Will New Business Tax Dull Texas' Competitive Edge?

By Jason L. Saving

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In today's global economy, high corporate tax rates are more harmful than ever because it has become easier for mobile productive resources to cross borders in search of more favorable business climates.

Nations seem quite aware of this. The European Union's corporate tax rates have fallen by a third over the past decade, with five member states making cuts in 2006 alone. Asian nations, too, have responded to global competition by reducing the tax bite on business. In fact, all members of the Organization for Economic Cooperation and Development impose lower corporate tax rates than they did in the mid-1980s.

It's in this context—though not for this reason—that Texas recently revamped the franchise tax, its main vehicle of corporate taxation. This year, the state implemented a version that's expected to raise more than twice the revenue of the old tax, changing both the number of businesses subject to taxation and the distribution of the burden across sectors.

The new way of taxing businesses raises an important issue: Will it erode the Texas economy's highly competitive business climate?

Rates and Revenues

Texas introduced the franchise tax just over a century ago—in 1907. As originally conceived, it targeted corporate assets, and the same basic idea was retained through the years. The initial levy was only 0.05 percent—a nickel for each $100 of taxable capital.

Before this year's reforms, companies paid either 0.25 percent of taxable capital or 4.5 percent of "earned surplus," which roughly corresponds to a firm's net income. In fiscal 2006, the franchise tax raised $2.6 billion, or 8 percent of total tax revenue. This places the franchise tax among the state's four biggest revenue raisers, far behind the sales tax but slightly ahead of the natural gas production tax (*Chart 1*).

While some may assume the franchise tax affects most Texas businesses, the state comptroller estimates that only 6 percent of firms, or one in 16, have any liability. To some extent, this isn't surprising, given that three-quarters of Texas businesses are sole proprietorships that don't fall under the state's corporate code. The 6 percent figure represents only about half the Texas firms subject to U.S. corporate income taxes.

Revenue from the franchise tax hasn't kept up with an expanding Texas economy. Between 1997 and 2006, for example, nominal franchise-tax receipts grew at an annual rate of 4.2 percent, versus 6.6 percent for the overall state economy. Moreover, the franchise tax had the lowest growth rate of Texas' major taxes in the decade, partly because productive resources shifted toward sectors and legal forms that bear a relatively small share of the franchise-tax burden.

Reform Issues

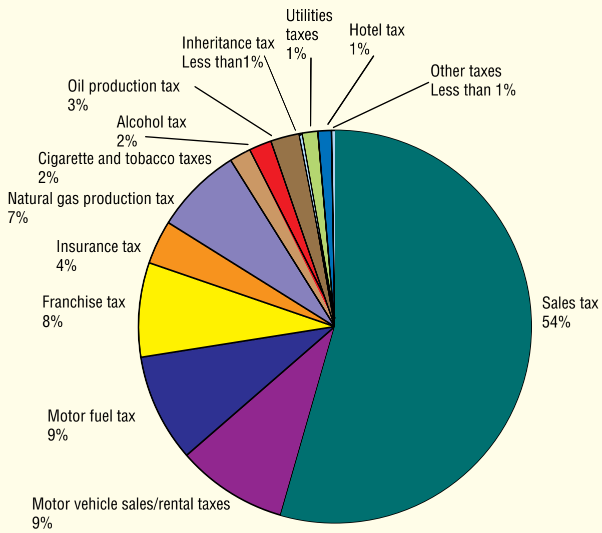
Economic theory suggests the tax code should treat similar businesses the same. When this doesn't occur, resources flow disproportionately to favored businesses and sectors, and overall economic activity falls below what it would have been in the absence of distortions.

One aspect of the franchise tax that produces unequal treatment is the legal status of businesses. For a variety of reasons, the franchise tax has never applied to sole proprietorships, which are generally small and comprise about three-quarters of Texas businesses.[1] The franchise tax also exempts partnerships and other noncorporate entities that share many of the economic characteristics of corporations.

These exemptions provide an incentive for businesses to operate as sole proprietorships or partnerships to escape franchise taxes—a spur that's particularly strong in states like Texas that don't levy personal income taxes.

Another feature of the franchise tax is the so-called Delaware sub loophole. By becoming a subsidiary of an out-of-state

Chart 1
Texas Tax Revenue, 2006



NOTE: Percentages don't add to 100 due to rounding.
SOURCE: Texas Comptroller, State of Texas 2006 Annual Cash Report.

holding company and funneling income to it, Texas firms can legally avoid most franchise-tax liability. Delaware has been a common choice as a headquarters state due to its favorable corporate tax laws. Former Texas Comptroller Carol Keeton Strayhorn once assessed the loophole's cost to the state treasury at about $300 million a year.

In addition, the franchise tax doesn't reflect the modern Texas economy. The tax's wealth-based nature imposes a relatively high burden on capital-intensive industries like manufacturing and mining but a relatively low burden on labor-intensive industries, such as construction and services.

Perhaps a justification could be made for this tax scheme in the early 20th century, when manufacturing and oil and gas constituted a substantial portion of Texas' economy. But in 2007, service-sector businesses made up two-thirds of the state economy, creating a situation in which similarly sized businesses had very different tax liabilities, depending on what they produced and how they produced it (*Chart 2*).

Do franchise taxes fall disproportionately on certain sectors of the Texas economy? The data say yes (*Chart 3*). Mining faces the highest franchise tax burden at $2,083 per employee, followed by utilities, transportation and information at $1,073 and manufacturing at $574. Construction, trade and "other services" (including professional and business services) pay between $97 and $308 per employee.

Similar but less dramatic trends hold when franchise tax burdens are measured in proportion to each sector's contribution to state gross domestic product. Mining's burden remains above average but is displaced by utilities, transportation and information as the highest, while construction and "other services" continue to face the lowest franchise tax burden.

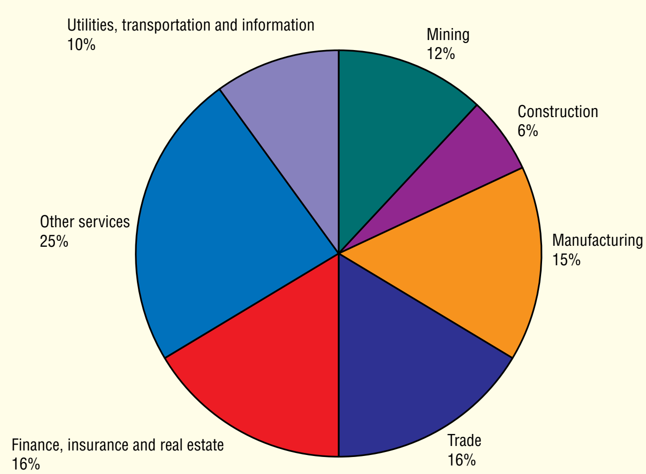
Services are increasingly important to the Texas economy, and low taxes provide a boost to the new engine of statewide growth. At the same time, public finance principles suggest it's inappropriate to offer preferential tax treatment to any sector because doing so hobbles the overall economy, even while potentially stimulating the favored sector.

A Tax Is (Re)born

Partly because of the resource-allocation issue, a succession of commissions, comptrollers and legislative committees urged franchise-tax reform for at least two decades. And on May 18, 2006, Gov. Rick Perry signed into law a bill that substantially revamped Texas' franchise tax.

The new version, which took effect Jan. 1, 2008, imposes a flat levy of 1 percent on "taxable margin," and it's for this reason that the revised franchise tax is often called a margin tax.[2] The new tax defines taxable margin as a firm's total revenue less one of two deductions—the cost of goods sold or compensation and benefits. Should neither be very large, firms can instead claim a

Chart 2
Texas GDP by Sector, First Quarter 2007



SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Dallas.

30 percent deduction, leaving an implicit levy of 0.7 percent on taxable margin.

Both capital-intensive and labor-intensive firms can substantially deduct their most important cost of doing business, so firms aren't penalized for producing a high volume of goods or hiring large numbers of people. Yet because this deduction doesn't include all costs of doing business, firms that lose money may still have tax liabilities—an important feature because the Texas Constitution prohibits corporate taxation based purely on income.

Cost of goods sold is the amount firms pay to produce or acquire merchandise, including storage costs, capital expenditures and labor compensation directly tied to production. Excluded are officer compensation, distribution and advertising expenditures, and payments made to undocumented immigrants.

The compensation and benefits category consists of cash payments to all employees, including managers, officers, owners, directors and partners, up to $300,000 per person. It also includes retirement plan and medical insurance expenditures as well as certain other outlays deductible under federal law, such as workers' compensation payments. As with cost of goods sold, no wages paid to undocumented immigrants can be included in the calculation, whether or not they worked on the books and paid federal income and payroll taxes.

How does a firm choose which deduction to take? While no generalization can be made, manufacturing-oriented firms will most likely find that cost of goods sold outweighs compensation, whereas service-oriented firms will find the opposite. Firms in between might find themselves at a competitive disadvantage, perhaps leading to spin-offs or further specialization.

The margin tax applies to partnerships and Delaware sub firms. As a result of these and other base expansions, the new tax is expected to hit about 12 percent of Texas firms, compared with the previous tax's 6 percent. Among the firms will be roughly half the state's non-sole proprietorships. Revenue is expected to rise by at least $3 billion in 2008, more than doubling the tax's 2006 intake of $2.6 billion.

Margin Tax's Burden

Public finance principles tell us that efficient tax regimes should be broad based and show no favoritism to particular sectors. And at first glance, the margin tax seems to satisfy these criteria: More businesses will pay the tax, and once-lightly taxed sectors are expected to shoulder a greater share of the burden.

This doesn't necessarily mean that the aggregate business tax burden will decline in every previously highly taxed sector. Some previously available exemptions won't be available under the margin tax, for

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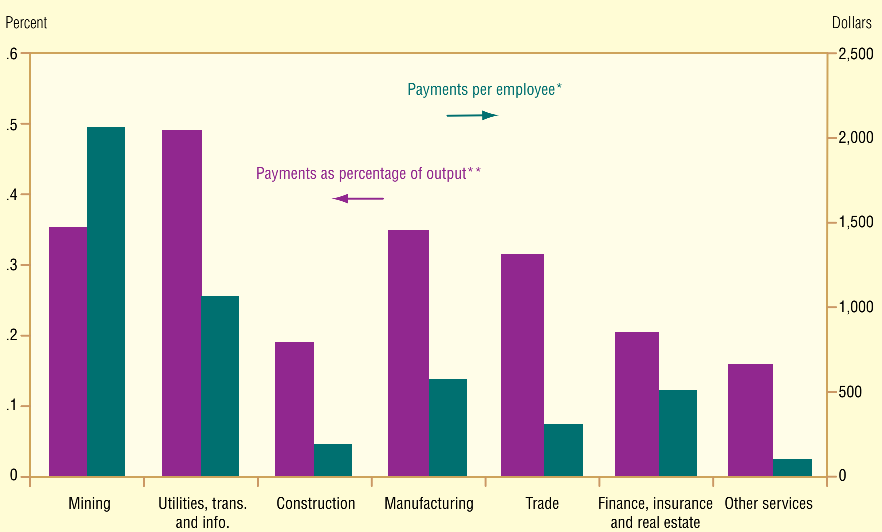
Chart 3

Franchise Tax Burden Differs Across Sectors



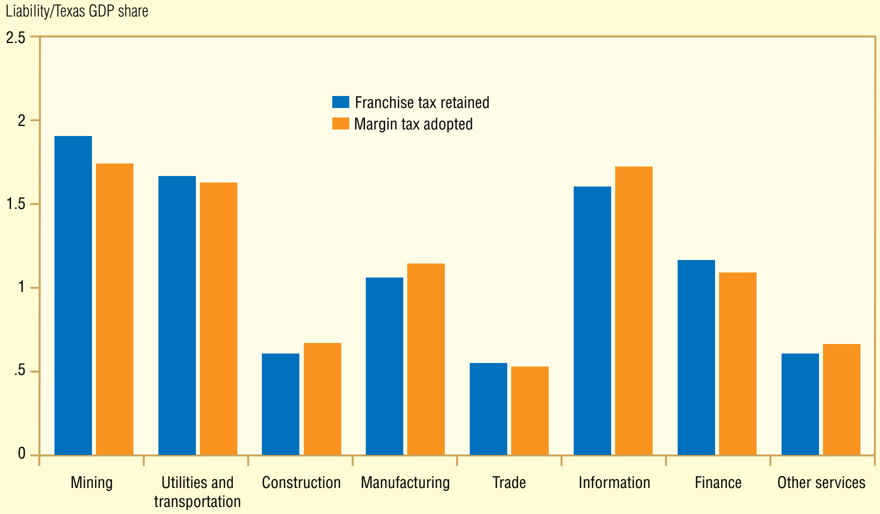
*August 2007 payroll employment.

**Annualized Texas GDP values by supersector, first quarter 2007.

SOURCES: Texas Workforce Commission; Texas Comptroller; Bureau of Economic Analysis; Federal Reserve Bank of Dallas.

Chart 4

Tax Burden Equalizes a Bit Across Industries



SOURCES: Legislative Budget Board, Tax Equity Note for HB 3, 79th Third Called Session; Texas Comptroller.

example. If a particular sector made disproportionate use of these exemptions, its total tax bill could increase, depending on how elements of the package offset each other.

How does the margin tax change the business tax burden borne by each sector? To find out, we compare projected 2008 figures for the margin tax with a scenario based on the franchise tax in its previous form.[3]

The construction and "other services" sectors will bear greater shares of the tax burden, although both will remain below the statewide average (*Chart 4*). The mining and utilities and transportation sectors will bear lower shares but remain above average. For these sectors, it appears the margin tax will offer more equal treatment.

This pattern doesn't hold across the board, however. The manufacturing and information sectors, for example, both face a slightly higher share of the burden even though they were above-average payers before the reform. While these changes are not dramatic, they do reinforce the point that the revised franchise tax won't—and can't be expected to—completely equalize tax burdens across sectors.

On a related note, some businesses within the manufacturing and information sectors are high tech, and others look more like old-economy firms. It's possible that the most capital-intensive firms within these sectors will pay less while the more labor-intensive firms will pay more, which would replicate the general trend for the broader economy. But we don't yet have evidence to evaluate this possibility; the level of aggregation provided by the data is too coarse to perceive these effects as clearly as we might like.

Texas' Business Climate

The margin tax has several implications for the state economy. First, it slightly raises Texas businesses' aggregate tax burden. Second, it to some degree reduces distortions across sectors, encouraging a more efficient—and productive—allocation of resources within Texas. Finally, it moves the tax structure toward treating similar businesses the same, which should also foster a better use of resources.

What does this mean for Texas' business environment? To answer this question, it's helpful to recall perceptions under the old franchise tax. Texas had the nation's sixth-best business climate and eighth-lowest overall tax burden, according to the nonpartisan Tax Foundation. Forbes.com placed the state's business climate second behind Virginia's, and the Fraser Institute ranked it eighth.

While any single study can be disputed, it's hard to challenge the general finding that the Texas business climate has been widely regarded as above average.

And this business climate has helped Texas compete globally. Recent *Southwest Economy* articles have documented how Texas is increasingly open to the global economy and how its growth rate has exceeded the nation's. Both measures are consistent with a favorable business climate.[4]

Today's globalizing, technology-rich economy allows factors of production to move faster and farther in seeking places where they can be used most effectively. In this environment, it makes sense that states like Texas with relatively favorable business climates would see their economies—and populations—grow faster than in the U.S. overall.[5]

Because the margin tax will raise more money than the previous franchise tax, it's tempting to conclude it will harm the state's business climate. But the new tax also treats sectors and businesses somewhat more equally than the old franchise tax did, producing a more efficient allocation of resources. The higher revenue and greater efficiencies will offset themselves to some degree, mitigating the negative impact of a higher franchise tax burden on the overall business climate.

Other tax changes made concurrently with the new margin tax—notably, a reduction in property tax burdens borne by both businesses and individuals—further mitigate the adverse impact and could arguably leave Texas with a slightly more favorable business climate than it had under the previous franchise tax. Such an outcome isn't a certainty, of course, and vigilance will be needed if Texas is to retain its reputation as an attractive place for business.

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Notes

[1] Seventy-five percent of U.S. and 74.2 percent of Texas businesses are sole proprietorships. Both figures exclude businesses that were too small to file tax returns.

[2] Certain firms in wholesale and retail trade face a reduced rate of 0.5 percent, and firms whose revenue falls below $300,000 are not required to pay the tax.

[3] All figures come from the official Tax Equity Note for the franchise-tax overhaul bill (HB 3).

[4] "Don't Mess with Texas," by Fiona Sigalla, Federal Reserve Bank of Dallas *Southwest Economy*, January/February 2005.

[5] "Census Data Show the Economy Matters," by Jason L. Saving, Federal Reserve Bank of Dallas *Southwest Economy*, July/August 2001.