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# BTC Brief

▶ NC BUDGET & TAX CENTER

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## No Stone Unturned: Eight Strategies for Addressing the State's Budget Gap

*Timely,  
accessible,  
and credible  
analysis of  
state and local  
budget and tax  
issues*

DESPITE BEING 15 MONTHS INTO A NATIONAL ECONOMIC RECOVERY, North Carolina continues to face high unemployment and lackluster job creation. And while state revenue collections are no longer decreasing year to year, they are far below pre-recession levels and will remain so for several years even with expected growth. Projections suggest that in fiscal year 2012 revenues will fall to 4.8 percent of the state residents' personal income, well below the level of revenue collection seen in North Carolina over the past two decades and well below what is needed to meet the state's needs.

Over the course of the recession, demand for certain state-funded services has increased alongside rising poverty and declining median household income. There are more adult workers upgrading their skills at community colleges and more elderly, disabled, and low-income residents in need of basic assistance. In addition, the state must continue to fulfill its obligations to educate children, keep the public safe, protect the environment, and invest in the public structures that support a sustained economic recovery and high quality of life for all North Carolinians.

The rising need for vital services and the depression of revenues to pay for those services is driving the state's budget shortfall. Current estimates suggest that state policymakers arriving in Raleigh this week face a \$3.7 billion shortfall. This shortfall is in addition to two years of budget cuts that have resulted in a 10-percent cumulative reduction of the state budget.

While the predictions of economists like those at Moody's Analytics suggest that North Carolina is likely to recover faster than the nation, it is certainly true that job growth will be slow, and state revenues will not recover to pre-recession levels for several years. It is therefore essential that policymakers in North Carolina leave no stone unturned as they seek solutions to the state's fiscal challenges. Here are eight strategies that should be top on policymaker's agenda for the first 100 days.

### ■ Finding Efficiencies — Evaluate expenditures based on their goals and determine whether there are better or more cost-effective ways to reach those goals.

The effort to find efficiencies should not compromise the access to or quality of services for the state's residents but instead serve to identify and redirect resources that can be more efficiently spent. For example, the Joint Select Committee on Ex-Offender Reintegration into Society recently recommended changes to North Carolina's sentencing laws that acknowledge the need to invest in community corrections programs and other strategies to reduce recidivism. Such changes that help ex-offenders successfully reintegrate back into communities can result in short- and long-term savings. An efficiency introduced last year was the creation of a Medicaid prescription drug list that promised to save North Carolina \$90 million annually.

### ■ Eliminate Ineffective Tax Expenditures — Evaluate all special tax breaks (credits, exemptions, deductions, etc.) and eliminate those that have not achieved their goals.

In fiscal year 2009-2010, the state lost \$5.8 billion in tax revenue due to special tax breaks that legislators created over the past several decades. This tax code spending does not appear in the state's budget, and most of these special tax breaks are never evaluated to measure the extent to which they are meeting their goals. Recent analysis by the UNC-Chapel Hill Kenan-Flagler Business School found that nearly half of companies receiving Article 3J (or Bill Lee Act) tax credits experienced a decline in employment growth from 1996 to 2006. Similar analysis is needed of a majority of these tax expenditures, and where national evidence that they are ineffective is available, such as with the sales tax holidays, legislators should consider eliminating them.

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### ■ **Improve Collections – Aggressively seek taxes due that are not being paid**

Tax compliance is essential to maintaining fairness in the marketplace. The NC Department of Revenue's efforts to ensure that both corporate and individual taxpayers contribute the taxes due should be supported. Closer scrutiny of major corporations' state tax liability resulted in additional tax collections of nearly \$420 million in 2009. Further efforts by the Department of Revenue to ensure the collection of the use tax from on-line shoppers could result in an additional \$162 million in revenue for the state if the full tax due on purchases were instead collected by the retailers.

### ■ **Raise Revenue Fairly – Ensure that low- and middle-income families don't pay more than their fair share to close the revenue gap.**

Economists have recommended that states consider tax increases that are primarily paid by higher-income taxpayers because these residents, unlike lower- and moderate-income residents, are likely to respond by reducing savings rather than cutting their spending, thus maintaining economic demand. It is particularly important that North Carolina policymakers ensure that revenue-raising proposals do not make worse the state's already upside-down tax system, which requires more from those with the least ability to pay. Making the state tax code fairer and more progressive would enable the state to raise more revenue even while maintaining current tax rates.

### ■ **Prioritize when Making Cuts – Make careful decisions based on goals and effectiveness when budgets must be cut**

State policymakers should consider developing a list of priorities by which they can judge current and proposed state spending. The state of Washington has established an ambitious prioritization process called Priorities of Government that could serve as a model for North Carolina. Performance data can and should be used responsibly in the decision-making process. It will be important, however, to make more transparent the process by which programs are targeted for performance reviews..

### ■ **Rethink the Distribution of State and Local Responsibilities – Consider transferring some responsibilities to local governments, and provide them with the tax authority needed to fund those responsibilities**

In 2007 the State and Local Fiscal Modernization Study Commission recommended the state take steps to redistribute the responsibilities between state and local governments. When and if the state does shift additional programmatic responsibility to local governments, it is important that the state evaluate local taxing authority as well. Another way to help local governments address their equally challenging budget deficits would be to rescind restrictions on how some local tax revenues can be spent and give new direct taxing authority to local elected officials rather than requiring voter approval.

### ■ **Pay Close Attention to Future Impact – Ensure that today's budget solutions don't simply pass the buck – or make matters worse – for North Carolina's future**

The slow economic recovery, in combination with an antiquated revenue system, means that the state's budget challenges are likely to continue for some time. Relying on one-time spending cuts and revenues to balance the budget is a short-term solution that will only increased the difficulties for the state's future economy. Policymakers must protect investments in areas that generate long-term savings, such as early childhood development and community-based health interventions and corrections programs. Additionally, state policymakers must consider the long-term costs associated with proposals to privatize public goods in exchange for quick cash infusions.

### ■ **Reform the State's Revenue System – Build a system that is adequate, stable and based on ability to pay**

Now is an important time for state policymakers to take steps to modernize the revenue system. Doing so can reduce volatility, improve long-term adequacy and ensure that low-income families and local businesses are not paying more than their fair share. Revenue reform can set the state on a sustainable path to long-term economic growth by ensuring that the state can maintain its current and future investments in public structures. Reform measures that would make the revenue system fairer and better able to meet the state's needs include broadening the base of the personal income tax and sales tax, implementing combined reporting for multi-state corporations, and eliminating ineffective, regressive tax expenditures.

## **Conclusion**

North Carolina's policymakers returning to Raleigh this week must take as their first task rebuilding the state's economy. Critical to that effort will be addressing the state's fiscal challenges with forward-thinking proposals and comprehensive strategies that maintain the state's public structures.