MAY 2015

FISCAL NOTES

ALSO INSIDE THIS ISSUE:

The History of the Texas Franchise Tax

by Josh Haney/Bruce Wright

THE COMPLEX EVOLUTION OF OUR MAIN BUSINESS TAX

Texas' primary tax on business, the franchise tax, is an important revenue source for state government — and often a controversial one, given the Legislature's consistent focus on maintaining Texas' business-friendly reputation.

In the past few decades, the tax (sometimes called the "margin" tax) has had a complex history as the focus of at least two special sessions, two Texas Supreme Court decisions (with more to come), three blue-ribbon committees and countless lower court decisions and administrative hearings.

CURRENT TAX BASICS

As described in Texas law, the franchise tax is levied in exchange for the "privilege" of doing business in the state. Part of this privilege includes liability protections under state law.

A business' tax liability is based on its "margin," which state law uniquely defines as total revenue minus one of four possible deductions (some of which are highly complex).

Once determined, this margin is multiplied by the percentage of the firm's business revenues earned in Texas during the year. The tax typically is due in May of each year. The current franchise tax is levied on the apportioned margin at the following rates:

0.5 PERCENT for retailers and wholesalers;

1.0 PERCENT for most other entities (such as manufacturers, construction firms, energy companies, etc.); and

0.575 PERCENT for small businesses with $10 million or less in total revenue for the year (these businesses forego certain other deductions).

For 2015, no tax is due from companies with $1,080,000 or less in total revenues, or with less than $1,000 in tax liability.

The 2013 Legislature enacted a temporary reduction in franchise tax rates. For tax reports due in 2015, the rates will be 0.475 percent for retailers and wholesalers and 0.95 percent for other entities (the small business rate remains unchanged). Under current law, the tax will revert to its previous rates for reports due in 2016.

In terms of its contributions to the state's tax revenues, the franchise tax is a distant second in size to the sales tax. In 2014, the franchise tax generated 9.3 percent of the state's total tax collections, while the sale tax accounted for almost 54 percent. Recent projections from the Comptroller's office have its share of tax collections shrinking to 8.6 percent by fiscal 2017.

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TEXAS' SECOND-LARGEST TAX

The Texas franchise tax accounted for more than 9 percent of total tax collections in fiscal 2014.

TAX COLLECTIONS BY SOURCE, FISCAL 2014

TAX	FISCAL 2014 COLLECTIONS	SHARE OF TOTAL COLLECTIONS
SALES TAX	**$27,385,709,242**	**53.7%**
FRANCHISE TAX	**$4,732,261,872**	**9.3%**
MOTOR VEHICLE SALES/RENTAL TAXES	$4,209,952,925	8.3%
OIL PRODUCTION AND REGULATION TAXES	$3,874,070,862	7.6%
MOTOR FUEL TAXES	$3,315,952,089	6.5%
INSURANCE TAXES	$1,947,908,252	3.8%
NATURAL GAS PRODUCTION TAX	$1,899,581,526	3.7%
CIGARETTE AND TOBACCO TAXES	$1,342,454,822	2.6%
ALCOHOLIC BEVERAGES TAXES	$1,053,231,009	2.1%
HOTEL OCCUPANCY TAX	$485,384,563	1.0%
UTILITY TAXES	$478,188,876	0.9%
INHERITANCE TAX	$11,543	0.0%
OTHER TAXES	$267,853,959	0.5%
TOTAL	**$50,992,561,539**	**100.0%**

Source: Texas Comptroller of Public Accounts

A Message from the Comptroller

WELCOME TO THE NEW *FISCAL NOTES*.

For nearly 40 years, this publication has provided Texans with information on our state's economy and the finances of its government. What began as a humble four-page, plain text newsletter has evolved considerably over the decades. And now it's changing again.

When I took this job, I promised a new focus on the "basics" — the primary missions of the Comptroller's office, which serves as the state's tax collector, bookkeeper and revenue estimator.

And *Fiscal Notes* will reflect that focus.

We'll still be running informative articles on a wide variety of topics related to the Lone Star State's economy. But you'll also see a new emphasis on in-depth analysis concerning state finances, featuring original research by our subject-matter experts, and presented in a way that helps Texas taxpayers understand how their tax dollars are collected and spent — and why.

The lead article in this issue, providing an overview of the tangled history of our state's most important business tax, provides a first look at our new approach.

I hope you'll join us as we usher in a new era for *Fiscal Notes*. And be sure to check us out online at **www.comptroller.texas.gov/fiscalnotes**.

GLENN HEGAR

Texas Comptroller of Public Accounts

FISCAL NOTES THROUGH THE YEARS

The Texas Comptroller's office has published its newsletter since 1975. *Fiscal Notes*' precursor *Financial Statement* began with monthly updates on state revenues and expenditures. By the late seventies, under its current title, *Fiscal Notes* had expanded its focus to matters affecting the broader state economy.

If you would like to receive paper copies of *Fiscal Notes*, contact us at **fiscal.notes@cpa.texas.gov**

STABILITY ENDS IN THE 1980S

Most of the franchise tax's history was rather uneventful. First levied in 1907, relatively minor changes were made to the tax for nearly a century. In the 1980s, however, the franchise tax entered a new and much more volatile era.

The first substantial challenge to the franchise tax came in the late 1980s, during a severe state economic downturn fueled by plunging oil prices. San Antonio-based Sage Energy Company filed a lawsuit arguing that the franchise tax violated the state's "equal and uniform" clause, which requires the state to levy its taxes consistently within each tax "classification" — that is, for each group of businesses to be taxed.

Texas courts traditionally have deferred to the Legislature in determining the makeup of these classifications, as long as they relate to the value of the item being taxed. In the case of the franchise tax, the "item" being taxed is the privilege of doing business in Texas. As a result, classifications made for the franchise tax must relate to differences in companies' ways of doing business that affect the value of this privilege. The state, for example, may subject a retailer to a different franchise tax rate than a manufacturer, due to their different business models, but two manufacturers in the same franchise tax classification must be treated similarly under the tax.

Sage maintained, however, that the state's method for determining franchise tax obligations could be affected by an individual company's accounting practices, which were unrelated to the value of doing business in Texas. (The case primarily concerned the use of "expense" versus "capitalized" accounting, and the way in which assets are treated under each method.) Sage argued further that the Comptroller's office required some businesses to use one accounting method, while permitting others to use a more tax-advantaged method.

A state court of appeals sided with Sage in the 1987 decision *Bullock v. Sage Energy*, which had a profound impact on the amount of revenue yielded by the franchise tax. Due to the *Sage* decision, the state was forced to refund a considerable portion of its franchise tax revenues throughout the late 1980s, with some years' refunds amounting to half of the tax's total collections.

In the first four years after the decision, Texas' annual franchise tax revenues declined by more than 30 percent. By 1991, franchise taxes accounted for just 4 percent of all tax collections, the lowest share in the tax's modern history.

1991 CHANGES

To counter this erosion in the franchise tax, the 1991 Legislature passed sweeping changes that raised taxes on most corporations. This overhaul included adding a new base component: "earned surplus," which was roughly defined as federal taxable income plus officer and director compensation, and was taxed at 4.5

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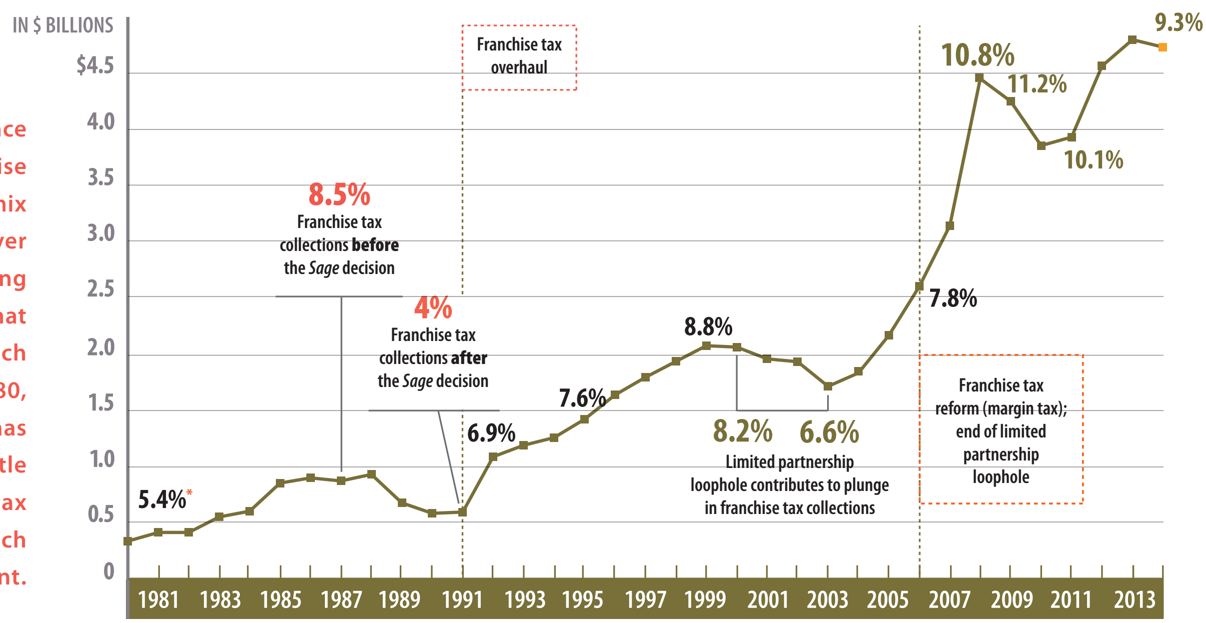
TALE OF A TAX

Total Annual Revenue, 1980-2014

The relative importance of the Texas franchise tax in the state's tax mix has varied widely over the years, fluctuating along with events that affected the tax's reach and returns. Since 1980, the franchise tax has accounted for as little as 4 percent of total tax collections and as much as 11 percent.



*Percent figures represent share of total tax collection.
Source: Texas Comptroller of Public Accounts

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After the 1991 expansion, many Texas businesses began to take advantage of the fact that partnerships were not taxed under the franchise tax, and reorganized to minimize their tax liability.

percent. At the same time, the rate at which capital could be taxed was reduced from $5.25 to $2.50 per $1,000 of taxable capital.

Businesses would now have to calculate their tax obligation on both base components. They would still be required to pay taxes based on their capital, albeit at the reduced rate. But businesses then had to calculate their tax liability based on the new earned surplus component. If this amount were larger than the capital-based amount, businesses also had to pay the difference between the two figures. For many businesses, this resulted in a higher overall tax obligation.

As a result, franchise tax revenue immediately rebounded, rising 82.2 percent in a single year to $1.1 billion, or 7 percent of all state tax revenue.

SHRINKING TAX BASE

Historically, the Texas franchise tax was levied only on corporations and, beginning in 1991, limited liability companies (LLCs) — the latter an alternative form of business that, like a corporation, offers some liability protection to its owners. This left other types of businesses, such as limited partnerships, limited liability partnerships (LLPs), general partnerships, sole proprietorships and business trusts, untaxed.

After the 1991 expansion, many Texas businesses began to take advantage of the fact that partnerships were not taxed under the franchise tax, and reorganized to minimize their tax liability. In 2002 alone, about a thousand corporations converted to limited partnerships to take advantage of this loophole, costing the state an estimated $143 million in 2003.

As a result of the loophole, tax cuts and broader economic trends, the explosive growth of the tax seen in 1992 did not last. Total revenue brought in under the franchise tax began a four-year slide in 2000; in 2003 alone, franchise tax revenues declined by 11.3 percent.

Meanwhile, the Texas economy was changing in ways unanticipated by lawmakers in 1991, leaving the business tax burden increasingly borne by capital-intensive industries such as mining (in Texas, primarily oil and gas production), while leaving a booming services sector relatively untouched. In 2004, for instance, mining companies contributed $10,840 in state and local taxes per employee; the services sector, which had experienced a tenfold increase in employment in the preceding decade, contributed just $407 per employee.

In the same period, pressure to reduce property taxes was building in the Legislature. During the 1997 legislative session, then-Governor George W. Bush pushed for sweeping legislation that would have raised the homestead exemption from $5,000 to $20,000, and reduced school district maintenance and operations (M&O) tax rates by 20 cents per $100 in property value. This bill also would have repealed the franchise tax and replaced it with a broader business activity tax. According to estimates at the time, this new business tax would have generated about a $1 billion more each year than the existing franchise tax.

Over the course of the session, however, the proposals were reduced to a more modest set of reforms, including a $10,000 increase to the homestead exemption and other changes to the school finance system. The proposed new business tax never made it into law.

INTRODUCING THE “MARGIN” TAX

Legislators continued grappling with the shrinking franchise tax base, but no significant reforms were enacted until the Texas Supreme Court forced the 2005 Legislature’s hand by declaring the school finance system unconstitutional.

The court found that the $1.50 cap on school-district property taxes was so universally applied that it essentially acted as a statewide property tax, which is prohibited under Texas’ constitution. The court gave lawmakers less than seven months to resolve the issue. Due to the short timeline, constitutional changes, which must be approved by voters, were essentially off the table.

In response, then-Governor Perry formed the Texas Tax Reform Commission, a 24-member panel of business leaders headed by former Comptroller John Sharp. The commission embarked on a whirlwind tour of the state, conducting 16 public hearings in three months and receiving testimony from hundreds of taxpayers. At the end of March 2005, the committee members delivered their recommendations, which included the first outlines of the modern franchise tax.

The most fundamental change to the franchise tax proposed by the commission, and subsequently approved by the Legislature as House Bill 3, was the introduction of the “margin” concept as the new base tax component, and the elimination of the previous bases of earned surplus or capital.

The expansion of the tax to nearly all entities with limited liability protection under state law effectively eliminated the incentive for corporate reorganization.

IMPACT OF THE 2006 REFORMS

The transition to the new margin-based tax and the reduction in school property taxes prompted by the 2006 legislation had varying effects on the state's industries.

INDUSTRY	TOTAL SCHOOL PROPERTY TAX AND FRANCHISE TAX LIABILITY BEFORE 2008		TOTAL SCHOOL PROPERTY TAX AND FRANCHISE TAX LIABILITY IN 2008	
	AMOUNT ($ MILLIONS)	SHARE OF TOTAL TAX BURDEN	AMOUNT ($ MILLIONS)	SHARE OF TOTAL TAX BURDEN
AGRICULTURE	$299.7	2.1%	$214.6	1.7%
MINING	1,647.2	11.4	1,214.0	9.8
UTILITIES AND TRANSPORTATION	2,059.8	14.3	1,644.9	13.3
CONSTRUCTION	233.2	1.6	302.8	2.4
MANUFACTURING	2,326.0	16.2	2,050.5	16.5
WHOLESALE AND RETAIL	1,541.1	10.7	1,457.9	11.7
INFORMATION	954.1	6.6	849.7	6.8
FINANCE, INSURANCE AND REAL ESTATE	3,867.85	26.9	3,004.2	24.2
ALL OTHER SERVICES	1,467.8	10.2	1,673.6	13.5
TOTAL	**$14,396.7**	**100.0%**	**$12,412.3**	**100.0%**

Source: Texas Comptroller of Public Accounts, Business Tax Advisory Committee Report January 2009

Initially, the new margin tax was projected to generate $5.9 billion in its first year, 30 percent more than actual receipts. This was problematic because the Legislature *also* reduced school property taxes by a third in 2006, and the new Property Tax Relief Fund could not entirely make up the difference.

The franchise tax's underperformance was attributed largely to the "cost of goods sold" deduction used to determine taxable margin, which was selected by unexpectedly high numbers of businesses, and to the broad way in which the deduction was originally interpreted by tax-payers. On the other hand, the new margin-based tax did prove successful in better aligning the tax with the modern Texas economy. Mining, for example, paid approximately 9.5 percent of the margin-based tax in 2008 — down from 16 percent in 2007 — while contributing 11 percent of the gross state product in both years.

Unsurprisingly, given the sweeping nature of the changes to the franchise tax, virtually every facet of thenew system soon faced administrative and legal challenges, two of which were ultimately decided by the state's Supreme Court.

Virtually every facet of the new system soon faced administrative and legal challenges, two of which were ultimately decided by the state's Supreme Court.

Another very important 2006 reform was the expansion of the tax to *nearly all entities with limited liability protection* under state law, including limited partnerships. This effectively eliminated the previous incentive for corporate reorganization. Other changes were introduced as well, including an increase to the "small business exception" (the threshold for zero tax liability went from total annual receipts of $150,000 or less to $300,000 in receipts and less than $1,000 in tax liability; the Legislature ultimately raised this threshold to the current $1,080,000 in total revenues).

Finally, the 2006 overhaul changed the disposition of franchise tax collections. Revenue that *would* have been generated under the previous tax structure would still be deposited into the General Revenue Fund, which the Legislature uses to fund a wide range of state programs and agencies. Any franchise tax collections in *excess* of this amount now were directed to a new Property Tax Relief Fund, which is used to supplement public education funding.

These changes to the franchise tax took effect for tax payments in 2008. In that first year, the franchise tax produced nearly $4.5 billion, 41.6 percent more than 2007 collections under the old formulation.

Despite this increase, however, the franchise tax still performed considerably below the state's expectations.

THE "INCOME TAX" CHALLENGE

The first major challenge to the new margin-based tax came in 2011, when Allcat Claims Services filed a lawsuit arguing that, among other things, the tax amounted to a *de facto* personal income tax.

According to the Texas Constitution, voters must approve such a tax through a state-wide referendum. Specifically, Allcat claimed that the franchise tax violated what is commonly referred to as the "Bullock" amendment to the constitution (due to the former lieutenant governor's role in the negotiations leading to it). This amendment reads, in part:

> [a] general law enacted by the legislature that imposes a tax on the net income of natural persons, **including a person's share of partnership and unincorporated association income,** must provide that the portion of the law imposing the tax **not take effect until approved by a majority of the registered voters** voting in a statewide referendum held on the question of imposing the tax. **[emphasis added]**

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Nearly 100 bills and resolutions relating to the franchise tax were filed in the 2015 legislative session.

According to the firm, which was established as a limited partnership, the franchise tax reduced Allcat's income, in turn reducing each partner's share and thus violating the Bullock amendment. During the trial, the plaintiffs also pointed out that the proportional income of a limited partnership is treated as income to each partner for federal tax purposes.

The Texas Supreme Court, however, agreed with the state's argument that Texas law considered limited partnerships to be separate entities from their owners, and that the franchise tax was strictly a tax on these businesses, not on the individuals or "natural persons" owning them.

Much was riding on this decision. Had partnerships been excluded from the new franchise tax, it would have represented a significant loss of revenue to the state. Partnerships accounted for approximately $579 million of franchise tax revenues in 2011, or about 13 percent of the total.

THE NESTLÉ CHALLENGE

The next significant court challenge came in 2012, from food giant Nestlé, and represented a much broader attack on the new franchise tax's constitutionality than the *Allcat* case.

Nestlé contended that the new tax had no genuine relationship to the value of the "privilege" of doing business in Texas because of its many deductions and exemptions, and was thus unconstitutional under both the state and federal constitutions. The company also maintained that, while it certainly manufactured food and beverages, it had no manufacturing operations in Texas. Instead, its Texas operations were more akin to retail or wholesale activity, which receives a much lower rate under the new tax. Thus, the company argued, it should be subject to the lesser rate.

Again, the Texas Supreme Court ultimately sided with the state, holding that the Legislature could consider the company's non-Texas business activity in determining which tax rate to apply.

MORE TO COME

While the *Allcat* and *Nestlé* cases ultimately had little impact on the new margin tax, it still faces numerous pending legal challenges, touching on everything from how the state calculates the portion of a company's activity that occurs in Texas to which expenses can be deducted from a firm's total revenue. These cases could affect the revenues brought in under the franchise tax. Nearly 100 bills and resolutions relating to the franchise tax were filed in the 2015 legislative session, 13 of which would repeal it entirely. Clearly, Texas' franchise tax will continue to be subject to legislative changes and court challenges for the foreseeable future. **FN**

FOR MORE INFORMATION on the Texas franchise tax, visit our website: **comptroller.texas.gov/taxinfo/franchise.**

For an in-depth look at the sources of state revenues, visit **texastransparency.org.**

Texas' franchise tax will likely face legislative changes and court challenges for the foreseeable future.

Lotto Money for Texas

by Bruce Wright

AN INTERVIEW WITH THE TEXAS LOTTERY DIRECTOR

Since their modern era began in 1964, America's state lotteries have spread across the country and become a $63 billion-a-year business… if it is a business.

The question itself illustrates the ambiguous and often delicate nature of the state lotteries' mission. Charged with generating money for state coffers, they need to be efficient and businesslike — but perhaps not *too* efficient and businesslike, given the continuing controversy concerning government involvement in what is, after all, a form of gambling.

Today, 44 states as well as the District of Columbia, Puerto Rico and the U.S. Virgin Islands run lotteries, and participate in multi-state games as well, the latter producing most of the eye-watering nine-figure jackpots publicized in recent years.

Since 1992, the Texas Lottery has managed to navigate competing demands and changing sales trends with considerable success, generating nearly $23 billion for state programs through the end of fiscal 2014. Since 1997, the lottery's proceeds have been channeled primarily into the Foundation School Fund, and fiscal 2014 was a record year, yielding $1.2 billion for public education as well as millions for other causes.

Yet the Texas Lottery's future recently was still in question. Despite a recent clean bill of health from the Texas Sunset Advisory Commission, the 2013 Legislature established an interim committee to consider the implications of abolishing the lottery — and replacing the billions in revenue it provides.

Fiscal Notes sat down with Gary Grief, executive director of the Texas Lottery, to discuss his organization's success and challenges.

GARY GRIEF

EXECUTIVE DIRECTOR, TEXAS LOTTERY

Fiscal Notes: Thanks for talking with us. I understand that 2014 was the lottery's best year ever.

Gary Grief: It was indeed. Our total sales reached $4.38 billion in fiscal 2014, a new high point in our history. But more importantly, we transferred $1.22 billion to the state. Of that, slightly more than $1.2 billion went to the state's Foundation School Fund, and that's a new record as well.

Another $11.5 million was transferred to the Texas Veterans Commission from the sale of our veterans-themed scratch-off games, in a transfer the Legislature authorized in 2009. That's a 33 percent increase over the previous record for revenue to fund veterans' assistance.

We also had approximately $78 million in prizes go unclaimed in fiscal 2014. Approximately $5 million of that went to the UT Medical Branch in Galveston, and the remainder to the Foundation School Fund.

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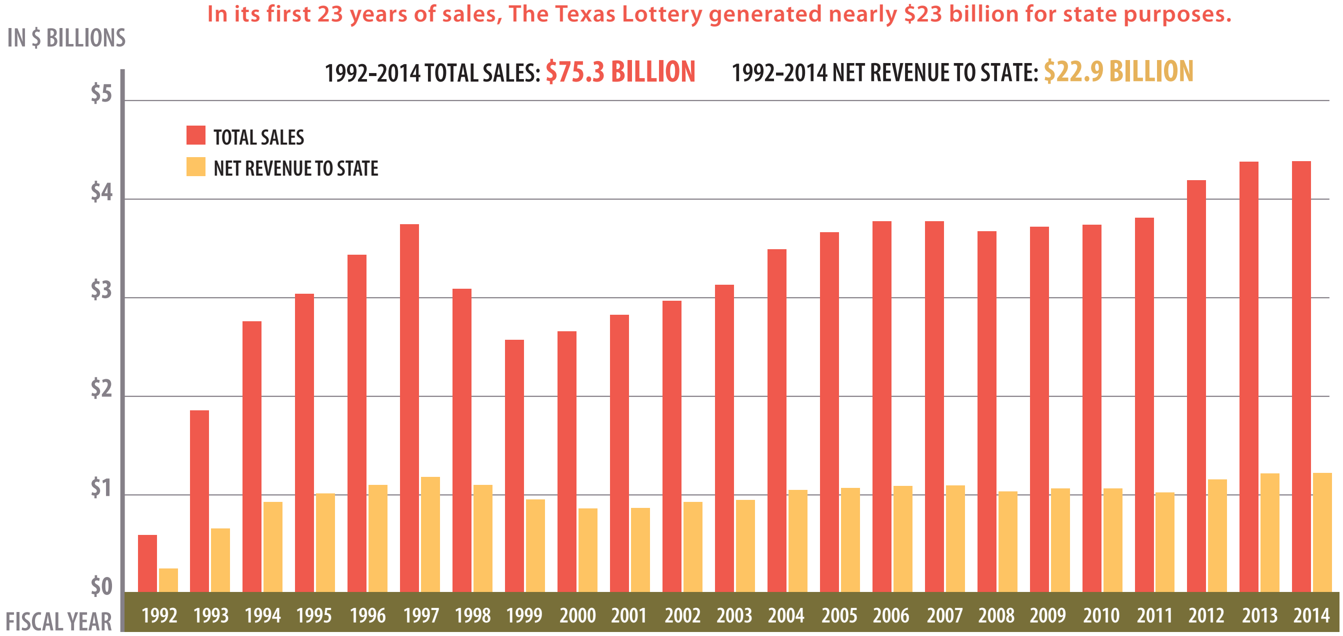
TWENTY-THREE YEARS, $23 BILLION

1992-2014

In its first 23 years of sales, The Texas Lottery generated nearly $23 billion for state purposes.



Source: Texas Lottery Commision

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"The money the lottery generates is no small amount, at $1.2 billion last fiscal year. But that's obviously just a fraction of the state's total education budget."

FN: After all these years, what would you say is the biggest misconception Texans may have about the lottery?

Grief: For 23 years, we've been dealing with a misunderstanding that occurred when the lottery was initially passed.

There's a public misconception that the lottery was going to solve all the funding challenges for public education. That's something the Texas Lottery and our Legislature have been dealing with since the lottery's inception.

The money the lottery generates is no small amount, at $1.2 billion last fiscal year. But that's obviously just a fraction of the state's total education budget. The lottery was never meant to completely fund education, despite the perception problem we continue to deal with — it was never meant to be a panacea. It was intended to add significant new revenue to state coffers. And it has done that exceedingly well.

BILLIONS IN SALES NATIONWIDE

U.S. state lotteries sold nearly $63 billion in lottery tickets in 2013.

2013 FINANCIAL RESULTS, 10 LARGEST STATE LOTTERIES
(IN MILLIONS)

STATE	LOTTERY TICKET SALES***	PRIZES	GOVERNMENT REVENUES
NEW YORK	$7,108.9	$4,219.0	$3,045.8*
FLORIDA	5,013.0	3,162.9	1,424.3
CALIFORNIA	4,445.9	2,652.1	1,262.1
TEXAS	**4,376.2**	**2,767.4**	**1,214.1**
PENNSYLVANIA	3,699.7	2,299.0	1,067.4
NEW JERSEY	2,821.4	1,670.4	1,085.0
MASSACHUSETTS	4,839.3	3,523.9	955.8
GEORGIA	3,635.9	2,332.5	927.5
MARYLAND	1,756.1	1,038.5	921.8*
OHIO	2,697.9	1,668.0	898.1*
U.S. TOTAL (43 STATES)**	**$62,617.6**	**$37,161.1**	**$19,657.9**

* Government revenue total includes some revenue from video lottery terminals as well as conventional lottery games.

** Excludes the Wyoming lottery, which began sales in August 2014.

*** Includes Keno data for New York, California, Massachusetts, Georgia, Maryland and Ohio.

Source: LaFleur's 2014 World Lottery Almanac

FN: Throughout the lottery's history, you've introduced new and different games. Is that to keep public interest up? How important is variety?

Grief: It's all-important. We must continue to innovate and find new game opportunities to maintain or increase our revenue levels, and we're not alone in that challenge — every lottery faces the same issue.

We started in 1992 with one-dollar scratch tickets and the Lotto Texas draw game, and that was our entire product portfolio. We still have one-dollar scratch games, and they're very successful, particularly as introductory games for new players who just want to see if they enjoy playing the lottery. But over time we've added $2, $3, $5, $10, $20 and $50 scratch-off tickets.

With these higher-priced tickets come bigger prize payout percentages and larger top prizes. These factors resonate extremely well with our players. The Texas Lottery has been an industry leader in these games and almost all state lotteries have followed suit. Having a variety of price points and play styles, "something for everyone," if you will, contributes to our revenue results.

FN: And then there are the number-based games. You've expanded those as well.

Grief: Correct. Since Lotto Texas, our very first draw game, was introduced, we have added Pick 3, Daily 4, Cash 5, Texas Two-Step and All or Nothing.

And we've joined both of the multi-state jackpot games, Mega Millions and Powerball, both of which have helped boost our revenue to education. We joined the Mega Millions game in 2005 and Powerball in 2010. Now all lottery states offer both.

This was a significant event for the lottery industry. The two games competed fiercely for a number of years, but we saw a tremendous uptick in sales when the two games began cross-selling — we had a much larger population base and it doubled the amount of drawings each week. Players typically shop between the two games for the biggest jackpot. That's what helped us reach our all-time record jackpot of $656 million for the Mega Millions game in March 2012.

FN: The Texas Lottery is known for having outsourced most of its functions to private vendors — far more than in many other states. Is Texas still unusual in that regard?

Grief: Right now, the lotteries in Indiana, Illinois and New Jersey are in the news for "groundbreaking" moves toward "privatization." In reality, what these states are doing is very close to adopting the Texas model.

"We outsourced more aspects of the lottery than any state had ever done before."

Our original legislation allowed for only a very limited number of employees. Out of necessity, we outsourced more aspects of the lottery than any state had ever done before, including field sales staff — which is the big difference between us and most other state lotteries.

We have International Game Technology (IGT) as our lottery operator, as well as an advertising vendor, three instant ticket printers and an outside audit firm. We've outsourced our telecommunications infrastructure, instant ticket storage and distribution, sales and marketing, all of the vehicles and facilities required — IGT handles all of that for us.

This is a significant contract that was bid out for the third time in 2010. We had bids from all three vendors in the world capable of providing the necessary goods and services, and IGT once again provided not only the best price, but the most highly rated technical proposal as well.

Our contract with IGT calls for them to receive 2.2099 percent of sales. That's a reduction from the rate under the previous contract, also with IGT, which was 2.6999 percent.

Our agency prides itself on being transparent. To that end, our website contains a voluminous amount of information, including all the documents related to our contract with IGT. We try to place anything of public interest on our website. We've learned we have to be our business.

FN: And is the outsourced model still working out?

Grief: Yes, it is. The Texas model provides us with some significant advantages over a traditional state-operated lottery.

It mitigates the risk of interruption to the revenue stream, due to the technical and resource redundancies available under the contract. It also gives us more flexibility to quickly respond to market and customer demands, and allows us to bypass the need for intensive capital investments in all the people, facilities, equipment, communication networks and other resources necessary to operate a $4.4 billion enterprise.

And it allows IGT to provide financial incentives to its staff to help us meet our revenue goals. The contractual relationship provides us real-time access to industry best practices around the world, and gives us access to a vast array of services, information, technology and skill sets.

For the printing of our scratch-off games, we use all three vendors in the world capable of providing us this service. Our annual instant-ticket printing budget is about $26 million. Once a year, we evaluate their services, sales, security, marketing acumen and any other relevant factors, and determine how much of our scratch-off game portfolio will be awarded to each ticket printer.

That's a strategy that has worked out very well for us. Our instant ticket vendors can't rest on their laurels and they're constantly competing for our business. A smaller state would have difficulty with this strategy, but we produce from 75 to 100 new scratch-off games a year, making this a very effective tool for us.

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FN: What's next for the Texas Lottery? What sort of new features can players expect?

Grief: We always move cautiously in considering new games. All of our games go through a rigorous review for legality and appropriateness before being presented to our commission for consideration. We receive public comments and make sure our legislative oversight committees are made aware of any new games as well.

We understand and respect the stated positions of our governor and Legislature — that there is no desire to expand the footprint of gaming in Texas. We've received that message loud and clear, and we always look to the Legislature for major policy decisions.

FN: And of course, the lottery has its share of opponents. What would you say to the persistent criticism that lotteries are a "tax on the poor," that too many of their sales come from people at the lower end of the economic scale?

Grief: Under state law, an independent demographic study of a sample of Texans and their lottery buying habits must be performed every two years. That said, several years ago our commission decided to have the study performed every year. The University of Houston has performed the study in recent years.

This type of demographic information is complex. However, I believe the study contains some evidence that refutes the notion that lotteries prey on the poor or the uneducated. But the demographic study is performed independently, and readers can draw their own conclusions from the results.

In addition, state law makes it very clear that the lottery may not unduly influence anyone to play. We take that charge seriously and, through our advertising agency, take great care to ensure our advertising does not target any particular demographic.

FN: Which leads us to the 2013 interim committee, and their charge to consider the impact of eliminating the lottery.

Grief: Our Sunset process in the 2013 legislative session was anything but smooth. The Sunset Advisory Commission has written that our agency "walks a tightrope" in balancing our mission with the state's attitudes toward gaming. We're charged with operating the lottery like a business to generate revenue for the state,

"We understand and respect the stated positions of our governor and Legislature — that there is no desire to expand the footprint of gaming in Texas."

"We realize that the lottery will always be heavily scrutinized, given the type of business we are engaged in. Our agency takes great pride in being open and transparent."

but we are and must be respectful of those opposed to the lottery in particular or gaming in general.

The agency came through its Sunset review with high marks, but, when our Sunset bill reached the floor of the House in 2013, it was initially voted down, which on its face would have shut down the lottery as of September 2014. But within a few hours, the House reconvened and voted it through, continuing the agency for 12 more years.

But language was added to our Sunset bill requiring a legislative review committee to be appointed during the interim, to study, among other things, phasing out the lottery — and that would include finding alternate sources of revenue. Our agency served as a resource to the committee as it undertook this charge. That review committee completed its work and submitted its report on December 1, 2014.

The committee recommended that the Legislature continue the Texas Lottery and the Texas Lottery Commission. Their report also stated that the loss of state funding for education and other valuable programs, and the loss to Texas businesses, would be gravely detrimental to the state if the lottery were abolished.

While we were pleased with the report, we realize that the lottery will always be heavily scrutinized, given the type of business we are engaged in. Our agency takes great pride in being open and transparent, and we will continue to take that approach through this legislative session and beyond. **FN**

State Revenue Watch FOR MAY 2015

This table presents data on net state revenue collections by source. It includes most recent monthly collections, year-to-date (YTD) totals for the current fiscal year and a comparison of current YTD totals with those in the equivalent period of the previous fiscal year.

NOTE: Texas' fiscal year begins on September 1 and ends on August 31.

NET STATE REVENUE — All Funds Excluding Trust

(AMOUNTS IN THOUSANDS)

Monthly and Year-to-Date Collections: Percent Change From Previous Year

Tax Collections by Major Tax	APRIL	YEAR TO DATE: TOTAL	YEAR TO DATE: CHANGE FROM PREVIOUS YEAR
SALES TAX	$2,310,978	$19,115,735	7.74%
PERCENT CHANGE FROM APRIL 2014	1.20%		
MOTOR VEHICLE SALES AND RENTAL TAXES	366,865	$3,016,868	14.02%
PERCENT CHANGE FROM APRIL 2014	51.22%		
MOTOR FUEL TAXES	293,323	$2,278,876	5.04%
PERCENT CHANGE FROM APRIL 2014	2.29%		
FRANCHISE TAX	285,925	$108,534	-61.86%
PERCENT CHANGE FROM APRIL 2014	15.69%		
INSURANCE TAXES	14,597	$1,219,122	4.35%
PERCENT CHANGE FROM APRIL 2014	-23.06%		
NATURAL GAS PRODUCTION TAX	52,475	$956,241	-18.22%
PERCENT CHANGE FROM APRIL 2014	-69.67%		
CIGARETTE AND TOBACCO TAXES	129,090	$960,887	11.72%
PERCENT CHANGE FROM APRIL 2014	1.80%		
ALCOHOLIC BEVERAGES TAXES	101,534	$746,148	9.77%
PERCENT CHANGE FROM APRIL 2014	-0.54%		
OIL PRODUCTION AND REGULATION TAXES	177,492	$2,023,380	-18.01%
PERCENT CHANGE FROM APRIL 2014	-46.30%		
INHERITANCE TAX	0	($32)	-380.56%
PERCENT CHANGE FROM APRIL 2014	N/A		
UTILITY TAXES[1]	99,613	$325,606	1.63%
PERCENT CHANGE FROM APRIL 2014	-5.79%		
HOTEL OCCUPANCY TAX	51,889	$335,697	10.64%
PERCENT CHANGE FROM APRIL 2014	3.56%		
OTHER TAXES[2]	61,090	$196,314	16.33%
PERCENT CHANGE FROM APRIL 2014	3.46%		
TOTAL TAX COLLECTIONS	$3,944,872	$31,283,377	4.35%
PERCENT CHANGE FROM APRIL 2014	-2.03%		

Revenue By Source	APRIL	YEAR TO DATE: TOTAL	YEAR TO DATE: CHANGE FROM PREVIOUS YEAR
TOTAL TAX COLLECTIONS	$3,944,872	$31,283,377	4.35%
PERCENT CHANGE FROM APRIL 2014	-2.03%		
FEDERAL INCOME	2,415,580	$23,656,369	7.30%
PERCENT CHANGE FROM APRIL 2014	-3.81%		
LICENSES, FEES, PERMITS, FINES AND PENALTIES	492,263	$6,075,889	16.05%
PERCENT CHANGE FROM APRIL 2014	3.09%		
INTEREST AND INVESTMENT INCOME	248,015	$636,119	-30.59%
PERCENT CHANGE FROM APRIL 2014	193.97%		
LOTTERY PROCEEDS[3]	177,105	$1,289,881	-1.66%
PERCENT CHANGE FROM APRIL 2014	0.55%		
SALES OF GOODS AND SERVICES	24,390	$299,474	76.51%
PERCENT CHANGE FROM APRIL 2014	-8.54%		
SETTLEMENTS OF CLAIMS	26,714	$524,554	-5.54%
PERCENT CHANGE FROM APRIL 2014	-30.75%		
LAND INCOME	74,915	$1,119,020	-10.08%
PERCENT CHANGE FROM APRIL 2014	-56.52%		
CONTRIBUTIONS TO EMPLOYEE BENEFITS	4	$40	-38.88%
PERCENT CHANGE FROM APRIL 2014	-16.36%		
OTHER REVENUE SOURCES	996,118	$3,272,609	4.66%
PERCENT CHANGE FROM APRIL 2014	20.37%		
TOTAL NET REVENUE	$8,399,974	$68,157,331	5.53%
PERCENT CHANGE FROM APRIL 2014	0.71%		

1- Includes public utility gross receipts assessment, gas, electric and water utility tax and gas utility pipeline tax.

2- Includes the cement and sulphur taxes and other occupation and gross receipt taxes not separately identified.

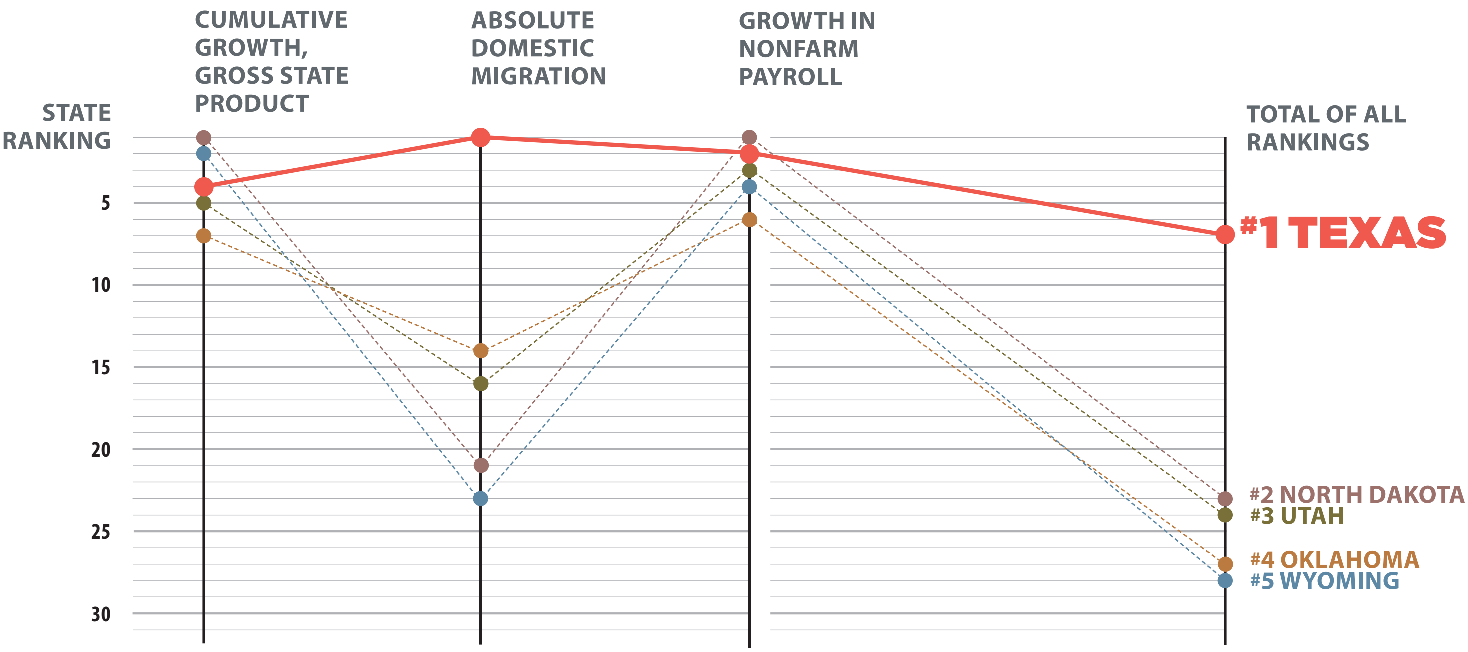
3- Gross sales less retailer commissions and the smaller prizes paid by retailers.

Note: Totals may not add due to rounding.

A Great Decade for the Lone Star State

TOP FIVE - AMERICAN LEGISLATIVE EXCHANGE COUNCIL'S ASSESSMENT OF STATE ECONOMIC COMPETITIVENESS, 2003-2013

In the 2015 edition of the American Legislative Exchange Council's assessment of state economic competitiveness, *Rich States, Poor States,* Texas ranked first overall for the 2003-2013 period. The ranking is based on three factors — gross product, migration from other states and payroll growth — that are "highly influenced by state policy."



GLENN HEGAR
Texas Comptroller of Public Accounts

Fiscal Notes is one of the ways the Comptroller's office strives to assist taxpayers and the people of Texas. The newsletter is a by-product of the Comptroller's constitutional responsibilities to monitor the state's economy and to estimate state government revenues.

Fiscal Notes also provides a periodic summary of the financial statements for the State of Texas.

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Texas Comptroller of Public Accounts
Publication #96-369,
May 2015