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General Assembly Update

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FY2007-09 Budget Roundup ... Higher Taxes, Bigger Government

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Tax Increases Will Likely Exceed Half a Billion Dollars

Thanks to the new state budget just passed by the General Assembly and signed by Governor Mike Easley (D), North Carolinians must brace themselves for another significant tax increase. The new budget authorizes tax increases of well over half a billion dollars for FY2008 alone. All of this comes in spite of a budget surplus of nearly \$1.4 billion.

- **A permanent sales tax increase of ¼ cent.** Instead of again renewing the “temporary” sales tax that was first passed in 2001, the General Assembly permanently raised the sales tax. The result is a \$258.4 million tax increase for FY2007-08.
- **An optional sales tax increase of ¼ cent.** As part of the Medicaid “swap” plan, local governments will have the option, pending voter approval, of tacking on another ¼ cent sales tax increase. If implemented in every county, this increase would also amount to a \$258.4 million tax increase.
- **An optional transfer tax increase.** Counties that choose not to increase their sales tax may instead triple the land transfer tax from 0.2 percent to 0.6 percent. This increase also amounts to roughly \$250 million for next year alone. (See Medicaid swap below.)
- **Tobacco tax increase of \$27.4 million over two years.** The sales tax rate on non-cigarette tobacco products will be increased from 3 percent to 10 percent to help pay for cancer research at UNC-Chapel Hill. This increase is expected to generate \$11.4 million in added revenue in FY2007-08 and \$16.5 million in revenue for FY2008-09.

Break for Small Businesses: “Temporary” Income Tax Rate Allowed to Sunset

Budget makers decided to finally allow the “temporary” income tax rate in the top bracket to sunset effective Dec. 31, 2007. This comes after lawmakers twice – in 2003 and, again, in 2005 – broke their promise not to renew the income tax increase. The move will help small businesses, in particular, many of whom pay under the personal income tax provisions. The General Assembly’s decision not to renew the tax will also inject an estimated \$134.5 million dollars into the economy in just the first 18 months after it goes into effect.

Spending Increase of 20 percent Over Two Years

At a total of \$20.7 billion, the General Fund budget increases spending by almost \$1.8 billion over last year – a jump of 9.5 percent.

- **A two-year increase of 20 percent.** Under the new budget, General Fund spending will have climbed by 20 percent between FY2006 and FY2008, compared to an estimated population increase of only 4.2 percent during the same period.
- **An annual spending increase of \$2,000 per family.** With the passage of the new budget, spending will have increased by 42 percent under Governor Mike Easley’s tenure. This is an increase of more than \$6 billion in spending over the \$14.53 billion budget signed by Governor Easley in 2001. During the same period, per capita General Fund spending shot up 29 percent, with the result that General Fund spending is now \$2,000 more for

the average family of four than it was under Governor Easley's first budget. All told, North Carolina's annual General Fund spending burden now equals more than \$9,000 – \$750 each month – per family of four.

Other Major Issues

► **Medicaid Swap:** The state will assume the county share of Medicaid costs in a plan that is to be phased in over the next three years. In exchange for their Medicaid burden being lifted, counties will transfer ½ cent of their sales tax revenues to the state. Low income, rural counties that have a high concentration of Medicaid recipients will benefit most from the swap. In these counties, foregone sales tax revenue will be much less than the Medicaid burden passed along to state taxpayers. Conversely, more urban, affluent counties, such as Wake and Mecklenburg, that have lower rates of Medicaid recipients and a growing sales tax revenue stream, will theoretically lose money from the swap. The budget, however, includes a “hold harmless” provision that will use state funds to reimburse those counties that lose money under the new plan.

► **State Earned Income Tax Credit (EITC):** In an attempt to offset the growing state and local tax burden on low income citizens, the budget implements an Earned Income Tax Credit effective FY2008-09. The credit will be refundable and set at 3.5 percent of the federal credit. Supporters claim this program will benefit roughly 825,000 recipients. But with an initial allocation of \$48.3 million in its first year, the EITC will result in a payout averaging less than \$5 per month per beneficiary.

► **Gas Tax Cap:** The state gas tax rate will be capped at 29.9 cents per gallon. North Carolina's current gas tax is the 13th highest in the nation. Without the cap in place, the rate could have jumped into the top five in the United States.

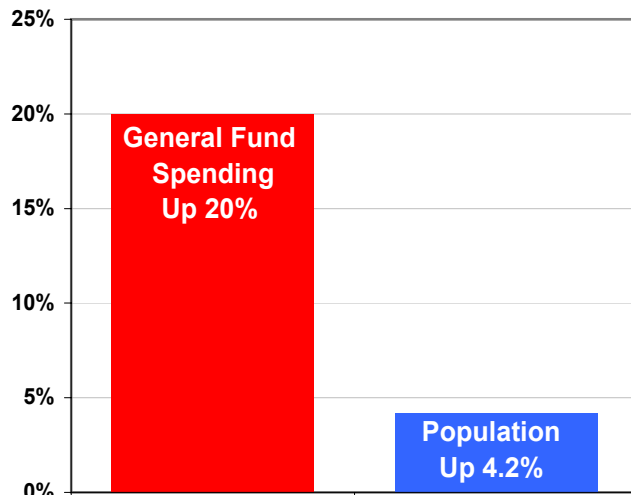
► **No Voter Approval on New Debt:** This year's budget authorizes roughly \$554 million in certificates of participation (COPs) for capital projects for higher education. The bulk of the projects are for the construction of new UNC research buildings. The COPs authorization is the largest in state history and represents over half a billion in new debt not subject to voter approval. Because COPs come with higher interest rates than general obligation bonds, the new plan will end up costing taxpayers millions more than traditional methods of financing.

► **Public Health Insurance for Half of N.C. Families:** The budget appropriates more than \$7 million over two years to provide taxpayer-subsidized insurance for children from families who earn up to 300 percent of the federal poverty level – an income range that includes half of all families in North Carolina. Specifically, the budget grants \$368,000 in FY2007-08 to the Department of Health and Human Services to “produce a report that identifies the most cost-efficient and cost-effective method for developing and implementing a program of comprehensive health care benefits for children ages 0 through 18 in families with annual incomes between 200 percent (\$41,300 for a family of four) and 300 percent (\$61,950 for a family of four) of the federal poverty level.” The budget then appropriates \$7 million in FY2008-09 to implement the program, which will be called NC Kids Care.

► **\$1 Billion Raise for Teachers and State Employees Over Next Two Years:** The budget gives a 5 percent pay raise to public school teachers, judges, community college instructors and UNC faculty. Most other state employees will receive a 4 percent pay increase. These salary increases will cost taxpayers \$489 million in each of the next two years, for a total of \$979 million. In addition, adding a step to the public school teacher salary schedule combined with salary increases for teacher assistants will cost another \$22 million. This equals more than \$1 billion over the next two years in pay raises for teachers and state employees.

► **Class Size Reduction:** The budget dedicates \$37.5 million in FY2007-08 towards maintaining a student teacher ratio of 18:1 for grades K-3. General Fund money for class size reduction was made necessary due to the shortfall in lottery revenue, which was supposed to be used for class size reduction. Studies of the effects of class

**North Carolina Growth Rates:
July 2005 - July 2007**



size reduction have found limited benefits from this initiative, with any short-term improvement for students disappearing in later grades.

► **700 New Government Jobs:** The budget creates 509.87 net new full-time state government positions for FY2007-08 alone, with an additional 181.69 already scheduled for FY2008-09. Overall, a total of 691.56 net new government jobs are planned for the next two years. This number does not include teachers and other school employees.

► **Tuition Subsidies for Middle-class Students:** The budget appropriates \$127.6 million over the next two years for Governor Easley's EARN (Education Access Rewards North Carolina) Scholars Fund. The program grants tuition subsidies to families of four earning up to \$41,300 per year – in effect, the lower middle class. The scholarships will be funded by \$27.6 million from the General Fund for FY2007-08, with another \$60 million the following year. The fund will also be supplemented with another \$40 million from the Escheat Fund (unclaimed property) in FY2008-09.

► **Elimination of Vacant Positions:** A provision in the budget authorizes the Office of State Budget and Management to find \$10 million in savings in each of the next two years by eliminating vacant positions it deems expendable.

► **More at Four:** Governor Easley's More at Four daycare program will be expanded by \$56 million. Over half of the monies (\$37.5 million) are to backfill shortfalls in lottery revenue. The remaining funds (\$18.5 million) are to expand the program by 10,000 more students.

► **Health Choice:** Even as it expands state funded healthcare for middle-class families, the budget caps NC Health Choice growth at 6 percent annually. NC Health Choice is North Carolina's version of the State Children's Health Insurance Program (SCHIP), a federal program that provides health insurance for children whose families make too much to qualify for Health Check/Medicaid, but whose income does not exceed 200 percent of the federal poverty level. The budget expands spending for the program by \$7.5 million per year, bringing total spending to just under \$60 million annually over the next two years.

► **Learn & Earn:** The budget provides \$6.4 million to create 12 new Learn & Earn (L&E) high schools over the next two years. In addition, the budget provides planning grants for 15 more L&E schools. The L&E program enables high school students to concurrently enroll and take courses in the University of North Carolina or community college systems and to take their high school courses in an integrated program on a college campus. Critics of the program argue that L&E schools have strayed from their original goal of providing job training for low income students and are actually attracting students who would attend college anyway.

► **Learn & Earn Online:** The budget also appropriates \$21.6 million over the next two years for a Learn & Earn online initiative that enables high school students to take online college courses.

► **Targeted Tax Credits:** The budget offers \$71 million over the next two years in the form of tax credits and breaks to preferred groups. These include long-term insurance care providers, software publishers, and aircraft part manufacturers. The budget likewise extends significant energy tax breaks to farmers and manufacturers and also allocates \$2.3 million in tax credits for the construction of a renewable fuel facility.

► **Shortchanging the Rainy Day Fund:** The budget sets aside \$175 million into the Savings Reserve Account – commonly referred to as the Rainy Day Fund – for FY2007-08. This amount falls far short of the House budget's recommended \$315 million in savings. The allocation brings the Savings Reserve Fund up to \$786 million, or roughly 4.2 percent of last year's General Fund operating budget. According to a new state statute effective July 1, 2007, the "goal of the General Assembly and the state (is) to accumulate and maintain a balance in the Savings Reserve Account equal to or greater than eight percent (8%) of the prior year's General Fund operating budget." Already in the first year, the General Assembly will fall significantly short of this savings goal.

