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POLICY PAPER

A TAXPAYER'S BILL OF RIGHTS (TABOR) FOR NORTH CAROLINA

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NOVEMBER 2004

EXECUTIVE SUMMARY

Gov. Mike Easley has proposed a tax and expenditure limit for North Carolina.[1] Unfortunately, Easley's well-intentioned proposal will not effectively constrain the growth of state spending and stabilize the North Carolina budget over the long term. This paper proposes a more effective tax and expenditure limit for North Carolina.

A taxpayer's bill of rights or TABOR amendment, modeled after a similar amendment in Colorado, will help North Carolina manage the size of its government. In 1992, Colorado voters passed TABOR by citizen initiative, amending the state constitution to 1) limit the growth in state revenue and spending to the growth of population plus inflation, 2) ensure surplus revenue above this amount is returned to taxpayers, and 3) require voter approval for tax increases or any weakening of the amendment's limits. As a result, Colorado taxpayers have received more than $3 billion in surplus revenue since 1992.

This paper examines how North Carolina would benefit from a similar taxpayer's bill of rights (TABOR) proposal. It begins with a thorough examination of recent trends in the North Carolina economy and the public sector as well as the state's current fiscal crisis.

Next, it outlines a TABOR proposal for North Carolina. Importantly, this includes identifying refinements and improvements on Colorado's TABOR – specifically, the creation of emergency and budget stabilization funds.

This paper simulates how a TABOR Amendment would have affected North Carolina's fiscal condition had it been implemented in 1995. In all, the TABOR proposal would have stabilized the budget cycle over the long-term while providing significant tax relief for taxpayers. Specifically, under TABOR, the state would have amassed a budget stabilization fund of $1.9 billion by 2000-01 that would have been used to offset the state's budget shortfall in 2001-02 caused by the national

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1 "Following Easley's Lead: Spending Caps Should be Tightened, Constitutional," Spotlight No. 228, *John Locke Foundation*, March 6, 2003.

recession. According to conservative assumptions, $1.4 billion would have been returned to taxpayers in the form of rebates or tax cuts. In addition, the state would currently have $400 million in an emergency fund and $1 billion a budget stabilization fund for use during economic slowdowns or unforeseen disasters.

While this paper suggests that a well-drafted taxpayer's bill of rights amendment would benefit taxpayers and the state's long-term fiscal condition, special interest groups have too much at stake to allow common-sense government constraint. Only when North Carolinians recognize the need to manage state spending will a TABOR amendment become a viable policy.

RATIONALE FOR A TAXPAYER'S BILL OF RIGHTS AMENDMENT IN NORTH CAROLINA

Tax and Expenditure Limits in the States[2]

Tax and expenditure limits are designed to address two problems: the increase in government revenues and spending relative to income in the long run; and the volatility of government revenues and spending over the business cycle.

Since World War II, the growth of government revenue and spending has outpaced the growth of income in most states. This is particularly true in states such as North Carolina that rely heavily on income tax revenues. Income taxes, especially progressive ones, have greater elasticity than other taxes. This means that when income rises, income tax revenues rise more rapidly than income. Similarly, when income falls, income tax revenues fall more rapidly than income.

A "ratchet up" of taxes and revenues often accompanies this volatility in income tax revenue over the business cycle. In periods of prosperity, because income is rising, governments tend to increase spending to match the increase in revenues. However, when income growth slows or a recession hits, and revenues fall, governments are reluctant to cut spending. As a result, there is pressure to increase taxes to offset the budget shortfall. Over time, this "ratchet up" effect results in increased government revenues and spending relative to private income.

A variety of different tax and expenditure limits have been introduced in the states. In total, 26 states have introduced such limits.[3] Recent studies show that the most effective of these tax and spending limits constrain the growth of government

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[2] Much of this discussion is drawn from Barry W. Poulson, "Tax and Spending Limits: Theory, Analysis, and Policy," Issue Paper 2-2004, *Independence Institute*, Golden, Colorado, January, 2004
[3] Ibid, p.2

revenue and spending to the sum of inflation and population growth. This type of tax and expenditure limit has been introduced in four states: California, Colorado, Missouri, and Washington. In all four states, the tax limit has at various points both constrained the growth of government and stabilized the budget over the business cycle. In recent years, California, Missouri, and Washington have suspended their tax and expenditure limits. In Colorado, however, the taxpayer's bill of rights amendment (TABOR) remains the most effective tax and spending limit in the country.[4]

A Taxpayer's Bill of Rights (TABOR)

The TABOR Amendment is a constitutional amendment that limits the growth of revenue and expenditure to the sum of inflation and population growth. The amendment also requires that surplus revenue be returned to taxpayers through tax rebates or cuts. In addition, voter approval is needed to approve any increase in taxes or debt.

Colorado voters approved a taxpayer's bill of rights in 1992 by a 54 percent margin.[5] Since then, more than $3 billion in surplus revenues has been returned to taxpayers in the form of rebates or tax reductions. A recent survey found that more than 60 percent of Coloradoans support TABOR – more than when it was passed a decade ago.

The TABOR Amendment has come under fire in Colorado because of the so-called "ratchet down" effect.[6] TABOR limits the growth of revenue to the sum of inflation and population growth. The limit applies to the previous limit, or to actual revenue, whichever is lower. When revenue falls in a recession, this sets a lower base against which the limit is applied. When revenue increases above the limit, surplus revenue must be rebated to taxpayers. As Colorado has recovered from the recent recession, revenue is projected to increase above the TABOR limit, requiring taxpayer rebates. The criticism is that these taxpayer rebates may be paid even though revenue has not yet recovered to the pre-recession level.

Efforts are underway in Colorado to correct this "ratchet down" effect of the TABOR Amendment. One proposal would hold the TABOR limit constant when there is a fall in revenue, and then trigger the limit once revenue has recovered to pre-recession levels. The proposal would also create a budget stabilization fund linked to the TABOR Amendment. In periods of economic growth, some surplus revenue could be set aside in a budget stabilization fund and then used to offset rev-

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4 Ibid, pp.10-16.

5 Barry W. Poulson, "Colorado's TABOR Amendment: Past Trends and Future Prospects," *Americans for Prosperity Foundation*, Washington, D.C., July 2004.

6 Ibid.

enue shortfalls in periods of recession. This modified TABOR Amendment is the basis for a model tax and spending limit recently adopted by the American Legislative Exchange Council.[7] It also will be considered here as a model for a taxpayer's bill of rights in North Carolina.

North Carolina Loses Its Competitive Edge in Economic Growth and Development

To understand the rationale for a taxpayer's bill of rights amendment in North Carolina, we need to explore some trends in the state economy. Income per capita in North Carolina has been significantly below the national average. North Carolina currently ranks 37th in the nation in the level of income per capita.[8]

Over much of the post World War II period, the growth of per capita income in North Carolina has exceeded the national average. In 1969, per capita income in North Carolina was less than 80 percent of the national average. In 1997, it was about 93 percent of that average.[9]

Recent evidence suggests, however, that North Carolina is an underachiever in economic growth. Since 1997, the rate of growth of income per capita in North Carolina has been below the national average. As a result, per capita income in North Carolina has fallen back below 90 percent of national per capita income. It's significant that this relative slowdown in economic growth occurred before the recession hit in 2001. Last year the growth of per capita income in North Carolina was only 1.6 percent, ranking among the lowest quintile in the nation. Every state in the Southeast had a higher rate of growth than North Carolina that year.[10]

North Carolina's slow pace in economic growth has resulted in underachievement in job creation. Throughout the 1990s, the unemployment rate in North Carolina was consistently below the national average. Over the last five years, the state's unemployment has risen significantly above the national average. The latest data for June of this year show unemployment at 5.5 percent, slightly below the national average of 5.6 percent. Last year the civilian labor force in North Carolina declined by almost 20,000 workers, going from a state with full employment and a rapidly growing labor force, to one of high unemployment and a shrinking labor force.[11]

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7 Ibid, passim.
8 U.S. Census Bureau.
9 Ibid.
10 Ibid.
11 U.S. Bureau of Labor statistics.

Spreading the Blame for the Loss in North Carolina's Competitive Edge

North Carolina's sluggish economic growth during recent years clearly reflects factors that have contributed to the recession and slower growth in the national economy. The military conflict in the Middle East, terrorist threats, and higher energy prices are major threats to the state's economic recovery, according to the North Carolina General Assembly's Financial Research Division.[12] In addition, it identifies other factors that have contributed to the economic downturn which are unique to North Carolina.

For example, the division says a disproportionate share of North Carolina's output and employment is accounted for by manufacturing. The share of manufacturing in gross state product in North Carolina is 23 percent, compared to 17 percent in the United States. The share of nonagricultural employment in manufacturing in North Carolina is 18 percent, compared to 12 percent for the country as a whole.[13]

Manufacturing employment in North Carolina began a steady decline in the mid-1990s, well before the current recession. The rate of decline has accelerated since the recession, reaching a peak of 8.8 percent in 2002. The hardest hit was the textile and apparel sectors, with job losses of 15 percent per year. The state Fiscal Research Division cites the North American Free Trade Agreement (NAFTA), as well as weakening market conditions, as sources of the slowdown in traditional manufacturing industries such as textiles and apparel, furniture, and tobacco.[14]

Over much of the 1990s, strong employment growth in nontraditional industries more than offset the job losses in the traditional manufacturing industries. Employment growth was particularly strong in the finance and service sectors, but job growth in the latter sectors also began to slow down well before the recession.[15]

A Discontinuous Increase in the Tax Burden

Since the slowdown in output and employment growth is evident prior to the recession, it is likely that other factors unique to the North Carolina economy contributed to this decline. One such factor has been the increased fiscal burdens imposed on North Carolina business and citizens – otherwise known as the tax burden.

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[12] "Fiscal and Budgetary Actions: North Carolina Assembly 2003 session," *Fiscal Research Division of the North Carolina General Assembly*, Raleigh, North Carolina, July, 2004.
[13] Ibid.
[14] Ibid.
[15] Ibid.

Historically, North Carolina has been a low tax state compared to the rest of the nation, and this low tax burden contributed to a high rate of economic growth. However, recent trends toward higher rates of taxation have significantly increased the tax burden on North Carolinians, and contributed to the weakening of the economy.[16]

In 1970, North Carolina's state and local tax burden as a percent of income was 8.7 percent, ranking among the low tax states at 37th in the nation. Over the last three decades, increased tax rates have raised state/local taxes as a share of income, reaching a peak of 10.1 percent in 2001. In the current recession, as income tax revenues have fallen that share has also fallen, reaching 9.7 percent in 2004. As income recovers from the recession, however, that share will again increase. North Carolina has shifted from among the low tax states to about average compared to other states, ranking between 28th and 31st in recent years.[17]

The explanation for the increased tax burden over the last three decades is clear. In periods of prosperity, when revenues were increasing, state spending increased to match the growth in revenue. In periods of recession, the state responded to revenue shortfalls by increasing taxes to offset the deficit and balance the budget. This "ratcheting up" of taxes and spending over the business cycle has continued in the recent recession.

One of the reasons for this "ratcheting up" of taxes and spending over the business cycle is that North Carolina relies on the income tax for more than half of total revenue. With a graduated rate structure, the state income tax is highly progressive. When income is increasing, income tax revenues increase more rapidly than income. When income falls, income tax revenues fall more rapidly.

In some years in the mid1990s, income tax revenues were increasing at double-digit rates. When the recession hit, income tax revenues fell sharply. Over the last three years, the cumulative decrease in personal income tax revenues was over 8 percent. The decrease in corporate income tax revenues was more than 40 percent. As they have in the past, North Carolina legislators have responded to these revenue shortfalls by increasing taxes to balance the budget.[18]

Even before the recession hit, North Carolina had one of the most expensive personal income tax rates in the country, with a graduated rate structure from 6 percent to 7.75 percent. In response to the revenue shortfall, the state added an even higher rate of 8.25 percent kicking in at an income of $120,000. That's the eighth highest income tax rate in the nation.[19]

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16 "The Facts on North Carolina's Tax Climate," *The Tax Foundation*, Washington, D.C., July, 13, 2004.
17 Ibid.
18 Op. Cit. "Fiscal and Budgetary Actions"
19 Op. Cit. "The Facts on North Carolina's Tax Climate"

The corporate income tax rate in North Carolina is a flat 6.9 percent, which ranks 18th lowest among the states that levy corporate income taxes.[20]

North Carolina's state and local sales tax rate is 4.5 percent, just below the national average of 5 percent. However, state lawmakers recently raised the statewide sales tax rate from 6 percent to 7 percent to help close the budget gap.[21]

Compared to other states, North Carolina has relatively high excise taxes on gasoline and beer, and relatively low excise taxes on cigarettes. In response to the recent revenue shortfalls, the state has increased taxes on business, health insurance, satellite television, and other consumer goods. Legislators have even targeted candy for higher excise taxes. It has been estimated that these increased taxes will cost consumers in excess of $1 billion per year.[22]

North Carolina is one of 38 states that collect property taxes at both the state and local level. While the state's property taxes are low compared to other states, many cities and counties have boosted property taxes in response to revenue shortfalls in the current recession.[23]

North Carolina currently ranks among the top states in the rate of increase in taxes. The sharp increase in tax rates has been obscured by the fall in income tax revenues. But as the economy recovers, income tax revenues will again increase more rapidly than income, pushing the total state and local tax burden above 10 percent of income. It is this expected tax burden--more than the actual tax burden--that acts as a deterrent to economic growth and development in the state.

The Tax Foundation ranks the business climate in each state based upon how friendly the tax climate is to business.[24] Currently, North Carolina's business climate ranks at 24th in the nation. However, recent increases in the tax burden have begun shifting North Carolina to join the states with less friendly business climates. As businesses take investment and jobs to other states and other nations, this will contribute to further retardation in economic growth in North Carolina.

A Discontinuous Increase in the Debt Burden

When North Carolina passed a constitutional provision requiring voter approval for any new debt, the expectation was that this would constrain the debt accumulated by the state. That expectation has not been met. After several decades

20 Ibid.
21 Ibid.
22 Ibid.
23 Ibid.
24 Ibid.

in which total state debt was relatively stable, beginning in the mid-1990s, total debt has increased at an unprecedented rate. Current projections show that in the 2004-2005 fiscal year, total state debt will double from $4 billion to $8 billion. Debt service is also projected to double, from $296 million in 2003 to $587 million in 2006. This doubling of debt and debt service has fallen below the radar in terms of public awareness in North Carolina. To understand why, we need to explore the "fiscal sleight of hand" performed by state legislators.[26]

Since the mid-1990s, North Carolina voters have approved billions of dollars in new debt because legislators promised that the new obligations would not result in an increase in taxes. Through referendum, voters approved the following bonded indebtedness: $1.8 billion for school construction in 1996; $1 billion for water, sewer, and gas projects in 1998; $3.1 billion for college and university construction in 2000. The promise that this debt could be financed without raising taxes was not met. Debt service doubled by the end of the decade, and is projected to quadruple by 2006. The cost of this debt accounts for a significant share of the tax increases discussed earlier in this report. Recent estimates are that about one third of the tax increases are required just to service this debt.

Recognizing that citizens may have reached their limit in approving general obligation bonds, in recent years legislators have deftly performed another "sleight of hand" in issuing debt. They have increasingly relied on certificates of participation that do not require voter approval.

In June, the governor announced plans to issue $5 billion in bonds for capital improvements between now and 2008. At the same time, the General Assembly proposed a $3 billion bond issue for higher education. These bonds would be limited obligation bonds, which would be repaid out of state appropriations, with the buildings used as collateral. Because the taxing power of the states is not pledged behind these bonds, the courts have interpreted the constitution as not requiring voter approval. In reality, the state would never allow default on these bonds because that would undermine the state's credit rating and preclude any future bond issues.[27]

The bottom line is that citizens will have no say in the issuance of these certificates of participation. That will be left to the discretion of the Legislature. What citizens should expect is unconstrained growth in debt issue and in the taxes required to service that debt.

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25 Data from the North Carolina Office of the State Treasurer and Office of State Budget and Management.
26 "Let the Public Vote on Debt," Spotlight No. 243 *John Locke Foundation*, June 14, 2004
27 Ibid.

The Revenue Shortfall

There is universal agreement that North Carolina is currently experiencing a fiscal crisis. But there is disagreement regarding the nature and causes of the crisis.

At one level of analysis, the fiscal crisis is identified with revenue shortfalls that have accompanied the recent recession. Total state revenue decreased 6.2 percent when the recession hit, but has recovered since then. Current projects show revenue increasing 0.3 percent this year and 4.0 percent and 5.9 percent in the next two fiscal years.[28]

It is important to distinguish between these changes in actual revenue, and in budgeted revenue. The state Fiscal Research Division budgeted revenue growth of 1.9 percent in the current fiscal year. The difference between this budgeted revenue growth and actual revenue growth is defined as the revenue shortfall. Thus, even though actual revenue will increase in the current fiscal year, it is estimated that the state will experience a revenue shortfall of $221 million.[29]

A Structural Deficit in the State Budget

An alternative perspective on the current fiscal crisis is that North Carolina suffers from a long-run structural deficit because the revenue generated by the state is inadequate to finance government services.

As noted earlier, it's difficult to argue that this structural deficit is due to a lack of revenue. Over the last three decades, state and local revenue has increased significantly. In the 1990s, state revenue grew more than 7 percent per year, outpacing the growth in per capita income, which was 6.6 percent per year.

State revenues have exhibited volatility over the business cycle, decreasing in the current recession. But as the economy recovers, state revenue will again increase faster than income. Heavy reliance on income tax revenues will continue to expose the state to volatility in tax revenues, but it is not true that the fiscal crisis in North Carolina is due to a lack of revenue in the long run.

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28 Op. Cit. "Fiscal and Budgetary Actions"
29 Ibid.

Unconstrained Growth in State Spending

The fatal flaw underlying the current fiscal crises in North Carolina is unconstrained growth in state spending. State spending increased in the 1990s more rapidly than the growth in state revenues, in some years increasing at double-digit rates. When the recession hit, the state attempted to sustain this higher level of spending despite the fall in revenues. Over the last three years, state spending has been virtually unchanged. Next year state spending is projected to grow 7 percent, again outpacing the growth in revenue.[30]

The long run structural deficit in the state budget is due not to a lack of revenue, but rather to unconstrained growth in spending. In periods of rapid growth, such as the 1990s, this structural deficit is obscured by the rapid growth in revenue. But when recession hits, as it did three years ago, the structural deficit emerges when revenue falls and the state cannot sustain the higher levels of spending. With current fiscal policies, North Carolina will continue to experience a structural deficit punctuated by periods of fiscal crisis.

To explain the unconstrained growth in state spending, it is helpful to focus on the major expenditure items in the state budget: education, Medicaid, and debt service.

Education expenditures account for more than half of the state budget. Over the last decade, general fund expenditures for education increased 66 percent. Per capita expenditures for public education, K-12, are about average compared to other states while per capita expenditures for higher education is significantly above that in other states.[31]

For many years, the education lobby has argued that increased spending for K-12 public education is required to improve student performance. That view is increasingly challenged, as recent studies have measured student performance and state spending on education. In measures such as student test scores and graduation rates, it's not clear that education has delivered on these promises.

North Carolinians also must ask if they can continue to afford one of the most expensive systems of higher education in the country. Tuition at North Carolina's community colleges and universities is among the lowest in the country. This is only made possible by massive state subsidies. This means that all taxpayers in North Carolina – including low- income families – pay taxes to subsidize higher education. A disproportionate share of students, professors, and administrators are among the middle- and upper- income families. Such income transfers through subsidies to higher education are neither efficient nor equitable.[32]

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30 Ibid.
31 "Spending Growth Surges," Spotlight No. 244, John Locke Foundation, June 23, 2004.
32 Ibid.

Similar questions can be raised regarding Medicaid spending in North Carolina. Medicaid spending increased 224 percent over the last decade, more than any other component of state spending. At $2.2 billion, Medicaid spending now accounts for almost one fourth of the state budget, and that share is projected to grow in coming years. North Carolina spends significantly more per person on Medicaid than comparable states in the Southeast.[33]

The explanation for the unconstrained growth in Medicaid spending is a generous eligibility policy and benefits package. The benefits package under Medicaid is more generous than the average private health plan. North Carolina provides free health care and pre-school programs for families, some with incomes well above the poverty line. It is unclear whether this generous Medicaid program is delivering better health care to citizens than what is currently available in other states that have attempted to reign in the rising cost of the Medicaid program.[34]

Perhaps the most surprising factor driving state spending growth in North Carolina is the increased cost of debt service. As noted earlier, debt service doubled in the current fiscal year and is projected to double in the next two fiscal years. Debt service will become the most rapidly growing component of state spending. Because much of this debt is incurred for education construction, it deserves more scrutiny than has occurred heretofore. The John Locke Foundation has challenged the need for the significant increase in debt to finance construction in higher education. It argues that the capital construction and maintenance needs in higher education can be met through the normal budget process, rather than through issuance of more bonded indebtedness.[35]

A TAXPAYER'S BILL OF RIGHTS AMENDMENT FOR NORTH CAROLINA

Designing an Amendment for North Carolina

The fatal flaw in North Carolina's fiscal policies is unconstrained, unmanaged growth in spending that has created a structural deficit in the state budget. Even with the recent recovery from the current recession, revenue growth will be insufficient to fund the spending projected under current policies. Solving North Carolina's fiscal crisis in the long run requires the elimination of this structural deficit. The most effective way to constrain spending is to incorporate a taxpayer's bill of rights (TABOR) amendment in the constitution.[36]

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33 Ibid.
34 Ibid.
35 "Public Debt, Public Vote," Spotlight No. 234, *John Locke Foundation*, June 10, 2003.
36 The discussion in this section is based on Op. Cit. Barry W. Poulson, "Tax and Spending Limits: Theory, Analysis, and Policy" and Op. Cit. Poulson, "Colorado's TABOR Amendment: Past trends and Future Prospects."

A TABOR Amendment could be designed to both constrain the growth of spending and stabilize the budget over the business cycle. Colorado's TABOR Amendment has several essential features:

- It is a constitutional rather than a statutory tax and spending limit.
- It requires voter approval for any increase in taxes or debt.
- It limits the growth of revenue and spending to the sum of inflation and population growth.
- It requires that surplus revenue be returned to taxpayers through tax rebates/cuts.

An important refinement of Colorado's TABOR Amendment is the inclusion of an emergency fund and a budget stabilization fund. In periods of prosperity, when revenue growth exceeds the TABOR limit, surplus revenue should be allocated to an emergency fund and a budget stabilization fund. When the cap on these funds is reached, surplus revenue is then returned to taxpayers through tax rebates/cuts. When the economy enters a recession, money is transferred from the budget stabilization fund to the general fund to offset revenue shortfalls and stabilize the budget.

Distinguishing a TABOR Amendment from Gov. Easley's Proposed Tax and Spending Limit

It's important to distinguish between the proposed TABOR Amendment and the tax and spending limit proposed by Easley.[37] There are a number of reasons why the TABOR Amendment would be more effective in constraining the growth of spending and stabilizing the budget than the Easley proposal.

First, Easley has proposed a statutory rather than a constitutional tax and spending limit. Statutory limits have proven to be less effective because they are so easily circumvented and suspended by the Legislature. In other states, special interest groups have often succeeded in exempting expenditures for their interest group from the spending caps.

Second, Easley would limit general fund spending to a rolling 10 year moving average in the state's personal income. This is a less stringent cap than the TABOR limit. It would essentially lock in the current levels of revenue and spending as a share of state income. It would also be less effective in stabilizing the budget over the business cycle.

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37 Op. Cit. "Follow Easley's Lead."

Third, the Easley proposal does not require voter approval of tax and debt increases. This has proven to be one of the most popular and effective provisions of the TABOR Amendment in constraining the growth of government.

Finally, the Easley proposal makes no provision for returning surplus revenue to taxpayers. If surplus revenue is simply returned to the general fund, the limit will not effectively constrain the growth of government. If surplus revenue is allocated to North Carolina's Rainy Day Fund, this will also result in unconstrained growth in spending. There are few restrictions on the use of that fund.

This is why this proposal replaces the rainy day fund with an emergency fund and a budget stabilization fund with clear and explicit guidelines on the use of those funds.

Simulating a TABOR Amendment in North Carolina

The following is a simulation of an amendment in North Carolina. Table 1 shows the actual trend of revenue and expenditures over the last decade. Revenue increased rapidly in the 1990s, and then fell over the last three years, despite tax increases. Revenue is projected to recover above the pre-recession level in the next fiscal year.

Table 1 – Actual Expenditures and Revenue for North Carolina (in millions of dollars)

Fiscal Year	Expenditures	Revenue
1995-96	10,031.6	10,254.8
1996-97	10,607.6	11,193.1
1997-98	11,585.8	12,198.1
1998-99	13,111.6	13,406.9
1999-00	14,237.7	13,949.6
2000-01	14,050.1	14,595.5
2001-02	14,530.3	13,711.8
2002-03	14,355.1	13,758.8
2003-04	14,775.1	14,319.9
2004-05	15,849.8	15,169.8

Sources: Expenditures and Revenue: North Carolina State Budget Office; Fiscal Research Division of the North Carolina General Assembly.

Expenditures increased more rapidly than revenue in the 1990s, in some years growing at double- digit rates. With the onset of recession, expenditures decreased but have since recovered above the pre-recession level.

In Table 2, a taxpayer's bills of rights (TABOR) amendment is simulated for the North Carolina economy. Specifically, it examines how a TABOR Amendment would have impacted North Carolina had it been implemented in 1995-96. This simulation makes several simplifying assumptions. The TABOR limit is defined as the sum of inflation plus population growth. The limit is applied to actual revenues or the previous limit, whichever is lower. This limit constrains the growth in revenue the state can keep and spend each year. The assumption is that surplus revenue is rebated to taxpayers.

Beginning in fiscal year 1996-97, actual revenue exceeds the TABOR limit, resulting in surplus revenue, which is rebated to taxpayers. Surplus revenue is generated until fiscal year 2002-03 when actual revenue falls below the TABOR limit. The TABOR limit then applies to actual revenue. In FY 2004-05, revenue is again projected to exceed the TABOR limit generating surplus revenue. Over this decade, a total $7.3 billion in surplus revenue would be rebated to taxpayers.

Table 2. Simulating a TABOR Limit for North Carolina (in millions of dollars)

Fiscal Year	Revenue	TABOR Limit	TABOR Surplus
1995-96	10,254.8	10,254.8	
1996-97	11,193.1	10,777.8	415.3
1997-98	12,198.1	11,295.1	903.0
1998-99	13,406.9	11,859.9	1,547.0
1999-00	13,949.6	12,310.6	1,639.0
2000-01	14,595.5	12,729.1	1,866.4
2001-02	13,711.8	13,174.7	537.1
2002-03	13,758.8	13,758.8	
2003-04	14,319.9	14,319.9	
2004-05	15,169.8	14,735.2	434.6

Sources: Expenditures and Revenue: North Carolina State Budget Office; Fiscal Research Division of the North Carolina General Assembly. TABOR Limit: Based on Census Bureau data for inflation and population growth, U.S. Census Bureau.

The criticism of the TABOR Amendment is that it is effective in constraining the growth of government, but not very effective in stabilizing the budget over the business cycle. Some would argue that TABOR actually exacerbates the revenue shortfalls in periods of recession. It is possible that surplus revenue is generated, requiring taxpayer rebates, before the economy has recovered from the recession. These are flaws addressed in refinements of the TABOR Amendment.

In Table 3, several of these refinements of the taxpayer's bill of rights amendment are incorporated and then simulated for the North Carolina economy. The

TABOR limit is linked to an emergency fund and a budget stabilization fund. This simulation assumes a cap of 3 percent of the TABOR limit on the emergency fund, and 15 percent of revenues on the budget stabilization fund.

Beginning in fiscal year 1996-97, surplus revenue is sufficient to fully support the emergency fund. In fiscal year 1996-97, when the cap on the emergency fund is reached, additional surplus revenue is allocated to the budget stabilization fund. In fiscal year 1998-99, the cap on the budget stabilization fund is reached. Additional surplus revenue is then allocated to tax cuts. This simulation assumes that the tax cuts offset the surplus revenue, and thus reduce the revenue available in the following fiscal year. Over the next three years, tax cuts reduce revenue by a total of $1.4 billion.

In fiscal year 2001-02, revenue falls below the TABOR limit, due in part to the tax cuts and the recession. When revenue falls below the amendment's limit, it's then held constant. The revenue shortfall in that year, $439 million, is offset by transfers from the budget stabilization fund. Over the next three fiscal years, $1 billion in revenue shortfall is offset by these transfers from the budget stabilization fund.

In fiscal year 2004-05, revenue again exceeds the TABOR limit triggering surplus revenue that is allocated to the emergency fund and the budget stabilization fund.

Table 3. Simulating a TABOR Limit Linked to an Emergency Fund and a Budget Stabilization Fund for North Carolina (in millions of dollars)

Fiscal Year	Revenue	TABOR Limit	TABOR Surplus	Emergency Fund	Budget Stabilization Fund	Tax Rebates/ Cuts
1995-96	10,254.8	10,254.8				
1996-97	11,193.1	10,777.8	415.3	323.3	92.0	
1997-98	12,198.1	11,295.1	903.0	338.9	656.1	
1998-99	13,406.9	11,859.9	1,547.0	355.8	1,779.0	68.3
1999-00	13,881.3	12,310.6	1,570.7	369.3	1,846.6	1133.8
2000-01	13,393.4	12,729.1	664.3	381.9	1,909.4	219.6
2001-02	12,290.1	12,729.1	(439.0)	381.9	1,470.4	
2002-03	12,337.1	12,729.1	(392.0)	381.9	1,078.4	
2003-04	12,892.2	13,098.2	(206.0)	381.9	872.4	
2004-05	13,748.1	13,517.3	230.8	405.5	1,079.6	

Sources: Expenditures and Revenue: North Carolina State Budget Office; Fiscal Research Division of the North Carolina General Assembly. TABOR Limit: Based on Census Bureau data for inflation and population growth, U.S. Census Bureau.

This simulation experiment is a static analysis. It assumes that the taxpayer's bill of rights limit would not have changed the actual revenue generated by the tax system. In fact, this is a conservative assumption.

Returning surplus revenue to taxpayers would certainly have stimulated economic activity, generating higher levels of income and revenue. Permanent tax cuts would have had an even greater stimulus to economic activity than tax rebates. There is a substantial body of economics literature showing that taxpayers are more responsive to permanent, rather than temporary, reductions in tax rates.

Indeed, the major argument for tax cuts from a supply side perspective is the stimulus this gives to economic growth. This argument is particularly relevant to North Carolina because of the relatively high marginal rate of income taxation. Offsetting the surplus revenue by reducing these high marginal income tax rates would have provided a significant stimulus to economic growth over this period. The higher revenues generated by that economic growth would have offset reductions in revenue resulting from the lower tax rates.

In the simulation, when we assume that surplus revenue is offset with permanent tax cuts, expenditures would be reduced to match the revenue that the state is allowed to keep and spend under the tax limit. This, of course, is required by the balanced budget provisions of North Carolina's Constitution. Thus the TABOR limit is both revenue and spending limit.

Once the recession hits in fiscal year 2001-02, the revenue limit is held constant until revenue recovers to the pre-recession level. Even though actual revenue falls during the recession the state is permitted to spend up to the revenue limit. Further, the assumption is that money from the budget stabilization fund is used to offset the revenue shortfall. What this means is that while revenue is falling during the recession, state spending is maintained.

In this simulation, the share of state revenue and spending in state income would have decreased from 6.4 percent to 5.5 percent.[38] However, because transfers from the budget stabilization fund are used to sustain spending during the recession, the share of spending in personal income remains relatively stable during the recession.

Thus, there are two reasons why the TABOR Amendment stabilizes the budget over the business cycle. With lower levels of revenue and spending it is easier to adjust spending to balance the budget when the economy enters a recession. Further, access to a budget stabilization fund allows the state to sustain the level of spending in the face of declining revenues.

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[38] Based on U.S. Census Bureau estimates of personal income and projections of income growth in North Carolina.

The design of a TABOR Amendment for North Carolina could be modified to incorporate different assumptions than those made in this simulation experiment. The TABOR Amendment can be designed to achieve any desired trade-off between constraining the growth of government and stabilizing the budget over the business cycle.

For example, if the emphasis is on constraining the growth of government, then a smaller share of surplus revenue could be allocated to the budget stabilization fund, and a larger share allocated to tax rebates and cuts. If the emphasis is on stabilizing the budget over the business cycle, then a larger share of surplus revenue could be allocated to the budget stabilization fund.

It is clear that the design of a taxpayer's bill of rights amendment is unique to each state. A TABOR Amendment is especially important for a state such as North Carolina due to the heavy reliance on income tax revenues. As the data has demonstrated, income tax revenues are volatile compared to most taxes. Even if North Carolina reduced income tax rates, as we have assumed in this simulation experiment, income tax revenues would remain the major source of revenue. A generous budget stabilization fund equal to 15 percent of revenues is assumed to stabilize the budget over the business cycle. This generous budget stabilization fund would permit the state to offset the revenue shortfall in the recent recession. If one wanted to offset only part of the revenue shortfall, this would require a less generous fund. One could argue that the state should reduce expenditures when revenue falls in a recession. This more stringent approach would allocate less of the surplus revenue to a budget stabilization fund.

What Are The Prospects for a TABOR Amendment in North Carolina?

Easley has proposed a tax and spending limit for North Carolina. Unfortunately his proposal would be relatively ineffective both in constraining the growth of government, and in stabilizing the budget over the business cycle. To achieve these objectives North Carolina needs a more stringent tax and spending limit, such as the TABOR Amendment simulated in this study.

Unfortunately, special interests in North Carolina have pursued tactics designed to block an effective tax and spending limit or to introduce a watered down limit that would do little to manage the growth of government or stabilize the budget over the business cycle.

One of these special interests is the health care lobby. Like other states, North Carolina must begin to take a more critical look at the burgeoning costs of Medicaid. Other states have begun to introduce reforms designed to constrain the growth of these health care expenditures.

Not surprisingly, the most powerful of these special interests in North Carolina is the education lobby, which stands to lose the most from an effective taxpayer's bill of rights amendment.

Currently, North Carolina is at the end of the education lobbies "fiscal double play." After convincing North Carolinians that the state could finance a significant increase in debt and funding for the public schools without raising taxes, the education lobby now argues for increased taxes to sustain this higher level of spending. In this environment, calls to constrain the growth of revenue and spending and pursue more prudent fiscal policies tend to fall on deaf ears.

Before North Carolinians can pursue more prudent fiscal policies, they must confront the gorilla in the back yard. Education's "fiscal double play" has created a "Godzilla" in the form of high levels of spending for public education K-12 and higher education that could only be sustained with increases, not decreases, in taxes. After a decade of sharply higher levels of spending, North Carolinians have little to show for it beyond a bloated education bureaucracy and increased wages and fringe benefits for teachers, college professors, and administrators. No special interest group should have such a privileged position in the state budget.

Constraining the growth of state spending for public education could actually improve the performance of public schools. Economic studies have shown that when public education is funded at the local level rather than the state level, the performance of schools improves.[39] At the local level, citizens have a greater incentive to monitor their schools and hold the education bureaucracy accountable. At the local level, citizens are more likely to demand experimentation, including charter schools and privatization. Cities such as Milwaukee already have demonstrated that a voucher system can provide choices for students trapped in failing public schools.

Expanding the voucher system statewide, as Colorado has done, would create competition and greater opportunities for innovation to improve school quality. Colorado also is moving toward a privatized system of higher education, in which direct subsidies are replaced by vouchers that students can use at either private or public institutions. Privatization can create a level playing field in which competition between these institutions improves quality and lowers cost.

Only when North Carolina citizens recognize the need to constrain state spending will the stage be set for fundamental changes in fiscal policy, such as a taxpayer's bill of rights amendment.

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[39] "Solving Colorado's Educational Finance Problem," *Issue Paper 3-98 , Independence Institute*, Golden, Colorado, February, 1998.

Conclusion

Tax and spending limits are designed to address two problems: the increased burden of government taxation and spending in the long run; and the instability of revenue and spending over the business cycle. This study has shown that the tax burden in North Carolina has increased significantly relative to that in other states. Government revenue and spending have increased relative to state income in the long run. Because of the heavy reliance on the income tax, revenue and spending are very unstable over the business cycle. A taxpayer's bill of rights (TABOR) amendment could be introduced to address both of these problems.

This study simulates the impact of a TABOR Amendment in the North Carolina economy. A TABOR Amendment could both constrain the growth of government and stabilize the budget over the business cycle. This would set the stage for much needed reform in North Carolina's fiscal policies. Income tax rates could be lowered to reduce the heavy tax burden on North Carolinians. This would improve the business climate, attracting new investment and jobs. Higher rates of economic growth could allow income per capita in North Carolina to again converge toward the national average.

Unfortunately, in the current environment, proposals to introduce a TABOR Amendment have not made much headway. The major hurdle is educating North Carolina citizens about the need for fiscal discipline, which has been sorely lacking in the state. Only with this grassroots citizen support will politicians begin to undertake fundamental fiscal reform, such as the introduction of a TABOR Amendment in the constitution, and begin to pursue more prudent fiscal policies.

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