

## **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, 2008. 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 \$337.17 million or 1.07% as a result of this year's operations. Net assets of governmental activities increased by \$154.87 million, or 0.52%, and the lack of growth is attributable to the slowdown in the national and State economy. Net assets of business-type activities increased by \$182.29 million, or 10.63%, primarily due to the financial results of the Unemployment Compensation Fund. At year-end, net assets of governmental activities and business-type activities totaled \$29.97 billion and \$1.9 billion, respectively.
- Component units reported net assets of \$16.58 billion, an increase of \$986.22 million or 6.32% from the previous year.

#### ***Fund Financial Statements:***

- The fund balance of the General Fund decreased from \$2.607 billion at June 30, 2007 (as restated) to \$1.679 billion at June 30, 2008, a decrease of 34.84%. For fiscal year 2008, the General Assembly authorized the drawdown of beginning unreserved fund balance to finance the deficiency of total revenues under total expenditures of \$958.166 (excluding other financing sources and uses).
- The fund balance of the State Highway Fund increased from \$678.9 million at June 30, 2007 to \$891.75 million at June 30, 2008, an increase of 31.35%. The significant increase is attributable to \$287.57 million in grant anticipation revenue vehicle bonds (GARVEE's) issued in October 2007.
- The fund balance of the Highway Trust Fund decreased from negative \$67.81 million at June 30, 2007 to negative \$74.62 million at June 30, 2008, a decrease of 10.03%. Total revenues decreased by \$59.53 million or 5.27% due to decreases in gasoline tax and highway use tax revenues.
- The net assets of the Unemployment Compensation Fund (Trust Fund) increased from \$746.11 million at June 30, 2007 to \$847.69 million at June 30, 2008, an increase of 13.61%. However, the Trust Fund's financial performance has weakened because of the recent downturn in the national and State economy.
- The N.C. Education Lottery (NCEL) began selling instant game tickets in March 2007 and Powerball tickets in May 2007. Net ticket sales surpassed \$1 billion, a 21.7% increase from the previous fiscal year. The NCEL transferred \$349.31 million in 2008 to support educational programs.

#### ***Capital Assets:***

- The State's investment in capital assets (net of accumulated depreciation) was \$32.655 billion, an increase of 5.54% from the previous fiscal year-end.
- This year's major capital asset additions were for highway construction (\$1.5 billion), highway land improvements (\$525 million), construction/improvements of correctional facilities (\$34 million), and construction of a new psychiatric hospital (\$46 million).

#### ***Long-term Debt:***

- The State had total long-term debt (bonds and similar debt payable) outstanding of \$7.055 billion, an increase of 2.08% from the previous fiscal year-end. The long-term debt balance includes \$1.2 billion 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 and other postemployment benefits 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 157 and 158).

### 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 184 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 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 and other postemployment benefits 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, non-major discretely presented component units, and the statistical section.

## 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 \$337.166 million or 1.07% over the course of this fiscal year's operations. The net assets of the governmental activities increased \$154.873 million or 0.52% and business-type activities increased \$182.293 million or 10.63%. The following table was derived from the government-wide Statement of Net Assets:

### Net Assets June 30, 2008 and 2007 (dollars in thousands)

	Governmental Activities		Business-type Activities		Total Primary Government	
	2008	2007	2008	2007	2008	2007
Current and other non-current assets.....	\$ 15,223,629	\$ 17,524,607	\$ 2,252,278	\$ 2,118,160	\$ 17,475,907	\$ 19,642,767
Capital assets, net.....	32,622,721	30,915,226	32,515	26,673	32,655,236	30,941,899
<b>Total assets.....</b>	<b>47,846,350</b>	<b>48,439,833</b>	<b>2,284,793</b>	<b>2,144,833</b>	<b>50,131,143</b>	<b>50,584,666</b>
Long-term liabilities.....	8,571,615	7,676,773	4,682	3,885	8,576,297	7,680,658
Other liabilities.....	9,303,820	10,947,018	383,342	426,472	9,687,162	11,373,490
<b>Total liabilities.....</b>	<b>17,875,435</b>	<b>18,623,791</b>	<b>388,024</b>	<b>430,357</b>	<b>18,263,459</b>	<b>19,054,148</b>
Net assets:						
Invested in capital assets, net of related debt.....	30,931,799	29,715,168	32,515	26,673	30,964,314	29,741,841
Restricted.....	878,856	1,094,352	1,773,018	1,612,943	2,651,874	2,707,295
Unrestricted.....	(1,839,740)	(993,478)	91,236	74,860	(1,748,504)	(918,618)
<b>Total net assets.....</b>	<b>\$ 29,970,915</b>	<b>\$ 29,816,042</b>	<b>\$ 1,896,769</b>	<b>\$ 1,714,476</b>	<b>\$ 31,867,684</b>	<b>\$ 31,530,518</b>

The largest component of the State's net assets (\$30.964 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 (\$2.652 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 \$1.840 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 \$7.022 billion of bonds and certificates of participation outstanding at June 30, 2008, \$5.41 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, 2008, the State's governmental activities have significant unfunded liabilities for a court judgment payable of \$749.886 million and compensated absences of \$403.249 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, 2008 and 2007**  
*(dollars in thousands)*

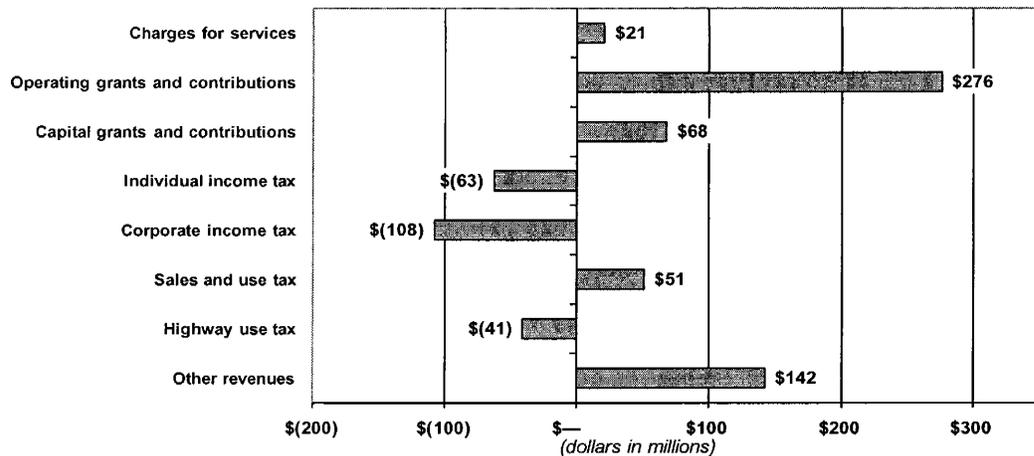
	Governmental Activities		Business-type Activities		Total Primary Government	
	2008	2007	2008	2007	2008	2007
<b>Revenues:</b>						
<b>Program revenues:</b>						
Charges for services.....	\$ 2,181,235	\$ 2,160,376	\$ 2,237,965	\$ 2,043,306	\$ 4,419,200	\$ 4,203,682
Operating grants and contributions.....	12,302,301	12,026,012	83,695	106,000	12,385,996	12,132,012
Capital grants and contributions.....	826,646	758,910	6,589	142	833,235	759,052
<b>General revenues:</b>						
Taxes						
Individual income tax.....	10,676,156	10,739,562	—	—	10,676,156	10,739,562
Corporate income tax.....	1,357,670	1,466,148	—	—	1,357,670	1,466,148
Sales and use tax.....	5,159,453	5,108,456	—	—	5,159,453	5,108,456
Gasoline tax.....	1,579,847	1,601,764	—	—	1,579,847	1,601,764
Franchise tax.....	738,741	671,151	—	—	738,741	671,151
Highway use tax.....	566,132	607,511	—	—	566,132	607,511
Insurance tax.....	505,936	487,081	—	—	505,936	487,081
Beverage tax.....	258,193	245,990	—	—	258,193	245,990
Inheritance tax.....	158,178	162,746	—	—	158,178	162,746
Tobacco products tax.....	249,664	241,687	—	—	249,664	241,687
Other taxes.....	339,158	330,888	—	—	339,158	330,888
Tobacco settlement.....	168,583	144,075	—	—	168,583	144,075
Unrestricted investment earnings.....	238,239	211,663	—	—	238,239	211,663
Miscellaneous.....	49,345	47,015	—	15	49,345	47,030
<b>Total revenues.....</b>	<b>37,355,477</b>	<b>37,011,035</b>	<b>2,328,249</b>	<b>2,149,463</b>	<b>39,683,726</b>	<b>39,160,498</b>
<b>Expenses:</b>						
General government.....	1,248,228	1,264,132	—	—	1,248,228	1,264,132
Primary and secondary education.....	10,635,026	9,126,169	—	—	10,635,026	9,126,169
Higher education.....	4,207,421	4,500,010	—	—	4,207,421	4,500,010
Health and human services.....	14,956,584	14,117,426	—	—	14,956,584	14,117,426
Economic development.....	746,660	624,106	—	—	746,660	624,106
Environment and natural resources.....	771,783	672,726	—	—	771,783	672,726
Public safety, corrections and regulation.....	2,623,835	2,465,974	—	—	2,623,835	2,465,974
Transportation.....	1,938,394	2,019,942	—	—	1,938,394	2,019,942
Agriculture.....	119,395	88,970	—	—	119,395	88,970
Interest on long-term debt.....	304,020	273,123	—	—	304,020	273,123
Unemployment compensation.....	—	—	1,002,866	864,981	1,002,866	864,981
N.C. State Lottery.....	—	—	712,718	559,373	712,718	559,373
EPA Revolving Loan.....	—	—	12,454	14,228	12,454	14,228
Regulatory commissions.....	—	—	34,791	31,144	34,791	31,144
Insurance programs.....	—	—	17,539	23,892	17,539	23,892
North Carolina State Fair.....	—	—	12,601	11,433	12,601	11,433
Other business-type activities.....	—	—	6,139	5,686	6,139	5,686
<b>Total expenses.....</b>	<b>37,551,346</b>	<b>35,152,578</b>	<b>1,799,108</b>	<b>1,510,737</b>	<b>39,350,454</b>	<b>36,663,315</b>
Increase (decrease) in net assets before						
contributions and transfers.....	(195,869)	1,858,457	529,141	638,726	333,272	2,497,183
Contributions to permanent funds.....	3,894	3,928	—	—	3,894	3,928
Transfers.....	346,848	312,810	(346,848)	(312,810)	—	—
<b>Increase (decrease) in net assets.....</b>	<b>154,873</b>	<b>2,175,195</b>	<b>182,293</b>	<b>325,916</b>	<b>337,166</b>	<b>2,501,111</b>
Net assets - beginning - restated.....	29,816,042	27,640,847	1,714,476	1,388,560	31,530,518	29,029,407
<b>Net assets - ending.....</b>	<b>\$ 29,970,915</b>	<b>\$ 29,816,042</b>	<b>\$ 1,896,769</b>	<b>\$ 1,714,476</b>	<b>\$ 31,867,684</b>	<b>\$ 31,530,518</b>

### **Governmental Activities**

For fiscal year 2008, revenues outpaced expenses and when combined with transfers from the State's business-type activities, an increase of \$154.873 million in net assets resulted for governmental activities. Total revenues increased 0.93% to \$37.355 billion. Total expenditures grew much faster at 6.82% to \$37.551 billion. The nominal growth in total revenues is attributable, in part, to the slowdown in the national and State economy. In 2008, employment and economic growth stalled, which explains the overall decrease in tax revenues (e.g., individual income, corporate income, highway use taxes, etc). However, transfers-in were higher in fiscal year 2008 due to the larger net profits achieved by the N.C. Education Lottery, a business-type activity.

The following chart reflects the dollar change in the revenues by source of governmental activities between fiscal years 2007 and 2008:

**Dollar Change in Governmental Activities Revenues by Source  
Between Fiscal Years 2007 and 2008**



The 6.82% increase in total expenses is attributable to growth in the State's two largest functional areas, primary and secondary education and health and human services. In 2008, primary and secondary education increased 16.53%, due, in part, to a recent court judgment made against the State. A Superior Court judge ruled that the State owed \$749.89 million for certain civil fines and penalties that should have been remitted North Carolina public schools and not diverted to other uses (see Note 21 to the financial statements). Education funding also increased because of enrollment increases at the State's universities, community colleges, and public schools and to salary increases for teachers and faculty. Despite enrollment and other funding increases, higher education expenses fell in fiscal year 2008 due to larger distributions of higher education bond proceeds in the prior year. Distributions of bond proceeds to colleges and universities for capital projects were \$609.63 million in 2007 compared to \$67.28 million in 2008.

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."

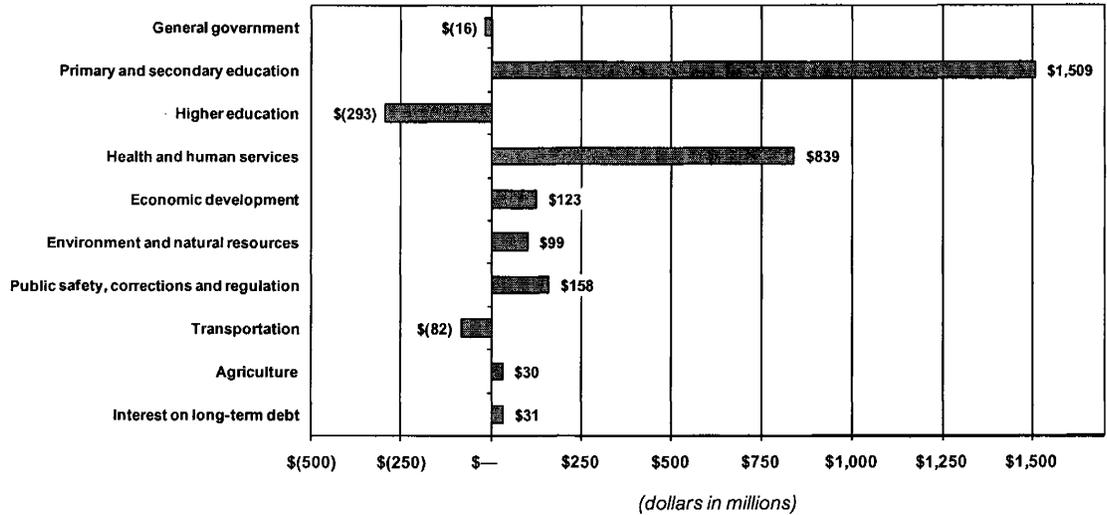
Total health and human services (HHS) spending increased 5.94% in 2008. The growth in health and human services is the result of increased spending for Medicaid (the State's largest public assistance program) and the opening of the new Central Regional psychiatric hospital in Butner. Because the State receives federal matching funds for the Medicaid Program, there was also a corresponding increase in program revenues (e.g., operating grants and contributions). 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. Below is a schedule of the Medicaid funding changes and the shift in local sales tax to the State:

<u>Date</u>	<u>Medicaid Funding Change</u>	<u>Shift Local Sales Tax to State</u>
10-01-07	State assumes 25% of counties' share	
7-01-08	State assumes 50% of counties' share	
10-01-08		50% of ½% local sales tax is shifted to State
7-01-09	State assumes 100% of counties' share	
10-01-09		Remaining 50% is shifted to State

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. Higher growth rates occur during years of economic distress and when major Medicaid expansions are enacted. Lower growth rates occur when the Medicaid eligible population is stable or declining.

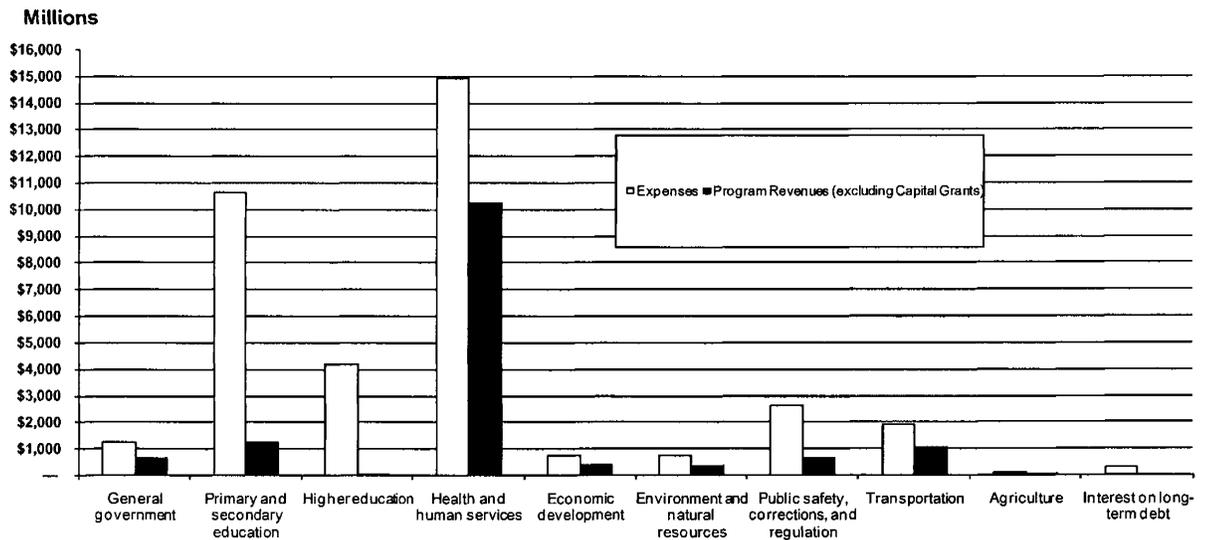
The following chart reflects the dollar change in the functional expenses of governmental activities between fiscal years 2007 and 2008:

**Dollar Change in Governmental Activities Functional Expenses Between Fiscal Years 2007 and 2008**



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, 2008**



***Business-type  
Activities***

Business-type activities reflect an overall increase in net assets of \$182.293 million or 10.63%, primarily because of the financial results of the Unemployment Compensation Fund. For fiscal year 2008, the Unemployment Compensation Fund had an operating income (excess of operating revenues over operating expenses) of \$90.439 million. The Unemployment Compensation Fund and the EPA Revolving Loan Fund comprise 93% 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 \$5.668 billion, a decrease of 11.06% from the prior fiscal year-end (as restated). The primary contributor to the decline was the General Fund, which had a 35.59% decrease in fund balance in 2008. However, the fund balance decline in the General Fund was partially offset by unspent debt proceeds reported in the Highway Fund and other governmental funds. The State issued debt in fiscal year 2007-08 for transportation improvement projects (Highway Fund) and for capital improvement and repair and renovation projects (other governmental funds). 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 \$2.607 billion at June 30, 2007 (as restated) to \$1.679 billion at June 30, 2008, a decrease of 35.59%. For fiscal year 2008, the General Assembly authorized the drawdown of beginning unreserved fund balance to finance the deficiency of total revenues under total expenditures of \$958.166 (excluding other financing sources and uses). While total revenues increased slightly, individual income taxes and sales and use taxes were virtually unchanged (changed less than 1%) and corporate income taxes fell by 6.76%. The tax rate on higher income taxpayers was reduced from 8.25% to 8% for tax year 2007 and from 8% to 7.75% for tax years beginning on or after January 1, 2008. Corporate income taxes are highly volatile over the business cycle. The rise in the North Carolina unemployment rate since June 2007 also contributed to the nominal change in tax revenues. A more detailed analysis of the General Fund is provided in the budgetary highlights section below.

#### *2007-08 General Fund Budgetary Highlights*

The appropriated budget included provisions that were designed to adjust General Fund revenues. The most significant revenue adjustments include 1) making permanent the additional 0.25% State sales tax rate that was set to expire on July 1, 2007, 2) reducing the top individual income tax rate from 8% to 7.75% effective January 1, 2008, and 3) authorizing a earned income tax credit for low income individuals and families effective January 1, 2008. 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 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, over-collection of revenues and unexpended appropriations for fiscal year 2006-07 were included to increase General Fund availability for fiscal year 2007-08.

The majority of funding increases for 2008 were for education, health and human services, employee benefit programs, and capital improvement projects. The budget for the public school system included an additional \$308.3 million. These funds were used to implement programs to improve student performance and graduation rates, to expand access to quality education alternatives, and to ensure students and faculty have 21st century technology in all classrooms. Specifically, the More-at-Four Program was increased by \$56 million to provide an additional 10,000 slots for at-risk four-year olds, \$17.6 million was provided to the Disadvantaged School Supplemental Fund, and \$37.5 million was provided to reduce class sizes in elementary school. Finally, \$70 million was appropriated for Accountability Based Curriculum bonuses for public school teachers. The budget for the University of North Carolina System included an additional \$185.5 million. The new EARN (Education Access Rewards North Carolina) scholars program, which will help low and moderate income students attend and graduate from a University of North Carolina campus debt free, is a unique partnership between high schools, community colleges, and universities. The EARN program will provide up to \$4,000 in individual need-based scholarships. Other expansion items that were funded include a summer bridge program designed to reduce dropout rates and recruitment and retention programs for teachers.

State funding for the Medicaid Program totaled \$2.92 billion in 2007-08 (compared to \$2.65 billion in 2006-07) and the total Medicaid budget was \$11.35 billion. The State Medicaid budget included \$252.88 million to support anticipated service cost increases and \$86.2 million to reduce the county share of Medicaid from 15% of the nonfederal share to 11.25% of the nonfederal share, effective October 1, 2007 (Note: the funds required to assume the counties' share were generated by reducing the amounts counties receive from an earmarking of the corporate income tax for school facilities). Additionally, the health and human services budget included \$62.4 million to begin operating the new Central Regional Hospital in Butner. This hospital is the first of three new state-operated psychiatric hospitals being built in North Carolina. Central Regional Hospital, which opened in September 2008, will serve patients from 26 counties.

The budget appropriated an additional \$758.6 million to support employee benefit programs. Specifically, the budget provided an average 5% compensation increase for all staff on the teacher salary schedule, an average 4.44% increase for public school administrators, a 5.0% increase for community college and University System faculty and a 4.0% increase for all other State employees. In addition, the budget provided funds to cover the increase in active and retired employee health-care premiums associated with rising costs. Finally, the budget authorized the final payment to the retirement system for funds that were withheld in fiscal year 2000-01.

The budget provided \$230.7 million in pay-as-you-go appropriations for priority education, public safety and infrastructure projects outlined in the State's Capital Improvement Plan. Specifically, the budget included \$108.2 million for several university systems projects, \$20 million for water resource development initiatives, \$8 million for a secondary data center, and \$7.5 million for infrastructure improvements at the State Ports. In addition, \$145 million from the fiscal year 2006-2007 credit balance was earmarked for the Repairs and Renovations Reserve.

#### *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 State 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 2007-08 fiscal year was prepared approximately 18 months prior to the final budget existing at June 30, 2008. The final budget reflects all budget revisions made throughout the fiscal year to adjust for known facts. Therefore, the original budget is an estimate based on information that is 18 months old. Consequently, when the original budget is compared to the final budget, it would be expected that significant variances can occur.

Additional factors leading to variances between original and final budget in fiscal year 2007-08 include the following:

- 1) Awarding of new unanticipated federal grants and/or the awarding of unanticipated increased or decreased amounts in long-standing federally supported programs. This also leads to the necessity of budgeting the unanticipated required state match.
- 2) Statewide encumbrance carry-forward budgeted amounts from fiscal year 2006-07 totaled \$379.5 million.
- 3) Allocation of statewide reserves (\$758.6) to agencies and universities for the purposes of legislative increases, salary adjustments, retirement and hospitalization formula adjustments, contingency and emergency, and information technology related programs.
- 4) Receipt of and the budgeting of over-realized receipts, prior year receipts, and unanticipated donations or grants.
- 5) Inaccurate and unreasonable revenue and expenditure budget amounts entered by the agency during the continuation budget preparation process.

*Variances - Final Budget and Actual Results*

Actual total revenue collected (both tax and non-tax) slightly exceeded budgeted amounts in fiscal year 2007-2008. This primarily occurred because North Carolina adopted a cautious revenue outlook for fiscal year 2007-08 and thus was able to avoid the budget shortfalls affecting so many other states. Reflective of a slowing economy, sales and use tax collections for fiscal year 2007-08 were \$67.7 million under budget, as the consumer continued to fight a tightening labor market, falling home prices, and rising fuel and food prices. The individual and corporate income tax collections fueled by North Carolina's strong employment and income gains slightly exceeded the 2007-08 forecasts.

Departmental federal funds actually received by agencies were less than the final authorized budgeted federal fund revenues. A variance between the budget and actual federal funds will usually occur because federal fund actual receipts are reflective of the actual expenditures. Therefore, if qualifying federal costs are not incurred by an agency, the actual receipt of federal funds could be significantly less than what has been budgeted.

The expenditure variances between the final budget and actual for the functional areas of education, health and human services, justice and public safety, and correction and regulation were the result of these agencies receiving actual departmental revenues that were less than the budgeted amounts. Therefore, expenditures and requirements that are dependent upon the receipts of these revenues could not occur.

### **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 (NCDOT), including the maintenance and construction of the State's primary and secondary road systems, the Division of Motor Vehicles, the State Highway Patrol, transit, rail and ferry system. 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 \$678.9 million at June 30, 2007 to \$891.75 million at June 30, 2008, an increase of 31.35%. The significant increase is attributable to \$287.57 million in grant anticipation revenue vehicle bonds (GARVEE's) issued in October 2007. This innovative financing tool was used to accelerate the funding of transportation improvement projects across the State by leveraging future federal transportation revenues. At June 30, 2008, \$187.79 million of the GARVEE proceeds were unspent.

Total revenues increased by \$117.35 million or 4.28% primarily due to an increase and more timely notification of federal obligational authority required to seek reimbursement from the Federal Highway Administration. However, the increase in federal funds was partially offset by a decrease in gasoline tax collections. Higher gas prices and a cap on the State gas tax are the major causes for the gasoline tax decrease.

Transportation expenditures increased by \$199.71 million or 7.96%. The increase is attributable to national and international demand for steel, concrete and asphalt. The costs for these products have increased by over 79% since 2002. The North Carolina Construction index, which reflects the prices of construction materials for projects, has risen faster than the consumer price index. Higher gas prices also resulted in spending 20% more on fuel this year.

Population growth is placing an increasing demand on the State's transportation system. North Carolina's population grew from 7.65 million in 1999 to 9.27 million in 2008, an increase of 21.18%. This growth is expected to continue for the foreseeable future. The *U.S. Census* estimates North Carolina's population growing to approximately 12.2 million by 2030, which would place the state as the 7<sup>th</sup> most populated state in the country. 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.

Transportation is fundamental in continuing North Carolina's prosperity and quality of life as the state's population continues to grow. To address the growing demand on the on the transportation system, increased cost of supplies, and declining funding, NCDOT continues to seek innovative solutions to meet the growing stress on the transportation system.

**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 2008 and 2007 were \$172.543 million and \$57.49 million, respectively. The amount transferred in 2007 was reduced to reflect 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 decreased from negative \$67.81 million at June 30, 2007 to negative \$74.62 million at June 30, 2008, a decrease of 10.03%. Total revenues decreased by \$59.53 million or 5.27% due to decreases in gasoline tax and highway use tax revenues. The factors contributing to the decrease in gasoline tax revenues were discussed previously in the analysis of the Highway Fund. Gasoline tax revenues decreased as consumers reduced fuel consumption. A decrease in vehicle sales and a lower value per transaction contributed to the overall decrease in highway use tax.

Total expenditures decreased by \$24.67 million or 2.81%. The decrease was due primarily to the Governor's "Moving Ahead" transportation initiative, which is coming to completion.

NCDOT will be challenged in its ability to meet the future transportation needs of the State. Flexibility in current revenues and investigation into other revenue sources and innovative financing will be needed to help meet these demands.

**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 \$746.11 million at June 30, 2007 to \$847.69 million at June 30, 2008, an increase of 13.61%. However, the Trust Fund's financial performance has weakened because of the recent downturn in the national and State's economy. The Trust Fund's operating margin (operating revenues less operating expenses) decreased from \$236.45 million (or 21.5% of operating revenues) in 2007 to \$90.44 million (or 8.28% of operating revenues) in 2008. Unemployment benefit expenses increased 15.97% in fiscal year 2008 to over \$1 billion. The decline in operating margin is explained by the State's rising unemployment rate, which increased from 4.9% in 2007 to 6% in June 2008. The State's unemployment rate in September 2008 rose further to 7%. A 20% surcharge on unemployment contributions, effective January 1, 2005 as required by statute, remained in effect during the current fiscal year. The surcharge was assessed because of the Trust Fund's low reserves in prior years.

**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. As required by enabling legislation, net revenues of the NCEL are transferred four times a year to the N.C. Education Lottery Fund (a nonmajor governmental fund). At year end, the net assets of the NCEL are zero. The NCEL has no changes in the net assets from year to year.

For fiscal year 2008, net ticket sales surpassed \$1 billion, a 21.7% from the previous fiscal year. The growth in sales is attributable, in part, to the NCEL creating 51 new instant scratch-off games and increasing instant prize payouts. The NCEL transferred \$348.31 million to the N.C. Education Lottery Fund in 2008 to support educational programs for the State. The amount transferred in 2007 was \$314.354 million.

The Lottery Commission approved a budget for 2008-09 to provide \$385.5 million to the State's Education Lottery Fund. 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 \$59.68 million during the current fiscal year, a 6.91% increase from the prior fiscal year-end. Operating income was \$11.677 million (excess of operating revenues over operating expenses). Net nonoperating revenues were \$38.087 million, consisting primarily of federal capitalization grants and investment earnings. The \$10.183 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, 2008, the State's investment in capital assets was \$32.655 billion, an increase of 5.54% 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	
	2008	2007	2008	2007	2008	2007
Land.....	\$ 10,660,936	\$ 10,083,640	\$ 3,452	\$ 3,114	\$ 10,664,388	\$ 10,086,754
Buildings.....	1,815,826	1,826,814	17,306	12,830	1,833,132	1,839,644
Machinery and equipment.....	671,094	662,798	4,339	3,256	675,433	666,054
Infrastructure:						
State highway system.....	17,081,956	16,314,633	—	—	17,081,956	16,314,633
Other infrastructure.....	97,442	98,644	6,886	6,941	104,328	105,585
Intangible assets.....	103,669	105,734	—	—	103,669	105,734
Art, literature, and other artifacts.....	66,280	64,823	—	—	66,280	64,823
Construction in progress.....	2,125,518	1,758,140	532	532	2,126,050	1,758,672
<b>Total.....</b>	<b>\$ 32,622,721</b>	<b>\$ 30,915,226</b>	<b>\$ 32,515</b>	<b>\$ 26,673</b>	<b>\$ 32,655,236</b>	<b>\$ 30,941,899</b>
Total percent change between fiscal years 2008 and 2007	<b>5.52 %</b>		<b>21.90 %</b>		<b>5.54 %</b>	

*This year's major capital asset additions were for highway construction (\$1.5 billion), highway land improvements (\$525 million), construction/improvements of correctional facilities (\$34 million), and construction of a new psychiatric hospital (\$46 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 increased significantly when adjusted for inflation.

The State completed construction of a 1,000 bed close custody prison in Columbus County in May 2008 and inmate occupancy began in September 2008. The total cost of this facility was \$102.4 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 216 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 \$153.4 million, of which \$132.2 million will be financed by COPs. The remaining balance will be financed by capital appropriations and federal grants. At year-end, construction in progress for the Central Prison medical center totaled \$10.06 million.

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 40 thousand inmates as of November 2008. 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 21(F) to the financial statements, the State has commitments of \$1.22 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 \$618.83 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 \$7.055 billion, an increase of 2.08% from the previous fiscal year-end (see table below).

**Outstanding Debt as of June 30**  
(dollars in thousands)

	<b>Governmental</b>	
	<b>Activities</b>	
	<u>2008</u>	<u>2007</u>
General obligation bonds.....	\$ 5,533,760	\$ 5,902,330
Special Indebtedness:		
Lease-purchase revenue bonds.....	235,045	245,045
Certificates of participation.....	965,880	727,640
GARVEE bonds.....	287,565	—
Notes payable.....	<u>33,187</u>	<u>36,901</u>
Total.....	<u>\$ 7,055,437</u>	<u>\$ 6,911,916</u>
 Total percent change between fiscal years 2008 and 2007		 <b>2.08 %</b>

During the 2007-08 fiscal year, the State issued \$275 million in certificates of participation (COPs) and \$287.565 million in grant anticipation revenue vehicle bonds (GARVEEs). The proceeds of the COPs will be used to finance various State and university capital improvement projects (\$200 million) and projects for the repair and renovation of State facilities and related infrastructure (\$75 million), which were authorized for special indebtedness financing by previous sessions of the General Assembly. The repair and renovation projects were prioritized based on those projects related to life safety code requirements and water intrusion remediation. The proceeds of the GARVEEs will be used to accelerate the funding of various transportation projects identified in the current State Transportation Improvement Plan (see Note 17).

The State issues two types of tax-supported debt: general obligation bonds and various types of “special indebtedness” (i.e., debt not subject to a vote of the people). General obligation bonds are secured by the full faith, credit, and taxing power of the State. The payments on special indebtedness (e.g., lease-purchase revenue bonds and COPs) and equipment installment purchase contracts are subject to appropriation by the General Assembly. Some appropriated-supported debt may also be 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 GARVEEs are a revenue bond-type debt instrument where the debt service is to be paid solely from federal transportation revenues.

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 \$7.055 billion in 2008, in part due to large issuances for higher education capital projects. Prior to 2004, the State only issued general obligation debt. The following is a summary of recent debt authorizations.

*Special Indebtedness*

The budget bill enacted by the 2008-2009 Session of the General Assembly authorized the issuance of up to \$734.03 million of special indebtedness (e.g., COPs) as follows:

- \$512.22 million for higher education projects. Significant projects include \$109.1 million for the Centennial Campus library at North Carolina State University, \$69 million for a School of Dentistry at East Carolina University, \$69 million for a School of Dentistry expansion at the University of North Carolina at Chapel Hill, and \$57.22 million for the Energy Production Infrastructure Center at the University of North Carolina at Charlotte.

- \$109.09 million for correctional facilities. The projects include \$45.17 million for a health care and mental health facility at the N.C. Correctional Institute for Women, \$26.02 million for minimum security additions at Scotland Correctional Institution and Tabor Correctional Institution, and \$37.9 million for medium security additions at Bertie Correctional Institution and Lanesboro Correctional Institution.
- \$50 million for acquiring State park lands and conservation areas.
- \$62.72 million for other State projects.

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, \$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, and \$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.

#### *Repair and Renovation Authorization*

The 2002-2003 Session of the General Assembly authorized the issuance of \$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 was allocated to the University of North Carolina System. Each of the 16 constituent institutions of the UNC System received a portion of the proceeds for repairs and renovations. The remaining \$143 million of the proceeds was used to make repairs and renovations to various state facilities. The State has issued all of the authorized repair and renovation debt.

#### *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 2008, 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 fund debt paid from highway fund revenues, non tax-supported special indebtedness (e.g., COPs) paid from non-general fund supported trust funds, other self-supporting or non-tax supported debt such as revenue bonds and short term tax anticipation notes, and other postemployment benefits ("OPEB").

According to the report, all of the State's debt ratios are at or below the median levels for the State's peer group composed 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:

<b>State of North Carolina General Obligation Bond Credit Ratings</b>		
<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

These ratings are the highest attainable from all three rating agencies. 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 Fitch Ratings, Aa1 by Moody's Investors Service, and AA+ by Standard & Poor's. Special indebtedness, such as COPs, is not subject to a vote of the people and its repayment is based on the State's annual debt service appropriation. For these reasons, special indebtedness is rated lower than the State's general obligation bonds and typically carries a higher interest rate.

### **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***

During the budget deliberations, the Governor recommended lowering revenue expectations for fiscal year 2008-09 because of a slowing national economy. The budgeted revenue forecast for fiscal year 2008-09 assumed slow growth in the first half of the fiscal year, with strengthening to begin in the spring of 2009. In order to deal with the possibility of a weaker than expected April, the Governor directed the Office of State Budget and Management to take steps necessary to ensure that the budget is balanced on June 30, 2009. Specifically, allotments (on an annualized basis) for general government agencies were reduced by 5% and allotments for other state agencies were reduced between 1.5 % and 4%. In addition, capital projects paid for with cash will be delayed, reserves and unspent capital funds will be retained, and repairs and renovations of state buildings will be delayed.

The 2007 Session of the General Assembly enacted the following changes to revenue laws:

- Effective October 1, 2008, the 4.25% state sales tax 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. 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.

## ***Conditions Expected to Impact Future Operations***

### **State Health Plan**

The State Health Plan (Plan) ended fiscal year 2008 with a deficit of \$140.14 million (see Note 15 to the financial statements). The deficit was incurred because the Plan underestimated administrative expenses, which increased by 19%, and used an incorrect forecasting model. More specifically, the Plan did not fully realize savings associated with member out-of-pocket cost sharing and provider discounts under the preferred provider organization (PPO) options. In addition, utilization of medical services, including outpatient services in particular, was higher than projected. The phase-out of the indemnity plan, including the transition of all members to one of three PPO options, was completed, effective July 1, 2008. The Plan revised its financial projections for fiscal year 2009 as a result of the financial performance in fiscal year 2008 and to address forecasting concerns and other factors. Current estimates indicate the Plan will need \$300 million in additional resources to operate through the end of fiscal year 2009, and to ensure cash availability going into fiscal year 2010.

### **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 209,000 (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 65% increase 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 and improving customer service through its new information technology system, which went live in October 2007.

Financially, the North Carolina retirement systems are better positioned than most retirement systems for the current financial difficulties. The primary system was funded at 104.7% at the end of 2007. The primary system is also conservatively invested, with significant holdings of U.S. Treasury and agency bonds. However, the State has taken advantage of the overfunding in recent years to reduce its contribution below the cost of currently accruing benefits. It is likely that the State will have to increase its contribution in future years to levels that are more in line with historical funding and the cost of current accruals. In addition, 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.

### **Impact of Current Market Conditions on Retirement System Funding**

The N.C. Retirement Systems are designed and administered to fare better than those in many other states in the current financial turmoil. They are generally overfunded and conservatively invested, and do not guarantee cost of living adjustments. However, the financial crisis could have the following key impacts on the Retirement Systems:

- **State Contribution.** The State has reduced its contribution to the Teachers' and State Employees' Retirement System (TSERS) in recent years by spending the overfunding in the system. The State is currently contributing 3.36% of pay for most employees, totaling about \$400 million. This contribution is significantly lower than the actuarial normal contribution of 6.26%. The State's employer contribution will need to increase modestly to 3.57%, equivalent to approximately \$29 million, in the next fiscal year. However, continuing market difficulties impacting investment returns could speed the necessary acceleration of the State's employer contribution toward the actuarial normal level. By the 2010-2011 fiscal year, the State's contribution to TSERS could increase to close to 6%.

- Local Government Contribution. Local governments have paid essentially the same contribution for over 20 years, but current market conditions may force them to increase their contribution.
- Cost of Living Adjustments (COLAs). COLAs for retirees are not guaranteed in the N.C. Retirement Systems, so limited funds in both the Retirement Systems and the State budget will likely result in lower or no COLAs. The contribution increases noted above are before granting any COLAs. Any COLAs that the Governor and the General Assembly want to provide for next fiscal year and the year after will require additional appropriations.

#### **Escheats Fund**

Legislation passed in 2005 authorized the State Treasurer to diversify the investments of the Escheats Fund (Fund). Previously, the Fund was limited to participating in the Long Term Investment Portfolio. The State Constitution mandates that proceeds of the 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 Fund in other public and private investments. As of June 30, 2008, the Fund had invested \$89.9 million in these investment types.

#### **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.osc.nc.gov/financial/financial.html>.