STATE AID TO MUNICIPALITIES
State Budget Decisions Affect Local Property Taxes

Prepared by the New Hampshire Municipal Association

July, 2016

Understanding the various types of aid provided by the state to local governments is critical to understanding the effect that state-level budgetary decisions have on local property taxes. With the property tax as the primary source of local revenue, reductions in any state aid program, or the shifting of state costs to municipalities, most likely results in increased property taxes. The following explains the state aid programs relied upon by local governments as well as recent trends in funding those programs.

A major category of state aid is educational funding to school districts. This is comprised of a number of programs, the most significant of which are adequate education aid to meet the state's constitutional obligation, building aid and catastrophic aid (special education). Education funding goes directly to school districts, not to cities or towns (except in the nine cities where the city council and the school board are one in the same). Education funding received by school districts affects the local school property tax rate, not the municipal property tax rate.

As summarized on the schedule prepared by the Legislative Budget Assistant's Office (LBAO) and included on page 14, state aid to municipalities fall into the three categories:

General Funds

- Meals and Rooms Distribution
- State Revenue Sharing (Suspended 2010-2017)
- State Retirement Normal Contribution (Repealed 2013)
- Railroad Tax Distribution

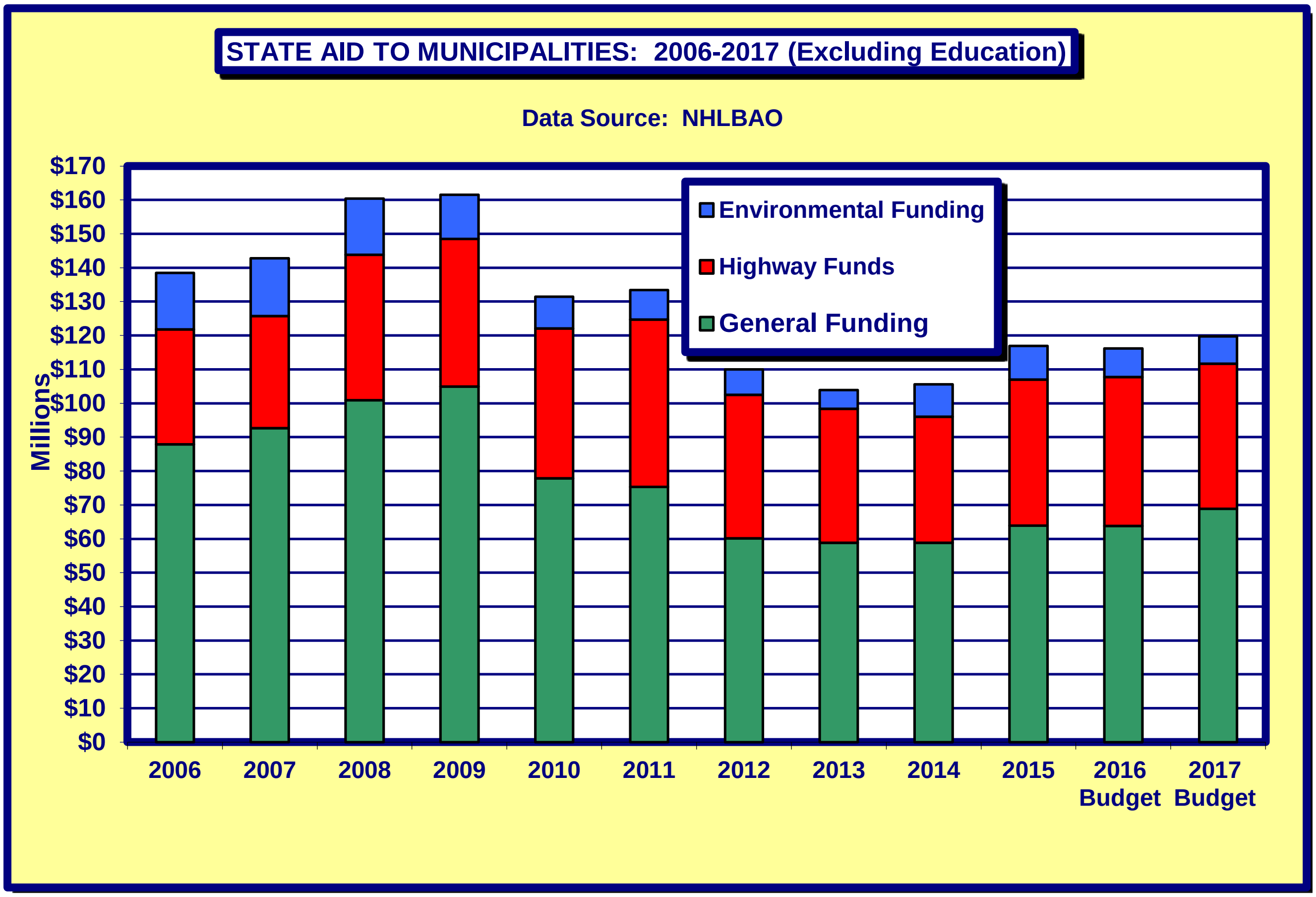
Environmental

- Flood Control
- Landfill Closure Grants
- Public Water System Grants
- Pollution Control Grants
- Water Supply Land Protection Grants

Highway Funds

- Block Grants
- State Highway Construction Aid
- Municipal Bridge Aid

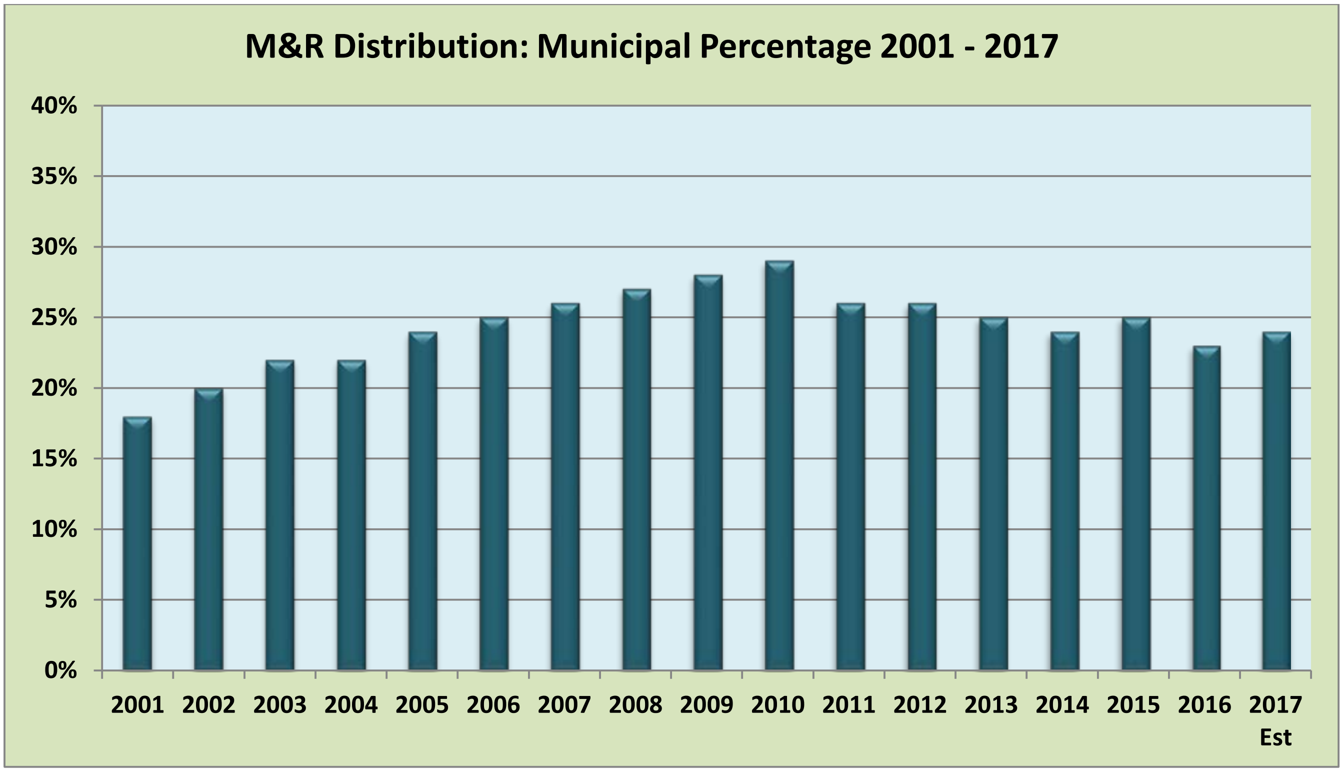
As illustrated in the following graph, overall there were significant decreases in both state general fund assistance and state environmental assistance to municipalities in the 2010-2014 budgets, with slight increases in 2015 and budgeted in 2017.



Meals and Rooms Distribution

One of the most significant general state aid revenues to municipalities is the meals and rooms tax distribution under RSA 78-A:26. When the meals and rooms tax was first enacted in 1967, the intent was to share the revenue with municipalities, with the state retaining 60% of the revenues generated from the tax and municipalities receiving 40% of those revenues. The legislature decreased the municipal share several times (in 1977 and 1981) virtually freezing the funding below the 1976 level. It was not until 1993 that the meals and rooms tax statute was amended to provide a catch-up formula in order to reach the statutorily intended 60/40 split. The amendment provided a formula where 75% of the year-over-year increase in revenue from the meals and rooms tax (but not more than $5 million in any one year) is added to the previous year's municipal distribution.

The municipal share is distributed to cities and towns based on annual population estimates provided by the New Hampshire Office of Energy and Planning.



In 2001, the state/municipal share was 82%/18%. As the meals and rooms tax revenues gradually increased, so did the municipal share of those revenues. In 2010 the state/municipal split reached 71%/29%, which was based on the actual tax revenues received the prior state fiscal year (2009).

However, the catch-up formula was suspended from fiscal years 2010 through 2014, freezing the distribution to municipalities at the 2009 level of $53.8 million, while annual revenues from the meals and rooms tax increased by nearly $50 million over that period. By freezing the municipal distribution at the 2009 level, the trend of gradually approaching the 60%/40% split was reversed, with the municipal percentage declining to 24% in 2014. The catch-up formula was reinstated for fiscal year 2015, resulting in a distribution to municipalities in December, 2014 of $63.8 million, a $5 million increase, and approximately 25% of the revenues received in the prior state fiscal year. The catch-up formula was again suspended in 2016 while revenue from the tax continued to come in strong, well in excess of the prior year, resulting in a drop in the municipal share to 23%. For 2017, the catch-up formula was in effect providing an additional $5 million for a total distribution of $68.8 million or 24% of the prior year’s revenue. Had the catch-up formula continued rather than being suspended for six years, the December, 2016 distribution to cities and towns would have been approximately $81 million (30% of the meals and rooms tax revenues received the prior year) rather than $68.8 million (24%). Cumulatively, the suspension of the catch-up formula has resulted in a loss to municipalities of approximately $58 million from 2010 -2017.

Revenue Sharing

In 1969, reform of the manner in which the state taxed businesses led to the implementation of the business profits tax (BPT). This necessitated the elimination of antiquated taxes which were more reflective of an agricultural economy of the past. These taxes were assessed and collected by municipalities and were part of the property tax base for municipalities, school districts and counties (including the tax on stock in trade, taxes on studhorses, poultry, domestic rabbits, fuel pumps/tanks and other taxes). The initial intent of RSA 31-A was stated as follows:

> *In consideration of the removal of certain classes of property from taxation, which would otherwise have the effect of reducing the tax base of cities and towns of the state, it is hereby declared to be the policy of the state to return a certain portion of the general revenues of the state to the cities and towns for their unrestricted use…Chapter 5, Laws of 1970.*

On March 31, 1970, in testimony on House Bill 1, then New Hampshire Attorney General Warren Rudman responded to concerns that future legislators may choose not to honor this commitment to municipalities to fund revenue sharing, stating

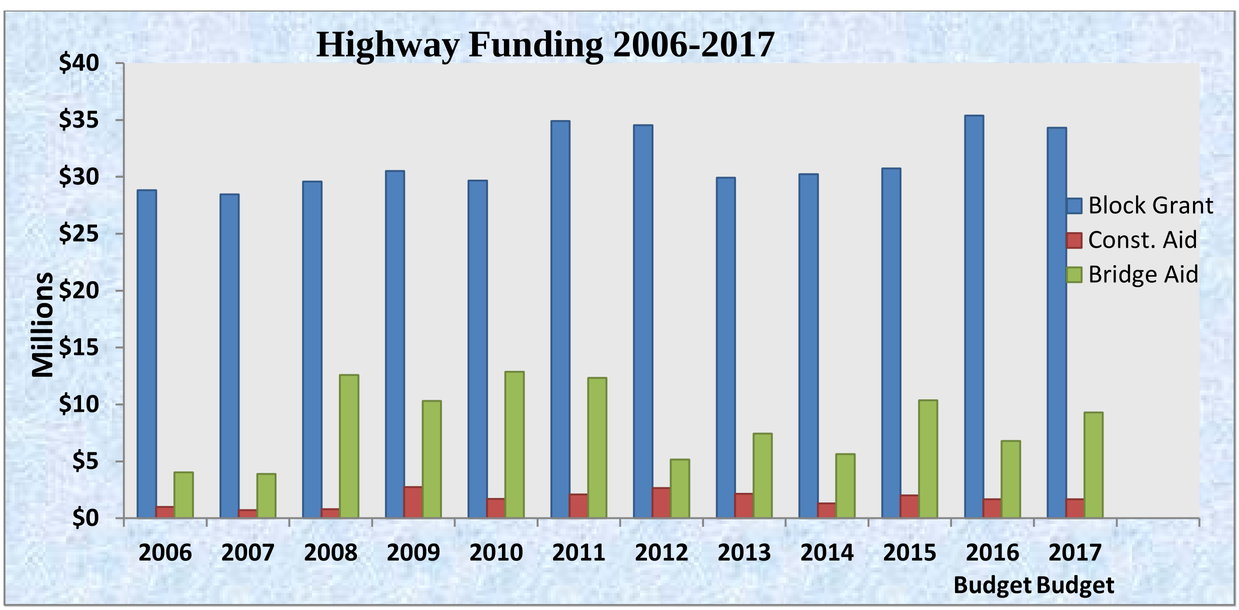
> *…this bill creates a new chapter in the statutes of the state of New Hampshire which is specifically entitled "Return of Revenue to Cities and Towns". And it says "there is hereby appropriated for each fiscal year a sum sufficient to make the payments provided for by this section". Now the charge has been leveled that future legislators might choose not to honor this pledge…It seems quite doubtful to me that once this bill is passed that any legislator would go back on its pledge to return revenue to cities and towns that originally belonged to those cities and towns. And I might also add, in passing, that I could hardly see a Governor signing a bill which would deprive cities and towns of the revenue which they once had."*

When enacted in 1970, RSA 31-A included a provision by which the funding of revenue sharing would increase by 10% each year. This 10% provision was short-lived, however, and was amended to 5% the following year with further reductions in subsequent years. In 1983, RSA 31-A was again amended to incorporate other revenue sharing formulae then in existence (such as the interest and dividend tax and the savings bank tax), thereby consolidating all such funding to municipalities under one statute.

Total revenue sharing in 1999 was $47 million. In 2000, as part of the statutory changes necessary for the state to fund adequate education obligations, $22 million of revenue sharing that had been allocated to school districts became part of the adequate education aid funding. This left the balance of $25 million annually as general revenue sharing for municipalities and counties, which remained constant through fiscal year 2009. Since 2010, revenue sharing has been suspended resulting in a loss to municipalities and counties of $25 million per year. The impact of this loss varies among municipalities, with deferred maintenance, use of reserves or fund balance, budget reductions and/or property tax increases among the common reactions to the loss of revenue sharing funds from the state.

Highway Block Grants

Twelve percent (12%) of the total road toll (gas tax) revenue and state motor vehicle fees collected in the preceding state fiscal year are distributed to municipalities through a local highway aid formula. This money comes from the state highway fund, not the state general fund, and provides funding to maintain and improve Class IV and Class V municipal roads and highways. Supplemental funds totaling $400,000 are distributed pursuant to a statute that provides additional funds to those communities with higher local roadway mileages and lower property valuations.



From fiscal years 2006 through 2010 the total amount of annual highway block grants ranged from $28.5 to $30.5 million. In 2009 the legislature enacted a temporary 2-year motor vehicle registration surcharge which increased both the amount of revenue in the state highway fund as well as the 12% share to municipalities in fiscal years 2011 and 2012, resulting in approximately $5 million more each year. The surcharge was repealed and block grant funding to municipalities returned to approximately $30 million per year from 2013 through 2015.

In 2014 the legislature raised the road toll for the first time in 23 years, increasing the rate by approximately 4 cents from 18 to 22 cents per gallon of gasoline effective July 1, 2014. This increase was expected to raise an additional $33 million per year in highway funding of which 12%, or an additional $4 million per year, is reflected in the highway block grant budget for cities and towns beginning in state fiscal year 2016.

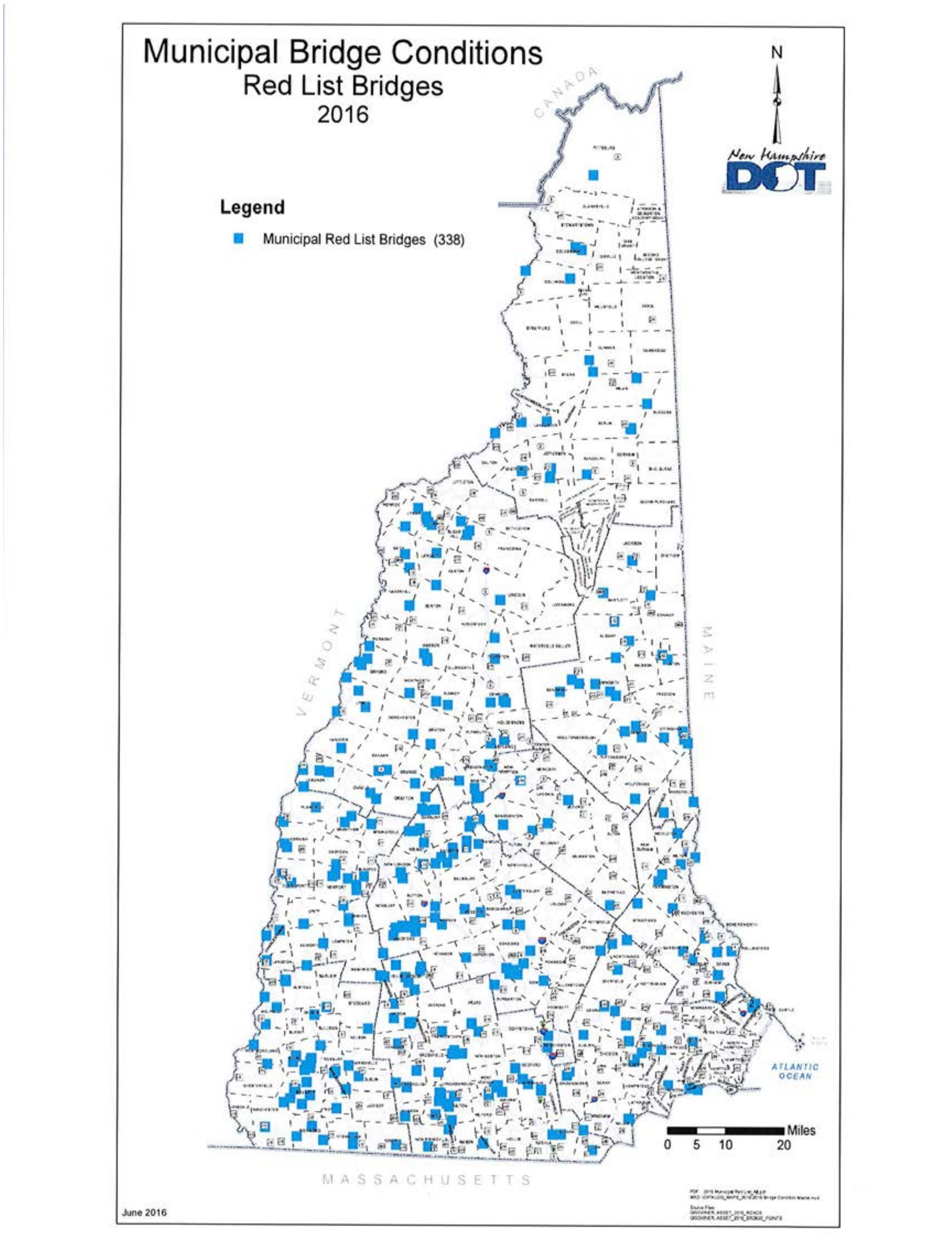
State Bridge Aid

Of the 1,685 municipally owned bridges in the state, 20% (338) were classified as "red listed" meaning the bridge is in poor condition, critically deficient and/or functionally obsolete. The State Bridge Aid program under RSA 234 provides that funding for construction or reconstruction of municipally owned bridges shall be borne 80% by the state and 20% by the municipality, subject to the available level of funding each year.

Historically, State Bridge Aid had been budgeted at approximately $6.8 million annually which typically funded about 10 bridge projects per year, and resulted in about a 10-year waiting list for state aid. Part of the revenue from the 2014 increase in the road toll discussed above was intended to double the amount of funding appropriated for municipal bridge aid, helping to reduce the 10-year waiting period to a more reasonable timeframe. The increase in State Bridge Aid in fiscal year 2015 reflects funding from the road toll increase which allowed the replacement or repair of more than twice the number of bridges typically done in a year. However, this funding increase was short-lived with the fiscal year 2016-2017 budget appropriations dropping back down to the historic level of $6.8 million per year – with all of the appropriation coming from the 4 cent road toll increase, which was supposed to supplement, not supplant, the bridge aid provided through the highway fund.

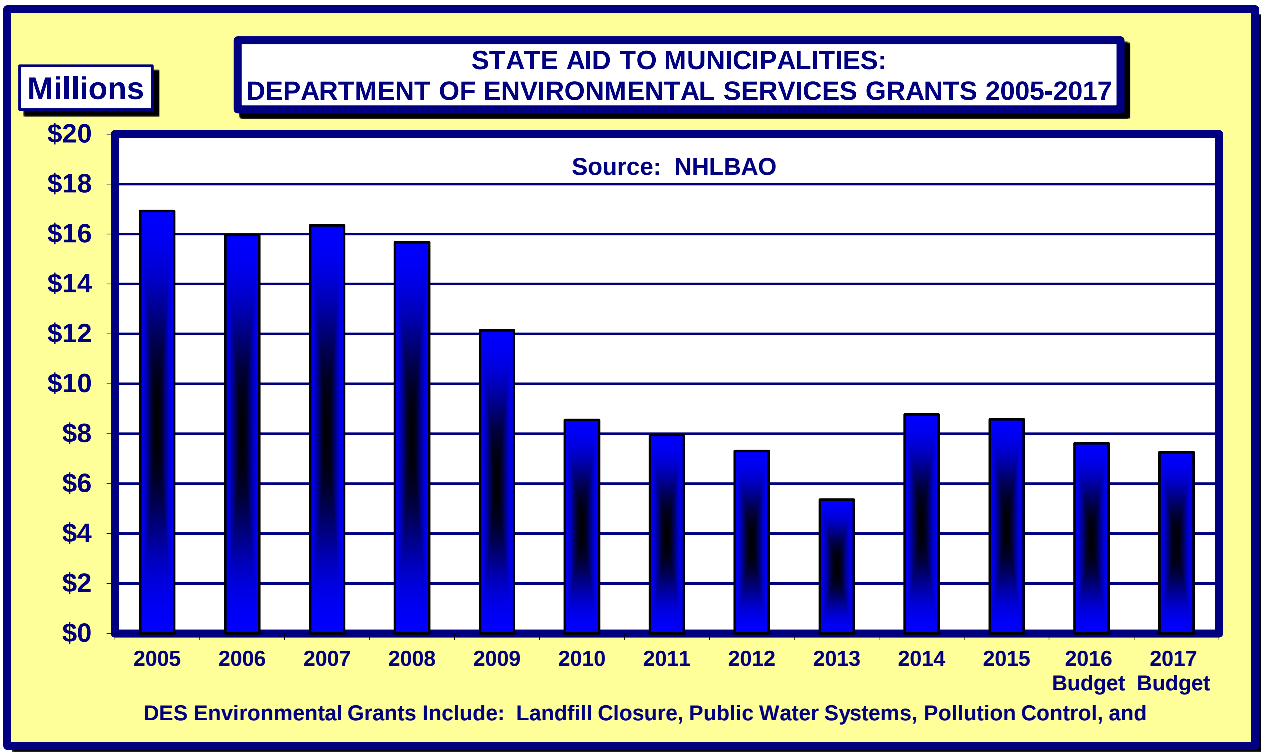
In 2016, HB 2016, dealing with the state 10-year transportation improvement program, was amended to provide an additional $2.5 million in municipal bridge aid for fiscal year 2017. Funding for this additional appropriation came from excess funds in the Department of

Transportation's winter maintenance budget due to the mild winter. The following Department of Transportation map shows the location of municipal red-listed bridges as of June, 2016.



Environmental Grants

Municipalities receive grants for the construction, improvement and expansion of municipal wastewater and public drinking water facilities, and also for assistance with the cost of landfill closures. Under this program, municipalities finance the full cost of the project up-front, complete construction and then apply for payment of the state share, which is 20% to 30% of the eligible project costs, usually paid by the state over the amortization period of the municipal financing (bonding or borrowing from the state revolving loan fund).



The amount of these grants began declining in 2008 with funding in 2013 less than 32% of the funding in 2005 ($5.6 million vs. $17.6 million). As part of the 2010-2013 budget reductions, the state only funded its obligations for grants approved through 2008 leaving municipalities to pick up the anticipated state share ($53 million) for 127 previously approved and completed infrastructure projects. These projects were placed on the Department of Environmental Services "Delayed and Deferred" list.

Fortunately, as part of the fiscal year 2014/2015 biennial budget, funding was restored for all projects on this delayed and deferred list. With the state making payments of this $53 million to municipalities over the amortization period of the municipal financing, the net effect on the 2014 and 2015 state budgets compared to 2013 were increases of approximately $4 million and $4.4 million, respectively. However, also as part of the 2014/2015 biennial state budget, a moratorium was placed on funding any new infrastructure projects that did not have local financing authorization by December 31, 2008. In 2016, HB 1428 provided funding for eight additional projects that received local financing approval prior to the December 2008 moratorium. However, as of the end of 2016, there are nearly 50 wastewater projects that would qualify for state aid in the near future if the moratorium was lifted.

Flood Control. Also included under the environmental funding category is money for flood control reimbursements to those municipalities in interstate flood control compacts. Under these compacts and state law, municipalities receive payments-in-lieu-of-taxes (PILOT) for taxable land that was taken to help mitigate downstream flooding from both the Merrimack and Connecticut rivers. Up until fiscal year 2012, municipalities were reimbursed by the State of New Hampshire for the full amount of the PILOT, even if the other states in the compacts (Massachusetts and Connecticut) did not make payments under the terms of the compact. In 2012 and 2013, the state only paid the New Hampshire share (approximately 30%) of the PILOT to municipalities when the other states did not make payments. However, in 2014 funding of $542,672 was provided to compensate municipalities for the PILOT shortfall in fiscal year 2012 and was paid to municipalities in state fiscal year 2015. Similarly, $163,285 was appropriated in 2016 to partially compensate for the shortfall in 2013. The 2014 - 2017 state budgets include full funding of the PILOT, and require payments to municipalities regardless of payments, or lack thereof, from other states.

New Hampshire Retirement System

The New Hampshire Retirement System (NHRS) was established in 1967 to consolidate and replace four separate pension plan systems: the New Hampshire Teachers Retirement System, the New Hampshire State Employees Retirement System, the New Hampshire Policemen's Retirement System, and the New Hampshire Permanent Firemen's Retirement System. NHRS is a public employee retirement system that administers one cost-sharing, multiple-employer pension plan providing a defined benefit annuity based upon a statutory formula, disability, and survivor benefits, for all full-time state employees, public school teachers and administration, permanent police officers, and permanent firefighters. Full-time employees of political subdivisions (such as county, municipal or school district employees) are also eligible to become members of the NHRS if the local governing body elects participation.

NHRS also administers four separate cost-sharing multiple-employer healthcare plans, known as Other Post-Employment Benefit (OPEB) plans, which provide a medical insurance subsidy to qualified retired members.

Demographics. As of June 30, 2015 there were 468 participating employers (cities, towns, counties, school districts, special purpose districts and the State of New Hampshire), and 81,161 active, retired and terminated-vested members of the NHRS. Employees comprised 50% of the membership, teachers comprised 36%, police officers 10% and firefighters 4%. For the medical subsidy plan, 10,265 retired members received the subsidy in 2015 while 3,056 active members (police and firefighters hired before July 1, 2000) were eligible to receive the subsidy in the future. Together the retired and active members of the medical subsidy plans represent 16% of the NHRS membership.

Funding. Funding for the NHRS comes from three sources: investment earnings, employee contributions, and employer contributions. Investment earnings fluctuate from year to year, with annual returns in the past 20 years reaching as high as 23% and as low as -18%. Over the long term, investment earnings provide anywhere from two thirds to three quarters of the funds needed to pay for pension benefits. For projection purposes, an "assumed rate" of investment return is adopted by the NHRS Board of Trustees. This assumed rate had been as high as 9.5%, was lowered to 8.5%, then to 7.75% in 2011, and was recently lowered to 7.25% for use in projecting future investment earnings.

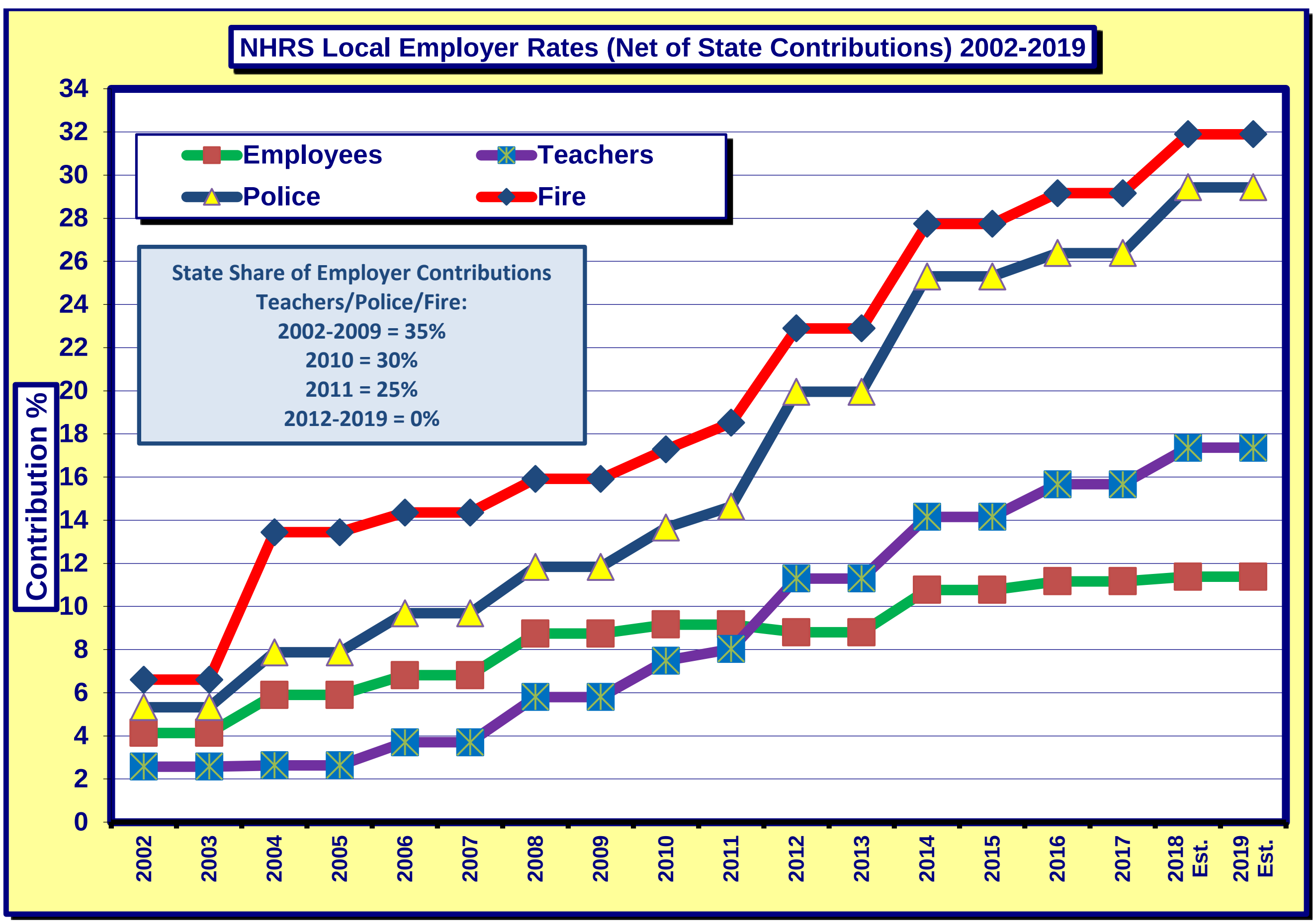
The Employee contribution rates are set by statute and were 5% of compensation for Group I (employees and teachers) and 9.3% of compensation for Group II (police and firefighters) until June 30, 2011. Legislation enacted in 2011 changed the employee contribution rates to 7% for employees and teachers, 11.55% for police and 11.8% for firefighters effective July 1, 2011. (Note: new Group I state employees hired after July 1, 2009 were contributing 7%).

While employee rates are set by statute and have changed only once in the past 20 years, employer rates are adjusted every two years based upon an actuarial valuation to ensure adequate funding for future pension liabilities. Through these biennial rate adjustments, employers not only contribute toward their current employees' retirement, but also bear the full financial burden of any shortfalls in the system, whether those shortfalls are the result of poor investment returns, insufficient funding in the past, losses from actuarial assumptions regarding member demographics (such as when employees will retire, their age at retirement, how long they will live after retirement, and their earnable compensation), or increases in liabilities from statutory changes to the plan design.

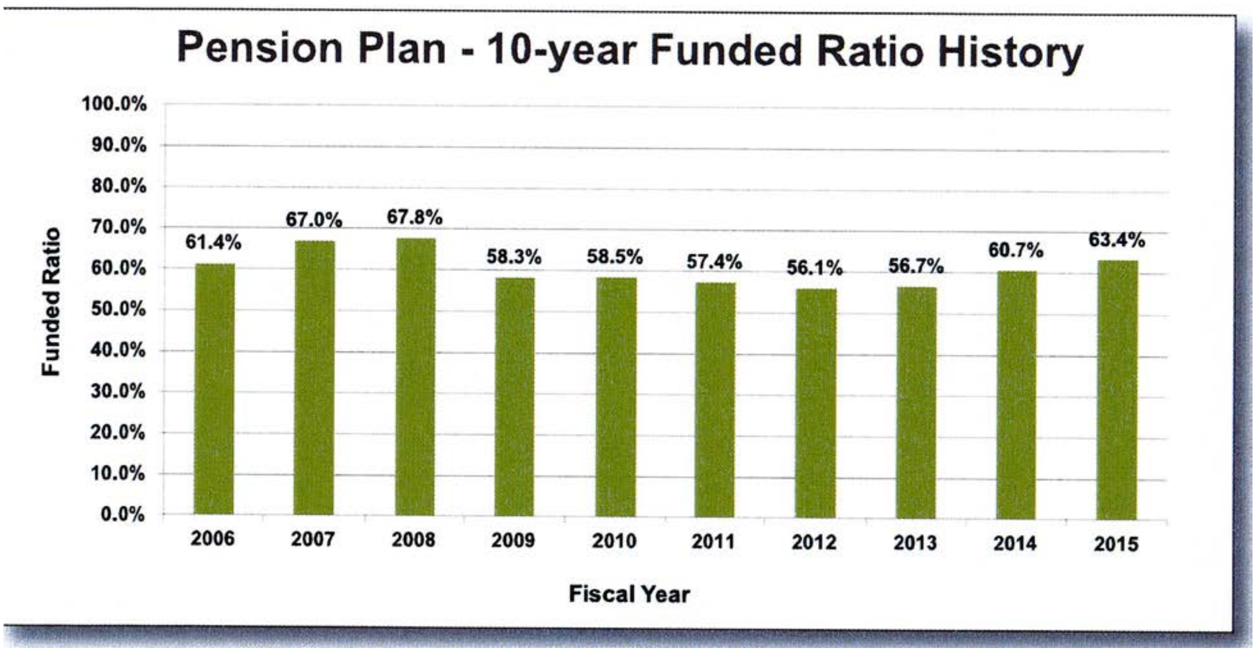
State Contribution for Teachers, Police and Fire. The State of New Hampshire had funded a portion of the normal retirement costs for teachers, police and firefighters, a practice that dated back to 1940 under the predecessor retirement systems. Since 1977, the state contribution had been set by statute at 35% of the cost, with municipalities, counties and school districts paying 65% of the cost for teachers, police and firefighters. (Municipalities, counties and schools pay 100% of the cost of all other employees enrolled in the NHRS.)

In the 2010-2012 budgets, the state contribution rate was lowered to 30% in 2010, to 25% in 2011, to $3.5 million in 2012 and then eliminated in 2013. This resulted in local governments paying 70% and 75% of the retirement costs for teachers, police and firefighters in 2010 and 2011 respectively, and ultimately the total costs in 2013 and beyond.

The graph below illustrates the local government employer contribution rates (percent of employer contribution on $100 of compensation) from 2002 through 2017, with estimated projected rates for 2018 and 2019.



Funding Status. A primary measure of the health of a public pension system is the funding ratio, which indicates the extent to which assets are available to cover current and future benefits. While a funding ratio of 100% or greater (meaning there are sufficient assets to fund all liabilities) is desirable, it is not necessarily a practical benchmark since all the benefits are not immediately due and payable, but generally stretch over a 25- to 30-year horizon. Therefore, a more common benchmark to measure the health of a public pension system is a funding ratio of 80%. The NHRS funded ratio for the pension plan as of June 30, 2015 was 63.4%.



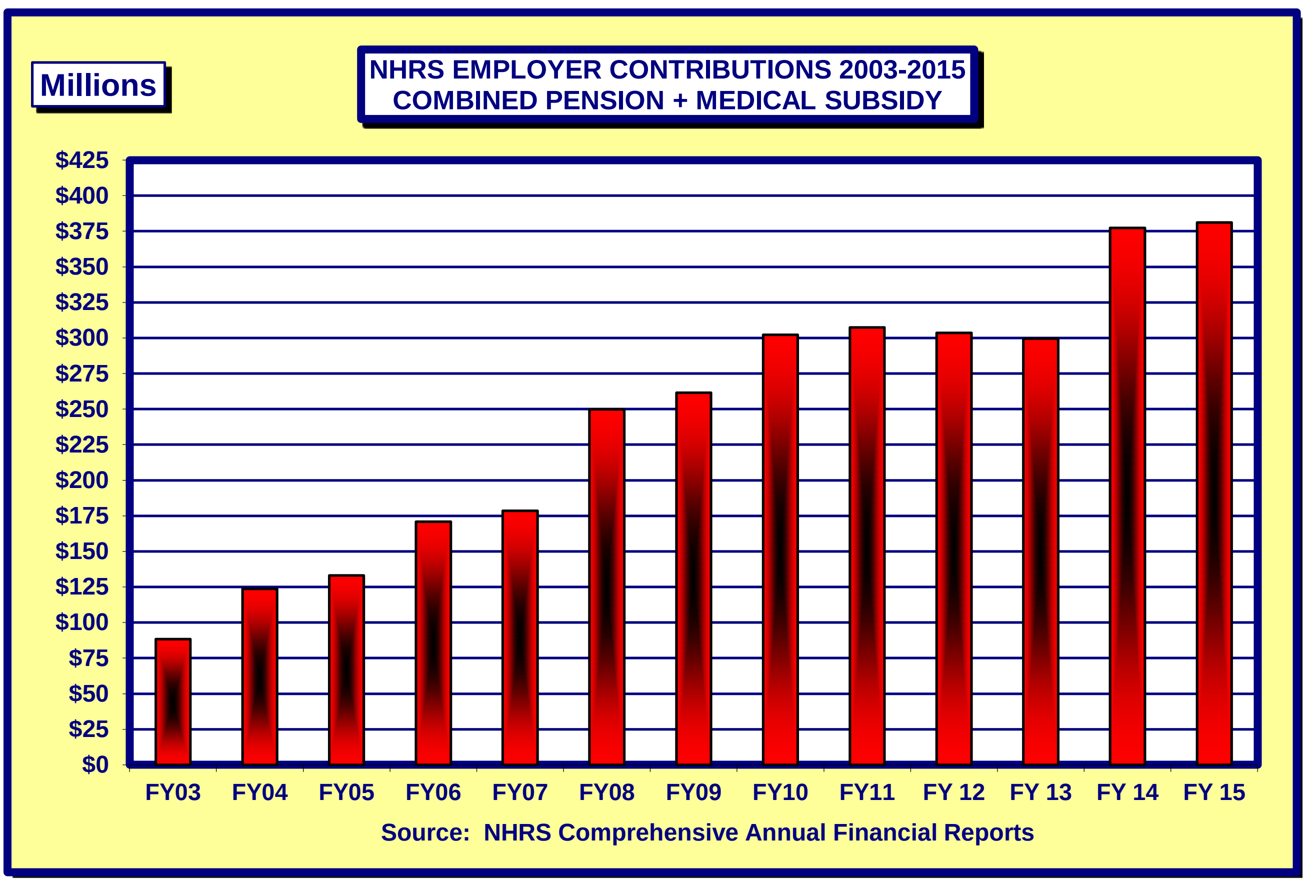
A number of factors have contributed over the years to this low funding ratio including:

- significant investment losses, most recently in 2008 and 2009,
- the practice of "gain-sharing" which diverted over $900 million from the corpus of the pension trust to fund additional benefits such as cost-of-living adjustments and medical subsidies, and
- an actuarial valuation methodology which masked the true financial condition of the system, resulting in artificially low employer rates during the years it was in effect.

Recent Statutory Changes. Regardless of these so-called "sins of the past" and despite increases in annual employer contributions from $88 million in 2003 to $381 million in 2015, the unfunded pension and OPEB liabilities continued to grow, resulting in significant biennial increases in employer rates. As of June 30, 2015, the unfunded liability for the pension plan was $4.2 billion, and accounts for 65%-78% of the required employer contributions. Since 2010, many statutory changes to the NHRS laws have occurred in an effort to mitigate these unsustainable rate increases to employers. The more significant changes include:

- change in the actuarial methodology to shed a brighter light on the true financial status of the system;
- elimination of the "gain-sharing" provision;
- increases in the employees contribution rates as noted above;
- increases in the retirement age and years of service;
- repeal of the automatic medical subsidy escalator;
- changes to the definition of "earnable compensation" to limit or eliminate provisions that allowed for pension spiking; and
- changes in the composition and qualifications of NHRS Board members and establishment of an independent investment committee.

The graph below shows the amount of annual NHRS contributions from all employers (including the State of New Hampshire as well as local government employers) from 2003-2015.



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SCHEDULE OF STATE AID TO CITIES, TOWNS, AND SCHOOL DISTRICTS

	AID BY CATEGORY	FY 2006 Actual	FY 2007 Actual	FY 2008 Actual	FY 2009 Actual	FY 2010 Actual	FY 2011 Actual	FY 2012 Actual	FY 2013 Actual	FY 2014 Actual	FY 2015 Actual	FY 2016 Budget	FY 2017 Budget
EDUCATION													
1	Adequate Education Aid	836,204,501	836,147,136	890,426,556	891,013,576	940,762,976	941,830,717	941,357,888	941,911,353	929,874,227	926,031,426	931,015,998	932,482,099
2	Building Aid	37,770,926	41,735,035	46,487,244	42,914,218	44,902,654	46,301,028	48,891,283	47,076,655	44,178,887	43,286,408	42,800,000	37,000,000
3	Court Ordered Placements	3,468,627	2,578,967	1,379,288	3,290,064	2,173,602	1,285,791	2,193,744	1,333,893	1,168,277	1,147,392	1,500,000	1,500,000
4	Driver Education	1,681,172	1,659,150	1,599,575	1,570,800	1,337,100	1,563,300	-	-	-	-	-	-
5	Dropout Prevention	246,032	297,176	956,918	1,730,024	1,004,666	2,122,110	486,860	711,635	373,782	820,126	600,000	600,000
6	Kindergarten Aid[1]	567,600	750,000	850,800	957,600	2,661,675	2,842,800	1,707,750	1,776,750	-	-	-	-
7	Kindergarten Construction Aid [2]	208,496	2,402,060	1,131,221	404,402	3,261,884	2,741,088	3,038,661	798,100	-	841,000	-	-
8	Local Education Improvement	90,268	427,535	366,419	626,926	66,143	625,396	23,950	-	-	-	-	-
9	Reading Recovery [3]	341,780	342,035	318,306	459,198	(33,493)	-	-	-	-	-	-	-
10	Retirement Normal Contribution - Teachers	-	18,588,116	30,196,769	30,811,480	32,537,542	27,809,968	2,198,706	-	-	-	-	-
11	School Breakfast	-	85,890	87,967	98,360	120,448	113,808	117,845	105,289	122,053	102,532	184,000	184,000
12	School Lunch	832,003	832,003	832,003	832,003	831,238	832,003	832,003	832,003	832,003	832,003	832,003	832,003
13	Catastrophic Aid (Special Education)	28,355,251	30,442,213	32,012,334	32,528,169	30,091,336	23,750,920	21,613,130	21,633,843	22,552,381	21,623,196	22,400,000	22,400,000
14	Tuition & Transportation	5,159,555	5,393,771	6,552,172	7,228,712	7,419,843	6,951,048	6,900,000	6,900,000	7,422,619	7,027,000	7,400,000	7,400,000
	Education Total	914,926,211	941,681,087	1,013,197,572	1,014,465,532	1,067,137,614	1,058,769,977	1,029,361,820	1,023,079,521	1,006,524,229	1,001,711,083	1,006,732,001	1,002,398,102
ENVIRONMENTAL													
15	Flood Control[4]	729,712	729,712	912,884	912,884	811,515	811,515	221,952	221,952	787,898	1,330,570	825,000	825,000
16	Landfill Closure Grants	2,067,751	2,030,802	1,944,036	1,287,790	981,070	894,703	927,658	899,812	1,080,206	886,850	792,116	776,245
17	Public Water System Grants	1,484,582	1,741,982	1,494,664	1,281,908	1,101,762	1,149,844	1,184,996	1,131,618	1,170,678	1,073,438	903,592	771,750
18	State Aid Grants - Pollution Control	11,826,356	12,195,029	10,820,000	9,003,767	6,463,893	5,902,524	5,199,986	3,327,666	6,519,872	6,610,139	5,922,493	5,705,957
19	Water Supply Land Protection Grants	577,301	373,750	1,398,942	571,655	-	-	-	-	-	-	-	-
	Environmental Total	16,685,702	17,071,275	16,570,526	13,058,004	9,358,240	8,758,586	7,534,592	5,581,048	9,558,654	9,900,997	8,443,201	8,078,952
OTHER GEN. FUNDS													
20	Meals & Rooms Distribution	47,104,777	50,903,052	55,513,020	58,805,057	58,805,057	58,805,057	58,805,057	58,805,057	58,805,057	63,805,057	63,805,057	68,805,057
21	Railroad Tax [5]	127,218	46,520	101,460	145,903	98,006	58,379	36,671	36,671	35,822	60,037	60,037	60,037
22	State Revenue Sharing	25,216,057	25,216,054	25,216,054	25,216,054	-	-	-	-	-	-	-	-
23	Retirement Normal Contribution [6]	32,917,007	35,091,224	50,229,497	51,564,947	51,522,121	44,269,159	3,500,000	-	-	-	-	-
	less: Teacher Normal Contribution	-	18,588,116	30,196,769	30,811,480	32,537,542	27,809,967	2,198,706	-	-	-	-	-
	Net Police & Fire Normal Contribution	-	16,503,108	20,032,728	20,753,467	18,984,579	16,459,191	1,301,294	-	-	-	-	-
	Other General Funds Total	105,365,059	92,668,734	100,863,262	104,920,481	77,887,642	75,322,627	60,143,022	58,841,728	58,840,879	63,865,094	63,865,094	68,865,094
HIGHWAY FUNDS													
24	Block Grants	28,819,381	28,456,617	29,600,000	30,512,000	29,665,000	34,897,125	34,538,280	29,918,270	30,233,035	30,743,994	35,389,250	34,331,094
25	State Highway Construction Aid[7]	1,004,324	706,985	787,746	2,738,625	1,699,338	2,098,821	2,663,100	2,140,210	1,298,657	2,005,862	1,681,400	1,681,400
26	Municipal Bridge Aid[8]	4,040,676	3,890,827	12,601,522	10,317,139	12,861,369	12,335,804	5,153,521	7,428,375	5,637,087	10,361,515	6,800,000	6,800,000
GRAND TOTAL		**1,065,796,353**	**1,079,877,713**	**1,160,231,360**	**1,162,956,017**	**1,184,048,496**	**1,177,748,315**	**1,131,577,714**	**1,117,420,567**	**1,105,156,797**	**1,106,221,168**	**1,114,429,546**	**1,113,673,242**

NOTES:
1. Beginning in FY 2014, kindergarten aid is now included as part of adequate education aid.
2. Kindergarten Construction Aid in FY 2012 includes $888,395 to pay for temporary kindergarten classrooms as permanent classrooms are built and appropriates $3,700,000 in bonds for the biennium ending June 30, 2013 for kindergarten construction. $841,000 was appropriated in FY 2014 but not spent. This amount does not lapse and is expected to be spent in FY 2015.
3. Negative amount is result of three school districts returning unused portions of their reading recovery funds.
4. The amount distributed in FY 2015 includes a dsitribution of $542,672 pursuant to Chapter 300, Laws fo 2014 to compensate communities for FY 2012.
5. Amounts for FY 2016 and FY 2017 are estimated based on FY 2015 actual expenditure.
6. Specific amounts distributed to school districts and municipalities are currently available for FY 2007 through FY 2012 only. For FY 2006, the teacher contribution is not distinguished from the police & fire contribution.
7. State aid construction includes $3.6 million that was bonded for FY 2008 and FY 2009.
8. Beginning in FY 2015, bridge aid includes revenue resulting from the increase in the road toll ($954,867 in FY 2015).