The New Hampshire Retirement System

The Impact of Recent NHRS Changes on Municipalities

Presented to the Town Manager of Hanover, NH

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EXECUTIVE SUMMARY

The New Hampshire Retirement System (NHRS) was signed into the New Hampshire Constitution in 1985, making retirement benefits for government employees a legal requirement. Since 1985, the NHRS has undergone reforms including a shift from the use of the Open Group Aggregate equation to the Entry Age Normal equation, methodologies used to determine the funding necessary to support the NHRS. Before the transition to the more accurate Entry Age Normal equation, the state of New Hampshire incurred a large unfunded liability. As the unfunded liability grew and New Hampshire’s budget deficit widened, reforms to the NHRS were deemed necessary. In 2011, comprehensive pension reform removed all state funding for NHRS and shifted the financial burden onto employers, in this case local governments and school boards. Many municipalities find it challenging to come up with the necessary funds to cover the increased costs of employee benefits. This report seeks to better understand the impact of recent NHRS changes on municipalities in New Hampshire and how the governance structure and demographics of municipalities present challenges and provide certain solutions.

1. NATIONAL TRENDS IN RETIREMENT SYSTEMS

The New Hampshire Retirement System (NHRS) is in a challenging state, which is reflective of larger national trends. Nationally, various other states are also in financially exacting predicaments related to the inadequate funding of pension programs. The average funding of retirement systems only makes up approximately 3.8 percent of local and state budget expenditures, although there is variability within that statistic (Figure 1). Current understandings of pension programs, however, suggest that in the future retirement contributions will become a larger share of government budgets. Several factors influence this prediction. First, states and localities rely heavily on investment returns, yet a repeat of the 1982-2000 stock market boom is unlikely. In addition, states were using a less than accurate equation to calculate the necessary contributions from employees and employers in efforts to “keep [retirement plans] on a steady path toward full funding”. The Governmental Accounting Standards Board (GASB) defines this as “The Annual Required Contribution“ (ARC), which is a method of looking back at past expenditures in order to assess whether programs were fully funded. As a result localities are not contributing their full ARC (Figure 2). Lower than expected investment returns and employer contributions led to the creation of large unfunded liabilities for many states.
The impact of this change on state government’s ability to pay for pensions added economic pressure to localities in NH who are now charged with funding a greater portion of NHRS. Looking nationally, New Hampshire follows national trends as state and local governments generally raise employee contributions and/or reduce benefits for new workers in order to accommodate the increase in retirement expenditures coupled with budget crises due to the 2008 recession. Despite, these efforts the funded status for state and local pension plans are seemingly declining. 5 Considering the status of ARC funds at the state level is integral to understanding the impacts of local funding dilemmas on budgets.

National trends explain some of the New Hampshire Legislature’s recent decisions to stop funding. Pension costs account for only about four percent of state and local budgets. Cutting state funding for this area of spending is more politically feasible than for other areas. The lack of certainty for investment returns that fund the NHRS require funding to come directly from the government. The state government, however, faces significant expenses, illustrated in Figure 3 for FY2013. 6 From the state’s point of view, reducing government spending to account for budget shortcomings, due to the financial recession is the fiscally responsible thing to do. Other states, including Arizona and Louisiana, are also passing on the funding responsibilities of pension plans to localities. 7

2. METHODOLOGY

To understand how the New Hampshire Retirement System (NHRS) changes impacted local governments, we performed informative interviews with Hanover/Norwich Schools...
Superintendent, Dr. Frank Bass, the Town Manager of Hanover, Julia Griffin, and the Financial Analyst of the NH Municipalities Association, Barbara Reid. In addition to informant interviews, we reviewed the number of policy briefs released by the NHRS, the Congressional Committee report, and other policy reports regarding the NHRS and retirement systems at large. We also conducted in-depth research of the history of the NHRS and analyzed the impact of recent changes on both the state government and localities. This research allows us to properly understand the context of changes to the NHRS and the responsibilities it imposes on local governments in New Hampshire.

3. HISTORICAL OVERVIEW OF NHRS LEGISLATION

In 1967, the New Hampshire Retirement System was established to bring together the independent retirement plans for teachers, police, firefighters, and state employees. The current NHRS serves 51,000 active members and 25,800 current recipients in 500 local governments. The NHRS members are divided into two groups: Group I, government employees and teachers, and Group II, police and fire.

The NHRS provided retirement payments with occasional Cost of Living Adjustments (COLAs) until 1983 when the NH legislature established the Special Account fund to create a steady source of funding. The NHRS became a permanent fixture when it was established as a part of the NH State Constitution in 1985. In the late 1980s, the NHRS funds were strong and as a result, the legislature authorized pension funds to be maintained even after retirees started receiving Social Security. This decision led to a quick depletion of available funds and local governments were overwhelmed by the additional costs. In response, the legislature implemented the Open Group Aggregate methodology in 1991 to project needed resources and determine the amount employees, employers, and the state should contribute to the fund. This model severely underestimated total costs, but due to the strong economic climate of the 1990s this was not apparent and did not become an issue until 2004 when NH incurred a $204 million unfunded liability. In response, the legislature switched to the more accurate Entry Age Normal funding methodology and temporarily suspended the practice of putting money into the Special Account fund.

Before 2011, the NHRS was predominantly funded by investment returns, state funds, and employee and employer contributions. As stated previously, in 2008, investment returns were substantially below projections forcing the state to make up the costs through the Special Account fund in addition to COLA and Medical Subsidy Program costs. Since the practice of transferring funds to the Special Account was ended in 2004, the fund has been depleted forcing an overhaul of the NHRS in the last few years.

Recognizing the potential need for pension reform, Governor Lynch issued a Commission to Study the Long Term Viability of the NH Retirement System in 2008. The Commission made five main recommendations to the NH Legislation that were
focused on three themes: pre-funding COLA by increasing the cost to employees, stabilizing the current medical subsidy program by earmarking trust funds for the program, and increasing employer contribution. In addition, the Commission recommended establishing a new health care model that would be open to all public employees including Group I, state employees and teachers. The Commission encouraged the NH Legislature to find alternative methods for funding COLAs and the Medical Subsidy Program because these costs are allocated directly from the Special Account fund, which has been severely depleted.

Despite the Commission’s recommendations, the changes made between 2009 and 2011 do not reflect these suggestions. In 2009, the state of New Hampshire was still recovering from the recession. They reduced their share of contributions to the NHRS from 35 percent to 30 percent and, then again, to 25 percent in 2011. As part of the 2011 comprehensive pension reform the following year the state pulled all funding and placed the financial burden on the employee and employers to cover the cost. Since state law sets employee contribution rates, the bulk of the financial burden is now placed on employers or local governments. In order to reduce the financial burden on local governments, the 2011 pension reform also increased the amount employees must pay into the system, raised retirement age for newly hired workers, limited earnable compensation for employees, and reduce maximum initial benefits for employees. The NHRS factsheet about the 2011 Pension reform notes that, “Legislation enacted in 2011, primarily House Bill 2 (Chapter 224, Laws of 2011), made several major changes to the law governing the retirement system. Cumulatively, those changes are projected to reduce employer costs by more than $3 billion over the next 20 years.” However, current projections show that costs to localities will still increase by $50 million, about 1-2 percent annually.

In addition, the 2011 legislation abolished the Special Account fund and all remaining funds as of June 30, 2011 were transferred to the State Annuity Accumulation Fund. The closing of the Special Account led to the reform of the Medical Subsidy and COLA benefits. The Medical Subsidy was frozen capping their benefits at the current level. The legislature also did not appropriate funds for COLA for 2012 or 2013, so there is no guarantee of a COLA payment for retirees.

4. IMPLEMENTATION OF NHRS AT THE STATE LEVEL

The NH state legislative reforms from 2007-2010 did not fundamentally change the administration of the program – that is, the NHRS is still a state-run program. The NHRS Board of Trustee administers the program. Pursuant to RSA100-A: 14, the Governor of New Hampshire and the Council appoint: four public members not involved with the NHRS, four employee members (1 police, 1 fire, 1 teacher, and 1 state employee), and four employer members for the NHRS Board. These last four members represent the NH School Boards Association, the NH Municipal Association, the NH Association of
Councils, and the State of NH. The State Treasurer is an Ex Officio Member of the NHRS Board of Trustees and gets to vote, ensuring that employers and employees both get equal representation, but the members not involved in NHRS have sufficient authority to facilitate policy changes. The NHRS’ Board of Trustees ensures the viability of the fund by a) employing highly qualified personnel with accounting and investing experience, b) adopting administrative rules, c) establishing the allocation of trust funds and d) formulating investment philosophy and guidelines.

4.1 Funding the NHRS

The NHRS’ budget consists of employer contributions, employee contributions, and a state trust fund based on the investment returns of the NHRS. Laws pertaining to NHRS enable the state to collect taxes from employers and employees and to distribute them accordingly. These taxes are collected annually and paid to the state by employers and employees, which contribute to the NHRS fund. The NH state legislature sets contribution rates annually, which are then administered by the NHRS Board of Trustees. Employees are split up into groups – teachers/employees, police members, and fire members. The NHRS Board of Trustees statutorily establishes employee contributions – teachers/employees pay 7.0 percent, police members pay 11.55 percent, and fire members’ pay 11.8 percent. New NHRS requirements have also raised the minimum retirement age for new workers, limited earnable compensation, limited initial maximum benefits, and limited the number of public employee representatives on the NHRS Board of Trustees. The NH legislature adopted the “Prudent Investor Rule,” which fulfills long-term funding requirements. This investment philosophy aims to generate consistently high returns at the lowest level of risk. The NH legislature adopted these methods due to increased uncertainty and decreased investment returns. Consequently, the lack of funding from investment returns has placed more of a burden on employees and employers. In response to multiple years of low investment returns, the legislature lowered projected returns from 8.5 to 7.77 percent. By deciding to no longer directly fund the NHRS in 2012, the legislature left local governments and employees to fund the difference.

4.2 The Special Account

The Board of Trustees also manages the Special Accounts fund, which is used to pay for COLA and the Medical Subsidy Benefits. Enacted in 1997, the COLA provided supplemental benefits to account for cost of living increases. The COLA was voted on annually by the state legislature and provided retirees with additional allowances. New Hampshire uses an Ad Hoc design for the distribution of COLA, which means that the state legislature determines each year whether it will award a COLA. Unlike many states, COLAs in New Hampshire are not guaranteed or linked to any index, such as the Consumer Price Index (CPI). By placing the COLA in control of the legislature, adjustments are only implemented when politically feasible. The Special Account can
also be used to fund these supplemental benefits with “excess earnings” from investment returns when the fund performs particularly well. The definition of “excess earnings” fluctuated annually until 2007, when it was defined as 0.5 percent of investment earnings after 85 percent of the projected need are met.

By diverting funds from the NHRS to the Special Accounts fund when returns were below projections, the state created an unfunded liability for the NHRS. This tension placed a larger burden on employers and taxpayers as the legislature increased contribution rates to close the gap. In 2012, the New Hampshire Legislature abolished the Special Account and stopped funding COLA, placing the entire burden of funding investment account surpluses on states and localities.

The Medical Subsidy program of the NHRS provides 10,000 retirees with a medical insurance policy that allows them to remain on their former employers health care plan. This payment is made by the NHRS to the retiree’s former employer. In 2001, the NHRS placed limits on eligible recipients – Group I members, teachers and state employees, are not eligible for the medical subsidy if they retired after July 1st, 2004, while Group II, police and fire members, are only eligible if they were active or retired NHRS members as of June 30th, 2000. The NHRS imposed these limits because of the lack of returns on investments. Once a retiree reaches the age of 65 or begins receiving Social Security benefits, the medical subsidy is reduced to the Medicare Supplemental rate.

The NHRS benefits are distributed differently depending on the program. The Medical Subsidy is paid directly to the employer to cover medical insurance costs. For a retiree to receive pension benefits, he/she must file an application to the NHRS no more than 90 days or fewer than 30 days before their effective date of retirement. Overall, the state legislature plays a large role in setting regulations and funding allocations through the NH Board of Trustees.

5. RESPONSE BY NH LOCAL GOVERNMENTS TO NHRS CHANGES

The financial burden placed on employers elicited a rapid response from municipalities. Local governments in New Hampshire challenged the large increase in employer contributions with litigation, while also adjusting their systems of taxation. Municipalities have needed to increase their local revenue in order to cover the additional NHRS payments for employers. Their choices, however, are limited because most municipalities can only raise revenue through property taxes or user fees. User fees are statutorily authorized so many times they cannot be adjusted, forcing many municipalities to raise property taxes. The ability of municipalities to raise property taxes, however, depends on their governance structure and demographics.
5.1 Litigation

Employees and employers confronted the 2009 and 2011 legislative changes to the NHRS in the courts. In Cloutier v. The State of New Hampshire, Cloutier, a retired judge, argued that the benefit changes made in RSA-100 were unconstitutional and that he was entitled to the benefits that were in effect when he was appointed to be a judge. The New Hampshire Superior Court ruled in Cloutier’s favor, but the New Hampshire Supreme Court ruled RSA-100 was constitutional. Currently, the New Hampshire Superior court is hearing two cases. Both American Federation of Teachers v. State of NH and Personal Fire Fighters of NH v. State of NH, challenge the constitutionality of increasing member contribution rates arguing it “impairs vested contract rights.” The American Federation of Teachers is also arguing that changes to the definition of Earnable Compensation and the freezing of COLA benefits are also unconstitutional.

Employers also challenged the constitutionality of the 2009 changes to NHRS. More than 300 municipalities, school districts, and counties filed a lawsuit against the State of NH challenging the constitutionality of the 2009 reforms arguing they constitute an unfunded mandate. Both the NH Superior Court and NH Supreme Court ruled in favor of the State of NH asserting that the reduction of state funding to NHRS did not constitute an unfunded mandate.

The judicial support of legislative changes to NHRS is perceived as a setback to employees and employers as their financial burdens significantly increased over the last few years. Employee contributions increased by about two percent and as a result of the State of NH pulling all funding for NHRS, employer contributions have increased 20 plus percent.

5.2 Tax Caps

Tax caps only allow municipalities to increase their budgets and their taxes by a set amount. For some municipalities, such as Laconia and Dover, the increase in NHRS employer contributions is a large percentage of their entire tax base. In Laconia, for example, the tax cap is around $420,000 and $350,000 of that is going to be needed to cover the increase in NHRS employer contributions. Since about 83 percent of their tax base is being used to pay for employee benefits, there is very little money left to cover other needs in the community, such as infrastructure repair. The city of Dover also faces similar problems. Before the 2011 legislative changes to NHRS, the increase in retirement costs exceeded the available tax base under the tax cap. The tax cap places challenging restrictions on the amount of funds municipalities can generate to cover retirement costs.
5.3 Strength of Tax Base

Another limitation for municipalities is the strength or wealth of their tax base. Wealthier municipalities, such as Hanover or Bedford, are able to respond to employer increases by raising property tax values, but this is not an option for all municipalities. For some, this is problematic for residents. If municipalities cannot raise taxes, they must make cuts to the services they provide or their number of full time employees. Even in municipalities with a strong tax base, raising property tax rate is not a long-term solution. The town and school district of Bedford wrote in a letter to the editor about this very dilemma:

However, we are gravely concerned about our ability to build the infrastructure necessary to expand our tax base, maintain our existing infrastructure and staffing levels, and sustain our Legislatively mandated commitments to our employees while, at the same time, to not overburden our taxpayers.

The Town of Hanover also expressed similar concerns, illustrating the need for a long-term solution to increasing retirement costs.

Towns with a strong tax base typically rely on property taxes increases to fund budget shortfalls. However, an increase in property taxes alone is not sufficient for many municipalities to fund their contributions after recent changes to the NHRS. Many municipalities have been forced to withdraw from their “rainy day funds.” The limitations and dangers of taking funds from reserves are discussed below in relation to the town of Hanover. Other localities have cut non-essential services. While others, have transitioned full time employees to part time or encouraged early retirement. Part time employees are not eligible for retirement benefits, reducing the costs to employers. This practice, however, is currently under discussion in the NH legislature. Unions argue that the transition to more part-time employees is actually detrimental to the retirement system because fewer funds are coming into the account. On the other hand, municipalities argue that cutting down full time employees is the only way they can pay for their mandated employer contribution to the NHRS. Municipalities responded to the increase in employer contributions in a myriad of ways depending on the challenges their governance structure and demographics present.

5.4 Other Consequences

In addition to financial consequences, the changes to the NHRS could also affect employers’ ability to attract and retain qualified employees. The NHRS is a Defined Benefit (DB) plan meaning that retirees are guaranteed a monthly retirement benefit based on a formula that takes into account employees’ earnings, years of service, and age. Employees receive the guaranteed benefits regardless of how the investments perform, but they might not receive supplemental benefits such as COLA or Medical Subsidy
benefits. Without these benefits, some retirees might not be able to live on retirement benefits alone and will be forced to re-enter the workforce. In a Defined Benefit plan, taxpayers and employers shoulder most of the risk associated with funding retirement benefits.

6. HANOVER, NH

6.1 Town of Hanover’s Response

The FY2014 Proposed Budget for the Town of Hanover, awaiting passage at the 2013 Town Meeting, illustrates the impact of NHRS policy reform and its implications for tax rates, service provision, and overall costs. The Hanover budget addresses the difficulties associated with the current fiscal landscape noting that, “the budget proposal…has been developed in the midst of what continues to be an enormously complex economic downturn, further complicated by …political partisanship… Sadly, local communities…are suffering as a result.”\textsuperscript{40} The budget details the challenges the residents and local officials will face in the coming fiscal year, preparing them for an increase in spending. The budget overview states that the FY2013-14 proposed budget is 4.7 percent about the total appropriations for FY 2012-13.\textsuperscript{41}

Looking at the particular breakdown of revenue and expenditures over time it becomes clear that Hanover is facing increased costs due to the recession and the reallocation of funding responsibility from the state to localities.\textsuperscript{42} Particularly, focusing on the NHRS reforms the budget outlines the increase overtime of employer contributions. The budget notes that:

Employer contributions to the New Hampshire Retirement System (NHRS) are increased significantly in the proposed budget due to changes in actuarial assumptions used to value the NHRS pension plan…[On July 1\textsuperscript{st}, 2013 a] ~20+\% increase in NHRS employer contribution rates…[will] take effect.\textsuperscript{43}

The “changes to the actuarial assumptions” refers to changes made in projected investment returns from 8.50 percent to 7.75 percent (Figure 4).\textsuperscript{44} “Changes in the actuarial assumptions” also describes the adoption of the more accurate Entry Age Normal method to calculate the ARC. The changes in Employer contribution rates are drastic.\textsuperscript{45} Looking at the progression of Employee Benefit costs over time shown in Figure 4 illustrate the increase in

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<th>Town of Hanover Employer Contribution Rates to NHRS</th>
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<tr>
<td>Period</td>
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<td>July 1, 2013 – June 30, 2015</td>
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<td>July 1, 2011 – June 30, 2013</td>
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<td>July 1, 2009 – June 30, 2010</td>
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<td>July 1, 2003 – June 30, 2005</td>
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Figure 4. Change in Employer Contribution Rates
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NHRS employer contribution rates overtime showing a rather severe increase over the last four years, with an 8 percent increase from 2013 alone.\(^{46}\)

Overall, the projected increase in cost for the town of Hanover as a result of state pension reform will be around $250,000. Hanover plans to increase property taxes by 2 percent to cover some of these costs. The rest will be pulled from their “Rainy Day” fund—an account made up of yearly excess expenditures—in order to prevent raising taxes abruptly. The Hanover “Rainy Day” fund contains approximately $240,000, which is almost enough to offset the increased costs, although this is only a viable solution in the short run. The Town of Hanover must become more prudent and be willing to contribute more financially in order to shoulder the future costs of the NHRS.

In an effort to conceptualize the local governance perspective on the potential impacts of the NHRS reforms, we conducted an Interview with the Hanover Town Manager Julia Griffin. Griffin noted that, “[NHRS] increases are the biggest single driver of our budgets that we currently face in New Hampshire”\(^{47}\) confirming verbally what budgetary and policy based evidence suggest. Hanover and many other localities are faced with tough decisions and must rely on their elected officials and citizenry to decide what they value and where the priorities lie. Griffin outlined the decision making process that Hanover relies on stating that, “when you see a big expenditure increase like a retirement contribution hit a budget what tends to suffer are the nice, but not essential services that you provide, the core services are more difficult to cut.”\(^{48}\) She also acknowledges the legal limitations associated with the process that make funding the NHRS onerous. To exemplify these limits, Griffin mentioned that localities have no say in employee or employer mandated contributions and that they are simultaneously required by law to be members of NHRS, which stifles many possibilities for creative funding. Although, she asserts that, “We’re a very fiscally sound community and we also have a lot of money set aside in various reserves”\(^{49}\) highlighting the ways the town is anticipating increased costs. Hanover Town Manager Griffin illuminated and confirmed many of the nuanced dynamics associated with the NHRS reform. Examining the budget puts Griffin’s insights into perspective, illustrating Hanover’s preparation for the increase of costs due to the NHRS reforms.

6.2 Hanover/Norwich School District’s Response

The local government and school district in Hanover NH are separate entities, therefore, the school district must also address the increase in NHRS employer contribution rates. Frank Bass, superintendent of School Administrative Unit #70, an intrastate school district that oversees Hanover and Norwich public schools, believes the rise in contribution rates for Group I teacher employees will have diverse impacts at the local level. SAU #70 relies on stable infrastructure that allows its schools to retain the best and brightest teachers. Hanover’s education budget is lean and as a result the community isn’t forced to pay a lot more to absorb the costs of the pension budgetary impacts. Hanover
also implements innovative revenue-raising policy. SAU #70 markets its schools as some of the best in the upper valley and many foreign students are involved with exchange programs. With four or five kids, the school is able to raise about $100,000, which helps alleviate some of the costs of rising employer contribution rates.

That being said, Bass believes the district has an obligation to look at all of its programs and emphasize certain programs and cut back others that aren’t as successful. SAU #70 is also cobbling positions together within the district in order to hire people for full-time positions in an effort to alleviate budget restraints — a process that is less expensive, but provides the same quality service.

Superintendent Bass is optimistic about Hanover, but also sees how the rise in contribution rates will negatively affect other districts and limit their abilities to hire/retain teachers. As the former superintendent of the Pelham-Windham School District, Bass sees significant differences in the needs of the schools. Pelham-Windham suffers from more population overload and a greater need for facilities, so budgetary restraints are further agitated by other concerns. The community’s response in this district is divided, as contributions for pensions increase, whereas Hanover residents incur less of the burden. This could affect Pelham-Windham’s ability to hire new teachers while simultaneously compounding other infrastructural problems. In terms of Group I, teacher employees, the rise in employee/employer contribution rates could potentially limit the hiring and retaining of employees, depending on the context in which this change unfolds.

Overall, the Town and School District of Hanover are being affected by the rise in NHRS employer contribution rates, but due to the strength of their budgets they are absorbing the costs well. The local government is able to increase revenue by increasing property taxes because of their strong tax base, and their access to reserve funds. In the case of the school district, Hanover receives excess revenue from tuition being paid by students outside their district. This extra source of revenue is important to covering the increasing employer contributions.

7. CONCLUSIONS

The changes made to the New Hampshire Retirement System are crucial to balancing the New Hampshire state budget. Yet, the subsequent increase in employee and employer contributions is challenging for local municipalities. Municipalities are increasing their sources of revenue to make up for the 1-2 percent increase to their annual budgets to cover employer contributions to the NHRS. The amount of revenue municipalities can raise, however, is limited by their governance structure, in the form of tax caps, and the strength of their tax base. The Town of Hanover is in position to absorb the excess costs because of their strong tax base, but even for Hanover raising property taxes and relying on reserves are not long-term solutions. The State of New Hampshire and local
municipalities understand that a long-term solution to funding the New Hampshire Retirement System is needed if the state wants to maintain both their constitutional obligation to their employees and the financial strength of local municipalities.

8. LOOKING FORWARD

As a next step, we would like to survey a number of local municipalities in the state of New Hampshire. We plan to send out a survey to all the municipalities on the NH Municipality Listserv that we have access to through Julia Griffin, the Town Manager of Hanover. We would conduct follow up interviews with municipalities, who indicate they would be open to an interview. The survey would include questions about their governance structure, challenges to raising the needed funds to cover increases to employer contributions, and if they have made changes to their property taxes, services offered, employers, or their governance structure. From this information, we hope to create a matrix that synthesizes the challenges to local governments and their subsequent responses to cover the increase costs.

We believe that this matrix could be useful for local officials when talking with state legislatures about the broad effects on local government in NH. In addition, it could be an internal resource to understand how other municipalities are addressing these costs and what would be the best option for their municipality. For state legislatures, it would be a valuable resource to help them understand the needs of local municipalities and the possible NHRS reforms.
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