BY ROBERT TANNENWALD
PHOTOGRAPHS BY MARY KOCOL

Daniel Webster, one of New Hampshire's most famous citizens, once declared, "There is nothing so powerful as truth." For over 50 years, the *Manchester Union Leader*, the Granite State's most widely circulated newspaper, has included this famous quote on its masthead and its editorial page. However, the truth can also be frustratingly complex, as the New Hampshire Commission on Education Funding found as

HEAT, LIGHT, AND TAXES IN THE GRANITE STATE

it analyzed alternative solutions to New Hampshire's education funding problem. The Commission, created by Governor Jeanne Shaheen in April 2000, issued its final report in January 2001. § The Commission's origins can be traced back to a 1997 New Hampshire Supreme Court ruling that the state could no longer rely on local property taxes to pay for its public schools. The Granite State was not the first to see its system of financing education struck down by judicial decree. Over the past 35 years, court decisions have induced at least 19 states, including every state in New England except Maine and Rhode Island, to diminish the role of the local property tax in school funding. § For New Hampshire, however, radical reform of school finance is an especially unsettling prospect. Many of New Hampshire's citizens take great pride in their state's limited, decentralized government. Until the Court decision *(Claremont v. the State of New Hampshire)*, no other state had delegated such a large fraction of its fiscal responsibilities to cities and towns. New Hampshire is the only state, other than Alaska, that levies neither a broad-based personal income tax nor a retail sales tax. (And, unlike Alaska, New Hampshire has no oil upon which to levy severance taxes.) Instead, New Hampshire has relied heavily on the local property tax. Many New Hampshire residents and some economists believe that this strategy has been an important competitive advantage for the state, enabling it to grow faster than any of its New England neighbors for the past several decades. Certainly, the absence of a sales tax has contributed to the growth of malls and many other retail establishments near New Hampshire's border with Massachusetts.

Over the past 35 years, court decisions in at least 19 states have reduced the role of local property taxes in school funding

According to the state Supreme Court's decision (commonly referred to as "*Claremont II*"), the constitutional flaw in New Hampshire's local property tax is rooted in the wide variation in per pupil property wealth across municipalities. Fiscally comfortable towns, such as Bedford, were able to raise ample money for education and other municipal functions with a property tax rate of $17 per $1,000 of property value, while the property-poor town of Berlin imposed a levy more than twice as high. These large differences violate the requirement of the state's constitution that taxes be "reasonable and proportional." The Court further ruled that, given the difficulty of raising sufficient property tax revenues in fiscally stressed towns, reliance on the tax also violated the constitutional duty of the state to provide every school-age child with an adequate education. The Court told the legislature to determine what constitutes an adequate education, how much achieving educational adequacy would cost, and how the funds should be raised — other than through the local property tax.

So, with the bang of a gavel, New Hampshire was confronted with possibly the most challenging fiscal issue in its history. Short of a constitutional amendment directing the state's Supreme Court to "butt out" of the educational funding arena, which was contemplated, significantly higher state taxes seemed inevitable.

In 1999, the state met the Court's mandate with what was then viewed as temporary patchwork consisting of a state property tax, increases in business profits taxes and excise taxes, and tobacco settlement money. The legislature passed an income tax, but Governor Jeanne Shaheen vetoed it. By the beginning of 2000, forecasters were projecting budget deficits in fiscal biennium 2001-2002, and credit rating agencies were warning the state to resolve the issue or see its bonds downgraded. In response to the pressure to craft a long-term solution, the Commission went to work.

Governor Shaheen instructed the Commission to conduct a comprehensive, objective evaluation of revenue options designed to raise $825 million, the amount that the legislature had determined was needed to provide an adequate education for every New Hampshire student in the year 2000. She told the Commission's members that economic competitiveness should be their primary concern: In devising new ways to fund schools, the state must "enable New Hampshire to compete in the new and increasingly global economy." In addition, the Governor directed the Commission to evaluate the impact of each funding option on "particular sectors..., property values, and taxpayers" and to consider whether the option could "provide stable, sufficient, and administratively efficient sources of revenue for the foreseeable future." She instructed the Commission *not* to make recommendations, but simply to evaluate the pros and cons of various alternatives.

The Commission looked at a variety of policy options: taxes on personal income, property, retail sales, value added, gross receipts, capital gains, and purchases of tobacco products and motor fuels. It also considered arrangements in which the state would legalize video lottery terminals and share in a portion of the revenues that their operation would generate. In the end, the Commission focused much of its analysis on three candidates: the property tax, a general sales tax, and the personal income tax.

In evaluating the various alternatives, the Commission used seven criteria:

COMPETITIVENESS. New taxes should not diminish New Hampshire's attractiveness as a place in which to live, work, shop, and invest.

FAIRNESS. The burdens imposed by new taxes should be distributed equitably.

ADEQUACY AND STABILITY. New taxes should generate enough revenue to finance adequate schooling, year in and year out.

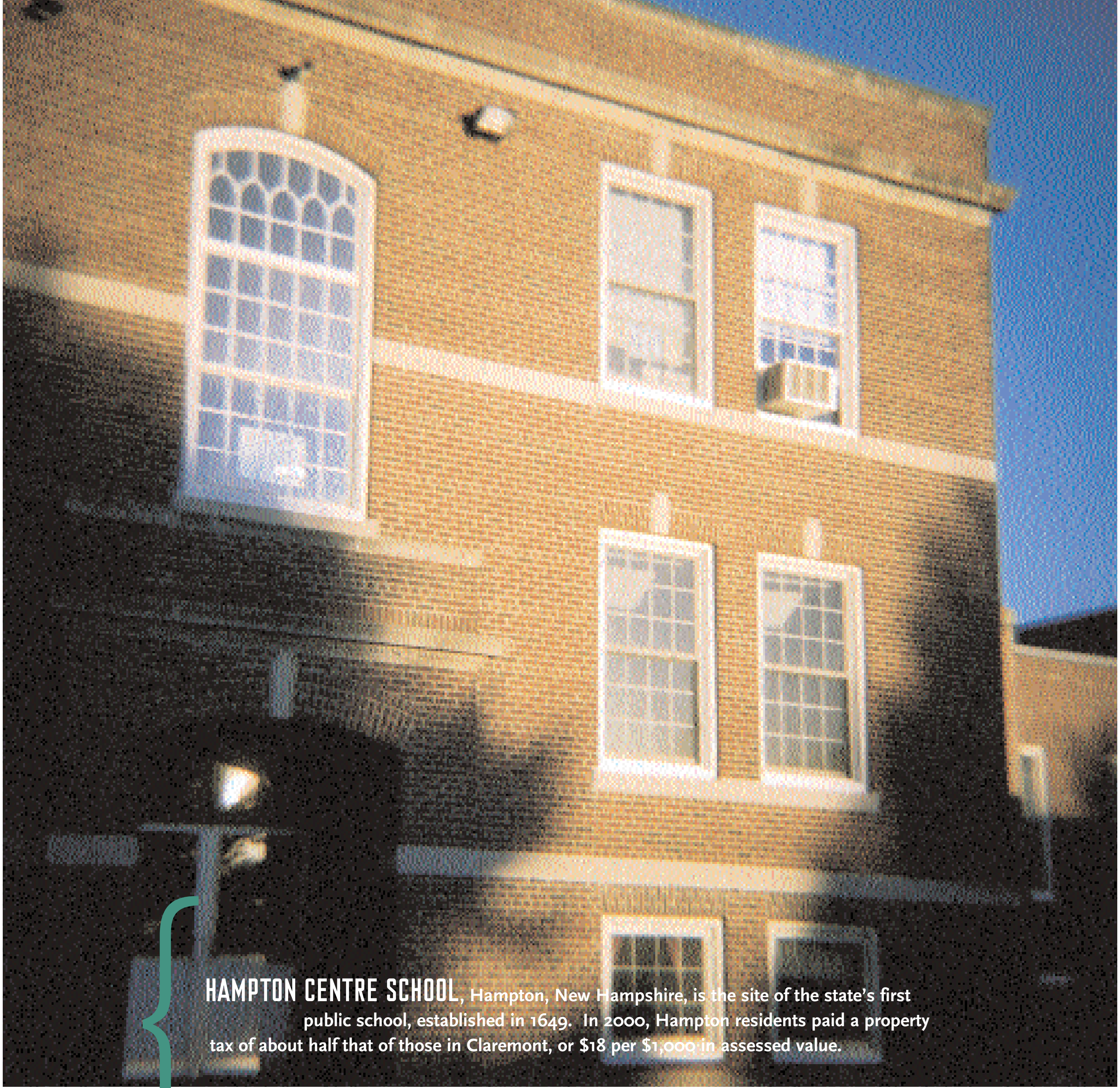
EXPORTABILITY. New taxes whose burdens are borne more by nonresidents are preferable.

NEUTRALITY. New taxes should distort economic choices as little as possible.

SIMPLICITY. A new tax should be simple to administer and impose low compliance costs.

The Commission produced a wealth of analysis, much of which is presented in its report. One conclusion that emerges from this analysis is that there are few simple answers. The most careful and dispassionate empirical studies often produce inconclusive or even contradictory results. Often, the data needed to resolve a particular issue are missing. To some degree, the Commissioners functioned like detectives, relying on a combination of theory, evidence, and common sense to form their judgments.

As the overview to the Commission's report points out, the "Commission found no single tax to be superior — or inferior — on all counts." For example, a sales tax would be more re-



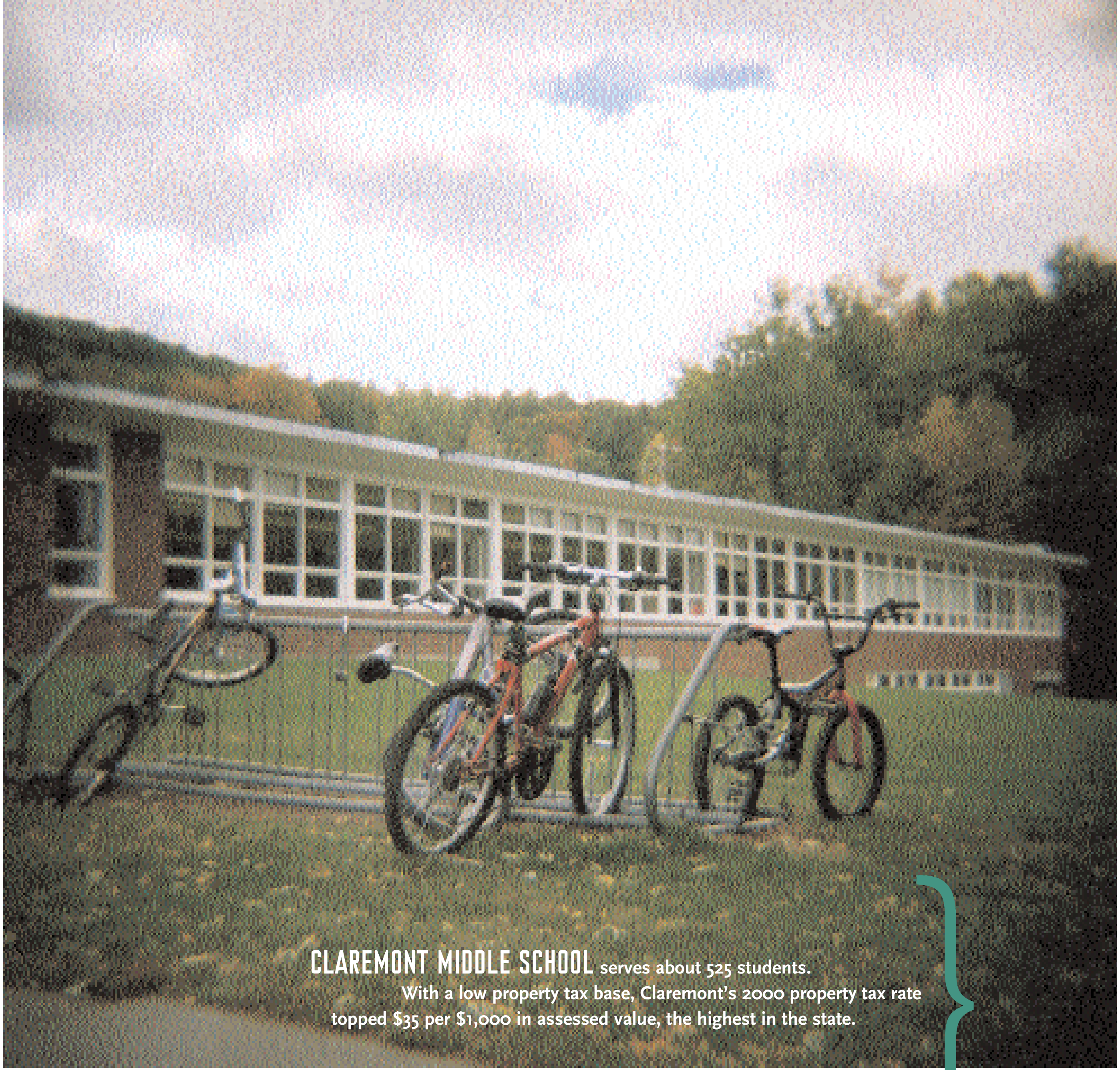
HAMPTON CENTRE SCHOOL, Hampton, New Hampshire, is the site of the state's first public school, established in 1649. In 2000, Hampton residents paid a property tax of about half that of those in Claremont, or $18 per $1,000 in assessed value.

gressive than some of the other alternatives considered; but a larger share of the burden would be borne by non-New Hampshire residents than under other options. While the Commission considered all seven criteria in its evaluations, perhaps the most salient — and controversial — findings related to competitiveness and fairness.

COMPETITIVENESS: WHAT IS THE IMPACT ON JOBS?

In addressing the issue of competitiveness, the Commission estimated the impact on job creation of a state income tax, a state property tax, and a retail sales tax. In each case, it was assumed that the tax would raise $825 million per year, all earmarked for education. The Commission concluded that each tax option would depress New Hampshire's total employment by between 3,000 and 7,000 jobs (0.5 and 1.1 percent, respectively) in the year 2000 relative to the pre-Claremont-decision tax system. The Commission found no consistent evidence that one tax would have a more depressing effect than another.

In arriving at these estimates, the Commission confronted several related questions. First, would the imposition of a new state tax earmarked for education cause school districts to reduce local property taxes by an equal amount? Or would localities cut back only part way, resulting in an overall increase in total state and local taxes and public spending? Based on studies of the experience in other states, the Commission as-



CLAREMONT MIDDLE SCHOOL serves about 525 students. With a low property tax base, Claremont's 2000 property tax rate topped $35 per $1,000 in assessed value, the highest in the state.

sumed that cuts in local property taxes would offset 50 percent of the increase in state taxes, so that total state and local taxes would increase by 50 percent. Second, would the effects of increased state and local taxes be offset by the beneficial effects of increased spending on education? Although employers are attracted to areas with well-educated workforces, a review of the evidence led the Commission to conclude that educational outcomes would not improve sufficiently to compensate employers for higher taxes.

To estimate the effect of the three tax options on employment, the Commission used two approaches. In the "direct" approach, the Commission consulted the economics literature on the effects of changes in state and local tax burdens (measured as taxes per capita or taxes relative to income) on employment levels. From this review of previous studies, estimates were made of the likely employment impact of higher tax burdens in New Hampshire.

In the "indirect" approach, the Commission considered who would bear the burden of each tax. This is one of the thorniest issues in the study of taxation. The imposition of a tax may cause the individuals or businesses paying the tax to alter behavior. This change in behavior may shift the tax burden to other individuals and businesses, causing them, in turn, to alter *their* behavior and shifting the tax burden yet again. Questions of tax incidence permeate all discussions of tax competitiveness.

Because New Hampshire employers compete intensely for workers with firms in neighboring states, the Commission concluded that the imposition of a personal income tax would force firms to pay higher compensation. Some previous research also indicated that an increase in the sales tax would also be reflected in higher compensation costs. The Commission then computed the effect of these higher labor costs on employment using the relationships estimated in previous studies. In the case of the property tax, empirical evidence argues against a shifting of the tax burden to employers in the form of higher labor costs. Yet, many studies have found that the impact of the property tax on employment is similar to, or even greater than, that of other state and local taxes.

ARE NEW HAMPSHIRE PROPERTY TAXES REGRESSIVE?

A comparison of the estimated average property tax burdens of low-income and upper-middle-income households in Lebanon in 2000.

	LOW-INCOME HOUSEHOLDS	UPPER-MIDDLE-INCOME HOUSEHOLDS
RENTERS		
Annual cash income	$15,000 to $20,000	$65,000 to $70,000
Share of households in this income category that rent	80%	10 to 15%
Rent paid, as a share of income	40%	20%
Total property taxes paid by landlords, as a share of gross rent collected	10%	7%
Total property taxes paid by households in this category, as a share of income	4%	1.4%
HOMEOWNERS		
Value of home	$50,000 to $80,000	$225,000 to $275,000
Share of households in this income category that own	20%	85 to 90%
Property tax rate (per $1,000 valuation)	$28.48	$28.48
Total property taxes paid	$1,425 to $2,280	$6,400 to $7,800
Total property taxes paid by households in this category, as a share of income	7.1 to 15.2%	9.2 to 12.4%
OWNERS AND RENTERS		
Total property taxes paid, as a share of income	4.6 to 6.2%	8.0 to 11.3%

Source: New Hampshire Commission on Education Funding

FAIRNESS: WHO BEARS THE BURDEN?

Most would agree that the burden imposed by new taxes should be distributed equitably. But reasonable people can differ on what constitutes "fairness." To some, a fair tax is one that assesses individuals or families according to the benefits they receive from the resulting public spending. Others believe that fairness is achieved by levying taxes according to the ability to pay. In the United States, this usually implies that tax systems should be "progressive," that is, the share of income that an individual or family pays in taxes should rise as income rises. However, what degree of progressivity is "fair" is very contentious. Some people believe fairness requires proportionality; others contend that consumption rather than income is a better measure of households' ability to pay taxes.

The Commission analyzed how each new state tax would affect the tax burdens of New Hampshire residents by income class. To highlight the different distributional effects of the tax alternatives, the Commission assumed that local taxes were reduced by the amount of the state tax increase; in other words, total tax revenues did not change. The tax burden for each income class was measured as total state and local taxes paid by residents in that class divided by their total money income. Money income includes not only wages and salaries, dividends, interest, pensions, and realized capital gains, but also cash transfers from all levels of government, such as public welfare, unemployment insurance payments, and Social Security.

In analyzing fairness, the Commission made somewhat different assumptions about tax incidence than it did in assessing competitive implications. For the most part, the Commission assumed no shifting; tax burdens fall on those incurring the tax liability. Thus, the burden of sales taxes on consumer goods and services is borne by households in proportion to the value of their taxable purchases, and the burden of income taxes is borne by households in proportion to their taxable income. While data limitations contributed to this decision, it also reflected the mindset of Commission members. They understood that taxes "stick where they hit" for a considerable period of time. Tax burdens are shifted only after some taxpayers change their behavior to reduce their exposure. These behavioral changes, such as moving to another state, are often costly and time consuming. Until they are completed, those initially liable for a tax bear much of its burden. Commission members were especially interested in analyzing how tax burdens are distributed before shifting occurs because other widely circulated studies of the fairness of New Hampshire's taxes have adopted this perspective. The Commission wanted a clear comparison between its findings and those of other evaluations.

The Commission found no clear evidence that any of the tax options would have a larger impact on competitiveness

An important exception to the general assumption of no shifting pertained to property taxes on residential rental property. The burden here was assumed to be borne by tenants in proportion to their rent. Given New Hampshire's tight housing markets, it seemed reasonable to think that landlords would pass on higher property taxes to their renters.

As an indicator of fairness, the Commission computed the ratio of the tax burden of the highest income class to that of the lowest income class under each tax scenario. The higher the ratio, the more progressive the tax system. The Commission found the substitution of income taxes for a property tax would generally make New Hampshire's tax system more progressive, while the substitution of taxes on consumption, such as various forms of sales taxation, would make the system less progressive. The Commission concluded that the substitution of a state property tax for local property taxes would not significantly change the fairness of the state's revenue system.

Although the Commission found that the introduction of an income tax would be most progressive, it also found — much to the surprise of many in New Hampshire and contrary to the conclusion of other studies — that the current tax system, heavily dependent on the property tax, is also relatively progressive. It is commonly believed that property taxes impose a higher burden on low-income households than on high-income households. For homeowners, this perception is correct. Most of the widely circulated studies focus their analysis on homeowners, or on a segment of the population (such as the married nonelderly) where the incidence of homeownership is unusually high. To some degree, this is understandable; 70 percent of New Hampshire households own their own home. However, the incidence of homeownership is distributed very unevenly across income groups. Homeownership is much less common among the poor than among the well-to-do, and including renters in the analyses changes the results significantly.

The substitution of income for property taxes would tend to make the system more progressive; a sales tax less so

According to conventional wisdom, the property tax burden of low-income renters is high, at least as high as the burden borne by low-income homeowners. It is usually assumed that landlords shift much of their property tax burden to their tenants in the form of higher rent. However, even if this is true — and the Commission assumed it is — renters and homeowners in a given income class may not face comparable tax burdens. Indeed, the Commission found that, other things equal, the renter is likely to bear the lower burden.

To appreciate how the Commission came to this conclusion, consider the example in the table, "Are New Hampshire Property Taxes Regressive?" Susan Almy, a New Hampshire state representative initially skeptical of the Commission's conclusion, asked two landlords renting low-income units in her hometown of Lebanon for their total property taxes and total gross rental collections in 2000. In each case, the ratio of property taxes to rent was about 10 percent. Suppose (1) that this ratio is generally representative of low-income renters in Lebanon; (2) that their rent is, on average, about 40 percent of income; and (3) that landlords pass on all property taxes to tenants in the form of higher rents. Then, the property tax burden of the average low-income renter in Lebanon in 2000 would be about 4 percent of income (that is, 10 percent x 40 percent).

What about Lebanon's low-income homeowners? Real estate listings suggest that the average house or condominium owned by households with incomes between $15,000 and $20,000 is worth between $50,000 and $80,000. The property tax bill on such a property would be between $1,425 and $2,280. Thus, the average property tax burden would be between 7 percent and 15 percent of income. Since only about 20 percent of Lebanon's low-income households are homeowners, the average property tax burden of all low-income households, combining both renters and owners, is between 4.5 percent and just over 6 percent.

Compare these figures to similar calculations for households earning $65,000 to $70,000 a year. Renters at this income level pay about 20 percent of income as rent, and the percentage of rent covering property taxes is probably closer to 7 percent than 10 percent, since more of their rent goes towards amenities such as better maintenance and security. Thus, their property tax burden would be about 1.5 percent. In contrast, as the table lays out, the property tax burden on homeowners in this income class would be between 9 percent and 12.5 percent of income. Since 85 percent to 90 percent of households in this income category are homeowners, the average property tax burden for upper-middle income households, both renters and homeowners, is between 8 percent and 11 percent.

Critics of the Commission's analysis point out that it fails to evaluate the distributional impact of the property tax among households with incomes above $70,000. These account for about one-third of all New Hampshire households. For this income group, New Hampshire's property tax is very likely regressive. However, much of the concern about the regressivity of the property tax centers on lower-income households; and here, as demonstrated, tax burdens are not as heavy as commonly thought.

POSTSCRIPT

After the Commission issued its final report, Governor Shaheen recommended the imposition of a 2.5-percent sales tax dedicated to school funding. The state legislature rejected her plan, as well as an alternative broad-based tax on consumption and a personal income tax. The legislature eventually opted to meet its school funding requirement by retaining the statewide property tax, raising business taxes and the telecommunications service tax, and eliminating an exemption from the real estate transfer tax.

The future remains uncertain, however, as the constitutionality of the state property tax might be successfully challenged. In January 2001, a judge in Rockingham District Court ruled that the tax violated the state constitution. In May, the state Supreme Court, in a split decision, reversed that ruling but left the door open for future challenges. Additionally, the communities that filed the original Claremont suit have declared their intention to go back to court to challenge the manner in which the state has determined the price tag of providing adequate schooling for every educable child in the state.

As Daniel Webster knew, and the Commission found out, in order to shed a little light, you have to generate a little heat. One hopes that state policymakers have found more of the former and less of the latter in the Commission's report and, and that they will find it a useful tool as they continue to deal with New Hampshire's school funding dilemma. ❋