CENTER for PUBLIC POLICY PRIORITIES
WORKING FOR A BETTER TEXAS™

State Budget Do's and Don'ts

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Why Consider New Revenue

The Comptroller's revenue estimate projects the state will take in $92.6 billion in General Revenue over 2014-15, plus another $8.8 billion previously unanticipated from 2012-13, for a total of $101.4 billion. This is more than we had last time, but not more than we need this time. Just to restore spending to pre-recession levels, which requires covering population growth and inflation, Texas needs at least $108 billion. We should draw on the $11.8 billion Rainy Day Fund projected by the end of 2015. But even if we spent every penny of the Rainy Day Fund, it would still not be enough to:

- finish out 2012-13,
- write a budget for 2014-15 at pre-recession levels,
- reverse various accounting maneuvers, and
- stop misusing dedicated funds.

In the short run, Texas needs more revenue to make ends meet, and in the long run, we must create a 21st Century revenue system to ensure a prosperous future.

Some Modest Steps to Raise Revenue

Tweaks to the Margins Tax

The franchise tax alone cannot close the structural deficit the Legislature created in 2006. The tax, which is now forecast to produce an additional $4 billion per biennium due to the 2006 changes, would have to suddenly double to eliminate the continuing deficit. However, small changes could be made to generate significant amounts of money. For instance, raising the tax rate from the current 1 percent of taxable margin (0.5 percent for retail and wholesale) to 1.25 percent (0.625 percent for retail and wholesale) could raise an additional $2.2 billion per biennium. Changing the calculation of the tax from the current taxable margin to the more traditional net income calculation would eliminate situations in which companies fail to make a profit, but still owe franchise tax.

Tax Business and Professional Services

Taxing services would broaden the sales tax base to better grow along with the economy and the need for public services. Taxing business and professional services (except health care), such as legal and accounting services, alone could have raised $6.1 billion in the 2012-13 biennium. By generating more revenue at current tax rates, a broader tax base would help reduce the pressure for increases in the state sales tax rate. A broader base would also generate more revenue for local governments' sales taxes, reducing the pressure on local property taxes.

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Sunset review of tax exemptions

The many exemptions in the Tax Code should undergo a review similar to the sunset review that most state agencies face every 12 years. Once a tax exemption is in place, it is rarely re-examined to determine whether the exemption is fulfilling its original intent or whether there is a more efficient or effective way to achieve that goal. The legislature should regularly scrutinize tax breaks to determine if their economic benefits are worth their costs in future revenue losses. Any new exemptions should routinely include a sunset date. Bills to create a sunset review of exemptions have been filed in past sessions, but have not yet reached floor debate.

Quality Assurance Fee

A Quality Assurance Fee (QAF) could be assessed on the revenues of health care providers in Texas to provide the required state match for additional Medicaid federal funding. For example, a QAF of 3.4 percent of hospital gross receipts could raise roughly $4 billion in state revenue over two years, which would be matched with roughly $5.7 billion in federal revenue, according to a recent estimate by Deloitte for the Texas Health and Human Services Commission. Texas currently assesses a QAF only on facilities for persons with intellectual disabilities. The 2006, 2008, and 2012 Code Red reports recommended creating a QAF and using the revenue, plus federal matching dollars, to reimburse hospitals and physicians at higher Medicaid rates, improving access to health care. A new QAF could also help Texas draw a $9-to-$1 federal match to cover over 1 million uninsured adults under the Affordable Care Act's Medicaid expansion, and help fund care for the uninsured, residency training, and health care delivery and payment reforms that promote health homes, clinical integration, and payment tied to improved outcomes under Texas' newest Medicaid 1115 waiver.

Sales price disclosure

The accuracy of the system for appraising property for taxation could be improved to ensure that taxes paid are based on the actual market value of taxpayers' property. The state should require that sales prices in all real estate transactions be disclosed. Disclosure is required in 35 states; Texas is the only state that is highly dependent on property taxes but trying to function without knowing actual sales prices. If desired, the law could make disclosure to the appraisal district confidential to protect privacy. Increasing the amount of taxable property value by ensuring that all property is on the tax rolls and accurately valued is particularly important to schools. Higher property values would produce more local revenue, reducing the need for state aid and freeing state money for increased spending on education or other state services, or for reducing school property tax rates. The Legislative Budget Board (LBB) has estimated that mandatory disclosure would save the state and school districts $190 million a year in its fourth year of operation. Local governments would also benefit from more accurate property appraisals, improving these governments' ability to meet the needs of Texas families. The LBB estimates that mandatory sales price disclosure would increase city and county property tax revenue by $107 million a year after four years.

"Green" taxes

As concern over global warming has increased, attention has focused on using the tax system to discourage emissions of harmful greenhouse gases and fund energy efficiency. So-called "green taxes," such as a tax on coal use, a higher fee on highly polluting diesel fuels, and a tax on inefficient energy producers, could generate as much as $1 billion per biennium and support programs such as home weatherization or removal of older polluting cars from Texas highways.

Some Modest Steps to Increase Fairness

Low-income rebate

The lowest-income families, who are less likely to be property owners, may have not seen any benefit from the repeated efforts to reduce property taxes. One innovative program, adopted several times by the Senate during recent legislative sessions, would have targeted the 1.5 million households who use a Lone Star Card for Food Stamps or cash assistance. These families would have received a cash payment or additional nutritional assistance of $10 per month. This small benefit would also help mitigate the regressivity of Texas' state and local tax system. Many other states use income tax credits, such as the state earned income tax credit (EITC) offered by 24 states (counting the District of Columbia), to improve the equity of their tax systems. One state without a personal income tax—Washington—has adopted a credit that is linked to a family's federal EITC benefit. Since the Internal Revenue Service (IRS) is responsible for determining eligibility and calculating a family's credit, only minimal administrative processing is left to the state. The state can use IRS data to alert families of their eligibility for the credit and automatically generate applications. Families simply sign and return the form to confirm their residency and accept their credit.

Property tax circuit breaker

Property taxes can rise even when a family's ability to pay those taxes has not changed. Most states address this problem by offering a "circuit breaker" program, which links property taxes to a family's income.

Just as an electric circuit breaker protects wiring from an electric overload, a property tax circuit breaker protects a taxpayer from tax overload by reducing property taxes that exceed a certain percentage of a taxpayer's income. Unlike a homestead exemption, the amount of the reduction depends on both income and the property tax bill. This allows states to target benefits to homeowners having the greatest difficulty paying property taxes, such as elderly homeowners on a fixed income, without providing tax breaks to wealthy retirees. A unique feature of circuit breakers is the ability to benefit renters, who pay property taxes indirectly—through higher rents rather than directly to local governments. Twenty-six states and the District of Columbia provide relief to both renters and homeowners, while two states have circuit breaker programs for renters only.

Missteps to Avoid

Spending limits

One of the Texas Constitution's limits on state spending is a cap on the spending of state tax revenues that are not constitutionally dedicated. Spending cannot grow faster than the Legislative Budget Board's estimate of the rate of economic growth, which is measured by state personal income growth—the best indicator of the ability of Texans to support state services. The proposal to limit spending growth by a simple measure of population growth plus consumer inflation ignores the reality that health care costs, a major element in the state budget, are growing far faster than the general rate of inflation. Similarly, the number of school-age and over-65 Texans, who require a greater level of state services, is growing faster than the population as a whole. The proposed restriction would thus force annual reductions in the level of services and pit groups of Texans against each other.

Keep Texas a Majority-Rule State; Don't Adopt Minority Rule

Requiring a vote of two-thirds of the legislature to raise the rate of a state tax—rather than a simple majority vote—would violate the basic principle of majority rule that is at the heart of American democracy. A supermajority requirement would produce dangerous gridlock and would also hamper the state's ability to generate new revenue to close future budget shortfalls or improve state services.

Sales/property tax swap

Replacing school property taxes by increasing the sales tax would require nearly doubling the current state sales tax rate. Local school property taxes are expected to generate about $17 billion for operating costs in the 2012-13 school year. To raise that amount of money from the current sales tax base, the state tax rate would have to be increased from 6.25 percent to close to 11 percent. Most families would pay more if a higher sales tax replaced property taxes, because the sales tax is extremely regressive. For 80 percent of Texans, replacing school property taxes with a higher sales tax would mean a much larger overall tax bill. On average, only families earning more than $126,000 would pay less in taxes.

To generate enough money without raising the sales tax rate, sales taxes would have to cover necessities that are currently untaxed, such as groceries; doctors' visits and medicine; and natural gas, electricity, and water used in the home.

Replacing property taxes with sales taxes would destabilize funding for public education. When it comes to something as important as public education, Texas should not put all its eggs in one basket. Using both property and sales taxes buffers our schools from economic downturns. While the sales tax is the major source of state tax revenue, collections can be quite volatile, as demonstrated when sales tax revenue fell in both 2009 and 2010. In contrast, property tax values are much more stable, so can provide a better base of support for public education.

Eliminating school property taxes would sever an important link between a community and its public schools. Under the current system, communities wishing to raise their own property taxes to improve their local schools can vote to do so. If school funding were centralized into the state sales tax, this opportunity would be eliminated. Schools would only have the amount of money per student assigned by the state to all school districts. Communities could no longer add to this basic level of funding with local property taxes to supplement the basic state program.

Gambling Expansion

Gambling has the same effect as a regressive tax—families with less income tend to lose a much greater percentage of that income to gambling than do higher-income families.

The state has turned to gambling in the past in a search for non-tax revenue, most recently by establishing a state lottery. Analyzing the lottery as a revenue source highlights the problems with any further reliance on gambling, such as video lottery terminals (VLTs) or casinos, to fund public services. The Texas lottery began with rapidly growing ticket sales and revenue for the state, but after five years public interest fell off quickly, leading to a sharp drop-off in participation. Once, the lottery could pay for almost two weeks of Texas public education; now it covers less than five days. Revenue from VLTs or casinos could be expected to be similarly uncertain and volatile.