TEXAS PUBLIC POLICY FOUNDATION
Testimony

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Center for Fiscal Policy

Simplify Texas' Business Franchise Tax Until Elimination

Testimony before the Senate Finance Committee in support of SB 142

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

Madame Chair Nelson 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 SB 142 that would simplify the determination of cost of goods sold for purposes of computing the franchise tax. This would be a beneficial step until the margins tax is eliminated.

Problems with Texas' business franchise tax—often called the "margins tax"—are so costly that it fails as good public policy and hinders Texans from reaching their full potential. Basic economics explains that taxes on businesses are simply passed onto Texans in the form of higher prices, lower wages, and fewer jobs. The 84th Texas Legislature reduced this burden by cutting the margins tax rates 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 continue to simplify the onerous margins tax, which SB 142 would accomplish, until it is completely abolished.

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.

This overhaul led to the creation of a broader-based, gross receipts-style margins 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 bases and tax rates. The tax base is determined by a firm's taxable margins, which is the lesser of total revenue minus 30 percent of total revenue, cost of goods sold, compensation, or $1 million. To reduce the burden of the margins tax, the 84th Texas Legislature provided total taxpayer savings of $2.6 billion. This included cutting the margins tax rates by 25 percent to 0.375 percent for wholesalers/retailers and to 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 beginning January 1, 2016.

Though these changes lowered the burden of the margins tax on businesses, the complexity remains. One indicator of this is that since its inception in 2008 there has been a large cumulative shortfall in margins tax collections compared with projections. Although the Great Recession may partially explain this gap, the poor projections also reflect the complexity of the margins 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 margins tax, the fact that it is so different from the federal corporate income tax forces many businesses to keep multiple financial books. Because of these substantial costs of compliance and potential litigation surrounding the calculation of the cost of goods sold, which can includes different items from the ones used for the federal corporate income tax, businesses often spend more on the resources needed to comply with it than on their tax liability.

Both the burden and complexity of the margins tax have a detrimental effect on Texas' business climate, which is why it should eventually be eliminated. For example, the Tax Foundation finds that Texas could improve the state's business tax climate from 14th to third best nationwide if this onerous tax was eliminated.

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We recommend simplifying the margins tax calculation by passing SB 142 so that businesses don't have to spend valuable time determining their optimal cost of goods sold method. This will allow them opportunities to focus on being more productive and creating additional jobs. Of course, the best path to removing the cost of compliance and tax liability on businesses, and therefore all Texans, is to abolish the margins tax.

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.

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