FISCAL REALITIES FOR THE 90's

March 1991

REPORT OF THE ECONOMIC FUTURE STUDY COMMISSION

February 27, 1991

Honorable James G. Martin
Governor

Honorable Henson Barnes
Senate President Pro Tem

Honorable Daniel T. Blue, Jr.
Speaker, House of Representatives

Dear Governor Martin, President Pro Tem Barnes, and Speaker Blue:

In late September 1990, the Governor, President Pro Tem, and Speaker each appointed ten distinguished North Carolinians from all walks of life as members of the Economic Future Study Commission. Twenty-eight members served on the Commission, from its inception in late September until today. On behalf of all my fellow Commission members, I am pleased to present to you an official copy of the Commission's final report, entitled Fiscal Realities for the Nineties.

The charge to the Commission, as expressed in Senate Bill 1426, required that we focus our work on the long term. Our recommendations, however, are geared to the medium term as well. The Commission identified five fundamental trends that may be expected to have the most significant impacts upon state expenditures and our capacity to support them. The Commission's proposals have been designed to address problems and opportunities associated with these trends. The proposals are grouped into four general areas: (1) Modernization of Revenue Structures, (2) Budget Reform, (3) State/Local Fiscal Relations, and (4) Public Education Improvements.

Staff members of the Fiscal Research Division rendered outstanding service to the Commission and especially to the Chairman, under very great time pressure for all of us. We are indebted to them for their hard work, patience, and expertise.

I believe that I speak for my fellow Commission members in stating that this undertaking, while arduous, was a stimulating learning experience for all of us. I am thankful for the opportunity to serve with this outstanding group of citizens.

Sincerely,

Malcolm Gillis

Malcolm Gillis
Commission Chair

EXECUTIVE SUMMARY

Introduction

North Carolina may expect to confront a new set of fiscal realities similar to, but not identical with those facing the 33 other states already struggling to offset revenue shortfalls in 1991. In some ways, our State is better prepared to cope with these realities than many of our sister states. Unlike some of those, we have not saddled ourselves with heavy debt obligations. Our debt service burden, under 1% of general fund revenue, is one of the lowest in the nation and our bond rating is among the highest. Also, the State has maintained a stable and supportive environment for business activity. In addition, past public investments in our state university system continue to pay handsome dividends not least of which has been the attraction and retention of concentrations of technologically advanced business. And on the fiscal front, our income tax structure has been recently revamped to expand the tax base and to relieve tax pressures on the working poor.

In other ways, however, North Carolina may be less prepared to deal effectively with emerging fiscal realities. Nowhere is this more apparent than in public education, from kindergarten through high school. The fiscal health of State and local governments depends vitally upon the State economy. More than any other single factor, the future course of economic development in North Carolina, from now until at least the coming century, depends upon the degree to which new entrants to the labor force possess the cognitive and problem-solving skills and personal characteristics required to sustain increased productivity in a rapidly changing national and world economy.

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Two-thirds of State general fund spending — and one-third of county-level spending — is devoted to education. If state-local revenue structures are to remain supportive of public education needs, it is imperative they be made more responsive to future growth in income and consumption. The struggle to improve educational quality, however, involves much more than greater infusion of tax dollars into our education system. Changes are required as well on the expenditure side of the budget, so as to assure North Carolina taxpayers that public funds for education are being well and effectively used. As detailed in the Commission's report, these changes involve, among others, institutional, process and training reforms conducive to better management in public education.

This report addresses changes in the structure of the State budget that should be undertaken to allow North Carolina to cope most effectively with the emerging fiscal realities of the nineties. The charge to the Commission expressly requested it to focus upon longer-term trends likely to have major bearing upon the fiscal health of the State, and to recommend proposals for adapting the revenue side of the budget to these trends. The Commission, however, decided early on that its time horizon should consider the medium as well as the longer term, and also interpreted its charge to encompass certain critical changes on the expenditure side of the budget, particularly those involving reform of budgetary processes.

The Commission identified five major socioeconomic trends that might be expected to have significant implications for state and local taxation and spending needs, and the capacity to satisfy these needs. The Commission then fashioned a series of principles and objectives to guide budgetary reform over the medium to longer term, along with a number of specific options for implementing reform.

The remainder of this Executive Summary presents a brief sketch of trends most relevant for the Commission's purposes, together with a summary of the 42 principles, objectives, and options that may play important roles in bringing the State budget and economy safely through the remaining years of this century.

Trends and Fiscal Realities

The Commission has distinguished between trends over which we in North Carolina may exercise at least some control (e.g. educational outcomes) and those over which we lack any control (e.g. globalization of the world economy). Our proposals for policy reform are addressed to the former; the discussion in this section is focused upon the latter trends, to which we must adjust.

The Commission identified five particularly notable socioeconomic trends molding the fiscal realities for the State in the coming decade.

- Globalization of world markets
- Demographic transitions
- Continued evolution of Federal budget priorities
- The worldwide fiscal revolution of recent years
- Growing environmental constituencies.

(1) Globalization of World Markets

The pace of globalization, or consolidation of world markets for products and services, has accelerated sharply over the past decade, bringing with it a dramatic increase in world economic interdependence that is beginning to penetrate into virtually every aspect of economic life in every corner of the State. Measures must be taken soon to position the State to partake fully in the benefits of globalization, while reducing our vulnerability to costs that may be associated with it.

Indicators of growing globalization are not difficult to find. By 1989, foreigners owned 15% of the U.S. capital stock, with much of this shift in ownership occurring in the past 4 years. Today, money balances in excess of $500 billion each day are transferred instantaneously across national borders along sophisticated electronic highways. International telephone calls have risen by 16-fold from 1977 to 1989. In North Carolina, about 642 foreign-owned companies were already operating in 1990, bringing jobs, technology and growth in the tax base.

The accelerating trend toward globalization is being fueled by a wide range of economic and political developments in Europe and the Pacific Rim: the complete economic unification of Europe in 1992, the collapse of socialism in central and eastern Europe, and the continued rapid growth in several nations in the Eastern Pacific Rim, encompassing a market growing at between $4 and $5 billion per *week*.

The opportunities, in terms of employment opportunities alone, flowing from globalization are clear. The challenges posed by globalization include above all the need to improve the workforce preparedness that is so essential for sustained increases in the productivity of our labor force and the competitiveness of our industries.

(2) Demographic Transitions

Much of the State's enviable record of economic growth from 1970 through 1989 was attributable to growth in the labor force, aided materially both by net in-migration and by rates of labor force participation, in North Carolina that were well above that for the nation as a whole.

For the next decade, the State can no longer count on growth in the labor force to fuel economic expansion; a major demographic transition is almost upon us: the marked slowing in growth of the 18–65 year-old group that supplies virtually all of our labor force. The rate of increase in this category is now projected at one-half that of the past two decades. Much more ominous, however, are current projections of growth in the 18–34 year age group. This group increased by 450,000 in the seventies and by 150,000 in the eighties, but for the nineties this group will actually *decrease* by 140,000 barring an unexpected surge of in-migration. The decline in numbers of younger workers and consumers will have immense economic implications for the State. This is the group that accounts for nearly all entry-level labor force growth, almost all first purchasers of housing, autos and other big-ticket items.

Other demographic factors present significant challenges to the State budget and economy. First, the number of residents above age 64 is projected to increase by 170,000. Many of these will be poor and uninsured persons requiring additional social and health services. Second, after declining steadily over the past two decades, the projected share of the population in the 5–17 age group will actually increase during the nineties, before declining again toward the end of the decade. The temporary rise in the school-age population will inevitably accelerate problems in education finance.

Finally, North Carolina, like much of the rest of the nation has not yet been able to provide an economic or social setting that would enable its minority citizens to fully partake in the opportunities provided by the last decade of economic expansion, much less in the prospective opportunities available in the globally-linked economy of the future. This is manifest in many ways discussed in the Commission's report: in large income disparities between minority and majority families, even greater disparities in wealth, higher rates of mortality (especially for infants), and higher drop-out rates for minorities. The socioeconomic implication of these disparities is far-reaching. In the economic sphere, the report shows how these disparities combine to strike employment growth in small firms, particularly those owned by the 22% of our population that is black.

(3) **Evolution of Federal Budget Priorities**

North Carolina can take small comfort in the knowledge that two-thirds of the states are now facing fiscal stress, ranging in degree of severity from troublesome to truly perilous. This budgetary malaise is not wholly attributable to the current recession. It is also an outgrowth of evolving patterns of federal budgetary responses to continued high deficits, responses that have resulted in large negative spillovers to state and local budgets. Three sets of federal deficit-reducing responses have had and are likely to continue to have severe implications for the fiscal health of North Carolina and other state governments:

- Further Federal encroachment on jointly-shared tax bases
- Federal spending mandates to the states
- Progressive federal withdrawal from program of financial assistance to state-local governments.

In October, the Federal budget-reduction package, involving increases in federal taxes on gasoline, tobacco, beer, and other items, will result in revenue losses to North Carolina alone of about $109 million for the 1991–95 period. But recent examples of federal encroachment on tax bases used also by the states pale in importance against the possibility of enactment of a federal sales tax that might take the form of a value-added tax. This possibility, while unlikely over the next two years, is favored by many in Congress, and is no means outside the realm of possibility later this decade.

The October Federal budget package contained merely the latest examples of federally mandated changes in programs with no funding to pay for them. Overall, these mandates have proven extremely costly to the states. In Medicaid alone the mandated state share of costs in North Carolina has been rising at an annual rate of 17% over the past seven years.

Finally, under the banner of the New Federalism, the Federal government has been progressively withdrawing from programs that formerly channeled large amounts of assistance to state and local governments for education, law enforcement, water and sewer services, and other activities. Between 1981–82 and 1989–90, the federal contribution to total state-local revenues declined by nearly 25%.

(4) The Worldwide Fiscal Revolution

The tax reform movement is almost universal. In recent years dozens of nations have moved away from attempts to "fine-tune" tax systems to achieve non-revenue goals. The principal tools of fiscal "fine-tuning" were high tax rates and abundant individual and corporate tax preferences (incentives). These tools have been increasingly discarded by country after country as ineffective and/or counter-productive. The principal thrust of the worldwide wave of tax reform has been two-fold. First, to "level the playing field" in income taxation through base-broadening (abolition of incentives and preferences) and rate flattening. Second, there has been a growing reliance upon more comprehensive, simpler taxes on consumption, especially the value-added tax. In income taxation, 57 nations other than the U.S. reduced their top rate of tax in the five years between 1984 and 1989. Many of these tax rate reductions were very substantial: 50% in Britain and New Zealand, 60% in Brazil, 33% in Iceland and Norway, and 30% in Japan. These sharp reductions were largely "financed" by abolition of special tax preferences and incentives.

Coupled with the phenomenon of globalization, the still ongoing worldwide fiscal revolution has important implications for tax policy in North Carolina. Globalization has been accompanied by a growing mobility of both financial and physical capital. The increased mobility means that no country can long maintain rates of tax on income from capital much above the prevailing world average, which has fallen notably in recent years. In addition, states with taxes on capital much higher than in other jurisdictions will tend to experience growing migration of capital to other states and other countries. Though there have been cases in which high state taxes on capital income have been associated with growing inflows, these circumstances have been confined to instances wherein states utilize the excess receipts to provide superior services for businesses and through education, a more highly qualified labor force. The worldwide fiscal revolution therefore has implications for policy reform on both the tax as well as the expenditure side of the budget.

(5) Growing Environmental Constituencies

The environmental movement in the United States has many disparate constituencies. One does not have to agree with all the aims and methods of all these diverse groups to recognize that the overall constituency for environmental protection is growing, not only among rural and urban dwellers in the bottom half of the income scale, but also among the ranks of top-level managers in the nation's largest firms. Moreover, the concerns of this constituency are being heard by increasingly receptive ears, especially in Washington.

In the best of circumstances, the growing body of environmental legislation will result in significant improvements in the quality of life without imposing needless burdens upon the citizens of North Carolina, the enterprises for which they work, or the governments they elect. But even under the best of circumstances, implementation of environmental objectives already required by law will surely involve sizable increases in demands on state and local budgets at a time when these governments are already struggling to meet expenses. The Commission report cites many examples.

Beyond these budgetary considerations, the State needs to begin to seriously consider how to accommodate both environmental objectives and economic development. We cannot assign infinite values to the benefits of the former and infinite values to the costs of the latter. The reverse is also true. Accommodating environmental concerns and economic development may require fundamental changes in the institutional and policy frameworks we use to address economic problems.

These changes may require a shift away from the cumbersome, and administratively burdensome, regulatory system upon which we now rely to protect the environment. This "command and control" system has proven to involve heavy burdens of administration and compliance. It has also been sluggish in responding to technological changes that have not only produced new forms of waste, but new waste-reducing technologies. The "traditional" approach to pollution abatement has also proven ineffectual in dealing with the fastest growing source of pollution: so called "non-point" discharges by households and small firms.

The breadth and dynamics of environmental pressures require new thinking about mechanisms for pollution abatement that are capable of broad and continuous technological responses to pollution. Market-based economic instruments, including environmental taxes as substitutes for command and control regulation, are gaining increased acceptance worldwide, from Norway to Finland and Hong Kong and Holland. These taxes can be imposed in a revenue-neutral way, allowing other taxes, including those on businesses, to be reduced commensurately.

Growing environmental constituencies, the growing evidence of the unsuitability of present institutions and policies for dealing with pollution are aspects of the fiscal realities of the nineties that no state can ignore for much longer, if it expects to come even respectably close to reconciling environmental concerns with economic development and prospective budgetary resources.

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b) Specific Objective: **20**

State corporate tax incentives are largely ineffective and undermine tax fairness and simplicity objectives.

Commission Vote: The Commission was unanimous in endorsing this objective.

Implementation Option **21**

Eliminate all special exemptions, deductions and credits under the corporate income tax.

Commission Vote: Consistent with its view on the specific objective above, the Commission voted unanimously in favor of this option.

c) Specific Objective: **22**

Sumptuary taxes not levied on an ad valorem basis should be periodically reviewed and updated for inflation.

Commission Vote: The Commission endorsed this objective with a near-unanimous majority.

d) Specific Objective: **23**

User fees for services of primary benefit to the recipient should, to a reasonable extent, reflect at least some portion of the operating cost of providing the service, and, so far as practical, the agency collecting the fee should retain the fee for use in providing the service.

Commission Vote: This option was accepted unanimously by the Commission.

e) Specific Objective: **24**

The State should begin systematically reviewing all policies pertinent to deriving revenues from the taxation of non- renewable resources.

Commission Vote: The Commission endorsed this objective by a 2:1 majority.

f) Specific Objective: **24**

All the State adjustments to federal taxable income, such as additional personal deductions and credits, should be limited to those that are related to expenses of earning income or which further define the taxpayer's ability to pay.

Commission Vote: The Commission endorsed this objective with a unanimous vote.

g) Specific Objective: **25**

The intangibles tax has adverse effects on location decisions of business and households and impacts negatively on death tax collections. The tax should be repealed.

Commission Vote: The Commission endorsed this objective with a near unanimous vote.

h) Specific Objective: **26**

State excise tax bases should be adjusted to eliminate discrimination in taxes levied on similar products.

Commission Vote: The Commission unanimously endorsed this objective.

Implementation Option: **26**

The cigarette excise tax should be expanded to a tobacco products tax (adds cigars, smokeless tobacco).

Commission Vote: The Commission was unanimous in endorsing this option.

i) Specific Objective: **27**

The General Assembly should strongly consider the potential of a State lottery to raise revenue.

Commission Vote: The Commission endorsed this objective by a very narrow margin.

j) Specific Objective: **28**

The General Assembly should commission a study of the overall economic benefits of pari-mutuel betting on horse racing and dog racing.

Commission Vote: The Commission endorsed this objective by a 3:1 majority.

BUDGETARY PROCESSES **29**

Guiding Principle: The process of deciding how much of the income of the State's citizens should be devoted to the funding of State programs should be modernized to make it responsive to the future economic needs of the State.

Commission Vote: The Commission unanimously favored this principle.

a) Specific Objective: **29**

Increases in the State's general fund operating budget should not exceed the estimated growth of the income of its citizens.

Commission Vote: The Commission endorsed this objective unanimously.

b) Specific Objective: **30**

Funds should be appropriated to a program based on its objectives, projected performance measures, and an evaluation (performance indicators) of its past performance.

Commission Vote: The Commission approved this objective unanimously.

c) Specific Objective: **31**

The statute requiring line-item detail should be changed to allow the governor and departments to prepare and administer a budget on the program level.

Commission Vote: The Commission approved this objective unanimously.

d) Specific Objectives: **32**

Measures should be enacted to minimize the uncertainty of revenue and expenditure estimates used in the budget process and budgetary mechanisms should be established to protect the State's fiscal condition against unanticipated negative events.

Commission Vote: The Commission approved this specific objective by a unanimous vote.

Implementation Option: **34**

The State should base its fiscal year General Fund operating budget on the prior calendar year revenue. If the actual fiscal year revenue exceeds the prior calendar year revenue, one-half of the resulting surplus will be used to fund a rainy day fund, and the other half shall be used for capital projects and other one-time expenditures. Once the reserve fund equals 5% of the General Fund operating budget, any excess may be used to increase spending in state-dedicated fund programs, for capital projects or for future tax relief.

Commission Vote: The Commission approved this implementation option by a 3:2 majority.

e) Specific Objective: 35

The interests of future generations are a major concern of the people of North Carolina. The State should tie the funding of long-term capital projects to the use of the projects by future generations (begin using bond financing in lieu of pay-as-you-go financing).

Commission Vote: The Commission endorsed this objective by an overwhelming majority.

f) Specific Objective: 36

Fiscal analyses of the State's budget outlook and new initiatives that would affect future budgets should be performed on a long-term basis (five-year fiscal notes).

Commission Vote: The Commission approved this objective unanimously.

g) Specific Objective: 37

The State should strengthen the mechanism for periodic review of efficiency and organization.

Commission Vote: The Commission approved this objective by an overwhelming majority.

Implementation Option: 38

A commission should be formed to review the efficiency and organization of State government. The Commission should start with a review of the implementation of the 1985 State Efficiency Commission. During its review, the Commission should specifically consider the role of public/private partnerships, privatization of State programs, and program consolidation.

Commission Vote: The Commission approved this option by an overwhelming majority.

h) Specific Objective: 38

The State should begin the process of setting aside a portion of annual revenues as a maintenance reserve for State buildings.

Commission Vote: The Commission approved this objective by an overwhelming majority.

i) Specific Objective: 39

State university campuses should be allowed the option of increasing tuition and to use part of the additional receipts for need-based financial aid and part to enhance academic programs.

Commission Vote: The Commission endorsed this objective by an overwhelming majority just short of unanimity.

STATE/LOCAL FISCAL RELATIONS 43

Guiding Principle: State and local fiscal relationships in North Carolina should be re-examined in light of changes in fiscal federalism.

Commission Vote: The Commission endorsed this guiding principle unanimously.

a) Specific Objective: 44

Local government should be provided additional revenue sources to meet infrastructure needs.

Commission Vote: The Commission endorsed this objective by a 2:1 majority.

Implementation Option: 45

Counties should be given general authority to levy a land transfer tax, with the proceeds dedicated to infrastructure needs.

Commission Vote: The Commission endorsed this option by a 2:1 majority.

b) Specific Objective: 45

An institutional arrangement should be established to ensure an on-going review of state/local fiscal relations.

Commission Vote: The Commission endorsed this objective by an overwhelming majority.

PUBLIC EDUCATION 47

Guiding Principle: Public education continues to have an important role in the vitality of the State's economy. Measures should be enacted to improve the management effectiveness and the quality of the educational experience.

Commission Vote: The Commission endorsed this objective unanimously.

a) Specific Objective: **49**

The Superintendent of Public Instruction should be appointed instead of elected.

Commission Vote: The Commission vote on this objective was only one short of full unanimity.

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b) Specific Objective: **50**

Tenure should be eliminated for administrative positions.

Commission Vote: The Commission endorsed this objective unanimously.

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c) Specific Objective: **51**

Tenure should be phased out for all public education teachers below the university level. This can be best implemented by increasing the merit pay applicable to those teachers giving up tenure.

Commission Vote: The Commission endorsed this objective by more than a 2:1 majority.

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d) Specific Objective: **52**

Substantially more attention should be paid to the training of principals and other school administrators.

Commission Vote: The Commission unanimously supported this objective.

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e) Specific Objective: **53**

The State budget process for education funding should be amended to include more setting of performance objectives and evaluation of program performance.

Commission Vote: The Commission supported this objective by a very wide majority.

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f) Specific Objective: **53**

Local school boards should be authorized to implement those policies which they think will improve education performance (i.e., longer school day, lengthen school year, class size reduction), and measures implementing these policies, retaining minimum standards and allowing for local flexibility, should be promptly enacted.

Commission Vote: The Commission unanimously endorsed this objective.

g) Specific Objective:

To ensure that local public schools are administered effectively and efficiently, local school systems should be granted the maximum degree of flexibility in spending funds and administering programs that is consistent with broad guidelines established by the state board of education. They should be held accountable for their effectiveness through use of performance measures and standards established by the State.

Commission Vote: The Commission unanimously endorsed this objective.

FISCAL REALITIES FOR THE NINETIES
REPORT OF
THE ECONOMIC FUTURE STUDY COMMISSION

The Economic Future Study Commission was established on August 30, 1990 by Senate Bill 1426. By September 25, the full complement of 30 Commission members, including a chair, had been named by the Governor, the Speaker of the House, and the President Pro Tem of the Senate. The first meeting of the Commission was held on October 17. Over the next 14 weeks, the Commission was convened for 8 meetings, typically requiring day-long intensive sessions, with substantial internal discussions. Thirty-four outside speakers from the public and private sectors presented their views before the Commission (a list is provided in Appendix One). The Commission concluded its deliberations on January 29, 1991, having considered and voted upon 42 principles, objectives, and implementation measures pursuant to its charge.

COMMISSION'S APPROACH TO DELIBERATIONS

The resolution creating the Economic Future Commission charged the Commission with the following duties:

"(1) Review the State's needs for changes in the revenue and budget structure to meet the needs of the State over the long term;

(2) Make a comprehensive review of the State and local tax system, particularly in light of future economic trends that may affect revenues generated by existing taxes; and

(3) Recommend proposals to enhance the State's revenue position, adapt the State tax structure to changes in the economy, avoid placing undue tax burdens on any segment of the population, and preserve the positive impact of the tax structure on the economic future of the State."

This mandate presented a formidable set of tasks, given the short time-frame for deliberations. Blue-ribbon tax or budget reform commissions in other states typically have two years or more to complete their task and $500,000 or more to hire full-time consultants and writers. The Economic Future Commission spent about one-twentieth of that amount. Instead of outside consultants, the Commission used in-house legislative staff, agency personnel, and a resource person from the Institute of Government.

Commission's Approach

The charge to the Commission, presented fully in Appendix Two, was focused explicitly upon the medium to long term, and was confined, to the extent feasible, to consideration of economic issues, particularly projected economic trends expected to affect, and be affected by, the revenue and expenditure sides of the budgets of state and local government in North Carolina.

The charge required, in the end, that the Commission recommend proposals to enhance the State's revenue position, and adapt the State tax structure to changes in the economy. The Commission, however, recognized early on that given the nature of future economic trends, helpful adaptation and reform of state and local budget policies and processes to allow our citizens to benefit from them could not be confined to the tax side of the budget. Accordingly, the Commission interpreted its charge to encompass also the formulation of proposals for reform of several critical non-tax policies and budget processes having a critical bearing upon the effectiveness of government spending, particularly in education, which accounts for about two-thirds of annual outlays from the general fund. This aspect of the Commission's work was aided immensely by the availability of numerous recent reports from blue-ribbon commissions established to study education and workforce preparedness from kindergarten through the community college system (a list is provided in Appendix Three).

The Commission also decided that its time horizon should consider the medium as well as the longer term. The focus on the medium-to-long range questions differs from the "conventional wisdom" in the halls of the Legislature that the Commission was established to resolve the 1991–93 budget gap. The Commission received no direction other than the wording of the authorizing resolution. The Commission did take the position that the current crisis provides an excellent opportunity for the Governor and General Assembly to deal with long-term issues. The continued use of short-term solutions will mean that State leaders will be forced to continue making piecemeal, and possibly inconsistent, adjustments to the revenue and spending structure. To the extent that the Commission's recommended objectives assist in the adoption of solutions needed for the next two years, so much the better.

The Commission's approach differs from prior commissions also in its emphasis upon fiscal philosophy and principles in lieu of hard dollar recommendations. The Governor and member of the General Assembly have far more experience in developing workable specifics than a commission not versed in the day-to-day operations of State government. Thus, readers will not find draft legislation or detailed fiscal impact statements in this report. In addition, the Commission did not set fiscal impact targets for its package of ideas. Some of the proposals may lead to additional revenue; others will reduce revenue. But the sum and substance of the Commission's revenue proposals is that, if adopted, they would clearly strengthen the revenue-generating capacities of the tax system over time.

Concerns about the critical need to have an educated and adaptable work force have led to the creation of numerous commissions to reform education. The Economic Future Commission decided at a very early stage not to duplicate the work of these other groups. Instead, the Commission focused on a handful of management and quality issues most essential to the improvement of public education in the State. In some cases, the Commission's policy objectives simply affirm the recommendations of other groups.

The Economic Future Commission expresses thanks to the numerous speakers who took time from their schedules to make presentations. In many cases, the Commission was very specific about the types of information and discussion it expected from speakers. This approach helped keep the proceedings on track and stimulated the flow of new ideas.

Identification of Major Trends

The Commission expended considerable energies in attempting to identify and understand those future economic and socioeconomic trends that might be expected to have the most significant impact upon state and local taxation and spending needs, as well as the capacity to satisfy these needs. We distinguished between trends over which we in North Carolina may exercise at least some control (educational outcomes), and those over which we have little or no control (globalization). The discussion in this section is confined to the latter group; several of the Commission's proposals for policy reform are addressed to the former. Also, the medium to longer term time horizon of the Commission precluded explicit focus upon implications of shorter-term trends and current events, except to the extent that they may involve long-lasting effects. The likely consequences of the present recession for the 1991-92 budget are therefore excluded on these grounds. The Persian Gulf War and its aftermath and the severe travails of the U.S. financial sector, extending now to some sectors of the commercial banking system, are excluded not because of the absence of long-lasting implications, but because their ultimate economic effects, as opposed to their currently projected costs, are unknowable at the present time.

A number of other identifiable trends will involve significant implications for the economic future of the State, including those in technology and information processing. However, the consequences of these trends should be less pronounced for the tax and expenditure sides of the budget than for the five trends to be discussed below. These trends appear to be particularly notable for Commission purposes, not only because they may have major implications for state and local budgets and the ability of North Carolina taxpayers to support them, but because their importance is likely to grow each year over the coming decade. They are:

- Globalization, or rapidly growing consolidation of world markets both for products and for services,

- Demographic transitions, particularly those involving shifts in the age structure of the population and the labor force,
- Continued evolution of federal budget priorities, increasingly constrained by entitlement spending, tax limitations, and international realities,
- The worldwide fiscal revolution of the past half decade, involving changing perspectives on the use of the tax side of the budget to attain non-revenue goals, and
- Growing constituencies for environmental protection and improvement, with membership extending well beyond privileged economic and intellectual groups, to urban workers and rural farmers.

Globalization: The pace of international economic change has been accelerating sharply over the past decade; virtually all of these changes are irreversible in character. The result has been a dramatic increase in world economic interdependence, with huge volumes of goods, people, information and capital crossing national borders every day. These developments penetrate into virtually every aspect of economic life in every corner of the State. North Carolinians need to understand the dimensions of these changes and their implications if we are to position the State to partake fully in the benefits flowing from them, while reducing our vulnerability to the costs associated with them.

For the United States as a whole, the highly respected National Bureau of Economic Research (NBER) has reported that by 1989, foreigners owned just about 15% of the U.S. capital stock. While this is a relatively small share compared to foreign ownership patterns in Western Europe, the rate at which foreign firms are acquiring U.S. productive assets increased by threefold from 1984 to 1989. These figures have been confirmed elsewhere: *Business Week* (May 14, 1990) reported that foreign-based multinational firms spent about $200 billion in acquiring existing plants and building new ones in the U.S. from 1986 to 1990. This has occurred even as more and more U.S.-based firms with familiar American names have stepped up their investments abroad, now totaling over $1.3 trillion. Many U.S. firms have begun to derive more than half their sales and profits from abroad. Whether originally based in the U.S., Europe, or Asia, a new type of company has evolved. These are truly global firms which have stockholders on three continents, do research and develop new products in several nations, and hire executives regardless of nationality. This trend is accelerating as world markets consolidate further, to the point that the national identity of many large firms is becoming increasingly obscure.

Nowhere is the globalization of the world economy more apparent than in the markets for money and capital. Today, money balances well in excess of $500 billion each day are transferred instantaneously from country to country along sophisticated electronic highways where international borders are not recognized.

Acceleration of the trend toward globalization is being fueled by a wide range of economic as well as political developments. These include, but are not confined to, the complete economic unification of Western Europe on January 1, 1992, the implosion of socialism in Eastern and Central Europe, and the outlook for a continuing boom in the nations of the Eastern Pacific Rim.

Within one year, economic borders will cease to exist in virtually all of Western Europe. Products will move across national boundaries unimpeded by tariffs or by differing safety and health standards. People will traverse borders almost as easily, creating a unified market that—even without the Eastern part of Germany—will be initially 1/3 larger than the United States. Capital already moves almost without constraint between European Community nations. The implications of Europe 1992 will be far-reaching for the United States in general, especially for Eastern Seaboard states such as our own that have worked hard to cultivate and expand economic ties to Europe.

The Revolution of 1989 in Central and Eastern Europe marked the collapse of socialism as a credible approach to social and economic organization in Europe. Growing economic, as well as political, ties between the U.S. and Europe and former Soviet satellites will in time open large new markets for agricultural and industrial products, including machinery, and will help to fuel economic expansion in the labor-short nations of Western Europe.

North Carolina has a truly large stake in the continuation of the economic boom in several nations of the eastern Pacific Rim. This group includes, of course, Japan, Korea, Taiwan, Singapore, and also rapidly growing Indonesia, Malaysia, and Thailand. The latter three nations alone contained 254 million people in 1989. The Pacific Rim market has surpassed $4 trillion, and is growing at more than $4 billion per week. Once thought of primarily in terms of an exporter of goods to North Carolina, the Pacific Rim is increasingly serving as a major destination for North Carolina's products. Indeed, in 1990, Japan alone received nearly twice the value of North Carolina exports than any European country. No doubt, as the Southeast Asian countries on the Rim such as Indonesia, Malaysia and Thailand continue to grow at rates well in excess of western Europe, they will provide increasingly rich opportunities for North Carolina's exports, if North Carolina is able to seize these opportunities.

To take advantage of these opportunities, North Carolina will need to make investments in supporting infrastructure. For example, the proposed global air cargo–industrial complex for North Carolina would give the State a competitive edge in capturing a larger proportion of Pacific Rim, European and Latin American trade and investment via overnight delivery of state products to virtually any place in the world. The complex would also attract new just-in- time manufacturing and distribution facilities of foreign and U.S. corporations, substantially boosting jobs and State tax revenue.

Some of the manifestations of rapidly growing international economic interdependence are unsettling to many Americans; some in Congress have called for curbs on foreign ownership of American industrial and agricultural assets. The State of North Carolina, however, has been, up until now, one of the principal beneficiaries of the globalization of world markets, and has warmly received the jobs and new investments brought by foreign-based investors. Still, few citizens realize that even by 1990, a total of 642 foreign-owned companies were operating in North Carolina, in areas ranging from baking through construction to pharmaceuticals. This total included 149 from Germany, 125 from the United Kingdom, 79 from Japan, 50 from Canada, and nearly 200 from all other nations.

The emergence of substantial numbers of new foreign-based firms, particularly from the wider and stronger European Community, presents a wide array of economic and social opportunities and challenges for the state. The opportunities take the form of new prospects for employment, expanded opportunities for learning from innovatively applied technologies, and a growing tax base to support public needs. The challenges posed by globalization include above all the need to improve the workforce preparedness that is so central to competitiveness for our industrial and service sectors. All the other challenges, including the vexing problem of the income taxation of foreign-based firms with worldwide activities, are decidedly secondary. Workforce preparedness requires more effective general as well as specialized education, so that our labor force is seen as not only employable, but capable of sustaining the same increases in productivity shown by workers in Japan, Germany and in many newly industrializing nations in East Asia that have placed heavy emphasis on the education of the young.

Demographic Transitions:* Profound demographic changes already under way by 1991 may be expected to have significant implications for the demand for government-provided services, as well as the capacity of state and local governments to support these services over the coming decade.

Over the past thirty years, North Carolina has enjoyed sustained, often rapid, economic growth relative to most of the rest of the nation. As a result, per capita income, as low as 71% of the national average in 1970, today approaches the national average, much more so in urban areas (97%) than in rural areas (76%). Further, overall employment in the State grew by roughly 25% per decade after 1970. Moreover, in every year from 1960 through 1988, save one (1975), the rate of unemployment in North Carolina has been lower than in the nation at large. By mid-1988, 81 of the state's 100 counties had unemployment rates below 5%, tantamount to virtual full employment; no county had unemployment rates above 10 percent. By the end of January of 1991, however, the employment picture had

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* This section draws heavily upon information and insights presented to the Commission by Dr. Charles E. Bishop and Nathan T. Garrett.

darkened. Only 34 counties had rates of unemployment below 5%, while seven, primarily rural, counties had more than 10 percent.

Upward movement in unemployment rates will surely abate as the world and national economies work themselves out of recession, perhaps by early 1992 if the Persian Gulf War is not protracted beyond a few months. Whether the State's economy will be able to resume the strong economic growth of the past three decades and push down unemployment rates close to those prevailing in the last half of the eighties is, however, another question.

Much of the State's enviable record of economic growth and development from 1970–1989 was doubtless attributable to maintenance of a stable and supportive environment for business activity, but it is also true that this record has been heavily dependent upon growth in the labor force, aided materially by net in-migration and by unusually high rates of labor force participation. Just in the decade 1980–1990, net in-migration added 7% to the total population. The labor force participation rate in North Carolina substantially exceeds that for the nation as a whole, largely because North Carolina has one of the highest participation rates for women.

In-migration may or may not contribute significantly to growth in the labor force in the coming years, but it is highly doubtful that the State can attract larger net additions to our skilled labor force than in the past, and large numbers of unskilled migrants will simply compound the problems we will face in the nineties. Nor can we continue to count on increasing rates of labor force participation to sustain growth in the labor force, given that these rates are already quite high. The most significant aspect of demographic trends affecting the labor force is nearly upon us now: the marked slowing in growth of the 18–65 year old group that supplies most of our labor force. The rate of increase in this category is now projected at one half that of the past two decades. More ominous, however, are current projections of growth in the 18–34 year age group, the group that will provide for all entry-level labor force growth and all first-time consumers of housing, autos, as well as a substantial share of spending on a wide range of consumer goods and services. This group increased by 450,000 in the 1970's and by 150,000 in the eighties. For the nineties, this group, barring an unexpected surge in in-migration, will actually decrease by 140,000 even though the decline in the number of 18 year-olds should abate by 1994. The decline in numbers of younger workers and consumers in North Carolina will have immense economic implications for the State.

Other dimensions of the shift in the age structure of our population also present serious challenges to the State, and will contribute to growing strain on state and local budgets. First, the number of North Carolina residents above age 64 is projected to increase by about 170,000. Many of these will be poor and uninsured people requiring additional social services, especially health-related services. This presents serious problems for a state that has the ninth worse death rate (589 per thousand) among 12 southern states, all of which (save Florida) have mortality rates well above the national average (546 per thousand).

Second, after declining steadily over the past two decades, the projected share of the population in the 5–17 year age group will increase perceptibly during the nineties, before declining again towards the end of the decade. The rise in the school-age population may be expected to place increased demands upon educational finance and the education infrastructure generally.

Third, North Carolina, like much of the rest of the nation, has not been able to provide an economic or social setting to enable its minority citizens to fully partake in the opportunities provided by economic expansion in the past, much less in the more competitive, globally-linked economy of the future. This is manifest in many ways.

Nationally, average income for black families barely increased at all over the period 1970–89. In real, 1989 dollars, their family income in 1970 was $20,067; in 1989, $20,209 (The National Urban League, "The State of Black America," 1990). In 1988, the percentage of blacks living below poverty levels (31.6%) was three times that of whites. In North Carolina, less than one-fifth of those eligible for Headstart training are served. Many of these are minorities. Also, the most significant factors underlying high mortality rates are race and income, which are not unrelated. Across the South, the higher a county's minority population and the lower its per capita income, the higher is the death rate. The number of minorities who drop out of school is perilously high, and the proportion of minorities finishing college disproportionately low. Since only college-educated youth experienced a rise in real wages over the past decade, and since this situation is unlikely to change during the next decade, incomes of minorities will likely remain appreciably lower than for whites for the coming decade. It is widely known that black workers earn substantially less than white ones. Much less widely recognized is the overwhelming disparity in wealth nationwide between black and white households, particularly younger ones. An NBER study published in 1990 concluded that in 1978, the average young white family had more than five times the assets of the average young black family. The average wealth of households headed by someone between age 24 and 34 was $23,700 for whites and $4,200 for blacks. Even more strikingly, financial assets (bank accounts, stocks, etc.) of young white households were 42 times those of young black households.

The socioeconomic implications of these financial disparities are far-reaching. To take but one example germane to the Commissions' charge: two-thirds of employment growth in North Carolina from 1983–87 was attributable to the start-up of new businesses, primarily small, locally owned firms. Over roughly the same period, the number of new black-owned firms increased by 46%, according to the 1987 *Survey of Minority-Owned Business Enterprises*.

The upshot of this information is quite simple. Against heavy odds, black-owned firms apparently contributed strongly to employment growth in North Carolina in the middle of the decade, especially for the 22% of our population that is black. The odds were heavy for many reasons, not least of which are the difficulties faced by black firms in raising capital. Lower earnings of blacks leave less room for savings, and therefore very limited possibilities for accumulating sufficient capital to start a business, as borne out by the data showing financial assets of white households as a very large multiple of that for black ones. These considerations suggest not only that government policies (whether tax, spending or financial) that discriminate against small firms discriminate also against employment growth generally, and in black-owned firms in particular.*

The foregoing discussion by no means exhausts all of the demographic considerations having an important bearing on the future of the State economy and state-local budgets. For example, we know with some certainty that a large number of State workers will be retiring within the next years and that by the year 2000 there will be as many retirees as active employees.

Evolution of the Federal Budget: By the end of fiscal year 1991–92, North Carolina will have coped, after a fashion, with three consecutive years of severe budgetary stringency, and in the process will have placed at risk much of what has been gained in education, public health, and other fields earlier in the eighties. In some areas, particularly in university education, many years may be required to make up for ground lost from 1989–92. Small comfort can be taken in the knowledge that at least thirty-three other states, including twenty-eight states east of the Mississippi, have been experiencing similar fiscal difficulties, according to the National Association of State Budget Officers. This nationwide state of budgetary malaise is not wholly attributable to the current, and so far, relatively mild recession. It is also an outgrowth of evolving patterns of federal budgetary responses to continued high deficits: $318 billion in the present fiscal year (about 5% of GNP, the highest proportion since 1986), even before accounting for the entire cost of the Persian Gulf War.

More than a decade of Federal attempts to cope with ever-looming deficits have resulted in large negative spillovers to state and local budgets. The emerging fiscal realities of Federal bail-outs, first of savings and loan associations and now possibly commercial banks, suggest that this trend will persist for some time. Three

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* Testimony by Nathan Garrett identified several aspects of the current tax system that discriminate against small firms. These include features of the State franchise tax (which causes firms to pay tax even when they are suffering losses), the intangibles tax (which overstates the value of accounts receivable), and the use tax (inadequately enforced against out-of-state catalog suppliers). The Commission did not include specific proposals for reform of these features, largely on ground that its focus was on broader policy issues. Nevertheless, strong cases can be made for these changes.

sets of federal deficit-reducing responses have had and are likely to continue to have severe implications for the fiscal health of states. These are: further federal encroachment on jointly-shared tax bases, federal spending mandates to the states, and progressive federal withdrawal from programs of financial assistance to states.

The most recent examples of federal encroachment upon tax bases used also by states may be found in some of the measures adopted by Congress in October 1990, as part of a five-year deficit reduction plan. These include increases in federal taxes on gasoline, tobacco, beer, wine and spirits, and full extension of Social Security coverage to certain state and local employees. Together, these measures will cost states at least $14 billion over the period 1991–95 (about $2.8 billion per year). North Carolina alone will lose about $109 million from the excise tax changes alone.

But recent examples of federal encroachment on tax bases used also by the states pale in importance against the possibility of enactment of a federal value-added tax. A value-added tax extending through the retail level would have a base essentially identical to the retail sales taxes used by 45 states. This possibility, while unlikely over the next two years, is favored by many in Congress, and a low-rate value-added tax is by no means outside the realm of possibility later this decade. Nearly sixty nations now utilize value-added taxes, including all European Community members and Canada.

The October Federal budget package was also the most recent example of a long series of measures contributing to the erosion of State fiscal vitality through federally mandated changes in Medicaid and other programs, with no provisions of funding to pay for them. These included mandated state payments of Medicare deductibles, capped entitlement programs for the elderly and disabled, further mandated state reimbursement of prescription drugs, and a 130% increase in the base of the Medicare payroll tax (as employers, states will bear the cost along with the private sector). Overall, these mandates alone will cost states about $4.2 billion before 1995. In North Carolina, Medicaid is the fastest growing state expense, expanding by 18% annually over the last 7 years.

Finally, the Federal Government has been progressively withdrawing from programs that formerly channeled large amounts of federal assistance to state and local governments for education, law enforcement, urban development, water and sewer services and virtually every other area formerly under the sole responsibility of state and local governments. Even as late as 1981–82 the federal contribution to state-local revenues was 20.9%. By 1989–90, this proportion had declined to 16%. By January 1991, the President proposed that the last large remaining programs would devolve to the states, apparently with a guarantee that no state would actually lose money in the process. In any case, implementation of this proposal would mean that the process of Federal withdrawal from assistance programs to states and localities would be virtually complete.

Implications of the Worldwide Fiscal Revolution: The first 35 years of the post-war period were ones in which nations around the world attempted to "fine-tune" their tax systems to achieve a wide variety of non-revenue goals. Many, but not all, of these goals were widely perceived as worthwhile: to redistribute income, to promote job formation, to direct investment resources to "priority" sectors or sectors of "national need," to encourage mineral exploration, to promote the development of poor regions within a nation or a state, to promote domestic shipbuilding, to attract foreign investment, to encourage energy conservation, and to restore historical properties. Other goals sought by fiscal fine-tuning were perhaps less worthy, but all required the use of either tax incentives such as income tax exemptions or credits, or high marginal rates of tax, or both. Indeed, the presence of the incentives themselves required higher tax rates on activities not favored by incentives, which in turn increased the value of incentives to those receiving them. Moreover, many well- intentioned tax incentive programs fell victim to the ingenuity of taxpayers, or their tax attorneys, so that many degenerated quickly into notorious tax shelters such as those riddling the U.S. income tax prior to 1986. In any case, by the late seventies, pursuit of non-revenue objectives began to so overload tax systems that they began to fail in performing their fundamental function: raising revenue in an orderly and non-inflationary fashion, to support expenditure programs desired by citizens.

High-income tax rates in particular proved singularly ineffective in redistributing significant amounts of income from rich to poor. Instead, the principal function of high marginal income tax rates seems to have been to justify higher taxes on everyone. As it happens, experience virtually everywhere, including not only the U.S., Canada, Scandinavia, the European Community, and dozens of developing countries, indicates that the expenditure side of the budget, including outlays for education, public health, and medical care is a far more potent instrument for income redistribution than the tax side of the budget. The inherent superiority of the expenditure side of the budget in achieving significant income redistribution over time has been catalogued in dozens of countries, and is no longer in real dispute. Still, a quarter of a century ago, the United States income tax code provided for a top marginal rate of 91%, while that of Britain was 92.5%. Not ten years ago, the top U.S. rate was 70%. Slightly more than five years ago, the U.S. rate was 50%. Today it is 31% for the wealthiest, while the top British rate is now 40%.

This revolution in taxation has been by no means confined to the United States and Britain. In the five years between 1984 and 1989, 57 nations reduced their top rate of income tax, while only two raised this rate. Moreover, many of the tax rate reductions were particularly large: 50% in Britain and New Zealand, 60% in Brazil, 33% in Iceland and Norway, and 30% in Japan. Virtually all countries enacting sharp reductions in income tax rates coupled rate reductions with reforms involving very substantial broadening of the tax base, through abolition of special tax incentives and ending tax shelters. As a result, in many countries, higher income groups ended up paying a higher proportion of total income taxes than when tax rates were much higher, as in the U.S.

Several reasons account for the worldwide movement away from high marginal tax rates, special tax incentives, and fiscal fine-tuning generally. First has been growing recognition of the inefficacy of high tax rates in securing income redistribution goals and of the damage of high rates to incentives to save, invest, and work. Second has been a growing realization that special tax incentive programs not only tend to fail in achieving the desired results, but are vastly inferior to the strongest tax incentive program ever devised anywhere: lower tax rates for everyone, made possible by elimination of tax preferences for the favored few. Third, the interplay of high marginal tax rates and special tax incentives and preferences rendered many tax systems virtually inadministerable.

Finally, globalization of world markets constitutes a powerful reason for lower, more uniform rates of tax imposed on as broad a base as possible. Globalization has been accompanied by, and indeed partly due to, the expanding mobility of world resources, especially, but not exclusively capital. Technological developments have contributed greatly to this mobility. The costs of transporting plant and equipment across international boundaries are much lower than a decade ago. In many cases, the amount of capital required to produce any given volume of products or services has been lowered, partly because greater and greater computing power has been achieved with progressively smaller chips. As a result, production processes that once required dozens of acres can now be compressed into plants with a fraction of the floor space. Communications have become drastically more accessible and progressively less expensive. For example, between 1977 and 1987, international telephone calls to and from the U.S. rose from 300 million minutes annually to nearly 5 billion minutes, a 16-fold increase. And technological developments in communication have vastly facilitated the decentralization of capital as well as shifts in the use of capital through out-sourcing of components of products, as exemplified in the proposed North Carolina air cargo-industrial complex, cited in the "Globalization" discussion. Finally, a growing proportion of capital is taking the form not of tangible real property, but of information, extremely difficult to tax because it can be reduced to chips and sent across national boundaries by satellite.

For all of these reasons, the growing degree of capital mobility in the world's increasingly consolidated markets mean that no country can long maintain rates of tax on income from capital much above the prevailing world average, which we have seen to have fallen notably over the past decade. It also means that states with higher than usual corporate tax rates will tend to face growing migration of capital beyond their borders, unless they are using their tax revenues to provide superior services for business and a more highly qualified labor force. If the corporate income tax is to remain a significant source of revenue for states, then no state can afford to maintain expensive tax preferences that require tax rates on non-favored firms to remain high. These considerations are reflected strongly in the Commission proposals pertaining to income taxation.

Growing Environmental Constituencies: The environmental movement in the United States has many diverse constituencies. Some are single-minded in the pursuit of their objectives, a very small proportion are not averse to use of unorthodox methods, and some have been accused of pursuing environmental goals to advance personal agendas. But these traits are not shared by the vast majority of citizens who for many different reasons have become increasingly vocal regarding environmental protection and sustainable use of natural resources. Some have been galvanized to protect the immediate interests of their families and friends, accounting in part for strong "not-in-my-backyard" attitudes toward siting of plants for treating hazardous or low-level radioactive waste. Others have been spurred by growing visual evidence of carelessness or lawlessness in waste disposal, as in repeated instances of medical wastes washing up on beaches, or clandestine dumping of contaminants along rural roads. Many of these groups are also motivated by broader quality-of-life concerns, and are no less willing to place monetary values on clean rivers and estuaries as upon the shoes they wear or the food they consume.

On occasion environmental groups may have been victimized by misleading or incorrect information pertaining to acid rain, global warming, hazardous waste disposal, and air and water quality, but they are not always wide of the mark nor are their arguments usually based on irrationality, emotion, and fear. In any case, their numbers are growing, particularly among rural and urban dwellers in the bottom half of the income scale, and even among the ranks of top-level managers in the nation's largest enterprises. Moreover, their concerns are being heard by increasingly receptive ears in government, particularly in Washington, as witnessed by the recent passage of the new Federal Clean Air Act. This legislation mandating the states to enforce clean air standards will involve sizable costs to the private sectors regardless of its ultimate impact upon air quality.

In the best of circumstances, the growing body of environmental legislation at all levels of government will ultimately result in significant improvements in the quality of life without imposing needless burdens on the citizens of North Carolina, the enterprises for whom they work, or the governments they elect.

But even under the best of circumstances, implementation of environmental objectives already required by law will very likely involve a sizable increase in demands on state and local budgets, at a time when governments are struggling with poverty and a large backlog of unmet social needs. The costs of cleanups for water and soil resources may fall disproportionately upon many jurisdictions. The cost of retrofitting government-owned facilities that generate pollution or potentially hazardous wastes may be quite substantial over the coming years. The costs to some governmental jurisdictions of implementing environmental legislation and regulation is not trivial even now. For states that fail to implement

EPA air quality standards, federal highway funds may be cut off. By 1994, federal dollars for local wastewater treatment plants will virtually dry up. Perhaps 35% of the 120 local sanitary landfills have useful lives of less than five years.

It has become increasingly difficult, under current institutional arrangements and policy frameworks, to accommodate environmental concerns and economic development. Our current approach for addressing environmental problems relies almost exclusively upon a "command and control" regulatory system. This system has been administratively burdensome for government as well as industry. In addition, technological changes have produced new types of waste as well as new types of waste-reducing technologies. The command and control system of regulation has proven very sluggish in responding to these changes. Moreover, the current system has evolved primarily to handle "point-source" pollution largely from large scale polluting activity such as electric power plants. But an increasing fraction of all pollution results from numerous small generators of so-called "non-point" discharges by households and small firms involving, for example, agricultural run-off or garbage disposal. The traditional approach to pollution abatement has proven ineffectual in dealing with this source of pollution arising from innumerable sources.

An alternative approach for coping with both point-source and "non-point" pollution relies heavily upon economic instruments for pollution abatement, particularly the appropriate use of environmental taxes that work through market mechanisms. The breadth and dynamics of environmental pressures requires the kind of broad and continuous technological responses that can be induced by market-based signals, but not by much more cumbersome command and control mechanisms. Finally, environmental taxes, including those upon household waste disposal and urban road congestion, can be applied in a revenue-neutral way, allowing other taxes (including those on businesses) to be reduced commensurately.

The Commission devoted considerable time to discussion of revenue-neutral environmental taxes as a substitute for current regulatory approaches to pollution abatement. While these market-based instruments are gaining increasing acceptance from Norway to Hong Kong to Finland and Holland, the Commission declined to endorse or reject this approach. Rather, the Commission concluded that much greater public discussion of the issue is warranted before North Carolina moves strongly to substitute environmental taxes for current regulatory arrangements.

REVENUE STRUCTURE

Guiding Principle: The State's revenue structure should be modernized to reflect changes in the economic environment in the State and to insure that sufficient revenues are generated without having to repeatedly resort to *ad hoc* revenue adjustments.

Commission Vote: The Commission was unanimous in endorsing this principle.

Major steps in the modernization of the State's revenue structure were in fact taken following the 1989 report of the *Tax Fairness Study Commission*. The prime focus of the Tax Fairness Study Commission was upon equity in the tax system: to insure that the tax system did not place undue burdens on the poorest members of society, while assuring that the relatively well-off paid taxes commensurate with their incomes. The 12 basic recommendations made by the Commission were designed to make the North Carolina tax system more equitable for all citizens. Three of these proposals were enacted into law in essentially the same form as proposed by the Commission: revision of the State personal income tax to conform more closely to the Federal tax base (and thus federal tax reform), enactment of a comprehensive tax enforcement and compliance package, and an increase in the tax credit for child and dependent care. One further proposal, the equalization of the income tax treatment of retirement income, was adopted by the General Assembly, but in a somewhat different form than that favored by the Commission and was partly prompted by a U.S. Supreme Court decision. These measures did much to enhance both *vertical* and *horizontal* equity in the North Carolina tax system.

Vertical equity in taxation means that the tax system should distribute burdens across people in accordance with ability to pay, as measured by income or wealth or consumption, or all three. The enactment of the personal income tax proposal of the *Tax Fairness Commission* made a significant contribution to vertical equity by substantially raising the amount of tax-free income. As a result, 700,000 low-income people were effectively taken off the income tax rolls and the tax burden on almost two million "working poor" taxpayers was reduced. Further, as a result of a Commission proposal, the income tax credit for child care credit was raised from 7% to 10% for dependent children under age 7. Because any income tax credit of any given size constitutes a higher proportion of total taxes paid by those with low incomes than those with high incomes, this measure made a small contribution to vertical equity.

Horizontal equity in taxation means that taxpayers with equal ability to pay should contribute equally. One of the proposals of the Tax Fairness Commission adopted by the General Assembly enhanced horizontal equity: the partial equalization of the tax treatment of retirement income and the enactment of much of the commission's proposed tax enforcement and compliance package.

Prior to the 1989 change, the first $4,000 of retirement income of Federal retirees was exempt while state and local retirees enjoyed a full exclusion. Now, the first $4,000 of all public pensions is exempt and private sectors retirees receive a $2,000 exclusion. So while great improvement has been made, there still remains a horizontal equity issue for private versus public pension exclusions.

Tax evasion, an illegal activity, clearly damages both vertical and horizontal equity in a tax system. If tax evasion is more prevalent among higher- than lower-income people, vertical equity is clearly reduced. If, among groups with similar levels of income, some groups are more prone to evade tax (by hiding or understating income or overstating deductions) horizontal equity suffers. To the extent that the stiffer fines and penalties and the tax amnesty program proposed by the Commission helped reduce tax evasion, overall equity of the tax system was improved.

Enactment of several of the measures proposed by the Tax Fairness Study Commission allowed our Economic Future Commission to focus more closely upon issues of tax modernization: cleansing the tax system of provisions having harmful and largely needless effects, intended or unintended, upon the future course of economic growth and development in North Carolina. This approach also allowed the Commission more time to isolate features of the system that discriminate in favor of certain forms of consumption, or which result in tax revenue losses with little or no corresponding social benefit.

Modernization also requires that the State tax system be made more responsive to future growth of income and consumption in North Carolina. If this goal is not achieved, then the General Assembly will be forced to resort time and again to *ad hoc* measures to increase revenues or curtail spending. By their nature, *ad hoc* revenue and expenditure adjustments under severe budget pressure are unlikely to contribute to tax equity or tax modernization, except by accident.

Notwithstanding the partial implementation of the proposals of the Tax Fairness Commission, our Commission has concluded that further measures to improve equity are both desirable and feasible. These include the extension of the base of the sales tax to more consumer services, the elimination of certain sales tax preferences for purchase of certain items used primarily by upper income individuals, and the repeal of virtually all income tax incentives and credits.

The Commission did not recommend one measure that, under certain circumstances, could contribute substantially to tax equity: the adoption of an income tax credit to offset the burden of the sales tax on food purchased for home consumption by low-income families, as used in at least a dozen states. North Carolina, along with 19 of the 45 states using sales taxes, includes food in the tax base (Food Stamp purchases are exempt). Because such a high percentage of family expenditures in the lowest income groups is for food, failure to exempt food without question renders a sales tax regressive if consumer services are not taxed. However, exemption of food for home consumption would, in North Carolina, result in revenue loss of over 14% of total sales tax revenue (over 20% if all food purchases are exempted). This is not an advisable step at a time when the state faces a projected 1991-92 deficit equal to nearly one-seventh of projected expenditures.

A food tax credit under the personal income tax would reduce regressibility of the overall tax system. A credit of $250 would be sufficient to offset sales tax of $5,000 worth of food purchases, and the credit could be phased out for high-income households. But the very success of the Tax Fairness Commission proposals in removing 700,000 people from the income tax rolls means that the food tax credit would not relieve the sales tax burden of the people needing it most. Therefore the Commission did not consider this option.

a) Specific Objective:

The State sales tax should apply to goods and services purchased by individuals for personal use; services purchased primarily by businesses should not be included in the base of the tax.

Commission Vote: A majority of the Commission voted, by a small margin, in favor of this objective.

Revenue, equity, administrative and economic development considerations underlie the arguments in favor of this objective. Fears that taxes on services might later be extended, as in the failed Florida initiatives of 1987, to business services, accounted for virtually all of the minority votes.

Implementation Option:

1. Eliminate tax on "producer goods" (purchase of tangible personal property by business for use in providing a good of service).

Commission Vote: The Commission voted, by a very wide margin, to recommend this proposal.

Taxation of producer goods leads to unintended inequities, and clearly undermines the competitiveness of North Carolina industry. North Carolina is unusual among the 45 states imposing sales taxes and the over sixty nations employing a national sales tax in that most other jurisdictions go to great lengths to *avoid* including producer goods (goods used in production such as equipment, machinery, etc.) in the base of the sales tax. Twenty-two states exempt those goods altogether. Thirteen states, all west of the Mississippi, do not. Indeed, one of the fundamental reasons why the nations of the European Community (EC) and more than forty other countries have adopted the value-added tax has been precisely the ease with which producer goods can be excluded from the scope of this tax. Sales taxes are intended to, and work best when levied on personal consumption expenditures. When goods used in production are taxes as well as final products, an element of multiple taxation of the same consumer expenditures is introduced.

The only possible argument in favor of including producer goods in the base of the sales tax is based on revenue considerations. Against this argument may be arrayed a strong set of objections to the taxation of producer goods.

The world's leading authority on sales taxation for the past fifty years has long and successfully argued against taxation of producer goods, citing the following objections to this practice.*

1. The tax will not constitute a uniform percentage of consumer expenditures, since some goods require more taxable producers goods than others, per dollar of sales. The consequence of the multiple taxation is discrimination against certain families because of their relative preferences for various goods. *Commodities that the General Assembly seeks to exempt will carry some tax burden.*

2. The tax will affect the choice among various methods of production, since the tax liability will not be uniform with all methods, thus causing loss of efficiency in production processes. *Replacement of old equipment will be delayed.*

3. Firms will be given *incentive to produce for their own use goods* that are subject to tax, since they can reduce tax liability by doing so. They will pay tax only on materials.

4. *Firms in the state will be placed at a competitive disadvantage* in competing with firms in states not taxing producers goods and in selling in world markets. Again, the adoption of value-added sales taxation in Europe is a result largely of efforts to exclude producers goods from tax for reasons of competitiveness.

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* John F. Due, *Sales Taxation* (University of Illinois Press, 1957) and John F. Due and Raymond Mikesell, *Sales Taxation State and Local Structure and Administration* (Baltimore, Johns Hopkins Press, 1983).

Implementation Option:

2. Extend Sales Tax to Include Additional Consumer Services.

Commission Vote: The Commission endorsed this proposal by more than a 2:1 majority.

When sales taxes were first introduced in the thirties, they were imposed almost exclusively upon the sale of tangible personal property. Beginning in the sixties, it became increasingly clear that service expenditures were becoming a growing proportion of total personal consumption expenditures, and that distinguishing between purchases of goods and services for purposes of the sales tax had no economic or equity basis. Moreover, the failure to tax services began to cause difficulties in sales tax administration, since many firms, especially repair shops, are already registered vendors and taxation of their entire receipts is much simpler than having to separate taxable material from exempt services.

Certain services are already subject to the North Carolina sales tax. These include services provided by operators of hotels, motels and tourist homes and camps, dry cleaning and laundry services, and the gross receipts of public utilities.

The strongest reasons for including more consumer services in the scope of North Carolina sales tax relate to the need to accommodate the State's fiscal system to future trends in consumer spending, and to equity considerations.

Food accounts for at least 20% of the present base of the North Carolina sales tax. Sales of tangible personal property account for the remaining 80%. About 10% of this amount comes from sales of producer goods, which the Commission proposes to exempt. Consumer expenditures upon food will increase at a rate below that for the growth of personal income (i.e., consumption of food is income inelastic).

Consumer expenditures on tangible personal property may be expected to increase by no more than the rate of growth in income. Consumption of personal services, however, tends strongly to be income elastic: it rises at a rate faster than income. Therefore, failure to tax consumer services will saddle North Carolina with a sales tax base that will be increasingly less responsive to growth in personal income. Since fully one-quarter of general fund tax revenues will be derived from the sales tax in 1990–91, this is a serious matter for the future fiscal health of the State.

In addition, inclusion of consumer services in the sales tax base will make at least a small contribution to vertical and horizontal equity in the tax system. Vertical equity would be enhanced because spending on services is income elastic: higher income families tend to spend a higher proportion of their income on services. Horizontal equity will be increased because taxation of services will reduce discrimination against families spending a higher proportion of their income on goods, relative to other families at the same level of income.

Evidence from other states indicates that full taxation of all services, including personal and professional services (but excluding contracting and rentals) would add about 30% to the yield of the tax. It is very important to note, however, that the Commission does not endorse full taxation of all services, as adopted in Florida in 1987 and then repealed. In particular, taxation of services rendered primarily to business firms (legal, accounting, advertising, architectural, janitorial services, and freight) is subject to precisely the same problems as arise in the taxation of producer goods, which the Commission rejects.

Implementation Option:

3. Eliminate current tax preferences on the sale of items of tangible personal property for use by individuals for personal use.

Commission Vote: The Commission voted, by an overwhelming majority, to endorse this proposal.

The Commission urges the General Assembly to eliminate the preferential 2% sales tax rate and the $1,500 tax limit on dealer sales of boats and aircraft purchased primarily for personal use. Railway locomotives and railcars should be fully exempt because they are producer goods. Revenue as well as equity considerations argue in favor of abolishing these preferences, which primarily benefit high-income individuals.

b) Specific Objective:

State corporate tax incentives are largely ineffective, and undermine tax fairness and simplicity objectives.

Commission Vote: The Commission was unanimous in endorsing this objective.

Most, but not all of the special corporate tax preferences now in place date from the days before the worldwide fiscal revolution that began in the late seventies, when governments sought to "fine-tune" tax systems to achieve non- revenue objectives. With the widespread movement toward broadening of income tax bases taxed at lower, more administerable tax rates, special income tax incentives have begun to be removed from tax systems, in some nations abolished altogether. This has been done in order to allow governments to offer a much more widely available tax incentive that does not complicate tax administration nor penalize non-favored activities: lower tax rates for all firms. The special corporate tax preferences used by North Carolina have in addition been singularly ineffective in yielding the results they were intended to encourage. By removing them, the State will send a strong message to owners and managers of firms worldwide: North Carolina has abandoned fiscal fine-tuning in favor of simple tax laws applying evenhandedly to all business activity, at rates only high enough to provide the revenues essential to make the State a desirable place in which to invest and live. The perception of North Carolina as a state wherein business activity is conducted under clearly specified, and simple, tax rules, rather then subject to the changing whims of administrative authorities, is important for the economic future of the state.

Finally, corporate tax preferences have diminished vertical equity of the tax system, since (if they benefit anyone at all), the benefits tend to be concentrated in the hands of higher income families.

Implementation Option:

Eliminate all special exemptions, deductions and credits under the corporate income tax.

Commission Vote: Consistent with its view on the specific objective above, the Commission voted unanimously in favor of this option.

The State corporate income tax should reflect the principle that all costs of producing a good or service, including capital costs reflected in depreciation allowances, should be deductible from gross business income in arriving at taxable income. Beyond that, no special preferences that necessitate higher taxes on those not receiving preferences should be allowed. It is extremely important that all, not just most, corporate tax preferences be abolished. The presence of even one special credit, exemption or deduction constitutes a powerful tool in the hands of interests seeking to benefit from tax preferences. If special preferences can be justified for one activity or purpose, they can more easily be justified for others. The corporate tax then becomes vulnerable to all manner of demands, justifiable in isolation, for special treatment. Each new provision conferring special treatments is difficult to resist. This is because the benefits of special treatment are concentrated in the hands of the few receiving them, while the costs are diffused over the entire taxpaying public.

Finally, the Commission wished to state clearly and explicitly that the foregoing proposal should not be construed as involving any changes in the way the State assesses tax on the income of multi-state or multinational firms. Specifically, the Commission rejects any notion that so-called "unitary" principles should be used by the State of North Carolina in apportioning the income of multi-state or multinational firms.

c) Specific Objective:

Sumptuary taxes not levied on an ad valorem basis should be periodically reviewed and updated for inflation.

Commission Vote: The Commission endorsed this objective with a near-unanimous majority.

Sumptuary taxes include those levied upon tobacco products and alcoholic beverages. The tradition in North Carolina, as in many other states, has long been to impose sumptuary taxes on a specific, rather than an *ad valorem* basis. A specific tax is a tax expressed in terms of taxes due per quantity: so many cents per quart, per package, or per bottle. Revenues from ad valorem taxes (taxes imposed on value) adjust automatically to higher prices. In the presence of continuing inflation, real (inflation adjusted) revenues from specific taxes decline steadily per unit of item purchased. For example, consider a specific tax of 21 cents per bottle of wine, imposed in, say, 1971. Over the past 20 years, the consumer price index has tripled. If the specific tax per unit remained unchanged from the level in 1971, the real tax burden per unit of wine purchased would have declined by 2/3 to 7 cents, expressed in dollars of 1970. To approximate the intent of the General Assembly in imposing the 21 cent tax in 1970, the tax would need to be raised to 63 cents per bottle, merely to compensate for inflation.

In addition, the consumption of sumptuary items, particularly tobacco, tends to be quite income-inelastic: as income rises, spending on sumptuary items rises much more slowly. The combination of specific taxes that remain unadjusted for inflation and the income inelasticity of consumption of sumptuary items means that revenue from these sources grows very slowly, especially on a per capita basis. For example, excise taxes on cigarettes and alcoholic beverages furnished 8.6% of state general fund tax revenues in 1971, but now provide only 2.3%.

Periodic update and review of specific tax rates on sumptuary items will not allow revenues from these sources to keep pace with growth in personal income; but by at least allowing per unit sumptuary tax revenues to keep pace with inflation, this step will reduce future pressures for raising rates on other taxes, particularly the sales tax, where (given no increases in the tax rate) revenues will just barely keep pace with income growth even if more consumer services are taxed, and will fail to keep pace if services are not taxed.

d) Specific Objective:

User fees for services of primary benefit to the recipient should, to a reasonable extent, reflect at least some portion of the operating cost of providing the service, and, so far as practical, the agency collecting the fee should retain the fee for use in providing the service.

Commission Vote: This option was accepted unanimously by the Commission.

The bulk of spending by governmental units is for programs benefiting society as a whole. The "public good" nature of these services means that it is impossible to parcel out benefits to each user and apply fees based on benefits received. However, the State provides many services where either the primary benefits go to users or governmental costs are incurred as a result of specific activities of the user. For these services, the Commission recommends that fees bearing some relation to the cost of providing the service be levied.

There are many reasons for this recommendation. For one thing, in many cases a government agency is competing directly with private activities. A classic example is a campground at a State park. If no fees, or unduly low fees are charged at the State facility, private suppliers are at a competitive disadvantage.

Secondly, prices provide economic signals to service providers and users that help to allocate scarce resources. If prices for a State facility are set too low, the public will overuse it. In addition, the low prices will tend to lower the return on capital in private facilities to the point at which it is not profitable to engage in business. Thus, prices help to retain a proper balance between public and private services.

Finally, proper pricing of direct services reduces the internal subsidies that occur if prices are set too low. Levying a fee reduces the burden on State appropriations funded by general tax dollars.

The Commission realizes that it is not good public policy to try to charge fees equal to full cost for all services. Even some apparently direct services to identifiable individual users provide benefits to many members of society. In addition, user fees that are set too high will discourage use of public facilities by lower-income persons. For these individuals public facilities may be the only affordable option.

e) Specific Objective:

The State should begin systematically reviewing all policies pertinent to deriving revenues from the taxation of non- renewable resources.

Commission Vote: The Commission endorsed this objective by a 2:1 majority.

Mining and extraction of non-renewable resources has played a larger role in the economic history of the State than is commonly recognized. For example, at various times in the first half of the 1800's, the state was the leading producer of gold in the country. Today, North Carolina is an important producer of phosphates. Tar, of course, has a very special place in the cultural history of the state.

Taxation of non-renewable resources involves very complex technical issues not encountered in the taxation of manufacturing or service industries. Inappropriately designed taxes imposed on extraction of non-renewable resources can lead to serious unintended consequences on extractive investment, can result in wasteful extractive methods, and can also lead to substantial tax revenue losses, relative to sensibly applied resource taxes in other states.

The Commission did not believe that these complicated issues could be adequately examined in the 14 weeks the Commission had available for deliberations. At the same time, the Commission understands that the question of the taxation of extractive activities has not been systematically and comprehensively reviewed in recent memory.

The Commission therefore recommends that the executive and legislative branches appoint a Study Commission on the Taxation of Non-Renewable Resources. The Commission should be given at least a full year to complete its work, which should begin by the end of the 1991 legislative session.

f) Specific Objective:

All the State adjustments to federal taxable income, such as additional personal deductions and credits, should be limited to those that are related to expenses of earning income or which further define the taxpayer's ability to pay.

Commission Vote: The Commission endorsed this objective with a unanimous vote.

The Commission emphasizes that this objective does not apply to such exclusions from income as Social Security, Railroad Retirement, and other retirement income. Neutral income tax treatment of retirement income requires either that contributions be deducted from taxable income during a taxpayer's working lifetime and the retirement income be taxed, or alternatively, the contribution should not be deductible and the retirement income should not be taxed. Since the federal and state income taxes do not generally allow deductions of employee contribution for Social Security or most other retirement options (excluding 401-K plans) then certainly for that portion of retirement income based on employee's contributions, retirement income should not be taxed.

Otherwise, implementation of the objective as expressed above is essential for protecting the integrity and fairness of the personal income tax. The same arguments marshaled earlier in support of the abolition of all corporate tax preferences apply here with no less force.

g) Specific Objective:

The intangibles tax has adverse effects on location decisions of business and households and impacts negatively on death tax collections. The tax should be repealed.

Commission Vote: The Commission endorsed this objective with a near unanimous vote.

The Commission's call for repeal of the intangibles tax echoes that of the Tax Fairness Study Commission in 1989. Many states that have imposed this tax have now left the field, for many of the same reasons cited below.

Contrary to widely-held perceptions, payment of the intangibles tax is not confined only to high-income persons; it also has disproportionately negative effects upon small businesses, particularly those catering to lower-income customers. This is because that part of the intangibles tax that is imposed upon accounts receivable is imposed upon the face value of the accounts, not upon the face value reduced by a reasonable allowance for doubtful accounts. This works a special hardship upon firms whose continued existence requires the extension of credit to persons having a reduced ability to pay, and therefore a history of high bad debts.

The intangibles tax also encourages the migration of a potentially significant portion of the death tax base. Anecdotal evidence, including testimony before the Commission, suggests that over the past decade or so, a significant number of North Carolina's wealthiest taxpayers have legally established their principal place of residence in other states, primarily to avoid intangible tax liability. Upon death, the right to death tax revenues generally accrues to the state where the deceased taxpayer legally resides. It is clear that the portion of the intangibles tax levied on financial instruments has served to reduce collections from the North Carolina estate and inheritance tax.

In addition, testimony before the Commission suggests that the presence of the intangibles tax may, in a world of rapidly growing mobility of capital (see section 4, Economic Trends) also have the effect of discouraging both relocations of firms to North Carolina as well as start-up of new investments by firms based outside the state. If so, the tax would be a more significant barrier to new investments by out-of-state firms that rely heavily upon highly-skilled, and highly-paid, managers, many of whom may have taken a large portion of their compensation in stock dividends or their equivalent.

h) Specific Objective:

State excise tax bases should be adjusted to eliminate discrimination in taxes levied on similar products.

Commission Vote: The Commission unanimously endorsed this objective.

By definition, tax systems divert resources from the private sector to finance the provision of governmental services. One principle of sound tax policy is to try to minimize the degree to which the tax system impacts decisions made by consumers, workers, investors and other economic actors.

Taxing some items under the general sales or selective excise taxes at favored rates (including exempting items) affects the relative prices of close substitutes. This increases consumption of lower-priced items. The additional purchases, in turn, affect the decision of producers as well as other agents in the distribution chain. In other words, differential tax rates of similar products can have a far-reaching impact on the allocation of resources in the economy.

Implementation Option:

The cigarette excise tax should be expanded to a tobacco products tax (adds cigars, smokeless tobacco).

Commission Vote: The Commission was unanimous in endorsing this option.

The exclusion of cigars and smokeless tobacco from the scope of the excise tax structure was anomalous. The exclusion favored the rapid growth of consumption of smokeless tobacco in recent years, and involved non-trivial sacrifices in revenue from sumptuary taxes.

i) Specific Objective:

The General Assembly should strongly consider the potential of a State lottery to raise revenue.

Commission Vote: The Commission endorsed this objective by a very narrow margin.

The Commission's views were more sharply divided on this issue than on any others brought to a vote. On the one hand, a statewide lottery could potentially bring in as much as $200 million a year, beginning the first full year of operation. In addition, many North Carolina residents living near the borders of neighboring states with lotteries have reportedly been enthusiastic participants in the lotteries of those states. Thus, enactment of a lottery for our state would, it is argued, only serve to capture revenues now flowing elsewhere.

On the other hand, experience from the 33 jurisdictions (32 states and the District of Columbia) operating lotteries before 1990*, and testimony presented before the Commission by Philip Cook, suggests that lotteries are a regressive source of revenue, in the sense that, as a percentage of income, the tax implicit in lottery purchases declines as income increases. Moreover, among those who do play, the most active 20% of players wager about 65% of the total. Over the course of a year, about 60% of the adult population of lottery states participate in the lottery. These figures mean that only 12% of the adult population, preponderantly in the lower half of the income distribution, account for nearly two-thirds of wagers. With per capita sales of $110 in 1989, this means that 20% of the players pay an annual lottery tax of $363. Evidence suggests that for the most part, lottery expenditures are not taking the place of other gambling in the household budget. Rather, lotteries attract new participants to gambling, as well as habitual gamblers.

In addition, net revenue gain from lotteries have often fallen short of expectations, certainly in Florida, where a lottery was created in 1988. Nationwide, lotteries in 1986 accounted for only 3.3% of revenue in states that run them. If a lottery were enacted here, it might produce as much as 2.5% of general fund revenues.

Finally, the lottery has not been a panacea for dealing with the operating budget deficit in states. Not only are revenue flows undependable, but many states have found that budget makers reduce the normal level of state or local spending on the programs funded by the lottery.

Should the General Assembly approve a lottery for the state, there are important lessons to be learned from the experiences of the 33 jurisdictions already operating lotteries. Experience suggests, in particular, that restrictions placed on advertising,

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* See Charles T. Clotfelter and Philip J. Cook, *Selling Hope: State Lotteries in America* (Cambridge, Harvard University Press, 1989).

promotion, and new products, as in Virginia and Wisconsin, can play important roles in curbing many of the possible excesses encouraged by state-sponsored gambling.

> **j) Specific Objective:**
>
> The General Assembly should commission a study of the overall economic benefits of pari-mutuel betting on horse racing and dog racing.
>
> Commission Vote: The Commission endorsed this objective by a 3:1 majority.

Pari-mutuel betting on horse racing is allowed in 43 states. States not allowing such activities either do not have major metropolitan markets to draw from or adequate training areas.

Generating additional state and local revenue is not the primary reason for allowing pari-mutuel betting. In fact, the industry estimates that net gambling revenues have declined from 5-6% of the amount bet to 3% and will decline by the end of the century to less than 1/2%.

The Economic Future Commission recommends a review of the economic benefits of legalized betting. These benefits include the enhancement of farmland values, additional tourism, the development of breeding programs, and a stimulus to the agri-business industry in the State.

BUDGETARY PROCESSES

Guiding Principle: The process of deciding how much of the income of the State's citizens should be devoted to the funding of State programs should be modernized to make it responsive to the future economic needs of the State.

Commission Vote: The Commission unanimously favored this principle.

Much of the machinery used to develop the State budget was adopted in 1921 in the form of the Executive Budget Act. At the time the Act was adopted, the total State budget amounted to $11.6 *million*. The 1991–92 State Budget recommended on January 31 by the Governor is $13.2 *billion* (including federal funds and departmental receipts).

The new machinery was considered progressive at the time it was adopted. It described in detail each step of the biennial budget process from agency request for funds to final legislative decision. Over the next seven decades, the Executive Budget Act has been re-written and expanded many times.

The language added during the last 70 years represents a vast improvement over the original framework. In fact, Deputy State Budget Office Marvin Dorman noted in his presentation to the Commission that much of the budget machinery now in place is adequate to deal the execution of the authorized budget.

There is a problem, however, with the fact that many of the current budget practices have not been codified into the Act. More important, the massive budget shortfalls during the 1989–91 biennium suggest that even current budget practices could stand improvement. The Economic Future Commission feels that there is no better time to overhaul the State's budget process than the present.

a) Specific Objective:

Increases in the State's general fund operating budget should not exceed the estimated growth of the income of its citizens.

Commission Vote: The Commission endorsed this objective unanimously.

The proportion of income of taxpayers devoted to funding the provision of services by the government to its citizens reflects, in part, the desire of taxpayers for government services. However, as the role of government grows in a modern society it is more likely that a growing number of the new services will be more of a private or commercial activity nature and thus compete with and duplicate private sector alternatives. In addition, tax burdens rise when new revenues are approved to finance the additional governmental activity. As earlier discussion indicates, tax rates much higher than in other jurisdictions provide disincentives to individuals or businesses to undertake economic activities. In North Carolina, for example, state and local tax revenues have risen one-fourth faster during the last 8 years than the income of the State's citizens.

Part of the reason for increased state and local taxes has been the role of New Federalism in turning back program responsibilities. However, New Federalism has not led to a corresponding reduction in the burden of federal taxes, as measured by the ratio of federal receipts to gross national product.

The major reason for the rise in North Carolina is that the State, beginning in 1985, undertook a new education improvement initiative that was estimated to cost, when completed, an amount representing a 13% increase in the State's general fund operating budget. The newest initiative, Senate Bill 2 (performance-based pay) will add another 2% to the budget. While the Commission feels there was a clear need for new initiatives, the General Assembly has developed no long-term plan for financing the 15% expansion in the budget resulting from education improvement.

An option the General Assembly could have considered at the time was a review of existing programs. Such an analysis would have identified obsolete programs, determined privatization possibilities, and eliminated program duplication. These measures would have allowed important new initiatives in education to be funded without higher taxes.

In the last two decades, 20 states have chosen to limit the size of the budget, or tax collections, to some measure of income or inflation. These rules tend to force states to find funds for new programs within the existing budget by reducing or eliminating existing programs. This difference is one reason North Carolina's tax burden has risen relative to other states during the last decade.

b) Specific Objective:

Funds should be appropriated to a program based on its objectives, projected performance measures, and an evaluation (performance indicators) of its past performance.

Commission Vote: The Commission approved this objective unanimously.

Recently the Governor has instituted through the State Office of Policy and Planning and the Office of State Management and Budget a new process whereby agencies are required to submit work plans stating the objectives of the agency for the upcoming budget period. The Commission believes that this initiative is a good start toward a comprehensive system of budgeting based on objectives and performance indicators.

The use of management objectives is widespread in the private sector, especially in evaluating the performance of operating divisions of a corporation. In addition, modern personnel policy dictates the evaluation portion of performance-based pay plans.

c) Specific Objective:

The statute requiring line-item detail should be changed to allow the Governor and departments to prepare and administer a budget on the program level.

Commission Vote: The Commission approved this objective unanimously.

During each legislative session the budget committees are faced with available revenues that are far less than perceived spending needs. Recent years have seen the addition of large federal legislative and judicial mandates and the increased cost of health insurance for teachers and state employees. Finally, the State's commitment to improved education has further tightened an already difficult situation.

To avoid raising taxes, the General Assembly has increasingly looked to reductions in the current operating budget. Each legislative session, the leadership of the budget committees gives subcommittee chairpersons spending reduction targets for each functional area of the budget. So far, so good.

The problem is that actual cuts are always far less than the target and the budget is fixed with fee adjustments, one-time financing options such as accelerating tax payments, and drawing down the year-end credit balance. The State, however, now has run out of one-time balancing options.

One reason for the failure could be the approach used to review agency spending. Traditionally, the Governor and the General Assembly rule out employee layoffs and elimination. This means that 80% of the operating budget is taken off the table and the cuts must come from piecemeal reductions in the 20% of the budget that deals with non-personnel costs.

In one of the Commission's meetings on budget reform, Deputy State Budget Officer Marvin Dorman and State Treasurer Harlan Boyles recommended replacing the line-item budget approach with one that looks at the relative worth of a state program.

Line-item budgeting persists because it is easy for decision-makers to understand. It is hard to value governmental programs where the services provided go to society as a whole and competing private alternatives do not exist. In addition, the tools used in program evaluation are less exact than simply reviewing hard numbers in an agency budget.

However, line-item budgeting does not produce significant reductions in the size of government. It leaves in place programs that should be eliminated while frustrating the delivery of worthy programs.

The Commission does not downplay the need to periodically review the operations of state agencies. In fact, a formal recommendation on this issue is contained later in this report. In addition, line-item data is still required by program managers and auditors for accountability purposes.

The Commission's recommendation is that the Governor and General Assembly review the State operating budget on the basis of the relative value of whole programs instead of spending line items in a particular program. Program budgeting can be accomplished by requiring agencies to prepare objective statements as part of annual work plans and to develop statistics which can be used to measure programs performance and conduct self-evaluations of its past and future need.

d) Specific Objectives:

Measures should be enacted to minimize the uncertainty of revenue and expenditure estimates used in the budget process and budgetary mechanisms should be established to protect the state's fiscal condition against unanticipated negative events.

Commission Vote: The Commission approved this specific objective by a unanimous vote.

Forecasting State revenues and expenditures has always been an inexact science and under present technology always will be. In fact, in some cases a forecast is more "art" than "science".

Economists can give many legitimate reasons why a projection can go wrong, including:

- A lack of timely, reliable data.
- Unanticipated changes in how individuals and groups normally respond to economic signals.
- An inability to capture with forecasting techniques all of the factors affecting the item being forecast.
- The impossibility of anticipating political decisions (military actions, monetary policy, and federal budget actions).
- The inability to anticipate natural events that might have a bearing on the economy.
- Unintentional biases of the forecaster.

During the stable economic environment of the mid-1960's and mid-1980's, State revenue forecasts were very reliable. However, at business cycle turning points, projected scenarios tend to fall apart. The result is that the revenue forecasts consistently underestimate both the size of a economic downturn and the magnitude of the subsequent recovery.

On the spending side of the budget it is often difficult to predict the increase in utilization or costs of certain entitlement programs such as Medicaid and Aid to Families with Dependent Children, particularly when the economy sours. For some states, this has been as much of a factor in causing budget shortfalls during the 1990-91 fiscal year as declining revenue growth.

In addition, it is impossible to build into spending plans the impact of natural disasters such as Hurricane Hugo in 1989 or unfavorable court decisions.

When unanticipated budget shortfalls appear after the budget is authorized, each agency's authorized spending level is reduced by the Governor as Director of the Budget. The timing of the reductions causes a major distortion in the operating plan of the agency, leading to reductions in the operating efficiency and effectiveness of the agency. If the economic problems last more than a few months, the agency's long-term plans will be distorted by budget cuts. As the economy improves, funding is restored and the agency has to gear up again. In conclusion, the mechanics of the current budget process, coupled with the inability to predict business cycle patterns, leads to a "feast or famine" pattern of agency operations.

One effective tool used by 35 other states to deal with the hazard of forecasting is a budget stabilization reserve or "rainy-day fund." Under this budget procedure, a state during good times will place a portion of its revenue growth in a special reserve. When an unanticipated decline in the economy occurs or emergency spending is necessitated, the accumulated funds in the reserve will be drawn down.

The effect of using a budget stabilization fund is to smooth out the year-to-year fluctuations in state spending. Without a rainy-day fund mechanism, the tendency is to go overboard in funding new programs in an expanding economy, only to reduce them when the economy declines.

A permanent budget reserve fund has been recommended for North Carolina by the Deputy State Budget Officer, the State Treasurer, the State Auditor, and the State Controller. In addition, the bond rating agencies recommend a permanent rainy-day fund.

Implementation Option:

The State should base its fiscal year General Fund operating budget on the prior calendar year revenue. If the actual fiscal year revenue exceeds the prior calendar year revenue, one-half of the resulting surplus will be used to fund a rainy day fund, and the other half shall be used for capital projects and other one-time expenditures. Once the reserve fund equals 5% of the General Fund operating budget, any excess may be used to increase spending in State dedicated fund programs, for capital projects, or for future tax relief.

Commission Vote: The Commission approved this implementation option by a 3:2 majority.

A bill encompassing this implementation option was introduced during the 1989 legislative session. Another bill would have used the prior calendar year revenue basis for determining spending availability. Both bills were discussed during the 1989 and 1990 sessions and were referred at the end the 1990 session to the Revenue Laws Study Commission. The latter gave both proposals a favorable recommendation and requested the Economic Future Commission to further study each proposal in light of their impact on the state budget process. Finally, a special provision in the final 1990–91 General Fund budget adopted during the 1990 session created a temporary reserve fund and provided that the Economic Future Commission should establish permanent rules for the reserve.

This Commission heard presentations from the sponsors of each proposal and agreed that either would eliminate the uncertainties involved with using revenue estimates during the budget process. House Bill 2293 has the additional advantage of establishing a permanent rainy-day fund.

The implementation option allows one-half of the excess revenues generated during an economic recovery to be deposited in the budget reserve. To ensure sufficient funding for needed capital improvement projects (including infrastructure needs), the remaining half of the excess revenue can be used for one-time spending items.

Once the budget reserve fund reaches 5% of the operating budget, the additional excess revenues could be returned to taxpayers, be used for additional spending in dedicated funds such as the clean water revolving loan fund, or be used to fund capital projects. The feeling of the Commission is that the use of the 5% target for the budget reserve fund, coupled with the normal 3% level of operating appropriations that go unexpended each year, will provide a sufficient cushion against contingencies.

The fact that the rainy-day fund target grows with the size of the operating budget will ensure that the impact of the reserve fund will not be eroded by inflation or budget growth. In many states, the Legislature has established the reserve fund at a lump-sum amount that does not keep up with economic growth.

Another benefit of the proposal is that the General Assembly can finish its budget deliberations earlier in the legislative session. No longer will the appropriations committees be required to wait until May 1 to receive final revenue estimates from forecasters (based partly on April personal income tax collection data). Earlier state budget decisions will provide better information for local government units during their budget process.

A fiscal year budget based on the prior calendar year revenue will usually result in a year-end surplus rather than a shortfall. Recent shortfalls have occurred even when state revenues have increased over the prior year because revenue did not grow as fast as the budgeted spending increase based on projected revenue growth. If fiscal year spending is limited to the amount of revenue collected during the prior calendar year, a shortfall will occur only in a severe economic downturn where state revenue declines over the prior year.

e) Specific Objective:

The interests of future generations are a major concern of the people of North Carolina. The State should tie the funding of long-term capital projects to the use of the projects by future generations (begin using bond financing in lieu of pay-as-you-go financing).

Commission Vote: The Commission endorsed this objective by an overwhelming majority.

During the last seven decades the standard of living of North Carolinians has risen substantially relative to the U.S. average. For example, in 1929, the first year in which the U.S. Department of Commerce collected income data for states, our per capita personal income was 47% of the U.S. average. For 1989, the latest year for which data is available, North Carolina's per capita income is 86% of the U.S. average.

Although the overall standard of living for the State has risen, not all regions of the State have shared equally. *Regional Directions*, a recent report of the State Office of Policy and Planning, reported that per capita income for the mountain counties in North Carolina is still 21% less than the U.S. average. Worse yet, residents of the Coastal Plain are 27% below the average. The decline of the tobacco-driven economy in rural areas of North Carolina does not bode well for the future of these areas.

The Commission agrees with the opinion expressed by bond rating agencies during their recent review of North Carolina's fiscal practices that a growing state like North Carolina must meet its infrastructure and other needs related to economic development to continue to be attractive. Since capital projects will be used by future generations, it is reasonable for future generations to share in the cost. An appropriate way for cost sharing to occur is through bond financing, so that facilities may be enjoyed on a "pay-as-you-use" basis.

Fairness aside, bond financing for long-lived projects does not place any net burden in the lap of the future generation, provided the loan proceeds are used for projects with an overall rate of return at least equal to that which could be earned on private investment alternatives. If adequate facilities are available and industrial development occurs, incomes will rise, retail spending will respond, profitability of firms will increase, and property values will rise. All of these increases will lead to additional growth in state and local revenues. The new revenues will, in turn, make it easier to meet debt service payments on the bonds. In other words, the increase in the standard of living of the future generation resulting from timely investment decisions in good projects provides the wherewithal to allow the next generation to pay its share of investment costs.

It takes years for governmental units to fund capital projects on a pay-as-you-go basis. Thus, there is an opportunity cost to not using debt financing to meet State needs. This creates a social cost in terms of declining quality of the public sector capital stock, which eventually translates into a decline in the standard of living of the state's citizens, a clear burden on future generations.

The timing could not be better for bond financing in North Carolina. During the last decade, outstanding State general obligation debt has fallen by one-third, while local government units, which use more conservative fiscal practices, have doubled their outstanding debt by 100%. Viewed another way, the State general fund debt service costs in 1983 were 2.2% of revenue. At this level the State had no trouble maintaining it AAA bond rating. The current debt service burden is .9%. Even with the proposed $275 million of prison bonds, the debt burden will rise to only 1.1%. Clearly it is time for the State to take advantage of the decline in tax-free bond rates from the record 12% level in 1982 to under 7% today, and free-up revenues for the operating budget.

f) Specific Objective:

Fiscal analyses of the State's budget outlook and new initiatives that would affect future budgets should be performed on a long-term basis (five-year fiscal notes).

Commission Vote: The Commission approved this objective unanimously.

During the review in 1990 of state fiscal practices by the bond rating agencies, the agencies strongly recommended that North Carolina formalize the process of long-term fiscal notes and fiscal analyses. Long-term fiscal notes are multi- year analyses of proposed revenue or spending proposals. In addition, long-term revenue and spending forecasts can be used in analyzing the total budget picture.

Finally, analyses of capital improvement projects could require estimates of annual maintenance costs for the life of the project.

The Congressional Budget Office has used "out-year" analyses of federal budget proposals for years. In recent years, some legislators in North Carolina have asked for four-year projections of the state general fund balance when contemplating budget proposals. In 1985, the year-by-year implementation schedule of the new Basic Education Plan was outlined during legislative deliberations.

Critics might complain that it is impossible to know what revenues or expenditures will amount to years in the future. This complaint misses the point. The objective of the exercise is for decision-makers to fully understand the long-term implications of their decisions. The fact that one cannot precisely pin down a future year cost does not mean that it will not occur.

If long-term analyses help legislators better understand programs, it might lead to more consistency in State budgeting. For example, it could lead to ensuring that a stable long-term source of funding is developed for a new spending initiative This could prevent the State from having to stop or defer the progress of a needed program as a result of a revenue shortfall.

g) Specific Objective:

The State should strengthen the mechanism for periodic review of efficiency and organization.

Commission Vote: The Commission approved this objective by an overwhelming majority.

During the last two decades two state government efficiency studies have been conducted by a special commission of private business leaders who have donated their time. These studies have identified areas in which state services could be delivered more efficiently, ways in which program duplication could be avoided, and methods of increasing user fees.

The Economic Future Commission is of the opinion that the efficiency studies could be even more beneficial by ensuring that such reviews take place on a periodic basis. This would ensure more follow-through on the recommendations of each commission.

Implementation Option:

A commission should be formed to review the efficiency and organization of state government. The commission should start with a review of the implementation of the 1985 State Efficiency Commission. During its review, the commission should specifically consider the role of public/private partnerships, privatization of state programs, and program consolidation.

Commission Vote: The Commission approved this option by an overwhelming majority.

The latter issue, also referred to as "program fragmentation and duplication," would be an important emphasis for the next efficiency commission. There are a number of state agencies that may at times look at this problem. However, these agencies for the most part concern themselves with systems, planning and procedures, often with one agency, rather than subject matter audits involving many different agencies providing a specific service.

The State Auditor does devote a substantial part of his staff's work to "performance audits", which essentially review the operations of an agency in carrying out its mission. Where appropriate, the Audit Report will address questions involving fragmentation and duplication.

Many of the Audit recommendations are favorably received and follow-up action taken by agencies. In fact, glaring problems are usually addressed by the agency prior to the issuance of the report. However, there are many cases in which turf battles, inertia due to program size, public apathy, disagreement about the recommendations, and the impact of outside interest groups derail the recommendations. In addition, high turnover in members of the General Assembly, especially in the rotation of key leadership positions, contributes to less-than-adequate follow-up action.

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h) Specific Objective:

The State should begin the process of setting aside a portion of annual revenues as a maintenance reserve for State buildings.

Commission Vote: The Commission approved this objective by an overwhelming majority.

A considerable amount of State construction of facilities took place during the high-growth years of the 1960's. Much of those facilities are now in serious need of repairs and renovation. There have been no funds set aside to create a maintenance fund for these facilities. As a result, repair and maintenance needs must compete with the new capital projects. Because there is no sizable natural constituency for repairs and renovations, these needed improvements are not made on a timely basis. This causes further damage to the facilities and substantial costs when the repairs are finally made. Only in recent years has the General Assembly begun setting aside part of its capital appropriations for repairs and renovations.

There are a number of methods that could be used to provide an automatic mechanism for a repair and renovation fund. One would be to earmark a specified portion of general fund revenues each year for specific appropriations. Another is to float bonds for these projects in the same way bonds are used for new construction.

The State Capital Assets and Improvements Study Commission recently recommended a way to finance repairs and renovations. That Commission put forth the idea of assessing each agency's budget on the basis of a certain amount per square foot of space occupied by that agency. The proceeds from this assessment would become part of a special reserve in the Office of State Budget and Management. Spending from this fund would be based on priorities established by a periodic inventory of needs by the State Construction Office.

i) Specific Objective:

State university campuses should be allowed the option of increasing tuition and to use part of the additional receipts for need-based financial aid and part to enhance academic programs.

Commission Vote: The Commission endorsed this objective by an overwhelming majority just short of unanimity.

It is difficult to exaggerate the role played by the State's public universities over the past half century in the enrichment of economic, cultural and political life of the State. For example, the very existence of the Research Triangle complex with its high incomes, and unemployment rates sharply below the national average, is attributable in large part to investments made by the State in research universities before and after 1965. Our research universities enjoy international repute and are among the leading performers of basic and applied research among public universities. The short-term economic benefits from research dollars flowing through the universities are large and palpable: for every dollar of in-state expenditures from these research funds, at least one additional dollar in economic activity is generated within the state. The medium- to long-term benefits are without doubt, far more substantial, but also far more difficult to quantify. Noted analyst Edwin Mansfield, however, has estimated that, conservatively placed, the rate of return worldwide from academic research is on the order of 28%. There are good reasons for believing — owing to the nature of research in agriculture, medicine and science, the rate of return from research at North Carolina's major research universities is even higher.

The sixteen campuses of the State university system served the advanced educational needs of nearly 124,000 students in 1990–91, nearly 40 percent of total enrollment in higher education in North Carolina. Past investments in the system have positioned the State to extract maximum benefits from the dramatic shift, already underway, in the wealth of the world, from owners of natural resources to those who own and generate ideas and knowledge.

The State can extract the full potential of the system's capacity to contribute to the State's economic future only if the individual universities are well managed, so that each dollar of outlay on education, research and public service goes to the best available uses. Just as in the private sector, approaching this outcome requires timely information, careful planning and reliance upon priority budgeting.

The very sizable potential contributions of the universities are, however, at risk, not just because of three consecutive years of severe budgetary stress, but because of institutional arrangements limiting the ability of the universities to plan ahead and to respond to changing conditions in flexible fashion. Even in good years, where budgetary stress is minimal or absent, university leadership does not know how much State funding will be available even when they enter the fourth quarter of the fiscal year, owing to the system of quarterly allotments that actually governs spending. It is little comfort that all other State agencies suffer from the same problem. But the impact is so much more severe for universities, where decisions on recruitment of faculty (and the attendant investments in start-up cost for facilities and instrumentation) necessarily are geared to cycles of more than one year in length.

Elsewhere in this report the Commission has strongly endorsed reforms such as replacing the line-item budget approach that will facilitate sensible planning by all State agencies, as well as universities. But, in addition, the option of adjusting tuition to the special needs and circumstances of individual campuses appears essential as well. Against this option have been arrayed a number of objections, all of which merit careful consideration.

It has been traditionally asserted that the State's conscious policy of maintaining tuition at low levels, compared with other states, has allowed a larger proportion of our citizens to receive the opportunity for higher education. Indeed, North Carolina ranks tenth among states in numbers enrolled in institutions of higher learning, exactly matching our rank in numbers of people. However, public and private institutions other than the State university system account for about 60% of enrollments. Higher education is indeed highly accessible in North Carolina, and there is no questions that very low tuition has helped make it so. The question, however, is whether maintenance of a policy of very low tuition for all universities remains the best way to keep education accessible to low-income families.

Between 1970 and 1990, the real cost of tuition (measured in 1970 dollars) for in-state students at the University of North Carolina-Chapel Hill actually declined: from $225 to about $201. The real burden of tuition on the State's poor declined as well: even though the nominal value of tuition rose to $604 by 1990, tuition as a percent of real per capita income fell from 2.8% to 1.7%. Expressed as a percent of per capita income, then, tuition in 1990 was an even bigger bargain in 1990 than in 1970. Indeed, one recent study indicates that between 1973-74 and 1990-91, the share of UNC costs paid by in-state students fees fell from about 13% to just over 8%.

Even if tuition were to be doubled or tripled, the State subsidy to each student enrolled would still represent but a small fraction of the annual cost of providing higher education. While no one really knows what this figure is, owing partly to the way the universities are constrained in planning their spending, it cannot be much less than $20,000 per student per year in the major research universities of the State. If so, then for in-state students, the State subsidizes well over 90% of the cost of education.

On some campuses, much of this subsidy goes primarily to students from relatively high-income backgrounds. For example, according to a recent report*, North Carolina median family income was $28,300. Fully 80% of parents of 1988 graduates from our leading research universities (Research 1) had incomes in excess of $30,000. For the system as a whole, 44 percent of parents had income in excess of $40,000. Unless we have reason to believe that the capacity to administer financial aid for needy students is greatly diminished in North Carolina relative to other states with much higher tuition, this pattern of subsidization does not appear to represent the best method of lifting families out of poverty through education.

Other arguments have been arrayed against the type of tuition option recommended by an overwhelming majority of the Commission. These arguments include: a) the undermining of the authority of the Board of Governors of the University of North Carolina in supervising the 16 universities, b) the possible increase in rivalry between the schools, and most serious, c) division of the school along racial and economic lines. These are strong assertions, meriting much more extended and thoughtful public discussion than has transpired thus far. There is nothing to be lost from such a discussion, and much to be gained, particularly where the debate concerns our universities, where, presumably, spirited, well-informed discussion of all issues is to be prized, not avoided.

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* UNC General Administration, *The Class of 1988: Early Careers of Graduates from the Sixteen Campuses of the University of North Carolina* (June 7, 1990).

STATE/LOCAL FISCAL RELATIONS

Guiding Principle: State and local fiscal relationships in North Carolina should be re-examined in light of changes in fiscal federalism.

Commission Vote: The Commission endorsed this guiding principle unanimously.

The system of fiscal federalism in the U.S. at the beginning of the 1980's had been evolving since the Depression. Major changes occurred in the 1960's when the President and Congress agreed to establish numerous new programs at the federal level that previously had been funded at the state level. Many of these programs involved shared program and funding responsibilities between the federal government, states, and localities. In addition, a federal revenue-sharing program was started to share the wealth of the federal tax base with units pre-empted by the federal use of these sources.

The build-up of federal initiatives was based upon the perception that states were unwilling or, in many cases, unable to provide certain services needed by its citizens. The primary examples were in the social programs. Thus, the use of federal funding that was financed with a progressive income tax helped equalize resources between states and allowed for alleviation of poverty for people in low-income regions.

With the rise of "New Federalism" this program infrastructure began to be dismantled. A major reason for the shift was a growing view that citizens were better served by services provided at the state and local level and that modernization of state tax bases and improvements in the quality of non-federal program delivery meant that state and local units had the ability to meet the needs of their citizens.

As federal aid has been reduced or eliminated during the last decade, states have had to choose whether to pick up the reduced funding. Where states have retained programs abandoned at the federal level, the financing of major programs has been shifted back to state capitals and has been one reason for a gradual increase in state and local tax burdens during the last decade.

One problem with the new system is that while Congress has turned back programs to state and local units, the Congress has continued to mandate new programs that must be financed in part by state and local units. The classic example is Medicaid. During the last seven years, the state share of Medicaid costs in North Carolina has risen from $200 million to $627 million, an annual increase of 17%.

The problem has been compounded in recent years by the activist stance taken by federal courts in reviewing state policies. For example, states have been under court order to equalize the funding of public schools between school districts, to upgrade corrections and mental health facilities, and to revamp their tax laws to eliminate discriminatory provisions.

Since 1989, an economic recession and spiraling health costs have brought the issue to a head. The concern of local government officials in North Carolina, as repeatedly expressed in testimony before the Commission, is whether there will be a natural tendency for the Governor and state legislators to pass budget problems through to local units as the federal government has done to states, especially since citizens feel they get more for their tax dollar from local services.

The stability of local government finance has been further undermined because almost a half billion dollars worth of state reimbursements for mandated local tax relief and State tax sharing have been converted from an automatic earmarking from State taxes to an annual appropriation. This makes the funding more visible and vulnerable to State budget cuts.

Standing alone, shifts in program and funding responsibilities seems fairly innocent. The problem comes when one considers that under the rules used in North Carolina during the last six decades, local units must seek State approval to levy additional taxes other than the property tax. In addition, increases in certain State taxes make it more difficult for local boards to generate taxpayer support for new local taxes.

Counties and cities have a difficult time using the property tax to raise additional revenue even though studies indicate that property tax burdens in North Carolina are 30% below the U.S. average. The adoption of a 2 cent local sales tax during the last two decades has allowed a reduction of 20% in the statewide property tax burden. However, the property tax is by far the most visible major tax in the U.S. and is one tax for which citizens feel they have some control. Wage and price increases that lead to automatic increases in a person's income and sales tax burden go largely unnoticed.

a) Specific Objective:

Local government should be provided additional revenue sources to meet infrastructure needs.

Commission Vote: The Commission endorsed this objective by a 2:1 majority.

The provision of infrastructure is a key element in making a local area attractive for economic development. There has been a continuing series of sharp cutbacks in federal assistance for capital projects. In addition, a tight state budget means little state aid. Resistance to property taxes makes it difficult for counties and cities to use this source of financing.

Implementation Option:

Counties should be given general authority to levy a land transfer tax, with the proceeds dedicated to infrastructure needs.

Commission Vote: The Commission endorsed this implementation option by a 2:1 majority.

In 1958 the federal government turned the real estate conveyance tax over to states to use as a revenue source. The State picked up the tax at the old federal rate: $1 per $1,000 of the money changing hands. The tax rate has not changed since that time. The tax is collected by the county register of deeds and goes directly to the county general fund.

Since 1985 seven counties in the Northeastern part of the state have been allowed by local legislation to adopt a local conveyance tax, commonly called a "land transfer tax," at the rate of $10 per $1,000 of the full sales price. In all cases the authorizing legislation has specified that the proceeds be dedicated to capital facilities.

The land transfer tax is a natural choice to finance infrastructure as additional water and sewer facilities and other public projects enhance the market value of the property served. When the property changes hands, additional conveyance tax revenue will provide the county a payback for the improvements.

The Commission recommends that authority to levy the new tax be granted on a statewide basis.

b) Specific Objective:

An institutional arrangement should be established to ensure an on-going review of state/local fiscal relations.

Commission Vote: The Commission endorsed this objective by an overwhelming majority.

The U.S. Advisory Commission on Intergovernmental Relations (ACIR) recently celebrated its 25th anniversary. The ACIR is comprised of elected and appointed officials of all three levels of government and private citizens. The ACIR has been at the forefront in analyzing the changing landscape of intergovernmental relations and has made many recommendations to strengthen the fiscal federalism system. In addition, the organization's research is of invaluable assistance to state and local officials.

Many states have created a statewide intergovernmental relations commission made up of state and local officials and private citizens. These groups continually review state and local trends in each state and look for ways to make the system more workable. The organizations are particularly helpful in providing a forum for state and local leaders to interact.

The Economic Future Commission recommends the establishment of a state/local fiscal relations commission for North Carolina similar in structure to intergovernmental commissions in other states.

PUBLIC EDUCATION

Guiding Principle: Public education continues to have a central role in the vitality of the State's economy. Measures should be enacted to improve management effectiveness in educational spending and the quality of the educational experience.

Commission Vote: The Commission endorsed this principle unanimously.

More than six decades ago North Carolina pioneered many innovations in educational finance and programs to enhance educational opportunity in primary and secondary education. The State, although then very poor relative to the rest of the nation (income per capita in North Carolina was less than 55% of the national average at the time), also managed to nurture the oldest public university in the nation into one of the leading institutions of higher learning in the land prior to the second World War. By the sixties, the State had gained international repute for the quality and coverage of its much enlarged university system, and for the accessibility and effectiveness of its community college system, now extending to nearly sixty locations.

But the State in recent years has been straining to live up to its own standards of educational quality and access. The strain has become especially apparent in the last two years of budgetary stringency. But, if the conclusions reached by the several blue-ribbon commissions established to study education and workforce preparedness, the outcome of the Governor's January Educational Summit, and testimony before our own commission mean anything at all, it is now clear that the struggle to maintain educational quality is much more than merely a matter of overcoming our present and projected budgetary woes. Institutional weaknesses, organizational defects and unwieldy processes are undermining our best efforts to prepare the youth of this State to partake fully in the economic, social and cultural opportunities available in a rapidly changing, more interdependent world.

In addition, the inability of local government units in rural areas of the State to provide adequate school facilities and fund supplemental resources makes it difficult for school children in these counties to compete with students in well- off urban areas. In the ten years prior to 1933, the State became the national leader in equalizing education resources by taking over the full responsibility for funding the operation of local public schools. Though facility funding is a local responsibility, the State has stepped in on numerous occasions to offer assistance funded from State tax revenues. But even the strenuous efforts of the State and the equalizing impact of federal funding has not eliminated all differences in opportunity as wealthy local areas can supplement the federal and State dollars. The recent work of the Public School Forum and numerous State commissions in recommending further equalization measures merits serious attention.

More recent investments that we have made in public education in grades K through 12 are yielding returns that fall far short of the standards of the past and our reasonable expectations for the future. This represents missed opportunities that have largely irreversible, (or reversible only by virtue of extraordinary effort), results for the young that have been poorly served by our educational system. Moreover, the future success of economic policies supportive of international competitiveness of our industries and the sustained development of the State depend critically upon the presence of a well educated labor force developed both by general education and vocational training. The former nurtures the broad capabilities, especially literacy and numeracy, that enable people to function as effective members of society and on the job. The latter provides the more specialized skills necessary for entering the labor market or to increase productivity, for as borne out in a number of recent studies, "productivity determines wealth and standard of living." *

Other states, and other industrial nations, as well as the newly industrializing rapidly growing countries of the Pacific Rim are launching educational reforms designed to better prepare students for rapidly changing national and world economies. North Carolina must move in this direction too. The Economic Future Commission was not impaneled to recommend a detailed program of educational reforms to upgrade the workforce, or develop the broad cognitive and problem-solving skills and personal characteristics that make workers trainable, managers innovative and teachers effective. The Commission lacks both the expertise and the time and resources to approach those tasks. Rather, the Commission has confined itself to attempts to identify, with the help of previous studies and the guidance of noted specialists appearing before us, certain critical measures for improving the management effectiveness and the quality of the education experience in North Carolina.

We are virtually unanimous in agreeing that the problems these measures address are binding constraints upon the State's ability to reverse past trends of disappointing academic achievement, skills shortages and above all, inadequate and inefficient utilization of the resources we have invested in public education. Until these constraints are broken, particularly in the management and leadership of education, the results of efforts to channel greater financial resources into education will continue to fall well short of that required for an educated population in the 21st century.

In this regard, the views of one particularly well-respected and highly regarded educator expressed before the Commission are well worth sharing with all citizens of the state.

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* See for example, Michael Porter, *The Comparative Advantage of Nations*, which notes, among other things, that industries are competitive or uncompetitive, not nations.

"North Carolina will lose the public schools by the end of this decade unless effective school-based leadership is provided."*

State government in North Carolina has, in many respects, an unusually high degree of leverage over the future course of management changes affecting public educational outcomes. Nationwide, spending for education accounts for about one-third of state government budgets. In North Carolina, two-thirds of the general fund operating budget of the State government is devoted to education. At the county level, education represented one-third of total outlays in 1989.

a) Specific Objective:

The Superintendent of Public Instruction should be appointed instead of elected.

Commission Vote: The Commission vote on this objective was only one short of full unanimity.

This objective has been roundly supported by several specialized commissions studying education. It also received the strongest and most broad-based support from the 40 participants in the January 1991 Education/Workforce Preparedness Summit convened by the Governor. Participants at the Summit were drawn from a broad cross-section of knowledgeable educators, businessmen and public figures. Four recent reports by education and workforce preparedness task forces, commissioners and boards support the appointment of the State Superintendent of Public Instruction. These reports included those by:

1. Task Force on Excellence in Secondary Education
2. N.C. Association of School Administrators
3. N.C. Citizens for Business and Industry
4. State Board of Education

The reasons for endorsement of this proposal have differed somewhat across the various reports. Where preferences were expressed for appointment authority, the State Board of Education was identified as the choice. The Economic Future Commission expresses no preferences on appointment power: appointment could be made by the Governor, the General Assembly or the State Board of Education.

The Commission's prime concern is that the best available professional be secured to execute educational policies established by the State. Lines of authority and governance should be demarcated clearly, and the performance of the appointed Superintendent reviewed periodically according to well publicized and clearly

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* Statement by Dr. Jay Robinson, Commission meeting of January 29, 1991.

enunciated criteria. The Commission also endorses the view that methods, techniques and approaches proven effective in management of private sector business should also be expected to be applicable to management of schools as well.

b) Specific Objective:

Tenure should be eliminated for administrative positions.

Commission Vote: The Commission endorsed this objective unanimously.

Again, this measure has been strongly supported by other recent commissions and task forces on education, including the Task Force on Excellence in Secondary Education, the North Carolina Citizens for Business and Industry, and the Education/Workforce Preparedness Summit.

Provision of tenure for principals, assistant principals and other administrators sharply reduces the accountability of principals to local school boards. Administrative tenure severely limits the prospects for improving public education, inasmuch as the single most important determinant of the quality of any given school is the ability, training, and motivation of the leadership of that school.

The chair of the Workforce Preparedness Commission noted earlier in the year that in the 700 stores in his chain of retail establishments, where the managers are good, problems are few. But where management is weak, there is no end to the 15
problems that arise. Managers in this enterprise who prove ineffective are 8
removed; they are not transferred to manage other stores unless and until they can demonstrate proficiency in management. Similarly, the Commission has heard highly credible testimony that where principals are capable, schools tend to be strongly effective. Where principals are poor managers, schools strongly tend to be poor. Local school boards require nothing less than similar authority to change school leadership. Tenure in administration merely serves to transfer weak management to other sites, when they can be transferred at all.

Moreover, highly respected testimony before the Commission indicates that, with tenure in administration, particularly in communities where school boards are elected rather than appointed, school boards tend not to deal with difficulties in the schools, because the school boards may use the problem of administrative tenure as an excuse for inaction.

One possibility for implementing this option with a minimum of dislocation would be to "grandfather" principals currently employed. Much better, however, would be to implement a program that would provide superior training for all principals, as well as a five-year grace period to allow them to improve their managerial skills. At the end of the grace period, position changes would be made in those cases where management skills have been insufficiently improved.

Such measures could be coupled with major changes in the criteria for compensation of school administrators. For example, administrator pay is now based on school size and years of services. Therefore levels and rates of increase in compensation are totally unrelated to any measure of performance. Recent policy changes ignited by Senate Bill 2 provides local school systems with the options of tying administrator compensation to performance.

c) Specific Objective:

Tenure should be phased out for all public education teachers below the university level. This can be best implemented by increasing the merit pay applicable to those teachers giving up tenure.

Commission Vote: The Commission endorsed this objective by more than a 2:1 majority.

Tenure for teachers in the public school system in grades K through 12 was first awarded in 1971. Tenure remains unavailable for teachers in the Community College System. Many Commission members favored profound changes in the tenuring process, short of phasing tenure out gradually over time. Their views, in fact, were broadly similar to that expressed in the recent report of the Task Force on Excellence in Secondary Education. Recommendation Seven of the Task Force called for the General Assembly to review the Fair Employment and Dismissal Act. This review would seek to "determine if the reasons for dismissal should be refined and if the due process procedures could be streamlined."

Other Commission members favored immediate abolition of tenure, with appropriate safeguards to protect teachers from abuse of due process and from arbitrary actions by principals and/or school boards. However, other Commission members in the first group noted that teacher tenure does not present the same problem in all schools. They favored addressing the tenure issue through three measures. The first would tighten criteria for tenure to ensure that only exceptionally qualified teachers would receive tenure. The second would involve changes in the process through which teachers are evaluated. The third would require concrete measures to improve the quality of school administration through adoption of two other Commission recommendations: ending tenure for administrators, and enhanced and expanded training for principals.

In the end, however, the Commission opted for the proposal for phasing-out tenure with incentives to give up tenure voluntarily. Several Commission members were of the view that once teachers are granted tenure, it becomes all but impossible to remove them, even for extreme malfeasance. Some members voiced repeated concern over the inability of State educational officials over the 14 weeks of Commission meetings to supply information regarding the number of teacher certificates revoked over the past few years. Testimony presented at the end of the

Commission deliberations indicate, however, that out of 62,000 full-time classroom teachers, only 10 certificates were revoked in the past year.

In any case, the Commission favors a phased approach to the tenure issue, with establishment of a *quid pro quo* for already tenured teachers. Teachers voluntarily giving up tenure would be eligible for a significantly increased merit pay schedule, with term contracts of between two and five years between the teacher and the local school board, coupled with appropriate improvements in the process for evaluating teachers.

d) Specific Objective:

Substantially more attention should be paid to the training of principals and other school administrators.

Commission Vote: The Commission unanimously supported this objective.

The Commission devoted considerable effort toward developing an understanding of the process by which administrators are trained, and concluded that present arrangements do very little to prepare the State's 3,000 administrators for management of budgets, curricula and personnel. The Commission concluded that while many other of the other shortcomings of our public school system cannot be easily reversed by large infusions of new monies (unless major institutional weaknesses are rectified first), training of school administrators merits a substantial increase in financial resources.

Training was also one of the major issues of the Task Force on Excellence in Secondary Education, which stressed the need for funds to train and re-train administrators as well as teachers and school board members.* At present, a statewide total of $750,000 per year is spent on keeping the skills of administrators at a high level, or about $250 per administrator.**

The problem, however, extends well beyond inadequate financial resources for training. (Knowledgeable officials appearing before the Commission indicated that existing programs are plagued by low quality, the fact that 95% of trainees are part-time, unduly brief field experience in the programs and the lack of careful screening and recruiting.) In particular, further investment in training programs will have limited pay-offs unless and until requirements for admission to graduate school for administrators are redefined. All that is required at present is a bachelor's degree from an accredited institution.

e) Specific Objective:

The State budget process for education funding should be amended to include more setting of performance objectives and evaluation of program performance.

Commission Vote: The Commission supported this objective by a very wide majority.

Public school funding comprises two-thirds of the State's general fund operating budget. Under the current funding mechanism the number of students, not performance, determines the operating funds going to each school administrative unit. Beginning in 1985, the State has undertaken major initiatives including the Basic Education Plan, SB 2, and the new teacher salary plan to try to improve education quality. However, the discussion of objectives, plans, and accountability have only begun to be discussed during the last two years under the SB 2 umbrella. Concerns about the apparent lack of improvement in student performance after almost $800 million of additional spending on education improvement means that more attention should be directed to the process of setting objectives and evaluating performance.

f) Specific Objective:

Local school boards should be authorized to implement those policies which they think will improve education performance (i.e., longer school day, lengthen school year, class size reduction) and measures implementing these policies, retaining minimum standards and allowing for local flexibility, should be promptly enacted.

Commission Vote: The Commission unanimously endorsed this objective.

This objective has a natural tie-in to the discussion of education objectives and performance evaluation. After local boards agree to performance objectives, then strategies and policies must be developed to guide units to the achievement of those goals.

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*Recommendation 2 of the Task Force proposal that the General Assembly appropriate $500 per year each year for the next four years for activities to refine the management skills of administrators. The Task Force also proposed directing the University of North Carolina to strengthen administrator training programs.

** The State budget for 1990–91 contains a line item of $8.9 million for staff development, but the vast majority of these funds are used for teacher staff development.

There is no shortage of research supporting different theories of which tools, techniques, and institutional structures lead to the best student performance. Since the publication of the Reagan Administration's "A Nation At Risk" study in 1983, almost all states have poured money into those programs thought to be best in each state.

Since the early 1930's, local boards of education in North Carolina have been subjected to State policies and guidelines. The lack of improvement after massive additional State funding in recent years suggests that the "top-down" approach should be abandoned in lieu of granting local boards general authority to implement those programs and policies they feel will help them to meet or exceed the performance objectives established by the State Board of Education.

g) Specific Objective:

To ensure that local public schools are administered effectively and efficiently, local school systems should be granted the maximum degree of flexibility in spending funds and administering programs that is consistent with broad guidelines established by the State Board of Education. They should be held accountable for their effectiveness through use of performance measures and standards established by the State.

Commission Vote: The Commission unanimously endorsed this objective.

The Commission believes that spending flexibility for local schools is a necessary element of a comprehensive reform package that includes the establishment of performance objectives, increases in program and budgetary latitude for local units, and accountability measures.

The fiscal revolution that took place in North Carolina during the 1921–33 period led to a highly centralized system of education funding in North Carolina. In fact, this State has served as a model since that time. Centralized State funding based on student population, coupled with additional federal dollars until 1981, led to a major reduction in funding inequities between local jurisdictions.

During recent years, however, many interested parties have begun to feel that more local flexibility in the use of State dollars for education is needed. For example, the substitution of "block grant" funding for federal categorical assistance is one example of how to build-in more spending flexibility.

LIST OF SPEAKERS

EDUCATION

Walter Davis	Commission Member
Bob Etheridge	Superintendent N.C.Department of Public Instruction
Gene Causby	Executive Director N.C. School Boards Association
Bob Scott	President N.C. Community Colleges System
Mark Musick	President Southern Regional Education Board
William Burkhardt	Chief Executive Officer Bahlsen, Inc.
Dr. Ed Bishop	Special Assistant to the Provost University of North Carolina-Chapel Hill
Juliann Tenney	Executive Director Southern Growth Policies Board
Lowell Thomas	Senior Vice President NCNB
John Dornan	Executive Director Public School Forum
Dr. Jay Robinson	Vice President University of North Carolina-Chapel Hill
Peter Leousis	Director of Policy Research/Finance Public School Forum
Dr. Barbara Tapscott	Chairperson State Board of Education
Rose Marie Lowry	Vice President/President Elect N.C. Association of Educators
Dr. Jerry Paschal	Chairman, Division of Superintendents N.C. Association of School Administrators

BUDGET REFORM

Senator Bill Goldston	State Senator
Representative Art Pope	State Representative
Marvin Dorman	Deputy State Budget Officer
Harlan Boyles	State Treasurer
Ed Renfrow	State Auditor
Fred Talton	State Controller
Ron Aycock	Executive Director NC Association of County Commissioners
David Reynolds	Executive Director NC League of Municipalities

TAXATION

Dr. Malcolm Gillis	Commission Chairman
Betsy Justus	Commission Member and Secretary of Revenue
Bill Rustin	Executive Director NC Retail Merchants Association
Susan Valauri	Executive Director National Federation of Independent Business North Carolina Chapter
James Broyhill	Secretary NC Department of Economic and Community Development
Roger Bone	Representative Tobacco Institute

ENVIRONMENTAL TAXES

Dr. Robert Repetto	World Resources Institute, Washington, D.C.
Lee Daniel	Section Chief, Air Quality Division NC Department of Environment, Health and Natural Resources
Charles Case	Representative Chemical Industry Council

STATE/LOCAL FISCAL RELATIONS

Dr. Don Liner	Faculty Member Institute of Government University of North Carolina, Chapel Hill
Ron Aycock	Executive Director NC Association of County Commissioners
David Reynolds	Executive Director NC League of Municipalities

GENERAL

Kenneth Johnson	Commission Member
Nate Garrett	N.C. Institute of Minority Economic Development
Kenneth Mayhew	Commission Member
Phil Cook	Professor Duke University
Dr. Bob Berlam	Executive Director State Employees Association

ECONOMIC FUTURE COMMISSION

Sec. 22. (a) The Economic Future Study Commission is created. The Commission shall:

(1) Review the State's needs for changes in the revenue and budget structure to meet the needs of the State over the long term;

(2) Make a comprehensive review of the State and local tax system, particularly in light of future economic trends that may affect revenues generated by existing taxes; and

(3) Recommend proposals to enhance the State's revenue position, adapt the State tax structure to changes in the economy, avoid placing undue tax burdens on any segment of the population, and preserve the positive impact of the tax structure on the economic future of the State.

(b) The Commission shall consist of 30 members to be appointed as follows:

(1) Two members of the Senate appointed by the President Pro Tempore of the Senate.

(2) Eight public members appointed by the President Pro Tempore of the Senate.

(3) Two members of the House of Representatives appointed by the Speaker of the House of Representatives.

(4) Eight public members appointed by the Speaker of the House of Representatives.

(5) Two members of the General Assembly appointed by the Governor.

(6) Eight public members appointed by the Governor.

The President Pro Tempore of the Senate, the Speaker of the House of Representatives, and the Governor shall ensure that the members of the Commission are representative of all North Carolinians, including representatives of business and industry, professionals, educators, ethnic groups, environmental advocates, low-income citizens, and consumers. The three appointing officers shall jointly designate one member to serve as chair of the Commission.

(c) Members appointed to the Commission shall serve until the Commission makes its final report. Vacancies on the Commission shall be filled by the same appointing officer who made the original appointments.

(d) Upon request of the Commission or its staff, all State departments and agencies and all local government agencies shall furnish to the Commission or its staff any information in their possession or available to them. The Commission, while in the discharge of official duties, may exercise all the powers provided for under the provisions of G.S. 120-19, and G.S. 120-19.1 through G.S. 120-19.4.

(e) The Commission shall submit a final report of its findings and recommendations to the 1991 General Assembly on or before February 1, 1991, by filing the report with the Speaker of the House of Representatives and President Pro Tempore of the Senate. The Commission shall terminate upon filing its final report.

(f) The Commission shall have its initial meeting on or before September 1, 1990. The Commission shall meet upon the call of the chair.

(g) The Commission may contract for professional, clerical, or consultant services as provided by G.S. 120-32.02. Upon approval of the Legislative Services Commission, the Legislative Services Officer shall assign professional and clerical staff to assist in the work of the Commission. Clerical staff shall be furnished to the Commission through the offices of House and Senate supervisors of clerks. The expenses of employment of the clerical staff shall be borne by the Commission. The Commission may meet in the Legislative Building or the Legislative Office Building upon the approval of the Legislative Services Commission. Commission members may travel to other states in order to examine other states' revenue and budget structures, upon the approval of the Legislative Services Commission.

(h) Members of the Commission shall receive per diem, subsistence, and travel allowances as follows:

(1) Commission members who are also General Assembly members, at the rate established in G.S. 120-3.1;

(2) Commission members who are officials or employees of the State or local government agencies, at the rate established in G.S. 138-6; and

(3) All other Commission members, at the rate established in G.S. 138-5.

APPENDIX THREE

LISTING OF EDUCATION STUDY COMMISSIONS

COMMISSION	CREATED BY	FOCUS OF REPORT
Task Force on Excellence in Secondary Education	Superintendent of Public Instruction	Fundamental issues affecting secondary education
Governor's Commission on Workforce Preparedness	Governor	Improve academic thinking, employability skills of future workforce
Twenty-Point Plan for Reshaping K–12 Education	Superintendent of Public Instruction	Modernization of K–12, pre-kindergarten economically disadvantaged, workforce preparedness, role of community colleges
Rural Initiative Study	Public School Forum	K–12 funding equalization
Public Education Reform Task Force	N.C. Citizens for Business and Industry	K–12 improvement
Schools for the Twenty-First Century	Tarheel Principal's Association	K–12 improvement
Taskforce on Basic Education Program	Department of Public Instruction	Evaluation of Basic Education Program
Joint Legislative Commission on Basic Education Program	N.C. General Assembly	Evaluation of Basic Education Program
Education Study Commission	N.C. General Assembly	Methods for developing local school improvement plans
Comprehensive Plan for Improving North Carolina Education	N.C. Association of School Administrators (Division of Superintendents)	K–12 improvement