GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2007

Legislative Fiscal Note

BILL NUMBER: House Bill 1016 (Fifth Edition)

SHORT TITLE: State Medicaid Swap.

SPONSOR(S):

FISCAL IMPACT ($ Million)

	Yes (X)	No ( )		No Estimate Available ( )	
	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11	FY 2011-12
BUDGETARY IMPACTS:					
State					
State Takeover of State County Medicaid Spending	-86.2	-271.2	-593.2	-671.0	-744.5
State Takeover of 1/2 Cent Local Sales Tax	0.0	184.2	460.9	563.4	592.6
Corporate Tax ADM Adjustments	44.7	0.0	0.0	0.0	0.0
State Holds Counties Harmless			-12.8	-24.3	-19.0
Annuties Tax			52.4	55.5	58.9
Earned Income Tax Credit		-35.6	-36.0	-36.4	-36.9
Subtotal for State	**-41.5**	**-122.6**	**-114.3**	**-112.8**	**-148.9**
Counties					
State Takeover Of County Medicaid	86.2	271.2	593.2	671.0	744.5
State Takeover of 1/2 Cent Local Sales Tax	0.0	-130.0	-325.4	-397.8	-418.4
Corporate Tax ADM Adjustments	-44.7	0.0	0.0	0.0	0.0
State Holds Counties Harmless			12.8	24.3	19.0
Counties Holds Cities Harmless	0.0	-54.2	-135.5	-165.6	-174.2
Subtotal for Counties	**41.5**	**87.0**	**145.1**	**131.9**	**170.9**
Cities					
State Takeover of 1/2 Cent Local Sales Tax	0.0	-54.2	-135.5	-165.6	-174.2
Counties Holds Cities Harmless	0.0	54.2	135.5	165.6	174.2
Subtotal for Cities	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

POSITIONS (cumulative):

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: The state and local sales tax is administered by the Department of Revenue. The Medicaid program is administered by the Division of Medical Assistance of the Department of Health and Human Services.

EFFECTIVE DATE: See Bill Summary

BILL SUMMARY:

Medicaid Takeover. The State would take over county funding of Medicaid on a phased-in basis according to the following schedule:

25%	10/01/07
50%	7/01/08
100%	7/01/09

Sales Tax Takeover. The State would take over ½ % of the local option sales tax according to the following schedule:

October 1, 2008	¼ %
October 1, 2009	¼%

The takeover would be accomplished through a repeal of a portion of the local sales tax and a new state levy beginning on the same day.

County Hold-Harmless. Provides that the State would hold a county government unit harmless if its repealed sales tax amount for a fiscal year exceeds the amount of its Medicaid service costs assumed by the State for that fiscal year. This provision would be in place for 2007-08 through 2016-17 (10 years).

City Hold-Harmless. Provides that the sales tax allocations to county government units would be adjusted by the Department of Revenue to hold the municipalities in the county harmless from repeal of the local sales tax.

ADM Funding Formula. Under the corporate income tax, 7.25% of net collections are allocated to counties based on average daily membership (ADM). These funds are to be used for school facilities. For the 2007-2008, the bill reduces the ADM allocation to a county according to the following schedule:

(1) Reduction equal to 60% of the expected Medicaid savings if the expected Medicaid savings for 2007-08 is less than the statutory ADM allocation; or

(2) Reduction equal to 60% of the statutory ADM amount if the expected Medicaid savings are more than the statutory ADM distribution.

Medicaid Savings Earmarking. Provides that a county must use a portion of the funds freed-up by the State assumption of part of the county's Medicaid payments for public school capital outlay purposes. The required expenditure is based on the difference between the statutory ADM earmarking and the adjusted amount it actually received following the ADM funding formula change (see above paragraph).

OTHER PROVISIONS

Earned Income Tax Credit. The Internal Revenue Code provides a refundable income tax credit for individuals who work and whose adjusted gross income does not exceed a specified amount. The amount of the federal Earned Income Tax Credit (EITC) varies, depending on whether the taxpayer has children and the amount of earned income.

The bill provides for a State earned income credit to certain taxpayers who qualify for the federal EITC. The credit would be equal to 5% of the federal amount and would be available to taxpayers whose filing status is either Married Filing Jointly or Head of Household. In addition, the applicant must have at least one qualifying child. The credit would become effective for taxable years beginning on or after January 1, 2008, and ending December 31, 2013.

Annuity Taxation. A State tax of 1.9% of gross premiums is levied on insurance carriers. The bill would extend the tax to annuities, effective beginning with the 2009 tax year. The tax would apply to the front-end amount paid for an annuity. Qualified plans (IRA's, 401-K's, etc.) would be exempt from the tax.

ASSUMPTIONS AND METHODOLOGY: **Medicaid Takeover.** Data for the federal, state, and county share of Medicaid was developed during the process of putting together the General Fund budget for the 2007-09 biennium. This Fiscal Research Division analysis indicated that the county share of Medicaid will be $517.0 million for 2007-08 and $566.0 million for 2008-09. For future years this amount is projected to grow 8-11% per year.

The legislation directs the State to pick up funding responsibility for a specified percentage of the nonfederal share of the Medical Assistance Program that is now borne by counties. The fact that the takeover is written as a specified percentage of county costs for a certain time period, and not by type of Medicaid program, made it easy to do a simple mathematical calculation of the impact of each step of the phase-in. The remaining calculation allocated the cost of each phase-in step to each fiscal year. This calculation **assumed** a one-month lag between the starting date of a new step and the actual fiscal impact.

The combination of the effective dates in the bill and the one-month lag means that for the 2007-08 fiscal year, there would be a 25% takeover that would become effective October 1, 2007 but would affect state and county spending for eight months (November-June). The July 1, 2008 takeover of 50% would mean that from a cash flow perspective there would be a 25% reduction for one month and 50% for the remaining eleven months. For the final step effective July 1, 2009 the fiscal impact would be equal to a 50% for one month and 100% for the remainder of the year.

Sales Tax Takeover. Data on the impact of shifting a portion of the local sales tax to the State was developed as part of the General Fund revenue estimate for the budget process. This analysis included a review of the 2005-06 local sales tax by local tax authorization because the total tax is comprised of a 1% tax adopted in 1971 and as three separate ½ cent taxes (1983, 1986, 2001).

The 2005-06 amount for each Article was grown by the projected State sales tax growth for 2006-07 and future years, adjusted for State tax law changes. The growth estimates are the same as those used in the budget process.

The next step was to determine the impact on each fiscal year of the shift taking place on October 1. This was accomplished by a review of the new sales tax remittance system going into effect October 1, 2007 and an analysis of the cash-flow impact of the 2003 Department of Revenue rules having to do with the reconciliation of the state and local portion of the jointly-collected sales tax. These rules were adopted at the time that the quarterly distribution of the tax to local units was shifted to monthly. The net effect of the change and the agency rules is that a July 1 effective date for a tax law change would lead to a fiscal year impact of 97.1% of the annualized amount. For an effective date later than July 1, we first determine the impact per month (annualized dollars divided by 12 months) and then multiply the monthly impact by the number of months past July 1. This total would then be subtracted from the July 1 effective date impact to determine the fiscal year impact for an effective date other than July 1.

County Hold-Harmless. The amount needed to hold harmless certain counties was determined by a county-by-county analysis of the impact of the provisions of the bill. The starting point for this exercise was the actual county Medicaid expenditures for 2005-06 and the actual sales tax distribution for that year. For this data county share ratios were determined by dividing the amount for a specific county by the statewide total for all counties. The share ratio for Medicaid expenditures was then applied to the projected statewide county share of Medicaid expenditures. The projections are the same as those used in the "Medicaid Takeover" methodology described above. In the same fashion, the sales tax share ratios for 2005-06 were used to allocate the statewide forecast of local sales tax revenue (See "Sales Tax Takeover" methodology discussion).

City Hold-Harmless. The amount needed to hold harmless certain cities was determined by a county-by-county analysis of the impact of the provisions of the bill. In order to make the analysis manageable, all of the cities within the county were grouped together. Then, share ratios of local sales tax collections for each county grouping of cities was established based on actual 2005-06 experience. These ratios were then used to allocate the projected future statewide amount of local sales tax receipts. The statewide amount was tied to the growth rates used in the State budget process to forecast State sales tax revenues.

ADM Funding Formula. The forecast of the statewide amount of corporate income tax earmarking for school facilities was part of the General Fund revenue forecast used for state budget purposes. This amount for each year was then allocated to counties based on each county's share, relative to the statewide total, for the 2005-06 fiscal year.

Earned Income Tax Credit. The federal EITC and the state EITC relationship is straight forward since the state credit is simply a percentage of the federal. The question of which taxpayers the credit affects, and whether it is refundable, depends on the amount of earned income, filing status, and number of children. Based on 2005 IRS data, most returns claiming the EITC received a refund, and 40% had adjusted gross income below $10,000. In 2007, to qualify for the EITC a taxpayer must report earned income, and the federally adjusted gross income must be less than:

$37,783 ($39,783 married filing jointly) with two or more qualifying children
$32,241 ($35,241 married filing jointly) with one qualifying child
$12,590 ($14,590 married filing jointly) with no children

Using data provided by the Internal Revenue Service and the Congressional Budget Office, projections of North Carolina taxpayer participation in the federal program were developed. In 2005, the most recent year of available data, North Carolina taxpayers received 3.52% of the total federal EITC credits.

Based on this relationship and estimated future federal EITC claims, an estimate of the amount of credits received by North Carolinians was calculated. An estimated 940,000 North Carolina taxpayer returns will claim a federal EITC in the 2008 tax year. Five percent of federal claims would equal nearly $70 million. Data from the Bearing Point income tax microsimulation model (contracted by Fiscal Research) indicate that nearly 52% of federally eligible EITC claimants will qualify for the refundable 5% state tax credit as provided in the bill. Since taxpayer participation rates in state programs, as compiled by the Center for Budget and Policy Priorities, have ranged between 81% and 93%, the estimated fiscal impact assumes the state participation rate will be 90%.

Based on this analysis it is estimate that the credit would reduce General Fund revenues by $35.6 million for the 2008-09 fiscal year. Future fiscal year estimates are based on the nationwide growth projections of the EITC made by the congressional Joint Committee on Taxation.

Annuity Taxation. The 2005 Biennial Tax Expenditure report of the Department of Revenue indicates that the tax exclusion for premiums received from annuities has an impact of $95.0 million. The data source cited is “Life and Annuity Business financial summary for 2003”. This is a tabulation of the Department of Insurance from insurance company annual reports.

We went to this source and found the same data for the 2006 calendar year. The financial item of interest is called “direct annuity considerations”. Discussions with the Department of Insurance indicated that this item represents payments made to purchase an annuity. The 2006 amount was $5.70 billion. Applying the 1.9% tax rate to this amount would yield $108.3 million of annual liability for 2006. We then grew this number to 2009 by using a conservative estimate of the overall growth of the State’s economy for this period. This bumped the yield up to $123.5 million, or 14% higher than 2006.

The last step was to account for the fact that qualified plans (401-k’s for example) would not be taxed under the proposal. The best estimate we have is that this would reduce the tax base by 60%. The tax on the remaining 40% would yield $49.4 million for 2009. Applying 6% growth would bring this amount to $52.4 million for 2009-10.

SOURCES OF DATA:

TECHNICAL CONSIDERATIONS: None

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