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THE GOVERNOR'S FY2013-15 BUDGET PROPOSAL

Investments Would Fall Short of What is Needed to Rebuild a Strong Economy

BY TAZRA MITCHELL, PUBLIC POLICY FELLOW, AND
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EXECUTIVE SUMMARY

- Governor Pat McCrory proposed a \$20.6 billion General Fund budget for fiscal year (FY) 2013-14 and a \$21.3 billion budget for FY2014-15. While the proposal represents a 1.8-percent increase over the \$20.2 billion FY2013-14 base budget, it would nonetheless spend 8.4 percent less than the last state budget approved before the onset of the Great Recession (FY2007-08) when adjusted for inflation.¹ As such, this proposal would continue to significantly underfund basic public services and structures.
- The proposal for FY2013-14 redirects the entire projected current-year credit balance of \$441 million to fulfill current-year Medicaid obligations and rebuild the Rainy Day Fund and the Repair and Renovations Fund. It increases gross total revenue availability over base tax and non-tax revenues by diverting \$217.5 million from non-General Fund sources to the General Fund, and it depletes gross availability by \$52.0 million by repealing the estate tax. The proposal leaves \$130.8 million unspent and carries forward this balance into FY2014-15.
- The proposal deposits \$181.1 million of FY2013-14 revenue into state savings accounts, including a newly established Medicaid Risk Reserve. It also provides \$185.0 million for the state portion of the Medicaid rebase to address the projected growth in the number of eligible individuals and consumption of services while calling for an increase in Medicaid co-payments. It provides a 1-percent pay raise for teachers and state employees as well as a 1-percent cost-of-living adjustment for retirees.
- Although the proposal would increase overall spending by 1.8 percent over the base budget, of the six major areas included in the budget—the K-12 system, Community Colleges, the UNC System, the Department of Health and Human Services, Justice and Public Safety, and Natural and Economic Resources—only Health and Human Services experienced a net increase. As such, the proposal would fail to maintain current service levels in several areas despite the state's improving economic picture.
- The proposal represents a shift away from economic development investments targeted at low-income, distressed populations and communities and toward more broad-based economic development efforts that appear more focused on business attraction.
- The proposal includes boilerplate language that indicates support for revenue-neutral rate-reducing tax reform. Such an approach is based on the false premise that income taxes are a barrier to economic growth, although recent history and empirical research show that tax cuts have little to no bearing on economic performance. Revenue-neutral tax reform is misguided at this time because such reform would lock in historically low levels of revenue and, as a result, underfund the vital public structures that are the foundations of a strong economy.

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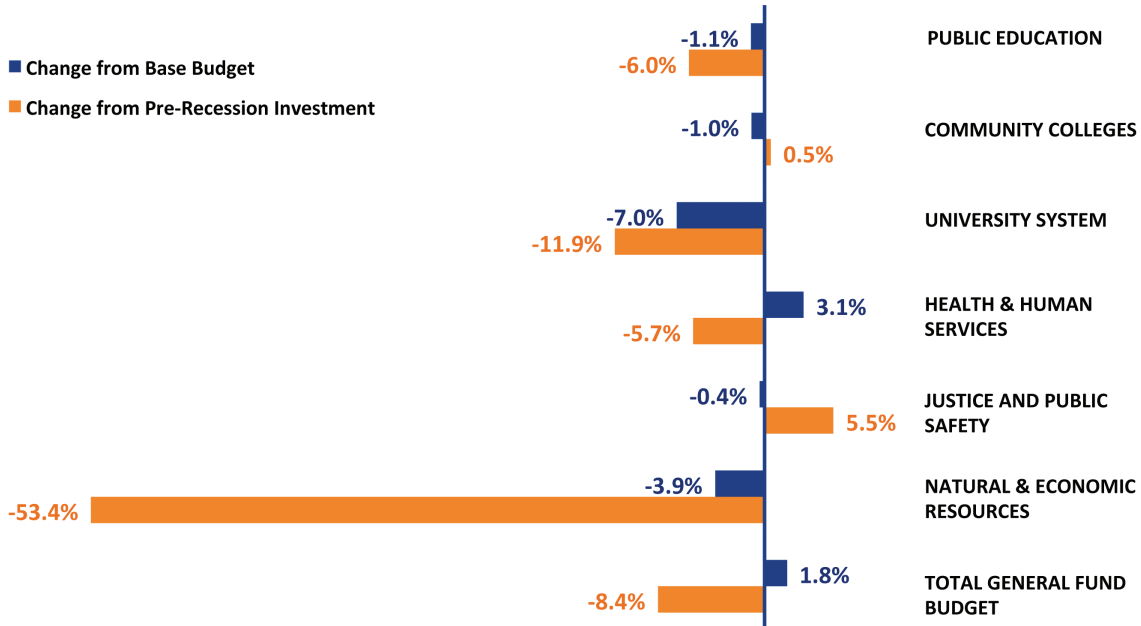
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OVERVIEW

Governor McCrory's proposed biennial budget for fiscal years 2013-2015 comes just as North Carolina's economic recovery is beginning to take hold and revenue collections are slowly recovering. While representing a small step toward reinvestment overall, the budget falls far short of what is needed to maintain current service levels in education, justice, and public safety. Moreover, because the proposal provides no details about the tax changes the governor will propose, it is unclear how and who will support the spending priorities.

FIGURE 1: Governor McCrory's budget proposal for FY2013-14 would increase spending by 1.8% (\$358 million) over the base budget, but spending would drop 8.4% (\$1.9 billion) lower than pre-recession levels (FY2007-08 adjusted)



State investment in almost every area of the budget is far below pre-recession levels under this proposal. When compared to state spending before the Great Recession (FY2007-08, adjusted), the proposal for FY2013-14 reflects a tremendously diminished baseline budget, with appropriations down \$1.9 billion, or 8.4 percent (see Figure 1). As such, this proposal would continue to significantly underfund basic public services and structures.

This issue of BTC Reports provides an analysis of the governor's proposed budget in detail with a specific focus on the potential impacts on low- and moderate-income North Carolinians and the long-term fiscal health of the state.

HOW DOES THE GOVERNOR PAY FOR HIS BUDGET?

Governor McCrory's budget proposal is built on the expectation of base tax and non-tax revenues of nearly \$20.6 billion. These revenues come from the existing tax structure, primarily from the state personal income tax, sales tax, and corporate income tax, as well as a \$218.1 million transfer from the Highway Fund.² The proposal's spending side requires just above \$20.6 billion, or \$358 million above the base budget (what is needed to maintain current service levels). The gap between expected revenues and spending priorities results in a shortfall of \$34.7 million. To address this shortfall, the proposal increases General Fund availability by diverting dollars from the Public School Building Capital Fund and non-General Fund sources (see Figure 2).

None of the current-year surplus is carried forward to supplement general availability for FY2013-14. The governor's proposal redirects the entire projected current-year credit balance of \$441 million—consisting of a \$102.6 million revenue surplus, \$125.0 million in anticipated state agency reversions, and \$213.4 million in unappropriated funds—to fulfill current-year Medicaid obligations and rebuild the Rainy Day Fund and the Repair and Renovations Fund.

| FIGURE 2: HOW DOES THE GOVERNOR PAY FOR HIS BUDGET? | | |
|--|--------------------------|--------------------------|
| | FY2013-14 | FY2014-15 |
| Baseline Revenue Forecast | \$ 20,567,000,000 | \$ 21,513,600,000 |
| + Net General Fund Credit Balance | \$ 0 | \$ 0 |
| <i>Unappropriated Balance</i> | \$ 213,432,878 | \$ 130,825,236 |
| <i>Revenue Overcollections</i> | \$ 102,600,000 | \$ - |
| <i>Reversions</i> | \$ 125,000,000 | \$ - |
| <i>Medicaid Funding</i> | \$ (123,100,000) | \$ - |
| <i>Rainy Day Fund</i> | \$ (200,000,000) | \$ (130,825,236) |
| <i>Repairs and Renovations Reserve</i> | \$ (117,932,878) | \$ - |
| + Recommended Revenue Changes | \$ 165,493,840 | \$ 153,304,087 |
| <i>Fund Transfers from Non-General Fund Sources</i> | \$ 217,493,840 | \$ 210,304,087 |
| <i>Repeal Estate Tax</i> | \$ (52,000,000) | \$ (57,000,000) |
| Total Revenue Available | \$ 20,732,493,840 | \$ 21,666,904,087 |
| – Appropriation Requirement | \$ 20,601,668,604 | \$ 21,334,544,066 |
| REMAINING GENERAL FUND BALANCE | \$ 130,825,236 | \$ 332,360,021 |

With a net credit balance of zero dollars, the proposal raises a total of \$217.5 million in gross General Fund availability over base tax and non-tax revenues. The increased availability includes enhancements from the following sources:

- \$75 million from permanently repealing the county share of the corporate income tax that is dedicated to the Public School Building Capital Fund
- \$65 million from the Gold LEAF Foundation
- \$27.5 million from the Parks and Recreation Trust Fund
- \$25 million from the Master Settlement Agreement funding³
- \$9.9 million from the Natural Heritage Trust Fund
- \$4.1 million from repealing the NC Public Campaign Fund
- \$4 million from the Solid Waste Trust Fund
- \$2.7 million from the Scrap Tire Disposal Account
- \$2 million from the NC Flex FICA Fund
- \$1.2 million from the White Goods Management Account
- \$1 million from repealing the NC Political Parties Financing Fund

Education Lottery Funding

Availability is reduced by \$52.0 million in gross pre-budget expenditures by repealing the state estate tax. Net of all adjustments to availability, the proposal supplements nearly \$20.6 billion in base tax and non-tax revenues with \$165.5 million in one-time General Fund availability, raising total General Fund availability to \$20.7 billion. The result is an unspent General Fund balance of \$130.8 million.

The governor's proposal appropriates approximately 20 percent, or \$100 million, of lottery revenues to counties for school capital needs—an amount that is well below the statutory 40-percent requirement. The proposal uses \$26 million in lottery revenues to purchase computer tablets with reading software to improve 3rd grade reading achievement and \$17.1 million to fund 5,000 permanent slots to the NC Pre-K program.⁴

REVENUE PLAN

On the revenue side of the ledger, the governor fails to either include details of his vision for tax reform or set forward a plan for how and who will support the spending priorities he establishes in his budget. His proposal includes vague boilerplate language that indicates support for revenue-neutral reductions in personal and corporate income tax rates. Such an approach is based on the false premise that income taxes are a barrier to economic growth, even though recent history and empirical research show that tax cuts have little to no bearing on economic performance.^{5,6}

The principle of revenue-neutral tax reform is also misguided at this time because, by design, such reform would neither lower nor increase the total amount of revenue the state takes in. North Carolina's current revenue levels are at historically low levels as a share of the state's economy. Revenue-neutral tax reform would lock in this inadequate revenue flow and, as a result, would underfund the vital public structures that are the foundations of a strong economy.

The lack of details on the revenue side of the ledger makes it difficult to assess whether the governor's rate-reducing tax ideas could truly achieve revenue neutrality while meeting the baseline forecast and sustaining public investments. Furthermore, the proposal is thin on details about who will pay to support these investments.

Repeal of the State Estate Tax

The only specific tax change in the governor's proposal is the repeal of the state estate tax, which would reduce tax revenues by \$52 million in FY2013-14 and nearly \$300 million over the next five years.⁷ In the 2011 tax year, only 23 multi-million-dollar estates were subject to the state estate tax, and it is likely that even fewer heirs would be subject to this tax in future years because the estate exemption level was recently raised to \$5.25 million.^{8,9}

Repealing the estate tax would impede the state's ability to balance contributions from taxpayers across the income spectrum and would lessen the current degree of progressivity in the overall tax system. Repealing this critical tool would also mean fewer resources to invest in the public structures—like education, health, and public safety—that support broader, long-term economic growth.

The governor released his budget proposal including this windfall for a handful of wealthy estate beneficiaries just one week after he signed a bill that allows the state Earned Income

Tax Credit to expire in tax year 2014. Combined, these decisions demonstrate a pursuit of tax policy changes that would shift taxes away from wealthy individuals to middle- and low-income residents.

Revenue Forecast

Based on a revenue forecast that is a consensus between the North Carolina Office of State Budget and Management and the Fiscal Research Division of the North Carolina General Assembly, the governor's proposal is built upon a modest projection of tax revenue growth of 3.6 percent in FY2013-14, which is below the long-term average growth rate of 4.8 percent. This cautious approach is appropriate given the state's uneven and slow economic recovery.

Whereas the revenue forecast projects modest growth in the personal income tax and the sales tax in both years of the biennium, corporate income tax collections are expected to increase only in FY2014-15. The forecast also finds that the 2011 business tax exemption reduced personal income tax collections in the current fiscal year; this exemption was originally estimated to reduce state revenues by \$336 million but was revised upward to \$460 million.¹⁰

Federal Budget Uncertainty

The consensus revenue forecast is predicated on the assumption that the automatic, across-the-board federal spending cuts known as sequestration will be resolved and will not significantly impact the state's economy. The first round of these spending cuts went into effect on March 1 and will impact the state in FY2013-14 from July to the end of September 2013.¹¹ These cuts will affect the state budget, although to what extent is unknown.

The second round of cuts is scheduled to go into effect on October 1, 2013 and would impact the state during part of both FY2013-14 and FY2014-15 through the end of September 2014. However, Congress still has the opportunity to address these cuts as they work on the 2014 federal budget.

The greater uncertainty is whether the reserves in the governor's proposal will be sufficient to cope with the first and potentially second rounds of sequestration cuts. The proposal would add \$200 million to the Rainy Day Fund each year of the biennium for a total balance of \$619 million in FY2013-14 and \$819 million in FY2014-15, representing 3.0 percent and 3.8 percent of General Fund appropriations respectively. The proposal would also add \$603 million to other reserves over the biennium that could potentially help address sequestration- and emergency-driven budget shortfalls.

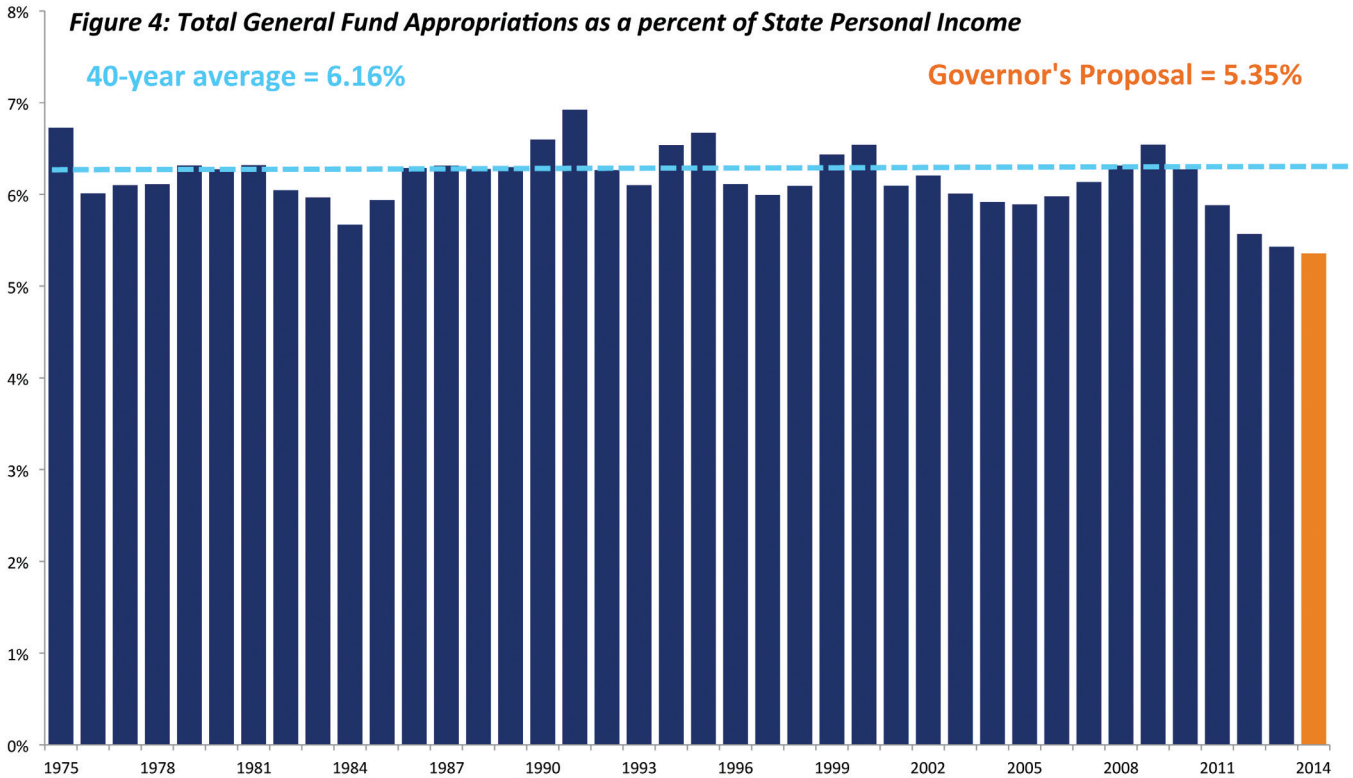
THE SPENDING PLAN

The governor's proposal would increase total General Fund spending by \$358.0 million, or 1.8 percent, in FY2013-14 and \$905.5 million, or 4.4 percent, in FY2014-15 over the base budget. Total General Fund spending would be \$20.6 billion in FY2013-14 and \$21.3 billion in FY2014-15 (see Figure 3).

FIGURE 3: PROPOSED FY2013-2015 BUDGET OVERVIEW

| | | |
|--|--------------------------|--------------------------|
| Pre-Recession Budget (FY2007-08, Inflation-Adjusted) | \$ 22,501,984,743 | |
| | FY2013-14 | FY2014-15 |
| Recommended Base Budget | \$ 20,243,669,050 | \$ 20,429,009,621 |
| <i>Proposed Expansions</i> | \$ 1,034,400,885 | \$ 1,622,098,614 |
| <i>Proposed Cuts</i> | \$ (676,401,331) | \$ (716,564,169) |
| Total General Fund Appropriations | \$ 20,601,668,604 | \$ 21,334,544,066 |
| Percentage Change from Pre-Recession Budget | -8.4% | -5.2% |
| Percentage Change from Base Budget | 1.8% | 4.4% |
| % Change from FY2013-14 Budget | / | 3.6% |

In historical context, the proposal reflects a diminished baseline budget when compared to pre-recession levels of spending, adjusted only for inflation (not adjusted for population growth or increased demand for services). In fact, the proposal would not only make FY2013-14 the year of North Carolina's lowest overall state General Fund spending as a share of the economy in 42 years but would also keep spending well-below the 40-year average share of 6.16 percent (see Figure 4). Compared to the base budget, the proposal would slightly increase state spending as a share of the state's economy to 5.35 percent—yet, state spending as a share of the economy would still be 1.4 percent lower than in FY2012-13.



The following sections provide an overview of major changes proposed in Education, Health and Human Services, Justice and Public Safety, Natural and Economic Resources, and Transportation.

Education

The governor proposes an overall decrease in state investment in education of \$284 million, or 2.4 percent relative from what is needed to maintain current service levels. Some areas of the education budget do receive expanded investment reflecting policy choices to support technology in the classroom and equipment for jobs in emerging industries.

FIGURE 5: PROPOSED EDUCATION APPROPRIATIONS

| | FY2013-14 Base Budget | FY2013-14 Proposed | Change from Base Budget (\$) | Change from Base Budget (%) |
|--------------------|----------------------------------|-------------------------------|---|--|
| Public Instruction | \$ 7,984,924,757 | \$ 7,899,768,926 | \$ (85,155,831) | -1.1% |
| Community Colleges | \$ 1,037,430,475 | \$ 1,026,803,219 | \$ (10,627,256) | -1.0% |
| UNC System | \$ 2,709,551,807 | \$ 2,520,644,276 | \$ (188,907,531) | -7.0% |
| TOTAL | \$ 11,731,907,039 | \$ 11,447,216,421 | \$ (284,690,618) | -2.4% |

K-12 Public Education

Cuts to the K-12 public education budget during and after the Great Recession have been significant. The state's public education system provides a critical foundation in the preparation of children for the jobs of the future and participation in the civic life of their communities. While the governor's proposal includes expansion items, it does not make up for these previous cuts, which were delivered primarily through local management flexibility cuts, nor the loss of federal EduJobs dollars last year.¹² Overall, the governor's K-12 public education budget would spend \$85 million, or 1.1 percent, less than the base budget.

The proposal provides \$10.6 million and \$11.2 million to account for growth in student enrollment, based on average daily attendance, in FY2013-14 and FY2014-15, respectively. The proposal suggests that funding for student enrollment growth would result in 921 and 1,813 additional teacher positions in FY2013-14 and FY2014-15, respectively. However, the proposal does not provide explicit funding for these additional positions, and local school districts are still struggling with limited funds for existing students; thus, the number of new teachers that would actually enter classrooms is uncertain.

Other expansion items in the proposal include investments in learning tools. The proposal partially restores funding for school textbooks, instructional supplies, and equipment. In FY2013-14, \$58.2 million is provided for textbooks, while \$9.4 million in funding for instructional supplies and equipment is also made available.

There is also partial funding in the proposal for elements of the Excellent Public School Act, Senate Bill 361, which is not yet state law. The proposal provides \$28 million for summer reading camps and other requirements. However, the Fiscal Research Division reports a higher cost of \$38.5 million in FY2013-14 and \$33.8 million in FY2014-15 to implement the act's summer reading camps and parent plans.

There are notable cuts in the governor's proposal that would affect students' classroom experience. Funding for teacher assistant positions is reduced by \$117 million, an effective zeroing-out of this line item in the state budget. However, the proposal states that these funds are to be reallocated to local school systems, which can ultimately decide how to spend the funds.

Research shows the quality of students' education is clearly linked to teacher quality, which can be enhanced through professional development.¹³ Yet, the governor's proposal reduces funding for two programs designed to improve the quality of teachers in the classroom. The proposal eliminates the NC Center for the Advancement of Teaching, resulting in \$3.2 million in savings by FY2014-15 and the loss of 39 full-time positions. The center is a year-round professional development program that provides teachers with intensive cross-disciplinary seminars in a multiple learning disciplines. The proposal would also phase out and then eliminate the Teaching Fellows Scholarship Program, resulting in \$6.2 million in savings by FY2014-15. The program was created in 1986 with the mission of recruiting talented high school graduates into the teaching profession and helping them develop leadership qualities.

Community Colleges

The unprecedented growth in enrollment since the beginning of the Great Recession has tapered off, but the community college system continues to play a critical role in the state's economy and recovery by providing skills training and retraining for the jobs of the future. The governor's proposal would reduce funding for the community college system by \$10 million, or 1 percent, compared to the base budget.

The proposal would reduce funding for enrollment by \$20 million in FY2013-14. It also would change the formula for funding enrollment; instead of calculating enrollment based on either current-year levels or a three-year average, whichever is higher, the governor proposes using a two-year average.

The proposal would increase tuition and fees for community college students, but in the continued difficult economic environment such a move could impact students' ability to enroll in and complete their educational programs. Tuition would increase from \$69 per credit hour to \$70 per credit hour in FY2013-14. If this increase is implemented, community college tuition will have increased 46 percent for residents since the start of the Great Recession.¹⁴ Tuition for non-residents would increase by \$4 per credit hour under the governor's proposal. In addition, senior citizens would be charged tuition and continuing education fees would increase by \$5 per course.

The proposal would increase funding for technical education equipment and infrastructure by \$14 million. It would also use non-recurring dollars to continue the NC Back to Work program, which provides long-term unemployed workers with access to training to prepare for various industry-recognized credentials.

Finally, the governor's proposal would provide modest support for performance-based funding. Some community colleges would receive a portion of the \$5 million allocated based on new metrics of performance designed in last year's legislative session.

UNC System

The University of North Carolina (UNC) system is the oldest public university system in the country and serves as an anchor for learning, engagement, and economic development in communities across the state. The UNC system has been particularly hard hit in recent years by budget cuts. In the past year, the system underwent a strategic planning process that set new priorities for the next five years. The UNC system would receive a 7 percent cut, almost \$189 million, from the base budget under the governor's proposal.

The cut would have been greater if the proposal had not increased non-resident tuition by

between 12.3 percent and 6 percent, depending on the campus. These tuition increases would generate \$54 million in receipts. It is unclear what impact these tuition increases would have on out-of-state enrollment, especially given that they are in addition to tuition increases approved by the UNC Board of Governors last year.

There is no appropriation for need-based financial aid. One-million dollars from the Escheats Fund that was allocated to the community system but was not spent in the current fiscal year would be transferred to the UNC system. The lack of need-based financial aid would impact an estimated 8,400 students, and all aid packages would likely be smaller. Affordability of higher education continues to be a challenge for North Carolina residents who have been impacted by successive tuition hikes at the UNC system.

Expansion items in the proposal are centered on the UNC strategic direction committee's focus on a state educational attainment goal, support for workforce preparation, and support for research and development in emerging industries.

The UNC Board of Governors adopted a goal of having 32 percent of the state's residents attain a bachelor's degree or higher by 2018. To achieve that goal, the governor's proposal provides \$4 million in recurring and \$3 million in non-recurring funds to support an "Early Warning System" to monitor how students are progressing in their programs, to support transfer students and veterans, and to encourage performance improvement on campuses. In the category of strengthening academic quality, the proposal makes important investments in academic advising and career counseling, provides a platform for adult students to engage in four-year degree programs, and establishes distance learning and core competency certifications and assessments.

Finally, the proposal identifies key industries where the UNC system can support research, scholarship, and training of the future workforce and invests \$4.6 million in FY2013-14 and \$17.9 million in FY2014-15 to support these initiatives. These industries are advanced manufacturing, data sciences, defense, military and security, energy, marine and coastal sciences, and pharmaco-engineering. In addition, the proposal provides \$1.3 million in FY2014-15 to support innovative faculty and \$1.5 million in FY2013-14 and \$3 million in FY2014-15 for faculty retention and professional development.

Health and Human Services

The governor's proposal would increase spending on health and human services by \$143.1 million, or 3.1 percent, over the base budget. The expansion is largely attributable to increased funding for Medicaid, which is a health insurance and long-term care program serving people who are poor, disabled, and elderly. Medicaid would continue to be second largest appropriations-supported item in the state budget. Even with the additional funding, the proposal would still fall short of pre-recession spending for health and human services by nearly \$285.2 million.¹⁵

Health and human services funding aims to ensure that the state's young citizens thrive early, seniors have access to quality and affordable health care, and people with disabilities have the supports they need to contribute to their communities.

FIGURE 6: PROPOSED HEALTH AND HUMAN SERVICES APPROPRIATIONS

| | FY2013-14 Base Budget | FY2013-14 Proposed | Change from Base Budget (\$) | Change from Base Budget (%) |
|---------------------------|----------------------------------|-------------------------------|---|--|
| Central Administration | \$ 54,028,354 | \$ 58,894,045 | \$ 4,865,691 | 9.0% |
| Aging | \$ 54,443,196 | \$ 54,942,341 | \$ 499,145 | 0.9% |
| Child Development | \$ 259,254,083 | \$ 264,823,328 | \$ 5,569,245 | 2.1% |
| Public Health | \$ 156,784,502 | \$ 142,836,502 | \$ (13,948,000) | -8.9% |
| Social Services | \$ 170,629,904 | \$ 176,877,922 | \$ 6,248,018 | 3.7% |
| Medical Assistance | \$ 3,069,576,810 | \$ 3,212,080,320 | \$ 142,503,510 | 4.6% |
| Child Health | \$ 80,131,026 | \$ 70,082,285 | \$ (10,048,741) | -12.5% |
| Services for the Blind | \$ 8,178,618 | \$ 8,178,618 | \$ - | 0.0% |
| Mental Health/DD/SAS | \$ 706,797,747 | \$ 714,174,172 | \$ 7,376,425 | 1.0% |
| Health Service Regulation | \$ 16,761,992 | \$ 16,761,992 | \$ - | 0.0% |
| Vocational Rehabilitation | \$ 39,284,143 | \$ 39,274,143 | \$ (10,000) | 0.0% |
| TOTAL | \$ 4,615,870,375 | \$ 4,758,925,668 | \$ 143,055,293 | 3.1% |

**Child
Development**

The proposal would increase state spending to the Division of Child Development and Early Education by \$5.6 million, or 2.1 percent, over the base budget. The number of permanent slots in the NC Pre-K program—which prepares at-risk 4-year olds for success in school—would increase by 5,000 under the proposal, with recurring funding composed of a \$9.1 million appropriation and \$17.1 million in lottery revenues. This move would make permanent most of the additional slots that were temporarily added in October 2012 for FY2012-13 via Governor Beverly Perdue’s Executive Order 128.

Medicaid

The proposal would increase state spending to the Division of Medical Assistance by \$142.5 million, or 4.6 percent, over the base budget. It includes \$185 million in FY2013-14 and \$390 million in FY2014-15 for the Medicaid rebase, which is an adjustment that reflects changes in costs resulting from enrollment growth or decline, the level and types of services consumed, and inflation. Because the federal Affordable Care Act requires everyone to obtain health insurance or pay a fee, enrollment in Medicaid is projected to increase as North Carolinians who are currently eligible but not enrolled sign up for the program.

Using a portion of the current-year credit balance, the proposal would pay off the current-year Medicaid shortfall. Using base revenues, the proposal would also establish a Medicaid Risk Reserve to manage unexpected cost overruns and would appropriate \$90 million each year of the biennium to this fund.

To offset the cost of expansion items in the Division of Medical Assistance, the proposal would increase Medicaid co-payments for some services by 30 percent from \$3.00 to the allowable maximum of \$3.90, saving \$8.3 million over the biennium.¹⁶ The proposal would also reduce hospital payments for Medicaid outpatient services from 80 percent to 70 percent of cost, for a total savings of \$61.3 million over the biennium. Hospitals would also have to pay a higher up-front assessment charge on non-Medicare revenue to support the Medicaid program, at a cost of \$60 million per year.

To comply with the Affordable Care Act, the proposal would redirect \$23 million in FY2013-14 and \$48 million in FY2014-15 from the NC Health Choice program to the Medicaid program to

provide health care coverage for children living in households with incomes below 133 percent of the federal poverty level. The proposal estimates that 51,000 children will be covered by the Medicaid program due to federal health care reform.

NC Health Choice

The proposal would decrease state spending on NC Health Choice by \$10 million, or 12.5 percent, over the base budget. It includes a \$6.2 million appropriation in the first year of the biennium and \$11.2 million in the second for the NC Health Choice rebase. Under the proposal, hospital payments for outpatient services would also be reduced from 80 percent to 70 percent of cost for the NC Health Choice program, for a total savings of \$1.3 million over the biennium.

The proposal decreases funding to NC Health Choice by \$12.6 million in FY2013-14 and \$26 million in FY2014-15 to reflect the decrease in costs as children are transferred from Health Choice to Medicaid, as mentioned above. Yet, the funding reduction for this transition in the Health Choice program is less than the expansion in the Medicaid program.

Aging and Adult Services

The proposal would increase state spending to the Division of Aging and Adult Services by nearly \$500,000, or 0.9 percent, over the base budget. State funds would be used to replace \$500,000 in expiring federal funding for Project CARE, a program that provides comprehensive support to caregivers of persons with Alzheimer's disease and dementia. There is no new funding to address the growing needs of a rapidly aging population at a time when demand for senior services far outstrips supply. The number of older adults in North Carolina continues to grow; however, inadequate funding means many of them do not have access to the proven and cost-effective senior services that would make it possible for them to live with dignity in their own homes as long as their health allows.

Noticeably absent from the proposal is any new funding for temporary, short-term assistance to adult care and group homes to support the transition of individuals with severe mental illness to community living arrangements, a program known as the state's Transitions to Community Living Plan. The FY2012-13 budget provided a \$37.9 million non-recurring appropriation to support transitions by paying monthly stipends to adult care and group homes for residents no longer eligible to receive Medicaid-reimbursable personal care services but for whom community placements had not yet been arranged. The governor's proposal provides no new funds for individuals who are not able to transition by the end of the year due to limited housing options or for other reasons.

Public Health

The proposal would decrease state spending to the Division of Public Health by nearly \$13.9 million, or 8.9 percent, over the base budget. The proposal would cut Early Intervention—a program serving children from birth to age 3 with or at risk for disabilities—by \$8 million for each year of the biennium. The proposal would also make an \$8 million cut each year of the biennium to the AIDS Drugs Assistance Program, which helps low-income people with AIDS afford their medicine. According to the budget proposal, the governor holds that these two reductions would not affect current service levels.

The proposal would appropriate a recurring \$1 million to support tobacco use prevention

and cessation programs that formerly received considerably more financial support from the Health and Wellness Trust Fund, which was eliminated in 2011.

Social Services

The proposal would increase state spending for the Division of Social Services by nearly \$6.2 million, or 3.7 percent, over the base budget. There would be an additional \$1.1 million in FY2013-14 and \$1.2 million in FY2014-15 to help an additional 200 foster-care youth access post-secondary education. The proposal would also make a non-recurring appropriation of \$4.8 million for each year of the biennium to partially offset reductions in federal funding for child welfare services at the county level. North Carolina food banks would receive a recurring \$2 million appropriation under the proposal, a move that could reduce hunger among the more than 1 in 5 North Carolinians facing food insecurity.¹⁷

Mental Health

The proposal would increase state spending to the Division of Mental Health by \$7.4 million, or 1.0 percent, over the base budget. Despite the significant public attention paid to inadequate funding for community mental health services, the proposal includes no new funding for these services beyond new investments in drug treatment courts (see the Justice and Public Safety section) and what is mandated by a United States Department of Justice Settlement.¹⁸ As such, the proposal would appropriate \$13.3 million over the biennium for housing and support services to address the state's inappropriate housing of mentally ill adults in adult care homes rather than community settings.

Justice and Public Safety

The governor's proposal would decrease funding for justice and public safety by \$9.1 million, or 0.4 percent, from the base budget. While the proposal would spend 5.5 percent more than the pre-recession budget on justice and public safety, this growth can be attributed to state lawmakers' decision to transfer the State Highway Patrol out of the transportation budget and into this section of the General Fund budget in 2011. This growth is offset by a commensurate decrease in the transportation budget and as such has no net economic impact. The transfer was worth \$198.5 million in FY2012-13.

Funding for justice and public safety programs aims to build safe communities through maintaining law and order and providing at-risk juveniles and adults with an opportunity to get their lives back on track and return to their communities.

FIGURE 7: PROPOSED JUSTICE AND PUBLIC SAFETY APPROPRIATIONS

| | FY2013-14 Base Budget | FY2013-14 Proposed | Change from Base Budget (\$) | Change from Base Budget (%) |
|-----------------------------|--------------------------|-------------------------|---------------------------------|--------------------------------|
| Judicial | \$ 458,416,996 | \$ 459,008,142 | \$ 591,146 | 0.1% |
| Judicial - Indigent Defense | \$ 114,505,898 | \$ 119,429,109 | \$ 4,923,211 | 4.3% |
| Justice | \$ 77,773,575 | \$ 76,364,535 | \$ (1,409,040) | -1.8% |
| Public Safety | \$ 1,722,061,784 | \$ 1,708,808,266 | \$ (13,253,518) | -0.8% |
| TOTAL | \$ 2,372,758,253 | \$ 2,363,610,052 | \$ (9,148,201) | -0.4% |

Judicial Branch

The governor's proposal would increase funding for the judicial branch by \$591,000, or 0.1 percent, from the base budget. The proposal anticipates recurring savings of \$3.5 million from a voluntary reduction in force of 62 full-time employees.

Most notably, the proposal would re-establish state support for drug treatment courts, which provide a treatment option for drug offenders that is more cost-effective than prison. State funding would support 45 full-time positions and comprise of \$3.4 million in FY2013-14 and \$3.7 million in FY2014-15.

Indigent Defense

The governor's proposal would increase funding for Indigent Defense Services by \$4.9 million, or 4.3 percent, from the base budget. Perhaps the most significant expansion item in this section of the proposal is the non-recurring \$5 million appropriation to increase funding for private assigned counsel representing the indigent population. North Carolina courts have seen an increase in indigent cases since the beginning of the Great Recession.

Department of Justice

The governor's proposal would decrease funding for the Department of Justice by \$1.4 million, or 1.8 percent, from the base budget. The proposal would reassign approximately 211 attorneys within the Department of Justice to the agencies to which they routinely provide services, reducing spending by \$17.4 million over the biennium. This funding would also support a reserve account to facilitate the transfers and provide agency-level support.

Other notable improvements include increased support for the state crime lab, with one-time funding for new lab equipment and recurring funding for enhanced and expanded DNA-testing and toxicology capabilities. Total appropriations for these investments would be \$8.7 million over the biennium.

Department of Public Safety

The governor's proposal would decrease funding on net for the Department of Public Safety by \$13.3 million, or 0.8 percent, from the base budget. The largest reduction in the department would be the closing of five state prisons for adult males, which would eliminate 685 full-time positions and save \$20.3 million in FY2013-14 and \$34.1 million in FY2014-15. The proposal would also close one youth development center (YDC), which is a long-term, secure community that rehabilitates at-risk juveniles, and would eliminate 25.4 full-time positions as a result. This would be the fourth YDC eliminated since 2011. The proposal would also reduce YDCs operating budgets.

The proposal would provide a combination of recurring and non-recurring funding of \$7.1 million in FY2013-14 and \$14.3 million in FY2014-15 to support 323 probation and parole officers and fully implement the Justice Reinvestment Act of 2011 over the biennium. Other notable expansions in FY2013-14 include \$312,000 to establish the Center for Safer Schools and \$107,000 to support the Tarheel Challenge program for at-risk students who have dropped out or been expelled from high school.

Natural and Economic Resources

The governor's proposal would reduce funding for natural and economic resources by \$13.6 million—a 3.9-percent reduction from the base budget and a 53.4-percent cut from pre-recession levels. In FY2014-15, the budget would reduce spending by \$30.8 million from the base budget—an 8.9-percent reduction from the base budget, a 4.5-percent reduction from the previous year, and a 55.5-percent reduction from pre-recession spending levels.

The natural and economic resources section of the budget includes the Department of Commerce, the Department of Environment and Natural Resources, the Department of Labor, and the Department of Agriculture and Consumer Services.

FIGURE 8: PROPOSED NATURAL AND ECONOMIC RESOURCES APPROPRIATIONS

| | FY2013-14 Base Budget | FY2013-14 Proposed | Change from Base Budget (\$) | Change from Base Budget (%) |
|-----------------------------------|--------------------------|-----------------------|---------------------------------|--------------------------------|
| Agriculture and Consumer Services | \$ 108,918,334 | \$ 106,917,756 | \$ (2,000,578) | -1.8% |
| Labor | \$ 16,196,339 | \$ 15,696,339 | \$ (500,000) | -3.1% |
| Environment and Natural Resources | \$ 109,140,591 | \$ 117,261,525 | \$ 8,120,934 | 7.4% |
| Clean Water Management Trust | \$ - | \$ 6,750,000 | \$ 6,750,000 | * |
| Wildlife Resources Commission | \$ 18,476,588 | \$ 17,886,979 | \$ (589,609) | -3.2% |
| Commerce | \$ 33,469,442 | \$ 39,368,324 | \$ 5,898,882 | 17.6% |
| Commerce - State Aid | \$ 59,714,814 | \$ 28,452,642 | \$ (31,262,172) | -52.4% |
| TOTAL | \$ 345,916,108 | \$ 332,333,565 | \$ (13,582,543) | -3.9% |

*Funding for the Clean Water Management Trust Fund was shifted to a non-recurring basis in FY2012-13. The proposal would appropriate \$6.75 million in non-recurring funding for FY2013-14, which represents a \$4 million drop from FY2012-13 levels and a \$115 million drop from FY2010-11 levels.

Department of Commerce

The Department of Commerce works to support the economic development of the state, including its diverse regions and communities. The governor proposes significant expansions to Commerce in both years of the biennium. The department would receive an increase in funding of \$5.9 million, or 17.6 percent, over the base budget in FY2013-14 and an increase of \$7.4 million, or 22.1 percent, over the base budget in FY2014-15.

The governor has noted publicly that he will prioritize rebranding the state to improve economic opportunities in the future. He begins that effort by appropriating \$2.5 million in recurring funds each year for development of a comprehensive branding strategy. In addition, he appropriates \$200,000 in each year of the biennium for the development of a strategic economic growth plan, which would include the reorganization of the Department of Commerce as a public-private partnership. Having the state's department that is in charge of working with business run by a private, profit-making entity would be a significant policy shift for North Carolina.

Reductions to the Department of Commerce are mostly associated with position reductions, agency-wide operating budget efficiencies, and a shift to receipt support for some programs.

Major expansions are made to programs that provide incentive grants, support small business development and Main Street revitalization, and expand broadband access, including:

- Recapitalization of the Job Maintenance and Capital Development program – This program provides incentive grants for capital investments creating more than 1,000 jobs. The proposal would appropriate a non-recurring \$6.7 million increase in funding in FY2013-14 and a \$7.5 million non-recurring increase in FY2014-15.
- Recapitalization of the Main Street Solution Fund – The proposal would appropriate a \$900,000 non-recurring expansion in each year of the biennium to provide staffing and technical support for this program, which is aimed at small-town business development and revitalization.
- Resumption of funding for the One NC Small Business Program – The General Assembly eliminated this program last year. The proposal would appropriate \$900,000 in non-recurring funds in each year of the biennium to help leverage federal funds related to small-business technology transfer and innovations research.
- Resumption of funding for the Broadband Connectivity Incentive Grant Program – The General Assembly eliminated this program last year. The proposal appropriates \$350,000 in FY2014-15 to incentivize the private-sector provision of broadband service in underserved communities.

The budget for the Department of Commerce also includes discretionary subsidy programs for the attraction, retention and growth of business in the state. Job Development Investment Grant (JDIG) Reserves receive significant increases in funding in both years of the biennium in the proposal. This fund is intended to cover current-year liabilities incurred in JDIG deals signed in previous years (e.g., a deal signed in 2009 phases in over 12 years, and so a portion of this expansion provides funding to cover the 2013, 2014, and 2015 allotments of incentives for that deal). The JDIG reserves would increase by \$32.6 million to \$60 million in FY2013-14 and to \$71 million in FY2014-15. The One NC program, which also funds business incentives, would see a slight expansion in FY2014-15 of \$2.8 million.

Another economic development tool is the support of non-profit, community-based and minority economic development organizations. The proposal would make a \$31 million reduction (52.4 percent) from the base budget in FY2013-14 and a \$35.7 million reduction (57.7 percent) from the base budget in FY2014-15 in state funding for these organizations.

Notable is the recurring zeroing-out in FY2013-14 of funding for the Association of Community Development Corporations, the Community Development Initiative, the Land Loss Prevention Project, Future Farmers of America, Farm in the Classroom, and the Indian Economic Development Initiative. These programs serve minority communities that have historically been excluded from much of the economic gains in the state, and the elimination of state support for these programs would undermine their ability to support targeted economic development in some of North Carolina's most distressed communities.

In addition, the proposal would make a recurring cut to the Regional Economic Development Commissions by 8.7 percent in both years. The Rural Center would receive a non-recurring cut of 42 percent in FY2013-14, and the Biotech Center would receive a non-recurring cut of 58 percent.

Environment & Natural Resources

Paired with the overall expansion of the Commerce budget, the governor's proposal represent a shift away from economic development targeted at low-income, distressed populations and communities and toward more broad-based economic development efforts that appear more focused on business attraction.

The Department of Environmental and Natural Resources (DENR) experienced significant funding cuts and significant changes to the allocation of its sub-agencies in recent years. In FY2013-14, the governor proposes an increase in funding of \$8.1 million, or 7.4 percent, for DENR over the base budget. In FY2014-15, the budget proposes an increase of \$565,214 to DENR, representing a 0.5 percent expansion from the base budget.

The proposal calls for more than \$1 million in efficiencies from several divisions, including Conservation, Planning, and Community Affairs, Marine Fisheries, Water Quality, and the North Carolina Zoo. It calls for an additional \$284,262 in information technology efficiencies per year over the biennium.

Important expansions are made to water quality infrastructure and include:

- A \$1.2 million non-recurring increase for the Drinking Water State Revolving Fund in FY2013-14
- A non-recurring \$5 million increase to the Clean Water State Revolving Fund match in FY 2013-14
- The restoration of the Non-commercial Underground Storage Tank Program with appropriations of \$3.5 million in each year of the biennium

Last year, the state budget shifted funding for the Clean Water Management Trust Fund to a non-recurring basis. This year, the governor proposes \$6.75 million for FY2013-14, which represents a \$4 million drop from last year's levels and a \$115 million cut from FY2010-11.

Other Areas of the Natural & Economic Resources Budget

In FY2013-14, the budget proposes a \$2 million reduction in appropriations for the Department of Agriculture and Consumer Services—a 1.8-percent reduction from the base budget. In FY2014-15, the budget continues FY2013-14 levels, which represents a 1.8 percent drop from the base budget. Reductions come from a \$2 million management flexibility cut and the elimination of vacant positions. Expansions involve the restoration of recurring funding for a range of programs made non-recurring last year, including the Agriculture Water Resources Assistance Program, the Southeastern North Carolina Agriculture Center and Farmers Market, and the Wine and Grape Growers Council.

The proposal does not mention the Farmland Preservation Trust Fund, which means this fund would continue to receive its recurring appropriation of \$1.7 million.

In FY2013-14, the governor's proposal decreases overall funding for the Department of Labor by \$500,000—a 3.1-percent drop from the base budget. This reduction comes from budgeting \$500,000 in over-realized receipts per year over the biennium and reducing overall department appropriations by same amount. The FY2014-15 budget proposes appropriations identical to those in FY2013-14.

Transportation

The governor's proposal would increase spending in the transportation budget by \$228.1 million, or 8.1 percent, over the base budget. The state's transportation system helps form vital social and economic structures by connecting people to services, businesses, and other opportunities across North Carolina—especially those who are transit-dependent and living in rural areas where there has been little job growth since the economic downturn.

The transportation budget is supported by revenue from the Highway Fund and Highway Trust Fund, which receive revenue generated by the state's gas tax, highway use tax, and Division of Motor Vehicle fees. The proposal would divert \$218.1 million from the Highway Fund to the General Fund to support the State Highway Patrol and other purposes. While transfers from the Highway Trust Fund to the General Fund have declined over the past several years, the proposal would discontinue this practice over the biennium.

FIGURE 9: PROPOSED EDUCATION APPROPRIATIONS

| | FY2013-14 Base Budget | FY2013-14 Proposed | Change from Base Budget (\$) | Change from Base Budget (%) |
|--------------------|--------------------------|-------------------------|---------------------------------|--------------------------------|
| Highway Fund | \$ 1,696,197,124 | \$ 1,937,200,000 | \$ 241,002,876 | 14.2% |
| Highway Trust Fund | \$ 1,118,600,000 | \$ 1,105,700,000 | \$ (12,900,000) | -1.2% |
| TOTAL | \$ 2,814,797,124 | \$ 3,042,900,000 | \$ 228,102,876 | 8.1% |

The Governor's Proposal Would Allow the Cap on the State Gas Tax to Expire

The governor's proposal would not extend the cap on the state gas tax, which was put in place July 2012 and is scheduled to expire at the end of June 2013. The gas tax accounts for more than half of state revenues dedicated for transportation projects, but the revenue forecast indicates that gas tax collections are coming in below target for the current year and will continue to decline over both years of the 2013-15 biennium due to falling gas consumption and the shift toward more fuel-efficient and hybrid-electric vehicles.

The state already faces a significant long-term transportation funding gap, harming its ability to build and maintain a transportation system that is efficient, safe for motorists, and meets the needs of a growing state.¹⁹ While consideration of alternative revenues will be required over the long term, allowing the cap to expire will improve revenue collections needed to address the growing strains on North Carolina's transportation infrastructure as well as the current backlog of needed maintenance of stressed roads, bridges, and railroads.

Highway Fund

The governor's proposal would increase spending in the Highway Fund by \$241.0 million, or 14.2 percent, over the base budget. Due to falling gas tax revenues, the proposal would cut \$1.5 million in both the State Aid to Municipalities program and the Secondary Construction Program in FY2013-14. Maintenance programs for primary and secondary roads would also experience decreased funding, but on net, maintenance programs would receive \$205.7 million in additional spending under the proposal in FY2013-14.

The proposal would make a 2-percent cut to multi-modal transportation programs over the biennium, with cuts to the Public Transportation Division amounting to \$1.7 million in the first year and \$2.2 million in the second year of the biennium. All funding for the Small Urban Construction Fund would be redirected to support the Contingency Program, a newly established economic development fund, and weekend service at the Division of Motor Vehicles.

Highway Trust Fund

The governor's proposal would decrease spending in the Highway Trust Fund by \$12.9 million, or 1.2 percent, over the base budget. In FY2013-14 the proposal would reduce funding for the interstate system by \$8.4 million, reduce funding for the urban loops program by \$3.4 million, and reduce state aid to municipalities by \$880,000. The secondary roads program would experience a slight increase of \$382,000 in FY2013-14.

CONCLUSION

The governor's budget proposal for the biennium is not sufficient to maintain current service levels in many critical areas of the budget, including the education of our children, safety of our communities and access to justice for our citizens. Indeed, the proposal ignores the reality of growing need and continues to invest well below pre-recession spending levels even as the economy recovers and revenue collections rebound slightly.

¹These figures reflect the comparison of the governor's proposed \$20.6 billion FY2013-14 budget to the FY2007-08 inflation-adjusted enacted budget of \$22.5 billion (\$20.7 billion, unadjusted).

²The majority of that transfer is to support the State Highway Patrol, which was shifted to the Justice and Public Safety section of the General Fund budget in 2011. The remaining money would go to other purposes. This practice is contrary to a 2007 General Assembly resolution that budget writers would phase out the use of transportation funds to increase General Fund availability by 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.

³Additional funds may be available in April 2013 pending the results of a final audit of disputed payments arbitration per the Master Settlement Agreement, according to the governor's budget document. Page 17.

⁴In October 2012, Governor Beverly Perdue allocated an additional \$20 million for the expansion of the NC Pre-K program via Executive Order Number 128. Governor Perdue diverted one-time money from other health and human services to pay for the expansion. The most recent estimates show that this temporary funding will provide approximately 4,900 additional slots in the program by the end of FY2012-13, according to the Fiscal Research Division of the North Carolina General Assembly.

⁵Johnson, Cedric. "A "Laffable" Plan for Tax Reform - The Civitas/Laffer/Senate Plan for North Carolina Shifts Load to the Poor, Middle-class." North Carolina Budget and Tax Center. January 2013.

⁶Leachman, Michael, et al. "State Personal Income Tax Cuts: A Poor Strategy for Economic Growth." Center on Budget and Policy Priorities. March 2013; and, Williams, Erica and Johnson, Nicholas. "ALEC Tax and Budget Proposals Would Slash Public Services and Jeopardize Economic Growth." Center on Budget and Policy Priorities. February 2013.

⁷The estate tax is a tax on inherited property such as cash, real estate, stock, or other assets, and is only levied on the portion of the estate's value that exceeds a limit set by law.

⁸Fiscal Note for House Bill 101. FY2013-14. Fiscal Research Division of the North Carolina General Assembly. February 2013.

⁹Special data request to the North Carolina Department of Revenue. February 2013.

¹⁰Boardman, Barry. "Overview of General Fund Revenue." Fiscal Research Division of the North Carolina General Assembly. Presentation to the Joint Appropriations Committee. February 5, 2013.

¹¹The federal fiscal year runs from October 1st to September 30th whereas the state fiscal year runs from July 1st until June 30th.

¹²Burch, Brenna. "Time to Step Up: With Federal Recovery Funds Gone, State Lawmakers Must Recommit to Funding Public Education with General Fund Appropriations." North Carolina Budget and Tax Center. April 2012.

¹³Darling-Hammond, Linda. "Teacher Quality and Student Achievement: A Review of State Policy Evidence." Education Policy Analysis, Volume 8, Number 1. January 2000.

¹⁴Sirota, Alexandra and Burch, Brenna. "Underpreparing for the Future: North Carolina's Divestment in Post-Secondary Education." North Carolina Budget and Tax Center. April 2012.

¹⁵The pre-recession figure reflects FY2007-08 spending and is adjusted for inflation.

¹⁶The high co-payments would not apply to emergency services, family planning services, pregnancy-related services, or preventive services for children, according to the budget proposal. Maximum nominal copayment amounts are set by the Centers for Medicare and Medicaid Services.

¹⁷Food Research and Action Center. "Food Hardship in America 2012: Data for the Nation, States, 100 MSAs, and Every Congressional District." February 2013.

¹⁸The Department of Justice's press release announcing the settlement agreement is available at: <http://www.justice.gov/opa/pr/2012/August/12-crt-1040.html>.

¹⁹Just to maintain the current levels of transportation service over the next three decades, the North Carolina Department of Transportation estimates that the state would require an additional \$32.2 billion. See: "North Carolina Statewide Transportation Plan." North Carolina Department of Transportation. August 2012.



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