

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

The following is a narrative overview and analysis of the State of North Carolina's (the State) financial performance for the fiscal year ended June 30, 2007. 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 by \$2.534 billion or 8.7% as a result of this year's operations. Net assets of governmental activities increased by \$2.211 billion, or 8% due, in part, to higher than expected growth in tax revenues. Net assets of business-type activities increased by \$323.184 million, or 23.3% due to the strong financial results of the Unemployment Compensation Fund. At year-end, net assets of governmental activities and business-type activities totaled \$29.844 billion and \$1.712 billion, respectively.
- Component units reported net assets of \$15.425 billion, an increase of \$2.107 billion or 15.8% from the previous year. About a quarter of the increase (\$562.2 million) is due to the net increase in capital assets, net of related debt for the University of North Carolina System and community colleges. The capital asset additions were financed in part by state debt proceeds.

Fund Financial Statements:

- The fund balance of the General Fund increased from \$1.966 billion at June 30, 2006 (as restated) to \$2.577 billion at June 30, 2007. The increase is explained primarily by higher than expected growth in individual income and corporate income taxes.
- The fund balance of the Highway Fund increased from \$568.785 million at June 30, 2006 to \$593.969 million at June 30, 2007, an increase of 4.4%. The fund balance growth was attributable to higher gasoline taxes and to legislative increases in motor vehicle license and registration fees, effective October 1, 2006.
- The fund balance of the Highway Trust Fund increased substantially from negative \$134.998 million at June 30, 2006 to a positive \$17.121 million at June 30, 2007. Key factors in eliminating the 2006 deficit were the substantial reduction in transfers to the General Fund and the growth in gasoline tax and highway use tax revenues.
- The net assets of the Unemployment Compensation Fund grew from \$507.477 million at June 30, 2006 to \$746.108 million at June 30, 2007. The net asset growth is explained by the State's lower unemployment rate and by a 20% statutory surcharge on unemployment contributions.
- The N.C. Education Lottery (NCEL) began selling instant game tickets in March 2006 and Powerball tickets in May 2006. In the first fifteen months of operation, the NCEL earned more than \$377 million to support educational programs for the State, meeting its goal of transferring 35% of total revenues.

Capital Assets:

- The State's investment in capital assets (net of accumulated depreciation) was \$30.916 billion, an increase of 5.2% from the previous fiscal year-end.
- This year's major capital asset additions were for highway construction (\$1.2 billion), highway land improvements (\$477 million), construction of correctional facilities (\$70 million), and construction of a new psychiatric hospital (\$47 million).

Long-term Debt:

- The State had long-term debt (bonds and similar debt payable) outstanding of \$6.912 billion, an increase of 6% from the previous fiscal year-end. The long-term debt balance includes \$972.685 million of special obligation (non-voted) debt issued for governmental activities.
- The State regained Moody's Rating Service Aaa rating status in January 2007 after having been downgraded to Aa1 in August 2002. In support of the upgrade, Moody's cited strong financial performance, replenishment of depleted reserves, recent economic gains that surpass national averages, and the State's effective fiscal management and healthy financial outlook.
- The State maintained its AAA bond rating with Standard and Poor's and Fitch Ratings.

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 54) 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 56 and 57) 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, the N.C. State Lottery 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 76. 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 153 and 154).

Fund Financial Statements

The fund financial statements provide more detailed information about the State's most significant funds (i.e., major funds) – not the State as a whole. 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 particular purposes. In addition to the major funds, page 180 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 cash and other financial assets that can readily be converted to cash flow in and out (i.e., inflows and outflows of spendable resources) and the balances left at year-end that are available for spending (i.e., balances of spendable resources). Consequently, the governmental fund financial statements provide a detailed short-term view that helps users determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. The State prepares the governmental fund financial statements using the modified

accrual basis of accounting and a current financial resources measurement focus. Because this information does not encompass the additional long-term focus of the government-wide statements, a reconciliation schedule, which follows each of the governmental fund financial statements, explains the relationships (or differences) between them. Information is presented separately in the governmental fund financial statements for the General Fund, the Highway Fund, and the Highway Trust Fund, all of which are considered to be major funds. Data for all other governmental funds are combined into a single aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the form of combining statements elsewhere in this report.

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, the N.C. State Lottery 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 Property Fire Insurance Fund, the Motor Fleet Management Fund, Computing Services Fund, and the State Telecommunications Services Fund. Because the State's internal service funds predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. Information is presented separately in the proprietary fund financial statements for the Unemployment Compensation Fund, the N.C. State Lottery Fund, and the EPA Revolving Loan Fund, all of which are considered to be major funds. Conversely, separately aggregated columns are presented for the nonmajor enterprise funds and the internal service funds. Individual fund data for the nonmajor enterprise funds and internal service funds is provided in the form of combining statements elsewhere in this report.

Fiduciary funds -- Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the State's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets. These funds include pension and other employee benefit trust funds, private-purpose trust funds, investment trust funds, and agency funds.

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 74** of this report.

Required Supplementary Information

Following the basic financial statements and notes to the financial statements is Required Supplementary Information (RSI), which accompanies the basic financial statements. The RSI is mandated by the GASB and includes General Fund budgetary comparison schedules reconciling the statutory to the generally accepted accounting principles (GAAP) fund balances at fiscal year-end, and pension plan trend information related to funding progress and contributions.

Other Supplementary Information

Other supplementary information includes the introductory section, the combining financial statements for non-major governmental funds, non-major enterprise funds, internal service funds, fiduciary funds, and non-major discretely presented component units.

FINANCIAL ANALYSIS OF THE STATE AS A WHOLE

Over time, increases or decreases in net assets serve as a useful indicator of whether a government's financial position is improving or deteriorating. The State's combined net assets increased \$2.534 billion or 8.73% over the course of this fiscal year's operations. The net assets of the governmental activities increased \$2.211 billion or 8% and business-type activities increased \$323.184 million or 23.3%. The following table was derived from the government-wide Statement of Net Assets:

Net Assets June 30, 2007 and 2006 (dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2007	2006	2007	2006	2007	2006
Current and other non-						
current assets.....	\$ 17,519,604	\$ 15,182,356	\$ 2,115,414	\$ 1,706,801	\$ 19,635,018	\$ 16,889,157
Capital assets, net.....	30,889,259	29,363,786	26,673	26,975	30,915,932	29,390,761
Total assets.....	48,408,863	44,546,142	2,142,087	1,733,776	50,550,950	46,279,918
Long-term liabilities.....	7,599,257	7,285,532	3,885	3,779	7,603,142	7,289,311
Other liabilities.....	10,965,284	9,627,568	426,458	341,437	11,391,742	9,969,005
Total liabilities.....	18,564,541	16,913,100	430,343	345,216	18,994,884	17,258,316
Net assets:						
Invested in capital assets,						
net of related debt.....	29,689,201	28,052,926	26,673	26,975	29,715,874	28,079,901
Restricted.....	1,076,470	890,602	1,612,943	1,286,477	2,689,413	2,177,079
Unrestricted.....	(921,349)	(1,310,486)	72,128	75,108	(849,221)	(1,235,378)
Total net assets.....	\$ 29,844,322	\$ 27,633,042	\$ 1,711,744	\$ 1,388,560	\$ 31,556,066	\$ 29,021,602

The largest component of the State's net assets (\$29.716 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 (\$2.689 billion). Net assets are restricted when constraints placed on their use are 1) externally imposed by creditors, grantors, contributors, or laws or regulations of other governments or 2) legally imposed through constitutional provisions. 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 \$921.3 million 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 \$6.875 billion of bonds and certificates of participation outstanding at June 30, 2007, \$5.88 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, 2007, the State's governmental activities have significant unfunded liabilities for compensated absences in the amount of \$382.316 million (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, 2007 and 2006
(dollars in thousands)

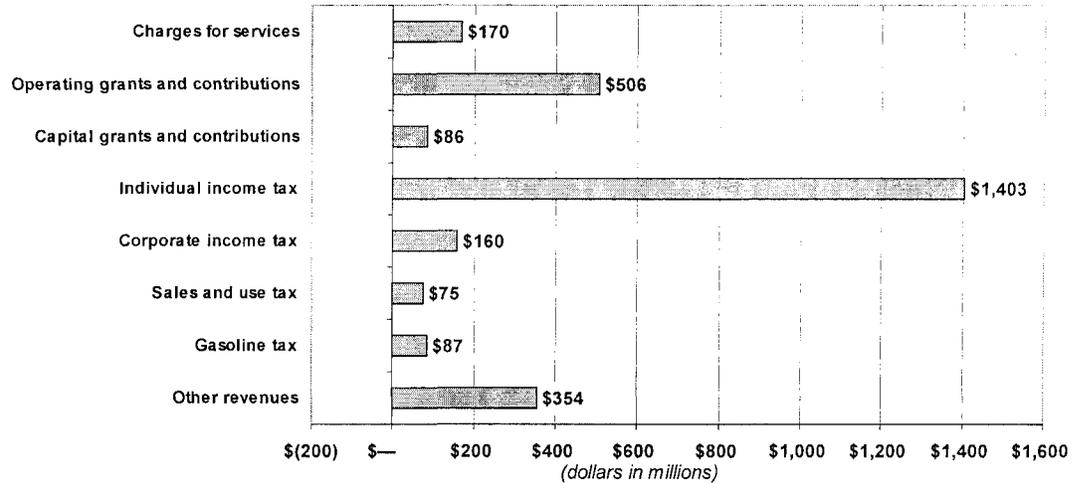
	Governmental Activities		Business-type Activities		Total Primary Government	
	2007	2006	2007	2006	2007	2006
Revenues:						
Program revenues:						
Charges for services.....	\$ 2,160,500	\$ 1,990,401	\$ 2,043,306	\$ 1,400,064	\$ 4,203,806	\$ 3,390,465
Operating grants and contributions.....	12,009,937	11,504,184	106,000	63,745	12,115,937	11,567,929
Capital grants and contributions.....	1,000,079	914,090	142	258	1,000,221	914,348
General revenues:						
Taxes						
Individual income tax.....	10,739,562	9,336,745	—	—	10,739,562	9,336,745
Corporate income tax.....	1,466,148	1,306,193	—	—	1,466,148	1,306,193
Sales and use tax.....	5,108,456	5,033,040	—	—	5,108,456	5,033,040
Gasoline tax.....	1,601,764	1,514,626	—	—	1,601,764	1,514,626
Franchise tax.....	671,151	628,029	—	—	671,151	628,029
Highway use tax.....	607,511	577,237	—	—	607,511	577,237
Insurance tax.....	487,081	442,297	—	—	487,081	442,297
Beverage tax.....	245,990	233,315	—	—	245,990	233,315
Inheritance tax.....	162,746	133,158	—	—	162,746	133,158
Tobacco products tax.....	241,687	187,566	—	—	241,687	187,566
Other taxes.....	330,888	294,986	—	—	330,888	294,986
Tobacco settlement.....	144,075	139,638	—	—	144,075	139,638
Unrestricted investment earnings.....	212,074	123,170	—	—	212,074	123,170
Miscellaneous.....	47,170	37,252	15	—	47,185	37,252
Total revenues.....	37,236,819	34,395,927	2,149,463	1,464,067	39,386,282	35,859,994
Expenses:						
General government.....	1,265,450	1,028,506	—	—	1,265,450	1,028,506
Primary and secondary education.....	9,096,758	8,213,146	—	—	9,096,758	8,213,146
Higher education.....	4,405,930	3,471,916	—	—	4,405,930	3,471,916
Health and human services.....	14,360,634	13,439,582	—	—	14,360,634	13,439,582
Economic development.....	624,306	644,733	—	—	624,306	644,733
Environment and natural resources.....	723,504	614,527	—	—	723,504	614,527
Public safety, corrections and regulation.....	2,483,398	2,250,524	—	—	2,483,398	2,250,524
Transportation.....	2,019,917	1,798,846	—	—	2,019,917	1,798,846
Agriculture.....	89,257	105,256	—	—	89,257	105,256
Interest on long-term debt.....	273,123	264,287	—	—	273,123	264,287
Unemployment compensation.....	—	—	864,981	849,945	864,981	849,945
N.C. State Lottery.....	—	—	559,373	153,125	559,373	153,125
EPA Revolving Loan.....	—	—	14,228	11,414	14,228	11,414
Regulatory commissions.....	—	—	31,144	28,510	31,144	28,510
Insurance programs.....	—	—	26,624	16,009	26,624	16,009
North Carolina State Fair.....	—	—	11,433	10,497	11,433	10,497
Other business-type activities.....	—	—	5,686	5,735	5,686	5,735
Total expenses.....	35,342,277	31,831,323	1,513,469	1,075,235	36,855,746	32,906,558
Increase (decrease) in net assets before contributions and transfers.....	1,894,542	2,564,604	635,994	388,832	2,530,536	2,953,436
Contributions to permanent funds.....	3,928	4,674	—	—	3,928	4,674
Transfers.....	312,810	67,740	(312,810)	(67,740)	—	—
Increase (decrease) in net assets.....	2,211,280	2,637,018	323,184	321,092	2,534,464	2,958,110
Net assets - beginning - restated.....	27,633,042	24,996,024	1,388,560	1,067,468	29,021,602	26,063,492
Net assets - ending.....	\$ 29,844,322	\$ 27,633,042	\$ 1,711,744	\$ 1,388,560	\$ 31,556,066	\$ 29,021,602

Governmental Activities

For fiscal year 2007, revenues outpaced expenses and when combined with transfers from the State's business-type activities, an increase of \$2.211 billion in net assets resulted for governmental activities. Total revenues increased 8.3% in fiscal year 2007 to \$37.237 billion. The increase in revenues is attributable mostly to higher than expected growth in individual income and corporate income tax collections. Additionally, the legislature increased driver's license, vehicle registration, and other motor vehicle fees, effective October 1, 2005. Fiscal year 2007 includes a full year implementation of these fee increases (included in "Charges for services" above). Gasoline tax collections were higher because of increases in the motor fuels tax rate. Net transfers-in were much higher in fiscal year 2007 due to the new State lottery, which only had 3 months of sales in the prior year.

The following chart reflects the dollar change in the revenues by source of governmental activities between fiscal years 2006 and 2007:

**Dollar Change in Governmental Activities Revenues by Source
Between Fiscal Years 2006 and 2007**



Total expenses increased by 11% to \$35.342 billion, primarily because of funding increases in the State's three largest functional areas, primary and secondary education, higher education, and health and human services. In 2007, primary and secondary education increased 10.8% and higher education increased 26.9%. The growth in education funding is related to enrollment increases at the State's universities, community colleges, and public schools and to salary increases for teachers and faculty. The significant growth in higher education is also due to larger distributions of higher education bond proceeds in 2007.

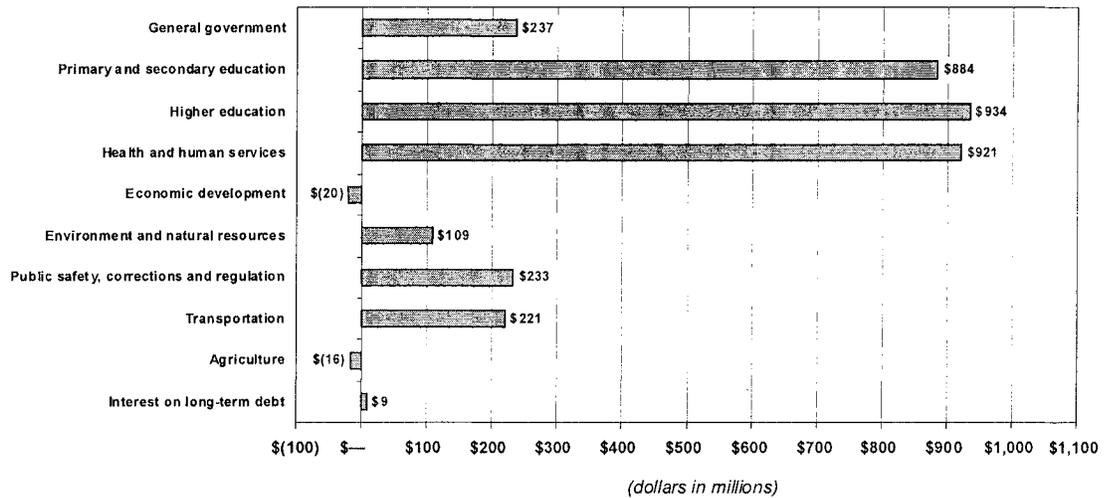
Higher education expenses are financed primarily by State appropriations. The State Constitution provides that "the benefits of the University North Carolina and other public institutions of higher education, as far as practicable, be extended to the people of the State free of expense."

Total health and human services (HHS) spending increased 6.9% in 2007. For comparison, HHS spending increased by less than 1% in 2006 and increased by 14.1% in 2005 and 10.5% in 2004. The growth in health and human services is the result of increased spending for Medicaid, which is the State's largest public assistance program. Medicaid is a federal entitlement program, which means individuals found eligible for Medicaid have legal rights to receive services and cannot be denied coverage by the State. In North Carolina, Medicaid is administered by the State and counties and financed with federal, State, and county funds. The slow growth in State funding for Medicaid in 2007 was due to a higher federal match rate and savings to the State from the new Medicare Drug Plan. Higher growth rates occur during years of economic distress and when major Medicaid expansions are enacted. Lower growth rates occur when the Medicaid population is stable or declining.

The 2007 Session of the General Assembly enacted legislation requiring the State to assume the counties' share of the nonfederal share of Medicaid costs over a three-year period, beginning October 1, 2007. To provide resources to assume these costs, the legislation phases out the local sales tax by one-half cent and makes a corresponding increase in the State sales tax rate.

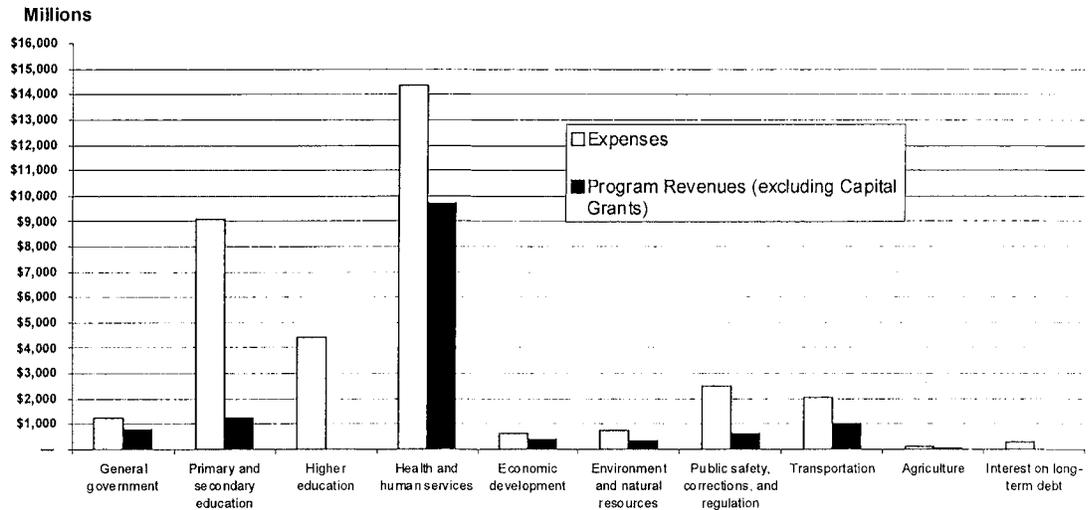
The following chart reflects the dollar change in the functional expenses of governmental activities between fiscal years 2006 and 2007:

Dollar Change in Governmental Activities Functional Expenses Between Fiscal Years 2006 and 2007



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.

Expenses - Governmental Activities Fiscal Year Ended June 30, 2007



Business-type Activities

Business-type activities reflect an increase in net assets of \$323.184 million or 23.3%, primarily because of the strong financial results of the Unemployment Compensation Fund. For fiscal year 2007, the Unemployment Compensation Fund had an operating income (excess of operating revenues over operating expenses) of \$236.448 million. The Unemployment Compensation Fund and the EPA Revolving Loan Fund comprise 94% of the total net assets of business-type activities. The N.C. State Lottery Fund has no net assets since its net profits are distributed to the State's governmental activities, as required by statute. A more detailed discussion of the State's business-type enterprise activities is provided in the following section (see Enterprise Funds).

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 \$6.349 billion, an increase of 21.2% or over a billion dollars from the prior fiscal year-end (as restated). Over half of the increase is explained by the strong financial performance of the General Fund, which realized higher than expected growth in tax revenues during the fiscal year. Another contributing factor was the \$164 million increase in fund balance of the Escheat Fund (nonmajor governmental fund) in 2007. The Escheat Fund reported a substantial increase in total revenues due, in part, to the General Assembly reducing the holding period for unclaimed securities and to a settlement reached in March 2000 with insurance companies that led to large remittances of uncashed refund checks in the current period. 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 increased from \$1.966 billion at June 30, 2006 (as restated) to \$2.577 billion at June 30, 2007, an increase of 31.1%. The increase is explained primarily by higher than expected growth in individual income and corporate income taxes. For individual income taxes, withholding tax collections grew by 8% while collections of estimated taxes and final payments grew by 11% and 26%, respectively. The withholding growth rate is similar to that of a pre-recession economy and reflects both job and wage growth. Increases in estimated and final payments also reflect changes in non-wage income. Corporate income taxes, which are highly volatile over the business cycle, grew by 12.3% because of improved demand for products and services and because of the Department of Revenue's Settlement Initiative Program. This initiative began in February 2006 and allowed taxpayers who had participated in income-shifting or other identified tax strategies to pay 100% of the tax and interest and receive a waiver of some percentage of the penalties. For the 2006-07 fiscal year, corporate income tax collections under this initiative were over \$101 million. A more detailed analysis of the General Fund is provided in the budgetary highlights section below.

2006-07 General Fund Budgetary Highlights

The appropriated budget included provisions that were designed to adjust 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% and the highest individual income tax rate from 7.75% to 8.25%. The 2006 Short Session of the General Assembly (2006 Session) reduced the State sales tax rate to 4.25%, effective December 1, 2006 and reduced the top income tax bracket to 8%, effective January 1, 2007. Additionally, they increased the baseline revenue forecast by \$698.9 million because of the growing economy and reduced the transfer from the Highway Trust Fund by \$195.2 million to complete reimbursement of a one-time transfer made to the General Fund in fiscal year 2002-03. Prior to fiscal year 2005-06, the tobacco products tax had traditionally not been considered a major source of General Fund tax revenue. However, the 2005 Session of the General Assembly raised the tobacco products tax by 25 cents effective September 1, 2005 and by another 5 cents effective July 1, 2006. The following table summarizes the revenue adjustments made by the 2006 Session (dollars in millions).

Revenue Adjustments – 2007 Fiscal Year
2006 Short Session of the General Assembly

Adjustment to baseline revenue forecast.....	\$ 698.9
Reduce State sales tax from 4.5% to 4.25%	(140.1)
Reduce top income tax rate at 8.25% to 8%.....	(28.6)
Reduce transfer from Highway Trust Fund.....	(195.2)
Other changes.....	(24.1)
Total 2007 adjustments.....	\$ 310.9

The majority of funding increases for 2007 were for education, human services, and employee benefit programs. The budget provided full funding for enrollment increases in the public schools (\$76.3 million), the University of North Carolina System (\$79 million), and the community college system (\$7.1 million). In addition, the budget appropriated \$41.9 million to ensure full funding for low wealth local education agencies whose ability to generate local revenue per student is below the State average. It also provided funds for ABC teacher bonuses earned in the 2005-06 school year (\$90 million). In accordance with General Statutes, receipts from the N.C. Education Lottery Fund were budgeted to support class size reduction (\$127.9 million) and to support the Governor's More-at-Four Program (\$66.6 million). An additional \$18 million of lottery proceeds will support program expansion. The More-at-Four program prepares at risk four-year-old children for success in school.

The budget provided \$664 million in 2006-07 for teacher and State employee salary increases. Specifically, teachers received an average 8% salary increase, community college faculty and professional staff received a 6% recurring increase and a 2% one-time bonus, university faculty and professional staff received a 6% increase, and all other State employees received a 5.5% increase. In addition, the budget included a 3% cost-of-living adjustment for retirees and approved payment of \$30 million to repay funds withheld from the Retirement System in 2000-01 due to the budget crisis.

State funding for the Medicaid Program totaled \$2.6 billion in 2006-07 (compared to \$2.5 billion in 2005-06) and the total Medicaid budget was \$8.9 billion. The slow growth in General Fund appropriations for the Medicaid Program in fiscal year 2006-07 was due to a higher federal match rate and savings to the State from the new Medicare Drug Plan. The 2006 Session of the General Assembly made policy changes to the Medicaid program and increased the budget by \$45.6 million to support these changes. The most significant policy changes included a one-time cap on the county share of Medicaid (\$27.4 million) and funding for inflationary increases for Medicaid providers effective January 1, 2007 (\$12 million).

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.

Variances – Original and Final Budget

In general, the variances between original and final budget are attributable to the timing and length of the budget preparation process. The original budget for the 2006-07 fiscal year was prepared approximately 18 months prior to the final budget existing at June 30, 2007. The final budget reflects all budget revisions made throughout the fiscal year to adjust for known facts. Furthermore, it cannot be assumed that each agency accurately prepares their budget. Consequently, when the original budget is compared to the final budget, it would be expected that significant variances can occur.

The *federal funds* budget variance between original and final budget was \$1.4 billion. This variance resulted from the awarding of new federal grants and the awarding of increased amounts in long-standing federally supported programs. Also, variances occurred because of understatement of the original federal budget during the continuation budget process.

The budget increase for *intra-governmental transactions* revenue is primarily attributable to the following: \$242.8 million of statewide encumbrance carry forward amounts from fiscal year 2005-2006, \$144.3 million of Department of Health and Human Services (DHHS) Medicaid Disproportionate Share, \$24.36 million of Mental Health Trust Fund transfers to DHHS, and transfers between divisions of DHHS. None of these amounts were included in the original budget.

The budget increase for *contributions, gifts, and grants* of \$1.1 billion is attributable primarily to DHHS's budgeting of state match throughout the fiscal year, as opposed to including a reasonable original budget estimate. The budget increase for *Universities* of \$609.8 million is attributed to underestimated tuition amounts and the budgeting of fiscal year 2005-06 carry-forward amounts.

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, hospitalization, retirement, and salary adjustment.

Variances - Final Budget and Actual Results

Actual revenues collected exceeded final budget for several reasons. First, the revenue forecast was on the conservative side of "most likely". Secondly, this forecast was prepared months prior to the beginning of the fiscal year and as the time period between a fiscal year and forecast preparation increases, forecasted amounts become less accurate. Finally, the economy performed much better than anticipated. Strong employment and wage growth fueled individual income collections that exceeded expectations. In addition, corporate collections continued to surge due to strong corporate profits and improvement in the business climate.

Departmental *federal funds* actually received by agencies were \$1.32 billion less than the final budget. Actual federal draw downs are reflective of the actual expenditures of federal funds. Therefore, if qualifying costs are not incurred by an agency, the actual drawdown of federal funds could be significantly less than what has been budgeted. This was the situation in fiscal year 2006-07.

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

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 and secondary 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 increased from \$568.785 million at June 30, 2006 to \$593.969 million at June 30, 2007, an increase of 4.4%. Total revenues decreased by \$46.8 million or 1.68% primarily because of a significant decrease in federal funds. Full Federal Obligation Authority was not available from the Federal Highway Administration until March 2007, thereby delaying the rate at which federal reimbursement could be billed. However, the decrease in federal funds was partially offset by increases in gasoline taxes and fees, licenses, and fines. Gasoline taxes increased due to a revised rate of 29.9 cents per gallon in fiscal year 2007 (now capped) versus an average of 28.5 cents per gallon in fiscal year 2006. Gasoline taxes are indexed to the wholesale price of fuel over a six-month period, which remained high in fiscal year 2007. The tax rate increase offsets the 2.8% decrease in gallons of motor fuel sold during the fiscal year. In 2006, the General Assembly increased motor vehicle license and registrations fees effective October 1, 2006. The increase in 2007 represents a full year implementation of these increases versus a partial impact in 2006. These fees included driver's license, vehicle registration, and other fees collected by the Division of Motor Vehicles.

Transportation expenditures increased by \$61.184 million or 2.5%. Double-digit inflationary increases in the costs of aggregate, asphalt, and gasoline along with increased costs to replace heavy equipment countered decreased contract lettings to result in an overall expenditure increase. Debt service expenditures increased from zero in 2006 to \$20.766 million in 2007. Outstanding loans from the Town of Cary and the City of Wilson were repaid. These loans are part of the Department of Transportation's innovative financing plan to assist in accelerating project delivery and to help offset double digit inflation in construction costs.

Population growth is placing an increasing demand on the State's transportation system. North Carolina's population grew from 7.55 million in 1998 to 9.03 million in 2007, an increase of 19.6%. According to the *2006 Report on the Condition of the State Highway System*, prepared by the Division of Highways, over the past 10 years (1995 to 2005), the number of paved miles increased by more than 12.3% and the square footage of bridge deck area grew by 20.5%. During this same 10 year period, vehicle miles traveled increased by 32.6%. This rapid increase in vehicle miles traveled places a heavier burden on the existing infrastructure and accentuates the need for additional capacity, safety, and maintenance funding to address the deterioration in service created by the increase in traffic. Furthermore, many of the State's highways were built as farm-to-market roads and were not designed to handle the heavy traffic volumes of today and other highways such as the interstate highway system, which has celebrated its 50th anniversary, are nearing the end of their functional life.

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% to 26%. 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.

On October 17, 2007 the State issued \$287.57 million of Grant Anticipation Revenue Vehicle (GARVEE) bonds. The GARVEE bonds are payable solely from federal aid revenues received on behalf of the State. There are currently 29 projects slated for the use of GARVEE funds. By the use of innovative financing plans such as the GARVEE program, project delivery time can be accelerated and inflationary pressures minimized.

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 a specific set of highway construction needs in North Carolina. Additionally, the Highway Trust Fund provides supplemental allocations for secondary road construction, supplemental assistance to municipalities for local street projects, 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. The enabling legislation also specifies that a designated amount will be transferred each year to the General Fund (see Note 9 to the financial statements). The amounts transferred to the General Fund for fiscal years 2006 and 2005 were \$252.55 million and \$243.77 million, respectively. The amount transferred for fiscal year 2007 was reduced to \$57.49 million. This decrease represented the repayment of the balance of a loan made to the General Fund in fiscal year 2003.

The fund balance of the Highway Trust Fund increased substantially from negative \$134.998 million at June 30, 2006 to \$17.121 million at June 30, 2007. The key factors in eliminating the 2006 deficit were the substantial reduction in transfers to the General Fund referenced above and the growth in gasoline tax and highway use tax revenues, which increased by 5.8% and 5.2%, respectively. Gasoline tax collections increased due to the revised rate of 29.9 cents per gallon in fiscal year 2007 versus an average of 28.5 cents per gallon in fiscal year 2006. The tax rate increase offsets the 2.8% decrease in gallons of motor fuel sold during the fiscal year. Highway use tax transactions decreased by 0.2% in 2007; however, the average dollar amount per transaction increased by 5.4% resulting in an overall increase in collections. Total expenditures increased by \$13.308 million or 1.5%.

The 2006 Report on the Condition of the State Highway System also noted that since passage of the Highway Trust Fund in 1989, the Department of Transportation has paved over 10 thousand miles of unpaved secondary roads, leaving only 3,400 miles of secondary roads to be paved. In view of the fact that the paved secondary road system has not kept up with the demands of increased urbanization and traffic, the 2006 Session of the General Assembly approved changes in the General Statutes that govern the use of secondary road construction funds. House Bill 1825 allows the use of these funds, originally designated to pave secondary roads, on the paved secondary road system in order to improve their functionality through safety, modernization, and condition improvements.

In 2003, the 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. More than 2,200 miles of highway are being improved through "Moving Ahead" projects. Additionally, it allows \$70 million for public transit, rail, ferry, bicycle, and pedestrian projects. The State is nearing completion of the "Moving Ahead" initiative.

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 (Trust Fund) increased from \$507.477 million at June 30, 2006 to \$746.108 million at June 30, 2007, an increase of 47%. The net asset growth is explained by the State's lower unemployment rate and by a 20% surcharge on unemployment contributions that became effective January 1, 2005, as required by State statute. The surcharge, which is projected to remain in effect through August 31, 2008, was assessed because of the Trust Fund's low reserves in prior years. The State's unemployment rate was 4.9% at June 2007 compared to 4.8% in June 2006. Overall employment increased by 52,123 workers over the past twelve months. The slight decline in manufacturing jobs was more than offset by growth in service jobs. The State unemployment rate is down significantly from the recession peak in 2002, when the seasonally adjusted rate climbed to 7% in January 2002.

The Trust Fund's improved financial performance over the last two fiscal years allowed its reserves to be replenished and its short-term debt to be extinguished. The operating income (excess of operating revenues over operating expenses) was \$236.448 million this year versus \$252.998 million in 2006. Unemployment benefit expenses increased 1.8% in fiscal year 2007 to \$863.511 million. In May 2006, the State officially ended borrowing from the federal government to cover unemployment benefits. The use of short-term borrowing came about in early 2002 when the economic downturn caused the State to pay significantly more in unemployment benefits than it received in employer contributions for three consecutive years. The Trust Fund's cash and cash equivalent balances now exceed \$399 million.

N.C. State Lottery Fund

The N.C. Education Lottery Fund (NCEL) first began selling game tickets on March 30 2006 (instant game) and first began selling multi-state on-line (Powerball) game tickets on May 30, 2006. The NCEL borrowed \$4 million from the State Treasurer in February 2006 to help cover start-up expenses before the start of ticket sales. These funds were repaid to the State Treasurer in April 2006.

During the 2006-07 fiscal year, the NCEL moved into permanent offices and launched its own on-line games, Carolina Pick 3 and Carolina Cash 5. In addition to launching these two new games, the NCEL increased the number of retailers to approximately 5,800. The NCEL also created new instant scratch-off games and introduced them every two weeks. In the first fifteen months of operation, the NCEL earned more than \$377 million to support educational programs for the State, meeting its goal of transferring 35% of total revenues.

The Lottery Commission approved a budget for 2007-08 to provide \$341.5 million to the State's Education Lottery Fund. The NCEL introduced its first on-line raffle game, Sizzlin' Millionaire, on May 11, 2007 and plans to offer another one in fiscal year 2008. Subsequent to 2007, the General Assembly approved new legislation to provide the NCEL with more flexibility in instant ticket prize payouts.

As established in the enabling legislation, lottery funds are to be distributed for educational purposes as follows:

1. 50% to support reduction of class size in early grades and to support prekindergarten programs for at-risk four-year-olds who would otherwise not be served in high-quality settings (*Note: to this point, these programs have been funded by the General Fund*).
2. 40% for public school construction.
3. 10% to the State Education Assistance Authority to fund college and university scholarships.

EPA Revolving Loan Fund

The net assets of the EPA Revolving Loan Fund increased by \$87.8 million during the current fiscal year, which was an 11.3% increase from the prior fiscal year-end. Operating income was \$11.1 million (excess of operating revenues over operating expenses). Net nonoperating revenues were \$66.564 million, consisting primarily of federal capitalization grants and investment earnings. The \$10.513 million transferred in from other governmental funds (i.e., special revenue funds) consisted of clean water bond proceeds and additional funds to meet a required federal match.

Capital Asset and Debt Administration

Capital Assets

As of June 30, 2007, the State's investment in capital assets was \$30.916 billion, an increase of 5.19% 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	
	2007	2006	2007	2006	2007	2006
Land.....	\$ 10,064,383	\$ 9,481,462	\$ 3,114	\$ 3,114	\$ 10,067,497	\$ 9,484,576
Buildings.....	1,823,159	1,860,631	12,830	13,529	1,835,989	1,874,160
Machinery and equipment.....	661,101	662,585	3,256	2,321	664,357	664,906
Infrastructure:						
State highway system.....	16,314,633	15,368,301	—	—	16,314,633	15,368,301
Other infrastructure.....	88,126	112,560	6,941	7,479	95,067	120,039
Intangible assets.....	105,734	106,943	—	—	105,734	106,943
Art, literature, and other artifacts.....	64,833	60,485	—	—	64,833	60,485
Construction in progress.....	1,767,290	1,710,819	532	532	1,767,822	1,711,351
Total.....	<u>\$ 30,889,259</u>	<u>\$ 29,363,786</u>	<u>\$ 26,673</u>	<u>\$ 26,975</u>	<u>\$ 30,915,932</u>	<u>\$ 29,390,761</u>
Total percent change between fiscal years 2006 and 2007	5.20 %		(1.12)%		5.19 %	

This year's major capital asset additions were for highway construction (\$1.2 billion), highway land improvements (\$477 million), construction of correctional facilities (\$70 million), and construction of a new psychiatric hospital (\$47 million).

The largest component of capital assets is the State highway system. North Carolina has a 79 thousand mile highway system, making it the second largest state-maintained highway system in the nation. The most recent report on the condition of the State highway system (December 2006) noted that while the system continues to grow, the traditional highway maintenance funds necessary to maintain it have not changed significantly when adjusted for inflation.

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. Each of the 16 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. At year-end, the authorized but unissued repair and renovation debt was \$75 million.

A 1,000 bed close custody prison is currently under construction in Columbus County, with an estimated completion date of April 2008 and inmate occupancy estimated for September 2008. The total estimated cost of this facility is \$104.3 million. The primary funding source for this facility was certificates of participation (COPs). In addition, COPs have been authorized for the planning and construction of a new regional 120 bed medical center and 200 bed mental health center to be located at Central Prison in Raleigh. The estimated cost for the construction of the medical and mental health centers is \$151.86 million, of which \$132.2 million will be financed by COPs. The remaining balance will be financed by capital appropriations and federal grants.

The Department of Correction is undertaking construction initiatives to address a prison cell shortfall and to allow for the implementation of sentencing reform. The State's correctional facility population has more than doubled since 1980 to approximately 39 thousand inmates as of November 2007. 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 20(F) to the financial statements, the State has commitments of \$1.31 billion for the construction of highway infrastructure, which are expected to be financed by gasoline tax collections, motor vehicle fees, and federal funds. Other commitments for the construction and improvement of state government facilities totaled \$572.61 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 (bonds and similar debt payable) outstanding of \$6.912 billion, an increase of 6.03% from the previous fiscal year-end (see table below).

Outstanding Debt as of June 30

(dollars in thousands)

	Governmental Activities	
	2007	2006
General obligation bonds.....	\$ 5,902,330	\$ 5,738,815
Lease-purchase revenue bonds.....	245,045	263,845
Certificates of participation.....	727,640	454,060
Notes payable.....	37,276	62,298
Total.....	\$ 6,912,291	\$ 6,519,018
Total percent change between fiscal years 2006 and 2007	6.03 %	

During the 2006-07 fiscal year, the State issued \$502.745 million in general obligation bonds (excluding refunding bonds) and \$300 million in certificates of participation (COPs). The new general obligation debt represents a consolidation of clean water bonds and higher education bonds and constitutes the remaining authorized amounts of such bonds (see next page). The proceeds of the COPs will be used to finance the repair and renovation of State facilities and related infrastructure (\$100 million) and various State and university capital projects authorized for special indebtedness financing by previous sessions of the General Assembly (\$200 million). The repair and renovation projects were prioritized based on those projects related to life safety code requirements and water intrusion remediation.

The State refinanced \$80 million of its existing debt in fiscal year 2007 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 \$4.48 million over the next fifteen years.

The State issues two types of tax-supported debt: general obligation bonds and various types of "special indebtedness", which are also known as appropriation-supported debt. General obligation bonds are secured by the full faith, credit, and taxing power of the State. The payments on all other types of long-term debt, including COPs, lease purchase revenue bonds, and equipment installment purchase contracts are subject to appropriation by the General Assembly. Some appropriation-supported debt is also secured by a lien on facilities or equipment. 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.

The State's long-term debt (bonds and similar debt payable) has increased significantly in recent years, rising from \$1.521 billion in 1997 to \$6.912 billion in 2007, in part due to large issuances for higher education capital projects. The following is a summary of recent debt authorizations.

Special Indebtedness

The budget bill enacted by the 2007-2008 Session of the General Assembly authorized the issuance of up to \$669.15 million of special indebtedness (e.g., COPs) as follows:

- \$481.14 million for higher education projects. Significant projects include \$119.61 million to for a genetics science building at the University of North Carolina at Chapel Hill, \$53 million for a nanoscience building to be used jointly by the University of North Carolina at Greensboro and North Carolina Agricultural and Technical State University, \$41.61 million for a health and gerontological building at Western Carolina University, and \$38 million for an animal hospital at North Carolina State University.
- \$120 million to acquire State park land, natural heritage land, and to acquire waterfront properties or develop facilities for the purposes of providing public and commercial waterfront access.
- \$35 million for an education and visitors center at Tyron Palace.
- \$33.01 million for correctional facilities.

The budget bill enacted by the 2006-07 Session of the General Assembly authorized the issuance of up to \$672.1 million of special indebtedness as follows: \$429.3 million for psychiatric hospitals and a public health laboratory for the Department of Health and Human Services, \$132.2 million for medical and mental health centers for the Department of Correction, \$45.8 million for higher education projects, and \$64.8 million for other State projects.

Higher Education Authorization

The 1999-2000 Session of the General Assembly authorized the issuance of \$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 are being 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 demands 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. The State has issued all of the authorized higher education bonds.

Clean Water and Natural Gas Authorization

The 1997-1998 Session of the General Assembly authorized the issuance of \$1 billion of clean water and natural gas general obligation bonds, which were subsequently approved by the voters of the State. The bonds proceeds were allocated as follows: 1) \$800 million to provide grants and loans to local governments for clean water projects and 2) \$200 million to provide grants and loans to public or private entities for construction of natural gas facilities to facilitate the expansion of natural gas service to unserved areas of the State. The State has issued all of the authorized clean water and natural gas bonds.

Highway Bond Authorization

The 1995-1996 Session of the General Assembly authorized the issuance of \$950 million of highway general obligation bonds, which were subsequently approved by the voters of the State. The bond proceeds were allocated to pay capital costs as follows: 1) \$500 million for urban loops, 2) \$300 million for highways in the Intrastate System, and 3) \$150 million for paving unpaved roads of the secondary highway system. The State has issued all of the authorized highway bonds.

Debt Affordability Advisory Committee

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 February 2007, the State Treasurer completed the most recent Debt Affordability Study for North Carolina. The report provides the Governor and the General Assembly with a basis for assessing the impact of future debt issuance on the State's fiscal position and enables informed decision-making regarding both financing proposals and capital spending priorities. A secondary purpose of the report is to provide a methodology for measuring, monitoring and managing the State's debt levels, thereby protecting, and perhaps enhancing North Carolina's bond ratings.

The Committee adopted the following target and ceiling guidelines as the preferred measure used to determine the amount of net tax-supported debt that can be prudently authorized by the State:

- Net Tax-Supported Debt Service as a percentage of General Tax Revenues should be targeted at no more than 4% and not exceed 4.75%;
- Net Tax-Supported Debt as a percentage of Personal Income should be targeted at no more than 2.5% and not exceed 3.0%; and
- The amount of debt to be retired over the next ten years should be targeted at no less than 55% and not decline below 50%.

The definition of net tax-supported debt excludes obligations of component units, highway construction general obligation debt supported by separate taxes, special indebtedness (e.g., COPs) supported by funds other than the General Fund, guaranteed energy performance contracts approved pursuant to G.S. 142-64 and not supported by separate appropriations, and other postemployment benefits ("OPEB").

According to the report, all of the State's debt ratios are below median levels for all 50 states and for the State's peer group composed primarily of states rated "triple A" by all three rating agencies. Thus, the study concludes that North Carolina's debt is considered manageable at current levels. 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 bond credit ratings are as follows:

State of North Carolina General Obligation Bond Credit Ratings		
<u>Rating Agency</u>	<u>Rating</u>	<u>Outlook</u>
Fitch Ratings	AAA	Stable
Moody's Investors Service	Aaa	Stable
Standard & Poor's Rating Services	AAA	Stable

The State's general obligation bonds are rated AAA with a "stable" outlook by Fitch Ratings, AAA with a "stable" outlook by Standard & Poor's Ratings Services, and Aaa by Moody's Investors Service with a "stable" rating, the highest ratings attainable. On January 12, 2007, Moody's reinstated North Carolina's Aaa rating, citing the State's strong financial performance, replenishment of depleted reserves, recent economic gains that surpass national averages, and the State's effective fiscal management and healthy financial outlook.

The COPs and lease-purchase revenue bonds issued by the North Carolina Infrastructure Finance Corporation have underlying ratings of AA+ by Standard & Poor's, AA+ by Fitch, and Aa1 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 preceding biennium.

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

Next Year's Budget and Rates

The 2007 Session of the General Assembly made the following changes to revenue laws and the State Health Plan.

Revenue Law Changes

The 4.25% State sales tax rate that was originally scheduled to be reduced to 4% on July 1, 2007 was permanently extended. Effective October 1, 2008, the 4.25% rate will increase to 4.5%, and effective October 1, 2009, the rate will increase to 4.75%. On these effective dates, there will be a corresponding reduction in the local sales and use tax rates. These changes reflect the State's decision to begin a phased-in assumption of county Medicaid payments and include hold harmless provisions that will be paid from State sales and use tax collections.

The top individual income tax rate of 8% is statutorily set to decrease to 7.75% for taxable years beginning on or after January 1, 2008.

The existing cap on the variable component of the motor fuels tax was extended by two years. The variable wholesale component of the motor fuels tax rate is capped at 12.4 cents per gallon for the period July 1, 2007 through June 30, 2009 for a total tax of 29.9 cents per gallon.

The excise tax on tobacco products other than cigarettes was raised from 3% to 10%, effective October 1, 2007. The tax increase is to be credited to the newly established University Cancer Research Fund of the University of North Carolina System. Allocations from this fund are to be used only for the purpose of cancer research under University of North Carolina Hospitals or the Lineberger Comprehensive Cancer Center.

State Health Plan Changes

Several changes to the Preferred Provider Organization (PPO) Plans were approved and the Indemnity Plan was eliminated, effective July 1, 2008. The premium rate increase for fiscal years 2008 and 2009 was 11.2 percent for the PPO plans and 11.4 percent for the Indemnity plan. The rate increases were effective October 1, 2007. Other PPO plan changes include the removal of the visit limitation for mental health, occupational, speech and physical therapy services and an increase in the copayment for chiropractic visits. The pharmacy copayment for second tier drugs was also increased by \$5 on both the PPO and Indemnity plans. The individual deductible for the Indemnity Plan increased from \$350 to \$450 and the aggregate family amount increased from \$1,050 to \$1,350.

Conditions Expected to Impact Future Operations

Escheats Fund

Legislation passed in 2005 authorized the State Treasurer to diversify the investments of the Escheats Fund. Previously, the Fund was limited to participating in the Long Term Investment Portfolio. The State Constitution mandates that proceeds of the Escheat Fund shall be used to aid needy and worthy North Carolina students enrolled in public institutions of higher education. The continuing demand on resources at the universities and community colleges has necessitated regular tuition increases. The establishment of a modern investment allocation strategy aimed at increasing returns was identified as a way to enhance the Fund's constitutionally provided purpose. Under the new provisions, the State Treasurer is authorized to invest up to 20% of the assets of the Escheats Fund in other public and private investments. As of June 30, 2007, the Escheats Fund had invested \$72.3 million in these investment types.

Providing Retirement Benefits

It is widely anticipated that the progression of the baby boomer cohort from full-time career status into retirement will have significant economic, social, and political impact throughout the country. Predicting specific ramifications of this phenomenon is difficult. In North Carolina, we anticipate some impact to the State's public sector workforce, as boomers increasingly leave active service and retire, and to the state and local government retirement systems. The impact to the retirement systems could be both financial and administrative.

Administratively, the significant increase in the number of retirements to process and maintain will challenge current operations. The total number of members receiving a retirement benefit in the state and local system is approximately 181,000 (includes system retirees, beneficiaries, and members receiving a disability retirement allowance). That number is projected to increase to 345,000 by the year 2025 – roughly a doubling in the total number of state and local retiree accounts maintained by the agency over the next 17 years. To help address this need, the Retirement Systems Division is currently increasing organizational efficiencies by implementing a \$34 million replacement of its information technology system, which became operational in October 2007.

Financially, the North Carolina retirement systems have experienced a trend of robust fiscal health (the system's funding has averaged 108% for the last six years). Any substantive cost increases will not primarily be driven by the cost of providing an actual pension, since employees and employers fund the pension over an employee's service career. However, a significant increase in cost may come from providing cost of living adjustments (COLAs) for a significantly larger retiree pool since those are not pre-funded.

University of North Carolina System

Dental Education and Outreach. The University of North Carolina at Chapel Hill (UNC) and East Carolina University (ECU) have engaged in a collaborative effort for dental education and dental outreach. The core steps are to expand the size of the dental school at UNC with a focus on education, research, and outreach and to establish a new dental school at ECU, which would expand the education of comprehensive general dentistry practitioners, conduct research, and extend dental services into unserved and underserved primarily rural areas of North Carolina. This initiative is expected to raise the national recognition of dental education in North Carolina through an expansion of the availability of primary care dentists, the development of innovative clinical educational models for the provision of dental service to the underserved, the extensive use of distance education and teledentistry clinical consultation, and expanded research.

UNC Online. The University of North Carolina System established a common gateway, UNC Online, to provide online courses and degree programs offered by the sixteen campuses of the University of North Carolina in March 2007. This project takes the current on-line education offerings from the system's sixteen campuses and centralizes them with plans to expand the operation into a national program. The first focus is to serve students within the State, then advertise in surrounding states to become the dominant regional provider of online education.

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>.