

# GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2011

## Legislative Fiscal Note

**BILL NUMBER:** House Bill 344 (Fourth Edition)

**SHORT TITLE:** Tax Credits for Children with Disabilities.

**SPONSOR(S):** Representatives Stam, Randleman, Jordan, and Jones

<b>FISCAL IMPACT (\$ in millions)</b>					
	<b>Yes (X)</b>	<b>No ( )</b>	<b>No Estimate Available ( )</b>		
	<b><u>FY 2011-12</u></b>	<b><u>FY 2012-13</u></b>	<b><u>FY 2013-14</u></b>	<b><u>FY 2014-15</u></b>	<b><u>FY 2015-16</u></b>
<b><u>STATE IMPACT</u></b>					
Revenue (tax credits):	(\$1.4)	(\$5.9)	(\$6.5)	(\$6.6)	(\$6.7)
Operational Savings:	\$0	\$8.2	\$16.5	\$16.8	\$17.0
Trnsf. Out Gen Fund:	N/A	(\$4.1)	(\$4.1)	(\$4.2)	(\$4.2)
Trnsf. In Spec. Ed. Fund:	N/A	\$4.1	\$4.1	\$4.2	\$4.2
<u>Trnsf. To LEAs:</u>	<u>\$0</u>	<u>\$0</u>	<u>(\$0.9)</u>	<u>(\$1.1)</u>	<u>(\$0.3)</u>
<b>Net State Impact:</b>	<b>(\$1.4)</b>	<b>\$2.3</b>	<b>\$9.2</b>	<b>\$9.0</b>	<b>\$10.0</b>
<b><u>LEA IMPACT</u></b>					
Revenue:	N/A	N/A	N/A	N/A	N/A
<u>Operational Savings:</u>	<u>N/A</u>	<u>\$1.9</u>	<u>\$3.9</u>	<u>\$4.0</u>	<u>\$4.0</u>
<b>Net LEA Impact:</b>	<b>N/A</b>	<b>\$1.9</b>	<b>\$3.9</b>	<b>\$4.0</b>	<b>\$4.0</b>
<b><u>POSITIONS</u></b>					
<b>(cumulative):</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>
 <b>NOTE:</b> This fiscal note relies on numerous assumptions that could result in the actual fiscal impact differing significantly from the numbers in the table above. Please see Assumptions & Methodology for likely ranges of fiscal impact.					
 <b>PRINCIPAL DEPARTMENT(S) &amp; PROGRAM(S) AFFECTED:</b> North Carolina Department of Revenue, North Carolina Department of Public Instruction (DPI), Local Public Schools					
 <b>EFFECTIVE DATE:</b> This bill is effective for taxable years beginning January 1, 2011, and applies to semesters beginning on or after July 1, 2011. Certain changes to tax credit eligibility become effective January 1, 2016, and apply to semesters beginning on or after July 1, 2016.					

**BILL SUMMARY:** The legislation creates a new tax credit for parents of children with special needs who choose to educate those children in a nonpublic school or in a public school at which tuition is charged per G.S. 155C-366.1. The credit amount is set at \$3,000 per semester, up to two semesters a year (a maximum of \$6,000 for a full academic or taxable year). The credit is non-refundable, but any unused portion of the credit may be carried forward for the succeeding three years.

To qualify for the tax credit, the taxpayer must be able to deduct a personal exemption for an “eligible dependent child.” An “eligible dependent child” is one who:

1. Is a child with a disability as defined by G.S. 115C-06.3(1);
2. Was determined to require an individualized education program (IEP) as defined by G.S. 115C-06.3(8);
3. Receives special education or related services on a daily basis;
4. Is a child for whom the taxpayer is entitled to deduct a personal exemption under section 151(c) of the Code for the taxable year; and
5. Was enrolled in and attended a public school or receiving special education or related services through the public schools as a preschool child with a disability for at least the two preceding academic semesters prior to first receiving the tax credit.

In order to maintain eligibility, the bill would require all eligible dependent children to be reevaluated every three years by the local education agency (LEA) in order to verify that the child continues to be a child with a disability as defined by G.S. 115C-106.3(1). LEAs would be reimbursed for these evaluations from the Fund for Special Education and Related Services.

A student would no longer be eligible if he or she:

1. Was placed in a nonpublic school or facility by a public agency at public expense;
2. Spent time enrolled as a full-time student in a postsecondary educational institution;
3. Was 22 years or older during the entire semester; or
4. Graduated from high school prior to the end of the semester.

It is important to note that the initial eligibility requirement (“was enrolled in and attended a public school for at least the two preceding academic semesters prior to first receiving the tax credit”) is changed from two academic semesters to one academic semester beginning with semesters beginning on or after July 1, 2016.

The legislation also amends G.S. 115-C to create the Fund for Special Education and Related Services (“the Fund”). The Fund will be a special revenue fund under the control of the State Board of Education. Revenue of the Fund will be used only for special educational and related services for children with disabilities. Revenue for the Fund will come from a transfer at the end of each fiscal year, beginning in fiscal year 2012-13, from income tax revenue, equal to the number of credits taken under this act multiplied by \$2,000.

## **ASSUMPTIONS AND METHODOLOGY:**

### **Overview**

The impact of the bill is dependent entirely on choices made by parents of children who have special educational needs meeting the criteria specified in the bill. As there is no data available regarding elasticity of demand for the specific educational circumstances for which the tax credit is granted, this analysis must make an effort to estimate, using available data, potential public behavior in the presence of the new law.

### **Data and Assumptions**

#### Size of the Tax Credit

This analysis assumes an average tax credit of \$2,700 per year. Because the tax credit proposed by H344 is not refundable, most tax filers will not receive the full \$6,000 tax credit. On tax returns with at least one dependent child and with adjusted gross income between \$30,000 and \$500,000, the median State tax liability was \$2,700.<sup>1</sup> That means approximately half of the people qualifying for the tax credit proposed by this bill would receive a credit of \$2,700 or less instead of \$6,000. The allowance for carry-forward of the tax credit means that the median filer would receive tax credits of \$2,700 and \$600 in the two years after the eligible child is no longer receiving the credit.

#### Percent of Eligible Students Moving Out of Public School

This analysis assumes that 1% to 2% of eligible children will take advantage of the tax credit proposed by this bill. A program similar in design to the program proposed by this bill, Florida's McKay Scholarship Program for Students with Disabilities, has a participation rate of approximately 5%. There are several reasons why one would anticipate a significantly lower participation in the tax credits proposed by H344:

1. The McKay Program is marketed to students and their families. There are no funds available to market the tax credit proposed by this bill.
2. The McKay Program provides scholarships to any special needs student ranging from \$4,746 to \$19,133. The tax credits proposed by this bill are capped based on the parent or guardian's tax liability.
3. The McKay Program provides families with an up-front scholarship, while the tax credit proposed by H344 only reduces a parent or guardian's taxes after the parent or guardian has already paid the student's tuition.
4. Approximately half of the students receiving the McKay Scholarship are eligible for free or reduced-price lunch (family income of 185% of the poverty level, or less). Families qualifying for free or reduced-price lunch are unlikely to utilize a non-refundable tax credit to offset the costs of private school tuition.

#### Eligible Population of Students

DPI estimates that somewhere between 120,000 and 140,000 students could potentially meet the definition of "eligible dependent child" under this bill. DPI does not track which students receive special education or related services on a daily basis. Therefore, this analysis presents a range of possibly eligible students, rather than a point estimate. For future years, the number of eligible students is anticipated to grow by 1.37% per year, reflecting the 10-year average growth in average daily membership (ADM).

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<sup>1</sup> Derived using the Fiscal Research Division's North Carolina Individual Income Tax Model.

### Turnover Rate

This analysis assumes an annual turnover rate of eligible dependent children of 15%. That is, from one year to the next 15% of the children generating a tax credit in year 1 will not be generating a tax credit in year 2. There are many reasons for turnover, including loss of eligibility, moving out of State, or decision to place student back in a public school.

### State and Local Expenditures per Student

The estimated reduction in State expenditure per child using the tax credit is \$8,160, and the estimated reduction in local expenditures per child using the tax credit is \$1,931. The FY 2010-11 State average transfer of appropriation to charter schools of \$4,562 per child serves as a reasonable proxy for the total avoided annual State operational expenditure for a student who transfers out of a typical public school. The per child supplemental appropriation of \$3,599 for each child with special needs (for up to 12.5% of a school system's population) serves as a reasonable proxy for the additional State average expenditure for a child with special needs. A total of \$8,160 is therefore used as a proxy for the average operational savings to the State that results from a student with an IEP transferring (i.e., withdrawing) from the public schools to a nonpublic school. The average local expenditure per child for operational expenses is \$1,931.

### **Estimated Fiscal Impact of Tax Credits**

The fiscal impact of H344 primarily stems from two factors: number of tax credits issued, and students who transfer from public schools to nonpublic schools. The tax credits decrease State revenue. But each transferring student also reduces State and local expenditures on public schools, as State and local school systems would no longer be financially responsible for educating the child for which the credit was granted. The net impact is essentially the difference between the tax credit, and the expenditures per child.

Note that timing issues affect the first-year fiscal impact in three ways:

1. The analysis assumes the average tax credit granted in April 2012 is \$1,350, reflecting those students moving out of public schools during the Fall 2011 semester.<sup>2</sup> In future years, a tax credit of \$2,700 per year is assumed.
2. The percent of eligible students transferring out of public schools is discounted by 50% in the first year to account for limited public awareness of a new program. It is assumed that the program will not reach its full capacity of 1% to 2% of eligible students until the 2012-13 school year.
3. State and local governments do not realize savings from reduced expenditures until the 2012-13 fiscal year. This delay is because allotted ADM is based off of the higher of projected ADM or prior year actual ADM. Therefore, the reduced enrollment experienced in the 2011-12 school year will impact allotted ADM – and therefore State and local budgeting decisions – in the 2012-13 school year.

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<sup>2</sup> For simplicity's sake, this analysis assumes that all taxes are filed, and credits granted, in April.

### **Fund for Special Education and Related Services**

There is no net fiscal impact associated with the *creation of* the Fund, as this bill simply transfers monies into the Fund that would have otherwise ended up in the General Fund.

However, monies from the Fund are used to reimburse LEAs for reevaluations. The reimbursement of LEAs for reevaluation services represents a fiscal cost to the State, as reevaluations deplete the Fund and reduce amounts that would have otherwise been made available for services for children with disabilities

This analysis assumes an annual turnover rate of eligible dependent children of 15%. That is, given an initial cohort of 1,000 “eligible dependent children,” one would anticipate needing 614 reevaluations three years later ( $1,000 * 0.85^3$ ). Future cohorts of required evaluations are smaller than the initial cohort. New entrants in any given year are assumed to be the amount required to replace the 15% turnover, plus enough to account for overall program growth of 1.37% per year.

## Estimated Fiscal Impact on State and LEAs

	2011-12*****		2012-13		2013-14		2014-15		2015-16	
Eligible Student Pool*	120,000	140,000	121,644	141,918	123,311	143,862	125,000	145,833	126,713	147,831
<b>Usage Percent</b>	<b>1%</b>	<b>2%</b>	<b>1%</b>	<b>2%</b>	<b>1%</b>	<b>2%</b>	<b>1%</b>	<b>2%</b>	<b>1%</b>	<b>2%</b>
Tax Credits Granted**	600	1,400	1,216	2,838	1,233	2,877	1,250	2,917	1,267	2,957
Cost of Tax Credits (lost State Rev.)	(\$810,000)	(\$1,890,000)	(\$3,283,200)	(\$7,662,600)	(\$3,329,100)	(\$7,767,900)	(\$3,375,000)	(\$7,875,900)	(\$3,420,900)	(\$7,983,900)
Tax Credits Carried Forward***	\$0	\$0	(\$243,000)	(\$567,000)	(\$546,480)	(\$1,275,390)	(\$608,805)	(\$1,420,605)	(\$617,220)	(\$1,440,315)
State Exp. Per Eligible Student	\$8,160	\$8,160	\$8,160	\$8,160	\$8,160	\$8,160	\$8,160	\$8,160	\$8,160	\$8,160
Reduced Public School Expenditures ****	N/A	N/A	\$4,896,000	\$11,424,000	\$9,922,560	\$23,158,080	\$10,061,280	\$23,476,320	\$10,200,000	\$23,802,720
Transfer OUT of General Fund	N/A	N/A	(\$2,432,000)	(\$5,676,000)	(\$2,466,000)	(\$5,754,000)	(\$2,500,000)	(\$5,834,000)	(\$2,534,000)	(\$5,914,000)
Transfer IN to Special Education Fund	N/A	N/A	\$2,432,000	\$5,676,000	\$2,466,000	\$5,754,000	\$2,500,000	\$5,834,000	\$2,534,000	\$5,914,000
Transfer out to LEAs for Reevaluations	\$0	\$0	\$0	\$0	(\$553,500)	(\$1,290,000)	(\$651,000)	(\$1,518,000)	(\$183,000)	(\$429,000)
<b>Net Fiscal Impact on State</b>	<b>(\$810,000)</b>	<b>(\$1,890,000)</b>	<b>\$1,369,800</b>	<b>\$3,194,400</b>	<b>\$5,493,480</b>	<b>\$12,824,790</b>	<b>\$5,426,475</b>	<b>\$12,661,815</b>	<b>\$5,978,880</b>	<b>\$13,949,505</b>
LEA Exp. Per Eligible Student	\$1,931	\$1,931	\$1,931	\$1,931	\$1,931	\$1,931	\$1,931	\$1,931	\$1,931	\$1,931
Reduced LEA Expenditures ****	N/A	N/A	\$1,158,600	\$2,703,400	\$2,348,096	\$5,480,178	\$2,380,923	\$5,555,487	\$2,413,750	\$5,632,727
Cost of Reevaluations	\$0	\$0	\$0	\$0	(\$553,500)	(\$1,290,000)	(\$651,000)	(\$1,518,000)	(\$183,000)	(\$429,000)
Reimbursement from Special Ed Fund	\$0	\$0	\$0	\$0	\$553,500	\$1,290,000	\$651,000	\$1,518,000	\$183,000	\$429,000
<b>Net Fiscal Impact on LEAs</b>	<b>\$0</b>	<b>\$0</b>	<b>\$1,158,600</b>	<b>\$2,703,400</b>	<b>\$2,348,096</b>	<b>\$5,480,178</b>	<b>\$2,380,923</b>	<b>\$5,555,487</b>	<b>\$2,413,750</b>	<b>\$5,632,727</b>

\*Grows by 1.37% per year to reflect the 10-year average growth in allotted ADM

\*\*For FY11-12, number of tax credits granted is discounted by 50% to account for limited public awareness of program.

\*\*\* Assumes turnover rate of 15%.

\*\*\*\* Because allotted ADM is based off of the higher of projected ADM or prior year actual ADM, savings from reduced expenditures are not realized until the 2012-13 school year.

\*\*\*\*\* Assumes average tax credit in FY11-12 is \$1,350. Assumes tax credit in all future years of \$2,700.

## Estimated Fiscal Impact on State and LEAs -- MIDPOINT ESTIMATE

	2011-12*****	2012-13	2013-14	2014-15	2015-16
Eligible Student Pool*	130,000	131,781	133,587	135,417	137,272
<b>Usage Percent</b>	<b>1.5%</b>	<b>1.5%</b>	<b>1.5%</b>	<b>1.5%</b>	<b>1.5%</b>
Tax Credits Granted**	1,000	2,027	2,055	2,084	2,112
Cost of Tax Credits (lost State Rev.)	(\$1,350,000)	(\$5,472,900)	(\$5,548,500)	(\$5,625,450)	(\$5,702,400)
Tax Credits Carried Forward***	\$0	(\$405,000)	(\$910,935)	(\$1,014,705)	(\$1,028,768)
State Exp. Per Eligible Student	\$8,160	\$8,160	\$8,160	\$8,160	\$8,160
Reduced Public School Expenditures ****	N/A	\$8,160,000	\$16,540,320	\$16,768,800	\$17,001,360
Transfer OUT of General Fund	N/A	(\$4,054,000)	(\$4,110,000)	(\$4,167,000)	(\$4,224,000)
Transfer IN to Special Education Fund	N/A	\$4,054,000	\$4,110,000	\$4,167,000	\$4,224,000
Transfer out to LEAs for Reevaluations	\$0	\$0	(\$921,750)	(\$1,084,500)	(\$306,000)
<b>Net Fiscal Impact on State</b>	<b>(\$1,350,000)</b>	<b>\$2,282,100</b>	<b>\$9,159,135</b>	<b>\$9,044,145</b>	<b>\$9,964,193</b>
LEA Exp. Per Eligible Student	\$1,931	\$1,931	\$1,931	\$1,931	\$1,931
Reduced LEA Expenditures ****	N/A	\$1,931,000	\$3,914,137	\$3,968,205	\$4,023,239
Cost of Reevaluations	\$0	\$0	(\$921,750)	(\$1,084,500)	(\$306,000)
Reimbursement from Special Ed Fund	\$0	\$0	\$921,750	\$1,084,500	\$306,000
<b>Net Fiscal Impact on LEAs</b>	<b>\$0</b>	<b>\$1,931,000</b>	<b>\$3,914,137</b>	<b>\$3,968,205</b>	<b>\$4,023,239</b>

\*Grows by 1.37% per year to reflect the 10-year average growth in allotted ADM

\*\*For FY11-12, number of tax credits granted is discounted by 50% to account for limited public awareness of program.

\*\*\* Assumes turnover rate of 15%.

\*\*\*\* Because allotted ADM is based off of the higher of projected ADM or prior year actual ADM, savings from reduced expenditures are not realized until the 2012-13 school year.

\*\*\*\*\* Assumes average tax credit in FY11-12 is \$1,350. Assumes tax credit in all future years of \$2,700.

**TECHNICAL CONSIDERATIONS:**

There are many technical considerations that should be considered as this fiscal note is based on a number of assumptions. The fiscal impact presented here is an estimate, and any number of factors could move the fiscal impact up or down in a significant way.

**Gaming the System**

It is possible, but unlikely, that some parents of potentially eligible children who have never attended public schools would enroll their children in public schools for the required two semesters in order to then be able to avail themselves of the credit in a subsequent year. It seems unlikely, however, that a significant number of parents who have already made a decision not to send their children to public schools would make this choice, even in the face of potential financial gain. The analysis therefore assumes that any costs associated with this group of children will be negligible. To the extent that this assumption is incorrect, the analysis will understate total cost and overstate total savings created by the bill.

**SOURCES OF DATA:** North Carolina Department of Public Instruction (DPI), Fiscal Research Division’s North Carolina Individual Income Tax Model, Florida’s McKay Scholarship Program.

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**DATE:** June 13, 2011



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