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TESTIMONY OF JEFF McLYNCH
INSTITUTE ON TAXATION AND ECONOMIC POLICY
BEFORE THE NEW HAMPSHIRE GENERAL COURT
HOUSE COMMITTEE ON WAYS & MEANS
MARCH 5, 2009

Chairwoman Almy, Members of the Committee, thank you for the opportunity to appear before you this afternoon. My name is Jeff McLynch and I am the Northeast Regional Director of the Institute on Taxation and Economic Policy (or ITEP). Founded in 1980, ITEP is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy issues with an emphasis on tax fairness and adequacy.

I am here today to offer testimony on House Bill 642, which was introduced by Representative Jessie Osborne earlier this year and which would improve New Hampshire's tax system, both by generating additional revenue and by shifting greater responsibility for such revenue onto those state residents with a greater ability to pay.

In the time that has been allotted to me this afternoon, I would like to expand upon that general conclusion. In particular, my aim is to:

- offer a brief description of the bill;
- present ITEP's estimates of the revenue the bill would yield and of the effect the bill would have upon taxpayers at various income levels;
- examine some of the key differences between ITEP's estimates and the analysis of the bill conducted by the Department of Revenue Administration, and;
- discuss the need for an income tax in New Hampshire.

To begin, HB 642 would make six major changes to New Hampshire's tax system. It would:

- institute a new education income tax, with a relatively broad base, sizable personal and dependent exemptions, a single rate of 5%, and credits for renters, homeowners, and filers with out-of-state tax liabilities;

- institute a new property tax abatement program, under which filers would receive a tax rebate equal to upwards of as much of their property taxes as exceeds eight percent of their incomes;

- raise the existing statewide education property tax rate, which can vary from jurisdiction to jurisdiction, to a new, uniform level of 5.5 mils and provide a new $200,000 homestead exemption;

- repeal the existing interest and dividends tax;

- repeal the existing business enterprise tax, and;

- reduce the business profits tax rate to 7.5 percent.

Impact of HB 642 on State Revenue

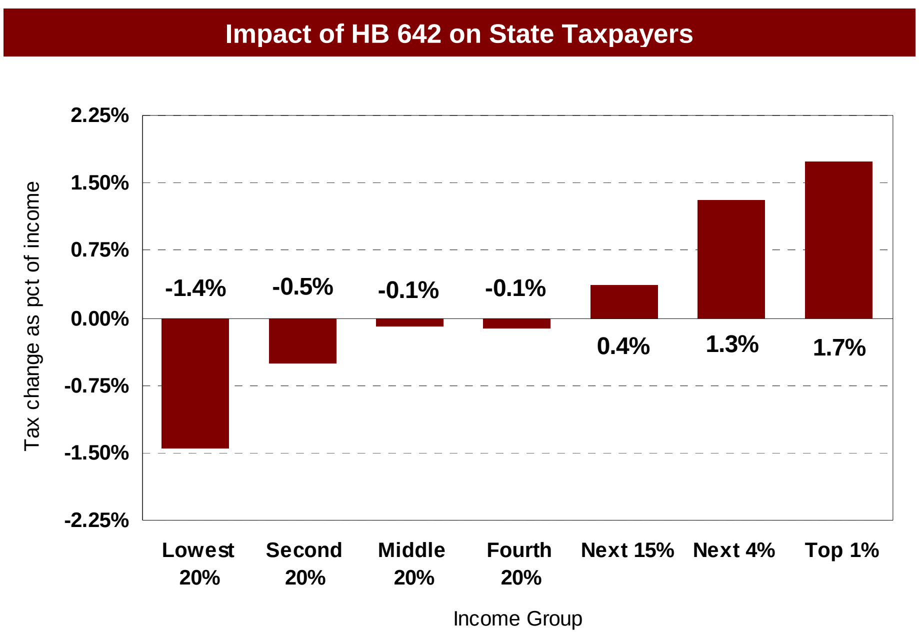
Provision	Change in Revenue ($M)
Institute a new statewide education income tax	803
Institute a new property tax abatement program	(107)
Increase the existing statewide education property tax rate to 5.5 mils and provide a homestead exemption of $200,000	182
Repeal the existing interest and dividends tax	(116)
Repeal the existing business enterprise tax	(222)
Reduce the business profits tax rate to 7.5 percent	(44)
TOTAL	**496**

Figures based on 2008 incomes and assume changes fully implemented in 2008; estimates for property tax abatement program assume 50% utilization rate

ITEP estimates that had each of these changes been in place in 2008, New Hampshire would have collected, in the aggregate, an additional $496 million in tax revenue. The new education income tax that the bill would create would have, on its own, produced roughly $803 million, while the alterations in the statewide education property tax would have yielded another $182 million. These gains would, of course, have been offset, in part, by the elimination of the interest and dividends and business enterprise taxes – moves that would have reduced tax revenue by $116 million and $222 million respectively – as well as by the $44 million in revenue lost to the drop in the business profits tax rate. In addition, the property tax abatement program that the bill would institute could be expected to cost approximately $107 million, though, as I will discuss in more depth later, somewhat higher costs are possible.

While the state of New Hampshire would see another $496 million flow into its coffers as a result of HB 642, the aggregate tax increase experienced by New Hampshire residents would be considerably less than that amount, for a variety of reasons. The most important of those reasons is the interaction between the New Hampshire tax system and the federal income tax. As the Members of this Committee are aware, federal taxpayers may elect to deduct the state and local taxes they pay in determining their incomes for federal tax purposes. Consequently, as state and local taxes rise, federal taxable income falls – and, with it, the federal income taxes people owe. In the case of HB 642, the income and property tax changes it would make would lead to a roughly $140 million reduction in the federal income taxes owed by New Hampshire residents. In other words, more than 25 percent of the impact from HB 642 would be exported to the federal government.

Perhaps even more importantly, while HB 642 would produce $496 million in additional revenue, the tax changes witnessed by New Hampshire residents would vary tremendously by income level. Taking all of the provisions of the bill together – including the new property tax abatement program – and accounting for the "federal offset" I've just detailed, HB 642 would:



- reduce the taxes paid by the poorest fifth of New Hampshirites – those individuals and families with incomes below $24,600 in 2008 – by 1.4 percent of income or by $205 on average.

- reduce the taxes paid by New Hampshirites in the middle fifth of the income distribution – that is, taxpayers with incomes ranging from $39,800 to $64,700 in 2008 – by about 0.1 percent of income. These middle-class taxpayers would receive a tax cut of $53 on average.

- increase the taxes paid by the wealthiest fifth of New Hampshirites – a group that includes taxpayers with incomes over $98,400 in 2008 – by 1.0 percent of income or by $2,250 on average. Within this group, the very richest 1 percent of New Hampshire taxpayers would experience a tax increase equivalent to 1.7 percent of income. These taxpayers – whose average income exceeded $1.3 million in 2008 – would pay an additional $23,340 in taxes on average, should HB 642 become law.

In short, HB 642 would render New Hampshire's tax system far more progressive, lowering taxes for those individuals and families who are struggling to make ends meet and raising taxes for those taxpayers who benefitted disproportionately from the federal tax cuts of the past eight years.

ITEP's estimates differ from the recent analysis conducted by the Department of Revenue Administration – and included in the fiscal note for HB 642 – in a number of key respects. First and foremost, the estimates I have presented are more comprehensive; with only a few exceptions, they reflect each of the provisions contained in Representative Osborne's legislation. The DRA has indicated, however, that it can assess neither the impact of the property tax or renters credits that would be available through the income tax under HB 642, nor the cost of the property tax abatement program that the bill would institute; each of these provisions is central to the aim of the bill. As a result, the fiscal note for HB 642 states that "this bill will have an indeterminable fiscal impact on state revenues…"

Nevertheless, DRA likely understates the amount of revenue that the new education income tax would produce. Absent credits, DRA expects that the income tax imposed under HB 642 would yield $976 million; under the same circumstances, ITEP estimates that the income tax would yield $1.2 billion. This nearly $240 million difference largely arises from two sources. First, DRA appears to use data from 2006 to produce its estimate; ITEP relies upon projections for 2008. Second, DRA appears to miscalculate the amount of taxable income under the measure, perhaps by as much as $3.2 billion. The Department appears to deduct the full aggregate amount of personal and dependent exemptions from aggregate adjusted gross income to arrive at aggregate taxable income; it fails to account for taxpayers whose individual adjusted gross income is less than the amount of exemptions for which they are eligible. This discrepancy, in turn, reduces the yield of the income tax by about $160 million.

KEY DIFFERENCES BETWEEN DRA AND ITEP ESTIMATES

	DRA		ITEP	
	Amount ($1000)	***Description***	***Amount ($1000)***	***Description***
Adjusted gross income (AGI)	37,411,489	2006 federal adjusted gross income less income from pensions and Social Security	39,096,154	Projected 2008 federal adjusted gross income less income from pensions, Social Security, and US obligations or already taxed under BPT, plus income from obligations of other states
Exemptions (gross)	17,470,555	Gross 2006 federal exemptions multiplied by amounts specified in bill	18,523,295	Projected 2008 federal exemptions, adjusted for dependent filers, multiplied by amounts specified in bill
Exemptions (net)	17,470,555	Gross exemptions unadjusted for taxpayers with AGI less than relevant exemption amount	14,809,729	Gross exemptions adjusted for taxpayers with AGI less than relevant exemption amount
Taxable income	19,940,934	AGI less net exemptions	24,286,425	AGI less net exemptions
Income tax prior to credits	976,621	Taxable income multiplied by 5 percent rate specified in bill, plus equivalent amount of tax paid on income from obligations of other states, less equivalent amount of tax paid on income already taxed under BPT and on income from US obligations	1,214,321	Taxable income multiplied by 5 percent rate specified in bill
Credit for taxes to other states	(155,000)		(251,243)	Figure based on projected 2008 federal itemized deductions for income taxes paid and Census 2000 data on commuting patterns
Property tax & renters credits	N/A		(159,948)	
Net income tax	821,621	Income tax prior to credits less estimated credits	803,130	Income tax prior to credits less estimated credits

To be sure, ITEP's estimates are not without their own limitations. More specifically:

- HB 642 offers two sizable pension exclusions – one for income attributable to a pension to which the taxpayer had made after-tax contributions and one for income attributable to a pension that the taxpayer received in lieu of Social Security. Due to data limitations, ITEP is unable to estimate the impact of these provisions of HB 642 and, thus, follows the DRA's lead in excluding all pension income from taxation. This necessarily understates the yield of the income tax.

- Similarly, neither ITEP nor DRA includes in their respective estimates the impact of the bill's $5,000 exemption for dependent filers, the bill's deduction for capital gains income derived from timber sales, and the bill's exclusion of interest and dividend income derived from college tuition savings plans; while the net effect of these shortcomings is to overstate the amount of revenue HB 642 would produce, the impact is likely fairly modest.

- ITEP's estimate of the impact of the credit the bill offers for, in essence, taxes paid to other states is considerably higher than the figure provided by DRA. If the actual impact of the credit is closer to the level anticipated by DRA, then ITEP's estimate of the yield of the income tax would rise.

- Finally, as noted earlier, ITEP estimates that the property tax abatement program included in HB 642 would cost approximately $107 million. This cost assumes that 50 percent of eligible taxpayers file claims under the program. If a smaller percentage of taxpayers file claims, the cost would, of course, fall; if a larger percentage file, it would rise. At the extreme, if every eligible taxpayer filed a claim – an outcome that seems unlikely given the experience of the federal government with the Earned Income Tax Credit and of state governments with other, similar "circuit breaker" tax credits – the cost of the program would climb to $218 million.

Before concluding, I would like to turn from the particulars of Representative Osborne's legislation to one of its fundamentals. As I noted at the outset, HB 642 would generate significant new revenue for the state of New Hampshire – at a time when greater revenues are clearly necessary – and would do so in an extremely fair manner. It is able to achieve these two ends largely because it would, for the first time, impose a broad-based income tax in New Hampshire.

Much has been made about the "New Hampshire Advantage" and the state's lack of a personal income tax. Policymakers and voters alike expound upon its virtues, but this distinction, if maintained, will diminish, rather than expand, economic opportunities here in the Granite State, for the absence of an income tax makes it all but impossible for New Hampshire's tax system to produce revenue in a fair and sustainable fashion.

The fairness of a state's tax system is largely determined by two factors: the mix of the different taxes it levies and the design of each of those taxes. Most of the taxes states and localities typically impose are regressive – they require low- and moderate-income taxpayers to devote a larger share of their incomes to paying taxes than upper-income taxpayers do. The principal source of revenue in New Hampshire – the property tax – certainly fits this description. For individuals, homes and vehicles are usually the only types of property taxed; yet, these are typically the only types of property owned by individuals and families in the lower half of the income distribution.

To mitigate the regressivity of sales, excise, and property taxes, states must levy a personal income tax. The personal income tax, because it is directly linked to one's ability to pay, is the most progressive major tax levied by states and localities. Of course, given the degree to which states and localities depend on regressive forms of taxation, a personal income tax, by itself, is not a sufficient means for achieving a tax system that is progressive overall. It must also be designed to produce an especially progressive outcome, combining features that mitigate the impact of the tax on low- and moderate-income taxpayers – such as sizable personal exemptions or refundable credits – with, in the ideal, a graduated rate structure, so that the tax rate one effectively pays rises with income.

For a tax system to be considered sustainable, it must yield a stream of revenue that grows at the same pace as the services it is intended to fund; over the long-run, both should grow along with the economy. To achieve that particular rate of growth, the taxes that make up a given tax system must, in turn, reflect the broader economic developments within the state. New Hampshire's tax system, with its particularly heavy reliance upon property taxes, reflects only a portion of total economic activity in the state.

In sum, for any state to have a fair tax system that will ensure those with the greatest ability to pay will bear more responsibility for funding government services, it must levy a progressive income tax. For any state to have a sound tax system that will yield an adequate stream of revenue into the future, it must levy a progressive income tax. HB 642 would levy a income tax that, within the constraints imposed by the New Hampshire Constitution, would achieve a progressive result; for that reason, it is certainly worth your consideration.

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