NORTH CAROLINA'S FISCAL REVOLUTION

The tax structure it produced has left this state in an enviable position

by Charles D. Liner

NORTH CAROLINA'S tax structure, a product of a major tax reform in 1921 and bold legislative action in the 1930s, has put this state in an enviable position. North Carolina is less in need of basic tax reforms than most states and far less susceptible to radical initiatives like California's Proposition 13. The state tax structure, which automatically produces substantial increases in revenues at existing rates as the state's economy grows and prospers, should afford an opportunity in future years for the state to improve government services through increased spending and, at the same time, to reduce North Carolinians' tax burden, either directly by reducing state tax rates or indirectly by enabling local governments to reduce property taxes.

NORTH CAROLINA'S enviable position is primarily the result of a reorganization of government finance and taxation that occurred during the 1931 and 1933 sessions of the General Assembly in response to a major fiscal crisis precipitated by the Great Depression. North Carolina's fiscal revolution was unprecedented in American history, and to this day no state has come close to matching the boldness of the measures taken then.

Counties and municipalities were in serious financial trouble even before the depression. In 1928 per capita state and local debt in North Carolina was 4½ times the average in other states and higher than in any state except New York; property tax levies for debt service equaled 46 percent of total property tax levies. With the onset of the depression, the burden of debt and high property tax rates produced a serious financial crisis for counties and municipalities and popular demand for relief from high property tax rates.

In response to these conditions, the 1931 General Assembly took over responsibility for all operating expenses of the public schools for a six-month term and full operating and financial responsibility for all county roads and prisons. Thus, in one stroke the state assumed responsibility for three major functions of county government that had been financed mainly from local property taxes. These measures reduced county property tax levies by 29 percent and total property tax levies by 20 percent in only one year. The state also created the Local Government Commission to control local debt and to help local governments cope with their debt problems.

Despite these measures the fiscal crisis had worsened by the time the General Assembly convened in 1933. More than 60 counties and about 150 of the 200 municipalities faced default on debt payments, and the state faced a large deficit for the current fiscal year. The 1933 General Assembly responded as boldly as the 1931 legislature. It committed the state not just to keeping the schools open but also to extending the term of every school in the state to eight months. North Carolina thus became the first state to finance equal school terms throughout the state (the eight-month school term was then the longest state-supported term in the nation). The General Assembly also abolished the state property tax, which had been imposed temporarily to finance schools, and abolished all local school property taxes. To finance its new responsibilities and to balance the budget, the General Assembly increased rates on state taxes and enacted the 3 percent retail sales tax and alcoholic beverage taxes.

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THE FISCAL REVOLUTION of 1931-33 was based on two key and long-established principles: first, that the state is ultimately responsible for achieving a uniform, statewide school system; and, second, that the state should derive revenues to support state programs from taxes other than the property tax, which it should leave to counties and municipalities to use for their purposes.

The first principle had been established when the state created the statewide school system in 1839 by mandating equal school terms and by distributing state funds on a per capita basis. The principle had been reaffirmed in the 1868 Constitution, which required a general and uniform school system with a minimum term of four months (the term was increased to six months in 1918). Before 1931 the main problem in achieving a uniform school system was that schools had to be financed largely by state and local property taxes. To achieve the constitutionally mandated school term, poor counties with low tax bases had to impose higher property tax rates than wealthier counties. Urban counties were able to spend more for schools and to have a longer school term than rural counties. Between 1901 and 1931 the state tried to remedy this problem by making a special appropriation to an "equalizing fund," which was distributed only to the poorer counties to bring their school terms up to the minimum and to equalize tax rates, but the urban counties were still able to provide better schools and longer terms.

Full state funding of the eight-month school term in 1933 brought schools in poorer, rural areas to full equality, at least financially, with schools in urban areas. At the same time, however, the General Assembly reaffirmed the policy that the people could tax themselves to improve their schools above the level provided by the state. The legislature abolished existing local school taxes, but it authorized the holding of referenda on levying an additional property tax to supplement the state-financed school programs.

The second principle, the separation of state and local revenue sources, had been established in 1921, when the state eliminated the state property tax and replaced the lost revenues by enacting a progressive income tax on individuals, a corporation income tax, and a state gasoline tax to finance a new state highway system created when the state took over responsibility for 5,500 miles of county roads.

The fiscal revolution of 1931-33 not only solved the immediate fiscal crisis but also provided long-lasting benefits to the state. First, it permanently reduced reliance on the property tax. Second, it gave the state a tax structure that was very responsive to economic growth and therefore enabled the state and local governments to cope with post-war fiscal pressures caused by the baby boom and increased demand for government services. Third, it resulted in a more equitable distribution of government services, particularly for public schools, and a fairer distribution of tax burdens.

Between 1930-31 and 1936-37, local tax revenues fell from two-thirds of total state and local tax revenues to slightly over one-third. County property tax revenues were reduced by half between 1928-29 and 1933-34. Today, property taxes account for less than 25 percent of total state and local tax revenues, compared with an average of over 36 percent for the nation (in recent years the percentage has been about 43 percent in California and over 50 percent in some northeastern states).

THE SHIFT of financial responsibility for schools, roads, and prisons and the reduced reliance on local property taxes proved especially beneficial after World War II, when the baby boom and general prosperity increased the demand for schools and other government services. As it turned out, the tax system adopted in 1933 enabled the state to meet increased demands without significantly changing the tax structure or even raising tax rates, whereas in most states property tax rates increased substantially and most states had to enact new income or sales taxes and increase rates on existing taxes. This is perhaps the most remarkable aspect of the fiscal revolution. It produced a tax structure that has remained essentially unchanged. (The gasoline tax has increased from 6 cents to 9 cents, although 1 cent is earmarked for municipal streets, and the top income tax bracket of 7 percent was added in 1937, but otherwise the rates of the three major state taxes have not changed.) Yet this tax structure has brought about dramatic increases in state tax revenues that permitted the state to increase expenditures and improve programs. State tax revenues have grown from $44 million in 1933-34 to over $2.3 billion in 1977-78. Between 1969-70 and 1977-78, General Fund tax collec-

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tions increased at an average annual rate of 12.1 percent despite two recessions during this period. This growth rate results in a doubling of tax revenue about every six years.

The constant growth in its tax revenues---which finance not only state-operated programs like highways, prisons, higher education, and mental hospitals but also schools and other health, education, and welfare programs administered by counties acting as agents of the state---has enabled the state to increase expenditures dramatically in every area, expand existing programs, and inaugurate new programs. (A large system of community colleges, for example, was created almost from scratch in the 1960s.) General Fund expenditures today are over eight times the level of 1959-60 and over 16 times the level of 1949-50. Total state expenditures have increased from only $50 million in 1933-34 to almost $4 billion in 1977-78. This constant growth has also enabled the state to relieve fiscal pressures on local governments by taking over financial responsibility for the courts system and by sharing its tax base with local governments, the most noteworthy example being the local-option sales tax.

THERE ARE four central issues today in state and local government finance in the United States: the fiscal condition of cities and states, the role of the property tax, equality in school finance, and growth in government spending and taxation. The fiscal condition of North Carolina counties and cities contrasts sharply with the condition that existed before the fiscal revolution. Both the state and local governments have low debt and good credit ratings (only two states had lower per capita state and local debts in 1975-76). Reliance on the property tax is low, property tax rates are lower than in most states and fairly stable in most places, and, in contrast to the situation in many other states, local schools do not depend primarily on local property tax revenues.

But the last two issues do present questions for North Carolina. Disparities in school finance between poor and wealthy jurisdictions are not as large as in many other states, where the method of financing schools mainly from local property taxes has come under attack in the courts. But significant disparities do exist because the state no longer finances all operating expenses and the wealthier school districts are better able to supplement state funds with local funds. Although federal grants, which tend to favor poor jurisdictions, offset differences in local funds to some extent, essentially the same situation exists today that existed before 1931---poorer counties must impose higher property tax rates than wealthier counties in order to raise a given amount of revenue. (The same problem exists with respect to state-mandated programs that must be financed from local property taxes.) It is interesting that a recent study commission recommended a system of equalizing school grants like that used between 1901 and 1931.

Controlling the growth of government spending and taxation is perhaps the key issue in government finance today. Many states have enacted or are considering tax or spending limitations of one sort or another. North Carolina ranks 49th in per capita state and local government spending and 45th in per capita state and local taxation. These low rankings are due in part, however, to the state's low income, the relatively low cost of living, and to the fact that there are no large cities and most people live in small towns or rural areas where per capita expenditures tend to be low. It is paradoxical, nevertheless, that North Carolina ranks among the top few states in growth of state and local government spending. Between 1965-66 and 1975-76, for example, per capita general expenditures of state and local governments in North Carolina increased 209 percent, a rate surpassed by only five states (Hawaii, Maryland, New Jersey, New York, and South Carolina).

Because the growth in state spending in North Carolina has been financed by a tax structure that automatically produces large increases in revenue with constant tax rates, there has been relatively little popular resistance so far to the growth in government spending financed from state revenues. There is constant pressure at the local level to keep property tax rates low, but property tax revenues also have generally increased substantially because of economic and population growth and increases in real estate values.

MOST NORTH CAROLINIANS would probably agree that the growth in government expenditures since World War II has been justified by the needs created in shifting from a predominantly rural to a more urban and industrialized state, and also by the need to expand and improve public schools and higher education to serve the burgeoning school-age population. But the question for today is not whether past growth in spending and taxation has been justified but whether such growth should continue at the same rate as in the past.

Since the demands on state tax revenues should not be as great as they have been in the past, North Carolina should be able to both improve government services through increased spending and provide some relief from current tax burdens.

One new element is the high rate of inflation. Until the rate of inflation increased in the late 1960s, state revenues increased mainly due to real growth in the state's economy. But state income taxes increase the percentage of income paid in taxes even when the increase in income merely offsets increases in the cost of living.

Increases in revenues from the existing state tax structure are independent of the need for government spending. In the past, although there has been a surplus of revenues over expenditures every year since the depression, the General Assembly has chosen eventually to spend all tax revenues, and on occasion it has increased some tax rates and enacted minor new taxes such as the soft drink and cigarette taxes. But today the state no longer faces the huge demands for increased spending that it faced earlier. For example, in education, which accounts for two-thirds of General Fund expenditures, the state now faces a baby bust instead of a baby boom---school enrollments are falling and will continue to fall. The point is not that the level of state spending is adequate but rather that there is a good chance that in the years ahead the pressure to spend the large increases in revenue generated automatically by the existing tax structure may not be as great as it has been in the past.

If the General Assembly should choose to reduce the rate of growth in state spending, it will have to take deliberate action to reduce the growth in tax revenues, for otherwise tax revenues will continue to increase as in the past. Assuming continued growth in the state's economy, if the tax structure is not changed we can expect total state tax revenues to double roughly every six years.

If the General Assembly chooses to provide a general reduction in tax burdens, it has essentially three options. First, it can reduce state taxes. The main candidates would be the personal income tax and the retail sales tax, since gasoline tax revenues are not growing very fast. Reduction of rates or even repeal of other state taxes would not provide general tax relief. The problems in granting tax relief through the personal income tax are that (1) this tax is usually regarded as the most equitable tax because it is based on ability to pay and (2) the poorest families and individuals do not pay income taxes and therefore would not receive tax relief. However, the tax could be "indexed," or adjusted annually to account for inflation, so that tax revenues increase only with increases in real incomes. The retail sales tax rate of 3 percent is already low---only three states have lower rates, and 30 states have higher rates. One possibility is to exempt food sales from the retail sales tax. While this measure would provide relief for everyone, it would result in a large loss of revenue at once---over $150 million in state revenues next year and over 25 percent of local government sales tax revenues. The state could recover some of the lost revenues, however, by increasing the state and local sales tax rates on items other than food.

A second option is for the state to use its growing revenues to enable counties and municipalities to reduce the property tax. This could be done in one or both of two ways. First, the state could share its tax base or its revenues with local governments, perhaps through a general revenue sharing program similar to federal revenue sharing, thereby enabling local governments to reduce property taxes. Second, the state could take over more of the financial responsibility for statewide or state-mandated programs that are now partly financed by counties through the property tax.

As a third option, the state could provide direct property tax relief through a circuit-breaker system similar to those already enacted in more than half the states. With a circuit-breaker system, the state would give an income tax credit or a rebate for local property taxes that exceed a certain percentage of family income. The circuit-breaker is intended to relieve excessive property taxes on the poor and elderly. It is not, however, a general tax relief measure.

THE FISCAL REVOLUTION of 1931-33 left North Carolina with a sound system of state and local finance and a state tax structure that has permitted an expansion and improvement of government services without the need to increase tax rates substantially or to enact major new taxes. As the state's economy grows and prospers, tax revenues from the existing tax system will continue to increase as they have in the past. Since the demands on state tax revenues should not be as great as they have been in the past, North Carolina should be able to both improve government services through increased spending and provide some relief from current tax burdens. □