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Proposals to Change Protective Services for Children and the Elderly

The quality and effectiveness of state services designed to protect the young and the elderly have come into question recently in Texas. High profile cases of child neglect and abuse have called attention to problems with Child Protective Services, a division of the Department of Family and Protective Services (DFPS). At the same time, reports of elderly adults living in deplorable conditions in some regions has brought scrutiny of how Adult Protective Services, also a division of DFPS, operates. Investigations into these services have resulted in recommendations for change detailed in reports that will be presented to the 79th Legislature when it convenes in January 2005.

Child Protective Services (CPS)

Children who are abused, neglected, or abandoned are under the care of the DFPS, formerly Protective and Regulatory Services (PRS), which oversees child protective services and adoption and foster care, in addition to its other responsibilities of child care licensing and adult protective services. When CPS receives a report of abuse, neglect, or abandonment, case workers conduct an investigation and may offer services to stop or prevent abuse

or neglect while the child stays in the home, or may remove the child for placement in foster care. CPS also is involved placing children in foster care into adoptive families and in assisting children in the transition from foster care into adulthood and emancipation.

In June 2004, a grand jury indictment in Hidalgo County charged the state with failing in its mandate to protect the children of Texas from abuse and neglect. The case, heard in the 92nd state District Court, involved

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Problems at the Source: Streamlined Sales Tax Project Update

Texas had been in the vanguard of the 42 states (and the District of Columbia) seeking nationwide uniformity in the application of state sales tax law and regulations, but recently the momentum behind its participation in the Streamlined Sales Tax Project (SSTP) has slowed. Texas was among the first states – there now are 21 (see Figure 1, page 8) – to enact statutes implementing most of the provisions of the SSTP's multi-state agreement designed to simplify and modernize state sales and use tax collection and administration, thereby reducing sellers' tax compliance burden. Doing so theoretically could persuade Congress to authorize mandatory collection of state and local sales and use taxes on interstate (remote) transactions – i.e., those between a state's taxpayers and

businesses located out of state. Collection of such taxes currently is restricted by the U.S. Constitution's commerce and due process clauses, based on three U.S. Supreme Court decisions (*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1967); *Miller Bros. Co. v. State of Maryland*, 347 U.S. 340 (1954)). This change would allow state and local governments to require collection of sales and use taxes on catalog, Internet, and other remote sales.

Sales and use taxes.

Washington, D.C. and 45 states impose sales and use taxes. The state sales tax rate in Texas is 6.25 percent of the price paid for all taxable goods and services,

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allegations of sexual abuse by a stepfather of three young girls and resulted in charges against DFPS of three felony counts of bodily injury to a child by failing to protect them. The Hidalgo County District Attorney said that the indictment was intended to be a message to the state and later dropped the charges after Gov. Rick Perry ordered a complete review of CPS.

Allegations of the state's failure to protect children in danger of abuse or neglect have not been confined to Hidalgo County. In Bexar County, the deaths of three children – two from starvation, one from beating – garnered significant

Staffing, case loads, and legislative action

Over the last few sessions, the Texas Legislature has increased funding to CPS. The HHSC Implementation Plan, which contains initial findings from the agency's review of CPS, reports that the Legislature cut funding for CPS staff in 1995, but has increased funding ever since. While the absolute number of caseworkers has risen, the case load has grown even more quickly. According to the Center for Public Policy Priorities (CPPP), which advocates increased spending for social services, inflation and population growth have outpaced new spending so that the state now spends about 30 percent less on child protection, in relative terms, than it did a decade ago.

As a result, critics say CPS case workers are asked to do too much and are paid too little, resulting in high turnover and a relatively inexperienced workforce. CPS data show, for example, that in fiscal 2002 the average monthly case load for a CPS investigator was 51 cases, which increased to 61 cases by fiscal 2004. Over the same period, the average tenure for a CPS case worker fell from 4.7 years to 4.2 years. The average case load in Texas compares unfavorably with the 15 to 18 cases per worker recommended by national child advocacy groups.

attention and indicated that CPS might not be fulfilling its mission in that area of the state. This was particularly evident in one of the cases where the child died of starvation less than 12 hours after a case worker visited the family. The Comptroller's Office also uncovered widespread problems in the foster care system, which it detailed in an April 2004 report titled *Forgotten Children*.

A review of CPS by the Health and Human Services Commission (HHSC) has found a fundamental problem at the case worker level, and the commission has issued a preliminary report with recommendations for immediate corrective action. Other plans have surfaced, including proposals from the House Select Interim Committee on Child Welfare and Foster Care and the Senate Health and Human Services Committee. General recommendations from these reviews are summarized in the following section.

Recommendations. The HHSC case review of CPS uncovered inconsistencies in the application of CPS policies and service delivery across the state. It found that in some cases, if CPS policies had been applied consistently, children would not have been left at risk. It also revealed that CPS has insufficient staffing levels to respond to referrals and that case workers often do not have adequate experience or supervision. The investigating team concluded that case workers face excessive workloads that render them unable to comply with agency policies. Though the report suggests ways to improve compliance, it attributes the problem to "a critical shortage of caseworkers." In testimony before the interim committees, stakeholders also have raised questions about CPS caseworkers' failure to appropriately call in law enforcement on some cases and possible problems with false reports using up resources in the system.

In its *Forgotten Children* report, the Comptroller's Office found that the foster care system – a mix of state-run and outsourced services – faces many of the same problems as the abuse investigation area of CPS: too few case workers with insufficient experience to handle an increasing number of cases. In addition, the office found that inadequate licensing standards and lax enforcement of regulatory or contractual requirements allowed a wide array of living standards among foster homes. The report also criticized the agency's oversight of how psychotropic drugs are prescribed for children in the foster care system.

Hire more case workers. The most common theme among reports on CPS is that the agency is understaffed. According to HHSC, CPS received authorization from the 78th Legislature to fill 356 new positions over the biennium, and was permitted to expedite the hiring of the remaining 123 positions before January 1, 2005, rather than over the remainder of the fiscal year.

How many additional case workers are needed in the future is a matter of debate. Some advocates for children say the agency needs to triple its number of case workers, while others say that the Legislature should enact a statute requiring the agency to maintain a certain case load target. A plan put forward by Rep. Toby Goodman proposes that the Legislature ensure CPS has enough case workers to bring the case load down to 25 cases per worker, although he does not advocate setting the number of caseworkers in statute.

Other proposals address training issues for case workers. Testimony about high turnover and inexperienced case workers has prompted some stakeholders to call for better training of all case workers to improve their investigative skills. Specifically, Sen. Jane Nelson calls for law enforcement-style training, including forensic interviewing and investigatory techniques, for all case workers.

Spend more on child protection. According to advocates for additional funding, Texas spends about 60 percent less than other states on protecting children. In 2000, the state spent an average of \$110 per child, versus the national average of \$277. To meet the national average level of funding, lawmakers would need to increase state funding by more than \$300 million per year and collect federal matching funds to make up the rest.

Supporters of increased funding say it is the only way CPS can keep pace with the needs of the population it is supposed to serve. According to CPPP, Texas has the sixth-highest child population growth rate in the nation, which has created an urgent need for additional case workers to fix the problems experienced by the system. Some observers have put the cost of hiring these employees and paying associated costs, such as technology and supervision, at \$680 million in additional funds for fiscal 2006-07, while others say that lesser amounts would be sufficient.

Other advocates say that the system needs a change in culture rather than additional funding. According to one group, Justice for Children, CPS should utilize law enforcement, rather than social workers, to conduct investigations. Other stakeholders favor a county-based system, under which investigations would be carried out at the local level rather than by the state. Many counties might view this as an unfunded mandate unless the state allocated funding for local law enforcement to take on that responsibility.

The focus on additional funding for CPS fails to account for the complexity of the problem, according to other advocates who favor a broader-based approach to additional funding. They say that Texas should put new money into protecting children, some of which should go to programs that prevent abuse and neglect in the first place, such as untreated substance abuse and mental health problems within the family.

In addition to the debate over additional funding, some advocates for children say that Texas needs to rework the way it funds child welfare. CPPP says that the current funding system, which increasingly relies on money from the Temporary Assistance to Needy Families (TANF) block grant and Crime Victims Compensation fund, is not sustainable because those sources of revenue are not growing with the population and are allocated primarily for other purposes. In recent years, the Legislature has chosen to use TANF funds for investigations and foster care at the expense of prevention programs. Because TANF's primary dedication is for cash assistance, the state's options are limited in spending the block grant, making it impossible for the state to shift TANF funds indefinitely to child welfare.

Privatize more of the system. DFPS fails to perform its duties well because it tries to do too much, according to advocates for privatizing parts of the child welfare system. The agency should focus on investigations and farm its remaining functions out to the private sector where foster care placement, adoption services, at-risk family support services, and other case management services can be done better and more cheaply, they say. Already, the child welfare system operates through a mix of private and public service providers, so a mechanism is in place for increased privatization. Although gaps in service exist, the state could

encourage development of services in areas not currently served by a private agency through financial incentives or easing regulatory requirements for a period of time.

Some supporters of privatization say that the state should require agencies to become accredited with a national organization to impose consistency in services across the state. However, not all supporters say it should be mandatory because of the high cost associated with accreditation, although accredited agencies may have an advantage in marketing themselves to potential foster parents.

Opponents of privatization say that the private side of the child welfare system is rife with problems and that the state should not rely on it further. Contract management, enforcement, and accreditation have been at issue in the foster care system, with children found in poor living conditions at privately run agencies and homes. While DFPS's contract management could be strengthened with additional resources, it could take away care dollars from children.

The state has a mandate to care for all children, including those with special needs or other characteristics that make them very difficult to care for. Those children are not attractive to private agencies and homes, opponents say, because they require far too many services and supports to be profitable. In addition, many rural areas of the state do not have sufficient private resources to care for children in the system. Because few private agencies can operate without making a profit, these children would be left without the care they now receive from the state. While DFPS could encourage private business to fill the gaps, this would cut into money that could be used to care for children, privatization opponents say.

Others support the idea of privatization, but urge caution in transferring case management duties to the private sector. Reps. Elliott Naishtat and Ruth Jones McClendon, who offered letters of dissent to the House Select Interim Committee's recommendations, and other stakeholders have said that moving case management to the private sector would require significant clarification about the roles and responsibilities of both the private and public entities because in the end, the public entity still would be responsible for the

children. They recommend further study of the division of work before moving forward with privatization.

Strengthen accountability throughout the system.

Scrutiny of the investigative arm of CPS and the actions of case workers has generated recommendations that focus mainly on how reducing case loads would improve adherence to agency policies. The service side of the agency, including foster care and adoption placement, has accountability problems as well, according to several reports. In view of proposals for increased privatization of the system, recommendations to improve accountability focus mainly on contract management because most of the problems occur in privately run homes.

Following HHSC's review, DFPS now requires an independent review before closing any investigation involving children who are age three or younger when abuse and neglect cannot be ruled out. Advocates favor more such checks on the system so that inexperience or high work loads do not prevent children from being protected.

Develop more foster families. One of the problems in the system identified by some observers is that Texas has too few foster care families overall, particularly in certain areas of the state where there are more children in need of placement than families to accommodate them. Advocates say that children should be placed in a home that is reasonably close in proximity to the one they were taken from so that they can be near extended family, friends, or other supports if they exist.

One way to attack this problem, according to the House Select Committee on Child Welfare, is to expand the relative caregiver placement pilot program. The 78th Legislature enacted SB 58 by Zaffirini, which established a one-year pilot program to place children who are under the state's conservatorship with a "relative caregiver" – someone related to the child by consanguinity (a blood relative) who is not licensed to provide foster care or who later is appointed the child's permanent managing conservator. The program included a one-time payment for an initial placement and reimbursement of other expenses, funded through a rider in the PRS budget. The law requires DPS to report an evaluation of the program by January 2, 2005.

Increase adoption incentives and subsidies. Texas offers adoptive families subsidies to help with the costs of special services, such as therapy or medical care. The state also reimburses foster care families for some expenses. In some cases, such as the adoption of a group of siblings, the subsidy may be used for living expenses. Both foster care rates and adoption subsidies depend on the level of expense associated with bringing a specific child into the home. For example, rates are higher for children with special health-care needs. Adoption subsidies range from one-time reimbursement to as much as \$516 per month.

Supporters of increasing adoption subsidies say that they help create a strong network of families willing to adopt. While some children may be easy to place, large groups of siblings and special-needs children are difficult, in part because they place such a large financial burden on the adopting family. The state's goal should be to move children out of state facilities and into adoptive homes, which supporters say would occur following an increase in the subsidies.

Other stakeholders say that there are better ways to spend any new money allocated to PRS. The state has increased adoption subsidies and foster care rates in each of the last three state budgets, bringing them up to reasonable levels. The need now is for additional case workers to help the children in the system.

Require co-location of CPS and law enforcement. Some stakeholders have testified about problems that occur in investigations when CPS case workers hesitate to involve law enforcement because they fear a police presence will frighten parents and make the investigation more difficult. Creating a common location for protective services and law enforcement – known as “co-location” – can help improve the response of authorities to reports of child abuse, say supporters, and benefit parents and children as they go through the investigation process. The child advocacy center (CAC) model is a prominent example of co-location. CACs already exist in some parts of Texas and would be required for all counties with populations greater than 75,000 under Sen. Nelson’s plan. Some stakeholders say that co-location is a good idea, but are wary of plans that require moving costs or new buildings that would take funding away from direct care.

Establish statewide standards and pay for attorneys ad litem. An attorney ad litem is a lawyer appointed to represent the interests of a minor. In Texas, attorneys ad litem are appointed by the court and reimbursed at the local level. Some advocates for children say that the state should set standards for choosing attorneys ad litem and pay for them out of state funds. They say that there is wide variation in the quality of representation and the amount of reimbursement across the state. Opponents of establishing statewide standards and paying for attorneys ad litem at the state level say that counties have significant responsibilities and latitude in running their courts, traditionally an area of the legal process that is controlled locally. Other stakeholders have proposed sanctioning attorneys ad litem for failure to perform their duties, rather than making the selection process more stringent.

Create a system to track children. Schools play an integral role in ensuring the safety and well-being of children. Not only is the school system often the first to identify and report potential abuse to CPS, it also serves as a way to find and track children. One case from the Dallas/Ft. Worth area involved an seven-year-old boy who had once been removed from a family that had been investigated repeatedly for abuse and neglect. Under investigation again, the family removed the boy from school and transferred to a different school district, leaving no way for his last known school, or case workers, to find him. He later was found, emaciated and beaten, in his family’s new apartment.

Some child advocates support the creation of an integrated data-tracking system through which schools could track students through their academic careers. While such a system would not create a perfect trail for investigators to follow, it would be a step in the right direction, they say. Schools are often the only constant in an abused child’s life, as spotty as the child’s attendance may be. In practical terms, supporters say that the initiative should be funded and spearheaded by the state because local school districts simply do not have the resources to implement such a project.

Others say that a child-tracking system is not feasible and that the state should require courts to render judgments against abusive or neglectful families that include mandatory reporting, similar to that required of parolees. They say it

would be less burdensome for schools and more appropriate because the state would track the children who are at risk, rather than every child in the state.

Other stakeholders have proposed directing the state to enter into multi-state agreements to share access to state reporting systems. Under the agreements, Texas then could perform background checks in other states as well as at home.

The House Select Interim Committee on Child Welfare's recommendations addressed the welfare of children who have been adopted. The committee recommends that the state perform an unannounced visit to the home once a year until the child is 18 years old. Opponents of this plan, including Rep. Goodman, say that it would be unnecessarily obtrusive to adoptive families.

Examine prescription rates of psychotropic medications. One area of concern in the comptroller's report was the possible over-prescription of psychotropic medications to children in the foster care system. Earlier this year, DFPS established a group of medical professionals and child advocates to recommend guidelines and limitations on prescribing these medications. Some critics of the system have said that all investigations, including the review of prescribing patterns, should be conducted by a third party and not the agency itself. The comptroller's report recommended the establishment of a medical review team that would look not only at prescription drugs but also at diagnostic services and therapy. Sen. Nelson's plan would set guidelines for prescribing psychotropic drugs and attempt to better track which drugs a child is taking by requiring the agency to designate a single person who can give consent for treatment for children in the system and require the creation of a medical passport – a portable version of the child's medical history.

Terminate rights for parents convicted of abuse. Some advocates for children say that parental rights to all children should be terminated when a parent of multiple children is convicted of abusing one child. In investigating the death of a three-month-old girl in El Paso, CPS discovered that her mother had been convicted of abusing another child in the past. State law currently protects the parental rights to unharmed children of convicted abusers,

and critics say that any attempt to change the law likely would be unconstitutional because no crime would have precipitated the action.

Establish checks in the system to ensure that children are not removed inappropriately. While much of the criticism leveled at the agency has been about failing to remove children from dangerous situations, some parents groups say the agency sometimes removes children too quickly. One group in Harris County says that CPS removes a disproportionate number of African-American children into custody and often places them with strangers rather than other family members. According to CPS, about 30 percent of children in custody are African American, compared to 35 percent who are Hispanic and 33 percent who are Anglo. The agency's policy, whenever possible, is to place the child with a family member who has passed a background check.

Require that parents pay child and medical support. Some advocates for children say that DFPS is not aggressive enough in obtaining child and medical support for children in its care. Those payments sometimes are part of the court orders that grant DFPS conservatorship. The House Select Committee on Child Welfare recommends that parents pay support even after parental rights are terminated until a child reaches age 18.

Adult Protective Services (APS)

The mission of APS is to protect elderly or disabled adults from harm or exploitation no matter what setting they live in. Reports from the El Paso area of APS failing to help elderly residents living in horrific conditions surfaced earlier in 2004 and prompted a review of that function.

Much of the concern arose when a local newspaper reported that an 87-year-old woman was found in her backyard with a broken hip and a body temperature of 85 degrees. APS previously had visited the woman but was unable to conduct a thorough investigation because she refused officials entry into her home. She subsequently began living in her car after her home had become overrun by cats and trash, according to news reports. With similar accounts of other cases from across the state, Gov. Perry issued an executive order directing HHSC to investigate APS and make recommendations for improving protection of the elderly.

HHSC first investigated APS in El Paso, then expanded its review statewide. It found that the El Paso region performed poorly compared to the statewide average, especially regarding the percent of cases closed within 60 days, the percent of in-home investigations that progressed into service delivery, and high caseloads. Other problems discovered statewide include inconsistent application of policies and procedures, lack of clear process steps for each investigation, and few performance standards. In practical terms, this meant that cases were handled very differently by individual offices, allowing for wide variation in the quality of services. Even within one region, two cases might be handled using different decision-making criteria and with very different outcomes.

HHSC found the following primary needs to be addressed in the system: training of case workers so that they would know what appropriate course of action to take with current cases, staffing of several strategic positions, rapid development of tools for case workers to use in evaluating cases, and transfer of the local guardianship program – through which the state appoints a guardian to make decisions for the client – to the Department of Aging and Disability Services (DADS). Initiatives to address these and other problems identified during the review are expected to be applied throughout the entire system to improve services in all regions, with the initial implementation to take place in El Paso.

Some of the initiatives required immediate funding, while others will be the basis for requests for additional funding for fiscal 2006-07. In total, the changes are expected to cost \$35.6 million. In October, the governor announced that \$1.5 million of Workforce Investment Act funds from the Texas Workforce Commission would be used to fund training of all APS caseworkers across the state. In addition, HHSC identified \$12.8 million in savings from reorganization that would be used for APS in fiscal 2005, leaving about \$21.3 million required for fiscal 2006-07. HHSC shifted some full-time employee positions from the guardianship program to caseworkers and supervisors in APS, which is expected to lower daily case loads from 35 to 30 per case worker. In addition, HHSC plans to add 63 new caseworkers and reduce case loads to 28 per worker by 2007. Another initiative would improve technology support for case workers in the field. HHSC would spend \$4.6 million on laptops, telemedicine, and digital cameras to assist field investigations.

In addition to appropriations requests, the HHSC plan calls for legislative action during the upcoming session. While much of the caseworker training and recruitment falls within HHSC's statutory authority, the report identified four additional issues that require legislative action:

- **Change the statute limiting disclosure of information.** Sharing information with third parties outside the investigative process helps clients obtain services from community organizations, but current state law prohibits APS from sharing information without a client's consent.
- **Permanently move the guardianship program and clarify the guardianship process.** The program's temporary placement in DADS should be made permanent in statute. Also, the program needs clearer identification of roles and responsibilities among participants.
- **Involve police earlier.** Under current law, the police only are called after APS has reached a finding of abuse, but earlier involvement would help with evidence collection and subsequent prosecution of neglect or endangerment cases.
- **Extend emergency removal timelines and authority.** The law currently allows only a doctor to sign an emergency order to remove a client from the home or other setting and sets its maximum duration at 72 hours or a 14-day extension. The plan called for more health care practitioners to have the authority to sign emergency removal orders and more time for the maximum allowed order.

Other recommendations not in the HHSC report also relate to APS and the investigation of their services. A proposal by Rep. Goodman calls for APS to be moved to DADS instead of continuing to reside at DPFS. Also, critics of the system in the El Paso area have called for the establishment of a toll-free line for residents to report problems with the agency, similar to the one established for CPS.

– by Kelli Soika

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one of the highest in the nation. The maximum combined state-local rate allowed in any jurisdiction is 8.25 percent, and most taxpayers live in communities that tax at that rate.

The impetus for the SSTP derives from statutory complexity, regulatory peculiarities, and constitutional restrictions that have hindered state governments from collecting sales and use tax revenue from the burgeoning Internet market. The boundary-free nature of electronic commerce (e-commerce) has heightened emphasis on use taxes. Typically equivalent in rate to the sales tax, the use tax is levied on remote sales where the parties to the transactions are not located in the same state. Remote sellers with established connections (nexus) to distant states are supposed to collect and remit use taxes. Likewise, customers buying from sellers that do not have nexus are supposed to pay it themselves. Neither happens very often, and enforcement is problematic, which creates equity and fairness issues with regard to traditional “bricks-and-mortar” retailers that collect and remit sales taxes on site while the vast majority of taxes on online sales go unpaid.

Although measurement is difficult, current revenue losses to states generally from untaxed remote sales are estimated in the tens of billions of dollars and predicted to grow significantly during this decade. In October 2004, the Comptroller’s Office estimated that Texas would not collect

\$856 million from remote sales made during fiscal 2004-05, and local government would forgo \$231 million. Losses are growing at twice the pace of sales tax collections, according to the Comptroller’s Office. (For more background on the SSTP and relevant issues, see *Taxing E-commerce and Other Remote Sales: Choices for Texas*, HRO Focus Report Number 77-19, April 9, 2002.)

How sales tax sourcing affects cities

In Texas, the source for allocating sales tax collections to local governmental entities (aside from metropolitan transit authorities and city transit departments) is the point where the transaction originates. At least six other states – California, Kansas, Ohio, Tennessee, Utah, and Washington – also use this origin-based sourcing. Most states, however, use destination-based sourcing, which allocates sales tax revenue where customers first take control of their purchases – usually the seller’s place of business. But if the goods are delivered, shipped, bought online, or downloaded, or if the services are performed off site – such as at the customer’s business or residence – tax revenue is reallocated accordingly. For example, if Texas adopted destination-based sourcing as the SSTP proposes, a Dallas resident who ordered a home computer from Dell Inc. in Round Rock would pay sales tax to the city of Dallas, rather than to the city of Round Rock under current law.

Figure 1: States, as of August 2004, that have enacted legislation to comply with SSTP

Arkansas	Nebraska	Tennessee
Indiana	Nevada	Texas
Iowa	North Carolina	Utah
Kansas	North Dakota	Vermont
Kentucky	Ohio	Washington
Michigan	Oklahoma	West Virginia
Minnesota	South Dakota	Wyoming

Source: National Conference of State Legislatures

Unlike some participating states, Texas largely is in compliance with the SSTP's multi-state agreement, with the notable exception of the sourcing rule. A provision included in the comptroller's omnibus fiscal management bill (HB 2425 by McCall, enacted in 2003 by the 78th Legislature) switched local allocation to destination-based sourcing for taxable services only, the same approach the state uses for taxing services. Sourcing of local sales taxes on tangible personal property remained origin-based.

Earlier this year, the Comptroller's Office publicized its new requirements for changing collection of local sales taxes on services and local use taxes on items shipped to other Texas jurisdictions to destination-based sourcing. The outcry from many retailers and service providers and several legislators was so great, however, that the Comptroller's Office delayed implementation in July 2004 "at the request of key legislative leaders," according to a statement issued by the office.

The potential fiscal impact of this change in the sourcing rule would be diverse and varied depending on the nature of local economies. Bedroom communities consuming more than they sell, such as Highland Park in metropolitan Dallas, likely would benefit from the change. The effect would be minimal in many areas because new revenue gains would offset any losses. But cities with businesses that generate high volumes of sales from elsewhere in Texas would suffer.

Waxahachie, for example, has two cement plants, a steel-building manufacturer, and a 500-employee fiberglass insulation factory. City Manager Robert Sokoll estimates a \$1 million annual budget loss from changing to destination-based sourcing. A study conducted for the city of Grapevine estimates annual losses at between \$2.4 million and \$3.1 million. In Carrollton, similar losses reportedly would range from \$10 million to \$14 million. But nowhere would the fiscal pain be worse than in Round Rock, home of Dell Inc.

The city of Round Rock levies local sales taxes at the maximum combined rate of 2 percent, producing more than \$48.6 million in revenue in fiscal 2004, or more than 60 percent of its general operating budget. One percent is allocated to general revenue, 0.5 percent to property tax reduction, and 0.5 percent to economic development and transportation improvements. Dell generates approximately

\$1.2 billion annually in taxable statewide sales that, along with similar transactions sourced to Round Rock by other businesses (including Sears, Roebuck & Co. and a sheetrock supply plant), yield approximately \$24.6 million annually in sales tax revenue. That sum comprises 37 percent of Round Rock's total general revenue, with Dell's share accounting for half the city's sales tax revenue, according to city fiscal officials. They attribute 30 percent of Round Rock's total general revenue solely to Dell, a company that claims to operate one of the world's highest volume e-commerce websites.

Moreover, the city has leveraged its 0.5 percent economic development sales tax to borrow \$57 million through bonds and state-allocated federal loans for local highway projects. Further complicating the situation is a 1993 incentive package requiring the city to pay Dell a portion of its sales tax collections attributable to Dell and to refund half of Dell's municipal property taxes on land and facilities it leases or owns. Dell currently receives approximately \$7.6 million annually under the 60-year economic development agreement, according to the City Manager's Office.

Round Rock officials are active in the SSTP process and maintain ongoing discussions on sourcing issues with the Comptroller's Office. Instead of the provision on taxable services in HB 2425, however, city officials had hoped for bracketing language that would have carved out an exception for Round Rock in the multi-state agreement.

Most Texas cities initially favored the SSTP, according to the Texas Municipal League (TML), based on the representation that it would affect only interstate sales, not intrastate transactions. TML subsequently has withdrawn its support, however, calling the sourcing rule change "a monumental shift in sales tax law that uniquely affects Texas cities." TML predicts that destination-based sourcing would mean long-term budgetary chaos, dramatic revenue losses for larger cities, and overall net losses from shipping taxable goods into unincorporated areas where no municipal sales taxes would be collected. Furthermore, TML claims that business interests have "hijacked" the streamlining process to take advantage of reduced variation in business taxation across states while ignoring the local fiscal impact of changing the sourcing rule.

Proposed solutions

A few viable options for resolving the sourcing issue are under discussion, but no consensus has emerged. Utah and Washington officials have suggested some type of “hold-harmless” provision, such as state rebates, to reimburse losing local entities at least partially. But if the mechanism incorporates population, such as Utah’s proposed formula that also includes total tax collections, Round Rock still would be devastated financially, according to Round Rock City Manager David Kautz. Because it has only about 80,000 residents, he said, the city would recoup only a fraction of its lost revenue through such a formula.

Rebating also can lead to disagreements over the amounts of prospective losses and which entities should receive how much reimbursement. One possible variation would be to collect sales taxes based on destination but allocate revenue based on origin. The reporting and allocation methods would be burdensome, however, and could hurt potential beneficiaries, according to the Comptroller’s Office.

Kautz suggested exempting sourcing of intrastate transactions, which would maintain the origin basis for taxes on sales within Texas. Ohio officials have proposed relaxing the sourcing rule for small businesses to allow them to continue operating on an origin basis. Both approaches are unattractive to big business, which already calculates a myriad of local tax rates and wants overall uniformity in exchange for collecting sales taxes on remote sales nationwide. In addition, some states levy sales taxes on vendors’ gross receipts, not on customers’ purchases as does Texas, heightening the need for conformity. Moreover, tax officials point out that treating intrastate and interstate sales differently would be unfair to out-of-state companies, defeating the purpose of the SSTP and complicating any congressional approval of mandatory remote sales tax collection.

Other options include grandfathering all governmental entities that use origin-based sourcing, creating situation-specific exemptions, or omitting sourcing from the multi-state agreement altogether. None of the solutions offered to date, however, appears acceptable to the states and businesses now driving the SSTP. The lone exception is

the development of special sourcing rules for “unique” industries, such as wireless telecommunications and movable heavy-equipment leasing.

There is little reason to believe that the SSTP implementing states will budge on the contentious sourcing issue. By next summer, when tax code changes are expected to take effect in several states, including Ohio, the SSTP should be able to reach its agreed-to threshold of 10 conforming states comprising at least 20 percent of the U.S. population even without the participation of Texas. The multi-state agreement calls for a committee of conforming states’ representatives to form a governing board of member states by October 1, 2005, at the earliest. Until Texas comes into compliance, its representatives cannot vote on governance or compliance matters, nor can Texas participate in any ensuing remote sales tax collection process. The project initially would be voluntary, and businesses would not have to collect remote sales taxes for Texas. If the conforming states do not make an exception – and the group did not discuss the sourcing rule at its November meeting – then Texas might seek relief at the federal level if Congress eventually voted to empower states to make sellers’ compliance with the SSTP mandatory.

The Supreme Court left it to Congress to grant states the power to require interstate sales tax collection. Whether the new Congress (or any in the near term) will do so is an open question, especially if Texas, California, New York, and other large states are not involved. On November 19, Congress extended for the second time its 1998 moratorium on new, multiple, discriminatory state taxes on e-commerce, as well as on Internet access charges. The ban, which now expires in 2007, was enacted to give states and stakeholders time to reform the sales tax system while allowing the emerging e-commerce economy to take root. (Texas and several other states that tax online access are grandfathered.) The fiscal impact of a purely voluntary system is unknown.

The Comptroller’s Office is attempting to gauge the statewide impact of changing the sourcing rule in Texas, as required by HB 2425. The report is due to be published by the end of December 2004. One challenge has been obtaining valid data to measure city-to-city movement of taxable goods and services. While determining any fiscal gains that the state’s more than 1,000 communities might realize from sales

not currently sourced to them is difficult, the Comptroller's Office believes that destination-based sourcing eventually would benefit some cities' budgets. As with other aspects of e-commerce, quantifying the local fiscal effects of changing the sourcing rule remains an inexact science.

– by Patrick K. Graves

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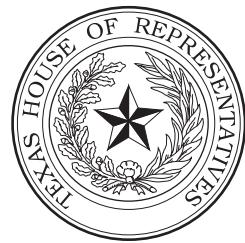
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