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BTC Brief

NC BUDGET & TAX CENTER

May 2009

Between a Rock and Hard Place: NC's Worsening Budget Gap Calls for Spending Cuts and Tax Increases

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

Written By:
Elaine Mejia
Project Director

North Carolina's state budget trajectory has taken a sharp turn downward. Revenues for the current year are expected to fall behind projections by $3.2 billion. In response, Governor Beverly Perdue was forced to dip into the state's reserves and tap into federal recovery dollars that the legislature was counting on to balance the budget for the next two years. According to a new report from the Center on Budget and Policy Priorities, North Carolina has the third largest revenue shortfall (as a percentage of the current state budget) of any state in the nation this year.[i]

For fiscal year 2009-10, the state is expected to face a $4.6 billion gap -- that is the difference between the amount of spending needed to maintain current state services and the amount of revenue the tax system is expected to generate. This figure grows to $4.8 billion when certain expansion costs are included, such as maintaining open enrollment in the State Children's Health Insurance Program and covering the cost of community college enrollment growth.

This budget shortfall is more than 20% of the current state budget which means that NC has the 11th largest projected budget gap for fiscal year 2009-10. At their peak, the budget crises of the early 2000s reached only 14% of the state budget at the time. State fiscal relief from the federal government included as part of the federal recovery package is expected to fill in one-quarter of budget gap for the next fiscal year. This means that the NC House of Representatives, which is currently crafting its budget without any revenue enhancements, will have to reduce state spending by an unprecedented 15%.

North Carolina is certainly not alone in facing this fiscal crisis. At last count, 47 states are facing budget gaps for the next fiscal year.[ii] And according to panelists at a May 22 event held by the National Conference of State Legislatures, the scope and severity of state budget gaps are much larger than was anticipated only a few months ago. [iii]

P.O. Box 28068
Raleigh, NC
27611-8068
Editor: Elaine Mejia
919/856-2176
elaine@ncjustice.org
www.ncjustice.org

Economic Analysis: Well-crafted tax increases should be part of the solution

All states except Vermont have provisions in their constitutions that prohibit their governments from incurring deficits. Thus, they must balance their budgets every year by raising taxes, cutting spending or both. So far during the current recession, 16 states have already enacted tax increases to help deal with their respective budget shortfalls, and 17 others are seriously considering doing so.[iv]

The current recession was primarily caused by a steep drop in consumer demand due to the crash of the nationwide housing market. Congress and President Obama designed the American Recovery and Reinvestment Act (ARRA) to stabilize the economy by injecting deficit-supported cash to prop up consumer demand. This was done through a variety of means, including increasing food stamps, extending unemployment benefits and assisting states with their current budget shortfalls. The portion of ARRA designated to provide fiscal relief to states was $140 billion over three fiscal years. NC will receive at least $6 billion overall from AARA only half of which, however, can be used to alleviate the FY 2009-2012 budget shortfalls. Unfortunately, the scope of state budget gaps is now expected to exceed $350 billion over that time period, far eclipsing the federal support funding.[v]

A recent report by the Center for Economic Policy Research found that states can maximize the impact of the federal recovery dollars by taking a balanced approach to their respective budget deficits, including spending cuts and tax increases.[vi] If North Carolina elects to fill its current and upcoming budget gaps with spending cuts alone, it could dramatically decrease economic activity in the state and considerably worsen the recession. This is because the economic multiplier of government spending is 1.5, whereas the multiplier effect of leaving an equivalent amount of money with taxpayers is 0.9 because as a portion of these funds are saved and not spent.[vii]

Lawmakers should consider economic multipliers when evaluating different revenue options. Renowned economists Joseph Stiglitz and Peter Orzag concluded in a paper written at the outset of the previous recession that tax increases on higher-income taxpayers are preferable to cutting spending for closing state fiscal deficits in the short run.[viii] This is because reductions in public spending will decrease economic demand by a greater amount than the spending cuts themselves, whereas higher-income taxpayers can absorb increased taxes by saving less, thus maintaining overall consumer demand in the short term.

Past Performance: NC raised taxes to partially fill budget gaps in past recessions

North Carolina experienced significant budget shortfalls resulting from the past two recessions in the early 1990s and the early 2000s. During both of these periods, state leaders elected to fill in a portion of the state's budget gap with tax increases, some of which were temporary.

In the 1990s the state raised the sales tax by a penny, increased the cigarette tax by three cents per pack, and increased the top personal income tax bracket from 7% to 7.75% (on married households with income above $100,000 and single filers with income above $60,000). The state also increased the corporate income tax rate from 7% to 7.75% (the current rate is 6.9%) and applied a four-year surcharge to the corporate income tax.

In the early 2000s North Carolina increased the state sales tax rate by one-half percent and added a top income tax bracket of 7.75% on married household income above $200,000. The amount of money raised through these tax increases was equivalent to 3.5% of total state revenue at the time. Aiming for a similar target today would mean raising taxes by more than $600 million.

In neither the '90s nor the '00s did raising taxes hurt the state's economic recovery. Rather, doing so allowed North Carolina to achieve several short- and long-term policy objectives. The state was able to maintain some of the public investments it had made toward improving education levels, improving public safety, providing low-income children, elderly and disabled residents with access to quality health care, and making the environment cleaner.

In addition, the state was able to stabilize demand in the economy by not shrinking its spending at the same rate as the private sector. This effect was particularly true of the state's choice in the early '90s and early '00s to raise income taxes on higher-income earners, and it was true as well of the move in the early '90s to temporarily ask profitable corporations to increase their tax contribution.

Conclusion

As North Carolina's largest employer and by far its greatest investor in education, health care, and the well-being of low-income families, spending by the state government has a tremendous impact on the state's economy. While some spending reductions will certainly be necessary to balance the budget, cutting spending by $3 billion will put tens of thousands of public-sector and private-sector employees out of work, will negate federal economic recovery efforts, and will prolong the current recession in North Carolina. Lawmakers should heed the lessons of the past, the approach taken by other states, and the economic research and include a well-crafted revenue package as part of the solution to the current fiscal crisis.

[i] Lav, Iris and McNichol, Liz, "State Budget Troubles Worsen," Center on Budget and Policy Priorities, May 18, 2009.
[ii] Ibid.
[iii] White, Nicola M., "State Budgets May Be Worse Off Than Reported, NTA Panelists Say," taxanalysts, May 26, 2009.
[iv] Johnson, Nicholas, Andrew Nicholas and Steven Pennington, "Tax Measures Help Balance State Budgets: A Common and Reasonable Response to Shortfalls," Center on Budget and Policy Priorities, May 18, 2009.
[v] Lav, Iris and Liz McNichol, "State Budget Troubles Worsen," Center on Budget and Policy Priorities, May 18, 2009.
[vi] Baker, Dean and Riva Deutsch, "The State and Local Drag on the Stimulus," Center for Economic Policy Research, May 2009.
[vii] "Estimated Macroeconomic Impacts of the American Recovery and Reinvestment Act of 2009," Congressional Budget Office, March 2009.
viii Orzag, Peter and Joseph Stiglitz, "Budget Cuts Vs. Tax Increases at the State Level: Is One More Counterproductive than the other during a recession?" November 6,2001.