The Long Term Gap in North Carolina's Revenues and Expenditures

Prepared by Institute for Emerging Issues

Introduction

The fiscal discipline imposed by the recent recession, combined with a series of tax increases has put North Carolina in a position where the current short-term economic outlook is good. In fact, North Carolina is enjoying a $2.4 billion surplus of revenues over expenditures. Unfortunately, the revenue increase is largely based on volatile revenue sources, and the revenue availability is primarily nonrecurring in nature.

Over the long term, the revenue outlook appears much more bleak. The reasons for this are simple: state revenues will decline in the future when the economy experiences a downturn; and North Carolina may overcompensate for prior tax increases by cutting taxes to levels below those needed to maintain services; and future expenditures for basic services will be unable to keep up with the revenue base upon which they depend.

North Carolina has spending obligations that are growing more rapidly than the economy. Education and medical services for the poor and disabled are two of the most critical. Compounding the issue, the fraction of residents who complete secondary and higher education is growing, as is the fraction of residents who are eligible for Medicaid. At the same time, North Carolina depends on revenue sources that grow more slowly than the economy. In particular, the state leans heavily on a retail sales tax, whose base continues to shrink.

The following sections outline the largest expenditure needs, followed by the largest revenue sources upon which the state depends. This overview reveals that revenue sources in the future will be unable to keep up with both growth in the economy and basic expenditures. This problem is what is termed a "structural deficit." Most states face this problem. Some are in much more difficult circumstances than North Carolina. Nearly all must modernize elements of their revenue systems if structural deficits are to be rectified.

North Carolina's Largest Critical Expenditures

Part of North Carolina's structural deficit is due to the fact that revenues are unable to finance continual expenditure growth year after year. Continual spending here refers to the existing services and programs rather than the addition of new ones.

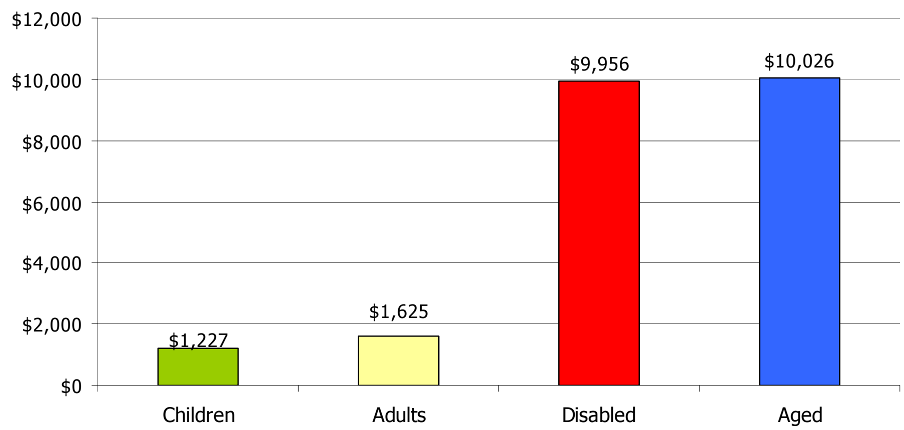
North Carolina's spending on Medicaid and education accounts for 77 percent of the state's current expenditures. The costs of these important services have increased dramatically in recent years and will continue to do so in the coming years. There are many ways to limit these increasing costs, but it would be optimistic to imagine that any proposed solutions on the spending side could do more than keep costs in line with growth in the overall economy. Furthermore, Medicaid reform will require Federal action.

Medicaid Spending

Nationally, Medicaid covers over 45 million clients, including low-income women and their children, the disabled and the elderly. Medicaid covers about one-third of all births in the country and provides health insurance for one in every five children. It accounts for almost one-half of total spending on long-term care and significant portions of state spending on programs for the mentally ill and developmentally disabled.

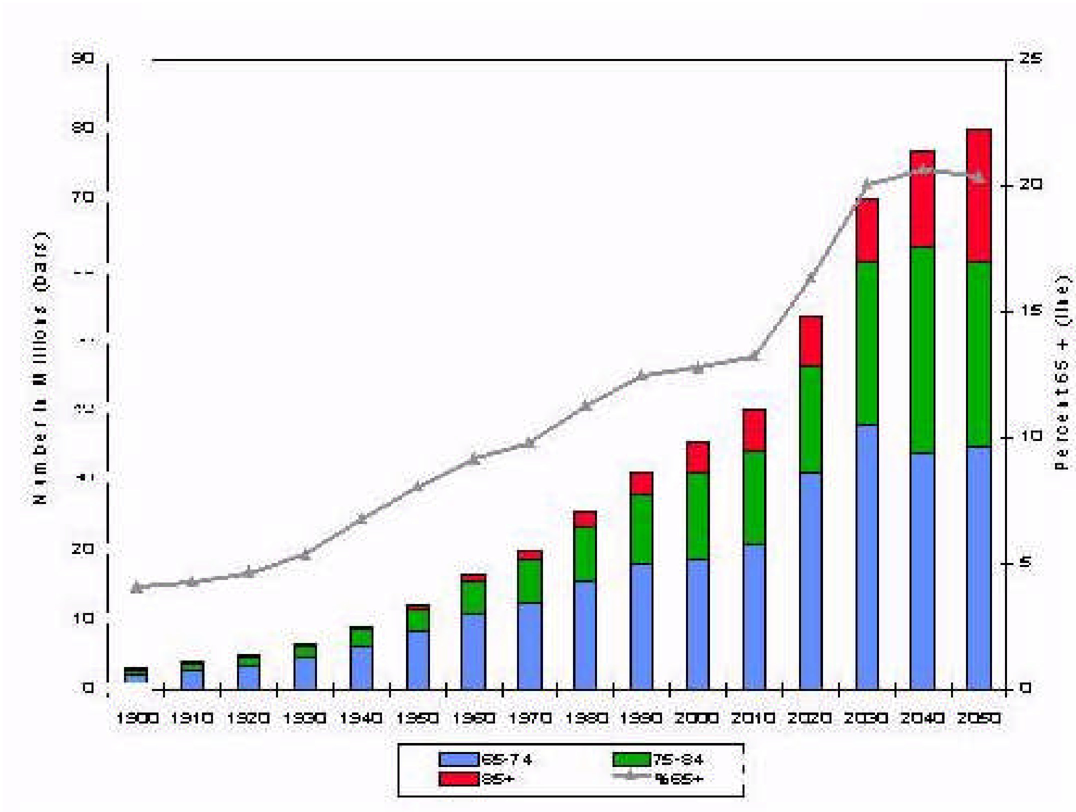
Medicaid is a major item in North Carolina's state budget, where it accounts for 17 percent of state spending. By 2030, Medicaid is likely to grow to 53 percent of overall state spending based on moderate national growth assumptions by the Congressional Budget Office (CBO) applied to current state spending.

National Annual Medicaid Spending Per Recipient By Group



Increased state Medicaid costs reflect a national trend. Over the last fifteen years, nationwide Medicaid spending has increased from approximately $1.5 billion in 1990 to $7.5 billion in 2005. The Congressional Budget Office (CBO) estimates that Medicaid costs may rise 9 percent per year over the next ten years. Currently, 80 percent of Medicaid expenditures are for the elderly and disabled. As the baby boom generation ages and needs increasing levels of medical care, costs are likely to rise exponentially.

Population of 65+ Citizens Nationwide



North Carolina is greatly affected by these trends. The state is aging considerably, due in part to the influx of older Americans moving to North Carolina for retirement. Among all age groups in the state, the greatest population increase is projected to occur among individuals 65 years and older. As a result, the state will be increasingly invested in the healthcare needs of the elderly. Not only is the state growing older, but also it is becoming more diverse. Among all racial groups, the Hispanic population is growing the fastest. Data suggests that this population group uses Medicaid.

<u>Education</u>

Education spending in North Carolina accounts for roughly 60 percent of overall state spending. Increased education spending in the years to come depends on several factors including population growth, rising per pupil costs and a landmark court case known as *Leandro.*

North Carolina is set to grow at an astounding rate. By 2030, the state's population is projected to increase by over 50 percent from the 2000 Census figures, lifting the state to a rank of 7th in total population. Overall, this growth will be driven by an influx of people from outside of the state. Based on U.S. Census data, from 2000 to 2004, North Carolina netted an increase of 39,137 people per year, the fifth highest in the United States over that same period. Wake County had the 25th highest rate of net immigration for all counties among the United States and Currituck County ranked 18th among the nation's counties in its rate of annual growth from domestic immigration. As a result of this growth, North Carolina will be forced to focus its attention in several areas, including capacity of the state's school system to handle increasing enrollment.

Beyond the influx of students from a growing population, the number of students continuing their education after high school is expected to rise. The U.S. Census Bureau estimates that over the next 15 years the percentage of high school graduates going on to college will rise from 32 percent to 41 percent. Coupled with the passing of the echo boom generation -- the large pool of children born between 1982 and 1995 -- through college, this promises to dramatically increase college enrollment in the coming years.

In addition to the numbers enrolled in school, per pupil costs have been rising steadily over the past two decades, and this trend is projected to continue.

Finally, increased education costs in the years to come will be based in part on a landmark court case entitled *Leandro*.[1] Low-income school districts sued the state charging that children in their districts had been denied an adequate education because the state's system of funding education failed to provide adequate resources for low-income school districts.

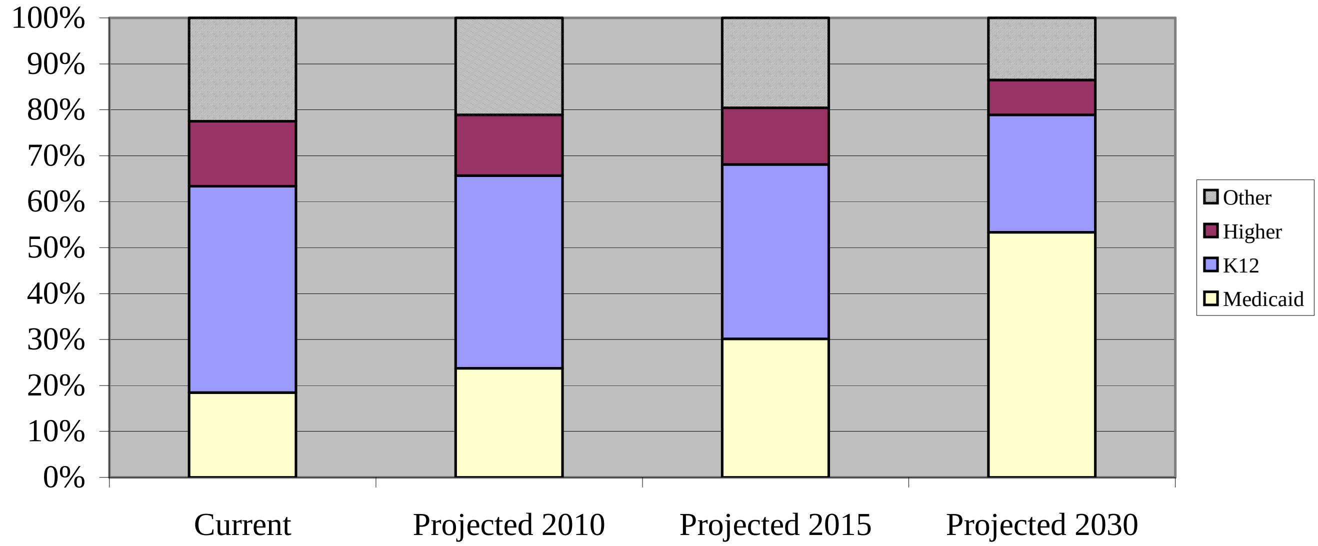
The North Carolina Supreme Court ruled that the ultimate responsibility of educating the population of North Carolina falls on the state and not on localities. As a result, the courts have mandated that the state must supplement local districts that cannot afford to provide students with a basic education. While the exact liability the state faces is still in question, increases in costs for primary and secondary education will be born, at least in part, by the state in the years to come.

The graph on the next page illustrates the role that education and Medicaid will continue to play in the years to come. Even though education will comprise a significant portion of all state expenditures, Medicaid will continue to grow the fastest.

Problems will exist in other spending categories. North Carolina's population is expected to grow rapidly in the next 25 years, leading to a dramatic increase in spending on infrastructure. Yet neither Federal nor state sources of revenue dedicated to road construction are able to meet even today's needs.

[1] *Leandro v. State*, 488 S.E. 2d 249 (1997).

North Carolina State Government Spending in Major Expenditure Categories



North Carolina's Largest Revenue Sources

North Carolina depends most heavily on two revenue sources – the retail sales tax and the personal income tax. At present, these two revenue sources comprise 84 percent of the total state revenue. However, certain characteristics of these two revenue sources contribute to the structural deficit referenced earlier.

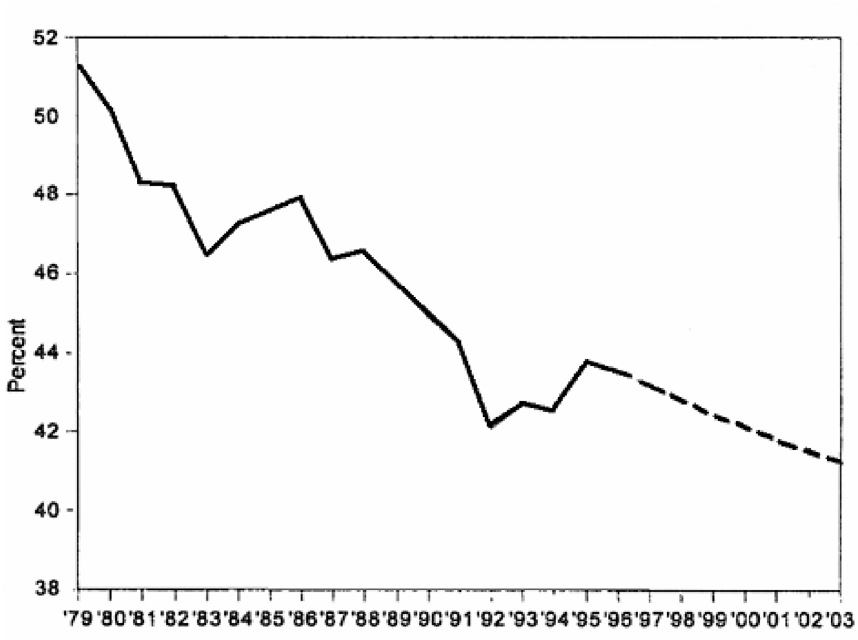
<u>Retail Sales Tax</u>

The retail sales tax is levied on all tangible goods and a few basic services. In other words, the tax only applies to a part of all the sales in the economy. This retail base -- as a proportion of the whole -- has and will continue to decline over time, contributing to structural problems for the state's revenue system. This decline is due to three factors:

- Increased movement toward a service economy
- Increased interstate sales
- Decreased personal spending as a percentage of income among wealthy residents

First, the North Carolina economy is shifting from goods to services, yet services remain largely untaxed. As a result, an increasingly large percentage of the economy is not taxed. Second, the growth of the Internet has led to a proliferation of on-line sales. On-line sales are not subject to sales taxes. Finally, the state's wealthiest residents are spending less on goods as a percentage of personal income. The graph below on the next page shows this trend over time.

Sales Tax Base as a Percentage of Personal Incomes



The combination of all these factors will lead the retail sales tax revenue to decline from approximately 30 percent of all state revenue collected to a significantly smaller percentage over time.

<u>Personal Income Tax</u>

The personal income tax in North Carolina is the largest source for state revenue, accounting for roughly half of all state revenue. North Carolina has a progressive income tax structure with the bottom rate set at 6 percent and the top rate set at 8.25 percent for income in excess of $120,000 per year. During the 2006 General Assembly Short Session, the Legislature reduced the top personal income tax rate from 8.25% to 8% to take effect on January 1, 2007, somewhat reversing a temporary tax increase that was put into effect in 2001.

Bracket creep, a term used to describe how inflation pushes individuals into higher tax brackets, has largely made up for the decline in sales tax revenue. In the short run, bracket creep helps increase state revenues, but this development is unsustainable in the long run unless there are constant increases in the top rate of the income tax. North Carolina's state income tax structure will eventually become flatter and flatter as many taxpayers become crowded into the top rates. If the state moves to reduce the top rate, this will further reduce the growth of income tax collections relative to economic growth.

This income tax flattening creates the following concerns:

- Decreased progressivity
- Reduction in revenue growth

Under a progressive income tax schedule, wealthier residents pay a larger percentage of their income in tax compared to others. Under a flatter income tax structure, individual taxpayers pay a similar percentage of their income in tax.

Under a progressive income tax, revenues grow quickly but tend to be volatile based on the state of the economy. Without a progressive income tax, overall revenue growth becomes steadier but grows at a slower rate than the economy.

In combination, North Carolina depends heavily on two sources of revenues with fundamental problems. The sales tax does not grow as the economy grows. The income tax as currently structured is volatile, and cannot grow as quickly in the future as it has in the past.

The Gap

In conclusion, the current budget surplus is likely to be eroded in just a year or two by increasing expenditures and volatile revenue sources. In the long run the state budget faces a structural deficit that demands attention. No single solution exists that will solve this problem.