



# **“Choosing a New Path”**

## Using the Projected Budget Surplus for Property Tax Reduction

Part I of the Final Report of the Texas Conservative Coalition  
Research Institute  
Task Force on State Taxation

**March 2006**

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Part I

#### **Summary of Findings**

Because the Texas Supreme Court implored policy makers to “choose a new path” for public school finance, the Texas Conservative Coalition Research Institute (TCCRI) Task Force on State Taxation makes the following recommendations in anticipation of the Third Called Special Session of the 79<sup>th</sup> Legislature:

Immediate requirement:

- Dedicate the entire value of the current surplus to property tax reduction to meet the Supreme Court’s ruling (*Neely v. West Orange-Cove*).

The 80<sup>th</sup> Legislature should convene with the following long-term objectives:

- Steer public school finance away from reliance on an inequitable, economically-damaging, and administratively-costly tax that will continually put the State on a collision course with the constitutional prohibition against a statewide property tax;
- Shift the method of public school finance by applying current and future surpluses to the reduction -- and eventual elimination -- of property taxes; legislators should continue to rely on consumption taxes, as they have proven to be a consistently reliable, transparent source of revenue with a low cost of compliance; and,
- Enact constitutional spending restraints, and more effectively utilize existing revenue, to hasten abolition of the school district maintenance-and-operations (M&O) tax.

### General Background

Property taxes are a constitutional and economic problem.

In *Neely v. West Orange-Cove*, the Texas Supreme Court found that because independent school districts lack “meaningful discretion” over property tax rates<sup>i</sup> the “public school finance system violates article VIII, section 1-e of the Texas Constitution.”<sup>ii</sup> Article VIII, section 1-e reads, “no State *ad valorem* taxes shall be levied upon any property within this State.”

In *Neely v. West Orange-Cove*, the Court relied on its explanation in *Edgewood IV* to explain the most recent ruling:

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.<sup>iii</sup>

The problem underlying the Court’s ruling is that “local tax rates have increased markedly since 1993-1994.”<sup>iv</sup> The Court continued:

Then, only 2% of the districts, with 1% of the students, were taxing at the \$1.50 maximum M&O rate; now, 48% of the districts, with 59% of the students, are taxing at the cap, and 67% of the districts, with 81% of the students, are taxing at or above \$1.45. In 1993-1994, 90% of the districts, with 85% of the students, had tax rates below \$1.40; that group has now shrunk to 20% of the districts, with 10% of the students.<sup>v</sup>

This evidence also underscores the fundamental problem created by the school property tax. Use of *ad valorem* taxation by units of local government as a primary means to fund their activities, coupled with school property taxes, has translated into intolerable levels of property taxes assessed against homeowners and businesses. Exorbitant property taxes levied by school and other local government entities equates into an economic problem for the state.

In just over a decade, the total amount of money raised by the four different property tax levies has more than doubled. The total property tax levy exceeds \$30 billion annually and is growing. From 1991 to 2001, real per capita property taxes in Texas increased almost 25 percent. Much of this is due to the increase in school M&O property taxes. Through a combination of increased rates and/or appraised values, homeowners have seen their annual tax bills increase inexorably. In Harris County alone, the taxable value of homesteads, as determined by appraisers, rose by more than 46% from 1996 to 2001, causing tax bills to increase by nearly 57%.<sup>vi</sup>

Furthermore, property taxes are damaging to business within the state, especially those that are capital intensive, because property taxes directly tax capital. As a result, investment in plant and equipment in Texas is less than it otherwise would be, with consequent job losses. Business also must deal with the property tax on “personal” property such as desks and office equipment, making the cost of compliance and the risks associated with it that much greater.

The growth of local government, as reflected in growth of property tax receipts, has outpaced the Texas economy. This is evident when the growth in the property tax levy over the last four years is compared to the change in the Consumer Price Index (CPI) and Gross State Product (GSP). The sum of the increase in CPI and GSP for each year is less than the percent increase in the total property tax levy.<sup>vii</sup>

As a consequence, a majority of Texans believe that property taxes are “too high” or “much too high”, according to a statewide poll conducted by TCCRI.<sup>viii</sup>

Therefore, the challenge before the Texas Legislature is both constitutional and economic: it must revamp its system of funding public education so that over time the State:

1. Complies with Article VIII, section 1-e;
2. Relieves taxpayers of the burdens associated with property taxes; and
3. Meets its mandate “to make suitable provision for the support and maintenance of an efficient system of public free schools.”<sup>ix</sup>

In order to meet those three objectives, the state must move away from its reliance on the property tax as a source of funding for public education. Optimally, the property tax should be abolished. As noted by the Court in *Edgewood* and *West Orange-Cove*, the property tax is inherently inequitable, so its proceeds must be redistributed under a centralized scheme of wealth transferal known popularly as “Robin Hood.” The “Robin Hood” system not only subsidizes tax increases for property-poor districts, it also provides a convenient escape hatch for school administrators in property-rich districts to justify increasing tax rates and encouraging appraisal creep rather than implementing cost-saving measures.

Property taxes are abrasive to those compelled to pay them because any levy applied to income, savings and investment ultimately deprives people of the just fruit of their labor. Exactly how the state might abolish property taxes is a subject for Part II of this report, but the general proposition is that dedicating all future surpluses, combined with restraints on appropriations and expansion of the consumption tax, would eliminate the root cause of our constitutional and economic problems: the *ad valorem* tax.

### **Recommendations of the Task Force**

The TCCRI, working through two task forces over the course of three years, has had occasion to examine the nature, cause and consequence of the property tax and the challenge posed to the Legislature by the Supreme Court. With the aid of lawmakers, policy analysts, and taxpayers, the Institute has considered and distilled various proposals and has reached the following conclusions:

1. The Third Called Special Session of the 79<sup>th</sup> Legislature should focus exclusively on the single issue that was found unconstitutional in *West Orange-Cove*: a system that, in effect, has become a statewide property tax.
2. Property tax reduction should be addressed, for now, by dedicating all current surplus revenue to reduce the school M&O tax rate. This step would provide approximately twenty cents of property-tax relief per year over the next two years. [The amount of tax “buy-down” could be higher once the Office of the Comptroller issues its final estimate at the start of the Third Called Session.]
3. To preserve and expand this tax relief, the Legislature should:
  - Dedicate all future surpluses to property tax reduction.
  - Require a vote of the people for any proposed increase of the M&O rate at the local level. [Local discretion accords with the Court’s *West Orange-Cove* decision: “Local supplementation is made a core component of the system structure, necessitated by the basic philosophy of local control.”<sup>x</sup>]
  - Expand the base of consumption taxes.
  - Pass budgetary reforms to keep reducing property-tax receipts over time with the aim of eliminating the tax. [Reforms include strengthening the constitutional limitation on growth of spending, as well as eliminating contingency appropriations.]<sup>xi</sup>
  - Enact property tax reforms such as lowering the appraisal cap, direct election of appraisal boards, and lowering the rollback rate.

### **Charting a New Direction for Public School Finance**

The Texas Supreme Court has again warned that a patchwork approach to school finance is not a permanent fix:

We remain convinced, however, as we were sixteen years ago, that defects in the structure of the public school finance system expose the system to constitutional challenge. Pouring more money into the system may forestall those challenges, but only for a time. They will repeat until the system is overhauled.

This admonition by the Court is significant but is consistently overlooked. The Supreme Court has recognized that the crux of the problem in our public school finance system is the property tax. The State cannot achieve equity *and* comply with Article VIII, section 1-e of the Texas Constitution if the property tax remains a primary source of revenue for public education.

Such reliance, especially given the multitude and diversity of school districts, inevitably makes it difficult to achieve efficiency because of the vast disparities in local property wealth...<sup>xii</sup>

Furthermore, the Supreme Court has clearly established that the property tax is a state tax which presents intractable constitutional problems.

We held in *Edgewood III* that “[a]n *ad valorem* tax is a state tax....when the State so completely controls the levy, assessment and disbursement of revenue, either directly or indirectly, that the authority employed is without meaningful discretion.”<sup>xiii</sup>

**The current court, reinforcing the opinion of an earlier court, emphatically states: “The Legislature can avoid these constitutional conundra by choosing a new path altogether.”**<sup>xiv</sup> That new path is to eliminate the property tax through a combination of:

1. Dedicated budget surpluses produced by economic activity;
2. Enhanced savings as a result of budget discipline
3. Continued expansion of the sales & use tax to accelerate the extinction of school property taxation.

Even though the concept of dedicating surpluses to property tax reduction and elimination has yet to be debated by the Legislature, criticisms of that approach rest on two assumptions:

1. That creating a new tax to supplement the current system is a “permanent fix” whereas using the surplus is a temporary or “quick fix.”
2. The amount of the surplus (“new money”) the Legislature might have to maintain the property tax reduction, or lower property tax rate more, is unpredictable year-to-year.

The policies enacted as attempts to address the tax problem identified in *Edgewood* have proved to be either illusory or deleterious. Expansion of the Franchise Tax and approval by the voters of the Lottery in 1991 were heralded by Governor Ann Richards as a fix to state finances and a supplement to public school finances. Governor Bush’s proposal to increase business taxes was defeated. His increase in the homestead exemption in 1997 proved to be another fleeting attempt to provide property tax relief as a consequence of rapidly increasing property tax rates and appraisals in the wake of *Edgewood*.

More than a decade later, as the Court again warns, the Legislature is confronted with the same set of seemingly perplexing and vexing questions with the same array of options that have proven fruitless in addressing those questions. Judging by the *West Orange-Cove* decision alone, the patchwork approach of school finances is an abject failure since the system of public school finance has been ruled unconstitutional.

New taxes *may* temporarily abate the problem, but they *definitely* will serve to grow government rather than eliminate the source of the problem. The only thing likely to be “permanent” about adopting a new tax is the new tax itself, a certainty that the new tax will have to be raised often as long as the current system remains unchanged, and a certainty that property tax rates will creep up again.

Furthermore, unless revenues generated by a new tax are constitutionally dedicated to property tax reduction, the promise of reduced property taxes wilts under the light of experience. The Legislature frequently shifts money from statutorily-dedicated funds -- the Highway Fund, the Economic Stabilization Fund (“Rainy Day” Fund), the Telecommunications Infrastructure Fund, and the System Benefit Fund -- to pay for expanded programs and other services despite the promised purpose of the funds. Constitutional dedication is essential.

However, the only permanent solution to the public school finance challenge is to eliminate the property tax altogether. What is vital at this juncture is to try a new path that not only weans the system of public education from reliance on the property tax but does so in a manner that comports with fundamental principles of fiscal conservatism. Dedicating current and future surpluses to that end is one piece of the best approach.

Surpluses represent several things:

1. The reliability of the current state system of generating revenue, which depends mostly on consumption taxes<sup>xv</sup>;
2. Our economy is robust and should be strengthened, not weakened, through sound tax policy; and,
3. An over-taxation of the people.

“New Money,” or the surplus, is defined as the revenue amount in the Biennial Revenue Estimates (BRE), less the amount appropriated for the previous biennium. “New money” revenue totals<sup>xvi</sup> for the last seven biennia are:

<b>Biennium</b>	<b>“New Money” (in billions)</b>
2006-07	\$6.4
2004-05	\$-7.4 (deficit)
2003-03	\$5.1
2000-01	\$5.6
1998-99	\$3.6
1996-97	\$4.5
1994-95	\$1.8

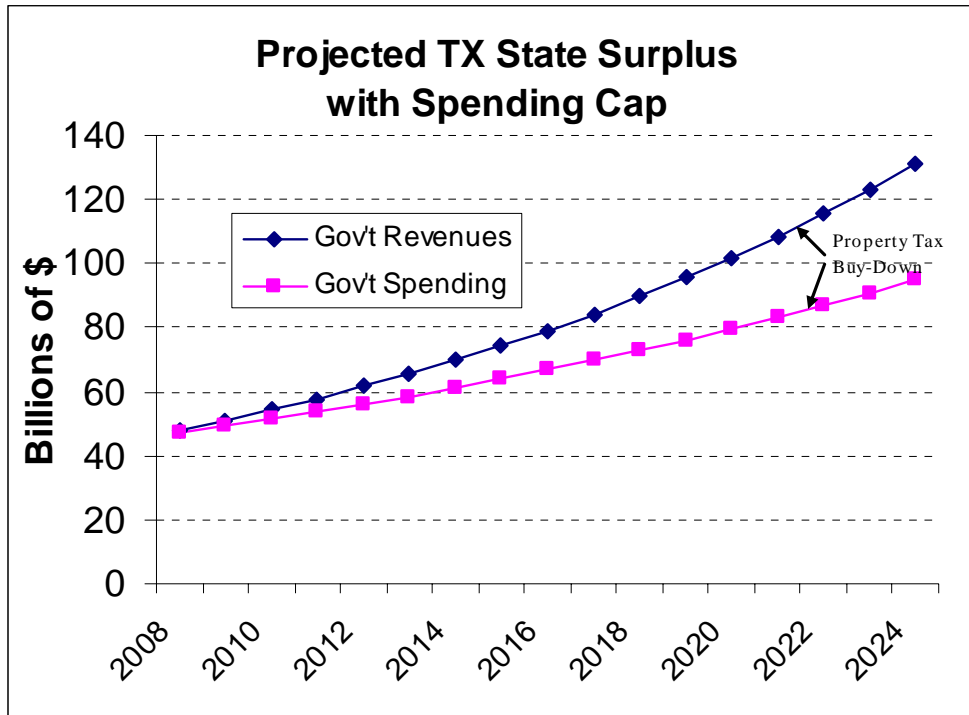
If “new money” had been dedicated to property tax reduction over the course of the last twelve years, the case brought by *West Orange-Cove* and other interveners would have been undermined or the decision forestalled. Additionally, if spending over the course of those seven biennia had been even modestly reduced those surpluses would have been higher. In fact, meaningful discretion, the mantra of the Supreme Court school finance

opinions, would not only have been maintained, it would have been significantly enhanced.

As the 79<sup>th</sup> Legislature grappled for answers to the property tax question, *it is undeniable that the Legislature actually spent its way out of a tax cut*. If \$5 billion of the \$6.4 billion surplus had been used specifically for property tax reduction, the Legislature would have anticipated the Supreme Court opinion by several months and could have already reduced school district M&O taxes by twenty-five (25) cents for each of the next two years. Combined with the current estimated surplus of \$4.3 billion, the school district property taxes could have been reduced by twenty-one (21) cents for nearly the next four years.

Spending restraint is another key to eliminating school district M&O taxes. When confronted with a massive shortfall in revenue, the 78<sup>th</sup> Legislature met its obligation to balance the budget without raising taxes. The Legislature proved that spending discipline is a legitimate and successful fiscal tool. It must be a permanent practice of the Legislature.

Looking at the last fifteen years, the state revenue collection system has been remarkably robust in delivering an average of 6.5% annual increases into the state. Over the same period, the state's population increases plus inflation have only been 4.5%. If that same ratio were to hold true, by limiting the increase in spending to population plus inflation, the property tax will be eliminated in approximately sixteen years assuming the current surplus does not increase.<sup>xvii</sup>



With surplus dedication, strict spending restraint, foresight, and patience the Legislature can grow the gap between government revenues and government spending; and shrink the property tax, eventually to zero.

### Conclusion

Because “new money” is a distinctly reliable feature of the budget cycle in Texas, using dedicated surpluses for property tax reduction is a sound fiscal tool. Furthermore, as the evidence bears out, had there been as serious a commitment to reducing the overall growth of government as there was in the 78<sup>th</sup> Legislature, then the amount of “new money” available for property tax reduction would have been even more significant over time.

Now that Governor Perry has called for a special legislative session to begin on April 17, 2006, the Texas Conservative Coalition Research Institute Task Force on State Taxation has concluded its research efforts. A permanent solution will be found in consistently returning surplus revenue to the people and businesses that generated them in the form of lower property taxes, coupled with future spending restraint and expanded consumption taxes, will move Texas toward abolition of school property tax altogether. There can be no better “permanent” solution to any problem than to remove its root cause.

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### Citations and Notes

<sup>i</sup> *West Orange-Cove CISD*, 176 S.W. 3D 746 (TEX. 2005), page 79.

<sup>ii</sup> *Id.*, page 83.

<sup>iii</sup> *Edgewood IV*, 917 S.W. 2d at 738.

<sup>iv</sup> *West Orange-Cove CISD*, 176 S.W. 3D 746 (TEX. 2005)

<sup>v</sup> *Id.*

<sup>vi</sup> “Appraisal Cap’s Impact on Government and the Economy,” TCCRI Research Report, July, 2005, page 1

<sup>vii</sup> *Id.*, page 1

<sup>viii</sup> “Texans Don’t Want More Taxes,” Statewide Poll sponsored by TCCRI, conducted by Wilson Research Strategies, January, 2004.

<sup>ix</sup> TEX. CONST. art. VII, § 1.

<sup>x</sup> *West Orange-Cove CISD*, 176 S.W. 3D 746 (TEX. 2005), page 83

<sup>xi</sup> For additional recommendations, see “Roadmap to Responsible Reform,” published by TCCRI, January, 2003.

<sup>xii</sup> *Id.*, page 76

<sup>xiii</sup> *Edgewood III*, 826 S.W.2d at 502

<sup>xiv</sup> *Id.* at 503

<sup>xv</sup> Sales and Use tax collections, the largest single portion of state taxes, totaled \$824 million in 1972; by 2005 they reached \$16.3 billion. The corresponding growth rate for the underlying base—before adjusting for legislative changes—was 8.4 percent (1972-2001). Since 1972 there has only been one dip in state sales and use tax collections over the previous year and that was in 2002 and the decline was one percent.

<sup>xvi</sup> Biennial Revenue Estimates, Office of the Texas Comptroller of Public Accounts.

<sup>xvii</sup> Estimate by Dr. Byron Schlomach, Chief Economist, Texas Public Policy Foundation.

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The contents of this report do not represent an endorsement from any individual member of the Board of Directors of the Texas Conservative Coalition Research Institute or any individual member of the TCCRI State Taxation Task Force. There may be some policy recommendations or statements of philosophy that individual members may be unable to support. We recognize and respect their position and greatly appreciate the work of everyone involved with the Task Force.