HOUSE RESEARCH ORGANIZATION bill analysis 4/28/2015

HB 32
D. Bonnen, et al.
(CSHB 32 by Wray)

SUBJECT: Reducing franchise tax rate and expanding E-Z computation eligibility

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 7 ayes — D. Bonnen, Bohac, Button, Darby, Murphy, Springer, Wray

2 nays — Martinez Fischer, C. Turner

2 absent — Y. Davis, Parker

WITNESSES: For — Peggy Venable, Americans for Prosperity-Texas; Will Newton, NFIB/Texas; James LeBas, Texas Apartment Association; Richard A. (Tony) Bennett, Texas Association of Manufacturers; Stephen Minick, Texas Association of Business; Todd Staples, Texas Oil and Gas Association; Vance Ginn, Texas Public Policy Foundation; Ronnie Volkening, Texas Retailers Association; Dale Craymer, Texas Taxpayers and Research Association; (*Registered, but did not testify*: Adrian Acevedo, Anadarko Petroleum Corp.; Jon Fisher, Associated Builders and Contractors of Texas; Dan Hinkle, British Petroleum, EOG Resources; Greg Macksood, Chesapeake Energy; Richard Lawson, Chevron; Warren Mayberry, DuPont; Marty Allday, Enbridge Energy; Samantha Omey, ExxonMobil; Angela Smith, Fredericksburg Tea Party; Mindy Ellmer, LyondellBasell Industries; Lindsay Sander, Markwest Energy; Julie Moore, Occidental Petroleum; Ed Longanecker, President, Texas Independent Producers and Royalty Owners Association; Cade Campbell, SM Energy Co.; Sarah Matz, TechAmerica; Bill Stevens, Texas Alliance of Energy Producers; James LeBas, Texas Association of Manufacturers, AECT, Texas Oil and Gas Association, and Texas Chemical Council; Scott Norman, Texas Association of Builders; Bill Hammond, Texas Association of Business; Hector Rivero, Texas Chemical Council; Matt Burgin, Texas Food and Fuel Association; Justin Bragiel, Texas Hotel and Lodging Association; Troy Alexander, Texas Medical Association; Thure Cannon, Texas Pipeline Association; Kenneth Besserman, Texas Restaurant Association; Les Findeisen, Texas Trucking Association; John W. Fainter, Jr., Association of Electric Companies of Texas, Inc.; Matt Long; Sandy Ward)

Against — Dick Lavine, Center for Public Policy Priorities; Dennis Borel, Coalition of Texans with Disabilities; Celina Moreno, MALDEF; (*Registered, but did not testify*: Renee Lopez, Bob Kafka, and Albert Metz, Adapt of Texas; Cheasty Anderson and Patrick Bresette, Children's Defense Fund-Texas; Will Francis, National Association of Social Workers-Texas; Cathy Cranston, Personal Attendant Coalition of Texas; Eileen Garcia, Texans Care for Children; John Patrick, Texas AFL-CIO; Dwight Harris, Texas American Federation of Teachers; Harrison Hiner, Texas State Employees Union; Maxie Gallardo, Workers Defense Project; Freddy Gonzalez; Jennifer McPhail)

On — Kevin Kavanaugh, Legislative Budget Board; C. LeRoy Cavazos, San Antonio Hispanic Chamber of Commerce; (*Registered, but did not testify*: Ursula Parks, Legislative Budget Board; Tom Currah and Jennifer Specchio, Comptroller of Public Accounts)

BACKGROUND: The Texas franchise tax, or "margins" tax, applies to each taxable entity that does business or is organized in the state. Under Tax Code, sec. 171.002, the tax is calculated as either 1 percent or 0.5 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 $10 million or less may choose to pay the franchise tax using this comparatively less complex calculation. The tax due is the taxable entity's apportioned total revenue, as defined by sec. 171.106, multiplied by the E-Z tax rate, which is 0.575 percent.

According to the comptroller, the franchise tax comprised 4.5 percent of state revenues, or $4.73 billion, in fiscal 2014.

DIGEST: CSHB 32 would decrease the franchise tax rate from 1 percent to 0.75 percent. The bill also would decrease the franchise tax on retailers or wholesalers from 0.5 percent to 0.375 percent.

A taxable entity with no more than $20 million in total revenue, up from

$10 million in current law, could choose to pay the franchise tax under E-Z computation and rate provisions. The bill would decrease the tax rate under this computation from 0.575 percent to 0.331 percent.

The bill would take effect January 1, 2016, and would apply only to a franchise tax report originally due on or after that date.

SUPPORTERS SAY:

CSHB 32 would be a boon for economic development and investment in the state. It would reduce compliance costs and business overhead while sending a message that Texas's business climate is the best in the nation.

Aggregate economic impact. Because this tax cut would directly reduce the burden on businesses, the bill would have a direct and immediate effect on job creation. The bill would provide nearly $1.3 billion in relief to Texas businesses in fiscal 2016, freeing up that money for use in creating jobs and investment. CSHB 32 would go a quarter of the way to eliminating the franchise tax, which by some estimates could result in as much as $3.4 billion in annual investment and up to 129,000 new jobs within five years.

Compliance costs. Businesses are negatively affected not just by the cost of the tax itself but the compliance costs associated with computing the tax due. This bill would make nearly 14,000 more businesses eligible to use the E-Z computation, reducing compliance costs and allowing those businesses to cut their overhead.

According to the Tax Foundation, Texas is 39th in the nation in corporate tax complexity and burden largely because of the franchise tax's complexity. The Tax Foundation also notes that if the franchise tax were repealed, Texas would rank as the best in the nation. This bill could make Texas' business climate better and reduce overhead for businesses newly eligible for the E-Z computation.

Tax cut alternatives. This bill would do more for the Texas economy than increasing the homestead exemption. Analysis from the Legislative Budget Board shows that a $2.56 billion franchise tax reduction returns

7,730 more jobs and $10.35 billion more GDP growth than an equivalent increase in the homestead exemption.

This bill would accomplish the goal of a low and broad tax; exempting businesses would not. If the franchise tax is made as broad as possible, it can be made as low as possible, minimizing the impact on business in the state. Exempting businesses under a certain size would go against this philosophy and merely increase the already-disproportionate tax burden on larger, capital-intensive businesses. About 900,000 businesses already are exempt, and the state should not enact policies that leave a small percentage of businesses carrying 100 percent of the burden.

Spending alternatives. Current versions of the state budget include increases to funding in many areas of vital state services. It is likely that both public education and transportation will receive additional funding. The state already is set to invest more, and the revenue lost under this bill would not be needed.

This bill would decrease the footprint of the government and empower Texans to make decisions with the forgone tax revenue that are best for the economy. By contrast, there will always be another government program to fund, regardless of its effectiveness. Texas should adopt tax policies that allow the state to focus on those government programs that have the greatest return on investment.

Revenue stability. The state would have plenty of revenue to meet its obligations in future biennia. The budget surplus in this biennium likely is not unique. Although oil prices (and severance tax revenue) are low, oil likely will not stay at its current prices. Even if it does, the state will have about $11 billion in the rainy day fund at the beginning of the next biennium. Even if there is an unexpected decrease in tax revenue, the state will have substantial savings to draw upon.

Additionally, the Texas Conservative Coalition Research Institute estimates that while revenue increased by 6.7 percent in fiscal 2014, the state saw only 3.7 percent economic growth. The state has room for fiscal

adjustments.

OPPONENTS SAY:

Aggregate economic impact. This bill ultimately could have an insignificant effect on businesses. The impact to the average Texan could be minimal; the Legislative Budget Board's tax/fee equity note indicates that the average tax rate would be reduced by only 0.09 percent, which is not worth a multibillion-dollar investment.

By some estimates, a significant portion of the benefits from this tax cut would go to out-of-state consumers and businesses. The Legislature should craft its tax plan so that Texas businesses and consumers see maximum benefit.

Although the estimated aggregate gains as a result of this bill might seem impressive, they could be shortsighted. Not funding critical infrastructure like schools and transportation will cost far more in long run when Texas becomes increasingly less competitive and costs begin to add up.

Compliance costs. As the state does not have a personal income tax (a tax that many consider the most economically harmful), Texas has a significant advantage over many other states when it comes to attracting businesses. Decreasing the franchise tax rate would do little to improve an already excellent business climate.

Spending alternatives. This bill would cost the state $2.56 billion in revenue during the 2016-17 biennium. This money can and should be spent elsewhere. The state has an obligation to fund basic services that protect its future.

There are any number of potential ways to invest tax revenue which would save the state billions in future biennia. Studies show that every dollar spent on prekindergarten education saves the state between $3.50 and $7. This is because prekindergarten education significantly decreases the likelihood of reliance on special education and social services in later years. Investments in this area have demonstrably increased high school graduation rates, leaving the state's economy more competitive and its

workforce more educated. Funding for public education in general is still not back to pre-2011 levels, when the state cut a significant amount from school budgets. The state needs to fully fund this obligation before considering a tax cut.

Investing in transportation also would pay far more dividends in the long run than a tax cut. The Texas A&M Transportation Institute found that delays and fuel costs as a result of congestion cost the state $10.1 billion and more than 472 million hours of travel time. TRIP, a national transportation research group, found that an inadequate transportation system costs Texas more than $23 billion, which includes costs from congestion, air pollution, and public safety. In other words, billions of dollars are lost every year because Texas does not properly fund its transportation infrastructure.

Revenue stability. This tax cut may not be sustainable. There has been an illusion of plenty caused by the shale oil boom, with severance tax revenue from oil and gas sales up significantly. However, these severance taxes (and the state's revenue estimates) are heavily reliant on the price of oil going back up. There is no guarantee this will happen, and any number of geopolitical factors beyond the capacity of the state to predict could prevent an increase in the price of oil.

In addition, some of the current surplus was left over from last session, and the state has no guarantee of such a luxury in the 2018-19 biennium. Making tax cuts from a one-time influx of money would not be the most responsible approach, as revenue is variable and tax cuts are permanent. The political climate of the state would not allow a tax hike, which could leave the state in a difficult fiscal situation in future biennia that might have to be solved by cutting vital state services. This is a particularly salient issue for the franchise tax because it indirectly funds the Foundation School Fund.

OTHER OPPONENTS SAY:

Tax cut alternatives. Instead of reducing the franchise tax rate as much, the state would gain more by exempting businesses with lower revenues and tax burdens from the tax entirely. A large portion of the economic

harm caused by the tax is due to compliance costs and bookkeeping. This bill would not ensure that the compliance costs do not outweigh the benefits that the state can provide with the added revenue.

NOTES: The Legislative Budget Board's fiscal note estimates that the bill would have a negative impact of $2.56 billion to the property tax relief fund through the 2016-17 biennium. The tax/fee equity note indicates that the bill would reduce the effective tax rate for all households by 0.09 percent for taxes effective in fiscal 2017.