

THE FRANCHISE TAX:

AN IMPORTANT COMPONENT OF STATE REVENUE

Broad prosperity requires public investment in schools, colleges, affordable health care and other building blocks of job creation and economic growth. An important source for these investments is the state franchise tax, which the Texas Legislature dramatically reduced by 25 percent in 2015.

The goal of a Texas where everyone is healthy, well-educated and financially secure will be harder to reach if the Legislature further reduces or eliminates the franchise tax without enacting a replacement. Businesses benefit from state services and have a stake in the state's well-being.

CPPP RECOMMENDS

- Maintain the franchise tax rates at current levels so businesses pay their fair share toward a prosperous Texas.
- Require regular review of all state and local tax breaks to eliminate wasteful giveaways.
- Invest in schools, health care, and other services essential to making Texas the best state for hard-working families.

What is the franchise tax?

Only businesses pay the franchise tax. What they owe is based on their total revenue minus what they pay in compensation to employees or to purchase goods that are packaged or processed, then sold. The difference between revenue and these costs is called the "margin," which is why the tax is commonly known as the "margin tax."

The largest Texas tax paid solely by businesses, the franchise tax had been the second-largest source of state tax revenue, after only the state sales tax. But in 2015 the Texas Legislature reduced the franchise tax rate by one fourth, leading to a more than \$1 billion drop in annual state revenues. Bills to phase out the franchise tax were heard in the 2017 session and are being proposed in 2019: Senate Bill 66 and Senate Bill 2326 are some examples.

In 2006, legislators substantially revised the tax as part of their response to the Texas Supreme Court's decision directing the state to reform the school finance system. School districts were required to cut their local property taxes by one-third, and the state promised to make up the difference with increased state aid. The revised franchise tax was expected to supply a substantial portion of the necessary state revenue. The increase in revenue from the revisions was placed in a new "Property Tax Relief Fund," which helps supply the state's share of public school

The Franchise Tax

funding. Franchise tax receipts that would have been generated by the pre-2006-revision tax go to the state's General Revenue Fund, which is used to support public education, health and human services, and other state services.

Why should I care about the franchise tax?

The Property Tax Relief Fund received \$1.8 billion in franchise tax revenue in 2015. Because of the 2015 tax cut, the Property Tax Relief Fund only received \$856 million in franchise tax revenue in 2018 — an estimated \$1.2 billion reduction in what businesses would otherwise have contributed to state support for our schools through this tax.

For the 2020-2021 budget cycle, the Comptroller estimated that the franchise tax would raise almost \$8.2 billion for the Property Tax Relief and General Revenue funds. Eliminating the franchise tax without enacting a new state revenue source, at a time when the Legislature is proposing to commit \$9 billion in new state aid to public schools, would set the stage for significant state budget cuts in the future.

If a previous legislature had eliminated the franchise tax, the impact on the 2020-2021 proposals would be very detrimental. Here's what an \$8 billion cut to General Revenue support for state services would mean: In health and human services, at least 20 percent would be slashed from health care, child protective services, and services for Texans with disabilities. And since most General Revenue spending on health and human services draws down a

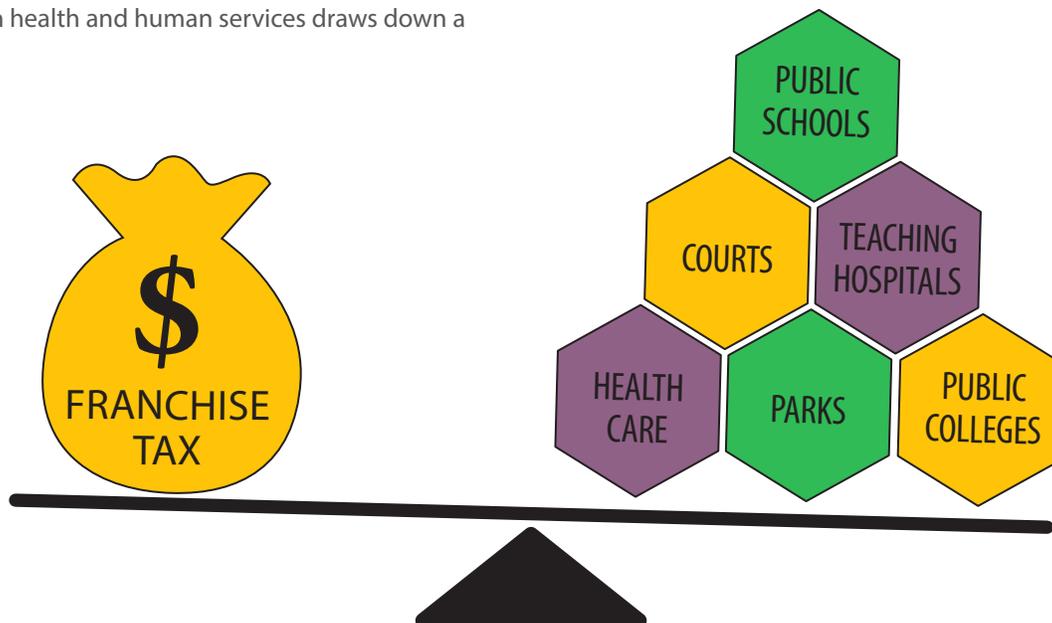
federal match, another \$12 billion in federal support could be eliminated, too. Cuts like these would mean catastrophic cuts to nursing home care and services for children at risk, and longer waitlists for programs for Texans with disabilities.

For state-supported institutions of higher education, \$8 billion is almost 50 percent of the General Revenue they receive. Additional tuition increases at public colleges to make up for the loss of state budget support would be very likely, which would further burden students struggling to pay for the significantly increasing cost of college.

The Department of Criminal Justice, which receives more than half of General Revenue spending on public safety and corrections, would only be able to implement massive cuts in its budget by closing state prisons.

An \$8 billion cut could also be achieved by completely eliminating General Revenue spending on all of the following, combined: general government functions; business and economic development; courts; parks and environmental protection; consumer protection and other regulatory agencies, and the Legislature itself.

The bottom line for Texans is that the state franchise tax generates resources that are very important to fulfilling the vision we all want of a healthy, prosperous, safe Texas. Cutting it further or eliminating it would seriously erode Texans' well-being.



CPPP is an independent public policy organization that uses research, analysis and advocacy to promote solutions that enable Texans of all backgrounds to reach their full potential. Learn more at CPPP.org. For more information, please contact Oliver Bernstein at bernstein@cppp.org or call 512.823.2875.