

POLICY REPORT

Spend and Tax

A History of General Fund Crises in N.C. and How to Prevent Them

JOSEPH COLETTI
SEPTEMBER 2006

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And the lean and the ill favoured kine did eat up the first seven fat kine: And when they had eaten them up, it could not be known that they had eaten them; but they were still ill favoured, as at the beginning. So I awoke.

— *Genesis 41:20-21*

EXECUTIVE SUMMARY

The General Assembly 2006 short session adjourned on July 28. Legislators' budget and tax decisions made during this session follow a pattern going back at least to 1984. Contrary to the popular rhetoric about "tax and spend" policies, the pattern that emerges is one of "spend and tax" policies. Lawmakers multiply the ups and downs of the private sector business cycle and turn variability into volatility.

During economic booms, tax revenues increase and legislators fund new programs that cannot be sustained during an economic bust. When the economic bust arrives, legislators raise taxes to pay for those new government programs.

This state government pattern of "spend in good times" and "tax in bad times" was documented for the period 1993 to 2005 in a February 2006 JLF *Spotlight*. General Fund spending followed tax revenues up from 1993 to 2000, but not down from 2001 to 2003 when recession

decreased tax revenues. Instead, legislators raised taxes.

This paper expands the inquiry back another decade to 1984 to include another business cycle. A similar pattern of "spending in good times" and "taxing in bad times" existed during this earlier period. The 2006-07 North Carolina budget passed in July continues this pattern of spending available funds. Fiscal restraint beginning in 2007 is needed to avoid tax increases when revenue growth inevitably slows.

The best way to ensure the necessary fiscal restraint in future years and end the destructive cycle of spending and taxing is to enact spending limits that prevent state government from growing faster than population and inflation. Government would keep a large surplus up to 30 percent of General Fund appropriations as a rainy day fund to balance spending in recessions. Only after spending is controlled can the General Assembly seriously address the need for tax reform.

Figure 1: Annual Percent Change in Personal Income and General Fund Availability, 1985-2006

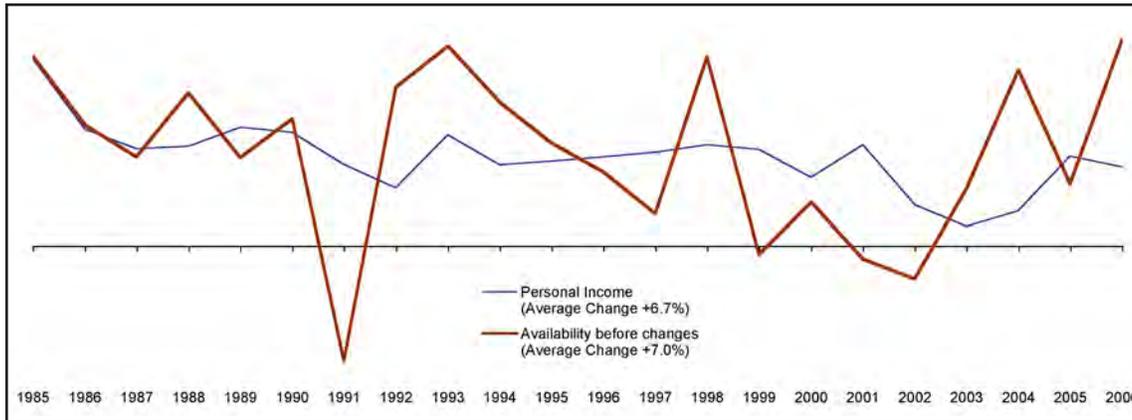
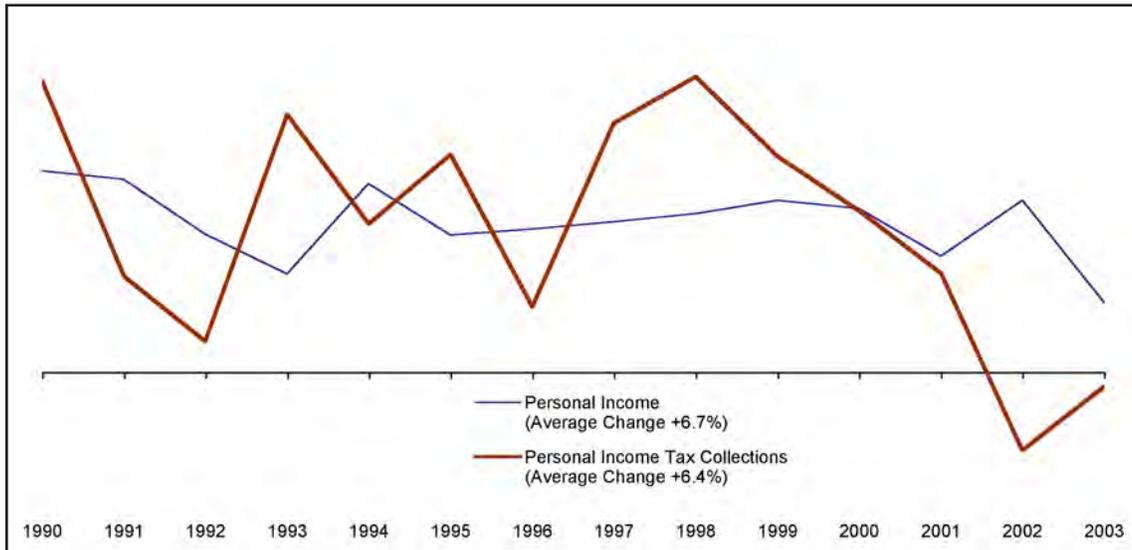


Figure 2: Annual Percent Change in Personal Income and Personal Income Tax Collections, 1990-2003



BACKGROUND

North Carolina should be the model of fiscal probity. The governor is constitutionally required to balance the budget each year.¹ In good years, the legislature sets money aside in a saving reserve account to help when the economy slows. Why, then, has the General Assembly started five of the last six legislative sessions facing a deficit?

Policy analysts on the left see the problem in tax revenues that grow slower than personal income.² But this is only true in some years and certainly not the case over longer periods of time. It is more accurate, and widely acknowledged, that state tax revenues are more volatile than personal

income see Figures 1 and 2. Tax revenues will grow more slowly than income, or even shrink, in some years, and will rocket upward in other years. Short term variability and long term growth is typical for most states, particularly those with progressive income taxes such as North Carolina.³

Randall Holcombe and Russell Sobel in their classic 1997 study on state fiscal crises marked the first of these in the 1982 recession. They found rapid growth of the economy and government during the 1950s and 1960s with no significant issues for state governments. The 1970s conjunction of inflation, oil crisis, and other factors made fiscal problems during the decade

A NOTE ON METHODOLOGY

For the purpose of this paper, we examined the annual legislative session overviews prepared by the North Carolina General Assembly's Fiscal Research Division for the years 1984 through 2005, except 1986. Prior to 1993, availability amounts after legislative changes are from tables showing condition of the General Fund. Availability before legislative changes is calculated based on these numbers and the current year revenue bill changes.

Any effects from prior legislation are not considered. To provide two examples, the 1985-86 budget bill was forecast to lower revenues \$170 million in 1988-89, but it does not count as a tax cut in 1988-89. Only the \$161 million in additional revenue reductions enacted in the 1988 legislative session count for 1988. Similarly, the temporary sales and income tax rate hikes first passed in 2001 count as increases in 2003 and 2005 because they were set to expire in those years.

seem part of the overall economic distress. But 1982 was clearly a budgetary phenomenon. Budgetary crises returned in 1991 and 2001. Each crisis brought more attention to the problem of state finances, but the attention faded as the economy improved. Holcombe and Sobel found that the changing nature of state expenditures presented long term challenges but that these happened too slowly to produce crises. The simple ups and downs of revenues, however, did cause short term crises.⁴

The increasing social spending by state government and shrinking budget for highway spending have hampered governments' ability to control spending and avoid a fiscal crisis when revenues drop. Government spending also moves more in the direction of social programs each year due to growth in Medicaid and education.

In addition to the proportion of money directed to social services, the amount of spending grows to meet the amount of revenue available in good years. Legislators are more willing and able to respond to the demand for expanded service when they have higher revenues. This increases the fiscal pressure when revenues fall. This pattern is clear in the 1980s expansion before the 1991 recession and again in the 1990s expansion before the 2001 recession.

The rest of this paper is in three sec

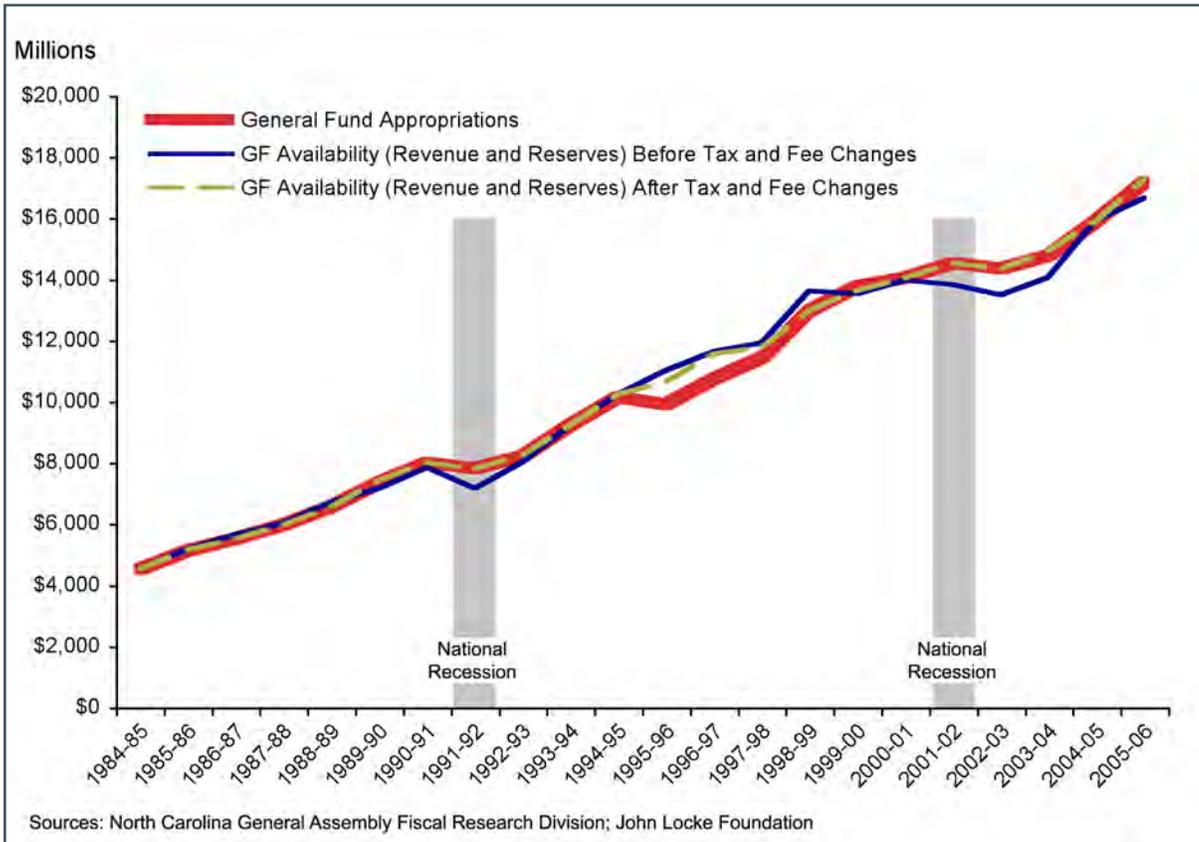
tions. The first section examines how General Fund availability (revenues, reversions, and transfers) changed from the 1984 legislative session to the 2006 session. The second section considers specific legislative tax and spending changes in response to the fluctuations in General Fund tax revenue and availability. The third section compares the two main proposals to deal with the problem of volatile revenue streams (tax reform and spending restraint) – and offers reasons to emphasize one over the other.

PATTERN RECOGNITION

Legislators face constant demand to expand government services. From 1984 to 1988, this was not a problem as general fund availability grew at a compound annual rate of 8.2 percent, even as the 1985 tax cuts phased in.⁵

In 1989, the General Assembly created the Highway Trust Fund to pay for new construction, meaning more taxes outside of the General Fund. They also added over \$100 million in new taxes and fees within the General Fund. Availability before the revenue changes was 9.3 percent higher than the year before. After the changes, the lawmakers had 13.2 percent more money available in the General Fund than they had the previous year. They increased spending 12.2 percent that year.

FIGURE 3: GENERAL FUND APPROPRIATIONS AND AVAILABILITY BEFORE AND AFTER REVENUE LAW CHANGES, FY 1984-85 TO FY 2005-06



Availability the following year, 1990, also did not grow as fast as the perceived needs, despite a 5.8 percent rise. Lawmakers added another 150 million in funds and spent them all—an 8.8 percent increase in appropriations from the prior year. Not all of the additional spending was chosen in Raleigh. Federal expansion of Medicaid eligibility first started to weigh on the state budget at this time, too.

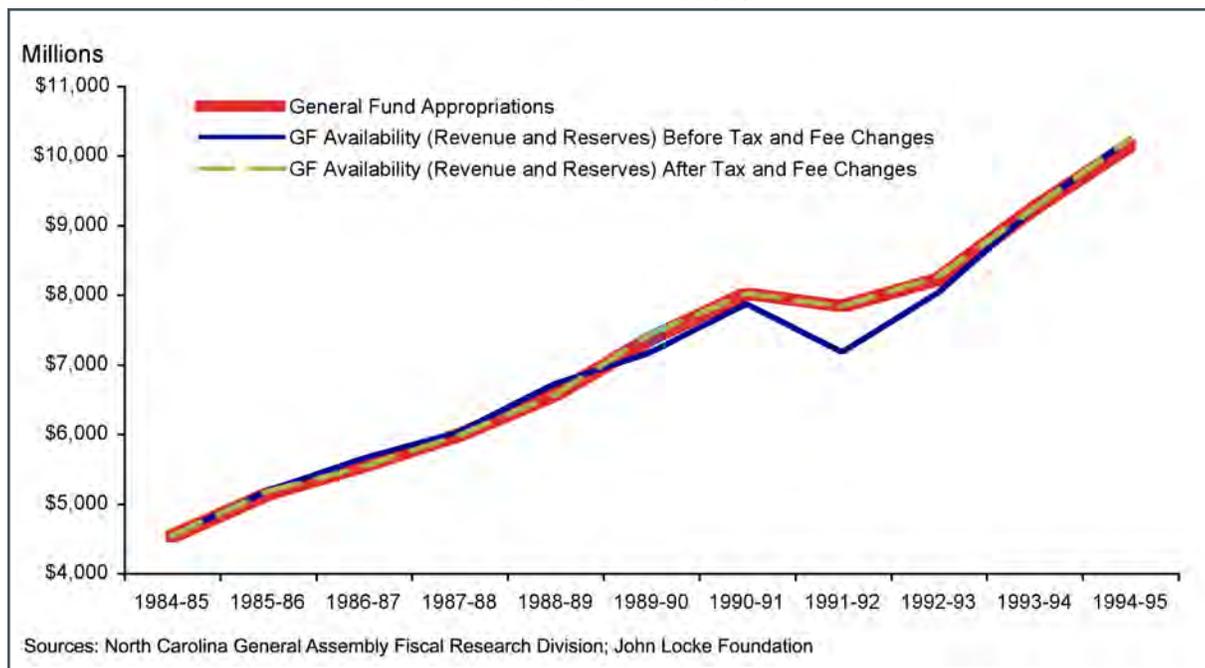
Recession in 1991 led to a nearly 850 million 10.5 percent fall in General Fund availability. Higher sales and income taxes brought availability back up to 7.8 billion from 7.1 billion, though still short of the previous year's 8.0 billion in availability. Spending also dipped from 8.0 billion to 7.8 billion.

General Fund availability and appropriations grew rapidly again in 1993 and 1994.

Spending dipped in 1995 and remained below the original availability through 1998, when the New Economy boom sent availability soaring by 15.7 percent. This tremendous gain prompted the General Assembly to make new long term spending commitments, such as further expanding Medicaid eligibility, and further tax reductions. Growth in availability slowed the next two years before turning negative in 2001, but spending did not decline again until 2002, the second year of lower availability.

As in 1991, the General Assembly responded to the 2001 recessionary fall in revenues by raising personal income and sales tax rates, as well as other fees and taxes. The difference being in the size of the tax hikes and that the 1991 tax increases were permanent, but the 2001 increases were intended to be temporary.

FIGURE 4: GENERAL FUND APPROPRIATIONS AND AVAILABILITY BEFORE AND AFTER REVENUE LAW CHANGES, FY1984-85 TO FY 1994-95



The 2001 recession coincided with the first year of Gov. Mike Easley's first term. His first three years in office were relatively frugal, with spending increases of just 5.1 percent. Funding even this growth, however, required tax and fee increases each year. Once revenues started to climb again in 2004, spending ratcheted right back up—increasing at a compound annual rate of 8.5 percent over the past three legislative sessions. That increase is very close to the annual increase in the four years from 1996 to 1999.

LEGISLATIVE RESPONSES

Some analysts blamed the 2001 fiscal crisis on tax cuts “financed by the economic boom” of the 1990s.⁶ This version of the story coincided with claims that most of the increase in spending went to education, health care, and law enforcement. States also dedicated money to their rainy day funds, just not enough to deal with a three year revenue slide.⁷ Others blamed spending increases, noting that North Carolina's tax revenues in fiscal year 2001 were 16.1

percent higher than in fiscal year 1990 and the state on average had collected more than of 2.4 billion in “windfall” revenues each year during the period.⁸

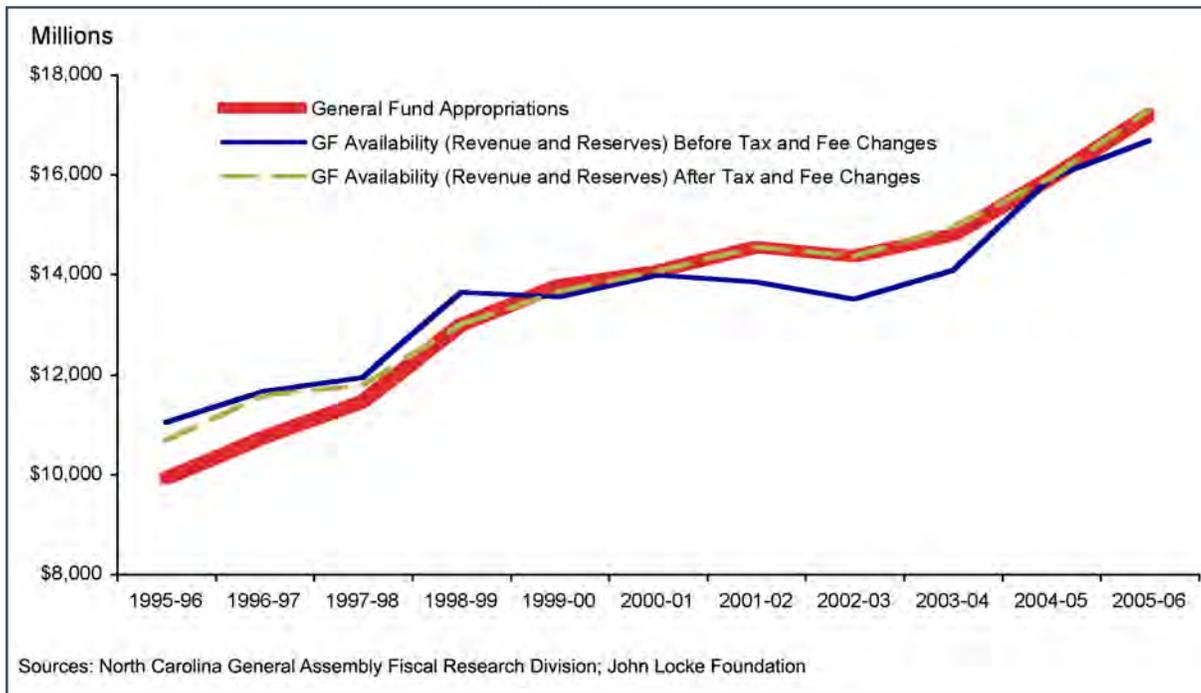
North Carolina's experience suggests that spending growth explains better how a fall in tax revenue can produce a fiscal crisis than tax cutting does.

Spending

As the three largest areas of the state budget, it almost goes without saying that most new spending would go to education, health care, and law enforcement. Education and Medicaid account for about three of every four General Fund dollars. This explains why education spending was able to grow by 3.5 billion with lower percentage increases than the rest of the General Fund, which grew by 2.9 billion.

Another factor in the rapid growth of education, health, and law enforcement spending was the explosion in Medicaid costs. Throughout the 1990s, General Fund operating expenses for Health and Human Services grew at a 10 percent annual rate,

Figure 5: General Fund Appropriations and Availability Before and After Revenue Law Changes , FY1995 96 to FY 2005 06



mostly due to Federal and state expansions of Medicaid eligibility and higher prescription costs. Medicaid's growth moved Health and Human Services from a 15 percent share of the General Fund operating budget in 1991 to a 24 percent share in 2002. North Carolina spent 3.4 billion on Health and Human Services in 2002, up from 1.1 billion in 1991. The university system slipped from 16 percent of the budget in 1991 to 12 percent in 2002 and public education K-12 dropped from 46 percent to 41 percent over the same period.

Spending on health and education entails future commitments and political pressure for more spending in these areas. The commitment comes in the promise of benefits and the embedding of programs in the continuation budget. The political pressure comes in the creation of constituencies for the new spending. As Tennessee Gov. Phil Bredesen learned when he confronted the difficult task of scaling back his state's TennCare public health program, nobody likes the elected official who cuts

benefits to 300,000 people.

Taxes

Given the choice of cutting benefits a lot for a few recipients and raising taxes a little for the whole state, therefore, it is no surprise that lawmakers are more comfortable spreading the pain as broadly as possible. Sales taxes are a particularly good way to raise a lot of money for a small change in rates (in fiscal year 2006-07 budget, one percent of the sales tax generates 960 billion).

Taxes have gone up when revenues fell short of expectation. In 1991 the General Assembly raised the state sales tax to four cents from three cents, adding 430 million in revenue. The legislature also raised the corporate income tax rate to 7.75 percent 85 million and added a third personal income tax bracket of 7.75 for those married filing jointly with incomes above 100,000 51 million. Lawmakers also imposed a number of other tax and fee hikes and transferred money from other

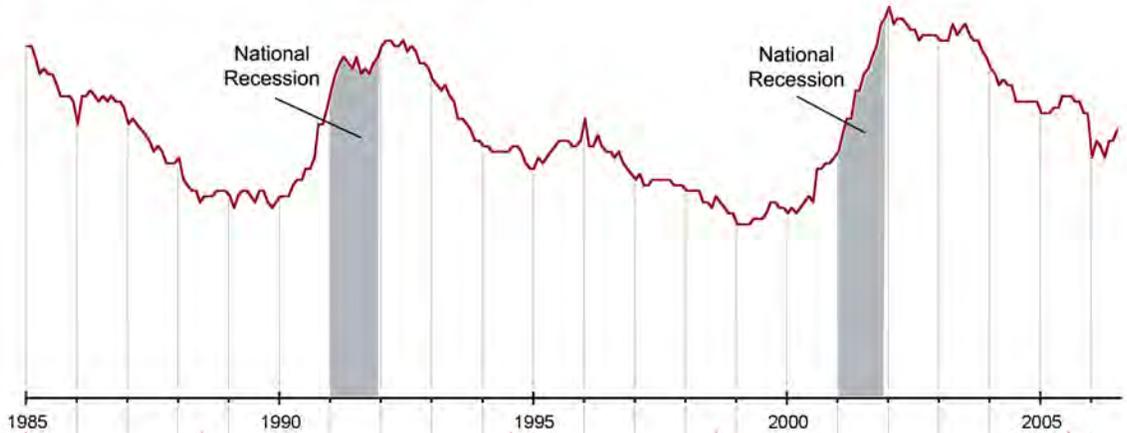
Figure 6: Spending Always Rises; Taxes Ratchet Up

Spending increases in good times and bad. The increased spending in good economic times increases the burden on government when the economy turns down. This graph shows the trends in spending and taxes compared to unemployment as a proxy for the economic cycle.

In addition to the general pattern, two other points are worth noting:

1. Spending grows more in dollar terms than taxes rise and fall.
2. Tax hikes are larger than tax cuts.

N.C. Unemployment Rate (1985-2006)



Period	Spending Change	Taxes, Fees Change
1985-88	Spending UP, +\$2.0 Billion	Taxes, Fees DOWN, -\$430 million
1989-94	Spending UP, +\$3.6 Billion	Taxes, Fees UP, +\$851 million
1995-98	Spending UP, +\$2.0 Billion	Taxes, Fees DOWN, -\$737 million
1999-2005	Spending UP, +\$4.2 Billion	Taxes, Fees UP, +\$1.1 Billion

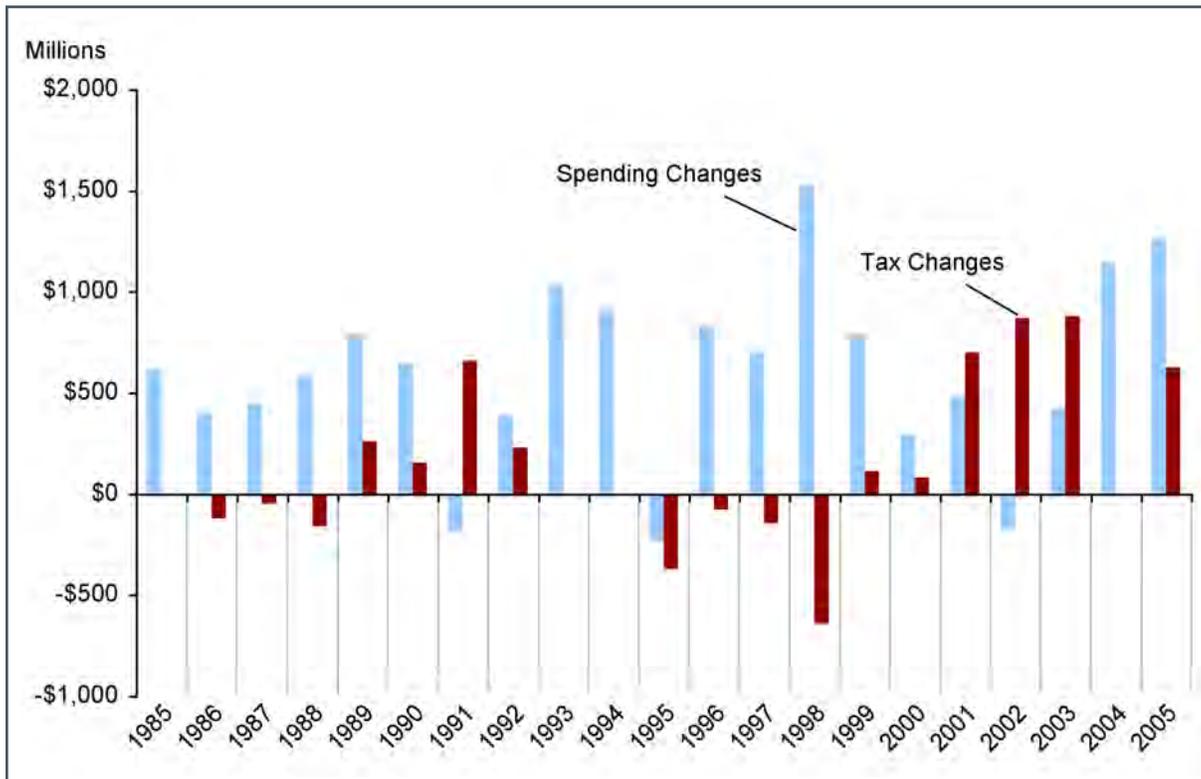
Spending Changes (1985-2006)



Tax and Fee Changes (1985-2006)



Figure 7: Spending and Tax Changes, 1985-2005 Legislative Sessions



funds to increase expected availability by 657 million that year. They added another 227 million in taxes and fees in 1992. In fact, taxes and fees increased in every year of Gov. Jim Martin's second term by a total of \$1,293 million, more than offsetting the 338 million of tax and fee relief in Martin's first term 1985-1988.

When Jim Hunt became governor again in 1993, he benefited from a strong economy and the permanent tax hikes of the Martin administration. There was no biennial charade of extending the sunset for the taxes as there has been in 2003 and 2005. Instead, Gov. Hunt was able to ride the economic wave of the late 1990s and lower taxes by 1,243 million.

Unlike the tax increases, which were broad to minimize political damage, the tax cuts were targeted to maximize political advantage. The headline tax cuts also coincidentally passed in the gubernatorial election year of 1996. Lawmakers did not

cut the general sales tax rate, but exempted food from the local sales tax and cut the state sales tax rate for food to two cents from four cents giving taxpayers four cents of tax relief at half the cost to the state 36.7 million. They also trimmed the corporate tax rate to 6.9 percent, which is still highest in the Southeast.⁹

More direct targeting in 1996 came in the form of the William S. Lee Act. The Lee Act, which underwent significant revisions in 2006, provides tax credits to "good" corporate citizens who hire workers, buy equipment, or move their headquarters to North Carolina. If a company hires workers in a poor county such as Bertie, it gets more credits than if it hires workers in a wealthy county such as Buncombe.

Even with inflation, the \$1,243 million in tax relief provided between 1995 and 1998 did not equal the 1,294 million in tax increases enacted between 1989 and 1992. Neither the tax hikes nor the tax cuts ad

dressed the volatility of the state's reliance on sales and income taxes to fund government services. If anything, the carve outs made the situation worse and set the stage for a deeper fiscal crisis when the next recession eventually hit.

Repeating the pattern of a decade earlier, the General Assembly began raising taxes and fees to keep up with spending growth two years before the recession began. Lawmakers added 109 million in new taxes, fees and transfers in 1999 and another 78 million in 2000. Revenues fell 218 million in 2001 from 2000, but spending demands increased 480 million, which left 698 million to be covered by taxes, fees, and transfers. Again the sales tax did most of the work, as the state increased the general sales tax rate by one half cent 246.3 million and took another stream of state collected revenue from counties starting in 2003 04 in exchange for the option to impose an additional half cent sales tax. Lawmakers also added a fourth personal income tax bracket of 8.25 percent for those married filing jointly with incomes over 200,000 per year 125.5 million

But revenues fell by more than 1 billion in 2002. Lawmakers responded with 866 million in taxes, fees and transfers. They also cut spending by 178 million. They renewed the 2001 temporary tax hikes in 2003 and 2005 before trimming a quarter point from the personal income tax rate starting January 2007 and the sales tax starting December 2006 in the 2006 session.

This is about the point in previous economic cycles when lawmakers would look for ways to cut taxes. The budget for fiscal year 2006-07 adds \$400 million in long-term commitments financed with short term funds. Adding this to the 500 million in lost revenue from the once again expected end of temporary taxes, Gov.

Mike Easley and the General Assembly will be staring at another billion dollar short fall in 2007, with a need to raise taxes or cut spending. Such shortfalls are inevitable when spending grows to the funds available in good years.

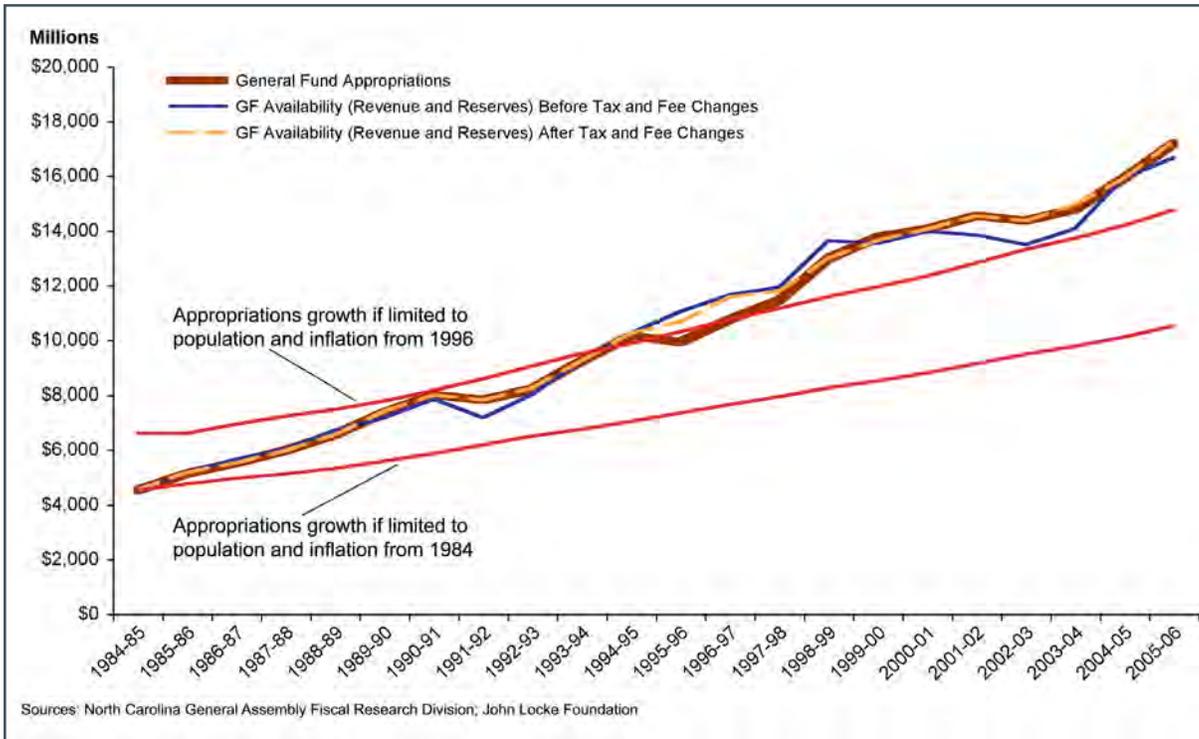
ENDING THE CYCLE

Tax variability is inevitable when a state relies on income and sales taxes for its revenues. Progressive income taxes increase variability because of their reliance on high income earners and other earners' movement across brackets, which accelerate revenue trends up and down. States must therefore find a way either to limit revenue volatility or to limit their exposure to this volatility. Some ways to achieve one of these objectives include tax reform, alternate revenue sources, rainy day funds, and tax and expenditure limits such as a taxpayer protection amendment.

Moving to a flat-rate personal income or consumed income tax would help offset some of the current variability of progressive income tax rates and a retail goods sales tax. Flat rates make revenues less susceptible to changes in earnings among those with higher incomes. Even small percentage changes in high incomes can have large effects on tax collection revenue. During booms, incomes at the top end also have more room to rise.

Eliminating income tax brackets also eliminates the potential for individuals to move between brackets movement that accelerates tax revenue gains and losses. Under a broad consumption tax, all purchases of goods and services would be taxable at the full rate. The current retail sales tax has a lower rate for groceries than for prepared foods, and exempts the services of a tax preparer while taxing the purchase of tax preparation software. Neither a flat tax regime nor a consumption tax would end revenue variability, meaning the state

Figure 8: General Fund Spending, Revenue vs. Population Growth and Inflation,
FY 1984-85 to FY 2005-06



would still face shortfalls, but smaller peaks and valleys could keep these shortfalls from becoming crises, particularly if they were tied to other fiscal reforms.

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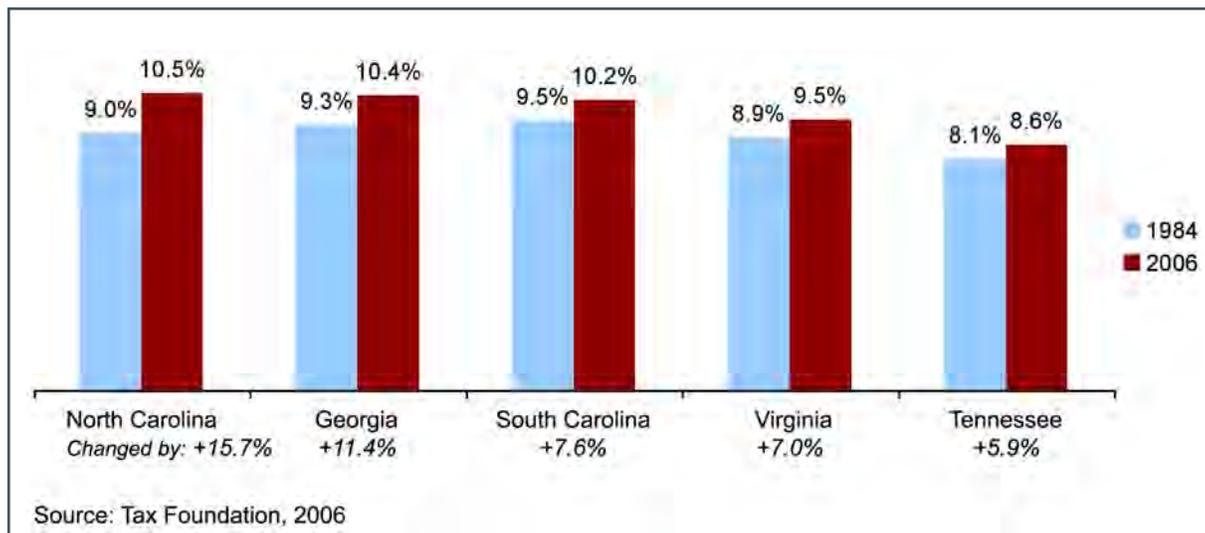
Recent research has found that alternate sources of revenue, such as lotteries and casino gambling, help reduce variability through diversification. This portfolio effect is more evident with a lotto draw, such as Powerball.¹⁰ As witnessed in the

2006 passage of North Carolina's "Education Lottery," however, lawmakers treat such revenue enhancers as a way to pay for new programs rather than a way to smooth revenues over time.

Holcombe and Sobel concluded that North Carolina would have needed a surplus or rainy day fund equal to 30 percent of the 1988 budget to get through the lean years of 1989 to 1992. No state had saved as much as it needed. North Carolina had five percent of its general fund budget (\$393 million) in the rainy day fund, roughly one eighth the \$3.1 billion that would have been necessary to avoid tax increases during the downturn.¹¹ Compare this to the pride with which legislators in July 2006 spoke about the \$324 million they had set aside for the state's Savings Reserve Account rainy day fund in the fiscal year 2006-07 budget.

"We put \$323 million into the 'rainy day' fund, another \$20 million for a contingency fund," state Sen. Walter Dalton told

Figure 9: Tax Burden as Share of Personal Income, North Carolina vs. Adjacent States, 1984 and 2006



Carolina Journal. “The rainy day fund is the healthiest it’s been in many, many years.”¹² On “Legislative Week in Review,” Rep. Rick Glazier bragged, “This year we are saving in this budget 323 million into savings for the rainy day fund and the total deal with this state’s future problems on top of the 312 million already there. And so the appropriations chairs on both sides and the speaker and the leadership have planned over 600 million to take care of the future needs of this state.”¹³

The statutory cap for the Savings Reserve, however, is five percent of the previous year’s current operations appropriation. Even if the account were fully funded, which it is not, the state would have less than a sixth of what it would need to get through another downturn.

It is also not enough to have adequate savings; those savings must be used to meet real needs, not legislative whims like tea pot museums, concert halls, or marketing for basketball tournaments. The best way to ensure this happens is by limiting all expenditures. Tax and expenditure limits, such as Colorado’s Taxpayer Bill of Rights (TABOR) or North Carolina’s oft proposed Taxpayer Protection Act, provide one method to accomplish this. Previous ver-

sions of the Taxpayer Protection Act would cap General Fund spending growth at the combined rate of population growth and inflation, and so keep real per capita General Fund spending constant.

Revenues collected above that rate would go into an Emergency Reserve Fund, up to three percent of the General Fund. Remaining revenues would fill the rainy-day fund, renamed Budget Stabilization Fund, up to 18 percent of the General Fund. Any revenues left after filling the Budget Stabilization Fund would go back to taxpayers in the form of a tax rebate or a rate reduction.

Once the budget is secured from fiscal crises in this way, it would be safer to attempt tax reform in a way that reduces the tax burden on all citizens of the state. Colorado was able to replace its progressive income tax with a flat tax, thanks in part to TABOR’s success in restraining government growth.

From 1984 to 2006, North Carolina’s state and local tax burden has climbed from 9.1 percent of personal income to 10.5 percent. In the process, the state has gone from the 35th highest taxed state in the country to 23rd. North Carolina now has a higher tax burden than any of the surrounding states, and a full percentage point

higher than Virginia's. In 1984, the state's tax burden was squarely in the middle, just a tenth of a percentage point higher than Virginia's.¹⁴

It is unrealistic to expect a lower tax burden without reducing the government's demand for additional revenue. But there is little chance of accomplishing this without a hard limit on what lawmakers can spend the rice paper limits attempted so far have slid aside to accommodate rapid spending increases in 2004, 2005, and 2006. These budgets have set up a repeat of the spend and tax patterns of the last two decades, but it is not too late to stop a "fiscal crisis" in a few years.

CONCLUSION

Income tax and sales tax revenues have greater variability than the underlying economy. When revenues grow, general fund appropriations grow to meet the avail

able funds. These appropriations often are recurring costs that are either neutral or countercyclical, so they also increase even while revenue falls. The fall in revenue and continued spending commitments produce fiscal crises. Lawmakers have responded to the fiscal crises of the early 1990s and early 2000s with much higher taxes and slightly lower spending.

Tax relief during the next economic upturn has not offset the higher taxes. What tax relief lawmakers provided was also more targeted than the tax increases, making the tax system less fair and more volatile. Meanwhile, government spending accelerated to match the renewed revenue growth.

Lawmakers should implement a hard spending limit tied to population and inflation to limit the growth in government spending and put aside larger pools of money to keep future revenue shortfalls from creating fiscal crises.

NOTES

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5. All numbers in this section from the North Carolina General Assembly Fiscal Research Division *Overview* publications for legislative sessions 1984 through 2005. Budget numbers for the 2006 session are from the budget bill S1741.
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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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