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Contact: Dick Lavine, lavine@cppp.org
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FRANCHISE TAX CUTS COULD ENDANGER FEDERAL ECONOMIC RECOVERY AID

On Monday, May 4, the House will consider HB 4765 by Representative Rene Oliveira, which would reduce franchise tax revenue available to fund the 2010-11 budget by $172.1 million. Bills that reduce franchise tax revenue, which is dedicated to replacing school property tax revenue lost to the tax cuts enacted in the 2006 special session, could endanger the state's receipt of federal stimulus money that is intended to restore state support for education by signaling that the state does not need the federal aid for this purpose. In any event, now is not the time to cut business taxes. Texas needs to focus on protecting families.

- **The proposed budget uses federal stimulus money to fund the Foundation School Program – the main source of state support for public education.**
- **Reducing franchise tax revenue would reduce revenue to the Foundation School Program**
- **The federal government therefore could conclude that the state is using federal stimulus money to fund a tax cut, rather than to support public education.**
- **We should not reduce state revenue before funding critical state needs.**
- **We need public spending during economic weakness to both stimulate our economy and protect our most vulnerable citizens.**

Cutting Franchise Taxes Could Endanger Federal Economic Recovery Aid

Use of recovery money

The federal stimulus bill (the American Recovery and Reinvestment Act of 2009 - ARRA) allocates to Texas, through the State Fiscal Stabilization Fund, $3.2 billion that may be used only to support public and higher education. The state must first use this allocation to "provide the amount of funds, through the state's primary elementary and secondary funding formulas, that is needed to restore, in each of fiscal years 2009, 2010, and 2011, the level of state support provided through such formulae to the greater of the fiscal year 2008 or fiscal year 2009 level." (ARRA, sec. 14002(a)(2)(A)). A similar provision applies to higher education funding.

If any stabilization funds remain after the state has "restored" state support for education, the money must be sent to school districts according to the Title I formulas, which are linked to the number of low-income students in the national school lunch program.

Questions have been raised about whether Texas needs the recovery money to "restore" state funding through the Foundation School Program – the state's primary school funding formula – or whether the proposed LBB budget would have fully funded the state's share of the formulas, so that no additional money was needed to "restore" funding.

All twelve Texas Democrats in Congress have signed a letter asking the U.S. Secretary of Education to "ensure that federal funds from the State Fiscal Stabilization Fund reach local school districts" and that "stabilization dollars cannot supplant state funding for education, but rather must go to increasing support for our local schools." The superintendents of eleven of the largest school districts in Texas sent a similar letter to the Secretary in early April. On April 6, the Midland school board adopting a resolution asking the Legislature allow the stabilization funds to flow to the local districts.

Use of franchise tax revenue

Any increase in franchise-tax revenue over its 2007 level – before the changes made in the 2006 special session took effect – goes to the Property Tax Relief Fund (PTRF) and may be used only to replace school property tax revenue lost to the tax-rate reductions required by the 2006 special session. In other words, the Property Tax Relief Fund is used solely to help finance the Foundation School Program, the primary school-finance funding formula. (The PTRF also includes revenue from the increase in the cigarette tax passed in 2006 and other small sources.)

Any bill that reduces franchise tax revenue – by increasing the small-business exemption, lowering the tax rate, or increasing deductions – therefore directly reduces revenue to the Foundation School Program.

In order to maintain the state's share of school funding, this revenue loss must be replaced by another source of money. The Senate and House Appropriations versions of the 2010-11 budget plan on using $1.77 billion in Stabilization money for the Foundation School Program.

There is a danger that the U.S. Department of Education may find that any legislation that reduces revenue to a fund that is dedicated to supporting public education, while the state at the same time uses stabilization funds that may be used only to "restore" education funding, is a violation of the terms of ARRA. Because the stabilization money is being distributed in two phases, to ensure compliance with the provisions of ARRA, Texas could be putting a significant share of federal aid in jeopardy by enacting any franchise tax cut during this session.

Other problems

Bill reduces revenue needed for state services

A number of important proposals are not funded in the current versions of the appropriations bill, including such items as restoration of 12-month eligibility for Medicaid.

Technical issues

HB 4765 by Representative Rene Oliveira would exempt a business with total revenue of less than $1 million from the franchise tax. Currently, businesses with total revenue of less than $300,000 are exempt, and tax liability is phased in for businesses with up to $900,000 in total revenue. The problem with a simple $1 million exemption is that, while the tax on a business with $1 million in total revenue owes no tax, a business with $1,000,001 in total revenue could owe $5,750 under the bill. However, creating a phase-in starting with $1 million to avoid this "cliff" could significantly add to the cost of the bill.

Conclusion

Texas cannot afford a tax cut during this economic downturn when we need public spending both to stimulate our economy and protect our most vulnerable citizens. As the economic studies show, helping families is far more effective as an economic stimulus than a business tax cut. See *Assistance for Hard-Pressed Families is One of the Best Ways to Preserve and Create Jobs* (CBPP Jan. 2009) at http://www.cbpp.org/cms/index.cfm?fa=view&id=2229&zoom_highlightsub=1.64. We need to focus on Texas families.