

# 2

## The State Budget

---

This chapter summarizes the budget process and fiscal provisions of the 2007–08 state budget. Some of the chapters that follow include more detailed information regarding budget provisions affecting specific state departments and agencies. This chapter also outlines two 2007 acts that provide for stronger fiscal control in state government.

### **The Budget Process**

The North Carolina state government operates on a fiscal year that begins July 1 and ends June 30. During regular sessions in odd-numbered years, the General Assembly adopts a state budget that makes appropriations for the following two fiscal years (the fiscal biennium). In even-numbered years, the legislature conducts a short session to make adjustments to the state budget for the second year of the biennium.

In each odd-numbered year, at the beginning of the regular session of the General Assembly, the Governor, director of the budget by virtue of the state constitution, begins the biennial budget process by submitting budget recommendations for the next two fiscal years to the legislature. These budget recommendations include consensus estimates of the amount of revenues available for appropriations, estimates of the appropriations needed to continue existing programs at current levels, and recommended appropriations for expansion of existing programs, for new programs, and for capital improvements. In 2007 Governor Mike Easley released his budget proposal on February 22.

Although the House and Senate appropriations subcommittees usually meet jointly to review the Governor's budget proposal, the House of Representatives and the Senate each develop their own versions of the budget. In recent years the House and the Senate have alternated from biennium to biennium the responsibility for initially passing an appropriations bill for continuing operations, expansion, and capital improvements for state departments and agencies. In 2007 the House of Representatives was responsible for taking the lead in preparing the budget. It passed an appropriations bill (House Bill 1473) on May 11, 2007, that was received by the Senate on May 14. The Senate passed its version of House Bill 1473 on May 31. The House did not concur with the Senate's proposed changes to House Bill 1473, and a conference committee was appointed to negotiate compromises where the two bodies differed.

The budget negotiators were unable to reach an agreement by June 30, the end of the fiscal year. As a result, a temporary spending plan, the 2007 Continuing Budget Authority (House Bill 2044), was enacted on June 29 as S.L. 2007-145, authorizing continuation of state appropriations at the level in effect as of June 30. The act also appropriated funds for increases in average daily membership, extended some provisions that were due to expire, and delayed the effective dates of others. The conference committee finally reached agreement on a compromise bill, which was adopted by roll-call reading on three separate days in each chamber in late July. The Current Operations and Capital Improvements Appropriations Act of 2007 was signed by the Governor on July 31, 2007, and became law as S.L. 2007-323. Following the enactment of the budget bill, the General Assembly adopted the 2007 Budget Technical Corrections Act (House Bill 714), making technical corrections and some substantive changes to the budget. On August 6, the Governor signed this bill into law as S.L. 2007-345.

The 2007 budget negotiations lasted approximately two months. The large number of bills filed this session, a total of 3,645, approaching the record of 3,700 set in the 1980s, no doubt prolonged the entire legislative process. However, much of the lengthy budget conference activity focused on the dramatic disparities between the House and Senate versions of the budget, which differed by \$263 million on roughly \$20 billion in spending. In addition, the House budget included tax and fee increases while the Senate budget increased only fees. The House sought to provide one-time allocations to help counties with Medicaid costs and to fully repay the state pension system—both provisions absent from the Senate proposal. While the House budget authorized borrowing almost \$450 million for capital improvements, the Senate proposed borrowing over \$1.2 billion for capital improvements. Another complication was introduced when updated revenue figures showed more availability than had previously been estimated.

Taxes were also a major conference topic. There was intense debate over the proposed inclusion of a local option land transfer tax to help provide Medicaid relief for counties. Opponents of the tax argued that it would deter buyers from purchasing homes and negatively affect the real estate business. Another debate centered on providing an earned income tax credit (EITC) to give tax relief to low-income residents, and there was prolonged discussion regarding whether to extend the 8 percent income tax rate and the additional one-fourth percent increase in the state portion of the sales tax or to allow these provisions, adopted in 2001 as temporary revenue raising measures, to sunset July 1. Further complicating the budget negotiation process was a shortfall in the expected revenues from the State Education Lottery, resulting in an effort to include in the budget appropriations from the General Fund to maintain smaller class sizes in grades K–3 and expand the More at Four Program.

Ultimately, the conferees reached compromises on the disputed provisions and presented a budget that includes the local option transfer tax, the EITC, and a reduction in the 8 percent income tax rate and makes the one-fourth percent sales tax increase permanent. The budget also provides monies from the General Fund to offset the education lottery shortfall and includes relief for counties from Medicaid responsibilities. Notably, the budget also authorizes the largest amount of new nonvoted debt ever, approximately \$550 million for capital improvements and \$120 million for land conservation.

## **The 2007–08 Budget**

S.L. 2007-323 (H 1473) appropriates approximately \$20.7 billion (including capital improvements appropriations) from the General Fund for fiscal year 2007–08. The General Assembly appropriates monies from the General Fund to support most areas of state government ranging from education, to economic development initiatives, to health and human services, to public safety. Money in the General Fund comes 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. The General

Assembly makes smaller appropriations for specific purposes from the Highway Fund and the Highway Trust Fund.

The General Fund availability used in developing the budget for fiscal year 2007–08 is as follows:

• Beginning unreserved fund balance	\$ 1,173,100,000
• Tax revenues	18,643,100,000
• Nontax revenues	874,690,000
• Adjustments	237,951,810

Several of the adjustments to the General Fund availability were tax related, including the following:

• Maintaining state sales and use tax rate at 4.25 percent	\$258,400,000
• Corporate tax earmarking adjustments	44,700,000
• Long-term care insurance tax credit	(7,000,000)
• Adoption tax credit	(3,000,000)
• Privilege tax on software publishers	(2,800,000)
• Reserve for manufacturers' and farmers' energy tax provisions	(10,000,000)
• Nonprofit energy tax credit	(500,000)
• Reserve for work opportunity tax credit	(3,000,000)
• Firefighter/EMS income tax deduction	(1,000,000)

### Appropriations

The General Assembly made the following appropriations for fiscal year 2007–08:

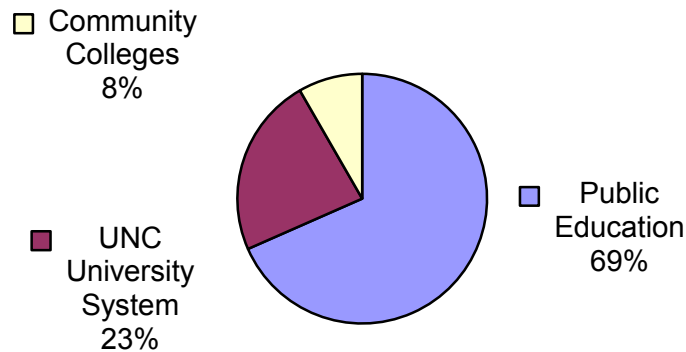
• Total General Fund	\$20,658,337,712
• Highway Fund	1,832,110,000
• Highway Trust Fund	1,128,280,000

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

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

As in previous years, education and health and human services received the largest share of the General Fund operations appropriations. The appropriation for education was \$11.3 billion or 55 percent of the budget, and the appropriation to the Department of Health and Human Services was \$4.6 billion or 22 percent of the budget for fiscal year 2007–08. Combined, education and health and human services account for 77 percent of the appropriations. The education appropriations are further divided among the public school system (elementary, middle, and high schools, including public charter schools), the community college system, and the UNC college system, as the following graph illustrates.

### FY 2007–08 General Fund Appropriations for Education



Also included in the 2007–08 appropriations were revenues from the Education Lottery. Although actual revenues were less than projected, total revenues transferred from the State Lottery Fund for fiscal year 2007–08 equaled \$350 million. Pursuant to G.S. 18C-164(d), the appropriations made from the Education Lottery are as follows:

- Class size reduction \$ 90,364,291
- More at Four 84,635,709
- Public school building capital fund 140,000,000
- Scholarships for needy students 35,000,000

The General Fund appropriations also included funding for capital improvements totaling \$230,741,000. Capital improvements include constructing, repairing, or renovating state buildings, utilities, and other capital facilities and acquiring sites, buildings, and land for state government purposes. Appropriations for fiscal year 2007–08 also include \$20 million for water resource development projects. These projects will be located in multiple counties and cities across the state.

The Highway Fund includes a provision that authorizes additional rail service to some parts of the state. The fund appropriates \$3,850,000 for fiscal year 2007–08 to relocate or construct new tracks and rail interchange facilities to improve rail access to various areas as a more cost effective alternative to new highway construction.

### General Fund Budget Highlights

Following are some highlights of the \$20.7 billion 2007–08 state spending plan. The figures reflect expenditures or, in the case of taxes and fees, an increase or decrease in revenues.

#### Salaries and Benefits

- Average 5 percent salary increase for public school teachers, 5 percent for community college and university faculty and judges, and 4 percent for most state employees: \$490.3 million
- Additional 31-year salary step for public school teachers: \$9.9 million
- Cash influx to cover projected shortfall in state employee health plan and elimination of indemnity plan in July 2008: \$110.2 million
- Fifth and final installment to repay retirement funds intercepted in 2001 to reduce budget shortfall: \$45 million
- Cost-of-living increase of 2.2 percent for state retirees: \$35.7 million

#### Public Education

- Provide more funding for low-wealth school districts and schools with at-risk students: \$23 million

- Provide additional money to help small-county school districts: \$2.1 million
- Expand More at Four prekindergarten program by 10,000 slots, and increase money per slot: \$56 million
- Deliver college courses electronically to high school students through Governor Mike Easley's Learn and Earn Online program: \$11.5 million
- Upgrade public school broadband connectivity: \$12 million
- Establish district dropout prevention competitive grant program: \$7 million
- Fund pilot program for five school districts with teacher recruitment and retention bonuses, teacher mentoring, and science and math assistance: \$4.4 million

#### **University of North Carolina System**

- Restore funding for projected fall university enrollment: \$6 million
- Provide operating, equipment, and faculty startup funds for UNC programs at North Carolina Research Campus in Kannapolis: \$16.5 million
- Begin Education Access Rewards North Carolina Scholars program, which will provide grants to low-income college students: \$27.6 million
- Fund Wake Forest Institute for Regenerative Medicine at Wake Forest University to attract federal investment to Piedmont Triad Research Park: \$8 million
- Provide General Fund support for UNC Hospitals cancer research: \$5.6 million

#### **Community Colleges**

- Funding for enrollment of additional 2,300 students: \$3.3 million
- Increase in community college tuition by 6.3 percent: (\$7.5 million)
- Additional funds for Allied Health programs: \$5.6 million
- Improvements in community college broadband connectivity: \$3.8 million
- Purchase of instructional equipment: \$10 million
- Competitive grant program for campuses for facility and equipment needs: \$15 million
- Advanced planning of capital projects and master plans: \$8 million

#### **Health and Human Services**

- Reduce county share of Medicaid from 15 percent of nonfederal share to 11.25 percent in October 2007 and to 7.5 percent in July 2008: \$86.2 million
- Fully fund N.C. Health Choice program: \$7.5 million
- Open and fund new central regional psychiatric hospital in Butner: \$62.4 million
- Transfer half of forensic unit beds from Dorothea Dix Hospital to Broughton Hospital in Morganton: \$4.7 million
- Fund competitive grant program for rural health centers: \$5 million
- Remove 643 children from child-care subsidy waiting list and increase lagging subsidy rates: \$8.4 million
- Fund state match to purchase more than 634,000 treatment courses of antivirals for use in case of pandemic flu and create climate-controlled storage space: \$8.3 million
- Fund HIV prevention and related activities, including counseling and testing: \$2 million
- Hire 54 public school nurses: \$2.7 million

#### **Natural and Economic Resources**

- N.C. Rural Economic Development Center funds for water and sewer system grants to local governments: \$100 million
- Expansion of N.C. Rural Economic Development Center Economic Infrastructure Fund and creation of the Rural Economic Transition Program: \$19 million
- N.C. Agricultural Development and Farmland Preservation Trust Fund, designed to prevent loss of farmlands: \$8 million
- Creation of the Biofuels Center of North Carolina, which will encourage growth in biomass production and development in keeping with legislative-mandated study: \$5 million
- One North Carolina Fund for economic development: \$14 million
- One North Carolina Small Business Fund for economic development: \$4.8 million

- Creation of incentives for broadband in rural areas and distribution of funds for cable access channels through e-NC authority: \$4 million

#### **Justice and Public Safety**

- Modernize technology in court system: \$9.8 million
- Hire 77 court personnel, including new assistant district attorneys, DA investigators, and legal assistants: \$4.2 million
- Fund 150 new deputy clerks of court positions: \$4.6 million
- Raise hourly rate for privately assigned attorneys for indigent defendants in non-capital cases: \$4.1 million
- Hire more sworn agents, staffers, and technicians at State Bureau of Investigation and fund startup costs for Triad regional crime laboratory: \$1.5 million
- Provide funding for gang prevention, intervention, and suppression initiative grants: \$4.8 million

#### **Other Agencies and Funds**

- State Energy Office operations: \$7.7 million
- Expansion of N.C. Arts Council grants, the Grassroots Arts Program, and the public school arts project: \$3 million
- N.C. Housing Trust Fund, including money to build apartments for people with disabilities: \$12.5 million
- Continuation of the home foreclosure protection pilot program: \$1.5 million

#### **Reserves and Capital Projects**

- Special indebtedness for construction projects, including prison additions, university projects, and Tryon Palace visitors' center, issued over four years: \$550 million
- Special indebtedness for land conservation, with repayments likely from parks and natural heritage trust funds: \$120 million
- Resources building for and expansion of the Museum of Natural Sciences in Raleigh: \$25 million
- East Carolina University dental school: \$25 million
- UNC–Chapel Hill dental school addition: \$25 million
- N.C. State University Centennial Campus library: \$17 million
- UNC–Charlotte energy production infrastructure center: \$19 million

#### **Tax Provisions**

- State portion of sales tax made permanent at 4.25 percent: (\$258.4 million)
- Counties held harmless in Medicaid tax swap: \$19.3 million
- Renewal of long-term insurance tax credit: \$7 million
- Adoption tax credit equal to 50 percent of federal credit: \$3 million
- Reserves for energy tax phaseout provisions and work opportunity tax credits: \$13 million
- Sales tax refund for aircraft parts manufacturers: \$800,000
- Increase in judicial fees, dedicated to court system technology and staff upgrades: (\$35.5 million)

S.L. 2007-323 provides that “[t]he Joint Conference Committee Report on the Continuation, Expansion, and Capital Budgets, dated July 27, 2007 . . . shall indicate action by the General Assembly on this act and shall therefore be used to construe this act, as provided in the State Budget Act, Chapter 143C of the General Statutes, or the Executive Budget Act, Article I of Chapter 143 of the General Statutes, as appropriate, for these purposes shall be considered a part of this act . . . .” The report, which was prepared by the Fiscal Research Division of the General Assembly, is available on the General Assembly’s website at: [www.ncleg.net/sessions/2007/budget/budgetreport7-27.pdf](http://www.ncleg.net/sessions/2007/budget/budgetreport7-27.pdf). This report specifies in detail how the appropriations made in the act are to be allocated and expended. Each year the Fiscal Research Division also publishes an overview of the budget, which can be found on its website at [www.ncleg.net/fiscalresearch/frd\\_reports/frd\\_reports.shtml](http://www.ncleg.net/fiscalresearch/frd_reports/frd_reports.shtml).

## Fiscal Control

S.L. 2007-520 (H 1551) enacts new Chapter 143D of the General Statutes to require each state agency to create and maintain a system of internal control in accordance with standards and policies to be established by the State Controller. The new law applies to every entity for which the state has oversight responsibility, including universities, hospitals, community colleges, and clerks of court. The act defines *internal control* as a process “designed to provide reasonable assurance regarding the achievement of objectives related to the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.” Each state agency must maintain documentation and submit periodic certified financial reports to the State Controller. A state employee’s willful or continued failure to comply with the new law is sufficient cause for disciplinary action, including dismissal.

S.L. 2007-424 (H 1401) enacts new Article 79 of G.S. Chapter 143 to require certain state agencies to establish an internal auditing program. The new law applies to state agencies that have an annual operating budget of more than \$10 million, have more than 100 full-time equivalent employees, or receive and process more than \$10 million in a fiscal year. The term *state agency* includes each department created pursuant to G.S. Chapter 143A or 143B, the judicial branch of state government, the University of North Carolina, and the Department of Public Instruction. The internal auditing program must, among other things, provide an effective system of internal controls that safeguards public funds and assets and minimizes incidences of fraud, waste, and abuse. The new law sets out requirements and standards for internal auditing programs and the minimum qualifications of internal auditors. The act establishes the Council of Internal Auditing, which will be supported by the Office of State Budget and Management and consist of five ex-officio members as well as the State Auditor, who is a nonvoting member. The council’s duties include developing guidelines and best audit practices, administering a peer review system for audits, and conducting hearings regarding effectiveness of or interference with internal auditing.

*Sheria Reid*