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CHAPTER ONE

INTRODUCTION

The challenge facing this Commission was to evaluate revenue options that would generate the \$825 million the Legislature deemed necessary to fund an adequate education in fiscal year 2000.

After meeting with citizens at public forums across the state, analyzing findings by the Commission research staff and other experts, and its own extensive deliberations, the Commission realized that it was involved in something far more critical than tax options and funding formulas.

The Executive Order that established the Commission charged that: "It is critical that our tax system enable New Hampshire to compete in the new and increasingly global economy." The members of this Commission believe that funding that will create and maintain an excellent education system is essential to New Hampshire's quality of life and economic well being. All the state's citizens must have the opportunity to receive an education that will truly enable them to participate fully in today's labor market. Employers must continue to see New Hampshire as an attractive and profitable business location.

New Hampshire currently enjoys a vibrant economy. Even with signs that the economy may now be cooling, the state compares favorably with its neighbors by most economic measures. The Commission is sensitive to the need to sustain this growth and recognizes that tax and fiscal policies are important drivers of this economic engine. Economic and other factors unique to New Hampshire make the new revenue challenge especially difficult. But a strong economy, a favorable tax climate and a competitive workforce are not mutually exclusive goals. The challenge to the state's executive and legislative leadership is to strike the right balance.

Indeed, during public forums and other sessions, the Commission frequently heard from citizens and economists that tax policy alone can be only one piece of the state's economic fabric. Other factors, such as the quality of the state's workforce and its educational systems -- and the ability of its citizens to compete in today and tomorrow's economy -- matter as much or more, they said.

The Commission fully appreciates that any new tax option carries social, political and economic implications well beyond those identified in this report. Its mandate is limited to evaluating ways to raise a set amount of revenue through a set of tax options and to measure those taxes against a set of policy criteria.

Time and resources limited its ability to examine such broader implications and to suggest ways to mitigate potentially negative effects of a given revenue option. The Commission depends upon policy makers to identify more comprehensively and to examine this full range of implications as they build an actual tax policy for the state.

This study examined a wide variety of tax alternatives to meet the funding required and to produce findings as definitive and precise as the research would allow, given the assumptions made for each option. Those assumptions – as well as some of these findings -- may be challenged, and constructive dialogue that helps the state move toward the best possible fiscal policy is welcomed.

The Commission has done its best to give policy makers and the public an information framework that is reasonably comprehensive yet more succinct, more readable and more cohesive than any they have had before.

Rather than an end to a discussion, this report is intended to serve as a step toward continuing an informed debate that leads to a positive outcome.

State of New Hampshire
By Her Excellency
Jeanne Shaheen, Governor

EXECUTIVE ORDER 2000-2

**An order establishing
A Commission to Analyze the Economic Impacts
of Various School Funding Revenue Options**

WHEREAS, the New Hampshire Supreme Court's Claremont II decision requires the State to provide no less than an adequate education to all public school students in New Hampshire and that any taxes used to fund that mandate be proportional and reasonable pursuant to Part II, Article 5 of the New Hampshire Constitution; and

WHEREAS, the Legislature has set the initial cost of funding an adequate education at \$825 million annually; and

WHEREAS, it is critical that the State meet its Claremont II school funding obligation in a way that will both maintain the strength of the New Hampshire economy and promote excellence in our state's education system; and

WHEREAS, it is critical that our tax system enable New Hampshire to compete in the new and increasingly global economy;

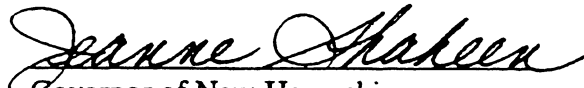
NOW, THEREFORE, I, JEANNE SHAHEEN, Governor of the State of New Hampshire, by virtue of the power and authority vested in me by part II, article 41 of the New Hampshire Constitution, do hereby issue this order to become effective immediately:

1. A Commission is hereby established for the purpose of analyzing the economic impacts of various school funding revenue options.
2. In undertaking its analysis, the Commission shall analyze various school funding revenue options and determine with respect to each revenue option the following:
 - To what extent will the revenue option impact the New Hampshire economy as a whole?
 - To what extent will the revenue option impact particular sectors of the New Hampshire economy, property values, and taxpayers?
 - Can the option provide a stable, sufficient and administratively efficient source of revenue for the foreseeable future?
 - Does the revenue option enable local communities to lower property taxes?
 - Are there any changes to other state laws and/or state taxes that would mitigate the economic impact of the revenue option?

Executive Order 2000-2

3. The Governor shall appoint members to the Commission who are leaders in the fields of business and economics and who can provide an objective analysis of various revenue options.
4. In undertaking its analysis, the Commission shall seek the input of economists, New Hampshire businesses, and New Hampshire citizens across the state.
5. The Commissioner of Revenue Administration shall cooperate with the Commission in its work.
6. The Commission shall report its findings to the Governor no later than January 1, 2001.

Given under my hand and seal at the
Executive Chambers in Concord, this
4th day of April, in the year two
thousand.


Governor of New Hampshire

New Hampshire Commission on Education Funding

Chairman

David T. McLaughlin
President-Emeritus, Dartmouth College

Members of the Commission

Stephen P. Barba, President and Managing Partner
The Balsams Grand Resort Hotel

Joseph A. Baute, Director
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Johnson & Dix Fuel Corporation

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CHAPTER TWO

OVERVIEW

This Commission has sought to balance its evaluation of taxes that would meet revenue needs with consideration of the policy tradeoffs of different tax options. Taxes had to be compared not only to each other, but also to other factors, such as the state's competitive standing. The broad conclusion: if reasonably imposed, no one of these tax options would prove detrimental to New Hampshire's economy or its social fabric. But too much dependence upon any single tax – or new tax rates that are too high – could risk economic harm.

If the question is, "Which tax would be the best?", this Commission found no single tax to be superior – or inferior -- on all counts. Some tax options have great revenue potential, but could stunt economic growth or in the eyes of many, distribute tax burdens unfairly. Other taxes may have a relatively small effect on the economy, but complicate tax compliance and enforcement.

In this report, the Commission evaluated each tax option as if it *alone* were to meet the \$825 million target. In fact, it is unlikely that any one tax will meet the full funding requirement. Such single-tax dependence would either impose an unduly harsh burden on certain sectors or populations or would have to be set at an unrealistically high rate. For that reason, putting together combinations of revenue options may offer the greatest promise for meeting the funding requirement. Though the Commission was unable to conduct an in-depth analysis of all combination tax options, it poses some possibilities in Chapter 5.

One underlying assumption is important to point out here. After reviewing economic research, the Commission assumed that any of the tax options (except the property tax) raising \$825 million for education would ultimately reduce local property taxes by about half that amount. If in fact the effect on local property taxes were different, so too would be the resulting data and the effects on competitiveness.

Each of the individual revenue options evaluated by this Commission has strengths and weaknesses. Given limited time and research resources, the Commission gave most emphasis to those options that could adequately meet the fiscal requirement specified in the Executive Order. Some options – excise and capital gains taxes, for example – do not hold that revenue potential. A lack of sufficient analytical data prevented deeper analysis of the gross receipts tax.

Chapter Three explains the policy grounds against which tax options were weighed, which revenue options were evaluated, and how. Chapter Four presents the Commission's in-depth analysis and findings, measuring each tax

against the policy criteria. This chapter also discusses the proposal to legalize video lottery terminals (VLTs). Though revenues from VLTs do not come from a broad-based tax, supporters of VLTs contend that such expanded gambling could represent a significant source of revenue. Consequently, VLTs are evaluated as a revenue option, but not fully against the set of policy criteria designed for more traditional taxation proposals.

Chapter Five presents some examples of the impact of possible tax combinations, and Chapter Six contains additional observations and limited findings on other revenue options not fully analyzed by the Commission.

A full copy of this report, plus additional reports and other material, is available on the Commission's web site (www.edufundingcommission.com) which will be available until May 31, 2001.

While it is risky to reduce lengthy and methodologically cautious research to simple statements, the Commission made these broad findings about the major tax and revenue options before it:

Personal income tax

The competitive effect of a personal income tax on the state's economy depends upon how much of its burden is passed through by employers in the form of higher wages. If a significant amount of the burden is passed through, the state's competitive position could be significantly harmed; but if 50 percent or less is passed through, the income tax would be no more detrimental than any of the other broad-based taxes evaluated. As long as it includes significant personal exemptions, the income tax would be relatively progressive.

About 78 percent of the burden of this tax would be borne by New Hampshire residents. Other taxes evaluated have a similar in-state burden. But the income tax burden would be disproportionately felt in higher income counties. This tax would be relatively simple for regulator enforcement and taxpayer compliance if it were based on federal taxable income.

Sales taxes

If set at an excessively high rate, this tax could hurt the state's competitive position by indirectly raising wage costs and by driving away both non-resident and resident shoppers from New Hampshire, especially in border cities and towns. However, research done for the Commission by Ernst & Young indicated that for most firms, a sales tax would have less overall negative impact on investment in New Hampshire than any tax other than a consumption-based VAT. While job losses due to an income tax would generally fall in higher skilled positions, job losses from a sales tax would generally be felt in lower skilled retail positions.

Sales taxes are regressive, but they would also shift the burden to non-New Hampshire residents more than any other tax option, assuming rates were not so high as to drive away shoppers. Imposition of the tax would require relatively extensive new record keeping requirements for both the private and the public sector.

Property tax

By exempting inventories and personal property, the negative effect of this tax on returns to New Hampshire businesses overall would be less than suggested in other economic analyses. The tax base is volatile due to the high fluctuations in cyclical real estate values. The tax also seriously distorts housing choices made by taxpayers. Measuring the progressiveness of this tax is determined in part by the percentage of rent payments by tenants, especially low-income residents, that is attributable to the property tax. The Commission's analysis set this figure at five percent. At that level, the property tax is relatively progressive at lower income levels and highly regressive at high-income levels. The tax overall is not as progressive as an income tax with exemptions.

This tax could also impose considerable administrative expenses to assure fairness in implementation of an increase above the current rate.

Value Added Tax (VAT)

Analyses indicate that the consumption-based VAT, which is less volatile than an income-based VAT, could affect industry more than any other tax by depressing rates of return on investment. Since the tax must be paid regardless of a firm's profitability or its cash flow characteristics, small businesses with chronic cash flow problems and, possibly, retailers could face significant problems. The tax would be relatively easy to administer due to its similarity to the current business enterprise tax (BET).

Legalization of Video Lottery Terminals (VLTs)

Most of the impact of this revenue source would be borne by non-New Hampshire residents. VLTs would be a regressive income source, since the burden falls disproportionately on individuals in lower income brackets who tend to spend a higher percentage of their income on gambling than do those in higher income brackets. Revenue estimates made by the Commission could be significantly reduced if Massachusetts were also to legalize gambling. While the Commission was provided with outside studies that indicated higher revenues from legalized VLT, the difference in the revenue estimates was due mainly to the assumptions made in each case. This revenue source would require additional regulation.

Brief summaries such as these can at best only touch upon the more in-depth analysis that follows in this report. As new tax policies are considered, a thorough review should be made of the more complete analysis. If indeed the end result of the legislative process is a combination of revenue options to achieve full funding, this report sheds important light on the individual components of such revenue packages.

Tax decisions must also be considered not just on direct fiscal and economic grounds, but for their implications on land use planning, the environment and other important areas.

The best outcomes will be those that fund fully K-12 education without compromising the unique strengths of the New Hampshire economy and quality of life.

CHAPTER THREE

BACKGROUND AND METHODOLOGY

Before the Commission could get to its hard analysis of revenue-raising options, it had to develop criteria against which to measure them. Then the wide range of options had to be narrowed to a smaller number of taxes that could be manageably studied. This chapter explains the general policy criteria, which revenue options were selected, and the analytical methods and assumptions used to evaluate those options.

TAX POLICY GOALS

In evaluating each tax option, the Commission considered widely accepted tax policy criteria, some of which at times conflict.

Fairness (Distributional Equity)

- **Tax burdens should be distributed as fairly as possible.**

While people may differ on what constitutes a “fair” tax, there are several acceptable ways of measuring the distribution of tax burdens.

The “benefit” principle calls for people to pay taxes in proportion to the benefits they receive from government programs. The gasoline tax, for example, pays for the roads on which the taxpayer drives. The benefit principle can conflict with the “ability to pay” principle, which calls for tax burdens to be distributed based on the taxpayers’ capacity to bear them.

Under a progressive tax system, effective tax rates increase with taxpayers’ income, which means a family with low income puts a smaller percentage of its resources into taxes than a family with high income. Under a regressive tax system, high-income people pay a lower percentage of their income in taxes than do low-income people. Some people would prefer a tax system under which everyone pays the same fraction of their income in taxes, regardless of income levels or ability to pay.

Adequacy and Stability

- **The tax should generate a revenue stream sufficiently strong and stable to raise revenues to the targeted level of education funding over time.**

The Executive Order creating the Commission called for it to evaluate revenue sources that will raise a minimum of \$825 million annually, the amount the Legislature deemed necessary to meet the requirements of the Claremont decision in Fiscal Year 2000. In its analysis, the Commission's use of "adequacy" refers to the capacity to meet numerical goals rather than the legal term conveyed in the Claremont decision. And while the Commission directed its work toward achieving that \$825 million goal, it made no judgement as to the appropriateness of that figure.

While the Commission's mandate was to examine the \$825 million annual target, research analyzed by the Commission makes it clear that in fact, the actual new total tax burden will be less than that amount. This is because some of the \$825 million in new revenue will be used to reduce existing local property taxes. The Commission chose to assume that, fully implemented, any state tax raising \$825 million per year for primary and secondary education would ultimately reduce local property taxes by about half that amount, or \$412.5 million. In other words, total state and local tax revenues would increase by \$412.5 million under all revenue options examined.

The Commission realizes that a greater share of the \$825 million might go to local property tax relief than to new educational spending. But it chose the \$412.5 million assumption based on several studies, including an analysis conducted in 2000 by the Josiah Bartlett Center examining how municipalities have used state-financed education grants in the current year.

Others would make different assumptions. And even the Commission's assumed increase might be too high in some cases, such as the statewide property tax, because such a large portion of its revenues would not be redistributed to school districts in the form of grant money from the state. Instead, as is true with the current state property tax, these revenues would stay in the communities in which they were raised. Changing other assumptions, however, would tend to impact the results in the opposite direction.

As a broad policy goal, a reliable and stable tax raises neither more nor less than the amount needed. It also has a revenue stream that grows relatively constantly despite changing economic conditions.

Competitiveness

- **The tax should not hinder New Hampshire's economic competitiveness.**

Competitive taxes encourage businesses to locate and grow within the state. To many observers, New Hampshire's unique fiscal attributes -- low tax burden, decentralized fiscal arrangements, and the lack of a broad-based income or sales tax -- have significantly strengthened the state's economy, especially its critical high technology sector, which comprises a significant population of firms attracted by New Hampshire's perceived tax advantages. The Commission scrutinized how each revenue option might affect New Hampshire's competitive standing, especially its attractiveness as a place for firms to hire more workers and build more facilities.

Exportability

- **Non-residents should bear their fair share of the tax burden.**

One obvious way to export a tax burden to non-residents is to tax goods and services they purchase. The present rooms and meals tax is an example of such burden shifting. The state can also shift tax burdens to citizens all over the nation by imposing taxes such as property and income taxes, which are deductible from federal taxable income.

Neutrality

- **The tax should not distort spending and other market choices made by New Hampshire's residents and businesses.**

The Commission evaluated how each tax option might distort the way households and businesses allocate their resources, how much they choose to spend on material and other needs and wants. A neutral tax distorts as little as possible market choices such as how much to save, where to live and work, whether to own or rent, where and what to buy, how much to work and in what profession.

Simplicity

- **The tax should be simple to administer and carry minimal compliance costs.**

Public frustration with taxes is often driven by the difficulty in understanding them and the cost to comply with them. A simple tax minimizes

lengthy, complex calculations and eases record-keeping requirements. Those subject to the tax comprise a group that is small and identifiable enough to enable cost-effective enforcement. Tax laws and regulations are sufficiently clear to generally avoid litigation.

Selection Of Revenue Options And Tax Structures

The Commission identified four major types of tax bases—wealth, consumption, income and production -- and then narrowed that field to options that could be manageably analyzed. A chapter later in this report explores possible combinations of such taxes.

Wealth taxes include taxes on real estate, personal property, estates, and gifts. **Consumption taxes** cover retail sales, personal expenditures, and the sale of various commodities, such as tobacco products, alcoholic beverages, and motor fuels. **Income taxes** include those on personal income, wages, dividends and interest, and business profits. **Production taxes** include transactions or gross receipts taxes, value-added taxes (without deductions), and severance taxes.

The Commission did not consider taxes so difficult to administer at the state level that they are rarely adopted or those which would be levied on bases that are virtually non-existent in New Hampshire, such as energy resources, or which are patently inequitable – such as the head tax.

Of the remaining taxes, the Commission evaluated revenue options that have been proposed in recent years as sources of funding for education in New Hampshire. These are taxes on personal income, property, retail sales, capital gains, value added, gross receipts, tobacco products, and motor fuels. The Commission also considered the introduction of video lottery terminals. It also heard though did not fully evaluate suggestions that increased spending on tourism promotion could generate significant revenue for the state.

The Commission needed to specify structural characteristics for each of the tax options it considered in order to evaluate the breadth of each tax base and the tax rate that would have to be imposed to meet the educational funding requirements. If a particular tax were implemented, how would New Hampshire define its base? What exemptions, deductions, and exclusions would the state allow? With such structural questions answered, the Commission could analyze each option's impact on the state's economy.

Personal income tax

Structural issues for this tax included how closely the state's definition of taxable income should conform to the federal definition, the level of personal exemptions, and what deductions, if any, should be allowed.

The Commission considered four potential income tax bases familiar to taxpayers who fill out federal income tax returns: gross income, adjusted gross income, taxable income, and income tax liability. Every state with an income tax uses one of these four options or a closely related version. Some states, including Rhode Island and Vermont, pursue a practice known as "piggybacking," under which income taxpayers simply pay an amount equal to a portion of their federal tax.

Though piggybacking would greatly simplify tax compliance, the Commission rejected it as an option since it has been found unconstitutional in New Hampshire because of the state's requirement of proportionality in taxation. Using federal gross income as a structural starting point posed another potential problem -- state policymakers could enact specialized tax preferences that would serve to diminish the fairness by unbalancing the distributional effects or otherwise affect the tax's neutrality and simplicity.

Ultimately, the Commission adopted two personal income tax variants using federal adjusted gross income (AGI) as a base. The first is an income tax proposal that would tax AGI at a rate of 4.3 percent, allowing significant personal exemptions. The second would set a lower rate, but would allow no personal exemptions. These two options allowed the Commission to compare how varying exemption levels affect the tax's economic impact.

The Commission also evaluated an income tax based on federal taxable income instead of federal AGI, an option that implicitly embraces the federal personal exemption levels as well as all federal deductions.

Sales Tax and Gross Receipts Tax

In structuring its sales tax options, the Commission considered the extent to which necessities (primarily food and clothing), services, and purchases by business should be taxed.

If relatively few items are exempted from the tax base, the tax rate necessary to raise a given amount of revenue can be lower, which would reduce the tax's impact on both the non-resident customer base of New Hampshire's retailers and on New Hampshire's own consumers. Many people, however, believe that a fair sales tax should exempt food, clothing, and other necessities -- but this would require a higher rate.

As for other sales tax options, the Commission found that the taxation of services has proven highly unpopular and administratively difficult in many states. It also found a potential problem with taxes on business purchases of goods and services such as raw materials: This tax would exempt “vertically integrated” industries that produce their own raw materials and components, thus discriminating against firms that must purchase these items on the outside. Many New Hampshire firms are in this latter category.

After considering these concerns, the Commission selected four sales tax options, which vary in the breadth of their definition of taxable sales (for further detail, see the worksheets in the Appendix).

The Commission’s research staff had difficulty finding sufficient data to evaluate in the same manner as it evaluated other taxes a proposed version of the gross receipts tax. The tax called for in this proposal has been labeled as a “consumption” tax that would cover all transactions, whether business-to-business or business-to-household. A brief analysis of the tax appears in a worksheet in the Appendix.

Variants of a Value Added Tax (VAT)

A value added tax (VAT) is one that requires businesses to pay tax on payments to workers, investors, and creditors – in other words, to those contributors to an enterprise who are responsible for the “value” that it “adds” to the economy by transforming raw materials and intermediate inputs into a new good or service. These payments include compensation, dividends, and interest.

Because New Hampshire businesses are already familiar with the Business Enterprise Tax (BET) – which is very similar to a value added tax -- the Commission decided to evaluate only those VAT alternatives that employ this “addition method” of collection.

One alternative was an income-based VAT; the other was a consumption-based VAT. Under the income-based alternative, the base of the BET would be expanded to include rental payments and retained earnings, so that all elements of income --compensation, interest, rent, and profits (dividends plus retained earnings) -- would be taxed. Under the consumption-based VAT, the base of the BET would be similarly expanded, but firms would be able to deduct their net investment purchases.

Variants of the Property Tax

The Commission considered evaluating several property tax alternatives that differed in the mechanisms of relief they would provide to low-income

households, including homestead exemptions. Policy makers will need to consider such relief mechanisms once a firm proposal is put in place. A tax on land only was also considered. Because of time restraints and limits on necessary data, the only property tax option evaluated by the Commission uses a definition of taxable property similar to that of the current state property tax.

Capital Gains and Excise Taxes

Concerned about tax complexity, the Commission analyzed a tax whose base would conform to the federal definition of taxable realized gains. (Capital gains is already a component of adjusted gross income for personal income tax purposes). For the same reason, the Commission evaluated only increases in the rates of the state's existing tobacco and motor fuels taxes.

Legalization of Video Lottery Terminals (VLTs)

Though not a tax option like those described above, the Commission analyzed VLT legalization as a revenue-generating option.

Analytical Methods And Key Assumptions

The Commission was able to find an array of impartial and well-designed research and developed its own tools to estimate the effect of each revenue option on individual citizens as well as the economy of New Hampshire. The Commission had both limited time and research resources, and in some cases, a lack of sufficient state-level data limited its analysis of specific tax options and criteria.

The following assumptions and analytical methodology were used to evaluate the various revenue options against the policy criteria listed in the first section of this chapter. More complete information is found in the work sheets and other material in the Appendix.

Fairness (Distributional Equity)

To estimate how tax payments would vary as a percentage of different taxpayers' income, the Commission constructed its own model of New Hampshire's households and the myriad economic decisions they make. Building upon baseline data supplied by Minnesota Implan Group Inc., Commission researchers carefully melded disparate statistics to produce a consistent set of data suitable for policy analysis.

The Commission examined what would happen if a particular revenue

option were to supplant the local property tax as the primary funding source for the targeted revenue needed. How would the distribution of tax burdens change across income classes? Would low-income people pay a higher or lower percentage of their income in taxes? How, if at all, would the impact on low-income households differ from the impact on their high-income counterparts?

It is important to note that, due to data limitations, the Commission's analysis of fairness (distributional equity) of the state's taxes *prior to the Claremont decision* is limited to property taxes and the rooms and meals tax.

The analysis of tax alternatives does take into account the degree to which the burdens of sales taxes and consumption-style VATs are borne by non-residents. As a result, the estimated progressivity of all tax scenarios is high, especially for those in which local property taxes are replaced by an income tax with significant exemptions, an income tax based on federal taxable income, or a statewide property tax.

Adequacy and stability

To evaluate the adequacy of each revenue option, the Commission looked to both the future and the past.

Looking ahead, the Commission sought to forecast how much revenue each tax option would generate through 2003. Because complete state-level data for every tax base are not available, the Commission used forecasts for the national economy prepared by Standard & Poor's Data Resources Inc. to measure how the base of each tax would grow if the tax were imposed nationally. The Commission then used forecasts of the state's share of gross domestic product and personal income prepared by the New England Economic Project to estimate New Hampshire's share of that national tax base.

Because of problems inherent in short-run forecasting, the Commission wanted to evaluate the longer-term adequacy of each tax option. To do that, the Commission examined the growth trends of each revenue option's base going back to 1968, analyzing how various factors can affect long-term revenue adequacy. This enabled the Commission to evaluate the stability of each tax option as well. In analyzing these growth patterns, the Commission purposely used *per capita inflation-adjusted* terms. That is, the Commission assumed that an "adequate" revenue source is one whose base expands at least as rapidly as the population, even after adjusting for inflation.

Competitiveness

One of the great debates among economic researchers is whether – and how much – tax policy affects economic competitiveness. In evaluating this

issue, the Commission faced not only such conflicting analysis, but also a lack of sufficient empirical evidence for each revenue option.

The Commission focused on the impact each revenue option would have on jobs. Each option could affect the state's employment by raising the costs of doing business in the state. Tax policy, for example, can lead to higher labor costs as workers respond to the adoption of a tax or increase in its rate by demanding higher wages and salaries. That, in turn, could raise business costs in New Hampshire, which might slow business expansion or cause some firms to relocate to other states, taking jobs with them.

Commissioners explored another way that substituting the local property tax with a state tax to finance schools could indirectly raise the costs of doing business in the state by allowing government to grow faster.

Commissioners heard theoretical arguments, backed by some empirical evidence, that centralized funding could lead to a loosening of fiscal discipline at the local level by weakening the link between taxes paid and public services received. Others, however, claimed that spending on primary and secondary education, especially if financed by state government, would in fact produce a competitive asset of its own that would neutralize the deterrent of higher overall tax burdens. After a thorough review, Commissioners were unable to reach a conclusion.

As noted earlier, the Commission assumed that any state tax raising \$825 million in revenue would ultimately reduce property taxes by half that amount, or \$412.5 million. However, if that ratio were different – 75-25 or 65-35, for example – the resulting data and the effects on competitiveness could be significantly different. Though it feels such research is needed, the Commission was unable to complete such sensitivity analyses itself.

With its working assumptions set, the Commission then used several econometric models to estimate how various state tax options would affect employment. The Commission used a variety of approaches to gauge these impacts so that its estimates would be as free of bias and inaccuracy as possible.

The Commission also asked the consulting firm Ernst & Young to use the “representative firm” method to evaluate the impact of selected revenue alternatives on New Hampshire's business investment climate. Ernst & Young constructed hypothetical firms representative of industries important to New Hampshire's economy, including computers, fabricated metals, electronic components, general merchandising, and business services. Each hypothetical firm was assumed to make a major new investment in New Hampshire, such as a new plant, office or store. Ernst & Young computed the after-tax rate of return

to such new investment under various tax options to analyze the degree to which the tax reduces the profitability of business investment in the state.

Exportability

Relying on a methodology developed by Stanford economist Charles McLure in 1967, the Commission estimated the extent to which non-residents would bear the burden of each tax option.

The Commission estimated the extent to which non-resident households accounted for the base of taxes, such as the personal income tax, that would be paid by households. For example, non-residents who own second homes in New Hampshire share the burden of property taxes; non-resident commuters working in New Hampshire would bear part of the burden of an income tax. The Commission also estimated how much federal tax relief New Hampshire residents would enjoy if the tax alternative were deductible from federal income taxes, since each federal tax dollar saved is one less dollar of tax burden borne by the state's residents.

The Commission also analyzed how much of the new tax burden could be exported by businesses. Research staff estimated the extent to which firms that would be liable for the tax, compete in local versus national markets. Local businesses cannot export any of the tax burden, but national businesses could shift some of the burden to non-resident consumers or stockholders. The Commission also evaluated the degree to which residents of New Hampshire who commute to neighboring states "import" part of these states' income tax burden.

Neutrality

The Commission used one of its tools -- its tax analysis model -- to evaluate the neutrality of each revenue option. As noted earlier, a neutral tax does not distort economic choices, leaving it to free markets to determine how people choose to allocate their time, money, and property. A tax that is not neutral, however, causes households to change their spending and other economic decisions. This economic pain comes on top of the actual amount of taxes paid. The Commission's model is able to put a dollar value on the increase or decrease in the economic well being of New Hampshire's households as their economic choices are subject to varying tax-induced distortions.

Simplicity

The Commission hired two consultants to evaluate complexity in selected revenue options. Dr. James Sjoquist of Georgia State University analyzed state personal income taxes, sales taxes, and value-added taxes. Jane Malme of the

Lincoln Institute of Land Policy did the comparable analysis for state property taxes. Both consultants discussed aspects of each tax option that generate record-keeping requirements for taxpayers, that complicate tax enforcement, and that can lead to extensive litigation.

CHAPTER FOUR

EVALUATION OF TAX OPTIONS ACCORDING TO THE TAX POLICY CRITERIA

The previous chapter describes the Commission's tax policy criteria, the revenue options it chose to analyze, and the methodology of that analysis. This chapter provides the core results of that process.

The major part of this chapter measures the various revenue options against each of the policy criteria, except when data were insufficient to permit conclusions. A set of worksheets detailing each revenue option is in the Appendix, along with a list of research sources and other notes.

A second section of this chapter summarizes a Commission report and other findings about the revenue potential from the legalization of video lottery terminals in New Hampshire. The full VLT report is also in the Appendix. The third section of this chapter describes how different parts of the state and different industries are affected by various tax options.

Fairness (Distributional Equity)

The Commission evaluated the progressivity of each revenue option, but it did not specify what degree of progressivity has the most desirable level of distributional equity. That is an inherently subjective judgement that New Hampshire policymakers must make for themselves.

Key findings

- Despite widely held assumptions, the property tax is relatively progressive at lower income levels, though not as progressive as an income tax with significant exemptions. Progressivity of a property tax declines as income levels rise and the tax becomes quite regressive at high income levels;
- A property tax would hit low-income homeowners hard, especially in communities where the tax results in higher overall rates;
- Four tax options other than the statewide property tax would increase the progressivity of New Hampshire's tax structure. In order of progressivity, they are: the capital gains tax; an income tax with significant personal exemptions; an income tax based on federal taxable income; and the value added tax of the income type;

- All of the sales tax options, the excise taxes, and the consumption-based value-added tax would decrease the progressivity of the state's tax system;
- Because people in lower income brackets tend to spend a higher percentage of their income on gambling, revenue from VLTs is likely a regressive source of income.

Discussion

Property Tax

Despite assumptions to the contrary, the Commission found that the property tax is progressive for many low-to-middle-income households, though generally not for households with incomes greater than \$70,000. Households with annual incomes under \$15,000 actually pay a lower fraction of their income in property taxes than households with incomes above \$70,000. **(See Chart 4-1, Progressivity of Tax Options.)**

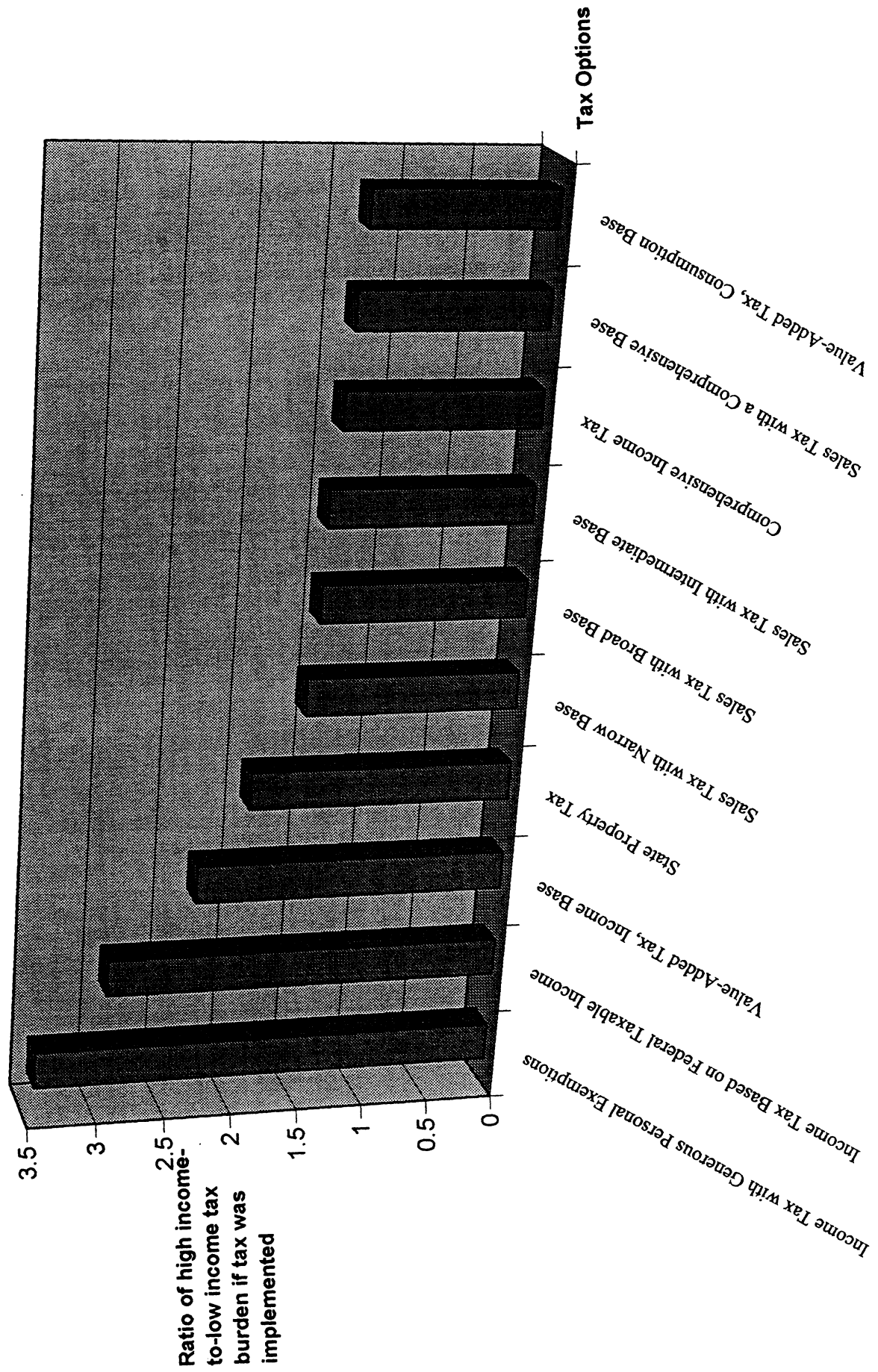
The property tax burden is progressive because most low-income people are renters. (For low-income *homeowners*, however, the property tax is a major burden, though a homestead exemption could address this.) Renters do bear some of their landlords' property tax burden in the form of higher rents. However, the Commission's analysis – backed by independent economists – found that about five percent of the total rent paid by a tenant actually goes toward the landlord's property tax on that rental property. Since even most low-income tenants pay under 50 percent of their income in rent, this means that tenants bear a property tax burden of approximately 2.5 percent of their income (5 percent x 50 percent = 2.5 percent).

The Commission realizes that this conclusion about the property tax burden borne by renters will surprise many observers. But the data used here are solidly grounded in hard analysis by Commission researchers, who rechecked these findings with both leading economists and against current analysis in the economic field.

But while solidly based in hard economic theory, these numbers may nonetheless be seen as contrary to the real life experiences of landlords, mortgage bankers and renters themselves. The Commission fully understands this possible disparity between hard economic analysis and public perceptions.

Disagreements exist about how to properly measure the property tax pass through to renters. The Commission is aware of, and fully respects, contrary views, some of which are based on the fact that some states allow an income tax deduction for renters that is based on calculations that show a much higher property tax pass-through than was used in this report. However, its

CHART 4-1
Progressivity of Tax Options



responsibility was to base its tax analysis on the most solid economic research available to it, and it remains satisfied that its property tax analysis is appropriate.

By contrast, property taxes on New Hampshire's homeowners average over two percent of the value of their home, which is usually worth many times their annual income. In addition, the ratio of home value to income tends to decline with income, which is why analyses of the distributional characteristics of the property tax that focus primarily on homeowners find the tax to be regressive.

It should be noted also that the Commission's distributional analysis does not take into account the federal loss offset, which exaggerates the progressivity of the income tax and the property tax.

The property tax burden is probably regressive over the top part of the income spectrum, even with renters taken into account. Unfortunately, the data base used by the Commission includes only the category of income over \$70,000, without further breakdown. This left the Commission unable to provide detail on the distribution of property tax burdens among different levels of higher income households. Analysts with access to more data on higher income households have found that the property tax burden is lower on those with incomes in excess of \$200,000 than it is on their middle-income counterparts. (See Appendix - Bibliography).

Income-based Taxes

The capital gains tax would be by far the most progressive tax option -- 45 percent of all realized taxable gains in New Hampshire came from households with annual adjusted gross incomes in excess of \$1 million.

The next most progressive state income tax would be one that uses federal adjusted gross income (AGI) as a base, allowing for significant personal exemption levels. An income tax based on federal taxable income would be somewhat less progressive, partly because federal personal exemption levels are less significant than under the AGI base and because many federal deductions, such as those for state and local taxes and mortgage interest, disproportionately benefit middle and upper income households.

The Commission's analysis reveals that a comprehensive income tax based on AGI used for federal taxation purposes would be less progressive than the pre-Claremont New Hampshire tax system. Except at the lowest income levels, AGI is a fairly constant percentage of cash income in New Hampshire.

An income-style value added tax (VAT) would increase the progressivity

of the state's tax system. An income-type VAT is more progressive than a comprehensive tax on AGI because its base includes corporate retained earnings, which are an indirect form of income that goes to corporate shareholders, who are concentrated in high-income brackets. An income-style VAT is more progressive than a consumption-based VAT.

Sales Tax Options

Any of the sales tax options, the excise taxes, and the consumption-based VAT would be regressive. Though some studies have found that exempting necessities such as food and clothing would ease this sales tax regressivity, the Commission's analysis found that the proportion of income spent on food and clothing is similar among income classes. The analysis of higher-income effects of the sales tax was limited by the fact that data for households earning more than \$70,000 a year are not further broken down.

Of the four sales taxes evaluated by the Commission, progressivity would be reduced the most by the comprehensive sales tax (see definition in work sheet). The base of this tax would include many services, such as medical care, barbershops and beauty parlors, and certain amusements that make up a disproportionately large portion of the income of low-income households.

Legalization of Video Lottery Terminals (VLTs)

While few studies have specifically focused on the regressivity of taxing VLTs, studies analyzing casino revenues have found a clear pattern of regressivity. In essence, the data indicate that revenue from gambling places a heavier burden, as a proportion of income, on lower income groups.

Adequacy and Stability

Key findings

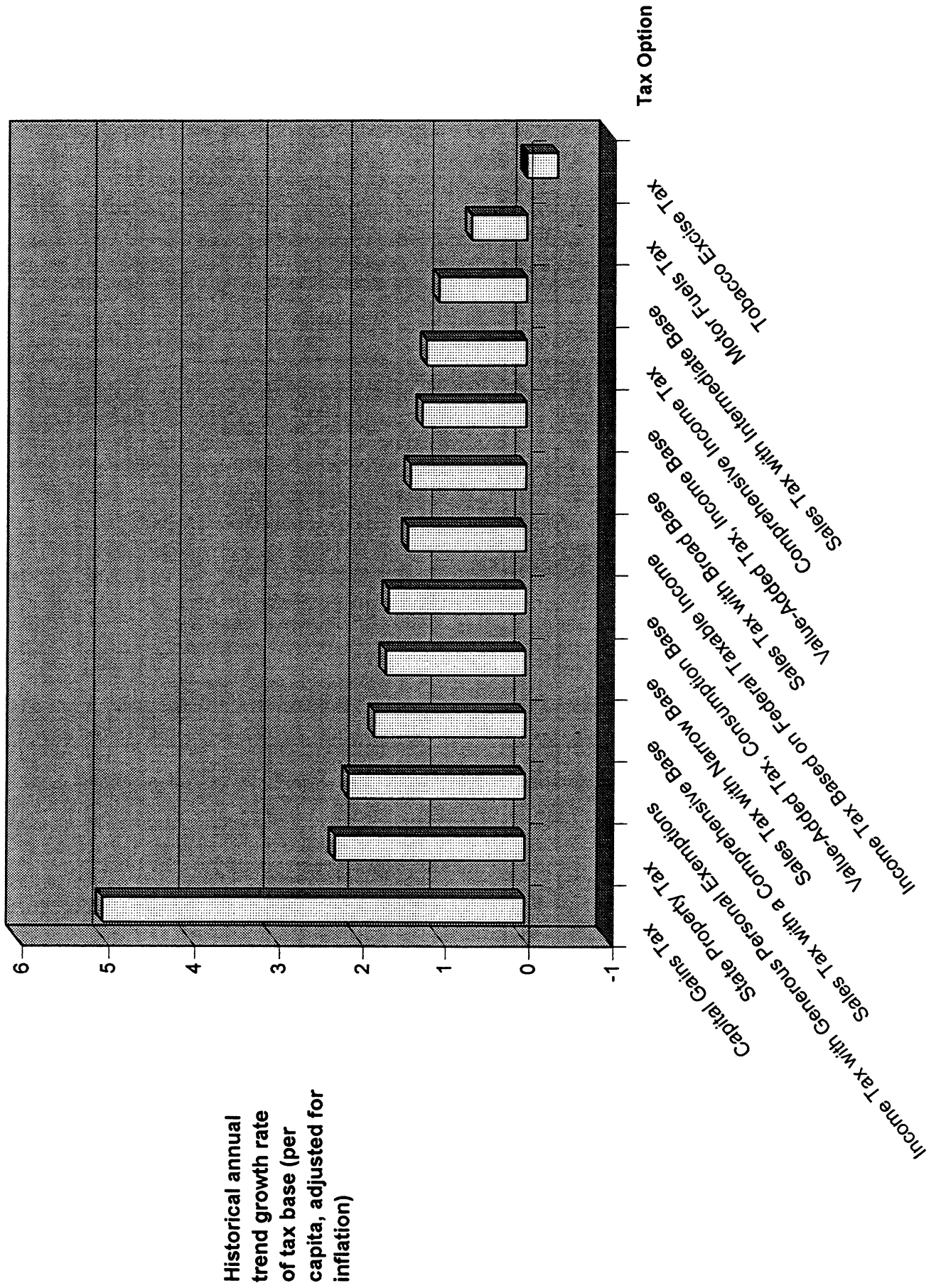
- Based on historical patterns, five of the broad-based tax options would probably grow at least as rapidly as personal income over the long run. **(See Chart 4-2, Trend Growth Rates of Tax Options.)** But changing economic and other conditions could alter such growth patterns. Those tax bases that have expanded most rapidly in recent decades have tended to be the most volatile;
- If the capital gains tax were the sole funding source, it would require a rate of at least 24 percent, which is higher than the current maximum federal income tax rate on this form of income;
- The stability and adequacy of all of the personal income tax bases considered by the Commission could be affected by federal tax legislation, unless the state ties its tax to the federal tax code at a set point in time;
- Revenue from VLTs and other expanded gambling could be vulnerable to factors such as legalization in Massachusetts and other border states.

Discussion

Because many of the tax options have broad bases that will probably expand with the economy over time, New Hampshire should be able to generate adequate revenues from them without frequent and significant increases in their statutory rates. The excise taxes on motor fuels and tobacco, as well as the tax on capital gains, are exceptions. The bases of all three taxes are so narrow that no one of them can be solely relied upon to meet education funding requirements. Since capital gains are so volatile and the bases of both excise taxes have grown considerably more slowly than personal income in recent decades, none of these three taxes should be relied upon, even to meet a targeted percentage of such requirements.

The historical behavior of five of the broad-based tax options suggests that their bases would probably grow at least as rapidly as personal income over the long run. The tax bases of the income tax with significant exemptions, the narrow-based sales tax, the comprehensive sales tax, the property tax, and the consumption-based value added tax have all grown more rapidly than personal income over the past three decades. But caution is needed when projecting future revenues on the basis of such historical trends.

CHART 4-2
Trend Growth Rates of Tax Options



Income Taxes

While historically stable, the bases of all proposed income taxes can be affected by changing conditions or laws.

The base for an income tax with significant exemptions, for example, has expanded so rapidly in recent years because high-income households account for such a large percentage of its base. But a stock market crash and deterioration in other economic conditions would significantly slow such growth.

The stability and adequacy of all of the personal income tax bases would also be continually subject to changes in federal tax legislation. Their bases would shrink or expand each time the federal government enacted or repealed an exclusion. Pending proposals for medical savings accounts and expanded retirement savings accounts are cases in point. Modifications of deductions, such as those for mortgage interest or charitable deductions, and personal exemptions, would also affect the revenue productivity of taxes based on the federal taxable income. However, such disruptions could be avoided if any income tax law passed by the Legislature were to define AGI as the federal definition in place at the time of the bill's passage.

In estimating the statutory tax rate needed under each income tax option to raise \$825 million, the Commission did not take into account implications for the business profits tax. Under a personal income tax, profits earned by unincorporated businesses are included in the tax base. Yet, the profits earned by such firms are already subject to New Hampshire's business profits tax at a rate of 8 percent. Under the income taxes considered by the Commission, they would be taxed at a lower rate. The state might have to raise the income tax rate to offset the resulting loss in revenue.

Sales Taxes

The relatively rapid growth exhibited by sales tax bases reflects the downward drift in the nation's savings rate. But with household debt at such a high level, consumers may retrench, which would slow growth in the volume of taxable sales. The potential explosion of electronic commerce – which is difficult to tax -- also threatens all sales tax bases. And while historical growth in the comprehensive sales tax base reflects in part the shift in households' consumption patterns from goods to services, this shift is slowing as consumers are drawn more to computers and other consumer electronics goods.

Property Tax

The rapid historical average growth of taxable property largely reflects the speculative real estate boom of the late 1980s and early 1990s (see graph in property tax worksheet). Given tighter financial regulation and lessons learned from the boom experience, such volatility is unlikely to be repeated in the foreseeable future.

In some respects, traditional indicators of adequacy and volatility do not apply to the property tax, since it is the one tax whose base is measured by governments in advance through the appraisal process. To achieve a given revenue goal, policymakers then set the rate. But since raising property tax rates is politically difficult, the relative volatility of taxable property is a potential concern.

Value Added Tax

A value added tax of the consumption type tends to be less volatile than one based on income because it permits businesses to deduct a relatively volatile item -- net investment -- on their income statements.

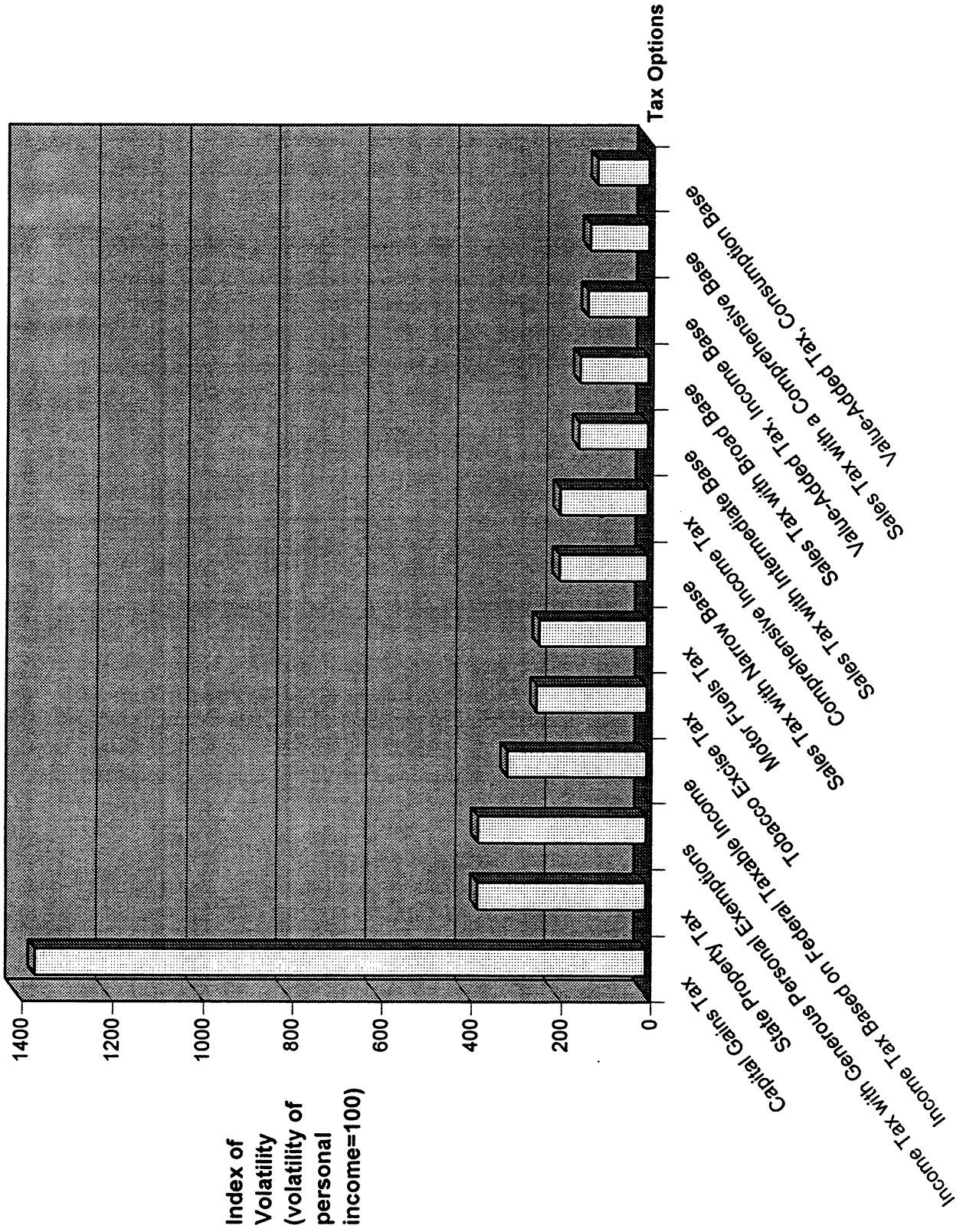
Legalization of Vide Lottery Terminals

Though other states have experienced positive, and sometimes strong, growth rates in net income from VLT operations, such growth may not continue during economic downturns. Further, legalization of VLTs in Massachusetts and other border states could significantly reduce VLT spending within New Hampshire. The introduction of VLTs would also slightly reduce instant lottery ticket sales.

Capital Gains

If the sole source of educational funding were the capital gains tax, the state tax rate would not only exceed the current maximum federal rate, but would likely cause investors to slow their rate of capital gains realizations, which would in turn reduce revenues to the state. The capital gains tax is also a highly unstable source of revenue because it can oscillate sharply with swings in the stock market. (See Chart 4-3, Volatility of Tax Options.)

CHART 4-3
Volatility of Tax Options



Competitiveness

Key findings

- Any new broad-based state tax could affect the state's overall competitive standing as well as that of individual firms;
- Studies comparing property, sales and income taxes -- the three broad-based taxes extensively used by states and municipalities -- have generally found that sales and property taxes retard employment growth more than income taxes;
- If it were the sole source of education funding, a narrow-based sales tax would have a major impact on border communities, where local economies depend heavily upon out-of-state shoppers;
- But a personal income tax could inflict more competitive damage on New Hampshire than indicated by some analyses, especially if all or most of the tax burden were passed on in the form of higher wages;
- The impact of the property tax on the business investment climate in some communities could be significant, though this tax appears to be the least damaging to the overall business investment climate of New Hampshire;
- While expanded gambling might negatively affect other entertainment businesses, it would also increase room and meals spending at facilities with new VLT operations.

Discussion

On the basis of extensive analysis of empirical data, the Commission found that if any of the revenue options it reviewed had been in place in the year 2000 -- and the tax system in place was the pre-Claremont system -- the level of statewide employment would have been reduced by 0.5 percent to 1.1 percent, or about 3,000 to 7,000 jobs.

However, if certain assumptions were changed, that job loss figure could significantly rise. And private sector job loss might be offset to some extent by increased public sector employment stimulated by the influx of new tax revenues.

As described in Chapter 3, this analysis examined several paths through which each option could affect job growth by, for example, directly affecting labor costs. Also, when the state assumes a larger role in financing local public services, such as education, fiscal discipline can erode at the local level, leading to growth in the total size of the state and local public sector. The tax burden can increase accordingly, directly or indirectly raising the cost of doing business, which can discourage job creation.

New Hampshire has benefited from firms moving into the state. Though some analysts believe that many of these firms -- especially in the manufacturing sector-- are tax-sensitive, studies reviewed by the Commission did not fully support that view. Studies also disagree on which tax option carries the greatest competitive liability -- the outcome largely depends on the structure of the tax and how much of the tax is transferred in the form of higher wages or prices. Studies have generally found that property and sales taxes affect firms more negatively than the income tax. This may reflect the fact that while partnerships and sole proprietorships pay personal income taxes only in profitable years, most businesses, including incorporated ones, bear significant property and sales tax liabilities even in years when they are not profitable.

In fiscal year 1999, non-residential property accounted for 26 percent of assessed property value in New Hampshire. But according to Ring (1999), about 40 percent of all state and local sales tax revenues come from business purchases of taxable goods and services. That figure is based on national data -- heavy cross-border purchasing by consumers might alter the actual New Hampshire number.

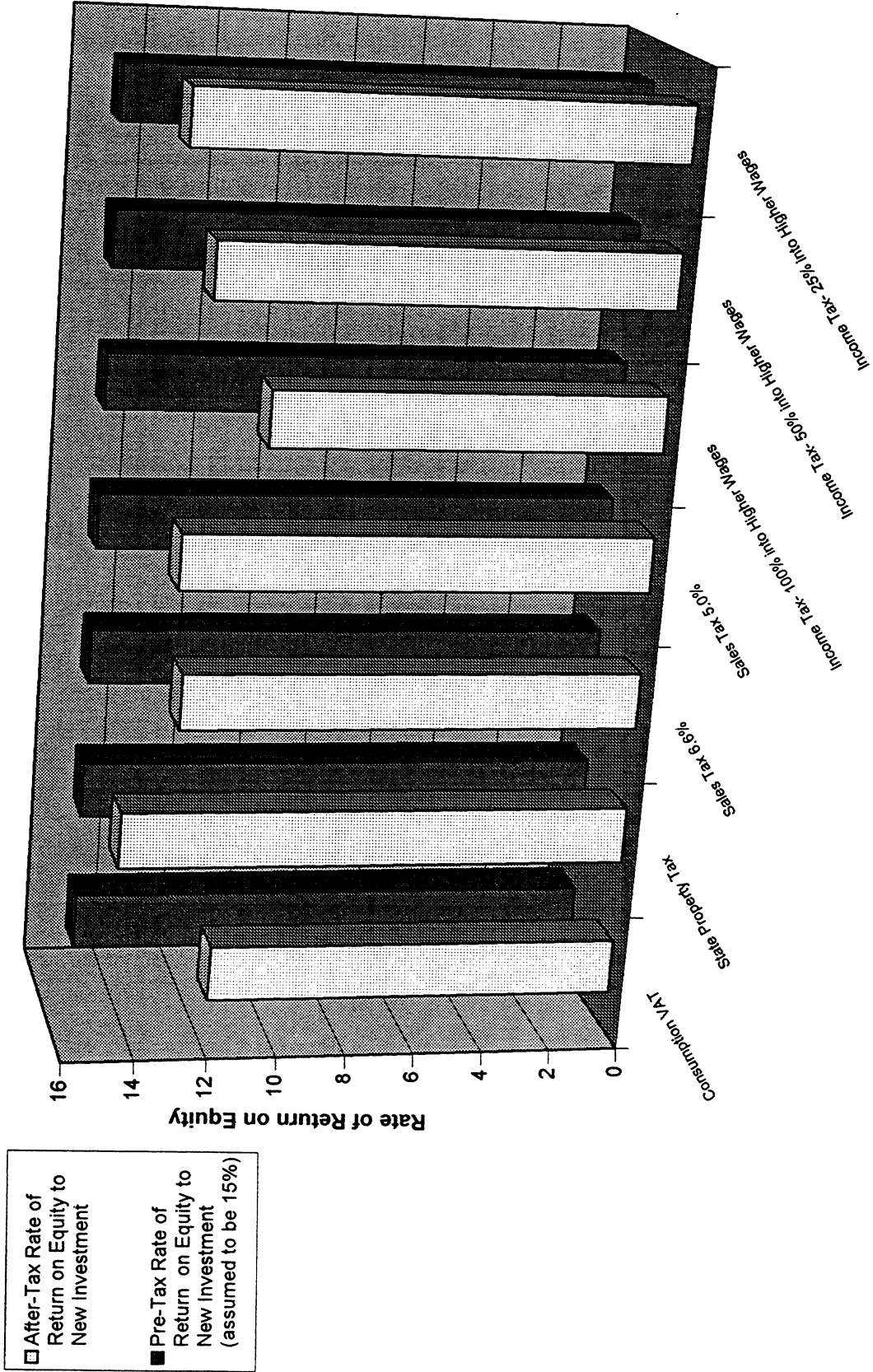
To better quantify the impact of the tax options on New Hampshire businesses, the Commission contracted with Ernst & Young to prepare a "representative firm" analysis showing how each tax would affect the return on investments made by industry in New Hampshire. It should be noted that in Table 4 of the Ernst and Young analysis all simulations, other than the two that involve a VAT, contain the assumptions that the BET tax rate will remain at 0.50 percent and the BPT rate will stay at eight percent. But these rates include temporary surcharges of 0.25 percent and one percent, respectively. The result is that the tax burden is inflated by \$53 million for these calculations compared to what it would be (\$412.5 million) if the surcharges were removed.

The results of the Ernst & Young analysis are summarized in **Chart 4-4, Impact of Tax Alternatives on Returns to New Investment**. The full Ernst & Young tables for each revenue option are in the Appendix. The following summaries are based on Ernst & Young's work as well as research by Commission staff.

Income Tax

The Commission found that the competitive damage inflicted by an income tax would depend upon how much of the new tax burden were passed on in the form of higher labor costs. Firms might be more reluctant to hire new workers, resulting in shrinkage in employment opportunities and deterring migration into the state.

CHART 4-4
Impact of Tax Alternatives on Returns to New Investment



Prepared by Ernst and Young, LLP - Quantitative Economics and Statistics

Note: This chart presents estimates of the effective after-tax rate of return to new investments of hypothetical firms representative of industries important to New Hampshire's economy. These industries include three in manufacturing-- electronic components, computers, and fabricated metals-- general merchandise retailing and business services. The lower the after-tax rate of return, the higher the tax burden on the investment project. The estimates presented here are the average rate of returns for all industries. See appendix for details.

According to the Ernst & Young analysis, if all of the income tax were reflected in higher wages, it would be the most competitively damaging tax option. But if only 50 percent of the income tax passed through as higher wages, the income tax would be about as damaging as, or in some cases, less damaging than a narrow-based sales tax. And if only 25 percent of the income tax was reflected in higher wages, competitive damage would be fairly mild – only the statewide property tax would do less competitive damage.

The Commission found scant empirical evidence revealing what percentage of state income tax burdens would actually be reflected in higher wages. The few well-designed studies it uncovered suggest that this percentage would be at least 70 percent. Conventional economic theory, however, suggests that little, if any, of the personal income tax burden is shifted forward to employers.

Economists have generally portrayed workers as immobile, tied to the region where they live. So if their income is subject to tax, they have no choice but to absorb it without any compensating increase in wages. While this portrait was reasonably accurate in the “old economy”, it is less so today, especially in New Hampshire. Skilled workers, more critical to industry than ever before, are knowledgeable, mobile, and scarce. Such workers have been attracted to the state at least in part by its tax status – it is reasonable to ask how changes in the state’s tax structure might affect such skilled worker migration to the state.

The compensation of low-wage workers may be less affected by an income tax if personal exemptions or deductions keep their tax liability low. However, higher compensation for skilled workers could affect the whole pay scale, raising the costs of all types of labor.

Income tax opponents appearing before the Commission cited studies (for example, Vedder 1995, Vedder and Moore 1999, and Dye 1999) to back their claim that New Hampshire would suffer far more economic damage from an income tax than from any other state tax. After reviewing these studies, the Commission found the empirical research underpinning them to be flawed in several respects, such as failing to control for other major economic events.

An income tax might inflict more damage on New Hampshire’s business tax climate than other options in another way. Compared to other tax options, the burden of an income tax is distributed more in line with taxpayers’ ability to pay. As a result, increases in the tax, although burdensome, would be less likely to galvanize adamant opposition from adversely affected groups. In this manner, the income tax’s very advantages could make it more of a threat to fiscal discipline.

Sales Tax

Ernst & Young's analysis found that for most firms, a sales tax would have less overall negative impact on investment in New Hampshire than any tax other than consumption, VAT or state property tax. At the same time, however, a narrow-based retail sales tax would have a major impact on border cities and towns whose economies depend heavily on out-of-state shoppers. Further, if the sales tax pushed up wages, it would be especially damaging to non-manufacturers, who would face both a new direct tax on business purchases as well as higher labor costs (Manufacturers enjoy sales tax exemptions.)

Property Tax

Ernst & Young's analysis found that the property tax appears to exert the least depressing effect on returns to investment in New Hampshire. This finding appears to contradict other empirical evidence indicating that property taxes generally stifle growth in employment at least as much as other state and local taxes. However, the Ernest & Young analysis concerns returns to investment, not employment. Moreover, New Hampshire's property tax is generally levied only on land and structures, which make up only a small portion of a firm's assets. Furthermore, there is little evidence that the property tax is passed on in the form of higher wages.

The Commission did not evaluate how the redistribution of property tax burdens across cities and towns -- a feature of the state property tax -- would affect employment. Shapiro, England, Kenyon, and Connor (1999) found that under a statewide property tax, tax burdens would generally rise in communities rich in jobs compared to those in communities where jobs are relatively scarce. This would slow employment growth.

Value Added Tax

A value added tax levied at a rate high enough to raise \$825 million -- while also replacing revenues from a repealed business profits tax (BPT) and business enterprise tax (BET) -- would create serious problems for many businesses with limited or uneven cash flow. In essence, the tax would have the same effect as a BET with a base slightly broader than the current one and a statutory tax rate several times higher. Consequently, a VAT would tax a wide variety of expense payments, from compensation to interest. The deduction for net investment featured in the consumption-based VAT, although a competitive plus, would not be sufficient to offset the tax's relatively depressing effects on returns to investment, according to the Ernst & Young analysis.

Legalization of Video Lottery Terminals

Studies evaluated by the Commission have found that an increase in legalized gambling can siphon off dollars from spending on other entertainment. These studies indicate an eight percent reduction due to such “cannibalization,” which in the case of New Hampshire would translate into a \$36 million reduction in entertainment spending. However, because of New Hampshire’s lack of a sales tax, that does not translate into a similarly direct decline in state revenues. Indeed, spending on restaurants and lodging – and direct taxes from such rooms and meals spending – would likely rise at VLT facilities.

Exportability

Key findings

- Of all broad-based tax options considered, a sales tax is the most exportable, as long as its rate is not significantly higher than those of other states;
- VLTs would also be a revenue source paid mainly by non-residents;
- Because capital gains tax payments could be deducted against federal taxable income and rebound primarily to high-income households, an even larger percentage of the capital gains tax would be exportable. Each dollar of state tax deducted would save the typical higher income taxpayer between \$.33 and \$.37 cents on each dollar in federal taxes;
- Income tax and other tax options would be exported at rates similar to the long-run exportability of the state’s current tax system as a whole.

Discussion

The burdens of different taxes would be exported to non-residents in different ways and to varying degrees.

Sales Tax

Sales taxes with an intermediate, broad, and comprehensive base would be the most exportable, with 27 percent to 38 percent of the burden of these taxes borne by non-residents. Under New Hampshire’s current tax structure, the comparable figure is between 19 percent and 22 percent.

These three sales taxes would be so exportable because, given the breadth of their bases, they could raise revenues sufficient to meet educational funding requirements at reasonably low statutory rates. Retailers would thus be able to retain a significant portion of their non-resident customer base, although they would lose some out-of-state shoppers formerly attracted to the state’s

totally sales tax-free environment.

A comprehensive sales tax rate of 3.1 percent – the rate needed to raise the required \$825 million -- would reduce statewide sales by 11 percent. The sales loss in border areas would be much larger. **(See Chart 4-5, Percent of Sales Tax Base Taxed Away Under Different Sales Tax Options.)**

Income Tax

Under each of the personal income tax alternatives, non-resident workers commuting to New Hampshire would bear about 11 percent of the burden, worth about \$91 million. Non-residents would also indirectly bear a roughly equivalent amount of the income tax burden since the income tax can be deducted from federal taxes, creating a revenue loss that would be borne by taxpayers nationwide. Since they have a higher propensity to itemize deductions and pay higher federal marginal tax rate, higher-income taxpayers would benefit the most from this ability to deduct every dollar of state income tax payments.

Property Tax

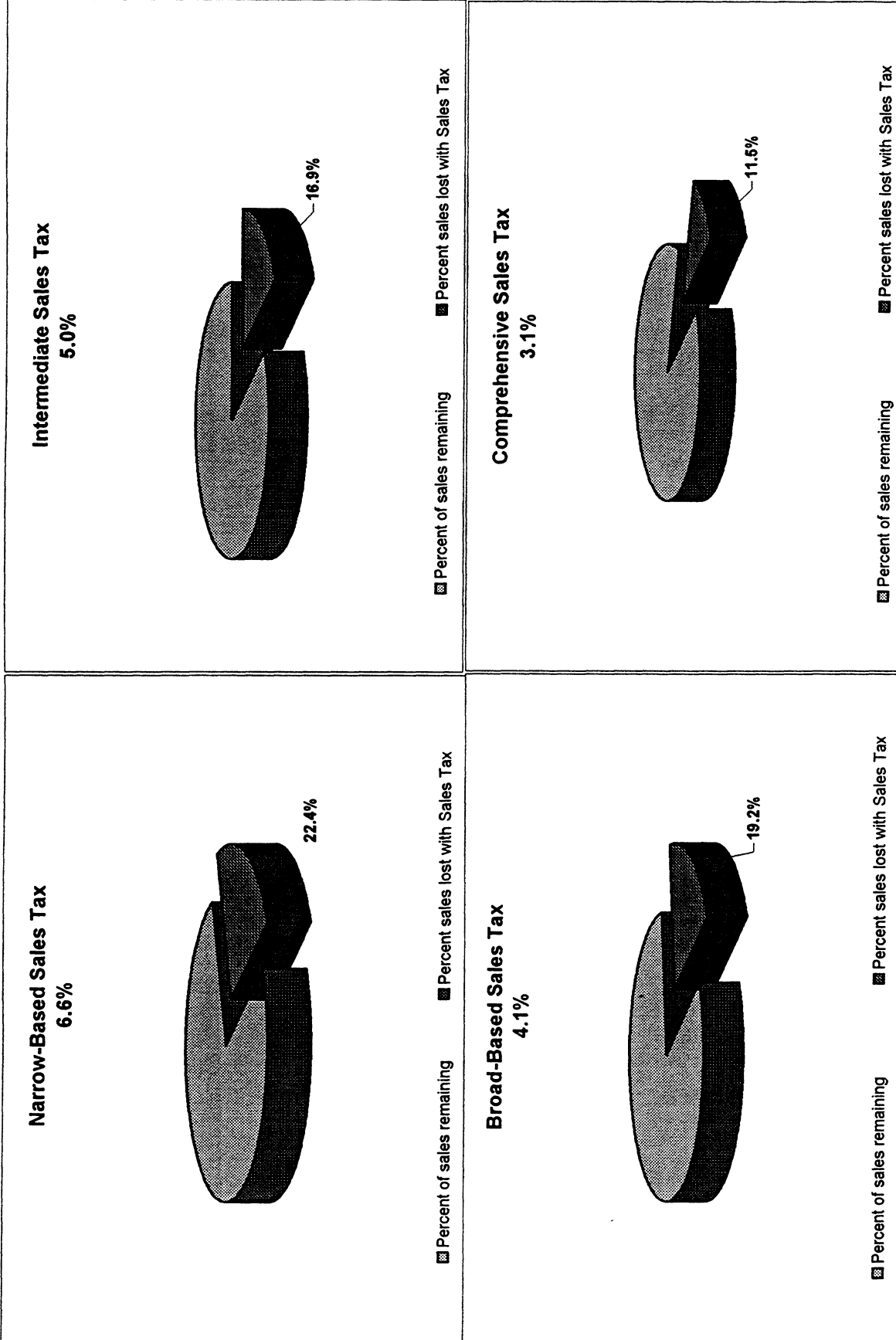
Approximately 74 percent of the property tax is borne by homeowners. About 12 percent of this residential property tax burden on homes is shifted to non-residents through the federal loss offset.

Another estimated 5.5 percent of the property tax burden is borne by non-resident owners of vacation homes. Industrial and commercial property accounts for 10 percent and eight percent of the tax base, respectively. Since manufacturers compete in national markets, they are able to shift almost half of their property tax burden to owners of capital nationwide. Although owners of commercial property are less able to export their burden, they still shift a significant percentage of it to non-resident consumers who flock to New Hampshire to purchase tax-free retail goods and services.

Value Added Tax

Businesses could export some of the burden of value added taxes to non-resident customers by raising prices and to non-resident workers by lowering wages and salaries. Non-residents owning shares in New Hampshire firms would also bear some of the burden of a VAT to the extent that the tax was reflected in lower profits.

CHART 4-5
Percent of Sales Tax Base Taxed Away Under Different Sales Tax Options



Neutrality

Key findings

- Any tax alternative would create fewer distortions on household market decisions than the current property tax-dependent system.
- An income tax based on federal taxable income, if substituted for local property taxes, would be the most neutral of all options analyzed with respect to economic choices made by households.
- A comprehensive sales tax and a comprehensive income tax based on federal adjusted gross income would distort household choices the most.
- The impact of other options on tax-induced distortions of household choices would be relatively modest.

Discussion

The tax options examined by the Commission would distort the economic decisions of New Hampshire's households in varying ways and to varying degrees. The Commission used its tax model to examine each option's effect. The model was able to quantify in dollar terms the gain or loss in households' economic well-being that each change in tax mix would generate by ameliorating or exacerbating distortions.

Taxes differ in the kinds of household decisions they distort. A property tax discourages purchases of homes while encouraging renting and spending on items other than housing. Some economists contend that an income tax discourages people from working and saving. A sales tax distorts households' mix of consumption and where they choose to shop, especially whether they shop in New Hampshire or a neighboring state – or even at a web site.

Because New Hampshire has depended so heavily on property taxation, the most costly distortions wrought by its tax structure have skewed choices involving shelter. Because housing expenses account for such a large percentage of the average household's budget, the economic costs of these distortions have been substantial. If the state were partially to substitute alternative forms of taxation for the property tax, these distortions would diminish. People would be better off because their housing choices would better reflect their actual preferences. However, new behavioral distortions would then replace the old ones.

Under all the tax options examined by the Commission, the net effect on the overall neutrality of the tax system would be mild or moderate.

Choices distorted by two of the tax options -- a comprehensive income tax based on federal AGI and a comprehensive sales tax -- would involve a large portion of the state's economy. Still, the costs associated with the resulting exacerbation of distortions would be only a few tenths of a percent of gross state product.

By contrast, an income tax based on federal taxable income imposes very low tax burdens on households toward the bottom of the income scale, limiting the degree to which taxes alter their economic decisions. More significant, the federal tax base features two powerful pro-housing incentives -- deductions for mortgage interest and property taxes -- that would partially offset the anti-housing bias inherent in New Hampshire's current tax structure.

Simplicity

Key findings

- The comprehensive income tax based on federal AGI and the value added tax levied on an income base would be the least complicated for both taxpayers and administrators.
- New Hampshire's recent experience with a state property tax suggests that it can be complicated even though the state has extensive experience in property valuation.
- Other revenue alternatives considered by the Commission can each cause additional complexity.

Discussion

While none of the options considered by the Commission are clearly the simplest, the *additional* compliance costs imposed by a tax on AGI would be low since New Hampshire residents already report adjusted gross income on their federal tax return. The Department of Revenue Administration (DRA) could rely heavily on federal tax return data for enforcement.

Similarly, an income-based VAT resembles the current BET. Because items not reported under the BET, such as rent and retained earnings, are already reported under the state's BPT and the federal corporate income tax, businesses already keep records of items they would need to report on an income-based VAT return. A consumption-based VAT would also be relatively simple, although taxpayers would have to add back depreciation and subtract gross investment.