BTC Brief

NC Justice Center
Opportunity and Prosperity for All

NC BUDGET & TAX CENTER

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Timely, accessible, and credible analysis of state and local budget and tax issues

Surplus or Shortfall?

Finally some breathing room, but not much.

OVERVIEW

When state lawmakers arrive in Raleigh for this year's legislative session, they will be confronted by the state's first budget surplus since 2000. Unfortunately, they will soon discover that the oasis of surplus revenues is more like a mirage. According to NC Budget & Tax Center calculations, revenues available for fiscal year 2007 will be approximately $695 million more than what is needed to maintain current service levels. However, after removing one-time revenues from the calculations, the precarious nature of the state's financial position becomes evident. If non-recurring revenues are left out of the calculations, the surplus falls to a mere $63 million.

FY 2006-07 Budget Surplus Estimate (in millions)	
Availability adjustments	
Budgeted carryforward funds	$517
Current year revenue surplus (final amount TBD)	$214
Adjust baseline revenue forecast for 2006-07	$214
Replace General Fund More-at-Four and class-size reduction funding with lottery tax revenues	$210
Agency reversions	$115
Subtotal:	$1,270
Additional spending to maintain current services	
Repairs/ Renovations & Rainy Day Fund contributions	$225
2% employee and teacher pay raise	$130
ABC school bonuses	$120
Higher education enrollment growth	$100
Subtotal:	$575
Balance/ Surplus:	**$695**
Balance excluding one-time revenues:	**$63**

P.O. Box 28068
Raleigh, NC
27611-8068
Editor: Elaine Mejia
919/856-2176
elaine@ncjustice.org
www.ncjustice.org

REVENUE OUTLOOK IMPROVING

Revenues through January are $214 million ahead of projections, growing at an annual rate of 7.6% compared with the 5.6% budgeted. It is premature to conclude that revenues will continue to come in ahead of schedule because the original forecast assumed greater revenue growth in the second half of the year and final income tax payments due in April make up a large share of state revenues. It is safe to assume, however, that the additional $214 million expected to be left over after this year can be added to the base forecast for next year.

In addition to an improving baseline forecast, the budget for the current year left $518 million in unspent funds to be carried forward into next year. Last fiscal year about $115 million of agency "reversions" (or moneys allotted to agencies and programs but unspent) was carried forward, and this likely will be the case again. Finally, assuming the NC lottery tax is in place before the fiscal year begins, approximately $210 million will be transferred from the lottery fund to the general fund to pay for current More-at-Four and class-size reduction initiatives. All of these items combined would leave state lawmakers with an additional $1.2 billion in revenues next year, nearly twice what the typical "expansion" budget requires.

DEMANDS ON NEW REVENUES: Education and Tax Cuts Compete for Attention

Unfortunately for state budget writers, this sizeable surplus evaporates if non-recurring revenues are removed and additional spending needed to maintain current services is accounted for. Currently unfunded budget items that must be covered to maintain current services will cost approximately $600 million, instantly consuming all of the recurring dollars of the surplus. These include a modest 2% pay raise for state employees and teachers, required contributions to the repairs and renovations fund, and the cost of university and community college enrollment growth. Any additional spending for new initiatives, such additional teacher pay raises or reduction of the child-care waiting list, will require dipping into the one-time revenues, possibly deepening future budget shortfalls.

In addition to new spending proposals being considered, some constituencies are pressuring lawmakers to make new, permanent tax cuts. Tax cuts proposals receiving the most attention are a reduction in the gas tax, a reduction in the tax on corporate profits, and a reduction in the top personal income tax rate.

STRIKING THE RIGHT BALANCE AND AVOIDING ELECTION-YEAR PITFALLS

State lawmakers are facing a different - although no less challenging -situation this year in comparison to recent shortfalls. Without changes in state law, two tax cuts will automatically take effect in 2007 when a temporary half-cent sales tax and the 8.25% income tax bracket expire. Furthermore, the spike in the gas tax that went into effect in January will likely subside this summer, as wholesale gas prices are lower than the previous six-month period on which the current tax rate is based. These facts, combined with the need for improvements in state services and the somewhat uncertain nature of the revenue outlook, should direct lawmakers away from additional tax cuts. Likewise, lawmakers should weigh spending demands carefully in light of the one-time nature of the current surplus.

Prepared by Elaine Mejia, Project Director. Phone: (919) 856-2176

NC Justice Center / P.O. Box 28068 / Raleigh, NC / 27611-8068 / 919/856-2570/ www.ncjustice.org