THE POLICY PAGE
An Update on State and Federal Action

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Do Tax Incentives Work?
The Case of the Unused Franchise Tax Credits

In 1999 the Legislature passed SB 441, which created franchise tax credits for research-and-development, capital investment, job creation, and child care spending. Credits that have already been earned under these provisions, but not yet used to reduce franchise tax payments, total $464 million. These credits could be used to reduce state revenue for up to 20 years in the future. This huge backlog may also indicate that companies would have undertaken these activities in the absence of a tax credit, since it may be many years before they receive any benefit from the credits.

UNUSED CREDITS

In 1999 the Legislature passed SB 441, which created franchise tax credits for corporations that spend money for certain research-and-development, capital investment, job creation, and child care spending. These credits can be used to reduce a portion of the company's franchise tax payments to the state. Credits that are not used may be carried over and used to reduce future franchise tax payments.

Through 2004, only 22% of all the credits earned under these provisions have been used to reduce tax payments. The unused credits – totaling $464 million – are a substantial drain on future state revenue.

The existence of this huge backlog may also indicate that corporations may have undertaken these activities even if no tax credit were offered. Apparently many companies were willing to make these investments knowing that any payoff in reduced tax liability would occur, if at all, only in the distant future. These investments were made, instead, because of the economic benefits to the companies in terms of greater sales and profits. The state may be foregoing substantial revenue unnecessarily.

RESEARCH AND DEVELOPMENT

The research-and-development (R&D) credit is based on a corporation's increase in research spending. A company earns a credit equal to 5 percent of research expenses, which may be used to reduce its franchise-tax liability by up to 50 percent. Unused credits may be carried forward for 20 years.

Companies have earned credits worth $303.3 million since 2001. However, they have been able to use only $52.4 million to reduce their franchise tax payments <u>The remaining $250.9 million can be carried forward to reduce future tax payments for up to 20 years.</u>

Significantly fewer credits were earned in 2004 ($50.4 million) than in any prior year, barely more than half as many as in 2003 ($93.3 million).

More than 40% of the R&D credits were earned by 55 corporations in the electronics industry. Another one-quarter went to companies providing business services. R&D credits were also earned by companies in sectors such as food, home furniture retail, and wholesale trade! Companies with fewer than 100 employees accounted for only 9.7 percent of the total credits used.

Corporations earning the credit were concentrated in Dallas, Collin, and Travis Counties, where more than three-quarters of the credits were earned.

CAPITAL INVESTMENT

The capital investment credit is earned by investments in Strategic Investment Areas – counties with above-average-unemployment and below-average per-capita income. The investment must be at least $500,000 or create at least ten new jobs. The credit is equal to 7.5 percent of the investments made, up to 50 percent of a company's tax liability, and is taken over five years.

Companies have earned credits worth $288.3 million since 2001, but they have used only $75.9 million of these credits. Future installments of these credits could reduce future franchise tax payments by up to $212.3 million. The amount of credits earned in 2003-04 ($210 million) is almost three times the amount earned in the prior two years.

Although companies in 111 counties have made qualifying investments, Brazoria and Jefferson Counties together account for 60% of all the investments earning credits in the state. Just five firms in the petroleum refining industry account for one-fifth of all credits earned, averaging $1.1 million in credits each. Firms with fewer than 100 employees used only 5.2 percent of the total credits.

The median average wage paid by corporations claiming the credit was $36,000, compared to a statewide median wage of $37,500.

JOB CREATION

The job creation tax credit is equal to 5 percent of the wages paid. Like the investment credit, the new jobs must be in a Strategic Investment Area, and unused credits may be carried over for five years.

A total of 2,192 jobs were reported to have been created by companies claiming the credit. These jobs had a median annual wage of $34,900 -- $2,600 below the statewide median wage.

Companies have used $3.2 million in credits to offset franchise taxes since 2001. They also have $0.6 million in unused credits. This is only a tiny fraction of the credits earned for R&D or capital investment.

Nearly 40% of all credits were earned in Bexar County alone. Job creation credits were earned by only 42 companies, only 5.2 percent of which had fewer than 100 employees.

CHILD CARE

The child-care credit in SB 441 is also smaller than the R&D and capital investment credits. The child-care credit is equal to half of a company's spending on an on-site child care center or purchase of child-care services for employees. The after-school credit is equal to 30 percent of cash donations for funding a before- or after-school care program.

Companies have used $1.27 million in child-care credits since 2001. Only 37 firms in 15 counties have claimed these credits, which cannot be carried forward. Corporations with fewer than 100 employees accounted for 41 percent of those claiming credits.

Harris County firms received 40 percent of all child-care credits in the state.

Only four companies took advantage of the after-school credit, earning only $6,533 in credits, so no detailed information is available due to privacy restrictions.

WHERE DID ALL THIS INFORMATION COME FROM?

SB 441 required more complete reporting of the impact and use of tax credits than any prior legislation. It serves as an excellent model of the kind of review that the Legislature should carry out of all other current tax exemptions. These exemptions must be scrutinized to determine if their economic benefits are worth their costs in future revenue losses.

The R&D, capital investment, and job creation credits expire at the end of 2009, ensuring a legislative review of their effectiveness before re-enactment. Other exemptions and credits -- not only involving the franchise tax, but also for property, sales, severance, and other taxes-- should also be subject to a similar sunset process regularly to eliminate ineffective or inefficient provisions.

The full report on SB 441 is available at http://www.window.state.tx.us/specialrpt/sb441_05/

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