

# spotlight

No. 422 – May 8, 2012

## 2012 STATE SPENDING AT A RECORD HIGH

*Albeit Concealed, State Spending Has Grown For Decades*

**KEY FACTS:** • Total state spending per capita is at its highest level ever in the 2012 fiscal year and has more than tripled since 1970—from \$1,701 to an authorized \$5,247.

• Over the past four decades, state spending has grown much faster than personal income, rising as a percentage from 10.9 in 1970 to 14.4 in 2012.

• A simple cap on state spending at inflation and population growth since 2000 would have restrained spending to \$38.5 billion, 75 percent of the current \$51.5 billion.

• In real, per capita terms, spending on all reported categories has more than doubled since the mid-1970s. That includes education, corrections, health and human services, transportation, and debt servicing.

• General fund spending per capita has declined by 16 percent since 2009, but per capita spending outside of the general fund increased by 26 percent and more than compensated for the general fund's decline.

• General fund spending comprises 38 percent of total state spending in 2012, down from 53 percent in 1970 and 59 percent in 2000.

• Federal aid continues to comprise an ever-larger portion of the state budget. In 2012, 36 percent of state revenue is from federal aid, up from 21 percent in 1975 and 24 percent in 2000.

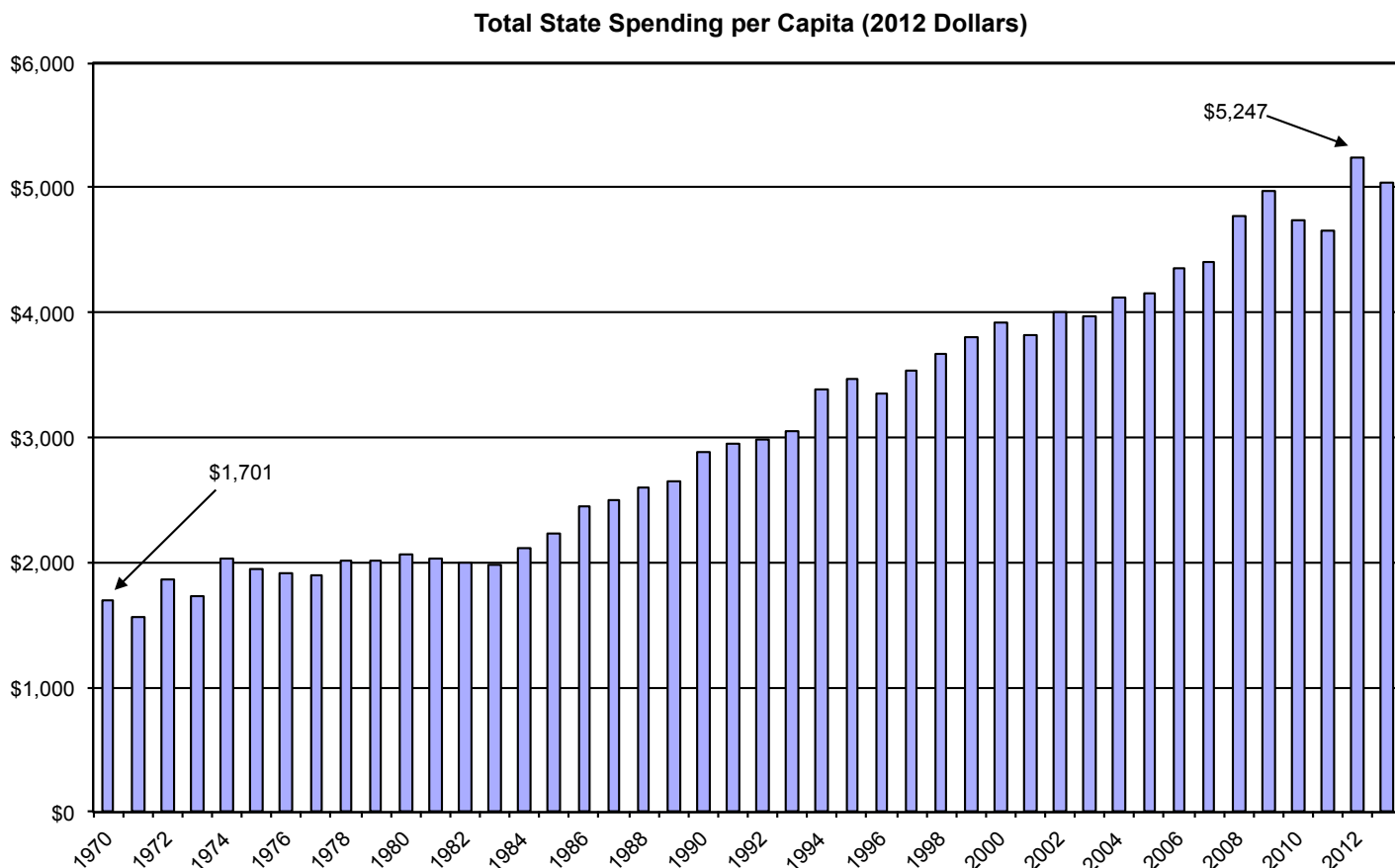
• North Carolina's cash-basis accounting conceals spending and is generating unfunded liabilities—obligations to pay without sufficient funds set aside. The state's largest is for employee retirement health benefits, unfunded by at least \$34.2 billion at the end of 2010. The \$4.4 billion growth of this specific liability over 2009 and 2010, constituted 4.8 percent of total state spending for that period.

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a mid heated, partisan debates over incremental budget adjustments, one can be forgiven for losing track of the longer-term trend of state spending. The North Carolina legislature's shifts toward spending outside of the general fund,<sup>1</sup> increased reliance on federal aid, and spending through deferred compensation have also concealed the size of state spending.

A simple aggregation of the data, however, affirms that over the past four decades and in recent years North Carolina has experienced a persistent rise in state spending, both in per capita terms and as a proportion of income. Adjusted for inflation, state spending per capita has more than tripled since 1970—from \$1,701 to an authorized \$5,247 for this 2012 fiscal year, which is higher than at any time during those four decades.<sup>2</sup>



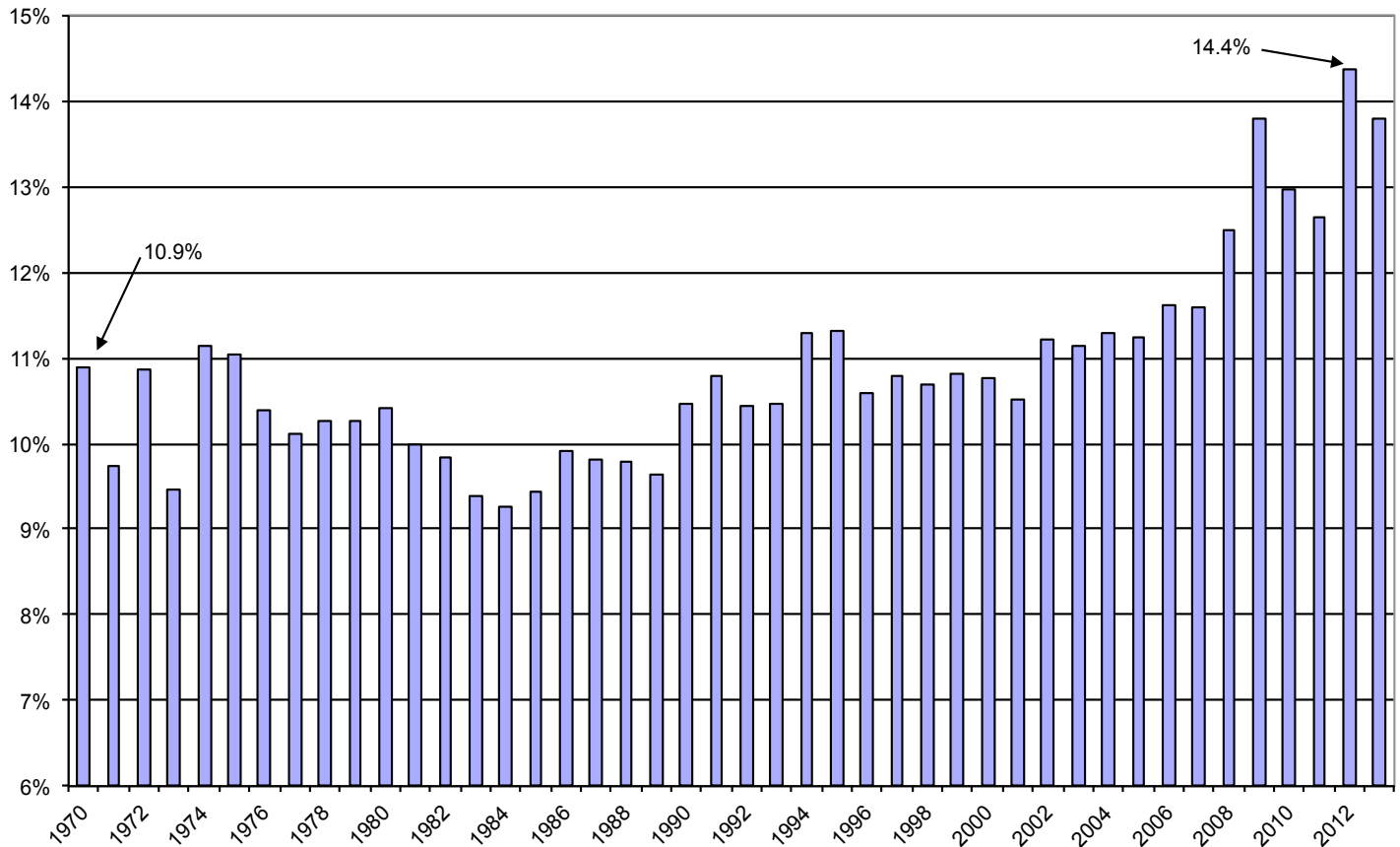
*Sources: North Carolina Office of State Budget and Management, Census Bureau, Bureau of Economic Analysis*

The spending expansion has been so rapid that it has far exceeded personal income growth during that period. Prior to 2008, state spending had not exceeded 12 percent of personal income, and it got down to 9.3 percent in 1984. Yet, for 2012 it is on course to be 14.4 percent.

If legislators had restrained state spending to inflation and population growth since 2000—which a majority of North Carolinians support<sup>3</sup>—state spending would be at \$38.5 billion in 2012. That equates to 75 percent of the current spending level of \$51.5 billion.

Even when one breaks the spending down into categories—education, corrections, health and human services, transportation, and debt servicing—the trends remain similar. In real, per capita terms, all of these spending categories have more than doubled in size since the mid-1970s.

**Total State Spending as a Percentage of Income**



Sources: North Carolina Office of State Budget and Management, Bureau of Economic Analysis

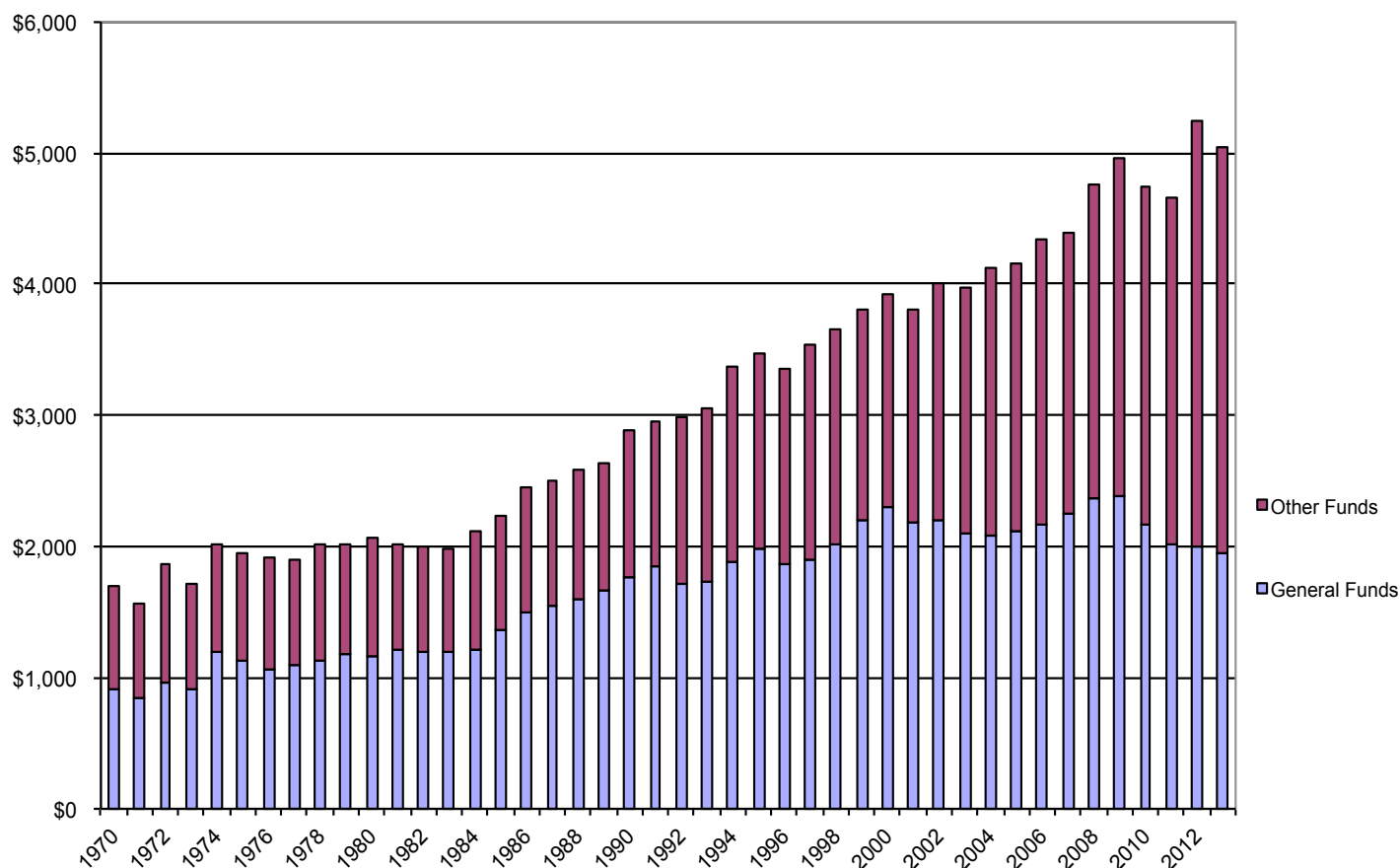
As a percentage of income, though, there are a few exceptions to the aggregate rise—education, transportation, and debt servicing.

- Although much higher in per capita, inflation-adjusted terms, state spending on education has fluctuated around 4 percent of total income for the past 40 years. The high point came in 1991 at 4.8 percent, and the low point was in 1973 at 3.5 percent. This year, 2012, sits right on the forty-year average of 4.2 percent.
- Transportation spending is set to constitute 1.3 percent of income in 2012, the highest level since 1979. However, in the mid-1970s it got up to 1.7 percent.
- Debt servicing is notable because of a disproportionately high rise in recent times. Since 2000, it has increased in per capita terms by 128 percent and more than doubled as a percentage of income. At nearly \$1 billion per year, the interest paid out is part of a broad and worsening debt problem for North Carolina.

### *Under the Radar*

For a variety of reasons, the persistent growth in state spending has not been easily visible to constituents, journalists, and policy professionals. Some publications and outlets have even claimed that state spending has shrunk over the past forty years.<sup>4</sup>

**General versus Total State Spending per Capita (2012 Dollars)**



*Sources: North Carolina Office of State Budget and Management, Bureau of Analysis*

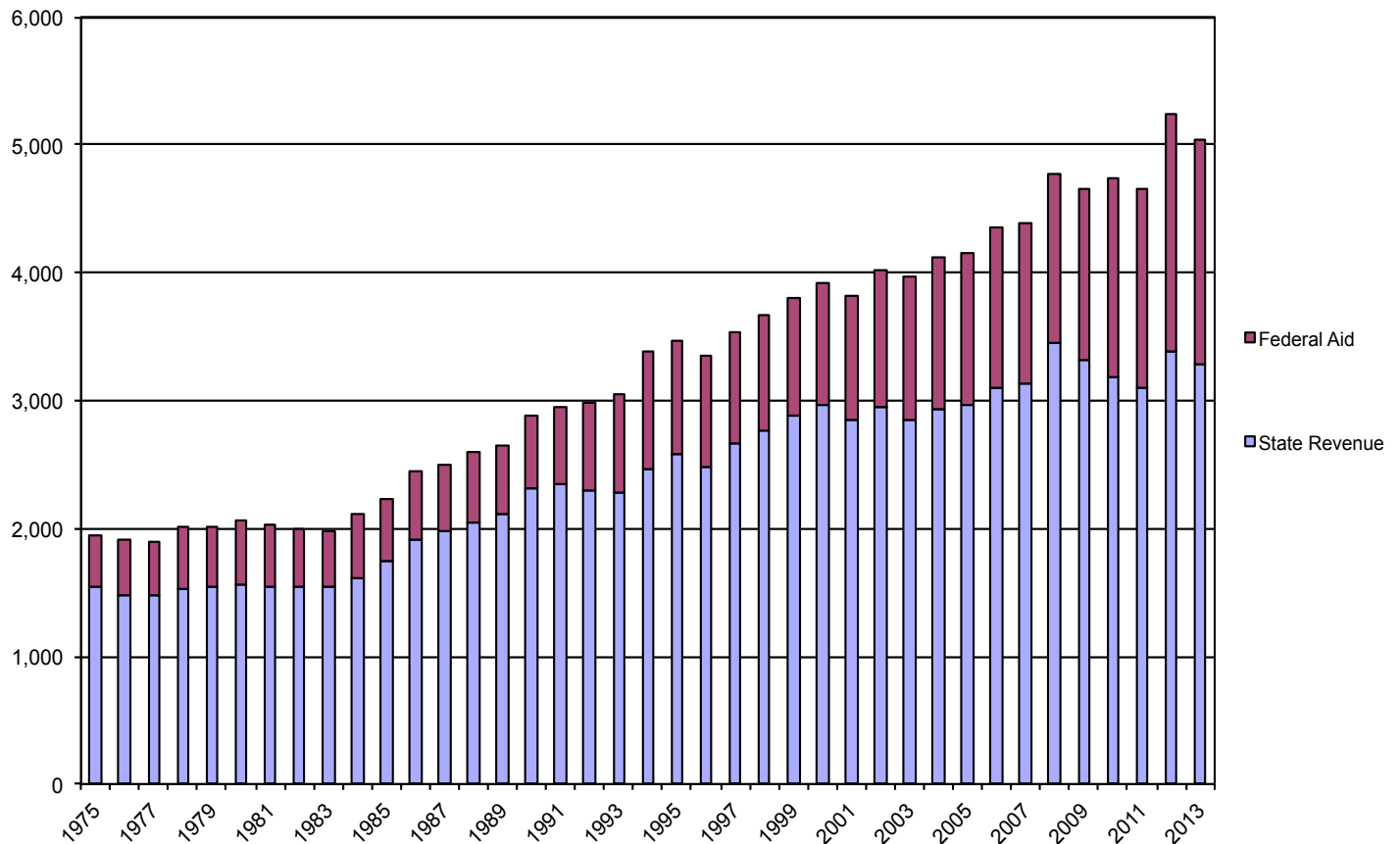
An undue focus on the general fund, for example, is one explanation for the misperception. As demonstrated in the graph, general fund spending has gone down, but so has its share of total spending. It now equates to 38 percent of total spending, down from 53 percent in 1970 and 59 percent in 2000, and increased spending outside of the general fund has more than compensated for its decline.

Similarly, the federal-versus-state revenue breakdown may be another source of confusion. The state-imposed tax burden has increased at a slower rate than spending, but that is because federal aid continues to constitute an ever-larger portion of the budget. This year, for example, 36 percent of state revenue is federal aid, up from 21 percent in 1975 and 24 percent in 2000.

While the burden of federal aid may not be immediately visible in the form of state taxes, it still merits concern as North Carolinians will feel it either through federal taxes or through debt and the inflation tax. However the federal money may be derived, it competes with and diverts resources away from the private sector, both in North Carolina and other states. Additionally, along with federal mandates for how the state must use the money, history suggests that such grants lead to increases in future state and local taxation by approximately 40 percent of each grant's value after it runs out.<sup>5</sup>

As much as state spending may have increased officially, there is even more to be found off the books. State officials in the United States, including those in North Carolina, use cash rather than accrual approaches to accounting.<sup>6</sup> This means some forms of spending do not appear on the annual budget if the actual dollar transfer occurs at a later date.

**State Revenue versus Federal Aid per Capita (2012 Dollars)**



*Sources: North Carolina Office of State Budget and Management, Bureau of Economic Analysis*

The state's defined benefit retirement plans for government workers are particularly problematic in this manner. As a form of deferred compensation, these are promises to pay certain amounts in the future—debts—for work conducted in the past. Without sufficient money set aside to pay these debts, they are unfunded liabilities and a transfer of current expenses into the future.

Retirement health benefits are the state's largest unfunded liability at \$34.2 billion at the end of the 2010 calendar year.<sup>7</sup> That was up from \$29.8 billion at the end of 2008, an increase of \$4.4 billion in two years (in 2012 dollar purchasing power). Unfortunately, the state's Comprehensive Annual Financial Report does not report the value of the unfunded liabilities further back than 2008. However, to put the recent magnitude into perspective, the increase in retirement health benefits (unfunded liabilities) constituted 4.8 percent of total reported spending in fiscal years 2009 and 2010 combined.

Even these measures of state unfunded liabilities are likely to be underestimates since they follow from an assumed return on investment of 7.25 percent.<sup>8</sup> Analysts from both the Congressional Budget Office and the Institute for Truth in Accounting recommend discounting these future payments at rates closer to 4 percent, and recent dramatic declines in the funding levels of state pensions have affirmed this vulnerability.<sup>9</sup> (Curiously, pensions for legislators still have more than 126 percent funding set aside, so those income streams are safe, unlike many of the others.<sup>10</sup>)

Table 1: North Carolina Ratio of Pension Funding to Future Liabilities<sup>11</sup>

	2006	2011
Teachers and State Employees	106.5%	95.4%
Judicial	107.6%	91.6%
Legislative	131.9%	125.6%
Firemen and Rescue	94.6%	86.0%
National Guard	72.4%	68.1%

### *Concluding Remarks*

Along with a correction to confused discourse on the matter, the finding that state spending has grown so markedly, and in a concealed manner, carries clear implications.

First, since the growth has been so consistent in one direction, against the wishes of constituents, a constitutional protection appears necessary. That could come in the form of a simple cap on spending at inflation and population growth or a super-majority requirement for any such spending or tax increases.

Second, those who study and report on the state's spending would do well to bear in mind that the general fund represents only approximately one third of the total and is not an accurate gauge of overall spending. Further, the official budget does not account for deferred compensation that generates unfunded liabilities.

Third, debt-financed federal aid comprises a growing portion of state spending, which enables the state to bypass its balanced budget amendment and increase spending beyond tax revenues. Given the precarious and severe indebtedness of the federal government, such transfers merit opposition from North Carolina's federal representatives, along with calls for a federal balanced budget amendment similar to what 49 of the 50 states have.

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1. State general funds are for the ordinary and discretionary expenses of the executive, legislative, and judicial departments, for debt servicing, and for capital outlay. They are derived from within the state so do not include federal aid. Nor do they include other funds such as program specific taxes and fee revenues—college tuition, for example—that are not available for discretionary spending.
2. North Carolina Office of State Budget and Management, “2011-2013 Post-Legislative Budget Summary,” [http://www.osbm.state.nc.us/files/pdf\\_files/2011PLS\\_rev.pdf](http://www.osbm.state.nc.us/files/pdf_files/2011PLS_rev.pdf), accessed May 1, 2012.  
These numbers utilize the GDP deflator as the price indexing data input. The GDP deflator is the broadest inflation measure available from the Bureau of Economic Analysis and best reflects the purchasing power of the United States dollar. There are other measures available, such as the Consumer Price Index and the BEA's State and Local Government Index, but they are not as comprehensive and measure a targeted sample of prices, rather than the overall purchasing power of the dollar. Regardless which inflation measure one chooses, though, the outcome disparities are minimal.
3. John W. Pope Civitas Institute, “December 2009 Poll Results,” Question 26, <http://www.nccivitas.org/2009/december-2009-poll-results/>, accessed April 10, 2012.
4. Edwin McLenaghan, “State Investments in Public Services Declining Even as Demand Grows: State Funding for Education, Health, and Public Safety Remain Historically Low,” North Carolina Justice Center BTC Brief, December 2011, <http://www.ncjustice.org/sites/default/files/BTC%20Brief%20-%20State%20Investments%20Declining.pdf>, accessed May 1, 2012.  
Jane Stancill, “State spending down to 1996-97 levels,” News & Observer, July 12, 2010, [http://projects.newsobserver.com/under\\_the\\_dome/state\\_spending\\_down\\_to\\_199697\\_levels](http://projects.newsobserver.com/under_the_dome/state_spending_down_to_199697_levels), accessed May 1, 2012.
5. Russell Sobel and George R. Crowley, “Do Intergovernmental Grants Create Ratchets in State and Local Taxes? Testing the Friedman-Sanford Hypothesis,” Mercatus Center at George Mason University Mercatus Working Paper, September 7, 2010, <http://mercatus.org/publication/do-intergovernmental-grants-create-ratchets-state-and-local-taxes>, accessed May 1, 2012.
6. For more on how state officials conduct their accounts, please see material from the Institute for Truth in Accounting: <http://northcarolina.statebudgetwatch.org/>. Additionally, here is a simple definition, with the distinction between accrual and cash accounting: <http://www.investopedia.com/terms/c/cashaccounting.asp#axzz1rHoQQjVb>.
7. North Carolina Office of State Controller, “2011 Comprehensive Annual Financial Report,” p. 180, [http://www.ncosc.net/financial/11cafr/2011\\_Comprehensive\\_Annual\\_Financial\\_Report.pdf](http://www.ncosc.net/financial/11cafr/2011_Comprehensive_Annual_Financial_Report.pdf) accessed May 1, 2012.
8. Op. cit. note 7, p. 140.
9. Frank Russek, “The Underfunding of State and Local Pension Plans,” Congressional Budget Office Economic and Budget Issue Brief, May 2011, <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12084/05-04-pensions.pdf>, accessed May 1, 2012.
10. Op. cit. note 7, p. 178.
11. Ibid.