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THE HOUSE BUDGET: Deteriorating revenue picture forces tough decisions

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Executive Summary

- On June 13, the NC House of Representatives passed its version of a state budget, appropriating \$18.65 billion for fiscal year 2009-10 (FY09-10). The House budget has little in common with the governor's and Senate's proposed budgets because the anticipated budget shortfall grew substantially between the time those proposals were created and the House's deliberations.
- Facing a \$4.6 billion gap between the general fund spending needed to maintain current services and the amount of tax revenue available in FY09-10, House budget writers used a combination of spending cuts, federal recovery funds, and tax and fee increases to balance their budget.
- The House tax plan raises \$783.6 million in fiscal year 2009-10 by closing corporate tax loopholes, broadening the sales tax base slightly to include some services, increasing the sales tax rate by 0.25%, and raising income taxes on married households earning more than \$200,000 per year and singles earning more than \$120,000 per year.
- The proposed FY09-10 budget includes \$3 billion in spending reductions, the largest of which are achieved by increasing class sizes in public schools for grades 4 through 12, eliminating third grade teacher assistants, increasing university and community college tuition, reducing payments to Medicaid providers, and making more than \$500 million in unspecified cuts to the Medicaid program.
- The House FY09-10 spending plan also includes \$927 million in expansion funding, the vast majority of which is for the state employee health plan, enrollment growth in higher education and Medicaid, and the final step in the state's assumption of all county Medicaid costs. However, most of the expansion items are offset by large unspecified cuts to the continuation budget.

Overview

Members of the House of Representatives faced a daunting task when they began to craft their proposed two-year budget. In the weeks after the Senate voted on its budget, the revenue forecast for fiscal year 2009-10 (FY09-10) dropped by \$1.35 billion. The House's options for balancing the budget dropped further when Governor Beverly Perdue tapped into federal recovery assistance that legislators had planned to use to help balance the 2009-11 biennium budget. While considerable attention has been paid to the House plan to raise taxes by \$783.6 million (or 4% of the proposed budget), the fact remains that for every one dollar in additional taxes in the House budget, there are three dollars in spending reductions. Negotiations between House and Senate conferees could be particularly difficult this year because the two budgets are very different, both in their overall size and in the nature of the tax proposals. This issue of BTC Reports examines the House budget proposal in detail, with a special focus on the impact the proposed tax and spending plans would have on low- and moderate-income North Carolinians.

Deteriorating Revenue Outlook

In crafting its proposed budget, the House of Representatives faced a dramatically bleaker revenue picture than did the governor or Senate. The state's April 15 tax collections saw the largest one-year drop in revenue from year to year on record – 10.8%. This led administrative and legislative economists to revise the revenue forecast for the upcoming biennium, reducing projected tax revenues by \$1.35 billion in year one and \$1.89 billion in year two. In addition, the drop in tax revenues forced Governor Perdue to dip into additional federal recovery assistance dollars that budget writers had been counting on to balance the FY09-11 budget. The consensus revenue forecast assumes a 1.9% decline in revenues for FY09-10 and modest growth of 3.2% for FY10-11 (Figure 1).

FIGURE 1

A CHANGING REVENUE PICTURE				
FY 2009-10	Governor	Senate	House	House v. Senate
Baseline Forecast	\$18,860,934,764	\$18,861,500,000	\$17,516,400,000	\$(1,345,100,000)
+ Federal Recovery Funds	\$1,713,904,975	\$1,630,604,605	\$1,378,577,500	\$(252,027,105)
TOTAL	\$20,574,839,739	\$20,492,104,605	\$18,894,977,500	(\$1,597,127,105)
FY 2010-11	Governor	Senate	House	House v. Senate
Baseline Forecast	\$19,902,853,080	\$20,008,383,971	\$18,114,100,000	\$(1,894,283,971)
+ Federal Recovery Funds	\$1,210,938,510	\$1,224,741,739	\$1,017,886,698	\$(206,855,041)
TOTAL	\$21,113,791,590	\$21,233,125,710	\$19,131,986,698	(\$2,101,139,012)

Overall Balancing Act

The House relies on a mix of spending cuts (\$3.06 billion), tax increases (\$783.6 million), fee increases (\$81 million) and federal recovery dollars (\$1.38 billion) to balance its FY09-10 budget (Figure 2). The net spending change to the continuation budget is less than the spending cuts by \$927 million because "expansion" funding was needed to fund the state employee health plan requirements and enrollment growth in Medicaid, the community colleges and the universities, and an additional \$268 million was needed to assume the remaining portion of the counties' Medicaid costs. The Senate and governor's budgets both failed to account for the additional money needed to assume the counties' share.

FIGURE 2

HOW DID THE HOUSE BALANCE THE FY 2009-10 BUDGET?	
Total General Fund Availability (<i>Baseline Revenue Forecast</i>)	\$17,516,400,000
Adjusted Continuation Budget	\$22,075,170,781
Projected Shortfall b/t Available Revenues and Amt Need to Continue Services	\$(4,558,770,781)
+ House Tax Plan	\$783,600,000
+ New Fees	\$81,172,651
+ Other Adjustments to Availability	\$273,870,117
+ Federal Recovery Funds (Treated as Receipts/Cuts offset by ARRA funds)	\$1,378,577,500
<i>FMAP Assistance</i>	\$856,972,804
<i>Fiscal Stabilization- Education</i>	\$467,570,877
<i>Reduction to Non Instructional Support- replaced with receipts from ARRA</i>	\$356,970,583
<i>Reduction to Materials and Supplies- replaced with receipts from ARRA</i>	\$46,448,981
<i>Reduction to allowable items in University budget</i>	\$64,151,313
<i>Fiscal Stabilization-General- Allocated throughout budget</i>	\$40,820,020
<i>Use of AARA Funds to Reduce GF Allocation (Misc)</i>	\$13,213,799
+ Spending Cuts	\$3,058,687,296
- New Spending (Enrollment Growth, State Health Plan, etc)	\$(927,464,714)
Total Available to Address Shortfall	\$4,648,442,850
Unappropriated Balance Remaining	\$89,672,069

The Revenue Plan

The House budget includes a tax plan that would raise an additional \$783.6 million in revenue in FY09-10 and \$974.2 million in FY10-11 (**Figure 3**). An additional \$81 million and \$86 million, respectfully, would be raised from new and increased fees. Unlike the tax increases proposed and enacted in 2001, the proposed tax and fee changes would be permanent. The proposed tax increases, though significant, would fill only 17% of the budget shortfall in FY09-10 and 22% in FY10-11. Also, the \$783.6 million plan would represent only 4% of the general fund for FY09-10. The proposed fee changes are wide-ranging and include increased costs for various business licenses, marriage licenses, and various inspection and court-related fees.

The major components of the House tax plan include:

- Two new top earners income tax brackets (**Figure 4**)
- Business tax changes the most notable of which is mandatory combined reporting. In recent years, tax loopholes have allowed a growing number of large, profitable, multi-national companies to avoid paying corporate income taxes in North Carolina. Combined reporting (used in more than half of the states with a corporate income tax) would close loopholes and help to level the playing field between small, in-state businesses and multi-national corporations.
- A small expansion of the sales tax base to include digital downloads; warranty, installation, and repair services; and a conversion of the privilege tax on entertainment to the sales tax. The House plan also increases the sales tax by .25 making the combined state and local sales tax 7% (for most counties).

FIGURE 3

DESCRIPTION OF HOUSE TAX PLAN - Revenue Raised (in millions of dollars)				
	Effective Date	2009-2010	2010-2011	2011-2012
INCOME TAX CHANGES				
Two New Top Income Brackets	1/1/2009	\$256.7	\$183.1	\$196.8
BUSINESS TAX CHANGES				
Mandatory Combined Reporting	1/1/2010	\$18.5	\$43.7	\$48.3
Expand Franchise Tax to include LL Bus Entities	1/1/2010	\$59.0	\$131.1	\$134.7
Adopt Throwback Rule	1/1/2010	\$5.9	\$14.7	\$16.4
Conform Bank Expense Deduction	1/1/2010	\$4.5	\$8.8	\$11.0
SALES TAX CHANGES				
Increase State Sales Tax by .25	8/1/2009	\$195.0	\$200.0	\$206.0
Tax Click Thru Provision and Add digital goods to base	10/1/2009	\$13.2	\$17.8	\$18.8
Add warranties, installations and repairs to base	10/1/2009	\$176.2	\$244.0	\$257.0
Add local and interstate courier services to base	10/1/2009	\$23.0	\$91.1	\$96.0
Convert privilege tax on amusements/movies to sales tax	10/1/2009	\$23.6	\$31.6	\$33.2
EXCISE TAX CHANGES				
Increase Liquor Tax	8/1/2009	\$8.0	\$8.3	\$8.6
TOTAL		783.6	974.2	1026.8

The House tax plan will result in a small net tax increase on all North Carolina households (Figure 5).

The Spending Plan

The House general fund budget appropriates \$18.65 billion in FY09-10 and \$19.3 billion in FY10-11. The proposed appropriation for FY09-10 is \$2.7 billion less than the originally adopted budget for FY08-09. If the House spending plan were enacted, state general fund spending per person would be approximately \$1,993 and would represent a smaller share of the state's total personal income than at any time in the past 20 years. After accounting for the expansion items, the plan proposes a net spending reduction to the continuation budget of \$2.13 billion in FY09-10.

For several weeks House budget writers attempted to craft a budget with no additional revenue enhancements. This would have meant reducing state spending by an unprecedented 15%, laying off thousands of teachers and other workers, and dramatically cutting Medicaid and mental health services for older adults, disabled and special needs children and adults, and low-income children. Although the House budget now includes some revenue increases, it would still make significant spending cuts to all areas of state government. The following sections highlight some of the proposed reductions.

Public Education

The House budget reduces the general fund appropriations to public schools by more than \$1 billion in FY09-10 and by more than \$1.2 billion in FY10-11. It includes the following cuts and policy changes:

FIGURE 4

TWO NEW TOP INCOME BRACKETS					
Tax Rate	MFJ	HOH	Single	MFS	
6%	Up to \$21,250	UP to 17K	UP to 12,750	Up to 10,625	Current Structure
7%	21,250-100K	17K -80K	12750-60K	10625-50K	
7.75%	100K-200K	80K-160K	60K- 120K	50K-100K	
8.25%	200K - 500K	160K-400K	120K-300K	100K-250K	2 New Brackets
8.50%	Over 500K	Over 400K	Over 300K	Over 250K	

MFJ = Married Filing Jointly; HOH= Head of Household; MFS= Married Filing Separately

FIGURE 5

IMPACT OF HOUSE TAX CHANGES							
North Carolina Residents, 2008							
2008 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$16,000	\$16,000 - \$28,000	\$28,000 - \$47,000	\$47,000 - \$77,000	\$77,000 - \$159,000	\$159,000 - \$372,000	\$372,000 - Or More
Average Income in Group	\$10,000	\$22,000	\$37,000	\$60,000	\$105,000	\$227,000	\$1,011,000
Personal Income Tax Changes – as % of Income	-	-	-	-	+0.00%	+0.04%	+0.37%
Sales Tax Changes (Base and Rate)- as % of Income	+0.49%	+0.32%	+0.26%	+0.21%	+0.14%	+0.08%	+0.05%
Excise Tax Changes – as % of Income	+0.01%	+0.01%	+0.00%	+0.00%	+0.00%	+0.00%	+0.00%
TOTAL TAX CHANGE (compared to 2008 Law)	+0.49%	+0.32%	+0.26%	+0.21%	+0.14%	+0.12%	+0.42%
House Plan – Avg. \$ Change	\$49	\$71	\$97	\$126	\$152	\$271	\$4,244

Source: Institute on Taxation and Economic Policy, May and June 2009. Does not include proposed business tax changes.

- **Increase class sizes in grades 4 through 12:** The plan saves \$183.7 million in FY09-10 by increasing class sizes in grades 4-12 by two students on average and \$264.6 million in FY 2010-11 by increasing class sizes by three students on average. This change would result in a loss of 3,500 teaching positions statewide.
- **Reduce funding for textbooks:** The proposal would reduce funding for textbooks by \$47.9 million in FY09-10 and by \$90.4 million in FY10-11.
- **Eliminate funding for third-grade teaching assistants:** This cut of \$130 million eliminates 4,500 teaching assistant positions statewide. Some teaching assistants in K-2 classrooms may be reassigned to third grade classrooms by school districts.
- **Reduce transportation funding:** The House budget would reduce funding for transportation costs, both personnel and vehicles, by \$29 million, or 7.5% in each year of the biennium.
- **Suspend transfer to Public School Building Capital Fund:** The House spending plan saves \$60.5 million each year by suspending the transfer of corporate income tax revenues from the general fund to the Public School Building Capital Fund.

Health and Human Services

- **Maintains funding for dropout prevention grants:** The House budget includes \$13 million each year in recurring dollars for this program that allows local organizations (schools, churches, nonprofits, etc.) to apply for funding to implement innovative programs aimed at preventing children from dropping out of public schools.

The House budget reduces the general fund appropriations to the area of Health and Human Services by \$1.6 billion in FY09-10 and \$1.5 billion in FY10-11. The following highlights help to illustrate the changes to the HHS budget:

- **Reduce funding for Medicaid:** The final House budget did not include many of the most egregious reductions that were under consideration before the House added a revenue package to its budget. Nonetheless, the plan still makes significant reductions in this area, including \$82 million in reductions for provider rate payments and \$507 million in unspecified reductions to the continuation budget.
- **Reduce funding for early childhood programs:** Funding for Smart Start would be reduced by \$5 million, and funding for More at Four would be reduced by \$10 million. The House budget also implements a study of a potential merger of these two initiatives.
- **Reduce funding for mental health services:** The House budget makes substantial cuts to mental health funding. The plan would require local management entities to dip into their reserves to pay for operating expenses (\$50 million) and would make \$75 million in unspecified reductions to the continuation budget. It also reduces funding for Community Support Services in Medicaid by \$59 million in year one and eliminates this funding entirely in year two, saving \$116 million. Finally, it freezes slots for the Community Alternatives Program for disabled adults and people with mental retardation and developmental disabilities, saving \$14.6 million.

Community Colleges

The House budget proposes a net reduction of \$91 million for the community college system and its 58 institutions. The following proposed changes are noteworthy:

- **Increase community college tuition:** The House budget proposes an increase in community college tuition of \$8 per credit hour, from \$42 to \$50. This additional funding is offset by a \$30.8 million reduction in general fund appropriations. In a related measure the House budget also proposes an increase in university tuition of 8% at all UNC institutions.
- **Enrollment growth funding:** The spending plan includes \$58 million for enrollment growth. Enrollment of full-time students exceeded projections by more than 15,000 in 2008-09.
- **Reductions to continuation budget and management flexibility reductions:** While the budget does provide for enrollment growth funding, the unspecified reductions to the continuation budget (\$67 million) and a proposed management flexibility reduction (\$16.8 million) more than offset that funding. It is not yet clear what impacts these cuts will have on the services provided by the community college system.

Justice and Public Safety

The House budget recommends a net spending reduction of \$255.7 million to the continuation budget for all of the agencies that fall under the Justice and Public Safety category. In particular, the plan recommends closing eight rural prisons and moving those prisoners to more modern facilities, although that will mean more crowded institutions. The following changes to community corrections and juvenile programs are noteworthy:

- **Sentencing Services:** This budget proposes a \$657,407 reduction to this program, which provides detailed sentencing information to judges and recommends specific community-based options that are appropriate for individual offenders.
- **Boys and Girls Club:** The budget proposes eliminating state funding for programs offered by this organization, saving the state \$400,000.
- **Support our Students:** The House budget would eliminate funding for this program, which provides positive after-school alternatives with adult supervision designed to reduce delinquency, adolescent pregnancy, and early experimentation with drugs and alcohol. This move would save \$5,911,294 in state dollars.
- **Funding for Juvenile Crime Prevention Councils and Criminal Justice Partnership Program** will remain at current levels.

How does the House treat Federal Recovery Dollars

The House FY09-10 budget contains an additional \$1.38 billion in nonrecurring general fund spending reductions that are offset by anticipated federal recovery funds. Three funding streams from the federal recovery act are specifically dedicated to helping states close their budget gaps: a temporary increase in the Medicaid FMAP (federal Medicaid assistance percentage), a state fiscal stabilization fund to maintain education spending at FY05-06 levels, and a second state fiscal stabilization fund for general use.

The education stabilization funds are shown as a reduction of \$400 million in public education appropriations for non-instructional support and classroom materials and as a reduction of \$64 million to the UNC system budget. Increased federal Medicaid assistance reduces the general fund appropriations for HHS by \$857 million. The \$40 million in general state fiscal stabilization funds available through the federal recovery act are used to offset a reduction in general fund appropriations to the Justice and Public Safety budget. This is the most responsible way to account for these funds considering that they are one-time funds and after FY 2010-11 will not be available to help balance the general fund budget.

Additional federal recovery dollars are available to North Carolina but do not flow through the general fund. Examples include money for transportation, home weatherization, unemployment benefits, local governments and school districts.

Conclusion

The state House of Representatives budget process ought to serve as a reality check for North Carolina. The current recession is a deep one and the state's outdated revenue system is ill-equipped to ensure the necessary resources to preserve state investments. During times of deep fiscal crises North Carolina's citizens and leaders face difficult choices. The NC House, facing a large budget gap, chose to raise state

taxes by a modest amount to avoid harming individuals who need public services and to avoid setting back the quality of state services by decades. Negotiations between the House and Senate conferees will involve the usual deliberations on the specific spending proposals, but they will also include a more rigorous than usual debate on the best way to raise the funds necessary to balance the budget.

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