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# BTC Reports

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## THE FY2012-13 HOUSE BUDGET:

An inadequate and temporary fix for North Carolina's growing budget pressures

BY BRENNA BURCH, *Public Policy Analyst*, with TAZRA MITCHELL, *Public Policy Fellow*

### Executive Summary

- The North Carolina House's \$20.3 billion budget proposal for fiscal year 2012-2013 (FY2012-13) would increase total state spending by \$338.7 million, or 1.7 percent, over the \$19.9 billion continuation budget, but it would do so by relying heavily on one-time money rather than by raising recurring revenue.
- The House budget would increase General Fund availability by a net total of \$338.7 million over base tax and non-tax revenues of \$19.9 billion in order to pay for its budget. Gross total availability is significantly reduced by several major expenditures made within the availability statement, including payment of roughly 75 percent (\$154 million) of North Carolina's significant current-year Medicaid shortfall, estimated at \$205.5 million at the time of this publication.
- In order to meet both one-time and recurring state obligations—including paying off the current-year Medicaid shortfall and paying down next year's shortfall, funding an extension of the existing Work Opportunity Tax Credit, funding a proposed new corporate tax credit for private-school scholarship contributions, depositing funds into the state's reserve account for upkeep of state properties, and temporarily offsetting the loss of federal recovery dollars for education—the House would raise \$815.6 million in General Fund availability, which includes the credit balance, non-tax revenues, and fund transfers.
- Net of paying down part of both current and projected Medicaid shortfalls and funding other items, the House budget increases total General Fund availability by \$571.6 million in one-time money to pay for both recurring and non-recurring state obligations. This amount is further adjusted to reflect an accounting maneuver in last year's budget that shifted approximately \$188 million for the State Highway Patrol from the Highway Fund within the Transportation budget to the General Fund. While this shift has no net economic impact, it makes total General Fund availability and spending appear significantly higher than FY2010-11 levels. Net of this accounting maneuver, total state spending would increase by \$338.7 million from the continuation budget under this proposal.

- The House budget’s reliance on one-time money means its most sizeable spending increases and restorations are temporary. The House budget takes no significant actions to address the state’s growing structural budget deficit, and it does not provide any long-term relief from recurring budget pressures in key areas of state investment, particularly education and human services, which will face sizeable budget gaps going into the FY2013-15 biennium.

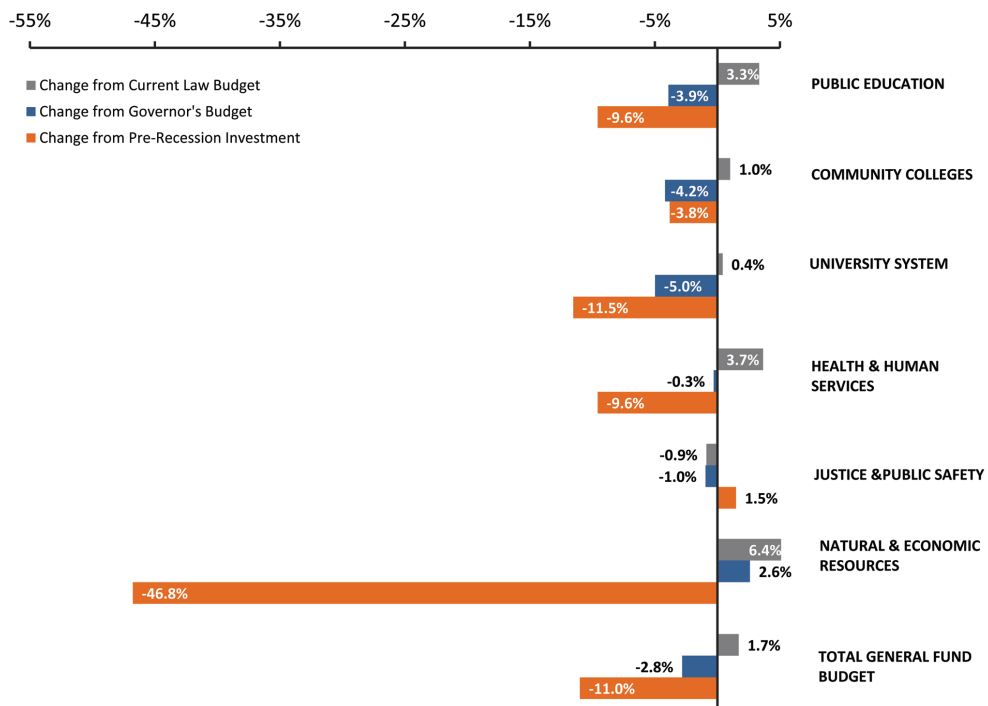
**Overview**

The NC House’s budget proposal would increase net state spending by \$338.7 million over the FY2012-13 continuation budget. However, that increase would restore just 20 percent of the \$1.7 billion in cuts made to state investments in education, health, public safety, and infrastructure in last year’s budget. In addition, the increases would be temporary because the majority of availability in the House budget is attributable to one-time sources.

When compared to state spending before the Great Recession, the House budget reflects a tremendously diminished baseline state budget – one that has resulted in fewer teachers in classrooms, aging and out-of-date textbooks, skyrocketing tuition rates for college students at public colleges and universities, higher costs for accessing the courts, crumbling roads, and structurally unsound bridges. Despite making minor restorations in funding for some state-supported institutions and infrastructures, the House budget falls woefully short of what is needed to spur a strong and sustainable economic recovery for North Carolinians in communities across the state.

The chart below places the House budget in context of the continuation budget, the governor’s budget proposal (which includes a 3/4-cent sales tax increase that would raise \$760 million in new revenue), and state spending before the Great Recession (FY2007-08, adjusted for inflation).

**FIGURE 1: House Budget Spends 1.7% More than Continuation, 11% Less than Pre-Recession**



*In its budget, the House relies heavily on financial resources that are not available in the long term. As such, the House budget offers a piecemeal and unsustainable approach to funding the needs of a growing state, an approach that would not adequately fund the education, well-being, and safety of all North Carolinians.*

**HOW DOES THE HOUSE PAY FOR ITS BUDGET?**

The House budget raises a total of \$815.6 million in General Fund availability. This total includes a \$232.5 million revenue surplus, \$205.5 million in anticipated state agency reversions, \$247.8 million in transfers from the Highway and Highway Trust funds,<sup>1</sup> \$88.5 million in fund transfers and other adjustments to availability, and \$41.3 million in unappropriated funds from FY2011-12. The House budget would reduce this additional availability by spending \$154 million on reducing the current-year Medicaid shortfall,<sup>2</sup> depositing \$62 million into the Repairs and Renovations Reserve Account, and spending \$28 million in other pre-budget expenditures. In total, the House budget would

supplement \$19.7 billion in base tax and non-tax revenues with \$571.6 million in one-time General Fund availability, raising total General Fund availability to \$20.3 billion.

Since the House budget does not raise new revenue, North Carolina's

**FIGURE 2: THE HOUSE FY2012-13 BUDGET**

	<b>FY2012-13</b>
Pre-Recession Budget (FY2007-08, Inflation-Adjusted)	\$ 22,783,606,634
FY 12-13 Original Recommended Continuation Budget	\$ 20,817,534,214
FY 12-13 Certified Approved Budget	\$ 19,937,449,375
<i>Recurring Adjustments</i>	\$ (99,484,096)
<i>Nonrecurring Adjustments</i>	\$ 438,191,287
<b>Total FY 12-13 General Fund Appropriations</b>	<b>\$ 20,276,156,566</b>
% Change from Pre-Recession Budget	-11.0%
% Change from Original Recommended Continuation	-2.6%
% Change from Certified Approved Budget	1.7%

growing structural budget deficit remains unaddressed. A budget shortfall is the difference between maintaining the current quality and quantity of state services and the amount of revenue that the current tax system is expected to generate.<sup>3</sup> Tax and non-tax revenue sources for the General Fund, independent of transfers from the Highway and Highway Trust funds, are projected to generate \$19.7 billion in FY2012-13—\$571.5 million less than what is needed to fund the House budget's spending target of \$20.3 billion.

The projected \$243 million shortfall in funding for Medicaid in FY2012-13 constitutes another budget pressure of significant size.<sup>4</sup> This is the amount required to pay Medicaid liabilities over the coming year beyond what Department of Health and Human Services officials believe they can "backfill" with other agency funds.

**CREDIT BALANCE (ONE-TIME MONEY)**

The House budget uses a net current-year credit balance of \$479.2 million, consisting of \$41.2 million in unappropriated funds, \$205.5 million in anticipated state agency reversions, and a \$232.5 million revenue surplus. A state's credit balance is entirely one-time money coming from unforeseen events such as lower-than-authorized state agency spending and revenue over-collections. While this year's revenue surplus is fully attributable to stronger-than-expected personal income tax collections, the data necessary to fully understand what drove this year's modest revenue surplus was not available at the time of this publication. In keeping with a slow and uneven state economic recovery, state sales tax collections are projected to come in slightly lower than target, as are state corporate income taxes.

The House budget would transfer a total of \$247.8 million from the state's two major

## TRANSPORTATION FUNDS AND OVERALL AVAILABILITY

The House budget proposal would transfer \$247.8 million from the Highway Fund and Highway Trust Fund to the General Fund and other state agencies. Nearly 90 percent of this revenue would come from the Highway Fund, which is supposed to pay for road maintenance, public transportation and the state's five intermodal divisions. Per North Carolina statutes, most of the transfers in the proposal are embedded in the General Fund budget, including \$188 million to support the State Highway Patrol and \$47.7 million to support the Driver License Program.<sup>6</sup> The proposal would also create new

transfers and restore previously eliminated transfers on a recurring basis, even though legislators voted in 2007 to phase out transfers to the General Fund from the Highway Fund and Highway Trust Fund by FY2013-14.<sup>7</sup>

The House budget would also divert an anticipated \$42 million education-lottery surplus to increase overall General Fund availability. Lottery funding for class-size reduction, early childhood education, and need-based college scholarships would not change from the level appropriated in last year's budget, but the House budget

would bypass the statutory 5-percent transfer to the Education Lottery Reserve Fund, which is supposed to serve as a savings account in case the lottery's net proceeds in any year do not equal the amount appropriated by the legislature to education programs.<sup>8</sup> The House budget would also transfer \$62 million to the Repairs and Renovations Reserve Account, approximately half as much as the one-quarter of the state's end-of-year credit balance (\$119.8 million) directed by statute. The Repairs and Renovations Reserve Account fund balance is currently \$124.5 million.<sup>9</sup>

## ADDRESSING THE MEDICAID SHORTFALL

Session Law 2012-0002/S.B. 797, "Payment of 2012 Medicaid Costs/Inmate Medical Costs," appropriates \$205.5 million to address the current-year shortfall in funding for Medicaid obligations, namely the payment of claims for medical services received by program beneficiaries. Legislative leaders and the Office

of State Budget and Management agreed to revise the shortfall estimate upward to \$205 million in May, with legislators indicating that higher-than-estimated program utilization across all categories of eligibility drove the shortfall.<sup>10</sup>

Obscured in the larger budget debate is the fact

that the legislature knowingly underfunded the Medicaid program by hundreds of millions of dollars in the budget it passed last year. This fact was expressed repeatedly by numerous concerned parties, including the Department of Health and Human Services,<sup>11</sup> individual legislators,<sup>12</sup> and a range of

advocates<sup>13</sup> representing Medicaid's many diverse stakeholders. Had legislators chosen to raise the necessary revenue to fund the Medicaid program at the level recommended by the Office of State Budget and Management in the current year, the shortfall would not exist.

sources of transportation funding—the Highway Fund and the Highway Trust Fund—to the General Fund. Of that amount, \$188 million is attributable to an accounting maneuver made in last year's budget through which the legislature shifted the accounting for the State Highway Patrol from the Highway Fund to the General Fund.<sup>5</sup>

From a fiscal perspective, the defining characteristic of the House budget is its reliance on non-recurring funds to pay for numerous recurring state obligations. While it is encouraging to see House budget writers acknowledge the need for higher spending on kindergarten through 12th grade (K-12) education and health and human services simply to keep pace with demand, the one-time nature of the funds appropriated for these

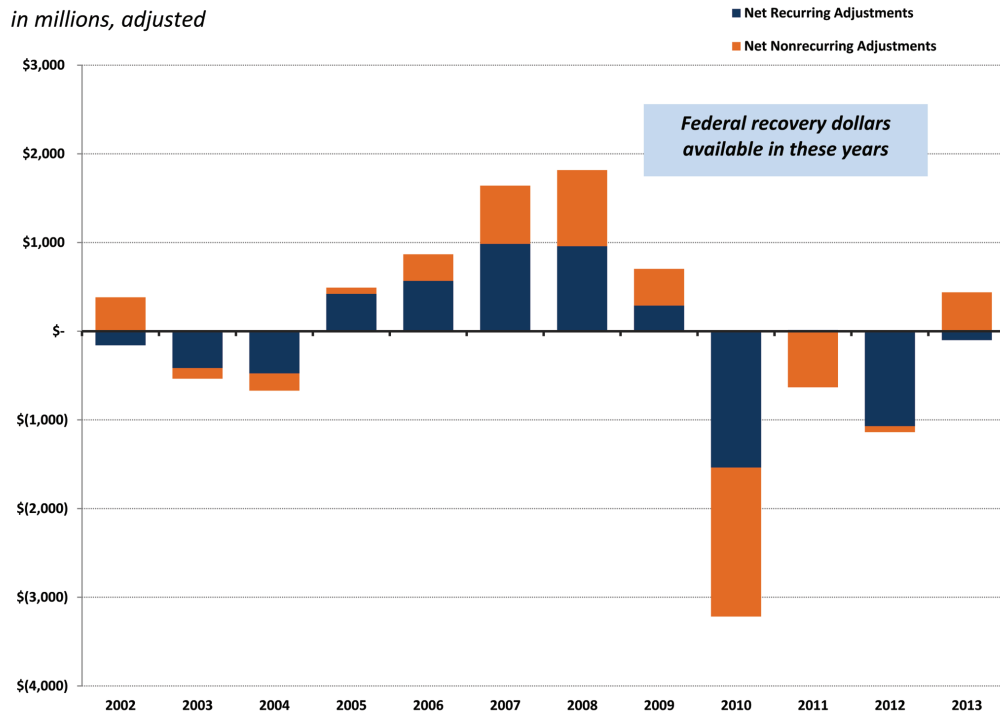
### ONE-TIME MONEY FOR RECURRING COSTS

purposes would do little to improve the state's fiscal status in FY2012-13 and also would create a looming funding "cliff" for key areas of state investment heading into the FY2013-15 biennium.

The chart below details the extent to which recurring and non-recurring adjustments to the state budget have been made since FY2001-02. It is important to note that in fiscal years 2009 through 2012, federal recovery funds were available to supplant a portion of state General Fund appropriations, particularly for K-12 education and Medicaid. The

majority of these funds were drawn down and spent in FY2009-10 and FY2010-11, which explains the sharp drop in recurring General Fund appropriations in FY2009-10. Unlike in FY2009-10, the decrease in recurring state spending in FY2011-12 was not offset with federal recovery funds or other sources of support, which is why the FY2011-13 state budget is projected to have a negative and lasting effect on North Carolina's economic recovery and labor market.<sup>14</sup>

**FIGURE 3: Recurring and Non-Recurring Adjustments to Appropriations, FY2002 to FY2013 (House Budget)**



**THE REVENUE PLAN**

Despite significant state budget pressures driven by annual growth in recurring state liabilities, the loss of remaining federal recovery dollars, and the needs of a growing and rapidly aging state population, the House budget would not raise any new revenue to address these fiscal challenges. Independent of that decision, there are two revenue-related provisions of note in the House budget: an extension of the state's Work Opportunity Tax Credit and a reserve for a freestanding piece of legislation that would establish a tax credit for corporate contributions to funds that give scholarships for private schools (H.B. 1104, Scholarship Funding Corporate Tax Credit).

**WORK OPPORTUNITY TAX CREDIT EXTENSION**

The House budget would extend North Carolina's Work Opportunity Tax Credit (WOTC) at an estimated cost of \$800,000 in FY2012-13. The state credit is equal to 6 percent of the federal WOTC, which is a tax credit available to private, for-profit businesses that hire individuals from "target groups" that have consistently faced significant barriers to employment. Eligible hires include recipients of Temporary Assistance to Needy Families benefits, Supplemental Nutrition Assistance Program (food stamps) recipients, high-risk youth, and veterans who are unemployed and/or have disabilities. The objective of the

**RESERVE FOR  
H.B. 1104,  
SCHOLARSHIP  
FUNDING CORPORATE  
TAX CREDIT**

federal and state tax credits is to enable persons in these target groups to become employed and self-sufficient and to encourage employers to hire from these groups by reducing their federal income tax liability.<sup>15</sup> The state portion of the WOTC is set to expire on January 1, 2012,<sup>16</sup> but the House budget would extend the credit through tax year 2013.

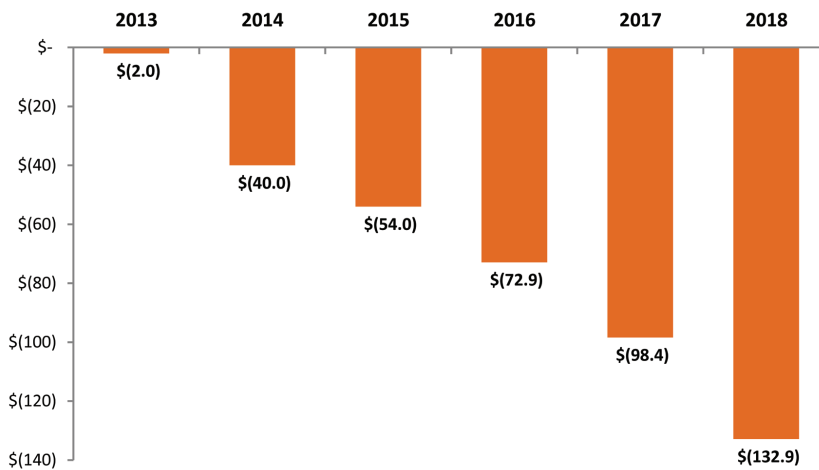
The House budget also includes a \$617,379 negative reserve (reduction to General Fund availability) in anticipation of passage of House Bill 1104, "Scholarship Funding Corporate Tax Credit." This legislation would allow corporations that make monetary donations to certain "scholarship-funding organizations" to claim a tax credit equal to the amount the donation would reduce their federal corporate taxable income – meaning that the credit

would be equal to the amount of the monetary donation, dollar for dollar.

While the FY2012-13 cost of this tax credit would be capped at \$2 million, the cap would increase dramatically to \$40 million in FY2013-14. Moreover, the credit would include a "trigger" mechanism that would automatically increase the cap on the credit by 35 percent for the subsequent tax year once eligible corporate taxpayers claim 90 percent of the cap on the credit in a given year. For example, the cap for the total credit would automatically increase to \$54 million for tax year 2015 as soon as corporations claimed \$36 million in credits for tax

**FIGURE 4: Projected Annual Cost of H.B. 1104, Scholarship Funding Corporate Tax Credit**

Revenue loss, in millions



year 2014. Because there is no disincentive for profitable corporations to claim this credit to reduce their total tax liability, and because total annual corporate tax revenues, at approximately \$1 billion annually, are well in excess of the value of the credit, any reasonable fiscal analysis of this legislation would assume that the full value of the credit would be claimed in any given tax year.

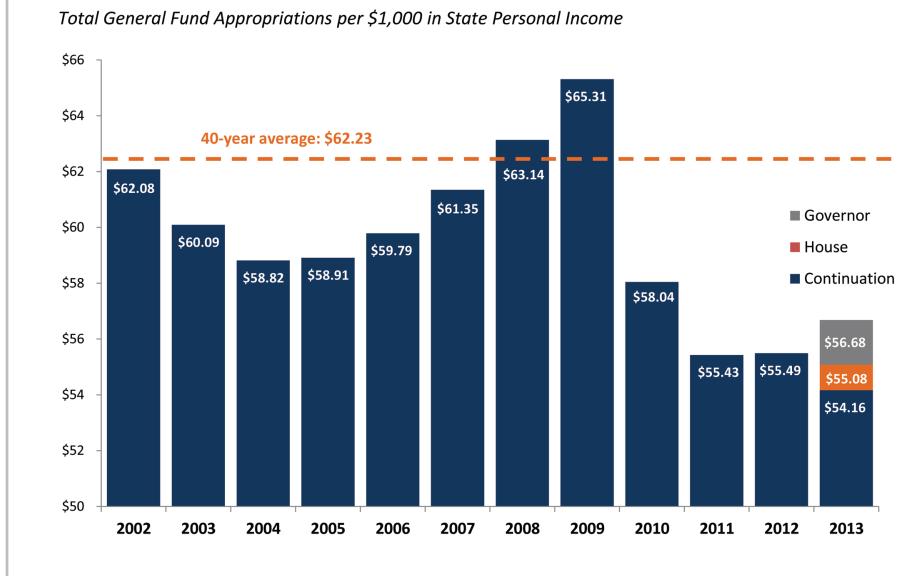
**NON-TAX REVENUE  
SHORTFALLS**

Several key sources of non-tax General Fund revenue were revised significantly downward in response to weaker-than-anticipated collections. Judicial fees, which were steeply increased as part of last year's budget, are expected to come in \$20 million below projections. Also, state investment income suffered this year; this non-tax revenue had been budgeted at \$59.4 million for the current fiscal year but is now projected to come in at less than half that amount, at \$21.6 million.

**THE SPENDING  
PLAN**

The House budget would increase total General Fund spending by \$338.7 million, or 1.7 percent, over the continuation budget. The majority of expansion spending would take place in the K-12 education budget, which would increase by \$248.1 million, or 3.3 percent, over the continuation budget. The House budget would also reduce the projected \$243 million Medicaid shortfall for FY2012-13 by restoring a net \$130.3 million to the Division of Medical Assistance – a 3.7-percent increase over the continuation budget, but still almost \$113 million less than agency estimates of what is needed to meet the program's obligations in the coming year.

**FIGURE 5: General Fund spending as a share of North Carolina's economy would fall to a new 40-year low under House budget**



In historical context, the House budget would not constitute any significant increase in overall state spending as a share of the North Carolina economy. Over the past 40 years, average General Fund spending per \$1,000 in North Carolina personal income was \$62.23. The FY2012-13 continuation budget would mark a new low point in General Fund spending as a share of the state's economy, at just \$54.16 per \$1,000 in state personal income. The House budget would increase

that amount to \$55.08, which would make FY2012-13 the year of North Carolina's lowest overall state General Fund spending since the Nixon administration.

**PUBLIC EDUCATION**

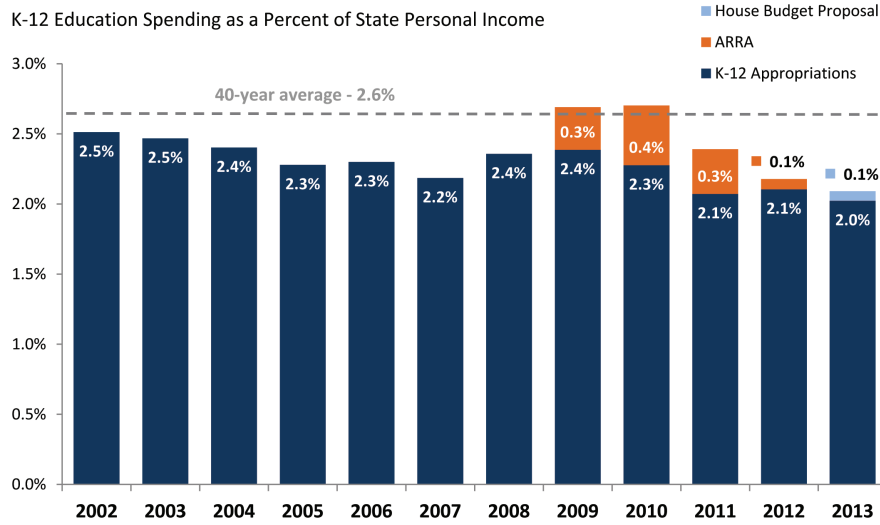
The House proposes an overall increase to the K-12 education budget of \$248.1 million, or 3.3 percent compared to the continuation budget. It would eliminate the \$74 million increase in the Local Education Agency (LEA) Flexibility Adjustment, a massive recurring cut to the K-12 public school budget that is set to go from \$429 million to \$503 million in the continuation budget. The House budget would further appropriate \$229 million in one-time money to offset the loss of federal EduJobs money—\$30 million less than the \$259 million that school districts statewide will lose in the upcoming year.<sup>17</sup> Those federal dollars currently support 4,000 to 5,000 public-school jobs, and the continuation budget includes no money to replace the expiring funding.

**FIGURE 6: RECOMMENDED EDUCATION APPROPRIATIONS**

	FY2012-13 Continuation Budget	FY2012-13 Governor's Recommended	FY2012-13 House Recommended	Change from Continuation Budget	% Change from Continuation
Public Instruction	\$ 7,444,122,100	\$ 8,006,375,540	\$ 7,692,234,560	\$ 248,112,460	3.3%
Community Colleges	\$ 985,000,000	\$ 1,038,504,897	\$ 995,000,000	\$ 10,000,000	1.0%
UNC System	\$ 2,551,672,698	\$ 2,696,757,060	\$ 2,562,230,839	\$ 10,558,141	0.4%
<b>TOTAL</b>	<b>\$ 10,980,794,798</b>	<b>\$ 11,741,637,497</b>	<b>\$ 11,249,465,399</b>	<b>\$ 268,670,601</b>	<b>2.4%</b>

The sum effect of the House budget would be to keep total funding for North Carolina's public schools approximately the same as last year. If the House budget were to become law, North Carolina's public schools would have approximately the same total funding from all sources – state, federal, and local – as they did in FY2011-12. However, districts would once again face a severe budget gap in FY2013-14 due to the fact that the House budget uses one-time funds to partially fill in the loss of EduJobs money. This gap is likely to be approximately \$688 million in FY2013-14, even before accounting for anticipated enrollment growth.<sup>18</sup>

**FIGURE 7: House K-12 budget partially offsets loss of EduJobs money, but falls far short of 40-year average state investment in education as a share of the economy**



Moreover, the House budget would not move spending on public education toward pre-recession levels. Over the last 40 years, state spending on K-12 public education has averaged 2.6 percent of state personal income; that means lawmakers typically committed \$25.90 in state revenues to funding public schools for every \$1,000 earned by North Carolinians. Under the House budget, lawmakers would commit only \$20.80 per \$1,000 in North Carolina personal income to the state's public schools – an amount almost 20 percent lower than the state's historic commitment to public education.

## FILLING THE K-12 EDUJOBS SHORTFALL

Through the American Recovery and Reinvestment Act of 2009, Congress made federal funds available for public education to supplant state General Fund appropriations from FY2008-09 through FY2011-12 in order to reduce the impact of the recession on the classroom and educational experience. Federal law allowed local educational authorities a

great deal of flexibility in how they used the lion's share of these recovery dollars. BTC analysis of North Carolina Recovery Act expenditure data for K-12 education from FY2008-09 through February 2012 shows that 92 percent of these federal recovery funds for public education – a total of \$1.47 billion – were used to pay public school salaries and

benefits for thousands of teachers and other classroom personnel.<sup>19</sup> While the House budget proposes a short-term “patch” for this funding shortfall in the form of \$229 million in one-time money, state inaction to address the expiration of this funding will constitute a de facto cut to the state's already-underfunded public school system.

### COMMUNITY COLLEGES

Although the House budget would restore some of the cuts to the community college system made in last year's biennial budget, it would still leave the system funded at 3.8 percent below pre-recession levels. The House budget's partial restoration of the management flexibility reduction by \$4.3 million is just 5 percent of the total reduction in this category slated for FY2012-2013. The community college system would still need to make budget cuts equivalent to \$83 million in FY2012-13. Community college enrollment is projected to decline by 1.1 percent next year, and as a result the system's budget would be cut by \$12 million in the form of a technical adjustment.

The tuition increases included in last year's biennial budget remain in place, and next



**UNIVERSITY OF NORTH  
CAROLINA SYSTEM**

year the cost per credit hour will rise by another \$2.50 to \$69. North Carolina has increased tuition to its community colleges by 58 percent since FY2008-09. Rising tuition can become a barrier to achieving educational goals, especially for low-income and adult students. On a positive note, an anticipated \$5 fee increase for continuing education passed in last year's budget would be eliminated, keeping these courses more accessible to students.

The House budget would increase spending on the UNC System by \$10.6 million, or 0.4 percent, over the continuation budget. However, this increase is due to non-recurring adjustments and, as such, would be temporary. In last year's biennial budget, the UNC System sustained \$347.1 million in mostly recurring cuts, which have increased classroom size, hampered faculty retention efforts, and, most notably, made a postsecondary education at a public university less affordable.<sup>20</sup>

Enrollment at UNC campuses is projected to increase from 200,696 full-time equivalent students to 201,476 in FY2012-13, but the House budget does not provide commensurate funding to meet that increased demand. Instead, the House budget maintains continuation funding levels, resulting in reduced student support, administration, and classroom space across the system's 16 campuses.

The House budget would restore \$4.7 million to the UNC need-based grant program, which was cut by \$35 million last year. This amount is insufficient to reduce the impact on low-income students and their families of tuition increases that will take effect next year.

The budget would also restore 4.2 percent of the management flexibility cut made in last year's budget, leaving \$405 million in recurring cuts to be made in FY2012-13. Due to the challenging budget environment at North Carolina's public universities, reports from this past school year suggest that many campuses struggled to recruit and retain faculty. In light of this fact, the House budget includes \$3 million for the Faculty Recruiting and Retention Fund established in 2006 for the purpose of offering salary increases to help the UNC System be competitive in these efforts.

In order to restore some state funding for UNC-TV, which was placed on continuation review in last year's budget, the House budget would eliminate the remaining \$18 million appropriated to UNC Hospital to subsidize the cost of charity care provided through that institution. This change signals a significant policy shift within the UNC budget.

Special provisions in the House budget would require the UNC Board of Governors to provide more detailed reporting on UNC's endowment funds, including the amount and percentage of endowment assets distributed for financial aid or otherwise reducing the costs of attending a UNC System school. This is significant because there was little information publicly available during recent debate over tuition hikes about the use of endowment funds to defray cost increases. A separate provision would direct the NC General Assembly's Fiscal Research Division to study the impact of the tuition surcharge mandated last year on student achievement or graduation rates.

**HEALTH AND HUMAN  
SERVICES**

The House budget for Health and Human Services increases spending by \$162.7 million, or 3.7 percent, over the continuation budget. While House budget writers' acknowledgment of the growing costs of providing care and support for children, elderly persons, and other vulnerable North Carolinians is encouraging, the increased spending in this budget proposal would still lag pre-recession spending by 9.6 percent and, more importantly, does not fully address the projected \$243 million Medicaid shortfall for FY2012-13.

**FIGURE 8: RECOMMENDED HEALTH AND HUMAN SERVICES APPROPRIATIONS**

	FY2012-13 Continuation Budget	FY2012-13 Governor's Recommended Budget	FY2012-13 House Recommended	Change from Continuation Budget	% Change from Continuation
Central Management & Support	\$ 44,577,987	\$ 57,798,511	\$ 46,085,628	\$ 1,507,641	3.4%
Aging Division	\$ 37,019,667	\$ 41,895,316	\$ 38,519,667	\$ 1,500,000	4.1%
Child Development	\$ 266,102,933	\$ 309,287,534	\$ 280,602,933	\$ 14,500,000	5.4%
Public Health	\$ 157,538,834	\$ 168,365,609	\$ 178,309,229	\$ 20,770,395	13.2%
Social Services	\$ 186,183,068	\$ 177,103,952	\$ 177,103,952	\$ (9,079,116)	-4.9%
Medical Assistance	\$ 2,907,276,302	\$ 3,014,833,460	\$ 3,037,547,318	\$ 130,271,016	4.5%
NC Health Choice	\$ 83,717,865	\$ 80,915,808	\$ 81,710,435	\$ (2,007,430)	-2.4%
Services for the Blind	\$ 8,372,886	\$ 8,204,550	\$ 8,204,550	\$ (168,336)	-2.0%
Mental Health / DD / SAS	\$ 710,712,232	\$ 717,535,251	\$ 714,295,816	\$ 3,583,584	0.5%
Health Service Regulation	\$ 16,133,031	\$ 18,025,590	\$ 17,925,590	\$ 1,792,559	11.1%
Vocational Rehabilitation	\$ 37,528,128	\$ 37,528,128	\$ 37,528,128	\$ -	0.0%
<b>TOTAL HHS APPROPRIATIONS</b>	<b>\$ 4,455,162,933</b>	<b>\$ 4,631,493,709</b>	<b>\$ 4,617,833,246</b>	<b>\$ 162,670,313</b>	<b>3.7%</b>

*CHILD DEVELOPMENT*

The House budget would restore \$15 million in recurring funds for NC Pre-K, which would expand the number of existing program slots by approximately 1,700. However, this funding restores only half of the \$32 million recurring cut made to the program in last year's budget. In contrast, the House budget expands funding for Smart Start, which was cut by \$37 million in last year's budget, by just \$3.5 million – funds that are intended to test literacy efforts in certain local programs.

*MEDICAID*

The House budget would provide \$168 million in recurring funds to keep pace with projected enrollment growth and service consumption, but that amount is less than the forecasted \$243 million shortfall for the program in the coming year.<sup>21</sup> The House budget also assumes \$59 million in savings through expanding participation in the state's managed care program, Community Care of North Carolina (CCNC). Actual savings from expanding participation in CCNC for the current budget year fell significantly short of projected savings of \$90 million assumed by last year's budget, due in part to the logistical challenges of rapidly enrolling thousands of medically complex individuals, many of whom are elderly, into managed care for the first time.<sup>22</sup>

*PUBLIC HEALTH*

The FY2011-12 budget eliminated the award-winning Health & Wellness Trust Fund, transferring its remaining fund balance to the Division of Public Health and directing the division to continue some, but not all, of the fund's tobacco cessation and prevention programs.<sup>23</sup> The House budget includes \$5.5 million in one-time funds for tobacco cessation and prevention initiatives targeting children in kindergarten through 12th grade; that amount is \$17.2 million less than what is needed to continue current anti-tobacco efforts.

**MENTAL HEALTH,  
DEVELOPMENTAL  
DISABILITIES,  
AND  
SUBSTANCE ABUSE**

The House budget makes only minor changes to funding for the Division of Mental Health, Developmental Disabilities, and Substance Abuse (MH/DD/SAS) in FY2012-13, increasing total funding by \$3.6 million over the continuation budget. However, last year's budget cut the division's funding by \$57 million, and under the continuation budget it will be cut by an additional \$12 million in FY2012-13. The House budget would also cut \$10 million from community services and \$8.5 million from local management entities (LMEs), which manage services for individuals served by the division, and it would eliminate pass-through funding for drug courts.

Notable expansion funding in the MH/DD/SAS budget includes \$18 million to increase the number of community hospital beds via three-way contracts and \$7 million for Cherry Hospital and Broughton Hospital.

Although it is not accounted for within the MH/DD/SAS budget, the House has proposed to create a \$50 million Transition to Community Living fund, which would be used to remedy the U.S. Department of Justice’s finding that North Carolina has long been inappropriately housing many individuals with mental illness in adult care homes rather than in community-based settings. The House budget would establish a Blue Ribbon Commission on Transitions to Community Living, which would be tasked with examining the state's system of community housing and community supports for people with mental illness and/or intellectual and developmental disabilities and developing a plan to transition North Carolina’s current mental health infrastructure into a statewide system of “person-centered” services and supports emphasizing individuals’ dignity, choice, and independence.

It is encouraging that House budget writers acknowledge that meaningful reforms to North Carolina’s treatment of these individuals will come at a price, but until a plan is set forth to transition individuals with mental illness or other disabilities into more appropriate settings, it is not possible to fairly assess the value of this proposal.

**JUSTICE AND PUBLIC SAFETY**

The proposed House budget would reduce spending on Justice and Public Safety (JPS) by \$20.5 million, or 0.9 percent, from the continuation budget.

**FIGURE 9: RECOMMENDED JUSTICE AND PUBLIC SAFETY APPROPRIATIONS**

	<b>FY2012-13 Continuation Budget</b>	<b>FY2012-13 Governor's Recommended</b>	<b>FY2012-13 House Recommended</b>	<b>Change from Continuation Budget</b>	<b>% Change from Continuation</b>
Public Safety	\$ 1,694,715,876	\$ 1,686,139,368	\$ 1,679,193,043	\$ (15,522,833)	-0.9%
Judicial	\$ 435,141,107	\$ 444,034,884	\$ 436,313,762	\$ 1,172,655	0.3%
Judicial - Indigent Defense	\$ 112,748,733	\$ 112,748,733	\$ 112,748,733	\$ -	0.0%
Justice	\$ 80,864,138	\$ 82,245,859	\$ 74,725,380	\$ (6,138,758)	-7.6%
<b>TOTAL</b>	<b>\$ 2,323,469,854</b>	<b>\$ 2,325,168,844</b>	<b>\$ 2,302,980,918</b>	<b>\$ (20,488,936)</b>	<b>-0.9%</b>

*DEPARTMENT OF PUBLIC SAFETY*

The House budget cuts funding for the Department of Public Safety by \$16.5 million, or 1 percent, from the continuation budget and would eliminate a total of 115.48 full-time equivalent positions. The proposal anticipates \$2 million in savings by shifting medical costs for eligible inmates to Medicaid as well as \$11.4 million in additional savings from eliminating 82 vacant positions and cutting other services. The proposal would close one Youth Development Center, eliminating 57 positions, and would add 5 positions to the Parole Commission to address increased workload resulting from the Justice Reinvestment Act.

The House budget would also divert funding from two non-General Fund revenue sources to the Department of Public Safety. It would move \$5 million in one-time funds from the Statewide Misdemeanant Confinement Fund to offset a reduction to the Treatment for Effective Community Supervision program. The proposal would also divert \$2.3 million in recurring funds and \$585,000 in one-time funds from the Highway Fund to cover operating and maintenance costs for the Voice Interoperability Plan for Emergency Responders (VIPER) program. Additionally, the Department of Public Safety would acquire the Department of Natural and Environmental Resources’ Geodetic Survey Section.

*DEPARTMENT OF JUSTICE*

The House budget would cut funding for the Department of Justice by \$5.1 million, or 6.4 percent, from the continuation budget and would eliminate a net total of 21 positions. The Consumer Protection Division would lose all state funding and become fully receipt-supported under this proposal, which would affect 17 positions. The proposal would also fund the creation of a new DNA section to the Triad Regional Crime Lab.

INDIGENT DEFENSE

The House Budget increases funding for the Administrative Office of the Courts by \$1.2 million, or 0.3 percent, over the continuation budget, funding a net of 33 additional positions. The proposal anticipates nearly \$1.4 million in savings by eliminating vacant positions. It would remove the Family Court program from continuation review and restore 44 positions and nearly \$2.9 million in funding on a recurring basis.

The House budget would make no changes to the continuation budget for the Office of Indigent Defense Services (IDS). Last year's budget cut funding for IDS by \$12.7 million.<sup>24</sup> In addition, a recurring funding shortfall will leave an estimated \$16 million in unpaid fees to private attorneys who represented indigent clients on behalf of IDS in FY2011-12.<sup>25</sup>

## NATIONAL MORTGAGE SETTLEMENT FUNDS

A recent report by the Pew Center on the States indicated that many states receiving National Mortgage Settlement funding this year are using portions of the benefits to address budget gaps unrelated to the spending requirements set forth in the actual settlement.<sup>26,27</sup> While it appears that North Carolina will use the majority of settlement funds going to state agencies and non-state

entities for the purposes outlined in the settlement agreement, there are several exceptions presented in the House budget.

The House budget would allocate \$14.3 million in one-time National Mortgage Settlement funds within the Justice and Public Safety budget. Although the funds are supposed to expand state efforts aimed at detecting, investigating, and

prosecuting lending and financial crimes, \$3.2 million of this amount would be used to offset unrelated General Fund spending cuts, including a reduction to the Department of Justice's operating fund to pay for the construction of a new crime lab and a reduction to the administrative budget for the Conference of District Attorneys within the Judicial Branch.

## NATURAL AND ECONOMIC RESOURCES

The House budget would increase spending on Natural and Economic Resources by \$23 million, or 6.4 percent, over the continuation budget. Even more significantly, the budget would shift two major divisions within the Department of Environment and Natural Resources – the NC Forestry Service and the Division of Soil and Water Conservation – to the Department of Agriculture and Consumer Services.

The House budget proposal makes no changes to funding for the NC Biotechnology Center and the Rural Economic Development Center from the continuation budget, although the Rural Center is given additional grant-making flexibility within its existing Rural Jobs Infrastructure Grant Fund.

## AGRICULTURE AND CONSUMER SERVICES

The Department of Agriculture and Consumer Services would increase dramatically in size and scope under the House budget. Two major divisions within the Department of Environment and Natural Resources (DENR) – the NC Forest Service and the Division of Soil and Water Conservation – would be transferred to this department, and several of the regional offices cut from the DENR budget last year would be restored within the Agriculture budget. In total, funding for the Department of Agriculture and Consumer Services would increase by \$49.6 million, nearly 80 percent, over last year as a result of these changes.

The Department of Environment and Natural Resources would be further dismantled in the House budget, with multiple divisions within the organization transferred to other state agencies along with their funding. In total, the budget for DENR would be cut by \$44.9 million, or 30.3 percent, from the continuation budget as a result of these changes. In addition to moving the NC Forest Service and the Division of Soil and Water

**FIGURE 10: RECOMMENDED NATURAL AND ECONOMIC RESOURCES APPROPRIATIONS**

	FY2012-13 Continuation Budget	FY2012-13 Governor's Recommended	FY2012-13 House Recommended	Change from Continuation Budget	% Change from Continuation
Agriculture and Consumer Services	\$ 62,198,634	\$ 62,504,083	\$ 111,774,658	\$ 49,576,024	79.7%
Commerce	\$ 33,250,463	\$ 53,351,176	\$ 49,460,665	\$ 16,210,202	48.8%
Commerce - State Aid	\$ 30,151,984	\$ 33,151,984	\$ 31,785,022	\$ 1,633,038	5.4%
Environment and Natural Resources	\$ 148,148,105	\$ 160,312,552	\$ 103,279,160	\$ (44,868,945)	-30.3%
Wildlife Resources Commission	\$ 17,221,179	\$ 17,665,000	\$ 17,700,000	\$ 478,821	2.8%
NC Biotechnology Center	\$ 17,551,710	\$ 18,076,710	\$ 17,551,710	\$ -	0.0%
Rural Economic Development Center	\$ 25,376,729	\$ 45,376,729	\$ 25,376,729	\$ -	0.0%
Clean Water Management Trust Fund	\$ 11,250,000	\$ 11,250,000	\$ 11,250,000	\$ -	0.0%
Labor	\$ 15,836,887	\$ 15,536,887	\$ 15,836,887	\$ -	0.0%
<b>TOTAL</b>	<b>\$ 360,985,691</b>	<b>\$ 417,225,121</b>	<b>\$ 384,014,831</b>	<b>\$ 23,029,140</b>	<b>6.4%</b>

*DEPARTMENT  
OF ENVIRONMENT  
AND  
NATURAL RESOURCES*

Conservation to the Department of Agriculture, the House proposal would move the Division of Environmental Health to the Department of Health and Human Services and the Division of Geodetic Surveys to the Department of Public Safety.

The House budget would privatize the North Carolina Zoo in Asheboro, cutting the state's contribution by \$369,541 in accordance with recommendations of the House Select Committee on Public-Private Partnerships. The zoo would be privatized as of January 1, 2013, with the private operator receiving \$10 million in annual state support – an amount equivalent to total state appropriations for the zoo in its current public state.

The House budget would restore funding for DENR field offices that were eliminated in last year's budget, but it would reduce their total appropriation by \$350,000. Special provisions also require DENR to develop performance measures and evaluation strategies for ensuring office effectiveness.

Special provisions in the DENR budget would also reclassify and consolidate several vacant positions to provide staff support to the Oil and Gas Board, contingent on the legislature's creation of the board. These administrative changes suggest that House budget writers anticipate a need to develop a regulatory regime for hydraulic fracturing ("fracking") in North Carolina.

*CLEAN WATER  
MANAGEMENT  
TRUST FUND*

Created in 1996, the Clean Water Management Trust Fund provides significant financial assistance to local governments and nonprofits to aid in strategic water-related infrastructure development and the purchase of riparian land to protect long-term water quality. In the years since its inception, the trust fund has helped rehabilitate crumbling water/sewer lines, outdated pump stations, and low-capacity storm-water systems across rural North Carolina—infrastructure critical for attracting and retaining industry and ensuring that water-related tourism resources remain unpolluted.

The House budget would eliminate all recurring funding for the Clean Water Management Trust Fund, replacing it in FY2012-13 with \$11.3 million in non-recurring funds. The FY2011-12 budget cut \$88.8 million from the fund's annual appropriation, which used to be \$100 million per year. The House budget would also prioritize funding grant applications that can provide matching funds and those that participate in U.S. Department of Defense programs that provide funds for military buffers.

*COMMERCE*

Under the House budget, the Department of Commerce would see a \$16 million, or 48 percent, increase in total agency funding, with a large share of the increase going to its discretionary incentive programs. The One North Carolina Fund, which provides

matching funds to local governments to assist in industrial recruitment and retention, would receive a \$9 million recurring appropriation, and the Jobs Maintenance and Capital Development Fund, which targets large-scale private capital investment, would receive a one-time increase of \$7.5 million, which would comply with recommendations made in Governor Perdue's proposed budget. At the same time, the House budget transfers \$30 million in one-time funds from the OneNC Fund (leaving a \$30 million balance) to the General Fund to increase overall General Fund availability.

The House budget also proposes several policy changes intended to enhance the accountability, transparency, and long-term fiscal sustainability of these programs. First, it would shift the OneNC appropriation to a cash-flow basis, requiring the Department of Commerce to provide annual estimates of fund obligations for each year before receiving its appropriation. It would also require the department to study the absolute minimum required to operate the OneNC Fund "successfully" and report to the General Assembly every April. These provisions would give the legislature greater authority over evaluating the program and tying its appropriation to that evaluation.

Second, the House budget would take an important step toward measuring and capping the long-term fiscal obligations for multi-year incentive deals. Under this proposal, the state would take on no more than \$14 million in incentive-related liabilities in any given year, ensuring that the Department of Commerce takes future-year liabilities into account when negotiating incentive deals, which phase in over 12 years. Additionally, companies would have only one year to demonstrate successful completion of performance criteria for the previous year and to request grant disbursement for that year. Under current law, a company that receives an incentive can wait as long as ten years to demonstrate performance and request disbursement.

Finally, the budget strengthens the department's transparency requirements by bringing its existing incentive and evaluation reporting requirements in line with the recommendations of the Joint Legislative Committee on Economic Development Oversight, which called for an annual grant report on firm performance, current obligations, and incentive effectiveness analysis. An additional House budget provision mandates new reporting requirements related to conducting evaluations of current state economic conditions and performance benchmarks.

#### COMMERCE STATE AID

Under the House proposal, the amount of state pass-through funding to non-state entities engaged in economic development efforts would increase by 5.4% over continuation levels (an increase of \$993,538 in recurring funds and \$639,500 in non-recurring funds). However, this overall expansion masks across-the-board cuts to virtually every program except for the Economic Development Regional Partnerships, which would get a \$1.3 million recurring increase and a \$1.3 million non-recurring increase. This comes on top of the \$2.2 million in recurring funds already appropriated from continuation for the partnerships. Nine entities would receive cuts of 1.5 percent, and the Community Development Initiative would be cut by 5 percent from the continuation budget.

The House budget would also make several policy changes, including directing the Legislative Research Commission to study the alignment and membership of the regional development commissions to evaluate effectiveness and determine possible improvements after questions about their success were raised in the most recent Joint Legislative Committee on Economic Development Oversight report.

#### WILDLIFE RESOURCES COMMISSION

The House budget would take the commission's Conservation Education Program off continuation review but restores only \$478,821 of the program's FY2010-11 budget of \$778,821.

## TVA SETTLEMENT FUNDS DIVERTED FROM WESTERN NC COMMUNITIES

In April 2011, the U.S. Environmental Protection Agency announced a settlement with the Tennessee Valley Authority (TVA) to resolve Clean Air Act violations at a number of TVA coal-fired power plants in Tennessee, Alabama, and Kentucky. As part of this settlement, TVA agreed to provide North Carolina \$11.2 million over the next five years with

the goal of promoting energy efficiency and remedying past environmental damage in western North Carolina.

The House budget would obligate the settlement funds to the Department of Agriculture and Consumer Services—an agency that has not traditionally managed environmental restoration projects and whose spokesman said

had little expertise in this work—and would earmark those funds solely for forestry projects. In addition, because almost all of the state's forestry projects are either the Piedmont or eastern North Carolina, virtually none of the settlement funds would end up in western North Carolina, the region for which they were intended.

### TRANSPORTATION

The House's proposed \$3.1 billion transportation budget constitutes a funding reduction of nearly \$150 million, or 4.6 percent, from the continuation budget. The transportation budget is supported by revenue from the Highway Fund and Highway Trust Fund, which are funded by the state's gas tax, highway use tax, and Division of Motor Vehicle fees. The House budget appropriates approximately \$2 billion in revenues to the Highway Fund and \$1.1 billion to the Highway Trust Fund. Nearly three-quarters of the transportation cuts included in the proposal would fall on the primary and secondary road systems.

The House budget anticipates a shortfall in gas tax revenue driven by declining fuel consumption as well as its proposal to cap the state's gas tax at 37.5 cent per gallon starting in FY 2012-13. The governor's budget also proposed capping the gas tax at the same level. The tax is currently assessed at 38.9 cents per gallon and is adjusted twice yearly to reflect changes in the average wholesale price of gas.<sup>28</sup>

Capping the gas tax is estimated to cost the transportation budget \$81.6 million in FY2012-13.<sup>29</sup> The cap is a short-sighted policy change that could result in huge long-term costs, especially given the revenue shortfall that the transportation budget already faces.

Beyond FY2012-13, the House proposal would also require the Department of Transportation to budget under the assumption that the gas tax will be set at 35 cents for FY2013-14 through FY2106-17. This policy change would restrict the department's ability to base transportation planning on actual revenues and would further delay needed repairs and upgrades even if adequate revenues are collected.

#### HIGHWAY FUND

The House budget would cut Highway Fund programs by \$132.7 million, or 6.2 percent, from the continuation budget and would eliminate 22 positions. Notable cuts include the following:

- \$107.4 million cut from primary and secondary road programs
- \$4.8 million cut from state aid to airports and municipalities
- \$2.6 million cut from public transportation grants

The proposal would also restore \$47.7 million in recurring funding to the Driver License Program, which passed its continuation review. The budget would also delay adjustments to ferry tolls included in the continuation budget and appropriate \$2.5 million in one-time money to the Ferry Division to offset the loss in revenue resulting from the delay.

#### HIGHWAY TRUST FUND

The House budget would cut funding for Highway Trust Fund programs by nearly \$16.6 million, or 1.5 percent, over the continuation budget. Notable cuts include the following:

- \$9.3 million cut from the interstate system
- \$3.8 million cut from urban loop projects
- \$1 million cut from both state aid to municipalities and the secondary road system

## CONCLUSION

The proposal would also codify the Mobility Fund—which was created in 2010 to fund high-priority transportation projects aimed at easing congestion and enhancing connectivity—and appropriate \$45 million to the fund on a recurring basis.

The House budget's overreliance on one-time money, coupled with its lack of new revenue, takes no significant or long-term actions to set North Carolina back on a more sustainable fiscal and economic path. As in any year when short-term political and fiscal concerns trump longer-term budgetary issues, this budget constitutes yet another missed opportunity for meaningful change. Should the Senate's approach to their budget be similar to the House plan in regards to its major fiscal elements, the damage done by last year's biennial budget<sup>30</sup> will continue to impede and delay North Carolina's recovery from the Great Recession.

- 1 \$188 million of this transfer reflects an accounting change made in the FY2011-13 budget moving the State Highway Patrol to the Department of Public Safety, and with it all Highway Fund revenues for its budget. Beginning in FY2013-14. While this accounting practice makes this change look like increased General Fund spending, it is offset by a commensurate decrease in the Transportation budget and as such has no net economic impact.
- 2 The House budget would pay for \$154 million, or 75 percent, of the \$205.5 million current-year Medicaid shortfall with General Fund dollars. S.L. 2012-002 directs the State Controller to pay the remaining \$51.5 million with \$29 million in funds from within the Department of Health and Human Services and \$21 million in unanticipated federal CHIPRA bonus receipts.
- 3 Mejia, Elaine, November 2008. Understanding the Current and Upcoming State Budget Shortfalls. BTC Brief: NC Justice Center, Raleigh, NC.
- 4 Burch, Brenna, May 23, 2012. "Addressing the Medicaid shortfall." Available at <http://pulse.ncpolicywatch.org/2012/05/23/addressing-the-medicaid-shortfall/>
- 5 Burch, Brenna. "Accounting maneuvers obscure actual depth of cuts in legislative budget," June 14, 2011. Available at <http://pulse.ncpolicywatch.org/2011/06/14/accounting-tricks-obscure-actual-depth-of-cuts-in-legislative-budget/>
- 6 Fiscal Research Division. "21st Century Transportation Committee Finance Subcommittee: Highway Fund and Highway Trust Fund Transfers, Diesel Tax Options." January 2008. Available here: <http://www.ncleg.net/documentsites/committees/21stCenturyTransportationFinance/1-16-08/HF%20and%20HTF%20Budget%20and%20Transfers.pdf>
- 7 See North Carolina Session Law 2007-323 at <http://ncleg.net/Sessions/2007/Bills/House/PDF/H1473v10.pdf>
- 8 See N.C.G.S. § 18C-164 for detail on the Education Lottery Reserve Fund. The fund is intended to reserve a portion of any lottery revenue surplus for use in years when the lottery brings in actual revenues below forecast, but this transfer has been bypassed in other recent budget years in order to increase overall General Fund availability.
- 9 NC Office of the State Controller, Monthly General Fund Report for May 2012.
- 10 Burch, Brenna, May 23, 2012. "Addressing the Medicaid shortfall." Available at <http://pulse.ncpolicywatch.org/2012/05/23/addressing-the-medicaid-shortfall/>
- 11 <http://pulse.ncpolicywatch.org/2012/01/20/cansler-gop-strategy-squeeze-medicaid-pressure-perdue-administration-video/>
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- 15 NC Division of Employment Security <http://www.ncesc1.com/business/savemoney/wotc.asp>
- 16 N.C.G.S. § 105-129.16G.
- 17 See Burch, Brenna, May 2012. Time to Step Up: With Federal Recovery Funds Gone, State Lawmakers Must Recommit to Funding Public Education with General Fund Appropriations. BTC Brief: NC Justice Center, Raleigh, NC and McLenaghan, Edwin, September 2011. North Carolina's Disappearing Educators. BTC Brief: NC Justice Center, Raleigh, NC.
- 18 \$429 million LEA Adjustment + \$259 million EduJobs loss = \$688 million
- 19 See Burch, Brenna, May 2012. Time to Step Up: With Federal Recovery Funds Gone, State Lawmakers Must Recommit to Funding Public Education with General Fund Appropriations. BTC Brief: NC Justice Center, Raleigh, NC and McLenaghan, Edwin, September 2011. North Carolina's Disappearing Educators. BTC Brief: NC Justice Center, Raleigh, NC.
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- 27 North Carolina Department of Justice, "Foreclosure Settlement Benefits to North Carolina Economy," released February 2012. Available at <http://www.ncdoj.gov/getdoc/3b791613-2ed1-4448-8d29-89396c6b203d/ForeclosureSettlementBenefits.aspx>
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- 30 See Freyer, Allan. "Legislative budget would cost North Carolina 30,000 jobs, billions in economic output," June 13, 2011, <http://www.ncjustice.org/?q=node/870>

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