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TESTIMONY OF ROBERT TANNENWALD, SENIOR FELLOW, CENTER ON BUDGET AND POLICY PRIORITIES, BEFORE THE NEW HAMPSHIRE BUSINESS TAX COMMISSION

Executive Summary

- Business tax cuts and/or new business tax incentives will not put New Hampshire back on a path of stable, widely shared prosperity because:

    1. Business tax reductions will not pay for themselves. In order to finance them, the state will have to raise taxes elsewhere or cut vital public services.

    2. To stay competitive, the Granite State needs to keep teachers in classrooms and cops on the beat, and to have adequate water supplies, widely accessible health care, and well maintained roads and bridges.

    3. Business taxes are only 2 percent of business costs, on average. Labor compensation is a much larger share of these costs, dwarfing business taxes in importance. By trying to stimulate the state's economy by reducing business taxes, New Hampshire's policymakers would be trying to wag a large dog by a very short tail.

- The debate over business tax policy has become confused by complicated, misleading, widely quoted "indices" that attempt to compare states in terms of business costs, business "climates", and "business tax climate". These indicators should be given little credence in the business tax policy debate.

- State government must rely somewhat heavily on business taxes to avoid a broad-based income tax or sales tax . New Hampshire can't have its fiscal cake and eat it too.

Full Remarks

Mr. Chairman, members of the Commission, thank you for the opportunity to testify before you this afternoon. For the record, I am Robert Tannenwald, a Senior Fellow with the Center on Budget and Policy Priorities. The Center is a nonpartisan organization engaged in research at the federal and state levels on fiscal policy and public programs that affect low- and moderate-income

households and individuals. I specialize in state and local public finance. For 28 years, I pursued this specialty at the Federal Reserve Bank of Boston, as an applied scholar, advisor to policymakers, and manager of other researchers and analysts. I've done a lot of research on New England's economy and its state and local taxes, focusing especially on state tax competitiveness. I have directed the research and/or served as a member of several state tax study commissions in New England, including New Hampshire's Commission on Education Funding in 2000.

All of us want this "Great Recession" to end. (Regardless of what the National Bureau of Economic Research says, to most of us it still feels like a recession). We want the pink slips, foreclosures, and bankruptcies to stop. The people of New Hampshire want their governments and businesses to work together to help bring their economic lives back to normal and to return the Granite State to a path of stable, widely shared prosperity.

How much would reductions in state business taxes help? Not much, if at all, for two principal reasons:

- **Business tax cuts do not pay for themselves.** Consequently, if New Hampshire were to cut business tax rates and/or offer new business tax credits, it would have to impose cuts in public services or impose countervailing tax increases to balance its budget. These offsetting measures would create an economic drag, negating much, if not all, of the initial stimulus.

  (It has been argued that lowering tax rates or granting new tax credits might boost the state's economy so much that the state would enjoy more jobs, business investment, and tax revenues all at the same time. In my 30-plus years as a public finance economist, I have come across no credible evidence that state business tax reductions would produce such a "win-win" result.)

- **Business taxes are a small percentage of total business costs.** Nationwide, state and local taxes account for about 2 percent of business costs. By comparison, compensation of employees accounts for 18 percent of business costs in manufacturing and between 18 percent and 60 percent of costs in retail, services, information, and financial intermediation, depending on the specific line of business. New Hampshire has some of the most expensive labor in the nation. How can the state grow its economy by cutting business taxes, when the cost of labor looms so large? In pursuing the tax-cut option, New Hampshire would be trying to wag a large dog by a very short tail.

While these factors undermine the case for business tax cuts, debate over their wisdom has become bogged down in widely publicized but largely irrelevant statistics. I am referring to misunderstood "indices," measures that compare states in terms of "business costs", "state business climate", or "state business tax climate". New Hampshire's ranking according to these indicators provides little insight into how effectively business tax reductions would put residents of the Granite State back to work, keep them in their homes, or lift struggling business into the black.

Consider, for example, Forbes.com's index of business costs. In 2009 the Granite State ranked 40th out of the 50 states according to this measure; that is, its business costs were the 10th highest. However, this cost index is driven mostly by labor costs and energy costs. As I have already noted,

New Hampshire has some of the highest labor costs in the country. Energy costs are among the highest as well. This is why New Hampshire ranks so poorly on this particular index.

To the extent that this index takes taxes into account, it incorporates states' total tax level. The level of business taxes has little to do with it. New Hampshire has the lowest total tax level in the nation. Were it not for New Hampshire's rock-bottom overall tax level, the state would rank even worse according to Forbes' business cost index.

Forbes ranked the Granite State 47th in terms of regulatory burden, another poor rating sometimes interpreted to mean that the state's business taxes are too high. However, regulatory burden and tax burden are two different animals.

According to Forbes, New Hampshire is rich in other qualities that are important to a state's economic competitiveness: for example, availability of labor supply (New Hampshire ranks 6th), growth prospects (5th), quality of life (2nd only to Massachusetts). Forbes gives a state's quality of life high marks to the extent that its poverty rates, crime rates, and cost of living are low, and the caliber of its schools and the health of its citizens are high. A state cannot attain these valuable competitive attributes without cops on the street, teachers in the classroom, and widely accessible, affordable health care. Maintaining these valuable qualities requires revenue. With a total tax level that's already the lowest in the nation, at some point, by cutting taxes, New Hampshire will cut off its nose to spite its face.

Forbes ranked Utah as the best state in the nation for business and careers in 2009, the first time that Utah has earned this honor. There is some confusion about how Utah became "Number 1". Some have argued it did so in large part by lowering its top marginal corporate tax rate from 7 percent to a flat 5 percent. Actually, Utah lowered its personal income tax rate, not its corporate rate, which has been 5 percent for many, many years. More important, according to Forbes, Utah unseated the former perennial "Number 1", Virginia, because its labor and energy costs grew more slowly than those in Virginia. These two cost items, especially labor costs, are the big 800-pound gorillas that move Forbes' rankings. If you could tame these costs, you could really make a difference in New Hampshire's competitiveness; unfortunately, the factors that affect them — the price of oil, the weather, national and regional trends in labor markets — are largely beyond your control as policymakers.

Another often cited, widely misunderstood measure is the Tax Foundation's Business Tax Climate Index. This Index measures neither the burden of a state's taxes as a whole, nor that of any one of its taxes in isolation from the others. Rather, it gives a state high marks for having taxes that, in the Tax Foundation's judgment, do not affect economic choices. States that score well on this index have low *statutory* tax rates and broad tax bases with relatively few tax credits, special exemptions, and exclusions. Such states score well even if their overall tax *levels* — taxes paid relative to income earned — are high or the incentives they offer to businesses to locate within their borders are weak or non-existent. This formula for judging a state's business tax climate has some strange policy implications.

Consider the following illustrations:

- Three years ago, by enacting an R&D tax credit, New Hampshire diminished its Tax Foundation rating, because this tax credit discriminates in favor of industries intensive in research and development. The Tax Foundation would disapprove of the current proposal to expand the state's R&D credit.

- Vermont currently has a graduated personal income tax rate, with the lowest rate at 3.55 percent and the highest at 8.95. The Green Mountain State ranks poorly according to the Tax Foundation's index because its graduated rate structure allegedly discourages work effort and initiative and the top rate, 8.95 percent, is high relative to that of other states. Suppose Vermont started to tax all income at a uniform rate of 8.95 percent. Vermont's overall tax level would soar. But according to the Tax Foundation, its business tax climate would improve relative to its current value because the state, although still imposing a high top rate, would tax all households at that same high rate. Do you think that such a huge increase in taxes paid by families and small businesses would make your western neighbor more "welcoming" to business? It would, according to the Tax Foundation's Business Tax Climate Index.

New Hampshire does well overall on the Tax Foundation's measure because it has no broad-based income or sales tax. That is, the statutory tax rates for these non-existent taxes are effectively zero. The state's absence of business tax breaks compared to other states also raises its ranking. The Granite State has the 7th best business tax climate, according to the Tax Foundation.

Of all the widely circulated measures of business tax competitiveness, the "least worst one" one is the Council of State Taxation's (COST) effective business tax rate. In constructing this measure, COST totals up all the business taxes paid in a state. These include taxes on corporate income; sales taxes on business purchases; taxes on non-residential property; license taxes; unemployment insurance taxes; and personal income taxes paid by sole proprietorships and partnerships. It includes taxes paid by all types of businesses, not just corporations. Ideally, COST would then divide total business taxes by business profits earned within the state. However, estimates of business profits are not readily available on a state-by-state basis. So, COST divides total business taxes by private sector gross domestic product (GDP), using the latter as a proxy for profits.

According to this highly imperfect measure, New Hampshire's effective business tax rate is a little high, but not much, compared to other states. It ranked 31th among the 50 states in Fiscal Year 2009, the latest year for which estimates are available (I am ranking the state with the lowest business tax burden first, that with the highest tax burden last). The state's business taxes were 5 percent of state private sector GDP, compared to 4.7 percent for the nation as a whole. Regionally, the state compared favorably to Maine, New York, Rhode Island, and Vermont, and unfavorably to Massachusetts and Connecticut.

New Hampshire's modestly elevated business tax burden is not surprising. The state's heavy reliance on local property taxes, the largest component of business taxes in most states, is the primary reason why its business tax burden is a little high. New Hampshire has long championed strong, independent local governments, whose only major source of revenue is the property tax.

Since municipalities can't discriminate among property taxpayers, businesses and households alike pay high property taxes in the Granite State.

The state, meanwhile, has consistently rejected a broad-based state income tax or sales tax. That leaves the state few revenue options other than business taxes, the rooms and meals tax, real estate transfer taxes, and federal aid. Under these very restrictive limitations, it is surprising that your business tax level compares favorably with as many states as it does.

New Hampshire cannot have its fiscal cake and eat it too. If you reduce business taxes, and you do not raise other taxes, your public services will suffer. Yet, improvements in high quality public services—like education, public safety, and the maintenance and renovation of infrastructure — would bolster New Hampshire's competitive standing as much as, if not more than, cuts in business taxes.

Again, thank you. I would be happy to answer any questions.