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Analyzing the Financial Impact of the 2007 Medicaid Funding Reform Legislation on North Carolina Counties

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Introduction

The General Assembly enacted comprehensive Medicaid funding reform legislation in the 2007 Appropriations Act (S.L. 2007-323) after years of intense lobbying by counties across the state. The cornerstone of the legislation is the state assuming the counties' Medicaid costs,[1] but it contains several other provisions that impact county revenue. Specifically, in exchange for the elimination of the counties' Medicaid costs, the legislation temporarily reduces county allocations from the Public School Building Capital Fund (PSBCF), phases out the counties' authority to levy a one-half cent local option sales and use tax (local sales tax), and requires counties to hold municipalities harmless for their loss in local sales tax revenue. The Appropriations Act also requires the state to guarantee counties a certain return as a result of the exchange of Medicaid costs for local sales tax revenue (Medicaid swap) and provides counties with a choice of an additional local option revenue source pending voter approval.

In order to understand the financial impact of the legislation on North Carolina counties, it is important to look both at the individual effect of each of these provisions and their collective impact on counties' expenditures and revenues. It is particularly important to recognize that, aside from the new local option revenue sources, most of the financial "gain" to counties from the funding reform legislation does not result from an actual increase in revenue—instead, the gain results from the state assuming the counties' Medicaid costs.[2] The corresponding financial "loss" to counties, however, from

1. The counties' Medicaid costs as of July 2007 were 15 percent of the non-federal share of Medicaid costs and Medicare Part D clawback payments, excluding administrative costs. The state will assume the counties' share of Medicaid costs, excluding the administrative costs, over a three-year period.

2. Some counties may receive additional revenue from the state because of a provision in the legislation requiring the state to guarantee counties a financial gain of at least $500,000 as a result of the Medicaid swap. This revenue guarantee is described in the final section of this bulletin.

the one-time reduction in allocations from the PSBCF, the repeal of a portion of the local sales tax authorization, and the municipal hold harmless payments, does result in an actual decrease in county revenue. In other words, the legislation reduces county expenditures on Medicaid and, in exchange, reduces county revenue. Despite the projected revenue losses, most counties will experience an aggregate financial gain as a result of the comprehensive funding reform—although the amount of financial gain is likely to vary significantly among counties.[3]

This bulletin provides an overview of the various legislative provisions, separating them into two key sections. The first section details the changes in revenue that will cause a financial loss to counties. Proceeding chronologically, it begins by describing the temporary decrease in PSBCF funds during FY 2007–08 and the current local sales tax scheme. It then presents a comprehensive overview of how the legislation alters local sales tax levies beginning in FY 2008–09 and provides an illustrative example of the potential financial impact on a hypothetical county. The second section describes the legislative provisions that will generate a financial gain for counties—including a brief summary of the states' assumption of counties' Medicaid costs, a more detailed discussion of the $500,000 revenue guarantee to counties and, finally, an overview of the additional local option revenue sources now available to counties pending voter approval.

Financial Loss to Counties

In exchange for the state assuming the counties' Medicaid costs, the legislation reduces county revenue sources. In the first fiscal year, FY 2007–08, it decreases the average daily membership (ADM) funds allocated to counties from the PSBCF during FY 2007–08.[4] Thereafter, it repeals the counties' authority to levy the Article 44 local sales tax over a two-year period and requires the counties to hold municipalities harmless for any loss in their local sales tax revenue. The legislation also changes the allocation method of the Article 42 proceeds, which may have a negative financial impact on some counties. Each of these provisions is discussed in turn.

PSBCF Allocation Reduction

During FY 2007–08 only, the legislation reduces the amount of each county's PSBCF funds by the lesser of 60 percent of the expected ADM allocation or 60 percent of the amount of the county's

3. Under the current legislation, some counties may experience a net financial loss, at least in the short-term, as a result of the Medicaid funding reform legislation because of low Medicaid-eligible populations. The financial loss may be mitigated by adoption of one of the two new local option revenue sources. Based on current Medicaid cost escalation projections, all counties likely will experience a net financial gain in the long-term.

4. The PSBCF was established by the General Assembly to assist county governments in meeting their public school building capital needs and their equipment needs under their local school technology plans. The state makes quarterly distributions to the PSBCF from a portion of its corporate income tax revenue. This revenue is then allocated to each county on a per ADM basis and placed in an ADM allocation account maintained by the Department of Public Instruction (DPI). A county and its local board of education must jointly apply to DPI for distribution of the allocated funds on a project-by-project basis. A local match of one dollar of local funds for every three dollars of state funds must be identified and designated for the requested project, except for school technology projects. If approved by DPI, the requested funds are transferred to a disbursing account established for the county in the State Treasurer's Office and made available for expenditure by the county's finance officer. *See* N.C. Gen. Stat. § 115C, Art. 38A (2007) (hereinafter, G.S.); *Procedures Manual: Public School Building Capital Fund*, School Planning, Division of School Support, NC Department of Public Instruction (2003), *available at* http://www.schoolclearinghouse.org/otherinf/ADMFund/ADMfund.htm (last visited Dec. 29, 2007).

Medicaid share assumed by the state during this fiscal year.[5] Counties must hold their local public school districts harmless for the reduction in ADM funds. Specifically, a county must "use" funds equivalent to the difference in what the county would have been allotted in ADM funds under G.S. 115C-546.2(a) and what actually is allotted to the county's ADM allocation account (public school hold harmless revenue) for purposes set out in G.S. 115C-546.2(b).[6] The ADM funds may be expended in FY 2007–08 or likely may be placed in a capital reserve account for future expenditure for one or more of the authorized purposes.[7] Unlike the funds a county receives from the PSBCF, the county and local board of education do not need to seek approval from the Department of Public Instruction before expending the public school hold harmless revenue and the county does not have to supplement the public school hold harmless revenue with a specified match of local revenue.

Repeal of Local Sales Tax Authority

Current Local Sales Tax Scheme

Before analyzing the impact of the Medicaid funding reform legislation on local sales tax revenue, it is useful to review the current local sales tax scheme. North Carolina counties are authorized to levy up to 2.75 percent (2.75 cents per $1.00) in local sales taxes. The 2.75 percent is comprised of five separate local sales taxes—all counties levy four of the five taxes totaling 2.5 percent. Counties received authorization from the General Assembly to levy an additional one-quarter cent local sales tax as of July 31, 2007 (bringing the total authorization from 2.5 percent to 2.75 percent), pending voter approval in individual counties.[8] All of the local sales taxes apply to specified base transactions.[9]

5. According to DPI, it will deduct 60 percent of the ADM allocation during the November 2007, February 2008, and May 2008 allocations because it has no way of knowing what the state will assume in Medicaid payments in FY 2007–08. DPI will adjust a county's allocation if the county's Medicaid payment assumed by the state is less than its ADM allocation at the end of FY 2007–08. *See State Assumes Medicaid Responsibilities, at* http://www.schoolclearinghouse.org/otherinf/ADMFund/ADMfund.htm (last visited Dec. 29, 2007).

6. G.S. 115C-546.2(b) specifies that a county must use the monies allocated from the Public School Capital Building Fund for "capital outlay projects including the planning, construction, reconstruction, enlargement, improvement, repair, or renovation of public school buildings and for the purchase of land for public school buildings; for equipment to implement a local school technology plan that is approved pursuant to G.S. 115C-102.6C; or for both." If the county determines that it does not need all or part of the funds allocated to it for the specified capital outlay projects, "the unneeded funds allocated to that county may be used to retire any indebtedness incurred by the county for public school facilities." Finally, if a county determines that its public school building needs and its school technology needs "can be met in a more timely fashion through the allocation of financial resources previously allocated for purposes other than school building needs or school technology needs . . . the county commissioners may, with the concurrence of the affected local board of education, use those financial resources to meet school building needs and school technology needs and may allocate the funds it receives [from the Public School Building Capital Fund] for purposes other than school building needs or school technology needs to the extent that financial resources were redirected from such purposes."

7. The legislation states that "In fiscal year 2007-2008, a county must use a portion of the revenue that is available to it, as a result of the assumption by the State of part of the county's Medicaid payments, for the purposes set out in G.S. 115C-546.2(b). The portion that must be used for these purposes is an amount equal to the difference between what the county would receive under G.S. 115C-546.2(a) based on its per average daily membership and the adjusted amount it receives [as a result of the ADM funds reduction calculation]." It is likely that the legislature intended that counties supplement their appropriations to local school districts by the amount of the ADM funds reduction in FY 2007–08, although there is no specific non-supplant language in the legislation.

8. *See* G.S. 105, Art. 46. A county may not levy the additional one-quarter cent local sales tax if it levies a local land transfer tax pursuant to Article 60 of Chapter 105 of the North Carolina General Statutes.

9. The list of base transactions is found in G.S. 105-467.

Three of the local sales taxes (totaling 2 percent) apply to the sale of certain food products exempt from the state sales and use tax under G.S. 105-164.13B (exempt food products).

The taxes are characterized by the articles in G.S. Chapter 105 under which they are levied, and the proceeds attributable to each tax are allocated among the counties by one of two methods—the per capita method, whereby the proceeds are placed in a statewide pool and allocated among the counties based on relative populations, or the point-of-origin method, whereby the proceeds are returned to the counties to which the goods were delivered. The following list details each tax, describing both its application and the allocation method of its proceeds.

- Article 39 One Cent Tax:[10] Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.
- Article 40 One-Half Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated among the counties on a per capita basis.
- Article 42 One-Half Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated among the counties on a per capita basis.
- Article 44 One-Half Cent Tax:[11] Applies to the base transactions only; it does not apply to the sale of exempt food products. One-half of the proceeds are allocated on a per capita basis and one-half of the proceeds are allocated on a point-of-origin basis.
- Article 46 One-Quarter Cent Tax: Applies to the base transactions only; it does not apply to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.

Once the tax proceeds are allocated among the counties, the DOR distributes revenue from the Articles 39, 40, 42 and 44 taxes among each county and its eligible municipalities according to one of two distribution formulas—per capita or *ad valorem*. The board of county commissioners of each county selects the distribution formula and may change it in April of each year, taking effect for the following fiscal year.

Under the per capita formula, the county's total population is added to the population of all eligible municipalities in the county. This adjusted population figure is divided into the local sales tax revenue available to the county to determine the county's per capita amount. The resultant figure is then multiplied by the population of the county and each eligible municipality to determine each unit's share of the county's allocation.

Under the *ad valorem* formula, the tax levy of the county and the tax levy of each eligible municipality are added to determine the total levy. Each taxing unit's levy as a proportion of the total levy represents the proportion of the local sales tax revenue that each taxing unit receives. Ad valorem

10. References to the Article 39 one cent tax include the Mecklenburg County one cent sales and use tax under S.L. 1967-1096. Mecklenburg County also levies an additional 0.5 percent local sales tax pursuant to local legislation, the proceeds of which are restricted to funding public transportation.

11. Some counties receive an additional distribution based on the transitional hold harmless provisions in G.S. 105-521. During the 2001 legislative session, the General Assembly repealed reimbursements that had been made to local governments by the state since the mid-1980s in compensation for the loss, through legislative action, of important local government revenue sources, including the removal from the property tax base of manufacturers', wholesalers', and retailers' inventories, the repeal of the intangibles tax, the expansion of the property tax homestead exclusion, and the repeal of the sales tax on food stamp purchases. In an effort to mitigate any adverse effect on local governments from the repeal of the reimbursements, the legislature authorized counties to levy the Article 44 tax and adopted a transitional hold harmless provision in G.S. 105-521 to compensate any county that received less revenue from the new tax than it would have received from the reimbursements during the 2002-03 fiscal year. The transitional hold harmless payment currently sunsets in 2012.

tax figures used in the formula are those of the fiscal year immediately preceding the fiscal year in which the distributions are made.

The DOR distributes the proceeds of the Article 46 tax (if levied) to the county only—there is no requirement and, in fact, no authorization for a county to share the proceeds with municipalities in the county.

Municipalities may spend their portion of local sales tax proceeds for any public purpose that they are authorized to undertake, and counties may do the same with the proceeds of the Article 39 one cent tax, the Article 44 one-half cent tax, and (if levied) the Article 46 one-quarter cent tax. For counties, however, the proceeds of the other two one-half cent taxes are partially earmarked until at least 2011; for the Article 40 tax, 30 percent is earmarked, and for the Article 42 tax, 60 percent is earmarked for school capital outlay or for debt service on county borrowing for school projects.

Table 1 illustrates the current annual local sales tax distribution scheme for a hypothetical, representative county—Carolina County—which has one incorporated municipality located within its territorial boundaries. Carolina County's total population is 139,786, with a municipal population of 85,641. The county levies four of the five local sales taxes, totaling 2.5 percent. The table depicts how the revenue derived from the Articles 39, 40, 42, and 44 taxes is allocated to Carolina County and then shared between the county and its single municipality.

The total amount of the allocable proceeds to Carolina County collected by the state during the fiscal year is $41,426,769, which represents the county's portion of the revenue from the Articles 40, 42 and 44 taxes that is allocated among all 100 counties on a per capita basis and the revenue from the Articles 39 and 44 taxes that is derived from goods delivered in the county.

The proceeds allocated to Carolina County are distributed between the county and its incorporated municipality on a per capita basis, the distribution method selected by the county's board of commissioners. The county's share of the local sales tax is $25,688,504. This amount is determined by dividing the total distributable proceeds of $41,426,769 by the adjusted population of 225,427 (determined by adding the total county and municipal populations), which equals $183.77022 (the DOR uses five decimal places to calculate the per capita ratio). The per capita ratio of $183.77022 is multiplied by the total county population of 139,786 to determine the county's share of the local sales taxes of $25,688,504. The same methodology is used to determine the municipality's share, where the per capita ratio of $183.77022 is multiplied by the municipality's population of 85,641. The resulting amount is $15,738,265.

Table 1. Local Option Sales and Use Tax Allocation and Distribution for Carolina County

Population Figures for Carolina County		
County Population		139,786
Municipality Population		85,641
Adjusted Population		**225,427**
Allocation of Local Sales and Use Tax Proceeds to Carolina County		
Article 39 (1.0 percent point of delivery)	$	16,575,027
*Article 40 (.5 percent per capita)		8,705,149
*Article 42 (.5 percent per capita)		8,629,265
Article 44 (.25 percent per capita/.25 percent point of delivery)		7,517,328
Total Allocation		**41,426,769**
Distribution of Local Sales and Use Tax Proceeds to County		
Article 39	$	10,278,080
Article 40		5,398,013
Article 42		5,350,958
Article 44		4,661,452
Total Distribution		**25,688,504**
Distribution of Local Sales and Use Tax Proceeds to Municipality		
Article 39	$	6,296,947
Article 40		3,307,136
Article 42		3,278,307
Article 44		2,855,876
Total Distribution	**$**	**15,738,265**

*Note that the total distributable proceeds derived from both the Articles 40 and 42 taxes are based on a one-half cent tax and on a per capita allocation method. However, the amounts are different. This is primarily due to the statutory provisions in G.S. 105-501, requiring that certain monies (to support the DOR, the Property Tax Commission, the School of Government Training Program in Property Tax Appraisal and Assessment, and the Local Government Commission) be deducted from the proceeds of the Article 42 tax. This adjustment also impacts the cost of collection retained by the state and the per capita adjustments required by G.S. 105-486(b).

Changes to Local Sales Tax Scheme

While the Medicaid funding reform legislation does not alter the basic mechanics of the current local sales tax scheme, it does eliminate the counties' authority to levy the Article 44 one-half cent tax over a two year period—increasing the state's comparable sales and use tax by one-quarter cent as of October 1, 2008 and one-quarter cent as of October 1, 2009—and it changes the allocation method of the Article 42 one-half cent tax revenue among counties from per capita to point-of-origin. It also sets forth certain hold harmless provisions that impact the amount of local sales tax revenue actually distributed to counties.[12]

12. The legislation also makes conforming changes to the transitional hold harmless funds calculation in G.S. 105-521 to account for the repeal of the Article 44 tax.

October 1, 2008 through September 30, 2009

From October 1, 2008 through September 30, 2009, the authorization for the Article 44 one-half cent tax is reduced to one-quarter cent. All counties are authorized to levy up to 2.5 percent in local sales taxes (including the Article 46 one-quarter cent) during this time period. The net proceeds of the remaining Article 44 one-quarter cent tax are allocated on a point-of-origin basis—returned to the county in which the goods were delivered.

Each county is required to hold all eligible municipalities located within the county, and incorporated as of October 1, 2008, harmless for the loss of the Article 44 one-quarter cent tax. The monthly hold harmless payment for each municipality is calculated as 50 percent of the proceeds from the Article 40 one-half cent tax distributed to the municipality less revenue from the sale of exempt food products.[13] (In FY 2008-09, this amount is reduced to account for revenue distributed from the repealed portion of the Article 44 tax during the second quarter of the fiscal year.) The reason for indexing the hold harmless proceeds to the Article 40 one-half cent tax is to approximate the actual loss of revenue from the repealed portion of the Article 44 tax and to ensure that the funds reflect growth in local sales tax revenue over time. Figure A illustrates the municipal hold harmless calculation for FY 2008–09.

Figure A. Municipal Hold Harmless Calculation for FY 2008–09

A = Municipal Share of Art. 40 Proceeds (less proceeds from exempt food products)

.50 x A = Municipal Hold Harmless Amount*

*This amount is reduced by any actual distributions from the repealed portion of the Article 44 tax during October, November, and December 2008.

The proceeds are distributed directly to each eligible municipality by the DOR from the county's Article 39 local sales tax proceeds. While a county may levy up to 2.5 percent in local sales taxes (2.25 percent if it has not adopted the new Article 46 tax), the county will not receive its full share of the revenue because of the hold harmless requirement, causing its effective tax distribution[14] to be lower.

October 1, 2009 and Beyond

The authorization for the remaining Article 44 one-quarter cent tax is repealed as of October 1, 2009. All counties are authorized to levy up to 2.25 percent in local sales taxes (including the Article 46 one-quarter cent tax) after this date. The method for allocating the proceeds from the Article 42 one-half cent tax among the counties also switches from per capita to point-of-origin. The four remaining local sales taxes are as follows:

- Article 39 One Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.
- Article 40 One-Half Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated among the counties on a per capita basis.

13. The reason for backing out the revenue from the sale of certain food products exempt from the state sales and use tax under G.S. 105-164.13B is that the Article 44 tax does not apply to this subset of transactions.

14. For purposes of this bulletin, the term effective tax distribution refers to the percentage distribution of the proceeds received by a county or its municipalities from the local sales tax levied by the county.

- Article 42 One-Half Cent Tax: Applies to the base transactions and to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.
- Article 46 One-Quarter Cent Tax: Applies to the base transactions only; it does not apply to the sale of exempt food products. The proceeds are allocated on a point-of-origin basis.

Each county is required to hold all eligible municipalities located within the county, and incorporated as of October 1, 2008, harmless for the loss in revenue from the repeal of the entire Article 44 one-half cent tax. The monthly hold harmless payment for each eligible municipality is calculated as 50 percent of the Article 40 tax proceeds distributed to a municipality less revenue from the sale of exempt food products, plus 25 percent of the Article 39 tax proceeds distributed to a municipality less revenue from the sale of exempt food products.[15] (The amount determined by taking 25 percent of the Article 39 tax proceeds distributed to a municipality less revenue from the sale of exempt foods products is reduced to account for revenue distributed from the repealed portion of the Article 44 tax during the second quarter of FY 2009–10.) Figure B illustrates this calculation under Step 1. The reason for indexing the hold harmless amount to the Articles 39 and 40 tax proceeds is to approximate the actual loss of revenue from the repealed Article 44 tax and to ensure that the funds reflect growth in local sales tax revenue over time.

The hold harmless calculation also must factor in any increase or decrease in municipal revenue due to the change in the Article 42 tax proceeds allocation method from per capita to point-of-origin. To calculate the revised hold harmless amount, subtract the amount determined from taking 25 percent of the Article 39 tax proceeds distributed to a municipality from the amount determined from taking 50 percent of the Article 40 tax proceeds distributed to a municipality. This calculation approximates the effect of the allocation change in the Article 42 one-half cent tax because the Article 39 tax proceeds are allocated on a point-of-origin basis and the Article 40 tax proceeds are allocated on a per capita basis. Figure B illustrates this calculation under step 2. The difference, positive or negative, is added to the hold harmless amount to determine the revised hold harmless amount. Therefore, the hold harmless amount is increased if a municipality loses revenue because of the switch of the Article 42 tax revenue allocation method from per capita to point-of-origin. Alternatively, the hold harmless amount is decreased if a municipality gains revenue because of the switch in the allocation method.[16]

The proceeds are distributed directly to each eligible municipality by the DOR from the county's Article 39 local sales tax proceeds. Again, while a county may levy up to 2.25 percent in local sales taxes (2.0 percent if it has not adopted the new Article 46 tax), the county will not receive its full share of the revenue because of the hold harmless requirement, causing its effective tax distribution to be lower.

15. The reason for backing out the revenue from the sale of certain food products exempt from the state sales and use tax under G.S. 105-164.13B is that the Article 44 tax does not apply to this subset of transactions.

16. Under the current formulation, the revised hold harmless calculation negates the effect from the change in allocation method of the Article 42 tax proceeds on any municipality. In the original budget provision, S.L. 2007-323, the revised hold harmless amount was determined by subtracting 50 percent of the Article 40 tax proceeds distributed to a municipality less revenue from the sale of exempt food products from 25 percent of the Article 39 tax proceeds distributed to a municipality less revenue from the sale of exempt food products. The hold harmless payment distributed to the municipality increased by the absolute amount of the difference only if the resultant figure was negative. In other words, the revised hold harmless provision was intended to compensate only those municipalities that lose revenue as a result of the change in allocation method. S.L. 2007-345 (HB 714) modified the formula to both simplify the calculation and account for the fact that the Article 42 tax applies to certain food exempt from the state sales tax. The modified provision, however, is not limited to impacting only those municipalities that lose revenue as a result of the change in allocation method.

Figure B. Municipal Hold Harmless Calculation as of FY 2009–10

Step 1:

A = .50 x Municipal Share of Art. 40 Proceeds (less proceeds from exempt food products)
B = .25 x Municipal Share of Art. 39 Proceeds (less proceeds from exempt food products)*

A + B = Municipal Hold Harmless Amount

Step 2:

C = Municipal Hold Harmless Amount (calculated in Step 1)
D = .50 x Municipal Share of Art. 40 Proceeds
E = .25 x Municipal Share of Art. 39 Proceeds

C + (D – E) = Revised Municipal Hold Harmless Amount

*This amount is reduced by any actual distributions from the repealed Article 44 tax during October, November, and December 2009.

Table 2 illustrates the financial impact on Carolina County's local sales tax revenue after the total repeal of the Article 44 tax, which reduces its local sales tax from 2.5 percent to 2.0 percent, and the allocation change of the Article 42 tax proceeds.[17] The population figures and distributable proceeds used in Table 1 also are used in Table 2. There are two important differences, though. First, the distributable proceeds from Article 44 are not found in Table 2 because of the Medicaid swap. Second, the allocation method for the proceeds of the one-half cent Article 42 tax has been changed from the per capita to the point-of-origin basis, which lowers the amount distributed to the county from $8,629,265 to $8,420,448. This decrease suggests that Carolina County benefits more from the state-wide per capita allocation rather than the point-of-origin allocation.[18] The impact of these two changes lowers the total amount of allocable proceeds from $41,426,769 as shown in Table 1 to $33,700,624 as shown in Table 2.

The first column illustrates how the allocable proceeds of $33,700,624 would be shared between the county and its municipality using the per capita distribution method before the hold harmless payment is made to the municipality. The effective tax distribution for both the county and the municipality is 2.0 percent.

The second column includes the hold harmless payment to the municipality of $2,935,206, which is subtracted from the county's distribution of its Article 39 tax proceeds. The municipality's hold harmless payment represents the sum of: (1) 50 percent of its share of Article 40 (less proceeds from exempt food products) or $1,485,055; (2) 25 percent of its share of Article 39 (less proceeds from exempt food products) or $1,370,820; and (3) the amount determined by subtracting 25 percent of its share of Article 39 tax proceeds from 50 percent of its share of the Article 40 tax proceeds or $79,331. Because the hold harmless payment to the municipality is taken from the county's distribution of its Article 39 tax proceeds, Carolina County's effective tax distribution decreases to 1.72 percent. On the other hand, the municipality's effective tax distribution in this example increases to 2.46 percent. These percentages will vary among all 100 counties based on the number of municipalities within a county and their relative populations or their relative property tax levies.

17. Regardless of whether Carolina County adopts the new Article 46 tax, it would not be part of this calculation.

18. Note that some counties may receive compensation for the revenue loss due to the change in allocation method pursuant to the provisional revenue guarantee from the state, which is discussed later in this bulletin.

Table 2. Local Option Sales and Use Tax Allocation and Distribution for Carolina County (After Full Implementation of Medicaid Funding Reform Legislation)

	Before Municipal Hold Harmless	After Municipal Hold Harmless
Population Figures for Carolina County		
County Population	139,786	139,786
Municipality Population	85,641	85,641
Adjusted Population	**225,427**	**225,427**
Allocation of Local Sales and Use Tax Proceeds to Carolina County		
Article 39 (1.0 percent from point of delivery)	$ 16,575,027	16,575,027
Article 40 (.5 percent from per capita)	8,705,149	8,705,149
Article 42 (.5 percent from point of delivery)	8,420,448	8,420,448
Total Allocation	33,700,624	33,700,624
Distribution of Local Sales and Use Tax Proceeds to County		
Article 39	$ 10,278,080	10,278,080
Article 40	5,398,013	5,398,013
Article 42	5,221,472	5,221,472
Total Distribution	20,897,565	20,897,565
Effective Tax Distribution	**2.00**	**1.72**
Distribution of Local Sales and Use Tax Proceeds to Municipality		
Article 39	$ 6,296,947	6,296,947
Article 40	3,307,136	3,307,136
Article 42	3,198,976	3,198,976
Hold Harmless Payment		2,935,206
Total Distribution	$ 12,803,059	15,738,265
Effective Tax Distribution	**2.00**	**2.46**

Financial Gain to Counties

Understanding the impact of the Medicaid funding reform legislation on county revenue is important, but it cannot be considered in isolation. To fully comprehend the financial impact of the legislation, the changes to county revenue must be viewed within the context of the legislation's other provisions—the provisions that will generate a financial gain for counties.

State Assumes Counties' Medicaid Share

As of July 1, 2007, the counties' Medicaid costs was 15 percent of the non-federal share of Medicaid costs and Medicare Part D clawback payments. The legislation phases out the counties' share of these costs over a three-year period—with the state assuming 25 percent beginning October 1, 2007, 50 percent beginning June 1, 2008, and 100 percent beginning June 1, 2009.[19] Counties will continue to pay any local administrative expenses associated with their Medicaid programs.

State Guarantees Financial Gain to Counties

The state guarantees that all counties experience an annual financial gain of at least $500,000 as a result of the Medicaid swap. Based on current legislation, the guarantee is limited, however. It requires only that the difference between the financial gain a county experiences from the state assuming its Medicaid costs and the financial loss it experiences from either the loss in ADM funds or the loss of its projected share of the repealed Article 44 tax proceeds, plus any loss or gain in revenue from the change in the allocation method of Article 42 tax proceeds, is at least $500,000. The state will make a supplemental payment to the county for the difference if the amount is less than $500,000.[20] In determining whether a county qualifies for a supplemental payment from the state, the DOR does not account for the amount that the county must expend to hold municipalities harmless for the loss of their portion of the repealed Article 44 tax proceeds.[21]

For FY 2007–08, the state must reimburse the county for the absolute value of the difference if the amount of the county's Medicaid share paid by the state minus the amount by which the county's PSBCF allocation is reduced does not equal or exceed $500,000. (Recall that counties must use a portion of their additional revenue capacity to hold local school systems harmless for the reduction in ADM funds.) Figure C illustrates the county supplemental payment calculation for FY 2007–08.

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19. According to the authorizing legislation, the state assumes: (1) 25 percent of the counties' Medicaid claims from October 1, 2007 through May 31, 2008; (2) 50 percent of the counties' Medicaid claims from June 1, 2008 through May 31, 2009; and (3) 100 percent of the counties' Medicaid claims as of June 1, 2009.

20. To obtain revenue for the supplemental payments to any qualifying counties, the Secretary of Revenue must withhold proceeds from the sales and use tax collections under G.S. 105, Art. 5.

21. G.S. 105-523(a) states that "[i]t is the intent of the General Assembly that each county benefit by at least five hundred thousand dollars ($500,000) annually from the exchange of a portion of the local sales and use taxes for the State's agreement to assume the responsibility for the non-administrative costs of Medicaid." It is unclear from this language alone whether the Legislature intended that a county receive at least $500,000 net of the loss of its portion of the Article 44 proceeds only or net of the loss of these proceeds and the loss of Article 39 revenue because of the municipal hold harmless requirement. The actual supplemental payment calculation in G.S. 105-523(b), however, does not factor in any revenue loss to the county due to the municipal hold harmless requirement. According to the North Carolina Association of Conty Commissioners, the failure to include the municipal hold harmless payment in the county's supplemental payment calculation was the result of a technical drafting error.

As of this writing, a proposed technical correction has been drafted to include the municipasl hold harmless payment in the county supplemental payment calculation. If adopted by the General Assembly, additional counties likely will qualify for a supplemental payment from the state.

Figure C. County Supplemental Payment Calculation for FY 2007–08

A = Amount of County Medicaid Share Assumed by the State
B = Amount of County ADM Funds Reduction

If A – B < $500,000, then $500,000 – |A – B| = State Supplemental Payment to County*

*The state does not have to reimburse the county if the resulting amount is less than $100.

Thereafter, G.S. 105-523 requires the DOR to calculate the projected revenue loss to the county from the local sales tax changes and to compare that loss with the amount of revenue a county gains from the state assuming the county's Medicaid payments.

For the period after the first one-quarter cent of the Article 44 tax is repealed (October 1, 2008, through September 30, 2009), the state must reimburse the county for the absolute value of the difference if the amount of a county's Medicaid costs assumed by the state minus $500,000 (county hold harmless threshold) is less than the county's *repealed local sales tax amount*. A county's repealed local sales tax amount is calculated as 50 percent of the Article 40 tax proceeds distributed to a county less revenue from the sale of exempt food products. (This amount is reduced to account for revenue distributed from the repealed portion of the Article 44 tax during the second quarter of the fiscal year.) Figure D illustrates the county supplemental payment calculation for FY 2008–09.

Figure D. County Supplemental Payment Calculation for FY 2008–09

Step 1:

A = County Share of Art. 40 Proceeds (less proceeds from exempt food products)

.50 x A = Repeated Sales Tax Amount*

Step 2:

B = Amount of County Medicaid Share Assumed by the State
C = Repealed Sales Tax Amount (calculated in Step 1)

If B – $500,000, < C, then |C – (B – $500,000)| = State Supplemental Payment to County**

*This amount is reduced by any actual distributions from the repealed portion of the Article 44 tax during October, November, and December 2008.
**The calculation presented in this figure may change pending adoption of a proposed technical correction that includes the municipal hold harmless payment.

After the Article 44 tax is completely phased out on October 1, 2009, the state must reimburse the county for the absolute value of the difference if the amount of a county's Medicaid costs assumed by the state less $500,000 (county hold harmless threshold) is less than the county's repealed local sales tax amount.[22] A county's repealed local sales tax amount is calculated as 50 percent of the Article 40 tax proceeds distributed to a county less revenue from the sale of exempt food products, plus 25 percent of the Article 39 tax proceeds distributed to a county less revenue from the sale of

22. Note that, as of the date of this writing, there is a codification error in G.S. 523(b)(1), as of October 1, 2009, that states that the state must reimburse the county for the absolute value of the difference if the amount of a county's Medicaid costs assumed by the state "plus" $500,000 is less than the county's repealed local sales tax amount.

exempt food products.[23] (In FY 2009–10, this amount is reduced by any actual distributions from the repealed Article 44 tax during October, November, and December 2009.) Added to this figure is the amount, positive or negative, determined by subtracting 25 percent of the Article 39 tax proceeds distributed to a county from 50 percent of the Article 40 tax proceeds distributed to a county.[24] This calculation approximates the effect of the change in allocation method of the Article 42 one-half cent tax revenue because the Article 39 tax proceeds are allocated on a point-of-origin basis and the Article 40 tax proceeds are allocated on a per capita basis. Thus, if a county loses revenue because of the switch of the Article 42 tax revenue allocation method from per capita to point-of-origin, the repealed local sales tax amount is increased by the amount of the projected loss. Alternatively, if a county gains revenue because of the switch in allocation method, the amount of the projected gain lowers the repealed local sales tax amount. Figure E illustrates the county supplemental payment calculation beginning in FY 2009–10.

The state supplemental payments are made semiannually. The Secretary of Revenue estimates the hold harmless amount and sends each county 90 percent of the estimated amount with the March local sales tax distribution. The Secretary of Revenue determines the actual amount at the end of the fiscal year and remits the balance to each county by August 15.

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23. G.S. 105-472(b1) directs the Secretary of Revenue to reduce each county's monthly allocation of its Article 39 tax proceeds by the amount necessary to hold all eligible municipalities within its territory harmless for the loss of the Article 44 tax revenue. There is an ambiguity in the current statutory language as to whether the repealed local sales tax amount is calculated before or after the hold harmless funds due to eligible municipalities are subtracted from a county's Article 39 tax proceeds. According to the plain language of the statute, a portion of the repealed local sales tax amount is calculated as 25 percent of the Article 39 proceeds "distributed" to a county. This language implies that the repealed local sales tax amount is calculated after the hold harmless funds due to eligible municipalities are subtracted from the county's Article 39 tax revenue.

Viewing the statutory scheme as a whole, however, it does not appear that the legislature intended that the repealed local sales tax amount be calculated after the hold harmless funds due to eligible municipalities are subtracted from the county's Article 39 tax proceeds. First, the purpose of the repealed local sales tax amount is to approximate the loss to the county from the repeal of the Article 44 tax. In order to have an accurate approximation of that loss, the repealed local sales tax amount must be calculated as a percentage of the Article 40 and Article 39 proceeds due to the county before the municipal hold harmless funds are subtracted from the Article 39 proceeds. Second, G.S. 105-523(a)(2)c. requires that the repealed local sales tax amount be increased or decreased by the difference between 50 percent of the Article 40 tax proceeds and 25 percent of the Article 39 tax proceeds. The purpose of this calculation is to approximate the effect of the change in the allocation method of the Article 42 tax proceeds from per capita to point-of-origin. If the calculation is based on the Article 39 proceeds actually distributed to the county (after the municipal hold harmless funds have been subtracted), the formula does not accurately approximate the effect of the change in allocation method.

As of this writing, a technical correction has been drafted that would prevent this potential circular calculation.

24. Note that, as of the date of this writing, there is a codification error in G.S. 105-523, as of October 1, 2009, that states that the revised repealed sales tax amount is determined by subtracting 50 percent of the Article 40 tax proceeds distributed to a county, less revenue from the sale of certain food exempt from the state sales and use tax, from 25 percent of the Article 39 tax proceeds distributed to a county, less revenue from the sale of certain food exempt from the state sales and use tax. Only if the resultant figure is negative, is the hold harmless payment distributed to the county increased by the absolute amount of the difference.

Figure E. County Supplemental Payment Calculation as of FY 2009–10

Step 1:

A = .50 x County Share of Art. 40 Proceeds (less proceeds from exempt food products)
B = .25 x County Share of Art. 39 Proceeds (less proceeds from exempt food products)*

A + B = Repealed Sales Tax Amount

Step 2:

C = Repealed Sales Tax Amount (calculated in Step 1)
D= .50 x County Share of Art. 40 Proceeds
E = .25 x County Share of Art. 39 Proceeds

C + (D – E) = Revisesd Repealed Sales Tax Amount

Step 3:

F = Amount of County Medicaid Share Assumed by the State
G = Revised Repealed Sales Tax Amount (calculated in Step 2)

If F - $500,000 < G, then |G – (F – $500,000)| = State Supplemental Payment to County**

*This amount is reduced by any actual distributions from the repealed Article 44 tax during October, November, and December 2009.
**The calculation presented in this figure may change pending adoption of a proposed technical correction that includes the municipal hold harmless payment.

Table 3 illustrates how the Medicaid Swap impacts Carolina County. The county's hold harmless threshold is $7,311,036 as shown under Step 1, representing Medicaid costs assumed by the state of $7,811,036 minus the provisional revenue guarantee of $500,000. The county's revised rephead proceeds or $129,487 in this example. Because the hold harmless threshold (county benefit) is greater than the revised repealed sales tax amount (county loss), the county will not receive a supplemental payment from the state.

Table 3 also shows the financial impact on Carolina County from the Medicaid Swap under Step 2, which is a financial gain of $3,020,097. The gain is created because the economic benefit of the state assuming the county's Medicaid costs exceeds the actual loss of sales tax revenue.

Table 3. Impact of Medicaid Swap on Carolina County

Step 1: Calculating provisional guarantee from state		
County Benefit		
Medicaid Costs	$	7,811,036
Provisional Revenue Guarantee		(500,000)
Hold Harmless Threshold		**7,311,036**
County Loss		
50 percent of Article 40 (less food)	$	2,423,955
25 percent of Article 39 (less food)		2,237,497
Adjustment in Article 42 (per capita to point of origin)		129,487
Revised Repealed Sales Tax Amount		**4,790,939**
Step 2: Calculating financial gain/loss		
County Impact		
Medicaid Costs	$	7,811,036
Revised Repealed Sales Tax Amount		(4,790,939)
***Net Financial Gain (Loss)**	$	**3,020,097**

*Note that the net financial gain to Carolina County does not include the municipal hold harmless payment of $2,935,206 as shown in Table 2. Therefore, Carolina County experiences an actual financial gain of $84,891 in this example, representing the net financial gain of $3,020,097 minus the municipal hold harmless payment of $2,935,206.

New Local Option Taxes

Finally, the General Assembly authorized two new local option revenue sources for counties in addition to the Medicaid swap. The new revenue sources are intended to help counties fund additional services and facilities necessitated by growth, including, but not limited to, public school facilities and other infrastructure projects. As of July 1, 2007, the legislation allows counties to adopt either up to a 0.4 percent land transfer tax (in 0.1 percent intervals) or an additional one-quarter cent local sales and use tax (the Article 46 tax), the proceeds of which may be used for any public purpose. There is no requirement and, in fact, no authorization for a county to share the proceeds of either of these new revenue sources with municipalities.

A county must hold an advisory referendum on either additional revenue source and may hold a referendum on both at the same time.[25] If the majority of those voting in the referendum vote for the levy of the local land transfer tax or additional local sales tax, the board of county commissioners may adopt a resolution levying the tax after providing ten days' public notice. (If both ballot measures are successful, a board of county commissioners may implement either but not both of the additional revenue options.)

Local Land Transfer Tax

The local land transfer tax applies to transfers of interests in real property located within the county. It is payable by the seller of the interest and applies to the consideration or value, whichever is greater, of the interest conveyed, including the value of any lien or encumbrance remaining on the property at the time of the conveyance. If the property is located in two or more counties, a transfer of an interest in the property is taxable only by the county in which the part with the greater value lies.

The legislation specifically exempts certain transferors from the tax, specifically governmental units and instrumentalities of governmental units. It also exempts certain conveyances of interests in real property to the same extent that they are exempt from the state land transfer excise tax[26]—transfers that are required by operation of law; leases for a term of years; transfers by or pursuant to the provisions of a will, by intestacy, or by gift; transfers where no consideration in property or money is due or paid by the transferee to the transferor; transfers that are accomplished by merger, conversion, or consolidation; and transfers made by an instrument securing indebtedness.[27]

Once the levy of the land transfer tax is approved by the voters and authorized by a resolution of the governing board, it may become effective the first day of the second succeeding calendar month after the date the resolution is adopted.[28] No county has received voter approval to levy the land transfer tax as of the date of this writing.[29]

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25. The legislation prescribes the form of the ballot questions for both the local option land transfer tax and additional local option sales tax.

26. The state imposes an excise tax on each conveyance of an interest in real property at a rate of $1.00 per $500 of the consideration or value of the interest conveyed. The tax is collected by the register of deeds of each county. One-half of the proceeds are credited to the county's general fund and one-half of the proceeds, less the county's allowance for administrative expenses, are remitted to the Department of Revenue. G.S. 105, Art. 8E.

27. Unlike the state land transfer excise tax, the local land transfer tax does not apply to contracts for the sale of standing timber, although it is unclear whether it applies to timber deeds. See Kara A. Millonzi, *Local Finance, in* N.C. Legislation 2007 (Christine Wunsche ed. 2007).

28. The administrative provisions for the state land transfer excise tax, codified in G.S. 105-228.32 through G.S. 105-228.37, apply to the local land transfer tax. A county may repeal or reduce the rate of the local land transfer tax by resolution, but the repeal or reduction may not become effective until the end of the fiscal year in which the repeal or reduction resolution is adopted.

29. The local land transfer tax is projected to generate a significant amount of revenue for counties. The North Carolina Association of County Commissioners has provided revenue estimates for the local land transfer tax in each county, if levied at the maximum rate of 0.4 percent , at http://www.ncacc.org/documents/ revenueauthority_073107.pdf (last visited Nov. 27, 2007). It may prove difficult to actually levy, though. In the fall of 2007, 16 counties held a referendum on the local land transfer tax. The referendums failed to pass in any of the counties, often by a wide margin. Local land transfer tax referendums were defeated in Brunswick, Chatham, Davie, Gates, Graham, Harnett, Henderson, Hoke, Johnston, Macon, Moore, Pender, Rutherford, Swain, Union, and Washington Counties. *See* Todd McGee, *Five Counties See Sales Tax Approved by Voters, at* http://www.ncacc.org/revenueoptions_ 110607.html (last visited Nov. 27, 2007). Five of the counties put both the local land transfer tax and the additional local sales and use tax on the ballot; voters rejected both in all five counties. A county considering this option in the future likely will have to engage in

Article 46 Local Sales and Use Tax

As discussed previously, counties have authority to levy an additional one-quarter cent local sales tax (the Article 46 tax). The adoption, levy, collection, administration, and repeal of the Article 46 tax must be in accordance with the Article 39 local sales and use tax provisions,[30] except that the new tax does not apply to the sale of exempt food products. The proceeds of the new local sales tax also are allocated on a point of origin basis—returned to the county where the goods were delivered.

According to the authorizing legislation, the county commissioners must adopt a resolution to levy the tax once the additional local sales tax is approved by the voters in a county. The tax does not become effective until the first day of the calendar quarter after the resolution is adopted and only after the county gives the Secretary of Revenue at least sixty days advance notice. Six counties—Alexander, Catawba, Martin, Pitt, Sampson, and Surry —have received voter approval to levy the additional one-quarter cent local sales tax as of the date of this writing, but the tax has not yet become effective in any of the counties.[31]

Summary

The Medicaid swap as authorized in the 2007 Appropriation Act (S.L. 2007-323) represents a major financial reform for North Carolina counties. It eliminates the counties' Medicaid costs over a three-year period, which historically has been one of the fastest growing expenditure areas in county government. Another important feature of this reform is that it eliminates disparities among counties regarding the wide-range of Medicaid costs as a percentage of total county budgets. In exchange for the state assuming the counties' share of Medicaid costs, the legislation temporarily reduces county allocations from the Public School Building Capital Fund and phases out the counties' authority to levy a one-half cent local sales tax.

A critical aspect of the legislation is that counties are required to hold municipalities harmless for their loss in local sales tax revenue, which reduces the effective local sales tax rate of counties because the hold harmless proceeds are taken from the counties' local sales tax revenue. There is a provisional revenue guarantee for counties; however, not all counties will receive hold harmless payments from the state in the short-term and the growth in Medicaid costs should eliminate all hold harmless payments to counties in the long-term.

The General Assembly also recognized that escalating Medicaid costs are not the only financial difficulty facing North Carolina counties. Therefore, the new legislation gives counties the option of adopting one of two new local option revenue sources, pending voter approval, to aid them in funding other operational and capital needs

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a public information campaign to educate voters about the nature of the tax and the individual county's specific needs for additional revenue; even then there is no guarantee that a referendum will be successful.

30. Note, however, that G.S. 105-537 requires that the advisory referendum on the question of whether to levy the new local sales tax be held in accordance with the procedures of G.S. 163-287.

31. In the fall of 2007, 16 counties held a referendum on the Article 46 tax. The referendums were successful in five ofthe counties. The new local sales and use tax referendums were successful in Catawba, Martin, Pitt, Sampson, and Surry Counties. They failed in Columbus, Cumberland, Davie, Graham, Greene, Harnett, Hertford, Johnston, Lenoir, Robeson, and Rutherford Counties. *See* Todd McGee, *Five Counties See Sales Tax Approved by Voters, at* http://www.ncacc.org/revenueoptions_ 110607.html (last visited Nov. 27, 2007). Additionally, Alexander County held a successful referendum in January 2008. *See* Special Election, Alexander County, North Carolina, Official Results, *at* http://www.co.alexander.nc.us/index/jan_08_08.php (last visited Feb. 21, 2008).The earliest date that the new tax will take effect in any of these counties is April 1, 2008.

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