Center for Public Policy Priorities

THE POLICY PAGE

An Update on State and Federal Action

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HOW TO JUDGE WHAT'S PROPOSED IN THE SPECIAL SESSION

In the current special session the Legislature could make significant changes to the state's revenue system, as well as to the school-finance system. The tax system established in a special session could determine the size of state budgets for the next ten years or more. Both tax and school finance proposals can be judged by the same criteria – equity, adequacy, and sustainability. This Policy Page will compare HB 3, the tax bill filed in the House for the special session, the version of the tax bill that the Senate passed during the regular session, the proposal by Governor Perry, and HB 15, an alternative school finance bill filed by Rep. Hochberg for the special session.

Groups that normally are not concerned with public education must not ignore this session. Public education accounts for 42% of state general-revenue spending—as much as health and human services and higher education combined! Any significant change in school finance must therefore involve significant changes in the state tax system. The tax system that emerges from a special session would determine how much general revenue the state will have available to spend on all other state services for years to come.

TAX REFORM SHOULD IMPROVE THE EQUITY OF TEXAS' REVENUE SYSTEM

The simplest way to judge the fairness of a tax system is to compare the percentage of income different families pay in taxes. In a state with a fair tax system, taxes are linked to a family's or business' ability to pay those taxes. In Texas, the families with the lowest income pay the highest percentage of their income in taxes; the families with the highest income pay the lowest percentage of their income in taxes. In other words, those who can least afford it pay the most. A system that takes a higher percentage of the income of a lower-income family is called "regressive." Texas has the fifth most regressive state and local tax system of the 50 states. See: *Who Pays Texas Taxes?* http://www.cppp.org/files/7/pop_226.pdf

Both the House and Senate proposals during the regular session failed to improve tax equity. Because each relied heavily on raising regressive taxes, such as the sales tax, in order to reduce less regressive property taxes, the bills would have shifted the tax burden from higher-income families onto lower- and middle-income families. See *Equity Note Confirms that Most Texas Families Would Pay More Under HB 3, the "Tax Relief Bill,"* http://www.cppp.org/files/7/pop_232.pdf, *Senate Has Opportunity to Protect Families Hit Hardest by House Version of HB 3, the "Tax Relief Bill"* http://www.cppp.org/files/7/POP234.pdf, and *Senate Version of HB 3, the "Tax Relief Bill," Shows Slight Improvement Over House Version* http://www.cppp.org/files/7/POP239.pdf.

On June 22, a tax equity note was released for the newly filed HB 3. The result was similar to the bills considered during the regular session – a tax cut for the 20% of Texas families with incomes over $100,000, a tax increase for the 80% of families with incomes under that level.

Although no tax equity note has been prepared for Gov. Perry's plan, which has not been filed as a bill, it is likely that it would have a similar regressive impact, since it relies almost exclusively on raising regressive consumption taxes in order to fund property tax cuts.

SALES TAX INCREASES

The major cause of the regressivity of these approaches is their heavy reliance on higher sales taxes. The current House bill, HB 3, as filed in the special session, would raise the state sales tax rate from the current 6.25% to 7.25%, which would be the highest state sales tax rate in the U.S. It would also raise the motor vehicle sales tax to 7.35%. The Senate version from the regular session would have raised the sales tax to 6.75%. Gov. Perry's plan would roughly split the difference, raising the sales tax to 6.95%.

HB 3, as filed, would also expand the sales tax base to include bottled water, auto repair, and certain computer services. Gov. Perry's plan would similarly tax car repairs, computer repairs and programming, and cosmetic surgery.

SENATE'S NOVEL INNOVATION

The Senate, during the regular session, adopted an innovative approach to reducing the burden of the sales tax on the lowest-income families. The 800,000 households who use a Lone Star Card for food stamps or TANF benefits would have received a cash payment or additional nutritional assistance of roughly $10 per month. This additional benefit would have almost entirely protected the 10% of Texas families with incomes under $13,400 from other changes in the bill. The innovation was an important recognition of the harsh impact of sales taxes on the lowest-income families and should be an element in any tax plan adopted during this special session.

PROPERTY TAX CUTS

The benefits of cuts in property tax rates go initially to businesses, which pay more than half of all property taxes in Texas, and to homeowners. Renters pay property taxes too, but indirectly through their rent payments to their landlords. Renters benefit from property tax cuts only to the extent that lower taxes are reflected in lower rents.

The current House bill, HB 3, as filed, would reduce the cap on the school district maintenance and operations tax rate from the current $1.50 to $1.10. During the regular session, the Senate approved a similar cut. Gov. Perry would cut the rate to $1.20 in 2007, reduced to $1.05 in 2010. No plan offers benefits to renters, who account for one-third of Texas households.

HOMESTEAD EXEMPTIONS

Property tax reductions can also be made by increasing the homestead exemption. Because a flat dollar exemption gives a much greater percentage reduction to a $100,000 home than to a $1 million home, significantly increasing the homestead exemption can concentrate the benefit of property tax reductions on lower- and middle-income homeowners. In contrast, a reduction only in the property tax rate gives an equal percentage reduction to all homeowners, as well as to businesses.

HB 15 by Rep. Hochberg, filed in the special session, would distribute property tax cuts primarily through a higher homestead exemption – raising the current exemption from $15,000 to $45,000. HB 15 would also cut property taxes to $1.25. Gov. Perry has proposed raising the homestead exemption by $7,500, to $22,500. During Senate floor debate in the regular session, a proposed amendment to increase the homestead exemption to $30,000 and cut the maximum tax rate to $1.20, rather than $1.10, failed by a vote of 12-18.

CIGARETTE TAX

The state cigarette tax is currently 41cents per pack, 39th highest among the 50 states and well below the national median of 69.5 cents per pack. Many states facing revenue problems in recent years have increased their cigarette taxes, with 17 states now taxing $1 or more per pack. HB 3, as filed, would raise the tax by $1.00, as would Gov. Perry. During the regular session, the Senate passed an increase of 75 cents.

Like a sales tax increase, a cigarette tax would be highly regressive. However, because smoking is a health risk, and higher cigarette taxes reduce smoking – particularly among more price-sensitive teenage smokers – an increase in the tax would have other beneficial effects besides raising revenue.

BUSINESS TAXES

The state's major business tax – the corporate franchise tax – covers only a fraction of the firms doing business in Texas, because it applies only to corporations and limited liability companies.

HB 3, as filed, would extend the franchise tax only to forms of business protected from liability, but not to sole proprietorships, general partnerships or a list of other business forms, particularly those with primarily passive income from investments. The Senate, during the regular session, would have taxed most forms of business other than sole proprietorships and certain passive entities. Gov. Perry apparently would not expand the types of businesses subject to the franchise tax. All three plans attempt to close the Delaware Sub and Geoffrey's loopholes.

Gov. Perry would also double the occupation fees paid by many professionals, including lawyers, doctors, accountants, and real estate brokers.

TAX CHANGES SHOULD PROVIDE AN ADEQUATE AMOUNT OF REVENUE

These tax bills are intended to raise state taxes only to reduce local school property taxes. They were designed to be revenue neutral – any new state revenue was intended solely to cut property taxes. This was the chief problem with HB 3 in the regular session.

More than cutting property taxes, Texas needs to improve public education, adequately fund health and human services, increase access to higher education, and support other important public services. The tax bill considered during the regular session was flawed in its basic purpose.

HB 3, as filed during the special session, would fund property tax cuts by diverting 15% of any future budget "surplus," into increased state aid for school districts, so that districts could generate the same amount of total revenue at a lower local tax rate.

The problem is in the definition of "surplus." Texas has traditionally considered any projected increase in revenue over the prior biennium to be "surplus," even if it simply reflects the growth in revenue due to increased population, economic growth, or inflation. The federal government defines a projected surplus to be more than would be necessary to maintain the current level of programs, taking into account growth in population, enrollment or caseloads, as well as inflation in the cost of providing services. The Texas definition, by comparing only future revenue to current revenue, misses entirely the need to fund increasing demands and costs of state services.

A REFORMED TAX SYSTEM SHOULD GROW WITH THE NEEDS OF THE STATE

A major failing of the Texas state and local tax system is its inability to keep up with the growth of the state economy. This creates a "structural deficit" – public revenues do not keep pace with residents' need for basic public services. (For more details, see the Texas Revenue Primer http://www.cppp.org/files/7/rev_primer_web.pdf.)

Over the past decade, state tax revenue has dropped steadily as a percentage of the state's economy. As a result, funding for public services has come increasingly from local property taxes. As the state has moved away from its obligation to fund public education, school property taxes have had to rise to make up the difference. In addition, counties and hospital districts have had to pick up the burden of providing health care to the increasing number of people no longer covered by state programs.

Artificially capping local property taxes or property appraisals, as proposed by Gov. Perry, would treat the symptoms of an inadequate state revenue system, but not fix the cause. (See *Cap on Appraisal Growth Would Mainly Benefit Wealthy Homeowners, Create Dangerous Imbalances* , http://www.cppp.org/files/7/pop_223.pdf).

The best way to significantly cut property taxes and meaningfully increase revenue for public education would be through a state personal income tax. See *The Best Choice for a Prosperous Texas,* http://www.cppp.org/files/7/prosperous_texas.pdf

An alternative would be to modernize the sales tax to better match our 21st Century economy by expanding the sales tax base to cover services that are currently untaxed, including most business and professional services. But, because of the highly regressive nature of the sales tax, even an expanded base would unfairly burden low- and moderate-income families. We should also reform our franchise tax to make it a broad-based business tax paid by all businesses, including partnerships and professional associations, which would also better reflect future economic growth.

And, in order to ensure that everyone pays their fair share of property tax, we need to require disclosure of the sales price of all real estate transactions and adequately fund the comptroller's property value study, so that all property is appraised at its full market value.

If these changes were made, state and local revenue would be able to grow to meet future needs, without continual rate increases. Investing these additional revenues can create ever greater wealth through strong public schools and accessible higher education, equipping residents to be successful entrepreneurs or part of a dynamic workforce. We can also afford to care for those in need, while building a more prosperous state for all of us.