DEALING WITH A STATE BUDGET CRISIS
An Interview with Jim Johnson

Interviewed by Gray Wilson‡

Jim Johnson is a Visiting Professor of the Practice at the Sanford School of Public Policy at Duke University. Mr. Johnson is also a partner in Blount Street Advisors, a Raleigh-based government relations and business consulting firm that he founded in 2006. Until December 2005, he was the Director of the North Carolina General Assembly’s Fiscal Research Division, which is the legislature’s nonpartisan budget and finance policy staff. Before becoming director in 1999, he worked at the Division on budgetary and policy issues in K-12 education and in health and human services. Mr. Johnson is a graduate of the University of North Carolina-Chapel Hill, where he earned a Bachelor of Arts in political science, and of North Carolina State University, where he earned a Master of Public Administration. He has also participated in the Program for Senior Executives in State and Local Government at the Harvard Kennedy School of Government.

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I recently spoke with Mr. Johnson about his insights into the budget crises currently facing North Carolina and other states across the country. In the following excerpts, he discusses government employee pension funds, revenue-side solutions, the effects of the crisis on local governments, the role of the federal government in dealing with the crisis, and privatization.

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GW: Dealing with state employee retirement plans seems to be a relatively universal problem across states.

JJ: Well, I think the problem isn't the same in all the states, number one. It's not the same in North Carolina as in, say, Illinois. North Carolina's pension fund is currently funded at approximately 95-100 percent of its projected liabilities to current and future retirees—and there's a story about how it got to this level of funding. There were decisions made a couple of decades ago to reduce the unfunded liability, and successive Governors and the legislature stayed on that path. The reason we're somewhat below 100 percent right now is very straightforward. Number one, the stock market went down. Number two, a very conscious decision was made in 2001 to reduce the contribution to the pension fund, because at that time the system was funded in excess of its liabilities, at 104-105 percent. I was the director at the Fiscal Research Division at that time and agreed with the decision. The legislators saw temporarily reducing the funding as a trade off against cuts in other areas of the budget, specifically education and human services. The problem is that the state did not return to a higher contribution rate after recession ended and revenues increased again.

JJ: I think the issue of defined-benefit versus defined-contribution is somewhat of a separate policy question from the funding of liabilities. There are good reasons . . . to argue that you ought to go to defined-contribution. The major reason is that it's portable, and [young professionals don't] think you're going to work anywhere more than five years in a row, and you can't take a defined-benefit with you to the next job. So there's an argument that the defined-contribution plan benefits your younger employees. In the long run a defined contribution plan gives you better control over your costs because the employer's liabilities do not exceed the dollar amount provided to the employee – there is no guaranteed benefit.

---Government Employee Pension Funds---

i Explanatory note: A defined-benefit pension plan is one in which a retired employee's benefits are determined by a set formula, and do not depend on investment returns. A defined-contribution plan is one in which an employee pays into an individual account during his or her career, and benefits upon retirement depend on investment returns from that account. The employer may also make a contribution to the individual account, but has no financial liability beyond that amount.
JJ: If you actually run the numbers in NC the transition costs to a defined-contribution would probably be greater in the intermediate term than the cost of the defined benefit plan alone, because of the need to fund both plans. Now that might be an expense you want to incur, for good policy reasons, but the transition costs have to be funded. If you cap the defined benefit retirement system and say that nobody can qualify for that plan who is not currently vested, then you are operating two programs until all of the beneficiaries of the defined benefit plan die. When I came to work for the General Assembly in the mid 1970's the state operated a retirement home for the widows and daughters of Confederate Veterans. Liabilities can last a long time.

GW: Do you think NC’s experience in dealing with the pension plan has been different because its state employees don’t have collective bargaining rights?

JJ: Probably. . . . The legislature has maintained tight control over COLAs [Cost-of-Living Adjustments], so there is no statutory right to an automatic COLA increase in the state retirement system. There are two explanations for that. You might say “Oh, well that’s just great budgeting.” True. Well it’s also great politics. Why is that? Because if you create by statute an automatic COLA, the employees are going to be back saying, “Well, what have you done for me lately?” And they forget that you’ve given them the COLA. On the other hand – some very clever retail politicians figured this out – if we make the employee groups come to us every year, (a) we don’t have to give them as much because the first thing they’ll have to do is to spend their political effort to get the COLA, and the second thing is that we can control the cost. But it was as much political as it was good budgeting. But it’s good politics not to give away the COLA, so that you can give something away every year – or not give it away every year to control your costs. It also turns out that these same politicians created in statute and in the House and Senate rules a system that requires two actuarial estimates for the cost of any bill that makes changes to the state or local government retirement systems. These actuarial fiscal notes must be complete before the bill is considered.

COLAs also lead to a very interesting question in North Carolina and in a number of other states about implied contracts in the public sector. The legal theory of implied contracts in North Carolina is present in something called
the Bailey case. The N.C. Supreme Court said there was an implied contract that retirement benefits would not be taxed, and therefore the benefits of employees who were fully vested in 1989 were exempt from state income tax. In my opinion the Court should not have injected itself into what is essentially a tax policy issue that properly was the responsibility of the General Assembly and the Governor.

The doctrine of implied contracts is not unique to North Carolina. In Colorado, where the legislature has tried to take back the COLA statute, apparently attorneys for employees are arguing against the statute on the basis that once you have granted a COLA by statute that the legislature cannot repeal that statute. So I think that what [the North Carolina legislature] avoided having to deal with that doctrine on COLA. There’s a debate this year as to whether retirees and employees can be required to pay for some portion of their health insurance cost. If the bill passes there will probably be litigation based on the implied contract doctrine.

But I think if North Carolina had collective bargaining, there would probably have been bargaining around things like automatic COLAs. That would have been very logical for the employees’ associations – teachers, state, employees, and retirees. The legislature so far has resisted, and I think that’s pretty well dead now, maybe for the next decade.

---Revenue-Side Solutions---

GW: What’s the role of revenue-side solutions in solving the state budget crisis?

JJ: Well, let’s go back to the question of what caused the crisis. The problem clearly is that the revenue has dropped—especially sales and personal income taxes. It’s not just all spending.

With the sales tax one of the big issues in every state is whether you tax services, and how you might do that. Some states currently tax services more than others. North Carolina does it only a little. Some states like Florida attempted

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it unsuccessfully. Texas applies the sales tax to a fair amount of services. So I think that the restructuring of the state sales tax to broaden the base is going to be a continuing issue. . . Interestingly enough, some Republicans are beginning to talk about it, and they talked about it during the last election. They think about it as broadening the revenue base, but setting the rate so that it is revenue-neutral. The projection of a revenue-neutral rate for services that are not currently taxed that is a very serious technical challenge. The current majority in the North Carolina legislature doesn’t see increasing taxes as an option. It’s possible that in the next elections in some states one of the issues will be tax reform, including a sales tax on services. We will also likely see a continued debate on a sales tax on internet purchases, with the on-line sellers like Amazon continuing to resist this effort, and the retail merchants with a bricks and mortar presence supporting the application of the sales tax to decrease the on-line seller’s comparative price advantage.

--- Local Governments---

GW: Are local governments getting the short end of the stick in all of this?

JJ: Yes. A couple of things are going to happen.

Since most of the state budget is in education, as state aid to public schools and community colleges is cut, it will be the local school boards—because of the way that education is governed in this state—who are going to be responsible for firing teachers. . . . The buck will stop at the local level with the school boards and the county commissioners.

At the local level the values of commercial and residential property that are subject to the property tax have dropped dramatically. The mantra on Wall Street was “Housing prices have never dropped more than five percent two years in a row since the Great Depression.” Well they did. What’s happening now is that—and it’s just beginning to play out in different counties in North Carolina, and across the country—as property is revalued over the next few years, the property tax base, which makes up most of the local government revenues in this state, is going to shrink. If you look at Florida, Nevada, and some of the beach communities in North Carolina there is going to be less local government revenue coming from the existing property tax base. The choice will be cutting services or raising the property tax rate, never an easy
decision. County and city property tax revenues are used to fund schools, community colleges, health departments, parks, and some streets and roads, and other municipal service. This decline in property tax revenue is lagging the revenue declines at the state level, because of this revaluation cycle, that's usually three to seven years.

GW: So between losing money on property revaluation and losing funding from the state government, how are local governments going to be able to sustain the public schools?

JJ: Well let's put it another way. Even with the sales tax rebounding, which it is, it's not enough to close the gap. I happen to think that it's going to be very challenging for the public schools. Local money is mostly in teachers and buildings. At the state level it's probably 80 percent plus when you add in the fringe benefits, retirement, and health benefit costs. So I think it's going to be very challenging. We are likely to see bigger class sizes in K-12, like we're already seeing in the universities and community colleges. We're also probably going to have fewer assistant principals, guidance counselors and personnel that many legislators do not see as classroom-related positions.

An interesting question that I'm thinking about is when does the impact of the cuts become so great that the issue goes to court? In almost every state in the country there have been lawsuits based on the state constitutions— not the federal—around the rights of students. In North Carolina . . . it's the right to a sound basic education.

Similar questions arise in the mental health systems around the country, which are primarily funded by the states. Cutting funding is not a federal budget question, but if you ask the question from a legal standpoint “where did all of these patients rights in the mental health system come from?” starting in the early 1970s, many of the rights of the mentally ill have their roots in case law in the federal courts, deeply embedded in an entire string of cases that have been litigated through the appellate courts. It's very difficult to imagine the Roberts Court undoing what is 25-30 years worth of case law in this area. And when I say mental health, I'm grouping a number of things together—the mentally ill, the developmentally disabled and substance abuse. In the public schools, there are certain rights attached to special ed[ucation], and those are tied to both federal and state law. Both federal and state money support special education.
So I think that with all of these systems, questions will now arise on the legal side as to—GW: What’s the floor?—JJ: Yes what’s the floor, that’s a good way of saying it, or has the floor now become the basement?

GW: How can states reform their budget processes to insulate themselves the next time something like this comes around?

JJ: Well, they can’t . . . . in a downturn of this magnitude you can’t insulate yourself, but there will be a good deal of conversations going forward about the size of reserve funds.

---The Role of the Federal Government---

GW: What’s the role of the federal government in helping states through this? Does it have a role? Should it have a role?

JJ: Well the answer is they should, in my opinion, but that’s a value judgment. If you look at the biggest item in state budgets—in total dollars, not just state dollars—it’s the Medicaid program. In every state in the country now, with a couple of exceptions somewhere, the Medicaid budget is bigger in total than your school budget. Education generally is the biggest state expenditure, but in total Medicaid is bigger. And I think the debate is now, how much flexibility—and we’ve been through this before—the state should be given to manage the Medicaid program, how does that fit in with what happens with the National Health Program. There are folks . . . who think that Medicaid at some point should be shifted upstream to the national level . . . On the other hand, [shifting responsibility for Medicaid to the federal government would] probably leave [states] with less room for experimentation. If the states don’t have any skin in the game there’s not much incentive to the governors to experiment. And there’s always, given the diversity among the fifty states, a good reason to think about experimentation in the US.

---The Role of Privatization---

GW: What’s the role of privatization in dealing with the budget crisis?
JJ: Well, and I’ll say I have a vested interest in this, iii there are a lot of different places that you might think about privatization, and the record is mixed as far as I can tell, and I don’t know that we’ve necessarily created a set of best practices. We tried it in the prison system in North Carolina and it just didn’t work very well, and we wound up taking them back over. Maybe the state picked the wrong company, who knows. On the other hand the state has successfully outsourced a number of IT services for years. The question is whether you have systems in place where you really can judge what the costs and outcomes of privatization. It’s kind of geeky, but those systems need to be in place to determine if you’re getting good value for the taxpayer. In my opinion, there is a role for the private sector in providing various services. I think that it’s very difficult, especially in the area of infrastructure (transportation, technology, water and waste water) for the government to mobilize the capital that’s needed without engaging the private sector.

---A Piece of Advice---

GW: What advice do you have for the next generation of policy-makers?

This is a great time to be in the public sector, and a great challenge. I think that what I see right now is, especially among many of the people that I’ve worked with who are now in key positions across state government, this continued budget crisis is burning them out. And that’s not unexpected. Public managers have been dealing with a budget crisis since 2000. There was a short interlude of a year or two about mid-decade, and then problems begin again in 2008. So keep your optimism is my first piece of advice, bring that with you to your new position. Optimism, new ideas, and different ways of looking at problems are ways you can impact the lives of people. I think trying to make a difference is why we all got in this business.

iii In his government relations consulting work, Mr. Johnson represents Aqua America, a publicly traded water company.