

THE BEST FISCAL CHOICE

Refund Tax Overpayments, Rejuvenate the Economy

Summary: For the first time since 2001, Gov. Mike Easley is proposing a budget plan that does not include new tax increases. However, his 2004-05 plan does contain hundreds of millions of dollars in new spending financed by previous, costly tax hikes on North Carolina families and businesses. A better fiscal choice would be to eliminate low-priority items from the budget and repeal prior sales and income tax increases. The best choice would be to implement JLF's Freedom Budget plan.

This week, Gov. Mike Easley released his proposed adjustments to the North Carolina state budget for the FY 2004-05 fiscal year. Contrary to the state's experience over the past three years, the governor and legislature are not faced with a deficit for the current fiscal year. The 2003-04 General Fund budget is projected to end with a \$146 million unappropriated balance, some \$100 million in authorized spending that will revert to the General Fund, and approximately \$198 million in revenue collections above the 2003-04 forecast. Furthermore, the administration estimates that General Fund revenue collections for 2004-05 will also exceed last year's projections by about \$200 million.¹

Of the \$444 million in surplus going into the 2004-05 budget year, the governor proposes that \$105 million be deposited in the state's Rainy Day reserve account and another \$24 million be immediately redirected to expanded business-subsidy programs. That leaves \$315 million to add to expected General Fund revenues of \$15.5 million for the 2004-05 fiscal year.²

Before examining how the governor proposes to spend these dollars, it is important to remember why there will be significantly higher revenues in 2004-05. It isn't because of economic growth; North Carolina's economic recovery continues to lag the Southeast in terms of jobs and income growth. The "surplus" is actually related directly to prior passage of tax increases on retail sales, individual income, corporate income, and other economic activity. In FY 2004-05, the fiscal impact of the tax hikes and extensions enacted in 2003 will total approximately \$554 million³ — representing 85 percent of the projected increase in General Fund revenue of about \$654 million.⁴ These are dollars that, except for the legislated tax increases, would have remained in the hands of the households and businesses that earned them in the first place.

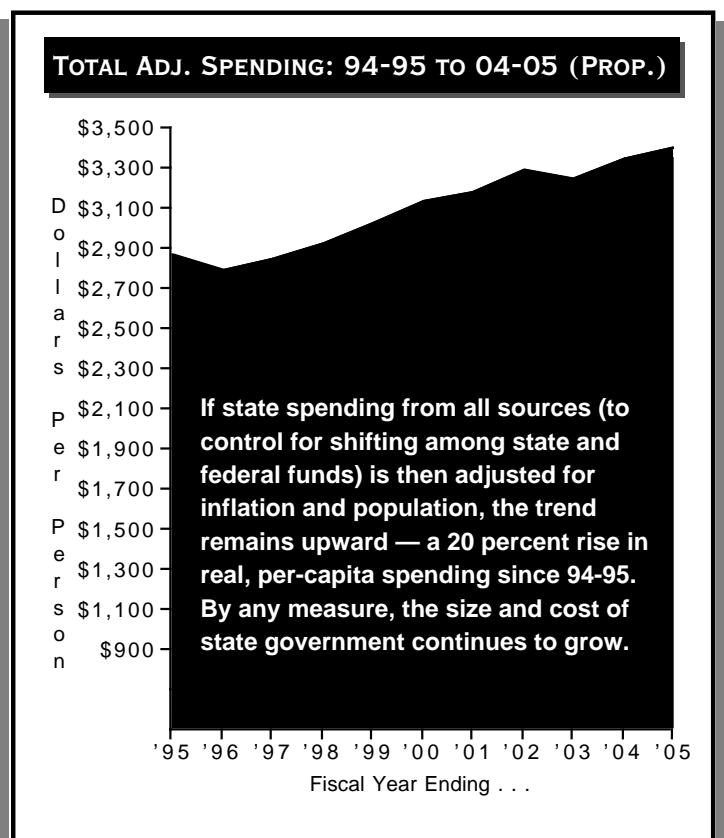
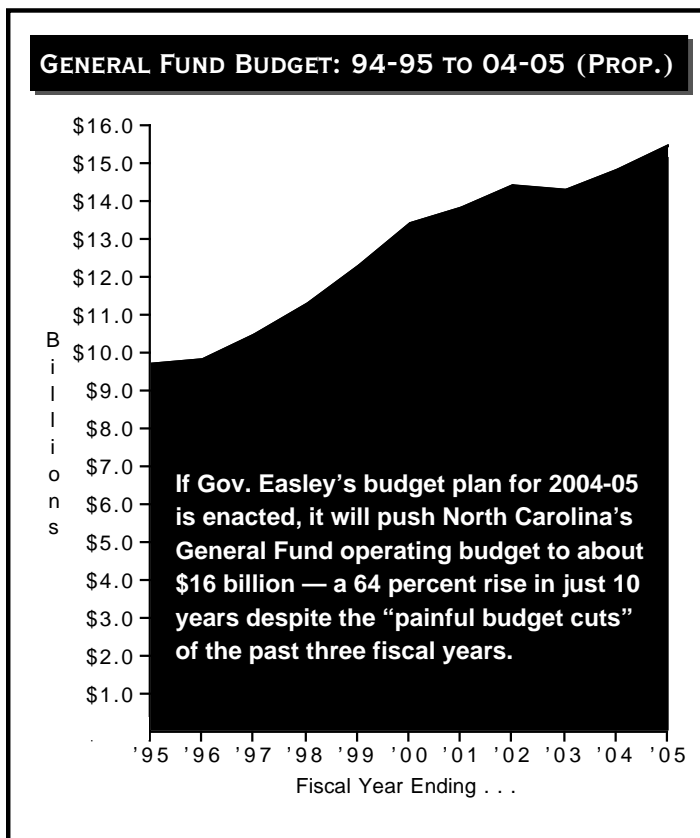
The Spending Plan and Recent Spending Trends

Gov. Easley's 2004-05 budget adjustment would increase General Fund spending by \$1.08 billion over the authorized budget for FY 2003-04, which represents an annual spending hike of 7.4 percent. However, the administration argues that the 2003-04 baseline is artificially low because of some \$200 million in state Medicaid expenses that were financed for 2003-04 only by one-time federal funds. Bringing these expenses back onto the General Fund books isn't really a spending increase, it is argued, and so the real increase in General Fund authorizations will be \$876 million in 2004-05, or 5.5 percent. Whatever the merits of this argument, the \$200 million must either show up as a spending increase in FY 2003-04 or FY 2004-05. If the former, then last year's increase in General Fund spending was a robust \$630 million, or 4.4 percent — far higher than what the Easley administration and state legislative leaders said at the time.

More importantly, the 2003-04 and proposed 2004-05 budgets should be put in context. North Carolina state government experienced rapid growth throughout most of the 1980s and 1990s. With few exceptions, each fiscal year saw dramatic gains in spending as lawmakers appropriated the proceeds of surging revenues — due in part to the state's reliance on "progressive" income-tax rates that cause tax revenues to grow faster than the overall economy as households move up to higher tax brackets. Of course, what goes up faster must go down faster; North Carolina and other states with multi-rate income taxes saw revenue growth drop off more dramatically during the 2001-03 period than did the average state.

Some might assert that the so-called "painful budget cuts" imposed since 2001 have significantly offset the effects of previous spending growth. That is incorrect. For one thing, many of these "cuts" were really just reductions in the rate of increase in state education and public-assistance programs, which continued to add hundreds of millions of dollars annually. Moreover, a large share of the "cuts" weren't even reductions in the rate of increase — they simply reflected shifts of funding responsibility from the General Fund to other sources of revenue, such as federal funds, trust funds, or fees. While these might have the effect of seeming to reduce General Fund expenditures, they do not constitute a reduction of services or of the size and scope of government.

The longer-term trends in state spending are, as the graphs below reveal, almost relentlessly upward. If the governor's 2004-05 budget plan is enacted, General Fund operating spending will reach nearly \$16 billion, or 64 percent higher than the authorized figure for FY 1994-95. It is true that service needs in some programs have also grown during this period because of population growth and the declining value of the dollar. But as previously mentioned, these General Fund numbers don't capture those items shifted to other parts of the budget. If the total state budget from all sources is adjusted for population and inflation, real spending per person still rose from \$2,900 in 1994-95 to more than \$3,400 — nearly a 20 percent increase.



2004-05 GF Budgets At A Glance: Easley Plan vs. JLF Freedom Budget

(Preliminary, In Millions)

Spending Category	Authorized 2002-03	Authorized 2003-04	% Change	Freedom Bdg 2003-04	% Change	Easley Plan 2004-05	% Change	Freedom Bdg 2004-05	% Change
Public Education	\$5,894.6	\$6,035.1	2.4%	\$5,916.9	0.4%	\$6,148.7	1.9%	\$5,939.3	0.4%
Community Colleges	\$669.3	\$660.9	-1.2%	\$659.5	-1.5%	\$680.2	2.9%	\$620.4	-5.9%
UNC System	\$1,768.1	\$1,792.1	1.4%	\$1,573.5	-11.0%	\$1,869.6	4.3%	\$1,494.1	-5.0%
Health & Human Serv.	\$3,596.4	\$3,379.8	-6.0%	\$3,335.5	-7.3%	\$3,812.5	12.8%	\$3,570.8	7.1%
Agriculture	\$50.4	\$48.5	-3.9%	\$32.0	-36.5%	\$48.6	0.2%	\$32.1	0.3%
Commerce	\$44.2	\$55.2	24.8%	\$8.9	-79.8%	\$62.4	13.1%	\$14.5	62.5%
Labor	\$14.2	\$13.3	-6.4%	\$11.6	-18.3%	\$13.0	-1.9%	\$11.6	0.0%
Environment/Nat. Res.	\$215.3	\$209.2	-2.9%	\$190.2	-11.7%	\$213.3	2.0%	\$186.8	-1.8%
Correction	\$880.1	\$940.2	6.8%	\$914.1	3.9%	\$946.6	0.7%	\$918.2	0.4%
Crime Control/PS	\$27.8	\$28.7	3.5%	\$13.2	-52.5%	\$30.0	4.4%	\$12.2	-7.6%
Courts/Judicial	\$373.9	\$377.6	1.0%	\$374.2	0.1%	\$401.3	6.3%	\$379.4	1.4%
Juvenile Justice	\$129.0	\$130.3	1.0%	\$121.3	-6.0%	\$134.3	3.1%	\$124.9	3.0%
Justice	\$70.9	\$71.0	0.1%	\$65.4	-7.8%	\$71.5	0.7%	\$66.4	1.5%
Transportation	\$10.9	\$11.4	4.8%	\$5.7	-47.6%	\$11.2	-2.2%	\$0.0	-100%
Other Departments	\$327.2	\$326.8	-0.1%	\$330.7	1.1%	\$324.3	-0.8%	\$293.2	-11.3%
Debt Service	\$255.7	\$388.9	52.1%	\$251.9	-1.5%	\$421.7	8.4%	\$234.5	-6.9%
Other Items/Reserves	-\$9.3	\$278.3		\$176.1		\$624.6		\$296.9	
Subtotal-Operating	\$14,318.6	\$14,747.5	3.0%	\$13,980.8	-2.4%	\$15,813.7	7.2%	\$14,195.2	1.5%
Capital/R&R	\$31.2	\$27.6		\$29.4		\$47.6		\$0.0	
Subtotal-GF Budget	\$14,349.8	\$14,775.1	3.0%	\$14,010.2	-2.4%	\$15,861.3	7.4%	\$14,195.2	1.3%

SOURCES: State Budget Office, Locke Foundation calculations

Expansion Items in FY 2004-05 Proposal

Of the \$876 million in expansion items in the state-funded portion of the governor's 2004-05 budget proposal, funds to accommodate expected enrollment growth in the public schools (\$19 million), UNC system (\$65 million), community colleges (\$20 million), and scholarship students in private universities (\$2.6 million) comprise a sizable percentage. Add to that \$51 million for class-size reduction in third grade, \$108 million for ABCs bonuses for teachers, and nearly \$7 million for other K-12 initiatives, and about a third of the expansion budget is accounted for. Another \$451 million finances pay raises and benefits for current and former state employees.

While some of these expenditures may be questionable — indeed, in the Locke Foundation's Freedom Budget published in 2003, some were financed by tuition increases or foregone entirely⁵ — much of the remaining expansion budget lacks even a plausible rationale given the needs facing North Carolina. These needs include not only accommodating growth in demand for core state services but also an end to the diversion of hundreds of millions of dollars each year to the General Fund from highway funds (which are desperately needed to address the state's long-standing road capacity and maintenance needs) as well as tax relief to enhance freedom and strengthen an economic recovery that remains, by most measures, lackluster.

Instead, Gov. Easley's budget includes:

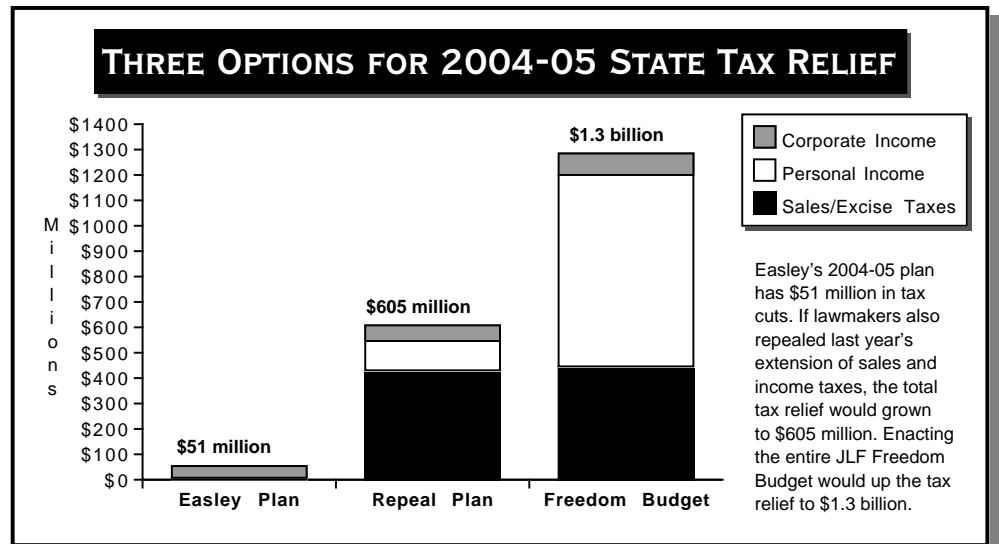
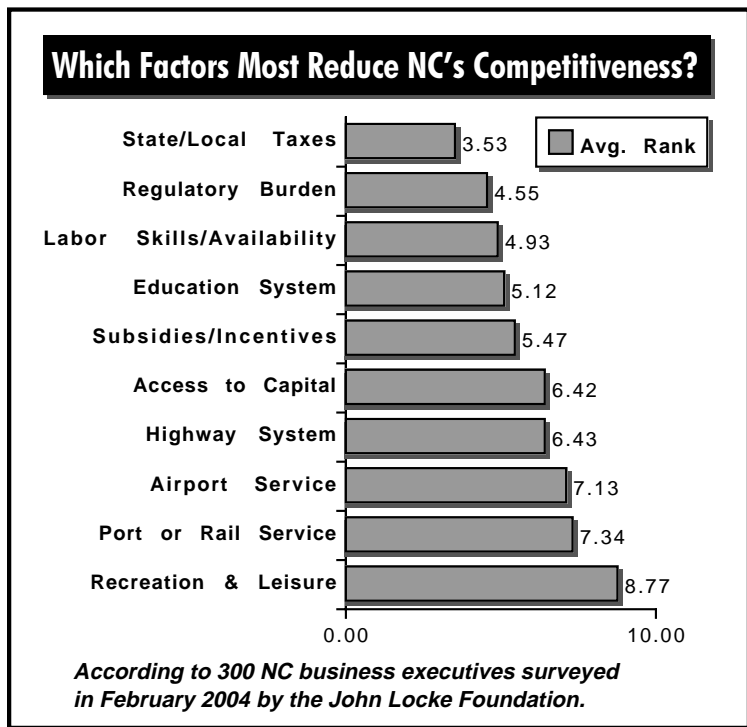
- \$53 million in new business subsidies in either the current fiscal year or 2004-05, including \$20 million for direct cash grants, nearly \$10 million in training subsidies, \$5 million more to subsidize the biotechnology industry, and \$500,000 for state promotion at the 2005 U.S. Open at Pinehurst.
- \$30 million in new public-assistance spending, including expansions of a subsidized health-insurance plan for families with incomes well above the poverty line and the governor's More at Four preschool initiative.
- \$2.5 million more to subsidize cultural, artistic, and other projects that should be local or private responsibilities.

A Trio of Tax-Cut Choices

In total, there are some \$160 million in indefensible or low-priority expansion items in the 2004-05 plan. If added to \$54 million in low-priority items in last year's expansion budget and another \$340 million in similar savings outlined in the Freedom Budget, the resulting savings would allow lawmakers to repeal immediately the sales and income taxes extended last year. Along with Easley's tax cuts, this choice would reduce the tax burden by \$605 million *without a fundamental change in major state programs such as Medicaid or education.*

However, an even better choice would be for state leaders to think more fundamentally about the proper role of state government and the need to institute basic reforms in the way taxpayers' dollars are spent in areas such as non-teaching and research positions in the public schools and universities, heavy subsidies for the relatively affluent who attend state colleges and universities, a Medicaid program that remains one of the most expensive in the region, and quasi-entitlement programs providing free health care and preschool for families with incomes well above the poverty line. If the entire Freedom Budget agenda on these and other areas were enacted, the resulting savings could finance not only the repeal of last year's tax hikes but also a tax-reform plan that would 1) cut the top marginal tax rate on both personal and corporate income to 6 percent, more in line with competing states; 2) provide \$166 million in tax credits to families so they can choose their own preschool, health care, and education providers rather than having to rely on government programs; and 3) repeal additional tax increases while also eliminating some special tax breaks and biases that are unfair and warp economic decisionmaking. The total net savings to taxpayers from this tax-reduction option would be nearly \$1.3 billion.

Tax cuts that let North Carolinians keep more of their own money would enhance personal freedom and reduce reliance on government. But they would also be welcome as a means of making the state's business climate more attractive for new enterprises and jobs. In a recent JLF survey of 300 business executives from across the state, the tax burden was ranked as the most significant factor reducing the state's competitiveness, followed by the regulatory burden and concerns about skills and educational quality. Other studies confirm the influence of tax rates on state economic growth.⁶



	Easley Plan	Repeal Plan	Freedom Budget
Corporate Income	\$44	\$58	\$80
Personal Income	\$5	\$118	\$754
Sales/Excise Taxes	\$2	\$429	\$447

Enacting sound state budgets is about embracing sound principles and priorities. The best fiscal choice for North Carolina in 2004-05 would be to fund core state services but otherwise to stop overcharging taxpayers and to return their money to them in the form of tax relief.

— John Hood, President

NOTES

1. *North Carolina State Budget: Recommended Adjustments 2004-05*, Office of State Budget and Management, May 2004, p. 13.
2. *Ibid.*
3. *North Carolina State Budget: Post-Legislative Budget Summary 2003-05*, Office of State Budget & Management, Oct 2003, p. 11.
4. *Recommended Adjustments 2004-05*, p. 12.
5. *The Freedom Budget: Nine "Rs" for North Carolina Fiscal Responsibility*, John Locke Foundation, April 2003, found online at www.JohnLocke.org.
6. "The Best Incentives: Target policies fail while tax rates, services matter," Spotlight No. 239, John Locke Foundation, Dec. 8, 2003.