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SPOTLIGHT

No. 251— March 8, 2005

C'S ARE FOR TAXES

"Temporary" Taxes Yield Lower Grades

Summary: The state of North Carolina and our governor, Mike Easley, received mediocre grades on two recent report cards. Tax increases that were to be temporary when passed in 2001, but which continue in the governor's budget through at least 2006, contribute to the low grades. The additional tax bracket and half-cent sales tax will have added nearly $1.9 billion between their original sunset and July 2007, while Gov. Easley's additional taxes will bring almost as much in FY2006-07 alone.

Two very different report cards published in early March gave the state government and governor Mike Easley grades of C. The Government Performance Project (GPP) judged how state governments use information and management processes to improve performance with measurable results. The Cato Institute graded those governors who had been in office since 2001 on their enacted and proposed tax and spending policies.

State governments as a whole are scored in the GPP report card, which in the past focused on processes, but emphasizes results this time. North Carolina's grade of C+ puts it in the lower tier of states. Among nearby states, its grade is the same as Tennessee's. Our north neighbor, Virginia, is one of only two states to receive an overall grade of A-. Georgia receives the highest marks for managing people.[1]

North Carolina's 1970s-vintage information technology systems are a significant drag on the government's ability to function, particularly in personnel. Capital spending and project monitoring in transportation and other areas are also weaknesses for the state according to the GPP's findings. Once built, non-urban roads become the state's responsibility, but counties determine where and when they are built. Also, when he took office, Governor Mike Easley ended a decade-old practice of the Office of State Budget and Management to review performance and publish the results of its review. The GPP is acutely critical of such activities because they have allowed standards to drop and have led to a lack of coordination.

Although both the State Treasurer and Governor have warned about rising debt loads, North Carolina drew praise for its modest debt and long-term outlook. The GPP is less critical of the state's imposition of temporary taxes in 2001, but notes their scheduled end as a "big problem regarding structural balance." Fiscal Research Division analysts have said, however, that the structural deficit is over $1 billion and the ex-

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tension of sunsetting taxes only covers about half of that. The governor's budget adds $312 million in taxes in fiscal 2005-06 and another $545 million in fiscal 2006-07.

Taxes are a significant factor in Governor Easley's low scores on the Cato Institute report card, while general profligacy by governors sets a low curve to boost the letter grade to a "B" on spending and a "C" on revenues and tax rates. A lower corporate tax rate and no increase in cigarette taxes were positives. Revenue collections through 2002 were down more than spending. Recommended tax increases would have yielded faster growth than spending, but enacted taxes have grown at 0.4 percent in real terms each year since 2002, half the 0.8 percent annual rate of growth in spending.[2]

Governor Easley's grade on the Cato study may have been lower if his current budget or an earlier budget gimmick were included. Cato did not count a half-cent sales tax increase the state effectively imposed on counties by rescinding local grants, which was in addition to the state-level temporary half-cent increase that now has no expiration date. Adding further to state revenues are an extension of the estate tax and a 900 percent increase in the cigarette tax over two years. All told, the governor will have increased the tax burden on North Carolinians in fiscal 2006-07 by nearly $1.8 billion.[3] Given the state's mediocre grades in the GPP report card, higher taxes and spending, even for worthwhile objectives, are likely to be misallocated. The executive and legislative branches need to work together to rein in spending growth, taxes, and debt issuance. At the same time, management controls also need to be reinstated to ensure funds go where they are intended and effective.

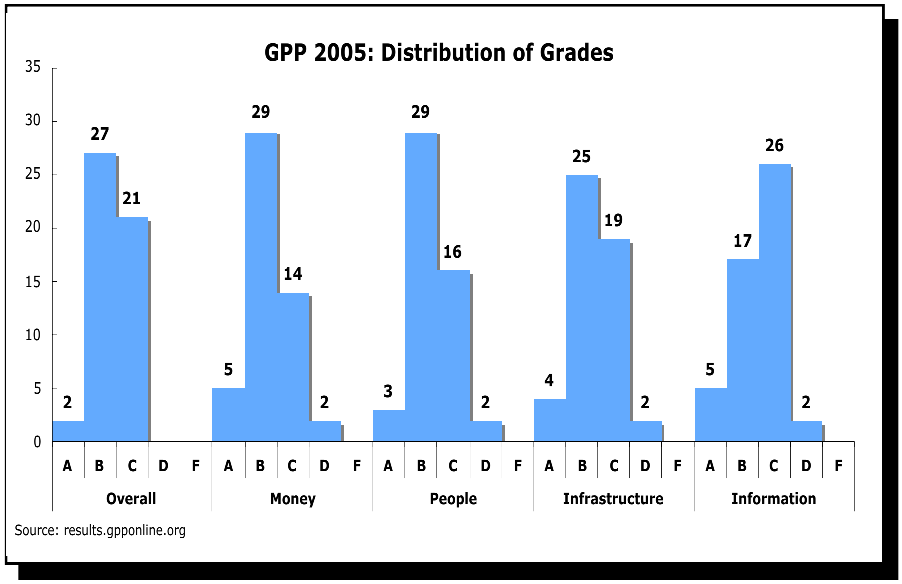
— Joseph Coletti, Fiscal Policy Analyst

NOTES

[1] http://results.gpponline.org

[2] "Fiscal Policy Report Card on America's Governors: 2004," Policy Analysis #537, Cato Institute, March 1, 2005.

[3] "North Carolina State Budget 2005-2007," Office of State Budget and Management, February 23, 2005 and Fiscal Research Division, May, 2004



GOVERNMENT PERFORMANCE PROJECT
GRADING THE STATES 2005

	NC	SC	GA	TN	VA
Overall	C+	B	B	C+	A-
Money	B-	B+	B-	B-	A
Long-Term Outlook	+	0	0	0	+
Budget Process	0	+	0	0	+
Structural balance	0	0	0	-	+
Contracting/Purchasing	0	0	0	0	+
Financial Controls/Reporting	0	+	-	0	+
People	C+	A-	A	C-	A-
Strategic Workforce Planning	-	+	+	-	+
Hiring	-	+	+	-	0
Retaining Employees	0	0	0	0	0
Training and Development	0	+	+	0	+
Managing Employee Performance	0	+	+	-	+
Infrastructure	C+	C+	C+	B-	A-
Capital Planning	-	0	0	0	+
Project Monitoring	-	0	-	0	0
Maintenance	0	-	-	-	+
Internal Coordination	0	0	0	+	+
Intergovernmental Coordination	0	+	+	0	0
Information	C+	B	B-	C+	A-
Strategic Direction	0	0	0	0	+
Budgeting for Performance	-	+	0	0	0
Managing for Performance	-	+	0	-	+
Program Evaluation	0	0	0	0	+
Electronic Government	0	0	0	+	+

Note: "+" = Strength, "0" = Mid-level, "-" = Weakness
Source: results.gpponline.org

Gov. Easley's Cato Institute Fiscal Policy Report Card

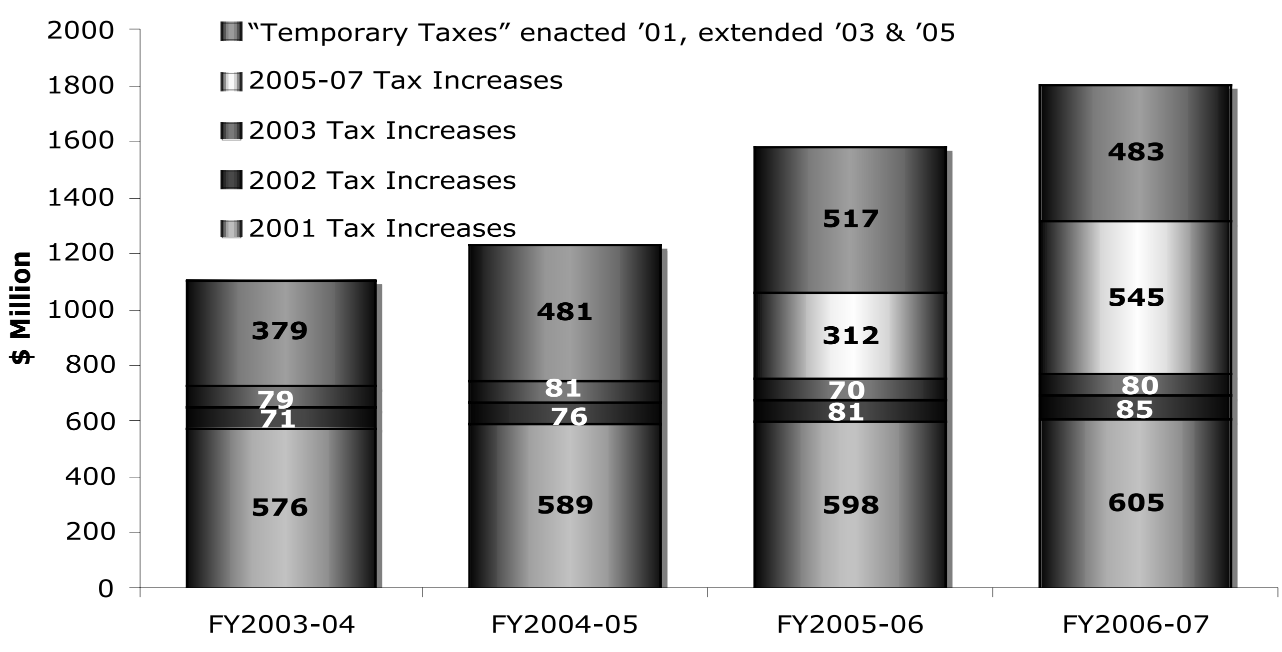
	Result	Rank	Median	Average	High	Low
Overall Grade	53	8 of 17	52	52	77	30
Grade	**C**	T-8 of 17				
Spending Variables	Result	Rank	Median	Average	High	Low
Score	61	5 of 17	57	54	92	21
Grade	**B**	T-3 of 17				
Average Annual Change in Real per Capita Direct General Spending through 2002	-0.2	1 of 17	3.2	3.4	8.3	-0.2
Average Annual Change in Direct General Spending per $1,000 Personal Income through 2002	-0.3	4 of 17	2.1	2.2	7.4	-0.8
Average Annual Change in Real per Capita Direct General Spending through 2005	0.8	13 of 17	-0.3	-0.5	2.0	-3
Average Annual Change in General Fund Spending per $1,000 Personal Income, 2002-2005	1.0	12 of 17	-1.4	-1.4	3.7	-6.8
Revenue and Tax Rate Variables	Result	Rank	Median	Average	High	Low
Score	50	9 of 17	50	50	68	32
Grade	**C**	T-7 of 17				
Average Annual Change in Real per Capita Own-Source General Revenue through 2002	-1.3	5 of 17	0.6	1.0	11.0	-3.0
Average Annual Change in Own-Source General Revenue per $1,000 Personal Income through 2002	-3.3	7 of 17	-2.2	-1.7	2.1	-6.1
Average Annual Recommended Tax Changes as % of Prior Year's Spending through 2005	1.3	T-12 of 17	0.7	0.7	5.2	-0.3
Average Annual Recommended Change in General Fund Revenue per $1,000 Personal Income through 2005	1.6	12 of 17	0.3	0.1	3.9	-3.5
Average Annual Change in Real per Capita General Fund Revenue, 2002-2005	0.4	T-9 of 17	0.4	0.4	5.1	-3.4
Change in Top Personal Income Tax Rate (% point)	0.75	13 of 13	0.0	-0.3	0.8	-1.0
Change in Top Corporate Income Tax Rate (% point)	-0.75	3 of 17	0.0	-0.2	1.3	-2.0
2004 Combined Top Income Tax Rates (personal plus corporate)	15.5	T-12 of 17	14.5	12.6	21.0	0.3
Change in Sales Tax Rate*	0.5	T-10 of 15	0.0	0.4	1.6	0.0
Change in Gas Tax Rate (cents per gallon)	1.9	14 of 17	0.0	1.2	9.0	0.0
Change in Cigarette Tax Rate (cents per pack)	0	T-1 of 17	35	40	100	0

Numbers are percentages unless otherwise indicated

*Does not include imposed voluntary local rate increase of 0.5 cents. Including this would drop Gov. Easley into a four-way tie for 11th, with the second highest sales tax increase among the 15 governors rated.

Source: Cato Institute, Fiscal Policy Report Card on America's Governors: 2004

Effects of FY2001-07 Tax Increases and Extensions



Source: Office of State Budget and Management 2005-07 Budget, NCGA Fiscal Research Division