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HOUSE OF REPRESENTATIVES

SELECT SUBCOMMITTEE ON FISCAL REFORM

REPORT TO THE FINANCE COMMITTEE

June 13, 1991

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SUMMARY OF RECOMMENDATIONS

1. We recommend that the General Assembly limit General Fund current operations appropriations for any fiscal year to the equivalent of actual receipts during the most recently completed calendar year.

2. We recommend that the proposed legislative actions with respect to state finances at each session be embodied in four (4) bills:

   (1) a current operations base budget appropriations bill,
   (2) a current operations expansion budget appropriations bill,
   (3) a capital improvements appropriations bill, and
   (4) a budget revenue bill (if needed).

3. We recommend that the General Assembly resolve to adopt the current operations appropriations bill by April 1 of each year.

4. We recommend that each current operations appropriations bill adopted by the General Assembly recite in the bill the availability (beginning balance plus revenue) estimates on which it is based.

5. We recommend that the General Assembly, in adopting the current operations appropriations bill each year, ensure that the fund balance of the State is at all times sufficient to clear all state-issued checks that are presented for payment.

6. We recommend that the General Assembly establish by July 1, 1995, a savings reserve or rainy day fund that will equal five per cent of the annual General Fund current operations appropriations and specify the conditions under which it can be spent.

7. We recommend that the House of Representatives amend its rules to provide that every bill or amendment that establishes or enlarges a governmental program or service carry a fiscal note as to its costs over the next ensuing six (6) fiscal years, with special emphasis on personnel requirements and costs.

8. We recommend that the General Assembly adopt a policy that it will give high priority in making each year's appropriations to providing capital funds for the repair and maintenance of the State's buildings.

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Summary of Recommendations Con't.

9. We recommend that the General Assembly proceed cautiously in imposing user fees on users of state government's services.

10. We recommend that the General Assembly authorize a thorough study of the adequacy of state and local government revenue sources and the allocation of responsibility among the State and its counties and municipalities for financing and performing government services, with a report and recommendations to the 1992 session of the 1991 General Assembly.

11. We recommend that the General Assembly order a thorough management survey of and report to the General Assembly on the executive branch of state government with respect to the needfulness, effectiveness, and economy of each activity and program maintained by the State.

Introduction

On May 28, 1991, Representative George W. Miller, Jr., Co-chair of the Finance Committee of the House of Representatives, established the Select Subcommittee on Fiscal Reform of the Finance Committee. He assigned to that Subcommittee the tasks of (1) identifying for the Finance Committee the chief factors that have contributed to the financial problems the State of North Carolina has experienced during the last two years and (2) advising the Finance Committee on measures that should be taken by the General Assembly to avoid a recurrence of those problems, insofar as they are within the control of the State of North Carolina.

The members appointed to the Select Subcommittee by Co-chairman Miller are Representative John H. Kerr, III (Chair), Representative Harry C. Grimmer, Representative Thomas C. Hardaway, Representative Julia C. Howard, Representative Judy Hunt, Representative Robert C. Hunter, Representative W. Stine Isenhower, Representative Mary Long Jarrell, Representative Josephus L. Mavretic, Representative Liston B. Ramsey, Representative Wade F. Wilmoth, and Representative William H. Withrow. Ex officio members are Speaker Pro Tempore Marie W. Colton and Representative Miller and Representative Joe Hackney, Co-chairs of the Finance Committee.

The Subcommittee has held five meetings to date. It has heard from four invited witnesses: State Treasurer Harlan E. Boyles, State Auditor Edward Renfrow, Secretary of Revenue Betsy Justus, and State Controller Fred W. Talton. These witnesses gave oral testimony and responded to questions from members of the Subcommittee. Some of them also submitted written material reflecting their views. They have the thanks of the Subcommittee for their contributions. We also had the benefit of the Report of the Economic Future Study Commission entitled "Fiscal Realities for the '90's." Published in

March 1991, that report reflects the work of a 30-member study commission created in 1990 by action of the General Assembly. A part of that Commission's attention was directed to the same issues that are before the Subcommittee. The staff of the Fiscal Research Division has been very helpful in providing information on the Subcommittee's request.

It is anticipated that the work of the Subcommittee will be continued throughout this 1991 session of the General Assembly, at least, and that it will issue further reports on its findings and recommendations to the Finance Committee.

The General Fund operating budget has been tight since the fiscal year 1985-86, when the General Assembly embarked on an eight-year, $800-million Basic Education Program at the same time that it enacted, at Governor James G. Martin's urging, a $220-million tax reduction package. In recent years, the General Assembly has granted salary increases to teachers and state employees at rates that have exceeded inflation, initiated a new salary plan for public school teachers, and adopted the School Improvement and Accountability Act of 1989 (Senate Bill 2, as it is familiarly known), which provides performance-based pay for teachers. These initiatives resulted in the cumulative equivalent of a one-fifth increase in the size of the General Fund budget. No permanent plan (i.e., no revenue increases or budget cuts in other programs) was adopted to fund these increasingly expensive programs. The State has instead financed those increasing costs from annual growth of 10 to 12 per cent in the existing revenue system and by liquidating a $400 million budget surplus.

The Constitution of North Carolina requires a balanced budget, so the projected deficits of the last two years had to be averted. That was done by a variety of management devices employed by the Governor--including reducing

quarterly allotments, freezing vacant positions, restricting non-personnel expenditures, spending the "rainy day fund" we established in 1990, and suspending capital outlay projects for which funds had been appropriated. The General Assembly in 1989 and 1990 has done its part by reducing proposed expenditures, cutting the previously adopted budget for 1990-91, and other stringent measures.

Fiscal year 1991-92 promises a continued grim picture. The gap between currently estimated revenues and the current services budget for 1991-92 is $1.2 billion, or 14.4 per cent of the spending base. If normal expansion items were included, the gap would be 19 per cent. How to cope with the largest budget deficit since the Great Depression of the 1930's has been the chief preoccupation of the 1991 legislative session.

As an incident of money shortages, there have been many days during 1990-91 when the General Fund cash balance fell below zero, making it necessary to borrow temporarily from other state reserve funds in order to be able to honor the State's checks upon presentation. This has not previously been a problem in modern times because revenues have sufficiently exceeded expenditures to keep the State's cash balance adequate to meet current requirements.

How did North Carolina get into this state of fiscal distress? How did we move so quickly from a time of prosperity, when despite state General Fund expenditure increases in the range of ten per cent a year during the 1980's, year-end credit balances remained high, into a time of constantly deepening deficits?

The answers are many and we do not claim to know all of them or the precise relative importance of those we can identify. In the recital that follows, we will note the fiscal developments of the last two years, the legislative responses to them, and factors contributing to the problems

encountered. Our findings as to problems and recommended responses will follow the historical account.

The 1989-91 Budget as Adopted in 1989

The 1989 General Assembly departed from past practice and adopted what it considered to be an essentially full-scale budget for the 1990-91 fiscal year. The General Fund budget included 1990-91 funding for the Basic Education Program in accordance with the original eight-year implementation schedule, funded anticipated mandated increases in the Medicaid program, included a program of prison construction to bring the State into compliance with federally imposed mandates, appropriated a complete schedule of capital improvements, included an estimated increase in health insurance costs for state employees, and funded a six per cent pay raise for teachers and state employees. In addition, the 1989 session approved the most ambitious public works program in the history of the State: a $9.3 billion highway construction program to be completed over a 13.5 year period and financed by increased motor fuel taxes and a new highway use tax replacing the sales tax on motor vehicles. The one major item left for action in 1990 was first-year funding for the School Improvement and Accountability Program (Senate Bill 2). Otherwise, the 1989 session envisioned only minor budget adjustments in the 1990 session.

It was recognized that these heavy commitments would seriously strain the State's resources, but the General Assembly rejected a proposal by Governor James G. Martin to increase the State's general sales tax by one cent. Instead, several short-term measures were adopted, including a two-year allocation to the General Fund of $279 million for 1989-90 and $356 million for 1990-91 in receipts that otherwise would have been credited to the Highway Trust Fund.

The decision to adopt a fully formed 1990-91 budget in 1989 was based on two goals adopted by the House and Senate leadership early in the session. First, there was broad support for a new teacher salary plan as part of the effort to improve the public school system. The plan called for increasing teacher pay on average by six per cent each year for three years, beginning with the 1989-90 fiscal year. By embedding the first two installments in a newly enacted pay schedule, the General Assembly hoped to demonstrate its determination to carry through with the plan. When other state employees, who for the prior two years had received annual pay increases lower than those awarded to teachers, pushed for parity, the General Assembly extended the six per cent increase to all state employees for each year of the biennium.

The second reason for adopting a full 1990-91 budget in 1989 was the hope of limiting the length of the 1990 session to as brief a time as possible. By making all major budgetary decisions in 1989, the leadership hoped that the General Assembly could complete its 1990 session quickly, and getting the salary increase issue out of the way was a major factor in this planning.

Unfortunately, a major revenue shortfall upset the plan. The 1990 legislative session not only found that it had to make major reductions in the 1990-91 budget it had adopted in 1989; it found its members unwilling in an election year to reduce or eliminate the second-year pay raise for teachers and state employees that had been approved in 1989. Instead of a two-week session spent on approving a few new capital projects and tending to minor details, the 1990 session found itself enmeshed in the thorny issues of program curtailment and possible tax increases.

The current operations and capital improvements budgets adopted in 1989 were based on projected increases in available revenue of 13.6 per cent for 1989-90 and 4.9 per cent for 1990-91. The 1989-90 increase included a number

of non-recurring increases such as income taxes on capital gains stemming from the RJR-Nabisco buyout, a change in the method of accounting for local tax reimbursements, acceleration of certain revenues, a few minor tax increases, and the impact on the General Fund of the Highway Trust Fund legislation. After adjusting for these factors, revenue growth due to economic factors was projected to be 8.8 per cent in 1989-90 and 7.4 per cent in 1990-91. As the 1989-90 fiscal year unfolded, it became increasingly clear that these projections were too high. Actual revenue growth in 1989-90 turned out to be 6.6 per cent rather than the 13.6 per cent needed to balance the budget, and the portion of revenue growth due to economic factors proved to be 5.6 per cent rather than the 8.8 per cent forecast. Other contributing factors included unanticipated problems with specific sectors of the economy, unexpected consequences arising from certain tax changes made in 1989, and continuing uncertainty about the capital gains tax issue at the federal level. To make matters worse, the State had experienced major unanticipated expenditures in 1989-90 of $62 million.

The 1989-90 fiscal year was only three months old when the Office of State Budget and Management warned state agencies and institutions that there might be trouble ahead. In January, agencies were told that revenues were $171 million below budget estimates and unanticipated expenditures of $60 million had been incurred. As a result, the Governor ordered third quarter allotments reduced by two per cent. Six weeks later, the revenue deficit was put at $204 million and the Governor delayed capital improvement projects totaling $109.1 million. In mid-April, the projected revenue deficit had grown to $400 million.

By the time the General Assembly convened in late May, 1990, there was a serious fiscal crisis as personal income tax collections for April had fallen

far below estimates. In his budget recommendations to the General Assembly, Governor James G. Martin estimated a probable General Fund shortfall of $505 million for 1989-90 and $335 million for 1990-91. To cope with a problem of this magnitude, the Governor recommended cancellation of capital projects totaling $137 million--$42 million authorized in prior years and $95 million authorized for 1989-90. He also suggested a number of one-time measures, including moving the June payday to July, deferring payment of state assistance for public school construction, borrowing from an unemployment reserve fund, transferring funds from the Highway Trust Fund, and adjusting the State's contribution rate to employee retirement systems. Legislative opposition and legal constraints led the Governor to abandon of all of these options except transferring the June payday.

By early June, 1990, the Office of State Budget and Management was estimating that the June 30 credit balance in the General Fund would be $1.8 million. Eventually the June 30 credit balance proved to be $22.2 million, after the July 20 report from the Department of Public Education showed public school expenditures to be a little over $20 million less than previously estimated. This $22.2 million credit balance was only three-tenths of one per cent of the $6.9 billion 1989-90 General Fund budget. (By comparison, the June 30, 1988, credit balance was $392.9 million, which was 6.8 per cent of General Fund revenues for that year.)

The General Assembly's Fiscal Research Division suggested that some of the factors contributing to the 1989-90 revenue shortfall were affecting only that fiscal year while others would affect future fiscal years as well. Factors affecting both years of the biennium included an abnormally low inflation rate during a time of economic recession, sluggish motor vehicle sales, and declining corporate profits due to pressures from foreign

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competition and higher interest costs attributable to leveraged buyouts. (Both RJR-Nabisco and Burlington Industries had recently gone through leveraged buyouts, resulting in substantial corporate debt, the repayment of which reduced or eliminated taxable profits; these two corporations were once among the State's largest taxpayers.) Most recent economic recessions have been accompanied by inflation which has helped cushion the effect on tax revenues of declining economic activity because price increases due to inflation are reflected in increased revenues from sales and income taxes. In fact, over 90 per cent of General Fund revenues are affected in one way or another by wage and price inflation. In 1989-90, taxable wages and consumer prices for goods subject to the sales tax remained stable. New motor vehicle sales were not as brisk as estimated, partly because dealers marketed new cars aggressively before the new highway use tax enacted in 1989 went into effect and manufacturers unexpectedly discontinued sales incentives. Decreased corporate profits also seemed likely to continue indefinitely for a variety of reasons.

The Fiscal Research Division also identified four factors that might be temporarily depressing revenue growth in the first year of the biennium: a change in the tax treatment of small corporations, the 1989 Tax Fairness Act which based the state individual income tax on a percentage of federal income tax liability, 1989 legislation changing the individual income tax status of retirement benefits, and continuing uncertainty over proposed congressional changes in federal taxation of capital gains. A 1989 change in the state income tax statutes allowed certain small corporations (known as Subchapter S corporations from the portion of the federal Internal Revenue Code affecting them) to be taxed as if they were partnerships. The Department of Revenue estimated that 1989-90 corporate income tax revenues were reduced by 12 per

cent ($85 million) as a result of this change. While much of that revenue showed up on individual income tax returns in 1989-90, an unknown amount was anticipated to spill over into 1990-91. The Fiscal Research Division has estimated that the S Corporation Act was responsible for a permanent revenue loss of $40 million and a temporary 1989-90 loss of $40 million. Other 1989 changes in the individual income tax may have required high-income taxpayers to pay more in quarterly estimated tax payments, while withholding taxes of lower-income individuals declined. The net result of these changes was to shift some tax revenue from one fiscal year to the next. Finally, continuing congressional debate over President Bush's proposal to reduce the federal income tax on capital gains may have encouraged high-income taxpayers to defer selling assets. In all, the Fiscal Research Division was able to identify at least some of the causes lying behind about $290 million of the 1989-90 revenue shortage. The remaining $214 million (estimated as of May 16) it could not explain on the basis of data available at that time. Ultimately, the 1989-90 revenue deficiencies proved to be $549.8 million. This amount comprised a shortfall of $429.4 million in General Fund revenue collections and a $120.4 million shortfall in Highway Trust Fund revenues that were to have been transferred to the General Fund.

On the expenditure side, two natural disasters and other unanticipated events pushed expenditures up by about $62 million. It cost the State about $18 million to match federal assistance for the victims of Hurricane Hugo in the fall of 1989 and a tornado in the spring of 1990. The cost of implementing the new salary schedule for public school teachers enacted in 1989 was $22 million more than estimated, due to a one-time cost for longevity pay. Health insurance for state employees turned out to be $7 million more costly than estimated. Finally, the cost of funding the 1988-89 carryforward of 11th and 12th month teacher salaries was $15 million.

Although the Governor's expenditure reductions had staved off a cash-basis deficit by a hair's breadth, they were not sufficient to ward off a threat to the State's AAA credit rating. On June 8, 1990, Standard & Poor's placed North Carolina state bonds on credit watch. This action meant that the rating agency was giving serious consideration to lowering the State's credit rating. Even though the state budget for 1989-90 may have been balanced on the cash basis, the fact remained that unless something else was done, the General Fund would end the 1989-90 fiscal year with a $173.8 million deficit as reported under Generally Accepted Accounting Principles (GAAP), the standard applied by the credit evaluation. To make matters worse, all indications were that the State faced budget difficulties in 1990-91 at least as serious, if not more than so, as those it had just weathered.

At the urging of the Office of State Budget and Management, the General Assembly responded to the crisis with Chapter 813, ratified on June 21. This act took three steps that had the effect of reducing General Fund liabilities and increasing assets, thereby resulting in GAAP-based financial reports showing the June 30 financial position of the General Fund to be positive rather than negative. First, the act required utility companies to pay certain accrued franchise and sales taxes by June 25 (under existing law these taxes would not have been payable until July 30). Although these payments took place after the June 20 closing of the Revenue Department's books for the 1989-90 fiscal year and were therefore not used by the General Assembly in estimating the June 30 credit balance, Chapter 813 made the money "measurable and available" in the 1989-90 fiscal year, which enabled the State to report it as 1989-90 revenue on the modified accrual basis of accounting and allowed the General Assembly to take it into account in estimating 1990-91 revenue availability. Second, the laws governing distribution to local governments of

portions of the beer-wine excise tax, the utility franchise tax, and the intangibles tax were amended in such a way that the liability reserves formerly maintained to offset these revenues were eliminated, with a corresponding increase in fund balance. Finally, certain venture capital investments made from the General Fund and Highway Fund were shifted to the Escheats Fund, resulting in elimination of the liability reserves formerly maintained to offset those investments.

For many years the State had distributed the franchise tax levied on gross receipts from the sale of electric power, natural gas, and telephone service within cities and towns to the municipalities from which the revenue was generated. (The State retains all franchise tax collections from sales in unincorporated areas.) Similarly, both counties and cities received a share of the state excise tax on beer and wine sold within their boundaries. Since the inception of the intangibles tax in 1937, statutes levying ad valorem taxes on certain classes of intangible personal property have stated that the tax is levied "on behalf of" local governments and have provided for distribution of the net proceeds of the tax, after certain statutory deductions, to local governments on the basis of formulas set out in the statutes. Previously, the statutes providing for sharing these state-levied taxes with local governments directed the Secretary of Revenue to set aside for distribution to local governments a specified portion of this revenue according to precise formulas spelled out in the statute. For that reason, GAAP-based financial statements reported a General Fund liability equal in amount to the local portion of franchise, beer-wine, and intangibles taxes being held in the General Fund because, under the statute, these amounts were owed to local governments and were unavailable for any other use.

Chapter 813 changed all of the statutes calling for distribution of franchise, beer-wine, and intangibles taxes to local governments to eliminate any suggestion that local governments are legally entitled to any portion of these taxes. Consequently, the entire net proceeds of these taxes collected in fiscal year 1989-90 were reported as General Fund revenues. Some of this revenue had already been distributed to local governments earlier in fiscal year 1989-90 but $141.1 million was on hand in June pending distribution in October. Chapter 813's amendments allowed changes in the method of accounting for this money that resulted in eliminating from the GAAP-based financial statement for the General Fund liability reserves totaling $141.1 million. Local governments did not suffer a revenue loss in 1990-91 as a result of this move because the Current Operations Appropriations Act contained appropriations and special provisions designed to ensure that the amount paid out to local governments would not change. Nevertheless, the changes did make the amount of money to be shared with local governments from these sources in future fiscal years dependent not on actual collections but on the terms of the annual state appropriations act.

The final changes made by Sections 10 through 12 of Chapter 813 released $23 million from liability reserves in the General Fund that had been established to offset state investments in the North Carolina Enterprise Corporation and in limited partnership interests in partnerships managed primarily for the purpose of investing in venture capital firms and corporate buyout transactions.

Altogether, the accounting changes made possible by Chapter 813 improved the financial condition of the General Fund by some $222.4 million, resulting in a June 30 GAAP-based credit balance estimated at $5.2 million. Ultimately, the GAAP-based credit balance proved to be in the neighborhood of $100 million when final revenue and expenditure totals were reported.

Revision of the 1990-91 Budget

Having tended to the 1989-90 budget, the General Assembly in its 1990 session next turned to adjustments to the 1990-91 budget needed to offset a revenue shortfall that in early June was estimated at $335.4 million for the upcoming fiscal year. Of this amount, $243 million was attributed to lower General Fund revenue estimates and $92 million to reduced transfers from the Highway Trust Fund due to lower estimates of the yield of the highway use tax. The estimated $22.2 million credit balance partially offset this amount, leaving $313 million to be found elsewhere. For the better part of two months, the two chambers debated over whether to make up the shortage by reducing expenditures, by increasing revenues from taxes and fees, or some combination of the two. At the same time, the General Assembly was under increasing pressure to fund several new program initiatives and to restore funding for capital projects delayed in order to balance the 1989-90 budget. By June 19, the Senate had rejected any tax increase and had adopted a budget bill that funded the first year of the School Improvement and Accountability Program (Senate Bill 2), and proposed modest new spending for infant mortality reduction programs, drug abuse initiatives, and new prisons. The Senate balanced the budget with spending cuts, lower funding for the Basic Education Program, a hiring freeze, the transfer of the drivers' education program to the Highway Fund, and tax accelerations. The House searched unsuccessfully for a 61-vote majority for a modest tax increase that at least would have avoided the need to cut spending commitments made in 1989 for the public schools. Among the ideas considered were a one-half cent increase in the state sales tax, with or without removing the $80 ceiling on sales of certain agricultural equipment and industrial machinery and the $300 limit on aircraft sales, and a series of increases in taxes on beer, wine, liquor, and cigarettes.

Before the 1990 session convened, Governor Martin had proposed that all state agencies be directed to reduce 1990-91 expenditures by 5.2 per cent, with 3 per cent to come from permanent cuts to be identified by the agencies themselves and 2.2 per cent from mandated spending curtailment. The latter proposal gave agencies broad latitude to spread spending reductions across the budget without having to target the reductions in advance. The final budget plan agreed to by the House and Senate conferees adopted the Governor's solution. Before the session opened on May 21, each state agency had submitted line-item by line-item proposals for reducing its 1990-91 budget by three per cent. These reductions totaled $244.7 million. For the most part, they were accepted by the General Assembly and the Current Operations Appropriations Act was amended accordingly. In addition, most state agencies, with the exception of the community colleges, were directed to hold expenditures against 1990-91 appropriations, as modified by other 1990 reductions and increases, to 98 per cent of total appropriations to the agency. This was accomplished by including in each agency's budget a "negative reserve" equal to two per cent of the total of all other budget line items. The effect of the negative reserve was that the agency's total spending against General Fund appropriations for current operations could not exceed 98 per cent of the agency's authorized 1990-91 budget. All told, the negative reserves amounted to $97.9 million, which was 1.3 per cent of the total 1990-91 budget.

The choice of the three per cent legislated reduction and the two per cent negative reserve had implications for the 1991-93 biennium that may not be immediately apparent. Line items not fully expended and positions left unfilled in order to meet the two per cent negative reserve remained in the continuation budget for 1991-93 unless the Governor determined that they were not needed to maintain existing programs at their current level. Therefore,

Section 7 of Chapter 1066 instructed the Office of State Budget and Management to manage quarterly allotments so as the realize at least $40 million in savings from leaving positions vacant. Employees of the General Assembly and teaching positions in the public school system and the UNC system were not to be used to meet this quota. That left $57.9 million to be made up in other ways.

Together, the mandated budget and spending reductions cut $342.6 million from the $7.8 billion 1990-91 General Fund budget that had been adopted in 1989. This left only $29 million for capital improvements projects that had been delayed and critically needed new spending for current operating items ($22 million from the 1989-90 credit balance and a net $7.2 million from mandated appropriations and spending reductions). More money was needed. The General Assembly generated it by accelerating the collection of certain taxes. Chapter 945 made permanent the accelerated payment schedule for utility franchise and sales taxes that had helped improve the 1989-90 modified accrual credit balance. This made an estimated $58.3 million available for expenditure in 1990-91 in addition to twelve months worth of such taxes to be collected and paid out in 1990-91 under the new monthly payment schedule. Chapter 945 also accelerated the payment of withheld individual income taxes by employers for an estimated gain of $113.5 million. Chapter 984 accelerated the schedule for payments of estimated corporate income taxes of moderate-sized corporations, for an estimated gain of $41.9 million. Chapter 984 also required individuals and corporations requesting extensions of time in which to pay income and franchise taxes to pay the estimated tax by the normal deadline, for an estimated gain of $40 million. All of these revenue gains were one-time windfalls that will not again be available to increase revenues in future fiscal years, except to the extent that earlier payment increases the

State's investment earnings. Taxpayers paid no more than they otherwise would have paid; they simply paid it earlier.

The total amount anticipated from these 1990-91 revenue accelerations was $253.7 million, not including a possible resulting increase in investment earnings. Added to the $22.2 million beginning credit balance (cash basis), the total of $275.9 million offset the $275.6 million appropriated by Chapter 1074: $7.7 million for additional recurring current operations items, $221 million in non-recurring capital improvements and other one-time items, and $46.5 million to replace corporate income tax revenues formerly earmarked for public school construction. The latter change is discussed below.

Two other changes made in the budget process affected the total estimated availability of revenue for 1990-91, but were offset by appropriation of like amounts: the Budget Stabilization Reserve and a change in the method of funding the Public School Building Capital Fund and the Critical School Facility Needs Fund.

As discussed above, Chapter 813 changed the method of accounting for the portion of franchise, beer-wine, and intangibles taxes shared with local governments. Section 11 of Chapter 1066 appropriated $242.7 million to local governments from the proceeds of these taxes and directed that the amount of the appropriation in excess of actual revenue collections revert to the General Fund, while the appropriation is to be increased to the extent that collections exceed estimates. Thus, these appropriations were to be funded from current 1990-91 revenue collections. There remained the $141 million being held in the General Fund on June 30, 1990, pending distribution in October. Because of the accounting change, that money was technically available for appropriation to offset any General Fund item in 1990-91. The General Assembly chose not to spend the windfall. Instead, Section 10 of

Chapter 1066 appropriated $141 million to the Office of State Budget and Management as a Budget Stabilization Reserve for the stated purpose of providing "a mechanism to stabilize the annual funding availability for carrying out state programs and providing financial assistance to local government units"--and so we gained a "rainy day fund."

The Public School Building Capital Fund and the Critical School Facility Needs Fund, which are used to assist counties in meeting school capital outlay needs, are funded by earmarking just over seven per cent of corporate income tax collections for that purpose. For the 1990-91 fiscal year, it is estimated that $46.5 million will go to those two funds from that source--$10 million to the Critical School Facility Needs Fund and $36.5 million to the Public School Building Capital Fund. Formerly, this money was credited directly to the funds and was not reported as General Fund revenue. Section 28 of Chapter 1066 repealed the statutory language that earmarked this revenue, with the stated intent that a like amount would be appropriated in the capital budget act, to be funded from non-recurring revenues. Chapter 1074 in fact did so. Like the payday delay and the revenue accelerations discussed above, these strategies were available only once and will have no effect on future fiscal years.

Another series of actions by the 1990 session that affected the 1990 budget included a number of fine-tuning amendments to tax legislation enacted in 1989 and a new tax credit for federal retirees. Together, these tax law changes reduced General Fund revenues by $7.3 million. The loss was offset by increasing a number of fees to yield an additional $7.6 million. Finally, $17 million was transferred from the Highway Trust Fund to the Highway Fund and from there to the General Fund offset the cost of the drivers' training program in the public schools.

In addition to current revenues and the credit balance remaining from the previous year, bond issues are a major source of revenue for capital improvements projects. The 1990 session tapped this source for up to $275 million to be used for prison facilities. Chapter 933 authorized the State Treasurer to issue up to $75 million in non-voted state bonds to fund construction of nine prison facility projects specified in the act. Because the total of these bonds was less than two-thirds of the amount by which the outstanding debt of the State was reduced in the biennium that ended June 30, 1989, Article V, § 3(1) of the North Carolina Constitution allowed the State to issue them without voter approval. Chapter 935 allowed the issuance of another $200 million in state bonds for prison construction that the voters approved in an election held concurrently with the November, 1990, general election.

The net effect of Chapters 1066 and 1074 was to authorize an increase in spending for the 1990-91 fiscal year by $1.3 million. Whether by coincidence or by design, this figure essentially matched the $1.8 million June 30 General Fund credit balance (cash basis), not including reversions in the Public School Fund.

Resolution 76, the 1990 session's last action, cast an eye to the future fiscal condition of the State. In placing a credit watch on the State's bonds, Standard & Poor's was looking as much to the future as to the June 30, 1990, condition of the General Fund. Given the State's commitment to such long-term spending programs as the Basic Education Program and expanded prison facilities, coupled with an apparent slowing of revenue growth, the rating agencies were looking for evidence that the State intends to take positive steps to address the impending gap between revenues and expenses in fiscal year 1991-92 and beyond. In an address to a joint session of the House and Senate on June 21, Governor Martin attempted to meet this expectation by

asking the General Assembly to adopt a resolution of intent to increase the state sales tax from three per cent to four per cent in 1991, a measure he had first proposed in 1989. He garnered virtually no support for that proposal. When that initiative failed, the Governor, accompanied by his top financial advisers and State Treasurer Harlan Boyles, went to New York to confer with representatives of the bond rating agencies. Four days later, Standard & Poor's announced that North Carolina retained its prized AAA rating for the time being but that the credit watch would remain in effect.

Resolution 76 stated that the General Assembly remained committed to its initiatives to improve public education at all levels and to addressing the infrastructure and human services needs that will enable the State's economic development climate and quality of life to remain attractive. It then listed six actions that have been taken to preserve the State's reputation for fiscal integrity: (1) a formal "rainy day fund" (i.e., the Budget Stabilization Reserve discussed above) had been established for the first time; (2) the current operations budget had been reduced and the time for implementing prior legislative initiatives (i.e., the Basic Education Program and the School Improvement and Accountability Program) had been extended; (3) procedures for reaching consensus between the legislative and executive branches on the process of estimating revenues had been formalized; (4) a major study directed toward developing recommendations for resolving the long-term General Fund deficit had been commissioned; (5) actions had been taken for 1990-91 to keep expenditure flows in line with revenues and to identify further permanent budget reductions (e.g., the two per cent negative reserves allotted to most state agencies); and (6) bond issues, rather than current revenues, had been used to finance prison construction, thereby taking some of the pressure off current revenues.

After reciting these positive steps, Resolution 76 recognized the need to take others in the near future.

Revenues and expenditures were projected over four years (1991-92 through 1994-95), various assumptions being made about growth on both sides of the ledger.

Finally, Resolution 76 stated that the General Assembly intended in the future to base all executive and legislative analyses of General Fund availability, general obligation bond authorizations, and bills affecting revenues and expenditures on a four-year fiscal outlook and to include in the analysis of proposed capital improvement projects an estimate of projected current operating costs of each facility over its useful life.

Resolution 76 was apparently what the rating agencies were looking for. On August 24 Standard & Poor's lifted the credit watch on North Carolina bonds and reaffirmed the State's AAA credit rating.

1990-91 Budget Experience

In May of 1990, the Governor's Office of State Budget and Management and the General Assembly's Fiscal Research Division made a revised consensus revenue estimate for the fiscal year 1990-91. That estimate projected revenue growth of 6.6 per cent, based on the economy. The adoption of numerous tax accelerations and fee increases, the change in the method of funding school facilities assistance, and the change in the method of accounting for state-local shared taxes pushed the actual budgeted growth rate up to 11.0 per cent.

The 6.6-per-cent economy-based growth rate was in line with the thinking of the mainstream national forecasters, including the financial services arm of Standard and Poor's Corporation. The events of August 2, however, rendered that forecast obsolete. The initial shock of the invasion of Kuwait sent oil

prices from $18 to almost $40 a barrel, and at the gas pump, gas prices went from $1.08 to $1.50 a gallon. Overnight, a slow-growth economic outlook became one of mild recession.

In early November, the decision was made by the President to double the size of the American military force in the Middle East. That decision, coupled with heated national debate in December and January over its prudence, caused the most precipitate drop in consumer confidence in over 40 years. In addition, corporate profits took a nosedive as corporations were unable to pass on higher fuel costs to customers. The nation was headed for a major recession.

The Gulf War ended in late February. As expected, consumer confidence bounced back. Improved consumer attitudes were, however, offset by the realization that the economy had become mired in a major recession. The unemployment rate continued to rise, auto sales fell further, and state revenues continued to fall. The economic condition of North Carolina was worse than that of the United States at large, due to the dispatch of 100,000 troops from the Carolinas to war duty. During the war, state sales tax collections in the "military" counties fell by over 10 per cent and apartment vacancy rates in one couty rose to over 50 per cent.

Complicating the picture was the fact that in the fall of 1990, the first analysis of the income tax restructuring act of 1989 was completed by the Department of Revenue. That analysis indicated that the income redistribution portions of the act were overall essentially revenue-neutral. The Fiscal Research Division has expressed concern, however, that there is a permanent annual revenue loss of $85 million, because the rate design in the 1989 act did not sufficiently account for the tremendous growth of S corporation conversions in the wake of federal tax reform.

As in 1989-90, freezes on hiring to fill vacancies, restrictions on non-personnel expenditures, cancellation of General Fund capital improvement spending plans, quarterly allotment reductions, and other administrative strategies were employed to forego budgeted expenditures altogether or at least to defer them to the 1991-92 fiscal year, where they will enlarge a General Fund deficit already reckoned at $1.2 billion. The $141 million "rainy day fund" was also used by the Governor to help achieve a balanced budget.

Federal Fiscal Policy

The General Assembly's task of state financial planning and budgeting has been greatly handicapped by changes in federal financial policy and practice.

For reasons that we do not fully understand, the State of North Carolina is a substantial net exporter of tax dollars to Washington; that is, the federal taxpayers of North Carolina pay out significantly more than the State receives in return in federal expenditures of all kinds in North Carolina.

As the Congress has come to realize that the federal budget is increasingly out of balance, it has reduced federal revenue sharing with the states and federal financial support for programs in which the State shares responsibility with the federal government. The Congress has not, however, reduced requirements it places on the states and local governments for the provision of services. Indeed, federal mandates seem to have grown in proportion as federal funds to help with meeting those mandates have shrunk. The cost of meeting those mandates is one of the factors that denies the General Assembly the degree of control over the State's budget that we are generally thought to have.

Fiscal Reform Proposals

Put in simplest terms, the State of North Carolina, like the United States, has developed an increasingly costly standard of living that it does not have the steadily rising income sufficient to support. Unlike the federal government, however, the State cannot borrow to pay its current expenses: it must balance its budget year by year. That requires that we reduce our expenditures or increase our income, or do both, to bring them into alignment. To date, we have done neither with complete success. This session of the General Assembly has set itself the task of cutting expenses and increasing revenues sufficiently to balance the State's budget on more than the precarious, year-at-a-time basis that we have adopted in recent years.

While we have only begun our efforts to define the State's fiscal problems and devise solutions to them, we are prepared to make several proposals for change that we urge the 1991 session of the General Assembly to consider. They affect both the revenue and expenditure aspects of state budgeting.

State and Local Finance Study

The revenue systems of the State and its local governments are closely intertwined and any careful consideration of either must take the other into account. Given the recurrent financial problems of the State and its counties and cities, it would be timely for the General Assembly to authorize a thoroughgoing study of how we finance state and local government services in North Carolina and whether more adequate and dependable means of financing those services can be devised. Such a study necessarily would include the issue of where responsibility for performing governmental services should be lodged, as well as the question of how they should be financed. The study, if adequately done, would take at least a year. A study commission with that

assignment and instruction to report in time for action by the General Assembly of 1993 would be an appropriate way to address this subject in its largest aspect. We will prepare a resolution calling for such a study.

. We recommend that the General Assembly authorize a thorough study of the adequacy of state and local government revenue sources and the allocation of responsibility among the State and its counties and municipalities for financing and performing government services, with a report and recommendations to the 1992 session of the 1991 General Assembly.

Revenue Recitals in Appropriation Acts

We believe that it would clarify the financial availability (opening credit balances plus revenues) on which our appropriations are based were recited in the current operations appropriation bill, as is done by counties and cities when they adopt their annual budget resolutions. In that manner, however the availability estimates were arrived at, they would by adoption become the General Assembly's own estimates, with appropriate details as to their composition. When we now adopt an appropriation act, we necessarily imply that we believe there will be money in the State Treasury sufficient to cover those expenditures. To recite the details of those implied resources would serve the ends of candor and clarity.

We recommend that each current operations appropriations bill adopted by the General Assembly recite in the bill the availability (beginning balance plus revenue) estimates on which it is based.

Keying Revenue Estimates to Prior Years

Attention has been given during the current session of the General Assembly to devising means whereby certainty may be introduced into determining revenues when making up a budget for the next fiscal year or biennium. The proposal to tie revenue estimates for the new fiscal year to actual revenues during a recently completed period would have the advantage of certainty. It also would have the purpose and effect of significantly limiting the capacity of the General Assembly to provide for the steadily increasing costs of government, costs over which the General Assembly often does not have control. Such a limitation would be only statutory and would not be a truly limiting factor if the General Assembly were determined to use anticipated growth in revenues in the upcoming fiscal year to meet identified state needs. What we need most is the firm resolve to pay our bills in the fiscal year in which they come due; with it, we would not need such limiting statutes and without it, they would be of limited effect.

It would reinforce our resolve, however, if we established a statutory policy limiting appropriations for any fiscal year to the equivalent of actual receipts for the most recently completed calendar year, and we so recommend. A transitional period of five years would enable the shift to the new policy to be made with a minimum negative effect. Were the proposed policy now in force, the appropriations for 1991-92 and 1992-93 would each be limited to the equivalent of actual receipts for the calendar year 1990. If receipts for the upcoming fiscal year exceed those committed to appropriations, the excess would remain as a year-end credit balance for later use.

We recommend that the General Assembly limit General Fund current operations appropriations for any fiscal year to the equivalent of actual receipts during the most recently completed calendar year.

Program Cost Escalation and Fiscal Notes

One large contributor to the current fiscal plight of the State is that we--the General Assembly--acting in the light of what we considered the public interest, have over the last several years committed the State to several programs, especially in the field of public education, that have large and constantly rising costs. To those express commitments should be added the expectations on the part of state employees that a long-standing practice of making annual pay increases of five or six per cent is an entitlement, not a benefit that should be keyed to the State's fiscal condition. Health protection program costs have their own dynamic upward thrust. Overlay federal government requirements with respect to Medicaid that increase its costs to the State by 17 per cent a year. Load on court orders requiring large capital outlay (and attendant operating costs) for prison facilities. Suddenly, these cumulative increases consume more than a reasonable revenue increase in good times, and drive the state budget into serious deficit in times of general economic recession, such as the present.

The lesson to be learned from this recital is that the General Assembly must be critically aware of the long-term costs of every program we adopt or expand, and of our ability to meet those costs over the next several years.

It is a common assertion among members of the General Assembly that "one session of the legislature cannot act to bind its successors." While that is literally true, as a practical matter we do it at every session. Legislative acts and programs, one put on the law books in response to some perceived need, are not easily removed. They begin with (or soon acquire) interested

constituencies both inside and outside the General Assembly. In the case of government programs, they have associated costs, and those costs predictably rise with time due to program expansion, staff growth, salary increases, inflation, and other predictable if not inexorable factors. There is a natural tendency on the part of advocates of a new program or service to minimize its estimated long-term costs, lest those later costs burden the prospect of initial acceptance of the program by the General Assembly. Few members of the General Assembly would have thought, for example, when the Office of Lieutenant Governor was made full-time in 1973, that its operating costs by 1990-91 would be $584,000 a year.

We now require by the rules of both houses that fiscal notes be prepared with respect to a proposed bill or amendment on request of certain committee officers. Consideration should be given to requiring a broader, mandatory use of the fiscal note: Every bill or amendment that would have the effect of establishing or enlarging a governmental program or service that the State of North Carolina would be expected to assist in financing should carry a fiscal note as to its costs for each of the next six fiscal years. If the program has a fixed life, the cost projections should extend over its full life.

That fiscal note should include information on the personnel requirements as well as the dollar costs of the program. The General Assembly in 1989 provided in G.S. 143-10.2 that

> [t]he total number of permanent State funded employees, excluding employees in the State's public school system funded by way of State aid to local public school units, shall not be increased by the end of any State fiscal year by a greater percentage than the percentage rate of the residential population growth for the State of North Carolina.

While that restraint is only statutory and the General Assembly can override it by an appropriation act that is of force equal to the restriction, it voices sound public policy that the General Assembly should keep constantly in

view. A mandatory fiscal note that sets forth personnel requirements to accompany every program initiation or enlargement would enable the General Assembly to be aware of how closely the mandate of G.S. 143-10.2 is being followed, and we so recommend.

A further example of the kind of fiscal note needed pertains to the prison system. Every proposal that would impose or materially increase prison sentences should carry a fiscal note informing the General Assembly of the dollar costs of that change: How many people would be imprisoned, for how long, at what cost? The study might be broadened to include estimates of the cost of alternatives to imprisonment where appropriate.

We recommend that the House of Representatives amend its rules to provide that every bill or amendment that establishes or enlarges a governmental program or service carry a fiscal note as to its costs over the next ensuing six fiscal years, with special emphasis on personnel requirements and costs.

Building Maintenance Costs

So too with new buildings: A longer-term view of their costs of operation and maintenance should be taken. There is a tendency to think that when we have provided funds to erect a building (or accepted a building donated to the State), the costs are at an end. In fact, they are only beginning. The State now makes no regular provision for the maintenance of its hundreds of buildings and the protection of its large investment in them. Maintenance funds are an early sacrifice in times of budget reductions. It is often easier to get a large appropriation for a new building than smaller sums for its continued maintenance once it is in use. The result is the deterioration of valuable assets for want of timely care and maintenance.

We believe that it would be prudent investment on the part of the State to establish a policy that a fixed amount (perhaps keyed to the cost of building replacement) be appropriated each year for the specific purpose of maintenance and repair of buildings, and that that program take priority over providing funds for new buildings.

We recommend that the General Assembly adopt a policy that it will give high priority in making each year's appropriations to providing capital funds for the repair and maintneance of the State's buildings.

Adoption of Budget by April 1

One of the valid criticisms made of the General Assembly's appropriation process is that in the long session, at least, the budget has not for several years been completed before the beginning of the new fiscal year. When the terms of the appropriations act are as much in doubt as they are this year, that makes it exceedingly difficult for state agencies and institutions and for counties and cities to plan their budgets. For example, our budget for 1991-92 will include many reductions below current appropriation levels that will take effect on July 1, 1991. But if we are as late in adopting a budget this year as in recent long sessions, that date will have been well past when the agencies and units know definitively how much they will have to cut. That is particularly troublesome when the cuts involve the dismissal of current employees due to the lack of funds to pay them.

For these reasons, we recommend that the General Assembly routinely plan its work with a determination to adopt the current operations appropriations bills not later than April 1 of each year, and propose a statutory amendment to that end. The adoption of our recommendation that the budget availability in each fiscal year be keyed to the actual receipts in the most recent calendar year would make enactment of the budget by April 1 feasible.

We recommend that the General Assembly resolve to adopt the current operations appropriations bill by April 1 of each year.

Appropriations Bills

We believe that it would make the appropriations process more understandable to follow consistently the traditional organization of appropriations into four bills: (1) the Current Operations Base Budget Appropriations Bill, (2) the Current Operations Expansion Budget Appropriations Bill, (3) the Capital Improvement Appropriations Bill, and (4) the Budget Revenue Bill.

We recommend that the proposed legislative actions with respect to state finances at each session be embodied in four bills:

(1) a current operations base budget appropriations bill,

(2) a current operations expansion budget appropriations bill,

(3) a capital improvements appropriations bill, and

(4) a budget revenue bill (if needed).

Rainy Day Fund

The desirability of a "rainy day fund"--a substantial reserve set aside by appropriation for use only in the event that revenue shortfalls or emergency calls for expenditures not anticipated when the appropriations bills were under review imperatively require its use--is often acknowledged. Not until the fiscal year 1990-91 was such a fund created in North Carolina, however, and then it was the incidental by-product of an accounting strategem adopted to show that the State's budget was balanced on June 30, 1990, by GAAP standards. The availability of that $141 million fund helped the State avoid having in 1990-91 a year-end deficit of large proportions or taking drastic actions to prevent it.

The General Assembly should provide a similar reserve or rainy day fund for 1991-92 and each future year. We are not now prepared to suggest the magnitude of that fund, but we note that the two per cent of the General Fund budget that this year's rainy day fund constituted was certainly not excessive and had it been two or three times as large, other less desirable actions (which will not again be available for use in future years) need not have been taken.

One way to create such a fund would be to set aside a portion of the State's year-end credit balance for that use. Another would be to earmark unusual or windfall income to the State for that fund. We prefer the former course and will propose legislation to that effect.

Whatever the source of the rainy day fund or reserve, its use by the General Assembly or the Governor should be restricted by writing into the authorizing statute the limited uses to which it could be put. Examples would be events such as have contributed to fiscal havoc for the State in recent years: the need to pay unforeseen costs arising from a natural disaster, such as Hurricane Hugo, or substantial shortfalls in projected revenues on which appropriations are dependent. Setting up the rainy day fund as a trust fund might also help secure it from causal expenditure.

We recommend that the General Assembly establish a savings reserve or rainy day fund by July 1, 1995 that will ultimately equal five per cent of the annual General Fund current operations appropriations and specify the conditions under which it can be spent.

Fund Balance Maintenance

The State Controller urged upon us the adoption of policies that will ensure that the State maintains at all times a fund balance equal to at least five per cent of General Fund appropriations (currently, about $400

million). That would enable the ordinary financial business of the State to be carried on, unembarrassed by the necessity of frequently borrowing from state reserve funds (and paying interest on the loans) in order to be able to honor checks of the State upon presentation. We were advised that borrowing for this purpose in 1990-91 cost the State $10 million, one-half in interest paid and one-half in lost opportunity costs.

The proposed rainy day fund would serve that purpose so long as it remains intact. The sounder way to meet the need for a continuously adequate fund balance would be to enact a revenue system that generates sufficient income throughout the year to meet the State's operating costs and leave a modest margin in the bank.

We recommend that the General Assembly, in adopting the current operations appropriations bill each year, ensure that the fund balance of the State is at all times sufficient to clear all state-issued checks that are presented for payment.

User Fees

We note a tendency for state agencies and institutions that find budget restrictions handicapping to resort to user fees of various kinds. User fees on government services should be imposed selectively and sparingly. Access to most government services should not be limited to those citizens who can readily pay for them or who are willing to take an means test to prove themselves unable to pay for them.

We recommend that the General Assembly proceed cautiously in imposing user fees on users of state government's services.

Performance Audit of State Government

The General Assembly should give serious consideration to ordering a thoroughgoing survey or performance audit of the executive branch of state

government, including such matters as employee benefits. The purpose of this survey would be to provide the Governor and the General Assembly with information necessary to make intelligent decisions about possibilities for economies through program curtailment or other means. Its execution probably would require the employment of special staff or consultants to work with a legislatively established study commission that would review staff findings and make action recommendations to the General Assembly. Such a survey would not be inexpensive, but it should be money well spent.

We have received suggestions for drastic means of forcing such a re-evaluation of governmental programs, including a statutory sunsetting of all state programs and agencies at the end of a stated period. That strategy might have the value of forcing early legislative decision on the continuation or discontinuation of each agency. Realism suggests, however, that few programs would be discontinued in that way. More than likely, the scale of the task of reviewing all state ageancies for termination or renewal in a short period would lead to the routine renewal of most of them, not their careful examination.

We recommend that the General Assembly order a thorough management survey of and report to the General Assembly on the executive branch of state government with respect to the needfulness, effectiveness, and economy of each activity and program maintained by the State.

Conclusion

The State of North Carolina must treat its current financial crisis as an opportunity for the kind of fiscal reform that would be appropriate at any time but is not feasible under calmer circumstances.

This opportunity calls for full cooperation between the Governor and the General Assembly, and between the House of Representatives and the Senate, without regard to partisan considerations. Its address must be large in scope, for it must comprehend both changing federal-state fiscal policies and the vital relationships between the State and its counties and cities in their shared responsibilities for meeting the needs of the people of North Carolina for protection and service. Some issues admit of short-term solutions; others will require longer term study. All are worthy of our best efforts.

The mission of the Finance Committee and of the House leadership will be to build consensus, first within the House membership and then with our Senate colleagues, so that legislative initiatives in the area of fiscal and budgetary reform bring real and lasting change.

The fiscal problems of North Carolina are serious. The public wants and deserves action to solve these fiscal problems and will pay the price of the solutions if what is asked of them is well justified. This opportunity must not be lost.

Our own task is large; the life of this Select Subcommittee has been short. We recommend that the existence of the Subcommittee be extended at least to the end of the current 1991 session of the General Assembly, so that we may have time to consider and provide more thoughtful response to some of the issues within our charge.

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