nhfpi New Hampshire Fiscal Policy Institute

issue brief

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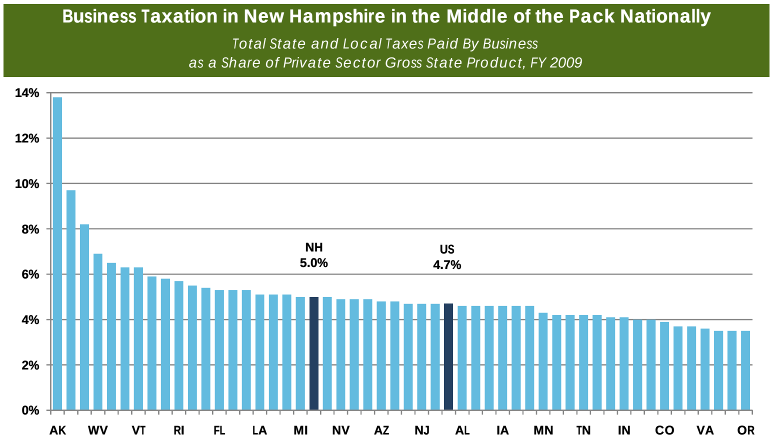
Business Taxes in New Hampshire: Where Do They Stand? How Much Do They Matter?

In recent months, a number of proposals have been put forward to reduce the two main business taxes New Hampshire imposes at the state level – the business profits tax (BPT) and the business enterprise tax (BET). While these proposals vary in the approaches they would use to lower taxes – one measure would reduce rates, another would raise a threshold at which businesses must begin to pay taxes, and still others would expand deductions or credits – most appear to be motivated by the beliefs that business taxes in New Hampshire are excessively high and that, as a result, the state is at a competitive disadvantage in attracting and retaining employers. Going one step further, a common justification offered for such proposals is the belief that lowering business taxes would spur economic growth – and do so to such a large degree that it would generate revenue for the state, rather than lose it.

These beliefs ignore several relevant facts about business taxation in New Hampshire and, more generally, about the impact that taxes may have on economic activity. As this Issue Brief explains:

- The overall level of taxation faced by businesses operating in New Hampshire is comparable to the national average.
- The BPT and BET constitute a relatively small share of the total taxes paid by businesses operating in New Hampshire. Property taxes, which could rise due to reductions in local aid, are a much larger part of businesses' total tax bill.
- Most businesses operating in New Hampshire pay little or no BPT or BET.
- Of those businesses that incur a BPT or BET liability, the large majority are based outside New Hampshire.
- The business tax proposals now before the legislature, if enacted, could reduce state revenue by more than $100 million over the next two years, thus greatly exacerbating the state's existing FY 2012-2013 budget deficit and potentially forcing even deeper cuts in public services such as health care or higher education.
- A large body of economic literature indicates that business taxation has, at most, a very modest effect on business location decisions. Other factors, including factors influenced by public expenditures, tend to be more important.
- Rigorous studies conducted in other states of the impact that business tax cuts have on state revenue collections conclude that such changes in tax policy fall well short of "paying for themselves."

The overall level of taxation faced by businesses operating in New Hampshire is comparable to the national average.



Source: Ernst & Young, Council on State Taxation

Much of the recent debate about business taxation in New Hampshire has focused on the relative level of the statutory tax rate under the business profits tax (BPT) – that is, under New Hampshire's version of a corporate income tax – or on the degree to which the state depends upon the BPT and business enterprise tax (BET) as sources of revenue. Less attention has been paid to effective tax rate measures that attempt to assess more thoroughly the impact that taxes may have on businesses operating in the state or that reflect the level of business taxation compared to businesses' ability to pay those taxes.

Studies that explore the effective tax rates faced by businesses generally find that New Hampshire is in the middle of the pack nationally. For instance, since the early 2000s, Ernst & Young, in conjunction with the Council on State Taxation (COST), "a nonprofit trade association consisting of nearly 600 multistate corporations," has produced a report each year that explores trends in the taxes paid by businesses at the state and local level. In the latest version of this report, for FY 2009, Ernst & Young finds that, in the aggregate, the state and local taxes paid by businesses amount to 5.0 percent of private sector gross state product in New Hampshire, only modestly above the national mark of 4.7 percent and good for a ranking of 19th among the 50 states and the District of Columbia.[i]

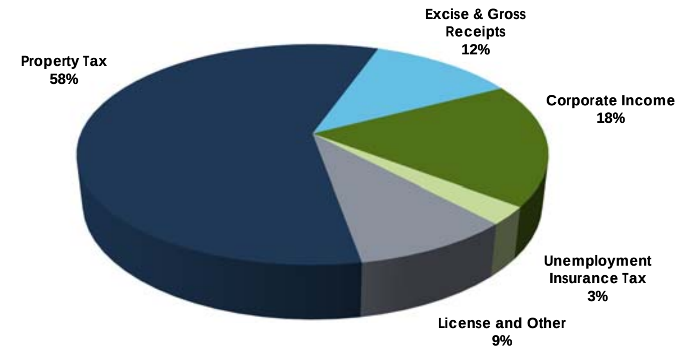
Earlier work by Robert Tannenwald, a former Vice President of the Federal Reserve Bank of Boston, uses a modified version of the approach found in the Ernst & Young / COST studies and arrives at a similar finding. He determined that, for FY 2000, total state and local taxes paid by businesses equaled 4.7 percent of state personal income in New Hampshire, just the 20th highest level out of the fifty states and almost exactly the same as the aggregate national figure.[ii]

Of note, a still more recent study produced by Ernst & Young, again in collaboration with COST, concludes that New Hampshire had one of the lowest levels of taxation on new investment in the nation in 2009.[iii] It calculates that business taxation in New Hampshire reduces the 30 year rate of return on five different types of capital investment by 5.4 percent in the aggregate – only six states had lower effective tax rates under its methodology.

To be sure, studies such as those generated by Ernst & Young / COST have their limitations and methodological shortcomings; for instance, given the assumptions it makes about the in-state sales produced by new investments, the most recent Ernst & Young / COST study may be skewed towards states that employ apportionment formulas that heavily favor (or that rely entirely on) sales as a factor in determining state tax liability.[iv] Still, they may be more indicative of where New Hampshire stands relative to other states than a simple comparison of statutory tax rates.

The BPT and BET constitute a relatively small share of the total taxes paid by businesses operating in New Hampshire.

The Property Tax is the Most Significant Business Tax in New Hampshire
Composition of Taxes Paid by New Hampshire Businesses, FY 2009

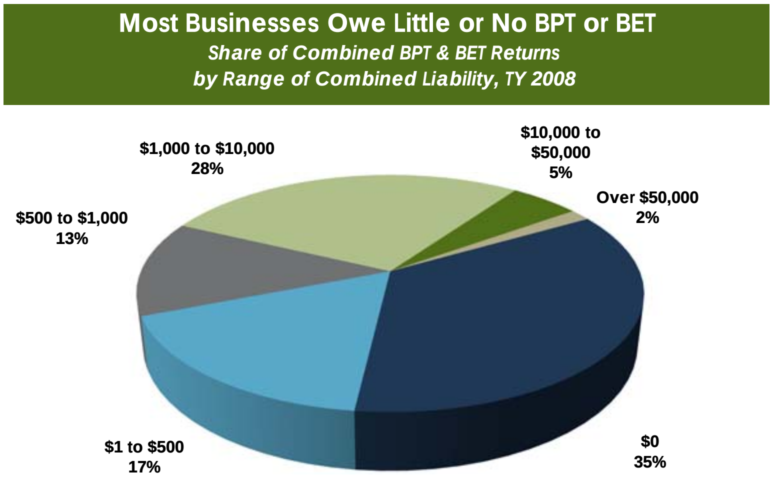


Source: Ernst & Young, Council on State Taxation

The series of Ernst & Young / COST studies cited above reveal one other important fact about business taxation in New Hampshire. By their accounting, the state's two principal business taxes – the BPT and the BET – comprise approximately 18 percent of businesses' total state and local tax bill, as seen in the figure at right.[v] Not surprisingly, given the overall structure of New Hampshire's tax system, property taxes make up a far larger share of what businesses pay to help finance the operations of government. More specifically, for FY 2009, the Ernst & Young / COST study calculates that property taxes constitute nearly three out of every five dollars in taxes paid by businesses operating in New Hampshire, the second largest proportion of any state, trailing only Vermont.

Given this reality, as well as the current budget context in New Hampshire, efforts to reduce the BPT or the BET are unlikely to yield the results proponents intend. As will be discussed below, to close the state's projected FY 2012-2013 budget gap, the budget approved by the House of Representatives would reduce spending by close to half a billion dollars over the next two years. Any state revenue loss arising from a reduction in the BPT or BET would thus likely force additional cuts in spending.[vi] To the extent that additional spending reductions at the state level lead to a further decline in aid to cities, towns, and school districts – which the House budget would decrease by nearly $115 million in the coming biennium – property tax increases may occur. If that proves to be the case, then, depending on the specific BPT or BET change written into law, individual firms or companies may not see their total tax bills shrink and could well see them grow.

Most businesses operating in New Hampshire pay little or no BPT or BET.

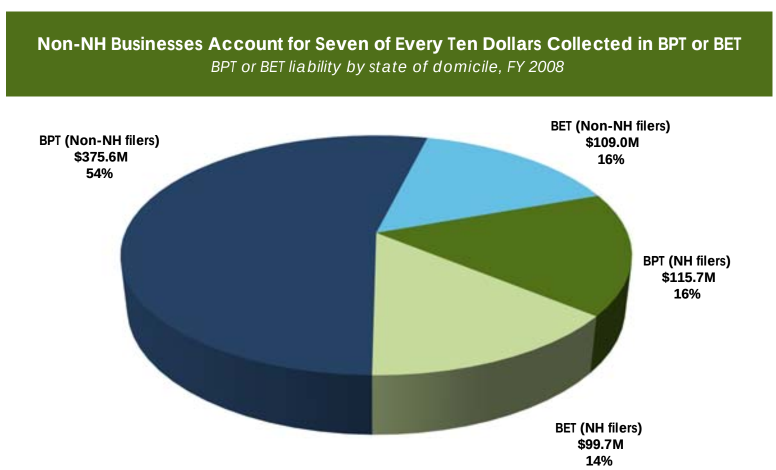


Source: NHFPI calculations based on NH Department of Revenue Administration data

Data from the New Hampshire Department of Revenue Administration (DRA) reinforce the fact that, for many businesses, the BPT and BET amount to a very small part of their overall tax liability. Indeed, as the figure at left makes clear, the majority of businesses operating in New Hampshire owe either very little or nothing at all under the BPT or BET. In particular, more than 23,000 BPT/BET returns in tax year 2008 – or over one third of total returns – showed no business profits or business enterprise tax owed that year. Another 11,400 returns – or 17 percent of the total – had combined liabilities of less than $500; returns in this latter category owed an average of $218 between the two taxes. There are a variety of reasons why a company may not owe tax in a given year, such as the use of various deductions, exemptions, or credits. However, it is also worth noting that the DRA estimates that as many as 130,000 to 150,000 companies are doing business in New Hampshire at any one time, but received only roughly 67,000 returns under these two taxes, suggesting that some companies that may be required to file a BPT or BET return – and that may face some liability under one or both of those taxes – are not now doing so.[vii]

Of those businesses that incur a BPT or BET liability, the large majority are based outside New Hampshire.

Additional DRA data suggest that the bulk of the revenue the state collects from its two main business taxes comes from companies that have headquarters and operations outside of New Hampshire. In FY 2008, those companies filing returns from addresses outside of New Hampshire faced an aggregate gross BPT liability – that is, the amount all such companies owed prior to any refunds – of $375.6 million or 76 percent of the total such liability.

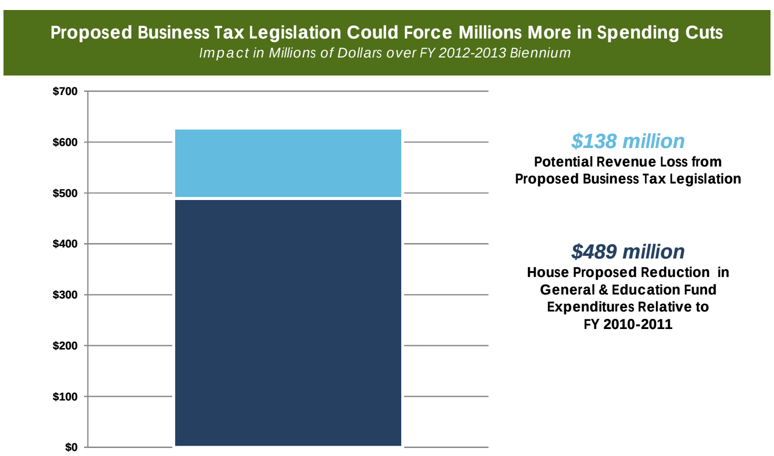


Source: NHFPI calculations based on NH Department of Revenue Administration data

Likewise, companies filing returns from addresses outside of New Hampshire faced a gross BET liability of $109 million, a sum equal to 52 percent of the overall liability. Consequently, filers based outside of New Hampshire accounted for approximately 70 percent of the total BPT-BET liability in FY 2008, as seen in the figure above.

Given the nature of the modern economy – in which an order placed via computer in Concord is just as likely to be fulfilled in Berlin, Germany and shipped from Lisbon, Portugal as it to be delivered from either of those New Hampshire cities – this is not entirely surprising. Still, the distribution of BPT and BET liability, both among businesses generally and by state of domicile, should raise important questions about which businesses might benefit from any changes to those two taxes and the impact that such changes may have on the New Hampshire economy. For instance, a reduction in the business profits tax – whether by a modification of its rate or by an extension of the period over which companies may apply their credits for business enterprise taxes paid – may allow a corporation to retain more of its earnings or to pay larger dividends to its shareholders. However, those funds will not necessarily be reinvested in New Hampshire and, indeed, to the extent a corporation has operations elsewhere in the country or across the planet, the likelihood that additional investments will be made here in the Granite State may be reduced.

Proposals to cut business taxes could force even deeper cuts in public services such as health care or higher education.



Source: NHFPI calculations based on LBA, DRA data

Due in large measure to the impact of the national recession and the protracted recovery from it, New Hampshire is expected to face a budget shortfall of roughly half a billion dollars for the FY 2012-2013 biennium. The version of the budget approved by the New Hampshire House of Representatives in March would close that gap almost exclusively through cuts in spending, reducing General and Education Fund expenditures from an anticipated level of $4.88 billion for the current biennium to $4.39 billion in the upcoming one, a difference of approximately $489 million.[viii] Reflected in that total are numerous General Fund reductions that would have serious economic consequences for New Hampshire in both the short- and long-run, including an $11 million cut in support for child-care assistance that enables low-income families to secure and maintain employment; a $159 million decline in funds for uncompensated care, which will result in the loss of tens of millions of dollars in aid from the federal government; and a $114 million reduction in appropriations for the University System of New Hampshire, which will likely make it significantly more difficult for New Hampshire residents to obtain the education and skills they need to compete in the global marketplace.

In this context, reducing business taxes would likely lead to even deeper cuts in spending. At present, six main pieces of legislation pertaining to business taxation are pending before the New Hampshire Senate and House of Representatives:

- HB 154, which would increase a threshold amount for taxation under the BET;
- HB 187, which would extend the period over which filers could carry forward the BET credit against the BPT;
- HB 213, which would lower the BPT rate from 8.5 percent to 8.0 percent in two stages;
- HB 557 and SB 125, both of which would make it easier for certain businesses to increase the amount of compensation they deduct in determining their BPT liabilities, and;
- SB 126, which would increase the limit on the amount of net operating loss (NOL) filers may carry forward under the BPT from $1 million to $10 million.

Based on the fiscal notes prepared by the Department of Revenue Administration for these measures, if each one were enacted, the total revenue loss for the FY 2012-2013 biennium could be as much as $138 million.[ix] In light of the state's substantial budget deficit, whatever revenue loss may arise from such legislation will have to be offset in some fashion, either through additional cuts in services or through additional revenue resulting from either underlying economic growth or from compensatory changes in tax policy. Of course, using any additional revenue to reduce taxes means that any spending cuts used to balance the budget – such as those proposed to child care, health care, or higher education – would have to remain in place.

Business taxation has, at most, a very modest effect on business location decisions.

> The things that create the conditions that lead to the growth of good jobs are a skilled, educated, stable and dedicated workforce, a substantial group of highly educated and motivated entrepreneurs, above-average infrastructure and government services, a high overall quality of life and a sufficient pool of investment capital. Low tax rates, lax regulations and enfeebled employees come in way down the list of factors that create a positive business environment.
>
> *Former Wisconsin Secretary of Economic Development, Chandler McKelvey, Milwaukee Journal Sentinel, April 11, 2011*

Proponents of reducing business taxes maintain that doing so will make New Hampshire a more attractive location in which to situate new businesses or to expand existing ones. Yet, a substantial body of economic research suggests that business taxes have, at most, a relatively modest impact on these kinds of decisions, an impact that is likely outweighed by other factors and influences. As one summary of the literature, conducted by Stephen Mark, Therese McGuire, and Leslie Papke, puts it:

> …while most researchers find taxes to be a statistically significant factor in business location and expansion decisions, the economic effect of taxes tends to be both small and less important than other factors. Labor force availability and quality, for example, appear to be more important for explaining differences across locations in economic activity.[x]

One of the principal reasons taxes exert such limited influence over business decision-making is that they constitute just a fraction of the total costs businesses face. For instance, in a similar research survey, Robert Lynch finds that, in the aggregate, the state and local taxes paid by businesses in 2000 amounted to just 0.8 percent of their overall costs, after accounting for the federal deductibility of such taxes.[xi] Thus, Lynch notes:

> …differences in tax burdens across states are so modest that they are unlikely to outweigh the differences across states in the other costs of conducting business. These other "costs of conducting business" are the most important factors affecting business investment decisions and include the cost and quality of labor, the proximity to markets for output (particularly for service industries), the access to raw materials and supplies that firms need, the access to quality transportation networks and infrastructure (e.g., roads, highways, airports, railroad systems, and sewer systems), quality-of-life factors (e.g., good schools, quality institutes of higher education, health services, recreational facilities, low crime, affordable housing, and good weather), and utility costs.[xii]

Consequently, as Mark, McGuire, and Papke state, economic research on this subject:

> …make[s] clear that a policy of cutting taxes to induce economic growth is not likely to be efficient or cost-effective in the general case.[xiii]

This conclusion is echoed in a recent analysis by Peter Fisher, who observes:

> …the preponderance of evidence from many dozens of studies over a period of 30 years or more is that business tax cuts, *if they could be enacted without cutting public spending*, have some positive effect on state economic growth, but that this effect is quite small.[xiv]

As discussed above, the conditions stipulated by Fisher do not now exist in New Hampshire. Business tax cuts would either lead to further spending reductions or would preclude the restoration of reductions proposed by the House of Representatives to close the state's current budget gap. In fact, many of the reductions contained in the House's version of the budget will have adverse consequences for the "other costs of conducting business" identified by Lynch as important in affecting business decision-making, such as quality infrastructure and institutes of higher education. Accordingly, as Timothy Bartik of the Upjohn Institute cautions:

> If …state and local tax cuts are financed by cutting public services, the result may be lower business activity.[xv]

Changes in tax policy fall well short of "paying for themselves."

Given the preceding discussion, it is easy to understand how reductions in the taxes paid by businesses – and, in particular, reductions in corporate income taxes like the BPT – would fail to pay for themselves, the claims of proponents notwithstanding. Corporate income taxes comprise a relatively small part of the taxes paid by businesses. Taxes, in turn, make up only a very small fraction of total business costs. Costs such as labor, energy, and transportation have a much greater impact on businesses' bottom lines, yet state's efforts to mitigate those costs are hampered by spending cuts necessitated by reductions in business taxes. As a result, changes in tax policy likely have little impact on businesses' decisions to invest, to hire, and to grow. By extension, then, changes in tax policy are unlikely to spur economic growth to such a large degree that the resulting change in revenue will be sufficient to offset initial losses.

Economic analyses conducted by three states – Arizona, Oregon, California – over the past decade and a half affirm this line of reasoning. They find that changes in corporate income taxes may yield some additional economic activity, but usually only enough to replace 15 to 25 percent of the initial revenue loss associated with such changes. For example, a simulation performed by the Oregon Legislative Revenue Office using its Oregon Tax Incidence Model found that, while a $100 million cut in state corporate income taxes would lead to some gains in employment, personal income, and business investment, such "new taxable economic activity would recoup only $16 million of the original $100 million tax cut."[xvi] What's more, two of the key mechanisms by which a state may recoup a portion of a given tax cut are not present in New Hampshire, as the state lacks both a broad-based sales and income tax. Thus, any growth in incomes realized by New Hampshire residents or in the number of purchases of most goods or services made within the state's borders would not be reflected in higher revenue for the state in the way that they might in other states.

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[i] Cline, Robert, et. al., *Total State and Local Business Taxes,* Ernst & Young Quantitative Economics and Statistics Practice, March 2010.

[ii] Tannenwald, Robert, *Massachusetts Business Taxes: Unfair? Inadequate? Uncompetitive?*, Federal Reserve Bank of Boston, August 20, 2004.

[iii] Cline, Robert, et. al., *Competitiveness of State and Local Business Taxes on New Investment,* Ernst & Young Quantitative Economics and Statistics Practice, April 2011.

[iv] In general, to determine the corporate income tax it owes to a given state (or, in the case of New Hampshire, the BPT or BET it may owe), a company uses a formula specified by law to calculate the amount of the income it and all of its affiliates have earned nationwide that is attributable to its operations in that state. This formula, known as an apportionment formula, has traditionally used the share of a

company's property located in the state, the share of its total sales that occur in the state, and the share of its total payroll paid to its workforce in that state to apportion its income to the state for tax purposes. Most states, New Hampshire included, now give greater weight to the share of sales that occurs in-state in their apportionment formulae.

[v] Ernst & Young, like the US Census Bureau, includes the business enterprise tax (BET) in its definition of corporate income taxes.

[vi] Alternatively, if revenue collections in excess of anticipated levels are used to offset the initial revenue loss resulting from business tax cuts, spending reductions included in the FY2012-2013 budget that otherwise could have been mitigated would have to remain in place.

[vii] Adapted from New Hampshire Fiscal Policy Institute, *An Overview of New Hampshire's Tax System,* December 2010.

[viii] NHFPI calculations based on Office of the Legislative Budget Assistant Surplus Statement of March 24, 2011.

[ix] This sum assumes, consistent with initial and existing fiscal notes prepared by the Department of Revenue, that HB 213 would reduce BPT revenue over the FY12-13 biennium by $27.6 million and that the legislation pertaining to reasonable compensation (SB 125 or HB 557) would yield a revenue loss of $99 million over the same period, if implemented in FY 2012. The Department's initial fiscal note for HB 154 suggested that it would shrink BET revenue by as much as $12.5 million during the FY 12-13 biennium, but it has subsequently revised that note to indicate that the potential revenue loss is indeterminable. It has stated that the revenue losses resulting from HB 187 and SB 126 are indeterminable as well, but does note that the annual revenue loss due to New Hampshire's existing net operating loss (NOL) provision, currently capped at $1 million, has exceeded $12 million each year since 2005. In addition, if the five different pieces of business tax legislation now pending before the House and Senate were enacted, some interaction among the various changes would occur, but the impact on the total revenue loss is unclear. Lastly, while HB 154 and HB 213 currently lie on the table in the House, they have also been included in a provision in HB 2, the budget trailer bill, stating the intent of the House of Representatives to enact such legislation should the state collect revenue in excess of the levels projected by the House for FY 12-13.

[x] Mark, Stephen T., et. al. "The Effect of Taxes on Economic Development," *District of Columbia Tax Revision Commission: Taxing Simply, Taxing Fairly,* September 1998, p. 45-46.

[xi] Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development,* Economic Policy Institute, 2004, p. 4.

[xii] *Ibid*., p. 6.

[xiii] Mark, et. al., p. 46.

[xiv] Fisher, Peter S., *Corporate Taxes and State Economic Growth,* Iowa Fiscal Partnership, February 2011, p. 3; emphasis in the original

[xv] Bartik, Timothy J., "Solving the Problems of Economic Development Incentives," *Growth and Change*, Spring 2005, p. 142.

[xvi] Mazerov, Michael, *Cutting State Corporate Income Taxes is Unlikely to Create Many Jobs,* Center on Budget and Policy Priorities, September 14, 2010, p. 12-13.