



NC Justice Center

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BTC Reports

Vol 15 No 3 • April 2009

THE NEWSLETTER OF THE NC BUDGET & TAX CENTER

North Carolina
Budget & Tax
Center

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THE GOVERNOR'S BUDGET PROPOSAL: Spending cuts limited but the plan overall is precariously balanced

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Executive Summary

- Governor Beverly Perdue has proposed a \$20.98 billion general fund budget for fiscal year 2009-10 and a \$21.65 billion budget for fiscal year 2010-11. The governor's proposed budget, if enacted, would reduce general fund appropriations by \$42 million, or 1.8%, over the authorized fiscal year 2008-09 budget. However, it is a \$596 million, or 2.9%, increase after adjusting for mid-year reductions (**Figure 1**).
- The governor closes the estimated \$3.4 billion budget gap by using federal recovery dollars (\$1.7 billion), enacting spending cuts (\$1.3 billion), increasing excise taxes (\$501 million), and making other small revenue and fee changes (\$80 million).
- The governor's revenue plan includes a small increase in the state Earned Income Tax Credit for working families. However, the plan overall is highly regressive and will weaken North Carolina's long-term fiscal solvency by increasing the state's reliance on inefficient revenue sources. For example, the plan includes a \$1 increase in the cigarette tax, an increased rate on other tobacco products, and a 5% surcharge on alcohol - all tax increases that more heavily impact low-income people and that are unreliable long-term revenue sources.
- The governor's \$1.3 billion spending reductions are derived primarily by budgeting for less than 100% of the salary cost of agencies' budgeted positions (\$232 million), requiring agency heads to make discretionary reductions at a later date (\$274 million), suspending longevity pay for two years (\$173 million) and reducing costs in the Medicaid program (\$147 million).

FIGURE 1

GOVERNOR'S FY 2009-2011 BUDGET OVERVIEW	
FY 08-09 Authorized Budget	\$21,355,967,434
FY 08-09 Budget after mid-year cuts	\$20,385,000,000
	FY 09-10
Recommended Continuation Budget	\$22,113,897,166
Recommended Cuts to Budget	\$(1,302,313,973)
Recommended Expansion Budget	\$169,533,021
Total FY 09-10 General Fund Appropriations	\$20,981,116,214
% Change from Authorized FY08-09 Budget	-1.8%
% Change from Revised FY08-09 Budget	2.9%
	FY 10-11
Recommended Continuation Budget	\$22,814,943,571
Recommended Cuts to Budget	\$(1,288,726,899)
Recommended Expansion Budget	\$122,862,646
Total FY 10-11 General Fund Appropriations	\$21,649,079,318
% Change from FY09-10	3.2%

■ A smaller portion of the governor's spending reductions are more targeted, such as a proposed cut to the Clean Water Management Trust Fund, eliminating the Sentencing Services program and reducing the number of More-at-Four slots available for at-risk preschoolers.

■ The governor's budget, while avoiding deep reductions to most state services, is structurally out of balance. In fact, the governor's budget spends nonrecurring funds to cover recurring expenses of \$633 million in the first year and \$1.3 billion

in year two. Paying for the governor's fiscal year 2011-12 budget would require revenue growth of approximately 10% that fiscal year.

Overview

When Governor Beverly Perdue released her first proposed state budget on March 17, 2009, most advocates breathed a sigh of relief. The budget calls for relatively few cuts in state programs and services and no furloughs or pay cuts for state employees. A closer look, however, reveals the tradeoff is a precariously balanced budget that the General Assembly is unlikely to accept in its entirety. The governor's plan would close the estimated \$3.4 billion budget gap with federal stimulus funds, spending reductions and tax increases on alcohol and tobacco products. The following issue of BTC Reports analyzes the governor's proposed budget in detail with a special focus on the potential impacts on low- and moderate-income North Carolinians and the long-term fiscal health of the state (Figure 2).

The Revenue Plan

The governor's budget proposes tax and fee increases that would generate a net increase in revenues of \$581 million in the first year of the biennium and \$708 million in year two. In addition to these increases, the governor's budget assumes revenue growth of 0.1% in fiscal year 2009-10 (FY09-10) and 5.4% in fiscal year 2010-11 (FY10-11). The plan does not assume any transfer from the rainy day fund because the governor has set aside that money to balance the current year's budget if necessary.

The two major revenue increases proposed by the governor are a \$1 per pack increase in the cigarette tax and a 5% surcharge on alcohol purchases. While these raise more than \$700 million annually once fully implemented and help prevent deep

Budget is precariously balanced

spending cuts, the plan is highly regressive and increases the state’s reliance on inefficient revenue sources. Increases of 50 cents per pack or higher on cigarettes, and certainly the governor’s proposed \$1 increase per pack, have been proven to have measurable effects on teen smoking rates.

Figures 3 and 4 provide details of the governor’s revenue plans, including an analysis of how they would impact North Carolinians.

The governor's budget is very tightly balanced in the first year, leaving only \$175 million unappropriated at the end of the first year that, if it materializes, can be set aside in the rainy day fund. The governor's budget uses \$633 million of one-time revenues to pay for ongoing spending in year one and \$1.3 billion of one-time funds for ongoing spending requirements in year two (Figure 5). Most of that one-time money in the first year is federal stimulus money, and North Carolina can expect to see additional federal dollars in FY10-11. But then that revenue source will likely disappear, and state revenue would have to grow more than 10% to maintain current services in FY11-12.

Moreover the governor's budget plan relies on optimistic projections of tax revenue growth, which is particularly difficult to predict in the current economy. Concerns

FIGURE 2

HOW DOES PERDUE PAY FOR HER BUDGET?				
	FY 09-10	% of total	FY 10-11	% of total
Baseline Revenue Forecast	\$18,860,934,764		\$19,902,853,080	
Initial Appropriation Requirements	\$22,283,430,187		\$22,937,806,217	
Recommended Continuation Budget	\$22,113,897,166		\$22,814,943,571	
Recommended Expansion Budget	\$169,533,021		\$122,862,646	
Governor Perdue’s Projected Shortfall	(\$3,422,495,423)		(\$3,034,953,137)	
+ Recommended Revenue Changes	\$581,000,000	17%	\$708,000,000	23%
+ Federal Recovery Funds	\$1,713,904,975	50%	\$1,210,938,510	40%
FMAP Assistance	\$1,003,677,475		\$500,711,010	
Fiscal Stabilization- Education	\$580,966,000		\$580,966,000	
Fiscal Stabilization-General	\$129,261,500		\$129,261,500	
+ Spending Reductions	\$1,302,313,973	38%	\$1,288,726,899	42%
Reducing agency salary budgets	\$231,972,195	18%		
Suspend longevity pay	\$173,000,000	13%		
Management flexibility reductions	\$273,280,237	21%		
Medicaid savings	\$147,026,271	11%		
Other	\$477,035,270	37%		
Total Available to Address Shortfall	\$3,597,218,948		\$3,207,665,409	
Remaining Balance	\$174,723,525		\$172,712,272	
<i>Transferred to Fiscal Responsibility Reserve</i>				

The Spending Plan

created by the small appropriation to the rainy day fund and the rosy revenue forecast are compounded by the fact that much of the governor's spending reductions are taken from tightening agency budgets and leaving deep spending cuts unspecified..

The governor's proposed budget, if enacted, would reduce general fund appropriations by \$42 million, or 1.8%, over the authorized FY08-09 budget. However, it is a \$596 million increase, or 2.9%, compared to the FY08-09 budget in place after mid-year reductions. The FY10-11 budget would increase spending by \$668 million or 3.2% over FY09-10.

The plan relies on \$1.7 billion in federal recovery funds in year one and \$1.2 billion in year two. In year one the plan includes \$1.3 billion in proposed spending reductions and \$169.5 million in proposed spending increases.

Proposed Spending Reductions

The proposed budget makes spending cuts from the continuation budget for FY09-10 by \$1.3 billion. The governor does propose some specific cuts to services, such as closing five prisons and eliminating funds for several smaller programs such as the Sentencing Services program. However, the majority of the proposed spending cuts are from the following measures:

BUDGET FOR LESS THAN 100% OF AGENCY SALARIES (\$232 MILLION) – Typically North Carolina determines agencies' salary budgets by assuming that all budgeted positions are filled throughout the year. Like any large employer, each agency has turnover

of employees, some more than others. The governor proposes reducing agency salary budgets to be more in line with typical agency turnover. This measure does produce substantial recurring savings but has a significant downside. Agency reversions account for most of the funds typically left over at the end of the fiscal year, and by law North Carolina is required to put 25% of the leftover funds into the state's rainy day fund. Leftover funds are also typically used to pay for repairs and renovations of state

FIGURE 3

GOVERNOR PERDUE'S RECOMMENDED REVENUE CHANGES		
Recommendation	FY09-10	FY10-11
Tobacco Tax Changes	\$343	\$457
<i>Increase Cigarette Tax rate from \$.35 to \$1.35</i>	<i>\$311</i>	<i>\$415</i>
<i>Increase tax rate on other tobacco products from 10% to 28%</i>	<i>\$32</i>	<i>\$42</i>
Alcohol Tax Changes (5% surcharge)	\$158	\$210
Increase state EITC to 6.5%	0	(\$21)
Improved Enforcement	\$50	\$75
Fees (Increase professional license fee from \$50 to \$200)	\$27	\$31
Disproportionate Share Allocation	\$25	0
Small Business Tax Relief	(\$12)	(\$24)
IRC Update	(\$10)	(\$20)
Caregiver Tax Credit	0	(\$0.80)
Total Revenues	\$581	\$708

All figures in millions of dollars

buildings. If agency reversions are no longer available for these purposes, North Carolina will need to develop other policies to account for these functions.

MANAGEMENT FLEXIBILITY REDUCTIONS (\$273 MILLION) – Public schools, community colleges, universities and the courts system are all subject to additional

FIGURE 4

HOW WILL THE GOVERNOR'S 3 MAJOR TAX PROPOSALS IMPACT NORTH CAROLINIANS?							
	<i>Average Impact as a % of Income and Average \$ (2007)</i>						
2007 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than \$28,000	\$16,000 – \$46,000	\$28,000 – \$75,000	\$46,000 – \$159,000	\$75,000 – \$379,000	\$159,000 – Or More	\$379,000 –
Average Income in Group	\$10,000	\$22,000	\$36,000	\$59,000	\$104,000	\$231,000	\$1,131,000
Cigarette Tax Increase- % of Income	0.7%	0.4%	0.3%	0.2%	0.1%	0.1%	0.01%
Cigarette Tax Increase- Avg \$	\$ 75	\$ 95	\$ 97	\$ 107	\$ 105	\$ 122	\$ 145
Alcohol Tax Increase-% Income	0.2%	0.2%	0.1%	0.1%	0.1%	0.03%	0.01%
Alcohol Tax Increase- Avg \$	\$ 15	\$ 35	\$ 42	\$ 51	\$ 60	\$ 75	\$ 114
EITC Increase- % Income	-0.1%	-0.1%	-0.0%	—	—	—	—
EITC Increase- Avg \$	\$ -11	\$ -14	\$ -0	\$ —	\$ —	\$ —	\$ —
Net Impact, Three provisions- %	0.8%	0.5%	0.4%	0.3%	0.2%	0.1%	0.02%
Net Impact, Three provisions-Avg	\$ 79	\$ 115	\$ 134	\$ 158	\$ 165	\$ 197	\$ 259

SOURCE: ITEP Microsimulation Tax Model, March 2009

"management flexibility" cuts. These are unspecified reductions that will need to be made by agency administrators after the start of the fiscal year. These types of reductions have been made before in North Carolina, but not to the degree that the governor proposes (5%, for example, in the case of the courts' budget). Moreover, in the past, the agencies were able to meet much of these reduction targets by using lapsed salary funds - funds that will no longer be available if the governor's plan to appropriate less than 100% of the cost of the budgeted positions is implemented.

SUSPEND LONGEVITY PAY FOR TEACHERS AND STATE EMPLOYEES (\$173 MILLION NONRECURRING)

– The governor's spending plan suspends longevity payments to state employees. Under current personnel practices, North Carolina pays employees who have worked for the state for more than ten years bonus payments between 1.5% of annual salary (10 years of service) and 4.5% (25+ years of service).

MEDICAID SAVINGS (\$147 MILLION)

– The governor proposes freezing reimbursement rates to Medicaid providers, negotiating lower prescription drug costs, and implementing a False Claims Act. North Carolina has higher reimbursement rates than many other states, and therefore freezing the slated inflationary increase is a reasonable proposal. However, it is difficult to know at what point these types of reductions will impact availability of care. Health care advocates have long called for better negotiations with pharmaceutical companies for prescription drugs, and the governor's proposal would force Medicaid to move to a preferred drug list if substantial savings are not found through negotiation. The Medicare program has successfully implemented and realized substantial savings from a False Claims Act like the one the governor proposes for Medicaid.

PROGRAMS SLATED FOR ELIMINATION (\$39 MILLION) – The governor's budget proposes eliminating 73 initiatives, including:

- **Sentencing Services (\$2.6 million)** – This program proposes sentencing plans that, when appropriate, use community-based punishments in lieu of incarceration. The result is reduced admissions to prisons and the provision of appropriate treatment or rehabilitative services for offenders.
- **Two 25-bed units at Broughton and Cherry Mental Hospitals (\$6 million)** - In the past year an additional 175 local beds have been established, and the governor's budget provides funding for an additional 111 local beds in the next year. As part of this transition to more local crisis support, the budget proposes eliminating 50 in-patient beds at state mental hospitals.
- **Support Our Students (SOS) (\$5.9 million)** – The North Carolina Department of Juvenile Justice and Delinquency Prevention awards SOS grants to community-based non-profit organizations, school systems, and local government agencies to administer quality after-school programs for students to prevent juvenile crime. Approximately 14,000 students participated in these programs in FY07-08.

Other substantial reductions

- **Public Schools Improving Student Accountability categorical fund (\$38 million)** – The governor proposes eliminating this fund which local school districts use to provide extra tutoring and materials for failing students. The governor's budget states that school districts should offset this cut by using the increased funding provided through the federal recovery act for Title I and Individuals with Disabilities Education Act (IDEA).
- **Clean Water Management Trust Fund (\$25 million)** – The governor's budget would reduce the annual appropriation to this fund to \$75 million, down from \$100 million in past years. This program issues grants to local governments, state agencies and conservation non-profits to help finance projects that specifically address water pollution problems.

Proposed expansion of services

Health and Human Services

Not surprisingly, given the state's fiscal predicament, there is little funding proposed to increase services. The following are noteworthy service expansions in various budget categories:

- **NC Health Choice** - The governor's plan provides funding for an additional 8,000 low-income children to enroll in the NC Health Choice insurance program. This expansion is partially paid for by redirecting funds that were designated for NC Kids Care, a new health insurance program for middle-income families struggling to provide health insurance for their children. It is not clear when, or if, the NC Kids Care program will begin.
- **Project CARE (\$500,000)** - This program, which receives matching federal funds, provides comprehensive support to caregivers of persons with dementia. In a related effort, the governor's revenue plan includes a tax credit available to caregivers.
- **Home and Community Care Block Grant (\$1 million)** - This program provides funding for a variety of services that enable older adults to remain in their homes and avoid costly stays in long-term care. In addition to the proposed increase, the governor's budget would restore the reductions made during the current fiscal year.

FIGURE 5

GOVERNOR PERDUE'S BUDGET RELIES ON ONE-TIME MONEY		
	FY09-10	FY10-11
Recurring Money	\$20,652,873,274	\$20,610,853,080
<i>Recurring Revenues</i>	<i>\$18,860,934,764</i>	<i>\$19,902,853,080</i>
<i>Revenue Changes (Net)</i>	<i>\$581,000,000</i>	<i>\$708,000,000</i>
<i>Amount of Federal Recovery Expected in Next Fiscal Year</i>	<i>\$1,210,938,510</i>	<i>\$0</i>
minus Recurring Expenses (Net)	\$21,285,496,149	\$21,932,864,261
<i>Continuation Budget</i>	<i>\$22,113,897,166</i>	<i>\$22,814,943,571</i>
<i>Recurring Expansion</i>	<i>\$102,788,635</i>	<i>\$118,290,017</i>
<i>Recurring Reductions</i>	<i>\$(931,189,652)</i>	<i>\$(1,000,369,327)</i>
Recurring Balance	(\$632,622,875)	(\$1,322,011,181)

- Local mental-health bed capacity** - The governor's budget would provide funds for an additional 111 local mental-health in-patient slots, which allow for immediate in-patient treatment in communities. The governor recommends a corresponding decrease of 50 beds at state-run mental hospitals.
- Supervision of ex-offenders (\$10.2 million)** - The governor's budget includes additional funding to hire parole/probation officers, supervisors and trainers and additional funding to improve recruitment and retention of probation/parole officers.
- Dropout prevention grants (\$6.7 million)** - The governor proposes increasing funding for this grant-based initiative which allows local groups such as non-profits, churches and schools to develop pilot projects to reduce dropouts.
- Learn and Earn College high schools (\$3.6 million)** - This funding will expand the Learn and Earn program to 12 more high schools throughout the state. This would bring the total number of participating schools to 68.
- Need-based financial aid (\$23.4 million)** - This appropriation would fully fund the UNC System's identified need for financial aid assistance for low-income students.
- Allied health Programs (\$4.8 million)** - This funding would be used to hire an additional 65 nursing faculty to be distributed throughout the community college system to address the growing demand for health care workers.
- Vocational and Technical Education Programs (\$3 million)** - This funding would provide grants to community colleges to address the shortage of workers in technical fields including transportation, engineering, industrial, military, construction and green technology sectors. Funding will be matched by the Golden Leaf Foundation.
- Equipment and Technology (\$5 million)** - These funds will be used to address the technology and equipment needs in the community colleges. The system has identified a \$18.7 million in need in this area.

Justice and Public Safety

Public education

Universities

Community colleges

Is public school spending really increased?

The inflow of federal recovery money is critical to the expansion of the education budget. However, the combined effect that the governor's cuts and the stimulus money will have on school districts' budgets is still not clear. What is clear is that the effect will vary across the state depending on the number of Title I schools (over 35% of students on free lunch) and special-needs children in each district. It is fair to conclude that some districts may see an overall net gain in funding, while wealthier districts may see a break-even or possibly a net-loss scenario.

The present lack of clarity is due to rules regarding how the federal recovery money may be spent by school districts and schools. The governor's budget accounts for \$330 million in federal recovery funds each year of the biennium for school districts' Title I and IDEA programs, although this money will not impact the general fund. However, unlike the fiscal stabilization money dedicated to education that can be treated like state-generated revenue, these funds must supplement existing state and local funding. Title I money may supplant non-federal spending in systems under financial duress, but the supplant provisions for IDEA funds are more strict and waivers have not been granted historically.

The confusion over federal rules means the \$144 million management flexibility cut is a sensible approach, at least until the federal position on supplanting is clarified. It is likely federal money will be able to offset the elimination of the state's Improving Student Accountability fund. The combination of stimulus money and cuts could lead to scenarios where local school districts make new one-time investments in special-needs education programs and use Title I money to offset state cuts in programs for disadvantaged children, while overall increasing class sizes and trimming administration, teaching materials and textbooks.

How does the Governor use federal recovery dollars?

The American Recovery and Reinvestment Act (ARRA), which President Obama signed into law in February, included aid to state and local governments. In total, North Carolina will receive approximately \$6.1 billion in federal recovery funds over the next three years. More than half of that total (\$3.7 billion) is for state fiscal relief and therefore is intended to help the state limit harmful cuts that would negatively impact the economy and delay economic recovery. The remaining money either flows to other funds (Highway Fund, unemployment insurance, etc.), local governments and school districts, or is intended to supplement spending on key programs that will help working families and stimulate the economy.

The federal recovery dollars slated for state fiscal relief are divided into three funding streams: a temporary increase in the Medicaid FMAP (federal Medicaid assistance percentage) (\$2.25 billion total), a state fiscal stabilization fund to maintain education spending at FY05-06 levels (\$1.16 billion total), and a second state fiscal stabilization fund for general use (\$258.5 million total). The increase in the Medicaid FMAP began in the current fiscal year and approximately \$750 million was used to prevent additional cuts to the FY08-09 budget and to pay for increased Medicaid enrollment. In FY09-10, \$1.7 billion in state fiscal relief is available to North Carolina, and the governor proposes using those funds to close roughly half of the state's budget shortfall. Another \$1.2 billion is available to the state in FY10-11. However, it is important to keep in mind the temporary nature of these funds.

The state is also set to receive additional federal recovery dollars that will not directly impact the general fund's status, including \$839 million for transportation, \$338 million in targeted funds for school districts, \$67.5 million for increased child-care subsidies, and \$112 million for home weatherization.

Transportation budget

Declining collections from the fuel tax and the vehicle sales tax are the major drivers of the significant cuts in the state's transportation budget. Fuel tax collections (the major revenue stream for the Highway Fund) are predicted to decline 2.5% in FY09-10 and an additional 3.5% in FY10-11. Vehicle sales tax collections (the major revenue source for the Highway Trust Fund) are predicted to decline 4.0% in FY09-10, but the governor's budget forecasts an optimistic increase of 9% in the second year.

The revenue forecasts are reflected in the appropriation for maintenance (funded through the Highway Fund) and construction (funded through the Highway Trust Fund) budgets. Under the governor's plan, the maintenance budget would decline 13% or \$125 million in FY09-10 and 17%, or \$156 million, in FY10-11. The construction budget would decline 12%, or \$200 million, in FY09-10 and 10% or \$178 million in FY10-11. This construction budget decline will be more than offset by the \$735 million in federal recovery dollars coming to the state in 2009 and 2010. Hence the net effect of the budget and stimulus will be to significantly cut maintenance activities while maintaining new construction.

Conclusion

The governor's budget provides a solid starting place for budget negotiations. In particular, it is laudable that the governor recognized the need to raise revenues and not to balance the budget with spending cuts alone. However, the specific revenue and spending proposals and the precarious way in which the budget is balanced overall will be sources of debate as the budget process now moves to the General Assembly.

BTC *Reports*

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