POLICY PAGE

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THE SHARP COMMISSION PLAN

Plan Would Create Continuing Deficit, Harm School Funding Equity, and Increase Tax Regressivity

The Texas Supreme Court ruled in November 2005 that the state's current school-finance system violates the constitutional ban on a state property tax, since local districts lack "meaningful discretion" to set local tax rates. The Court gave the Legislature until June 1, 2006, to respond. The Court also found that "the public education system has reached the point where continued improvement will not be possible absent significant change" and that "it remains to be seen whether the system's predicted drift toward constitutional inadequacy will be avoided by legislative reaction to widespread calls for changes."

Before the ruling, the Governor appointed a commission, chaired by former Comptroller John Sharp, to make recommendations on tax reform and school funding. In this *Policy Page*, we analyze the Sharp Commission's proposed tax plan. Although the commission proposes an innovative business tax, the commission creates serious budget problems by cutting old taxes more than it raises new taxes. On the legal front, the commission's plan does not create the necessary "meaningful discretion" over local tax rates required by the Supreme Court. Finally, the plan increases the overall regressivity of the state's tax system.

The Sharp Commission Plan Would Create a Continuing Deficit

The Sharp Commission proposal would raise less money in new taxes than the amount lost by cutting old taxes, leaving the state in a hole. This deficit would exist not just in the first year—when an additional $1.4 billion would be required to make the plan balance for fiscal year 2006—but in all future years for which projections have been made.

On Friday, April 14, the Comptroller released a fiscal note that presented the anticipated changes in revenue over the first five years of the plan. The Sharp Commission plan would be $1.4 billion short of balancing in fiscal 2007, its first year of operation. More importantly, the deficit would grow in each succeeding year.

The problem is that the new revenue sources proposed by the plan—a new business tax, higher cigarette and other tobacco taxes, and the "liar's affidavit" enforcement of the motor-vehicle sales tax—won't grow as fast as the property tax revenue they would replace.

Let's look only at the effect of the Sharp plan on the 2008-09 and 2010-11 budgets, when the new business tax would be in full operation. The cost of replacing foregone school property tax revenue if the maximum school tax rate were reduced from the current $1.50 per $100 of property valuation to $1.00, as proposed by the commission, would increase by $1.6 billion from one biennium to the next. Whatever revenue source the legislature enacted to fund property tax reductions would have to grow by this amount each biennium just to keep in balance.

Some of this replacement revenue would, according to the commission's proposal, come from increasing the cigarette tax by $1.00 per pack. However, the comptroller estimated that the amount generated by the increase would drop by $112 million per biennium. (This is good news for public health, since it would indicate declining tobacco consumption, but not so good news for the state budget.) So the new revenue source would have to grow fast enough to make up for the diminishing revenue from the cigarette tax, too.

The proposed new revenue source, a new business tax, is not up to this task. Net revenue from the new tax, after taking into account the elimination of the current corporate franchise tax, would increase by only $877 million from one biennium to the next—$715 million short of the amount needed to keep up with the need to replace lost property tax revenue. Combined with the drop in cigarette tax revenue, the Sharp Commission plan would fall behind by an additional $823 million just between 2008-09 and 2010-11, the first two biennia of full implementation.

According to the comptroller's estimate, the 2008-09 budget would have a hole of $4.2 billion—the difference between the amount raised by the proposed new revenue sources and amount foregone in school property taxes. In the 2010-11 budget, the hole would grow by that additional $823 million, to a total of $5 billion.

The So-Called Surplus Should Not Be Used to Balance the Sharp Commission Plan

In February 2006, the Comptroller estimated that revenue collections through August 2007 would exceed General-Revenue related spending approved thus far by about $4.3 billion, or about 6% of the GR budget. If the economy continues to perform better than expected, the $4.3 billion in unused revenue could grow by another $1 to $2 billion before the biennium ends in another 16 months.

On the minus side of the ledger, however, the state has not yet officially included in the 2006-07 budget some big-ticket expenditures such as $295 million for school textbooks approved in 2005; $444 million for the Medicare "clawback"; or $100 million for nursing home rates and residents' personal needs allowances, trauma care, and other health and human service items approved by the leadership in mid-February 2006.

Looking to the future, a "current services" budget for 2008-09 will have to find a way to cover the cost of more than $940 million in education and child protective services programs currently funded by the "Rainy Day Fund," as well as $4 billion to cover general inflation and population growth. In addition, $3 billion is needed to rebuild the Rainy Day Fund itself so that it equals at least 5% of GR spending, the bare minimum recommended by state finance experts.

Finally, it must be acknowledged that part of the reason why revenues currently exceed spending is that approved spending levels are grossly inadequate, with many critical areas of state spending still reeling from $7.5 billion in GR cuts approved by the 2003 legislature, and costs shifted to locally to school districts, cities, and counties.

Once the current and future requirements for new General Revenue are recognized, it is easy to see why the use of even $1 billion a year in "surplus" revenue for property tax reductions is ill-advised: it digs a deeper hole for future legislators, and leaves the state totally unprepared for an economic downturn or an unforeseeable event that drastically changes revenue or spending assumptions. Rather than make the totally unrealistic assumption that new revenue will grow 6% annually—each and every year from now on—Texas needs to have as one of its budget priorities a Rainy Day Fund balance that will help the state weather the next inevitable economic recession or slowdown.

A Family Budget Analogy

In many ways, Texas is like working parents who has been doing their best to support their family on a too-small monthly paycheck. Growing expenses erase the family's small savings and unpaid bills start piling up. Then, during the holiday season, extra hours of work translate to a modest bonus. Is that bonus a "surplus" that should immediately be used to help the family move into a larger, more expensive apartment, putting off to another day the problem of how to continue paying the rent? Or would it be wiser to use the bonus on the unpaid bills, save any remaining amount, and find a better job that will provide more income long after the holiday season is over?

The Sharp Commission Plan Will Harm School Funding Equity

The Texas Supreme Court has repeatedly ruled, in both the *Edgewood* cases and the recent *West Orange-Cove* case, that all school districts must be able to generate substantially similar revenue per student at similar tax rates. Under the current school-finance system, property-wealthy districts are able to raise over $500 per student more than lower-wealth districts at the current maximum tax rate of $1.50. Any increase in this funding gap could be found to be unconstitutional.

The Sharp Commission plan would cut the tax rate in all school districts to $1.00 by tax year 2007 and permit districts to raise their local rates by up to 6 cents per year, up to a maximum rate of $1.30. But the plan provides no revenue to equalize the additional local revenue that would be generated if districts chose to raise their rates, as they would likely do to keep up with inflation and attract and retain qualified teachers. This "local discretion" was at the heart of the recent court ruling and must be equalized in order to be "meaningful," as required by the court.[1] Each penny in additional local taxes would cost the state $150 million a year in equalization aid and must be provided for in any school-finance plan.

In addition, the current level of equalization has fallen behind the court's mandates. The state's current target is that at least 85% of students should attend school in districts with substantially equal access to revenue. According to projections by the Legislative Budget Board fewer than 75% of students are now within the equalized system.[2] Additional state equalization aid will be needed to return the school-finance system to at least the minimum required level of equity.

The Commission Plan Would Increase Regressivity

Texas' state and local tax system is extremely regressive—families with lower incomes pay a much higher percentage of that income in state and local taxes than do families with higher incomes. The Sharp Commission plan would exacerbate this unfairness.

The Commission has released tax equity notes showing the effect of its proposal on families of different income levels. Separate notes were prepared including and excluding the effect of a higher cigarette tax, which is very regressive. It is acceptable to treat the cigarette tax separately, since it can be viewed as a public health measure as much as a revenue source.

But even the equity analysis that excludes the cigarette tax shows that the commission plan would increase regressivity.[3] Families in every income group would get a tax cut, since the plan would cut property taxes by more than it would increase revenue from a new business tax and other sources. But the benefits of this tax cut would go disproportionately to higher income families. Low- and middle-income families would have their total tax burden reduced by 0.14% of their family income, while the one-fifth of Texas families with the highest incomes would get a tax break that was twice as big—0.27%. More than 60% of the total tax cut would go to 20% of families.

Some of this unfairness could be reduced by adopting the Lone Star Card rebate plan approved by the Senate last year. Through the Lone Star Card—the electronic benefits card used to distribute food stamp and TANF benefits—families with the lowest incomes could receive extra food assistance that would help offset the additional burden of the Sharp Commission proposals. In addition, some provision should be made to ensure that renters, who would not directly benefit from a reduction in property taxes, receive some share of the windfall that would otherwise go solely to their landlords.

A Higher Sales Tax is Not a Good Alternative

As explained above, the Sharp Commission plan would run a continual deficit and would not provide any new money to improve our public schools. Some might be tempted to turn to the sales tax as a source of additional revenue. School-finance plans considered in earlier special sessions included proposed increases in the state sales tax of up to 1%, from the current 6¼% to 7¼%. The state's extraordinary reliance on the sales tax, which currently provides more than half of state tax revenue, is the key factor in the tax system's extreme regressivity. A sales tax increase would be even more regressive than the Sharp Commission proposal and should be avoided.[4]

Success Should be Measured by Improved School Funding

The measure of success for the special session, which begins April 17, should be whether the education system is improved enough to avoid "drifting toward constitutional inadequacy." Instead, the Sharp Commission and too many legislators are focusing only on reducing property taxes. The revenue from the proposed new business tax and increased cigarette tax could be better directed.

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[1] For a further legal analysis of the need to equalize "meaningful discretion," see *The Public Education Challenge* at http://www.cppp.org/files/7/Texas%20Trilogy%201%20-%20The%20Public%20Education%20Challenge.pdf

[2] *Fiscal Size-Up 2006-07*, table 82, page 176 – http://www.lbb.state.tx.us/Fiscal_Size-up/Fiscal_Size-up_2006-2007_0106.pdf

[3] http://www.ttrc.state.tx.us/files/W12.pdf

[4] *Texas Revenue Primer* at http://www.cppp.org/research.php?aid=361.