



NC 2011 Regular Legislative Session Budget and Fiscal Policy Highlights

Fiscal Brief

July 14, 2011

Executive Summary

When the 2011 General Assembly convened in January, they were confronted with the loss of \$1.6 billion in federal American Recovery and Reinvestment Act (ARRA) funds, \$1.3 billion in expiring temporary taxes and another \$800 million in estimated funding needs - a budget gap preliminarily estimated at \$3.7 billion. By March, improvements in the State's slowly-recovering economy, lower than expected funding needs for enrollment growth in public education and Medicaid, and further refinement of the estimate for the State Health Plan brought the gap to \$2.6 billion.¹

The legislature took steps early on to address the gap, enacting Senate Bill 109 (Session Law 2011-15), directing Governor Beverly Perdue to increase reversions from the current operating budget by \$538 million. That action, along with \$2 billion in reductions primarily in education and Medicaid, helped close the gap. On June 4th, 2011, House Bill 200 was ratified, appropriating \$19.7 billion in General Fund spending for FY 2011-12. Governor Beverly Perdue vetoed the bill on June 12th but the General Assembly overrode the veto and House Bill 200 (S.L. 2011-145, Appropriations Act of 2011) became law on June 15, 2011.

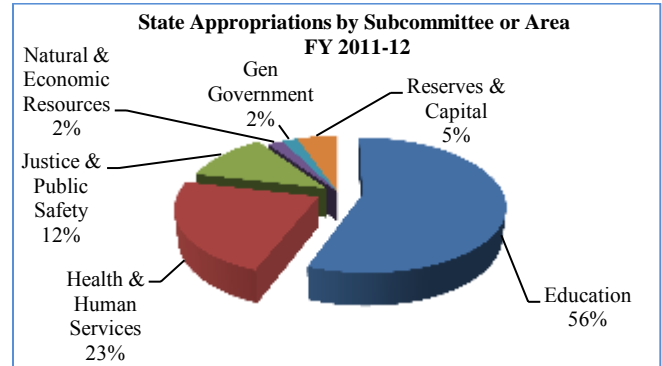
This brief summarizes the General Assembly's major budgetary actions to close the \$2.6 billion gap, reorganize and consolidate government, and to reform the State's justice system.

FY 2011-12 Budget

The General Assembly enacted a \$19.7 billion budget for FY 2011-12, closing a \$2.6 billion budget gap using a combination of adjustments to General Fund availability (36%) and spending reductions (64%).

¹ For a history of the budget gap, click on [Fiscal Year 2011-12 Budget Gap](#)

As Figure 1 shows education and health and human services received the majority of State appropriations.



General Fund Availability

Baseline Revenue

The consensus forecast maintained a cautious approach to the State's revenue outlook, not allowing modest improvements over the last year to influence overall expectations.

In February economists in the Fiscal Research Division and the Office of State Budget and Management issued the annual consensus forecast. Baseline revenue would grow 4.6 percent to \$18.8 billion for FY 2011-12, enough to offset nearly \$1 billion of the \$1.3 billion in expiring temporary sales and income taxes.

The \$18.8 billion represents a decline of \$336.1 million from the previous year's collections. That decline, along with the uncertainty surrounding the pace of growth in the economy, including weaknesses and instability in the housing and employment markets, furthered strengthened the State's position that a full economic expansion during the next biennium was improbable.

General Fund revenues are forecast to grow 5.6 percent in FY 2012-13.

Unreserved Fund Balance

Senate Bill 109 (S.L. 2011-15) authorized the Governor to reduce spending using powers, ordinarily available only in times of revenue shortfall, granted under Article III, Section 5 of the North Carolina Constitution. Excluding the judicial and legislative branches of government, the Governor was directed to take the necessary actions to reduce General Fund expenditures and increase availability by \$538 million for the remainder of FY 2010-11. This action, along with \$180.8 million in over-collections and a \$237 million balance remaining from June 30, 2010 yielded a final unreserved fund balance of \$522.3 million.²

Adjustments to Revenue and Availability

The General Assembly enacted a total of \$19.7 billion in general availability including adjustments to income taxes, fees and various other funds. The most significant adjustments are highlighted below:

- **Small Business Tax Cut** - State income taxes were reduced by \$131.6 million in FY 2011-12 and \$335.6 million in FY 2012-13. The tax law change allows a tax deduction of up to \$50,000 for business income for small businesses, excluding C-corporations but including pass-through entities, sole proprietorships, and farming operations that are subject to the personal income tax.
- **Federal Estate Tax** - State estate tax losses are \$57.1 million and \$72.2 million, respectively, over the biennium. The ongoing loss is due to federal estate tax changes in 2011 and 2012, which reduce the number of estates with a State estate tax liability.³

- **Fees for State Operations** - Various fees were increased to help offset \$64 million of the cost of State operations including \$62 million from the court system and the remainder from State parking and filings from investment companies.
- **Availability from Other Sources** - The budget transfers \$236 million in one-time funds from other sources into the General Fund (excluding the transfer of funds to pay for specific programs or services such as the State Highway Patrol). The primary sources include \$72 million in revenue from the suspension of the corporate income tax earmark for public school construction, \$17.6 million from Golden LEAF, \$57 million from other tobacco Master Settlement Agreement funds, and \$40 million from an accounts receivable initiative and the sale of state assets.

General Fund Appropriations

The enacted budget is 5.5 percent lower than Governor Perdue's \$20.8 billion recommended continuation budget and represents a 4.3 percent decrease from the previous year's operating budget (adjusting for ARRA funds). Major budget adjustments are outlined below.

Budget Cuts

A total of \$2 billion or 10 percent was cut from the Governor's recommended continuation budget for FY 2011-12. That percentage drops to a net decrease of 5.5 percent when adjusting for increases in spending such as education enrollment growth, contributions to the State's retirement systems and transfers of funds that support specific programs or services such as the State Highway Patrol. Table 1 lists the major reductions.

² The projected unreserved fund balance prior to enactment of H.B. 200 was \$830.4 million. Adjustments enacted include \$308 million in transfers to the Savings Reserve and Repairs and Renovations Reserve Accounts, \$125 million for prior year Medicaid costs, and additional appropriations in H.B. 344 (S.L. 2011-395) and H.B. 22 (S.L. 2011-391)

³ House Bill 124 (S.L. 2011-5) conformed the State's estate tax to federal law. This change was enacted after release of the State's consensus revenue forecast thus the amount is reflected as an adjustment to revenue.

Table 1
FY 2011-12 Major Budget Cuts in House Bill 200

<u>Education</u>	
LEA Adjustment (Public Schools)	(124,217,542)
Textbooks & Instructional Supplies (Public Schools)	(134,137,219)
School Administration (Public Schools)	(47,104,374)
Management Flexibility (Community Colleges)	(50,777,984)
Categorical Funding (Community Colleges)	(22,670,636)
Management Flexibility (University System)	(413,987,494)
<u>Health & Human Services</u>	
Smart Start	(37,600,000)
Mental Health Community Services	(27,180,807)
Provider Assessments (Medicaid)	(60,183,120)
Community Care of NC	(90,000,000)
Provider Rates & Inflation	(109,274,493)
<u>Justice and Public Safety</u>	
Position Eliminations & Operating Costs (AOC)	(12,935,761)
Youth Development Center Closures	(8,303,456)
Position Eliminations & Operating Costs (DOC)	(21,482,770)
Justice Reinvestment Act	(9,976,921)
<u>Natural & Economic Resources</u>	
Position Eliminations & Operating Costs (DENR)	(6,703,043)
Clean Water Management Trust Fund	(88,750,000)

Table 3
FY 2011-12 Major Budget Increases in House Bill 200

<u>Education</u>	
Enrollment Growth (Public Schools)	55,882,651
Class Size Reduction (Public Schools)	61,697,942
Enrollment Growth (Community Colleges)	34,140,158
Enrollment Growth (University System)	46,818,123
Need-based Financial Aid (University System)	37,891,429
Operating Costs for New Buildings/Programs (University System)	23,031,614
<u>Justice and Public Safety</u>	
Operating Reserves for New Buildings/Programs	10,000,000
<u>Natural & Economic Resources</u>	
Drinking Water State Revolving Loan Fund	7,118,600
Operating Reserves for New Buildings/Programs	3,110,805
Jobs Maintenance & Capital Development Fund	6,000,000
One North Carolina Fund	10,000,000
Emergency Rural Jobs Infrastructure Fund	5,000,000
<u>Statewide Reserves</u>	
Severance Reserve	69,000,000
State Retirement Systems Contribution	259,218,042
State Health Plan	7,119,541

Table 2 compares the previous year's appropriations (including adjustments for ARRA funds) to FY 2011-12 by subcommittee or area:

Table 2

Subcommittee/Area	FY 2010-11		FY 2011-12	Difference
	FY 2010-11	w/ARRA		
Education	10.81	11.33	10.99	-3.0%
Health & Human Services	3.95	5.02	4.50	-10.5%
Justice & Public Safety	2.12	2.13	2.33	9.4%
Natural & Economic Resource:	0.47	0.47	0.40	-13.9%
General Government	0.44	0.44	0.41	-7.1%
Statewide Reserves & Capital	1.18	1.18	1.06	-10.2%
Total	18.96	20.56	19.68	-4.3%

Note: When adjusting for the transfer of \$196 million into the Justice and Public Safety Subcommittee area to support the State Highway Patrol, the increase of 9.4 percent drops to less than 1 percent.

Budget Increases

Even though the FY 2011-12 budget is 5.5 percent lower than the Governor's recommended continuation budget and 4.3 percent less than the previous year's budget, the General Assembly appropriated over \$650 million in additional funding for FY 2011-12. Table 3 lists the primary increases.

Budget and Fiscal Policy Highlights
Savings Reserve Account

G.S. 143C-4-2 sets a goal for the Savings Reserve Account of at least 8 percent of the previous year's operating budget. The goal for FY 2011-12 is \$1.5 billion. The 2011 Appropriations Act, as amended by H.B. 344 (S.L. 2011-395), directed the State Controller to reserve \$184 million from the June 30, 2011 unreserved fund balance, bringing the Savings Reserve Account balance to \$296 million, 1.6 percent of the prior year's operating budget.

State Health Plan

The General Assembly enacted major changes to the State's health plan to cover a projected shortfall over FY 2011-12 and FY 2012-13. The 2011 Appropriations Act included the funding needed for the Plan, but the key measures needed to address the shortfall were in Senate Bill 323 (S.L. 2011-85), as amended by House Bill 578 (S.L. 2011-96). These measures included:

- Increasing employer premium contributions (\$109.3 million from the General Fund, \$5.1 million from the Highway Fund and \$22.5 million from other sources over the biennium);

- Increasing member out-of-pocket expenses (\$133.7 million over the biennium);
- Increasing member premiums (\$224.6 million in additional revenue over the biennium);
- Establishing a premium for active and retired members in the Standard 80/20 Plan;
- Eliminating the Comprehensive Wellness Initiative; and
- Moving the management of the Plan including benefit design to the State Treasurer and Board of Trustees.

Education

Appropriations for Public Schools, Community Colleges, and the University System totaled \$11 billion for FY 2011-12. This represents a reduction of \$923.6 million (7.8%) from the Governor's recommended continuation budget, including net reductions of:

- \$117.5 million (10.7%) for Community Colleges. Of the \$117.5 million reduction to Community Colleges, \$47.7 million (40.6%) is offset by an increase in tuition.
- \$459.1 million (5.8%) for Public Schools. Reductions in public schools were targeted to preserve allotments that primarily fund teachers and teaching assistants. School districts were also given broad budgetary flexibility and teacher and administrator paperwork requirements were substantially reduced. In addition, education reform provisions were included in the budget. Class size allotment ratios in the early grades were reduced from 1 teacher per 18 students to 1 teacher per 17 students as the first installment of a plan to reduce the ratio to 1:15. Five additional instructional days were added to the K-12 instructional calendar for a total of 185 instructional days beginning in FY 2011-12.
- \$347.1 million (12.0%) for the UNC System. For the University system, the General Assembly aimed to minimize the impact of reductions by allowing UNC to determine where to take most budget cuts and by providing it additional operating flexibility.

Additionally, the legislature acted to stabilize funding for the State's public universities' need-based financial aid programs by reducing the impact on the Escheat Fund and by replacing a portion of that funding with General Fund dollars. Financial aid for private college students was also reduced 12.3 percent in FY 2011-12 and was consolidated into one, need-based program in FY 2012-13.

Medicaid

The General Assembly enacted a \$3 billion Medicaid budget that continues coverage for all eligible North Carolina residents and maintains the current mix of mandatory and optional services over the next biennium. The legislature joined 43 other states in adopting Medicaid assessments on hospitals. The assessment on hospitals and other willing healthcare providers is expected to yield \$60 million in savings to Medicaid. Participating hospitals are expected to collect \$370 million in additional revenue.

The budget continues to shift State Medicaid policy toward improved management of patient care and greater use of generic drugs. For FY 2011-12 these initiatives include:

- Community Care of North Carolina (\$90,000,000)
- Health Homes for Chronically Ill (\$16,146,384)
- Capitated Behavioral Health (\$10,537,931)
- Generic Prescription Dispensing (\$15,000,000)

Also, the legislature eliminated \$63 million in inflationary increases and further reduced provider reimbursement rates by \$46 million.

Job Creation and Economic Development

A total of \$146.5 million was appropriated for programs and initiatives focused on job creation and economic development. These include:

- Emergency Rural Jobs Infrastructure Fund – Provides \$5 million in nonrecurring funds for each year of the biennium to the Rural Center to establish the Emergency Rural Jobs Infrastructure Fund, which will provide grants to local government units for multiple types of infrastructure projects, including public water, sewer, natural gas, fiber, and building restoration projects, and is expected to generate approximately 1,000 private sector jobs.

- One North Carolina Fund - Provides \$10 million in nonrecurring funding to provide grants to private businesses for infrastructure development, equipment purchases, or repair and renovations to existing facilities.
- Jobs Maintenance and Capital Development Fund - Provides \$6 million to meet the obligations of the Bridgestone/Firestone and Goodyear agreements for grant year 2010.
- Broadband Connectivity - Provides \$1 million in nonrecurring funds to encourage private businesses to provide broadband connectivity in underserved areas in mixed urban-rural counties and rural counties.
- Repairs and Renovations Reserve Account - Provides \$124.5 million in nonrecurring funds for the repair and renovation of State facilities and related infrastructure such as roof replacements, drainage and landscape improvements and repairs to electrical, plumbing, roof and heating and air-conditioning systems.
- Removing statutory restrictions on the number of design-build projects and public-private partnerships, enabling DOT to reduce costs and expedite project completion; and
- Requiring increased privatization and budgetary transparency.

Governmental Reorganizations and Consolidations

More at Four and Smart Start – H.B. 200 transfers the More at Four pre-kindergarten program for four year olds from the Department of Public Instruction to the Department of Health and Human Services’ (DHHS) Division of Child Development. This moves the State’s pre-kindergarten program into DHHS, where the State’s largest investment for early childhood development is administered. While the budgets of More at Four and Smart Start were reduced by 20 percent each, \$16 million and \$37.6 million respectively, the consolidation is expected to result in administrative efficiencies and economies of scale by combining the State’s payment systems and oversight functions. The budget also establishes a parent co-payment, projected to generate up to \$20 million annually to help offset reductions.

House Bill 200 also requires DHHS to maintain current standards set by the More at Four program and to improve the quality of care for families receiving child care subsidy. Further, high quality child care centers (defined as four- and five-star child care centers) are required to use State-approved curricula with a focus on reading and literacy. These changes are intended to enhance the learning environment in child care settings by creating classrooms that serve children regardless of their socioeconomic status.

Department of Environment and Natural Resources

– The legislature significantly altered the structure of the Department of Environment and Natural Resources (DENR) and the Department of Agriculture & Consumer Services (DACS). Three divisions were transferred out of DENR and several programs were completely eliminated. The following highlights the DENR changes:

<u>FROM</u>	<u>TO</u>
Division of Forest Resources \$55.3 million and 642 FTE	DACS
Division of Soil & Water Con.	DACS

Transportation

The General Assembly appropriated \$6.4 billion from the Highway Fund and the Highway Trust Fund for the State’s transportation needs over the 2011-13 biennium. Of that total, \$2.4 billion or 38 percent is dedicated to maintain and preserve the State’s transportation system. The additional \$565 million for maintenance, a 30 percent increase from the previous biennium, will enable the Department of Transportation (DOT) to resurface approximately 8,000 road miles and repair over 900 structurally-deficient bridges. The budget also increases urban loop funding by \$230.4 million, continuing the acceleration of projects in Charlotte, Greensboro, and Wilmington.

The legislature also enacted changes in transportation policy including:

- Removing specific urban loop projects from statute and requiring DOT to develop prioritization criteria;
- Requiring future funding for the Mobility Fund be held in reserve until new project selection criteria are developed;

FROM

\$20.9 million and 46 FTE

Division of Env. Health
\$20.6 million and 221 FTE

TO

DHHS

- Providing supervision for all felons released from prison to facilitate community reintegration and reduce failure and subsequent recidivism;
- Diverting all first-time drug offenders into treatment by expanding the Deferred Prosecution Program; and
- Providing increased incentives for prison inmates to participate in treatment.

The balance of the Division of Environmental Health was transferred to other divisions within DENR and five programs were eliminated.

Department of Public Safety – Effective January 1, 2012, H.B. 200 established the Department of Public Safety (DPS), consolidating the Departments of Crime Control and Public Safety, Juvenile Justice and Delinquency Prevention, and Correction. The new agency is comprised of four divisions – Law Enforcement, Correction, Juvenile Justice, and Administration. The structure of DPS maintains the separation between the juvenile and adult systems while allowing coordination of administrative and facility management functions. Net savings from consolidation will be \$1.1 million in FY 2011-12 and \$3.6 million in FY 2012-13. As the consolidation process moves forward, additional savings are anticipated in areas such as purchasing and training.

The initiative is projected to save the State more than \$70 million and reduce the need for 3,000 prison beds over the next five years.

In addition, H.B. 642 reforms the Criminal Justice Partnership Program to provide more focused services for offenders and moves most misdemeanants out of the State prison system into county jails.

Other Budgetary Highlights

In addition to the sections outlined throughout this brief, a more detailed presentation of fiscal and budgetary highlights by subcommittee can be found at [2011 Summary of Selected Finance, Appropriations and Other Budget-Related Actions](#).

Justice Reinvestment Act

The 2011 Appropriations Act authorizes court fee increases totaling \$35 million to offset the cost of housing misdemeanants as well as \$10 million in other budget reductions enacted as part of the reform of the State's justice system. However, House Bill 642, S.L. 2011-192, the Justice Reinvestment Act, was the primary vehicle for the reform. The act changes sentencing laws and correctional policies, allowing the State to shift savings from incarceration to community-based treatment alternatives. The major components of the act include:

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- Allowing probation officers to use short-term incarcerations in jail rather than revocations and prison time;
- Capping revocations for purely technical violations at 90 days, rather than imposing the entire active sentence;
- Creating a new status offense of Habitual Breaking and Entering to accelerate active sentences;