

PROTECTING FAMILIES AND BUSINESSES

A Plan for Fiscal Balance and Economic Growth

KEY FACTS: • Between December 2007 and December 2010, private-sector employment shrank 9.1 percent, while state and local government payrolls grew 4.2 percent.

• North Carolina's per-capita personal income climbed in the 1990s and nearly equaled the national average in 1998. Incomes in North Carolina have fallen compared with the nation as a whole in the dozen years since then.

• Educational achievement also accelerated in the 1990s with growth unmatched since then.

• Higher spending since then has not translated into better returns on investment for North Carolina taxpayers.

• This budget proposal would spend \$18.3 billion and return spending to the same levels, adjusted for population and inflation, as in the mid-1990s.

• In addition to ending the temporary sales tax and income tax surcharges, this budget would reduce the tax rates on personal and corporate income, setting the stage for future tax reform.

• A detailed spreadsheet of the recommendations offered here is available at <http://tinyurl.com/JLF2012NCBudget>.

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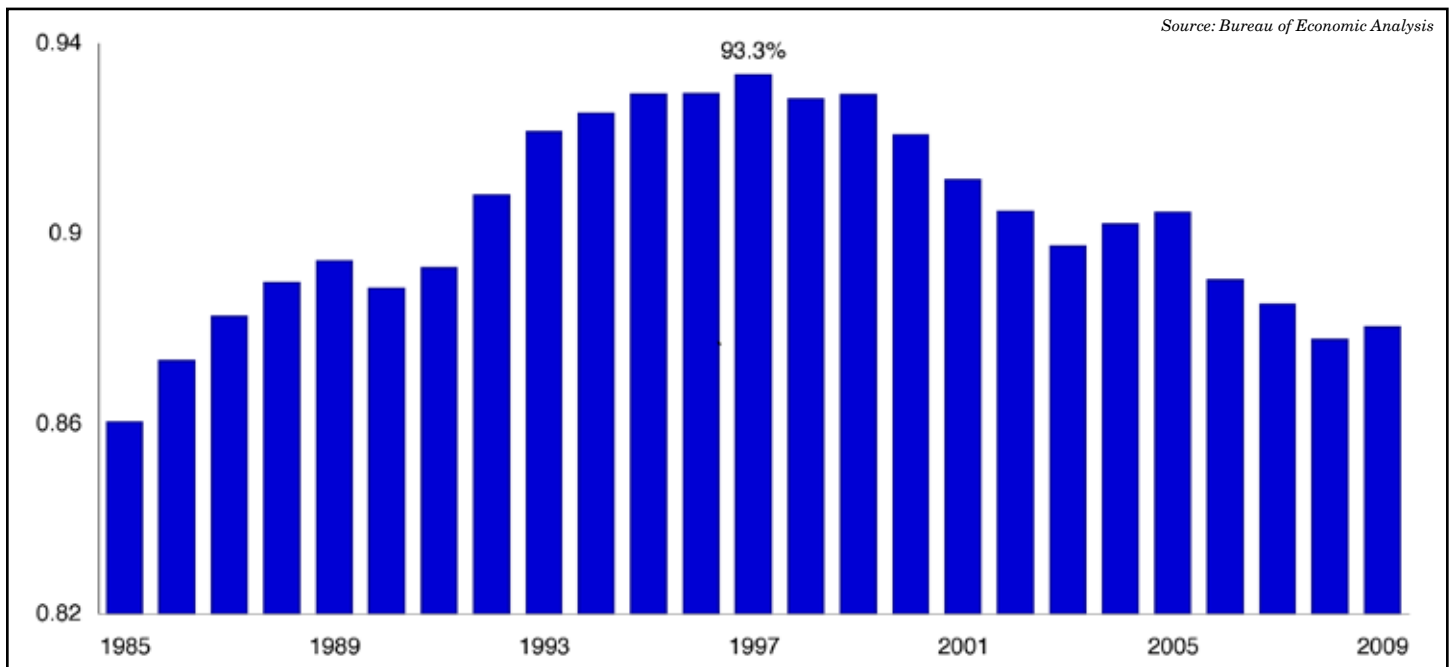
We all want better education, health care, and transportation for North Carolinians. The question is whether there is a better and less costly way to accomplish those goals than the approach the state has taken for a generation. North Carolina state government faces an estimated \$2.4 billion spending gap for the coming fiscal year, with \$21.2 billion of promised spending and just \$18.8 billion of expected revenue.¹ State legislators and the governor should look to transform government, not just do less of the same thing. This budget proposal shows a way to do that while spending just \$18.4 billion.

Over thirty years, from 1978 through 2008, budgeted appropriations grew three times faster than population and inflation. Per-capita General Fund appropriations (using constant 2010 dollars) climbed to \$2,412 in fiscal year 2008 from \$1,170 in fiscal year 1978.

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Figure 1. North Carolina per-capita personal income ratio to the nation peaked in 1997



Unfortunately for North Carolina taxpayers, personal income growth compared to the rest of the country peaked in 1997. Per-capita personal income that year was 93 percent of the national average, up from 86 percent in 1985. By 2009, however, per-capita personal income in the state was again just 88 percent of the national average, the same level it was in 1987.

Under this plan, state General Fund spending per capita would be \$1,891; the same level adjusted for inflation as in 1996 (\$1,888) and most of the 1990s (\$1,890). In other words, this budget proposal returns spending to levels last seen when North Carolina per-capita personal income was at its highest compared with the national average.

Figure 2. State appropriations return to the 1990s average
General Fund appropriations per capita (constant 2010 dollars)

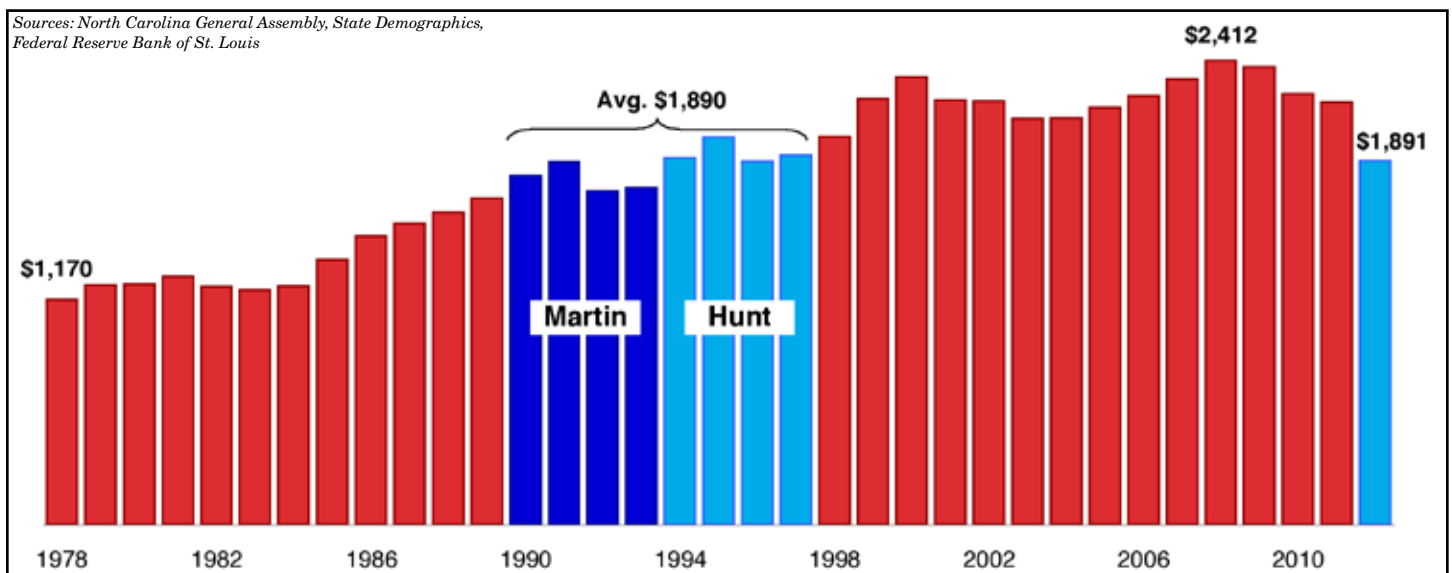
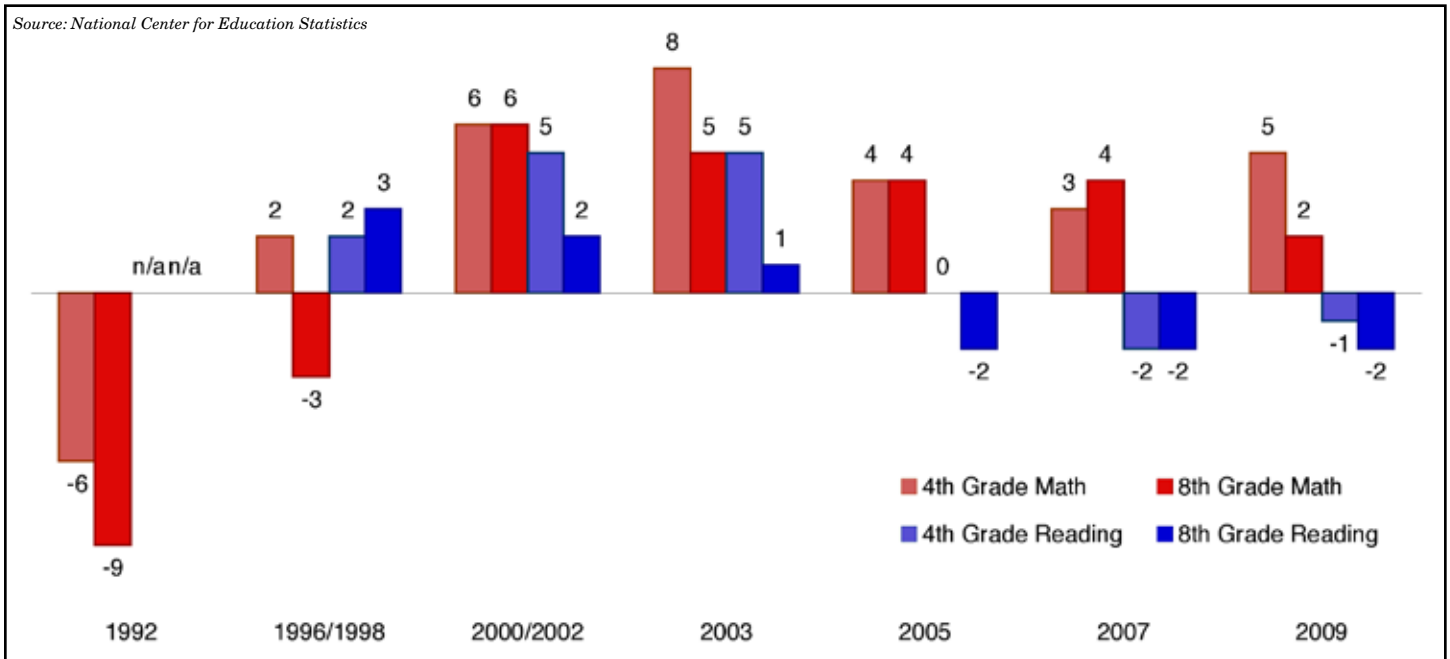


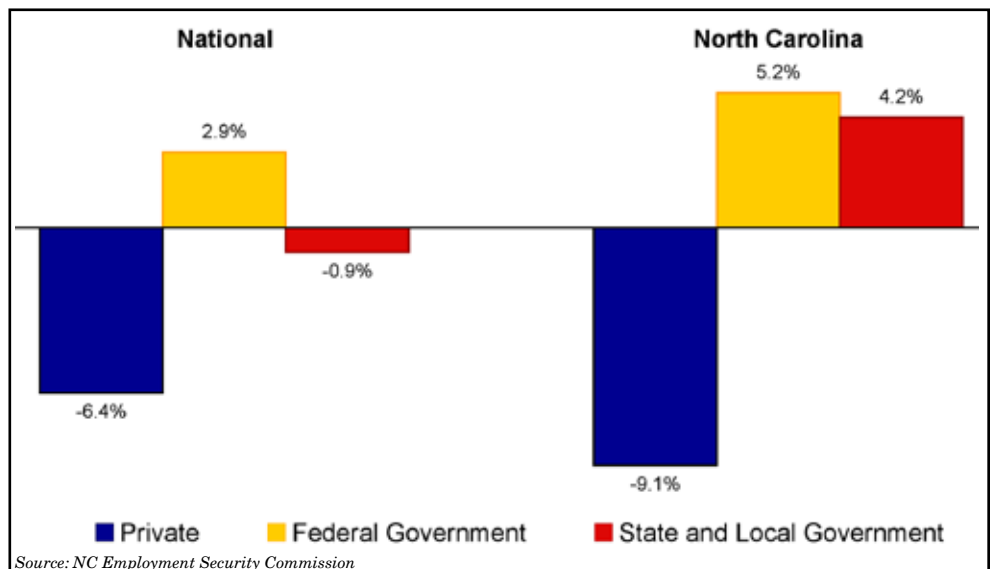
Figure 3. After major gains in the 1990s, North Carolina lost ground in education in the 2000s
North Carolina NAEP score differences from the U.S. average



The picture in education is not as clear as with state incomes, but it does show that North Carolina’s gains were greater before spending took off. In 1992, North Carolina students were well below the national average on math. Just four years later, state performance had just about equaled the national average. By 2000, students in the state were scoring six points above the national average in both fourth grade and eighth grade. Scores since have fluctuated, mostly down. The first assessment in reading showed North Carolina students slightly ahead of their national counterparts in 1998. Performance among eighth graders has stagnated and fourth graders were not much better, despite adding \$2 billion of annual state appropriations by fiscal year 2008.

The recession hit the private sector faster and harder than it hit government. Private-sector payrolls shrank 9.1 percent between December 2007 and November 2010. That means more than 300,000 jobs disappeared in North Carolina in three years. State and local government payrolls, however, expanded 4.2 percent over the same period. Stimulus spending mainly allowed government to keep growing. But taxpayers are tapped out and the federal spigot to states is off. Now it is time for governments to downsize as the private sector has already done.

Figure 4. North Carolina has had larger private job losses and government job gains than the nation



Why not raise taxes?

Research has shown that raising taxes is not an effective way to address government imbalances. The best way to slow government growth is to rein in entitlements and government employment.²

In North Carolina, spending and taxes have ratcheted up together over time.³ Adding taxes has historically just made government larger and more vulnerable to the next economic slowdown. Higher taxes therefore slow the economy twice — first by taking money out of the private sector that could otherwise be invested productively, and second by indicating that spending and taxes will both rise again in the future.

North Carolina already has one of the highest tax burdens in the South, higher tax rates than most states, and one of the worst business tax climates in the country. Advocates for higher taxes recognize this and instead argue for “tax reform” to hide their desire to transfer more money from the private sector to the public sector.

Instead of raising taxes, the budget proposed here includes reductions in personal and corporate income tax rates to set the stage for future tax changes that actually reform the tax code in a way that does not take more money from North Carolina’s families and businesses.⁴

This proposal would reduce the corporate income tax rate to 4.9 percent from January 1, 2012, and to 4.0 percent from January 1, 2013.

It would also simplify and reduce personal income tax rates. As of January 1, 2012, this would expand the bottom tax rate of 6.0 percent to those earning up to \$50,000, reduce the 7.0 percent rate to 6.75 percent for those earning up to \$100,000, and reduce the rate for those earning more than \$100,000 from 7.75 percent rate to 7.5 percent. On January 1, 2013, the state would have two tax rates 6.0 percent for everyone earning less than \$100,000 and 6.5 percent for higher income individuals.

Who will take care of society?

Some readers may be willing to grant that higher taxes are not a good answer, but they may still ask whether that is not a better option than an alternative with smaller government providing fewer services.

This is the debate at the heart of government budgeting. What should government do? What does the constitution allow it to do? What does it do well? What can it reasonably hand off to other sectors of society?

Government is like Microsoft before broadband, handing down a proprietary operating system (law) for everyone with little ability to fix bad lines of code. It assumes that a few people running “government-modified organizations (GMOs)” can make better decisions than the natural, organic interaction of millions of service users and providers. This setup results in, among other things, a Medicaid program that provides less health care than promised, schools that graduate half of African-American males, colleges and universities that graduate less than a quarter of their students in four years, and targeted tax incentives that fail to create or keep jobs.

North Carolina, with 9.5 million residents and a \$400 billion diversified economy, is too complex for 170 politicians in the General Assembly and a few thousand bureaucrats in Raleigh to manage. It may be better to farm out more activities to individuals and companies who can be contractually bound to produce results instead of spelling out the methods to state employees and allowing them to choose the results they will achieve.

Proposal highlights

This budget proposal starts with the idea that government plays an essential role in some areas. The focus is on directing scarce resources to those areas where government has a role and where it is effective.

Almost every cut we offer is a permanent reduction in spending. Spending increases are generally one-time chang-

Table 1. JLF Budget Proposal Summary, Fiscal Year 2011-12

	<i>Starting Amount</i>	<i>Changes</i>	<i>Final</i>
Education	\$11,913,511,629	\$(1,588,110,456)	\$10,325,401,173
Medical Assistance	\$3,314,539,538	\$(261,387,120)	\$3,053,152,418
Other HHS	\$1,613,200,110	\$(268,485,345)	\$1,344,714,765
Justice and Public Safety	\$2,296,746,147	\$(110,397,203)	\$2,186,348,945
General Government	\$455,140,147	\$(85,017,945)	\$370,122,202
Natural & Economic Resources	\$479,788,478	\$(272,418,232)	\$207,370,246
Reserves and Adjustments	\$747,761,563	\$122,590,147	\$870,351,710
Total General Fund	\$20,820,687,612	\$(2,463,226,154)	\$18,357,461,458

es. In budget lingo, the cuts are recurring and the increases are nonrecurring. This marks a reversal from the standard way budgets were constructed in the past, when spending increases were made in perpetuity and cuts were temporary.

The specific changes are based on principles to make government more transparent and accountable,⁵ reward results, merge redundant agencies,⁶ and end distortions that reward politically favored groups at the expense of the general welfare.

Overall, our alternative budget, available online at <http://tinyurl.com/JLF2012NCBudget>, limits spending to \$18.4 billion on expected revenue of \$18.7 billion.

- *Child Care Subsidies, More at Four, and Smart Start*⁷

State spending on pre-kindergarten health and education programs has had limited success. Smart Start has had little demonstrable effect on child outcomes but costs more than \$200 million per year. Child-care subsidies are poorly structured and encourage parents to use the most expensive day care available. To the extent these programs have much impact, they cover the same children as More at Four, which has proven successful. Better to eliminate Smart Start and redirect both More at Four and child-care subsidies to flat payments narrowly targeted toward at-risk children.

- *K-12 education*

Personnel costs are the largest share of spending on education. Natural attrition of teachers combined with retirement incentives should produce over \$175 million in savings for the state.

Schools can also find savings among non-teaching personnel, teacher assistants, and assistant principals. School districts and the State Board of Education should measure potential savings from outsourcing transportation, food service, and janitorial services. Student performance can be better evaluated at lower cost with nationally normed tests.⁸

Greater savings can be achieved if the state followed examples in other states and relied more on the North Carolina Virtual School for core classes and electives. In 1996, the state had 119 school districts. That number is down to 115, but the number of school district bureaucrats is up to 7,019 from 5,236.

North Carolina also has potential to have more cost effective education if legislators remove the cap on charter schools, make it easier for smart people to become teachers, and provide tax credits for special needs children to attend non-public schools.

Table 2. Ten Recommendations with Largest Savings

<i>Program</i>	<i>Recommendation</i>	<i>Savings</i>
Smart Start	Eliminate ineffective, redundant program	\$188,000,000
Teachers	Eliminate vacant positions	\$174,200,000
Teacher Assistants	Reduce appropriation	\$142,372,831
UNC Tuition	Increase tuition \$500/year on average, more at flagship schools	\$100,000,000
Clean Water Management Trust Fund	Divert funding to core functions and higher priorities	\$100,000,000
K-12 Noninstructional Support	Reduce and contract services, save 25 percent	\$99,251,327
UNC Centers and Institutes	End GF Appropriation to non-academic centers and institutes	\$90,000,000
Medicaid Adult Dental and Dentures	Eliminate services	\$64,000,000
Medicaid Personal Care Services	Reduce optional services	\$62,326,055
K-12 Transportation	Contract transportation, save 15 percent	\$60,456,335
Total Savings:		\$1,080,606,547

Once these changes are in place, the state can reform funding into a per-student grant to local school districts. That would be the educational equivalent of managed care instead of fee-for-service medicine and would give local school boards more ability to put resources where they are most effective. **Total savings: \$1.0 billion.**

- *Community Colleges and Universities*⁹

Three quick steps to reduce spending on higher education are to cap enrollment, expand the share of students from outside North Carolina, and increase tuition. Tuition hikes should be larger at the two flagship schools, UNC-Chapel Hill and North Carolina State. Any tuition increases can be partially offset by student aid for those most in need. Legislators should also pay for financial aid from the General Fund instead of the Escheats Fund of unclaimed property, which is not the state’s money in the first place but which is being undermined by current policy. Universities should consider their course offerings and eliminate some classes, departments, and entire colleges. New departments should not be staffed unless their funding is offset by reductions elsewhere. Non-teaching institutes and centers should also be closed, particularly those that have missions to advocate public policy. Higher education institutions should also rely more on virtual classes and combine their operations to ensure better coordination. **Total savings: \$564 million.**

- *Medicaid*¹⁰

North Carolina used \$1.6 billion in federal stimulus, \$1 billion for Medicaid. The last time the General Fund was as small as the state’s revenue in the coming year was fiscal year 2006. Medicaid that year took \$2.5 billion in state appropriations, but it is expected to cost \$3.3 billion in 2012. Federal health care legislation maintenance-of-effort requirements mean the state cannot cut eligibility. Reductions in payments to doctors will also face greater scrutiny from Washington. Cutting services is the main option available.

These cuts are painfully necessary. If the federal health care law is ruled unconstitutional, North Carolina would have more flexibility to adjust payments from individuals. The state should also seek a broader waiver that would make federal funding a block grant with freedom for the state to transform Medicaid in a way that saves money and provides better care for recipients. **Total savings: \$261 million.**

- *Prison, Probation, and Parole*¹¹

Changes in the criminal justice system are overdue. Reforms in this area have potential for long-term savings,

but less immediate impact. The Council on State Government will provide recommendations in the near future, and the John Locke Foundation has signed the Right on Crime statement of principles based on Texas's effective model of reform.¹² This proposal sets aside \$20 million in reserve to pay for new services needed for successful reform. Early intervention, effective community-based alternatives to incarceration, and better post-release monitoring are among the steps that can reduce the burden on courts and prisons while maintaining public safety. **Total savings: \$110 million.**

- *Corporate subsidies and special tax breaks*¹³

The Department of Commerce takes on economic development activities better handled by the private sector. The North Carolina Biotechnology Center, Rural Economic Development Center, motion picture tax credits, other special tax credits, Job Development Investment Grants (JDIG), and numerous programs within the Department of Commerce are attempts by government officials to second-guess the decisions of entrepreneurs and investors in North Carolina, other states, and other countries. The proceeds that fund these programs would better promote economic development if used for state employee pensions, education, Medicaid, and lower taxes for every individual and business in the state. **Total savings: \$103 million.**

- *Environment and Natural Resources*

North Carolina's burdensome environmental regulations, including water rules and renewable energy requirements hurt families, businesses, and government projects. The General Assembly created the Clean Water Management Trust Fund in 1995 to purchase land along rivers, provide grants to projects, and build greenways. In the past two years, legislators cut this appropriation from \$100

Table 3. General Fund Availability Statement

	FY 2011-2012	FY 2012-2013
Unreserved Credit Balance	673,000,000	310,175,654
Savings Reserve Account	(523,000,000)	(160,175,654)
Repairs and Renovations Reserve Account	(150,000,000)	(150,000,000)
Beginning Unreserved Fund Balance	0	0
Revenues Based on Existing Tax Structures	18,129,800,000	19,181,900,000
Non-Tax Revenues		
Investment Income	59,400,000	76,700,000
Judicial Fees	217,800,000	217,800,000
Disproportionate Share	100,000,000	100,000,000
Insurance	71,400,000	73,500,000
Other Non-Tax Revenues	182,500,000	182,500,000
Highway Fund Transfer	20,200,000	17,600,000
Highway Trust Fund Transfer	41,500,000	26,000,000
Subtotal Non-Tax Revenues	692,800,000	694,100,000
Total General Fund Availability	18,822,600,000	19,876,000,000
Adjustments to Availability: 2011 Session		
Cut Corporate Income Tax Rate to 4.0% by Jan. 1, 2013	(115,942,029)	(347,826,087)
Reduce Personal Income Tax Rates to 6.0% and 6.5% by Jan. 1, 2013	(199,329,000)	(1,273,584,000)
\$1,000 Per Child Tax Deduction	(150,000,000)	(150,000,000)
Remove Special Treatment of Pension Benefits	32,500,000	65,000,000
Repeal Sales Tax Holidays	11,700,000	11,700,000
Tax Severance Pay as Compensation	6,750,000	13,500,000
Eliminate Google and Apple Tax Credits	5,000,000	10,000,000
Eliminate Film Industry Production Expenses Tax Credit	22,000,000	72,000,000
Eliminate Qualified Business Credit	3,500,000	7,000,000
Eliminate Low-Income Housing Credit	20,000,000	40,000,000
Eliminate Dry Cleaning Equipment Credit	850,000	1,700,000
Eliminate Historic Structures Credit	3,250,000	6,500,000
Eliminate Cogeneration Plants Credit	20,000	40,000
Eliminate Gleaned Crops Credit	20,000	40,000
Eliminate Renewable Energy Property Credit	150,000	300,000
Eliminate R&D Tax Credit	14,250,000	28,500,000
Eliminate Computer Manufacturing Facilities Credit	5,000,000	10,000,000
Eliminate Mill Rehabilitation Credit	5,800,000	11,600,000
Eliminate Job Creation Credit	9,500,000	19,000,000
Eliminate Business Property Credit	25,000,000	50,000,000
Eliminate Railroad Intermodal Facilities Credit	100,000	200,000
Eliminate State Port Usage Credit	300,000	600,000
Eliminate Recycling Facility Credit	250,000	500,000
Eliminate Cigarette Export Credit	3,267,142	6,534,283
Eliminate Political Parties Financing Fund Designation	1,000,000	2,000,000
Eliminate Public Campaign Fund Designation	100,000	100,000
Transfer from Tobacco Master Settlement	140,000,000	140,000,000
Establish Tax-Me-More Fund for Those Wishing to Pay Higher Tax Rates	1,000	5,000
Subtotal Adjustments to Availability: 2011 Session	(154,962,887)	(1,274,590,804)
Revised General Fund Availability	18,667,637,113	18,601,409,196
Less: General Fund Appropriations	(18,357,461,458)	(18,254,343,051)
Unappropriated Balance Remaining	310,175,654	347,066,145

million to \$50 million. This budget proposal would remove the other half of the appropriation. The North Carolina Zoo, state aquariums, and parks should rely more on private donations and entrance fees from visitors, which the governor moved toward. These changes and others would result in a smaller Department of Environment and Natural Resources, which should allow the state to sell the Green Square complex being built in downtown Raleigh. **Total savings: \$135 million.**

- *Employee benefits (Pensions and health insurance)*

A recent report based on North Carolina's audited financial statements, shows the state has \$43.4 billion in unfunded liabilities, mainly for pensions and retiree health benefits.¹⁴ The Future of Retirement Study Commission recommended giving state employees an optional 401(k)-like defined contribution (DC) pension and a number of changes to make the existing defined benefit (DB) pension less generous.¹⁵ Other states have gone further towards DC pensions, arguing that they are better for state employees and taxpayers alike. The average public employee nationally has average tenure of just 7.2 years,¹⁶ and just a fraction of state employees make it to the thirty-year mark needed to qualify for full benefits. This means that most state employees will not receive their full pension benefit, but that taxpayers are responsible for shortfalls in pension returns.

Health care obligations for retirees are all but entirely unfunded — a nearly \$30 billion hole. The State Health Plan also needs \$150 million more just to get through the next fiscal year. Federal health insurance overhaul provisions mean any changes to state employee insurance coverage could leave the state more vulnerable to federally mandated changes that will raise the cost of insurance in the future. State employees should pay a portion of their insurance premiums, and the state health plan should move to a defined contribution insurance plan with high deductibles and a health savings account (HSA), regardless of federal threats. This is the only way to shrink the actuarially required contribution that is now equal to 20 percent of payroll.

Moving to a defined contribution pension plan will not affect state appropriations in FY2012, though it will improve overall state finances. Moving to a defined contribution insurance plan with employees paying a share of their premiums can have both long-term and immediate impacts.

Overall

This budget proposal saves more than \$3 billion from projected spending, reduces tax rates for individuals and businesses, ends targeted tax breaks for selected companies and industries, and sets North Carolina state government on a fiscally sustainable path.

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End Notes

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