

**NORTH CAROLINA GENERAL ASSEMBLY**

**LEGISLATIVE FISCAL NOTE**

**BILL NUMBER:** HB 1633 Second Edition

**SHORT TITLE:** Accelerate Local Option Sales Tax

**SPONSOR(S):**

<b>FISCAL IMPACT</b>					
	<b>Yes (X)</b>	<b>No ( )</b>	<b>No Estimate Available ( )</b>		
	<u><b>FY 2002-03</b></u>	<u><b>FY 2003-04</b></u>	<u><b>FY 2004-05</b></u>	<u><b>FY 2005-06</b></u>	<u><b>FY 2006-07</b></u>
<b>REVENUES</b>					
<b>General Fund</b>					
-Local Reimbursements	333.4				
-Local Hold Harmless	(81.2)				
<b>Net to General Fund</b>	<b>252.2</b>				
<b>Local Governments</b>					
-½ Cent Sales Tax*	278.8				
-Local Reimbursements	(333.4)				
-Local Hold Harmless	81.2				
- DOR Administration	(0.3)				
<b>Net to Local Governments</b>	<b>26.3</b>				
<b>EXPENDITURES</b>					
General Fund					
Department of Revenue**	.3				
*Assumes 100 counties enact tax in September 2002					
**Up to \$275,000 can be withheld from local sales tax collections for implementing half-cent local option.					
<b>PRINCIPAL DEPARTMENT(S) &amp; PROGRAM(S) AFFECTED:</b> NC Department of Revenue, Local Governments, Office of the Governor, Office of State Budget.					
<b>EFFECTIVE DATE:</b> Section 1 (Local Sales Tax) September 1, 2002, Section 5 (Use Tax Distribution) taxable years beginning on or after January 1, 2002, Section 8 (Repeal Reimbursements) July 1, 2002. The remainder becomes effective when law.					

**BILL SUMMARY:** Section 1 of the bill authorizes local county commissioners to levy an additional ½ cent local sales tax, effective September 1, 2002. This tax would not apply to food. Section 2 makes conforming changes to the language to be used on the ballot should county

commissioners choose to place the local sales tax change before the public for a vote. Section 3 makes conforming changes to continue the local sales tax distribution on a quarterly basis until July 1, 2003. Sections 4 and 8, in combination, repeal the local government reimbursements and hold local governments “harmless” for at least a portion of the loss. This “hold harmless” payment is eliminated July 1, 2012. Section 5 modifies the distribution of the local portion of use taxes collected on the individual income tax form. Section 6 allows local governments to amend their budget ordinances to reduce the property tax levy if they receive additional and unanticipated revenues. Section 7 outlines the timeline that counties must follow when notifying the Department of Revenue of their intention to levy the additional ½ cent. Section 9 creates a special revenue distribution process for the additional ½ cent that applies only to September 2002 collections. Section 10 allows the Department of Revenue to use up to \$275,000 of local sales tax revenue to fund implementation of the new tax. Section 11 exempts Department of Revenue from standard contract and bid requirements, but only as it relates to items needed to administer the additional local option sales tax. Sections 12 through 14 make conforming language changes in the existing local sales tax statutes. Section 15 waives the public notice and hearing requirements for the additional ½ cent tax, if the new tax becomes effective before January 1, 2003. Sections 15.1 through 15.7 attempt to limit the Governor’s ability to withhold the local portion of revenues shared with cities and counties by declaring these funds local revenue. Specifically, Section 15.1 addresses beer and wine taxes, while Section 15.2 discusses the franchise tax on electricity. Section 15.3 considers the tax on piped natural gas. Section 15.4 addresses the tax on telecommunications. Section 15.5 considers the Highway Fund and Highway Trust Funds allocated as Powell Bill funds. Section 15.6 addresses the distribution to electric cities. Section 15.7 adds intent language to clarify that the funds committed or appropriated by the legislature for local governments shall not be reduced unless the governor has exhausted all other sources of revenue for the state. It also states that the governor must be authorized by the legislature to withhold these funds.

## **ASSUMPTIONS AND METHODOLOGY:**

### **LOCAL OPTION SALES TAX**

In 2001, the General Assembly approved a sales tax “swap”. Under this proposal, the state levies an additional ½ cent sales tax, bringing the state rate to 4.5%, and the total rate to 6.5%. This additional ½ cent sunsets on June 30, 2003. Starting July 1, 2003, county commissioners are authorized to levy an additional ½ cent at the county level, moving the local rate to 2.5% but holding the combined rate at 6.5%. Also effective July 1, 2003, the state will stop paying local governments approximately \$333.4 million in reimbursements for previous tax law changes in the areas of property taxes on inventory and intangibles, the homestead exemption, and sales taxes on food purchased with food stamps.

Sections 1 through 3, 7, and 9 through 15 collectively allow county governments to levy an additional ½ cent of local sales tax 10 months earlier than existing law. This means that in counties that choose to levy the tax, the combined state and local sales tax rate will be 7.0% (4.5% state, 2.5% local) until the state sunsets its recently enacted ½ cent in July 2003. The rate in Mecklenburg County will be 7.5% for the same time period, assuming Mecklenburg chooses to levy the tax.

Fiscal Research believes that in FY 2001-02, each penny of local sales tax generated \$716.8 million in revenue. (This estimate does not include food.) Using a growth rate of 1.2% suggests the following non-food, sales tax revenue stream for FY 2002-03:

<b><u>Fiscal Year</u></b>	<b><u>Revenue from 1 Cent</u></b>	<b><u>Revenue from 1/2 Cent</u></b>
2002-03	\$725.40	\$362.70

Once adjustments are made for the September effective date, the total estimated statewide potential revenue available to local governments from this additional ½ cent is approximately \$278.8 million. However, since the language is permissive and counties can decide to enact the tax at any time, no exact fiscal estimate is possible on this portion of the bill.

The Department of Revenue has indicated that it will be unable to process the September taxes collected under this provision in the traditional manner due to computer programming limitations. As a result, the amount of revenue each county and associated municipality receives from this tax in this month will be distributed on the basis of their proportion of the previous fiscal year’s sales tax revenue (per capita and point of origin). In making this calculation, the Secretary of Revenue will only consider those communities that choose to levy the tax. Beginning October 1, 2002, distribution will be made as normal, with funds distributed one-half on a per capita basis and ½ on a point of origin basis.

Section 7 allows local governments to begin levying the tax on the first day of any calendar month on or after September 1, 2002, and limits the amount of notice local governments must give the Department of Revenue for local sales tax changes effective between September 1, 2002, and December 31, 2002. No revenue side impact is expected as a result of this expedited process.

Sections 12 through 14 re-title and re-codify the existing local sales tax statutes. No fiscal impact is expected from these sections of the bill.

Section 15 eliminated the public notice and hearing requirements for adopting the additional ½ cent tax when the tax is adopted without a vote of the people. No fiscal impact is expected as a result of this portion of the bill.

**Repeal of Local Government Reimbursements and Modification of Hold Harmless Payments**

Sections 4 and 8, in combination, repeal the local government reimbursements and hold local governments “harmless” for at least a portion of the loss.

Since 1979, the General Assembly has made several changes to tax law that impact local governments. The state’s cities and counties have received reimbursements from the state for some of these losses, particularly as they relate to the sales and property tax bases. The state reimburses

local governments for property tax losses related to the repeal of taxes on inventories and intangibles, as well as some of the losses associated with the homestead exemption. Locals also receive a reimbursement for sales taxes that are no longer paid on items purchased with food stamps.

According to the Department of Revenue’s Tax Research Division, annual reimbursements are as follows:

<b>Reimbursement</b>	<b>Amount (Millions)</b>
Food Stamps	\$6.4
Intangibles	\$128.7
Homestead	\$8.2
Retail & Wholesale Inventory	\$82.0
Manufacturers Inventory	\$108.1
<b>TOTAL</b>	<b>\$333.4</b>

Section 8 of the bill repeals all of these reimbursements. Because all reimbursement amounts are either fixed or frozen, no growth is included in the estimate.

Section 4 of the bill instructs the Secretary of Revenue to make a hold harmless payment in FY 2002-03 to those local governments whose gain from the sales tax is less than 100% of their loss from the repealed reimbursements. (Current law continues a 100% hold harmless payment in perpetuity, starting in 2003-04.) The legislation offers a hold harmless payment to all communities, regardless if they levy the new tax, but only makes a payment for the gap between the estimated sales tax revenue (as if they levied the tax) and the reimbursement. (This mirrors the existing law that does not come into effect until FY 2003-04.)

Because there is no hold harmless payment in FY 2002-03 under existing law, all of the FY 2002-03 hold harmless payment is a loss to the state General Fund and a gain to local governments.

This section of the bill also eliminates all hold harmless payments effective July 1, 2012.

**MODIFY USE TAX PAYMENTS**

Section 5 modifies the distribution of the local portion of use taxes collected on the individual income tax form. North Carolina consumers have been liable for use tax payments on all purchases on which sales tax are not collected since 1939. The use tax is imposed at the same rate as the sales tax and is designed to capture the revenue lost through sales by retailers that do not collect North Carolina sales tax. Unlike the retail sales tax that is collected by the merchant, the consumer pays the use tax directly to the state. From a practical standpoint, the use tax generally applied to traditional out of state purchases for consumption in North Carolina or those sales made through a catalog or mail order company. The 1999 General Assembly approved HB 1433 to simplify use tax collection by providing that the use tax will be paid on the taxpayer’s income tax return. That legislation also indicated that the state should forward one-third of the proceeds collected on this line to the state’s counties and cities in proportion to their total local sales tax payments. At that time, the combined state rate was 6%, with 2% or one-third of that amount being local sales taxes. Since that time, the combined state rate has increased to 6.5% and could go to 7.0% under the

provisions of this bill. As a result, one-third is no longer the appropriate proportion to forward to local governments.

The Department of Revenue reports collecting approximately \$4.5 million in use taxes from the individual income tax returns for calendar year 2001. The distribution formula in existing law, the standard sales tax growth rates, and an adjustment factor for a higher sales tax rate, are used to compute the following revenue stream:

	<b>FY 2001-02</b>	<b>FY 2002-03</b>	<b>FY 2003-04</b>	<b>FY 2004-05</b>	<b>FY 2005-06</b>	<b>FY 2006-07</b>
<b>State</b>	\$3,000,000	\$3,187,800	\$3,176,802	\$3,510,684	\$3,672,175	\$3,841,096
<b>Local</b>	\$1,500,000	\$1,593,900	\$1,588,401	\$1,755,342	\$1,836,088	\$1,920,548
<b>TOTAL</b>	<b>\$4,500,000</b>	<b>\$4,781,700</b>	<b>\$4,765,203</b>	<b>\$5,266,026</b>	<b>\$5,508,263</b>	<b>\$5,761,643</b>

The bill requires that the proportion of the tax paid to local units reflect what proportion of the general rate is actually local tax. Therefore, under the current rate structure, local units should receive 30.8% of the revenue (2.0% is 30.8% of a 6.5% tax). If the new rate in this bill is used, locals should receive 35.7% of the funds (2.5% is 35.7% of a 7.0% rate). When the state's extra ½ cent is repealed in July 2003, the locals should begin receiving 38.5% of the revenue (2.5% is 38.5% of a 6.5% rate). Using these ratios suggests the following new revenue streams:

	<b>FY 2001-02</b>	<b>FY 2002-03</b>	<b>FY 2003-04</b>	<b>FY 2004-05</b>	<b>FY 2005-06</b>	<b>FY 2006-07</b>
<b>State</b>	\$3,000,000	\$3,191,785	\$2,997,313	\$3,238,606	\$3,387,582	\$3,543,411
<b>Local</b>	\$1,500,000	\$1,589,915	\$1,767,890	\$2,027,420	\$2,120,681	\$2,218,233
<b>TOTAL</b>	<b>\$4,500,000</b>	<b>\$4,781,700</b>	<b>\$4,765,203</b>	<b>\$5,266,026</b>	<b>\$5,508,263</b>	<b>\$5,761,643</b>

Note: Because individual income tax returns reflect purchases made during a calendar year and all sales tax rate changes become effective in July, the average of the two fiscal year's proportions are used to determine the division of state and local revenue.

The projected potential revenue changes as a result of this bill are as follows:

	<b>FY 2002-03</b>	<b>FY 2003-04</b>	<b>FY 2004-05</b>	<b>FY 2005-06</b>	<b>FY 2006-07</b>
<b>State</b>	\$3,985	(\$179,489)	(\$272,078)	(\$284,594)	(\$297,685)
<b>Local</b>	(\$3,985)	\$179,489	\$272,078	\$284,594	\$297,685

However, because the provision that allows this item to remain on the individual income tax return expires with tax year 2002, the only impact seen as the result of this bill is the first fiscal year.

### **CHANGE LOCAL BUDGET ORDINANCES**

Section 6 allows local governments to amend their budget ordinances to reduce their property tax levy to reflect any additional and unanticipated revenues. Because this only applies to local units, no state General Fund impact is expected. Further, since the language is permissive and only gives local governments a new method to respond to the unclear status of revenues from the state or a local sales tax increase, no local estimate is possible on this portion of the bill.

**SECURE LOCAL REVENUES**

In the spring of 2001, as a result of substantial budget shortfall, the governor escrowed \$95.0 million of reimbursement payments to local governments. This payment is made as a reimbursement for revenues lost by the state’s repeal of the property tax on various inventories. The funds were placed in an escrow account in case they were needed to balance the state budget on June 30, 2001. These funds were later released to the local units. In 2002, again facing a difficult fiscal situation, Governor Easley escrowed the spring inventory tax reimbursement to local governments. This \$95.0 million was again placed in a special account to hold in case it was needed to balance the state budget in 2002. At the same time the governor announced he was holding an additional \$114.0 million in reimbursements and shared revenues to secure his ability to balance the state budget. The \$114 million included the following estimated amounts:

<i>Fund Type</i>	<i>Amount Withheld</i>
<b>Franchise Utility Tax</b>	
March Distribution	35.6
June Distribution	25.0
<b>Piped Natural Gas</b>	
March Distribution	6.9
June Distribution	11.8
<b>Beer and Wine Tax</b>	26.8
<b>Homestead Exemption</b>	7.9
<b>TOTAL</b>	<b>114.0</b>

Sections 15.1 through 15.7 are an attempt to secure these revenues from future gubernatorial action. This legislation has no direct impact on the budgets passed by the General Assembly, as these shared revenues have not been used in the legislative process for state expenditures. However, the legislation could limit the options available to the governor. Because of the lack of clarity about what actions will be required of the governor in future years, and the impact this particular legislation will have on the individual’s decisions, no fiscal estimate is possible on the impact of the legislation.

**SOURCES OF DATA:** NC Department of Revenue, Tax Research Division.

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