



# Failure of Texas' Business Margin Tax

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## Key Points

- Basic economics explains that taxes on businesses are simply passed onto taxpayers in the form of higher prices, lower wages, and fewer jobs.
- Problems with the business margin tax are so costly that it fails as good public policy and hinders Texans from reaching their full potential.
- Though legislators have taken steps to reduce the state's business margin tax burden, they should eliminate it, thereby increasing the state's competitive advantage that supports economic prosperity.

Basic economics explains that taxes on businesses are simply passed onto taxpayers in the form of higher prices, lower wages, and fewer jobs. In other words, businesses do not pay taxes; taxpayers do. This has been at the heart of the discussion about the business tax in Texas known technically as the franchise tax but commonly called the “margin tax.”

The margin tax has failed to be a simple form of taxation and has failed to allow businesses to reach their full potential. Problems generated by the margin tax are so costly that it fails as good public policy and should be phased out and ultimately eliminated.

Texas has had a business tax since the late 1800s. After multiple revisions, a version of the franchise tax was enacted in 1992 that taxed corporations' net worth and earned surplus. Under pressure from a Texas Supreme Court ruling declaring the state's school finance system unconstitutional, the Texas Legislature attempted to reduce local property taxes and replace lost revenue by overhauling the state's corporate franchise tax in 2006 ([Texas Comptroller 2015a, 15](#)).

This overhaul led to the creation of a broader-based, gross receipts-style margin tax that went into effect in January 2008 and was far more complex and unique among all taxes nationwide. Its complexity mainly stems from the use of multiple tax rates and tax bases. Before the recent changes by the 84th Texas Legislature, the tax rates were 0.5 percent on wholesalers/retailers and one percent on all other businesses, unless a company uses the E-Z computation with a rate of 0.575 percent. The tax base could be determined by the company's taxable margin, which is the lesser of total revenue minus 30 percent of total revenue, cost of goods

sold, compensation, or \$1 million. Alternatively, for companies with \$10 million or less in total revenue, they could use the E-Z computation tax base of total revenue times an apportionment factor ([Texas Comptroller 2015a, 15](#)).

To reduce the burden of the margin tax, the 84th Texas Legislature reduced the revenue generated from the margin tax by \$2.6 billion ([HB 32, Fiscal Note, 1-2](#)). To accomplish this, it cut the rates by 25 percent to 0.375 percent for wholesalers/retailers and 0.75 percent for all other businesses while raising the ceiling to file with the E-Z computation to \$20 million at a lower 0.331 percent tax rate. These changes take effect on January 1, 2016.

Though these changes lowered the burden of the tax on businesses, the complexity remains. One indicator of this is that since its inception in 2008 there has been a cumulative \$2.8 billion shortfall in margin tax collections ([Texas Comptroller 2015b](#)) compared with projections ([Texas Comptroller 2015c](#)). Although the Great Recession may partially explain this gap, the poor projections also reflect the complexity of the margin tax as even the state's revenue estimators, it seems, are baffled when it comes to projecting the revenue generated from this poorly designed tax.

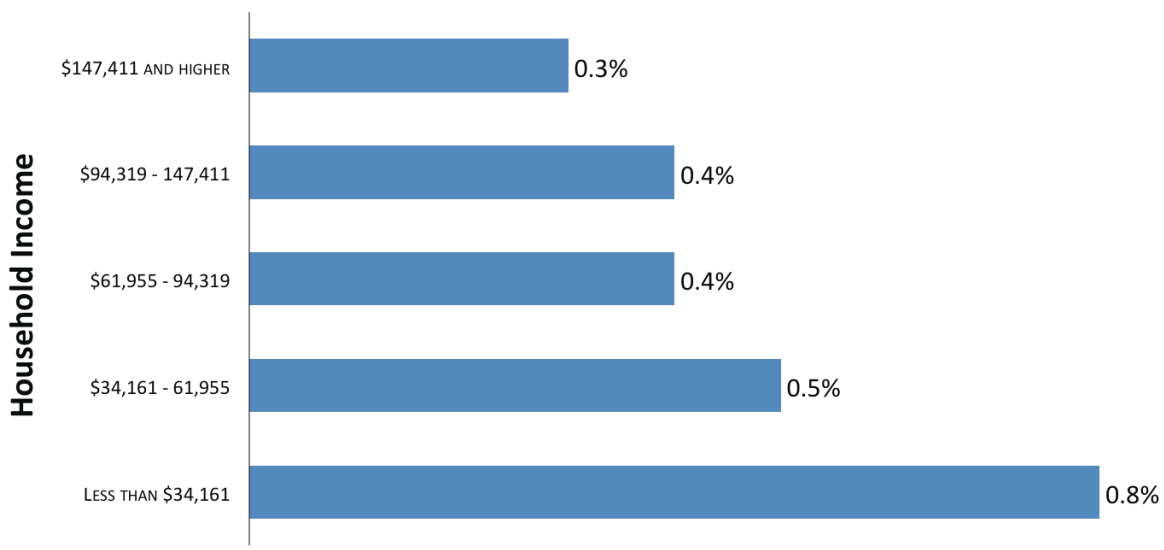
In addition to the inherent complexity of the margin tax, the fact that it is so different from the federal corporate income tax forces many businesses to keep multiple financial books ([TTARA 2011, 4](#)). Because of these substantial costs of compliance and potential litigation surrounding the calculation of the cost of goods sold ([Henchman 2011, 2](#)), businesses often spend more on the resources needed to comply with it than on their tax liability.

Both the burden and complexity of the margin tax have a detrimental effect on Texas' business climate. Ginn and Heflin (2015, 4-9) review the evidence of the substantial costs of capital-based taxes that are similar to the margin tax and outline the potential economic gains from its elimination. Drenkard (2015, 11) finds that Texas could improve the state's business tax climate from tenth to third best in the nation if this onerous tax was eliminated, boosting the state's economic competitiveness.

Although the margin tax is portrayed as a tax on businesses, the truth is that the vast majority of the tax burden falls on ordinary Texans. Chamberlain and Fleenor (2006, 1) note that the margin tax structure, along with practically all business taxes, creates costs by requiring businesses to pay a tax at each stage along the economic chain, also known as "tax pyramiding," which not only increases the costs of doing business but eventually passes those costs onto consumers.

The Texas Comptroller (2015a, 54) shows that the tax's burden as a percent of total household income tends to fall most on the backs of those with the lowest income (Figure 1) while the highest income group pays the vast majority of it.

**Figure 1: The Margin Tax Disproportionately Burdens Lower Income Texans as a Percent of Their Total Household Income**



Source: Texas Comptroller

Overall, the margin tax is a very costly, complex tax that hinders Texas' economic competitiveness. The costs it imposes on a business hinder its ability to hire new workers, fund investment opportunities, or remain in business, reducing the state's potential economic output and job creation contributing to less tax revenue (Ginn and Heflin 2015). As these costs are passed on to consumers, they reduce consumers' purchasing power and reduce their quality of life—particularly in the case of lower income Texans.

Although the 84th Texas Legislature substantially cut the margin tax, there's more to do to end the overwhelming costs of diverting funds from the private sector and complying with a complex tax.

### Recommendations

Given the harmful costs of the margin tax, we recommend the following:

- ★ Eliminate the business margin tax. One option for eliminating the margin tax is a four-year phase out. The combination of current budget surpluses, increased tax revenue from economic growth, and modest restraint on spending increases would more than offset any state revenue losses from the elimination of the margin tax.

Legislators would be wise to eliminate the state's business margin tax, thereby allowing Texas to join Wyoming and South Dakota as the only states without personal income and general business taxes, increasing the state's competitive advantage that supports economic prosperity. ★

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