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How to Fill the Hole in the Texas Revenue System

Overview

The $27 billion revenue shortfall faced by the Legislature in 2011 was not solely the result of the national recession and the needs of a growing population. Roughly a third of this gap was due to decisions made five years before, when the Legislature required school districts to cut their property taxes, but failed to create new sources of state revenue to fully replace the foregone revenue, creating a $10 billion hole or structural deficit. This hole will appear in every state budget until the Legislature fills it with additional revenue.

What Happened?

In 2006 the Legislature required school districts to reduce their school property tax rates by one-third, but committed to replacing the foregone property tax revenue so that the school districts would maintain their total state/local revenue. To fund this commitment, the state reformed the franchise tax (now popularly known as the "margins tax," for reasons explained below) and increased the cigarette tax. However, the new state revenue raised by these changes falls some $10 billion short in each biennium of replacing the property tax revenue given up by the school districts.

Why Did the Legislature Require School Districts to Reduce their Property Tax Rates?

The Legislature was responding to a Texas Supreme Court ruling (West Orange Cove ISD v. Neeley). School districts complained to the Court that, in order to raise sufficient revenue to meet state education requirements, they were in effect being forced to tax at or near the maximum tax rate of $1.50 per $100 of property valuation for their annual maintenance and operations (M&O). The Court held this was equivalent to a state property tax, which is prohibited by the Texas Constitution. The Court instructed the Legislature to give districts "meaningful discretion" to set local tax rates.

The Legislature developed a plan under which school districts would be required to reduce their M&O tax rates by one-third – in most cases, from $1.50 to $1.00. (Taxes for debt service were unaffected.) The state promised to provide additional state aid, so that each district would continue to receive the same amount of total revenue per student (adjusted for student and district characteristics) from local property taxes and state aid as they did before the change. Districts would then be permitted to increase their local rates by up to four cents by a vote of the school board, plus another 13 cents with voter approval, for a new maximum M&O tax rate of $1.17.

The Legislature also increased certain other public education spending, including a pay increase for teachers and a specific allotment per high school student. These additional expenditures are unrelated to the property tax reductions and are therefore not included in calculations of the structural deficit, which is a straightforward comparison between the amount of property tax revenue foregone by school districts and the amount of new state revenue raised by the changes passed in 2006.

How Did the Legislature Plan to Raise New State Revenue?

Franchise Tax

Most of the new revenue was expected to come from changes in the franchise tax, the state's major business tax. The tax had been criticized for many years as being too easy to avoid. Only corporations and firms with similar legal structures were liable for the tax, so it was relatively easy for a firm to reorganize legally (without actually changing their business operations) to avoid having to pay the tax. Numerous loopholes were used to shift Texas income out of state and away from taxation, with cryptic names such as "Geoffrey's" and "the Delaware Sub."

The Legislature transformed the franchise tax by extending it to most legal forms of business, except sole proprietorships and general partnerships owned by "natural persons" (i.e. real people, not companies). Sole proprietors and general partnerships owned by natural persons were excluded for fear that taxing their income would be considered a state personal income tax and thus subject to the provisions of the "Bullock Amendment" to the Texas Constitution, which includes voter approval of the tax in a statewide referendum. However, the Texas Supreme Court recently ruled that the franchise tax may be applied to limited partnerships, since they are being taxed as separate legal entities, even though partnership income may be eventually distributed to the individual partners. (In Re Allcat Claims Service, L.P. and John Weakly, Relators)

The Legislature also changed the way the franchise tax is calculated. The former tax was essentially a corporate income tax, with a tax rate of 4.5 percent of net income ("earned surplus"), with an alternative minimum tax of 0.25 percent of net assets ("taxable capital"). The new tax was based on the difference (or "margin") between gross receipts and either the cost of goods sold or the cost of compensation. This is the origin of the popular name for the reformed franchise tax – the "margins tax." The tax rate is 1 percent of this margin (0.5 percent for retailers and wholesalers), with a maximum rate of 0.7 percent of gross receipts.

Cigarette and Tobacco Taxes; Used Cars

The Legislature raised the tax on cigarettes from 41 cents a pack to $1.41 a pack. The tax on other tobacco products – cigars, snuff, chewing tobacco, and smoking tobacco – was increased to 40 percent of manufacturer's list price. The calculation of the "standard presumptive value" of a used car for purposes of the sales tax was also changed.

How Much Money was Needed to Replace the Foregone School Property Taxes?

The Legislative Budget Board (LBB) estimated that the cost of replacing the property tax revenue foregone because of the required one-third cut in the M&O tax rate would be $14.2 billion in the 2008-09 biennium. The LBB continues to use this number for the cost in all succeeding biennia.

How Much Money did the Legislature Expect to Raise from the 2006 Tax Changes?

According to the fiscal notes for the bills passed in the 2006 special session, the changes in the franchise tax were expected to increase revenue by $6.8 billion in the 2008-09 biennium and $7.7 billion in 2010-11.

The fiscal note estimated that changes in the cigarette and other tobacco taxes would bring in $1.4 billion in 2008-09 and $1.3 billion in 2010-11.

The fiscal note estimated that the change in the motor-vehicle sales tax would raise $85 million in 2008-09 and $86 million in 2010-11.

In total, the Legislative Budget Board forecast that the 2006 tax changes would produce $8.3 billion in 2008-09 and $9.1 billion in 2010-11.

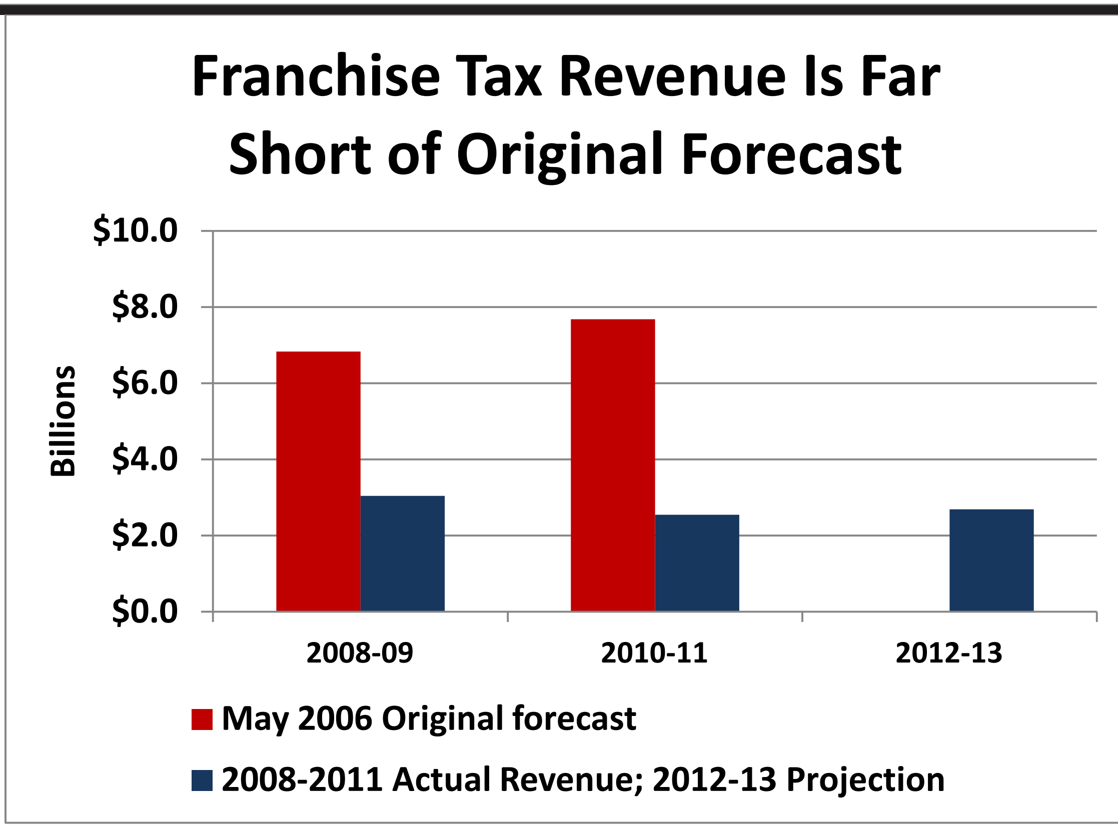
Thus, even when the bills were passed in 2006, the fiscal notes warned that the new state revenue would be far short of the $14.2 billion necessary each biennium to replace the property tax revenue lost to the required tax cuts – by $5.9 billion in 2008-09 and $5.1 billion in 2010-11.

Proponents of the property tax cut argued that state tax revenue would grow over time, eliminating the gap between the amount of new tax revenue from the 2006 changes and the amount needed to maintain school district funding. This has not happened. Instead, the state has had to spend general revenue to supplement money from the revised taxes to replace the foregone property tax revenue. Don't forget, even if franchise tax revenue had performed as expected from the beginning, and had not also suffered from the effects of the economic recession, there still would have been a significant structural deficit.

How Much Money did the 2006 Tax Changes Actually Raise?

The 2006 legislation created the Property Tax Relief Fund (PTRF) to receive the additional revenue generated by the tax changes passed in the special session. The fund may be used only to replace the property taxes foregone by school districts, done by helping fund the Foundation School Program, the state's main school-aid program. The Comptroller must estimate how much the franchise tax would have raised under the former law, then deposit any franchise tax revenue over that amount into the PTRF. She makes similar calculations for the cigarette and tobacco taxes and for the used-car sales tax.

The extra revenue from changing the franchise tax has fallen far short of the original estimates. The PTRF received only $3.05 billion from the franchise tax in 2008-09 and $2.55 billion in 2010-11 – $3.78 billion short of the fiscal note estimate for 2008-09 and $5.13 billion short for 2010-11. In 2012-13 the franchise tax is expected to produce $2.69 billion in additional revenue due to the 2006 changes – still less than in 2008-09.



Sources: Fiscal Note to HB 3 (2006 special session); Annual Cash Reports 2008-2011; Certification Revenue Estimate, December 2011.

The cigarette and tobacco taxes have actually exceeded estimates, bringing in $1.89 billion in 2008-09 and $1.75 billion in 2010-11 – $470 million over estimate in 2008-09 and $440 million over in 2010-11. These taxes are forecast to generate an additional $1.64 billion in 2012-13 – less than in the two prior biennia. The used-car sales tax has brought negligible amounts of new revenue – $34 million in 2008-09 and only $15 million in 2010-11, with just $29 million expected in 2012-13.

How Big is the Difference Between the Foregone Property Taxes and the New State Revenue?

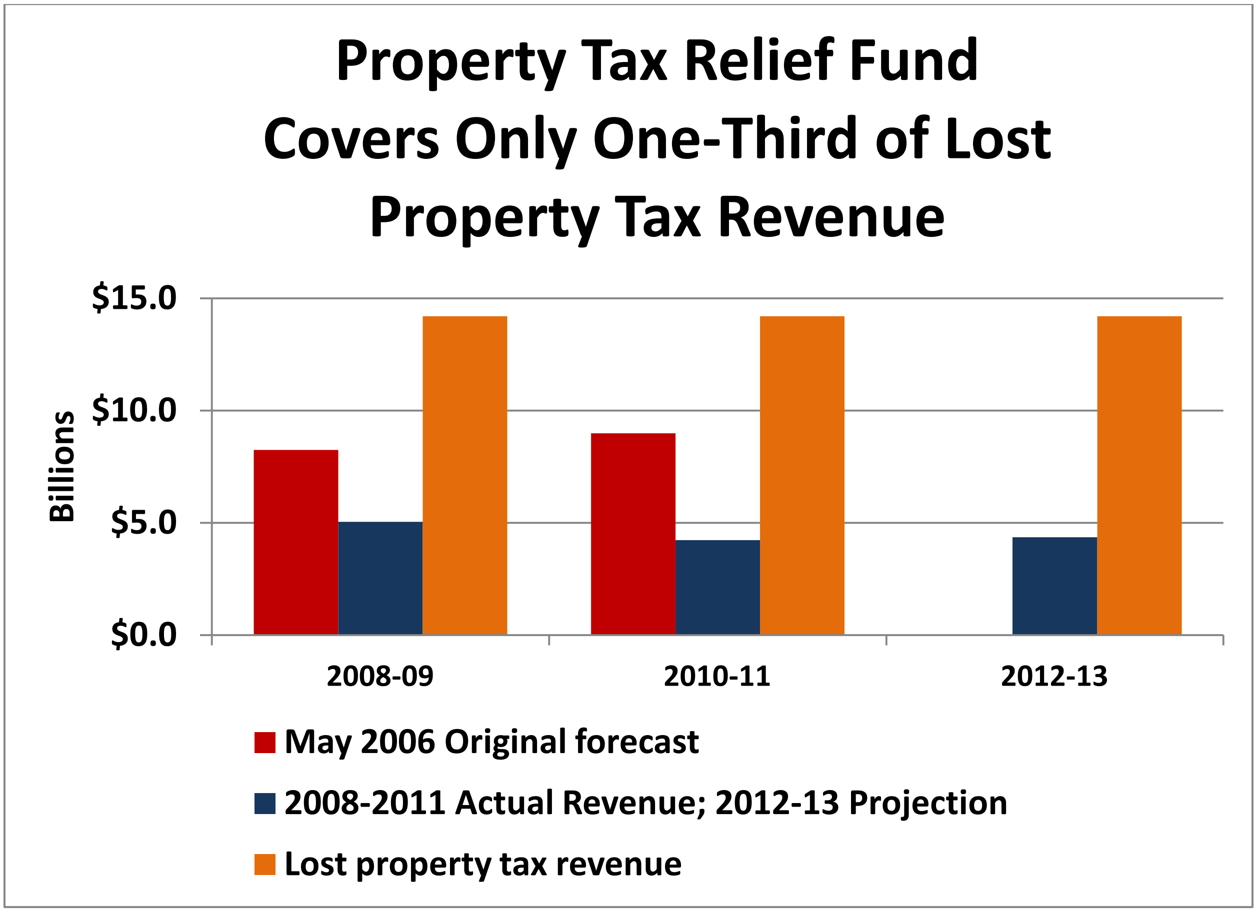
The key question is how big the difference is between the amount needed for the state to keep its promise of replacing the property taxes the Legislature required school districts to give up and the new state revenue created by the 2006 tax changes. In other words, how big is the state's structural deficit?

The answer is almost $10 billion per biennium.

In 2008-09, the additional state revenue created by the 2006 tax changes was $5.04 billion. In 2010-11, it was $4.23 billion. And, according to the Comptroller's December 2011 Certification Revenue Estimate for 2012-13, the total will be $4.36 billion in 2012-13.

Remember: the amount needed to replace the property taxes that school districts were required to give up is $14.2 billion per biennium.

So the structural deficit was $9.16 billion in 2008-09, $9.95 billion in 2010-11, and an anticipated $9.84 billion in 2012-13.



Sources: Fiscal Notes to HB 1, 3, 4, and 5 (2006 special session), HB 2 (2007); Annual Cash Reports 2008-2011; Certification Revenue Estimate, December 2011; LBB Fiscal Size-Up 2008-09.

How can the Structural Deficit be Eliminated?

The structural deficit is a result of the disparity between the property tax revenue no longer flowing to school districts and the ability of the state to replace that revenue from state taxes. The deficit can be closed from either end – either by allowing school districts to raise more money from property taxes or by increasing state revenue to support public education.

Property Taxes

The heart of the problem is that the state cannot currently fund its commitment to school districts to maintain their 2006 level of state/local revenue per student. A smaller property tax cut would have been easier for the state to cover. For instance, in 2006 the House-passed version of the tax-cut bill would have required school districts that taxed at an M&O tax rate of $1.50 per $100 of property valuation to reduce that rate to $1.33, rather than to $1.00. This smaller tax cut would have required the state to replace only $4.4 billion per biennium – almost exactly the amount currently deposited into the Property Tax Relief

Fund by the 2006 tax changes. Allowing school districts to raise tax rates and collect more revenue could reduce or eliminate the structural deficit.

School districts must currently receive voter approval, through a Tax Ratification Election (TRE), for any tax rate increase above the four cents that a school board can raise on its own. There have been 416 such elections; in 296 of these the voters have ratified the proposed rate. This is an approval rate of 71 percent, which indicates widespread public willingness to pay higher property taxes to support their local schools.

As a result of these elections, 245 districts now have an M&O tax rate at the maximum rate of $1.17, another 52 tax at between $1.04 and $1.17, and 625 at $1.04. Only 102 districts, many of which had 2006 tax rates below the maximum of $1.50, have M&O rates below $1.04. The fact that nearly one-fourth of Texas school districts are again at the maximum permitted tax rate, the key issue in the 2005 West Orange Cove decision, will undoubtedly be important in the upcoming school-finance lawsuits.

Franchise Tax

Although the underperformance of the franchise tax has contributed to the size of the structural deficit, no realistic changes could be made to the tax that would themselves close the entire $10 billion biennial gap.

The franchise tax brought in a total of $7.79 billion in 2010-11, $2.55 billion of which was determined to be due to the 2006 tax changes and therefore deposited in the Property Tax Relief Fund. In order to generate enough money from the franchise tax alone to produce the additional $9.84 billion expected to be needed to completely replace the property taxes foregone by school districts, the amount generated by the franchise tax would need to more than double! Compared to revenue under the former franchise tax, revenues would have to nearly triple.

However, there are changes that could be made to both increase revenue from the franchise tax and eliminate some objections to the current structure of the tax.

Because the tax is based on a firm's "margin" (the difference between its gross receipts and either its cost of goods sold or its cost of compensation), it is possible for a business to owe the franchise tax even in a year in which it has not made a profit. Returning to the tax base of the franchise tax before the 2006 changes, which was essentially a tax on income, would eliminate this objection and might increase the revenue generated each year, particularly if the expanded number of firms now subject to the tax is maintained.

Of course, increasing the tax rate from the current 1 percent of taxable margin (0.5 percent for retailers and wholesalers) would also raise additional revenue. An increase to 1.25 percent (and 0.625 percent) could produce an additional $2 billion per biennium.

Other taxes

The state must expand its sales tax base to include additional services, preferably with a plan to offset the regressive effect on low-income families. The Tax Code must be subjected to sunset review in order to root out outmoded or wasteful tax breaks, such as the $1 billion-per-year high-cost natural gas exemption. And the state needs to look closely at various Healthy Texas taxes, such as increasing tobacco and alcohol taxes or creating a sugar-loaded soft drink tax. Depending on other tax choices, the state may need to consider increasing the sales tax rate, again with protections for low-income families, who are most affected by sales taxes.

Conclusion

The $10-billion structural deficit created in 2006 will appear in every state budget until the Legislature fills the hole with additional revenue. The underfunding of public education formulas by $4 billion in the 2012-13 budget, as well as the elimination of another $1.3 billion in specific programs such as dropout prevention and state grants for full day pre-K, were a direct result of the Legislature's failure to deal with the structural deficit. As long as the Legislature refuses to eliminate the structural deficit, it will be unable to meet the needs of our state for education and health and human services.