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Texas Conservative Coalition
Research Institute

State Budget & Taxation Task Force

FINAL REPORT

February 2025

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Limit local spending based on population and inflation

The Legislature should adopt a joint resolution that, if approved by voters, would limit the rate of increase in annual spending by a local unit to population plus inflation growth. Exceptions would be made for disaster situations and for proceeds from bonds that are approved by a supermajority of voters. If adopting a joint resolution is not feasible, then consider a statutory cap, as in Senate Bill 18 (85S1).

Policy Recommendation 2

Strengthen the state's constitutional spending limit by enshrining the provisions of SB 1336 (87R) in the Texas Constitution

Texas' constitutional spending limit should be strengthened and supplemented in order to address its fundamental shortcomings. This requires three key reforms: (1) apply the spending limit to all general revenue (including dedicated general revenue) and general revenue–related funds; (2) require a three-fifths vote of the Legislature to override the state spending limit; and (3) make the tax spending limit refer to changes in population plus inflation, rather than personal income growth or the growth of the state's economy. These reforms could be accomplished by enshrining the provisions of SB 1336 in the constitution.

Policy Recommendation 3

Limit local government debt based on property value

The Legislature should adopt a joint resolution that, if approved by voters, would prohibit local governments in Texas from issuing tax-supported debt in an amount that exceeds a certain percentage of the taxable value of property within their boundaries. Exceptions could be made for disasters, for grandfathering, and for bonds approved by a supermajority of local voters.

Policy Recommendation 4

In addition to policy recommendation 3, the Legislature should require that all bond elections be held on the November election date and that all bonds be approved by a supermajority (perhaps 2/3rds) of voters.

Policy Recommendation 5

Prohibit the use of statutorily dedicated accounts for budget certification

Prohibiting the practice of funds consolidation is a critical reform that will restore truth-in-budgeting. Dedicated accounts should be used only for their intended purpose—not to grow the state budget. Expressly prohibiting the use of statutorily dedicated accounts for budget certification in the constitution would be the most effective way to end the funds consolidation process. This would improve the transparency of the state budget and would ensure that statutorily dedicated accounts are used only for their intended purpose. If the use of these balances for funds consolidation were prohibited, the Legislature would have to appropriate the balances in these funds to their dedicated purposes over time, since retaining a balance in these funds would no longer serve a broader budgetary purpose.

Furthermore, each tax or fee imposed by the state should be set at a rate that sufficiently meets the needs of the purpose for which it is being collected, lowering the unnecessary burden on taxpayers. Since many general revenue-dedicated (GRD) accounts currently hold a large aggregate balance, it is clear that many of the associated taxes and fees are higher than what is necessary for the accounts to achieve their intended purposes. The House Ways and Means Committee and the Senate Finance Committee should undertake a review, engaging with industry stakeholders and the general public, to establish appropriate fees and tax rates as part of the process of ending the practice of funds consolidation.

Given the often-fierce debates over how best to appropriate state funds, reforming the manner in which GRD accounts are used in the budget certification process is most feasible when the state has a large budget surplus, as it will in the 2026-27 biennium. As the Legislative Budget Board (LBB) acknowledged in 2019, "The extent to which the Legislature implements measures to reduce reliance on these [GRD] balances [to certify the budget] should consider the prevailing fiscal conditions." The 89th Legislature should seize the opportunity and make the necessary changes.

Policy Recommendation 6

Amend the Texas Constitution to narrow the permissible uses of the ESF to cover revenue shortfalls, state debt retirement, one-time infrastructure projects, and expenses related to a state of disaster

Narrowing the uses of the Economic Stabilization Fund (ESF) would achieve what is frequently considered a best practice in governance of state rainy day funds. For instance, the Institute on Taxation and Economic Policy has argued that "rainy day funds should only be used to reduce the impact of budget shortfalls that arise from cyclical economic downturns—not to cope with long-term structural problems." Similarly, the Mercatus Center at George Mason University has suggested that states should "[e]nact rules governing the use of rainy day funds":

> State legislators can do more to ensure fiscal stability for their states by adopting requirements for deposits made to their rainy day funds and by setting strict rules about withdrawals. States that have already adopted such rules have, on average, lower spending volatility across years than states without such rules.

Amending Article III, Section 49-g(m) of the Texas Constitution to specify that other than in times of budget shortfall for a current biennium, the ESF may only be used for retirement of existing debt, one-time infrastructure payments, or to cover expenses related to a state disaster as declared by the governor under the Texas Government Code §418.014 would achieve this goal. House Joint Resolution 94 (84R, Burkett) should be used as a model for future legislation. HJR 94 proposed amending Article III, Section 49-g(m) as follows:

...the legislature may, by a two-thirds vote of the members present in each house, appropriate amounts from the economic stabilization fund <u>to:</u>
(1) <u>retire state debt;</u>
(2) <u>pay costs associated with a state of disaster declared by the governor; or</u>
(3) <u>pay nonrecurring costs of infrastructure projects</u>
[~~at any time and for any purpose~~].

It is important to note that legislation like HJR 94 would *still allow funds from the ESF to be used to address budget shortfalls*, since those situations are covered under Sections 49-g(k) and (l) of Article III of the constitution.

Policy Recommendation 7

Dedicate all funds that would otherwise flow to the ESF but for its balance reaching the constitutional limit to property tax relief

When the ESF balance swells to such a figure that the constitutional limit on transfers to it applies, that is a sure sign that the state's taxpayers are overfunding government. Absent legislative appropriations from the ESF, it is a virtual certainty that the limit will be reached in the 2026-2027 biennium, and consequently $3 billion in severance tax revenue is expected to be retained in General Revenue (GR) rather than flowing to the ESF. If the limit is indeed reached, the Legislature should dedicate any such retained revenue to property tax relief, preferably to the reduction of school maintenance and operations (M&O) taxes. While this dedication would ideally be done through a constitutional amendment, a statutory dedication would be an improvement over current law.

Policy Recommendation 8

Use the surplus to provide tax relief, ideally through compression of school M&O tax rates

Whichever option it chooses, the Legislature should consider dedicating at least half of the $23.8 billion budget surplus for the 2026-2027 biennium—$11.9 billion—to property tax relief through buying down school district M&O taxes.

Policy Recommendation 9

If the homestead exemption is increased, dedicate equal revenue to property tax relief for businesses

Policy Recommendation 10

Make permanent the 20 percent appraisal cap for certain non-homestead real property

Policy Recommendation 11

Require any rate in excess of a local taxing unit's no-new-revenue rate to be approved by local voters in an election

The State Budget in Perspective

The Texas economy continues to be the envy of other states. In January 2025, the Comptroller in his Biennial Revenue Estimate (BRE) for the 2026-2027 Biennium projected an ending general revenue (GR) balance of $23.8 billion for 2024-2025 biennium, which concludes on August 31, 2025.[1] But that rosy forecast is subject to the usual caveats; projections of economic growth (or contractions) are always tentative at best.

It is a given that, due to the large surplus, there will be many proposed spending increases in the 89th regular legislation session. It is critical that legislators consider proposals to increase spending (other than spending to finance tax cuts at the local level) with a skeptical eye, in the same manner they would if the state had no surplus at all. The state having a large surplus essentially means taxpayers are being overtaxed during the current biennium; the focus of the 89th Legislature should be on refunding most of those excess funds to the state's taxpayers.

Key Data from the BRE

As of January 2025, the Comptroller projects that the state will still see average annual real growth of 2.5 percent in gross state product (GSP) in the upcoming biennium. More specifically, the Comptroller projects real growth in GSP of 2.5 percent, 2.6 percent, and 2.5 percent in FYs 2025, 2026, and 2027, respectively. This growth, while steady, is below the 3.1 percent growth rate over the previous 10 years. The state's unemployment rate was 4.2 percent in November 2024. The Comptroller expects that figure to hold steady for FY 2026 before ticking up to 4.3 percent in FY 2027.

The Comptroller estimates that there will be $194.6 billion in general revenue–related (GRR) funds available for general-purpose spending in the 2026-2027 biennium, up from the $188.2 billion in the January 2023 BRE. Table 1 illustrates how this figure compares to projected balances available for certification in past BREs.

Figure 1

Biennial GR-Related Funds Available for Certification, 2002-2003 through 2026-2027

Biennium	General Revenue-Related Funds Available for Certification in BRE (in billions of dollars)	Percent Change in General Revenue-Related Funds Available for Certification in BRE compared to Previous BRE
2002-03	60.9	n/a
2004-05	54.1	-11.17%
2006-07	64.7	19.59%
2008-09	82.5	27.51%
2010-11	77.1	-6.55%
2012-13	72.2	-6.36%
2014-15	96.2	33.24%
2016-17	113.0	17.46%
2018-19	104.9	-7.17%
2020-21	119.1	13.54%
2022-23	112.5	-5.54%

[1] This Task Force Report often refers to the projected carryover GR balance of $23.8 billion for the 2024-2025 biennium as "the budget surplus."

2024-25	188.2	67.29%
2026-2027	194.6	3.40%

Source: Comptroller, Biennial Revenue Estimates.

It is important to note that the Comptroller's estimate of revenue available for certification that is announced in January of odd-numbered years is subject to later revision, and that the above table reflects projections, rather than revenue that was actually received during the applicable biennium. Nevertheless, the data in the table is noteworthy because it shows that the state—however modestly—is poised to build upon the extraordinary jump in funds that were available for discretionary spending by the 88th Legislature.

The total revenue the state expects to receive in the 2026-2027 biennium is $362.15 billion; however, this figure does not include the projected carryover budget surplus of $23.8 billion from the 2024-2025 biennium. The breakdown of that $362.15 billion is shown by fiscal year in Table 2, along with corresponding amounts for FY 2025 for reference.

Figure 2

Sources of All Funds Revenue, FYs 2025 through 2027 (in billions of dollars)

	FY 2025	FY 2026	FY 2027
GR-R	83.60	86.96	89.47
Dedicated GR	3.73	3.68	3.69
Federal Income	58.83	58.15	56.88
Other Funds	32.78	31.52	31.81
ALL FUNDS	178.94	180.30	181.85

Source:[1]

In summary, the state's fiscal position is strong and is projected to be steady during the 2026-2027 biennium. Although the projected $23.8 billion budget surplus is smaller than the surplus at the end of the 2022-2023 biennium, it is still a massive surplus, larger than the entire budget of some states. It is rare for the Legislature to oversee a budget surplus of such magnitude, which underscores how important the 89th Legislature's decisions will be for the future of the state.

Taking the steps outlined in this Task Force Report will ensure that government in Texas operates within its proper scope. But above all else, the Legislature should prioritize property tax relief. Although reforms in recent years have significantly restrained growth in property taxes, the state still has a high property tax burden relative to other states. Given the state's strong financial condition and its surplus revenue, it should return significant tax revenue to Texans. The Legislature should devote, at a minimum, half of the $23.8 billion surplus to property tax relief. As discussed in this Task Force Report, the optimal way of delivering this relief is for the state to "buy down" school district maintenance and operations tax rates; essentially, the state compresses these tax rates and then reimburses school districts for the forgone revenue. Increasing the homestead exemption from school property taxes and providing targeted tax relief to businesses should also be considered. Before examining potential property tax reforms, this report first discusses how the state constitution can be improved to control government spending.

The Tax Spending Limit

The spending limit contained in Article VIII, Section 22 of the Texas Constitution (sometimes called the "tax spending limit") provides that, "In no biennium shall the rate of growth of appropriations from state tax revenues *not dedicated* by this constitution exceed the estimated rate of *growth of the state's economy.*"[2]

The constitution grants the Legislature authority to provide statutory guidance to facilitate implementation of the spending limit. Under this guidance, the rate of growth of the state's economy is calculated by the Legislative Budget Board (LBB) by "dividing the estimated Texas total personal income[2] for the next biennium by the estimated Texas total personal income for the current biennium."[3]

The tax spending limit is an important restraint on the growth of state government. It does, however, have the following shortcomings:

1. The limit applies only to non-dedicated state tax revenue, rather than all general revenue of the state.
2. The limit applies only to state spending, not local government spending.
3. The limit may be overridden by a simple majority vote of the Legislature if it finds that an emergency exists.
4. The limit is based on an estimate of future personal income growth, and these estimates have traditionally been subject to significant margins of error.

As discussed in detail below, Senate Bill 1336 (87R; Hancock, et al.) made tremendous progress towards a stronger spending limit. Before turning to that bill's details, each of the above shortcomings in the tax spending limit is discussed.

All General Revenue Versus Dedicated General Revenue from State Taxes

The first major weakness of the state's current tax spending limit is that it applies only to state *tax* revenues *not dedicated* by the Texas Constitution. Thus, state revenue that is dedicated by the constitution, as well as all state non-tax revenue, escapes the application of the limit. This means an enormous amount of money is not subject to the limit. In the 2024-2025 biennium, GRR appropriations of state tax revenue dedicated by the state constitution were $26.6 billion, and $19.6 billion of GRR appropriations were financed with non-tax revenue (e.g., fees, license, fines, and lottery proceeds).[4]

Leaving aside the considerable state revenue outside its scope, the tax spending limit is phrased in a manner that is not transparent. As the Senate Finance Committee pointed out in an August 2020 interim report, the tax spending limit could be simplified by phrasing the amount subject to the spending limit to mirror the ways in which funds are discussed in the budget (GR, GR-Dedicated, Federal Funds, Other Funds, and All Funds).[5]

For the tax spending limit to be effective, it is critical that it apply to all state general revenue, whether dedicated or not, and whether attributable to taxes or non-tax sources. Doing so would be a significant change that would enhance the state's spending limit; it would no longer be a "tax spending" limit, but a general spending limit. A spending limit that does not apply to all state funds can be circumvented and will always be a less-than-optimal restraint on the growth of state spending.

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[2] The Legislative Budget Board relies on the U.S. Bureau of Economic Analysis' definition of "personal income", which consists of "the income that...residents get from paychecks, employer-provided supplements such as insurance, business ownership, rental property, Social Security and other government benefits, interest, and dividends," but not capital gains. See https://www.bea.gov/resources/learning-center/what-to-know-income-saving.

No Limit on Local Government Spending

Texas' current constitutional spending limit applies only to certain aspects of state spending; it does not impose any limit on local spending. The arguments for capping state spending by reference to population growth and inflation, which are discussed below, apply with equal force to local government spending.

An indication that spending at the local level in Texas has become problematic and that local governments are living beyond their means is the growing aggregate debt burden of local governments in Texas. As of August 31, 2024, the combined local debt in Texas was $333.3 billion[6]—a per capita burden of approximately $10,652 per resident.[3] Furthermore, these numbers do not take into account the interest that will be paid on that $333.3 billion in principal.

Figure 3

Texas Local Government Debt by Year

As of Fiscal Year End	Local Debt Outstanding (in billions)
2007	$141.4
2008	$160.3
2009	$174.6
2010	$183.8
2011	$192.7
2012	$195.8
2013	$200.3
2014	$205.3
2015	$212.4
2016	$218.5
2017	$218.0
2018	$230.0
2019	$240.0
2020	$251.8
2021	$266.4
2022	$284.2
2023	$309.8
2024	$333.3

Source: Texas Bond Review Board Annual Reports on Local Debt

As Table 3 shows, at the end of fiscal year 2007, the total debt held by Texas local governments was $141.4 billion. Over the ensuing 17-year period, that figure has soared by a net of about $192 billion. That increase alone is vastly greater than the state's total outstanding debt of $73.0 billion as of August 31, 2024.[7] This substantial increase in local government debt is striking because Texas' economy experienced solid growth of 4.9 percent annually from July 1, 2007 to July 1, 2024.[8] Despite this growth, local governments still felt compelled to borrow to finance their spending. Excessive local debt is the key reason the Cato Institute ranks Texas 43rd out of 50 states in terms of its combined state and local debt.[9]

The excessive borrowing of local governments in Texas is especially concerning given the relatively high burden of property taxes in Texas. While borrowing may allow local governments to "string out" debt payments over time, paying down principal of many billions of dollars in addition to the interest on that amount inexorably puts upward pressure on property taxes, which are easily the most significant revenue source for local bond repayment. The Bond Review Board's 2024 annual report indicated that $229.2 billion of the $333.3 billion in outstanding local debt is scheduled to be paid back with tax revenue (the remainder is attributable to alternatives such as revenue bonds, which are repaid with revenue generated from projects, such as water and utility fees).[10] As noted elsewhere in this Task Force Report, the Legislature has enacted significant property tax relief over the last several legislative sessions, which

[3] Using an estimated state population of 31,290,831 as of July 1, 2024, per U.S. Census estimates. See https://www.census.gov/quickfacts/fact/table/TX/PST040224.

slowed the rate of growth of maintenance and operations (M&O) property taxes imposed by local governments. However, growing local debt is still a concern because much of it is repaid through interest and sinking (I&S) property taxes, not M&O property taxes.

Implementing a limit on spending by local governments could be accomplished by a simple statutory change. Recognizing the threat of excessive spending by local governments, Senate Bill 18 (85S1, 2017) proposed to limit local government spending by reference to state population growth and inflation. Under the bill, a local government could exceed its spending limit only if the voters approved the excess spending or if the governor declared the area governed by the local government a disaster area. Importantly, the spending limit would not have applied to funds raised by voter-approved bonds, or to a gift, donation, or grant to the local government. If necessary, the bill's provisions could always be amended to substitute local population growth for state population growth. Although it was not enacted into law, the bill struck the correct balance between fiscal prudence and flexibility.

While critics of spending limits are sure to complain that they place local governments in desperate fiscal positions, there is ample evidence that voters are willing to provide authorization to spend. For example, on election day in November 2024, "88 local governments held 215 bond elections, with 68 local governments approving 175 bond elections totaling $28.65 billion. Approximately 40 bond elections were defeated totaling $7.87 billion of potential debt."[11] Approval of 175 out of 215 bond elections is a rate (81.4 percent) that makes clear that voters are willing to approve new local debt if local governments can make a reasonable case for it.

Policy Recommendation 1

Limit local spending based on population and inflation

The Legislature should adopt a joint resolution that, if approved by voters, would limit the rate of increase in annual spending by a local unit to population plus inflation growth. Exceptions would be made for disaster situations and for proceeds from bonds that are approved by a supermajority of voters (see discussion further below). If adopting a joint resolution is not feasible, then consider a statutory cap, as in Senate Bill 18 (85S1).

Low Bar to Override the Spending Limit

As noted above, the constitution also authorizes the Legislature to override the current spending limitation by a simple majority vote, provided that it is a record vote and that the Legislature finds that an emergency exists.[12] Although this provision has been exercised only once, it renders the existing spending limit a virtually meaningless "safeguard" against higher spending. Any budget passed by the Legislature already requires a majority vote in each house. Thus, a Legislature that collectively wishes to pass a budget which exceeds the spending limit simply faces a voting hurdle identical to the one it would face if the proposed budget were within the constitutional spending limit.

To address this shortcoming, the constitution should be amended to require a three-fifths vote requirement to override the spending limit. This change would require 90 affirmative votes in the House and 19 in the Senate to override the constitutional spending limit. A precedent for this is set by the constitutional requirements for appropriating funds from the Economic Stabilization Fund (ESF); the constitution establishes a three-fifths requirement (Art. III, 49-g, (k)) to appropriate ESF monies to address a current biennium shortfall.

Shortcomings of Basing the Current Constitutional Limit on Personal Income Growth

Perhaps the most critical flaw in the current constitutional limit on state spending is the manner in which it is calculated. Under current law, prior to a legislative session, the LBB adopts the constitutional spending limit that will be enforced for the upcoming biennium based on projections of personal income growth. It should be noted that the estimates of personal income growth frequently differ from actual income growth, and sometimes wildly so (see Figure 1). Moreover, the tax spending limit speaks of the "estimated rate of growth of the state's economy," and it is arguable whether personal income growth is the best measure of that.

More broadly, it should be obvious that personal income is not a sensible basis for a state spending limit: as personal income (wages, salaries, investment income, etc.) increases, the "need" for government services and assistance programs should decrease along with the spending on those programs. A spending limit that is functionally based on personal income growth assumes that state spending should continue to grow even as Texans become better-off. State spending and personal income should have an inverse relationship—not a direct one, as Texas' current spending limit does.

A far more reasonable approach to defining a constitutional spending limit is to base the limit on a population growth and inflation formula. At the simplest level, this would allow the state to continue to provide current services even as the state's population grows. Most importantly, in times of economic surplus, state spending could not exceed this "current services" standard. Conversely, whenever population growth slows (or even declines), state spending would have to be reigned-in accordingly.

A comparison of Texas' population growth plus inflation against actual and estimated personal income growth underscores the point that the population plus inflation measure is consistently the more conservative option and would therefore be the more effective type of spending limit. Table 4 and Figure 1 show the estimated and actual biennial rates of growth in personal income over the last several biennia, as well as corresponding population growth plus inflation.[4]

Figure 4

Biennial Adopted and Actual Rates of Personal Income Growth and Population Plus Inflation, 1996-97 to 2024-2025

Biennium	Percent Growth in Adopted Personal Income	Percent Growth in Actual Personal Income Growth	Percent Growth in Population + Inflation
1996-97	13.98	15.59	9.01
1998-99	11.12	17.04	7.49
2000-01	13.44	15.37	13.04
2002-03	14.09	6.84	7.64
2004-05	11.83	9.89	10.06
2006-07	11.34	18.39	10.62
2008-09	13.11	11.87	7.20
2010-11	9.14	6.46	8.57
2012-13	8.92	14.3	6.72
2014-15	10.71	10.51	5.63
2016-17	11.68	4.45	6.54
2018-19	8.00	13.14	6.74
2020-21	9.89	11.37	8.77*
2022-23	7.06	13.53**	15.70*
2024-25	12.33	-	-
2026-2027	8.93	-	-

Sources: Legislative Budget Board,[13] except as otherwise noted below.

**Population plus inflation for 2020-21 was calculated based on U.S. Census population estimates as of July 1, 2019, and*

[4] Although the phrase "population plus inflation" is sometimes used in this Task Force Report, calculating population plus inflation actually involves multiplication. The calculation for determining population and inflation growth is [(1 + change in population rate) * (1 + change in inflation)] - 1.

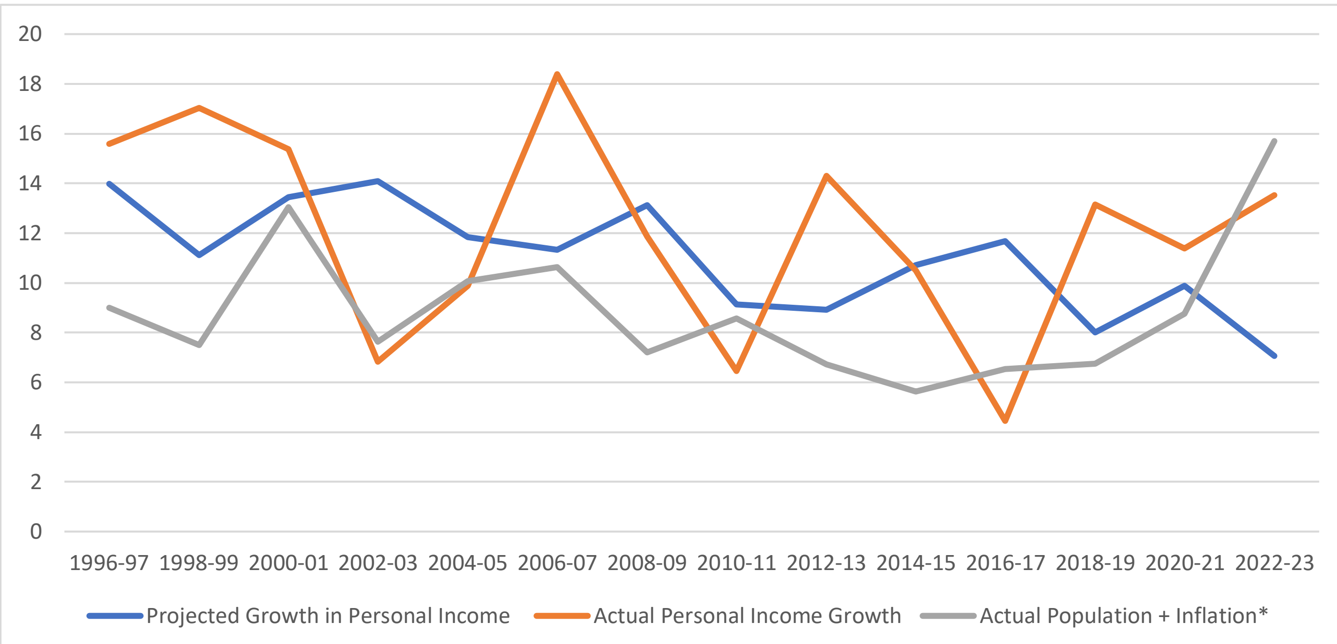
July 1, 2021, and inflation data from September 2019 and September 2021. A similar methodology was used for data for the 2022-2023 biennium.

***Personal income growth in the 2022-2023 biennium is estimated based on data from the Department of Commerce for years 2022-2023.[11] It is not precisely accurate because the state fiscal year starts September 1st.*

"-" signifies data is not yet available.

Figure 5

Biennial Actual & Estimated Personal Income Growth and Population + Inflation, 1996-1977 to 2023-2023



Sources: See Table 4.

From the 1996-1997 biennium through the 2020-21 biennium (inclusive), a population and inflation limit averaged 8.8 percent per biennium, while the average limit using estimated personal income growth averaged 11.0 percent per biennium—25 percent higher. The frequently wide variation between the adopted spending limit and actual personal income growth (i.e., the difference between the blue and orange lines in Figure 1) is also noteworthy. The data shows that actual biennial personal income growth over that same period is very volatile, vacillating wildly from a high of 18.4 percent to a low of 4.5 percent. Forced to deal with this unpredictability, LBB frequently adopted spending limits both far below and far in excess of actual personal income growth. For example, the estimated personal income growth rates for the 2002-03, 2016-17, and 2018-19 biennia were 14.1 percent, 11.7 percent, and 8.0 percent, respectively. However, the corresponding actual growth rates were dramatically different: 6.8 percent, 4.4 percent, and 13.1 percent, respectively. In contrast, the population and inflation metric is considerably more stable, generally staying in a narrower band between 6 and 11 percent for each biennium, with the glaring exception of the 2022-2023 biennium, when inflation was high across the country.

Senate Bill 1336: A Landmark Reform

In 2021, the Texas Legislature enacted Senate Bill 1336 (87R; Hancock, et al.), which made important strides in strengthening the tax spending limit. The bill imposes a statutory limit on the rate of growth in state appropriations of "consolidated general revenue" (CGR). CGR encompasses the general revenue fund in the state treasury, any dedicated fund within the general revenue fund, and any general revenue–related (GRR) fund. GRR funds include the Available School Fund, the State Technology and Instructional Materials Fund, the Foundation School Account, and the Tobacco Settlement Account.[15]

The limit on the rate of growth in CGR appropriations in a given biennium under SB 1336 is based on (a) the average of the estimated population growth in the state in that biennium and the preceding biennium, and (b) the average of the estimated growth in inflation in the state during that biennium and the previous biennium. The limit does not apply to appropriations made for tax relief or to pay for costs arising from a disaster. In addition, the limit can be exceeded at any time if each chamber of the Legislature finds by a three-fifths vote that an emergency exists and that the limit should be exceeded.

It is difficult to overstate the importance of SB 1336. Codifying the bill was a landmark accomplishment for conservatives in their struggle to ensure that the principle of limited government is followed in Texas. The bill's limit on the rate of growth in CGR appropriations addresses all of the shortcomings of the constitutional spending limit discussed above, except that the bill does not impose any limit on the rate of growth in spending by local governments.

But work remains for conservatives on the issue of a spending limit. SB 1336 is a statutory limit, not a constitutional limit. A constitutional limit is stronger and more firmly established because eliminating such a limit (through a constitutional amendment) would require both approval by the voters as well as a two-thirds vote in each chamber of the Legislature. It may be tempting for conservatives to rely on the protection of SB 1336, but nothing prevents a majority in a future legislature from repealing the provisions of SB 1336. Therefore, conservatives should not be content with SB 1336, but rather should continue to push for a constitutional amendment which effectively places the provisions of SB 1336 in the constitution.

The Legislature recently confronted a similar situation with respect to the state's prohibition on a state income tax. Prior to the 86th Legislature, then-Article VIII, Section 24 of the Texas Constitution authorized the Legislature to enact a personal income tax, with the qualification that doing so required the approval of voters in a referendum. Under that provision, a majority of the Legislature could impose a state income tax as long as a majority of state voters agreed. Although the imposition of an income tax was not popular at that time (or now), Gov. Greg Abbott presciently called for the Legislature to draft a constitutional amendment that would forbid the imposition of a state income tax. Such an amendment would mean that a future legislature could enact a personal income tax only with a subsequent constitutional amendment, which would require both the approval of voters and a two-thirds vote in each chamber of the Legislature (as opposed to a simple majority in each chamber, as under pre-2019 law). House Joint Resolution 38 (86R; Leach, et al.) passed the Legislature and was approved by voters as Proposition 4 in November 2019.

There is some similarity between the state's lack of an income tax as of early 2019 and the current spending limit under SB 1336: as things stood in early 2019, a future legislature, with a simple majority vote, could push for a state income tax (although enacting one would also require the approval of voters). The state's policymakers wisely raised the bar to the imposition of a personal income tax by amending the constitution. By comparison, a future legislature could repeal SB 1336 with a simple majority vote, without needing any approval from voters to do so. In short, politicians opposed to limited government have an easier path to overturning the spending limit of SB 1336 than they did in seeking a personal income tax prior to 2019. The 89th Legislature should exercise the same foresight regarding the current statutory spending limit under SB 1336 that the 86th Legislature did regarding a personal income tax, and permit voters to enshrine the provisions of SB 1336—supplemented by a limit on the rate of growth in spending by any local government—in the constitution. Passing the necessary House or Senate joint resolution would be challenging but not impossible; in 2019, SB 1336 received votes of 87-60[5] in the House and 19-12 in the Senate.

Policy Recommendation 2

Strengthen the state's constitutional spending limit by enshrining the provisions of SB 1336 in the Texas Constitution

Texas' constitutional spending limit should be strengthened and supplemented in order to address its fundamental shortcomings. This requires three key reforms: (1) apply the spending limit to all general revenue (including dedicated general revenue) and GRR; (2) require a three-fifths vote of the Legislature to override the state spending limit; and (3) make the tax spending limit refer to changes in population plus inflation, rather than personal income growth or the growth of the state's economy. These reforms could be accomplished by enshrining the provisions of SB 1336 in the constitution.

Limiting the Ability of Local Government to Take on Excessive Debt

Aside from enshrining the limits of SB 1336 in the constitution, the Legislature should seek another amendment to the constitution: imposing a limit on the ability of local governments to take on debt. The state is subject to four different constitutional spending limits: the "pay-as-you-go" or balance budget limit (discussed below); the spending limit (discussed above); the limit on tax-supported debt; and the limit on welfare spending.[16]

The limit on tax-supported debt, found in Article III, Section 49-j, prohibits the Legislature authorizing state debt if, in any fiscal year the resulting maximum annual debt service paid out of the General Revenue Fund, excluding revenues that are constitutionally dedicated to purposes other than payment of state debt, would exceed 5 percent of the average annual unrestricted General Revenue Funds for the previous three years.

The joint resolution that led to the debt limit constitutional provision was House Joint Resolution 59 (75R; 1997). In its analysis of that resolution, the House Research Organization (HRO) summarized one argument of the supporters:

> Statutory debt restrictions provide little protection against rising debt, because the Legislature can simply raise the debt limit when it wants to borrow more money. There is no guarantee that the Legislature will not incur excessive debt. The federal government and federal budget deficit provide a prime example of the historical and political tendency to take care of today's problems by spending tomorrow's revenues. Excessive debt impinges on the ability to fund current government operations.[17]

The point about the federal debt seems even more persuasive now. At the end of the 1997 fiscal year, the federal debt was roughly $5.4 trillion. Today, 27 years later, it is over $36 trillion.[18]

A limit on the debt issued by any local government entity could be phrased in terms of the taxable value of property within the local government entity's boundaries. For example, the Washington Constitution imposes a cap on tax-supported (i.e., payable from property taxes), non-voter-approved debt equal to 1.5 percent of taxable values. If three-fifths of voters approve, the limit on total debt is increased to 5 percent of taxable values. Cities and school districts are permitted to issue debt of up to 10 percent of taxable values in certain circumstances.[19] Notably, these constitutional caps in Washington are often supplemented by stricter statutory caps.[20]

Texas could apply a similar cap to local debt, with the percent of the relevant taxable value to be determined. While critics would undoubtedly argue that such a provision would prevent local governments from adapting to changing circumstances or responding to a

[5] The full tally was 87 Ayes, 60 Nays, and 1 Present Not Voting. This tally reflects the journal entries made by several representatives to correct their initial, mistaken votes.

future crisis, such a provision could easily be drafted to afford flexibility. First, taxable values within local governments' boundaries will grow over time, thus giving local governments the ability to issue more debt as inflation and population grow. Second, allowances or adjustments could be made for:

- Disaster situations;
- Debt which is approved by a supermajority (perhaps two-thirds) of local voters;
- Local government entities with small populations. Such entities might have to make capital expenditures which do not scale as well as they might for larger local governments; and
- "Grandfathering" to ensure that any local government currently over the proposed constitutional limit would not have its tax-funded capital improvement projects interrupted.

An additional strategy to combat local debt would be to require a supermajority of voters to approve issuance of any bond that is repaid with property tax revenue. A concern under current law is that bond elections can have low turnout, which increases the likelihood of tax increases being approved even if they are (often) politically unpopular. The Bond Review Board maintains a database of bond elections, and it contains numerous examples of this low turnout problem. For example, Irving ISD held a bond election in 2023, with five propositions totaling more than $700 million in bonds.[21] The largest of these propositions was for over $538 million and was approved on the May election date by a margin of 3,623 to 2,772, a total of 6,395 votes.[22] For context, in the 2021-2022 school year, Irving ISD served over 32,000 students.[23] Regardless of whether that particular proposition had popular support, it is concerning that hundreds of millions of dollars in spending and associated property tax increases are being approved by a relatively small number of voters. To address this problem, the Legislature should consider moving all bond elections to the November election date and requiring a supermajority—perhaps 2/3rd—of voters to approve the issuance of the applicable bonds.

Policy Recommendation 3

Limit local government debt based on property value.

The Legislature should adopt a joint resolution that, if approved by voters, would prohibit local governments in Texas from issuing tax-supported debt in an amount that exceeds a certain percentage of the taxable value of property within their boundaries. Exceptions could be made for disasters, for grandfathering, and for bonds approved by a supermajority of local voters.

Policy Recommendation 4

In addition to the policy recommendation immediately above, the Legislature should require that all bond elections be held on the November election date and that all bonds be approved by a supermajority (perhaps 2/3rds) of voters.

The "Pay as You Go" Limit and the Problem of GR-Dedicated Funds

Article 3, Section 49a(b) of the Texas Constitution contains the state's "pay as you go" spending limitation. This limitation reads: "[Subject to certain exclusions] ... no appropriation in excess of the cash and anticipated revenue of the funds from which such appropriation is to be made shall be valid." The Comptroller, through the Biennial Revenue Estimate released near the beginning of a regular legislative session, certifies the general revenue available to the state for the upcoming biennium. General revenue accounts include the state's main general revenue account, into which all non-dedicated tax collections are deposited.

General revenue accounts also include approximately 170 other accounts which are funded by certain taxes and fees, the revenue from which is dedicated to specific purposes. Commonly known as "general revenue-dedicated accounts," these accounts may receive revenues from a variety of sources, which are typically linked to the purpose of the fund. For instance, the Game, Fish, and Water Safety account (Account # 0009) is funded with revenue from sources such as fees for licenses and permits regarding game and fish; fines for violation of laws pertaining to wildlife protection and conservation; fees for oyster bed rentals and permits; and proceeds from the sale and lease of grazing rights.[24]

The balances in these general revenue-dedicated accounts often have a surplus. These surplus balances are taken into account by the Comptroller in his certification of general revenue available for a given biennium. Through a process known as "funds consolidation," general revenue-dedicated accounts can be consolidated, and their total collective balance may be applied toward certifying that the state budget does not exceed available revenue. This funds consolidation poses two related problems.

The first problem with funds consolidation is that it creates an incentive for the Legislature to leave balances in general revenue-dedicated accounts so that they can be used to certify that the state budget is within available general revenue. When policymakers go through the often-contentious process of ensuring that appropriations do not exceed projected revenue in an upcoming biennium, the unappropriated amounts in general revenue-dedicated accounts swell the projected revenue. This allows the Legislature to spend more than it would otherwise be authorized to spend. As former House Speaker Joe Straus stated in 2012: "The practice of 'funds consolidation' has evolved from a one-time accommodation and turned into a decades-long bad habit in our state's budget process."[25]

As a result of the incentive the Legislature has in allowing unappropriated balances in general revenue-dedicated funds to grow, large balances have accrued in many general revenue-dedicated accounts. One fund alone, the Texas Emissions Reduction Plan (TERP) account, is projected to have a $2 billion balance by the end of the 2024-25 biennium.[26] Aside from the TERP, the next largest fund balances in the most recent report are, in descending order:

- Employment Training and Investment Holding ($451.4 million);
- Clean Air ($312.6 million);
- Parks and Wildlife Conservation and Capital ($212.6 million);
- Texas Department of Insurance Operating ($206.1 million);
- Oil and Gas Regulation and Cleanup ($179.4 million);
- University of Houston Current ($162.2 million);
- Game, Fish, and Water Safety ($159.4 million);
- Solid Waste Disposal Fees ($134.2 million);

- University of Texas at Austin Current ($117.3 million);
- Subsequent Injury ($115.2 million).

Table 5 illustrates the extent to which funds consolidation has grown over the past 24 years.

Figure 6

General Revenue-Dedicated Accounts and Balances Used for Budget Certification (in billions)

72nd Legislature, 1991	$0.54
73rd Legislature, 1993	$0.94
74th Legislature, 1995	$1.31
75th Legislature, 1997	$1.14
76th Legislature, 1999	$1.34
77th Legislature. 2001	$1.63
78th Legislature, 2003	$2.20
79th Legislature, 2005	$2.75
80th Legislature, 2007	$3.08
81st Legislature, 2009	$3.67
82nd Legislature, 2011	$4.95
83rd Legislature, 2013	$4.17
84th Legislature, 2015	$3.48
85th Legislature, 2017	$5.30
86th Legislature, 2019	$5.76
87th Legislature, 2021	$5.65
88th Legislature, 2023	$5.92
CUMULATIVE TOTAL	$53.83

Source: Texas Comptroller of Public Accounts[27]

The "cumulative total" line in Table 5 is of great importance. This cumulative total to some extent double counts (or triple counts, or even more) the same unappropriated funds in a given general revenue-dedicated account that are carried forward from one biennium to the next. Nevertheless, irrespective of any double counting, the $53.83 billion total is not an overstatement. This has allowed the Legislature to make much higher appropriations than it otherwise would have been able to make. A simple example illustrates this effect: suppose that a general revenue-dedicated account has unappropriated funds of $1 million. Over the course of five biennia, that $1 million is not appropriated, and is not decreased or increased in any way. Even though it is only $1 million, the fact that it is used to certify general revenue in five separate biennia means that it authorized the Legislature to increase total spending over that period by $5 million.

The second problem with funds consolidation is that using general revenue-dedicated funds for budget certification creates serious transparency and accountability concerns. Dedicated revenue should be used for the purpose for which it was raised and for which the public was led to believe it would be used. If the state continuously has an aggregate surplus in its general revenue-dedicated amounts, it is essentially an admission that the taxes and fees which generated this surplus were unnecessarily high.

A detailed examination of any of these accounts illustrates the point. The Solid Waste Disposal Fees fund (SWDFF), for example, is authorized by Chapter 361 of the Health & Safety Code, which aims to "safeguard the health, welfare, and physical property of the people and to protect the environment by controlling the management of solid waste."[28] The Texas Commission on Environmental Quality (TCEQ) raises revenue by imposing a fee on solid waste that is disposed of in the state. For example, landfill operators must pay a fee of 94 cents per ton of waste.[29] Under current statute, the revenue from these fees is bifurcated; 66.7 percent goes to "municipal solid waste permitting programs, enforcement programs, and site remediation programs, and to pay for activities that will enhance the state's solid waste management program."[30] The remaining 33.3 percent is dedicated to the SWDFF to fund "local and regional solid waste projects consistent with regional plans approved by [TCEQ]."[31]

Charging a small fee to better manage the disposal of waste and promote the health of the public and the environment sounds like excellent policy when described at a general level. But the wisdom of charging fees for solid waste disposal at their current level is much more questionable when looking at the history of the SWDFF. The biennial report to the 80th Legislature estimated an ending balance of $76.2 million in the SWDFF.[6] Since then, the SWDFF has ended each biennium with a significant balance after accounting for revenue into the fund and appropriations out of it—usually an ending balance of well over $100 million. It is one thing for the state to have unexpectedly strong revenue in a year, which can create a surplus in a given GRD account. But when a GRD account is carrying very significant balances year after year, taxpayers have the right to ask: "Why are we paying taxes and fees for a specific purpose when the government is essentially hoarding money (raised through previous fees and taxes) that was supposed to be spent on that purpose?" Taxpayers have a right to demand: either spend the dedicated revenue to achieve the goals for which it was raised, or cut the taxes and fees that are generating the revenue.

Due to concerns about the problems of funds consolidation, there has been some effort in recent legislative sessions to reduce the state's reliance on balances in dedicated accounts to certify the budget. The 83rd Legislature enacted House Bill 7 (83R, 2013), which directed the Legislative Budget Board and the Comptroller of Public Accounts to review the funds consolidation process and legislative dedications of revenue. The 83rd Legislature also reduced reliance on dedicated accounts by almost $800 million compared to the previous budget, while the 84th Legislature reduced that reliance by another $700 million. Unfortunately, as Table 5 illustrates, that mini-trend reversed course in the 85th session, with the $5.92 billion mark for the 88th session being the all-time high. The 88th Legislature considered a bill that would have extended the initial six years during which the LBB was to review the use of dedicated funds for certification purposes. House Bill 3258 (88R, 2023) passed the House, but it did not receive a hearing in the Senate (neither did its companion bill, SB 1735).

The 84th Legislature also considered a resolution authored by Rep. Darby (HJR 111, 84R) that should be pursued again. HJR 111, which passed the House unanimously but was left pending in the Senate Committee on Finance, would have amended the constitution to prohibit:

- The Comptroller from using funds in general revenue-dedicated accounts for budget certification beginning with the 2022-23 biennium;
- The Comptroller from including funds in general revenue-dedicated accounts in the preparation of the Biennial Revenue Estimate for all or part of a state fiscal year beginning after September 1, 2016; and
- An appropriation from a general revenue-dedicated account being made for a purpose other than that for which the revenue was collected, unless the revenue or account dedication is repealed.

Finally, the 86th Legislature passed House Bill 3745 (2019) into law, which modified the administration of the TERP account. The bill extended the fees and surcharges which fund the TERP account, but provided that those funds would be deposited in an account outside of the state treasury effective FY 2022. The Texas Commission on Environmental Quality (TCEQ) oversees this account, and appropriations can be made from it for dedicated purposes only and without legislative appropriation.

Policy Recommendation 5

Prohibit the use of statutorily dedicated accounts for budget certification

Prohibiting the practice of funds consolidation is a critical reform that will restore truth-in-budgeting. Dedicated accounts should be used only for their intended purpose—not to grow the state budget. Expressly prohibiting the use of statutorily dedicated accounts for budget certification in the constitution would be the most effective way to end the funds consolidation process. This would improve the transparency of the state budget and would ensure that

[6] That is not to say that the problem did not exist before the 80th Legislature; rather, the Comptroller's reports on dedicated funds only go back to the 80th Legislature: https://comptroller.texas.gov/transparency/reports/use-of-general-revenue-dedicated/.

statutorily dedicated accounts are used only for their intended purpose. If the use of these balances for funds consolidation were prohibited, the Legislature would have to appropriate the balances in these funds to their dedicated purposes over time, since retaining a balance in these funds would no longer serve a broader budgetary purpose.

Furthermore, each tax or fee imposed by the state should be set at a rate that sufficiently meets the needs of the purpose for which it is being collected, lowering the unnecessary burden on taxpayers. Since many GRD accounts currently hold a large aggregate balance, it is clear that many of the associated taxes and fees are higher than what is necessary for the accounts to achieve their intended purposes. The House Ways and Means Committee and the Senate Finance Committee should undertake a review, engaging with industry stakeholders and the general public, to establish appropriate fees and tax rates as part of the process of ending the practice of funds consolidation.

Given the often-fierce debates over how best to appropriate state funds, reforming the manner in which GRD accounts are used in the budget certification process is most feasible when the state has a large budget surplus, as it will in the 2026-27 biennium. As the LBB acknowledged in 2019, "The extent to which the Legislature implements measures to reduce reliance on these [GRD] balances [to certify the budget] should consider the prevailing fiscal conditions."[32] The 89th Legislature should seize the opportunity and make the necessary changes.

The Economic Stabilization Fund (The "Rainy Day" Fund)

The Economic Stabilization (Rainy Day) Fund (ESF) was created after its approval by voters in the November 1988 constitutional amendment election. Article III, Section 49-g of the Texas Constitution establishes four sources of revenue for the ESF:

- 50 percent of any unencumbered general revenue (GR) balances on the last day of a biennium;
- 37.5 percent of oil and natural gas production tax revenues in excess of what those taxes generated in the fiscal year ending August 31, 1987 ($531.9 million for oil and $599.8 million for gas[33]);
- Interest earned on the balance of the Fund; and
- Any additional amounts appropriated directly to the ESF by the Legislature.

The constitution directs the Comptroller to calculate and deposit these revenues into the ESF; however, deposits to the ESF balance in a given biennium do not take place if the ESF balance reaches a figure that is equal to 10 percent of deposits (subject to certain exclusions) to general revenue in the previous biennium.[34] In this case, the funds that otherwise would be deposited to the ESF instead remain in the general revenue fund. The limit for the 2026-27 biennium is $26.51 billion,[35] up from $26.38 billion for the 2024-25 biennium.[36]

While there is no minimum required balance for the ESF, oil and gas tax revenue that would otherwise flow into the State Highway Fund (SHF) is directed to the ESF if the ESF falls below a "sufficient balance."[7] The sufficient balance for ESF purposes is equal to seven percent of the certified GR-related appropriations made for that state biennium.[37] For the 2024-2025 biennium, that figure is $11.21 billion.[38] As discussed below, the Comptroller projects that the constitutional limit on transfers to the ESF will (absent any appropriations from the ESF) come into play in the 2026-2027 biennium; as a result, the sufficient balance for that biennium will not be relevant.

Senate Bill 69 (86R; Nelson) made two important changes to how the ESF is administered. First, the sufficient balance of the ESF for a given biennium, starting with the 2022-23 biennium, was no longer set by a legislative committee, but rather is equal to 7 percent of the certified general revenue-related appropriations made for that biennium. Second, SB 69 greatly expanded the ability of the Comptroller to invest a portion of the ESF as a prudent investor would, which will help the fund at least keep pace with inflation. As the Comptroller stated in 2017, the pre-SB 69 guidelines for investing the ESF were so cautious and restrictive that they led to investing the fund in a manner akin to "burying the money in a hole on the Capitol lawn."[39] In contrast, SB 69 permits the Comptroller to invest up to three-quarters of the ESF in accordance with the prudent investor standard. The remainder will be invested in safe, liquid investments to ensure the state can tap the fund as needed. Over time, SB 69 should yield significant additional revenue for the state and ensure that the ESF's value is not eroded by inflation. That bill appears particularly prescient now, given the tremendous growth in the ESF balance since the 86th Legislature. As the Comptroller noted in the BRE for the 2026-2027 biennium, the investment earnings on the ESF's balance are expected to top $1 billion in each of FY 2026 and FY 2027.

[7] The term "sufficient balance" is no longer used in statute as a result of Senate Bill 69 (86R, 2019); however, this Task Force Report continues to use the term because the concept remains in statute.

Current and Projected Balances in the ESF

The projected ending balance of the ESF for the 2024-25 biennium is $24.28 billion. When the transfer of FY 2025 severance tax revenue to the ESF takes place in early FY 2026, the balance is projected to hit the cap of $26.51 billion, resulting in $307 million being retained in general revenue. In FY 2027, no transfers to the ESF are expected for the same reason; an estimated $2.6 billion that would flow to the ESF if its balance were not at the constitutional limit will instead be retained in general revenue. Absent any appropriations from it, the ESF is expected to end the 2026-2027 biennium with an all-time high balance of $28.50 billion. Although the ESF's limit for the upcoming biennium is $26.51 billion, that limit, when reached, only prevents additional transfers of severance tax revenue to the ESF. Because the ESF earns investment income (to which the limit does not apply), its balance is expected to be above $26.51 billion throughout virtually the entire 2026-2027 biennium.

Use of the Economic Stabilization Fund

Article III, Section 49-g, subsections (k), (l), and (m) outline the three situations in which the Legislature may appropriate funds from the ESF:

> (k) For the current biennium: If the Comptroller certifies that appropriations from GR made by the preceding legislature exceed available GR and cash balances for the remainder of that biennium. This type of appropriation from the ESF requires a *three-fifths vote* in both the House and Senate.
>
> (l) For a succeeding biennium: If the Comptroller estimates that anticipated revenues for the succeeding biennium will be less than the revenues that the Comptroller estimates to be available in the current biennium. This type of appropriation from the ESF requires a *three-fifths vote* in both the House and Senate.
>
> (m) For any purpose and at any time: this type of appropriation requires a two-thirds vote in both the House and Senate.

The Importance of Maintaining a Healthy Balance in the ESF

Maintaining a healthy balance in the ESF is critical to ensuring that the state can meet future revenue shortfalls, and to retain Texas' strong bond ratings. In its 2024 annual report on state debt, the Texas Bond Review Board noted that credit rating agencies such as Moody's and Fitch had given Texas' general obligation bond debt their highest ratings. In giving Texas this rating, Moody's noted that the state's high credit rating "reflects Texas's dynamic economy that will continue to surpass national growth; impressive population expansion that will well-outpace the nation and drive employment growth; substantial reserves that help safeguard against economic and revenue downturns; and strong fiscal management and governance…"[40]

When voters endorsed the creation of the ESF in 1988, they approved a constitutional amendment "establishing an economic stabilization fund in the state treasury to be used *to offset unforeseen shortfalls in revenue*." Until the 83rd Legislature, with two narrow exceptions, the ESF had only been used to make supplemental appropriations related to revenue shortfalls: SB 7 (71S6, 1991), HB 7 (78R, 2003), HB 10 (79R, 2005), and HB 4 (82R, 2011). The two exceptions, SB 171 (73R, 1993) and SB 532 (73R, 1993), related to Texas Department of Criminal Justice (TDCJ) capacity issues and totaled less than $200 million.

Despite the clear wording of the 1988 constitutional amendment, the Texas Constitution states that the ESF may be used for any purpose with the appropriate legislative approval. Article III, Section 49-g(m) states that "the Legislature may, by a two-thirds vote of the members present in each house, appropriate amounts from the economic stabilization fund at any time and for any purpose." It was under this constitutional provision that the 83rd Legislature passed legislation proposing a $2 billion appropriation from the ESF for water infrastructure and considered legislation appropriating ESF revenue for transportation infrastructure. The 83rd Legislature also used the ESF to undo the $1.75 billion deferral of the final Foundation School Program payment of the 2012-13 biennium, underscoring the beginnings of a troubling trend of the Legislature using the ESF for what should be core GR expenditures. In the supplemental appropriations bill for the 2018-19 biennium (86R; SB 500), the Legislature included more than $500 million appropriation from the ESF for one-time payments to certain participants in the Teacher Retirement System, even though the state's fiscal position at the time was relatively strong. That bill also appropriated an additional $5.5 billion for various purposes, although many of them were related to Hurricane Harvey. House Bill 2 (87R), the supplemental bill for the 2020-21 biennium, continued the trend by appropriating more than $530 million, although this was understandable given the COVID-19-related downturn that was affecting the state's finances then. The 88th Legislature passed HJR 3—and the voters approved in November 2023—a constitutional amendment appropriating all ESF interest, dividends, and investment revenue earned during fiscal 2023 to the Texas University Fund (TUF) in fiscal 2024—up to $100 million. The amendment also provided that, starting in fiscal year 2025, the previous fiscal year's earnings appropriated to the TUF from the ESF may be increased based on the Consumer Price Index, not to exceed 2 percent.[41]

It is only through the defects of the original constitutional language creating the ESF that expenditures from the Fund such as those during the 83rd Legislature are permitted. As noted above, Article III, Section 49-g(m) of the Texas Constitution allows funds to be spent from the ESF for any purpose upon a two-thirds vote of the Legislature. In order to protect the balance of the ESF and promote fiscal restraint, this provision should be substantially narrowed.

Policy Recommendation 6

Amend the Texas Constitution to narrow the permissible uses of the ESF to cover revenue shortfalls, state debt retirement, one-time infrastructure projects, and expenses related to a state of disaster.

Narrowing the uses of the ESF would achieve what is frequently considered a best practice in governance of state rainy day funds. For instance, the Institute on Taxation and Economic Policy has argued that "rainy day funds should only be used to reduce the impact of budget shortfalls that arise from cyclical economic downturns—not to cope with long-term structural problems."[42] Similarly, the Mercatus Center at George Mason University has suggested that states should "[e]nact rules governing the use of rainy day funds":

> State legislators can do more to ensure fiscal stability for their states by adopting requirements for deposits made to their rainy day funds and by setting strict rules about withdrawals. States that have already adopted such rules have, on average, lower spending volatility across years than states without such rules.[43]

Amending Article III, Section 49-g(m) of the Texas Constitution to specify that other than in times of budget shortfall for a current biennium, the ESF may only be used for retirement of existing debt, one-time infrastructure payments, or to cover expenses related to a state disaster as declared by the governor under the Texas Government Code §418.014 would achieve this goal. House Joint Resolution 94 (84R, Burkett) should be used as a model for future legislation. HJR 94 proposed amending Article III, Section 49-g(m) as follows:

...the legislature may, by a two-thirds vote of the members present in each house, appropriate amounts from the economic stabilization fund <u>to:</u>
(4) <u>retire state debt;</u>
(5) <u>pay costs associated with a state of disaster declared by the governor; or</u>
(6) <u>pay nonrecurring costs of infrastructure projects</u>
[~~at any time and for any purpose~~].

It is important to note that legislation like HJR 94 would *still allow funds from the ESF to be used to address budget shortfalls*, since those situations are covered under Sections 49-g(k) and (l) of Article III of the Constitution.

Policy Recommendation 7

Dedicate all funds that would otherwise flow to the ESF but for its balance reaching the constitutional limit to property tax relief.

When the ESF balance swells to such a figure that the constitutional limit on transfers to it applies, that is a sure sign that the state's taxpayers are overfunding government. Absent legislative appropriations from the ESF, it is a virtual certainty that the limit will be reached in the 2026-2027 biennium, and consequently $3 billion in severance tax revenue is expected to be retained in GR rather than flowing to the ESF. If the limit is indeed reached, the Legislature should dedicate any such retained revenue to property tax relief, preferably to the reduction of school M&O taxes. While this dedication would ideally be done through a constitutional amendment, a statutory dedication would be an improvement over current law.

Property Tax Reform, Reduction, and Relief

Texas has an opportunity to show that more government is not the way forward. Rather than creating new government programs, growing existing programs, or hiring more public employees, Texas can underscore its faith in the free market by permanently lowering taxes and setting itself on a private sector path to prosperity. The state's franchise tax and local property taxes are both unnecessarily burdensome, and should be the focus of any legislative efforts to provide tax relief. Legislation in the 86th, 87th, and 88th legislative sessions delivered reforms that have helped limit the growth of property taxes, but current property tax burdens throughout the state are still high relative to other parts of the country. The Legislature should pursue a number of property tax reforms, including buying down school M&O tax rates with surplus state revenue and eliminating or reducing taxes on tangible personal property used in a business (possible reforms on the latter topic are discussed in Section VI below).

Raising approximately $47.2 billion (All Funds) in FY 2024,[44] the sales and use tax is not only the single largest single tax revenue generator in the state,[45] it is also one of the least onerous and most efficient and transparent forms of taxation. Consumption taxes in general (of which Texas' sales and use tax is an example) are a superior form of taxation because they do not penalize work, savings, or investment. Twenty years ago, then-Federal Reserve Board Chairman Greenspan testified to the following economic benefits of consumption taxes: "many economists believe that a consumption tax would be best from the perspective of promoting economic growth ... because a consumption tax is likely to encourage saving and capital formation."[46] The logic behind that position holds true today. Property taxes and the franchise tax are therefore where lawmakers should focus their tax relief efforts. These two taxes are especially punitive toward businesses, job creation, capital investment, and, in the case of the property tax, home ownership. Reforming these taxes to put the state on a path to greater economic prosperity demands bold action.

As discussed below, the Legislature has made great strides in reforming property taxes since 2019. The projected budget surplus at the end of the 2024-2025 biennium will allow the Legislature to build upon those earlier reforms.

The Effects of Recent Property Tax Relief

Through House Bill 3 (86R, 2019) the Legislature used surplus revenue to reduce, or "compress," school M&O tax rates by seven cents per $100 of taxable value. In addition, HB 3, along with Senate Bill 2 (86R), lowered the percentage by which a taxing unit's year-over-year (YoY) M&O tax revenue, subject to certain adjustments, may increase without the approval of local voters in an election (2.5 percent for school districts and 3.5 percent for most other taxing units[8]). Furthermore, HB 3 implemented a mechanism by which school district M&O tax rates are automatically further compressed if local *or* statewide property values increase beyond 2.5 percent in a given year.

In 2021 the Legislature adopted a resolution increasing the homestead exemption from school district taxes from $25,000 to $40,000 (the associated constitutional amendment was approved by voters in 2022).

In 2023, the 88th Legislature had a record budget surplus at its disposal and used it to deliver a package of strong property tax reforms to Texans. The relevant legislation changed the law in the following ways:

- Increased the homestead exemption from school district property taxes from the current $40,000 to $100,000. A "hold harmless" provision ensures that

[8] A small number of taxing units, referred to as special taxing units (STUs), are subject to higher caps than those set forth in HB 3 and SB 2. Because of their relatively minor importance, this Task Force Report does not discuss STUs.

surplus state revenue compensates school districts for the forgone revenue.

- Compressed school M&O tax rates by 10.7 cents per $100 of taxable value, subject to the condition in current law that a school district's Tier 1 M&O tax rate may not be less than 90 percent of any other school district's Tier 1 M&O tax rate.

- Provided a cap of 20 percent in the year-over-year growth in the appraised value of any non-homestead real property. The cap applies only to properties with an appraised value of $5 million or less, although that $5 million figure is adjusted annually for inflation This cap, however, is applicable only for tax years 2024, 2025, and 2026; after December 31, 2026, this change is scheduled to "sunset" and revert to former law, which does not provide any cap in the year-over-year growth in appraised values for non-homestead properties.

- Provided that appropriations made for property tax relief are not subject to the constitutional tax spending limit, which states that appropriations of state tax revenue that are not dedicated by the constitution may not, for a given biennium, increase (relative to the previous biennium) at a rate greater than the estimated rate of growth of the state's economy in that biennium.

- Increased the number of directors on an appraisal district's board of directors from five to nine, but only for counties with a population of 75,000 or more. Of the four additional directors, three must be elected by voters (the other is the county tax assessor-collector). Members of appraisal review boards must now be appointed by the board of directors, and this appointment would require the affirmative voter of at least two of the three elected directors. However, for counties with a population of less than 75,000, the applicable judge would continue to appoint members of the appraisal review board.

The 2023 homestead exemption increase and the compression provided $12.7 billion in property tax relief to Texans in the 2024-2025 biennium (another approximately $5.3 billion was budgeted to maintain earlier compression of school district M&O tax rates).

The cumulative effects of these reforms and the 2023 reforms discussed below are becoming increasingly evident as time passes. In 2018, only New Jersey and Illinois had higher effective property tax rates on single family homes than Texas (2.18 percent).[47] But by 2023, according to ATTOM Data Solution, a property tax research firm, Texas' effective homeowner property tax rate had "fallen" to 12th-highest.[48] But much work remains to be done. Table 6, taken from the Comptroller's 2022-2023 biennial report on property taxes, shows the growth of property taxes over time, disaggregated by taxing unit type.

Figure 7

Property Tax Levy Growth by Taxing Unit Type, 1998-2023

Tax Year	Special Purpose District Levy	% Change in SPD	County Levy	% Change in County	City Levy	% Change in City	School Levy	% Change in ISD	Total Levy	Total % Change
1998	$1,883,080,138		$2,619,628,810		$2,970,251,205		$11,228,753,261		$18,701,713,414	
1999	$2,063,101,426	9.56%	$2,646,645,113	1.03%	$3,179,745,715	7.05%	$11,917,859,505	6.14%	$19,807,351,759	5.91%
2000	$2,888,621,638	40.01%	$2,873,452,097	8.57%	$3,504,092,996	10.20%	$13,301,083,561	11.61%	$22,567,250,292	13.93%
2001	$2,651,610,746	-8.20%	$3,246,024,017	12.97%	$3,847,976,857	9.81%	$15,026,153,737	12.97%	$24,771,765,357	9.77%
2002	$2,867,735,633	8.15%	$3,507,842,313	8.07%	$4,117,776,708	7.01%	$16,262,058,353	8.23%	$26,755,413,007	8.01%
2003	$3,084,209,240	7.55%	$3,774,835,414	7.61%	$4,366,866,303	6.05%	$17,198,357,427	5.76%	$28,424,268,384	6.24%
2004	$4,579,488,574	48.48%	$4,089,744,284	8.34%	$4,518,242,703	3.47%	$18,428,882,515	7.15%	$31,616,358,076	11.23%
2005	$3,617,024,497	-21.02%	$4,402,504,841	7.65%	$4,863,361,658	7.64%	$20,186,781,140	9.54%	$33,069,672,136	4.60%
2006	$3,970,005,374	9.76%	$4,937,454,611	12.15%	$5,286,535,198	8.70%	$20,811,154,860	3.09%	$35,005,150,043	5.85%
2007	$4,512,711,637	13.67%	$5,352,522,462	8.41%	$5,895,031,685	11.51%	$18,796,244,425	-9.68%	$34,556,510,209	-1.28%
2008	$4,952,792,863	9.75%	$5,863,884,238	9.55%	$6,406,453,878	8.68%	$21,124,726,350	12.39%	$38,347,857,329	10.97%
2009	$5,134,342,018	3.67%	$6,035,439,440	2.93%	$6,546,689,972	2.19%	$21,681,527,731	2.64%	$39,397,999,161	2.74%
2010	$5,395,436,477	5.09%	$6,036,573,208	0.02%	$6,553,776,429	0.11%	$21,582,858,323	-0.46%	$39,568,644,437	0.43%
2011	$4,924,190,615	-8.73%	$6,208,531,842	2.85%	$6,661,221,363	1.64%	$21,923,148,715	1.58%	$39,717,092,535	0.38%
2012	$5,530,689,644	12.32%	$6,505,085,887	4.78%	$7,004,163,084	5.15%	$22,965,265,816	4.75%	$42,005,204,431	5.76%
2013	$5,311,005,897	-3.97%	$6,949,426,677	6.83%	$7,271,470,566	3.82%	$24,397,363,508	6.24%	$43,929,266,648	4.58%
2014	$6,363,499,461	19.82%	$7,448,383,408	7.18%	$7,768,696,671	6.84%	$26,570,247,739	8.91%	$48,150,827,279	9.61%
2015	$6,952,742,838	9.26%	$8,016,707,675	7.63%	$8,318,105,027	7.07%	$27,894,584,723	4.98%	$51,182,140,263	6.30%
2016	$8,028,538,312	15.47%	$8,335,177,994	3.97%	$9,099,861,446	9.40%	$29,469,130,143	5.64%	$54,932,707,895	7.33%
2017	$9,128,216,329	13.70%	$9,144,582,770	9.71%	$9,730,426,404	6.93%	$31,751,930,542	7.75%	$59,755,156,045	8.78%
2018	$8,485,263,910	-7.04%	$9,602,798,872	5.01%	$10,387,752,412	6.76%	$34,723,549,607	9.36%	$63,199,364,801	5.76%
2019	$8,909,719,354	5.00%	$10,423,290,377	8.54%	$11,146,148,401	7.30%	$36,065,930,857	3.87%	$66,545,088,989	5.29%
2020	$9,486,152,671	6.47%	$11,290,528,493	8.32%	$11,963,476,245	7.33%	$37,759,657,465	4.70%	$70,499,814,874	5.94%
2021	$10,400,963,921	9.64%	$11,694,130,764	3.57%	$12,495,940,682	4.45%	$38,946,142,782	3.14%	$73,537,178,149	4.31%
2022	$10,409,180,231	0.08%	$12,797,292,169	9.43%	$13,634,471,866	9.11%	$43,949,038,027	12.85%	$80,789,982,293	9.86%
2023	$12,723,403,616	22.23%	$14,174,524,582	10.76%	$15,049,228,872	10.38%	$39,496,580,852	-10.13%	$81,443,737,922	0.81%
AVERAGE ANNUAL INCREASE	7.08%		6.17%		5.92%		5.10%		5.63%	

Source: Comptroller, Biennnial Tax Report 2022-2023 (January 2025).

As Figure 6 illustrates, property tax levies grew at a far too high rate of 9.86 percent in 2022, although that rate fell to 0.81 percent in 2023 as the reforms of the 88th Legislature were implemented. While school district property taxes fell by over 10 percent in 2023, that reduction was more than offset by double-digit increases in each of special district, county, and city tax levies.

How are some local taxing units seeing such growth in tax revenue given the Legislature's reforms discussed above? The problem has several components. First, as noted above, current law provides that YoY growth in a local taxing unit's property tax revenue may rise by a certain amount (generally 2.5 percent or 3.5 percent) before voter approval is required. Second, these YoY caps apply to M&O taxes, but not to I&S taxes, which are used to fund capital improvements. While voters must approve property tax-supported bonds, voter turnout is often low in these elections, making it possible for politically unpopular tax increases to nevertheless be approved (see the discussion earlier in this Task Force Report about the growth of local debt throughout Texas). Third, as the state continues to grow, new property is placed into service and goes onto the tax rolls. New houses are built, some homeowners add improvements to their houses, and some property that benefitted from temporary tax incentives returns to property tax rolls after the incentives expire.

An increase in property tax revenue can be understandable when the population in a local taxing unit grows and new houses are constructed. But the other two causes of property tax increases mentioned in the paragraph above call for reform. Three reforms to pursue are: (1) use surplus state revenue to "buy down" school district M&O taxes; (2) abolish the business personal property tax, or if that cannot be accomplished, significantly reduce it; and (3) require voter-approval elections for any property tax rates which increase property tax revenue to any extent.[9]

General Concerns with Property Taxes

Before discussing the four reforms listed above, it is helpful to consider why property taxes are such a concern in Texas. Despite landmark property tax reform in the 86th Legislature, a common complaint among Texans concerns the amount of their property tax bills. From 1999 through 2023, annual property tax levies in Texas quadrupled, from $20.28 billion to $81.44 billion.[49] The property tax system should be a concern for conservatives everywhere for three reasons in particular. First, as a practical matter, property taxes are particularly onerous because of a liquidity problem they pose for taxpayers. That is, the tax burden on a taxpayer rises as the value of his or her property appreciates, even if there is no readily available means for the taxpayer to use the increased value of his or property to pay the increased tax.

For example, assume a taxpayer who earns $60,000 a year pays property taxes of 2.5 percent a year on a house and land worth $180,000, or $4,500 a year. If the taxpayer's property appreciates at an annual rate of 5 percent, the taxpayer cannot readily pay the increased taxes out of the increase in the property value. In contrast, a taxpayer who is unable to pay sales tax on an item will not purchase the item in the first place and thus does not have to pay sales tax. Even prior to the explosion in housing values across the state in the last few years, taxpayers who were faced with increasing property tax bills that exceed their ability to pay were sometimes forced to borrow from a property tax lender to keep their homes.[50] A 2022 news report noted that, "The [property tax lending] industry began to flourish in Texas in the 1990s and grew steadily until the pandemic cut its fortunes short. Peaking in 2019, property tax lenders processed a total of $198 million in loans that year, according to state records. In 2020, that number dropped to a little more than $165 million.[51] The average interest rate of these loans was more than 13 percent for residential properties and almost 12 percent for commercial properties.[52]

Notably, the healthy demand for loans at high interest rates suggests that a great many property owners are struggling to pay their property tax bills. Owners who wish to avoid loans with such high rates, or who do not qualify for such loans, might be pressured into selling their homes to "downsize" and reduce their property tax bills.

Second, in contrast to sales taxes, property taxes impose significant compliance costs. There is no ready way to determine the precise value of a home, which necessitates the appraisal process, which in turn leads to disputes between homeowners and taxing authorities. The annual revenue taken in by the state's

[9] A fourth reform— requiring a super-majority of voters to approve the issuance of bonds that will be paid back with property tax revenue— is discussed earlier in this report.

property-tax consulting industry can be thought of as the price of these compliance costs, or more accurately, as a part of those costs, because many other costs (e.g., time lost by homeowners as a result of appraisal dispute) are not captured in that figure.

Third, and most fundamentally, property taxes are concerning to conservatives because they limit the value of private property rights. Functionally, there is a strong similarity between a property tax system and a system in which taxpayers lease property from the government for an annual fee. If taxpayers must pay government on an ongoing basis for the use of their own property, they cannot be said to have true ownership of that property. Such a lease-like arrangement is difficult to reconcile with a high regard for private property rights.

Respect for private property rights and recognition of the liquidity problems which property taxes pose for taxpayers argue against raising revenue through a property tax system. If a property tax system cannot realistically be abolished, conservatives should focus on limiting property taxes and raising necessary revenue through more efficient and equitable means.

Buying Down School District M&O Taxes with State Revenue

In his January 2025 Biennial Revenue Estimate for the 2026-2027 biennium, the Comptroller projected that the state will end the 2024-2025 biennium with a $23.8 billion surplus (after taking into account certain constitutionally required transfers), although he emphasized that, as always, economic projections are imprecise.[53] With this large surplus, the Legislature should make property tax relief its chief priority in the 89th Legislature. *At a minimum, for every dollar of increased state spending in the 2026-2027 biennium, at least one dollar should be directed to property tax relief.* Of course, under this formulation, state appropriations effectively used to fund property tax cuts should not be viewed as increased state spending, but rather as spending for tax relief.

The best way to provide Texans with property tax relief is for the state to use its surplus revenue to "buy down" school district M&O taxes, a process which is already in place to an extent due to HB 3 from the 86th Legislature. Through this process, the state compression percentage is lowered, thereby lowering the minimum and maximum property tax rates school districts can impose, with the state holding harmless school districts for the forgone local tax revenue. Under current law, the maximum and minimum Tier 1 M&O tax rates a school district can impose vary from district to district depending on the property value in the district, although there is an absolute cap and an absolute floor that apply to all districts. For the 2024 tax year, no district may impose a Tier 1 M&O tax rate greater than $0.6855 per $100 of taxable property value, or a rate lower than $0.6169 per $100 of taxable property value.[54]

The state has a history of buying down school M&O taxes. In response to a Texas Supreme Court decision, the Legislature modified the school finance system in House Bill 1 (79S3, 2006), which, among other things, slashed the maximum M&O tax rate which school districts could impose and provided state funding to "hold harmless" school districts for the lost revenue. As noted above, HB 3 (86R) overhauled the school finance system, again compressing local tax rates and using state funds to increase funding for school districts. Over time, the automatic compression mechanism in HB 3 will use state revenue to reduce school district M&O tax rates. Moreover, the Legislature bought down school M&O tax rates by almost 11 cents per $100 of taxable value in 2023.

These past measures demonstrate that the state can fulfill its constitutional duty to offer quality education to all children in Texas, while at the same time providing property tax relief. School district M&O taxes are an attractive target to cut because they are generally the single largest component of a taxpayer's property tax bill; in the 2023 tax year, school district taxes (both M&O and I&S) comprised $39.50 billion of the $81.44 billion in property taxes statewide: 48.5 percent.[55] The vast majority of that $39.50 billion was from M&O tax revenue.[56]

But there are other good reasons for providing property tax relief through a buydown of school district M&O rates. First, as a type of property tax, school district M&O taxes have all of the flaws of this category of taxes, which are discussed in detail above. Second, this approach has virtually no administrative costs. The collection of property taxes of course has administrative and compliance costs, but simply making rates lower does not increase those costs. Third, buying down school district M&O rates delivers broad tax relief. A homestead exemption increase—while a welcome tax cut—benefits only homeowners. In contrast, buying down rates benefits people who own non-homestead homes and businesses. In addition, lowering school district M&O tax rates lowers costs for landlords, which in a competitive market enables them to pass on at least a portion of the savings to renters in the form of lower rent.

Several strong bills which recognize the goal of buying down school M&O rates have been filed in recent years. Each of House Bill 958 (87R; Oliverson, et al.) and House Bill 2074 (87R; Shaheen) would have dedicated 90 percent of the general revenue for a biennium that exceeds 104 percent of the GR for the previous biennium to reducing the state compression percentage, thereby compressing school district M&O tax rates. House Bill 59 (87R; Murr, et al.) would have outright eliminated Tier 1 M&O taxes, with the forgone revenue being replaced by an alternative mechanism, such as increased sales taxes. HB 59 was approved in committee but did not receive a vote on the House floor. Similar legislation in the 88th legislative session included House Bill 612 (Shaheen), House Bill 174 (Oliverson), and House Bill 29 (Murr).

The Legislature could consider either of two approaches discussed below to implement a mechanism by which substantial portions of biennial growth in state funds are dedicated to property tax relief.[10]

1. Dedicate 90 percent of the difference between (a) GRR in a biennium over (2) the population plus inflation-adjusted GRR of the previous biennium to school district M&O compression; or

2. Alternatively, dedicate 80 percent of biennial ending GR balances to school district M&O compression.

The state tends to grow its revenues over time. As Table 7 illustrates, if the first option above had been in place since 2010, the state would have been able to generate significant compression of school district M&O tax rates. For reference, school district M&O tax revenue for FY 2025 (including recapture revenue) is expected to be approximately $32.21 billion.[57]

[10] The constitutional tax spending limit, discussed above, does not pose a challenge for policymakers seeking to buy down school district M&O rates with GR. A constitutional amendment approved by voters in 2023 makes clear that state spending to pay for property tax relief is not subject to the limit.

Figure 8

Amounts hypothetically dedicated to buying down school district M&O property tax rates by using 90 percent of the difference between GRR over the population + inflation adjusted GRR for the previous biennium

Biennium	GRR*	Population growth + inflation over the biennium**	Biennial GRR adjusted for population + inflation over the biennium	90% of GRR Growth over population + inflation adjusted GRR from previous biennium (cannot be less than zero)	Cumulative Amount Dedicated to Buying Down School District M&O Tax Rates
2008-2009	$85,890,504	7.20%	$92,074,620	n/a	n/a
2010-2011	$76,569,503	8.57%	$83,131,509	$0	$0
2012-2013	$90,832,218	6.72%	$96,936,143	$6,930,638	$6,930,638
2014-2015	$103,658,514	5.63%	$109,494,488	$6,050,134	$12,980,772
2016-2017	$108,536,421	6.54%	$115,634,703	$0	$12,980,772
2018-2019	$111,095,016	6.74%	$118,582,820	$0	$12,980,772
2020-2021	$117,581,455	8.77%	$127,893,349	$0	$12,980,772
2022-2023	$159,311,344	15.70%	$184,323,225	$28,276,196	$41,256,967

**Source: Comptroller's Certification Revenue Estimates (Table A-2 in each report)*

***Source: See Table 4.*

Several points about Table 7 deserve emphasis. First, the amounts in the second-from-the-right column are zero dollars for several biennia because there was insufficient growth in GR-R funds. This raises a second, corollary point: the methodology in Table 7 provides an ample "cushion" which allows for reasonable growth in state spending. This is seen clearly in the table. GR-R was almost $6.5 billion greater in 2020-2021 than it was in the preceding biennium. But no portion of that increase was used to provide additional compression. Given this cushion, the state should be able to fund government services as needed even as it provides tax relief. Moreover, a significant portion of state spending—most notably federal income—would not be affected by this method of delivery property tax relief.

Third, Table 7 should not be interpreted as indicating that $41.3 billion in *additional* compression would have been delivered to taxpayers. This would involve substantial double counting, because the Legislature did of course provide substantial compression in some of the years listed, most notably during the 2024-2025 biennium (which reflected the massive jump in GRR in the 2022-2023 biennium).

Fourth, compression is an ongoing commitment. Once a given amount of dollars is committed to it, the same amount must be committed in future biennia to ensure that school district M&O tax rates do not rise back to their previous levels. For example, assuming HB 958 had been in place, there was insufficient GR-R revenue in the 2016-2017 biennium to provide additional compression. Nevertheless, the almost $13 billion worth of compression attributable to previous biennial surpluses remained in effect. While the Comptroller will occasionally project a biennium-over-biennium drop in projected revenue, as it did for the 2010-2011 biennium, the state quickly rebounds from these rare downturns. Just as it did in the 2010-2011 biennium, the state can temporarily tighten its belt.

The second of the tax relief options listed above would be even more straightforward: dedicate 80 percent of ending GR balances that would otherwise carry over to the next biennium to property tax relief.

Figure 9

Amounts hypothetically dedicated to buying down school district M&O property tax rates by using 80 percent of the certified ending GR balance at the end of each biennium (all dollars in billions)

Biennium	Ending GR Balance after all required transfers*	80% of Ending GR balance after all required transfers
2010-2011	$1.14	$0.91
2012-2013	$5.51	$4.41
2014-2015	$8.34	$6.67
2016-2017	$0.88	$0.70
2018-2019	$4.72	$3.78
2020-2021	$11.23	$8.98
2022-2023	$39.24	$31.39

Source: Comptroller, Certification Revenue Estimates

The total amount of property tax relief delivered under this method is not the sum of the figures in the rightmost column, because such summing would double count the same dollar. For example, given the fungibility of money, the $31.39 billion figure for 2022-2023 incorporates the $8.98 billion figure from the previous biennium. And as with the first option discussed above, the Legislature did in fact use some of ending GR balances for compression.

Policy Recommendation 8

Use the surplus to provide tax relief, ideally through compression of school M&O tax rates

Whichever option it chooses, the Legislature should consider dedicating at least half of the $23.8 billion budget surplus for the 2024-2025 biennium—$11.9 billion—to property tax relief through buying down school district M&O taxes.

The Homestead Exemption from School District Property Taxes

While school district M&O compression should be the primary mechanism for delivering property tax relief, another possibility is increasing the homestead exemption from school property taxes. The political popularity of increasing the homestead exemption is difficult to overstate, as illustrated by Table 9.

Figure 10

Homestead Exemption Increases Approved by Texas Voters

Year approved by voters	Increase in homestead exemption	Legislation	Proposition	Percent of voters voting in favor of the proposition
1997	$5,000 to $15,000	HJR 4 (75R)	1	94%[58]
2015	$15,000 to $25,000	SJR 1 (84R)	1	86%[59]
2022	$25,000 to $40,000	SJR 2 (87S3)	2	85%[60]
2023	$40,000 to $100,000	HJR 2 (88S2)	4	83%[61]

If the Legislature opts to increase the homestead exemption, it is important to recognize that increasing the homestead exemption shifts the relative burden of school taxation to non-homestead owners—most prominently, commercial property owners. This can be illustrated with a simple example. Assume a school district in which half the taxable property is commercial property, and the other half is homesteads. The school district raises $10 million in property tax revenue—$5 million from each of the two categories of property owners. If the homestead exemption is increased and the state holds the school district harmless, and all else remains equal, the amount of taxes paid by homestead owners will decline (for the sake of illustration, to $4 million). Commercial property owners still pay $5 million in taxes to the school district. Before the homestead exemption increase, commercial property owners paid 50 percent of the taxes. After the increase, they pay 55.6 percent of those taxes (i.e., $5 million divided by $9 million), and homestead owners pay the other 44.4 percent.

Thus, as the homestead exemption increases, businesses are responsible for an ever-greater percentage of school district taxes. Not only is the effective school district property tax rate higher on businesses than it is on homestead owners, but the tax base of businesses (i.e., which property of theirs is subject to taxation) is broader because businesses, unlike individuals, must pay property tax (both school and non-school property taxes) on their tangible personal property, subject to certain exceptions.

Furthermore, year-over-year growth in the appraised value of a homestead in Texas, excluding new improvements, is capped at 10 percent. As noted above, legislation in 2023 provided a cap of 20 percent in the year-over-year growth in the appraised value of certain non-homestead real property—namely, those with an appraised value of $5 million or less (inflation-adjusted over time). But the cap applies only to tax years 2024, 2025, and 2026, after which no cap will apply. Whether to extend it is an interesting question that requires an analysis of appraisal caps in general.

As a preliminary matter, it should be noted that non-school taxing units in Texas generally have the ability to set their M&O tax rates provided that year-over-year tax revenue growth (excluding revenue from new property) does not exceed certain levels. For most non-school taxing units, that level is 3.5 percent, but for some (often smaller) taxing units, it is 8 percent. If a taxing unit wants to set its rates higher, it must obtain approval from local voters in an election. A school district is subject to a different set of rules, but its year-over-year growth in local M&O tax revenue is similarly constrained. By contrast, in the non-school district context, a taxing unit can simply respond to any narrowing of its tax base by simply increasing its rates, subject to the year-over-year limitations mentioned above.

Thus, appraisal caps by themselves do not reduce taxes system-wide, although they may do so for the particular taxpayers whose properties are subject to the appraisal cap. Rather, appraisal caps partially shift the burden of taxation from property owners whose properties are subject to the cap, to those whose properties are not. The 10 percent appraisal cap for homestead owners in Texas thus results in some taxes that would otherwise have been paid by homestead owners being paid for instead by non-homestead property owners (e.g., businesses). The Comptroller estimates that in tax year 2023, the 10 percent cap had a "cost" of $637 million.[62] This cost had to be paid for by non-homestead owners.

The shifting of tax burdens, or subjecting taxpayers to different effective tax rates, should generally be avoided as a matter of policy. However, it is fair to ask if, assuming an appraisal cap is in place for homestead owners, whether non-homestead owners should also benefit from a cap. If such owners also benefit from a cap, that can offset or even eliminate the shifting of the tax burden that flows from the appraisal cap on homesteads. Because the cap on non-homestead property valued at less than $5 million (adjusted for inflation) in current law is 20 percent, and that for homestead owners is 10 percent, there will still be some shifting of taxation from the latter to the former. But that is better than no cap at all.

In short, the current system of property taxation in Texas—particularly with respect to school district taxes—places a disproportionate burden on businesses.

While increases in the homestead exemption are always welcome, ideally they would be paired with business-specific property tax relief to offset the already disproportionate burden of taxation businesses in the state bear. An ideal target would be to reduce taxes on businesses' tangible personal property.

Policy Recommendation 9

If the homestead exemption is increased, dedicate equal revenue to property tax relief for businesses.

Policy Recommendation 10

Make permanent the 20 percent appraisal cap for certain non-homestead real property.

Tax Rate Elections for Any Taxing Unit that Increases Revenue Year-Over-Year

As discussed above, the 86th Legislature made remarkable strides in restraining the future growth of property taxes in the state. The Legislature should continue to expand on the foundation laid by SB 2 and HB 3 by asking the fundamental question: *why should voter approval of any year-over-year increase in M&O tax revenue not be required?* Currently, growth in year-over-year M&O revenue (excluding revenue from new property) is capped at 2.5 percent or 3.5 percent, although some smaller taxing units and community college districts have an 8 percent cap. In addition, the 2.5 and 3.5 percent caps are temporarily eased in the case of disasters. A strong argument can be made that *any* annual increase in M&O revenue (except for that attributable to new or improved property) should require voter approval. The requirement of voter approval is already present to a large extent with I&S taxes that fund capital improvement projects because voters must approve the issuance of new bonds.

Allowing local governments to increase taxes every year without an election could lead to the presumed default that M&O revenue "should" increase to the capped amount every year. This presumption is counter to the idea that government should constantly be examining its expenditures and seeing how it can reduce taxes as technology progresses and society becomes wealthier. Proponents of allowing local governments to raise increased revenue without an election will point to inflation and how it erodes the value of money over time. This erosion, their argument goes, justifies small increases in annual revenue to keep spending in real dollars constant. This argument should be countered by two considerations.

First, notwithstanding the spike in inflation in 2021 and 2022, inflation in the coming years is likely to be low. According to the Federal Reserve Bank of St. Louis, as of January 2025, the expected average annual inflation over the next 30 years as predicted by the financial markets is just 2.35 percent.[63]

Second, property tax caps do not apply to newly constructed properties or to new improvements to existing property. Given the rate at which Texas is growing, these exceptions to the cap will generate significant revenue for local governments.

Third, and most importantly, Texas voters have shown a consistent willingness to approve the issuance of debt when local governments can provide a good reason for that issuance. As stated above in this Task Force Report's discussion of local spending, on election day in November 2024, 88 local governments held 215 bond elections, with 68 local governments approving 175 bond elections totaling $28.65 billion. Thus, any claim that local governments will not be able to carry out necessary functions if increased property tax revenues are contingent on voter approval rings hollow.

Texas has been an economic beacon to the rest of the country over the last few decades. It will continue to be and property values across the state will continue to rise. Despite the reforms of SB 2 and HB 3, the Senate Committee on Property Tax aptly stated in its November 2020 interim report: "Taxpayers are in desperate need for additional property tax relief. As property values continue to increase, tax rates must fall. To that end, the tax code should be amended to require a vote on any rate increase over the no-new-revenue rate."[64]

Policy Recommendation 11

Require any rate in excess of a local taxing unit's no-new-revenue rate to be approved by local voters in an election.

The Business Personal Property Tax

As noted above, Texas' property tax system places a disproportionate burden on businesses. Part of the state's heavy property tax burden is reflected in its broad general rule that tangible personal property used in a business or for the production of income, such as a business's machinery, furniture, supplies, and inventory, is subject to local property taxes. This tax on tangible personal property tax used for the production of income is referred to herein as the "business personal property tax" (BPPT), and tangible business personal property is referred to herein as "BPP."

Overview of the BPPT

Generally, taxpayers must submit a rendition statement of all tangible personal property used for the production of income that they own, or manage and control as a fiduciary, as of January 1st of a given year.[65] The rendition statement is filed with the appraisal district office in the county in which the property is taxable.[66] Taxable property is then subject to local governments' standard property tax rates. There are numerous exemptions to the BPPT; Table 10 lists some of the larger or better-known exemptions. The figure adjacent to each exemption is the "cost" of the exemption, i.e., the property tax revenue forgone by local governments state-wide as a result of the exemption.

Figure 11

Select Exemptions to the Business Personal Property Tax and Their Estimated Value (FY 2025)

Exemption	Estimated Value of the Exemption in 2025
For income-producing personal property valued at under $2,500	$1.6 million
For farm products	$188.1 million
For offshore drilling equipment not in use	$0.1 million
For railroad rolling stock	$23.4 million
Motor vehicles for income production and personal use	$0.3 million
For pollution control property	$175.7 million
For freeport property and cotton stored in warehouses	$508.2 million
For tax increment financing	$185.6 million
For projects under the Texas Economic Development Act (Chapter 313)	$1.02 billion

Source: Comptroller, Tax Exemptions & Tax Incidence Report (January 2025)

As Table 11 illustrates, the BPPT generates significant revenue for local governments. In 2023, business tangible personal property constituted roughly 8.5 percent of the statewide property tax base and the BPPT generated perhaps $6.9 billion in revenue.

Figure 12

Estimated Revenue from the BPPT (2023)

	2023
School District Taxable Value of Property in the State*	$4,014,755,531,497
Estimated School District Taxable Value of BPP**	$341,803,744,732
Estimated Percentage of School District Taxable Value Consisting of BPP***	8.51%
Total Property Tax Levy in the State****	$81,443,737,922
Estimated Property Tax Levy on BPP*****	$6,933,865,434

Source: The underlying data is from the Comptroller, Biennial Property Tax Report, 2022-2023.

**This value is only an approximation of the total taxable property in the state; due to differing local tax exemptions and several state statutes (e.g., Chapter 313, Tax Code), the total tax base for school districts is somewhat different than the tax bases for cities and counties.*

***This estimate is derived by summing the school district taxable values for Commercial Personal, Industrial Personal, and Special Inventory (categories L1, L2, and S, respectively) in the Comptroller's Biennial Tax Report.*

****This estimate is obtained by dividing School District Taxable Value of Property in the State by Estimated School District Taxable Value of BPP.*

*****This estimate is determined by adding together the property tax levies by school districts, cities, counties, and special districts, as they are set forth in the Comptroller's Biennial Tax Report.*

******This estimate is calculated by multiplying the Total Property Tax Levy in the state by the Estimated Percentage of School District Taxable Value Consisting of BPP. This number is approximate; because property tax rates vary by local taxing unit, total revenue from the BPP is not necessarily the same as the number that is equal to the product of the Total Property Tax Levy in the state and the Estimated Percentage of School District Taxable Value Consisting of BPP.*

Economic Dynamics of the Current BPPT

As economist Dr. John Merrifield noted in a 2022 paper, "The widespread persistence of [BPP] taxation is [a] testament to its sole virtues; inertia and obscurity."[67] The BPPT is poor tax policy for several reasons. First, it violates the principle of "horizontal equity"—the idea that similarly situated taxpayers should be treated equally. Under current Texas law, a business must pay property taxes on the tangible personal property it holds for the production of income (inventory, furniture, equipment, supplies, etc.). Intangible property, however, is generally exempt from the BPPT (although a few types of intangible property are taxable). A retailer (for example, a grocery store or hardware store) potentially faces a significant burden under current law in that its inventory is subject to property tax. Similarly, a manufacturing business may face high taxes as a result of the machinery it uses in the manufacturing process. In contrast, service-oriented businesses, such as software companies and accounting and law firms, are far less likely to face significant property taxes on their property because the bulk of their assets are often intangible.

Second, the BPPT imposes significant compliance costs on businesses. In cases where taxation is appropriate policymakers should aim to minimize the transactional and compliance costs associated with the tax. However, property taxes are generally costly to administer and comply with when compared to other forms of taxation. Under the current BPPT system, a business must determine the value of its tangible assets in preparing its rendition statement to the applicable appraisal district. Although a taxpayer may submit a good faith estimate of value, the taxpayer must be prepared to defend this estimate. Even a small business may have dozens of items for which a value must be reported, and determining the value of an item can involve significant research by the taxpayer. Alternatively, a taxpayer may provide the historical cost of the item of property and the year in which it was purchased, but this requires a taxpayer either to keep records of his or her purchases for a long period of time, and in some cases to know what the previous owner of an item of property paid for it. A dispute between a taxpayer and the appraisal district over the value of the taxpayer's tangible personal property must be settled at an appraisal review board hearing or in court. Many taxpayers opt to retain professional assistance in calculating or contesting their BPPT liability, which of course imposes further costs on them. As the Senate Finance Committee stated in an August 2020 report:

> Industries that rely heavily on inventory have identified the business personal property tax as a significant burden. In addition, small business owners report difficulties in compliance, given the complexities involved in reporting and assigning values to their assets. Texas law requires business owners to report business personal property to the appraisal district for assessment and taxation. This process can be costly for both taxpayers and the appraisal district (internal footnotes omitted).[68]

The BPPT imposes compliance costs not just on taxpayers, but also on local governments. In 1995, the Legislature passed House Bill 366 (74R), which, in conjunction with House Joint Resolution 31, established a $500 exemption for taxpayers subject to the BPPT.[69] HJR 31 provided in part that:

> The Legislature may exempt from ad valorem taxation tangible personal property that is held or used for the production of income and has a taxable value of less than the minimum amount sufficient to recover the costs of the administration of the taxes on the property, as determined by or under the general law granting the exemption.

As the House Research Organization's analysis of HB 366 explained, some counties were incurring administrative costs with respect to properties with little value that were subject to the BPPT, to the point that the administrative costs exceeded the revenue raised by the tax.[70] It should be noted that the $500 exemption was not indexed to inflation, even though that would be appropriate given the rationale for its creation. Fortunately, the exemption was increased to $2,500 by Senate Bill 1449 (87R; Bettencourt, et al.).

A third aspect of the BPPT which makes it poor policy is that it applies to businesses even when those businesses are operating at a loss. Businesses in their first several years of existence are particularly likely to operate at a loss. Startups, struggling businesses, and capital-intensive businesses are also vulnerable to shouldering a tax burden which is entirely disconnected from their profitability or their ability to pay the tax. Ideally, startups should be directing their cash flow into expanding their workforces and developing their offered products and/or services, rather than dealing with an administratively burdensome tax. The burden of the BPPT on small and new businesses is exacerbated by the lack of a cap on the tax; in contrast, annual increases in the appraisals of residential homesteads, for example, are generally capped at 10 percent.

Fourth, the BPPT distorts economic behavior. While all taxes affect behavior to some extent, policymakers should aim to disrupt the interactions of businesses and consumers as little as possible so that a free market can function most efficiently. In the case of the BPPT, businesses have an incentive to minimize their capital investment and inventory holdings. For example, a business considering a purchase of expensive machinery to produce goods more efficiently may opt instead to use less efficient manual labor in light of the BPPT. In turn, this decision results in lower productivity, stunting economic growth. As the Tax Foundation has stated, "There is evidence that the elimination of [the BPPT] increases investment in capital. In Ohio, policymakers exempted manufacturing equipment from the state's [BPPT], resulting in greater capital investment and a shift from labor."[71] Similarly, a company may refrain from ordering additional inventory due to concern that its holdings will be subject to the BPPT.

Economic Effects of Increased Exemptions to the BPPT

Repealing the BPPT should be the goal of the Legislature, but if that cannot be accomplished, increasing exemptions to the BPPT would still provide substantial economic benefits to the state. While a BPPT is flawed by its nature, there are several aspects about Texas' version that make it particularly burdensome

First, as noted above, Texas has high property tax rates relative to most of the country. Thus, all else being equal, an exemption from property tax in Texas is more valuable than in other states.

Second, Texas is the largest-producing state of both oil[72] and natural gas.[73] Given the size of its oil and gas industry, Texas is an especially poor place in which to impose a BPPT, which by its nature burdens capital-intensive industries in particular. Third, while many states include tangible personal property in their tax base to at least some extent, Texas is one of only nine states that fully taxes inventory (five others have partial taxes on it).[74]

Finally, Texas' base exemption of $2,500 is trivial. Of the states that tax BPP, a number offer exemptions of $50,000 or more.[75]

Increasing exemptions to the BPPT (or eliminating it altogether) would likely provide a net benefit to the state. A corollary of the BPPT's distortion of economic behavior is that businesses have a strong incentive to operate in low-tax jurisdictions. Indeed, much of the "Texas Miracle" is credited to Texas government out-competing other states by welcoming migrating and new businesses through a combination of low taxes and light regulation.

Ohio is an instructive example; the state overhauled its tax system in 2005, which among other things eliminated its BPPT on new investment in manufacturing and phased out its BPPT on other business tangible personal property. For the next four years, Ohio won Site Selection Magazine's "Governor's Cup" award as the state with the most major business expansion projects.[76] This success has been lasting; Ohio earned the second-highest ranking (behind Texas each year) from 2014 through 2020 in terms of the number of expansion projects.[77]

The BPPT is a flawed tax that penalizes certain types of businesses, such as capital-intensive businesses and retailers; is administratively burdensome; applies to businesses regardless of profitability; and erodes the state's competitive edge relative to other states. The Legislature should work toward the long-term goal of eliminating the tax in light of these inherent flaws.

Policy Recommendation 12

Main: Eliminate the BPPT in its entirety or, if that is not possible, provide a percentage discount off the BPPT liability of every taxpayer subject to that tax.

The Legislature should eliminate the BPPT entirely based on the aforementioned reasons. This could carry a biennial cost of $14 billion or more, and accordingly might require a phase-in. If the BPPT cannot be eliminated, however, an excellent alternative would be to grant a percentage discount off the BPPT liability of every taxpayer subject to it. For example, every BPPT taxpayer could be granted a 40 percent discount, such that a taxpayer's tentative $100,000 BPPT liability is reduced to $60,000.

If the above options cannot be implemented due to competing budget priorities, the Legislature could at the very least exempt basic necessities from the BPPT. Texas law already exempts medicines, prescription drugs, and unprepared food from sales tax,[78] recognizing that taxing purchases of necessities is poor policy. Subjecting these same items to a different tax (the BPPT) is similarly poor policy. Consumers are still reeling from the global inflation spike in 2021 and 2022, and imposing taxes on businesses that stock these necessities puts upward pressure on the prices of those goods.

Policy Recommendation 13

Exempt unprepared food, medicine, and prescription drugs from the BPPT

If the Legislature opts not to enact the above measure, it could consider any one or more the following options, which are ordered from smallest expected fiscal impact to largest.

Policy Recommendation 14

Alternative: Increase the BPPT exemption to $100,000

Policy Recommendation 15

Alternative: Exempt businesses that have gross receipts under the franchise tax no-tax threshold (currently $2.47 million) from the BPPT

Policy Recommendation 16

Exempt all inventory from the BPPT

Policy Recommendation 17

Alternative: Exempt BPP from school district M&O taxation

One final aspect of the BPPT that deserves emphasis is that it can apply to property with respect to which the property owner has paid sales tax. For example, the purchase of computers by a business would be subject to sales tax, and then subject to BPPT each year the business owns the computers. Subjecting ownership of property to two different taxes is poor policy.

A particularly striking example of this policy can be seen with equipment involved in the provision of telecommunication services. Longstanding Texas law[79] exempts tangible property used in the manufacturing process from sales tax, which prevented the sort of double taxation noted above. What constitutes "manufacturing" in a modern economy is not always clear. In 2013, the Legislature enacted House Bill 1133 (83R), which made clear that tangible property used in the distribution of cable television service, Internet service, or the transmission of telecommunications services qualifies as property used in manufacturing and should therefore be exempt from sales tax. The bill provided for this exemption by allowing telecommunication providers to file refunds for sales tax on the applicable BPP. Notably, however, the legislation capped statewide annual refunds of this type to $50 million. Telecommunication providers that file refund requests receive a prorated refund under the $50 million cap. House Bill 3358 would have removed the $50 million cap, but only for six years. The bill was unanimously voted out of committee but did not receive a vote in the House.

If the BPPT cannot be eliminated in the 89th legislative session, one alternative way of combating it would be to focus on eliminating the BPPT on property that is currently subject to it, as well as sales tax at the time of purchase. A logical target here would be the permanent removal of the $50 million cap discussed above. The fiscal impact would be significant but minimal compared to the cost of eliminating the BPPT; the fiscal note for HB 3358 stated that the Comptroller annually receives $110 million in sales tax refund requests relating to telecommunications BPP, and $50 million in refunds relating to those requests are already paid out under current law.

Policy Recommendation 18

Eliminate the cap on sales tax refund requests relating to BPP used to provide telecommunications services

Eliminating the $50 million cap would help address the poor tax policy of subjecting BPP to both the BPPT and sales tax, and recognize that "manufacturing" in a modern, high-tech economy encompasses the use and consumption of tangible personal property in the provision of telecommunication services. Ironically, the state currently subsidizes the expansion of broadband services through the recently created The Texas Broadband Infrastructure Fund (House Bill 9, 88R)—$1.5 billion in the 2024-2025 biennium[80]—and also subjects BPP used in providing broadband services to onerous and outdated taxation.

The Franchise Tax

Overview

The tax base for the franchise tax, referred to as a business's margin, equals the business's total annual revenue minus its choice of a deduction. When calculating its margin, a business can generally choose to deduct one of the following from total revenue: 30 percent of total revenue, cost of goods sold, cost of compensation, or $1 million.[81] Once the business's margin is known, the franchise tax liability is calculated by multiplying it by the applicable tax rate. Currently, the franchise tax rate is 0.375 percent for retailers and wholesalers, and 0.75 percent for other businesses.

There are, however, two provisions for small businesses to ease the burden of the franchise tax. First, businesses with gross receipts under the "no tax due threshold"—which is currently $2.47 million but is adjusted periodically for inflation—owe no tax.[82] [11] Second, businesses with less than $20 million in gross receipts can opt for the EZ Computation Rate, which simplifies the tax calculation process and results in a tax rate of 0.331 percent, but does not permit the deductions that can be claimed under the standard, more complex calculation method.

Since the current iteration of the Texas franchise tax was first collected in 2008 (and even before it was enacted), the tax has been controversial and a source of much criticism. Many of these criticisms stem from the fact that the franchise tax is a form of (gross) margins taxation, which is generally acknowledged to be an inefficient form of taxation with high compliance costs for businesses that are subjected to it.[83] Rather than being based on the income or profit of a business, the franchise tax is based on the gross receipts of a business. According to a 2024 Tax Foundation report, Texas is one of only seven states to levy a gross receipts tax, although three others permit local gross receipts taxes.[84] Since 2017, several states have beaten back attempts to impose a gross receipts tax by highlighting the flaws of such a tax.[85]

Understanding these issues and the negative impact that the franchise tax is having on the state's business climate,[86] the Texas Legislature has already set itself on the path toward elimination of the franchise tax. In the 2015 legislative session, House Bill 32 reduced the rates of the tax by one-quarter, increased the annual maximum revenue threshold for filing an "EZ" franchise tax return from $10 million to $20 million, and lowered the EZ filing tax rate by 42 percent. House Bill 32 (84R, 2015) also directed the Comptroller of Public Accounts to study the future fiscal and economic effects of repealing the franchise tax. Per the LBB, the cuts to the franchise tax enacted in HB 32 amounted to a $2.6 billion tax reduction over the course of the 2016-17 biennium alone. The Comptroller's 2026-2027 Biennial Revenue Estimate, released in January 2025, projected that the tax would raise $14.13 billion throughout the 2024-2025 biennium, with $3.95 billion going to the Property Tax Relief Fund and the remaining $10.18 billion going to general revenue.[87] For the 2026-2027 biennium, those numbers are expected to increase to $4.21 billion and $11.46 billion, respectively ($15.67 billion in all).[88]

During the 86th Legislature, Senate Bill 66 (Nelson) would have phased out the franchise tax gradually in the following manner: if a BRE for a given biennium shows general revenue-related funds available for certification by the Comptroller that are more than 5 percent greater than the same figure for the preceding biennium, half of the excess funds would be used to lower franchise tax rates. The process would be repeated each subsequent biennium. Over time, this mechanism would result in an elimination of the franchise tax.

The 85th Session also offered some interesting paths to eliminating the franchise tax. House Bill 28 would have accomplished a phaseout of the franchise tax by first identifying the lesser of $3.5 billion or the ending balance of general revenue-related funds available for certification for the preceding biennium. Franchise tax rates would then be set to generate franchise tax savings equal to this amount. The process would be repeated each biennium. When the franchise tax so adjusted would be less than 15 percent of the franchise tax rate effective on September 1, 2017, the franchise tax would be eliminated entirely. Additionally, HB 388

[11] The no-tax due threshold amount was doubled by Senate Bill 3 (88S2).

(85R; Murphy) would have phased out the franchise tax on a definite date. It would have phased out the franchise tax by reducing it incrementally each year for four years, then keeping the tax rate constant for one more year before eliminating the tax entirely.

House Bill 3404 (87R; Guillen) would have eliminated the franchise tax on January 1, 2022, with no provision for the forgone revenue. House Bill 391 (88R; Goldman), also proposed immediate repeal of the franchise tax.

Although the foregoing bills were not enacted into law, the Legislature should continue to pursue the idea behind them. Given the state's strong financial position, outright repeal of the franchise tax is possible and should be pursued. If immediate repeal is not feasible, then a phaseout of the tax should be considered.

The Fiscal and Economic Imperative of Eliminating the Franchise Tax

Although the franchise tax is the state's primary business tax, it generated only 8.4 percent of all state tax revenue and 3.8 percent of all state revenues in FY 2024.[89] Incrementally reducing or slowing the growth of state outlays by one or two percent for each of the next two or three biennia could see the tax phased out five or six years from now. Alternatively, the tax could be entirely eliminated in the 89th Legislature.

Americans for Tax Reform has argued that "the [franchise] tax has significantly diminished the competitive advantage that Texas companies have over their out-of-state competitors. Worse, for all the economic harm the margins tax does, it generates relatively little revenue for state government coffers."[90] Professor John Mikesell of Indiana University described the franchise tax as follows:

> [The franchise tax is] a badly designed business profits tax, like those that emerged in the newly independent states of the former Soviet Union...combin[ing] all the problems of minimum income taxation in general—excess compliance and administrative cost, penalization of the unsuccessful business, undesirable incentive impacts, doubtful equity basis—with those of taxation according to gross receipts.[91]

By eliminating the franchise tax, Texas would join states such as New Jersey, Kentucky, and Michigan, all of which repealed their gross receipts taxes within a few years of adopting them after realizing the flaws of that manner of taxation.

Policy Recommendation 19

Eliminate the franchise tax through a phaseout

Like all forms of margin-based taxation (where tax liability is based on the top-line revenue of a business, rather than some calculation of net income), the Texas franchise tax has serious flaws. The tax is complex, with businesses having a multitude of ways to calculate their liability, unclear rules pertaining to what can be excluded from "total revenue" in adjusting their gross revenue, as well as what items can be included in the deductions for either "cost of goods sold" or "compensation." Margins taxation is also especially punitive for businesses that have narrow margins and can create situations in which businesses owe tax to the state despite having recorded a loss. The Tax Foundation summarized problems with the tax thusly:

> With the Texas margin tax collecting far less in revenue than expected, causing significant confusion and compliance costs, resulting in significant litigation and controversy over "cost of goods sold" definitions, and facing calls for substantial overhaul and even repeal, it should not be used as a model tax reform for any other state.[92]

Eliminating the franchise tax—which again, accounted for only 3.8 percent of all state revenue and 8.4 percent of all state tax revenue in FY 2022—would make Texas one of only three states without a corporate income tax or gross receipts-style business tax,[93] which would be a boon for investment, job creation, and economic growth. The Legislature should continue its phaseout of the franchise tax. To avoid a situation in which repeal of the tax exacerbates an unanticipated shortfall in state revenue, the Legislature could eliminate the franchise tax over time by using as a template legislation from the 85th or 86th legislative sessions that was discussed above, such as SB 66 (86R; Nelson). Using such bills as a model would ensure that the phaseout of the franchise tax goes smoothly.

Endnotes

[1] Comptroller, *Biennial Revenue Estimate 2026-2027* (January 2025), p. 28.

[2] Texas Const. Article VIII, Section 22 (Emphasis added).

[3] Section 316.002(b), Government Code.

[4] Texas Register, 49 Tex. Reg. 9358, 15 Nov. 2024, https://www.sos.state.tx.us/texreg/pdf/backview/1115/1115ia.pdf.

[5] Senate Finance Committee. *Interim Report*. State of Texas, Texas Legislature, Senate, August 2020, pp. 14-16, https://senate.texas.gov/cmtes/86/c540/c540.InterimReport2020.pdf.

[6] Texas Bond Review Board. *Local Government Annual Report 2024*. Texas Bond Review Board, January 2025, p. iii, https://www.brb.texas.gov/wp-content/uploads/2025/01/2024LocalARFinal.pdf. "Local government" as used here includes the following political subdivisions: cities, counties, health and hospital districts, water districts, community/junior/college districts, and independent school districts.

[7] Texas Bond Review Board. *Annual Report for 2024,* December 2024, p. iv https://www.brb.texas.gov/wp-content/uploads/2025/02/AR2024.pdf.

[8] Data from the Federal Reserve Board of St. Louis indicates that from mid-2007 to mid-2024, Texas' gross state product grew at a rate of 4.9 percent annually. See, "Gross Domestic Product: All Industry Total in Texas." *FRED*, Federal Reserve Bank of St. Louis, updated 20 Dec. 2024, https://fred.stlouisfed.org/series/TXNQGSP.

[9] "Freedom in the 50 States 2023: Texas Government Debt." *Cato Institute*, https://www.freedominthe50states.org/debt/texas. Accessed 10 Feb. 2025.

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[12] Article VIII, Section 22(b), Texas Constitution.

[13] Legislative Budget Board, Technical Memorandum (November30, 2020).

[14] "State annual summary statistics: personal income, GDP, consumer spending, price indexes, and employment." U.S. Bureau of Economic Analysis.
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[15] Comptroller, Biennial Revenue Estimate, 2022-23 (p. 1).

[16] Legislative Budget Board. *Fiscal Size-up 2022-23*. Legislative Budget Board, March 2022, p. 29, https://www.lbb.state.tx.us/Documents/Publications/Fiscal_SizeUp/Fiscal_SizeUp_2020-21.pdf.

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