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Center for Fiscal Policy

Reforming Texas' Tax System

Testimony before the House Ways and Means Committee

by The Honorable Talmadge Heflin & The Honorable Chuck DeVore

Chairman Hilderbran and Members of the Committee:

I am Talmadge Heflin, director of the Center for Fiscal Policy and this is my colleague Chuck DeVore, Senior Fellow for Fiscal Policy at the Texas Public Policy Foundation. The Foundation is a non-profit, non-partisan free-market research institute based here in Austin. On behalf of the Foundation, I would like to thank you for the opportunity to present our ideas on reforming Texas' tax system.

Although Texas is generally well-regarded in the area of taxation, it is the Foundation's view that there is still ample opportunity to improve Texas' tax system to enhance the state's economic competitiveness and make it more attractive for businesses and entrepreneurs.

With that said, here are 10 tax reforms for the 83rd Texas Legislature to consider, listed in no particular order.

#1: Make the small business franchise tax exemption permanent.

Small businesses in Texas have endured a great deal of uncertainty over the past few legislative sessions because of the Legislature's reluctance to make the $1 million small business tax exemption permanent. This ambiguity in the Tax Code presents a tremendous obstacle for small businesses looking to plan ahead and the situation is deserving of a long-term solution.*

To permanently resolve this issue and strengthen Texas' small business climate, the Foundation strongly recommends that the Legislature consider extending the $1 million small business tax exemption indefinitely. This will bring an added measure of certainty to the Tax Code and provide small businesses with the opportunity to plan for the future.

#2: Require any rate increase in the revised franchise tax (or margin tax) to be approved by a supermajority vote of each house of the legislature.

Raising taxes on Texas businesses constitutes poor public policy, especially as businesses have seen the total amount of state and local taxes they pay every year increase in recent years.

According to the State Business Tax Advisory Committee's Report to the 82nd Legislature, Texas businesses saw a roughly 12 percent increase in their state and local tax bills between fiscal 2007 to fiscal 2009 whereas the average U.S. business saw just about a 2 percent increase over the same period.[1]

In addition, Texas is one of eight states that saw their "state-levied business taxes increased as a percentage of total taxes collected over the period fiscal 2007 to fiscal 2009. Of these eight states, the ones with the largest percentage increases were Texas and Michigan, at 2.5 percent and 3.2 percent respectively."[2] So not only are Texas businesses carrying a greater tax load than businesses in other states, but Texas businesses have also seen their total tax bills increase during a period of great economic turmoil.

To protect the competitiveness of Texas businesses from further erosion, the Foundation recommends that the Legislature consider requiring a supermajority of both houses before the margin tax rate can be increased.

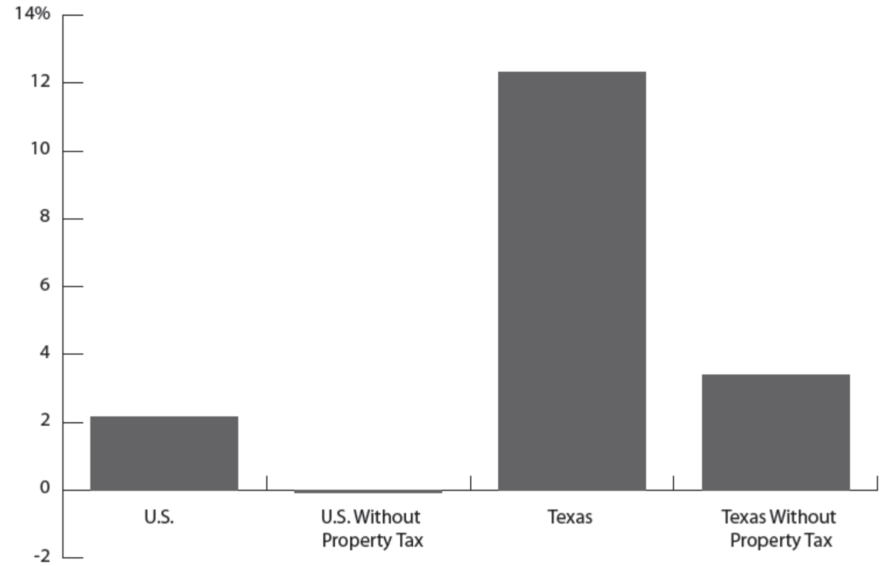
#3: Eliminate the property tax and replace the "lost" revenues with an expanded sales tax.

Texas' property tax burden—ranked 14th highest nationally[3] by the Tax Foundation—continues to weigh heavily on homeowners and businesses around the state; but our past research has shown that relief may only be a few modest reforms away.

* Currently, the $1 million small business tax exemption is set to expire in 2014. For further detail on this exemption, see Article 37 of Senate Bill 1 of the First Called Special Session of the 82nd Legislature.

continued

Chart 2
2007-2009 Percent Change in Taxes paid by Business



Source: Ernst & Young Total State and Local Business Taxes Fiscal 2009.

According to the Foundation's study, *Enhancing Texas' Economic Growth through Tax Reform*,[4] Texas can eliminate its property tax burden entirely by replacing the revenue with a reformed sales tax. The study identifies four scenarios, two of which are listed below, in which the sales tax base and rate can be reasonably adjusted to produce the same amount of revenue:

- 12.5 percent, if the current sales tax based is used and the sale of property is included; and
- 9 percent, if all services that are taxed in at least one other state are taxed in Texas and property sales are included.

If the property tax swap were to become a reality, personal income in Texas could potentially increase in the range of $3.1 billion to $3.3 billion in the first year. Over a five-year period, assuming property taxes were replaced dollar-for-dollar with a higher sales tax burden, personal income could, on a cumulative basis, increase between $21.3 billion and $52.1 billion—2 percent to 4.3 percent higher than would have been the case otherwise.

The strong economic growth that tax reform would produce would spur an estimated five-year net gain of 127,700 to 312,700 new jobs.

For these reasons, the Foundation strongly recommends that the Legislature consider eliminating property tax and replacing the revenues with a reformed sales tax.

#4: If complete abolition is impossible, eliminate school maintenance and operations property taxes.

In the event that a complete abolishment of the property tax is unworkable, it is the Foundation's hope that the Legislature would at least consider eliminating the school M&O property tax while also replacing the revenues with an expanded sales tax base. Under this recommendation, the I&S component of the property tax that services school bonds would remain in place. By taking this first step, the Legislature would be working towards providing substantial tax relief to Texas homeowners and businesses.

#5: Eliminate Texas' sales tax holidays and lower the sales tax rate to make this revenue neutral.

Understandably, Texas' sales tax holiday enjoys tremendous political popularity; however, it is the Foundation's view that this policy is little more than a costly gimmick that does little to encourage actual economic growth and investment.

Rather than encourage additional economic activity, sales tax holidays tend to shift the timing of consumer purchases, causing economic distortions.

In addition, outside studies have shown that "sales tax holidays create complexities for tax code compliance, efficient labor allocation, and inventory management."[5]

Given these concerns, the Foundation recommends eliminating Texas' sales tax holidays and providing taxpayers with genuine, long-term relief by reducing the state's sales tax rate year-round.

#6: Require a supermajority to approve any new state taxes or increases in the rate of existing taxes.

Creating new taxes or raising existing ones is a policy decision that often carries with it major consequences for everyone including businesses, employees, and homeowners. For this reason, as well as others, the Foundation recommends that only a supermajority of elected officials be allowed to create any new taxes or raise existing ones.

#7: Dedicate the use of certain motor fuels tax revenues for mobility-only projects.

While many believe that revenue collected from the tax on gasoline and diesel fuel should be spent only on transportation-related infrastructure, too often the money in State Highway Fund 006 is appropriated for purposes that are only superficially connected to mobility.

Though this issue has always been a point of contention, diversions of the state's motor fuels tax revenues have become an increasingly hot topic in Texas as pressure mounts for more transportation dollars.

As we have advised in the past, the Foundation recommends eliminating the practice of diverting money out of the State Highway Fund to pay for non-transportation related projects thus ensuring that motor fuels tax revenues are solely used for improving mobility.

#8: Eliminate the "tax on a tax" application of the sales tax to taxes and fees on a telephone bill.

Sales taxes levied on telecommunications services function in part as a "tax on a tax" since they are levied on other taxes.

The sales tax is being levied on charges such as utility gross receipts, the Texas Universal Service Fund (USF), the Federal USF, and municipal franchise fees. Consumers are paying taxes on taxes and fees. Over a five year period from FY 2008 through 2012, this has cost consumers an average of $113 million per year, or, about $500 million.

#9: Eliminate taxes on production goods that are used to deliver consumer telecommunications service.

The Texas sales tax is levied on certain non-retail, or higher order, telecommunications equipment that is not a consumer product. Examples are machinery, equipment, and software purchased by telecommunications companies that are used in delivering consumer-based products and services. Taxing this equipment at various stages along the production process places a hidden tax on consumers.

Examples of such equipment are as follows 1) antennas, 2) amplifiers, 3) poles, 4) wires and cables, 5) rectifiers, 6) duplexers and multiplexers, 7) receivers, 8) repeaters, 9) transmitters, modems, and routers, and 10) power equipment and storage devices. Telecommunications companies could not deliver retail consumer services without these items, though they are currently being taxed as though these were themselves retail goods. All in all, consumers, telecom employees, or shareholders are paying almost $400 million per year for equipment taxes.

#10: Limit the growth of state and local government spending through an improved tax and expenditure limit.

As the Foundation's past research on local government spending has shown, there exists a tremendous need for controls on the growth of local budgets.

Consider that over the past two decades, aggregate local government spending has risen sharply, increasing from $40.3 billion in fiscal 1992 to $121.4 billion in fiscal 2009, representing an increase of 201 percent. This far outstrips the sum of population growth plus inflation increases over the period, which rose just a combined 93 percent.[6]

During the last regular legislative session, House Bill 2952* would have taken steps to address this issue; however, the bill died in the legislative process.

With these reforms in place, the Foundation is confident that the state's business climate will be improved and that Texas will have the best opportunity possible to retain its title as America's economic engine.

Thank you for your time and I look forward to answering any questions you may have. ✯

* For more detail, see: http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=HB2952.

[1] The Business Tax Advisory Committee, "Report to the 82nd Legislature," December 2010.

[2] Ibid.

[3] Tax Foundation, "State and Local Property Tax Collections Per Capita by State, Fiscal Year 2009," February 2012.

[4] Arduin, Laffer, & Moore Econometrics, "Enhancing Texas' Economic Growth Through Tax Reform," Texas Public Policy Foundation, April 2009.

[5] Mark Robyn, Micah Cohen, and Joseph Henchman, "Sales Tax Holidays: Politically Expedient but Poor Tax Policy," Tax Foundation, July 2011.

[6] Talmadge Heflin and Robert McDowall, "Update: Trends in Texas Government: Local Government Spending," Texas Public Policy Foundation, April 2012.

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