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## THE FINAL FY 2010-2011 BUDGET FOR NORTH CAROLINA: Will It Support Economic Recovery?

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### Executive Summary

- On June 30, 2010, the General Assembly passed the adjusted state budget for fiscal year 2010-2011. The final General Fund budget provides for \$18.96 billion in appropriations, which is 15.9 percent less in state-funded spending than would be needed to maintain services at 2008-2009 levels (as reflected in the continuation budget) and 3.1 percent less than the certified biennium budget. Even with federal aid, the adjusted state budget represents a 2.8 percent reduction from last year's budget.
- The budget gap continued to balloon after last year's gap of \$4.6 billion; this year policymakers faced an additional shortfall of \$1.2 billion.
- Policymakers relied almost exclusively on spending cuts, efficiencies, and one-time fixes to address the additional budget shortfall. These measures enabled lawmakers to minimize harm to state services in the short-run while postponing tackling the budget crisis to come when temporary taxes expire and federal recovery dollars disappear next year.
- The final budget includes almost \$482 million in federal Medicaid assistance that Congress may withhold from the state. The budget gives the state budget director authority to plug the resulting budget hole if federal funds are not provided by reducing Medicaid provider rates, cutting state agency appropriations by one-percent, and tapping the state retirement system and other funds—a practice likely to compromise the solvency of these funds in the future.
- The budget includes limited expansion funding targeted to programs and services aimed at supporting economic recovery goals such as preparing the state's workforce through education and training and meeting critical health needs.
- North Carolina is experiencing a modest recovery from the recession that eliminated nearly 300,000 jobs in the state. The budget must continue to serve as a guide in these tough economic times: investing in the systems that can support working families and their participation in a fast-changing economy and reforming the systems that have failed to provide adequate revenues to enable the state to make the necessary investments for sustained economic growth.

## Overview

The Great Recession has increased demand for services at the same time that it has reduced available revenue, putting pressure on our public systems at the exact time when their rapid response is critical to the state's economic recovery. Heading into this year's budget process, policymakers in North Carolina were facing a budget shortfall of \$1.2 billion, \$703 million due to a downward revision of the revenue forecast and \$539 million due to increased costs to maintain state services (See Figure 2). Last year, state leaders addressed the shortfall of \$4.6 billion through a balanced approach of spending cuts, tax increases and federal aid. This year, the range of tools employed by policymakers was narrowed due to the unreliability of federal aid and the fact that leaders decided before the session that raising revenue was "off the table." Ultimately, the final FY 2010-2011 adjusted budget limits cuts to critical services essential for the state's recovery by employing a series of one-time, unsustainable fixes.

Policymakers relied on spending reductions, technical adjustments and federal recovery dollars to close the gap—reducing the 2010-2011 budget by \$601 million to \$18.96 billion (See Figures 1 and 3). The result is that the state is making the lowest level of investment per capita in fourteen years. For North Carolinians and the state economy as a whole, such low levels of spending reduce economic activity that contributes to the state's economic recovery. Accounting for the contribution of federal recovery dollars, the state's ability to deliver services at 2008-2009 levels was reduced by 8.6 percent.<sup>1</sup>

Policymakers made significant cuts to programs and services fundamental to education, safety and health. The public school system received \$275 million less in state funds including teachers' salary adjustments and cuts to technology systems that can facilitate

**FIGURE 1**

<b>OVERVIEW OF FINAL ADJUSTMENTS TO FY10-11 GENERAL FUND BUDGET</b>		
FY10-11 General Fund Appropriations Only		
<b>FY 09-10 Certified Budget</b>	<b>\$19,008,079,980</b>	
<b>FY10-11 Original Continuation Budget</b>	<b>\$22,554,891,906</b>	
<b>FY10-11 Certified General Fund Budget</b>	<b>\$19,559,764,576</b>	
<b>FY10-11 Final Adjusted General Fund Budget</b>	<b>\$18,958,293,337</b>	
<i>Change from FY 09-10 Certified General Fund Budget</i>	<i>\$(49,786,643)</i>	<i>-0.3%</i>
<i>Change from FY 10-11 Certified General Fund Budget</i>	<i>\$(601,471,239)</i>	<i>-3.1%</i>
<i>Change from FY10-11 Continuation Budget</i>	<i>\$(3,596,598,569)</i>	<i>-15.9%</i>
FY10-11 General Fund Appropriations + Federal Recovery Assistance		
<b>FY 09-10 Certified Budget</b>	<b>\$20,405,943,837</b>	
<b>FY10-11 Original Continuation Budget</b>	<b>\$22,554,891,906</b>	
<b>FY10-11 Certified General Fund Budget + Federal Recovery Dollars*</b>	<b>\$21,215,290,950</b>	
<b>FY10-11 Final Recommended Adjusted General Fund Budget + Federal Recovery Dollars*</b>	<b>\$20,613,819,711</b>	
<i>Change from FY 09-10 Certified General Fund Budget</i>	<i>\$207,875,874</i>	<i>1.0%</i>
<i>Change from FY10-11 Certified General Fund Budget</i>	<i>\$(601,471,239)</i>	<i>-2.8%</i>
<i>Change from FY10-11 Continuation Budget</i>	<i>\$(1,941,072,195)</i>	<i>-8.6%</i>

\* Includes \$578m in additional federal aid to states that is still pending in the US Congress

<sup>1</sup> Mejia, Elaine. July 9, 2010. *How low is too low? FY 2010-11 State Budget Sets Spending at Its Lowest Level in 14 Years*

**FIGURE 2**

<b>DEFINING THE BUDGET GAP</b>	
<b>FY10-11 Certified Budget</b>	<b>\$19,559,764,576</b>
<b>+ Budget Pressures</b>	
Medicaid growth	\$430,564,713
Higher Education Enrollment growth	\$86,682,281
Restoration of Continuation Review Programs	\$21,991,648
<b>Total Budget Pressures</b>	<b>\$539,238,642</b>
<b>= New Recommended Total GF Appropriations</b>	<b>\$20,099,003,218</b>
<b>- Revised Baseline Forecast</b>	<b>\$18,940,011,278</b>
<b>New FY10-11 Budget Gap</b>	<b>\$(1,158,991,940)</b>

**FIGURE 3**

<b>HOW DID LAWMAKERS CLOSE THE BUDGET GAP?</b>	
<b>+ Adjustments to Availability</b>	<b>\$41,751,216</b>
Unemployment Insurance Tax Credit	\$(34,100,000)
Department of Revenue Settlement Initiative	\$110,000,000
Loss of Estate Tax Revenue	\$(85,000,000)
Disproportionate Share	\$35,000,000
Other Adjustments	\$15,851,216
<b>+ Additional Federal Recovery Dollars (used to offset reduced GF appropriations)</b>	<b>\$617,936,025</b>
FMAP extension for Medicaid	\$481,621,383
FMAP funds for Part D Clawback	\$79,419,834
TANF Emergency Funds	\$54,184,341
Other ARRA	\$1,421,552
+ Other Federal Dollars	\$1,288,915
<b>+ Net Spending Reductions</b>	<b>\$522,773,856</b>
Spending Cuts	\$850,055,730
Expansion items other than budget pressures	\$(327,281,874)
<b>Total Available to Close Gap</b>	<b>\$1,182,461,097</b>
Balance Remaining	\$23,469,157

classroom learning. The Health and Human Services system reductions in state funding totaled \$553 million and included an array of cuts and changes to mental health programs that will likely impact services. Funding changes in the budget will result in an estimated loss of 573 filled and vacant positions in the public sector.

Nevertheless policymakers made a significant effort to preserve a number of investments that train and educate the workforce of tomorrow and protect the health of the state's citizens. Notably, policymakers fully funded the increased enrollment in community colleges and the surging demand for Medicaid services, partially restored funding for mental health community services funds, as well as expanded enrollment in the NC Health Choice children's health insurance program. In addition, K-12 classroom funding was largely insulated from significant cuts. The state's only education program for prison inmates—a key tool for successful re-entry into the community

and participation in the workforce—was reinstated with partial funding.

North Carolina's budget represents an essential tool for supporting economic life. In this report, the Budget and Tax Center provides an analysis of the decisions made during

**FIGURE 4**

<b>HOW THE FINAL BUDGET DEALT WITH THE POSSIBLE LOSS OF FMAP FUNDS (IN PRIORITY ORDER)</b>	
Transfer from Disaster Relief Reserve Fund	(30 000 000)
Transfer unclaimed lottery prize money and excess receipts	(35 000 000)
Use of interest from all other funds	(50 000 000)
Use of balance in General Fund availability	(23 469 157)
Reductions of Medicaid provider rates	(26 618 975)
Use of funds from the Savings Reserve Fund	(37 307 714)
Reduction in retirement system contributions	(139 000 000)
One percent management flexibility reduction	(177 500 000)
<b>TOTAL</b>	<b>(518 895 846)</b>

today's difficult economic times. Due to the changing economic forecasts that arose throughout the budget process, this report will focus on the ultimate priorities set out in the final budget rather than comparing the final budget to those offered by the Governor, Senate and House. An in-depth analysis of the impact budget decisions will have for low- and moderate-income families in North Carolina and on the state's long-term economic prospects will require a longer time frame to conduct. However, the public systems that can best connect North Carolinians to opportunity and prosperity have no doubt been affected by the Great Recession and the difficult decisions that were required in this year's budget.

## The Revenue Plan

North Carolina faces an ongoing and serious revenue challenge driven by longstanding structural issues built into our tax collection system long before the current recession. In fact, the last time that significant changes were made to the state's tax code was during the Great Depression. More than 75 years later, an economic downturn has once again demonstrated that the current tax system is unable to raise the necessary resources to maintain public investments in essential programs and services. State lawmakers laudably passed a revenue package in last year's budget that was projected to generate \$1.36 billion in FY 2010-2011, which served a vital role in protecting investments in education, public safety and health care. However, North Carolina's revenue system has yet to be reformed in a comprehensive way. In this year's budget, the revenue plan changed very little from the biennium budget, but worsening economic conditions caused a \$703 million downward revision in revenue estimates.

Compounding recession-driven losses, the federal government's failure to extend the estate tax represented a significant impact on the availability of revenue to the state. Due to the "sunsetting" of the federal law, to which the North Carolina state tax was linked, the state was unable to budget \$85 million that had been expected.

In an effort to support small businesses in these tough economic times, state policymakers increased the sales tax prepayment threshold from \$10,000 to \$20,000 for businesses and provided for a refundable tax credit on unemployment insurance taxes in an effort to incent the private sector to ramp up production and hire new workers. The result is a projected reduction in available revenues of \$7 million and \$34 million, respectively. However, there is little evidence to suggest that these tax proposals will change employer behavior and lead to increased economic activity and job creation.

Finally, the budget anticipates the collection of \$110 million in revenue from the Department of Revenue's ongoing efforts to assess corporate tax payments. However, at the same time, the General Assembly approved legislation to eliminate the Department of

## The Role of Federal Aid in the Adjusted Budget

Revenue's ability to levy a penalty on companies that substantially underpaid the taxes owed. The Department of Revenue has stated that they can no longer guarantee their ability to collect the full \$110 million without this policy tool.

Federal dollars amounted to seven percent of the certified budget for 2009-2010 and eight percent of the 2010-2011 adjusted budget. Resources from the American Recovery and Reinvestment Act (Recovery Act), while still flowing into states and out into communities, have already begun to taper off. In the adjusted 2010-2011 budget, \$617 million of over \$1.6 billion in total federal aid was applied to offset General Fund reductions. This federal aid will provide funding to the K-12 system to reduce the impact of cuts on the classroom as well as support early intervention, child care, foster care and adoption assistance, and vocational training.

Of that \$617 million, however, the vast majority — \$482 million — reflects the enhanced Federal Medicaid Assistance Percentage, the increased share of Medicaid costs assumed by the federal government under the Recovery Act. Unfortunately, Congress has thus far failed to extend this essential fiscal relief. If not remedied, this will result in a combination of further cuts and shifting of funds. In the final budget, the state budget director is directed to find the money by further reducing appropriations or transferring resources from specific funds. The state budget director is also authorized to dip into various funds and the interest on them to plug the budget hole—a practice that will likely compromise the solvency of funds in future years. Most notable among the sources that will be tapped are the state's retirement system, Medicaid provider rates, and one-percent management flexibility reductions spread across all agencies (See Figure 4).

## The Spending Plan

The final General Fund budget provides for \$18.96 billion in appropriations in FY 2010-2011. This represents a reduction by 16 percent in the amount needed to continue state services at 2008-2009 levels. When the federal stimulus funds are accounted for, the reductions represent 2.8 percent compared to the original FY 2010-2011 certified budget.

Where possible, policymakers sought to identify investments that could be delayed without affecting core public programs, but many additional cuts will clearly inhibit the ability of essential public programs to serve the needs of North Carolinians. These cuts include reductions to available funds for early childhood education, mentoring programs and child protective services funds for counties. Some of the most significant reductions will be at the discretion of administrators in the community college and university systems, and in the justice and public safety system, where reductions will be made through "management flexibility" (See Figure 5).

The vast majority of new spending funds enrollment growth and health care cost inflation in Medicaid, the community college and university system and N.C. Health Choice. Additional expansions will restore funding to programs that received cuts last year, like the AIDS drug assistance program, and invest in technologies to assess student performance and monitor crime statistics, for example. New spending will also increase funds to the Biotechnology grant program and the One NC and Small Business Fund in an effort to support sector-specific economic development and general business attraction (See Figure 6).

## EDUCATION

The final FY 10-11 budget, including federal stimulus money for fiscal relief, reduces overall education spending on public schools, community colleges and universities by \$1.2 billion or 10 percent from the recommended continuation budget level.

### Public Schools (K-12)

In the final adjusted budget, lawmakers reduced the state appropriation to public schools by \$275 million compared to last year's biennium budget. More than \$186 million of these reductions are "technical adjustments" based on adjusted pupil counts or the replacement of General Fund dollars with funds from other revenue sources. Major highlights include:

**FIGURE 5****SIGNIFICANT SPENDING REDUCTIONS IN THE FY 10-11 BUDGET**

<b>Education</b>	
<b>K-12 Cuts</b>	
Mentoring Programs	\$(9,214,190)
Reductions to Instructional Supplies	\$(3,289,447)
Delay School Bus Replacement	\$(11,900,000)
Public School Transportation	\$(10,000,000)
Limited English Proficiency Programs	\$(4,000,000)
Child and Family Support Teams	\$(2,500,000)
<b>Community Colleges</b>	
Tuition Increase	\$(30,025,612)
Management Flexibility Reductions	\$(15,000,000)
<b>Universities</b>	
Management Flexibility Reductions	\$(70,000,000)
Repeal of Non-resident Scholarship In-State Tuition Waiver	\$(9,432,978)
Reductions to Aid to UNC Hospitals	\$(8,000,000)
Reductions to UNC Advertising budgets	\$(2,500,000)
<b>Health and Human Services</b>	
<b>Division of Child Development</b>	
Electronic Benefit Payment System for Child Care Subsidy Program	\$(6,000,000)
Reductions to Smart Start	\$(5,000,000)
<b>Mental Health/Developmental Disabilities, and Substance Abuse Services</b>	
Mental Health Division Management Funds	\$(7,180,807)
<b>Division of Public Health</b>	
Immunization Changes (elimination of state reimbursement of vaccines)	\$(15,894,853)
<b>Division of Medical Assistance (Medicaid)</b>	
Community Care Network of North Carolina (CCNC) Savings	\$(45,000,000)
Pharmacy Program Improvements (reimbursement & approval changes)	\$(5,556,096)
Add Mental Health Drugs to Preferred Drug List (PDL)	\$(10,000,000)
Enhanced Mental Health Changes (through rate utilization & mgmt)	\$(41,000,000)
Conduct Independent Assessments on Mental Health Services	\$(7,730,207)
Reform In-Home Personal Care Services	\$(50,714,943)
Eliminate reimbursements of Medicaid 'never events'	\$(5,000,000)
Reduce Medicaid fraud through Program Integrity Savings	\$(40,000,000)
<b>Division of Social Services</b>	
Reductions to Child Welfare Contracts	\$(1,238,821)
Reductions to funds for Work-First State-County Special Assistance	\$(3,388,044)
Reductions to state funding for county foster care/child protective services	\$(2,390,896)
<b>Division of Vocational Rehabilitation</b>	
Reductions to Vocational Rehabilitation services	\$(1,288,915)
<b>Justice and Public Safety</b>	
<b>Judicial</b>	
Management Flexibility Reductions for Administrative Office of the Courts	\$(6,700,000)
Reductions to Technology Services Program	\$(2,616,294)
<b>Judicial-Indigent Defense</b>	
Reductions to NC Prisoner Legal Services Program	\$(142,031)
Reductions to Center for Death Penalty Litigation Program	\$(23,821)
<b>Justice</b>	
Reductions to Operating Budgets to FY 08-09 levels	\$(2,562,000)
<b>Juvenile Justice &amp; Delinquency Prevention</b>	
Management Flexibility Reductions	\$(2,713,342)
<b>Corrections</b>	
Reductions for lower than projected inmate population	\$(22,000,000)
Reduce Inmate Medical Costs (through Medicaid/Medicare tie-in)	\$(20,500,000)
Reductions to Criminal Justice Partnership Program	\$(1,100,000)
<b>TOTAL CUTS (NOT OFFSET BY FEDERAL DOLLARS)</b>	<b>\$(850,055,730)</b>

**FIGURE 6**

<b>SIGNIFICANT SPENDING EXPANSIONS IN THE FY 10-11 BUDGET</b>	
<b>Education</b>	
<b>K-12 Cuts</b>	
Expand Student Diagnostic and Intervention Initiative	\$10,000,000
Textbook Replacement Funding for Emergencies	\$2,500,000
<b>Community Colleges</b>	
Fully Fund Enrollment Growth	\$81,045,467
Partially Restore Funding for Prisoner Education	\$21,000,000
<b>Universities</b>	
Increase in Enrollment Growth Funding	\$5,636,814
Increase Need-Based Financial Aid	\$8,195,517
Partially Restore Building Reserves for New & Renovated Buildings	\$24,005,142
ECU Dental School Operation Funds	\$6,000,000
Increase in Scholarship Aid to Private College Students	\$4,551,764
Coastal Wave Energy Research	\$2,000,000
<b>Health and Human Services</b>	
<b>Mental Health/Developmental Disabilities, and Substance Abuse Services</b>	
Increase funds for In-Patient Hospital Beds for Crisis Response	\$9,000,000
Restoration of previous cuts to Community Service Funds through LMEs	\$40,000,000
<b>Division of Public Health</b>	
Relieve Waiting List for AIDS Drug Assistance Program	\$14,177,632
Funds for Immunizations for 2010-11 school year	\$3,000,000
<b>NC Health Choice/Children's Health Insurance</b>	
Increase Enrollment in NC Health Choice by 2%	\$6,500,000
<b>Division of Medical Assistance (Medicaid)</b>	
Increase Medicaid funds to account for faster enrollment growth	\$430,564,713
<b>Division of Aging and Adult Services</b>	
Funds for Project C.A.R.E.	\$100,000
<b>Justice and Public Safety</b>	
<b>Judicial-Indigent Defense</b>	
Partial Restoration of Sentencing Services Program	\$2,123,426
<b>Justice</b>	
Medicaid Fraud Investigation Teams	\$600,000
<b>Juvenile Justice &amp; Delinquency Prevention</b>	
Restoration of Samarkind Youth Development Center in Moore County	\$3,521,954
<b>Corrections</b>	
Operating Reserves for new Central Prison Hospital & Mental Health Facility	\$5,326,218
Operating Reserves for new Women's Prison Hospital & Mental Health Facility	\$2,705,474
<b>Environment &amp; Natural Resources</b>	
Wastewater State Revolving Fund Match	\$6,398,128
Drinking Water State Revolving Fund Match	\$6,201,872
Jobs Maintenance and Capital Development Fund (Goodyear & Firestone incentives)	\$6,000,000
One NC Fund (for business recruitment, specifically small businesses)	\$12,500,000
One NC Small Business Fund (matching grants to small businesses)	\$1,500,000
Regional Economic Development Commissions	\$5,000,000
Biofuels Center	\$5,000,000
Institute for Regenerative Medicine	\$10,000,000
NC Biotechnology Center	\$5,000,000
Home Grown Jobs (Rural Economic Development Center)	\$3,125,000
Small Business Assistance Fund (Rural Economic Development Center)	\$1,000,000
<b>Other</b>	
Capital Improvements	\$11,173,440
<b>TOTAL EXPANSION</b>	<b>\$866,520,516</b>

## ■ Changes to distribution of lottery receipts

The most significant development in the education budget this year is the temporary change to the distribution of lottery receipts. When the lottery was first established, 40 percent of the estimated lottery receipts each year were earmarked for the school capital fund to assist counties to meet their school construction needs, 50 percent was set aside for class size reduction in K-3 and for pre-kindergarten (More at Four), and 10 percent went for post-secondary scholarships for needy students.

This coming year, when lottery receipts are expected to increase significantly, 48 percent of receipts or \$220.6 million will be earmarked for K-3 teacher salaries, while the More at Four distribution is reduced by \$5 million to a

little over 17 percent of receipts (down from 20 percent in 2006-07).

Scholarships for post-secondary students comprise 9.6 percent or \$44.1 million of expected lottery receipts. The school capital fund for 2010-11 appropriates barely a quarter of all lottery receipts. However and in a significant change, the local effort requirement for counties to receive this money is dropped for 2010-11, and counties may, upon application from their local school board, use the school capital distribution for teacher salaries.

Whereas the initial law directed receipts in excess of any annual appropriation to be split 50/50 between post-secondary scholarships and school construction, all unanticipated receipts in

2010-11 will be distributed to counties based on student head counts for "school construction," i.e. teacher salaries. In addition more than \$31 million of unanticipated receipts from 2009-2010 are re-routed to the school capital fund (i.e. for teacher salaries) to be distributed to counties who did not receive school construction funding in 2009-10 because they failed to meet local tax effort requirements. Most of these counties are in the mountains or eastern part of the state.

The sum total effect of these temporary changes is that in 2010-11 three-quarters of lottery receipts could be used for K-12 teacher salaries. This is up from the roughly 30 percent spent on K-3 teacher salaries in pre-recession years.

- Filling a \$121 million hole in K-12 education with lottery receipt money (this is the single largest technical adjustment)
- The use of \$30.5 million in federal Temporary Assistance for Needy Families (TANF) Emergency Contingency Fund dollars to replace General Fund money for More at Four on a one-time basis.
- The realization of more than \$64 million in savings from adjusted head counts, lower-than-expected teacher salaries and ending one county's eligibility for small county supplemental funding.

In addition to the technical cuts, there are more than \$24.6 million in cuts that are offset by efficiency gains or reduced estimates of costs for maturing projects. Whether such gains are realized in all cases remains to be seen. These include:

- A \$5.5 million cut that eliminates the direct appropriation for the North Carolina Virtual Public Schools program,
- \$1 million in recurring and \$3 million in non-recurring cuts to the School Connectivity Initiative, and;
- \$2 million in recurring and \$10 million in non-recurring cuts for the NC WISE program.



The largest substantive cuts for 2010-11 target the following:

- Teacher professional development (abolition of the mentoring allotment of \$9.2 million),
- Transportation (a \$10 million recurring cut to operations and a one-time elimination of \$11.9 million for school bus replacement).
- Education services for students with limited English was cut by 5 percent or \$4 million.
- More at Four lottery receipts appropriation was cut \$5 million or 5.9 percent.

School districts also received a major tool with which to balance budgets: in 2010-11 they will be able to furlough school employees who earn more than \$32,000 per year for a maximum of two days.

### *Community Colleges*

The final budget expands the community college budget by \$42.6 million over last year's appropriation, an increase of 4.2 percent. This figure, however, is still 5 percent below what would be required to maintain services at 2008-2009 levels. While an additional \$103 million in spending was approved, roughly \$60 million in cuts will also be made for the upcoming year.

A majority of the expansion money is associated with fully funding enrollment growth for the coming year. Funding growth in the community college system is important considering the dramatic increase in demand and enrollment since the start of the recession. The expanded funding for additional students is partially offset, however, by an increase in tuition. Tuition for residents will increase by \$6.50 per credit hour, while non-residents will face an increase of \$7.20. For full-time resident students, this increase means an additional \$208 per year.

Other important changes to the community college system include a \$15 million "management flexibility" reduction. Managers in the community college system will be responsible for how the \$15 million in cuts are made but have been directed not to impact activities that are involved in retraining dislocated workers. The final budget also included restoration of partial funding for the Prisoner Education program and Small Business Centers and provides additional funds for minority male mentoring.

### *UNC System*

The final budget for the University system increased last year's appropriation by \$10 million, or 0.4 percent. Notable changes include a \$70 million management flexibility cut and \$8 million in reduced aid to hospitals for the coming year. This year's \$70 million management flexibility cut comes on top of the \$73 million management flexibility cut in last year's budget, and legislators gave universities the option to protect programs by raising annual full-time tuition by up to \$750 (on top of last year's increase by the lesser of \$200 or 8 percent). While only UNC-Chapel Hill, NCSU, and the UNC School of the Arts opted to implement the full \$750 increase, each of the 16 UNC institutions voted to increase tuition (several by more than 30% compared to last year). The General Assembly stipulated that at least 20 percent of the additional funds raised by this year's increase—and half of last year's increase—must be allocated for need-based financial aid, but for many students from low- and moderate-income families, the increase in aid is unlikely to cover the full cost of the tuition hike at a time when family budgets are already over-stretched.

The budget agreement allows the university to retain the tuition increase from the last budget, offsetting the cuts by \$34.7 million. The budget also ended the practice of providing non-resident full scholarship athletes with in-state tuition rates, a \$10 million savings. The budget expanded state-funded need-based aid to UNC students as well as aid to private college students. The budget also includes \$25 million for the operating and maintenance costs associated with new or renovated buildings. UNC will be able to furlough employees earning more than \$32,000 per year in order to meet the management flexibility cut target.

## HEALTH AND HUMAN SERVICES

The Health and Human Services budget received a 32 percent cut in state-funded appropriations relative to the continuation budget. One-time federal aid for the coming year reduces the cut to just 13 percent.

The final budget agreement reduced state funding for the Division of Child Development Services by 17 percent. A large portion of these cuts were offset, however, through the use of federal Temporary Assistance to Needy Families (TANF) Emergency fund dollars to support child care subsidies, which are vouchers for low-income families to use towards quality child care. In addition, the child care subsidies program received a \$6 million recurring cut in anticipation of savings from a new electronic benefits (EBT) payment system. Smart Start, the state's early childhood education program that provides wrap-around services such as health care and dental screenings to thousands of children across the state received a 2.5 percent, or \$5 million, reduction.

The Division of Medical Assistance received a \$351 million reduction, or 12.9 percent for the upcoming fiscal year. This reduction is partially offset by enhanced FMAP funds for Medicaid [See Figure 3]. The budget included a total of \$221 million in spending reductions not offset by federal stimulus dollars. Many of these cuts are in the form of savings through new efficiencies and modifications to program eligibility. To reduce Medicaid costs, the budget adopts the Senate proposal to save \$45 million by making fuller use of the Community Care Network of North Carolina (CCNC) and securing \$40 million in savings from an anti-fraud initiative in Medicaid. Within the area of mental health, the final budget includes \$10 million in savings by adding mental health drugs to the Preferred Drug List and a \$41 million reduction in funding to be achieved through rate and utilization management. Finally, the budget cuts \$51 million from the In-Home Personal Care program by tightening the eligibility standards and focusing the program on serving adults with the most intense needs.

The final Health and Human Services budget includes some expansion items. Most significantly, due to higher program growth than projected and un-realized savings, Medicaid appropriations were increased by \$430 million. An additional \$9 million is included to increase local in-patient bed capacity for those receiving mental health services in area hospitals. Previous cuts to community-based mental health services were also partially restored by a \$40 million increase in funding. The budget also provides an additional \$6.5 million for NC Health Choice, which provides health insurance to low-income children. However, there are reasonable doubts whether the \$6.5 million is sufficient funding to fully cover the increase in demand for more than half the fiscal year. Finally, the budget also includes an additional \$14 million for the state's AIDS drug assistance program to fully serve those on the waiting list.

## TRANSPORTATION

The major development in transportation was the establishment of a new pot of money known as the "Mobility Fund." This Fund will be used initially to underwrite the second phase of the I-85 Yadkin River Bridge project. In 2010-11, funding will come in the form of \$24 million of unspent 2009-10 Turnpike Authority money from the delayed Monroe Bypass toll road project. In addition, \$15 million will be transferred from the Highway Trust Fund in 2010-11 that was destined for the Garden Parkway, another delayed toll road project.

The manner of funding of the Mobility Fund places extra pressures on scarce Highway Trust Fund resources after 2011.

- In 2011-12, \$31 million will be transferred to the Mobility Fund from the Highway Trust Fund. This money in years past went into the General Fund as compensation for vehicle sales tax revenue changes in 1989 that routed tax revenue to the Highway Trust Fund and away from the General Fund. In addition, the Turnpike Authority will receive \$15 million per year from the Highway Trust Fund to cover debt for the Garden Parkway.

- In 2012-13, \$45 million will be transferred from the Highway Trust fund.
- In 2013-14 and going forward, the transfer from the Highway Trust Fund will total \$58 million per year.
- From 2013-14 the funding for the controversial Mid-Currituck Bridge at Corolla will also increase with an additional \$13 million per year to be transferred from the Highway Trust Fund.

In the coming months, the Department of Transportation will consult with stakeholders and the public in drawing up a set of qualification and prioritization principles that will guide the allocation of money to Mobility Fund projects. At present, the Fund is designed for projects of statewide and regional significance, and non-highway projects are to receive preferential consideration.

## JUSTICE AND PUBLIC SAFETY

Overall, FY 10-11 spending for Justice and Public Safety (General Fund appropriations plus federal stimulus receipts) was reduced by \$224.8 million or 10 percent compared to the continuation budget. This includes \$64 million in reductions compared with last year's certified budget. The most significant cut was to coverage of inmate medical costs, due to anticipated savings from linking costs to Medicare or Medicaid fee schedules (\$20.5 million) and a reduction due to the lower-than-projected inmate population (\$22 million).

Several divisions within Justice and Public Safety were mandated to make cuts via the use of management flexibility reserves. This will require departments such as Juvenile Justice & Delinquency Prevention (\$2.7 million cut) and the Administrative Office of the Courts (\$6.7 million cut) to make unspecified department reductions. Other reductions to Justice and Public Safety programs include a \$142,031 cut (5 percent) to NC Prisoner Legal Services, a \$1.1 million cut (12 percent) to the Criminal Justice Partnership Program, and 5 percent reductions to several programs, such as Harriet's House and Summit House that are residential prisoner re-entry programs serving formerly incarcerated women. Additionally, savings of \$250,000 within the Office of Indigent Defense Services will be realized by increasing the fees to appoint indigent defense attorneys.

There were some expansion items within the Justice and Public Safety budget, including the restoration of the Sentencing Services Program funding (\$2.12 million) and the Samarkand Youth Development Center (\$3.5 million). In addition, to expand the Medicaid Fraud Criminal Investigation Team, which will aid in reducing fraudulent Medicaid expenditures, \$600,000 was allotted to the Department of Justice. Finally, the Prisoner Education Program was partially restored, which is listed and described in the Education section of this report.

## Challenges and Opportunities

Looking ahead to FY 2011-2012 and beyond, the likelihood of a significant state budget shortfall is high. Budget writers will have to contend with the "sunsetting" of the Federal two-year \$2.4 billion revenue package and the possibility that the Federal government may fail to provide additional state fiscal relief. Given the prospects of a slow economic recovery, it is very likely that revenue growth will not be sufficient to cover the budget shortfall. Legislative fiscal analysts have predicted that revenues will not recover to the originally projected FY 2008-2009 levels until FY 2013-2014.

Hence, legislators will be faced with three options: to continue to make cuts, to raise new revenue or to pursue some combination of the two.

The cuts thus far have been deep. Thousands of educators and core service providers have already lost their jobs and many essential services have been rendered weak and inadequate. It is therefore difficult to conceive of a cuts-only solution to a projected 2011-13 shortfall in excess of \$3 billion per year. Cuts of such a magnitude would cripple the

state's economy and significantly damage the quality of life for all North Carolinians.

Instead, the General Assembly and Governor must continue to implement administrative efficiencies, identify ineffective programs and, most importantly, enact reforms to the state's tax system to make the revenue stream more stable and reliable over time.

Key steps in modernizing our tax code that would assist in closing the 2011-13 budget gap could include broadening the base of the sales tax to include more services, broadening the base of the state income tax by basing it on adjusted gross income rather than federal taxable income, adding new, higher rates for high-income filers, ending ineffective tax expenditures such as the Article 3J tax credits and moving to a combined reporting system for corporate taxes.

## **Conclusion**

In the most difficult budget year in memory, the General Assembly relied on a series of short-term fixes that attempted to prevent mass lay-offs of teachers and other public sector workers while putting off much-needed reform for a later date.

Nevertheless, some significant new developments appeared. The transportation budget included a new major project fund, albeit one not funded by any new sources of revenue. Lottery receipts will be used to save teacher jobs in all grades. Community colleges facing significant pressure from increased enrollment will receive support, but tuition will increase at both community colleges and in the UNC system.

The possibility of the FMAP shortfall forced a scramble for additional funds that includes the possibility of public sector furloughs and further depletion of funds that provide for long-term stability and the retirement system. Clearly, there continues to be a role for federal support of states in the face of the ongoing state revenue crisis into FY 2011-2012 and beyond.

Next year will present far more difficult challenges for which short-term fixes will be inadequate. It is clear that a more comprehensive approach incorporating tax reform will be needed to reach a balanced budget in a manner that will put the state on a path to economic recovery.

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