

SUBJECT: Super-majority legislative approval of an increase in the franchise tax rate

COMMITTEE: Ways and Means — favorable, without amendment

VOTE: 7 ayes — Keffer, Ritter, Otto, Bonnen, Y. Davis, Paxton, Pitts

0 nays

2 absent — Flores, Peña

WITNESSES: For — Talmadge Heflin, Byron Schlomach, Texas Public Policy Foundation; (*Registered, but did not testify:* Tom Aldred, Texas Conservative Coalition; Michele Gregg, Texas Apartment Association; Michael Quinn Sullivan, Texans for Fiscal Responsibility)

Against — (*Registered, but did not testify:* Dwight Harris, Texas Federation of Teachers; Dick Lavine, Center for Public Policy Priorities)

BACKGROUND: The 79th Legislature during its third called session in 2003 enacted HB 3 by J. Keffer, which established the “revised franchise tax.” The tax will take effect January 1, 2008.

The tax is computed by determining a taxable entity’s total revenue. From this amount, the entity may deduct either its cost of goods sold or total compensation — up to \$300,000 per employee indexed to inflation — plus benefits. If the entity’s margin after making its deduction is more than 70 percent of its total revenue, the business is taxed on only 70 percent of its total revenue.

Once the entity’s taxable margin is determined, a rate of 1 percent is applied to that margin for an entity that is not engaged in retail or wholesale trade. For a taxable entity that is engaged primarily in retail or wholesale trade, a rate of one-half of 1 percent is applied to the entity’s taxable margin.

Under Tax Code, sec. 171.003, any increase in the rate of the tax must be approved a majority of the state’s voters in a referendum. This requirement does not apply to a decrease in the rate, but does apply to an increase in the rate following a decrease. The requirement does not apply

to a change in the manner in which the tax is computed, administered, enforced, or applied.

DIGEST:

HJR 44 would amend the Texas Constitution to require that any bill increasing the franchise tax rate that was in effect on the date the bill was filed would have to be passed by a record vote of three-fourths of all the members elected to each house of the Legislature upon final consideration in each house. This provision would not apply to a bill changing the manner in which the tax was computed, administered, enforced, or applied.

The proposal would be presented to the voters at an election on Tuesday, November 6, 2007. The ballot proposal would read: "The constitutional amendment requiring any increase in a franchise tax rate to be approved by three-fourths of all the members elected to each house of the legislature."

SUPPORTERS
SAY:

HJR 44 would provide taxpayer protection by requiring super-majority approval of an increase in the rate of the revised franchise tax. By limiting the ability of the Legislature to increase the rate of the franchise tax without three-fourths approval of both the House and the Senate, the resolution would mitigate against "rate creep," which is caused by the temptation among lawmakers slowly to raise the rate of a tax over time, eventually resulting in a much more substantial tax than the one initially enacted. HJR 44 would protect the business climate in the state of Texas, as well as consumers since they ultimately pay for all business tax increases when the cost is passed on.

Requiring super-majority approval of any increase in the franchise tax rate would encourage the Legislature to address revenue requirements by holding down spending rather than raising taxes. The tax rate could not be raised without 113 "aye" votes on final passage in the House and 24 in the Senate. While this standard would be high, in an extraordinary circumstance when broad support for a rate increase existed, the threshold could be met.

The current statutory requirement that a rate increase be approved by the voters of Texas is insufficient. A future Legislature could eliminate that provision with a simple majority vote, allowing elected officials to raise the tax rate without any additional constraint. A constitutional super-

majority requirement ratified by the voters would institute a hard-and-fast limitation that could not be ignored by a future Legislature.

The constitutional restriction would apply only to increases in the tax rate, not to other changes to the tax affecting its application, computation, administration, or enforcement. For example, any technical or correcting changes to the way an entity's margin was calculated or the definition or size of allowable deductions would not be off limits. The Legislature would have ample flexibility to improve the administration of the tax, as only the rate applied to businesses would be restricted.

**OPPONENTS
SAY:**

HJR 44 would tie the hands of future Legislatures by imposing an unrealistic super-majority requirement before the franchise tax's rate could be increased. It is difficult to anticipate what could happen in the future, and at some point a rate increase could be necessary. For example, the state could face a catastrophic natural disaster, an economic depression, or other unforeseeable occurrence requiring additional revenue to support state services. Alternately, the Legislature could face yet another court order related to school finance, requiring additional state funding for public education. HJR 44 could force the state to increase the rate of other taxes, such as the regressive sales tax, which would have no super-majority requirement, or be faced with cutting vital state programs.

The rate of the franchise tax is only one component determining a business's tax bill. The margin on which the rate is applied has at least as much to do with the tax burden shouldered by businesses. Under HJR 44, the Legislature could keep the franchise tax rate static, while making any number of other changes that still would result in a larger tax bill for a business.