

**Testimony of  
Michael P. Ettlinger, Tax Policy Director  
Institute on Taxation and Economic Policy  
Regarding  
HOUSE BILL 109  
January 19, 1999**

Thank you Mr. Chairman and members of the Committee for the opportunity to appear today. I will be discussing three aspects of House Bill 109, the Hager/Below/Fernald Education Funding and Property Tax Relief Plan. I will be addressing the income tax revenue estimate, the distributional impact and the economic impact of this legislation.

**The Institute on Taxation and Economic Policy (ITEP) and the ITEP Tax Model**

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980. Since 1996 ITEP has used a microsimulation tax model to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data that is extrapolated to the year being analyzed. This is the type of tax model used by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, and the Congressional Budget Office and many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records (including 6,790 records for New Hampshire). Included in the sample are federal tax returns, with statistically valid samples from every state and the District of Columbia. A sampling of records from the U.S. Decennial Census five percent sample (which contains a random sample of five percent of all census forms received by the Census Bureau) are also included, and statistically matched with the tax return records. The data on the records is extrapolated to subsequent years using federal tax micro and

tabular data, Census Bureau Current Population Survey micro and tabular data, and government and other widely respected macro data sources.

These, and other, data are used by the model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. The modules calculate tax liability on a record-by-record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 1996, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. This study was released jointly with Citizens for Tax Justice. *Who Pays?* shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices.

ITEP often conducts research in individual states. This work has been primarily funded by private foundations. Recent major foundation-funded state studies include *Building a Better Arkansas Tax System* (1997), *Tax Strategies for a Strong Minnesota* (1998) and *Choices for Iowa: Building A Better Tax System* (1998). The Arkansas study was funded by the Winthrop Rockefeller Foundation and the Joyce Foundation funded the Minnesota and Iowa studies.

In addition, ITEP has begun to do analyses on a contract basis. For example, ITEP was retained last year by the District of Columbia Tax Revision Commission to conduct revenue and incidence analysis of the current District of Columbia tax system and to help develop reform proposals. In 1997 ITEP was hired by the Maine Municipal Association to analyze a proposal the association developed for changes to Maine's tax system. Also in 1997, several labor unions in Oregon retained ITEP to analyze business taxes in that state.

### **Comparison of Recent ITEP Model Results with Actual and Predicted Revenues**

The ITEP Personal Income Tax model reports revenues that are very close to actual revenues and state revenue departments' projections. In the personal income tax modeling work done by ITEP last year, model results for Iowa, the District of Columbia, Minnesota, California and Maine have been within three percent of revenues or projections as reported by state officials. In addition, the ITEP estimate for the current New Hampshire narrow-based income tax (the interest and dividends tax) for 1998 is within one-half of one percent of official estimates.

The ITEP model's personal income tax module can run federal, as well as state tax law. The model produces results consistent with reported state-by-state information on federal taxes as well national projections from federal government estimators. In particular, the ITEP model produces results extremely close to the 1996 federal Internal Revenue Service tabular data for New Hampshire (1996 is the latest year for which this data is currently available). The ITEP model reports Adjusted Gross Income that is 1.0% higher than that reported by the IRS.<sup>1</sup>

## **Income Tax Revenue Estimate**

We have analyzed what the income tax proposed in House Bill 109 would raise for several tax years. By tax years we mean the year for which a tax return is filed. For example, our estimate for the year 2000 reflects the amount of tax that would be paid on year 2000 tax returns, filed by April 15 in 2001. Most of the revenue for tax year 2000 would be collected in calendar year 2000 through withholding. Some portion of the revenue would, however, be collected in calendar 2001—mostly at the time of tax return filing.

If the personal income tax specified in House Bill 109 had been implemented in 1996, it would have raised \$507 million. This estimate assumes everything in House Bill 109 as drafted, including personal exemptions of \$10,000 and dependant exemptions of \$4,000. This estimate, and the other estimates I will present, does not account for the revenue lost with the repeal of the interest and dividends tax.

If, as appears more likely, the personal income tax were implemented in the year 2000, the revenue would be \$720 million. Note that this is substantially more than the 1996 estimate—42 percent more. This large difference is due to two factors. First is increasing income. Federal Adjusted Gross Income, which is approximately the tax base used in this tax, grew by 8.1 percent from 1994 to 1995 and by 9.1 percent from 1995 to 1996 in New Hampshire. Our year 2000 estimate reflects a projected average growth rate in Adjusted Gross Income of 6.8 percent per-year from 1996 to 2000, or 30 percent overall.

This growth in income obviously only partially explains the reason the 2000 estimate is so much higher than the 1996 estimate. The other reason is that the 1996

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<sup>1</sup>A comparison of tax liability is not readily available. The IRS table tax liability line includes the FICA self-employment tax in addition to personal income tax liability. ITEP has only calculated the personal income tax liability.

estimate was done using the same exemption amounts as the 2000 estimate. The reduction in the real value of the exemptions over time has a very significant impact on revenues. This has been observed in many tax systems that do not index exemptions and other provisions of their tax code for inflation or other indicators.

An example can serve to illustrate how our estimate for 2000 can exceed our estimate for 1996 by more than the growth in income. Assume a married couple with annual income in 1996 of \$25,000. In our 1996 analysis they get \$20,000 of exemption under House Bill 109, leaving them with \$5,000 of taxable income. Just to keep the math simple, let's say their income went up by an even 20 percent by 2000. This gives them year 2000 income of \$30,000. They still, however, get an exemption of \$20,000. \$30,000 minus the \$20,000 exemption leaves them with \$10,000 of taxable income. So despite their income being only 20 percent higher, their taxable income doubles from \$5,000 to \$10,000 and their tax liability doubles. Thus, analyzing H.B. 109 for the year 2000 produces a great deal more revenue than an analysis using the same exemptions for 1996.

Income Growth vs. Tax Liability Growth Without Indexing for Inflation: A Sample Married Couple with No Children			
	1996	2000	% change
Income	\$25,000	\$30,000	+20%
Exemptions	\$ -20,000	\$ -20,000	—
Taxable Income	\$5,000	\$10,000	+100%
Tax	\$200	\$400	+100%

Note that under House Bill 109 the unfair result illustrated above doesn't actually occur to anyone once the legislation is adopted. The exemption amounts are indexed to inflation. Thus, taxes do not go up for taxpayers in real terms unless their income goes up at a rate greater than inflation. Revenue will still rise faster than inflation because, overall, with real economic growth, the populace sees its income rise faster than inflation. And, because the exemptions are constant in real terms, revenue will increase at a greater rate than income growth (as the income increases, the exemptions exempt a lower share of income). But the tax growth will only reflect real growth in prosperity and ability to pay.

The reason we did the 1996 estimate is that it is our understanding that the Department of Revenue Administrations (DRA) has done a 1996 estimate and we wanted to provide a basis of comparison. We used the year 2000 exemptions of House Bill 109 because that is what were told DRA is doing. Those of you who recall my testimony last March will remember that there was, at that time, substantial disagreement between the DRA and ITEP estimate for 1995. At that time, DRA

estimated revenue for this income tax of \$342 million. The ITEP estimate was \$492 million.

As actually implemented in 2000 and in subsequent years, the revenue would be substantially greater than as modeled in 1996 for the reasons I've indicated: the growth in income and the reduced value of the exemptions in real terms.

The gross revenue we estimate for 2001 is \$757 million and \$799 million for 2002. Note that the growth in revenue for those two years averages only 5.3 percent. This growth number is lower than the implied growth rate from 1996 to 2000 because of the indexing of the exemptions and because we're being cautious in our estimates of income growth. We estimate Adjusted Gross Income will grow by a rate of 5.1 percent over these two years.

1996	\$507	no indexing
...	...	"
1999	\$678	"
2000	\$720	"
2001	\$757	indexing
2002	\$799	"

## **Distribution**

New Hampshire has a regressive tax system. Those with lower incomes pay a higher share of their income in taxes than those with higher incomes.

New Hampshire, in fact, has one of the more regressive tax systems in the country. New Hampshire's tax system would be even more regressive if the state had a general sales tax. Nevertheless, reliance on other consumption taxes like those on gasoline and tobacco and high, regressive, property taxes, make for a highly regressive system.

Middle-income taxpayers in New Hampshire pay 7.0 percent of their income in taxes while the best off one-percent, with average incomes of \$824,000, pay only 3.8 percent. Low-income taxpayers pay 9.9 percent. Some may be surprised by this high percentage at bottom of the income spectrum. It should be noted that even small dollar amounts of taxes place a substantial burden on those with low incomes. Thus, although home values are lower at low income levels, and the level of home ownership is lower, relatively small average amounts of property taxes in dollar terms place a substantial burden on low-income people. In addition, our model conservatively assumes that only half the property tax on rental property is passed on to renters in the form of higher rents.

## New Hampshire Taxes in 1998 As Shares of Family Income for All Taxpayers

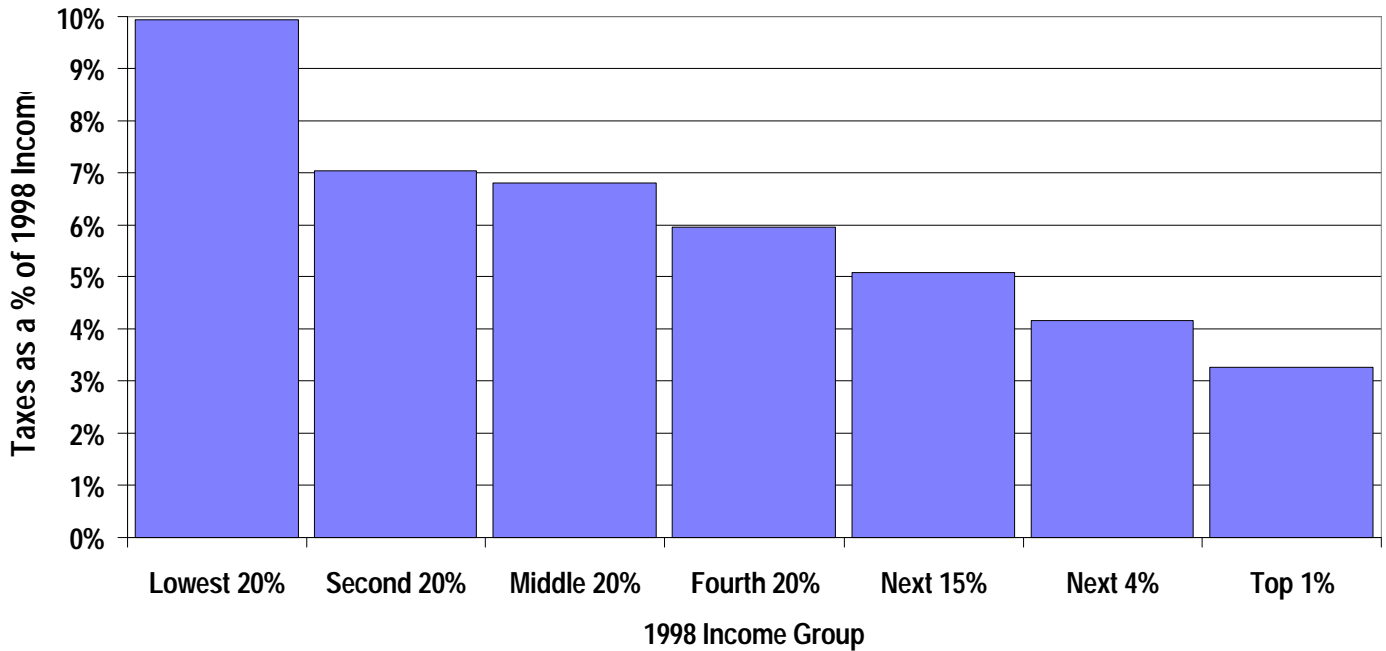
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	\$9,500	\$22,000	\$35,100	\$54,300	\$88,200	\$173,000	\$824,000
Income Range	Less than \$16,200	\$16,200 – \$27,800	\$27,800 – \$43,600	\$43,600 – \$67,900	\$67,900 – \$126,000	\$126,000 – \$269,000	\$269,000 or more
<b>Consumption taxes</b>	<b>2.5%</b>	<b>1.8%</b>	<b>1.5%</b>	<b>1.1%</b>	<b>0.9%</b>	<b>0.5%</b>	<b>0.2%</b>
Excise taxes, individuals	2.1%	1.5%	1.2%	0.9%	0.7%	0.4%	0.2%
Excise taxes, business	0.5%	0.4%	0.3%	0.2%	0.2%	0.1%	0.1%
<b>Property taxes</b>	<b>6.9%</b>	<b>5.0%</b>	<b>5.1%</b>	<b>4.8%</b>	<b>4.5%</b>	<b>3.9%</b>	<b>2.4%</b>
Property taxes on families	6.7%	4.8%	4.8%	4.4%	4.2%	3.3%	1.1%
Business property taxes	0.2%	0.2%	0.3%	0.3%	0.3%	0.6%	1.3%
<b>Income taxes</b>	<b>0.5%</b>	<b>0.3%</b>	<b>0.4%</b>	<b>0.4%</b>	<b>0.5%</b>	<b>0.7%</b>	<b>1.2%</b>
Interest & Dividends Tax	0.2%	0.0%	0.1%	0.1%	0.1%	0.3%	0.6%
Corporate Income Tax	0.3%	0.3%	0.3%	0.3%	0.3%	0.4%	0.6%
<b>Total before Federal Itemized Offset</b>	<b>9.9%</b>	<b>7.1%</b>	<b>7.0%</b>	<b>6.3%</b>	<b>5.9%</b>	<b>5.1%</b>	<b>3.8%</b>
Federal Itemized Deduction Offset	—	-0.1%	-0.2%	-0.4%	-0.8%	-0.9%	-0.6%
<b>Net Taxes after Federal Offset</b>	<b>9.9%</b>	<b>7.1%</b>	<b>6.8%</b>	<b>6.0%</b>	<b>5.1%</b>	<b>4.2%</b>	<b>3.3%</b>

## HB 109 As Shares of Family Income for All Taxpayers

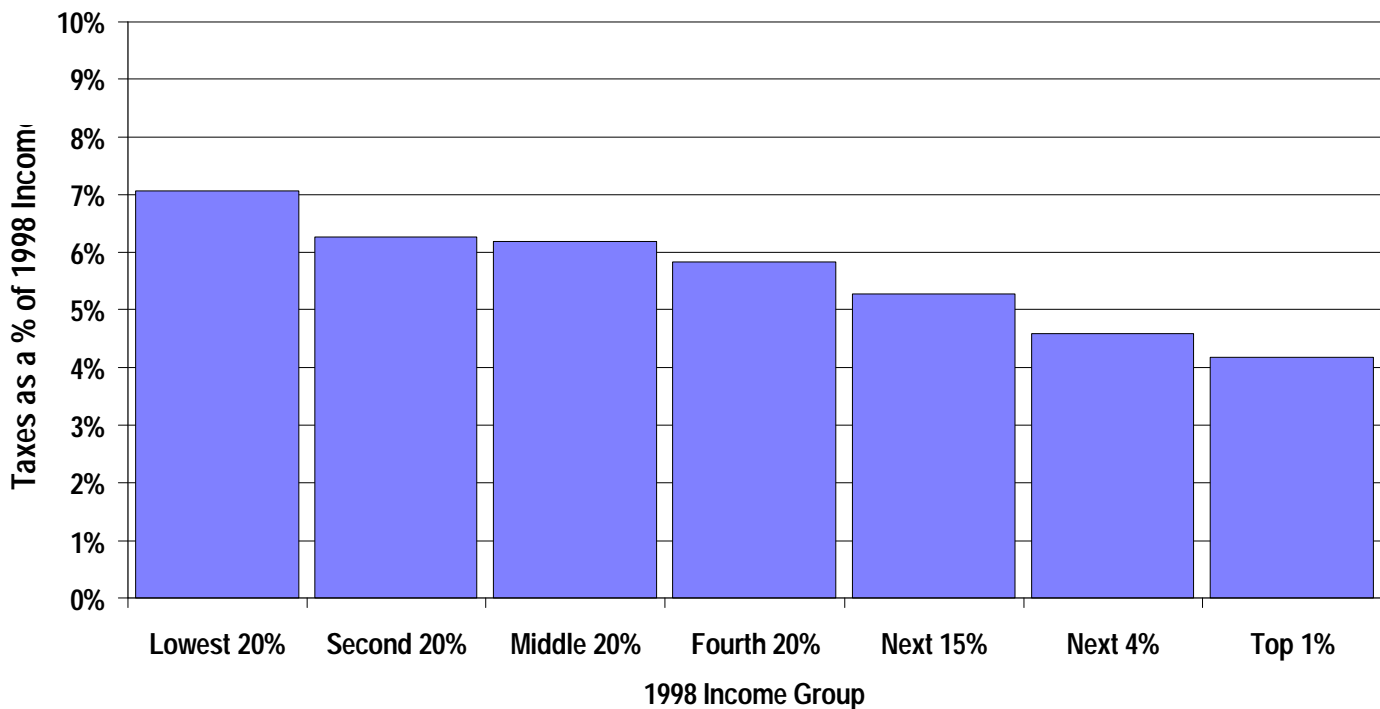
Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	\$9,500	\$22,000	\$35,100	\$54,300	\$88,200	\$173,000	\$824,000
Income Range	Less than \$16,200	\$16,200 – \$27,800	\$27,800 – \$43,600	\$43,600 – \$67,900	\$67,900 – \$126,000	\$126,000 – \$269,000	\$269,000 or more
<b>Consumption taxes</b>	<b>2.5%</b>	<b>1.8%</b>	<b>1.5%</b>	<b>1.1%</b>	<b>0.9%</b>	<b>0.5%</b>	<b>0.2%</b>
Excise taxes, individuals	2.1%	1.5%	1.2%	0.9%	0.7%	0.4%	0.2%
Excise taxes, business	0.5%	0.4%	0.3%	0.2%	0.2%	0.1%	0.1%
<b>Property taxes</b>	<b>3.9%</b>	<b>2.9%</b>	<b>3.0%</b>	<b>2.8%</b>	<b>2.7%</b>	<b>2.3%</b>	<b>1.7%</b>
Property taxes on families	3.7%	2.7%	2.7%	2.6%	2.4%	1.9%	0.7%
Business property taxes	0.2%	0.2%	0.3%	0.3%	0.3%	0.5%	1.1%
<b>Income taxes</b>	<b>0.6%</b>	<b>1.6%</b>	<b>1.9%</b>	<b>2.2%</b>	<b>2.5%</b>	<b>2.9%</b>	<b>3.6%</b>
HB 109 Personal Income Tax	0.3%	1.3%	1.5%	1.9%	2.2%	2.5%	3.0%
Corporate Income Tax	0.3%	0.3%	0.3%	0.3%	0.3%	0.4%	0.6%
<b>Total before Federal Itemized Offset</b>	<b>7.1%</b>	<b>6.3%</b>	<b>6.3%</b>	<b>6.2%</b>	<b>6.1%</b>	<b>5.7%</b>	<b>5.5%</b>
Federal Itemized Deduction Offset	—	-0.0%	-0.1%	-0.3%	-0.8%	-1.1%	-1.3%
<b>Net Taxes after Federal Offset</b>	<b>7.1%</b>	<b>6.3%</b>	<b>6.2%</b>	<b>5.8%</b>	<b>5.3%</b>	<b>4.6%</b>	<b>4.2%</b>
<i>Change from Current Law BEFORE Offset</i>	<i>-2.9%</i>	<i>-0.8%</i>	<i>-0.7%</i>	<i>-0.1%</i>	<i>+0.2%</i>	<i>+0.6%</i>	<i>+1.7%</i>
<i>Change from Current Law AFTER Offset</i>	<i>-2.9%</i>	<i>-0.8%</i>	<i>-0.6%</i>	<i>-0.1%</i>	<i>+0.2%</i>	<i>+0.4%</i>	<i>+0.9%</i>

SOURCE: Institute on Taxation and Economic Policy, January 1999.

### All New Hampshire Taxes in 1998 as Shares of Family Income - After Federal Offset



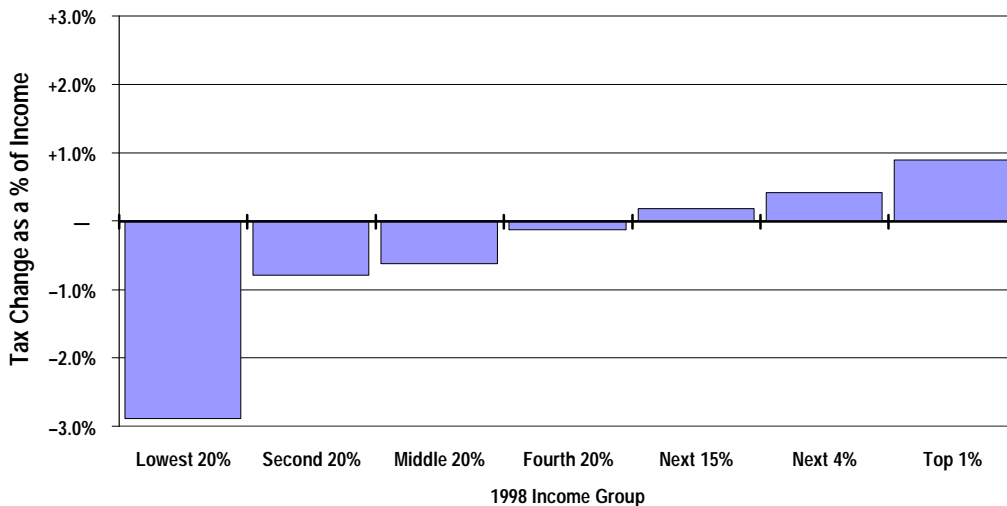
### New Hampshire Taxes With HB 109 - After Federal Offset



If H.B. 109 had been adopted in 1998, the tax system would be less regressive. As the tables and charts show, taxes would be cut for all but the top income quintile—with the middle 20 percent receiving a tax cut of 0.7% of income and the bottom group having a tax cut of 2.8 percent of income. The best-off one-percent would see the largest increase, equal to 1.7 percent of income.

These numbers, however, ignore an important factor. Property and state personal income taxes are deductible on the federal tax return. Thus, if a taxpayer has their property taxes cut, their deductions go down and their federal personal income tax liability goes up. If a taxpayer has their state personal income tax liability go up, their federal tax liability goes down. The table shows the total change in taxes after accounting for federal tax changes. This is the true impact on the people of New Hampshire. Here we see that the tax cut at lower incomes is slightly less before accounting for federal tax consequences—a cut of 0.6% of income for the middle group instead of 0.7% of income. For the top group, however, the tax increase is significantly less using this measure: 0.9 percent of income instead of 1.7 percent. There are two reasons that the effect on the better-off is larger. First, they are in higher federal marginal tax brackets so deductions for state and local taxes paid are more valuable to them. Second, the wealthy are more likely to itemize their taxes on their federal tax returns and be able to take advantage of the deductions.

**HB 109: Tax Change from Current Law as a Share of Income  
(After Federal Offset)**



The adoption of a personal income tax would better connect New Hampshire citizens' tax bills to their ability to pay. This is important in the broad sense that those who have



more are asked to contribute more. It is also important, however, even to those for whom the current New Hampshire tax system does not usually burden very heavily. As many people in New Hampshire remember from the recession of the early 1990s, property tax bills do not decline when income declines. The income tax burden declines when income declines, whether the downturn be temporary or permanent. This helps taxpayers in dealing with challenges such as economic recessions or personal misfortunes.

## **The Economic Impact**

As discussion of an income tax for New Hampshire progresses, the question of the economic impact of such a tax will no-doubt be hotly contested. We do not, in this testimony, attempt to definitively quantify the economic impact of New Hampshire adopting a personal income tax. We suggest, however, that some of the apocalyptic predictions that will no doubt be made, are, at best, exaggerations.

At any given time, using any given measure of economic performance, some states are doing well and some states are doing less-well. Frequently, a given state will rank high by some measures and low by others. And which states are doing well and which states are doing poorly by any given measure typically varies substantially over time. For this reason, the conclusion of any analysis of whether having low personal income taxes help a state economically is heavily dependent on the economic measures used and the time periods selected.

Nevertheless, one broad statement is clear: There are states with high personal income taxes with economies that have performed very well and states with low, or no, personal income taxes with economies that have performed very badly.

ITEP recently did detailed studies of the Iowa and Minnesota tax systems and compared them to the other states in the region. Minnesota has done the best in the region by almost any economic measure. Minnesota also has one of the highest income taxes in the country, and the highest in the region. South Dakota, with no personal income tax, has done worse than Minnesota, and by several economic measures worse, than states in the region that have personal income taxes.

Nationally, four of the top ten states in per-capita personal income are also in the top ten in income tax burden. New Hampshire, of course, is also in the top ten in per-capita personal income, but it's the only state without a personal income tax to make the list.

There are high income tax states like North Carolina and Delaware that have, over a long period of time, had good economic growth by a variety of measures. Low, or no personal income tax states such as North Dakota, Alaska and Wyoming have done poorly by a number of measures.

Since it adopted its personal income tax, effective in 1992, Connecticut has ranked fourth among the states in per-capita personal income growth—one of the best measures of the financial well-being of the citizens of a state. In fact, Connecticut reclaimed its position as having the highest per-capita income in the country in 1996, after falling to second prior to the adoption of the income tax.

This evidence does not prove that adopting a personal income tax would be beneficial to the New Hampshire economy, although that might well be the case. It highlights, however, the fact that there are 41 states with broad-based personal income taxes, most of them doing quite well. Furthermore, even the ones with the highest personal income tax burdens are not suffering in any way that is apparent from the data.

An honest assessment of the data over long periods of time leads to the conclusion that personal income taxes do not adversely impact on states' economies in any significant way. This really shouldn't be surprising. After all, there are other things that are far more likely to have an impact. Compared to other costs of doing business—labor costs, proximity to markets, quality of work force and a variety of other factors—the burden of the personal income tax is quite a small factor.

The argument is sometimes made that state personal income taxes influence the locational preferences of entrepreneurs and CEOs. The suggestion is that these individuals, who have a disproportionate impact on a state's economy are far more likely to locate in a state where they will pay less tax. There are, however, a number of flaws in this argument.

First, as mentioned above, there are other factors which are far more likely to affect the success or failure of a business venture than personal income tax liability.

Second, presumably we are talking about wealthy businesspeople, since middle- and low-income businesspeople are actually better off in a state that relies more heavily on progressive income taxes than regressive taxes. One of the primary benefits of being wealthy is the opportunity to live where one wants to. A few percentage points of personal income tax is unlikely to have a major impact on the decision of where to enjoy one's prosperity. An example of this that has recently been in the press is the

founder and President of Gateway computers. He recently moved himself, most of the company's executives and engineers from South Dakota, where there is no personal income tax, to California which has a one of the highest top personal income tax rates. He decided he wanted to live in Southern California, he was having trouble attracting other talented individuals to South Dakota and he was in a position to do what he wanted—so he did.

Third, the differences between states in the personal income tax liability for a wealthy person is typically quite small. This is, in part, because of the impact of the deduction on the federal tax return for state taxes. A wealthy person in a state with a tax rate of 6 percent pays that percent of his or her taxable income to the state. But if they are in the top federal tax rate bracket (approximately 40%), their federal personal income tax is reduced by an amount equal to 2.4 percent of their taxable income. Thus the net cost of the state income tax is only 3.6 percent.

In the specific case of New Hampshire and House Bill 109, the argument that this bill would harm New Hampshire's economy is particularly weak. For one thing, New Hampshire would still have one of the lowest personal income taxes in the country. New Hampshire currently ranks 42nd in personal income tax as a share of personal income. The interest and dividends tax puts New Hampshire above states that have no personal income tax whatsoever and above Tennessee which has a similar tax.

We estimate that if the personal income tax of House Bill 109 were adopted, that New Hampshire would rank 40<sup>th</sup> in personal income tax collections—above only North Dakota and Mississippi of the states with broad-based personal income taxes. And, because House Bill 109 indexes its exemptions for inflation, something that many other states do not do, New Hampshire would very likely remain at the bottom of the list.

In addition, at a 4 percent rate, after the offset for lowered federal tax payments because of the deduction of state income taxes paid, the top effective rate would be only 2.4 percent. This is unlikely to be a substantial deterrent for wealthy entrepreneurs and businesspeople who are paying 40 percent in the federal income tax.

Finally, one must balance the bad of the income tax against the good. For many citizens taxes would go down under House Bill 109. Property taxes would go down substantially for most individuals and businesses would also see a significant property tax cut.

In addition, funds that have, to date, left the state would remain in New Hampshire. First, as mentioned above, federal income tax payments by New Hampshire residents would go down overall. If House Bill 109 was in law, New Hampshire citizens would pay between \$40 and \$50 million less in federal personal income taxes. That is \$40 to \$50 million that under current law would go to Washington, which, under H.B. 109, would instead be retained in the state.

Additionally, those who live outside of New Hampshire but work in the state would now pay New Hampshire personal income tax. This is money that currently is paid by these people to their home states. With passage of House Bill 109, these funds would remain in New Hampshire.

If New Hampshire were to adopt H.B. 109, it is highly unlikely that there would be any significant negative economic consequences. New Hampshire would still be a low-tax state, still be a low-income tax state and would lose its title as the highest property tax state. And the offsetting benefits to adoption of the income tax proposed in House Bill 109 would be significant.