

2

The State Budget

As is the case during short sessions of the General Assembly, the major focus of lawmakers during the 2006 short session was making adjustments to the second fiscal year (fiscal year 2006–07) of the biennial state budget adopted during the 2005 session (S.L. 2005-276). With healthy growth in state revenues for the second year in a row, this year’s budget process presented legislators with a revenue surplus of over \$1 billion, reversing the trend of declining revenues and budget deficits experienced in the 2001 and 2003 sessions. The surplus allowed lawmakers to fund, among other things, the highest level of salary increases for teachers and state employees in at least a decade. Additional major appropriations and other budgetary actions are summarized in this chapter.

The Budget Process

The 2006 session of the 2005 General Assembly reconvened on May 9, 2006. The next day, Governor Easley formally presented his recommended adjustments to the fiscal year 2006–07 budget, and House and Senate appropriations committees began conducting budget hearings. Keeping with the tradition that the Senate and the House of Representatives exchange responsibility for initiating the formal budget process each biennium, the Senate filed the bill that would become the legislation modifying the fiscal year 2006–07 state budget (the House of Representatives will initiate the budget process in the 2007 biennial session). Senate Bill 1741 (Modify Appropriations Act of 2005) was filed in the Senate on May 22, 2006. The majority of the Senate’s work on its version of the legislation was virtually complete by that time, and Senate Bill 1741 passed the Senate three days later on May 25, a record seventeen days after the session’s convening. The House passed its version of the budget bill on June 15, and each chamber appointed its members to the conference committee that would negotiate a compromise between the two versions of the bill. Just meeting the June 30 fiscal-year-end deadline,¹ the conference report, which embodied the final product of the budget negotiations, was reported in to both

¹ Because the budget bill had not yet become law on June 30, the General Assembly passed House Bill 2351 (S.L. 2006-52) to extend certain budget authorizations beyond the end of the fiscal year. S.L. 2006-52 also contained a provision setting its own expiration date at 11:30 p.m. on July 7. S.L. 2006-52 was signed by the Governor and chaptered on June 30.

chambers on June 30 and given final approval by both chambers on July 6. Governor Easley signed the ratified bill into law on July 10 and it was chaptered as S.L. 2006-66.²

Budget Highlights

A significant portion of the 2006–07 state budget surplus was appropriated for teacher and state employee salary and retirement increases, totaling \$688 million in additional funding.

- Public school teachers and instructional support staff received a total average salary increase of 8 percent.
- Public school principals and assistant principals received a total average salary increase of 7 percent.
- Community college faculty and professional staff received a 6 percent salary increase and a 2 percent one-time bonus.
- University faculty and EPA non-faculty employees received a 6 percent salary increase.
- All other state, university, community college, and public school employees received a 5.5 percent salary increase.
- Teacher and state employee retirees received a 3 percent cost-of-living increase.

Other budget highlights include the following:

- For the first time, proceeds from the new North Carolina Education Lottery were part of the budget deliberations. The projected \$425 million in lottery proceeds was allocated as follows:
 - \$127.8 million for reducing class size
 - \$84.6 million for prekindergarten programs (More at Four)
 - \$170 million for the Public School Building Capital Fund
 - \$42.5 million for need-based college scholarships
- \$41.9 million to fully fund the Low Wealth Supplemental Funding formula to assist low-wealth counties with their public school needs
- \$27 million in new Disadvantaged Student Supplemental Funding (DSSF) to help local school systems serve students who are most at risk of academic failure
- \$162.4 million to fully fund projected enrollment growth of new students in public schools, community colleges, and UNC System campuses
- \$21.5 million in increased funding for college need-based financial aid
- \$90.3 million for mental health related needs, including community-based mental health, substance abuse and crisis services, housing, and the Mental Health Trust Fund
- \$27 million of additional funds for the judicial system budget, funding such items as ninety new assistant district attorney positions, seventy-five deputy clerk positions, seventeen district court judge positions, and several other categories of positions intended to improve the effectiveness of the court system, along with technology and infrastructure upgrades
- \$15 million to the One North Carolina Fund for economic development and business recruitment initiatives along with an additional \$10 million reserve in the Department of Commerce for economic development projects
- \$100 million to fully fund the Clean Water Management Trust Fund
- \$20 million for a newly created State Emergency Response Account to fund state disaster preparation and response programs

This year's budget act is also characterized by what it does not contain. Unlike the budget acts of many prior sessions, this session's act contains relatively few substantive law changes not directly related to a fiscal item (either an appropriation or a finance item). Only 156 pages in

² In North Carolina the Governor does not have line-item veto authority, so the Governor must either accept or reject the state budget as enacted by the General Assembly in its entirety.

length, the document's slimness (as compared to many previous budget acts) attests to its lack of non-budget-related substantive law changes.³

The 2006-07 State Budget

With a few limited exceptions (such as highway maintenance and construction), virtually all functions of state government are funded through the General Fund. This is the fund from which monies are appropriated by the General Assembly through the budget process to support most areas of state government ranging from education to economic development initiatives to health and human services to public safety. Funding comes to the General Fund from three main sources: (1) tax revenues, (2) federal funds (such as block grants and matching funds for certain programs), and (3) receipts (such as tuition, fees paid for certain government services, and investment income). Section 5(3) of Article III of the North Carolina Constitution requires that the state budget be balanced, so the budget as enacted by the General Assembly cannot appropriate more funds than are projected to be received during the fiscal year.

General Fund Availability

S.L. 2006-66 appropriates a net total of almost \$1.3 billion dollars in new revenue available to the General Fund for fiscal year 2006–07. The vast majority of this new revenue was realized from tax revenues collected above the previous year's projections ("overcollections") (\$1.072 billion) and an increase in projections of the next fiscal year's revenue collections (\$699 million), with the remainder coming from unappropriated funds carried forward from the previous fiscal year (\$117.2 million), and funds unexpended ("reversions") in the previous fiscal year (\$125 million). The budget also projected collections in non-tax revenue of \$854 million.

Subtracted from the budget's total availability were a \$378.8 million combination of tax reductions and a reduction in the transfer from the Highway Trust Fund to the General Fund. The two largest tax cuts enacted were a reduction in the state sales tax rate from 4.5 percent to 4.25 percent and a reduction in the top personal income tax rate from 8.25 percent to 8.0 percent. Also deducted from the budget's total availability were the statutory transfers to the state's Savings Reserve Account (\$323.8 million) and the Repairs and Renovations Reserve Account (\$222.2 million).

This combination of surplus revenues, tax cuts, and statutory earmarkings left a total revised General Fund availability for the upcoming fiscal year of \$18.8 billion dollars, as is shown below in Table 1.

Table 1. 2006–07 General Fund Availability

	FY 2006–07
Unappropriated balance from FY 2005–06 (S.L. 2005-276)	\$ 117,227,875
Net adjustments (S.L. 2005-345)	(4,148,833)
Net adjustments (S.L. 2005-435, S.L. 2005-406, S.L. 2005-376, S.L. 2005-391)	(5,826,000)
Adjustment from estimated to actual 2005–06 beginning unreserved balance	6,133,946
Revised unappropriated balance remaining 2005–06	113,386,988
Emergency appropriation for Department of Correction (S.L. 2006-2)	(15,000,000)
Projected reversions from FY 2005–06	125,000,000

³ Following enactment of the budget bill, the General Assembly adopted Senate Bill 198 (S.L. 2006-221), which made a number of technical corrections to the budget bill. Several substantive law changes were included in this legislation.

Projected overcollections from FY 2005–06	1,072,100,000
Year-end unreserved credit balance before earmarkings	1,295,486,988
Less: projected credit to Savings Reserve	(323,871,747)
Less: projected credit to Repairs and Renovation Reserve Account	(222,229,189)
Revised year-end unreserved credit balance	749,386,052
Revenues based on existing tax structure	16,951,416,000
Nontax revenues	
Investment income	78,700,000
Judicial fees	168,605,271
Disproportionate share	100,000,000
Insurance	51,543,813
Other nontax revenues	202,719,921
Highway Trust Fund transfer	252,663,009
Highway Fund transfer	-
Subtotal nontax revenues	854,232,014
Total General Fund availability	18,555,034,066
Adjustments to availability: 2006 Session	
Adjustment to baseline revenue forecast	698,864,995
Reduce sales tax from 4.5% to 4.25% (December 1, 2006)	(140,100,000)
Reduce top personal income tax rate from 8.25% to 8.0% (January 1, 2007)	(28,600,000)
Mill rehabilitation income tax credit	(2,800,000)
529 Savings Plan income tax deduction	(1,000,000)
Logging machinery sales tax exemption	(2,870,000)
IRC update	(5,100,000)
Joint filing options under personal income tax	(1,000,000)
Railroad cars tax exemption	(400,000)
Bill Lee Act wage standard—certain manufacturers	(800,000)
Bill Lee Act adjustment—Clayton project	(800,000)
Extend aviation fuel tax credit	(90,000)
Extend real property donation tax credit	(100,000)
Small business health insurance credit of \$250 (January 1, 2007)	(7,200,000)
Internet facility sales tax exemption	(2,250,000)
Oyster tax credit	(23,000)
Gas cap reserve	(367,000)
Reduce transfer to Highway Trust Fund	(195,176,407)
Adjust transfer from Insurance Regulatory Fund	455,846
Adjust transfer from Treasurer's office	281,784
Subtotal adjustments to availability: 2006 Session	310,926,218
Revised General Fund availability for 2006–07 Fiscal Year	18,865,960,284
Less: total General Fund appropriations for 2006–07 Fiscal Year	(18,865,960,284)
Unappropriated balance remaining	0

For purposes of documenting General Fund appropriations, the budget bill and the budget report⁴ group functions and agencies within state government into seven main categories:⁵

- Education
- Health and Human Services
- Justice and Public Safety
- Natural and Economic Resources
- General Government
- Statewide Reserves and Debt Service
- Capital Improvements

During the short session budget process, adjustments are made to the fiscal year 2006–07 budget as enacted the previous year, so budget figures in S.L. 2006-66 reflect adjustments (either increases or decreases in funding) to the previously adopted budget. Table 2 details these adjustments and includes the revised total appropriations for each agency or program listed.

⁴ The budget report accompanies the budget bill. It outlines line item appropriations within state agencies and is incorporated into the budget bill by reference.

⁵ Because the transportation budget is funded from the Highway Fund and the Highway Trust Fund, which are separate from the General Fund, transportation is not one of the General Fund appropriations categories.

Table 2. 2006–07 General Fund Appropriations Adjustments

General Fund Appropriations						
Fiscal Year 2006–07						
2006 Session						
	2006–07 Certified appropriation	Recurring adjustments	Nonrecurring adjustments	Net changes	Position changes	2006–07 Revised appropriation
<u>Education:</u>						
Community colleges	\$ 767,295,886	\$ 29,342,577	\$ 34,817,450	\$ 64,160,027	\$ 5.00	\$ 831,455,913
Public education	6,579,807,097	34,783,999	105,160,022	139,944,021	5.00	6,719,751,118
University system	2,120,397,081	126,039,967	2,617,930	128,657,897	511.95	2,249,054,978
Total education	9,467,500,064	190,166,543	142,595,402	332,761,945	521.95	9,800,262,009
<u>Health and Human Services:</u>						
Office of the Secretary	118,880,919	(63,346,653)	8,183,417	(55,163,236)	3.00	63,717,683
Aging Division	29,495,139	5,535,886	0	5,535,886	8.00	35,031,025
Blind and Deaf/Hard of Hearing Services	9,681,220	0	75,000	75,000	0.00	9,756,220
Child Development	267,356,799	28,049,617	1,012,291	29,061,908	10.00	296,418,707
Education Services	34,281,895	778,548	218,235	996,783	23.00	35,278,678
Facility Services	15,959,466	0	200,000	200,000	0.00	16,159,466
Medical Assistance	2,751,209,159	(132,150,000)	24,600,000	(107,550,000)	0.00	2,643,659,159
MH/DD/SAS	602,556,655	53,733,357	6,505,000	60,238,357	93.00	662,795,012
NC Health Choice	51,882,902					51,882,902
Public Health	150,814,496	16,859,242	1,276,000	18,135,242	144.00	168,949,738
Social Services	190,679,285	15,219,957	462,607	15,682,564	0.00	206,361,849
Vocational Rehabilitation	42,142,193			0		42,142,193
Total Health and Human Services	4,264,940,128	(75,320,046)	42,532,550	(32,787,496)	281.00	4,232,152,632

The State Budget

Justice and Public Safety:

Correction	1,048,492,502	17,657,493	17,254,211	34,911,704	153.00	1,083,404,206
Crime Control and Public Safety	35,153,488	2,024,324	3,929,956	5,954,280	16.00	41,107,768
Judicial Department	345,760,410	16,174,876	10,916,836	27,091,712	271.75	372,852,122
Judicial—Indigent Defense	88,648,414	1,657,191	5,025,938	6,683,129	1.00	95,331,543
Justice	78,697,271	1,435,897	3,270,941	4,706,838	16.00	83,404,109
Juvenile Justice and Delinquency Prevention	138,873,166	2,961,819	492,701	3,454,520	58.00	142,327,686
Total Justice and Public Safety	1,735,625,251	41,911,600	40,890,583	82,802,183	515.75	1,818,427,434

Natural and economic resources:

Agriculture and Consumer Services	51,032,884	2,224,113	1,359,449	3,583,562	31.00	54,616,446
Commerce	36,728,265	2,550,483	33,817,000	36,367,483	9.00	73,095,748
Commerce—state aid	11,722,085	546,000	6,657,138	7,203,138	0.00	18,925,223
Environment and Natural Resources	168,451,089	2,364,324	12,487,638	14,851,962	25.00	183,303,051
DENR—Clean Water Mgmt. Trust Fund	100,000,000	0	0	0	0.00	100,000,000
Labor	14,434,925	413,894	200,000	613,894	3.50	15,048,819
NC Biotechnology Center	10,583,395	2,000,000	500,000	2,500,000	0.00	13,083,395
Rural Economic Development Center	25,052,607	(500,000)	0	(500,000)	0.00	24,552,607
Total natural and economic resources	418,005,250	9,598,814	55,021,225	64,620,039	68.50	482,625,289

General government:

Administration	58,818,473	1,875,856	1,498,683	3,374,539	22.00	62,193,012
Auditor	10,840,918	57,564	0	57,564	0.00	10,898,482
Cultural Resources	62,917,147	1,374,034	4,046,982	5,421,016	31.00	68,338,163
Cultural Resources—Roanoke Island	1,783,374	0	0	0	0.00	1,783,374
General Assembly	46,965,432	0	38,284	38,284	0.00	47,003,716
Governor	5,344,528	100,000	0	100,000	0.00	5,444,528
NC Housing Finance Agency	4,750,945	0	17,437,500	17,437,500	0.00	22,188,445

Insurance	28,110,582	425,846	30,000	455,846	5.00	28,566,428
Insurance—Worker's Compensation Fund	4,500,000	0	0	0	0.00	4,500,000
Lieutenant Governor	753,037	88,433	0	88,433	1.00	841,470
Office of Administrative Hearings	2,969,712	269,578	11,789	281,367	2.00	3,251,079
Revenue	80,673,250	513,294	766,488	1,279,782	1.00	81,953,032
Secretary of State	9,369,633	441,217	26,850	468,067	5.25	9,837,700
State Board of Elections	5,069,307	585,044	201,576	786,620	31.00	5,855,927
State Budget and Management	6,021,795	240,438	169,500	409,938	3.00	6,431,733
State Budget and Management—Special	5,111,429	755,232	598,021	1,353,253	0.00	6,464,682
State Controller	10,044,511	0	0	0	0.00	10,044,511
Treasurer—operations	8,295,843	281,784	0	281,784	0.00	8,577,627
Treasurer—retirement/benefits	8,651,457	514,000	0	514,000	0.00	9,165,457
Total general government	360,991,373	7,522,320	24,825,673	32,347,993	101.25	393,339,366
<u>Transportation</u>	0	0	0	0		0
<u>Statewide reserves and debt service:</u>						
Debt service:						
Interest/redemption	619,291,140	0	(50,000,000)	(50,000,000)		569,291,140
Federal reimbursement	1,616,380	0	0	0		1,616,380
Subtotal debt service	620,907,520	0	(50,000,000)	(50,000,000)	0.00	570,907,520
Statewide reserves:						
Compensation increases	235,185,705	673,523,862	14,970,657	688,494,519		923,680,224
Reserve for contingent appropriations	85,000,000			0		85,000,000
Salary Adjustment Fund: 2005–07 biennium	4,500,000			0		4,500,000
Salary Adjustment Fund: 2004–05 fiscal Year	4,500,000			0		4,500,000
Teachers' and state employees' retirement	13,810,800	27,107,200	0	27,107,200		40,918,000

The State Budget

contribution						
Retirement system payback	0	0	30,000,000	30,000,000		30,000,000
Death Benefit Trust	12,899,200			0		12,899,200
Disability Income Plan	6,586,500			0		6,586,500
State Health Plan	142,728,000			0		142,728,000
Contingency and emergency	5,000,000			0		5,000,000
Information technology rate adjustments	(2,300,000)			0		(2,300,000)
Information Technology Fund	8,025,000	7,559,349	34,527,880	42,087,229	52.75	50,112,229
Job Development Incentive Grants Reserve	12,400,000			0		12,400,000
Reserve for Heating and Cooling Assistance		0	10,000,000	10,000,000		10,000,000
Reserve for Legal Expenses			1,065,710	1,065,710		1,065,710
Trust Fund for MH/DD/SAS			14,390,000	14,390,000		14,390,000
State Emergency Response Account		0	20,000,000	20,000,000		20,000,000
Pending ethics legislation		401,871	21,000	422,871	4.00	422,871
Subtotal statewide reserves	528,335,205	708,592,282	124,975,247	833,567,529	56.75	1,361,902,734
Total reserves and debt service	1,149,242,725	708,592,282	74,975,247	783,567,529	56.75	1,932,810,254
Total General Fund for Operations	17,396,304,791	882,471,513	380,840,680	1,263,312,193	1,545.20	18,659,616,984
Other General Fund expenditures:						
Capital improvements	0	0	206,343,300	206,343,300		206,343,300
Repairs and renovations	0			0		0
Total other General Fund expenditures	0	0	206,343,300	206,343,300	0.00	206,343,300
Total General Fund budget	17,396,304,791	882,471,513	587,183,980	1,469,655,493	1,545.20	18,865,960,284

The Highway Fund and Highway Trust Fund

S.L. 2006-66 also makes adjustments to funding for roadway construction and maintenance and other Department of Transportation functions from the two primary sources dedicated to these programs: the Highway Fund and the Highway Trust Fund. As with General Fund appropriations, the budget act shows adjustments to these funds for the coming fiscal year as enacted the previous year.

The approved budget for the Highway Fund for fiscal year 2006–07 is \$1.79 billion, a \$254 million increase in funding over what was previously enacted for this fiscal year. The approved budget for the Highway Trust Fund for fiscal year 2006–07 is \$1.1 billion, a \$35 million reduction in funding from what was previously enacted. In recognition of concerns about transfers of funds from the Highway Trust Fund to the General Fund, this transfer was reduced by \$195 million, allowing for increased expenditures in the transportation area.

Capital Improvements

The General Assembly approved \$206.3 million in capital projects to be funded from the General fund (additional capital projects were authorized through special indebtedness, which is discussed below). These appropriations include the following:

- \$8.77 million for two new Veterans Affairs nursing home facilities
- \$1.25 million to the Department of Agriculture for laboratory upgrades
- \$7.5 million to the North Carolina Ports Authority for container cranes at the Wilmington port
- \$8.5 million for a new state Emergency Operations Center
- \$1.5 million to the Department of Cultural Resources for a new visitor center at Tryon Palace
- \$17.5 million to the Department of Environment and Natural Resources to expand the Hickory Nut Gorge State Park by roughly 1,000 acres and to build a new storage shed for the North Carolina Zoo and a new headquarters for Division of Forest Resources District 9
- \$20 million to match federal funds for various navigation, beach protection, stream restoration, and water recreation projects throughout the state
- \$139.9 million to the University of North Carolina for various projects and capital planning throughout the UNC System

Additional capital projects were authorized for funding from the Repairs and Renovations Reserve Account:

- \$11.8 million for a new hospital and mental health facility at Central Prison
- \$2.8 million for the Palmer Memorial Institute State Historic Site
- \$1.9 million for road and parking lot improvements on the Elizabeth City State University campus
- \$6.4 million to repair steam lines and steam tunnels on the North Carolina Central University campus
- \$416,000 for improvements to Rhodes Hall at the University of North Carolina at Asheville

Special Indebtedness

Continuing a recent trend of financing capital construction with special indebtedness under Article 9 of G.S. Chapter 142, in 2006 the General Assembly authorized the issuance of \$719 million in new debt. Commonly referred to as “certificates of participation,” special indebtedness is nonvoted debt that may be secured only by an interest in state property being acquired or

improved. There is no pledge of the state's faith and credit or taxing power to secure the debt. Thus, voter approval is not necessary for the borrowing. Special indebtedness may take one or more of the following forms: installment purchase contracts (with or without certificates of participation), lease-purchase contracts (with or without certificates of participation), or bonds.

S.L. 2006-231 (S 1621) authorizes \$20 million of special indebtedness to purchase land to be used as state game land and to be administered by the Wildlife Resources Commission. The act authorizes another \$20 million in special indebtedness for a new parking deck to be constructed in downtown Raleigh. Effective January 1, 2007, S.L. 2006-231 also increases from \$35 million to \$42 million the amount of special indebtedness authorized in 2004 for the construction of five youth development centers.

The 2006 appropriations act (S.L. 2006-66) authorizes the following new special indebtedness:

- \$40 million for capital projects at the North Carolina Museum of Art
- \$20 million to complete the Central Regional Psychiatric Hospital for the Department of Health and Human Services (DHHS)
- \$24,841,300 for a new Secondary State Data Center
- \$45,827,400 for a new center city classroom building at the University of North Carolina at Charlotte
- \$101 million for a DHHS Public Health Laboratory and Office of Chief Medical Examiner
- \$145.5 million for the DHHS Eastern Regional Psychiatric Hospital
- \$132.2 million for the Department of Correction Regional Medical Center and Mental Health Center
- \$162.8 million for the DHHS Western Regional Psychiatric Hospital

The General Assembly also authorized additional borrowing through guaranteed energy savings contracts, performance contracts under which a contractor guarantees energy savings in an amount equal to the financed cost of energy saving improvements. (*See* G.S. Chapter 143, Article 3B, Part 2.) S.L. 2006-90 (S 402) amends G.S. 143-64.17 to provide that guaranteed energy savings contracts can include savings from water and other utilities, not just electric utilities. The act also increases the maximum term for a contract from twelve to twenty years and increases from \$50 million to \$100 million the maximum aggregate principal amount payable by the state under guaranteed energy savings contracts (G.S. 142-63).

Norma Mills

Martha H. Harris