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FINAL REPORT OF THE SELECT COMMITTEE ON TAX EQUITY

For review at the meeting of December 8, 1988

The Select Committee on Tax Equity

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Acknowledgements

The Texas tax system is an intricate puzzle which only a handful of persons know well and possibly no one understands entirely. That makes undertaking a study of its workings a daunting task—and one that could not have been accomplished successfully without the help of a great many people.

The Committee is grateful for the guidance and support of Governor William P. Clements, Lieutenant Governor William P. Hobby and House Speaker Gibson D. Lewis. These officials had the vision to recognize the need for a study of the Texas tax system and have shown a continuing interest in the Committee's work. Among the members of these officials' staffs, the Committee particularly appreciates the advice and assistance of Frank Battle of Lieutenant Governor Hobby's staff and Dale Craymer of the Speaker's staff and the House Ways and Means Committee. We owe a special debt to Dale Craymer, who contributed a large part of the analysis that makes up the body of the Committee's research and who invented the phrase (if not the fact) that "the Texas tax system does not mirror the economy."

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A study of the Texas tax system could not have been accomplished successfully without the help of a great many people.

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This is neither the first nor the last state tax study, and the Committee owes much to its predecessors.

Connie Johnson and Dixie Evatt of the State Board of Insurance and Randy Yarbrough of the Texas Alcoholic Beverage Commission.

The Committee also benefitted from advice, assistance and information from many other sources. We are grateful to Bill Allaway and Phil Anderson of the Texas Association of Taxpayers for their continuing, insightful analysis of the Committee's work and their efforts in developing the Committee's tax impact model. We also appreciate the generous cooperation and assistance of John Sessions and Will Erken of Peat Marwick & Main. They helped to clarify many questions of tax practice and were also instrumental in the development of the tax impact model. The Committee staff also relied on advice and comments from Lin Team, Lloyd Kennedy, L.G. (Skip) Smith, Chris Collis, Rex Spivey, Tom Hagen and Bob Strausser. Any errors in judgement—on tax policy or otherwise—rest with the Committee staff and not with these excellent advisers. Special thanks also go to Mona Schumate for her help in untangling recent changes in the sales tax and their impact on state administrative policy.

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This is neither the first nor the last state tax study, and it will be apparent to anyone who has followed the development of such studies nationally that the Committee owes much to its predecessors. We are especially grateful to Steve Gold of the National Conference of State Legislatures for continuing advice and the ever-indispensable interstate comparisons on a wide range of tax issues. Special acknowledgement and thanks also go to Bob Ebel of the U.S. Advisory Commission on Intergovernmental Relations. He was instrumental in helping develop the research plan for this project and in providing comments and support throughout.

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Finally, the Committee is grateful to the many people who took time to attend our meetings and especially to those who wrote to us or testified at one of our public hearings. Their comments provided a vivid and useful picture of the problems—and potential—of the Texas state and local fiscal system.

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FINAL REPORT OF
THE SELECT COMMITTEE ON TAX EQUITY

INTRODUCTION

Since 1983, Texas state and local governments have faced a difficult period financially. In part, their problems have been a result of the state's economic difficulties, which began with the slump in the oil and gas industry and eventually expanded to other important industries such as construction, real estate, finance and manufacturing. However, the state's economic woes provide only part of the explanation for Texas state and local government's fiscal dilemma over the past half decade. The state's economic difficulties also uncovered other problems with the tax system which were present even in the late 1970s, when the state economy and state and local finances were arguably at their zenith.

> The Legislature adopted House Bill 2 in March 1987, creating the Select Committee on Tax Equity.

The Texas Legislature wrestled with these problems during regular legislative sessions in 1983, 1985 and 1987, and during special legislative sessions in 1984 and 1986. Throughout this period, many plans were devised for tax system restructuring. Many of these plans focused on the goal of making the state and local tax system more responsive to economic growth and less reliant on older parts of the state economy—notably the oil and gas industry. Lieutenant Governor William P. Hobby summarized this policy direction in a 1986 speech: "The ideal structure would be a tax structure that automatically funds the needs of the state, and obviously, a resource-based tax system doesn't do that."

State Comptroller Bob Bullock further outlined the shortcomings of the tax system in a speech in early 1987: "Some major parts of our tax structure are 80 years old. Even the newest major tax is a quarter of a century old. This old tax structure leans on the old economy. The new economy is virtually untaxed."

House Bill 2

Despite a general consensus about the need for changes in state and local tax policy, actual structural changes proved difficult to achieve in a period when the primary concerns were dealing with large budget shortfalls and ensuring funding for such vital budget areas as education and transportation. This being the case, the Legislature adopted House Bill 2 in March 1987, creating the Select Committee on Tax Equity. (See Appendix B for the full text of House Bill 2.)

The legislation created a 13-member panel with the task of reviewing the state and local tax system in detail and reporting its findings to the Governor and the Legislature. Four members each of the Committee were selected by the Governor, the Lieutenant Governor and the Speaker of the House. The 13th member is the Comptroller of Public Accounts, who is a designated member under the provisions of House Bill 2. The Committee's chair was selected jointly by the Lieutenant Governor and the Speaker. (Background information on Committee members is summarized in Appendix C.)

The Committee's Work

The Committee began meeting in May 1987, shortly after the selection of Committee members. Early on, the Committee set an ambitious mission for itself, focusing on a complete review of the state and local tax system and the available options for changing the system. A mission statement developed by the Committee in the summer of 1987 is shown in Table 1.

The work of the Committee stretched between May 1987 and December 1988. During that time, the Committee held more than two dozen meetings in Austin and around the state to gather information, to hear from experts in the field of state and local tax and expenditure policy and to take testimony from individual Texans and from business leaders from around the state. The Committee's work generally progressed through four phases:

- Committee organization and development of basic information on the state and local tax system.
- Public hearings at locations across the state.
- Data collection, research and the gathering of views from leading state and local tax experts.
- Development of findings and recommendations.

TABLE 1. Mission Statement of the Select Committee on Tax Equity

In August 1987, the Select Committee on Tax Equity adopted this mission statement as a guide to its work in examining the Texas state and local tax system and preparing recommendations for the Governor and the Legislature.

The mission of the Select Committee on Tax Equity is to recommend to the State the standards and options for developing a fair, viable and economically competitive state and local tax system capable of generating sufficient revenues to meet expected needs in the future.

In fulfilling this mission, the Committee will:

1. Establish criteria for determining and evaluating state and local revenue options.
2. Analyze the current state and local revenue system, including:
   - The composition, dependability and flexibility of the tax system and its adequacy to meet the state's longer-term needs.
   - The relative burden imposed by the tax system on taxpayers and the relative equity of that burden.
   - The relationship between taxes and the overall revenue needs of state and local government in Texas.
   - The relationship between the tax burden and the benefits citizens receive from government in Texas.
   - The impact of the state and local tax system on economic development.
   - The relative simplicity of the tax system—both in terms of government administration and taxpayer compliance.
3. Determine the impact of federal tax reform on the Texas state and local tax system and on businesses and individuals.
4. Review and evaluate forecasts of the most likely range of state and local revenue needs.
5. Identify and analyze the revenue options available to Texas state and local government by:
   - Examining the revenue potential of each option.
   - Analyzing how each option compares to the evaluation criteria established and its impact on the various segments of business and individual taxpayers.
   - Assessing the relative impact of each option on economic development.
6. Make recommendations that fulfill the overall mission of the Select Committee on Tax Equity.

Public hearings played important role in this process. Over the course of its deliberations, the Committee heard from over 400 witnesses. During its public hearing phase, the Committee took testimony from anyone interested in addressing the Committee. To make its work as open to Texans as possible, the Committee conducted hearings in Abilene, Amarillo, Austin, Beaumont, Corpus Christi, Dallas, El Paso, Fort Worth, Harlingen, Houston, San Antonio and Tyler in late 1987 and early 1988 (Figure 1).

The Committee's Report

From these public hearings and the other work of the Committee come the findings and recommendations contained in this report. As is noted later in the report, the Committee's goal is to provide "a realistic vision of what a fair and reliable tax system should be and [to] provide a clear and consistent blueprint for its realization."

Chapter 1 of the report provides an overview of the current state and local tax system. It outlines the composition of the system and reviews its recent performance.

Chapter 2 provides a look at how the Texas tax system compares with the tax systems in other states. While each state clearly must develop fiscal policies that meet its own unique needs, such comparisons nonetheless provide a valuable—and commonly used—touchstone for evaluating individual tax systems.

Chapter 3 is an especially important portion of the report. It contains the Committee's conclusions regarding the current tax system. It is, in effect, the base on which the recommendations in subsequent chapters rest. In the same vein, Chapter 4 discusses the Committee's vision for the tax system over the next decade—the Texas tax system of tomorrow. It shows how the various Committee recommendations fit into that vision.

Chapters 5 through 9 contain the specific findings and recommendations of the Committee. They are organized into chapters reflecting major issues concerning—the state and local tax system: the sales tax, the franchise and other business taxes, the property tax and other local taxes, the personal income tax and a final chapter containing other issues considered by the Committee.

A final Chapter 10 sums up the report and shows the estimated fiscal impacts of the Committee's recommendations.

A separate volume of this report contains the many analytical reports prepared for the Committee. It is the Committee's hope that these analyses, which cover the width and breadth of state and local tax policy, will prove beneficial to future researchers and policy makers.

At the time of the Committee's creation, Speaker Gib Lewis reviewed the Legislature's goals in establishing a special panel to study the difficult and important topic of taxes. He said that the panel should consider all available alternatives and concluded that "most of the information they need is readily available." For the most part, that has proven to be the case. But one deficiency the Committee has found is the relatively low level of understanding of state and local tax and spending policies by the average Texan—that is, by the people who are directly affected by government's action or lack of it.

It is the Committee's hope that this report—in addition to its effects on future tax policy—helps fill this gap in understanding. Ultimately, the solutions to the state's fiscal problems—like the solutions to all of the challenges facing Texas today and in the future—lie with the people of this great state.

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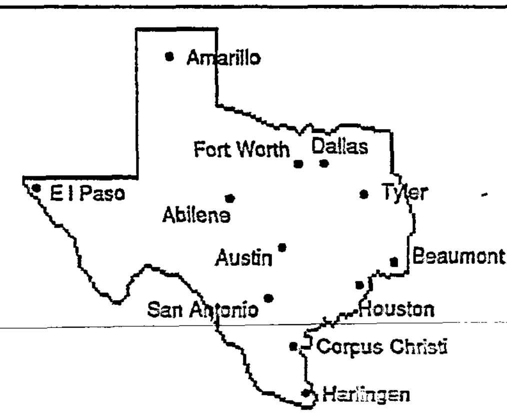
FIGURE 1. Public Hearings of the Select Committee on Tax Equity, 1987-88



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CHAPTER ONE

THE TEXAS TAX SYSTEM TODAY

State and local taxes occupy a prominent role in the Texas economy. Texans pay taxes to more than 3,300 governments, including the state, cities, counties, school districts and literally hundreds of special districts serving specific local needs ranging from water service to mosquito control.

Some parts of this multilayered tax system date back to the state's earliest days and even to the days of the Republic of Texas. The tax system that has evolved in the 150 years since the founding of the Republic is complex and reflects policy decisions made in a hundred different circumstances to meet the state's ever-changing needs through the decades.

Given this context, it is useful to begin this report with a discussion of the Texas state and local tax system as it exists today. This chapter looks first at the combined state and local system and then examines taxes at the state and local levels separately.

Texans pay taxes to more than 3,300 governments, including the state, cities, counties, school districts and literally hundreds of special districts.

The State and Local Tax Mix

In 1987, the most recent year for which complete data are available, Texas state and local governments collected more than $22.3 billion in taxes—equal to just under ten percent of state personal income. State tax collections accounted for just over half of that total, while local tax income represented just under half. On a per capita basis, Texas state and local governments collected about $1,329 per person—equal to about 80 percent of the national average of $1,665 per capita.

Taxes accounted for about 56 percent of the $39.6 billion in general revenue raised by Texas governments from all sources in 1987. Most of the rest came from federal and state aid, user fees and charges and numerous miscellaneous sources like interest income.

Among the major state and local tax sources, the one dominant tax is the property tax. In 1987, it accounted for 41 percent of Texas state and local taxes, compared with a national average of just under 30 percent. Property tax levies in Texas totaled about $10 billion in 1987, all of it at the local level.

The second most important state and local tax source by a wide margin is the sales tax. It is the major tax used by state government and is used locally by cities, metropolitan transit authorities and by a growing number of counties as a result of legislation adopted in 1987. In 1986, the tax accounted for just over a quarter of total state and local tax income in Texas, slightly more than the role of the tax in state and local tax systems nationally.

The remaining third percent of Texas' state and local mix came from a wide range of tax sources, including the state oil and gas severance, motor fuel and franchise taxes and various local taxes like hotel-motel occupancy taxes and a franchise tax on banks.

As Figure 1 illustrates, the major difference between the Texas state and local tax mix and state and local tax mixes nationally is the use of income taxes, which accounted for about 26 percent of collections nationally but which are not used in Texas. These taxes have been replaced in this state by more extensive use of the property tax locally and oil and gas severance taxes at the state level.

State and Local Collection Trends

Trends in Texas state and local tax collections between 1970 and 1987 are charted in Figure 2. Over this period, state and local tax income grew at an average rate of 11.4 percent a year, with the strongest growth in the late 1970s, a time of high inflation and strong economic growth in the state. This growth is all the more remarkable because it occured without a major state tax increase. The state passed a major tax bill in 1971 and did not do so again until 1984.

Tax growth at both the state and local levels slowed dramatically as the state economy slumped in 1983. Tax growth surged again in 1985, but in that case, the cause was not purely economic. It was also a result of the 1984 tax bill, which was adopted to support new education and transportation spending. Nonetheless, tax growth in this period did receive a boost from a

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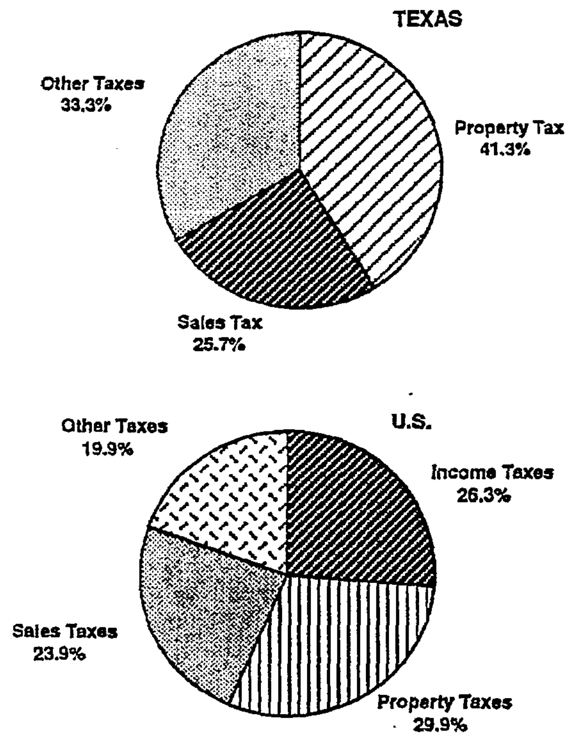
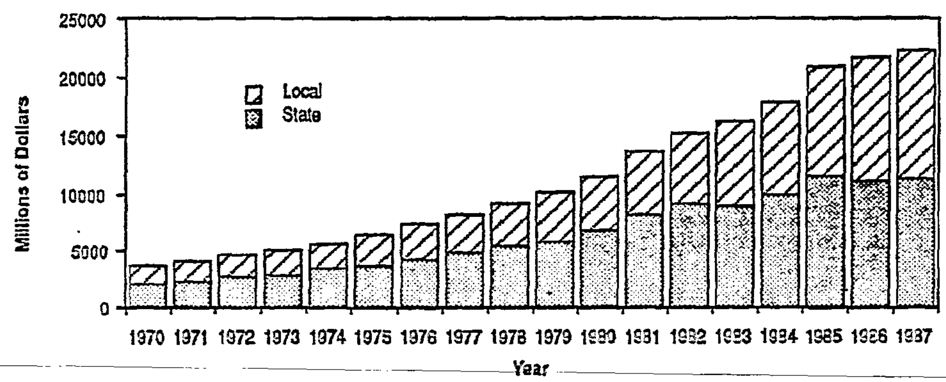
FIGURE 1. Texas and U.S. State and Local Tax Mix, 1987



Source: U.S. Department of Commerce, Bureau of the Census, *Government Finances in 1986-87* (Washington, D.C., November 1988).

FIGURE 2. Texas State and Local Tax Collections, 1970-87



Source: Select Committee on Tax Equity.

marked improvement in the state's economic fortunes beginning in 1984. However, this recovery was cut short by the collapse of world oil prices in early 1986, which sent both the state economy and government finances into a tailspin.

Another important trend in the Texas state and local tax mix over the past few years has been the shift in the share of tax collections produced by the two levels. In 1970, state taxes accounted for about 56 percent of the state and local mix, but with strong growth in its major taxes, that share rose to almost 60 percent by 1981. Beginning in 1982, however, the state's share began to decline with the decline in energy prices. By 1987, state tax collections amounted to only slightly more than half of the total, despite the large tax increase in 1984.

This shrinking share of state collections reverses a long-term trend in the Texas tax system. Prior to World War II, local taxes represented about two-thirds of all taxes collected in Texas. This local dominance began to wane during the war, as state government came to play a more prominent role in education, transportation and public welfare. The shift to a greater state role in the state-local tax mix continued after the war and into the 1950s and 1960s, as the role of state government continued to expand. The relative roles of the two levels were almost completely reversed by the early 1980s. It is too early to speculate on what the future trend in this relationship will be. Both state and local governments have enacted major tax increases since 1986, but often, these increases have been necessary to replace other tax income lost because of poor economic conditions. However, the recent movement to a more even balance between the two levels seems the most likely course.

The State Tax System

In fiscal year 1988, Texas state government collected $20.4 billion in revenues. This total was generated from a number of revenue sources, including taxes, federal funds, interest income, licenses and fees, land income and scores of other minor sources.

Taxes were by far the most important of these sources. Their importance is illustrated in Figure 3, which shows a detailed breakdown of state revenues by source for fiscal year 1988. In that year, taxes accounted for about 61 percent of all state income--just under $12.4 billion of the $20.4 billion the state generated from all sources. In contrast, federal funds, the second largest source, represented about 22 percent. All other sources combined contributed the remaining 17 percent, with no one source accounting for as much as seven percent of the total.

The Major Taxes. The major tax comprising the state tax system are shown in Figure 4, while Table 1 summarizes the tax rates and taxable bases for the major state taxes.

As the figure indicates, the sales tax is the leading state tax, producing more than $6.2 billion in collections in 1988—over half of all state tax income. This total represents an increase of 35.2 percent over 1987; however, much of this growth resulted from tax increases enacted in 1986 and 1987.

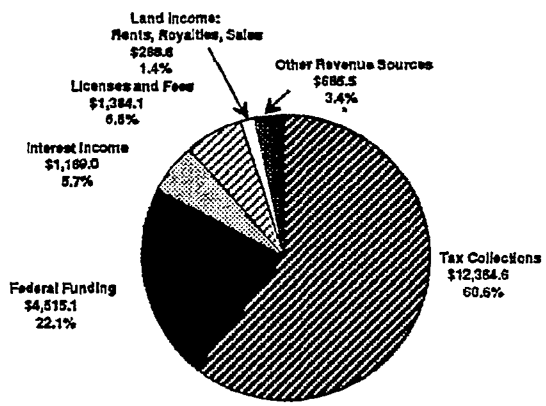
The state sales tax was originally enacted in 1961 and became the most important state tax source by the mid-1960s. The tax, whose rate was raised to six percent statewide in 1987 and whose base has been expanded significantly in recent years, is levied on a broad range of goods and services. Over its 27-year life, it has proven responsive to economic growth. Even during the state's economic problems in the mid-1980s, the tax experienced only one year where year over year revenues declined—in 1983.

This does not mean, however, that the sales tax has been largely unaffected by the state's economic slump. As was the case in 1988, much of the tax's growth since 1983 has been the result of major tax rate increases and tax base expansions. If the effect of these various revenue measures are excluded from the figures, sales tax collections would have declined in 1986 and 1987, as well as in 1983.

The second most important state tax category after the sales tax is the motor fuels taxes on gasoline, diesel and liquefied petroleum gas. These taxes produced just under $1.5 billion in revenue in 1988, equal to just under 12 percent of state tax income. This collection total was up 15.8 percent from 1987. Like the sales tax, most

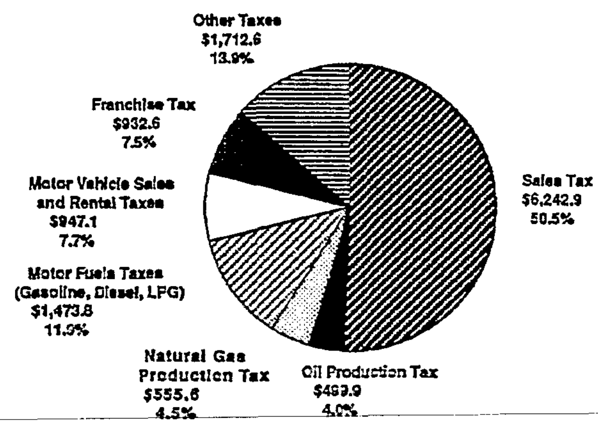
In 1988, taxes accounted for about 61 percent of all state income.

FIGURE 3. Texas State Revenue by Source, 1988 (Millions of Dollars)



Source: Comptroller of Public Accounts, *Annual Financial Report*, 1988.

FIGURE 4. Texas State Tax Revenue, 1988 (Millions of Dollars)



Source: Comptroller of Public Accounts, *Annual Financial Report*, 1988.

TABLE 1. Rates and Bases of Major Texas State Taxes, 1988

Description of Tax	Rate and Base
Sales and Use Tax	Six percent of the retail sale price of tangible personal property and selected services.
Natural and Casinghead Gas Tax	7.5 percent of the market value of gas produced in the state.
Oil Production and Regulation Taxes	Production: 4.6 percent of the market value of oil produced in the state. Regulation: 3/16 of one cent on each barrel produced.
Motor Fuels Taxes	15 cents/gallon for gasoline, diesel and liquefied gas.
Motor Vehicle Sales and Rental Taxes	Sales: Six percent of vehicle sales price, less any trade-in. Rental: Six percent of gross rental receipts.
Tobacco Products Taxes	Cigarette: $13 per 1,000 weighing three pounds or less (26 cents per pack of 20); $15.10 per 1,000 weighing more than three pounds. Cigar and Tobacco Products: Rates vary depending on weight.
Corporation Franchise Tax	Domestic and foreign corporations, unless other wise provided for, pay whichever yields the greater tax: (1) $6.70 per 1,000 of taxable capital and surplus; (2) $150. This is a temporary rate and is scheduled to revert to 5.25 per $1,000 of taxable base in 1990.
Alcoholic Beverage Taxes	Beer: $6/barrel. Liquor: $2.40/gallon Wine: Alcoholic volume not over 14 percent - 20.4 cents/gallon. More than 14 percent - 40.8 cents/gallon. Sparkling wine - 51.6 cents/gallon. Malt Liquor (Ale): 19.8 cents/gallon. Mixed Drinks: 12 percent of gross receipts. Airline Beverage Tax: 5 cents per serving.
Insurance Companies Taxes	Life, health and accident insurance company rates: 2.5 percent of gross premium receipts if the value of Texas investments is less than 90 percent of similar investment in the comparison state. 1.8 percent if value is between 90 percent and 100 percent. 1.1 percent if value is greater than 100 percent. If a carrier collects total gross premiums of less than $450,000, the tax rate is half the rate determined above. Fire and casualty insurance company rates: 3.5 percent of gross premium receipts if the value of Texas investments is less than 85 percent of similar investments in the comparison state. 2.4 percent if value is 85 percent to 90 percent. 1.2 percent if value is greater than90 percent. Unauthorized insurance premium rate: 3.85 percent of gross premiums charged. Surplus lines insurance rate: 3.85 percent of gross premiums charged. (Comparison state is defined as the state—other than Texas—in which an insurance carrier owns the largest amount of investments.)
Inheritance Tax	A tax equal to the amount of the federal credit is imposed on the transfer of property at death.
Utility Taxes	Public Utility Gross Receipts: 1/6 of one percent of gross receipts. Gas, Electric and Water Utility: (1) Cities 1,000-2,500 pop. - 0.581 percent of gross receipts; (2) Cities 2,500-10,000 pop. - 1.070 percent; (3) Cities 10,000 pop. or more - 1.997 percent. Gas Utility Administration: 1/4 of one percent of gross receipts of gas utilities.
Hotel and Motel Tax	Six percent of consideration paid by occupant.

Source: Comptroller of Public Accounts.

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of this growth is accounted for by tax rate increases enacted in 1987. The fuels taxes are levied at a rate of 15 cents per gallon. Since they are based on the quantity of fuel consumed, rather than its price, their revenue performance is largely limited to the growth in demand for motor fuels. For this reason, their growth trajectory is relatively flat over time, since motor fuel use in Texas has grown relatively slowly in recent years as the automobile and truck fleets have become more fuel efficient.

Many of the underlying difficulties with the performance of the state tax system in recent years have been related to the performance of the state oil and natural gas severance taxes. In 1988, these taxes produced just under $1.1 billion in combination—equal to 8.5 percent of state tax income. This appears to be a sizable share of the state tax mix until you realize that the two taxes produced $2.4 billion at their peak and accounted for more than 28 percent of state tax collections in the early 1980s.

With their tie to oil and gas prices and to state oil and gas production, it is difficult to foresee a significant change in this trend. State production of both oil and gas has been declining since the 1970s, and prices in the world energy markets continue to be volatile, although they remain far below the levels they reached in the early 1980s. Forecasters do not see an improvement in this situation in the immediate future.

Another major state tax category is the motor vehicle sales and rental taxes. These taxes accounted for $947 million in collections in 1988, or about 7.7 percent of state taxes. The 1988 collections were up 18 percent over 1987, again reflecting the effects of that year's tax bill, which increased the vehicle tax rate from five to six percent. (Most of the income generated from this source comes from the sales tax portion of the tax.)

The motor vehicles sales and rental taxes operate in essentially the same manner as the general sales tax, although they differ from the sales tax in their administration. Like the state sales tax, they are levied at a six percent rate. However, while there is some local sharing of the tax income with counties, there is no separate local tax as there is with the the sales tax. Thus, while the general sales tax rate is as much as eight percent in many parts of the state, the motor vehicle taxes goes no higher than six percent.

The corporation franchise tax netted $932.6 million for the state in 1988–7.5 percent of state tax income and an increase of 6.7 percent over 1987. This tax is levied on corporations doing business in the state. The rate is $6.70 per $1,000 of taxable base, which is made up of the portion of the company's assets that are allocated to Texas based on its business activity in the state. This is another rate that was increased in 1987, although it is a temporary increase. The rate is scheduled to return to the previous rate—$5.25 per $1,000 in taxable base—in 1990.

Until recently, the franchise tax was one of the most reliable state taxes, routinely posting double-digit growth. However, this trend has been eroded by both weakness in the state economy and—more importantly—litigation attacking various portions of the tax base. The effects of this litigation, which is projected to begin showing up in collection trends in 1989, is expected to erode collections from the tax to $440 million in that year.

In addition to these major sources, the state also uses a wide range of lesser levies. One important group that is not shown in the figure is the special taxes levied on insurance companies. In 1988, these taxes produced $546.8 million–about 4.4 percent of state tax collections.

Also important are the so-called "sin" taxes on alcoholic beverages and tobacco products. The taxes on tobacco products, of which the cigarette tax is the most important, produced $417 million in 1988, representing about 3.4 percent of tax income. The various alcoholic beverages taxes on liquor, wine, beer, mixed drinks and other beverages netted the state $315.5 million in 1988, 2.6 percent of collections. With the exception of a tax levied on gross receipts from mixed drink sales, these taxes are based on the quantity of liquor or tobacco consumed and do not rise along with rising prices. With mounting health concerns in recent years, much of the

Many of the underlying difficulties with the performance of the state tax system in recent years have been related to the performance of the state oil and natural gas severance taxes.

State tax collections actually declined in 1983 and 1986.

growth in these taxes has come from rate increases and from the inflationary elements of the mixed drinks tax.

The state also levies several special taxes on utility companies, the most important of which is a gross receipts tax on privately-owned gas, water and electric companies. Taken together, these taxes produced about $185 million in 1988. As might be expected, the utility taxes were strong revenue producers during the years of rising energy prices, but their productivity has flagged with slumping prices. In fact, the taxes produce less income now than they did in the early 1980s.

A final state tax worth mentioning is the inheritance tax, which is imposed on estates. The tax netted the state $108.4 million in 1988. Since income from the tax depends heavily on the size of the estates of Texans dying in a given year, it tends to fluctuate from year to year.

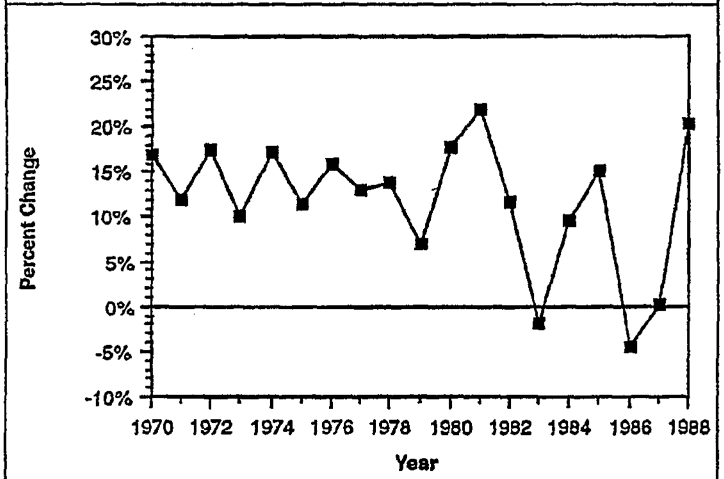
Overall Collection Trends. State tax collections have sputtered in recent years, reflecting the problems in the system and the overall economy. This trend, however, is hidden in the raw collection figures because of major revenue measures passed to deal with these problems and to increase spending in certain areas of the budget.

For example, Figure 5 shows the growth in state tax collections for 1970 through 1988. Over this period, the state experienced extremely rapid growth in a majority of years and particularly during the 1970s.

Actual state tax collections declined in 1983 and 1986. However, even that performance is somewhat misleading since the collections from the mid-1980s on are heavily influenced by tax legislation, as the data for the 1970s are not. Without the various tax measures adopted during the 1980s, tax collections would have declined from prior year levels in four of the six years since 1982.

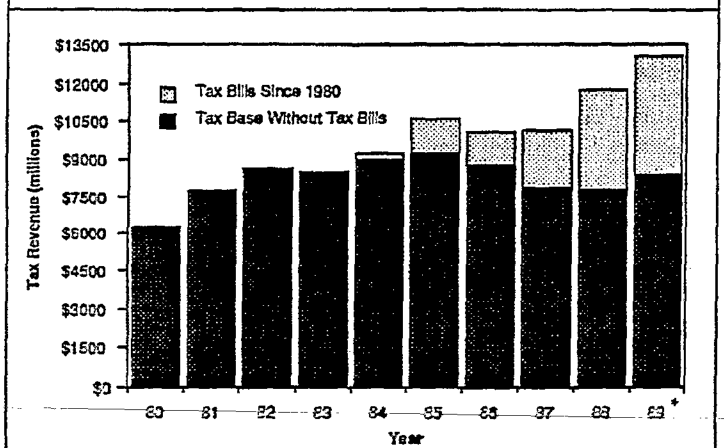
Over than period, the state has adopted three major tax bills—in 1984, 1986 and 1987. In addition, it has adopted other tax legislation, including a 1983 bill changing the due dates on the sales tax and other major state taxes to reap a one-time cash flow gain estimated at the time to be just under a half billion dollars. Had none of this tax legislation been enacted, collections today would be at or below 1981 levels (Figure 6).

FIGURE 5. Growth in Texas State Tax Collections, 1970-88



Source: Select Committee on Tax Equity.

FIGURE 6. Effect of Legislation on State Tax Growth, 1980-89



Source: House Ways and Means Committee.

* Estimated.

The Local Tax System

As in the case of state government, taxes are a critical component of the local tax mix, although they do not account for as significant a percentage as at the state level. This can be seen in Figure 7, which summarizes overall Texas local government general

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revenue sources in 1987, the most recent year for which local data are available. Taxes accounted for 42 percent of local income, more than any other single source, but significantly less than the 61 percent share at the state level.

The reason for this difference can be seen in Table 2, which summarizes the major sources of income for cities, counties, school districts and special districts in 1987. The difference is explained in part by the the large inflow of intergovernmental aid, particularly state public education assistance, which accounts for almost half of the total income of school districts. Local governments also make much more extensive use of user fees and charges than does state government. Cities and counties, for example, both raise roughly a fifth of their revenue from charges for services, while special districts raise almost a third of their income from charges. The state, by contrast, raises less than seven percent of its income from fees.

The Role of the Property Tax. Another important distinction between the state and local tax systems is the difference in major taxes relied on by the two levels. The sales, motor fuel, severance and franchise taxes play prominent roles at the state level. Locally, heavy reliance is placed on the property tax. (State use of the property tax ended in the late 1970s.)

The property tax is the primary tax for virtually all units of local government in Texas, from the largest cities to the smallest special districts. The 1987 property tax levy totaled $10 billion, while actual collections equaled more than $9.2 billion. This represents about 35 percent of total local revenue. Well over eight out of every ten local tax dollars in Texas are raised from the tax.

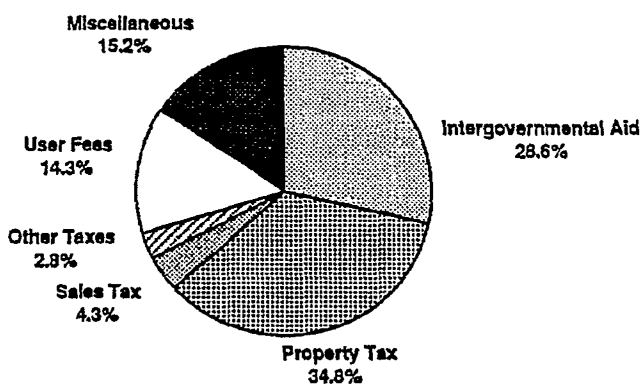
Over half of the all property tax collected in Texas goes to finance public schools. About 20 percent of the total is raised each by cities and counties, while special districts account for the remaining 3.5 percent.

Returning to Table 2, it is possible to see the differing role the property tax plays in the various local government tax mixes. It accounted for 45 percent of the total income of counties but only a quarter of city receipts. Cities have access to the sales tax and to a number of other taxes not available to counties. School districts generated about 42 percent of their income from the property tax, while special districts, which rely heavily on charges and various miscellaneous sources, derive only 10.5 percent of their total income from the property tax.

Property tax revenues have increased substantially over the past few years, nearly

Well over eight of every ten local tax dollars are raised from the property tax.

FIGURE 7. Texas Local Government General Revenue, 1987



Source: U.S. Department of Commerce, Bureau of the Census, *Government Finances in 1986-87* (November 1988).

TABLE 2. Texas Local Government Revenue by Source, 1987

Revenue Source	Counties	Municipal Governments	School Districts	Special Districts
Federal Aid	3.3%	7.4%	0.7%	10.6%
State Aid	5.0	2.9	48.6	5.9
Other Aid	1.7	1.6	0.2	3.0
Taxes:				
Property	45.3	24.8	42.4	10.5
Sales Tax	0.0	12.2	0.0	7.6
Motor Vehicle License	3.3	0.0	0.0	0.0
Other Taxes	1.3	7.5	0.0	0.0
Total Taxes	49.9	44.5	42.4	18.1
Charges for Services	17.9	20.1	4.9	31.6
Miscellaneous Revenue	22.2	23.5	3.2	30.8
Total	100.0%	100.0%	100.0%	100.0%

Source: U.S. Department of Commerce, Bureau of the Census, Government Finances in 1986-87 (November 1988).

Note: Table excludes utility and retirement system revenues. The Census Bureau classifies license fees as taxes. License fees are excluded from state tax tables.

Over the last few years, city sales tax growth has lagged growth in the state sales tax.

doubling since 1980. This is due both to an increase in the assessed value of the tax base and to increases in property tax rates. As in the case of state taxes, the property tax has been significantly affected by the state's economic problems; however, it is less clear how tax increases and economic changes have interacted locally, since their is no single source of information on the underlying causes of local tax growth.

Like the major state taxes, the local property tax base has been significantly affected by legislative decisions in recent years. In 1979, the Legislature enacted sweeping reforms in the property tax system, creating central appraisal districts and establishing uniform procedures for administration of the tax.

Just prior to that, voters had approved a major tax relief act, which eliminated the property tax on intangible assets and added separate tax treatment for agricultural land. It also restructured tax exemptions for veterans and the elderly and increased the general homestead exemption for school taxes. These measures, along with minor exemptions granted since then have increased the dollar value of property tax exemptions from $19.4 billion in assessed value in 1979 to $132 billion by 1986, a nearly seven-fold increase.

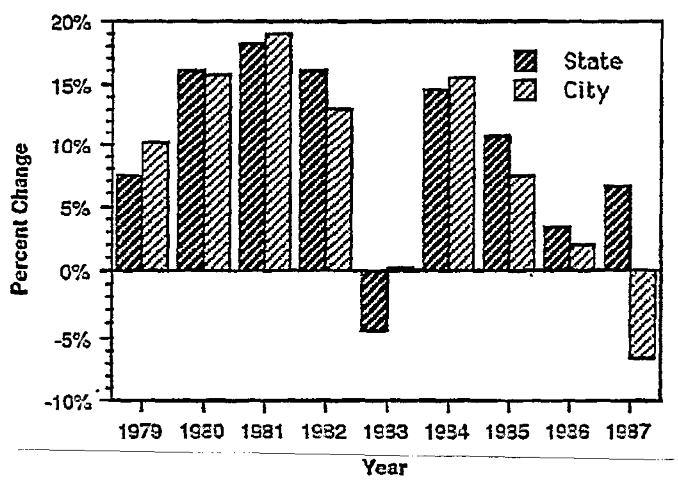
The Sales Tax. The sales tax is the next most important local tax source, although it accounts for only a fraction of the income raised by the property tax, accounting for only about four percent of total local revenue in 1987.

In part, this relatively limited role is a result of limitations on the use of the tax locally. It is available only to cities, transit authorities and, as of January 1, 1988, certain counties. At present, about 1,050 cities have levied a sales tax. The city rate can be either one or one and a half percent. Six transit authorities use the sales tax, with rates ranging from one-fourth to one percent. At this writing, 91 counties have opted for the relatively new one-half percent sales tax. The city tax accounted for about 12 percent of thier revenues in 1987. It accounted for about 7.6 percent of special district revenues.

Figure 8 charts city sales tax growth rates versus growth in state sales tax collections over the past decade. Over the last few years, city sales tax growth has lagged growth in the state sales tax. This is primarily explained by the recent large state tax increases, which have focused mainly on increases in the state tax rate while cities are locked by law at a one percent rate. State legislation only benefits the local tax when an expansion of the sales tax base is involved. Since 1984, cities have gained from expansions of the sales tax base of approximately 12 percent. The state has gained from the base expansions and from a 50 percent increase in the tax rate—increasing from four percent in 1984 to six percent in 1988.

Beyond the sales tax, other local tax options are fairly limited. Local governments share income from the portion of the franchise tax on banks, but this income is relatively small. In addition, cities and counties can levy hotel-motel occupancy taxes, a tax source shared with the

FIGURE 8. Growth Trends in Texas State and Muncipal Sales Tax Collections, 1979-87



Source: Comptroller of Public Accounts.

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state. Counties and cities also share the state mixed drinks tax revenue, while counties collect a portion of the state motor vehicle sales tax.

Conclusion

As this chapter illustrates, the Texas state and local tax system today is a mixed bag of differenct taxes used to different degrees by different units of government. There are, however, several important observations which can be drawn from a detailed examination of the system.

Foremost among these is the fact that both the state and local tax systems rely heavily on a single tax source—the sales tax at the state level and the property tax locally. Historically, these taxes have performed well, generally growing with the economy, while providing relative stability and predictability. Both sources have been affected by the recent slump in the economy, but there is no reason to believe they will not recover their typically positive growth patterns as the overall economy improves.

Although they both rest heavily on a single tax source, there are significant differences in the diversity of the state and local systems. The state employs a fairly broad range of taxes, including various general and special business levies, the oil and gas severance taxes and important excise taxes on motor fuels, alcoholic beverages and tobacco. The local system, in contrast, is significantly more limited. Most local governments rely on the property tax as their major--and sometimes their only--tax source. The sales tax plays a prominent role in city finances and in the finances of a handful of transit authorities and counties. No other tax source is prominent at all locally.

This local dependence on property taxes has a couple of important implications. First, it has made local revenue systems more reliant on nontax sources, like user fees and intergovernmental aid. Second, it has left local governments heavily dependent on a tax source—the property tax—which is unpopular with taxpayers, implying built-in resistance to local tax increases. Both of these factors have had a significant effect on local fiscal policies in Texas in recent years.

Finally, it is useful to note that although it has a much greater range of tax options available to it, the state has used a fairly narrow range of sources in constructing the three tax bills enacted since 1984. Much of the burden has been carried by the sales and motor fuels taxes. The sales tax's role in the tax mix has been pushed up from 41 percent of taxes in 1984 to 51 percent in 1988. The motor fuels taxes have also played a prominent role in recent tax measures. Their role in the state mix has also doubled—from 5.7 percent in 1984 to 11.9 percent in 1988. In contrast, the oil and gas severance taxes—whose rates have not changed—have declined dramatically from 23.8 percent of tax collections in 1984 to 8.5 percent in 1988. The other taxes have fluctuated in a much more narrow range and have played much less important roles in recent tax increases.

Both the state and local tax systems rely heavily on a single tax source—the sales tax at the state level and the property tax locally.

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Data in this chapter will be updated in a subsequent revision.

CHAPTER TWO

HOW TEXAS COMPARES

A critical examination of the Texas tax system must ultimately focus on what is best for the state's specific future needs. Recommendations for change should be based on some consensus about where the state is—or should be—going in terms of its own, unique policy needs. Texans pride themselves on the unique aspects of their state's economy and culture, and the state's fiscal policies should reflect a sense of that uniqueness.

There is much to be learned from studying how other states approach the problems of equitably raising and spending money.

That does not mean, however, that comparisons with the taxing and spending policies of other states are without merit. There is much to be learned from studying how other states approach the problems of equitably raising and spending money. Such interstate comparisons are an important step in understanding the Texas tax system and how it has evolved.

Naturally, these comparisons are best approached with a clear understanding of their inherent limitations. The first of these is a recognition that what works in one state will not, necessarily, work in others—or vice versa. For example, Oregon has no general sales tax, the trade-off being a personal income tax that raises over 65 percent of the state's total tax revenue. In contrast, Massachusetts levies substantial income *and* sales taxes on its citizens, despite the fact that its economy is presently the envy of the nation with its strong high tech manufacturing sector and supporting industries. Similarly, it is impossible to draw a pure direct comparison between Texas and other major industrial states because of the important role the state's oil and gas resources have traditionally played in financing both state and local government.

Also to be avoided is the tendency to focus on state or local government tax and spending policies to the exclusion of the other level. The split between state and local spending responsibilities differs greatly among the states. For example, some states fund public education largely at the state level, others fund it primarily at the local level and the rest split the responsibility between the two levels. The *total* tax burden on a state's citizens consists of combined state and local taxes (as well as federal taxes), just as the state's overall spending policy reflects the combined decisions made at both the state and local levels.

Economic Comparisons

A useful starting point for any discussion of interstate comparisons is to gain some sense of how Texas compares with other states in general economic terms. This can be seen in broad brush in Table 1, which shows 50-state comparisons for such common economic barometers as population, income and employment.

Texas is one of the most populous states and has one of the largest state labor pools. It ranks third among the states both in population and the number of nonagricultural jobs, trailing only California and New York in both instances.

The table also illustrates the relatively strong population growth Texas has experienced during the 1980s, recent economic problems notwithstanding. Texas' overall population grew by 17.3 percent from 1980 to 1986, according to Census Bureau estimates. This is well ahead of the overall U.S. population which grew by 6.4 percent over the period. It is also higher than the growth rate for the other ten most populous states except Florida. In fact, only four states—Alaska, Arizona, Nevada and Florida—grew faster than Texas during the first half of the decade. The state added almost 2.5 million people from 1980 to 1986, according to Census estimates.

On the other hand, Texas' per capita personal income—essentially all income earned in the state annually divided by state population—is not among the nation's leaders. In fact, it has lagged the national average in recent years. In the second quarter of 1986, for example, Texas per capita personal income totaled $13,704, ranking Texas 28th among the states, $767 *below* the national average of $14,471. Significantly, in 1981 and 1982, Texas per capita personal income actually *exceeded* the national average, but with the economic problems of the 1980s and concurrent strong economic growth in other states, the state has sunk back below the national average. (Prior to the 1981-82 period, Texas personal income per capita had historically been below the national average.)

TABLE 1. Interstate Economic Comparisons

State	1986 Population: Total	1986 Population: Rank	1986 Population: % Change 1980-86	Personal Income: Per Capita 1986/Q2	Personal Income: Rank	Non-Farm Jobs: Number[1]	Non-Farm Jobs: Rank	Job Distribution, 1986[2]: Goods Producing	Job Distribution, 1986[2]: Service Producing	Job Distribution, 1986[2]: Government
Alabama	4,053	22	4.1%	$10,950	46	1,461	24	30.5%	49.2%	20.3%
Alaska	534	49	32.8	17,575	3	222	49	15.6	53.7	30.7
Arizona	3,317	25	22.1	13,294	29	1,341	25	23.0	60.1	16.9
Arkansas	2,372	33	3.8	10,761	48	814	33	31.0	51.1	17.8
California	26,981	1	14.0	16,594	6	11,272	1	23.3	60.4	16.3
Colorado	3,267	27	13.1	15,335	10	1,402	23	20.6	61.3	18.1
Connecticut	3,189	28	2.6	19,077	1	1,602	21	29.2	58.6	12.2
Delaware	633	47	6.5	14,513	16	303	44	28.8	56.1	15.1
Florida	11,675	5	19.8	14,121	20	4,590	6	28.9	65.9	15.2
Georgia	6,104	11	11.7	13,012	33	2,675	12	27.3	55.6	17.1
Hawaii	1,062	39	10.1	14,419	18	437	42	9.4	69.1	21.5
Idaho	1,003	41	6.2	11,398	41	335	43	20.8	58.0	21.2
Illinois	11,553	6	1.1	15,467	9	4,777	5	23.6	61.4	14.9
Indiana	5,504	14	0.2	13,104	31	2,228	14	31.8	52.8	15.4
Iowa	2,851	29	-2.2	13,823	24	1,077	29	22.2	53.5	19.3
Kansas	2,461	32	4.1	14,538	15	983	31	23.5	56.6	19.8
Kentucky	3,728	23	1.9	11,227	42	1,277	27	27.5	53.9	18.6
Louisiana	4,501	18	7.0	11,223	43	1,524	22	21.1	57.9	21.0
Maine	1,174	38	4.3	12,529	35	477	39	27.4	54.3	18.3
Maryland	4,463	19	5.8	16,442	7	1,951	18	17.9	61.9	20.1
Massachusetts	5,832	12	1.7	17,269	4	2,981	10	24.9	62.1	13.0
Michigan	9,145	8	-1.3	14,068	21	3,639	8	30.9	52.7	16.4
Minnesota	4,214	21	3.4	14,895	13	1,891	19	23.8	59.9	16.3
Mississippi	2,625	31	4.1	9,824	50	849	32	31.3	46.4	22.4
Missouri	5,066	15	3.0	13,724	27	2,132	15	24.7	59.4	15.9
Montana	819	44	4.1	11,758	39	276	45	13.6	60.9	25.5
Nebraska	1,598	36	1.8	14,676	14	654	34	17.2	62.0	20.8
Nevada	963	43	20.3	15,036	12	469	40	11.9	75.0	13.1
New Hampshire	1,027	40	11.5	15,719	8	489	38	31.3	56.0	12.7
New Jersey	7,620	9	3.5	18,183	2	3,487	9	24.3	60.3	15.4
New Mexico	1,479	37	13.5	11,085	45	528	37	16.9	57.0	26.2
New York	17,772	2	1.2	16,992	5	7,906	2	19.8	62.7	17.5
North Carolina	6,331	10	7.7	12,189	38	2,732	11	36.4	48.0	15.6
North Dakota	679	46	4.1	13,236	30	249	47	12.4	62.0	25.6
Ohio	10,725	7	-0.4	13,792	25	4,475	7	28.9	55.9	15.2
Oklahoma	3,305	26	9.2	12,476	36	1,140	28	22.6	55.3	22.0
Oregon	2,698	30	2.5	13,099	32	1,057	30	22.0	59.2	18.9
Pennsylvania	11,889	4	0.2	13,842	23	4,795	4	26.8	59.0	14.2
Rhode Island	975	42	2.9	14,471	17	442	41	30.9	36.0	13.1
South Carolina	3,378	24	8.2	11,100	44	1,338	26	33.9	47.2	18.9
South Dakota	708	45	2.5	12,189	37	252	47	16.1	69.6	23.3
Tennessee	4,803	16	4.6	11,712	40	1,929	17	30.5	53.2	16.3
Texas	16,682	3	17.3	13,704	28	6,581	3	24.0	58.9	17.0
Utah	1,665	35	14.0	10,808	47	634	35	29.9	56.8	22.3
Vermont	541	48	5.8	12,669	34	234	48	27.9	55.7	16.4
Virginia	5,787	13	8.2	15,200	11	2,557	13	23.8	55.8	20.4
Washington	4,463	20	8.0	14,386	19	1,770	20	22.2	58.1	19.7
West Virginia	1,919	34	-1.6	10,662	49	597	36	25.1	53.4	21.6
Wisconsin	4,785	17	1.7	13,729	26	2,015	16	28.7	55.2	16.1
Wyoming	507	50	8.0	13,995	22	199	50	22.4	50.9	26.8
U.S. Total	240,452	–	6.4%	14,471	–	99,045		24.8%	58.3%	16.9%

Source: U.S. Department of Commerce, Bureau of the Census; U.S Department of Commerce, Bureau of Economic Analysis, Regional Economic Information System; U.S. Department of Labor, Bureau of Labor Statistics, *Employment and Earnings*, Vol. 34, Number 5 (May 1987).

1. Annual data for 1986.
2. Goods-producing industries include mining, construction and manufacturing. Government includes all levels of government. Service industries include transportation, utilities, trade, finance, services and related industries. Nonagricultural jobs only.

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A final observation which can be drawn from Table 1 is the degree to which Texas' economic mix has come to resemble the national mix. In 1986, about 24 percent of the state's nonfarm jobs were in goods-producing sectors of the economy—manufacturing, mining and construction. This was relatively close to the 24.8 percent national average. About 59 percent of state employment was in the so-called service sectors, including retail and wholesale trade, transportation, utilities, financial services, general services and related industries. This was only slightly higher than the national average. Seventeen percent of the state's jobs were in government employment at all levels, almost identical to the 16.9 percent national average.

These job figures are another area where the state has witnessed significant changes in recent years. As recently as 1984, 26.5 percent of the state's jobs were in the goods-producing industries, with 57.1 percent in the service sectors and 16.4 percent in government. The shift in composition away from the goods-producing industries to the service and government sectors is not large but nevertheless is fairly dramatic, coming as it did over only a two-year period. The shift illustrates the degree to which the Texas economy is being affected by the diverging fortunes of some of its most important industries.

Government Spending Patterns

Beyond the basic economic comparisons, another important question is how governments in the various states spend their money. After all, governments tax to pay for their various programs, and any tax system inevitably must be designed to underwrite budgetary decisions.

Table 2 shows figures for per capita

Beyond the basic economic comparisons, another important question is how governments in the various states spend their money.

TABLE 2. State and Local Government Spending Per Capita, 1985

State	Per Capita Government Spending	Rank	State Share of Total	State	Per Capita Government Spending	Rank	State Share of Total
Alaska	$10,813	1	70.5%	Connecticut	$2,655	26	56.8%
Wyoming	4,588	2	51.1	Iowa	2,610	27	52.1
New York*	4,018	3	44.4	Ohio*	2,550	28	50.3
Utah	3,477	4	56.1	Illinois*	2,517	29	50.3
Washington	3,465	5	54.3	Kansas	2,517	30	47.2
Minnesota	3,248	6	50.2	South Dakota	2,511	31	54.8
Nebraska	3,238	7	49.3	Tennessee	2,457	32	52.4
California*	3,191	8	50.3	Pennsylvania*	2,454	33	51.7
Hawaii	3,037	9	79.2	Georgia	2,433	34	50.5
Oregon	3,009	10	51.4	Oklahoma	2,389	35	54.3
Delaware	2,984	11	65.5	**Texas***	2,384	36	45.1
Massachusetts	2,975	12	58.7	Maine	2,362	37	60.3
Nevada	2,951	13	46.1	Alabama	2,338	38	58.3
Montana	2,951	14	53.2	West Virginia	2,326	39	59.9
Colorado	2,912	15	45.3	Florida*	2,305	40	44.3
North Dakota	2,906	16	64.0	North Carolina*	2,222	41	54.8
Michigan*	2,836	17	51.7	Virginia	2,217	42	53.4
Wisconsin	2,834	18	52.2	South Carolina	2,145	43	59.8
Rhode Island	2,834	19	64.6	Idaho	2,114	44	55.3
New Jersey*	2,823	20	50.8	Indiana	2,099	45	52.3
Arizona	2,814	21	46.2	Kentucky	2,063	46	62.3
New Mexico	2,774	22	59.9	Mississippi	2,043	47	55.1
Vermont	2,733	23	66.7	New Hampshire	2,033	48	50.7
Louisiana	2,673	24	54.8	Missouri	2,004	49	51.2
Maryland	2,666	25	52.8	Arkansas	1,883	50	57.1
				U.S. Average	**$2,757**	—	50.9%

Source: Brizius and Foster, *State Policy Databook*, 1987 and U.S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1987.

*One of the 10 most populous states according to current Census Bureau estimates.

Education in Texas is a prime driver of overall spending at both the state and local levels.

state and local spending among the 50 states for fiscal year 1985. Texas ranked 36th in overall state and local spending per capita in that year. The state's total state and local spending per capita was $2,203, well below the U. S. average of $2,516. The Texas per capita total was lower than all of the other 10 most populous states except Florida, which ranked 41st and North Carolina, which ranked 49th.

The table also illustrates that the division between state and local spending differs somewhat in Texas compared with the majority of the states. In Texas, state government spending made up 45.1 percent of total state and local expenditures in 1985. In 42 of the states, state government spending accounted for *more than half* of the state-local total, with a national average of about 51 percent. This difference is related to several factors, including the large number of local government units in Texas (cities, counties, school districts and special districts) and the large share of public education expenses borne locally.

In fact, education in Texas is a prime driver of overall spending at both the state and local levels. This can be seen in Table 3, which compares the percentage spent on selected governmental functions at the state and local levels in Texas compared with the U.S. average.

TABLE 3. State and Local Spending for Selected Functions, Texas and the U.S. Average, 1985

Function[1]	Texas State	Texas Local	U. S. Average State	U. S. Average Local
Aid to Local Governments	34.9%	—	34.7%[2]	—
Public Schools	—[3]	44.9	—[3]	39.4
Higher Education	19.4	3.6	12.8	2.4
Welfare and Health	20.0	8.4	22.0	13.1
Public Safety and Highways	10.1	12.0	8.8	13.4

Source: U. S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1987.

1. Does not include all functional spending categories.
2. Includes state aid to public education—virtually 100 percent of the total in Texas' case, considerably less than 100 percent in the case of the U. S. average.
3. Included in the aid to local governments total.

As Table 3 shows, a large percentage of state spending Texas is comprised of aid to local governments. Although this total does include some minimal grant programs administered by the state in other program areas, the vast majority of the total is state funding for local public schools. Coupled with higher education funding, this implies that over *half* of all state spending is for education. The national figure is much smaller.

Moreover, almost half of local spending in Texas in 1985 was for education, with 44.9 percent going to support public schools and another 3.6 percent spent on higher education—primarily local support of junior colleges. In contrast, 39.4 percent of local spending nationally was dedicated to public schools, with an additional 2.4 percent for local higher education support.

In the other two functional categories shown in the table—welfare and health and public safety and highways—Texas is relatively similar to the national averages. It spends a smaller percentage at both the state and local levels on health and welfare. It spends slightly more at the state level on public safety and highways. However, it spends a smaller percentage at the local level on the function.

Per Capita Spending. The analysis can be taken a step further to look at how Texas compares nationally and with the other more populous states in terms of its per capita state and local spending in key functional areas (Table 4). According to the Census Bureau data Texas spent *less* per capita than the national average in 1985 in all of the functional categories shown except education, where Texas was about ten percent above the national average. Education was also the main area where Texas is above the majority of the other populous states. It ranked near the middle of the ten states on per capita spending for health and hospitals and public safety and highways. It ranked last among the states on per capita spending on welfare programs. In overall per capita spending, Texas ranked 36th among the 50 states, behind all of the most populous states except Florida and North Carolina.

State and Local Revenues

State and local governments pay for the services they provide with a mix of income sources of which taxes are an important—but not entirely predominant—part. According to the Census Bureau, in fiscal 1985, state and local revenue in Texas from all sources totaled $38.9 billion. Table 5 shows how the mix of sources of this income compares with the national average mix for all states.

As the table shows, Texas—with its traditionally strict qualifying requirements for federal matching income assistance programs like Aid to Families with Dependent Children and Medicaid—was much less reliant on federal assistance than the average state. In fact, among the 50 states, only two—Alaska and Arizona—had a smaller percentage of their total revenues coming from federal sources in 1985.

Texas was more reliant on the property tax than the national average. Surprisingly, however, the share of total revenues coming from the sales tax—the leading state revenue source and an important source locally—was only slightly higher in Texas than it was nationally. The role played by the tax appears to be related to the fact that the state has historically guarded the tax and has limited its use locally to cities, municipal transit authorities and a small number of counties. This, of course, is one area where later data is likely to show changes, given the recent increases in the sales tax rate and expansion of the tax base in Texas.

The table also illustrates that Texas has neither personal nor corporate income taxes. In contrast, the personal income tax played a fairly prominent role in most states, while the corporate income tax is a relatively less significant percentage of the average state's overall revenue mix.

One area where Texas diverged sharply from the national trend was in the "Other Taxes" category. In part, this is misleading, since this category contains the state franchise tax, which is essentially equivalent to the corporate income tax in other states, both in size and the types of taxpayers affected. The category is also larger than the national average because of

Texas is more reliant on the property tax than the national average.

TABLE 4. Per Capita State and Local Spending For Selected Functions, Most Populous States and U.S. Average, 1985

State	Education	Welfare	Health & Hospitals	Public Safety & Highways	Total (Rank)[1]
California	$817	$377	$228	$244	$3,191 *(8)*
Florida	628	147	214	250	2,305 *(40)*
Illinois	691	313	141	307	2,517 *(29)*
Michigan	872	434	250	249	2,836 *(17)*
New Jersey	813	296	149	287	2,823 *(19)*
New York	900	596	338	317	4,018 *(3)*
North Carolina	737	160	178	213	2,222 *(41)*
Ohio	773	325	181	235	2,550 *(28)*
Pennsylvania	649	328	130	248	2,454 *(33)*
Texas	848	136	189	235	2,384 *(36)*
U.S. Average	$772	$291	$208	$262	$2,757

Source: U.S. Department of Commerce, Bureau of the Census; Brizius and Foster, *State Policy Databook*, 1987.

1. Does not include all categories of state and local spending. Totals do not add. Rankings are based on all 50 states.

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TABLE 5. Sources of State and Local Revenue, Texas and U.S. Average, 1985

Source	Texas	U. S. Average
Federal Assistance	13.7%	17.8%
Property Taxes	21.4	17.4
General Sales Tax	14.5	14.1
Personal Income Tax	0.0	11.7
Corporate Income Tax	0.0	3.2
Other Taxes	22.4	12.1
User Fees	13.0	12.5
All Other Sources	15.0	11.2
Total	100.0%	100.0%

Source: U.S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federal ism*, 1987.

Texas' reliance on oil and gas severance taxes, which are not a prominent part of the revenue bases in most states.

Finally, Texas was close to the national average in its reliance on user fees and somewhat higher than average in the income it receives from other nontax sources. In large measure, this latter fact is related to the degree to which the state has benefitted from land and investment income, revenue sources which, like the severance taxes, are closely tied to the state's mineral wealth.

TABLE 6. State and Local Government Taxes Per Capita, 1985

State	Per Capita Tax Revenue	Rank	State Share of Total	State	Per Capita Tax Revenue	Rank	State Share of Total
Alaska	$4,585	1	83.9%	Iowa	$1,331	26	60.5%
Wyoming	2,589	2	60.6	Ohio*	1,331	27	59.6
New York*	2,334	3	49.8	Maine	1,328	28	64.8
Connecticut	1,816	4	59.1	Virginia	1,307	29	59.6
Minnesota	1,767	5	71.5	Louisiana	1,298	30	63.0
New Jersey*	1,749	6	58.0	Oklahoma	1,289	31	69.7
Massachusetts	1,715	7	65.0	**Texas***	**1,267**	**32**	**55.1**
Hawaii	1,652	8	77.9	Utah	1,258	33	63.9
California*	1,645	9	66.5	Nebraska	1,251	34	54.0
Maryland	1,629	10	60.4	New Mexico	1,249	35	81.0
Wisconsin	1,611	11	69.0	West Virginia	1,203	36	78.9
Michigan*	1,609	12	59.9	Georgia	1,181	37	63.1
Delaware	1,558	13	83.1	Florida*	1,181	38	62.3
Rhode Island	1,479	14	60.0	Indiana	1,181	39	67.3
Illinois*	1,474	15	53.8	North Carolina*	1,144	40	73.2
Colorado	1,448	16	50.1	New Hampshire	1,126	41	39.7
Nevada	1,443	17	69.8	Missouri	1,091	42	60.2
Washington	1,435	18	73.7	South Carolina	1,076	43	73.7
Oregon	1,420	19	52.4	South Dakota	1,043	44	51.9
Vermont	1,392	20	61.3	Kentucky	1,033	45	78.7
Pennsylvania*	1,385	21	61.6	Idaho	1,022	46	72.0
Montana	1,383	22	55.5	Tennessee	996	47	60.6
Arizona	1,376	23	66.4	Alabama	990	48	74.0
North Dakota	1,357	24	74.8	Arkansas	967	49	75.8
Kansas	1,357	25	58.3	Mississippi	918	50	77.0
				U.S. Average	**$1,465**	**—**	**61.7%**

Source: Brizius and Foster, *State Policy Databook* 1987; and U.S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1987; Texas Research League.

*One of the 10 most populous states according to current Census Bureau projections.

Tax Burden and Tax Mix

In 1985, Texas state and local governments generated about $1,267 per capita in tax income (Table 6). This ranked the state 32nd lowest nationally and was significantly below the national average of $1,465 per capita. Among the ten most populous states, only Florida (38th) and North Carolina (40th) ranked lower.

The table also shows the share of the overall tax burden made up of state taxes. As the table shows, this percentage varies widely from state to state. In Texas, about 55 percent of collections were at the state level in 1985. This is actually somewhat less than the national average, which was about 62 percent in that year.

Table 7 takes a closer look specifically at what sources are used to generate each state's tax income, eliminating other sources of income and focusing on four general tax bases available to state and local governments—income, property, sales and a catch-all other tax group.

As noted earlier, one of the most prominent features of the Texas state and local tax structure is the absence of either a personal or a corporate income tax. Combined Texas state and local governments accrue 37.5 percent of their tax revenue from property taxes, 25.5 percent from the general sales tax, and the remainder from other taxes. Texas ranks 13th nationally in its use of the property tax, 20th in its use of the sales tax, and eighth for other taxes.

In contrast, the U.S. averages are 30.1 percent for the property tax, 23.5 percent for the sales tax and 20.9 percent for other tax sources. The remaining 25.5 percent of tax revenue under the U.S. average is raised through income taxes.

Examination of the tax mix data yields several points. In many cases, states trade reduced reliance on one tax for much heavier reliance on other taxes (a trade-off that is most conspicuous in states that chose not to levy a particular kind of major tax). For instance, Oregon levies a personal income tax with no sales tax. Washington has no state income tax, relying instead on sales and property taxes. Texas has followed a similar pattern. States with considerable mineral wealth accrue the bulk of their tax revenue through other taxes. The property tax dominates local government finances, with 19 states generating more than 90 percent of their local tax revenue through ad valorem taxation.

The Business-Individual Split

Another form of "tax mix"—one that is more subtle and less easily identifiable than the simple categorization of taxes by type—is the mix of taxes that have their initial impact on business or individuals. While it is a fairly simple matter to determine what percentage of revenue a given state or city collects from the property, sales or income taxes, it is more difficult to ascertain the extent to which a governmental entity is levying a disproportionate share of taxes on business or individuals. Part of the difficulty lies in a functional definition of "initial impact." Another problem lies in collecting accurate data that is detailed enough to allow a split to be estimated. In some cases—as with Texas' corporation franchise tax—this is not a particular problem. With others—notably the sales and excise taxes which reflect a mix of transactions by businesses and individuals—it is a major analytical hurdle.

A detailed analysis of the business-individual split by state was completed as part of the work of the Select Committee. It showed that about 63 percent of Texas state and local taxes have an intital impact on business. Based on a recent national study of this issue, this direct business share is signifcantly higher than the average state. In a 1987 study, Robert Tannenwald of the New England Federal Reserve Bank found that nationally, about 31.8 percent of state and local taxes had an initial impact on business.

The reason for this divergence is obvious: the majority of states rely on the personal income tax as a key revenue source, while the Texas tax system, with the strong role of the severance taxes, has a much larger direct business impact. In fact, Tannenwald found that only two states–Alaska and Wyoming–had a heavier business tax burden, and they are, of course, also major severance tax states. However, the effects of severance taxes do not completely explain

In many cases, states trade reduced reliance on one tax for much heavier reliance on other taxes.

TABLE 7. The State and Local Tax Mix, 1985

State	Income Taxes	Property Taxes	General Sales Taxes	Other Taxes
Alabama	24.2%	12.2%	28.4%	35.2%
Alaska	13.0	18.6	2.5	65.9
Arizona	19.1	28.1	36.2	16.7
Arkansas	26.6	19.7	29.7	24.1
California	32.3	25.6	28.4	13.7
Colorado	20.0	33.3	31.5	15.2
Connecticut	13.0	40.3	25.6	21.0
Delaware	47.2	14.1	0.0	38.8
Florida	3.1	32.6	33.8	30.4
Georgia	28.4	26.6	27.0	18.0
Hawaii	27.4	18.0	39.9	14.6
Idaho	26.5	26.8	25.3	21.3
Illinois	21.8	36.6	22.4	19.2
Indiana	23.7	31.3	32.8	12.2
Iowa	24.8	38.7	19.9	16.6
Kansas	22.9	37.1	19.7	20.3
Kentucky	31.0	18.2	21.2	29.6
Louisiana	13.5	14.9	36.9	34.8
Maine	22.1	36.0	22.2	19.7
Maryland	39.1	25.3	15.1	20.5
Massachusetts	39.2	34.4	13.9	12.5
Michigan	34.9	38.1	15.9	11.1
Minnesota	36.9	27.3	17.6	18.1
Mississippi	16.4	21.7	38.3	23.6
Missouri	23.8	23.1	33.7	19.4
Montana	19.6	46.2	0.0	34.2
Nebraska	18.8	41.1	21.7	18.4
Nevada	0.0	22.0	33.4	44.6
New Hampshire	11.0	61.0	0.0	28.0
New Jersey	21.1	41.5	16.7	20.7
New Mexico	7.5	12.4	38.9	41.2
New York	36.1	30.5	19.0	14.4
North Carolina	34.0	22.3	20.7	23.0
North Dakota	12.9	24.5	22.3	40.3
Ohio	30.8	29.8	21.2	18.1
Oklahoma	19.8	17.2	23.1	40.0
Oregon	38.6	43.2	0.0	18.2
Pennsylvania	30.5	26.3	17.5	25.7
Rhode Island	25.5	40.0	18.4	16.1
South Carolina	19.4	24.5	24.7	21.3
South Dakota	2.6	41.5	30.2	25.7
Tennessee	6.8	24.2	43.5	25.5
Texas	0.0	37.5	25.5	37.0
Utah	23.0	27.9	33.7	15.4
Vermont	23.0	38.5	12.0	26.5
Virginia	29.4	28.4	16.4	25.8
Waxhington	0.0	27.9	49.1	23.0
West Virginia	22.4	17.2	36.2	24.2
Wisconsin	34.7	32.8	18.5	14.0
Wyoming	0.0	43.9	16.3	39.8
U.S. Average	25.5%	30.1%	23.5%	20.9%

Source: U.S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1937; U.S. Department of Commerce, Bureau of the Census.

the large share of the state's taxes which are directly on business. Tannenwald also found that the Texas tax system had the third largest percentage of state and local taxes with an initial impact on business when severance taxes were excluded, following only West Virginia and Delaware in this case.

The argument that business taxes estimates should not include severance taxes is based on the assumption that taxes levied on energy products are passed on to energy consumers, the majority of whom live in other states. In the majority of cases, the actual burden of the severance tax falls outside of the state, so the tax's impact on the state's economy and business climate is minimal, according to some experts. Unfortunately, this analysis ignores the very high percentage of Texas oil and gas production that is consumed in the state—either directly by Texas consumers or as inputs to various industries. Including the severance taxes among the taxes with an initial impact on business makes more sense, so Texas' mix should remain with its initial impact of just over 60 percent with a direct impact on business and 40 percent directly impacting individual Texans.

Conclusion

This chapter shows both differences and similarities between Texas and the other states. As might be expected, a part of this difference stems from the prominent role the energy industry has played in Texas. Texas' recent economic problems, for example, have not been mirrored in most other states, so Texas' ranking in per capita personal income has slipped below the national average. On the other hand, federal statistics show the state has continued to grow and add jobs, although the character of the jobs that have been created in recent years—largely in the service and governmental areas—is slowly reshaping the face of the state economy.

In the spending area, much of state and local policy hinges on education. The state spends half of its income on education and has actually increased its spending in this area significantly in the last few years. In fact, education is one of the few areas where Texas spends significantly above the national average. It spends below the national average in other major areas examined.

State and local government in Texas pays for this spending with a mixture of taxes based heavily on the sales and property taxes and a varying mixture of other sources—both tax and nontax. Texas' mix differs from the average in the degree of reliance on the property tax, on the fact that it has not had to resort to personal or corporate income taxes and in its use of severance taxes.

Surveying the range of tax and spending policies offered in the various states, it is obvious that they develop in response to diverse situations which generally are not replicated anywhere else in exactly the same way. There is no model tax and spending system. Interstate comparisons represent a useful set of benchmarks and a source of ideas, but each state must craft its fiscal system in line with its particular needs.

It is obvious that state and local spending policies develop in response to diverse situations which generally are not replicated anywhere else in exactly the same way.

CHAPTER THREE

THE CURRENT TAX SYSTEM: CONCLUSIONS AND PROBLEM STATEMENT

> The problems which created the need for the recent massive tax bills have not been fully addressed, and new challenges lie ahead.

The Texas tax system served our state well from the 1960s to the early 1980s. Adjustments were needed from time to time, but by and large, Texas was blessed with a tax system characterized by low tax rates and strong growth.

Those days are over. Since 1983, the State of Texas has adopted three major tax bills to address problems with the existing tax system and to meet critical new state needs. In 1984, the state enacted far reaching expansions of its education and transportation programs. Tax legislation in 1986 and 1987 was necessary to deal with major budget deficits created by the economic recession that plagued the state economy. In total, more than $9 billion of the $41 billion in total revenue the state expects to collect in 1988-89 will result from legislation enacted since 1983. Local governments have added billions of dollars more.

The state fiscal system is momentarily in balance after the infusion of almost $6 billion in new revenues from the 1987 tax legislation. Still, the problems which created the need for that massive tax bill have not been fully addressed, and new challenges doubtlessly lie ahead.

Locally, our cities, counties and school districts are hard pressed to meet the demands of a growing population and aging infrastructure. Local governments suffer the dual problems of reductions in federal assistance and the erosion of their property tax bases because of weakness in local economies. The result is rising property tax rates and growing public discontent with the tax.

The Select Committee on Tax Equity was created by the 70th Texas Legislature to examine the tax system in detail and to recommend needed repairs—to provide a blueprint for restoration. The Committee has set as its mission "to recommend to the State the standards and options for developing a fair, viable and economically competitive state and local tax system capable of generating sufficient revenues to meet expected needs in the future."

The Committee has heard from over 400 individuals, including major taxpayers, state and local officials, tax experts and individual Texans in more than two dozen public hearings and more than a hundred hours of public testimony. It has produced more than 40 separate studies analyzing a wide range of tax issues. In short, it has conducted one of the most thorough reviews of a state and local tax system ever undertaken. This alone is a tribute to the foresight of the state's leaders and their desire to provide a tax system that is fair, simple and stable.

From the mountain of research and opinion it has collected, the Committee has identified a number of weaknesses in the current system which will be addressed in subsequent chapters of this report and, it is hoped, subsequently in legislative action. These weaknesses and the Committee's conclusions about them are addressed below.

Judging the Tax System

Early in its work, the Committee identified nine criteria for judging a "good" tax system. They were: adequacy, equity, efficiency, stability, economic competitiveness, simplicity, balance, breadth of the tax base and intergovernmental linkages. For simplicity, these criteria can be collapsed into the following categories:

Adequacy. A "good" tax system should produce adequate revenues to run government in a stable and predictable manner. It should make use of a variety of revenue sources with the widest possible bases.

Equity. A "good" tax system should be fair, both to individual citizens and to businesses operating in the state.

Economic Efficiency. A "good" tax system should not unnecessarily or unintentionally interfere with private economic decisions. It should be competitive with the tax systems used in other states, but it should not rely heavily on tax incentives that favor certain businesses or industries to the exclusion of others.

Simplicity. A "good" tax system should be as

The first requirement of a tax system is that it be adequate to raise money to support the activities of government.

Simplicity. A "good" tax system should be as simple as possible to administer for both taxpayers and the tax collector.

These admittedly are ideals that no tax system is likely to achieve completely. They often conflict with one another. For example, equity may only be achieved by sacrificing some simplicity, as in the case of exemptions from the sales tax. A sound tax policy is built on a balance among these goals.

Adequacy

The first requirement of a tax system is that it be adequate to raise money to support the activities of government. In this area, the Committee finds several weaknesses in the current system:

(1) *The revenues produced by the Texas tax system often have not grown with the state economy, while state and local spending historically has grown with the growth of the economy or faster.* Because of this situation, the state has adopted new tax increases every three to four years to push revenues up to the level of spending. The Committee does not consider this to be a desirable long-term fiscal policy. Ideally, both revenue and spending should be tailored so that in most years their growth rates closely coincide without the need for new taxes. The problem should be addressed from both the spending and the revenue sides of the fiscal equation.

(2) *Rates for many of state and local governments' major taxes are approaching their practical limits.* As additional tax measures have been adopted locally and at the state level, rates for the property, sales, franchise and other taxes have been pushed higher and higher. As a result, Texas governments find themselves with less and less flexibility should further increases be needed in the future.

(3) *Important parts of the Texas tax system are unstable.* In part, problems with the tax system are a result of the economic turbulence the state has experienced recently, but they also result from the state's heavy reliance on taxes based on volatile commodity prices and business capital investment, notably the oil and gas severance taxes and the franchise tax. The tax system should move in concert with the economy. Problems arise when swings in collections from important state and local revenue sources are more volatile and less predictable than the economy—as has been the case often in recent years.

(4) *Growing reliance on the sales and property taxes is a source of concern.* Over the past two decades, our state and local tax system has rested heavily on the sales tax, the property tax and the oil and gas severance taxes. One of those sources—the severance taxes—has declined dramatically in importance. State and local dependence on the other two continues to grow.

(5) *The local government fiscal system is showing major stresses.* Partly because of their own policies and partly due to the pressures of a growing population with growing service demands, local governments are under mounting fiscal pressure. Their revenue options are relatively limited compared with state government's. The next "fiscal crisis" in Texas is as likely to be in local finances as in state finances.

Equity

Fairness is critical to a viable tax system. Taxpayers must believe that the tax system does not benefit some groups or individuals at the expense of others. Business taxpayers must believe that the tax system creates a level playing field for all industries. It also is important that governments not use their powers of taxation to harm the working poor and moderate income families.

(1) *The Texas tax system places a heavier proportionate burden on low and middle income Texans than it does those with higher incomes.* A Texas family with an annual income of about $15,000 pays more than five percent annually in direct state and local taxes. A family with an income of over $60,000 a year pays just over three percent. These impacts are higher when the final incidence of business taxes (shifted to individuals in higher prices, lower wages or reduced

profits) are added in, but the pattern is the same—low and moderate income Texans pay a greater share of their income in taxes than those at the upper end of the income scale. One important role of tax policy should be to weigh the trade-offs between the distribution of the tax system's burden and other important considerations, such as administrative simplicity and the desires of individual taxpayers. The tax system should not discourage savings and investment. It should not discourage Texans from "doing well" economically. By the same token, it should not impose an unfair burden on Texans struggling to make ends meet.

(2) *Some taxes impose special burdens on certain Texans.* Most notable among these is the property tax, which taxes "wealth" that has often not been realized by the taxpayer. Rising property values have placed a special strain on the equity of the tax system as it applies to the low income elderly and others whose incomes are not rising to match rising tax burdens.

(3) *The Texas tax system falls inequitably on different types of businesses.* Under the current tax system, a handful of industries bear the major burden of taxation, while others bear far less than their proportionate share. The manufacturing industry, for example, accounts for 16 percent of Texas' economic activity and pays about the same percentage of our state's taxes. Service industries, in contrast, make up 30 percent of the economy but pay only six percent of state taxes. The state's major business tax, the franchise tax, is limited to the corporate business form, putting a lesser proportionate burden on partnerships and proprietorships. As a result, only 15 percent of the businesses operating in the state pay the franchise tax (although these businesses clearly account for the majority of the state's business activity).

Economic Efficiency

State and local taxes are only one factor among many in business investment decisions, and tax costs are often small in comparison to such factors as labor and transportation. Nonetheless, studies show that state and local tax policies can have an impact on economic activity. They can support strong, stable economic growth, or they can be an impediment to investment and a barrier to development.

The tax system should not discourage Texans from "doing well" economically.

(1) *Taxes with an initial impact on business make up a larger share of the Texas tax system than they do in most states.* While some industries are heavily taxed and others are not, the direct impact of the Texas tax system is clearly on business. Six of every ten dollars raised by Texas governments comes from direct business taxes, compared with a national average of less than a third. Taxes on business are not necessarily bad, but they can distort business decisions and lead to lower investment and employment if tax rates become too high or their bases fall too heavily on capital or labor.

(2) *The tax system places too great a burden on capital investment, and parts of the system may be impediments to economic growth.* All taxes interfere to some degree with private economic decisions. Texas bases a large percentage of its tax system on consumption—such as the sales and motor fuel taxes—a policy which minimizes the impact on savings and investment. However, other parts of the tax system work to offset this policy benefit. Examples are the franchise tax, the unemployment insurance tax, the sales tax on machinery and equipment and certain aspects of the property tax. (The sales tax on machinery and equipment is due to be phased-out beginning in 1991.)

(3) *The corporation franchise tax imposes a special burden on certain methods of financing capital investment.* The franchise tax is based heavily on a firm's capital assets. Testimony before the Committee suggests that this presents a hurdle to investment in the state by the capital-intensive basic industries which are essential to the state's continued growth and development and introduces components to business decisions on investment which may be detrimental to the long-term economic interests of the state.

(4) *Local property tax policies represent a*

Tax policy has increasingly moved from the legislative and administrative arenas to the courts.

special burden for many industries. Property taxes are the largest single source of taxes for government in Texas, totalling $9.6 billion in 1986 and accounting for 40 percent of state and local tax collections (compared to 25 percent for the sales tax). The tax on business inventories and the lack of an exemption for goods in transit through the state are areas of particular concern.

(5) *Uncertainty over the direction of state and local tax policy hurts Texas' economic attractiveness.* A business considering an expansion of capacity or a new venture must feel some assurance that the return will justify the investment. There are enough barriers to investment—fierce foreign competition, labor costs, government regulations—without adding the uncertainty of a frequently-changing tax system. This too often has been the case in Texas in recent years. Moreover, tax policy has increasingly moved from the legislative and administrative arenas to the courts. The franchise tax is the subject of continuing litigation, even more than other state taxes. Tax policy should be orderly and consistent and should be able to stand up to review by the courts.

(6) *Texas governments should also avoid creating uncertainty by the indiscriminate use of special tax incentives and abatements to attract industry.* In particular, local governments in Texas are making increased use of special incentives and abatement programs to attract new firms. Certainly, economic development should be encouraged, but evidence from other states suggests that overuse of these policies can foster inequities within the business tax system, can punish existing businesses and can create an atmosphere of uncertainty where it appears tax policy is up for grabs.

Simplicity

A system need not—indeed cannot—achieve utter simplicity of form or content, but it also should not be totally unwieldy to understand and administer. As one writer points out: "Good tax policy and bad tax policy can look remarkably similar if the law requires a higher order of administrative capability than actually exists."

(1) *Parts of the Texas tax system are becoming increasingly complex.* Recent changes in the tax system, particularly under the 1987 tax bill, have made it more complicated for both individual taxpayers and state administrators. As the state moves beyond the recent period of fiscal emergency, the complexities and ambiguities in the tax laws should be reduced or eliminated.

(2) *The sales tax presents special administrative problems.* As the state's use of the sales tax has increased, the administrative problems and inequities of the tax have also increased. This is especially true in the area of service taxation. As selected services have been added to the sales tax base, fine lines have had to be drawn between what is taxable and what is not. Taxing services, in itself, is not inherently complicated, but picking out particular services to be taxed or not taxed adds greatly to the complexity of sales tax administration. The state taxes some services but not others. It taxes some services in certain cases—as in the case of services provided by a debt collection agency—but not others—as when attorneys provide the same collection services. There has also been a proliferation of sales tax rates locally because of the number of jurisdictions using the tax. Thirty-one different combinations of state and local sales tax are theoretically possible and 25 are now in effect. This places a heavy burden on the businesses who must collect and remit the tax and represents a special burden for small taxpayers.

(3) *Business tax policy is another area of the tax system where complexity is a problem.* The franchise tax base for taxpayers depends on the "books and records" they maintain. Until recently, the tax law did not specify how these books should be maintained, causing recordkeeping problems and confusion for taxpayers and leading, ultimately, to court challenges of the law.

These court challenges have complicated franchise tax administration by eliminating a large part of the tax base for certain tax-payers in certain circumstances. Recent attempts to resolve some of these problems by conforming tax policy to generally accepted accounting principles do not ap-pear to have been wholly successful, because generally accepted principles are also subject to many exceptions, ambiguities and issues of interpretation. Additionally, the state maintains a maze of special industry taxes left over from an earlier era in state tax policy. These taxes unnecessarily complicate and confuse the state's business tax policy.

(4) *The multiplication of taxing jurisdictions has also made the property tax too complex.* There currently are more than 3,300 local jurisdictions levying property taxes in Texas. The state has made dramatic strides in centralizing appraisals, but other administrative practices, such as the actual collection of the tax and various exemptions and other policies, continue to rest with literally thousands of entities, causing significant additional work and cost for taxpayers.

(5) *Adding to the complexity and lack of flexibility in the tax system is the complex network of state funds and revenue earmarking policies that mark the state tax system.* The Texas state accounting system is composed of more than 450 separate accounting funds which segregate the various revenues and expenditures of the government. In addition, many of the state's primary revenue sources are earmarked by the Constitution or by statute to certain specified uses. This system of segregation and revenue earmarking makes the overall state fiscal system more inflexible than is desirable.

(6) *The Texas fiscal system and related issues are poorly understood by taxpayers.* One problem the Committee has encountered—and finds highly disturbing—is the widespread lack of understanding of the Texas state and local fiscal system, how it is financed and what it buys. For many Texans, the debate over state and local fiscal policies is being conducted in a shadow world of poorly understood policies and programs. In fiscal matters, complete public trust can only be built on complete public understanding. Efforts to inform the citizens of Texas on state and local fiscal issues should be an on-going process.

Retaining the Best, Discarding the Worst

Though rates have risen and the importance of some taxes has shifted over time, the composition of the tax system today is remarkably similar to its composition 25 years ago.

This is not inherently bad. Predictable, consistent tax policy is one hallmark of a sound tax system. The Texas tax system served the state well for two decades. During that time, it embodied many principles of taxation beneficial to Texans and the state's economic development.

But after 25 years, the system has developed serious problems. The state economy has changed, but the tax system has not always kept pace. Like most tax systems, it has evolved slowly through a series of compromises dictated by the changing needs of each legislative session. These changes often represent patches and appendages to the system. Tax policies which have outlived their usefulness sometimes remain in the law. Antiquated tax approaches, like the franchise tax, play prominent roles in the tax system and lay government open to costly litigation and fiscal uncertainty. As state Comptroller Bob Bullock told the Texas Senate in 1987: "We are developing a 21st century economy, whether by design or default. The question now is: Do you want a tax system that is in step with that economy?"

Some steps have been taken to correct the tax system's problems in recent legislative sessions. Our state's leadership has clearly recognized the need for change, but much more must be done before the structure is finally set right. The worst of the current system should be discarded; the best should be retained.

"We are developing a 21st Century economy, whether by design or default. The question now is: Do you want a tax system that is in step with that economy?"

Comptroller Bob Bullock

CHAPTER FOUR

THE TEXAS TAX SYSTEM TOMORROW

Texas' fiscal problems have persisted through much of the 1980s despite spending restraint by government and significant tax increases to replace revenue lost due to poor economic conditions. It now appears that the fiscal system at the state level is in balance; however, that balance is delicate, and many of the problems underlying Texas' recent fiscal difficulties have not been resolved. To help avoid new fiscal crises in the future, the tax system should be modified and improved today. Now is the time to begin ensuring that tomorrow's tax system is both fair and workable.

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Based on its months of study and analysis, the Select Committee on Tax Equity has developed a set of recommendations that will accomplish these goals. Its details are contained in this and succeeding chapters. The recommendations are comprehensive in their scope and would affect all major components of the state and local tax system. They would make fundamental changes in the system and would address the problems with the current system identified in Chapter 3.

The recommendations do not attempt to construct a "crystal palace" of tax ideals based on arcane tax theories. Instead, the recommendations collectively reflect a realistic vision of what a fair and reliable tax system should be and provide a clear and consistent blueprint for its realization.

Building on the Existing Structure

Any reform of the current tax system must start with the elements already in place, and in Texas, that leads first to the sales tax. In Chapter 5, the Committee details policy recommendations for this pivotal tax. Texas has been fortunate to have been able to base its tax system so heavily on the sales tax to this point. The tax generally grows with the economy. It has proven to be a stable revenue source, and it receives high marks from taxpayers. Nonetheless, the Committee has two major concerns about the tax for the future: its current high rate and its regressive nature, which is aggravated as the tax rate creeps higher.

Because of its positive qualities, the Committee believes the sales tax should remain the cornerstone of the state fiscal system in the next decade. We recommend, however, that any future increases in the tax to meet additional revenue needs should be approached with care. If possible, the state should avoid rate increases and should pursue a policy of expanding the tax base to additional services. Indeed, the Committee favors reducing current rates through base expansion if the fiscal situation allows. This policy would have the effect of making the tax—and the tax system—more responsive to economic growth. It would also benefit local governments, where rate increases would not.

On the other hand, Texas state government should steer away of increased reliance on its other important state tax sources of the past two decades—the oil and gas severance taxes.

Today, the prospects for higher oil prices do not appear great, but if the past 15 years teach anything, it is the degree to which market conditions affecting this volatile commodity can change—often dramatically—in a short period of time. Texas has been weaned from reliance on resource-based taxes in the worst possible way—by wrenching fiscal crisis. It should be in no hurry to repeat this experience in the future. State government should learn to live permanently with severance taxes playing a diminished role in its tax mix.

Local Fiscal Problems

Since its reform in 1979, there is ample evidence that the property tax has served Texas local governments well. The tax provides a large and generally stable base, and the 1979 reforms did much to improve tax administration and make the tax fairer. Nonetheless, the Committee is concerned about the dominance of the tax in local finances. Texas counties, school districts and special districts are almost totally reliant on the property tax as their source of income, and while our cities enjoy a wider range of revenue options, they, too, must typically rely on the tax whenever new income is needed.

In the past, this dependence has served a useful purpose, according to proponents of the tax. They

The tax system ultimately belongs to the people and businesses who must pay the taxes and receive—or forego—the services of government.

argue that taxpayer resistance to the property tax works to mitigate tax increases that might otherwise have occurred had other revenue alternatives been available. However, such heavy reliance on a single revenue source also leads to inflexibility, and the Committee is concerned that the tax may not prove an adequate vehicle to address all of the legitimate needs Texas local governments may face in the next decade.

It is the Committee's belief that local tax systems in Texas must be diversified over the next ten years. To this end, Chapter 7 outlines changes in tax policy which would promote this diversification by adding new local revenue sources. There is also a need for state and local leaders to come to a greater understanding of local fiscal problems and how they should be approached. The needs of our cities, counties and school districts are very much a matter of state—as well as local—concern.

The Role of the Personal Income Tax

One possible "solution" to many of the state and local government fiscal ills the Committee has heard often during its life is the personal income tax. As is discussed in Chapter 8, the income tax represents a huge potential source of revenue for Texas governments, and it is an issue that deserves thoughtful consideration by all Texans.

After careful review of the tax's potential and the current state and local fiscal situation, it is the Committee's conclusion that the income tax is not yet needed in Texas. History shows that such major changes in basic tax policy flow from periods of crisis or public consensus. Neither of these conditions exist in Texas today on this issue. The tax system ultimately belongs to the people and businesses who must pay the taxes and who receive—or forego—the services of government. We believe the income tax will not be a central focus of Texas tax policy as long as the policy choice is between the income tax and other tax options. It *will* become a focus of debate when the choice is between the tax and foregoing critical state and local services such as education, transportation and public safety. For the present, Texas can build a strong, fair and reliable tax structure with the components already in place. Common sense dictates that that approach is the best one for the state today.

On the other hand, the Committee recognizes that the day may come when the state will need to seriously consider an income tax among its tax options. While the Committee does not advocate action on the tax at this time, Chapter 8, outlines the basic characteristics of an income tax that could work well for the state if it is needed.

The tax would employ a single flat rate. It would be simple to administer and would be highly productive. The Committee believes that the first policy choice regarding the tax should be to use it to relieve pressure on the sales and property taxes, although in reality, the fiscal situation at the time of the tax's enactment would dictate what could—and could not—be done in this regard.

A major concern that should be addressed now is the issue of time to implement the tax. Current estimates suggest that it would require two and a half years to start up a Texas income tax and another year would be needed to have it fully operational. If this tax is to be available for any future fiscal crisis, the state needs to consider ways to address this implementation lag.

Business Tax Reform

In a related area, the Committee also recommends against the imposition of a corporate income tax at this time. It simply does not make sense to impose this tax in the absence of a personal income tax, and the Committee believes the state should not have one without the other.

The Committee does believe, however, that fundamental reform of the state's general business tax policy is needed. The failings of the current franchise tax have been well documented, both in terms of its inequitable effect on different industries and its aged structure which has laid the tax open to base-eroding litigation.

The alternative outlined by the Committee in this area (Chapter 6) is a tax combining the general stability of a net worth tax—

like the current franchise tax—with a component sensitive to a business' current activity in Texas as a measure of its ability to pay. The Committee also feels strongly that at least some noncorporate businesses should pay the tax and the reforms proposed by the Committee account for that new policy direction. A tax structured in this way would provide more stability than a corporate income tax and would be fairer than the current franchise tax.

The Committee has also closely examined the impact of the Texas tax system on the economy and on the prospects for state economic growth. In general, we believe that the logical, consistent implementation of changes like those discussed in this report will contribute to the basic economic advantages of the Texas fiscal system.

In this vein, the Committee does not subscribe to the notion of "buying" economic development through single-shot tax concessions. However, there are several policy "sore thumbs" in current state and local tax policy that are placing Texas at a real competitive disadvantage compared with other states. The Committee, therefore, has recommended changes in the local taxes on business inventories and on state sales tax policies with regard to production machinery and equipment and research and development equipment and supplies.

A Better Tax System

Stripped of philosophical distinctions, a government is basically the sum of the services it provides. In Texas, state and local governments are responsible for providing schools and roads, for helping the needy and for the insurance of public safety. Taxes are the price Texans pay for those services, and for one side of this fiscal equation to function properly, the other must function properly as well.

Like the governments it finances, Texas state and local tax system is also the sum of its parts. It represents the reconciliation of different views about who or what should be taxed, how they should be taxed and by how much. It is, in short, a series of choices that reflect the wisdom, needs and conventions at the time they are made.

It is important that these choices periodically come under careful scrutiny. Economic, social and political circumstances change, and tax policy must be reviewed to ensure that it fits current needs and concerns. This is a conspicuous moment for such a review in Texas. Texas—and its state and local fiscal system—are emerging from a difficult period when many of the state's long-held economic assumptions have been challenged. It is time to rethink old methods of doing business, to modernize them if appropriate and to replace them if necessary.

The people of Texas deserve a state and local tax system that is fair, stable and dependable. They should demand a tax system which will allow state and local government to provide a reasonable level of services with the reasonable certainty that revenue and spending growth will be closely matched without the necessity of repeated tax increases. The tax system should accomplish these things without imposing an undue or inequitable burden on any individual or business.

These are not unobtainable goals. They are the hallmarks of a good tax system, and they clearly are within reach of the Texas tax system. The Committee believes that with the changes it outlines, all of these goals can be achieved in the tax system of tomorrow.

The people of Texas deserve a state and local tax system that is fair, stable and dependable.

CHAPTER FIVE

THE SALES TAX

The sales tax is the mainstay of the Texas tax system and its importance is growing. In 1987, state sales tax collections totalled \$4.6 billion—45 percent of total tax collections of \$10.3 billion. Because of the increase in the state sales tax rate to six percent, limited base broadening and economic growth, state sales tax collections are expected to grow to almost \$7.8 billion, or 59 percent of total state tax collections of \$13.2 billion in 1991. The tax also provides \$1.3 billion a year for Texas cities and for a number of metropolitan transit authorities and counties.

The sales tax is the mainstay of the Texas tax system and its importance is growing.

During times of good economic health, the sales tax is a good revenue producer. With a growing economy, the tax provides large amounts of money to fund state government. Only once in the 27-year history of the tax have collections declined from the previous year, and even adjusting for tax law changes, the sales tax would have declined only three times. Instead, the tax has frequently been marked by double-digit growth.

In the past, when the Texas economy has suffered, taxable sales have declined, costing the state vital tax revenues at a time of increased need. However, much of that decline was attributable to the drop in taxable purchases of capital machinery and equipment. For example, in 1983, overall sales tax collections declined 4.5 percent from the preceding year. In fact, taxable retail sales increased 2.1 percent that year, while sales tax paid by oil and gas firms dropped 40.1 percent and sales tax paid by manufacturers dropped 21.6 percent.

The 70th Legislature enacted a phase-out of the sales tax on machinery and equipment. As this part of the tax base is phased out, the sales tax will become even more stable and less subject to decline during recessionary times. This policy decision should help make the sales tax an even more reliable revenue source, although it will cost revenue.

Based on these observations, the Committee concludes that the sales tax is a good revenue tool that can adequately serve as the state's leading revenue source. The following sections outline additional recommendations concerning the tax.

Taxation of Additional Goods and Services

Table 1 shows major potential goods and services that could be used to expand the sales tax base in the future, either to produce additional revenue or to lower the overall tax rate. While the goods and services in the table represent a significant source of potential revenue, the Committee recognizes that some of the items simply are not appropriate targets for sales taxation. For example, the business tax working group of the Committee considered but laid aside the idea of restoring the tax on residential gas and electricity sales as a method of expanding the sales tax base. Similarly, the exemption of food for home consumption is unlikely to be eliminated—and should not be—because of equity considerations.

Nonetheless, the Committee believes that if new revenues are needed by the state in the immediate future, expanding the sales tax base to additional services remains a desirable policy alternative. One of the problems with the current tax system identified in the Committee's findings and conclusions is the fact that "the revenues produced by the Texas tax system often have not grown with the state economy. . . ." The service industries are among the fastest-growing parts of the Texas economy, and the long-term economic outlook is for a continuation of this trend. Broadening the sales tax base to include more services would tap this potential and would provide a tax base that would better keep pace with the economy.

The Committee recommends that the state give strong consideration to using sales tax base expansion as a means of lowering the tax rate. Again, in its findings and conclusions about the current tax system, the Committee concluded that "rates for many of state and local government's major taxes [including specifically the sales tax] are approaching their practical limits." Even if it were not used to raise revenues, base expansion could be used as a way of reducing this pressure.

Finally, the Committee's findings and conclusions note that "the local government fiscal system is showing major stresses," in part because of the limited number of revenue options available locally.

TABLE 1. Selected Potential Additions to the Sales Tax Base

Policy Option	Comment	State Fiscal Impact (Millions of Dollars) 1990	1991	1992	Date of Full Implementation[1]	Administrative Effects
Expand the tax base to these services:[2]	These tax estimates assume a 1/1/90 starting date.					
Labor charges on new residential construction		$25.8	$59.2	$65.7	1/1/90	Some cost
Labor charges on new nonresidential construction		24.6	49.6	52.8	1/1/90	Some cost
Barber and beauty services		14.4	27.2	30.7	1/1/90	Some cost
Health care practitioner services	Includes chiropracters, optometrists, nursing services, etc.	9.9	20.0	23.1	1/1/90	Significant costs
Dental services		35.9	72.7	82.2	1/1/90	Significant costs
Nursing care facilities and services		5.2	16.2	20.8	1/1/90	Significant costs
Health care services	Includes medical labs, dental labs, drug treatment centers, etc.	8.3	19.0	22.8	1/1/90	Significant costs
Veterinary services	Includes agricultural and nonagricultural services.	4.6	10.3	12.2	1/1/90	Some cost
Miscellaneous transportation services	Intrastate transport other than regular transport of passengers.	77.2	139.7	157.4	1/1/90	Significant costs
Accounting, auditing and bookkeeping services		25.3	63.3	77.4	1/1/90	Some cost
Funeral service providers		7.5	17.3	20.7	1/1/90	Some cost
Real estate commissions		37.9	64.6	65.0	1/1/90	
Brokerage services	Includes bond brokerage, investment banking, investment counseling, financial advice, etc.	24.2	45.7	51.6	1/1/90	Some cost
Legal services	Includes all legal services.	73.7	155.2	177.5	1/1/90	Significant costs
Engineering services		35.5	88.9	108.7	1/1/90	Some cost
Architectural services		13.5	33.8	41.4	1/1/90	Some cost
Total Services:		**$423.5**	**$882.7**	**$1,010.0**		
Expand the tax base to these items:	Starting date is 1/1/90 unless otherwise noted.					
Farm machinery and equipment		20.3	36.7	39.4	1/1/90	Some cost
Livestock		40.3	71.6	73.7	1/1/90	Minor costs
Feed		42.5	76.4	80.5	1/1/90	Minor costs
Seed		6.3	11.5	12.3	1/1/90	Minor costs
Farm supplies	Includes fertilizer, pesticides, etc.	16.2	30.0	32.4	1/1/90	Minor costs
Horses, mules and work animals		3.4	6.0	6.2	1/1/90	Minor costs
Agricultural use of gas and electricity		7.0	13.0	14.1	1/1/90	Minor costs
Residential gas and electricity		208.8	378.9	407.5	1/1/90	Minor costs
Retail sales of motor fuels	Current excise tax would continue.	53.1	563.0	635.1	7/1/90	Significant costs
Aviation fuel	Not currently subject to motor fuels tax or sales tax.	9.4	33.5	34.4	1/1/90	Significant costs
Purchases of commercial aircraft	Excludes craft for interstate use.	0.1	0.1	0.1	1/1/90	Minor costs
Food for home consumption	Restaurant food is now taxed.	407.9	691.9	721.3	1/1/90	Some/significant
Water		36.4	62.1	63.1	1/1/90	Minor costs
Railroad rolling stock		0.6	1.1	1.2	1/1/90	Minor costs
Total Goods:		**$862.3**	**$1,975.9**	**$2,121.4**		

Source: Select Committee on Tax Equity and Comptroller of Public Accounts.

1. The date of full implementation assumes enactment in the 1989 legislative session and is used for purposes of making fiscal estimates only.
2. Medical services and accounting services are not included since the Committee recommends that they not be taxed under the sales tax.

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Continued expansion of the sales tax base would help address that problem, since a broader base would benefit local governments using the sales tax as well. Moreover, in the case of some of the services, their inclusion may add to the progressivity of the tax system, since they are believed to fall more heavily on higher income Texans.

The Impact of Base Broadening. Assertions by critics that sales tax base broadening, especially taxation of professional services, would result in large reductions in output and employment are misleading. Claims that service taxation would result in tens of thousands of lost jobs invariably assume that the alternative to sales tax on services would be no tax at all. They also assume that an increase in state taxes would result in a new reduction in demand for goods and services, and thus a reduction in demand for the employees who produce goods and services.

This is not necessarily the case. Because Texas governments run on balanced budgets, any tax on services is in lieu of other taxes or higher tax rates, or in lieu of government spending on wages, goods or public services. Whatever revenues state government derives from private sector activity are returned to the private sector in the form of government payments which bolster private sector output and employment.

It is also sometimes argued that sales taxation of services consumed by businesses at intermediate stages of production would substantially increase the cost of doing business in Texas and thus drive businesses to locate in other states.

However, aggregate business expenditures for services currently not taxed represent, at most, about 3.5 percent of total business expenditures or cost of production. State and local sales taxation of these expenses would raise the total cost of doing business no more than three-tenths of one percent in the aggregate. While obviously the impact on certain businesses could vary substantially, it is unlikely that this small cost increase would significantly hinder overall economic development in the state.

Regressivity of the Sales Tax. The fact that the sales tax is regressive, i.e taking a higher proportion of income from the poor than from the wealthy, is the most common criticism leveled against the sales tax.

Any sales tax, regardless of the rate, tends to be regressive. This is true because poor people spend a larger portion of their income than the rich.

The Texas sales tax is no more regressive than similar taxes in other large industrial states. The Texas sales tax burden is high simply because the rate is high. Texas is currently tied with three other states for the highest sales tax rate when compared to the ten largest states and tied for third when compared to all states.

Despite its regressivity, the sales tax is widely accepted by the public as a fair form of taxation. This is because people feel they have some control over their purchases and thus, can affect their total sales tax burden. In addition, everyone pays the tax—poor, wealthy, small business, big business. Adding more services to the sales tax base may help to lessen the regressivity of the tax.

Limitations on Base Broadening. Although the Committee supports the broad addition of services to the sales tax base, there are certain limitations that the state needs to observe to avoid problems that have arisen in other states and to help ensure equity.

First, medical services should not be subject to the sales tax. Taxation of these services would be especially burdensome on the elderly, many of whom live on fixed incomes and already depend heavily on government Medicare aid. Lower-income families would also be unfairly burdened by the tax, since many lack health insurance and would have to bear the burden of the tax directly.

Second, the Committee recommends that advertising services also not be taxed. Earlier efforts to tax these services in Texas and elsewhere have uncovered major administrative difficulties in enforcing and collecting the tax. The result could be an arbitrary and essentially unworkable tax.

Third, to preserve the competitive position of Texas service businesses in national markets, only purchases of services for in-state consumption should be taxed. When business services are taxed under the sales tax, tax pyramid-

Despite its regressivity, the sales tax is widely accepted by the public as a fair form of taxation.

Sales tax exemptions should be subjected to systematic, continuing legislative review.

ing is minimized by provision of an appropriate sale for resale exemption. Language in the current statute and rules is sufficient for both these purposes and should be retained when extending the sales tax base to additional services.

In this same vein, the Committee believes that the Texas sales tax should avoid any apportionment concept in defining taxable services, as has been attempted recently in some other states. Although apportionment formulas are necessary to allocate the tax base under the franchise tax, such formulas are essentially untried and are likely to prove unworkable for sales and use taxes. As the experience in other states indicates, their introduction is likely to result in taxpayer confusion, increases in recordkeeping costs and costly litigation for the state.

Fifth, the state should avoid the practice of taxing selected services while excluding others, particularly in the area of business services. The current practice of taxing some business services and not taxing others creates confusion and uncertainty on the part of taxpayers. It also adds to the perception that the tax system discriminates against some types of business to the benefit of others.

Finally, the Committee supports the policy, begun in House Bill 61 in 1987, of not taxing sales of services between affiliated firms. To subject such services to tax would unfairly penalize the affected taxpayers because of their form of business organization, a policy the Committee believes the state should seek to eliminate from the tax structure.

Legislative Review of Exemption Policies. The Committee believes the state should remain open to the addition of items other than services to the sales tax base. For this reason, *the Committee recommends that sales tax exemptions be subjected to systematic, continuing legislative review.* Many exemptions were granted years ago under circumstances that no longer hold today and some exemptions may not warrant continuing.

The Sales Tax Permit Fee

A fee by definition is a charge to an individual or business for a specific service performed or benefit conferred. Issuance of a sales tax permit represents less the granting of a benefit or privilege than the imposition of a burden. Individuals or businesses must bear the majority of the cost of collecting and remitting sales tax to the state.

Testimony heard by the Committee, along with correspondence received by the members, illustrates strong public support for the repeal of the sales tax permit fee and the Committee recommends that the sales tax permit fee be repealed.

Local Sales Tax Rate Problems

The proliferation of sales tax rates throughout the state should be simplified.

Currently, 1,050 Texas cities impose a local city sales tax. The city tax rate may either be one or one and one-half percent. There are also six metropolitan transit authorities (MTA) with sales tax rates of one-fourth, one-half, or one percent. Additionally, 91 counties have opted for a one-half percent county sales tax.

The cumulative city, county and MTA rate may not exceed two percent under current law. The total cumulative state and local sales tax rate may be any one of nine rates, from a low of six percent to a high of eight percent.

Firms that do business in more than one local taxing jurisdiction now face up to 24 different state and local sales tax rate combinations.. In order to collect and remit the correct taxes due, it is necessary to keep track of exactly which city, county and MTA their sales take place in and what the applicable tax rate is for each of the taxing jurisdictions.

Another problem with the current local sales tax system is the discrepancy between the application of city and MTA sales taxes. If goods or services are delivered or performed outside of an MTA boundary, the MTA tax does not apply. If the goods or services are delivered or performed inside an MTA, the MTA tax does apply. City sales and use taxes, on the other hand, apply in either situation.

Firms that do business in multiple jurisdictions or whose amount of sales subject to tax differs for state versus local taxes must file separate tax reports for state, city, county and MTA tax.

The Sales Tax Prepayment Discount

Current law provides taxpayers the option of remitting sales taxes a month or more in advance of the date due, based on a reasonable estimate of tax liability.As an inducement to prepay, businesses are permitted to retain an amount equal to 1.25 percent of the taxes prepaid. This prepayment discount represents a rate of interest paid by the state to borrow tax monies from businesses before the tax is due. The discount is approximately equivalent to an annual rate of thirteen percent.

Based on estimates by the Comptroller's office, the state will forego just under $35 million in sales tax revenues in the form of prepayment discounts in the 1990-91 budget period.

Repeal of the prepayment provision would eliminate this cost to the state, but with significant adverse consequences for cash flow and the amount available for appropriation by the next Legislature. Absent prepayments, money currently remitted to the state in August of each year would not be received until September and October, which would put it into a later fiscal year. Actual cash collections of tax revenue would decline by almost $220 million during the 1990-91 biennium.

Because revenues available to finance appropriations are certified on a cash (rather than accrual) basis, such a slowdown in cash collections within the next budget period would have to be net against the savings from elimination of prepayment discounts. The net effect would be reduction of the amount available to be spent by approximately $185 million. *In view of the probable adverse budgetary consequence of repeal, the Committee recommends that the sales tax prepayment discount be continued.*

Machinery and Equipment Exemption

Of the 45 states and the District of Columbia that levy a sales tax, Texas is one of only 12 states that tax manufacturing equipment and machinery purchases at the full tax rate. Ten states tax them at a reduced rate or provide some exemptions while the majority—29 states—have no tax on these purchases. This tax puts Texas at a disadvantage to other states in attracting new businesses. In addition, it adds a highly volatile element to the state's tax base.

For these reasons, the Committee supports the policy of not taxing manufacturing machinery and equipment purchases under the sales tax. Should available revenues permit, the Legislature should consider implementing this exemption sooner than the current scheduled phase-in. Eliminating the tax will make Texas more attractive to new businesses, and will help create new jobs. It will also help to make sales tax collections more stable, especially in times of economic distress.

Under current law, this tax is scheduled to be eliminated over five years, starting in 1991. *The Committee recommends a slight revision in this schedule which would result in even greater economic benefit by speeding-up the exemption without substantially increasing the amount of foregone tax revenues.* Instead of providing a phased-in tax credit over five years, the state should turn to a four-year schedule, allowing rebates for a portion of taxes paid in the early years as shown in Table 2.

Texas is one of only 12 states that tax manufacturing equipment and machinery purchases at the full tax rate.

TABLE 2. Proposed Change in the Machinery and Equipment Exemption Schedule

	Current Law		Proposed Law	
Year	Credit	Rebate	Credit	Rebate
1990	0%	0%	0%	0%
1991	20%	0%	0%	25% of 1990 taxes
1992	40%	0%	25%	25% of 1991 taxes
1993	60%	0%	50%	0%
1994	80%	0%	75%	0%
1995	100%	0%	100%	0%

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Research and development equipment should be included in the phase-out schedule for production machinery and equipment.

Research and Development Equipment

The state, in an effort to prevent the sales tax from acting as a barrier to business development, will gradually phase-in an exemption for industrial machinery and equipment starting in 1991. *To further this attempt, research and development equipment should be included in the phase-out schedule for production machinery and equipment, or, if available revenues permit, should be exempted immediately.*

A phased-in exemption for research and development equipment on the same schedule as that currently provided by law for manufacturing equipment would reduce tax revenue in the 1990-91 biennium by less than $6 million.

Such an exemption would help encourage investment in research and development activities in the state and would help put Texas on a more equal footing with the other states who currently have such an exemption. (At present, 15 states provide some form of special treatment of research and development purchases under their sales tax, including such major industrial states as Massachusetts, New Jersey and New York.)

The Committee recommends that this exemption be fairly broadly based. It should exempt tangible personal property consumed predominantly (i.e., more than half the time) in research or development in an experimental or laboratory sense. The exemption should include the sale of gas, electricity, refrigeration and steam when consumed directly and exclusively in research and development (i.e., 100 percent) if not currently exempted. It should not include product testing, management studies, marketing studies, advertising or similar items. It should include installation services for exempted items as may be appropriate.

Federal Nondeductibility of the Sales Tax

The Committee recognizes that changes in federal income tax law under the Tax Reform Act of 1986 make the sales tax nondeductible for federal income tax purposes. However, evidence presented to the Committee suggests that the impact of this change in Texas is not serious enough to deter the state from its longstanding policy of reliance on the sales tax as its main revenue source.

THE FRANCHISE TAX AND OTHER BUSINESS TAXES

Taxes are ultimately paid by people, and economists generally agree that taxes initially levied on business will eventually find their way to individuals. Business taxes may be shifted to individuals in the form of higher prices, lower wages or reduced profits. Nonetheless, taxes on business are a dominant feature of the Texas state and local tax system, and the question of how business should be taxed has become a central issue of state tax policy.

> The question of how business should be taxed has become a central issue of state tax policy.

In Texas, this issue has never been completely resolved. This is partly a result of the conflicting goals of state and local tax policy, with government's need to raise money clashing with the desire of policymakers and the business community to maintain a healthy climate for economic growth. The result in Texas—as in most other states—has been the development of an assortment of general and special business taxes.

Research presented to the Committee indicates that more than 60 percent of Texas state and local taxes come from direct taxes paid by business (Table 1). Even adjusting for the oil and gas severance taxes, Texas is above the national average in the share of its taxes derived from direct business taxation. Nationwide, business taxes account for about a third of state and local taxes.

Given the role of business taxes in the Texas state and local tax system and the current problems with the state economy, it is not surprising that Texas policymakers and business leaders—both in this state and considering moving to the state—worry about the stability and soundness of Texas business tax policies.

In recent years, this concern has been compounded by problems with the state's chief general business tax—the corporation franchise tax. The tax has been under serious and repeated legal challenge in the courts, and at the same time, many business and government leaders are concerned about the fairness of the tax's distribution among various industries in the state. The initial burden of the tax falls heavily on capital-intensive industries, imposing a comparatively smaller burden on less heavily capitalized segments of the economy. In many cases, these less heavily taxed industries have business activity in the state equal to, if not greater than, the more heavily taxed industries.

Concerns over the impact of the tax system on business do not end with the franchise tax, however. As the Committee's findings and conclusions about the current tax system note: "The manufacturing industry, for example, accounts for 16 percent of Texas' economic activity and pays about the same percentage of our state's taxes. Service industries, in contrast, make up 30 percent of the economy but pay only six percent of state taxes." The two most important taxes for state and local government in Texas—the sales and property taxes—both are major taxes on business, a fact which is underscored in Table 1.

One general finding of the Committee's research in this area is that Texas state and local governments rely heavily on taxes paid directly by business. The national average is about a third of state and local taxes from direct business levies, compared with 63 percent in Texas. The Committee believes future state tax policy should be sensitive to this fact and that major increases in the *share* of direct business taxes in the Texas tax mix should be avoided if possible.

Moving beyond this general policy objective, the following sections look at specific business tax policy recommendations developed by the Committee. Taken together, the Committee feels they would improve Texas' business tax policy and would help eliminate many of the problems and inequities that mark the current system.

The Franchise Tax

The current franchise tax was adopted in essentially its current form in 1907. Since then, the major change in the tax has been to increase the rate from the original 50 cents per $1,000 of taxable value to the current temporary rate of $6.70 per $1,000 of taxable value (a rate scheduled to drop back to $5.25 in 1990). One other major change in the tax's long history was the phase-out of long-term debt from the tax base in the early 1970s, a change made primarily to remedy the perceived inequity of taxing debt.

The franchise tax base should be expanded to more fully reflect the role of various industries in the state economy.

The state's recent problems with the tax come primarily from two directions, involving both the inner workings of the tax and its impact on various segments of Texas industry. In fiscal year 1988, franchise tax collections totaled $932.6 million, excluding payments by banks, which are local revenues. However, this large tax base is being seriously eroded by a series of court challenges to the 81-year old statute and to the administrative rules which have been developed to administer it. How serious are these challenges? In 1989, the Comptroller projects that the tax will equal only about half of the 1988 figure—$483.8 million—owing largely to past and future litigation (Table 2). Hundreds of millions of dollars will be lost from tax base erosion and from expected refunds of past taxes.

A second fundamental issue arises from the current distribution of the franchise tax among industries. The franchise tax base—primarily equity-based assets—is extremely narrow as a measure of a business' ability to pay and has dramatically different effects on different types of business, depending on their asset structure and receipts in the state and on the way they are organized to do business. It is possible for two firms to have the same overall level of sales and profits in Texas and for one to pay a large franchise tax bill and the other to have only a small bill. Moreover, many firms are not subject to the tax at all simply because they are organized as partnerships or other business forms and not as corporations.

The Committee has devoted considerable time and attention to reviewing the various problems with the current franchise tax and possible alternatives. From this review, it is clear that the "easiest" approach for the short run would be to stay with the current structure and attempt yet another set of patches to deal with recent litigation and shore up tax revenues. While that approach might be easier in the short run, the Committee believes it is the wrong approach for our state. Texas should rebuild its general business tax over time, moving to a new structure that accomplishes several policy goals.

First, the tax base should be expanded to more fully reflect the role of various industries in the state economy. The goal of state policy should be to spread the business tax burden so that its distribution is more nearly in line with the distribution of state economic activity among industries. To the degree possible, the tax should be based on each firm's long-term investment in the state, its current economic circumstances and its ability to pay.

Second, the Committee believes all forms of business organization should be taxed in an equitable and consistent manner. The current system focuses on the taxation of corporations to the exclusion of other business forms. This orientation is a remnant of a time when the franchise tax was essentially a license fee for the privilege of doing business in the state in the corporate form. The tax has long since moved beyond that role in the Texas tax system. It has evolved into the state's general business tax, and

TABLE 1. Estimated Direct Impact of Texas Taxes on Businesses and Individuals

Tax	Individuals	Business
Alcoholic Beverage Taxes	87%	13%
Cigarette and Tobacco Product Taxes	100	0
Corporation Franchise Tax	0	100
Hotel/Motel Taxes	15	85
Inheritance Tax	100	0
Insurance Taxes	44	56
Motor Fuel Taxes	66	34
Motor Vehicle Sales and Rental Taxes	71	29
Natural Gas Tax	0	100
Oil Production Tax	0	100
Property Tax	31	69
Sales Tax	54	46
Telephone Tax	46	54
Utility and Other Taxes	41	59
Total (Weighted Averages)	37%	63%

Source: Select Committee on Tax Equity from data supplied by Comptroller of Public Accounts; Texas Hotel and Motel Association; Public Utility Commission; State Board of Insurance; State Property Tax Board, *Annual Report*, 1986.

because of its basis on net worth and the corporate form, it excludes many businesses from taxation. That implies that the businesses that *are* taxed are bearing more than their fair share of the franchise tax burden. *Other business forms—including proprietorships, partnerships, business trusts, professional associations and professional corporations—should be brought into the business tax system.*

Third, capital investment should be deemphasized over time as the sole basis of taxation. At a minimum, it should be combined with additional tax base elements which reflect the current level of activity and the taxpayer's ability to pay.

Fourth, based on a review of the possible alternatives to the franchise tax, the Committee recommends against two possible approaches at the present time: a broad-based gross receipts tax and a corporate or business profits tax. Evidence reviewed by the Committee strongly suggests that gross receipts do not represent an acceptable measure of ability to pay for use in a general business tax like the franchise tax. Adopting such a tax base would be harmful to the state's business climate in the Committee's judgement.

In the case of a tax based solely on profits, the arguments against its adoption in Texas at this time are more complex. One major issue is the current level of public opposition to a tax of this type. However, there are other objections as well. As the narrowest business tax base, profits have often proven to be extremely volatile and difficult to predict in other states. One of the Committee's conclusions in its review of the current system was that "problems arise [in tax systems] when swings in collections from important revenue sources are more volatile and less predictable than the economy . . . ." The adoption of a tax based solely on profits would not contribute to this problem's solution. Moreover, profits are not the only way of measuring the tax-

Other business forms—including proprietorships, partnerships, business trusts, professional associations and professional corporations—should be brought into the business tax system.

TABLE 2. Franchise Tax Base Erosion Problems

Cause	Issue	Status	Possible Solution
Sage Energy case *(Bullock v. Sage Energy Company)*	Is surplus measured by books and records or by a uniform standard for similar businesses?	Refunds now given for prior periods only.	S.B. 1170 (1987 Legislation) should have solved problem for future years.
Sun Oil case *[State v. Sun Oil Co. (Delaware)]*	Can contingent liabilities be deducted from surplus?	Refunds now given for prior periods only.	S.B. 1170 should have solved problem for future years.
Shell Oil case *(State of Texas, et.al. v. Shell Oil Company)*	Can an impairment reserve for non-producing leaseholds be deducted from surplus?	Refunds given and deleted from current tax.	This type of contra-asset account for amortization could be defined as taxable.
Sun Refining case *(State v. Sun Refining and Marketing, Inc.)*	Can preacquisition earnings of a subsidiary that are not distributed to the parent be deleted from surplus?	Refunds given and deleted from current tax.	Statute could be amended to define value of subsidiary to the parent; however, this would make consolidated filing virtually impossible.
Revised policy on calculation of taxable capital	Can negative surplus be used to reduce stated capital?	Refunds given and deleted from current tax.	Prohibit reduction of stated capital by negative surplus.
Capital Cable case	"Push-down accounting"—should amounts added to the books of an acquired company to reflect acquisition costs be included in surplus?	Case is still awaiting trial.	If the case is lost, amend law to allow appraisal capital (reflecting acquisition costs, in this case) to be added to surplus.

Source: Select Committee on Tax Equity.

Note: As of December 1988, losses of revenue from the franchise tax due to litigation, including both refunds and future taxes, are estimated by the Comptroller's office to be $340 million for the 1988-89 biennium and $1.06 billion for the 1990-91 biennium.

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The Committee believes that changes in the franchise tax should be set in motion now with the goal of complete revision of the tax over a three to five-year period.

paying capacity of business. Unprofitable firms also benefit from the various services of government and should also contribute to its support. The Committee believes a workable general business tax base for Texas today should be based partly on net worth, like the traditional franchise tax, and partly on some measure of current business activity in the state, of which profits and other factors are a part.

With specific regard to corporate profits as a future tax base for the state, the Committee believes a corporate income tax should only be considered when a personal income tax is considered. In a majority of states, these two taxes are linked to ensure equitable treatment of all types of income, and this policy would make sense for Texas.

The changes needed to meet these various policy goals should not be made abruptly but should proceed in a logical, orderly progression. In part, this is a technical necessity stemming from the time needed to make any major change in the tax system. Estimates by the Comptroller of Public Accounts suggest that a major restructuring of the franchise tax would require more than two years to fully implement. *The Committee believes that changes in the franchise tax should be set in motion now with the goal of complete revision of the tax over a three to five-year period. Any short-run changes in business tax policy should be tailored toward that end. The state should avoid temporary patches in the current tax which would prolong its use in its current form or which would reverse legal challenges fairly won by taxpayers.*

Finally, it should also be clearly recognized that any major changes in the structure of business taxation will inevitably produce shifts in tax burden among taxpayers, even if the change produces no increase in income for the state.

First Steps in Modifying the Tax. The Committee recommends that changes to the franchise tax in the upcoming legislative session focus primarily on moving toward the policy goals discussed above. We do not support changes in the current franchise tax law designed solely to "plug" problems created by recent litigation. Ultimately, this may prove to be a necessity because of state revenue and budget considerations, but it should be viewed and understood as a matter of expedience—as a preferred alternative to additional taxes—rather than as sound tax policy.

Consolidated Reporting. One important improvement that can be made in the short term is to require consolidated reporting of franchise taxes by parent and subsidiary firms. Consolidation offers the advantage of more accurately reflecting the economic reality of groups of affiliated corporations which are created and operated as a single economic unit and not as a group of independent entities. Consolidation is neutral with regard to the decision to organize as one business with several divisions or as a group of corporations with common ownership. Moreover, investments in subsidiary corporations would no longer be subject to double taxation as they are under the current tax. Finally, this approach would eliminate some of the inefficient reorganizations used to avoid the current franchise tax.

In changing to consolidated reporting, it will be necessary to specify the acceptable method or methods of consolidation. Among the choices available are: worldwide unitary, water's edge unitary, domestic incorporated (used for federal income tax), all corporations in the group doing business in Texas (nexus consolidation) and possibly others. *The Committee believes worldwide unitary should not be considered as an option.* This approach has met with serious taxpayer resistance in other states and promises to introduce new administrative problems if it were adopted in Texas. The water's edge approach is becoming more common and could be a reasonable choice. It might be preferable to allow the taxpayer an option and allow it to justify a particular method. However, consolidation should be required or the current use of restructuring for tax avoidance purposes will continue.

In the long-term, consolidation would simplify the franchise tax by making its administration more like general business taxes in other states. The change would result in an estimated revenue loss of approximately $30 million a year, but this change could be delayed until 1991 if revenue is a concern. Such a delay would give both state tax administrators and individual taxpayers an opportunity to adjust to the change.

Inclusion of New Taxpayers. One of the Committee's major goals is to include in the tax base certain noncorporate businesses which function in ways similar to corporations. The Committee believes that small businesses should *not* be involved, primarily for reasons of administrative efficiency, but we feel that larger businesses should not be excluded from general business taxation simply because they are not organized as corporations.

There are any number of approaches which could be used to identify the businesses to be included in the revised taxpayer base. *In general, the Committee believes that all businesses should be subject to the franchise tax with some exceptions. Therefore, it is recommended that all business organizations—corporate and noncorporate—be subject to the tax. This would include a minimum tax of $100 for small taxpayers. The Committee recommends that businesses with less than $50,000 in gross receipts be excluded from the tax to simplify administration and to avoid placing an undue burden on new or struggling small firms. The tax should also include provision so that corporations involved in partnerships are only taxed once on their partnership interest.*

Recognizing that these recommendations represent a significant shift from the current, narrowly defined tax policy, the Committee believes they should not be implemented until 1991 to allow state tax administrators the time needed to canvass all businesses likely to be involved and to notify them of the change in the law.

Single Factor Apportionment. Under the current franchise tax, the tax base is apportioned among Texas and the other states where a corporation does business using the percentage of Texas gross receipts as compared to total gross receipts of the taxpayer. At the taxpayer's request, additional factors such as property and payroll can be included in the calculation. Obviously, there is no incentive to use additional factors unless the result is a reduced tax liability. The type of businesses that profit from the use of additional factors tend to be foreign corporations with substantial sales into Texas but more property and payroll in other states. *The Committee recommends that the use of additional factors be eliminated.*

Inclusion of Long-Term Debt. A working group of the Committee considered inclusion of long-term debt in the franchise tax base, as was done prior to the early 1970s. The argument for adding debt is to make the tax system neutral in the treatment of firms based on whether they use debt or equity to finance their operations. After considerable discussion, the working group took no position on the issue. The evidence of the possible benefits and harms of this change was too unclear to justify a major change in tax policy in this area.

A Broad-Based Business Tax. It is important to recognize that over the long term, continued repairs to the current franchise tax will be counterproductive and could damage the state's attractiveness to business. The tax is too narrowly based, does not cover all legitimate business entities and will continue to be eroded by litigation and legitimate tax avoidance through corporate restructuring for tax purposes. Recent increases in the tax rate have almost guaranteed not only that this process will be ongoing but that it will, if anything, accelerate over time.

Given this unpromising scenario and its review of available general business tax options, the Committee concludes that the franchise tax needs substantial revision to provide a broader base and lower rate. The state should also add incentives for such important economic development goals as capital investment and job creation in Texas.

Ultimately, the Legislature will decide the correct form of general business taxation in Texas; however, based on the policy goals outlined earlier, the Committee has developed a proposal for significant long-term business tax reform. This proposal is detailed in the appendix at the end of this chapter.

Over the long term, continued repairs to the current franchise tax will be counterproductive and could damage the state's attractiveness to business.

The Utility Taxes

Gas Pipeline Taxes. There currently are two taxes levied specifically on businesses

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Severance taxes should not be increased in an effort to maintain their traditional prominence in the state tax system.

operating as intrastate gas pipelines in Texas. These are the Tex. Rev. Civ: Stat. Ann. art. 6060 tax on the gross income from operation as an intrastate gas pipeline and the portion of the gas, water and electric utilities tax levied on gas utilities based on the business they do in incorporated cities.

Objections to the two taxes as they apply to the gas industry center on the fact that they tax intrastate operations in a field that is very competitive on an interstate basis. Gas that is shipped by several intrastate pipelines, as often happens, is subject to a compounding of the tax. Also, nonutility brokers of natural gas sales can compete with utilities without paying either tax. There also is a differential in the gas, water and electric utilities tax rates among cities of different population that is a vestige of the distant past and serves no current purpose.

To remedy this problem, the Committee recommends a tax on the gross receipts from transportation or sales of natural gas in Texas to replace the two current taxes. It could be applied to the local transactions involving gas that will be or has been in interstate commerce, as well as transactions currently taxed. It could cover not only pipelines, but also brokers whether or not they qualified as utilities. This change would result in more evenhanded treatment of the industry and more equitable taxation of direct competitors.

The result for the tax system would be the imposition of two special taxes on the utility industries--one on gas utilities and pipelines and a second on water and electric utilities.

Utility Regulatory Fees. There currently are two small gross receipts taxes in the state tax system that generally duplicate other gross receipts taxes in the industries and receipts they cover. These are the public utility regulatory assessment and the gas utilities administration tax, the art. 6060 tax discussed above. They were originally passed to fund the agencies charged with regulating the particular industries to which they applied. Currently, the taxes are placed in the state general revenue fund and have no relationship to the agency funding. They duplicate the other taxes on these industries, with the exception of the telephone industry, which is now exempt from utility gross receipts taxes. *The Committee recommends these taxes be repealed and the rates of the major taxes on these industries (as discussed above) be adjusted to replace any revenue lost from this repeal.*

Severance Taxes

The Committee examined several possible options relating to the severance taxes but has elected to make no specific recommendations for policy changes in this area. *In general, the Committee believes that oil and natural gas severance taxes should not be increased in an effort to maintain their prominence in the state tax system.* The instability of the severance taxes has been a major cause of the state's fiscal problems, and they should not be allowed to return to the level of importance in the tax system that they achieved in the late 1970s and early 1980s.

The Committee also examined possible changes in the severance tax rate structure designed to improve the equity of the tax system and to maximize development and recovery of the state's petroleum resources. There was simply not enough available data to judge the possible long-term consequences of such programs. The issue should continue to receive serious attention, given the current conditions in this vital state industry. In addition, the state should be sensitive to providing the oil and gas industry, as well as other industries, more equitable treatment in the state tax structure in the future.

Finally, the Committee also considered and rejected as unwise any expansion of new severance taxes on such resources as lignite or timber.

Insurance Gross Premiums Tax

Taxes on the insurance industry in Texas have been embroiled in litigation in recent years, with hundreds of millions of dollars in taxes being paid under protest and subject to possible refunds to taxpayers. Foreign (out-of-state) and domestic insurance companies have been pitted against one another in battles before the courts and the Legislature. The resources expended have done nothing to help the insurance consumer, the state or the industry. It is thus clear something must be done to resolve the disputes so the industry may return to its primary business.

The primary—but by no means the only—dispute concerns the use of a tax rate that is graduated based on the percentage of investment of its reserves the individual insurance company makes in Texas. The majority of domestic companies achieve the lowest rate; most foreign companies pay higher rates. This has led to a call from the foreign companies for a flat rate tax and elimination of the investment incentive. Critics question whether the incentive has any influence on investment decisions in the first place, serving only as a competitive hurdle for out-of-state companies.

The Committee did not develop a recommended alternative for dealing with this problem. In fact, the available solutions are well-known. It is a case of the parties in the dispute finding common ground, and it appears to the Committee that negotiation is needed more than new proposals.

One option the Committee did examine which may have merit is the new insurance tax statute adopted in Florida. The new Florida law provides an incentive factor that may mean more to the state than the current factor based on investment. The tax is a flat rate tax, originally adopted at 2.25 percent but since reduced to 2.0 percent, with a credit allowed for a percentage of payroll in Florida up to a stated maximum. The original credit was ten percent up to a limit of 50 percent of the tax. This has been raised to a 15 percent credit up to 75 percent of the tax. Salary is defined not to include sales commissions, so that the incentive is to put administrative offices in the state. This could have a direct impact on job creation in the state, according to supporters of the approach. It could also resolve some of the disputes over the current taxes.

The Committee recommends that consideration be given to the Florida approach as one option for ending the stalemate over insurance taxation.

Appendix—Proposed Approach to Long-Term Reform of the Texas Business Franchise Tax

The Committee believes the state's general business tax should be based on both a firm's long-term investment in the state—its stake in the state and its services over the long haul—and its level of current activities in the state—a measure of its current ability to pay. Given these dual objectives, the revised tax should not be based solely on net worth or capital assets, as the current franchise tax is. That approach ignores the current level of a business' activity in the state and its ability to pay. It also should not be based on profits, since that approach ignores the taxpayer's long-term stake in Texas and the benefits many temporarily unprofitable firms enjoy from their location in the state. Finally, it should not be based on gross receipts, since that tax base does not represent an accurate reflection of either long-term investment in Texas or current activity.

The Committee recommends a revised franchise tax that retains its essential tie to net worth, but that incorporates a new element reflecting current business activities in the state. This current activities base would be implemented initially at a reduced level to avoid undesirably large increases in the tax bill of most taxpayers. It would be done no earlier than fiscal 1992 to allow the time state tax administrators need to prepare for the change.

Base. The Committee believes the tax should be computed using two separate base components: net worth and current business activities. The net worth component would be calculated much as it is under the current tax:

Taxable capital base =
Total assets - Total debts

The definition of total assets and total debts would follow the current franchise tax statute and administrative regulations, including changes recommended earlier in the report.

Figure 1 shows the base for determining the "current activities" base.

The actual tax due would be the combina-

The Committee recommends that the revised franchise tax retain its essential tie to net worth, but that a new element be introduced reflecting current business activities in the state.

tion of the tax due computed from the two bases or a minimum tax of $100, whichever is greater. Certain exclusions for smaller taxpayers outlined earlier would be allowed.

The business activities tax base has some of the characteristics of a value added tax but features a decreased emphasis on the role of compensation in the tax base, as discussed below. For most firms, the gross business activity base would be calculated from Form 1120, line 11 (U.S. Corporation Income Tax Return), although some modifications might be needed. Intercorporate receipts within consolidated groups would be deleted through consolidated reporting, as discussed earlier in the chapter. It might also be appropriate to delete some other types of dividend, interest and miscellaneous unearned income.

This approach would produce a broad, stable base that would not duplicate the net worth base's incidence. It would emphasize the current level of business activity and ability to pay. Its expected effect would be to broaden the franchise tax away from its current narrow emphasis on capital-intensive industries without producing the massive shifts in tax burden experienced in other business tax options reviewed by the Committee.

Compensation Deduction. A major factor in the current activities base as formulated here would be compensation to employees. This is one measure of the firm's current activity in the state. However, the Committee feels it is important not to overburden this element, thereby discouraging Texas firms whose receipts have an inherently large compensation element. The Committee recommends limiting the compensation portion of the current activities base by a compensation reduction, which would effectively eliminate half of all compensation from the tax base (e.g., the compensation reduction would equal 0.5 times total wages, salaries, commissions, benefits and other compensation paid). *Note: This deduction could be modified to significantly change the distribution of the tax.*

Capital Investment Deduction. One of the most important initiatives state government can undertake to promote the full recovery of the Texas economy is to encourage—or at least not discourage—capital investment in the state. Therefore, the Committee recommends a reduction in the business activities portion of the revised franchise tax base equal to the cost of capital assets placed in service in Texas in the current year. The assets would have to remain in service in Texas for at least two years or the deduction would be recaptured. A standard for the use of mobile capital assets, such as railroad rolling stock or aircraft, would have to be devised.

Job Creation Deduction. Another important consideration for the tax is its relationship to the creation of new jobs for Texas. This is an especially important consideration for a tax that has compensation as a major part of its tax base. A deduction would be created for the wages and other compensation for any new jobs created during the first year of the new job. A company would have to show a net increase in compensation paid and employment to qualify for the deduction.

Rate Structure. Tax rates would be set for each of the components of the tax base based on the revenue needs of the state. The goal of this Committee is to produce a tax that would be revenue neutral when compared with the current franchise tax base at a $5.25 per $1,000 rate and adjusted to exclude the effects of various anticipated

FIGURE 1. The "Current Activities Base"

Gross receipts + Other income - Cost of goods sold = Gross business activity base

	Gross business activity base
Less:	Compensation deduction Capital investment deduction Job creation deduction
Taxable current business activities base	

Source: Select Committee on Tax Equity.

refunds and litigation losses. This would equal approximately $780-800 million in annual collections based on Committee staff estimates.

This proposal will be submitted to the Comptroller for official analysis, but a rough estimate is that a tax rate of between 0.225 and 0.3 percent ($2.25 to 3.00 per $1,000 of taxable base) would be needed on the two bases to produce this level of revenue under the assumptions outlined above, depending in part on the deduction structure adopted.

Basic Design Considerations. Although it would be more complex than the current franchise tax, the new general business tax need not be an extraordinarily difficult tax with which to comply. Essentially, the Committee has developed the proposal based on information businesses routinely maintain for federal tax purposes or for compliance with taxes in other states.

Table 1 shows a model calculation for four sample firms using one variation of the tax. Figure 2 shows a simplified model form showing the basic computation of the tax as it is proposed.

TABLE 1. Tax Calculation For Sample Firms--Proposed Revised Franchise Tax (Millions of Dollars)

Tax Calculation	Vertically Integrated Petroleum Company	Small Accounting Firm	Merchandise Retailer	General Legal Services Firm
Net Worth Base				
1.Total assets	$17,762.492	$.092	$50.000	$3.525
2.Total debts	9,481.384	.045	29.800	1.823
3.Net assets (1-2)	8,281.108	.047	20.200	1.702
Business Activity Base				
4.Adjusted gross business activity base	5,418.536	.210	36.225	16.277
5.Total compensation	738.537	.060	11.025	4.738
6.Compensation deduction (5 X 0.5)	369.268	.030	5.513	2.369
7.Taxable value (4 - 6)	5,049.268	.180	30.713	13.908
Apportionment				
8.Receipts everywhere (Schedule B)	10,646.450	.210	105.000	15.981
9.Texas receipts (Schedule B)	2,630.738	.210	94.500	10.388
10.Percentage of business in Texas (9 / 8)	24.710%	100.000%	90.00%	65.00%
Calculation of Tax				
11.Taxable capital allocated to Texas (3 X 10)	2,046.262	.047	18.180	1.106
12.Taxable business activity in Texas (7 X 10)	1,247.674	.180	27.641	9.040
13.Capital investment deduction[1]	88.522	.003	6.465	0.131
14.Job creation deduction[2]	N/A	N/A	N/A	N/A
15.Taxable business activity [12-(13+14)]	1,159.152	.224	21.176	8.909
16.Tax rate applied to both bases	0.250%	0.250%	0.250%	0.250%
Total tax due [(11 + 15) X 16]	**$8.01 million**	**$560 (dollars)**	**$98,400 (dollars)**	**$25,000 (dollars)**
Tax due under current franchise tax ($5.25 rate)	**$10.7 million**	**$0 (if partnership) or $247 (if taxable now)**	**$95,400**	**$0 (if partnership) or $5,800 (if taxable now)**

Source: Select Committee on Tax Equity.

1. The capital investment deduction is estimated by taking half of annual purchases of personal property for the model firm and factoring it by the apportionment factor and adding half of the estimated annual purchases of real property in Texas.

2. Insufficient data is available to produce an estimate of this factor.

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FIGURE 2. Example of Franchise Tax Report--Page 1

TEXAS BUSINESS FRANCHISE TAX REPORT - CORPORATIONS ONLY FORM 000 19XX

Taxpayer Identification Number	Name
Charter Number	Address
FEIN	City, State, Zip Code

Computation of Tax

Net Worth Basis

1. Total Assets	1	
2. Total Debts	2	
3. Net Assets (Subtract line 3 from line 2)	3	
Business Activity Basis		
4. Gross Business Activity base (Federal Form 1120, line 11)	4	
5. Labor costs included in federal schedule A, line 3	5	
6. Adjusted Gross Business Activity base (Add lines 4 and 5)	6	
7. Wages, salaries, commissions, benefits and other compensation paid	7	
8. Compensation deduction (Divide line 7 by 2)	8	
9. Business Activity base (Subtract line 8 from line 6)	9	
Apportionment		
10. Percentage of Texas business (From line 15, Schedule B)	10	
Calculation of tax		
11. Net worth basis taxable value allocable to Texas (Multiply line 3 times line 10)	11	
12. Net worth basis tax due (Line 11 times tax rate, 0.25 percent)	12	
13. Business activity basis taxable value allocable to Texas (Multiply line 9 times line 10)	13	
14. Capital investment deduction (See Schedule C)	14	
15. Job creation deduction (See Schedule D)	15	
16. Total deductions (Add lines 14 and 15)	16	
17. Taxable value (Subtract line 16 from line 13)	17	
18. Business activity basis tax due (Multiply line 17 times tax rate, 0.25 percent)	18	
19. Total tax liability (add lines 12 and 18)	19	
20. Credits (Refunds, tax deposits, or estimated payments - attach schedule)	20	
21. Tax due (Subtract line 20 from line 19)	21	

A copy of the taxpayer's federal income tax return, Internal Revenue Service Form 1120 and all schedules included in that return, must accompany this return.

[Note: Different forms would be required for business organizations other than corporations.]

Instructions for completing this form:

Item 1 - Total Assets. Includes the total balance sheet assets of the corporation shown on the books and records of account maintained in accordance with generally accepted accepted accounting principles, except for those corporations with surplus less than $1 million, which may report on the basis used to report on the corporation's federal income tax return. Includes stated capital. See

Item 2 - Total Debts. Includes the balance sheet liabilities of the corporation less those items that are not debts within the meaning of Texas Tax Code §171.011, being contingent as to either amount or due date..

Item 3 - Net Assets. Under the newly revised calculation of taxable capital, negative surplus can reduce stated capital. Stated capital plus surplus is therefore equal to net assets.

Item 4 - Gross Business Activity base. Includes allreceipts from sales, provision of services and unearned income, less returns, cost of goods sold and allowances as provided by the Internal Revenue Code. From line 11 on Form 1120 of the federal Corporation Income Tax Return.

Item 5 - Labor costs included in federal Schedule A, line 3. Labor costs should be included in item 7, below.

Item 7 - Wages, salaries, commissions, benefits and other compensation paid. Includes all forms of compensation paid to employees, partners and principles, commissions to independent repsentatives, but not independent contractors performing services other than marketing. Includes wages, salaries, benefits, insurance, pension contributions, and employer paid taxes.

Item 14 - Capital Investment Deduction. A deduction is allowable for the value of capital assets placed in service in Texas during the tax year and remaining in service in Texas for not less than two years. Deductions may be taken during the year the asset is placed in service, but if removed from Texas or taken out of service, the deduction must be recaptured in such future year. Complete Schedule C to claim this deduction.

Item 15 - Job Creation Deduction. A deduction may be claimed for qualified jobs created in Texas. Complete Schedule D to claim this deduction.

Item 20 - Credits. Credits may be taken for adjustments to prior years returns, tax deposits, estimated payments or for refunds of tax paid in error. Attach explanation of the reason for the adjustment.

FIGURE 2. Example of Franchise Tax Report—Page 2

SCHEDULE B - APPORTIONMENT

Use this schedule for apportionment of tax base between Texas and other states. Use only the factors which you have received permission to use. If permission to use additional factors has not been given, use only receipts factor.

NOTE: PERMISSION MUST BE GRANTED BY THE STATE FOR THE TAXPAYER TO USE OPTIONAL ADDITIONAL FACTORS. REQUESTS MUST BE RECEIVED NO LATER THAN THE DUE DATE OF THE RETURN.

Receipts Factor		
1. Gross receipts from business everywhere	1	
2. Gross receipts from business in Texas	2	
3. Percentage of Texas receipts (Divide line 2 by line 1)	3	
Property Factor		
4. Assessed value of property everywhere	4	
5. Assessed value of property in Texas	5	
6. Percentage of Texas property (Divide line 5 by line 4)	6	
Payroll Factor		
7. Total payroll	7	
8. Payroll in Texas	8	
9. Percentage of Texas payroll (Divide line 8 by line 7)	9	
Other Factor (Explain ______________)		
10. Total	10	
11. Amount in Texas	11	
12. Percentage in Texas (Divide line 11 by line 10)	12	
Apportionment Calculation		
13. Number of factors used	13	
14. Total of percentages (Add lines 3, 6, 9 and 12, as applicable)	14	
15. Apportionment percentage (Divide line 14 by line 13)	15	

Enter result on line 15 on line 10, Form 000.

SCHEDULE C - CAPITAL INVESTMENT DEDUCTION

For additional information, see instructions for item 11, Form 000.

1. Cost of capital assets placed in service in Texas in 1988	1	
2. Cost of capital assets for which a deduction was taken in a previous year but removed from service before two years from the date placed in service	2	
3. Capital investment deduction (Subtract line 2 from line 1)	3	

Enter result on line 3 on line 14, Form 000.

SCHEDULE D - JOB CREATION DEDUCTION

For additional information, see instructions for item 11, Form 000.

1. Number of full time equivalent employees in Texas in 1988	1	
2. Number of full time equivalent employees in Texas in 1987	2	
3. Difference (subtract line 5 from line 4) (If less than 1, you do not qualify for deduction.)	3	
4. Total compensation paid (as defined in Form 000, line 7) in 1988 in Texas	4	
5. Total compensation paid (as defined in Form 000, line 7) in 1987 in Texas	5	
6. Difference (Subtract line 2 from line 1) (If less than $1, you do not qualify for deduction.)	6	
7. Compensation paid to employees in new jobs in Texas (See Instructions)	7	

Enter result on line 7 on line 15, Form 000.

Instructions for Schedule D

Items 1 and 2 - Full time equivalent employees is based on the number of workers who are working 40 or more hours per week, with part time employeescountedas fractional employeesbased on the percentage of 40 hours worked.

Items 4 and 5 - Compensation includes wages, salaries, commissions, benefits and other compensation paid but not payments to independent contractors other than commissioned salesmen.

Item 7 - Employers may deduct compensation paid for the first year of each new job created. The deduction should be taken in the year in which the compensation is actually paid. To qualify for the deduction, total compensation paid in Texas and total number of full time equivalent employees must have increased over the previous year. The deduction must be based on new positions created and filled, not on general salary increases or turnover of current employees.

CHAPTER SEVEN

THE PROPERTY TAX AND OTHER LOCAL TAXES

Property taxes have a long history in Texas, dating back to the formation of the Republic, and Texas local governments historically have relied on the property tax as their principle source of tax revenue. While state government's use of the tax has been eliminated, the property tax today remains the single most important revenue source for Texas local government today, representing about 35 percent of all local income with total collections of almost $9.7 billion in 1986, it is the largest single tax used by government at any level in Texas and totals only slightly less than *all* taxes collected by state government.

Texas local governments historically have relied on the property tax as their principle source of tax revenue.

Since the late 1970s, the property tax has undergone major reforms in Texas. Although these reforms have made significant improvements in the tax and its administration, there are several important issues which have not been wholly resolved. These include the taxation of business personal property, the further development of the tax appeals process, the development of a final policy for local use of property tax abatements for economic development, the consolidation of local collection efforts and several other issues. These issues were examined in detail by the Committee, and its findings and recommendations are summarized in this chapter.

The Committee also looked at various alternatives for local revenue diversification, and the chapter also includes a discussion of a proposed local fuels tax.

Treatment of Business Inventories

Under current Texas law, all business personalty—including furniture, fixtures, inventories and goods in transit—is subject to the property tax. The taxation of any type of personal property is considered a major problem for property tax administrators because such property is often mobile and difficult to find, and even when it can be located, it is difficult to appraise. In the case of business personalty, critics argue that it also bears no identifiable relationship to either taxpaying ability or to the benefits the business might receive from government.

As a practical matter, the bulk of individual personal property has been removed from the tax rolls in Texas and nationwide. Many states have also removed the tax on business personalty at some level—generally either the tax on inventories or goods-in-transit. Table 1 shows current policies in this area nationally. At present, six states have no tax on business personal property, while 30 states have a full or partial exemption of business inventories. Four states allow a local option exemption. Texas is one of only ten states which provide no business personalty exemption at all. It is the *only* state that provides neither an inventory exemption nor a goods-in-transit exemption in some form. Research presented to the Committee suggests that an increasing number of states have moved to extend their exemptions in this area as an economic development strategy.

The Committee considered a number of possible approaches to a workable policy in this area. There are essentially three major options for structuring the exemption itself, with any number of possible variations. First, all business personalty could be exempted. This policy alternative is not recommended. It would be far too sweeping and too costly for Texas local governments. Second, some or all business inventories could be exempted. Finally, the exemption could be limited to goods-in-transit—that is, to items held temporarily before shipment.

Based on its review of the available options, the Committee recommends that Texas implement a full exemption of business inventories. This exemption should be phased-in over a six-year period to mitigate the fiscal effect on local governments.

The Committee also looked at methods of offsetting the fiscal effects on local governments. First, it is recommending a local fuels tax (see the discussion later in this chapter), which will partly offset the loss for cities and counties. The Committee recommends that the Legislature go further, choosing between one of two options:

(1) Make the inventory tax exemption subject to local option. This is the least desirable approach in the

TABLE 1. Taxation of Business Personal Property*

State	Personal Property Not Taxed	Business Inventory: Inventory Not Taxed	Business Inventory: Inventory Partially Exempt or Local Option	Freeport Exemption: Freeport Exemption Available	Freeport Exemption: Goods Must Be From Out of State	Freeport Exemption: Goods Must Be Going Out of State	Freeport Exemption: Goods Must Remain in Original Pkg.
Alabama		X		X(1)		X	
Alaska			Local Option (2)				
Arizona		X		X	X	X	
Arkansas				X		X	
California		X					
Colorado		X		X		X	
Connecticut		X		X	(3)		X
Delaware	X						
Florida		X		X	X	X	
Georgia			Local Option	X(4)	X	X	
Hawaii	X						
Idaho		X		X	(5)	X	
Illinois	X						
Indiana				X(6)		X	X
Iowa			Partially Exempt	X	X	X	
Kansas		(7)		X		X	
Kentucky				X(8)	(3)		X
Louisiana				X	X	X	
Maine		X		X		X	
Maryland		X(9)	Local Option				
Massachusetts		X(10)		X	X		X
Michigan		X		X(11)		X	
Minnesota		X					
Mississippi		X(12)		X		X	
Missouri		X		X	X	X	
Montana		X		X	X	X	
Nebraska		X		X	(13)	X	
Nevada		X		X	X	X	
New Hampshire		X					
New Jersey		X		X			
New Mexico		X(14)		X	X	X	
New York	X						
North Carolina				X		(15)	X
North Dakota		X					
Ohio				X	X	X	
Oklahoma				X	X	X	
Oregon		X		X	X	X	
Pennsylvania	X						
Rhode Island		(16)					
South Carolina		X		X	X		
South Dakota	X(17)			X(18)		X	
Tennessee		X		X	X	X	
Texas				(19)			
Utah		X		X		X	
Vermont			Local Option(20)				
Virginia		X		X(21)		X	
Washington		X		X	X		
West Virginia				X(22)			
Wisconsin		X					
Wyoming		X		X		X	
Totals	6	29	1-Partially Exempt 4-Local Option	35	16	27	5
					13-Goods Must Come From AND Go Out of State		

Source: Steven D. Gold, "How the Taxation of Business Property Varies Among the States," *Assessment Digest*, January 1987; Commerce Clearing House, *State Tax Guide*.

* 49 states provide some form of tax relief for business personal property; Texas is the only state which does not.

Notes:
(1) Valid for not more than 36 months following consignment or storage of the property.
(2) Inventory is subject to state property taxes, but local option exemption is authorized.
(3) Only the property of residents must be destined for out of state shipment.
(4) Exemption applies to property imported into the U.S. by waterborne commerce through any Georgia port.
(5) Property of a nonresident must be stored in the original package and be brought in from out of state.
(6) Phase-in for certain property until 1989.
(7) Vehicles in dealers' inventories are exempt.
(8) Subject to a tax of 0.1 cents on each $100 of fair cash value in lieu of all other taxes.
(9) An income tax credit is allowed for personal taxes paid.
(10) Manufacturing corporations are exempt from personal property tax. Businesses operating as merchants are exempt from tax on most types of personalty except business machinery.
(11) Alcoholic beverages excepted.
(12) No tax applies to manufacturers' products if they will be shipped or sold to other than the final consumer and not at retail.
(13) Warehouse must be licensed and regulated by the state.
(14) Inventory is exempt with exception of certain centrally assessed taxpayers.
(15) Property not destined for out of state must have been shipped in from outside the state.
(16) Only manufacturers' inventories are exempt; goods offered for retail sale are taxable.
(17) Personal property that is not centrally assessed is exempt.
(18) Must be shipped to final destination within 12 months of assessment date.
(19) Texas' freeport exemption was ruled unconstitutional by the Dallas Court of Appeals in *Dallas County Appraisal District, et al. v. L.D. Brinkman & Company (Texas), Inc.* on October 31, 1985.
(20) Municipalities may exempt inventories and tax business machinery and equipment instead.
(21) Items must be stored in a marine or airport terminal.
(22) Phased-in over five consecutive assessment years beginning July 1, 1987.

Committee's view because it will create a patchwork of local policies statewide. However, it would provide local decisionmakers with some flexibility. In the event this approach was adopted, consideration should be given to eliminating the phase-out provision.

(2) Provide for local sharing of the revised franchise tax once it is in place (in addition to the proposed fuels tax discussed later in this chapter).

Property Tax Classification

Some states treat different types of property differently by law, either in their assessment practices or in the tax rates applied to the property. Thus, for example, there may be different tax rates applied to industrial property, commercial property and residential property. There has been some discussion of the idea of shifting the Texas property tax to a classified system, where, for example, business personal property would be taxed at a different rate. *The Committee feels that any classification system should be avoided.* Major strides have been made in improving Texas property tax administration and making the tax more equitable. These gains could be seriously undermined by the adoption of a system of property tax classification.

Property Tax Abatements

Property tax abatements are an economic development incentive used in 29 states to encourage business activity in specific areas. Policies vary widely among the states.

Abatements have been used by Texas local governments for a number of years under a statute designed to encourage the redevelopment of blighted areas. In 1987, the Texas tax abatement law was amended to allow abatements for broader economic development purposes. Cities, counties and school districts may abate the new value of real property for a period not to exceed 15 years. Abatements may not be granted by local governments until they have adopted general guidelines governing the abatements they will grant. Once enacted, these guidelines are in force for two years.

Length of Abatements. Research presented to the Committee suggests that among the states offering abatements, most limit the abatement period to five or ten years. This limitation is designed to ensure that the abated property ultimately does find its way onto the tax roles before becoming obsolete. Only five states, including Texas, have maximum abatement periods longer than ten years.

The Committee recommends that the maximum abatement period allowed in Texas be reduced from 15 years to ten years. This will bring Texas in line with a majority of other abatement states and will ensure that the abated property eventually becomes part of the local property tax base.

The Committee recommends that the maximum abatement period allowed in Texas be reduced from 15 years to ten years.

Abatements for Modernization. Tax abatement is most often thought of in the context of business and industrial relocation; however, major modernization or expansion of existing businesses can also contribute to the development of a local economy. When tax abatement is offered only to attract new firms, comparable firms already located in the taxing jurisdiction are, in effect, treated unfairly.

The Committee believes that as a general policy where tax abatement is offered to new firms, it should also be available for major modernization and expansion of existing businesses as well.

State-Level Involvement. Currently, there is no central reporting of abatement agreements. The State Property Tax Board maintains a record of values exempted by local school districts as part of its responsibility in determining property values for state aid purposes. The State Property Tax Board also maintains information on tax abatements in other taxing jurisdictions; however, this information is incomplete, since local governments are not required to report to the Board.

As a means of better coordinating abatement programs statewide, the Committee recommends creating a central registry for tax abatement agreements. The Committee believes this registry should be maintained by the Department of Commerce as part of its responsibility to oversee state economic development efforts. It should be emphasized that the purpose of this registry would not be to serve as a method of limiting the right of local governments to employ abatements under current law. In-

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A major goal of tax abatements is to bolster local governments in times of economic distress.

stead, it would be a way of providing a more comprehensive understanding of what abatements are being granted and where they are located statewide.

The Committee also recommends other action by state government in this area. Since state law has been amended to allow tax abatement for economic development purposes, many more local governments have become interested in offering them. There currently is an informal sharing of information among state agencies and local governments regarding the development of guidelines and the process of negotiating with abatement applicants. In some parts of the state, a great deal of expertise is available. However, in others, there has been only limited experience with abatements, and some governments—particularly smaller ones—may not have access to any form of guidance or assistance when considering adopting an abatement policy. *To deal with this problem, the Committee recommends that the state provide technical assistance regarding abatements to local governments upon request.* Again, an appropriate agency to implement this recommendation would be the Department of Commerce.

Sunset Provision. Finally, the Committee notes that a major goal of tax abatements is to bolster local economies in times of economic distress. Abatement programs should be used for this purpose and should not be allowed to degenerate into tax giveaways when economic conditions improve. *Therefore, the Committee believes that the abatement law should be made part of the state's regular sunset review process and should be subject to periodic review as to its effectiveness and whether it should be continued.*

Other Administrative Actions. Three other largely administrative issues related to tax abatements have also been raised before the Committee and appear to merit action by the state. One of these deals with the legal obligations arising from the adoption of abatement guidelines by local government. Another deals with the written notifications required when local governments enter into abatement agreements. The final issue relates to the protection of proprietary business information incorporated in abatement agreements.

Under current law, governments planning to enter into abatement agreements must adopt general guidelines governing the abatements they will grant. These guidelines are intended to ensure consistent policy within the taxing jurisdiction and are in effect for two years after adoption.

Some local governments have raised concerns about applicants for abatements interpreting these agreements to mean that if they meet the standards in the guidelines, the abatement legally becomes a property right and must be granted. This clearly is not the intent of the law or of local policy, and the Committee believes that local governing bodies should have the sole discretion to grant abatements. *The current abatement law should be amended to make it clear that the adoption of guidelines does not grant property, contract or other legal rights to applicants and that abatements are granted only by the decision of the local government involved.*

Prior to the 1987 changes in the abatement laws, requirements for local governments to grant abatements in certain cases were much more restrictive. If a city or county decided to grant an abatement, other affected taxing jurisdictions had a choice of either offering the abatement on the same terms or suffering a penalty—the added value could not be taxed by the jurisdiction for twice as long as the abatement was in effect. To avoid local jurisdictions becoming subject to this penalty inadvertently because of miscommunication, legislation was passed in 1987 requiring that a written notice of a pending abatement agreement be delivered to all affected taxing jurisdictions at least seven days prior to the agreement taking effect.

In the same legislative session, legislation was adopted which significantly changed the overall tax abatement law, including the penalty provision. Local governments now have a choice, by law, as to whether they will enter into an abatement agreement. If they choose not to abate, no penalty results. This change effectively eliminates the need for the seven-day written notice, except as a method of communication and cooperation. Local officials are concerned that the notice requirement could invalidate otherwise legal abatement agreements if it is overlooked or is distributed less than seven days before the agreement was to take effect. *The Committee supports the concept of communication among local jurisdictions in this area but recommends that the seven-day notice requirement be repealed. However, specific provision should be made in the law for public notice of pending abatement agreements to ensure the opportunity for taxpayer input as part of the abatement process.*

A final administrative change concerns the applicability of the Texas Open Records Act to material submitted by businesses seeking tax abatements. As part of most current abatement application processes, businesses are often required to submit detailed information regarding various technical aspects of the proposed development. In some cases, proprietary information may be involved, which local governments may be required to make public under the Open Records law. *While it remains sensitive to the public's right to access to all appropriate information about an abatement proposal, the Committee favors a temporary exception to the Open Records requirement to protect this type of highly technical proprietary information in abatement applications. The exception should apply for only a limited period so that all information related to the abatement request is eventually part of the public record. The information would be available to local government officials.*

This exception clearly should only apply to technical details about the specific processes, equipment and so on to be part of the development to prevent firms from having to damage themselves competitively to gain an abatement. It should not extend broadly to cover all detailed information about the property to be abated.

Circuitbreaker Tax Relief

Tax "circuitbreakers" are mechanisms which provide property tax relief to specific groups of taxpayers, normally based on income or other measures of need. For example, instead of providing an across-the-board homestead exemption for all homeowners, a circuitbreaker could provide exemptions based on the income of the taxpayer. Most circuitbreaker programs in other states are tied to a state personal income tax. Of the 31 states with circuitbreaker programs, only two—Nevada and South Dakota—do not have personal income taxes.

The Committee has reviewed the circuitbreaker concept and concludes that it could not be effectively implemented without a personal income tax. For this reason, the Committee does not recommend any circuitbreaker program or other additional local tax relief programs. It also does not recommend any changes in relief measures already in effect.

Tax Rate Limitations

Recently, the question of whether counties are subject to the tax rollback provisions found in the Property Tax Code has come before the courts. Under the rollback provision, a taxing jurisdiction must determine each year the tax rate which, based on new appraisal figures, will produce the same amount of revenue that was generated the previous year from the previous appraisal value and rate. The rollback provision is triggered when the governing body of a local taxing unit adopts a tax rate that is more than eight percent above that rate required to raise the same amount of tax revenue that was raised in the prior year. In such cases, the voters of the taxing unit may petition for an election to limit the increase to no more than eight percent.

Two appeals courts and the Attorney General have offered opinions on whether this rollback provision as it applies to counties is in conflict with the Texas Constitution. For example, Article VIII, section 9 allows county commissioners courts to "levy *whatever tax rate may be needed* for the four (4) constitutional purposes . . ." (emphasis added).

Attorney General Opinion No. JM-792 (September 22, 1987) held that counties are not subject to the rollback provisions because of the constitutional provisions allowing action by the counties. This opinion led to litigation. In the case of *Vinson v. Burgess*, the Eastland Court of Appeals held that county rollback elections *were not* legal. In *Winborne v. Commissioners' Court of*

Recently, the question of whether counties are subject to the tax rollback provisions found in the Property Tax Code has come before the courts.

Taxpayers should have the constitutional right to appeal and limit the effective tax rates of all local taxing jurisdictions under certain circumstances.

Ellis County, the Waco Court of Appeals held the rollback elections *were* legal.

Regardless of the eventual outcome of this conflicting litigation, the Committee believes that taxpayers should have the constitutional right to appeal and limit the effective tax rates of all local taxing units under certain circumstances, and that the state intended such a limitation to apply to all units of local governments, including counties. *Therefore, the Committee recommends that counties clearly be made subject to the rollback provisions found in Section 26.07 of the Property Tax Code, and that the Constitution be amended to ensure that counties are included, regardless of how the current court actions are resolved.*

Consolidation of Property Tax Collections

Texas property tax law underwent significant reform in 1979. Among the changes made was the consolidation of property appraisals into countywide central appraisal districts. Prior to that time, taxpayers often received several different valuations on their property from various taxing units.

During debate on the 1979 reforms, consolidation of property tax collections was also discussed but was not adopted. Under current law, taxing jurisdictions are authorized, but are not required, to contract with other jurisdictions or private firms to collect their property taxes.

Based on data from the State Property Tax Board, there are 3,234 local taxing units in the state (includes some overlap where a jurisdiction is served by more than one appraisal district). Of these, 2,045 are involved in some sort of collection consolidation arrangement. The collecting agencies break down as follows:

(1) central appraisal districts collect for 776 jurisdictions;
(2) county offices collect for 813 jurisdictions; and
(3) 456 jurisdictions are served by private firms, school districts or cities.

Although many taxing jurisdictions have entered into some form of tax collection agreement, many Texas taxpayers continue to receive multiple property tax bills on the same property from various overlapping taxing jurisdictions. The Committee believes that significant economies could be achieved by complete consolidation of the collection function. However, we are also cognizant of the need to work toward complete consolidation in a slow and orderly process. *To this end, the Committee recommends that central collection of property taxes be phased-in over a period of five years. The choice of tax collector within each district should be determined locally by all of the taxing units involved. While it should promote consolidation as an efficiency move, the state should not specify which agency should be responsible for collection locally.*

Property Tax Appeals

Under current law, if taxpayers disagree with the assessment placed on their property by the central appraisal district, they may appeal the appraisal to the local appraisal review board. If they are still dissatisfied after a decision by the local review board, the next step is to file a lawsuit in district court. Particularly in the case of small claims, the expense of filing a lawsuit may discourage some taxpayers from further action and effectively deprive them of an avenue of appeal.

Twenty-six states provide for some form of administrative appeal beyond the local level. In Texas, a state level appeals commission has been considered by the Legislature a number of times, but has never passed. *The Committee recommends that a state level appeals commission be established to review property appraisal appeals from the local appraisal review boards. Following past proposals in this area, the appeals board should conduct its work on a regional basis to insure that all taxpayers have access to the process without the necessity of traveling long distances.*

All taxpayers should have access to this appeals commission regardless of the amount of the appraisal in dispute. A filing fee should be assessed to offset some of the costs involved. Subsequent appeals to the courts from this process should be made under the substantial evidence rule, meaning that the evidence presented to the courts would be the material presented in the administrative appeals process. The Committee does not believe that such appeals should be heard de novo by the courts.

Uniformity of Appraisal Rolls

Under current law, chief appraisers are required to certify their district's appraisal roll to the State Property Tax Board (SPTB) each year. In October 1987, the agency proposed rules to require submission of the roll in a specified format. Currently, the information is submitted in a variety of summary formats. In some cases, SPTB field personnel are copying appraisal roll information by hand, which may contribute to mistakes in reporting and is needlessly inefficient.

As a result of discussions on these proposed rules, a committee was appointed by the Board to examine the advantages and disadvantages of the proposal. A pilot project is in progress to further study the effects of this proposal on appraisal districts and the advantages to be gained from uniform and complete reporting.

After having reviewed the evidence regarding this possible change, the Committee feels that more uniform reporting would not only assist the Property Tax Board in carrying out its responsibilities, but it would also greatly improve the quality of information on local property tax practices. *Therefore, the Committee recommends that the State Property Tax Board be given specific statutory authority to proceed with the adoption of the proposed rules requiring uniformity in the reporting of appraisal information to the Board.*

Disclosure of Sales Information

Sales information is considered essential in the appraisal process for property tax purposes. A lack of such information arguably can result in less accurate appraised values and higher costs associated with obtaining market information. Mandatory disclosure of sales information is common in other states—40 of the 50 states currently have some form of mandatory disclosure law. Most states adopted these disclosure laws in the late 1960s to continue sales disclosure information formerly obtained under the federal documentary stamp tax law, which was repealed in 1968. In Texas, this was not done, and as a result, information can only be obtained when voluntarily disclosed by the property owner. Proponents of mandatory disclosure argue that the current process leads to limited and inconsistent information.

In its review of the State Property Tax Board, the Sunset Advisory Commission considered a full disclosure requirement for the sale of real property. Table 2 summarizes the elements for a mandatory disclosure program recommended by the Commission staff. This proposal was not finally acted on by the Commission, and in fact, the Commission made no official recommendations in this area. Among the concerns raised in discussions of mandatory sales disclosure laws are paperwork requirements, validity of sales evidence and privacy rights of individuals involved in the disclosure. The Committee on State and Local Taxes of the American Bar Association has developed model legislation that addresses these concerns.

The Committee recommends that a mandatory sales disclosure reporting system be adopted by the Legislature and administered by the State Property Tax Board. This process could follow the elements outlined in the Sunset Commission report or any one of several workable approaches used in other states. The availability of this information would help to ensure that property appraisals are as close to market value as possible and consequently improve the fairness and equity of the local property tax system.

Mandatory disclosure of sales information is common in other states--40 of the 50 states currently have some form of mandatory disclosure law.

Changes in the Property Tax Base

The Committee considered the current property tax exemptions and the issue of whether some of these exemptions should be expanded or deleted. *Other than the taxation of business inventories discussed earlier, the Committee makes no recommendations for changes in the current exemptions under the property tax.*

TABLE 2. Pocess for Disclosure of Information on the Sale of Real Property

(1) The purchasers of real property would be required to file information about the transaction, including the selling price.

- Specific types of information required would be set in statute, would relate strictly to appraisal and would not cover other financial aspects of the buyer or seller.
- Disclosure form would be developed by the State Property Tax Board (SPTB) and would be limited to one page.
- Actual form and specific information required would be adopted through rule-making procedures which would provide for public comment.
- SPTB and local appraisal districts would be prohibited from requiring additional information concerning the sale.

(2) The disclosure form would be filed with the county clerk before the deed could be recorded.

- Disclosure form would not be attached to the deed nor would it become a part of the county clerk's records.
- Only one form would be required for each sale, no matter how many parcels were involved.
- An authorized closer would be authorized to charge a fee to recover the cost of filing the form.

(3) The county clerk would forward the form to the appraisal district.

- Appraisal district would reimburse the county clerk for any cost associated with transporting the forms to the district.

(4) The appraisal district would add appraisal roll information to the form.

- Information would be limited to data routinely developed by the district for its use, such as:
  - identification of the property on the appraisal roll;
  - assessment of whether the sale is an arm's length transaction; and
  - determination of the actual market value of the property if the sale is used to determine that value.

(5) The appraisal district would send one copy of the form to the State Property Tax Board and retain one copy for district use.

- Forms at the SPTB and appraisal district would be destroyed five years after filing.

(7) The information would be confidential except that certain information would be available to parties in formal appeals.

- Disclosure of the information would carry the same penalty that is established under the Open Records Act for disclosing closed records. Such offense is classified as official misconduct and is punishable as a misdemeanor.
- Information made available to a taxpayer appealing an appraisal to the district would be limited to the information used directly in the current year's appraisal.
- Information on sales within a school district would be available to a school district which files a formal appeal of the SPTB value study.
  - Information would be limited to sales in the categories of property appealed for the year of the finding under appeal.
  - Confidentiality provisions would extend to the school district.

(8) The statute would indicate that it is the intent of the Legislature that appraisal roll values be adjusted not only up, but also down, when sales data show that such adjustment appropriately reflects the property's full market value.

Source: Texas Sunset Advisory Commission, modified proposal of Sunset staff, July 24, 1983.

Local Fuels Tax

Texas local governments historically have relied heavily on the property tax as their principle source of tax revenue. The introduction of a local sales tax for cities in 1968 was the first major departure from the previous pattern. Since that time, the sales tax's use has largely been expanded to allow transit authorities and some counties to adopt it. This, along with some minor occupation taxes, has been the extent of local tax diversification in Texas. *A clear policy goal for Texas should be to develop additional revenue alternatives for its local governments so that they can deal with the growing demands placed on them without overreliance on the property tax.*

In numerous other states, local governments have augmented their tax bases through the use of local excise taxes on such items as alcoholic beverages, tobacco products and motor fuel. These may be administered by local governments or piggybacked onto a similar state tax.

The Committee believes that the motor fuel tax offers an important potential source of future revenue for Texas local governments. A large number of our cities and counties face growing problems developing and maintaining their street and road systems, and these systems do not benefit from state highway program dollars for the most part. There also is no comprehensive state assistance program to help meet local transit needs.

In a total of 14 states, local governments are authorized to tax motor fuels through either a cents-per-gallon motor fuels tax or a sales tax. A possible local fuels tax was considered by the Legislature in 1985 but was not adopted.

The Committee recommends that the state add one cent to the rate of the existing motor fuel taxes and that the proceeds be specifically dedicated to the local level for use by cities and counties in acquiring rights-of-way for roadways and for construction, maintenance and policing of such roadways. These are uses which would seem to fit the requirements for use of the motor fuel taxes in Article VIII, sec. 7a of the Texas Constitution.

To avoid constitutional problems, the Committee recommends that one quarter of the income from the tax increase be dedicated to public education, as is done with income from the current state motor fuel taxes. This would mean that approximately $75 million a year would be available to local governments for roadway use through this tax. The state should also examine closely the question of whether this use of the fuels tax constitutes a legitimate state purpose. If not, a constitutional amendment would be necessary to authorize this allocation.

A final issue relates to the allocation of tax revenue to cities and counties. Because of the way fuels taxes are collected—from fuel distributors—it would be highly cumbersome to devise an allocation based on the point of sale, as is done with the local sales tax. *Instead, the Committee recommends that the local fuels tax be allocated to local governments based on a formula which could be composed of one or more of the following factors:*

(1) the population of the jurisdiction relative to the population of all affected jurisdictions;
(2) the area in square miles of the jurisdiction relative to the area of all affected jurisdictions; and/or
(3) the number of miles of streets and roads in the jurisdiction relative to the miles of road in all affected jurisdictions.

In the past, the state has used factors similar to these to allocate state lateral road funds to counties.

The Committee strongly recommends that the local fuels tax be distributed to jurisdictions with primary road maintenance responsibility in an area. That is, funds should flow to cities for roadways within their boundaries and to counties for areas outside of cities.

A clear policy goal for Texas should be to develop additional revenue alternatives for its local governments so that they can deal with the growing demands placed on them without overreliance on the property tax.

THE PERSONAL INCOME TAX

The personal income tax represents a powerful source of revenue for state and local government in many states. Nationwide, forty-three states and over 3,500 local governments employ the tax. It accounts for almost a third of all state tax revenue nationally, making it one of the most important sources of state revenues.

The personal income tax represents a huge potential source of revenue for the State of Texas.

The personal income tax also represents a huge potential source of revenue for the State of Texas. Estimates prepared for the Select Committee indicate the tax could produce $5-6 billion a year at a three percent rate, and at slightly higher rates, it could produce more revenue annually than the sales tax.

To date, the state has chosen not to tap this enormous potential. *It is the conclusion of the Committee that the state is not ready to do so now.* This is true for several reasons. First, there is no current fiscal crisis which would merit the sort of dramatic shift in tax policy that the adoption of an income tax would signify. Testimony before the Committee also indicates that there is no consensus among Texans on this issue. This is true not only of the average citizen but also of the state's business and government leaders. The history of the Texas tax system—and indeed, the history of most tax systems—illustrates time and again that no change of this magnitude can be achieved successfully without crisis or consensus.

In more than one way, the state is fortunate that such a crisis is not at hand. Material and testimony presented to the Committee show that it would take state tax administrators more than two and a half years to set up a program and begin collecting a personal income tax. If, for example, the tax were enacted in June 1989, the Comptroller estimates that no revenue would flow into the state treasury from the tax until January 1992. It would require another full year—until January 1993—to make the tax fully operational. The Committee finds the implications of this analysis of great significance. *Since the implementation period is longer than one of the state's two-year budget periods, the tax could not now be used to meet a current fiscal emergency.*

While the Committee does not advocate the adoption of an income tax at this time, it does believe the tax should be viewed as a viable tax alternative for the state in the future. This is particularly true in light of the Committee's conclusion that the "rates for many of state and local governments' major taxes are approaching their practical limits." It may never be necessary to enact a personal income tax in Texas. On the other hand, limits on the use of existing taxes may eventually compel the state to look to new sources like the income tax. In this context, the Committee believes that rejecting the tax out of hand without systematic consideration would be short-sighted and would rob the state of the flexibility it may need to deal with future fiscal circumstances in a timely and equitable fashion.

To this end, this chapter of the report lays out the results of the Committee's in-depth deliberations on this tax option. These are the characteristics we believe a Texas personal income tax should possess if it were enacted.

Pros and Cons of a Texas Personal Income Tax

In its examination of the tax, the Committee reviewed a considerable amount of information and testimony about the income tax as a revenue option. From this material, a number of recurring themes, both for and against the tax, can be found. Briefly summarized, these are the arguments *against* the tax, including several factors that have already been discussed:

(1) There is only limited public support for the tax, and in some areas, there is strong public opposition.

(2) There is no immediate revenue need that would validate adoption of a major new tax.

(3) The administrative burden and costs associated with the tax outweigh any benefits that could be gained from adding it to the tax mix—especially when there is no pressing need.

(4) Adding the tax could diminish the state's economic attractiveness.

It is our conclusion that the best state income tax would be simple and broad-based.

(5) Adding the tax could promote large increases in government spending.

Major arguments *in favor* of adopting a Texas personal income tax include the following:

(1) The current tax system lacks diversification and balance. Adding the tax—particularly if traded off against the sales tax—property tax or both, would improve the tax system.

(2) The tax could be brought into the tax system and used as a way of dealing with a number of troublesome areas of state spending policy, including, for example, education and prisons.

(3) The tax could be used by state government as a means of providing greater revenue flexibility at the local level—either through direct sharing of the tax or through reductions in other state taxes (e.g., sales and fuels taxes) that would make room for greater local use.

(4) The tax could be used to improve the overall equity of the state and local tax system. It could be designed to make the tax system more nearly reflect the ability to pay of individual citizens.

(5) It would provide a large, relatively stable source of revenue that would generally grow with the state economy.

General Policy Considerations

Based on the information presented to the Committee, it is our conclusion that the best state income tax would be simple and broad-based. It would be levied at as the lowest rate possible and would be indexed for inflation to prevent "bracket creep." Table 1 shows the key features of personal income taxes in other states. The following discussion summarizes the characteristics the Committee believes should be part of a sound income tax policy.

Base. *The Committee believes the tax should be based on federal Adjusted Gross Income (AGI).* All but six of the states with broad-based personal income taxes tie their taxes to the federal system at some point, and this approach makes the most sense from the standpoint of creating a tax that is both familiar to taxpayers and relatively simple to administer. AGI is the most common point of linkage to the federal system, with 27 states using it as their base.

AGI includes most normal sources of income, including interest and dividend income. It permits a few deductions, including certain business expenses, without imposing a large array of important federal tax preferences on state tax policy. *The Committee recommends against a separate, special tax on interest, dividends or capital gains.*

The Committee also recommends that Texas should follow the example of most current income tax states by allowing a credit for income tax paid to other states by Texans and by taxing the income of nonresidents earned in Texas.

Exemptions, Deductions and Credits. *The Committee favors personal exemptions for taxpayers and dependents in line with federal tax law. The Committee also favors granting a standard deduction in line with the federal standard deduction. To maintain simplicity and the broadest possible base, the Committee does not recommend allowing itemized deductions or other exemptions, adjustments or tax credits.* At a low tax rate, such preferences would serve little, if any, purpose.

Rate Structure. The rate structure most often used in other states is graduated, with nominal rates rising progressively with income. However, since federal tax reform, there has been a clear trend toward greater compression of rate structures or to flat rate taxes, and most of the relatively new income tax states have opted for flat or severely compressed tax rate structures. At present, five states have flat rates, while the remainder have at least two rates.

Based on its review of the evidence, the Committee finds a persuasive case for a flat rate structure, should Texas decide to adopt the tax. This approach would be less complex and less vulnerable to base erosion. Moreover, a flat rate would be less prone to complex manipulations that could undermine the tax's workability or its economic stability. Finally, a flat rate is most nearly in keeping with the Committee's goal, as set out in its conclusions about the current tax system, that "the tax system should not discourage savings and investment. It should not discourage Texans from 'doing well' economically."

It is important to underscore that the personal exemptions and standard deductions built into the tax would provide basic protection for Texans in the lowest income levels. For example, with the personal exemption and standard deduction that will be in effect in federal tax law in 1989, a family of four with an income of under $13,000 would pay no tax. The overall effect of these provisions would be to make the impact of the tax mildly progressive for all income levels without the use of multiple rates.

Although the Committee believes a flat rate is the best approach, it has no recommendation on exactly what that rate should be. That is a decision which logically would be dictated by the circumstances under which the tax was adopted. Based on an analysis prepared by the Select Committee staff, the tax described in this chapter would produce about $6 billion annually at a three percent rate in the third year after adoption. It would produce about $7 billion by the fifth year after adoption.

Tax Limitations. *The Committee recommends that no maximum rate be set for the tax.* Such a limitation would restrict government's ability to use the tax in real fiscal emergencies or to support new spending programs for which there is broad-based support. On the other hand, the Committee believes that the potential of the tax to raise funds for government is so large, that some built-in safeguards are desirable. *Therefore, the Committee recommends that if an income tax is adopted, any increase in its rate above the initial levy should require a so-called "super majority" vote of three-fifths of the members voting in each house of the Legislature.*

This requirement should be submitted for approval by the voters as a constitutional amendment so Texans would be assured to the degree possible that there are clear and unequivocal limits on the state's use of the tax.

Other than the limitations outlined above, the Committee does not recommend any other limitations on the tax, including the constitutional prohibition of the tax. While checks on increases in the tax are appropriate, it is not wise to preclude the tax from the options open to the state in times of emergency or public need.

Indexing. Many progressive income taxes permit increases in either nominal or real income to generate a disproportionate increase in tax liabilities. This happens because taxpayers' incomes are pushed into higher tax brackets and more people are brought into the bottom of the tax base as their incomes rise. At the same time, the values of fixed exemptions, deductions and credits fall as incomes rise relative to them. The net effect is a silent tax hike, known as "bracket creep." Even in a flat rate structure, such as the one discussed above, there is some bracket creep due to the eroded value of exemptions and deductions.

Bracket creep became a major tax policy issue nationally during the period of high inflation in the late 1970s. To combat this tendency, eight state income taxes and the federal tax have been "indexed" for inflation. This means they are periodically adjusted to remove the effects of inflation on taxable income.

Texans should not be expected to pay increasing amounts of tax simply because of inflation. *If Texas should adopt an income tax, the Committee recommends that the statute include an index for inflation. This should be done regardless of whether the state adopts a flat or graduated rate structure.*

Administration. *The Committee feels the tax clearly should be administered at the state level, and that administration should be the responsibility of the Comptroller of Public Accounts as the state's chief tax collector. A system of withholding should be established for the tax based on the federal model.*

Because of the long lead time needed to implement this tax, the Legislature should be advised to direct a study of the requirements for implementation of the tax by the Comptroller's office, the goal being to improve the prospects for implementing the tax in enough time to contribute to the solution of a fiscal emergency. This study should include an analysis of the expected costs of implementing and operating the tax. It should also include an investigation of the possibility of privatizing some

With the personal exemption and standard deduction that will be in effect in federal tax law in 1989, a family of four with an income of under $13,000 would pay no tax.

TABLE 1. Summary of State Personal Income Tax Structures, 1987

State	Rates	Income Brackets Under	Income Brackets Over	Personal Exemptions Single	Personal Exemptions Joint	Personal Exemptions Dependents	Size of Standard Deduction %	Size of Standard Deduction Single	Size of Standard Deduction Joint
Flat Rate States:									
Illinois	2.5%		Flat Rate	$1,000	$2,000	$1,000	–	–	–
Indiana	3.2		Flat Rate	1,000	2,000	1,000	–	–	–
Massachusetts	5.0[1]		Flat Rate	2,200	4,400	1,000	–	–	–
Michigan	4.6		Flat Rate	1,500	3,000	1,500	–	–	–
Pennsylvania	2.1		Flat Rate	X	X	–	–	–	–
States Using Federal Tax Liability as Tax Base:									
Rhode Island				23.46% of federal income tax liability					
Vermont				25.80% of federal income tax liability					
States Using Federal Taxable Income as Tax Base:									
Colorado				5% of federal taxable income					
Idaho	2.0-8.2%	$1,000	$20,000			Same as federal			
Minnesota	4.0-9.0	3,000	6,000			Same as federal			
North Dakota	2.7-12.0	3,000	50,000			Same as federal			
South Carolina	3.0-7.0	4,000	10,000			Same as federal			
States Using a Credit for the Personal Exemption:									
Using Own Tax Base:									
Arkansas	1.0-7.0%	$3,000	$25,000	$20	$40	$20	10.0%	$1,000	$1,000
Using Federal Adjusted Gross Income as Base:									
California	1.0-9.3	3,650	23,950	51	102	51	–	1,880	3,760
Iowa	0.4-10.0	1,000	45,000	20	40	15	15.0	1,230	3,030
Kentucky	2.0-6.0	3,000	8,000	20	40	20	–	650	650
Oregon	5.0-9.0	2,000	5,000	85	170	85	13.0	1,800	3,000
Wisconsin	4.9-7.0	7,500	15,000	20	40	20	–	5,200[2]	7,560[2]
States Using a Deduction for the Personal Exemption:									
Using Own Tax Base:									
Alabama	2.0-5.0%	$500	$3,000	$1,500	$3,000	$300	20.0%	$2,000	$4,000
Mississippi	3.0-5.0	5,000	10,000	6,000	9,500	1,500	15.0	2,300	3,400
New Jersey	2.0-3.5	20,000	50,000	1,000	2,000	1,000	–	–	–
North Carolina	3.0-7.0	2,000	10,000	1,100	2,200	800	10.0	550	–[3]
Using Federal Adjusted Gross Income as Base:									
Arizona	2.0-8.0	1,155	6,930	1,998	3,992	1,198	19.4	998	1,996
Delaware	1.0-8.8	1,00	40,000	1,000	2,000	1,000	10.0	1,000	1,000
Georgia	1.0-6.0	750	7,000	1,500	3,000	1,500	15.0	2,300	3,000
Hawaii	2.25-10.0	1,000	20,000	1,900	3,800	1,900	–	1,000	1,700
Kansas	2.0-9.0	2,000	25,000	1,000	2,000	1,000	16.0	2,400	2,800
Louisiana	2.0-6.0	10,000	50,000	4,500	9,000	1,000	–[4]	–[4]	–[4]
Maine	1.0-10.0	2,000	25,000	1,000	2,000	1,000	16.0	2,500	3,100
Maryland	2.0-5.0	1,000	3,000	1,000	2,000	1,000	15.0	2,000	4,000
Missouri	1.5-6.0	1,000	9,000	1,200	1,200	400	–	Same as Federal	
Montana	2.0-11.0	1,300	46,400	1,060	2,120	1,060	20.0	1,990	3,980
Nebraska	2.0-5.9	1,800	27,000	1,000	2,200	1,100	–	2,530	3,740
New Mexico	1.8-8.5	5,200	41,600	2,000	4,000	2,000		Same as Federal	
New York	2.0-8.5	1,000	14,000	900	1,800	900	–	3,600	6,300
Ohio	0.75-6.9	5,000	100,000	650	1,300	650	–	–	–
Oklahoma	0.5-6.0	1,000	7,500	1,000	2,000	1,000	15	2,000	2,000
Utah	2.75-7.75	750	3,750	750	1,500	750	15	1,000	2,000
Virginia	2.0-5.75	3,000	14,000	700	1,400	700	15	2,000	4,000
West Virginia	3.0-6.5	10,000	60,000	2,000	4,000	2,000	–[5]	–[5]	–[5]
Washington D.C.	6.0-10.0	10,000	20,000	885	1,770	885	–	2,000	2,000
States Taxing Dividend and Interest Income Only:									
Connecticut	1.0-12.0%	$54,000	$100,000	Limited tax					
New Hampshire	5.0	Flat Rate		Limited tax					
Tennessee	6.0	Flat Rate		Limited tax					
States With No Personal Income Tax:									
Alaska									
Florida									
Nevada									
South Dakota									
Texas									
Washington									
Wyoming									

Source: U.S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1988 Edition (Washington, D.C., December 1987), Table 15; U.S. Department of Commerce, Bureau of the Census, *State Government Tax Collections in 1987.*

1. *Massachusetts:* 10% rate on interest, dividends and capital gains; no tax if gross income equal to or below $8,000 single filers or $12,000 for joint filers.
2. *Wisconsin:* Standard deduction gradually phased out and disappears when AGI equals $50,830.
3. *North Carolina:* Spouse with smaller income allowed an additional $1100 deduction; no joint filing.
4. *Louisiana:* Standard deduction is combined with personal exemption.
5. *West Virginia:* Personal exemption intended to cover all deductions--no standard or itemized deductions allowed.

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parts of the processing system. Such privatization, however, should not be carried out in a way that would violate the confidentiality of taxpayer information. Table 2 shows the result of research conducted for the Committee on the implementation schedules for income taxes in selected other states.

Designated Uses of the Tax Revenue. The Committee has heard proposals under which a new income tax would be used to reduce or replace a number of taxes, most notably including the sales and property taxes. The tax could be used, for example, to reduce state reliance on the sales tax significantly, thus allowing an overall reduction in the sales tax rate or perhaps allowing some expansion in local access to that tax.

A working group of the Committee also considered the possibility of designating the use of the tax's income without replacing other existing taxes. A logical example of this approach might be to earmark the tax for public education.

Although there are good arguments for these policy approaches, the Committee makes no recommendation concerning the dedication of the tax for a specific purpose or its use as a replacement for any current taxes. As has already been indicated, the circumstances under which an income tax might be adopted in Texas are unknown and cannot be reasonably predicted at this time. It is therefore not appropriate for the Committee to specify dedications in the absence of a demonstrated need.

The Link Between Personal and Corporate Income Taxes. *The Committee recommends that a corporate income tax be considered whenever a personal income tax is considered.* In the vast majority of states, these two taxes are linked to ensure equitable treatment of all types of income and this policy would make sense for Texas.

The aggregate level of taxes and how they are spent are probably more important issues than the presence or absence of a particular tax.

TABLE 2. Time for Implementation of Most Recent State Personal Income Taxes

State	Bill Passed	Bill Effective	Withholding Began	First Returns Filed	Time Before Action Required	Number of Filers
Illinois	6/30/69	8/1/69	8/1/69	4/15/70	31 Days	4.3 million (1972) 4.7 million (1986)
Maine	6/28/69	7/1/69	8/4/69	4/15/70	36 Days	340,000 (1969) 512,000 (1986)
Michigan	7/20/67	10/1/67	10/1/67	4/15/68	73 Days	3.35 million (1968) 3.73 million (1986)
New Jersey	7/8/76	7/1/76	8/30/76	4/15/77	53 Days	3.2 million (1976) 4.0 million (1987)
Nebraska	4/12/67	1/1/68	1/1/68	4/15/69	263 Days	566,000 (1968) 686,000 (1986)
Ohio	12/20/71	1/1/72	1/1/72	4/15/73	11 Days	3.2 million (1972) 4.2 million (1987)
Pennsylvania	3/4/71 8/31/71	1/1/71 6/1/71	6/1/71 10/1/71	* 4/15/72	* Immediate	5.29 million (1987)
Rhode Island	2/26/71	1/1/71	2/26/71	4/15/72	Immediate	474,000 (1986)

Source: Select Committee on Tax Equity.

* Bill passed March 4, 1971. It was declared unconstitutional but was reenacted with revisions on August 31.

Taxes appear to become a problem economically when they create an unusual or special burden on some segment of the economy.

Effect on the Economy. The Committee has reviewed information on the impact of an income tax on the state economy, a critical concern at this juncture in the state's history. Research reveals no clear answer to the question of what effect taxes in general have on state economies and economic decisions. The same is true of individual taxes, including the income tax. Clearly, an income tax would reduce the level of private savings, investment and consumption. However, this would be true of any tax, and many economic development studies have found that certain government spending issues (education, transportation, etc.) are of equal or greater importance than taxes.

Taxes appear to become a problem economically when they create an unusual or special burden on some segment of the economy. High personal income tax rates would make the state less attractive, but so would higher sales tax rates or low educational opportunities. A major distinction among taxes in national surveys and the work of this Committee is the fact that some taxes—notably the property and income taxes—are consistently viewed less favorably than other alternatives by the public.

Despite the unfavorable public view of the income tax, most states have adopted the tax without real evidence of damage to the their economies. *The mixed nature of the data suggests that the most important aspect of Texas' lack of an income tax is its role as a "selling tool" for the state—it gives the state an obvious and recognizable comparative advantage. In economic terms, however, the aggregate level of taxes and how they are spent are probably more important issues than the presence or absence of a particular tax.*

CHAPTER NINE

OTHER ISSUES

In addition to its overall review of the Texas' state and local tax system, the Select Committee also examined several related issues. The two most important were the issue of a state lottery and the use of various types of tax and spending limitation by government. This chapter reviews the Committee's findings on those issues.

Although it is not a tax, the lottery is a revenue option which has received considerable attention in Texas in recent years.

The Lottery

Although it is not a tax, the lottery is a revenue option which has received considerable attention in Texas in recent years. Lottery proposals have been introduced in the last three sessions of the Legislature. A 1987 public opinion poll showed that 70 percent of Texans favored a lottery to support state government, while 21 percent opposed the idea. (The remainder expressed no opinion.)

Lottery proponents argue that it is a relatively "painless" way to raise substantial amounts of money and that many citizens prefer the lottery to a tax of equal size. It is certainly an option to which state governments have increasingly turned in recent years. Today, 27 states and the District of Columbia have operating lotteries, and five states are in the process of enacting recently approved lotteries(Table 1).

A Texas lottery would raise substantial income for the state. Once it reached maturity (in about five years), it could be expected to produce approximately $600 million a year in revenue, excluding prizes and the cost of administration. An important limitation to its usefulness as an income source, however, is the fact that it would require a constitutional amendment to enact and several years to achieve maturity. For this reason, it would have only limited use in addressing a fiscal emergency.

This is not the only problem with a lottery, according to critics. It is strongly opposed by many Texans on moral grounds, and opponents argue that it preys on the people least able to afford it. There also is concern that government should not be involved in gambling, and that income from the lottery can become unstable if player interest declines over time, a trend found in some other state lotteries.

The Committee gave the lottery serious consideration but determined that it was not an appropriate area of Committee interest. However, one major finding which should be underscored is that while a lottery can raise substantial revenues, this income is not sufficient to deal with fiscal problems of the magnitude the state has faced in recent years. A lottery should not be viewed as a panacea to a major fiscal crisis.

Tax and Spending Limitations

One factor magnifying the extent of the state's fiscal problems in recent years has been the fact that it holds no reserves against bad times. This is a common practice in business and makes sense for government as well. Recognizing this, 28 states have adopted budget reserve or so-called "rainy day" funds.

Texas has now joined this growing majority in the form of Proposition 2, which voters approved in the November 8 election. Proposition 2 creates a state economic stabilization fund in the state treasury which would receive transfers of half of any unencumbered state general revenue balances and 75 percent of oil and gas severance tax revenues above annualized 1987 collections from those taxes. *The Committee believes that Proposition 2 represents a reasonable step toward preparing for the next fiscal "rainy day" in Texas and supports full implementation of the amendment.*

Other Limitations. The Committee considered several other possible limitations on state spending and revenue authority but has no other recommendations in this area. In general, the state does a good job of maintaining fiscally responsible budget practices. *However, based on its research into this issue, the Committee recommends that if any additional limitations are considered that they be written into the Constitution and not simply into state statutes.* Evidence from other states indicates that statutory limitations are too easily discarded when it becomes convenient and provide no real limitation.

TABLE 1. Lotteries in the States, 1988

State	Instant	Numbers	Lotto	Other	Total
Arizona	$32.8	$0.0	$118.8	$0.0	$151.6
California	902.9	0.0	716.4	0.0	1,619.3
Colorado	95.6	0.0	0.0	2.9	98.4
Connecticut	76.9	167.9	273.9	0.0	518.7
Delaware	7.1	33.7	9.2	0.0	50.0
District of Columbia	3.7	104.7	9.0	1.9	119.2
Florida	—[1]	—	—	—	—
Idaho	N.O.	N.O.	N.O.	N.O.	N.O.
Illinois	253.9	431.9	644.5	0.0	1,312.3
Indiana	N.O.	N.O.	N.O.	N.O.	N.O.
Iowa	77.8	0.0	32.5	0.0	110.3
Kansas	20.7	0.0	0.0	0.0	20.7
Kentucky	N.O.	N.O.	N.O.	N.O.	N.O.
Maine	26.7	8.1	39.4	0.0	74.2
Maryland	69.4	546.2	163.3	0.0	778.9
Massachusetts	430.9	399.2	406.8	33.2	1,270.0
Michigan	117.4	499.6	394.5	0.0	1,011.5
Minnesota	N.O.	N.O.	N.O.	N.O.	N.O.
Missouri	114.4	14.4	29.1	0.0	157.9
Montana	15.6	0.0	0.0	0.0	15.6
New Hampshire	29.2	6.2	30.0	0.0	65.4
New Jersey	82.9	620.4	439.2	0.0	1,142.4
New York	76.9	653.9	738.5	71.2	1,540.5
Ohio	197.4	483.9	522.4	0.0	1,203.7
Oregon	56.0	7.6	64.2	0.0	127.8
Pennsylvania	226.6	648.4	387.9	138.1	1,401.0
Rhode Island	—[2]	—	—	—	—
South Dakota	11.7	0.0	0.0	0.0	11.7
Vermont	18.4	1.4	12.2	0.0	31.9
Virginia	N.O.	N.O.	N.O.	N.O.	N.O.
Washington	46.9	12.8	130.6	0.0	190.2
West Virginia	37.1	9.6	11.7	0.4	58.7
Wisconsin	N.O.	N.O.	N.O.	N.O.	N.O.
Total	**$3,010.7**	**$4,649.7**	**$5,173.9**	**$247.5**	**$13,081.9**

Source: *Gaming and Wagering Business*, selected issues.

Note: 1987 calendar year sales by type of game (millions of dollars); N.O. means lottery was not operational in 1988.
1. Operational in January 1988.
2. Information not available.

House Bill 2

H.B. No. 2

AN ACT

relating to creation of the Select Committee on Tax Equity.

The committee shall conduct studies and make findings regarding the burden of state and local taxation ....

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. SELECT COMMITTEE ON TAX EQUITY. (a) The Select Committee on Tax Equity is composed of:

(1) four public members appointed by the governor;
(2) two public members and two members of the senate appointed by the lieutenant governor;
(3) two public members and two members of the house of representatives appointed by the speaker of the house of representatives; and
(4) the comptroller of public accounts.

(b) The speaker of the house of representatives and the lieutenant governor shall jointly select the chairman of the committee from among its members.

(c) The committee shall meet at the call of the chairman.

(d) Public members of the committee serve two-year terms expiring September 1 of each odd-numbered year.

SECTION 2. PURPOSE; DUTIES. The committee shall conduct studies and make findings regarding the burden of state and local taxation borne by various segments of the state's economy and by various categories of individual taxpayers. In the studies the committee shall assess:

(1) the relative portion of the total amount of these taxes that is received from each segment of the business community and each category of individual taxpayers;

(2) the impact of state and local taxation on economic development in this state; and

(3) the relationship between taxes and the revenue needs of the state and local governments and between the tax burden and benefits taxpayers receive from government in this state.

SECTION 3. REPORTS. As necessary and appropriate, the committee shall issue reports of its findings from the studies required in Section 2 of this Act. The committee shall file copies of the reports with the Legislative Reference Library, Texas Legislative Council, secretary of the senate, and chief clerk of the house of representatives.

SECTION 4. STAFF. On the request of the committee the Legislative Budget Board, Texas Legislative Council, governor's office, senate, and house of representatives shall provide the staff necessary to carry out the duties of the committee.

The committee shall issue reports of its findings from the studies required . . . in this Act.

SECTION 5. WITNESSES; PROCESS. The committee may issue a subpoena or other process to a witness at any place in this state, compel the attendance of the witness, and compel the production of a book, record, document or instrument that the committee requires. If necessary to obtain compliance with a subpoena or other process, the committee may issue a writ of attachment. A subpoena or other process may be issued by the committee may be addressed to and served by any peace officer of this state or any of its political subdivisions. The chairman shall issue, in the name of the committee, a subpoena or other process as the committee directs. If the chairman is absent, the vice-chairman or any designee of the chairman may issue a subpoena or process in the same manner as the chairman. A witness attending proceedings of the committee under process is entitled to the same mileage and per diem as a witness before a grand jury in this state. The testimony given at any hearing conducted under this Act shall be given under oath subject to the penalties of perjury.

SECTION 6. COOPERATION OF OTHER AGENCIES. If needed in the discharge of its duties, the committee may request the assistance of any state agency, department, or office. The agency, department, or office shall provide the requested assistance.

SECTION 7. EXPENSES. The operating expenses of the committee shall be paid from available funds of the governor's office and from the contingent expense fund of the senate and the contingent expense fund of the house of representatives, as agreed by those entities. The committee members are entitled to reimbursement from those funds for their expenses incurred in carrying out this Act.

SECTION 8. EXPIRATION. This Act expires September 1, 1991.

SECTION 9. EMERGENCY. The importance of this legislation and the crowded condition of the calendars in both houses create an emergency and imperative public necessity that the constitutional rule requiring bills to be read on three several days in each house be suspended, and this rule is hereby suspended, and that this Act take effect and be in force from and after its passage, and it is so enacted.

Approved: March 30, 1987
Effective: March 30, 1987

APPENDIX D

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