

## A NEW YEAR, A NEW HOLE

### *NC Must Close Budget Gap While Cutting Taxes*

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Summary: According to state economists, North Carolina will face another budget deficit in FY 2001-02 of between \$450 million and \$900 million. The state's economy, weighted down by high taxes and poor public services, continues to lag behind the rest of the country. Unlike last year, policymakers cannot exempt such big-ticket items as Floyd relief, tobacco-settlement funds, universities, Medicaid, and bonds from scrutiny — and they should consider repealing last year's tax hikes.

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**D**uring much of 2001, the new administration of Gov. Mike Easley and the North Carolina General Assembly were embroiled in a heated debate about a growing state budget deficit. Pegged at half a billion dollars early in the year, the budget gap — a product of rapid growth in Medicaid and other state programs plus lower-than-expected revenues — grew to nearly \$900 million at its apogee. The governor and legislature eventually decided to increase taxes to cover most of the deficit, opting for state spending growth in FY 2001-02 of more than 5 percent.<sup>1</sup>

Unfortunately, this so-called “balanced” budget slipped into the red shortly after passage. Despite an anticipated gain of nearly \$660 million in additional taxes in FY 2001-02 — both from increases in tax rates and from changes in collection methods — state revenues have failed to meet projections, or even to grow at all, during the past few months. At the same time, Medicaid has again proven to be a budget-buster, with spending expected to exceed the Sept. 2001 projections by more than \$100 million.<sup>2</sup>

The legislature's fiscal staff has put the FY 2001-02 budget gap at between \$450 million and \$900 million. The midpoint of \$675 million would be a reasonable projection to use for budgeting purposes over the next few weeks. For FY 2002-03, the continuation budget alone will likely experience a deficit of at least \$375 million.<sup>3</sup>

Although other states are also experiencing significant economic downturns and budget deficits, North Carolina was the only one to enact a major tax increase in 2001. A new round of tax hikes would be disastrous for the state's economy, which is already hamstrung by a tax burden highest in the Southeast and, for the first time, higher than the national average. Indeed, as its unemployment rate is also the highest in the Southeast and higher than the national average, North Carolina would benefit greatly from tax reduction in 2002 to encourage investment in new industries and jobs.

Now is the time for North Carolina's leaders to do what they failed to do in 2001 — set firm priorities for state spending and get control of Medicaid, university subsidies, debt service, and other large expenditures. In addition, policymakers should be willing to revisit the mistakes of the past, such as routing much of the state's share of the national tobacco settlement to private entities rather than the General Fund and allocating too much state money to Hurricane Floyd relief. In the latter case, about \$400 million of the \$837 million originally budgeted for relief remains unspent more than two years after the disaster occurred. Although some argue that mismanagement or red tape explains the difference, the magnitude of the unspent funds is so large that the only reasonable explanation is that state officials misjudged the "emergency" needs during the hurried 1999 special session, as we observed at the time.<sup>4</sup>

## GENERAL FUND TAX BURDEN INCREASES ENACTED IN 2001 LEGISLATIVE SESSION

IN MILLIONS OF PROJECTED FISCAL IMPACT

| Major General Fund Tax Changes    | FY 01-02       | FY 02-03       |
|-----------------------------------|----------------|----------------|
| Sales/Income Tax Hikes            | \$435.3        | \$614.4        |
| Other Consumer/Business Tax Hikes | \$61.3         | \$64.3         |
| Increased Tax-Collection Powers   | \$50.0         | \$50.0         |
| Accelerated Business Tax Payments | \$112.1        | \$6.0          |
| <b>TOTAL INCREASED TAX BURDEN</b> | <b>\$658.7</b> | <b>\$734.7</b> |

SOURCE: Joint Conference Comm Report, Sept. 19, 2001

Although North Carolina's fiscal problems will offer a tremendous challenge to state officials, they can be addressed while protecting and even improving the finances of the state's beleaguered businesses and families. As outlined below, we believe that by reclaiming taxpayer money from the Golden LEAF Foundation and Floyd accounts, delaying the issuance of new state bonds, tapping the state's rainy-day reserve, eliminating some expansion items from last year's budget, and achieving needed savings in the state's base budget, North Carolina policymakers can close the projected budget gap over the next two fiscal years while providing significant economic stimulus through tax relief. Specifically, we propose that last year's increases in sales, income, and business taxes — totaling \$165.5 million in the remainder of FY 2001-02 and \$679 million in FY 2002-03 — be repealed or offset by an equivalent amount of reductions in income and sales tax rates.

The proposal outlined in the table below would yield a General Fund budget of \$14.3 billion in FY 2001-02 (still an increase of 1.4 percent). It would not reduce regular state expenditures on classroom teachers or public safety. It would still fund a generous Medicaid program, the vast majority of the cost of attending state colleges and universities, most of the current Smart Start program, and previously scheduled increases for the state health plan.<sup>5</sup>

## ROUGH OUTLINE OF JLF ALTERNATIVE BUDGET FOR MARCH-JUNE 2002, ALL OF FY 2002-03

IN MILLIONS OF PROJECTED FISCAL IMPACT

| Major Proposed Changes                 | FY 01-02 | FY 02-03 |
|--|----------|----------|
| Est. Deficit (Mid-Range for 01-02)     | \$675.0  | \$375.0  |
| Cost of Repealing/Offsetting Tax Hikes | \$165.5  | \$678.7  |
| Reclaim Unspent Floyd Relief Funds     | \$250.0  | NR       |
| Reclaim Unspent Tobacco Settlement     | \$150.0  | NR       |
| Withdraw from Savings Reserve          | \$70.0   | NR       |
| Suspend Issuance of State Bonds        | \$12.3   | R        |
| Reduce Medicaid Rates, Services        | \$42.8   | R        |
| Eliminate Selected Expansion Items     | \$40.4   | R        |
| Changing Course Base Budget Savings    |          |          |
| Education                              | \$74.9   | R        |
| Higher Education                       | \$35.2   | R        |
| Corporate Subsidies                    | \$18.0   | R        |
| All Other                              | \$49.9   | R        |
| Redirect 1/2 Tobacco Settlement to GF  | \$96.9   | R        |
| Additional Tuition at UNC/Comm. Coll.  |          | \$81.5   |
| Total Budget Savings/Reallocations     | \$840.5  | \$1055.3 |

DATA SOURCES: N.C. Office of State Budget, Fiscal Research Div.

### Conclusion

North Carolina, like other states, is facing significant fiscal pressures. Our leaders can help the state weather this storm and recover lost economic ground without gutting core governmental functions if they set reasonable priorities and rethink old, bad decisions on hurricane relief, the tobacco settlement, and university bonds. By balancing the budget and repealing last year's tax hikes, North Carolina can regain its competitive edge and the national respect lost last year.

— John Hood, President

### NOTES

1. See "Wrong Set of Priorities," Locke Foundation Spotlight No. 206, Sept. 20, 2001.
2. Data obtained from Division of Medical Assistance, NC Dept. of HHS, Jan. 2002.
3. Data obtained from Fiscal Research Division, NC General Assembly, Jan. 21, 2002.
4. See "No Floyd Fiscal Crisis," Locke Foundation Spotlight No. 174, Nov. 22, 1999.
5. More details on proposed budget savings can be found in John Hood, et. al., "Changing Course IV: An Alternative Budget for North Carolina," John Locke Foundation, May 2001.