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Texas's Margins Tax: Principles for Reform

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Texas's franchise tax—better known as the "margins tax"—does not work as advertised. The tax has not achieved any of the goals its creators set out for it. In the 2012 legislative session, the Texas legislature should consider replacing it with some other means of raising revenue ... or with nothing at all.

> The Texas legislature should consider doing away with the margins tax and replacing it with some other means of raising revenue ... or with nothing at all.

This paper describes how the margins tax works, outlines the promises made at the time of its creation, describes how those promises were broken, and provides to policymakers three guiding principles.

The Margins Tax and How it Works

Gov. Rick Perry signed a bill to create the margins tax in 2006 following a legislative special session on revenue measures. The tax that exists today closely follows the lines the bipartisan Texas Tax Reform Commission laid out.[1]

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[1] John Sharp et al., "Tax Fairness: Property Tax Relief for Texans: Report of the Texas Tax Reform Commission," March 29, 2006, http://govinfo.library.unt.edu/ttrc/files/TTRC_report.pdf.

In theory, the tax is a 1 percent levy on businesses' "taxable margins." (Qualifying wholesalers and retailers pay .5 percent.) Whereas economics textbooks define "margin," "profit," and "income" as synonyms, Texas considers the tax a "franchise tax" imposed for the privilege of operating as a business, rather than a "personal income tax," which the state constitution forbids unless voters approve it in a referendum.[2]

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In reality, however, it operates much like an income tax. The taxable income base consists of the least of "total revenue minus cost of goods sold; total revenue minus compensation; or total revenue times 70 percent."[3] Although it resembles an income tax in many ways, which would require a referendum to initiate, the Texas Supreme Court found the tax constitutional in November 2011. The court's opinion also appeared to leave the door open for the legislature to impose a general-purpose business income tax without specific voter approval.[4]

Promises Made, Promises Broken

The margins tax replaced a higher-rate, narrower-base franchise tax of 4.5 percent. In the past, larger corporations commonly avoided the tax by moving their headquarters to other states without relocating their actual operations.

The tax reform commission that designed the new margins tax said it followed five fundamental principles. Because of their importance, these principles are worth quoting in full:

> **Fairness**: The tax system must provide a level playing field that is essential for healthy, free market competition.
>
> **Broad Based**: Those who benefit from Texas's resources and services must pay their share.
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> **Modern**: The tax system must reflect the realities of a rapidly evolving economy.
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> **Understandable**: Those considering locating or expanding business in Texas should know what their obligations will be. Small business owners must be able to focus their time and resources on creating jobs rather than navigating a maze of government regulations.

[2] Texas Constitution, Article 8, Section 24, http://www.statutes.legis.state.tx.us/Docs/CN/pdf/CN.8.pdf.

[3] 3 Office of the [Texas] Comptroller of Public Accounts, "Texas Franchise Tax," http://www.window.state.tx.us/taxinfo/franchise/margin.html.

[4] *In re Allcat Claims Service, L.P. and John Weakly, Relators*, Supreme Court of Texas, 11-058, http://www.supreme.courts.state.tx.us/historical/2011/nov/110589.pdf.

Competitive: The tax system must allow Texas to attract jobs. Texas must be the most competitive state in the nation when it comes to building or moving a business here, risking capital, and winning in a global economy.[5]

The failure of the tax to keep its proponents' promises helps explain why the legislature should consider eliminating it.

The legislature also projected the margins tax would generate significant new revenue. By most accounts, the tax has not achieved any of these goals. It is not fair, broad-based, modern, understandable, or competitive, and it has produced less revenue than expected. Nor is it popular, according to business groups. More than 80 percent of those surveyed by one group of businesses said they would prefer to return to the previous system.[6] The failure of the tax to keep its proponents' promises helps explain why the legislature should consider eliminating it.

Although superficially impartial—1 percent for all businesses and .5 percent for wholesalers and retailers—the tax treats nearly identical operations differently and fails to take modern economic realities into account. In addition, it frequently forces companies selling goods across state lines to pay tax twice on the same product. For example, if a mortgage company domiciled in Texas sells a mortgage to another company in a differing state, the Texas company must pay both the margins tax in Texas and the other state's tax.

Among other inequities, cable television operators pay differently than dish television service providers, mortgage lenders pay different rates depending on the precise method by which they package their mortgages, and small businesses in some capital-intensive markets (car dealers, for example) are taxed at much higher effective rates than sizeable enterprises that rely heavily on human capital, such as law firms. The list of unfair circumstances is substantial. The tax simply does not achieve its promises of modernity or fairness.

Although broader than its predecessor—most enterprises do pay something—the tax has not attained fairness in the comprehensible way promised by its creators. Not counting numerous technicalities that accountants use to reduce their clients' tax liabilities, the comptroller's office lists more than 15 specific "exclusions from revenue" and a schedule of five discounts available.

Additionally, confusion over the calculation of the cost of goods sold not only has increased the cost of compliance for taxpayers but also caused the filing of illegitimate deductions, contributing to the low performance of this revenue stream. Initially, the calculation was to be identical to that in the federal tax code. However, the wording of the final legislation has led to uncertainty among business owners over the amount they owe. Such uncertainty gives rise to economic instability as taxpayers reserve their cash for the worst instead of investing it into growing their businesses. For some enterprises, filing the margins tax approaches the complexity of a state income tax.

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[5] Sharp et al. (2006), *supra* note 1, p. 15

[6] National Federation of Independent Business, "State Financing in Texas," November, 2011, http://www.nfib.com/nfib-in-my-state/nfib-in-my-state-content?cmsid=32452.

In 2011, the two-year revenue gap resulting from the tax’s failure significantly attributed to the projected $27 billion shortfall, which led many to raise major questions about whether the tax should be repealed.

Finally, though the margins tax is less burdensome than a state income tax, there is no evidence that it is particularly competitive for Texas. Although Texas does make the Tax Foundation’s list of states that do not impose a corporate income tax, the percentage of state government revenue derived from the margins tax is in the same neighborhood as the corporate tax take in the two most comparably sized states. Texas receives slightly more than 4 percent of its total revenue from the margins tax, while comparably sized Florida collects 8.7 percent of its revenue from its corporate income tax and New York obtains 2.1 percent of its revenue from its own franchise tax.[7] In short, as a matter of government revenues, Texas’s margins tax is essentially equivalent to many states’ corporate income taxes.

Even so, the tax has not produced the expected revenue. It was projected to raise at least $5.9 billion annually, but collections in 2008–10 were short $1.4 billion, $1.6 billion, and $500 million respectively.[8] Although the margins tax brings in nearly twice as much (as a percentage of revenue) as the narrower franchise tax it replaced, the tax still generates far less than expected. In 2011 the two-year revenue gap resulting from the tax’s failure significantly attributed to the projected $27 billion shortfall, which led many (including several leading newspapers) to raise major questions about whether the tax should be repealed.[9]

By all accepted measures, the margins tax has failed and ought to be replaced.

Principles for Reform

At this point there’s no sure way to say what would be the best replacement for the margins tax, but in the year between now and the time the Texas legislature convenes, lawmakers should keep three key principles in mind.

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[7] See Office of the [Texas] Comptroller of Public Accounts, "Revenue by Source for Fiscal Year 2011," http://www.window.state.tx.us/taxbud/revenue.html; Florida Revenue Estimating Conference, *2011 Florida Tax Handbook*, http://edr.state.fl.us/content/revenues/reports/tax-handbook/taxhandbook2011.pdf, p. 16; Robert L. Megna et al., "2011-2012 Executive Budget: Economic and Revenue Outlook," http://publications.budget.ny.gov/eBudget1112/economicRevenueOutlook/economicRevenueOutlook.pdf, p. 23. Calculations by the authors based on $2.8 billion in franchise tax collections out of $132.5 billion total revenue.

[8] 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).

[9] *Austin American Statesman*, "Margins Tax Isn't Best Option, But It's Here," November 29, 2011, http://www.statesman.com/opinion/margins-tax-isnt-best-option-but-its-here-2001916.html.

Principle 1: All Direct Business Taxes Are Problematic.

As legal structures, businesses obviously do not use or consume anything themselves—all the government services that taxes support are ultimately provided by and for specific individuals. That doesn't mean taxing businesses is intrinsically unjust—they are granted special privileges by the state for which a fee could be assessed—but it is problematic for one simple reason: It's difficult to figure out who pays the taxes in the end. Ultimately, businesses always will pass on the tax to some individual somewhere.

Taxes assessed on businesses often end up being paid by those businesses' employees in the form of lower wages and fewer benefits.

Some examples can illustrate. A business with significant market power—say, a monopoly water utility—may simply be able to raise prices to cover its entire tax burden. But this is often hard to do, because most firms have competitors. Likewise, a firm can always reduce returns to its owners. This, however, is also unattractive since publicly owned firms live and die based on their stock prices, and privately owned ones have to provide high-enough returns to keep their owners happy and creditors paid. Thus, taxes assessed on businesses often end up being paid by those businesses' employees in the form of lower wages and fewer benefits.

Even when businesses do not pass on tax increases to their employees in this way, it's almost impossible to tell who will actually pay them in the end. Since it's possible to directly impose other kinds of taxes, such as income taxes (on individuals), sales taxes (on consumer purchases), and capital gains taxes (on corporate ownership), it stands to reason that governments are often better off taxing something other than businesses. This isn't because businesses deserve to be tax-free, but rather because all business taxes ultimately get passed on elsewhere. Thus, it's simpler, easier, and cleaner to tax these other activities instead of taxing businesses.

Principle 2: Keep the Tax Simple.

A complicated tax almost always will be less fair than a simple one, if only because the people who negotiate its complexity will pay less than those who don't. Most sales taxes, many property taxes, and some types of flat-rate income taxes can be simple, and thus intrinsically fairer. The margins tax is not simple and thus is unfair.

A simpler tax also may be more efficient in collecting revenue. One reason the margins tax has produced less revenue than expected is its complexity and the number of deductions and loopholes it allows. Eliminating these deductions and loopholes would make it simpler and fairer.

Principle 3: Don't Rule Out Eliminating the Tax and Not Replacing It

> The legislature probably should keep an open mind toward the idea of imposing some sort of new tax to replace the margins tax.

Between the 2010–2011 and 2012–2013 bienniums, Texas's overall revenue estimates fell by 2.9 percent. As a result, the portion of the 2012–2013 budget paid for by state revenues decreased (overall spending increased because of increased federal transfers.)[10] In consequence, the legislature cut spending across the board by 2.5 percent (with a few areas exempted) and made deeper cuts in some areas. The world has not ended as a result, and by most measures Texas's economy is healthier than that of the nation as a whole.

As the margins tax currently comprises only about 4 percent of Texas's overall revenue, eliminating it and replacing it with nothing (if no other revenue is found) could probably be done without enormous problems. Given that it is the most obviously unfair and problematic tax in the budget, the surface case for eliminating it outright is quite strong.

On the other hand, it's impossible—particularly more than a year before revenue estimates for 2014–2015 are made available—to assert for certain that the state really can do without the revenue from the margins tax if it is not replaced with anything. It may emerge that other taxes are more onerous, that certain key spending priorities cannot be met without the revenue the margins tax provides, or that the legislature simply cannot agree on what to cut. In these circumstances it may be necessary to replace the tax with something else. At present, then, the legislature probably should keep an open mind toward the idea of imposing some sort of new tax to replace the margins tax.

Conclusions

Texas's margins tax does not work as advertised. It is unfair, produces less revenue than promised, and does not meet any of the objectives its creators set out for it. Hence, the legislature should consider moves that would eliminate it entirely. In doing this, the legislature should look to raise its revenue from areas other than business taxes, keep any taxes it imposes simple, and keep an open mind regarding whether the tax needs to be replaced at all.

The margins tax is broken. The Texas legislature can fix it. When it convenes in 2012, efforts to do so should rank among its top priorities.

[10] State [of Texas] Office of the Comptroller of Public Accounts, Biennial Revenue Estimate, 2012–2013, http://www.window.state.tx.us/taxbud/bre2012/96-402_BRE_2012-13.pdf.

About the Authors

Eli Lehrer is vice president of Washington, DC. operations for The Heartland Institute and national director of its Center on Finance, Insurance, and Real Estate, which coordinates Heartland's work addressing issues relating to insurance, risk, and credit markets and has field offices in Tallahassee, Florida, Columbus, Ohio, and Austin, Texas.

Lehrer played a major role in founding the smartersafer.org coalition, a coalition of taxpayer, environmental, insurance, and free-market groups dedicated to risk-based insurance rates, mitigation, and environmental protection.

Prior to joining Heartland, Lehrer worked as speechwriter for U.S. Senate Majority Leader Bill Frist (R-TN). He previously worked as a manager in the Unisys Corporation's Homeland Security Practice, senior editor of *The American Enterprise* magazine, and as a fellow for The Heritage Foundation. He has spoken at Yale and George Washington Universities.

Lehrer holds a B.A. (cum laude) from Cornell University and an M.A. (with honors) from The Johns Hopkins University, where his Master's thesis focused on the Federal Emergency Management Agency and flood insurance. His writings have appeared in *The New York Times*, *Washington Post*, *USA Today*, *Washington Times*, *Weekly Standard*, *National Review*, *The Public Interest*, Salon.com, and dozens of other publications. He is also a blogger for the Huffington Post.

As an attorney and political strategist, **Julie Drenner**, director of The Heartland Institute's Texas office, has long promoted sound public policy by shepherding issues ranging from legal reform to public health through the legislative process. She drafted more than 20 pieces of legislation and testified in numerous hearings during the past four legislative sessions. CNN, the *Los Angeles Times*, News Austin 8, KLBJ, and the *Dallas Morning News* have interviewed and quoted her statements at key times regarding bills under consideration.

Drenner's involvement in her local community led her to become a founding member and serve as chairman of the board for the Austin Pregnancy Resource Center, an organization dedicated to serving women and children in need.