To Be Rather Than to Seem: Fiscal Responsibility and the Political Economy of North Carolina

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ABSTRACT

Real state spending per capita has increased fourfold in North Carolina since 1970. Three sources of revenue allowed for this increase: (1) tax increases, (2) increased debt, and (3) increased federal transfers. The latter two revenue sources have served to mask the true cost of increased spending—that is, they have created a fiscal illusion by transferring costs to future generations of workers and by dispersing costs across all federal taxpayers and debt holders. We argue that despite recent reforms, North Carolina's long-run spending trend is unsustainable. To return the state to long-term fiscal solvency, reforms must likewise be focused on long-term institutional incentives. To be competitive with other states, North Carolina's taxes, regulations, and property rights protections must all be competitive.

JEL codes: H70, R5

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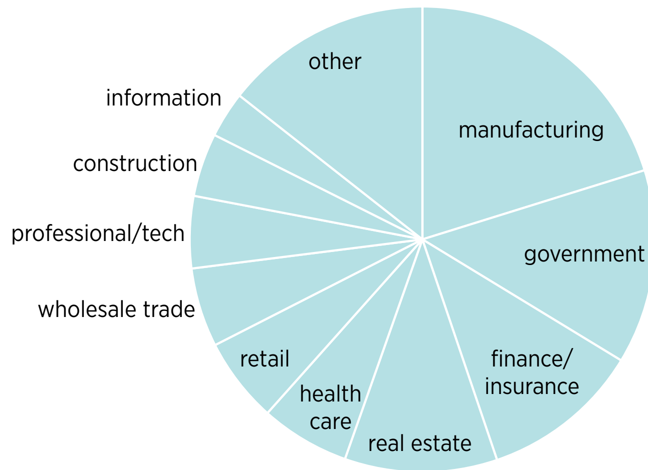
North Carolina's political leadership faces an important decision: Will the state continue the positive reforms that have helped it enjoy greater economic growth than the national average? North Carolina is 40th in spending per capita,[1] and its unemployment rate was 5.8 percent in September 2015, while the national average was 5.1 percent.[2] It ranks 16th in state and local average tax burden.[3] Policy changes and trends in North Carolina today will affect economic conditions for decades to come.

North Carolina has the 9th largest economy in the United States, with a gross state product of $471.3 billion in 2013,[4] and it has the 10th largest population, estimated at 9,848,060 in 2013 by the US Census Bureau.[5] For the most recent year of complete data, the Bureau of Economic Analysis calculates North Carolina's income per capita at $39,171, ranking it 39th of the 50 states.[6] The state's economy has historically been based on agriculture, but the past 20 years have seen significant urbanization and service-sector growth.[7] Overall, the state's economy is very diverse (figure 1). According to the Bureau of Labor Statistics, North Carolina's recent unemployment rate of 5.8 percent in September 2015 was above the national average (5.1 percent).[8] Manufacturing

1. Kaiser Family Foundation, "Total State Expenditures," accessed December 14, 2015, http://kff.org/other/state-indicator/total-state-spending/.
2. Bureau of Labor Statistics, "Local Area Unemployment Statistics," last modified October 20, 2015, http://www.bls.gov/web/laus/laumstch.htm.
3. Tax Foundation, "North Carolina: The Facts on North Carolina's Tax Climate," accessed October 26, 2015, http//taxfoundation.org/state-tax-climate/north-carolina.
4. Bureau of Economic Analysis, "Regional Data: Personal GDP and Income," http://www.bea.gov/iTable/iTable.cfm?reqid=70&step=1&isuri=1&acrdn=1#reqid=70&step=1&isuri=1.
5. US Census Bureau, Population Data, accessed December 14, 2015, http://www.census.gov/topics/population/data.html.
6. "North Carolina," Bureau of Economic Analysis Bearfacts, accessed December 14, 2015, https://www.bea.gov/regional/bearfacts/pdf.cfm?fips=37000&areatype=STATE&geotype=3.
7. North Carolina remains the country's leading producer of tobacco, and agriculture is important in many less-urbanized parts of the state, particularly the west.
8. Bureau of Labor Statistics, "Local Area Unemployment Statistics."

FIGURE 1. NORTH CAROLINA ECONOMY BY SECTOR, AS A SHARE OF STATE GDP, 2012



Source: "Economic Snapshots: Gross Domestic Product by State," North Carolina Chamber of Commerce, 2014 (2012 data), https://www.nccommerce.com/Portals/47/Documents/Economic%20Snapshots/State%20GDP%20May%2014.pdf.

employment and production have been in decline as a portion of the state's output. North Carolina's government leaders have been particularly interested in nurturing the growing information and biotech industries centered in the Research Triangle Park area, as well as the financial sector centered in Charlotte, the state's largest city. While these areas have been thriving, the effect of some probusiness policies requires careful evaluation.

One of the state's key means for encouraging development is tax reform. North Carolina's current personal income tax system consists of a flat rate of 5.8 percent. In 2011, the total state and local average tax burden of 9.85 percent ranked North Carolina 17th highest out of 50 states, placing it above the national average of 9.8 percent. North Carolina's taxpayers paid $3,564 per capita in state and local taxes.[9] Due to tax reform passed in 2013, North Carolina climbed from a rank of 44th in 2013 in the Tax Foundation State Business Tax Climate Index to a rank of 16th in 2014.[10] North Carolina was also tied for 13th among the states on the 2014 *Economic Freedom of North America* report.[11] The Economic Freedom index is derived from each state's score in key areas, such as size of government, taxation, and regulation. The state is unusual in that

9. Tax Foundation, "North Carolina."
10. For the most up-to-date state rankings, see Scott Drenkard and Joseph Henchman, "2015 State Business Tax Climate Index," Tax Foundation, October 28, 2014.
11. Dean Stansel, José Torra, and Fred McMahon, *Economic Freedom of North America* (N.p.: Fraser Institute, 2014).

it has relatively low property tax rates: North Carolina's state and local governments collected approximately $900 per person in property taxes in 2013, which ranks the state 12th lowest nationally.[12]

North Carolina ranks 25th in the *Freedom in the 50 States* fiscal policy ranking published by the Mercatus Center at George Mason University.[13] While North Carolina's government consumption plus subsidies and employment scores in the Mercatus index are slightly worse (higher) than average, its debt is significantly better (lower) than average. Overall regulatory burden is considered lower than the national average, with particularly favorable labor laws, such as the right-to-work and no state minimum wage. However, insurance regulation is considered more burdensome than the national average. All these areas will be covered in more detail in later sections of this paper.

1. POLITICAL ECONOMY ISSUES IN THE BACKGROUND

Because of the incentives facing them, elected officials and bureaucrats focus on short-term goals; debt and unsustainable federal transfer growth are unlikely to become problems for politicians who currently hold office. Therefore we should not necessarily expect public officials to manage finances as householders do. Political scientists have documented a mismatch between the time horizons of public officials and private citizens.[14] This essential conflict is explored in detail in Geoffrey Brennan and James Buchanan's *The Reason of Rules*, where the authors urge a constitutional revolution.[15] We must analyze the *institutional* framework that determines the incentives of policymakers in order to understand why policies are selected in the first place. This is especially important if we hope to give effective suggestions for reform,

12. Tax Foundation, "North Carolina."

13. William P. Ruger and Jason Sorens, *Freedom in the 50 States: An Index of Personal and Economic Freedom*, 2013 ed. (Arlington, VA: Mercatus Center at George Mason University, 2013), http://freedominthe50states.org/.

14. For a survey of the literature, see James C. Clingermayer and Richard C. Feiock, *Institutional Constraints and Policy Choice: An Exploration of Local Governance* (Albany: State University of New York Press, 2001). For a detailed analysis of debt finance decision-making in American cities, see James C. Clingermayer et al., "Turnover, Transactions Costs, and Time Horizons," *American Review of Public Administration* 38, no. 2 (June 2008): 167–79.

15. "Constitutional commitments or constraints become means by which members of a polity can incorporate long-term considerations into current-period decisions. In the absence of such constraints, individuals will be led, almost necessarily, to adopt a short-term perspective in politics." Geoffrey Brennan and James M. Buchanan, *The Reason of Rules: Constitutional Political Economy* (Indianapolis: Library of Economics and Liberty, 1985), http://www.econlib.org/library/Buchanan/buchCv10c5.html.

as this institutional framework also explains why policies persist or change over time.

An overreliance on debt financing is the most important fiscal issue faced by governments today. Our analysis is based substantially on the insights of James Buchanan and Richard Wagner,[16] who explain how debt financing erodes the voting public's desire for fiscal restraint. Buchanan and Wagner describe an "old-time fiscal religion" when lawmakers reined in spending throughout the United States, construing it as a thing of the past: since World War II, responsible budgeting has been abandoned. Politicians have an incentive to run deficits both during recessions (as suggested by Keynesians) *and* in good times, since they can get the benefits from current spending while pushing future costs on to later generations.

"An overreliance on debt financing is the most important fiscal issue faced by governments today."

Long before Buchanan and Wagner, Adam Smith called creative accounting based on the debasement of currency a "juggling trick" that allows the government to mask the true cost of public spending.[17] John Stuart Mill warned about the dangers of indirect taxes such as public borrowing.[18] Public debt is insidious because it transfers responsibility for the debt to the future, causing current voters to care less about the costs of such debt.[19]

Like many other states, North Carolina has maintained an increase in total spending without a proportional

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16. James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (Waltham, MA: Academic Press, 1977).
17. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. R. H. Campbell, A. S. Skinner, and W. B. Todd (Oxford: Clarendon Press, 1979 [1776]), 2:930.
18. John Stuart Mill, *Principles of Political Economy with Some of Their Applications to Social Philosophy*, ed. W. J. Ashley, 7th ed. (London: Longmans, Green, and Co., 1909 [1848]), book V, ch. 2.
19. This phenomenon is known as "fiscal illusion," so named by Italian economist Amilcare Puviani in his book *Teoria della Illusions Finanziaria*, reprint (Milan: Isedi, 1973 [1903]). For an empirical analysis of the effects of fiscal illusion over a period from 1966 to 2006, see Paulo Reis Mourão, "Towards a Puviani's Fiscal Illusion Index," *Hacienda Pública Española*, IEF 187, no. 4 (December 2008): 49–86. For a survey of the effects of fiscal illusion in Sweden, see Tino Sanandaji and Björn Wallace, "Fiscal Illusion and Fiscal Obfuscation: Tax Perception in Sweden," *Independent Review* 16, no. 2 (Fall 2011): 237–46.

increase in taxes, thus creating a fiscal illusion. Fortunately, the government of North Carolina has taken more steps than many other states to enforce fiscal responsibility. Section 2 of this paper explains North Carolina's fiscal and economic situation in detail. Section 3 explores the debt financing and fiscal illusion policy more deeply. We believe these are the issues most threatening to North Carolina's economic future. In section 4 we closely consider regulatory challenges faced by the state and fiscal issues related to public services policy in areas such as health care and education. Section 5 evaluates several possibilities for reform not covered in earlier sections, based both on the experiences of other state governments and on political and economic theory. Concluding remarks follow.

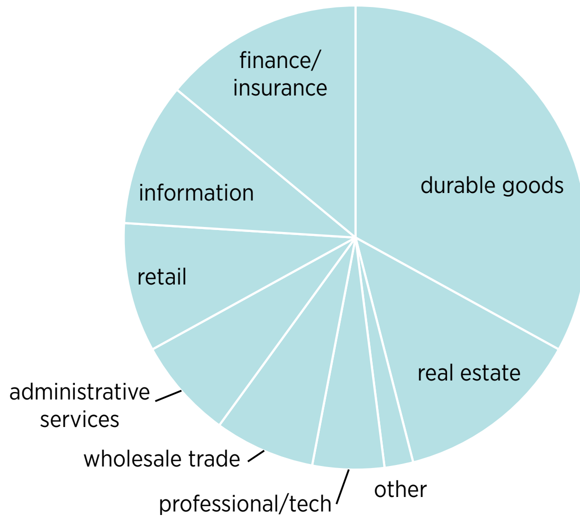
2. STATE FISCAL AND ECONOMIC SITUATION

Like the nation, over the past 40 years North Carolina has experienced an increase in both worker productivity and per capita income. Large cities, such as Charlotte and Raleigh, have experienced rapid population and economic growth, whereas agricultural and manufacturing production have been in decline. In the past, North Carolina's economy was dependent on agricultural goods (including tobacco) and textile and furniture manufacturing. But the economy has become more diverse over the past few decades, with growth in the areas of banking, financial services, tourism, software, and biotechnology. It is worth noting that the production of durable goods and real estate have also been important contributors to growth since the end of the Great Recession (figure 2). On the other hand, the manufacture of nondurable goods has experienced negative growth. One of the key areas of growth has been the government sector, including the state government, which is discussed further in section 3.

North Carolina has experienced strong long-run economic growth, with real state GDP growing at an average annual rate of just over 3 percent since 1970. To get a sense of the power of economic growth, that 3 percent annual growth translates into a 375 percent cumulative increase in GDP, from $117 billion (inflation adjusted to 2009 dollars) in 1970 to $440 billion in 2013, using Census Bureau data.[20] Even when accounting for the financial crisis of 2008, which hit the Charlotte area particularly hard, North Carolina's growth since 1970 has been above average compared to US growth (2.78 percent) over the same period.

20. Authors' calculations using data from the US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

FIGURE 2. PRIVATE INDUSTRY SHARES OF REAL GDP GROWTH IN NORTH CAROLINA, 2011–2012



Note: "Other" private industry growth is a net figure.

Source: "Economic Snapshots: Gross Domestic Product by State," North Carolina Chamber of Commerce, 2014 (2012 data), https://www.nccommerce.com/Portals/47/Documents/Economic%20Snapshots/State%20GDP%20May%2014.pdf.

Under Governor Pat McCrory's administration (2013–present), North Carolina has undergone significant tax reform. Nearly every tax rate was cut, effective 2013. The individual income tax brackets of 6 percent, 7 percent, and 7.75 percent were eliminated and replaced with a single tax rate of 5.8 percent. This rate will be further reduced to 5.75 percent in 2015. The corporate income tax rate was cut in 2014 from 6.9 percent to 6 percent, and it will be further cut in 2015 to 5 percent. The state estate tax was repealed, retroactively effective January 1, 2013. The state sales tax has not increased, but the tax reform reduced the number of exempt purchases in order to broaden the sales tax base.

Despite these tax rate reductions, current estimates of 2014 tax revenue show a net increase, from $22.7 billion in 2012 to an estimated $23.4 billion in 2014.[21] This recent change in tax policy, combined with recent efforts to reduce spending growth, earned the McCrory administration a grade of A in the Cato Institute's 2014 *Fiscal Policy Report Card on America's Governors*.[22] In the Tax Foundation's most recent (2014) rankings on state business

21. US Census Bureau, "State Government Tax Collections" (Historical Data), accessed December 14, 2015, http://www.census.gov/govs/statetax/.

22. Nicole Kaeding and Chris Edwards, *Fiscal Policy Report Card on America's Governors, 2014* (Washington, DC: Cato Institute, 2014).

tax climates, North Carolina's overall rank climbed from 44th to 16th in the nation.[23]

It is too early to tell what the long-run revenue effects of these tax cuts will be. If there is a reduction in revenue, it is imperative that these tax cuts be balanced by spending reductions. Thus far, North Carolina has been among the most successful states in maintaining an exemplary bond rating: only nine states, including North Carolina, maintained a AAA credit rating from the three major rating agencies.[24] This is due in part to the state's low net tax-supported debt per capita—$633 in 2013 according to North Carolina's Department of State Treasurer.[25]

3. SPENDING GROWTH

The state government has steadily increased its spending since the 1970s (figure 3). The spending increase over the period is significant, rising from $5.2 billion (inflation adjusted) in 1970 to $37.7 billion in 2013, an increase of more than 600 percent. All else being equal, some growth in spending is to be expected in a state that has experienced both population and economic growth over the same period. However, as figures 3–5 show, the increase in spending far exceeds the rate of population growth or even the overall economic growth. Figures 3–5 use the US Census Bureau's numbers for state spending rather than the combined state and local spending numbers. This is deliberate, because much local spending—particularly local spending that is financed by localities—is outside the purview of the governor and the state legislators. The purpose of this study is to examine the state's overall fiscal health *at the state level*. The reported figures already include a great deal of local spending in the form of state spending on K–12 education, higher education, state road spending, and so forth. While such spending is local, it is distributed politically at the state government level.

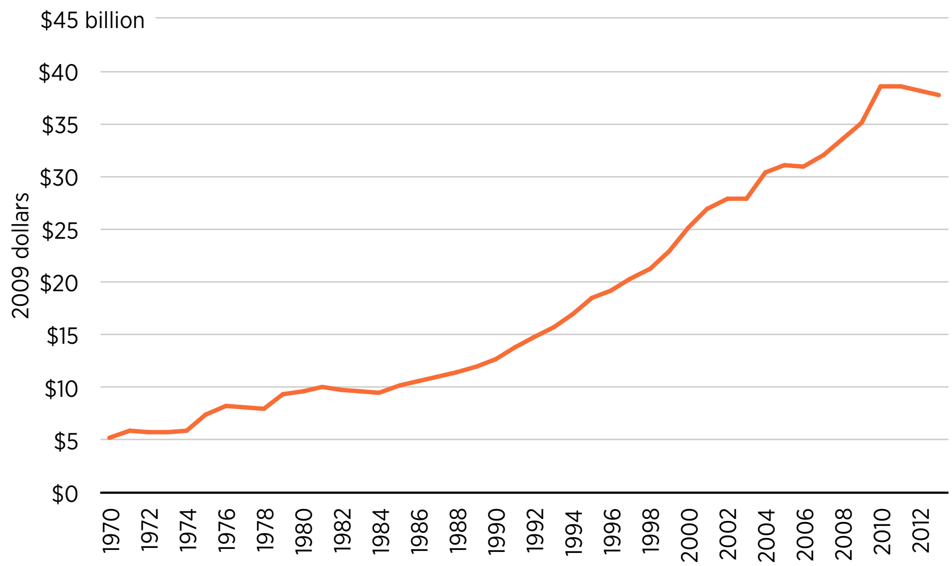
Adjusting for population, spending has still risen steadily over the past 40-plus years, nearly quadrupling from $1,024 (inflation adjusted) per person in 1970 to $3,831 in 2013 (figure 4). Further, state spending as a percentage of GDP has more than doubled from 1970, when state spending was approximately

23. Tax Foundation, "North Carolina," accessed December 14, 2015, http://taxfoundation.org/state-tax-climate/north-carolina.

24. The Census Bureau reports bond ratings for state and local governments in the *Statistical Abstract of the United States: 2012*, https://www.census.gov/library/publications/2011/compendia/statab/131ed.html.

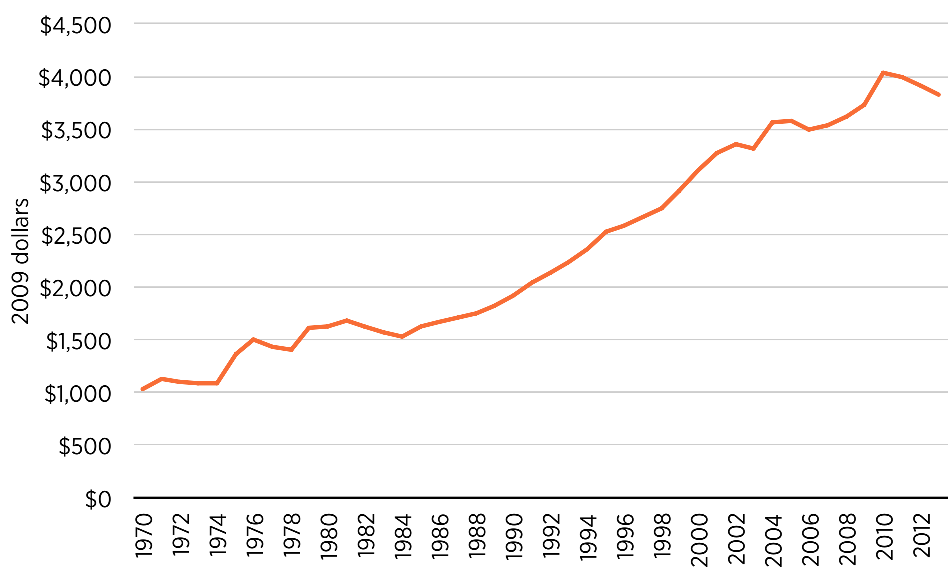
25. The department also estimates this figure will drop to $540 by 2015 due to population growth. (Note that these numbers are different from the gross debt numbers reported in figure 14.) Debt Affordability Advisory Committee, "State of North Carolina Debt Affordability Study" (Department of State Treasurer, Raleigh, NC, February 1, 2014).

FIGURE 3. NORTH CAROLINA TOTAL SPENDING, 1970–2013



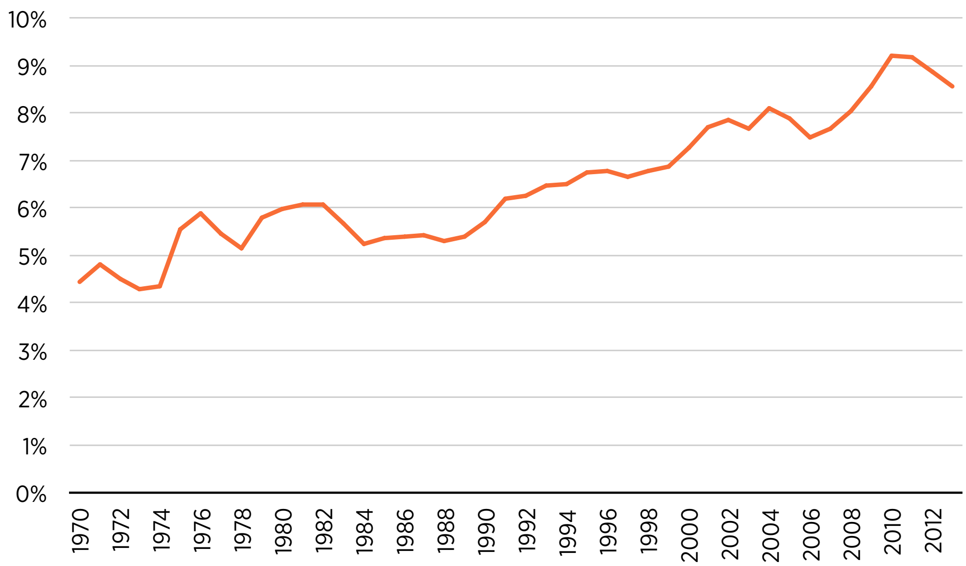
Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

FIGURE 4. NORTH CAROLINA TOTAL SPENDING PER CAPITA, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

FIGURE 5. NORTH CAROLINA SPENDING AS A PERCENTAGE OF STATE GDP, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

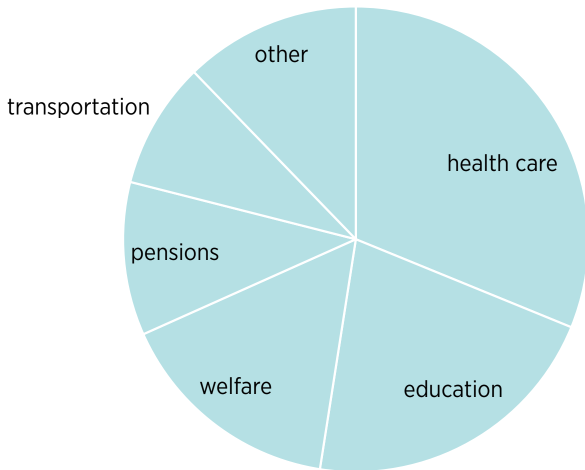
4.4 percent of GDP, to 8.6 percent in 2013, the most recent year of fully available spending data (figure 5). Like the United States generally, North Carolina has experienced strong long-run growth, but its state government spending has consistently outpaced its economic growth.

State Spending by Area

We break down the US Census Bureau state spending into five major areas: public pensions, health care, education, welfare, and transportation. The remainder is categorized as "other state spending." As real state spending in North Carolina has grown since 1970, so has real spending in every one of those categories. Health care and education expenditures together amount to more than half of all state spending, with health care taking up 31 percent of spending and education taking up 21 percent (figure 6).

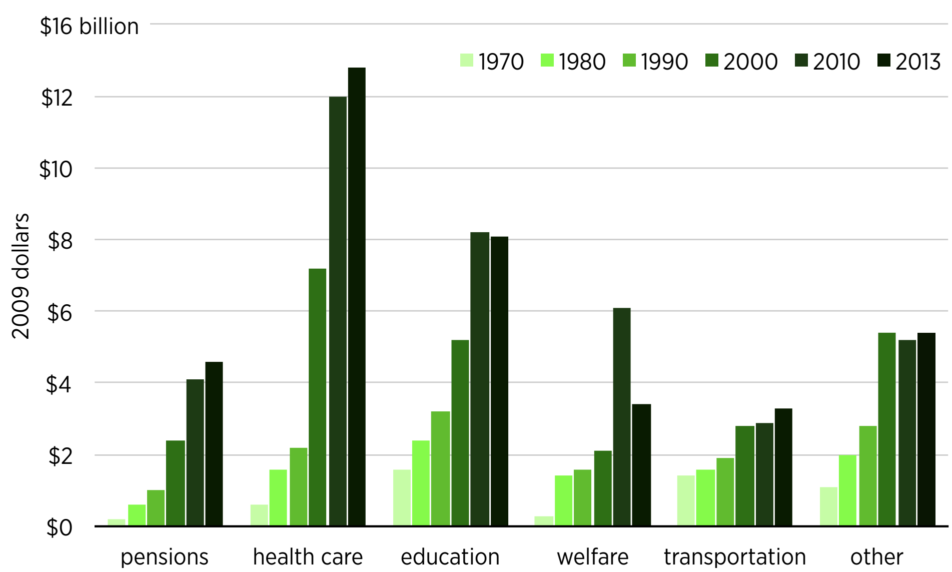
Spending in these areas has grown steadily in real terms—education spending in North Carolina has grown by more than 500 percent in real terms since 1970, while healthcare and pension spending have each grown by more than 2,000 percent (figure 7). Over the same period, real transportation spending has grown by a seemingly modest 200 percent. Welfare spending has grown in real terms since 1970, but the growth is overstated in figure 7

FIGURE 6. MAJOR AREAS OF NORTH CAROLINA SPENDING AS A SHARE OF TOTAL SPENDING, 2010



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

FIGURE 7. NORTH CAROLINA EXPENDITURE LEVEL CHANGES BY CATEGORY, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

because unemployment insurance claims had driven state welfare spending to an all-time high of $6.1 billion (adjusted for inflation) in 2010. For 2013, the last full year of available data, the figure had fallen below $4 billion, and tentative data for 2014 indicate that the number has fallen significantly since then, in part due to the McCrory administration's decision to limit unemployment benefits to 20 weeks in order to pay back unemployment insurance debt to the federal government.[26]

Spending has increased more rapidly in some areas than others. Considered as a portion of overall state spending, education and transportation expenditures have actually fallen since 1970 (figures 8 and 9). In 1990 education was still the highest area of state spending, but by 2000 it was surpassed by health care.

According to the Census Bureau, in 2012 North Carolina ranked very low (45th) in total education spending per student—at $8,200, above only Arizona, Idaho, Mississippi, Oklahoma, and Utah.[27] The state ranked somewhat higher (38th) in instructional spending per student. The Center on Budget Policy and Priorities reports that in inflation-adjusted terms, North Carolina has actually *decreased* spending per student by 14.5 percent since 2008.[28] While proponents of increased education spending use these rankings as evidence that North Carolina is falling behind in education, academic performance metrics tell a different story. For example, North Carolina's National Assessment of Educational Progress (NAEP) found that only fourteen states have higher average scores in reading than North Carolina and only five states have higher average scores in mathematics.[29]

One of the main reasons for North Carolina's low ranking in per-student spending is that teacher salaries are lower on average than in most other states. The National Center for Education Statistics reports that North Carolina's inflation-adjusted average teacher salary was $45,947 in 2012–2013, which is well below the national average of $56,383 and places it 47th among the states and the District of Columbia.[30] Setting aside the value judgment of how much

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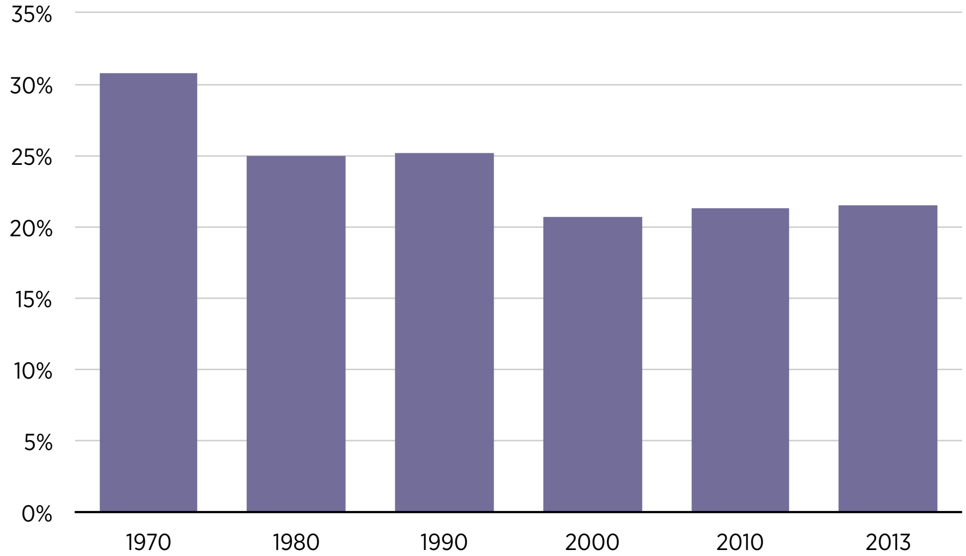
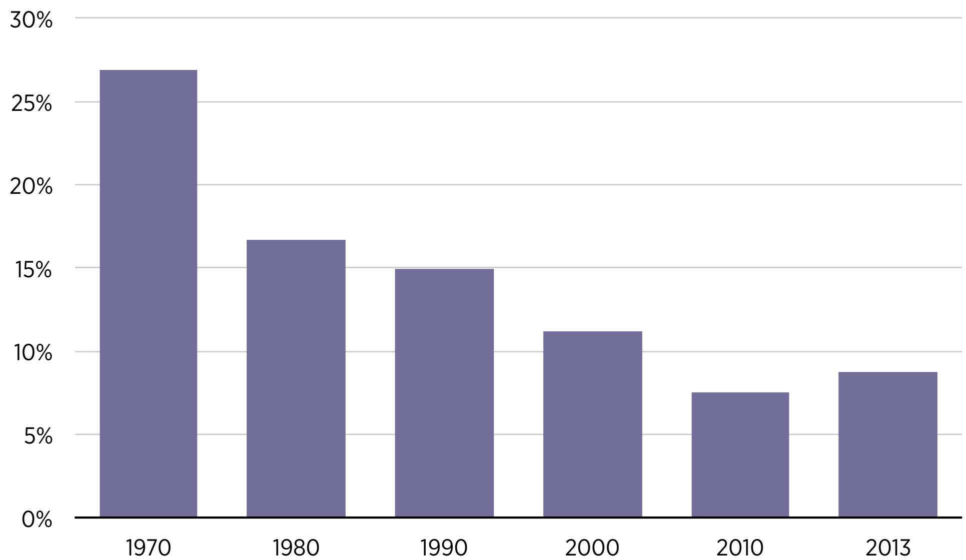
26. For more information on the McCrory administration's decision to repay this federal debt, see Governor Pat McCrory's office, "Unemployment Debt Drops by Near $2 Billion," press release, August 13, 2014, http://governor.nc.gov/press-release/unemployment-debt-drops-nearly-2-billion.
27. Mark Dixon, "Public Education Finances: 2012" (2012 Census of Governments, US Census Bureau, Washington, DC, May 2014).
28. Michael Leachman and Chris Mai, *Most States Still Funding Schools Less Than Before the Recession* (Washington, DC: Center on Budget and Policy Priorities, October 16, 2014).
29. See the NCES Report Card at National Center for Education Statistics, http://nces.ed.gov/nationsreportcard/.
30. National Center for Education Statistics, US Department of Education, *Digest of Education Statistics: 2012*, NCES2014-015, December 2013, http://nces.ed.gov/programs/digest/d12/index.asp.

FIGURE 8. NORTH CAROLINA EDUCATION SPENDING AS A SHARE OF TOTAL SPENDING, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

FIGURE 9. NORTH CAROLINA TRANSPORTATION SPENDING AS A SHARE OF TOTAL SPENDING, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

teachers should be paid, North Carolina's relatively low level of education spending among the states is one of a few factors that allow for lower state spending than otherwise.

Critics of the state's relatively low level of education spending[31] argue that the relatively low salaries will make North Carolina uncompetitive in the long run, as attracting quality teachers becomes more difficult. While this argument is intuitive, there is no solid evidence that higher levels of education spending are associated with higher levels of student performance. In a comprehensive analysis of state education spending and academic performance, Andrew Coulson found an overall correlation of 0.075.[32] Further, the four states (plus the District of Columbia) with the highest teacher salaries according the 2012 National Center for Education Statistics report—New York, Massachusetts, the District of Columbia, Connecticut, and California—had NAEP performance rankings of 19th, 1st, 22nd, 37th, and 27th, respectively. It is also worth noting that those five all have a relatively high cost of living, which complicates direct salary comparisons. Overall, some of the highest-salary states have high NAEP rankings—Massachusetts, New Jersey, and Pennsylvania rank high in both measures—while some relatively low-salary states also maintain relatively high NAEP rankings; for example, Indiana, Florida, Washington state, Vermont, Colorado, New Hampshire, and Hawaii all have teacher salaries that are below the national average, yet all rank in the top 10 states for NAEP performance. Overall, seven out of the top 10 states for NAEP performance have teacher salaries below the national average. Half of the top 10 for NAEP performance—Florida, Indiana, Colorado, Washington state, and California—are below the national average of $10,608 in spending per pupil.

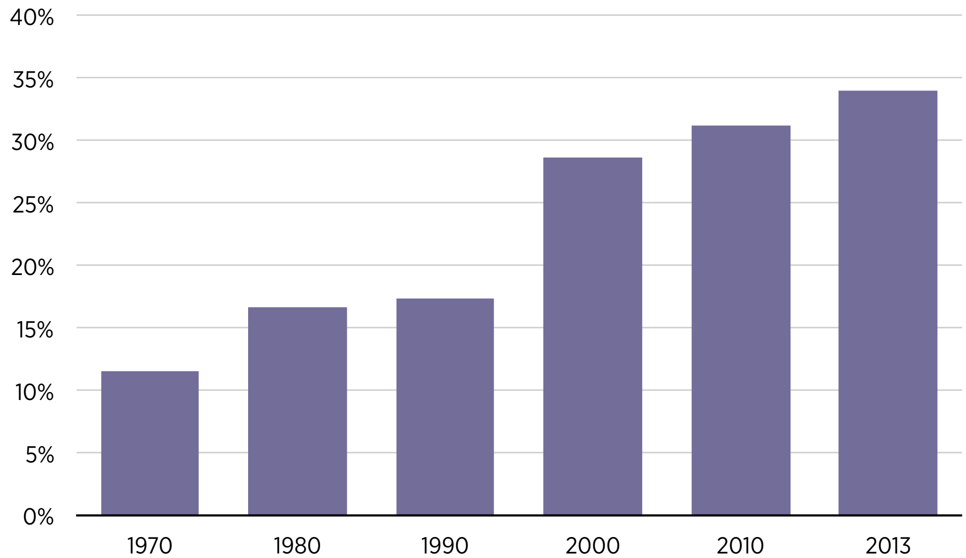
As with all forms of spending, the real question is whether education spending is efficient: Can it attain a high level of performance for a lower cost? North Carolina is better than average in this regard among the states, but both costs and performance can be improved.

While education remains a significant part of overall spending, transportation spending has diminished markedly in relative terms: from 27 percent of

31. North Carolina's low ranking in teacher pay is frequently criticized in the media. See, for example, "NC Must Pay for Quality Teachers," *News & Observer*, January 31, 2015, http://www.newsobserver.com/opinion/editorials/article10240409.html. Regional news agencies have reported extensively on North Carolina's relatively low per-pupil education spending. See, for example, "Report: North Carolina Schools among Lowest in Per-Pupil Spending," *WITN*, updated October 16, 2014, http://www.witn.com/home/headlines/Report--279510312.html.

32. Andrew J. Coulson, "State Education Trends: Academic Performance and Spending over the Past 40 Years" (Policy Analysis No. 746, Cato Institute, March 18, 2014), 4.

FIGURE 10. NORTH CAROLINA HEALTHCARE SPENDING AS A SHARE OF TOTAL SPENDING, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

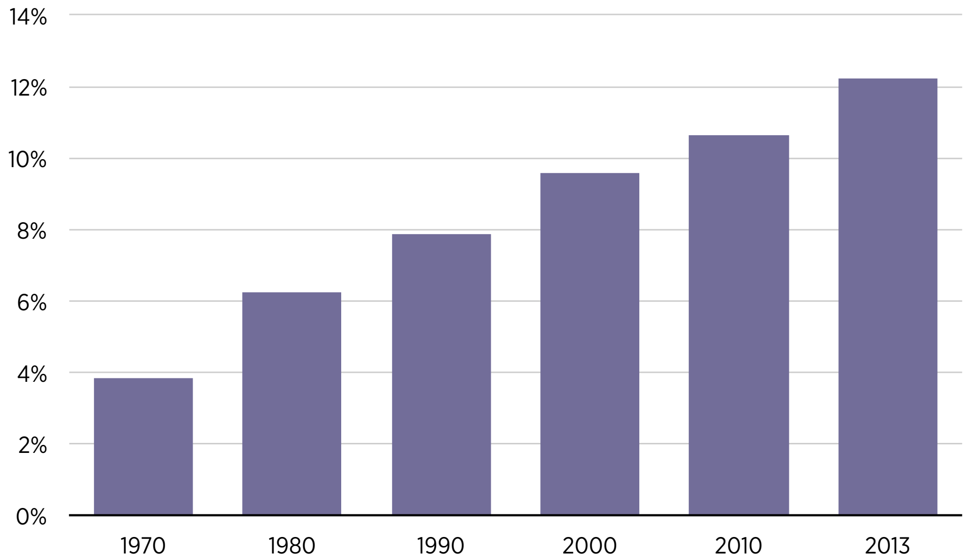
state spending in 1970 to 7.5 percent in 2013 (figure 9). This decrease in the percentage of total spending has been driven by increases in other spending areas rather than by cuts to real spending on transportation infrastructure.

Healthcare and pension spending have risen as a portion of overall state spending. We have already mentioned that healthcare spending now amounts to more than 31 percent of overall spending in North Carolina (figure 10). The increases in healthcare spending are largely driven by Medicaid spending, which grew at an annual rate of 14 percent in North Carolina according to the Kaiser Family Foundation.[33] The rate of growth (i.e., the increase in the increase) in Medicaid spending fell after that, but from 2010 to 2012 the growth in Medicaid spending was 6.1 percent, well above the national average of 3.3 percent.[34] The primary drivers of recent Medicaid spending growth are the expansion of eligibility and growing enrollments.[35]

The rising pension costs, which now account for more than 10 percent of state spending (figure 11), have a similar cause to health care. North Carolina's public pension systems, including the Teachers' and State Employees'

33. Kaiser Family Foundation, "Average Annual Growth in Medicaid Spending."
34. Ibid.
35. John Holahan and Alshadye Yemane, "Enrollment is Driving Medicaid Costs—But Two Targets Can Yield Savings," *Health Affairs* 28, no. 5 (2009): 1453–65.

FIGURE 11. NORTH CAROLINA PENSIONS SPENDING AS A SHARE OF TOTAL SPENDING, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

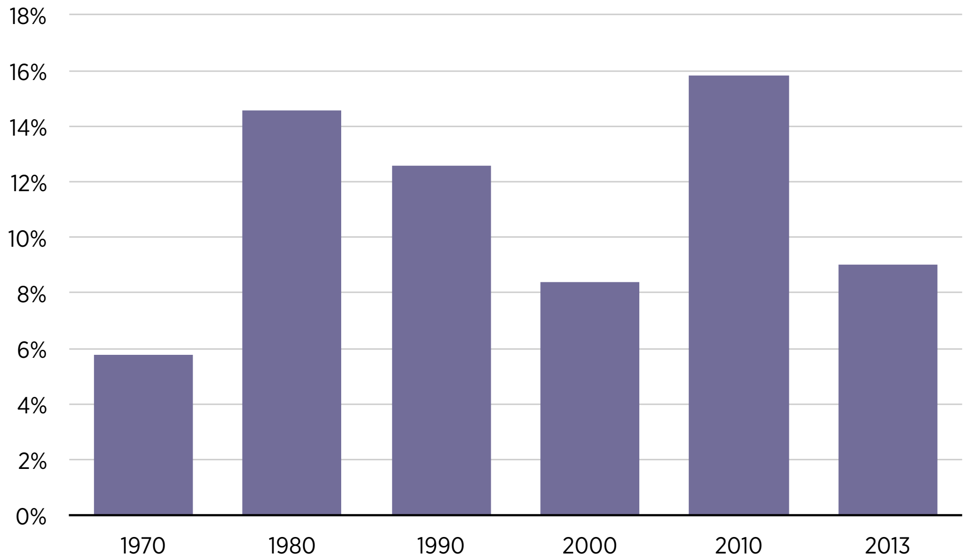
Retirement System (TSERS), are seeing a decline in participants paying into the program and an increase in payees (retirees and survivors) collecting benefits (see the section titled "Debt Growth" below).

Welfare spending appears to have grown sharply from 2000 to 2010, but the trend observed in both figure 7 and figure 12 is misleading. The trend is largely driven by the expense of unemployment benefit payments during the Great Recession; from 2010 to 2012 inflation-adjusted welfare spending fell from $6.1 billion (2009 dollars) to $4 billion, and as noted above, the tentative estimates for 2013 and 2014 spending show a continued decrease.

How were these spending increases possible? It is generally true that for state spending to increase, revenue from some source (or sources) must increase accordingly. Furthermore, North Carolina has a balanced budget amendment intended to limit spending without increases in revenue. Figure 13 shows how income tax revenue has increased in real terms over the past 40 years, but not rapidly enough to cover the increased spending seen in figures 3–5.

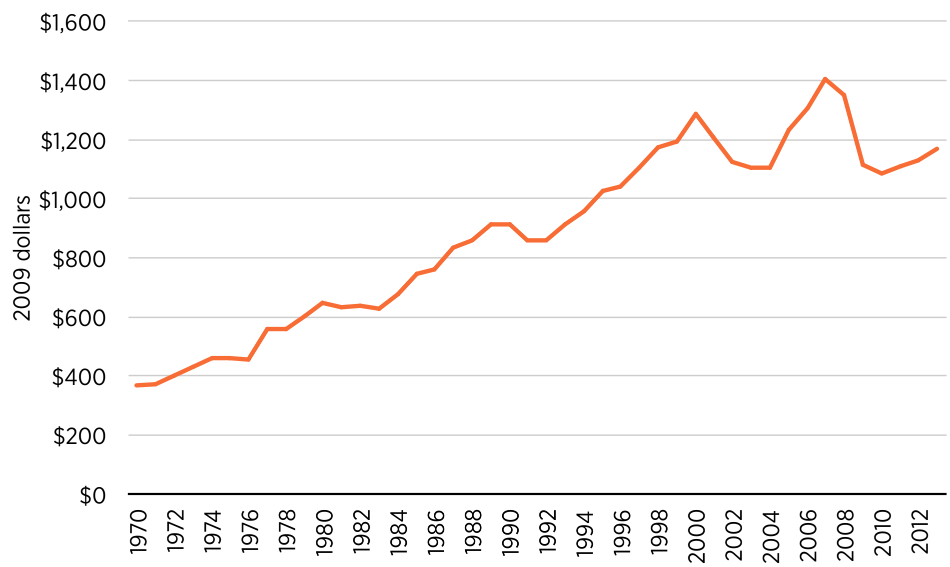
Income tax revenue per person also increased steadily. In other words, the tax revenue growth has not only come from population growth—a significant portion has come from increasing the tax burden on individual earners. Most other revenue sources have increased similarly at a steady pace, but not

FIGURE 12. NORTH CAROLINA WELFARE SPENDING AS A SHARE OF TOTAL SPENDING, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

FIGURE 13. NORTH CAROLINA REAL INCOME TAX REVENUE PER CAPITA, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

at a sufficient pace to cover spending growth. In sum, increased spending was made possible by a combination of increased tax revenue and increases in state-issued debt.

Balanced Budget Amendments

North Carolina's lawmakers have made at least token efforts to signal fiscal responsibility. All the states except Vermont have a balanced budget amendment in their constitutions. North Carolina's was adopted in 1977. It requires that the state conduct its fiscal affairs on a cash basis, at least on the revenue side of the ledger, and it prohibits the state government from spending more money than is added to the state treasury in any given fiscal period. The amendment gave constitutional sanction to what had been statute law since the enactment of the Executive Budget Act in 1925.

Both the state constitution and section 143C of the General Statutes of North Carolina (part of the Executive Budget Act) require the governor to "continually survey the collection of the revenue" and "effect the necessary economies in state expenditures" in order to keep the budget balanced.[36] The governor recommends a budget, which is enacted by the General Assembly. The intent of the balanced budget requirement is to direct the governor and state lawmakers to curtail expenditures if revenues fail to materialize in the anticipated amounts.

Soft vs. Hard Constraints

While self-imposed limits like balanced budget amendments with soft constraints—that is, constraints that can be overcome with federal aid—have not been successful in imposing fiscal responsibility, several other constraints have worked in North Carolina and elsewhere.[37] The best-known example of this is probably Colorado's Taxpayer Bill of Rights (TABOR), which has tied spending increases to the Consumer Price Index and population growth, and requires voter approval to temporarily override TABOR limits.[38] More generally, main-

36. Statutes of the North Carolina General Assembly § 143C (2006), available at http://www.ncleg.net/Sessions/2005/Bills/House/PDF/H914v5.pdf. North Carolina's state constitution designates the governor director of the budget.
37. For more on soft budget constraints, see Yingi Qian and Gérard Roland, "Federalism and the Soft Budget Constraint," *American Economic Review* 88, no. 5 (1998): 1143–62.
38. A brief description of Colorado's Taxpayer Bill of Rights is available from the Colorado Department of the Treasury, http://www.colorado.gov/cs/Satellite/Treasury_v2/CBON/1251592160342.

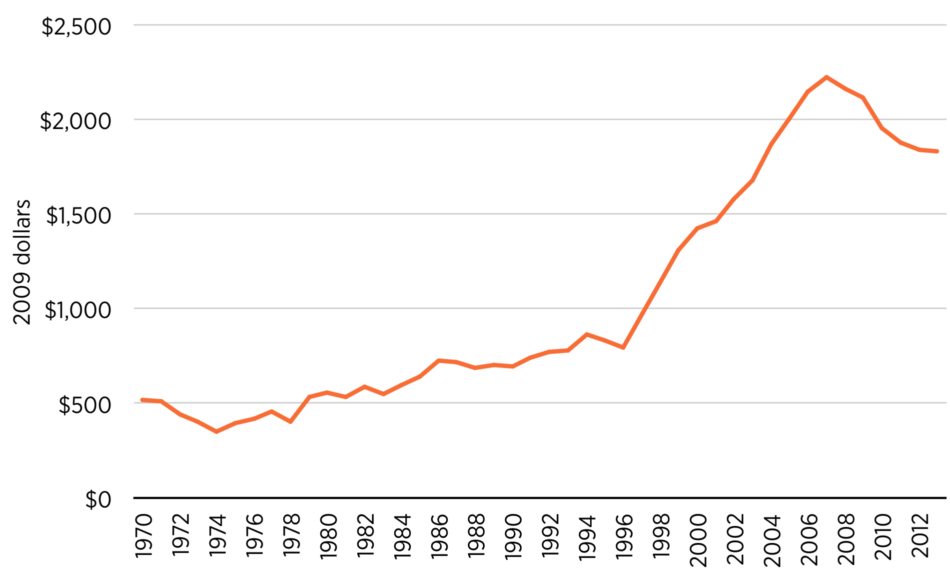
taining a AAA bond rating leads to fiscal restraint for a wide range of government entities. A government's ability to borrow is restricted by the willingness of third parties to lend money, at least in the absence of a fiat currency with expansionary monetary policy.

Balanced budget amendments can be effective only in so far as they provide hard constraints on government spending. This restriction would be in line with the classical principle of public finance: Government expenditures should be matched by their receipts in the long run. If these constitutional amendments do not provide hard constraints, they may only serve to encourage states to hide their liabilities in order to be seen as acting in accordance with the law. This can give the public a false sense of security and perpetuate the fiscal illusion discussed above.

Debt Growth

Between 1970 and 2005, North Carolina's state debt per person quadrupled, from just over $500 per person to over $2,000 in 2009 dollars (figure 14). However, the sharpest increase in debt growth was over the 10-year period from 1995 to 2005, and it is noteworthy that the debt burden on individuals has decreased

FIGURE 14. NORTH CAROLINA REAL DEBT PER CAPITA, 1970–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

somewhat from its peak in 2006. However, debt per person is overall much higher than it was a generation ago, and the trend toward increased debt requires further explanation.

Beginning in the 1990s, the main change in state debt per capita, as observed in figure 14, is the result of an increased reliance on debt-financed capital projects, such as transportation repairs and renovations and a massive investment in university development. Debt-financed projects affect the budget in an important way: in the short run, less of the state's General Fund is taken up with servicing such debt. However, the long-run tendency for the state has clearly been to accumulate debt at a rapid pace. While debt is not harmful in itself, fiscal responsibility means that a plan must exist to balance income and expenditure in the long run; furthermore, a reliable system must be in place to evaluate the supposed returns on spending. In most cases, it is impossible to evaluate any returns versus the opportunity cost because the evaluator lacks knowledge of what the private sector would have done had those tax dollars been left in their hands.[39]

North Carolina's true picture of public debt is more complex, primarily because of two factors. First, the official debt understates the burden of the state employee pension plan. Second, the federal government gives considerable aid to the states, including North Carolina, and much of the federal budget is itself debt financed.

North Carolina has seven different state employee pension plans, as well as a disability plan and a death benefit plan. However, the majority of state employees fall under the Teachers' and State Employees' Retirement System. As of the end of 2013, TSERS had just over 310,000 active participants and over 187,000 retirees and survivors receiving benefits.[40]

"Between 1970 and 2005, North Carolina's state debt per person quadrupled, from just over $500 per person to over $2,000 in 2009 dollars."

39. This problem has long been studied and championed by political economists, dating back at least to Frédéric Bastiat's 1848 essay, "What Is Seen and What Is Not Seen," http://www.econlib.org/library/Bastiat/basEss1.html.
40. See *Teachers' and State Employees' Retirement System of North Carolina: Report on 71st Annual Valuation*, prepared by Buck Consultants for the North Carolina Department of State Treasurer, October 2014, https://www.nctreasurer.com/ret/Board%20of%20Trustees/TSERS ActuarialValuation_December31_2013.PDF.

There are another 125,000 eligible individuals who are not yet receiving benefits. One notable trend, consistent with current US demographic trends, is that the number of those paying into the system is decreasing while the number of retirees is increasing. This is not a concern for a fully funded system, but if the system ever becomes a pay-as-you-go system, that is, where current workers' payments are used to pay retiree benefits, then the demographic trend can create a major strain on the state budget.

The question then becomes whether TSERS is fully funded. As of the end of 2013, the treasurer's report gives an actuarial accrued liability of $65.8 billion and an actuarial value of assets of $62.4 billion, which comes out to a 94.8 percent funded ratio. However, the actuarial liability is calculated based on a discount rate of 7.25 percent. The reasoning behind that discount rate is that it is based on average market returns to the pension fund. In fact, the treasurer's report claims that the assumed discount rate of 7.25 percent is conservative; after all, the TSERS fund earned more than a 12 percent return. However the earnings are not actually relevant; the appropriate discount rate, according to market valuation economists, is not the expected return on a fund, but rather the fund's risk.[41] The reasoning is simple: the return is uncertain whereas the obligations are definite. Failure to pay or even reduce promised benefits to state employees is politically unviable. Defined benefits like the TSERS and other state-funded pensions in North Carolina are essentially guaranteed. Therefore the appropriate comparison is a fund that pays its returns with near certainty. As financial researchers Ronald J. Ryan and Frank J. Fabozzi suggest, the closest risk equivalents are treasury securities.[42] As of the end of 2013, the same date used for the most recent North Carolina Treasurer's Report on TSERS, the notional 15-year treasury bond rate was 3.84 percent. Using a lower discount rate obviously means that the present value of pension liabilities will be higher, growing from the North Carolina Treasurer's claimed $65.8 billion to $96.9 billion when assuming a 3.84 percent discount rate instead of the state's 7.25 percent. Therefore the funded ratio is 64.4 percent instead of 94.8 percent, when using a risk-appropriate discount rate. The true shortfall is $34.5 billion rather than $3.4 billion—a tenfold increase in the unfunded liability.

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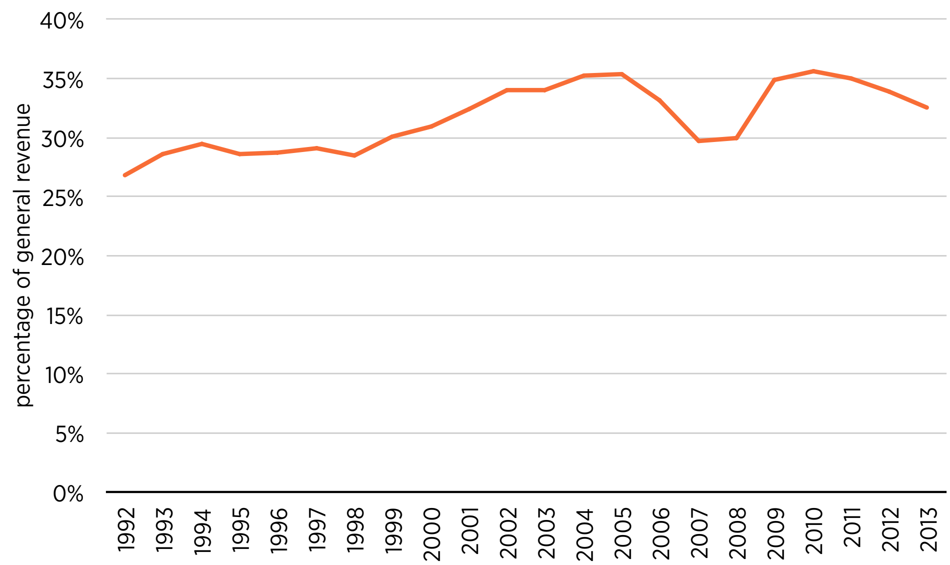
41. Andrew G. Biggs, "Proposed GASB Rules Show Why Only Market Valuation Fully Captures Public Pension Liabilities," *Financial Analysts Journal* 67, no. 2 (2011): 18–22; Ronald J. Ryan and Frank J. Fabozzi, "Rethinking Pension Liabilities and Asset Allocation," *Journal of Portfolio Management* 28, no. 4 (Summer 2002): 7–15.
42. Ryan and Fabozzi, "Rethinking Pension Liabilities and Asset Allocation," 10.

FIGURE 15. FEDERAL AID TO NORTH CAROLINA, 1992–2013



Source: US Census Bureau, "State Government Finances" (Historical Data), accessed December 14, 2015, https://www.census.gov//govs/state/.

Since 1992 federal aid has risen as a share of North Carolina's general revenue from just under 27 percent to almost 33 percent in 2013 (figure 15). According the National Association of State Budget Officers, North Carolina ranks 26th among the states in the portion of overall state spending that is covered by federal aid. This federal aid is yet another part of the answer to the question of how state spending has grown so quickly relative to both economic and population growth. North Carolina's true debt burden is higher than the reported figures from the Census Bureau to the extent that federal aid to North Carolina is itself debt financed.

Overall, North Carolina has seen large increases in state spending, made possible by a combination of factors: (1) higher tax revenues (and a greater tax burden on individuals); (2) increased use of state debt to finance spending projects; and (3) increased federal aid as a portion of general revenue. The next section explores the political economy of increased spending.

The End of Federalism?

Unfortunately, increased reliance on federal funds weakens any restraint stemming from North Carolina's position in a federalist system. Clearly the easiest way to mask spending is to transfer the fiscal responsibility to a higher level of government where local rules do not apply. This decrease in local spending authority is a pattern that can be observed throughout the United States, and it may be the most dangerous trend in American public finance with no clear solution. This is true especially at the local level, where states are increasingly relinquishing control of their finances.

Following Richard Wagner,[43] analysis should distinguish between federalism where the levels of government are actually separate and those situations where there is a cartel between the levels of government. We should only expect the federalist system to lead to better outcomes when governments must compete for the support of citizens.[44] A body of research suggests some effect of federalism constraining government spending.[45] If instead local and national governments simply collude, federalism becomes a way for politicians to actually exacerbate the problem of fiscal illusion. Wagner suggests that the 16th and 17th amendments to the US Constitution[46] were critical in cartelization of the federal government system. Particular consideration should be placed on the ability of the federal government *and* state governments to levy income taxes on citizens.

It is certainly true that the cost of moving from one US state to another is typically much lower than the cost of moving from one nation to another—for example, there are no state-to-state immigration restrictions or quotas. So might this discipline a state like North Carolina? This line of reasoning,[47] however, assumes that the government of North Carolina has some compelling interest in keeping its population levels up over long periods of time. Bryan Caplan argues that such an incentive has never existed, that by using the property tax to raise local revenue, local governments can eliminate the revenue

43. Richard E. Wagner, *American Federalism: How Well Does It Support Liberty?* (Arlington, VA: Mercatus Center at George Mason University, 2014).
44. This manner of intergovernmental competition should be considered an extension of the classic model in Charles M. Tiebout, “A Pure Theory of Local Expenditures,” *Journal of Political Economy* 64 (1956): 416–24.
45. See George R. Crowley and Russell S. Sobel, “Does Fiscal Decentralization Constrain Leviathan? New Evidence from Local Property Tax Competition,” *Public Choice* 149, no. 1 (October 2011): 5–30; Jason Sorens, “Fiscal Federalism, Jurisdictional Competition, and the Size of Government,” *Constitutional Political Economy* 25, no. 4 (2014): 354–75; Dean Stansel, “Interjurisdictional Competition and Local Government Spending in U.S. Metropolitan Areas,” *Public Finance Review* 34, no. 2 (March 2006): 173–94; Ryan Yeung, “The Effects of Fiscal Decentralization on the Size of Government: A Meta-Analysis,” *Public Budgeting and Finance* 29, no. 4 (Winter 2009): 1–23.
46. Amendments allowing Congress to directly levy an income tax and the direct election of US senators, respectively.
47. This is what Mancur Olson might have called the “stationary bandit” model of local public finance. See Olson, “Dictatorship, Democracy, and Development,” *American Political Science Review* 87, no. 3 (1993): 567–76.

pressure for keeping population high.[48] Notably, taxes on real property in North Carolina are levied only at the city and county level;[49] the state itself does not tax real property. In any case, since local governments are nonprofit institutions and policymakers have no residual claimancy if their state is fiscally successful, we should expect them to care little about a state's long-run economic health compared to whatever short-term political gains they can achieve by increasing debt and spending.

In order to understand the behavior of state policymakers, we need to be explicit about what their goals are. Necessarily, state policymakers want to stay in office (or they will not be policymakers for long); therefore their actions must conform to the short-run concerns of the electorate. For this reason, we should expect them to obfuscate spending where they can, especially if responsibility for taxing and spending can be shifted to another party, such as the federal government.

Citizens must insist on transparency in the fiscal affairs of their governments. To the extent that legislators can hide their true liabilities and inflate the value of their assets, they likely will. Relying on self-imposed constraints, even at the constitutional level, is not sufficient to rein in fiscal irresponsibility. North Carolina is still better than most states on spending transparency, though: the state government received a B+ rating from the US Public Interest Research Group in its rating of citizen access to government spending data.[50] Still, the burden falls on the voters to take advantage of this available information and insist on responsible spending. And despite the relative transparency of North Carolina's budget, there are still major areas of fiscal behavior that are completely opaque (although this is not a problem unique to the state).

The lack of fiscal transparency in North Carolina has multiple causes. As previously mentioned, the receipts from federal transfers are rarely reported and are viewed as federal spending, even when spent by the state government. State debt also presents a transparency problem, as increased debt allows for greater spending today while the full tax burden will not be realized for many years. The emphasis on spending from the General Fund gives the impression that most spending is on education, when the reality is that in total, education

48. Bryan Caplan, "Has Leviathan Been Bound? A Theory of Imperfectly Constrained Government with Evidence from the States," *Southern Economic Journal* 67, no. 4 (April 2001): 825–47.
49. Up-to-date local property tax rates are available at North Carolina Department of Revenue, Property Tax Rates and Revaluation Schedules for North Carolina Counties, http://marketing.thrivenc.com/acton/attachment/4901/f-0057/0/-/-/-/-/file.pdf.
50. US PIRG Education Fund, *Following the Money 2014: How the 50 States Rate in Providing Online Access to Government Spending Data*, April 2014,.

“While North Carolina’s assumed average annual rate of 7.25 percent is lower than the assumed rate of some other states, it is high enough to give a false impression of solvency.”

spending has actually been surpassed by healthcare spending, as noted in section 3.

Another transparency problem is related to the state’s future liabilities. In North Carolina, the Teachers’ and State Employees’ Retirement System has seen very low returns in recent years, which has created an unfunded liability of more than $3.7 trillion in 2012 (the most recent reported year) according to the state treasurer.[51] As great as that unfunded liability is, remember that the liability itself is calculated based on an assumed average annual rate of return of 7.25 percent. That rate, while not atypical among the US state pension systems, is very high when compared with comparably risked assets, such as US Treasury bonds. When a lower-risk rate of 4 percent is used (10-year Treasury bonds earn less than 3 percent), the unfunded liability grows significantly. The state employee retirement benefits must be paid, and the use of a relatively high-risk asset’s rate of return conceals billions of dollars’ worth of state obligations.[52] While North Carolina’s assumed average annual rate of 7.25 percent is lower than the assumed rate of some other states, it is high enough to give a false impression of solvency; a nearly certain liability is being weighed against a highly uncertain return.

4. OTHER CHALLENGES

In addition to spending growth, North Carolina—like many states—faces significant fiscal challenges related to targeted incentive programs and insurance regulation. Many state governments attempt to promote particular business areas by subsidizing them or giving them targeted tax breaks. However, such programs only encourage rent-seeking behavior. States also control most regulation of insurance. If these regulations are complex and burdensome, they can seriously affect a state’s competitiveness.

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51. Buck Consultants, *Teachers’ and State Employees’ Retirement System of North Carolina: Report on 71st Annual Valuation*, October 2013, available at https://www.nctreasurer.com/ret/Pages/Valuation-Reports.aspx.
52. See Biggs, “Proposed GASB Rules Show Why.”

At the end of 2013, North Carolina's legislature decided not to renew its targeted tax incentive program for the motion picture industry, which caused a number of large protests.[53] Proponents of the tax incentive program say that jobs will be lost. The film industry, however, accounts for only about 4,000 jobs in North Carolina.

Such programs are often very difficult to discontinue when they become an obvious burden. Because some people have much to lose by their discontinuation, they fight any changes so long as fighting costs less than losing the benefit. Gordon Tullock calls this problem the transitional gains trap.[54] To encourage growth and prevent wasteful competition for government favor, governments should apply tax breaks generally rather than using them to target specific industries.

North Carolina has also targeted incentive programs to encourage technological research and renewable energy use.[55] We recommend that these programs be discontinued and replaced with more general cuts to taxes and spending. Recent research by economists Christopher Coyne and Lotta Moberg suggests that these policies do more harm than good.[56] The authors say that "policymakers often overlook the unseen and unintended negative consequences of these targeted benefits, including increased lobbying and cronyism, costly misallocation of resources, and a system that is biased against smaller firms. A better policy would be a level playing field, which does not discriminate between businesses."[57]

Large and influential firms are able to lobby the state legislature for benefits, but this encourages rent seeking. Elimination of the targeted programs removes the incentive for rent seeking and lowers the cost of doing business in the state.

Heavy insurance regulations also have adverse consequences. In 2014 North Carolina received an "F" rating from the R-Street Institute,[58] which bases ratings on how free consumers are to purchase the insurance they want, how

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53. Peter Fricke, "Film Subsidies under Scrutiny in North Carolina," *Daily Caller*, October 13, 2014, http://dailycaller.com/2014/10/13/film-subsidies-under-scrutiny-in-north-carolina/.
54. Gordon Tullock, "The Transitional Gains Trap," *Bell Journal of Economics* 6, no. 2 (1975): 671–78.
55. Economic Development Partnership of North Carolina, Thrive in North Carolina website, accessed October 29, 2015, http://www.thrivenc.com/incentives/financial/tax-credits.
56. Christopher J. Coyne and Lotta Moberg, "The Political Economy of State-Provided Targeted Benefits" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, May 2014).
57. Ibid.
58. R. J. Lehman, "2014 Insurance Regulation Report Card" (R Street Policy Study No. 30, R Street Institute, December 2014), http://www.rstreet.org/wp-content/uploads/2014/12/RSTREET30.pdf.

free insurers are to provide the insurance consumers want, and how effective the state bureaucracy is at discharging its duties, such as monitoring fraud and insurer solvency. R-Street highlights residual auto insurance and rate controls as reasons for the poor grade. The auto insurance regulation, particularly the clean risk surcharge, makes it almost impossible for insurers to lose money, but it causes significantly higher rates for consumers. More than a fifth of North Carolina drivers cannot find an insurer that will give them any coverage at all.[59] Of all the US residual auto insurance subscribers, 81 percent live in the state of North Carolina.

We recommend that North Carolina remove all regulations on the sale of insurance except for the monitoring of solvency and prevention of insurance fraud. Existing regulations limit consumer choice and make it harder to do business in the state.

5. POLICY RECOMMENDATIONS

North Carolina has done some things right, given the improvement in its fiscal situation in recent years. However, there is much more that could be done to ensure a continued path to success. According to University of Rochester political science professor David Primo, North Carolina is already one of 17 states with a "strict" balanced-budget requirement that includes a no-carryover rule and an elected high court.[60] The no-carryover rule simply requires that a current-year deficit cannot be carried over beyond the next year. The presence of a strict balanced-budget requirement is part of the reason former Governor Bev Purdue's administration (2009–2013) found it necessary to initiate statewide spending cuts when tax revenues fell during the recession. North Carolina also has separate finance and appropriation committees, which prior research has shown to be a significant constraint on spending per capita.[61]

One proven spending-limiting policy that North Carolina lacks is a line-item veto.[62] However, we would argue that a line-item veto is a double-edged sword. It deals with the problem of limited and bundled goods—that is, it allows governors the discretion to reduce wasteful spending by approving only the

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59. R. J. Lehmann, "NC Auto Insurance System: Good for Insurers, Bad for Consumers," *Heartlander Magazine*, April 4, 2013, http://news.heartland.org/newspaper-article/2013/04/04/nc-auto-insurance-system-good-insurers-bad-consumers.
60. David M. Primo, *Rules and Restraint: Government Spending and the Design of Institutions* (Chicago, IL: University of Chicago Press, 2007), 89.
61. For example, see Matthew Mitchell and Nick Tuszynski, "Institutions and State Spending: An Overview," *Independent Review* 17, no. 1 (Summer 2012): 37.
62. Ibid.

parts of a bill that have popular support or are fiscally sound. But it can also give a governor the ability to sign off on spending increases while vetoing cuts included in the original bill. However, since prior research has shown that a line-item veto tends to reduce overall spending on net, it is a reform worth considering.

More transparency is needed to create political incentives that are consistent with economic prosperity. State reporting on revenues and spending is primarily focused on the General Fund, which excludes a large portion of both revenues and spending. For example, it excludes federal funds and highway funds. The state treasurer in particular could improve transparency by reducing the emphasis on receipts and spending to and from the General Fund and placing more emphasis on the state's total revenue and total spending from all sources.

On the tax side, North Carolina has already taken significant steps toward reform. As mentioned in section 2, both personal and corporate income tax rates have been and will continue to be reduced, with minimal impact on revenues. The tax base was broadened, and some exemptions were eliminated, which accomplishes two goals: First, lower rates make North Carolina more appealing relative to its neighbors, to the extent that the personal and corporate rates actually are lower than those in other states. Second, the simplification of the tax code increases overall tax transparency.

Privatization

Proponents justify spending in most areas by claiming that it is a legitimate public good to state constituents. Such spending continues to grow under this justification: A primary reason given for resistance to austerity or any spending cut is that key services for many citizens will simply cease to exist. However, the public good justification for most public sector spending areas is rather weak; it is hard to even identify one major area of state spending that would qualify as a legitimate public good. The key criterion for a true public good is *nonexcludability*.[63] But services like education, health care, and pension planning are not even superficially nonexcludable, that is, nonpayers certainly can be excluded from the benefits of those services. The state provides such services because they are believed to have spillover benefits for society. However,

63. Most definitions of a public good include a second criterion, *nonrivalry*, but the characteristic that actually makes a public good public rather than private is nonexcludability. For a discussion of this distinction, see Campbell R. McConnell, Stanley L. Brue, and Sean M. Flynn, *Microeconomics: Principles, Problems, and Policies*, 20th ed. (New York: McGraw-Hill Education, 2015), 91.

the claim of spillover benefits is, strictly speaking, at most an argument for subsidies rather than for public provision. A public good's nonexcludability means that private firms cannot collect a price for a good and therefore will tend not to produce that good. However, where spillover benefits exist, the standard microeconomic analysis is that private firms *will produce* the good in question, just not at the socially optimal level. Therefore, markets will tend to underproduce goods that have spillover benefits, such as vaccines and primary education. But underprovision is not a lack of provision. For example, there are private schools that would exist absent a public education system. Our strongest recommendation is for the state of North Carolina to embark on a wide-ranging campaign of increased reliance on privately provided services in high-cost areas of state spending, such as pension planning, education, and health care. Beyond an increased reliance on market-provided services, a marginal movement toward increased user fees for government services and peak-use pricing should increase the efficiency of state-run industries.

While North Carolina's medical expenditures are below the national median ($6,444 vs. $6,815 per capita),[64] the state has one of the highest shares of spending on inpatient hospital services (37.5 percent vs. the national average of 20.3 percent). Healthcare costs have become an incredibly important part of federal and state budgets, and North Carolina is no exception. Importantly, an aging population means that this trend is expected to continue for decades. Controlling rising healthcare costs will therefore be of importance to states that are not willing to drastically increase taxes.

An increased reliance on the private market for health care, with greater choice, accountability, and market solutions, would have several advantages for the state. These market solutions could even include more outright privatization of hospitals, but further research would be required to evaluate the best practices for moving from state ownership to private ownership. Conceptually, most hospital care has little or no public good justification; only a small fraction of hospital work is for preventing the spread of contagious diseases, which has clear spillover benefits.

The state pension system should be gradually shifted toward private management. Fortunately, this process has already begun among a subset of state employees—as of January 1, 2013, all full-time state employees in the University of North Carolina system are now eligible for the state's Optional Retirement Program (ORP), which is a defined-contribution plan managed by an employee's chosen provider, either Fidelity or TIAA-CREF. Both of those

64. Kaiser Family Foundation, "Average Annual Growth in Medical Spending."

providers offer many different investment options to suit the employee's retirement goals. We recommend that TSERS be phased out over time and that new state hires be shifted into the ORP, which not only has lower costs for the state agencies, but also allows state employees greater portability of their retirement savings.

North Carolina's education expenditure is lower than the national average. In 2012 state expenditure was $8,200 per student.[65] Still, private schools spend less money per pupil than public schools and achieve similar results. Moving toward greater reliance on private schools would both reduce some of the burden of education on state budgets (if vouchers or subsidies were means tested) and increase the scope of educational choice in North Carolina. Several states operate successful education voucher programs to subsidize privately operated education. The expansion of private education need not conflict with concerns about equal access to education for young people; the question is whether privately or publicly operated schools will deliver the best education outcomes for the lowest cost. Private schools consistently outperform public schools on this measure, especially in low-income, urban areas where public schools do very poorly.

North Carolina's expenditures on transportation could be drastically reduced by using private highway management, or even privatized highways funded by user fees (i.e. tolls). While this would be challenging for local and municipal governments managing surface streets, many states have had success in improving their transportation infrastructure and reducing congestion by privatizing portions of their state highway system.

Recently, metropolitan centers such as Atlanta, Georgia, have had success with peak-load pricing. With today's technology, it is relatively inexpensive to monitor traffic patterns and charge drivers for driving in certain lanes at peak hours. This type of pricing increases efficiency by making transportation available to those who value it most.

"With today's technology, it is relatively inexpensive to monitor traffic patterns and charge drivers for driving in certain lanes at peak hours."

65. Dixon, "Public Education Finances: 2012."

While some worry that only the rich will be able to afford to use these lanes, the money raised through peak-load pricing can be reinvested in expanding the transportation infrastructure to accommodate a growing population. Furthermore, if roads are too small and in disrepair, *no one* is able to drive in a timely manner, regardless of wealth.

A number of states have had success in privatizing liquor sales in recent years. North Carolina is now one of only 18 states with control or monopoly jurisdictions. While beer and wine can be sold in supermarkets and convenience stores, the state holds a monopoly on liquor sales and operates a number of alcoholic beverage control (ABC) stores. The North Carolina ABC Commission sets statewide prices for liquor.

Like other monopolies, the goal of the alcoholic beverage control legislation is to limit output and increase price. Furthermore, without the discipline of the market, government-run alcohol monopolies make poor financial decisions. Workers at North Carolina's ABC stores make more than the market wage and receive benefits and bonuses even when the stores fail to turn a profit. These inefficiencies have attracted the attention of local media.[66]

Even more than most government industries, there is no economic justification for state ownership of a liquor monopoly. These liquor monopolies have not reduced alcohol-related problems like underage drinking or car accidents.[67] A study on Pennsylvania's ABC system found that divestiture of the state-owned stores could generate a significant windfall for the state.[68] A 2008 report from the Program Evaluation Division of North Carolina's General Assembly suggests that many of North Carolina's ABC boards actually lose money and do not respond to market signals for determining pricing, labor needs, or even the number of stores needed to serve the population.[69]

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66. "State Examines ABC Boards' Salaries, Ethics Policies," *WRAL.com* (Raleigh, NC), December 16, 2009, http://www.wral.com/news/local/wral_investigates/story/6598131/.
67. Donald J. Boudreaux and Julia Williams, "Impaired Judgment: The Failure of Control States to Reduce Alcohol-Related Problems" (Report No. 14, Virginia Institute for Public Policy, July 2010); Michael LaFaive and Antony Davies, "Alcohol Control Reform and Public Health and Safety" (Policy Brief, Mackinac Center for Public Policy, May 14, 2012).
68. According to one estimate in 2007, Pennsylvania could generate a $1.7 billion windfall from ABC divestiture. See Geoffrey F. Segal and Geoffrey S. Underwood, Reason Foundation, "Divesting the Pennsylvania Liquor Control Board," testimony before the Senate Majority Policy Committee of the Pennsylvania General Assembly, April 18, 2007.
69. Program Evaluation Division of the North Carolina General Assembly, "North Carolina's Alcohol Beverage Control System Is Outdated and Needs Modernization" (Report No. 2008-12-01, December 10, 2008).

State Constitution Amendment Procedure

In 1971, the North Carolina state constitution amendment procedure was overhauled with the rest of the constitution. Since that year, there have been more than 20 amendments. Previously, the constitution could only be amended by a legislative initiative of the General Assembly; now, the state constitution can be amended by a vote or "convention of the people."

Leaving constitutional amendments up to general votes diminishes the value of the constitution as a way to enforce generality norms. The easier constitutions are to change, the less distinct they become from the general body of legislation. If a constitution is to have value in restricting the scope of legislation, it should be hard to change and such changes should require serious deliberation.

Voters in a general election suffer from two major problems: rational ignorance and rational irrationality. Voters are rationally *ignorant* in that they cannot possibly know the details of every piece of legislation. Therefore their votes on any individual piece of legislation will not be based on a thorough understanding of that legislative item or the legal ramifications of its passage. This would not be a problem if voters then voted randomly on issues: mistakes in one direction would be balanced by mistakes in the other direction. Unfortunately, voters have preferences in beliefs motivated by systematic biases, what public choice economist Bryan Caplan calls *rational irrationality*.[70] Instead of voting randomly on issues when they have no information about them, voters systematically vote in favor of policies that contradict the recommendations of informed observers.

Leaving important decisions to an uninformed group of voters has predictable results. If all it takes is a vote to amend the constitution, such amendments will be passed in the name of expediency. We recommend that the constitutional amendment procedure be changed to preserve the intent of constitutional, representative government.

Legislative Term Limits

Legislative term limits have been suggested as a way to reduce the agency problem—that is, the lack of direct accountability—for politicians. Those in favor of term limits argue that reducing politicians' tenures will reduce the growth of government spending and corruption.

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70. Bryan Caplan, *Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton, NJ: Princeton University Press, 2007).

However, empirical scholarship in this area reveals there is very little difference between the behavior of politicians in states where legislative term limits exist and where they do not.[71] The underlying causes of inefficiency seem unrelated to the tenure of particular politicians in office. In fact, since one problem of government spending is that incumbent politicians need not fear punishment for bad economic outcomes that are delayed beyond their tenure, reducing politicians' tenures in general seems counterproductive.

The governor of North Carolina is limited to two consecutive terms in office but can run again after leaving office for at least one term. Broader term limit legislation has been discussed, but failed to receive the minimum number of legislative votes in order to appear as a 2014 ballot initiative.

CONCLUSION

North Carolina has the nation's ninth largest economy and is undergoing a gradual transition from an agricultural economy to a service-based economy and regional leader in banking and finance. With spending growth increases over the past three decades, debt has increased sharply as well. The use of state debt to finance spending has risen most sharply since the beginning of the 1990s. The increased use of debt hides the overall increase in state government spending and allows for greater annual government spending without requisite tax increases. Federal aid to North Carolina has led to increased spending. Increased dependence on federal aid erodes North Carolina's control of its fiscal future. Recent tax reforms have both reduced rates on personal and corporate income taxes, eliminated exemptions, and they have broadened the tax base. To the extent the tax cuts have been accompanied by a reduction in spending, they have been a success. The overall long-run trends of spending and debt growth must be addressed with significant reforms which should focus on improving North Carolina's overall level of economic freedom, which has been shown to be a strong driver of sustainable growth.

71. Edward J. Lopez, "Term Limits: Causes and Consequences," *Public Choice* 114, no. 1–2 (January 2003): 1–56; H. Abbie Erler, "Legislative Term Limits and State Spending," *Public Choice* 133, no. 3 (December 2007): 479–94. Both Lopez and Erler (see previous note) provide a review of the literature on term limits. While some studies on gubernatorial term limits have shown a weak connection between term limits and lower spending, the literature on state legislative term limits is quite clear: states with legislative term limits see higher spending growth than those without.

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