spotlight

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The Political Spending Cycle

Spending Binges Lead to High-Tax Hangovers

SUMMARY: **State tax revenues grow in strong economies. Politicians use the new revenue to create or expand government programs. In recessions, revenues fall and tax rates rise to pay for the higher level of spending. Spending and taxes in the last ten years illustrate this pattern. As North Carolina enters another period of expanding revenues, Gov. Mike Easley and the General Assembly must avoid the temptation to increase spending so they do not have to increase taxes in the next recession.**

The economic business cycle of growth and recession is well known. State governments have a corresponding "political spending cycle." State politicians have incentives in times of strong economic growth to ratchet up spending on new or expanded government programs and on tax cuts. The increased spending is a permanent commitment based on a temporary revenue surge. When the economic bust comes, revenues shrink, but the new programs still need to be funded. Balanced budget requirements lead politicians to increase tax rates, often above the pre-boom level, to meet the increased demands of programs and recessionary transfer payments. This is the mechanism that makes state government spending grow faster than the economy or personal incomes.

Now, as company profits and personal incomes recover with the economy, tax collections are running ahead of projections in most states and, after years of concern about fiscal crisis, state lawmakers are "eying voter-friendly ways to spend the extra cash."[1] Education and health care are at the top of the list for new spending initiatives. In North Carolina, tax revenues for the current fiscal year are already $89 million ahead of projections according to the General Assembly's Fiscal Research Division. As the May start of the election-year legislative session approaches, expect to hear plenty of suggestions for spending this money. Legislators and Gov. Mike Easley should look again at the lessons from the 1990s boom and bust to avoid a repeat of North Carolina's own spending and tax increases.

Spending in North Carolina

Were spending increases in the 1990s limited to needed spending in educa-

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tion, health and corrections as some suggest? It would be difficult to judge all of the spending increases in each state, but in North Carolina the answer is clearly "no." *Business Carolina* stated that in the 1990s, "[r]evenue soared, but spending flew past it as lawmakers feasted on pork-barrel projects as if they were Lexington barbecue."[2]

But pork projects can only take so much revenue, and spending grew by 38 percent between fiscal years (FY) 1995 and 2001 – faster than the 30 percent combined rate of population growth and inflation – for real per capita growth of 9 percent. So while pork barrel spending accounts for some of the increased spending, this excessive rate of growth in government and its longer term consequences could only come from program expansions in Medicaid, education, and corrections, which together take more than three-fourths of the General Fund. The same *Business Carolina* article found that Gov. Jim Hunt often made programs bigger while trying to make them better.[3] New spending on education, Medicaid and corrections led to 42 percent growth in these areas from FY1995 to FY2001. In real per capita terms, the increase was nearly 12 percent.

North Carolina Tax and Fee Increases, Fiscal Years 1991-2007

Fiscal Year	Tax & Fee Increases $ Million	Cumulative Change[1] $ Million
1991	49.3	49.3
1993	789.3	838.6
1995	12.2	850.8
1997	-460.9	389.9
1999	-276.2	113.74
2001	8.0	121.74
2003	923.4	1,045.14
2005[2]	195.6	12,40.74
2007[2]	326.6	15,67.34

1. *Not adjusted for inflation or other effects over time*
2. *Does not include extension of 4.5% sales tax rate or 8.25% income tax rate*

Taxes in North Carolina

While it is true that North Carolina and other states did cut taxes in the late 1990s, these tax cuts did not match the increases imposed in the late 1980s and early 1990s. Cato Institute researchers found that net tax cuts in all states from FY1995 through FY2001 were $3 billion less than the tax increases imposed from FY1990 through FY1994. States increased taxes another $8 billion in FY2002.[4]

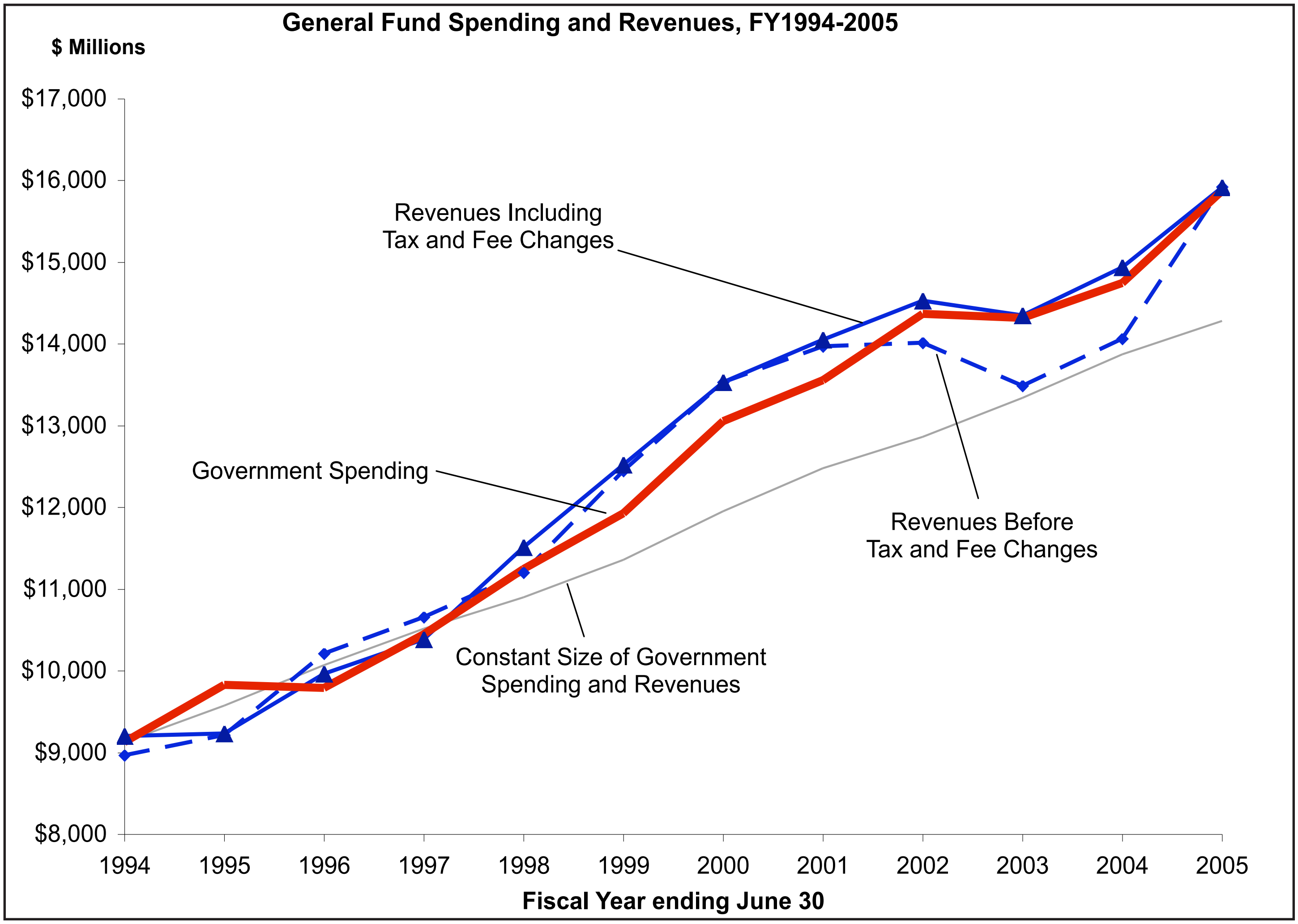
The pattern in North Carolina is similar. The state added $789.3 million in new taxes in FY1993, cut taxes $736 million in FY1997 and FY1999, and has raised taxes by more than $1.4 billion since FY2001.[5]

What Could Have Been

Instead of the annual spending increases that absorbed higher tax revenues from FY1997 through FY2001, then-Gov. Jim Hunt and the General Assembly could have continued to hold spending to a fixed level per person adjusted for inflation. This Constant Size of Government level of spending and taxes is the basis for what in other states is called a "taxpayer bill of rights" (TABOR) and in North Carolina has gone under the name Taxpayer Protection Amendment.

From FY1994 to FY1997, North Carolina's government grew in line with this standard. Tax and fee cuts returned money to the people. With the 1990s boom, however, government revenue from taxes and fees soared (see dashed line). Instead of refunding the extra revenue to North Carolinians, however, the General Assembly took the opportunity to add new programs, and spending followed revenues skyward even after revenues began to return to normal in FY2002. They were also able to put some money in the state's Budget Stabilization Reserve, or "rainy day" fund, during this period.

As revenues under existing law fell in FY2002 and FY2003, legislators faced the choice of cutting spending or raising taxes and pulling money from other government pots, such as the rainy day fund. They chose the latter, so that while revenue collections under existing law in FY2003 and FY2004 would have returned to the TABOR model of revenues and spending, the General Assembly passed "temporary" sales and income tax increases that are still with us today.



Conclusion

The experience of the last ten years demonstrates that the only sure way to limit what legislators spend is to limit what legislators can spend. This is best done not with a requirement to balance the budget, but with an amendment to the state constitution that limits real per capita spending growth and makes it much more difficult to raise taxes. As North Carolina's experience demonstrates, "rainy day" funds are just another pot of money for legislators to tap, along with higher taxes and fees. Such funds are not effective at tempering the growth of government by forcing politicians to set priorities.

In the current system, legislators will always find a reason to increase spending. Once enacted, it is harder to rollback programs with significant benefits to a few beneficiaries than to increase taxes a little on every other citizen. A half-cent sales tax hike, a three-cent gas tax hike, or a two-percent phone tax hike does not seem inconvenient to most consumers.

It is clear that the General Assembly should not commit the state to new spending programs just because the short-term fiscal condition appears healthy. A little self-discipline during short-term booms can go a long way toward heading off fiscal crises during harder times.

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Notes

1. Deborah Solomon, "States, Flush in Election Year, Loosen Up," *Wall Street Journal*, Jan. 12, 2006, p.A4.
2. Ned Cline, "Budget forces Easley to grow into his job," *Business Carolina*, November 2003, http://www.businessnc.com/archives/2003/11/capital.html
3. *Ibid.*
4. Chris Edwards, Stephen Moore, and Phil Kerpen, "States Face Fiscal Crunch after 1990s Spending Surge," Cato Institute *Briefing Paper* #80, Feb. 12, 2003, http://www.cato.org/pubs/briefs/bp-080es.html
5. Author calculation based on budget documents.