

Who We Are

We are the North Carolina Progress Board. We were created in 1995 by the General Assembly to "...encourage understanding of critical global, national, state and local...trends that will affect North Carolina in the coming decades..." and to

- define a long-term state vision in eight critical "issue areas" (the *imperatives*):
 - Healthy Children and Families
 - Quality Education for All
 - A High Performance Workforce
 - A Prosperous Economy
 - A Sustainable Environment
 - A 21st Century Infrastructure
 - Safe and Vibrant Communities
 - Active Citizenship/Accountable Government;
- set measurable goals for attaining the state's future vision;
- keep score and report progress to the General Assembly and people; and
- promote citizen action and governmental accountability.

Helping citizens understand where public money comes from and where it goes is integral to our mission. If you would like to know more about the state budget or the North Carolina Progress Board, please visit us at www.theprogressboard.org.



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Our State, Our Money

A Summary of the Citizens' Guide to the North Carolina Budget

Introduction

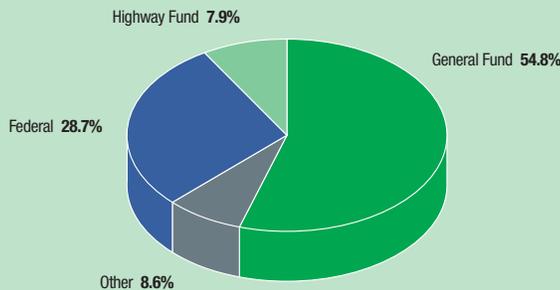
Despite encouraging news about North Carolina's economy, our state still faces tough fiscal questions. Should we cut or raise taxes? Will our revenues keep pace with economic shifts? Can we reduce spending without impairing crucial services? Will deferring infrastructure investments today only increase our costs tomorrow? Can we tap our debt capacity any more without putting our long-term fiscal stability at risk?

This primer is about North Carolina's budget. Ensuring vital public services and a balanced budget requires hard choices. The more we know about the state budget, the more we can help shape those choices.

What is the State Budget?

The Total State Budget contains \$31.2 billion from the General Fund, Highway Funds, Federal Funds and certain earmarked funds (e.g., tuition for colleges and county funds for Medicaid). The General Fund budget—often referred to as the *State Budget*—accounts for 55% of all state resources.

TOTAL STATE BUDGET BY FUND TYPE, FY 2004–05



SOURCE: Fiscal Research Division, NC General Assembly

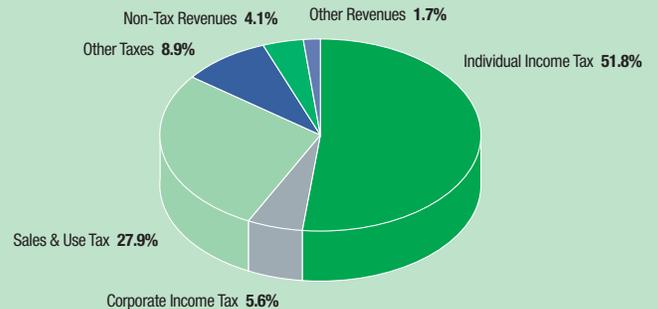
This primer is about the General Fund because it is the largest single state budget, with the lion's share of funds over which our elected officials have most control. For more information on other state funds, please see the full text of *Our State, Our Money: A Citizen's Guide to the North Carolina Budget*.

Where Does the Money Come From?

This fiscal year (FY04–05), the General Fund receives over \$15.5 billion from several revenue sources (excluding bond proceeds). Two sources account for nearly 80% of total

revenues. The individual income tax, a graduated tax on 6.0% to 8.25% of wages, capital gains and other personal income, generates nearly 52% of General Fund revenue. The sales and use tax, a flat tax on 4.5% of certain sales (and a more stable revenue source than the income tax), produces 28% of General Fund revenue.

GENERAL FUND REVENUES BY SOURCE, FY 2004–05

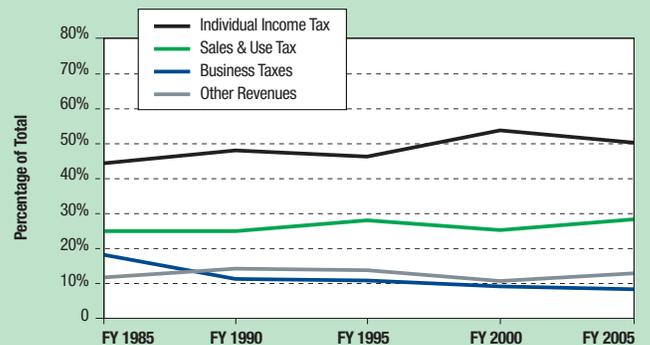


SOURCE: Fiscal Research Division, NC General Assembly

The other General Fund revenue sources include corporate income tax (a 6.9% tax on corporate income), other tax revenue (e.g., tobacco/alcohol excise taxes, business franchise taxes and estate taxes) and non-tax revenue (e.g., user fees, licenses and fines). Property taxes are paid to local governments.

Policy decisions, as well as global trends, have altered the mix of state revenue sources. During the 1990s, North Carolina enacted tax cuts representing about 7% of revenues, relying instead on economic growth to boost revenues. Rising equity

RELATIVE CHANGES IN GENERAL FUND REVENUES BY SOURCE, FY 1985–2004



SOURCE: Fiscal Research Division, NC General Assembly

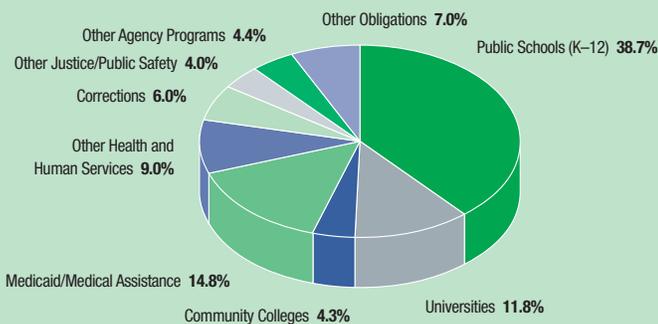
investments, service sales and Internet commerce had profound impacts on individual income and sales and use taxes. Many goods purchased over the Internet and services do not generate sales taxes.

The declining importance of the corporate income tax has placed greater demands on other resources, such as the individual income and sales and use taxes. Yet, rising E-commerce and other factors have made it more difficult for even these two fiscal powerhouses to meet the state's fiscal demands.

Where Does the Money Go?

This fiscal year (FY04–05), the General Fund budget provides over \$15.5 billion for numerous state and local programs (excluding bond costs). Two program areas incur over 78% of General Fund costs. Public education (e.g., public schools, universities and community colleges) accounts for nearly 55% of General Fund expenditures while health and human services (e.g., Medicaid, public health, social services and child development) account for nearly 24%.

GENERAL FUND EXPENDITURES BY PROGRAM, FY 2004–05



SOURCE: Office of State Budget & Management

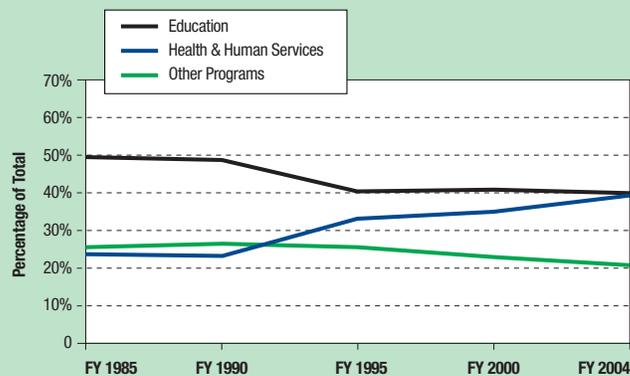
The other General Fund program areas include corrections, other justice and public safety programs (e.g., law enforcement, courts and juvenile justice), other agency programs (e.g., administration, cultural resources, revenue, agriculture, natural resources and environment) and other obligations (e.g., debt service and reserves).

Two programs merit special attention—public schools (K–12) and Medicaid. North Carolina pays a higher share of public school costs than other states (68% versus a national average of 50%). Our state government pays the base salaries for virtually all teachers and administrators, plus most school bus and book costs. And, every 20,000 increase in public school enrollment translates to over \$100 million in added costs.

The second most pressing General Fund commitment is Medicaid. North Carolina and its counties pay over one-third of Medicaid costs, and these costs have increased more rapidly than those of any other state program. About 42% of total Medicaid costs are generated by disabled persons and 29% by people age 65 and over. During hard times, many turn to Medicaid as the only affordable health insurance.

North Carolina's spending priorities have changed over the last 15 or 20 years. As state spending on health and human services and prisons has garnered a larger share of the state budget, relatively fewer resources have been available for other programs.

RELATIVE CHANGES IN GENERAL FUND APPROPRIATIONS BY PROGRAM, FY 1990–2004



SOURCE: Fiscal Research Division, NC General Assembly

Since 1990, health and human service costs have soared from 15% to 24% of General Fund appropriations (excluding debt and reserves). Prison costs also have increased as a percent of the General Fund budget. As a result, public school costs have dropped from 46% to 43% of the budget and university and community college costs have dropped from a combined 22% to 17% of the budget. The harsh reality is that our short-term obligations are forcing us to invest relatively less on those programs with the greatest long-term promise.

Where Have We Been?

During the 1990s, we made some big investments, such as improving water quality, raising teacher pay, initiating the Smart Start Program and issuing higher education bonds. We also pursued aggressive tax-cutting policies. Then, we were stunned by unforeseen events, including two hurricanes and costly court rulings. In 2001, our economy faltered, with dramatic job and stock market losses. These four factors combined to create a serious fiscal crisis for North Carolina.

In 2002, state officials used temporary measures to balance the budget. For example, the state diverted funds slated for other purposes, like highway and tobacco settlement funds, to the General Fund. The state extended two temporary tax increases enacted in 2001. The state also ended payments to local governments in exchange for allowing them to increase the local sales tax rate by .5¢ (Note: All 100 counties have increased the local sales tax rate to 2.5¢).

For the fiscal year ending June 30, 2004, the General Assembly and governor faced some painful choices. In the end, state officials extended the 2001 temporary tax increases, but rejected efforts to raise tobacco and alcohol taxes. The final FY04 budget included deep cuts in some areas (e.g., Medicaid) and modest increases in other areas (e.g., smaller public school classes), but otherwise maintained prior year spending levels. Stronger-than-expected revenue growth in 2004 allowed some funding increases for vital services and contributions to the state's *rainy day* fund. Tough choices, however, remain when the General Assembly reconvenes in early 2005.

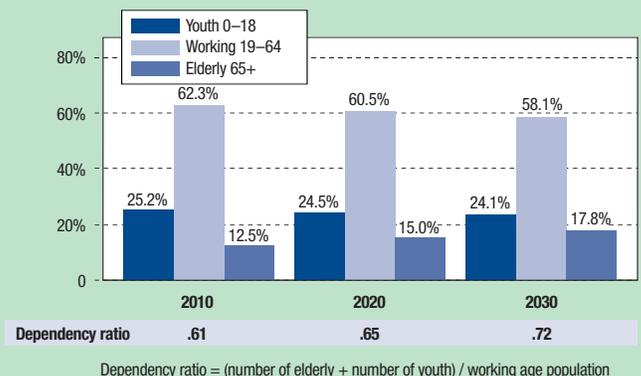
Where Are We Going?

In the coming years, sweeping changes in North Carolina's population and economy could profoundly impact our state's budget.

POPULATION CHANGES—A continued influx of new people will heighten demands for education and other vital public services. By 2010, our state's population will grow by a projected 18%. Depending on the relative growth rate of the youth population, public school and university enrollments could grow even faster.

Future demographic changes, such as the aging of our population, could pose even greater burdens. The share of our population 65 or older is projected to rise from 12% in 2002 to 15% in 2020 and nearly 18% by 2030. The ratio of elderly and youth to working age people (the *dependency ratio*) is estimated to soar from 61% in 2010 to 72% in 2030.

PERCENTAGE OF POPULATION BY AGE GROUP, 2010–2030



Dependency ratio = (number of elderly + number of youth) / working age population

SOURCE: Office of State Budget & Management and US Bureau of the Census

In short, we will have fewer in the work force to fund the needs of an ever-growing population of children and elderly.

ECONOMIC SHIFTS—The furniture, textile and tobacco sectors—once the foundation of our manufacturing economy—may continue to suffer. More manufacturing jobs may move offshore, replaced by service jobs with lower wages or benefits. Emerging economy jobs may pay higher wages, but require more education. The individual income tax may become more dependent on volatile non-wage income and growing Internet purchases may further erode the sales and use tax.

OTHER FACTORS—There are a host of other factors that could affect the state budget. Catastrophic climatic events could mandate infusions of public monies. Federal or judicial rulings could place new burdens on state officials. Relying on economic growth or short-term budgetary fixes—without making hard choices about revenue sources and expenditure priorities—may be insufficient to balance our state budget.

What Can We Do?

North Carolina has a proud history of rising to new challenges. Just as previous generations made tough choices that have benefited us, we can now act on behalf of future generations. By asking hard questions about tax and spending policies, defining our expectations and holding our government accountable, we can give our children a better state in which to live. If you would like to learn more about shaping our state's future, visit our website at www.theprogressboard.org.