

Show Me the Money

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INTRODUCTION

The anticipated special session on school finance will undoubtedly focus on issues of adequacy – how much money is necessary to fund public education – and equity – how this amount is to be distributed among school districts. However, there is a separate set of issues of adequacy and equity that will also have to be addressed – the adequacy and equity of Texas’ revenue system.

On the state level, public education absorbs 43 percent of the state’s general revenue budget, a proportion greater than the amount of state general revenue spent on higher education and health and human services combined. On the local level, school property taxes account for 60 percent of all property taxes levied in the state. Any examination of the sources of revenue for public education will thus necessarily involve an examination of the entire state and local revenue system.

OVERVIEW

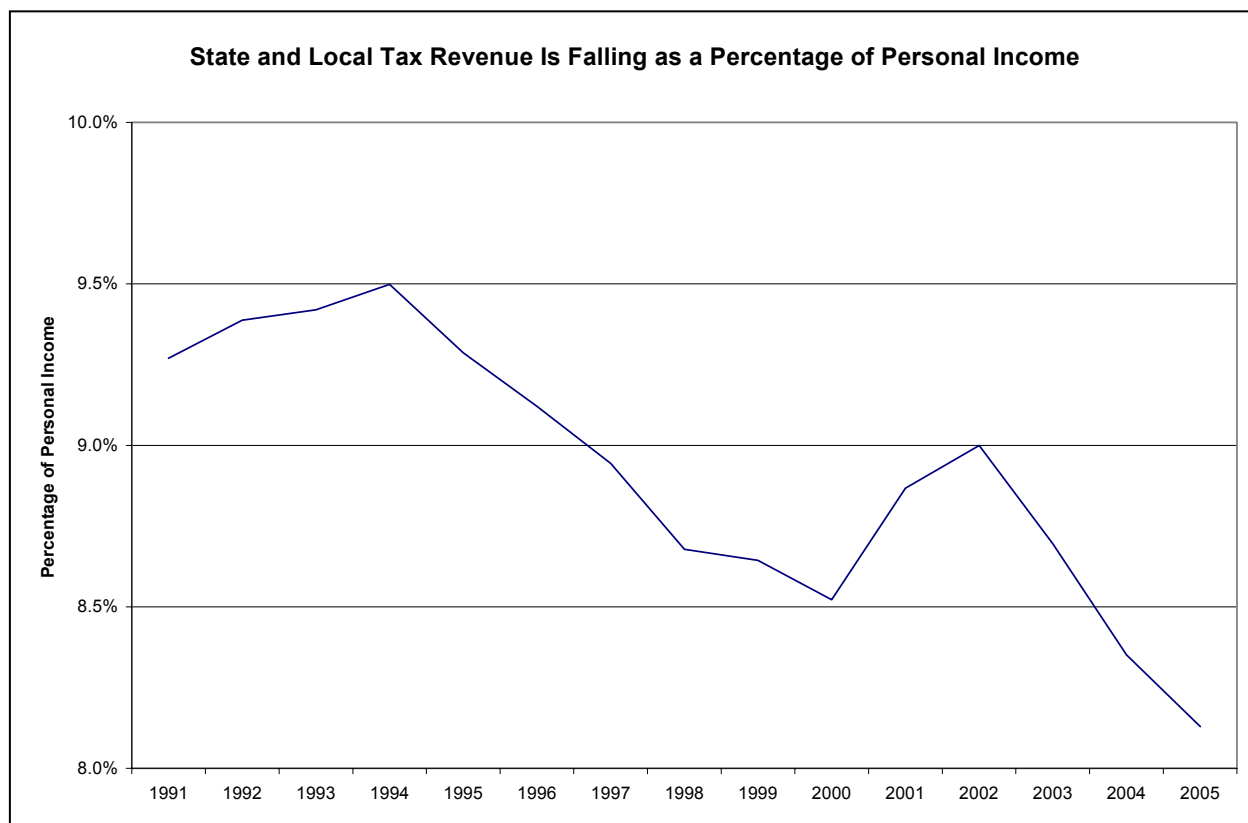
The current state and local revenue system has proven unable to keep up with the growth of the state economy. A tax system should be able to keep pace with economic growth, generating additional revenue without increases in tax rates. Stable tax rates allow for reliable business planning and promote public support for necessary revenue generation. Growth in the state economy also roughly reflects the growth in demand for government services, including inflation and population growth.

The gap between the growth in revenue generated by the current tax system and the faster growth in demand for services creates a “structural deficit.” This deficit will appear as continual revenue shortfalls facing budget-writers.

Texas state and local taxes have declined steadily as a percentage of personal income – a standard measure of a state’s economy – since 1991, the last year in which major changes were made to the tax system. If state tax collections had remained at their 1991

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proportion of personal income, the state would have an additional \$15 billion in revenue in the 2004-05 biennium.



In Texas' previous economic slowdown, in the 1980s, the state maintained revenue only by increasing tax rates. For example, the rate for the state sales tax, the major source of state tax revenue, was increased from 4 percent to 4 ¼ percent in 1984, 5 ¼ percent in January 1987, 6 percent in October 1987, and the current 6 ¼ percent in 1990. Certain services were added to the sales-tax base during this period, including cable television service, most non-automotive repair services, repair and remodeling of nonresidential real property, long-distance telephone services, and data processing and information services.

The motor-vehicle sales tax followed a path similar to the general sales tax, while the motor-fuels tax was raised from 5 cents per gallon to 10 cents in 1984, 15 cents in 1986 and the current 20 cents in 1991. The cigarette tax was increased steadily from 18.5 cents per pack to the current 41 cents per pack by 1990. The corporate franchise tax was restructured in 1991 to include an "earned surplus" component that reflected corporate profits.

State tax rates have not increased since 1991. However, local school districts have raised school property tax rates consistently over this period, reflecting the state's failure to fulfill its obligation to fund education. The statewide average school tax rate per \$100 of property value rose from \$1.07 in 1991 to \$1.60 in 2002. As a consequence, the state's

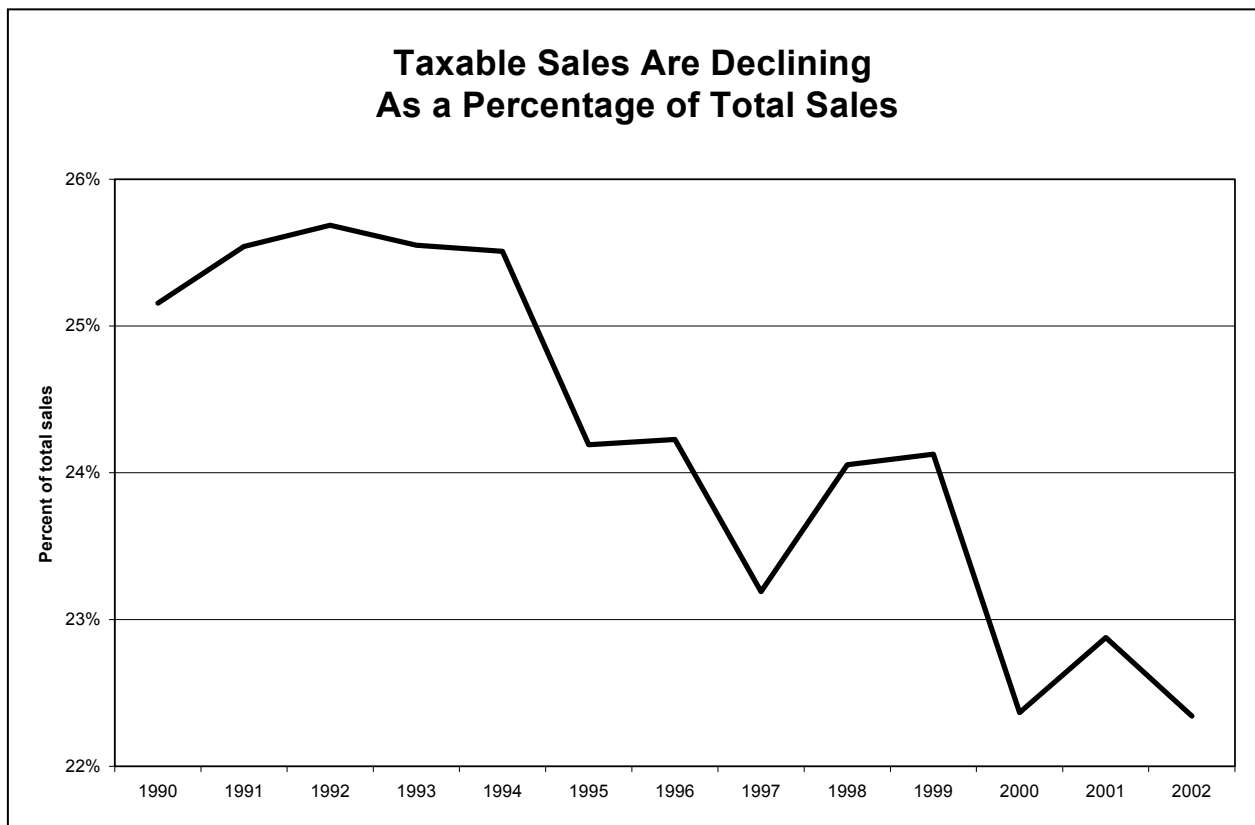
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share of state/local public education expenditures has fallen from 47 percent in 1991 to 42 percent in 2002; the state share is expected to drop below 40 percent in the coming state budget.

ADEQUACY

The inadequacy of the Texas tax system is caused by its heavy dependence on the sales tax, which generates 55 percent of state tax revenue. The sales tax has produced the majority of state tax revenue every year since 1988.

The sales tax applies to a shrinking percentage of all sales transactions in the state. Sales volume has grown faster than sales-tax receipts.



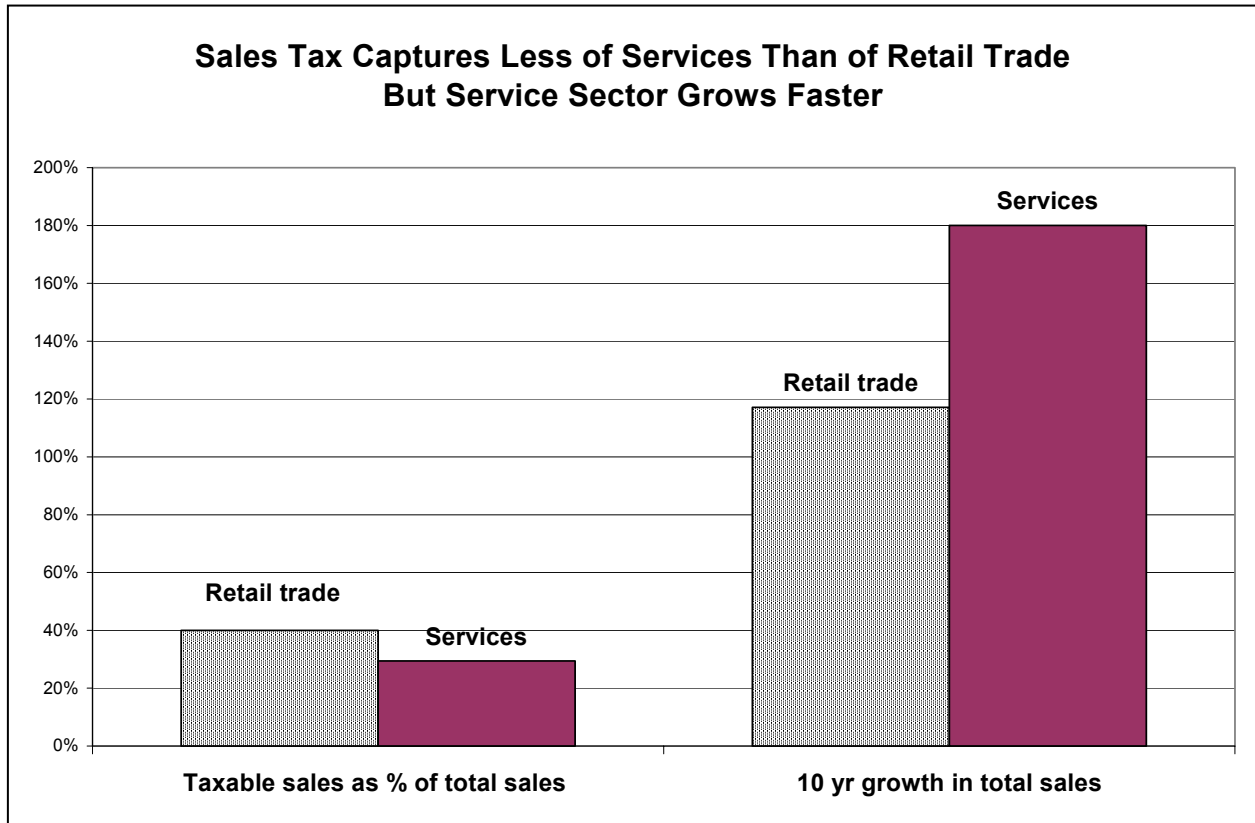
This decline partially reflects untaxed Internet and mail-order sales. U.S. Supreme Court opinions currently prohibit a state from collecting the sales tax from out-of-state sellers that do not have a physical presence in that state. Most states, including Texas, are negotiating a national Streamlined Sales Tax Agreement to eliminate these legal restraints.

The primary cause of the sales tax's inability to track increased total sales is its failure to mirror changes in the state's modern economy. Texas adopted the sales tax in 1961, when

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most sales involved goods – tangible items. However, the faster growing sectors in the 21st century economy involve the sale of services, rather than tangible goods.

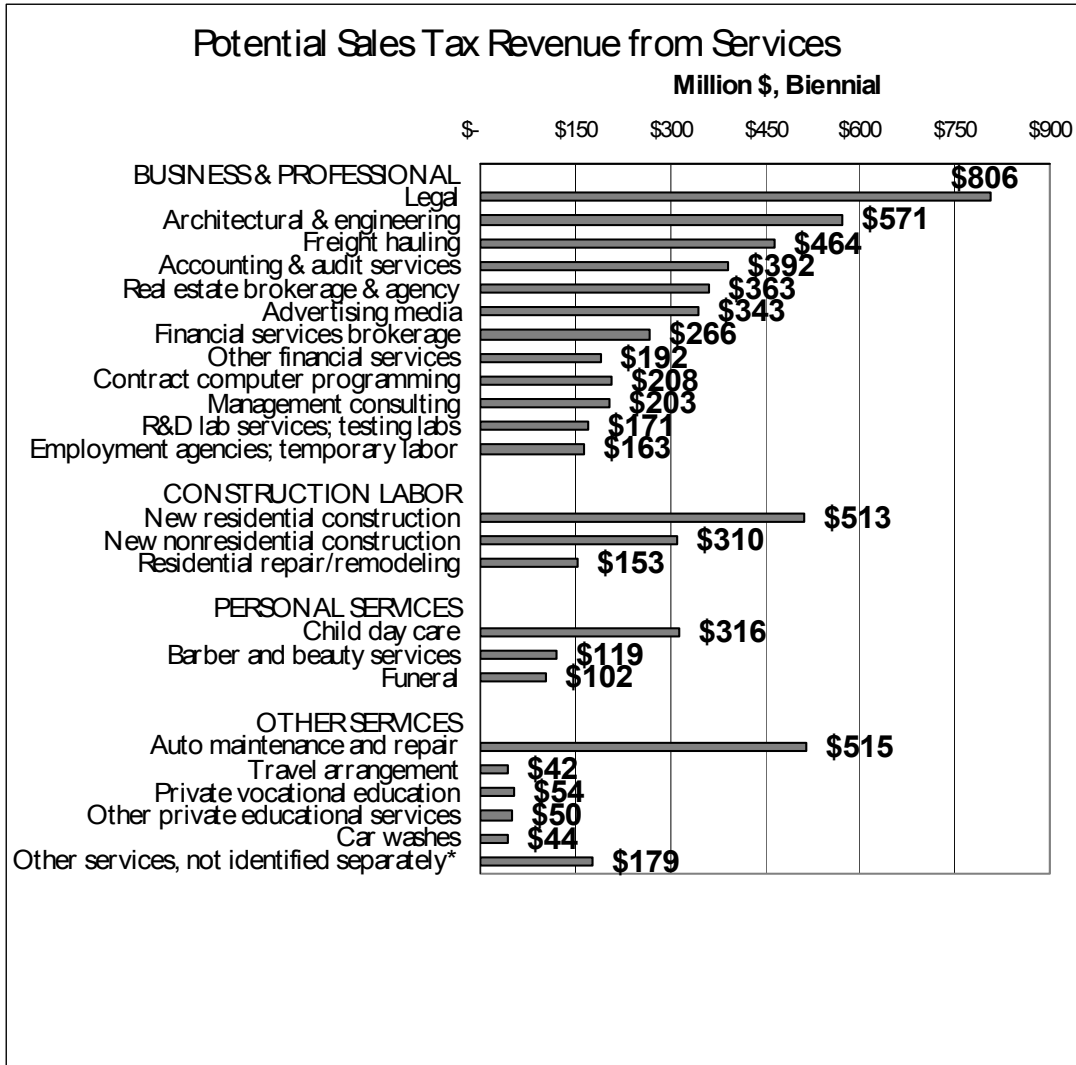
The sales tax applies to 40 percent of the retail trade in goods, but only 30 percent of the sale of services. Over the past 10 years, sales of services have grown at a pace one and one-half times faster than the growth in retail trade in goods.



Modernization of the sales tax would expand the tax base to cover services that are currently untaxed, including most business and professional services. The comptroller has estimated that taxing these services (except medical and dental services) could raise \$6.5 billion in 2004-05.

Many of these exempt services are used largely by business and higher-income families – for example, legal services (\$806 million), architectural and engineering services (\$571 million), and freight hauling (\$464 million). Other services with large revenue potential that would have more direct impact on families include auto maintenance and repair (\$515 million) and new residential construction (\$513 million).

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The school-finance plan passed by the Senate in May 2003 contained a very broad provision that would have applied the sales tax to almost all services, except health care services.

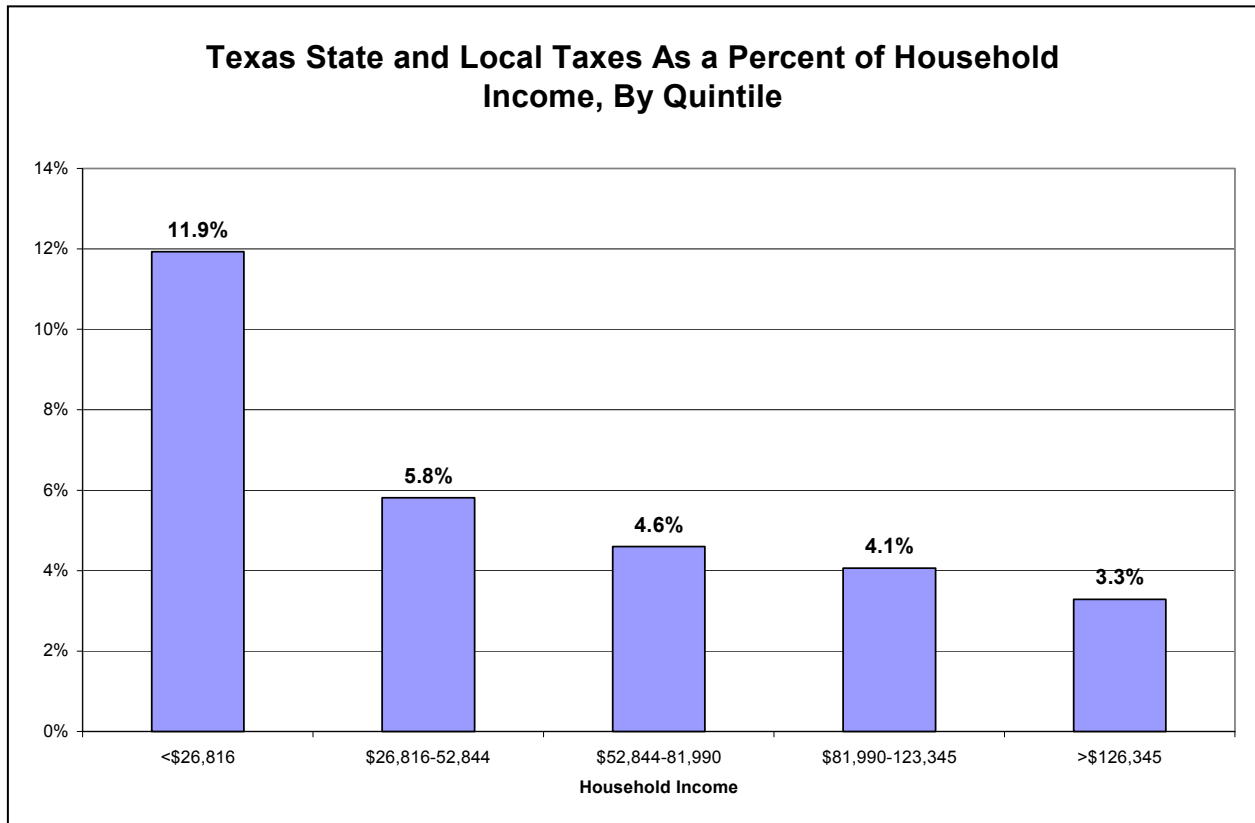
EQUITY

The Texas tax system is strongly regressive – low- and moderate-income Texas families pay a much greater percentage of income than do higher-income families. A recent study rates Texas’ system as the 5th most regressive among the 50 states.¹

The comptroller calculates, by household income, industry, business type, and homeowner/renter, the tax burden of the five largest state and local taxes – sales tax, school property tax, motor-vehicle sales tax, gasoline tax, and franchise tax.² According to her study, the 20 percent of Texas families with annual incomes under \$26,800 (the lowest income “quintile”) pay a total of 11.9 percent of their income in these five taxes

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each year. In contrast, these taxes account for only 3.3 percent of the incomes of the 20 percent of families making over \$126,400 (the highest income “quintile”).



The sales tax is the major factor in this regressive pattern. Taxes that are based on consumption, such as the sales tax, are inherently regressive because lower-income families tend to spend a much larger proportion of their annual income, while higher-income families can afford to save a portion of their income. This pattern is exacerbated if business and professional services, which are disproportionately used by higher-income families, are not taxed. On the other hand, Texas exempts groceries, residential utilities (gas, electric, water), and medicines, which prevents the sales tax from being even more regressive.

The sales tax takes a 3.7 times greater share of the income of a family in the lowest income quintile than of the highest-income group. The similar ratio for the school property tax is only 3.1. Using higher sales-tax rates and an expanded sales-tax base to reduce property taxes, as proposed by the Senate school finance plan of May 2003, thus ratchets up the regressivity of the system even more.

The Center has calculated that replacing school property taxes entirely with sales taxes would increase taxes on all income quintiles except the highest. Although families in the lowest income group would face only a marginal increase, families in the middle income quintile could see a 10 percent increase compared to their current total sales/property tax

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obligation. Families with the highest income, in contrast, could enjoy a 9 percent drop compared to their current load.

If We Replace Property Taxes...

Average household income	Sales taxes currently paid	Property taxes currently paid	Total sales and property taxes currently paid	Same statewide total, if paid entirely through sales tax	Change in taxes paid	
\$15,300	638	800	1,439	1,447	9	1%
\$42,900	925	1,043	1,968	2,098	129	7%
\$72,400	1,286	1,376	2,662	2,916	254	10%
\$110,400	1,683	1,970	3,653	3,818	165	5%
\$226,500	2,562	3,805	6,367	5,810	-556	-9%

PERSONAL INCOME TAX

One way out of the Texas' revenue dilemma would be adoption of a personal income tax, which would improve both the equity and adequacy of the state/local revenue system.

There is widespread and well-known reluctance by state office-holders to discuss this alternative openly. A recent Texas Poll taken by the Scripps Howard newspaper chain indicates that the leadership is lagging behind the public. A majority of the 1,000 adult Texans polled – 52 percent – supported a personal income tax if used to reduce property taxes and support education. The tax was opposed by 44 percent; another 4 percent didn't know.³ Several of the state's leading newspapers have similarly endorsed adoption of an income tax.⁴

A broad-based personal income tax is used by 41 other states (two other states tax only interest and dividends). These states rely on income tax revenue for 27.5 percent of their total revenue derived from income, sales, and property taxes.⁵ As a consequence, their reliance on sales and property taxes is much lower than Texas'. Sales taxes account for 40.2 percent of three-tax revenue in the average state, but 57.3 percent in Texas. The average state relies on property taxes for 32.4 percent of three-tax revenue; property taxes provide 42.7 percent of revenue in Texas.

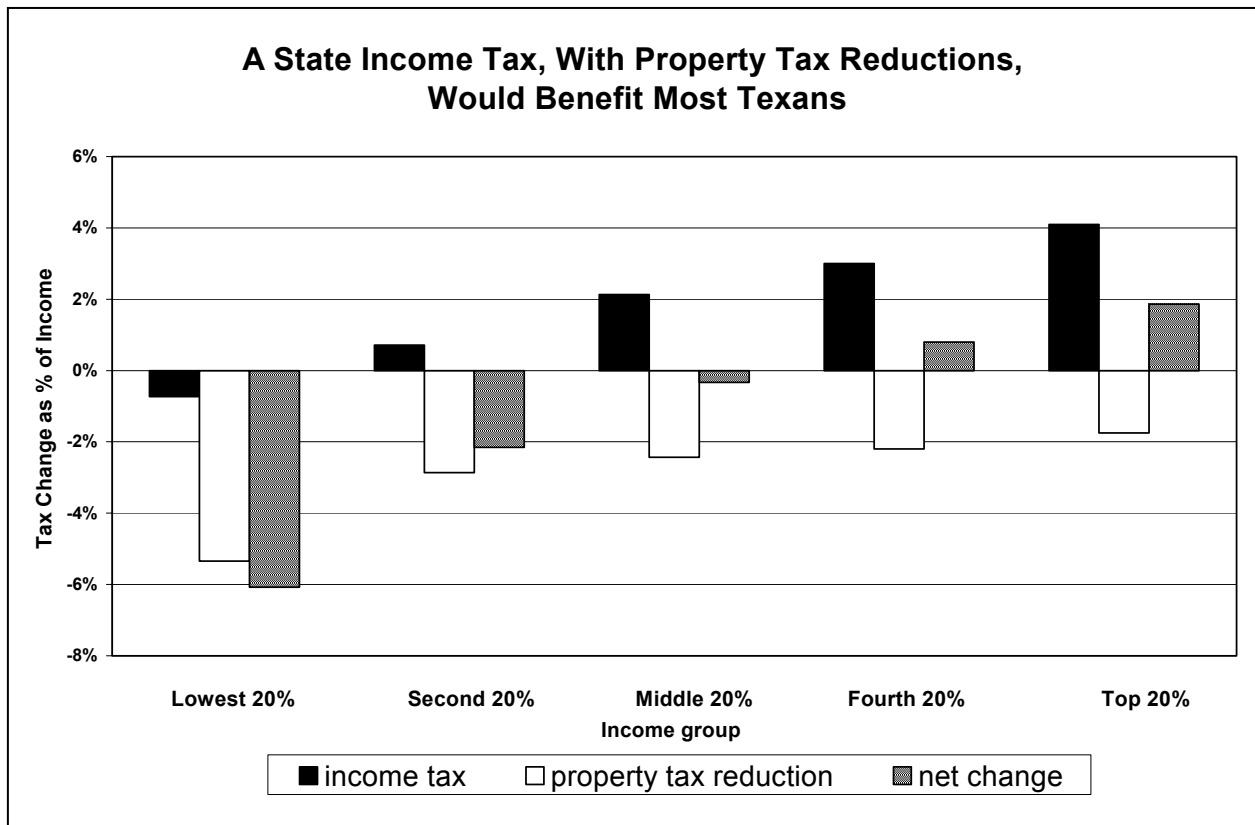
The Texas Constitution, Article 8, Section 24, outlines the procedure to be followed for implementation of a personal income tax. The tax could be enacted by a simple majority of the Legislature, but would not become effective until approved by a statewide referendum. Any changes that increased the income-tax rate or increased overall tax liability would also be subject to voter approval.

Two-thirds of income-tax revenue would go to reduce school district maintenance and operations (M&O) taxes; the remaining one-third would be dedicated to the support of education. The maximum M&O tax cap, which is currently \$1.50 per \$100 in valuation, would be reduced in proportion to the reduction in property taxes. Local school districts could ask their voters for approval to raise this cap.

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The Center has calculated, with the assistance of a national tax research organization, the impact of an income tax on Texas. In order to use an existing framework into which to insert Texas family income data, the Center chose the rates, exemptions, and deductions used by Kansas, which has income-tax collections that are slightly below the national average as a percentage of personal income.

A personal income tax based on this structure would have generated total revenues of \$17.3 billion if applied to Texas income in 2000. Two-thirds – \$11.5 billion a year – would have been sufficient to reduce school M&O taxes by 90 percent. The maximum rate would shrink to roughly 15 cents, compared to the current \$1.50. The remaining revenue – \$5.8 billion a year, or \$11.6 billion in a state fiscal biennium – would be dedicated to funding education. This net increase would help cure the state’s problem of inadequate revenue.



An income tax can also help offset the regressivity of the rest of the revenue system. The Kansas tax does not tax the income of a family of four with an income of less than \$24,100. The tax rate increases with each additional \$30,000 of income, from 3.5 percent to 6.25 percent and a maximum marginal rate of 6.45% (roughly the median maximum rate among states with income taxes).

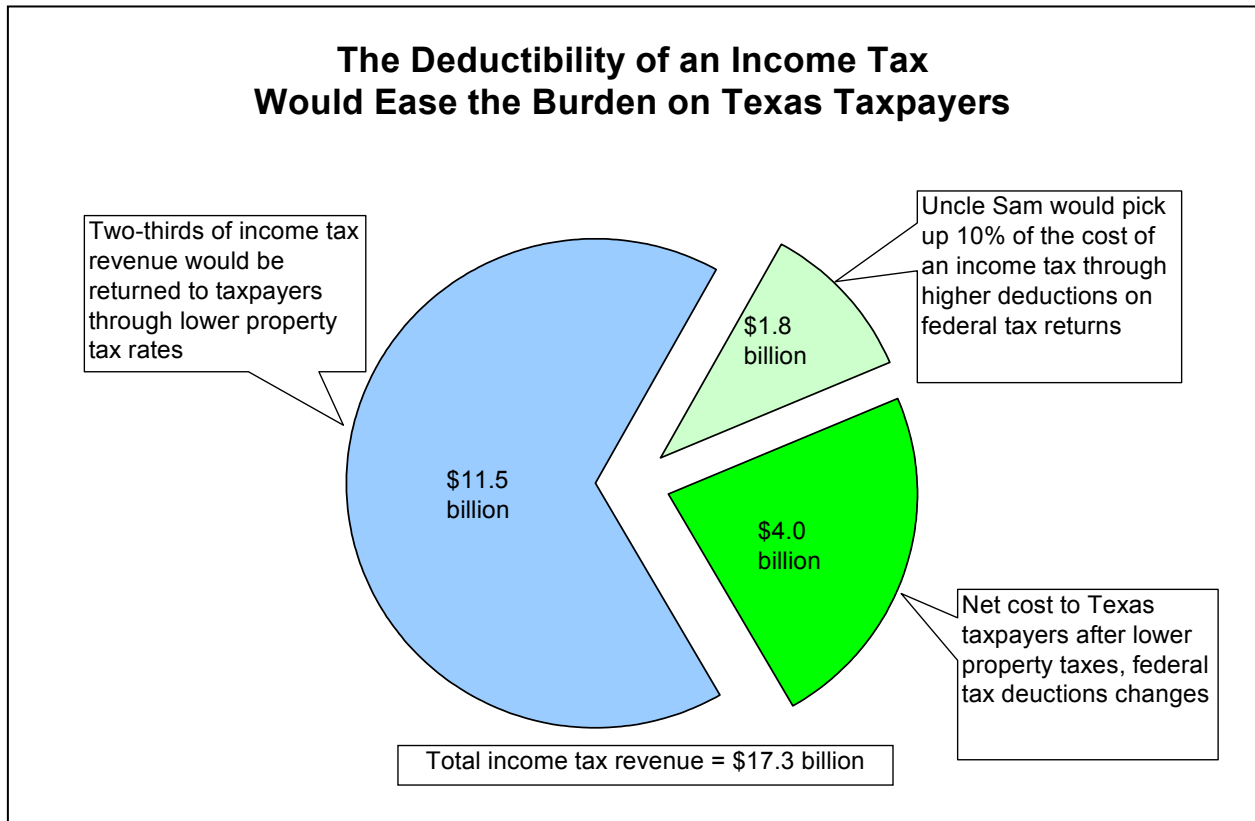
The shift in taxes is dramatic. An income tax, combined with the required property tax reductions, would reduce net taxes for a majority of Texas families. Those in the lowest income quintile would see their tax burden cut by 6.1 percent of income, with smaller cuts for the next two higher quintiles. The largest tax increase would be on the one-fifth

Putting the Sides Together

of families with the highest income, who would pay an additional 1.9% of their income in taxes.

However, the highest income group would also gain most from the deductibility of state income taxes on their federal income tax forms, which is included in these calculations and reduces the net burden by one-fifth.

On a statewide basis, the deductibility of an income tax shifts about 10 percent of the cost of a new state income tax onto the federal government. This potential federal subsidy for state taxpayers is lost with the state's heavy reliance on sales taxes, which are not deductible.



The coming school finance debate offers the opportunity for a full examination of all the revenue options available to fund public services in Texas. Each alternative has its advantages and disadvantages. Prematurely limiting the debate by eliminating consideration of one of the most potent options – the state personal income tax – would sharply reduce the probability of finding a long-term solution to Texas' continuing structural budget deficit.

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ENDNOTES

¹ *Who Pays? A Distributional Analysis of the Tax Systems In All 50 States*, 2nd Edition, Institute on Taxation and Economic Policy, Washington, D.C., January 2003.

² *Tax Exemptions & Tax Incidence*, Comptroller of Public Accounts, Austin, TX, January 2003.

³ “State Income Tax Gains Support, Survey Finds,” Hughes, Polly Ross, *Houston Chronicle*, May 15, 2003.

⁴ E.g. “It’s High Time to Update Texas’ Tax System,” *American-Statesman* Editorial Board, *Austin American-Statesman*, May 10, 2003. “Support Is Growing for State Income Tax,” *Corpus Christi Caller-Times*, May 18, 2003.

⁵ *CQ’s State Fact Finder 2003*, Hovey, Harold A. and Kendra A., CQ Press, Washington, D.C., 2003. Table F-15, page 154.