North Carolina's Biennial Budget: Oil Change or Overhaul?

by Mike McLaughlin

The North Carolina General Assembly convened in Raleigh for its 1991 session under the cloud of a \$1.3 billion gap between estimated income and outgo if the full complement of expansion items in its \$8.8 billion General Fund budget were to be funded. By April the gap had grown to more than \$1.6 billion. But with the public singing a state version of the George Bush chorus—no new taxes—lawmakers found themselves on the horns of a dilemma. Even the cost of continuing prior commitments alone exceeded estimates of available revenue. Yet the state is beset with problems that cost money to fix—low SAT scores, a high infant mortality rate, scores of citizens who have no health insurance, and a substantial number of people living in poverty. And no lawmaker wants to see pink slips delivered to state workers in the home district. The tension between the desire to hold down taxes and the desire to continue old programs and add new ones has set off a round of hand-wringing in Raleigh that may be unmatched since the Great Depression. This article attempts to lay out the choices facing the General Assembly as it wrestles with where to add programs, where to cut programs, and whether to raise taxes.

Gov. Jim Martin likens the task of dealing with the state's budget woes to trying to bring a sailboat through a roiling inlet in a storm. Sen. George Daniel (D-Caswell) uses a more plebeian analogy. To Daniel, who represents a rural district near the Virginia border, the budget is like a sputtering old jalopy "with smoke pouring out of both ends." Daniel doesn't think the legislature can get the budget vehicle home without pulling it over and looking under the hood.

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The two politicians are using different analogies, but they are pointing to the same problem—a $1.6 billion difference between needs and projected revenue for the 1991–92 fiscal year. Martin scrimped and scraped and put together an austere $7.75 billion General Fund budget with only $242 million in new money—a fraction of the original estimate of the need.

But the Democratic leadership of the General Assembly was skeptical of Martin's budget plan from the start. Daniel is among those legislators who believed Martin's budget amounted to adding a bottle of STP and a can of Radiator Stop Leak. The machinery, they say, might run for a couple more years, but eventually it's going to break down.

The legislature has never been shy about tinkering with the Republican governor's budget proposal—a source of frustration for the Martin administration. Although the governor proposes a budget, the legislature must enact it and takes great pains to shape the document toward its own ends.

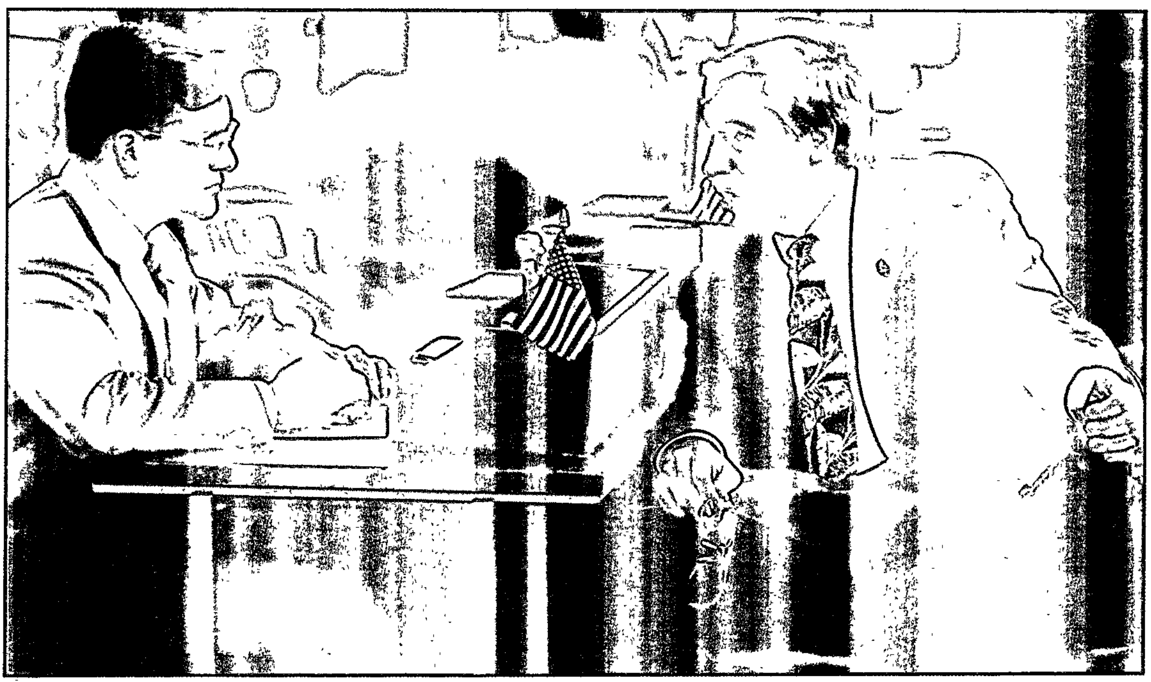
This year the fiscal mechanics seemed intent on an overhaul instead of a tune-up. And with all the paint and bodywork, what rolled out of the Appropriations Committee at the end of the process did not even resemble what rolled in from governor's Office of State Budget and Management. "All the tactics he uses are simply digging us a deeper hole," says Rep. David Diamont (D-Surry), co-chairman of the House Appropriations Committee. "We have to face the problem head-on."

Where Did the Shortfall Come From?

The threat of red ink has brought about all kinds of finger-pointing about who is to blame for the state's fiscal woes. Sen. Ken Royall (D-Durham), long a budget titan in the General Assembly, traces the shortfall directly to the Martin-inspired tax cuts the General Assembly enacted in 1985. The cuts reduced state revenues from inventory and intangibles taxes by more than $220 million annually.

Administration officials counter that surplus funds typically are spent by the legislature for programs, so the tax cuts are not to blame for the shortfall. They say the recession is the main culprit and note that the legislature has rejected subsequent tax increase proposals that would have helped.

Rep. Johnathan Rhyne (left), House minority leader (R-Lincoln), and Rep. David Diamont (D-Surry), House Appropriations Committee co-chairman, talk shop on the House floor. Both spent much of the session wrestling with how to balance to 1991–92 budget.



Karen Tam

Steps to a Biennial State Budget

1. About a year before the General Assembly convenes for a new session, Office of State Budget and Management sends forms to state agencies asking for budget requests for the next biennium. Agencies must return their requests by September before the new session but may be required to return them much sooner. OSBM will work with the governor and the Advisory Budget Commission in developing a biennial budget to present to the General Assembly.

2. OSBM analysts review requests and confer with departments.

3. Advisory Budget Commission tours state facilities to assess capital improvement needs in the fall before the new session.

4. State agencies appear before ABC in October, November, or other specified times in the fall to explain budget requests.

5. Governor and ABC collaborate on budget proposal for presentation to the General Assembly. Typically, they do not agree on what the budget should contain, and the governor submits a separate proposal to the legislature. Governor unveils his proposed budget in conjunction with his State of the State Address to the General Assembly in January.

6. Separate bills are filed encompassing the governor's expenditure and revenue proposals. Throughout the spring, appropriations committees of the House and Senate review spending requests and finance committees review revenue proposals, often making major revisions.

7. Ideally, before June 30 and the beginning of a new fiscal year, budget bills are reported out of committee to the floors of the Senate and the House, with separate bills for continuation, expansion, capital outlay, the judiciary, aid to local governments, and a bill to cover items left out of the other bills.

8. Conference committee irons out differences between Senate and House versions of the budget bills. Legislature typically adjourns soon after the budget is passed, and reconvenes the following year to make adjustments to the continuation budget.

Source: Joseph S. Ferrell, *Handbook for Legislators*, Institute of Government, 1990, pp. 93–101.

Martin's budget chief, Marvin Dorman, says consumer confidence plunged off the charts in the fall of 1990, cutting deeply into retail sales and hammering the state's tax coffers. Martin says states across the nation are facing severe revenue shortfalls because of the recession, and North Carolina is in far better shape than many of these states. According to the National Association of State Budget Officers, 22 of the 26 states east of the Mississippi anticipated a revenue shortfall of some magnitude for the 1990–91 fiscal year.[1]

Nancy Temple, Martin's chief of staff, believes the legislature was guilty of bumping up revenue estimates for the 1989–90 fiscal year so it would have more money to spend without adopting a 1-cent sales tax increase proposed by Martin—and then got caught by the recession. "From their perspective, they probably could have gotten away with that in the past with some minor adjustment," says Temple.

The legislature's Democratic leadership, however, says Martin administration assertions of inflated revenue estimates are themselves inflated. Royall, Senate Appropriations chairman for the 1989 and 1990 sessions, says the legislature budgeted only $50 million more in revenue than did the governor's budget officer and held nearly half of that in reserve in case revenues did not meet the estimate. The legislature was more conservative from the start about available revenues for the 1991–92 fiscal year, counting on $200 million *less* revenue for 1991–92 than did the governor in preparing his budget. April receipts made even these revenue estimates seem too optimistic, and the revenue figures were adjusted downward once again.

No one is questioning the severity of the recession, but growth in state revenues actually was already on the decline when the downturn came. David Crotts, the legislature's chief revenue analyst, says actual General Fund revenue growth averaged 8.8 percent for four years beginning in 1984–85, then tailed off sharply in 1989–90 and 1990–91. He says by the end of the 1991–92 budget year, the cumulative impact of three years of below-average revenue growth will have reached nearly $1 billion.

And there are other factors. The legislature has enacted long-range programs like the 10-year, $800 million Basic Education Plan without passing tax hikes or cutting other programs to pay for them. Revenue growth, combined with a healthy budget surplus, has in the past paid for these kind of commitments, but the income tax and sales tax make up the bulk of state revenues, and collections drop sharply in a recession.[2] Now the surplus is gone, and revenues are lagging. An aggravating factor is that the legislature in 1990 adopted the federal structure for its state income tax. The action removed 700,000 low-income citizens from the tax rolls, but also caused an unanticipated dip of up to $85 million in state revenues because of a change in the way certain corporations are taxed.[3] (For more on tax fairness, see *North Carolina Insight*, Vol. 11, Nos. 2–3, April 1989, pp. 138–152.)

The state also embarked on a "pay-as-you-go" capital construction financing binge in the mid-1980s that used up a reservoir of public support for tax increases while doing little to improve the financial health of the General Fund. Among the increases were: a half-cent local option sales tax hike in 1986 to help cities and counties with water and sewer and school projects; an increase in the corporate income tax from 6 percent to 7 percent to pay for critical school construction needs in 1987; and an $8 billion tax hike for highway improvements in 1989. Fiscal analysts and the agencies rating North Carolina's bonds say financing capital projects with bonds—the "pay-as-you-use" philosophy—would improve the state's cash flow and help it better meet operating expenses.[4]

And while the state has embarked on some expensive new programs—road-building and the Basic Education Plan being the primary examples—much of the growth in the state budget has come in areas that really are not discretionary, such as health care and corrections. Meanwhile, the federal share of the state budget has continued its decade-long decline. Nationally, federal aid fell from 26.5 percent of state and local outlays in 1978 to 18.2 percent in 1988.[5]

At the state level in North Carolina, the drop has been less dramatic, but still significant. Federal funds made up about 23.8 percent of the total state budget in 1980, and had dropped to about 20.2 percent by 1990–91, according to the Office of State Budget and Management.[6]

But if federal revenue has been declining as a percentage of the total state budget, mandates to provide additional services have been increasing. The state's share of Medicaid costs alone has been rising at a rate of 17 percent a year since 1985–86, and is projected to reach $689 million in 1992–93—a three-fold increase in only seven years.[7] Court decisions also have forced increased spending in areas such as corrections and the "Willie M" program for potentially violent adolescents, and the threat of a court mandate has encouraged increased spending in others.

State officials have often cited a fear that the federal government would take over operation of the state's prison system as a driving factor behind increased spending for corrections. In April 1989, the state agreed to spend $800 million to bring its 89-unit prison system up to the 50-square-foot-per-inmate standard recommended by the American Correctional Association. Each new prison cell adds to operating costs, and voter approval of $200 million in prison bonds in November 1990 means still more prison construction.

Exacerbating the problem, says Royall, is that the legislature has been slipping into using windfalls for recurring expenses. The state also has increasingly relied on one-time gimmicks requested by Governor Martin, such as delaying

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Sen. Marc Basnight (D-Dare) (left) and Rep. David Diamont (D-Surry), House and Senate Appropriations Committee co-chairmen, discuss fiscal policy in the House chamber.

the last payroll of the fiscal year so it falls in the next fiscal year, and speeding up tax payments for business to make the budget balance. Crotts refers to these sorts of budget maneuvers as "one-time plugs." The latest of these is Martin's decision to use $106 million budgeted for August teacher salaries to help close this year's budget gap. The decision means the money will have to come out of the 1991–92 fiscal year budget. The bottom line is that the state now faces a river of red ink that has been rising behind a dam of accounting maneuvers.

Hard times have also prompted serious discussions about reforming the process of adopting a state budget. Among the suggestions are: adopting more conservative revenue forecasting methods, establishing a permanent rainy day fund, and prohibiting the use of one-time revenues to fund the operating budget. Other ideas include requiring long-term fiscal notes that estimate the cost of new programs, using bonds to finance long-term capital projects, and requiring that a final budget be adopted before July 1 and the start of a new fiscal year.

But for the short term, legislators faced three basic choices as they wrestled with adopting a 1991–93 budget. They could: (1) cut expenditures; (2) raise taxes; or (3) cut expenditures and raise taxes. How much money must be saved by cuts or added through tax increases depended to a large degree on whether the legislature decided to add new programs.

Proposed Spending for New and Existing Programs

Martin's expansion budget included at least five major new items plus $97 million to restore most of the state's $141 million rainy day fund, which he spent to help close the current fiscal year's (1990–91) revenue gap (See Table 1, page 7 for a list of selected new spending needs that have been identified for the 1991–92 fiscal year). Among Martin's expansion requests were:

- $40 million for the Department of Community Colleges to improve work force preparedness;
- $18.9 million to allow teachers to move up one step on a 30-step salary schedule (a raise of

approximately 2 percent);

■ $27 million for 2 percent performance-based pay raises for state workers;

■ $22 million to implement the provisions of Senate Bill 2, a 1989 measure enhancing local accountability of public schools in exchange for more local flexibility;

■ and $12.8 million for a preschool program for 3- and 4-year-old handicapped children.

Martin proposed bond financing to pay for some $395 million in capital improvements. He also wanted the state to issue some $200 million in bonds for prison construction. The prison bonds were authorized by the voters in November 1990. Martin wanted them issued late in fiscal year 1991–92 so that the only cost for the year would be $1.5 million for planning and debt service.

But Martin's expansion budget also left out some big-ticket items with strong constituencies. Chief among them was the Basic Education Plan, which would cost $84 million for the sixth of 10 planned installments. And he left unresolved how

Table 1: Selected New Spending Proposals and Cost, in Millions

Superintendent's 20-point plan to improve schools	$366.0
School finance (Public School Forum proposal)	150.0
Legal settlement with state and local retirees	144.0*
Federal Medicaid mandates	139.0
House Democrats' public education plan	118.7
Health insurance premiums for state employees	100.0
Partially restore rainy day fund	95.0
Basic Education Plan	84.0**
Prison construction	75.0
1% pay raise for state employees	55.0
Martin's work force preparedness program	40.0
School finance (N.C.Center for Public Policy Research proposal)	30.0
1% performance pay raise for state employees	27.0***
Local accountability for schools initiative (Senate Bill 2)	22.0
One-step pay raise for teachers (approximately 2%)	18.9
Preschool program for 3- and 4-year-old handicapped children	12.8

* The state is appealing a Wake Superior Court ruling in favor of the retirees.

** Sixth of 10 annual installments of a plan designed to set minimum standards for class size, curriculum, and support personnel for the North Carolina public schools.

*** Martin's budget proposes a performance raise averaging 2 percent for state workers effective Jan. 1, 1992, or halfway through the fiscal year.

Source: Office of State Budget and Management, General Assembly's Fiscal Research Division, N.C. Center for Public Policy Research.

Table 2. Figuring the Budget Shortfall For Fiscal Year 1991–92, in Millions

Normal revenue	$8,351
Less: slower economy	1,005*
Less: loss of Highway Trust Fund transfer	186
Revenue forecast	**$7,160**
Continuation budget from 1990–91	$7,836
Plus: Medicaid increase mandated by federal government	139
Plus: corrections increase for new prisons	39
Plus: state employees health plan	100
Plus: caseload, enrollment, inflation adjustments	167
Adjusted continuation budget	**$8,281**
Continuation budget shortfall	$1,121
Planned expansion items:	
Basic Education Plan	84
Senate Bill 2 (local accountability and flexibility for schools)	22
Salary increases	318
Miscellaneous expansion	122
Total operating budget shortfall	**$1,667**

* Cumulative impact of slower growth for 1989–90, 1990–91, and 1991-92 fiscal years.

Source: Legislature's Fiscal Research Division, May 1991 to pay for more than $100 million in anticipated premium increases for the state employees' health plan.

A less expensive but arguably more important omission was the second $10 million installment of a $20 million package legislators pledged in 1990 to battle infant mortality. A cadre of ranking legislators pledged the additional resources when the state lodged a last place ranking in provisional 1988 data released by the National Center for Health Statistics. North Carolina tied with Missouri for 46th in provisional rankings for 1989, moving out of the cellar and away from the heat. Martin's 1991–92 budget included only $3 million in continuation spending increases and $393,000 in expansion funds for the fight against infant mortality. He called for additional increases of $4.2 million in 1992–93, but the result would be less total money stretched out over a longer period of time than the amount initially pledged.

The Martin budget also omitted a number of proposals to improve the public schools. State Superintendent of Public Instruction Bob Etheridge's 20-point plan, which carried a $366 million price tag for the biennium, was largely ignored in the governor's budget package. Proposals to equalize state funding between the state's poorer and more affluent school districts—a $30 million plan proposed by the North Carolina Center for Public Policy Research and a $150 million plan put forth by the Public School Forum of North Carolina—also got short shrift.[8] Martin did include $6 million in fiscal year 1992–93 for school systems with less than 3,000 students. His plan would earmark the money for small school systems instead of targeting systems with low tax wealth but high tax effort as the Center had proposed.

But Martin had to address a $500 million shortfall in the *continuation* budget before he could even think about *expansion*. That shortfall has since grown to more than $1 billion and may get even larger. Combined with prior education initiatives, salary increases, and other normal expansion, the shortfall has produced a 1991–92 fiscal year budget gap exceeding $1.6 billion (See Table 2, page 8 for a breakdown of the budget gap as the legislature's Fiscal Research Division figured it in May 1991).

Many of these policy options and promises got thrown out the window with first reports of a major dip in state revenues. Still, the early estimates of the shortfall illustrate the magnitude of the problem facing legislators as they attempt to adopt a 1991–92 fiscal year budget.

As an analysis of the state's General Fund quickly shows, lawmakers would have to cut deeply into public education if they were to close the gap without raising taxes. That's because spending for the public schools makes up 45.9 percent of the General Fund operating budget. And *total* spending for education—including state universities and community colleges as well as public schools—eats up 67 percent of the General Fund budget. The remainder of the budget is consumed by human resources, 15.2 percent; general government, 11.9 percent; and corrections, 5.9 percent.

Legislators wrestled with the question of whether cuts alone could close the gap, but Martin insisted early the answer was no. "There are several legislators who think that programs can be eliminated or who generally think bureaucracy can be eliminated," says Martin, "[but] the tightening of the bureaucracy has already taken place. What we have to think about now is eliminating services." That, says Martin, would mean eliminating programs for a child who is mentally retarded or a family with elderly parents suffering from senility or Alzheimer's disease. "State government can easily be depicted as just a bunch of bureaucrats, but that's inaccurate and highly inflammatory," says Martin. "They [state workers] deliver services to people who need them."

Martin's budget took a back-door approach to raising taxes by asking the legislature to authorize local governments to levy a half-cent sales tax increase. This would have freed $242 million in state money that now goes to local governments for a modest expansion program and for re-establishing the state's short-lived rainy day fund.[9] Local governments would use the sales tax revenue to replace lost state funds.

But the sales tax idea got a tepid response in the General Assembly, despite the support of local government officials who would prefer raising taxes to depending upon the General Assembly for an appropriation each year. An added incentive for local officials was that sales tax revenues increase with inflation and economic growth.

Legislators who opposed the idea generally fell into three camps: (1) those who do not like to cede state taxing authority to local governments; (2) those who would prefer more progressive tax options such as closing loopholes or raising income tax rates for higher-income citizens; and (3) those who believe the gaps can be closed with cuts alone. Heading the third camp was Republican Lt. Gov. Jim Gardner, who had proposed a budget of his own, balanced with deep cuts to selected agencies. (See Table 3, page 11 for a rundown of various cuts discussed.) Gardner circulated a resolution calling for a budget with no new taxes, and 42 of the 53 Republicans in the legislature endorsed it.

Will The Cuts Go Deep Enough?

Across-the-board budget cuts were another possibility. Each 1 percent cut would yield $72.3 million in budget savings. But Martin argued there was no more room for these kinds of cuts. The legislature imposed across-the-board budget cuts of 3 percent for the 1990–91 fiscal year.

On top of these reductions, agencies also were asked to spend 1.4 percent less than their actual budget. This, in the jargon of the governor's budget office, is known as budgeting negative reserves. Martin administration officials like this approach because it gives managers the flexibility to find budget savings over the course of the year. The Democratic leadership of the General Assembly, however, has taken the position that negative reserves are a minus rather than a plus because they do not provide permanent budget cuts. In any event, the negative reserves required for 1990–91 were not enough. When revenues still fell short, agencies were asked for additional reversions of $132.9 million, or 1.8 percent. Martin had to go to the well yet another time when April revenues fell short of expectations, increasing reversions to

A Glossary of Selected Budget Terms

Continuation Budget—Budget for ongoing state programs. Also referred to as the base budget.

Expansion Budget—Budget for new state programs and salary increases.

Capital Budget—Budget for capital projects such as new buildings and land purchases. Traditionally funded with reversions, or money unspent at the end of a budget year.

General Fund—Covers operating costs of general government programs. Education expenditures make up 67 percent of General Fund expenditures, while spending for human resources totals 15.2 percent of the fund. Primary sources of revenue are income and sales taxes.

Highway Fund—Pays for highway maintenance and construction. Primary source of revenue is the gasoline tax.

Progressive Tax—A tax is progressive when the ratio of tax to income rises as income rises.

Regressive Tax—A tax is regressive when the ratio of tax to income falls as income rises.

Recurring—An expenditure that will recur each year and thus must be figured into the continuation budget for the next fiscal year. An example would be an ongoing program that requires the hiring of additional personnel.

Non-recurring—A one-time expenditure that does not become a continuation expense in the next budget year. An example would be an appropriation for a new piece of equipment or a repair.

Reversions—Money budgeted but unspent because of vacant positions and other agency savings. These funds revert to the General Fund, or are carried over to the next budget year. Reversions typically have been used for one-time expenses such as capital projects because they cannot be depended upon as a steady, or recurring, revenue source.

Negative Reserves—This practice amounts to building reversions into the budget in advance. An agency head might be allotted $100 in the budget but allowed to spend only $97. It would be up to the agency head to find the $3 savings over the course of the year. The Martin administration says this practice provides management flexibility and thus is preferable to across-the-board cuts.

Table 3: Major Targets for Potential Cuts, in Millions

Programmatic cuts prescribed by the legislature	$375.0
Additional cuts proposed by Martin in May 1991	313.3
Increased negative reserves proposed by Martin	113.0
Delete non-mandatory inflationary increases	100.0
Negative reserves kept at current level	98.0
Across-the-board budget cuts (1 percent) to all departments	72.3
Cut contributions to employee retirement and disability programs	57.0
Delay public schools construction	45.0
Cut support for higher education, requiring 20% tuition increases in UNC system to cover the difference	28.0
Cut administrative support for Local Educational Agencies	18.9
Cut funding for Department of Public Instruction staff (Gardner plan)	10.1
Privatization of driver's education	10.0
Cut Microelectronics Center funding (Gardner plan)	6.2
Cut state support for certain administrative staff in counties with dual school systems	4.7
Cut Biotechnology Center funding (Gardner plan)	3.9
Cut Microelectronics Center funding (Martin plan)	3.2
Cut all state funds appropriated to Rural Economic Development Center (Gardner plan)	1.7
Cut funding for Department of Public Instruction staff (Martin plan)	1.5
Cut administrative funds for Rural Economic Development Center, transfer grant programs (Martin plan)	0.5

Source: Office of State Budget and Management, Lieutenant Governor's Office, General Assembly's Fiscal Research Division.

$173.4 million. Using reversions, a delay of capital projects, the shifting of some teacher salaries into the next fiscal year, and other measures, Martin identified $729.3 million in savings to close the 1990–91 budget gap.

Martin tightened the screws still further in his 1991–92 budget, increasing negative reserves and cutting out most inflationary increases. The actual proposed decrease for the 1991–92 fiscal year approaches 9 percent of what spending would have been in 1990–91 without all these forced economy measures.[10] That's why Martin insists the fat has already been wrung out of the budget and why he proposed the local option sales tax increase to free money for a modest expansion program.

Martin's budget drew criticism on the editorial pages of the state's major newspapers. *The Charlotte Observer*, picking up on Martin's sailing imagery, described his budget as "like trying to sail a leaky boat without fixing the leaks."[11] The *Winston-Salem Journal* questioned whether the governor had set "too cautious a course," adding, "Any sailor knows that without wind, his ship can go nowhere."[12]

The governor whipped up gale-force rhetoric with several of his economy measures in education. Omission of the Basic Education Plan was one instant issue. Democratic Superintendent of Public Instruction Bob Etheridge refused to take the program off the table. Etheridge told members of the legislature's joint Appropriations Committee the performance enhancements promised in Senate Bill 2 could not be accomplished without the resources provided through the BEP. Another volatile issue was Martin's proposal to provide administrative funds for only one school unit in each of the state's 100 counties. In effect, this could force merger in up to 34 school systems. The proposal saved Martin $4.7 million in his budget. It could cost him support among legislators who represent counties that do not wish to consolidate their schools.

Martin also proposed cutting administrative funding to the private, nonprofit Rural Economic Development Center and shifting its grants programs to the Department of Economic and Community Development. That would save $500,000 —a relatively modest sum—but could prove unpopular with rural constituents who support the Center. Martin administration officials say rural economic development programs could be operated with lower administrative costs within the Department of Economic and Community Development. And he cut $7 million out of the budget of the Microelectronics Center of North Carolina for the biennium.

Both centers are the initiative of a prominent Democrat. Martin's 1988 gubernatorial opponent, former Lt. Gov. Bob Jordan, backed the Rural Economic Development Center, while former Gov. Jim Hunt shepherded the Microelectronics Center of North Carolina initiative through the General Assembly.

Martin set a Jan. 31, 1992, effective date for salary increases for state workers. That pushed half of the cost of the increase into the next fiscal year.

But Lieutenant Governor Gardner upped the ante on Martin with his own budget plan. Gardner's budget closely tracked that of the governor, and he credited Martin with taking a shortfall that was "really a wish list of niceties and presenting a budget that focuses on necessities."

Gardner, however, proposed avoiding a tax increase through even deeper cuts—mostly in public education—and through a slight increase in negative reserves.[13] He also would restore only a third of the $95 million Martin wanted returned to the state's rainy day fund, would phase in a fraction of what Martin budgeted for work force preparedness, and would transfer from the General Fund to the Highway Fund the $28 million cost of operating the state's driver education program. "State government is not Santie Claus," Gardner told a standing-room-only crowd in the Administration Building press conference room, one month after Martin released his budget. "Its only source of revenue is the pockets of taxpayers."

But the deepest cuts occurred in the legislature's appropriations committees, for at least two reasons—the Democratic leadership rejected Martin's negative reserves concept and decided his revenue assumptions were too optimistic. If projected revenues did fall short, there would be too little money coming in to pay for Martin's taut budget. And with negative reserves eating up any budgeted but unspent money, a revenue shortfall could require layoffs or furloughs—measures that thus far had been avoided. That's why appropriations committee leaders declared an end to negative reserves early in the 1991–92 session, instructing subcommittees instead to find $400 million in cuts to specific state programs. This meant cutting out real jobs held by real people—not just eliminating vacant positions.

State education officials warned that they could cut all administrators and their staff at the state and local level and still come up with only $80 million

Bill Sanders

Teachers tried to give legislators a lesson in priorities with a mid-April march on the Legislative Building.

in savings, far short of the $170 million they'd been asked to supply.[14] The cuts, they warned, would reach into the classroom.

Republican lawmakers questioned the motives behind such deep cuts in education, arguing that the budget could be balanced without them. "The public school cuts are unnecessary and wrong," argued Rep. Johnathan Rhyne (R-Lincoln), House minority leader, at a mid-April news conference called by Gardner to register Republican opposition to raising taxes. "It's being used to panic parents into accepting new and massive tax increases."

That same week the House and Senate appropriations committees approved about $375 million in permanent cuts. Martin later proposed still more cuts of $313.3 million. But even if the legislature were to accept all of Martin's recommendations, the problem would be far from solved. It would take as much as an additional $433 million to balance the continuation budget and more money still if the legislature wanted to adopt an expansion budget.

What About a Tax Increase?

With the magnitude of the budget crunch, the Democratic leadership of the General Assembly began to talk about a tax increase. Perhaps the most tempting item on the menu of potential tax hikes is the *sales tax*. An increase of just a penny on the dollar would produce nearly $480 million in revenue—enough in a single swoop to make the money crunch manageable. Only an across-the-board 1 percent increase in the personal income tax, which produces about $550 million, would raise that kind of revenue. And a sales tax increase likely would be an easier pill for the public to swallow than an increase in the personal income tax.

That's not to say a sales tax hike would be welcomed. Rep. Paul Luebke (D-Durham) believes the sales tax hike has the strongest support among well-heeled corporate lobbyists. Luebke points to a July 1989 statewide poll that showed the public—given a choice between a tax hike on alcohol, cigarettes, corporate income, sales, or per-

Table 4: Potential Tax Hikes and Resulting Revenue, in Millions

1% increase in personal income tax (across-the-board)	$550
1 cent increase in sales tax.	480
Reinstate inventory tax.	190
1 cent per pack tax on cigarette manufacturers	180
Lottery, first full year of operation	200
Eliminate cap on sales tax on machinery and farm equipment, and raise tax to 3%	120
1% increase in corporate income tax	80
1% increase in personal income tax (joint return, taxable income above $50,000)	105
Initiate pollution taxes	54*
1% tax on all services	60
1 cent increase in gas tax	40
Apply utilities tax to interstate telecommunications	39
1% surtax on personal income tax liability	36
1 cent increase in soft drink tax	29
Eliminate tax break for manufacturers with heavy-out-of-state sales (double-weighted sales)	20
1 cent increase in beer tax	13
Eliminate sales tax cap on boats, aircrafts	10
Eliminate tax credit for dividends from N.C. corporations	10
1 cent increase in cigarette tax	7

* Based on 1989 bills by former Sen. William Barker (D-Pamlico) that would have taxed industry for discharging pollutants into the air (S.B. 1251) and water (S.B. 1252).

Source: N.C. General Assembly's Fiscal Research Division sonal income—strongly preferred a corporate income tax increase over a sales tax hike.

But whatever the public sentiment, there are other strong arguments against a sales tax increase. A 1 percent increase would push the combined state and local sales tax to 6 cents on the dollar. While 33 states charge more than North Carolina's current combined rate of 5 cents, most of these states do not tax food, says Don Liner, a tax expert at the University of North Carolina at Chapel Hill's Institute of Government.

And even though food stamp purchases are exempt, the sales tax remains regressive; that is, lower-income citizens pay a higher proportion of their paychecks in sales taxes than do higher-income citizens. "The budget crisis is real," says Luebke. "The needs in education, health care, and substance abuse are very real, and we need to raise revenues to help those programs. But the tax increase must be progressive." Luebke would favor closing tax loopholes or raising the corporate income tax to raising the regressive sales tax. Other lawmakers worry that applying a sales tax hike during a recession will only make it worse by discouraging spending.

Still, a look at other potential tax hikes and the revenue they produce shows why a sales tax hike is so tempting (See Table 4, page 14). North Carolina's *tax on cigarette sales*, for example, is the lowest in the nation at 2 cents per pack.[15] A 1-cent-per-pack increase in this so-called sin tax would move the state out of the cellar, but would produce only $7 million in revenue, hardly enough to send the typical legislator charging into battle against the state's strong tobacco lobby.

A 1-cent-per-pack tax on all cigarettes produced in the state would yield revenue in the $180 million range, but no other state charges a significant tax on items manufactured in the state. Besides the reluctance to tax tobacco among many legislators, the worry is that the industry could shift production elsewhere. Advocates say if North Carolina were to adopt a *producer tax on cigarettes*, Kentucky and Virginia—the other two states with substantial cigarette production capacity—would quickly follow suit. That might block any production shift, but foes point to a fairness issue—no other goods are taxed at the producer level in North Carolina. Why, they ask, should tobacco be singled out? And so the debate goes back and forth.

A 1 cent increase in the state's *gas tax* would produce $40 million. But the legislature increased the gas tax by a nickel a gallon in 1989, and the federal government followed suit with a nickel increase of its own in 1990. The gas tax goose, then, has recently been plucked.

The state could turn to the other sin taxes by increasing its *levy on beer and wine*. A 20 percent increase in the burden on these potables would produce $28 million in tax revenue. But again, the federal government beat the state to the punch with its 1990 tax package, which doubled the tax on beer from 16 cents to 32 cents per six-pack and increased the wine tax from 3 cents to 21 cents per 750 milliliters.

A 1 percent hike in the *personal income* tax for households with gross income above $70,000 would produce about $100 million. But many of the state's higher-income citizens wound up paying more when the state adopted the federal income tax structure in 1989, and North Carolina taxes personal income at a higher rate than all but seven other states. The 1990 federal deficit reduction package placed limits on itemized deductions and personal exemptions for high-income taxpayers. The legislature is expected to adopt similar changes to keep the state income tax structure consistent with the federal government. The result would be a $10 million tax hike for citizens earning more than $100,000 a year.

The *corporate income tax* was increased from 6 percent to 7 percent in 1987 to pay for school construction (business got a tax break during the same session—repeal of the inventory tax—that helped sell the corporate tax hike). An additional 1 percent increase would raise $80 million, but the tax is now higher than surrounding states. State industrial recruiters worry that they already are at a competitive disadvantage in attracting new firms to North Carolina. Although economists and tax experts often argue that tax considerations are not that important when firms make decisions to relocate, states are cautious about getting too far in front of their neighbors.

So despite the array of choices for increasing state taxes, there are no easy choices that will produce large amounts of revenue. That's why the legislature may be tempted to look in the near future at new revenue sources like a *state lottery*, which could net $150 million to $200 million annually.[16] How much revenue a lottery would produce depends in part upon how heavily the state is willing to promote it and how much prize money is returned to participants. It would take at least a year to put the question of a lottery before the voters and get it up and running, so the impact on the current crisis would be nil.

Expanding the sales tax to services such as legal fees, landscaping, and auto repairs would also produce a surge in state revenues and help modernize the state tax code. As consumer spending on services increased, so would state revenues. But bitter battles and the ultimate repeal of new services taxes in Florida and Massachusetts do not bode well for states that otherwise might consider this option.

Increasing fees and charges to recoup more of the cost of services provided by the state is another option for enhancing state revenues. Environmentalists have joined the budget debate with a proposal called the *Budget for a Green Assembly,* which calls for greater fees and charges to pay for inspection and permitting programs and for pollution taxes that would require industry to pay for environmental damages.[17] "The budget is the most important environmental issue of the session," says Bill Holman, a lobbyist for the Sierra Club, the Conservation Council of North Carolina, and the N.C. Chapter of the American Planning Association.

Holman says taxes and fees can be used to promote sound environmental policy. And he says well-intentioned legislation can be thwarted by underfunding for state personnel. "Take the solid waste law," says Holman. "It's a good example of a pretty good law that's not going to be implemented because there's nobody to do the work."

The Economic Future Study Commission also advocates greater use of fees and charges in its report to the 1991 General Assembly.[18] And the commission advocates restructuring the tax system to promote economic growth and assure that tax revenues keep pace with a changing economy. One of its more ambitious proposals would place a tax on personal services. Malcolm Gillis, a Duke University economist and the commission chairman, says such a tax would provide more equity and revenue growth because higher-income citizens tend to spend a greater percentage of their income on services. The commission also would like to close all corporate income tax loopholes

Rep. Theresa Esposito (R-Forsyth) during a pensive moment in an Appropriations Committee meeting. The foot-thick stack of documents at her elbow is Governor Martin's proposed budget, but Esposito is among those Republican legislators following the no-tax lead of Lt. Gov. Jim Gardner.

Karen Tam

and incentives, believing that a lower overall tax rate is better for the economy than tax breaks for selected industries.

But if the atmosphere is ripe for exploring new revenue sources, the budget bind also has improved the prospects for long-range reforms that might prevent such a pinch in the future. On the opening day of the session, Sen. William Goldston (D-Rockingham) filed his bill to base the 1991–92 budget on revenue produced in the 1990 calendar year.[19] Goldston's original bill would also: restrict revenue estimates for new taxes to 75 percent of estimated collections; require that reversions be used for capital projects or other one-time expenditures; and limit the legislative session to about three months each year.

The Goldston plan would remove the uncertainty of revenue estimates from the budget equation. It also would exacerbate the current shortfall because the state could count on virtually no revenue growth in putting together its budget package—unless it raised taxes. The legislature's fiscal research staff estimates the impact at $482.1 million for the 1991–92 fiscal year and more than $800 million for 1992–93.

A variation on the Goldston theme is a bill by Rep. Art Pope (R-Wake) that would phase in over five years the use of previous calendar year revenues in budgeting.[20] Pope's plan, endorsed by Gardner, would shift the state gradually to prior-calendar-year budgeting so that the full impact would not be felt until 1996–97. The plan also includes a formula for building a rainy day fund that equals 5 percent of the General Fund budget, a widely recommended standard for the states.

A third bill by Sen. Roy Cooper (D-Nash) and Sen. Alexander Sands (D-Rockingham) would—among other things—link revenue estimates to actual growth in state and personal income.[21]

Also among reforms that may be considered are revisions to the 1925 Executive Budget Act[22] and a move toward a more program-oriented budget. State Treasurer Harlan Boyles says the Executive Budget Act lodges too much power in the governor to make mid-course adjustments in the budget enacted by the General Assembly. The Martin administration believes the Executive Budget Act has served the state well and that no major changes are needed.

But the Martin administration is not at loggerheads with the treasurer on every budget-reform issue. For instance, Boyles believes that if budget requests were presented in the form of programs rather than by line item, they could be more easily evaluated and prioritized by legislators. Boyles says this would discourage duplication and put a premium on performance. The governor's budget office says it agrees with this program-oriented approach. Again, the goal is to avoid meat-axe across-the-board cuts such as the 3 percent cuts the legislature enacted in 1990. Across-the-board cuts, Boyles argues, treat every state agency as though each of its programs were of equal value, and they are not.

But whether the 1991 General Assembly produces lasting budget reforms is at this point table talk at a poker game. The immediate task is producing a balanced budget, and the state constitution mandates that the legislature do exactly that.[23]

The options are clear—budget cuts, tax increases, or some combination of the two—but the choices are not easy. No legislator wants to risk sinking the sailboat of state. But blowing a political career through a tax increase without public support is equally unenticing.

A Las Vegas bookie would lay odds on a tax hike, despite all the rhetoric about making deep cuts. Even before the November election, many incumbents and hopefuls were owning up to the need for increased revenues. A case in point is a Nov. 4, 1990, *Charlotte Observer* poll of 74 candidates seeking 40 seats in the newspaper's primary circulation area. The poll found 65 percent of the candidates would support a tax hike to close the budget gap. One incumbent, Sen. Austin Allran (R-Catawba), went so far as to opine that anyone who thinks the budget can be balanced without a tax increase is "naively ignorant or just dishonest."[24]

The legislature has increased taxes 14 times since 1979, with the governor often playing a role by proposing or supporting the increase.[25] While many of these tax hikes have been relatively small change, some have been significant. The gas tax has gone up three times, the corporate income tax has been increased, and a 2 cent local-option sales tax has been authorized. A 15th tax increase would raise few eyebrows among those who observe the legislative process.

Still, some legislators feel strongly that the public is fed up with tax increases, and the political situation has strengthened the hand of the budget cutters. Martin—by removing himself from consideration for the 1992 U.S. Senate race—exacerbated his lame-duck status. Republican legislators are following the "no-new-taxes" lead of Gardner, who is expected to be the GOP nominee for governor in 1992.

Democrats, on the other hand, are not enthusiastic about raising taxes without the votes of Republicans. They have the 1992 election to think about and the prospect of running against a ticket that includes a popular president and a gubernatorial candidate who eschews any tax increase. So the political factors make the decisions facing legislators all the more difficult. "I don't think a lot of members realize how difficult it's going to be to go into the home district and tell people, 'You're doing well, but we're going to have to cut your position out,'" says Diamont.

Still, the silver lining to the dark budget cloud that hangs over state government may be that circumstances have forced the legislature to review its spending and to set priorities. "This process is something that is cyclical and it's something that we need to go through," says Diamont. "We must question programs and see if they're effective. If you give us $2 billion we'll find a way to spend it, and we're never going to have the money to meet the needs of what this legislative body feels needs to be done. I tell you something else we're going to get out of this—leadership."

FOOTNOTES

[1]Marcia Howard, *The Fiscal Condition of the States,* National Association of State Budget Officers, December 1990, p. 3.

[2]Janet G. Stotsky, "Coping with State Budget Deficits," *Business Review,* January–February 1991, pp. 15–7.

[3]G.S. 105–131. David Crotts, the legislature's chief fiscal analyst, says federal tax reform allowed tax liabilities of Subchapter S corporations—those with less than 35 shareholders—to be assessed against individuals rather than the corporation as a whole. The state picked up this change when it adopted the federal tax structure in 1990, Crotts says, but the legislature did not anticipate the number of corporations that would seek the new tax status and did not adjust individual rates sufficiently to adjust for losses on the corporate side.

[4]Standard and Poor's, a New York bond-rating firm that controls the state's prized AAA bond rating, is among those advising the state to rely more on bond financing to pay for capital projects.

[5]*Significant Features of Fiscal Federalism,* Advisory Commission on Intergovernmental Relations, Vol. II, August 1990, p. 42.

[6]"Overview of The North Carolina State Budget," Office of State Budget and Management, October 1990, p. 8.

[7]General Fund Fiscal Update for legislators from Senior Revenue Analyst David Crotts, Feb. 7, 1991, p. 6.

[8]Martin's biennial budget appropriates $6 million in 1992–93 in supplemental funding for small school systems—those with less than 3,000 students. The Center's proposal is not based on size but on wealth and tax effort. In testimony before an interim legislative study subcommittee on educational equity on March 11, 1990, Center Director Ran Coble recommended that financial assistance go to 10 counties with low tax wealth but high tax effort.

[9]The legislature agreed to reimburse local government for revenue lost through the repeal of the inventory tax in 1985 and partial appeal of the intangibles tax in 1987.

[10]Martin said $700 million had been cut from the $7.6 billion 1990–91 General Fund budget, based on 1989 appropriation levels—a decrease of about 9 percent.

[11]"Sailing Through the Storm," *The Charlotte Observer,* Feb. 1, 1991, p. 8A.

[12]"Setting Sail Without Wind," the *Winston-Salem Journal,* Feb. 3, 1991, p. 12A.

[13]Gardner would chop more than $29 million for administrative staff from the Department of Public Instruction's budget, compared to about $6.2 million in cuts in the Martin budget. The Martin budget also allows DPI to forego $15 million in negative reserves in the first year of the biennium, while the Gardner budget exempts DPI from only $1.1 million, but an additional $15.2 million in the 1992–93 fiscal year. Thus, Gardner's net reductions for public education exceed Martin's by some $36.7 million for the 1991–92 fiscal year.

[14]Tim Simmons, "Panel Told Funding Cuts Could Reach Into the Classrooms," *The News and Observer* of Raleigh, March 27, 1991, p. 1A.

[15]"State Excise Rates," *The Book of the States 1990–91,* The Council of State Governments, Lexington, Ky., p. 316.

[16]Discussion of implementing a state lottery raises a host of issues, many of which are not fiscal. Opponents such as Rep. Coy Privette (R-Cabarrus) argue that the state should not be promoting gambling and that some low-income people would spend a higher percentage of their incomes playing the lottery. Sen. Ken Royall (D-Durham), perhaps the leading proponent of a lottery referendum, argues that a lottery is essentially a volunteer tax and points to consistent support for a lottery found in public opinion polls. As of this writing, three separate bills have been filed in the 1991 session calling for a referendum on a state lottery: S.B. 2; H.B. 15; and H.B. 21. A fourth bill, H.B. 1113, would establish a state lottery and dedicate the proceeds to capital projects, with the public voting after five years on whether to keep it operational. For more on the lottery issue, see Steve Adams, "The Numbers Game—The Lottery for North Carolina?" *North Carolina Insight,* Vol. 7, No. 4 (April 1985), pp. 24–33.

[17]*Budget for a Green Assembly: Environmental Budget and Policy Recommendations, 1991,* produced jointly by the North Carolina Chapter of the Sierra Club, the Conservation Council of North Carolina, the North Carolina Alliance for Conservation Action/North Carolina Wildlife Federation, the North Carolina Environmental Defense Fund, and the North Carolina State University Chapter of the Student Environmental Action Coalition.

[18]*Fiscal Realities for the Nineties: Report of the Economic Future Study Commission,* Feb. 27, 1991, p. 26.

[19]S.B. 5 of the 1991 Session.

[20]H.B. 198 of the 1991 Session.

[21]S.B. 833 of the 1991 Session.

[22]Chapter 143, Article 1, N.C. General Statutes.

[23]Article III, Sec. 5(3) of the N.C. Constitution reads in part, "The budget as enacted by the General Assembly shall be administered by the Governor. The total expenditures of the State for the fiscal period covered by the budget shall not exceed the total of receipts during that fiscal period and the surplus remaining in the State Treasury at the beginning of the period."

[24]Greg Trevor, "N.C. Candidates Willing to Hike Taxes for Budget," *The Charlotte Observer,* Nov. 4, 1990, p. 1A.

[25]Inventory prepared by the legislature's Fiscal Research Division. The legislature also has reduced taxes a number of times over the course of the decade, but the net result is $954 million in new taxes, according to the Fiscal Research Division's calculations.