John Locke FOUNDATION

spotlight

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Spending Beyond Government Means

Even politicians must face fiscal truths

KEY FACTS: • Tax revenue in North Carolina is volatile because of the dependence on income and sales taxes.

• Proper budgeting would account for the rise and fall in tax revenues over time.

• Instead of proper budgeting, legislators have been on a spend-and-tax roller coaster for the past twenty years, spending when tax revenues are high and raising taxes when revenues are low.

• **$2,311:** *The amount of budgeted appropriations per person for the current fiscal year ending June 30, 2009.*

• **41.3 percent:** *The amount by which inflation-adjusted spending per person climbed between FY 1989 and FY 2009.*

• **$3.0 billion:** *The amount state government could save if spending per person were brought back to 1990s levels, adjusted for inflation.*

State government in North Carolina obtains most of its money from two volatile taxes. First is the progressive income tax, which provided 56 percent of state government revenue in 2007. It grows faster than the economy in expansions as people earn more and move into higher tax brackets, but shrinks faster in contractions as people earn less and move into lower tax brackets. Second is the sales tax, which provides another 27 percent of revenue. People make more and larger taxable purchases as the economy grows and their outlook brightens, but they cut back when the economy slows and their prospects dim. These two taxes, together with the corporate income tax, make up roughly 90 percent of state General Fund revenue each year.[1]

Wise budget writers would adjust to these cycles by spending less than is available in fat years and setting aside a portion to maintain core services in lean years. Once an adequate amount was set aside, the government could even return the rest to taxpayers.

Instead, spending in the state follows the same cycle. Spending climbs as

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fast as tax revenues in years of plenty, then slows in lean years while tax rates jump. Then as the economy grows, tax revenues and spending again climb together.[2]

State government appropriations per person in fiscal year (FY) 2009 were $2,311; more than the $2,248 per person in FY 2000 after adjusting for inflation, even though the earlier year was the peak of the previous spending cycle.[3] Spending in the state has ebbed and flowed over time, ratcheting upward with each cycle (Figure 1). More worrisome, spending this cycle has been on continuing programs instead of capital.

Average state appropriations through the 1990s were $1,848 per person adjusted for inflation. Returning spending to that level would save the state $3.0 billion from the $21.4 budgeted for FY 2009 – more than the potential shortfall in the next budget.

The current fiscal year's spending relied heavily on transfers from a number of reserve accounts even before actual revenues started coming in below projections, another indication that tax revenues were not keeping up with legislators' desire to spend more. Per-person appropriations adjusted for inflation in FY 2008 were 3.9 percent higher than in FY 2000. Operating appropriations per person, adjusted for inflation, climbed 8.8 percent between FY 2000 and FY 2008. From the time the budget bottomed out in FY 2003 to FY 2008, per-capita spending adjusted for inflation climbed 14.7 percent. The increase from FY 1989 to FY 2009 has been 41.3 percent.

Figure 1. General Fund Appropriations Per Person, Adjusted for Inflation, FY 1979 – FY 2009

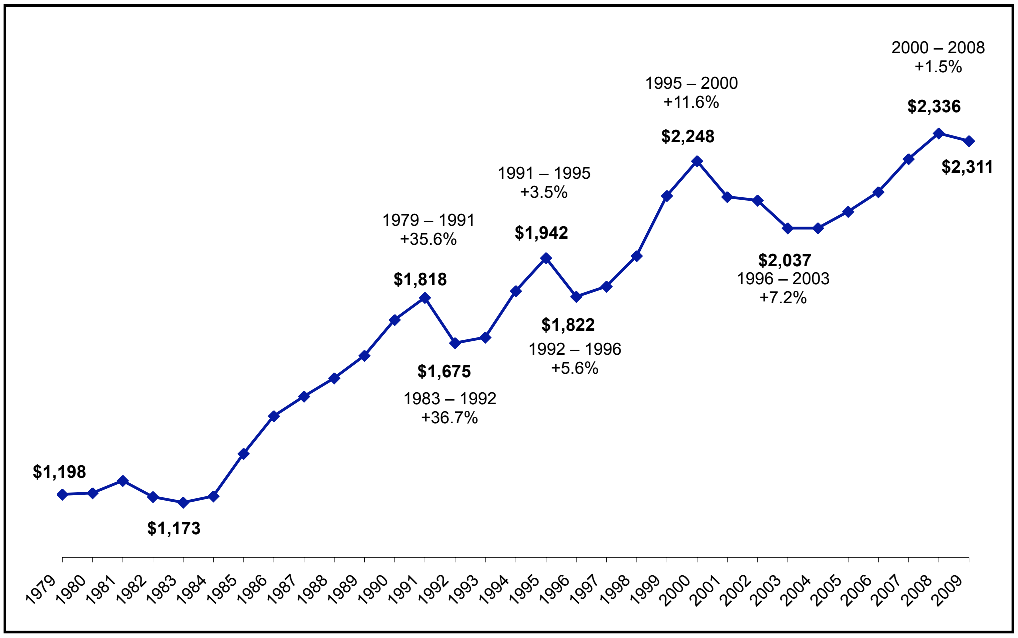
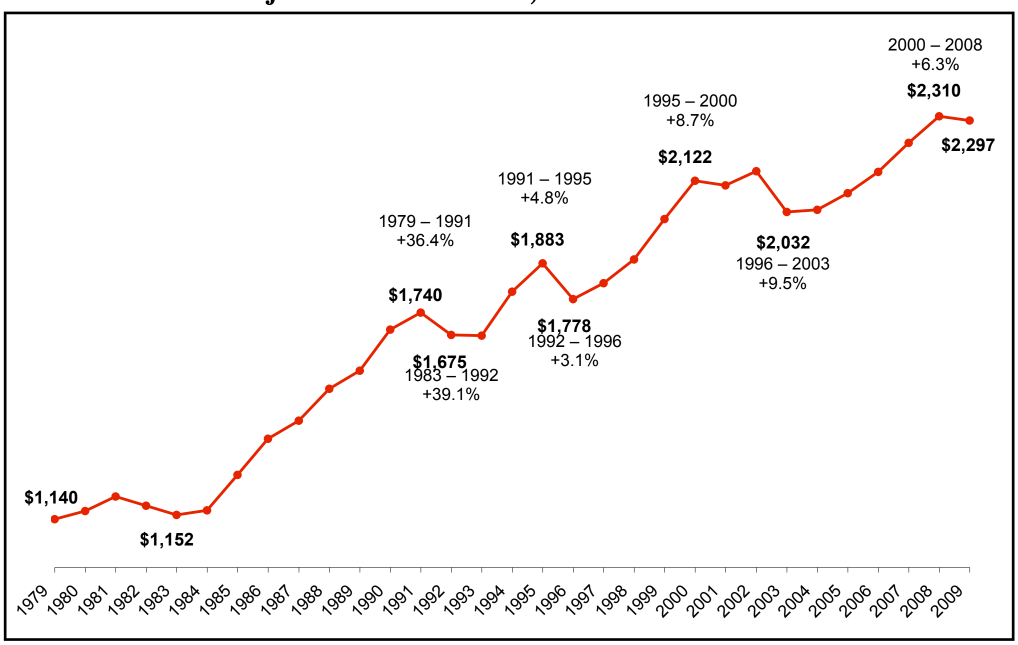


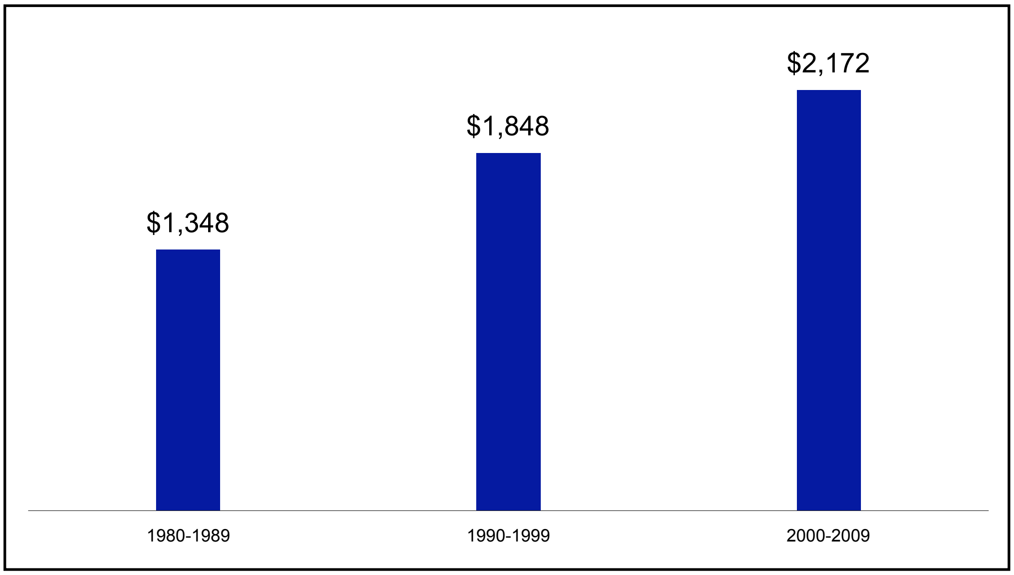
Figure 2. General Fund Operating Appropriations Per Person, Adjusted for Inflation, FY 1979 – FY 2009



Starving Savings

The Savings Reserve Account, the rainy-day fund, is supposed to get "one-fourth of any unreserved fund balance," according to the State Budget Act.4 Legislators disregarded that provision in the FY 2009 budget, which set aside no money for saving, despite lower revenue expectations.[5] Past experience and best practices from other states show the savings reserve should be at least 10 percent of the previous fiscal year's General Fund spending. North Carolina's reserve is less than four percent, and Gov. Perdue could take out half or more of that just to get through June.

Figure 3. Average Inflation-Adjusted General Fund Appropriations Per Person Per Decade, 1980s Through 2000s



Hiding Debt

In addition, the General Assembly violates the spirit of the constitutional provision requiring a balanced budget by borrowing money without voter approval. Legislators have passed $3.1 billion in debt without voter approval since 2003. That is equal to the amount of the last bond package that did receive voter approval in 2001. Such hidden debt has been legislators' preferred way to pay for capital projects this decade. As a result, inflation-adjusted General Fund appropriations for capital projects have fallen from $51 per person in the 1990s (2.4 percent of total General Fund appropriations) to $20 per person in the 2000s (0.9 percent).

Conclusion

As with previous budget crises facing the state of North Carolina, the shortfall in FY 2009 and the projected shortfall for FY 2010 are as much the result of rampant spending as of lower than expected revenue. Revenue volatility is a long-standing problem in North Carolina given the state's tax structure. The General Assembly has consistently failed to budget accordingly, instead creating a spend-and-tax roller coaster. Rather than set aside money in good times, legislators have created new programs and taken on additional debt to finance capital projects, both of which reduce flexibility for future budget writers.

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End Notes

1. Figure 2.1, *Statistical Abstract of North Carolina Taxes*, 2008, North Carolina Department of Revenue, www.dornc.com/publications/abstract/2008/index.html.
2. For more on this cycle, see "Spend and Tax: A History of General Fund Crises in N.C. and How to Prevent Them," John Locke Foundation *Policy Report*, Sept. 14, 2006, www.johnlocke.org/policy_reports/display_story.html?id=75.
3. Per-capita appropriations in this report are based on General Fund appropriations for fiscal years 1991 through 2009 from Table 9 of the 2007 Post-Legislative Summary for fiscal years 1991-2008 and budget bills for fiscal year 2009, population estimates in July of the previous year from the Office of State Budget and Management (1978-2008), and GDP deflator levels on July of the previous year from the Federal Reserve Bank in St. Louis.
4. G.S. 143C-4-2, as created by the 2006 Budget Act S.L. 2006-203.
5. S.L. 2008-107, Section 2.2 (c1).