



2008

BUILDING TEXAS

THE TAX AND BUDGET PRIMER



Additional Reading

Center for Public Policy Priorities. *The Texas Health Care Primer*. Revised November 2007.
www.cppp.org/research.php?aid=715&cid=3&scid=4

House Research Organization. *Schools and Taxes: A Summary of Legislation of the 2006 Special Session*. May 25, 2006. www.hro.house.state.tx.us/focus/schools&taxes79-13.pdf

House Research Organization. *Writing the State Budget: 80th Legislature*. February 14, 2007.
www.hro.house.state.tx.us/focus/writing80.pdf

Texas Senate Research Center. *Budget 101: A Guide to the Budget Process in Texas*. January 2007.
www.senate.state.tx.us/SRC/pdf/Budget101_2007-web.pdf

Legislative Budget Board. *Financing Higher Education in Texas: Legislative Primer*. Third Edition. January 2007.
www.lbb.state.tx.us/Higher_Education/HigherEd_FinancingPrimer_0107.pdf

Legislative Budget Board. *Financing the Judiciary in Texas: Legislative Primer*. First Edition. January 2007. www.lbb.state.tx.us/Other_Pubs/Judiciary_Leg_Primer_0107.pdf

National Association of State Budget Officers. *State Expenditure Report 2006*. December 2007.
www.nasbo.org/Publications/PDFs/fy2006er.pdf

BUILDING TEXAS

THE TAX AND BUDGET PRIMER

2008



Center for Public Policy Priorities

The Center for Public Policy Priorities is a 501(c)(3) nonprofit, nonpartisan research organization committed to improving public policies to better the economic and social conditions of low- and moderate-income Texans. We pursue our mission through independent research, policy analysis and development, public education, advocacy, coalition building, and technical assistance.

Contributors

F. Scott McCown, Executive Director

Dick Lavine, Senior Fiscal Analyst

Eva DeLuna Castro, Senior Budget Analyst

Lesley Ramsey, Outreach Director

© Center for Public Policy Priorities, May 2008

You are encouraged to copy and distribute without charge with credit to CPPPP.

900 Lydia Street • Austin, TX 78702 • Phone (512) 320-0222 • Fax (512) 320-0227

www.cpppp.org

Conclusion

As we send this primer to press, our country faces significant economic uncertainty. Texas is unlikely to be immune from any serious weaknesses in the national economy (recession, high inflation, weak dollar, tight credit), so we must plan prudently.

Texas legislators who will convene in January 2009 to write a budget for 2010-11 will be starting from a base of inadequate revenue compared to the need to invest in public structures for a more prosperous future. In addition, the legislature has committed to school property tax cuts that are far larger than the new state taxes enacted to replace the lost revenue, creating an immediate drain on resources badly needed for other purposes. It may be necessary to exhaust cash balances in 2009 to fund the property tax cuts.

By January 2011, when the legislature convenes to write the budget for 2012-13, the state's fiscal position may be worse. Any deep or prolonged recession between now and 2011 could significantly reduce tax receipts. But whatever happens in our economy, in 2011 Texas will still be facing serious, growing needs with a tax system that doesn't raise enough money to fund those needs.

At a minimum, Texans need to take the modest steps to change our revenue system outlined on pages 35-38, while avoiding the harmful missteps described on pages 39-44. Texans must also begin a serious discussion about how to restructure our revenue system to maintain our prosperity and build the Texas of tomorrow. We hope this primer fuels that discussion.

and local governments already rely too heavily on sales taxes and other consumption taxes (on sales of motor vehicles, gasoline, cigarettes, and alcohol), which account for almost three-fourths of state tax revenue. These taxes takes a much greater percentage of income from a low- or moderate-income family than from a higher-income family (see page 23).

Sales tax holiday

For three days each August, Texas shoppers do not pay sales tax on clothes, shoes, and school backpacks that cost less than \$100. Proposals have been made to lengthen the sales tax “holiday” or the list of tax-exempt items. Although the tax holiday was created to help lower-income families, it ends up giving a larger tax break to higher-income families who can afford to spend a lot of money in one shopping trip. Families with enough income to pay for a school year’s worth of clothes do better than families who can buy just one outfit at a time. One study showed that more than 40% of the total tax savings goes to families with incomes over \$70,000. See www.cppp.org/research.php?aid=703&cid=7 for more information.

Gambling

Gambling has the same effect as a regressive tax—families with less income tend to lose a much greater percentage of that income to gambling than do higher-income families.

The state has turned to gambling in a search for non-tax revenue, most recently by establishing a state lottery. Analyzing the lottery as a revenue source highlights the problems with any further reliance on gambling, such as video lottery terminals (VLTs) or casinos, to fund public services. The Texas lottery began with rapidly growing ticket sales and revenue for the state, but after five years public interest fell off quickly. The underlying problem is a sharp drop-off in participation. In the year of peak revenue, 70% of adult Texans bought at least one lottery ticket, but by 2006 only 45% of adults bought tickets. Revenue from VLTs or casinos could be expected to be similarly uncertain and volatile.

Supermajority for franchise tax rate increase

Requiring a vote of two-thirds of the legislature to raise the rate of the franchise tax—rather than a simple majority vote—would violate the basic principle of majority rule that is at the heart of American democracy. A supermajority requirement would hamper the state’s ability to meet future budget shortfalls by generating new revenue, rather than by relying solely on cuts in services. Of course, the most likely future shortfall is due to the 2006 decision to reduce school property taxes by much more than the new revenue generated to replace them, primarily through changes in the franchise tax.

Table of Contents

Foreword	3-4
Who is Texas?.....	5
What are Texas’ Needs? Are We Meeting Those Needs?	6-7
What are Texas’ Spending Priorities?	
Local government	8-9
State government.....	10-11
How Does Texas’ State Spending Compare to Other States?	
How Is It Changing?	12-13
Does the State Have a “Surplus”?.....	14
What is the State’s Rainy Day Fund?.....	15
What State and Local Taxes Do Texans Pay?.....	16-17
Where Do State Revenues Come From?.....	18-19
What Taxes Does the State Collect?	20-21
Who Pays Texas Taxes?	22-23
Who Pays School Property Taxes?.....	24-26
Statewide homestead exemptions • Over-65 “tax freeze” • Local optional percentage homestead exemption • 10% cap on appraisal increases • Local optional over-65 and disabled exemption • Other deductions • Productivity value loss (“ag exemption”)	
How Has Funding for Public Services Changed in Texas?	
Local government share is higher	27-28
Sales tax applies to a shrinking share of economy.....	28-29
Federal funds are more critical than ever	30-31
What Part of a Balanced Tax System is Texas Missing?	32

What Changes Were Made to the Revenue System in 2006?	33-34
What are Some Modest Steps to Raise Revenue?	35-36
Sales price disclosure • Quality Assurance Fee • Sunset review of tax exemptions • Green taxes	
What are Some Modest Steps to Increase Fairness?	37-38
Property tax circuit breaker • Low-income rebate	
What Missteps Should We Avoid?	39-44
Spending limits • Property tax cuts • School property tax abatements • Property value study margin of error • Warehouse inventory • Central Appraisal District board members and chief appraiser • Appraisal caps • Sales/property tax swap • Sales tax cap • Sales tax holiday • Gambling • Supermajority for franchise tax rate increase	
Conclusion	45
Additional Reading	46

Sales/property tax swap

Some have proposed that local school property taxes should be replaced with new state revenue raised by a state sales tax rate increase or expansion of the sales tax to more goods and services.

Replacing school property taxes by increasing the sales tax would require nearly doubling the current state sales tax rate. Local school property taxes are expected to generate about \$15 billion for 2007-08 school operating costs. To raise that amount of money from the current sales tax base, the tax rate would have to be increased from 6.25% to about 11%.

Most families would pay more if a higher sales tax replaced property taxes. The sales tax is extremely regressive, meaning it takes a much larger percentage of the income of a low- or moderate-income family than of a higher-income family. For 80% of Texans, replacing school property taxes with a higher sales tax would mean a much larger overall tax bill. Only families earning more than \$110,000 would pay less in taxes.

To generate enough money without raising the sales tax rate, sales taxes would have to cover necessities. Families would have to pay sales taxes on currently untaxed items such as groceries; doctors' visits and medicine; and natural gas, electricity, and water used in the home. Businesses would also have to pay on essential business and professional services.

Replacing property taxes with sales taxes would destabilize funding for public education. When it comes to something as important as public education, Texas should not put all its eggs in one basket. Using both property and sales taxes buffers our schools from economic downturns. While the sales tax is the major source of state tax revenue, collections can be quite volatile. For example, sales tax revenue fell in 2002 and 2003. In contrast, property tax values are much more stable, so can provide a better base of support for public education.

Eliminating school property taxes would sever an important link between a community and its public schools. Under the current system, communities wishing to raise their own property taxes to improve their local schools can vote to do so. If school funding were centralized into the state sales tax, this opportunity would be eliminated. Schools would only have the amount of money per student assigned by the state to all school districts. Communities could no longer add to this basic level of funding with local property taxes to supplement the basic state program. See www.cppp.org/category.php?cid=7 for more information.

Sales tax cap

In addition to the 6.25% state sales tax, local governments can levy local sales taxes, as long as the total sales tax rate does not exceed 8.25%. The 2007 session saw several proposals to break the total sales tax "cap" by allowing increased local sales taxes for such purposes as funding commuter rail systems or emergency medical services, or to supplant property taxes. Texas state

lower-priced homes. A lower cap would affect more homes than the current cap, but would probably not change the distribution of benefits.

Another problem is that, by limiting only the value of homesteads, the cap results in businesses paying a greater share of property taxes. The 35% of Texas families who rent their homes also have to pick up an additional share of property taxes, since they pay the tax bill of their landlord, who passes it on to them in the form of higher rents. But expanding the cap to cover business property just creates other problems. The value of business property is very sensitive to changes in the economy, so it tends to rise and fall much more than the value of homes. If business property that was covered by an appraisal cap suffered a sharp fall in market value, even if the value of the property quickly recovered, the cap could hold the taxable value significantly below market value for years.

Because the lower valuations would reduce the amount schools would collect in property taxes, a lower cap would increase the cost to the state of supporting public education. The Legislative Budget Board has estimated that a 3% cap would cost the state \$517 million annually by the third year after it took effect. In addition, the lower values would reduce county property tax revenue by \$208 million a year and city revenue by \$180 million a year.

A lower cap on appraisal increases would create severe imbalances within the property tax system by further weakening the link between the market value of a residential homestead and its taxable value. An artificial cap creates the “Welcome, Stranger” phenomenon: The taxable value of a homestead would be raised to its true market value when it was sold. Two neighbors living in identical houses would pay the same amount in property taxes, as long as neither moved. But if one sold his or her home, the newcomer (the “stranger”) would be charged taxes on the full market value of that house, while the person who did not move would pay on only a fraction of the true value. This would provide a real disincentive to moving into a nicer home and might discourage people from moving to Texas.

Another odd result of a cap on residential appraisals is a strong incentive for local governments to attract retail business, rather than new homeowners. Retail centers supply local governments with sales tax revenue, which would be unaffected by an appraisal cap and could exceed the cost of any additional demand for public services, such as police and fire protection and new roads. Local governments might also create or increase fees to pay for routine services such as garbage collection or street maintenance. Since fees are often collected on a per-household basis, they would further unfairly burden low- and moderate-income families.

See www.cppp.org/research.php?aid=556 and www.cppp.org/research.php?aid=77 for more information on appraisal caps.

Foreword

Texas is our home. Homes have many structures and systems—foundations and framing, electrical and plumbing, heating and air conditioning—all engineered to function together. A home requires regular maintenance, and as a family grows or has other new needs, a home must be updated.

For generations, Texans have worked together through our state and local governments to create the state we call home. Like any home, Texas has many structures and systems. These public structures—our civil and criminal justice systems, our public education systems, our transportation systems, and our health and social services systems—have a great deal to do with determining what kind of place Texas is to live.

Currently, our public systems are straining to keep up with the demands of our growing and vibrant state. Since 2000, Texas has added almost as many people to its population as live in the cities of Houston and Austin put together. Half of these new Texans are children, the next generation responsible for Texas.

Planning for our future is essential. What are our goals? What public systems do we need to meet those goals? What will these systems cost? How do we raise the money? Together, we must answer these questions. And just as a smart builder uses good engineering principles to build a home, we should look to good fiscal principles in building Texas.

A good budget is balanced. A good budget promotes future economic prosperity through investments in public structures that create opportunities for all Texans. A good budget sets aside money when times are good to provide Texas families protection when times are tough.

A good revenue system contributes to economic growth. A good revenue system relies on diverse sources for stability. A good revenue system draws upon the strongest parts of our economy while requiring all of us to contribute based upon our ability.

(continued)

In recent years Texas has departed from these principles. But change is in the air. We sense a growing willingness to take a longer look, to think about what we need for a prosperous future, to get back to sound planning.

We offer this primer as a tool for understanding where we are today and what it is going to take to create a place of opportunity and prosperity for all Texans.

F. Scott McCown
Executive Director

A study by the International Association of Assessing Officers in 2001 stated that the comptroller lacks sufficient funding, staff, training, computerization, and information support technology to perform such a large study. Additional funding might allow the comptroller to increase the accuracy of the study and expand its coverage to include industrial property.

Warehouse inventory

In 2001, voters approved a constitutional amendment to allow local governments to exempt from property taxes merchandise that is stored temporarily en route to another location. In 2007, the legislature implemented this amendment with House Bill 621, which granted the exemption unless the city, county, school district, or community college district decided to tax these goods. However, the bill may have inadvertently exempted all inventories, not just those in transit, so many local governments decided to continue to tax these items. Implementation of this exemption, even in its limited form, would reduce school property tax revenue by \$64.1 million in the 2010-11 biennium.

Central Appraisal District board members and chief appraiser

The purpose of central appraisal districts is to determine the market value of taxable property. This is a technical function that should have no political component. The members of the appraisal district board are appointed by the local jurisdictions levying taxes on property in that county. The board then appoints the chief appraiser, who manages the district office. The appraisal function is totally separate from setting tax rates, which is done by each local taxing unit, or creating exemptions and special treatment, which is done by the legislature. Electing appraisal board members or the chief appraiser would introduce harmful political considerations into the appraisal process. After all, the most likely campaign promise would be to cut appraised values, even if they no longer accurately reflected true market value.

Appraisal caps

Under current law, the taxable value (appraisal) of a homestead may not increase faster than 10% per year.

Appraisals in each county are made by central appraisal districts, which set the property value used by all local taxing units—school districts, cities, counties, community colleges, and special districts—in taxing property within their jurisdictions.

There have been repeated proposals to reduce this cap, which is intended to protect homeowners from “sticker shock” due to extreme inflation in property values. An appraisal cap would increase the disproportionate share of property taxes paid by lower-income families. More than half of the benefit of the current cap goes to families with incomes over \$110,000 per year. Higher-income families live in higher-priced homes, which tend to gain in value more quickly than

School property tax abatements

School districts may grant property tax abatements to businesses that make a specified level of investment and meet certain wage and benefit requirements. The cost of the property tax revenue lost to these abatements is borne by the state through the school finance system. In the 2010-11 biennium, abatements are expected to reduce Foundation School Program revenue by more than \$500 million—enough to fund a pay raise of nearly \$1,000 for all classroom teachers! The abatement program was recently expanded to include nuclear and coal gasification plants, potentially greatly increasing the cost to the state. In addition, the requirement for a minimum number of new jobs was eliminated. Concern over the program’s continued expansion led to the creation of interim studies by the House State Affairs, Economic Development, and Energy Resources Committees; their reports are due before the 2009 legislative session. See www.cppp.org/research.php?aid=652&cid=5 for more details.

Property value study margin of error

To ensure the accuracy of property values set by local appraisal districts, the comptroller annually double-checks their work by studying a sample of properties in each district. Since the state gives more aid to school districts with lower property values, values that are lower than actual market values cost the state more money.

The comptroller each year carries out a “ratio study,” comparing the local appraisal district’s estimate of market value to the comptroller’s own determination. If the appraisal district’s value is within 5% of what the comptroller determines is correct, then the district’s values are used in distributing state aid to schools. If the local value is too low, the state-determined valuation is used (after a two-year grace period). The comptroller also conducts a performance audit of any appraisal district that falls short of the required measures of accuracy.

The state’s study does not directly affect the value on which taxes are levied. It does, however, give school districts a strong incentive to ensure accurate valuations by their appraisal district, whose board of directors includes several members appointed by school districts in the county.

Increasing the margin of error would weaken the incentive for accurate valuations, leading to deliberately lowered appraisals. The Legislative Budget Board estimated that a 10% margin of error would cost the state \$825 million a year in general revenue from the Foundation School Fund by the fourth year of implementation.

The comptroller does not report statewide median appraisal ratios for industrial real or personal property, noting that too few sample observations are available to produce meaningful ratios, so the state accepts local valuations. However, since industrial property accounts for more than 9% of total taxable value statewide, this is a significant shortcoming in the study.

Who is Texas?

The Lone Star State offers a vast landscape and diversity of lifestyle unrivalled by any other state in the nation. Whether you prefer the bustle of a big city or the solitude of the West Texas plains, hiking and biking along winding Hill Country trails or lounging near the surf of the state’s 600 miles of coastline, you can find a place to make your home in Texas.

Strong public structures have supported the drive and aspirations of rugged Texas individualists. Texas is the #1 exporting state in the nation: our transportation infrastructure and public maintenance of ports, waterways, railways, and highways make this possible.

In 2006, Texas was home to the 4th, 7th, and 9th most populous cities in the nation (Houston, San Antonio, and Dallas), and to three of the fastest growing metro areas (Austin-Round Rock, McAllen-Edinburg-Mission, and Laredo).

Indeed, population growth poses some of the challenges we face moving into the future. Texas is riding a wave of demographic changes that are sweeping the nation. In 2003, Texas became the 4th state (the others are Hawaii, New Mexico, and California) in which non-White residents are more than half of the population. Also significant, children and the elderly comprise greater shares of our population. The table below shows how some of Texas’ demographics—many of which create a greater need for public services—compare to the national averages.

	U.S. Average	Texas	Texas rank
Adults without a high school degree, 2006 (% of adults age 25 and over)	15.9%	21.4%	2nd
Birth rate, 2006 (live births per 1,000 population)	14.2	17.0	2nd
Share of population under age 18, 2006	24.6%	27.7%	3rd
Limited English Proficient students/English Language Learners in public schools, 2005-06 (% of all students)	9.1%	15.7%	4th
Poverty rate, 2006	13.3%	16.9%	7th
Child poverty rate, 2006	18.3%	23.9%	7th
Elderly (age 65+) poverty rate, 2006	9.9%	12.3%	9th
Family income ratio: top 20% to bottom 20%, 2004-06	7.3	7.9	9th

SOURCES: U.S. Census Bureau, American Community Survey; National Center for Health Statistics; National Center for Education Statistics; Economic Policy Institute/Center on Budget and Policy Priorities. Washington, D.C., is not included in 50-state rankings.

What are Texas' Needs? Are We Meeting Those Needs?

Our state's population is changing in important ways. We are growing and becoming more diverse. We are becoming less rural and more urban and suburban. As we advance into the 21st century, elderly residents will account for a greater share of our overall population. How we manage and improve our public structures to prepare for these changes will largely determine the opportunities available to future Texans.

A recent national study by the Tax Policy Center and Federal Reserve Bank of Boston concluded that Texas has greater requirements for state and local spending than most other states, but makes less effort to raise the necessary revenue.

The need for public services

The study calculates each state's expenditure need—the amount a state would have to spend on its residents to provide the average level of services provided by state and local governments. This calculation takes into account the socioeconomic and demographic characteristics of a state, as well as the local cost of providing services.

For instance, the relative need for public education spending is determined by the number of school-age children and the proportion of those children living in poverty. This is then adjusted for the cost of providing education—such as teachers' salaries—compared to other states. (Texas' costs are slightly below the national average.)

The effort to meet that need

The study separately calculates how much each state actually spends compared to the amount it would need to spend to provide the average level of services. Texas spends only 79% of the amount calculated as necessary to meet the needs of its residents at the average national level.

The ability to raise revenue

The study then looks at Texas' revenue capacity—the total revenue state and local governments could raise if they applied a national-average level of taxes and fees.

The first step determines the total tax base available—for instance, the amount of annual sales or the total property value, minus exemptions usually applied. Then the study applies the national-average tax rate to each potential tax base. This gives the revenue capacity per capita. Texas' revenue capacity is below average—33rd among the 50 states.

What Missteps Should We Avoid?

Spending limits

One of the Texas Constitution's limits on state spending is a cap on the spending of state tax revenues that are not constitutionally dedicated. Spending cannot grow faster than the Legislative Budget Board's estimate of the rate of economic growth, which is measured by state personal income—the best indicator of the ability of Texans to support state services.

In the 2007 session, proposals were filed to limit spending growth to the growth of population and inflation, and to expand the scope of the cap to include all sources of state revenue other than federal funds. These simplistic suggestions ignore the reality that health care costs—a major element in the state budget—are growing far faster than the general rate of inflation. Similarly, the number of school-age and over-65 Texans, who require a greater level of state services, is growing faster than the population as a whole. The proposed restrictions would thus force annual reductions in the level of services and pit groups of Texans against each other.

In Colorado, which had a very restrictive population-and-inflation revenue cap, voters decided in 2005 to suspend the limit so that the state could begin restoring funding for public services and avoid making even more drastic cuts.

Property tax cuts

The money generated by tax changes made in the 2006 special session falls far short of the amount needed to replace property tax revenue lost to the required tax rate cuts. Any further rate reductions would only create a larger hole in future state budgets. In addition, it is important to remember that the property tax is a good revenue source that should retain its major role in funding public education and other local government services.

The property tax has performed relatively well as a revenue source for Texas school districts, cities, and counties. From 1995 to 2006, the value of taxable property statewide grew at the same rate as taxable sales, although neither tax base kept up with growth in personal income. Both total and taxable property values statewide have increased every year over the past ten years, but taxable sales fell from 2001 to 2002, and remained below 2001 levels in 2003—the cause of the large state budget shortfall that faced the 2003 Legislature.

The proportion of total property value that is subject to the school property tax has stayed relatively constant since the homestead exemption was tripled in 1997; about 80% of total value is taxable, after accounting for exemptions, agricultural valuations, the over-65 tax freeze, and the cap on appraisal growth. In contrast, the sales tax covers a shrinking proportion of total sales. Taxable sales accounted for 25% of all sales in 2002, but only 21% of all sales in 2006, as untaxed services grew in importance in the Texas economy.

A unique feature of circuit breakers is the ability to benefit renters, who pay property taxes indirectly—through higher rents rather than directly to local governments. Twenty-six states and the District of Columbia provide relief to both renters and homeowners, while two states have circuit breaker programs for renters only.

These states make some assumptions about how much of a rent payment represents property taxes, which can vary among regions and according to local market conditions. Property tax rent equivalents vary from 6% to 35% of rent, with most states in the 15% to 20% range. Benefits can be as high as \$2,100 per year and average nearly \$1,100.

Although benefits are linked to household income, a state does not have to have an income tax to successfully operate a circuit breaker program. Five of the nine states lacking a state personal income tax—Alaska, Nevada, South Dakota, Washington, and Wyoming—have adopted circuit breakers. See www.itepnet.org/pb10cb.pdf for more information.

Texas Has Greater Public Needs, But Makes Less Effort

	U.S. Average	Texas	Texas rank
Expenditure need	\$6,007	\$6,456	6th
Actual expenditure	\$6,007	\$5,127	47th
Revenue capacity	\$4,659	\$4,271	33rd
Actual revenue	\$4,659	\$4,107	37th
Fiscal capacity	100	86	39th

SOURCE: *Measuring Fiscal Disparities Across the U.S. States: A Representative Revenue System/Representative Expenditure System Approach, Fiscal Year 2002*, joint report by Tax Policy Center (Urban Institute and Brookings Institution) and the New England Public Policy Center at the Federal Reserve Bank of Boston, November 2006. www.urban.org/UploadedPDF/311384_fiscal_disparities.pdf

Actual revenue effort

A state's revenue effort indicates how much a state and its local governments are taxing their available resources compared to other states. Texas' actual revenue per capita is below its capacity. **In other words, Texas has a below-average total tax base, and it taps this base at a below-average rate.**

What should Texas do?

Texas needs to promote the growth of its tax base so that it will be able to better meet the needs of its residents. Over the long term, this will require investments in public systems, particularly education, health and human services, and transportation.

To make that investment, Texas must call more upon the resources it already has.

See www.cppp.org/research.php?aid=597&cid=7 for more information.

What Are Texas' Spending Priorities?

Local government

In 2005, Texas' local governments—such as school districts, cities, counties, and community college and hospital districts—had an estimated total of \$77 billion in general spending, or \$3,368 per state resident. In comparison, the national per-capita average for local government spending was \$3,844 in 2005, 14% higher than in Texas.

The figure on the next page shows that by far, the primary area of local spending is public elementary and secondary education. Our local spending is particularly concentrated in this category not because Texas spends more than other states do per pupil, but because of our younger population. Almost one in five Texans (19.4%) was school-age (5 to 18 years old) in 2006, compared to 17.8% nationally. Higher education's share of local spending (i.e., community colleges) is also higher, again because of Texas' younger population.

In the area of Medicaid, cash assistance, and other public assistance, Texas local government spending is considerably below the national average. This is because in Texas, Medicaid and cash assistance are primarily a state function, whereas other states administer these services at the county level or have local programs in addition to state-funded services.

Interest on debt takes a relatively higher share of Texas local government spending mainly because of rapid population growth and the ensuing need to finance the building of schools and other basic infrastructure through bonds. Long-term debt in 2005 averaged \$5,679 per capita for Texas local governments, 1.4 times as much as the U.S. local government average (\$4,204) and 7.4 times as much as Texas state government debt (\$768) per capita.

One important thing to consider when analyzing local government spending is that it usually includes (as in the text above and the figure at right) revenues from state and federal government. Looking only at "own-source" spending, Texas' local governments provided \$54 billion in public services in 2005, compared to \$49 billion for Texas state government.

Another thing to note is that Texas has more local governments (4,835 in 2007) than all other states except for Illinois and Pennsylvania. Texas also has huge local variations in population and taxable resources—for example, property values or retail sales. As a result, the Texas state average for local governments may be quite different from the spending by a particular city, county, or school district. Usually, more up-to-date and detailed information about a local community's spending priorities can be found in a government's adopted budget or Comprehensive Annual Financial Report, often available online.

What Are Some Modest Steps to Increase Fairness?

Low-income rebate

The lowest-income families, who are less likely to be property owners, may have not seen any benefit from the recent property tax reductions. One innovative program, adopted several times by the Senate during recent legislative sessions, would have targeted the 800,000 households who use a Lone Star Card for Food Stamps or cash assistance. These families would have received a cash payment or additional nutritional assistance of \$10 per month.

This small benefit would also help mitigate the regressivity of Texas' state and local tax system. Many other states use income tax credits, such as the state earned income tax credit offered by 23 states, to improve the equity of their tax systems. One state without a personal income tax—Washington—this year adopted a credit that is linked to a family's federal EITC benefit. Since the Internal Revenue Service (IRS) is responsible for determining eligibility and calculating a family's credit, only minimal administrative processing is left to the state. The state uses IRS data to alert families of their eligibility for the credit and automatically generates applications. Families simply sign and return the form to confirm their residency and accept their credit.

Property tax circuit breaker

Property taxes can rise even when a family's ability to pay those taxes has not changed. Most states address this problem by offering a "circuit breaker program," which links property taxes to a family's income.

Just as an electric circuit breaker protects wiring from an electric overload, a property tax circuit breaker protects a taxpayer from tax overload by reducing property taxes that exceed a certain percentage of a taxpayer's income. Unlike a homestead exemption, the amount of the reduction depends on both income and the property tax bill. This allows states to target benefits to homeowners having the greatest difficulty paying property taxes, such as elderly homeowners on a fixed income, without providing tax breaks to wealthy retirees. A common formula would rebate to taxpayers one-half of their property taxes in excess of 5% of family income, with benefits phased out as income rises.

The District of Columbia and 33 states currently have circuit breaker programs. Many programs are targeted at the elderly, but seven allow all households to participate without regard for age. Five other states provide more generous benefits to the elderly. Limits can be as high as \$82,650 for joint filers, averaging about \$30,000 among participating states. Maximum annual benefits reach \$1,530, with an average of \$750.

(continued)

be used to reimburse hospitals and physicians at higher Medicaid rates, improving low-income Texans' access to health care. The new QAF and federal funds could also allow some disproportionate share hospital program funds to be redirected to improvements such as electronic health records; increased graduate medical education funding; additional residency programs; increased ambulatory care/disease management; and more medical facilities.

Sunset review of tax exemptions

All Texas state agencies face periodic "sunset" review, usually every 12 years. A date is set on which an agency will be abolished unless legislation is passed to continue its functions, forcing the legislature to examine each agency and change its mission or operations if needed. The many exemptions in the Tax Code should undergo a similar review. Once an exemption is in place, it is rarely re-examined to determine whether the exemption is fulfilling its original intent or whether there is a more efficient or effective way to achieve that goal. The legislature should regularly scrutinize tax breaks to determine if their economic benefits are worth their costs in future revenue losses. Bills to create a sunset review of exemptions were recommended by the House Ways and Means Committee in the past two sessions, but did not reach the House floor.

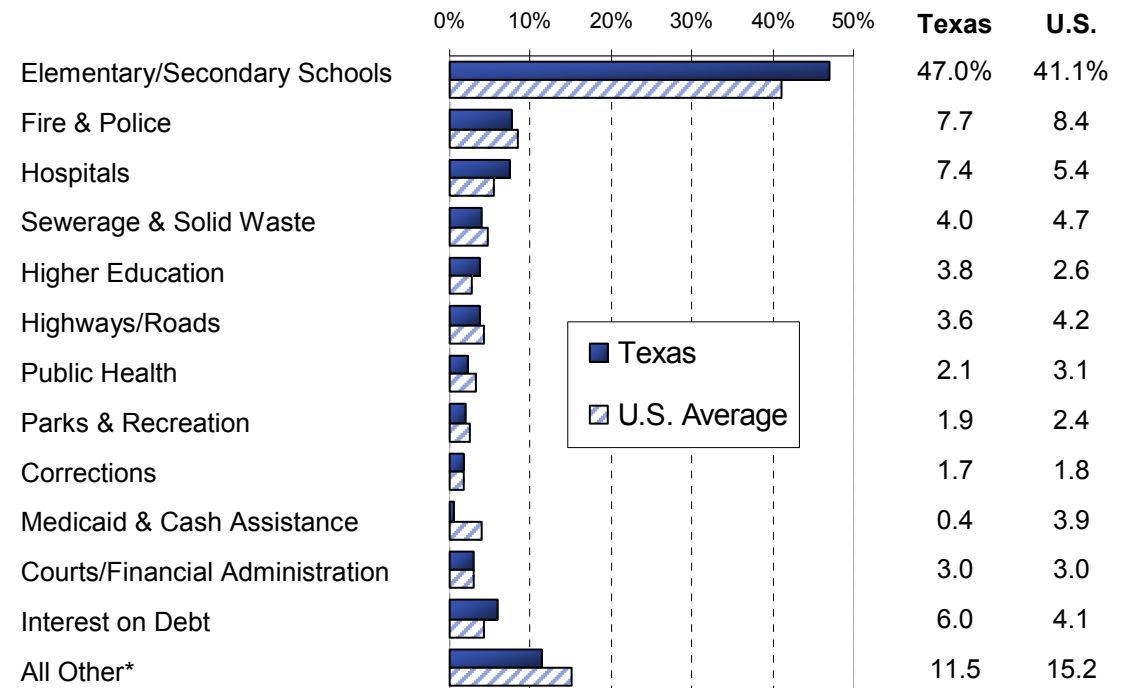
Green taxes

As concern over global warming has increased, attention has focused on using the tax system to discourage emissions of harmful greenhouse gases and fund energy efficiency. So-called "green taxes," including a tax on coal use, a higher fee on highly polluting diesel fuels, and a tax on inefficient energy producers, could generate as much as \$1 billion per biennium, which could support such programs as home weatherization or removal of older polluting cars from Texas highways.

Caps on the amount of carbon dioxide and other greenhouse gases emitted by industry are already in place in other parts of the world. Several multi-state agreements in the U.S., involving a total of 24 states, will implement a cap-and-trade system that auctions off emission permits. A similar national system will be considered over the next few years.

It is important that caps be auctioned off, rather than merely given away. The revenue could then be distributed to cushion low-income families from the effect of higher prices of fossil-fuel energy products or to support their purchase of energy-efficient products, as well as compensate companies for their financial losses. These "climate-change rebates" could be provided through the Lone Star Card (already used in Texas to distribute Food Stamp and cash assistance), which would minimize administrative costs.

Where Local Government Spending Goes, 2005
(Percent of total spending)

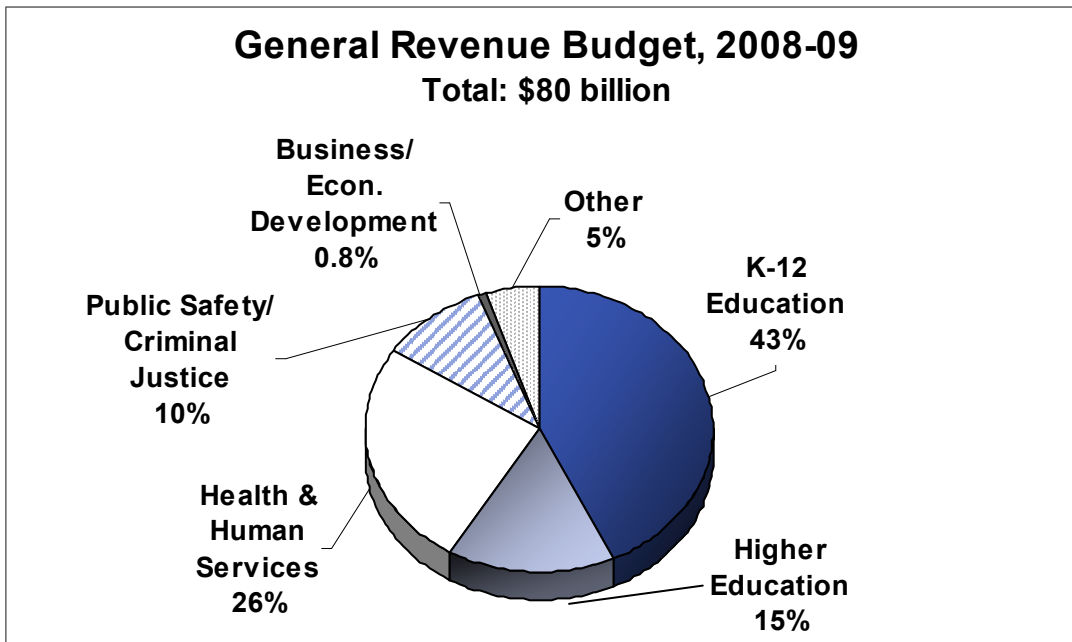
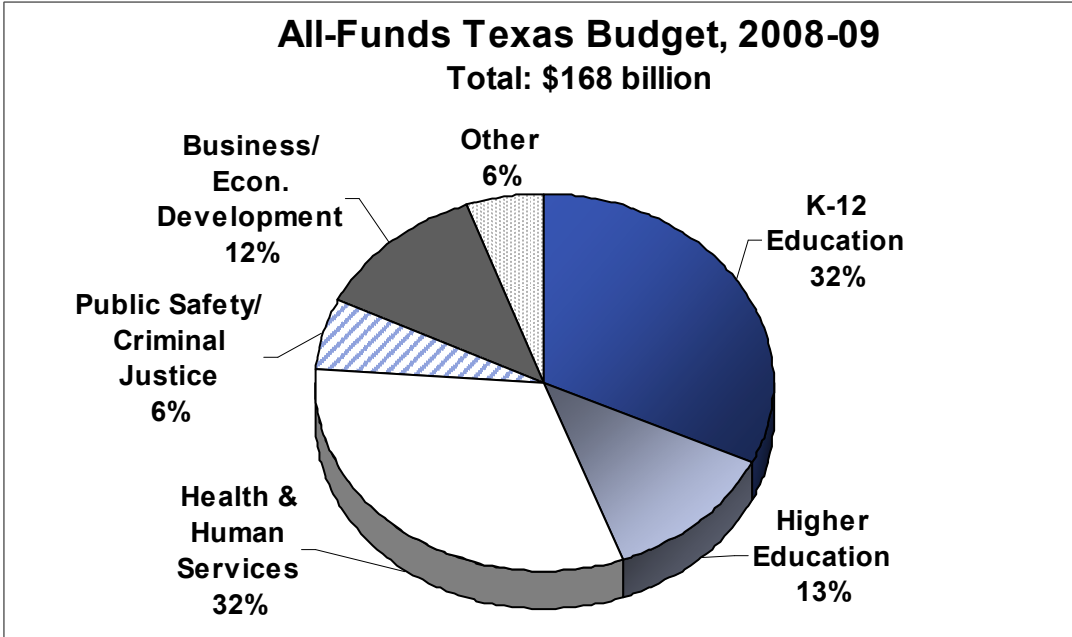


* "All Other" includes Libraries, Public Transit, Aviation, Protective Inspection/Regulation, Natural Resources, Housing & Community Development, Public Buildings, and Other Government Administration.

Economic impact

In 2005, local government payrolls accounted for about 6% of personal income in Texas. Forty-two counties (one in six) get more than twice the state average—12% to 23%—of their personal income from local government employment. Almost all of these counties are in West Texas, around Lubbock, San Angelo, and El Paso, or in South Texas.

Not surprisingly, public schools account for the lions' share of local government jobs and payrolls: of the 1 million full-time equivalent workers in Texas' local governments in March 2006, almost 642,000 (62%) were teachers and other public school employees.



What Are Some Modest Steps to Raise Revenue?

Sales price disclosure

The accuracy of the system for appraising property for taxation could be improved to ensure that taxes paid are based on the actual market value of taxpayers' property.

Local appraisal districts base valuations of property on the best information available from commercial sources, but the districts lack the comprehensive knowledge of real estate values needed for full accuracy. In particular, price information on high-end homes and on business property is very hard to obtain. To remedy this, the state should require that sales prices in all real estate transactions be disclosed. Disclosure is required in 35 states; Texas is the only state that is highly dependent on property taxes but trying to function without knowing actual sales prices. If desired, the law could make disclosure to the appraisal district confidential to protect privacy.

Increasing the amount of taxable property value, by ensuring that all property is on the tax rolls and accurately valued, is particularly important to schools. Higher property values would produce more local revenue, reducing the need for state aid and freeing state money for increased spending on education or other state services, or for reducing school property tax rates. The Legislative Budget Board (LBB) has estimated that mandatory disclosure would save the state \$174 million a year by 2012.

Local governments would also benefit from more accurate property appraisals, improving these governments' ability to meet the needs of Texas families. The LBB estimates that mandatory sales price disclosure would increase city and county property tax revenue by \$125 million a year in 2012.

Quality Assurance Fee

A "Quality Assurance Fee" (QAF) could be assessed on the revenues of hospitals and free standing surgery centers in Texas to secure additional Medicaid federal funding. For example, a QAF of 3% of revenues would raise \$1.1 billion in state revenue, which would be matched with \$1.7 billion in federal revenue.

Thirty-five states have quality assurance fees or provider taxes that produce similar matches. Texas currently assesses a QAF only on public and private intermediate care facilities for persons with mental retardation. In recent legislative sessions, unsuccessful attempts have also been made to use a QAF to improve the funding of nursing home care.

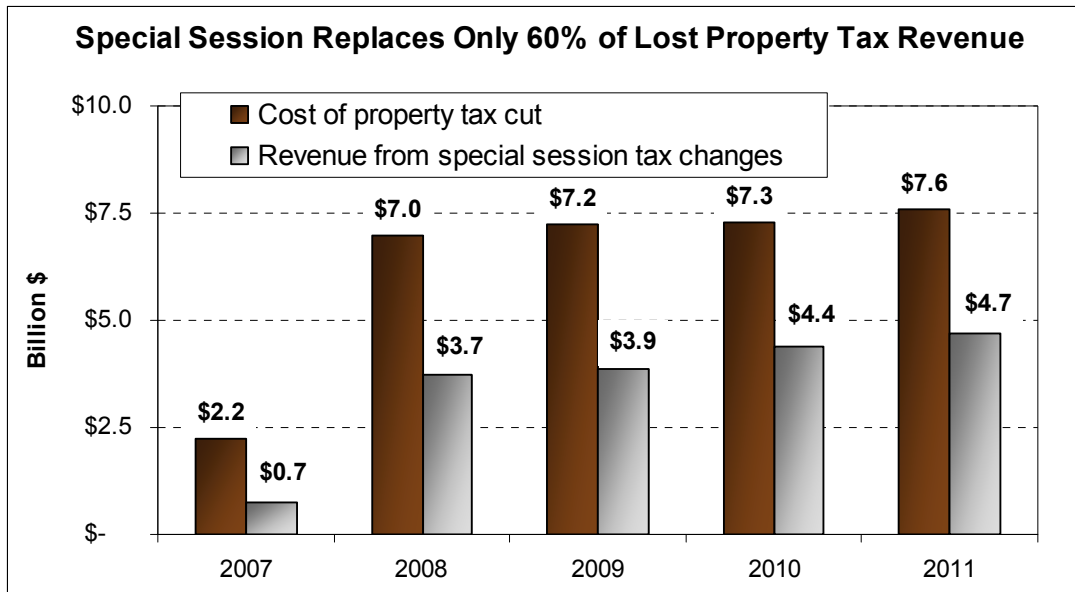
The April 2006 *Code Red* study by Texas' public medical schools recommended creating a hospital and surgery center QAF. The new QAF revenues, plus federal matching dollars, could

based on a firm's "margin"—the difference between its total revenue, and its cost-of-goods-sold or its compensation. The tax rate, which had been 4.5% of net income, is now 1% of taxable margin for most companies and 0.5% for those primarily engaged in retail or wholesale trade.

The new "margins" tax is currently expected to generate \$6.1 billion in the 2008-09 biennium for property tax cuts. However, since the first tax payments are not due until May 2008 and phase-in provisions may distort these first year's receipts, this amount is highly uncertain. A better estimate of revenue from the new tax may not be available until May 2009, near the end of the next regular legislative session.

Also in 2006, the legislature increased the state cigarette tax by \$1 a pack, from 41 cents to \$1.41; raised taxes on certain other tobacco products; and made a small change in the tax on the sale of used cars. In addition to making the Texas state/local tax system more regressive, the cigarette/tobacco tax increase is projected to be a declining source of new revenue, raising \$1.42 billion in 2008-2009, but only \$1.31 billion in 2010-2011.

The property tax cuts required by the 2006 special session are expected to reduce local school tax revenue by \$14.2 billion in the 2008-09 biennium. The tax changes made in the 2006 special session are currently forecast to produce only \$7.6 billion in 2008-09—only a little more than half of the money necessary to maintain school funding. The rest will be made up with \$731 million in cigarette taxes and other revenue deposited into the Property Tax Relief Fund in 2007, and \$5.9 billion from General Revenue.



State government

The state budget for Texas currently stands at \$168 billion for 2008 and 2009.* The top chart shows the "All-Funds" budget by major function. It differs from the bottom chart because it includes \$51 billion in federal funds; \$31 billion in revenue (such as State Highway Fund 6 and the Property Tax Relief Fund) earmarked primarily for business and economic development and education; and \$6 billion in dedicated money within the General Revenue fund.

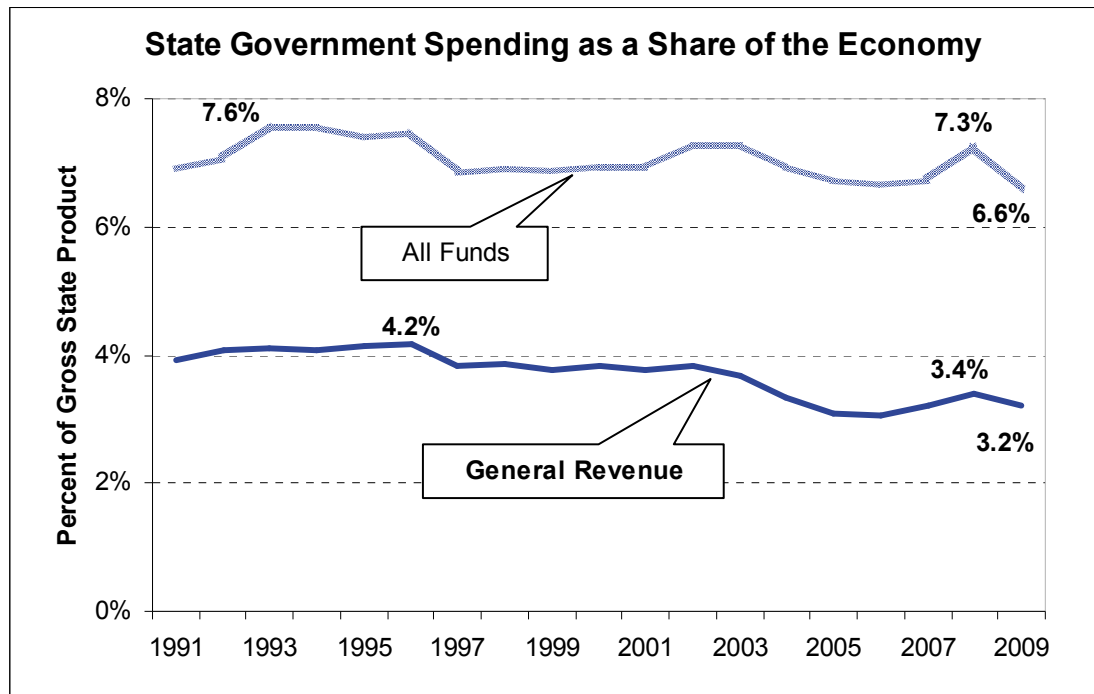
The bottom chart shows the General Revenue budget for 2008-09 by major area of spending. Public elementary and secondary schools receive 43 cents of every General Revenue dollar spent, and higher education receives 15 cents. Health and human services account for 26 cents of every General Revenue dollar; a state dollar in this category more often than not is matched by federal funds for Medicaid, the Children's Health Insurance Program, foster care, and other health and social services.

Public safety and criminal justice costs—primarily, the operation of state prisons and other facilities for adult and youth offenders—use 10 cents of every General Revenue dollar. Business and economic development, a significant part of the All-Funds budget, receives hardly any General Revenue at all. Most revenue in this area comes from federal and state highway money and federal employment, training, and child care grants. Other major uses of General Revenue include state employee health care and pensions.

General Revenue spending is often described as the "discretionary" part of the budget, giving some the impression that legislators are free to allocate General Revenue without too many restrictions. But according to the Legislative Budget Board, 83% of General Revenue and GR-Dedicated spending in 2008-09 was budgeted in compliance with the state constitution; federal or state law, regulations, and formulas; or court orders. This means that only 17% of General Revenue-related spending should be considered "discretionary."

* Texas is one of only 9 states with a true biennial budget that makes appropriations for a two-year period. In 12 states, legislators biennially enact two annual budgets, and the remaining 29 states use an annual budget process.

SOURCES: Legislative Budget Board, House Bill 1, 2007 Regular Session, Conference Committee Report, as modified by House Bill 2, House Bill 15, and Governor's Vetoes; *Fiscal Size-Up 2008-09*; National Conference of State Legislatures.



	U.S. Average	Texas	Texas rank
State government spending as a share of Gross Domestic Product, 2006 (includes capital outlays)	10.3%	6.6%	49th
State government general spending per capita, 2006	\$4,508	\$3,229	50th
State government "own-source" spending per capita, 2006 (excludes federal aid)	\$3,106	\$2,007	50th
Local government "own-source" spending per capita, 2005 (excludes state and federal aid)	\$2,914	\$2,934	12th
Federal government spending per capita, 2005	\$7,706	\$6,485	42nd

What Changes were Made to the Revenue System in 2006?

Local property taxes

In November 2005 the Texas Supreme Court struck down the state's school finance system and gave the legislature a June 2006 deadline to enact a constitutional system. The key issue was that the vast majority of school districts were taxing at or near the statutory maximum tax rate for annual operating costs ("maintenance-and-operations" or M&O) of \$1.50 per \$100 of property value. School districts argued that they could not lower the rate without giving up revenue necessary to provide a constitutionally adequate education, nor could they raise the rate under state law—in other words, that the situation was the same as if the state had set a statewide tax rate of \$1.50. School districts said that local school property taxes had therefore become a state property tax, which is prohibited by the Texas Constitution.

The Supreme Court agreed that the system had become a state property tax and that the legislature must provide enough funding to allow local districts to meet the state's educational standards, while leaving school boards "meaningful discretion" over their local property tax rates. The court did not specify how the legislature should fix the problem.

In a special legislative session in April-May 2006, the Texas legislature responded by requiring school districts to reduce their M&O tax rates by one-third over two years—in most cases, from \$1.50 to \$1.00 per \$100 of property value—with the lost revenue replaced by additional state aid. School boards could then raise this "compressed rate" by 4 cents by a vote of the board, and by as much as 17 cents with voter approval, providing the required "meaningful discretion."

More than 900 of the roughly 1,000 school boards immediately raised their rates to provide the additional necessary funding not supplied by the state-local revenue swap. In November 2007, 120 districts asked their voters to approve additional tax increases. More than three-fourths of these requests were approved, indicating public awareness of the continuing inadequacy of state support for public schools.

State tax changes

To partially replace the lost property tax revenue, the legislature changed the state's basic business tax and raised cigarette and tobacco taxes. The rest of the lost revenue was replaced with available General Revenue.

The franchise tax, the state's business tax since 1907, was significantly reformed. Because the old franchise tax applied only to certain forms of business (corporations and limited liability companies), it could be evaded by merely changing the legal structure of a company to an exempt form. The new tax applies to most forms of business, except sole proprietorships and general partnerships. The former tax was based on net income or assets, while the new tax is

What Part of a Balanced Tax System is Texas Missing?

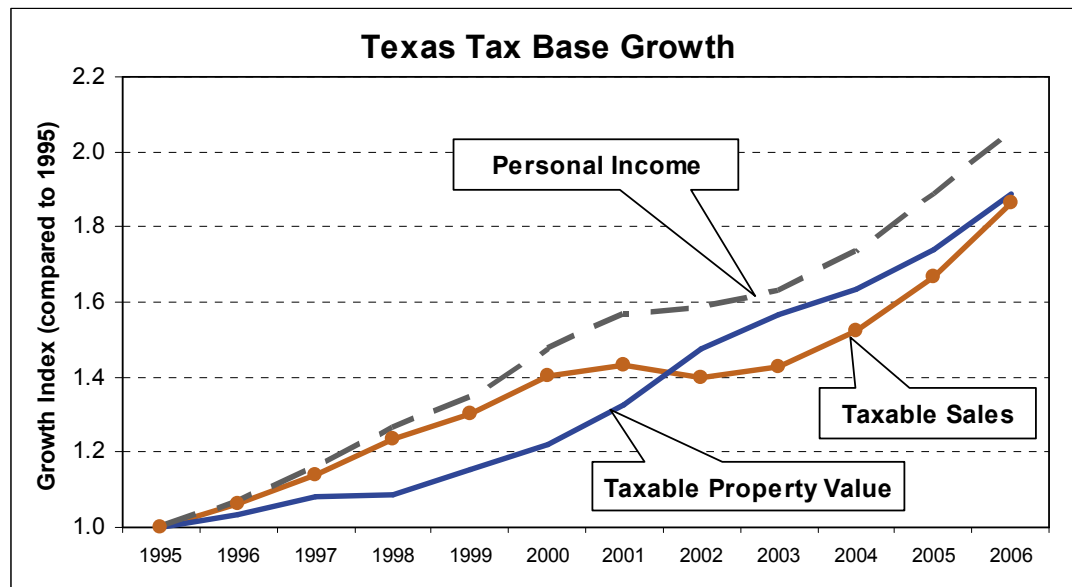
A good tax system should have a balance among different sources of revenue, so that the shortcomings of any single tax can be offset by the strengths of another.

The chart below shows that in 2006, both the amount of taxable sales and the taxable value of property were 1.9 times as much as they were in 1995. However, the sales tax was more volatile in this period, causing state sales tax collections to fall for two straight years in 2002 and 2003, while property values grew steadily. Personal income grew faster than either taxable sales or property values.

Both the sales tax and property tax are regressive taxes, requiring a larger portion of the income of low- and moderate-income families than of higher-income families. In contrast, a personal income tax can apply higher rates to higher incomes, helping to offset the regressive effects of sales and property taxes.

Most states rely on a balance of all three revenue sources—known as a “three-legged” stool for its stability. Because Texas is trying to fund a modern state with just a two-legged stool, it suffers from instability and inequity.

See *The Best Choice for a Prosperous Texas: A Texas-Style Personal Income Tax*, www.cppp.org/research.php?aid=591 for more information.



How Does Texas State Spending Compare to Other States?

National data consistently show Texas at or near the bottom of the 50 states in public spending when its economy (Gross State Product) or population are taken into account. Per capita, Texas ranked 50th in state government spending and 49th in state taxes in 2006. In 1992, Texas ranked 50th in per capita state spending and 46th in state taxes per capita. Furthermore, per-capita spending by state government in Texas is much lower than that of the federal or local governments.

State aid per K-12 pupil—another measure often used to compare state government spending—rose in Texas in the late 1990s with a state-funded increase in the property tax homestead exemption and a teacher pay raise, but subsequently declined, leaving a larger share of school costs to be picked up by local property taxpayers. In the 2005-06 school year, state revenue per student in average daily attendance (ADA) was only \$3,219, putting Texas in 47th place nationally on this measure. On a similar measure—the share of revenue for public schools that comes from state government—Texas ranked 46th in 2005-06, at 33.9%. In 2006-07, the first school year after the legislature’s recent changes to the school finance system, state aid rose to \$4,002 per student. Consequently, Texas’ ranking in state aid per pupil also improved, to 42nd place, but state money merely replaced local dollars lost to property tax cuts. (See pages 33-34.)

How Is It Changing?

Spending by Texas state government from all sources of revenue (All Funds) has been roughly 7% of the economy, as measured by Gross State Product (GSP), since 1997. Spending peaked in 1993-94 at 7.6% of GSP, fell slightly until 1997, and except for 2002-03, has been just above or below 7%.

General Revenue (GR) spending, which excludes federal aid and state funds dedicated to certain purposes such as state highways or local property tax reductions, has shown less fluctuation. General Revenue spending averaged 4.1% through 1995, rose to 4.2% in 1996, then dropped to about 3.8% from 1997 to 2003. Major legislative budget cuts made in the 2003 session reduced GR spending’s share of the economy to 3.1% by 2005-2006. Actions taken in the special Spring 2006 session on school finance and continued in the General Appropriations Act for 2008 and 2009 raised state GR spending’s share of the Texas economy somewhat, to a biennial average of 3.3%. This is still considerably below spending levels before the 2003 cuts.

SOURCES: National Association of State Budget Officers; U.S. Bureau of Economic Analysis; Legislative Budget Board; Comptroller of Public Accounts; U.S. Census Bureau; National Education Association.

Does the State Have a “Surplus”?

Because of the accounting method used for state government appropriations and revenue estimates, Texas can claim a “surplus” in any time period during which beginning balances plus expected revenues exceed expenditures. This is not the same thing as saying Texas has more money than it needs to fund current services, especially when longer-term fiscal obligations are taken into account.

The state will probably end the current budget cycle with a General Revenue balance of \$2 billion in August 2009, according to the comptroller’s November 2007 revenue estimate. This is significantly lower than the 2006-07 ending balance of \$8.8 billion and indicates the dangerous direction in which state finances are heading.

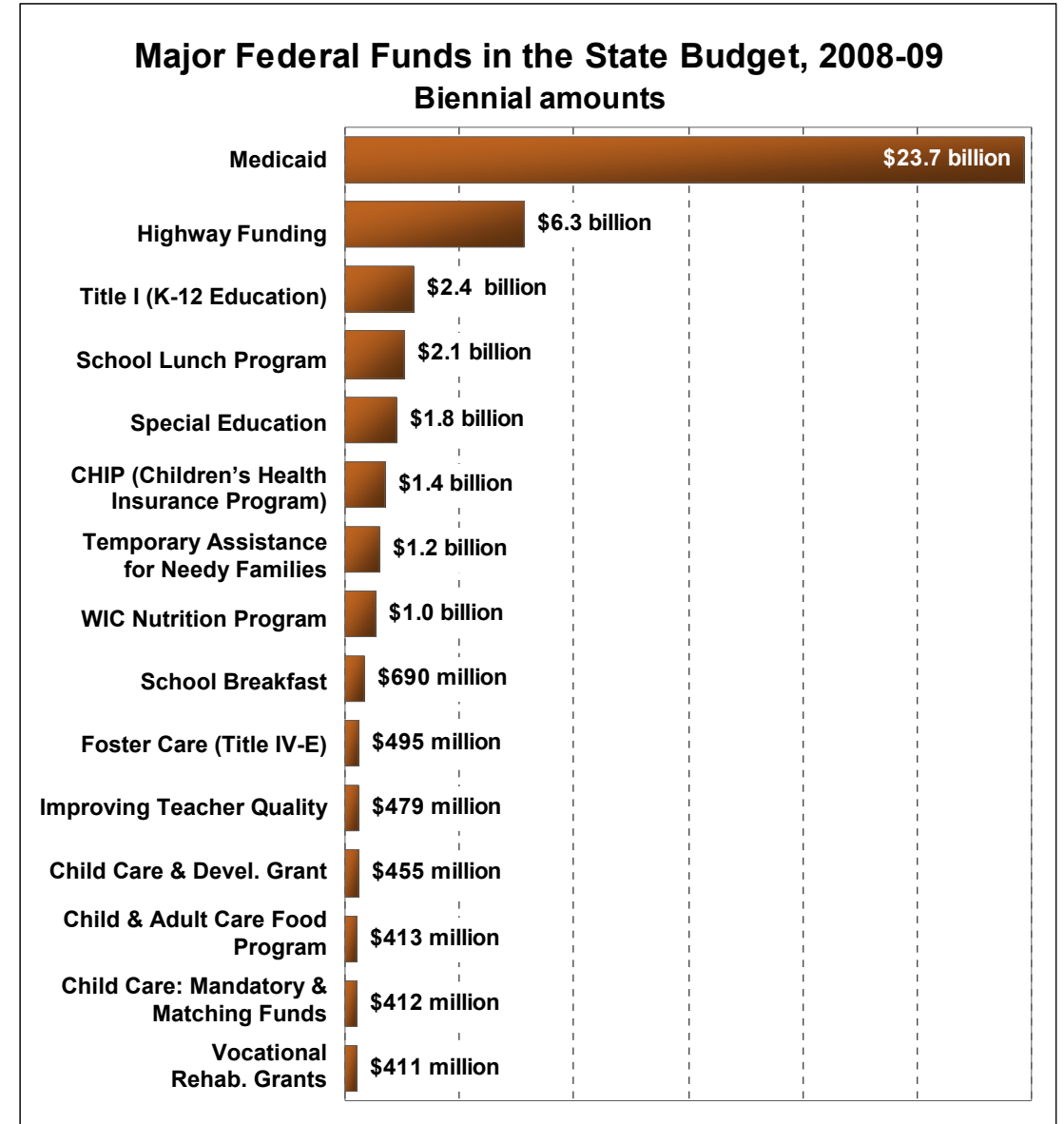
It should be noted that the November 2007 estimate does not take into account the economic slowdown that has recently become apparent, which could reduce state and local government revenue. It also does not adjust for the fact that \$3 billion in General Revenue that will accumulate, unspent, by the end of 2009 is earmarked revenue in various dedicated accounts, such as the System Benefit Fund, Emissions Reduction Program, Trauma Facility/EMS Fund, and state parks funds. To spend these GR-dedicated balances on anything other than their originally intended purpose, legislators would have to change state law.

The school property tax cut enacted in 2006 is taking full effect in 2008-09, reducing local property tax revenue by \$14.2 billion. Money from the Property Tax Relief Fund is expected to provide \$8.3 billion to replace the lost property taxes. The remaining \$5.9 billion is General Revenue, accounting for most of the \$6.8 billion drop in the balance of that fund. In addition, \$3 billion in General Revenue is being set aside in the Property Tax Relief Fund to help cover the cost of the property tax cuts in 2010 and 2011.

So, even though the state currently anticipates having some unspent revenue, in the long run the cost of replacing school property taxes could far exceed expected revenue from the tax changes made in 2006. By the 2010-11 budget, this mismatch could create a severe shortfall—requiring new sources of revenue to avoid damaging cutbacks in state services.

The estimates for 2008-09 cited above are from November 2007, while estimates for 2010-11 are from 2006 fiscal notes. The shortfall could increase considerably if property values grow less than expected—requiring more state aid to ensure that schools receive the promised amount of revenue—or if the reformed franchise, or “margins” tax, raises less revenue than was forecast.

SOURCES: Comptroller of Public Accounts, *2008-09 Certification Revenue Estimate*, November 2007; *Report on Use of General Revenue-Dedicated Funds*, 2007; Legislative Budget Board, Fiscal Notes for House Bills 1, 3, 4, & 5 (79th Legislature, 3rd Called Session), 2006; House Bill 2, 80th Legislature, 2007.



SOURCE: Legislative Budget Board, *Texas Fact Book*, April 2008.

Federal funds are more critical than ever

Federal funds are a vital part of any state budget, and they are particularly important in the Texas state budget. Texas ranks 8th highest in federal funds as a share of state government spending (35% in 2006). In contrast, local governments in Texas got only 4% of their revenues from federal aid in 2005, slightly lower than the national average (4.5%) for local government.

Texas uses a significant amount of matching federal funds in certain programs, particularly Medicaid and the Children’s Health Insurance Program, greatly expanding health care access for low-income residents. In fiscal 2008, a state dollar spent on Medicaid services brings \$1.53 in federal funds to Texas; a state dollar for CHIP generates \$2.62 in federal funds.

Texas could do a better job of maximizing Medicaid funds, the largest grant to state governments. Medicaid federal spending grew annually by only 7.4% on average in Texas from 1996 to 2005, compared to 8.5% annual growth in the rest of the United States.

Because a large share of state revenue, particularly for health and human services (see table below), comes from federal programs, how Congress addresses federal deficits is critically important. Proposals that address federal deficits by cutting aid to the states—rather than repealing federal tax cuts that have mainly benefited high-income families—could prove devastating to Texas and other states.

The 15 largest federal grants in the state budget are shown on the next page. Medicaid is by far the largest, bringing almost four times as much federal revenue to Texas as the second largest, Highway Planning and Construction. Federal programs such as Food Stamps (\$2.9 billion in 2006) and Unemployment Insurance (\$1.6 billion in 2006) are not listed because funds for these benefits are not appropriated in the state budget.

Federal Funds as a Percent of All Funding for Selected Areas of the Texas State Budget, Fiscal 1987, 1997, and 2007

	1987	1997	2007
Health and Human Services	47.4	58.1	59.5
Education	7.6	9.9	13.4
Business/Economic Development	41.7	42.2	43.8
All State Spending	21.2%	28.7%	32.2%

SOURCES: National Association of State Budget Officers; U.S. Census Bureau; Legislative Budget Board, *Fiscal Size-Up 2008-09, Staff Performance Report to the 78th Legislature*.

What is the State’s Rainy Day Fund?

In 1988, voters amended the Texas Constitution to create the Economic Stabilization Fund, commonly called the “Rainy Day Fund,” after the sharp decline in state revenue caused by the bust in oil and gas prices in the mid-1980s.

The constitution requires that deposits to the fund be made 1) when unencumbered General Revenue remains at the end of a biennium, and 2) when oil or gas production taxes collected in a fiscal year exceed the amounts each tax collected in 1987. The legislature can also appropriate money to the fund but has never done so. Recent rapid growth in the fund is due almost entirely to higher collections of natural gas taxes. By the end of the 2008-09 budget cycle, the balance is expected to be \$5.7 billion (not counting the natural gas tax transfer for fiscal 2009, which is made after the end of the fiscal year).

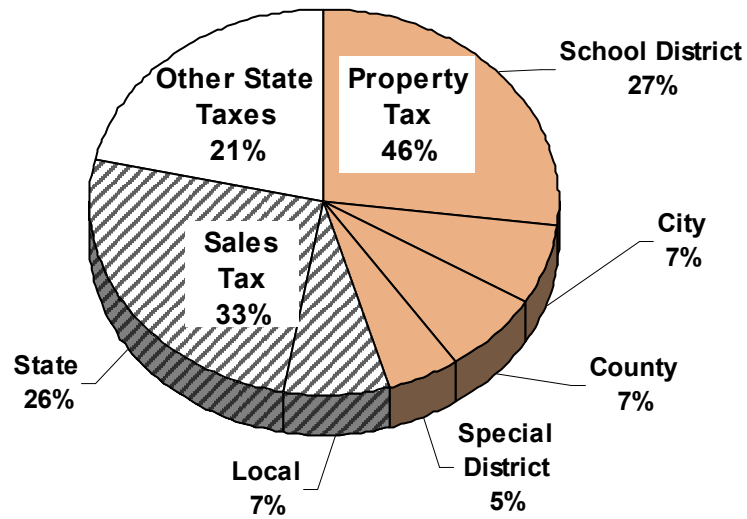
The constitution limits how big the Rainy Day Fund can become. The cap works out to about 10% of revenues, excluding interest and investment income and fund transfers, deposited in General Revenue in the prior biennium. The current cap is about \$7.4 billion; for the next budget cycle (2010-11), the cap would be \$7.7 billion, based on state revenue forecasts.

Experts such as the Government Finance Officers’ Association recommend that states have as much as 15% of their current general spending set aside in a Rainy Day Fund, significantly more than the 5% long considered adequate for state reserves. The main reason for raising the benchmark is the size and duration of states’ 2000-01 budget deficits and the painful lessons learned when state reserves proved to be quite inadequate. Of the 41 states with a reserve fund, 30 used it to reduce budget shortfalls that arose in 2001 and subsequent years. By one estimate, use of Rainy Day Funds helped close one-fourth of state deficits from 2001 to 2004.

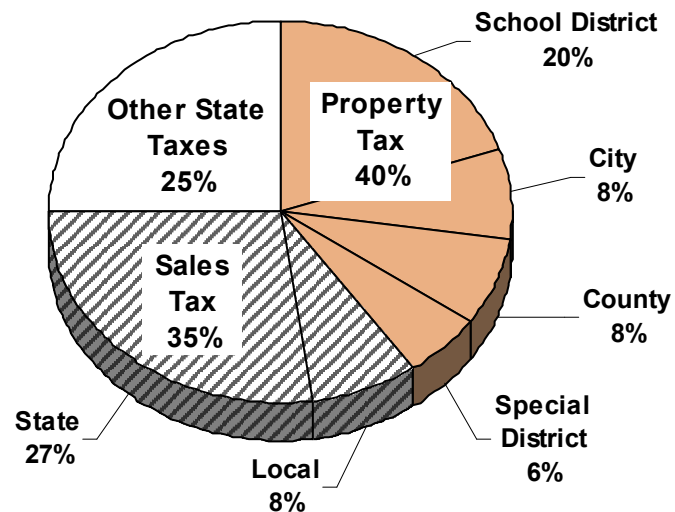
Until recently, Texas’ reserve was not large enough to meet even a 5% benchmark, partly because of legislative decisions to use the fund. In 1991, \$29 million of the Rainy Day Fund was spent on public schools, and in 1993, \$197 million was used for criminal justice. The 2003 legislature spent \$1.2 billion from the Rainy Day Fund—almost all that legislators expected it to contain through 2005. One-third went to cover CHIP (Children’s Health Insurance Program) and Medicaid shortfalls for 2003; the remainder was appropriated for 2004-05 to fund retired teachers’ health care and the creation of the Governor’s Enterprise Fund. The 2005 legislature spent \$1.9 billion in Rainy Day Funds, using roughly half for 2005 shortfalls, and the other half for 2006-07 budget items (including the new Emerging Technology Fund and child protective services reforms). Legislators did not appropriate any money from the fund in 2007.

SOURCES: Comptroller of Public Accounts, *Certification Revenue Estimate 2008-2009*; Legislative Budget Board; Texas House Research Organization; Center on Budget and Policy Priorities, “Rainy Day Funds: Opportunities for Reform,” Revised April 2007.

Major State & Local Taxes in Texas, 2007



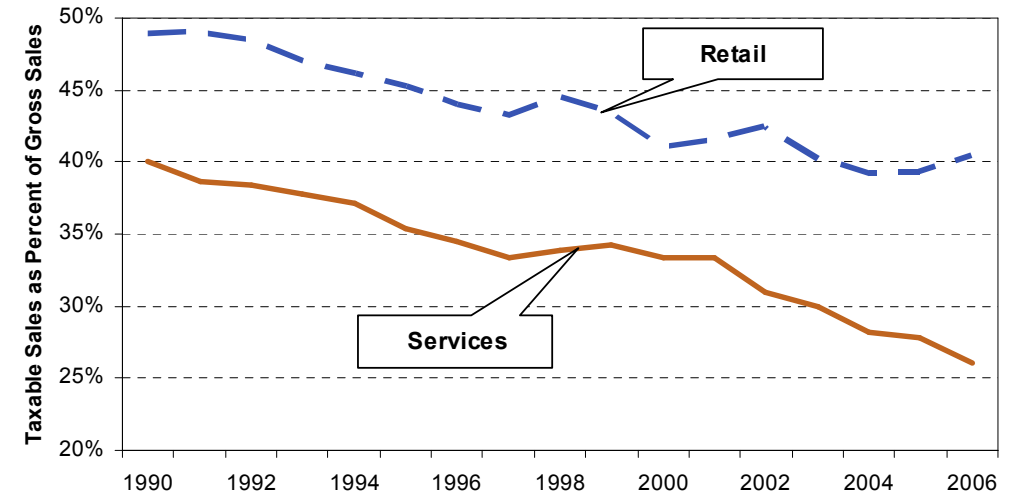
Major State & Local Taxes in Texas, 2009 (forecast)



would broaden the sales tax base to better grow along with the economy and the need for public services. By generating more revenue at current tax rates, a broader tax base would also help reduce the pressure for increases in the state sales tax rate. A broader base would also generate more revenue for local governments' sales taxes, reducing the pressure on local property taxes.

However, the recent changes in the franchise tax will increase regressive taxes paid by many service industries, so consideration of changes in the sales tax base should be postponed until the effect of the franchise tax reforms can be fully understood.

The Sales Tax Applies to a Decreasing Percentage of Sales



SOURCE: Comptroller of Public Accounts, Quarterly Sales Tax Historical Data. "Services" does not include finance, insurance, real estate, or information industries. "Retail" includes accommodation and food services.

taxes rose to make up the difference. In addition, after the 2003 state budget cuts, counties and hospital districts had to fund health care for residents no longer covered by state programs.

Although state tax rates did not increase during this period, school districts and other local governments raised property tax rates consistently, reflecting the state's pushing down of the obligations to fund schools and health care. The statewide average property tax rate per \$100 of property value rose from \$1.93 in 1991 to \$2.78 in 2005, before falling to \$2.62 in 2006, due to the school tax cuts made in the 2006 special session. The tax rate for schools alone increased from an average of \$1.07 in 1991 to \$1.68 in 2005, before dropping to \$1.54 in 2006.

For 2008 and 2009, state tax revenues are projected to be around 4.3% of personal income—slightly higher than the 4.0% low point reached in 2005, but still well below the levels seen in the first half of the 1990s (4.8% to 4.9%).

If state taxes had retained their 1994 proportion of personal income, the state would have had an additional \$12 billion in revenue to fund the 2004-05 budget. This would have eliminated most of the deficit that led to state budget cuts in 2003 and the shifting of costs to local governments.

SOURCES: Comptroller of Public Accounts, *Annual Cash Report* and *Annual Property Tax Report*, various years; U.S. Census Bureau.

Sales tax applies to a shrinking share of the economy

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

The percentage of all sales (totaling \$1.5 trillion in 2006) that is subject to the state sales tax is shrinking over time. As the chart on the next page shows, since 1990 sales volume has grown faster than sales tax receipts in the retail and services sectors. By 2006, the sales tax applied to 40% of retail sales and to only 26% of sales in services industries—down from 49% of retail sales and 40% of the sales of services in 1990. In retail, this partly reflects untaxed Internet and mail-order sales, but the larger overall problem is that the sales tax has not changed along with changes in the economy.

Texas adopted a sales tax in 1961, when most sales involved goods—tangible items. However, in the modern economy, the fastest growing sectors involve services rather than tangible goods.

Many services are currently untaxed. For instance, the first \$25 in monthly Internet access fees and 20% of the price of data processing and information services are exempt from the sales tax. Taxing services, particularly business and professional services that are currently largely exempt,

What State and Local Taxes Do Texans Pay?

Although Texas has a below-average tax bill, ranking 37th among the states in state and local taxes paid per resident in 2005, it ranked 19th in sales taxes and 13th in property taxes per resident. These two taxes are high because Texas does not have a state personal income tax, which most other states use to ease the pressure on other sources of revenue. Looking at it another way: Texas has a very low state tax bill, ranking 49th in state taxes per resident. But Texas has a very high local tax bill because the state “pushes down” to local governments a larger share of costs.

These charts look at state and local taxes from the point of view of the taxpayer—what taxes does the average Texas family pay? The top chart shows the taxes paid before the changes made in the 2006 special session were fully implemented. The bottom chart is an estimate of the taxes that will be paid in 2009. The difference between the two charts is a shift from property taxes to the reformed franchise tax, part of “other state taxes.”

In 2007, nearly 80% of all state and local taxes paid by Texas taxpayers went to just two taxes—property and sales taxes. The property tax was the largest tax paid by the average family. About 60% of property taxes supported local elementary and secondary schools; the rest went to cities, counties, and special districts such as community colleges, hospital districts, and water districts.

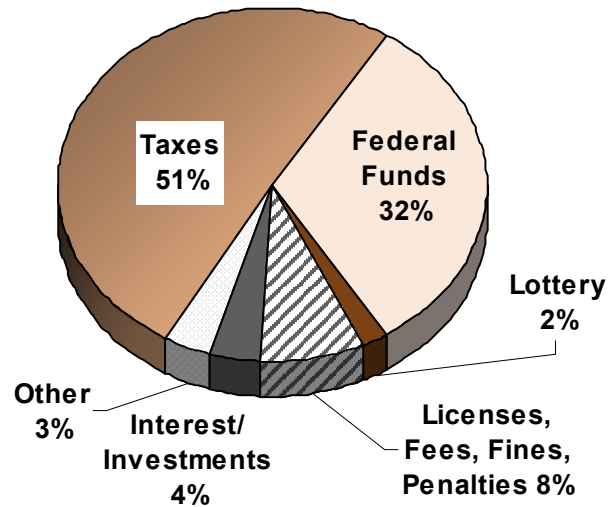
Property taxes are expected to account for a smaller proportion of all state and local taxes in 2009—dropping from 46% of all taxes to 40%. The change is due to the drop in taxes for schools, from 27% of all taxes to just 20%. The share of property taxes going to public schools would drop from about 60% of property taxes to 50%. The increase in the franchise tax, which partially replaces the lost property taxes, would raise “other state taxes” from 21% of total taxes to 25%. Most of the rest of the reduced property tax revenue will be replaced in 2008-09 by state General Revenue balances built up in prior years.

The state sales tax of 6.25% accounts for the lion's share of sales taxes collected. Cities, counties, transit authorities, and other local taxing units may levy sales taxes of up to 2% combined, for a total maximum sales tax of 8.25%. All other state taxes combined, such as the motor vehicle sales tax, franchise tax, and taxes on gasoline, cigarettes, and alcohol, make up about one-fifth of all state and local taxes paid in Texas.

SOURCES: Comptroller of Public Accounts, *Annual Property Tax Report-Tax Year 2006*; *Annual Cash Report 2007*; U.S. Bureau of the Census.

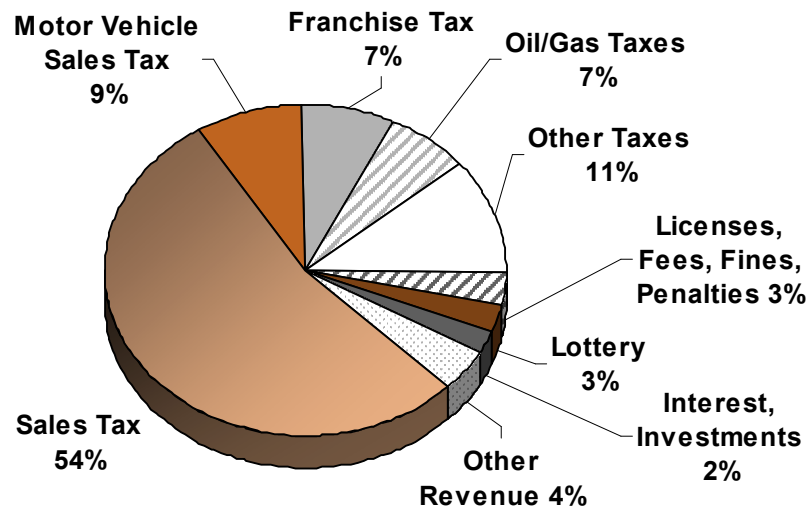
All State Government Revenue, 2008-09

Total: \$160 billion



State General Revenue (GR), 2008-09

Total: \$78 billion



How Has Funding for Public Services Changed in Texas?

Local government share is higher

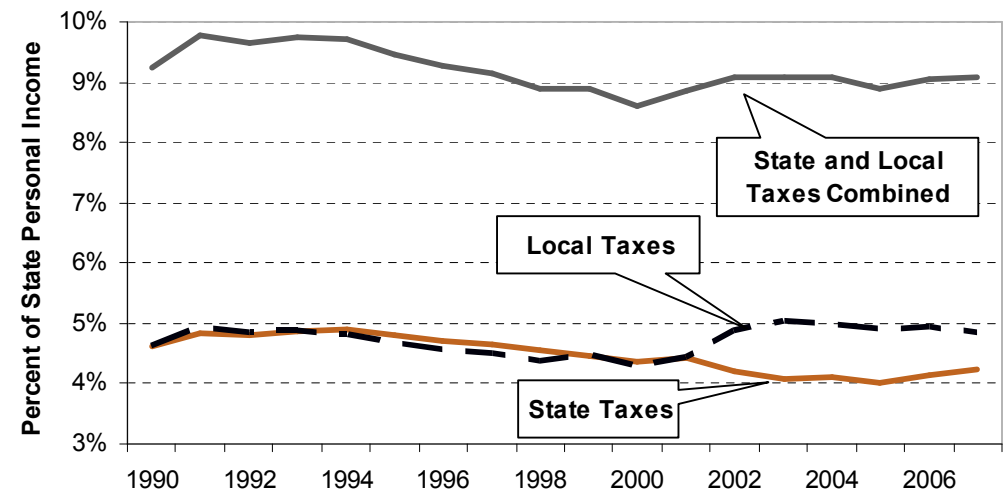
When the revenue available to a government fails to grow at the same rate as its obligations to its citizens, vital services such as education are not maintained, with the consequence that our future as a prosperous state with a skilled workforce is jeopardized.

As the chart below shows, state and local taxes have decreased since the early 1990s as a share of state personal income—a standard way to measure tax effort. Personal income reflects the ability of Texans to pay taxes. Growth in personal income also reflects a growing need for public services, since income growth is linked to growth in population and inflation.

State and local taxes combined fell from an estimated 9.8% of personal income in 1991, to a low of 8.6% in 2000. In 2007, an estimated 9.1% of Texans' income paid for state and local taxes. This is similar to the state/local tax level seen a decade earlier, but more of the tax bill is being paid to local governments, rather than to the state, as was the case before 2002.

As a result, funding for public services has increasingly come from local property taxes. As the state moved further away from its obligation to fund public K-12 education—dropping the state share of school funding from 47% in 1991 to an estimated 34% by 2006—local school property

Texas Tax Effort Has Dropped Since Early 1990s, Mostly Due to Outmoded State Tax System



Local optional percentage homestead exemption

Any taxing district, including a school district, city, county, or special district, may offer an exemption of up to 20% of the value of a home, with a minimum of \$5,000. This optional percentage exemption is in addition to the dollar-amount homestead exemption. For 2006, 218 school districts granted local option percentage homestead exemptions ranging from 1% to 20%, reducing taxable value by \$27.9 billion. See www.cppp.org/research.php?aid=105&cid=7 for more information.

10% cap on appraisal increases

The taxable value of a homestead may not increase by more than 10% per year, not including improvements to the property. This cap lowered taxable value by \$14.2 billion in 2006. Lowering the appraisal cap would shift the burden of property taxes onto lower-income families, tax similar properties differently, and discourage the sale of real estate. For more information about appraisal caps, see pages 41-42.

Local optional over-65 and disabled exemption

Taxing units, including school districts, may offer these homeowners an additional exemption of at least \$3,000. For 2006, 195 school districts offered this type of exemption, lowering taxable value by \$6.5 billion in 2006.

Other deductions

Various other reductions in taxable value are available to businesses, including “freeport” exemptions for certain inventory, an exemption for pollution control equipment, tax abatements, and tax increment financing arrangements. These tax breaks cut taxable value by \$26.1 billion in 2006.

Productivity value loss (“ag exemption”)

Not shown in the chart is the taxable value lost to the “ag exemption,” which values farm, ranch, and timberland based on the land’s capacity to produce agricultural products, rather than on its full market value. This special treatment is no longer reported separately, but in 2006, the ag exemption reduced the value of acreage by two-thirds—from \$195.3 billion to \$63.8 billion.

Where Do State Revenues Come From?

The 2006 special legislative session significantly changed Texas’ state and local tax system. This primer explains what the revenue system looks like in the 2008-09 biennium, based on November 2007 projections by the state comptroller of public accounts.

The top chart shows all sources of state government revenue (“All Funds” revenue), including money received from the federal government and state funds dedicated to certain purposes, such as highways or property tax reductions. The bottom chart shows only the sources of state General Revenue.

About half of total state revenue comes from taxes. Another third comes from the federal government.

General Revenue—the part of the budget that has to be certified by the state comptroller—is much more dependent on taxes, which make up 88% of all General Revenue dollars.

Gross lottery collections total \$3.1 billion in All-Funds revenue. After subtracting for expenses, including prizes, in 2008-09 the lottery is forecast to net just over \$2 billion in General Revenue—enough to pay for about one week of public school each year.

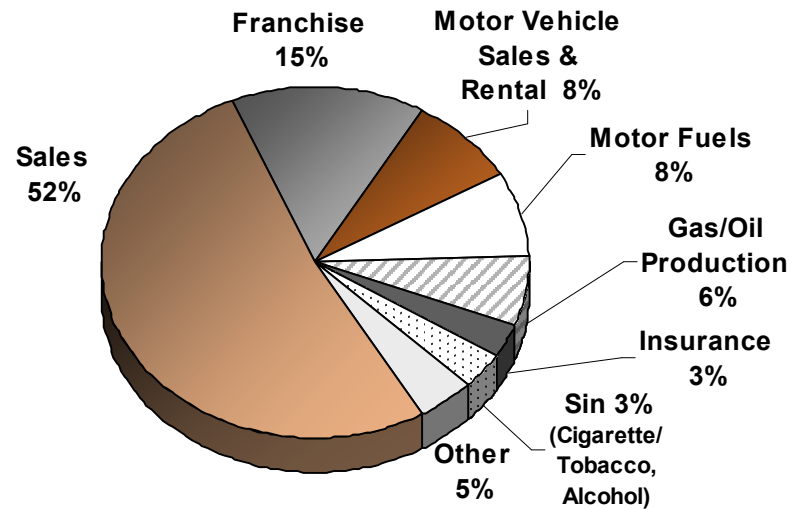
The state is expected to take in \$160.5 billion from all sources in 2008-09—\$10.9 billion (7.3%) more than in 2006-07. Increased franchise tax collections, due to changes made in the 2006 special session, account for more than half of this increase (\$6.2 billion).

General Revenue collected in 2008-09 is expected to total \$78.4 billion—only \$2.4 billion (3.2%) more than in 2006-07. Combined with \$7 billion in balances unspent at the end of fiscal 2007, this yields \$85 billion in General Revenue available for the 2008-09 biennium.

SOURCE: Comptroller of Public Accounts, *2008-09 Certification Revenue Estimate*, November 2007.

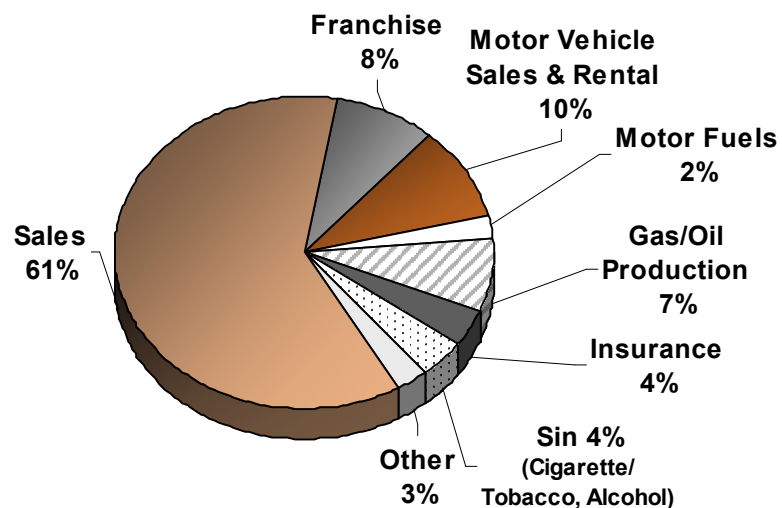
All-Funds State Taxes, 2008-09

Total: \$81 billion



General Revenue State Taxes, 2008-09

Total: \$69 billion



Who pays school property taxes?

Single-family homes account for nearly half of all the property value in Texas. However, various exemptions and special treatments reduce the taxable value of homesteads (owner-occupied homes), so that single-family residences are only 43% of school property taxable value, as shown in the top chart. Commercial property, including apartments, is 29% of taxable value, while industrial property is 9% and oil and gas wells account for 7%.

Property in Texas had a total market value of \$1.55 trillion in 2006. Exemptions and special treatments of \$192 billion reduced this amount by 12%, to a taxable value of \$1.36 trillion. Homeowners are the beneficiary of most of these exemptions, as shown in the bottom chart. (See www.cppp.org/files/7/POP271Foreclosures.pdf for more details.)

In the 2006 tax year, school districts levied \$20.9 billion in property taxes (including both maintenance-and-operations taxes for annual operations and interest-and-sinking-fund taxes for debt service on bonds), for a statewide average tax rate of \$1.54 per \$100 of property value—a drop of 8% from the 2005 statewide average rate of \$1.68.

Statewide homestead exemptions

All homeowners qualify for a \$15,000 exemption from school taxes. Homeowners age 65 or older and persons with disabilities qualify for an additional \$10,000 exemption from school taxes. In 2006, statewide exemptions reduced the taxable value of homesteads by \$84 billion.

Over-65 “tax freeze”

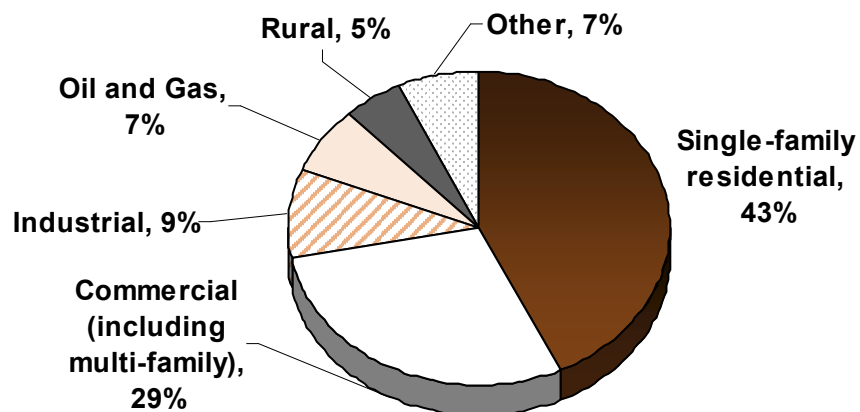
The amount of school taxes on a homestead is “frozen” once a homeowner reaches the age of 65. To be exact, a ceiling is established at the level of school taxes paid in the year in which the homeowner turns 65. Taxes can fall below this ceiling, but not rise above it, unless the home is improved. Recent legislation allows a city, county, or community college district to adopt a tax ceiling. A similar freeze is available to disabled homeowners. The tax freeze reduced taxable value by \$33.3 billion in 2006.

The school-tax ceiling can be transferred if an age-65+ or disabled homeowner moves to another homestead in Texas. The new ceiling is based on the percentage of school tax paid in the former home, compared to the tax bill that would have been paid if there were no ceiling.

If the age-65+ homeowner dies, the benefits can transfer to the surviving spouse, as long as he or she is 55 or older and lives in and owns the home. Benefits are also transferred to a surviving spouse who is disabled.

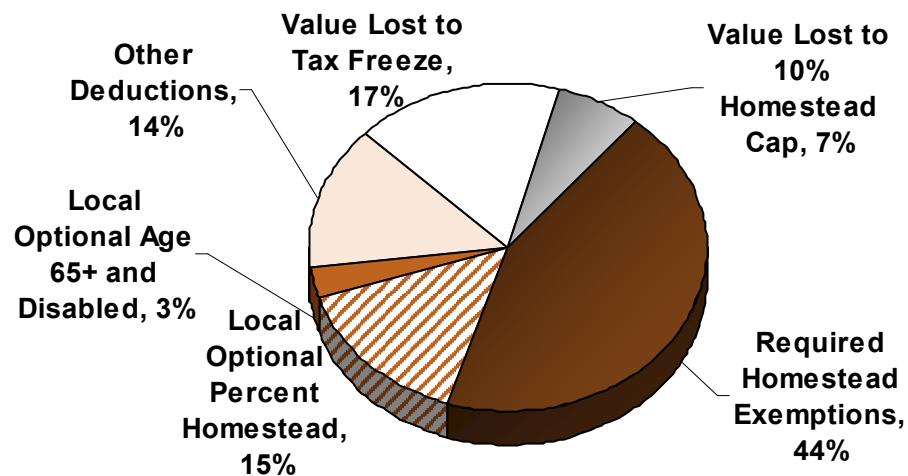
Taxable property by category, 2006

Total: \$1.36 trillion taxable for schools



School Property Tax Exemptions, 2006

Total: \$192 billion



SOURCE: Comptroller of Public Accounts, *Annual Property Tax Report-Tax Year 2006*.

What Taxes Does the State Collect?

The top chart shows the contribution of taxes—rather than all sources—to state revenue (“All Funds” taxes). The bottom chart shows taxes that produce General Revenue (GR).

Two taxes flow into funds other than General Revenue. One is the franchise tax, which was significantly changed in the 2006 special legislative session and is now popularly called the “margins tax.” The tax accounts for 15% of All-Funds tax revenue, but only 8% of GR taxes. This is because all additional revenue generated by the changes, over the amount that would have been collected under the former law, goes into the Property Tax Relief Fund. This fund can be used only to reduce school property tax rates by replacing lost property tax revenue and is not General Revenue.

The franchise tax is expected to generate \$11.9 billion in 2008-09: \$5.8 billion will go into General Revenue, and \$6.1 billion will be deposited in the Property Tax Relief Fund.

Three-fourths of state motor-fuels taxes (on gasoline and diesel fuel) goes to the State Highway Fund, which is not part of General Revenue. One-fourth goes to the Available School Fund, which is distributed to school districts and counts as General Revenue. Motor-fuels taxes are 8% of All-Funds tax collections, but only 2% of General Revenue tax collections.

By far the largest source of tax revenue is the general sales and use tax, which is expected to generate 52% of state All-Funds tax revenue and 61% of General Revenue in 2008-09. The sales tax has produced over half of state tax revenue every year since 1988.

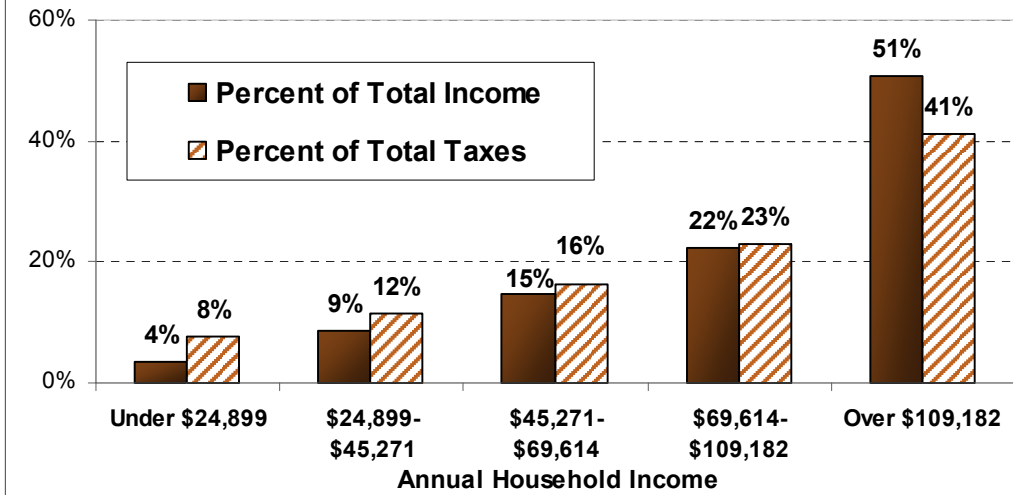
The motor vehicle sales and use tax, which is a separate tax from the general sales tax, and severance taxes on oil and natural gas production are also major sources of tax revenue.

Sales taxes and other taxes linked to consumption—the motor vehicle sales tax, the motor fuels taxes, and “sin taxes” on cigarettes, tobacco, and alcohol—account for 71% of All-Funds tax revenue and 78% of General Revenue taxes.

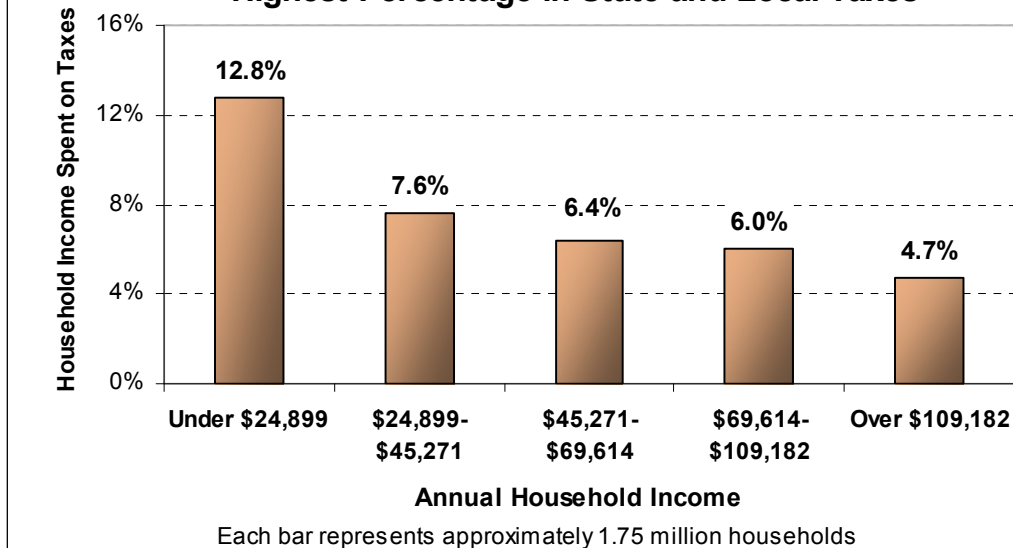
Taxes initially paid by businesses, including the franchise tax, natural gas and oil production taxes, the tax on insurance premiums, and other taxes, provide the rest of state tax collections.

SOURCE: Comptroller of Public Accounts, *2008-09 Certification Revenue Estimate*, November 2007.

The Highest-Income Texas Households Pay Less Than Their Fair Share of State and Local Taxes



Texas Households with the Lowest Income Pay the Highest Percentage in State and Local Taxes



Who Pays Texas Taxes?

The Texas state and local tax system requires low- and moderate-income families to contribute a disproportionate share of their income to the support of vital public services. The five pairs of bars in the top chart each represent one-fifth of Texas households—about 1.75 million households—arranged from lowest to highest income. The bar on the left in each pair shows the percentage of the state’s personal income accounted for by the families in that group. The bar on the right shows the percentage of all state and local taxes paid by families in that group. As you can see, four-fifths of Texas families contribute more to the support of public structures than their share of personal income, while the one-fifth of families with incomes over about \$110,000 pay a smaller share.

Another way to look at the fairness of Texas’ tax system is to examine the share of family income that goes to paying for public services. The second chart shows state and local taxes as a percent of household income, using the same income quintile ranges as in the top chart.

The one-fifth of households with the lowest income pay almost three times as much in taxes as a share of their income, than do the one-fifth of households with the highest incomes. A system that takes a much greater percentage of income from a low- or moderate-income family than from a higher-income family is called “regressive” by economists. Texas’ tax system is the 5th most regressive among the states.

The sales tax, which is based on consumption, is largely to blame. Consumption taxes are extremely regressive. For instance, an average Texas low-income family pays 5.9% of its income in sales taxes, while an average high-income family pays only 1.8% of its income in sales taxes.

The sales tax exempts most groceries, residential utilities (gas, electric, water) and medicines. Even with these exemptions for necessities, though, the sales tax by its nature is still regressive.

To ensure a prosperous future for all, taxpayers who can afford to pay more, *must* pay more because as the bottom chart shows, only they can afford it. Our regressive tax system already takes a greater share of the income of low-income families, hindering their advancement to the middle class. Asking those with more to pay a greater share is fair because they have gained the most from our current public structures, and their continued prosperity depends upon their reinvesting in building our future public structures.

SOURCES: Comptroller of Public Accounts, *Tax Exemptions & Tax Incidence*, February 2007; Institute on Taxation & Economic Policy.