Good morning Madam Chair and Members of the Committee,

House Bill 1118 is similar to HB 1158 in that it would significantly flatten the state's current five-bracket system. The primary differences involve the rate and the design of the base.

House Bill 1118 would impose a 1.99 percent rate in contrast to the 1.5 percent rate of HB 1158. The 1.99 percent rate is also a truly flat rate as it applies to all taxable income. By contrast, HB 1158 would imposes an unwieldly large exemption structure to exempt roughly 60 percent of the current tax base from income taxation creating a de facto two-tiered system.

Since workers and small business owners consider the impact of taxation on their next dollar of income when they make decisions about how much to work and where to work, a 1.99 percent rate will yield greater economic benefits than the current 2.9 percent rate. While not as low as the 1.5 percent rate, HB 1118's truly flat rate will still set conditions for in-migration and an increase in the labor force in North Dakota, on the margin as workers would be able to take home more of their next dollar of income.

Reducing the individual income tax to a flat 1.99 percent would improve the state's tax neutrality and lower barriers to productivity. But the challenge again is that states in the region and across the country that directly compete with North Dakota forgo at least one major tax, often the individual income tax, and thus effectively have a top marginal rate of 0 percent. A nearly 2 percent rate, modest as it may be, will still have to compete with states where residents pay nothing and file no return.

In deciding on the rate, it should not so much be an issue of whether to choose 1.99 or 1.5, but what the state can afford. If the state can only afford a $383 million cut, the cost of HB 1118, then the legislature should leave the rate at 1.99 percent. But if it can afford more, the rate could be set lower. Whatever the legislature decides, the rate should be set as a function of affordability and sustainability.

A bill with a flat rate of anything more than 1.1 percent would likely amount to a tax increase on the lowest income earners, which is why HB 1118 increases the resident tax credit from $300 to $800 for single filers and from $700 to $1,600 for married filers. The increased credit would shield lower-income filers from increased tax liability due to their exposure to a higher rate. The intent of the $44,757 exemption for single filers and the $74,757 exemption for married filers in HB 1158 is the same. *Ideally*, the rate would be low enough that large credits or exemptions are unnecessary.

There are trade-offs to both approaches, but in choosing between the two, the credit design is preferred as it is already part of the state's tax code and does not create as substantial of a de facto two-tiered system as the exemption would. (An $800 credit is equal to a $40,201 exemption against a 1.99 percent tax credit, an increase of $25,126 from the status quo.)

When assessed by the Tax Foundation's *State Business Tax Climate Index*, the truly flat rate and increased credit design of HB 1118 would result in North Dakota's overall tax competitiveness ranking increasing from 17th to 8th. The individual income tax structure would improve from the 27th to the 9th most competitive in the country.

If the system were redesigned with a large exemption for taxable income, as HB 1158 proposes, the state's overall ranking would only improve from 17th to 13th. The exemptions would cause the individual income tax ranking to underperform by 8 positions, moving from 27th to just 17th.

In our view, a reform that would yield immediate economic benefits for North Dakota while also generating the greatest possibility for future elimination of the individual income tax would be to create a truly flat tax applicable to the current base at the lowest rate sustainable for the state.

Thank you again for the opportunity to testify on HB 1118. I'm happy to answer any questions the committee may have.