
Considerations in Alternative Funding Systems for Texas School Finance

Dale Craymer
President, Texas Taxpayers and Research Association
(512) 472-8838
dcraymer@ttara.org
www.ttara.org

Presented to the
Joint Interim Committee to Study the Public School
Finance System
September 24, 2012

This page is intentionally blank.



Generic Issues with Replacing Property Taxes

Statewide or Local Replacement? Property taxes in Texas are a local tax. If these local taxes are to be replaced with some alternative source of revenue, should the new revenue be a local or a statewide tax? If the replacement tax is to be locally levied, new disparities would be created. A statewide tax would eliminate local inequities, but there would be much controversy over how the money was distributed to local governments.

Revenue Target? The size of the replacement tax would depend on what was being replaced (annual figures from 2011; non school taxes are estimates):

- | | |
|--|----------------------|
| ● Basic maintenance and operations? | \$16.4 billion |
| ● Maintenance and operations enrichment? | \$1.2 billion |
| ● Facilities (i.e. interest and sinking fund taxes)? | <u>\$4.4 billion</u> |
| ● All of the Above | \$22.0 billion |
| ● City Property Taxes | \$6.6 billion |
| ● County Property Taxes | \$6.7 billion |
| ● Special District Taxes | <u>\$5.7 billion</u> |
| ● Total all Property Taxes | \$41.0 billion |

Rate Creep. After school maintenance and operations were reduced in 2006, other property taxes rose substantially. If only the *school* property tax is targeted for reduction and other local property taxes are retained, would additional restrictions be placed on other property taxes to limit rate creep?

Enrichment/Local Control. If current dollars used for local enrichment are to be replaced, would districts be allowed to generate enrichment dollars in the future, and if so, how?

Replacing Existing Debt Taxes. Do existing bond covenants allow for alternative sources of funding other than the property tax, or would the bonds have to be refinanced?

Financing Future Facilities. If current dollars used for local facilities are to be replaced, would districts be allowed to levy future taxes for facilities and if so, how?

Evaluating Alternative Revenue Sources. Replacing local school taxes would be a substantial shift in state tax policy and result in the movement of billions of dollars from one set of taxpayers to another set of taxpayers. Given the magnitude of the task, beyond the school finance issues, a serious analysis at a minimum should include

- Impact on business/individual tax burdens
- Impact on taxes paid by individuals by income group
- Impact on state regions
- Impact on the business economy by industry
- Impact on interstate competitiveness
- How a replacement tax would be administered in the real world



What Issues in Litigation Would a Statewide Tax Fix?

Issue	Fixed?	Comments
State Property Tax	Maybe	The Texas Constitution prohibits a state property tax. Whether the local property tax could be construed as a state property tax is an issue that would be eliminated by replacing the school tax; however, if a local school property tax was allowed for enrichment or other general purposes, the system could eventually be in violation if the local taxes began to coalesce around a particular rate, unless the constitutional amendment specifically addressed enrichment taxes.
Equal and Uniform Taxation	Maybe	The Texas Constitution requires that taxation be equal and uniform. Plaintiffs contend that this provision is violated because local school districts may impose substantially similar tax rates yet may have access to very different levels of revenue. This is really more of an issue of access to revenue than an issue of taxation.
Equity	No	Equity is based on the disparity in revenues available to school districts under the school finance formulas. Equity is not a function of taxes collected; it is function of the interaction of tax revenue and state aid under the school finance formulas in Chapters 41 and 42 of the Education Code. Unless school finance formulas are rewritten, in particular to eliminate provisions extending “hold harmless” or “target revenues,” issues of equity will not be resolved simply by replacing current local taxes with a state tax. Further, the equity issue could be resolved simply by rewriting current formulas.
Adequacy	No	Adequacy is based on the level of funding available to schools, not how a particular level of funding is raised.
Efficiency	No	“Efficiency” as defined in the Taxpayers for Real Efficiency and Equity in Education (TREE) focuses on bureaucratic waste and would not be impacted by a statewide tax.



State Property Tax: Issues to be Addressed

Constitutional Amendment. The Texas Constitution prohibits a state property tax. Amending the Texas Constitution requires a two thirds vote of each house of the legislature as well as a majority vote of the people.

Method of Taxation: The Legislature could take one of two approaches in putting a constitutional amendment before voters:

- Establish a uniform rate set in the Constitution, or
- Give the legislature the authority to set the rate.

If the amendment specifies that a state property tax is imposed at a specific rate, future courts might scrutinize as to whether additional local *enrichment* taxes might evolve into a statewide tax and be unconstitutional.

Determine the Target Tax Rate. Currently, the average tax rate for maintenance and operations (including “enrichment”) is \$1.05. If the legislature adopted a uniform tax rate of \$1.05, voters in 719 districts would see their taxes rise, while voters in 305 districts might see their taxes decline (absent the imposition of any additional taxes for local enrichment). Impact on a district’s total revenues would depend on any changes in school finance formulas.

Existing Local Option Exemptions. Currently, 218 school districts allow some type of optional percentage homestead exemption up to 20 percent of the value of the home; while 806 districts do not. The state would have to establish a uniform policy if it were to replace the local school tax with a state property tax.

	Current Law	Eliminate optional homestead exemption	Give all homesteads 20% exemption
M&O Tax Rate (per \$100)	\$1.05	\$1.03	\$1.12
Tax Impact on Homeowners	n.a.	+ \$240 million	- \$770 million
Tax Impact on Businesses	n.a.	- \$240 million	+ \$770 million

System of Property Tax Administration. Governance of the property appraisal and tax collection system is currently local. With a state property tax, the state would have the greatest interest in issues of property tax administration. The Comptroller’s current methods assistance program documents disparities in appraisal practices across appraisal districts. The state would have to strengthen the current appraisal system to ensure uniformity. Further, the state would become the largest property tax levier in each district, giving them the lion’s share of appointments to the local central appraisal board (unless legislation specifically stated otherwise), and the greatest responsibility for appraisal district budgets (nearly \$400 million across the state).



Texas' Property Taxes Compared to Other States

Currently:

- **High Rate.** Texas has the 3rd highest effective property tax rate on industrial property, 76 percent higher than the national average, and
- **High Rate.** Texas has the 10th highest effective tax rate on homestead property (41 percent above the national average).
- **Broad Base.** Texas also subjects more property to tax than most other states. Texas taxes all business tangible personal property including inventories. Nationwide, 9 states exempt business personal property while inventories are exempted in 41 states. Texas, like 29 other states, does offer an exemption for goods that are a part of interstate or international commerce (i.e. Freeport property).

If the school tax for maintenance and operations was eliminated and replaced with something other than a property tax:

- **High Rate.** Texas' would have the 19th highest effective tax rate on *industrial* property, still 9 percent *higher* than the national average, and
- **Low Rate.** Texas would have the 39th highest effective tax rate on homestead property, 35 percent *below* the national average.
- **Broad Base.** Texas would still subject more property to tax than most other states. Texas taxes all business tangible personal property including inventories. Nationwide, 9 states exempt business personal property while inventories are exempted in 41 states. Texas, like 29 other states, does offer an exemption for goods that are a part of interstate or international commerce (i.e. Freeport property).

Note: Figures on tax rates are from *50 State Property Tax Comparison Study* by the Minnesota Taxpayers Association and the Lincoln Institute of Land Policy, April 2011.



Sales Tax: Issues to be Addressed

Rate? The current sales and motor vehicle sales taxes¹ generate \$4.4 billion per one percent of tax rate. At a minimum, an increase of 4 percentage points would be required to eliminate the school tax for maintenance and operations. Texas' current state tax rate of 6.25 percent ranks us 13th highest among the states, and 11th highest when local taxes of up to 2 percent are included. Adding a minimum of 4 percent to those rates, Texas would have the **highest** state sales tax rate at 10.25 percent—3 percentage points higher than second place California. Adding in local sales taxes would bring Texas' total combined rate to 12.25 percent, almost 3 percentage points above second place Tennessee.

Base? Texas' has the 14th broadest sales tax base (measured by comparing taxable sales relative to personal income) among the states—about 16 percent broader than the national average (Texas taxes more services than most other states). If the sales tax base was expanded to generate sufficient revenue to replace the local school tax for maintenance and operations, Texas would have the 3rd broadest tax base, behind Hawaii and Wyoming (states that have very low tax rates).

Tax Avoidance. A 2009 study² estimates that Texas will lose \$870 billion as a result of purchases through electronic commerce. Should Texas substantially increase its sales tax base or rate, Texas would likely see much greater erosion of its tax base.

Statute of Limitations. Currently, a taxpayer's sales tax liability may be revised up to four years from the date the tax is due. Increasing the sales tax trades a more certain tax—the property tax—for one which may administratively be far less certain. In order to provide financial certainty, a substantial sales tax increase should be coupled with a reduction in the statute of limitations for tax liability.

Administerability. States have wrestled with how to administer sales taxation of services. Particularly daunting are transactions across state lines and those in which only a portion of services are attributable to Texas.

Enforcement. Some aspects of an expanded sales tax may be very difficult to enforce. For example, if Texas extended sales taxes to sales of real property, property owners could avoid taxes by placing ownership of their property into a limited liability company (LLC). The owner could then sell the LLC as opposed to the property itself. A taxable transaction would not have taken place since the LLC is still the owner of record. An ancillary issue is how the additional sales tax would affect mortgage lending and property sales values.

Deductibility. Property taxes are deductible from federal income taxes, while the sales tax deduction is set to expire in 2012 and must be reauthorized.

¹ Most states include motor vehicle sales in their general sales tax base.

² Donald Bruce, William F. Fox, and LeAnn Luna, State and Local Government Sales Tax Revenue Losses from Electronic Commerce, The University of Tennessee, April 13, 2009.



Income Tax: Issues to be Addressed

State Comparisons. Nationally, 43 states levy a personal income tax (2 of these only tax investment income). Texas is one of 7 states without a personal income tax.

“Bullock” Amendment. Article 8 Section 24 of the Texas Constitution outlines the procedures by which the legislature may impose a personal income tax:

- The legislature may pass the tax as a general law with a simple majority vote. A record vote is not required.
- Before the tax takes effect, it must be approved in a statewide referendum by a majority of registered voters voting.
- The provision submitted to voters must clearly state the rate of the tax.
- Any subsequent changes to the rate or the base of the tax that generates additional revenues must be approved in another public referendum.
- Not less than two thirds of the revenue from the income tax must be used to reduce school maintenance and operation property taxes.
- Any amounts remaining shall be used for the support of “education.”
- To the extent the income tax revenue is used to reduce local school taxes, schools may increase their tax rates back, subject to voter approval.

Tax Shift. Replacing current local school taxes dollar-for-dollar with a state personal income tax would result in roughly an \$8 billion shift in taxes from businesses to individuals.

Structure of the Tax. A personal income tax could be structured as a flat, single rate tax, or with differing rate schedules taxing higher incomes at higher rates. Of the 41 states, 38 have progressive income tax structures while 3 have flat taxes (although deductions are allowed). Two options to replace local school M&O taxes are shown below—one with a flat tax of 2.85 percent on adjusted gross income as reported to the IRS and another that simply requires taxpayers to pay an amount equal to 22 percent of their federal tax liability.

Range of Income	Tax at 2.85% of Adjusted Gross Income			Tax at 22% of Federal Tax Liability	
	Number of Taxpayers (\$ ml.)	Amount Collected (\$ bl.)	Effective Tax Rate	Amount Collected (\$ bl.)	Effective Tax Rate
Under \$25,000	5.6	\$1.3	3.0%	\$0.2	0.5%
\$25,000 to \$50,000	3.6	\$2.7	3.0%	\$1.0	1.1%
\$50,000 to \$100,000	3.5	\$4.4	3.0%	\$2.9	1.9%
\$100,000 to \$200,000	1.9	\$3.9	3.0%	\$4.1	2.9%
\$200,000 to \$500,000	0.5	\$2.2	3.0%	\$3.4	4.4%
\$500,000 to \$1,000,000	0.1	\$0.9	3.0%	\$1.7	5.5%
\$1,000,000 or more	0.0	\$2.2	3.0%	\$4.3	5.5%

