



THE BEST CHOICE FOR A PROSPEROUS TEXAS

2005

Contact: Dick Lavine, lavine@cPPP.org

WE NEED TO CREATE A BETTER, MORE PROSPEROUS FUTURE FOR ALL TEXANS

We can do this by:

- raising the money necessary to strengthen our public schools, colleges and universities;
- raising the money necessary to strengthen our health care system;
- ensuring our ability to meet other vital state needs into the future.

To do so, we must:

- change our tax mix to match our changing modern economy; and
- modestly increase total tax revenue.

These changes will allow us to:

- increase the state share of the cost of public education, reducing pressure on local property taxes;
- ensure access to higher education for students from all backgrounds by avoiding further tuition increases; and
- absorb health care costs that now fall on overburdened local governments.

This Policy Brief weighs our choices to accomplish these goals.

PROPERTY TAXES CAN'T CARRY ANY MORE OF THE LOAD

We cannot rely on the property tax to pay more of the cost of education and other services. The state pays a shrinking percentage of the cost of public schools; now providing just over 35% of state and local support. To continue an adequate level of education, school boards have had to raise their local property taxes, raising the statewide average school tax rate from \$1.07 in 1991 to \$1.65 in 2003. Local governments – cities, counties, and hospital districts – have also raised property taxes to make up for the state's failure to pay for important public services ranging from community colleges and roads to health care.

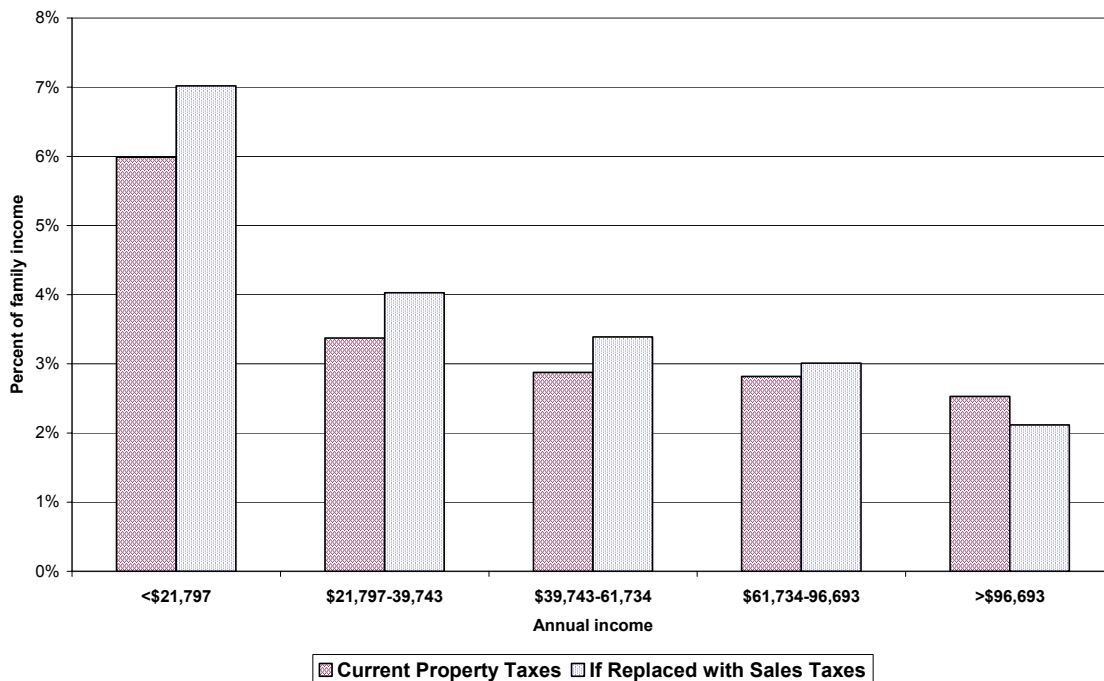
Texans now pay \$1,300 each in property taxes – \$780 in school property taxes alone – the 13th highest property tax bill among the states. These high property taxes have created pressures that have eroded the property tax base through tax breaks like exemptions, abatements, and freezes. Tax breaks only shift the cost of public services onto those taxpayers that do not get special breaks. We need to ease property taxes for everyone, not carve out exclusive deals for a few.

SALES TAXES CAN'T CARRY ANY MORE OF THE LOAD

The sales tax is near its limit. Texans pay \$1,180 per person in sales taxes and similar consumption taxes. Texas' state rate of 6¼% is tied for 8th highest in the country; no state has a rate over 7%. Texas' state and local combined maximum rate of 8¼% is 15th highest.

The sales tax is very unfair, since it takes a much greater percentage of the income from a low- or moderate-income family than from a higher-income family. Economists describe this kind of lopsided tax as “regressive.” Because Texas relies on the sales tax for the majority of its state tax revenue, our state and local tax system is rated the fifth most regressive in the nation.

If We Replaced Current School Property Taxes with Sales Taxes



Source: Data from Texas Comptroller of Public Accounts. Calculations by CPPP.

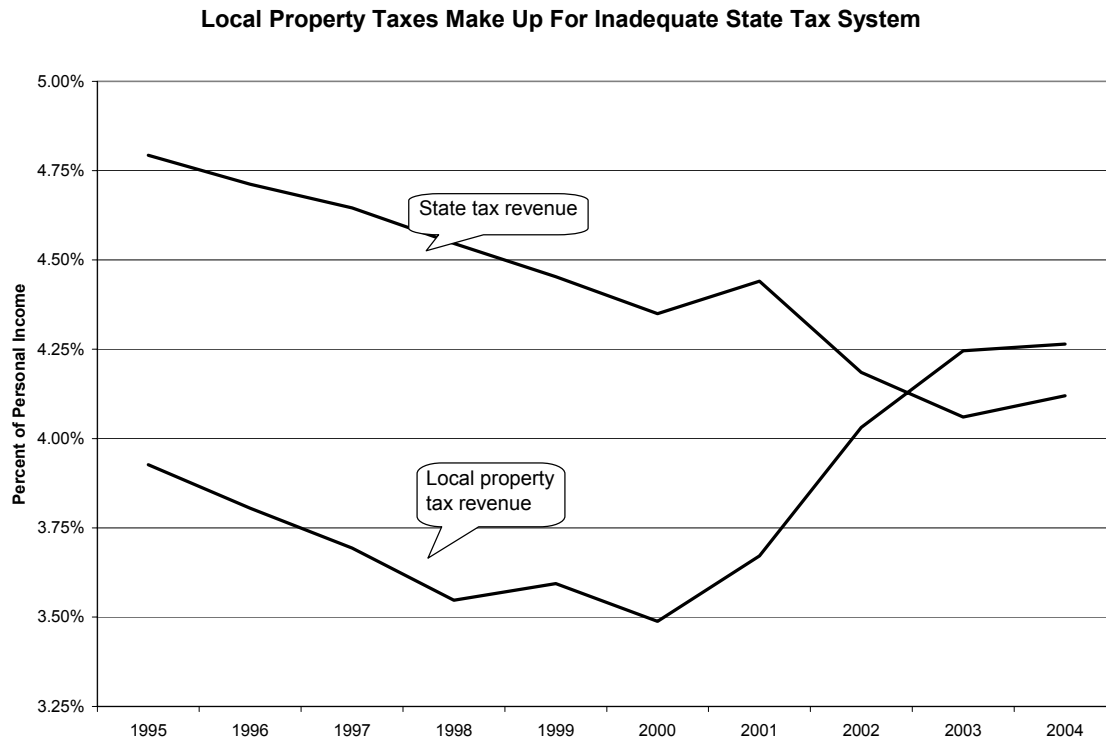
Some have suggested increasing the sales tax to reduce the property tax. This would be a bad trade because sales taxes are more regressive than property taxes. As *Chart 1* shows, if Texas increased the sales tax to reduce the school property tax, four-fifths of Texas families would be worse off. Only those Texas households with incomes over \$96,700 a year would benefit.

TEXAS NEEDS A TAX THAT CAN CARRY THE LOAD

Our state tax system does not keep up with our growing economy. *Chart 2* shows that local governments have had to rely on higher property taxes in order to find necessary revenue. State tax revenue has fallen as a percentage of personal income almost every year since 1995. If Texas merely tapped the same portion of the state economy in taxes in 2004-05 that it collected in 1995, the state would have had enough to fund the 2004-05 biennial budget without cutting services, easing the pressure on local property taxes.

Instead, school districts and other local governments have turned to property taxes to fund public education, hospitals, jails, and roads. In the past few years property taxes have increased much faster

than personal income, leading to widespread complaints that the taxes were increasing faster than the ability of homeowners to pay them.



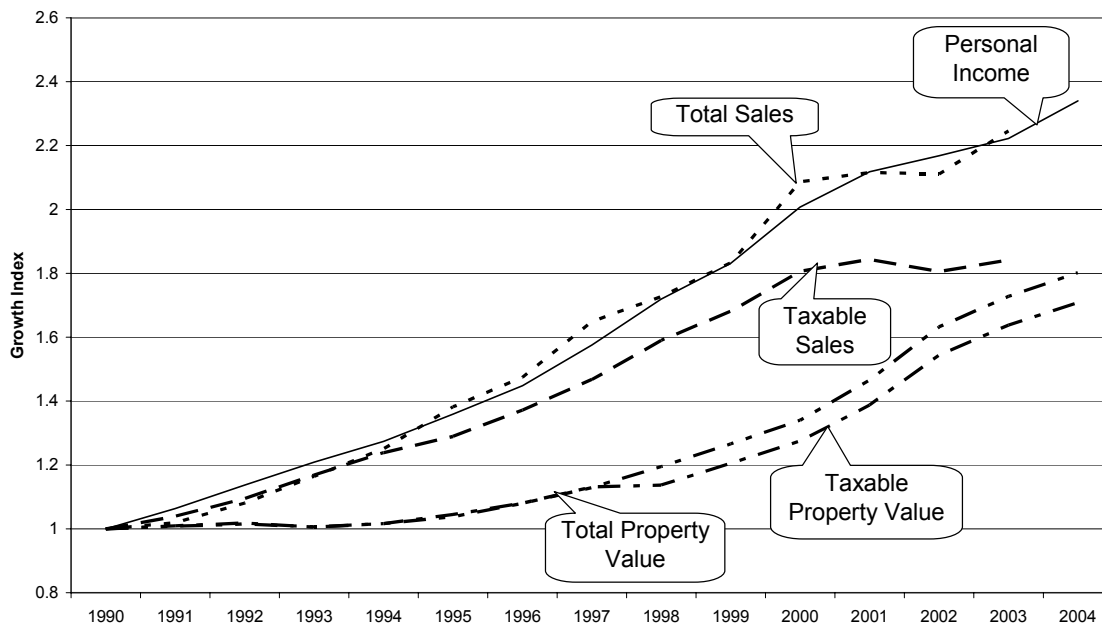
Source: Data from Texas Comptroller of Public Accounts. Calculations by CPPP.

Chart 3 shows how Texas' tax bases – the amount that is subject to a tax, without adjusting for changes in the rate of the tax – have changed since 1990.

A key factor in Texas' lagging state tax revenue is the state's heavy reliance on the sales tax, which supplies more than half of its tax revenue. We tax mainly the sales of goods, but we increasingly sell services, so the gap between total sales and taxable sales is growing quickly. Even though total sales tracks the economic growth, as measured by personal income, taxable sales falls far short. In addition, sales tax revenue can be volatile. State sales tax revenue fell for two years straight, from 2001 to 2003. The sales tax rate has not changed since 1990.

Property values grow steadily, but usually more slowly than personal income. The gap between total property values and taxable property values opened in 1997 when the state increased the amount of home value exempted from school taxes. Other exemptions, abatements, exemptions, and freezes continue to erode the property tax base. Both the higher values seen in chart 3 and higher rates have contributed to the increase in property taxes since 1990.

Texas' Tax Bases Fall Short: They Don't Keep Up With Economic Growth Or Are Unreliable



Source: Data from Texas Comptroller of Public Accounts. Calculations by CPPP.

EXPANDING THE SALES TAX BASE AND IMPROVING THE FRANCHISE TAX

The sales tax base should be modernized to include services. This would help sales tax revenue grow naturally with our current economy without raising the rate, but after excluding those services that should not be taxed (such as medical care), even an expanded sales tax does not raise enough money to provide for a prosperous future.

Our corporate franchise tax should also be brought up-to-date to eliminate loopholes and include all firms doing business in Texas. However, both an expanded sales tax and an improved franchise tax still have the same basic problems: they do not raise enough money; they are regressive.

A PERSONAL INCOME TAX SOLVES THESE PROBLEMS

An income tax can produce the money we need to fund the investments that will create a prosperous future for all Texans. Revenue from an income tax grows naturally with the growth in the state's economy, so Texas would not continue to struggle to finance schools and health care year after year. An income tax is also directly linked to a family's ability to pay taxes, so it can help offset the unfairness of other taxes. Balancing property, sales, and income taxes would maintain adequate and stable funding to improve Texas' future.

THE CONSTITUTION GUARANTEES VOTER CONTROL OVER AN INCOME TAX

A Texas constitutional amendment, designed by Lieutenant Governor Bob Bullock and adopted by the voters in 1993, is the blueprint for adopting a smart, Texas-style income tax. This amendment (Article 8, Section 24) gives voters total control over the amount of the tax. The amendment also mandates how the state must spend the income-tax revenue. Under this constitutional amendment, a bill establishing a personal income tax with a specified rate can take effect only after voter approval in a statewide referendum. Once the voters approve the tax, the tax cannot be increased without voter approval in another statewide referendum.

AN INCOME TAX WOULD REPLACE MOST OF THE SCHOOL PROPERTY TAX

The Constitution requires that two-thirds of the revenue from an income tax must go to reduce school property taxes. This could cut the local tax rate – in most school districts now \$1.50 per \$100 of property value for maintenance and operations (M&O) – to roughly 50 cents. The maximum M&O tax rate – also now generally capped at \$1.50 – must be reduced by the same percentage as total M&O taxes. If the income tax cut the property tax rate in half, then it would also cut the tax cap in half. After the cap was cut, only the voters in a school district could increase their district's maximum tax rate.

The state must spend the remaining one-third of income tax revenue on education, and only on education.

A REAL-LIFE EXAMPLE SHOWS HOW AN INCOME TAX COULD CUT PROPERTY TAXES AND IMPROVE TEXAS PUBLIC EDUCATION

We took the income tax from Kansas, a state with income-tax revenue per resident slightly below the national average, and applied its rates, brackets, and deductions to the incomes of Texas families in 2004. The Kansas tax has three income brackets, with rates that range from 3.5% to 6.45% of federal adjusted gross income, minus state exemptions and deductions. A family of four pays no tax on income under \$24,400. The Kansas tax form is very short and easy to complete.

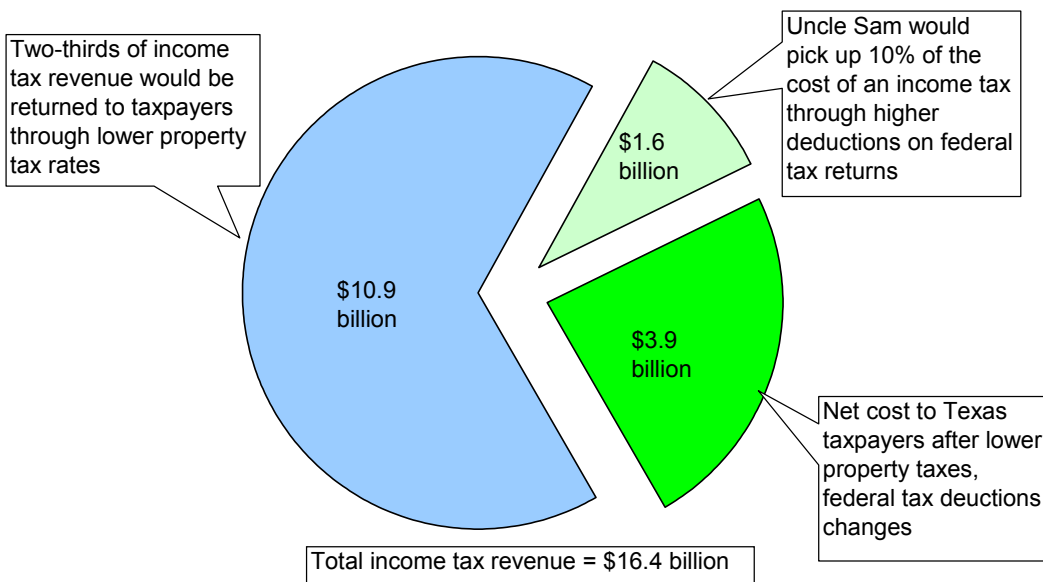
Applying this below-average, standard-style tax to Texas would have generated \$16.4 billion in revenue for Texas in the year 2004.

Income tax revenue	\$16.4 billion a year
<u>Property tax cuts</u>	<u>- 10.9 billion a year</u>
Dedicated to education	\$ 5.5 billion a year

Two-thirds of that money (\$10.9 billion per year) would have gone to cut school property taxes. This would have reduced taxes for maintenance and operations in 2004 almost 65% and would have slashed the maximum M&O tax rate in 2004 to about 55 cents. This new lower tax cap could be raised only with the approval of the voters of an individual school district. The rest of the money (\$5.5 billion per year) would have been devoted to education, allowing us to reduce Robin Hood, increase equity, and improve our public schools for all students.

Of course, Texas would write its own income tax. We used the Kansas tax for 2004 merely to demonstrate how an income tax could work. Texans would decide the brackets, the rates, and how much the tax raised, subject to absolute voter control at the ballot box.

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



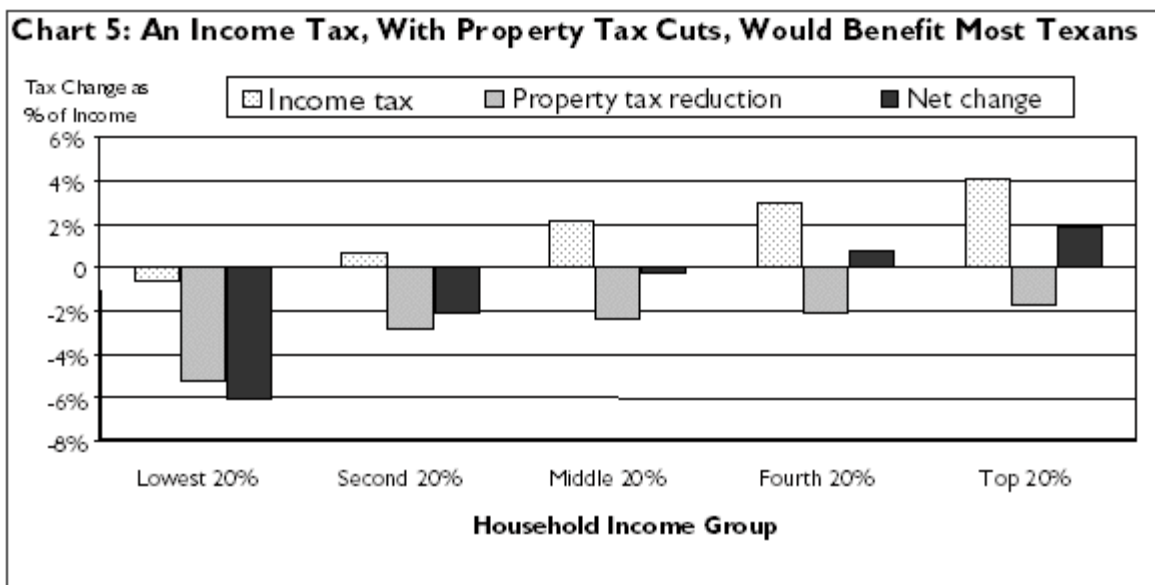
Source: The Institute on Taxation and Economic Policy

STATE INCOME TAX PAYMENTS ARE DEDUCTIBLE FROM THE FEDERAL INCOME TAX

State income tax payments are deductible from taxable income in calculating federal income taxes. Deductibility shifts part of the cost of public education to the federal government. *Chart 4* shows that, although the tax would have raised \$16.4 billion in 2004, the net cost to Texas taxpayers would have been only \$3.9 billion. Lower property taxes would have returned most of the new revenue (\$10.9 billion) to taxpayers. Uncle Sam would have picked up 10% of the total cost of the income tax (\$1.6 billion) through higher deductions on federal tax returns.

MOST TEXAS FAMILIES WOULD PAY LESS IN TAXES WITH AN INCOME TAX

As *Chart 5* shows, most families would gain more from property tax cuts than they would pay in income taxes. In 2004, the top income group, with incomes over about \$97,000 a year, would have paid less than 2% of their income with an income tax. Since this group gets almost all the benefit of the federal income tax deduction, however, the federal government would have absorbed about a third of even this 2%.



Source: The Institute on Taxation and Economic Policy

An income tax could help balance the unfair burden placed on low- and middle-income families by the rest of the state tax system, particularly the sales tax. (In fact, some states, like Kansas, have a state Earned Income Tax Credit in addition to the federal Earned Income Tax Credit, which helps low-income families.) Relying on revenue from a system of several sources – balancing volatile, but fast-growing, taxes with steady revenue streams – can provide a secure source of support from state and local services that will also increase along with needs.

INCOME TAXES SUPPORT ECONOMIC GROWTH THROUGH EDUCATION

Some fear that an income tax would be bad for our economy. Consider the evidence. Forty-one states have a broad-based personal income tax. Most of these states have higher personal income, lower dropout rates, fewer uninsured children, and better transportation systems than Texas – the foundations for a prosperous future for their residents.

Through investing in public education, universities, health care, and transportation, Texans could accelerate our economic growth. A state with healthy children who stay in school produces skilled workers who earn more at better jobs. Prosperous consumers and good transportation attract new businesses. Investing more now in public services will create a more robust economy in the future.

The net cost of the standard income tax we have used as an example – less than \$4 billion a year – is only one-half of one percent of Texans' total personal income. Even after such a modest net tax increase, which would be fairly shared among all Texans, our state would still have lower taxes than most others. Despite what Texans have been told, an income tax is the best choice to meet our goals. Through this smart investment, Texans can ensure healthy children, educated residents and skilled workers. This, in turn, will ensure all of us a brighter future.