Impact on Local School Administrative Units of the 2007–2008 Legislation to Reform Medicaid Funding

By Kara A. Millonzi

In its 2007 Appropriations Act, the North Carolina General Assembly enacted a series of interrelated measures affecting Medicaid funding, state and local sales and use taxes, and the Public School Building Capital Fund (Medicaid funding reform legislation).[1] The cornerstone of the Medicaid funding reform legislation is the state's assumption of a large portion of the counties' Medicaid costs, which historically have been one of their fastest-growing areas of expenditure. The Medicaid relief comes with some costs to counties, though. To partially compensate the state for assuming the counties' Medicaid costs, the legislation reduces the state's allocation of revenues to counties for public school capital outlay and effectively converts a portion of the counties' local sales and use tax revenue to a state revenue source.

What is the fiscal impact of all these provisions on counties and local school administrative units? Will counties, for example, experience a net financial gain or loss? Will local school administrative units be compensated for the loss of state revenue allocations for public school capital outlay? Will the legislation affect other state and local funds currently available for local school administrative units? This article addresses these questions as it examines the complex Medicaid funding reform legislation and the legislation's effect on both counties and local school administrative units. The article briefly describes North Carolina's Medicaid program and explains how the program was funded before the Medicaid funding reform legislation. It then summarizes the legislation's major provisions and details each provision's likely financial impact on counties and local school administrative units.[2]

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1. S.L. 2007-323 § 31.16. Several of the legislation's provisions subsequently were modified by S.L. 2007-345 and S.L. 2008-134.

2. For a more comprehensive review of the Medicaid funding reform legislation, see Kara A. Millonzi and William C. Rivenbark, "Phased Implementation of the 2007 and 2008 Medicaid Funding Reform Legislation in North Carolina," *Local Finance Bulletin* No. 38 (September 2008).

North Carolina's Medicaid Program

Medicaid is a federal–state entitlement program that provides basic health care and long-term care for low-income citizens. It was established in 1965 when Congress enacted Title XIX of the Social Security Act.[3] Medicaid offers federal matching funds to states for the costs of paying health care providers to serve covered individuals. States are not required to establish Medicaid programs, but those that do must provide certain medical services to qualifying groups of low-income people, including children, pregnant women, people with disabilities, and senior citizens.[4] A state may choose to provide additional services, but it must administer its Medicaid program on a uniform, statewide basis.[5]

North Carolina implemented its Medicaid program on January 1, 1970.[6] The program is jointly administered by state and county agencies. Each county's department of social services manages Medicaid locally, processing applications and determining whether applicants are eligible for services. The state Department of Health and Human Services' Division of Medical Assistance administers Medicaid at the state level. Among its responsibilities are overseeing the processing of claims by and payments to medical providers, supervising local Medicaid administration by

3. 42 U.S.C. §§ 1396–1396v (2006).

4. Federally mandated services provided to Medicaid recipients include both inpatient and outpatient hospital care; nursing home care; physician services; laboratory and diagnostic x-ray services; immunizations and other screening, diagnostic, and treatment services for children; family planning, health center, and rural health clinic services; nurse midwife and nurse practitioner services; and physician assistant services. *See Medicaid in North Carolina: Annual Report, State Fiscal Year 2006* (Raleigh: Division of Medical Assistance, North Carolina Department of Health and Human Services, April 2007), www.dhhs.state.nc.us/dma/2006report/2006report.pdf (last accessed April 9, 2008).

5. Additional services provided under North Carolina's Medicaid program include clinical services, diagnostic testing, prescription drugs, dental care, eye care, mental health services, physical and occupational therapy services, hospice care, case management, private-duty nursing, and screening and preventive services. *See id.*

6. *Id.*

the counties, and ensuring that the administration of the state Medicaid program is consistent with federal and state requirements.

Federal, state, and county governments jointly finance North Carolina's Medicaid program, with the federal government paying the largest share of the costs. The federal share, established annually, is based on North Carolina's average per capita income over the most recent three years, as compared with the national per capita income.[7] As the state's per capita income increases, the federal payments for the state's Medicaid program decline.

Before fiscal year (FY) 2006–2007, North Carolina required counties to pay 15 percent of the nonfederal share of the costs of Medicaid services provided to county residents, plus any local administrative expenses associated with Medicaid that were not funded by the federal government.[8] In FY 2006–2007 the aggregate county Medicaid costs were estimated as approaching $488 million, reflecting an 85 percent increase since 2000. Citing rising Medicaid-eligible populations, escalating Medicaid costs, and lack of local control over those costs, counties sought permanent relief from their share of the Medicaid burden. The General Assembly responded in 2006, enacting a one-time cap on the county Medicaid share for FY 2006–2007. Specifically the legislation provided that the state would pay the aggregate county share of the nonfederal share of Medicaid payments (including Medicare Part D) that exceeded the county share for FY 2005–2006, to a maximum of $27.4 million.[9]

The relief was temporary, though, and the aggregate county Medicaid costs were projected to exceed $517 million in FY 2007–2008. Counties continued to lobby for a permanent solution. The legislature heeded their call in 2007 by enacting comprehensive Medicaid funding reform legislation that eliminates the counties' responsibility for the 15 percent of the nonfederal share of Medicaid costs.

Medicaid Funding Reform Legislation

The Medicaid funding reform legislation phases out the counties' share of Medicaid costs over a three-year period, with the state assuming 25 percent of the costs beginning October 1, 2007; 50 percent beginning June 1, 2008; and 100 percent beginning June 1, 2009.[10] Counties will continue to pay any local administrative expenses associated with their Medicaid programs that are not otherwise funded by the federal government. Administrative expenses generally include the costs of determining the eligibility of people who apply for services and of performing other functions required by the program; the amounts vary across counties.

In exchange for eliminating the counties' Medicaid costs, the legislation does the following:

- Temporarily reduces state distributions to the Public School Building Capital Fund (PSBCF) for expenditure on public school capital outlay
- Phases out the counties' authority to levy a one-half-cent local-option sales-and-use tax (for short, local sales tax) and increases the state's sales and use tax by a comparable amount
- Alters the method of allocating the proceeds of another one-half-cent local sales tax

The legislation requires counties to compensate local school administrative units for the loss of state funds for public school capital outlay and to compensate municipalities for the loss of their share of local sales tax revenue. The legislation also requires the state to guarantee counties a certain return as a result of the exchange of Medicaid costs for the reduction in county allocations from the PSBCF and local sales tax revenue (the Medicaid swap), which will mitigate the counties' financial losses from the reduction in revenue. In fact, despite the projected revenue losses, all counties will experience an aggregate financial gain as a result of the Medicaid swap, although the amount of the gain is likely to vary significantly across counties.[11]

Finally, although not directly related to the Medicaid swap, the legislation provides counties with a choice of one of two additional local-option revenue sources, subject to

7. *Id.*

8. Counties also were responsible for 15 percent of the state's "clawback" payments (payments taken back in a different way than they were given) under Medicare Part D. Before January 2006 coverage of outpatient prescription drugs was provided to "dual eligibles"—low-income elderly people or people with disabilities who are enrolled in both Medicare and Medicaid—through Medicaid. States paid a share of the costs of this coverage. Effective January 1, 2006, Medicare Part D, not Medicaid, began offering the drug coverage for dual eligibles. Pursuant to a clawback provision, states must reimburse the federal Medicare program for most of their estimated Medicaid savings from not having to fund a portion of the drug coverage for dual eligibles. *See* Andy Schneider, "The 'Clawback': State Financing of Medicare Drug Coverage," Issue Paper (Kaiser Commission on Medicaid and the Uninsured and Henry J. Kaiser Family Foundation, June 2004), www.kff.org/medicaid/upload/The-Clawback-State-Financing-of-Medicare-Drug-Coverage.pdf (last accessed April 9, 2008).

9. S.L. 2006-66 § 10.9E (S. 1741).

10. The legislation eliminates the counties' responsibility for 15 percent of the nonfederal share of Medicaid costs and Medicare Part D clawback payments.

11. For purposes of this article, financial gain or loss is determined by subtracting the loss of revenue to the county—the consequence of the one-time reduction in allocations from the PSBCF, the repeal of a portion of the local sales tax authorization, and the required compensation of municipalities—from the gain to a county as a result of the state's assumption of the county's nonadministrative Medicaid costs and any supplemental payment made to the county by the state. In other words, financial gain or financial loss is measured by the reduction in county expenditures on Medicaid compared with the reduction in county revenue.

voter approval, the revenue from which may be used for any lawful purpose. If approved, the proceeds from the additional revenue sources also may help offset the reduction in county revenue from the Medicaid swap and may increase a county's ability to fund additional projects or services. Each of these provisions is discussed in turn.

Temporary Reduction of County Allocations from the PSBCF

The PSBCF was established by the General Assembly to assist county governments in meeting their capital needs for public school building and the equipment needs of their local school administrative units under the local school technology plans. The state makes quarterly distributions to the PSBCF from a portion of its corporate income tax revenue.[12] This revenue is then allocated to each county on the basis of average daily membership (ADM).[13] Subsequently, it is placed in an ADM allocation account maintained by the Department of Public Instruction (DPI), to be spent on authorized projects.[14] Authorized projects include funding capital outlay for planning, building, repairing, or renovating public school buildings; purchasing land for public school buildings; and purchasing equipment to implement a local school technology plan.[15] 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. For most projects, a match of one dollar of local funds for every three dollars of state funds must be identified and designated for the requested project.[16] 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.[17]

Reduction of ADM Funds

In exchange for the state assuming the first 25 percent of the counties' nonadministrative Medicaid costs, the Medicaid funding reform legislation decreases the quarterly distributions to the PSBCF and, correspondingly, the ADM funds allocated to counties from the PSBCF during FY 2007–2008. The funds are reduced by the lesser of 60 percent of the expected ADM allocation or 60 percent of the amount of the county's Medicaid share assumed by the state during that fiscal year.

Because it has no way of knowing the actual amount of Medicaid costs assumed by the state for FY 2007–2008 until the end of the fiscal year, DPI is deducting 60 percent of the ADM allocation during each of the quarterly distributions in FY 2007–2008.[18] DPI will adjust a county's allocation in August 2008 if the county's Medicaid payment assumed by the state in FY 2007–2008 is less than its projected ADM allocation for the fiscal year before the 60 percent reduction. The adjusted amount will be the difference between

12. N.C. Gen. Stat. § 115C-546.1 (2007) (hereinafter G.S.). The state also makes quarterly distributions to the PSBCF from a portion of the state's lottery proceeds, in accordance with G.S. 18C-164(c)(2). These funds are allocated to local school administrative units for capital projects for school construction or for debt service incurred for school construction projects, according to the following formula: 65 percent on the basis of average daily membership (explained in n. 13), and 35 percent to local school administrative units located in whole or in part in counties in which the effective county tax rate as a percentage of the state average effective tax rate is greater than 100 percent. Counties do not have to provide matching funds to supplement the expenditure of these funds on approved projects. *See* G.S. 115C-546.2(d). The lottery proceeds distributed to the PSBCF and the allocation of these monies to local school administrative units are not affected by the Medicaid funding reform legislation.

13. "Average daily membership" is the sum of the number of days in membership for all students in individual local education agencies, divided by the number of school days in the term. The total number of school days in a given term that a student's name is on the current roll of a class, regardless of his or her being present or absent, is the "number of days in membership" for that student. *See* North Carolina Department of Public Instruction, Data & Reports—Student Accounting, www.ncpublicschools.org/fbs/accounting/data/ (last accessed April 21, 2008).

14. G.S. 115C-546.2.

15. Specifically, G.S. 115C-546.2(b) states that a county must use the monies allocated from the PSCBF 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 PSBCF] for purposes other than school building needs or school technology needs to the extent that financial resources were redirected from such purposes." For purposes of G.S. 115C-546.2(b), public school buildings include only facilities for individual schools that are used for instructional and related purposes. Public school buildings do not include centralized administration, maintenance, or other facilities.

16. A local match is not required to purchase equipment to implement a local school technology plan that is approved pursuant to G.S. 115C-102.6C.

17. *See* G. S. 115C-38A; *Procedures Manual: Public School Building Capital Fund* (Raleigh: School Planning, Division of School Support, North Carolina Department of Public Instruction, 2003), www.schoolclearinghouse.org/otherinf/ADMFund/ProceduresManual-PublicSchool_2003_.pdf (last accessed December 29, 2007).

18. *See* State Assumes Medicaid Responsibilities (Revised) (January 3, 2008), www.schoolclearinghouse.org/otherinf/ADMFund/StateAssumeMedicaidRevised.pdf (last accessed May 2, 2008).

60 percent of the county's projected ADM allocation before the reduction and 60 percent of the Medicaid payment assumed by the state during the fiscal year. If the county's Medicaid payment assumed by the state in FY 2007–2008 is more than its projected ADM allocation for the fiscal year before the 60 percent reduction, no adjustment will be necessary.

In April 2008 DPI reported that the first-quarter (August 2007) ADM allocation was not reduced as required by the Medicaid funding reform legislation. To compensate for this error, it eliminated the third-quarter (February 2008) distribution and reduced the fourth-quarter (May 2008) distribution by more than 60 percent.[19] The error will have no affect on any adjustment due to a county's ADM allocation account at the end of the fiscal year.

The legislation decreases the ADM funds allocated to counties during FY 2007–2008 only. Beginning with the first-quarter distribution in FY 2008–2009 (August 2008), the counties' ADM allocations will be in accordance again with G.S. 115C-546.1 and G.S. 115C-546.2.

Public Schools' Hold-Harmless Monies

The legislation requires counties to hold local school administrative units harmless for the reduction in ADM funds. Specifically, a county must "use" funds equivalent to the difference in what the county would have been allocated in ADM funds under G.S. 115C-546.2(a) and what actually is allocated to the county's ADM account for purposes set out in G.S. 115C-546.2(b).[20] If the county determines that it does not need these "public school hold-harmless monies" for any specific capital outlay or school technology project, it may use them to pay debt service incurred for public school facilities.[21] Counties may expend public school hold-harmless monies in FY 2007–2008, or they may place the funds in a capital reserve account for future expenditure for one or more of the authorized purposes.

Unlike the funds in a county's ADM allocation account, the county and the local board of education are not required to seek approval from DPI before expending the public school hold-harmless monies, and the county does not have to supplement the public school hold-harmless monies with a specified match of local revenue. Furthermore, unlike the funds in a county's ADM allocation account, for which the county and the local school administrative unit must jointly apply, a county may expend the public school hold-harmless monies without consulting the local board of education. Public school officials, however, are well advised to communicate with county officials to ensure that the public school hold-harmless monies are appropriated and allocated to one of the approved purposes.

County Supplemental Payment

Although a county must expend its own funds to hold local school administrative units harmless for the reduction in state ADM funds, the county will not experience a financial loss as a result of the transaction. In fact, the state guarantees that each county will receive a net financial gain of at least $500,000 in FY 2007–2008 as a result of the Medicaid funding reform legislation. Thus 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 in FY 2007–2008, minus the amount by which the county's PSBCF allocation is reduced, does not equal or exceed $500,000 (county supplemental payment). Counties received 90 percent of their supplemental payments in March 2008 and will receive the balance in August 2008.

Table 1 illustrates the impact of the Medicaid funding reform legislation on a hypothetical county and its local school administrative unit in FY 2007–2008. The county's total Medicaid costs assumed by the state during the fiscal year are $1 million, which represents 25 percent of the county's nonadministrative Medicaid costs. The projected ADM allocation from the PSBCF before the Medicaid funding reform legislation is $900,000. On the basis of the funding reform legislation's requirements, there is a one-year reduction in the county's ADM funds equivalent to 60 percent of either the amount of Medicaid assumed by the state or the projected ADM allocation, whichever is less. In this case, the projected ADM allocation ($900,000) is less than the amount of Medicaid costs assumed by the state ($1 million), so the ADM reduction is 60 percent of $900,000, or $540,000. Subtracting the $540,000 from the projected ADM allocation of $900,000 yields the actual ADM allocation of $360,000 for this fiscal year. The Medicaid swap amount, defined as the gain from the state's assumption of the county's Medicaid costs ($1 million) minus the loss of ADM funds ($540,000), equals $460,000. Because the amount of financial gain to the county is less than $500,000, the state makes a supplemental payment to the county in the amount of $40,000. After the supplemental payment, the county's total financial gain is $1,040,000 (amount of Medicaid costs assumed by the state of $1 million plus the county supplemental payment of $40,000). Finally, the county must use a portion of its Medicaid savings to compensate its local school administrative unit for the loss of ADM funds. In this example, the county must expend $540,000 for one or more of the authorized purposes set forth in G.S. 115C-546.2(b). This leaves the county with a total financial gain of $500,000, the minimum amount guaranteed under the legislation.

19. *Id.*

20. Although the legislature probably intended that counties supplement their local appropriations to local school administrative units by the amount of the reduction in ADM funds, the legislation does not contain an explicit nonsupplant provision.

21. See n. 15 for the text of G.S. 115C-546.2(b).

Table 1
Impact of the Medicaid Funding Reform Legislation on a Hypothetical County

A	B	C	D	E	F	G	H
Amount of Medicaid costs assumed by state	Projected ADM allocation	ADM adjustment (.60 x B)	Actual ADM allocation (B – C)	Medicaid swap amount (A + C)	County supplemental payment ($500,000 – E)	Total financial gain to county (F + G)	Public school hold- harmless payment
$1,000,000	$900,000	($540,000)	$360,000	$460,000	$40,000	$1,040,000	$540,000

Changes in the Local Sales Tax Scheme

Beginning in FY 2008–2009, in exchange for the state's assumption of the counties' Medicaid costs, the legislation repeals a portion of the counties' local sales tax authority and alters the method of allocating some of the proceeds of the remaining local sales taxes.

Current Local Sales Tax Scheme

North Carolina counties currently are authorized to levy up to 2.75 percent (2.75 cents per $1.00) in local sales taxes. The 2.75 percent consists of five taxes. All the counties levy four of the five taxes, totaling 2.5 percent.[22] Counties received authorization from the General Assembly to levy an additional local sales tax of .25 percent as of July 31, 2007 (bringing the total authorization from 2.5 percent to 2.75 percent), subject to voter approval in individual counties.[23] All the local sales taxes apply to specified base transactions.[24] 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.

The taxes are referred to by the articles in G.S. 105 under which they are levied, and the proceeds attributable to each tax are allocated among the counties by one of two methods: per capita, whereby the proceeds are placed in a statewide pool and allocated among the counties on the basis of population; or point of origin, whereby the proceeds are returned to the counties to which the goods were delivered. The following list describes the method of allocating the proceeds of each tax:

- Article 39 one-cent tax: the proceeds are allocated on a point-of-origin basis.[25]
- Article 40 one-half-cent tax: the proceeds are allocated on a per capita basis.
- Article 42 one-half-cent tax: the proceeds are allocated on a per capita basis.
- Article 44 one-half-cent tax:[26] one-half of the proceeds are allocated on a per capita basis, and one-half on a point-of-origin basis.
- Article 46 one-quarter-cent tax: the proceeds are allocated on a point-of-origin basis.

Once the tax proceeds are allocated among the counties, the North Carolina Department of Revenue (DOR) distributes revenue from the Articles 39, 40, 42, and 44 taxes to each county and its eligible municipalities according to one of two distribution formulas, per capita or ad valorem.[27]

22. *See* G.S. 105–39, -40, -42, and -44.

23. *See* G.S. 105-46. A county may not levy the additional one-quarter-cent tax if it levies a local land-transfer tax pursuant to G.S. 105-60.

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

25. References to the Article 39 one-cent tax include the Mecklenburg County one-cent sales tax under S.L. 1967-1096. Mecklenburg County also levies one-half-cent local sales tax pursuant to local legislation, the proceeds of which are restricted to funding public transportation.

26. Some counties receive an additional distribution based on the transitional hold-harmless provisions in G.S. 105-521. In 2001 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. 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 2002–2003 fiscal year. The transitional hold-harmless payment currently expires in 2012.

27. Under the per capita formula, the county's total population is added to the populations 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 resulting 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 tax figures used in the formula are those of the fiscal year immediately preceding the fiscal year in which the distributions are made.

The board of county commissioners of each county selects the distribution formula and may change it in April of each year, to take effect the following fiscal year. 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 its municipalities.

Portions of the proceeds of two of the local sales taxes are earmarked for public school capital outlay or for debt service on county borrowing for school projects until at least 2011: for the Article 40 tax, 30 percent; and for the Article 42 tax, 60 percent. A county's share of the proceeds of the remaining taxes—Articles 39, 44, and 46 (if levied)—is not earmarked for any specific purpose.

Impending Changes in the Current Local Sales Tax Scheme

The Medicaid funding reform legislation makes two major changes in the current local sales tax allocation and distribution scheme.[28] First, it eliminates the counties' authority to levy the Article 44 one-half-cent tax. Second, as of October 1, 2009, it changes the method of allocating the proceeds of the Article 42 local sales tax from per capita to point of origin.

Repeal of the Article 44 Tax. The legislation repeals, over a two-year period, counties' authority to levy the Article 44 tax—50 percent as of October 1, 2008, and the remaining portion as of October 1, 2009—and it increases the state's sales and use tax by a comparable amount.[29] In addition to losing their share of the Article 44 tax proceeds, counties will lose a portion of their share of the Article 39 tax proceeds because counties are required to use a portion of the local sales tax proceeds they receive from the Article 39 tax to hold harmless all eligible municipalities located in the county and incorporated as of October 1, 2008, for the loss of the municipalities' share of the Article 44 tax proceeds.

The actual loss in local sales tax revenue will be mitigated in some counties by a supplemental payment from the state. The state again guarantees that all counties will experience an annual financial gain of at least $500,000 as a result of the Medicaid swap.[30] The legislation requires that the difference between the financial gain a county experiences from the state's assumption of its Medicaid costs and the financial loss the county experiences from the loss of its projected share of the Article 44 tax proceeds plus the loss of the portion of its Article 39 tax proceeds used to satisfy the municipal hold-harmless requirement be at least $500,000.[31] The state will make a supplemental payment to the county for the difference if the amount is less than $500,000.

Unlike the temporary reduction of ADM funds from the PSBCF in FY 2007–2008, the repeal of the Article 44 tax will not directly affect local school administrative units. It will have a financial impact on counties, though, causing most to face a significant decrease in local sales tax revenues. Recall, however, that all counties will experience a financial gain of at least $500,000 each fiscal year. Thus, all other things being equal, counties will have additional financial capacity to fund public schools and other programs and services because the reduction in expenditures on Medicaid plus any supplemental payment from the state will exceed the reduction in revenues. Counties are not required, though, to use any additional financial capacity to increase their appropriations to, or levels of support of, public schools.

Change in the Method of Allocating Article 42 Proceeds. As of October 1, 2009, the method of allocating the Article 42 tax proceeds changes from per capita to point of origin. Individual counties will experience an increase or a decrease in revenue because of the change, depending on their relative populations and the relative amount of commercial activity within their borders. The financial impact of this change, positive or negative, will be factored into both the municipal hold-harmless calculation and the county supplemental-payment calculation.

What effect does the change in allocation method have on the portion of the proceeds from this tax that are earmarked for public school capital outlay? (Recall that, until 2011, 60 percent of a county's portion of the revenue from the Article 42 tax is earmarked for public school capital outlay or debt service on public school projects.) Legisla-

28. As discussed above, the legislation also authorizes counties to adopt an additional one-quarter-cent local sales tax, the proceeds of which may be used for any public purpose. The new local sales tax may not be levied, however, in any county that adopts a new local land-transfer tax, as authorized by G.S. 105-60.

29. Currently the combined local and state sales taxes total 6.75 percent in most counties—2.50 percent of which is local sales taxes and 4.25 percent of which is the state sales tax. The combined total will be 7.00 percent in counties that adopt the Article 46 local sales tax. (The combined total currently is 7.25 percent in Mecklenburg County, pursuant to local legislation.) The repeal of the Article 44 local sales tax does not change the combined local and state sales tax total. Instead, the local sales tax authority is reduced to 2.00 percent (2.25 percent in counties that adopt the Article 46 local sales tax), and the state sales tax is increased to 4.75 percent.

30. Recall that in FY 2007–2008 the state guarantees that all counties will experience an annual financial gain of at least $500,000 as a result of the exchange of Medicaid costs for ADM funds.

31. As of FY 2009–2010, this calculation also will factor in any loss or gain in revenue to the county from the change in the method of allocating the proceeds of the Article 42 tax, from per capita to point of origin. Note that originally the supplemental calculation did not include the amount that the county expends to hold municipalities harmless for the loss of their portion of the repealed Article 44 tax proceeds. G.S. 105-523 was amended by Sections 14 and 15 of S.L. 2008-134 to include the municipal hold-harmless amount in the calculation.

tion passed in 2008 ensures that at least as much local sales tax revenue is earmarked for public school capital outlay as would have been earmarked if the change in allocation method had not occurred.[32] As of October 1, 2009, counties are directed to use 60 percent of the sum of the following for public school capital outlay purposes or to retire any indebtedness incurred by the county for public school capital outlay purposes:

- The amount of revenue the county receives from the Article 42 tax.
- If the amount allocated to the county under G.S. 105-486 (Article 40 tax) is greater than the amount allocated to the county under G.S. 105-501(a) (Article 42 tax), the difference between the two amounts.[33]

The second part of the calculation measures the difference between the amount of Article 42 tax proceeds allocated on a per capita basis and the amount allocated on a point-of-origin basis. It appears that the legislature intended that the phrase "amount allocated to the county" be interpreted to refer to the amount a county *receives* from both the Article 40 tax and Article 42 taxes—after the full amount of the proceeds due to the county from these taxes are distributed among the county and any eligible municipalities.[34]

Additional Local-Option Revenue Sources

Although not directly related to the Medicaid swap, the final component of the Medicaid funding reform legislation authorizes two new local-option revenue sources for counties, subject to voter approval. As of July 1, 2007, counties may adopt either up to a 0.4 percent land-transfer tax (in 0.1 percent increments) or, as discussed earlier, an additional 0.25 percent (one-quarter-cent) local sales tax, the proceeds of which may be used for any public purpose.[35] There is neither a requirement nor an authorization for a county to share the proceeds 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. If the majority of those voting in the referendum vote for the levy of the local land-transfer tax *or* the 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, the board may implement one or the other but not both. Because the referendum is advisory, the board does not have to levy either of the taxes. The board may not levy the taxes in the absence of voter approval, though.

As of May 2008, nineteen counties have held advisory referenda on the local land-transfer tax. All the referenda have failed, many by a wide margin.[36] The local-option sales tax has proven moderately more successful, passing in eight of thirty-five counties.[37]

The local land-transfer tax applies to transfers of interests in real property located in the county. It is payable by the seller of the interest and applies to the value of the property 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 their

32. S.L. 2008-134, § 13.

33. The earmark currently is set to sunset in 2011.

34. Note, however, that the phrase "amount allocated to the county" may have a specific meaning under G.S. 105-486 and G.S. 105-501(a) referring to the full amount of local sales tax revenue due to the county before the revenue is divided out among the county and its eligible municipalities. *See* A. Fleming Bell, II, et al., "Local Government and Local Finance," in *North Carolina Legislation 2008,* ed. Christine B. Wunsche (Chapel Hill: UNC School of Government, forthcoming). Under this interpretation, at least some counties may be required to earmark significantly more revenue for public school capital outlay than they would have been required to earmark had the change in allocation method not occurred. (A few counties even may have to earmark more money than they actually receive in Article 42 proceeds.) This interpretation appears contrary to the legislature's intention, which was simply to hold public schools harmless for any loss in earmarked Article 42 proceeds, not to cause counties to have to earmark significantly more revenue for capital school outlay purposes. That said, it is unclear how a court would interpret the phrase "amount allocated to the county" if the amount earmarked by a county for public school capital outlay is challenged by its local school administrative unit.

35. Note that a bill introduced during the 2008 Legislative Session (S 1951) would have repealed the counties' authority to levy the local land transfer tax. It also would have allowed county commissioners to specify a particular purpose or purposes for expenditure of the proceeds of the quarter-cent Article 46 tax on the referenda ballot asking voters to approve or disapprove the additional local sales-and-use tax authority. The bill passed in the Senate but did not make it out of the House Committee on Rules, Calendar, and Operations.

36. In November 2007, referenda failed in Brunswick, Chatham, Davie, Gates, Graham, Harnett, Henderson, Hoke, Johnston, Macon, Moore, Pender, Rutherford, Swain, and Union counties. In May 2008, referenda failed in Ashe, Gates, Orange, and Tyrrell counties.

37. In November 2007, referenda succeeded in Catawba, Martin, Pitt, Sampson, and Surry counties. They failed in Columbus, Cumberland, Davie, Graham, Greene, Harnett, Hertford, Johnston, Lenoir, Robeson, and Rutherford counties. In January 2008 a referendum succeeded in Alexander County. In May 2008, referenda succeeded in Cumberland and Haywood counties. They failed in Duplin, Edgecombe, Gaston, Greene, Guilford, Henderson, Hertford, Lee, Lincoln, Moore, Nash, Onslow, Randolph, Rockingham, Stanly, Wayne, Wilkes, and Wilson counties. The earliest date that the new tax took effect was April 1, 2008.

instrumentalities. 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: 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 in which 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.[38] Further, the local land-transfer tax does not apply to instruments conveying an interest in property as the result of foreclosure.[39]

Counties are not legally required to share the proceeds of the new revenue sources with local school administrative units. A board of county commissioners may adopt a resolution pledging to use all or a portion of the new revenue for a specific purpose, including financing public school projects, but the board is not legally bound by its pledge. The same board (or future boards) may change at any time the purpose for which the funds will be used.

Conclusion

The Medicaid funding reform legislation will have a significant financial impact on many counties. It eliminates the counties' nonadministrative share of Medicaid costs. The Medicaid relief does not come without tradeoffs, though—namely, a one-time reduction in ADM funds allocated to counties and a permanent reduction in local sales tax revenue for counties. The ultimate impact of these tradeoffs on individual counties is difficult to predict. Also, even though local school administrative units are held harmless for the loss in ADM funds, the effect of the tradeoffs on future appropriations to public schools is equally difficult to ascertain. At a minimum, local school officials need to understand their counties' changing financial pictures and work proactively with county officials to secure needed resources for public schools. ■

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38. The state imposes an excise tax on each conveyance of an interest in real property, at a rate of $1 per $500 of the consideration or the value of the interest conveyed. The tax is collected by the county's register of deeds. One-half of the proceeds is credited to the county's general fund, and one-half, less the county's allowance for administrative expenses, is remitted to DOR. G.S. 105-8E. Unlike the state land-transfer excise tax, the local land-transfer tax does not apply to contracts for the sale of standing timber. Its application to timber deeds is unclear. *See* Kara A. Millonzi, "Local Finance," in *North Carolina Legislation 2007,* ed. Martha H. Harris and Christine B. Wunsche (Chapel Hill: UNC School of Government, 2007), www.sog.unc.edu/pubs/nclegis/nclegis2007/16%20Local%20Finance.pdf (last accessed April 21, 2008).

39. G.S. 45-45.2.