TEXAS PUBLIC POLICY FOUNDATION
Testimony

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Center for Fiscal Policy

Texans Prosper from Eliminating Business Franchise Tax

Testimony before House Ways & Means Committee for HB 28

by Dr. Vance Ginn, Economist in the Center for Fiscal Policy

Chairman Bonnen and Members of the Committee:

My name is Dr. Vance Ginn and I am an economist in the Center for Fiscal Policy at the Texas Public Policy Foundation, a 501(c)(3) non-profit, non-partisan free market think tank based here in Austin. Thank you for the opportunity to speak today in support of HB 28 that would provide a path toward improving the economic competitiveness of Texas and standards of living of Texans by putting the state's business franchise tax on a path to elimination using surplus dollars.

Texas' business franchise tax—often called the "margins tax"—was revamped in 2006 to increase revenue for the state in support of efforts to reduce local property taxes after the Texas Supreme Court ruled the property tax system unconstitutional. Unfortunately, as has been documented in research and court cases and argued by legislators and Texans, the margins tax hinders economic activity because it is an inefficient and costly tax that ultimately harms all Texans.

Simply put, businesses do not pay taxes; people do in the form of higher prices, lower wages, and fewer jobs available. The 84th Texas Legislature reduced this burden by cutting the margins tax rates by 25 percent and lessening the cost of compliance for a total taxpayer savings of $2.6 billion. To continue last session's progress, we recommend that legislators adhere to the overwhelming research on economic rankings and standards of living that would be improved by eliminating the margins tax as quickly as possible. HB 28 would be a valuable step in that direction.

The truth is that the margins tax has been a failure. It has failed to help keep local property taxes low. It has failed to meet tax collections expectations. It has failed to keep the state out of court over the financing of public schools. Additionally, it's not only the roughly $3.9 billion per year in general revenue (GR) and property tax relief fund (PTRF) dollars that burden businesses, but it's also the substantial cost of compliance that further burdens businesses whether they owe the tax or not.

Figure 1: Substantial Economic Gains from Eliminating Texas' Business Margins Tax

	Year After Elimination	TPPF (2014-2018)	BHI (2013-2017)	Merrifield & DeAngelis (2006-2013)	LBB (2018-2022)
Real Personal Income (Pre-Tax)	1	$10.8 B	-	$1-$2 B	$2.2 B
	5	$16.0 B	-	$5-$8 B	$5.2 B
Real Disposable Personal Income	1	-	$6.4 B	-	$1.9 B
	5	-	$9.8 B	-	$4.6 B
Private Sector Non-farm Employment	1	67,800	31,500	22,000	32,100
	5	129,200	41,500	61,500	51,900

Source: Texas Public Policy Foundation

Measures of economic competitiveness for states indicate that Texas is losing its advantage, primarily because of the margins tax. The Fraser Institute's latest report *Economic Freedom of North America* (EFNA), which ranks states on 10 different measures related to government spending, taxes, and labor market restrictions, ranks Texas third best overall

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while Florida moved up to second best. Texas' unique margins tax contributes to it ranking only 33rd for state and local property taxes and other taxes.

The Tax Foundation's recent report *2017 State Business Tax Climate Index* ranks the states based on the burdens of each state's corporate income tax, individual income tax, sales tax, unemployment insurance, and property tax. Texas' overall ranking declined one position to 14th nationwide. Again, a major impediment to keeping Texas from being more competitive is the Tax Foundation's corporate income tax measure, which includes the margins tax that remained unchanged as the second worst. The Tax Foundation notes that the state's overall business tax climate would increase to third best if the margins tax was eliminated.

Multiple studies have examined the economic effects of eliminating the margins tax with dynamic economic models. **Figure 1** on the previous page reports the cumulative economic gains above those from the status quo from four studies, including one by the Foundation. Although these studies use different research methods and periods, the overarching conclusion is that Texas would prosper more without the margins tax. The Foundation's results are substantially higher than from the other models for at least two reasons. One is that the models use different base years, which can contribute to different results because the estimated positive growth rates are applied to different initial values. Another is that our vector autoregressive (VAR) economic model may be more precise as it is able to implicitly calculate the potential gains from compliance cost avoidance that may not be adequately considered in other models. Regardless, even the most conservative estimated effects indicate that Texas would prosper more without the onerous margins tax.

There is often the question of how to replace the decrease in revenue when cutting the margins tax rates and eventually eliminating the tax. While it is too soon to have a final calculation, early reports for franchise tax collections indicate the dynamic economic effects of reducing the rates last session. The Texas Comptroller's *2018-19 Biennial Revenue Estimate* shows that franchise tax collections in the 2016-17 biennium are estimated to be 18.6 percent less than in the 2014-15 biennium. This decline is less than the 25 percent cut in the tax rates even at a time when there was slower economic growth from less oil and gas activity, a weaker global economy, and other economic factors. Of course, these data are preliminary results of the longer-run benefits of the $2.6 billion in taxpayer savings, but they indicate that more tax revenues were collected after a specific tax cut than a static analysis would suggest from a broader base. In addition, the tax cut likely led to a broader base for other taxes, resulting in more collections than otherwise.

Margins tax collections are deposited in GR and the PTRF. Collections expected under the previous franchise tax structure before FY 2008 are deposited in GR while the rest are deposited in the PTRF. The Texas Comptroller estimates that total margins tax collections in the 2018-19 biennium will be $7.8 billion, or 2.4 percent above 2016-17 collections, representing 7.3 percent of total tax collections. Of this amount, $1.8 billion will be deposited in the PTRF and $6 billion in GR. Therefore, the only portion that may need to be held harmless is the $1.8 billion to the PTRF, which could be funded with increased GR from other taxes as the economy expands and if government spending is allowed to increase by no more than population growth plus inflation.

While some will argue that businesses wouldn't pay taxes if the franchise tax is eliminated, the Texas Comptroller's 2017 report *Tax Exemptions and Tax Incidence* notes that this is not the case. The tax incidence, which is the share of the tax paid by different groups, for sales tax revenue is 58.2 percent on individuals and 41.8 percent on businesses. Therefore, even without the margins tax, businesses will continue to pay state taxes, along with local sales and property taxes, for essential government provisions.

While eliminating the margins tax will enhance Texas' prosperity, the stakes go beyond just the Lone Star State. This transformational policy would make Texas a leader for America—and even the world—in tax policy. For example, Texas would join only South Dakota and Wyoming as states that do not impose a gross receipts tax nor a corporate income tax. Moreover, states would not have the opportunity to point to Texas' margins tax as good tax policy like Nevada did when arguing for a gross receipts tax. The research shows that Texas succeeded economically in spite of the margins tax, not because of it.

Although the budget is a little tighter in the 85th Legislature, the ultimate goal of eliminating the margins tax should remain. If the choice is to phase out the margins tax, the research indicates it is preferable to do so by lowering the tax rates for everyone instead of raising the revenue exemption threshold that leaves fewer firms paying the margins tax. However, it should be noted that phasing out the margins tax reduces the potential economic gains by leaving the tax in place and associated compliance costs until elimination.

By spurring job creation and reducing the tax burden, the combination of no business tax or income tax supports the potential to lift hundreds of thousands of Texans, and possibly many more Americans, out of poverty. Now is the time to put the margins tax on a path to elimination to benefit all Texans; if not, Texans will lose out on billions of dollars in personal income and tens of thousands of private sector jobs. This is why we support the use of surplus dollars to permanently cut the margins tax rates as in HB 28 and suggest combining these cuts with projected revenue growth above a certain threshold as in SB 17 to eliminate the margins tax as quickly as possible.

Thank you for your time and I look forward to your questions.

About the Author

Vance Ginn, Ph.D., is an economist in the Center for Fiscal Policy at the Texas Public Policy Foundation. He is an expert on Texas' state budget, franchise tax, tax and expenditure limit, and other fiscal issues. Before joining the Foundation in September 2013, Ginn was a Koch Fellow, and taught at three universities and one community college in Texas. He has published peer-reviewed articles in academic journals, as well as commentaries in major media outlets across Texas and the nation.

About the Texas Public Policy Foundation

The Texas Public Policy Foundation is a 501(c)3 nonprofit, nonpartisan research institute. The Foundation's mission is to promote and defend liberty, personal responsibility, and free enterprise in Texas and the nation by educating and affecting policymakers and the Texas public policy debate with academically sound research and outreach.

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The public is demanding a different direction for their government, and the Texas Public Policy Foundation is providing the ideas that enable policymakers to chart that new course.

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