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Tax Hikes on The Horizon

The Hole in the Budget That Can't Be Ignored

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There is a growing hole in the New Hampshire state budget. Alone it would require tax increases that would cause undue economic damage. Coupled with a planned but undefined increase in education spending, the amount will be too large to close with small changes to our current tax structure.

New Hampshire's state budget is required to be balanced in only the most technical of senses. Both the spending and revenue numbers in the budget are estimates. A budget that seems balanced at the time of passage will become a problem later if some spending had been left out of the budget estimates or agreed to outside the budget process. Similarly, optimistic revenue estimates can exaggerate the revenue that will realistically be available to spend and force emergency cuts later.

The New Hampshire House of Representatives has passed a proposed budget that has both problems. Revenue estimates are exaggerated and will have to be changed in the Senate. Spending increases are much higher than the recent average but don't take into account a massive education funding increase that is purposely being left out of the current budget even though it will become effective immediately. Simply put, there is a hole in the budget that has passed the House and is being considered by the Senate.

By one calculation the hole will approach $200 million. But when the planned off-budget spending increases are added in, the total shortfall will be $800 Million.

The Effect of Exaggerated Revenues

The easiest way to create a budget problem is to exaggerate revenue. As a result of the exaggeration, spending is then set at a level to match the unrealistic revenue estimate and a crisis occurs when the revenue doesn't materialize. The budget passed in June 2001 is a good example. Then-Governor Jeanne Shaheen considered vetoing the budget because revenue estimates were unrealistic. In the end she let the budget pass but its shortcomings occupied the remainder of her time in office.

She was right about revenues. Business tax revenues had been exaggerated by $97.6 million. Despite the beginning of the short lived Real Estate Transfer Tax boom, the business shortfall led to a budgeted revenue hole of $98.2 million when the biennium ended.[1] For the last 18 months of her time in office Gov. Shaheen was forced to issue executive orders to restrain spending. Her successor, Craig Benson, did the same during the final six months of the budget he inherited. In all the two of them were forced to issue six different executive orders[2] to decrease spending outside normal planning process of the budget. At the end of fiscal year, however, the budget required a one-time $25 million grant from the federal government and a transfer of $69.6 million from the state's reserve funds to achieve balance.[3]

The consequences of this budget imbalance were significant. It put great pressure on the next budget to increase taxes to keep up with a level of spending that was obviously beyond the tax structure's ability to pay. That temptation was resisted only because then-Governor Craig Benson was insistent that he would veto any increase in any tax.

More serious, national bond rating agencies lowered the state's bond rating. According to State Treasurer, our credit rating was lowered because "the state produced current year operating deficits for state fiscal years 2000 through 2003." The result is higher interest rates and a greater cost of debt. It is the equivalent of paying a higher mortgage rate.[4]

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[1] *The Department of Administrative Services publishes monthly comparisons of actual revenue v. budgeted revenue at http://admin.state.nh.us/accounting/Prior%20years.asp. This data is taken from the last report of each fiscal year. FY2002 (ending June 2002) showed business tax revenues $61.5 million below estimate and total general revenues $62.6 million below. The shortfalls for FY2003 were $36.1 and $10.6. The non-business tax revenue for FY2003 is inflated with the addition of the unanticipated $25 million federal grant so the real shortfall compared to budgeted estimates is $35.6 million. In each year, Medicaid enhancement revenues were slightly higher than expected so the total two- year shortfall in all monies available for the general fund was$62.4 Million. There are some small variations once audited data is compiled many months later but not this purpose I used the monthly reports because they represent the information available each month to legislators during the process.*

[2] *The executive orders are discussed in the state's bond information supplement found here: http://www.nh.gov/treasury/Divisions/DM/NHState2-OS.pdf*

[3] *At that time the state had multiple reserve funds. A transfer of $33.9 million closed out the former health care transition fund and an additional $35.7 million significantly lowered the revenue stabilization account commonly known as the rainy day fund.*

[4] *The State Treasurer in his 2004 annual report wrote that a strong local economy and reasonable levels of debt were overshadowed by "the fact that the state produced current year operating deficits in state fiscal years 2000 through 2003. As a result of that poor financial performance the state's credit rating was downgraded" in December 2003. See page 6 of http://www.nh.gov/treasury/Divisions/DocsForms/AnnualReport2004.pdf*

So the June 2001 budget produced a huge deficit because of exaggerated revenue estimates. The June 2003 budget was just the opposite. According to our bond statements, the state's official representation to the nation's financial community, then-Governor Craig Benson vetoed the budget because it relied on one-time revenues and didn't increase the state's reserves. As a result, a negotiated compromise passed in September that relied on very conservative revenue estimates. Good economic performance if it came would rebuild the state's depleted reserves.

In contrast with 2002-03, revenues exceeded the budgeted amount and the state produced a surplus of $82 million. A huge surplus made everyone's life easier and the next legislature borrowed $30 million as a one-time infusion to the next budget. They kept the other $50 million aside but finally released it to the rainy day fund after the next year's revenues came in ahead of schedule as well.[5]

The budget that was passed in June of 2005 also included conservative revenue estimates. In addition, it included $100 million in tax increases[6] and the one-time infusion of $30 million from the previous surplus. It will produce a revenue surplus of about $104 million. Projections in the Governor's budget call for operating surpluses of only $20 million. That means spending was $84 million higher than the budget – possible only because of the flexibility gained through cautious budgeting.

The budget that has passed the House and is currently being considered by the Senate is much closer to the June 2001 budget than the June 2003 budget. The immediate source of difficulty is revenue estimates.

The Recent History of Estimating Revenue

The most difficult part of any budget is projecting into the future how much revenue will be available. Some taxes are easy to estimate and others are much more volatile. In New Hampshire, business taxes are volatile and extremely difficult to estimate accurately. For the most part, the rest of our state taxes have been estimated within very small margins. The Real Estate Transfer Tax has been an exception recently because of the volatility caused by the housing boom and the end of that boom.

<u>Business Taxes:</u> Since the new tax rates were set eight years ago, business taxes have been as

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[5] *Buried deep inside the trailer bill for the 2005 budget was a brief paragraph suspending the law that automatically placed any surplus in a rainy day fund. The size of the surplus led some legislators to announce plans for spending the surplus until public pressure forced them to keep only $30 million and put the rest back in the rainy day fund.*

[6] *The state's tobacco tax went up 54% and will produce an estimated $101.4M more at the new rate than the same number sales at the old rate would produce.*

much as 13.6% below budget and as much as 19.2% above budget[7]. In six of the eight years, the budget projection was wrong by at least 8%. For comparison purposes, that range of 33 percentage points represents a $179 Million margin of error on the 2006 business tax total of $546 Million. So far this year, business tax revenue is $64 Million ahead of projections.

<u>Real Estate Tax:</u> The other significantly volatile tax in recent years has been the Real Estate Transfer Tax. A housing boom and escalating property values followed by the rapid end of the boom has caused this tax to be unpredictable. Over the last five years, the RETT has been as much as 36% above budget and 32% below budget but always at least 13% off from the budget one way or another. Predicting this tax has been very difficult. Its 68 point range of variation represents a $108 million margin of error off its 2006 base of $158 million.

<u>Other Taxes:</u> As volatile as business and real estate taxes are, other taxes are relatively predictable. After taking out the two volatile taxes, the total remaining taxes have not deviated from budget by even one percentage point over the last eight years. The range has been from 0.87 above to 0.92 below. That range leaves a margin for error of only $24 Million off the 2006 base of $1370 Million.

The two most volatile taxes comprise about 34% of unrestricted tax revenue. The margin for error based on their recent history is $287 million in 2006 or about $300 Million per year in 2008 and 2009. Conservative critics of the current revenue estimates suggest they are about $100 million too high over 2 years. That analysis is based largely on a claim that the volatile taxes, business and real estate transfer taxes, were inflated in recent years by record corporate profit levels and the housing boom.

The Hole in the Budget

The hole in the budget that will lead to tax hikes has been created by both a spending side problem and a revenue side problem. As we've seen, projecting the two most volatile taxes is risky and difficult. Because of that uncertainty, it is both sensible and necessary to forecast those two taxes conservatively. With a more cautious revenue projection, revenues at the lower end of the projected range will not create a crisis like the optimistic estimates that wreaked havoc with the 2002-2003 budget. If revenues do exceed expectations, the windfall can be used for the inevitable claims on the budget that occur. After all, in the current budget just ending, the legislature did manage to spend almost all of the extra $104 million of revenue.

<u>The Revenue Problem</u>

The revenue side problem is approximately $200 million but in a range from $151-$236 million:

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[7] *The budgeted number is derived from the end of the year "Actual v. Plan" page of the monthly revenue report published by Administrative Services and compared to the audited actual revenue numbers published long after the fiscal year ends. The 19.2% is a ten-month total for the current year based on the monthly revenue report.*

The former Republican chairman of the Ways and Means committee, Norm Major, claims the House budget estimates are $100.4 million too rosy.[8]

- *Business taxes*: Most of the remaining total comes from the volatile business and real estate taxes that should slow down as the record housing market cools and corporate profits come off their 2006 record levels. Prudence suggests using a more cautious number. In additional, business revenues have been enhanced by a significant collections campaign that began as a campaign pledge of Craig Benson's in 2002. Those additional revenues artificially inflate the rate of increase. In that light, Rep. Major's assertions seem prudent. Even if Major is only partially right, the shortfall in business taxes is likely to be between $37 and $53.1 million.

- *The Real Estate Transfer Tax* is much more problematic. From 2002-2005, the RETT increased by a ridiculously high 60.1%. Revenues leveled off for a year and then collapsed. They have been more than 20% below estimate for nine straight months and counting. Revenues for 2007 will represent a decline of about 12% over 2006. Revenues will likely continue to decline before leveling off. A small 6% decline and then level for the second year would make the House numbers off by $47.7 million. Even if the 2007 level were sustained for two years and didn't decline, revenues would still be $34.5 million below the House budgeted estimates.

- *The Interests and Dividends Tax* is also somewhat responsive to corporate profits levels. Basic levels of savings are more likely to be part of the individual exemption on the first $4800 of a couple's return. However, tax returns so far this year have been surprisingly strong. In fact, over the last three years revenues have increased more than 90% after a 30% decline in 2002-2003. In that light, the House estimates are probably fairly conservative in the first year and a moderate estimate in the second.

- *Insurance Premium Tax* revenues have been very strong and a change in the insurance tax is unlikely to have a significant impact on revenues in the very short term. In addition, the tax change will not affect premiums paid on health insurance policies which seem to be rising in New Hampshire at a strikingly high rate. While that is bad news for consumers, it helps with tax collections. In that light, the House estimates on Insurance Premium Taxes are fairly modest increases over the current fiscal year and at the low end of historical averages.

Tobacco Taxes: While the Governor had proposed a 35% increase in tobacco taxes, the House budget increased that to 56%. The larger increase will decrease total tobacco and other collateral

[8] *See "House Budget in the Red," New Hampshire House of Representatives Republican Office Press Release, April 11, 2007(http://www.nhhousegop.com/index.htm). Major claims the business tax estimate is $53.1 million too high, Interest and Dividends $15.7M, Real Estate Transfer $14.3M, Tobacco $9M, and Insurance Taxes $8.2M.*

sales to certain business by more than $200 million. Those same small businesses have suffered through a reduction of about 21 million packs and the collateral sales as a result of the tax increase two years ago.

Each time the tobacco tax is raised, sales drop significantly. Each time a neighboring state raises its rates, our sales climb. When Massachusetts raised its tax 71 cents to $1.51 in 2002, we saw a 20 percent jump in sales over the next two years. When we raised our tax from 52 to 80 cents two years ago, we saw an 11 percent decline.

Following our 2005 tax hike, sales declined by about 7 million packs. In Massachusetts, sales increased by 8.5 million. Our decline wasn't as severe because Maine raised its tax and we increased cross-border sales with the smaller Maine market. This year, sales have declines by an additional 14 million packs.[9]

Over the last two years we lost 11 percent based on a 28-cent increase. A 45-cent increase should be much worse. We lost 11 percent of sales because the price advantage on a carton was only $7. A 45-cent increase would reduce the price difference to less than the price of one gallon of gas. The 45 cent increase will likely have a greater impact on sales than the 11% loss from the last increase. If the annual reductions are 5 and 10 percent instead of the 3.4% and 7.5% we just experienced, the House budget estimate is too high by $41 million.[10]

If the Senate takes into account the devastating impact to small business and goes back to the tax increase proposed by the governor, decreased sales of 4% and 8% and he lower rate will make the House budget estimate off by $87 million.[11]

Collateral damage: New Hampshire sells significantly more cigarettes than its residents consume. Because each neighboring state has a higher tax rate, as many as 40 percent of our cigarettes are sold to residents of neighboring states crossing over to buy by the carton and save themselves some money.

But the economic impact doesn't stop there. A cost-conscious shopper driving across the border brings more than just cigarettes to the cash register. According to the New Hampshire Grocers Association, for each dollar of cigarettes purchased, the out-of-state consumer will buy more than $3 worth of other sundry items. Many of them, such as beer and lottery tickets, also contribute to our tax revenues. The Grocers Association has estimated that a 28-cent increase will lead to a

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[9] *An accurate estimate of the number of packs sold can be derived by dividing tobacco tax revenues by the tax rate. Since about 99% of tobacco tax revenues are from cigarettes not other products, this pack equivalent is very accurate. The total loss for 2007 assumes the last two months follow the same trend of the previous 10 producing estimated sales of 174.3 million packs. By comparison, sales in 2005 were about 195.2 million.*

[10] *The two year total of sales would be 314.6 million packs at the higher rate.*

[11] *At the 28 cent increase, the two year total of packs sold would be 321.3 million.*

loss of $93 million in total sales to the grocery and convenience stores. Even worse, the 45-cent increase that is included in the House budget will cause a loss of about $200 million in sales. That number is based on a conservative estimate of sales loss at 7%. We've already seen a reduction of 11%.

Not all of the lost additional purchases will affect tax collections but many of them do. Cost-conscious border shoppers tax advantage of our price advantages on beer and our different lottery games. About 25% of the cost of cigarettes is New Hampshire Tax. If 8% of the collateral sales revenue is made up of lottery tickets or beer taxes, then a $1 loss of cigarette sales will generate an additional $1 loss of other state revenue, a good rule of thumb. Therefore additional losses to other state revenue should range between $37 and $44 million.

In addition, the federal government is considering a change to the federal tobacco excise tax that is projected to reduce New Hampshire revenue under current assumptions by $13 or $15 million depending on the elasticity assumption used.[12] It is beyond the scope of this paper to project the likelihood of its passage so the number is not included in estimates of the total size of the budget shortfall.

Registration Charges: The budget was balanced with a hike in the car registration charge (a fee or tax depending on your perspective) of $6 million. The $6 new charge per motorist is calculated to create no great outcry but the fee of as much as $200 per truck hurts the important trucking industry disproportionately. Because of that economic impact, the new charge will likely change and reduce the total by $2-4 million.

Summary of Estimated Revenue Shortfalls		
	Low range	High range
Business Taxes	$37 million	$53.1 million
Real Estate Transfer Tax	$34.5 million	$47.7 million
Interest and Dividends, Insurance	0	0
Tobacco Taxes	$41 million	$87 million
Other Tobacco Related Sales	$37 million	$44 million
Registration Charges	$2 million	$4 million
Total	$151.5 million	$235.8 million

The Spending Problem

[12] *Based on a trade analysis done for Altria, a cigarette manufacturer, "61 Cent Cigarette Increase Could Cost New Hampshire $16 million annually." The paper projects lost sales that would affect both the tobacco lawsuit settlement payments and tobacco taxes. The Treasury model produces a loss of $13.97 million and the CBO model $15.72 million. Both are based on older models of demand elasticity. I suspect the impact is somewhat lower with the current higher prices.*

On the spending side, budgets are made to be broken. The House made admirable efforts to make their spending estimates more open. They avoided the past practice of leaving out some spending only to have it authorized later by the elite super-legislature called the "Legislative Fiscal Committee." This is a substantial improvement. However, supplemental spending occurs in every biennium, even in the face of fiscal crisis.

For example, in the 2002-2003 budget, even after six executive orders reduced spending, the final net appropriations for the biennium were higher than the budget anticipated. The initial budget used revenue of $4.04 billion. A year later, halfway through the budget cycle, the treasury estimated $4.21 billion. The final number was $4.238 billion, about $198 million higher than the original estimated revenue. A similar situation occurs every year.

One of the most important reforms is the governor's announcement that he will require monthly spending updates to be posted on the internet just as monthly revenue comparisons currently are.

Supplemental Appropriations: Because the revenue estimates used to balance the budget don't allow for a later readjustment, it is sensible that the budget either forbid supplemental spending or specifically budget an amount that can not be exceeded without cutting other spending to make room. Capping the amount of supplemental spending at 1% of the general fund would allow for a contingency of approximately $45 million.[13] That number should be specifically budgeted to admit the reality of what will almost certainly occur and provide at least some budget structure to currently off -budget decision making.

However, all other changes to revenues or spending pale in comparison to a potential increase in education spending that would require a complete restructuring of the budget. In response to the latest in the Claremont series of lawsuits, the "Londonderry decision," the House has passed a "definition of an adequate education." This is not an education directive but a list of the things the state government must cost out and send a check to local communities for.

The bill has already passed the House, is almost certain to pass the Senate, and has the support of the Governor. Its proponents have suggested that we can wait to total the exact cost until sometime next year even though we'll start paying for the cost before we know how much it is. They argue that worrying about how much it will cost will hinder decision making and focus the debate on dollars not students. The other school of thought argues that all bills require a fiscal note because no decision that affects the budget can be made independent of cost. To vote a financial obligation without knowing an amount is irresponsible.

The price tag will not be included in the current budget but the undefined obligation begins immediately. It's not that we don't owe the money until the legislature votes to define the actual cost, the bill takes effect "upon passage" and is a definition of what the state will pay. The

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[13] *The House-passed budget estimates unrestricted revenue exclusive of "Medicaid enhancement" of $4.56 billion.*
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obligation will be incurred but we are waiting for an accountant to add up the amount. It is a little like going on a shopping spree and waiting for the credit card bill to come. You owe the money, you're just waiting for the shock of opening the envelope in the mail.

If the difference between the proposed cost and what we spend today were an insignificant amount, it would not matter. However, the increase is huge. The vice chairman of the committee that worked on the bill said a very rough estimate of the cost is probably about $1.2 billion compared to the $890 million we are projected to spend without the bill[14]. That additional $310 million dollars is not part of a budget that calls for revenue of $2,317 million in the second fiscal year of the budget.[15]

The additional cost will be obligated for both fiscal years although determined well after the first fiscal year begins. Without a change to the effective date of the bill, the budget is out of balance by at least $620 billion if the Dunn estimate is correct. If his very rough estimate is low by just 10%, the budget is $860 million out of balance on this item alone.

Estimated Range of Budget Imbalance		
	Low estimate	High estimate
Revenue Estimates	$151 million	$236 million
Supplemental Appropriations	$45 million	$45 million
Education Funding Problem	$620 million	$840 million
Total Hole in the Budget	$816 million	$1121 million

Tax Hikes on the Horizon

A huge spending obligation of $620 - $840 million will push the size of the hole in the budget over a billion dollars. Given the size of the developing hole in the budget, there are a limited number of solutions available to policymakers.

Other than the education funding issue, the problem is close to $250 million. Therefore, the education funding problem should be treated separately to make a solution manageable.

[14] *See for example the story in the 15 May 2007 Concord Monitor, "Seantors Grill Reps on Costless Approach." The figure $610 million is an approximation based on Rep. Dunn's estimate compared to total nominal state aid of approximately $890.36 million budgeted for each of the next 2 years. That number includes the statewide property tax "aid" that is not actually sent but retained locally. On the other hand, if his very rough estimate were off by 10%, it would add another $240 million to the state budget.*

[15] *The bill takes effect "upon its passage" which will likely occur at the end of this fiscal year. The bill assumes that it is defining what the state must pay to towns for education aid. That fiscal obligation begins when the bill is signed. To avoid a financial obligation for both FY2008 and FY2009, the effective date would have to be moved forward two years.*

- The $620 - $840 million education funding obligation cannot be solved within the state's current revenue structure. The only feasible solution is to delay the effective date of the act until the measure's actual cost can be identified. Without knowing the size of the problem, a solution can't even be discussed. If the state decides to incur this huge cost, the impact of tax increases, a completely changed revenue structure, and reductions to other government programs will have to be debated within the context of the next budget. Anything else will require reopening the budget at a later date to add an item that represents more than 25% of annual spending. To do so would require significant tax increases and spending reductions. The turmoil would require a discussion of spending priorities and economic incentives that can't be done in just a few weeks.

The rest of the spending hole may seem small in comparison to the larger problem but it too puts an impossible strain on our state's admirable tax structure.

- Business Taxes are already too high and can't be raised any further. The last time education funding was increased, businesses bore the brunt of the burden. The Business profits tax saw a 21% increase (from 7 to 8.5) and the Business Enterprise tax was increased 300 percent (from 25 to 75 basis points). Our corporate tax rates are now 38th best in the country, not quite as good as Massachusetts at 36th.[16] New Hampshire economist Lisa Shapiro's influential study of the economic consequences of state business taxation found "even a small additional increase in business taxation … creates a significant drag on the state's economy."[17]

- The Statewide Property Tax will raise $363 million but that entire amount is retained locally, never enters the state treasury, and is a tax only on paper. The level was set to eliminate the donor town problem that had created enormous divisions between communities in New Hampshire. To increase the tax to a level high enough to create cash flow to the state treasury would reduce real grants to many towns[18] and create dozens of new donor towns. In addition, there is a bipartisan consensus that the state to eliminate the statewide property tax while it is still an accounting gimmick.[19]

- The only other current state tax that raises a significant amount of money is the Meals and Rooms Tax borne in large measure by the state's precarious tourist economy.

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[16] *See Curtis Dubay and Christ Atkins, "State Business Tax Climate Index," The Tax Foundation, October, 2006 at http://www.taxfoundation.org/publications/show/78.html*

[17] *The Shapiro study was a response to increased tax rates and the concern that the legislature might look to further squeeze taxes out of businesses a few years ago. See Lisa Shapiro, "Budget Deficits and Business Taxes in New Hampshire," May 2002 at http://www.gcglaw.com/resources/economic/businesstaxes.html*

[18] *Current state aid is a function between what the state property tax would nominally raise in a town and the amount of aid the formula theoretically produces. As one rises the other falls.*

[19] *For a discussion of the problems with state taxation of property, see my paper "The Opportunity to Eliminate the Statewide Property Tax," http://www.jbartlett.org/files/pdf/policy_matters_web.pdf*

> However, at 8% the tax is already too high for a state so reliant on tourism. To raise even $50 million would require a 25% increase and send tourists away from out hotels and restaurants. Given the precarious nature of a tourist economy, any increase is intolerable.

Raising any tax will impact some sector of the economy and cause economic losses. Raising a broad basket of taxes merely spreads that pain around so that everyone is equally miserable. Alternatively, the spending that causes a $250 million hole is about four percent of a $5 billion budget.