

## The Best Idea They Won't Talk About

*Why a state income tax might save you money and improve education. No, really.*

BY DAVE MANN

**O**n April 17, the Texas Legislature will convene in special session for yet another attempt to re-jigger the way we fund public schools. If you're keeping score at home, this will be lawmakers' sixth try in three years to fix a broken school-finance system. This time around they absolutely, positively have to come up with a plan. Last fall, the Texas Supreme Court declared the current system unconstitutional and gave lawmakers a deadline of June 1. The goal, once again, is to cut property taxes and—if there's some cash left over—increase funding for school districts. In the weeks that follow, you will hear more talk about various state taxes than you ever wanted to. There are sales and property taxes, of course, but there's also the cigarette tax and perhaps liquor taxes. Don't forget the franchise tax and the governor's broad-based business tax, which some lawmakers are calling a gross-receipts tax and others would rather see configured as a business-profits tax. If all that tax talk doesn't give you a headache, you must be an accountant.

But there's one tax that you probably won't hear much about, and that's the one that might actually fix the system. It's the revenue source that dare not speak its name—a state income tax.

Of course, it's usually around this time of year—when federal tax returns come due—that many Texans privately thank their maker that we're one of only nine states without an income tax. No extra forms, no worrying about forking over additional money to a state agency, no added hassle.

That is, unless you're a public school teacher wondering why your salary is so far below the national average or you're a school district administrator trying to figure out why your budget can't pay for art classes anymore or you're a homeowner coping with property taxes that have doubled since you bought your house. The root of these problems is structural: Our outdated tax system delivers too little revenue to state coffers. That means the Legislature spends far too little on public schools; Texas ranks 38th nationally in average spending per student, and that ranking has been heading south lately. To compensate for meager education monies from the Capitol, local governments have hiked property taxes as high as possible. That's a terribly inefficient way to fund schools: Texans pay some of the highest property tax rates in the country, and in return, we're getting a consistently cash-starved school system that doesn't educate kids well enough (Texas' average SAT score ranks 48th in the nation). If that sounds like a rip-off, then we may have a better deal for you.

We know what you're thinking: Here comes the liberal hard sell that we all need to pay more taxes to boost the public schools, save our children, yadda, yadda, yadda. But therein lies the twist. Under a state income tax, you would likely pay less in state taxes. Study after study shows that a state income tax would give the majority of Texans a net tax cut and still provide several billion dollars more for education. Lower taxes and better schools—sound too good to be true? To find out, we asked some of the state's tax-policy experts—both conservative and liberal—how a Texas income tax would actually work.

It's common knowledge around the Capitol that you don't tangle with Dick Lavine about taxes unless you know your numbers. Lavine majored in economics at Harvard and holds a law degree from the University of Pennsylvania. He now works as an analyst and lobbyist for the Center for Public Policy Priorities (CPPP), a liberal Austin think tank, and has been a longtime proponent of a state income tax. He's crunched the numbers many times and says the income tax is clearly the best way help abate two of the main problems he sees with the Texas tax structure. First, the current system will never generate the revenue the state needs for education, and second, the money it does bring in comes disproportionately from middle- and low-income families. "The biggest problem in Texas is we have a structural deficit," Lavine says. "The growth in spending is much faster than the growth in revenue." The system relies too heavily on taxing goods (sales tax) and land (property taxes). As Fred Lewis, director of the grassroots group Citizens Commission on Education Excellence and an income tax proponent, puts it, "We have a 19th-century tax system in a 21st-century economy." (Lewis is spearheading a petition to bring Texas' spending on education up to the national average.) A 19th-century model works well for an economy based on physical infrastructure—local factories and refineries, for example. But it leaves untapped two growing sectors of the 21st-century economy—professional services (lawyers, doctors, and information services) and personal income (salary and investment gains). That means, when the economy expands, Texas doesn't take in as much tax revenue as it should.

The other problem Lavine sees is the system's astounding inequity. According to the state comptroller's office, if you earn \$20,000 a year, you pay 12 percent of your income in various state taxes (those making just \$12,000 a year—basically at the poverty line—fork over 14 percent). But if you earn \$177,000 or more, you pay just 5 percent to the state. That's the magic of relying so heavily on sales and property taxes—two of the most regressive taxes around.

It will take a lot of cash to significantly cut property taxes and increase school funding at the same time. If enacted, the governor's recently released business-tax plan [see "Sharp Ideas?" page 8] would raise about \$4 billion annually—only enough to offset property tax cuts. That would lower your property tax bill by about 33 percent. Meanwhile, state Sen. Eliot Shapleigh (D-El Paso), one of the few elected officials publicly pushing an income tax, estimates that Texas schools require another \$3.2 billion annually to reach the national average in per capita funding. At the very least, schools need more than \$1 billion in new money each year just to keep up with population growth. Either way, we're talking about at least \$5 billion to \$7 billion in new money that the state needs. And Lavine doesn't see many reforms that can consistently bring in that kind of dough.

Lawmakers could expand the list of items subject to the sales tax (goods such as food, medicine, natural gas, electricity, and water are now exempted) or raise the sales tax rate, which would likely give Texas the highest rate in the nation. They could also enact some form of broad tax on businesses, as Gov. Rick Perry and others have suggested. Both of these options might actually make the system even more regressive. Lavine's calculations, based on data from the comptroller's office, show that if sales taxes were used to replace property tax cuts, all families making less than \$96,000 a year—which is about 80 percent of us—would see their taxes increase. (Only those making more than \$96,000 would get an overall tax cut.) As a result, it's unlikely that sales or business tax increases alone would raise enough money in the long term—the state's spending needs would eventually outstrip them. After all, there's only so much blood you can squeeze from middle-income and poor families.

On the other hand, Lavine argues, an income tax would make the system fairer and generate oodles of new revenue. He hopes that when the Lege has exhausted all of its other options, it will eventually come around on the income tax. Conveniently enough, the contours for an income tax are already laid out in the Texas Constitution. That's the handiwork of Bob Bullock, the late lite gov. and comptroller. In 1991, Bullock was just a few weeks into his first term as lieutenant governor when he shocked the Austin political glitterati by advocating a state income tax. With Gov. Ann Richards and most other elected officials opposed to the idea, Bullock lost that fight. Two years later, he seemingly switched sides: He pushed through a constitutional amendment that requires a public vote on any state income tax proposal. Conventional wisdom posits that Bullock's amendment makes it almost impossible to ever implement a state income tax. But Bullock also included stipulations that might make an income tax more palatable to many Texans. For instance, Bullock's amendment requires that two-thirds of all the revenue raised through an income tax go toward cutting property taxes. The other third must fund public schools. That's in the constitution. So legislators couldn't raid income-tax revenue for any other spending goodies unless they first amended the constitution (that ain't gonna happen). Lawmakers couldn't just hike the income-tax rate willy-nilly, either. Bullock's amendment specifies that once implemented, a state income tax can't be increased unless voters approve a rate hike at the polls. It would be the only tax over which the public had control. (In fact, a 2003 Scripps-Howard poll found that when respondents were told of those constitutional requirements, 52 percent said they would support a state income tax.)

A state income tax would be a cash cow. In 2004, Lavine and researchers from a Washington, D.C., think tank took the Kansas income tax formula and applied it to Texas. (Kansas is a nice example because it's around the national average on most measures of revenue and spending.) The Kansas system levies a 3.5 percent tax on people who make up to \$15,000 a year, 6.25 percent on \$15,000 to \$30,000, and 6.45 percent on income more than \$30,000. In Texas, that would bring in at least \$18 billion annually for the state. That means two-thirds (or \$12 billion) would go toward property tax cuts—enough to reduce your property tax bill by more than 66 percent (twice the reduction provided by the governor's current plan). The remaining \$6 billion raised by the state income tax would go to additional funding for public schools—enough to cover teacher pay raises, new textbooks, facility improvements, English as a Second Language courses, you name it.

Who would pay for all that? Mostly, families with higher incomes. According to CPPP, if we instituted the Kansas system to cut property taxes, 60 percent of Texas households would receive a net tax cut. The poorest 20 percent of households would realize a reduction in their state taxes of more than 6 percent. A family that earns \$50,000 a year and that owns a house would pay roughly 1-2 percent less in state taxes. Only the richest 20 percent of families (those earning about \$100,000 or more) would see their overall state taxes increase, but by a mere 2 percent. Because their incomes are so high, that slight increase would generate a lot of new money for the state.

So there it is: An income tax such as Kansas' would provide \$6 billion in new funding to educate our kids, and in exchange, most Texans would receive a tax cut. Of course, other analysts see things differently.

“There are structural problems with an income tax that make it a bad way to fund your government,” said Michael Quinn Sullivan. He’s vice president of the Texas Public Policy Foundation (TPPF), a free-market think tank that claims to provide the “intellectual ammunition” for the current Republican leadership of Texas. It comes as no surprise that Sullivan and his colleague Byron Schlomach—an economist and former staffer for Rep. Kent Grusendorf (R-Arlington)—are against an income tax.

They concede that poor families would seem to benefit from replacing property taxes with an income tax, but, they argue, that’s a simplistic, superficial analysis. Sullivan and Schlomach contend that an income tax would drain the economy—what they term the “indirect costs” of an income tax. They present this scenario by way of example: Under an income tax system, business owners wouldn’t want to reduce their employees’ salaries by withholding income tax because employees rely too much on the money in their paychecks. So business owners would end up paying the tax out of their revenues. To make up that amount, companies might lay off janitors or other low-wage employees. “The full cost of the tax comes in lost job opportunities and it comes in lost revenues,” Schlomach said.

“Even the most progressively designed income tax is inherently regressive,” Sullivan adds. “The people at the bottom bear the brunt.”

Moreover, the TPPF analysts argue, an income tax is more volatile, more tied to swings in the economy and would leave Texas’ state budget more vulnerable in an economic downturn. California, for instance, which has an income tax, is still trying to patch the holes in its budget from the 2001-2002 recession. (Lavine concedes this point, noting that the income tax isn’t perfect and isn’t a cure-all—just the best of limited options. He also points out that Texas has some budget safety valves, such as the rainy day fund, that would help mitigate the effects of a recession.)

Sullivan and Schlomach favor consumption levies like the sales tax because it’s a more “visible” tax, meaning that people see the tax every day when they buy goods. TPPF disputes the notion that the sales tax is regressive. They argue that poorer folks spend less money and therefore probably pay less sales tax. “When my kids need new jeans, we buy them at Wal-Mart,” Sullivan says. “When people who make more money than me buy jeans, they buy them at the Gap. Who do you think pays more in sales tax?”

But Lavine says the real question is what percentage of our income goes to buy a pair of jeans. Poorer families inevitably spend a higher percentage of their income on goods and pay a higher percentage of their income in sales taxes. As for an income tax harming the economy, he notes that 41 other states have income taxes, and many of their economies are just fine. In fact, many other states are better positioned than Texas because they spend handsomely on schools and will produce a better-educated workforce. That, Lavine argues, should be the whole point. “The income tax would generate so much for public education, and kids would benefit because they would get better jobs. You can’t say that the economy isn’t better off when we have a better public education system.”