

# THE CASE FOR FUNDING PUBLIC EDUCATION WITH THE BUSINESS ACTIVITY TAX

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Ladies and gentlemen and esteemed public officials, I appear before you today to make the case for more efficient and equitable taxation for the funding of public education by the adoption of a state business activity tax, the BAT.

In order to strike to the heart of how to fund Texas public education, the following questions were addressed:

## ***First, what is the cost of excellent education?***

Whatever else may be required, there is general agreement that the most important improvement in public education is to be found in providing better teachers – better qualified, better incentivized, and better accountable for performance. However, that is not evident in how we spend education dollars, and how we manage most public schools.

My first study of Texas public school finance was undertaken in 1991, addressing the same questions. From 1974-75 school year to 1989-90, real spending per pupil had risen 51 percent to fund decreasing pupil to teacher ratio from 22.4 to 16.6 students per teacher. Yet teachers' salaries, which were 73 percent of total payroll in 1970 declined to 58 percent of payroll by 1990. Despite the disproportionate increase in numbers of teachers required, *non teaching personnel grew faster than teachers!*

Revisiting teachers' compensation as of school year 2002-03 finds school districts still paying teachers' only 58 percent of payroll. Despite a 79 percent increase in funding per student since 1989, teachers' average salary only increased 54 percent, compared to 66 percent increase in the average wage and salary in the private sector.

The evidences of how public education spends the money it receives continues to clearly infer that *funding is adequate if the manner in which it is spent efficiently addresses priorities.*

## ***Second, what changes are required in spending public education funding?***

Texans can no longer allow unions to tell school management how teachers should be compensated. Pay based upon dubious accreditation and seniority must be modernized with compensation at market rates for required skills by grade level and extent of specialization, and incentive compensation for individual performance based upon demonstrated value added. Principals must have the right to hire and fire based upon teachers' skills and performance at will, subject only to an expedited due process, the same as is universally necessary to survival in private enterprise. The principal should be held to the same standards, as his or her terms of employment.

This is the critical change in use of funding necessary to achieving the excellent schools Texans deserve.

## ***Third, how should responsibility for funding public education be divided between the state and local districts?***

The criteria for state funding should meet the test of "efficiency" as stipulated by the Texas Constitution and defined by Webster's Dictionary as "the least expenditure to achieve the desired result," based upon relatively equal local tax effort as interpreted by the Texas Supreme Court. For public education, that includes the cost of instruction, instructional materials, supervision, classrooms and transportation strictly necessary, much as the earlier "little red schoolhouse".

Equalization of funding the *necessities* of education should determine the amount of equalization which should be underwritten by the state. Current equalization does not meet this test; based upon the current fiscal year 2004-05, probably six billion dollars additional state funding would be required to meet this criterion, and to also redress the “de facto” unconstitutional statewide ad valorem tax created under current law.

The proposed basis for funding for the current 2004-05 school year would provide 17.4 billion state assistance, including teachers’ retirement and instructional materials, for a statewide operating budget of \$29.4 billion and capital budgeting of \$4.6 billion, or \$34 billion in total. The state would be funding 50 percent of total state public education, including federal and local sourcing. The result would be reduction of the average state school ad valorem tax from \$1.52 per 100 to \$1.00 per 100 assessed value.

***Finally, how should the state tax code be altered for optimally efficient and equitable taxation?***

The question of how to reform the state tax code in order to meet the standards of optimal efficiency and equity must include not only how to finance public education, but of equal importance is to do so in a manner which promotes the maximum growth of incomes of all Texans. To do so, the business unfriendly tax burden and its additional inequities of taxing capital intensive industries must be addressed by a consumption based tax.

The report prepared for TPPF titled “An Economic Evaluation of the Business Tax Burden in Texas” by Milton Holloway provides very useful data to show why business tax reform is necessary. The capital and property intensive sectors of Texas commerce – agriculture, mining, manufacturing, utilities and finance – pay on average 6.2 percent of each dollar of economic activity, compared to 2.3 percent on average for services, retailers and wholesalers. Simply stated, capital intensive industries are overtaxed, while service industries are under taxed.

To remedy this, the simultaneous reform of all business taxation is proposed along with the reform of public education funding *by introduction of the business activity tax, a subtraction method value added tax to be levied upon all employers and commerce.* The business activity tax (BAT) proposed would be determined as follows:

Total Revenues (excluding borrowing)  
 less: Purchases for Inventory  
     Purchased Services  
     Building and Equipment Expenditures  
     Employee Compensation up to Minimum Wage  
 = Taxable Value Added  
 x BAT Rate  
 = **BAT Tax Due**

Note that the BAT as originally proposed has been altered to provide the addition of exemption for all wages and salaries up to minimum wage (\$5.25 per hour, or \$10,920 per year) to prevent regressivity and loss of lower paying jobs.

The BAT as proposed would replace all business specific taxes, including:

Corporate Franchise Tax	\$1.8 bil
Insurance Premium Taxes	1.1 bil
Natural Gas Tax	1.5 bil
Oil Production and Regulation Tax	0.6 bil
Utilities Gross Receipts Taxes	<u>0.4 bil</u>
<b>State Business Taxes Replaced</b>	<b>\$5.4 bil</b>

It is proposed that the BAT would also replace the five cents per gallon of motor fuel taxes currently dedicated to education, which should be returned to highway funding.

The alterations to the state tax code and funding would total as follows:

State Business Taxes Eliminated	\$5.4 bil
Return School Motor Fuel Tax to Highways	0.7 bil
Increase State Public School Funding	<u>6.0 bil</u>
<b>Funding Required from State BAT Tax</b>	<b>\$12.1 bil</b>

The yield from the BAT as proposed would be \$5.1 billion per 1 percent rate, after a 10 percent allowance for estimation and evasion loss. *The required BAT tax to fund \$12.1 billion would be a 2.4 percent BAT rate.*

*In addition to the above tax relief it would be an ideal time, given the current surge in real estate values and assessments to eliminate the business personal property tax on the inventories and equipment component of ad valorem taxes, without the need for substitution.*

The overall effect of these changes in total would be transition from excessive taxation of capital intensive corporations to as equitable and attractive business tax code for Texas as possible, while ending the “crisis” in public school funding. The BAT as prescribed taxes a consumption base comparable to a comprehensive retail sales tax with minimum wage rebates, or a consumed income tax with minimum wage deductions, but would be efficiently taxed upon commercial income allowed by the Texas Constitution. The proposal is “tax neutral” in sum total, that is, the BAT would substitute funding equal to those taxes to be eliminated, and would preserve the intention that *all* employers and commerce are included for the broadest and most equitable tax base, at the lowest possible tax rate.