

Appendix B

Expert Testimony and Source Material

October 25-26

- B-1. Public School Finance Seminar
Facilities Financing Programs*
David Anderson, General Counsel, Texas Education Agency
Joe Wisnoski, Assistant Commissioner for School Finance and Fiscal Analysis,
Texas Education Agency
- B-2. The Texas Public School Finance System: An Outline Summary of Legal
Challenges and Constitutional Standards*
Jeffrey S. Boyd, Deputy Attorney General for Litigation, Office of the Attorney
General
- B-3. Funding K-12 Education*
Steve Smith, Manager of NCSL's National Center on Education Finance

January 24-25

- B-4. Cost-of-Education Index Study*
Harrison Keller, Project Director, University of Texas Charles A. Dana Center
Uri Treisman, Professor of Mathematics, University of Texas Charles A. Dana
Center
Lori Taylor, Principle Researcher, University of Texas Charles A. Dana Center
- B-5. Texas School Finance and Real Estate Values*
R. Malcolm Richards, Director, Real Estate Center, Texas A&M University

February 7-8

- B-6. The Presentation to the Joint Committee on Public School Finance*
John Connoly, Executive Director, Texas School Coalition and the South Texas
Coalition of Schools
Doug Otto, Superintendent, Plano ISD
Martin Pena, Executive Director, Texas School Coalition and the South Texas
Coalition of Schools
Roberto Zamora, Superintendent, La Joya ISD

- B-7. *School Finance 2003: When Rising Costs Meet Capped Taxes*
Pat Forgione, Superintendent, Austin ISD and President, Texas School Alliance
- B-8. *Funding Public Education*
Dick Lavine, Fiscal Analyst, Center for Public Policy Priorities
- B-9. *Issues of Concern to Charter Schools*
Christi Martin, Administrator, Association for Charter Educators
- B-10. *Financing the Public Schools of Texas: Some issues of Growth, Equity, and Efficiency*
Ray Perryman, President, Perryman Group

March 7

- B-11. *Presentation to the Joint Select Committee on Public School Finance*
John McGeady, Legislative Budget Board
Robert Norris, Legislative Budget Board
John O'Brien, Legislative Budget Board
Ursula Parks, Legislative Budget Board
- B-12. *Overview of the Property Tax System in Texas*
Billy Hamilton, Comptroller of Public Accounts
Dan Wilson, Comptroller of Public Accounts
Tim Wooten, Comptroller of Public Accounts

April 3

- B-13. *Texas Taxes*
James LeBas, Chief Revenue Estimator, Comptroller of Public Accounts

May 9

- B-14. *Keeping Up With School Costs: Is It a Tax Base Question?*
John Kennedy, Senior Analyst, Texas Tax Payers and Research Association

September 13

- B-15. *Education Finance Adequacy*
Michael Griffith, Policy Analyst, Education Commission for the States
- B-16. *Project Proposal*
Harrison Keller, Director, University of Texas Charles A. Dana Center
- B-17. *History of Cost Studies in Texas*
Joe Wisnoski, Assistant Commissioner for School Finance and Fiscal Analysis,
Texas Education Agency
- B-18. *Kansas School Finance and Cost of a Suitable Education**
Dale Dennis, Deputy Commissioner, Kansas State Department of Education
*copies of this report are available upon request

Expert Source material

- B-19. *Per Capita Expenditures*
Texas Education Agency
- B-20. *Tax Exemption and Tax Incidence*
Texas Comptroller of Public Accounts

B-1. *Public School Finance Seminar
Facilities Financing Programs*
David Anderson, General Counsel, Texas Education Agency
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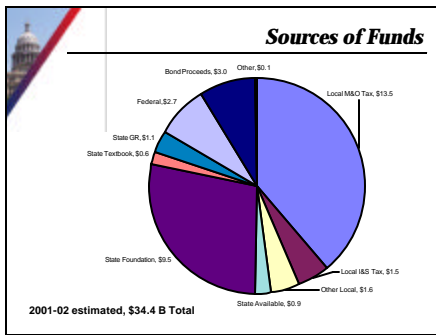
Public School Finance Seminar

David Anderson
Joe Wisnoski

Big Picture of School Finance

The system is huge

- Annual state aid and local taxes exceed \$24 billion.
- 1% error in projecting state cost is worth \$220 million in a biennium.
- It takes large amounts to make meaningful change in a system this large.



Big Picture of School Finance

Wealth is tax base per student, not absolute

- A penny of tax rate in Houston ISD generates \$6 million
- A penny of tax rate in Divide ISD generates \$2,165

But,

- At \$1.50 tax rate, Houston ISD produces \$4,775 per ADA
- At \$1.50 tax rate, Divide ISD produces \$9,175 per ADA

Big Picture of School Finance

Almost all money in the system is geared to overcome disparities in local property values

Any change tends to impact the equity of the system

Three Basic Variables

Number of Students

- More students increase state cost
- Fewer students decrease state cost

Property Values

- Higher values save the state general revenue (GR)
- Lower values cost the state GR

Tax Rates

- Higher tax rates increase state cost & local budgets
- Lower tax rates decrease state cost & local budgets

Marginal (State) Cost of Students

System Guarantee of \$100/Student

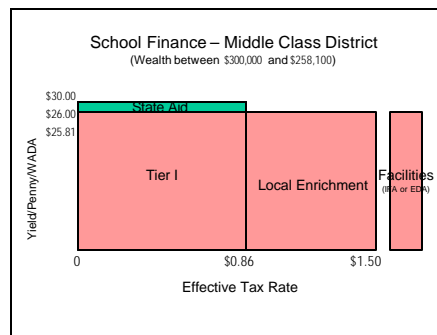
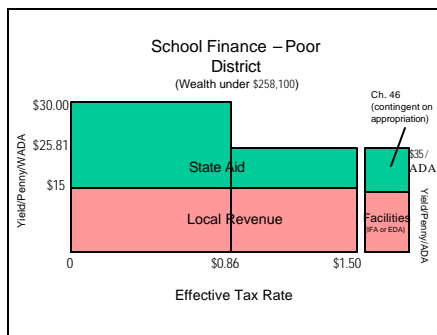
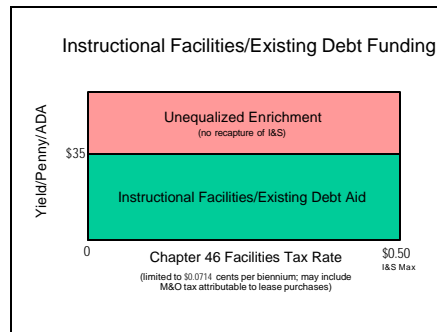
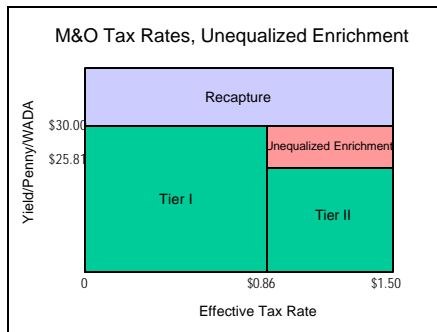
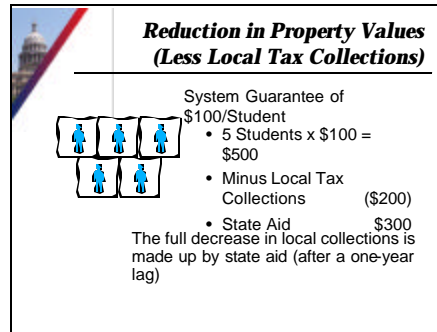
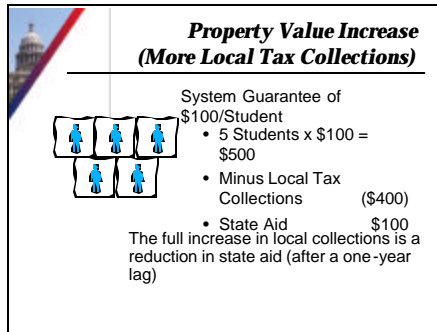
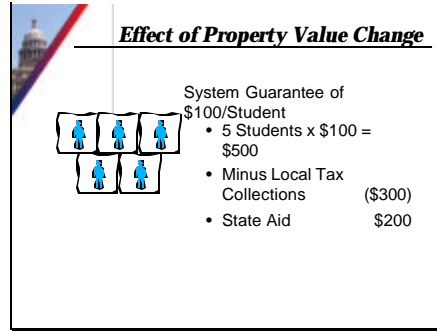
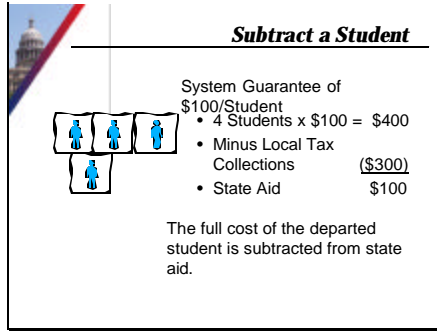
- 5 Students x \$100 = \$500
- Minus Local Tax Collections (\$300)
- State Aid \$200

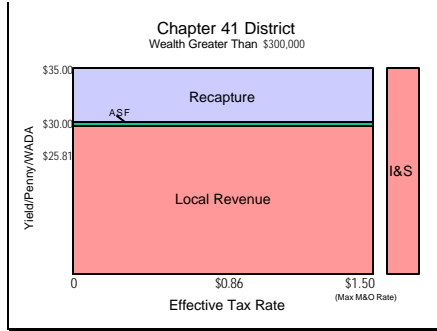
Add a Student

System Guarantee of \$100/Student

- 6 Students x \$100 = \$600
- Minus Local Tax Collections (\$300)
- State Aid \$300

The full cost of the additional student is paid in state aid.





- ### Outlines of the Safe Harbor
- 85% of Students in Tier II
 - \$600 revenue gap at \$1.50 tax rate (15%)
 - 98% equalized revenue
 - Facilities addressed
 - Meaningful discretion to set tax rate
 - Sufficient funds to meet Ch. 39 accountability system

- ### Rules of Thumb for the FSP
- An increase of 1 student (enrolled) on average raises the cost of the FSP/state aid by about \$5,500
 - An increase of \$1 billion in tax base generally reduces state aid by about \$15 million
 - An increase in tax rate of 1¢ raises the total Tier 2 amount by \$132 million, and costs an additional \$46 million in state aid

- ### Weights and Adjustments
- District level adjustments
 - Cost of education index
 - Small district, < 300 square miles
 - Small district, > 300 square miles
 - Mid-size
 - Minimum ADA

- ### Weights and Adjustments
- Program weights – “add-ons”
 - Bilingual 0.10
 - Gifted/talented 0.12
 - Compensatory 0.20 or 2.41

- ### Weights and Adjustments
- Program weights – “FTE”
 - Career and technology 1.37
 - Special education
 - Homebound 5.0
 - Hospital Class 3.0
 - Speech Therapy 5.0
 - Resource Room, Self-Contained 5.0
 - Mild/Moderate, Self-Contained Severe 3.0
 - Off-Home Campus 2.7
 - Non-Public Day School 1.7
 - Vocational Adjustment 2.3
 - Care and Treatment 4.0
 - State School 2.8
 - Mainstream 1.1

- ### 77th Legislature Major Formula Changes
- Guaranteed Level of \$25.81 in 2001-02
 - Guaranteed Level of \$27.14 in 2002-03
 - Equalized Wealth Level of \$300,000 in 2001-02
 - Equalized Wealth Level of \$305,000 in 2002-03
 - Gap aid

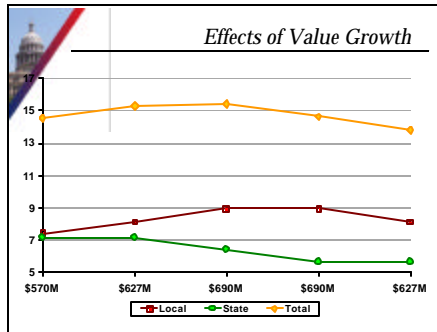
- ### Chapter 41 – Wealth Equalization
- A district with wealth per weighted student above \$300,000 – the equalized wealth level – must act to reduce access to its tax base
 - Districts subject to Chapter 41 must exercise at least 1 of 5 available options or the commissioner of education intervenes

Chapter 41 – Wealth Equalization

- Voluntary consolidation
- Detachment/annexation
- Purchase attendance credit from state
- Educate non-resident students
- Tax base consolidation

Funding Rules

- Prior year property values



Funding Rules

- Prior year property values
- Tax effort computation
- Biennial lag in recognizing tax effort
- Pay on estimates / settle-up
- Pay if funds available (optional homestead, value declines, value protest effects)
- Facilities limits

Exceptions

- Adjust prior-year property value for:
 - Declines in value for current year greater than 4%
 - Exclusion of certain exemptions, including captured appraised value in TIF zones
 - Exclusion of half of optional homestead if funds available
 - Natural or economic disaster
 - Tuition payment

Exceptions

- Tax effort computation
 - Excludes TIF zone taxes
 - May be adjusted if significant taxpayer withholds payment under protest
 - Tax credits under HB 1200
 - Tax credits under service in lieu of payment

Exceptions

- Full-year ADA, except:
 - Decline exceeding 2% due to military base closure
 - Decline exceeding 2% not related to military base closure
 - Significant percentage of migrant students
 - Disasters, floods, extreme weather, fuel curtailment, or other calamity

Exceptions

- Pay on estimates, except:
 - District proves estimates are inaccurate and cause financial hardship
 - Property values are higher than estimated and appropriations are insufficient
 - District tax effort expected to be less than sufficient to reach Tier 2 ceiling

Exceptions

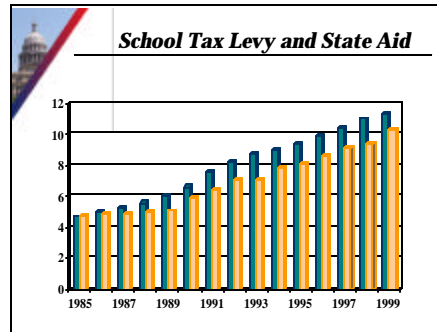
- Chapter 41 Hold Harmless provision allows certain districts to retain enough tax base to produce the revenue per WADA the district had in 1992-93 if \$1.50 tax effort is achieved
- Discounts can affect final cost
 - CAD cost shifting
 - Efficiency credits
 - Early agreement credits
 - Tuition credits

Structural Issues – Formula Change

- Complexity makes understanding the system and predicting effects difficult
- Discrete consideration of individual formulas tends to be promoted by winners, but also tends to overlook losers
- Zero-sum mentality

Structural Issues – Equity’s Influence

- Defense of accountability system (GI Forum lawsuit)
- Statewide desegregation order (*US v. Texas*)



Facilities Financing Programs

David Anderson
Joe Wisnoski

Big Picture of Facilities Financing

Recent Bond Issue Activity

Year	Volume	Percent of Texas Market
1998	\$3,283,573,126	33.5%
1999	\$3,907,129,307	34.3%
2000	\$3,516,126,555	38.3%
2001	\$4,405,923,463	34.4%

Source: Municipal Advisory Council, Texas Bond Reporter

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Big Picture of Facilities Financing

Outstanding Bonded Debt
\$20,953,043,916 as of FY 2000
Source: Bond Review Board

2000-01 Bonded Debt Service
\$1,940,000,000
Source: Bond Review Board

Replacement Value of School Facilities
\$40,000,000,000
estimated, based on current student counts and 1992 inventory data on square footage

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State Role in Debt Service Equalization

Instructional Facilities Allotment

- Application-based allotment for bonded debt and lease purchase agreements that finance construction of instructional facilities
- Guaranteed yield approach to tax rate equalization
- First allotments in 1997-98
- 312 recipients in 2000-01
- 370 recipients in 2001-02

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State Role in Debt Service Equalization

Instructional Facilities Allotment

- Cost controlled by appropriation
- Prioritization scheme
 - Wealth per ADA
 - Adjustment for student growth
 - Adjustment for lack of existing debt
 - Adjustment for denial of funding
- Biennial limit of \$250 in debt service per ADA, or \$100,000 for districts with less than 400 ADA

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State Role in Debt Service Equalization

Instructional Facilities Allotment

State Aid Formula:

$$FYA = (\$35 \times ADA \times BTR \times 100) - (BTR \times (DPV / 100))$$

Where:

- BTR is the bond tax rate, calculated by dividing the districts tax collections for eligible debt by the property value divided by 100.
- Beginning in 2001-02, tax collections could include taxes collected in 1999-2000 or more recent years that were not equalized by other formulas.

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State Role in Debt Service Equalization

Instructional Facilities Allotment

Funding History

Fiscal Year	Appropriation for New Awards	Awards	Expended
1998	\$200 M for both years	\$65 M	\$ 65 M
1999		\$66 M	\$109 M
2000	\$50 M in 2000	\$50 M	\$175 M
2001	\$50 M in 2001	\$50 M	\$224 M
2002	\$50 M in 2002	\$50 M	\$245 M (partial)
2003	\$50 M contingent in 2003		

* Costs normally decline due to property value growth and debt schedules, but yield increased in 2000.

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State Role in Debt Service Equalization

Existing Debt Allotment

- Allotment for bonded debt with payments in the 2000-01 school year
- Guaranteed yield approach to tax rate equalization
- First allotments in 1999-2000
- 534 recipients in 2000-01
- 546 recipients in 2001-02

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State Role in Debt Service Equalization

Existing Debt Allotment

- Operates as an entitlement
- No application or prioritization
- No restriction to instructional facilities
- Limited by tax rate of \$0.29 (\$0.12 in 2003)
- Equivalent to \$1,015 of debt service

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State Role in Debt Service Equalization

Existing Debt Allotment

State Aid Formula

$$EDA = (\$35 \times ADA \times EDTR \times 100) - (EDTR \times (DPV / 100))$$

Where:

- EDTR is the existing debt tax rate, calculated by dividing the district's tax collections for eligible debt by the property value divided by 100.
- Beginning in 2001-02, tax collections could include taxes collected in 1999-2000 or more recent years that were not equalized by other formulas.

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State Role in Debt Service Equalization

Existing Debt Allotment

Funding History

Fiscal Year	Cumulative Continuing Cost*
2000	\$444.6 M
2001	\$478.3 M
2002	\$522.8 M
2003*	\$441.0 M

* 2003 is appropriated amount only, and reflects only a limit of \$0.12.

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Facilities Funding Problems and Issues

- Insufficient access to IFA
- Debt that doesn't fit in
 - Ineligible for IFA
 - Above limits for EDA or IFA
- Small district facility replacement financing in IFA
- Refunding transactions becoming ever more complicated
- Lease purchase impact on Tier 2
- Limits in IFA based on payments in first biennium/escalating debt problem
- EDA biennial tax rate limit

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B-2 *The Texas Public School Finance System: An Outline Summary of Legal Challenges and Constitutional Standards*
Jeffrey S. Boyd, Deputy Attorney General for Litigation, Office of the Attorney General

CHRONOLOGY OF SIGNIFICANT EVENTS AND LEGAL PROCEEDINGS

1949 Gilmer-Aiken Act

- First comprehensive overhaul of Texas' school finance system.
- Created the Minimum Foundation Program (MFP) to equalize state aid.
- Guaranteed minimum amount of funds per student, but did not ensure adequate funding for minimum quality.
- Allowed local enrichment.
- Reduced total number of districts and provided for minimum teachers' salaries
- Funded 80% by state, 20% by local effort.

1971 *Rodriguez v. San Antonio I.S.D.*, 337 F.Supp. 280 (W.D. Tex. 1971).

- Intervening legislation encouraged districts to develop special education programs with matching state funds, but only the wealthier districts were capable of doing so, resulting in greater inequality.
- Property-poor districts challenged system as violation of equal protection (discrimination based on economic status).
- District court agreed, holding the system violated equal protection guarantees of United States Constitution.

1973 *Rodriguez v. San Antonio I.S.D.*, 411 U.S. 1, 93 S.Ct. 1278 (1973).

- U.S. Supreme Court reversed, finding state system bore rational relationship to furthering state goals of providing minimum education while encouraging local control.

1989 Edgewood I (*Edgewood I.S.D. v. Kirby*) 777 S.W.2d 391 (Tex. 1989) (Mauzy, J.).

- Intervening legislation (1975) renamed MFP to Foundation School Program (FSP), created second tier of financing to provide more state money to poorer districts.
- Property-poor districts challenged inequity in funding under Texas Constitution. Trial court found system violated Texas Constitution; court of appeals reversed.
- Facts (as recited by Supreme Court):
 - # FSP “attempts to ensure that each district has sufficient funds to provide its students with at least a basic education” by distributing aid “according to a complex formula such that property-poor districts receive more state aid than do property-rich districts.” *Id.* at 392.
 - # Two-tiered FSP provided for:
 - (1) Basic Allotment per “weighted student in average daily attendance” (WADA) for districts that tax at minimum rate, funded with state and local revenue; plus
 - (2) Guaranteed Yield (or Equalized Enrichment) per WADA for each cent above the Tier 1 minimum rate, funded by the state.
 - # But the FSP “does not cover even the cost of meeting the state-mandated minimum requirements,” and does not provide for facilities or debt service. *Id.*
 - # Because of “glaring disparities in the abilities of the various school districts to raise revenues from property taxes,” the “property-rich districts can tax low and spend high while the property-poor districts must tax high merely to spend low.” *Id.* at 392-93.
- Governing legal standard: Tex. Const. art. VII, § 1:

“A *general diffusion of knowledge* being essential to the preservation of the liberties and rights of the people, it shall be the duty of the Legislature of the State to establish and make *suitable* provision for the support and maintenance of an

efficient system of public free schools”
(emphasis added).

- Supreme Court holdings:
 - # Plaintiffs’ challenge is not a “political question” outside the courts’ jurisdiction. “If the system is not ‘efficient’ or not ‘suitable,’ the legislature has not discharged its constitutional duty and it is *our* duty to say so.” *Id.* at 394 (emphasis in original).
 - # “Efficient” means “the use of resources so as to produce results with little waste;” and those who drafted and ratified art. VII, § 1 “never contemplated the possibility that such gross inequalities could exist within an ‘efficient’ system.” *Id.* at 395. They instead “stated clearly that the purpose of an efficient system was to provide for a *general* diffusion of knowledge.” *Id.* at 396.
 - # The system “is neither financially efficient nor efficient in the sense of providing for a ‘general diffusion of knowledge’ statewide, and therefore it violates article VII, section 1 of the Texas Constitution.” *Id.* at 397.
 - # Under an “efficient” system, “districts must have substantially equal access to similar revenues per pupil at similar levels of tax effort.” *Id.*
 - # Efficiency does not mean “that local communities would be precluded from supplementing an efficient system established by the legislature; however any local enrichment must derive solely from local tax effort.” *Id.* at 398.

1991 Edgewood II (*Edgewood I.S.D. v. Kirby*) 804 S.W.2d 491 (Tex. 1991) (Phillips, C.J.).

- Intervening legislation: Responding to *Edgewood I*, the 71st Legislature in 1990 adopted SB 1 with the goal of ensuring fiscal neutrality (similar yield for similar tax rates) among the districts having at least 95% of students. SB 1 required biennial studies to detect gaps among those districts, to be followed by adjustments in funding to address the gaps. But otherwise maintained the basic system (2-tiered FSP with basic allotment and guaranteed yield), while excluding the wealthiest five percent of the districts.
- Supreme Court held: System is still unconstitutional.

- SB 1 does not “remedy the major causes of the wide opportunity gaps between rich and poor districts.”
- # “To be efficient, a funding system that is so dependent on local ad valorem property taxes must draw revenue from all property at a substantially similar rate.” *Id.* at 496.
 - # Notes that “[t]he question of local enrichment continues to be controlled by this Court’s opinion in *Edgewood I.*” *Id.* at 495 n.11.
 - # Suggests as possible remedies changing district boundaries, state/local funding allocations, consolidation of districts, consolidation of tax base.
 - # On Rehearing: “Once the Legislature provides an efficient system in compliance with article VII, section 1, it may, so long as efficiency is maintained, authorize local school districts to supplement their educational resources if local property owners approve an additional local property tax.” *Id.* at 500.

1992 Edgewood III (*Carrollton-Farmers Branch I.S.D. v. Edgewood I.S.D.*), 826 S.W.2d 489 (Tex. 1992) (Gonzalez, J.).

- Intervening legislation: The 72nd Legislature (1991), through HB 351, established 188 County Education Districts (CEDs), most consisting of districts within a single county, with sole duty to levy, collect, and distribute property taxes.
 - # Required them to levy ad valorem taxes.
 - # Set the specific rate for such taxes.
 - # Directed how proceeds would be distributed.
- Districts and students sued, asserting that HB 351, *inter alia*
 - # levies a state ad valorem tax in violation of Tex. Const. art. VIII, § 1-e (“No State ad valorem taxes shall be levied upon any property within this State.”).
- Supreme Court held HB 351 creates an unconstitutional state ad valorem tax.
 - # “If the State mandates that a tax be levied, sets the rate, and prescribes the distribution of the proceeds, the tax is a state tax, regardless of the instrumentality which the State may choose to use.” *Id.* at 500

- # “An ad valorem tax is a state tax when it is imposed directly by the state or when the state so completely controls the levy, assessment and distribution of revenue, either directly or indirectly, that the authority employed is without meaningful discretion.” *Id.* at 502.
- # “How far the State can go toward encouraging a local taxing authority to levy an ad valorem tax before the tax becomes a state tax is difficult to delineate. . . . Each case must necessarily turn on its own particulars. Although parsing the differences may be likened to dancing on the head of a pin, it is the Legislature which has created the pin, summoned the dancers, and called the tune. The Legislature can avoid these constitutional conundra by choosing another path altogether.” *Id.* at 503.
- Justice Cornyn, joined by Justice Gammage, concurred and dissented
 - # “An ‘efficient’ education requires more than elimination of gross disparities in funding; it requires the inculcation of an essential level of learning by which each child in Texas is enabled to live a full and productive life in an increasingly complex world.” *Id.* at 525-26.
 - # “[T]he Legislature should forthrightly embrace the equally difficult issue of how the educational dollar in Texas is spent. A focus on results is required by the court’s opinions in *Edgewood I* and *Edgewood II*, and requires the legislature to articulate the requirements of an efficient school system in terms of educational results, not just in terms of funding.” *Id.* at 527.

1995 Edgewood IV (*Edgewood I.S.D. v. Meno*), 917 S.W.2d 717 (Tex. 1995) (Cornyn, J.)

- Intervening legislation: The 73rd Legislature (1993), through SB 7, created the current system, involving:
 - # Tier 1 basic allotment (\$2300 per student in ADA) to those districts that tax at an M&O rate of at least 86 cents.
 - # Tier 2 guaranteed yield (equalized enrichment) of \$20.55 per WADA for each additional penny up to a cap of \$1.50.
 - # Cap on each district’s taxable property per student (\$280,000).
 - Districts exceeding the cap must choose to (1) consolidate with another district; (2) detach property;

- (3) purchase ADA credits; (4) contract to educate non-resident students; or (5) consolidate tax bases with another district.
 - If district fails to choose by deadline, State must (1) detach property and annex it to another district; or (2) consolidate the district with one or more others.
- Poor and wealthy districts sued. Supreme Court upheld system, holding, *inter alia*,
 - # “[A]n efficient system does not require equality of access to revenue at all levels.” *Id.* at 729. “[U]nequalized local supplementation is not constitutionally prohibited.” *Id.* at 730.
 - # The Legislature equates a “general diffusion” with the provision of an accredited education. “Efficiency” requires substantially equal access to funding up to the legislatively defined level that achieves a general diffusion of knowledge – that is, “substantially equal access to the funds necessary to provide an accredited education.” *Id.* at 730 & n.9.
 - # Efficiency does not prohibit allowing districts to generate additional funds (local enrichment) by taxing higher than \$1.50: “Once all districts are provided with sufficient revenue to satisfy the requirement of a general diffusion of knowledge, allowing districts to tax at a rate in excess of \$1.50 creates no constitutional issue. Districts that choose to tax themselves at a higher rate under these laws are, under this record, simply supplementing an already efficient system.” *Id.* at 733.
 - # The \$1.50 cap on M&O rates does not result in an unconstitutional ad valorem tax:
 - Although the system imposes both a minimum (86 cents per \$100) and a maximum (\$1.50 per \$100), and thus *limits* the districts’ discretion, it does not remove all discretion. *Id.* at 737.
 - Although the system *encourages* districts to tax at the maximum rate, it does not *require* that they do so. *Id.* at 738.
 - But future economic changes could remove all discretion, resulting in state ad valorem tax: “If the cost of *providing for a general diffusion of knowledge* continues to rise, as it surely will, the minimum rate at which a district *must tax* will also rise. Eventually, *some* districts may be forced to tax at the maximum allowable rate *just to provide a general diffusion of knowledge*. If a cap on tax rates were to become in effect *a floor as well as a ceiling*, the conclusion that

the Legislature had set a *statewide* ad valorem tax would appear to be unavoidable because the districts would then have *lost all meaningful discretion* in setting the tax rate.” *Id.* at 738.

- # Efficiency requires substantially equal access to *facilities funding* necessary for a general diffusion of knowledge, but evidence in this case does not demonstrate inefficiency yet. *Id.* at 746.

2001 *West-Orange Cove Consolidated I.S.D. v. Nelson, Cause No. GV1-00528, 250th Judicial District Court, Travis County, Texas (McCown, J., July 24, 2001) (Appeal pending: Cause No. 03-01-00491-CV, Third Court of Appeals).*

- Intervening legislative changes:
 - # Basic allotment increased from \$2300 to \$2387 (1995), \$2396 (1997), then \$2537 (1999).
 - # Guaranteed Yield increased from \$20.55 to \$21.00 (1995), \$24.70 (1999), \$25.81 (2001), \$27.14 (2002).
 - # Equalized Wealth Level increased from \$280,000 to \$295,000 (1997), \$300,000 (2001), \$305,000 (2002).
 - # Facilities:
 - 1995: \$170 million Facilities Assistance Grant Program
 - 1997: \$200 million Instructional Facilities Allotment guaranteed-yield program
 - 1999: Existing Debt Allotment
 - # Other 2001 changes:
 - gap funding adjustment for 37 districts who do not get Tier 2 funds but are not wealthy enough to be subject to Chapter 41
 - adjusted ADA if > 2% annual decline
 - broadened eligibility for compensatory education program
- Wealthy districts sued, alleging they have lost all discretion in setting M&O rates; they are or soon will be at the \$1.50 cap, and thus seek declaration that the system creates an unconstitutional state ad valorem tax.
- Defendants sought dismissal for lack of ripeness, asserting (1) no pleading or evidence that *all* districts have to tax at \$1.50 (2) no pleading or evidence that plaintiffs have to tax at \$1.50; (3) no

pleading or evidence that any district must tax at \$1.50 to provide a general diffusion of knowledge/accredited education.

- Trial court dismissed, finding:
 - # For ad valorem case to be ripe, the system must require a “significant number of districts to tax at the cap, something approaching or exceeding half the districts.”
 - Only 19% tax at \$1.50; 81% do not (two plaintiffs do not).
 - Only 12% of those that don’t grant optional exemption are at \$1.50.
 - # “If the tax were a state ad valorem tax, the court would have to strike down the tax, not the cap, which would create a crisis in Texas. One must be careful for what one prays.”
 - # “The property-rich districts have candidly said to the court that the Legislature wants the court to force the Legislature to do the right thing and raise taxes. Regardless whether this is true and regardless whether it would be good for education, it would do great harm to our democracy. Such an illegitimate course of action would weaken both the judicial branch and the legislative branch. . . . If the Legislature has not spent enough, then the citizens will say so in their own time and order increased funding for education from the voting booth. An order to spend more from the citizens would be both legitimate and effective. The court fears that an order to spend more from the judiciary would be neither.”

2001 *Hopson v. Dallas I.S.D.*, Cause No. 01-2750-G, 134th Judicial District Court, Dallas County, Texas.

- Taxpayers sued districts in which they live, alleging (1) system imposes state ad valorem tax in violation of Tex. Const. art. VIII § 1-e; (2) use of WADA in determining equalized wealth level in Chapter 41 violates Tex. Const. art. VIII § 1-a (mandating equal and uniform taxation).
- Defendant Irving I.S.D. filed third-party petition against Commissioner of Education.

B-3. Funding K-12 Education

Steve Smith, Manager of NCSL's National Center on Education Finance

Overview

- Revenue and Funding Structures
- Distribution of Funds
- Thorough, Efficient, and Equitable Systems
- Litigation Surrounding Education Finance

Where Does the Money Come From? State Funding

- State Funding is Approximately 48% of Total Funding
 - General Fund
 - Sales tax, State income tax
 - 25 - 40% of a State Budget
 - Single Largest Item
 - Lottery
 - Questions concerning dependability
 - Education Trusts
 - Seem to be Growing in Popularity
- Local Funding is Approximately 45% of Total Funding
 - Property Tax is Largest Revenue Source
 - Other Local Revenue Sources
 - Local Sales Tax
 - Local Income Tax
 - Fees
 - Growing Interest in Reducing Dependence on Local Property Taxes
- Federal Funding is Approximately 7% of Total Funding
 - Title I is Largest Expenditure
 - Over \$8 Billion Dollars Targeted for At-Risk Students
 - IDEA Grants (Special Education)
 - Nearly \$6 Billion Dollars Now Allocated, (Only \$3 Billion in 1996-97)
 - Full Funding?

Michigan Experience

- Prior to 1994-95 School Year Michigan Education was 80% Locally Funded and 20% State Funded
- In July 1993, the Legislature Eliminated Local School Property Taxes, Reducing by Nearly \$7 Billion the Annual Funding for Michigan's Public Schools

- Offered Voters Two Solutions to Make up the \$7 Billion Dollar Shortfall
- Voters Chose Option that:
 - Increased State Sales Tax from 4% to 6%
- Created a 6 mil State Property Tax on Homestead and Non-Homestead Property
 - Prior to Passage Average Homestead Mileage Rate in the State was 34
- Created a 12 mil Local Property Tax on Non-Homestead Property
- Reduced State Income Tax from 4.6% to 4.4%
- Increased Tobacco Taxes
 - From 25 cents to 75 cents per pack of cigarettes
 - 16% tax on other non cigarette products
- New System Worked Well Through 1990's, However People are Nervous Now.

Minnesota Experience **Ensuring Equity of Taxation at the Local Level**

Taking Wealth Into Account With Use of Property Taxes

- In Connecticut they Weigh Per Capita Income and Median Household Income at 50% each to Determine the Wealth of a District.
- This “Wealth Indicator” is then Compared to the Wealthiest District in the State, and the Property Value for the District is Reduced Accordingly.
- For Example: If District A is at 90% of the Wealthiest District on the Wealth Indicator, They will have Their Property Value Reduced 10% in the State Funding Formula.

Homestead Exemptions

- In Louisiana there is a \$75,000 homestead exemption, and the tax value of property in the state is somewhat low compared to what homes actually sell for. This results in minimal property tax revenues across the state. The funding of education is based on state income tax and state sales tax.

Circuit Breaker:

- In Vermont property taxes are capped at a certain percentage of an individual's income. This “circuit breaker” is used in order to address the situation where you may have a retired person who has lived in the same house for 50 years, and their neighborhood has had dramatic appreciation.

How is the Money Distributed?

- State Aid
 - All States Provide Funding for Education Through Finance Formulas and/or Categorical Funds

- All but North Carolina and Hawaii Require Local Support in Order to Receive State Funding
 - Hawaii is a State Run System
 - North Carolina Allows Districts to Supplement State Aid but it is not Required
- Those States that Require a Certain Local Effort Usually Have a Foundation Program
 - Foundation Program
 - Created to “Equalize” Districts Ability to Pay
 - The Foundation Level is a Minimum Amount the State Feels is Required in Order to Provide an Adequate Education
 - Therefore, the State Requires Each School District to Levy a Certain Millage Rate and the State Will Provide the Difference Between the Generated Local Share and the Foundation Level

Variations Within Foundation Programs

- While Many States Require a Minimum Percentage for Participation, Some States Have Also Set a Limit on the Maximum
- Some States Have Recaptured Local Funding if The Local Required Effort is Greater than the Foundation Level
- What is the Best Foundation Funding System that is Equitable but Also Allows Local Decision Making?

Adjustments to Foundation Level

- Student Needs: Many States Multiply the Foundation Level by a Weight for Certain Classifications of Students
 - For Example:
 - Foundation Level = \$5,000
 - At- risk Weight = 1.2
 - Funding Level = \$6,000 for At-risk Students
- Geographical Differences:
 - Some States also Provide Sparsity Adjustments and Cost of Living Adjustments to the Foundation Level.

Funding for Facilities

- Nationally estimates range from \$100 Billion to over \$300 Billion needed for School Facilities
- 11 States Subsidize, Reimburse, or Match Local Funding for Construction Projects
- 12 States use a Formula for Determining the Amount of State Funding Each District Receives
- 6 States Have Established a New Agency to Oversee School Construction.
- 5 States Provide Low-Interest Loans for Low-Income School Districts to Help Support Their School Construction Efforts

- 4 States Require the Governor and the state Legislature to Approve all School Construction Projects Prior to State Funding Being Made Available
- Are Federal Resources Being Accessed Sufficiently?

Special Education Funding

- Four Major Distribution Systems
 - Pupil Weighted System - New York, Florida
 - Reimbursement System - Michigan, Idaho
 - Census Based/Flat Grant - Colorado, Vermont
 - Resource Based - Virginia, Tennessee

Strengths and Weaknesses

Pupil Weighted System:

Strength - Ensures Extra Funding for Each Student

Weakness - Incentive for Misclassification of Students

Reimbursement System:

Strength - Remove Local Burden

Weakness - No Incentive for Efficiencies

Census Based System:

Strength - Simplicity

Weakness - Does not take District Variations into Account

Resource Based:

Strength - Have specified number of personnel

Weakness - What about other costs beyond personnel

Medicaid Funding Fully Accessed?

INCENTIVES AND SANCTIONS

- 27 States Publicly Categorize or Rank School/Districts
- Over 30 States Reward Schools and/or School Districts (16 provide Monetary Incentives)
 - If Monetary Rewards are Used, How Much Should They Be, and What Should They Be Based On?
- Over 30 States Sanction Schools and/or Districts (5 States Allow the Withholding of Funds)
 - What Appropriate Sanctions Should Be Put in Place, Additional Funds, Technical Assistance, State Takeover?

Financial Reporting and Best Practices

- New Requirements from the Government Accounting and Standards Board (GASB)
 - Implemented from 2002-2005
 - Will Allow More Detailed Analysis of Expenditures

- State Responsibility to Identify Best Practices
 - Best Financial Management Practices used in Florida
 - Best Teaching Practices

Determining the Foundation Level

- Numerous Ways States Determine Foundation Level
 - Pupil-Teacher Ratios and Salary Levels
 - Actual Spending of the Districts
 - Inflation-Related Increase Over a Prior Year’s Level
 - How Much the Legislature is Willing and Able to Spend

Should Foundation Levels and a “Thorough and Efficient Level” be the Same?

- If Yes, How can a “Thorough and Efficient” Level of Funding be Defined?

Things to Consider in Regard to a Thorough and Efficient System

- How Do you Define “Thorough and Efficient”?
- How Much Does a “Thorough and Efficient” System Cost?
- Where Does the Money Come From to Provide Such a System?
- How Do You Distribute the Money in an Equitable Manner?

Why is Defining a “Thorough and Efficient” (I.E. Adequate System) an Issue?

- AFTER A NATION AT RISK (MID-’80s), STATES IDENTIFIED NUMEROUS WAYS TO STRENGTHEN EDUCATION DELIVERY SYSTEMS (LONGER SCHOOL DAY, LONGER SCHOOL YEAR, SMALLER CLASS SIZE, HIGHER PAID STAFF, ETC.)
- SCHOOL FINANCE LITIGATION HAS FOCUSED ATTENTION ON ADEQUACY:
- DO AVAILABLE RESOURCES ASSURE THAT STUDENTS CAN FULFILL STATE CONSTITUTIONAL EXPECTATIONS?

Why is Adequacy an Issue?

- STANDARDS-BASED REFORM IMPLIES AN INTEREST IN THE ADEQUACY OF FUNDING
- THE STATE’S ROLE IS TO SPECIFY PERFORMANCE STANDARDS, MEASURE WHETHER THEY ARE BEING ACCOMPLISHED, AND HOLD STUDENTS, TEACHERS, SCHOOLS, AND/OR SCHOOL DISTRICTS ACCOUNTABLE FOR RESULTS
- ONE IMPLICATION IS THAT SUFFICIENT RESOURCES NEED TO BE IN PLACE TO THINK THAT SCHOOL DISTRICTS COULD BE SUCCESSFUL

- MOST STATES USE SOME FORM OF A FOUNDATION PROGRAM TO ALLOCATE STATE SUPPORT, WHICH REQUIRES THAT A FOUNDATION LEVEL BE SPECIFIED
- THE FOUNDATION LEVEL -- OR BASE COST -- SHOULD HAVE SOME “MEANING”
- IN MANY STATES, THE FOUNDATION LEVEL IS SET TO SPEND AS MUCH AS THE LEGISLATURE IS WILLING TO PROVIDE
- THE MEANING SHOULD BE IN TERMS OF THE EXTENT OF SERVICES THAT CAN BE PROVIDED OR THE LEVEL OF PERFORMANCE THAT CAN BE ACHIEVED

ALTERNATIVE WAYS TO ADDRESS BASIC ADEQUACY

- THE FUNDAMENTAL PROBLEM IS THAT THERE IS NOT AN EASILY UNDERSTOOD STATISTICAL RELATIONSHIP BETWEEN STUDENT PERFORMANCE AND PER PUPIL SPENDING
- IF THERE WERE, POLICY MAKERS COULD GRAPH THE RELATIONSHIP AND USE IT TO SPECIFY EITHER HOW MUCH MONEY WOULD BE NEEDED TO REACH A CERTAIN LEVEL OF PERFORMANCE OR HOW MUCH PERFORMANCE COULD BE ATTAINED AT A GIVEN LEVEL OF RESOURCES
- THEREFORE, POLICY MAKERS NEED TO DEVELOP A RATIONAL WAY TO LINK PERFORMANCE TO SPENDING

ALTERNATIVE WAYS TO ADDRESS BASIC ADEQUACY

- SEVERAL APPROACHES HAVE BEEN DEVELOPED IN THE LAST FEW YEARS TO DO THAT BY DETERMINING AN ADEQUATE FOUNDATION LEVEL
 - PROFESSIONAL JUDGEMENT
 - SUCCESSFUL SCHOOL DISTRICT (OR SCHOOL)
 - WHOLE-SCHOOL MODEL (FOR EXAMPLE, NEW AMERICAN SCHOOLS OR EDISON)
 - COMPLEX STATISTICAL APPROACH
- THE PROFESSIONAL JUDGEMENT APPROACH ASSUMES THAT EXPERIENCED EDUCATORS CAN SPECIFY THE RESOURCES OF PROTOTYPE SCHOOLS GIVEN WHAT STUDENTS ARE EXPECTED TO ACCOMPLISH AND THAT THE COST OF THOSE RESOURCES CAN BE DETERMINED.

SUCCESSFUL SCHOOL DISTRICT (OR SCHOOL)

- THE SUCCESSFUL SCHOOL DISTRICT APPROACH ASSUMES THAT A BASIC COST CAN BE CALCULATED BY EXAMINING THE BASIC EXPENDITURES (TOTAL LESS SUPPLEMENTAL SPENDING FOR SPECIAL

EDUCATION, AT-RISK PUPILS, TRANSPORTATION, ETC.) OF SCHOOL DISTRICTS THAT MEET STATE PERFORMANCE STANDARDS.

Whole School Approach

- ASSUMES THAT THE COST OF THOSE APPROACHES CAN BE DETERMINED AND THAT THEY PRODUCE SATISFACTORY RESULTS

What States Are Using

- A FEW STATES HAVE USED EITHER THE PROFESSIONAL JUDGEMENT OR THE SUCCESSFUL SCHOOL DISTRICT APPROACHES — NO STATES HAVE ACTUALLY USED THE OTHER APPROACHES TO DETERMINE A FOUNDATION LEVEL ALTHOUGH THEY HAVE BEEN USED TO STUDY THE ISSUE.

Successful School District Framework

- THE SUCCESSFUL SCHOOL DISTRICT APPROACH PROVIDES A FRAMEWORK FOR MAKING A SERIES OF DECISIONS ABOUT THE CHARACTERISTICS OF THE SCHOOLS WHOSE BASIC EXPENDITURES WILL BE EXAMINED. FOR EXAMPLE, THE FOLLOWING KINDS OF DECISIONS NEED TO BE MADE:
 - HOW WILL SUCCESS BE DETERMINED (ABSOLUTE STANDARD, CHANGE OVER TIME, OR RELATIVE STANDARD)?
 - WILL ALL SUCCESSFUL DISTRICTS BE EXAMINED OR ONLY THOSE THAT HAVE PARTICULAR CHARACTERISTICS IN TERMS OF SIZE, WEALTH, PROPORTION OF PUPILS FROM LOW INCOME FAMILIES, ETC.?
 - WILL EFFICIENCY BE CONSIDERED IN ANY WAY (ONLY LOOK AT RELATIVELY LOW SPENDING DISTRICTS OR DEVELOP A WAY TO MEASURE EFFICIENCY)?

THE NEED TO DEAL WITH OTHER COST PRESSURES

- AFTER A BASE COST, OR FOUNDATIONLEVEL HAS BEEN DETERMINED, IT IS NECESSARY TO DEVELOP A SET OF MODIFICATIONS TO THAT FIGURE IN RECOGNITION OF COSTS ASSOCIATED WITH SUCH THINGS AS SPECIAL EDUCATION, AT-RISK PUPILS, SIZE, GEORGRAPHIC DIFFERENCES, ETC.
- FAR LESS IS KNOWN ABOUT HOW TO MAKE THESE ADJUSTMENTS.

THE NEED TO DEAL WITH OTHER COST PRESSURES

- SOME STATES USE PUPIL WEIGHTS THAT REFLECT THE RELATIVE COST OF PROVIDING CERTAIN KINDS OF SERVICES (FOR EXAMPLE, IF A PUPIL

IS WEIGHTED AT 2.3, THE COST OF SERVING THAT PUPIL IS 2.3 TIMES THE COST OF SERVING A PUPIL WITH NO SPECIAL NEEDS.

- OTHER STATES REIMBURSE DISTRICTS FOR SOME PORTION OF THE COSTS THEY INCUR IN PROVIDING SERVICES.

THE NEED TO DEAL WITH OTHER COST PRESSURES

- OTHER STATES SUPPORT A PARTICULAR SET OF SERVICES FOR DISTRICTS THAT MEET ELIGIBILITY REQUIREMENTS (FOR EXAMPLE, BY PROVIDING FUNDS TO REDUCE CLASS SIZE IN DISTRICTS IN WHICH A SPECIFIC PROPORTION OF PUPILS COME FROM LOW INCOME FAMILIES).
- THE LEVELS OF FUNDING COULD BE SET USING THE PROFESSIONAL JUDGEMENT APPROACH (IN THE CASE OF PARTICULAR PROGRAMS). THE SUCCESSFUL SCHOOL DISTRICT APPROACH PROBABLY WOULD NOT WORK FOR PARTICULAR PROGRAMS

The Future

- STATES ARE GOING TO CONTINUE BUILDING EDUCATION ACCOUNTABILITY SYSTEMS.
- AS A RESULT OF THAT IMPETUS, AND OTHER FACTORS SUCH AS LITIGATION, THE STATES ARE GOING TO HAVE TO ADDRESS THE ISSUE OF ADEQUACY.
- TO SOME EXTENT, ADDRESSING ADEQUACY WILL RESOLVE THE EQUITY ISSUE THAT HAS FACED STATES FOR A CENTURY.
- THE ABILITY TO ADDRESS THE ADEQUACY ISSUE WILL IMPROVE AS MORE INFORMATION BECOMES AVAILABLE ABOUT STUDENT PERFORMANCE AND ABOUT SCHOOL SPENDING.

School Finance Litigation

- Adequacy is The Major Issue
 - Standards Based Movement and Accountability System Have Influenced Move to Adequacy
 - Courts are Saying Inequities are Legal as Long as they are Above Certain Level
 - Courts Appear Less Open to Argument That Education Funding is Prerogative of the Legislature
 - New York and Wyoming Decisions
 - What Revenue Structure System is Constitutional
 - New Hampshire, Vermont
- Increasing Number of Plaintiffs are Seeking Changes to Only a Few Districts and/or Specific Components of the System
 - Connecticut Case for Desegregation

- Funding for Capitol Outlay is Being Challenged
 - Arizona, Colorado, Alaska
- State Responsible for Funding Pre-K?
 - North Carolina Court Found that the State Was Responsible for Providing Pre-K Education to At-risk Children

B-4. Cost-of-Education Index Study

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A Study of Uncontrollable Variations in the Costs of Texas Public Education
Summary of Findings

This report fulfills the request of the 76th Texas Legislature for the Charles A. Dana Center, in coordination with the Comptroller of Public Accounts, “to conduct a study of variations in known resource costs and costs of education beyond the control of a school district” and to “make recommendations to the 77th Legislature as to methods of adjusting funding under Chapter 42, Education Code, to reflect variations in resource costs and costs of education.” The Dana Center was directed to perform this work with the assistance of the Texas Comptroller of Public Accounts, the Texas Education Agency, and Texas A&M University, and to submit recommendations to the legislature by November 1, 2000.

This report includes

- a brief history of educational spending adjustments, including a discussion of Texas school district officials’ perspectives on the issue of “uncontrollable” costs (costs beyond the control of school district officials) and a review of cost-of-education strategies employed by other states,
- an explanation of the existing Cost-of-Education Index (CEI), including an analysis of the consequences of updating the CEI with more current data, and
- analyses of three alternative models for a new Texas cost-of-education adjustment: a wage index, a salary index, and a cost-function index.

To aid the reader, a glossary of school finance terms used in this report is included in Appendix A.

The salary model and the cost-function model described in this report were constructed using data on school district expenditures from the 1998–99 school year. As soon as complete data for the 1999–2000 school year become available, we will publish a technical supplement containing an updated set of district index values for both of these models, and an updated analysis of the consequences of updating the existing CEI with new data.

This report contains a short description of the advantages and disadvantages of updating the existing CEI. It also examines several education cost-adjustment models and their advantages and disadvantages, as well as the potential total impact on the Foundation School Program of applying each of these models to existing school finance formulas. Finally, this report provides an overview of issues to consider in adopting a new Texas CEI.

This Summary of Findings contains an overview of the entire report.

SECTION 1: EDUCATION COST INDEXING IN THEORY AND PRACTICE

To address the issue of uncontrollable cost variations in the context of the financial pressures currently faced by Texas school districts, our researchers first conducted a series of formal interviews with officials from twenty-seven school districts to determine the financial pressures

they face. In these interviews, some issues were raised repeatedly, regardless of the size and location of the school district. Especially important issues were cost pressures related to increased salaries for teachers and other personnel, the costs of recruitment, the costs of health insurance and other benefits, and the costs of building and maintaining schools. Other issues were raised only by certain types of districts. For example, administrators in small districts focused on higher costs for some goods and services in their communities and on the costs of transportation. Administrators in large districts, on the other hand, emphasized conditions that made recruiting teachers difficult, including long commute times, safety concerns, and a shortage of affordable housing. Officials from large districts also expressed concerns about the highly competitive job market in metropolitan areas and about teacher perceptions of urban students as being more difficult to teach.

Section 1 also contains a brief history of education cost adjustments in Texas and a short discussion of adjustments to school district funding in other states. Many states adjust school district funding to counteract differences in the costs of education that are related to a district's size or location. Only a few states, however, adjust school district funding to account for regional variations in the cost of education. These states include Texas, as well as Colorado, Florida, Ohio, and Wyoming. Other states' adjustments are designed to capture general variations in the cost of living. Texas is the only state that currently uses data on school district expenditures to adjust for variations in the cost of education.

SECTION 2: THE EXISTING TEXAS COST-OF-EDUCATION INDEX

This section provides an explanation of the existing Texas Cost-of-Education Index, including an analysis of the effects of updating the existing CEI using more current data. The CEI is the mechanism that Texas uses to adjust Foundation School Program calculations to compensate for variations in resource costs and uncontrollable costs of education. Under current law, the CEI affected the distribution of approximately \$1.23 billion in state aid to school districts during each year of the 1999–2000 biennium.

The existing CEI adjusts funding to school districts based on five uncontrollable factors that a 1990–91 Legislative Education Board study found to have a significant impact on the costs of education. These factors include

- (1) Average competitive salary for beginning teachers,
- (2) Location in a county with a population of less than 40,000,
- (3) Percentage of pupils that are low-income,
- (4) District type—in particular, whether a district is classified as rural or as in an independent town, and
- (5) District size, in terms of students in average daily attendance.

Based on an analysis of these five factors, every Texas school district is assigned a CEI value between 1.00 and 1.20, which is used to adjust foundation program calculations for both Tier 1 and Tier 2 of the Foundation School Program. The existing CEI, however, has not been updated since its adoption by the Foundation School Fund Budget Committee in December 1990, which means that roughly thirteen percent of all state aid to school districts is currently distributed on the basis of a ten-year-old analysis of school district expenditures.

Two points illustrate the limitations of the existing Cost-of-Education Index. First, the existing CEI only includes the uncontrollable factors that were found to have an impact on teacher salaries in 1990. Our analysis found that not all of the factors included in the calculation of the existing CEI are still statistically significant. Second, the existing CEI leaves out several factors—such as

teacher certification status—that affect the cost of hiring teachers. In particular, the existing CEI omits community characteristics—such as the average price of a house—that influence teachers’ willingness to live and work in an area. Beginning competitive teacher salary is the only community characteristic included in the existing CEI. In addition, significantly more data are available now than were available when the existing CEI was constructed in 1990.

An updated CEI would have a range of index values from 1.03 to 1.23, which is similar to the existing CEI. However, according to an analysis conducted by the school finance division of the Texas Education Agency, implementing the updated CEI would require a total annual increase in state aid to school districts of between \$296 million and \$368 million, depending upon how the index values were rounded. On the average, major urban districts and major suburban districts would be the primary beneficiaries of updating the existing CEI. Major urban and suburban districts would receive total projected increases in state aid of at least \$87 million and \$134 million, respectively. From a regional perspective, districts in Region I (Edinburg) and Region XVI (Amarillo) would receive somewhat less state aid than they would under current law, with total projected decreases of no more than \$7.1 million and \$9.4 million, respectively. It is important to note, however, that this analysis is based on the assumption that the updated CEI would be applied to the Foundation School Program in the same way that the existing CEI is applied. For example, the new index would be applied to seventy-one percent of the Basic Allotment, and fifty percent of the effects of the CEI would be applied in determining a district’s counts of students in Weighted Average Daily Attendance (a component in the calculation of Tier 2 state aid). The updated CEI can easily be made revenue-neutral, however, by adjusting the percentages in the current finance formulas to which the CEI is applied. For a comprehensive discussion of how the existing CEI is applied to the Foundation School Program, see section 2.3.

SECTION 3: ALTERNATIVE APPROACHES TO A NEW TEXAS COST ADJUSTMENT

This section presents three alternative approaches to creating a new Texas adjustment—a *wage index*, which explores variations in the local costs of doing business; a *salary index*, which explores variations in school district expenditures on personnel; and a *cost-function index*, which explores cost variations that are directly related to educational outcomes. From a theoretical perspective, there is no “best” approach to a new Texas adjustment. Each approach has advantages and disadvantages, which are described below.

Section 3.1: Capturing Variations in the General Cost of Doing Business: Texas Wage Indices. Given that education is so labor-intensive, one way to address the problem of how to capture uncontrollable regional variations in the costs of education is to look beyond labor costs for school districts alone and instead to measure variations in overall labor costs in various markets in Texas. For section 3.1, we constructed a series of wage indices designed to capture variations in the general cost of doing business in Texas, including a Professional Industries Index, a Professional Occupations Index, a Financial and Service Industries Index, and an All Industries Index. The analysis revealed that a Financial and Service Industries Index does a slightly better job than the other indices of predicting the salaries of teachers, administrators, and support staff. Thus, the Financial and Service Industries Index seems to be the most credible choice for a wage index that would reflect market wages for education.

The principal advantage of a wage index as an adjustment strategy is that it avoids the difficult problems associated with distinguishing *controllable* variations in school district expenditures from those that are *uncontrollable*. After all, it is unlikely that school districts will be able to affect the general labor market. The wage index is also the index most similar to the education cost indexing strategies used in other states.

A potential disadvantage of the wage index is that it draws on wage and salary information for non-teachers and may not fully reflect the actual market for teachers faced by Texas school districts. In particular, this index is unable to pick up district-level variations in the price of labor. For example, every school district in a metropolitan area would receive the same index value as every other district in that metropolitan area, and districts outside of metropolitan areas would receive the same index value as every other district in the same county.

Another important issue to consider is that, according to the school finance division of the Texas Education Agency, the wage index would be the most expensive alternative to implement, requiring a total annual increase in state aid to school districts of about \$4.7 billion. The largest projected increases would be for districts in metropolitan areas. Again, this analysis is based on the assumption that the wage index would be applied to the Foundation School Program in the same way that the existing CEI is applied. Ultimately, the wage index represents a good measure of what it would cost public schools to be competitive with banks, high technology organizations, and other groups competing for highly qualified college graduates. Nevertheless, the absence of a revenue structure to support salaries comparable to those offered to other professional employees in metropolitan areas makes implementing the wage index problematic.¹

Section 3.2: Price Variations Revealed in School District Expenditures: Texas Teacher Salary Indices. Because teacher salaries are the largest component of school district expenditures, another approach to capturing uncontrollable regional variations in the costs of education is to model differences in teacher salaries from district to district. This section presents salary indices designed to reflect the uncontrollable factors that influence the salaries that teachers are willing to accept from school districts. This approach is similar in spirit to that of the existing Texas CEI. Unlike the existing CEI, which includes factors that influence the salaries that school districts are willing and able *to pay*, the teacher salary indices approach the question of teacher compensation from the perspective of salaries that teachers are willing *to accept*. The teacher salary indices also incorporate more information on teacher characteristics and community characteristics.

We constructed two different salary index models. The *baseline* model incorporates all of the measurable factors that we have identified as important determinants of what salaries teachers are willing to accept from school districts. The *essentials* model incorporates only a subset of the student, district, and community characteristics from the baseline model. The essentials model has been designed to be intuitively as well as statistically appealing. (This is discussed in more detail in section 3.2.) We estimated separate essentials models for urban and rural school districts, because the data suggested that it was an appropriate distinction. We also estimated a version of the essentials model that includes district contributions toward health insurance as part of teacher compensation.

The essentials salary index would adjust funding to school districts based on eleven uncontrollable factors that were found to have a significant impact on the costs of education. These factors include

- (1) District size in terms of average daily attendance,
- (2) Distance to the nearest teacher certifying institution,
- (3) Distance to the center of the nearest metropolitan area,
- (4) An indicator for whether the district participates in Social Security,
- (5) Percentage of students who are immigrants,
- (6) Percentage of students who are limited English proficient,
- (7) Percentage of students who are mainstreamed special education,

- (8) Average house price,
- (9) Average cooling days,
- (10) Unemployment rate, and
- (11) Population density.

Based on an analysis of these eleven factors, every Texas school district is assigned an index value between 1.000 and 1.281 for the essentials salary index and between 1.00 and 1.34 for the essentials salary and benefits index. Our analysis indicates that the basic pattern of salaries is not sensitive to the inclusion or exclusion of benefits. However, a comparison of these two indices suggests that school districts constrained by the state's minimum salary scale offset it by offering fewer benefits. On average, it appears that teacher salary and benefits are practically dollar-for-dollar substitutes.

The principal advantage of these salary indices is that they offer the greatest potential for a new adjustment that is both fair and easy to implement in the context of current school finance formulas.

There are three principal disadvantages to these salary indices. First, there is a risk that important factors have been omitted from the salary indices analysis. For example, although surveys suggest that teachers are not especially sensitive to the condition of the buildings in which they work, we suspect that school districts with more attractive facilities and equipment are better able to attract and retain teachers. Unfortunately, information that would permit a comparison of facilities across school districts is not available. We would also have liked to include in our analysis more information on teacher training and professional qualifications, but the data was unavailable.

A second disadvantage of these salary indices, which also pertains to the existing CEI, is the difficulty in distinguishing between controllable and uncontrollable costs. Because the salary models are drawn from information on the actual salaries received by Texas public school teachers, they provide good models of teacher compensation. It is up to the researcher, however, to make distinctions between controllable and uncontrollable factors that can be used to explain variations in the costs of education. Such distinctions are inherently subject to criticism. In the salary indices models, the specified student and community characteristics are all treated as uncontrollable factors, and all other factors that influence salaries—including any relevant omitted factors—are treated as controllable factors.

A third disadvantage of these salary indices also pertains to the wage index and to the existing CEI. All these indices are designed to capture local variations in the price of labor. As such, they capture only one part of uncontrollable cost variations. Cost variations related to the prices of nonlabor inputs are not addressed by any of these indices. Cost variations related to the varying intensity with which districts must use their resources (for example, the high costs associated with the operation of a very small school district) also are not addressed.

According to Texas Education Agency estimates, applying the *essentials teacher salary index* in the same way that the existing CEI is applied would result in a total annual decrease in state aid to school districts of approximately \$88 million. Major urban districts and major suburban districts would receive a moderate annual increase in total state aid of \$74 million and \$21 million, respectively. On the average, total state aid to other types of districts would be reduced. The *essentials salary and benefits index*, which includes an estimate of school district contributions for health insurance benefits as part of teacher compensation, would require a total annual increase in state aid to school districts of approximately \$510 million. On average, almost every school district would receive an increase in state aid, although small rural districts would experience a moderate decrease in annual state aid of about \$7 million total. These estimations

are based on the assumption that the salary indices would be applied to the Foundation School Program in the same way that the existing CEI is applied. A revenue-neutral application of either index can be devised, however, by adjusting the percentages to which the salary indices would be applied to the current finance formulas.

Section 3.3: Cost Variations Related to Educational Outcomes: A Cost-Function Index. The cost indexing strategies discussed thus far are focused on uncontrollable variations in the prices that districts must pay for their most important resource—teachers. *Prices*, however, are only part of the cost equation. Some districts must also cope with costs that derive from variations in the needs of their students and with costs associated with being too small to take advantage of economies of scale. Arguably, these factors are frequently beyond school district control. For section 3.3., we constructed an education cost-function index that is designed to capture these other factors. The basic perspective of an education cost-function index is that school districts combine purchased *inputs* (such as teachers and other personnel) with *environmental factors* (such as student characteristics and district size) to produce *educational outcomes*. The cost-function index is designed to capture variations in the costs to districts of producing a given level of educational outcomes, given the prices the districts must pay and the environmental factors which the districts face.

Because of significant overlap with the purpose of other adjustments, such as the Small District and Mid-Sized District Adjustments, it would not be proper simply to replace the existing CEI with cost-function index values in the current school finance formulas. In principle, a more appropriate approach would be either (1) to estimate cost-function index values which could be used in combination with some or all of the current school finance formulas; or (2) to use the cost-function index values as the sole adjustment to the Basic Allotment in Tier 1 of the Foundation School Program and to much of the Tier 2 Guaranteed Yield Program. As such, it is difficult to make direct comparisons between the cost-function index and the other indices. If the cost-function index were applied to the Foundation School Program in a manner that would provide all districts with at least their current levels of Tier 1 and Tier 2 funding, the projected annual cost to the state would be approximately \$493 million.

The cost-function index addresses not only uncontrollable variations in the price of labor, but also uncontrollable costs that derive from variations in student needs, from geographic isolation, and from costs associated with being too small to take advantage of economies of scale. As such, the cost-function index is a more comprehensive index than the existing CEI, the wage index, or the salary indices. Constructing a cost-function index that reasonably describes educational practices in Texas involves identifying the relevant prices of inputs, environmental factors, and measures of educational outcomes.

A disadvantage of the cost-function index discussed in this report is that the analysis has been limited by a lack of data on nonlabor inputs and on educational outcomes. Another disadvantage of the cost-function index is that it is less intuitive and less transparent than the other indices. It does not lend itself to simple tabular presentations, because it incorporates complex interactions between district characteristics (reflecting, for example, the fact that small increases in the proportion of low-income students will tend to have a different impact on the costs of a small district than on the costs of a large district). Although the underlying relationships among the index factors are stable, these interactions suggest that shifts in student demographics over time could have very different effects on the index values for different school districts, depending on their initial situations.

OTHER ISSUES TO CONSIDER IN ADOPTING A NEW TEXAS COST ADJUSTMENT

Application to the Foundation School Program. The existing CEI is applied to seventy-one percent of the Basic Allotment, and the impact of fifty percent of the effects of the CEI is applied in determining a district's count of students in Weighted Average Daily Attendance. The Legislature may wish to explore the modification of these percentages in adopting a new CEI, particularly the fifty percent weighting. For a detailed discussion of how the existing CEI is applied to the Foundation School Program, see Section 2.3.

Transition Mechanisms. When updating the existing CEI or adopting a new adjustment, an important issue to consider pertains to mechanisms to ease the transition from one adjustment to another. Under each of the education cost indexing strategies discussed in this report, some school districts would experience reductions in state aid. The Legislature may wish to explore transition mechanisms for implementing any new adjustments.

Periodic Updating. Districts' index values have not been updated since the existing CEI was adopted in 1990. In our research, we found that many districts have changed significantly since the existing Cost-of-Education Index was constructed. Furthermore, it was determined that the existing index leaves out several factors that have an impact on the cost of hiring teachers. To avoid these issues in the future, the state should consider periodic updating of any new adjustment with current data, and the state should periodically reexamine the index methodology to ensure that the index continues both to capture appropriate cost factors and to reflect district conditions appropriately. Annual or biannual calculation of district index values would seem appropriate, and a thorough review of the underlying methodology could be conducted on a less frequent basis, depending on the volatility of economic conditions.

¹ Thanks to Moak, Casey, and Associates, LLP, for highlighting the fact that the Texas school finance system currently lacks a revenue structure to support implementation of this wage index.



B-5. *Texas School Finance and Real Estate Values*
R. Malcolm Richards, Director, Real Estate Center, Texas A&M University

TEXAS SCHOOL FINANCE AND REAL ESTATE VALUES

RELIANCE ON PROPERTY TAX MAY DAMAGE REAL PROPERTY
OWNERS

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TEXAS SCHOOL FINANCE AND REAL ESTATE VALUES RELIANCE ON PROPERTY TAX MAY DAMAGE REAL PROPERTY OWNERS

INTRODUCTION

Texas has struggled with the problem of creating “an education system that efficiently diffuses knowledge throughout its citizenry.” The basic property tax system in place prior to adoption of the so-called *Robin Hood* plan, resulted in vastly unequal access to resources among Texas schools. Robin Hood sought to rectify that shortcoming. However, Robin Hood did not diminish reliance on the ad valorem property tax for the support of public education. Instead, an increasing tax burden has weighed heavily on Texas real property leading many to question the effect of real property tax increases on Texas real estate. Although many complicating factors intervene, property tax increases generally work to reduce property values and reduce the wealth of owners at the time the changes occur. The following discussion explains how a competitive economy works to impose the burden of taxation mainly on real estate.

PROPERTY TAXES AND PROPERTY VALUE

The question of how property taxes affect property values has perplexed economists, engendering a series of arguments regarding who bears the final incidence of the tax. Assessment and collection only determine the first impact of the tax burden. At first glance, current owners appear to have opportunities to avoid the tax by passing it on to the end users of the real estate. However, a competitive economy works to impose the entire cost of the tax on current owners by reducing the value of the property that serves as the tax base. That conclusion emerges from analysis of the complicated web of relationships within the real estate economy.

For concerns about the distribution of the tax burden, the questions are 1) who will bear the tax burden and 2) do the benefits of the governmental expenditure accrue to those taxpayers? A cost effective public finance system should result in individual tax burdens that roughly approach the benefits of public expenditures enjoyed by those individuals. Presumably, a superior educational system would enhance property values. Indeed, real estate agents readily promote location within a preferred school district as an important determinant of home values within that district. With a fixed supply of homes within the district, sellers presumably could capture the value of the superior schools by increasing their asking prices to the limit that the market will bear. Consequently, schools in that area can capture some of that value enhancement in property tax levies. This report assumes a constant level of public education by holding expenditures per student at a constant level. This allows examination of the value-related effects of an increased tax burden without explicitly addressing the issue of potential value enhancements.

In the short term, imposing a tax on property disrupts the efficiency of real estate markets. A tax on property increases ownership costs, thereby reducing effective demand for that property. The tax also works to increase development costs, reducing net revenues to developers. Thus, a tax imposed on property results in less development,

higher prices to consumers and reduced revenues to developers than the economy would have produced absent the tax.

This effect results from the economic activity that does not occur because the tax has siphoned revenue from the real estate market. Fewer potential homebuyers can afford a new house. Fewer retailers can afford to rent space for a shop, etc. Every class of property subject to the added tax will face the same tendencies. This deadweight loss to the economy may be small for incremental changes in tax assessments. Further, increasing incomes may swamp the effect but the tendency is undeniably present.

At the most basic level, long-run competitive pressures preclude an owner's ability to pass the tax on to end users. For example, suppose an owner had negotiated a lease requiring tenants to pay property taxes. The lease allows the owner to avoid the tax liability in the intermediate run by passing a tax increase through to tenants. However, as leases expire, tenants typically explore available options. When they find comparable space not subject to the tax increase, they tend to move to the lower cost location. As more and more tenants exercise that option, the original owner will be forced to reduce rents to keep the building occupied. This competitive pressure will act to drive the rent down by the amount of the property tax, returning the tax burden to the property owner. When such an owner sells the property the buyer takes the elevated tax burden into account when formulating an offer. Ultimately, the reduction in price will equal the capitalized value of the increased tax load. Thus, competition with properties not subject to the tax increment ultimately serves to impose the burden of the tax increase on the current owner.

Now suppose, the property owner sustains a tax increase that generally applies to all taxable properties throughout Texas. No competing real estate investments escape the increased burden, thus removing the pressures to lower rents. In this case, the tenant appears to bear the burden of the tax. However, competition for investment capital in the economy again works to return the tax burden to the property owner. Investors routinely consider the returns investments will generate before committing capital. When competing investments escape the property tax, those seeking to sell real estate must lower their asking price to compensate for the added tax burden. In the modern economy, the property tax has evolved from a tax on all wealth to one mainly concentrated on real property. Many investment alternatives not subject to property taxation vie with real estate for capital and that competition tends to drive down real property prices to compensate for the tax on its value. Once again, the tax burden returns to the property owner.

Although the examples illustrate the effects of a property tax on current investment owners, the same conclusion applies to all types of real estate. This occurs because real estate cannot be moved. Its fixed location ensures that real estate will bear the brunt of property taxes. Capital and labor can migrate to locations that provide superior returns; real estate cannot. Because capital and labor are mobile, they must earn the competitive market rate for their participation in an economic activity. However, real estate must take the remainder of the income stream after capital and labor have been compensated.

Property taxes reduce that residual income and hence lower a property's value as an investment. That factor applies across the board to all classes of real property.

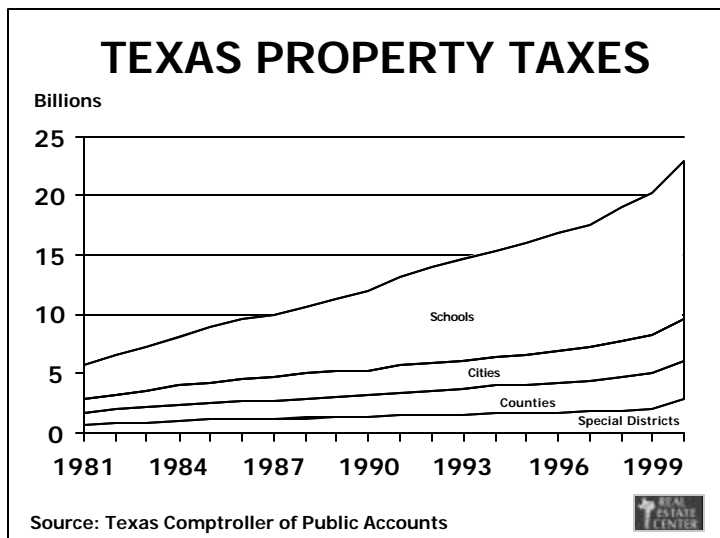
PROPERTY TAXES INFLUENCE BEHAVIOR

Although the modern real estate economy is considerably more complex than the simple system outlined above, the foregoing discussion demonstrates why buyers of real property do respond to property tax levels. Essentially, these buyers seek to avoid bearing the tax burden when they purchase a property. Although projected plans for using the real estate provide for property tax payments, buyers shop around among locations and thus can have the effect of driving buyers from high tax locations to areas with lower tax levies. Corporate managers deciding on building a facility that will serve markets over a broad area consider the tax climate as an integral part of their planning process. When other factors are equal, they will choose the state with the most favorable tax climate. Likewise, homebuyers weigh the tax implications of their home purchase. The final decisions will see buyers locate where taxes are lowest when all other factors are equal. Proliferation of tax increment finance zones and tax abatements reflect an acknowledgement of the role property taxation plays in economic decision making.

The Texas property tax system with its complicated mixture of exemptions and preferential valuation provisions unquestionably affects real property decisions. The freeze on homestead school taxes for those over the age of 65 provides the elderly with an incentive to locate in districts with relatively low property tax rates. Further, it encourages them to purchase low cost homes to establish a low school tax liability. Portability of the freeze means that a low, potentially zero, school tax liability can be transferred to another home in another location. Including wildlife management as an agricultural use ensures that livestock will vanish from much of the land purchased for recreational use. Taxing new plants at high rates prompts business to lobby for tax abatements or to look beyond Texas for an operating location. These are but a few examples of how the property tax affects the pattern of land use throughout the state. Clearly, the effects of property taxes and property tax changes involve land use decisions that cross state and local boundaries, pitting one location against another. Understanding how school financing affects real estate entails an assessment of the Texas system within the context of potential competitors.

CURRENT SCHOOL FUNDING AND TEXAS PROPERTY TAXES

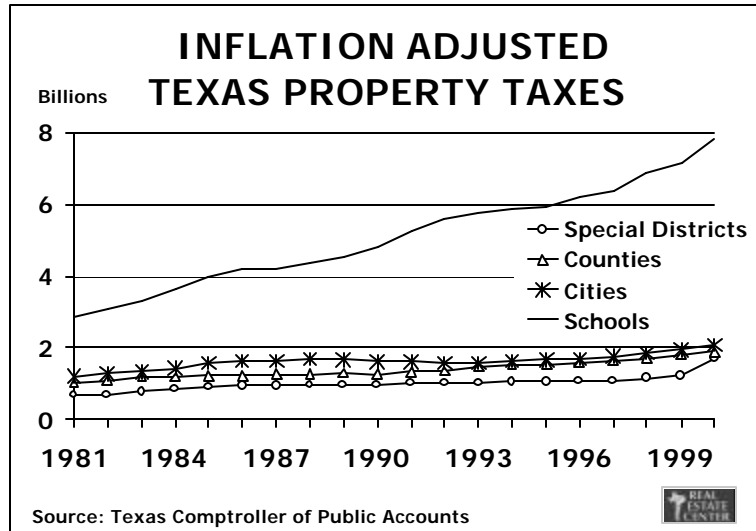
Over the past two decades, the drive to find a solution to the problem of equitable financing of Texas public schools produced a system that has shifted school



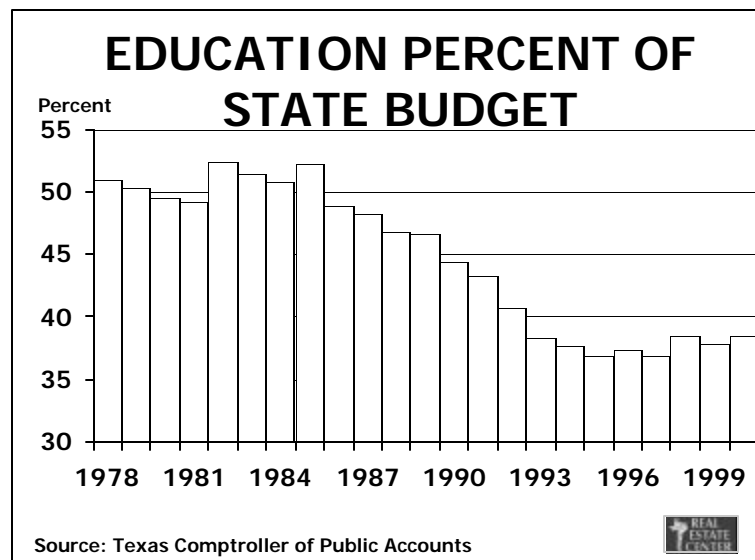
funding from the state general fund to local property taxes. As a result, Texas homeowners have endured a relentless run-up in property taxes that places them 7th among the fifty states and the District of Columbia, according to a study done by the government of the District of Columbia. This reliance on local tax base to fund the public education system, with an expanding population of students, has persistently driven local maintenance and operating tax rates toward their statutory maximum. As more districts approach the \$1.50 rate, a crisis in funding looms for Texas schools. That crisis threatens to increase an already substantial tax burden on real property in Texas

As the accompanying chart illustrates, Texas school property taxes have expanded from \$2.8 billion in 1980 to \$13.6 billion in 2000 a 367.1 percent total increase, equating to an

8.5 percent compounded annual increase. In 1981 school taxes composed 49.7 percent of total property tax levies in Texas. By the 2000 tax year, school levies represented 58.1 percent of statewide property tax levies (Comptroller's Office -- Property Tax Data). After adjusting for inflation using the Consumer Price Index for all goods, school taxes increased 172.4 percent while cities' levies increased by 71.7 percent and counties' levies rose 85.1 percent. The inflation-adjusted rate of increase for schools averaged 5.4 percent compounded annually.



The above factors suggest that schools must have substantially improved and school age populations expanded in the intervening years, given the substantial rise in real local property tax levies. However, studying those local assessments only indicates a part of the picture. School budgets typically consist of locally levied taxes plus funds from the state and federal governments. Beginning in 1985, state government substantially reduced the portion of its budget flowing to education as



indicated in the following chart. In 1981, education composed 49.2 percent of the state budget. By 1985 education comprised a peak 52.2 percent of state expenditures. That percentage fell throughout the remaining years of the century to 38.4 percent in 2000 (Comptroller of Public Accounts).

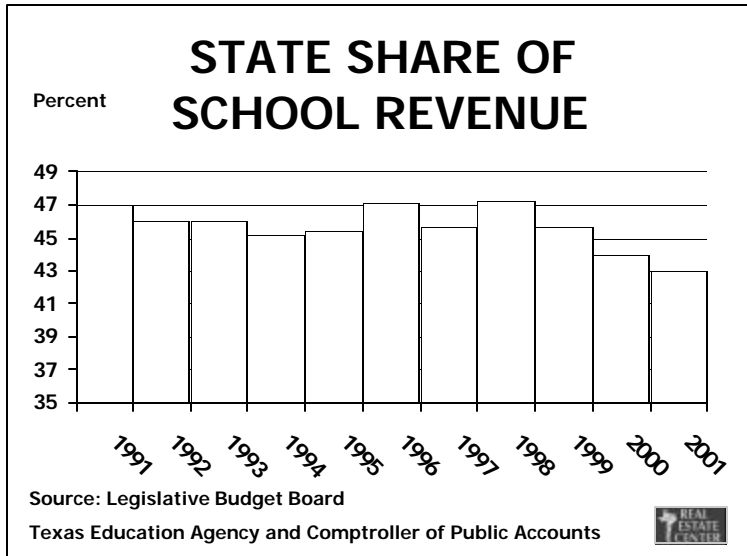
Enlarged tax bases following property tax reform facilitated growth in local school tax levies during and following the 1980s. The proportion of the state budget dedicated to education atrophied while local school property tax levies ballooned. Diversion of state funds to other activities led to a steady reduction in the share of school budgets supported from the state. The percentage of Texas public school expenditures received from the state declined from 47 percent in 1991 to an estimated 43 percent in 2000 (Legislative Budget Board). Per pupil expenditures in Texas during the 1998-99 school year included

\$548 in federal funding;
\$3,309 in local funds and
\$2,738 in state monies.

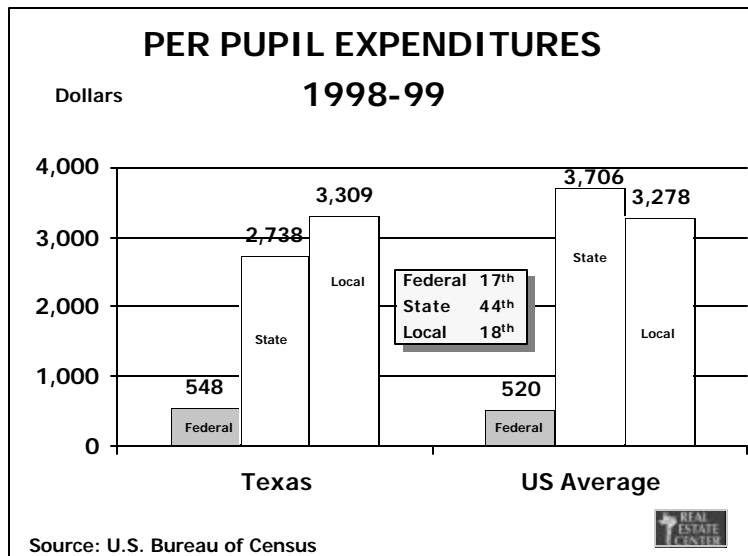
Among all states, that places Texas 17th in federal funds, 18th in local funds, but 44th in state funds. Texas compares admirably with the national averages of \$520 for federal support and \$3,278 for local contributions per pupil.

However the state contribution falls far short of the average \$3,278 in state monies (U.S. Bureau of the

Census). The Texas local property tax has served to support Texas schools at 88 percent of the national average expenditure per pupil despite a state contribution that falls at 73.8 percent of the average state contribution per pupil. Clearly, Texas depends heavily on local property taxes for school funding.



The chart on the following page shows the effective tax rate for single family residential properties in the largest city in each of the 50 states and the District of Columbia. The city government for the District of Columbia compiles this list each year to compare tax burdens around the nation. The effective tax rate calculated in that report consists of the officially imposed tax rate multiplied



by the ratio of assessed value to market value for each city listed.

Assuming that the ratios supplied are accurate representations of the relationship between assessed values and market values, the effective tax rate represents the percentage of market value paid as property taxes each year. For example, an effective tax rate of \$1.00 per \$100 of market value equates to property taxes of 1 percent of market value. Assuming a constant market value, in 100 years an owner would pay total taxes equal to the property's market value for this \$1.00 rate. A rate of \$2.00 would cut the time required for taxes to equal market value to 50 years.

Comparing effective rates indicates the relative property tax burden among the cities in various states. Ranking 7th nationally, Houston posted an effective tax rate of \$2.59 per \$100 of value for the year 2000. Houston's burden fell well below rates for Bridgeport, Connecticut; Providence, Rhode Island; Newark, New Jersey; Manchester, New Hampshire and Milwaukee. However, the Houston burden was more than 2.78 times

STATE	2000 PROPERTY TAX RATE (\$ PER \$100 OF VALUE)	PROPERTY TAX RATE RANKING	1998-99 STATE & LOCAL REVENUE ADJUSTED FOR COST OF LIVING \$ PER PUPIL	STATE AND LOCAL REVENUES AS A % OF PER CAPITA DISPOSABLE INCOME	TOTAL REVENUE PER PUPIL RANKING
New Jersey	3.71	3	8,718	38.98	1
New York	0.81	47	8,368	37.41	3
Connecticut	4.55	1	7,000	31.30	4
Rhode Island	3.52	2	7,933	35.47	5
Illinois	0.93	45	6,505	29.09	17
Washington	1.12	40	6,214	27.78	26 (median)
Texas	2.59	7	6,047	27.04	36

■ **Table: Property Tax Burden and State and Local School Revenues**
Source: Government of District of Columbia and U. S. Census Bureau

the \$0.93 rate in Chicago and 3.24 times the \$0.81 rate for New York City. Houston taxpayers faced a property tax burden that was 1.7 times the median rate nationally of \$1.52 in Columbia, South Carolina. This evidence indicates that Texas property tax burdens rank among the highest in the country.

Comparing expenditures of state and local funds adjusted for cost of living differences as a percentage of per capita disposable income indicates the degree to which each state is willing to support public education. The results of that comparison indicate that New Jersey tops the list dedicating 39 percent of their disposable income to education. Texas spends 27.04 percent, lagging the median state rate of 27.8 percent. By all of these measures, the Texas system falls short of reaching the median. New York ranking 3rd in

revenues per student and 47th in property tax burden, indicates little correlation between high property tax burdens and sizable revenues per pupil in school funding. In fact, ranking high in property tax burden at 7th, Texas drops well below the median, ranking 36th in total revenues per pupil.

Finally, economic changes reshuffle the property tax burden through resulting changes in value. An economic shock to one part of the tax base can cause a significant increase to other taxable properties. For instance, in the past several years, companies have scrambled to lay the fiber optic infrastructure to support broadband access to the Internet. Much of that investment undoubtedly found its way onto tax rolls at values reflecting the cost of the assets. Now, that industry faces slack demand, reportedly operating at 10 to 15 percent of capacity. Obviously, those assets are now worth a fraction of their installed cost. Presumably, chief appraisers will be forced to recognize these circumstances by reducing assessed values for that property to a fraction of their current value. That reduction will shift the tax burden from those businesses to all other property owners not experiencing value reductions.

This kind of shifting occurs from year to year as property making up the tax base appreciates at different rates. For example, if homes appreciate more rapidly than business property, the tax burden will shift to residential property. The chart on the next page shows the percentage that each class of property represented in the Texas tax base over the past decade. Obviously, total residential property values expanded more rapidly than the other categories. Presumably, residential tax payments also increased as a proportion of the total. Given these facts, residential property has faced a rising tax burden in the aggregate and owners probably also faced increasing individual tax burdens. Not only has the sagging of the high-tech sector threatened that part of the tax base, falling oil and gas prices promise to reduce assessed values for that portion of the tax base as well. In view of the problems currently roiling the economy, homeowners can look forward to higher property tax bills in the future as growth in the remainder of the tax base slows.

Year	Business Property	Residential Properties	Land	Oil & Gas
1993-94	40.6	44.1	8.4	6.0
1994-95	40.4	45.8	8.1	5.1
1995-96	40.1	47.0	7.9	4.3
1996-97	41.2	46.7	7.6	4.0
1997-98	40.8	46.7	7.4	4.6
1998-99	40.7	47.2	7.3	4.1
1999-2000	40.6	48.7	7.3	2.8
2000-2001	39.0	50.1	7.0	2.9

■ Table: Percentage Distribution of Texas Property Tax Base
Source: Comptroller of Public Accounts -- Property Tax Division

ESTIMATED IMPACT OF HIGHER PROPERTY TAXES ON HOUSTON HOME PRICES

The experience of homeowners in the Houston economy provides an insight into the impact of property tax increases on property owners. As the foregoing discussion explains, an increase in property taxes will translate into a decline in property values. Examining the Houston home prices as a relationship between typical expenditures on housing and personal income provides an estimate of the effect of a property tax induced increase in the level of housing expenditures. Essentially, a one dollar increase in property taxes will cause a one dollar increase in housing expenditures. The relationship between the level of housing expenditures and home values demonstrates the impact of that increase on values. To identify that relationship, we estimated an econometric model that measured the correlations between home prices, housing expenditures and personal income.

Using information obtained from surveys of consumer expenditures conducted by the U.S. Bureau of Labor Statistics for Houston, we discovered that an increase of one dollar in property taxes drives down the average home price by \$37.95. For example, if expenditures for property taxes increased by \$100.00 from \$4,397 to \$4,497 (an increase of 2.3 percent in 1999-2000), then the average home price fell by \$3,795. That amounts to 2.8 percent of the \$137,200 average Houston home price in 1999-2000.

Alternatively, estimating the relationship in terms of the percentage change for a given percent property tax increase indicates that a 10 percent increase in housing expenditures causes the average home price to drop by 8.8 percent. Both of the estimated econometric models indicated a large decline in home values for property tax increases. Because of the nature of statistical estimation, this large effect may reflect specific conditions in the Houston market during the time studied. Further, the property tax effect may also include influences from a related economic influence not included in the report. However, these estimates confirm the negative influence that property tax increases can have on value.

CONCLUSION

Property taxes act as a drag on the value of the real estate forming the tax base. Increasing tax burdens ensure a negative influence on real estate values and can influence land use decisions as owners seek to avoid or reduce tax liabilities. The Texas school finance system, relying heavily on local property taxes, imposes a heavy burden on Texas homeowners. Further, homeowners' face the potential for rising real tax burdens as the value of their homes increase more rapidly than values for other classes of property. As Texas moves forward, demographic experts predict an expanding student population base. In addition, the composition of that population will include an ethnic shift. An increasing proportion of that student population will come from Hispanic households. Presumably, many of those Hispanic students will come to the system speaking English as a second language. Texas faces a growing challenge to provide resources to meet the educational needs of this expanding segment of its student population. These factors may require greater spending per student to accomplish the goal of efficiently educating Texas school children.

Clearly, the state has chosen to increasingly rely on local property taxes to fund public education. The foregoing factors indicate an escalating need for funds in the future. Relying on the local property tax for those revenues will increase the already high

property tax burden on all Texas real estate. That pressure will prompt property owners to seek more exemptions and abatements. It will tend to reduce real estate values and prompt owners to find methods to avoid the tax. Many will seek legal advice as they strive to structure ownership to minimize school tax liabilities. All of this activity translates into an increasing cost of dealing with the tax. Increasing ownership cost translates into reduced affordability. Heavy reliance on property tax will adversely impact the supply of affordable housing in the future. Texas officials would do well to consider all of these factors as they search for an optimal school finance system.

APPENDIX -- MODEL SPECIFICATION

The Bureau publishes a survey of consumer expenditures for a number of important Metropolitan Statistical Areas. Houston and Dallas-Fort Worth are two major metro areas in Texas included in the regional surveys of consumer expenditures. These surveys are useful sources of information to investigate the impact of higher property taxes on the real estate industry of the metro areas. Using the expenditure data for Houston, together with data from other sources, the following analysis shows the impact of higher property taxes on house prices in the Houston metro area.

A survey of 1,733 consumer units in Houston in 1999-2000 showed that homeowners spent \$4,397 on mortgage and interest charges, property taxes, maintenance, repairs, insurance and other housing expenses. Expenditures on housing are a volatile variable because payments for mortgage interest compose a major component of total housing expenditures. In 1999-2000, expenditures on owned dwellings accounted for 9.5 percent of total expenditures per consumer (\$46,299) in the Houston metro area (Table 1). Property taxes accounted for 21 percent of total expenditures on owned dwellings in 1999-2000.

Higher property taxes increase total expenditures on owned dwellings by homeowners and are expected to have a negative impact on house prices and/or home sales. Using the expenditures data and house price data for Houston and cointegration analysis, the following two equations are estimated to investigate the impact of higher housing expenditures, including property taxes, on Houston's house prices:

Using levels of variables: $\text{HousePrice} = -37.95 \text{ DwellExp} + 5.66 \text{ Pincome}(1)$

Using logarithms of variables: $\text{HousePrice} = -0.88 \text{ DwellExp} + 1.76 \text{ Pincome}(2)$

where HousePrice equals average house price, DwellExp equals expenditures on owned dwellings, Pincome equals per capita personal income. All three variables are in real terms with the consumer price index for Houston used to deflate time series of house prices, income and expenditures.

YEAR	TOTAL EXPENDITURES	HOUSING EXPENDITURES	HOME PRICES
1987	28,798	2,764	81,300
1988	29,903	2,627	79,700
1989	29,769	2,762	88,200
1990	30,217	2,664	90,600
1991	32,298	2,594	92,200
1992	32,823	2,585	99,000
1993	34,062	2,877	106,500
1994	36,221	2,959	105,900
1995	38,339	3,013	105,700
1996	38,208	3,586	112,600
1997	40,017	3,539	120,700
1998	43,038	4,122	128,000
1999	46,299	4,397	137,200

■ **Table: Consumer Expenditures and House Prices in Houston**
Source: Bureau of Labor Statistics

- B-6. *The Presentation to the Joint Committee on Public School Finance*
 John Connoly, Executive Director, Texas School Coalition and the South Texas Coalition of Schools
 Doug Otto, Superintendent, Plano ISD
 Martin Pena, Executive Director, Texas School Coalition and the South Texas Coalition of Schools
 Roberto Zamora, Superintendent, La Joya ISD

**Presentation to Joint
 Committee on
 School Finance**

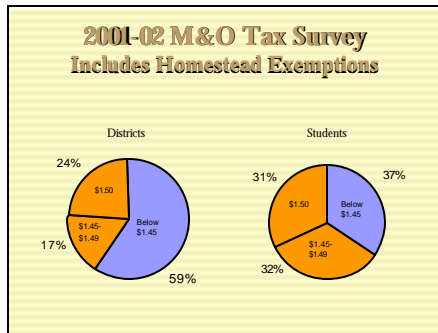
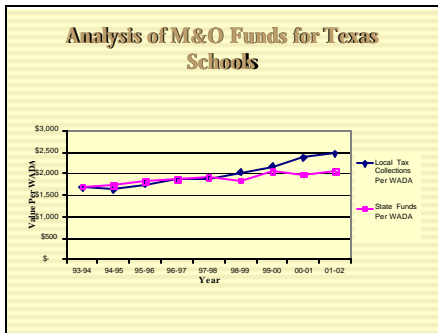
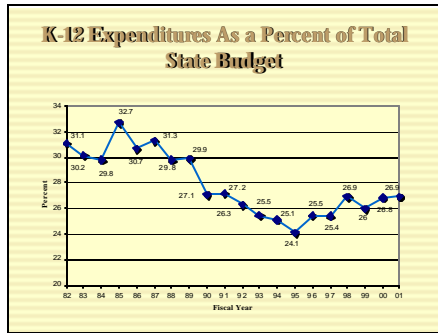
by
 Representatives From
 South Texas Association of Schools
 And the Texas School Coalition

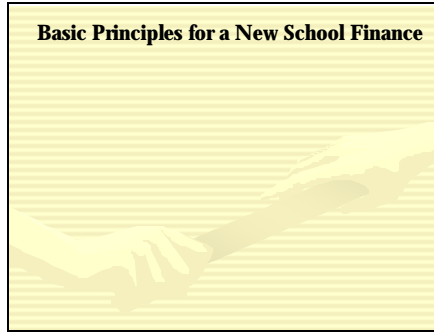
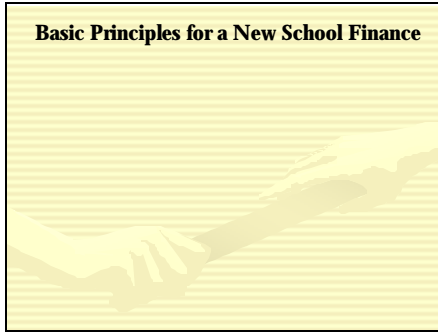
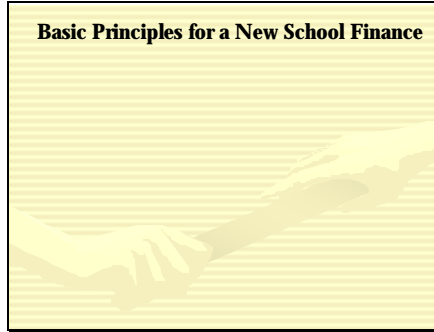
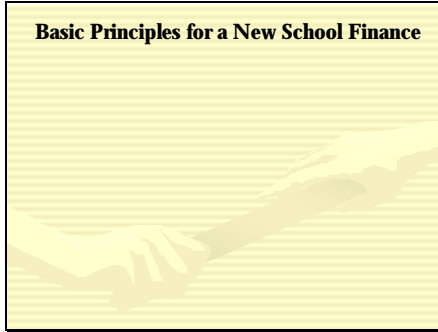
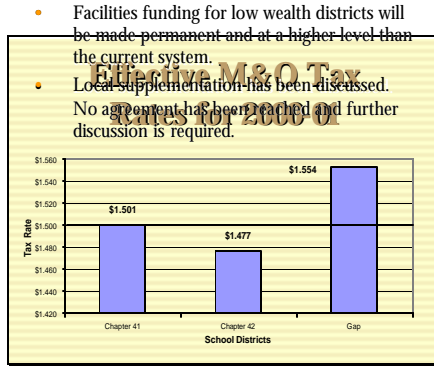
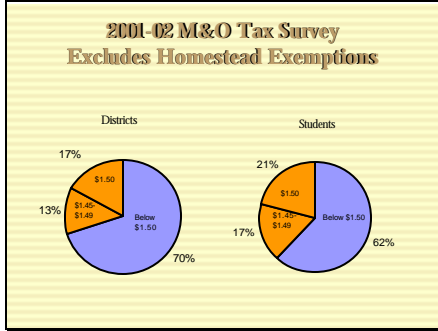
Presenters

- Dr. Roberto Zamora President of South Texas Association of Schools, Superintendent of LaJoya I.S.D.
- Mr. Martin Pena Executive Director of South Texas Association of Schools, Former Superintendent of Los Fresnos I.S.D. and Point Isabel I.S.D.
- Dr. Doug Otto President of Texas School Coalition, Superintendent of Plano I.S.D.
- Dr. John Connolly Executive Director of Texas School Coalition, Former Superintendent of Highland Park I.S.D.

1999 State Tax Rankings

- Rank Per Capita **48th**
- Rank as a % of personal income **47^h**
- Rank as a % of Gross State Product **49^h**





- B-7. *School Finance 2003: When Rising Costs Meet Capped Taxes*
Pat Forgione, Superintendent, Austin ISD and President, Texas School Alliance

I. EXECUTIVE SUMMARY

Texas school districts are facing challenges in their efforts to provide all students with a quality education. These challenges include:

- Preparing students to meet rising academic standards
- Recruiting and retaining qualified personnel
- Serving the needs of a growing population of students with special needs
- Building and maintaining adequate facilities
- Funding growing costs for utilities, fuel, insurance, and supplies

The current standard for funding public education in Texas requires that districts receive similar amounts of revenue for similar tax efforts, up to the level of an accredited education. Because all districts are accredited, this minimal standard is currently being met. However, significant changes in the accountability system scheduled to begin in 2002-03 could result in a sharp increase in the number of low-performing districts.

As costs of providing an accredited education rise, two-thirds of Texas students are in districts that are at or near the \$1.50 maintenance and operations tax rate cap; these districts have virtually no access to additional revenue. This trend will be accelerated by an anticipated slow down in property value growth over the next few years. The state's percentage share in funding education, meanwhile, has reached its lowest level in 50 years. Recent infusions of state funding have largely been targeted for specific purposes, providing school districts with little flexibility to determine how to spend the additional funds.

In 2003, Texas school districts not only will face the challenge of educating students to meet rising academic standards in a globally competitive market, but also will face doing so at a time when access to revenue could be severely restricted.

II. FRAMING THE CONTEXT

Texas school districts have steadily improved student performance over the past decade. Though faced with growing populations of more difficult-to-educate students, the state's largest districts have made remarkable gains.

With the evolution of the accountability system, districts are now faced with growing expectations for student performance at the same time that access to revenue becomes increasingly constrained.

Both state and local systems for financing public education will be under severe stress by 2003. At the state level, current patterns of school finance combined with a slowing economy are expected to produce significant stress in the coming legislative session. Meanwhile, the state's percentage share of education funding has diminished, and local districts have raised tax rates to keep up with rising costs.

At the local level, a significant increase in the number of districts at or near the maximum legal maintenance and operations (M&O) tax rate of \$1.50 is expected,¹ especially if property value growth slows over the next few years as expected. Already, as of last year, 30 percent of Texas students attend school districts at \$1.50 M&O tax rate; 34 percent more are in districts within pennies of that cap.

This document is intended to help school districts educate legislators and other elected officials about two core issues in school finance: cost and funding. The first part of the document discusses what drives the cost of a “general diffusion of knowledge.” The second part addresses the equity of the system for students, teachers, communities, and taxpayers. In other words, the document explores the questions: How much will education cost? And, what is an equitable system to pay for education?

¹ Note: Some Texas school districts are not subject to the general \$1.50 cap on M&O taxes but are instead subject to a total \$2 cap on M&O and debt service combined. A 1950s-era special law allows these districts in Harris County to operate under this higher cap.

III. How much will education cost?

How much does a “general diffusion of knowledge” for all students cost?

The Texas Supreme Court has stated that “districts must have substantially equal access to funding up to the legislatively defined level that achieves the constitutional mandate of a general diffusion of knowledge.” The Court said the Legislature has equated “a general diffusion of knowledge” with the provision of an accredited education system – and the state’s accountability system. Recent legislative and federal action has raised the bar, however. Districts face this new challenge with increased diversity among student populations, an increasingly complex market for recruiting and retaining educational personnel, increased facility needs, and rising prices for many cost elements. The new school finance system must address these factors if it is to provide a true “general diffusion of knowledge.”

Rising standards for an accredited education

The good news in public education is that Texas schools are improving. The most recent school ratings saw overall improvement, especially individual school ratings in urban districts. Statewide, a total of 1,908 campuses were rated “exemplary,” and 2,400 more were rated “recognized” – the highest numbers ever recorded in the nine years of the accountability system – even with higher performance bars for those ratings.

The challenge will be to keep up that high level of achievement with a major change in expectations for students. In recent years, lawmakers enacted several pieces of legislation that significantly increased expectations of student performance. New curriculum standards, the Texas Essential Knowledge and Skills (TEKS), became effective in 1998. The “no pass, no promote” policy for elementary and middle school students begins this year. Significantly expanded assessment requirements are scheduled. In addition, the federal government is now implementing the No Child Left Behind Act, which calls for states to raise the bar each year with measurable “adequate yearly progress.” Higher stakes accountability measures will be in effect in the very near future.

Beginning in Spring 2003, third-grade students must pass the state assessment in reading to be promoted to the fourth grade.² This “no-pass, no-promote” rule will be phased in for more grades and subjects in future years. Also in Spring 2003, a more difficult assessment system, the Texas Assessment of Knowledge and Skills (TAKS), will be put into place. The TAKS, based on the state’s more challenging new curriculum, is expected to substantially raise the bar with respect to student and teacher performance and also will be given at more grade levels and in more subjects.

² There are exceptions. If a student fails the exam twice, the district may promote the student if the student passes a commissioner-approved alternate assessment of appropriate grade level. Also, if a student is to be retained, a grade placement committee may vote to promote the student if the vote is unanimous.

As the new laws come closer to reality, and headlines proclaim, “State warns of massive test failures,”³ school district leaders have realized that a major increase in resources will be necessary to ensure children are not held back. If a 70 percent passing standard were applied to the test today, the passing rates for students would fall dramatically. A 20-point drop in the passing rate was estimated by TEA. Districts with high concentrations of at-risk students, such as many of those in TSA, will face the greatest challenges. Application of the new standard could mean that only 30 percent of eighth grade “at-risk” students pass all portions of the test. For third graders, facing the rule of no pass, no promote, the problem could be worse. Currently one out of every five at-risk third graders fails the reading TAAS. Under new standards, TEA indicates this could rise to one out of every three. When math is added to the requirement, the failure rate could approach two out of three. So that no child is left behind in third grade this school year or in the years to come, districts have been implementing systems and programs, such as TEKS training, reading programs, and early childhood programs. While the state has provided money for teacher professional development, especially in reading, and for prekindergarten grants, these programs are straining district budgets.

For high school, the stakes are also high. First, new reading and math TAKS will be given at ninth grade, where many students are already at risk.⁴ Second, a tougher exit-level exam, required for graduation, will test Algebra I, geometry, English III and writing, early American and U.S. history, biology, and integrated physics and chemistry.⁵ The effect of adding just Algebra to the exit exam cannot be overstated. TEA data on end-of-course tests indicates that only two out of five students currently pass all tests taken. If these results are extended to the new testing program, 60 percent of 11th graders would fail one or more portions of the new test and thus be at risk of not receiving a diploma. Third, during the 2001 session, the Legislature made the Recommended High School Program the “default” curriculum in high schools statewide.⁶ To prepare students for the more difficult exit exam and graduation requirements, districts will need to attract and hire more teachers, particularly in areas such as Algebra where a large percentage of teachers are not certified to teach the subject. Districts also will need to provide more training for teachers and upgrade chemistry and physics labs.

Lawmakers also directed the commissioner of education to develop and incorporate new indicators for the accountability system that address dropout reporting and the performance of students who are eligible for compensatory education. These new standards will also increase the need for new resources.

Qualified personnel

The educational challenges of the future cannot be met without a well-trained teaching staff, supported by qualified counselors, principals, and administrators. The cost of

³ *Dallas Morning News*, March 23, 2001, page A1.

⁴ TSA appreciates the Legislature’s creation in 1999 of the Ninth Grade Grant Program, which should help address these at-risk students in ninth grade.

⁵ The new exit-level exam will be a graduation requirement for the Class of 2005.

⁶ There are exceptions for students for whom the Recommended High School Program is not appropriate.

providing staff is the single biggest cost in education. Statewide, personnel costs consume about 82 percent of districts' budgets.

The rising educational standards, or even those in place today, cannot be met with the existing pool of educational staff. Personnel costs are impacted not only by educational needs, but also by market forces. The current labor market for teachers and other education professionals requires school districts to compete not only with other school districts, but also with the private sector for qualified workers. The competition for qualified workers is especially intense in urban areas, where large employers can offer much greater opportunities for jobs outside of education. Houston ISD, for example, has been recruiting teachers overseas, because teacher shortages are so great.

Significant shortages in personnel are already occurring in specific areas. The existing teacher workforce does not include an adequate supply of science and math teachers, a situation that will be further exacerbated by the requirement for all students to complete the Recommended High School curriculum. Shortages also exist within special program fields such as special education and bilingual education.⁷ Finally, thousands of teachers are teaching outside of their professional area – a significant sign of a shortage of personnel. Addressing these shortages will be expensive, yet critical, if students are to receive instruction from appropriately certified teachers.

In addition, a significant shortage also exists in the pool of principals and assistant principals. This shortage will only be exacerbated by the pending “retirement bubble,” i.e., a large proportion of the current, experienced campus administrators are eligible to retire in the next few years. Districts will have to offer higher salaries to both teachers and administrators in order to recruit and retain an adequate supply of qualified personnel.

School district budgets are extremely sensitive to and profoundly impacted by mandates that affect staffing. Some requirements increase the number of employees, such as new programs, extra duties, stricter enforcement of class-size laws, or a new curriculum emphasis. Other requirements increase the costs of personnel, such as across-the-board salary increases or additional benefits.

Generally, in a tight labor market, school districts must find new sources of revenue to increase compensation and benefits. Despite the Legislature's passage of a \$3,000 salary increase in 1999 for every teacher, teacher shortages remain a significant problem in certain areas. Likewise, despite the recent passage of a statewide program for public school employee health insurance,⁸ the continuing dramatic rise in the cost of health insurance is expected to persist in squeezing district budgets.

⁷ The following are the Texas designated subject-matter teacher shortage areas for the year 2001-2002: Mathematics, Special Education, Bilingual/ESL, Science, Foreign Language (languages other than English), and Technology Applications. Letter from Jim Nelson, Commissioner of Education, to the Superintendent Addressed, October 8, 2001.

⁸ TSA districts will receive funds from the state for healthcare costs but will not be eligible to participate in the statewide program until 2005.

The challenge of special populations

Meeting the educational challenges of the future requires school districts to provide a growing number of students programs to meet a variety of student needs, such as English-as-a-Second-Language (ESL), bilingual education, compensatory education, special education, prekindergarten, and alternative education programs. In urban areas, the student population is highly mobile, and the proportion of economically disadvantaged students is increasing. Teachers are often more difficult to recruit and retain in these areas.

School buildings and equipment

School facility costs are driven by growing enrollments, technology and electrical infrastructure expansion, major retrofitting and rewiring of facilities, renovation and repair of aging facilities, costly repairs for such items as asbestos and mold abatement, stricter enforcement of class-size limits, safety and security concerns, and the increased need for laboratory classroom capacity. Costs for opening new schools are a significant factor for growing districts, not only for the building costs but also for personnel and fixed operating costs as well. The developing state-local support system for debt service has done much to assist school districts in this area, but more remains to be done.

Technology costs

Many major infrastructure costs and hardware costs have been addressed thanks to the Legislature's creation of the technology allotment in 1990 and the Telecommunications Infrastructure Fund in 1995. These two sources of technology funds – the \$30 per student allotment funding instructional technology and training and the competitive TIF grants paying for infrastructure and hardware projects – have put Texas in the forefront of a commitment to educational technology.

Also during the 1990s, schools saw an explosion in technology and its uses to improve K-12 education. There is a new course, Technology Applications, which is now part of the required curriculum for K-12 and is a graduation requirement. There are online courses and email systems to keep in touch with parents. There is teacher training available over the Internet. There are costs that did not exist in 1990, such as the cost of network administrators, and the costs of keeping them. And there are increasing calls for schools to provide computers to students who cannot afford them.

With the TIF scheduled to end in 2005, and with a need to maintain, update, and replace technology on a continual basis, ongoing technology funds will be needed that can be budgeted on a predictable basis. Schools can most efficiently employ technology if they plan over a multi-year timeline. The technology allotment is a stable, efficient source of funding that allows districts to plan for technology needs in advance over a period of years. The technology allotment has not increased from \$30 per student since the Legislature created it in 1990, although the Texas Education Agency recommended an increase in 2001.

Rising costs – the hidden driver in the cost of education

Like any employer, school districts face rapid cost escalations in other areas, such as sudden hikes in utility costs, fuel prices, health insurance, other insurance costs, and supplies. During the 2000-01 school year, districts faced higher than anticipated fuel prices, which resulted in higher costs for transportation and utilities. In addition, with new accountability measures necessitating extended-day or extended-year programs for at-risk students, utility usage has increased and will continue to increase. Fuel costs and costs of buses are on the rise as well. Public schools are not treated the same as some institutions of higher education, which receive price breaks on utility costs.

Although the costs are increasing, the formulas designed to assist school districts in providing differential support are not. Sometimes, a specific formula is set up to fund a cost, but the formula is rarely updated to reflect actual costs. For example, although the transportation allotment was intended to reflect the actual cost of transportation, the state has not increased the allotment since House Bill 72 in 1984. Meanwhile, costs have more than doubled over the past 17 years.

The Legislature in 2001 began to address the pressing issue of rapidly escalating health insurance premiums and some school districts' inability to obtain any or any affordable health insurance. However, health insurance costs continue to rise at a double-digit rate. If this cost inflation is not addressed, the 2002 increase in support could be overwhelmed by the rising tide of insurance inflation.

IV. HOW WILL WE PAY FOR EDUCATION?

What is an equitable system to pay for education costs?

Texas has been judged to have one of the most equitable school finance systems among the major states. This degree of financial and student equity achieved over the long legislative and judicial process of re-design during the late 1980s and early 1990s must be preserved. The requirements for financial equity must continue to be the basis for the provision of the necessary resources to all school districts in meeting the challenges of higher accountability standards. Just as formulas recognize differences in costs, some finance formula features recognize districts' access-to-revenue factors, such as the concept of a guaranteed yield per penny of tax effort and the limits on access to revenue at specific tax rates.

Funding formulas used for distribution should reflect variations in costs to educate different populations of students, variations in the ability to raise local revenue, and variations in costs associated with school district characteristics such as labor market differences. In addition, funding formulas should not result in the need to prorate state funds.

A new funding system must provide for equity – equity for students, teachers, and taxpayers. Texas courts have spoken only to the issue of property taxpayer equity. The broader issues of student and teacher equity have yet to be addressed in Texas courts, although they are under substantial litigation in other states.

Equity for students and teachers

Current school finance formulas include a number of features designed to recognize the need for differential support for teachers and students. Formulas that recognize cost differences for meeting the needs of certain types of students (weights) and salary cost differences for certain types of school districts (size adjustments and the Cost of Education Index (CEI)) have long been a part of the school finance system.

Funding weights, which are used to provide additional funding for students who need additional resources, are not based on current research on the cost to serve students and fall short of meeting the actual needs. Although special education formulas were adjusted in 1993, the weights for compensatory education and ESL/bilingual education have remained constant for years.

The CEI provides additional funding to meet differential salary needs in different districts. The differential is designed to recognize uncontrollable costs, primarily labor cost differences among districts. Differences in district size are also recognized for small, sparse, and mid-sized districts. The adjustments used by the state have not been seriously considered for more than a decade.⁹ The school finance system of the future must recognize updated factors reflecting the real world of school district and personnel costs.

Equity for the community and the taxpayer

Under classic definitions in school finance, Texas has achieved a high degree of financial equity for local taxpayers. The provisions of Tier II, caps on high-wealth districts, and state support for facilities have all given credence to the concept that Texas does adhere to the principle of similar revenue for similar tax effort. This element of the late 20th century must be retained in the 21st century. Equitable support for both operations and facilities is a fundamental ingredient of any new school finance system.

Provision of an equitable system for property taxpayers does not mean that the state has an equitable tax structure for the support of public education. Although state dollars for education have increased in recent years, the state's share of the total cost of education is at its lowest in 50 years. The state now bears only 42 percent of the cost. The partnership has moved from the state-local system visualized by state leaders to a local-state system.

⁹ An exception is the mid-sized adjustment, which was adopted in 1995. A technical correction was made to this adjustment in 2001.

Under the current system, increases in property values primarily benefit the state (all other things being equal) by reducing the district's entitlement to state funds. In other words, increases in the value of property do not necessarily produce increases in school district revenue. Unlike cities or counties, which can better keep up with inflation by reaping and keeping extra tax revenue from higher property values, school districts cannot keep the tax revenue from higher property values. Nor do the school finance formulas recognize inflation.

School districts, therefore, have relied on local tax rate increases to keep up with the costs. As a result, a growing number of districts are approaching the \$1.50 tax rate cap for maintenance and operations. At the same time, property value growth is expected to slow substantially over the next few years. Even a slow-down in economic growth creates fiscal stress on school district budgets. Under the current system, with a capped tax rate and a slow-to-grow tax base, districts' access to additional revenue is sharply restricted.

Flexibility

Increases in funding that the state has authorized over the past three legislative sessions have been significantly enhanced by the state's treatment of local property value growth; the more the local growth, the less the state's fill-in-the-difference obligation, which creates a "surplus" in the state revenue designated for public education. For three sessions, the state has used part of this "surplus" state revenue to increase funding dedicated to specific purposes, such as tax relief, salary increases, and health insurance benefits.¹⁰ This expansion of "dedicated" new state dollars and the corresponding lack of "flexible" local dollars has eroded the ability of school districts to make local decisions that reflect the needs of local constituents – or to meet the coming demands of a more challenging accountability system.

Cost containment measures

Finally, school districts for years have realized that they will one day hit the \$1.50 tax rate cap for maintenance and operations. To put off reaching that day, many districts already have aggressively put into place cost containment measures to achieve efficiency. TSA districts report, for example, that they have reduced staffing, developed staffing ratios for each type of campus based on student enrollment, cut operating expenses, implemented energy management programs, eliminated perfect attendance incentive programs, consolidated summer school programs to save utility costs, put on hold major purchases such as buses and air conditioning renovation, and charged food services for their share of utilities.

¹⁰ TSA supported the Legislature's increasing of money for health insurance, because it was a crisis situation where rapidly escalating costs meant some districts were priced out of offering health insurance. TSA, however, also supported allowing districts to get flexible funding to address other critical needs, such as the need to meet the future rising standards in the accountability system.

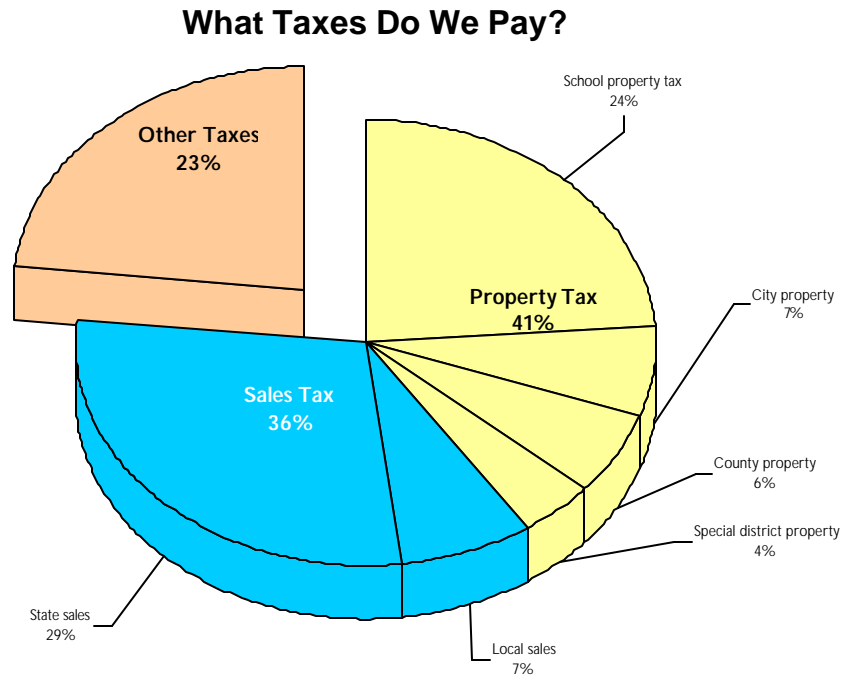
V. FUTURE DECISIONS

By 2003, Texas school districts and educators will be swimming against the tide of a diminishing revenue stream. It will be a year when growing TAKS goals meet slowing tax rolls.

School districts will badly need a revenue stream that keeps up with the costs of education: the rising academic expectations, the need for qualified personnel, the challenge of special population students, school buildings and equipment, technology, and other rising costs. Helping school districts afford these costs, so that all students in the public education system have the opportunity to demonstrate exemplary performance, will be the biggest challenge of the coming legislative sessions.

With these challenges ahead, the Texas School Alliance appreciates the work of the Joint Select Committee and looks forward to working with the Legislature on this critical issue in the 2003 session.

B-8. *Funding Public Education*
 Dick Lavine, Fiscal Analyst, Center for Public Policy Priorities



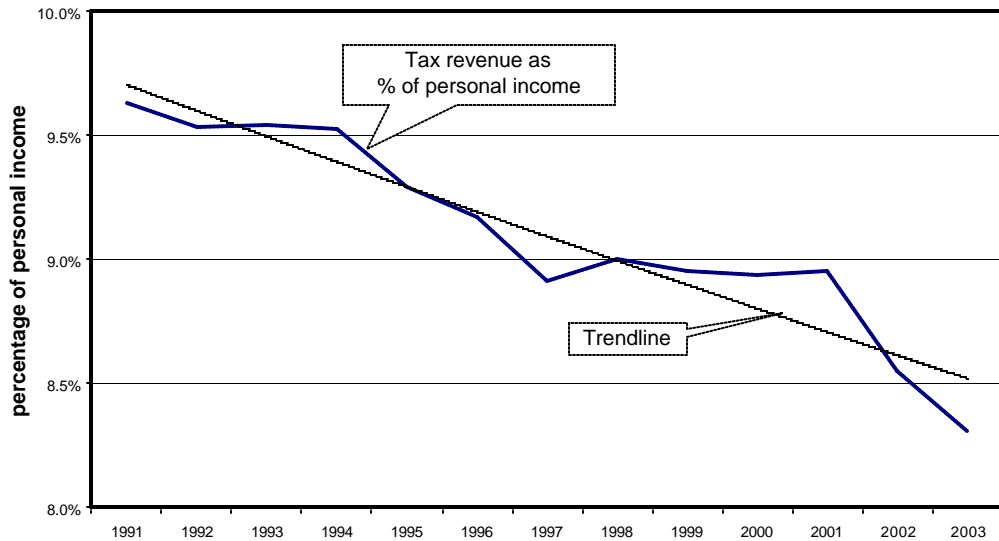
Limited Sales and Use Tax

Table 3 Cost of Selected Service Exclusions from the Sales Tax Fiscal Years 2001 to 2006 (in millions of dollars)						
Construction labor						
New residential construction	\$252.5	\$261.5	\$273.4	\$288.1	\$305.6	\$325.6
New nonresidential construction	216.3	224.0	234.2	246.8	261.7	278.9
Residential repair and remodeling	81.8	84.7	88.6	93.3	99.0	105.4
Personal services						
Barber and beauty services	48.3	51.5	54.7	58.4	62.3	67.1
Funeral	42.7	45.2	47.7	50.6	53.5	56.7
Child day care	144.3	150.5	157.2	164.4	171.8	179.5
Miscellaneous personal services	12.8	13.6	14.6	15.7	17.0	18.4
Business and professional services						
Physicians services	547.9	583.8	620.7	663.1	707.4	761.2
Dental services	176.2	187.8	199.6	213.3	227.5	244.8
Other health care	293.6	312.8	332.5	355.3	379.0	407.9
Legal services	346.1	368.8	392.1	418.9	446.9	480.9

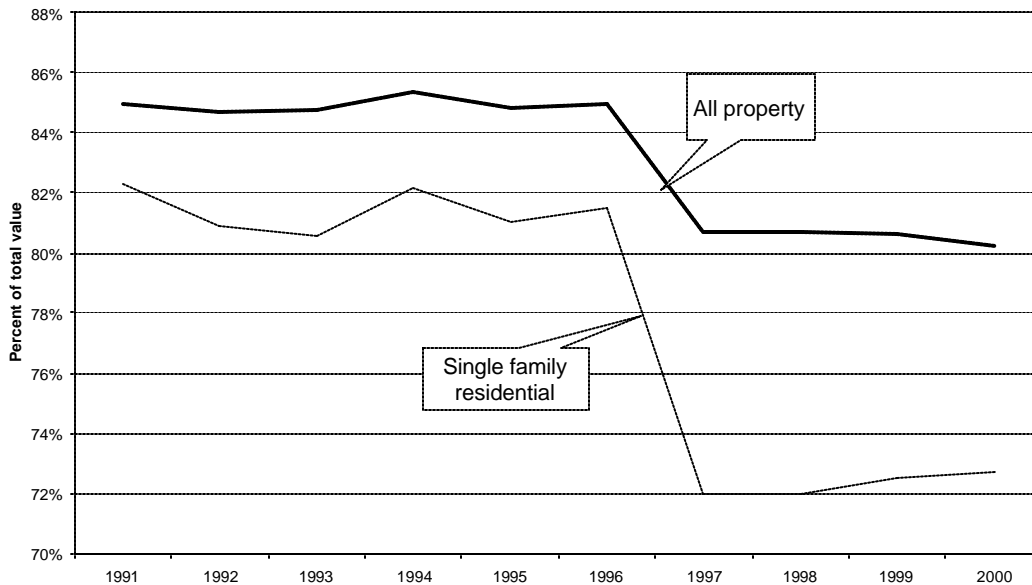
Accounting and audit services	168.2	179.2	190.5	203.6	217.2	233.7
Architectural and engineering services	245.0	261.0	277.5	296.5	316.3	340.3
Management consulting and public relations	87.0	92.7	98.6	105.3	112.3	120.9
Contract computer programming	89.4	95.3	101.3	108.2	115.5	124.3
Research and development laboratory services	36.8	39.2	41.6	44.5	47.5	51.1
Economic and sociological research	15.4	16.4	17.4	18.6	19.8	21.3
Testing labs	36.6	39.0	41.5	44.3	47.3	50.9
Advertising media	161.1	171.8	182.6	195.0	207.8	221.4
Employment agency services	25.5	27.2	28.9	30.9	32.9	35.4
Temporary labor supply	44.5	47.4	50.4	53.8	57.4	61.8
Financial services brokerage	176.8	188.4	200.2	213.9	227.9	242.9
Other financial services	66.0	68.9	72.6	77.1	82.1	87.9
Real estate brokerage and agency	164.4	171.6	180.9	192.0	204.4	218.8
Freight hauling	213.5	229.7	248.8	271.5	295.7	322.1
Other transportation (except scheduled passenger)	13.2	14.1	14.9	16.0	17.0	18.3
Veterinary Services	27.4	29.1	31.0	33.0	35.3	37.9
Other Services						
Automotive maintenance and repair	221.0	235.5	250.3	267.5	285.3	307.0
Car washes	19.0	20.2	21.5	23.0	24.5	26.4
Travel arrangement	30.7	32.7	34.8	37.1	39.6	42.6
Private vocational education	23.1	24.6	26.2	28.0	29.8	32.1
Other private educational services	21.6	23.1	24.5	26.2	27.9	30.1
Interior design		5.9	6.3	6.7	7.2	7.7
Total	\$4,054.4	\$4,297.6	\$4,558.0	\$4,861.1	\$5,183.0	\$5,561.8
Note: Totals may not sum because of rounding.						

Carole Keeton Rylander
Texas Comptroller of Public Accounts

State and Local Tax Revenue Doesn't Keep Up With Economic Growth



Taxable Value Is Stable as a Percent of Total Value (except for the higher homestead exemption)



School Property Tax

Table 1
School Property Tax
Tax Year* 2001 to 2006
(in millions of dollars)

Section	Item	2001	2002	2003	2004	2005	2006
11.11	Public property (state and local)	cbe	cbe	cbe	cbe	cbe	cbe
11.111	Public property used to provide transitional housing for indigent persons	cbe	cbe	cbe	cbe	cbe	cbe
11.12	Federal exemptions	cbe	cbe	cbe	cbe	cbe	cbe
11.13	Residence homesteads:						
(b)	State mandated \$15,000	\$944.2	\$982.3	\$1,021.8	\$1,063.0	\$1,105.9	\$1,150.4
(c)	State mandated 65-and-over or disabled \$10,000	159.3	165.7	172.4	179.3	186.5	194.1
(d)	Optional over-65 or disabled	79.0	84.7	90.9	97.5	104.5	112.1
(n)	Optional percentage	306.2	330.0	355.6	383.2	413.0	445.0
11.14	Tangible personal property not producing income	cbe	cbe	cbe	cbe	cbe	cbe
11.145	Income-producing tangible personal property having value of less than \$500	0.1	0.1	0.1	0.1	0.1	0.1
11.146	Mineral interest having value of less than \$500	0.8	0.8	0.8	0.9	0.9	0.9
11.15	Family supplies	cbe	cbe	cbe	cbe	cbe	cbe
11.16	Farm products	cbe	cbe	cbe	cbe	cbe	cbe
11.161	Implements of farming, ranching, and timber	cbe	cbe	cbe	cbe	cbe	cbe
11.17	Cemeteries	cbe	cbe	cbe	cbe	cbe	cbe
11.18	Charitable organizations	cbe	cbe	cbe	cbe	cbe	cbe
11.181	Charitable organizations improving property for low-income housing	cbe	cbe	cbe	cbe	cbe	cbe
11.182	Community housing development organizations improving property for low- and moderate-income housing	cbe	cbe	cbe	cbe	cbe	cbe
11.183	Associations providing assistance to ambulatory health care centers	cbe	cbe	cbe	cbe	cbe	cbe
11.19	Youth spiritual, mental, and physical development organizations	cbe	cbe	cbe	cbe	cbe	cbe
11.2	Religious organizations	cbe	cbe	cbe	cbe	cbe	cbe
11.21	Private schools	cbe	cbe	cbe	cbe	cbe	cbe
11.22	Disabled veterans	18.0	19.0	19.9	20.9	22.0	23.1
11.23	Miscellaneous exemptions	cbe	cbe	cbe	cbe	cbe	cbe
11.24	Historic sites	0.9	0.9	0.9	0.9	0.9	0.9
11.25	Marine cargo containers	cbe	cbe	cbe	cbe	cbe	cbe
11.251	Freeport Property	101.4	106.8	112.6	118.6	124.9	131.6
11.26	65-and-over "tax freeze" on homestead	288.9	306.4	324.9	344.6	365.4	387.5
11.27	Solar and wind-powered energy devices	1.5	1.6	1.6	1.6	1.6	1.6
11.271	Offshore drilling equipment not in use	cbe	cbe	cbe	cbe	cbe	cbe
11.28	Tax abatement	25.5	20.6	16.6	13.4	10.9	8.8
11.3	Nonprofit water supply or wastewater service corporation	cbe	cbe	cbe	cbe	cbe	cbe
11.31	Pollution control property	40.3	42.2	44.1	46.2	48.3	50.6
11.32	Certain water conservation initiatives	0.0	0.0	0.0	0.0	0.0	0.0

23.23	Limitation on appraised value of homestead (10% cap)	151.5	160.7	170.4	180.7	191.6	
203.2	Productivity value loss (Secs. 23.41, 23.52, 23.73 & 23.9803, Tax Code)	1,161.7	1,232.0	1,306.5	1,385.5	1,469.4	1,558.3
311.013	Tax Increment Financing	22.2	20.9	19.6	18.4	17.3	16.3
	Total	\$3,301.5	\$3,474.4	\$3,658.7	\$3,854.7	\$4,063.2	\$4,284.5

cbe: cannot be estimated because of insufficient appraisal data.
 * Tax year means calendar year (January 1 through December 31).
 Note: Totals may not add due to rounding.

Carole Keeton Rylander
 Texas Comptroller of Public Accounts

STATE REFUNDS FOR ECONOMIC DEVELOPMENT

82 Companies Refunded \$10 Million for 2000 School Taxes

The Texas Tax Code provides for state tax refunds for economic development. Some Texas property owners are eligible to receive refunds on their net state sales and use taxes and franchise taxes for paying local school taxes. The total for all refunds collectively may not exceed \$10 million, the maximum amount made available by the Texas Legislature.

Of the 122 individual refund applications received for 2000 school taxes, the Comptroller’s office approved 114 applications representing 82 companies. While the approved 2000 refunds totaled \$46.3 million, these 82 companies received prorated refunds totaling \$10 million.

Tax year 2000 was the fourth year that companies could apply for reimbursement of school taxes paid on a property that received a county or city abatement but not a school tax abatement. Companies had to file refund applications by July 31, 2001 to reimburse them for paying 2000 school taxes.

Tax Code Section 111.304 requires the Comptroller’s office to submit a December 1 report to the Texas Legislature about the annual state refunds for companies who do not have school tax abatement agreements.

Prior years

Tax year 1997 was the first year that companies could apply for reimbursement of school taxes paid on a property that received a county or city abatement but not a school tax abatement. In that year, 10 companies received total refunds of \$4,886,663 to reimburse them for paying 1997 school taxes.

For tax years 1998 and 1999, the Comptroller’s office refunded the full \$10 million to 28 companies in 1998 and 62 companies in 1999.

No school abatements

Starting in 1997, property owners were eligible to receive refunds on their net state sales and net franchise taxes. The Tax Code requires the Comptroller’s office to issue state tax refunds to qualified property owners who entered into property tax abatement agreements—**after** January 1, 1996—with a city or county, but not a school district. Property owners with tax abatement agreements entered into on or before this date were **not** eligible for these state refunds.

Refund requirements

To be eligible for a refund, a property owner must have established a new business in a reinvestment zone, or expanded or modernized an existing business located in the zone. The city or county must have granted a tax abatement for the owner’s property, but not the school district.

Since entering into a city or county abatement agreement, the property owner must have increased the business’s payroll by at least \$3,000,000, specific to its property in Texas. Or, the owner must have increased the abated property’s appraised value by at least \$4,000,000. The maximum refund is the lesser of the school taxes paid or the amount of net sales and use tax and net franchise tax paid for the tax year the refund is claimed.

The property owner is barred from a refund if the company has agreed to an in-lieu-of-taxes payment—including a gift, grant, donation, or provision of in-kind services—to the city or county, if the payment exceeds \$5,000 in value.

A property owner’s refund equals the school property taxes paid by the owner in that tax year on property subject to a city or county abatement agreement. The refund also must be within the state’s annual cap of appropriated funds for these refunds.

2001 refund applications

To claim a refund for 2001 school taxes, a property owner must submit an application to the Comptroller’s office, along with the school district tax receipts showing the amount of school taxes paid on the property and other required documents. A property owner must file the refund application **by July 31, 2002**.

Senate Bill 1125 changed Tax Code Section 111.302, effective September 1, 2001.

Tax Code Section 111.302 now gives the Comptroller 90 days, rather than 60 days, to compute the total amount of eligible refunds.

A new subsection (d) added to Section 111.302 by the 77th Texas Legislature addresses county and city agreements with different terms. It states:

“(d) If an eligible person has entered into tax abatement agreements with the municipality and the county, and the agreements provided to the comptroller show that the agreements exempt different portions of property value, the refund amount shall be computed based on the greater of the portions exempted.”

If, in any year, the total amount of all refunds claimed by property owners exceeds \$10 million, the Comptroller’s office must reduce each claimant’s refund proportionally so that all property owners share in the state appropriated \$10 million.

The law also provides that property owners may receive these refunds on state taxes for the lesser of five years or the duration of the tax abatement agreement with the city or county. If the property owner or the taxing unit cancels the tax abatement agreement or the property owner relocates the business outside the reinvestment zone, the owner’s right to claim a refund ends.

For more information about this state refund program, contact Patricia Bailey at the Property Tax Division by e-mail to patricia.bailey@cpa.state.tx.us or call 1-800-252-9121, extension 3-4416. In Austin, call 512/463-4416.

Carole Keeton Rylander
Texas Comptroller of Public Accounts

To improve accuracy of property tax valuations:

Sales price disclosure

- Required in 35 states
- Can be kept confidential – for use only by appraiser or in appeals
- Texas is only state so dependent on property tax that lacks mandatory disclosure

Mandatory rendition

- Model penalty after current provisions for correction of error (Property Tax Code, sec. 25.25(d))
- If business did not render personal property, an appeal would fail if appraised value were not more than one-third greater than correct value

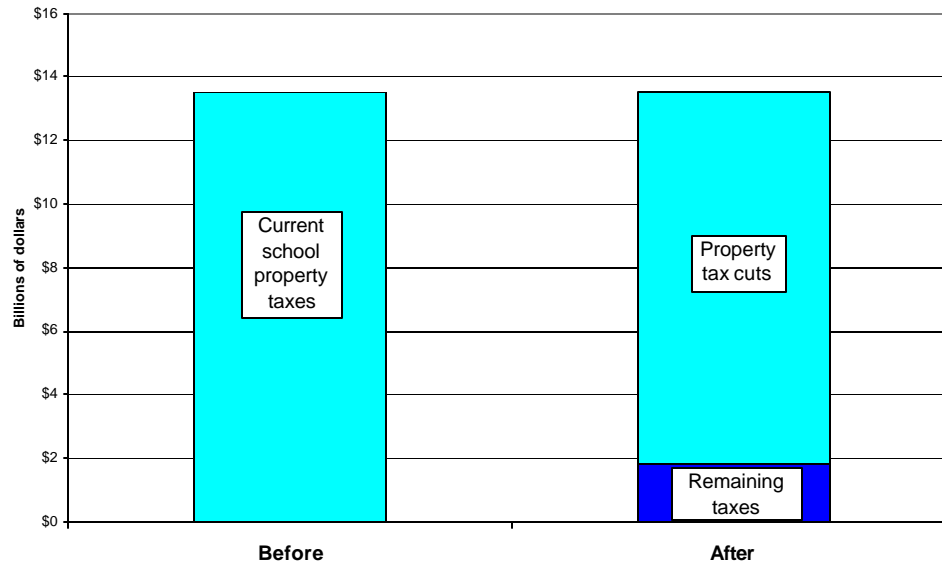
Homestead, over-65 application supplied at closing

- Access to 10% cap, exemption, tax freeze, tax deferral
- Increase public acceptance of property tax

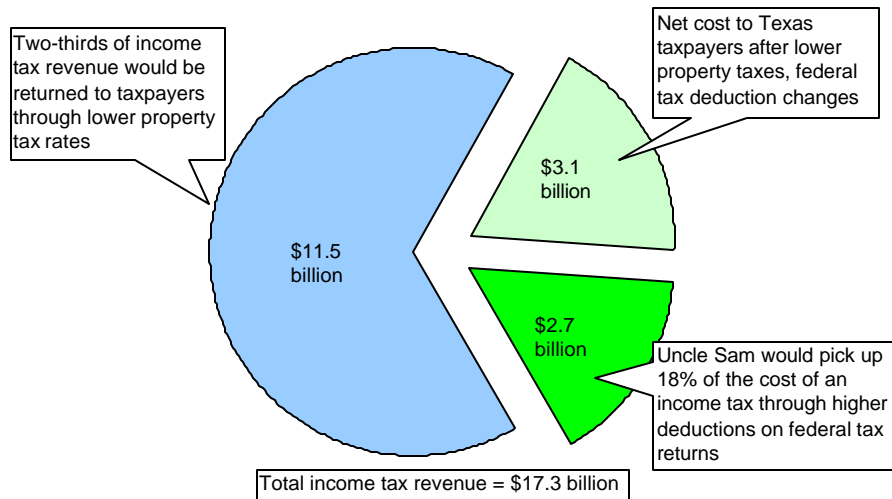
Let’s look at how an income tax could work in Texas.
Take the Kansas tax and apply it to Texas incomes.

Income tax revenue	\$17.3 billion
Property tax cuts	<u>-\$11.5 billion</u>
New state revenue	\$ 5.8 billion

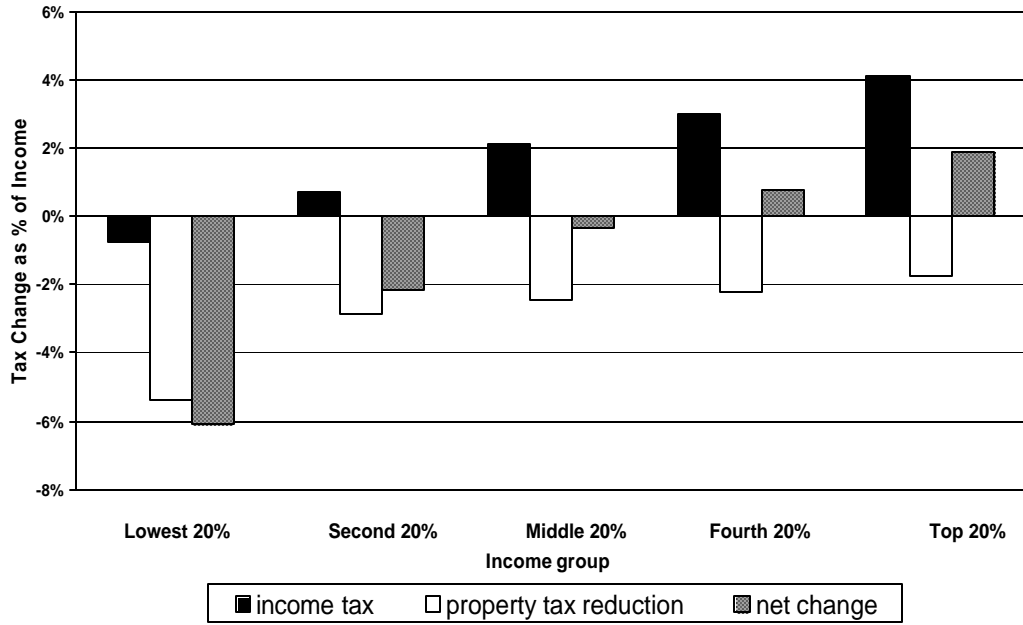
An income tax would slash school property taxes by 85%



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



A State Income Tax, With Property Tax Reductions, Would Benefit Most Texans



- B-9. *Issues of Concern to Charter Schools*
Christi Martin, Administrator, Association for Charter Educators

RESOURCE GAPS AFFECTING CHARTER SCHOOLS

Limited Access to Locally-generated Funds

- **Charter schools receive only a limited share of revenues generated through local property taxes for purposes of maintenance or debt service.** Local school districts are able to generate equalized funds above the state guarantee from their local tax base. These additional local funds are not included in the state calculation for the “local amount” that is provided to charter schools.
- **Charter schools** have no tax base of their own and thus have no mechanism to generate these additional funds available to the districts.

Inequitable Application of District-Level Adjustments

- **The average charter school receives approximately \$1600 less per student annually than a comparably-sized district would receive.** This difference results from the fact that for a charter school size-based funding adjustments are not based on the size of the charter school, but rather on the size of the district(s) from which it draws students. Most charter schools are very small, but happen to be located in large urban districts. Thus, most charter schools are effectively excluded from the Small District Adjustment. At the same time, charter schools must bear most of the same fixed, administrative costs as traditional school districts. Small charter schools, like small school districts, need help meeting these costs because they do not have the same economies of scale as larger districts.
- **If the Small District Adjustment were applied in the same way it is applied to school districts, the average charter school would receive approximately \$6,800 per student.** Currently, the average-sized charter school serves fewer than 200 students and receives approximately \$5209 per student annually. The average per pupil amount received by a traditional school district is \$6,445.
- **The statewide averaging formula described in HB 6 creates its own set of inequities.** Under the HB 6 approach, charter schools receive only a very diluted share of district-level adjustments. Essentially, the funding formula applies a homogenized version of traditional district funding that simply doesn’t fit charter schools. Rather than funding charter schools based on their actual size and location, the HB 6 formula calculates charter funding based on the average size and cost of education index applicable to the average school district. At a minimum, this formula should be revised to determine charter school funding based on average *charter school* characteristics.

No Facility Assistance from the State

- **Charter schools have access to neither the Instructional Facility Allotment (IFA), nor the Existing Debt Allotment.** As a point of reference, the IFA has leveraged over \$2 billion in state funds for school districts.

- **Charter schools do not have the benefit of the backing of the Permanent School Fund when they seek facility funding through bond financing.** Because of the Permanent School Fund guarantee, school district bonds receive the highest possible rating whereas charter school bonds are considered speculative. Consequently, charter schools either are not able to access bond financing or may only do so at much higher interest rates than those available to school districts.

B-10. Financing the Public Schools of Texas: Some issues of Growth, Equity, and Efficiency

Ray Perryman, President, Perryman Group

FINANCING THE PUBLIC SCHOOLS OF TEXAS:

SOME ISSUES OF GROWTH, EQUITY, AND EFFICIENCY

I. INTRODUCTION

There is perhaps no issue facing the Texas Legislature on an ongoing basis that is more important, more difficult, or more controversial than that of financing public education within the state. An excellent school system is essential to the long-term economic prosperity and quality of life of all Texans. Texas is adding about 70,000 net new students per year. Moreover, the percentage for which English is a second language and the proportion coming from households with limited educational backgrounds and economic disadvantages is escalating. When these demographics realities, which require additional financial resources, are combined with rapidly rising costs on many fronts, it is apparent that educational funding will be under significant and increasing pressure over time.

Texas has traditionally relied heavily on local property taxes to fund public schools. As community development patterns evolved toward affluent suburban areas in the 1970s and 1980s, extreme variations surfaced in the resources available and educational opportunities offered to students around the state. Legal challenges to the system and general concern over equity issues led to the creation of the present “Robin Hood” plan in which a portion of the revenue from “property-wealthy” districts (also known as Chapter 41 districts) is “recaptured” and distributed to “non-property-wealthy” districts (also known as Chapter 42 districts). The plan also caps local property tax rates for maintenance and operations (excluding debt service) at \$1.50 per \$100 valuation. (There are some minor exceptions to this rule, but they are not material to the overall analysis.) This transfer now amounts to over \$600 million per annum.

Current Problems

Even among those who originally crafted it to meet judicial mandates, Robin Hood was never regarded as an optimal long-term solution to school finances in Texas. Nevertheless, it may be regarded as a limited success in the sense that the state now has one of the most equitable school finance systems in the entire country. Difficulties are presently occurring on a significant scale in that many districts, including property-wealthy areas, are at or approaching the rate ceiling. Consequently, the overall level of resources to fund the system as costs increase is proving to be inadequate. Many districts with rising property values find their residents facing much higher taxes which are recaptured into the Robin Hood system, often leaving inadequate resources to fund their

own enrollment growth. Non-property-wealthy districts are also facing resource constraints and difficulties in maintaining programs, particularly in rural areas. The percentage of school revenues derived from local sources (as opposed to state revenue) has risen substantially in recent years, and litigation regarding the constitutionality of the system is again being vigorously pursued. When combined with escalating needs and fiscal requirements, the issue is again reaching crisis proportions.

These concerns have led many educators and taxpayers to demand that (1) Robin Hood recapture be reduced or eliminated; (2) overall property tax relief be granted; and (3) more aggregate funds be made available to pay for public education. Progress on any of these fronts obviously requires that alternative sources of funding be found. (Although not as widely discussed, there may also be opportunities to reduce costs or at least the rate of growth in costs through enhanced efficiencies and greater deployment of technology. It is unlikely that significant savings can be achieved in the immediate future. Thus, these approaches, while potentially a fruitful topic for long-range discussion and exploration, are not examined in the present analysis.)

Public Goods

Whenever the public sector requires additional fiscal resources for any purpose, it must remove them from circulation among business and households in the private market. Such extractions clearly reduce activity in the private sector, but are justified when the benefits to the population exceed the value of the levies. Because the gains to society of educated citizens exceed the private gains to individuals, schooling would likely be underconsumed in a market environment. Thus, education is a public good which is properly provided by government and funded through taxation. This fact has been recognized and accepted for more than two centuries.

As with any public good, the resources obtained from private sources to support education should reflect considerations of flexibility, growth potential to meet future needs, efficiency, and equity. The state and local tax system in Texas has evolved over an extended period of time and embodies many long-forgotten exigencies and compromises. While it is cumbersome in places and likely far from anything that would emerge from a laboratory experiment to design a perfect structure, the tax system has served the needs of the state through numerous changes and challenges. Given the complexity of the tax environment and the myriad interests surrounding it, a sudden and drastic overhaul seems improbable. Nevertheless, the quest for a more suitable approach to school finance also affords an opportunity to thoughtfully examine the overall framework and make a significant early step toward a more balanced fiscal system.

Purpose of the Study

The purpose of the present study is to analyze key characteristics of several potential sources of revenue for school finance. The Perryman Group (TPG) was asked to perform this investigation by a consortium of school districts and educational organizations.

These entities, which are listed in Appendix B, represent a broad cross-section of public school interests; they have not specified any constraints on this analysis or its conclusions. The results are provided to the Joint Select Committee on Public School Finance to assist in deliberations regarding educational funding. The report does not purport to offer a “magic bullet” solution or to recommend any specific funding mechanism (although the findings do point in some specific directions). It seeks merely to offer some observations and objective criteria by which alternatives may be meaningfully evaluated.

II. FRAMEWORK OF THE ANALYSIS

The current property tax system will be used as a base for comparative purposes. It is assumed that any additional revenue will be used to (1) replace or reduce Robin Hood recapture, (2) reduce property taxes, and/or (3) provide additional school funding. Thus, if the new revenue sources have superior characteristics relative to property taxes, their adoption represents an improvement in the overall system.

Issues such as *growth* and *flexibility* will be assessed using the inherent properties of the levies and growth projections in the relevant bases derived from the Texas Econometric Model.

Efficiency will be defined in terms of the total loss in economic activity from the imposition of a \$1 billion tax of each type considered. (The amount was chosen purely because it is a “round” number which facilitates index construction. The same principles apply irrespective of the amount allocated to new funding or property tax relief.) Thus, a tax is viewed as relatively more efficient than another if it claims fewer private resources from its implementation at a common revenue level.

Multiple indicators of foregone activity (expenditures, output, income, and jobs) will be calculated using the Texas Multi-Regional Impact Assessment System on a detailed industrial basis. Because the focus of economic development is typically on output (gross state product) and jobs, these two measures will be used to derive an “efficiency index” with property taxes assigned a value of 100. Because of different value-added and labor-intensity factors in various industries, some taxes may show losses in some activity measures and gains in others. (Efficiency in collections will also be noted, although it is not likely to be a highly significant issue.)

Equity in the present context refers to fairness in the allocation of tax collections across the various sectors of the economy. It will be defined as paying a share of taxes equal to the corresponding share of real gross state product in each industrial sector. An index will be created based on statistical variance from this norm, with the property tax again being set at 100.

With regard to the taxes examined, this report is restricted to major potential revenue sources. While some additional funds could be found by tweaking various minor levies, they would not be sufficient to materially impact school finance or address key issues presently surfacing. A motor fuel tax increase (which would be allocated 75% to

transportation and 25% to education) is also not examined in detail. While it would generate a notable increase in funds (probably somewhat less than \$200 million per year assuming a \$.05 per gallon increase), it is not enough to offset Robin Hood or add even 1% to overall funding. Moreover, the debate over this issue is likely to be focused more on transportation needs than education.

The analysis specifically considers the property tax (as a base), the sales tax, a business activity (value added) tax, the franchise tax, a gross receipts (or transactions) tax, and (just for grins) an income tax. If either of the new business taxes (business activity or gross receipts) were to be imposed, it is assumed that a modest dollar-level exemption would be incorporated. This approach would eliminate the vast majority of potential firms from taxes with relatively minor revenue consequences and greatly facilitate collections.

A state property tax (which has been discussed but would require a constitutional amendment) is also not considered separately. Although there could be some efficiencies gained in collections, such a tax would have virtually identical overall economic impacts (and net distributable consequences) as the current system.

It should also be noted that this analysis is conducted based on the initial incidence of the tax as opposed to the final incidence. This approach stems from three basic considerations. First, final incidence is impossible to measure with available data, as it literally changes moment-by-moment in response to supply and demand conditions in a multitude of markets. Second, public policy debates (and lobbying activity) are inevitably formed around initial incidence. Third, individual and corporate decision-making regarding locations and investments tends to be shaped by initial incidence. At a broad level, studies indicate that direct taxes on business tend to ultimately break out as (1) 65-70% being passed on to consumers in some form (predominately higher prices), (2) about 25% being passed on to workers through lower wages and benefits or reduced hiring, and (3) 5-10% being absorbed as lower profits or returns on investments. Since workers in Texas are also normally consumers in Texas, the practical effect is that 90-95% of business taxes are passed through in some form.

As a final observation before analyzing specific revenue options, the analysis will focus on the costs to the private sector of withdrawing \$1 billion by various mechanisms. In reality, the losses would be offset to a considerable degree by the spending on education by the public sector. (In fact, if the spillover benefits of education to society are included, the benefits likely exceed the costs.) Nonetheless, these gains will be identical irrespective of the source of the funds and, thus, do not affect the relative efficiency or equity of various revenue options and are not a part of the current analysis. Each of the relevant taxes is presently examined.

III. THE PROPERTY TAX

Property taxes have been the mainstay for school finance for several decades, but it appears unlikely that they can continue to play this role effectively. The base of this levy,

the assessed value of taxable property, is an unstable source of growth for revenues. While long-term increases have occurred and are anticipated for the future, the pace lags well behind that of other potential funding mechanisms. Over the past 20 years, the base has risen by 72% as compared with gains of over 250% in other fiscal sources. In fact, during an extended period from 1985-1995, the property tax base actually fell, while other measures rose by more than 60%. Over this same period, average property tax rates more than doubled. Although values have recovered in recent years, the rate of increase remains only about 60% as high as alternative bases. The tax also suffers from the fact that increased property values typically bear little relation to financial liquidity and, thus, ability to pay.

The Perryman Group is presently projecting that property values will continue to expand in the future, but at a pace well below that of overall business activity. Moreover, while it is unlikely that another 10-year stagnation will occur, property values are subject to less predictability and more prolonged cycles than the economy as a whole. Similarly, the rate of appreciation varies markedly across areas, thus adding uncertainty and complexity to the funding process.

With regard to efficiency, the estimated impacts of a hypothetical increase of \$1 billion per year in property taxes on the private economy in Texas is

- ✓ \$2.787 billion in annual Total Expenditures;
- ✓ \$1.289 billion in annual Gross State Product;
- ✓ \$0.747 billion in annual Personal Income;
- ✓ \$0.326 billion in annual Retail Sales; and
- ✓ 21,839 Permanent Jobs

In terms of its claims on private resources, the property tax is relatively efficient in comparison to other levies. Because of the complexity of the appraisal process, particularly for business property, it is approximately twice as expensive to administer per dollar of collections as other revenue sources. Detailed results by industry are presented in Table A.1 of Appendix A.

The property tax ranks last among the various alternatives in equity. Agriculture pays about 5.2 times as much in relative terms as its contribution to gross product, and Transportation, Communications and Utilities (TCU) pays about 2.0 times its output share. Manufacturing and Mining also pay significantly disproportionate shares.

Because the property tax ranks last in growth potential and equity among major potential levies, it would seem appropriate to diminish its relative importance in the school finance structure over time. The fact that many districts are now at or near the cap in their rates only magnifies this problem and further limits flexibility.

IV. THE SALES TAX

The state sales tax in Texas is currently at 6.25%, with local governments raising the levy to 8.25% in most major markets. This rate is among the highest in the US, although the base has many exemptions. If all such exemptions were eliminated, it would generate sufficient revenue to replace the property tax entirely. There are many elements of sales, however, which will likely remain not subject to taxations for reasons of regressivity (such as food-at-home and medicine) or practicality (such as advertising). The sales tax base is projected to grow well in excess of the property values and generally in line with (slightly below) other overall economic aggregates.

Because of potential variation in the rate and the base, there are myriad possible combinations of increases. For purposes of the present analysis a hypothetical \$1 billion increase is simulated which consists of approximately \$500 million in rates and \$500 million from a generic expansion of the base in the service sector. The overall losses to the private sector from this withdrawal would be

- ✓ \$2.888 billion in annual Total Expenditures;
- ✓ \$1.400 billion in annual Gross State Product;
- ✓ \$0.849 billion in annual Personal Income;
- ✓ \$0.405 billion in annual Retail Sales; and
- ✓ 25,735 Permanent Jobs

The detailed results by sector are found in Table A.2.

With regard to efficiency, the sales tax claims more resources than the property tax, particularly with regard to jobs. The sales tax exhibits considerably greater equity, with the most significant penalties being in Construction (with tax collections at 2.2 times the relative level of real gross product), Manufacturing (1.4 times), and Mining (1.3 times).

V. THE BUSINESS ACTIVITY (VALUE-ADDED) TAX

One potential alternative tax not presently levied in Texas is the business activity or value-added tax. This levy has been discussed in prior legislative sessions, and is similar in principle to the current business tax in Michigan (which is highly regarded for its fairness). It essentially taxes the difference between revenue and the cost of purchased items and is conceptually quite similar to a tax on nominal gross product. The current gas utility tax in Texas is collected in essentially this manner. Assuming an exemption for small business is included, it is very straightforward to administer compared to the franchise tax. Moreover, the base is expected to grow in line with the general economy and slightly faster than many other non-property tax sources. One desirable characteristic of the tax is that it does not substantially alter economic decision-making; companies will generally try to maximize value-added irrespective of an “after-the-fact” tax.

The impact on the private sector of a hypothetical \$1 billion business activity tax levy would be activity reductions of

- ✓ \$2.893 billion in annual Total Expenditures;
- ✓ \$1.422 billion in annual Gross State Product;
- ✓ \$0.838 billion in annual Personal Income;
- ✓ \$0.291 billion in annual Retail Sales; and
- ✓ 23,406 Permanent Jobs

The losses by major industrial category are given in Table A.3.

In terms of efficiency in the diversion of private activity, the business activity tax is more efficient than the sales tax but less than the property tax. Its efficiency projections are far superior to any other levy examined in this report, with the ratios of relative taxes to relative output being less than 1.2 for all sectors.

VI. THE FRANCHISE TAX

The principle method by which Texas currently taxes business at the state level is the corporate franchise tax. It is based on either the capital stock or net income of the company. One proposal that has been widely discussed is to modify the structure to include unincorporated enterprises. As presently implemented, the tax can be avoided by changing organizational form and many firms successfully reduce or eliminate their liability (to the point that many tax professionals refer to the franchise tax as “voluntary”). The base of the tax is projected to slightly exceed overall economic growth and to expand in line with future revenue needs. Because changing the base would potentially involve taxing individuals on a portion of their income, this approach could potentially raise constitutional issues.

Assuming a \$1 billion hypothetical franchise tax increase is achieved through a mixture of modifying the base and increasing the rate, the aggregate effect in private sector is estimated at

- ✓ \$2.846 billion in annual Total Expenditures;
- ✓ \$1.341 billion in annual Gross State Product;
- ✓ \$0.777 billion in annual Personal Income;
- ✓ \$0.273 billion in annual Retail Sales; and
- ✓ 21,483 Permanent Jobs

Disaggregated sectoral results are given in Table A.4.

The franchise tax only slightly less efficient than the property tax and superior to several other revenue alternatives according to this criteria. Its provisions related to capital cause it to be moderately less equitable than some of the other sources, although it is much more balanced than the property tax. The most disadvantaged sectors are Manufacturing (with a 1.7 ratio of relative taxes to relative real gross product) and TCU (with a 1.3 ratio). The levy on capital is also not specifically related to ability to pay in a given period.

VII. THE GROSS RECEIPTS TAX

The gross receipts tax is levied on the total revenues of a firm. It is conceptually equivalent to a transactions tax (a tax each time money changes hands), differing essentially only in the point of collection. If small business exclusions are implemented, the tax is relatively easy to administer. If this type of funding were implemented, there would likely be intense political pressure to exempt certain categories of goods and services. The gross receipt tax has previously been examined in Texas (the Telecommunications Infrastructure Fund is essentially such a tax on a single industry), and Washington uses it (with varying rates for industrial sectors) as its principle form of business tax. The growth in the base generally tracks overall economy activity. One drawback of the tax is the tendency toward “pyramiding” in that the tax is collected at each stage of the productions process. It also is subject to problems associated with discounting, as lower prices may drive higher gross receipts yet lower per unit profits. Both of these drawbacks are relative minor.

A hypothetical \$1 billion gross receipts tax would reduce aggregate private sector activity as follows:

- ✓ \$2.756 billion in annual Total Expenditures;
- ✓ \$1.280 billion in annual Gross State Product;
- ✓ \$0.740 billion in annual Personal Income;
- ✓ \$0.236 billion in annual Retail Sales; and
- ✓ 20,045 Permanent Jobs

See Table A.5 for sectoral findings.

This levy exhibits the most efficient use of revenues of all revenue sources considered. Its equity properties are also reasonably good, although well below those of the business activity tax. In particular, Mining (with a tax percentage almost 2 times its output percentage) and Retail Trade (with a corresponding rate of 1.6) are disadvantaged by this approach.

VIII. THE INCOME TAX (JUST FOR GRINS)

The absence of a state personal income tax is considered to be virtually a right of citizenship in Texas. It has little political support and requires a constitutional amendment for implementation. Nonetheless, it is appropriate to include it in the present analysis for comparative purpose and, as it turns out, to provide still another rationale to avoid it.

The base of the tax grows generally in line with (slightly below) overall business expansion, and administration is relative simple (particularly if it is tied to the federal levy). The vast majority of states collect this tax, and the lack of a personal income tax in Texas is often cited as an advantage in economic development.

A hypothetical (purely hypothetical) income tax of \$1 billion leads to an overall decrease in private business performance of

- ✓ \$2.805 billion in annual Total Expenditures;
- ✓ \$1.374 billion in annual Gross State Product;
- ✓ \$0.832 billion in annual Personal Income;
- ✓ \$0.527 billion in annual Retail Sales; and
- ✓ 27,565 Permanent Jobs

Detailed results for industrial sectors are exhibited in Table A.6

The income tax is the least efficient of all the funding sources considered. In other words, levying an income tax removes more private resources from productive use than any other major potential revenue source. Given that the tax is paid entirely by individuals, it is impossible to provide an equity measure that is strictly comparable to those computed for the alternatives previously examined. In order to make a reasonably similar construct, it is assumed that the revenues derived from income earned in each sector impacts the corresponding cost structure of relevant firms. Because income taxes directly affect “take home pay,” it is reasonable to assume that workers will seek to negotiate additional compensation from their employers to offset the tax. This pattern is observed in other states. The results of this analysis reveals that the personal income tax has equity properties which are in line with several of the alternative sources. In any case, the overall characteristics of the income tax are less attractive than those of several other potential funding mechanisms.

IX. SYNOPSIS

This report has offered a comprehensive assessment of potential revenue sources to reform and expand the funding of public education. The chart below summarizes key findings.

Table 1 Synopsis of Indicators of Relative Performance of Alternative Revenue Sources (Property Tax=100 in all cases)			
Revenue Source	Growth Index (Higher Values Reflect Greater Growth Potential)	Efficiency Index (Lower Values Indicate Greater Efficiency)	Equity Index (Lower Values Indicate Greater Equity)
Property Tax	100.0	100.0	100.0
Sales Tax	123.9	113.2	61.0
Business Activity Tax	125.9	108.7	17.4
Franchise Tax	126.8	101.2	66.2
Gross Receipts Tax	124.4	95.5	57.8
Personal Income Tax	125.7	116.4	61.6

This analysis is designed to provide objective information to assist in the evaluation of this critical issue for the future of Texas. Not surprisingly, no single measure emerged as optimal across all criteria. Moreover, the relative weights to be given to growth, efficiency, and equity are largely a matter of individual preference. Overall, it appears that the business activity tax provided the best combination of attributes, while franchise tax expansion and gross receipts levies also merit further consideration. Some type of hybrid approach containing elements of various measures is also possible, although it could add to administrative complexity.

It should also be noted that any effort to fundamentally change the school finance structure, even incrementally, will be the subject of intense debate and controversy. There are winners and losers in every potential modification. The issue will also inevitably have to be balanced with other fiscal priorities and overall patterns in tax policy. Nonetheless, this study clearly points to numerous options which could enhance the overall equity, efficiency, and ability to respond to increasing needs beyond the current public education funding mechanism. These options are clearly worthy of further discussion and consideration as the process of reforming and expanding school finance unfolds.

Respectfully submitted,



The Perryman Group

M. Ray Perryman, President

APPENDIX A

Detailed Sectoral Results

TABLE A.1
THE IMPACT OF A HYPOTHETICAL \$1 BILLION REVENUE INCREASE FROM A
PROPERTY TAX ON BUSINESS ACTIVITY IN TEXAS
DETAILED SECTORAL RESULTS

Sector	Total Expenditures	Gross Product	Personal Income	Employment (Permanent Jobs)
Agricultural Products & Services	-\$128,186,891	-\$38,018,296	-\$23,352,795	-658
Forestry & Fishery Products	-\$9,026,799	-\$4,011,402	-\$1,426,211	-35
Coal Mining	-\$7,927,708	-\$2,458,701	-\$2,403,841	-30
Crude Petroleum & Natural Gas	-\$114,537,467	-\$23,150,311	-\$11,574,497	-97
Miscellaneous Mining	-\$2,409,325	-\$785,699	-\$586,484	-10
New Construction	-\$9,235,467	-\$4,107,743	-\$3,288,211	-70
Maintenance & Repair Construction	-\$68,775,433	-\$37,511,604	-\$30,027,711	-637
Food Products & Tobacco	-\$110,500,271	-\$29,902,740	-\$13,701,876	-383
Textile Mill Products	-\$1,595,131	-\$426,972	-\$324,336	-9
Apparel	-\$18,999,256	-\$8,315,095	-\$5,331,861	-218
Paper & Allied Products	-\$19,322,429	-\$6,793,117	-\$3,940,795	-87
Printing & Publishing	-\$25,783,721	-\$11,731,290	-\$8,502,644	-215
Chemicals & Petroleum Refining	-\$172,153,272	-\$24,024,708	-\$14,190,832	-171
Rubber & Leather Products	-\$17,487,306	-\$7,613,964	-\$4,341,186	-124
Lumber Products & Furniture	-\$11,094,614	-\$4,273,922	-\$2,743,350	-79
Stone, Clay, & Glass Products	-\$11,913,055	-\$6,674,581	-\$3,267,974	-81
Primary Metal	-\$13,148,516	-\$3,895,854	-\$2,674,223	-54
Fabricated Metal Products	-\$24,645,839	-\$9,210,295	-\$6,010,131	-143
Machinery, Except Electrical	-\$24,069,928	-\$12,779,523	-\$7,009,770	-111
Electric & Electronic Equipment	-\$23,156,250	-\$16,357,600	-\$7,853,283	-121
Motor Vehicles & Equipment	-\$8,496,966	-\$1,693,224	-\$1,264,678	-26
Transp. Equip., Exc. Motor Vehicles	-\$9,624,651	-\$3,295,286	-\$3,104,129	-54
Instruments & Related Products	-\$5,497,378	-\$1,962,204	-\$1,818,451	-34
Miscellaneous Manufacturing	-\$6,865,442	-\$2,807,222	-\$1,856,133	-44
Transportation	-\$119,830,235	-\$77,688,582	-\$49,793,008	-1,020
Communication	-\$87,966,180	-\$62,513,119	-\$23,169,930	-317
Electric, Gas, Water, Sanitary Services	-\$253,239,672	-\$65,548,175	-\$24,648,410	-210
Wholesale Trade	-\$104,337,765	-\$78,152,319	-\$40,705,872	-792
Retail Trade	-\$326,554,162	-\$268,801,319	-\$161,798,082	-6,443
Finance	-\$49,833,377	-\$31,803,123	-\$15,687,603	-262
Insurance	-\$51,574,565	-\$30,252,703	-\$19,496,925	-372
Real Estate	-\$400,713,952	-\$89,787,865	-\$12,149,829	-199
Hotels, Lodging Places, Amusements	-\$31,707,496	-\$16,482,016	-\$10,743,948	-422
Personal Services	-\$66,969,952	-\$41,682,302	-\$32,235,400	-901
Business Services	-\$116,209,020	-\$73,179,373	-\$58,242,348	-1,148
Eating & Drinking Places	-\$148,473,733	-\$85,966,670	-\$46,260,578	-3,340
Health Services	-\$103,036,419	-\$70,271,222	-\$60,937,855	-1,528
Miscellaneous Services	-\$79,987,169	-\$32,116,989	-\$28,571,865	-1,085
Households	-\$2,984,776	-\$2,984,776	-\$2,919,805	-309
Total	-\$2,787,871,588	-\$1,289,031,905	-\$747,956,859	-21,839

All monetary values are given in constant (2001) dollars.

SOURCE: Texas Multi-Regional Impact Assessment System, The Perryman Group

TABLE A.2
THE IMPACT OF A HYPOTHETICAL \$1 BILLION REVENUE INCREASE FROM A
SALES TAX ON BUSINESS ACTIVITY IN TEXAS
DETAILED SECTORAL RESULTS

Sector	Total Expenditures	Gross Product	Personal Income	Employment (Permanent Jobs)
Agricultural Products & Services	-\$59,860,109	-\$18,119,336	-\$11,129,835	-312
Forestry & Fishery Products	-\$1,869,514	-\$1,478,959	-\$525,818	-12
Coal Mining	-\$6,616,811	-\$2,054,190	-\$2,008,353	-24
Crude Petroleum & Natural Gas	-\$96,340,555	-\$19,462,317	-\$9,730,625	-81
Miscellaneous Mining	-\$2,284,941	-\$777,928	-\$580,672	-9
New Construction	-\$32,007,865	-\$14,236,427	-\$11,396,133	-243
Maintenance & Repair Construction	-\$80,022,584	-\$43,364,319	-\$34,712,752	-735
Food Products & Tobacco	-\$111,431,397	-\$31,510,955	-\$14,438,783	-403
Textile Mill Products	-\$1,647,516	-\$431,241	-\$327,574	-9
Apparel	-\$20,816,519	-\$9,099,742	-\$5,835,009	-241
Paper & Allied Products	-\$19,968,459	-\$6,985,225	-\$4,052,222	-90
Printing & Publishing	-\$27,231,671	-\$12,365,564	-\$8,962,357	-228
Chemicals & Petroleum Refining	-\$148,375,644	-\$20,459,835	-\$12,085,150	-147
Rubber & Leather Products	-\$17,432,680	-\$7,611,134	-\$4,339,568	-126
Lumber Products & Furniture	-\$10,851,491	-\$4,167,127	-\$2,674,797	-77
Stone, Clay, & Glass Products	-\$13,256,696	-\$7,371,252	-\$3,609,071	-90
Primary Metal	-\$12,496,388	-\$3,738,126	-\$2,565,954	-53
Fabricated Metal Products	-\$25,324,060	-\$9,367,299	-\$6,112,596	-145
Machinery, Except Electrical	-\$20,900,097	-\$11,040,424	-\$6,055,836	-97
Electric & Electronic Equipment	-\$19,697,284	-\$13,796,327	-\$6,623,618	-102
Motor Vehicles & Equipment	-\$8,618,689	-\$1,708,076	-\$1,275,770	-26
Transp. Equip., Exc. Motor Vehicles	-\$7,834,120	-\$2,627,684	-\$2,475,281	-42
Instruments & Related Products	-\$4,954,363	-\$1,743,004	-\$1,615,314	-30
Miscellaneous Manufacturing	-\$7,015,887	-\$2,874,448	-\$1,900,590	-45
Transportation	-\$92,768,404	-\$63,363,472	-\$40,611,605	-831
Communication	-\$77,311,443	-\$54,979,009	-\$20,377,485	-279
Electric, Gas, Water, Sanitary Services	-\$190,508,465	-\$49,580,224	-\$18,643,898	-157
Wholesale Trade	-\$127,564,016	-\$95,553,983	-\$49,769,595	-968
Retail Trade	-\$405,472,770	-\$333,780,054	-\$200,910,382	-7,999
Finance	-\$41,689,996	-\$26,347,218	-\$12,996,349	-217
Insurance	-\$50,395,985	-\$28,543,157	-\$18,395,187	-350
Real Estate	-\$415,341,572	-\$69,902,624	-\$9,459,020	-156
Hotels, Lodging Places, Amusements	-\$44,207,719	-\$22,808,012	-\$14,867,623	-586
Personal Services	-\$87,296,848	-\$54,375,567	-\$42,051,845	-1,176
Business Services	-\$167,936,184	-\$107,272,127	-\$85,376,229	-1,682
Eating & Drinking Places	-\$182,054,771	-\$105,415,980	-\$56,726,691	-4,095
Health Services	-\$140,561,976	-\$95,397,626	-\$82,727,011	-2,073
Miscellaneous Services	-\$105,049,679	-\$42,748,886	-\$38,030,209	-1,444
Households	-\$3,392,876	-\$3,392,876	-\$3,319,027	-350
Total	-\$2,888,408,046	-\$1,399,851,755	-\$849,295,836	-25,735

All monetary values are given in constant (2001) dollars.

SOURCE: Texas Multi-Regional Impact Assessment System, The Perryman Group

TABLE A.3
THE IMPACT OF A HYPOTHETICAL \$1 BILLION REVENUE INCREASE FROM A
BUSINESS ACTIVITY (VALUE-ADDED) TAX ON BUSINESS ACTIVITY IN TEXAS
DETAILED SECTORAL RESULTS

Sector	Total Expenditures	Gross Product	Personal Income	Employment (Permanent Jobs)
Agricultural Products & Services	-\$69,348,281	-\$21,095,995	-\$12,958,243	-364
Forestry & Fishery Products	-\$2,971,376	-\$1,746,889	-\$621,082	-14
Coal Mining	-\$6,414,769	-\$1,983,145	-\$1,938,904	-24
Crude Petroleum & Natural Gas	-\$133,672,889	-\$27,022,600	-\$13,510,542	-113
Miscellaneous Mining	-\$2,741,926	-\$920,933	-\$687,426	-11
New Construction	-\$36,030,470	-\$16,025,604	-\$12,828,349	-273
Maintenance & Repair Construction	-\$79,382,216	-\$43,613,289	-\$34,912,040	-740
Food Products & Tobacco	-\$106,759,496	-\$29,882,851	-\$13,692,766	-382
Textile Mill Products	-\$1,612,746	-\$436,179	-\$331,318	-9
Apparel	-\$20,272,144	-\$8,874,415	-\$5,690,520	-234
Paper & Allied Products	-\$19,943,212	-\$7,010,209	-\$4,066,710	-92
Printing & Publishing	-\$28,513,569	-\$12,891,727	-\$9,343,712	-238
Chemicals & Petroleum Refining	-\$165,134,441	-\$23,160,089	-\$13,680,118	-167
Rubber & Leather Products	-\$18,280,218	-\$7,968,910	-\$4,543,568	-131
Lumber Products & Furniture	-\$12,167,188	-\$4,664,318	-\$2,993,953	-86
Stone, Clay, & Glass Products	-\$14,278,548	-\$7,884,332	-\$3,860,273	-96
Primary Metal	-\$14,106,277	-\$4,226,124	-\$2,900,924	-61
Fabricated Metal Products	-\$27,419,164	-\$10,213,858	-\$6,665,013	-160
Machinery, Except Electrical	-\$24,053,938	-\$12,756,984	-\$6,997,403	-112
Electric & Electronic Equipment	-\$22,918,298	-\$16,160,003	-\$7,758,409	-121
Motor Vehicles & Equipment	-\$8,797,923	-\$1,724,565	-\$1,288,074	-26
Transp. Equip., Exc. Motor Vehicles	-\$9,300,072	-\$3,157,259	-\$2,974,115	-51
Instruments & Related Products	-\$5,624,663	-\$1,984,358	-\$1,838,998	-34
Miscellaneous Manufacturing	-\$7,372,696	-\$3,018,671	-\$1,995,941	-48
Transportation	-\$111,326,997	-\$73,319,431	-\$46,992,679	-963
Communication	-\$76,979,061	-\$54,672,386	-\$20,263,834	-278
Electric, Gas, Water, Sanitary Services	-\$198,123,795	-\$51,502,024	-\$19,366,548	-164
Wholesale Trade	-\$180,543,690	-\$135,231,130	-\$70,435,557	-1,371
Retail Trade	-\$290,608,352	-\$239,213,208	-\$143,988,269	-5,734
Finance	-\$62,330,710	-\$39,857,742	-\$19,660,720	-332
Insurance	-\$59,745,396	-\$35,793,172	-\$23,067,575	-440
Real Estate	-\$394,862,571	-\$116,056,146	-\$15,704,370	-261
Hotels, Lodging Places, Amusements	-\$43,836,871	-\$22,039,350	-\$14,366,560	-567
Personal Services	-\$53,005,629	-\$32,674,690	-\$25,269,267	-705
Business Services	-\$214,449,650	-\$140,999,925	-\$112,219,677	-2,211
Eating & Drinking Places	-\$140,687,836	-\$81,458,759	-\$43,834,765	-3,165
Health Services	-\$126,339,130	-\$83,996,401	-\$72,840,084	-1,826
Miscellaneous Services	-\$99,846,728	-\$43,228,900	-\$38,457,221	-1,460
Households	-\$3,338,500	-\$3,338,500	-\$3,265,841	-344
Total	-\$2,893,141,436	-\$1,421,805,071	-\$837,811,368	-23,406

All monetary values are given in constant (2001) dollars.

SOURCE: Texas Multi-Regional Impact Assessment System, The Perryman Group

TABLE A.4
THE IMPACT OF A HYPOTHETICAL \$1 BILLION REVENUE INCREASE FROM A
FRANCHISE TAX ON BUSINESS ACTIVITY IN TEXAS
DETAILED SECTORAL RESULTS

Sector	Total Expenditures	Gross Product	Personal Income	Employment (Permanent Jobs)
Agricultural Products & Services	-\$66,578,549	-\$19,731,769	-\$12,120,274	-342
Forestry & Fishery Products	-\$2,356,937	-\$1,501,223	-\$533,754	-12
Coal Mining	-\$7,109,947	-\$2,197,680	-\$2,148,654	-26
Crude Petroleum & Natural Gas	-\$144,950,183	-\$29,305,096	-\$14,651,727	-123
Miscellaneous Mining	-\$3,151,335	-\$1,028,153	-\$767,470	-13
New Construction	-\$20,662,965	-\$9,190,456	-\$7,356,881	-157
Maintenance & Repair Construction	-\$69,818,119	-\$38,664,329	-\$30,950,455	-657
Food Products & Tobacco	-\$118,199,906	-\$32,801,385	-\$15,030,079	-422
Textile Mill Products	-\$1,936,874	-\$522,671	-\$397,041	-11
Apparel	-\$21,252,073	-\$9,306,548	-\$5,967,610	-246
Paper & Allied Products	-\$24,372,379	-\$8,647,967	-\$5,016,808	-111
Printing & Publishing	-\$31,482,964	-\$14,327,431	-\$10,384,293	-264
Chemicals & Petroleum Refining	-\$235,387,292	-\$34,404,899	-\$20,322,182	-246
Rubber & Leather Products	-\$22,936,552	-\$9,937,051	-\$5,665,705	-164
Lumber Products & Furniture	-\$16,774,775	-\$6,465,546	-\$4,150,104	-120
Stone, Clay, & Glass Products	-\$17,091,192	-\$9,451,811	-\$4,627,738	-116
Primary Metal	-\$19,844,895	-\$5,843,465	-\$4,011,122	-85
Fabricated Metal Products	-\$34,861,535	-\$13,179,318	-\$8,600,109	-206
Machinery, Except Electrical	-\$37,879,093	-\$20,137,295	-\$11,045,619	-178
Electric & Electronic Equipment	-\$35,964,268	-\$25,797,926	-\$12,385,585	-193
Motor Vehicles & Equipment	-\$10,924,083	-\$2,196,874	-\$1,640,858	-34
Transp. Equip., Exc. Motor Vehicles	-\$15,364,170	-\$5,352,519	-\$5,042,029	-89
Instruments & Related Products	-\$8,539,150	-\$3,074,016	-\$2,848,818	-54
Miscellaneous Manufacturing	-\$8,911,877	-\$3,644,046	-\$2,409,441	-58
Transportation	-\$121,752,014	-\$78,464,133	-\$50,290,070	-1,031
Communication	-\$79,883,309	-\$56,723,986	-\$21,024,237	-289
Electric, Gas, Water, Sanitary Services	-\$223,866,095	-\$57,949,198	-\$21,790,909	-184
Wholesale Trade	-\$172,323,449	-\$129,075,588	-\$67,229,420	-1,309
Retail Trade	-\$272,783,336	-\$224,538,984	-\$135,155,502	-5,382
Finance	-\$54,264,950	-\$34,767,154	-\$17,149,668	-290
Insurance	-\$52,882,159	-\$31,384,663	-\$20,226,449	-386
Real Estate	-\$346,499,427	-\$98,135,044	-\$13,279,348	-217
Hotels, Lodging Places, Amusements	-\$32,728,412	-\$16,625,685	-\$10,837,598	-427
Personal Services	-\$45,978,435	-\$28,372,489	-\$21,942,138	-613
Business Services	-\$153,721,818	-\$99,855,764	-\$79,473,667	-1,566
Eating & Drinking Places	-\$132,727,243	-\$76,850,738	-\$41,355,069	-2,986
Health Services	-\$96,947,360	-\$64,958,493	-\$56,330,763	-1,412
Miscellaneous Services	-\$79,877,943	-\$33,833,143	-\$30,098,572	-1,143
Households	-\$3,097,246	-\$3,097,246	-\$3,029,847	-321
Total	-\$2,845,684,309	-\$1,341,341,782	-\$777,287,613	-21,483

All monetary values are given in constant (2001) dollars.

SOURCE: Texas Multi-Regional Impact Assessment System, The Perryman Group

TABLE A.5
THE IMPACT OF A HYPOTHETICAL \$1 BILLION REVENUE INCREASE FROM A
GROSS RECEIPTS TAX ON BUSINESS ACTIVITY IN TEXAS
DETAILED SECTORAL RESULTS

Sector	Total Expenditures	Gross Product	Personal Income	Employment (Permanent Jobs)
Agricultural Products & Services	-\$79,835,196	-\$24,994,246	-\$15,352,748	-431
Forestry & Fishery Products	-\$4,069,380	-\$2,059,570	-\$732,259	-17
Coal Mining	-\$6,729,673	-\$2,082,034	-\$2,035,582	-25
Crude Petroleum & Natural Gas	-\$223,069,978	-\$45,099,965	-\$22,548,696	-191
Miscellaneous Mining	-\$3,563,907	-\$1,209,220	-\$902,638	-16
New Construction	-\$37,672,398	-\$16,755,895	-\$13,412,945	-285
Maintenance & Repair Construction	-\$81,390,621	-\$44,841,694	-\$35,895,373	-761
Food Products & Tobacco	-\$102,404,348	-\$28,253,750	-\$12,946,296	-362
Textile Mill Products	-\$1,630,238	-\$446,732	-\$339,340	-9
Apparel	-\$19,040,880	-\$8,334,762	-\$5,344,470	-221
Paper & Allied Products	-\$20,002,777	-\$7,076,605	-\$4,105,236	-92
Printing & Publishing	-\$27,064,122	-\$12,274,926	-\$8,896,674	-225
Chemicals & Petroleum Refining	-\$188,032,240	-\$27,104,552	-\$16,010,009	-195
Rubber & Leather Products	-\$19,039,971	-\$8,264,261	-\$4,711,955	-136
Lumber Products & Furniture	-\$13,825,836	-\$5,289,088	-\$3,394,970	-98
Stone, Clay, & Glass Products	-\$15,839,144	-\$8,657,691	-\$4,238,934	-105
Primary Metal	-\$16,839,046	-\$5,032,251	-\$3,454,280	-72
Fabricated Metal Products	-\$31,053,448	-\$11,672,728	-\$7,616,996	-183
Machinery, Except Electrical	-\$29,759,534	-\$15,819,827	-\$8,677,420	-140
Electric & Electronic Equipment	-\$27,484,118	-\$19,579,169	-\$9,399,974	-147
Motor Vehicles & Equipment	-\$9,051,801	-\$1,807,549	-\$1,350,052	-27
Transp. Equip., Exc. Motor Vehicles	-\$11,393,586	-\$3,930,341	-\$3,702,338	-65
Instruments & Related Products	-\$6,532,838	-\$2,335,863	-\$2,164,746	-40
Miscellaneous Manufacturing	-\$7,452,162	-\$3,039,780	-\$2,009,896	-48
Transportation	-\$108,879,348	-\$70,682,639	-\$45,302,671	-928
Communication	-\$72,207,498	-\$51,285,606	-\$19,008,554	-260
Electric, Gas, Water, Sanitary Services	-\$198,777,024	-\$51,503,311	-\$19,367,026	-163
Wholesale Trade	-\$136,919,205	-\$102,549,129	-\$53,413,032	-1,040
Retail Trade	-\$236,457,891	-\$194,640,588	-\$117,158,914	-4,665
Finance	-\$59,185,980	-\$37,958,153	-\$18,723,703	-316
Insurance	-\$55,083,917	-\$33,218,651	-\$21,408,380	-408
Real Estate	-\$372,478,528	-\$113,886,623	-\$15,410,814	-254
Hotels, Lodging Places, Amusements	-\$33,353,340	-\$16,890,686	-\$11,010,338	-434
Personal Services	-\$44,616,777	-\$27,527,679	-\$21,288,778	-595
Business Services	-\$160,707,584	-\$104,691,201	-\$83,322,110	-1,642
Eating & Drinking Places	-\$114,201,572	-\$66,122,748	-\$35,582,105	-2,568
Health Services	-\$98,321,914	-\$65,699,234	-\$56,973,118	-1,428
Miscellaneous Services	-\$79,574,885	-\$33,975,451	-\$30,225,185	-1,148
Households	-\$2,947,269	-\$2,947,269	-\$2,883,136	-305
Total	-\$2,756,489,974	-\$1,279,541,467	-\$740,321,691	-20,045

All monetary values are given in constant (2001) dollars.

SOURCE: Texas Multi-Regional Impact Assessment System, The Perryman Group

TABLE A.6
THE IMPACT OF A HYPOTHETICAL \$1 BILLION REVENUE INCREASE FROM AN
INCOME TAX ON BUSINESS ACTIVITY IN TEXAS
DETAILED SECTORAL RESULTS

Sector	Total Expenditures	Gross Product	Personal Income	Employment (Permanent Jobs)
Agricultural Products & Services	-\$51,856,557	-\$15,632,866	-\$9,602,511	-272
Forestry & Fishery Products	-\$1,309,558	-\$1,432,600	-\$509,349	-13
Coal Mining	-\$7,007,974	-\$2,181,657	-\$2,132,981	-28
Crude Petroleum & Natural Gas	-\$37,518,336	-\$7,560,082	-\$3,779,829	-33
Miscellaneous Mining	-\$902,624	-\$305,503	-\$228,045	-4
New Construction	\$0	\$0	\$0	0
Maintenance & Repair Construction	-\$67,802,021	-\$35,768,970	-\$28,632,739	-610
Food Products & Tobacco	-\$106,033,174	-\$30,406,384	-\$13,932,653	-392
Textile Mill Products	-\$1,394,222	-\$354,135	-\$269,012	-9
Apparel	-\$19,329,283	-\$8,445,910	-\$5,415,749	-225
Paper & Allied Products	-\$16,722,459	-\$5,767,111	-\$3,345,585	-77
Printing & Publishing	-\$23,537,892	-\$10,733,547	-\$7,779,508	-200
Chemicals & Petroleum Refining	-\$87,957,458	-\$10,588,185	-\$6,254,196	-77
Rubber & Leather Products	-\$12,776,035	-\$5,633,081	-\$3,211,761	-95
Lumber Products & Furniture	-\$5,280,560	-\$2,057,210	-\$1,320,483	-40
Stone, Clay, & Glass Products	-\$6,859,130	-\$4,060,822	-\$1,988,233	-51
Primary Metal	-\$5,523,625	-\$1,657,126	-\$1,137,499	-25
Fabricated Metal Products	-\$13,972,252	-\$4,963,747	-\$3,239,072	-78
Machinery, Except Electrical	-\$8,635,705	-\$4,508,538	-\$2,473,001	-41
Electric & Electronic Equipment	-\$8,372,155	-\$5,489,482	-\$2,635,501	-42
Motor Vehicles & Equipment	-\$6,740,329	-\$1,320,014	-\$985,923	-22
Transp. Equip., Exc. Motor Vehicles	-\$2,929,094	-\$869,777	-\$819,328	-15
Instruments & Related Products	-\$2,356,931	-\$792,735	-\$734,661	-15
Miscellaneous Manufacturing	-\$5,404,825	-\$2,224,282	-\$1,470,691	-37
Transportation	-\$79,327,218	-\$56,270,353	-\$36,065,398	-740
Communication	-\$82,727,422	-\$58,878,441	-\$21,822,768	-302
Electric, Gas, Water, Sanitary Services	-\$201,479,277	-\$52,485,070	-\$19,736,219	-170
Wholesale Trade	-\$85,153,995	-\$63,792,327	-\$33,226,431	-648
Retail Trade	-\$527,473,009	-\$434,211,489	-\$261,362,506	-10,410
Finance	-\$35,881,050	-\$22,370,939	-\$11,034,965	-188
Insurance	-\$49,290,698	-\$27,367,306	-\$17,637,375	-339
Real Estate	-\$491,994,795	-\$57,541,414	-\$7,786,334	-130
Hotels, Lodging Places, Amusements	-\$41,859,406	-\$22,188,605	-\$14,463,847	-573
Personal Services	-\$116,695,344	-\$73,021,821	-\$56,472,097	-1,584
Business Services	-\$110,058,798	-\$66,403,223	-\$52,849,306	-1,042
Eating & Drinking Places	-\$228,861,179	-\$132,519,109	-\$71,311,472	-5,150
Health Services	-\$146,129,659	-\$100,985,124	-\$87,572,376	-2,197
Miscellaneous Services	-\$104,502,396	-\$39,844,953	-\$35,446,807	-1,347
Households	-\$3,332,083	-\$3,332,083	-\$3,259,556	-346
Total	-\$2,804,988,528	-\$1,373,966,021	-\$831,945,767	-27,565

All monetary values are given in constant (2001) dollars.

SOURCE: Texas Multi-Regional Impact Assessment System, The Perryman Group

B-11. *Presentation to the Joint Select Committee on Public School Finance*
 John McGeady, Legislative Budget Board
 Robert Norris, Legislative Budget Board
 John O'Brien, Legislative Budget Board
 Ursula Parks, Legislative Budget Board

Presentation to the Joint Select Committee on Public School Finance

Prepared by the staff of the
Legislative Budget Board
March 7, 2002

District Property Values

- District property values have increased significantly in the past few years
- Values in the chart represent the year in which they apply for state aid purposes; the tax year is two years prior.

Year	Actual Percent Increase
1998	4.8
1999	7.2
2000	5.7
2001	7.0
2002	9.0
2003	11.1

Note: 2003 "actual" are the preliminary local assigned values from the Comptroller's preliminary 2001 study. The chart represents increase over prior year values.

Tax Rates

- Nominal rates are set by school districts and are the quotient of local levy divided by current year property values
- Effective rates are used for the calculation of state aid and are the quotient of local collections divided by prior year property values

Thompson

Findings:

- The total estimated one-year cost of this proposal is \$1.3 billion
- No districts lose state aid, all districts experience an increase in state and total revenue

Funding Formula Changes

Year	Equalized Wealth Level	Guaranteed Yield	Basic Allotment
1994	\$280,000	\$20.55	\$2,300
1996	\$295,000	\$21.00	\$2,387
1998	\$300,000	\$24.99	\$2,396
2000	\$271.14	\$25.81	\$2,537
2002	\$305,000		
2003			

Average Daily Attendance

- ADA increases about 2% per year
- Each year between 60,000-70,000 students are added to the system

Thompson

Plan Elements:

- Single tier with a \$30 per penny yield up to \$1.50
- Recapture begins at \$300,000 in wealth per WADA and increases with each penny of effort over \$1.40
- Dana Center's "salary and benefits" rolling average CEI model
- Elimination of current law hold harmless provisions
- Creates new provision allowing districts with \$1.50 tax rates to generate additional revenue

Thompson

Generates more state aid and more total revenue to all types of school districts.

- The average statewide state aid increase is \$251 per ADA
- Excluding Chapter 41 districts that generate on average \$50 in state aid per ADA, the statewide average increase is \$276 in state aid per ADA

Thompson

Chapter 41 Districts

- Local revenue per ADA increases, as the proposal allows Chapter 41 districts access to more local revenue than under current law
- The average increase in local revenue for Chapter 41 districts is \$753 per ADA

Foster

Plan Elements:

- Detaches non-residential property from Chapter 41 districts and annexes it to Chapter 42 districts
- Provides mechanism for districts to generate state aid at tax rates over \$1.50
- Requires the state to maintain the 85% of students in the equalized system in both years of the biennium

Foster

- Estimated cost of supplemental assistance to eligible districts is \$272 million annually
- Average assistance for the 290 eligible districts is \$176 per ADA
- Supplemental assistance would primarily benefit small, rural districts and certain low and mid wealth districts. Large suburban and high wealth districts tend to benefit the least

Moak/Casey

Tax Rate and Property Value Adjustments

- Property Values
 - Local Values
 - Current Year Values
- Tax Rates
 - Actual tax rates, except for local optional exemptions

Moak/Casey

- Replace compensatory education weight with an "at-risk" weight
- Replace bilingual education weight with "limited-English proficient" weight
- Simplify special education weights; uses current special education weights reduced by 1.0 for proxy of simplified system
- Add an indirect cost factor based on federal indirect cost-type calculation

Thompson

Gap Districts

- Current law "gap" districts experience significant state aid increases as compared to current law
- Average state aid increase for gap districts is \$275 per ADA

Foster

Findings:

- Detachment and annexation (D&A) of non-residential property is virtually revenue-neutral from the state's perspective
- D&A increases the ability of property-poor districts to generate revenue locally, thus decreasing the amount of state aid they earn. Conversely D&A automatically limits the ability of property-wealthy districts to earn local revenue above the current law recapture level
- D&A also eliminates the "windfall" currently earned by property-poor partner districts, as recapture is paid based on the WADA of the property-wealthy partner

Moak/Casey

Plan Elements:

Restructure the Foundation School Program

- Single-tier guaranteed yield program with recapture
- Guarantee all districts a revenue yield equal to the 95th percentile of wealth per WADA
- Provide annual cost-of-living plus 1% for all districts, regardless of wealth
- Equalized wealth level would be statutorily established at the 95th percentile

Moak/Casey

Modify calculation of per pupil entitlements, creating a "Program Factors" adjustment

- Create entitlement for full-day Pre-K programs for all four-year-olds
- Create a high school weight (1.05) and eliminate career & technology and gifted & talented weights
- Create first-year student weight for fast-growth districts

Moak/Casey

Create a "Community Factors" adjustment

- Transportation allocation converted to weighted adjustment
- Create single, small/mid-size adjustment formula, with adjustment based on student density
- Amend cost-of-education index using a modified Essentials Index (Dana Center) and multiply value by 0.6 (rather than 0.71)

Moak/Casey

Modify certain current categorical programs

- Eliminate compensatory education set-asides and replace with state funding for assessment costs
- Eliminate 9th grade, early elementary education, and technology allotments
- Eliminate current hold harmless provisions for homestead exemption, teacher salaries, and health insurance
- Expand textbook program to incorporate high-cost instructional technology systems

Moak/Casey

Facilities

- Modifications to facilities funding: Create funding assumptions for facilities based on expected funding needs of \$3 billion in capital funds per year
- Constitutional amendment to validate modified funding system
- Increase TEA review
- Automatic EDA-type funding
- Expansion of IFA program to include equipment and approved administrative facilities

Moak/Casey

Other elements

- Elimination of funding for certain categorical programs (e.g., 9th grade and early-elementary education) save the state an estimated \$450 million
- Changes to teacher health insurance funding increase state costs by \$490 million

Common Themes & Issues

Increase Funding Formulas by an Inflation Factor

- Statutorily increase certain Foundation School Program funding formulas by an inflation factor each year.
- Pro: Automatically keeps funding levels in sync with certain school district cost pressures.
- Con: The inflation factor can become a significant state budget driver.
- Using 2002 funding elements as a proxy, if the basic allotment, Tier 2 and Tier 3 guaranteed yield, and equalized wealth level had been increased by an inflation factor in 2002 and 2003, the estimated GR cost for the 2002-03 biennium would have been \$1.3 billion.

Common Themes & Issues

Adjust Settle-up Payments to Maintain Equity Standard

- Adjust annual settle-up with school districts to guarantee funding levels at the 85th percentile of wealth per student.
- Pro: Eliminates lag in adjusting formulas to meet equity standards. Provides additional state aid for school districts if Dallas ISD wealth per pupil increases above appropriations projections.
- Con: Increases uncertainty in funding formulas. Increases state costs if Dallas ISD wealth per pupil increases beyond projections used in the appropriations bill.
- Cost: The cost is dependent on the variation between the actual 85th percentile yield and the yield used for appropriations. In the 2000-01 biennium, the Tier 2 guaranteed yield was raised in excess of the 85th percentile primarily to help fund the teacher pay raise. In 2002-03 biennium, the Tier 2 yield was set, for both years, at the 85th percentile.

Moak/Casey

Teacher Health Insurance

- Separate funding of health insurance
- Retention of current \$1,000 health insurance/compensation allotment
- State funding for basic insurance plan in excess of required local contribution
- Specific insurance allotment to replace current formula funding of insurance contribution

Moak/Casey

Findings:

Formula Changes

- Net state aid increase associated with formula adjustments is \$6.4 billion
- Formula changes included in this estimate are: CEI change, inclusion of pre-kindergarten ADA, weights changes, yield and recapture threshold increases
- All categories of districts would realize increased state aid and total revenue under the proposal

Common Themes & Issues

Permanently Extend the Eligibility Date for the Equalized Debt Allotment

- Establish a date certain in the even-numbered calendar year prior to each legislative session for eligible debt under the Equalized Debt Allotment (EDA)
- Pro: It's a simpler system with more predictability for school districts. The Instructional Facilities Allotment (IFA) could ultimately be phased out as school districts would structure their debt issuances to meet the rolling eligibility date of the EDA
- Con: State costs are more dependent on school district debt activity. Under current law, the IFA is limited by appropriations and the legislature has to proactively move forward the EDA date each session.
- Cost: \$240 to \$270 million each biennium assuming \$3 billion in new debt eligible every two years.

Common Themes & Issues

Provide Supplemental State Assistance to Districts at \$1.50 Tax Rate

- Pro: Provides relief to those districts that have reached funding capacity in the current system.
- Con: May encourage increased tax effort.
- Cost: Would vary depending on specifics of supplemental assistance formula and extent to which state aid in base plan provided additional capacity in the system. As a point of reference, state aid in Tier 2 averages about \$49 million per penny of tax effort.

Common Themes and Issues

Revise the Cost-of-Education Index

- A number of options have been proposed for updating and/or revising the Cost of Education Index (CEI), including:
 - The Dana Center has laid out several options for modifying the CEI, focusing on improving the mechanism by which the state can compensate for uncontrollable district expenditures
 - The LBB in 1995 and 1997 laid out the Educational Development Index to replace the CEI. It focuses on student characteristics uncontrollable by districts

- B-12. *Overview of the Property Tax System in Texas*
Billy Hamilton, Comptroller of Public Accounts
Dan Wilson, Comptroller of Public Accounts
Tim Wooten, Comptroller of Public Accounts

THE TEXAS PROPERTY TAX SYSTEM

- I. Background of the Local Property Tax in Texas
 - A. Primary source of revenue in the United States from 18th century until WWII. Today, it is the primary source of revenue for local governments, schools, and service districts.
 - B. Property Tax in Texas 1836-present
 1. Republic of Texas levied first property tax in 1837. State Constitution of 1845 allowed state property tax for public education.
 2. In 1960s issues of tax equity and public school finance inequality became major concerns before the Legislature.
 3. U.S. Supreme Court in 1973 found the Texas school finance system to be constitutional, but in need of equalization and reform. Court encouraged the creation of a different method of school finance.
 4. In 1975, Legislature created a new mechanism for distributing state funds to school districts based on the market value of property in each school district. This narrowed the differences between property-poor and property-rich districts.
 5. Legislature in 1979 passed H.B. 621 (Peveto Bill), the new Property Tax Code.
 - a. The law establishes one central appraisal district in each of the 254 counties (Potter and Randall form a single appraisal district). By 1982, each taxing unit had joined an appraisal district.
 - b. The law eliminates fractional assessments, requiring appraisal of property at full market value throughout the state.
 - c. The law requires chief appraisers to appraise property regularly and reappraise at least once every three years.
 - d. One appraisal review board (ARB) in each county replaces individual taxing unit boards of equalization. Taxpayers now take

protests concerning property value to one board that decides the matter for all taxing units in the appraisal district.

e. Taxpayers may vote to limit tax increases through a referendum election called a rollback election.

f. Truth-in-taxation provisions of the Code require taxing units to publicize proposed tax rates, hold hearings, and publish other information that will help taxpayers see how tax rates affect levies.

g. The law established the State Property Tax Board (SPTB). (Now, the Property Tax Division of the State Comptroller's Office.)

h. The law standardizes the method of calculating and reporting tax rates.

6. In 2001, over half of all Texas property tax levies supported public education.

C. Legal Foundations of Property Taxation.

1. Power to tax is granted to taxing units through the Texas Constitution.
2. In general, a taxing unit has authority to tax property located within its boundaries on January 1.
3. The body of law governing property taxation comes from several sources.
 - a. The constitution and laws of the United States
 - b. The Texas Constitution
 - c. Written court decisions
 - d. The Property Tax Code
 - e. Opinions from the Attorney General
 - f. State agency rules

D. The tax calendar is a schedule of property tax activities broken down into four phases.

1. Appraisal Phase (January 1 through May 15)
2. Equalization and Review (May 15 through July 20)

3. Assessment Phase (July 25 through September 1)
4. Collection Phase (October 1 through January 31)

II. Appraisal Districts in Texas

A. Appraisal district boards of directors oversee activities of the 253 appraisal districts in Texas.

1. Most appraisal district boards have five members, but law permits up to 13 members. Members serve two-year terms beginning January 1, but staggered terms are allowed with consent of 3/4 of voting taxing units.

2. Directors are selected by voting units (school districts, incorporated cities, some conservation and reclamation districts, and counties) based on each voting unit's proportion of the previous years tax levy.

3. Appraisal district board has six basic responsibilities.

- a. Establish an office.
- b. Appoint a chief appraiser.
- c. Appoint an Appraisal Review Board (ARB).
- d. Adopt a budget.
- e. Provide for necessary services.
- f. Make general policy for the district.

B. Chief appraiser administers day-to-day operations of appraisal district.

1. In every district, the chief appraiser's responsibilities are to:
 - a. Discover, list, and value property,
 - b. Maintain field maps,
 - c. Organize periodic reappraisals,
 - d. Serve as custodian of the records,
 - e. Prepare appraisal records that will assure usable tax rolls,
 - f. Correct errors and omissions in the records,
 - g. Determine exemptions and special valuation requests,
 - h. Work with the ARB and the taxing units,

- i. Prepare and certify the appraisal rolls,
 - j. Attend district board meetings and ARB hearings,
 - k. Defend appraisal district values at ARB hearings, and
 - l. Notify taxpayers, taxing units, and the public about matters that affect property values.
 2. As administrator, the chief appraiser:
 - a. Prepares the annual budget,
 - b. Hires staff,
 - c. Receives and deposits quarterly payments from taxing units,
 - d. Supervises the work of contractors,
 - e. Keeps the board and the public informed,
 - f. Handles arrangements, notices, and mailings for board meetings,
 - g. Administers policies,
 - h. Maintains public records, and
 - i. Implements a financial reporting system.
 3. Chief appraiser and anyone who values property for tax purposes must register with the Board of Tax Professional Examiners (BTPE) and work toward designation as a Registered Professional Appraiser (RPA).
- C. Appraisal Review Board members correct and approve the appraisal records for the appraisal district.
 1. The appraisal district board appoints ARB members to two-year staggered terms.
 2. Most appraisal districts appoint three to nine members. Some larger counties may have up to 45 members, depending on population.
 3. ARB may establish its own procedures and rules of order. All ARB activities are subject to Open Meetings Act and Open Records Act.

4. The ARB's main duty is to equalize the market value of each taxable parcel of property in the appraisal district. The process involves several steps, most of which are dictated by the Property Tax Code.
 - a. The appraisal district completes appraisals and sends all required notices to taxpayers.
 - b. The chief appraiser submits the appraisal records to the ARB by May 15 for review and determination of challenges and protests. The ARB must begin its review within 10 days of submission.
 - c. The ARB hears and determines taxing unit challenges.
 - d. The ARB hears and determines taxpayer protests.
 - e. The ARB issues change orders after it determines taxing unit challenges and taxpayer protests. These are sent to the chief appraiser and to each protesting taxpayer or challenging taxing unit.
 - f. The ARB approves the appraisal records by July 20.
 - g. The chief appraiser certifies an appraisal roll to each taxing unit in the district by July 25. Each taxing unit then begins the tax rate calculation, adoption, and collection process.
5. A property owner or a taxing unit that is dissatisfied with an ARB determination may file a lawsuit in district court.

III. The Appraisal Process

- A. The chief appraiser's most important responsibility consists of three steps:
 1. Discovery - When appraisers discover property, they identify it and decide what its tax status is.
 2. Listing - After the discovery, the chief appraiser must list it correctly in the district's permanent records.
 3. Valuation - The chief appraiser places a value on each taxable real and personal property item. The law calls for periodic reappraisal of all property and appraisal of real property at least once every three years. In Texas, all appraisal districts appraise at full market value, unless the property qualifies for special appraisal, as provided by the Texas Constitution.

B. Three special-use valuation categories are exceptions to market value standard for appraisal. Diversion from qualified special-use results in the levy of additional taxes, called **Rollback taxes.**

1. Agricultural use valuation - Article VIII, Section 1-d of the Texas Constitution permits the appraisal of agricultural land based on its productivity value if the land meets three conditions.

- a. A person, not a partnership or corporation, must own the land.
- b. Agricultural activity must be the owner's primary occupation and source of income during the tax year.
- c. The land must have been in agricultural use for three years prior to receiving the special valuation.

2. Open-space land valuation - Article VIII, Section 1-d-1 of the Texas Constitution permits the chief appraiser to appraise agricultural land, open-space land, land used for wildlife management and timberland based on its productivity value if the land meets two conditions.

- a. The land must have been in use as agricultural or timberland for at least five of the previous seven years prior to the special valuation.
- b. The land must be in agricultural use to the degree of intensity common for the area.

3. Restricted use valuation - this land permitted for recreational, park, scenic land, and public access airport property. The restricted use must be filed in the form of a ten-year deed restriction.

C. An exemption is an exclusion of all or part of a property's value from taxation.

1. The Texas Constitution specifies 11 total property tax exemptions, including household goods, personal effects, property of religious organizations, etc.

2. The Texas Constitution also specifies several partial property tax exemptions. These include the various homestead exemptions, the disabled veterans exemption, exemptions for solar or wind powered or pollution control devices, the school tax freeze for persons age 65 and older and tax abatements in urban redevelopment areas.

3. The Property Tax Code exempts public property used for public purposes (with some exceptions).
4. Property exempt under federal law is automatically exempt from state and local taxation.
5. Personal property not used to produce income is exempt from taxation; however, the governing body of a taxing unit may decide to override this exemption and levy a tax (automobiles are taxed in several jurisdictions). The taxable status of travel trailers was addressed by the 77th Legislature, and involves special issues unique to that class of personal property.
6. The Property Tax Code exempts several types of property which the Constitution does not mention (theater schools, etc.). However, these exemptions are probably subject to constitutional challenge.
7. Between January and May, the chief appraiser decides which taxpayers and which property will receive exemptions.

D. The chief appraiser has legal responsibilities for preparing the appraisal roll within a statutory time frame.

1. January 1 - Date when the chief appraiser determines appraised value of property.
2. January 31 - Chief appraiser delivers applications for special appraisal and exemptions requiring annual applications.
3. April 15 - Last day for chief appraiser to accept renditions (except for good cause exceptions).
4. April 30 - Last day for chief appraiser to receive exemption and special valuation applications.
5. May 15 - Chief appraiser mails taxpayers notices of appraised value.
6. July 25 - Deadline for chief appraiser to certify the appraisal roll to each taxing unit.

E. The assessor calculates the taxable value of each property item on the unit's appraisal roll and gives this information to the governing body by August 1. Taxable value is the appraised value minus exemptions.

IV. A Taxing Unit is a Governmental Entity that Levies Property Taxes

A. The county commissioners court is the county governing body and the board of trustees (the school board) governs the school district. Cities often have city councils, and special districts often have boards of directors or commissioners.

B. Taxing unit governing bodies have five major responsibilities:

1. They appoint an assessor and a collector or an assessor-collector (county commissioners work with the elected assessor-collector).
2. They establish a tax office and provide funds for it.
3. They contract for goods and services.
4. They adopt the tax rate and approve the tax roll.
5. They spend tax revenues for government functions.

C. Assessment refers to the steps a taxing unit takes to determine the tax base and to adopt and impose a property tax.

1. August - The assessor submits the appraisal roll and taxable value to the governing body on or around August 1.

The assessor or a designated employee calculates the effective and rollback tax rates and the total tax base.

The taxing unit must publish the tax rate calculations, unencumbered fund balances and debt schedule in August.

The taxing unit must publicize the proposed tax rate and schedule meetings if the proposed tax rate exceeds the effective tax rate by three percent.

2. September - The taxing unit's governing body adopts a tax rate around or before September 1.

The assessor applies the tax rate to taxable value to determine the tax levy.

The assessor prepares the tax roll.

The unit's governing body approves the tax roll.

3. October - The assessor prepares the tax bills and mails them on or soon after October 1.

D. If a taxing unit increases its tax rate by more than eight percent (six cents for school districts) above the effective tax rate, the taxpayers of taxing units other than school districts may petition for an election to limit the tax increase to the eight percent level. Such an election is known as a tax rate rollback election. School districts are required to hold automatic rollback elections without the petition process if school boards adopt tax rates above their rollback rates.

E. The collector or the assessor-collector for a unit collects the property taxes and accounts to the governing body.

1. Taxing units usually mail bills in October or November with a delinquency date of February 1.

2. Taxes that are unpaid on February 1 are considered delinquent and additional penalty and interest are added to the original amount.

a. The penalty is a six percent charge the first month and an additional one percent per month until July 1, when the penalty becomes 12 percent permanently.

b. Interest accrues at one percent per month for as long as the tax remains delinquent.

c. In addition to penalty and interest, a taxing unit may charge up to 20 percent of penalty, interest, and taxes if it hires a private collections attorney.

V. The State Property Tax Board was formed in 1980 following passage of the Property Tax Code in 1979.

A. In 1991 the Comptroller assumed the duties and responsibilities of the State Property Tax Board.

The Comptroller has six major responsibilities relating to property taxes:

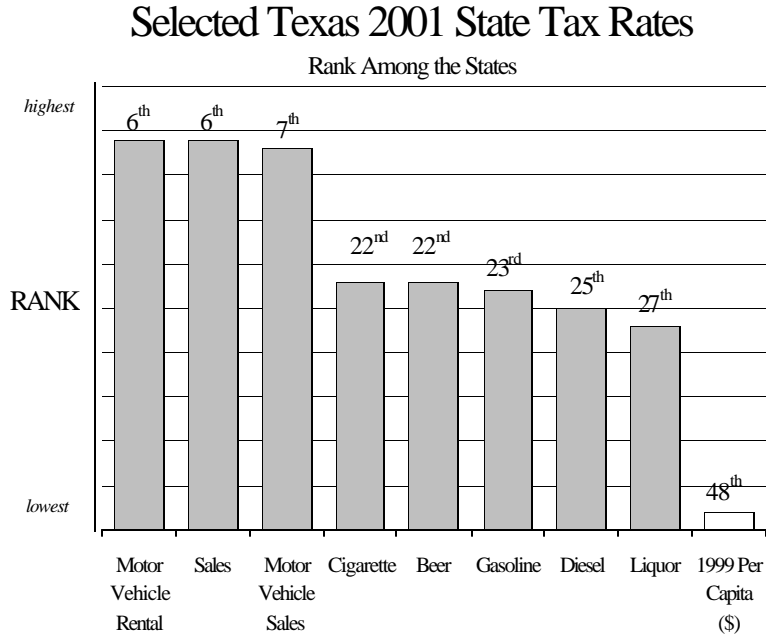
1. The Comptroller adopts rules and minimum standards for administration and operation of appraisal district offices and taxing unit offices.

2. The Comptroller prepares and distributes appraisal manuals, a rules handbook, and other technical and legal materials for use by local tax professionals.

3. The Comptroller publishes materials explaining taxpayer rights and remedies.
4. The Comptroller prescribes the contents of property tax forms and a uniform records system for appraisal districts and tax offices.
5. The Comptroller gives professional and technical assistance to local tax officials and taxpayers.
6. The Comptroller maintains a central registry for local reinvestment zones, tax abatements and tax increment financing agreements.
7. The Comptroller conducts and publishes an annual property value study for appraisal districts and school districts.

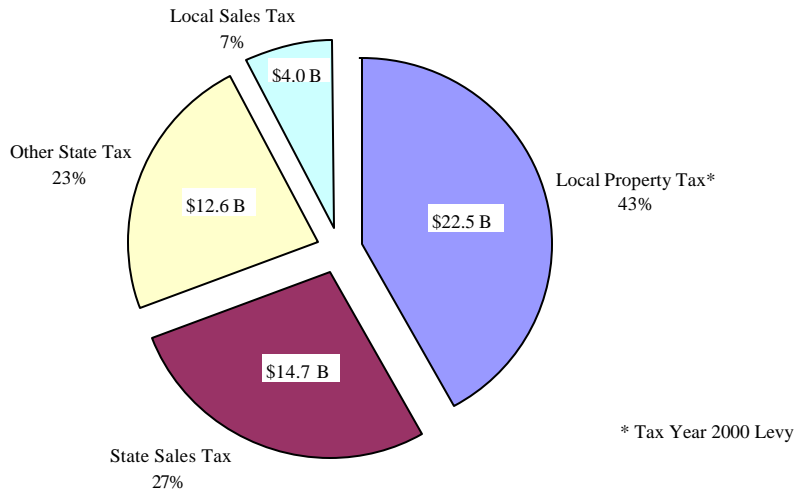
B-13. *Texas Taxes*

James LeBas, Chief Revenue Estimator, Comptroller of Public Accounts



SOURCE: U.S. Census of Governments and Commerce Clearing House

Texas State and Local Taxes FY 2001 Total = \$53.7* Billion



SOURCE: 2001 Annual Cash Report and 2000 Annual Property Tax Report of the Comptroller

*Totals may not add due to rounding.

State Tax Rankings, 1990

	Rank per capita		Rank as a % of personal income		Rank as a % of GSP
Alaska	1	Alaska	1	West Virginia	1
Hawaii	2	Hawaii	2	New Mexico	2
Delaware	3	New Mexico	3	Hawaii	3
Connecticut	4	West Virginia	4	Minnesota	4
New York	5	Delaware	5	Maine	5
Minnesota	6	Minnesota	6	Wisconsin	6
Massachusetts	7	Washington	7	Idaho	7
Washington	8	Wyoming	8	Washington	8
California	9	Kentucky	9	Montana	9
Maryland	10	Wisconsin	10	Arizona	10
Wyoming	11	Maine	11	Kentucky	11
New Jersey	12	Idaho	12	Alaska	12
Wisconsin	13	Mississippi	13	Mississippi	13
New Mexico	14	South Carolina	14	Oklahoma	14
Nevada	15	Arizona	15	South Carolina	15
Maine	16	Montana	16	Michigan	16
West Virginia	17	Iowa	17	Iowa	17
Rhode Island	18	New York	18	Arkansas	18
Michigan	19	Utah	19	Massachusetts	19
Arizona	20	Oklahoma	20	North Dakota	20
Iowa	21	North Carolina	21	New York	21
North Carolina	22	Massachusetts	22	Rhode Island	22
Vermont	23	North Dakota	23	Vermont	23
Kentucky	24	Arkansas	24	Utah	24
Idaho	25	California	25	Maryland	25
South Carolina	26	Vermont	26	Delaware	26
Illinois	27	Michigan	27	North Carolina	27
Pennsylvania	28	Louisiana	28	Indiana	28
Oklahoma	29	Nevada	29	California	29
Indiana	30	Indiana	30	Alabama	30
Georgia	31	Georgia	31	Connecticut	31
Kansas	32	Rhode Island	32	Pennsylvania	32
Montana	33	Connecticut	33	Kansas	33
Virginia	34	Alabama	34	Florida	34
North Dakota	35	Kansas	35	Georgia	35
Ohio	36	Maryland	36	Nevada	36
Florida	37	Pennsylvania	37	Ohio	37
Utah	38	Ohio	38	Oregon	38
Oregon	39	Illinois	39	New Jersey	39
Louisiana	40	Missouri	40	Missouri	40
Missouri	41	New Jersey	41	Illinois	41
Arkansas	42	Oregon	42	Wyoming	42
Nebraska	43	Nebraska	43	Nebraska	43
Alabama	44	Virginia	44	Tennessee	44
Colorado	45	Tennessee	45	Virginia	45
Mississippi	46	Florida	46	Louisiana	46
Tennessee	47	Texas	47	Colorado	47
Texas	48	Colorado	48	South Dakota	48
South Dakota	49	South Dakota	49	Texas	49
New Hampshire	50	New Hampshire	50	New Hampshire	50

State Tax Rankings, 1999

	Rank per capita		Rank as a % of personal income		Rank as a % of GSP
Connecticut	1	Hawaii	1	Hawaii	1
Delaware	2	New Mexico	2	West Virginia	2
Hawaii	3	Delaware	3	Michigan	3
Minnesota	4	Minnesota	4	Maine	4
Massachusetts	5	Michigan	5	Minnesota	5
Vermont	6	West Virginia	6	Mississippi	6
Michigan	7	Maine	7	Arkansas	7
Wisconsin	8	Arkansas	8	Wisconsin	8
California	9	Wisconsin	9	New Mexico	9
Washington	10	Kentucky	10	Montana	10
New York	11	Mississippi	11	North Dakota	11
New Jersey	12	Idaho	12	Kentucky	12
Maine	13	North Dakota	13	Idaho	13
New Mexico	14	Connecticut	14	Connecticut	14
Rhode Island	15	Utah	15	Oklahoma	15
Nevada	16	California	16	California	16
North Carolina	17	North Carolina	17	Vermont	17
Kentucky	18	Washington	18	Washington	18
Maryland	19	Montana	19	Delaware	19
West Virginia	20	Oklahoma	20	Rhode Island	20
Arkansas	21	Massachusetts	21	Utah	21
Pennsylvania	22	Iowa	22	Iowa	22
Illinois	23	Vermont	23	Kansas	23
North Dakota	24	Rhode Island	24	Pennsylvania	24
Idaho	25	Kansas	25	Massachusetts	25
Kansas	26	Wyoming	26	North Carolina	26
Utah	27	South Carolina	27	South Carolina	27
Iowa	28	Pennsylvania	28	Maryland	28
Wyoming	29	New York	29	Florida	29
Virginia	30	Arizona	30	Indiana	30
Mississippi	31	Indiana	31	Arizona	31
Indiana	32	Nevada	32	Alabama	32
Colorado	33	Louisiana	33	New York	33
Ohio	34	Alabama	34	New Jersey	34
Oklahoma	35	Oregon	35	Missouri	35
Oregon	36	Ohio	36	Ohio	36
Georgia	37	Missouri	37	Nebraska	37
Nebraska	38	Nebraska	38	Nevada	38
South Carolina	39	Georgia	39	Oregon	39
Arizona	40	New Jersey	40	Virginia	40
Florida	41	Florida	41	Illinois	41
Missouri	42	Maryland	42	Louisiana	42
Montana	43	Virginia	43	Wyoming	43
Louisiana	44	Illinois	44	Georgia	44
Alaska	45	Tennessee	45	Tennessee	45
Alabama	46	Alaska	46	South Dakota	46
Tennessee	47	Texas	47	Colorado	47
Texas	48	South Dakota	48	Texas	48
South Dakota	49	Colorado	49	Alaska	49
New Hampshire	50	New Hampshire	50	New Hampshire	50

State & Local Tax Rankings, 1990

	Rank per capita		Rank as a % of personal income		Rank as a % of GSP
Alaska	1	Alaska	1	New York	1
New York	2	New York	2	Montana	2
Connecticut	3	Wyoming	3	Maine	3
Hawaii	4	Montana	4	Arizona	4
New Jersey	5	Hawaii	5	Wisconsin	5
Massachusetts	6	Minnesota	6	Michigan	6
Maryland	7	Wisconsin	7	Minnesota	7
Minnesota	8	Maine	8	West Virginia	8
California	9	New Mexico	9	Vermont	9
Wyoming	10	Arizona	10	Maryland	10
Washington	11	Vermont	11	Oregon	11
Illinois	12	Michigan	12	Rhode Island	12
Wisconsin	13	Iowa	13	New Mexico	13
Michigan	14	West Virginia	14	Iowa	14
Delaware	15	Oregon	15	Alaska	15
Rhode Island	16	Washington	16	New Jersey	16
Vermont	17	Utah	17	Washington	17
Maine	18	Louisiana	18	Hawaii	18
Oregon	19	Massachusetts	19	Connecticut	19
Colorado	20	Kansas	20	Kansas	20
Nevada	21	New Jersey	21	Massachusetts	21
Arizona	22	California	22	Idaho	22
Virginia	23	Georgia	23	Pennsylvania	23
Iowa	24	Illinois	24	Florida	24
Pennsylvania	25	Rhode Island	25	Utah	25
Kansas	26	Nebraska	26	Illinois	26
Nebraska	27	Connecticut	27	North Dakota	27
Ohio	28	Maryland	28	Oklahoma	28
Georgia	29	North Dakota	29	Ohio	29
Montana	30	Idaho	30	Nebraska	30
Florida	31	Colorado	31	Colorado	31
New Mexico	32	Oklahoma	32	California	32
New Hampshire	33	South Carolina	33	Mississippi	33
North Carolina	34	Kentucky	34	Georgia	34
Texas	35	Ohio	35	South Carolina	35
Indiana	36	North Carolina	36	Indiana	36
Utah	37	Mississippi	37	Kentucky	37
Oklahoma	38	Texas	38	Virginia	38
North Dakota	39	Delaware	39	North Carolina	39
South Carolina	40	Pennsylvania	40	New Hampshire	40
West Virginia	41	Indiana	41	Arkansas	41
Idaho	42	Virginia	42	South Dakota	42
Louisiana	43	Nevada	43	Missouri	43
Missouri	44	South Dakota	44	Alabama	44
Kentucky	45	Arkansas	45	Wyoming	45
South Dakota	46	Florida	46	Nevada	46
Tennessee	47	Missouri	47	Texas	47
Alabama	48	Alabama	48	Tennessee	48
Arkansas	49	Tennessee	49	Louisiana	49
Mississippi	50	New Hampshire	50	Delaware	50

State & Local Tax Rankings, 1999

	Rank per capita		Rank as a % of personal income		Rank as a % of GSP
Connecticut	1	New York	1	Maine	1
New York	2	Maine	2	New York	2
New Jersey	3	Wisconsin	3	West Virginia	3
Massachusetts	4	Hawaii	4	Wisconsin	4
Minnesota	5	New Mexico	5	Vermont	5
Wisconsin	6	Minnesota	6	Minnesota	6
Hawaii	7	Vermont	7	Montana	7
Delaware	8	Connecticut	8	North Dakota	8
Maine	9	North Dakota	9	Rhode Island	9
Rhode Island	10	West Virginia	10	Connecticut	10
Maryland	11	Utah	11	Michigan	11
California	12	Rhode Island	12	Hawaii	12
Washington	13	New Jersey	13	New Jersey	13
Illinois	14	Michigan	14	Maryland	14
Michigan	15	Wyoming	15	Mississippi	15
Vermont	16	Arkansas	16	Arkansas	16
Colorado	17	Delaware	17	Pennsylvania	17
Pennsylvania	18	Idaho	18	Florida	18
Nevada	19	Mississippi	19	Kansas	19
Ohio	20	Kentucky	20	Iowa	20
Virginia	21	California	21	Oklahoma	21
Alaska	22	Ohio	22	Idaho	22
Wyoming	23	Louisiana	23	Ohio	23
Nebraska	24	Montana	24	New Mexico	24
Georgia	25	Iowa	25	Utah	25
Kansas	26	Washington	26	Washington	26
Iowa	27	Nebraska	27	Kentucky	27
Florida	28	Pennsylvania	28	Nebraska	28
North Carolina	29	Kansas	29	Indiana	29
North Dakota	30	North Carolina	30	California	30
Indiana	31	Arizona	31	Arizona	31
New Hampshire	32	Massachusetts	32	Illinois	32
Oregon	33	Georgia	33	Massachusetts	33
New Mexico	34	Oklahoma	34	South Carolina	34
Utah	35	Illinois	35	Missouri	35
Missouri	36	Indiana	36	Louisiana	36
Arizona	37	Alaska	37	Virginia	37
Kentucky	38	South Carolina	38	Colorado	38
Texas	39	Maryland	39	North Carolina	39
Idaho	40	Missouri	40	Georgia	40
Louisiana	41	Florida	41	Oregon	41
Arkansas	42	Virginia	42	Wyoming	42
West Virginia	43	Oregon	43	South Dakota	43
South Carolina	44	Colorado	44	Alabama	44
Oklahoma	45	Nevada	45	Nevada	45
Montana	46	Texas	46	Texas	46
South Dakota	47	South Dakota	47	Delaware	47
Mississippi	48	Alabama	48	New Hampshire	48
Tennessee	49	Tennessee	49	Tennessee	49
Alabama	50	New Hampshire	50	Alaska	50

Growth in the 1990's Taxes and State Economies

\$ in millions

		1990	1999	\$ Growth	% Growth
Texas	State Taxes	\$ 14,717	\$ 25,676	\$ 10,959	74%
	Local Taxes	13,526	23,555	10,029	74%
	State & Local Taxes	28,243	49,231	20,988	74%
	GSP*	388,099	687,272	299,173	77%
All States	State Taxes	300,489	499,510	199,021	66%
	Local Taxes	201,130	313,266	112,136	56%
	State & Local Taxes	501,619	812,776	311,157	62%
	GSP	5,666,233	9,253,147	3,586,914	63%

Real† per capita

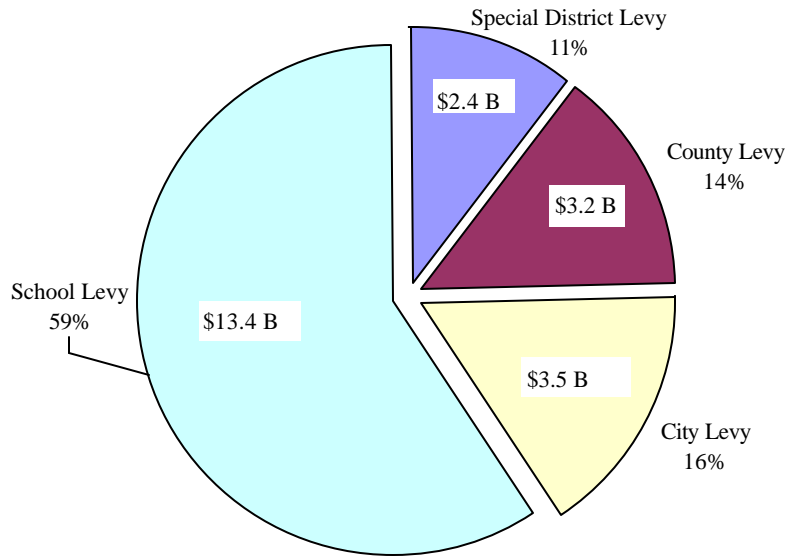
		1990	1999	\$ Growth	% Growth
Texas	State Taxes	\$ 866	\$ 1,059	\$ 193	22%
	Local Taxes	796	971	175	22%
	State & Local Taxes	1,662	2,031	369	22%
	GSP	22,848	28,349	5,501	24%
All States	State Taxes	1,208	1,515	307	25%
	Local Taxes	808	950	142	18%
	State & Local Taxes	2,016	2,465	449	22%
	GSP	22,831	28,109	5,278	23%

* *GSP is Gross State Product, the broadest measure of state economies.*

† "Real" dollars adjust for effects of inflation and reflect a 1990 base year.

SOURCES: U.S. Census of Governments, Bureau of Economic Analysis, and State Rankings 2001, Morgan Quitno.

Texas Property Taxes Levied FY 2001 Total = \$22.5 Billion*



SOURCE: 2000 Annual Property Tax Report of the Comptroller

* Tax Year 2000 Levy

FY 2001 School District Values and Levies

Category	\$ billions
A. Single-Family Residential	\$443.4
F1. Commercial Real	152.0
D. Acreage (Land Only)	96.7
L1. Commercial Personal	79.4
F2. Industrial Real	62.4
L2. Industrial Personal	49.4
B. Multi-Family Residential	46.2
J. Utilities	40.7
G. Oil, Gas, & Minerals	28.4
C. Vacant Lots	22.9
E. Farm & Ranch Improvements	22.1
Other categories	13.4
Total Value	\$1,057.0
Deductions	
Productivity Value Reduction	\$72.6
State Exemptions	69.9
Local % HS Exempt Grant	19.1
Value Reduced by Tax Freeze	17.7
Other Deductions	15.6
Value Lost to 10% Home Cap	9.5
Local 65+/Disabled Value	4.7
Total Deductions	\$209.2
Taxable Value	\$847.8
Actual Levy (\$ billions)	\$13.4

SOURCE: Annual Property Tax Report of the Comptroller

FY 2001 Texas State Taxes

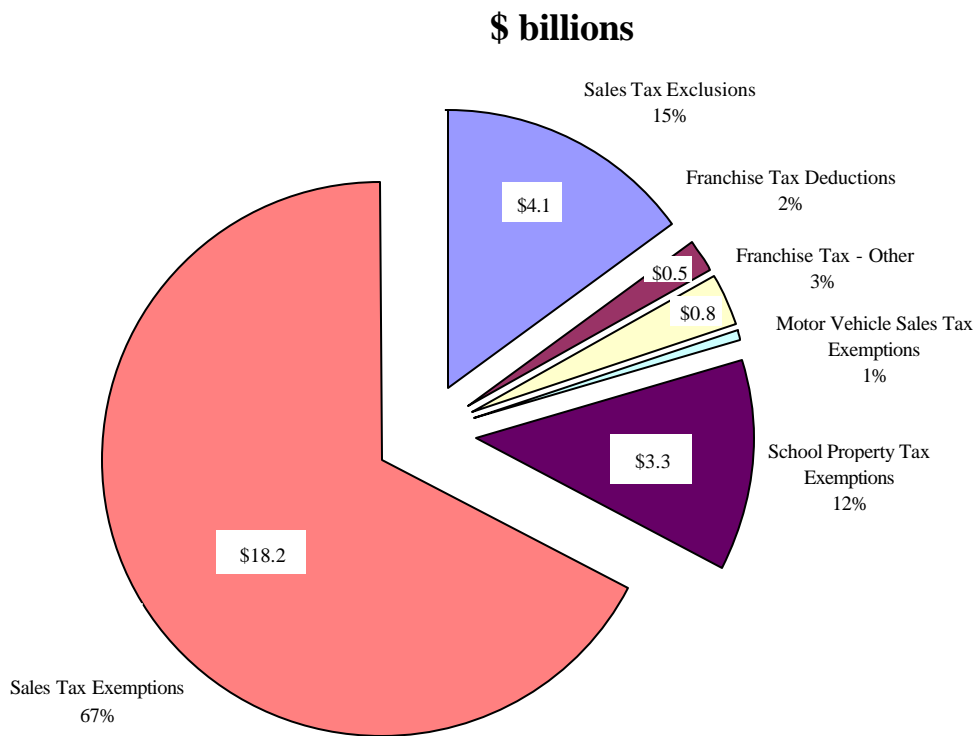
Rank	Tax	\$ millions		
		Revenue	% of Total	Cumulative
1	Sales Taxes	\$14,663	54%	54%
2	Motor Vehicle Sales and Rental Taxes	2,906	11%	65%
3	Motor Fuels Taxes	2,766	10%	75%
4	Franchise Tax	1,960	7%	82%
5	Natural Gas Tax	1,597	6%	88%
6	Insurance Taxes	820	3%	91%
7	Cigarette and Tobacco Taxes	585	2%	93%
8	Alcoholic Beverage Taxes	541	2%	95%
9	Oil Production and Regulation Taxes	443	2%	97%
10	Inheritance Tax	322	1%	98%
11	Utility Taxes	339	1%	99%
12	Hotel Occupancy Tax	247	1%	100%
13	Other Taxes	42	0.2%	100%

Total Tax Collections

\$27,230

Source: 2001 Annual Cash Report of the Comptroller

FY 2001 EXEMPTIONS, EXCLUSIONS, AND DEDUCTIONS



Value of Sales Tax Exemptions

Estimated, FY 2001

Rank	Exemption	\$ millions
1	Materials Used in Manufacturing	\$7,535.7
2	Insurance Premiums Taxed by Other Law	2,589.8
3	Motor Vehicles Taxed by Other Law	2,417.1
4	Food for Home Consumption	1,142.0
5	Motor Fuels Taxed by Other Law	1,125.1
6	Gas & Electricity - Residential	520.0
7	Manufacturing Machinery & Eqpt.	497.9
8	Gas & Electricity - Manufacturing	375.3
9	Ag Feed, Seed, Chemicals, and Supplies	230.2
10	Water	210.1
11	Sales to Governmental Entities	197.3
12	Mixed Drinks Taxed by Other Law	186.9
13	Prescription Medicine and Devices	182.5
14	OTC Drugs	136.5
15	Food Stamp Purchases	124.0
16	Packaging and Wrapping Supplies MFG	109.1
17	Containers	84.8
18	Aviation Fuel Taxed by Other Law	68.3
19	Boats and Boat Motors	52.7
20	Ag Machinery and Equipment	52.1
21	Gas & Electricity - Mining	36.9
22	Coin-Operated Services	34.8
23	School Lunches and Certain Food	34.7
24	Certain Ships	34.0
25	Clothing and Footware Holiday	31.2
26	Certain Drilling Equipment	24.2
27	Newspaper Inserts	22.8
28	Oil Well Services Taxed by Other Law	20.2
29	Newspapers	16.8
30	Aircraft - Certain Repair Equipment	16.3
31	Sales to Nonprofits	16.1
32	Property Used for the Improvement of Exempt Realty	15.5
33	Data Processing & Info Services (Partial)	14.9
34	Gas & Electricity - Agriculture	13.5
35	Livestock for Food	12.3
36	Internet Access (Partial)	11.4
37	Horses, Mules, and Work Animals	8.4
38	Railroad Fuel and Supplies	6.4
39	Magazine Subscriptions	6.1
40	Nonprofit or Religious Periodicals	4.8
41	Enterprise Projects Equipment	4.2
42	One Day Sales	3.7
43	Timber Operations (Eqpt)	2.6
44	Rolling Stock & Locomotives	1.9
45	Ag Containers	0.4
46	Commercial Fishing Ice	0.1
	TOTAL	\$18,231.5

Value of Sales Tax Exclusions

Estimated, FY 2001

Rank	Exclusion	\$ millions
1	Physicians Services	\$547.9
2	Legal Services	346.1
3	Other Health Care	293.6
4	New Residential Construction Labor	252.5
5	Architectural and Engineering Services	245.0
6	Automotive Maintenance & Repair	221.0
7	New Nonresidential Construction Labor	216.3
8	Freight Hauling	213.5
9	Financial Services Brokerage	176.8
10	Dental Services	176.2
11	Accounting and Audit Services	168.2
12	Real Estate Brokerage and Agency	164.4
13	Advertising Media	161.1
14	Child Day Care Service	144.3
15	Contract Computer Programmer	89.4
16	Management, Consulting and Public Relations	87.0
17	Residential Repair and Remodeling	81.8
18	Other Financial Services	66.0
19	Barber and Beauty Services	48.3
20	Temporary Labor Supply	44.5
21	Funeral Service	42.7
22	R&D Lab Services	36.8
23	Testing Labs	36.6
24	Travel Arrangement	30.7
25	Veterinary Services	27.4
26	Employment Agency Services	25.5
27	Private Vocational Education	23.1
28	Other Private Educational Services	21.6
29	Car Washes	19.0
30	Economic & Sociological Research	15.4
31	Other Transportation (Except Scheduled Passenger)	13.2
32	Misc. Personal Services	12.8
33	Interior Design	5.9
	TOTAL	\$4,054.4

SOURCE: Tax Exemption and Incidence Report of the Comptroller

Value of Property Tax Exemptions

Estimated, FY 2001

Rank	Exemption	\$ millions
1	Productivity Value Loss	\$1,161.7
2	Homestead - State Mandated \$15,000	944.2
3	Homestead - Optional Percentage	306.2
4	Homestead - 65 and Over Freeze	288.9
5	Homestead - State Mandated 65 and over or Disabled \$10,000	159.3
6	Homestead 10% Cap	151.5
7	Freeport Property	101.4
8	Homestead - Optional Over 65 or Disabled	79.0
9	Pollution Control Property	40.3
10	Tax Abatement	25.5
11	Tax Increment Financing	22.2
12	Disabled Veterans	18.0
13	Solar and Wind Powered Energy Devices	1.5
14	Historic Sites	0.9
15	Mineral Interest < \$500	0.8
16	Income Producing Tangible Property < \$500	0.1
	TOTAL	\$3,301.5

SOURCE: Tax Exemption and Incidence Report of the Comptroller.

Value of Franchise Tax Exemptions

Estimated, FY 2001

Rank	Exemption	\$ millions
1	IRS Sec. 501(c) (3)	\$243.2
2	Mutual Funds	204.6
3	Insurance Companies	139.0
4	Electric Coop	13.5
5	IRS Sec. 501(c) (6)	10.7
6	IRS Sec. 501(c) (5)	9.2
7	IRS Sec. 501(c) (4)	4.8
8	State Credit Unions	3.6
9	IRS Sec. 501(c) (8)	2.5
10	IRS Sec. 501(c) (7)	1.7
11	Title Insurance Firms	1.2
12	Homeowners Associations	1.2
13	Telephone Coop	0.8
14	Water Supply/Sewer	0.6
15	Solar Energy Companies	0.4
TOTAL		\$637.3

Deductions

1	Business Loss Carryover	\$208.1
2	Officer Compensation Exclusion - Small Corps	187.8
3	Interest Earnings on Federal Securities	53.7
4	Small Business Exception	46.4
5	Enterprise Zone Investment	3.9
6	Food and Medicine Receipts	3.6
TOTAL		\$503.5

Special Accounting Methods

1	GAAP Accounting Exemption	\$13.9
2	Transportation Firm Apportionment	11.1
3	Telephone Firm Apportionment	8.9
4	Investment Mgt Firm Apportionment	3.9
TOTAL		\$37.7

Credits and Refunds

1	R & D Credit	\$67.7
2	Investment Credit	45.2
3	Job Creation Credit	22.7
4	Before- and After-School Care Contributions	4.3
5	Child Care Credit	3.9
6	Temporary (FAS 96) Credit	0.4
TOTAL		\$144.2

SOURCE: Tax Exemption and Incidence Report of the Comptroller (Jan 2001)

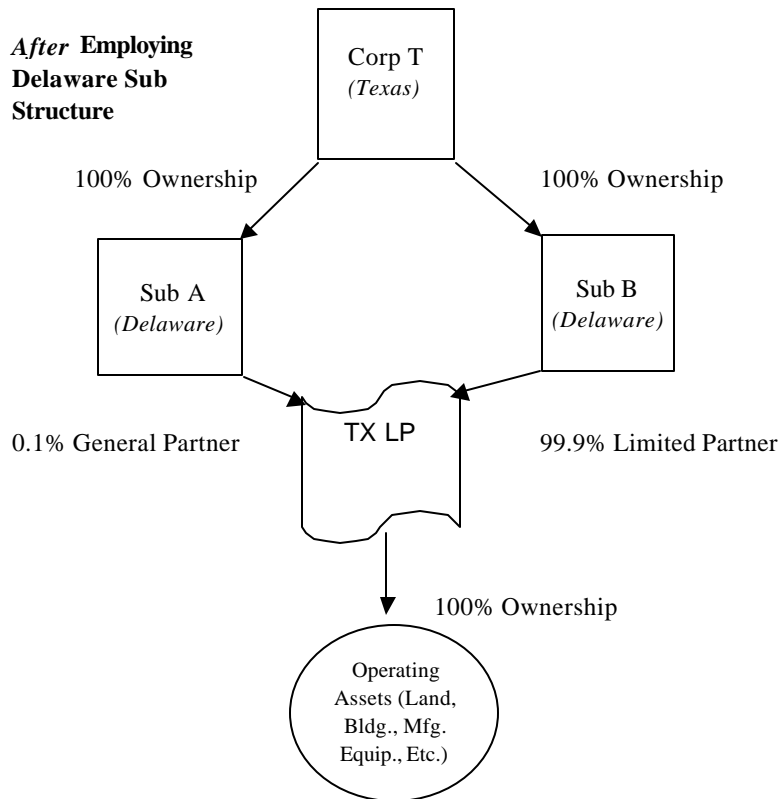
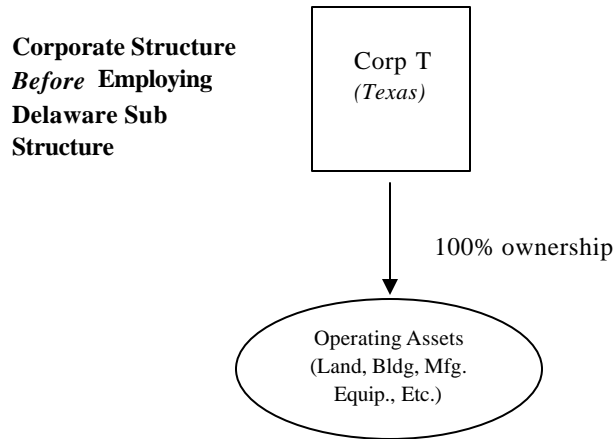
“Delaware Sub” Franchise Tax Planning Structure

Estimated Value

FY 2001: \$79 million

FY2002: \$104 million

FY2003: \$143 million



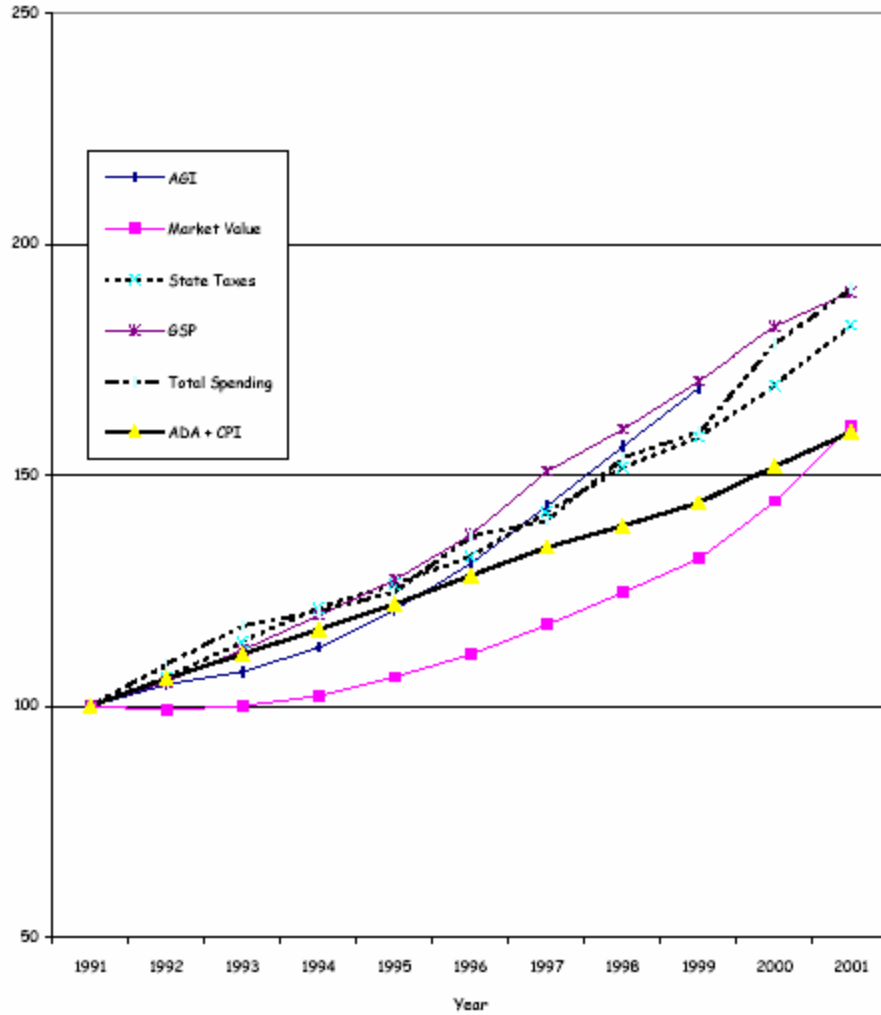
B-14. Keeping Up With School Costs: Is It a Tax Base Question?

John Kennedy, Senior Analyst, Texas Tax Payers and Research Association

Key Points in Assessing Tax Base Adequacy

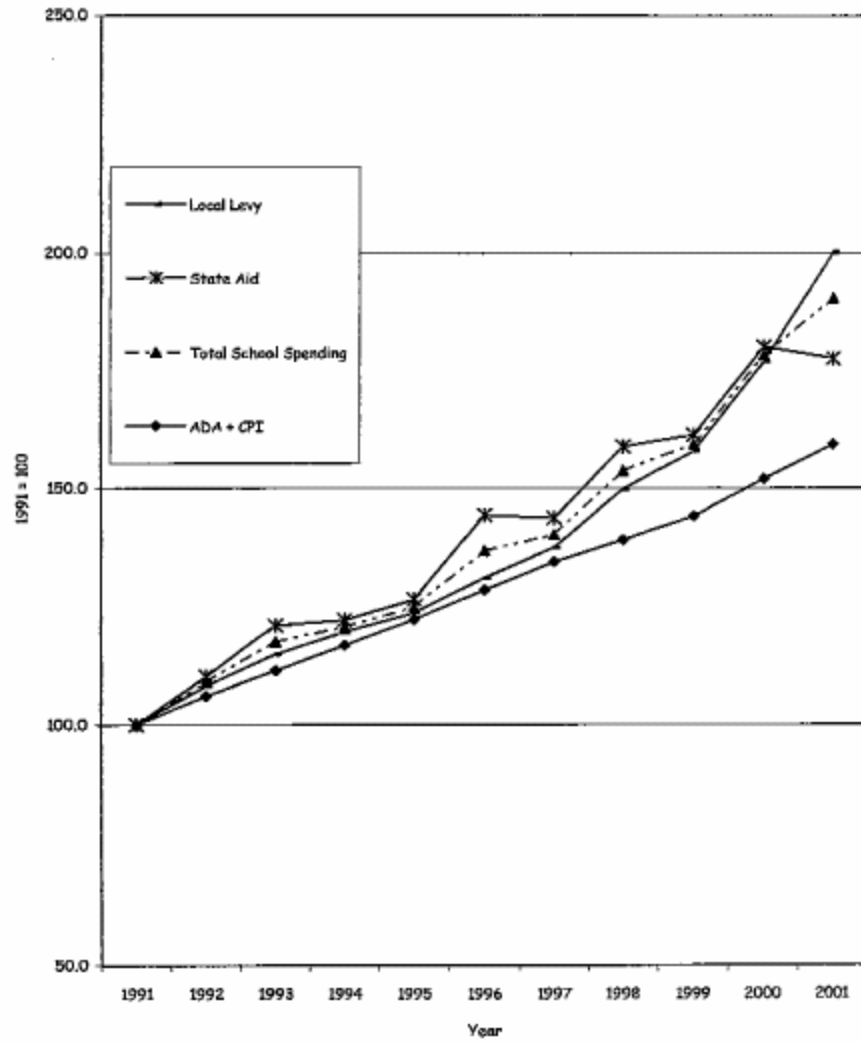
- There is no tax base that will automatically produce sufficient revenue to keep up with the combined effects of enrollment growth and inflation in addition to policy choices that increase the cost of public education.
- All the major tax bases work reasonably well during times of sustained economic growth but all struggle to keep up with spending demands during economic downturns.
- Barring some jolting economic shock, growth in revenues from the current state tax system more than keeps up with the underlying growth in school spending caused by enrollment growth and inflation.
- In recent years, the mismatch between revenue sources and school spending largely results from conscious policy decisions by the Legislature to make major program expansions, such as the salary schedule \$3,000 pay raise for teachers in 1999 and the school employee health insurance program in 2001.
- At the same time, policy choices have been made that reduce the ability of the local property tax base to carry the local load, including the \$10,000 increase in the homestead exemption, the portable over 65 tax limitation, and the 10% cap on annual increases in homestead taxable values.

Comparison of Growth Rates 1991-2001



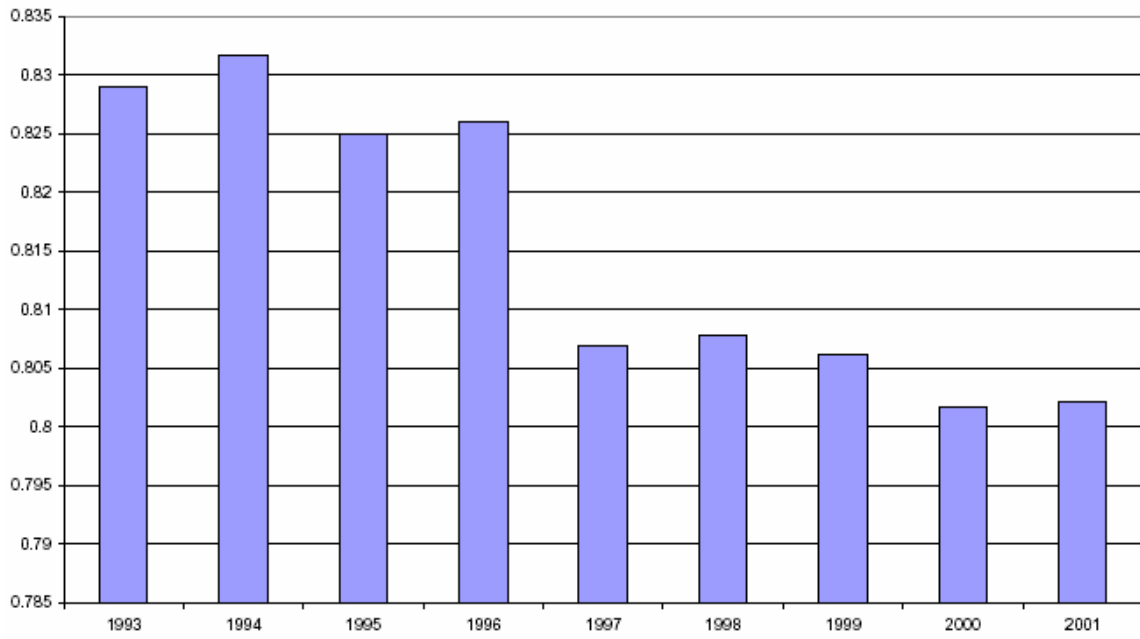
Sources: Internal Revenue Service, Statistics of Income
 Comptroller of Public Accounts, and
 Texas Education Agency

Comparison of Growth Rates 1991-2001



Sources: Comptroller of Public Accounts, and Texas Education Agency

Taxable Value as Percent of Market Value



Source: Comptroller of Public Accounts, Annual Property Tax Report, various years.

School Districts' State and Local Exemptions (Billions)

	1994	1995	1996	1997	1998	1999	2000	2001
Residential Property Market Value	295.52	315.90	334.01	354.55	379.91	414.09	465.49	521.14
\$15,000 (\$5,000) State Homestead	16.62	17.11	17.51	52.88	54.84	56.78	58.63	60.88
\$10,000 State Over-65 Homestead	9.60	9.87	10.07	9.06	9.39	9.58	10.15	10.34
State Veteran/Surviving Spouse Homestead	0.28	0.29	1.06	0.88	1.03	1.06	1.11	1.16
Local Option % Homestead	12.35	14.67	15.27	15.04	15.79	17.11	19.08	20.76
Local Option Over-65/Disabled Homestead	4.28	4.42	4.96	3.41	4.19	4.45	4.74	5.08
Over-65 Freeze Loss	13.34	18.73	19.24	13.04	14.33	15.61	17.73	21.69
10% Residential Value Cap	n/a	n/a	n/a	n/a	1.89	3.60	9.53	14.15
Tax Deferrals	0.00	0.00	0.00	0.00	0.28	0.06	0.33	0.40
Historical Designations	0.00	0.00	0.00	0.00	0.00	0.00	0.09	0.13
Total Exemptions	56.47	65.08	68.11	94.40	101.73	108.27	121.39	134.60
Residential Property Taxable Value	239.05	250.82	265.90	260.14	278.18	305.82	344.10	386.54
Percent of Residential Property Not Taxed	19%	21%	20%	27%	27%	26%	26%	26%
Business Property Market Value	348.38	356.62	374.21	399.60	417.64	433.38	460.65	514.54
Tax Abatements	9.70	9.86	9.44	5.53	3.92	2.53	1.82	1.62
Tax Increment Finance Zones (TIFs)	0.25	0.28	0.17	0.28	0.83	1.51	2.96	3.42
Freeport Exemption	2.35	2.85	3.64	4.23	4.59	5.87	7.23	10.54
Pollution Control Exemption	0.00	0.35	1.16	1.67	2.14	2.49	3.42	4.49
Miscellaneous Other	0.02	0.21	0.04	0.26	0.22	0.16	0.11	0.11
Total Exemptions	12.33	13.54	14.45	11.97	11.71	12.57	15.53	20.18
Business Property Taxable Value	336.05	343.08	359.76	387.64	405.93	420.81	445.12	494.35
Percent of Business Property Not Taxed	4%	4%	4%	3%	3%	3%	3%	4%
Farm & Ranch Land Market Value	80.72	80.40	81.37	82.18	86.07	90.61	96.69	102.73
Productivity Valuation Loss	57.31	57.69	59.05	59.94	62.72	66.46	72.59	78.20
Farm & Ranch Land Taxable Value	23.41	22.71	22.33	22.24	23.35	24.15	24.09	24.53
Percent of Farm & Ranch Land Not Taxed	71%	72%	73%	73%	73%	73%	75%	76%
Miscellaneous Property Market Value	23.62	25.51	24.53	24.93	29.53	28.16	34.18	38.80
Total Market Value	748.43	778.44	814.13	861.26	913.15	968.24	1,057.00	1,177.20
Total Exemptions	126.10	136.31	141.61	166.31	176.16	187.29	209.51	232.99
Total Taxable Value	622.33	642.13	672.52	694.95	736.98	778.95	847.49	944.22
Percent of All Property Not Taxed	17%	18%	17%	19%	19%	19%	20%	20%

Data Source: Property Tax Division, Comptroller's Office, Annual Property Value Studies and ISD Self Reports

TTARA 2/7/02

What About an Income Tax?

Constitutional Provisions:

A. "Lay your cards on the table"

"A..law...that imposes a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income, must...not take effect until approved...in a statewide referendum.... The referendum must specify the rate...."

B. 2/3 of revenue must be used for property tax rate reduction

"...not less than two-thirds of all net revenues...shall be used to reduce the rate of ad valorem maintenance and operation taxes levied for the support of primary and secondary public education."

C. Remaining revenue must be "used for education"

"The net revenues remaining...shall be used for support of education, subject to legislative appropriation, allocation, and direction."

- D. School district property tax "cap" is reduced to reflect income tax money
"The maximum rate at which a school district may impose ad valorem maintenance and operations taxes is reduced by an amount equal to one cent per \$100 valuation for each one cent per \$100 valuation that the school district's ad valorem maintenance and operations tax is reduced...."
- E. Any change in the Tax that increases revenue must be approved in a new election
"A...law...that increases the rate of the tax, or changes the tax, in a manner that results in an increase in the combined income tax liability of all persons subject to the tax may not take effect until approved...in a statewide referendum held on the question of increasing the income tax."

Consequences:

- A. Districts at the cap stay at the cap
The cap comes down to reflect the new income tax money.
- B. Local voters can approve raising the districts cap at any time
"...a school district may subsequently increase the maximum ad valorem maintenance and operation tax rate if the increased maximum rate is approved by a majority of the voters of the school district...."
- C. State share of school program goes up
- D. Individuals share of school costs go up
- E. Business share of costs go down
Business property makes up the majority of the property tax base.
- F. Over 65 homeowners get less relief than others
The over-65 freeze is based on the amount of tax paid, not the value subject to tax.

B-15. *Education Finance Adequacy*

Michael Griffith, Policy Analyst, Education Commission for the States

OVERVIEW

- Why have Adequacy Studies Become Relevant?
- What are the Systems for Determining Finance Adequacy?
- What Are the Weaknesses of Each Adequacy Study?
- What Measures Do States Use to Define an Adequate Education?
- Why Undertake An Adequacy Study?
- What States Have Undertaken Adequacy Studies?
- What Other States Are Currently Undergoing an Adequacy Study?
- Impact of These Adequacy Studies.
- Summary of Four States:
 - Mississippi Wyoming Ohio Maryland

WHEN IS EDUCATION FINANCE ADEQUATE?

- *“...schools are being adequately funded when the amount of funding provided is sufficient to allow students, schools and school systems to meet prescribed state performance standards.”*

From the Final Report to the Maryland Commission on Education, Finance, Equity and Excellence.

WHY HAVE ADEQUACY STUDIES BECOME RELEVANT?

- The situation has changed in the past few years as a result of several things:
 - *The evolution of “standards-based” reform as the approach of choice by states to improve public schools. This started with the publication of “A Nation At Risk” (1983).*
 - *The rise of school finance litigation driven by the implications of state constitutional language for the availability of adequate support for all students, not just an equitable distribution of state aid.*
 - *The development of a federal interest in student performance.*

WHAT ARE THE SYSTEMS FOR DETERMINING FINANCE ADEQUACY?

Successful Schools (Districts) Model:

This model looks at the spending of schools that meet performance standards established by the state. Certain cost are removed such as: At-Risk Funding, Food Services, Special Education and Transportation. Once these cost are removed the remaining average per-student cost for these schools is then used as the “Adequate Funding” amount.

Professional Judgment Model:

This approach uses education experts (educators, administrators and local school finance personnel) to identify resources needed to establish model schools that can achieve state education goals.

OTHER SYSTEMS FOR DETERMINING ADEQUACY:

- *Statistical Modeling*
 - This system puts state and local finance and enrollment information into a statistical formula which produces a per-student cost. (New York)
- *Whole-Schools Approach*
 - This assumes that: 1) there is a school approach that policymakers support (such as those developed by the New American Schools Development Corporation, a charter school or a private firm like Edison); 2) the cost of that approach can be determined; and 3) that such costs can be translated into a base cost figure and a series of adjustments. (New Jersey)

WHAT ARE THE WEAKNESSES OF EACH ADEQUACY STUDY?

Successful School (Districts) Model:

- Most states do not have enough successful districts/schools.
- Few, if any, successful major urban districts.
- Does not determine if any of the district are being efficient with their funding.

Professional Judgment Model:

- Professionals often construct “highest possible education” and not just “Adequate”.
- This system is tailored more to Input measures as apposed to Outcome measures.

Statistical Modeling

- Experimental Option that has not yet been used in a state.
- Once it does come on line it is difficult to explain to non-statisticians.

Whole-Schools Approach

- Has only been used in one state (New Jersey).
- Difficult to find a school approach that works.

WHAT MEASURES DO STATES USE TO DEFINE AN ADEQUATE EDUCATION?

• **Outcome Measures:**

- State Test Scores
 - *Total score*
 - *Improvement in test scores over time*
- Attendance Rate
- Graduation/Drop-out Rates

STATE MEASURES FOR AN ADEQUATE EDUCATION

WHY UNDERTAKE AN ADEQUACY STUDY?

- To comply with a court ruling (Ohio & Wyoming).
- To help align education finance systems with state accountability programs. (Illinois, Louisiana and South Carolina)
- To reevaluate the state's school finance system. (Kansas, Maryland, Mississippi, Montana, Oregon & Wisconsin)

WHAT STATES HAVE UNDERTAKEN ADEQUACY STUDIES?

ECS has found at eleven states that have undertaken adequacy studies (between 1993 & 2002), they are:

- Illinois
- Montana
- South Carolina
- Kansas
- Mississippi
- Wisconsin
- Louisiana
- Ohio
- Wyoming
- Maryland
- Oregon

- **There have been other studies that have been undertaken – but they have not been made public:**

New Hampshire

New York

North Carolina

WHAT OTHER STATES ARE CURRENTLY UNDERGOING AN ADEQUACY STUDY?

- Colorado
*Colorado School Finance Association
Successful Schools/Pro. Judgment*
- Kentucky
*State Sponsored Study
Professional Judgment*
- Nebraska
*Third Party Study
Professional Judgment*
- Montana
*State Sponsored Study
Professional Judgment*

IMPACT OF THESE ADEQUACY STUDIES:

- *For most states it is too early to tell:*
 - Six of the studies were completed between 2000 & 2002. (Kansas, Illinois, Louisiana, Maryland, Oregon and South Carolina)
- *Four states have instituted many of the recommendations in the study:*
 - Maryland (2002)
 - Mississippi (1993)
 - Ohio (1997)
 - Wyoming (1997)

MISSISSIPPI:

- *First State To Use an Adequacy Study (1993).*
- *“The Task Force on Restructuring the Minimum Education Program”, which operated out of the State Department of Education.*
- *What Drove the Study: The state wanted to review its rationale for education spending.*
- *What System Was Used: What would now be called a modified “Successful Schools” model.*
- *This system is still in use.*

WYOMING

- *What Drove the Study: Court decision: Campbell County v. State, 1995.*
- *What method was used: Professional Judgment*
- *Education Expectations: Once this program is implemented it will provide “Assured Opportunity (to all students) to Acquire Postsecondary Prerequisites.” (From the Court Ruling).*
- *Results: Per-student funding increased by 3.4% to 13.7% depending on the students grade level.*
- *Outcome: On February 23, 2001, the Wyoming Supreme Court accepted the state’s school funding system, which was based on the findings of this study, as constitutional.*

OHIO

- *What Drove the Study: Court case: DeRolph v. State, 1997*
- *What method was used: Successful Schools.*
- *Educational Expectations: Six criteria were used to select successful school districts – four different state test, drop-out rate and attendance rate.*
- *Results: A 37.5% increase in per-student funding from 1996-97 to 2001-2002.*
- *Outcome: The Supreme Court has ruled in favor of the “system” adopted by the study.*

MARYLAND

- *Two years ago the state established the Thornton Commission to review the equity and adequacy of its school finance system.*
- *The commission decided to use both the professional judgment approach and the successful school district approach (which was modified to examine successful schools since the state has so few districts).*
- *The recommendations of the study were adopted by the legislature and passed into law in April of this year.*

MARYLAND’S NEW SYSTEM

- *The new system uses a two-tiered approach (the figure from the Successful Schools approach serves as the foundation level while the figure from the Professional Judgment approach serves as the limit of the second tier).*
- *27 categorical programs were eliminated.*
- *Districts must now enter into agreements with the state about standards for student performance.*

The program will be phased in over six years with an increase in the cigarette tax being used to fund the first two years and a commission being created to recommend changes in the tax system in order to generate the funds needed in out years.

B-16. *Project Proposal*

Harrison Keller, Director, The University of Texas Charles A. Dana Center

*Estimating the Costs of a Thorough and Efficient Education System:
A New Kind of ‘Adequacy’ Study for Texas*

Policy discussions about Texas school finance have traditionally focused on considerations of equity, measured in terms of the distribution of funds available to school districts. In other states, however, the availability of detailed data on student achievement has shifted the focus of policy discussions—and litigation—away from considerations of “equity” and towards considerations of “adequacy” for achieving certain results in terms of student performance. The Texas Supreme Court’s decision in *Edgewood Independent School District v. Meno* (917 S.W. 2d 717), as well as the fact that Texas collects and makes available richer data about the finances and performance of its schools than any other state, suggests that the next round of school finance reform in Texas should be framed in terms of adequacy.

There are four recognized approaches to estimating the costs of producing certain levels of student achievement, each of which has been applied in other states.

- *The statistical approach.* This approach uses statistical analyses of data on school and/or district spending and performance to infer the cost of producing certain outcomes. It can include statistical controls for the characteristics of students and districts, and it can be used to generate data about school district efficiency. It is similar to the approach used to construct the Texas cost-of-education index and was applied in part in the Dana Center’s study of methods for adjusting district funding to reflect uncontrollable cost variations.
- *The successful schools approach.* This approach defines a level of performance, such as accountability ratings of “exemplary,” then examines the average expenditures of schools or districts that achieve the desired results. The Legislative Budget Board plans to include a basic version of this approach in their current fiscal studies.
- *The professional judgment approach.* This approach relies on the judgment of focus groups of educators to design model schools or districts that incorporate best practices with regard to management and instruction. Prices of the various elements of the model schools and districts are then estimated using statistical approaches, including adjustments for student and district characteristics.
- *The comprehensive school reform approach.* This approach, which is a version of the professional judgment approach, examines the levels of resources expended by schools and districts to implement various school reform models, such as Success for All/Roots and Wings. The price of producing certain levels of student achievement is inferred to be equal to the price of implementing programs like these that have been proven to improve student achievement.

Each of these approaches has certain strengths and limitations. *The statistical approach* can be used to create formulas that are sensitive to a wide range of factors that are beyond the control of school district officials. It can also be used to quantify the efficiency of schools and districts. It is more complex than the other three approaches, however, and is limited by the availability of data on the results that schools produce. *The successful schools approach* is easier for non-specialists to grasp. But, it ignores factors other than student performance that may influence district costs, as well as factors that may influence student performance. To compensate for this limitation, researchers who apply this approach usually incorporate adjustments derived in other studies in their recommendations. *The professional judgment approach* is arguably more sensitive to a range of outcomes that are not easily quantified, and it has proven particularly useful in states that lack rich data on the financing and performance of their public schools. However, this approach typically produces very high cost-estimates, and the relationship implied between the resources identified and the outcomes in question is speculative. *The comprehensive school reform approach* has the advantage of being connected to strategies that have been proven to improve student achievement. However, it is based on the questionable assumption that resources generally required to implement certain reforms will be universally appropriate.

A comparative adequacy study for Texas

The Charles A. Dana Center at The University of Texas at Austin proposes to conduct a comparative adequacy study for Texas that consists of four major components, working with a team of leading economists, educators, and education policy researchers. Several nationally recognized experts, including developers of each of the four recognized approaches for examining interactions between educational improvement and school finance, will serve as technical advisors. Over a two-year period, the Dana Center and its partners will:

1. Work with educators, policymakers, business leaders, and members of the public to specify *three sets of outcomes* that are measurable using Texas data, are aligned with federal requirements, and reflect the education goals of the state;
2. Conduct a landmark benchmarking analysis of *cost-effective schools and school districts*, to derive cost-estimates that include analyses of efficiency;
3. Conduct a *comparative analysis* of two approaches for connecting the financing and performance of schools, to generate ranges of projected costs; and
4. Construct a *dynamic computer model* that allows users to explore the fiscal implications of using the research findings to revise Texas school finance formulas.

Each of these components will produce major deliverables and is a major project in its own right. Together, they will generate a comprehensive set of peer-reviewed policy recommendations and technical tools for revising the Texas school finance formulas for Maintenance and Operations. A short description of each component follows.

Specifying multiple sets of outcomes

In most states, researchers have applied one or two of the approaches outlined above (most commonly, the successful schools approach and/or the professional judgment approach) to estimate the costs of producing certain levels of student achievement. In the Texas adequacy study, researchers will specify three *sets* of outcomes. They will then apply and extend the successful schools approach and the statistical approach to estimate *ranges* of costs associated with producing these results.

- a. *Statutory requirements:* The first set of outcomes for which the team will generate cost estimates will be those associated with current statutory requirements, including the implementation of TAKS, curbs on social promotion, the implementation of the Recommended High School Program as the default high school program, and new federal requirements as a consequence of *The No Child Left Behind Act of 2001*.
- b. *Public expectations:* The second set of outcomes will be derived from a Deliberative Poll, to be conducted in cooperation with the Center for Deliberative Polling at The University of Texas at Austin. Researchers will first poll a representative sample of Texans about their views towards public education, with an emphasis on school finance issues. Participants in the poll will then be invited to convene for a weekend to deliberate with each other and to interact with policymakers and education experts. At the end of the weekend, participants will be polled again to measure any changes in their views.
- c. *Professional judgment:* The third and final set of outcomes for which the team will generate cost estimates will emerge from a modified version of the professional judgment approach. The research team will convene education experts, business leaders, and others to specify educational outcomes that reflect the knowledge and skills required for the 21st century Texas workforce.

The use of multiple sets of outcomes will be most distinctive component of the Texas adequacy study, which will for the first time allow researchers and policymakers to make direct comparisons across different conceptions of—and different cost estimates for—public education. In addition, the use of the Deliberative Poll will provide new data on what Texans expect from their public schools—and about how those expectations might change with more information. Finally, the specification of multiple sets of outcomes will allow the research team to shed light on questions about the marginal costs of raising standards.

Benchmarking cost-effective schools and school districts

To date, none of the adequacy studies conducted in other states have included direct estimations of the efficiency and productivity of schools and districts. For example, the “successful schools” approach as applied thus far yields data about the *average* spending of different types of schools or districts meeting certain performance thresholds. In the Texas study, however, researchers will investigate the *cost-effectiveness* of different types of schools and districts.

Besides informing its cost estimates, the team’s research findings about schools’ and districts’ efficiency and productivity could potentially be useful in two other ways. *First*, these findings could be used to establish a system for identifying and rewarding cost-effective schools and districts. *Second*, follow-up studies of the budgeting and resource allocation practices of these schools and districts would allow researchers to catalogue cost-effective practices for addressing particular challenges, such as dropout reduction or increasing the numbers and diversity of students completing advanced courses.

Comparing across approaches

Another distinctive component of the Texas adequacy study will involve the concurrent application and extension of two approaches for connecting the financing and performance of schools: *the successful schools approach* and *the statistical approach*. Most states lack the necessary data to apply these two approaches and have therefore relied on less direct and data-intensive approaches, namely the professional judgment approach and the comprehensive school reform approach. But Texas’ rich data on the financing and performance of its schools will allow researchers to test standard hypotheses about connections among school finance policy and student performance. It is possible—although extremely unlikely—that the application of these two approaches to three sets of educational outcomes will result in a single cost estimate, with a single set of cost adjustments. More likely, it will generate *ranges* of cost estimates and adjustments, because each approach is sensitive to different kinds of considerations. Previous analyses in Texas, including the Dana Center-led study of cost indexing strategies, suggest that these cost estimates will range from amounts close to what the state and local districts currently spend to higher amounts associated with producing different kinds of results.

Dynamic computer modeling

In the final phase of the project, the researchers will develop a dynamic computer model that brings their findings into dialogue with the Texas school finance system. This model will allow users to explore the potential fiscal implications of the study’s findings and recommendations, including how the costs of implementation might change over time. This part of the project will extend a current Dana Center-led project to develop a dynamic computer model of the Texas school finance system.

B-17. History of Cost Studies in Texas

Joe Wisnoski, Assistant Commissioner for School Finance and Fiscal Analysis,
Texas Education Agency

Cost studies have been in law in Texas since at least 1984. The study charges have been amended numerous times, and the body charged with conducting the studies has also changed.

1984

HB 72 charged the State Board of Education (SBOE) with the Price Differential Index (PDI) study with assistance of comptroller and advisory committee. (The PDI was a predecessor to the cost of education index or CEI.) The SBOE adopted rules for computation of the PDI.

HB 72 also charged the SBOE with study of "**average accountable costs to school districts in providing quality education programs, personnel, and facilities that meet the accreditation standards prescribed by law and rule.**"

1987

SBOE continued to be charged with the PDI study with assistance of the state comptroller and an advisory committee. The SBOE was required to adopt rules for the PDI.

The SBOE was charged with a study of "**minimum basic accountable costs** per student to school districts in providing quality education programs, personnel, and facilities that meet the accreditation standards prescribed by law and rule."

Statute directed that the Legislature "**shall consider the recommendations** and report of the State Board of Education" in adopting the amount of the basic, special and transportation allotments.

1989

The Cost of Education Index (CEI) replaced PDI. The SBOE was still charged to adopt rules regarding the CEI.

The law also charged the SBOE with study of:

- (1) ***minimum basic accountable costs per student to school districts of providing education programs, personnel, and other operating costs that meet the accreditation standards prescribed by law and rule...***;
- (2) ***the estimated costs per student to school districts of providing exemplary education....that exceed basic accreditation levels;***
- (3) ***the costs of implementing the long-range plan for public school education...***;

- (4) *facility and debt service costs necessary to provide for both current and projected facilities for public schools...;*
- (5) *basic accountable costs per student for each programmatic area that is recognized by the Foundation School Program; and*
- (6) *the basic accountable costs of transportation."*

Statute directed that Legislature “shall consider the recommendations and report of the State Board of Education” in adopting the amount of the basic, special and transportation allotments.

1990

In special session, the responsibility for studies was **moved to the Legislative Education Board (LEB) and the Legislative Budget Board (LBB)**. The LEB was directed to adopt rules for the calculation of the qualified funding elements, which included:

- " (1) *a basic allotment...that represents the cost per student of a regular education program that meets the basic criteria for an accredited program including all mandates of law and regulation;*
- (2) *the formula or other provision for the cost of education index designed to reflect the geographic variation in known resource costs and costs of education beyond the control of school districts...;*
- (3) *appropriate program cost differentials and other funding elements..., with the program funding level expressed as dollar amounts and as weights applied to the adjusted basic allotment for the appropriate year;*
- (4) *the maximum guaranteed level of qualified state and local funds per student for the purposes of Subchapter H of this chapter that represents the costs as determined and limited under Subchapter F of this chapter for exemplary programs including the cost of facilities and equipment until such time as a funding formula for capital outlay and debt service is adopted under Subchapter I...;*
- (5) *the total tax rates for the local funding requirements..., including tax rates for capital outlay and debt service ...;*
- (6) *the formula elements for the funding formula for capital outlay and debt service...."*

The LEB and LBB were charged with certain biennial studies, which included:

- (1) *a study of the fiscal neutrality of the system...;*
- (2) *the accountable costs per student to school districts of providing educational programs, personnel, and other operating costs that meet accreditation criteria and the provisions of law and regulation;*

- (3) *a cost of education index designed to reflect the geographic variation in known resource costs and costs of education due to factors beyond the control of school districts;*
- (4) *program cost differentials designed by program to provide support for the added expense of high-cost courses or programs for students participating..., with the program funding level expressed as dollar amounts and as weights applied to the adjusted basic allotment...;*
- (5) *transportation and career ladder allotments;*
- (6) *the accountable costs per student to districts rated as exemplary...for the provision of personnel, programs, and other operating expenses, with the limitation that for the 1993-1994 and the 1994-1995 school years this level may not be less than 95 percent nor more than 100 percent of the 95th percentile of state and local revenue per pupil;*
- (7) *the levels of tax effort necessary for each tier...; and*
- (8) *capital outlay and debt service requirements and formula elements...”*

The **Foundation School Fund Budget Committee (FSFBC)** was charged with **adopting rules for calculation of the funding elements**, including CEI and program cost differentials. The funding elements to be adopted by the FSFBC mirror the LEB funding elements.

1991

The LEB again was charged with determining the equalized funding elements, and the FSFBC was charged with adoption of rules for the calculation of the elements:

- (1) *a basic allotment...that represents the cost per student of a regular education program that meets the basic criteria for an accredited program including all mandates of law and regulation;*
- (2) *adjustments designed to reflect the geographic variation in known resource costs and costs of education beyond the control of school districts;*
- (3) *appropriate program cost differentials and other funding elements..., with the program funding level expressed as dollar amounts and as weights applied to the adjusted basic allotment for the appropriate year;*
- (4) *the maximum guaranteed level of qualified state and local funds per student for the purposes of Subchapter H of this chapter;*
- (5) *the enrichment and facilities tax rate under Subchapter H of this chapter;*
- (6) *the formula elements for the funding formula for capital outlay and debt service...*
- (7) *the calculation of weighted students in average daily attendance....”*

1993

The LEB was abolished, and the LBB was charged with adoption of equalized funding elements to be provided to the FSFBC, which adopted rules for the calculation of the elements:

- (1) *a basic allotment...that represents the cost per student of a regular education program that meets the basic criteria for an accredited program including all mandates of law and regulation;*
- (2) *adjustments designed to reflect the variation in known resource costs and costs of education beyond the control of school districts;*
- (3) *appropriate program cost differentials and other funding elements..., with the program funding level expressed as dollar amounts and as weights applied to the adjusted basic allotment for the appropriate year;*
- (4) *the maximum guaranteed level of qualified state and local funds per student for the purposes of Subchapter H of this chapter;*
- (5) *the enrichment and facilities tax rate under Subchapter H of this chapter;*
- (6) *the formula elements for the funding formula for capital outlay and debt service...*
- (7) *the calculation of weighted students in average daily attendance....”*

The funding elements were essentially unchanged from the previous law. In addition, the CEI was set to the index adopted by the FSFBC in December 1990, except that the diseconomies of scale component was set to 1.00.

1995

The LBB was charged with adoption of equalized funding elements to be provided to the FSFBC, which adopted rules for the calculation of the elements:

- (1) *a basic allotment...that, when **combined with the guaranteed yield component**..., represents the cost per student of a regular education program that meets all mandates of law and regulation;*
- (2) *adjustments designed to reflect the variation in known resource costs and costs of education beyond the control of school districts;*
- (3) *appropriate program cost differentials and other funding elements..., with the program funding level expressed as dollar amounts and as weights applied to the adjusted basic allotment for the appropriate year;*
- (4) *the maximum guaranteed level of qualified state and local funds per student for the purposes of Subchapter F;*
- (5) *the enrichment and facilities tax rate under Subchapter F;*

- (6) *the calculation of weighted students in average daily attendance...;*
- (7) *the amount to be appropriated for the school facilities assistance program under Subchapter H.”*

In addition, the CEI was set to the index adopted by the FSFBC in December 1990, except that the diseconomies of scale component was set to 1.00.

1997

The FSFBC was abolished, and the LBB was charged with adopting rules for the equalized funding elements:

- (1) *a basic allotment...that, when combined with the guaranteed yield component..., represents the cost per student of a regular education program that meets all mandates of law and regulation;*
- (2) *adjustments designed to reflect the variation in known resource costs and costs of education beyond the control of school districts;*
- (3) *appropriate program cost differentials and other funding elements..., with the program funding level expressed as dollar amounts and as weights applied to the adjusted basic allotment for the appropriate year;*
- (4) *the maximum guaranteed level of qualified state and local funds per student for the purposes of Subchapter F;*
- (5) *the enrichment and facilities tax rate under Subchapter F;*
- (6) *the computation of weighted students in average daily attendance...;*
- (7) *the amount to be appropriated for the school facilities assistance program under Chapter 46.”*

In addition, the CEI was set to the index adopted in FSFBC rule as that rule existed on March 26, 1997.

1999

LBB was charged with adopting equalized funding elements:

- (1) *a basic allotment...that, when combined with the guaranteed yield component..., represents the cost per student of a regular education program that meets all mandates of law and regulation;*
- (2) *adjustments designed to reflect the variation in known resource costs and costs of education beyond the control of school districts;*

- (3) *appropriate program cost differentials and other funding elements..., with the program funding level expressed as dollar amounts and as weights applied to the adjusted basic allotment for the appropriate year;*
- (4) *the maximum guaranteed level of qualified state and local funds per student for the purposes of Subchapter F;*
- (5) *the enrichment and facilities tax rate under Subchapter F;*
- (6) *the computation of weighted students in average daily attendance...;*
- (7) *the amount to be appropriated for the school facilities assistance program under Chapter 46.”*

LBB was also charged with a determination of the projected cost to the state of ensuring that each district be able to maintain existing programs without increasing property tax rates.

2001

LBB was charged with adopting equalized funding elements:

- (1) *a basic allotment...that, when combined with the guaranteed yield component..., represents the cost per student of a regular education program that meets all mandates of law and regulation;*
- (2) *adjustments designed to reflect the variation in known resource costs and costs of education beyond the control of school districts;*
- (3) *appropriate program cost differentials and other funding elements..., with the program funding level expressed as dollar amounts and as weights applied to the adjusted basic allotment for the appropriate year;*
- (4) *the maximum guaranteed level of qualified state and local funds per student for the purposes of Subchapter F;*
- (5) *the enrichment and facilities tax rate under Subchapter F;*
- (6) *the computation of weighted students in average daily attendance...;*
- (7) *the amount to be appropriated for the school facilities assistance program under Chapter 46.”*

LBB was also charged with a determination of the projected cost to the state of ensuring that each district be able to maintain existing programs without increasing property tax rates.

- B-18. *Kansas School Finance and Cost of a Suitable Education**
Dale Dennis, Deputy Commissioner, Kansas State Department of Education
*copies of this report are available upon request

B-19. Per Capita Expenditures
Texas Education Agency

Year	Total State & Local Revenue	Total State Revenue	State & Local Revenue per ADA	State Revenue per ADA	State Revenue per WADA
1985-86		\$4,687,846,416		\$1,600	
1986-87		\$4,815,754,489		\$1,617	
1987-88		\$4,854,695,592		\$1,620	
1988-89		\$4,921,737,281		\$1,623	
1989-90	\$11,126,269,258	\$5,152,046,155	\$3,612	\$1,672	
1990-91	\$12,290,063,644	\$5,788,335,227	\$3,985	\$1,877	
1991-92	\$9,219,536,481	\$6,330,822,881	\$2,904	\$1,994	
1992-93	\$9,858,696,325	\$6,911,157,190	\$3,053	\$2,140	\$1,648
1993-94	\$15,842,364,371	\$7,268,099,457	\$4,803	\$2,204	\$1,691
1994-95	\$16,398,801,724	\$7,520,074,093	\$4,883	\$2,239	\$1,704
1995-96	\$17,636,047,832	\$8,307,858,341	\$5,144	\$2,423	\$1,836
1996-97	\$18,507,438,234	\$8,589,725,793	\$5,277	\$2,449	\$1,848
1997-98	\$19,379,445,162	\$9,118,276,418	\$5,422	\$2,551	\$1,916
1998-99	\$20,090,021,957	\$8,944,021,832	\$5,545	\$2,468	\$1,849
1999-00	\$22,536,094,196	\$10,622,105,258	\$6,135	\$2,892	\$2,141
2000-01	\$23,758,965,866	\$10,518,408,306	\$6,375	\$2,823	\$2,089
2001-02	\$25,403,926,081	\$10,488,613,816	\$6,670	\$2,754	\$2,043
2002-03	\$26,393,338,845	\$10,930,620,612	\$6,796	\$2,814	\$2,118

Limited Sales and Use Tax

The sales and use tax is the largest source of tax revenue for Texas state government, bringing in about 55 cents of every state tax dollar. The sales tax is a tax on transactions. In general, it is imposed on final sales, rentals, and leases of tangible personal property—physical goods—and on sales of some services, such as the repair of tangible personal property, amusements, and telephone services.

While total sales and use tax collections were \$13.9 billion in fiscal 2000, the tax is limited in scope compared to the total number and kind of transactions in the economy. The tax is limited by a host of exemptions and exclusions. For simplicity, this tax will be referred to as the "sales tax" throughout the remainder of this discussion.

Classifying sales tax exemptions

Sales tax exemptions can be divided into three general categories: exemptions, exclusions, and discounts. Estimates of these costs are provided in Table 1.

An *exemption* protects items that would be taxable except for specific provisions in the law. For example, since the Texas sales tax law taxes all sales of tangible personal property, groceries would be taxable if they were not specifically exempted.

Exclusions are transactions not taxed because they fall outside the general legal definition of a taxable sale. Exclusions include sales of intangibles, such as stocks and bonds, and sales and rentals of real property. Currently, only certain specified services are under the sales tax.

Discounts are handling fees that Texas law allows tax-permit holders to keep in exchange for collecting the sales tax and sending it to the state on time. The standard timely filer discount is 0.5 percent of the sales tax collected. An additional 1.25 percent discount is available to those who pay their estimated taxes in advance.

Exemptions are provided for certain basic necessities, such as groceries, residential gas and electric utilities, and prescription and over-the-counter drugs. Some sales are exempted when made to certain groups. For

Table 1
Cost of Sales Tax Exemptions, Exclusions, and Discounts
Fiscal 2001 to 2006
(in millions of dollars)

	2001	2002	2003	2004	2005	2006
Exemptions	\$18,231.5	\$19,187.1	\$20,161.5	\$21,310.1	\$22,546.1	\$23,833.5
Exclusions	4,054.4	4,297.6	4,558.0	4,861.1	5,183.0	5,561.8
Discounts	<u>116.7</u>	<u>120.5</u>	<u>126.7</u>	<u>132.9</u>	<u>138.2</u>	<u>143.7</u>
Total	\$22,402.6	\$23,605.2	\$24,846.2	\$26,304.1	\$27,867.3	\$29,539.0

Note: Totals may not add due to rounding.

Table 2
Cost of Sales Tax Exemptions
Fiscal 2001 to 2006
(in millions of dollars)

Section	Exemption	2001	2002	2003	2004	2005	2006
151.302	Sale for resale	cbe	cbe	cbe	cbe	cbe	cbe
151.303	Previously taxed items	cbe	cbe	cbe	cbe	cbe	cbe
151.304	Occasional sales	cbe	cbe	cbe	cbe	cbe	cbe
151.305	Coin-operated machine sales	negligible	negligible	negligible	negligible	negligible	negligible
151.306	Transfers of common interests in property	cbe	cbe	cbe	cbe	cbe	cbe
151.307	Exemptions required by prevailing law	cbe	cbe	cbe	cbe	cbe	cbe
151.3071	Installation of certain equipment for export	negligible	negligible	negligible	negligible	negligible	negligible
151.308	Items taxed by other law						
	Crude oil	0.0	0.0	0.0	0.0	0.0	0.0
	Motor vehicles	\$2,417.1	\$2,523.1	\$2,635.8	\$2,780.8	\$2,947.7	\$3,127.5
	Motor fuels	1,125.1	1,185.2	1,255.8	1,334.8	1,418.0	1,507.4
	Mixed drinks	186.9	192.7	197.8	202.3	208.0	213.6
	Cement	0.0	0.0	0.0	0.0	0.0	0.0
	Sulphur	0.0	0.0	0.0	0.0	0.0	0.0
	Aviation fuel	68.3	73.1	78.2	83.7	89.3	95.3
	Oil well services	20.2	19.2	18.2	17.3	16.4	15.6
	Insurance premiums	2,589.8	2,706.3	2,801.0	2,885.0	2,957.2	3,019.3
151.309	Sales to governmental entities	197.3	206.9	218.5	231.1	245.1	260.6
151.310	Religious, educational/public service organizations						
	Sales to nonprofits	16.1	17.2	18.3	19.5	20.8	22.4
	One day sales	3.7	3.9	4.2	4.5	4.8	5.1
151.3101	Amusement services	cbe	cbe	cbe	cbe	cbe	cbe
151.311	Property used for the improvement of exempt realty	15.5	16.1	16.8	17.7	18.8	20.0
151.3111	Certain personal property	cbe	cbe	cbe	cbe	cbe	cbe
151.312	Nonprofit or religious periodicals and writings	4.8	5.1	5.4	5.8	6.1	6.6
151.313	Health care supplies						
	Prescription medicine and devices	182.5	200.7	220.8	242.9	267.1	293.9
	Over-the-counter drugs	136.5	145.0	154.3	164.2	174.3	184.7
151.314	Food						
	Food for home consumption	1,142.0	1,184.6	1,227.4	1,272.7	1,315.9	1,368.4
	School lunches and certain food sales	34.7	36.9	39.3	41.9	44.7	48.0
151.3141	Food stamp purchases	124.0	132.0	140.4	149.7	159.9	171.8
151.315	Water	210.1	214.9	219.4	224.6	230.3	236.4
151.316	Agricultural items						
	Agricultural feed, seed, chemicals and supplies	230.2	232.3	234.3	238.7	244.7	250.5
	Livestock for food	12.3	12.4	12.5	12.8	13.1	13.4
	Agricultural machinery and equipment	52.1	52.6	53.0	54.0	55.4	56.7
	Horses, mules and work animals	8.4	8.5	8.6	8.7	9.0	9.2
	Commercial fishing ice	0.1	0.1	0.1	0.1	0.1	0.1
151.3161/2	Timber operations (equipment)	2.6	5.2	6.5	8.8	10.6	13.7
151.317	Gas and electricity						
	Manufacturing	375.3	377.7	379.4	387.7	402.3	415.8
	Residential	520.0	530.5	539.6	549.8	562.6	577.3
	Agricultural	13.5	13.4	13.2	13.1	13.1	13.2
	Mining	36.9	36.5	36.0	35.6	35.7	35.9
151.318	Manufacturing						
	Materials used in manufacturing	7,535.7	8,020.6	8,523.5	9,137.2	9,800.8	10,484.7
	Manufacturing machinery and equipment	497.9	529.9	563.1	603.7	647.6	692.8
	Packaging and wrapping supplies	109.1	116.1	123.4	132.2	141.9	151.8
	Film equipment (151.3185)	*	*	*	*	*	*

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Section	Exemption	2001	2002	2003	2004	2005	2006
151.319	Newspapers						
	Newspapers	16.8	17.9	19.0	20.4	21.9	23.4
	Newspaper inserts	22.8	24.2	25.8	27.6	29.6	31.7
	Newspaper manufacturing equipment	**	**	**	**	**	**
151.320	Magazine subscriptions	6.1	6.5	7.0	7.4	7.9	8.5
151.321	University student organizations	negligible	negligible	negligible	negligible	negligible	negligible
151.322	Containers	84.8	90.2	95.9	102.8	110.3	118.0
151.323	Certain telecommunications services	cbe	cbe	cbe	cbe	cbe	cbe
151.324	Mineral exploration						
	Certain drilling equipment	24.2	24.5	25.4	26.3	27.4	28.5
151.325	Internet access service (partial)	11.4	13.1	15.1	17.3	20.0	22.9
151.326	Clothing and footwear holiday	31.2	33.2	35.3	37.6	40.2	43.2
151.328	Aircraft						
	Certain aircraft	negligible	negligible	negligible	negligible	negligible	negligible
	Repair equipment for certain aircraft	16.3	17.5	18.9	20.6	22.5	24.5
151.329	Certain ships	34.0	36.5	39.5	43.0	46.9	51.1
151.3291	Boats and boat motors	52.7	56.1	59.7	63.7	68.0	73.0
151.330	Interstate shipments	cbe	cbe	cbe	cbe	cbe	cbe
151.331	Rolling stock						
	Railroad fuel and supplies	6.4	6.8	7.4	8.1	8.8	9.6
	Rolling stock and locomotives	1.9	2.1	2.3	2.5	2.7	2.9
151.332	Senior citizen organizations	negligible	negligible	negligible	negligible	negligible	negligible
151.335	Coin-operated services	34.8	37.0	39.4	42.0	44.8	48.2
151.336	Certain coins and metals	negligible	negligible	negligible	negligible	negligible	negligible
151.337	Sales by or to Indian tribes	cbe	cbe	cbe	cbe	cbe	cbe
151.338	Environment and conservation services	cbe	cbe	cbe	cbe	cbe	cbe
151.340	Official state coin	negligible	negligible	negligible	negligible	negligible	negligible
151.341	Development corporations	negligible	negligible	negligible	negligible	negligible	negligible
151.342	Agribusiness (agricultural containers)	0.4	0.4	0.4	0.4	0.4	0.4
151.343	Animal shelters	negligible	negligible	negligible	negligible	negligible	negligible
151.346	Intercorporate sales of services	cbe	cbe	cbe	cbe	cbe	cbe
151.347	Lawn and yard	negligible	negligible	negligible	negligible	negligible	negligible
151.348	Cooperative research ventures	cbe	cbe	cbe	cbe	cbe	cbe
151.349	Texas National Laboratory	0.0	0.0	0.0	0.0	0.0	0.0
151.350	Labor to restore property	cbe	cbe	cbe	cbe	cbe	cbe
151.351	Data processing and info. services. (partial)	14.9	17.8	21.0	24.4	28.3	30.4
151.353	Court reporting	negligible	negligible	negligible	negligible	negligible	negligible
151.354	Property management	negligible	negligible	negligible	negligible	negligible	negligible
151.429	Equipment used in enterprise projects	4.2	4.4	4.7	5.0	5.3	5.7
151.4921	Defense readjustment	cbe	cbe	cbe	cbe	cbe	cbe
151.431	Job retention	negligible	negligible	negligible	negligible	negligible	negligible
151.432	Ticket resellers	negligible	negligible	negligible	negligible	negligible	negligible
	Total	\$18,231.5	\$19,187.1	\$20,161.5	\$21,310.1	\$22,546.1	\$23,833.5

* Included in estimates of manufacturing items under Sec. 151.318.
 ** Included in the estimate of manufacturing machinery and equipment under Sec. 151.318.

Note: Totals may not add due to rounding.

Table 3
Cost of Selected Service Exclusions from the Sales Tax
Fiscal Years 2001 to 2006
(in millions of dollars)

	2001	2002	2003	2004	2005	2006
Construction labor						
New residential construction	\$252.5	\$261.5	\$273.4	\$288.1	\$305.6	\$325.6
New nonresidential construction	216.3	224.0	234.2	246.8	261.7	278.9
Residential repair and remodeling	81.8	84.7	88.6	93.3	99.0	105.4
Personal services						
Barber and beauty services	48.3	51.5	54.7	58.4	62.3	67.1
Funeral	42.7	45.2	47.7	50.6	53.5	56.7
Child day care	144.3	150.5	157.2	164.4	171.8	179.5
Miscellaneous personal services	12.8	13.6	14.6	15.7	17.0	18.4
Business and professional services						
Physicians services	547.9	583.8	620.7	663.1	707.4	761.2
Dental services	176.2	187.8	199.6	213.3	227.5	244.8
Other health care	293.6	312.8	332.5	355.3	379.0	407.9
Legal services	346.1	368.8	392.1	418.9	446.9	480.9
Accounting and audit services	168.2	179.2	190.5	203.6	217.2	233.7
Architectural and engineering services	245.0	261.0	277.5	296.5	316.3	340.3
Management consulting and public relations	87.0	92.7	98.6	105.3	112.3	120.9
Contract computer programming	89.4	95.3	101.3	108.2	115.5	124.3
Research and development laboratory services	36.8	39.2	41.6	44.5	47.5	51.1
Economic and sociological research	15.4	16.4	17.4	18.6	19.8	21.3
Testing labs	36.6	39.0	41.5	44.3	47.3	50.9
Advertising media	161.1	171.8	182.6	195.0	207.8	221.4
Employment agency services	25.5	27.2	28.9	30.9	32.9	35.4
Temporary labor supply	44.5	47.4	50.4	53.8	57.4	61.8
Financial services brokerage	176.8	188.4	200.2	213.9	227.9	242.9
Other financial services	66.0	68.9	72.6	77.1	82.1	87.9
Real estate brokerage and agency	164.4	171.6	180.9	192.0	204.4	218.8
Freight hauling	213.5	229.7	248.8	271.5	295.7	322.1
Other transportation (except scheduled passenger)	13.2	14.1	14.9	16.0	17.0	18.3
Veterinary Services	27.4	29.1	31.0	33.0	35.3	37.9
Other Services						
Automotive maintenance and repair	221.0	235.5	250.3	267.5	285.3	307.0
Car washes	19.0	20.2	21.5	23.0	24.5	26.4
Travel arrangement	30.7	32.7	34.8	37.1	39.6	42.6
Private vocational education	23.1	24.6	26.2	28.0	29.8	32.1
Other private educational services	21.6	23.1	24.5	26.2	27.9	30.1
Interior design	5.9	6.3	6.7	7.2	7.7	8.3
Total	\$4,054.4	\$4,297.6	\$4,558.0	\$4,861.1	\$5,183.0	\$5,561.8

Note: Totals may not sum because of rounding.

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Table 1
Cost of Franchise Tax Exemption, Deductions, Special Accounting Methods, and Credits
Fiscal 2001 to 2006
(in millions of dollars)

	2001	2002	2003	2004	2005	2006
Exemptions: For-Profit Corps	\$344.0	\$361.1	\$380.7	\$403.0	\$427.6	\$454.1
Exemptions: Non-Profit Corps	293.3	301.1	309.4	318.7	328.4	338.2
Deductions	503.5	518.3	531.8	549.5	570.5	593.6
Special Accounting Methods	37.7	39.6	41.2	43.5	46.2	49.3
Credits and Refunds	<u>144.2</u>	<u>223.3</u>	<u>237.4</u>	<u>261.5</u>	<u>279.7</u>	<u>299.8</u>
Total	\$1,322.7	\$1,443.4	\$1,500.6	\$1,576.1	\$1,652.4	\$1,735.0

Note: Totals may not add due to rounding.

One reason for granting special deductions or exclusions is to promote certain activities or behavior. For example, to encourage the development of solar energy sources, the Legislature has permitted firms to exclude from their tax base their purchases of qualifying solar energy devices.

Some deductions or exclusions may be granted to prevent the taxation of items exempt from taxation under federal law, such as interest income on U.S. Treasury securities. Other deductions or exclusions grant tax relief to small firms, such as the provision that allows small corporations to exclude executive compensation from their earned surplus tax base.

Special accounting rules. A special accounting rule allows a qualifying firm to use an accounting or computation method not available to all other franchise taxpayers. The special accounting rule may be designed to relieve small firms of certain accounting burdens. Also, in the same manner as a deduction or exclusion, a special accounting rule may be used to encourage certain activities. For example, regulated investment companies benefit from a special apportionment rule because the Legislature sought to encourage these firms to locate in Texas.

Credits. A credit allows a taxpayer a subtraction directly from tax owed. For this reason, a tax credit provides greater fiscal relief to taxpayers than a deduction of the same dollar amount.

Tax credits come in two types, distinguished by their frequency. One-time credits are available for a single tax period (or until they are used up). In contrast, continuing credits are available for use year after year. Each type can be used for a variety of purposes—e.g., to influence taxpayer behavior, to grant tax relief, or to smooth the flow of state and local tax receipts.

Refunds. Refunds operate much like credits, with one important difference. With credits, taxpayers receive a reduction in their tax liability. With refunds, taxpayers receive a payment from the state.

Refunds are typically used for the same purposes as are tax credits.

Special rates. A special rate usually takes the form of a lower tax rate for certain taxpayers, distinguished by either their line of business, or by their product. No special rate provisions currently exist in the Tax Code for franchise tax.

Table 2
Cost of Franchise Tax Exemptions
Fiscal 2001 to 2006
(in millions of dollars)

Section	Exemption	2001	2002	2003	2004	2005	2006
171.051	Grandfathered 1975			Included with IRS 501(c)(3)			
171.052	Insurance companies	\$139.0	\$144.8	\$151.2	\$158.0	\$165.1	\$172.4
171.053	Railway terminal co	*	*	*	*	*	*
171.055	Mutual funds	\$204.6	\$215.9	\$229.1	\$244.6	\$262.0	\$281.3
171.056	Solar energy co	\$0.4	\$0.4	\$0.4	\$0.5	\$0.5	\$0.5
171.057	Promote local area			Included with IRS 501(c)(6)			
171.058	Religious orgs			Included with IRS 501(c)(3)			
171.059	Burial organizations #	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
171.060	Agriculture fairs			Included with IRS 501(c)(5)			
171.061	Educational orgs			Included with IRS 501(c)(3)			
171.062	Public charity			Included with IRS 501(c)(3)			
171.063	IRS Sec 501(c)(2)	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
	IRS Sec 501(c)(3)	\$243.2	\$249.2	\$255.8	\$262.8	\$270.0	\$277.1
	IRS Sec 501(c)(4)	\$4.8	\$4.9	\$5.0	\$5.2	\$5.3	\$5.5
	IRS Sec 501(c)(5)	\$9.2	\$9.5	\$9.7	\$10.0	\$10.2	\$10.5
	IRS Sec 501(c)(6)	\$10.7	\$11.0	\$11.3	\$11.6	\$11.9	\$12.2
	IRS Sec 501(c)(7)	\$1.7	\$1.8	\$1.8	\$1.9	\$1.9	\$2.0
	IRS Sec 501(c)(8)	\$2.5	\$2.6	\$2.6	\$2.7	\$2.8	\$2.9
	IRS Sec 501(c)(10)	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
	IRS Sec 501(c)(16)	*	*	*	*	*	*
	IRS Sec 501(c)(19)	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
	IRS Sec 501(c)(25)	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
171.064	Nature conservation			Included with IRS 501(c)(3)			
171.065	Water supply/sewer	\$0.6	\$0.7	\$0.7	\$0.7	\$0.7	\$0.7
171.066	Natural gas facility	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
171.067	Convalescent homes	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
171.068	Cooperative housing	*	*	*	*	*	*
171.069	Ch 52 ag marketing			Included with IRS 501(c)(5)			
171.070	Lodges			Included with IRS 501(c)(8)			
171.071	Ch 51 ag coops			Included with IRS 501(c)(5)			
171.072	Housing finance			Included with IRS 501(c)(3)			
171.073	Hospital laundry	*	*	*	*	*	*
171.074	Development corp			Included with IRS 501(c)(6)			
171.075	Health coop			Included with IRS 501(c)(3)			
171.076	Ch 55 ag credit	\$0	\$0	\$0	\$0	\$0	\$0
171.077	State credit unions ##	\$3.6	\$3.8	\$4.0	\$4.2	\$4.5	\$4.8
171.079	Electric coop	\$13.5	\$14.3	\$14.9	\$15.8	\$16.9	\$18.2
171.080	Telephone coop	\$0.8	\$0.8	\$0.9	\$0.9	\$1.0	\$1.0
171.081	Title insurance firms	\$1.2	\$1.3	\$1.3	\$1.4	\$1.5	\$1.6
171.082	Homeowners assn	\$1.2	\$1.3	\$1.3	\$1.4	\$1.5	\$1.6
171.083	EMS corp			Included with IRS 501(c)(3)			
171.084	Trade show	*	*	*	*	*	*
171.085	Sludge recycling	*	*	*	*	*	*
171.086	Supercollider org	\$0	\$0	\$0	\$0	\$0	\$0
171.087	Scholarship org			Included with IRS 501(c)(3)			
	Total-exemptions	\$637.3	\$662.2	\$690.1	\$721.7	\$755.9	\$792.3

Qualifies for IRS 501(c)(13)
Qualifies for IRS 501(c)(14)
*Amount is negligible.
Note: Totals may not add due to rounding.

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Table 3
Cost of Franchise Tax Deductions, Special Accounting Methods, Credits, and Refunds
Fiscal 2001 to 2006
(in millions of dollars)

	2001	2002	2003	2004	2005	2006
Deductions:						
Small business exception	\$46.4	\$49.1	\$52.2	\$55.5	\$59.4	\$63.7
Enterprise zone investment	3.9	3.9	3.9	3.9	3.9	3.9
Food and medicine receipts	3.6	3.8	4.0	4.3	4.6	4.9
Solar energy device purchases	*	*	*	*	*	*
Business loss carryover	208.1	208.1	208.1	208.1	208.1	208.1
Officer compensation exclusion-small corps	187.8	198.3	207.2	219.7	235.0	251.9
Interest earnings on federal securities	<u>53.7</u>	<u>55.0</u>	<u>56.5</u>	<u>58.0</u>	<u>59.6</u>	<u>61.2</u>
Total deductions	503.5	518.3	531.8	549.5	570.5	593.6
Special Accounting Methods:						
Investment management firm apportionment	3.9	3.9	3.9	3.9	3.9	3.9
GAAP accounting exemption	13.9	14.6	15.3	16.2	17.3	18.6
Transportation firm apportionment	11.1	11.7	12.2	13.0	13.9	14.9
Telephone firm apportionment	<u>8.9</u>	<u>9.4</u>	<u>9.8</u>	<u>10.4</u>	<u>11.1</u>	<u>11.9</u>
Total special accounting methods	37.7	39.6	41.2	43.5	46.2	49.3
Credits and Refunds:						
Temporary (FAS 96) credit	0.4	0.4	0.4	0.3	0.3	0.3
Credit for wages paid to inmates of TDC	*	*	*	*	*	*
Credit for wages paid to persons committed to TYC	*	*	*	*	*	*
Child care credit	3.9	4.7	5.0	5.3	5.7	6.1
Research and development credit	67.7	128.8	137.0	147.1	157.4	168.7
Job creation credit	22.7	28.1	29.9	34.3	36.7	39.3
Investment credit	45.2	56.1	59.6	68.5	73.3	78.5
Before- and after-school care contributions	4.3	5.2	5.5	5.9	6.3	6.8
Refund for job creation in enterprise zones	<u>*</u>	<u>*</u>	<u>*</u>	<u>*</u>	<u>*</u>	<u>*</u>
Total credits and refunds	\$144.2	\$223.3	\$237.4	\$261.5	\$279.7	\$299.8

*Amount is negligible.

Note: Totals may not add due to rounding.

Franchise tax exemptions

Sec. 171.051(d). Franchise tax exemptions granted before September 1, 1975

Corporations that received exemptions before September 1, 1975 retain their exemptions. Prior to this date exemptions were administered by the Secretary of State. These exemptions may be of any type and include schools, churches, water supply corporations, and foundations.

Sec. 171.052. Insurance companies

Insurance, surety, guaranty, or fidelity companies that are subject to or that pay an annual premium tax levied under the Insurance Code and that have not been exempted from premium taxes are exempt from franchise tax.

Insurance companies exempt under this section are not required to register with the Comptroller.