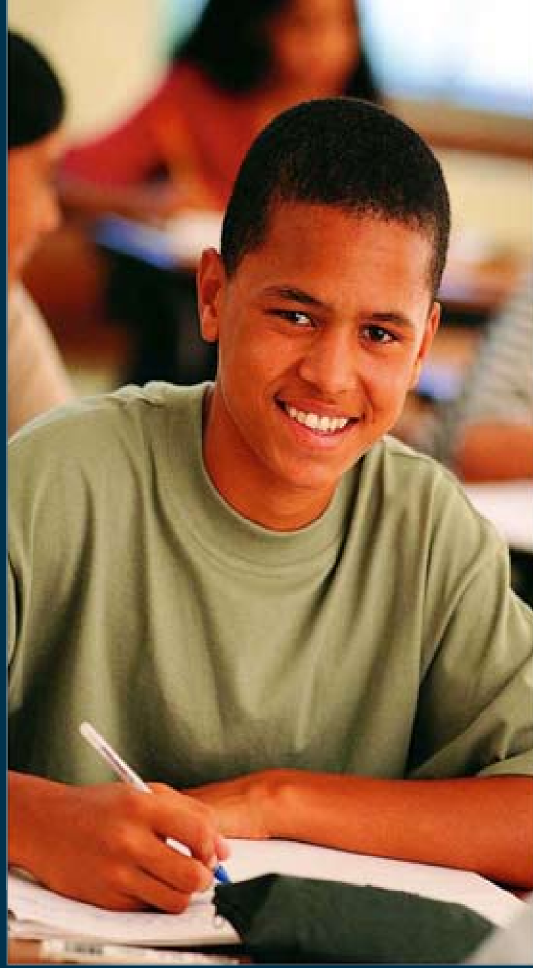

POLICY REPORT

A Better Bargain
Meeting North Carolina's Needs Without a $1 Billion Tax Hike

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FEBRUARY 2007

John Locke FOUNDATION

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Table of Contents

Executive Summary

Budgets reflect priorities. When families face a new expense, they must cut back on another expense. Governments do not have this limitation. When legislators find they have spent too much or that there are new activities worth funding, they can raise taxes to make sure the budget balances and pass along the tough decisions to businesses, entrepreneurs, and families.

Members of the North Carolina General Assembly are being bombarded with demands for a number of spending increases, in addition to the spending commitments made in prior sessions. Legislators could face two proposals to hide tax cuts during their budget deliberations for the 2007-2009 biennium.

The first proposal would raise taxes nearly $1 billion. It builds on an existing proposal for the state to take on the counties' share of Medicaid and one-cent of the local sales tax. In exchange, counties would then have the option to add a new one-cent local sales tax. One version of the proposal would include a state earned-income tax credit (EITC) to offset the regressive nature of the sales tax increase.

The second proposal, broached by Gov. Mike Easley, would extend the remaining temporary quarter-cent sales tax and add a state EITC. This proposal would not touch county Medicaid.

Incorporated into each of these proposals are calls to provide new tax options to counties to pay for schools and roads. Some proponents have also argued that implementation of an EITC or an expanded sales tax would modernize the state's tax system.

Good ideas exist to save costs in Medicaid so the state can take on the counties' share without raising taxes. Cost control is the most critical issue in private and public health care. Where Medicaid can lead, it should.

School construction can be more affordable with innovative construction and financing options such as public/private partnerships, lower regulatory burdens on school sites, greater accountability for school districts, and more school-choice options such as charter schools.

Road construction, too, can benefit from innovative financing, toll lanes, and public/private partnerships. Dedicating road money to roads, instead of diverting it to the General Fund or to public transportation would also help. Finally, when using the money to build and improve roads, the Department of Transportation should direct funds to those projects that will be the most cost-effective and relieve the most congestion.

The federal earned-income tax credit (EITC) has been reasonably effective at helping single parents escape poverty, but has also had significant levels of mistakes and apparent fraud. A state EITC would add minimal benefits ($94 on average) and do nothing to counter the costs of the federal program while committing $66 million per year. Real tax reform would reduce or eliminate the distortions in the state tax code, but must be done in conjunction with or following spending reform. Without getting control of spending, legislators will always feel compelled to raise taxes. Eliminating wasteful spending would also make it easier to enforce spending restraint on school construction and roads.

Introduction

The start of a budget biennium is a heady time in the General Assembly. Legislators, fresh from an election, feel the wind at their back and ready to remake government in their own image. Crafting a budget plan for the next two years provides the perfect opportunity to do just that. Pre-election spending decisions from the last session may have left a shortfall, but the next elec tion is still more than a year (and another budget vote) away. All those new programs sound good, so there is a great temptation to raise taxes to cover the apparent needs and create some new programs, too.

To the extent that new spending is necessary, however, it should replace less important items that have received money in the past. Lawmakers have an entire library of studies from the last twenty years to consult about which programs can be scaled back, made more efficient, or eliminated altogether. The most compre hensive of these studies was produced by the Government Performance Audit Com mittee (GPAC), which operated from 1991 to 1993.[1] All of the studies are still relevant because very few of their collective recom mendations have been implemented. With so many ideas on how to save money, there should be no need to raise new revenues.

Also, conventional wisdom notwith standing, even government budgets have limits. The buck stops somewhere, and usually that is a taxpayer's wallet. Raising revenues means higher taxes or fees, which leaves citizens less money to pay for their own needs (see sidebar).

Each time the General Assembly raises taxes on North Carolinians, lawmakers show their fellow citizens that selling Texas Pete in China, protecting the value of David Murdock's home in Kannapolis, and keeping a symphony orchestra in Raleigh, all existing programs, are more important than relieving Bertie County of its crip pling Medicaid burden, building adequate schools and roads in the Piedmont, or al lowing a family in Boone to save money for their children's education. True spending priorities are revealed by how the state ac

How higher taxes can affect businesses and individuals

Consider a cashier at a small local grocery store trying to support his two children on $10 an hour. If the sales tax goes up a penny, she could pay $300 a year more for everything she buys. That translates into 15¢ an hour, or a 1.5 percent raise. But his manager would need him to be 1.5 percent more productive or the store would lose money on her raise. Multiply that by each of the 100 employees of the store, and the manager now has to cut other costs or increase sales by $20,000 to compensate her employees for the new sales tax.

But wait, the manager has to increase produc tivity even more to cover payroll and income taxes and still provide her cashier $300 to cover his higher sales tax bill. Call it 20 percent to be conservative, and the necessary increase in gross profit is now $24,000.

A seemingly simple way to increase revenue, one that state government has just demonstrated to be effective, is for the manager to raise prices. In a $10 million store, the manager would have to raise prices by just a quarter of a percent (0.25 percent) to achieve this. Unfortunately, all of the store's customers all face the same new sales tax, and their employers are not as generous so they are looking to cut their bills.

Some customers decide to do more grocery shopping at a warehouse club. Others decide to skip the rotisserie chicken and roast their own chicken for half the price. Some cut back their wine purchases and others switch from organic produce to conventional. Now the manager has a dilemma on her hands. She has higher costs in her store but no real way to cover them. She also has to find a way to cover the $400 in sales tax for her own family of four, which she did not in clude in her own salary. And she and her husband were planning a night at the Umstead Hotel to celebrate their 25th wedding anniversary.

tually spends its money, not by the rhetoric that politicians use in pronouncing what is or is not important.

For 2007, some lawmakers appear to be considering a complex series of maneuvers to hide a tax increase of nearly a billion dollars ($940 million). Gov. Mike Easley has hinted at his own variation, which would be less sweeping, but would still tie a relatively popular idea to a tax increase.

North Carolina faces a number of challenges. The tax code is too complex, inefficient, and inequitable. Some counties devote more than one-fifth of their budget to pay for Medicaid. Other counties may spend more than $5 billion to build schools in the next 15 years. And the state's reputation for good roads has gone the way of Oldsmobile.

Budgets are about priorities. If lawmakers set the right priorities, they would be able to meet the state's challenges without smoke, mirrors, hoops, or other tricks. This paper will provide a summary of possible proposals from the General Assembly and from Gov. Easley. It will then examine some of the specific needs the proposals attempt to address – the county share of Medicaid, school construction, road construction, tax reform, and assistance to the poor – as well as some better ways of achieving those goals. The paper concludes with a summary of recommendations.

How to Hide a Tax Increase

Among the ideas being floated for the 2007 legislative session are two that include a higher sales tax rate – one from the legislative side and one from the governor. Each would use the higher taxes to fund one or more well-intentioned schemes. While some of the funding objectives may be admirable, however, tying them to a sales tax increase undermines fiscal responsibility. If legislators truly valued these objectives, they would find a way to pay for them without new taxes. That these new programs depend on new taxes for their creation indicates that legislators value them less than all existing programs, even film incentives.

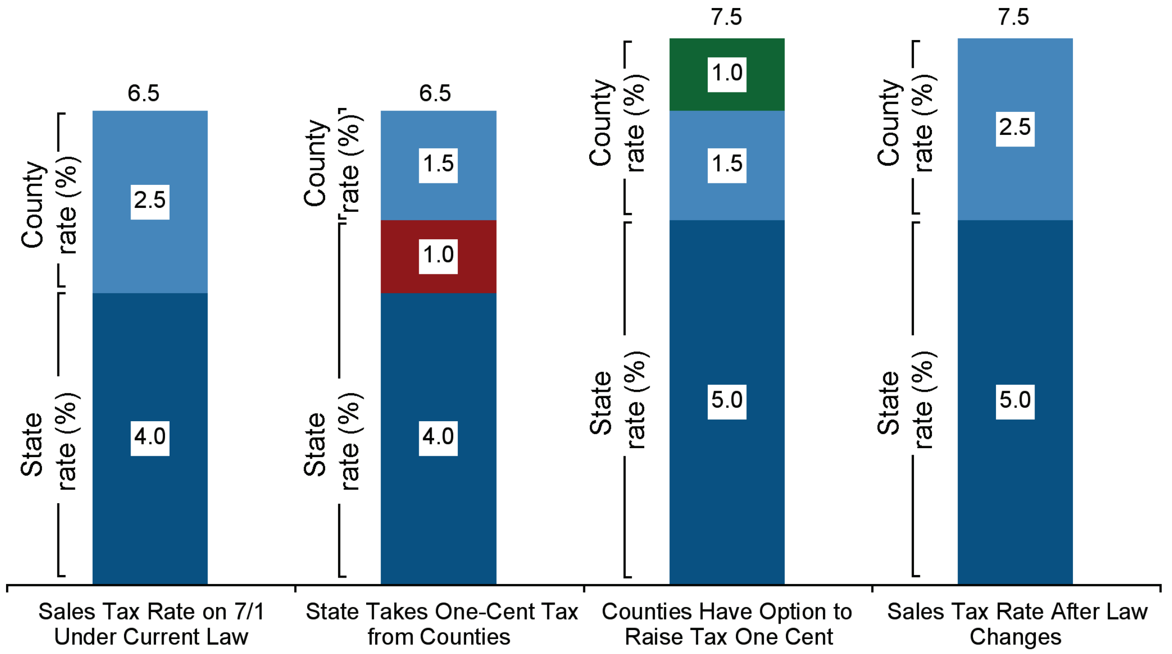
Another common feature of the two proposals is the inclusion of a state earned-income tax credit (EITC) that would supplement the existing federal earned-income credit. Unlike the federal credit, which has been a useful tool in reforming welfare, the state credit would simply be a welfare transfer payment. The EITC is designed to help those entering the work force with lower incomes, so it is a progressive tax credit. The sales tax places a higher burden on those who spend more of their income buying goods and so falls more heavily on the poor, so it is a regressive tax. The end result of combining a sales tax increase with an EITC, as both schemes would do, is not just to transfer money from one group to another, but to transfer money from one pocket of a poor person into another. Given this, there would be no reason to take the money in the first place.

At the federal level, the EITC has helped a number of single mothers move out of poverty and into work, but has done less to aid workers without children and married women. Studies by the IRS and General Accountability Office (GAO), however, have found that one-fifth or more of recipients either did not qualify for the EITC or received too large a credit. As a supplement to the federal EITC, a state program will face the same rate of overpayment and apparent fraud.

Variation 1: The Billion-Dollar Tax Hike

Some legislators, building on an idea of Sen. Tony Rand,[2] have been considering a way to raise the state sales tax rate by a penny. This would increase state tax revenue by $940 million.[3] The most transparent way to do this would be to raise the tax rate to 5.0 percent from 4.0 percent in the

Chart 1. Raising the Sales Tax



General Assembly.[†] Instead, the plan would take the penny from counties in exchange for relieving them of the $490 million they now spend on Medicaid benefits. Counties would then have the option to raise the local sales tax by a penny, back to 2.5 percent. Few counties would raise the tax less than the full penny lost, particularly wealthier counties who would be hurt more by the loss of revenue than helped by the Medicaid relief (see chart). In making this trade-off, the state would net an extra $500 billion in revenue – $1 billion in extra revenue from the additional penny tax, minus $500 million in Medicaid expenses. These are revenues available for new spending programs.

Counties have been seeking more ability to raise taxes at the local level to pay for school construction and other local items. A swap like this would largely take care of the three priority goals of the North Carolina Association of County Commissioners for 2007 – Medicaid, school construction, and tax and fee options.[4] Both the General Assembly and county commissions would be able to deny that they raised taxes. State lawmakers could claim it was a simple swap, and county commissioners would state that they were just covering their lost revenue.

Not content to swap $1 billion in revenues for $500 million in expenses, the possible deal also would include sweeteners at the state level to appease groups on the left and right. One would be an EITC intended to help low-income workers. Another would be a cut in the corporate income tax rate. An earned-income credit set at 10 percent of the federal level would cost the state roughly $100 million.[5] Reducing the corporate income tax rate to 6.0 percent from 6.9 percent would have a similar $100 million impact on revenues.

Variation 2: The Magnanimous Mugger (Gov. Easley's plan)

Gov. Mike Easley suggested in his year-end meeting with reporters that he, too, might consider a tax increase. The gover

[†] This assumes the remaining quarter-cent sales tax increase from 2001 expires June 30 as in current law.

Table 1. Medicaid Spending and Value of One-Cent Sales Tax by County

County	2005-06 County Medicaid Share	2005-06 Pct Budget for Medicaid	2005-06 Avg Amount 1% excl Food	2005-06 Pct Budget from 1% excl Food
Alamance	$6,766,024	6.6%	$8,759,899	8.5%
Alexander	$1,816,110	7.1%	$2,421,960	9.5%
Alleghany	$892,549	7.5%	$786,246	6.6%
Anson	$2,355,218	10.5%	$1,309,139	5.8%
Ashe	$1,925,274	8.1%	$1,993,873	8.4%
Avery	$1,226,449	5.2%	$1,708,613	7.2%
Beaufort	$3,763,715	9.1%	$3,482,688	8.4%
Bertie	$2,353,678	14.8%	$1,070,663	6.7%
Bladen	$3,298,818	9.5%	$2,135,539	6.1%
Brunswick	$4,786,930	3.9%	$7,767,139	6.3%
Buncombe	$12,488,552	6.6%	$20,104,605	10.6%
Burke	$5,552,515	9.2%	$5,390,951	8.9%
Cabarrus	$6,392,539	4.1%	$11,343,710	7.3%
Caldwell	$4,867,078	7.7%	$4,385,097	6.9%
Camden	$325,122	5.0%	$694,804	10.7%
Carteret	$3,074,471	5.1%	$5,759,179	9.6%
Caswell	$1,682,635	8.5%	$1,364,492	6.9%
Catawba	$6,938,591	4.8%	$11,085,532	7.7%
Chatham	$2,200,212	4.0%	$3,902,448	7.1%
Cherokee	$2,454,549	8.4%	$2,479,591	8.5%
Chowan	$1,179,489	7.4%	$1,119,943	7.0%
Clay	$675,756	5.9%	$836,675	7.3%
Cleveland	$7,434,147	11.0%	$6,834,186	10.1%
Columbus	$5,800,447	13.2%	$3,039,239	6.9%
Craven	$5,358,740	6.8%	$6,612,728	8.4%
Cumberland	$13,746,682	5.2%	$20,319,433	7.7%
Currituck	$865,260	2.5%	$2,803,896	8.1%
Dare	$1,218,282	1.4%	$6,333,332	7.3%
Davidson	$7,606,930	6.8%	$9,279,710	8.3%
Davie	$1,533,452	4.2%	$2,509,506	6.9%
Duplin	$3,660,808	10.9%	$3,218,439	9.6%
Durham	$11,839,064	2.2%	$16,838,989	3.1%
Edgecombe	$5,097,578	9.8%	$2,774,141	5.3%
Forsyth	$14,882,630	4.7%	$24,214,163	7.6%
Franklin	$3,054,552	6.4%	$3,679,058	7.7%
Gaston	$14,624,760	12.0%	$13,231,021	10.9%
Gates	$620,476	8.7%	$652,942	9.2%
Graham	$878,888	9.9%	$620,389	7.0%
Granville	$2,605,228	7.3%	$3,448,491	9.7%
Greene	$1,276,404	9.1%	$1,184,260	8.4%
Guilford	$19,666,079	4.0%	$30,159,577	6.1%
Halifax	$5,654,438	8.9%	$3,775,219	5.9%
Harnett	$5,405,244	6.5%	$6,543,862	7.9%
Haywood	$3,530,087	6.0%	$4,504,426	7.7%
Henderson	$5,286,190	6.0%	$7,474,616	8.5%
Hertford	$2,434,249	14.1%	$1,720,273	10.0%
Hoke	$2,239,761	10.2%	$2,269,587	10.3%
Hyde	$480,719	5.2%	$525,326	5.7%
Iredell	$6,336,815	5.1%	$11,781,534	9.5%
Jackson	$1,801,406	4.6%	$3,544,101	9.1%

Source: North Carolina Association of County Commissioners

County	2005-06 County Medicaid Share	2005-06 Pct Budget for Medicaid	2005-06 Avg Amount 1% excl Food	2005-06 Pct Budget from 1% excl Food
Johnston	$7,738,585	5.3%	$11,433,628	7.8%
Jones	$780,026	8.6%	$588,600	6.5%
Lee	$2,602,337	5.3%	$3,436,408	7.0%
Lenoir	$4,831,062	10.5%	$3,783,395	8.2%
Lincoln	$3,646,423	5.5%	$5,192,627	7.8%
Macon	$1,802,870	5.1%	$3,317,503	9.4%
Madison	$1,525,318	8.5%	$1,175,055	6.5%
Martin	$2,444,435	9.5%	$1,767,285	6.9%
McDowell	$2,753,034	9.0%	$3,253,332	10.6%
Mecklenburg	$29,244,549	2.7%	$73,956,998	6.8%
Mitchell	$1,186,361	9.3%	$1,256,168	9.8%
Montgomery	$1,885,878	8.8%	$1,540,366	7.2%
Moore	$3,694,403	5.4%	$6,156,092	9.0%
Nash	$5,319,765	7.4%	$5,627,910	7.8%
New Hanover	$9,172,760	4.0%	$18,951,292	8.3%
Northampton	$2,285,348	9.5%	$1,116,391	4.6%
Onslow	$5,267,416	4.9%	$10,580,126	9.8%
Orange	$4,063,284	2.9%	$7,593,291	5.4%
Pamlico	$921,236	6.4%	$918,061	6.4%
Pasquotank	$2,568,074	8.9%	$3,001,340	10.4%
Pender	$2,559,588	5.7%	$3,263,181	7.3%
Perquimans	$745,635	7.6%	$726,862	7.4%
Person	$2,466,852	6.0%	$2,699,406	6.6%
Pitt	$8,182,803	5.8%	$9,867,136	7.0%
Polk	$1,003,262	5.3%	$1,207,816	6.4%
Randolph	$6,965,082	7.3%	$8,120,253	8.5%
Richmond	$3,861,886	11.0%	$2,950,213	8.4%
Robeson	$12,860,714	12.8%	$8,101,295	8.1%
Rockingham	$6,231,152	7.1%	$5,285,835	6.0%
Rowan	$7,285,650	5.7%	$7,747,381	6.1%
Rutherford	$4,608,400	9.4%	$4,485,234	9.1%
Sampson	$4,742,147	7.5%	$4,110,264	6.5%
Scotland	$3,537,430	9.9%	$2,725,474	7.6%
Stanly	$3,468,928	5.8%	$3,586,157	6.0%
Stokes	$2,257,862	6.4%	$2,933,632	8.3%
Surry	$4,877,107	8.4%	$5,933,837	10.2%
Swain	$930,711	12.5%	$1,006,654	13.5%
Transylvania	$1,748,032	4.5%	$2,724,806	7.0%
Tyrrell	$327,970	6.9%	$283,661	6.0%
Union	$4,995,024	3.0%	$11,815,040	7.1%
Vance	$3,726,213	10.4%	$3,262,045	9.1%
Wake	$21,267,920	3.0%	$49,693,700	7.0%
Warren	$1,694,398	8.9%	$1,187,624	6.2%
Washington	$1,273,311	10.1%	$886,064	7.0%
Watauga	$1,483,123	3.8%	$4,145,035	10.6%
Wayne	$7,045,123	9.1%	$7,634,715	9.9%
Wilkes	$5,012,330	8.7%	$5,297,548	9.2%
Wilson	$5,385,456	7.3%	$5,284,870	7.2%
Yadkin	$2,254,264	8.0%	$2,498,214	8.9%
Yancey	$1,355,048	10.1%	$1,367,000	10.2%
Totals	$459,842,175	5.3%	$635,272,047	7.3%

nor's increase would come from extending the 4.25 percent state sales tax rate indefinitely instead of allowing it to return to 4.0 percent as scheduled. Part of the $260 million tax increase would be offset by tax relief for one million low-income taxpayers. The net effect would be that of a mugger leaving cab fare for his victim. But Easley has not been as anxious for the state to take on its full responsibility for Medicaid, so his proposal also leaves counties with 15 percent of the state's share of Medicaid payments.

Real Challenges, Real Solutions

In addition to the two proposals outlined above, legislators have heard a number of other proposals in recent weeks including a half-cent local-option sales tax for school construction[6] and calls from Congressman G.K. Butterfield to take on the county share of Medicaid[7] and from Lt. Gov. Beverly Perdue and State Treasurer Richard Moore to implement an earned-income tax credit.[8] Each of these proposals attempts to address one or more of the many real challenges facing North Carolina, but does not provide a real long-term solution.

Medicaid

Nowhere is the disconnect between money and policy more evident than in Medicaid, which was created to pay health care expenses for the poor. North Carolina is the only state that requires counties to pay a fixed share of the program's cost.[9] State lawmakers authorized $27 million to cap the county share in 2006, which saved counties about five percent of their cost. Counties only have limited ability to affect Medicaid spending through how they administer the program. When legislators in Raleigh or Washington, D.C., add new services or expand eligibility, as with the 2005 expansion to cover children in families that earn as much as three times the poverty level ($60,000 for a family of four in 2006),[10] county commissioners must either find room in their budget or raise the property tax. Poor counties are particularly hard hit by Medicaid expansions:

- 47 counties spend more on Medicaid than on school facilities
- 20 counties have more than one in four residents eligible for Medicaid
- 2 counties, Robeson and Bertie, dedicate more than 25 cents of their property tax to Medicaid.[11]

Medicaid clearly imposes a tremendous burden on county budgets, and state lawmakers have done little to ease this burden. President George W. Bush and members of Congress did more to save money on Medicaid, with the Medicare drug benefit passed in 2003[12] and the addition of more tools in the Deficit Reduction Act of 2005,[13] than state lawmakers have accomplished in the last five years. By shifting state Medicaid costs to the Federal Medicare program, the Medicare drug benefit helped save the state more than $70 million in fiscal year (FY) 2005-06 and will likely save $200 million more in FY 2006-07.

The 2005 Federal Deficit Reduction Act can save money for Medicaid by expanding states' ability to go after asset transfers. Long-term care is the most expensive part of Medicaid, and with Medicare Part D taking on more drug costs, also the fastest growing. A small number of individuals have used attorneys and financial planners to hide their wealth so they could have their nursing home expenses paid by Medicaid.

From the start, Medicaid was intended to meet the needs of poor Americans, not to protect the inheritance of Baby Boomers.

State lawmakers should refrain from expanding Medicaid any further and instead focus on ways to take advantage of federal flexibility to restructure the program with fewer optional benefits for fewer eligible groups.[14] But half of the recommendations made by the General Assembly's 2005 Blue Ribbon Commission on Medicaid Reform would have expanded Medicaid instead of reformed it.[15]

Some lawmakers and their allies have also sought ways to transform Medicaid into a single-payer health insurance pro gram despite the high costs encountered by states such as Tennessee and Oregon when they tried to expand their Medicaid programs. Both cases illustrate the need for cost control. As University of North Carolina, Chapel Hill, Professor Jonathan Oberlander wrote, "[I]ts absence may be, in the long run, the Achilles' heel of state-led health reforms that seek to move toward universal coverage without serious mecha nisms to control spending in their own pro grams and without limits on medical care inflation in the broader health system."[16]

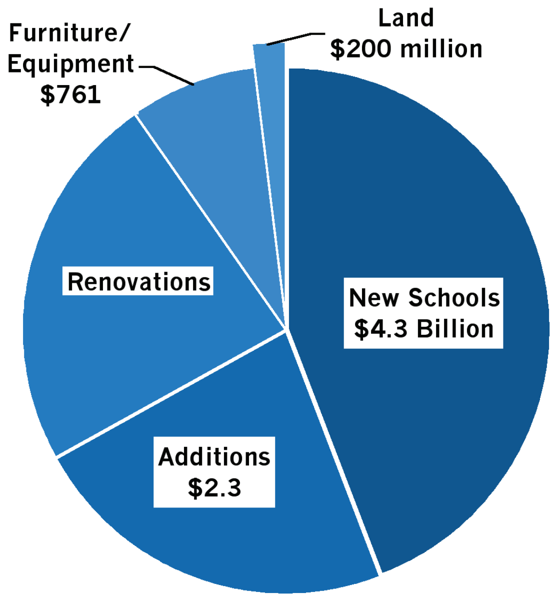
The best way to control health care costs is to control health care utilization.[17] This means somebody must ration care. The question then becomes who should do the rationing. Is it better for an insurance claims adjuster in Chapel Hill, a legislator or bureaucrat in Raleigh, or a mother in Wilson to judge the value of care for her daughter's fever? Florida, South Carolina, Kentucky, and West Virginia have moved toward patient-driven models for Medic aid that would give the mother more of a chance to make that decision.[18] The North Carolina legislature should follow suit.

Lawmakers should not be rewarded for avoiding cost-control measures with more revenue to accept the policy accountability and fiscal responsibility for the entire non-federal share of Medicaid spending.

School Construction

Just as rural counties struggle to pay

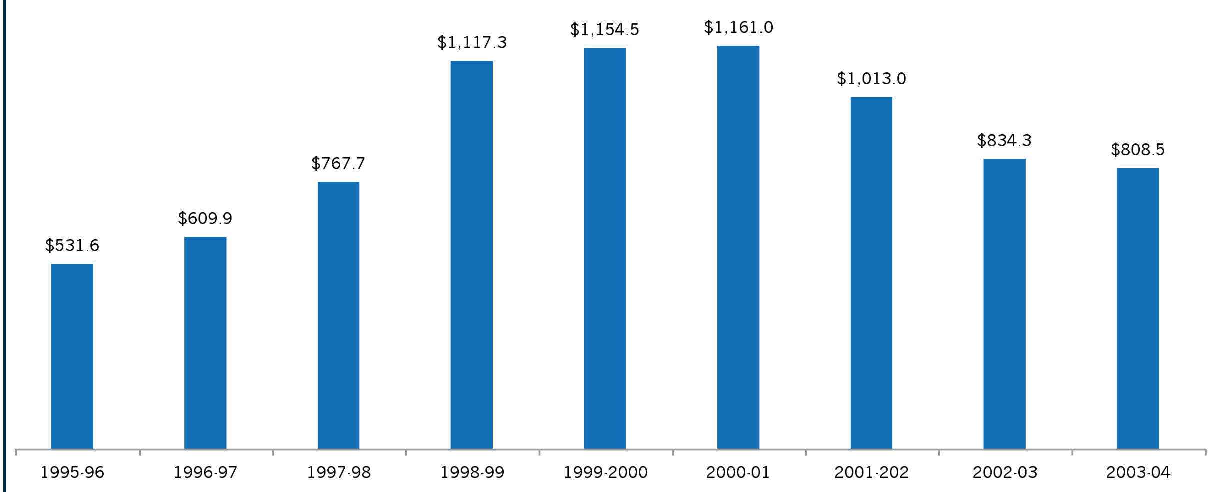
Chart 2. Five-Year Facilities Needs



Source: N.C. Dept. of Public Instruction

for all of their Medicaid recipients, North Carolina's fastest-growing counties face a tremendous challenge in providing enough space for all the students that will be en tering their schools in the next ten years. North Carolina's public school systems report facilities needs of over $9.8 billion over the next five years.[19] Although the facilities needs of school systems vary, rural counties generally require funds to repair and replace aging school buildings, while urban and suburban counties need to ease crowding and accommodate student enroll ment growth. Statewide, there has been a 27 percent increase in the number of mo bile units used by school systems over the last five years, and student enrollment is projected to grow by over 94,000 students or 7.1% over the next five years.[20] New or additional funding streams alone will not solve the problem. Now, more than ever, school systems, with the aid of the General Assembly, need to do a better job finding seats for students without overburdening the taxpayer.

Chart 3. Combined Federal, State and Local Capital Outlays for School Facilities, FY 1995-96 through FY 2003-04 (in millions of dollars)



Source: N.C. Dept. of Public Instruction

Use Innovative Construction and Financing Options: School systems can manage enrollment growth using proven, cost-effective construction, renovation, and maintenance solutions that are taxpayer-friendly and enhance educational opportunities. The General Assembly recently passed legislation that allows school systems to enter into long-terms leases for schools built by a private developer. These public/private partnerships would provide a cost-effective alternative to financing new construction by issuing long-term debt via bonds or certificates of participation. Other underused ways to reduce the cost of school construction include adapting or reusing commercial buildings, revising design or capacity standards, rethinking financing policies for athletic facilities, building modular schools, using satellite campuses, and using virtual schools. Finally, school systems may use innovative institutional arrangements such as real estate trusts, non-profit organizations, and county government management, to make construction and renovation projects more efficient.[21]

Reduce Regulatory Burdens: In urban and suburban counties, land is becoming scarce and costs for land and site development are skyrocketing. At the same time, school systems are encountering demanding and costly zoning and environmental regulations. Every additional zoning requirement could add tens of thousands of dollars to the cost of a school because such regulations often consume an inordinate amount of time and resources. For example, regulatory requirements for school property, including those regarding drainage, collection, and treatment, have increased over the years. Yet, there is little evidence that these and other requirements provide substantial benefits to the school building, school site, or surrounding property. Among builders and architects, many of whom recognize the futility of the regulations, there has been little effort to lobby for zoning requirements that offer greater flexibility for school construction. Builders, architects, and school officials should come together with city, county, and state officials to ease zoning requirements and environmental regulations for school construction in urban and suburban counties.[22]

Increase Accountability: Currently, no school system in North Carolina holds school leadership accountable for their capital planning and expenditures. School systems should award performance bonuses to senior administrators and facilities personnel who satisfy all of their school system's needs but keep capital expenditures low. Citizen advisory committees would add another layer of accountability by reviewing all aspects of the system's capital improvement strategy, including planning, budgeting, the construction process, and maintenance expenditures. Finally, the Department of Public Instruction should provide greater transparency in the school construction process by publishing detailed statistics and reports, including itemized lists of fees, design cost information, cost of building components, and cost overruns.

Implement School Choice: One important way to reduce the cost of school construction is to lift impediments to school choice. As more students attend charter, nonpublic, or home schools, none of which receive state funds for capital expenditures, school systems would have to create fewer seats schools to accommodate new students. The General Assembly should begin this process by removing the cap of 100 charter schools and establishing a process that allows the State Board of Education to expedite the approval and opening of new charter schools. In addition, the General Assembly should allow high-performing or high-demand charter schools, in consultation with the DPI Office of Charter Schools, to amend their charter and enroll as many students as they are able to accommodate. In addition, the state legislature should also offer a voucher or tax credit to parents who enroll their children in nonpublic or home schools. A comprehensive program of school choice would ease the burden on taxpayers, who invest an average of nearly $890 million a year in state, local, and federal funds on school facilities.[23]

Road Construction

The debate in January 2006 over the gas tax increase confirmed for many that the state is not spending road money wisely.[24] Others challenged the wisdom of taxing fuel consumption instead of road usage.[25] In June 2006, the Department of Transportation released its estimate of a $65 billion shortfall to build and maintain roads over the next 25 years — $920 million in just the next three years.[26] Looming congestion and bridge repairs further worsen the problem. Earmarks of transportation funding by North Carolina's Congressional delegation also came under scrutiny for their role in diverting funds to ribbon-cutting projects for members of Congress and away from planned road construction projects.[27]

North Carolina has 79,000 miles of state-maintained roads, second only to Texas. These roads account for 77 percent of all road-miles in the state.[28] The North Carolina Department of Transportation is funded almost entirely by taxes on those who own or operate cars and trucks in the state, but more than one-fourth of its budget goes to mass transit, ferry service, or some purpose other than building and maintaining roads in the nation's second-largest state highway system.

Since 2001, the General Assembly has taken $250 million a year from the Highway Trust Fund, which was created in 1989 to build urban loop highways and a 3,000-mile, four-lane arterial system to connect the coast to the mountains in 13 years. More than 17 years later, however, only about two-thirds of the work has been completed and the remaining mileage is slow in nearing completion. Originally intended to compensate for the loss of motor vehicle sales tax revenue with the creation of the Highway Trust Fund, this policy of shifting money to the General Fund lost its rationale in 2003, when all of the projects financed through the Trust Fund should have been completed. With so much left to do and the projects already five years behind schedule, the money should be dedicated to completing these projects instead of being diverted to the General Fund.

In addition, recent research has found that millions of transportation dollars each year are wasted on projects that are not cost-effective. The state needs to do a better job of prioritizing projects based on engineering criteria such as safety, congestion relief and road condition, then change the state highway funding formulas to fund the most worthy projects. Universtity of North Carolina-Charlotte Professor David Hartgen, in a 2004 study, found:

> *On average, the 349 major projects cost about 2.67 cents per vehicle-mile served, or about 5 percent of the cost of driving. However, their cost-effectiveness varied widely, from as little as about 0.3 cents per vehicle-mile to over $1.00 per vehicle-mile.*

Low traffic volume (less than 6,200 average daily traffic) and low volume-to-capacity (less than 0.35) projects were the least cost effective, according to Hartgen. The use of highway money to build train systems and cost ineffective projects has diverted much needed money from going to road maintenance. He concluded:

> *If the projects costing more than 5.3 cents per vehicle-mile (two times the state average) had been delayed or deleted, about $2.5 billion would have been saved, about the same as the maintenance shortfall. ...[T]he State's deteriorating road conditions could be reversed if just 9 percent of its highway capital budget could be diverted to maintenance.*[29]

Tolls, high-occupancy-toll lanes, and other user-based funding might fund some road construction more efficiently, equitably, and simply, and can do so sooner than current formulas otherwise permit.

Chart 4. Nearly $1.2 Billion Transferred from Highway Trust Fund After Projects Were to Have Been Completed

Fiscal Year	*Amount*
2002-034	$377.4 million
2003-04	252.4 million
2004-05	242.6 million
2005-06	252.6 million
2006-07	57.5 million
Total	**$1,182.5 million**

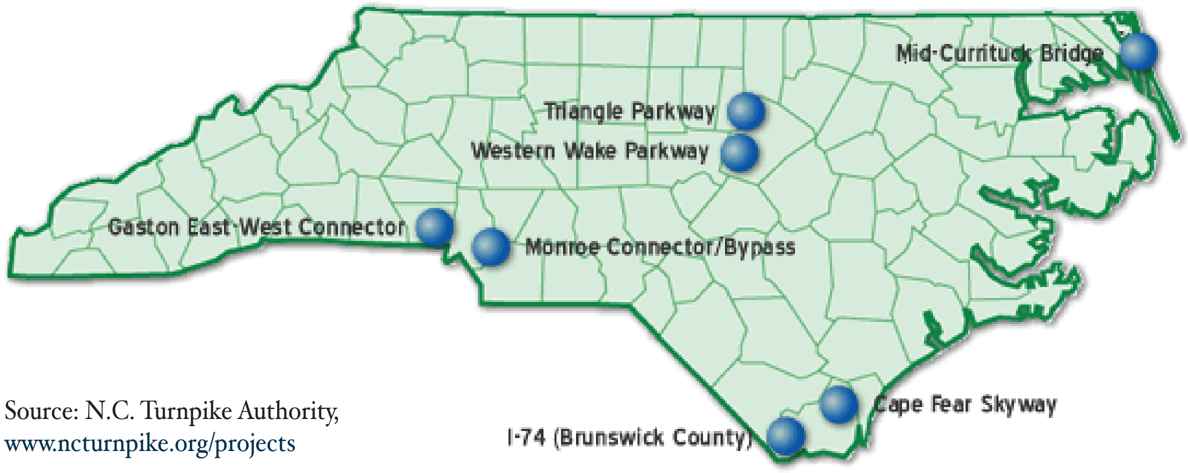
Source: Fiscal Research Division

The North Carolina Turnpike Authority is limited to building only new roads, but has seven projects in four areas of the state under review and could complete the Triangle Parkway as early as 2010[30] (see map).

The General Assembly should also permit greater use of financing devices commonly used in other states. Lumped together as innovative financing, these include a debt tool and two types of federal credit assistance. Credit assistance can help to increase private participation in meeting road transportation needs. Some of the more promising methods include:

- States pledge future federal-aid payments to debt service of Grant Anticipation Revenue Vehicles, or GARVEE bonds. A 2005 Brookings Institution study listed 16 states that together had issued 35 GARVEEs or similar bonds totaling $7.5 billion by the end of 2004.[31] As the name suggests, GARVEEs allow states to begin work on projects for which they have not yet received funds, but for which they anticipate receiving future federal grants. Because the federal-aid payments are not guaranteed, GARVEEs face higher interest rates than traditional bonds. The main

Chart 5. Projects of the N.C. Turnpike Authority



Source: N.C. Turnpike Authority, www.ncturnpike.org/projects

advantage is the ability to start projects sooner than would otherwise be pos sible, which can help keep costs down.

- The Transportation Infrastructure Finance and Innovation Act of 1998, TIFIA, established the federal De partment of Transportation's ability to provide credit assistance to "major transportation projects of national or regional significance."[32] In general, eli gible projects cost $50 million or more. TIFIA funds can take the form of direct loans, loan guarantees, or lines of credit to public and private project sponsors. These funds are subordinated debt, which makes them easier to leverage for greater private sector funding partici pation.[33] South Carolina and Texas are among just nine states that have used the TIFIA program. The Texas Turn pike Authority has used TIFIA for two projects.[34] The South Carolina Trans portation Infrastructure Bank (SCTIB) used a direct loan to initiate construc tion on for the Cooper River Bridge in 2001, but never used drew funds. The SCTIB was able to secure tax-exempt bonds in 2004 at a lower interest rate and retire the federal loan.[35]

- A State Infrastructure Bank, like the SCTIB, "is a revolving fund mechanism for financing a wide variety of highway and transit projects through loans and credit enhancement. SIBs are designed to complement traditional Federal-aid highway and transit grants by providing States increased flexibility for financing infrastructure investments." North Car olina established a State Infrastructure Bank in 1997 but the SIB has funded just two projects.[36]

- North Carolina is one of 20 states (as of 2004) with an enabling law for public/ private partnerships in road construc tion.[37] Private-sector participation is one option the Turnpike Authority can consider to provide the additional funds that tolls cannot. Other states have pro vided greater leeway for tapping private funds to build roads.[38]

In addition, some local governments, such as Cary, have taken the initiative to fund needed road expansions in anticipa tion of repayment from the state. This is another alternative that directs money to the highest priorities within the state, even without new local taxing authority.

The Earned Income Tax Credit EITC

The federal earned-income tax credit (EITC) is a relatively effective welfare policy. A 2004 study concluded that the federal EITC pulled "some 4.9 million people, including 2.7 million children ... out of poverty in 2002."[39]

But the federal earned-income credit also has a number of problems. It is a complicated process simply to determine whether one qualifies for the credit, with further complexities in calculating the amount of a credit to be taken. Whether because of complexity or basic fraud, the IRS found that between one-fourth and one-third of claimed credits were improp erly taken in the late 1990s. Either the per son did not qualify for the tax credit at all or qualified for a smaller credit. Although some evidence suggests the ratio of over payments may be lower, the IRS has not done a more recent comprehensive study.

The earned-income credit phases out at certain income levels, but there is little upward adjustment for married couples. If two single parents qualifying for the credit marry, the combined income of the couple may reduce the value of the credit or elimi nate it altogether. As a result, while the EITC has encouraged more single mothers to enter the workforce, it has had a mini mal effect on married mothers' apparent willingness to seek work.[40]

Moving from the federal to the state level, the value of an earned-income credit from both a monetary and policy perspec tive is significantly lower. The average fed eral credit was $1,800 in 2005, which would put the average state credit at $180, roughly 29 hours of work at the state minimum wage. Further, as a supplement to the fed eral credit, a state EITC would not correct any flaws in the federal program but would inherit all of those that exist.

Even with these problems, a state version of the EITC set at 10 percent of the federal credit would have been a good alternative to the 17 percent increase in the minimum wage that took effect January 1. Unlike a minimum wage, the EITC "com pensates for low wages without interfering with the labor market."[41] The tax credit is also better targeted than a minimum wage, which benefits a college student at Elon as much as a working mother in Elizabeth City. There is questionable utility in com bining a higher minimum wage and the tax credit. In fact, a person with no children who worked full time at the state minimum wage of $6.15, or a federal minimum of $7.25, would earn $160 too much ($12,300) to qualify for the federal earned-income credit, and so would not qualify for a state credit, either.

Regardless what other pros and cons a state EITC possesses, the fatal flaw of most proposals for an EITC is how to pay for it. Dedicating some new revenue from a general tax hike to provide targeted tax relief does nothing to address the broader problems in the tax system. Hiking the regressive sales tax to accomplish the nominally progressive goal of an EITC adds insult to injury and reduces the net value of the tax credit. There are problems with North Carolina's tax code, but add ing a parallel tax structure is not the way to improve problems in the main system. Only

Chart 6. EITC Rates for Persons with Two or More Dependents

Earned Income	*Marginal EITC Rate*
$0 – $10,000	-40%
$10,000 – $13,000	0%
$13,000 – $32,000	21.06%
Over $32,000	0%

Source: www.ncpa.org/pub/st/st250/images/st250_tab3.gif comprehensive tax reform, which depends ultimately on spending reform, can improve the state's tax code.

Spend and Tax Reform

North Carolina's reliance on a progressive personal income tax and a regressive sales tax on goods leave government revenues vulnerable to economic cycles. Tax collections grow faster than income in good years and shrink faster in bad years.[42] Targeted tax incentives and other carve-outs (including any earned-income tax credit) make the tax system more complex and penalize some choices while rewarding others.[43] Spending reform would end the boom and bust cycle of the state budget. A consumed-income tax and corporate income tax repeal would produce a simple, efficient, and equitable tax code that burdens a broad taxpaying base with a low tax rate.[44] Other methods of taxation would accomplish the same goal, but the legislative proposal moves in the opposite direction.

A consumed-income tax to replace the current standard income tax would make the tax system both fairer and more efficient. Such a tax would exclude all savings and investments from taxation, thereby eliminating the double taxation individuals and businesses now face.†

> *For working men and women, this implies that all work-related expenses,* i.e., *commuting expenses, educational expenses incurred for the purpose of enhancing future income, day care expenses, etc. should not be included in taxable income. In terms of analyzing the bias against saving, i.e., non-consumed income, these expenses are analytically equivalent to saved income. They represent forgone current consumption in an attempt to generate future income.*[45]

Another step toward tax fairness would be to eliminate the corporate income tax. As a legal entity, corporations cannot pay taxes; they collect them from employees through lower compensation, shareholders through lower stock prices and dividends, and customers through higher prices. Eliminating the tax would also serve as a strong economic incentive for those corporations staying in North Carolina and those relocating. Even if lawmakers were to keep the corporate income tax, they could lower the rate for all corporations if they would stop picking favored companies with tax credits and other subsidies such as the One North Carolina Fund. Eliminating corporate tax credits for certain actions and industries would save $200 million, which could be used to reduce the corporate income tax rate to 5.1 percent.[46]

It is important to recognize that lowering or eliminating the corporate income tax is not the same as lowering taxes on all businesses. Most business taxes are paid through the personal income tax. This is because 99.7 percent of all employer firms are small businesses and 60 percent of all corporate returns are filed by S-Corporations, pass-through entities whose owners pay taxes on the corporation's net income.[47] There is no more reason to subsidize small businesses than there is to subsidize large corporations,[48] but these numbers do indicate the importance of the personal income tax for businesses and individuals.

Economists who have appeared before the State and Local Finance Modernization Commission and those who took part in the Institute for Emerging Issues 2006 work project on Financing the Future have repeatedly emphasized the fundamental aim of tax reform – spreading a low rate across a broad base. Taxes exist to raise money, not reward or punish behavior. Any

† Standard economic analysis demonstrates that under the current income tax system the returns to saving and investment are taxed at least twice while consumption is taxed only once. For an in-depth explanation, see endnote 44.

reform, therefore, should make the system simpler, more efficient, and more equitable. Sufficiency of revenues is not an issue for tax reform, but for spending reform.

Spending reform is a necessity. Few would argue that the Global TransPark has been a success, but the state continues to throw good money after bad. While some people in the Raleigh area appreciate the North Carolina Symphony and the North Carolina Museum of Art, it is hard to argue why investment bankers in Charlottte should pay for them. For all the history of High Point as the furniture capital of the world, there is little reason for folks in the community of Hangin' Dog to pay for its marketing. There are numerous examples of such spending throughout the state budget, but the costs are dispersed and the benefits concentrated, so they are difficult to end. As long as programs like these continue to be funded while lawmakers talk about raising taxes to pay for schools, roads, Medicaid, public safety, and the poor, the need for spending reform will continue.

There are three procedural ways to reform government spending and slow its growth. The current method of budgeting starts with the question: "How much will it cost this year to do exactly what we did last year?" Instead of searching for efficiency or questioning the value of programs, the current system treats as a cut any attempt to restrain growth. In contrast, zero-based budgeting is what businesses do in theory. It forces agencies to ask the question: "If we were not doing this today, would we start?" Higher spending is called higher spending and existing programs face the same scrutiny as new programs. Zero-based budgeting does not have an enforcement mechanism, which could leave lawmakers as vulnerable to cries of poverty from agencies and their beneficiaries.

For the past decade, General Assembly leaders have thwarted attempts to act on a bill to cap spending growth at the combined rate of population growth and inflation. Excess revenues would go into reserve funds to smooth spending in recessions. Colorado voters passed a version of this called the Taxpayer Bill of Rights (TABOR) but undermined it by also passing a referendum to guarantee spending growth for public schools. The two were at odds, and in 2005 voters decided to take a five-year break from TABOR to allow greater spending growth. TABOR failed referendum votes in Maine, Nebraska, and Oregon in 2006.

A third option is to have a commission that offers a package of program reductions and eliminations to the General Assembly for an expedited yes-or-no vote, like the Base Realignment and Closing (BRAC) Commission did for the Pentagon. The BRAC commission put together a savings package "large enough to motivate taxpayers into matching the intensity of military base supporters" according to Michelle Muccio and Brian Riedl of the Heritage Foundation.[49]

One way or another, legislators must find a way to rein in spending. They cannot raise taxes indefinitely or they will cause people to vote with their feet and jeopardize the future prosperity of North Carolina.

Conclusion and Recommendations

Gov. Easley and state legislators face a number of significant challenges in crafting a budget for the next two years. The state should address looming crises in health care, schools, roads, and public safety (the judicial system and corrections). These are generally considered some of the basic functions of state government, but past legislatures have used money poorly within these functions and have wasted the money trying to pick winners with the Global TransPark, Randy Parton Theater, and

CIAA basketball tournament marketing. Now they want to raise taxes to fund what could otherwise be worthwhile projects instead of recognizing that state budgets manifest the priorities of legislators. New taxes pay for the least important projects that otherwise would go unfunded.

Legislators have plenty of ideas to choose from if they would like to spend taxpayers' money more efficiently and effectively. The Government Performance Accountability Committee (GPAC) made a number of recommendations 15 years ago, most of which have been ignored, as have a host of other studies and legislative proposals.

This report examined five key areas that will receive attention in the 2007 legislative session – Medicaid, school construction, road construction, assistance to the poor, and budgetary reforms.

- On Medicaid, the General Assembly should take over the share of spending it passed along to counties when establishing the program in North Carolina. The potential $500 million cost can be recovered through benefit and eligibility restrictions, particularly in long-term care. Cost control is critical to improving the viability of the entire health care system. Patient-centered Medicaid reform could accomplish more permanent savings with little or no negative effect on health outcomes.

- The General Assembly and local governments together can undertake steps to lower the forecast $10 billion need for school construction while still meeting the demand for capacity. School districts have many innovative construction and financing techniques at their disposal. Local governments can ease the zoning and environment regulatory burdens on school construction. County boards of commissioners can demand more accountability from their local school boards. Finally, the State Board of Education, Department of Public Instruction, and General Assembly can expand the cap on charter schools, expand the number of students allowed under existing charters, or provide a tax credit for parents who choose nonpublic education for their children.

- More of the state's road construction needs could be met if the General Assembly and Department of Transportation simply chose to spend tax and fee revenue collected from drivers on roads instead of bike programs, mass transit, or non-transportation needs. Transportation department officials should direct more road money to projects with sufficient traffic volume to make them cost effective. The state can take greater advantage of user-fees such as tolling, public/private partnerships, and other innovative financing methods to start projects sooner. Also, local governments can dedicate money to construct needed roads in anticipation of state funds.

- Tax credits at the state level should offset problems in the federal tax code, not simply extend targeted federal tax benefits. An earned-income tax credit (EITC) is a substitute for and improvement on a minimum wage, but legislators already approved a $1 increase in the minimum wage. Unless the minimum wage is repealed, it will continue to harm small businesses and make entry-level work harder to find. Even ignoring these issues and the problems of administering the federal credit, the proposed North Carolina EITC would be paid for by a broader tax increase, thereby moving the state further from the ideal tax reform of a flat, low rate spread across a broad base.

- Tax reform is itself an important goal for the state. There are too many carve-outs for government-approved groups and activities. Ideal tax reform would eliminate the corporate income tax and transform the personal income tax into a consumed-income tax, which would end the double taxation of saving and investment returns. Regardless what shape the tax code eventually takes, legislators should limit spending so that taxpayers do not face higher costs for government at the very time they can least afford to pay those costs. Remov ing corporate welfare, state subsidies of non-profit groups, and other pork are simple steps lawmakers can take to free money in the budget for items that are generally agreed to be appropriate functions of state government such as schools, roads, health care, and the justice system. Efforts to improve how money is spent on these functions and how the money is raised can have more impact if they do not have to compete in a General Fund budget larded with extras.

These could join the long list of un used recommendations, but the need to reform spending and taxes is real. Spending cannot expand faster than the economy indefinitely. Raising taxes may be easy, but the tax code is full of holes and the burden on those who pay taxes is high. Medicaid is straining county budgets. The demand for new schools and roads grows with the state's population. Add to these demands the need to provide such prosaic services as public safety, water, and sewer, and the challenge may seem daunting in the ex treme. With the right priorities, however, lawmakers can pass a budget that addresses the state's needs without limiting the abil ity of North Carolina families to meet their own needs.

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About the Author

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"To prejudge other men's notions before we have looked into them is not to show their darkness but to put out our own eyes."

JOHN LOCKE (1632–1704)

Author, *Two Treatises of Government* and *Fundamental Constitutions of Carolina*

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