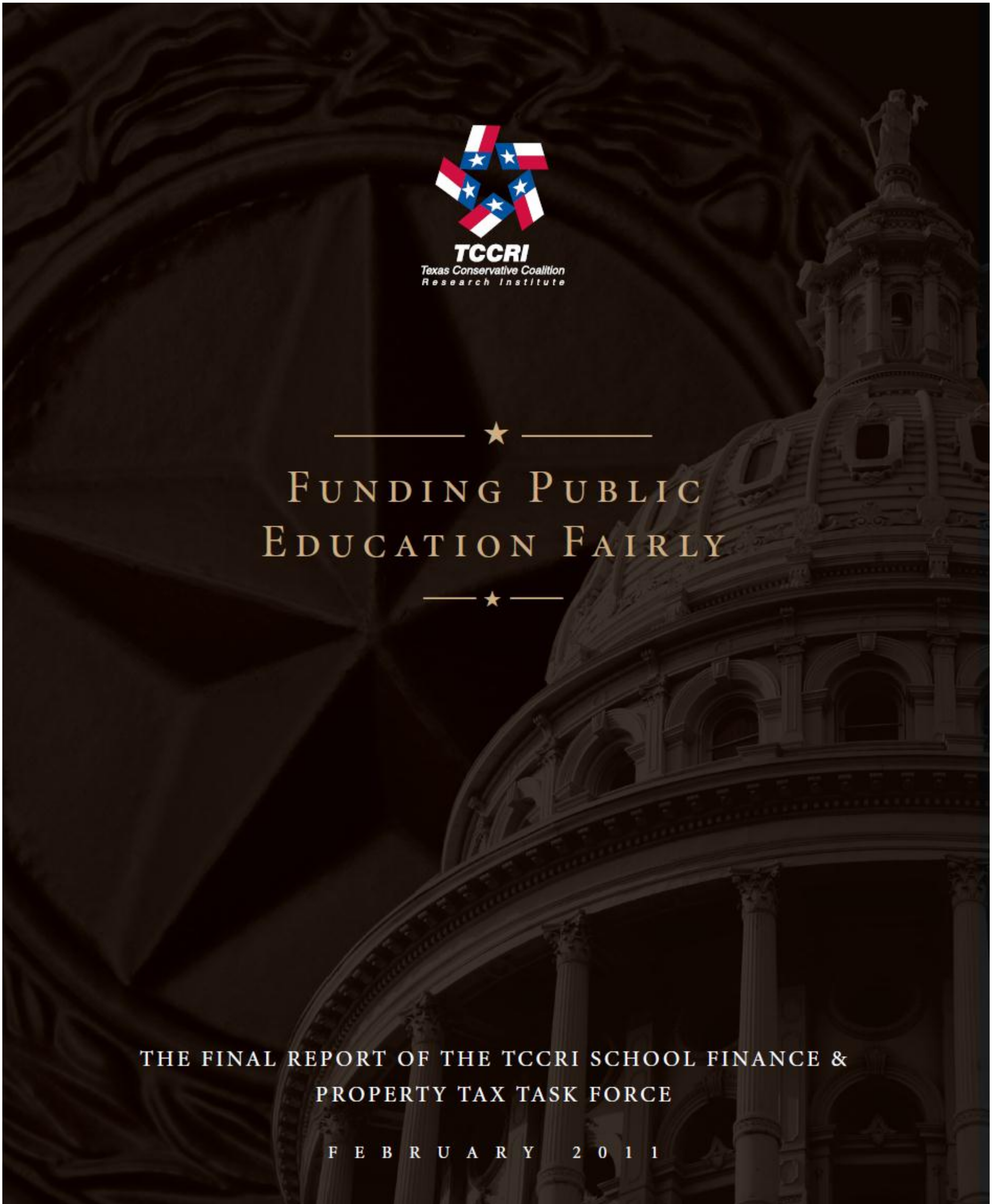

TCCRI
Texas Conservative Coalition
Research Institute

Funding Public Education Fairly

The Final Report of the TCCRI School Finance & Property Tax Task Force

February 2011

SCHOOL FINANCE AND PROPERTY TAX TASK FORCE

FINAL REPORT

For more information about any of the recommendations contained in this document, please contact the Texas Conservative Coalition Research Institute.

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ABOUT TCCRI TASK FORCES

The Texas Conservative Coalition Research Institute's Task Forces are the backbone of the Institute's research and education efforts. Based on the conservative principles of limited government, individual liberties, free enterprise, and traditional values, the Institute's Task Forces develop legislative leaders and sound public policy ideas by bringing together legislators, experts, industry leaders, and stakeholders in a unique forum that fosters discussion and debate among public and private sector leaders. This approach has proven to be very successful.

THE 2009-10 PROPERTY TAX TASK FORCE

The TCCRI School Finance and Property Tax Task Force was convened because property tax bills across the state continue to rise, highlighting the pernicious nature of the property tax and accelerating the next legal challenge to the system, despite legislatively-mandated school district property tax rate relief. Property taxes are the root of a growing social crisis in Texas, making homeownership unaffordable for many and creating a greater disincentive for business expansion among capital-intensive industries.

The Task Force considered both short and long term steps to provide meaningful tax relief by reducing the administrative and fiscal burdens posed by the property tax and finding a fairer, more reliable way to fully fund public schools.

We would like to thank State Senator Dan Patrick (R-Houston) and State Representative Phil King (R-Weatherford) for serving as Task Force Co-Chairmen.

The recommendations in this report do not necessarily represent an endorsement from any individual member of the Texas Conservative Coalition Research Institute Board of Directors or any individual participant of the School Finance and Property Tax Task Force.

There may be some policy recommendations or statements of philosophy that individual members are unable to support. We recognize and respect their position and greatly appreciate the work of everyone involved in the organization.

Executive Summary

School district property taxes place an enormous financial burden on homeowners and businesses. Texas' property tax burden on owner-occupied housing is the highest in nation, and as a result, its home ownership rate is 43rd of the 50 states. As a mortgage crisis continues to grip much of the nation, legislators in Texas can help families stay in their homes by reducing this property tax burden.

While short-term relief is imperative, there are also a number of long-standing, fundamental problems with the property taxes generally, and the maintenance and operations tax specifically, including:

- The property tax, unlike any other form of taxation, is assessed in perpetuity regardless of the property owner's ability to pay the tax or economic conditions.
- The property tax abridges private property rights: if one can never take full ownership of land or a house, the constitutional right to private property is a false promise.
- A costly and intrusive bureaucracy exists to appraise the taxable value of properties and oversee the collection of taxes from each property owner;
- The property tax will keep the state perpetually in court because the system of school finance lacks the meaningful local discretion that is required by the Texas Constitution and is rigged in such a way as to guarantee more state intervention in school district operations;
- The property tax has so many exemptions and loopholes that the businesses and homeowners who do not qualify for any of the exemptions bear an excessive and undue portion of the total burden; furthermore, childless homeowners pay the cost of educating the children of non-home-owning parents which, by itself, is a major inequity;
- Property tax rate relief financed by the Legislature is undermined by appraisal increases or school district tax rate elections, as well as increases in local debt; and,
- Property taxes are the remnants of an antiquated system of taxation that was necessitated because wealth was tied directly to the land: farming & ranching, primarily. As Texas has urbanized and the economy has shifted largely to manufacturing, research and development, retail, service and other sectors, the system of taxation has become outdated and inefficient. Indeed, wages and economic activity produced by agriculture are dwarfed by other industries.[i]

Many of these inherent problems are exacerbated by the extent to which the property tax burden has increased over the past two decades. **As result, legislators should set the state on a path toward a fairer system for funding public education that does not rely primarily on taxation of property.**

Introduction

The recent near-collapse of the mortgage industry has brought into sharp focus the issue of home ownership and the role it plays in American life. The federal government has spent hundreds of billions of dollars[ii] to address an economic crisis that has its roots in the collapse of a financial sector that was over-exposed to so-called "toxic" mortgage assets that were either in default or at risk of default.

The mortgage crisis has driven foreclosure rates up and has forced individuals and families from their homes.[iii] Against this backdrop, the single best thing legislators can do to keep people in their homes is to meaningfully reduce—and ultimately replace -- property taxes. Reducing property taxes will give home owners the financial ability to continue making mortgage payments; in turn, this will help keep mortgage lenders solvent, and is an effective way to arrest the financial downturn without resorting to taxpayer-funded bailouts.

Statistics from the U.S. Census Bureau show that Texas already has one of the lowest home ownership rates in the nation, ranking 43rd of the 50 states:

HOME OWNERSHIP RATES BY STATE (2009)

State	Home Ownership Rate	Rank
Alaska	66.8%	40
New Jersey	65.9%	41
North Dakota	65.7%	42*
Washington	65.5%	43
Texas	**65.4%**	**44***
Massachusetts	65.1%	45
Rhode Island	69.2%	46
Nevada	62.4%	47
Hawaii	59.5%	48
California	57.0%	49
New York	54.4%	50

Source: U.S. Census Bureau, Housing Vacancies and Homeownership Annual Statistics: 2009

It is worth noting that Texas has a better homeownership rate than California, despite California having enacted landmark property tax reform (Proposition 13) in 1978. However, California has a broader tax structure with a deleterious impact on homeownership, including a personal income tax that is among the highest in the nation. Despite this, Texas' homeownership rate is not much better than that of California.

Texas' low home ownership rate can be at least partly explained by the state's extraordinarily high property tax burden, as compared to other states. Research published in December 2008 by the Tax

Foundation reveals that the burden of Texas' property taxes on owner-occupied housing is among the highest in the nation:

PROPERTY TAXES ON OWNER-OCCUPIED HOUSING BY STATE (2009)

State	Rank (1=Highest Tax Burden)	Median Property Taxes as a Percentage of Home Values	Annual Taxes on Average-Priced Home*
New Jersey	1	1.89%	$3,610
New Hampshire	2	1.86%	$3,552
Texas	**3**	**1.81%**	**$3,457**
Wisconsin	4	1.76%	$3,362
Nebraska	5	1.76%	$3,362
Illinois	6	1.73%	$3,304
Connecticut	7	1.63%	$3,113
Michigan	8	1.62%	$3,094
Vermont	9	1.59%	$3,037
North Dakota	10	1.42%	$2,712

Source: The Tax Foundation: "Property Taxes on Owner-Occupied Housing by State" (2009) & Real Estate Center at Texas A&M University.

**The average price of a home sold in Texas in October 2010 ($191,000) is used as the basis for each figure in this column.*

Texas' low home ownership rate is strongly linked to its high property tax burden. Legislators must address Texas' low home ownership rate by reducing the property tax burden; this will be vitally important in the context of the continuing mortgage and financial crisis. A 2006 report by the Texas Department of Housing and Community Affairs highlighted the problem, citing that "[m]any people are able to acquire a loan and buy a house but are unable to keep up with payments on the loan because of high property taxes."[iv]

The scale of the problems that plague the mortgage industry are an indication of the extent to which politicians, regulators, and financiers were willing to overlook sound financial practices in order to sustain the unprecedented growth in home ownership that occurred throughout the 1990's and early 2000's. For the "American Dream" to be attained, homeownership was extended to low and moderate income groups who would not normally have qualified for mortgage loans. As the *New York Times* described in 1999:

> Fannie Mae, the nation's biggest underwriter of home mortgages, has been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people…the Department of Housing and Urban Development proposed that by the year 2001, 50 percent of Fannie Mae's and Freddie Mac's portfolio be made up of loans to low and moderate-income borrowers. Last year, 44 percent of the loans Fannie Mae purchased were from these groups.[v]

Increasing home ownership rates is a laudable goal, and the extent to which that goal was pursued is a testament to its quintessential role in the American Dream. Before the onset of the Great Depression, home ownership rates in the U.S. were beginning to approach 50 percent. However, once the Depression had taken its toll, the home ownership rate declined to 43 percent.[vi] Throughout the 1950s, 60s, and 70s, home ownership grew steadily; mirroring the nation's renewed prosperity and sustained economic growth.[vii] Even with a period of stagnation during the 1980s, America's home ownership rate was almost 70 percent by 2004 before the mortgage crisis began to hit.[viii]

The latest figures from the U.S. Census Bureau reveal that in the fourth quarter of 2009, the home ownership rate in the U.S. declined to 67.2 percent from its 2004 historical high of 69.2 percent. This drop has set home ownership in the U.S. back nine years, mirroring the rate in the fourth quarter of 2000.[ix]

Historically, the U.S. has had higher home ownership rates than comparable countries in Europe and around the world. A 2002 study, for example, noted that U.S. home ownership rates have been consistently 27 percentage points above that of Germany.[x]

Research demonstrates that home ownership is positively correlated nationally with a strong financial sector.[xi] At the individual level, home ownership is considered fundamental to the American family: home owners are more likely to be married and have children than those who do not own their homes.[xii]

The decline in the home ownership rate that was triggered by the recent and ongoing mortgage crisis will have a severe impact on the economic stability of families across the nation and Texas in particular.

While Congress and the federal government will end up spending more than $1.5 trillion on bailouts, eliminating school property taxes in Texas would cost less than $20 billion. Eliminating maintenance and operations property taxes would also be significantly more effective than the federal government's misdirected bailout: homeowners would be able to keep their homes and banks would continue to receive mortgage payments.

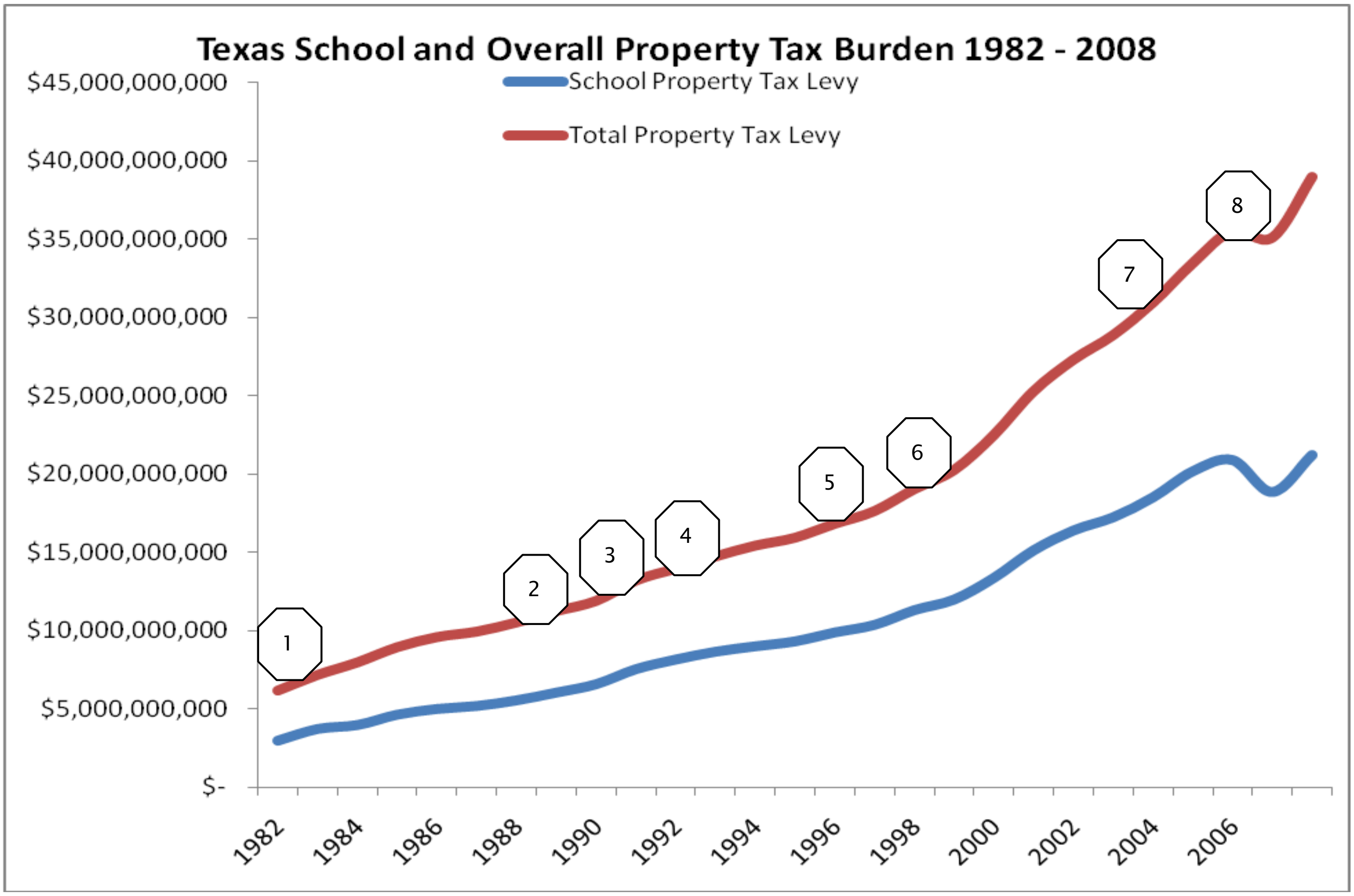
The Texas Legislature has worked for decades to make property taxes less burdensome, but to no avail. For instance, despite more than $14 billion in legislatively appropriated property tax rate cuts in 2007, increases in local rates, appraisals, and bond debt continue to push property tax bills ever-higher. In 2007, 115 school districts held tax rate elections to increase their tax rates from the cap of $1.04 to $1.17. On top of these rate increases, 197 school districts held bond issue elections in 2007, which issued at least $7.4 billion of new debt.

The problem, however, is much deeper than high tax bills. The property tax crisis is also a property rights crisis. Property taxes are perpetual, abrogating the right to own property in the truest sense. If one must pay local taxing authorities every year forever, then property ownership is reduced to nothing more than a form of renting from the government.

This report explores these arguments and lays out a path to school property tax elimination in Texas.

A Blueprint for Reform

State legislators have made repeated attempts to reform the property tax. Efforts have been made to reform the appraisal process, lower the appraisal cap, lower the maximum allowable tax rate, improve the accountability and transparency of school districts, and increase public participation in school district decisions. While some of these efforts have been successful around the edges, the system is structured in a way that will always work against property owners. The following chart illustrates this fact by placing the past three decades of property tax legislation and court decisions alongside the perpetually growing school district (blue) and overall (red) property tax burdens.



1 1982: Property Tax Code Implemented; Appraisal authority moved to County Appraisal Districts.

2 1989-90: *Edgewood I* decision determines the school finance decision to be unconstitutional; SB1 (71S6) provides funding for wealth equalization.

3 1991: *Edgewood II* decision finds the school finance system still unconstitutional; SB351 (72R) creates County Education Districts with property taxing authority; HB54 (72S1) creates the Texas Lottery to provide funding for public education; Comptroller assumes responsibility for the

Property Value Study.

4 1992-93: *Edgewood III* decision finds County Appraisal Districts' taxing authority to be unconstitutional; SB7 (73R) creates the "Robin Hood" system of recapture to address inequity between school districts. This new school finance system was declared constitutional in the *Edgewood IV* decision in 1995.

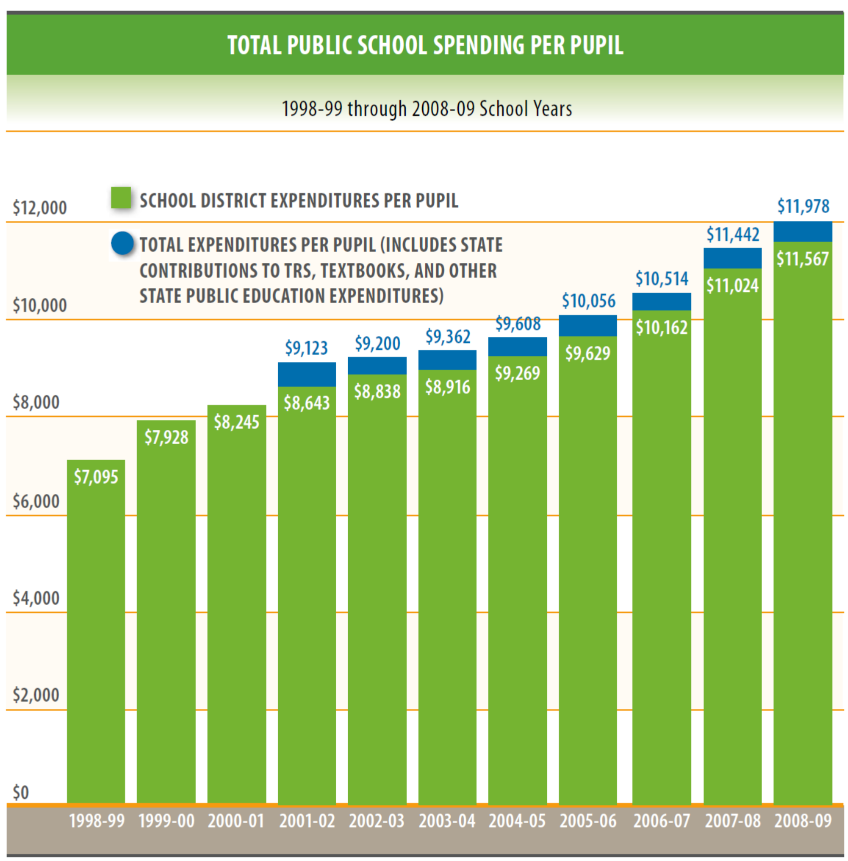
5 1997: HB4 (75R) increases the homestead exemption to $15,000; SJR43 (75R) establishes an annual 10 percent appraisal cap on residential property.

6 1999: SB4 (76R) compresses school district property tax rates.

7 2004: *West Orange-Cove* decision declares the school finance system unconstitutional.

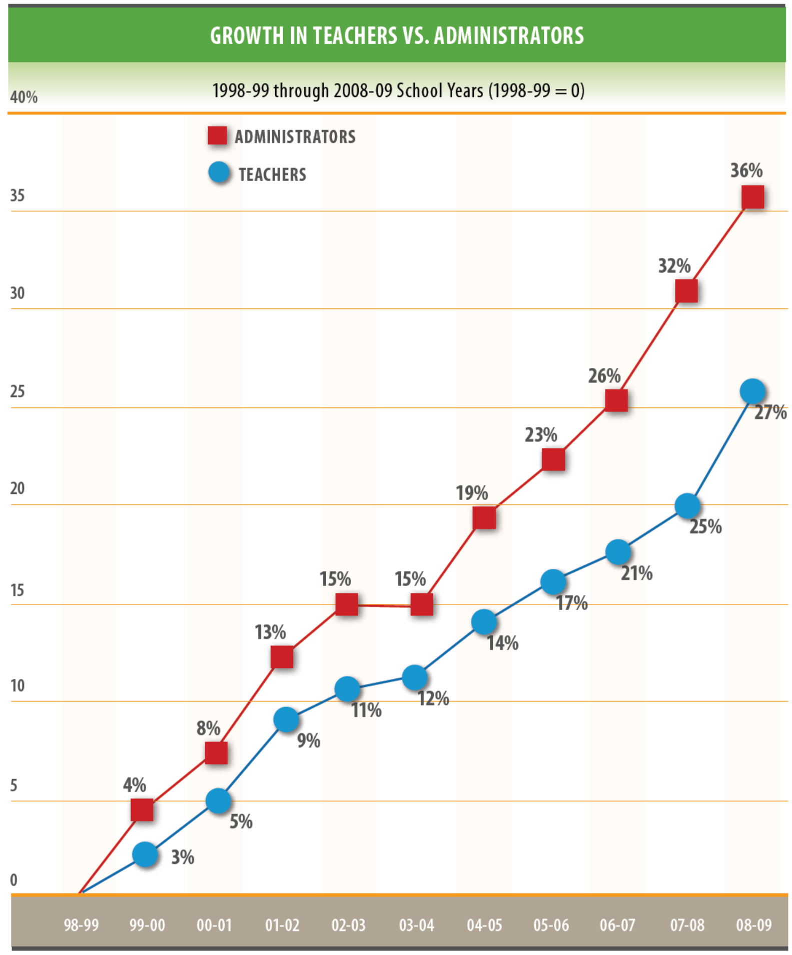
8 2006: HB1,2,3,4,&5 (79S3) compress school district property tax rates by 50 cents over two years by creating the Property Tax Relief Fund. The Fund receives revenue from an expansion of the Franchise Tax and adjustments to some state sales taxes.

As the chart shows, despite repeated attempts to fix and reform the school finance system, the burden it places on property tax payers – residential and business owners alike – has continued to grow inexorably. Even the 50 cent M&O rate reduction enacted in 2006 that resulted in the creation of the new business tax is only a blip on the property tax horizon.



Source: Texas Comptroller of Public Accounts, Texas Education Agency and Teachers Retirement System

Every factor points to the same conclusion: Taxpayers deserve a fairer, less-intrusive system that is robust enough to fully fund public education. While local school officials continue to impose ever-larger tax burdens on home owners and businesses, despite huge increases in state appropriations to public education [see chart], the state can eliminate school district property taxes and establish the permanent, reliable, dedicated, broad-based source of revenue that the public education system needs. Hand-in-hand with reforming the public school finance system must be an acknowledgement that school district spending cannot continue to grow at the rate seen over recent decades, and particularly when much of the spending growth has been focused away from classroom instruction and has been used to grow the public education bureaucracy. The growth in the number of administrators compared to the number of teachers illustrates this problem [see chart].



Source: Texas Comptroller of Public Accounts and Texas Education Agency.

As a result of this trend, were Texas' public education system a private company, it has grown to the point where it would be the fifth-largest in the world by employee count. Non-teachers account for half of all public education employees across the state, and three categories of non-teachers – campus administrators, central administrators, and professional support staff – each earn more per year on average than do teachers.[xiii] [*See TCCRI's State Budget Task Force Report for more information on public education bureaucracy*].

Any efforts to reform the public education finance system seek to reduce this unnecessary spending growth by reducing the number of non-teachers in the public education system. Public education spending must be focused on the classroom so that teacher and students (the core of the education system) are prioritized over bureaucracy and non-essential programs.

In addition, meaningful reforms must address the issue of school district mandates. Each legislature has a tendency to layer well-intentioned mandates on schools districts. For example, House Bill 3190 (80R) added a new requirement that all students practice bus evacuations twice a year—regardless of whether the school district operates a transportation system. Indeed, since 1995, the Legislature has enacted more than 60 mandates for school districts.[xiv]

The Texas Association of School Administrators and the Texas Association of School Boards note that "the issue is not whether it is appropriate for the Legislature to pass mandates; the issue is the strain state mandates place on school district budgets."[xv] It is therefore important to ensure that all mandates are necessary, and unnecessary mandates are repealed in order to relieve some of the financial burden they place on school districts. Senate Bill 468 (82R) by Senator Shapiro begins the process of alleviating some public education mandates and granting additional flexibility to school districts.

Shifting from property taxes to consumption taxes is a philosophical imperative if the constitutional provision that "a general diffusion of knowledge being essential to the preservation of the liberties and rights of the people" [Texas Constitution, Article VII, Section 1] is to be taken seriously. In other words, if public education is a constitutional imperative for all Texans, then all Texans should participate in the funding of the public education system. Since all Texans necessarily pay sales taxes, the sales tax is the fairest and broadest method for funding the public education system.

Analysis of a plan in Florida which would have replaced $8 billion of property taxes per year with an expanded state sales tax in the Sunshine State, found that:

- Property values in the state would have increased by $80 billion in total.
- $6.9 billion in new residential construction.
- $2 billion in additional disposable income.
- 72,465 new jobs created in the first five years of the property tax cut.[xvi]

This type of shift must be a long-term goal for legislators in Texas. A blueprint for how to begin transitioning away from property taxes to fund public education follows:

1. **Enact legislation "sunsetting" school district maintenance and operations (M&O) taxes by 2016.**
2. **Eliminate school district M&O property taxes on residences, using consumption taxes to replace the lost revenue**
3. **Eliminate school district M&O property taxes on all other property, including business and commercial properties, using consumption taxes, a tighter state spending limit, and surplus revenues to replace the lost revenue.**

With the phased approach outlined above, school district M&O property taxes can be completely eliminated and replaced with a fairer source of revenue, with the process beginning during the 82nd Legislature. The blueprint is described in detail in the following sections.

1. Legislation to "Sunset" school district M&O property taxes

Given the budget constraints likely to be faced by legislators in the 82nd Legislative session, it would be prudent to set the state on a long term path to school district M&O property tax elimination. Enacting legislation to "sunset" school district M&O property taxes by December 31, 2016 would give state policymakers four years to develop a fairer funding system based on sales taxes rather than property taxes. It would then fall to the 85th Legislature in 2017 to enact a new system before the current property tax system expires.

Under this approach, the Legislature will be able to act in a timely fashion to find a reasonable solution to the school district property tax problem, in contrast to the "fix" enacted by the 79th Legislature , which was forced to create a new business tax [*see TCCRI's Economic and Workforce Development Task Force report for more information on the business tax*] after the Supreme Court found the property tax system of school funding to be unconstitutional.

However, enacting "sunset" legislation in the 82nd Legislative does not preclude taking further steps outlined in the blueprint in order to provide meaningful tax relief for homeowners or businesses, such as lowering the appraisal cap to 5 percent (see Senate Bill 129/Senate Joint Resolution by Senator Patrick), or applying the current appraisal cap to business property (see House Bill 1079/House Joint Resolution 82 by Representative Phil King).

2. Eliminating school district M&O property taxes on residences.

The Office of the Comptroller indicates that in FY2009, school district M&O property taxation attributable to single family properties and multi-family properties totaled $9.2 billion:

SCHOOL DISTRICT M&O PROPERTY TAX LEVY ATTRIBUTABLE TO RESIDENCES, 2009:

Category	2009 Tax Levy
Single Family Properties	$8,299,844,427
Multi-Family Properties	$ 899,449,322
TOTAL	**$9,199,293,749**

Source: Comptroller of Public Accounts.

In the categories outlined above, "single family properties" refers to houses for single families, farm and ranch improvements, and mobile homes (categories A, E, & M1 per the Comptroller's annual analysis). "Multi-family properties" refers only to category B in the comptroller's annual analysis, which covers all types of multi-family dwellings.

In order to completely eliminate school district M&O property taxation on residences by transitioning to consumption taxes, legislators would need to raise the rate of the state sales and use tax, or close some of the exemptions and exclusions from the sales and use tax, or a combination of both approaches. The chart below projects the additional revenue that would accrue from incremental quarter cent increases in the state sales and use tax:

STATE SALES AND USE TAX RATES AND NEW REVENUE PROJECTIONS 2009 - 2013

State Sales and Use Tax Rate	Fiscal 2009 (million)	Fiscal 2010 (million)	Fiscal 2011 (million)	Fiscal 2012 (million)	Fiscal 2013 (million)
6.50 percent	$738.5	$770.3	$803.9	$837.2	$871.5
6.75 percent	$1,473.3	$1,538.8	$1,603.8	$1,670.2	1,738.7
7.00 percent	$2,204.5	$2,299.6	$2,399.8	$2,499.1	$2,601.6
7.25 percent	$2,932.1	$3,058.5	$3,191.9	$3,323.9	$3,460.2
7.50 percent	$3,656.0	$3,813.6	$3,979.9	$4,144.6	$4,314.6
7.75 percent	$4,376.3	$4,565.0	$4,764.0	$4,961.1	$5,164.6
8.00 percent	$5,092.9	$5,312.5	$5,544.2	$5,773.5	$6,010.4
8.25 percent	$5,806.0	$6,056.3	$6,320.3	$6,581.8	$6,851.8
8.50 percent	$6,504.1	$6,784.5	$7,080.3	$7,373.2	$7,675.7
8.75 percent	$7,196.1	$7,506.4	$7,833.6	$8,157.7	$8,492.3
9.00 percent	$7,882.1	$8,229.1	$8,580.4	$8,953.4	$9,301.9
9.25 percent	$8,562.0	$8,931.2	$9,320.6	$9,706.1	$10,104.3
9.50 percent	$9,235.9	$9,634.1	$10,054.2	$10,470.1	$10,899.6
9.75 percent	$9,903.8	$10,330.8	$10,781.2	$11,227.3	$11,678.8
10.00 percent	$10,565.7	$11,021.3	$11,501.8	$11,977.6	$12,469.0
10.25 percent	$11,221.7	$11,705.5	$12,215.9	$12,721.3	$13,243.1

Source: Texas Comptroller of Public Accounts.

As the chart shows, using sales and use tax rates alone, legislators would have to increase the rate by around 3.25 cents to 9.50 percent in order to generate the $9.2 billion that would be required each year to replace school district M&O taxes on residential property. However, this rate increase could be considerably lower if some existing sales tax exemptions and exclusions were eliminated in order to raise some of the required revenue.

The following charts are adapted from the Comptroller's "Tax Exemptions and Tax Incidence" report, and they outline the major exemptions and exclusions that could be considered by legislators. It is worth noting that this list is comprehensive, and includes exemptions such as the manufacturing exemption which would be unwise to eliminate. As a general principle, creating a fairer system for funding public education should not be achieved at the expense of economic development in the state. Indeed, eliminating the M&O tax is intended to spur economic growth. Some of the exemptions to the sales and use tax were created with that in mind, especially the exemption for materials used in manufacturing, and eliminating them would harm Texas' economic competitiveness at a time when the state should be protecting its jobs base and encouraging businesses to grow. However, eliminating some exemptions and exclusions will broaden the base of the sales, providing more funds to offset the shift away from the M&O, and require a smaller increase in the sales tax rate to achieve the objective.

MAJOR SALES TAX EXEMPTIONS (Greater than $100 million)

EXEMPTION	VALUE	DESCRIPTION
Manufacturing	**$8.200 billion**	This section exempts several types of items used in manufacturing products for sale, including materials that become part of the manufactured product. It also exempts tangible personal property that is necessary or essential to the manufacturing operation if it causes a physical or chemical change in the product being manufactured. The section exempts services performed directly on the manufactured product; certain chemicals used during the manufacturing operation; wrapping and packaging materials; and certain equipment used to reduce water use and to reuse and recycle wastewater streams in the manufacturing process. The exemption specifically excludes certain items, including equipment rented for less than a year, hand tools, office supplies, and equipment and supplies used in maintenance and janitorial activities.
Food	**$1.380 billion**	This section exempts food products for human consumption, like cereals, milk, meat, poultry, fish, eggs, vegetables, fruit, spices, salt, sugar, coffee, and tea. It does not exempt meals sold in restaurants, vitamins, over-the-counter medicines, soft drinks, ice, and candy. Meals, soft drinks, and candy are exempted if sold by certain organizations, like elementary or secondary public or private schools, student or parent-teacher organizations, churches, hospitals, retirement facilities, or members of nonprofit youth athletic organizations.
Gas and electricity	**$1.151 billion**	This section exempts certain sales of gas and electricity, including gas and electricity used in processing a product for sale; exploring for or producing and transporting a material extracted from the earth; agricultural operations; gas and electricity used by an electric utility; and gas and electricity used in residences—including apartments, nursing homes, and dormitories. The section also gives cities the option to tax the residential use of gas and electricity.
Health care supplies	**$0.434 billion**	This provision exempts sales of prescription and non-prescription drugs; corrective lenses and therapeutic devices prescribed by a doctor; insulin; hospital beds; hypodermic syringes or needles; braces; hearing aids; orthopedic, dental, or prosthetic devices; blood glucose monitoring test strips; and certain devices used by people who are blind or deaf.

Agricultural items	**$0.324 billion**	This section exempts certain agricultural items, including horses, mules, and work animals; animals that ordinarily constitute food (cattle, poultry, etc.); feed for farm and ranch animals and for animals held for sale; certain seeds and annual plants; chemicals used on a farm or ranch in production; and machinery and equipment used on a farm or ranch to build roads or water facilities. The section also exempts items used to produce agricultural products for sale, or to process, pack, or market agricultural products; underground irrigation equipment; and ice used by commercial fishing boats.
Water	**$0.263 billion**	This provision, which has been in the law since 1961, exempts sales of water. It does not include the disposal of waste-water, which is a nontaxable service.
Sales to government entities	**$0.255 billion**	This section exempts items sold, leased, or rented to governmental entities, including the United States, an agency or instrumentality of the United States, this state, or a county, city, special district, or other political subdivision of this state.
TOTAL	**$20.294 billion**	

Note: A range of other, smaller exemptions to the sales tax exist. These are each worth less than $100 million per year. Taken together, they total $505 million. They include: sales to non-profits, certain bingo equipment, food stamp purchases, newspapers, magazine subscriptions, certain drilling equipment, internet access service (partial), sales tax clothing and footwear holiday, certain ships, boats and boat motors, railroad fuel and supplies, coin-operated services, data processing and information services (partial).

SALES TAX EXCLUSIONS

EXCLUSION	VALUE
CONSTRUCTION LABOR	
New residential construction	$0.284 billion
New non-residential construction	$0.186 billion
Residential repair and remodeling	$0.092 billion
TOTAL	**$0.562 billion**
PERSONAL SERVICES	
Barber and beauty	$0.064 billion
Funeral	$0.055 billion
Child day care	$0.168 billion
Miscellaneous personal services	$0.011 billion
TOTAL	**$0.298 billion**
BUSINESS AND PROFESSIONAL SERVICES	
Physician services	$0.727 billion
Dental services	$0.259 billion

Other health care	$0.365 billion
Legal services	$0.354 billion
Accounting and audit services	$0.174 billion
Architectural and engineering services	$0.310 billion
Management consulting and public relations	$0.139 billion
Contract computer programming	$0.133 billion
Research and development laboratory services	$0.060 billion
Economic and sociological research	$0.021 billion
Testing labs	$0.047 billion
Billboard advertising	$0.023 billion
Employment agency services	$0.029 billion
Temporary labor supply services	$0.050 billion
Financial services brokerage	$0.156 billion
Other financial	$0.104 billion
Real estate brokerage and agency	$0.192 billion
Freight hauling	$0.224 billion
Other transportation	$0.016 billion
Veterinary services	$0.036 billion
TOTAL	**$3.419 billion**
OTHER SERVICES	
Automotive maintenance and repair	$0.219 billion
Car washes	$0.023 billion
Travel arrangement	$0.021 billion
Private vocational education	$0.032 billion
Other education services	$0.028 billion
Interior design	$0.008 billion
TOTAL	**$0.331 billion**
TOTAL	**$4.620 billion**

Between modest sales and use tax rate increases and closing some existing exemptions and exclusions, there is clearly scope to eliminate school district M&O property taxes on residential properties in the short to medium term. Such a reform could even be achieved by the 82nd Legislature. The possible combinations of rate changes and exemptions and exclusions that could be ended are numerous. The iteration suggested below is merely illustrative of how the $9.2 billion figure could be reached:

Raise the State Sales & Use Tax rate 2 cents to 8.25 percent:	*$5.806 billion*
End the Business & Professional Services sales tax exclusion:	*$3.419 billion*
Total:	*$9.225 billion*

3. Eliminating school district M&O property taxes on all other property, including business and commercial property.

Raising the additional revenue that would be required to completely eliminate the rest of the school district M&O property tax levy could be achieved through a combination of sales tax rate adjustments, closure of additional exemption and exclusions, and, over the long-term, dedication of state budget surpluses to property tax relief.

Texas consistently generates surplus revenues that, if not returned to taxpayers, are simply used to grow government. Since the 1994-95 biennium, Texas has generated $36 billion in state budget surpluses. Since the state's tax revenues consistently generate surpluses, it is appropriate to amend the Texas Constitution (Article III, Section 49-g(c)) with language similar to that proposed by House Joint Resolution 53 (80R) so that half of all surplus revenues certified by the Comptroller are dedicated to the Property Tax Relief Fund:

> (c) Not later than the 90th day of each fiscal biennium, the comptroller shall:
>
> (1) transfer to the budget stabilization fund one-half of any unencumbered positive balance of general revenues on the last day of the preceding fiscal biennium; and
>
> (2) transfer the remaining unencumbered positive balance of general revenues on the last day of the preceding fiscal biennium to the property tax relief fund.

Linking this legislation with a tighter constitutional spending limit based on population growth plus inflation (which was also a fundamental part of HJR 50 (80R)) will help increase the state's surplus revenues that can be dedicated to eliminating remaining school district M&O property taxes. Every dollar of surplus revenue accrued through spending restraint will reduce the extent to which the sales and use tax rate would need to be raised, or the base expanded in order to fund property tax elimination.

Consumption Taxes

Since consumption taxes form the core of the blueprint to shift away from property taxes to fund public education, it is worthwhile to highlight the benefits of consumption taxation and to address some of the arguments related to regressivity that are sometimes used by opponents of consumption taxation:

- **Consumption taxes build on the fact that consumers almost always pay all the taxes, and in that way, they are fair and broad-based**. The Comptroller's 2001 "Tax Exemptions & Tax Incidence" report reinforces this very important point:

> It should be recognized that any tax levied directly on a business will ultimately be paid by real, live people—if not consumers via higher prices, then business owners via reduced profits or employees via reduced wages ... In any case, or in any combination where the tax burden is borne jointly, the old cliché is true: 'Only people pay taxes.'

Consumption taxes are paid directly by consumers; they are not hidden.

- **Consumption taxes are transparent to the general public, making them fair and predictable.** Sales tax liability is easily calculated. In March of 2005, then-Chairman of the Federal Reserve Alan Greenspan testified before Congress:

> A principle that I believe is important now—but appears not to have weighed so heavily on those involved in the earlier reforms—is predictability in the tax code. By this I mean creating a tax system in which households and businesses can look into the future and have some reasonable degree of certainty about the future tax implications of decisions made today."[xvii]

Sales taxes meet that criterion. They are predictable because a person can calculate their tax liability prior to the purchase of a taxable good or service.

- **Consumption taxes are generally positive for job creation**. Consumption taxes are a superior form of taxation because they do not penalize work, savings or investment. A tax on consumption is most desirable for that very reason. In 2005, then-Federal Reserve Board Chairman Greenspan testified to the following economic benefits of consumption taxes: "…many economists believe that a consumption tax would be best from the perspective of promoting economic growth… because a consumption tax is likely to encourage saving and capital formation."[xviii]

All businesses benefit because investment in new facilities, for instance, would be encouraged; all homeowners benefit, for example, because homeownership would achieve its socially desired end rather than being a tax machine for government. A growing, healthy economy is required to provide for the future funding needs of our educational system. The state's consumption tax revenue has grown with the Texas economy.

- **<u>Consumption taxes are far less costly to administrate than the property tax</u>.** According to the Comptroller's 2009 Property Tax Report, County Appraisal Districts spent $379 million appraising more than 18 million properties in the state [*NOTE: we believe that the Comptroller's report noted above does not account for all costs of administration and compliance, though it is good starting point*]. This compares to just $134 million per year that the Comptroller's Office spends to ensure compliance with all state taxes.[xix]

Both the Senate and the House have previously considered and/or passed school finance plans that relied upon the sales and use tax to reduce property taxes: House Bill 4 (75R), House Bill 5 and Senate Bill 2 (78R), and House Bill 1 (78S4).

Reliable Revenue

While many tax plans have been considered by the Legislature since then, consumption taxes appear consistently as a reasonable alternative to the property tax.

Consumption taxes have been a remarkably reliable source of revenue. According to the Comptroller of Public Accounts, sales and use tax collections totaled $2 billion in fiscal year 1978. By comparison, in fiscal year 2007, the state collected $20.3 billion in sales tax revenue. From 1978 to 2007, the biennial revenues from the sales tax have increased without exception, despite economic downtowns in the late 1970's, 1980's and earlier this decade. Even in the aftermath of a global recession, biennial revenues for 2012-13 are estimated to be just 2.3 percent below the corresponding amount for 2010-11.[xx] By relying on sales taxes as the primary source of revenue for public schools, the Legislature can ensure a reliable and growing base of monies for education.

The perception of the regressivity of sales taxes is frequently used to argue against additional reliance on the tax. There are many ways, however, to address this perceived regressivity. According to the bill analysis of SB 2 (78R), the bill:

> [R]equired local revenue from state sales tax base expansion to be used for tax relief, unless another use is authorized by local voters. There is a 40 percent sales tax exemption for certain financial assistance and food stamp recipients (i.e., Lone Star Card recipients). Additionally, health care services are exempt from sales tax.[xxi]

Dr. George Zodrow of Rice University affirms the prospect that regressivity could be overcome:

> Concerns about the distributional effects of reducing or eliminating sales tax exemptions on goods consumed disproportionately by the poor could be addressed by introducing highly targeted means-tested sales tax rebate, perhaps involving expanded utilization of the Lone Star Card.[xxii]

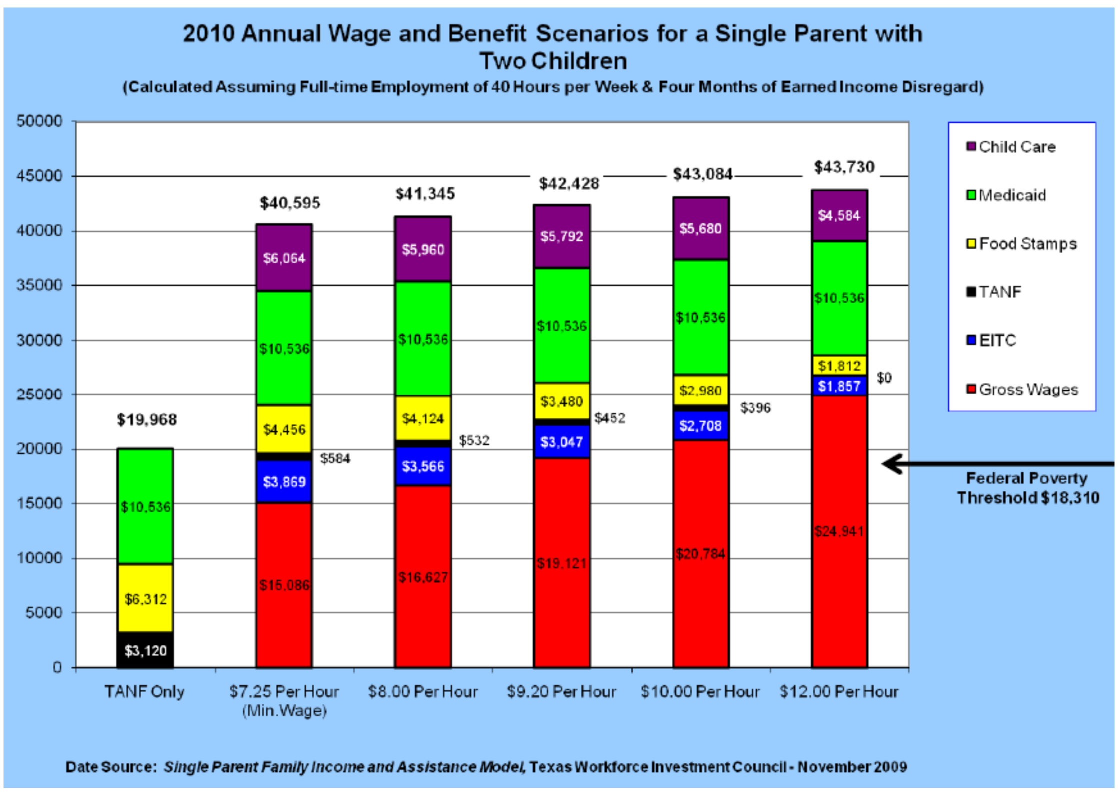
While it is true that lower income Texans spend great proportion of their incomes on sales taxes, there are three factors worth noting:

1. Higher income Texans spend more money on consumable items both in terms of quantity and cost, and therefore pay more sales taxes overall. This is not an insignificant feature of the sales and use tax. While upper income Texans can resort to tax strategies that limit their income tax or property tax liability, it is more difficult to escape consumption taxes except for buying goods over the Internet (from fewer and fewer retailers which simply refuse to the collect a tax that is owed) or having expensive purchases shipped to Texas and failing to comply with the use tax requirements.

2. While regressivity is an important factor, the non-cash assistance that lower income Texans receive from the state and federal government are significant offsets that must be considered.

   According to a report by the Texas Workforce Commission, a single parent with two children can receive up to $21,176 annually in non-cash assistance including the Earned Income Tax Credit (EITC), Temporary Assistance for Needy Families (TANF), Food Stamps, Medicaid and Child Care assistance. This Workforce data does not include other important, non-cash programs such as Early Childhood Intervention, Supplemental Security Income, and various mental health programs, as well as a Title IV-D child support enforcement carried out by the state or counties. The total value of these programs can annually exceed $20,000, depending on circumstances, but most assessments of regressivity take into account only direct cash income and calculate the effect on that basis.

   The Workforce Commission chart follows:



3. Since most taxes are ultimately borne by the consumer and laborer, business taxes merely amount to "hidden" taxes as the Comptroller's office has argued. Certain business taxes, such as the

previous franchise tax, are actually considered more regressive than the sales and use tax according to the Comptroller's Tax Incidence study.[xxiii]

The Border Issue

Other critics of raising Texas' consumption taxes to replace school district property taxes contend that Texans who live in close proximity to bordering states will cross state lines to make purchases in neighboring states with lower sales tax rates. They argue that this will harm businesses in Texas' border areas and drive some commerce out of the state.

However, these arguments are overstated. The percentage of the Texas population that lives close to other states is relatively small and in many locations is actually declining.

According to the State Demographer, only 884,000 Texans live within ten miles of another state. This is just 3.8 percent of the total state population. These states (Arkansas, Louisiana, New Mexico, and Oklahoma) have state sales taxes ranging from 4 percent to 6 percent, so they are already lower than Texas' 6.25 percent state sales tax. Indeed, at 4 percent, Louisiana has the lowest state sales tax of these four states, but the number of Texans living within 10 miles of Louisiana has declined from 191,000 in 2000, to 185,000 in 2007.[xxiv]

As the examples below show, the savings that could potentially accrue to consumers who elect to cross state lines to make purchases are minimal when the relative tax burdens and travel costs are factored in:

Example 1: The City of Center, Texas, seventeen miles from the Louisiana border, where the median household income is $26,000 a year:

- On a $100 dollar taxable purchase in Texas, a resident of Center would pay $10 in state sales taxes if the rate was increased to ten percent.
- Making a trip to the closest Wal-Mart in Louisiana would require a 70 mile roundtrip to Mansfield, LA. The same purchase, but with the Louisiana sales tax rate of 4 percent, would yield a tax bill of $4, or a $6 saving over the tax in Texas.
- Factor in gas at $3 gallon and 18mpg fuel consumption, the cost of trip itself is almost $12, wiping out all of the tax savings.

Example 2: The City of Muleshoe in the Texas Panhandle, which is almost 20 miles from the New Mexico border, and has a median household income of $25,500 a year:

- On a $100 dollar taxable purchase in Texas, a resident of Muleshoe would pay $10 in state sales taxes if the rate was increased to ten percent.

• Making a trip to the closest Wal-Mart in New Mexico would require a 75 mile roundtrip to Portales, NM. Because New Mexico imposes a Gross Receipts Tax instead of a sales tax, there would be no direct taxation on the purchase, thus yielding a tax bill to the consumer of zero and an apparent $10 saving over the cost of the purchase in Texas.
• However, factor in gas at $3 gallon and 18mpg fuel consumption, the cost of trip itself is more than $12, which again would wipe out the entire tax savings.

Note: Fuel consumption in these examples is based on a 2004 Ford F150 Truck, which, according to the U.S Department of Energy achieves a highway mileage of 18mpg and city mileage of 14mpg.

Although the State of New Mexico imposes no sales tax, its Gross Receipts Tax ranges from 5.125 percent to 7.875 percent, which is typically passed on to consumers. See the New Mexico Department of Taxation and Revenue: http://www.tax.state.nm.us/oos/GrossReceiptsTaxFAQ.pdf.

The Appraisal Problem: Doubling the Tax Burden Every 8 Years

Aside from the broad, systemic reforms discussed in the blueprint above, legislators must also focus on providing appraisal relief to property tax payers until systemic reforms take effect.

Property tax relief funded by the Legislature required school districts to reduce their property tax rates. Even with this rate relief in place, 10 percent increases appraisals in many parts of the state year after year —which are controlled at the local level — have left many property owners facing higher tax bills.

The current ten percent appraisal cap, which applies only to residential homesteads, provides virtually no protection for homeowners.

Even with the cap in place **the tax bill on a residential property can double every seven-and-a-half years even if the tax rate remains the same**:

Year	Tax Bill	10% Cap
2003	$5,000	+$500.00
2004	$5,500	+$550.00
2005	$6,050	+$605.00
2006	$6,655	+$665.50
2007	$7,321	+$732.05
2008	$8053	+$805.25
2009	$8858	+$885.78
2010	$9744	+$974.36
2011	$10,718	

The table above shows this doubling effect based on a starting tax bill of $5,000. However, the specific numbers used are immaterial, since the doubling effect will take place whether a homeowner's tax bill is $100 or $10,000. Since the figures in the table simply reflect the effect of the 10 percent appraisal cap on a tax bill without contemplating any increase in the tax rate, it is evident that were the tax rate to increase as well, the doubling effect would occur in an even shorter timeframe: a phenomenon that has likely been experienced by many thousands of property tax payers already.

However, even without rate increases, in the long term the doubling effect will tax many Texans out of their homes. The following table illustrates this point:

Year	Age of Property Owner	Tax Bill
2003	35	$5,000
2011	43	$10,718
2018	50	$21,436
2026	58	$42,872
2033	65	$85,744

Using the same starting-point as the previous example – a $5,000 tax bill in 2003 – the doubling effect is illustrated over a thirty year period. If the property owner is 35 years of age in 2003 when the tax bill is $5,000, when the property owner reaches 65 years of age in 2033, their tax bill will be $85,744 when the senior freeze kicks in. The property owner will be required to pay $85,000 in taxes every year of their retirement as long as they stay in their home: if they want to live for ten more years in their home, they will need to have $850,000 saved when they retire just so that they can pay their property taxes.

This point should be of extreme and urgent concern for policymakers. That such growth is built into the property tax system is simply unacceptable and unsustainable: in no other tax structure do tax bills rise relentlessly without regard for the taxpayers' ability to pay, and without regard for whether the increases are justified. In effect, property tax bills are tied to an artificial and unreasonably high inflation index putting property taxes on auto-pilot rather than moored to any economically or fiscally recognized standard.

Lower the appraisal cap and apply it equally to all real property.

The appraisal cap must be lowered to provide property owners with immediate relief from rampant appraisal increases. Lowering the appraisal cap to three percent and applying the cap to residential and business properties will ensure that all property tax payers are treated equally. Since the current appraisal cap does not apply to business properties, business owners in Texas are forced to bear a larger burden of appraisal increases then would be the case in an equitable system of property taxation.

However, businesses have legitimate concerns about the impact of appraisal caps in general. Caps may have the effect of distorting valuations and creating discrepancies within the appraisal process. While caps restrict appraisal increases, they are purely arbitrary and do not allow market value to be fairly reflected. For instance, the current 10 percent cap gives local taxing entities free access to 10 percent appraisal increases (and hence revenue increases) even if this does not reflect market trends and without regard to whether the money is needed.

In short, appraisal caps are an imperfect remedy for an afflicted tax system. The problems associated with appraisal caps simply underscore the need to eliminate property taxes altogether. However, until that goal can be achieved, lowering the appraisal cap to 3 percent and applying it uniformly to homes and businesses will provide immediate, short-term relief.

Even when the current appraisal cap is lowered, local governments and school districts still have a generous window for growth. A lower appraisal cap will promote greater transparency and accountability because it will limit the extent to which local officials can raise tax revenues without directly raising the rates at which local property taxes are levied. The high appraisal increases that are permitted by the current 10 percent cap allow tax bills to be raised by stealth, without the tax rate having to be raised.

Opposition from the business community to lowering the current appraisal cap is a result of the distortion that is created when an appraisal cap is applied only to residential properties; businesses will resist lowering the cap on residential appraisal because any ensuing shortfall in revenue will potentially be made up by higher taxes on business properties (which have no cap on their appraised value). Any appraisal cap must apply to all real property to prevent shifting of the tax burden between residential and business property owners.

Conclusion

Texas' public school finance system is broken. The state can no longer afford to rely on the punitive and pernicious property tax to fund one of its most important constitutional responsibilities. The current property tax-based system will face legal challenges over the next decade which can be averted only if the system is substantially reformed.

The state's sales and use tax has proven itself to be a reliable source of revenue that could be used to replace property taxes as the core funding stream for public education. In contrast to the property tax, sales taxes are fair and broad-based and would ensure that all residents of the state are contributing to the public education system.

Legislators can facilitate this reform by increasing efficiency in the public education system and cutting bureaucracy to help ensure that public education spending is focused primarily on classroom instruction.

In the short term, and until broad systemic change can be effected, legislators must focus their attention on reducing the negative impact of the property tax, primarily by lowering the appraisal cap and applying it equally to residential and business property.

ENDNOTES

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