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The Margin Tax Debunked

Dispelling Three Common Myths about Texas' Restructured Business Tax

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Key Points

- In fiscal 2008, the margin tax generated $1.4 billion less than expected… And in fiscal years 2010 and 2011, collections fell short by $500 million.
- The modest under-performance of the margin tax is small in comparison to the long-term growth of the Texas budget.
- Property tax relief was to be paid for with other revenues than besides the margin tax.
- The state does not have a "structural" deficit; budget shortfalls can be as easily addressed by restraining growth in spending than by seeking more tax revenue.

Introduction

In 2006, the Texas Legislature—under pressure from a Texas Supreme Court ruling* declaring the state's school finance system unconstitutional—sought changes to the Tax Code that would broaden the base of taxpayers paying into the system and generate additional revenue for the state that could be used to reduce Texas' local property tax burden. Ultimately, the Tax Code changes that lawmakers settled on that session, borrowed heavily from the Texas Tax Reform Commission,† brought to life the Texas margin tax, a cross between a modified gross receipts tax and a corporate income tax.

Under the restructuring, the state's old corporate franchise tax—which was based on the greater of a 4.5 percent tax on earned surplus (net income) or a 0.25 percent tax on taxable capital (net worth)—was replaced with a broad-based, low rate tax on a business' "taxable margin," a concept similar to taxable income.‡

Initially, expectations were high among businesses and lawmakers that the margin tax was going to be a marginal improvement over the old system; however, in the few short years since its inception, the tax has been plagued by a number of problems. Chief among these are: 1) the tax's inability to meet revenue projections; and 2) taxpayer- and tax collection-related challenges stemming from compliance, complexity, and cost issues.

In fiscal 2008—its first full year of collections—the margin tax generated $1.4 billion less-than-expected. In fiscal 2009, the revenue shortfall totaled $1.6 billion. And in fiscal years 2010 and 2011, collections fell short by $500 million.[1]

In addition, taxpayers in Texas have complained that the margin tax is a logistical nightmare, both from a tax-preparing and tax-paying standpoint. In a May 2008 survey conducted by the National Federation of Independent Business, 75 percent of survey respondents said they were dissatisfied with the new tax structure and "would choose the old franchise tax over the new margin tax."[2]

As a result of these shortcomings, some have begun calling for the legislature to "fix" the tax in the next legislative session, presumably by raising the rate, adjusting how the tax is calculated, or some combination of both. And it is expected that when the 83rd Legislature con-

* See *Neeley v. W. Orange-Cove Consol. Indep. Sch. Dist.*, 176 S.W.3d 746, (Tex. 2005).

† The Texas Tax Reform Commission was a 24-member panel of tax and business experts created by Texas Governor Rick Perry, in anticipation of the court's decision, whose stated mission was to "develop proposals to modernize the state tax system and provide long-term property tax relief as well as sound financing for public schools."

‡ In general, the tax rate is 1 percent for all businesses. The exception to this is for businesses primarily engaged in the retail or wholesale trade; the tax rate for those entities is 0.5 percent.

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venes in January 2013, lawmakers will seek to modify the tax regardless of whether or not the Texas Supreme Court rules it unconstitutional in the coming months.*

However, before lawmakers consider "fixing" the margin tax, it is important that they have the complete picture, void of any misconceptions. Below we discuss three common myths about the margin tax—and present the facts about each one.

MYTH #1: The margin tax's revenue shortfalls have crippled the state's revenue system and created a "structural deficit."

One of the most pervasive myths about the margin tax is that its revenue shortfalls have had a major impact on state income—but, in fact, those shortfalls represent only a fraction of what the state collects each biennium.

Consider, for example, the state's most recent biennium, fiscal 2010-11. The shortfall for the biennium totaled $1 billion, with collections falling short by $500 million in each fiscal year.† Certainly not insignificant, but a relatively small sum compared to average annual tax revenues of about $36 billion, and average annual net revenue to the state of approximately $88.6 billion.[3]

Expressed another way, in terms of percentages, the revenue shortfall from the margin tax in the 2010-11 biennium totaled just 1.4 percent of estimated total tax collections and 0.56 percent of estimated total net revenues. Again, not insignificant, but not exactly the fiscal calamity that some have made it out to be. Similarly, in the preceding biennium, the revenue shortfall turns out to be but a fraction of the whole.

In fiscal 2008-09—the only other two-year period in which the state's revised business tax was effective—the revenue shortfall was slightly larger than during the 2010-11 biennium but, again, still relatively minor in the grand scheme of things. For fiscal 2008-09, margin tax collections fell short by $3 billion for the biennium or about $1.5 billion annually. However, consider that total tax revenues for the biennium were estimated at an average of about $40 billion and average annual net revenues totaled approximately $85 billion.

Expressed in terms of percentages, the revenue shortfall from the margin tax in the 2008-09 biennium totaled 3.9 percent of estimated total tax collections and 1.8 percent of estimated total net revenues. Again, slightly higher than in the 2010-11 biennium, but still manageable.

Despite the shortfalls against revenue estimates, the $4 billion or so collected through the margin tax each year is a sizeable increase from the $1.8 billion or so collected annually under the old franchise tax. Additionally, the amount available for general revenue spending from both versions of the franchise tax is about the same. Texas' revenue system has adequate capacity with the margin tax.

This undermines the argument that the state budget—irrespective of how well the Texas economy performs—faces a funding shortfall, i.e., a "structural deficit," in perpetuity because the margin tax does not perform as expected. For, as we have seen, the revenue shortfall from projected estimates is only a small portion of total tax collections, and falls far short of even the $10-$15 billion budget shortfall Texas faced this year.

Additionally, the state budget is subject to the will of the Legislature. Every biennium lawmakers decide how much to spend on education, health care, and other priorities. To the extent that projected spending exceeds projected revenues, lawmakers can just as easily change the level of state spending as they can make adjustments to the state's revenue system. There was nothing structural about the state's budget shortfall this year.

MYTH #2: The margin tax needs to be "fixed" to increase state revenue.

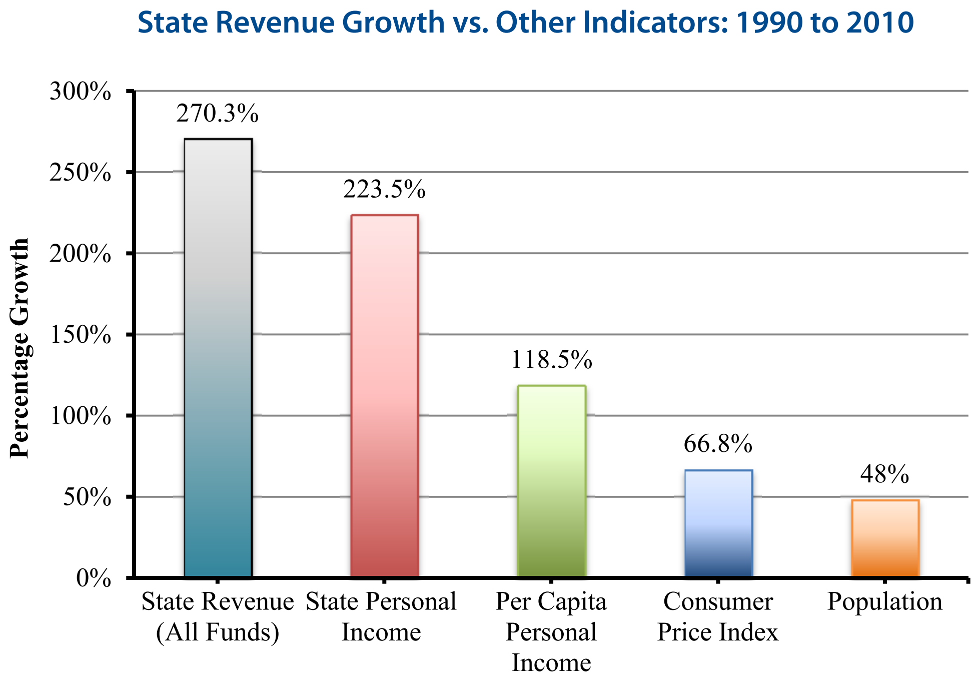
Texas does *not* have a revenue problem.

Between fiscal years 1990 and 2010, total net revenues to the state grew from $23.6 billion to $87.4 billion, an increase of 270.3 percent.[4]

By contrast, other economic and demographic measures—including state personal income, per capita personal income, the consumer price index, and population—increased at a

* As of the date of this publication, the Texas Supreme Court has not yet ruled on a case challenging the constitutionality of the margin tax, though a decision is expected soon. For more information on the case, see Case No. 11-0589 -- *Allcat Claims Service, L.P. and John Weakly v. Susan Combs, Texas Comptroller of Public Accounts and Greg Abbott, Texas Attorney General.*

† The 2010-11 Biennial Revenue Estimate projected All Funds margin tax collections at $8,880,706,000; however, actual collections, as reported in the 2012-13 Biennial Revenue Estimate, totaled just $7,876,666,000 a difference of $1,004,040,000.



Sources: Texas Comptroller of Public Accounts, Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau
All dollar estimates used to calculate percentage increases were in current dollars (not adjusted for inflation).

much slower rate over the same period. More to the point, between 1990 and 2010:

- State personal income—defined as the income received by all people from all sources—increased by 223.5 percent;[5]
- Per capita personal income—defined as total personal income divided by total population—grew by 118.5 percent;[6]
- The consumer price index*—a common measure of inflation—rose 66.8 percent;[7] and
- Population growth measured only 48 percent.[8]

In every instance above, state revenue growth has either exceeded or greatly exceeded the rate of growth of these other indicators, leaving one to reasonably conclude that revenues, or lack thereof, are not so much the issue but rather how quickly the state is consuming those revenues and for what purposes.

MYTH #3: The margin tax was intended to completely absorb the cost of statewide property tax relief.

A popular myth making the rounds is that the new revenue from the margin tax was supposed to cover the cost of statewide property tax relief. A relatively recent example of this was seen in a January 2011 *San Antonio Express-News* editorial:

> "To make up for the property tax cuts, the plan instituted a new, broad-based business activity tax to replace the old franchise tax…Well before the economic downturn that began in 2008, however, there were signs that the business tax wasn't going to come close to replacing lost property tax revenue."[9]

While it's true that part of the cost of statewide property tax relief is paid for via revenue from the new margin tax, it was never intended to pay for the entirety of that tax relief. Instead, it was intended to make sizeable contributions to the tax relief effort, along with revenue from other sources.

* U.S. All items, 1982-84=100.

For instance, the Legislature passed House Bill (HB) 5 during the 3rd Called Special Session of the 79th Legislature, increasing the cigarette tax rate by $1.00 per pack and the tax rate for other tobacco products to 40 percent of the manufacturer's list price. According to the Legislative Budget Board's Fiscal Note for HB 5, the bill was expected to raise in excess of $600 million every year beginning in fiscal 2008.[10]

Another expected source of increased revenue was from changes to the state's 6.25 percent retail sales-and-use tax on motor vehicles enacted in HB 4 during the 3rd Called Special Session. According to the Legislative Budget Board's Fiscal Note of HB 4, the tax was expected to have a positive fiscal impact of $30 million to $40 million in the five years after its enactment.[11]

Conclusion

As we inch closer to the next legislative session, the calls to "fix" the margin tax are sure to grow louder by those who want to increase state spending; but before lawmakers decide to go down that road, it is important that they are aware of the all the facts, such as:

- The margin tax represents but a fraction of the state's overall revenue picture;
- While the margin tax does produce less revenue than projected, the state does not suffer from a lack of revenue;
- Texas does not have a structural deficit: to the extent that projected spending exceeds projected revenues, lawmakers can just as easily change the level of state spending as they can make adjustments to the state's revenue system; and
- Qualms about the margin tax not covering the entirety of the cost of statewide property tax relief are baseless, as the new tax was never intended to cover the complete cost. ✮

Endnotes

1 Texas Comptroller of Public Accounts, "Biennial Revenue Estimate: 2008-2009," (Jan. 2007); "Biennial Revenue Estimate: 2010-2011 Biennium," (Jan. 2009); "Biennial Revenue Estimate: 2012-2013 Biennium," (Jan. 2011).
2 National Federation of Independent Business, Texas Chapter, "NFIB/Texas Survey Highlights: Prepared for the Business Tax Advisory Committee" (May 2008).
3 Texas Comptroller of Public Accounts, "Biennial Revenue Estimate: 2012-13 Biennium" (Jan. 2011) 41.
4 Texas Comptroller of Public Accounts, "Texas Revenue History by Source" (10 Nov. 2011).
5 Bureau of Economic Analysis, "Personal income and population (SA1-3)" (21 Nov. 2011).
6 Ibid.
7 Bureau of Labor Statistics, "Consumer Price Index-All Urban Consumers: U.S. All Items, 1982-84=100" (21 Nov. 2011).
8 Census Bureau, "Estimates Data: State" (21 Nov. 2011).
9 *Express-News* Editorial Board, "Lege can't ignore structural deficit," *San Antonio Express-News* (18 Jan. 2011).
10 Legislative Budget Board, Fiscal Note for HB 5.
11 Legislative Budget Board, Fiscal Note of HB 4.

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