The Comptroller's Office estimates the state could collect $104.7 million in fiscal 1998-99 by revoking the tax credits for the guaranty fund premium credit allowed insurance companies. Under current law, insurance companies may be assessed amounts to cover the insurance claims of an insolvent insurance company. Life, accident and health, and property and casualty insurers are allowed to apply as a tax credit on their premiums tax the amount paid into the guaranty fund at the rate of 10 percent a year until their entire assessment is recouped. Title insurers are allowed a recovery rate of 20 percent a year.

Other exemptions to insurance premium taxes include life and health Medicare/Medicaid premiums and examination fee and overhead assessment credits valued at $45 million and $8.7 million, respectively, over the biennium.

Other taxes

Remaining tax revenue sources represent 5.2 percent of state tax revenues. They include the state inheritance tax, hotel occupancy tax, utility taxes levied on gas, electric and water utilities, cement production tax, sulfur production tax, bingo rental tax, bedding tax, controlled substance tax and boxing and wrestling admissions tax.

Evaluating the Texas Tax System

Certain criteria have been generally recognized as standards for evaluating any system of taxation. These standards include: stable taxes from a variety of sources, equitable distribution of the tax burden, economically efficient taxes that promote growth, ease of administration, and accountability.

The tax system in Texas has achieved revenue growth and stability only through a series of tax rate increases and tax base expansions. Further, major economic changes, including downsizing in the oil and gas industry beginning in 1983 and a shift away from producing goods and toward providing services, have skewed the tax base.

The mainstay of the state tax system, the sales tax, has not kept pace with recent economic changes. In a healthy tax system, sales tax revenues grow as consumption increases, without changes in the sales tax rate. But in Texas, the Legislature raised the sales tax rate four times in six years, from 4 percent to 4.125 percent in 1984, 5.25 percent in 1986, 6 percent in 1987 and 6.25 percent in 1990. Furthermore, over the same period the Legislature expanded the tax base repeatedly to embrace more goods and services.

Balance among revenue sources

Most states try to reach a balance among income taxes, sales taxes and local property taxes. A balanced state and local tax system often promotes fairness, since a taxpayer who pays a disproportionate share of one tax may pay a relatively low share of another tax. The defects of each tax tend to "average out" and reduce taxpayer dissatisfaction.

In a balanced system, the weakness of one tax may be offset with the strength of another. For instance, a sales tax can be designed so that its revenue grows nearly in proportion to the economy. The sales tax is relatively popular with the voters since it is usually paid in small amounts and is less obvious than income or property taxes. However, the sales tax is regressive — it takes a higher proportion of income from low-income compared to high-income households. In contrast, while a personal income tax can be more progressive and its revenue tends to rise faster than overall economic growth, the revenue it generates can be relatively volatile. The personal income tax also tends to be less popular among voters than the sales tax.

On average, states rely on the sales tax and personal income tax to generate one-third each of total state tax revenues, with other taxes accounting for the remaining third. Since Texas does not impose a personal income tax, it compensates through the general state sales tax, which produces more than one-half of state tax revenue, and the motor vehicle sales tax, which produces another 10 percent of state tax revenue. Texas also derives more revenue than most states from excise taxes, such as the motor fuels tax (11.7 percent of state tax revenue in 1996) and "sin" taxes on tobacco and alcohol (5 percent). Excise taxes are regressive, and their revenue often lags behind the growth of the economy, although they provide a relatively stable source of revenue.

Texas relies on the property tax to raise an unusually large proportion of total tax revenue. In Texas, local property taxes account for 42 percent of total state and local taxes, compared to a national average of roughly 30 percent. This unique reliance on local property taxes has been an important factor in the public school finance system because school districts have vastly differing capabilities to generate revenue from their local property tax bases.

Equitable distribution of tax burden

An equitable tax system generally refers to one in which taxpayers of similar means pay similar taxes or one that levies taxes based on ability to pay. Ability to pay may be measured by the value of property holdings, consumer spending, or income. A tax system that takes an equal percentage of income from taxpayers at all income levels is considered "proportional." A system that takes a higher percentage of income from taxpayers with lower incomes is called "regressive," while one that takes a larger share of income from higher income taxpayers is called "progressive."

Judgments about whether a tax system is progressive or regressive generally are made on the basis of the state and local tax system as whole, not on particular taxes. A balanced system could contain a regressive tax providing a stable source of revenue that is offset by a more progressive, but less stable, tax to improve the equity of the general system.

The Texas tax system appears regressive when viewed in relation to income. A 1992 equity study conducted by the comptroller showed that Texas families with the lowest income paid proportionately more of their income in state and local taxes than did the wealthiest families. Families with a gross income of $10,000 paid an average of 8.11 percent of their annual income in state and local taxes; families with an income of $100,000 paid only 5.23 percent of their income in taxes.

The regressivity of the Texas tax system reflects its heavy reliance on the state and local sales tax, which is the most burdensome tax for all income levels except the wealthiest, who pay proportionately more in property taxes. The poorest families pay nearly twice as large a proportion of their income in sales taxes as do the wealthiest. Some of the smaller taxes — including those on alcohol, tobacco, gasoline and motor vehicle registration — are even more regressive. For instance, the poorest families pay nearly 1 percent of their income in alcohol and tobacco taxes, while families with average income pay about 0.5 percent, and the wealthiest pay 0.2 percent.

Increasing the sales tax rate in Texas could negatively impact individuals in all income categories, even if the increase were linked to a cut in property taxes. Individuals can only deduct property taxes and state income taxes from their federal income taxes. If the amount of property tax paid were reduced and replaced by consumption taxes, Texans who itemize deductions on their federal income tax returns would have to pay more in federal taxes. The 1991 report from the Governor's Task Force on Revenue recommended that the state tax policy maximize deductibility of state taxes from federal income taxes. Approximately 18 percent of Texans itemize on their federal income tax returns.

Economic efficiency and growth

Experts say taxes should have a neutral effect on consumer choices and produce economic efficiency and growth. A tax burden spread over many tax bases with few exemptions, deductions, or other special provisions also helps minimize economic distortion. For instance, when the state sales tax was expanded to include certain services, it lessened the effect that tax has in the choices consumers make on purchasing a product versus a service. The low overall tax levels in Texas also limit interference in private economic decisions.

Tax incentives, such as the recently created exemption from property taxes for pollution control devices, can distort economic market decisions by providing a government reward for certain behavior. However, these distortions are accepted because the behavior rewarded is considered socially desirable. Nonetheless, taxes are usually more effective in discouraging undesirable activities, such as smoking, than they are in promoting desirable activities, such as business investments. Tax incentives are often criticized as benefitting those who would perform the desired action regardless of the tax benefit. Unlike appropriations, "tax expenditures" made by tax incentives tend to be invisible and may grow without adequate review.

Taxes also may affect business decisions regarding where to locate facilities, although research indicates that the availability of a well trained workforce and good transportation are more important considerations than the tax burden in business siting decisions.

Tax policy is frequently affected by such considerations of interstate competitiveness. The state's relatively low tax burden overall may grant Texas a competitive advantage, but the high share of taxes paid by business may weaken the attractiveness of the state to relocating or expanding firms. The frequency with which state and local tax rates have been changed in recent years and the perceived inadequacies of the public education system also may detract from the state's competitive position. Long-term gains in personal income in Texas will be the ultimate indicator for how well the tax system promotes growth.

Ease of administration

A good tax system should be simple, say most experts. It should minimize administrative costs to the government and compliance costs to the taxpayer. Most taxpayers should voluntarily comply with the law, and efficient enforcement should prevent evasion. Citizens should understand the tax system and feel that most people are paying their fair share.

For most Texans, the state tax system is extremely simple. The average citizen rarely has to calculate state or local tax liability. Taxes are either built into prices, as with gasoline and cigarettes, or are computed by someone else, as with sales and property taxes. However, business taxation has become increasingly complicated, particularly as taxes have been expanded to cover services. Administering a tax on services is more difficult than administering a tax on goods, since even the location of the service can be hard to pinpoint. Businesses operating in many locations also must cope with a proliferation of taxing authorities, each of which may charge a different tax rate and offer different exemptions.

Accountability

A good tax system ensures accountability. The ideal system uses public debate in an open and explicit forum to raise taxes. Indirect procedures for changing taxes, such as tax preferences, exemptions or abatements, can jeopardize accountability.

Circuit Breakers

Property tax relief programs naturally focus on lowering the taxes of property owners. But some say that the 40 percent of Texans who rent their homes — and pay property taxes in the form of higher rents — should receive property tax relief as well.

In healthy real estate markets, property owners pass on property tax costs to renters in the form of higher rents. Reduced property taxes would provide additional profit for owners but no relief for renters, more of whom have lower incomes. To remedy this situation, some advocate a “circuit breaker” program to include renters in the property tax relief plan and reduce the regressivity of the property tax system.

Named after the electronic device that shuts off a power supply to prevent circuit overload, “circuit breakers” are designed to prevent citizens from being overloaded with excessive property tax payments. The legislature decides how much of a taxpayer’s income may be fairly spent on property taxes and designs a refund plan for those who are paying more than that percentage. Twenty-nine states and the District of Columbia have circuit breaker programs, down from 33 states in 1992. This session, HB 2716 by Maxey would create a circuit breaker program for Texas homeowners and renters.

A circuit breaker targets a specific population for tax credits or rebates. The value of the circuit breaker is based on the proportion of income paid in property taxes. The plans provide the lowest income taxpayers with the greatest benefits and high income taxpayers with lower, or no, benefits. States limit the dollar amount of benefits received, from $125 in West Virginia to $2,000 in North Dakota. All but four of the states with circuit breakers direct programs toward elderly or disabled taxpayers in order to limit their scope and expense. Iowa limits benefits to persons over 65, surviving spouses 61 or over, and the totally disabled and North Dakota, to persons over 65 and the disabled. All circuit breaker programs target homeowners; all but four also include renters. Circuit breakers for renters attribute a certain portion of rent to property taxes, from 5 percent in Arizona to 35 percent in Connecticut.

Circuit breakers for renters typically are established as sliding scale or threshold programs. Under the sliding scale program in Iowa, 23 percent of rent payment is considered to be the property tax equivalent. The program treats an individual who pays $500 in rent as paying a property tax bill of $115 per month, or $1,380 per year. That amount is then compared to the renter’s income. The lower the income, the smaller the share expected to go toward property taxes. Iowa rebates 100 percent of property taxes paid by persons with incomes below $6,000, decreasing to 25 percent for those with incomes up to $13,999. Individuals with incomes over $14,000 are not eligible for the rebate.

In a threshold program, the legislature designates a percentage of income that is fair for the eligible taxpayers to contribute in property taxes. Taxes above this threshold are subject to rebate. North Dakota designates 20 percent of rent as the property tax rent equivalent and establishes a threshold of 4 percent of total income to be paid in property taxes. Any property taxes paid in excess of that percentage are refunded.

Proponents argue that circuit breaker programs introduce equity to the property tax structure. Without circuit breakers, the tax break for property owners would be subsidized by renters, who would receive no tax break. In fact, renters usually are hit by increases in other types of taxes implemented to offset the property tax relief measures. Such a tax increase without a corresponding property tax break would be especially burdensome, especially for Texas’ low income renters. Applying a circuit breaker would reduce the likelihood that higher consumption taxes would force low income households to choose between rent payments and other necessities.

Opponents of circuit breaker programs say the property tax is already among the fairest taxes, more progressive than consumption taxes. Owners may pass savings on to renters and would be encouraged to do so once their property tax bills began to decline. Furthermore, a circuit breaker program would be difficult to administer and require complex calculations. Rent equivalent percentages would be difficult to arrive at and easily contestable. Most states with circuit breaker programs also have an income tax, through which benefits are calculated and rebates distributed. Since Texas does not have an income tax, both tasks would be complicated. Furthermore, programs in states without income taxes are less effective: participation drops unless administered by a central state entity. Finally, circuit breaker programs are expensive — states that extend benefits to all renters have much higher program costs than states with more limited programs.

— by Jenny Staff

An accountable system links responsibility for raising revenue to credit for spending it. For instance, both the National Conference of State Legislatures and the National Governors' Association have recommended that state governments avoid specifically directing how local governments should spend their own funds. The issue of so-called "unfunded mandates" has recently been debated in Texas. In May 1993 the voters considered and narrowly rejected by 49 to 51 percent a proposed constitutional amendment that would have exempted school districts from complying with future state educational mandates not fully funded by the state.

Accountability also requires avoiding hidden tax preferences for favored firms or groups of individuals. Some states have attempted to encourage accountability by setting expiration or "sunset" dates on taxes. Others require periodic assessment of overall tax policy or its impact on groups with different incomes or in different geographic locations. Texas requires the comptroller to report each biennium on how revenues from the state sales tax and corporate franchise tax are affected by exemptions, discounts, exclusions, and special methods of reporting, with recommendations for retaining, eliminating or amending these provisions. The Texas Performance Review has recommended repealing other tax exemptions, such as the motor fuels tax exemption for certain users and discounts for certain tax report filers.

Texas Public School Finance

Any discussion of changing property taxes must include the impact of such changes on the school finance system. Property taxes make up more than half of the money used by the 1,044 school districts in Texas, operating under a school finance system precariously balanced in order to meet constitutional requirements. Before the Texas Supreme Court ruled the current system constitutional in 1995, it had ruled previous systems unconstitutional three times.

Historical summary

The Texas Constitution has required the state to support public education since its adoption in 1876:

> A general diffusion of knowledge being essential to the preservation of the liberties and rights of the people, it shall be the duty of the Legislature of the State to establish and make suitable provision for the support and maintenance of an efficient system of public free schools. (Texas Constitution, Art. 7, sec. 1)

Long before the Texas school finance system was challenged in court, it had been widely criticized and subjected to numerous modifications. The first attempt to correct the radically different wealth levels among the then 6,000 school districts was enacted in 1915, when the Legislature appropriated $1 million to rural school aid, provided those school districts taxed property owners at certain rates.

The Gilmer-Aikin Committee, formed by the Legislature in 1947, proposed a new system setting a minimum education funding amount based on a complicated economic index that required each district to raise 20 percent of the minimum amount while the state covered the remaining 80 percent. Any district with available resources could tax above these rates in order to increase funding to its schools. By the 1960s the state had fallen in its obligations to meet 80 percent of those costs, and local funding of school continued to rise. Despite major adjustments in the school finance system in the 1970s, the local share of school finance continued to rise, exacerbating the disequalizing effect of the wide disparities in the value of taxable property among school districts.

In 1987 a Texas district court ruled that the school finance system was unconstitutional because it failed to provide an efficient system for education. In October 1989 the Texas Supreme Court unanimously ruled the finance system unconstitutional on efficiency grounds (*Edgewood I*). While the district court held that the constitution mandated that all districts be allowed equal access to revenues at all levels of taxation, the Supreme Court adopted a less stringent standard. The court held that school district revenues must be only *substantially equal* at similar levels of tax effort to be constitutional.

In response to *Edgewood I,* and under severe time constraints imposed by the court, the Legislature enacted SB 1 in 1990. That legislation required that 95 percent of all students be in a wealth-neutral system by 1995. SB 1 was considered by the district court in July 1990, and the court again held the system unconstitutional for not providing an efficient system. The Supreme Court reviewed that decision and affirmed it (*Edgewood II*). While the court noted some changes were made, it stated that those changes were merely a "band-aid" approach, and that, in order to fix the problems, the whole system must be changed.

The Legislature subsequently developed SB 351, which established a system of 188 county education districts (CED) across the state and authorized each CED to levy a tax rate based on the state's assessment of the district's property wealth and distribute the revenue on a per student basis. The local share rate would increase each year for the subsequent five years. The Supreme Court in *Edgewood III* did not decide whether SB 351 created an efficient system, but instead declared it unconstitutional for establishing a statewide property tax.

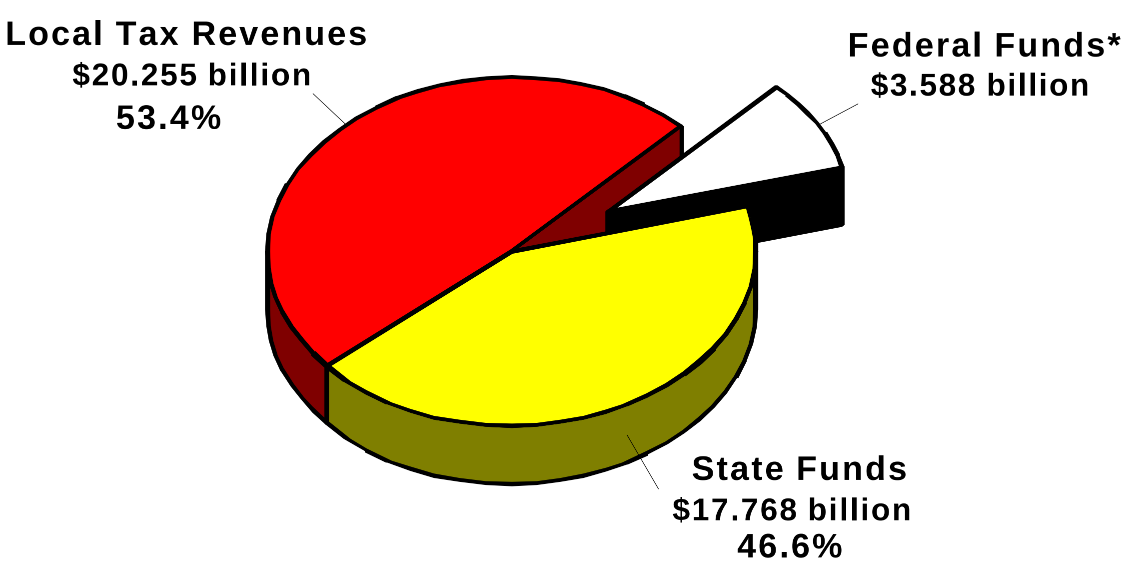
The Legislature's response to the *Edgewood III* ruling was to propose three constitutional amendments for the May 1, 1993, ballot allowing a CED tax rate of one dollar per $100 of property wealth. All three measures were rejected by voters by substantial margins. The 1993 Legislature then enacted SB 7, the current school finance system. In January 1995 the Supreme Court declared the system created by SB 7 constitutional (*Edgewood IV*).

Current finance system

Under SB 7, the current finance system, the state has created two tiers of school finance designed to provide state aid to school districts based on their local property wealth per student and level of tax effort. Tier 1 was designed to fund the "basic program" of the education system. It covers local taxation up to 86 cents per $100 of property valuation. Every district is guaranteed to raise from local revenues and state aid $28 per student per penny of tax effort or $2,408 per student at 86 cents. Tier 2 covers tax rates between 87 cents and $1.50 and was designed to create a guaranteed yield for tax efforts above the cost of the basic program. All districts in Tier 2 are guaranteed to earn from state and local sources $21 per student per penny of tax effort. While not officially named so, "Tier 3" in the system covers tax rates over $1.50. There is no guarantee of state revenue yield in Tier 3 and, except for some statutory exceptions, Tier 3 revenues can be used only for debt service.

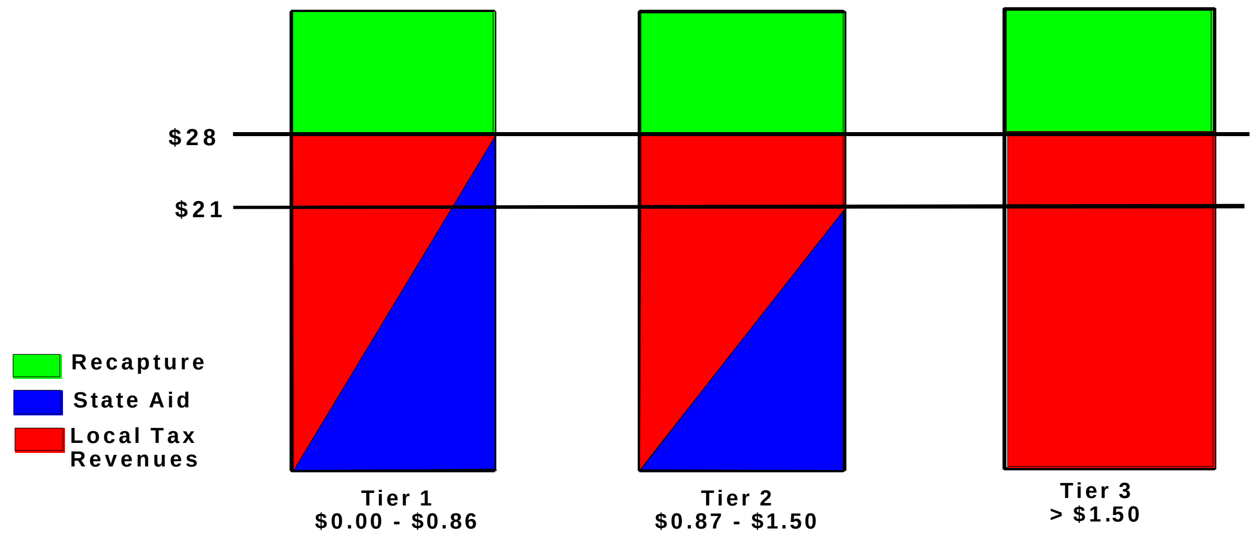
SB 7 limits district revenues in all three tiers to $28 per student per penny of tax effort or $280,000 of taxable property wealth per student. All revenue

Amount Projected for Education in Texas
Fiscal 1998-1999



*** Federal funds are not equalized in the school finance system and are not used to determine the percentage of state aid funding the cost of education.**
Source: **Comptroller's Office and Legislative Budget Board in testimony before the House Select Committee on Revenue and Public Education Funding.**

Current School Finance System



In Tier 1 and 2, as the amount of revenue from local taxes increases, the amount of state aid decreases.

Source: School Finance after SB 7, prepared by David Anderson, TEA Chief Counsel.

raised above this limit is subject to recapture using one of five options outlined in the statute. The most popular options allow a district to purchase attendance credits from the state or another district to lower its property wealth to the $280,000 limit.

In SB 7 the state also imposed a tax limit on all school districts. Districts may not charge more than $1.50 per $100 value on property without a statutory exemption. The $1.50 limit applies only to funds raised for maintenance and operations (M&O); funds raised to pay debt service (Interest and Sinking Fund or I&S) may push the tax rate higher than $1.50, but the state does not equalize funds raised above the $1.50 limit. One difficulty encountered in determining a district's tax rate is that some districts use I&S funds to cover M&O expenses. Therefore, simply separating the two rates may not always show a clear picture of the amount needed for each expense.

The state has established complicated funding formulas that use many different calculations and weights to correct for variances that increase the cost of education. All districts are adjusted by the cost of education index (CEI) — which considers teacher salaries in contiguous districts, county population, district type, percentage of low income students, and number of students — and many receive small, sparse or medium sized district allowances if they have less than a certain number of students. Students are weighted depending on the special programs they require, such as special education, career and technology (vocational education), compensatory education, bilingual/ESL, and gifted and talented programs. Once district and student weights are calculated, a district receives its weighted average daily attendance (WADA) amount, used for all school finance formulas. Critics of the weighting system have suggested, however, that it may encourage districts to classify more students in special programs in order to receive additional funds.

Other factors — such as facilities funding issues, lag time in the calculation of formulas, and mandatory adjustments to the minimum teacher salary schedule — further complicate this already complex system.

Problems with the current system

Many problems exist with the current school finance system — primarily because of the heavy reliance on property taxes for funding. However, 49 states use property taxes to fund schools to some degree, so some level of property taxation may be a necessary part of the finance system, especially if local control of school districts is valued.

Because Texas has so many school districts (1,044) and because there is such a great diversity of wealth levels among the various districts, raising all districts to the level of the wealthiest school district would be financially impossible. This reality has forced the state to implement "wealth limits" that keep wealthy school districts from spending more tax revenues than the state can afford to pay other districts.

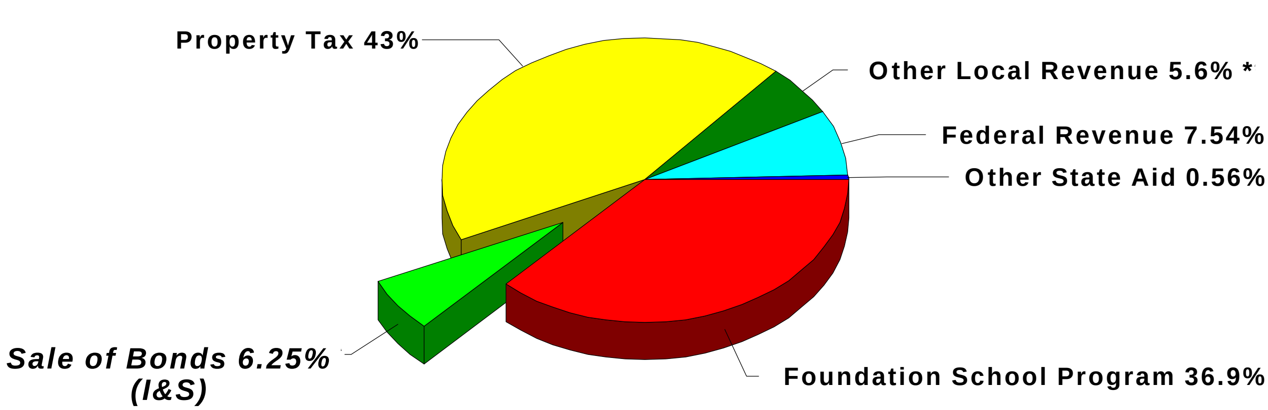
The equity of Tier 1, where all districts get the same amount for each weighted student, does not carry over to Tier 2. In Tier 2, schools are equalized to the $210,000 level, but recapture is not required until a district's property wealth has passed the $280,000 level. This gap means that at the maximum $1.50 tax rate, the wealthiest districts can raise about $600 more per student than the districts below the $210,000 level. The Texas Supreme Court found this gap constitutional because the system was still *substantially* equalized. Under SB 7, 85 percent of the schools in Tier 2 would receive the same amount per weighted student. Furthermore, at the time of the court's decision, a poor district would have to set a tax rate of $1.31 to receive the same tax revenues as a wealthy district would with a rate of $1.22, only a nine-cent difference.

Since the $1.50 tax rate cap was set in 1993, the average total tax rate for most school districts has from $1.28 to $1.42. Currently, there are roughly 60 districts at the maximum rate limit of $1.50, and some observers predict that in three years that number could grow to as many as 200 districts. If a significant number of schools reach the limit, the finance system's constitutionality could be challenged on two grounds: (1) that the state is not adequately funding education as prescribed by the constitution, and (2) that the cap prevents districts from retaining meaningful control over their own rates and thus constitutes an unconstitutional state property tax.

Facilities funding, while an essential element of school finance, has been largely removed from the basic school finance plan and considered a separate system. In fact it was not until *Edgewood IV* that equitable funding for facilities was ruled on by a court. The district court stated that the mechanism the state used for funding facilities was unconstitutional. The Supreme Court, however, reversed that decision because the plaintiffs did not meet their burden of proving that a lack of facilities funding created an unconstitutional finance system. The court did state that the lack of separate facilities funding could make the system unconstitutional in the near future.

With voter approval, districts may tax above the $1.50 rate limit specifically to fund facilities. While revenue raised above that limit is subject to recapture, it is not equalized by the state. In 1995,

Sources of School District Revenue



Average amount of M&O revenue is $5,330 per student per year.
Sale of bonds - I&S debt service - averages $355 annually in revenues per student.

* Other local revenue includes food service, cocurricular, interest income and miscellaneous revenue.
Source: Texas Association of School Boards, *The Basics of Texas Public School Finance*. Data originally compiled by TEA from 1994-1995 school year.

the Legislature appropriated $170 million to fund facilities in districts qualifying for assistance. However, subsequent applications for such assistance would require billions of dollars more in facilities funding.

According to critics of the system, one of the most pervasive problems in school finance, and one that may eventually create a crisis, is the gradual increase in tax rates and property appraisals to meet costs. Generally termed “tax creep” or “appraisal creep,” this process raises taxes only a few dollars each year. But over the course of a decade, tax creep can have a significant impact on property taxes. In the past 10 years, growth in local taxes driven by the rising cost of education has decreased the state share of school funding from 60 percent to 46 percent.

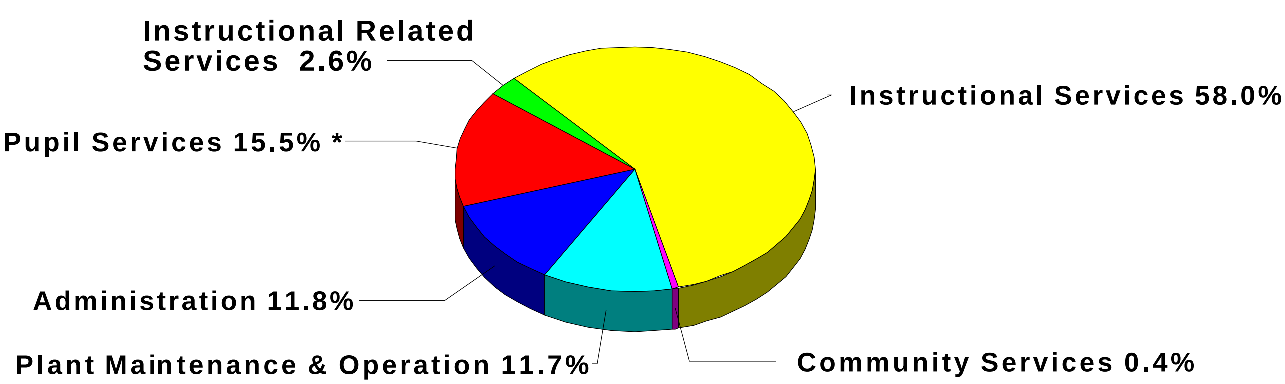
If the cost of education continues to rise and the state continues to make adjustments only for enrollment growth, local taxes must be raised just to keep spending per student constant. Then, if local taxes are raised in an equalized district, the state must spend additional money to fund such equalization. The system creates a perpetuating cycle in which local rates drive state spending, which, in turn, forces increases in local rates.

Because the current school finance structure focuses on equalizing tax effort, it creates an impetus for districts, no matter their wealth level, to raise tax rates. The state matches local tax efforts in Tier 2 according to a proportional formula. Thus, school districts below the equalization level are rewarded for every penny of tax effort. Conversely, the recapture provisions of the finance system force wealthy districts to increase rates more than they would normally because they must share their revenues. A district cannot raise more than $28 per student per penny of tax effort, so whatever a wealthy district could pay for with a two-cent increase without recapture might require a four-cent increase because of recapture.

Property tax rate increases, however, are not the only means a district has for raising money. Higher property tax appraisals can have the same effect. A district can keep its tax rate constant but still raise more money if there is an overall increase in property valuation. As districts reach the $1.50 cap, the only way they may increase revenues is to increase appraisal values. Across the state, property owners are complaining about “appraisal creep” — higher property appraisals without justifiable increases in value.

In 1995 the Legislature also tied the state mandated minimum salary schedule for teachers to the state share of the cost of education. The minimum salary schedule, which had been criticized

School District Operating Expenditures



Average amount of operating expenditures is $4,479 per student per year.

*** Pupil Services includes items such as cocurricular and transportation services.**
Source: **Texas Association of School Boards, *The Basics of Texas Public School Finance*. Data originally compiled by TEA from 1994-1995 school year.**

for years as an unfunded mandate on local districts, now is established by salary factor steps based on the level of the teacher's experience. If a district is unable to meet the requirements of the schedule, the state is required to fund the difference. Because instructor salaries make up more than half of the budget of every district, changes in the salary schedule can have a rippling effect on the entire school funding system.

Building a new school finance system

The school finance system in Texas has been adapted, updated and refurbished over the past 150 years to its current complex state. Critics say the time is ripe to clean the slate and develop an adequate, efficient system from scratch. The system, they say, reflects outdated educational needs; the nature of education has changed so radically that the entire system must be completely reevaluated.

Any system for financing public education must address some fundamental issues. The most important is how the state should determine the cost of providing every child in Texas with an education adequate to meet the constitutional requirements of a "general diffusion of knowledge." This determination must account for divergent costs in the 1,044 school districts as well as changes in what constitutes essential knowledge. Ten years ago few would have suggested that computer and Internet-based instruction were essential components of general knowledge, but in the next few years education in those skills will likely become essential.

A school finance system is also affected by the amount of revenue that should be contributed by local districts. Local money is used to support education in all states but Hawaii on the theory that funding part of the cost gives local residents a measure of control over the education system. Local revenues are raised through property taxes, and school districts can raise that rate if they want to spend more for education. A balance has to be struck between keeping local tax rates affordable and still allowing the local district to have some control over funding schools. Currently, local property taxes fund 54 percent of the cost of education. If that proportion could be lowered, property taxes could be used to fund other special needs in a district. Yet with the current high rates, many districts do not have the ability to raise additional money for such needs.

Throughout the history of school finance litigation, the courts have repeatedly stated that the "system remains unconstitutional not because any unequalized local supplementation is employed, but because the State relies so heavily on unequalized local funding in attempting to discharge its duty . . ." *(Edgewood II)*. An issue that has not been addressed by the courts, however, is what level of state funding would permit unequalized local enrichment without constitutional problems.

Enrollment growth creates uncertainty in budgeting as well. It is difficult to predict with any great degree of accuracy exactly how many students will be enrolled two years into a biennium. Additionally, it is even harder to tell what school districts those students will be moving into. Both the Legislative Budget Board (LBB) and Texas Education Agency (TEA) attempt to estimate the number of students that should be included in the budget; however, these figures rarely mesh. For fiscal 1998-1999, TEA has estimated a growth rate including 15,000 more students than LBB. While 15,000 students may not seem like many when there are 3.6 million children in the public school system, that variation can affect the biennial budget by nearly $100 million. Because certain school districts are more affected by enrollment growth than others, many have asked the Legislature to include a weight in funding formulas taking into account the special needs of fast-growth school districts and providing additional funds to meet those needs.

The Governor's Tax Plan

Governor Bush's tax proposal, introduced as HB 4 and HJR 4 by Craddick and Junell, would lower by $3.6 billion over fiscal 1998-1999 the amount of property taxes paid by homeowners and business to support public schools. The lost revenue to school districts would be replaced with state funds collected by a new tax on Texas businesses, a one-half cent increase in sales taxes and motor vehicle sales taxes, and surplus funds in the state treasury. HB 4 also would dedicate all of the lottery revenue to fund public education.

The proposed legislation is the culmination a year-long study by the Governor's Office. The governor's Citizens' Committee on Property Tax Relief concluded that Texans need relief from high property taxes, which have increased by 120 percent since 1985. The panel held 14 public hearings across the state in 1996 and found public sentiment in favor of property tax relief. The committee reported that high property taxes inhibit business capital investment and threaten home ownership. Further, they concluded that the stagnating property tax base makes property taxes an inadequate foundation for public school funding.

In March 1996 a working group consisting of staff from the offices of the governor, lieutenant governor, House speaker and comptroller developed three possible alternatives to replace current school property taxes: the business activity tax, a gross receipts tax, and a broadened sales tax base. The governor specifically requested that the personal income tax not be an option.

The Governor's Office has said that the primary objective of the plan is to provide property tax relief for homeowners and business by substituting state tax revenues for local property taxes. The $1 billion from existing fund balances used to offset school property taxes would constitute an overall tax reduction, according to the governor, and the plan would provide for more equitable taxation of business by spreading the tax burden among all businesses. It would lessen the tax burden of capital-intensive industries that now pay a larger percentage of business taxes and increase the burden of labor-intensive industries that are not now paying an equitable portion of taxes levied on business. So that small business would be protected from undue taxation, the business activity tax would apply a $500,000 standard deduction.

Property tax relief proposal

Under the governor's tax plan, the homestead exemption on residential property value would increase by $20,000 beyond the current standard deduction of $5,000, for a total deduction of $25,000. However, the additional $20,000 homestead exemption would apply only to the calculation of that portion of assessed taxes that go to support a school district's maintenance and operations (M&O). Taxes used to service debt would continue to be calculated based on the $5,000 homestead exemption. The increased homestead deduction would be added to any local options deductions, which can cover up to 20 percent of the assessed value of the home.

In addition to the increased homestead deduction, the proposal would reduce by 20 cents the property tax rate for school district M&O. This tax rate reduction also would apply to the frozen tax rate of those 65 and older. Also, retail and wholesale business inventories would be exempted from school M&O taxes.

HJR 4 would require the comptroller to reimburse school districts from other available tax revenues if the Texas School Trust Fund, set up to reimburse school districts for lost tax revenues, lacked sufficient funds.

HB 4 also has two tax roll-back provisions to limit "tax creep," or the ability of a school district to raise tax rates. It would prohibit a school district from reducing or repealing any local option tax exemption for two years after HJR 4 was approved and would require a two-thirds vote of a school board to increase property tax rates for M&O taxes and limit the increase to two cents per year or four cents over three years.

Educational groups have voiced concerns about HB 4 because of tax rollback provisions that would limit both "tax creep" and local school boards' ability to raise additional school tax revenue. Advocates for lower income individuals have criticized the governor's proposal because overall tax savings would be negligible and some individuals, notably renters, would actually see their total tax liability increase.

Replacement taxes

The governor's tax proposal would make up the revenues lost from lower property taxes with higher state sales and motor vehicle taxes and a new Business Activity Tax (BAT) to replace the corporate franchise tax. HB 4 would raise state sales and motor vehicle sales taxes by 0.5 percent, to 6.75 percent.

Modeled on Michigan's Value Added Tax, the BAT would apply to all forms of business — including corporations and limited liability companies, limited partnerships, partnerships, trusts, estates, and sole proprietorships — and be levied at a rate of 1.25 percent of sales in Texas. The tax would cover only business activity, not investment activity. The tax base would include federal taxable income, plus wages and other compensation, such as costs for retirement and health insurance programs, and depreciation. The cost of new capital investments and a standard deduction of $500,000 would be subtracted to adjust the tax base for each business.

The Governor's Office anticipates the BAT would raise about $1 billion more than the franchise tax would have raised in fiscal 1998-99. HJR 4 would require a three-fifths vote in each house of the Legislature to increase the BAT tax rate and would specifically exempt the BAT from the Texas constitution's prohibition against a personal income tax, to remove any doubt about taxing non-corporate business income.

Proponents of the BAT say it would:

- grow with increased business activity;
- be "economically efficient" since the low tax rate levied on a broad base would have little effect on business decisions;
- be equitably applied to all business;
- be a stable revenue source compared to taxes based on income, which fluctuate with business cycles;
- be relatively simple to calculate and administer; and
- basically be a consumption tax and like other consumption taxes, such as sales taxes, could be passed on to customers.

Generally support for the governor's plan has come from capital intensive industries, such as the chemical industry, because it would lessen their tax load and redistribute the tax burden among a broader spectrum of business. Computer manufacturing companies, such as Texas Instruments and Compaq Computer, like the inventory exemption provision because it would lower their tax liability.

Opponents of the BAT say it would:

- be a hardship on companies in bad business years because, unlike a tax based on profits or income, it would be levied regardless of ability to pay;
- unfairly shift the tax burden to companies with high labor costs and potentially inhibit employment or salary or benefit increases; and
- as a consumption tax, be regressive, requiring lower income people to pay a higher proportionate share of their income in taxes.

Labor intensive businesses, such as K-Mart and members of the Texas Health Care Association, are against the BAT since it would increase their tax liability.

Some observers have voiced the concern that the BAT could be viewed as an income tax since it would impose a tax on sole proprietors, as well as individual partners in a partnership, and as such could be challenged in the courts. The Texas Constitution prohibits an individual income tax unless approved by a majority of Texans at the polls. Others say the BAT could not be considered an income tax because the basis on which the taxes are calculated are very different. For example, the BAT tax base would include compensation and employee benefits and deduct the costs of new capital investments. Depreciation allowed under an income tax would not be allowed under the BAT. However,

Governor's Tax Proposal
Fiscal 1998-1999

Tax savings item	Amount (in billions)	Replacement source	Amount (in billions)
$25,000 homestead exemption	$1.79	State surplus balance	$1.00
Business inventory exemption	$0.66	1.25% business tax	$3.14
20 cents school tax rate reduction	$1.16	0.5 cent sales tax & motor vehicle tax	$1.62
Repeal of corporate franchise tax	$2.10		
TOTAL	$5.71		$5.72

if the amendment were approved by the voters, such constitutional considerations would become moot.

Potential impacts of the proposals

The Governor's Office estimated that the owner of a home valued at $61,500 (the average for Texas) would see a net savings of $262 per year, or $21.83 per month. Owners of a home valued at $200,000 would save $461 a year, or $38.41 per month.

The LBB Tax/Fee Equity Note to HB 4 said that all income groups would see a tax reduction under the proposal, with the overall average savings anticipated at about 3 percent. Families in the $75,000 to $100,000 income group would receive the largest overall tax reduction — 3.8 percent — and families in the $10,000 to $20,000 range would see the smallest savings — 1.8 percent. The LBB said the property tax on homestead would decrease by 24.5 percent and that sales taxes and motor vehicle taxes imposed directly on consumers would increase by 7.5 percent in 1999.

However, the sales tax rate increase would affect all citizens, particularly those in the lower income category. According to the LBB, HB 4 would make already an already regressive system slightly more regressive.

The impact on business would be more varied. The Governor's Office estimated that wholesale and retail trade would benefit the most from the tax relief proposal because of the tax exemption on inventory. The LBB has said that the agricultural industry would benefit the most, followed by finance, insurance, real estate and mining. Industries seeing the greatest increase in tax liability would be construction the and service sector. Overall, however, the governor's proposal would reduce tax liability to business and industry by 1.8 percent, according to the LBB.

School finance issues of HB 4/HJR 4

Certain aspects of the governor's proposal as outlined in HB 4 raise questions regarding equity and adequate funding of the public education system. Substituting state funds for local funds could affect equity in the school finance system, and the strict tax rollback provisions could hamper districts from raising needed funds.

Another concern about the impact of the proposal on the school finance system is long-term stability and potential for growth to meet enrollment and equity needs. Some have questioned whether the framework proposed by HB 4 and HJR 4 could meet enrollment growth or whether the issue would have to be revisited in the next few years. Over the last eight years, enrollment has grown at a steady rate requiring an infusion of about $1.2 billion each biennium to fund education. Many argue that any replacement for the current taxing system must be able to accommodate such growth.

HB 4 would require the state to reimburse school districts for local tax revenue losses resulting from the higher homestead exemptions and tax rate reductions. School districts would submit their loss figures to the comptroller, who would reimburse them with state money from the Texas School Trust Fund, funded with revenue raised under HB 4.

The dollar for dollar replacement of local money with state money would raise questions about equity. High-wealth districts that are currently subject to recapture would be required to send fewer local dollars under the governor's plan because they would raise less money. The Foundation School Fund, then, would receive less recapture money from the wealthiest districts, and the state would be required to make up the difference. Thus it would replace revenues previously raised by the wealthiest districts with revenues raised by state taxpayers.

HB 4 would increase the state share of the cost of education but calculate those dollars as if they came from local revenues. Equity questions arise because, while the proportions of state and local money would shift, those changes would not be reflected in the school finance formulas that attempt to equalize school funding.

HB 4 would keep districts from raising tax rates through strict rollback procedures. Under current law, any proposed increase in the effective tax rate of more than eight cents automatically triggers a rollback election, in which voters give their thumbs up or down to the rate hike. Under HB 4, an automatic election would be required if a district raised its effective tax rate by more than two cents. Effective tax rates, however, are different from the nominal rate. The nominal rate is the amount published on the tax form. The effective rate is the rate needed to raise the same amount of money as the district did the previous year. If the property wealth of the district goes up, the effective rate goes down because the district can charge less and still raise the same amount. If the property wealth decreases, the effective rate must increase to stay even.

While the strict rollback procedure is aimed at preventing "tax creep" that would reverse the benefits of the rate cut, concerns have been raised that such a strict provision might be considered a state property tax. According to *Edgewood III*, a tax can be considered an unconstitutional state property tax when the local taxing body has no meaningful discretion over the tax rate set. It could be argued that HB 4 would meet this criterion.

Tax Alternatives

Because of concerns regarding the state's future ability to finance public schools, the House select committee is exploring alternatives to the governor's proposal that would shift the tax burden of funding public schools from residential and business property owners to other sectors of the economy. For discussion purposes, the committee assumed a lower local property tax rate of $0.50 on residential property and $1.00 on business property. This would have the effect of reducing property taxes by $11.476 billion in fiscal 1998-99. Based on total public education funding for fiscal 1998-99 at $38 billion, the committee's scenerio would increase the state share of public school finance by $8.8 billion, to $26.5 billion, or 70 percent of public school funding. If a statewide property tax became part of the state allocation, the state would assume 90 percent of funding and localities 10 percent.

The select committee has identified nearly $9.745 billion in revenue from a number of existing sources that could be used to supplant local property taxes, including:

- expanding the sales tax base;
- expanding the franchise tax base;
- applying a six cents per gallon tax on certain motor fuels (i.e, aviation fuel);
- raising gasoline and diesel fuel tax by 10 cents per gallon;
- applying a tax on coal lignite use;
- expanding insurance premiums taxes;
- increasing the cement and fly ash tax rates;
- increasing the gas, electric and water utility tax rate;
- increasing the hotel and motel tax;
- raising the cigarette tax per pack by 20 cents;
- applying a sales tax on lottery ticket sales; and
- applying a sales tax on commercial leases.

Chairman Sadler also asked the Comptroller's Office to determine how much property tax relief the $1 billion state surplus could realize for homeowners. In a February 17 letter the office estimated the sum would provide an additional $11,000 homestead exemption for each home owner.

Besides the revenue sources mentioned above, the committee has looked at new sources of tax revenue, including the gross receipts tax, a value added tax and a statewide assessment of business property.

Business gross receipts tax

A business gross receipts tax is collected on the total receipts or total revenue of a business. The tax applies to all business sales; however, certain commodities or sales by certain entities, such as government or nonprofit entities, generally are exempted. Transactions of intermediate goods are taxed in this system, with the tax passed on in the form of increased prices to the next stage of production, creating a pyramid effect. Thus the net effect of the tax cascades and can be larger than if there were a single tax on the end user. The gross receipts tax can be exported in the cost of manufactured goods sold outside the state, one reason why Washington, whose major industries are Boeing and Microsoft, has a tax on gross receipts.

The pyramiding effect of the gross receipts tax has been criticized for making the effective tax rate greater than the nominal rate, especially when there are a number of stages of production; creating arbitrary tax rates between different economic sectors depending on the stages of production; and creating an incentive for companies to own all aspects of production, i.e., vertically integrate, to reduce the tax paid. The comptroller estimates that a one percent tax on gross receipts over $500,000 would raise almost $9.5 billion in the fiscal 1998-99 because of the enormity of the tax base caused by the pyramiding effect of collecting taxes at every stage of production.

Besides Washington, other states employing a business gross receipts type tax are Hawaii, Delaware and New Mexico. Hawaii and Washington, like Texas, do not have an income tax, and Delaware and New Mexico have a business gross receipts tax in lieu of a sales tax. In general, the states impose the gross receipts tax on different businesses at varying rates to adjust for profit margins of different businesses. For example, in Washington, the gross receipts tax ranges from 0.4 percent to 2 percent.

The gross receipts tax is considered a consumption tax because it typically is passed through to the ultimate level, the consumer. However, not all businesses can pass the cost of the tax on to the consumer but must absorb the expense in some way, producing a different kind of economic impact, like lowering wages or hiring fewer employees.

Business value added tax

A value added tax (VAT) is a tax on the value that a business adds to goods and services. The labor, machinery, buildings and capital used by a business in handling or processing its purchased goods and services add value to those purchases. A VAT is imposed on the value added at each stage of the production or distribution process. The business activity tax proposed by Gov. Bush is a type of VAT. The Michigan Single Business Tax adopted in 1975 as a replacement for the corporate income tax and other business taxes also is a VAT. In 1993 New Hampshire broadened the base of its business enterprise tax to the extent that it is considered to be similar to a VAT in impact.

A VAT is calculated by totaling a firm's compensation expenditures, depreciation, interest expense and profits to establish a gross tax base. Only the proportion of the tax base that is directly linked to the state is taxed. An apportionment formula based on some combination of the firm's gross receipts, payroll and property is used to adjust the gross base. The apportioned tax base is then further adjusted by deductions and exemptions that can be designed to promote certain goals, such as rewarding capital investments or protecting small businesses. The adjusted tax base is multiplied by the tax rate to determine the firm's tax liability. Another method, which reaches the same result, is to subtract from a firm's gross receipts the cost of goods and services purchased from other firms.

Personal income tax

Texas is one of seven states without a personal income tax. Texas, Alaska, Florida, Nevada, South Dakota, Washington and Wyoming do not tax personal income; Tennessee and New Hampshire tax only investment income. The 1991 Governor's Task Force on Revenue recommended implementing both personal and corporate incomes taxes in Texas. On November 2, 1993, a majority of Texans approved a constitutional amendment prohibiting the Legislature from imposing an income tax without voter approval.

Under Art. 8, sec 24, the Texas Constitution now requires that the voters of Texas approve any law that would impose an income tax or have the effect of increasing income tax liability on individuals, including a tax on an individual's share of income in a partnership or unincorporated association. In the initial vote, the ballot would have to spell out the income tax rate; in successive elections, it would have to state the manner in which income tax rates would be increased. Once an income tax was allowed, the Legislature could repeal or lower the rate on its own initiative.

All income tax revenue would be dedicated to fund education. At least two-thirds of the net revenue from an income tax would be used to reduce the rate of public school M&O property taxes; the remaining one-third would be used to support education, either public or higher education, as directed by the Legislature. A school district's maximum M&O tax rate would be reduced to account for the amount of income tax revenue dedicated to property tax relief. A school district could later increase its maximum M&O tax rate with voter approval.

The Comptroller's Office has calculated that a one percent personal income tax effective January 1, 1998, with standard deductions of $5,000 single/ $10,000 married/$7,500 head of household, would bring in $2.534 billion over fiscal 1988-89 and $4.376 in the following biennium.

Corporate income tax

The most common state business tax is the corporate income tax, imposed by all states except Texas, Nevada, Washington and Wyoming. The primary argument in favor of a corporate income tax is that it is directly related to a firm's ability to pay. A business pays an income tax only in years in which it reports a profit. Texas' current franchise tax requires a corporation to pay taxes based on its net worth in years in which it does not generate net income.

A corporate income tax does not discriminate among businesses according to their relative use of capital or labor, which varies among different sectors of the economy. A tax based on capital assets, such as the former Texas franchise tax, tends to tax more heavily firms in industries requiring large capital investment, e.g., manufacturing. Some argue a business income tax should be limited to large corporations to protect small business, the most vibrant sector of the state economy. Others say limiting a tax to corporations would unfairly favor other forms of business organization, such as partnerships, sole proprietorships and professional associations.

Revenues from a corporate income tax can fluctuate significantly as profits rise and fall during an economic cycle. The net worth component of the current Texas franchise tax acts as a floor to guarantee a minimum stream of revenue, even in years in which corporate income fails to generate state revenue through the income component of the tax. The corporate income tax is considered by many as very complex to figure and difficult to administer.

Statewide business property tax

A statewide business property tax could help to equalize public education funding by eliminating inequities in property taxes among one district to another caused by disparities in the value of business and commercial property. Because school districts with large business properties generally have per-student wealth well above the state average, they are able to support school programs with below-average tax rates. Although the disparity in tax rates has been narrowed by successive school-finance plans, some business properties could face large tax increases if a uniform property tax rate were levied statewide.

In response to the Texas Supreme Court's 1992 ruling in the *Edgewood* case, Gov. Ann Richards at one time proposed imposing a uniform state tax on business property and redistributing the revenue to school districts statewide. Since high-value business property — particularly refineries, power plants, and oil and gas production facilities — are responsible for much of the inequity in property wealth per student among school districts, allowing districts to tax only residential property could reduce much of the disparity in the property wealth available to each school district. The revenue collected from the statewide tax could be distributed to local districts according to a formula that would further reduce the variation in how school districts generate revenue.

Gov. Richards' proposal was questioned not only because of its potential impact on school funding but also because it would reduce local control over taxation. Local jurisdictions competing to attract business relocations and investments rely on property tax abatements and exemptions, some said, and tax appraisals and rates should be set by local officials, not by the state.

Several issues would have to addressed to implement a statewide business property tax system. These include how statewide appraisal standards would be set; whether appraisals would be conducted by the state or the local appraisal district; what mechanisms would assure equity among appraisal values; and who would collect current and delinquent taxes.

— by Patricia Tierney Alofsin and John J. Goodson

House Research Organization
Texas House of Representatives
Capitol Extension
Room E2.180

P.O. Box 2910
Austin, Texas 78768-2910
(512) 463-0752
FAX (512) 463-1962

Steering Committee: Henry Cuellar, Chairman • Peggy Hamric, Vice Chairman

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