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THE FINAL BUDGET AGREEMENT: AN AFFORDABLE INVESTMENT IN NORTH CAROLINA'S FUTURE

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Executive Summary

- The final 2007-09 budget increases state spending over the 2006-07 fiscal year by \$1.79 billion, or 9.5%, in the first year and by an additional \$27 million in the second year.
- With this increase, the general fund budget returns to the inflation-adjusted per-capita spending level of the 2000-01 budget. Real per-capita spending grew only 7% during this period.
- More than \$1 billion of the \$1.8 billion increase goes to education through expanded and new programs and increased teacher and faculty salaries. Other significant spending increases include funds for local water and sewer improvements and a 4% pay raise for state employees.
- The revenue plan includes a 3.5% refundable Earned Income Tax Credit, makes the 0.25-cent increase on the sales tax permanent, and eliminates the top income tax bracket, resulting in a tax reduction for the wealthiest North Carolinians.
- The plan includes a three-year state takeover of the counties' share of Medicaid costs. In exchange, the state will get some local sales tax revenue. Also, the state will allow county voters to enact additional local sales or land transfer tax increases.
- The budget is structurally balanced in that it responsibly uses the \$1.49 billion surplus, most of which is one-time revenue. The plan sets aside \$175 million for the rainy day fund and \$145 million for repairs and renovations. The budget for the first year includes only \$100 million more in recurring spending than will be collected through recurring revenue sources. It also includes \$107 million in tax reductions and \$344.6 million in tax and fee increases, leaving about \$1.96 billion for new spending. The first year of the budget leaves \$270 million unspent and therefore available to be spent in 2008-09.
- If revenue forecasts for year two remain on target and unspent agency funds are typical, lawmakers will have approximately \$645 million available for budget increases in 2008-09. After contributing to savings and restoring the nonrecurring ABC bonuses appropriation, around \$300 million will be left for pay raises, restoring other nonrecurring items, and funding any capital projects. A one-percent pay raise for all employees costs more than \$100 million.
- Despite the positive overall character of the budget, lawmakers will face ongoing pressure to address calls for transportation financing overhaul, more comprehensive state and local tax reform, and additional funding for mental health services.

Overview

The final 2007-09 budget agreement is an affordable and responsible approach to moving North Carolina forward. The plan will increase state spending by \$1.8 billion, or 9.5%, in the first year and another \$27 million, or 0.13%, in year two (see Fig. 1). The plan includes several major policy initiatives on both the tax and the spending sides of the ledger. The spending plan includes new programs such as the Learn and Earn and Earn Scholars programs and NC Kids' Care, which will provide health insurance to 12,000 uninsured children. The revenue plan includes a new refundable tax credit for working families and new revenue options for local governments. This issue of BTC reports analyzes the plan in detail and discusses some looming, unresolved fiscal issues facing the state in the coming months.

FIGURE 1

FINAL 2007-09 BUDGET OVERVIEW	
2006-07 Authorized Budget	\$18,865,960,284
2007-08 Recommended Continuation Budget	\$18,967,544,989
2007-08 Recommended Expansion Budget	\$1,690,792,723
Total 2007-08 General Fund Appropriations	\$20,658,337,712
\$ Change from Previous Fiscal Year	\$1,792,377,428
% Change from Previous Fiscal Year	9.5%
2008-09 Recommended Continuation Budget	\$19,492,587,728
2008-09 Recommended Expansion Budget	\$1,193,078,810
Total 2008-09 General Fund Appropriations	\$20,685,666,538
\$ Change from Previous Fiscal Year	\$27,328,826
% Change from Previous Fiscal Year	0.13%

Revenue Plan

State budget writers benefited from a nearly \$2 billion surplus from unexpected revenue growth in 2006-07. This mostly one-time surplus allowed lawmakers to grow spending by 9.5% while simultaneously enacting tax cuts and setting aside funds in the state's savings accounts. Figure 2 provides an overview of revenue availability for each year of the two-year plan.

The final budget included several significant tax policy changes. First and foremost, working families will benefit from a new 3.5% state Earned Income Tax Credit, costing \$48 million. At the other side of the income spectrum, lawmakers chose to spend \$94 million on a tax reduction for the wealthiest North Carolinians by allowing the top income tax bracket to expire. In order to provide needed recurring revenue to fund new education programs and take over the counties' Medicaid share, the temporary 0.25 cent on the state sales tax was made permanent. Maintaining the state sales tax rate at 4.25% will raise more than \$285 million in 2008-09. Other noteworthy tax changes include reinstating the long-term care insurance credit and enacting a state version of the federal adoption credit.

State Assumes County Medicaid Costs

The state will take over the counties' share of Medicaid costs over the next three years. In exchange, counties will relinquish portions of local revenue to the state. Another part of the swap agreement allows counties (with voter approval) to levy two new local taxes. The new options are a 0.4% land transfer tax, which would be added to the 0.2% excise stamp tax on conveyances that is already in place, or an additional 0.25-cent local sales tax. Figure 3 explains these tax changes in further detail.

FIGURE 2

FINAL BUDGET REVENUE AVAILABILITY

	FY 2007-2008	FY 2008-2009
Beginning Credit Balance		\$270,504,098
Revenue overcollections in FY 2006-07	\$1,368,100,000	
Agency reversions from FY 2006-07	\$125,000,000	
Total Carryforward	\$1,493,100,000	\$270,504,098
Rainy Day Fund	(\$175,000,000)	
Repairs and Renovations Reserve	(\$145,000,000)	
Total Expenditures from Carryforward	(\$320,000,000)	
FINAL CARRYFORWARD AMOUNT	\$1,173,100,000	\$270,504,098
Current Year Forecast		
Base General Fund Revenue Forecast (Tax and Non-Tax)	\$19,517,790,000	\$20,575,310,000
Proposed Tax Reductions	(\$106,673,000)	(\$150,599,820)
Proposed Tax and Fee Enhancements	\$344,624,810	\$511,281,495
Total Current Year Revenue	\$19,755,741,810	\$20,423,221,461
TOTAL REVENUE AVAILABLE	\$20,928,841,810	\$21,206,495,773

Establishes a 3.5% State Earned Income Tax Credit (EITC)

The final budget enacts a 3.5% refundable state Earned Income Tax Credit (EITC) in 2008-2009. The state EITC is a targeted tax reduction that will help more than 800,000 North Carolina low- and moderate-income families. Taxpayers who qualify for the federal EITC will be able to claim 3.5% of their federal credit on their North Carolina state income tax forms. The average taxpayer benefit is \$57 and the maximum benefit is \$165.

The state EITC is a refundable credit, so it will not only offset income taxes owed, but for many taxpayers, it will also help to offset the disproportionately negative impact sales and property taxes have on the lowest-paid workers. According to data provided by the Institute on Taxation and Economic Policy, North Carolina's lowest-paid workers (bottom 20%) pay 10.9% of their income to state and local taxes, while the wealthiest taxpayers (top 1%) pay only 6.3%. Moreover, the impact of the sales tax on low-income families is five times greater than the impact on the wealthiest 1%.

Maintains Sales Tax, but Eliminates Upper Income Tax Bracket

The final budget maintained the state sales tax rate at 4.25% but eliminated the 8% upper income tax bracket, the other temporary tax provision remaining from 2001.

Taxpayers in the bottom 20% (incomes under \$18,000) will pay on average \$16 in additional sales taxes. The new refundable state EITC will help balance the impact.

Only 60,000 taxpayers - just 2% of all taxpayers - will benefit from the elimination of the top income tax bracket, yet the tax reduction will cost the state \$94 million in lost revenue in 2008-09. A quarter of the tax reduction will benefit the 0.2% of taxpayers with average incomes of more than \$1 million. Not only will this cut make North Carolina's tax system less fair, but more importantly, it could have a serious impact on the state's ability to collect adequate revenues in the future. Lawmakers are shifting more responsibility for paying for public needs to low- and moderate-income taxpayers who have seen their wages stagnate, but they are not requiring those with the most money and fastest-growing incomes to pay their fair share.

FIGURE 3

MAJOR TAX POLICY CHANGES

	DESCRIPTION	REVENUE IMPACT IN 2008-2009
TAX REDUCTIONS		
For Individuals and Families		
3.5% Refundable State Earned Income Tax Credit	Establishes a new refundable state tax credit that piggy-backs on the federal program to benefit more than 800,000 low-and moderate-income working households	\$(48,300,000)
Elimination of the 8% Personal Income Tax Bracket	Provides a tax break to 60,000, or 2% of taxpayers, through sunseting the 8 percent income tax rate that applies to North Carolina's wealthiest taxpayers	\$(93,700,000)
Long-Term Care Insurance Credit	Reenacts tax credit for premiums paid on long-term care insurance for taxpayers with adjusted gross income under threshold	\$(7,200,000)
Adoption Credit	Creates a tax credit for qualified adoption related expenses that is equal to 50% of the taxpayer's federal adoption tax credit amount	\$(3,000,000)
For Businesses		
Working Opportunity Tax Credit	Extension of federal program that provides a credit to businesses for hiring disadvantaged workers	\$(3,000,000)
Mfg and Farmer's Energy Tax Provisions	Provides a sales tax exemption on all energy purchases for qualified manufacturers and farmers	\$(20,000,000)
Additional Tax Adjustments		
Changes Needed to Conform to Federal Tax Code	Includes extension of deduction for higher education expenses and qualified expenses of elementary and secondary teachers; and extension of enhanced small business expensing thresholds	\$(49,100,000)
TAX AND FEE INCREASES		
Sales Tax		
Maintained additional 1/4 cent on sales tax	Will keep the state sales tax rate at 4.25%	\$285,900,000
State Takeback of Local Sales Tax	State will begin to takeback a portion of the local sales tax in '08-09 in exchange for assuming fiscal responsibility for the county share of Medicaid	\$184,200,000
Fees		
Judicial Fees	Increased court fees will be used to address staffing and technology needs in the judicial system and will increase the amount transferred to Legal Aid	\$38,821,220
New Local Revenue Options		
0.4% Land Transfer Tax	Counties will have the option to ask voters through a referendum process to adopt a 0.4% land transfer tax. The new local taxes are meant to provide additional revenue for new school construction and other infrastructure projects	Varies. 61 Counties will raise more revenue through the land transfer tax than with the sales tax
0.25 Cent Sales Tax	Counties will also have the option to ask voters through a referendum process to adopt an additional 1/4 cent local sales tax	Varies. 39 Counties will raise more revenue through the sales tax than the land transfer tax

The Spending Plan

The final 2007-2009 budget will increase state spending over the current year by \$1.79 billion, or 9.5%, in the first year and an additional \$27 million, or 0.13%, in year two. More than \$1 billion of the \$1.8 billion increase goes to education through expanded and new programs and increased teacher and faculty salaries. The university system gets a 12% increase in 2007-08, the largest percentage increase of all state agencies. Teachers and community college instructors will receive a 5% pay raise under the plan, and all other state employees will receive a 4% pay raise.

In somewhat of a departure from prior years, the budget is close to being structurally balanced. In 2007-08, recurring expenditures only exceed recurring revenues by \$100 million, or 0.5% of the total budget.

Health and Human Services

The HHS budget will grow 8.7%, or \$374 million, in 2007-08 compared to the previous fiscal year. Of that increase, \$86 million will cover the state's first installment toward assuming the counties' share of Medicaid costs. Despite significant attention to inadequate funding for mental health, there is very little new funding for these services and lawmakers are looking to reform the system before they consider significant additional funding in this area. The major expansion spending items in Health and Human Services are:

- **Assume County Medicaid costs** (\$86 million increase in year one and \$271 million in year two) - This funding allows the state general fund to assume the county's share of Medicaid costs. Offsetting revenues transferred from local governments are included in the revenue plan.
- **NC Kids' Care** (\$368,000 in year one and increases to \$7 million in year two) - The budget establishes the framework for an affordable health insurance program for kids in families with incomes between 200% and 300% of the federal poverty level. Planning will begin during the 2007-08 budget year, and full funding will be provided in 2008-09. Approximately 10,000 children will qualify for this coverage.
- **Smart Start** (\$1.3 million increase in year one and \$5.5 million increase in year two) - This recurring increase provides funds to local agencies in every county to provide a variety of early-childhood-related services.
- **Child Care Subsidies** (\$8.4 million increase in year one) - This funding will reduce the waiting list of eligible children under this program by 643 and provides market-rate increases to providers consistent with the 2007 market-rate study.

Public Schools

State spending for public education will increase by \$676 million, or 9.1%, in 2008-09. The governor's budget included funding to significantly expand the new Learn and Earn program and add a related Earn Scholars program in the university system. Despite their hefty price tag, these initiatives are included in the final spending plan. The following expansion items highlight the spending plan for public schools:

- **Disadvantaged Student Supplemental Fund** (\$17.5 million increase) - These funds will be dispersed to all school districts based on the number of students considered "disadvantaged." These funds can be spent on certain activities designed to improve the performance of these students.
- **Learn and Earn Initiative/Online Expansion** (\$14 million increase) - These funds will make community college and university-level courses available to 20,000 high school students in year one and to 40,000 students in year two.

- **More at Four preschool program** (\$56 million increase) - This increase will expand the number of eligible children enrolled in this program by 10,000 and increase the funding per slot by \$400 per year. This program pays tuition for low-income children in high-quality preschool programs across the state.
- **School connectivity** (\$12 million increase) - These funds will allow public schools to begin implementing a new state plan for upgrading information technology infrastructure, with an emphasis on providing up-to-date instructional technology.
- **Offset lackluster lottery proceeds** (\$94.5 million increase) - The budget includes funding to offset the anticipated shortfall in net lottery proceeds for education. The General Assembly gave the Lottery Commission the flexibility to decrease the percentage of lottery sales that goes to education in order to increase lottery jackpots in the hope of driving up sales and therefore increasing the actual dollars flowing to education programs.
- **Dropout Prevention Grants** (\$7 million increase) - The budget establishes a Commission on Dropout Prevention housed within the Department of Public Instruction and creates a competitive grant program. The grant program aims to support innovative local efforts to reduce the number of students dropping out of school. Public schools AND other local organizations such as churches and community groups are eligible to apply for grants.

Universities

The university system receives an increase of \$301 million, or 12%, in the first year of the spending plan. This is by far the largest percentage increase of any state agency. In addition to the 4% to 5% pay raises, two new large research initiatives received funding - the new research campus in Kannapolis (\$16.5 million) and the new cancer center at UNC-Chapel Hill (\$5.6 million). Two programs that directly serve low-income families also received substantial increases. They are:

- **Earn Scholars** (\$27 million in year one; increasing to \$60 million in year two) - The budget establishes a new scholarship program to provide need-based financial aid awards of \$4,000 to students from families with incomes under 200% of the federal poverty level. An additional \$40 million in funding will come from the Escheat fund in year two, bringing the total appropriation to \$100 million annually.
- **Need-based financial aid** (\$35 million increase from Escheat funds) - The Escheat fund will assume full responsibility for need-based financial aid within the university system. Approximately 46,000 students receive tuition assistance under this program. Switching all funding to the Escheat fund reduces the general fund appropriation by \$21 million.

Community Colleges

The community college system will receive an increase of \$49 million, or 5.2% in 2007-08. Increasing enrollment has stretched the community college system's budget thin. While lawmakers publicly recognize the need for more resources in this area, their rhetoric is not met with significant additional resources. The spending plan includes a 5% increase in faculty pay, which should improve North Carolina's abysmal current national ranking of 41st lowest in this category. In addition to the pay raises, the following changes to the community college budget are worth mention:

- **Tuition increase** (\$7.5 million increase) - In-state tuition will increase by

**General Government
(including Housing)**

6.3%, from \$39.50 to \$42.00 per credit hour up to 16 hours. Full-time resident students will pay \$672 per semester or \$1,344 per year. Out-of-state tuition will increase from \$219.50 to \$233.30 per credit hour.

- **Equipment** (\$10 million nonrecurring increase) - This increase will allow all 58 campuses to purchase new classroom equipment.

Funding for the administrative agencies that fall under the General Government category will receive a \$24 million increase, or 5.7%, in fiscal year 2007-08. The following affordable-housing initiatives fall within this category:

- **North Carolina Housing Trust Fund** (\$5 million increase) - This increase brings the annual appropriation to \$8 million. An additional \$7.5 million in non-recurring money will fund housing for people with disabilities.
- **Home Protection Pilot Program** (\$1.5 million nonrecurring) - This amount is unchanged from the previous fiscal year but appears as an increase in the budget because the appropriation is nonrecurring. This pilot program provides short-term mortgage assistance loans to qualified workers who have lost their jobs through no fault of their own.
- **Migrant Housing** (\$124,000 increase) - This funding will support two additional agricultural safety officers to conduct migrant housing inspections, search for unregistered migrant housing, and train farmers and farm workers on safety issues.

FIGURE 4

2007-08 SPENDING CHANGES BY FUNCTION*					
	2006-07	2007-08	\$ CHANGE	% CHANGE	% OF BUDGET
Health & Human Services	\$4,282,975,588	\$4,653,823,495	\$370,847,907	8.7%	22.5%
Natural & Economic Resources	\$502,031,614	\$664,720,572	\$162,688,958	32.4%	3.2%
Justice & Public Safety	\$1,959,446,389	\$2,130,736,274	\$171,289,885	8.7%	10.3%
General Government	\$425,380,369	\$449,436,189	\$24,055,820	5.7%	2.2%
Total Education	\$10,783,499,548	\$11,809,150,981	\$1,025,651,433	9.5%	57.2%
<i>Public Schools</i>	<i>\$7,403,293,531</i>	<i>\$8,079,516,907</i>	<i>\$676,223,376</i>	<i>9.1%</i>	<i>39.1%</i>
<i>Community Colleges</i>	<i>\$935,718,292</i>	<i>\$984,357,122</i>	<i>\$48,638,830</i>	<i>5.2%</i>	<i>4.8%</i>
<i>Universities</i>	<i>\$2,444,487,725</i>	<i>\$2,745,276,951</i>	<i>\$300,789,226</i>	<i>12.3%</i>	<i>13.3%</i>
Debt Service	\$568,790,381	\$610,175,752	\$41,385,371	7.3%	3.0%
Reserves & Adjustments (excluding compensation increases)	\$137,493,095	\$110,189,534	\$(27,303,561)	-19.9%	0.5%
Capital Improvements	\$206,343,300	\$230,741,100	\$24,397,800	11.8%	1.1%
Total General Fund Budget	\$18,865,960,284	\$20,658,973,897			

*Compensation increases were allocated to budget categories in both years to accurately compare spending from 2006-2007 to 2007-2008

**Capital
Improvements
and Debt**

The final budget agreement includes \$231 million for one-time capital improvements such as the new dental school at East Carolina University and a new office building for the Department of Environment and Natural Resources. The plan also includes \$544 million in authorized new debt for other capital projects such as a new prison, a new visitors' center at Tryon Palace and several new university buildings. This amount exceeds the state treasurer's recommended new annual debt issuance cap of \$384 million. Furthermore, the Treasury cautioned the state against the recent trend of issuing more and more non-voter approved debt. None of the additional debt approved in the budget requires voter approval.

Rather than approve new debt for the estimated \$5 billion in statewide water and sewer needs, the state opted to include \$100 million in nonrecurring funds for urgent water and sewer upgrades to be distributed by the NC Rural Center.

**Stay Tuned:
Big Issues
Left Unresolved**

The legislature and the governor deserve credit for resolving two longstanding fiscal dilemmas - eliminating the counties' share of Medicaid costs and making permanent decisions on the temporary taxes. Three significant issues remain unresolved, however.

Roads/Infrastructure

According to analysts with the state Department of Transportation, North Carolina is facing a \$65 billion shortfall in transportation funding over the next three decades. At the same time, North Carolina receives low marks in national studies looking at the condition of transportation infrastructure. Despite this daunting figure, state lawmakers once again capped the gas tax at 30.5 cents per gallon. The rate typically fluctuates with the price of wholesale gasoline, going up when the price goes up. The last two legislative sessions have seen a freeze in this formula, worsening the funding gap for the Highway Fund. Legislation to increase the state's sales tax on cars, currently set at 3%, received some attention but did not ultimately succeed. Some advocates for more spending on roads are calling for a special session or possibly an interim gubernatorial-appointed study commission to discuss the state's options. Any increase in financing, particularly for expanding the road system, should be grounded in a solid planning process that emphasizes livable communities, environmental protection and benefits for low-income residents.

**Comprehensive
Tax Reform**

The State and Local Fiscal Modernization Commission that began meeting prior to the long session is slated to resume its work this fall. The state's revenue system is increasingly out of date and therefore unable to provide the revenue needed to sustain services. The system is also unfair to low- and moderate-income taxpayers who pay a much larger share of their incomes in state and local taxes than do wealthier taxpayers.

**Mental Health
Funding/Reform**

The state's mental health system received very little new money to support local mental health services in the 2007-09 budget. Two new state mental hospitals did receive substantial new funds, but that was offset by savings associated with the closing of Dorothea Dix Hospital in Raleigh. In recent months, it has come to light that the mental health reforms the state has been undergoing for the last several years have left the system in a state of chaos, with vastly different quality of care and accountability between the different Mental Health Authority regions. State officials,

including the leadership of Health and Human Services, have turned their eyes towards fixing the system before they address the large funding shortfall in this area.

**Looking Ahead
to 2008**

If revenue forecasts for year two remain on target and agency reversions are typical, lawmakers will have approximately \$645 million available for budget increases in 2008-09. After contributing to savings and restoring the nonrecurring ABC bonuses appropriation, around \$300 million will be left for pay raises, restoring other nonrecurring items, and funding any capital projects. A 1% pay raise for all employees costs more than \$100 million.

The revenue forecast developed by legislative fiscal staff is conservative by all accounts, leaving open the possibility that revenues could come in ahead of schedule. But with the slowdown in the housing market and a possible weakening of the job market predicted for the next several months, any revenue surplus is likely to be small.

FIGURE 5

2008-09 EXPANSION SPENDING WILL BE VERY LIMITED	
Budgeted carryforward from 2007-08	\$270,504,098
<i>plus</i> additional revenues unappropriated	\$250,325,137
<i>plus</i> agency reversions	\$125,000,000
Total available for new spending	\$645,829,235
<i>minus</i> estimated rainy day fund contribution	\$150,000,000
<i>minus</i> estimated repair and renovations contribution	\$100,000,000
<i>minus</i> restoring ABC bonuses	\$70,000,000
TOTAL AMOUNT AVAILABLE (for pay raises*, capital projects, etc.)	\$325,829,235
*Each 1% pay raise costs approximately \$100 million	

Conclusion

Lawmakers spent the state's surplus in 2007 wisely, setting aside funds for savings, one-time capital expenses and a few large long-term expansions of state government, such as NC Kids' Care and the Earn Scholars program. Beginning in 2008, however, the state's underlying structural deficit that has been reported on by the Budget & Tax Center for the past several years will reappear and make the task of formulating a budget difficult once again. Two things must be done in order to bring the budget into overall balance in the long-term - national health care reform that lowers annual increases in costs and state and local tax reform aimed at establishing a fairer and more stable revenue system for North Carolina's state and local governments.

APPENDIX

Selected FY2007-2008 Expansion Budget Highlights

Public Education	ABC Bonuses	\$70,000,000
	Disadvantaged Student Supplemental Funding	\$17,563,000
	Learn and Earn Initiative/Online Expansion	\$14,645,011
	Literacy Coaches	\$5,704,400
	Dropout Prevention Grants	\$7,000,000
	School Connectivity	\$12,000,000
	Children with Disabilities	\$5,000,000
	Teacher Assistants	(\$5,459,534)
Community Colleges	6.5% Tuition Increase	(\$7,500,000)
	Equipment	\$10,000,000
	Data Connectivity	\$3,827,600
Universities	Need Based Financial Aid (from Escheat fund)	\$35,600,000
	Earn Scholars	\$27,605,210
Health and Human Services	NC Kids' Care	\$368,000
	Smart Start	\$1,285,870
	Child Care Subsidies	\$8,400,000
	Maintain NC Health Choice Enrollment	\$7,507,992
	County Share Medicaid Relief	\$86,200,000
	HIV Prevention	\$2,000,000
Housing	Housing Trust Fund	\$12,500,000
	Home Protection Pilot Fund	\$1,500,000
Employee Benefits	Salary Increase for State Employees	\$501,903,140
	Retirement System Contribution	\$35,705,000
	Retirement System Payback	\$45,000,000
	State Health Plan	\$110,184,490

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