CSHB 4 Digest
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SUBJECT: Tax restructuring and school finance reform

COMMITTEE: Select Committee on Revenue and Public Education Finance — committee substitute recommended

VOTE: 11 ayes — Sadler, Hilbert, Brimer, Chisum, Craddick, Hernandez, Hochberg, Junell, Stiles, Williamson, Wilson

0 nays

WITNESSES: (*On preliminary draft of CSHB 4, testifying April 7 and April 8):*

For — Will D. Davis, Texas Association of Life and Health Insurers; Richard Geiger, Association of Fire and Casualty Companies of Texas; George B. Allen, Texas Apartment Association; Charles Holt, Common Cause of Texas; Bill Grusendorf, Texas Association of Rural Schools; Wayne Pierce, Texas Association of Mid-Size Schools; Stephan Fairfield, Texas Association of Community Development Corporations; Charles Anderson; Don Summers; Leonard Scarcella

Against — David Smith, Southwest Chapter, American Society of Travel Agents; Charles Perry, Avion Flight Centre, Inc.; Sergio Davila and Hector Farias, Coalition of Texas Customs Brokers; Bentley Fondren, Farias, Inc.; Paul Lawrence, Texas Motor Transportation Association and United Parcel Service; Robert Floyd, Texas Society of Association Executives; Karol Rice, Texas Council of Advertising and Magazine Publishing; Gerald Brady, Houston Alliance of Taxicab Companies; Judith Collins; Karl Kuhlman, Consolidated Taxi; Hannah Riddering; Kevin O'Hanlon; Ward Stutz and Jeff True, American Quarter Horse Association; Dane Harris, Texas Association of Business and Chambers of Commerce; Eric Hartman, Texas Federation of Teachers; David Pinkus, Small Business United of Texas; Karen Greenwade, Texas Counseling Association; Cyndi Crowley-Martinez, Texas Association of Staffing; Pamela Bratton, Career Consultants, Texas Association of Staffing; James K. Presnal, Texas Association of Nurserymen; Phil Crawford; Richard L. Vollmer; Marvin Elliott; Michael L. Davis, Tobacco Institute; William H. Tulloch, Burlington Resources Oil and Gas Company; Susan Matthiessen, Texas Association of Personnel Consultants; Diana Lee Bynum, Houston Customhouse Brokers and Freight

Forwarders Association; Dale Cummings, AMOCO Corporation; Chuck Space, Southwest Car Wash Association; Ronald L. Parrish, Tandy Corporation; Mitchell F. Peairson, Texas Buildings Owners and Managers Association; Rush Durkin, Houston Real Estate Council; Andrew Alexander, International Council of Shopping Centers; Joe Gunn, Texas AFL-CIO; Randy Wright, Texas Chapters of the Institute of Real Estate Management; Ladd Little, Food Vending; Moe Plaisance, International Association of Drilling Contractors; Roger Murphee and Curt Seidlits, Association of Electric Companies of Texas; Mary Stelter, Texas Chapter, American Society of Interior Designers; Irving Schwartz, Texas Association of Interior Designers; Andre Steaffelbach; Alan R. Lauck, The Lauck Group Incorporated; Mark Bielamowirz; Carl H. Kleimann, Texas Chapter of National Association for Professional Employer Organizations; Roger Woolsey; John Stephens, Southwestern Bell; Travis Taylor and Pat George, Texas Grain Sorghum Producers; Allan McMurtry; Les Vines, Texas Industries and Chaparral Steel; David Cowling, American Electronics Association; Bill Allaway, Texas Taxpayers and Research Association; Coby Gilbreath, Texas Sugarbeet Growers; Charles Beckendorf; Lois Burton

On — Yuridia Barrera; Maria Eliza Castillo; Evangelina Cortez; Eloisa Leal Coy, Dallas Public Schools; Andreus Goldsmith; Yvonne Gonzalez, Texas Alliance/Dallas Independent School District; Erica Sandoral; Brandon James; Eric L. Stein; Elizabeth Turner; Lisa Barrett, Texas Alliance for Human Needs; Karey Barton, Mike Reissig and Craig Daugherty, Comptroller's Office; Don Canaday and James B. Vine, Foundation Appraisers’ Coalition of Texas; J.T. Hill, ALCOA; Carl King, Texas Corn Growers Association; Romeo Romero, Laredo Independent School District; Will Schletter, Medical Group Management; Richard Lavine and Dianne Stewart, Center for Public Policy Priorities; Billy Bob Brown; Mike Price, Row Crop Production; Joe Ratcliff, Texas Association of Wholesale Distributors; Jannis Hayers, Texas Association of School Boards; Mike McLamore, Association of Texas Professional Educators; Richard Kouri, Texas State Teachers Association; Lynn Moak and Richard A. Middleton, Texas School Alliance; Bill Carpenter, Fast Growth School Coalition and Cypress-Fairbanks Independent School District; Johnny Veselka and Dr. Quentin Burnett, Texas Association of School Administrators; Bruce Wood, Equity Center; Dr. Jerry Olson, Texas Association of Business and

Chambers of Commerce; Ron Dipprey, Texas Chemical Council; Thomas J. Wolf; Alison Dieter, Gray Panthers; John W. Erwin, Jr., West Teleservices; Gerald D. Wehrwein, Energas; Norman Hahn; John M. O'Gorman and Rick Grundman, Southern Union Gas; Ray Reid, Entex; Pete Gasper, Laurie Smith Design Associates; Olaf Harris, Interior Design and Space Planning Services; Marla Bommarito-Crouch, University of Texas at Austin Advisory Committee; Bruce P. Bower; Robert Eckels, Conference of Urban Counties; David Collyer, Northwest Independent School District; Lonnie Hollingsworth, Texas Classroom Teachers Association; Robert Howden, National Federation of Independent Business/Texas

Selected Resource Witnesses and Invited Testimony — David Anderson and Joe Wisnoski, Texas Education Agency; David Dunn, John Keel and John O'Brien, Legislative Budget Board; Billy Hamilton, Craig Daugherty, Mike Reissig, Dan Wilson, Tim Wooten, Karey Barton, Teresa Comer and Ray Bonilla, Comptroller's Office; Albert Hawkins, James LeBas and Dale Craymer, Governor's Office; Frank Battle, Speaker's Office; James Nance, Eric Hougland, Carolyn Hall and David Kramer, Texas Legislative Council

BACKGROUND:

Local property taxes make up more than half of the money supporting the 1,044 school districts in Texas. The current finance system was adopted by the 73rd legislature as SB 7 in 1993. Under that system the state created two tiers of school finance designed to provide state aid to school districts based on their local property wealth per student and level of tax effort. Tier 1 was designed to fund the "basic program" of the education system. It requires districts to tax at least 86 cents per $100 valuation; in return, each student slot is guaranteed to receive $2,408, the basic allotment, from state funding and locally generated revenue. Tier 2 covers tax rates from 87 cents to $1.50, the maximum rate for maintenance and operations (M&O) purposes. Tier 2 is a guaranteed yield system, designed to provide each a district a set amount of revenue per student per penny of tax effort. For every penny of tax effort within Tier 2, the state guarantees a district it will receive $21 per student. While not officially named so, "Tier 3" covers rates above $1.50. Any revenue raised in Tier 3 is not equalized by the state and, with few exceptions, such revenues can only be used for debt service (Interest and Sinking Fund or I&S) used to pay back bonds issued to finance school facilities.

SB 7 limits district revenues in all three tiers to $28 per student per penny of tax effort or $280,000 of taxable property wealth per student. All revenue raised above this limit by a local district is subject to “recapture,” under one of the five options outlined in the statute. The most popular options allow a district to purchase attendance credits from the state or another district to increase the number of students it funds and thus lower its property wealth per student to the $280,000 per student level. This system of recapturing tax revenues from wealthy districts and distributing those revenues to poorer districts has come to be known as “Robin Hood.”

The current status of and issues involving school finance, property taxation and other state taxes are discussed in *The Tax System and Public School Financing in Texas*, House Research Organization Session Focus Number 75-11, March 24, 1997.

DIGEST SUMMARY:

CSHB 4 would create a new funding mechanism for financing public schools that relies more heavily on state revenues rather than local district taxes. The bill would lower residential property taxes, passing on some of these savings to renters, impose a statewide business property tax, and expand the tax bases for the sales tax and franchise tax as well as other taxes.

School finance

CSHB 4 would separate the financing of school district maintenance and operations (M&O) from the financing of new and existing facilities or debt service (known as interest and sinking fund or I&S). The M&O function would have two tiers, with guaranteed yields for each penny of tax effort: the basic program tier, with a maximum residential property tax rate of 70 cents per $100 valuation, and a local enrichment tier, with a maximum rate of up to 10 cents. Eligible districts could use the 10 cents to instead accelerate the payment of existing debt service. Financing for new facilities construction would be funded by a new facilities guaranteed yield tier.

The system would retain all current multipliers (called weights in the current system) for different classifications of students, adjustments for district factors of size, sparsity, and other costs of education, and an allotment for transportation costs.

The finance system would contain a two-year hold harmless clause, making the state responsible for directly funding any revenue shortfall districts experience in the 1997-1998 or 1998-1999 school years because of CSHB 4.

CSHB 4 would continue the minimum teacher salary schedule, setting the schedule in statute for the 1997-1998 and 1998-1999 school years, then specifying a formula to adjust it for future years based on an increasing guaranteed yield level. It also would add an experienced teacher allotment.

Residential property taxes

The statewide average M&O residential property tax rate would drop from $1.30 per $100 of valuation to 64 cents. The average statewide I&S tax rate would drop from 18 cents to six cents.

Renters relief

Renters would also see property tax savings under CSHB 4 for the first three years through guaranteed rent reductions. Landlords who owned property with more than four units would be required to lower the rents of the tenants by the same amount as the landlord saved in property taxes for the year. Alternatively, a landlord could remit the tax savings to the comptroller, who would rebate the money to the tenants.

Business property tax

CSHB 4 would impose a state property tax on all non-residential property. The tax rate would be constitutionally capped at $1.05 per $100 of valuation.

Sales tax and other taxes

CSHB 4 would eliminate numerous sales tax exemptions, which would increase state revenue by $1.183 billion in fiscal 1998-99. It also would raise the tax rate on a number of other taxes, including alcohol, tobacco, aviation fuel, gross premiums on all gas, electric and water utilities, manufactured housing, and coal and lignite use, which would raise a total of $1.207 billion in the next biennium. In addition, it would raise the tax on insurance premiums and lottery winnings, generating an extra $400 million and $300 million, respectively.

In total, the tax increases would amount to more than $3 billion for fiscal 1998-99.

Franchise tax
CSHB 4 would expand the franchise tax to include partnerships, professional associations and businesses trusts, but not sole proprietorships, and would gain about $763 million to the state in fiscal 1998-99. The bill would also would change the location-of-payer rule for apportioning Texas receipts. Gross receipts from interest, dividends, sales of intangibles and other business done in Texas would be apportioned to Texas if the commercial domicile of the receiving business was in Texas.

Effective date
CSHB 4 would take effect September 1, 1997, and apply to the 1997-1998 school year, but only if the constitutional amendment proposed by HJR 4 was approved by the voters on August 9, 1997.

Supporters say the House Select Committee on Revenue and Public Education Funding has achieved a truly bipartisan solution to the twin issues of burdensome residential property taxes and inadequate state funding for public education. The select committee conducted extensive research into and hearings on Gov. George W. Bush's proposal to provide school property tax relief in Texas. The select committee carefully examined the options available to achieve the general goal of reducing property taxes and improving the way Texas funds public education. CSHB 4 is the product of their work.

Taxes are not palatable to anyone. But the fact is that all citizens and businesses have a responsibility to pay their fair share for public services. Education benefits everyone in Texas. An educated workforce invites economic development. It is the state's responsibility to ensure that public education is financed equitably across Texas. CSHB 4 would carry out this responsibility in a straightforward manner to spread the burden throughout all Texas.

Under CSHB 4, the average residential tax rate for school maintenance and operations would drop from $1.30 to 64 cents, and the rate on business property would drop to $1.05. The average tax rate on debt service would drop from 18 cents to six cents. The state's share of the cost of education would rise from its current level of 46 percent to nearly 80 percent. The financing system would eliminate the need for recapture — popularly known as "Robin Hood."

Now is the time to enact some changes to the property tax and school finance system before a crisis occurs. The history of the Texas Legislature is one of responding to impending crises, especially relating to school finance. The U.S. Supreme Court in 1973 warned the Legislature that it must examine the equity of the school finance system before it comes to a point that it becomes unconstitutional, in *San Antonio ISD v. Rodriguez*, 93 S.Ct. 1278 (1973). The Legislature, however, did not attempt to significantly modify the system until it was held unconstitutional by the Texas Supreme Court nearly 15 years later. It is clear if the current system is allowed to continue, property tax rates will continue to rise to levels increasingly burdensome on all property owners. If this Legislature does not act this session in the hopes that the problem would be easier to solve later, the problems will simply be more severe and more difficult to fix.

The plan proposed in CSHB 4 would be revenue neutral but would achieve an overall tax reduction by using $1 billion of the general revenue surplus from the current biennium to provide property tax relief. The proposed restructuring of school finance would help to retire old debt service and build new facilities, two factors currently driving property taxes up. CSHB 4 would accomplish sweeping changes without increasing the rates on the sales or franchise taxes or creating any new taxes, but instead would remove special exemptions or loopholes in the current tax structure to spread the tax burden equitably on all.

Opponents say while the preliminary work of the Select Committee on Revenue and Public School Finance was careful and deliberate, formulation of the final version of the committee substitute was done in a rush to get a bill to the House floor in time for the legislation to be enacted in the regular session. This hasty drafting means that the financial impact of CSHB 4 to schools and taxpayers have not been adequately analyzed by interested parties. While the legislative process cannot be made to wait for everyone concerned, even those who have been closely following the committee's work during the entire session have not had the time yet to determine how they will be affected by the new language and changes to CSHB 4. The impact on the Texas economy could be substantial, with increased taxes in certain areas potentially driving businesses out of Texas.

CSHB 4 cannot succeed unless it uses a $1 billion surplus from general revenue to fund property tax reductions. This is money that was saved by the state and should instead be used to fund other needed programs left unfunded in the current draft of the appropriations bill. At the very least, the Legislature should be given the opportunity to weigh the benefits of those other programs against those provided in this bill. It is also unclear whether the structure provided will be able to fund the school system in the next biennium without a similar revenue surplus gained in other areas.

In shifting tax burdens, CSHB 4 would increase the regressivity of the tax system. Property taxes are among the least regressive taxes available because they generally increase proportionately to wealth. Sales taxes and similar taxes on utilities, tobacco and alcoholic beverages are more regressive because they actually take a higher percentage of the income of the poor than of the rich. CSHB 4 would reduce reliance on property taxes and shift much of it to sales and other regressive taxes, and would thus shift more of the tax burden from the rich to the poor.

The average taxpayer would see only about a two percent decrease in tax burden from the shifting proposed by CSHB 4. On average, businesses would see their tax liability reduced by 1.2 percent during fiscal 1998-99.

Other opponents say $1 billion or more of the general revenue surplus should be used to provide property tax relief without going through the difficulty and uncertainty of tax shifting proposed by CSHB 4. That money could alternatively be used to fund a circuit breaker program to lower the property tax burden just on those low income Texans for whom property tax bills consume a large portion of their income.

POINT-BY-POINT ANALYSIS:

PUBLIC SCHOOL FINANCE

Tier I - The Basic Program

CSHB 4 would replace the current two-tiered system for M&O with a single tier of guaranteed yield to fund total basic program costs for each district. Under CSHB 4 the guaranteed level of revenue would be $53.15 per student per penny of tax effort. Tax rates on residential property for the basic program tier would have an upper limit of 70 cents.

The Legislative Budget Board (LBB) would be required to compute the system's funding elements, including (1) the cost per student of a regular education program, (2) adjustments to reflect variations in resource costs, and (3) program cost differentials for special education, bilingual education, compensatory education, career and technology programs, and gifted and talented students education programs.

The following formula would be used in order to determine the guaranteed yield amount that a school would receive for each classification of student:

GYA = GL x S x SM x DTR x 100

GYA is the guaranteed yield amount, i.e. the amount of money the school would receive for the program.
GL is the guaranteed yield level, which would be set at $53.15 in CSHB 4 or any higher amount set in the general appropriations bill.
S is the number of students who attended the specific program, computed on average daily attendance. For special programs, it is the number of full-time equivalent (FTE) students in that program.
SM is the student multiplier for particular programs.
DTR is the district's tax rate, up to the maximum of 70-cents per $100 of property valuation.

For example, the guaranteed yield calculation for a school district with one thousand students in the regular program (SM =1.0) at a 70-cent tax rate would be as follows:

GYA = \$53.15 x 1,000 x 1.0 x \$.70 x 100 = \$3,720,500 = \$3,720.50 per student

The same formula would be used for each of the 17 special program multipliers. For example, if a school had three FTE students in a homebound special education program (SM = 5.0):

GYA = \$53.15 x 3 x 5.0 x \$.70 x 100 = \$55,807.50 = \$18,602.50 per FTE student

It would require 30 contact hours per week to make up one FTE student. In most special education programs, students only have one or two hours of contact time a day, so the funding for one FTE student actually reaches several students.

Once the formulas were calculated for each student multiplier available to the district, the GYAs for each multiplier would be added together to get the district's basic program cost. This cost, in turn would be adjusted by formulas for the variable cost of education and for size or population of the district, when applicable. Next, a transportation allotment, calculated the same as the current transportation allotment, would be added. The final sum would represent the total amount of money that a school would be eligible to receive under the basic program guaranteed yield tier.

Cost. The guaranteed yield for M&O would increase the cost to the state by approximately \$12.45 billion in the fiscal 1998-1999 biennium.

Supporters say the change from a two-tiered basic allotment and guaranteed yield system to a single-tiered guaranteed yield system would simplify the funding formula for the basic program. While the number of calculations involved in this system would still be extensive, it would not come close to the complexity of the current system. The simplicity would also allow the Legislature to more closely monitor the system and determine which parts are working and which programs were not fulfilling their potential. The current system makes it so difficult to change one factor without affecting other programs that most proponents of change are reluctant to suggest any modifications.

The Legislature has a constitutional obligation to provide for an adequate and efficient public education system. The Texas Supreme Court has held in the series of four *Edgewood* cases that an adequate system is one that meets the accreditation standards set out by statute and the Texas Education Agency (TEA). An efficient system is one in which all districts are given access to similar levels of funding at similar levels of tax effort. A system based on residential property only would diminish the differences between the poorest and the wealthiest districts because it would eliminate the wide wealth disparities caused by significant differences in business property values. The result would be a constitutionally efficient system.

The Texas Supreme Court has consistently said that an efficient education system would have to rely more on state funds than on local property taxes. Because local property values are so disparate across the state, any system that relies on those values to fund a majority of the cost of education will necessarily create inequities. Even in the flattened out system created by removing the commercial property base from local values, there would still be differences in wealth levels. Thus, in order to ensure the constitutionality of the system, the state must fund as large a share of the system as possible.

By creating an efficient system, CSHB 4 would eliminate the need for recapture, which takes money away from the wealthiest school districts and redistributes it to other districts, either directly or as state aid. Recapture has been criticized since its adoption, but was seen at the time to be the only way to create a constitutionally equalized system. Eliminating recapture would mean that wealthy districts no longer would be penalized for a factor that they cannot control — the property values in their district.

CSHB 4 is carefully constructed and could fully fund the needs of Texas schools while reducing property taxes. The amount of money that would be dedicated to public education though this bill is the same amount called for in the appropriations bill when a two cent increase in property taxes across the state was factored into the system, and CSHB 4 would meet the needs for enrollment growth and inflation as well. Additionally, the tax bases that would be tapped to provide property tax relief are tax bases that will continue to grow with the economy of the state.

CSHB 4 would not undercut but rather enhance local control over education programs. The current Robin Hood system effectively limits district flexibility to raise revenues for special needs. CSHB 4 would do away with this system and restore local control to local revenue decisions.

Opponents say under the system as proposed, there is no way to tell whether the amount of revenue raised by shifting taxes would be sufficient to cover the cost of education in the next biennium. The calculations used by the LBB and the Comptroller's Office are estimates for the next biennium, both for education costs and tax revenues. If the system is designed without significant breathing room to cover miscalculations in those estimates, schools across the state may run out of money before the next legislative session.

Creating a system in which the state is almost entirely responsible for the cost of education would be fiscally dangerous. While the state should be responsible for a large share of the cost, local districts should not be stripped of their ability to raise revenues should the state not meet its obligations. In the proposed system, if the state does not budget enough money for a particular district, that district would have no way to raise the operating revenue it needed. Under the current system, if the state fails in its obligations, the district can simply raise local property taxes by a penny or two. Under CSHB 4, a district would have significantly less property wealth and would thus be forced to raise local revenues many times higher than it would have to under the current system to make up for a similar shortfall.

Making the state responsible for the cost of education also would tend to remove some of the ability local districts may have in controlling their educational program. SB 1, the Education Code revision enacted in 1995, significantly increased local control of school districts; moving all funding decisions to the state level could undercut those gains. There is a correlation between funding and control. Because the Legislature would gain near total control over the revenue sent to schools and because that revenue stream would be even more unpredictable due to its inclusion in the appropriations process, local school boards would have no way to control their education programs nor make any long-term plans.

Student Multipliers

Current law sets out a number of weights that increase the amount of money a school can receive from the state based on the classification of students. The weights generally fall into five categories: special education, bilingual education, compensatory education, gifted and talented programs, and career and technology programs.

CSHB 4 would retain the same weight structure that exists in the current system. The weights would now be called student multipliers and moved into one section of the Education Code.

The LBB would be authorized to conduct biennial studies of the funding elements and multipliers to determine if they should be adjusted to better reflect the cost of educating students in these particular categories.

Supporters say in any education system there are certain populations of students that require proportionately higher costs to educate than others. These students should not be penalized because they are in special programs. Rather, the programs should be funded according to the student's needs. The weighting system continued in CSHB 4 has been designed over a number of years to reflect the needs of students in the various programs. CSHB 4 would not change the calculation of funding for these students in any way other than to reflect the new single-tiered system.

Opponents say creating classifications of students and basing funding on those classifications creates a system where schools are driven to classify as many students as possible as "special." Such classifications, while necessary for funding, are not always what is appropriate for the education of the student. Setting different levels for funding various programs also tends to drive schools to classify students in ways that will create the greatest total funding allowance.

CSHB 4 would do nothing to change the weighting system, that system should be simplified or done away with. If it is not possible to examine all the weights this session, the section defining the weights should be written to expire after the next regular session in order to create an impetus for an in-depth examination by the next Legislature of whether they are detrimental to students.

Special Program Funding

Current law funding of special programs is greatly affected by a practice known as "set asides." Under the Education Code, the commissioner and the State Board of Education (SBOE), in varying capacities, are authorized to withhold funds allotted under these programs and distribute the funds in a different manner. The SBOE is authorized to set aside funds for program administration. The commissioner may set aside funds for extended year programs, school counselors, pregnant students, TAAS study guides and other unanticipated expenditures.

CSHB 4 would eliminate provisions that require the commissioner to set aside portions of the funding provided for special programs. Certain special education and compensatory education programs, extended year programs, programs for pregnant and parenting students, and programs for gifted and talented students that formerly received funds set aside by the commissioner would now be funded directly by legislative appropriation, with the commissioner distributing appropriated funds to those programs.

Student counseling, which has been funded through similar set aside provisions, would also be funded by appropriation. Other costs formerly paid for by set asides would be funded by appropriations for those specific purposes. These would include the costs of developing and distributing certain study guides for parents of students who failed one or more parts of the TAAS test and the cost of administering the TAAS test itself.

CSHB 4 also would require the commissioner to establish rules for determining administrative costs for the various special programs rather than leaving the decisions the discretion of the SBOE.

Supporters say CSHB 4 would not cut the funding of any of these programs in any way, but move the funding from a set aside to an appropriated line item. In this manner, each program could be examined by the Legislature in the appropriations process and funded as needed.

Many of the changes proposed by CSHB 4 are designed to increase the flexibility of the system. The bill would allow these items to be examined in the appropriations process so that items that need to be expanded could be considered on their merits and increased individually without having to modify the whole finance system. Giving the commissioner rulemaking authority over administrative costs would create more accountability over the administrative aspects of these programs.

Opponents say that while CSHB 4 would not cut the funding of these programs, putting these important programs as individual line items in the appropriations process would make them subject to potential budget cuts if they became politically unpopular.

Abolishing the Foundation School Budget Committee

Current law establishes a Foundation School Budget Committee (FSBC), composed of the governor, the lieutenant governor and the comptroller. It is responsible for determining the amount of money to be used in the school finance system and may adopt rules for calculating all funding elements, including the basic allotment, the guaranteed yield, student weights, district multipliers, and enrichment and facilities rates.

CSHB 4 would abolish the Foundation School Budget Committee and move its estimating responsibilities to the LBB. Actual decisions on the amount of money to appropriate for the various guaranteed yield levels, as well as funds for the enrichment, existing facilities and new facilities tiers, would be determined through the appropriations process.

CSHB 4 would also move authority for many decisions made by the SBOE in determining school finance issues to the commissioner of education.

Supporters say the FSBC has not adequately served its purpose of keeping up with the needs and changes of Texas public schools. One of the significant problems with the committee is that the members cannot make changes that would have a significant impact on the budget of the state without the Legislature’s approval through the appropriations process.

The LBB is currently doing nearly all of the tasks that would be assigned to it by CSHB 4, and the Legislature through the appropriations process is already primarily in charge of determining how much more money can be given to schools each biennium. Removing the unnecessary step of having education funding set by the FSBC would allow the process to operate even more smoothly.

Changing the authority for set asides from the SBOE to the commissioner also would make for efficient operations. The SBOE, while an important elective body, often cannot agree on any changes to funding mechanisms because of the political issues that arise in a 15-member board. Moving these functions to the commissioner would provide for greater flexibility and budgeting more appropriate to the actual funding needs.

Opponents say moving the decisions affecting schools funding from the elected officials on the FSBC and the elected SBOE to the commissioner and enveloping those decisions within the appropriations process for the entire state budget would reduce accountability.

District Cost Adjustments

CSHB 4 would retain the adjustments available for small, mid-size and sparse districts. The formulas would be adjusted in order to conform with the move to a single tier system. The cost of education index (CEI) also would remain as is, with the multiplier used for its calculation adjusted to reflect the move to a single tier for M&O.

Supporters say the cost of education must be adjusted for factors outside of a district's control. It is an economic fact that student costs are higher proportionately for a small district than for larger ones that enjoy economies of scale. The small, mid-size and sparse adjustments under CSHB 4 would be identical in application to those currently used.

The cost of education adjustment considers the salaries of teachers in adjacent districts, county population, district type, percentage of low income students, and total number of students. It has been in place since 1990 in basically the same form. It is necessary to supplement the financial needs of all districts and should be continued at its current levels.

Opponents say district adjustments should be examined just like other weights to determine if they are truly needed. A disturbing aspect of the current structure is that the size of a district is counted both in the small or mid-size adjustment and in the CEI. Some say the amount of money these smaller districts actually need is only gained when both of these calculations are made, others claim the double calculation may be a way to hide exactly how much more small districts are receiving over other districts. One suggestion would be to make the two calculations a single adjustment so that the actual impact of the small district weight can be easily determined.

Other opponents say the district level adjustments in CSHB 4 would not take into consideration an increasingly necessary factor — the special costs of fast growing districts. While much of these costs may be addressed by the new facilities component of the system, other costs in district operations must be addressed by a weight or CEI adjustment.

Hold Harmless Provisions

Current law as enacted in 1993 contained a hold harmless provision for those districts that would not be able to raise the amount of money they had been receiving before 1993 under a $1.50 cap. Those districts are allowed to raise their rates over $1.50 to make up that difference.

CSHB 4 would include a two-year hold harmless provision that would fund any district to the level of funding it would have received for the 1997-1998 or 1998-1999 school years if CSHB 4 had not been enacted. CSHB 4 would not allow a hold harmless district to raise its tax rate above the 70 cent basic program guaranteed yield cap in order to receive these funds; instead, any funds necessary would be sent directly to the district from the state as part of the regular guaranteed yield payment schedule.

Districts subject to the current hold harmless provision would be able to retain that level of funding under CSHB 4. The commissioner of education would determine the hold harmless amount to which a district would be entitled, and that determination would be final and unappealable.

Cost. The hold harmless provision for current projected M&O revenues would add approximately $205 million to the cost of funding schools for fiscal 1998-1999.

Supporters say the hold harmless system is an essential component of any change in education funding. Without a hold harmless provision, some districts would experience a loss in funding as a result of the changes to the system. CSHB 4 attempts to create a system that works for the vast majority of schools. Those that would receive their current level of funding under this system must not be hurt by its implementation.

The hold harmless provision in CSHB 4 would expire in two years, forcing every district that received money under it to closely examine its education spending. Because the hold harmless funding in future years would be subject to the will of the Legislature, districts held harmless under CSHB 4 would have significant incentives to examine their spending and justify their variation from the system. Legitimate reasons do exist for funding variations, but the system should no longer blindly accept the rationale that current funding levels must be continued without justification.

The hold harmless provision would operate independently of the local enrichment function; in the current system, the two are tied. A district must increase its tax rate to keep funding at the previous year's level and only then can it provide enrichment for new programs. The hold harmless provision in CSHB 4 would ensure that a district would receive all it needs for its basic program through a 70 cent tax rate. Enrichment beyond that rate could then be used to develop unique programs that add to the basic program.

Opponents say funding the hold harmless provision for only two years would create uncertainty for those districts that would be adversely impacted by CSHB 4. These districts would be forced come back, hat in hand, each session to beg the Legislature to continue funding their districts at the levels they need to maintain current education programs. The hold harmless provision in CSHB 4 is vastly different from the current provision. The hold harmless provision in CSHB 4 would act as a subsidy to the district, and thus, would likely be the first thing cut if the system ran short of money.

Other opponents say many of the districts that would benefit from this hold harmless provision are already spending much more money per student than the districts in the rest of the state could ever hope to spend. If Texas is to ever have an efficient system, it should not spend its limited resources subsidizing the inflated budgets of a few districts, but should instead spread that money out to all districts to raise the overall guaranteed yield level.

Tier II - Local Enrichment/Existing Debt Service

CSHB 4 would establish a second tier of state aid that could be used to service existing debt or fund local enrichment. The maximum tax rate allowed in this tier for equalization would be 10 cents.

Districts with existing debt service would be allowed to use state aid to compress existing tax rates. State aid received for existing debt service could only be used to pay principal and interest on existing debt service. For existing facilities, a guaranteed yield amount would be determined by the following formula:

GYA = (GL x ADA x DTR x 100) - LR

GYA is the amount of state funds the district would receive for existing debt service.
GL is the guaranteed yield level, set in CSHB 4 at $21.35 per penny of tax effort or any higher amount set in the general appropriations bill.
ADA is the number of students in average daily attendance.
DTR is the existing debt service tax rate.
LR is the amount of local revenue raised by the existing debt service tax rate.

Under this formula, state aid would go only to districts with revenue per student per penny of I&S tax effort of less than $21.35.

Under CSHB 4, if the amount of money appropriated for existing debt service was not sufficient to cover the amount to which each school district was entitled under the guaranteed yield formula, the commissioner would have to transfer from the basic program enough money to meet such needs and reduce funds in the basic program as appropriate.

Those districts that would not qualify for state aid for existing debt service because their local revenues were greater than the yield amount or that had no existing debt service could, with voter approval, raise residential property tax rates by as much as 10 cents to fund local enrichment. Any school district receiving state aid for existing debt service at less than 10 cents of tax effort could use the remainder for local enrichment, with voter approval.

Local enrichment revenues would receive state equalization according to the following formula:

GYA = (GL x AADA x DTR x 100) - LR

GYA is the amount of funds the district would receive from the state for enrichment equalization.
GL is the guaranteed yield level, set at $9 in CSHB 4 or any higher amount set in the general appropriations bill.
AADA is adjusted average daily attendance, essentially the number of weighted students.
DTR is the district's enrichment tax rate.
LR is the amount of local revenue raised by the enrichment tax rate.

Using this formula, districts with local revenues of less than $9 per weighted student per penny of tax effort would be eligible for enrichment equalization funds from the state. The amount of state aid available would be computed according to the district's tax rate for the second year of the preceding biennium.

For the 1997-1998 and 1998-1999 school years, districts could not raise rates higher than 70 cents or 2.5 cents above the current effective tax rate, whichever was lower.

Funds raised by a district in the enrichment tier could be used for any lawful purpose, including capital outlay and debt service. The commissioner would be responsible for distributing funds to schools for local enrichment.

Cost. The new tier for existing debt service tier would cost the state an additional $300 million for the fiscal 1998-1999 biennium, but these costs would be partially offset by eliminating of the current $170 million facilities program (see below). The local enrichment tier would not incur any costs for fiscal 1998-1999; the projected cost of the tier if districts raised the full 2.5 cents authorized by the bill would be $3.5 million in fiscal 2000 and $10.5 million by fiscal 2002.

Supporters say the new second tier of state aid would benefit local districts by guaranteeing state funding for debt service and allowing districts to use additional equalized revenue for enrichment programs.

Many districts now set a rate for debt service that allows them to make payments on that debt entirely from local revenue. That local revenue draws additional state aid that a district then may use for maintenance and operations. Under CSHB 4, maintenance and operations would be fully funded through the guaranteed yield, so that any state assistance received for debt service could be used to significantly lower the rate assessed to taxpayers for debt service. Such action, known as tax rate compression, would result in a lower I&S tax rate to property owners in the affected districts. Compression would be particularly helpful to those districts with high I&S tax rates, but every district with an I&S tax rate over 40 cents should see some compression of their rates under the proposed LBB model.

Under the current system, local enrichment — supposedly allowed for in Tier 2 — has been used in most school districts to fund facilities. Under CSHB 4, local enrichment could also be supplemented by a guaranteed yield so that even the least wealthy districts could use enrichment measures to improve the quality of their schools.

Local enrichment is an integral part of school finance. It allows districts to develop innovative or special programs that the residents of the district want to include in their education program. In order to raise this revenue, a school board would have to tell the voters what programs they planned to create with this additional money, and the voters, through the election process, would have to approve the creation of those programs.

Local enrichment has been specifically authorized by the Texas Supreme Court. In *Edgewood IV*, the court stated that once the school finance system was substantially equalized, some unequalized local enrichment would be allowable.

Opponents say the goal of the system proposed by CSHB 4 may be laudable: give some relief for payment of existing debt service and equalized local enrichment while still remaining in reasonable budgetary constraints. However, the effect of such a compromise would be that no school would receive a completely adequate amount of money.

For existing debt service, the amount of state aid available would be set by appropriation and cover only districts that could not raise $21.35 per student per penny of tax effort. This is a low threshold that could be lowered even further in the appropriations process.

The structure developed by CSHB 4 and the revenue projections for the first biennium would mean that no school district could tap the 10-cent rate allowed for local enrichment until 1999. Even when enrichment was allowed, the guaranteed yield set in the bill is so low that only the poorest school districts would be able to benefit from any state aid for local enrichment.

Other opponents say that local enrichment should not be limited to only 10 cents. Because a district's voters would have to make the choice to tax themselves over the 70 cent rate, they should be allowed to go as high as they want in order to improve their schools. If district voters wished to tax themselves at a rate sufficient to put a computer on every desk in every school, they should be allowed to do so.

Tier III - New Facilities Funding

Current law under SB 1, enacted in 1995, provides for distributing state assistance for instructional facilities to low property wealth and high growth districts. To qualify for state assistance, a district had to have a property wealth per student lower than $276,000 and a total effective tax rate of $1.30 or a debt service tax rate of at least 20 cents.

The 74th Legislature appropriated $170 million to the instructional facilities assistance program. Districts could only apply for one project and were limited by the size of the project in relation to the number of students in the district. The entire $170 million was dispersed to districts, but many more qualifying districts applied for the funds.

CSHB 4 would fund new instructional facilities, using a guaranteed yield system. The following formula would be used to determine the amount of state aid a district was entitled to:

FYA = (FYL x ADA x BTR x 100) **-** (BTR x (DPV÷100)

FYA is the facilities yield amount, i.e. the amount of state aid a district would receive.
FYL is the facilities yield level, set in CSHB 4 at $36.40 or any amount higher set in the general appropriations bill.
ADA is the number of students in average daily attendance.
BTR is the bond tax rate for the current year.
DPV is the district's property value for the current year used to pay debt service taxes.

The calculation of BTR x (DPV÷100) would be equivalent to total revenue raised by the local district.

CSHB 4 would limit eligibility for state assistance for new facilities to bonds issued after September 1, 1997, with a weighted average maturity of at least eight years and subject to being called for redemption no earlier than 10 years after issuance. The bond tax rate set for repayment could not exceed the amount needed with state assistance to repay the bonds; however, that rate could be increased in order to ensure that enough taxes were actually collected to fund the local revenue share of the debt service.

Districts would have to apply to the commissioner for state facilities funds. The commissioner, in determining which districts would receive funds, would rank the districts by wealth level. Those with the lowest wealth level would have priority in state assistance. A district that applied for state assistance but did not receive it would have its wealth level reduced by 10 percent when it reapplied in the next fiscal biennium.

State facilities assistance would be guaranteed until the bonds were fully paid or the facility was sold. The amount a district would receive per student per penny of tax effort could not be decreased during that time but could be increased.

The maximum amount any district could receive would be limited to the greater of $100,000 or $250 per student per the amount of actual debt service payments for the biennium, whichever was less.

The facilities guaranteed yield could be used to fund lease purchase agreements paid for from a district’s M&O tax revenues.

CSHB 4 would require that the commissioner rather than the SBOE establish standards for the adequacy of school facilities. All facilities constructed after September 1, 1998, would have to meet these standards to be eligible for funding from state or local tax revenues.

Projects funded jointly by two or more districts would be entitled to a guaranteed yield amount per district that was 20 percent higher than the amount to which each individual district would normally be entitled.

If an instructional facility financed with bonds paid for by state and local funds were sold before the bonds were fully paid, the district would have to remit a portion of the net proceeds to the state based on the amount of state funds used for debt service.

Cost. The new debt tier would cost the state an additional $110 million for the fiscal 1998-1999 biennium, based on assumed issuance of $2 billion in new debt.

Supporters say one of the most significant costs for schools is facilities. The need for facilities is constant, as old facilities must be replaced and new facilities built for a growing student population. Facilities are normally paid for by bonds approved by the voters of the district. The voters then must pay property taxes in order to make payments on such indebtedness.

In districts where the student population is growing faster than normal, the need for facilities is even greater. While the tax base of such districts is growing, the startup costs of building enough facilities to house the new students often significantly outweigh the new growth. Under the current system, those districts that are already charging the maximum tax rate to cover M&O expenses do not receive any state aid for facilities. Under CSHB 4, a district could receive state aid for facilities no matter what its level of M&O taxes, so long as it qualified for the guaranteed yield and adequate money was appropriated.

The new facilities funding system proposed by CSHB 4 is designed to help districts that otherwise would not be able to raise enough money because of their lack of property wealth. Thus those districts with the lowest property wealth would receive first draw on the money appropriated for new facilities. However, the bill also recognizes that districts with reasonably high property wealth also need help to fund facilities, and so any district that did not receive state aid due to its wealth in one year would have its wealth level reduced the next time it applied, thus increasing its chances of receiving aid.

CSHB 4 would separate the funding for existing debt and new debt into two funding tiers. Resources would first be used to achieve faster repayment of existing debt, then moved to building new facilities. If the two were combined as they are now, those fast growing districts that already have significant debt service would have difficulty in receiving state aid to help pay for new facilities. The two-tiered approach would allow these districts to pay off existing debt and receive state aid for new facilities so long as they qualified for both programs due to their property wealth levels.

It is only fair to include non-residential property in the I&S tax base for school facilities. The system envisioned by CSHB 4 would tax residential and non-residential property at the same rate for existing debt service and new facilities construction. The state property tax proposed by CSHJR 4 and capped at $1.05 in the Constitution would apply only to M&O tax rates.

Opponents say the new facilities tier proposed by CSHB 4 would not ensure adequate funding of facilities because it would be based entirely on legislative appropriations. If the Legislature did not adequately fund the program, districts would not be able to use state aid to meet their facilities needs. Under the current system, those districts that fall below the equalized wealth level with tax rates under $1.50 will always receive some amount of state aid for their new facilities projects. Such assistance would not be guaranteed under CSHB 4.

The system proposed by CSHB 4 would create a pyramiding effect on state spending. Funding for the first biennium of the program at $100 million would have to continue for the next 20 years, the average life of new facilities bonds. If the program were funded at an additional $100 million in the second biennium, for the next 18 years the funding floor would be $200 million. Assuming just $100 million is added each biennium, by the time the Legislature reached the half-way point in the 20-year cycle, the funding floor — the amount of money needed to keep up with existing obligations — would total $500 million. It would be very difficult for the Legislature to fund this level of increase for facilities after the first few years of the program. There is no way to project what the economy of the state will be for the next 20 years. It is likely that this facilities program would eventually run out of steam and leave a number of districts that had been counting on the assistance to fend for their own facilities needs with a tightly restricted level of local property taxes.

Business property should be excluded from new I&S tax bases. In many instances, owners of business properties located in a school district are subject to the tax, but do not get to vote for or against bond issuance because they do not live in the district. Also, when there is a very large business tax base in a district, the I&S tax rate imposed by new bonds may seem small to the residential owners who vote for it, but the impact it has on businesses could be significantly larger. The maximum amount a business could be forced to pay in I&S taxes should be capped in the Constitution along with the M&O rate.

Teacher Salaries

Current law, enacted in 1995 as SB 1, established a new minimum teacher salary schedule, creating a base salary for 1995 in law and raising the minimum salary for beginning teachers by $1,500 a month in 1995 and an additional $1,445 a month in 1996. It established a 20-step pay scale that increased with each year of service. The 74th Legislature also enacted a formula to adjust the salary schedule upward based on increases in funding.

CSHB 4 would statutorily set the minimum salary schedule for teachers in the 1997-1998 and 1998-1999 school years at the level of the 1996 school year. It would establish formula factors for increasing the minimum salary schedule in future years when the guaranteed yield level was increased. If the guaranteed yield level did not increase in the fiscal 1999-2000 biennium, these salary factors would keep teacher salaries at current levels.

CSHB 4 would also fund an experienced teacher allotment for districts where minimum salaries for teachers and librarians were at least three percent higher than the statewide average minimums. A district could receive the difference between the minimum salaries it paid its teachers and librarians and the statewide average multiplied by 1.03.

Cost. The additional cost to the state for the experienced teacher allotment would be approximately $46 million for the fiscal 1998-1999 biennium.

Supporters say CSHB 4 would simplify the appropriations process for determining and managing teacher salary increases. It would improve on the formula developed in SB 1, adjusting the salary schedule based on increases in the guaranteed yield. CSHB 4 would not generate across-the-board increases in the current biennium, but according to LBB estimates, no increases would have been made under SB 1 because the funding per student would not have been increased for the fiscal 1997-1998 biennium.

The salary factors included are exactly the same as those that were included in SB 1 but they have been adjusted to reflect the new formula for future salary increases. By tying that formula to the amount set for the guaranteed yield, teacher salary increases could more easily be managed and determined in the appropriations process.

However, under CSHB 4, the minimum salary step schedule would still remain in effect, so all teachers who were on that schedule or whose salaries were based on that schedule would get pay increases for each year of the coming biennium.

In order to meet the growing salary needs of districts, CSHB 4 would include an experienced teacher allotment. This funding would help those schools where average minimum teacher salaries were higher than the statewide average meet the cost of the mandated salary schedule increases for teachers with more experience.

Opponents say the bill would fail to provide for any increase in teacher salaries, one of the most neglected items in school finance. Teachers are the most essential part of the education system, but Texas teacher salaries are below the nationwide average and will continue to fall unless significant increases are made.

SB 1 took a significant step toward national comparability by tying future teacher salary increases to increased state spending. Because the state would almost always have to increase state spending to meet enrollment growth needs, this provision became an automatic teacher salary increase mechanism. In statutorily setting the 1997 and 1998 minimum salary schedule at 1996 levels, the Legislature would be reneging on its promise that teachers salaries would be increased based on increased state spending.

Removing a significant portion of the tax base from local districts would make it more difficult for those districts to raise money to provide salary supplements to the minimum salary schedule. Districts that wish to provide such incentives to attract the best teachers could do so only by reducing spending in other areas.

Other Issues

Rollback provisions. CSHB 4 would prohibit a district from receiving revenue from tax rates greater than 70 cents or 2.5 cents higher than the current year's effective tax rate, whichever was lower.

Supporters say this provision is necessary to ensure that districts would not use the opportunity of a dramatic drop in rates to increase tax rates higher than they would normally be allowed to any ordinary year.

Opponents say that because CSHB 4 makes such dramatic changes to the system, districts could have significant revenue shortfalls. If such shortfalls occur, the districts should be allowed to increase taxes.

Comptroller's determination of district property values. Under CSHB 4, the comptroller would retain responsibility for determining the total value of taxable property in each district to calculate school funding formulas. The comptroller would also be required to determine the property value subject to M&O taxes and the value subject to existing I&S taxes. The calculation of the taxable value in the district for each tax base would remain as it is in current law.

If the final determination of an appraisal appeal on the taxable value of property in the M&O tax base reduced the total taxable property value for M&O by five percent or more, the commissioner would request that the comptroller adjust the district's property value to reflect such a determination.

Supporters say it is proper that the Comptroller's Office continue its function of calculating district property values. The only changes CSHB 4 would make would be to distinguish between M&O and I&S tax bases in order to make the calculations required by the bill's funding formulas.

Opponents say this imposition on the Comptroller's Office as well as the new duties required by increased tax collections would require more employees, adding additional costs to the program.

Penalty for tax collections. CSHB 4 would penalize districts that failed to collect taxes for both M&O and I&S tax bases by withholding a portion of state funds. The comptroller would be required to compute the amount of revenue a district would have received if it had collected all the taxes owed, according to the property values determined by the comptroller.

The difference between these figures would be certified to the commissioner in the following tax year. The commissioner then would be required to reduce the amount of state aid the district received for the current year by the comptroller-certified amount.

A school district could ask that the amount be modified it had failed to collect the taxes levied because of a factor beyond its control.

Supporters say district tax collection rates would be an important part of the new finance system. Because the state would pay for 80 percent of the cost, districts must ensure that they collect adequate local revenues to meet the remainder. The penalty for failing to collect taxes could be modified for factors beyond a district's control, but it would force those districts that had been lax in the past to attempt to optimize collections.

Opponents say that basing tax rates on the comptroller's valuation of district property would effectively remove any authority by the local appraiser to appraise values differently. Furthermore, schools should not be penalized for problems in collecting taxes. This provision would have a greater impact on low income districts because they generally have lower collection rates.

Technology Allotment. CSHB 4 would repeal the provision enacted in SB 1 allowing the SBOE to set aside additional money to fund the technology allotment over and above what was appropriated.

Supporters say this change is necessary to retain control over the budgeting process of the state. If legislation other than the appropriations bill could make an appropriation, the state would lose control of its finances.

Opponents say schools were promised the total amount SBOE determined was available to fund the technology allotment. Allowing this sum to be reduced simply because it was not included in the appropriations bill would mean the state could give with one hand and take away with the other.

Installment Periods. CSHB 4 would revise the payment schedule for disbursing state funds to schools. Under the new schedule 15 percent of the total amount due would be paid by the 25th day of both August and September. Seven percent would be paid by the 25th of each of the other 10 months.

Unpaid funds from the previous school year would be included in the September payments to the districts. Payments could be adjusted to correct prior error in allocation or distribution of funds.

Supporters say the proposed installments would guarantee sufficient cash flow throughout the school year while providing necessary start-up costs at the beginning of the academic year. In addition, the payment schedule would help the state maintain adequate cash flow.

Opponents say districts should receive either the entire amount or a more significant portion at the beginning of the school year. Districts are governed by elected school boards and have budgeting and accounting procedures; they should not be forced to act like a child waiting for a parent to dole out a monthly allowance.

Funding charter schools and other special schools. CSHB 4 would provide for funding open enrollment charter schools and other special school districts. Funding for districts without a residential tax base and for open enrollment charter schools would be based on the average M&O tax rate for all districts in the county. These districts also would be subject to the general hold harmless provisions. CSHB 4 would continue to fund certain other special schools, such as the Moody State School for Cerebral Palsied Children and the Texas Academy of Leadership in the Humanities at the same levels as current law.

Supporters say CSHB 4 would keep revenues for schools or districts without a residential tax base at current levels. The bill would also fund charter schools in such a way as to allow them to retain current revenue levels, while making the calculation of those revenues consistent with other districts in the state.

RESIDENTIAL PROPERTY TAXES

Definition of Residential Property

CSHB 4 would define residential property to include single and multifamily residences, mobile homes, and the residential portion, not to exceed 20 acres, of farm and ranch property. It would specifically exclude from the definition of residential property a hotel or motel and agricultural or timber land.

Supporters say the primary purpose of CSHB 4 is to provide residential property tax relief. To that end, it would give the greatest amount of property tax savings to residences.

Businesses would also see some tax benefits because business owners would receive property tax savings on their residences. Businesses account for the majority of taxable property in the state and should be required to pay their share commensurate with their means.

Opponents say the law should not distinguish between residential and business property for the purposes of taxation. It is blatantly unfair to tax landowners differently based on the use of their property. A more equitable approach to raising needed revenues would be to tax all property at the same rate.

Other opponents say multifamily residences with four or more separate units should be considered commercial property and taxed at that rate.

Residential Property Tax Rates

CSHB 4 would set a statewide cap of 70 cents per $100 of valuation on residential M&O tax rates. A district could raise that cap to 80 cents with voter approval. Tax rates for existing I&S debt would remain at the same level to the extent they were not affected by state aid for existing debt service. Rates for new debt would be determined by the amount of bonds voters approved under procedures established in current law.

Supporters say under CSHB 4 the average residential M&O property tax rate would drop from $1.30 to 64 cents and the average existing I&S tax rate from 18 cents to six cents. For most residential property owners, the savings in property taxes would more than make up for increased sales taxes.

Opponents say these rate reductions would come at a substantial cost in other taxes. The majority of people who would benefit from these reductions would not return the same amount to the system through other taxes. In effect, CSHB 4 would shift the tax burden from rich to poor and from residential property owners to businesses.

Renters Property Tax Relief

CSHB 4 would require landlords who rent four or more residential dwelling units to register and report property tax savings to the comptroller. Reporting would not be necessary for properties subject to the state property tax or any property that did not exist or did not include a habitable dwelling unit on January 1, 1996.

Landlords would have to file a registration and report to the comptroller by January 31 of 1998, 1999 and 2000 covering the preceding year. The report would identify the dwelling units and their owner, the amount of school property taxes paid for the years, the appraised value and taxable value of the property and information regarding renters, including their names and addresses.

For the years 1997, 1998 and 1999, the landlord would have to pay a fee to the comptroller equal to the difference between the amount of property taxes paid for that tax year and the amount that would have been collected at the property tax rate in effect for the 1996 tax year. Increases in appraised value due to improvements in the property could be deducted from the taxable value of the property used for the fee calculation.

A landlord would be entitled to a credit against the fee imposed for any rent reduction given to tenants for that tax year, based on the rents in effect as of January 1, 1997. Rent reductions to family members could not be used in calculating the credit.

The fee owed would be prorated for any time during the tax year that the landlord did not own the property. The fee would be subject to the normal enforcement and collection provisions of the Tax Code. The monies, less a deduction for program administration, would be rebated to the renters of those landlords who submitted fees. Rebates that could not be returned to a renter would be transferred to general revenue. At no time would the state be liable to a renter for any amount exceeding the fee actually received or collected from the landlord.

The section authorizing the renters' property tax relief would expire January 1, 2005.

Supporters say renters pay property taxes through their rents and thus property tax savings generated by CSHB 4 should be passed on to them. The fairest system to spread these savings is by having landlords reduce the rents by the amount saved in property taxes.

The alternative "circuit breaker" approach proposed by some would be very costly to administer. Furthermore, because that approach considers both income and rent paid, it would force some renters to subsidize rebates to other renters. The system proposed by CSHB 4 would be much more administratively efficient because the costs for running the program would come directly from the fees paid by landlords to the comptroller. It would also ensure that renters would get tax savings proportional to the savings on the property they rent.

CSHB 4 would establish a cutoff for the program at property with four or more units to keep the administrative costs of the system low. Where rental properties have fewer units, tenants are likely to have a better relationship with the landlord and should be able to negotiate a reduction in their rent without having to register with the comptroller. Frequently, renters of single family residences are liable for the property tax bill, so that calculation could simply be adjusted when the tax rate is lowered.

Opponents say including only renters in property with four or more units would not help a significant number of renters. Furthermore, the bill is unclear as to whether it would apply to landlords who rent or lease four or more units on a single piece of property or to landlords who own four or more units considering all their property. Either way, this legislation would still not reach a significant number of low income renters. A significant number of renters live on property with fewer than four rental units. And most of the single unit dwellings are leased by owners who have only that one unit.

CSHB 4 would not address the needs of low income renters who would be more substantially impacted by increases in regressive taxes such as the sales, utility, tobacco and alcoholic beverage taxes. Low income renters would receive the same relief as renters with high incomes, who would not be affected as greatly by the increases in other taxes.

A better proposal would be to allow low income renters to receive a rebate on part of their rent from the new state tax revenues. Such a “circuit breaker” would provide greater rebates to low income renters and those with high rents in relation to their income to offset the costs of other tax increases. The circuit breaker could be designed to also help the elderly and disabled. Circuit breaker plans are used in other states with great success.

STATE PROPERTY TAX

CSHB 4 would create, subject to approval of HJR 4, a state property tax to be levied on nonresidential property at a rate of $1.05 per $100 of property valuation. The $1.05 tax rate would apply only to the maintenance and operation (M&O) portion of public school taxes and would not affect current tax rates for school district interest and debt service (I&S). The state property tax would take effect September 1, 1997, and would apply to property on the tax rolls on January 1, 1997.

The property subject to the state property tax would be appraised by the local tax appraisal district, and the taxes would be assessed and collected by the local tax assessor-collector or the entity designed by the local county commissioners court. The state would reimburse the local tax assessor-collector for actual incremental costs of providing services for collecting the state property tax. The state would assume a share of each appraisal district's budget beginning January 1, 1998, but could withhold payment if the appraisal standards and guidelines set by the state comptroller were not followed. The comptroller and the state would not participate in governing or managing the local appraisal district.

The bill would allow a school district and the comptroller to challenge to the appraisal review board any property excluded from the M&O tax roll.

The effective tax rate would be calculated according to type of tax rate, either M&O or I&S. Two tax rolls would be maintained for purpose of calculating the two types of taxes.

The bill would require a hearing be held to consider a rollback election if a school district raised the effective M&O rate by 2.5 cents or more per $100 valuation, instead of by 8 cents or more under current law.

The attorney general would be responsible for collecting delinquent state taxes and would represent the state in judicial appeals. The attorney general could delegate collection of delinquent taxes to a county or district attorney or contract with a private attorney. If the delinquent taxes were collected by a private attorney, a penalty of 15 percent of the total amount due would be assessed on delinquent taxes collected after July 1 of the year in which they were due.

The property tax rate for individuals qualifying for the existing 65 or older tax freeze would be the lower of the tax rate the individual received when the exemption was first claimed or the 1997 adjusted M&O and I&S tax rates combined. The bill would allow individuals to transfer a proportional amount of the tax freeze from one homestead to another.

The bill also would change the tax payment that must be remitted pending an appeal to district court regarding property tax protests. A taxpayer would have to pay either the amount due on the portion of the taxable value of the property that was not in dispute or the total amount of taxes due on the property, whichever was less. The taxpayer would be liable for penalties on that portion of the tax bill that was upheld by the court if the taxes had not been paid by the due date. Reasonable attorney's fees of up to $100,000 could be paid to the prevailing party.

The bill would require the state comptroller to conduct a study of local appraisal evaluations of property subject to the state property tax in 1997 and 1998 and to submit a report to the 76th Legislature by January 15, 1999, with recommendations for the equal and uniform appraisal of property subject to the state property tax.

The state property tax would take effect September 1, 1997.

Supporters say CSHB 4 would lower the average business M&O property tax rate from $1.26 to $1.05, providing considerable tax savings to all Texas businesses, especially capital intensive business that have been shouldering a disproportionate share of state taxes. The $1.05 tax rate would be set in the Constitution, ensuring businesses that the tax rate could not be increased without statewide voter approval. The state would become responsible for 80 percent of public school funding. Increasing the state's share of school funding from 47 percent to 80 percent would ensure a more equitable method of funding quality education for all children, regardless of where they live. The statewide property tax on business in effect would eliminate the convoluted “Robin Hood” school finance system.

The statewide business property tax also would help equalize public school funding by eliminating inequities in property taxes between one district and another that are caused by disparities in the value of business and commercial property. High-value business property — particularly refineries, power plants and oil and gas production facilities — are responsible for much of the inequity in property wealth per student among school districts.

Local control would be maintained through the strong provisions enacted in 1995 by SB 1 and other provisions in the state education code. Local districts also could exercise enrichment options going beyond the basic educational program through voter-approved supplemental local tax rates of up to $0.10. These enrichment taxes also would enjoy state equalization.

Opponents say that separating business and residential property tax bases would be detrimental to business in the long run if the experience of other states that have done so is duplicated in Texas. When business and residential property taxes are part of the same system, the tax rates are linked. Once they are separated, as proposed in CSHB 4, business property owners would become more vulnerable to tax increases because generally the voters — generally residential property owners — are the ones who determine the level of property taxation. Linking business and residential property tax rates helps assure business that they would not receive disparate tax treatment.

Business property should not be treated differently from residential property to maintain a fair and equitable system. CSHB 4, however, not only proposes to have different appraisal jurisdictions but also would make the business property rate, set at $1.05, much higher than the $0.70 residential rate. At a minimum, the tax rates should be the same to maintain balance in the tax system. A tax rate of $1.10 for all property would provide property tax relief for all. The property tax crisis is not so severe that it warrants cutting residential property taxes in half.

Business wants to pay its fair share of property taxes, but does not want to be an easy target for future property tax increases. Capping the business tax rate in the Constitution would not keep the state from raising property valuations, and therefore taxes on business, when it was short of funds.

Other than the goal of getting rid of the "Robin Hood" school funding scheme, there is no good reason to separate business and residential property taxation. The ultimate effect could be a higher property tax burden for business.

The potential impact of creating a statewide tax on business property would be to reduce local control over taxation. School districts are concerned that having to rely even more on the Legislature for their funding could increase their vulnerability if the state experienced a budget crunch. Control inevitably follows funding, so a much higher share of state funds will inevitably mean more state control. Further, school districts with property wealth mainly from business property would be left with a small base for local enrichment and would be even more beholden to the state for money than districts with high value homes.

Tax Abatements

Current law, enacted in 1995, extended tax abatements until September 1, 2001, and also required the comptroller to refund state sales and franchise taxes on property located in a city and county tax abatement reinvestment zone under certain conditions.

Cities and counties can establish reinvestment zones within their territory and abate taxes on new facilities and expansion of existing facilities in the zone. A tax abatement agreement may exempt from taxation all or part of the increase in value of the real property for each year covered by the agreement. Before a city or county grants a tax abatement it must deliver written notice of its intent to enter into such an agreement with the other taxing units, such as school districts. The other taxing units have 90 days from the date of notice to enter into an identical abatement agreement or choose not to provide the abatement.

SB 7, the school finance law passed in 1993, added the value of property subject to a tax abatement agreement to the total taxable property of the school district, causing a loss in state aid. The state-tax refund enacted in 1995 offset school districts taxes, which can no longer be abated under the school finance law without jeopardizing state aid. State tax refunds are limited to $10 million a year. If the total amount of the requested refunds exceeds $10 million, the refund amount each business may receive is prorated accordingly. The refund is limited to the net amount of state franchise and sales taxes paid to the state or the total school property tax paid that year. The refund is limited to five years or to the term of the abatement, whichever is less.

CSHB 4 would require the state to honor tax abatement agreements in effect before January 1, 1997, on nonresidential state-taxed property. On or after January 1, 1997, the state would only honor tax abatement agreements on properties located in a reinvestment zone created on or before April 1, 1997, with the intent of abating city taxes; the city agreed to abate city taxes on the property on or before July 1, 1997; and the school district agreed to the abatement within 90 days.

Supporters say that the state should have to honor tax abatements already in place and those that are in the process of being created. Tax abatements are important in attracting and retaining business and the economic activity they bring to the community, and the least the state should do is honor past commitments and those that are presently being negotiated.

Opponents say that communities should decide whether to allow tax abatements. The state has been eroding the ability of communities to use this power economic development tool. CSHB 4 would effectively destroy what few tax abatement programs are still allowed by creating a statewide property tax on business property.

Open-Space Land

CSHB 4 would prohibit land from being designated as open-space land for valuation purposes if a contiguous parcel of the land was not eligible for the open-space valuation. The denial of open-space valuation would not apply if a parcel of the land was a person's homestead.

Supporters say that this provision would prohibit industry from taking advantage of open-space land designation to lower their property tax liability. The provision would close a loophole now being used by some business interests. For example, under CSHB 4 power companies could no longer put a few cows to graze under power lines, have the land designated open-space land, and pay lower taxes.

FRANCHISE TAX

Expanding Entities Taxed

CSHB 4 would expand, subject to approval of HJR 4, the corporate franchise tax to include all entities, not just corporations, doing business in Texas, except sole proprietorships and oil and gas joint operating agreements, beginning January 1, 1998. Business entities would be taxed on the higher of $2.50 per $1,000 of taxable capital or 4.5 percent of earned surplus. Taxed entities would include banking corporations, business trusts, corporations, limited liability companies, limited liability partnerships, limited partnerships, state or federal savings and loans, and professional associations and professional corporations.

The bill would exempt from the franchise tax business entities with a tax liability of $500 or less, up from the current threshold of $100 or less. Business entities exempt from the franchise tax would have to pay earned surplus franchise tax on income derived from taxable business interests.

The bill would repeal franchise tax exemptions for non-profit corporations classified under the following Internal Revenue Code (IRC) sections: 501(c)(5) (labor, agricultural, and horticultural activities); 501(c)(6) (business leagues, chambers of commerce, and real estate boards); and 501(c)(7) (social and recreation clubs). In addition, the bill would repeal franchise tax exemptions for:

- corporations with business interests in solar energy devices;
- development corporations;
- electric cooperatives;
- telephone cooperatives;
- sludge recycling operations;
- gross receipts deducted for certain food and medicine in calculating franchise tax;
- deduction of the cost of solar energy device from taxable capital apportioned to Texas; and
- temporary credit on net taxable earned surplus through September 1, 2012.

CSHB 4 would require the state comptroller to forfeit any entity's right to do business in Texas if it did not comply with provisions of the franchise tax law. The bill sets out conditions and grounds for forfeiture and reinstatement of the right to do business in the state.

Supporters say CSHB 4 would make the state's principal tax on business fairer and more equitable by applying the franchise tax to all partnerships but excluding sole proprietors. The fiscal note shows the state revenue gain from the franchise tax expansion would be nearly $763 million in fiscal 1998-99.

The franchise tax is currently paid only by corporations. Other forms of business organizations — including legal, medical, engineering, and accounting partnerships, limited partnerships, and joint ventures, as well as wealthy private investors — are currently exempt from the tax. Because of this narrow scope, only one out of six Texas businesses pay the franchise tax and some of the state's most profitable business operations escape fair taxation. CSHB 4 would apply the franchise tax to all business entities, except sole proprietorships, in order to increase the equity of the business taxation in Texas. Corporations would still be responsible for the large majority of franchise tax revenue, even after the rest of the business community was included in the tax. It is only fair that all forms of business that enjoy some limited liability provided by state laws should pay the franchise tax for the privilege of doing business in Texas.

The proposed expansion of the franchise tax would not include sole proprietorships and those with a tax liability of less than $500, thereby excluding small business firms and "mom and pop" businesses. However, large medical, law, accounting, engineering and architecture partnerships, some of which earn tens of millions of dollars a year, and wealthy investors with billion-dollar individual empires would finally start paying their fair share of the state business tax.

Corporations, which tend to have more land and property than unincorporated firms, would still continue to carry a larger portion of the tax burden because they pay both the franchise tax and property taxes. The bill would help eliminate the unfair competitive advantage enjoyed by unincorporated businesses.

Those who argue that the franchise tax should be paid only by corporations because of their special treatment under the law are clinging to the notion of the franchise tax as a license fee for doing business in the state in a corporate form. The preoccupation with a business' legal form has granted an undeserved economic advantage to partnerships and other unincorporated entities at the expense of corporations.

Extending the franchise tax to partnerships would not be a personal income tax, but a business income tax. A decision concerning adoption of a personal income tax involves totally different factors unrelated to business taxation; the likelihood of a personal income tax would be unaffected by expanding the tax to partnerships. CSHJR 4, the proposed constitutional amendment necessary to implement CSHB 4, would make it clear that applying the franchise tax to partnerships would not constitute taxation of personal income.

Opponents say that taxing partnerships is a form of income tax. The earned surplus component of a franchise tax on an unincorporated firm would be the same as a personal income tax on Texans in business for themselves. The compensation of a lawyer or doctor in private practice would be subject to the income-based franchise tax, but the salary of a doctor or lawyer working for a large company would be sheltered from state taxation.

Corporations have long enjoyed special treatment in Texas law. These legal distinctions were recognized when the corporate franchise tax was first adopted, and they remain valid today. Corporations enjoy the same legal status as a person, with constitutional rights that continue even if ownership or management changes. The “corporate shield” against liability is a legal privilege with economic value and is unavailable to partnerships. The franchise tax is the price corporations pay for these valuable privileges and protections.

Apportioning Franchise Tax Liability

Current law requires multi-state corporations to divide, or apportion, their total tax base into portions that represent business conducted in individual states. The apportionment computation results in a fraction that represents the state's share of a firm's total business. That fraction is applied to the firm's total tax base to compute the Texas tax base against which the tax rate will be applied. Texas law requires the use of the firm's gross receipts to calculate this apportionment fraction. The numerator of the fraction represents receipts in Texas and the denominator represents all receipts of the company

Under current law the sale of goods are sourced to the location where the goods were delivered. For example, if products are delivered to a Texas location, the receipts for those sales are added to both the numerator and denominator of the tax base. Receipts for goods delivered outside Texas are added only to the denominator.

CSHB 4, for the purposes of apportioning taxable capital and earned surplus, would define gross receipts to include receipts from the use of trademarks, franchises and licenses and the sale of real property located in Texas, including royalties for oil, gas or other mineral interests. Gross receipts on the sale of an investment or capital asset would only include the gain from the sale.

Gross receipts from interest, dividends, sales of intangibles, and other business done in Texas would be apportioned to Texas if the receiving business' commercial domicile (i.e., principal place of day-to-day operations) was in Texas. Gross receipts would not include interest, dividends, or stock proceeds for associated foreign corporations whose income predominantly comes from sources outside the United States and that do not do business in the U.S.

The bill would require the comptroller to adopt rules to apportion taxable capital or earned surplus on that portion of interstate business conducted in Texas by a telephone or transportation company.

Supporters say changing the location-of-payor rule and requiring that intangible assets be sourced to the commercial domicile of the recipient would close a large tax avoidance loophole and realize a revenue gain to the state of about $100 million in the next biennium.

Intangible assets, which include interest, dividends, royalties and capital gains, are difficult to apportion because it is difficult to identify their physical location. About 30 states source receipts of intangible assets to the location of a firm's commercial domicile. Under current law, the "location of payor" rule sources receipts from intangibles to the state of incorporation of the payer. Since most multistate firms incorporate in Delaware, these receipts become non-Texas receipts and reduce the firm's apportionment factor and tax liability.

Opponents say changing the location-of-payor rule would inhibit multistate companies from locating their headquarters in Texas and could cause some companies to relocate to other states because the increased tax liability from the change would be too great. This could have a detrimental effect on the state's economy.

The current location-of-payor rule has given Texas an advantage in attracting business. Many companies have moved their headquarters to Texas because of the favorable tax climate, and the rules should not be changed in the middle of the game. The revenue gain anticipated may not offset potential future revenue losses to the state that could occur under CSHB 4. Changing the location-of-payor rule would penalize Texas-based businesses only and could cause jobs to relocate to other states, thereby diminishing the entire tax base.

Calculating the Franchise Tax

Current law calculates the corporate franchise tax based on either taxable capital or earned surplus. Earned surplus is a firm's federal taxable income, before any net operating loss deductions, with officer and director compensation added back to the base.

CSHB 4 would require partnerships, business associations, and business trusts to determine their taxable capital by calculating their taxable capital accounts, undistributed profits, and surplus, subtracting any passive income and apportioning the appropriate taxable capital to Texas. These entities would use their reportable federal taxable income as a starting point for determining taxable earned surplus.

The net taxable capital or earned surplus for partnerships, professional associations and business trusts would *not* include passive income or income capital. Passive income would be defined as interest, dividends, rents, royalties, income from transferring of a capital asset or property held for investment, income from entities controlled, directly or indirectly, by a real estate trust, a regulated investment company, a real estate mortgage investment conduit, or a common trust fund, and income from oil and gas working interests held by the taxable entity if the taxable entity did not operate the oil and gas property.

Passive income capital would be defined as an amount that is the product of the passive income ratio for the taxable entity and the entity's apportioned taxable capital. The ratio would be calculated by dividing the aggregate cost for the taxable entity's total assets into the aggregate cost of all the taxable entity's passive income assets.

For taxable entities other than partnerships with no more than 35 owners, earned surplus would be a firm's federal taxable income before any net operating loss deductions, with compensation to officers, directors, and owners who own 0.1 percent or more of the firm, but who are not officers, added back to the base. The first $100,000 of compensation paid to an owner of 0.1 percent or more would be deductible.

For partnerships, the earned surplus base would be the total income of the partnership taxable to the partners. Partners could deduct $100,000 for each partner in a firm with 35 or fewer partners to the extent of compensation paid.

Supporters say the state needs to exempt income from passive investments, such as income received from investing in the stock or bond markets or in mutual funds, to ensure that savings are not taxed. The state has no intention of taxing passive income, where the owner does not have control over the investment decisionmaking. The definition of passive investment stipulated in CSHB 4 would ensure that the franchise tax would apply to firms in the business of investing, not to individuals participating in savings opportunities.

Opponents say the definition of passive investment is problematic and would be difficult to administer. The Internal Revenue Service Code dedicates 61 pages to describing passive investments; the Texas law would define the subject in only one page, leaving the state comptroller to interpret its meaning. Although the intent may not be to tax individual or family investments, it has the potential for creating a large loophole for tax avoidance.

SALES AND USE TAXES

CSHB 4 would impose, beginning October 1, 1997, the 6.25 percent state sales and use tax and and a local sales and use tax of up to 2 percent on certain services, goods and sales. These (and their estimates revenue gains for fiscal 1998-99) would include:

- appraisal services to evaluate the value of real or tangible personal property ($9 million);
- marina (i.e., boat dock) services ($2.1 million);
- commercial research services, such as marketing, opinion and other economic and educational research done for business, but not research and development for aircraft and spacecraft manufacturers or medical tests on humans or animals ($47 million);
- commercial research and development laboratory services ($19.8 million);
- custom computer programming services, including the design or analysis of a computer program ($63 million);
- employment agency services ($42.4 million);
- sludge and low-level radioactive waste disposal services ($670,000);
- motor vehicle repair services, excluding vehicle emissions testing and services ($270 million);
- non-coin operated motor vehicle wash or detailing services ($21.6 million);
- personal services, including dating services, shopping services for individuals, tanning salons, tattoo parlors, diet or weight watching services and private wedding chapels ($9 million);
- management and consultant and public relations services, including lobbying ($96.5 million);
- secretarial and mailing services ($10.2 million);
- transportation services, including freight hauling, courier, towing and limousine, or bus or van services, including airport shuttle service ($168.7 million);
- warehouse and storage services, excluding safety deposit boxes and agricultural product warehousing ($29 million);
- sanitizing, sterilizing or disinfection services ($1 million);
- occasional sale of certain aircraft ($5.3 million);
- magazine subscriptions ($45.4 million)

- handbills and circulars and inserts supplied to a newspaper from an external source ($36 million); and
- motion picture and video tape distribution ($24.2 million).

Other goods, services, and sales that would be subject to the sales and use taxes include:

- sports and athletic events;
- diving services, but not including scuba-diving training and instruction services;
- commercial notary services;
- certain oil well services, excluding services in the business of drilling an oil or gas well;
- patent brokerage services, excluding patent services provided by a lawyer;
- special order custom map making for one or a few individuals;
- traffic and crowd control services; and
- sports, athletic or other events or concerts provided by an institution of higher education.

The estimated revenue from these sources for fiscal 1998-99 would total about $7 million.

CSHB 4 would place a 3.25 percent sales tax on commercial sales of gas and electricity used for mining, generating $37.8 million in the biennium. The sale of gas and electricity for other commercial purposes would remain at 6.25 percent. Residential use of gas and electricity would continue to be exempt from taxation.

CSHB 4 would limit the function of a Texas customs broker to certifying goods for export if they were shipped to a foreign location and the customer did not take possession of the goods in Texas. (Currently customs brokers licensed by the state may refund state sales taxes to foreigners who purchase goods in Texas to be used or consumed outside the United States.)

CSHB 4 would exempt from the sales tax manufacturing machinery and equipment that becomes part of or makes or causes a chemical or physical change to the final product. It would also exempt equipment — such as actuators, boilers, and computerized control units — used to generate electricity or steam, if the electricity or steam was produced for ultimate sale or to power or supply equipment used directly in the manufacturing process. The sales tax exemption would not apply to intraplant transportation equipment used to move a product or raw material in connection with the manufacturing process, including all piping and conveyor systems.

CSHB 4 would require an intercorporate service sales tax be paid on any of the new services scheduled to be taxed beginning October 1, 1997. The bill would require that corporate affiliates pay sales taxes on such services as management and consultant services, customer computer programming services and commercial research services, such as marketing and public opinion services.

CSHB 4 would exempt the rental of bingo halls from the sales and use tax.

Goods, services, or items subject to the sales tax in CSHB 4 would continue to be exempt until January 1, 2000, if they are contained in a contract written before March 2, 1997.

Supporters say CSHB 4 would eliminate numerous sales tax exemptions and increase state revenue by $1.183 billion in fiscal 1998-99. There are strong public policy reasons for maintaining certain sales tax exemptions on basic consumer needs like food and medicine, but the services included in CSHB 4 do not warrant special tax treatment. None of the categories met the charge laid on them by the select committee to justify continuing their exemptions.

Expanding the sales tax base is a better solution than increasing the sales tax rate to resolve the issues of raising needed revenue while providing property tax relief. A higher sales tax would be more regressive than expanding the base on select services and goods that have enjoyed tax-free status.

CSHB 4 would require affiliated companies to pay for taxable services they provide, such as management and consultant services, just like independent companies would have to under the bill. This provision would ensure that all like services are taxed in the same manner regardless of business structure.

CSHB 4 would stipulate that equipment and material used indirectly in the manufacturing process would incur sales taxes. This provision would clarify that the exemption for property used in manufacturing covers equipment and material used *directly* in the manufacturing process. This provision would preempt lawsuits, such as the Tyler Pipe and Chevron cases, where Texas appellate courts ruled that equipment and material used indirectly in the manufacturing process was exempt from tax.

Opponents say the sales tax exemptions for many of the goods and services that would be taxed under CSHB 4 are valid and should be maintained. The select committee acted hastily; the reasons why these exemptions are in place should be closely examined in the interim and recommendations made to the 76th Legislature.

Taxing some of the services that would no longer be exempt from the sales tax — such as customer mapping services, commercial research, development or testing services and oil well services — would adversely affect the gas and oil industry, which is only now begun to rebound after years of turmoil.

The provision addressing the issues of the Chevron and Tyler Pipe cases is too broad. It could result in taxation of certain materials and equipment consumed in processing and necessary or essential to processing oil or gas by causing a chemical or physical change that may not physically come in contact with oil or gas. It could result in taxation of air compressors, turbines, pumps, quality control equipment, robotic assemblies and other categories of equipment that have previously, and for good reason, been exempt from taxation.

Taxing transportation services would discriminate against companies that transport property. Many transportation companies use regularly scheduled airline, train, and motor vehicle transportation in providing their service. Furthermore, the major competitor of private transportation companies is the U.S. Postal Service, and an 8.25 percent increase in costs would have the effect of putting Texas companies at a financial disadvantage. In addition, because goods are transported numerous times before they reach the final consumer, the 8.25 percent sales tax would cause the price of the final product to increase.

CSHB 4 would make too many arbitrary distinctions in separating what is taxable from what is not. For example, diving services used in construction, remodeling, maintenance or repair services would be taxed under the bill, while new construction and maintenance of real property would remain exempt. The only difference between the two services is that one is done above water and one under the water.

The definition of management consulting or public relation services is opened-ended and ambiguous and could make an infinitely broad range of services to taxation.

Requiring affiliated companies to pay for intercorporate services would increase the cost of doing business, be extremely difficult to administer, and could have the consequence of requiring companies to integrate into one company to avoid taxation.

Local Sales Tax — Elections

CSHB 4 would require cities, counties and other political entities that levy a property tax and a sales tax to hold an election on November 4, 1997, on the use of the additional revenue realized from the bill's imposition of the sales tax on additional goods, services and sales. The election would have to give local voters the opportunity to decide whether the additional revenue should be used to reduce property taxes, for general purposes, for specific special projects, or a combination of these options. In the case of a combination, the ballot language would have to specify the percentage of revenue to be used for each. Another election would have to be held if none of the options received a majority of the vote. If there were a tie for the highest number of votes or the second highest number of votes, then the governing body of the political entity would draw lots to determine which two propositions would be voted on in the subsequent election.

The bill would require that voters in Houston decide whether to use the additional city sales tax revenue to pay for renovating or constructing one or more sports facilities or to use the funds for general purposes. A sports facility would have to be owned and operated or managed by the city; the city could not lease or sell any interest in it and would have to collect 50 percent of revenue generated from the facility, including parking and concession revenue. In addition to the options required on the ballot, the Houston city council could allow voters the opportunity to vote to use the funds to reduce property taxes, for one or more specific purposes, or a combination of all the options.

For metropolitan transit authorities (MTAs) or other taxing entity that imposed a sales tax but no property tax on January 1, 1997, the comptroller would be required to compute an expanded tax base index by September 1, 1997, and inform the taxing entity of the index by September 15, 1997. The index would reflect the ratio of the new sales tax base to the current sales tax base. Beginning October 1, 1997, the taxing entity would be required to reduce its sales tax rate by a percentage equal to the entity's expanded tax base index.

The comptroller would be required to recompute the index by August 1, 1999, taking into account at least one year's actual economic experience, and notify the taxing entity of the new index. Taxing entities would be required to adjust their sales tax rate accordingly by October 1, 1999, or at the beginning of the next calendar after notification by the comptroller, whichever came first.

MTAs and other nonproperty-taxing entities, such as hospital districts and crime control and prevention districts, would not be required to reduce their sales tax rate if the voters approved exempting them from the state-mandated automatic tax rate reduction. The election could not be held before September 1, 1997, but could be ordered before that date.

Supporters say the purpose of CSHB 4 is property tax relief, and local taxing jurisdictions should give their citizens the opportunity to decide how to use the tax windfall from expansion of the sales tax base.

Opponents say the governing bodies of cities, counties, MTAs and other political entities that would gain additional revenue from the expansion of the sales tax base outlined in CSHB 4 should be able to decide how the revenue should be used just like they do for the current sales tax revenue. The elected governing bodies should decide how the money should be used, which is one of the responsibilities given them by the electorate. The voters are not intimately aware of budget needs and allocations.

Small cities also should be given the choice of whether to hold an election, depending on the amount of revenue anticipated from the tax expansion. Small cities should not be required to hold an election if the tax revenue would be less than the cost of the election.

Furthermore, CSHB 4 would not provide property tax relief for people who live in counties that have metropolitan transit authorities. Counties with a MTA tax are prohibited under current law from imposing a local sales tax. Therefore, the bill should be amended to allow counties with MTAs, mostly urban counties, to have an election on imposing a sales tax to induce property tax relief, but only to the extent that the local two-cent sales tax cap was lowered by reducing the MTA tax.

OTHER TAXES (Estimated Gain in Fiscal 1998-1999)

Insurance Premium Tax ($400 Million)

Current law. In fiscal 1996 the state collected $626.6 million in taxes from the insurance industry. Most of the revenue came from taxes insurers pay on premium income. The tax rate for surplus lines, unauthorized, and independently procured insurance is 4.85 percent of premiums. Life, accident and health insurers pay 1.75 percent of taxable premium income. Collections on other insurance lines are based on the insurer's portion of Texas-based investments and range between 1.3 percent and 2 percent. The average premium tax for these insurers is approximately 1.86 percent.

Insurers currently are allowed to deduct certain types of income and expenses from their total premium income. Tax-deductible items include Medicare and Medicaid premium income, assessments by and direct payments to the Texas Department of Insurance to cover the cost of conducting financial examinations of insurance companies, and insurers' contributions to their employees' health benefit plans.

Independently procured insurance is a policy for Texas property that is purchased out of state from a company not licensed in Texas. The company pays a tax on the premium for such a policy. Unauthorized insurance is insurance bought from unlicensed brokers or other unauthorized sources.

CSHB 4 would raise the tax on surplus lines, unauthorized and independently procured insurers from 4.85 to 5.85 percent. Taxes on life, accident and health insurers, including HMOs, would be increased from 1.75 to 2.25 percent of taxable premium income. For all other insurance lines, premium income would be taxed at 2.25 percent, rather than a varied rate based on Texas-based investments. The bill would eliminate deductions for Medicare and Medicaid premiums, TDI assessments, and insurers' contributions to employee health benefit plans.

Supporters say a flat tax would be more equitable and easier to calculate for property and casualty insurers and others that pay a different tax rate based on investment income. The higher tax cost would be offset by the reduced cost of figuring the tax. The current structure favors large companies that have the resources and expertise to manipulate their investments to qualify for the lowest tax rate.

Opponents say the Legislature should consider the impact CSHB 4 would have on Texas securities and other investments. The current system creates an incentive for insurers to invest a significant portion of approximately $16 billion in annual premium income in Texas investments. If the investment deduction were eliminated, insurers would very likely stop investing in Texas securities. The increased tax would probably be passed on to policyholders in the form of higher premiums.

Lottery Earnings ($300 million)

CSHB 4 would reduce by five percent the total amount of lottery earnings dedicated to winners. The reduced earnings would apply to tickets sold on or after September 1, 1997.

Supporters say the five percent reduction in lottery prize money would be in lieu of taxing the sale of lottery tickets. The state is looking for revenue sources to fund education, and raising the state share of lottery receipts is a logical place. It would also be in line with the provision in CSHJR 4 dedicating all lottery revenue to education.

Opponents say the amount collected from this "tax" on prizes may not be stable, especially if reduced prizes in turn depress lottery sales. A better way to raise revenue would be to tax lottery winners.

Alcoholic Beverage Taxes ($27.3 million)

CSHB 4 would increase alcoholic beverage taxes by 10 percent, beginning September 1, 1997. Airline or passenger train beverage permit holders would no longer be allowed to receive a refund for the state tax on beverages.

Supporters say that alcohol is a luxury item and can afford to be taxed at a higher rate. Alcohol sales are costly to regulate and misuse or overuse of alcohol can cause health and safety problems that are costly to the state. Furthermore, alcoholic beverages taxes were last increased in 1984.

Opponents say that increasing the tax on alcohol, including beer, would be regressive since it would take more money out the pockets of poor people who can least afford it.

Motor Fuel and Aviation Fuel Taxes ($146 million)

CSHB 4 would tax off-road use of gasoline and diesel motor fuel at four cents per gallon, except fuel used for commercial vessels, excluding gambling vessels, and agricultural purposes. The bill would repeal the exemptions for off-road use of motor fuel used for noncommercial marine, railway engine, industrial, commercial and construction purposes. (The on-road tax for gasoline and diesel motor fuel is 20 cents per gallon.)

CSHB 4 would institute a new tax on fuel used for aviation purposes at a rate of four cents per gallon.

The new taxes for motor and aviation fuel would take effect January 1, 1998, but the bill would allow the comptroller to begin rulemaking to implement the aviation fuels tax September 1, 1997.

Supporters say that Texas is one of only a few states that does not tax aviation fuel. The four cents tax would be lower than the tax in many of the other states. This tax would only amount to pennies per ticket. There is no good reason why airlines should not be taxed on their fuel.

Opponents say that it would be difficult for airlines to pass on the increased tax liability, estimated to be $120 million in fiscal 1998-99, to their customers. The airline industry is now rebounding from difficult times, and each additional cost affects its bottom line.

Hotel Occupancy Tax ($19 million)

CSHB 4 would increase the state hotel occupancy tax rate from 6 percent to 6.25 percent, beginning September 1, 1997. The same person occupying a hotel room for at least 30 days would not be liable for the hotel occupancy tax, but the tax would apply to an entity possessing a hotel room for 30 days.

Supporters say this tax was last raised in 1987, and the small increase would be paid in large share by out-of-state customers.

Opponents say the state tax is in addition to local taxes imposed on hotel rooms and could hurt the vital tourist industry that provides many needed jobs.

Cigarette and Tobacco Tax ($408.3 million)

CSHB 4 would, beginning September 1, 1997, increase the state tax on cigarettes from 41 cents to 61 cents per pack, the tax on cigars by 50 percent each, and the tax on other tobacco products by 50 percent. The cigarette tax was last increased in 1990.

Supporters say that cigarette and tobacco taxes should be increased to provide a disincentive for young people to begin smoking and an incentive for smokers to quit. The tax also would raise additional revenue to cover potential higher health care costs.

Opponents say that smokers already pay high taxes; raising taxes will not make them stop smoking. Many lower income people are smokers, and this tax would therefore be regressive.

Manufactured Housing ($15.9 million)

CSHB 4 would increase the tax on manufactured homes by 1.25 percent from 5 percent to 6.25 percent of sales price, beginning October 1, 1997. The tax was last raised in 1983.

Gas, Electric and Water Utility Tax ($494 million)

CSHB 4 would impose a gross receipts tax of 2.25 percent on all gas, electric and water utilities in Texas, beginning January 1, 1998. The bill would increase to 2.25 percent the gross receipts utility tax paid by investor-owned utilities. Currently these utilities pay taxes ranging from 0.581 to 1.997 percent on services provided in cities, based on the size of the city. They pay no gross receipts taxes on services provided in unincorporated areas. The bill would also require municipally-owned utilities and utility cooperatives to begin paying the 2.25 percent gross revenue tax from which they have been exempt.

Supporters say investor-owned utility companies and electric cooperatives would see a significant drop in their property tax liability in CSHB 4 and could easily absorb the increased taxes from this provision.

Opponents say the increased tax liability on investor-owned utilities would be severe not only because the tax rate would increase but also because the base would expand to include incorporated areas of the state. Electric investor-owned companies cannot automatically pass on the gross receipts tax, as they can the lignite coal tax, which is allowed as an automatic fuel adjustment, but must absorb the costs until their next rate case.

Electric cooperatives would have no choice but to pass the 2.25 percent tax through to their members, imposing a direct tax on a basic necessity, electricity. City-owned utilities also would have to pass the tax directly on to consumers.

Interstate Motor Carrier Sales and Use Tax ($43.4 million)

CSHB 4 would reinstate the 6.25 percent Texas-apportionment sales tax on certain motor vehicles, such as buses and trucks, operated interstate by Texas resident carriers or domiciled or doing business in Texas. The tax was scheduled to be repealed beginning September 1, 1997.

Cement Production Tax ($9 million)

CSHB 4 would increase the cement production tax from 2.75 cents per 100 pounds to 5.0 cents per 100 pounds or $1 per ton, beginning September 1, 1997. The tax was last increased in 1951.

Coal and Lignite Use Tax ($122.7 million)

CSHB 4 would impose a 7.5 percent tax on the use of coal and lignite in Texas, beginning December 1, 1997. The 7.5 percent tax would apply to the total price paid for the coal, including transportation costs. Use would include storage for use in Texas. The tax would not apply to use by a producer of coal who owned the coal in place and who used the coal or stored coal to be shipped out of state. If a person failed to file required reports or pay the tax, the bill would impose a penalty of 12 percent of the tax due. The offense would constitute a Class C misdemeanor, with a maximum penalty of a $500 fine. Revenue from the tax would be deposited to the general revenue fund.

Supporters say coal and lignite produce energy just like oil and gas and should be taxed as well.

Pari Mutual Wagering ($21.2 million)

CSHB 4 would change the state's share of wagers on live horse and greyhound racing from a sliding scale ranging from 1 percent to 5 percent to a flat 3.5 percent and raise the tax on televised or "simulcast" races from 1 percent to 3.5 percent.

Supporters say CSHB 4 would force the pari-mutuel racing industry to pay its fair share of taxes. The tracks have enjoyed the benefits of low taxes since 1991, when the tax was reduced to give them a chance to get on their feet. They have had ample opportunity to establish themselves and should now pay their fair share of state taxes. The 3.5 percent flat tax would still be less than the original 5 percent tax imposed when pari-mutuel racing was established.

Opponents say that imposing a flat 3.5 percent racing tax could cause tracks to fail, hurting the state economy, the racing industry, and local communities that support the tracks. The current tax structure was imposed in 1991 to allow the racing industry to develop, to compete with tracks in neighboring states, and to promote economic development and tourism. It should not be changed.

Texas racetracks are still a fledgling industry, and investors are not realizing a windfall from the tracks. In fact, many tracks are losing money. A 3.5 percent tax would make it difficult for tracks to meet their expenses and retire their large investment and could cause them to close. It would be far better for the state to collect the current tax of 1 to 5 percent of wagering than to collect 3.5 percent of nothing, which is what the state could receive if the higher tax caused tracks to fail.

If tracks are hurt by the new tax, local communities could also be hurt. Successful pari-mutuel tracks are economic development engines providing jobs at the tracks as well as spurring growth in tourism, dining and retail business.

A flat 3.5 percent tax would be out of line with pari-mutuel taxes in other states. Only two states — both with established pari-mutuel racing — have effective tax rates close to 3.5 percent.

Gas Utilities Rate Adjustments

CSHB 4 would permit gas utility companies to adjust rates they charge customers to reflect changes in gas utilities' property tax liability and gross receipts taxes, beginning January 1, 1998. The adjustments would become part of the customer gas rate. The gas utilities would be required to track changes in property taxes and gross receipts payments occurring since 1996. The responsible regulatory entity could review the rate adjustment and changes if it determined that the gas utility was not accurately recovering its costs.

Supporters say it makes sense to permit gas utility companies to pass through to their customers any increases or decreases in costs related to lowered property taxes and gross receipt taxes. Customers should have the opportunity to share in the savings from lowered property taxes, but if the utility gross receipts tax liability turned out to be larger, then the increase should be come part of the rate base.

Opponents say gas utilities, just like electric utilities, should have to absorb any additional tax costs resulting from CSHB 4. The tax system in Texas is already regressive enough, and allowing gas utilities to pass though any unforeseen tax increases would only make it more regressive on those with lower incomes. Gas is not an optional product; people need it to keep warm and to cook.

Taxicabs

CSHB 4 would impose an annual $100 tax to operate a taxicab. The tax would be prorated to $50 if the taxicab began operation after July 1 of a tax year. Taxicab operators would be liable for the full tax amount even if they quit operating the taxicab during a year. One quarter of the revenue from the tax would go to the foundation school fund; the remainder would be deposited to the general revenue fund.

The taxicab operator would pay the tax to the state comptroller, who would issue a permit to be affixed to the taxicab's windshield. It would be a Class C misdemeanor (maximum penalty of a $500 fine) to operate a taxicab without a permit or with a false permit.

Supporters say it is easier and fairer for taxicab drivers to pay an occupation tax rather than be subject to the sales tax.

Interior Designers ($3 million)

CSHB 4 would increase the registration application fee, annual renewal fee and reciprocal registration fee for interior designers from $100 to $200, beginning September 1, 1997. Fifty dollars of the fee would be deposited to the foundation school fund, and the remaining $150 would go to the general revenue fund.

Supporters say interior designers should pay occupational taxes that are equal to those of architects, since the professions overlap.

Vending Machines ($47.2 million)

CSHB 4 would apply the laws pertaining to coin-operated machines to "service coin-operated machines" and to automatic teller machines (ATMs). The owner of service coin-operated machines would be required to pay an annual $60 occupation tax on each machine, as other coin-operated machine operators are now required to do. The annual occupation tax on ATM machines would be $100 each. The bill specifically would exempt certain coin-operated machines from the tax, including newspaper dispensing machines, pay toilets, air dispensing machines, laundromat machines, and machines selling cigarettes and other tobacco products.

Supporters say that requiring all coin-operated machines to pay the same tax is only fair. ATM machines, which dispense money and generally charge at least a $1 fee for each transaction, should be required to pay more than coin-operated machines.

NOTES: **Comparison of Original to Substitute**

HB 4 as introduced would have lowered property taxes in the fiscal 1997-1998 biennium by instituting an additional $20,000 homestead exemption in fiscal 1997 and a 20-cent rate rollback in fiscal 1998. In order to recoup the revenue, the plan proposed implementing a new Business Activity Tax (BAT) to replace the current franchise tax, increasing the rate on sales and motor vehicle sales taxes by 0.5 percent, and diverting a $1 billion surplus from general revenue to public school finance. These measures would have generated approximately $3.6 billion in revenue. The introduced version of HB 4 did not address the school finance system; the revenues that a school district lost with the changes in the property taxes would have been refunded directly to that district through a new Texas School Trust Fund. (For a more thorough discussion of the introduced version of HB 4, see *The Tax System and Public School Financing in Texas*, House Research Organization Session Focus, Number 75-11, March 24, 1997).

The committee substitute to HB 4 would modify the school finance system to accommodate a 70-cent local residential property tax and a $1.05 statewide business property tax. Rather than replace the franchise tax with the BAT, the substitute would expand the base of the franchise tax and remove several exemptions. Instead of increasing the sales tax rate, CSHB 4 would repeal a number of exemptions to the sales tax and other taxes. CSHB 4 also proposes to use a $1 billion surplus of general revenue for property tax relief. In total, the proposal would replace approximately $4.1 billion in property tax revenue in the next biennium.

Related Legislation

The change proposed by CSHB 4 to the technology allotment for public schools also has been introduced as SB 297 by Ratliff and Bivins. SB 297 passed the Senate on February 5 and was referred to the House Select Committee on Revenue and Public Education Finance.

SB 1873 by Bivins, referred to the Senate Finance Committee, would also abolish the Foundation School Budget Committee and turn its functions over to the LBB and the appropriations process.