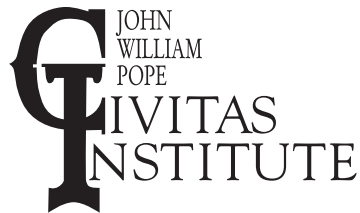


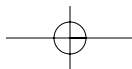
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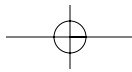
**UNLOCKING THE STATE BUDGET:
1985-2005**

A GUIDE TO SPENDING AND TAXATION



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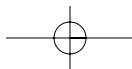


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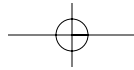


ABOUT THE SERIES

The Civitas Institute Public Policy Series

The purpose of the Civitas Institute Public Policy Series is to equip the legislator, as well as the layman, with the tools necessary to understand public policy in North Carolina. Toward this end, each guide does three things: defines basic terms, answers essential questions, and provides a legislative and political history regarding a particular policy area. Thus each guide consists of three distinct sections – Key Terms, Q & A, and a year-by-year Timeline – that can be used to easily find specific information on a particular issue or time period. Detailed charts and graphs provide additional data for those readers interested in learning more about select topics. Overall, the guides provide a roadmap for the citizen legislator – and perhaps more important, the average citizen – interested in learning more about essential policy ideas and long-term trends.

While each book in the Civitas series can be read on its own, the current guide on spending and taxation serves as a foundation for the series as a whole. Essentially, this is because the budget process is the annual focal point of the public policy debate in North Carolina. Whether or not this should be the case is a complex question, but the reality remains that the state's priorities are best perceived by looking at how the state spends its – that is, our – money.



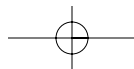
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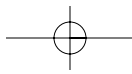
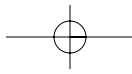
Special thanks to all those who helped make this project a success. Chloe Gossage created many of the charts and contributed to the writing and editing of the guide. Peter Andros compiled and wrote the historical narratives while Chloe, Becki Gray, Sven Larson and Jason Bennett put together the year-by-year tax, healthcare, and education boxes. Becki and Sven also helped in the writing of the guide while Jason wrote several early drafts. Finally, thanks also to Faye Edwards for designing the guide and the cover; Dion Terry for assisting with research; and Dennis Parker and Jennifer Taylor for providing editorial and design assistance.

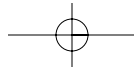


And to preserve [the people's] independence, we must not let our rulers load us with perpetual debt. We must make our election between *economy and liberty, or profusion and servitude*. . . .

Private fortunes are destroyed by public as well as by private extravagance. And this is the tendency of all human governments. . . . And the fore horse of this frightful team is public debt. Taxation follows that, and in it's train wretchedness and oppression.

Thomas Jefferson
to Samuel Kercheval (July 12, 1816)





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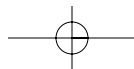
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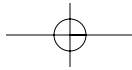
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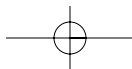
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EXECUTIVE SUMMARY

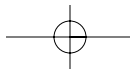
One would think that a 20-year history of anything, much less the North Carolina budget, would be rather dull. The current guide, however, is anything but boring. Intrigue, deception, corruption, boundless optimism – the state budget has it all. Want high-stakes drama? At \$20 billion a year, the stakes don't get much higher. Consider, for example, that over the past two decades:

- ▶ Spending has increased by 318 percent;
- ▶ Taxes have increased by 86 percent; and
- ▶ Per capita debt has increased by 465 percent.

These numbers, however, only tell part of the story. In itself, the budget is simply an itemized estimate of the anticipated revenue and expenditures for each biennium, or two-year legislative session. It is the budget process – the politics of how certain priorities and programs get funded over others – that is the story. With that point in mind, the current guide not only provides a detailed analysis of spending and taxation trends in North Carolina, but also a year-by-year narrative that identifies the people responsible for making these decisions. In the end, the main thing, after all, is not the budget. It is the people behind the budget, and the people of North Carolina that the budget is supposed to serve. That being said, if you want the inside story you'll have to read the book. In this Executive Summary we'll just be looking at the numbers.

By all accounts, the state is spending more and more, which also explains why the overall tax burden keeps rising. Based on Governor Mike Easley's (D) FY2007-2008 recommended General Fund budget, we anticipate a \$1.2 billion, or 6.4 percent, increase in spending over FY2006-2007. Now, it is true that a 6.4 percent increase does not sound like much. After all, a mere 6 percent pales in comparison to the double-digit budget growth common throughout the 1970s. But this is precisely where a bit of history – the sense of perspective provided by this guide – comes in handy. In fact, 6.4 percent of a \$20 billion budget is a lot more than 10 or 20 or 30 percent of a \$1 billion budget. From FY1972-1973 to FY1973-1974, for example, the General Fund budget went from \$1.17 billion to \$1.61 billion – an astounding increase of 38 percent. This 38 percent, though, translates into \$433.7 million. Fast forward 30 years to Governor Easley's third year in office. From FY2002-2003 to FY2003-2004 the General Fund budget went from \$14.36 billion to \$14.86 billion – an increase of 3.5 percent. This 3.5 percent is equivalent to \$508.1 million.

Thus while from one perspective – i.e., in terms of growth from year to year – the budget expanded more quickly during the 1970s, the budget is growing faster



now in terms of actual dollars. In order to come to grips with the state’s current budget crisis – or what, really, should be termed a spending crisis – we need to take a step back and look at the long-term spending and taxation trends that have shaped North Carolina’s economy.

Let’s look at spending first. What emerges is a pattern of massive increases over the past 20 years:

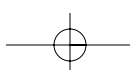
Total General Fund Authorizations	
FY1984-1985:	\$4.516 billion
FY1989-1990:	\$7.360 billion
FY1994-1995:	\$10.268 billion
FY1999-2000:	\$14.237 billion
FY2004-2005:	\$15.918 billion
FY2006-2007:	\$18.866 billion

As Figure 1 (below) shows, the budget went from \$4.5 billion in FY1985 to \$18.9 billion in FY2007. This is an increase of \$14.4 billion. Of course, some of this increase can be attributed to population growth, plus inflation. During the same period, North Carolina’s population went from 6.3 million persons to 8.9 million persons (as of July 2006) – an increase of 2.6 million. What about inflation? From 1984 to 2006, the U.S. inflation rate was 94 percent. Accounting for inflation, we would expect the budget to have almost doubled to \$8.8 billion. Yet even once we factor in inflation and population growth, we find that new spending has eclipsed both.

- Population Growth: 42 percent
- Inflation Growth: 94 percent
- Budget Growth: 318 percent

As for taxes, as a share of personal income, state and local taxes are much higher in North Carolina than in the rest of the Southeast. As Figures 2 and 3 illustrate, from 1985 to 2005, the state/local personal tax burden¹ went from 2.9 percent to 3.6 percent. When all taxes, such as sales taxes, are taken into account, North

¹This figure does not include sales tax, but is the standard measure used by the Bureau of Economic Analysis for “personal current taxes.” As such, it includes income taxes and taxes on personal property.



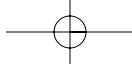
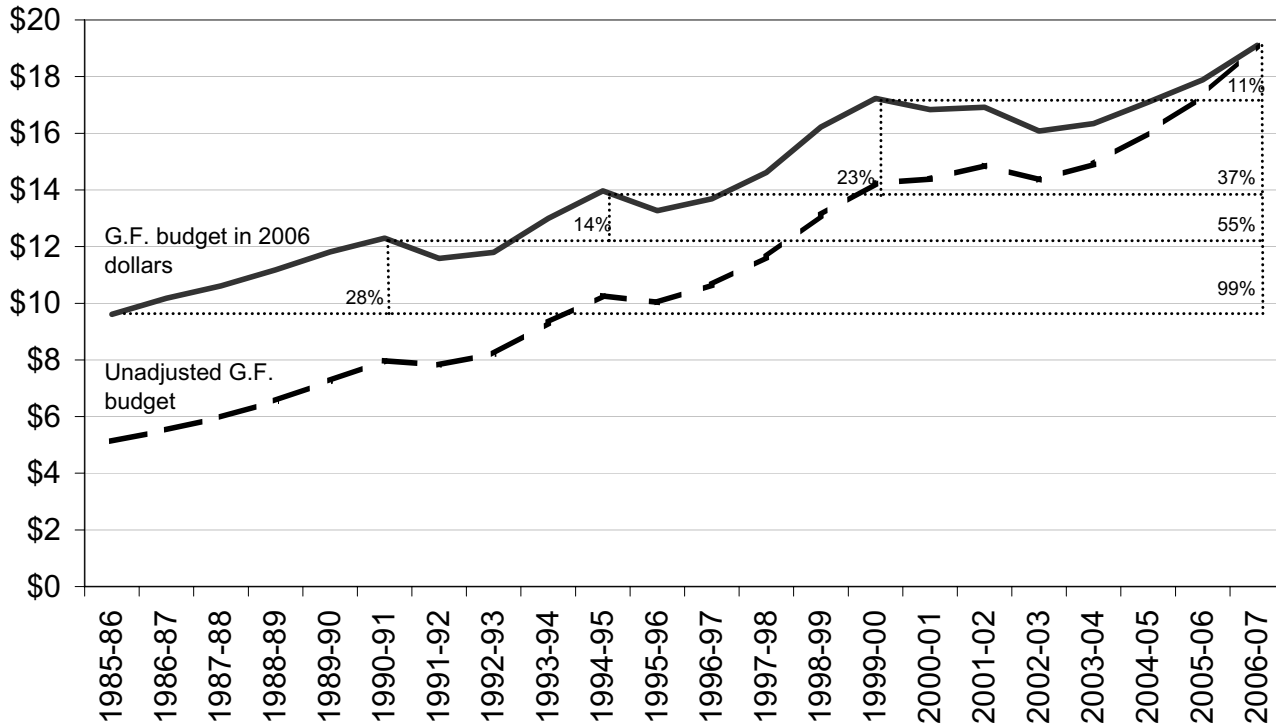


Fig. 1. Growth in General Fund Budget

Constant 2006 and Unadjusted Current Dollars
 Percent Increase in General Fund Budget in Constant 2006 Dollars

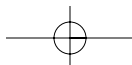


Carolina's state/local tax burden surged from 9.1 percent in 1985 to 10.5 percent in 2006.² During the same period, North Carolina's overall state/local tax burden went from 35th to 23rd nationally. (Maine is first, with an overall tax burden of 13.5 percent.) The result has been an overall increase of \$2295 tax dollars per capita.

Per Capita State and Local Taxes	
1985:	\$4.516 billion
1995:	\$7.360 billion
2006:	\$10.268 billion

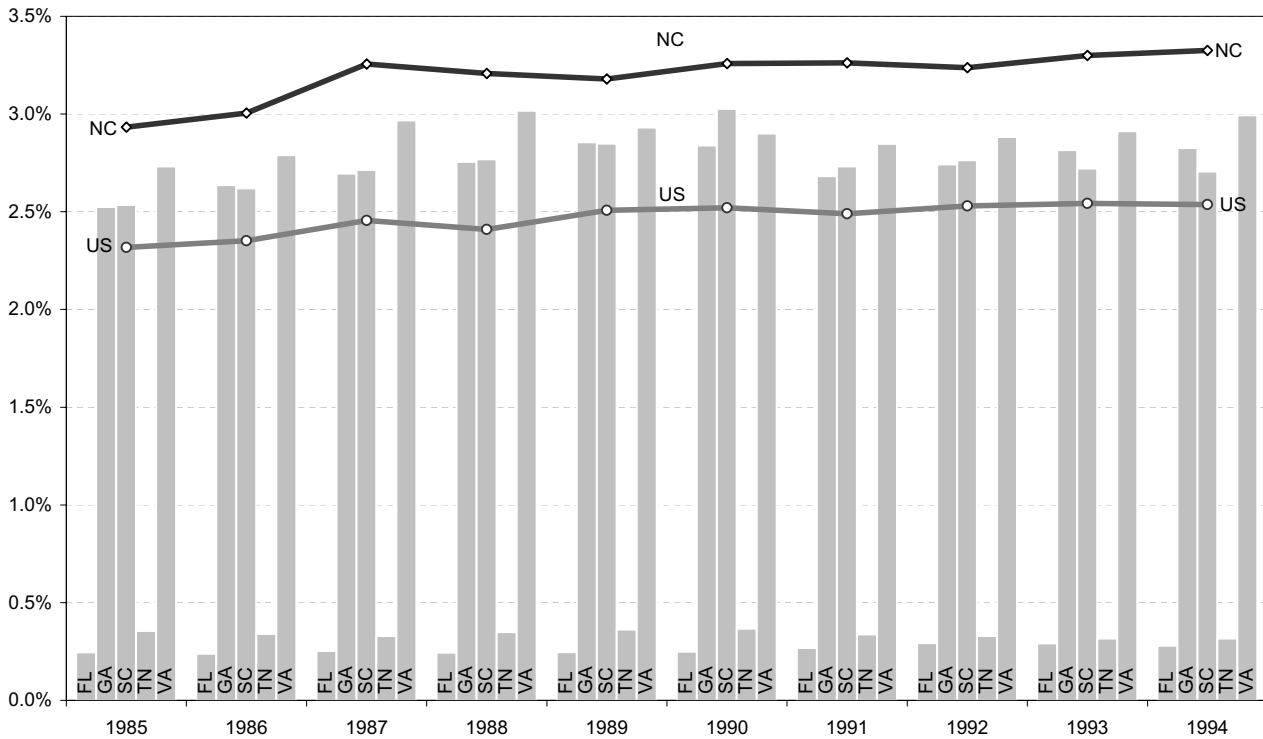
Accounting for an inflation rate of 95 percent, the overall tax burden should have risen by \$1169, which would translate into \$2400 in 2005. Hence we find that,

²Using different measures, Dr. Michael Walden of North Carolina State similarly finds that between 1991 and 1999, North Carolina's overall tax burden went from 15.4 percent to 15.8 percent. At the same time, the state went from having the 39th lowest tax burden to the 30th lowest. In particular, notes Walden, "The tax burden ranking rose for income and sales taxes and for fees and charges, fell for motor fuel and vehicle license taxes and other taxes, and was unchanged for the property tax." Michael Walden, "North Carolina's Relative Tax Burden"; available from <http://www.ag-econ.ncsu.edu/faculty/walden/nctaxburdenranking.PDF>.



along with state spending, taxes have risen more quickly than inflation – by more than \$1,000 per person. As a result, North Carolina’s overall state and local tax burden (for 2006) ranks first in the Southeast (N.C., Fla., Ga., S.C., Tenn., Va.).³

Fig. 2. State/Local Taxes as a Share of Personal Income: Southeast States, 1985-1994



As bad as all this sounds, things are actually worse. Consider that according to the Bureau of Economic Analysis, per capita personal income (current dollars) in North Carolina increased from \$12,699 in 1985 to \$31,029 in 2005. Even once we account for inflation, this increase should have theoretically translated into a decline in the tax rate. This is because the increase in personal income caused an increase in tax revenue, which means that legislators could have lowered taxes and still brought in the same amount of revenue. North Carolina’s growing population should have had a similar effect. Indeed, according to the groundbreaking work of late economist Julian Simon, population growth is good for the economy. Because of the dynamic effects of adding new persons to the economy, the increase in population not only broadened the tax base and the debt base, but can be correlated to the increase in personal income and productivity. As North Carolina’s population grows we should thus expect a decrease in the tax rate. Instead, the opposite has happened, which means that

³The Tax Foundation, “North Carolina State-Local Tax Burden Compared to U.S. Average (1970-2006)”; available from <http://www.taxfoundation.org/files/northcar.swf>; also personal correspondence with Tax Foundation, March 15, 2007.

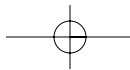
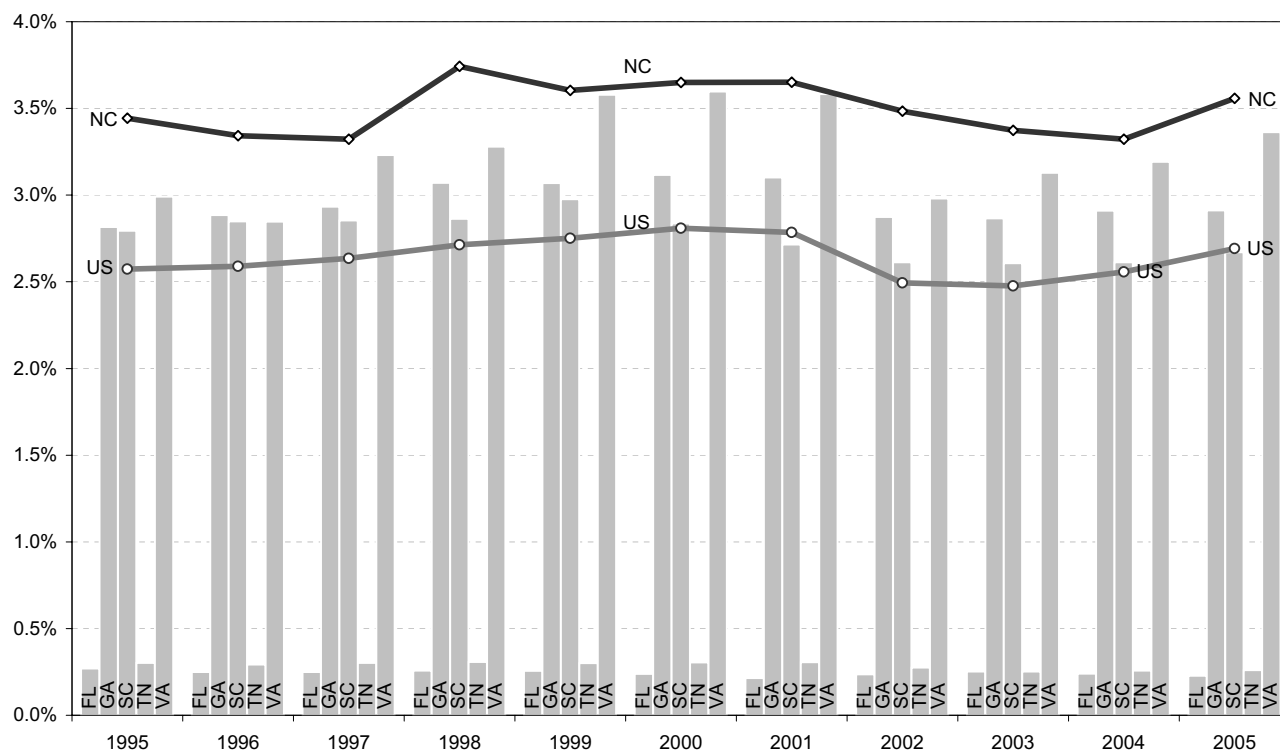


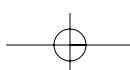
Fig. 3. State/Local Taxes as a Share of Personal Income: Southeast States, 1995-2005



population growth has helped mask some of the state’s long-term budgetary problems.⁴

Finally, let’s look at how much debt per capita has increased over the past 20 years. According to the North Carolina Constitution (Article III, Section 5), the governor and the General Assembly are charged with making necessary “economies in State expenditures” to balance the budget. Nevertheless, the government is still able to take on debt by issuing general obligation bonds, certificates of participation, and other such instruments. As of FY2005-2006, North Carolina’s total net indebtedness was \$5.7 billion. Of this, \$5 billion consisted of general obligation debt issued on behalf of local governments, as well as the state’s university and community college systems. The state also owes approximately \$650 million in various forms of “special indebtedness.” Under Governor Easley’s tenure, tax-supported debt has grown rapidly in North Carolina, doubling from \$2.8 billion in 2001 to \$5.7 billion in 2006. As the debt has risen, so has debt service – i.e., those payments on the principal of the debt, plus interest.

⁴Notes Simon: “Economic reforms away from totalitarianism and central economic planning in poor countries probably would have been faster and more widespread if slow growth was not explained by recourse to population growth. ... By 1989, the economics profession has turned almost completely away from the previous view that population growth is a crucial negative factor in economic development.” Julian L. Simon, “An Unreported Revolution in Population Economics”; available from <http://www.juliansimon.com/writings/Articles/REVOLUTI.txt>.



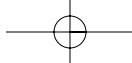


Fig. 4. General Obligation Debt Per Capita: 1988-1997

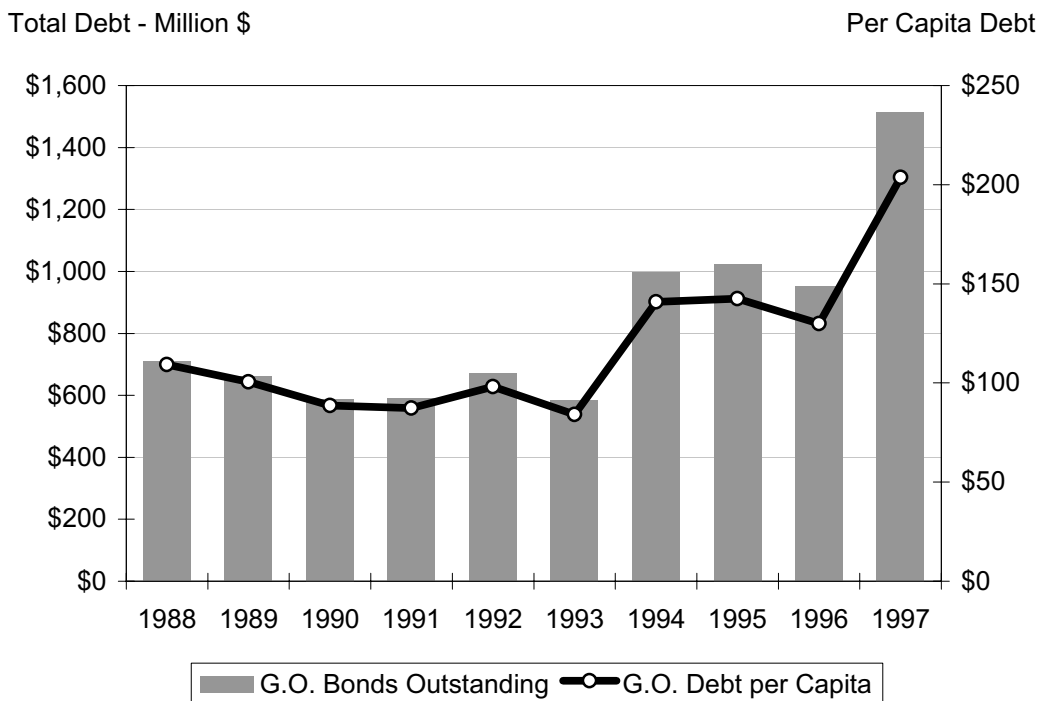
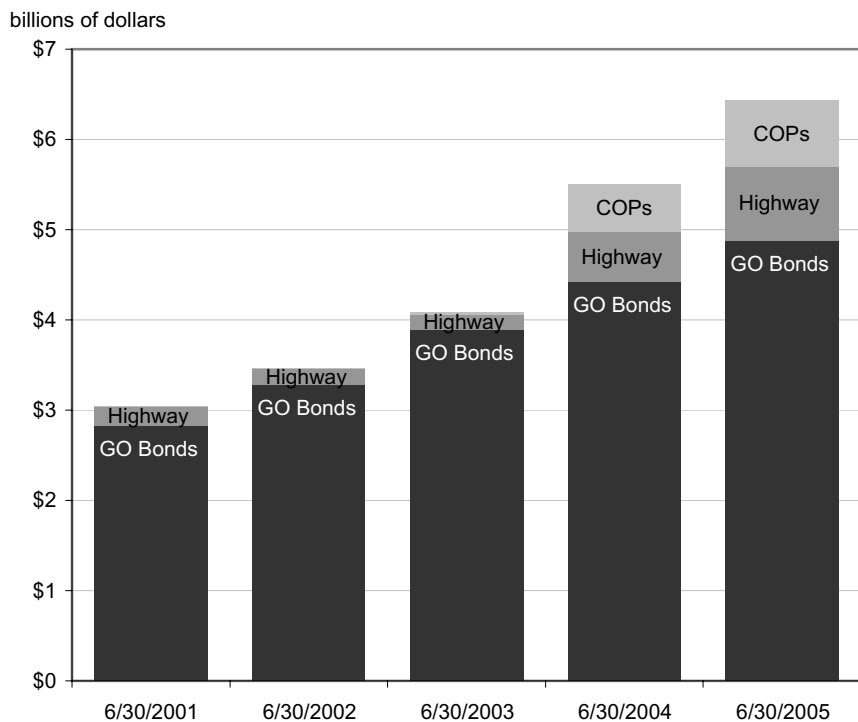
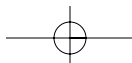
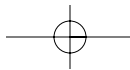


Fig. 5. Total Outstanding Debt: 2001-2005



Sources of Debt: Voter-Approved General Obligation Bonds (GO Bonds), Highway Tax-Supported Bonds (Highway), and Appropriation-Supported Certificates of Participation (COPs). (Other debt includes Nontax Supported (Revenue) Bonds of less than \$10 million.)





In FY1985, North Carolina’s budget for debt service was \$76.1 million, or \$18.57 per person. As of FY2007, this figure had increased almost tenfold to \$667 million, or \$89.25 per person. And this is just debt service. Debt per capita, measured in terms of general obligation bonds and other such loans, has also increased.

General Bonded/ Obligation Debt Outstanding	
FY1984-1985:	\$131.14 per person
FY1989-1990:	\$88.66 per person
FY1994-1995:	\$142.50 per person
FY1999-2000:	\$312.42 per person
FY2004-2005:	\$741.51 per person

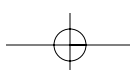
Accounting for inflation, we would expect debt per capita to have doubled over the past 20 years. But it has not doubled; it has increased more than fivefold. (Again, this increase – due to population growth – actually understates the amount of new debt taken on by the state.)

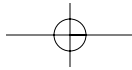
As Figure 4 (above) shows, the first spike in debt occurred in 1994, even as the state was enjoying a windfall in revenue thanks to a 1991 increase in income and cigarette taxes (passed, as in 2001, just as the recession began). This new debt was primarily fueled by Governor Jim Hunt’s (D) enthusiasm for bond revenue.

The increases seen under Governor Hunt are more than matched by those advanced in recent years by Governor Easley and the General Assembly. From FY2000 to FY2005, per capita debt more than doubled (Figure 5, above). These long-term trends only promise to get worse, with State Treasurer Richard Moore (D) contending that the state “could annually authorize \$384 million of new tax-supported debt” over the next 10 years.⁵ As a result, debt service will increase, as will debt per capita.

With the state budget having risen by \$14.4 billion over the past 20 years, it is clear that resolving North Carolina’s spending crisis entails more than just eliminating pork barrel appropriations on teapot museums and other such boondoggles. The state is facing long-term budgetary problems that will only be solved by long-term, fundamental reforms. Here, though, we must caution against taking refuge in easy answers. To begin with, even theoretically viable solutions, like a TABOR Amendment, are unlikely to get a hearing in today’s political climate.

⁵State of North Carolina, Debt Affordability Advisory Committee, Debt Affordability Study (Raleigh: Department of State Treasurer, 2007); available from http://www.nctreasurer.com/NR/rdonlyres/599BB76E-EA20-4705-9D15-A086DF3EB490/0/2007DAAC_Final.pdf.





Even more important is recognizing that the majority of voters in North Carolina are unlikely to be swayed by a platform that advances fiscally conservative alternatives at the perceived expense of education and healthcare. Today's voter wants it all. Future attempts at budget reform must be bundled with a confident, forward-looking fiscally and socially conservative philosophy that provides positive alternatives across a wide spectrum of public policy issues. It is with this end in mind that the Civitas Institute Public Policy Series was conceived.

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