HOUSE RESEARCH ORGANIZATION bill analysis	4/27/2017	HB 28 D. Bonnen, et al. (CSHB 28 by Shine)

SUBJECT: Phasing out the franchise tax

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 10 ayes — D. Bonnen, Y. Davis, Bohac, Darby, Murphy, Murr, Raymond, Shine, Springer, Stephenson

0 nays

1 absent — E. Johnson

WITNESSES: For — Samuel Sheetz, Americans for Prosperity-Texas; Will Newton, National Federation of Independent Business-Texas; James LeBas, Texas Chemical Council; Vance Ginn, Texas Public Policy Foundation; Dale Craymer, Texas Taxpayers and Research Association; (*Registered, but did not testify*: James LeBas, Association of Electric Companies of Texas, Texas Oil and Gas Association; Audra Conwell, Alliance of Independent Pharmacists of Texas; Jerome Greener, Americans for Prosperity-Texas; June Deadrick, CenterPoint Energy; Justin MacDonald, Hill Country Builders Association; John Kroll, MuniServices; Josiah Neeley, R Street Institute; David Mintz, Texas Apartment Association; Daniel Gonzalez and Julia Parenteau, Texas Association of Realtors; Scott Norman, Texas Association of Builders; Stephen Minick, Texas Association of Business; Robert Braziel, Texas Automobile Dealers Association; John Colyandro, Texas Conservative Coalition; Mario Munoz, Texas Merchandise Vending Association; Jim Sheer, Texas Retailers Association; Tricia Davis, Texas Royalty Council)

Against — Dick Lavine, Center for Public Policy Priorities; (*Registered, but did not testify*: Rene Lara, Texas AFL-CIO; Juan Flores, Texas Latino Education Coalition; Dwight Harris, American Federation of Teachers-Texas)

BACKGROUND: The Texas margins tax, or the "franchise tax," applies to each taxable entity that does business or is organized in the state. Under Tax Code, sec. 171.002, as amended by HB 32 by D. Bonnen in 2015, the tax is

calculated as either 0.75 percent or 0.375 percent of taxable margin, with the lower rate applying to taxable entities primarily engaged in retail or wholesale trade.

Tax Code, sec. 171.1016 provides for an "E-Z computation and rate." A taxable entity with total revenue of $20 million or less may choose to pay the franchise tax using this calculation. The E-Z rate, as amended by HB 32, is 0.331 percent.

According to the comptroller's biennial revenue estimate, the franchise tax collections are expected to be $7.82 billion in the 2018-19 biennium.

DIGEST:

CSHB 28 would require the comptroller to set the franchise tax rates to rates such that collections would be reduced by a certain amount. That amount would be either the ending balance of general revenue related funds in the preceding biennium or $3.5 billion, whichever is less.

The comptroller would be required to publish notice of the adjusted tax rates by December 15 of each odd-numbered year.

Each tax rate would be reduced proportionally. In a fiscal year that the adjusted tax rate would be less than 15 percent of the fiscal 2018 tax rate, the franchise tax would be eliminated and taxable entities no longer would be required to file or pay a tax.

CSHB 28 would take effect September 1, 2019, and would apply only to a report originally due on or after January 1, 2020.

The bill would not affect the applicability of existing law to audits, deficiencies, refunds, until barred by limitations. It also would not affect the status of a taxable entity that had certain privileges or certificates revoked; the ability of the comptroller, secretary of state, or attorney general to take action against taxable entities for actions that took place before the franchise tax was eliminated; nor the right of a taxable entity to contest a forfeiture, revocation, or lawsuit.

SUPPORTERS SAY:

CSHB 28 would be a boon for economic growth, eliminating the most burdensome tax currently imposed in Texas while maintaining the state's ability to meet its obligations.

Effectiveness. The franchise tax imposes major limitations on the Texas economy, and its phase-out could result in a gain of up to $16 billion in real personal income and nearly 130,000 jobs created in the state.

There are several qualitative reasons for these estimates, as the franchise tax imposes a variety of economic costs. Any form of business income tax effectively increases the cost of goods, which already are subject to sales tax, creating a tax pyramiding effect that is passed on to consumers. Additionally, the franchise tax imposes compliance costs on businesses. The majority of businesses do not use the E-Z computation, preferring the cost-of-goods-sold deduction, which can reduce their tax burden while increasing accounting costs and overhead. These compliance costs are not worth the limited amount of revenue the franchise tax contributes to the state budget.

Additionally, these compliance costs can drive away businesses considering locating in Texas. The Tax Foundation ranks Texas has having only the 14th best business tax climate, even though the state could be among the best if it eliminated the franchise tax. A state having no business or personal income tax is a huge draw for businesses considering relocation, and this in itself would create a solid return on investment for the bill. The direct impacts of relocating businesses would be magnified by the dynamic effects of economic activity, as more and more people move to Texas, work, spend, and create jobs.

While the franchise tax most directly burdens businesses, those costs, and thus the benefits of CSHB 28, are passed on to consumers in the form of higher prices and lower incomes. In fact, according to data from the comptroller, the franchise tax disproportionately burdens lower-income Texans as a percentage of their total household income. Though the aggregate impact of the bill would affect upper-income quintiles more, lower-income citizens would see a more direct benefits as a percentage of

their income.

Available revenue. While CSHB 28 would reduce revenue available in the future, based in part on balances in general revenue dedicated accounts, it is still up to the Legislature to decide to spend that money or not. Thus, for the purposes of certification, the money is still fungible.

Revenue volatility. Although CSHB 28 could result in increased revenue volatility, any variations would force the state to be more fiscally responsible. Even then, the state still would retain a sizeable balance in the Economic Stabilization Fund that could be used to reduce volatility, and sales tax collections are the first type of tax collections to pick up after a recession, which should limit any hardship.

Property taxes. The bill would use natural economic growth to phase out one of the most harmful taxes. While future franchise tax revenue could be used to offset property taxes, doing so would impose more economic costs because the franchise tax is so inefficient. It is better for the state to realize the economic benefits of eliminating the franchise tax than to try to inefficiently buy down property taxes.

Spending alternatives. Cutting the franchise tax would result in a higher return on investment than spending on education. Tax cuts — particularly cuts to the franchise tax — put money back into the economy, allowing businesses to create more jobs, which in turn increases consumer spending and other types of tax collections. For instance, in 2015 the Legislature cut the franchise tax rates by 25 percent with HB 32 by D. Bonnen, but revenue was only reduced by around 18 percent, possibly due to this dynamic effect.

Accountability. Many bills make obligations that the state must fulfill in the future, and this bill is no different. The franchise tax has such a profound negative impact on the Texas economy that it is worth making this particular obligation now.

Fairness. The franchise tax is structured such that some taxable entities

must pay tax even when they are losing money. About 57 percent of responding members of the National Federation of Independent Business/Texas surveyed have had to pay the franchise tax in years when they did not make a profit. While the Legislature could restructure the tax to resolve this issue, eliminating it would be better so as to secure the economic benefits.

OPPONENTS SAY:

CSHB 28 would lock the state into losing revenue that should be used to fund schools, place the state in a precarious fiscal position in future biennia, and threaten its ability to meet its long-term obligations.

Effectiveness. Any positive effects from the bill would merely make the tax system in Texas more regressive. According to the Legislative Budget Board, less than 6 percent of the reduction in tax incidence would go to the lowest income quintile, whereas the highest income quintile would receive 28 percent of the total reduction in tax incidence. The elimination of a revenue stream that is paid mostly by businesses would leave Texas almost totally reliant on the sales tax, which is highly regressive and hurts low-income citizens most.

The Legislative Budget Board also estimates that around 30 percent of the reduced tax incidence would go to out-of-state residents and would not directly benefit Texans.

Available revenue. CSHB 28 would place the state in a dangerous situation that would cause cuts to state services. The bill would treat the ending balance of general revenue related funds as though the revenue was totally available. However, in fiscal 2016-17, around $3.48 billion of the roughly $4.09 billion ending balance consisted of general revenue dedicated funds not spent but available to be used for certification. These funds are not simply general revenue, but originally collected for a particular purpose. Additionally, that $4 billion could include up to $2.5 billion in sales tax revenue that is constitutionally required to be transferred to the State Highway Fund. These factors create an illusion of revenue available, even though the state is obligated to use it for a particular purpose.

CSHB 28 also would limit the state's ability to address possible future crises in budget areas such as the Employees Retirement System of Texas, the Teacher's Retirement System, and the Texas Tomorrow Fund. Unfunded liabilities from these programs demand funding to keep them actuarially sound. The state should ensure it can fulfill its obligations before cutting taxes.

Revenue volatility. CSHB 28 would leave the state reliant on consumption taxes, which are historically volatile when compared to other types of taxes. The first thing consumers do during a recession is to cut their spending, which would directly impact the state budget. This would be magnified if the state were to be left with basically a single major revenue source in the sales tax. Because the Legislature has limitations on deficit spending, fluctuations in revenue would, under CSHB 28, result in much more harmful cuts to services such as human services and education.

Property taxes. CSHB 28 would not actually reduce the total tax burden, merely shifting it to other state revenue streams, the property tax system, and local government coffers. The property tax relief fund receives about half of its revenue from the franchise tax, and eliminating a method of finance merely requires the state to make it up with general revenue. This reduces general revenue that otherwise would be available to further provide potential property tax relief or increase the state's share of education funding, meaning that businesses and individuals could pay higher property taxes.

Spending alternatives. Education in Texas is critically underfunded, and the state will need additional funds in future biennia to cover its growing needs. Fully funding public education and higher education would have a better return on investment than any tax cut. At a time when the Legislature is considering reducing funding for its premier academic institution, it should not eliminate a much-needed stream of revenue.

Accountability. CSHB 28 would effectively take away control of a large

piece of the state budget, and voters cannot hold their legislators accountable for decisions they did not make. This bill would obligate future legislators to dedicate up to $3.5 billion to reduce franchise tax rates, even if doing so would be fiscally irresponsible.

OTHER OPPONENTS SAY:

Fairness. CSHB 28 would go too far in eliminating the franchise tax. The Legislature instead should focus on fixing the franchise tax to make it more fair or to reduce compliance costs. This would avoid the long-term fiscal disadvantages while gaining some of the economic benefits associated with elimination.

NOTES:

The Legislative Budget Board estimates that the bill would have a negative impact of up to $3.5 billion to the general revenue fund in fiscal 2020-21 and subsequent biennia.