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Unleashing Economic Growth:
Eliminating Texas' Business Margins Tax

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Key Points

- Failures of the margins tax and calls by Texans and legislators to eliminate it have resulted in multiple studies that examine the economic effects of accomplishing this.
- Although these studies use different research methods and time periods, the overarching conclusion is that Texas would prosper more without the margins tax.
- Eliminating the margins tax will assure that billions in new personal income and tens of thousands of new jobs for Texans statewide are not lost.

Introduction

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. We recommend legislators eliminate the margins tax.

Failures of the Margins Tax

Ginn and Heflin (2015) outlined the substantial costs of the gross receipts-style margins tax. In short, a business owner must maneuver through a complicated tax calculation to determine the product of the lowest of four different methods to calculate the tax base and one of two tax rates depending on the type of business. Complying with it is markedly different than complying with the federal corporate income tax, so many firms keep separate financial books; for instance, the cost of goods sold for a company under the margins tax is calculated differently than it is for the federal income tax (Henchman, 2). This broad-based, gross receipts-style margins tax is complex and unique among taxes nationwide; only Nevada has a similar gross receipts-style commerce tax that legislators passed in 2015 (Walczak).

Gross receipts-style taxes create a problem called "tax pyramiding" whereby a good is taxed at every stage of production resulting in a higher price and less output of the good (Drenkard). Moreover, since the tax is based on gross receipts and not profits, it can force businesses that have positive revenues but are running losses to fire workers or close their doors.

The Texas model of lower taxes and spending, less regulation, fewer frivolous lawsuits, and reduced reliance on the federal government has helped support an economic environment conducive to a robust labor market for more than a decade, often called the Texas miracle (Ginn). However, rankings of states' public policies relative to others suggest that this economic prosperity was in spite of the margins tax. According to the Fraser Institute's economic freedom index, Texas is the third most free state for the sixth straight year. However, it is ranked only 34th in the category of "sales tax revenue as a percentage of income." This measure includes both sales and gross receipt taxes, so the margins tax contributes to Texas' poor ranking (Stansel et al.). Moreover, the Tax Foundation ranks Texas as having only the 14th best business tax climate, a ranking that would be much higher if not for the margins tax's influence (Walczak et al.).

The margins tax contributes to an unnecessarily high cost of doing business in Texas that inhibits job creation and productivity growth. In order to consider how Texas could remain economically competitive with other states and keep the Texas miracle from fading, let us review the economic research on the economic effects of eliminating the margins tax.

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Economics Effects of Eliminating the Margins Tax

Multiple studies have examined the economic effects on Texas of eliminating the margins tax.

Ginn and Heflin (2015a) built a recursive vector autoregressive (VAR) model to estimate the dynamic economic effects of eliminating the margins tax on inflation-adjusted (real) personal income and private sector non-farm employment. While differences in individual choices make it impossible to estimate the economic effects to policy changes with absolute certainty, this model has an established record in the academic literature of performing relatively well. A VAR model is a rather simple, small-scale dynamic model that can help explain these effects better in some cases than more complex, large-scale models that make multiple assumptions and often include incorrectly estimated multipliers (Bjørnland, 4-5).

Others have also attempted to estimate the benefits to Texas of eliminating the margins tax. The Beacon Hill Institute (BHI) used the STAMP model, a large-scale dynamic computable general equilibrium tax model, to estimate the economic effects of eliminating the margins tax (TCCRI). Merrifield and DeAngelis employed a relatively small-scale dynamic model that examines the economic effects from a scenario where the tax was not enacted in 2006 and then simulates the potential economic responses. Finally, the LBB employed a large-scale dynamic model constructed by Regional Economic Models, Inc. (REMI) that provides forecasts of economic responses to policy changes.

Figure 1 shows the cumulative economic gains over the status quo of eliminating the margins tax using the research conducted by TPPF (Ginn and Heflin 2015a) and the other three studies discussed above.

Although these studies use different research methods and periods, the overarching conclusion is that Texas would prosper more without the margins tax. Our 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 the VAR 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.

These results indicate that Texas forgoes billions of dollars in personal income and tens of thousands of jobs each year it fails to eliminate the margins tax. The 84th Texas Legislature did make progress toward this end when it cut the margins tax rates by 25 percent and reduced the cost of compliance (HB 32, 1-2), yet the overwhelming research consensus shows that this wasn't enough; the margins tax should be eliminated.

Conclusion: Eliminate the Margins Tax

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 (Walczak, 22). 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 receipt tax. The research shows that Texas succeeded economically in spite of the margins tax, not because of it. Ending the margins tax would increase Texas' dwindling competitive advantage, as the

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

Tax Foundation notes that the state's national rankings would substantially improve to the best for corporate income tax and third best for overall business tax climate (Drenkard).

Although there may be available tax revenue concerns in the 85th Legislature, the ultimate goal of eliminating the margins tax should remain. While cutting the tax will result in a short-run drop in tax revenue, the associated dynamic increase in economic activity will likely generate additional tax revenue through other taxes that could replace all of the drop. However, considering that excessive government spending is a disease that contributes to symptoms of overly burdensome taxation and less economic activity, the more pertinent issue is to control government spending to no more than population growth plus inflation (Heflin and Ginn). If the choice is to phase the margins tax out over two budget periods, 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, phasing out the margins tax reduces the potential economic gains by the leaving the tax and associated compliance costs until elimination.

Eliminating the margins tax will bring billions of dollars in new personal income and tens of thousands of new private sector jobs, unleashing tremendous economic prosperity for Texas. ✯

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