NEW HAMPSHIRE FISCAL POLICY INSTITUTE

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State Tax Reductions Risk Loss of Federal Aid to New Hampshire

Reductions in State taxes included in the State Budget proposal passed by the House of Representatives would increase the risk New Hampshire loses significant amounts of aid from the federal government. A provision in the federal American Rescue Plan Act requires that federal aid to states not be used to directly or indirectly offset reductions in net tax revenue resulting from a law, rule, or administrative interpretation change.

While significant and important details explaining the ways in which this broad provision may be implemented have not yet been provided in federal guidance or rule, tax reductions in the House's budget proposals could result in a loss of a dollar of federal aid for each dollar of forgone State tax revenue. If the U.S. Treasury were to use similar methods to those used by the House or the New Hampshire Department of Revenue Administration to calculate potential lost revenue from tax changes, the forgone federal revenue could potentially total approximately $158 million during the next budget biennium, or $312 million in total between March 2021 and December 2024.

These estimates are subject to considerable uncertainty, but indicate that, if the State were to enact proposed tax reductions, New Hampshire could be relinquishing access to considerable federal resources as well as diminishing tax revenue. That change would substantially reduce resources available to support Granite State businesses, families, and economy through public services, direct aid, and investments and health and education.

CONDITION FOR FEDERAL AID

The American Rescue Plan Act (ARPA) provides aid to states for a variety of purposes, including specific flexible aid from the federal Coronavirus State Fiscal Recovery Fund (CSFRF). This aid can be used by states to:

- respond to the negative public health or economic impacts of the pandemic, including assistance to households, small businesses, nonprofits, or aid to impacted industries
- provide premium pay to people performing essential work during the COVID-19 crisis, either directly to workers or to eligible employers
- fill revenue shortfalls due to the pandemic to fund public services, with the shortfall measurement based on revenues collected in the most recently-completed full fiscal year prior to the crisis
- make necessary investments in water, sewer, or broadband infrastructure

The U.S. Congress placed two specific restrictions on state uses of these dollars. First, states cannot deposit these dollars into pension funds. Second, states cannot use CSFRF dollars to either directly or indirectly offset a reduction in net state tax revenue resulting from a change in law, regulation, or administrative interpretation that reduces any tax, including through rate reductions, rebates, deductions, credits, or delaying the imposition of a tax increase, between March 3, 2021 and December 31, 2024, or until all funds provided have been used or returned to the U.S. Treasury Department.

Under ARPA, states receiving CSFRF dollars are required to provide the U.S. Treasury Department with a detailed accounting of all uses of CSFRF funds and all modifications to the state's tax revenue sources during the covered period. Funds used in violation of the requirements would have to be returned.

Both this provision and a subsequent letter from U.S. Treasury Secretary Janet Yellen indicate that states receiving CSFRF funding and choosing to change policies to reduce their tax revenue would lose a dollar of federal funding for each dollar of lost revenue.

The purpose of this provision is to avoid certain inefficient deployments of these federal resources. Research suggests federal aid to state and local governments provide an economic boost because such aid often translates into jobs, such as through spending on education and infrastructure. Tax reductions, particularly those for wealthy individuals or on corporate profits, appear to be less effective economic stimulus than revenue support for public services, as well as unemployment compensation, food assistance, and infrastructure investments.

MORE CLARIFICATION PENDING

The specific interpretation and implementation of this ARPA provision will be critical for understanding the extent to which it impacts state fiscal policy decisions. Without specific guidance, key questions remain regarding the lost CSFRF aid that would result for certain actions.

The most prominent among those questions is the methods the U.S. Treasury Department will use to measure lost revenue. Economic activity changes over time, and has been particularly dynamic since the beginning of the pandemic, so many tax bases will shift quickly. Revenues in a rebounding economy may exceed prior revenues even with lower tax rates due to exogenous factors in the economy. Depending on the calculation methods used, a growing tax base could result in either lower or higher losses of federal aid at the end of 2024. The U.S. Treasury Department could develop its own sets of projections, rely on those used in state budget processes, or apply the provision only retroactively and make different sets of estimates based on known economic activity.

The provision also stipulates the loss of CSFRF aid would result from net state tax revenue reductions, meaning expansions of credits or certain tax reductions could occur without losses, but only if the revenue reductions were offset by other tax revenue increases. The U.S. Treasury Department could also exempt some changes, such as those related to conformity with the federal tax code, depending on the extent to which this provision is broadly or narrowly interpreted.

Additionally, there are certain legal questions around the potential expansive nature of this provision. Attorneys general from 21 states signed a letter expressing concern and a desire for clarity regarding this provision. Some state attorneys general have filed a lawsuit against U.S. Treasury Secretary Yellen already, and much of the substance of the legal questions may hinge on the U.S. Treasury Department's forthcoming regulations. The federal government routinely requires states to meet certain obligations before accessing federal dollars, including Medicaid matching funds and certain transportation aid.

RISKS IN CURRENT PROPOSALS

While the U.S. Treasury Department will provide more clarity, likely through guidance that could arrive in May 2021, this ARPA provision creates significant risk that any implementation of a tax reduction between March 2021 and December 2024 will jeopardize federal funds that would otherwise flow to New Hampshire. The potential for a dollar-for-dollar loss of federal assistance suggests current proposals, including the State Budget proposal from the House of Representatives and the Governor's original proposal, could reduce revenue available for services, economic assistance, and health and education supports by both the amount of forgone revenue from tax reductions and an equivalent amount of lost flexible federal funds.

New Hampshire's state government will receive approximately $959.1 million in CSFRF funding, which is subject to the ARPA tax reduction provision. Counties, cities, and towns will receive a separate sum of money totaling approximately $457.5 million and do not appear to be subject to this provision, pending final federal regulations.

If the dollar-per-dollar revision applies to all New Hampshire net tax reductions proposed in the House version of the State Budget *and* if the U.S. Treasury Department projects the revenue reductions from these tax provisions in the same manner as the House Finance Committee did in the Surplus Statement accompanying the State Budget proposal, New Hampshire would forgo $157.7 million in federal revenue during the State Budget biennium.

Using estimates from the Surplus Statement and projections from the New Hampshire Department of Revenue Administration, which are static analyses that make few assumptions and are calculated from fixed tax bases from prior or planned years, the potential forgone federal revenue could be approximately $312.4 million cumulatively in State Fiscal Years 2022, 2023, 2024, and 2025. This calculation assumes revenue impacts in State Fiscal Year 2025 that fall before December 31, 2024 can be based on the portions of revenue attributable to the first six months of State Fiscal Year 2021 in the State Revenue Plan for the two business taxes combined, the Meals and Rentals Tax, and the Interest and Dividends Tax.

These figures are only estimates, and are subject to considerable revision depending on both trends in State tax receipts and finalized federal regulations. But the magnitude of potential forgone revenue is significant over this longer time horizon. These estimates suggest the largest losses of federal aid would stem from the proposal to reduce the Statewide Education Property Tax for one year, as well as the permanent proposed reductions to the Meals and Rentals Tax and the Business Enterprise Tax rates and the phasing down of the Interest and Dividends Tax rate, leading to the eventual elimination of that tax in 2027.

LOOKING AHEAD

New Hampshire officials will be able to determine considerably more regarding the tax proposal's potential impact on State receipt of flexible federal aid after more ARPA guidance comes from the U.S. Treasury Department, likely in May 2021. The extent to which the provisions are interpreted narrowly or broadly by federal regulators may have a substantial impact, and those interpretations could change over time.

However, ARPA's restrictions on use of the funds granted to New Hampshire through the CSFRF suggest New Hampshire is at considerable risk of losing tens or hundreds of millions of dollars in federal aid if these proposed State tax provisions were to become law. Proposals that reduce net tax revenue increase the chances of both losing tax revenue for services and losing an equivalent of federal assistance for pandemic relief and economic investments.

Considerable ambiguity remains, and the potential for both iterative legal challenges and evolving federal implementation suggests that some uncertainty may linger around this provision for some time. Even with those ongoing questions, the text of ARPA clearly indicates that reducing net State tax revenue through policy change may substantially limit the State's resources to support New Hampshire's families, businesses, health care systems, and economy as Granite Staters seek to build a robust and inclusive recovery from the pandemic.

- *Phil Sletten, Senior Policy Analyst*