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Beyond the crystal ball: Projecting the 2009-10 general fund budget shortfall

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*Timely,
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analysis of
state and local
budget and tax
issues*

North Carolina's General Fund budget outlook for next year (FY 2009-10) continues to deteriorate. Tax revenues continue to decline at an accelerating pace while demands for certain categories of state services keep rising. With the current year's shortfall largely under control, state leaders must now deal with the deep budget gap facing the state for the upcoming fiscal year that begins July 1st.

The details for FY 2009-10

"Budget Shortfall" is best defined as the gap between anticipated revenues, assuming no changes to tax policy, and the amount of spending needed to maintain the current quality and quantity of public services. The following table provides a detailed projection for the FY 2009-10 shortfall.

Projected General Fund Budget Shortfall for 2009-10	
1) Structural gap from 2008-09 budget	
Recurring items paid for with non-recurring funds	\$155,687,426
Non-recurring items historically funded each year (incl. ABC bonuses)	\$219,951,726
2009-10 Implementation of tax reductions (EITC and gift tax)	\$39,000,000
Payments on new state debt	\$52,000,000
2) Projected adjustments to continuation budget	\$473,000,000
University enrollment	\$45,000,000
Community college enrollment	\$48,000,000
K-12 enrollment	\$80,000,000
Medicaid growth (assumes 10% increase)	\$300,000,000
Subtotal: New Revenue Needed to Pay for 09-10 Budget with no new spending	\$939,639,152
3) Additional costs	
State employee health plan shortage	\$600,000,000
Subtotal: Additional costs	\$600,000,000
4) Hypothetical drop in projected revenues	
Rebase revenues (assume 08-09 revenue shortfall scenarios from above)	\$2,200,000,000
Additional revenue decline	\$350,000,000
Subtotal: Revenue drop	\$2,550,000,000
Total before other spending pressures	\$4,089,639,152
5) Other spending pressures	
2% inflationary pay raise for state employees and teachers	\$260,000,000
1% COLA increase for Retirement System	\$33,000,000
Repairs and Renovations (typical requirement)	\$100,000,000
State Employee Pension Fund (\$359m need over 2 years)	\$29,000,000
SCHIP match	TBD
Replace lost EARN scholarship funding from Escheats Fund	TBD
Final Medicaid swap in Oct '09- .25 cent from locals will likely not cover the entire state takeover	TBD
Subtotal: Other spending pressures	\$422,000,000
Projected 2009-10 Budget Shortfall	\$4,511,639,152
Estimated federal assistance	\$1,700,000,000
% of shortfall addressed by federal assistance	38%
Shortfall remaining after federal assistance	\$2,811,639,152

Options for Addressing the Shortfall

The state has four options, which can be used in combination, for addressing next year's budget shortfall.

- 1) The state will be able use funds made available via the federal stimulus package. Current estimates are that the increased Medicaid funding from the federal government as well as funds available to protect education and other services will bring in \$1.7 billion. That amount could be offset by tax changes in the federal stimulus package that could cost North Carolina revenue. One estimate for North Carolina's revenue loss in 2009-10 is \$340 million (this potential loss is not factored into the shortfall calculations)
- 2) The state can enact spending cuts. According to documents from the Office of State Budget and Management, deep, broad budget cuts are being considered. Specifically, the Governor's office is currently considering reducing spending at most state agencies by 10 percent on average, with a 7.5 percent reduction for higher education and Department of Health and Human Services and a 4.5 percent reduction for the public schools. These spending cuts would free up approximately \$1.4 billion.
- 3) The state can tap its rainy day fund, whose current balance is approximately \$800 million. However, it is likely that only \$550 million will be available next fiscal year because state lawmakers are poised to use \$250 million from the fund to address the current shortfall in the state employee health plan. These three options would yield \$3.65 billion towards addressing the budget gap. However, this assumes that the rainy day fund is completely depleted and the Governor has not indicated so far that depleting the fund is under consideration. That leaves a gap of approximately \$900 million.
- 4) The final option is to consider new revenues. In the two most recent state budget shortfall periods, the early '90s and the early 00's, lawmakers took a balanced approach and raised revenues in addition to enacting significant spending reductions.

Looking ahead to 2010-11

Most economists are predicting that the economy will decline through 2009 and that the recovery will not begin until some time in 2010. Moreover the economic recovery is expected to be sluggish for some time. It is also important to note that revenue declines usually continue for some period after a recession ends and revenue gains are not seen until the recovery is well on its way. Meanwhile, demands for state services including enrollment growth, inflationary pressures on public employee wages and so on will continue to increase. Finally, there will be significantly less funding available from the federal stimulus available. A sluggish revenue picture, continued spending pressures and the loss of federal funding will create a large budget gap for 2010-11. As such lawmakers should act this year to improve the state's revenue outlook by taking steps to modernize state taxes and looking for spending reductions are recurring – ideally found by enacting efficiencies and identifying programs that are not effective.

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