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INTRODUCTION

State budgets throughout the United States have come under unprecedented pressure. In recent years, state coffers have gone from flush to dry, and the prevalence of balanced budget requirements in state constitutions and statutes\(^1\) has turned revenue

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\(^1\) See, e.g., ARIZ. CONST. art. IX, § 5 ("The State may contract debts to supply the casual deficits or failures in revenues . . . but the aggregate amount . . . shall never exceed the sum of three hundred and fifty thousand dollars . . . "); CAL. CONST. art. XVI, § 1 ("The Legislature shall not, in any manner create any debt or debts, liability or liabilities, which shall, singly or in the aggregate with any previous debts or liabilities, exceed the sum of three hundred thousand dollars . . . unless the same shall be authorized by law for some single object or work . . . "); COLO. CONST. art. X, § 16 ("No appropriation shall be made, nor any expenditure authorized by the general assembly, whereby the expenditure of the state, during any fiscal year, shall exceed the total tax then provided for by law and applicable for such appropriation or expenditure . . . "); CONN. CONST. art. III, § 18 ("The amount of general budget expenditures authorized for any fiscal year shall not exceed the estimated amount of revenue for such fiscal year."); DEL. CONST. art. VIII, § 3 ("No money shall be borrowed . . . but pursuant to an Act of the General Assembly, passed with the concurrence of three fourths of all the members elected to each [House]. . . "); IDAHO CONST. art. VIII, § 1 (stating that the "legislature shall not in any manner create any
shortfalls into a nationwide crisis.\textsuperscript{2} A combination of rising costs of and standards for education,\textsuperscript{3} political trends that have delegated many governmental functions to the state level,\textsuperscript{4} and judicial opinions echoing these political trends by reactivating states’ rights doctrines\textsuperscript{5} has given state governments expansive new responsibilities in public policy. These trends have collided with balanced budget requirements in the several states to produce what is essentially a systemic budget crisis.\textsuperscript{6}

North Carolina is a case in point. In article V, section 3, of the 1971 North Carolina state constitution, the State is prohibited from enacting unbalanced budgets that would require the State to borrow on its “faith and credit.”\textsuperscript{7} This balanced budget provision was also a part of the preceding state constitution of 1868.\textsuperscript{8} As such, the case law that has developed around the balanced budget requirement


\textsuperscript{3} See infra Part II.A.

\textsuperscript{4} See infra Part II.A.

\textsuperscript{5} See infra Part II.B.

\textsuperscript{6} See infra Part II (detailing the argument that the state budgeting problem has become systemic).

\textsuperscript{7} N.C. CONST. art. V, § 3(1).

\textsuperscript{8} The first two subsections of article V, section 3, are derived from article V, section 4, of the North Carolina Constitution of 1868. The fourth subsection is the progeny of article I, section 6, of the 1868 constitution.
extends continuously over a span of more than one hundred years, and the original justifications for the balanced budget are a species of nineteenth century policymaking.

The changes that have occurred in North Carolina's state government over the past century and a half are striking. Until 1868, North Carolina had no statewide public school system with compulsory attendance, the State received most of its tax revenues from the property tax, and social services were undertaken primarily at the local level by churches and other non-governmental charities. Moreover, the constitution was the result of a Reconstruction effort to reconfigure the State to govern itself responsibly. Thus, the unusual exigencies of that era suggest that, at the least, the provision deserves reexamination in light of the fact that the State now has a viable and stable government, in stark contrast to 1868.

Likewise, changes in North Carolina since the adoption of the modern balanced budget provision in 1977 have fundamentally altered the outlook of budgetary planning. The fiscal decisions of the last few years have been tremendously difficult, given the social policy goals of the State, the newly-interpreted constitutional requirement of a "sound basic education" for all school-aged children, existing obligations to current and former state employees, and a particularly difficult recession for North Carolina. The 2003 budget was balanced only after closing a gap in the billion-dollar

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9. See generally Hallyburton v. Bd. of Educ., 213 N.C. 9, 195 S.E. 21 (1938) (holding that the prohibition on borrowing without a referendum "is unambiguous, plain and direct"); Univ. R.R. Co. v. W. W. Holden, 63 N.C. 410 (1869) (holding that the State cannot contract for debt to build a railroad without referendum).


11. See STATE AND LOCAL GOVERNMENT RELATIONS IN NORTH CAROLINA: THEIR EVOLUTION AND CURRENT Status 6 (Charles D. Liner ed., 2d ed. 1995) [hereinafter STATE AND LOCAL] (noting that the 1868 constitutional convention instituted the constitutional provision for a "general and uniform" school system).

12. Id. at 7-8. See generally A. FLEMING BELL III & WARREN JAKE WICKER, COUNTY GOVERNMENT IN NORTH CAROLINA 175-233 (4th ed. 1999) (detailing the usage of the property tax).


15. See infra notes 30-31 and accompanying text.


17. See infra Part III.C.

18. See Current Operations, Capital Improvements, and Finance Act of 2002, ch. 126,
range, using a number of stopgap fixes.\footnote{After the boom years of the 1990s, in which the budget-makers enjoyed revenue windfalls and talk of greatly increasing the states’ power in the federal system,\footnote{North Carolina’s capacity to adapt to these many changing circumstances is plainly constrained by its self-imposed balanced budget requirement.} \textit{North Carolina’s} capacity to adapt to these many changing circumstances is plainly constrained by its self-imposed balanced budget requirement.}

This Comment illustrates how a number of trends in the law, policy preferences, and economic circumstances seriously call into question the old justifications for a constitutionally mandated balanced budget. These trends combine in a way that may not be clear either to lawmakers or the public at large. To date, there are no articles in the academic literature that analyze North Carolina’s constitutional restrictions on public debt. In fact, there is a paucity of law review commentary on the reassessment of the state balanced budget requirements. Thus, this Comment makes a contribution to the literature on the contemporary budget woes of state governments.

There are a number of possible alternatives to the state’s rather strict constitutional provision. Complete repeal is probably neither politically tenable nor fiscally desirable given the potential for legislative abuse of such unchecked fiscal freedom.\footnote{Among the possible mechanisms that would give legislators greater flexibility without handing them a blank check, this Comment argues that a provision which allows the State to borrow using relatively short-term instruments such as five or ten-year bonds without voter approval would be a compelling compromise between fiscal restraint and flexibility. In return for this moderate increase in financial planning capability, the legislature accepts a strict cap on spending growth as an amendment to the state constitution. This deal would take the form of a single referendum that would essentially function as an offer by the General Assembly to the state voters. If accepted and approved, both the government and the taxpayer would get what each wants; the legislature would receive much-needed flexibility to manage the government,\footnote{This fiscal arrangement would, lastly, enhance the General Assembly’s capability to manage} and the taxpayer would get a guarantee that spending not rise uncontrollably.\footnote{This fiscal arrangement would, lastly, enhance the General Assembly’s capability to manage}}

government programs and therefore enhance its argument in debates and negotiations on state-federal balances of power that the state is the optimal level of government for implementation of policy objectives.\textsuperscript{24}

I. THE CASE IN POINT: NORTH CAROLINA AND ITS RESTRICTION ON BORROWING

The purpose of the balanced budget provision of the North Carolina constitution, according to Professor John V. Orth, was to “effect the necessary economies” of the state budget;\textsuperscript{25} in other words, it mandated fiscal discipline by the General Assembly. The provision originated in the 1868 postwar constitution.\textsuperscript{26} In that Reconstruction-era constitution, the State was restricted in its power to acquire any new debt until all of its existing bonds were settled.\textsuperscript{27} In 1936, after those bonds were fully paid, the voters approved a constitutional amendment to enact a more permanent form of anti-debt restriction.\textsuperscript{28} This provision was incorporated into the 1971

\textsuperscript{24} See infra notes 246-49 and accompanying text.
\textsuperscript{26} Sanders, supra note 14, at 36-38.
\textsuperscript{27} N.C. CONST. art. V, § 4 (repealed 1971). Article V, section 4 provided:

Until the bonds of the State shall be at par, the General Assembly shall have no power to contract any new debt or pecuniary obligation on behalf of the State, except to supply a casual deficit, or for suppressing invasions or insurrections, unless it shall in the same bill levy a special tax to pay the interest annually.

\textit{Id.} See generally Univ. R.R. Co. v. W. W. Holden, 63 N.C. 410, 422 (1869) (holding that casual deficits, invasions, and insurrections were “outside of the ordinary expenses of the government” and therefore abnormal events); J.G. DE ROULHAC HAMILTON, RECONSTRUCTION IN NORTH CAROLINA 276 (1914) (chronicling the decisions by the 1868 Constitutional Convention on financial matters).


The General Assembly shall have the power to contract debts and to pledge the faith and credit of the State . . . for the following purposes: To fund or refund a valid existing debt; To borrow in anticipation of the collection of taxes due and payable within the fiscal year to an amount not exceeding 50 percent of such taxes; To supply a casual deficit; To suppress riots or insurrections, or to repel invasions. For any purpose other than these enumerated, the General Assembly shall have no power, during any biennium, to contract new debts on behalf of the State to an amount in excess of two-thirds of the amount by which the State’s outstanding indebtedness shall have been reduced during the next preceding biennium, unless the subject be submitted to a vote of the people of the State . . . In any election held in the State . . . under the provisions of this Section, the proposed indebtedness shall be approved by a majority of those who shall vote thereon.

\textit{Id.}
constitution as the new article V, section 3.\[29\] In 1977, North Carolina voters approved the current version of the debt restriction, one that required the governor to "effect the necessary economies in State expenditures" to ensure an operating balanced budget\[30\] and reformed the language of section 3, which now reads as follows:

(1) Authorized purposes; two-thirds limitation. The General Assembly shall have no power to contract debts secured by a pledge of the faith and credit of the State, unless approved by a majority of the qualified voters of the State who vote thereon, except for the following purposes:

(a) To fund or refund a valid existing debt;
(b) to supply an unforeseen deficiency in the revenue;
(c) to borrow in anticipation of the collection of taxes due and payable within the current fiscal year to an amount not exceeding 50 per cent of such taxes;
(d) to suppress riots or insurrections, or to repel invasions;
(e) to meet emergencies immediately threatening the public health or safety, as conclusively determined in writing by the Governor;
(f) for any other lawful purpose, to the extent of two-thirds of the amount by which the State's outstanding indebtedness shall have been reduced during the next preceding biennium.\[31\]

The provision is an austere one as state balanced budget requirements go.\[32\] Perhaps the most rigid feature of the section is simply the fact that it is constitutionally mandated. Unlike statutory balanced budget requirements in some states,\[33\] this one cannot

\[31\] N.C. CONST. art. V, § 3(1).
\[32\] See infra notes 196–211.
\[33\] See Lavinia L. Mears, Note, The Truth About the Balanced Budget Amendment, 20 SETON HALL LEGIS. J. 592, 607 n.113 (1996) (cataloging statutory and constitutional balanced budget provisions); see, e.g., N.H. REV. STAT. ANN. § 9:8-b (2001) (requiring adoption of a balanced budget, both as projected and as implemented); WASH. REV. CODE ANN. § 39.42.060 (West 2000) (limiting debt based on percentage of gross revenues required for servicing state debt to seven percent).
change as policy needs dictate without resorting to the cumbersome constitutional amendment process. Then, there is the absolute nature of the prohibition on borrowing as a practical matter. The six exceptions of article V, section 3, are not routinely part of budgetary planning, so in general, the State must balance its budget. Bond referenda do occur, but they are blunt, inflexible instruments. They must be approved by the General Assembly in order to be placed on the next statewide ballot, so as a matter of course they are something to which the General Assembly rarely resorts.

Exception (f), for example, is not a viable option under normal circumstances, because budget planners can use it only if in the preceding two years they paid down some significant portion of debt. Exception (c) allows the State to issue short-term debt within the fiscal year in order to preserve the smooth functioning of the government, but it is clearly not a useful tool when budgetary shortfalls are of a more long-term nature.

The next section of article V applies the same principle to county and city governments. Municipal corporations are creatures of the General Assembly’s incorporation powers, and their powers to contract for debt are similarly limited: “[t]he General Assembly shall have no power to authorize any county, city or town, special district, or other unit of local government to contract debts secured by a pledge of its faith and credit unless approved by a majority of the qualified voters of the unit who vote thereon.” By implication, the General Assembly may not borrow money for public purposes through the municipalities, so the prohibition on legislatively created debt is watertight throughout state and local government.

34. See N.C. CONST. art. XIII, § 4.

35. For example, after the flood caused by Hurricane Floyd, perhaps the worst natural disaster in North Carolina’s history, a good portion of the unforeseen expenses that the state incurred were paid for by the state’s rainy day fund, not financed by debt obtained under exception (e). See N.C. CONST. art. V, § 3(1)(e); GOVERNOR’S COMM’N TO MODERNIZE STATE FINANCES, FINAL REPORT 13 (2002) [hereinafter COMM’N TO MODERNIZE STATE FINANCES].

36. See Jane Stancill, Bonds Proposal Heading to Voters, NEWS & OBSERVER (Raleigh, N.C.), May 19, 2000, at B1. The school bond referendum was a significant commitment, and it is telling that contracting for debt would be achieved by appeal to education, a policy priority in the state. See Dan Kane, Easley: Schools Get Break on Cuts, NEWS & OBSERVER (Raleigh, N.C.), Mar. 22, 2002, at A1.

37. See sources cited supra note 36.

38. N.C. CONST. art. V, § 3(1)(f).


40. N.C. CONST. art. V, § 4(2). Municipalities can invoke the same exceptions that the State can invoke under section 3(1). See id.
Thus, the budget crises of state and local governments are interconnected in a way that those of the federal and state governments are not. Further, North Carolina funds a major portion of local governmental activities through state grants to municipalities. Although withholding monies from state coffers promised to the localities is an extreme measure, it became an important method by which the State balanced its own budget in fiscal year 2002, much to the chagrin of the hapless municipalities. Withholding $330 million that was to go to local governments went a long way towards recovering the nearly $1 billion budget shortfall, but it was a bitter pill to swallow for the municipalities that depended on the money.

II. UNSUSTAINABLE DEVELOPMENTS IN THE LAW AND POLITICS

One of the chief contentions of this Comment is that a number of seemingly independent trends have combined to create the recent fiscal gaps and that these trends do not appear to be receding. The nature of state and local government is radically different from 1868, when the original balanced budget requirement was formally debated at the postwar constitutional convention.


42. State and Local, supra note 11, at 10-14.


44. Rice, State Is Backing Out, supra note 43.


46. See generally Journal of the Constitutional Convention of the State of North-Carolina, at Its Session 1868 (Joseph W. Holden ed., 1868) (chronicling the proceedings of the 1868 state constitutional convention). In the postwar constitutional convention, there was substantial concern over the deterioration of North Carolina's financial position. See Record of the 1868 Constitutional Convention 756-64 (compiled 1971) (unpublished record of the proceedings of the 1868 North Carolina constitutional
governments are also substantially different than they were at the
time of the ratification of the new constitution in 1971,\textsuperscript{47} and the
budgetary realities and policy trends of recent years have continued
to change the fiscal playing field in ways that might not have even
been envisioned in the mid-1990s, when North Carolina and other
states had not yet faced the financial difficulties of recent years.\textsuperscript{48}

\begin{flushright}
Mr. President, this is no fancy sketch, no mere flight of the imagination. All this
can be done, and done speedily. The dark pall that once rested upon the State
like the miasma of death is now lifted forever, and it remains for us to accomplish
the rest. Adopt a sound financial policy, a liberal Constitution and a wisely
administered government, and the work is accomplished. Let us then open our
doors. Let us take away the only remaining obstruction. Let us restore to the
good old State her ancient fair fame, her honor, her credit, her time-honored
name for honesty and integrity. Do this and the most enthusiastic among us does
not dream of what is in store for North Carolina.
\end{flushright}

\textit{Id.} at 762.

The postwar debt load, according to Abbott, had been neglected and was
hampering the return of the state to fiscal normalcy. \textit{Id.} at 760. He therefore proposed
that North Carolina follow the lead of Missouri, also a slave state, and resolve to make
debt repayment a priority of the new government. \textit{Id.} at 760--62. His proposal, therefore,
called for a constitutional requirement that the State not contract any more debt until the
existing bonds were at par. \textit{Id.} at 750. His proposed additional provision allowed for a
lending of state credit only upon the passage of a voter referendum. \textit{Id.} The convention
debated the practicality of repaying the debt at that time, given the dire fiscal straits of the
state at the time and the proposed system for taxation. \textit{Id.} at 770--72. However, Abbott's
proposal, which included a companion constitutional provision requiring repayment of the
debt, was ratified by the convention. \textit{Id.} at 772. These were codified in the North
Carolina Constitution of 1868 in article V, sections 4 and 5. In this respect, the debates
reveal that the overriding problem that gave rise to this approach to state finance was the
fiscal disaster that the North Carolina faced in the aftermath of the Civil War. See generally \textit{NORTH CAROLINA STANDARD} (Raleigh, N.C.), Mar. 11, 1868, at 2--3 (reporting
on the business conducted at the convention and printing the major speeches that were
given).

\textsuperscript{47} See \textit{COMM'N TO MODERNIZE STATE FINANCES}, supra note 35, at 3.

\textsuperscript{48} See, e.g., \textit{NATIONAL ASS'N OF STATE BUDGET OFFICERS, BUDGET SHORTFALLS:
STRATEGIES FOR CLOSING SPENDING AND REVENUE GAPS} 1 (2002) [hereinafter \textit{BUDGET SHORTFALLS}]
limits and spending mandates); Lawrence O. Gostin, \textit{When Terrorism Threatens Health: How Far Are Limitations on Personal and Economic Liberties Justified?}, 55 \textit{FLA. L. REV.}
There are essentially three types of trends that have produced these changed circumstances: changes in government policy, judicial trends in constitutional jurisprudence, and new economic realities.

A. Governmental Policy Decisions

1. State Budget

Any overarching discussion of the state budget in North Carolina begins with education, which is by far its largest appropriations category. Education constituted fifty-six percent of the state budget in 2002–03,\(^4\) the vast majority of which was for primary and secondary school education.\(^5\) Overall, state citizens enjoy a relatively low total tax burden,\(^6\) and public instruction is funded almost entirely by the state budget and not local budgets, in contrast to many other states.\(^7\)

A number of policy initiatives in the 1990s charted a new course for public education in North Carolina. During these years Governor Jim Hunt made the public school system a priority,\(^8\) leading to numerous new programs. Among them were Smart Start,\(^9\) a state-


\(^{5}\) See id. (allocating to the Department of Public Instruction $5.9 billion of the $8.36 billion total education expenditures).


\(^{7}\) STATE AND LOCAL, supra note 11, at 11. In the early 1930s, the State took over financing public education, road construction, and prison administration and construction. Id.

\(^{8}\) See Todd Silberman, Education Chief Gives Nod to N.C., NEWS & OBSERVER (Raleigh, N.C.), Jan. 6, 2000, at B3 (reporting that U.S. Education Secretary Richard Riley's visit to the state honored the accomplishments of the Hunt administration in the area of education). Secretary Riley said of Governor Hunt's efforts: “North Carolina, under Gov. Hunt, has become a national leader in improving education,” Riley said in a written statement. “Gov. Hunt has worked tirelessly to improve teacher quality, raise standards, expand early childhood education, give children the learning power of technology and support improvements in public education. When a governor like Jim Hunt makes education a top priority, it makes all the difference to our children—and our nation.” Id. (quoting Richard Riley, U.S. Secretary of Education).

\(^{9}\) Amy Gardner, A Farewell Flourish, NEWS & OBSERVER (Raleigh, N.C.), Dec. 23,
level version of the federal government's Head Start program for early childhood educational development, initiatives designed to track student progress more effectively, and an ambitious program to elevate teaching standards by raising teacher pay and weeding out underachieving teachers. The results have been impressive. In terms of teacher training, North Carolina rose from having only eight teachers receiving certification by the National Board of Professional Teaching standards in 1994 to leading the nation in certification as of 2000–01. Teacher pay has risen from low levels to approximately the national average, and SAT scores have seen significant improvement. Higher standards have come at a cost, however, as the public school budget for the state has risen twenty-four percent from the 1997–98 school year to the 2002–03 school year.

Criminal justice initiatives of the 1990s were another significant legislative priority that increased the state's long-term financial obligations. Structured sentencing legislation, including the "three-strikes-and-you're-in" provision for habitual felons, was also

55. See id.
59. See id. at 6; PALASEK, supra note 57, at 7 (providing district-specific assessments of public school improvements); Gardner, supra note 54. Palasek contends that SAT performance is not impressive and remains sub par. PALASEK, supra note 57, at 7.
supported by Governor Hunt.\textsuperscript{62} Passed in a special session of the General Assembly to deal with crime in 1994, the “three strikes” statute requires that persons convicted of three violent felonies be given life prison sentences without parole eligibility.\textsuperscript{63} These structured sentencing initiatives also imposed more formal requirements on trial courts by specifying mandatory minimum prison terms.\textsuperscript{64} Whether or not these laws were good policy,\textsuperscript{65} they certainly had the effect of burgeoning prison populations in the state, thereby imposing continuing expenditures on future state budgets to maintain this population.\textsuperscript{66} The fiscal impact of burgeoning prison populations is long-term and inflexible, given that prison construction as well as inmate incarceration compel the State to enter into large prison construction and management contracts.\textsuperscript{67} Thus, these budgetary items are not generally discretionary spending that can easily be dropped in times of financial hardship.

\textsuperscript{62} Gardner, \textit{supra} note 54 (noting Governor Hunt’s support for the “three strikes” legislation); \textit{see} N.C. GEN. STAT. § 14-7.12 (2001) (mandating life without parole for violent habitual felons who are convicted of a third violent felony); \textit{see also} N.C. GEN. STAT. § 14-7.7 (2001) (defining “violent habitual felon”).

\textsuperscript{63} \textit{See} § 14-7.12.

\textsuperscript{64} \textit{See} Structured Sentencing Act, ch. 538, sec. 1, 1993 N.C. Sess. Laws 2298, 2307-11 (codified at N.C. GEN. STAT. §§ 15A-1340.10 to 1340.23 (2001)). An example of the structured sentencing initiative can be found at section 15A-1340.17(c), which established the sentencing requirements for a given class of crime and the convict’s prior criminal record.


\textsuperscript{66} \textit{See} WRIGHT, \textit{supra} note 65, at 8–9 (describing the projected cost and incarceration rate increases as a result of structured sentencing bills); Kane, \textit{supra} note 43 (noting that the burgeoning prison population required the construction of three new prisons at a cost of $60 million). The total Department of Corrections budget for 2001 reached $923 million, or over six percent of the total state budget. \textit{See} Current Operations and Capital Improvements Appropriations Act of 2001, ch. 424, pt. I, § 2.1, 2001 N.C. Sess. Laws 1670, 1673.

2. Federal Legislation

Federal policy choices in recent years have also impacted state budgets in significant ways. Perhaps foremost, the North American Free Trade Agreement of 1994 ("NAFTA") impacted North Carolina's revenue stream directly by lowering the state's gross economic output. NAFTA affected manufacturing in the state by facilitating the relocation of facilities to Mexico. Because of the sheer size of the manufacturing industry, North Carolina suffered more job losses than any other state as a result of the free trade policies of the 1990s and the first few years of the twenty-first century. So, while the state's consumers certainly benefited from lower product prices, which might give them more net purchasing power as a group, the overall effect on state revenues was likely a decrease in tax revenues. This decrease resulted because the state's individual and corporate income tax, which is more directly impacted by plant closings, constitutes a substantially larger percentage of state revenue.


Nevertheless, the free trade sentiments of many state politicians, even in a severely affected state like North Carolina, prevailed in the policy debate, leading to the passage of supporting legislation and treaty ratification. The pace of manufacturing facilities moving overseas has more recently begun to pinch the state as a whole, exacerbating what was already a stubborn recession.

NAFTA’s unemployment effects also indirectly impacted the state budget indirectly through increased outlays relating to unemployment benefits. The state’s Unemployment Insurance Fund, funded primarily through employer taxes and secondarily through federal grants, declined from a balance of $1.75 billion in 1997 to $793 million in 2002. The impact of foreign competition on the state budget is significant for two reasons. First, it demonstrates how much recessions can increase state budgetary outlays if the State

72. See 2002 CAFR, supra note 67, at 32 (reporting that individual and corporate income tax revenues for the fiscal year ending on June 30, 2002, totaled $7.8 billion, whereas sales tax revenues were $3.8 billion). Total income tax revenues funded thirty percent of this budget, as opposed to the sales tax revenues, which funded only fourteen percent. Id. at 33. Precisely analyzing the net effect of NAFTA on tax revenues would require accounting for the increased income taxes paid by retailers who import products at lower prices, as well as the decrease in sales taxes due to the lower consumption by those who have suffered an income loss due to plant closings. Without delving into a comprehensive econometric analysis, the substantial income losses due to plant closings, see supra notes 69–70, are probably much larger than the incremental gains in sales tax revenues caused by lower prices for consumable goods. In fact, there is strong evidence that sales tax receipts are particularly vulnerable to economic downturns in North Carolina. COMM’N TO MODERNIZE STATE FINANCES, supra note 35, at 5, 10. In other words, the income effect resulting from lower wages dominates the substitution effect benefits of lower prices.

73. See Clark & Velazquez, supra note 71, at 756–57.


76. See supra note 72.

77. See N.C. GEN. STAT. § 96-6 (2001).

78. See 2000 CAFR, supra note 69, at 150 (reporting $117 million in taxes receivable and $1.3 million in "intergovernmental receivables").


has decided to undertake increased responsibility for job losses under a free trade regime and a globalized economy. The economic rationale for this correlation is that "societies seem to demand (and receive) an expanded government role as the price for accepting larger doses of external risk," risk which comes from increased volatility and competition under free trade.

The second reason why free trade agreements such as NAFTA and the World Trade Organization ("WTO") create a systemic change to the state budget is the economic concept commonly referred to as the "compensation principle." The compensation principle states that, while winners—here, consumers—gain more under free trade than losers—here, manufacturing workers—all will be better off if the winners compensate the losers for their loss.

82. Id. at 998.
83. See id.
86. In the context of the decision to choose a policy of free trade, the compensation principle implies that, while aggregate economic gains always exceed losses when lowering trade barriers, there may be winners and losers after free trade. If winners compensate losers for their loss, the losers will not be made worse off, while the winners are made better off. Generally, however, compensation will occur via government spending, given that government is the least cost avoider; in other words, it is easier for the government to enact a general welfare program, such as unemployment insurance and worker retraining, than for individual winners to find individual losers and compensate them through private transactions. Further, because the government makes the choice to make free trade agreements, the government is the logical entity to carry out the compensation system, such that the legislature can enact both the free trade agreement and the domestic compensation system simultaneously. See Alia Adserà & Carles Boix, Trade, Democracy, and the Size of the Public Sector: The Political Underpinnings of Openness, 56 INT'L ORG. 229, 229–31 (2002) (outlining the theory of how free trade decisions and public sector expansion occur in tandem); Rodrick, supra note 81, at 1028–29. See generally Willem Thorbecke & Christian Eigen-Zucchi, Did NAFTA Cause a "Giant Sucking Sound"?, 23 J. Lab. Res. 647 (2002) (analyzing the net impact of NAFTA on trade and aggregate U.S.
Because the government makes the decision to sign free trade agreements, the typical way in which the winners bargain with the losers is through the political process.\textsuperscript{87} Government will also, generally, be the least cost avoider in a compensation scheme; in other words, projects such as unemployment insurance and worker retraining are funded by the winners through taxation, and government is the least expensive mechanism by which to carry out the compensation.\textsuperscript{88} In that respect, a global and liberalized economy depends on an expanded and responsive public sector, because in the absence of compensation, those that would lose under a free trade regime would obstruct the ratification of free trade agreements such as NAFTA and the WTO. North Carolina has accepted expanded governmental responsibility, responsibility that is at its highest when the economy is at its lowest ebb in the business cycle, as the price for the benefits of free trade.\textsuperscript{89} The difficult irony, of course, is that state revenues are depressed\textsuperscript{90} when the need for spending is most immediate.

Lastly, the United States Congress has enacted legislation changing the balance of federalism in recent years. The Welfare Reform Act of 1996\textsuperscript{91} was perhaps the most public of a number of national initiatives to return policy control to the state level.\textsuperscript{92} The Act, along with others like the Unfunded Mandates Reform Act,\textsuperscript{93} were flagship bills in the effort to reinvigorate the politics of decentralization in policy matters.\textsuperscript{94} While the Unfunded Mandates

\textsuperscript{87}. See Adserà & Boix, \textit{supra} note 86, at 229–30.
\textsuperscript{88}. See id.
\textsuperscript{89}. See supra notes 77–83 and accompanying text (explaining the cost of economic downturns to the unemployment assistance program).
\textsuperscript{90}. See \textit{Comm'n to Modernize State Finances}, \textit{supra} note 35, at 5, 10.
\textsuperscript{94}. See Evan H. Caminker, \textit{State Sovereignty and Subordinacy: May Congress Commandeer State Officers to Implement Federal Law?}, \textit{95 COLUM. L. REV.} 1001, 1003–04
Reform Act, which applies to all new federal regulatory actions that apply to the states, largely purports to reduce the budgetary pressures on the states coming from unfunded mandates, its symbolic importance as guarantor of state sovereignty under a reinvigorated process federalism merits its inclusion in this discussion.

Further, the Unfunded Mandates Reform Act also includes requirements that federal laws state explicitly when state laws are preempted, thus enacting a prophylactic against implied preemption and shifting the burden to parties asserting preemption to prove that a federal law supersedes state law. Thus, the Act maintains the integrity of the state regulatory frameworks in addition to bolstering their budgetary autonomy. Regulatory preemption was also the focus of disputes over several Clinton administration Executive Orders. In particular, Executive Order 13,083 in 1998 implied an expansion of federal regulatory authority and suggested that the burden to disprove preemption or to demonstrate the merits of a state waiver from regulations rested with the state. After state and local


96. See id. § 1501(2); see also CONTRACT WITH AMERICA 125 (Ed Gillespie & Bob Schellhas eds., 1994) (criticizing unfunded mandates).
98. See Unfunded Mandates Act of 1995, Pub. L. No. 104-4, § 423(e), 109 Stat. 48 (codified at 2 U.S.C. § 658b(e)). The Act requires that “the committee report accompanying the bill or joint resolution shall contain, if relevant to the bill or joint resolution, an explicit statement on the extent to which the bill or joint resolution is intended to preempt any State, local or tribal law, and, if so, an explanation of the effect of such preemption.” Id.
101. See id. at § 3(d).
102. See id. at § 5; Blake, supra note 99, at 300–01.
governments complained about this change in policy, President Clinton suspended the Order\textsuperscript{103} and later replaced it with a new Executive Order\textsuperscript{104} that restored the regime of deference to the states that had been federal executive policy since the Reagan administration.\textsuperscript{105} Thus, proponents of state autonomy have been successful not only by lobbying the U.S. Congress, but also through lobbying of the federal executive branch by state and local governments.

Academic responses to this "new federalism"\textsuperscript{106} have been mixed,\textsuperscript{107} but the elections of 2000 and 2002 placed the national government squarely in the hands of the Republican Party, a party that generally favors decentralized control of regulatory matters and social policy.\textsuperscript{108} While there are important reasons why the federal government's power may be expected to increase in some areas,
especially those of international concern, there are areas of policy in which proponents of state action have prevailed since 1996 and in which they may continue to influence political debates.

Notably, however, the Republican Party has become increasingly willing to enact federal laws that preempt state laws, as the Party's control over federal legislation has increased, even in areas of traditional state authority such as education. For example, the No Child Left Behind Act of 2001 gives the U.S. Department of Education broad new authority over quality controls in state education policy. In addition, the Sarbanes-Oxley Act of 2002 creates expansive federal restrictions on executive compensation and furthers existing federal regulatory controls over corporate governance. Like the No Child Left Behind Act, the Sarbanes-Oxley Act enacts a single, inflexible federal standard that may have been ineffectively drafted and, partly as a result, overbroad. The


110. See id. at 368 (noting recent devolution trends). In a classic article on federalism, Professor Herbert Wechsler argues that the legislative process creates important safeguards for federalism concerns and that the concentrated focus of the academic legal community on the U.S. Supreme Court tends to de-emphasize the legislative role in the defense of federalism. Herbert Wechsler, The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government, 54 COLUM. L. REV. 543, 543-44 (1954). The decentralization-inclined legislation of the 1990s, reinvigorating the interests of the states in matters of local policy, would appear to support his claim. Some Supreme Court Justices expressed support for Professor Wechsler's theory. See Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 565 n.9 (1985) (Powell, J., dissenting). It appears, however, that the current Court has faith in process federalism in light of current decisions. See infra notes 136-42 and accompanying text. See generally Larry Kramer, Understanding Federalism, 47 VAND. L. REV. 1485, 1528 (1994) (arguing that party politics is a key instigator of process federalism, though refuting Wechsler's explanations in the article). But see Marshall, supra note 97, at 147-49 (questioning the validity of Professor Wechsler's predictions).


116. Lehman, supra note 114, at 2117-18 (critiquing the legislation as overbroad and ineffectively drafted); see also id. at 2121-31 (detailing ambiguities in the statute regarding
fact that the legislation received overwhelmingly bipartisan support\textsuperscript{117} reinforces the notion that, even for members of Congress who espouse federalism in theory, the power of the Supremacy Clause is an alluring siren.\textsuperscript{118} Nevertheless, while federal control over policy priorities is hardly a dead letter,\textsuperscript{119} decentralization continues to be a popular governing philosophy\textsuperscript{120} for a party that is currently in control of Congress, the presidency, and a majority of the governor's mansions.\textsuperscript{121} The increase in responsibility at the state level of government, therefore, adds to the need for flexibility in the state's system of finance. Regardless of what the optimal level of taxation is for the state and federal levels of government, with responsibility over policy objectives comes a need for budgetary options capable of meeting those objectives.\textsuperscript{122} Even if one argues that the tax level should not change, such that more discretionary programs should be cut to fund the more long-term and constant programs cited above, the enhanced need for flexibility remains. In fact, because economic

director and executive compensation restrictions).

\textsuperscript{117.} Id. at 2120.

\textsuperscript{118.} See Marshall, supra note 97, at 141–44 (noting what legislation federalism proponents supported that did and did not resonate with the principles of federalism). Professor Marshall asserts that the support an item of federal legislation receives is generally dependent on its policy substance, not on whether its implementation will occur at the appropriate level of government. Id. at 144.

\textsuperscript{119.} See Bush Priorities Stay Jammed in Congress, WASH. POST, Oct. 26, 2003, at F2 (reporting that a Republican-sponsored bill to require most class actions to be filed in federal court failed by a single vote in the U.S. Senate); Jan Crawford Greenberg, GOP Renews Attack on Malpractice Awards: Republicans Seeking Limits on Medical Malpractice Judgments See Tort Reform as Potent Political Weapon for the 2004 Campaign, CHI. TRIB., Sept. 19, 2003, § 1, at 1 (reporting that the Republican Party remains committed to federal medical malpractice damage caps).


\textsuperscript{121.} Brooke Donald, GOP Showed National Gains, Controlling Congress, MILWAUKEE J. SENTINEL, Dec. 29, 2002, at 2J; Melanie Eversley, GOP Hears a Mandate; National Victories Kick Republican Agenda Into High Gear, ATLANTA J. & CONST., Nov. 7, 2002, at 1A.

\textsuperscript{122.} See Bent E. Sorensen & Oved Yosah, Is State Fiscal Policy Asymmetric Over the Business Cycle?, in ECONOMIC REVIEW—FEDERAL RESERVE BANK OF KANSAS CITY, Third Quarter 2001, at 48 (arguing that balanced budget rules limit policy flexibility and exacerbate the business cycle). But see id. at 49 (arguing that "political 'sacred cows' " can grow to inefficient levels during economic expansions and be unpopular to cut during downturns).
downturns often create enhanced needs, such as in the case of the state's unemployment insurance program\textsuperscript{123} and the greater volatility resulting from the trend toward globally open markets,\textsuperscript{124} the case for government services is at its greatest during downturns and at its least during good times. Unless one posits that the legislature can predict when downturns will come and how large they will be, such that government saving will solve the planning problem, there is a strong case for financial flexibility across the business cycle that can adapt to changes as they arise. Further, political process federalism involves state and federal legislators making decisions about the optimal balance between state and federal responsibilities.\textsuperscript{125} Arguments for decentralization in policy matters are, plainly, directly dependent on the capacity of the more localized governments to achieve policy goals.\textsuperscript{126}

B. Recent Judicial Trends

While legislative law and policymaking have significantly impacted state budgets in recent years, so too have judicial decisions. In North Carolina's state budget, education is the two-ton gorilla. In recent Supreme Court of North Carolina jurisprudence, the same might be said about \textit{Leandro v. State.}\textsuperscript{127} Decided in 1997, the decision added to a number of path-breaking state supreme court decisions around the nation interpreting state constitutional guarantees of public education to contain an implicit minimum standard requirement.\textsuperscript{128} The notion that the state's constitutional guarantee of public education\textsuperscript{129} might implicate judicial review of the legislature's solution potentially foretells a whole new era of litigation over public education. The Supreme Court of North Carolina, in an opinion written by Chief Justice Burley Mitchell, adopted a four-prong test for determining what constitutes a "sound basic education," thus

\begin{itemize}
\item \textsuperscript{123} See supra notes 77–83 and accompanying text.
\item \textsuperscript{124} See supra notes 69–76 and accompanying text.
\item \textsuperscript{125} See supra notes 97–98, 107–10 and accompanying text.
\item \textsuperscript{127} 346 N.C. 336, 488 S.E.2d 249 (1997).
\item \textsuperscript{128} See Margaret Rose Westbrook, Comment, \textit{School Finance Litigation Comes to North Carolina}, 73 N.C. L. REV. 2123, 2125–34 (1995) (reviewing several cases involving school finance litigation).
\item \textsuperscript{129} N.C. CONST. art. IX, § 2(1) (guaranteeing "a general and uniform system of free public schools . . . wherein equal opportunities shall be provided for all students").
\end{itemize}
holding:

For purposes of our Constitution, a "sound basic education" is one that will provide the student with at least: (1) sufficient ability to read, write, and speak the English language and a sufficient knowledge of fundamental mathematics and physical science to enable the student to function in a complex and rapidly changing society; (2) sufficient fundamental knowledge of geography, history, and basic economic and political systems to enable the student to make informed choices with regard to issues that affect the student personally or affect the student's community, state, and nation; (3) sufficient academic and vocational skills to enable the student to successfully engage in post-secondary education or vocational training; and (4) sufficient academic and vocational skills to enable the student to compete on an equal basis with others in further formal education or gainful employment in contemporary society.\textsuperscript{130}

This guarantee will probably require substantial attention and funding in order to ensure compliance and minimize litigation associated with the \textit{Leandro} standard.\textsuperscript{131} Further, the new "sound basic education" requirement is just as inflexible as the balanced budget provision of the constitution—it makes no exceptions for revenue shortfalls or economic downturns. This ruling is hardly unprecedented. From 1971 to 1997, twelve state supreme courts held that their respective states failed to meet the requirements of their state constitutions' education clauses.\textsuperscript{132} All state constitutions

\textsuperscript{130} \textit{Leandro}, 346 N.C. at 347, 488 S.E.2d at 255.
presently include some obligation for the state to provide for public education, so the constitutional gravity of education spending is a universal feature of state budgetary responsibilities.

At the federal level, several trends in United States Supreme Court jurisprudence place further responsibilities on state governments. In the past decade, there has been a slow but steady trend towards curbing the power of the federal government under the limitations of the Interstate Commerce Clause and the Tenth Amendment. In the 1992 case New York v. United States, the Court for the first time declared a federal act unconstitutional as impermissibly appropriating state power for its own regulatory purposes. This newly emboldened defense of state sovereignty soon found expression in a revived Interstate Commerce Clause, which the Supreme Court in United States v. Lopez held did not grant Congress the power to prohibit guns on the campuses of public schools. While the impact of these doctrines remains unclear, the

in favor of the plaintiffs' challenge to the constitutionality of the state education system. See Lukemeyer, supra, at 53; Sch. Admin. Dist. No. 1 v. Commissioner, 659 A.2d 854, 858 (Me. 1995). In 1997, the Supreme Court of North Carolina, see Leandro v. State, 346 N.C. 336, 347, 488 S.E.2d 249, 255 (1997), and the Ohio Supreme Court, see Derolph v. Ohio, 677 N.E.2d 733, 737 (Ohio 1996), also held that their respective states' education systems did not satisfy constitutional requirements to provide for public education. Thus, from 1971 to 1997, twelve state high courts found their school systems constitutionally deficient.

133. See Lukemeyer, supra note 132, at 6.
135. Id. amend. X.
140. See United States v. Morrison, 529 U.S. 598, 627 (2000) (striking down the Violence Against Women Act of 1994 as beyond Congress's power under the Interstate Commerce Clause); United States v. Alfonzo Coward, 151 F. Supp. 2d 544, 554 (E.D. Pa. 2001), remanded 296 F.3d 176 (3d Cir. 2002) (sustaining an Interstate Commerce Clause challenge to federal gun law); see also Gordon G. Young, The Significance of Border Crossings: Lopez, Morrison, and the Fate of Congressional Power to Regulate Goods, and Transactions Connected with Them, Based on Prior Passage through Interstate Commerce, 61 Md. L. Rev. 177, 178–80 (2002) (arguing that not all instances of interstate border crossings give the federal government power to regulate under the Interstate Commerce Clause). Morrison and Alfonzo Coward illustrate that the Interstate Commerce Clause challenges are certainly viable, but the specific foundations that they draw will only
philosophical posture that they take expands the prerogatives of the states under the U.S. Constitution in the modern governing era. Tenth Amendment protections are slowly but steadily being fleshed out in the federal court system.\textsuperscript{141} Congress's Interstate Commerce Clause power has likewise become a bit more unstable in both Supreme Court and lower federal court jurisprudence.\textsuperscript{142} These trends have not developed enough to impact the state budgets, though they suggest that states may have greater policy responsibility in the future, given the glacially advancing limits on congressional power.\textsuperscript{143} Thus, as the states gradually obtain more responsibility to make policy decisions, there will be correspondingly greater demands on the state budget.

Moreover, a quieter but perhaps much more significant trend has occurred within the realm of federal court power under the current Supreme Court. In a line of cases delineating the limits within which federal courts can enact rules, the Supreme Court repeatedly directed the federal courts to defer to state law as opposed to drawing from federal jurisprudence, absent a clear grant of power by the national government.\textsuperscript{144} The states have thus been given significantly greater responsibility to fill in the policy gaps left by federal law in recent years.\textsuperscript{145} The significance of these legal trends for the optimal financial structure of state government is not that tax levels need to change, but more broadly that financial flexibility is a necessary corollary to managing that enhanced responsibility.\textsuperscript{146} This assertion is, as contended in the previous Section on legislative approaches to become clear as the courts apply these doctrines in subsequent cases. See J. Mitchell Pickerill, Leveraging Federalism: The Real Meaning of the Rehnquist Court's Federalism Jurisprudence for States, 66 ALB. L. REV. 823, 826 (2003).

\textsuperscript{141} See Lund, supra note 137, at 896 n.6 (referencing U.S. Supreme Court and circuit court cases fleshing out Tenth Amendment protections). See generally George J. Thomas, The Brady Act, the Tenth Amendment, and America's Gun Cult, 30 UWLA L. REV. 23 (1999) (analyzing further Tenth Amendment usages in the context of gun control and the Brady Act); Michael Van Arsdall, Comment, Enforcing the Enforcement Clause: City of Boerne v. Flores Chips Away at Congressional Power, 48 CATH. U. L. REV. 249, 291–92 (1998) (discussing a case that, in the opinion of the author, is consonant with Tenth Amendment protections in the course of striking down federal law). Professor Nagel assures us, however, that the sky is not falling, and that the Rehnquist Court has not embarked on a grand scheme to hamstring the federal government with the Tenth Amendment. NAGEL, supra note 92, at 38–39.

\textsuperscript{142} See supra notes 138–39.

\textsuperscript{143} See supra note 136–40.

\textsuperscript{144} See Lund, supra note 137, at 895–901.

\textsuperscript{145} See id. at 900–01.

\textsuperscript{146} See Sorensen & Yosah, supra note 122, at 48.
fundamental shifts in federalism, not merely reactive. Rather, the capability of the states and their receptiveness to take on responsibility in the modern American governmental system is also a relevant factor in judicial protections of their role. If states remain hamstrung by restrictive financing options, the argument for their policy role being protected by constitutional doctrine as well as statutory interpretation of the scope of federal administrative power is substantially weakened.147 In that sense, the financial strength of the states is an integral part of the ongoing debate over the virtues of federalism and localized control of decision-making power.

While none of these decisions, save perhaps \textit{Leandro v. State}, is likely to spawn fiscal disaster, in concert they create an important new set of long-term responsibilities for state governments. The federal court decisions also resonate with political rhetoric of the last decade that extols the virtues of acting at the state—as opposed to the federal—level.148 While \textit{Leandro} applies only to North Carolina, a growing number of state supreme courts have come to similar conclusions with respect to their constitutional provisions for education under state governments' wings.149 The federal court

\begin{itemize}
  \item \textit{See McCulloch v. Maryland, 17 U.S. 316, 415} (holding, in its definition of the scope of federal legislative power, that the "constitution [was] intended to endure for ages to come, and, consequently, to be adapted to the various crises of human affairs"); see also Lino A. Graglia, \textit{Revitalizing Democracy}, 24 \textit{HARV. J.L. & PUB. POL'Y} 165, 166-67 (2000) (arguing that doctrinal evolution in constitutional approaches to federalism should embody notions of a "living Constitution" and adaptation to "new circumstances"). Professor Graglia argues that highly deferential review of congressional assertions of federal power, in which the courts defer to congressional judgment on the scope of its constitutional power, is worse than no review at all because it suggests to the Congress that its policy decisions are constitutionally sound. \textit{Id.} at 167. However, he prefers political process federalism to judicially monitored federalism. \textit{Id. Cf. Morton J. Horwitz, Foreword, The Constitution of Change: Legal Fundamentalism Without Fundamentalism, 107 \textit{HARV. L. REV.} 32, 51-56 (1993) (providing a historical overview of legal theorists and judges who have embraced the notion of a living Constitution that adapts to the needs and practical abilities of governments); William Jeffrey, Jr., The Constitution: "A Firm National Government", in \textit{How Federal is the Constitution?} 16, 27-30 (Robert A. Goldwin & William A. Schamba eds., 1987) (arguing that there are few limits on federal power); David M. Kennedy, \textit{Federalism and the Force of History, in How Federal is the Constitution?, supra, at 67-83} (Robert A. Goldwin & William A. Schamba eds., 1987) (illustrating the impact of economic and political change on evolving constitutional approaches to federalism). \textit{But see Antonin Scalia, Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws, in A Matter of Interpretation: Federal Courts and the Law} 3, 38 (Amy Gutmann ed., 1997) (arguing that constitutional interpretation must be firmly rooted in the original understanding of the text, not in evolving notions that take practical impacts of rulings into consideration).\end{itemize}

147. \textit{See infra Part III.A.}

decisions limiting the power of the national government, of course, impact all states as actors in the federal system. Thus, these trends have broad application across the country.

C. New Economic Realities

Bridging the fiscal deficits of 2001–02 proved to be a two-year nightmare for both the governor and the General Assembly. In the words of the Raleigh-based News and Observer, “Lawmakers called it the worst budget crisis since the Great Depression.” The General Assembly had to make up a nearly $2 billion shortfall, given the ongoing financial obligations and policy priorities of the state and sharply declining revenues. The severity of the recession in North Carolina exceeded that of many other states, given the sharp declines in manufacturing and tobacco, traditionally important economic activities for the state. The number of skilled jobs available in the high-paying technology sector also declined.

North Carolina’s experience was hardly unique. Throughout state legislatures across the nation, lawmakers faced similar dilemmas of revenue shortfalls and balanced budget requirements pinching the budget process. This occurred despite consistent state budget (holding that the state’s common schools must be adequately funded, substantially uniform, and that every child be afforded equal opportunity); Claremont Sch. Dist. v. Governor, 635 A.2d 1375, 1376 (N.H. 1993) (holding that the State has a duty to provide an education to every educable child in public school); Bd. of Educ. v. Nyquist, 439 N.E.2d 359, 368–69 (N.Y. 1982) (holding that the state constitution requires only minimal acceptable facilities and services, not equality); Seattle Sch. Dist. No. 1 v. State, 585 P.2d 71, 76–77 (Wash. 1978) (en banc) (holding that the State has a mandatory duty to make ample provision for basic education of all resident children through a uniform system); Alabama Coalition for Equity, Inc. v. Hunt, No. CV-90-883-R (Ala. Cir. Ct. 1993), reprinted in Opinion of the Justices No. 338, 624 So.2d 107, 165–66 (Ala. 1993) (holding that the State must provide all school-age children with substantially equitable and adequate educational opportunities).

151. Kane, supra note 43.
152. Id.
154. Martinez, supra note 153.
155. See NAT’L ASS’N OF STATE BUDGET OFFICERS, THE FISCAL SURVEY OF STATES 2–3 (May 2002), available at http://www.nasbo.org/Publications/fiscsurv/may2002fiscalsurvey.pdf; Rob Christensen & Amy Gardner, More Red Ink, NEWS & OBSERVER (Raleigh, N.C.), Jan. 24, 2002, at A1 (explaining that Virginia, Georgia, and South Carolina, for example, have similar budget shortfalls); see also BUDGET SHORTFALLS, supra note 48, at 1–2 (summarizing the financial difficulties of the states in
surpluses from only a few years before. However, one other major economic shock was entirely unique to the state—Hurricane Floyd of 1999. In addition to creating a supply-side shock to the eastern half of the state’s tax base through extensive crop damage and flooding, the natural disaster also increased fiscal outlays to help victims cope with loss. In the process, the State was forced to drain the rainy day fund, a mechanism designed to help the State cope with budget shortfalls through savings rather than financing. In this respect, North Carolina’s recent economic experience illustrates a fundamental shortcoming of the balanced budget requirement. Even when the state enjoys an unprecedented economic boom, as it did in the 1990s, and saves during that time in anticipation of future budgetary needs, a major hurricane plus a recession can easily wipe out this attempted provision for the future. Thus, to no small extent the current budget crisis was caused not by poor fiscal planning but by a constitutional straitjacket that can constrict even responsible lawmakers. This recent experience shows an intractable problem with relying on the rainy day fund mechanism for smoothing out financial resources across time, where recessions, natural disasters, and fiscal needs fluctuate. The rainy day fund combined with the balanced budget rule, while it has the advantage of requiring the highest caliber of fiscal discipline, errantly presumes that budget planners can predict the future in addition to relying precariously

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159. See 2000 CAFR, supra note 69, at 9 (reporting that the General Assembly allocated $836.6 million for flood relief in a special session devoted to the disaster).
161. See Stephanie Schmitt-Grohé & Martín Uribe, Balanced-Budget Rules, Distortionary Taxes, and Aggregate Instability, 105 J. POL. ECON. 976, 977 (1997). The authors present an economic model that demonstrates that “under a balanced-budget rule the rational expectations equilibrium can be indeterminate.” Id. In other words, assuming that lawmakers exhibit rational expectations behavior, where they predict the future based on the best available knowledge, the balanced budget rule itself creates economic indeterminacy. See id. at 982–86 (modeling the point of indeterminacy in the model). Relaxing the assumption of rational expectations by introducing self-serving motivations and imperfect information within the legislature would increase the indeterminacy of their model. Self-serving motivations, for example, would include overspending during booms as the result of political pressures, and imperfect information is the common phenomenon of not knowing what the future macroeconomic trend will be.
on a particularly austere level of lawmaker altruism.\textsuperscript{162} Financial instruments that allow lawmakers sufficient flexibility to deal with problems more accurately as they arise, rather than engage in guesswork as to what the future will hold, would improve the budgetary climate substantially. The thesis of this Comment is that coupling increased flexibility with constitutional restrictions on spending would be more consistent with the practical realities of the budget process.\textsuperscript{163}

The resulting policy choices have been harsh. While social service and crime problems tend to increase during times of economic hardship, the State was forced to cut social services targeting them in order to close the gap.\textsuperscript{164} Services that were considered to be less essential were cut by a much greater proportion.\textsuperscript{165} Spending on the environment and natural resources, for example, was cut by nine percent in the 2002–03 budget.\textsuperscript{166} Likewise, the pension plans of state employees and higher education tuition rates helped shoulder a significant share of the burden.\textsuperscript{167}

Lastly, a note about the history of revenue sources further illustrates the changed circumstances. In 1868, when the constitutionally mandated balanced budget originated, the primary source of revenue for state and local governments was the property tax.\textsuperscript{168} In 1900, for example, seventy-seven percent of combined state and local revenues came from the property tax.\textsuperscript{169} This trend continued until the 1930s, by which time the State had weaned itself off the property tax.\textsuperscript{170} During this time period, the State also began funding local governmental initiatives at a much greater rate.\textsuperscript{171} The property tax has historically been administered almost exclusively at

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{162}] See Sorensen & Yosah, supra note 122, at 49 (noting the tendency of politicians to overspend during booms). This point is a particularly important argument against relaxing the balanced budget rule because it suggests that lawmakers can overspend during booms and then rely on borrowing to get through revenue downturns. This is a key reason why relaxing the balanced budget rule should be accompanied by a companion restriction in spending growth in order to maximize flexibility while not encouraging the government to grow beyond its efficient size.
\item[\textsuperscript{163}] See infra Part III.D.
\item[\textsuperscript{164}] See ELAINE MEJIA, THE FINAL BUDGET AGREEMENT: LAST, BUT NOT LEAST? 3 (2003).
\item[\textsuperscript{165}] Richard Sutch, Has Social Spending Grown Out of Control?, CHALLENGE, May-June 1996, at 11 (noting the countercyclical nature of social spending).
\item[\textsuperscript{166}] Id.
\item[\textsuperscript{167}] Id. at 4.
\item[\textsuperscript{168}] See STATE AND LOCAL, supra note 11, at 8.
\item[\textsuperscript{169}] Id.
\item[\textsuperscript{170}] Id.
\item[\textsuperscript{171}] Id. at 8–9.
\end{itemize}
\end{footnotesize}
the local level,\textsuperscript{172} and as trends toward state implementation of services increased, the locally assessed property tax became a less attractive option.\textsuperscript{173} The significance of the property tax is that, as a revenue source, it is very stable.\textsuperscript{174} Property values are assessed only occasionally, so the taxes that flow from them remain relatively constant amid economic fluctuations. Thus, revenue stream instability was not nearly the concern that it is today, given the State's dependence on sales tax and income tax collections.\textsuperscript{175}

D. Unsolved Policy Issues Facing the States

This Comment does not argue for a particular level of taxation; rather, it suggests that trends in law and policy call for a constitutional modification of the budget process. However, some reference to significant and progressing policy shortcomings is necessary to illustrate the ongoing pressures on the modern state budget, legal obligations of the state, and the importance of maintaining a constant expenditure stream that is more independent of economic and demographic fluctuations.

Fundamental issues of legal rights as defended by the judicial branch form an important starting point. In his 2001 State of the Judiciary address, newly-elected Chief Justice I. Beverly Lake suggested that the existing funding level was inadequate for the judiciary to meet the legal needs of the state.\textsuperscript{176} Framing the problem as one of constitutional gravity, Chief Justice Lake asserted that the existing budget for the state court system "has not been able to meet adequately our constitutional responsibilities and expand our services as demanded by our growing population."\textsuperscript{177} In particular, he lamented the impact of judicial shortages on children through juvenile court, domestic dispute adjudication, and domestic violence:

I want to stress to you that each and every one of these children is just as important to North Carolina as any child in our public schools or in Smart Start, and I submit to you, they are much

\begin{itemize}
\item \textsuperscript{172} See James A. Maxwell, Financing State and Local Governments 126–27 (rev. ed. 1969).
\item \textsuperscript{173} Id.
\item \textsuperscript{174} Id. at 128, 133.
\item \textsuperscript{175} Comm'n to Modernize State Finances, supra note 35, at 2 (explaining North Carolina's reliance on income and sales tax revenues).
\item \textsuperscript{177} Id.; see also Matthew Eisley, Judiciary Funding Urged, News & Observer (Raleigh, N.C.), Mar. 27, 2001, at A3 (reporting on the Chief Justice's address to the General Assembly).
\end{itemize}
more at risk . . . . We must not let them down by failing to fund their future.\textsuperscript{178}

One of the important tools of the budget-cutter in lean years is not filling job vacancies until the fiscal shortage abates. Shortages in judicial staffing, the Chief Justice lamented, not only decrease the confidence that the public has in the court system and increase the frustration associated with it, but they also implicate basic issues of efficiency.\textsuperscript{179} For example, failure to adequately staff the courts with court reporters sometimes results in increased confusion, delay, and expense to the litigants.\textsuperscript{180}

On the criminal justice side, prisoners' rights continue to be at risk. Given that they are in the full custody of the State, the State has substantial responsibilities to ensure prisoners' constitutionally protected safety.\textsuperscript{181} In particular, the state's older jails that lack sprinkler systems and centrally controlled jail doors may be of significantly greater risk to inmates in the event of a fire.\textsuperscript{182} In this respect, judicial decisions specifying the constitutional rights of prisoners\textsuperscript{183} begin to push against the state constitution's mandate for a balanced budget. Like \textit{Leandro}'s requirement that the North Carolina General Assembly provide a "sound basic education,"\textsuperscript{184} conflicting state constitutional pressures may indeed invite increased litigation over the constitutionality of North Carolina budgets, a situation that is not without precedent in other states.\textsuperscript{185}

\textsuperscript{178} Lake, \textit{supra} note 176, at 5.
\textsuperscript{179} See \textit{id.} at 3, 5.
\textsuperscript{180} See \textit{id.} at 3. In the words of Chief Justice Lake:

> The damage from this kind of breakdown is measured not just in the cost of wasted time and resources, but also in the enormous amount of bad will and hostility generated and directed toward our court system by all those citizens who have been made to suffer the wasteful loss of valuable time out of their lives . . . .

> The cost of a court reporter is minimal compared to this.

\textit{Id.}

\textsuperscript{181} See \textit{generally} Hope v. Pelzer, 536 U.S. 730 (2002) (upholding the importance of humane treatment of prisoners and safe jail conditions as implicated in the Cruel and Unusual Punishment Clause).


\textsuperscript{183} Article I, section 27, of the North Carolina Constitution echoes the U.S. Constitution's prohibition on cruel and unusual punishments. See U.S. CONST. amend. VIII; N.C. CONST. art. I, § 27.


\textsuperscript{185} See \textit{generally} Darryl B. Simko, \textit{Of Pensions, State Constitutional Contract Protection, and Fiscal Restraint}, 69 TEMP. L. REV. 1059, 1064–71 (1996) (analyzing the recent experience of Michigan, New York, and Illinois in terms of the conflicting duties of the legislature to balance the budget while honoring state pension commitments and contracts). Raiding pension funds to balance the budget, which has been one solution of
Another area of concern is more abstract: the general tendency of policymakers to resort to short-term fixes that impose long-term costs when faced with budget pressures.\textsuperscript{186} In a sense, this practice is itself a kind of borrowing. Bad policy in the present and greater costs in the future are the heavy prices to pay for short-term savings. A typical example of this trade-off is a reduction in social spending that leads to increased crime in the future, which in turn translates to higher court costs and more prisoners.\textsuperscript{187} This may potentially be a net fiscal loss for the state, even without considering the negative impact of crime in society and the greatly decreased economic productivity of convicts during incarceration.

These dilemmas, brewing below the surface at present, will eventually surface and have to be faced regardless of the fact that budget makers in a recession are more concerned with bridging the existing fiscal gap than with solving new problems. The General Assembly can, of course, design short-term fixes when fiscal times are tough. In a worst case scenario, these fixes would become the subject of state constitutional litigation that would begin to question whether the state constitution is itself internally inconsistent—requiring the General Assembly to provide a sound basic education for all students, honor the contractual obligations to state pension plans, protect prisoners’ rights, and maintain a court system that does not unconstitutionally delay criminal and civil trials, while still preserving a balanced budget.\textsuperscript{188}

While this scenario may sound more like a clever thought experiment than a realistic possibility, one state supreme court has

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\item North Carolina's General Assembly, may also give rise to a takings claim if the pension funds are to be regarded as private property. \textit{See id.}
\item \textit{See Amy Gardner, Service Groups Fear Budget Ax, News & Observer} (Raleigh, N.C.), Apr. 22, 2002, at A1 (reporting on the cuts in grants given to non-profits and the possible long-term criminal costs associated with the cuts); \textit{see also} John J. Donohue III & Peter Siegelman, \textit{Allocating Resources Among Prisons and Social Programs in the Battle Against Crime}, 27 \textit{J. Legal Stud.} 1, 32–35 (1998) (describing the trade-off between current social spending and future spending on crime prevention). Professors Donohue and Siegelman make an empirical argument that targeted social spending towards at-risk youth will yield lower long-term costs to the state for programs like Job Corps, but that other programs like Head Start cannot be justified under a crime prevention rationale. \textit{Id.} at 35.
\item \textit{But see Leandro,} 346 N.C. at 352, 488 S.E.2d at 258 ("It is axiomatic that the terms or requirements of a constitution cannot be in violation of the same constitution—a constitution cannot violate itself.").
\end{enumerate}
\end{footnotesize}
already handed down this legal bombshell. In *Guinn v. Legislature*, the Nevada Supreme Court determined that the competing constitutional obligations on the state government were irreconcilable and suspended the constitutional requirement of a two-thirds vote to increase taxes. Drawing a distinction between substantive requirements of the government and procedural requirements of the legislative process, the court held that the latter must yield when in conflict. Because the legislature and governor were unable to resolve the impasse over the budget, given the existing contractual obligations of the State, the constitutional mandate for “support and maintenance of the public schools,” and the legislature’s inability to muster a supermajority to raise taxes, the court declared that the legislature was to proceed under simple majority rule. Internal inconsistency in a constitution is quite literally the precipice that can threaten the very viability of a constitutional government, given its dependence on the constitution as the immutable first principle on which the government is founded.

III. MODERN ALTERNATIVES

A. Approaches Taken by Other Governments

Assuming now that there is a case for reconsidering the wisdom of the balanced budget mandate, what practical alternatives are available to policymakers? North Carolina’s budget requirements are relatively strict compared to other states’ balanced budget provisions. Some states merely require that the governor submit a balanced budget to the legislature. Idaho and Texas do not compel the

189. 71 P.3d 1269 (en banc) (Nev. 2003), reh’g dismissed, clarified 76 P.3d 22 (Nev. 2003).
190. *Id.* at 1276.
191. *Id.* at 1275.
192. *Id.*
193. *Id.*
194. *Id.* at 1272.
195. See People v. Anderson, 493 P.2d 880, 886 (Cal. 1972) ("[W]herever possible we construe constitutional provisions in such a way as to reconcile potential conflict among provisions and give effect to each . . ."); *Guinn*, 71 P.3d at 1275; Leandro v. State, 346 N.C. 336, 352, 488 S.E.2d 249, 258 (1997) ("It is axiomatic that the terms or requirements of a constitution cannot be in violation of the same constitution—a constitution cannot violate itself."); Fino, *supra* note 48, at 775 (discussing the financial crunch that states have suffered as a result of tax restrictions combined with spending mandates).
196. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM, 1 BUDGET PROCESSES AND TAX SYSTEMS 6 (1993)
governor to submit a balanced budget but do require the legislature to pass a balanced budget, though the final deal between the executive and legislature need not be balanced. Conversely, Kansas mandates that the governor and legislature both present balanced budgets, but does not impose a requirement that the final deal be balanced. Lastly, Vermont, now alone among the states, continues to impose no budgetary restrictions on lawmakers with respect to budget balancing.

There are many other differences in the details of these requirements across the country. For example, some states, such as Massachusetts, Alabama, Alaska, and North Carolina,

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197. IDAHO CONST. art. VII, § 11.
198. TEX. CONST. art. III, § 49.
199. SIGNIFICANT FEATURES OF FISCAL FEDERALISM, supra note 196, at 6.
201. SIGNIFICANT FEATURES OF FISCAL FEDERALISM, supra note 196, at 6.
202. MASS. CONST. art. LXII, §§ 2, 3. These sections provide the following restriction:
Section 2. The commonwealth may borrow money to repel invasion, suppress insurrection, defend the commonwealth, or to assist the United States in case of war, and may also borrow money in anticipation of receipts from taxes or other sources, such loan to be paid out of the revenue of the year in which it is created.
Section 3. In addition to the loans which may be contracted as before provided, the commonwealth may borrow money only by a vote, taken by the yeas and nays, of two-thirds of each house of the general court present and voting thereon.
The governor shall recommend to the general court the term for which any loan shall be contracted.
Id.; see also MASS. GEN. LAWS ch. 29, § 6E (2003) (regulating the budget balancing by statute); Opinion of Justices to Senate, 236 N.E.2d 523, 527 (Mass. 1968) (stating that borrowing by public authorities under the control of the executive branch does not violate the constitutional debt restriction).
203. ALA. CONST. art. XI, § 213, amended by ALA. CONST. amend. XXVI.
204. ALASKA CONST. art. IX, § 8 (“No state debt shall be contracted unless authorized by law for capital improvements or unless authorized by law for housing loans for veterans, and ratified by a majority of the qualified voters of the State who vote on the question.”).
205. N.C. CONST. art. V, § 3; see also id. art. III, § 5(3) (requiring the Governor to ensure that no actual fiscal deficit arises during the year).
require balanced budgets as a part of the constitutional charter, whereas Mississippi\textsuperscript{206} and Arkansas\textsuperscript{207} impose balanced budget requirements solely by statute.\textsuperscript{208} Further, some mechanisms are stronger than others. For example, Idaho’s constitution requires a balanced budget, but apparently “there are no sanctions”\textsuperscript{209} for failing to balance the budget, as the legislature has over-appropriated budgets without successful challenge.\textsuperscript{210} New York and Virginia do not have balanced budget requirements with respect to bill passage, but rather impose a requirement on the executive not to spend more than actual revenues.\textsuperscript{211}

When a particular year’s revenue projections fall short of the legislature’s desired appropriations, there are two possible remedies for preserving a constant supply of governmental goods and services: spend the savings or borrow from the future. All states, including North Carolina,\textsuperscript{212} have provisions for saving when revenues exceed budgeted expenditures.\textsuperscript{213} Virtually every state has a unique method of dealing with such situations, ranging from complete legislative discretion\textsuperscript{214} to the automatic reversion of excesses to a reserve fund.\textsuperscript{215} North Carolina falls somewhere in the middle; by default, 25% of the annual excesses go into the rainy day fund until they reach 5% of the general operations budget total for the year.\textsuperscript{216} However, this mechanism is subject to the approval of the General Assembly\textsuperscript{217} and the governor through the legislative process.\textsuperscript{218}

Eventually, however, shortfalls will occur. Just as few private

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\item[206.] MISS. CODE ANN. §§ 27-103 to -139 (2003).
\item[207.] See ARK. CODE ANN. § 19-2-104 (1987) (mandating that state officials not spend more than their respective departments are appropriated). \textit{But cf.} ARK. CONST. art. V, § 39 (requiring a supermajority of seventy-five percent for any budget that exceeds $2.5 million in spending on items other than education, highways, confederate pensions, and state debt).
\item[208.] \textit{Significant Features of Fiscal Federalism}, supra note 196, at 6.
\item[209.] \textit{Id.} at 7.
\item[210.] \textit{Id.}.
\item[211.] \textit{Id.}; see also N.C. CONST. art. III, § 5(3) (requiring the Governor to maintain a balanced budget during the fiscal year).
\item[212.] See infra notes 229–32 and accompanying text.
\item[213.] \textit{Significant Features of Fiscal Federalism}, supra note 196, at 8 (noting that Kansas and Kentucky deposit money for state budget stabilization funds by appropriation).
\item[214.] See \textit{id.}.
\item[215.] \textit{Id.} (noting that Colorado has an automatic mechanism).
\item[216.] COMM’N TO MODERNIZE STATE FINANCES, \textit{supra} note 35, at 13.
\item[217.] \textit{Id.} at 9.
\item[218.] N.C. CONST. art. II, § 22(1).
\end{enumerate}
\end{footnotesize}
citizens go through life relying exclusively on savings, so too can governments be expected to run into severe—though temporary—shortfalls caused either by recessions or unpredictable expenditures resulting from, for example, natural disasters. If states like North Carolina should no longer be held to such strict budgetary requirements, there needs to be some workable policy solution that gives policymakers flexibility, while at the same time not giving the foxes the keys to the henhouse. Unrestricted, chronic borrowing remains as economically destructive as it was perceived to be in the eighteenth and early nineteenth centuries, when the American system of governance was being codified. Even though the Model State Constitution does not restrict borrowing, such a permissive recommendation would run the risk of creating precisely the temptation against which the balanced budget provision was designed to protect.

Perhaps the single biggest contributor to this danger is the public choice problem that lawmakers who pledge the state's full faith and credit in return for long-term debt do not internalize the full cost of their actions. Most legislators are highly unlikely to be in the legislature by the time a twenty- or thirty-year bond fully matures. For that reason, they face a skewed incentive structure; as profit maximizers, they will face the temptation of creating a project in the present time or lowering taxes to the great applause of their constituents while writing off the cost to a later generation of


220. See supra notes 157-62 and accompanying text.

221. Approximately half of the states require not just balanced budgets to be proposed but also to be either passed or implemented by the executive. SIGNIFICANT FEATURES OF FISCAL FEDERALISM, supra note 196, at 6.

222. In general, early American politicians were highly skeptical of public debt and worried that it, in the words of President Jefferson, could constitute "the greatest of the dangers to be feared" in the American governmental experiment. Id. at 13. Even the statist Alexander Hamilton recommended that public debt be avoided so as to build the nation's credit. Id. President Jackson built a good portion of his presidency around abolishing the national debt and has the distinction of being the only president in the nation's history to have passed on a debt-free government to his successor. Id. at 13-14. For more on period views on public debt, see generally William Breit, Starving the Leviathan: Balanced Budget Prescriptions before Keynes, in FISCAL RESPONSIBILITY IN CONSTITUTIONAL DEMOCRACY (James M. Buchanan & Richard E. Wagner eds., 1978).


224. See generally Einer Elhauge, Are Term Limits Undemocratic?, 64 U. CHI. L. REV. 83, 146 (1997) (stating that the average tenure, even at the higher rates of incumbency in the period studied, was about twelve years for persons in the United States Congress).
taxpayers.\textsuperscript{225} Such may be the case for the current federal debt load, currently over $4.5 trillion.\textsuperscript{226} It is hardly surprising that there are no constitutional limitations on the national Congress in maintaining fiscal responsibility.

\textbf{B. Procedural Alternatives}

Currently, state and federal governments in the United States restrict themselves to no debt without referendum or virtually unrestricted borrowing, or various procedural limitations on debt creation in the legislative process.\textsuperscript{227} Within that range, there are a number of mechanisms between utter fiscal freedom and the absolute prohibition on state debt without a referendum/special exception. One possibility is simply to make the balanced budget requirement statutory instead of constitutional. This approach, however, is probably neither realistic nor particularly desirable. At the practical level, the General Assembly might pass a statute that provided that, should a voter referendum on repealing the constitutional balanced budget requirement pass, a statutory mandate would become effective. Of course, such a deal with the voters would still amount to the legislature asking the citizenry to give it the keys to the henhouse just to keep it safe. While a legislature that later decided to void the statute would probably face the wrath of the voters, a shrewd legislature would be able to chip away at the law so as to render it ineffective while flying under their constituents’ political radar.

More palatable would be constitutional amendments that limit the legislature in some appropriate manner. Requiring a supermajority—perhaps either three-fifths or two-thirds—of both houses of the General Assembly in order to create public debt without voter approval would be one such check, virtually requiring some form of bipartisan resolve in order to create debt. While this would give a unified legislature flexibility to deal with a budget crisis with whatever financial instrument it sees as appropriate, it does not fully deal with the public choice problem of lawmakers putting off payment until after they leave office.

\textsuperscript{225} See Brown, \textit{supra} note 186, at 643–44.
\textsuperscript{227} Cynthia Sneed, \textit{An Examination of the Effects of Balanced Budget Laws on State Borrowing Costs}, 14 \textit{J. PUB. BUDGETING ACCT. & FIN. MGMT.} 159, 162–64 (Winter 2002) (providing a “summary of the state balanced budget laws including where in the budgeting process the budget is required to be balanced”).
C. *Substantive Alternatives*

In addition to the above procedural devices, there are a number of financial tools designed to alleviate fiscal fluctuations under the constraint of heightened policy obligations.\(^{228}\) First, an increase in the size of the required contribution to the Savings Reserve Fund, or rainy day fund, would help to mandate greater fiscal austerity.\(^{229}\) Currently, the State must deposit twenty-five percent of the money collected in taxes but not allocated in a given fiscal year.\(^{230}\) By raising this requirement to, for example, fifty percent, the State would merely be requiring that more of the windfall from a stronger-than-expected economy would be reserved for future needs. This recommendation, adopted by the Governor’s Commission to Modernize State Finances,\(^ {231}\) makes excellent sense, but it does not solve the problem of unforeseen fiscal shocks.\(^ {232}\)

Moreover, as the rainy day fund increases in size, this perverse incentive structure creates an incentive for lawmakers to fabricate or exaggerate crises in a given governmental program, crises that call for spending out of the rainy day fund. Given that lawmakers do not know when a recession will occur, they will, facing uncertainty, be even more inclined to spend the money in the current time period, given that the general expectation during economic booms is that they will continue for the foreseeable future. The perceived current need for a given program is simply more palpable than the unforeseen, speculative future recessionary need. Lastly, even if the legislature were to act in an unusually prudent manner and save for the future, the rainy day fund does involve tying up economic resources in the government’s coffers.

Going the opposite direction and simply requiring spending cuts in down years would solve the problem, albeit in a rather harsh manner. While this Comment strongly contends that spending cuts which follow declines in tax receipts are bad policy in the modern governing environment, it must mention the alternative. Not only is it a major part of the current approach, but also it has intuitive appeal for a private citizen who would rather have guaranteed austerity in

\(^{228}\) See generally *Budget Processes in the States*, supra note 196, at 59–66 (summarizing the contingency fund programs in all fifty states).

\(^{229}\) See *Comm’n to Modernize State Finances*, supra note 35, at 14 (recommending an increase in the mandatory contribution to the Savings Reserve Account).

\(^{230}\) *Id.* at 13.

\(^{231}\) *Id.* at 14.

\(^{232}\) See supra notes 150–63 and accompanying text.
the state budget than have to engage in the costs of overseeing the public sector's fiscal responsibility as a voter. This Comment, however, takes the position that the modern tax structure, policy priorities, the heightened need for public spending in recessionary periods, and recent judicial trends require greater flexibility in order to create the optimal state governing situation.

Mechanisms that best internalize the cost of debt are most preferable, because they would give legislators the incentive to design fiscal policy with fuller consideration of the true costs of deficit spending. They also lower the need for citizens to oversee whether their representatives are acting in a fiscally responsible manner. One plausible mechanism would preserve the balanced budget requirement but change it to a longer-term balance, in which only the four-year total need be debt-free. In effect, it preserves the existing mechanism but allows for more flexibility in the event of a short-term fiscal shock. The advantage of this mechanism is its intuitive appeal. In the practical setting of a voter referendum, amendment proponents can make the argument that the legislature could have planned better around the current fiscal pinch had it been able to deal with a four-year budgetary cycle instead of the current two-year cycle. Further, by aligning this period with the governor's four-year term, the voters can hold the executive clearly accountable for a four-year plan.

The downside of this proposition is that the uncertainty of forecasting into the future remains. While it would give lawmakers greater flexibility if a shortfall occurred early in the four-year cycle, it would hardly be different from the current system if the unanticipated shortfall occurred in the last year of the cycle. In that situation, as in the current one, solvency in that year would depend on ex ante saving for the uncertain future.

D. A Deal: Short Term Debt Creation Plus a Cap on Spending Increases

Perhaps the best instrument for the voters to give to the legislature and governor would be the power to create short-term debt without a referendum. By delegating the power to create fiscal instruments like a five-year bond, the problem of predicting future shortfalls is avoided, while the legislature still must pay the debt back soon enough that the legislators and/or political party that advocated for the bonds would remain closely connected to their maturation date. Even if individual legislators retire before the maturation date of the five-year bond, their political party would likely still remain accountable to the electorate for responsible decision-making.
Because bonds would be short-term, there would be significantly less opportunity to run up a lot of debt. Lastly, policymakers would have the benefit of planning for the future based on a clearer picture of the problem. Once the problem comes into focus, a more precise budget can be crafted using responsible borrowing while maintaining fiscal balance. The problem of having to go through the particularly cumbersome and uncertain referendum procedure would be unnecessary, except in the case where some over-arching problem required long-term debt.\footnote{233} This solution, then, achieves the intuitively appealing result of broadening the fiscal period to a five-year period while allowing solutions to be crafted as problems arise. Because the period is so short, there is a strong disincentive to rack up enormous amounts of debt like the federal government has done while still giving the legislature the power to deal flexibly with problems as they manifest themselves.

Allowing for short-term debt instruments without a referendum gives the legislature an incentive to overspend, however, given that a legislature can continue to add to the debt load with ever-larger short-term debt creation. So, while short-term debt partially internalizes the political costs of borrowing, it does not do so completely. For that reason, a companion constitutional provision that restricts expenditures to a set percentage of the state’s gross domestic product would give the voters the assurance that the underlying overall tax bill would not spiral out of control. Expenditure limitations are increasingly popular across the country.\footnote{234} Tying increases in expenditures to the growth in personal income without a voter referendum can be a strong form of restraining the public sector\footnote{235} and can offset the greater flexibility of added

\footnote{233. As a testament to the difficulty of this procedure, it took a monumental, multi-million dollar lobbying effort to get the higher education bond referendum passed in North Carolina’s 2002 general election. The bill to put the referendum on the ballot unanimously passed both houses of the General Assembly, and the fiscally conservative N.C. Citizens for Business and Industry led the publicity campaign for the referendum. See Jane Stancill, $3.1 Billion Plan for N. C. Colleges Heads to Voters, NEWS & OBSERVER (Raleigh, N.C.), May 19, 2000, at B1. As further testament to the energetic support the referendum got from the state’s leaders, news articles like this one virtually read like press releases from the pro-referendum lobby.}


\footnote{235. But see Tobin, supra note 1, at 155 (contending that a serious drawback of adding constitutional limits on the budgetary process is increased judicial activism in budget
flexibility in financing that would come from the above debt proposal.

This two-tiered referendum operates essentially as a bargain that the legislature offers to the voters. In return for having greater flexibility to smooth out sources of revenue, it consents to being subjected to a strict cap on spending, which is, in the long run, simply the definition of the liabilities that the government creates and for which taxpayers are ultimately responsible. Both parties therefore get what they most desire. The taxpayers get more assurance of fiscal austerity than they currently have, and the General Assembly has more fiscal flexibility to manage the continuity of government services and to deal with short-term revenue shocks, a flexibility which, as argued in Part II, it sorely needs in the modern economic and policy environment. In the long run, politicians even benefit somewhat from a spending growth cap because it reduces the ability of the legislature during expansionary periods to spend as much as it receives in the increased revenues coming from corporate and personal income taxes, therefore creating expectations within and outside the government for continued services at that level. The fact that a legislature in the following economic recession cannot possibly maintain that level of services absent a tax increase unfairly penalizes the recession-era government in the political sphere while unfairly rewarding the boom-era government.

That is precisely, however, what happened in North Carolina and across the country in the 1990s expansion versus the early 2000s recession. The unrealistic expectation of never-ending high state revenues mushroomed government services during the 1990s and left the subsequent politicians with the problem of having to deal out the tough medicine when revenues collapsed and the fiscal crisis developed. It is no surprise that Governor Easley, the recession-era

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Professor Tobin's concern certainly has been borne out in Guinn v. Legislature, where the Nevada Supreme Court decided to suspend part of the constitution as a solution to a political budget impasse. See generally Guinn v. Legislature, 71 P.3d 1269 (Nev. 2003), reh'g dismissed, clarified 76 P.3d 22 (Nev. 2003) (declaring a constitutional provision requiring a two-thirds supermajority for revenue raising legislation void as inconsistent with the constitutional requirement to fund public education); supra notes 189-95 and accompanying text.

Part II, infra, develops a case for converging statutory, legal, and economic trends creating a systemic fiscal dilemma for state government. See also Fino, supra note 48, at 775 (describing the financial impracticalities of voter referenda that constrain state financial flexibility on the revenue side while calling for ongoing programs involving substantial spending).

See supra notes 18, 53-63 and accompanying text.

See supra notes 17-18, 150-52 and accompanying text.
governor, has proposed a spending cap,\textsuperscript{239} as his administration has had to bargain with the General Assembly to hammer out the unpopular cuts to programs that were so enthusiastically expanded in the previous eight years.\textsuperscript{240}

Expenditure limits now exist in well over half the states, either in statutory or in constitutional form.\textsuperscript{241} The evidence on their ability to restrain fiscal expansion is increasingly robust.\textsuperscript{242} Innovation at the state level in expenditure limit mechanisms has been substantial. For example, Colorado has perhaps the most austere form of spending cap: its current form is a constitutional limit that bars increases in spending beyond the previous year’s level plus the rate of inflation.\textsuperscript{243} Connecticut\textsuperscript{244} and Michigan,\textsuperscript{245} on the other hand, have spending restrictions tied to increases in personal income, such that the overall percentage of income that goes to the state government remains relatively constant absent voter approval. Regardless of which specific mechanism would be chosen, the deal would remain the

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\item \textsuperscript{240} See supra notes 17–19 and accompanying text.
\item \textsuperscript{241} New, supra note 234, at 4; see, e.g., CONN. CONST. art. III, § 18. The amendment states, in relevant part:
\begin{quote}
The general assembly shall not authorize an increase in general budget expenditures for any fiscal year above the amount of general budget expenditures authorized for the previous fiscal year by a percentage which exceeds the greater of the percentage increase in personal income or the percentage increase in inflation, unless the governor declares an emergency or the existence of extraordinary circumstances and at least three-fifths of the members of each house of the general assembly vote to exceed such limit for the purposes of such emergency or extraordinary circumstances.
\end{quote}
\item \textsuperscript{242} See New, supra note 234, at 5–6. But see James Bennett & Thomas DiLorenzo, \textit{Off-Budget Activities of Local Governments: The Bane of the Tax Revolt}, 39 PUB. CHOICE 333–34 (1982) (noting that states can get around state-level spending limits by giving responsibilities to local governments). In North Carolina, that criticism would be less applicable, given that local governments are bound by the general prohibition on debt creation absent a referendum. N.C. CONST. art. V, § 4. In addition, municipalities can only impose taxes that the General Assembly authorizes. N.C. GEN. STAT. § 160A-206 (2001).
\item \textsuperscript{243} COLO. CONST. art. X, § 20 (“The Taxpayer’s Bill of Rights”); see also CAL. CONST. art. XIIIIB, § 1 (limiting increases in parts of the state budget to inflation plus population growth). Cf. New, supra note 234, at 4 (noting that this limitation does not pertain to total expenditures).
\item \textsuperscript{244} CONN. CONST. art. III, § 18.
\item \textsuperscript{245} MICH. CONST. art. 1X, § 26.
\end{itemize}
same: the voters give the legislature flexibility in return for spending restrictions. Such a bargain would provide an incentive for the legislature to put the referendum on the ballot, as well as for the voters to ratify the amendments. The end result would be fiscal austerity combined with the financial maturity that would give the State a much stronger position in advocating for greater responsibility over public policy matters at the federal level. With greater accountability to the citizens with respect to spending, as well as greatly expanded flexibility to provide continuous services across revenue fluctuations, this approach would combine the best of both worlds and answer perhaps one of the greater objections to federalism—the question of whether the states are better equipped to deal with policy problems than the federal government.246 This recurring theme affects all areas of law in questions of federal-state relations—congressional legislation,247 federal administrative decisions,248 and constitutional trends.249

CONCLUSION

North Carolina is but one of forty-eight states that are projected to face fiscal shortfalls for 2003–04.250 While aid from the federal government to help stem the problem would be a convenient fix,251 the large budget deficit at the federal level, along with impending tax

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246. See, e.g., William W. Buzbee, Brownfields, Environmental Federalism, and Institutional Determinism, 21 WM. & MARY ENVTL. L. & POL’Y REV. 1, 3 (1997) (contending that the federal government has generally outpaced the states in expertise regarding environmental policy); Richard L. Revesz, Federalism and Interstate Environmental Externalities, 144 U. PA. L. REV. 2341, 2375 n.123 (1996) (arguing that the federal government has a strong argument for control over environmental policy because of its greater expertise that states have trouble duplicating); Joel H. Swift, Fiscal Federalism: Who Controls the States' Purse Strings?, 63 TEMP. L. REV. 251, 254 (1990) ("[I]ndependent state initiation of spending programs, such as unemployment compensation insurance and income assistance to dependent families, has furthered the states' function as 'laboratories for experimentation' within our federal system."); For a discussion of judicial enforcement of constitutionally based federalism principles as a policy matter, see United States v. Lopez, 514 U.S. 549, 583 (1995); Ann Althouse, Inside the Federalism Cases: Concern About the Federal Courts, 574 ANNALS 132, 137 (2001); supra notes 90–97, 106–10, 130–40 and accompanying text.

247. See supra notes 68–98 and accompanying text.

248. See supra notes 99–105 and accompanying text.

249. See supra notes 134–43 and accompanying text.


251. See generally LAV, supra note 2 (arguing that federal aid is the best way to alleviate the ongoing state fiscal crises).
cuts and a Republican-controlled Congress and White House, makes a federal bail-out unlikely. North Carolina has used many of its short-term fixes and still faces a projected deficit. Having already identified many budget cuts that are less painful and used up its reserve of one-time fixes, 2003–04 promises to be another budget full of particularly difficult decisions. Without the benefit of flexible financing, it is hard to believe that short-term fixes with long-term greater costs, scrapped valuable investments, and neglected new responsibilities will not be prominent features of the budget. Like many states across the nation, many disparate trends have converged to create what is not merely a temporary fiscal crisis, but may well turn into a more fundamental crisis in confidence in state government's power to deal with modern policy problems. If states are to advocate for more state and local control of policy issues and for flexibility to innovate in the area of government services, they will continue to undercut their own arguments by the crippling nature of their financial capabilities. Gone are the days when state and local governments financed their pursuits with the stable property tax and policy objectives were limited in an agrarian society. North Carolina, the case in point for this Comment, commands a budget of $14 billion, a budget larger than that of Pakistan, the Philippines, or even Kuwait. Current political as well as federal judicial trends promote the importance of governmental action at the state level. A compelling case exists that the state constitution has not kept up with the times and that North Carolina has an opportunity to take a leadership position and strike an important new path towards modernization of state government in the American system. As John J. Parker, former Chief Judge of the Fourth Circuit Court of Appeals stated regarding the role of the state constitution:

The purpose of a state constitution is two-fold: (1) to protect the rights of the individual from encroachment by the state; and (2) to provide a framework of government for the state and its subdivisions. It is not the function of a constitution to deal with temporary conditions, but to lay down general principles of government which must be observed amid changing conditions. It follows, then, that a constitution should not contain elaborate

253. Kane, supra note 43.
254. Id.
legislative provisions, but should lay down briefly and clearly fundamental principles upon which government shall proceed, leaving it to the people's representatives to apply these principles through legislation to conditions as they arise.\(^{256}\)

The current North Carolina constitution, like that of many state constitutions, erects an inflexible legislative provision about how to finance and cope with trends in law, policy, and the economy. A public reassessment of long-standing restrictions on state debt would contribute greatly to the effectiveness of the modern state and its fundamental place in the American system of federalism.

ROBERT WARD SHAW

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256. Sanders, supra note 14, at 50.