The Beacon Hill Institute

Tax Reform in Texas: Lowering Business Costs, Expanding the Economy

Executive Summary

The Beacon Hill Institute at Suffolk University (BHI) applied its TX-STAMP® (Texas State Tax Analysis Modeling Program) to estimate the effects of two proposals that: (1) would abolish the state franchise tax and (2) cut the franchise tax rate by 50 percent, from 1 percent to 0.5 percent. We simulated the tax changes as revenue neutral on a dynamic basis in 2013, which captures the effect of the tax change on the state and local tax bases.

BHI found that eliminating the Texas Franchise Tax in 2013 would:

- increase private employment by 31,500 jobs;
- boost investment by over $3.2 billion; and
- increase real disposable income by $6 billion.

The TX-STAMP model also shows that as Texas businesses increase their investments and hire more workers to staff these new factories, stores and offices, the economic effects increase over time. Over the period the five-year period between 2013 and 2017, the Texas economy would:

- add an additional 10,000 private sector jobs, for a total of 41,5000 new jobs;
- increase investment by a total of $3.4 billion, up from $3.2 in 2013, and
- increase real disposable income would by another $4 billion, for a total of $10 billion over the period.

The elimination of the franchise tax would reduce tax revenues for the Texas state government. However, the boost to the state economy would also increase revenues for other state and local taxes, such as the sales tax. The franchise tax is expected to raise $4.210 billion in 2013 and $4.531 billion in 2017. However, eliminating the franchise tax only reduces overall state tax revenues by $3.925 billion in 2013 and $4.145 billion in 2017 as other tax revenues increase by $285 million in 2013 and almost $386 million in 2017. Local governments would realize a tax revenue increase of $460 million in 2013 and $600 million in 2017. The local businesses property taxes represent the bulk of the revenue increases, as new the investment increases the business property tax base.

Cutting the franchise tax rate to 0.5 percent would have similar, but more muted effects on the state economy. The franchise tax reduction in would:

- reduce state tax revenues by $1.302 billion in 2013, falling to $940 million in 2017;
- increase private employment by 12,200 jobs in 2013 and 16,200 in 2017;
- boost investment by over $1.8 billion in 2013; rising to $1.9 billion in 2017; and
- increase real disposable income by $2.6 billion in 2013 and $4.0 billion in 2017.

Tax policy has real implications for the health of state economies, a fact frequently neglected in discussions of most tax changes. Our results show that removing or cutting the Texas franchise tax would increase the return to capital investment, which, in turn boosts investment, employment and incomes of Texas families. The governor and new legislature should take tax reform seriously in the upcoming term to further promote the competitiveness of the Texas economy.

Introduction

The evidence is clear: Changes in tax rates have measurable effects on taxable activities, directly, and on other economic activities, indirectly.[1] Yet, policymakers seldom consider these effects adequately when they contemplate tax changes, partly because of inadequate access to quality analysis of the effects rooted in real numbers.

The Texas system of taxation relies on sales and property taxes for the bulk of state and local revenues. In doing so, the system avoids the economic distortions that income taxation produces, such as penalizing working, savings and investment. These distortions tend to hinder economic growth and, at the state-level, discourage labor and capital formation. Recently, the Texas franchise tax has taken on the features of a distortionary income tax on business that discourages economic activity.

The Texas franchise tax is levied directly on the state's business sector. The franchise tax has been levied in some form since the 1800s and was originally levied as a fee for the "privilege" of doing business in the state and enjoying the limited liability protection of the state.[2]

Texas policymakers have revised the franchise tax statutes to remake the tax from a gross receipts tax to business income tax. The most recent effort in 2008 expanded the tax to include partnerships, business trusts and professional associations and modified the tax base to include total revenues minus cost of goods, total employee compensation or 30 percent of total revenues. In addition, the state eliminated all previous exemptions, including those for research and development and new investment, and lowered the rate to 1 percent (0.5 percent for retailers and wholesalers) from 4.5 percent. The law also expanded the small business exemption ceiling.

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[1] Barry W. Poulson and Jules Gordon Kaplan, "State Income Taxes and Economic Growth," *Cato Journal* 28, no. 1 (Winter 2008: 53-71).
[2] "Understanding the Texas Franchise or Margins Tax," The Texas Taxpayers and Research Association, (October 2011: 1) http://www.ttara.org/files/document/file-4ea5bda9239ef.pdf.

The franchise tax is imposed on firms' profits, which, in turn, reduces the after tax return to capital and, any tax on the earnings of capital discriminates against saving and risk taking.

Texas avoids a second double taxation of the owners (shareholders) of firms organized as a corporation due to the absence of a state personal income tax. Thus, earnings by Texas businesses are only taxed once by the franchise tax and paid by firms and not a second time when distributed to shareholders. Nevertheless, the franchise tax therefore exerts a negative effect on investment, job creation and output that would otherwise take place in its absence.

The Texas Conservative Coalition Research Institute asked the Beacon Hill Institute (BHI) to estimate the fiscal and economic impact of abolishing the franchise tax and cutting the tax by 50 percent.

Tax Results

BHI used its State Tax Analysis Modeling Program (STAMP) to determine the effects of abolishing the Texas franchise tax on the state economy.[3] Texas-STAMP (TX-STAMP) is a five-year dynamic Computable General Equilibrium model that simulates the economic effects of changes in taxes, costs (general and sector specific) and other "exogenous" variable changes. As such, it provides a mathematical description of the economic relationships among producers, households, governments and the rest of the world.

TX-STAMP is general in the sense that it takes all the important markets, such as the capital and labor markets, and flows into account. It is an equilibrium model because it assumes that demand equals supply in every market (goods and services, labor and capital). This equilibrium is achieved by allowing prices to adjust within the model. And it is computable because it can be used to generate numeric solutions to policy and tax changes.

We assumed the franchise tax changes begin in 2013 and report the results for that year and 2017, five years after implementation. TX-STAMP allows us to calculate the dynamic revenue effects, as opposed to static effects, under the tax change.

Static estimates assume that there is no change in underlying economic activity in response to a change in tax law. For example, a static estimate of a cut in the franchise

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[3] For a description about the STAMP model see
http://www.beaconhill.org/STAMP_Web_Brochure/STAMP_HowSTAMPworks.html.

tax, say from 1 percent to 0.5 percent, would cause revenues to fall by 50 percent (=1 – 0.5)/1). A dynamic estimate would show a smaller drop in revenue because it would capture the positive effect on the tax base of the cut in the franchise tax. The complete elimination of the franchise tax would not enable any dynamic revenue effects for the tax itself, since the rate would be zero. However, businesses would have more money to make profitable investments in Texas, thus increasing investment and employment, incomes and retail sales which, in turn, push sales, property and other tax collections higher. One of the principal purposes of STAMP is to capture such dynamic effects.

Abolishing the Franchise Tax

Table 1 displays the results of abolishing the franchise tax against a baseline of no tax policy change.

Table 1: The Fiscal Effects of Eliminating the Texas Franchise Tax

	2013	2017
State Taxes	($ millions)	
Franchise Tax	-4,210	-4,531
Sales Tax	133.0	188.5
Vehicle	4.4	6.7
Motor Fuels	3.8	5.6
Oil & Gas	40.8	52.2
Insurance Occupation	5.2	7.6
Other Revenue	97.8	125.2
Subtotal	**-3,925.0**	**-4,145.2**
Local Taxes		
Sales Tax	47.2	68.8
Residential Property Tax	na	na
Business Property Tax	357.5	461.7
Other Revenue	54.8	70.3
Subtotal	**459.5**	**600.8**
Total	**-3.465.5**	**-3,544.4**

Abolishing the franchise tax would generate significant dynamic revenue gains to state sales tax, motor vehicle, fuels tax and other taxes. Eliminating the franchise tax would reduce revenues by $4.210 billion in 2013 and $4.531 billion in 2017. However, these revenue losses would be partially offset by increases in the revenues of other state taxes revenues. These revenues would increase by $285 million and $386 million in 2013 and 2017 respectfully, with the state sales tax contributing the largest portion of the increase.

In total, the loss of revenue increases over time because the state projects the franchise tax revenues will grow faster than the revenues for the other state taxes. In total, the state would lose $3.925 billion in 2013, rising to $4.145 billion in 2017.

Local sales taxes, property taxes and other revenues would increase by an additional $460 million in 2013, growing to $601 million in 2017. Combined state and local revenue would fall by $3.466 billion in 2013 and $3.544 billion in 2017.

The elimination of the franchise tax leads to a reduction in the after-tax burden on income derived from capital investments. This provides a powerful incentive for business owners inside Texas to invest in their businesses. Investment projects that may not have been profitable enough to justify the investment when taking into account the franchise tax, now become more profitable on an after tax basis. Moreover, firms looking to locate new facilities in the United States would find Texas even more attractive location in the absence of the franchise tax.

Table 2: The Economic Effects of Eliminating the Texas Franchise Tax

Year	Private Employment	Investment	Real Disposable Income	Real Disposable Income Per Capita
	(Jobs)	($ billion)	($ billion)	($ per capita)
2013	31,500	3.2	6.4	159
2017	41,500	3.4	9.8	209

In general, the elimination of the franchise tax leads a significant improvement in the state economy. The change would create 31,500 jobs and boost investment by $3.2 billion in 2013. Real disposable income would rise by $6.4 billion or $159 per Texas resident.

Investment projects take time to plan and build, and thus the full amount of new investment, the not to mention the accompanied employment and income, spurred by abolishing the franchise tax, would take time to fully materialize. Therefore, we also report the effects for 2017 in the bottom half of Table 2. The change would create 41,500 jobs and boost investment by $3.4 billion in 2017. Real disposable income would rise by $9.8 billion or $209 per Texas resident.

Reducing the Franchise Tax

Table 3 displays the results of reducing the franchise tax by 50 percent also would generate significant dynamic revenue. Cutting the franchise tax would reduce state tax revenues by $1.439 billion in 2013 and $1.077 billion in 2017. However, these revenue losses would be partially offset by increases in the revenues of other state taxes revenues. Total state revenues would fall by $1.302 billion in 2013 and $940 million in 2017.

Local sales taxes, property taxes and other revenues would increase by an additional $172.7 million in 2013 and $164.2 million in 2017. Combined state and local revenue would fall by $1.129 billion in 2013 and $776 million in 2017.

Table 3: The Fiscal Effects of Reducing the Texas Franchise Tax

	2013	2017
State Taxes	($ millions)	
Franchise Tax	-1,439.0	-1,077.0
Sales Tax	60.0	63.8
Vehicle	1.9	2.1
Motor Fuels	1.6	1.8
Oil & Gas	16.9	15.6
Insurance Occupation	2.1	2.4
Other Revenue	54.9	51.1
Subtotal	-1,302	-940
Local Taxes		
Sales Tax	21.3	23.3
Residential Property Tax	na	na
Business Property Tax	125.6	116.3
Other Revenue	25.8	24.6
Subtotal	172.7	164.2
Total	**-1,129**	**-776**

Similar to the scenario that eliminates the franchise tax, cutting the tax would provide a modest improvement to the state economy. The change would create 12,200 additional jobs and boost investment by $1.8 billion in 2013. Real disposable income would rise by $2.6 billion or $63 per Texas resident. Table 4 displays the results.

Table 4: The Economic Effects of Reducing the Texas Franchise Tax

Year	Private Employment	Investment	Real Disposable Income	Real Disposable Income Per Capita
	(Jobs)	($ billion)	($ billion)	($ per capita)

2013	12,200	1.8	2.6	63
2017	16,200	1.9	4.0	83

We also report the effects for 2017 in the bottom half of Table 4. The change would create 16,200 jobs and boost investment by $1.9 billion in 2017. Real disposable income would rise by $4.0 billion or $83 per capita.

Conclusion

When elected officials discuss tax changes, they tend to highlight the static revenue effects thinking that the change will result in revenue changes proportional to the tax rate change up or down. However, any honest discussion must include an estimate of how the state's economy will respond to tax changes, and the effect these changes will have on revenues. Tax cuts do not exist in a vacuum; consumers, investors and taxpayers often change their behavior in response to lower taxes, mitigating revenue losses.

Like all governments, Texas state government relies on a healthy underlying economy for tax revenue. As we show with TX-STAMP, lower businesses taxes attract and retain productive companies, while fostering entrepreneurs and start-ups. Eliminating or cutting the franchise tax would serve this end.

Methodology

To identify the economic effects of the tax discounts and understand how they operate through a state's economy, BHI utilized its STAMP (State Tax Analysis Modeling Program) model. STAMP is a five-year dynamic CGE (computable general equilibrium) model that has been programmed to simulate changes in taxes, costs (general and sector specific) and other economic inputs. As such, it provides a mathematical description of the economic relationships among producers, households, governments and the rest of the world.[4]

A CGE tax model is a computerized method of accounting for the economic effects of tax policy changes. A CGE model is specified in terms of supply and demand for each economic variable included in the model, where the quantity supplied or demanded of each variable depends on the price of each variable. Tax policy changes are shown to affect economic activity through their effects on the prices of outputs and of the factors of production (principally, labor and capital) that enter into those outputs.

A CGE model is in "equilibrium," in the sense that supply is assumed to equal demand for the individual markets in the model. For this to be true, prices are allowed to adjust within the model (i.e., they are "endogenous"). For instance, if the demand for labor rises, while the supply remains unchanged, then the wage rate must rise to bring the labor market into equilibrium. A CGE model quantifies this effect.

Finally, a CGE model is numerically specified ("computable"), which is to say it incorporates parameters that are believed to be descriptive of the actual relationships between quantities and prices. It produces estimates of changes in quantities (such as employment, the capital stock, gross state product and personal consumption expenditures) that result from changes in prices (such as the price of labor or the cost of

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[4] For a clear introduction to CGE tax models, see John B. Shoven and John Whalley, "Applied General-Equilibrium Models of Taxation and International Trade: An Introduction and Survey," *Journal of Economic Literature* 22 (September, 1984): 1008. Shoven and Whalley have also written a useful book on the practice of CGE modeling entitled *Applying General Equilibrium* (Cambridge: Cambridge University Press, 1992). See also Roberta Piermartini and Robert Teh *Demystifying Modelling Methods for Trade Policy* (Geneva, Switzerland: World Trade Organization, 2005) http://www.wto.org/english/res_e/booksp_e/discussion_papers10_e.pdf (accessed June 18, 2010).

capital) that result from changes in tax policy (such as the substitution of an income tax for a sales tax).

The Beacon Hill Institute at Suffolk University in Boston focuses on federal, state and local economic policies as they affect citizens and businesses. The Institute conducts research and educational programs to provide timely, concise and readable analyses that help voters, policymakers and opinion leaders understand today's leading public policy issues.

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