



NC Justice Center

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BTC Reports

Vol 15 No 8 • September 2009

THE NEWSLETTER OF THE NC BUDGET & TAX CENTER

North Carolina
Budget & Tax
Center

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THE 2009-2011 STATE BUDGET: Trifecta of spending cuts, tax increases and federal aid used to address historic shortfall

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Executive Summary

- On Aug 7, 2009, the General Assembly passed the final state budget for fiscal years 2009-10 (FY09-10) and 2010-11 (FY10-11). The final General Fund budget provides for \$19,008,079,980 in appropriations in the first fiscal year, which is 11% less in state-funded spending than the originally adopted budget for the previous fiscal year. In the second year of the adopted budget, spending will increase by \$547 million or 2.9%, over FY09-10 (**Figure 1**).
- Facing a budget gap of \$4.6 billion between the anticipated state tax revenues and the cost of continuing state services at current levels for FY09-10, state lawmakers chose to close the gap with a balanced approach that relied primarily on spending reductions (net of \$1.7 billion), revenue increases (\$1 billion), and federal assistance from the American Recovery and Reinvestment Act (\$1.4 billion).
- The revenue plan includes two temporary tax increases: a one-cent increase in the state sales tax, bringing the state and local total rate to 7.75% (set to expire June 30, 2011) and an income tax surcharge on high-income households and corporations (for tax years 2009 and 2010). The plan also includes modest increases in taxes on tobacco and alcohol products and a small expansion of the sales tax to digital products.
- The FY09-10 General Fund budget includes \$2.7 billion in spending reductions, the largest of which are achieved through cuts to local school districts, management flexibility reductions, reductions in payments to Medicaid providers, and more than \$500 million in unspecified cuts to the Medicaid program.
- The FY09-10 General Fund budget also includes just over \$1 billion in expansion funding, the vast majority of which is to pay for the state employee health plan, enrollment growth in higher education and Medicaid, and the final step in the state's assumption of all county Medicaid costs (in turn, the state will assume ¼-cent in local sales tax revenue). However, most

of the expansion items are offset by large unspecified cuts to the continuation budget. After accounting for new spending, the net reduction to the budget is \$1.7 billion.

- Many of the spending reductions will have immediate effects on direct services, such as Community Alternative Placements for families with children with developmental disabilities. Other reductions could have more long-term implications. For example, reduced funding to public schools could result in increased class sizes in grades 4 through 12, and cuts to payments to medical providers who treat Medicaid clients could impact access to services over time.
- A few areas of the state budget received additional resources despite the shortfall. Examples include \$17 million to increase enrollment in the Children's Health Insurance Program and \$13 million for dropout prevention grants.
- The final budget also enacted several spending reductions by putting in place efficiencies, such as improving fraud detection and negotiating for lower prices in state-funded health care programs and closing seven inefficient rural prisons.

Overview

The now year-and-a-half long recession has had a dramatic impact on state tax dollar collections across the country. Last year, North Carolina's state tax collections were \$3.2 billion short of what lawmakers had been counting on to pay for the state budget (North Carolina's 2008-09 fiscal year ended on June 30th). This forced the governor to take drastic measures to fill the budget void, which equaled nearly 15% of the total state budget. The

FIGURE 1

FY2009-2011 GENERAL FUND BUDGET OVERVIEW	
FY08-09 APPROPRIATIONS	\$21,355,967,434
FY08-09 ESTIMATED EXPENDITURES (W/FED STIMULUS USED TO ADDRESS MID-YEAR GAP)	\$19,650,972,334
FINAL BUDGET OVERVIEW FY2009-2010	
FY09-10 Adjusted Continuation Budget	\$22,075,170,781
Approved FY 09-10 Appropriations w/out Fed Stimulus	\$19,008,079,980
Change from previous year appropriations	-10.99%
Change from previous year estimated expenditures	-3.27%
Change from FY09-10 Continuation Budget	-13.89%
Approved FY 09-10 Appropriations w/ Fed Stimulus	\$20,405,943,837
Change from previous year appropriations	-4.45%
Change from previous year estimated expenditures	3.84%
Change from FY09-10 Continuation Budget	-7.56%
FINAL BUDGET OVERVIEW FY2010-2011	
FY10-11 Adjusted Continuation Budget	\$22,554,891,906
Approved FY 10-11 Appropriations w/out Fed Stimulus	\$19,555,540,945
Change from FY09-10 appropriations	2.9%
Change from FY10-11 Continuation Budget	-13.3%
Approved FY 09-10 Appropriations w/ Fed Stimulus	\$20,593,131,294
Change from FY09-10 appropriations w/fed stimulus	0.92%
Change from FY10-11 Continuation Budget	-8.70%

FIGURE 2

HOW WAS THE FINAL FY2009-2010 BUDGET BALANCED?		
Total General Fund Availability	\$17,608,367,011	
Baseline Revenue Forecast	\$16,796,300,000	
Non-Tax Revenues	\$720,100,000	
Projected Overcollections in FY08-09	\$91,967,011	
Adjusted Continuation Budget	\$22,075,170,781	
Gap Between Available Revenues and Cost of Maintaining Services	\$(4,466,803,770)	% of Shortfall filled
+Tax Changes	\$1,046,300,000	23.4%
+ New Fees	\$55,739,554	1.2%
+ Other Adjustments to Availability	\$308,197,826	6.9%
+ Federal Recovery Funds (Treated as Receipts/Cuts offset by ARRA funds)	\$1,397,863,857	31.3%
+ Spending Cuts	\$2,700,976,776	
- New Spending (Enrollment Growth, State Health Plan, etc)	\$(1,031,749,832)	
= Net Spending Reduction	\$1,669,226,944	37.6%
Total Available to Address Shortfall	\$4,477,328,181	
Unappropriated Balance Remaining	\$10,524,411	

governor cut close to \$1.3 billion from state services, including cuts to education, health care, public safety and state employee pay. She also drained the state's savings account, transferred money from a variety of funds and put a halt to all state hiring. The American Recovery and Reinvestment Act (ARRA), better known as the federal stimulus package, helped to lessen the amount of cuts by providing around \$1 billion to fill last year's budget gap.

North Carolina state lawmakers faced a daunting task when they began crafting the budget for the next two fiscal years, 2009-10 and 2010-11. Many of the strategies used by the governor to balance the FY08-09 budget were no longer available, such as delaying purchases and dipping into reserves. To make matters worse, state economists reduced the baseline revenue forecast for FY09-10 to \$17.5 billion, 16% lower than the original forecast for the previous fiscal year. The lower revenue forecast combined with typical spending pressures (enrollment growth in education, health care inflation, prison population growth, etc.) and counter-cyclical spending pressures (more residents eligible for various assistance programs and laid-off workers looking for retraining opportunities at community colleges) left state lawmakers with a \$4.6 billion budget hole, or 22% of the state budget, to fill.

Rather than cutting more than 20% of the state budget, lawmakers took a balanced approach to fill the state gap. They enacted \$1.7 billion in net spending reductions, raised an additional \$1 billion in revenue and relied on \$1.4 billion from additional federal assistance made available via the stimulus package (Figure 2). The additional tax revenue helped to avoid the most damaging of cuts to core services; however, the remaining cuts to state-funded programs and services will still have serious impacts on vulnerable North Carolinians and communities. This issue of BTC Reports examines the final budget proposal for fiscal years 2009-2011 in detail, with a special focus on the impact the proposed tax and spending plans would have on low- and moderate-income North Carolinians.

North Carolina's Revenue Problem

The global recession has taken a toll on North Carolina's revenue collections. In the fiscal year that ended on June 30, 2009 (FY08-09), revenues came in \$3.26 billion, or an unprecedented 15.2% below the amount needed to pay for the budget. In FY09-10, the shortfall grew to \$4.6 billion or 22% of the total budget. To put that in perspective, the state legislature's Office of Fiscal

FIGURE 3

FINAL TAX PACKAGE DETAILS		
Tax Change	FY 2009-2010	FY 2010-2011
1-cent sales tax increase	\$803,500,000	\$1,061,300,000
Personal income tax surcharge (See Fig 3A)	\$172,800,000	\$177,100,000
3 percent corporate income tax surcharge	\$23,100,000	\$25,500,000
Add digital products and click-throughs to sales tax base	\$11,800,000	\$24,100,000
Conform to Internal Revenue Code changes	\$(116,300,000)	\$(80,900,000)
Excise tax changes (See Fig 3B)	\$68,800,000	\$93,800,000
Adjust revenue distributions (Local to State)	\$22,100,000	
Suspend corporate income tax earmark for schools	\$60,500,000	\$64,500,000
TOTAL	\$1,046,300,000	\$1,365,400,000

FIGURE 3 A

Income Tax Surcharge Breakdown
If Married Filing Jointly: 2% surcharge on tax liability for taxable incomes between \$100,000 and \$250,000 3% for taxable incomes above \$250,000
If Single: 2% surcharge on tax liability for taxable incomes between \$60,000 and \$150,000 3% for taxable incomes above \$150,000
If Head of Household: 2% surcharge on tax liability for taxable incomes between \$80,000 and \$200,000 3% for taxable incomes above \$200,000

FIGURE 3 B

Excise Tax Changes
Increase excise tax on beer from 53.177 cents per gallon to 61.71 cents
Increase excise tax on wine from 26.24 cents per liter to 29.34 cents per liter
Increase excise tax on liquor from 25% to 30%
Increase excise tax on cigarettes from 35 cents to 45 cents per pack
Increase excise tax on other tobacco products from 10% to 12.8%

Research found that during the previous recession in 2001, the budget shortfall was 10.8% of the total General Fund budget, and in the 1990-1991 recession just 8.1%.

Recognizing the impact of the recession on the state's revenue collections, administrative and legislative economists agreed to a consensus revenue forecast that assumes a 1.9% decline in revenues for FY09-10 and modest growth of only 3.2% for FY10-11. Without the new taxes passed in the final budget, revenues would have fallen to \$17.5 billion in FY09-10. Even though there are some positive signs that North Carolina's economy is on a path to recovery, state economists think the recession will set revenues back at least five years, predicting it will be FY13-14 before North Carolina catches up to the original forecast for FY08-09 of \$20.8 billion.

Without the recently enacted tax increase, state General Fund appropriations would have fallen to their lowest level since fiscal year 1992-93. Rather than allowing the quality of public services to retreat to such an extent, lawmakers opted to take a balanced approach, filling the budget gap with spending cuts, federal assistance and new taxes. Even with these tax increases, however, inflation-adjusted state appropriations per person have fallen to their lowest level in thirteen years.

REVENUE PLAN

The final budget includes a tax plan that would raise an additional \$1 billion in FY09-10 and \$1.36 billion in FY10-11 (Figure 3). The new revenue raised from the plan allows the state to continue making important investments in education, public safety and health care and helps to mitigate the most devastating cuts that were previously considered. Of the three main strategies used to balance the budget, the new tax increases closed the smallest percentage of the budget gap, around 23%. Net spending reductions (38%) and use of federal stimulus funds (31%) were more significant.

The major components of the final tax plan include the following:

Federal Recovery Funds in the General Fund Budget

- A temporary one-cent increase in the state sales tax rate from September 1, 2009 through June 30, 2011. The increase brings the state rate to 5.75% and the local rate to 2% (with the exception of the counties with additional local-option sales taxes) bringing the combined sales tax rate to 7.75% in most locations.
- A small expansion of the sales tax to cover digital downloads and internet click-through purchases.
- A temporary income tax surcharge on high-income households (**Figure 3A**)
- A temporary 3% surcharge on corporate income tax payments.
- Small increases in cigarette and alcohol taxes (**Figure 3B**)

The final package results in a small net tax increase on all North Carolina households; however, it hits low-income families hardest. The bottom 20% of households will pay on average \$67 annually in new taxes, or .66% of their incomes. The top 1% of households will pay only .28% more of their incomes, or an average of \$2,848 (**Figures 4 and 4A**). While the income tax surcharge only applies to high-income households, the one-cent sales tax increase falls disproportionately on low- and moderate-income households.

A relatively smaller amount of additional revenue (\$55.7 million in FY09-10 and \$60 million in FY10-11) comes from an increase in various fees, including business and marriage licenses, and inspection and court-related fees. Another \$98 million was raised by transferring money from a handful of trust funds, including the Health and Wellness Trust Fund and the Tobacco Settlement Trust Fund. Increased Department of Revenue enforcement and a new compliance initiative to ensure taxpayers are paying what they owe will raise another \$210 million in FY09-10 and \$90 million in FY10-11.

The FY09-10 and FY10-11 budgets contain an additional \$1.4 billion and \$1 billion respectively in nonrecurring General Fund spending reductions that are offset by anticipated federal recovery funds. Three recovery funding streams are specifically dedicated to helping states close their budget gaps over a three-year period: a temporary increase in the Medicaid FMAP (federal Medicaid assistance percentage), a state fiscal stabilization fund to maintain education spending at FY05-06 levels, and a second state fiscal stabilization fund for general use.

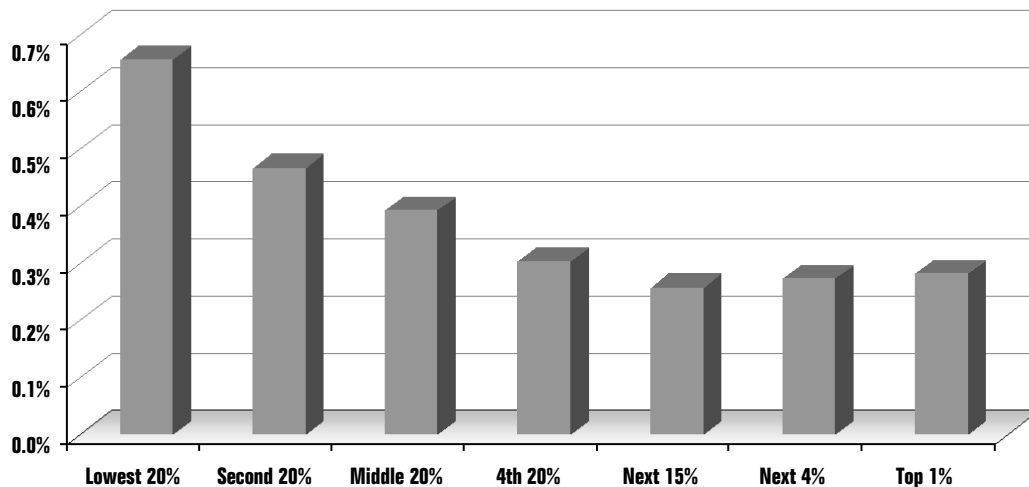
In FY09-10, education stabilization funds are shown as a non-recurring reduction of \$380 million in public education appropriations for non-instructional support and as a non-recurring reduction of \$138 million to the UNC system budget. The increase in the federal Medicaid assistance percentage was shown as a non-recurring reduction \$857 million to the General Fund appropriations for the Health and Human Services budget. Another \$12.92 million in general state fiscal stabilization funds available through the ARRA are used to offset a reduction in General Fund appropriations to the Justice and Public Safety budget. A little more than \$10 million in stimulus funds intended to supplement spending for programs most impacted by the recession were also used to make slight non-recurring reductions in General Fund appropriations to those programs (**Figure 5**). Additional federal recovery dollars are available to North Carolina that do not flow through the General Fund, such as money for transportation, home weatherization, unemployment benefits, local governments and school districts.

Accounting for federal assistance as non-recurring General Fund reductions and then offsetting them with the recovery money is the responsible thing to do because those stimulus funds are non-recurring and will not be available to help balance the General Fund budget after FY10-11. However, to accurately compare FY09-10 spending to the previous year and the recommended continuation budget, this report includes the \$1.4 billion of federal money in addition to the amounts appropriated in the General Fund budget.

FIGURE 4**IMPACT OF TAX CHANGES ON NC HOUSEHOLDS - AS % OF INCOME PAID BY INCOME GROUPS**

All North Carolinians, 2008 income levels							
2008 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$16,400	\$16,400 – \$28,600	\$28,600 – \$47,400	\$47,400 – \$77,000	\$77,000 – \$159,400	\$159,400 – \$373,100	\$373,100 – Or More
Average Income in Group	\$ 10,200	\$ 22,200	\$ 37,100	\$ 60,600	\$ 105,000	\$ 227,500	\$ 1,015,400
2-3% Surcharge on Income Tax Liability for Certain Taxpayers	—	—	—	0.00%	0.02%	0.11%	0.17%
1-Cent Sales Tax Increase	0.57%	0.40%	0.35%	0.27%	0.21%	0.15%	0.11%
3% Corporate Income Tax Surcharge	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.01%
Alcohol Tax Hikes	0.03%	0.03%	0.02%	0.01%	0.01%	0.01%	0.00%
Tobacco Tax Hikes	0.06%	0.04%	0.02%	0.01%	0.01%	0.00%	0.00%
TOTAL change as a % of income	0.66%	0.47%	0.39%	0.30%	0.26%	0.27%	0.28%
TOTAL average \$ change	\$67	\$104	\$145	\$183	\$270	\$618	\$2,848

SOURCE: Institute on Taxation and Economic Policy, July 2009

FIGURE 4A**TOTAL IMPACT OF TAX CHANGES ON NC HOUSEHOLDS — AS % OF INCOME PAID BY INCOME GROUPS****THE SPENDING PLAN**

The final General Fund budget provides for \$19,008,079,980 in appropriations in FY09-10. On its own, this amount represents a reduction to the continuation budget (the amount needed to continue state services at the current level) of \$3 billion, or 14%.

When the additional \$1.4 billion in receipts from the federal stimulus funds are accounted for, a total of \$20.4 billion is available to spend on state services. This still represents a 7.5% decline from the continuation budget and a 4.5% decline from the previous year's appropriations. Due in large part to increased federal help and the new revenue package, the bottom-line General Fund budget (appropriations plus federal assistance) is a 4% increase over the final estimated actual spending in FY08-09 although it is likely that FY09-10 actually spending will be somewhat lower than the original General Fund appropriations.

The FY09-10 budget includes \$2.7 billion in reductions (on top of the reductions made to

FIGURE 5

HOW FEDERAL RECOVERY FUNDS WERE USED TO CLOSE THE GENERAL FUND BUDGET GAP		
	FY 09-10	FY 10-11
FMAP (Medicaid) Assistance	\$857,352,497	\$502,565,621
Fiscal Stabilization- Education	\$517,484,296	\$517,484,296
<i>Reduction to Non Instructional Support</i>	\$379,668,352	\$373,281,648
<i>Reduction to allowable items in University budget</i>	\$137,815,944	\$144,202,648
Fiscal Stabilization-General- Allocated to JPS/Corrections	\$12,926,135	\$12,926,135
AARA Funds for Specific Purposes Used to Temporarily Reduce GF Allocation	\$10,100,929	\$4,614,297
<i>Early intervention/Early toddler program</i>	\$2,700,000	\$2,700,000
<i>Children's vaccines</i>	\$500,000	
<i>Foster Care and Adoption Assistance</i>	\$2,840,235	\$1,452,537
<i>Child support enforcement</i>	\$2,214,542	
<i>Older Blind Individuals Independent Living program</i>	\$260,590	\$260,590
<i>Independent Living/Vocational Rehabilitation</i>	\$201,170	\$201,170
<i>Home and Community Care Block Grants</i>	\$1,384,392	
TOTAL	\$1,397,863,857	\$1,037,590,349

FIGURE 6

DESCRIPTION OF EXPANSION SPENDING IN THE BUDGET	
State takeover of county Medicaid costs	\$252,566,010
Medicaid enrollment growth	\$154,748,266
Children's health insurance expansion	\$17,096,952
State health plan	\$132,214,752
Enrollment growth in community colleges, universities	\$129,536,101
UNC Need Based Aid	\$23,000,000
K-12 Dropout prevention grants	\$13,000,000
State retirement contributions	\$22,300,000
Severance Expenditures	\$47,957,108
Miscellaneous (mostly includes continuation review programs)	\$239,330,643
Total New Spending	\$1,031,749,832

account for the federal stimulus receipts) and \$1 billion in new spending for a net spending reduction of \$1.7 billion. The vast majority of the new spending is to pay for the state employee health plan, enrollment growth in higher education and Medicaid, and the final step in the state's assumption of all county Medicaid costs (in turn, the state will assume ¼-cent in local sales tax revenue) (Figure 6). However, most of the expansion items are offset by large unspecified cuts to the continuation budget.

Figure 7 compares spending in the FY09-10 budget (appropriations

plus federal stimulus receipts) to the previous year's appropriations, the previous year's actual spending, and the FY09-10 continuation budget for each major spending category. Every major spending category saw a cut from its continuation budget, with Health and Human Services being hit the hardest. An overview of budget decisions made in the areas of Education, Health and Human Services, and Justice and Public Safety follows.

Education

The FY09-10 budget, including federal stimulus money for fiscal relief, reduces overall education spending on public schools, community colleges and universities by \$664 million, or 5.4%, from the recommended continuation budget level. Figure 8 lists the most significant education budget changes.

FIGURE 7

FY2009-2010 BUDGET COMPARISONS BY SPENDING CATEGORIES	
EDUCATION	
Previous Yr. (FY08-09) General Fund (GF) Appropriations	\$11,418,586,853
Estimated FY08-09 Expenditures + Fed. Stimulus used for GF gap	11,638,672,644
FY 2009-2010 Recommended Continuation Budget	\$12,344,098,234
FY 2009-2010 Total Appropriations + Fed. Stimulus used for GF	\$11,680,412,993
<i>Change from previous year appropriations</i>	2.3%
<i>Change from previous year estimated expenditures</i>	0.4%
<i>Change from recommended Continuation Budget</i>	-5.4%
HEALTH AND HUMAN SERVICES	
Previous Yr. (FY08-09) General Fund (GF) Appropriations	\$4,914,916,942
Estimated FY08-09 Expenditures + Fed. Stimulus used for GF gap	4,353,279,435
FY 2009-2010 Recommended Continuation Budget	\$5,536,344,939
FY 2009-2010 Total Appropriations+ Fed. Stimulus used for GF	\$4,770,803,031
<i>Change from previous year appropriations</i>	-2.9%
<i>Change from previous year estimated expenditures</i>	8.8%
<i>Change from recommended Continuation Budget</i>	-13.8%
JUSTICE AND PUBLIC SAFETY	
Previous Yr. (FY08-09) General Fund (GF) Appropriations	\$2,088,869,859
Estimated FY08-09 Expenditures + Fed. Stimulus used for GF gap	2,118,774,568
FY 2009-2010 Recommended Continuation Budget	\$2,333,292,436
FY 2009-2010 Total Appropriations + Fed. Stimulus used for GF	\$2,197,555,938
<i>Change from previous year appropriations</i>	5.2%
<i>Change from previous year estimated expenditures</i>	3.7%
<i>Change from recommended Continuation Budget</i>	-5.8%
GENERAL GOVERNMENT	
Previous Yr. (FY08-09) General Fund (GF) Appropriations	\$459,387,180
Estimated FY08-09 Expenditures + Fed. Stimulus used for GF gap	450,694,524
FY 2009-2010 Recommended Continuation Budget	\$467,462,120
FY 2009-2010 Total Appropriations + Fed. Stimulus used for GF	\$440,876,661
<i>Change from previous year appropriations</i>	-4.0%
<i>Change from previous year estimated expenditures</i>	-2.2%
<i>Change from recommended Continuation Budget</i>	-5.7%
NATURAL AND ECONOMIC RESOURCES	
Previous Yr. (FY08-09) General Fund (GF) Appropriations	\$2,088,869,859
Estimated FY08-09 Expenditures + Fed. Stimulus used for GF gap	2,118,774,568
FY 2009-2010 Recommended Continuation Budget	\$498,140,559
FY 2009-2010 Total Appropriations + Fed. Stimulus used for GF	\$436,957,236
<i>Change from previous year appropriations</i>	-23.8%
<i>Change from previous year estimated expenditures</i>	-16.2%
<i>Change from recommended Continuation Budget</i>	-12.3%

FIGURE 8

SIGNIFICANT SPENDING CHANGES IN EDUCATION	
K-12	
<i>Adjust K-12 Budget to a level at or below FY 08-09 budget</i>	\$(79,903,050)
<i>Reduction of 7.5% to 14% to school district Central Administrations</i>	\$(14,613,199)
<i>Funding for all 200 Literacy Coaches eliminated</i>	\$(12,034,400)
<i>More at Four preschool program reduced by 5.8%</i>	\$(5,000,000)
<i>Cuts to local school districts (determined by local district; K-3 class size must remain at current levels)</i>	\$(225,000,000)
<i>Funding for Improving Student Accountability eliminated</i>	\$(38,339,798)
<i>Increased spending for drop-out prevention grants</i>	\$13,000,000
Community Colleges	
<i>Adjust Comm. College budget to a level at or below FY 08-09 budget</i>	\$(67,749,918)
<i>Management Flexibility Reduction (cannot impact activities involved in retraining displaced workers)</i>	\$(14,000,000)
<i>Funding for programs to teach life skills to disabled adults is eliminated</i>	\$(1,229,760)
<i>Tuition Increase of \$8 per credit hour</i>	\$(30,522,884)
<i>Fully Fund enrollment growth</i>	\$58,068,720
Universities	
<i>Adjust University Budget to a level at or below FY 08-09 budget</i>	\$(171,869,601)
<i>Management Flexibility Reduction applied to sr. and middle mgmt positions, centers and institutes, low enrollment programs, etc.</i>	\$(72,866,184)
<i>Reduce funding to UNC Centers and Institutes</i>	\$(12,000,000)
<i>Tuition increase of the lesser of \$200 or 8% at all UNC institutions - takes effect in 2010-2011. Saves \$35 m.</i>	
<i>Fully Fund enrollment growth</i>	\$44,197,776

Public Schools
(K-12)

Public school spending was reduced on net by \$409 million, or 5%, over the proposed continuation budget for FY09-10. Without the aid of the federal fiscal stabilization funds intended solely to mitigate cuts to education, overall public school spending would have dropped by another \$380 million.

The single largest cut to public schools is a flexibility cut to school districts of \$225 million in FY09-10 and \$305 million in FY10-11. The cut will be distributed pro-rated according to the average daily membership of each school district. School boards are instructed to reduce spending such that classroom services and services for at-risk and special-needs children are protected. Class sizes for kindergarten through grade 3 are to remain unchanged, but grade 4 through 12 class sizes may be increased to reach budget targets. School districts were asked to report the reductions to the Department of Public Instruction (DPI) by September 3, 2009. It is inevitable that this cut will result in fewer teachers, teacher's assistants, and classroom resources.

Funding for programs and allotments aimed at special needs and disadvantaged children were subject to major cuts this year. The Improving Student Accountability allotment for school districts to improve the performance of students scoring at Level I or II (considered below grade level) on certain state tests was eliminated (\$38 million both years). The rationale behind this cut is that the Disadvantaged Student Supplemental Fund and the At-Risk Fund support similar activities.

More at Four, the state's nationally lauded pre-kindergarten program aimed at four-year-old children from poor households, was cut by 5.8%, or \$5 million, both years. An Early Childhood Education and Care Task Force will consider administrative consolidation of More at Four with other early childhood programs (i.e. Smart Start, Head Start) in 2010. All 200 literacy coach positions were eliminated (\$12 million both years), while funding for the education of students with limited English proficiency was cut 2.5% (\$2 million both years).

The budget contains several cuts that reduce or eliminate expenditures designed to improve teacher quality. These total more than \$15 million in both years and include the elimination of staff development or professional development funds for both years (\$12.6 million per year), a 17.9% reduction in funds allotted to the new teacher mentoring program, and the elimination of the salary bonus pilot program to encourage higher-quality math and science teachers to work in Bertie, Columbus and Rockingham counties.

Teaching support, including materials and administration, received heavy cuts of more than \$92 million in FY09-10 and in excess of \$160 million in FY10-11, including a 2.5% cut in expenditures on non-instructional support personnel funding in both years; a 90% cut in the School Technology Fund, which assists school districts in the execution of technology upgrades; a delay in adoption of new mathematics textbooks in middle and high schools in the first year of the budget and a temporary moratorium on all new textbook adoption in the second year; reductions of 7.5%, 14% or 18% in funding for school districts' central office administration, depending on the enrollment of the school district; and the elimination of 64 state-supported DPI positions in the first year, an additional 11 in the second, and another 25 positions funded from other sources.

Finally, state spending on school transportation was reduced by 3.9% (\$15 million both years) and the schedule for school bus replacement was stretched in order to generate savings of \$6.3 million in FY09-2010 and \$10.3 million in FY10-11.

The major expansion to the education budget is the provision of \$13 million in recurring money to widen the dropout prevention grants program. These grants are given on a competitive basis to local schools, agencies and non-profit organizations.

Community Colleges

The community college system received a \$72.7 million net reduction in FY09-10 over the proposed continuation budget. The system did not receive any federal stimulus money intended for fiscal relief.

The largest cut to the community college budget was an unspecified reduction to the continuation budget of \$68 million, which more than offsets the \$58 million provided to "fully fund" enrollment growth. The recession has spurred enrollment growth, which is expected to increase by 7.6% to 216,884 students.

Community college tuition will increase by \$8 per credit hour starting in FY09-10 to free up another \$30.5 million in the budget. Tuition for residents will be \$50 per hour and \$241.30 for nonresidents. Tuition for full-time resident students will increase by a maximum of \$256 per year to \$1,600.

Administrators were tasked to cut another \$14 million at their discretion (management flexibility cuts), starting first with reducing expenditures on senior- and middle-management positions and on programs that have either low enrollment or low success rates. They were directed to minimize reductions to instruction, student services and retraining of dislocated workers.

Supplemental funding of \$1.2 million for programs that provide assistance and teach life skills to developmentally disabled adult students was eliminated from the budget. Colleges will continue to receive funds on a per-student basis for these programs.

FIGURE 9

SIGNIFICANT SPENDING CHANGES IN HEALTH AND HUMAN SERVICES	
Division of Child Development	
<i>Reduction to Child Care Subsidies</i>	\$(15,186,301)
<i>Reduction to Smart Start</i>	\$(15,965,000)
Mental Health/Developmental Disabilities/Substance Abuse Services	
<i>Adjust continuation budget to a level at or below FY 08-09 budget</i>	\$(74,408,533)
Eliminates 350 positions (no details given)	\$(12,858,290)
<i>Reduces services to CAP/MR-DD patients</i>	\$(16,000,000)
<i>Reduces state-funded services provided through Local Management Entities</i>	\$(40,000,000)
Increased funding for Crisis Services	\$(12,000,000)
Health Choice/Children's Health Insurance	
Increased funding for new enrollment	\$17,096,952
Eliminates the inflation increase in the per member/per month premium cost	\$(7,076,746)
<i>Establish/Increase co-pays for non-emergency emergency room visits</i>	\$(217,665)
<i>Increase co-pays for prescriptions drugs</i>	\$(450,000)
Medical Assistance (Medicaid)	
<i>Adjust continuation budget to a level at or below FY 08-09 budget</i>	\$(507,391,540)
<i>Reduces provider rates- administered at the discretion of the DHHS Sec.</i>	\$(76,440,896)
<i>Reduce prescription drug costs by increasing use of generics</i>	\$(25,000,000)
<i>Reduce funds for community support services</i>	\$(65,000,000)
<i>Reduce funds for High Risk intervention at Level III and IV group homes</i>	\$(15,860,960)
<i>Modification of the personal care services benefit</i>	\$(40,000,000)
<i>Increases co-pays on services by \$2</i>	\$(3,098,256)
<i>Consolidate Case Management Services</i>	\$(41,029,684)
<i>Reduce Nursing Home Cost Ceiling</i>	\$(2,298,778)
<i>Freezes CAP (Community Alternative Programs) slots for disabled adults</i>	\$(6,646,956)
Public Health	
<i>Reduces funds for AIDS Drug Assistance Program</i>	\$(3,074,119)
<i>Eliminate positions and reduce contracts in early intervention programs</i>	\$(660,054)
Division of Social Services	
<i>Reduces state funds for Work First Cash Assistance payments</i>	\$(7,178,459)
<i>Reduces funds for child advocacy centers</i>	\$(200,000)
<i>Reduces state aid to counties for administration of public assistance programs</i>	\$(5,473,985)
Eliminates funds for child support offices- takes effect in FY 10-11 and saves \$4.1m	
Division of Aging and Adult Services	
Eliminate quality improvement consultation program for adult care homes	\$(190,204)
Eliminate senior center outreach program	\$(100,000)
<i>Reduce Home and Community Care Block Grant funds</i>	\$(500,000)

The budget included some new funding to pay for an expansion of nursing, dental and radiology technology programs (\$4.8 million) and vocational and educational programs (\$4.5 million), and it provided funds for sorely needed investments in instructional equipment and technology (\$9 million).

The Prisoner Education program, funded through the community college system budget, was one of a handful of programs selected to undergo a continuation review to justify its existence. The program is a joint initiative between 45 community colleges and 78 prisons and provides part- and full-time instruction to inmates in job training and life-skills courses. The program's \$32.9 million annual appropriation was eliminated and replaced with one-time funds. The community college system and corrections department were asked to report on the cost of the program, analyze alternative sources of funding including prisoners' ability to pay, and determine which programs are most vital to the prisoner population.

Universities

The university system's FY09-10 spending is \$181.5 million less than the proposed continuation budget. ARRA funds of \$137.8 million helped to lessen the total net reduction to the university budget.

The largest cut to the university system was an unspecified reduction of \$172 million to the continuation budget. Like the community college system, this cut more than offsets the \$44 million provided to fund university enrollment growth.

Other notable cuts include the following:

- \$72.9 million management flexibility reduction targeted at senior and middle management, centers and institutes, low-enrollment degree programs, faculty workload, speaker series and institutional trust fund balances
- \$34.8 million reduction starting in FY10-11 and replaced by a tuition increase of \$200 or 8%, whichever is less, at all UNC institutions to raise \$34.8 million
- \$3.2 million reduction to the Legislative Tuition Grant for students attending private colleges, which reduces each grant from \$1,950 to \$1,850
- \$12 million reduction in funding to centers and institutes across the university system

Other than enrollment growth, the largest spending increase in the university budget was \$23 million for need-based financial aid. Another \$25 million was spread across the university system for specific projects, including ECU's dental school campus (\$3 million), the Kannapolis campus (\$3 million), the NCSU engineering school (\$5 million) and faculty and staff recruitment and retention (\$2 million).

Health and Human Services

Overall, FY09-10 spending for Health and Human Services (DHHS) (General Fund appropriations plus federal stimulus receipts) was reduced by \$765 million, or 14% compared to the continuation budget. The overall reduction would have been \$1.6 billion, or close to 30%, if it had not been for the additional federal assistance available. **Figure 9** highlights some of the significant spending changes in DHHS.

More than other categories of spending, the Health and Human Services spending plan and accompanying special provisions contain a significant amount of unspecified cuts. The Department of Health and Human Services is directed broadly to implement these unspecified reductions, leaving a cloudy picture of the full impact of the cuts to critical services.

For example, while the Medicaid program was allotted funding for an enrollment increase, the Medicaid program saw an unspecified cut of \$507 million. Also within the Medicaid program, the spending plan listed a \$41 million reduction due to greater care management by

Community Care of North Carolina, with the efficiencies from improved care yet to be spelled out. And the Division of Mental Health, Developmental Disabilities, and Substance Abuse Services received \$74.4 million in unspecified cuts, which again, will be at the discretion of the Department of Health and Human Services staff to apply. There is much to be determined in this area of spending, so programs that appeared to be safe in the budgeting process may still face damaging cuts.

Division of Child Development

The Division of Child Development received a net reduction of \$40 million, or 13%, compared to the FY09-10 continuation budget. One noteworthy cut is a \$15.2 billion recurring reduction to child-care subsidies. The federal stimulus package provided the state with funding intended to supplement the child-care subsidy program, recognizing the increased need for this program during a deep recession. While the state will receive \$54 million in federal money to reduce the waiting list and another \$13.5 million for quality initiatives and administrative costs, the funding reduction to the program means legislators did not use the federal funds as intended.

In addition, the budget reduces funding for Smart Start, an early childhood education program, by \$15.9 million, representing a 7% cut to the program. There is a growing interest among legislators in consolidating the state's early childhood education programs, namely Smart Start (housed in HHS) and More at Four (housed in DPI). To that end, the budget bill called for the establishment of a task force on the Consolidation of Early Childhood Education and Care, which is charged with submitting a plan for a more efficient and coordinated system by July 1, 2010.

Division of Mental Health, Developmental Disabilities, and Substance Abuse Services

The Division of Mental Health, Developmental Disabilities, and Substance Abuse Services received a \$155.2 million net reduction, or 19%, compared to the FY09-10 continuation budget.

- \$74.4 million reduction in unspecified cuts to the continuation budget to adjust the department's budget to the FY08-09 level
- \$12.8 million reduction through eliminating 350 positions in the division
- \$16 million reduction of funds for supplemental state-funded services provided to Community Alternatives Program participants
- \$40 million reduction in state-funded services provided through local management entities, which will each receive a 10% reduction per year
- \$12 million in new funding for crisis services to help increase inpatient bed capacity at community hospitals

NC Health Choice

NC Health Choice, the state's health insurance program for children of low-income working parents, is the only area of the Health and Human Services budget that had a net increase in spending in FY09-10 compared to the continuation budget. That net increase of \$8.4 million, or 12.3%, includes the following changes:

- \$17 million to increase enrollment in NC Health Choice by 7% in FY09-10 (capped at 9,098 more children) and 3% in FY10-11
- \$216,665 reduction achieved by establishing a \$25 co-pay for non-emergency visit for some recipients and increasing the existing co-pay from \$20 to \$25 for others
- \$450,000 reduction by increasing the co-pay for prescription drugs

In addition, DHHS was directed to increase efforts to simplify eligibility determination and the recertification process for NC Health Choice.

FIGURE 10

SIGNIFICANT SPENDING CHANGES IN JUSTICE AND PUBLIC SAFETY	
Juvenile Justice	
<i>Eliminates funds for the Center for the Prevention of School Violence</i>	\$(481,225)
<i>Eliminates pass through funding to Boys and Girls Club</i>	\$(400,000)
<i>Reduces Eckerd Wilderness Camp contract- closes 2 of 7 camps</i>	\$(2,768,714)
<i>Eliminates Funds for Gov's 1 on1 mentoring program</i>	\$(1,645,545)
<i>Eliminates the Support Our Students Program</i>	\$(6,627,532)
<i>Eliminates 29 positions at Youth Development Centers</i>	\$(948,994)
<i>Closes the Samarkand Youth Development Center</i>	\$(2,641,465)
Corrections	
<i>Eliminates 100 vacant positions and 87 filled positions</i>	\$(8,133,468)
<i>Closes seven prisons</i>	\$(8,442,814)
<i>Eliminates 127 Community Work Crews that provide labor to state and local govt. at no cost</i>	\$(4,780,105)
Judicial	
<i>Reduces pass-through to NC State Bar for Civil Justice Act, Financial Protection Law Ctr, and Land Loss Protection Ctr.</i>	\$(375,000)
Justice	
<i>Reduces funding for the NC Legal Education Assistance Foundation (NCLEAF)</i>	\$(125,000)
Judicial- Indigent Defense	
<i>Reduce funds to Prisoner Legal Services</i>	\$(62,204)
<i>Reduction to Sentencing Services</i>	\$(394,444)
<i>Sentencing Services program subject to continuation review; \$2.2m appropriation moved from recurring to non-recurring</i>	

Medical Assistance

The Division of Medical Assistance (or Medicaid) received a \$505 million net reduction, or 13.7%, compared to the FY09-10 continuation budget.

- \$507 million unspecified reduction to the continuation budget to bring spending to the FY08-09 authorized budget level
- \$154 million increase to pay for additional caseloads expected due to the recession; however, this increase was more than offset by the unspecified reduction to the continuation budget
- \$76.4 million reduction to provider reimbursement rates for all Medicaid services (the DHHS Secretary was given the discretion to set differing percentage rate cuts for each service)
- \$40 million reduction, or 50%, to personal care services, which provide assistance with activities such as bathing and moving about in the recipient's home, to modify how these services are used and reduce "overutilization"
- \$25 million reduction in prescription drug costs achieved primarily by increasing the use of generic drugs
- \$65 million reduction in Community Support Services, which means state support will be phased out entirely in FY09-10
- \$15.8 million reduction for high-risk intervention Level III and IV group homes for

youths being treated for moderate to severe behavioral and emotional issues

- \$41 million reduction through consolidating case management services (DHHS was directed to have a consolidation plan in place by December 1, 2009)
- \$69 million reduction through greater care management by Community Care of North Carolina, a provider-led coordinated community management system that manages most of the state's Medicaid population
- \$6.6 million reduction through freezing Community Alternative Placement slots for disabled adults and people with developmental disabilities

The Division of Medical Assistance also assumed \$252.5 million in new spending to pay for the final state take-over of the county share of Medicaid. The revenue baseline projection for FY09-10 reflects the transfer of ¼-cent of sales tax revenue from local governments to the state, which was the swap passed in the FY07-08 budget.

Justice and Public Safety

Overall, FY09-10 spending for Justice and Public Safety (General Fund appropriations plus federal stimulus receipts) was reduced by \$135.7 million, or 5.8%, compared to the continuation budget. **Figure 10** highlights some of the significant spending changes in Justice and Public Safety.

Transportation Budget

Declining gas tax revenues of more than 4% and vehicle-use tax revenues in excess of 12% were the drivers behind cuts in the Highway Fund and Highway Trust Fund budgets of 3½% and 13% respectively.

The allocations within the transportation budget are almost entirely decided via legislative formula. The one major change was the reallocation of more than \$80 million from the Highway Fund's secondary road budget to maintenance over two years.

Challenges and Opportunities

Challenges

The FY09-10 General Fund budget left very little room for errors in the revenue forecast. In fact General Fund appropriations are only \$10.5 million less than the anticipated revenue availability, by far the smallest gap in many years. Since the start of the fiscal year in July, the governor has already had to trim agency allotments slightly, ostensibly for cash flow reasons. This experience of the first few months of the fiscal year is only the next phase in what is likely to be several more years of budget challenges. In 2010 when lawmakers return to tweak the FY10-11 budget they will face continued pressures from enrollment-related growth in schools and prisons as well as continued pressures from medical care inflation and a sluggish revenue picture. In 2011, budget-writers will have to contend with both the sunset of the \$1 billion revenue package as well as the end of the additional state fiscal relief from the Federal government. Unfortunately, it is highly unlikely that robust revenue growth will be able to cushion this landing. In fact, legislative fiscal analysts have predicted that revenues will not recover to the FY08-09 originally-projected levels until FY13-14. It is extremely important that the governor and the general assembly continue to work diligently to identify ineffective programs, administrative efficiencies and make improvements to the state's tax system to make it more stable and reliable over time.

Opportunities

Heading into the fall there are optimistic signs that state leaders are looking to fundamentally reform the state budget for the better. The governor has appointed a

commission, the Budget Reform and Accountability Commission (BRAC), of outside experts to comb through every part of the state budget to look for efficiencies and examine the performance of various programs to determine if some funds should be re-allocated to better uses. In the short term, the commission is expected to come up with ideas that can be enacted quickly to help the state save money. Its goal will be to have recommendations in time for next year's legislative short session.

In the long term, BRAC will examine all of state government and make innovative recommendations to: eliminate unnecessary or unsuccessful programs; consolidate where possible and ensure we are investing effectively and efficiently; and to streamline the way state government works.

The budget bill included a provision that instructed the House and Senate finance committees to meet during the interim session to discuss how to reform the state's tax system to make it fairer and more stable. Members are charged with working together to come up with a comprehensive tax reform plan to present to the General Assembly before the 2010 session.

Conclusion

The deep recession, volatile tax system and continued failings of the health care system combined to make 2009, arguably, the most difficult budget predicament in North Carolina since the Great Depression. Rather than setting the quality of state programs and services back several decades state lawmakers opted to, as most other states have done, take a balanced approach relying on spending reductions, higher taxes and additional federal assistance to make ends meet. The struggle is far from over, however. In 2010 and especially in 2011, budget-writers will be facing tough decisions once again. In order to avoid raising tax rates and cutting services even further, the governor and the General Assembly must continue the important work that began in 2009 to examine ways to make state government more efficient and effective and to modernize the state's tax system.

BTC Reports

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