New Hampshire Fiscal Policy Institute

Testimony of Jeff McLynch,
Executive Director, New Hampshire Fiscal Policy Institute,
Before the Commission to Study Business Taxes
Regarding the Commission's Draft Report
February 6, 2012

Chairman Olbricht, Senators, Representatives, Members of the Commission, thank you for the opportunity to appear before you this morning. My name is Jeff McLynch and I am the Executive Director of the New Hampshire Fiscal Policy Institute (NHFPI), an independent, non-partisan organization dedicated to exploring, developing, and promoting public policies that foster economic opportunity and prosperity for all New Hampshire residents, with an emphasis on low- and moderate-income families and individuals.

I am here today to urge you to oppose the draft report that has been submitted for your approval, for several reasons.

First, taken together, the recommendations contained in the report would entail a sizable reduction in the amount of tax revenue New Hampshire collects. By extension then, they would significantly diminish the state's ability to provide public services, such as education and infrastructure, that businesses across the state rely upon to remain competitive. Importantly, a substantial body of economic literature suggests that the quality of the workforce and infrastructure in a state has more of an influence over businesses' location and expansion decisions than the level of business taxation.

Second, the recommendations fail to acknowledge not only that, on the whole, the level of business taxation in New Hampshire is already lower than in most states, but also that the single largest component of the collective business tax bill in New Hampshire is the property tax. Indeed, to the extent that reductions in the Business Profits Tax or Business Enterprise Tax lead to a drop in the amount of aid the state directs to local governing bodies, they could force an increase in taxes for some companies.

Third and finally, some of the specific changes in law envisioned in the report, such as a move towards single sales factor apportionment, could actually create a disincentive for some businesses to locate in New Hampshire and thus impede, rather than foster, economic growth. Of note, states that have chosen to adopt single sales factor have been no more successful in terms of promoting employment growth than states that follow a different approach to apportionment.

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Commission's Recommendations Would Lead to Substantial Revenue Losses and Diminish Ability to Provide Services on which Businesses Rely

To expand upon my first point, if the bulk of the Commission's recommended changes in tax policy were put in place for the entirety of the FY 2012-2013 biennium, it is likely that New Hampshire would experience a revenue loss totaling in excess of $100 million. More specifically, based on the Department of Revenue Administration's methodology in assessing similar legislation in the past, lowering the rate of the Business Profits Tax (BPT) from 8.5 percent to 7.5 percent would reduce the amount of BPT collected in FY12-13 by roughly $75 million. In addition, conforming to the federal Internal Revenue Code, as the report suggests, means that all of the changes in the federal corporate income tax that have been made since 2000 would be incorporated into New Hampshire's tax system. Chief among these federal changes is the creation, in 2004, of a deduction for domestic production activities. According to the US Congress' Joint Committee on Taxation, that deduction is expected to reduce federal corporate income tax collections by $8.4 billion in federal fiscal year 2011 or by roughly 4 percent. A similarly sized reduction in BPT revenue would mean a loss of close to $26 million over the FY12-13 biennium. Other recommendations, such as the extension of the Business Enterprise Tax (BET) carryforward and the elimination of any limit on the Net Operating Loss carryforward, would produce still further revenue losses.

Of note, the commission's report, in its current form, fails to assess the magnitude of these revenue losses. It does allow that revenue losses will occur and suggests that, in light of the state's current fiscal circumstances, the recommendations it contains may be impractical in the near term. Nevertheless, it is imperative to understand the amount of revenue that will be lost to such changes in tax policy, as revenue losses will invariably entail tradeoffs. These are tradeoffs that will most likely take the form of further spending reductions; accordingly, they are tradeoffs that will have a direct bearing on how attractive a location New Hampshire may appear to businesses.

Recent experience illustrates the danger of proceeding without sufficient information. Earlier this year, the Legislature enacted changes in statute that will allow taxpayers to carry forward, for ten years rather than five, a credit for any BET that they may have paid that they can use to reduce their BPT liabilities. When the legislation was initially adopted, little information was publicly available from the Department of Revenue Administration (DRA) about the impact the change would have on future revenue streams. Yet, a subsequent analysis from the DRA indicates that the revenue loss arising from the change could range from $32 million to $47 million annually, once fully implemented.

Importantly, efforts to reduce business taxes, as they will likely need to be paired with spending reductions to maintain budget balance, may ultimately hamper economic growth in New Hampshire. The reason for such an outcome is that, as economic research has demonstrated, factors other than business taxes are more important in determining where businesses locate, invest, and expand. Robert Lynch, Professor of Economics at Washington College in Maryland, notes that:

> ...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.[i]

States, of course, can help to reduce these costs, but only if they have the resources to do so.

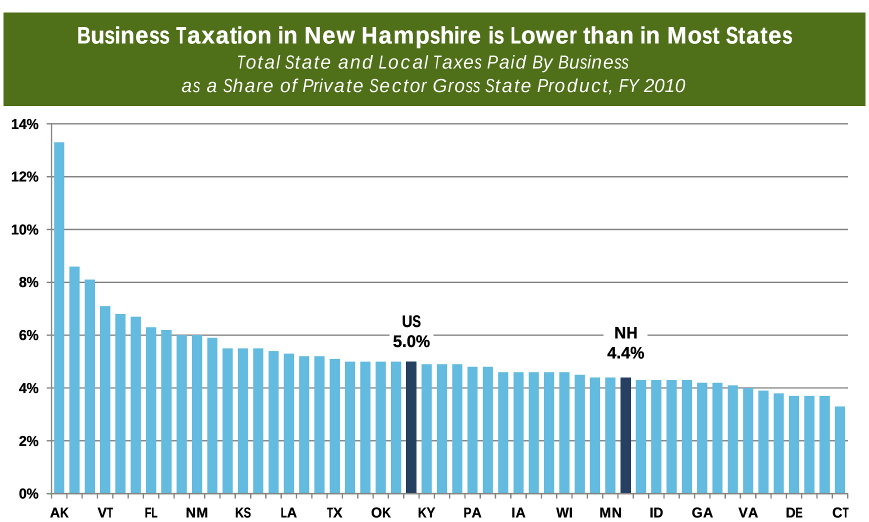
Timothy Bartik, Senior Economist at the Upjohn Institute, puts this relationship even more succinctly, concluding that:

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

Business Taxation in New Hampshire is Already Lower than in Most States

Although tax policy may not be as critical a factor in business decision making as the uses to which a state puts the resources generated by such tax policy, it is nevertheless useful to understand how tax policy in New Hampshire compares to other states.

During its deliberations, members of the Commission and witnesses before it have made references to publications and reports that portray New Hampshire's business tax climate in a negative light, focusing largely on the statutory tax rate under the BPT and how it ranks relative to the corresponding corporate income tax rate in other states.

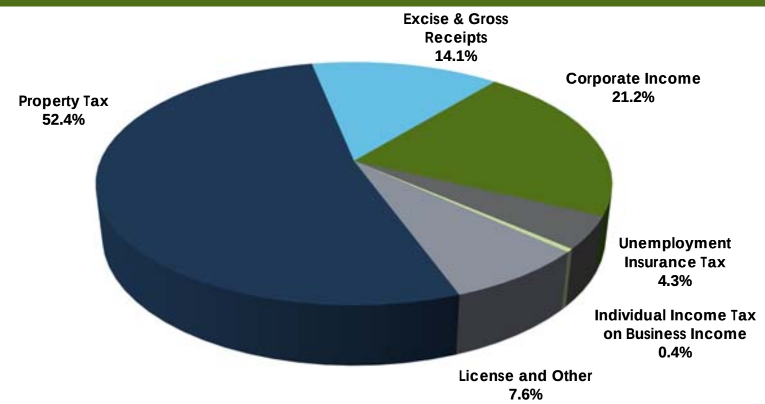


Yet, at least one study that examines the effective tax rates faced by businesses generally finds that business taxation in New Hampshire is lower than in most states. More specifically, since the early 2000s, Ernst & Young, in conjunction with the Council on State Taxation (COST), "a nonprofit trade 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 2010, Ernst & Young finds that, in the aggregate, the state and local taxes paid by businesses amount to 4.4 percent of private sector gross state product in New Hampshire, below the national mark of 5.0 percent and less than at least 33 other states and the District of Columbia.[iii]

Another 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.[iv] 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, the studies published by Ernst & Young and COST may have their limitations and methodological shortcomings. For instance, in determining the overall level of business taxation, it includes unemployment insurance taxes, even if the final incidence of those taxes is upon a firm's workers. Still, they may be more indicative of where New Hampshire stands relative to other states than a simple comparison of statutory tax rates.

The Property Tax is the Most Significant Business Tax in New Hampshire
Composition of Taxes Paid by New Hampshire Businesses, FY 2010



The series of Ernst & Young / COST studies 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 21 percent of businesses' total state and local tax bill. 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 state and local government. In fact, for FY 2010, the Ernst & Young / COST study calculates that property taxes constitute 52 percent of the state and local taxes paid by businesses operating in New Hampshire.

Consequently, efforts to reduce the BPT or the BET are unlikely to yield the intended economic results. As mentioned previously, any state revenue loss arising from a reduction in the BPT or BET would likely force further cuts in spending. To the extent that additional spending reductions at the state level lead to a further decline in aid to cities, towns, and school districts, 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.

Some Recommendations May Lead to Higher Taxes for Some Businesses and Individuals and May Create Disincentives to Locate in New Hampshire

Some of the Commission's specific recommendations may yield other unintended consequences. For instance, the Commission urges the Legislature to study a move away from the state's current apportionment formula, which "double weighs" the sales companies make in New Hampshire in determining their income subject to taxation here. However, switching a so-called "single sales factor" apportionment formula, which makes in-state sales the sole factor determining taxable income, may actually deter companies from establishing operations in New Hampshire or encourage them to leave.

The reason for this potential "disincentive" effect is that increasing the prominence of in-state sales in New Hampshire's apportionment formula may lead to a tax increase for some businesses, particularly those that have the bulk of their operations in other states, but that make a large proportion of their sales in New Hampshire. Data contained in DRA's annual tax expenditure report suggest that this has already occurred with the state's switch from an equally-weighted apportionment formula to one that "double weighs" sales. Overall, the Department notes that, after accounting for amended and adjusted returns, the change to a "double-weighted" formula is likely a net revenue loss for the state. Still, its data show that, among those tax returns filed in calendar year 2010, 5,859 experienced a tax increase due to the "double weighted" formula. Their total tax increase, in turn, was $15.3 million.

Accordingly, if New Hampshire were to adopt a so-called "single sales factor" apportionment formula, businesses currently in state – or those weighing a move here – which would pay higher taxes because of the change may seek to take advantage of existing federal nexus rules. These rules would permit them to locate their operations outside of New Hampshire and use out-of-state sales people to make sales into the Granite State without becoming subject to its business profits tax.

In sum, then, I urge you to oppose the draft report before you today. It would significantly diminish New Hampshire's ability to provide the public services that businesses across the state rely upon to remain competitive. It fails to acknowledge that business taxation in New Hampshire is already quite low relative to other states and it may ultimately create disincentives for businesses to remain in, or relocate to, New Hampshire.

Once more, I thank you for the opportunity to testify and would be more than happy to answer any questions you may have.

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[i] Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development,* Economic Policy Institute, 2004, p. 6.
[ii] Bartik, Timothy J., "Solving the Problems of Economic Development Incentives," *Growth and Change*, Spring 2005, p. 142.
[iii] Cline, Robert, et. al., *Total State and Local Business Taxes,* Ernst & Young Quantitative Economics and Statistics Practice, March 2010.
[iv] Cline, Robert, et. al., *Competitiveness of State and Local Business Taxes on New Investment,* Ernst & Young Quantitative Economics and Statistics Practice, April 2011.