

**SUBJECT:** State property tax, school finance revisions, franchise tax expansion

**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:** See CSHB 4.

**SECTION-BY-SECTION ANALYSIS:** **Section 1 - Prioritizing Spending for Education**  
**Current law** requires the Legislature to establish and fund an efficient system of free public schools. (Texas Constitution, Art. 7, sec. 1)  
**CSHJR 4** would provide that financial support of elementary and secondary public school education be the first priority of state spending. Payment of lawfully incurred state debt and dedicated revenue provided for in the Constitution would not be subject to school spending priorities.  
To fulfill its obligations for public school support, the Legislature would be allowed to set spending priorities and minimum financial effort, including guaranteed draws against state revenue not otherwise dedicated by the Constitution.  
**Supporters say** making education spending the state’s first priority would be consistent with the spirit of the Constitution, which states that the general diffusion of knowledge is “essential to the preservation of the liberties and rights of the people.” In order to fulfill its constitutional duties, the Legislature is proposing CSHB 4 to provide for adequate and efficient funding of public schools. CSHJR 4 would complement this effort by establishing clear legislative intent for the future that continuing or improving the education system should be the state’s first priority.  
This priority, however, would not jeopardize other debts the state must service in order to maintain its bond rating nor would the amendment

override other constitutionally dedicated funds already in existence that are not subject to the appropriations process.

**Opponents say** prioritizing spending for education could not ensure that the state would adequately fund the school system. The Legislature, through the appropriations process, determines the actual amount of money that goes to public schools. Appropriations may not be sufficient even if the draw were first in order of state spending.

**Other opponents say** while public school education should be a priority of the state, it should not be singled out as more worthwhile than other equally important responsibilities, such as higher education, public safety, criminal justice, and financial assistance to those in need, to name a few.

## **Section 2 - Allowing a State Property Tax**

**Current law** prohibits a state property tax. Property taxes for public education are determined by local taxing districts based on appraisals conducted by local appraisal districts. Taxing entities can abate taxes to businesses located in reinvestment or economic development zones, within certain limitations, without jeopardizing state aid to their schools.

**CSHJR 4** would allow the Legislature to fund public elementary and secondary schools by imposing a statewide property tax capped at \$1.05 per \$100 of valuation on nonresidential property not taxed by local school districts for maintenance and operating (M&O) expenses.

The Legislature would be authorized to determine how the property would be appraised, equalize the taxable value of property, and collect the state tax on subject property.

CSHJR 4 would require local tax appraisers to assess the value of property subject to the statewide tax located in their district. The value assessed on this property would be valid if the appraisal valuation conformed to or was equalized by the local appraisal review process to conform to accepted appraisal standards and practices. This section would expire on December 31, 1999.

The Legislature would be allowed to honor tax abatement agreements school districts had entered into prior to January 1, 1997.

**Supporters say** that CSHJR 4 would lower the average business M&O property tax rate from \$1.26 to \$1.05, providing considerable tax savings to all Texas business, especially capital-intensive business that have been shouldering a disproportionate share of school taxes. The \$1.05 tax rate would be set in the Constitution, assuring business that the tax rate could not be increased without statewide voter approval.

Furthermore, with this tax levy, the state would become responsible for 80 percent of public school funding, up from the current 47 percent, thereby guaranteeing a more equitable method of funding quality education for all children, regardless of where they live. The statewide property tax on business would help equalize public school funding by eliminating inequities in property taxes between districts due to 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. With the statewide tax and more equitable funding of schools, the need for the convoluted “Robin Hood” system would be eliminated.

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 programs through voter-approved and state supplemental local tax rates of up to 10 cents. These enrichment taxes also would draw state equalization funding.

Furthermore, 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.

**Opponents say** experiences in other states have proved that separating business and residential property tax bases is detrimental to business in the long run. Tax rates for business and residential property taxes are linked

only as long as the two are part of the same system; once they are separated, as proposed, business property owners would inevitably become vulnerable to tax increases because voters — residential property owners — determine the level of property taxation. If business property is separated out, the temptation for voters would be to hike business taxes more severely than residential taxes. A fair and equitable system demands that business property not be treated differently from residential property.

The funding scheme being proposed would not only require different appraisal jurisdictions for business and residential properties but also set the business property tax rate at \$1.05, much higher than the residential rate of \$0.70. At a minimum, the tax rates should be the same to maintain balance in the tax system. A tax rate of \$1.10 on all property would provide property tax relief for everyone. The property tax crisis is not so severe that it warrants cutting residential property taxes in half.

Business is more than willing to pay its fair share of property taxes, but not at the price of becoming 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. Apart from eliminating the “Robin Hood” school funding scheme, there is no good reason to separate business and residential property taxation. The ultimate result 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. If school districts must rely even more on the Legislature for their funding, a budget crunch could make them even more vulnerable than they are now. Control inevitably follows funding, so a higher state share of school funding would mean more state control. Additionally, school districts whose property wealth is 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.

Communities should be able to decide whether they wish to allow tax abatements rather than leaving this decision to the Legislature. The state has been eroding the ability of communities to use this powerful economic

development tool. CSHJR 4 would lay the groundwork for effectively destroying the few tax abatement programs that are allowed by creating a statewide property tax on business property.

### **Section 3 - Dedicating Lottery Revenue to Education and Collecting Taxes**

**Current law** dedicates one fourth of all revenue derived from state occupation taxes and all revenue derived from any statewide property tax and poll tax to fund public schools.

**CSHJR 4** would dedicate to public school financing all funds received by the state from the operation of lotteries, less amounts for prizes and administration. It would allow the collection of the proposed statewide property tax; authorize the Legislature to allow school districts to impose an ad valorem tax on residential property for public school M&O, subject to statutory limitations; and allow voters to approve additional property taxes for construction of facilities. It also would make conforming and corrective changes to Art. 7, sec. 3 of the Constitution, deleting language relating to the poll tax and rates for the prior statewide property tax that was repealed in 1982.

**Supporters say** when the constitutional amendment allowing a state lottery was presented to the voters, many believed that 100 percent of the proceeds would go to support public education. Although that was not the case, there is no reason why it should not be.

Dedicating lottery revenues to public education would allow those who play the lottery to feel that, even if they did not win, they were doing something positive for the children of Texas. Popular support for the lottery could increase if its revenues were clearly dedicated for education, enhancing revenues. Dedicating lottery revenue to education also would be consistent with the goal of prioritizing state spending on education.

Other changes made by section 3 of CSHJR 4 would be conforming in nature and merely reflect the new structure for funding public schools proposed by CSHB 4.

**Opponents say** dedicating lottery revenues to public education would be merely a symbolic act. Lottery revenues are deposited in the general revenue fund. State revenues are fungible. Which pocket the money goes in and which pocket it comes out of are not important, except for accountants and political perception. Texas voters could accomplish the same purpose by approving section 1 of CSHJR 4 to prioritize education spending.

It is misleading to promise voters that lottery revenues would be dedicated. Many may believe that this act would increase spending on public education. Yet dedicating lottery funds would just mean that state revenue from one source would be replaced with revenue from another. Additionally, lottery revenues would not even begin to cover the state cost of education, especially if the state share were substantially increased.

Dedicating lottery revenue could also cause some public-minded citizens to spend even more of their income on lottery tickets in the belief that they would be helping provide a better education system. While increased lottery revenue would be helpful, the lottery itself is regressive, taking more money per ticket out of the pockets of the poor than the rich.

**Other opponents say** earmarking state revenue complicates state budgeting. Legislators lose control over funds and have less flexibility when writing the state budget. The experience in other states has shown that dedicated funds merely substitute for other funds instead of augmenting them.

#### **Section 4 - Imposing Privilege or Franchise Taxes**

**Current law** provides for a franchise tax on corporations. Art. 8, sec. 24 of the Texas Constitution specifically prohibits taxing personal income, including a person's share of income in a partnership or unincorporated association, without voter approval.

**CSHJR 4** would amend the Constitution to allow the Legislature to impose a privilege or franchise tax based on income or taxable capital of a corporation, partnership, or business entity, and would exempt the tax from

the constitutional prohibition on personal income taxes. Sole proprietors would be exempt from a privilege or franchise tax. CSHJR 4 would exempt sole proprietors engaged in mechanical or agricultural pursuits from paying an occupation tax and would specifically allow taxes to be imposed on municipal gas, electric or water utilities.

CSHJR 4 would allow the use of earned income or receipts to measure or apportion to Texas a privilege or franchise tax after December 31, 1997. This section would expire January 1, 2000.

**Supporters say** CSHJR 4 would ensure the constitutionality of the proposal in CSHB 4 to expand the state franchise tax on all business entities, including partnerships. Sole proprietors would be excluded because they constitute a special situation. The franchise tax clearly is a business tax, but a constitutional provision clarifying that this tax could not be construed as a personal income tax for partnerships or unincorporated associations is necessary to avoid any possible misinterpretation by the courts.

The franchise tax must be expanded in order to ensure equitable taxation of all business entities. 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 of six Texas businesses pays the franchise tax, and some of the state's most profitable business operations escape taxation altogether. CSHJR 4 would allow the franchise tax to apply 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 the limited liability provided by state laws should pay the franchise tax for the privilege of doing business in Texas.

Extending the franchise tax to partnerships would not be a tax on personal income but a tax on business income.

**Opponents say** that taxing partnerships and unincorporated associations is taxing personal income. 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 taxation.

This proposed amendment would be an end run around the constitutional prohibition against a personal income tax. In effect, it would be asking voters to call a personal income tax on partnerships and unincorporated associations a business tax. If taxing income from partnerships and unincorporated associations were not a personal income tax, it would not have been specifically alluded to in Art. 8, sec. 24 of the Constitution.

### **Section 5 - Continuing Homestead Exemptions**

**Current law** provides several homestead exemptions. (Texas Constitution Art. 8, sec. 1-b). All residential property carries a \$5,000 homestead exemption. The Legislature may authorize an additional exemption available to those who are disabled or over 65. The amount of residential property taxes on the homesteads of persons aged 65 years or older may not increase from the time they reach that age until they cease to use the property for a homestead or make significant improvements.

The voters in any county, city, town or district may approve an additional homestead exemption of \$3,000 to the disabled or those over 65. The voters in any political subdivision may also approve an additional homestead exemption on all residential property of up to 20 percent of the value of the homestead. Currently about 20 percent of school districts include property subject to these “local option” exemptions.

County education districts were created in 1991 but declared unconstitutional and abandoned when the current school finance system was established in 1993.

**CSHJR 4** would provide that any exemption granted by local option in effect on the date CSHJR 4 was approved by the voters would continue until it was increased, decreased or repealed in the manner currently provided by law.



CSHJR 4 would allow the Legislature to authorize property tax freezes for persons over 65 to be transferred to a different homestead. If the residential property taxes imposed for the 1997 tax year were lower than the taxes currently being paid by a homeowner subject to a tax freeze, CSHJR 4 would require that the 1997 tax rate become the maximum rate that could be imposed on that property so long as it remained the residential homestead of the current owner. The tax could be increased, as provided by current law, only to reflect improvements that enhanced the property value.

CSHJR 4 would also make corrective changes to Art. 8, sec. 1-b, primarily deleting language referring to county education districts.

**Supporters say** it is essential to ensure that persons now receiving a break on their property taxes continue to enjoy the savings when property tax rates fall due to the enactment of CSHB 4. The lowered rates should not decrease the significance of the local option exemptions now in effect.

Persons over 65 who currently enjoy a tax freeze should not be penalized when property tax rates for everyone else are lowered. New rates that result in a lower total tax bill should become the rate at which homeowners' taxes are frozen.

Portability of the over-65 tax freeze is an important addition to the range of homestead exemptions and one that is being proposed independently of CSHJR 4 this session. Current law penalizes persons over 65 who move to a different residence, even those many people in this age category do move to smaller homes because they need less space. Some are also forced to move because they cannot afford to pay the property taxes assessed on their current home. However, by moving, they lose the freeze that they enjoyed.

The tax freeze for seniors is a benefit that should follow individuals, not the property they happened to be living in at the time they turned 65. CSHB 4, the enabling legislation to this amendment, would allow a person over 65 to carry a proportional rate reduction with them if they moved to a new home. Senior citizens should not be forced to stay in the same home after they turn 65 just to retain their property tax freeze.

**Opponents say** exemptions from property taxes already are responsible for significant losses in tax revenues. The current homestead exemptions, which account for 40 percent of all property tax exemptions, add up to \$45.98 billion in taxable property valuation lost to taxing entities. Before granting additional exemptions, the Legislature should consider if those who are taking advantage of such exemptions truly need them.

The portability of the over-65 tax freeze should be carefully structured to provide relief only to those seniors who actually need the exemption. One option would be to weight the amount of the exemption that is transferable based on the income of the individual. Other proposals introduced this session would allow the freeze to be transferred only if the person were forced to move because of governmental action such as condemnation of the property.

### **Section 6 - Eliminating Freeport Exemptions**

**Current law** allows a “freeport” exemption from property taxes for certain goods, wares, merchandise, tangible personal property and ores — except oil, gas and petroleum products — transported out of Texas within 175 days. The governing boards of local government entities choose whether to allow the freeport tax exemption. About 12 percent of school districts in the state now grant a freeport tax exemption.

**CSHJR 4** would impose the statewide property tax on those goods currently allowed a freeport exemption.

**Supporters say** collecting taxes on property now subject to the freeport exemption would increase the revenue to fund public schools. This exemption has prevented a sizeable portion of school districts from collecting property taxes on these inventories, thus reducing their revenues. Funding public education is one of the state's primary functions, and when CSHJR 4 is approved by the voters in August, the state will be responsible for 80 percent of the cost of public education. The state cannot afford to retain an exemption that has such a negative effect on the amount of revenue available to schools.

**Opponents say** the 12 percent of school districts now offering a freeport tax exemption do so because it is in the best overall interest of the community. The state should not be allowed to interfere with local decision-making relating to the economic good of a particular community by imposing the state ad valorem tax on this property. The freeport exemption allows Texas communities to be competitive with those in other states, only four of which tax goods in transit.

Texas is losing business and jobs to other states because of the tax on goods in transit. Warehousemen and manufacturers are locating or relocating to adjoining states to get out from underneath this tax burden. The major manufacturing and distribution centers located on the Oklahoma side of the Texas-Oklahoma border are sited there precisely to take advantage of business opportunities in Texas while avoiding the Texas goods-in-transit tax.

### **Section 7 - Appropriations Spending Limits**

**Current law**, Art. 8, sec. 22 of the Constitution, limits the rate of growth of state appropriations from tax revenues to the estimated rate of growth for the state's economy. Revenues that are constitutionally dedicated are not included in computing the growth in appropriations.

**CSHJR 4** would provide that the constitutional limit on appropriations growth would not apply to appropriations made to carry out the legislative priority of funding public education established in section 1 of CSHJR 4.

**Supporters say** the Legislature should not be unduly limited in prioritizing education spending. The state would have to fully fund 80 percent of the cost of education; local revenues would not be sufficient to make up for any shortfall. Local revenues would be further limited by rate caps, so local taxes could not be significantly increased to cover added costs in the second year of the biennium.

The provision limiting appropriations to the economic growth rate should not apply to public education because those costs will continue to grow, regardless of economic growth in the state. If state tax revenues failed to

grow with student enrollment, education funding would fall short. If the state is going to make education its funding priority, it must be allowed greater leeway in appropriations, or else it would have to reduce funding for other programs to make up for any downturn in tax revenues.

Under CSHJR 4, the Legislature would still be constitutionally prohibited from spending more money than available revenue. Approval of this amendment would not allow the state to run on an unbalanced budget, but simply allow education spending to grow as needed.

**Opponents say** the appropriations spending limits are necessary to maintain the fiscal stability of the state.

Other important programs, such as health care, criminal justice, assistance to those in need, and higher education would continue to be restricted by the constitutional growth limit. It would be unfair to remove restrictions on public education spending while keeping them on equally important programs.

### **Section 8 - Prohibition on Income Tax Not Applicable**

See analysis of Section 4 above.

### **Section 9 - Ballot Language**

CSHJR 4 would be presented to the voters at an election on August 9, 1997. The proposed ballot language would read:

“The constitutional amendment authorizing changes in law to reduce local property taxes and increase the state's share of public education funding, including the dedication of lottery revenue to the public schools, authorization of a limited state property tax on nonresidential property, authorization of a privilege or franchise tax on the income and capital of business organizations other than sole proprietorships, providing for the transfer to a different homestead of the school property tax freeze on

homesteads of the elderly, and establishment of public schools as the first priority of state spending.”

NOTES:

**Related Legislation**

Other legislation introduced this session has proposed dedicating lottery proceeds to public education. SB 105 by Nelson has been reported favorably, as amended, by the Senate Finance Committee. HJR 34 by Raymond and HJR 35 by Moffat both are pending in the House Select Committee on Revenue and Public Education Finance.

The portability of the over-65 property tax freeze has been proposed in HJR 57 by Alexander, pending in the House Select Committee, and SJR 43 by Cain, currently on the Senate Intent Calendar. SJR 22 by Harris would provide for transferring the tax freeze only upon the condemnation of the property. SJR 22 passed the Senate on February 22. It is pending, with its companion, HJR 38 by Goodman, in the House Select Committee.