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Increasing local sales taxes to pay for Medicaid: A solution worse than the problem?

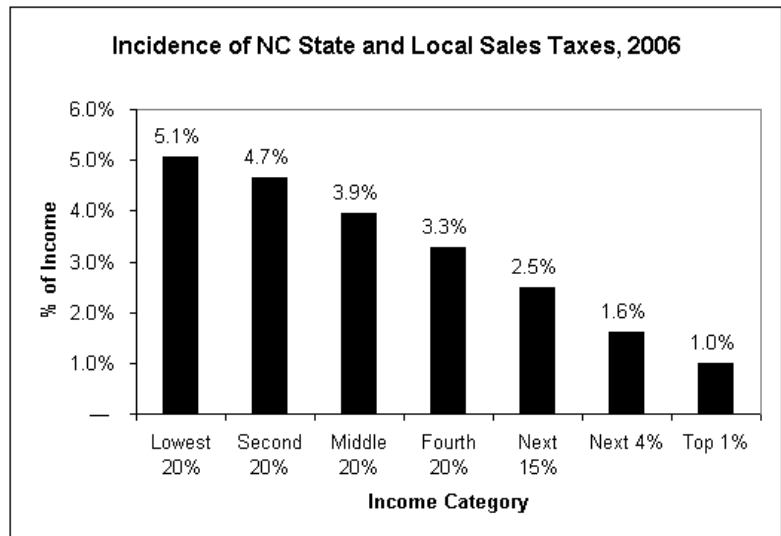
North Carolina is one of only two states in the nation that require local governments to finance a portion of the state's Medicaid program. The growing cost of the Medicaid program has put severe financial strains on local governments, particularly poorer ones with relatively large Medicaid populations. Consequently, momentum has been building for the state to assume the full cost of the Medicaid program. How best to do this is the subject of intense debate. The best reform would be one that grows out of a broader tax reform package that improves efficiency and fairness - not a simple swap of revenues and costs.

Medicaid is a health insurance program for low-income individuals financed jointly by states and the federal government. The federal government pays for two-thirds of the cost with the state paying the remaining one-third. North Carolina is unique in that it has elected to pass 15 percent of the state's share onto counties. In 2006-07, the county share will cost approximately \$488 million.

Making local governments responsible for a portion of Medicaid costs causes two problems. First, it saddles counties with a cost over which they have no control and that typically grows much faster than local revenues. Second,

because the county share is linked to a county's number of eligible Medicaid recipients, the cost is much greater for poorer counties - counties that have relatively limited financial resources to begin with. In fact, there are 20 counties where over 25 percent of the total population is insured through Medicaid.

One current proposal to provide relief to local governments calls for the state to assume local Medicaid costs in exchange for taking back 1 percent of the current 2.5 percent local sales tax. This would represent a net gain to the state of \$403 million in 2006-07. The impact on individual counties is mixed, however. Only 18 counties - those with Medicaid costs that outweigh the revenue generated by one percent of the sales tax - would see a net gain in the



short run. Those counties, primarily eastern ones, are Bertie, Bladen, Caswell, Columbus, Duplin, Edgecombe, Graham, Halifax, Jones, Lenoir, Madison, Martin, Montgomery, Northampton, Richmond, Robeson, Scotland, Warren.

Because most counties would not benefit from the proposed swap, the plan also calls for the state to authorize local counties to raise local sales taxes by up to another 1 percent. Unfortunately, raising the sales tax may create more problems than it solves because it would increase structural revenue shortfalls and increase taxes disproportionately on low- and moderate-income taxpayers.

First, North Carolina's retail sales tax base is steadily shrinking since the state taxes only 30 of a possible 168 services. Sales tax collections per person, after adjusting for inflation and rate changes, therefore have been declining for the last few decades. Tax analysts expect this trend to continue as an ever greater share of consumer spending goes to services rather than goods.

Second, higher sales taxes will make North Carolina's state and local tax system even more regressive. According to data provided by the Institute on Taxation and Economic Policy, taxpayers in the bottom 20 percent of the income distribution - those with an average annual income of \$9,100 - paid 10.9 percent of their income in state and local taxes in 2003. In contrast, the state's top 1 percent of income-earners, with average annual incomes of more than \$800,000, paid just 6.3 percent of their incomes in state and local taxes. Moreover, the impact of the sales tax on low-income families is five times greater than the impact on the wealthiest 1 percent.

Clearly, something should be done to relieve counties of the responsibility of paying for Medicaid. Under the current system poorer counties bear a much heavier burden of the health care costs of low-income elderly, disabled residents and children than richer counties. This burden compromises the abilities of these counties to provide high quality local public services such as school construction and law enforcement. Relieving this burden, however, should only be done in a way that improves the long-term efficiency and fairness of the state and local tax system.