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Follow the Money

North Carolina House misses a big opportunity to embrace smart public investments, prepare for federal uncertainty

By CEDRIC D. JOHNSON, POLICY ANALYST and ALEXANDRA F. SIROTA, DIRECTOR

The $22.9 billion state budget proposed by the House for the upcoming 2018 fiscal year – and the $23.8 billion budget for the following year – reflects a missed opportunity to embrace smart public investments and prepare for federal uncertainty brought on by cost shifts in Medicaid and food assistance, among other core public program and service cuts to the state from the federal level.

The House budget fails to fully address the unanticipated damage from Hurricane Matthew, which is estimated at $2.8 billion, and fails to invest at the level needed in skills training, community economic development, and services to poor families, even as communities continue to struggle with mass job loss and high poverty rates. This is in part because House budget writers continue to reduce available revenue and fail to direct revenue coming in over anticipated collections towards smart public investments. Instead, those dollars are put in savings rather than used to address unmet needs in the first year of the two-year budget.

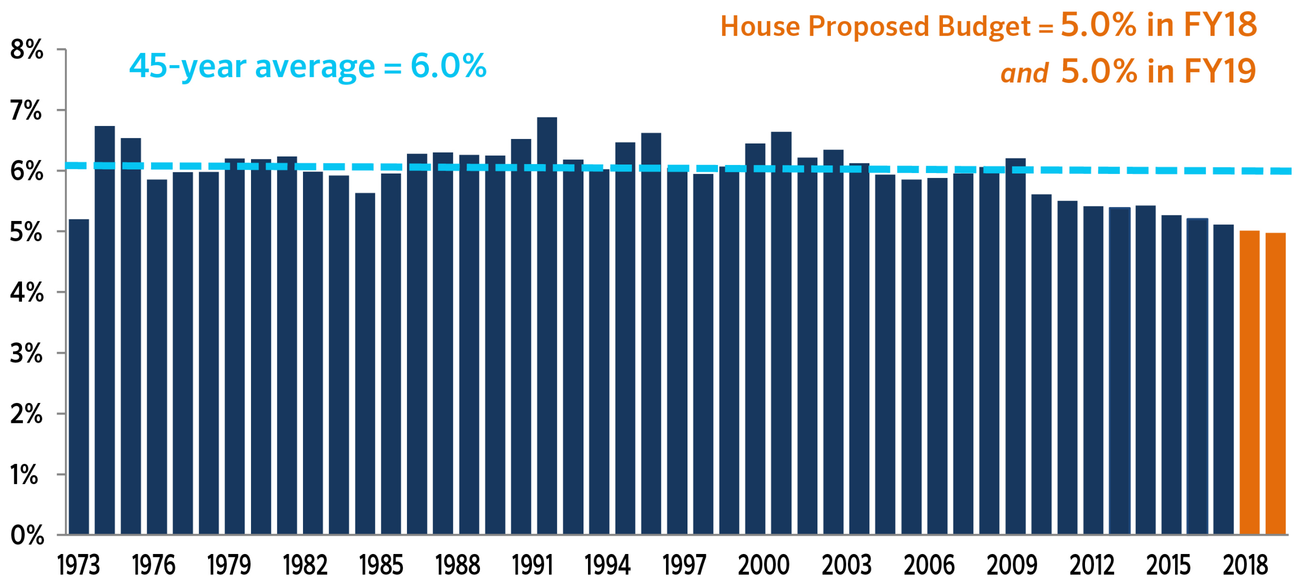
House budget would continue the decline in the state's commitment to its residents

The House budget would continue to move away from historic levels of investment relative to the state's economic health. The 45-year average of state investments as a share of the economy is 6 percent, which has allowed North Carolina to sustain the foundations of its economy and make transformative investments in early childhood and career training, for example.

Under the House's proposed biennial budget, the level of state investments would remain below that 45-year average: In both years, investments would be held at 5 percent as a share of the economy. The artificial constraints placed on the level and growth year over year of state appropriations mean that we are falling behind in good times, even as the population continues to grow and the costs of delivering education and health care in particular increase significantly faster than the cost of consumer goods and services.

The House budget is constrained by tax policy choices made since 2013 that have resulted in $2.8 billion less in annual revenue than would have been available under the old tax code.[1] These tax cuts have largely benefited the wealthy and profitable corporations.

FIGURE 1. **House budget continues to artificially constrain public investments regardless of the lost economic potential from such an approach**



The House has chosen to add to that loss by adopting tax changes that will continue to erode revenue. Tax law changes proposed by the House include an increase in the standard deduction by $1,000, resulting in a $55 tax cut for North Carolinians claiming the standard deduction and an increase in the cap on itemized deductions for mortgage interest and property taxes to $22,000 from $20,000 which primarily benefits higher income taxpayers. There are also various changes to business taxes including the reducing the franchise tax rate and the creation of a new tax break for research and development businesses with a portion of their business expenses in rural areas. These tax changes reduce available revenue by $120 million in the first year of the biennium and by $246 million in year two.

The House pays for its budget with over-collections, one-time money, and reductions to public services and institutions.

The state's tax system is expected to raise $22.3 billion in General Fund revenue — an amount that is severely constrained by previously approved tax cuts, as noted above.

In addition to base revenue, the House relies on revenue collections coming in above what officials anticipated ($580 million);money they anticipate agencies will return to the state (known as reversions, estimated at $271 million); and unappropriated dollars from the most recent fiscal year ($208 million). The House, like the Senate, is required to transfer $100.9 million of General Fund dollars to the state's Savings Reserve fund, per the special session disaster relief bill passed by state lawmakers in December 2016 to aid communities harmed by Hurricane Matthew. Lawmakers will place an additional $263 million in available revenue into the Savings Reserve fund. An additional $365 million is set aside in the state's Repair and Renovations fund.

The second year of the budget proposal is concerning because it relies on the unappropriated balance from the previous year and anticipated revenue growth that falls short of our growing needs in the state to meet basic responsibilities. There has been a significant shift in whether or how the growth in appropriation requirements from Fiscal Year 2017-18 to Fiscal Year 2018-19 in the House budget would be met given projections by Fiscal Research Division.[2] Early in the budget cycle anticipated year-over- year budget pressures totaled $1.1 billion to account for growing enrollment in K-12 and higher education as well as rising costs in the delivery of Medicaid services, provision of retirement and health plans for public employees, and the teacher pay plan.[3] The year-over-year appropriation requirement, however, is just $879 million in the House budget, which suggests that its writers do not plan to meet these budget pressures or will have to cut services provided for today in the state budget to fund those obligations.

FIGURE 2. How does the House pay for its budget?

HOW DOES THE HOUSE PAY FOR ITS BUDGET?	FY2018	FY2019
Unappropriated Balance	*$208,607,416*	*$279,227,665*
Disaster Recovery Appropriations (S.L. 2016-124)	*$(200,928,370)*	
Transfer from Savings Reserve	*$100,928,370*	
Over Collections FY 2016-17	*$580,600,000*	
Reversions FY 2016-17	*$271,000,000*	
Replenish Savings Reserve (S.L. 2016-124)	*$(100,928,370)*	
Savings Reserve	*$(263,000,000)*	
Repair and Renovations	*$(365,000,000)*	
+ Net General Fund Credit Balance	***$231,279,046***	***$279,227,665***
Revenues Based on Existing Tax Structure	*$22,303,700,000*	*$23,299,200,000*
Total Non-tax Revenues	*$849,000,000*	*$836,300,000*
Total General Fund Availability	**$23,383,979,046**	**$279,227,665**
Tax Law Changes	*$(120,100,000)*	*$(246,100,000)*
Diversion of Taxes from Short-Term Lease or Rental of Motor Vehicles to Highway Fund	*$(77,130,000)*	*$(79,060,000)*
Diversion to Savings Reserve (S.L. 2017-5)	*$-*	*$(130,135,500)*
Divert additional MSA funds to Golden Leaf	*$(5,000,000)*	*$(5,000,000)*
Transfer from Department of Insurance	*$2,971,205*	*$2,921,205*
Transfer from the Department of the State Treasurer	*$(5,492,586)*	*$(5,492,586)*
+ Recommended Revenue Changes	***$(204,751,381)***	***$(462,866,881)***
Total Revenue Available	**$23,179,227,665**	**$23,951,860,784**
– Appropriation Requirement	**$22,900,000,000**	**$23,779,584,013**
REMAINING GENERAL FUND BALANCE	**$279,227,665**	**$172,276,771**

The House budget is a missed opportunity

The House has taken one important step by stopping further income tax rate reductions that would primarily benefit the state's wealthiest taxpayers and profitable corporations. However, the House continues to pursue tax cuts that aren't revenue neutral and is aggressively saving even as the state has unmet needs and the Rainy Day Fund has a $1.4 billion balance.

We need a deeper commitment to move North Carolina forward during the current economic expansion. Missing opportunities now when the economy is growing will only make it more difficult for the state and families to contend with proposed federal cuts, as is discussed below, and more challenging in the next downturn when the state will need to balance its budget on cuts to core services.

FIGURE 3. **Choices in the House budget**

INSTEAD OF....	HOUSE BUDGET WRITERS COULD....
Cutting taxes by $120 million in the first year of the budget and by $246 million in the second year	▶ ***Serve nearly all eligible 4-year olds in the first year with pre-K education and serve all children in the second year***
Placing $263 million additional dollars in the Rainy Day Fund whose balance stands at $1.4 billion	▶ ***Address the damage of Hurricane Matthew in Eastern NC with a $500 million investment in rebuilding housing, small business, infrastructure, and farms***
Leaving $279 million unappropriated in the first year of the biennium	▶ ***Ensure that class size reductions will not result in reducing educational programming and job loss for teachers***

Increased investments in the House budget fall short of what is needed or recommended to promote the health and well-being of North Carolinians and thriving communities. In these areas, it would be possible to make the smart investments needed if the House invested the dollars already being collected; stopped cutting taxes; and reconsidered the tax changes since 2013. Here are just two examples:

- The House makes no additional investment in affordable housing over current funding levels to ensure access to affordable homeownership and rental opportunities for North Carolinians. This missed opportunity occurs despite the fact that more than half of North Carolinians are housing cost burdened[4] and such investments could provide relief to families, jobs to construction workers, and broader community benefits.

- The House budget makes no additional investment in school nurses to lower North Carolina's school nurse-to-students ratio to the national standard of 750 students per one school nurse. The budget does make changes to the allocation formula but reaching the national standard will not be realized without funding these shifts.

The NC General Assembly must plan for the federal governments proposed cost shift to states

Between the release of Senate and House respective budgets, several decisions and proposals at the federal level signal that the state should adequately prepare for significant cost shifts to the state from the federal level amid growing demand for services that heretofore have been funded with federal dollars. Among these changes are the estimated $6.6 billion in Medicaid costs that would be shifted to North Carolina under the per capita cap proposal in the American Health Care Act and the elimination and significant funding reductions to various federal programs that address hunger, promote education and skills training, provide a pathway out of poverty, and support infrastructure development in rural and urban communities.[5]

Rather than plan for these changes, the House proposes reducing state dollars committed to addressing important needs and replacing those with federal dollars that are not guaranteed to be sustained in the years ahead.

- Of particular note, the House budget writers **rely entirely on Temporary Assistance for Needy Families (TANF) block grant dollars to fund additional pre-K slots.** This program is slated to be reduced by 40 percent in President Trump's proposed budget.
- They **eliminate state funding to counties for the delivery of social services** and replace those dollars with the federal Social Services Block Grant which is slated for elimination.
- Finally, the writers also propose **using federal Community Development Block Grant dollars for water and sewer infrastructure, economic development, and neighborhood revitalization efforts**, primarily in rural communities and small cities – these federal dollars would be eliminated in the Trump budget. The President's budget proposal eliminates all funding through the Community Development Block Grant.[6]

In the face of significant federal cost shifts and growing needs in our state, North Carolina must be deliberate and thoughtful in preparing for a long-term trajectory that can sustain thriving communities. Failure to do so will mean that unmet needs become worse and our state becomes less competitive as a result.

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1. Special data request to ITEP, May 2017 of tax structure pre-2013 on current income distribution and levels.
2. Ibid
3. Ibid
4. "Rent Share of Household Income in the Fifth District," 5th District Footprint, Federal Reserve Bank of Richmond, Richmond, VA, December 2015. https://www.richmondfed.org/publications/community_development/5th_district_footprint/2015/footprint_20151221
5. Shapiro, Isaac, Richard Kogan and Chloe Cho, May 30, 2017. Trump Budget Gets Three-Fifths of Its Cuts from Programs for Low- and Moderate-Income People. Accessed at: http://www.cbpp.org/research/federal-budget/trump-budget-gets-three-fifths-of-its-cuts-from-programs-for-low-and and Center on Budget and Policy Priorities, House Republican Health Plan would Mean More Uninsured, Costlier Coverage in NC, accessed at: http://www.cbpp.org/sites/default/files/atoms/files/4-13-17health-factsheets-nc.pdf
6. Center on Budget & Policy Priorities, Trump Budget's Radical, Harmful Priorities. Accessed at: http://www.cbpp.org/research/federal-budget/trump-budgets-radical-harmful-priorities