

spotlight

No. 411 – June 21, 2011

AN OVERRIDING BUDGET

Fiscal year 2011-13 budget review

KEY FACTS: • The final budget for fiscal year 2012 avoids an \$850 million tax increase Gov. Bev Perdue sought, which means \$200 less in taxes per household.

• General Fund spending totals \$19.5 billion, two percent less than Gov. Perdue's original, \$19.9 billion proposal.

• In K-12 education, excluding the transfer of More at Four, the final budget spends just 0.6 percent less than Gov. Perdue's proposal.

• The state budget does not eliminate any teacher positions. County commissions and local school boards will decide if any teachers or teacher assistants lose jobs.

• Budget writers expect two proven programs in Medicaid (managed care and mental health waivers) to generate more savings without adverse health outcomes.

• Another Medicaid saving games federal reimbursement rules to generate \$1.3 billion in additional federal payments to hospitals and other providers.

• Income-tax changes could make future tax reform easier to accomplish.

• Proposed spending for fiscal year 2013 is \$400 million higher, but has no provision for the rainy-day fund or a fund balance at year's end.

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On Wednesday, June 15, five Democrats in the House stuck with Republicans to override Gov. Bev Perdue's veto of a budget plan for the next two fiscal years, starting July 1. It marks the first time since 2003 that North Carolina has had an operating budget in place before the start of the fiscal year and represents the earliest a budget has been ready since 1979.

State-only funding in the budget climbs from \$19.0 billion in fiscal year (FY) 2010-11 to \$19.7 billion for FY 2011-12 and \$19.9 billion for FY 2012-13. Gov. Perdue's budget proposal would have spent \$19.9 billion in FY 2011-12 and \$20.3 billion in FY 2012-13.

Table 1. Comparing Budget Proposals

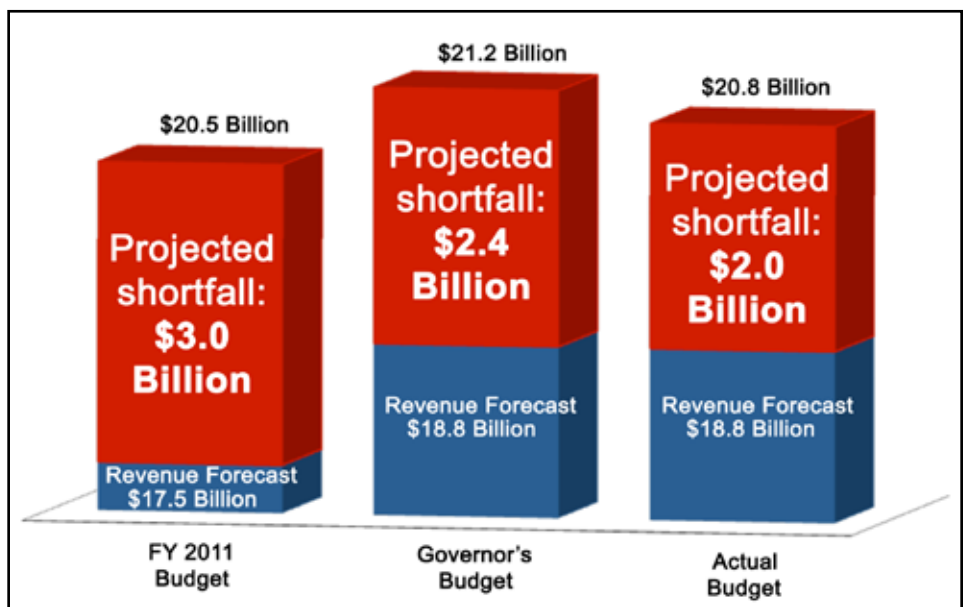
FY2011-12	Starting Amount	Governor's Budget FY 2011-12	House Budget FY 2011-12	Final Budget FY 2011-12
Public Instruction	\$7,923,543,951	\$7,572,712,912	\$7,164,492,057	\$7,464,492,057
Community Colleges	\$1,102,475,214	\$1,016,629,522	\$991,518,860	\$985,000,000
UNC System	\$2,887,492,464	\$2,657,835,835	\$2,440,375,132	\$2,540,375,132
General Government	\$455,140,147	\$430,543,973	\$399,359,518	\$408,003,897
Medicaid	\$3,314,539,538	\$3,180,907,603	\$2,961,588,184	\$2,958,388,184
Other Health and Human Services	\$1,613,200,110	\$1,534,310,494	\$1,503,834,357	\$1,536,738,768
Justice and Public Safety (excluding Highway Patrol)	\$2,296,746,147	\$2,206,925,331	\$2,136,090,998	\$2,134,798,986
Natural and Economic Resources:	\$479,788,478	\$407,146,517	\$388,391,359	\$402,964,442
Subtotal Agency Budgets	\$20,072,926,049	\$19,007,012,187	\$17,985,650,465	\$18,430,761,466
Total Reserves and Debt Service	\$747,761,563	\$891,000,910	\$1,120,520,297	\$1,054,269,293
Total Capital	—	\$4,535,000	—	\$4,535,000
Total General Fund (excluding Highway Patrol)	\$20,820,687,612	\$19,902,548,097	\$19,106,170,762	\$19,489,565,759

Adjusted for accounting differences and funds from the American Recovery and Restoration Act (ARRA) federal bailout of state governments, the FY 2011-12 budget spends \$19.5 billion, \$1 billion less than the \$20.5 billion budgeted in FY2010-11, \$1.3 billion less than the \$20.8 billion continuation request, and \$400 million less than Gov. Perdue's \$19.9 billion proposal (see Table 1).

Just as spending comparisons are difficult, there are numerous estimates of the size of the shortfall. When the legislature passed the FY 2010-11 budget last year, it had a structural deficit of \$3.0 billion with \$1.3 billion in temporary taxes, \$1.6 billion in ARRA spending, and another \$100 million in temporary fixes filling the gap between \$17.5 billion of expected revenue from ordinary sources and the \$20.5 billion appropriated. By February, the consensus revenue forecast had climbed to \$18.8 billion, but the continuation request had also expanded to \$20.8 billion, leaving a shortfall of \$2.0 billion (Figure 1).

But Gov. Perdue added another \$400 million to her estimate of necessary spending and created a shortfall of \$2.4 billion.¹ Most people working with the budget accepted this number, though WRAL and *The News & Observer* repeatedly rounded it up to \$2.5 billion² and some on the Left referred to a \$3.7 billion shortfall. We stick with the most straightforward measure (continuation budget minus expected revenue under current law) and call it \$2.0 billion shortfall.

Figure 1. How Big Is the Shortfall?



Filling the gap

Gov. Perdue and state legislators took different approaches to bridging the state’s funding gap. After expanding the shortfall to \$2.4 billion, the governor’s budget would have cut spending \$1.3 billion, used \$323 million in money from the current fiscal year, and reinstated three-fourths of the temporary sales tax for two more years at a cost to taxpayers of more than \$800 million per year. Other changes would have roughly balanced tax cuts and revenue grabs. Her report showed spending cuts as filling 72 percent of her new budget gap over two years.

When compared with the actual \$2.0 billion gap, not counting new spending, reinstating the temporary tax and other one-time measures filled 55 percent of the hole. Permanent net spending reductions totaled just \$900 million, or 45 percent of the shortfall. The sales tax extension and other temporary measures would close 70 percent of the \$933 budget shortfall in FY 2012-13. Permanent net spending reductions contribute another 43 percent, making room for a tax cut and \$173 million in reserve. With more than \$860 million in expiring taxes and one-time savings, however, budgeting in 2013 would have started with a structural deficit of more that \$700 million.

The House budget had permanent net spending reductions equal to the federally supported \$1.6 billion in FY 2010-11 spending to close 79 percent of the \$2.0 billion shortfall. One-time transfers and spending cuts and higher court fees equaled 27 percent of the shortfall and would have left \$123 million to help balance the budget in FY2012-13. Spending reductions alone would have put the budget in surplus the second year. Net spending and tax changes in the House plan would have left \$485 million unspent at the end of the biennium.

Instead of going to future budgets, the House budget’s surplus provided room to negotiate a deal before sending a final budget to Gov. Perdue for her likely veto. Senators went through their committee process, but negotiated with House Republicans and five House Democrats to produced final budget for which they would be prepared to override a veto. The final product is still weighted heavily toward spending reductions (\$1.3 billion) instead of temporary tax hikes (\$0), but with a greater reliance on temporary fixes (\$700 million) to get through FY 2011-12. Savings offset \$730 million of FY 2012-13’s \$933 million shortfall in the final budget, but there is no margin for a slower economy as the budget plan commits every dollar that year and would leave a \$100 million structural deficit to start the next biennium (Figures 2 & 3).

Figure 2. Filling the Gap, 2011-12

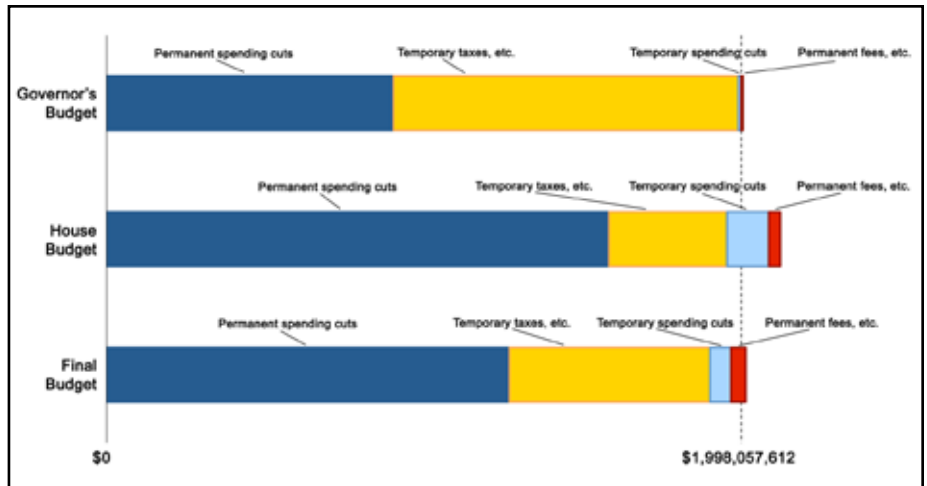
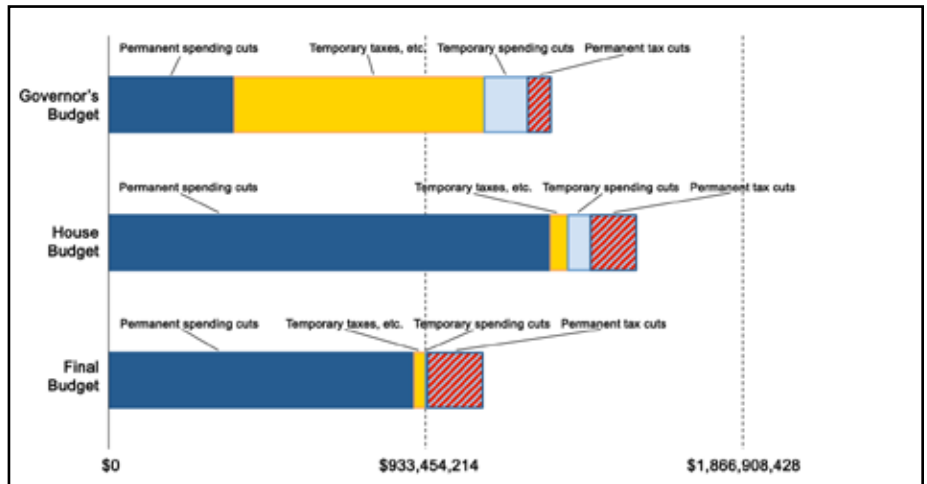


Figure 3. Filling the Gap, 2012-13

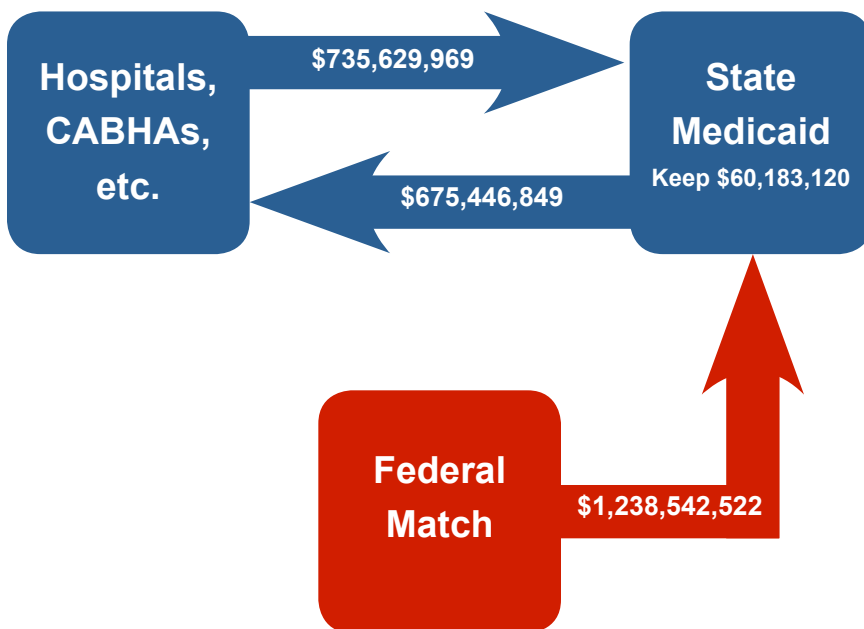


Schools, Medicaid, and Corporate Welfare

Critics of the final budget plan have misdirected their fire at spending changes in schools and Medicaid. They claim that reinstating the one-cent sales tax for another two years would mean a world of difference for students at no cost to families. The first problem with this argument is that even Gov. Perdue did not seek to reinstate the full billion-dollar tax hike. Also, the final budget for public schools was just \$108 million (1.4 percent) less than what Gov. Perdue proposed. Adding back the \$65 million transfer of More at Four to the Department of Health and Human Services, the difference falls to \$43 million (six-tenths of one percent).

Unlike Gov. Perdue’s proposal, the final budget does not shift workers’ compensation, tort claim, or school bus costs to local school districts. Liability insurance becomes a state responsibility, too, instead of imposing the cost on local school districts or teachers themselves. The budget restores threatened funding for teachers assistants and reduces class sizes in first through third grade. A special provision adds five more class days to the school calendar in public schools. Research has not shown consistent positive effects from either smaller class sizes³ or five additional learning days,⁴ but in these areas the budget is consistent with past state policy.

Figure 4. Gaming Medicaid



On Medicaid, critics at least get part of the story right. Recipients will have fewer services covered, and health care providers will get paid less. Each of these measures will mean worse health care provision for all Medicaid recipients, but they are a direct byproduct of ObamaCare “maintenance of effort” rules that forbid any reductions in eligibility. If the state cannot limit who receives Medicaid services, the only alternative is to limit what everyone on Medicaid receives.⁵

Their other claims are less realistic, however. Assessments on hospitals and other organizations save \$60 million from the state budget in FY 2011-12, but the main purpose of the assessment is to game Medicaid reimbursement rules and to pull more federal dollars into the state.⁶ The scheme,

which other states have used for years, will net \$1.2 billion in federal Medicaid dollars for the program, nearly \$2.5 billion over the biennium (see Figure 4). One of the acknowledged reasons for the assessment is to level the playing field between private hospitals and the state-run University of North Carolina hospital systems, including Rex.⁷

Budget writers count on more savings from two managed-care programs that have proven their ability to provide quality care and control cost, Community Care North Carolina (CCNC) for primary care and a capitation payment for mental health care management. The legislature’s cost-saving goals for these programs may be aggressive, but cost savings are part of the value these programs offer and that their advocates promised.

Corporate welfare goes through the tax code, the Department of Commerce, the Department of Agriculture, universities, community colleges, Job Development Investment Grants (JDIG), and Golden LEAF. Most of this funding is untouched, and there are \$25 million’s worth of expansions in addition to some smaller reductions. If critics of the bud-

get were not as fixated on reinstating the sales tax, they might have focused their fire on cutting those programs and redirecting the savings to more appropriate state government activities. Legislators tried reducing these funds earlier in the session only to have their attempt vetoed by the governor with too few votes to override in the House.

Taxes & Fees

Promises to keep temporary taxes temporary have a bad record in North Carolina. The last temporary sales-tax

hike still had a vestigial quarter-cent permanently in the state tax rate before Gov. Perdue assured voters they could trust that her one-cent tax hike would be temporary because she was the governor.

Gov. Perdue's version of compromise was to reinstate three-fourths of the sales tax. That fraction of a penny per dollar spent, however, would have cost each household more than \$200 a year and pulled \$800 million out of the private-sector economy. The Beacon Hill Institute estimated that allowing the sales tax to expire would lead to 11,000 new jobs as it works its way through the economy.⁸ Republican legislators gave up most of their tax reduction plans to spur job growth during negotiations for a final compromise budget and focused instead on protecting jobs of teacher assistants and other state employees.

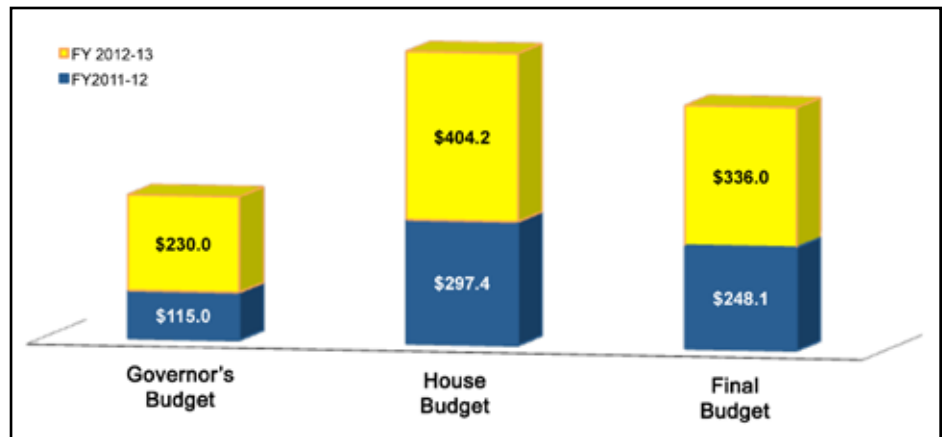
Two changes did survive. One is a tax break on the first \$50,000 of business income earned by small businesses that do not file corporate income taxes. This change can lower business costs and help them break even sooner than a similar amount of government purchases.⁹ The other is a change in how personal income taxes are calculated. Instead of starting with federal taxable income, subtracting out more items and adding back others, North Carolinians will start their tax forms with adjusted gross income (AGI) and just do subtraction. It is a small step toward tax simplification that could also make more significant reforms easier to attain.

Pensions, Health Care, and State Employees

Reform is still a challenge in how state employees are compensated. Although North Carolina has one of the best-funded retirement plans for state employees in the country, saying that is like saying Youngstown State was one of the cleanest football programs Jim Tressel ran. Required pension contributions will continue to rise as the losses from 2008 are absorbed into the actuarial equations. A defined contribution pension, like a 401(k) or IRA, will likely become a more attractive option for state employees as eligibility and payment rules for the traditional pension tighten in coming years. Until then, the final budget sets aside nearly \$240 million more for pensions over two years than the governor proposed (Figure 5).

Health insurance for state employees has less room for experimentation thanks to ObamaCare's rules. If the federal law is found to be constitutional, the state's best option may be to stop providing insurance, as Tennessee Gov. Phil Bredesen has said his state might in 2014.¹⁰ State employees and teachers will, for the first time ever, pay a small portion of their monthly premiums by July 2012 or sooner. This will help reduce the roughly \$30 billion unfunded liability the state has for retiree health benefits.¹¹

Figure 5. Pension Contributions (in millions of dollars)



Conclusion

The General Assembly managed to accomplish its most important task this year, passing a budget with no tax increases and a significant rebalancing of state government spending. It is the best possible budget given the governor's veto. Critics have misdirected their fire in pushing for tax hikes and complaining about reductions in Medicaid and public schools, instead of looking for savings in corporate welfare. The legislature should use this budget as a starting point to reform taxes and state employee pay and benefits.

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End Notes

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