

## WHERE TO FIND SAVINGS

### *Benchmarking, Setting Priorities the Key to Balance*

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**Summary:** As the 2004-05 budget process continues, policymakers should use regional and historical benchmarks to identify where to look for savings. Among major budget items, North Carolina spending on K-12 education and law enforcement is at the regional average but its Medicaid and higher-education expenses are higher than in comparable states. Reasonable restraint would save enough money to repeal last year's tax hikes and catch up on deferred repairs and renovations.

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**A**t this writing, the North Carolina House of Representatives is in the midst of fashioning its version of a 2004-05 budget plan. Gov. Mike Easley has already presented a proposal to adjust the state budget for the coming fiscal year. It would use a \$444 million surplus from FY 2003-04 and expected revenue growth to finance \$1.08 billion in new spending in FY 2004-05 — a 7.4 percent increase, including some \$200 million in Medicaid expenses moved back onto the General Fund budget after a one-year shift to federal funding.<sup>1</sup> Apparently, House appropriations leaders would like to offer higher state-employee pay raises than the roughly 2 percent average offered in the governor's budget, as well as make a contribution to the state's reserve for long-delayed repairs and renovations of state buildings.

To accomplish this, House budget-writers have reportedly identified tens of millions of dollars in savings in departments such as health and human services and the University of North Carolina system.<sup>2</sup> While lobbyists for the affected agencies and interests are objecting strenuously to the idea, the real problem with the House approach is that it does not go far enough to redirect the taxpayers' money to high priorities, including that of giving the money back to the taxpayers who originally earned it.

There will always be more "needs" than government can satisfy, given that these needs are not and can not be related to objective measurements of service or absolute standards of well-being. Making budget decisions in isolation, without trying to put the current situation into context, is a flawed process that will always work to the advantage of those with the best-organized lobbying efforts or the most compelling story to tell in the news media. Context can be provided by examining the historical trends in state expenditures and by finding regional or national benchmarks that help to clarify where North Carolina is in line and where it is out of line with similar states.

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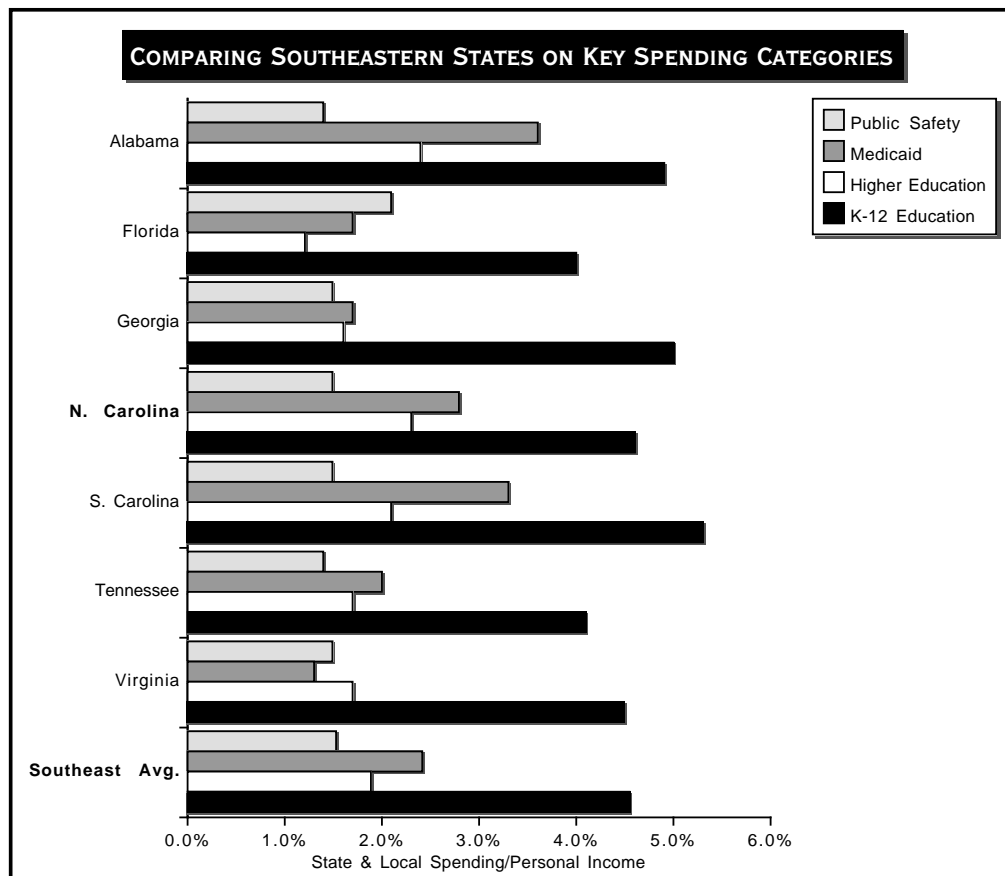
## North Carolina Spends More on Medicaid, Higher Education

In some ways, North Carolina is far from exceptional. According to the most recent census data, North Carolina is close to the national average in total state and local expenditures and total state and local revenues.<sup>3</sup> Our state has not been alone in experiencing deficits over the past three years, though North Carolina's fiscal problems began somewhat earlier than in the rest of the country. However, North Carolina does stand out for relying more on tax increases than most other states to bridge the gaps.<sup>4</sup> And within the Southeast — a region comprising Virginia, the Carolinas, Tennessee, Georgia, Florida, and Alabama — North Carolina does differ from the norm in some important ways. Most notably, North Carolina imposes the highest marginal tax rates on personal (up to 8.25 percent) and corporate (6.9 percent) income and only Georgia imposes a higher state and local tax burden (10 percent of personal income estimated in 2004) than North Carolina does (9.7 percent).<sup>5</sup>

The explanation likely lies in how North Carolina differs from other states on the spending side of the ledger. Four areas of spending represent the overwhelming majority of the budget in most states: K-12 education, higher education, Medicaid, and law enforcement (including corrections). As the chart below depicts, North Carolina's expenditures are at the regional average in K-12 education and law enforcement, but are above average for Medicaid and well above average for higher education. While there is nothing magical about an "average," it is meaningful that North Carolina spends significantly more on these purposes but appears to differ little in outcomes. For example, the share of North Carolinians who lack health insurance remains somewhat higher than average<sup>6</sup>, and the percentage of births at low birthweight — associated with infant mortality — also remains somewhat higher than average.<sup>7</sup> Similarly, while the University of North Carolina system receives among the most generous subsidies of all public-university systems in the United States, the share of North Carolinians with a four-year college degree is 23 percent — essentially the same as the rest of the region and lower than the national average.<sup>8</sup> While benefits clearly flow to those actually receiving North Carolina's higher allocation of tax dollars for these purposes — hospitals, doctors, manufacturers of drugs and medical devices, and other providers in the case of Medicaid and university professors and administrators in the case of UNC — it is not at all clear that outcomes are significantly better.

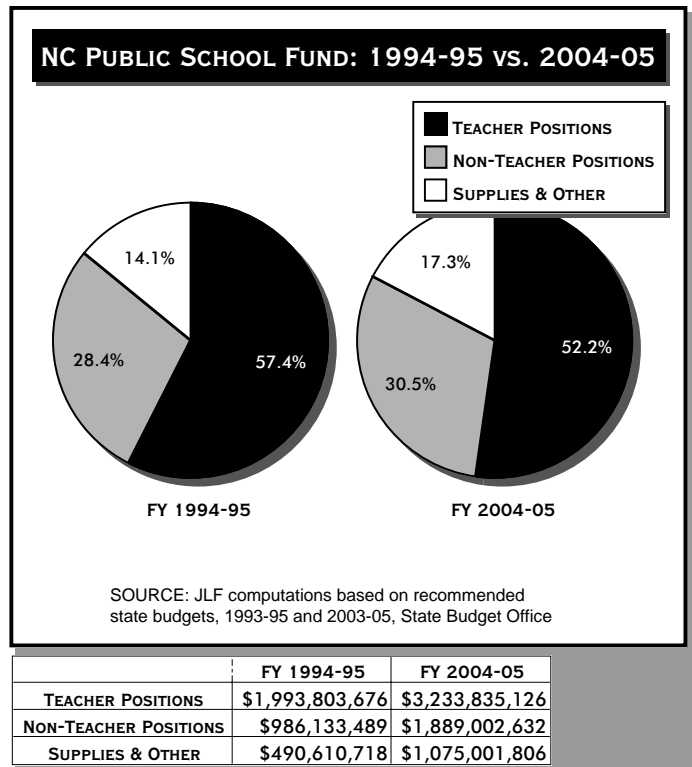
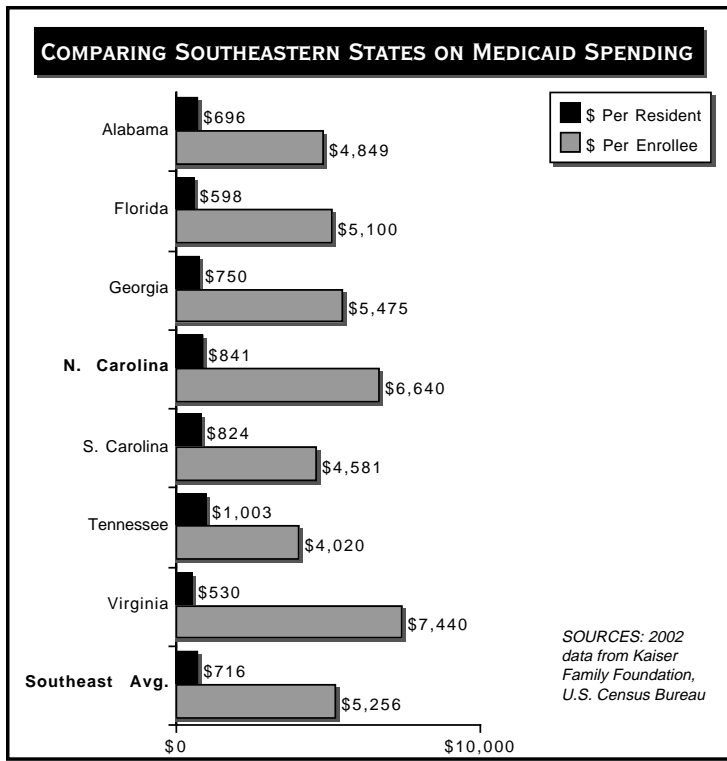
While enacting fundamental changes in state programs, and perhaps even rethinking their existence, might be good ideas for North Carolina policymakers to consider, there is obviously no need for radical changes to economize on state expenditures on health care and higher education.

North Carolina need only devote the same proportionate amount of tax dollars to these functions that our neighboring states do. After all, low-income and disabled persons still receive health care in these states, and their students go off to college in roughly similar numbers to their North Carolina counterparts, even though these activities are not as highly subsidized by state taxpayers.



	Southeast	Virginia	Tennessee	S. Carolina	N. Carolina	Georgia	Florida	Alabama
Public Safety	1.5%	1.5%	1.4%	1.5%	1.5%	1.5%	2.1%	1.4%
Medicaid	2.4%	1.3%	2.0%	3.3%	2.8%	1.7%	1.7%	3.6%
Higher Education	1.9%	1.7%	1.7%	2.1%	2.3%	1.6%	1.2%	2.4%
K-12 Education	4.6%	4.5%	4.1%	5.3%	4.6%	5.0%	4.0%	4.9%

In the Locke Foundation's 2003 report, *The Freedom Budget*, we listed specific proposals for saving money in the UNC budget. The largest items included the adoption of a 15-hour standard for full-time students, transferring half of the UNC system's overhead receipts for research to the General Fund to compensate for overhead expenses funded by taxpayers, and reducing the state's subsidy for the UNC hospital system, which has generated sizable surpluses. Even without tuition increases, these and other JLF recommendations would save \$133 million in FY 2004-05.<sup>9</sup>



On Medicaid, we proposed that the state adjust its eligibility standards, optional services, and reimbursements rates — as well as adopt new approaches to combat Medicaid fraud — in order to bring North Carolina’s expenditures in line with its neighbors over time. Specifically, North Carolina’s Medicaid expenses per resident were 17 percent above the regional average in 2002, while expenses per Medicaid enrollee were 26 percent above the regional average (see left-hand chart above). If the state set achieving parity as a goal, that would translate into a \$350 million to \$500 million savings for taxpayers. If accomplished over three years, the first-year savings at the midpoint would be approximately \$142 million.

### Setting Priorities in Education Spending

North Carolina lawmakers have invested significant sums of taxpayer dollars into improving the state’s public schools. While some indicators such as state and national test scores show significant gains in outcomes during the 1990s, indicators such as graduation rates show little or no improvement. Much of the dramatic increase in elementary and secondary education went to teachers in the form of compensation increases and class-size reductions, but within the Public School Fund distributed to local school systems there remained sizable shares devoted to non-teacher positions, including teacher assistants, and other purposes. Improving the quality of teaching in the public schools needs to remain a high priority for the state, but such an investment should first have been financed by redirecting existing funds away from lower-priority expenditures (see right-hand chart above). For example, the same studies cited by proponents of class-size reduction as proving the educational value of their preferred policy also demonstrated that the presence of teacher assistants did not appreciably affect educational outcomes. The Easley administration endorsed to a limited extent the idea of converting assistant positions into teacher positions to finance its class-size reductions, but the idea should be broadened and deepened to promote local control and ensure that taxpayers get the best return on their dollars. If the state budget for all non-teacher positions were combined into a single funding stream to allow for local flexibility and then reduced by only 6 percent from the FY 2004-05 authorization, that would free up \$113 million to hire new teachers and raise the pay of existing classroom teachers.

### Conclusion

By combining these big-ticket savings items with some smaller recommendations — such as foregoing any new expansions in 2004 not related to enrollment increases or public safety — North Carolina policymakers could save enough of the taxpayers’ money to balance the 2004-05 budget while repealing \$551 million in tax increases and adding \$53 million to the state’s repair and renovation reserve (see table on the next page). Judging by the available historical and regional benchmarks, these changes are defensible and prudent given the need to alleviate a tax burden that is high by regional standards and to rejuvenate an economic recovery that is weak by regional standards.

NOTES

1. "The Best Fiscal Choice," Spotlight No. 241, John Locke Foundation, Raleigh, NC, May 13, 2004.
2. Gary Robertson, "NC budget delayed with more complaints over education, health," *Times-News Online*, May 27, 2004.
3. Cited in *State and Local Sourcebook 2003*, Supplement to *Governing*, Washington, D.C., pp. 13-14, 69-71, 92.
4. "NC Near Top in Tax Hikes," Spotlight No. 233, John Locke Foundation, Raleigh, NC, June 4, 2003.
5. Data obtained from Tax Foundation, Washington, D.C., [www.TaxFoundation.org](http://www.TaxFoundation.org), State Finance section.
6. Regional average computed from U.S. Census Bureau report, "Health Insurance Coverage: 2002."
7. Regional average computed from 2003 data, "Kids Count Data Book Online," Annie Casey Foundation, [www.aecf.org](http://www.aecf.org).
8. Computed from 2000 data from National Center for Education Statistics, U.S. Department of Education, <http://nces.ed.gov>.
9. *The Freedom Budget: Nine "Rs" for North Carolina Fiscal Responsibility*, Locke Foundation, April 2003, found online at [www.JohnLocke.org](http://www.JohnLocke.org).

**HOW TO REPEAL 2003 TAX INCREASES, ADD TO REPAIR & RENOVATION FUND**

Proposal	Authorized 03-04	Easley 04-05	Proposed 04-05	Net Savings
• MEDICAID Reach regional average spending in three years by adjusting rates, services and combatting fraud.	\$1,987,409,086	\$2,360,559,993	\$2,218,893,326	\$141,666,667
• NON-TEACHER POSITIONS Combine codes within public school fund into a single block grant, reduce authorization 6%	\$1,853,695,960	\$1,889,002,632	\$1,775,662,474	\$113,340,158
• UNC BUDGET Increase FTE status to 15 hours, transfer 50% of overhead and hospital grant to GF, other savings	\$1,792,141,661	\$1,869,572,129	\$1,736,220,809	\$133,351,320
• CLASS SIZE REDUCTION Do not implement in 3rd grade		\$50,467,765	\$0	\$50,467,765
• HEALTH CHOICE Do not expand the program		\$9,052,824	\$0	\$9,052,824
• OTHER EXPANSION ITEMS Forego other expansions proposed by governor not related to enrollment, child abuse, law enforcement		\$42,826,485	\$0	\$42,826,485
• OTHER BASE BUDGET ITEMS Reduce or eliminate GF support for some nonprofits, low-priority agencies (Freedom Budget)		\$61,377,754	\$0	\$61,377,754
Total				\$552,082,973
<i>Cost to Repeal Tax Hikes</i>				\$550,800,000
• CAPITAL PROJECTS Use NASCAR track, other capital for repairs and renovations instead		\$20,055,680	\$0	\$20,055,680
• INCENTIVES Use one-time funds for recruitment fund and job training for repairs & renovations instead		\$24,100,000	\$0	\$24,100,000
• OTHER EXPANSION ITEMS Eliminate, use one-time money for repairs and renovations instead		\$8,671,165	\$0	\$8,671,165
Total				\$52,826,845
Repair, Renovation Amount	\$0	\$0	\$52,826,845	

SOURCES: Computations based on 2003 Freedom Budget, State Budget Office, Fiscal Research Division numbers