MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

The following is a discussion and analysis of the State of North Carolina's (the State's) financial performance, providing an overview of the activities for the fiscal year ended June 30, 2004. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section.

Financial Highlights

Government-wide Financial Statements:

— The State's total net assets increased slightly as a result of this year's operations. While net assets of governmental activities increased by $613.2 million, or nearly 2.7 percent, net assets of business-type activities decreased by $204.5 million, or about 21.3 percent (decline related to the Unemployment Compensation Fund). At year-end, net assets of governmental activities and business-type activities totaled $22.98 billion and $754.1 million, respectively.

— Component units reported net assets of $10.66 billion, an increase of $1.08 billion or 11.3 percent from the previous year. The majority of the increase ($762 million) is due to the net increase in capital assets for the University of North Carolina System and community colleges (component units). The capital asset additions were financed in part by State debt proceeds.

— GASB Statement No. 39 became effective during the fiscal year (see Notes 20 and 21 to the financial statements). The beginning net assets of the University of North Carolina System and community colleges were increased by $713 million to include nongovernmental component unit foundations.

Fund Financial Statements:

— As of the close of the fiscal year, the General Fund reported a total fund balance of negative $196.3 million, with reserves of $197.4 million, and an unreserved fund balance of negative $393.7 million. The total fund balance of the General Fund decreased from the prior year balance of negative $167.1 million.

— The Highway Fund and the Highway Trust Fund reported total fund balances of $227.8 million and $266.1 million, respectively.

— The State's two major enterprise funds, the Unemployment Compensation Fund and the EPA Revolving Loan Fund, reported net assets of $20.1 million and $640.5 million, respectively. The net assets of the Unemployment Compensation Fund decreased by 93 percent from the prior fiscal year-end.

Capital Assets:

— The State's investment in capital assets (net of accumulated depreciation) was $25.61 billion, which represents an increase of 7.7 percent from the previous fiscal year.

— The largest component of capital assets, the State highway system, includes roadway surfaces, bridges, signage, railings, markings, traffic signals, and other structures related to the State's motor vehicle transportation system. The system includes 78,615 miles of roadway, constituting the second largest highway system in the nation. The system also includes 17,250 bridges spanning 380 miles. At year-end, the State reflected $13.28 billion (net of accumulated depreciation) of highway system infrastructure.

— Major capital asset activity included additions to the State highway system ($1.2 billion), right-of-way acquisitions ($510 million) and the acquisition/construction of correctional facilities ($239 million).

Long-term Debt:

— The State had long-term debt outstanding of $5.54 billion, an increase of 34.9 percent from the previous fiscal year-end. The long-term debt balance includes $519.6 million of special obligation (non-voted) debt issued for governmental activities.

— The State maintained its AAA bond rating with Standard and Poor's and Fitch. In August 2002, Moody's downgraded the State's credit rating for general obligation debt from "AAA" to "Aa1", representing the first time since 1960 that North Carolina had less than a "AAA" rating. In September 2004, Moody's revised the State's outlook to positive from stable.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains additional required supplementary information (General Fund budgetary schedule, pension funding progress and contributions) and other supplementary information (combining financial statements) in addition to the basic financial statements. These components are described below.

Government-wide Financial Statements

The Statement of Net Assets and the Statement of Activities are two financial statements that report information about the State, as a whole, and about its activities that should help answer this question: Is the State, as a whole, better off or worse off as a result of this year's activities? These statements include all non-fiduciary assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid. The Statement of Net Assets (page 52) presents all of the State's assets and liabilities, with the difference between the two reported as "net assets". Over time, increases and decreases in net assets measure whether the State's financial position is improving or deteriorating.

The Statement of Activities (pages 54 and 55) presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g. uncollected taxes and earned but unused vacation leave).

Both statements report three activities:
Governmental Activities – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services.

Business-type Activities – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. The State's Unemployment Compensation Fund and the EPA Revolving Loan Fund are the predominant business-type activities.

Discretely Presented Component Units – Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. A description of the component units and an address for obtaining their separately issued financial statements can be found beginning on page 70. All component units are combined and displayed in a separate discrete column in the government-wide financial statements to emphasize their legal separateness from the State. In addition, financial statements for major component units are presented in the notes to the financial statements (pages 137 and 138).

Fund Financial Statements

The fund financial statements begin on page 58 and provide detailed information about the major individual funds. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for a particular purpose. In addition to the major funds, page 160 begins the individual fund data for the non-major funds. The State's funds are divided into three categories, governmental, proprietary, and fiduciary, and they use different accounting approaches.

Governmental funds -- Most of the State's basic services are reported in the governmental funds, which focus on how money flows into and out of those funds and the balances left at year-end that are available for future spending. The governmental fund financial statements provide a detailed short-term view of the State's general government operations and the basic services it provides. Governmental fund information helps determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. These funds are reported using *modified accrual* accounting, which measures cash and all other financial assets that can readily be converted to cash. Governmental funds include the general, special revenue, capital project, and permanent funds. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

Proprietary funds -- When the State charges customers for the services it provides, whether to outside customers or to other agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting; the same method used by private sector businesses. Enterprise funds are used to report activities for which fees are charged to external users for goods and services. The Unemployment Compensation Fund and the EPA Revolving Loan Fund are our most significant enterprise funds. Internal service funds are used to report activities that provide goods and services to the State's other programs and activities on a cost-reimbursement basis. - such as the State's State Property Fire Insurance Fund, the Motor Fleet Management Fund, Computing Services Fund, and Telecommunications Services Fund. Internal service funds are reported as governmental activities on the government-wide statements.

Fiduciary funds -- The State acts as a trustee or fiduciary, for its employee pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets. These funds, which include pension and other employee benefits, private-purpose, investment trust, and agency funds, are reported using accrual accounting. The government-wide financial statements exclude fiduciary fund activities and balances because these assets are restricted in purpose and cannot be used to support the State's own programs.

Notes to the Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found beginning on page 68 of this report.

Additional Required Supplementary Information

Following the basic financial statements and note disclosures is additional Required Supplementary Information that further explains and supports the information in the financial statements. The Required Supplementary Information includes General Fund budgetary comparison schedules reconciling the statutory and generally accepted accounting principles (GAAP) fund balances at fiscal year-end, and pension plan trend information related to funding progress and contributions.

Supplementary Information

Supplementary information includes the introductory section, and the combining financial statements for non-major governmental, proprietary, and fiduciary funds and for non-major discretely presented component units. These funds are added together, by fund type, and presented in single columns in the basic financial statements, but are not reported individually, as with major funds, on the governmental fund financial statements.

FINANCIAL ANALYSIS OF THE STATE AS A WHOLE

The State's combined net assets increased $408.7 million or 1.8 percent over the course of this fiscal year's operations. The net assets of the governmental activities increased $613.2 million or 2.7 percent and business-type activities had a decrease of $204.5 million or 21.3 percent. The following table was derived from the government-wide Statement of Net Assets:

Net Assets
June 30, 2004 and 2003
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
Current and other non-current assets	$ 10,668,632	$ 9,882,858	$ 1,217,551	$ 1,161,973	$ 11,886,183	$ 11,044,831
Capital assets, net	25,556,896	23,719,972	49,507	46,272	25,606,403	23,766,244
Total assets	36,225,528	33,602,830	1,267,058	1,208,245	37,492,586	34,811,075
Long-term liabilities	5,970,092	4,376,222	10,242	10,270	5,980,334	4,386,492
Other liabilities	7,274,030	6,858,429	502,697	239,375	7,776,727	7,097,804
Total liabilities	13,244,122	11,234,651	512,939	249,645	13,757,061	11,484,296
Net assets:						
Invested in capital assets, net of related debt	24,706,355	23,449,373	40,277	38,450	24,746,632	23,487,823
Restricted	1,454,729	1,068,233	665,547	863,426	2,120,276	1,931,659
Unrestricted	(3,179,678)	(2,149,427)	48,295	56,724	(3,131,383)	(2,092,703)
Total net assets	$ 22,981,406	$ 22,368,179	$ 754,119	$ 958,600	$ 23,735,525	$ 23,326,779

The largest component of the State's net assets ($24.75 billion) reflects its investment in capital assets (land, buildings, machinery and equipment, State highway system, and other capital assets), less related debt still outstanding that was used to acquire or construct those assets. Restricted net assets are the next largest component ($2.12 billion). Net assets are restricted when constraints placed on their use are either externally imposed or are imposed by law through constitutional provisions or enabling legislation. The remaining portion, unrestricted net assets, consists of net assets that do not meet the definition of "restricted "or "invested in capital assets, net of related debt."

The government-wide statement of net assets for governmental activities reflects a negative $3.18 billion unrestricted net asset balance. The State of North Carolina, like many other state and local governments, issues general obligation debt and distributes the proceeds to local governments and component units. The proceeds are used to construct new buildings and renovate and modernize existing buildings on the State's community college and university campuses, assist county governments in meeting their public school building capital needs, and to provide grants and loans to local governments for clean water and natural gas projects. Of the $5.54 billion of total long-term debt outstanding at June 30, 2004, $4.57 billion is attributable to debt issued as State aid to component units (universities and community colleges) and local governments. The balance sheets of component unit and local government recipients reflect ownership of the related constructed capital assets without the burden of recording the debt obligation. The policy of selling general obligation bonds and funneling the cash proceeds to non-primary government (non-State) entities has been in place for decades. However, by issuing such debt, the State is left to reflect significant liabilities on its statement of net assets (reflected in the unrestricted net asset component) without the benefit of recording the capital assets constructed or acquired with the proceeds from the debt issuances. Additionally, as of June 30, 2004, the State's governmental activities have significant unfunded liabilities for compensated absences in the amount of $327 million and a $7.5 million cost settlement payable to the federal government (see Note 7 to the financial statements). These unfunded liabilities also contribute to the negative unrestricted net asset balance for governmental activities.

The following financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

Changes in Net Assets
For the Fiscal Years Ended June 30, 2004 and 2003
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2004	2003	2004	2003	2004	2003
Revenues:						
Program revenues:						
Charges for services	$ 1,505,090	$ 1,339,016	$ 926,891	$ 688,786	$ 2,431,981	$ 2,027,802
Operating grants and contributions	10,108,124	9,042,843	305,053	504,550	10,413,177	9,547,393
Capital grants and contributions	884,345	527,498	892	1,241	885,237	528,739
General revenues:						
Taxes						
Individual income tax	7,407,455	7,122,099	—	—	7,407,455	7,122,099
Corporate income tax	760,180	921,611	—	—	760,180	921,611
Sales and use tax	4,293,040	4,029,403	—	—	4,293,040	4,029,403
Gasoline tax	1,276,627	1,154,986	—	—	1,276,627	1,154,986
Franchise tax	560,708	584,584	—	—	560,708	584,584
Highway use tax	578,346	552,759	—	—	578,346	552,759
Insurance tax	432,975	417,126	—	—	432,975	417,126
Beverage tax	213,271	198,848	—	—	213,271	198,848
Inheritance tax	128,352	112,150	—	—	128,352	112,150
Other taxes	313,985	289,261	—	—	313,985	289,261
Tobacco settlement	147,224	173,256	—	—	147,224	173,256
Federal grants not restricted to specific programs	136,859	136,859	—	—	136,859	136,859
Unrestricted investment earnings	77,225	103,987	—	—	77,225	103,987
Miscellaneous	62,601	41,137	3	—	62,604	41,137
Total revenues	28,886,407	26,747,423	1,232,839	1,194,577	30,119,246	27,942,000
Expenses:						
General government	807,248	773,807	—	—	807,248	773,807
Primary and secondary education	7,223,766	6,865,921	—	—	7,223,766	6,865,921
Higher education	3,140,794	2,814,375			3,140,794	2,814,375
Health and human services	11,729,904	10,611,537	—	—	11,729,904	10,611,537
Economic development	536,055	489,111	—	—	536,055	489,111
Environment and natural resources	599,575	538,032	—	—	599,575	538,032
Public safety, corrections and regulation	2,093,404	2,029,233	—	—	2,093,404	2,029,233
Transportation	1,870,578	1,640,007	—	—	1,870,578	1,640,007
Agriculture	82,394	73,974	—	—	82,394	73,974
Interest on long-term debt	191,228	151,258	—	—	191,228	151,258
Unemployment compensation	—	—	1,389,266	1,603,796	1,389,266	1,603,796
EPA Revolving Loan	—	—	5,342	4,266	5,342	4,266
Other business-type activities	—	—	43,014	30,750	43,014	30,750
Total expenses	28,274,946	25,987,255	1,437,622	1,638,812	29,712,568	27,626,067
Increase (decrease) in net assets before contributions and transfers	611,461	760,168	(204,783)	(444,235)	406,678	315,933
Contributions to permanent funds	2,068	1,806	—	—	2,068	1,806
Transfers	(302)	4,918	302	(4,918)	—	—
Increase (decrease) in net assets	613,227	766,892	(204,481)	(449,153)	408,746	317,739
Net assets - beginning - restated	22,368,179	21,601,287	958,600	1,407,753	23,326,779	23,009,040
Net assets - ending	$ 22,981,406	$ 22,368,179	$ 754,119	$ 958,600	$ 23,735,525	$ 23,326,779

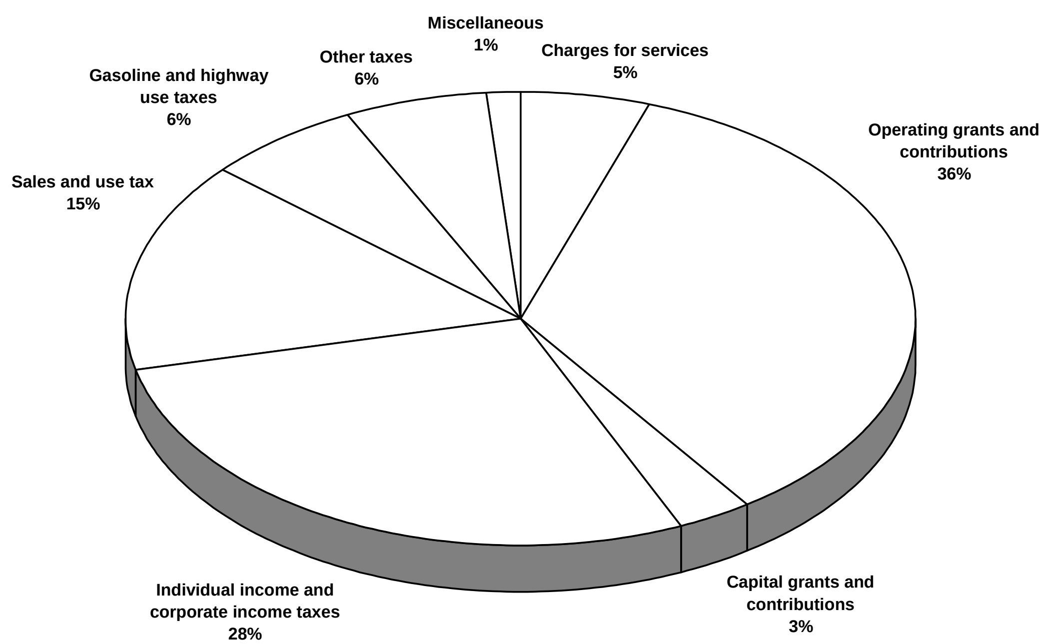
Governmental Activities

As a result of this year's operations, the net assets of governmental activities increased by $613.2 million or 2.7 percent. The net asset increase is primarily related to the overall growth in tax revenues (e.g., individual income, sales and use, and gasoline taxes) and spending reversions realized during the current fiscal year. The major exception to the growth in taxes was corporate taxes, which declined 17.5 percent from the previous fiscal year-end. Key factors in the decline in corporate taxes were reduced collections, an overall increase in the estimated refund rate, and the legislative suspension in the prior year of required distributions to special revenue funds. Although corporate profits were up, corporate tax collections were down because of tax code changes that allowed businesses to write-off expenses more quickly and the utilization of tax breaks and other incentives designed to attract new jobs to the State. Also, in the prior year, a portion of corporate income taxes, required to be distributed to special revenue funds, were retained by the General Fund to manage a budget shortfall.

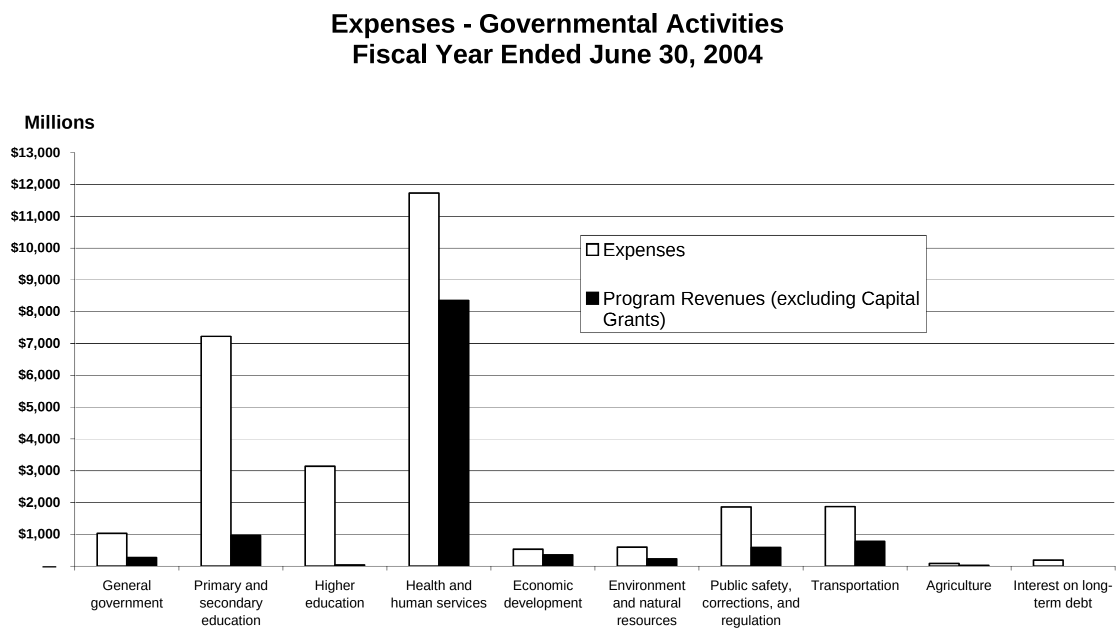
Total expenses of governmental activities grew by 8.8 percent during the current period (compared to total revenues growth of 8.0 percent). The majority of the spending growth was the result of funding increases in the State's two largest functional areas, education and health and human services. The increase in education spending is related to enrollment increases at the State's universities and community colleges and funding increases for the State's public schools. The growth in health and human services is the result of increased spending for Medicaid, which is the State's largest public assistance program. The growth in Medicaid is explained by an increase in individuals eligible for Medicaid services, a large increase in payments for dental services due to a lawsuit settlement that raised dental rates, and a significant increase in prescription drug payments and Disproportionate Share Hospital payments. There were also significant increases in the Electronic Benefits program due to higher client participation as a result of the recent economic downturn.

The following chart depicts revenue sources of governmental activities as percentages of total revenues for the fiscal year:

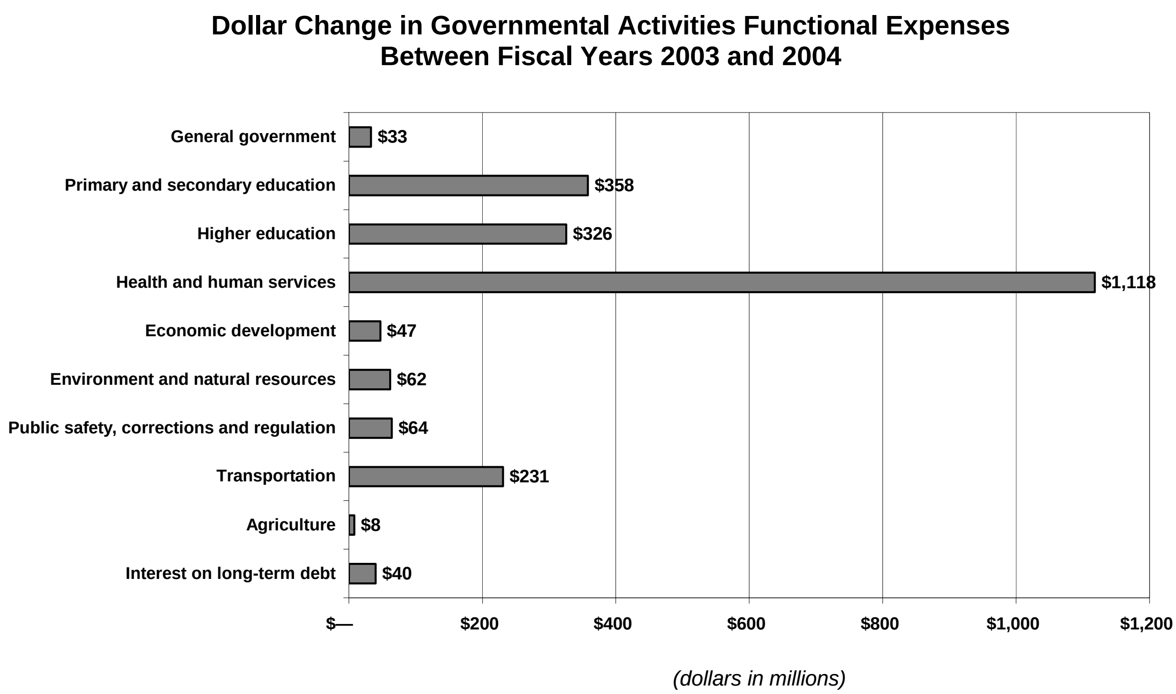
Revenues - Governmental Activities
Fiscal Year Ended June 30, 2004



The following chart depicts the total expenses and total program revenues of the State's governmental functions. This format identifies the extent to which each governmental function is self-financing through fees and intergovernmental aid or draws from the general revenues of the State.



The following chart reflects the dollar change in the functional expenses of governmental activities between fiscal years 2003 and 2004:



Business-type Activities

Business-type activities reflect a decrease in net assets of $204.5 million or 21.3 percent. The key reason for the decline was the Unemployment Compensation Fund's significant operating loss, which was financed by the proceeds of short-debt. At year-end, the net assets of the Unemployment Compensation Fund were $20.1 million, a decrease of $257.4 million or 92.7 percent from the prior fiscal year-end. The Unemployment Compensation Fund and the EPA Revolving Loan Fund are the predominant activities, comprising 87.6 percent of the total net assets of business-type activities. A more detailed discussion of the State's enterprise funds is provided in the following section.

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

The State uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements

Governmental Funds

The focus of the State's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. As of the end of the fiscal year, the State's governmental funds reported combined ending fund balances of $3.0 billion, a 14.7 percent increase from the prior fiscal year-end (as restated). The majority of the increase was related to debt proceeds recognized in other governmental funds for the N.C. Infrastructure Finance Corporation (Corporation), a blended component unit of the State. The Corporation issued debt for the repair and renovation of State facilities and for the acquisition and construction of correctional facilities. The major governmental funds are discussed individually below.

General Fund

The General Fund is the chief operating fund of the State. The fund balance of the General Fund decreased from a negative $167.139 million at June 30, 2003 (as restated) to a negative $196.287 million at June 30, 2004. A key factor in the decline was the Department of Revenue's revision of the refund rate for corporate taxes, which resulted in a $45.8 million reduction in corporate tax revenues for the 2004 fiscal year (Note: GAAP requires tax revenues to be reported net of estimated refunds). In addition, the total fund deficit continues to be influenced by the excess of accrued expenditures over accrued revenues for the State's Medicaid program. A more detailed analysis of the General Fund is provided in the budgetary highlights section (see next section).

2003-2004 General Fund Budgetary Highlights

The General Fund budget for fiscal year 2003-04 was signed into law on June 30, 2003. The enacted budget was founded upon an overall nominal (real growth plus inflation) economic growth rate of 3.5 percent for 2003-04. The appropriated budget included provisions that were designed to increase General Fund revenues. The most significant revenue adjustment was the continuation of two temporary tax increases that were scheduled to expire in 2003. In 2001, the General Assembly temporarily raised the State sales tax rate by a half-cent to 4.5 percent and the highest individual income tax rate from 7.75 percent to 8.25 percent. The budget continues the State sales tax rate at 4.5 percent and the 8.25 percent income tax bracket. In addition, several streamlining and conformity provisions, as well as departmental fees, were authorized that increase General Fund availability. Finally the Department of Revenue was given broader authority and resources to collect unpaid tax liabilities. The following table summarizes the 2004 revenue enhancements (amounts expressed in millions).

Revenue Enhancements – 2004 Fiscal Year

Maintain State sales tax at 4.5%	$ 341.8
Maintain top income tax bracket	37.5
Streamline tax revisions	78.5
Department of Revenue - Project Tax Collect	90.2
Tobacco settlement funds	66.8
Fee increases and trust fund transfers	87.0
Tax reductions for federal conformity	(70.0)
Federal fiscal relief	136.9
Federal disaster relief funds	108.8
Total 2004 enhancements	$ 877.5

The majority of funding increases for 2004 were in the education and human service areas. The budget provided full funding for enrollment increases in the University of North Carolina System ($46.6 million), the community college system ($32 million), and private colleges and universities ($2.8

million). In addition, the budget includes funds to hire additional public school teachers to reduce class size in the second grade ($25.3 million) and to expand the Governor's More-at-Four Program ($8.4 million), which helps prepare at risk four-year-old children for success in school. It also provides funds for the annual step increase for public school teachers ($48.1 million) and for ABC bonuses earned in the 2002-03 school year ($96 million).

The budget provides additional funding for the Health Insurance Program for Children ($12.2 million), which allows all eligible children to receive health care insurance (see Note 14C to the financial statements). In addition, expansion funds are provided for the Mental Health Trust Fund ($12.5 million) to facilitate the progress toward mental health reform.

The budget provided over $200 million in 2003-04 to support employee benefit programs. Specifically, it authorized a $550 one-time compensation bonus for State employees not included on the teacher salary schedule. In addition, the State Health Plan received sufficient funds to cover increased employee-related health care costs without reduction in benefits. The budget also began repayment of the funds withheld from the Retirement System in 2000-01 due to the budget shortfall (Note: the total obligation to the Retirement System was $129.9 million plus accrued interest). Legislation was enacted in 2001 to formalize the General Assembly's intent to repay the debt, subject to the availability of funds, over a five-year period beginning July 1, 2003. The budget authorized the payment of $10 million to partially repay the debt to the Retirement System. At year-end, the General Assembly authorized an additional payment of $20 million to the Retirement System.

General Fund Budget Variances

The original General Fund budget, including State appropriations and appropriations supported by departmental receipts, serves as a starting point or plan for the Governor to execute the General Fund budget pursuant to the powers granted by the Executive Budget Act. At the state level in North Carolina, it is not unusual for the budget to change during the fiscal year in relation to budget adjustments made to accommodate departmental receipts. The General Fund budget supported by State appropriation, is a subset of the General Fund financial schedule presented in the CAFR as required supplementary information. The current CAFR schedule reflects all spending required to support the State's General Fund activities and the funding to support those activities, including State tax and non-tax revenues, federal revenues, student tuition, and other fees, licenses, and fines.

Under current State budget management practice, particularly related to departmental federal receipts, primary emphasis is placed on comparisons of the final authorized budget and actual spending.

At the State level, budgetary cuts related to State appropriations are implemented by decreasing allowable actual expenditures, as opposed to decreasing the State appropriation through a formal legislative process. The Governor and State agencies maintain legal authority to spend the dollars originally appropriated to them, however, in recent years the actual spending has been limited by the collection of tax and nontax revenue. In extremely rare cases, the General Assembly has held special sessions to formally amend the State appropriation budget.

The portion of the original budget comprising departmental receipts is not intended to be the sole controlling point to manage the State's General Fund budget. The final budget includes amendments for departmental receipts collected during the fiscal year as allowed by law. General Fund departmental receipts are typically authorized for expenditure within the activity that generated the receipt. Historically, final estimated receipts have varied significantly from the original estimate at the beginning of the fiscal year. State agencies by law must spend departmental receipts prior to spending tax and nontax supported appropriations. If departmental receipts are higher than expected, appropriated dollars may go unspent and be re-appropriated in a subsequent fiscal year.

<u>Variances – Original and Final Budget</u>

The budget variance between original and final budget for f*ederal funds* revenue is attributable to the awarding of new federal funds during the fiscal year and funds being drawn down to reimburse unanticipated expenditures.

The budget variance for *intra-governmental transactions* revenue is attributable primarily to the following: $81.5 million of statewide encumbrance carry forward amounts from fiscal year 2002-2003, $126.4 million of Medicaid Disproportionate Share, $8.3 million of Department of Health and Human Services (DHHS)-cost report settlement, $272.9 million of DHHS-intra-governmental transfers within a DHHS general fund budget code, $351.2 million of DHHS funds transferred from various budget codes within DHHS, and $14.8 million of Mental Health Trust Fund intra-governmental transfers.

The budget variance for *contributions, gifts and grants* revenue is attributable primarily to the decision by the Division of Medical Assistance to change an accounting process to go on cost allocation, leading to the unexpected budgeting of $129.1 million for the State match.

For expenditures, the variances between the original budget and final budget are related to the corresponding revenue budget variances. As revenue budget accounts are increased, a corresponding increase occurs in the expenditure budget accounts. In addition to those increases, agency expenditure budgets were also increased by the allocation of statewide reserves such as the legislative salary increase, health insurance, and retirement reserves. There was also an additional appropriation of $88.1 million authorized for fiscal year 2003-2004 as a result of special sessions of the General Assembly.

<u>Variances - Final Budget and Actual Results</u>

The budget variance between final budget and actual revenues for *corporate income taxes* occurred because the growth in corporate profits exceeded the forecast. *Investment Income* was below the final budget because market interest rates were below the forecast.

Departmental *federal funds* actually received by agencies were $741.9 million less than the final budget. Of this variance, $357.2 million was attributable to the Department of Public Instruction. Actual federal draw downs are reflective of the actual expenditures of these federal funds. In addition, $190.8 million of the *Federal funds* variance is attributable to the Department of Health and Human Services not incurring qualifying costs as budgeted.

For expenditures, the variances between final budget and actual expenditures for *primary and secondary education* and *public safety, corrections, and regulation* occurred because actual revenues were less than the budgeted revenues; therefore, expenditures that depended on the receipt of these funds could not be made.

The State ended fiscal year 2003-04 with an over-collection of tax revenues of $242.4 million. The major tax categories that exceeded the budgeted forecast were *individual income* (1.1%), *corporate income* (9.2%), and *sales and use* (4.1%). In addition, unexpended appropriations or reversions of $159 million were realized. The State fiscal year 2003-04 closed out with a $289.4 million unreserved fund balance after transferring $116.7 million to the Rainy Day Fund and $76.8 million to the Repair and Renovation Reserve.

Highway Fund

The Highway Fund dates back to 1921, which is when the N.C. General Assembly first imposed the gasoline tax. It accounts for most of the activities of the North Carolina Department of Transportation, including the maintenance and construction of the State's primary, secondary, and urban road systems, the State Highway Patrol, the Division of Motor Vehicles, and transit and rail. The primary revenue sources of the Highway Fund are federal funds, three-fourths of gasoline taxes, vehicle registration fees, and driver's license fees.

The fund balance of the State Highway Fund decreased from $299.9 million at June 30, 2003 to $227.8 million at June 30, 2004, a decrease of 24 percent. The decline was the result of total expenditures exceeding total revenues for the current period. Over the past three years, the North Carolina Department of Transportation has used excess cash to advance construction projects and to accelerate contract resurfacing. Unbudgeted emergency relief expenditures for Hurricane Isabel and several ice storms also impacted cash flow. However, the excess of expenditures over revenues of $185.3 million in 2004 was smaller than the previous fiscal year because total revenues grew at a faster rate than total expenditures. Total revenues increased by $252.2 million or 11.7 percent primarily because of increases in gasoline taxes and federal funds. A 4 percent increase in taxable gallons sold combined with a 3 percent boost in the average fuel tax per gallon raised fuel tax revenues by $89.2 million. Federal billings rose $180.7 million due to increased Federal Highway Administration construction. Total expenditures increased by $207.7 million or 8.7 percent due to increased maintenance and construction expenditures. In addition, operating transfers to other funds increased by $24.4 million. During the fiscal year, the Highway Fund also received an advance of $15.4 million from a municipality for roadway and pedestrian improvements.

In September 2004, the State Board of Transportation approved a new long-range plan that prioritizes transportation investment for the next 25 years. The Statewide Transportation Plan provides a blueprint for greater investment in maintenance, preservation, and modernization of the State's existing highway system as well as other transportation options such as rail and public transportation. The share of transportation dollars spent on new highway projects will drop from 45 percent to 26 percent. The highway needs of the State's growing population will be accommodated in part by maintaining and upgrading existing roads and by increasing anti-congestion measures such as synchronized traffic signals.

The centerpiece of the plan is the Recommended Investment Scenario, which outlines priorities from the estimated $55 billion, in today's dollars, expected to be available over the next 25 years for transportation investment. Based on this scenario, the Department of Transportation (NCDOT) will be able to meet an additional 10 percent of its maintenance and preservation needs and nearly 25 percent more modernization infrastructure needs. Additionally, the scenario proposes increasing NCDOT's investment in other transportation modes. The plan also identifies $84 billion in total transportation needs and states that NCDOT will only be able to meet two-thirds of the State's 25-year transportation needs at its current funding levels, regardless of how NCDOT's resources are allocated. Full implementation of the Recommended Investment Scenario will be gradual.

Highway Trust Fund

Legislation creating the Highway Trust Fund was passed by the General Assembly in 1989. It was established to provide a dedicated funding mechanism to meet highway construction needs in North Carolina. The Highway Trust Fund also provides extra money for the State's municipalities to adequately maintain their streets and pays the debt service on the State's general obligation bonds issued for highway purposes. The principal revenue sources of the Highway Trust Fund are highway use taxes, one-fourth of gasoline taxes, and various title and registration fees. From the proceeds of the highway use tax, $252.4 million was transferred to the general fund for the 2003-04 fiscal year and thereafter, the transfer amount is scheduled to be $240 million per year subject to adjustment for inflation. The General Fund intends to repay by June 30, 2009 the $125 million (plus interest) advanced from the Highway Trust Fund during the 2002-03 fiscal year (see Note 9 to the financial statements).

The fund balance of the Highway Trust Fund increased from $208.2 million at June 30, 2003 to $266.1 million at June 30, 2004, an increase of 27.8 percent. The increase was attributable, in part, to $400 million of highway bonds issued on November 2003. The proceeds of these bonds were used to reimburse highway expenditures of prior years. These bonds constitute a portion of the $950 million highway bond authorization approved by the voters in November 1996 (Note: $250 million of such bonds were issued in 1997). At year-end, the remaining highway bond authorization was $300 million. Total revenues increased by $54.0 million or 5.7 percent, primarily because of increases in the gasoline tax and the highway use tax. Gasoline taxes rose $29.5 million due primarily to a 4 percent increase in taxable gallons sold combined with a 3 percent rise in the average fuel tax per gallon. Highway use taxes on vehicle registrations grew $25.6 million or 4.6 percent. Total expenditures increased by $220.9 million or 36.3%. The increase is due to a significant rise in contract lettings for the Transportation Improvement Program and N.C. Moving Ahead projects to address transportation infrastructure needs.

The 2003 General Assembly passed the Governor's "Moving Ahead" transportation initiative to allow, over two years, the use of $630 million of Highway Trust Fund cash balances for highway preservation, modernization, and maintenance. Additionally, it allows $70 million for public transit, rail, ferry, bicycle, and pedestrian projects.

Enterprise Funds

The State's enterprise funds or business-type activities provide the same type of information found in the government-wide financial statements, but in more detail. The major enterprise funds are discussed individually below.

Unemployment Compensation Fund

The net assets of the Unemployment Compensation Fund decreased by $257.4 million during the current fiscal year, which is a 92.7 percent decrease from the prior fiscal year-end. The decrease is explained primarily by the fund's significant operating loss (excess of operating expenses over operating income), which was financed by the proceeds of short-term debt. The operating loss was $509.6 million this year versus $956.1 million in 2003. At June 30, 2004, the short-term debt balance was $251.8 million compared to zero for the previous year-end. To ensure timely payment of unemployment benefits, the State received repayable advances from its Federal Unemployment Account and issued tax anticipation notes (see Note 6 to the financial statements). The State estimated that it will save millions of dollars in interest payments by selling tax anticipation notes instead of borrowing exclusively from the federal government. Unemployment benefit expenses decreased 13.4 percent in fiscal year 2004 to $1.39 billion. These expenses were lower because the State's unemployment rate fell during the second half of the fiscal year. North Carolina's seasonally adjusted unemployment rate was 5.5 percent in June 2004, making four consecutive months that the rate was below the national average. While manufacturing jobs declined since January 2004, all other sectors of the economy gained jobs during the second half of the fiscal year. Job gains were especially large in professional and business services and in educational and health services.

In fiscal years 2003 and 2002, the State also received funding for extended unemployment benefits. In March 2002, the U.S. Congress signed into law the Temporary Extended Unemployment Compensation Act of 2002. This program, which is financed entirely by federal funds, provided extended benefits to claimants who had exhausted their regular State unemployment benefits. This program ended during the 2004 fiscal year because of the decrease in the State's average unemployment rate.

The 2003 Session of the General Assembly enacted legislation to help preserve the integrity of the unemployment insurance tax system. Session Law 2003-67 (Senate Bill 326) clarifies that an employer cannot avoid an undesirable unemployment insurance rate by shifting employees to a newly created company with a more desirable tax rate. This practice is known as State unemployment tax avoidance or "SUTA dumping" (i.e., since the bulk of the old company's employees are moved to a new company and the higher tax rate of the older company is "dumped").

Starting January 1, 2005, a 20 percent surcharge will be in effect for unemployment insurance contributions, as required by State statute. The surcharge will be in effect because of the fund's low reserves. The proceeds of the surcharge will be credited to the Employment Security Commission Reserve Fund and will improve the solvency of the Unemployment Compensation Fund.

EPA Revolving Loan Fund

The net assets of the EPA Revolving Loan Fund increased by $58.9 million during the current fiscal year, which was a 10.1 percent increase from the prior fiscal year-end. Operating income was $9.99 million (excess of operating revenues over operating expenses). Net nonoperating revenues were $42.9 million, consisting primarily of federal capitalization grants and investment earnings. In addition, $7.4 million of clean water bond proceeds were transferred in from special revenue funds.

Capital Asset and Debt Administration

Capital Assets

As of June 30, 2004, the State's investment in capital assets was $25.61 billion, which represents an increase of 7.7 percent from the previous fiscal year-end (see table below).

Capital Assets as of June 30
(net of depreciation, dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
Land	$ 8,300,655	$ 7,713,505	$ 2,563	$ 2,563	$ 8,303,218	$ 7,716,068
Buildings	1,578,963	1,369,455	13,231	13,975	1,592,194	1,383,430
Machinery and equipment	562,864	551,155	1,314	1,047	564,178	552,202
Infrastructure:						
State highway system	13,284,267	12,444,212	—	—	13,284,267	12,444,212
Other infrastructure	76,859	80,489	7,866	8,669	84,725	89,158
Intangible assets	106,506	108,927	—	—	106,506	108,927
Art, literature, and other artifacts	1,126	7	—	—	1,126	7
Construction in progress	1,645,656	1,452,222	24,533	20,018	1,670,189	1,472,240
Total	$ 25,556,896	$ 23,719,972	$ 49,507	$ 46,272	$ 25,606,403	$ 23,766,244
Total percent change between fiscal years 2003 and 2004	**7.7 %**		**7.0 %**		**7.7 %**	

Major capital asset activity includes additions to the State highway system ($1.2 billion), right-of-way acquisitions ($510 million), and the acquisition/construction of correctional facilities ($239 million).

The largest component of capital assets is the State highway system and related right-of-ways. The State has approximately a 78,615-mile highway system, making it the second largest State-maintained highway system in the nation. The system continues to increase as roads are widened and new roads and bridges are constructed.

The 2002-2003 Session of the General Assembly authorized the issuance of up to $300 million of special indebtedness to finance the repair and renovation of State facilities and related infrastructure that are supported by the State's General Fund. Of the $300 million, approximately $157 million will be allocated to the University of North Carolina System (component unit). Each of the sixteen constituent institutions of the UNC System will receive a portion of the proceeds for repairs and renovations. The remaining $143 million of the proceeds will be used to make repairs and renovations to various State facilities located throughout North Carolina. The State issued $125 million in certificates of participation during the 2004 fiscal year to finance repair and renovation projects. At year-end, the remaining authorization was $175 million. In addition, the most recent session of the General Assembly (2003-2004) directed the transfer on June 30, 2004, of $76.8 million from the unrestricted credit balance of the General Fund in fiscal year 2004 to the Repairs and Renovations Reserve Account, to be applied to the repair and renovation of State and university facilities.

In July 2003, the N.C Infrastructure Finance Corporation (Corporation), a blended component unit of the State, acquired three close security correctional facilities by issuing $218.4 million in lease-purchase revenue bonds. Also, during the fiscal year, the Corporation issued $158.96 million in certificates of participation to construct and equip two close security correctional facilities and to begin designing a third facility. The Department of Correction is undertaking construction initiatives to address a cell shortfall and to allow for the implementation of sentencing reform. The State's correctional facility population has more than doubled since 1980. The rapid growth in inmates is attributable to increases in the State's population, increases in length of stay in correctional facilities, and changes in criminal laws.

As further detailed in Note 19(F) to the financial statements, the State has commitments of $1.9 billion for the construction of highway infrastructure, which are expected to be financed by gasoline tax collections and federal funds. Other commitments for the construction and improvement of State government facilities totaled $522.9 million, which are expected to be financed primarily by debt proceeds (certificates of participation), State appropriations, and federal funds.

More detailed information about the State's capital assets is presented in Note 5 to the financial statements.

Long-term Debt

At year-end, the State had total long-term debt outstanding of $5.54 billion, an increase of 34.9 percent from the previous fiscal year-end (see table below).

Outstanding Debt as of June 30
(dollars in thousands)

	Governmental Activities		Business-type Activities		Total	
	2004	2003	2004	2003	2004	2003
General obligation bonds	$ 4,982,860	$ 4,066,990	$ —	$ —	$ 4,982,860	$ 4,066,990
Revenue bonds	218,405	—	9,325	9,570	227,730	9,570
Certificates of participation	301,165	17,500	—	—	301,165	17,500
Notes payable	25,008	9,629	—	—	25,008	9,629
Total	$ 5,527,438	$ 4,094,119	$ 9,325	$ 9,570	$ 5,536,763	$ 4,103,689
Total percent change between fiscal years 2003 and 2004	**35.0 %**		**(2.6)%**		**34.9 %**	

The State's general obligation bonds are secured by a pledge of the faith, credit, and taxing power of the State. The revenue bonds issued by the State are secured solely by specified revenue sources. The certificates of participation (COPs) and lease-purchase revenue bonds issued by the N.C. Infrastructure Finance Corporation, a blended component unit of the State, are secured by lease and installment payments made by the State, and in the event of default, by a security interest in the leased facilities pursuant to a leasehold deed of trust (as applicable). The COPs issued for repair and renovation projects (see below) are not secured by a lien upon or security interest in the projects or any other property of the State. All payments of the State for the COPs and the lease-purchase revenue bonds are subject to appropriation by the General Assembly.

During the 2004 fiscal year, the State issued $1.159 billion in general obligations bonds (excluding refunding issues), $218.41 million in lease-purchase revenue bonds, and $283.96 million in certificates of participation (COPs). The new general obligation debt consisted of $708 million in public improvement bonds (consolidation of clean water bonds and higher education bonds), $400 million in highway bonds, $36 million in natural gas bonds, and $15 million in clean water bonds. The proceeds of the lease-purchase revenue bonds were used to acquire three close security correctional facilities in Alexander, Anson, and Scotland counties. The proceeds of the COPs will be used to construct and equip two close security correctional facilities in Greene and Bertie counties and to finance the cost of design and certain additional costs of a third close security correctional facility in Columbus County. The State also issued COPs for the repair and renovation of State facilities and related infrastructure that are supported by the General Fund.

The State refinanced $336.9 million of its existing debt in 2004 to improve cash flow and to take advantage of lower interest rates. By refinancing the debt, the State will reduce its future debt service payments by approximately $13.5 million over the next ten years.

Higher Education Authorization

The 1999-2000 Session of the General Assembly authorized the issuance of up to $3.1 billion of higher education improvement bonds, which were subsequently approved by the voters of the State. The $3.1 billion bond authorization represents the largest debt authorization in the State's history. The proceeds of these general obligation bonds will be used solely to construct new buildings and to renovate and modernize existing buildings on the State's 58 community college and 16 University of North Carolina campuses. These improvements are needed to meet enrollment demand and to ensure that the State's college and university buildings meet modern code requirements and are equipped to prepare graduates for twenty-first century jobs. The bond legislation passed by the General Assembly specifies the amount of bond funding that will flow to each community college and university campus. At year-end, the authorized but unissued higher education bonds were $1.37 billion.

Recent Legislation and Studies

The most recent session of the General Assembly (2003-04 Session) authorized the issuance of up to $468 million of special indebtedness to finance vital State facilities for health care and biotechnology. No more than $310 million of the special indebtedness may be issued during the 2004-05 fiscal year. The State is authorized to use special indebtedness to provide:

- $338 million for constructing five new projects in the University of North Carolina (UNC) System. These projects consist of a cancer center at UNC-Chapel Hill ($180 million), a cardiovascular institute at East Carolina University ($60 million), a bioinformatics Center at UNC-Charlotte ($35 million), a pharmacy program facility at Elizabeth City State University ($28 million), and a health center at UNC-Asheville ($35 million).
- $50 million for land acquisition and planning for five other projects in the UNC System;
- $35 million for constructing up to five youth development centers;
- $45 million for capital projects within the State Parks System, including repairs and renovations of park facilities and land acquisition. High priority uses of the debt proceeds include acquiring land near military bases to prevent encroachment.

The fiscal impact of the $468 million of special indebtedness on the General Fund is expected to be zero because of the annual transfer of revenue from other sources to the General Fund in an amount to cover the estimated debt service. The debt service for the UNC System facilities and the youth development centers will be reimbursed from the Health and Wellness Trust Fund and the Tobacco Trust Fund (special revenue funds). The debt service for the parks projects is fully funded by the streams of revenue available to the Parks and Recreation Trust Fund, the Natural Heritage Trust Fund, and the Clean Water Management Trust Fund (special revenue funds). The maximum annual debt service is estimated to be $47.4 million in fiscal year 2010-11. The total interest on the $468 million of debt is estimated to be $310 million.

Special indebtedness is non-voted debt that is generally secured only by an interest in State property being acquired or improved (e.g., certificates of participation and lease-purchase revenue bonds). With this type of debt, there is no pledge of the State's faith, credit or taxing power to secure the debt, which is why voter approval is not required. If the State defaulted on its repayments, no deficiency judgment could be rendered against the State, but the State property that serves as security could be disposed of to generate funds to satisfy the debt. Failure to repay the debt would have negative consequences for the State's credit rating. Article 9 of Chapter 142 of the General Statutes prohibits the issuance of special indebtedness except for projects specifically authorized by the General Assembly. The use of alternative financing methods provides financing flexibility to the State and permits the State to take advantage of changing financial and economic environments.

During the 2003-04 Session, the General Assembly created a Debt Affordability Advisory Committee (Committee) to annually advise the Governor and the General Assembly on the estimated debt capacity of the State for the upcoming ten fiscal years. The Committee is responsible for preparing an annual debt affordability study and establishing guidelines for evaluating the State's debt burden. The Committee is required to report its findings and recommendations to the Governor, the General Assembly, and the Fiscal Research Division of the General Assembly by February 1 of each year.

In April 2004, the State Treasurer presented to the House and Senate Finance Committees of the General Assembly, the second Debt Affordability Study for North Carolina. It provides a methodology for measuring, monitoring, and managing the State's debt capacity. The study evaluated the State's current and projected debt burden using indicators such as tax-supported debt to personal income, debt per capita, debt service to tax revenue, and rapidity of principal repayment ratios. In addition, the report includes several recommendations based on the results of the study. According to the report, all of the State's debt ratios are below median levels for all fifty states, as compiled by Moody's Investors Service, and for a peer group of seven states rated triple AAA by all three credit rating agencies. Thus, the study concludes that the State's debt is considered low and is manageable at the current level. However, due to the projected issuance of $2.2 billion of tax-supported debt over the next three years

(62 percent for higher education purposes), all of the State's debt ratios are expected to increase over this period. The State Treasurer noted in the report that credit rating agencies consider a debt affordability study as a positive factor when evaluating issuers and assigning credit ratings.

Credit Ratings

Credit ratings are the rating agencies' assessment of a governmental entity's ability and willingness to repay debt on a timely basis. Credit ratings are an important factor in the public credit markets and can influence interest rates a borrower must pay.

The State's general obligation bonds are rated "AAA" by Fitch Ratings, "Aa1" with a positive outlook by Moody's Investors Service (Moody's) and "AAA" with a stable outlook by Standard & Poor's Ratings Services. All three agencies base their prime ratings on the State's strong, diverse economic base, its sound financial management, and low debt levels. In September 2004, Moody's revised the State's outlook to positive from stable and noted the following:

> "*This rating reflects the State's slowly stabilizing economy, its improving tax revenues, its conservative debt policy, and its effective financial management. While general fund balances remain negative, flexible cash reserves outside the general fund are ample, and pension funding is exceptionally strong. Moody's expects that the state will continue to take actions to restore structural balance and rebuild reserves*."

In August 2002, Moody's downgraded the State's credit rating for general obligation debt from "AAA" to "Aa1", representing the first time since 1960 that North Carolina had less than a "AAA" rating. While Moody's praised the strength of executive powers available to insure a balanced budget, it advised that the primary reasons for the downgrade were the State's continued budget pressure, reliance on non-recurring revenues, and weakened balance sheet. Also, Moody's commented that the task of restoring structural budget balance and rebuilding reserves faces political and economic obstacles.

The certificates of participation and lease-purchase revenue bonds issued by the North Carolina Infrastructure Finance Corporation are rated "AA+" by Standard & Poor's, "AA" by Fitch, and "Aa2" by Moody's.

Limitations on Debt

The Constitution of North Carolina (Article 5, Section 3) imposes limitations upon the increase of certain State debt. It restricts the General Assembly from contracting debts secured by a pledge of the faith and credit of the State, unless approved by a majority of the qualified voters of the State, except for the following purposes:

1. To fund or refund a valid existing debt;
2. To supply an unforeseen deficiency in the revenue;
3. To borrow in anticipation of the collection of taxes due and payable within the current fiscal year to an amount not exceeding 50 percent of such taxes;
4. To suppress riots or insurrections; or to repel invasions;
5. To meet emergencies immediately threatening the public health or safety, as conclusively determined in writing by the Governor; and
6. For any other lawful purpose, to the extent of two-thirds of the amount by which the State's outstanding indebtedness shall have been reduced during the next preceding biennium.

More detailed information about the State's long-term liabilities is presented in Note 7 to the financial statements.

Budget and Economic Update

The General Fund budget for 2004-05 was signed into law on July 20, 2004. The enacted budget was founded upon an overall nominal (real growth plus inflation) economic growth rate of 5.5 percent for 2004-05. The budget continues the State sales and use tax rate at 4.5 percent and the 8.25 percent income tax bracket for fiscal year 2004-05 (Note: the half-cent sales tax increase and the high income tax bracket are scheduled to sunset at the end of the year), diverts a portion of the national tobacco settlement payments ($60 million), and uses monies left over at the end of the 2003-04 fiscal year ($289.4 million). It also earmarked an additional $116.7 million for the Rainy Day Fund and $76.8 million for the Repair and Renovation Reserve, indicating the State's intention to continue to replenish its reserves.

The 2004 hurricane season produced six tropical systems that directly impacted North Carolina. Federal, State, and local emergency management officials estimate that these storms caused over $200 million in damages that are eligible for governmental assistance. Assistance is for a variety of services including emergency protective measures, repair and replacement of homes, debris removal, stream clearance, and bridge repair and replacement. In order to match federal funds available to North Carolina for federal disaster recovery services, the Governor ordered State agencies to revert 0.75 percent of their 2004-05 budgets to provide an estimated $120 million for storm relief. Special exemptions are allowed for constitutionally mandated programs as well as emergency situations related to law enforcement, health care, and public safety.

North Carolina's seasonally adjusted unemployment rate as of September 2004 was 4.8 percent, more than a half a percentage point lower than the national unemployment rate of 5.4 percent. September was the seventh consecutive month that the State's unemployment rate was below the national average. For comparison, the State and national unemployment rates as of September 2003 were 6.4 percent and 6.1 percent, respectively.

2004-05 Revenue Update (Cash Basis)

For the first three months of the 2004-05 fiscal year, General Fund revenues, (tax and non-tax revenues) came in $74.3 million higher than the $3.5 billion forecast for the period. A continuation of the current trend would lead to revenue growth of 7.6 percent for the full year versus the 5.5 percent economic growth rate built into the budget. However, an analysis of the collection detail reveals that the improvement is not broad-based. Of the extra collections, $65.1 million came from one source, corporate income taxes. While other taxes are also increasing, the net surplus from other revenues is only $8.8 million. Additionally, $30 million of the extra corporate collections is the result of a one-time settlement in August 2004 of a long-standing corporate tax dispute not directly related to the economy. Also, $31.8 million of the corporate surplus came from a 33 percent rise in September 2004 payments. This rise is in contrast to the 10.2 percent decline in June and the 2.7 percent drop in April (April, June, and September are major corporate collection months). Because of the volatility of the corporate income tax, it will be difficult for the State to maintain this growth as higher interest rates and increased energy costs impact the economy

Other taxes are increasing but at different rates. The withholding of individual income tax receipts are $18.2 million behind schedule for the first quarter (4.6 percent growth versus budgeted rate of 5.7 percent). The primary factor is sluggish job growth. State and local sales tax collections rose by 8.2 percent for the July to September 2004 quarter versus the 6.1 percent projection for the period. However, the rate of growth slowed to 6.7 percent for September from almost 10 percent in August.

The impact of recent hurricanes has taken a severe toll on certain areas of the State. The effect on State and local revenues is hard to measure. In a typical disaster event, the front-end loss in withholding and sales tax revenue is eventually offset by gains during the recovery period due to reconstruction efforts and the makeup of lost production.

The improving revenue picture, though not as broad-based or as strong during prior recoveries, is dampened by the State's $1.1 billion structural budget gap for the 2005-06 fiscal year. The gap is due to a combination of tax increases that will expire ($525 million), one-time transfers used to balance the 2003-04 and the 2004-05 budgets, and one-time budget cuts. The budget gap numbers for North Carolina are typical of other states following the severe 2001-03 recession.

Conditions Expected to Impact Future Operations

The North Carolina Retirement System has identified major issues that will have a significant impact on the State's fiscal condition.

Demographic Factors: The Baby Boomers

The process of retirement for the demographic cohort known as the "Baby Boomers" will have tremendous economic, social, and political impact in North Carolina.

Two critical areas in which the "Boomer" retirement will be significantly consequential are: A) public sector workforce, and B) the cost to the State of providing retirement benefits.

Workforce Impact:

- The Baby Boomers are an eighteen-year cohort, currently between forty (40) and fifty-eight (58) years of age.
- In North Carolina this cohort constitutes approximately 59 percent of the State's public workforce. **Impact: the State's public sector workforce will have to be replenished as this cohort moves into retirement.**
- Further, replacement personnel will be drawn from a shrinking pool of workers made up of considerably smaller generations than the boomer predecessors. **Impact: the State will be faced with an increasingly competitive labor market**.
- **Implications: North Carolina will have to address these impacts by one or more of the following: expand its efforts to retain aging boomers in the public sector and thus slow the rate of retirement, or become more competitive in the labor market in order to recruit workers to State employment or reduce the number of public sector positions.**

Providing Retirement Benefits:

- The first year of the eighteen (18) year boomer cohort has just reached the average age of retirement in the State system for 2003, which is aged 58 ½. **Impact: the first of the Boomer cohort is on the cusp of retirement, marking the beginning of boomer retirement from the North Carolina public sector.**
- The total number of retirees in the North Carolina Teachers' and State Employees' Retirement System will increase 135% through 2022 (the total increase for both the State and the Local government systems is 141%). **Impact: the cost to the State of providing retirement benefits will increase**. (Note: Increasing costs are not driven by the cost of providing an actual pension as employees and employers fund the pension over the employee's service career. The increase in cost will come from administrative expenses and the cost of providing Cost of Living Adjustments (COLAs) for a significantly larger retiree pool.)
- While a set rate for Cost of Living Adjustments (COLA) is not specified in statute, the State has historically provided retirees with an annual COLA that matches the Consumer Price Index (CPI). **Impact: if the State continues to provide a COLA to retirees, expenditures from the General Fund will have to increase to cover the cost of providing such COLAs for an increasing pool of retirees.**
- **Implications: to be competitive in tomorrow's labor market, North Carolina will have to continue to provide attractive benefits such as the State's retirement plan; this will occur during a time when system administration and COLAs costs will increase significantly as the number of retirees exponentially expands.**

Retiree Health Care

The Governmental Accounting Standards Board (GASB) reporting guidelines that will require disclosure of the State's liabilities for retiree health care costs (i.e., GASB Statements No. 43 and 45) is one of the State's largest looming fiscal items. The Retirement System facilitates the benefit by making the deduction for the State Health Plan from retirees' pension checks. The Retirement System is also the front line organization for retirees who want to voice their concerns about changes, or potential changes, to benefits. Ultimately, the provision of health care for the State's public sector retirees is the responsibility of the State Health Plan. The unfunded actuarial liability for retiree health care is substantial because of the State's policy of funding these benefits on a pay-as-you-go basis.

In preparation for the new GASB standards on other postemployment benfits, the North Carolina General Assembly enacted legislation in 2004 establishing a Retiree Health Benefit Fund. The State's contributions to this fund are irrevocable, and the assets of the fund are not subject to the claims of the State's creditors. More detailed information about the State's obligations for Retiree Health Care is presented in the Letter of Transmittal.

In addition, the announcement of a new computer manufacturing facility by Dell, Inc. is expected to impact future operations.

Dell Manufacturing Facility

In November 2004, Governor Michael F. Easley announced that Dell, Inc. (Dell) will build a computer manufacturing facility in North Carolina. Dell, a leading manufacturer and distributor of computers and related products, plans to build and equip a state-of-the-art, 400,000-square-foot manufacturing and distribution facility in the Piedmont Triad region. Dell currently has two U.S. factories in Nashville, Tennessee and Austin, Texas. The North Carolina General Assembly convened a one-day special session on November 4, 2004 an approved an economic incentive for computer manufacturing companies that in the case of Dell, will provide up to $225 million in tax credits over the next fifteen years. For each year in which Dell meets the required performance targets, the State will provide a grant equal to 75 percent of the State personal income withholding taxes derived from the creation of new jobs.

Requests for Information

This financial report is designed to provide our citizens, taxpayers, customers, and investors and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the North Carolina Office of the State Controller, Accounting and Financial Reporting Section, 1410 Mail Service Center, Raleigh, N.C. 27699-1410. In addition, this financial report is available on the Office of the State Controller's Internet home page at http://www.ncosc.net/financial/financial.html.