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A Business Flat Tax: True Tax Reform for New Hampshire

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The holy grail of tax reform is a system that would tax all consumption in the economy a single time. Only one tax reform plan truly meets that definition and has become popularly known as "The Flat Tax." The Flat Tax was first introduced by economists Robert Hall and Alvin Rabushka in a book by the same name published by the venerable Hoover Institution.[1] Various attempts to enact the Flat Tax at the national level have been attempted such as the Armey-Shelby Flat Tax plan (named for Former Representative Dick Armey of Texas and Senator Shelby of Alabama and the 1996 Steve Forbes Flat Tax plan.

Unfortunately, the broader national tax reform movement has made little progress at the state level. Most state tax reform efforts have simply involved shifting one existing tax into another existing tax with marginal changes that lack a fundamental reexamination of the overall tax structure.

One significant exception to this was New Hampshire's adoption of the Business Enterprise Tax (BET) in 1993. The BET was created from the ground-up with the goal of creating a true consumption tax. Thanks to the pioneering efforts of Bill Ardinger, Stan Arnold, and others, New Hampshire made a tremendous leap forward for the state tax reform movement.[2]

In the intervening 20 years, however, the tax reform movement in New Hampshire has remained incomplete and at times has moved backwards as both the BET and Business Profit Tax (BPT) tax rates have been increased solely as a means for higher tax revenue. Each increase in the tax rate represented a squandered opportunity to completing the path toward a true consumption tax.

Now is the time to continue the push for tax reform as New Hampshire's economic growth has downshifted under the weight of higher tax rates. In fact, after the 1993 tax reform the average annual growth rate was an astounding 3.8 percent, but has since fallen to an anemic rate of only 1.1 percent. This downshifting has cost New Hampshire households dearly in lost income, which is the true cost of higher taxes.

This study will explain how folding the existing tax structure, including the BPT, BET, the now-defunct Medicaid Enhancement Tax (MET), and harmonizing the Interest and Dividends (I&D) tax rate, into a new Business Flat Tax (BFT) would make another dramatic leap in the journey for tax reform.[3] The BFT takes its cues from the national Flat Tax plan that would tax all consumption in the New Hampshire economy a single time at the business level.

New Hampshire is nationally lauded for its low overall tax burden. The enactment of the BFT would also propel New Hampshire's tax structure into the same level of prominence.

How Does the Business Flat Tax Work?

In order to have a true consumption tax, all consumption must be defined in the tax base. In its simplest form:

Consumption = Income minus Savings

There are many points in the economy where a tax can be placed to capture consumption. The retail sales tax (RST) attempts to do it at the point of sale. The individual income tax (IIT) attempts to do it at the household level. The BET attempts to do it at the business establishment level—defined as both commercial and non-commercial.

Of the three, the BET makes the wisest choice for a number of reasons:

1) Business establishments are the originating point for new income and wealth. As a business earns income it must pay its factors of production—labor through wages and salaries and capital through interest and dividends. Any money retained by a business is considered savings and/or investment. The payments to the factors of production then become the basis for consumption.

2) Taxing at the business establishment level greatly reduces the scope of tax collection. A RST may have millions of transactions that have to be tracked and enforced. In 2011, the Internal Revenue Service reports that the federal IIT tracked 678,296 taxpayers in New Hampshire.[4] Yet, according to the National Establishment Time-Series (NETS) database, as published by www.youreconomy.org, there were only 107,612 business establishments in New Hampshire in 2012.[5] Less tangible, but important to consider, is that scope matters for liberty.

3) Taxing at the business establishment level greatly reduces compliance costs. Private businesses are a creature of accounting by virtue of the need to calculate profit and loss. Also, business establishments of all types must also comply with a host of private and public rules and regulations governing their affairs. As a consequence, business establishments are the best equipped to serve as the nexus for tax collection with the lowest marginal costs for doing so.

4) Businesses don't actually pay taxes. While the statutory basis for collection of the BET is at the business establishment level, the actual tax burden falls on the payments to the factors of production. In essence, the BET is a form of tax withholding on these income streams.

5) The BET treats all business establishment types equally regardless of organization structure (C-corporation, S-corporation, partnership, LLC, or sole-proprietorship) or industry classification (manufacturing or service).

For these reasons, the BET is among the easiest taxes to file. As shown in the graphic on the previous page, the 2013 BET tax form fits on an average sized postcard. Currently, only business establishments with gross receipts of over $200,000 or an enterprise value tax base over $100,000 must file under the BET. The enterprise value tax base is the sum of compensation (mostly wages and salaries), interest, and dividends paid. This is then multiplied by the current tax rate of 0.75 percent to obtain the BET tax liability.

To be sure, the BET is a very comprehensive tax relative to other state taxes in the country. However, it is not yet a full consumption tax because it has two very large loopholes. The first loophole is that the BET does not apply to c(3) not-for-profits (though all other nonreligious not-for-profit types are included). The second loophole is that the BET does not apply to government establishments.

The BFT would close these loopholes. Each would add approximately $5 billion to the BFT base. If nothing else was done to the BFT, the tax rate would fall from the current 0.75 percent under the BET to approximately 0.55 under the BFT.

Additionally, the BFT would reform New Hampshire's tax structure by eliminating less efficient taxes and folding them into the more efficient BFT. In particular, the BFT would eliminate the BPT, the now-defunct MET, and harmonize the I&D tax rate. This could all be accomplished with a low, flat rate of approximately 2 percent (and a 2 percent I&D).

Will the BFT Help or Hurt the Economy?

The economic evidence over the last four decades shows that as tax rates rise, New Hampshire's economy suffers. By bringing down tax rates, the BFT will be a boon to the economy. Let's see how.

Chart 1 shows the relationship between the growth in real household personal income (in 2013 dollars) relative to a tax rate index between 1970 (when the BPT was first enacted) and 2013. The tax rate index is the sum of rates for the major taxes in New Hampshire: the I&D tax, Meals & Room tax, Real Estate Transfer Tax (RET), BPT, and BET.

Over this time-period there are 5 distinct episodes where the tax rate index is trending up or down:

1. The first episode, between 1970 and 1983, had not only the enactment of the BPT but, consequently, the largest increase in the tax rate index. The average annual increase in real household personal income was only 1.3 percent.

Print Form Reset Form

New Hampshire
Department of
Revenue Administration

2013
BET

000BET1311862

BUSINESS ENTERPRISE TAX RETURN

Business Organization Name

Taxpayer Identification #

For the CALENDAR year **2013** or other taxable period beginning: MMDDYYYY and ending: MMDDYYYY

You are required to file this return if the gross receipts were greater than **$200,000** or the enterprise value tax base is greater than **$100,000**.

USE FORM DP-87 TO REPORT IRS ADJUSTMENTS

		Round to the nearest dollar
Total Gross Business Receipts for this business organization		
1. Dividends Paid	1	
2. Compensation and Wages Paid or Accrued	2	
3. Interest Paid or Accrued	3	
4. Taxable Enterprise Value Tax Base (Sum of Lines 1, 2, and 3)	4	
5. New Hampshire Business Enterprise Tax (Line 4 multiplied by .0075) before credits	5	
6. Enter credits against BET. Use DP-160 to determine credit against BET	6	
7. Enter Tax Due (Line 5 minus 6). If negative, enter Zero	**TAX DUE** 7	

2. The second episode, between 1983 and 1990, had a decrease in the tax rate index thanks to a multi-year drop in the BPT from its highest point ever of 9.56 percent in 1983 to 8 percent by 1988. The average annual increase in real household personal income was twice that of the first episode at 2.6 percent.

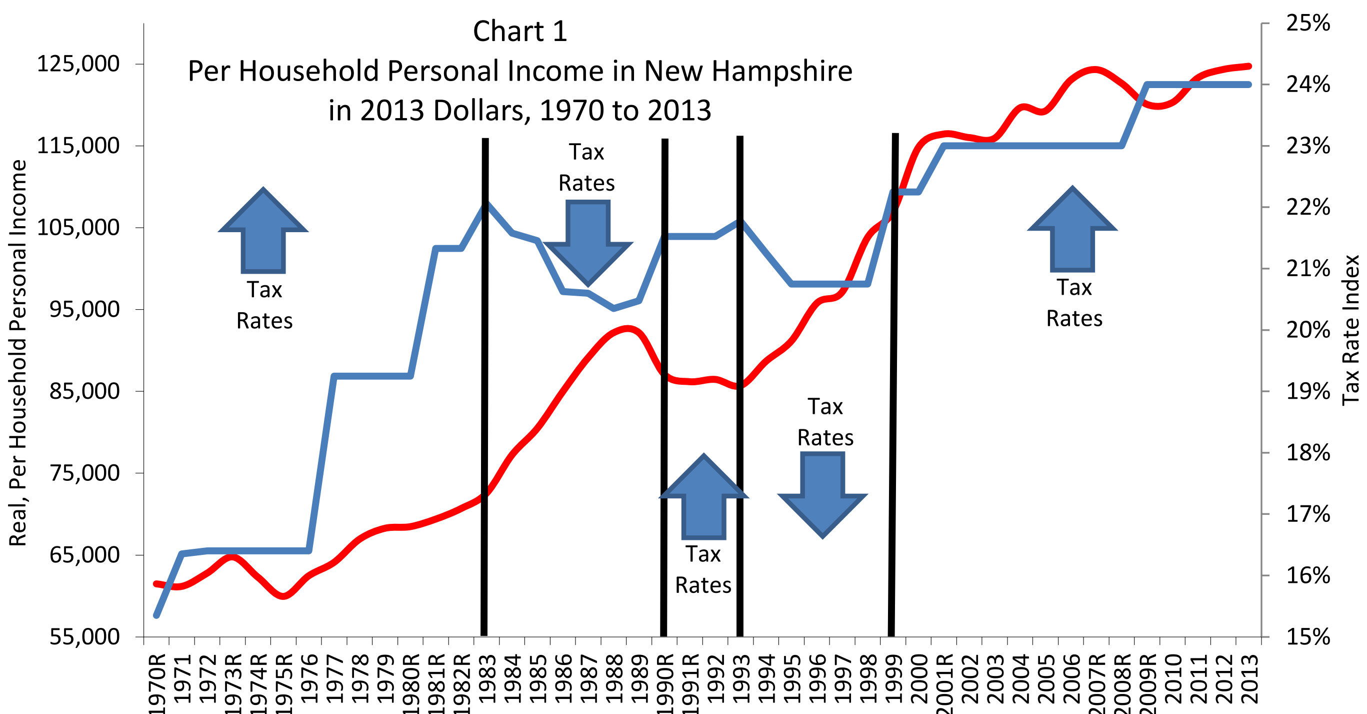
3. The third episode, between 1990 and 1993, had an increase in the tax rate index thanks to increases in the M&R and RET. The average annual increase in real household personal income was -0.5 percent—albeit this time-period was significantly impacted by a national recession.

4. The fourth episode, between 1993 and 1999, had a decrease in the tax rate index thanks to the BET tax reform package which dropped the BPT to 7 percent from 8 percent while also eliminating other smaller taxes. The average annual increase in real household personal income was an astounding 3.8 percent.

5. The final episode, between 1999 and 2013, had the largest increases in the tax rate index since the enactment of the BPT in the first episode. Not surprisingly, the results were the same as the average annual increase in real household personal income was only 1.1 percent.

This downshifting in economic performance between the last two episodes has cost New Hampshire's households dearly. In fact, if the final episode had the same growth rate as the fourth episode, New Hampshire's real household personal income would have been a whopping $54,748 higher—$179,482 versus $124,734. This lost income is the true cost of higher tax rates.

The economic evidence couldn't be clearer—as tax rates increase, especially the BPT, New Hampshire's economic performance suffers and vice-versa. The BFT plan would drop the tax rate index to 13.75 percent, the lowest rate since 1970 when the BPT



Source: U.S. Department of Commerce: Bureau of Economics Analysis, NH Department of Revenue, and NH Center for Economic Policy was first enacted. The economy will rejoice as a result.

Finally, keep in mind that the estimated BFT rate of 2 percent is based on a static analysis which means it does not take into account these positive growth effects. While the 2 percent BFT rate is meant to be revenue-neutral in the short-run, in the long-run the increased economic growth from tax reform will also bring in more state and local government revenue—a rising tide lifts all boats. This increased revenue should be used to further lower the BFT tax rate or increase the establishment exemption.

Will the BFT Hurt Not-For-Profits?

In 2012, according to data from the IRS, there were 5,463 registered not-for-profits, filing as c(3)s, in New Hampshire not currently subjected to the BET. These not-for-profits had revenue of nearly $9 billion and assets worth over a combined $23 billion.[6]

Just as with commercial establishments, most not-for-profits are very small. In fact, the top 20 not-for-profits in New Hampshire earn 58 percent of all revenue (over $5.2 billion) and have assets worth over $13 billion. Most of these not-for-profits are big hospitals and universities.

First, there is the issue of economic efficiency. These not-for-profits employ tens of thousands of New Hampshire residents who are also consumers—the most recent estimate made in 2006 pegs it at 98,532 people.[7] Keeping the loophole in place for not-for-profits (or government agencies) creates large distortions and inefficiencies in the labor market such that workers would be better off working for not-for-profits and not the commercial sector.

Second, there is the issue of fairness. Not-for-profits enjoy an unprecedented level of tax preferences relative to the commercial sector. They don't pay property taxes or the BPT/BET and contributions are tax deductible to individuals for federal individual income tax purposes. Asking not-for-profits to have some skin in the game is only fair.

Finally, there is the issue of transparency. Whether or not not-for-profits should be subsidized does not negate the fact that tax subsidies are not transparent and thus not subject to the same level of accountability as a government appropriation. As such, future subsidies to not-for-profits should be done through the budgeting process, not through an open-ended, hidden tax subsidy.

Will the BFT Hurt Small Businesses Who Are Not Making a Profit?

The BFT will help small businesses the most because it exempts savings and investment—technically referred to as immediate expensing. Under the BFT, it is theoretically possible to invest all revenue and pay no tax.

A growing small business needs to invest in capital, but under the BPT they must comply with complex and often arbitrary depreciation schedules that can run for years. Unfortunately, most small businesses will be out-of-business before their assets are fully depreciated for tax purposes.

Also, tax compliance costs will be greatly reduced with the elimination of the complex BPT. Currently businesses have to file both the BPT and BET and essentially pay the higher of the two (since the BET is a credit against the BPT). With just the postcard BFT to file, small businesses owners can focus on more important matters.

Government Does Not Tax Itself?

As mentioned before, the BFT is really nothing more than a consumption withholding system at the source. More specifically, the BFT for government agencies is more akin to a payroll tax since they don't pay dividends and very little interest. The federal payroll tax already sets a precedent for governments paying taxes on behalf of their employees (since half is paid by the employee and half is paid by the employer).

Also, as with not-for-profits, the loophole for government agencies creates economic distortions and inefficiencies in the labor market by favoring government employment over commercial employment.

Conclusion

Now is the time to complete the tax reform transformation in New Hampshire by enacting the fair, flat 2 percent Business Flat Tax. The BFT will reverse 40 years of increasing marginal tax rates in New Hampshire by outright eliminating the onerous BPT and harmonizing the I&D rate. The economic evidence shows that this will supercharge the economy. With the country's only Flat Tax and a booming economy, New Hampshire will be the envy of New England and the United States.

About the Authors

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As a public choice economist trained in applied microeconomics and econometrics, Wendy Warcholik has spent her career applying economic tools to the problems of state government. Her professional experience includes positions as Economist at the U.S. Department of Commerce's Bureau of Economic Analysis, Chief Forecasting Economist for the Commonwealth of Virginia's Department of Medical Assistance Services, Adjunct Scholar with The Tax Foundation (co-creator of the Tax Foundation's popular State Business Tax Climate Index, now in its tenth year of publication) and Research Fellow at The Oklahoma Council of Public Affairs. She has worked as a consultant to free-market think tanks across the country for the past seven years.

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J. Scott Moody has worked as a Public Policy Economist for over 17 years. He is the author, co-author and editor of 154 studies and books. He has testified before the House Ways and Means Committee of the U.S. Congress as well as various state legislatures. His work has appeared in Forbes, CNN Money, State Tax Notes, Portland Press Herald, New Hampshire's Union Leader, Hartford Courant, The Oklahoman, and Albuquerque Journal.

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Moody received his Master of Arts in Economics from George Mason University.

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