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ALL HANDS ON DECK:
Predictions for the FY 2010-11 and FY 2011-12 budget shortfalls and eight strategies for getting the state's fiscal ship back in balance

By Elaine Mejia, Project Director and Meg Gray Wiehe, Policy Analyst

- **The national recession** that began in December 2007 and the anemic recovery thus far have taken a heavy toll on North Carolina's economy. Despite some reports that the economy has stabilized, more than half a million members of the state's labor force remain out of work and other economic indicators also suggest that the road to recovery will be a long one.
- **The recession has depleted tax revenues,** hampering the ability of governments, particularly state and local governments that cannot operate in deficit, to fulfill their responsibilities. At the same time, the need for some public programs, such as health care for low-income residents and post-secondary education, has increased, putting these institutions under great strain.
- **The double-sided impact that the recession has had** on the state budget — depleting revenues and driving up costs — created an unprecedented shortfall for fiscal year 2009-2010 (FY 2009-10). The gap between the amount of revenue the existing tax system could generate and the funding levels required to maintain the current quality and quantity of state services reached $4.6 billion, or 20 percent of the state budget. North Carolina's leaders responded with a balanced approach, relying on spending reductions, taxes increases and federal assistance.
- **Unfortunately for state leaders,** budget projections for this year and the next indicate their work is far from over. The state will face a budget shortfall of approximately $1.6 billion in FY 2010-11 and an estimated $3.3 billion to $4.4 billion in FY 2011-12.
- **State leaders must continue to take a balanced approach** to managing this ongoing challenge by finding efficiencies, tapping all available resources, eliminating ineffective tax expenditures, improving tax collections, rethinking the distribution of state and local responsibilities, making spending reduction decisions based on well-grounded priorities, and, if necessary, raising additional revenue.

Overview

The recession and its aftermath have exacted heavy tolls on American society, first and foremost by leaving workers unemployed and forcing families to deplete their savings and personal wealth. But the economic downtown also has had deep negative effects on collective endeavors by eroding the ability of state governments to fulfill their basic responsibilities to educate people, maintain law and order, care for the most vulnerable residents, and protect the environment.

The recession began seriously impacting tax revenues during the middle of FY 2008-09, forcing Governor Mike Easley and then Governor Beverly Perdue to use their emergency budget powers to dip into reserves and into the state lottery fund, to furlough employees, and to freeze hiring and capital spending. Heading into FY 2009-10, Governor Perdue and the General Assembly grappled with a budget shortfall that exceeded 20 percent of the budget. North Carolina's policymakers took a balanced approach and addressed the budget gap with a combination of budget cuts (net reductions of $1.7 billion), increased taxes ($1 billion) and federal assistance ($1.4 billion).

However, the end of the state's budget troubles is not yet in sight. In the current fiscal year, tax revenues are falling behind yet again, although not to the extent that they were the year before, and state leaders must confront a budget shortfall of approximately $1.6 billion as they begin crafting the FY 2010-11 budget.

It is likely North Carolina will not escape the fiscal doldrums for some time to come because short- and mid-term economic projections are weak and because, historically, revenue recovery lags behind economic recovery. However, the state must fulfill its obligations to educate children and retrain adult workers, to provide basic assistance to low-income and disabled residents, to keep the public safe, and to protect the environment. Therefore, it is essential that state policymakers leave no stone unturned as they look for solutions to the state's fiscal crisis.

This report examines the impact the recession has had and continues to have on the state budget, looks forward to project the budget shortfalls for the next two years, and lays out eight strategies state policymakers should use to balance the budget.

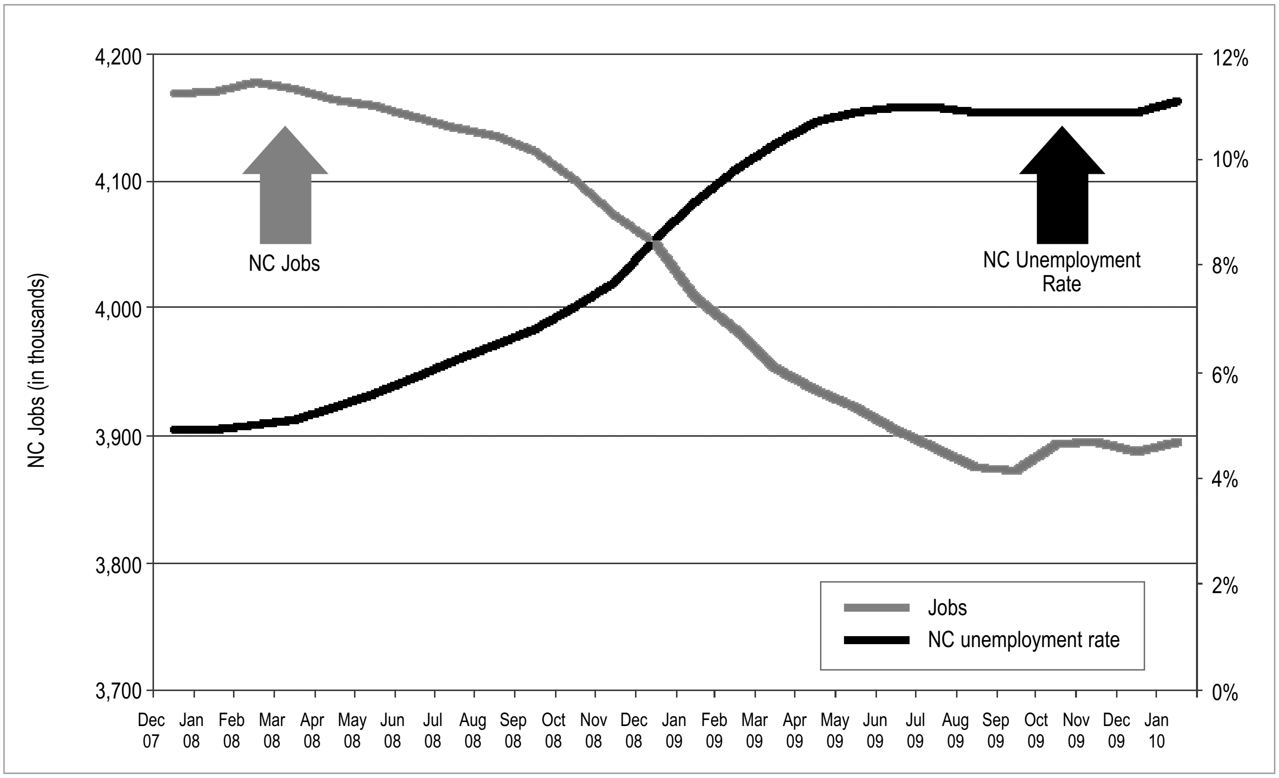
The Economy and the State Budget

The deep recession and nascent, lackluster recovery have caused unprecedented declines in state tax revenues while simultaneously increasing the need for certain types of public services. Combined, these forces have placed the budgets of virtually all states in a precarious position — the need for services has increased at the exact time that the ability to pay for those services has diminished. The Center on Budget and Policy Priorities, a national research organization that tracks state budgets, recently concluded that 48 states currently face budget shortfalls and that the cumulative budget shortfalls for the current year plus next year will "likely top $375 billion."[1] Keep in mind that, unlike the federal government, state governments cannot run deficits in order to maintain public services at pre-recession levels.

The national recession has impacted North Carolina's state tax revenues in several ways. First, personal income taxes, which make up more than half of General Fund revenue, dropped because the burst of the housing bubble resulted in a decrease in income from capital gains. As the recession progressed, job loss further eroded personal income tax revenues, particularly from taxpayers who had

FIGURE 1

North Carolina Job Loss and Unemployment Rate Since the Start of the Recession (December 2007- January 2010)



SOURCE: State and Regional Unemployment Rate and State and Regional Number of Jobs
Employment, Hours, and Earnings from the Current Employment Statistics survey (State and Metro Area) Seasonally Adjusted

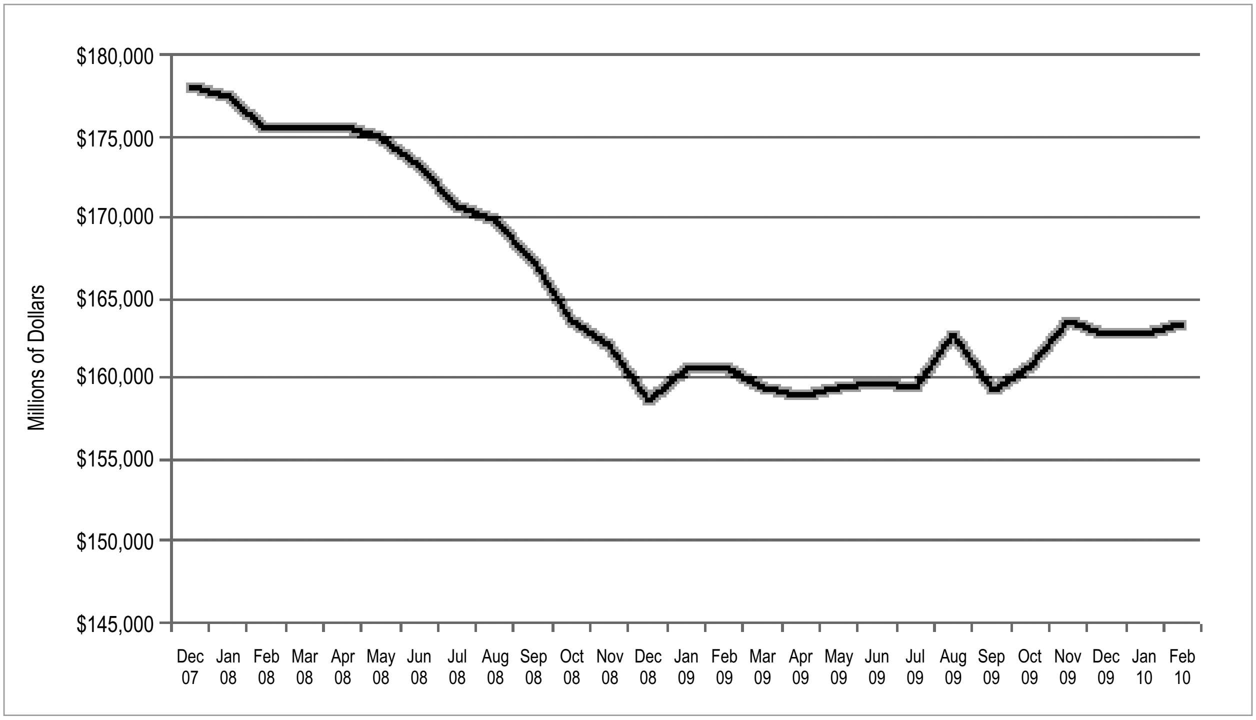
income taxes withheld from their paychecks. With the state's unemployment rate persistently high and the significant loss of North Carolina jobs, it will likely take several years before personal income tax revenues fully rebound. (**Figure 1**)

Sales tax revenues, which make up one-third of General Fund revenues, also decreased following the collapse of the housing bubble, particularly because that bubble had artificially inflated consumer spending through additional income from capital gains and home refinancing. In the months that followed, revenue from the retail sales tax declined as families adjusted to their new income levels by spending less money on goods and services and returning to a more normal rate of savings, which had hit a historic low before the recession **(Figure 2, p. 4)**. Consumer confidence, though better than at the height of the recession, remains weak, suggesting that sales tax revenues are likely to recovery slowly **(Figure 3, p. 4)**. This is particularly true because North Carolina's sales tax does not apply to most services, including areas of spending that are still growing such as health care and education, and will not apply to spending towards debt such as credit card payments.

The recession has also impacted the spending side of the budget equation. The need for most state-funded services, such as public schools, courts, and mental health services, did not diminish as the economy slowed, and some types of state services experienced a spike in costs. For example, the community college system,

FIGURE 2

US Real Retail and Food Service Sales Since the Start of the Recession (December 2007- February 2010)



SOURCE: FRED (Federal Reserve Economic Data), Economic Research Division, Federal Reserve Bank of St. Louis

FIGURE 3

US Consumer Sentiment (January 2006 - January 2010)

SOURCE: The Michigan Consumer Sentiment Index, the Survey Research Center at the Unversity of Michigan which many unemployed workers turn to for retraining, estimates it accommodated an additional 27,000 students this year compared to the prior year, an amount greater than the entire student enrollment at UNC-Chapel Hill. Similarly, the state's eligible Medicaid population has grown by nearly 200,000 residents since January 2008.

Past, Present, and Future Budget Gaps and Their Impact on Public Investments

As a result of steep revenue declines and increased pressures on public agencies, the state is facing several years of budget shortfalls — that is, the revenue the current tax system can generate will not be sufficient to maintain public services at current levels.

The FY 2008-09 and FY 2009-10 shortfalls and their impact

In FY 2008-09, state tax revenues fell behind projections by $3.2 billion, or 15 percent of the state budget, forcing Governor Easley and then Governor Perdue to act. The state cut agency spending mid-year, froze hiring and purchases, froze capital spending, furloughed employees for a half-day, and drew down a large portion of the state's reserves.

Heading into FY 2009-10, state policymakers faced a $4.6 billion budget shortfall, meaning that the gap between projected expenditures and revenues was an unprecedented 20 percent of the budget. Lawmakers addressed the gap by reducing spending (net reductions of $1.7 billion), raising revenues ($1 billion) and relying on fiscal assistance from the federal government ($1.4 billion). (**See sidebar for details.**)

The $1.7 billion in spending reductions enacted in FY 2009-10, though not nearly as

The Balanced Approach to the FY 2009-10 Budget Shortfall

Facing a budget gap of $4.6 billion between anticipated state tax revenues and the cost of continuing state services at current levels, state lawmakers took a balanced approach that relied primarily on spending reductions (net of $1.7 billion), revenue increases ($1 billion), and federal assistance ($1.4 billion).

The continuation budget (the current services budget) for FY 2009-10 was cut by a net 8.7 percent (cuts in general fund appropriations plus cuts that were offset by federal assistance). The budget actually provided for $1 billion in expansion spending to cover basic costs increases but then also included $2.7 billion spending reductions so that the net reduction was $1.7 billion.

The revenue plan included two temporary tax increases: a one-cent increase in the state sales tax (set to expire June 30, 2011) and an income tax surcharge on high-income households and corporations (for tax years 2009 and 2010). The plan also included modest increases in taxes on tobacco and alcohol products and a small expansion of the sales tax to digital products.

The FY 2009-10 budget contained an additional $1.4 billion in nonrecurring General Fund spending reductions that were offset by federal funds from the American Recovery and Reinvestment Act (as known as the federal stimulus package). Three recovery funding streams were specifically dedicated to helping states close their budget gaps over a three-year period: a temporary increase in Medicaid funding, a state fiscal stabilization fund to maintain education spending at FY 2005-06 levels, and a second state fiscal stabilization fund for general use.

large as they would have been without the temporary tax increase and federal aid, are affecting the ability of the state to meet its responsibilities. The budget reduced funding in all categories. Education received the smallest funding reduction at 5.4 percent, while Health and Human Services funding was reduced by 13.8 percent.

Cuts to public school funding have resulted in increased class sizes and teacher layoffs, as well as fewer literacy coaches, librarians and teaching assistants. In March, the Charlotte-Mecklenburg school boardvoted to begin the process of laying off approximately 600 teachers and cutting pay for all 224 assistant principals in 2010-11. The budget cuts have also impacted higher education. The UNC system abolished hundreds of teaching and non-teaching positions, many of which were filled. The community college system is grappling with budget cuts while simultaneously trying to cope with a spike in enrollment. Community college president Scott Ralls recently speculated that once the final tallies are in, the system may have accommodated a staggering 15 percent enrollment increase during the current school year compared to the previous year. Budget cuts within the system have meant that some campuses have not been able to enroll all applicants or have been unable to accommodate all students seeking certain high-demand courses, such as biotechnology, health care, life sciences, aerospace and green technology.

Cuts to programs that fall under the Health and Human Services (HHS) portion of the budget have also impacted individuals and communities. The deepest outright cuts to HHS programs were to community support services for people with mental illness and substance abuse issues and to personal care services that help individuals with medical conditions to remain in their homes and out of institutional settings. The mental health association of North Carolina estimates that 10,000 to 15,000 individuals currently need community support services but are unable to access them to due to funding constraints.

Cuts to the Justice and Public Safety portion of the budget have been widely felt as well. At the very time the state is exploring ways to reduce the demand for prison beds, lawmakers cut funding for the Sentencing Services program, which helps to place appropriate, non-violent offenders in alternative community settings. Meanwhile, the state is closing several small rural prisons and moving those prisoners to larger new facilities where they will be "double-celled" in order to accommodate the crowding. In recent weeks, the Chief Justice of the NC Supreme Court stated publicly that the "workload of our state courts is mindboggling." The system is under strain from the state's hiring freeze, has eliminated several positions and is not able to make technology upgrades that could improve efficiency.

The projected FY 2010-11 and FY 2011-12 budget shortfalls

Because North Carolina adopts a budget every two years, there is technically a General Fund budget already in place for next year (FY 2010-11). As is custom, the governor and the General Assembly will adjust the revenue forecast and spending allotments of that budget. They are facing a difficult situation.

At the end of the current fiscal year it is likely that recurring revenues will be approximately $450 million behind projections. This figure would be roughly $270 million higher were it not for additional one-time corporate tax settlements initiated by the Department of Revenue. That means the projected revenue for

FIGURE 4

Projected FY 2010-11 General Fund Budget Gap	
ESTIMATED REVENUE SHORTFALL	
Estimated Baseline Revenue Shortfall	$986,574,000
Estimated loss of state Estate Tax	$85,000,000
Total Revenue Shortfall	**$1,071,574,000**
ANTICIPATED BUDGET PRESSURES	
Unanticipated Medicaid growth	$500,000,000
Unanticipated Community College Enrollment growth	$85,000,000
Total Budget Drivers	**$585,000,000**
PROJECTED FY10-11 BUDGET GAP	**$1,656,574,000**

SOURCE: NC BTC estimates

next year will have to be revised downward by this recurring $720 million revenue shortfall from FY 2009-10, plus any change to the projected growth rate.

The tentative budget in place for FY 2010-11 includes a 3.2 percent projected growth rate, but based on current economic conditions and projections it is likely this growth rate will be revised downward. For the purpose of this report, it is assumed that the growth rate for FY 2010-11 will be lowered to 2 percent, adding an additional $193 million to the revenue shortfall.

Another development that is likely to depress revenues next year is the changes to the federal estate tax. For the past several years North Carolina has levied a small estate tax on only those estates that were subject to the federal estate tax. The federal estate tax ended on December 31, 2009 because Congress failed to prevent a sunset of the tax that was built into the 2001 changes to the federal estate tax law. As such North Carolina has no state estate tax currently, and legislative fiscal staff have estimated that this will result in an additional $85 million revenue loss to the state in FY 2010-11, bringing the total downward revision required for next year to more than $1 billion.

In addition to the anticipated revenue shortfall, the state continues to experience increased demand, especially in areas like community colleges and Medicaid where the need rises when the economy falters. These two pressures alone add an estimated $591 million to the new budget shortfall for FY 2010-11, bringing the total anticipated budget shortfall to $1.6 billion. It is likely that Congress will act to extend the timeline for the additional Medicaid assistance to states that was part of the 2009 American Recovery and Reinvestment Act. This would fill in approximately $450 million to $500 million of the state's anticipated budget gap, bringing the total gap that state lawmakers must address to just over $1 billion, or 6 percent of the budget. (**Figure 4**)

State lawmakers are likely to face another large budget gap for FY 2011-12, similar in scope to the gap they faced in 2009. This is partly due to slow

FIGURE 5

Preliminary FY 2011-12 General Fund Budget Gap Forecast (Range)	
Projected 2011-12 State General Fund Budget Gap (if FY10-11 cut by $1 billion)	$3,346,599,232
Revenue growth rate needed to fill the projected gap	20%
Projected 2011-12 State General Fund Budget Gap (if no additional cuts to FY10-11 budget)	$4,376,599,232
Revenue growth rate needed to fill the projected gap	27%

NOTE: The temporary taxes and federal recovery dollars used to address the budget shortfalls in FY09-10 and FY10-11 expire before FY 2011-12. Without these resources and given that economic recovery is expected to be weak , NC will face another daunting state budget shortfall in FY 2011-12, similar in magnitude to the budget shortfall of FY 2009-10. This estimate assumes that the FY 2010-11 budget gap is addressed by enacting roughly $1 billion additional spending cuts and relying on an additional $450 million in Federal matching funds for Medicaid expenses.

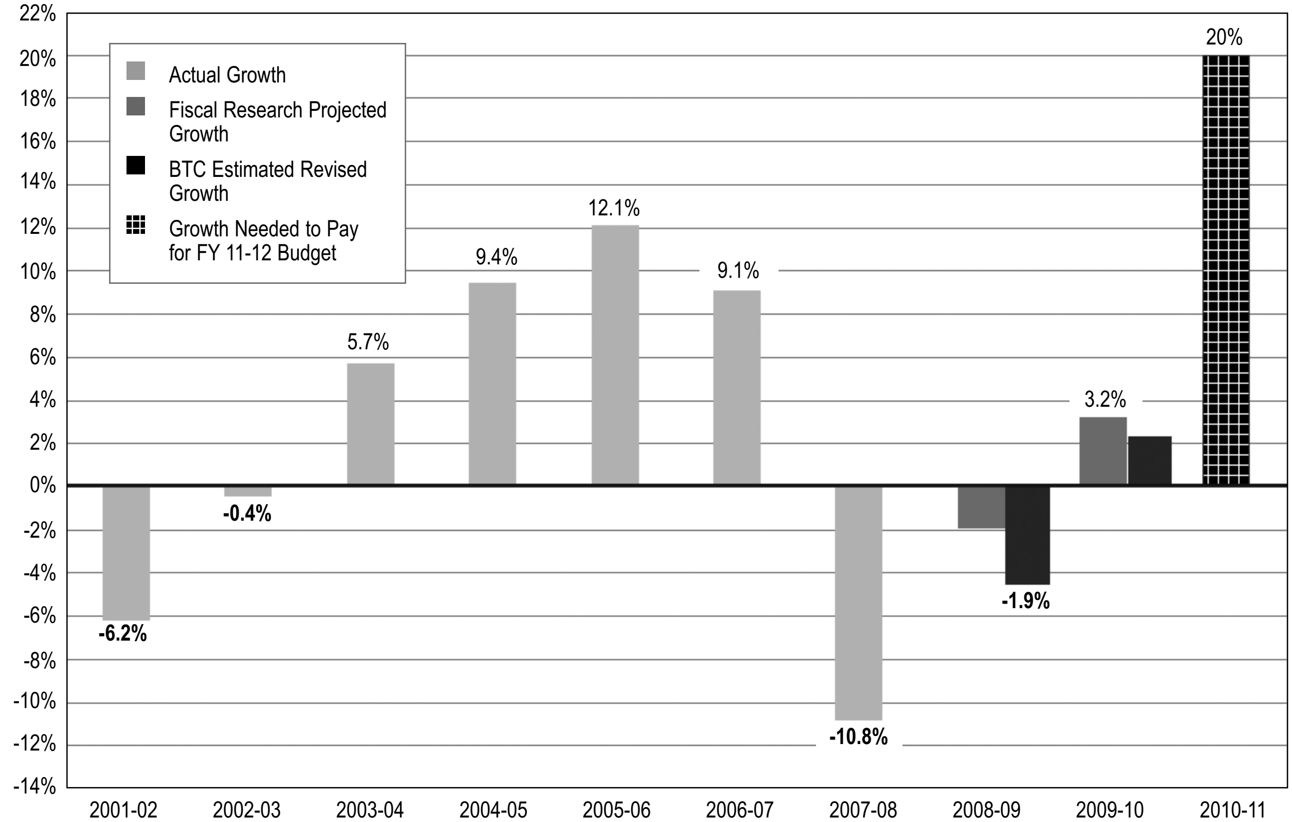
SOURCE: NC BTC estimates

economic growth projections and continued spending pressures, but the majority of the projected $3.3 billion to $4.4 billion budget shortfall (**Figure 5, p. 8**) is due to the expiration of the temporary state tax increase package enacted in 2009 ($1.3 billion in FY 2010-11) and nonrecurring federal aid ($1 billion to $1.5 billion in FY 2010-11). For revenue growth alone to cover this budget gap they would have to grow by more than 20 percent in one year. The highest revenue growth experienced in recent decades was 12 percent in FY 2007-08. (**Figure 6, p. 9**) This 12 percent growth rate was due to unsustainable economic activity that resulted from the effect the housing bubble on the national economy and is therefore, highly unlikely to be repeated. In the long-run the state should expect to see modest revenue growth that, at best, will grow with population and income gains.

It is difficult to pinpoint what economic conditions will be in 2011 and 2012. However one indication of the likelihood of a slow economic recovery is the latest employment projections from the Obama administration. The recent 2010 Economic Report of the President projected that the nation will not return to pre-recession levels of employment until at least 2018. These weak job growth projections along with a return to a more normal national savings rate will mean that consumer spending is also likely to recover slowly over several years. While most economists predict that North Carolina's economy will recover faster than the nation as a whole, it is worth noting that, after past recessions, fiscal recovery lagged behind economic recovery. Therefore, balancing the state budget will be a difficult task for the foreseeable future.

FIGURE 6

NC General Fund Baseline Revenue Growth (Past, Estimated, and Needed to Pay for FY11-12 Budget)



	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Growth	**-6.20%**	**-0.40%**	**5.70%**	**9.40%**	**12.10%**	**9.10%**	**-10.8%**	**-1.90%**	**3.20%**	**20%**

SOURCE: NC General Assembly Division of Fiscal Research and NC BTC estimates

Eight Strategies for Addressing the State's Ongoing Budget Gaps

The scope and long-term nature of the state's budget predicament will require state leaders to use every tool at their disposal. The following sections describe eight strategies that state lawmakers should employ to deal with the state's ongoing budget predicament.[2] **(see Figure 7, p.10 for a summary)**

***FINDING EFFICIENCIES* — Evaluate expenditures based on their goals and determine whether there are better ways to reach those goals.**

North Carolina has taken several steps in recent years to improve efficiency. Examples include instituting a managed care approach in publicly funded health care programs, creating a preferred drug list to control prescription drug costs in Medicaid, and using improved software technology to detect fraud in the state's Medicaid program. These types of initiatives free up resources to allow the state to continue to serve residents without affecting access to or the quality of those services. In 2009 the governor also established the Budget Reform and Accountability Commission (BRAC) to look for savings and efficiencies within state

FIGURE 7

Eight Strategies for Addressing the State's Ongoing Budget Gaps

1. FINDING EFFICIENCIES

Examples:

Gov.'s Budget Reform Commission - Ideas to Date:

Streamline purchasing and IT systems

Changes to Medicaid

ABC reform

Motorfleet management

Corrections Savings/Sentencing Reform

Recommendations of Performance Evaluation Division of NCGA

Recently Implemented

Preferred drug list strategy to control prescription drug costs

Improved software technology to detect fraud in the state's Medicaid program

2. USE ALL AVAILABLE RESOURCES

Examples:

Additional Federal Recovery dollars (extend FMAP match 6 months)

Use remaining Rainy Day funds

Drawdown additional funds

Tobacco settlement proceeds

Lottery or Highway Trust Fund

3. ELIMINATING INEFFECTIVE TAX EXPENDITURES

Examples:

Article 3J tax credits (formerly called "Bill Lee Act" credits)

Film Industry Credits

Sales tax exemption for electricity used by manufacturers

Sales and Use Tax Holiday

4. IMPROVING COLLECTIONS

Example:

Continue to support the Department of Revenue's successful tax compliance initiatives

5. INCREASE TAXES

Examples:

Mandatory Combined Reporting (i.e. Close Loopholes)

Expand Franchise Tax to include LL Bus Entities

Add warranties, repairs, etc to sales tax base

Convert privilege tax to sales tax

6. PRIORITIZATION WHEN MAKING CUTS

7. RETHINKING THE DISTRIBUTION OF STATE AND LOCAL RESPONSIBILITIES

8. PAYING CLOSE ATTENTION TO FUTURE IMPACT

Examples:

Don't over-rely on nonrecurring solutions (revenue increases or spending cuts)

Adopt revenue reforms that improve long-term adequacy

Preserve investments that generate long-term savings

government. Recent reports indicate that this commission is looking at, among other things, the state's motor fleet management system, Alcoholic Beverage Control system, and purchasing and information technology systems.

Over the past few years the General Assembly has also worked to improve the efficiency of state government services. In 2007 the General Assembly established its Program Evaluation Division, which has conducted myriad studies of state initiatives such as the state's vehicle inspection program, water and wastewater programs, oversight of the state's funding to nonprofits, and Medicaid funding of private duty nursing care. In addition to these studies the General Assembly also establishes study commissions to review programs and look for efficiencies. One current example of the General Assembly's efforts in this area is the Early Childhood Consolidation task force, which is in the process of reviewing proposals for improving coordination and streamlining the state's early childhood initiatives. This task force and other efficiency efforts are not meant to suggest that these areas of the state budget need fewer resources. In fact good arguments can be made that many areas of the budget, including early childhood education programs, should be expanded. Nonetheless, in an era of tight resources, the state should explore every opportunity to "do more with less."

Finally, there is an example of an outside organization working to help state government operate more efficiently. The Council of State Governments is currently evaluating ways North Carolina can reduce its spending on incarceration while simultaneously increasing public safety. This non-partisan, independent organization is expected to present state officials with recommendations for reforms that can result in short- and long-term savings. These recommendations could include changes to North Carolina's sentencing laws, the need to invest in community corrections programs and ways to reduce recidivism by helping ex-offenders successfully reintegrate back into communities.

***USING ALL AVAILABLE RESOURCES* — Employ reserves, rainy day funds and federal fiscal relief funds responsibly and wisely.**

North Carolina used most of its rainy day fund to address the $3.2 billion revenue shortfall of FY 2008-09. The state is also expected to use approximately $3.5 billion to $4 billion from FY 2008-09 through FY 2010-11 in federal aid made available through the American Recovery and Reinvestment Act of 2009. This is the amount that has and will offset cuts in the state's General Fund budget and does not include federal funds that went to non-General Fund efforts such as building weatherization and highway projects.

The state has intercepted money slated for other funds, such as corporate income tax revenues that were earmarked for public school construction, and put them into the General Fund instead. North Carolina may need to explore transferring money from other funds, including the state's annual tobacco settlement proceeds, which currently go to the Health and Wellness Trust Fund and the Golden Leaf Foundation and provide subsidies directly to farmers. Another example of resources raised by the state but that currently do not go into the budget are the lottery proceeds, half of which are designated for local school building costs, and car sales tax revenues that are directed to the Highway Trust

Fund for road maintenance efforts (in the past a portion of these funds were directed annually to the General Fund).

The state also has approximately $150 million remaining in its rainy day fund that could be used, although these would be nonrecurring funds and would arguably leave the state's reserves in an even more precarious position.

***ELIMINATING INEFFECTIVE TAX EXPENDITURES* — evaluate all special tax breaks (credits, exemptions, deductions, etc.) and eliminate those that have not achieved their goals.**

According to the latest edition of the North Carolina Department of Revenue's biennial Tax Expenditure Report, the state is forgoing $5.8 billion in tax revenue in FY 2009-10 because of the hundreds of special tax breaks created over the past several decades. Unlike on-budget spending for agencies and programs, this type of 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 stated goals (in the rare instance they even have stated goals).

One example of a recent effort to evaluate tax expenditures is the Joint Select Committee on Business Incentives, established by the General Assembly in 2008. This committee hired researchers at UNC-Chapel Hill's Kenan-Flagler Business School to evaluate the state's portfolio of economic development incentives. In particular, this study looked at the effectiveness of the Article 3J tax credits, which allow businesses to claim tax credits for certain types of investments (job creation, capital investments, etc.). The study found that "only 57.46 percent of companies receiving a Lee Act tax credit had a positive growth rate (i.e., more employees) in 2006 than they did in 1996." In addition, "Over 41 percent of the companies had a declining growth rate leading to fewer employees in 2006 than the business had in 1996." The analysis showed that companies that receive tax credits for research and development have stronger job growth than other companies, while companies that receive credits for capital investment actually experience job declines, on average.

There are countless other examples of costly tax preferences that the state has established over years that have not been evaluated. These include initiatives such as the state's sales tax holidays and the recent move to exempt manufacturers from paying sales tax on electricity purchases. The vast majority of tax spending is never subjected to the type of rigorous analysis that was conducted of the Article 3J credits, even though doing so might identify wasted resources and give the state an opportunity to redirect those resources to more effective strategies.

***IMPROVING TAX COLLECTIONS* — Aggressively seek taxes due that are not being paid.**

Over the past several years the Department of Revenue has undertaken several initiatives aimed at increasing tax compliance. During the current fiscal year the department generated an additional $420 million in tax payments after it subjected several hundred corporate taxpayers to closer scrutiny of their tax liability to North Carolina. The original revenue target for this effort was only

$150 million, meaning that the department generated $270 million more than it originally projected. State lawmakers should look for ways to continue to support the Department of Revenue's tax compliance initiatives.

***INCREASING TAXES* — particularly those that have a more positive impact on the economy than spending cuts.**

North Carolina is one of 10 states that have raised revenues by at least 5 percent as part of its actions to close the FY 2009-10 budget gap. This tax package, which is expected to generate $1.3 billion in FY 2010-11, consisted of a one-percent increase in the sales tax rate, a temporary surcharge on personal and corporate income tax payments, and small increases in excise taxes. 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.

There were several revenue-raising proposals that were considered but not enacted in 2009 that could be part of a balanced approach to addressing the FY 2010-11 budget shortfall. These include closing corporate tax loopholes ($30 million), expanding the franchise tax to limited liability businesses ($65 million), expanding the sales tax base to include warranties and repairs to real property ($224 million), and converting the entertainment privilege tax to a retail sales tax ($32 million).

***PRIORITIZING WHEN MAKING CUTS* — Make careful decisions based on goals and effectiveness when budgets must be cut.**

Even if all of the aforementioned approaches were enacted, the state's budget crunch is severe enough that cuts to state services still would be required. The majority of the budget reductions made in 2009 were unspecified; they were implemented as reduction targets that administrators had to meet. The largest of these was the $500 million unspecified reduction to the Medicaid program and the local flexibility reduction required of school districts.

Rather than taking an across-the-board or discretionary approach to budget reductions, 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 and other states.

North Carolina has attempted to improve the transparency and accountability of its budget process in recent years. The governor has begun collecting and reporting detailed performance data by agency and program in her proposed biennial budget that is sent to lawmakers, but legislators have yet to take full advantage of this information in their deliberations. The General Assembly has implemented a limited version of "zero-based budgeting" by selecting certain programs each year and subjecting them to a performance review before they can be included in the continuation budget. So far, however, the decisions about which programs are targeted has been questionable and most of the programs reviewed to date are small community-corrections programs. If the state is going to fully utilize this budget tool, lawmakers will have to be more transparent about how certain programs are targeted for review and begin reviewing other areas of the budget as well.

***RETHINKING 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 that the state take steps to redistribute the responsibilities between state and local governments. One recommendation, that the state assume the county's portion of Medicaid costs, has already been implemented. The commission recommended that the state continue to evaluate the distribution of duties and specifically mentioned elections responsibilities as another area to explore.

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. Unfortunately there are instances of the state usurping local revenues without rescinding any programmatic responsibilities. For example, in the FY 2009-10 budget, the state eliminated the practice of earmarking a portion of corporate income tax revenues to the public school building capital fund, which is distributed to local school districts. Some analysts have suggested that local authorities, particularly larger municipalities, be given greater authority over local roads, but this would also require more flexible local taxing authority. Another way to help local governments address their equally challenging budget deficits would be 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.

Another example of a recent effort to rethink state-local responsibilities is the budget reduction proposal from 2009 (that ultimately did not pass) that would have eliminated the additional administrative support the state provides to counties that maintain multiple school districts. Proponents of this change argued that if local elected officials and residents want to maintain multiple school districts, the local taxpayers should be responsible for the additional administrative costs. Likewise, some analysts have questioned the need for the state to continue to operate 115 separate school districts and have suggested that some districts, particularly in rural areas with small student populations, could be consolidated. These decisions are not easy to make in the short term, but they are important to dealing with future shortfalls, including the looming FY 2011-12 budget gap.

***PAYING CLOSE ATTENTION TO FUTURE IMPACT* — Don't create future messes when dealing with today's problems.**

Because the state's budget predicament is likely to continue for some time, it is important that state policymakers not make future deficits worse by over-relying on short-term solutions such as one-time spending cuts and one-time revenues. In addition, lawmakers should avoid cuts to areas of the state budget that result in long-term savings, including areas like early childhood development and community-based corrections programs.

Finally, the state must take steps, sooner rather than later, to improve the revenue system to reduce volatility and improve long-term adequacy of revenues. The fact that North Carolina's tax system is outdated exacerbated the decline in revenues caused by the recession. For the past several months the Senate and House finance committees have been meeting in joint session to review the state's current revenue structure and evaluate proposals to make the system more fair, adequate and stable. It is vital that state policymakers not abandon these efforts.

Conclusion

North Carolina's leaders have and continue to demonstrate their willingness to work hard and make the tough decisions necessary to address the state's deep and prolonged budget crisis in ways that recognize the short- and long-term benefits of maintaining healthy public structures. For the foreseeable future they will need to continue this level of work effort by studying every possible solution, no matter how small, and making bold decisions that will set North Carolina on a path toward economic growth and fiscal sustainability.

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1 Elizabeth McNichol and Nicholas Johnson, "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery." Washington, DC: Center on Budget and Policy Priorities, February 2010. Available at: http://www.cbpp.org/cms/index.cfm?fa=view&id=711

2 Seven of the eight strategies were adapted from a report by Iris Lav of the Center on Budget and Policy Priorities: " A Balanced Approach to Closing State Deficits." February 2010. Available at: http://www.cbpp.org/cms/index.cfm?fa=view&id=3084

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