



THE BEST CHOICE FOR A PROSPEROUS TEXAS: A TEXAS-STYLE PERSONAL INCOME TAX

January 2006

Contact: Dick Lavine, lavine@cPPP.org
F. Scott McCown, mccown@cPPP.org

INTRODUCTION

Part one of this trilogy of policy briefs explains the challenge facing Texas in funding public education. This policy brief explains why a Texas-style personal income tax is the best way to meet the needs of Texas. Only a personal income tax can significantly reduce reliance on property taxes – cutting the school operations tax from \$1.50 to \$0.50 – while providing adequately for education – over \$5 billion annually. Alternative tax proposals are not able to reduce property taxes as much or fund public education as well. An expanded business tax by itself cannot raise enough money. A higher sales tax would be volatile and regressive. An income tax would *reduce* taxes on the middle class and *benefit* the economy. Public opinion polls show that Texans are open to considering a Texas-style income tax.

A NEW BUSINESS TAX BY ITSELF WON'T RAISE ENOUGH MONEY TO SIGNIFICANTLY CUT PROPERTY TAXES

Texas' current corporate franchise tax must be improved and broadened to improve equity among various forms of businesses and among businesses in different sectors. This new tax could also generate additional revenue, but no business tax alone would be able to reduce property taxes by the amount targeted by state leaders.

The franchise tax currently supplies 7.3% of state tax revenue – \$2.2 billion of the \$29.8 billion in tax collections in 2005. Only seven states rely on their general business tax for a larger portion of state tax revenue, so Texas is already pushing the limit. But let's assume Texas were willing to match the third highest state (New Jersey), which gets 12% of its tax revenue from its corporate income tax. That new tax would bring in only \$1.6 billion per year more than the current franchise tax (\$3.8 billion of new total revenue of \$31.4 billion).

This additional \$1.6 billion a year could cut property taxes by only 15 cents per \$100 of property valuation.

In order to even come close to generating enough new money from a business tax alone to cut property taxes by 50 cents, Texas would have to exceed even the two extreme outlier states (New Hampshire and Alaska), which receive 20% of their tax revenue from their general business tax.

SALES TAXES CAN'T CARRY MORE OF THE LOAD

The sales tax is near its limit. Texans pay \$1,250 per person in sales taxes and similar consumption taxes each year. Texas' state rate of 6¼% is tied for 7th highest in the country; no state has a rate over 7%. Texas' state and local combined maximum rate of 8¼% is 15th highest.

The sales tax is highly “regressive” – it takes a much greater percentage of the income from a low- or moderate-income family than from a higher-income family. Taxes based on consumption, like the sales tax, are very regressive, since lower-income families tend to consume a much higher proportion of their income than do higher-income families. In Texas, the average low-income family pays 5.8% of its income in state sales taxes (not including local taxes), while an average high-income family pays only 1.7% of its income in state sales taxes. The sales tax exempts most groceries, residential utilities (gas, electric, water), and medicines, but even with these exemptions for necessities, the sales tax is by its nature still regressive.

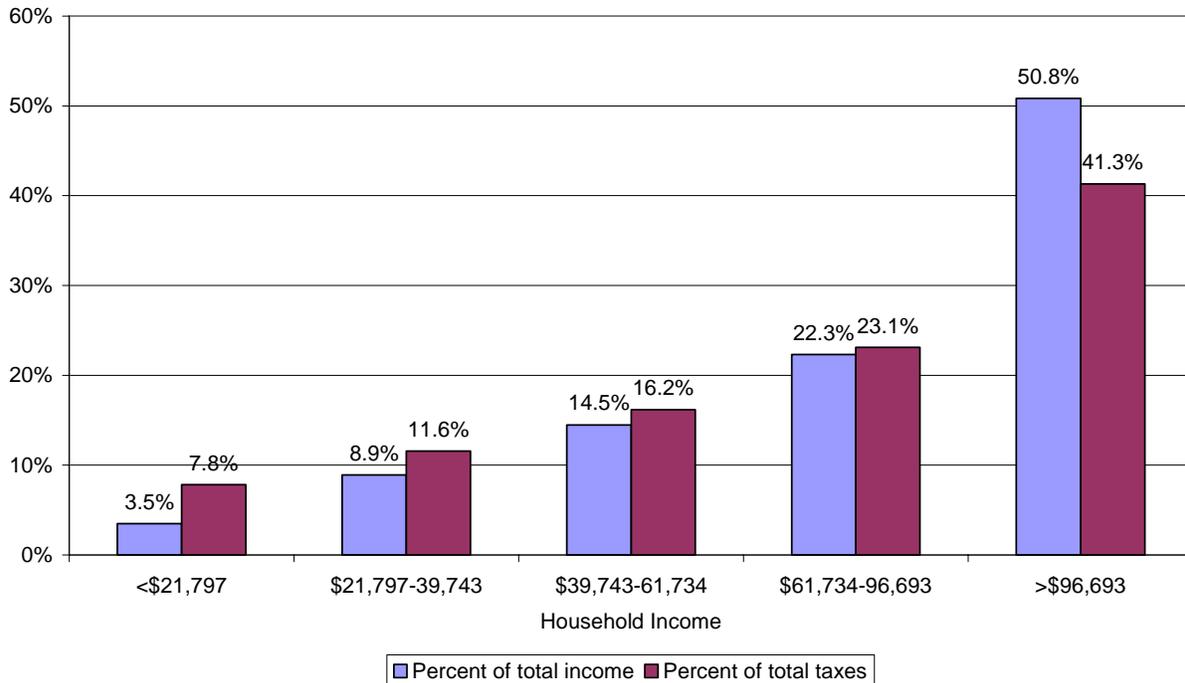
Because Texas relies on the sales tax for the majority of its state tax revenue, our state and local tax system is rated the 5th most regressive in the nation. The one-fifth of Texas households with the lowest income (less than \$22,000 per year) pays almost three times as much in taxes, as a percentage of household income, as the one-fifth of households with the highest incomes (over \$97,000 per year).

One way of looking at the impact of Texas's tax system is to rank all families according to their income, then divide them into five groups, each with the same number of families. The chart below shows that the one-fifth of families with the highest income receives more than one-half of all personal income in the state, but pays only 41% of state and local taxes. At the other extreme, the poor one-fifth of families receives only 3% of income, but pays 8% of all taxes.

A good tax system would match the share of taxes with the share of income. Each family would have an equal ability to pay its taxes. Since the fastest growing incomes are enjoyed by those at the top of the income ladder, our schools and other public services would be supported by a growing source of revenue. Taking a high percentage of income from low-income families makes it harder for them to accumulate assets, such as a car or a house, and move into the middle class. Finally, it is simply unfair to take more from those less able to pay and less from those more able to pay.

A tax equity note can evaluate the effect of any proposal on tax fairness. The House rules require that, before the House can consider any tax bill that “creates or impacts a state tax or fee” the Legislative Budget Board must prepare “a tax equity note that estimates the general effects of the proposal on the distribution of tax and fee burdens among individuals and businesses.” (Rule 4, section 34(b)(5)) The Senate has a similar rule that gives the chair of the Senate Finance Committee the option of requesting an equity note. (Rule 7.09(g)) In addition, the comptroller is required to prepare a biennial report on the overall incidence of the school property tax and any major state tax. These analyses include the effect of these taxes by family income level, between homeowners and renters, and among different industries.

The Top One-Fifth of Texas Households Pays Less Than Its Fair Share of Taxes



Data: Texas Comptroller of Public Accounts. Calculations: CPPP.

The sales tax base should be modernized to include services. This would help sales tax revenue grow naturally with our current economy without raising the rate and perhaps reduce volatility. However, after excluding services that should not be taxed, such as medical care, even an expanded sales tax does not raise enough money to adequately fund public education and reduce property taxes.

TEXAS NEEDS A TAX THAT CAN CARRY THE LOAD

Our state tax system does not keep up with our growing economy. The chart below shows that local governments have had to rely on higher property taxes in order to find necessary revenue. State tax revenue has fallen as a percentage of personal income since 1995. If Texas could tap merely the same portion of the state economy in taxes in 2006-07 that it collected in 1995, rather than the portion projected by the comptroller, the state would have an astounding \$15 billion more to fund the 2006-07 biennial budget and ease the pressure on local property taxes.

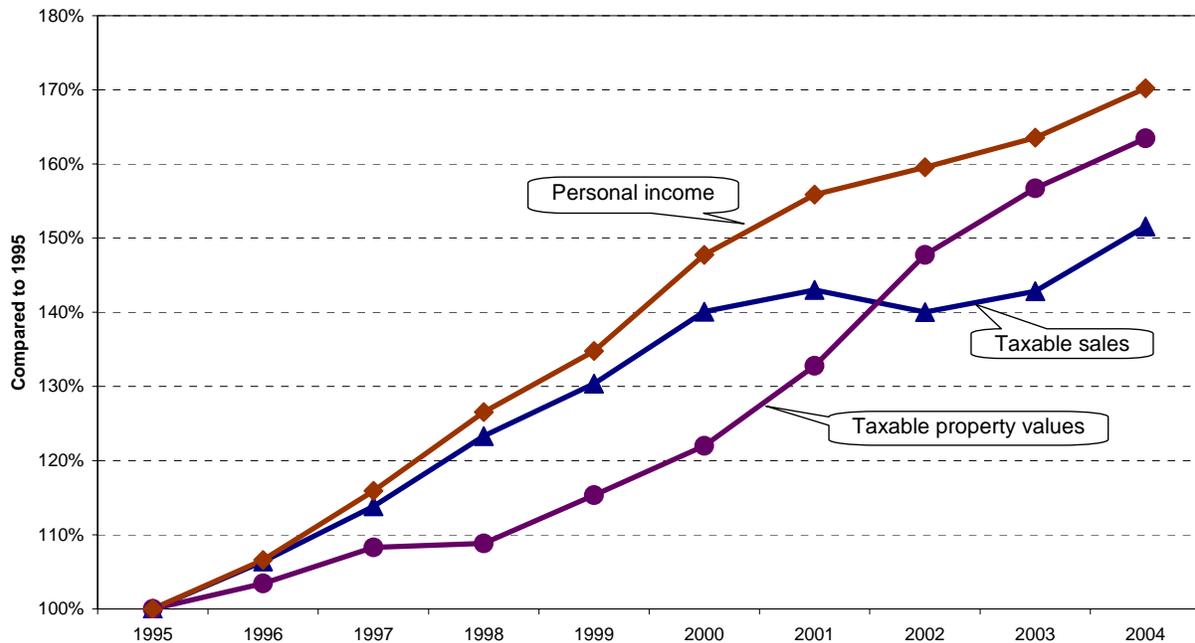
Instead, school districts and other local governments must boost property taxes to fund public education, hospitals, jails, and roads. In the past few years property taxes have increased much faster than personal income, leading to widespread complaints that the taxes were increasing faster than the ability of homeowners to pay them.

The chart below shows how Texas’ tax bases – the amount that is subject to a tax, without adjusting for changes in the rate of the tax – have changed since 1995.

A key factor in Texas' lagging state tax revenue is the state's heavy reliance on the sales tax, which supplies more than half of its tax revenue. We tax mainly the sales of goods, but we increasingly sell services, so taxable sales fall far short of keeping up with economic growth. In addition, sales tax revenue can be volatile. State sales tax revenue fell for two years straight, from 2001 to 2003. The sales tax rate has not changed since 1990.

Taxable property values have grown steadily, even after an increase in the homestead exemption in 1998 flattened growth for that year. But neither the sales nor property tax has matched the growth in personal income in Texas.

**Comparing Tax Bases:
Taxable Sales Are Volatile; Property Values Grow Steadily;
Income Performs Best**



Data: Texas Comptroller of Public Accounts. Calculations: CPPP.

A PERSONAL INCOME TAX SOLVES THESE PROBLEMS

An income tax can produce the money we need to fund the investments that will create a prosperous future for all Texans. Revenue from an income tax grows naturally with the growth in the state's economy, so Texas would not continue to struggle to finance schools and health care year after year. An income tax is also directly linked to a family's ability to pay taxes, so it can help offset the unfairness of other taxes. Balancing property, sales, and income taxes would maintain adequate and stable funding to improve Texas' future.

THE CONSTITUTION GUARANTEES VOTER CONTROL

A Texas constitutional amendment, designed by Lieutenant Governor Bob Bullock and adopted by the voters in 1993, is the blueprint for adopting a smart, Texas-style income tax. This amendment (Article 8, Section 24) gives voters total control over the amount of the tax. The amendment also mandates how the state must spend the income-tax revenue. Under this constitutional amendment, a bill establishing a personal income tax can take effect only after voter approval in a statewide referendum. Once the voters approve the tax, the rate cannot be increased without voter approval in another statewide referendum.

AN INCOME TAX WOULD BOTH REDUCE THE SCHOOL PROPERTY TAX AND INCREASE EDUCATION FUNDING

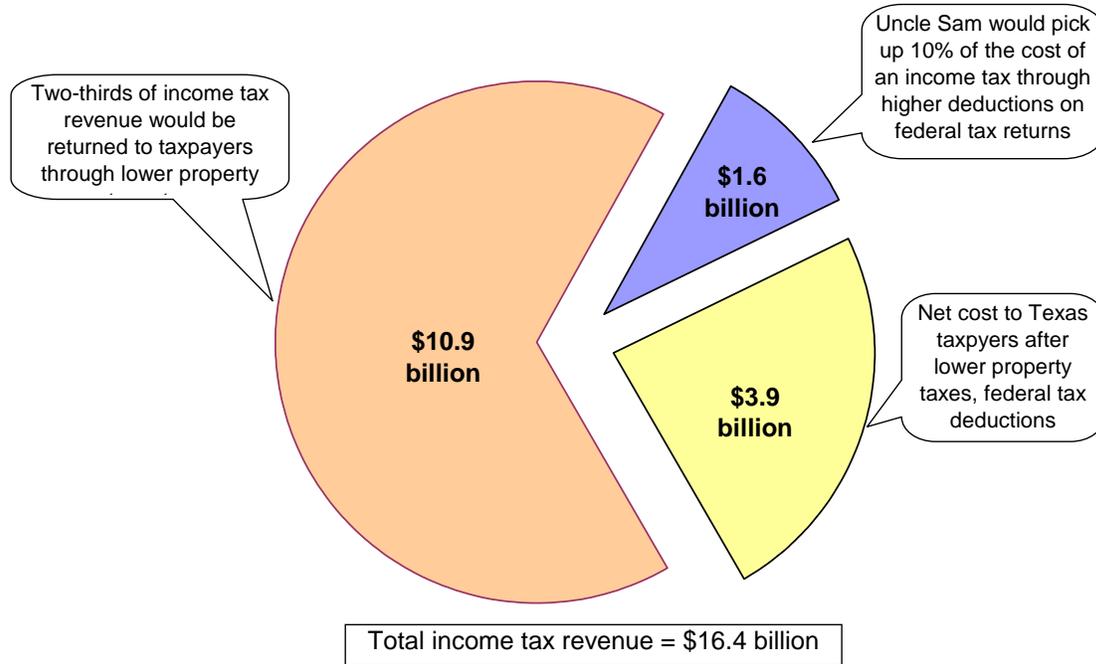
The Bullock Amendment requires that two-thirds of the revenue from an income tax must go to reduce school property taxes. This could cut the local tax rate – in most school districts now \$1.50 per \$100 of property value for maintenance and operations (M&O) – to roughly 50 cents! The maximum M&O tax rate – also now generally capped at \$1.50 – must be reduced by the same percentage as total M&O taxes. If the income tax cut the property tax rate by 65%, then it would also cut the tax cap by 65%. After the cap was cut, only the voters in a school district could increase their district's maximum tax rate. The Bullock Amendment then provides that the remaining one-third of income tax revenue could be spent, but only on education.

A REAL-LIFE EXAMPLE

We took the income tax from Kansas, a state with income-tax revenue per resident slightly below the national average, and applied its rates, brackets, and deductions to the incomes of Texas families in 2004. Of course, Texas would write its own income tax. We used the Kansas tax for 2004 merely to demonstrate how an income tax could work.

The Kansas tax has three income brackets, with rates that range from 3.5% to 6.45% of federal adjusted gross income, minus state exemptions and deductions. A family of four pays no tax on income under \$24,400. The Kansas tax form is very short and easy to complete. The chart below shows what would happen if a similar tax were enacted in Texas:

The Deductibility of an Income Tax Would Ease the Burden on Texas Taxpayers



Source: The Institute on Taxation and Economic Policy.

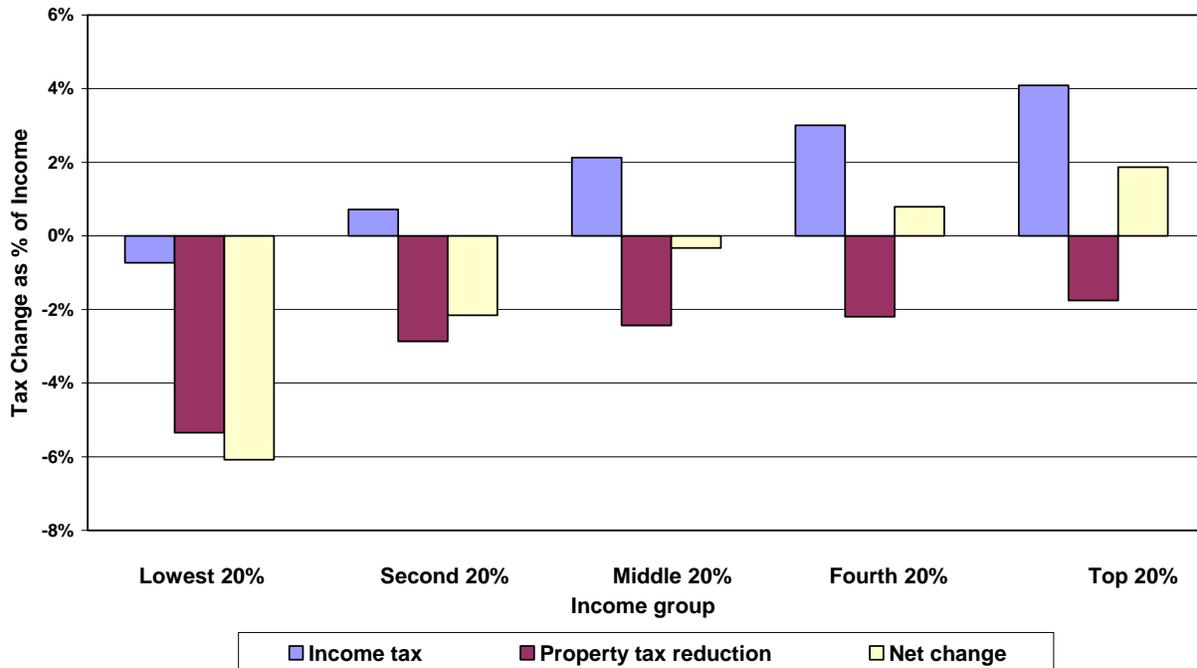
STATE INCOME TAX PAYMENTS ARE DEDUCTIBLE FROM THE FEDERAL INCOME TAX

State income tax payments are deductible from taxable income in calculating federal income taxes. Deductibility shifts part of the cost of public education to the federal government. The above chart shows that, although the tax would have raised \$16.4 billion in 2004, the net cost to Texas taxpayers would have been only \$3.9 billion. Lower property taxes would have returned most of the new revenue (\$10.9 billion) to taxpayers. Uncle Sam would have picked up 10% of the total cost of the income tax (\$1.6 billion) through higher deductions on federal tax returns.

MOST TEXAS FAMILIES, INCLUDING THE MIDDLE CLASS, WOULD PAY LESS IN TAXES WITH AN INCOME TAX

As the chart below shows, most families would gain more from property tax cuts than they would pay in income taxes. In 2004, the top income group, with incomes over about \$97,000 a year, would have paid less than 2% of their income with an income tax. Since this group gets almost all the benefit of the federal income tax deduction, however, the federal government would have absorbed about a third of even this 2%.

A State Income Tax, With Property Tax Reductions, Would Benefit Most Texans



Source: The Institute on Taxation and Economic Policy.

An income tax could help balance the unfair burden placed on low- and middle-income families by the rest of the state tax system, particularly the sales tax. Relying on revenue from a system of several sources – balancing volatile, but fast-growing, taxes with steady revenue streams – can provide a secure source of support for state and local services that will also increase along with needs.

AN INCOME TAX WOULD FOSTER ECONOMIC GROWTH

Some fear that an income tax would be bad for our economy. Consider the evidence. Forty-one states have a broad-based personal income tax. Compared to Texas, most of these states have higher personal income, lower dropout rates, fewer uninsured children, and better transportation systems – the foundations for a prosperous future for their residents.

Through investing in public education, universities, health care, and transportation, Texas could accelerate its economic growth. A state with healthy children who stay in school produces skilled workers who earn more at better jobs. Prosperous consumers and good transportation attract new businesses. Investing more now in public services will create a more robust economy in the future.

The net cost of the standard income tax we have used as an example – less than \$4 billion a year – is only one-half of one percent of Texans’ total personal income. Even after such a modest net tax increase, which would be fairly shared among all Texans, our state would still have lower taxes than most others. An income tax is the best choice to meet our goals. Through this smart investment, Texans can ensure healthy children, educated residents, and skilled workers. This, in turn, will ensure all of us a brighter future.

TEXANS ARE OPEN TO CONSIDERING A TEXAS-STYLE INCOME TAX

The Scripps Howard newspaper chain has for many years conducted the Texas Poll, a random-sample telephone survey of 1,000 adult Texans with a margin of error of ± 3 percentage points. One question asked consistently over time is: “Would you support an income tax if it reduced property taxes and the revenue was used to pay for public schools?” This question tracks the requirements of the Bullock Amendment.

In 2003, right after the well-publicized budget cuts of the 2003 regular session, the poll found that 48% of Texans supported a personal income tax. Other Texas Polls have consistently shown a genuine openness to a state personal income tax, even though state leaders refuse to seriously discuss the issue. If state leadership were to inform the public about the stringent provisions of the Bullock Amendment and advocate for an income tax, voter support for an income tax would only grow.