NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: House Bill 231 (House Finance Committee Substitute)

SHORT TITLE: Education Revenue Act

SPONSOR(S): Representative Allen

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

($million)

	FY 2001-02	**FY 2002-03**	**FY 2003-04**	**FY 2004-05**	**FY 2005-06**
REVENUES					
General Fund					
Increase Standard Deduction	(9.7)	(32.0)	(45.0)	(45.8)	(46.5)
Increase Child Credit		(19.8)	(54.8)	(55.0)	(55.3)
State Half Cent Sales Tax	198.4	398.7	419.8	110.3	
Repeal Reimbursements	333.4	333.4	333.4	333.4	333.4
Sales Tax/Hold Harmless	(157.7)	(35.0)	(29.1)	(24.4)	(20.1)
Earned Income Tax Credit		(93.8)	(109.0)	(119.2)	(124.0)
8.0% Income Tax Rate	62.8	51.5	30.8		
Tax HMOs/Blue Cross		33.8	30.6	33.2	35.9
Liquor Sales Tax	15.9	24.7	25.6	26.6	27.6
No Tax Break/Luxury Cars	1.7	2.4	2.6	2.7	2.9
Sales Tax Holiday	0	(9.4)	(9.8)	(9.3)	(9.4)
Total General Fund	**444.8**	**654.5**	**595.1**	**252.5**	**144.5**
Local Government					
Sales Tax Holiday	0	(5.2)	(5.4)	(5.6)	(5.8)
Local Half Cent Sales Tax*	198.4	398.7	419.8	441.2	462.8
Repeal Reimbursements	(333.4)	(333.4)	(333.4)	(333.4)	(333.4)
Sales Tax/Hold Harmless	157.7	35.0	29.1	24.4	20.1
Total Local Govt.	**22.7**	**95.1**	**110.1**	**126.6**	**143.7**

* Assumes all counties approve the tax

EXPENDITURES

General Fund					
Income tax withholding tables	.14				
Sales Tax changes	1.6	.4	.4	.4	.4
Earned Income Credit		.91	.92	.92	.92
Total General Fund	**1.74**	**1.31**	**1.32**	**1.32**	**1.32**
POSITIONS					
Dept. of Revenue	6	6	6	6	6

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: Department of Revenue; Alcoholic Beverage Control Commission; Division of Motor Vehicles

EFFECTIVE DATE: Part 7 (8.0% tax rate) is effective for taxable years beginning on or after January 1, 2001, but expires for taxable years beginning on or after January 1, 2004. Part 10c (transfer luxury car tax to General Fund) and Part 4 (repeal reimbursements) are effective July 1, 2001. Parts 9 (sales tax on liquor) and 10 (repeal tax cap on luxury cars) are effective October 1, 2001. Parts 1a ($5,500 standard deduction), 2a ($75 child credit), 6 (earned income tax credit), and 8 (insurance premium tax) are effective for taxable years beginning on or after January 1, 2002. Part 11 (sales tax holiday) is effective January 1, 2002 and applies to sales made on or after that date. Part 3 (1/2 cent local sales tax/hold harmless) is effective on December 1, 2001. Part 5 (half cent state sales tax) becomes effective on December 1, 2001 and expires on October 1, 2004. Parts 1b and 2b are effective for taxable years beginning on or after January 1, 2002. Parts 1b ($6,000 standard deduction) and 2b ($100 child credit) are effective for taxable years beginning on or after January 1, 2003.

BILL SUMMARY:

House Bill 231 PCS does the following:

Part 1) Increases the standard deduction for married filing jointly filers from $5,000 to $6,000,

Part 2) Increases the tax credit for children from $60 to $100,

Part 3) Authorizes a half cent local option sales tax and allows a 105% hold harmless guarantee on revenue previously received by local governments in state tax reimbursements,

Part 4) Repeals local government reimbursements for intangibles tax, inventory tax, reduced property valuation, and sales tax exemption for food purchased with food stamps,

Part 5) Increases state sales tax by half cent for three years,

Part 6) Creates an earned income tax credit that is equal to 10% of the federal earned income tax credit,

Part 7) Adds a new 8.0% individual income tax bracket for three tax years,

Part 8) Imposes a 1% gross premiums tax on HMOs and increases the gross premiums tax on medical service companies from .5% to 1%,

Part 9) Imposes a 6% state sales tax on liquor,

Part 10) Repeals the $1,500 highway use tax cap on motor vehicles and exempts fire and rescue vehicles from the highway use tax, and

Part 11) Creates a sales tax holiday on the first weekend in August each year for clothing, footwear, and school supplies valued at $100 or less per item and computer software and hardware valued at $3,500 or less per item.

ASSUMPTIONS AND METHODOLOGY:

Eliminate the Marriage Tax Penalty for the Standard Deduction

The term "marriage penalty" refers to the income tax situation where married individuals filing jointly pay more in tax than if the two individuals were unmarried filing as single persons. For example, the North Carolina standard deduction for single filers is $3,000, but for married filing jointly the standard deduction is $5,000. The personal exemption favors single filers, because the exemption is $2,500 until you get to a maximum of $60,000 Adjusted Gross Income (AGI) for single filers and $100,000 AGI for married filing jointly where it drops to $2,000. State tax brackets also favor single filers as shown below:

Single	0 to $12,750	$12,751 to $60,000	$60,000>
Married filing jointly	0 to $21,250	$21,251 o $100,000	$100,000>

Part 1 of House Bill 231 reduces the marriage penalty by increasing the standard deduction for married filing jointly taxpayers from $5,000 to $6,000. The standard deduction is increased to $5,500 in tax year 2002 and then to $6,000 in tax year 2003. The FY 2001-02 reduction in General Fund revenue will be $9.7 million due to estimated payments and withholding in the first half of tax year 2002. This change will benefit 762,340 couples in tax year 2002.

FY 2001-02	$9.7 mil.
FY 2002-03	$32.0 mil.
FY 2003-04	$45.0 mil.
FY 2004-05	$45.8 mil.
FY 2005-06	$46.5 mil.

The revenue estimate for the standard deductions was calculated using the North Carolina Individual Income Tax Model. This tax model was created by the Barents Group for the Department of Revenue and the General Assembly to use in estimating tax law changes. The model bases future year estimates on data from 1998 North Carolina individual income tax returns.

Increase Tax Credit for Children

The current $60 child credit was approved by the 1995 General Assembly. Part 2 of the bill increases the child credit from $60 to $75 per child in tax year 2002, and then increases the credit from $75 to $100 in tax year 2003. The first increase will reduce General Fund revenue $19.8 million in FY 2002-03 for taxpayers filing returns in the spring of 2003. The second year increase will boost the revenue loss to $54.8 million in FY 2003-04. This tax change will benefit 18,354 single tax filers, 496,286 married couples, and 411,648 heads of households in tax year 2002. This revenue estimate was calculated using the North Carolina Individual Income Tax Model.

Allow Half Cent Local Option Sales Tax

Part 3 of the bill authorizes counties to levy an additional ½ cent local sales tax, potentially bringing the local sales tax rate to 2-½%. However, the additional ½ cent will not apply to food. This local option tax can be enacted through a special election or a vote of the county commission.
The General Assembly's Fiscal Research Division and the Office of State Budget, Planning and Management have agreed to the following sales tax revenue projections for FY 2001-02 and FY 2002-03:

(Millions)

Fiscal Year	Revenue from 1 Cent	Revenue from 1/2 Cent
2001-02	$765.2	$382.6
2002-03	$797.3	$398.7

These estimates assume a full year of tax.

Fiscal Research and the State Budget Office have also agreed to sales tax growth rate estimates for the next several fiscal years. The growth rates, as well as the corresponding 1 cent and ½ cent revenue estimates (in millions), are listed below.

Fiscal Year	Growth from Previous Year	Revenue from 1 Cent	Revenue from 1/2 Cent
2003-04	5.3%	$839.6	$419.8
2004-05	5.1%	$882.4	$441.2
2005-06	4.9%	$925.6	$462.8

Adjusting for the December 1, 2001 effective date suggests the following potential revenue stream:

(Millions)

Fiscal Year	Local Sales Tax
2001-02	$198.4
2002-03	$398.7
2003-04	$419.8

2004-05	$441.2
2005-06	$462.8

While these estimates represent the total, statewide potential revenue stream to local governments, the language is permissive. As a result, no exact fiscal estimate is possible on the bill.

Hold Harmless Local Reimbursements at 105%

Part 4 of the bill repeals the existing reimbursements to local governments for previous law changes. These reimbursements total $333.4 million annually (see section below on local government reimbursements). However, Part 3 of the bill instructs the Secretary of Revenue to make an annual hold harmless payment to those local governments whose gain from the sales tax is less than 105% of their loss from the repealed reimbursements. The sales tax distribution formula mirrors the existing formula, with ½ of the revenues distributed on an adjusted per capita basis and ½ distributed on a point of sale basis.

In order to calculate a statewide hold harmless cost, FY 1999-00 annual sales tax reports were used to determine what proportion of all annual sales tax distributions were forwarded to each community. These percentages of the total were then applied to the estimated revenue streams noted above to create local sales tax revenue estimates. The individual revenue estimates were compared with the annual reimbursement data for each county and municipality. If a particular community's sales tax revenue did not compare favorably with 105% of the reimbursement amount, a hold harmless estimate was generated for that community. These individual hold harmless amounts were then totaled to determine the combined state liability for the 105% hold harmless provision. This calculation was made for each of the next five fiscal years.

(Millions)

Fiscal Year	Hold Harmless
2001-02	($157.7)
2002-03	($35.0)
2003-04	($29.1)
2004-05	($24.4)
2005-06	($20.1)

Repeal Local Government Reimbursements

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.

The legislature began exempting certain categories of intangible property in 1979. At that time, deposit accounts of less than $1,000 were exempted. In 1985 that exemption was expanded to include money on deposit, money on hand, and certain accounts receivable. In 1995 most of the remaining forms of intangible property were exempted. Through legislation in 1980, 1985, and 1987 the property tax on inventories was also removed. In 1985 the General Assembly exempted food stamps from local sales taxes. Most major changes in the homestead exemption have also included reimbursement, at least in part, by state government. Many of these reimbursement amounts are based on actual tax losses related to the first year of the repeal. These reimbursement amounts are fixed. The remainder was frozen in 1991.

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

(Millions)

Reimbursement	**Amount**
Food Stamps	$6.4
Intangibles	$128.7
Homestead	$8.2
Retail & Wholesale Inventory	$82.0
Manufacturers Inventory	$108.1
TOTAL	$333.4

Part 4 of the bill repeals all of these reimbursements. Because all reimbursement amounts are either fixed or frozen, no growth is included in the estimate.

Increase State Sales Tax

Part 5 of the bill increases the state sales tax rate by ½% to 4-½%. The new tax does not apply to food. The General Assembly's Fiscal Research Division and the Office of State Budget, Planning and Management have agreed to sales tax revenue projections and growth rates that create the following revenue forecast:

(Millions)		
Fiscal Year	**Revenue from 1 cent**	**Revenue from 1/2 Cent**
2001-02	$765.20	$382.60
2002-03	$797.30	$398.65
2003-04	$839.60	$419.80
2004-05	$882.40	$441.20
2005-06	$925.60	$462.80

The estimates above assume a full year of tax. However, this tax becomes effective December 1, 2001 and sunsets October 1, 2004. After adjustments for the effective and sunset dates, this portion of the bill will generate the following state revenue stream.

Fiscal Year	Potential Total Revenue
2001-02	$198.40
2002-03	$398.65
2003-04	$419.80
2004-05	$110.30

Create State Earned Income Tax Credit

The federal government has offered an earned income tax credit since 1975. A recipient must be a US citizen or resident alien for the entire year. The credit is for earned income such as wages, tips, and earnings from self-employment, but not unearned income such as pensions, Social Security benefits, workfare, or unemployment benefits. The taxpayer's investment income must be $2,400 or less.

For the 2000 federal tax year, a taxpayer must have a gross income of under $27,413 with one qualifying child or a gross income under $31,152 with two or more qualifying children. A qualifying child can be a son, daughter, adopted child, grandchild, stepchild or foster child under age 19 (under age 24 if full-time student) or any age if disabled. The qualifying child must live in the taxpayer's household more than six months. To receive the earned income credit without children, a taxpayer's income must be under $10,380 and the taxpayer must be at least age 25 but under age 65.

The amount that a taxpayer can receive from the federal earned income tax credit is found in the Earned Income Tax Credit (EITC) Table in the 1040 Instructions booklet printed by the Internal Revenue Service (IRS). For the 2000 tax year, the following credits apply:

A. **Childless Taxpayer** = The maximum credit earned is $353 with an income between $4,600 and $5,800. For every $50 increase in income after $5,800, the credit is reduced $3 to $4. The credit is phased out entirely at $10,350 in income.

B. **Taxpayer with One Child** = The maximum credit is $2,353 with an income between $6,900 and $12,700. For every $50 increase in income after $12,700, the credit is reduced $8. The credit is phased out entirely at $27,400 in income.

C. **Taxpayer with Two or More Children** = The maximum credit is $3,888 with an income between $9,700 and $12,700. For every $50 increase in income after $12,700, the credit is reduced $10 to $11. The credit is phased out entirely at $31,152 in income.

A state earned income tax credit is offered in fourteen states. Twelve of the fourteen states piggyback on the federal earned income tax credit, expressing the state rate as a percentage of the federal credit. The following states offer state earned income tax credits:

Refundable	% of Federal Credit
Colorado	10%
Kansas	10%
Maryland	15%
Massachusetts	15%
Minnesota	33% (average, varies by earnings)
New Jersey	10% (income <$20,000)
New York	22.5%
Vermont	32%
Wisconsin	4% - one child
	14% - two children
	43% - three children

Non- refundable	% of Federal Credit
Illinois	5%
Iowa	6.5%
Maine	5%
Oregon	5%
Rhode Island	26%

In 1998, the Internal Revenue Service reported that 642,853 North Carolinians with adjusted gross income of less than $30,000 filed returns with earned income tax credits (EITC) worth $1.036 billion. Of the North Carolina taxpayers that requested the EITC, 535,388 received refunds totaling $896.6 million. North Carolinians received refunds for 86.6% of their earned income credit in 1998. Preliminary numbers for the 1999 tax year show 628,571 taxpayers received $1.047 billion in earned income tax credits.

Among 1998 federal taxpayers with earned income tax credits, North Carolina residents made up 3.31% of the total US returns and received 3.36% of the US earned income tax credit amounts. The U.S. Treasury projects the EITC to grow from $30.45 billion in FY 1998-99 to $35.46 billion in FY 2004-05. Assuming North Carolinians continue to receive 3.36% of the U.S. earned income tax credits, the EITC benefits received by North Carolina residents will be as follows in the next five years.

FY 2001-02	$1,071 million
FY 2002-03	$1,104 million
FY 2003-04	$1,147 million
FY 2004-05	$1,192 million
FY 2005-06	$1,240 million

Assuming 100% participation in the state EITC program, the 10% state credit established in Part 6 of the bill would yield the following tax benefit:

FY 2002-03	$110.4 million
FY 2003-04	$114.7 million
FY 2004-05	$119.2 million
FY 2005-06	$124.0 million

It is unlikely that 100% participation will be achieved in the first year or two of an EITC program due to the lack of taxpayer awareness about the credit and the need to file a state tax return for those persons not filing state returns now. States with refundable credits have experienced 80% to 85% participation in the first year after enactment. In a 1999 telephone interview with the Wisconsin Department of Revenue, tax officials estimated that only 85% of the taxpayers eligible for the Wisconsin EITC applied for the credit in the program's first year. In Minnesota, the state Revenue Commissioner reported in 1997 that 10,000 Minnesota residents who qualified for the federal EITC failed to file state returns to collect the Minnesota EITC. These 10,000 citizens represented 15% of the eligible population. The New York Department of Taxation and Revenue found that only 83% of the taxpayers eligible for the state EITC applied in the program's first year. The number of applicants rose to 90% of eligible taxpayers in the second year of the EITC.

This fiscal note assumes that North Carolina taxpayers will follow the pattern of other state taxpayers in applying for a state EITC. In Tax Year 2002, it is assumed that 85% of the eligible taxpayers will apply for the credit. In Tax Year 2003, taxpayer awareness of the credit should increase and so will the percentage applying for the credit increase to 95%. By 2004, applications are assumed to reach 100%. Applying these percentages to the numbers shown above, the revenue impact will be as follows:

FY 2002-03	$93.8 million
FY 2003-04	$109.0 million
FY 2004-05	$119.2 million
FY 2005-06	$124.0 million

The first fiscal year impact will be in FY 2002-03 when taxpayers file their 2002 tax returns in the spring of 2003 to receive the refundable credit. Changes in employee income tax withholding are not anticipated.

Create New Tax Bracket for Taxable Income Over $200,000

Individual income tax rates are now 6%, 7%, and 7.75% as shown below.

Filing status		Taxable income is more than	But not over
	6%	$0	$12,750
Single	7%	$12,750	$60,000
	7.75%	$60,000	
	6%	$0	$17,000

Head of Household	7%	$17,000	$80,000
	7.75%	$80,000	
	6%	$0	$21,250
Married Filing Jointly	7%	$21,250	$100,000
or Qualifying Widow(er)	7.75%	$100,000	
	6%	$0	$10,625
Married Filing	7%	$10,625	$50,000
Separately	7.75%	$50,000	

Part 7 of the bill adds a new tax bracket for taxable incomes that are twice the current top rate as shown in the chart below.

8.0% for taxable incomes over:

$200,000	Married filing jointly
$160,000	Head of household
$120,000	Single
$100,000	Married filing separately

In tax year 2001, this tax increase will impact 9,848 single filers, 52,455 married couples, and 1,148 heads of households. The new 8% tax bracket sunsets after tax year 2003. The revenue estimates below were calculated using the North Carolina Individual Income Tax Model.

FY 2001-02	$62.8 mil.
FY 2002-03	$51.5 mil.
FY 2003-04	$30.8 mil.

First year revenues equal all of Tax Year 2001 for returns filed in spring 2002 and 45% of Tax Year 2002 because of withholding and two quarterly estimated payments. High-income taxpayers avoid a penalty if estimated payments during the tax year equal at least 90% of actual liability. In the FY 2002-03, taxpayers will pay the remaining 55% of the tax due in tax year 2002 and again pay 45% in estimated payments for tax year 2003. FY 2003-04 is equal to the remaining 55% of tax year 2003.

Equalize Taxation of HMOs & Medical Service Companies

I. HMOs

Under current law, HMO's are not subject to a gross premiums tax but do pay corporate income and franchise taxes and the insurance regulatory fee. Regular insurance carriers pay a 1.9% premiums tax and no corporate income or franchise tax.

According to Department of Revenue reports from HMO's, the historical premium volume that would be subject to the tax is:

Tax Year	Taxable Premiums ($ Billions)
1998	$1.568
1999	1.825
2000	2.180

This data indicates annual growth of 17.9%. For this estimate, an annual growth estimate of 10.0% was used. This yields $2.40 billion of taxable premiums for 2001 and $2.64 billion for 2002. The application of a 1.0% tax rate in Part 8 of the bill produces $26.4 million for the 2002-03 fiscal year.

Part 8 of the bill exempts HMO's from the corporate income and franchise taxes. According to the Tax Research Division of the Department of Revenue, these payments amounted to $3.63 million for the 1999 tax year. This amount was grown by 19% for 2000 and by 10% for 2001 and future years. The resulting corporate liability forecast is $4.63 million for 2002 (2002-03 fiscal year). In this analysis, it is assumed that the companies take their offset through lower final tax payments or higher refunds, not lower estimated tax payments. Thus, the calendar year change converts to fiscal year.

Finally, the fact that HMO's will make installment payments in April and June 2003 in addition to 2002 tax year payments in March 2003 means that in theory the 2002-03 fiscal year could contain a one-time windfall of $17.6 million. However, the statutes do allow an exemption from the required installment payments under certain circumstances. For this reason, the estimate includes only 25% of the potential windfall.

The finalized estimate for the proposal to tax HMO's at 1%, effective beginning with the 2002 tax year, is shown below:

	($ Millions) 2002-03	($ Millions) 2003-04
Premium Tax-Recurring	$26.4	$29.0
Premium Tax-Nonrecurring	4.4	
Less: Repeal of Corporate Taxes	-4.6	-5.1
Net Impact	$26.2	$23.9

II. Medical Service Companies

Blue Cross/Blue Shield and Delta Dental now pay a .5% premiums tax and no corporate income or franchise tax. Regular insurance carriers pay a 1.9% premiums tax and no corporate income or franchise tax. Part 8 of the bill increases the gross premiums tax on medical service companies such as Blue Cross/Blue Shield and Delta Dental to 1%.

The first step in estimating the impact of the rate increase on Blue Cross/Blue Shield and Delta Dental was to review the recent history of taxable premiums for these carriers. This data was provided by the Department of Revenue, the agency that collects the existing .5% tax. The data for recent years is shown below:

Tax Year	**($ Billions) Taxable Premiums**
1997	$1.082
1998	1.185
1999	1.175
2000	1.256

This data indicates that the average annual growth rate during this period was 3.8%. To be conservative, this fiscal analysis uses a 2.0% rate, yielding an estimate of $1.307 billion for 2002. The application of the .5% rate increase in the bill would mean an additional $6.53 million for the 2002 tax year (2002-03 fiscal year).
In addition, there would be a one-time windfall for the 2002-03 fiscal year due to the fact that in April, June, and October of each calendar year insurance companies must pay installments on their tax liability for that year. Unlike the corporate income tax, the installment payments are not based on a percentage of estimated liability for the year, but are tied to the annual liability for the prior year. The required percentage for each installment payment is 33 1/3% of the prior year's liability. Thus, for the 2002-03 fiscal year the General Fund will receive not only 100% of the 2002 calendar year liability (for which no installment payments have been made) but also two installment payments against the 2003 tax year. These installments would be equivalent to 66 2/3% of the prior year's annual liability, or $4.35 million. However, the statutes do allow an exemption from the required installment payments under certain circumstances. For this reason, the estimate includes only 25% of the potential windfall, or $1.1 million.

Impose State Sales Tax on Spirituous Liquor

Part 9 of the bill imposes a 6% state sales tax on spirituous liquor effective October 1, 2001. The North Carolina Alcoholic Beverage Control Commission reports annually on its retail sales and the volume of bottles sold in its 392 stores. Retail sales have grown from $308.6 million in FY 1994-95 to $367.7 million in FY 1999-00. The average annual growth rate in this five-year period is 3.82%. The five-year projection for the 6% sales tax on retail liquor sales is based on FY 1999-00 actual sales inflated each year by 3.82%. This growth rate appears reasonable based on sales in the first nine months of FY 2000-01 that exceed the annual average. Since there is no readily available data to predict how North Carolinians will react to an increase in liquor prices, no adjustment is made in retail sales based on consumption. Sales tax collections in FY 2001-02 will be for only eight months given the October 1 effective date and a month lag in collections. Instead of a full year's collections of $23.8 million as shown in the chart below, the state will collect only $15.85 million.

Liquor Sales

	Retail Sales	6% State Sales Tax
FY 2000-2001	$381,703,699	
FY 2001-2002	$396,284,781	$23,777,087
FY 2002-2003	$411,422,859	$24,685,372
FY 2003-2004	$427,139,213	$25,628,353
FY 2004-2005	$443,455,931	$26,607,356
FY 2005-2006	$460,395,947	$27,623,757

Repeal Tax Break for Luxury Cars/No Fire & Rescue Vehicle Tax

Part 10 of the bill deletes the $1,500 cap on the 3% Highway Use Tax for non-commercial vehicles and exempt fire trucks and rescue vehicles owned by qualifying volunteer fire departments and volunteer rescue squads from the Highway Use Tax. The additional revenue generated from this section of the bill will go to the General Fund, not the Highway Trust Fund.

According to the Division of Motor Vehicles, approximately 4,800 vehicles were taxed at the maximum rate of $1,500 (corresponding to a vehicle price of $50,000) in FY1999-2000. The tax on these vehicles totaled $7.2 million. The actual average price of these vehicles is not available, but it is reasonable to assume that there is a gradual decline in the number of vehicles in each price bracket as the price moves higher. The number of vehicles in the price bracket from $48,000 to $49,000 was 390. It is assumed that there were 300 vehicles in the price bracket from $49,000 to $50,000 and that there is a constant percentage decline in the number of vehicles as the price bracket changes. Because the number of vehicles in each tax bracket decreases as the tax brackets increase, the average tax paid by vehicles in each bracket is something less than the midpoint of the bracket. That is, in each bracket most of the vehicles are clustered toward the lower end. It is assumed that in each $30 tax bracket the average vehicle will have a tax due of $10 greater than the minimum for that bracket. Using this methodology, the average value of the 4,800 vehicles that paid the maximum tax in FY1999-2000 was $66,350 and the additional tax that would have been paid for the average vehicle was $491 (equal to 3% of the average value in excess of $50,000). In FY1999-00 the fiscal impact would have been the number of vehicles (4,800) multiplied by the additional tax per vehicle ($491), or $2,358,296. This figure is used as the base and the fiscal impact is assumed to grow for the fiscal note forecast period by the same percentage as the Highway Use Tax collections as projected by the Office of State Budget, Planning and Management (see table below).

Forecast Growth Rate in Highway Use Tax

Fiscal Year	Growth Rate
FY2000-01	1.6%
FY2001-02	3.0%

FY2002-03	7.8%
FY2003-04	5.8%
FY2004-05	5.7%
FY2005-06	5.2%

Section 10(d) of the bill exempts vehicles purchased by volunteer fire departments. According to the Department of Insurance, approximately 1,000 volunteer fire departments would qualify for this tax exemption. Each of those departments will have approximately three qualifying vehicles that are replaced on a twenty-year cycle. The result is that approximately 150 vehicles are purchased each year. Based on their high cost and weight (generally over 26,000 pounds), the loss in Highway Use Tax would be 150 vehicles at $1,000 each or about $150,000 per year.

Section 10(d) also exempts vehicles purchased by volunteer rescue squads. According to the North Carolina Association of Rescue and EMS, there are approximately 400 rescue squads that would qualify under the legislation. On average, these rescue squads would have approximately 1.5 emergency service vehicles each and the State total would be about 600 vehicles. Since these vehicles are replaced about every eight years on average, there will be approximately 75 emergency service vehicles purchased each year. These vehicles generally cost over $50,000 but they generally weigh less than 26,000 pounds and would therefore be taxed at $1,500 per vehicle. The loss in Highway Use Taxes would therefore be 75 vehicles at $1,500 each or about $112,500 per year.

The net impact of the Highway Use Tax changes is shown below. The first year revenue is reduced by one fourth ($1.7 million) due to an October 1, 2001 effective date.

	FY 01-02	**FY 02-03**	**FY 03-04**	**FY 04-05**
Highway Use Tax (delete $1500 cap)	**$2,467,910**	**$2,660,407**	**$2,814,710**	**$2,975,149**
Highway Use Tax (exempt vehicles)	**($262,500)**	**($262,500)**	**($262,500)**	**($262,500)**
Net impact	**$2,205,410**	**$2,397,907**	**$2,552,210**	**$2,712,649**

Begin Sales Tax Holiday

Part 11 of the bill creates a temporary, three-day sales tax exemption for clothing, clothing accessories, school supplies, computers, printers, and educational software. The exemption does not apply to clothing and footwear items that exceed $100.00. This is generally referred to as a sales tax holiday. The temporary exemption or “holiday” occur each year over the first weekend in August. Some version of a sales tax holiday exists in seven other states and the District of Columbia.

Arthur Andersen Consulting, under contract with the National Retail Federation, developed a model to be used by states to determine the sales tax impact of a variety of sales tax holidays. This model incorporates data from the U.S. Census Bureau of Economic Analysis, U.S. Catalog Market Report, Forrester Research, Eggert's Blue Chip Estimates, the Florida Retail Association, the Texas Controller's Office, and various state governments.

Assuming a three-day exemption that applies to clothing, accessories, and footwear with a $100 per item cap, the model indicates a FY 2002-03 state revenue loss of $8.31 million. One-half of that amount or $2.91 is the expected local loss.

The sales tax holiday also includes computers, printers, printer supplies, and educational software ($3,500 cap). A similar sales tax holiday for computers exists in Pennsylvania. Using results of that computer sales tax holiday as a proxy for North Carolina, making adjustments for population and income, suggests this portion of the holiday will cost an additional $2.5 million in the first year.

Combining these loss figures, using a 4% growth rate, and taking into account the new sales taxes provision included in the primary bill, creates the following five-year cost estimate.

($million)

	2001-02	2002-03	2003-04	2004-05	2005-06
State	0	9.39	9.77	9.28	9.35
Local	0	5.19	5.40	5.62	5.84

Note: Interpretation of this bill section by the Department of Revenue could alter the fiscal impact of the legislation.

Expenditures

I. Sales Tax Changes

The Department of Revenue has projected that the implementation cost of a half cent sales tax with a 105% hold harmless clause will be $1,470,321 in nonrecurring expenses and $116,886 in recurring expenses in FY 2001-02. Future recurring costs are estimated to be $386,357 per fiscal year. The Department requests the following nonrecurring expenses:

Planning, Development & Technology	FY 2001-02
Contractual Services	$750,000
Computers	$23,000
Taxpayer Assistance	
Temporary Wages	$54,000
Social Security Contribution	$4,131
Examination and Collection	
Temporary Wages	$54,000
Social Security Contribution	$4,131

Administrative Services	
Temporary Wages	$9,000
Social Security Contribution	$689
Postage/Forms	$350,000
Furniture/Office Equipment	$27,600
Documents/Payment Processing	
Temporary Wages	$180,000
Social Security Contribution	$13,770
Total Nonrecurring Expenses	$1,470,321

The recurring expenses proposed by the Department are for 5 new positions in the Examination and Collections Division and 1 position in Taxpayer Assistance. The first year salaries and benefits in the chart below are for 3 months for five positions and 6 months for one position.

	FY 2001-02	FY 2002-03
Planning, Development & Technology		
Maintenance Agreements - Equipment/Software	$1,800	$1,800
Taxpayer Assistance		
Salaries (1 position - 1/1/02)	$25,865	$51,729
Fringe Benefits	$5,179	$10,356
Examination and Collection		
Salaries (5 positions – 4/1/02)	$59,007	$236,030
Fringe Benefits	$12,060	$48,242
Travel - In state	$10,000	$40,000
Administrative Services		
Telephone service/General office supplies	$2,975	$5,100
Total Recurring Expenses	$116,886	$393,257

NOTE: Current law allows the Department of Revenue to reduce local sales tax distributions to absorb the cost of collection. While the bill does not explicitly give the Department this authority for the new tax, the data used to calculate revenues includes that administrative expense. Recent reports from the Department indicate that the cost of collection is $0.484 per $100.00 of collections. Applying this ratio to the estimated statewide revenues suggests that $1.11 million has been allocated from the FY 2001-02 revenues for administration. In FY 2002-03 that amount increases to $1.9 million. Out year projections include $2.0 million in FY 2003-04, $2.1 million in FY 2004-05, and $2.2 million in FY 2005-06.

II. Income Tax Withholding Tables

To implement the new 8.0% tax rate and increased standard deduction, the Department of Revenue estimates that it will need a one-time appropriation of $143,228 in FY 2001-02. These funds will be used to print and mail revised withholding tables to employers.

III. State Earned Income Tax Credit

Of the 642,853 North Carolinians with adjusted gross income of less than $30,000 that filed returns with earned income tax credits (EITC) in 1998, 535,388 taxpayers received a refund of their earned income tax credit. It is the Department's belief that these federal taxpayers are not filing a state tax return because the standard deduction and personal exemptions reduce their state tax liability to zero. However, this fiscal note assumes these taxpayers will return to the tax rolls to collect the state EITC. The Department estimates that the first year cost of printing and mailing forms to these new taxpayers will be $913,143 in FY 2002-03. The Department estimates the recurring cost of administering the EITC is $919,610 each year. The Department has provided the following expenditure detail:

	FY 2002-03	FY 2003-04
Accounting Division		
Labor	$16,253	$18,361
Additional checks & envelopes	$23,428	$23,428
Postage	$181,900	$181,900
Returns Processing Division		
Labor	$437,741	$437,741
Personal Taxes Division		
Tax Forms and Instructions	$33,940	$172,580
Labels & envelopes	$16,201	
Postage	$203,680	$85,600
Total Recurring Expenses	$913,143	$919,610

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