

TESTIMONY BEFORE THE
JOINT SELECT COMMITTEE ON PUBLIC SCHOOL FINANCE

MAY 9, 2002

FUNDING PUBLIC EDUCATION:
ALTERNATIVE REVENUE SOURCES

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Mr. Chairman, Members of the Committee:

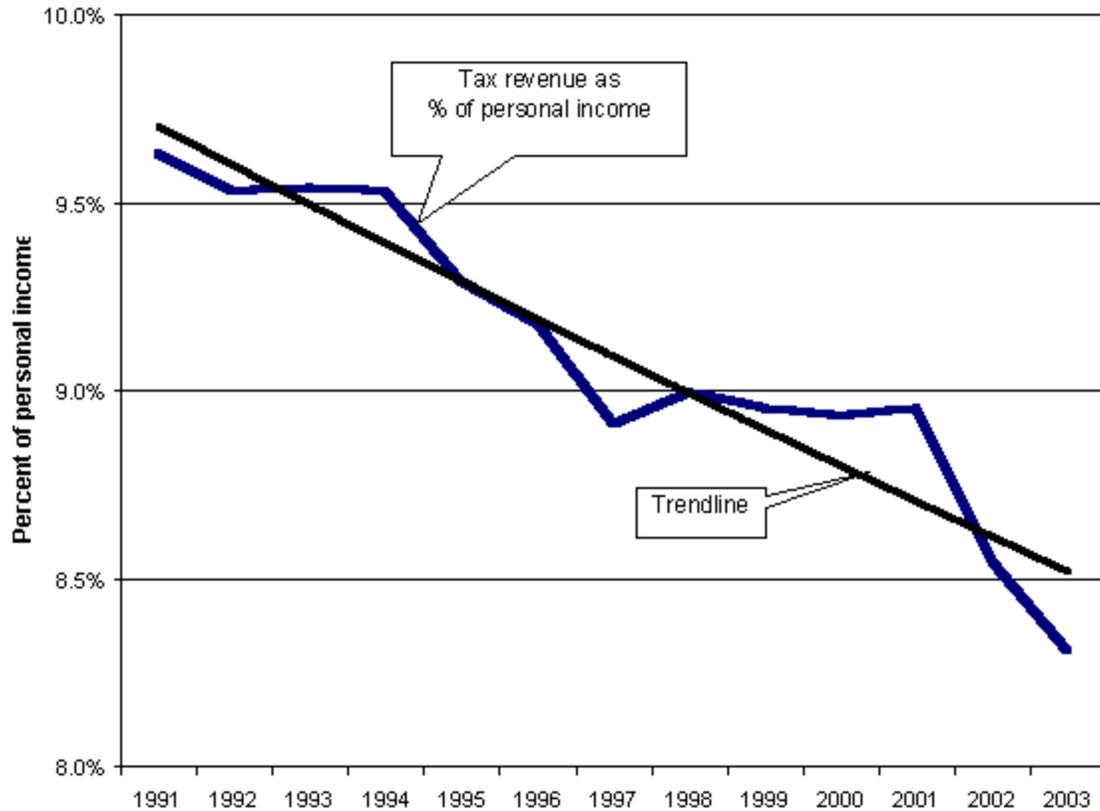
Thank you for inviting me to testify before you today.

I would like to talk about our state and local revenue system and the structural problems that keep it from generating the amount of money we need to support public education and other vital public services. I will then offer several concrete proposals for changes within the current system that would improve our ability to fund our schools. I will conclude with an examination of the advantages of adding an entirely new tax to our revenue system.

STRUCTURAL DEFICIT

Our basic problem is that state and local tax revenue does not keep up with the growth of the Texas economy. I am measuring economic growth by growth in personal income, which shows the ability of Texans to pay taxes. The growth in personal income also generally reflects the need for public services, tracking the growth in population and inflation. In addition, higher personal income mirrors changes in the nature of the economy, which now demands higher skills from workers, requiring more students to continue their education through high-school graduation to post-secondary institutions.

State and Local Tax Revenue Doesn't Keep Up With Economic Growth



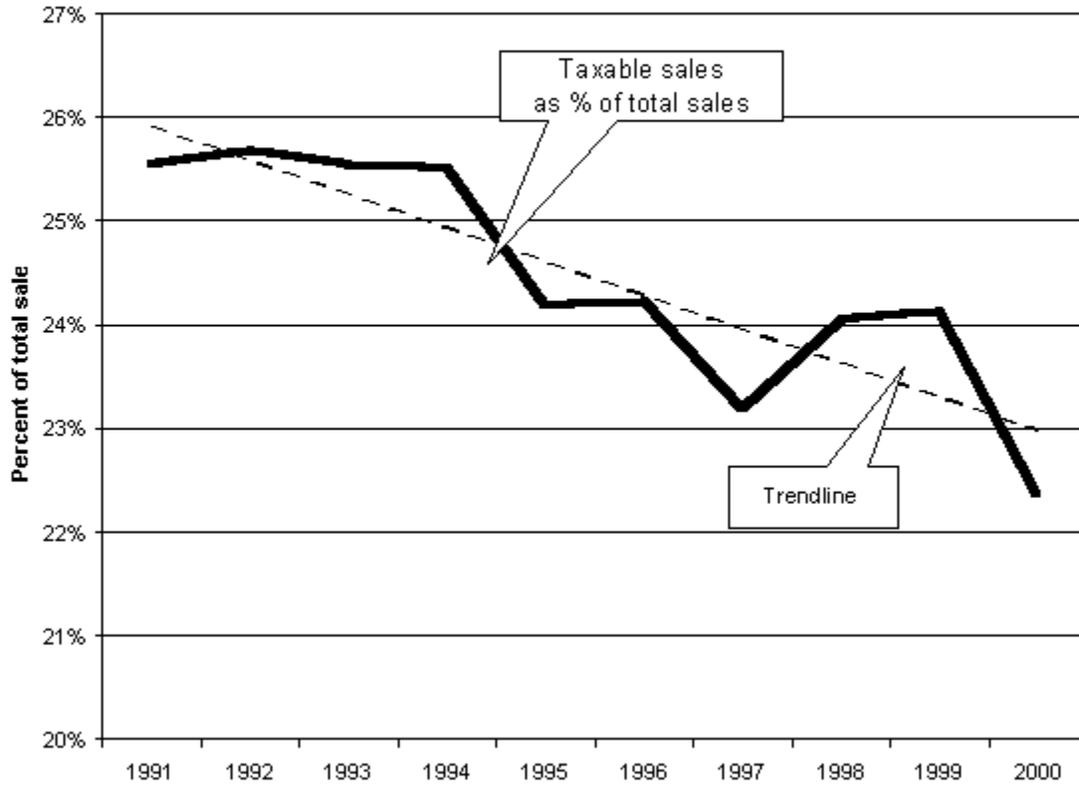
MODERNIZE THE SALES TAX

A major reason that the Texas tax system cannot keep up with economic growth is its heavy dependence on the sales tax.

Over time, the sales tax has applied to a shrinking percentage of all sales transactions in the state. Sales volume has grown faster than sales tax receipts.

Part of this reflects leakage to Internet and mail-order sales. But the larger problem is that the sales tax has not changed along with changes in the nature of the economy.

Taxable sales are dropping as a percentage of total sales

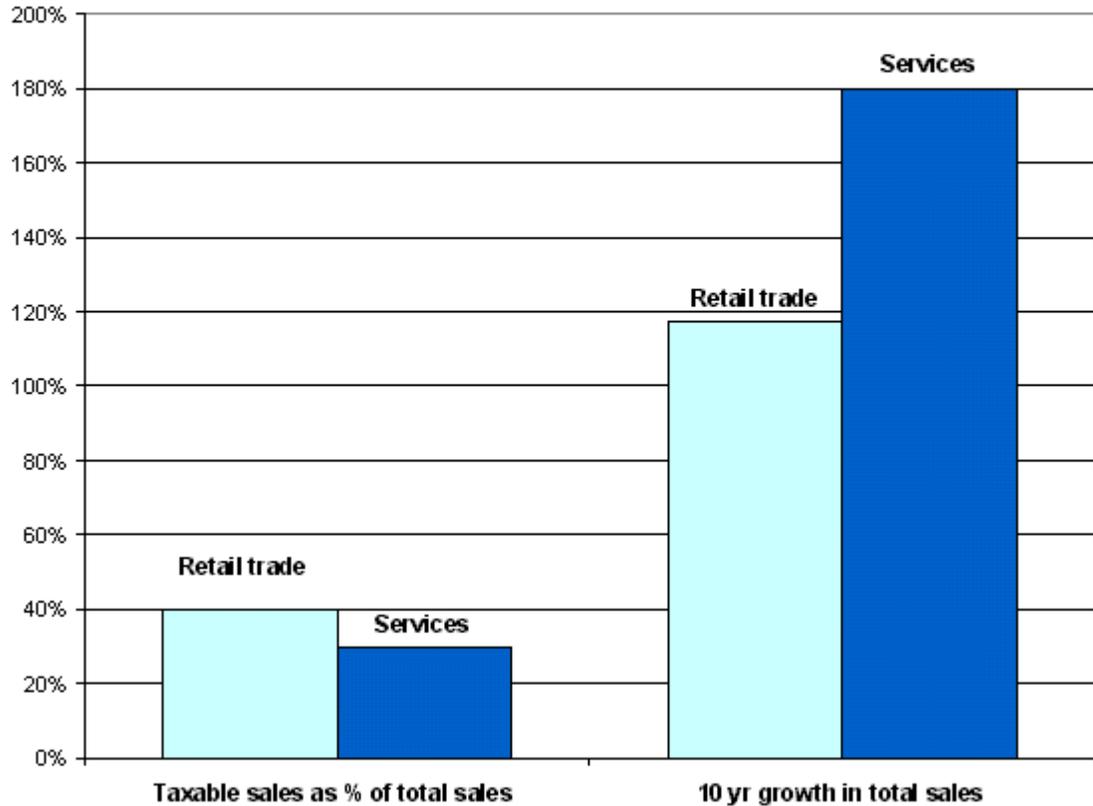


Texas adopted a sales tax in 1961, when most sales involved goods – tangible items. However, in the modern economy the fastest growing sector involves services – actions, rather than items.

The sales tax applies to 40 percent of retail trade in goods, but only 30 percent of the sales of services. Over the past ten years, sales of services have grown at a pace one and one-half times faster than the growth in retail trade in goods.

The state could generate additional revenue by expanding the sales tax to cover services that are currently untaxed, including most business and professional services.

**Sales tax captures less of services than of retail trade ;
services sector grows faster**



The Comptroller, in her January 2001 report on tax exemptions, estimated that taxing services (except medical and dental services) could raise \$7.5 billion in 2004-05. Her estimate may change in her report due in January 2003. The largest exclusions in each category of services are shown here.

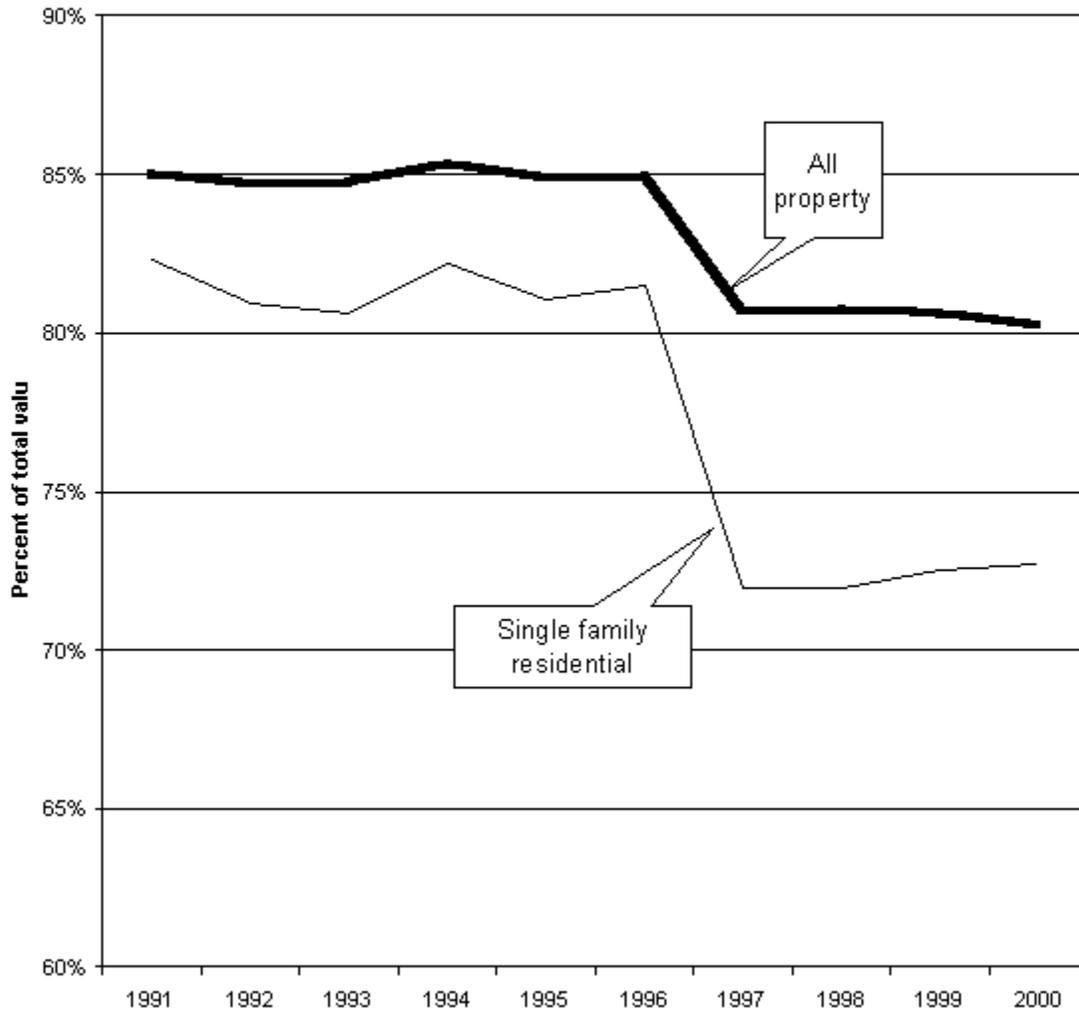
Service excluded from sales tax	Revenue lost in 2004-05
Business and professional services	
Legal	\$866 million
Architectural and engineering	\$613 million
Freight hauling	\$567 million
Financial services brokerage	\$442 million
Accounting and audit services	\$421 million
Advertising media	\$403 million
Real estate brokerage and agency	\$396 million
Contract computer programming	\$224 million
Management consulting	\$218 million
Other financial services	\$159 million
Construction labor	
New residential construction	\$594 million

New nonresidential construction	\$509 million
Personal services	
Child day care	\$336 million
Barber and beauty services	\$121 million
Funeral	\$104 million
Other services	
Automotive maintenance and repair	\$553 million
Travel arrangement	\$77 million
Private vocational education	\$58 million
Other private educational services	\$54 million
Car washes	\$48 million

IMPROVE THE PROPERTY TAX

The school property tax, unlike the sales tax, has been able to capture a relatively stable percentage of total value. Except for a large drop in 1997, when the statewide homestead exemption was tripled, the proportion of reported property value that is lost to exemptions has not changed significantly .

Taxable Value Is Stable as a Percent of Total Value (except for the higher homestead exemption)



Total revenue lost to school property tax exemptions in 2004-05 is estimated to be \$7.9 billion. This projection, from the Comptroller's January 2001 tax exemption report, may change in her report due in January 2003.

There are few easy opportunities to increase revenue by eliminating exemptions.

Exemptions available to homeowners account for nearly 60 percent of lost revenue. Almost half of this is due to the \$15,000 statewide exemption. The productivity valuation for agricultural land ("ag valuation") accounts for another one-third of lost revenue.

Business tax breaks cost relatively little, although they may not be very effective at accomplishing their goal of promoting economic development. New business tax breaks with potential for large costs to the state in the future include HB 1200 abatements and the expanded freeport exemption for which a constitutional amendment was passed last November.

School property tax exemption	Revenue lost in 2004-05
Ag valuation	\$2.85 billion
Residential	
\$15,000 statewide homestead	\$2.17 billion
Optional percentage homestead	\$796 million
Over-65 tax freeze	\$710 million
10 percent cap	\$372 million
Over-65 homestead	\$365 million
Optional over-65 homestead	\$202 million
Disabled veteran	\$43 million
Business	
Freeport	\$244 million
Pollution control	\$95 million
TIF (tax increment financing)	\$36 million
Abatements	\$24 million

The way to get more revenue from the school property tax is to make it function better.

The Legislature should create reasonable penalties to force businesses to report (“render”) their personal property to appraisal districts. According to the appraisal districts, there is \$36 billion in unreported business personal property in the state, which could generate \$1 billion in school property taxes in 2004-05.

The Legislature should also require disclosure of the sales price of all real estate transactions. Disclosure is required in 35 states; Texas is the only state so dependent on property taxes that tries to function without this type of information. Although no estimate has been made of the additional value that could be uncovered, there is no doubt that the property tax system could work more efficiently with more accurate information.

To ensure that the benefits granted to homesteads are enjoyed by all eligible Texans, the Legislature should require that an application for a homestead exemption be included at the closing of the sale of any residential property.

To improve accuracy of property tax valuations:

Sales price disclosure

- Required in 35 states
- Can be kept confidential – for use only by appraiser or in appeals
- Texas is only state so dependent on property tax that lacks mandatory disclosure

Mandatory rendition

- Model penalty after current provisions for correction of error (Property Tax Code, sec. 25.25(d))
- If business did not render personal property, an appeal would fail if appraised value were not more than one-third greater than correct value

Homestead, over-65 application supplied at closing

- Access to 10% cap, exemption, tax freeze, tax deferral
- Increase public acceptance of property tax

SUNSET THE TAX CODE

Finally, the entire Tax Code should be subjected to a periodic Sunset review. Just as state agencies are reviewed every 12 years and made to justify their continued existence, each tax exemption should be periodically examined and, if its continued existence cannot be justified, removed from the Tax Code.

To pick just one example: In 1993 the Legislature removed the incentive in the school-finance formulas for school districts to grant property-tax abatements. Certain companies complained that they had been relying on these abatements in planning new locations and asked for reimbursement from the state for school taxes paid on properties that had received abatements from the local city or county. A reimbursement procedure was enacted in 1995 (Tax Code, sec. 111.304) that now costs the state \$20 million per biennium. The refund may have made sense as a measure to ease the transition while companies adapted to the new rules, but it has clearly outlived its original purpose. In addition, it has been superseded by HB 1200 (77th Legislature), which provides a new avenue for school-tax abatements.

CONSIDER A STATE PERSONAL INCOME TAX

The Center for Public Policy Priorities has calculated that a personal income tax in Texas could have generated \$17.3 billion in total revenue in 2000.

We used the Kansas income tax as a model. Kansas was chosen only because it represents an average state; Texas would design its own tax. Kansas ranks 28th in income taxes per capita and 31st in state and local “own source” general revenue per capita. The Kansas rate structure, deductions, and exemptions were applied to Texas income data from 2000 for CPPP by the Institute on Taxation and Economic Policy, a Washington, D.C. tax research organization, using their nationally known microsimulation model.

Under the state constitution (Art 8. sec. 24, adopted in 1993), two-thirds of the net revenue of a personal income tax – in this case, \$11.5 billion – would go to reduce school district maintenance and operations (M&O) tax rates. This would leave a net increase in state revenue of \$5.8 billion for one year – roughly \$12 billion for a biennial period.

Let's look at how an income tax could work in Texas

Take the Kansas tax and apply it to Texas incomes

Income tax revenue	\$17.3 billion
Property tax cuts	-\$11.5 billion
Net new state revenue	\$5.8 billion

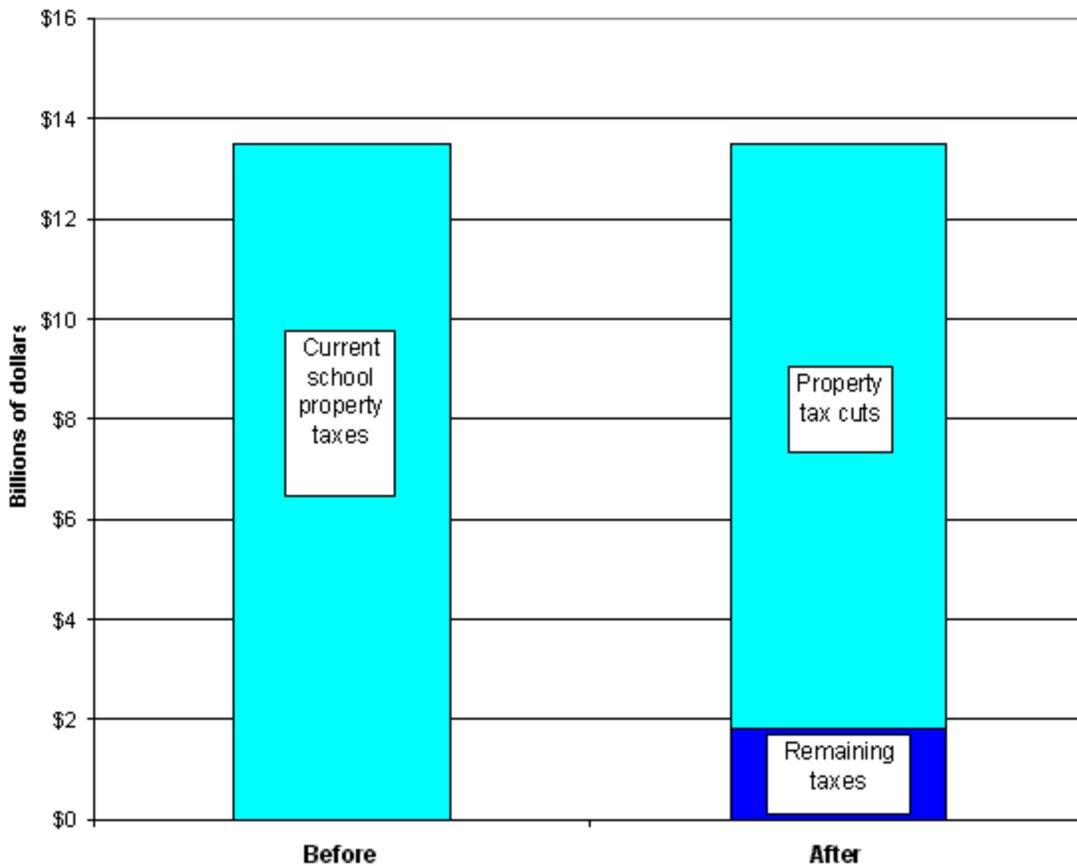
Devoting two-thirds of the revenue from this sample income tax to reducing school M&O taxes would have cut these taxes in 2000 by more than 90 percent.

Under the constitutional provisions, there would also be a proportional cut in the maximum M&O tax rate, now \$1.50 for most school districts, to under 10 cents. However, a district could increase its maximum rate with voter approval.

The remaining one-third of income tax revenue is dedicated by the constitution “for the support of education, subject to legislative appropriation, allocation, and direction.” The sample tax would have generated \$5.8 billion per year (almost \$12 billion per biennium) for education.

An income tax must be approved by the voters in a statewide referendum before taking effect. The state lottery was adopted by a similar procedure.

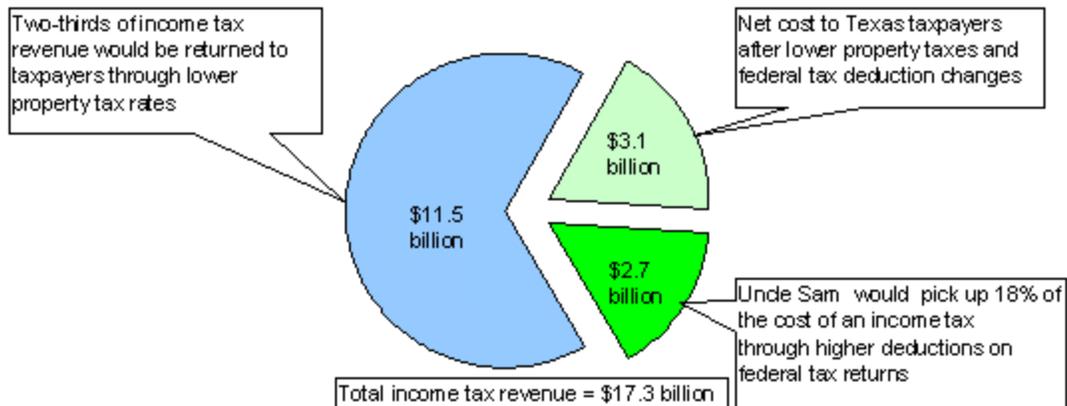
An income tax would slash school M&O taxes by 90%



A state personal income tax would also reduce federal income taxes for some Texas taxpayers, since state income taxes are deductible from federal taxable income. Although school property taxes are also

deductible, those families that would have to pay more in a state income tax than they gain from property tax reductions would benefit from the additional net federal deduction. Overall, the federal government would absorb almost one-fifth of the burden of a state personal income tax.

The Deductibility of an Income Tax Would Ease the Burden on Texas Taxpayers



An income tax would help reduce the unfairness of the current tax system. Since income tax rates are higher on taxpayers with higher income, only the 40 percent of Texas families with the highest incomes (those with an annual family income over \$50,000) would pay more with an income tax than under the current system. The majority of Texas families would see property tax cuts that were greater than their income tax bills.

A State Income Tax, With Property Tax Reductions, Would Benefit Most Texans

