

spotlight

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NEXT COME THE TAXES

Spending growth continues in latest budget

KEY FACTS: • Gov. Mike Easley and the General Assembly continue the spend-and-tax cycle, increasing the General Fund \$1.8 billion, 9.5 percent, over last year.

• General Fund spending on operations reaches \$20.7 billion in FY 2007-08, a 43 percent increase in just five years, similar to the five-year period through FY1997-98.

• The budget adds \$694 million in new debt not subject to a vote by the citizens, including \$120 million to set aside land.

• More at Four and class size reductions get \$93.5 million to make up for shortfalls in lottery revenues.

• The Highway Trust Fund budget transfers \$172 million from the Trust Fund to the General Fund and adds \$4.4 million for administration, but cuts \$5.9 million from actual construction.

• The once-temporary 0.25 percent sales tax increase becomes permanent, costing taxpayers \$258 million in FY 2007-08.

• Medicaid will burden counties less over the next three years, but because they also lose tax revenues, many counties will be little better off.

• Children in families earning up to the state median income will be eligible for subsidies to purchase Medicaid coverage.

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the \$1.8 billion spending surge in the final budget passed by the General Assembly and signed by Gov. Mike Easley continues a five-year trend that has pushed the General Fund to \$20.7 billion in fiscal year (FY) 2008 from \$14.3 billion in FY 2003. This repeats the spend-and-tax cycle of North Carolina state government seen in the 1980s and 1990s – spending increases to match tax revenue growth in fat years, then when the economy slows tax rates increase to cover the promised benefits.¹ With a Savings Reserve Account (rainy day fund) balance equal to just 3.9 percent of General Fund appropriations, policymakers have left themselves little room to maneuver when income-tax collections inevitably decline.

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Even the good news in the budget – allowing the temporary 8.0 percent income-tax rate to expire and agreeing to take over the counties’ share of Medicaid – was mitigated. The temporary sales tax remains and Medicaid was subject to a swap of tax revenues for spending burden, which could lead to tax increases in some counties as early as January 2008. The rest of the budget is unremittingly bad or ugly.

Table 1. Final FY 2007-08 Budget Compared with Proposals and Previous Budgets

	Final Budget S.L. 2007-323	% Change vs Gov	% Change vs House	% Change vs Senate	% Change vs 2006-07	% Change vs 2002-03
Public Education	7,714,429,569	1.5%	1.3%	1.2%	14.8%	30.9%
UNC System	2,626,271,017	-0.3%	2.5%	-0.1%	16.8%	48.5%
Community Colleges	938,106,160	2.4%	1.2%	2.0%	12.8%	40.2%
Total Education	11,278,806,746	1.1%	1.6%	1.0%	15.1%	35.4%
Medicaid	2,920,359,272	1.3%	2.6%	4.6%	10.5%	33.4%
Other HHS	1,710,742,125	0.1%	-0.7%	1.0%	7.7%	21.6%
Total HHS	4,631,101,397	0.9%	1.4%	3.2%	9.4%	28.8%
Correction	1,214,065,645	-0.3%	0.0%	0.0%	12.1%	38.0%
Other JPS	843,652,721	1.6%	2.0%	-1.6%	14.8%	40.7%
Total JPS	2,057,718,366	0.5%	0.8%	-0.6%	13.2%	39.1%
NER	654,161,013	31.0%	21.8%	27.1%	35.5%	92.8%
General Govt	437,078,174	2.1%	2.0%	2.6%	11.4%	38.3%
Debt Service	610,175,752	-1.8%	-1.8%	-1.8%	6.9%	138.7%
Reserves	758,555,164	14.9%	-8.4%	9.2%	-44.3%	N/A
TOTAL Operating	20,427,596,612	2.1%	1.5%	2.2%	9.5%	42.8%
Capital Improvements	230,741,100	261.2%	35.0%	321.0%	11.8%	640.6%
TOTAL BUDGET	20,658,337,712	3.0%	1.8%	3.1%	9.5%	44.1%

Spending Growth

The final operating budget spends almost \$300 million more than the House proposed and \$440 million more than the Senate. General Fund spending on operations increased 9.5 percent, almost \$1.8 billion, over fiscal year (FY) 2006-07. On top of a 9.5 percent increase last fiscal year and earlier increases, the General Fund operating budget has increased 42.8 percent in five years, a 7.4 percent compound annual rate. Spending per person is 14.6 percent higher over the five-year period after inflation.

To keep up with state government spending, per-capita personal income for North Carolina, which was \$27,711 in 2002,² would have to reach \$36,497 this year. To do this, per-capita personal income would have to grow 13.2 percent from the \$32,234 in 2006.³

Education

The final budget, excluding salary increases, spends \$1 billion more on K-12 public education. Nine percent (\$93.5 million) of that covers shortfalls in expected lottery revenue for class-size reductions⁴ and the More at Four preschool program.⁵ Gov. Easley’s Learn and Earn program receives \$3.1 million in FY 2008 to double the number of schools involved to 18 and to provide planning grants to 15 more schools.⁶ The budget also includes \$7.7 million to train and place 100 literacy coaches to help teachers teach eighth-grade students in 100 schools how to read.⁷ Despite the spending to expand programs that have not been evaluated, the General Assembly did not increase the number of charter schools allowed in the state – a less expensive way to experiment that has been evaluated.⁸

The University of North Carolina and Community College systems become more intertwined in state efforts to recruit businesses and promote industries with funds dedicated to nanotechnology,⁹ design innovation,¹⁰ bioenergy,¹¹ “regional cluster-based economic development,”¹² hosiery technology,¹³ motorsports,¹⁴ wine-making,¹⁵ general “competitiveness,”¹⁶ and other areas totaling \$23 million. The NC Research Campus in Kannapolis receives \$16.5 million through UNC¹⁷ and another \$1.4 million through the Community Colleges.¹⁸ Even Wake Forest University, a private university, received \$8 million to study regenerative medicine.¹⁹ UNC schools also receive \$647 million of capital spending, \$141 million from the General Fund and \$506 million in certificates of participation (COPs), a form of debt.

Medicaid

The legislature would take the 15 percent of the non-federal share of Medicaid from counties by FY 2009-10, in exchange for school construction funds in FY 2007-08 and sales tax revenues in following years. This was sold as relief for counties who would then have more money to build schools and other infrastructure. While 11 counties that spend less than \$1 million on Medicaid will have an immediate savings of half or more of their expenditures in FY 2007-08, only two more counties will join their ranks with at least half their burden removed by FY 2011-12 – two years after the swap is complete. On the other end, 13 counties will have gained back less than ten percent of their Medicaid burden by FY 2011-12. That is one reason why counties also now have the option, with voter approval, to levy a new 0.25 percent sales tax or 0.4 percent real estate transfer tax.

At the same time, the budget includes a Medicaid expansion called NC Kids Care, which would subsidize families with incomes up to the state median who wish to purchase Medicaid coverage for their children.²⁰

Taxes and Fees

The temporary top income-tax rate of 8.0 percent reverts to 7.75 percent in January 2008. Lower-income earners will likely be able to claim an earned income tax credit (EITC) equal to 3.5 percent of the federal credit, worth an average \$70 at the state level, starting in 2009. The once-temporary quarter-cent sales tax increase is now permanent, which will leave most people paying a 6.75 percent sales tax rate (unless they live in Mecklenburg) and cost them \$258 million in FY 2007-08. State compliance with federal tax code changes will save taxpayers \$57 million. Other tax and fee changes in the budget leave a net \$7 million, but all of the other tax reductions are targeted to specific groups such as bakery thrift stores, railroads, and aircraft part manufacturers.

Finally, if all counties were to enact either the sales tax or transfer tax increase, they would add another \$250 million in taxes.

Transportation

Table 2. General Fund Availability Changes, 2007-2009

	FY2007-08	FY2008-09
Maintain State Sales & Use Tax Rate at 4.25%	258,400,000	285,900,000
Judicial Fees	35,586,118	38,821,220
Health & Human Services/Health Service Regulation Fees	1,705,501	1,642,407
Secretary of State Corporate Annual Report Fees	563,016	563,016
Close REIT Loophole	minimal	
Sales Tax Exemption for Bakery Thrift Store	-100,000	-100,000
Enhance 529 Plan Deduction (House Bill 1016)	-200,000	-200,000
Railroad Incentives	-200,000	-300,000
Non-profit Energy Tax Credit	-500,000	-500,000
Adjust Sales Tax Holiday	0	-600,000
Research & Development Credit Enhancement	-400,000	-800,000
Sales Tax Refund for Aircraft Part Mfgs.	-800,000	-800,000
Firefighter/EMS Income Tax Deduction	-1,000,000	-1,000,000
Credit for Constructing Renewable Fuels Facilities	0	-2,300,000
Sales Tax Refund - Research Supplies	0	-2,600,000
Adoption Tax Credit	-3,000,000	-3,000,000
Reserve for Work Opportunity Tax Credit	-3,000,000	-3,000,000
Modify Tax on Property Coverage Contracts	-1,500,000	-3,100,000
Privilege Tax on Software Publishers	-2,800,000	-4,000,000
Long-term Care Insurance Tax Credit	-7,000,000	-7,200,000
Reserve for Manufacturers' and Farmers Energy Tax Provisions	-10,000,000	-20,000,000
Earned Income Tax Credit	0	-48,300,000
IRC Conformity	-56,900,000	-49,100,000
Net Tax and Fee Increase	208,854,635	180,026,643
Transfers - not new taxes		
Adjust Transfer from Insurance Regulatory Fund	80,274	56,274
Adjust Transfer from Treasurer's Office	110,758	98,758
Transfer from Closed Capital Account	3,506,143	0
TOTAL	3,697,175	155,032
Medicaid Swap - not new taxes		
State Takeback of Local Sales Tax	0	184,200,000
Corporate Tax Earmarking Adjustments	44,700,000	0
State Hold Harmless for Counties	-19,300,000	-3,700,000
TOTAL	25,400,000	180,500,000

Because of lower tax collections, Highway Trust Fund spending on construction dips \$8.2 million in FY 2007-08. Spending to administer the Trust Fund, however, increases \$4.4 million, and the transfer to the General Fund remains at \$172 million.

Maintenance funding through the Highway Fund shifts from urban roads (down \$41.3 million) to primary roads (up \$24.8 million) and secondary roads (up \$16.5 million). Legislators decided to transfer \$2 million more to the General Fund instead of cutting the transfer by \$16 million as proposed by Gov. Easley. They also added \$14 million for economic development-related road projects.²¹ A positive note: with federal funding gone, legislators cut \$23 million that would otherwise have gone to light rail in the Triangle.²²

Hidden Items

Three additional items illustrate the need to read state budgets carefully. An otherwise obscure-sounding provision would allow vendors at Bank of America Stadium to begin selling alcohol at 11 A.M. on Sundays, two hours before early Panthers football games.²³ Land for Tomorrow receives \$120 million in certificates of participation and \$8 million in direct appropriations toward its goal of \$1 billion to buy land so it cannot be developed.²⁴ Also, a \$2.2 million appropriation for the Kerr-Tar Economic Development Corporation includes \$250,000 to fund a pilot project for affordable housing in Vance County.²⁵

Conclusion

This budget sets up future legislative sessions for higher taxes or dramatic spending cuts when the economy and

Table 3. Availability and Appropriations Possible in Conference

	FY2007-08	FY2008-09
Expected tax revenue	18,643,100,000	19,670,200,000
Unappropriated Balance	-	270,504,098
Non-tax revenue	874,690,000	905,110,000
Reversions	125,000,000	-
Overcollections	1,368,100,000	-
Availability before Legislative Changes	21,010,890,000	20,845,814,098
Income tax changes	(68,100,000)	(108,800,000)
Sales tax changes	257,500,000	281,800,000
Medicaid swap related changes	25,400,000	180,500,000
Energy tax breaks	(10,500,000)	(22,800,000)
New fees and fee increases	37,854,635	41,026,643
Other transfers and changes	(4,202,825)	(11,044,968)
Availability after tax changes	21,248,841,810	21,206,495,773
Savings Reserve Account	(175,000,000)	-
Repairs and Renovations Reserve	(145,000,000)	-
Net Availability	20,928,841,810	21,206,495,773

	FY2007-08	FY2008-09
Adjusted Continuation Budget	18,967,544,989	19,492,587,728
Recurring Adjustment	894,192,674	1,165,511,624
Nonrecurring Adjustments	565,858,949	27,567,186
Capital	230,741,100	0
Revised Appropriation	20,658,337,712	20,685,666,538

	FY2007-08	FY2008-09
Recurring Revenue before changes	19,517,790,000	20,845,814,098
Adjusted Continuation Budget	18,967,544,989	19,492,587,728
New Recurring Spending	894,192,674	1,165,511,624
Total Recurring Spending	19,861,737,663	20,658,099,352
Surplus/(Deficit) before revenue changes	(343,947,663)	187,714,746

	FY2007-08	FY2008-09
Expected Revenues	19,517,790,000	20,845,814,098
Previous Year Surplus	2,367,790,000	1,175,614,098
Other Availability Changes	(956,738,190)	(814,932,423)
Final Availability	20,928,841,810	21,206,495,773
Final Appropriation	20,658,337,712	20,685,666,538
Surplus/(Deficit) after revenue changes	270,504,098	520,829,235

tax revenues slow. Infrastructure investments have gone wanting while new programs in other areas have been added, so there is talk of a special session to deal with transportation needs. Any new spending on roads, however, should either come from redirecting existing revenue, from tolls, or from leveraging federal funds – not from higher taxes.

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End Notes

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8. Terry Stoops, “Why Charter Schools Are Good for North Carolina,” John Locke Foundation Policy Report, May 2007, www.johnlocke.org/policy_reports/display_story.html?id=84.
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10. Ibid., p. F 20.
11. Ibid., p. F 21.
12. Ibid., p. F 18.
13. Ibid., p. F 25.
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20. Ibid., p. G 12.
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23. S.L. 2007-323, Section 6.25, www.ncleg.net/Sessions/2007/Bills/House/PDF/H1473v10.pdf, p. 23.
24. Ibid., p. H 9.
25. Ibid., p. H 14.