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The State Budget

This chapter summarizes in broad terms the fiscal provisions of the 1999–2001 state budget and legislation affecting the budget process. More detailed information regarding budgetary actions affecting specific state departments and programs is included in following chapters.

The Budget Process

North Carolina's state budget operates on a fiscal year that runs from July 1 to June 30. During legislative sessions in odd-numbered years, the General Assembly adopts a biennial state budget that makes appropriations for each of the following two fiscal years. In the "short" session in even-numbered years, adjustments are made in the budget for the second year of the biennium.

The state budget process begins with the formulation of budget recommendations by the Governor, who by virtue of the state constitution is director of the budget. At the beginning of the first regular session of the General Assembly in each odd-numbered year, the Governor presents comprehensive budget recommendations for each of the two fiscal years of the biennium. The Governor's recommendations include estimates of the amount of revenues available for expenditure, estimates of the amount of appropriations needed to continue existing programs at their current level, and recommended appropriations for expansion of programs and for capital improvements. Governor James B. Hunt, Jr., submitted his recommended budget to the General Assembly in February 1999. A copy of the Governor's budget recommendations for 1999–2001 is available through the Internet at <http://www.osbm.state.nc.us/osbm/bgt9901.html>.

In recent years, while the House and Senate Appropriations Subcommittees initially met jointly to review the Governor's proposals, each house developed its own version of the state budget. The budget has tended to be split into several bills, with, for example, one bill continuing existing programs, a second dealing with expansion of programs, and a third focusing on capital improvements. After each house has adopted its version of the budget, a conference committee must resolve the different program priorities and policy considerations. The conference committee report incorporating the budget agreement must then be adopted by both chambers and submitted to the Governor for approval. Given the differing priorities of the House and Senate, this can be a lengthy process. When the leadership of the two chambers are not members of the same political party, the varying budget priorities can be especially hard to resolve, thus adding even more time

to the process. In 1998, for example, the widely divergent approaches of the two chambers resulted in a budget process that stretched over five months, running until late October.

The 1999 session marked a substantial departure from these recent trends. With the leadership of both chambers in the hands of a single political party, the opportunity existed for a more expeditious agreement on the state budget (though in the past this possibility has often been thwarted by the different approaches taken by the two chambers on other than partisan bases). Still, Speaker Black early in the session announced the goal of completing work on the state budget in June. Senate President Pro Tempore Basnight pledged cooperation in attempting to meet that goal. Considerable skepticism greeted this announcement, in large part based on recent experience. In the period between 1981 and 1997, the General Assembly usually completed its work on the biennial budget in late July to mid-August (the completion dates being Aug. 28 in 1997, July 28 in 1995, July 24 in 1993, July 13 in 1991, Aug. 10 in 1989, Aug. 14 in 1987, July 18 in 1985, July 22 in 1983, and July 8 in 1981). Not since 1979 had all of the budget bills been adopted prior to the start of the fiscal year. However, both chambers adopted the conference report for the entire 1999–2001 state budget on June 30, 1999.

Several adjustments in the budget process facilitated this accomplishment. First, rather than developing substantially differing budgets and then meeting to negotiate the differences, the House and Senate worked to develop consensus on major budget issues during the budget development process. The House and Senate Appropriations Subcommittees met jointly throughout the spring, splitting only when the final budget bills of the respective chambers were to be approved. Second, many of the Joint Appropriations Subcommittees met twice a day for much of the session. Third, although hundreds of individual appropriation bills were introduced, the entire state budget was consolidated into a single consensus bill (H 168). Fourth, also avoided in 1999 was the practice of including as “special provisions” within the budget bill substantive provisions that are unrelated to the budget. In fact, after a question was raised about welfare reform provisions that were included in the budget bill reported to the House Appropriations Committee, those provisions were removed from the budget bill and subsequently considered as a separate bill.

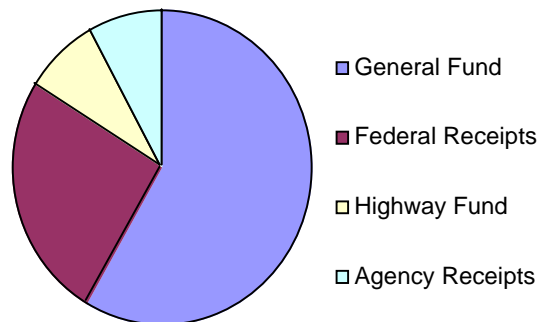
By tradition the House and Senate alternate the responsibility for initially passing a bill making appropriations. In 1999 the House of Representatives took the lead in adopting the budget. The House Appropriations Committee reported its omnibus appropriations bill, H 168, on June 1. The bill was considered and adopted on the House floor on June 2. Forty-one amendments were considered, and seventeen were adopted. The Senate Appropriations Committee reported its substitute for the House budget on June 16. This Senate budget reflected the consensus developed in the joint committee work and was substantially similar to the bill reported by the House Appropriations Committee. On June 17 this bill was considered and adopted on the Senate floor, where ten amendments were offered and six adopted.

Conferees were appointed by the House on June 17 and by the Senate on June 21. The conference report was submitted on June 29 and was adopted by both chambers on June 30. The conference report resolved two of the more controversial points of disagreement—proposals to increase the homestead property tax exemption for elderly homeowners and to allow The University of North Carolina to increase tuition—by sending them to study committees. The conferees also rejected the House proposals adopted as floor amendments to shift \$3 million in funding from small school systems to low-wealth school systems and to shift \$1.5 million from research universities’ overhead receipts to the equipment and furnishing of a biotechnology research facility at North Carolina Central University. All capital improvement projects proposed by each chamber were included in the final bill. The bill (S.L. 1999-237) was signed into law by Governor Hunt on July 1.

The 1999–2001 Budget

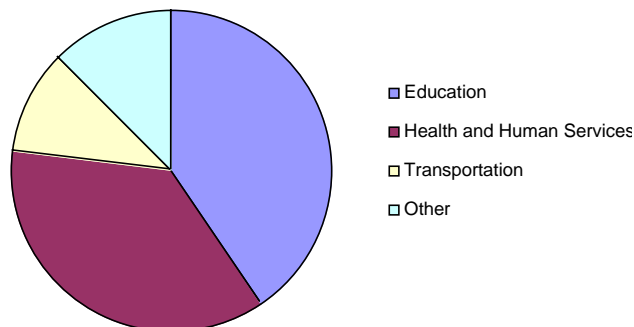
The state budget is supported by four major sources of funding: (1) the General Fund, (2) the Highway Fund and Highway Trust Fund, (3) federal funds (including matching funds, categorical grants, and block grants), and, (4) other receipts (such as tuition payments to state universities). Appropriations from the General Fund and nontax revenues support nearly 60 percent of the total state budget, federal funds pay for just over 25 percent, and the remaining 15 percent of the total state budget is supported by highway funds and agency receipts. These figures are illustrated in Chart 2-1.

Chart 2-1. Source of Fund:



The total state budget for 1999–2000, considering all of these funding sources, is approximately \$23.4 billion. Spending for education (public schools, community colleges, and universities) accounts for about 40 percent of the total state budget (approximately \$9.5 billion in 1999–2000). Health and human resources programs account for about 35 percent (some \$8.5 billion), and transportation programs account for about 10 percent (\$2.5 billion). This allocation of funding by general purpose is illustrated in Chart 2-2.

Chart 2-2. Allocation of Funds



The General Fund

The General Fund consists of state tax revenues (other than the motor fuels tax), nontax revenues (such as court fees and investment income from state funds), transfers from the Highway Trust Fund, and the unreserved General Fund balance from the prior fiscal year. Appropriations from the General Fund support virtually all state government programs and services other than highway construction and maintenance.

Revenue Availability. The General Assembly was presented with good financial news as the 1999–2001 budget preparations began. A strong state economy produced almost \$334 million in

tax revenues for 1998–99 above projections for that fiscal year. When combined with an additional \$106 million in unexpended appropriations from that year, the state was able to begin the 1999–2000 fiscal year with a substantial surplus. Table 2-1 summarizes the funds available.

However, several factors reduced the apparent flexibility that this presented to the General Assembly. First, because of prior legislative commitments, a portion of the fund balance had to be directed to designated programs. Accordingly, \$150 million was transferred to the Reserve for Repair and Renovations, \$30 million to the Clean Water Management Trust Fund. The General Assembly opted not to make additional transfers to the state Savings Reserve Account (or Rainy Day Fund) established under G.S. 143-15.3. Second, the state had to make its second major refund payment to federal, state, and local government retirees for illegally taxed retirement benefits (an obligation flowing from the *Bailey/Emory/Patton* litigation discussed below). The state's 1999 obligation was \$399 million. These commitments, combined with tax reductions in previous years, left the General Assembly with fewer spending options in 1999–2001 than otherwise would have been the case.

Table 2-1. 1999–2001 General Fund Budget Availability

	1999–2000 (\$ Millions)	2000–2001 (\$ Millions)
Unappropriated Balance	0.2	
Revenue Collections in 1998–99 in Excess of Authorized Estimates	333.9	
Unexpended Appropriations during 1998–99	106.3	
Transfer to Savings Reserve	0	
Transfer to Reserve for Repair and Renovations	(150.0)	
Transfer to Clean Water Management Trust Fund	(30.0)	
Ending Fund Balance	260.4	
Beginning Unrestricted Fund Balance	260.4	0
Revenues Based on Existing Tax Structure	12,368.4	13,105
Revenues-Gains on Asset Sale (RJR)	69.0	—
Nontax Revenues	523.8	550.5
Disproportionate Share Receipts	105.0	105.0
Transfer from Highway Trust Fund	170.0	170.0
Highway Fund Transfer	13.6	13.8
Transfer from Disproportionate Share Receipts Reserve	20.0	0.0
Transfer from Flexible Benefit Reserve	1.3	0.0
Total Availability	13,531.5	13,944.3

Appropriations from the General Fund. The 1999–2000 budget appropriates \$13.055 billion from the General Fund for current operations.

Included in this amount are the following appropriations above \$500 million:

- \$5.26 billion for the Department of Public Education
- \$1.64 billion for the University System
- \$0.58 billion for the Community College System
- \$2.78 billion for the Department of Health and Human Services
- \$0.89 billion for the Department of Correction.

The 1999–2000 budget includes \$397.6 million for compensation increases for state employees. As of July 1, 1998, the state budget supported 254,837 state employees (including 134,098 employees in the public school system, 31,432 in the University System, 11,007 in the Community College System, and 78,300 in state departments). For most state employees the compensation increase took the form of a 3 percent raise (2 percent for career growth and 1 percent for cost of living) and a one-time \$125 bonus. Salaries for public school teachers were increased by 7.5 percent.

The General Fund appropriations also include \$77 million in capital improvements. These capital projects are summarized in Table 2-2.

Table 2-2. 1999–2000 Capital Improvements—General Fund

Department of Administration	
Indian Cultural Center Land Acquisition Reserve	\$250,000
Department of Agriculture and Consumer Services	
State Fairgrounds Multipurpose Building	9,500,000
Eastern Agricultural Center	1,000,000
Western NC Farmers Market	250,000
Southeastern Farmers Market and Agricultural Center	500,000
Vernon James Research and Extension Center	827,168
Department of Community Colleges	
Grants for Repairs and Renovations	14,500,000
Department of Cultural Resources	
Museum of Art Expansion and Renovation	1,000,000
Department of Environment and Natural Resources	
Water Resources Development Projects	9,245,000
Museum of Natural Sciences—Upfit and Exhibits	4,000,000
Reserve for Forestry Headquarters	2,000,000
Museum of Forestry—Capital Projects	250,000
Department of Health and Human Services	
Whitaker School—Construction	5,400,000
Eastern Vocational Rehab Facility Repairs and Renovations	2,000,000
Office of Juvenile Justice	
Stonewall Jackson School—Demolition and Removal of Old Homes	337,000
State Ports	
Continued Development of Facilities	6,000,000
University of North Carolina	
Focused Enrollment Growth Supplemental Repairs and Renovations Funding	20,000,000
Total Capital Improvements—General Fund	\$77,059,168

The Highway Fund and Highway Trust Fund

The Highway Fund is funded by the motor fuels tax and other revenue related to motor vehicles. It provides funding for most of the operations of the state Department of Transportation (NCDOT). The Highway Trust Fund is funded by a portion of the per-gallon motor fuels tax and other dedicated revenues. It funds the special program of highway construction authorized by the 1989 General Assembly.

The 1999 Appropriations Act allocates \$1.15 billion from the Highway Fund for current operations and expenses. This includes about \$120 million in highway construction and \$463 million in state road maintenance. Just over \$100 million is devoted to NCDOT administration and operations, some \$84.8 million is provided as state aid to cities, and just over \$57 million is for state aid for public transportation and railroads.

The 1999 Appropriations Act also allocates \$880 million from the Highway Trust Fund. Of this, just over \$401 million is devoted to the Interstate System, \$162.2 million to urban loops, \$75.9 million to secondary roads, and \$42 million to state aid to cities.

Federal Block Grants

The 1999 Appropriations Act allocates more than \$804 million in federal block grants to a number of state programs, primarily in the area of human services. Table 2-3 summarizes the amounts of the various block grants available to the state.

Table 2-3. 1999–2000 Block Grant Allocations

DHHS Block Grant Provisions	
Community Services Block Grant	\$13,030,672
Social Services Block Grant	\$74,911,329
Low-Income Energy Block Grant	\$19,920,759
Mental Health Services Block Grant	\$6,498,831
Substance Abuse Prevention and Treatment Block Grant	\$38,579,723
Child Care and Development Fund Block Grant	\$194,680,226
Temporary Assistance to Needy Families (TANF) Block Grant	\$364,119,968
Maternal and Child Health Block Grant	\$16,784,030
Preventive Health Services Block Grant	\$5,599,783
NER Block Grants	
Welfare to Work Block Grant	\$23,663,882
Community Development Block Grant	\$45,000,000

Tax Refunds

Judicially mandated refunds of previously collected taxes continued to have a significant impact on state budget making in 1999.

Government Employee Retirement Benefits. In 1998 the state supreme court held that the state had improperly taxed the retirement benefits of federal, state, and local government retirees. *Bailey v. State of North Carolina*, 348 N.C. 130, 500 S.E.2d 54 (1998). This settlement and those of two related cases, referred to collectively as the *Bailey/Emory/Patton* settlement, produced a state liability of approximately \$799 million in tax refunds or credits. \$400 million of this was

provided for in the 1998 budget (S.L. 1998-164). Section 6(c) of S.L. 1999-237 funded the remaining \$399 million of this obligation.

Intangibles Tax. A second tax refund liability arose in 1999. G.S. 105-203 (now repealed) imposed an intangibles tax on shares of stock and provided a taxable percentage deduction reducing a taxpayer's liability for this tax in proportion to the issuing company's income taxed in North Carolina. In 1997 the North Carolina Supreme Court held the statute unconstitutional because it violated the Commerce Clause by discriminating against out-of-state companies. Taxpayers then sued for refunds on behalf of taxpayers who had paid intangibles tax on stocks for the 1990 to 1994 tax years without protest or timely requests for refunds. In December 1998, the North Carolina Supreme Court held, in *Smith v. State of North Carolina*, 349 N.C. 332, 507 S.E.2d 28 (1998), that these refund claims should not have been dismissed. As a result, on May 25, 1999, the Superior Court of Wake County held the state liable for \$360 million in refunds and interest for the 1991 to 1994 tax years. The court later held that the state was liable for an additional \$110 million in refunds and interest for the 1990 tax year.

S.L. 1999-327 (S 1043) approves a settlement agreement executed by the Speaker of the House of Representatives and the President Pro Tempore of the Senate on July 8, 1999. It appropriates \$200 million from the Savings Reserve Account for fiscal year 1999-2000 to a settlement fund to pay tax refunds. It further directs the General Assembly to allocate the remaining \$240 million to the settlement fund by July 10, 2000.

Within the settlement fund, 85 percent of the funds will be allocated to the "Smith/Shaver Claims Fund Account," and 15 percent will be allocated to the "Smith/Shaver Administration Account." Interest and earnings on all proceeds will be added as principal to the taxpayers' Claims Fund Account. The state is immune from any further liability for claims brought by taxpayers regarding the payment of intangibles tax.

Tobacco Settlement

Phase I Settlement

In late 1998, forty-six states, including North Carolina, and four tobacco manufacturers (Phillip Morris, Inc., R. J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation, and Lorillard Tobacco Company) signed the Master Settlement Agreement to settle existing and potential claims of the states against the manufacturers for damages arising from the tobacco products of the manufacturers. The manufacturers agreed to make payments to the states totaling \$206 billion through the year 2025. The amount that North Carolina will actually receive remains uncertain, but projections are that the state will receive some \$4.6 billion over the next twenty-five years from this settlement.

Pursuant to the terms of the Master Settlement Agreement, North Carolina and the four tobacco manufacturers entered into a consent decree, filed in Wake County Superior Court on December 21, 1998. This consent decree directed the Attorney General to create a nonprofit corporation for purposes of receipt and distribution of 50 percent of the funds allocated to North Carolina under the Master Settlement Agreement. The consent decree also required that the creation of the corporation had to be approved by the General Assembly by March 15, 1999.

One of the first acts of the 1999 General Assembly was approval of legislation to implement this agreement, generally referred to as Phase I of the settlement. S.L. 1999-2 (S 6) approves the creation of a nonprofit corporation to receive and distribute 50 percent of funds allocated to North Carolina. S.L. 1999-2 directs that these funds be used for the public charitable purposes of providing economic-impact assistance to economically affected or tobacco-dependent regions of the state.

Board of Directors. The act approves the governance of the nonprofit corporation by a fifteen-member board of directors who will hold four-year staggered terms. Five members will be appointed by the Governor, five by the President Pro Tempore of the Senate, and five by the

Speaker of the House. The Governor is to appoint the initial chair, with subsequent chairs to be elected by the directors. Members of the General Assembly are not eligible for service on the board during their legislative term of office.

Reports and Operations. The nonprofit corporation must consult with the Joint Legislative Commission on Government Operations prior to the adoption of the corporation's bylaws and its annual operating budget. The corporation is also required to make an annual report on its activities and expenditures to the commission. The nonprofit corporation is subject to North Carolina's open meetings law. It may not dispose of its assets without approval of the General Assembly. The charter of the nonprofit corporation may be repealed and the corporation dissolved by the General Assembly at any time.

Future Funds. S.L. 1999-2 further states the intent of the General Assembly to allocate the remaining 50 percent of the Phase I settlement funds as follows: 25 percent is to go to a trust fund to be established by the General Assembly for the benefit of tobacco producers, tobacco allotment holders, and persons engaged in tobacco-related businesses, and 25 percent is to go to a trust fund to be established by the General Assembly for the benefit of health. The General Assembly did not establish these additional trust funds for the remaining 50 percent of the Phase I settlement funds prior to adjournment in 1999.

Phase II Settlement

The Master Settlement Agreement contains provisions that are expected to result in a decline in demand for tobacco products. The four tobacco manufacturers acknowledged the adverse effect that the terms of the agreement would have on tobacco growers and agreed to address the economic concerns of tobacco growers and tobacco quota holders. The manufacturers agreed to establish a trust called the National Tobacco Grower Settlement Trust. They agreed to pay up to \$5.15 billion over the next twelve years into the Trust, referred to as Phase II settlement funds. Proceeds of the Trust would be allocated directly to tobacco growers and tobacco allotment holders in fourteen grower states, including North Carolina, based on a plan developed by a nonprofit corporation in each state composed of government leaders and public members.

S.L. 1999-333 (H 74) provides for the management and distribution of the Phase II funds.

Board of Directors. The act provides for the appointment of a board of directors of the nonprofit corporation that is to distribute money to tobacco growers and allotment holders in North Carolina. It authorizes the Speaker of the House of Representatives to appoint one State Representative and the Senate Pro Tempore to appoint one State Senator to the certification board. The other members of the board are the Governor, the Commissioner of Agriculture, the Attorney General, two members of the North Carolina congressional delegation selected by the delegation, and four to seven citizens appointed by the Governor.

Immunity for Board. The act provides for limited immunity from liability for the members of the board while performing their duties on behalf of the board. Immunity is not provided for intentional wrongdoing, willful or wanton misconduct, or motor vehicle accidents. Since the board will be a private board, not a state agency, its members will not be covered by the liability insurance coverage that the state obtains for its officers and employees.

Tax Exemption and Credits. The act provides an income tax exemption for the interest, investment earnings, and gains of the trust established to compensate those who suffer economic loss as a result of the settlement agreement. A comparable corporate and trust income tax deduction is provided in the event that the trust does not qualify for the exemption.

The act also creates a corporate income tax credit for manufacturers who produce cigarettes for export to a foreign country. The amount of the credit varies depending upon the amount of cigarettes exported in the tax year compared to the amount exported in 1998. This credit is effective for taxable years beginning on or after January 1, 1999. It will not apply to cigarettes exported on or after January 1, 2005.

The tobacco export credit and tax exemption for the earnings of the settlement trust fund are expected to reduce General Fund revenues by \$8.7 million in fiscal year 1999–2000, \$9 million in

fiscal year 2000–2001, \$9.3 million in fiscal year 2001–2002, \$9.6 million in fiscal year 2002–2003, and \$9.9 million in fiscal year 2003–2004.

Export Sales. S.L. 1999-333 also makes it unlawful to sell cigarettes in North Carolina if the cigarettes were originally manufactured for export to a foreign country. The Secretary of Revenue is authorized to cancel the license or certificate of registration of a person who violates this law. A violation of this law is a Class A1 misdemeanor and an unfair trade practice. A package of cigarettes that violates this law is considered contraband and may be seized by a law enforcement officer. The Secretary of Revenue is authorized to cancel the license or the certificate of registration, whichever is applicable, of a person who violates this law.

Judicial Approval. The Superior Court of Wake County must approve the Trust and the payments made under it. A court settlement was signed in Wake County Superior Court on August 20, 1999, approving the settlement of the Phase II funds and the distribution of the payments out of these funds to the fourteen grower states.

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