

*Financial Model -
Executive Summary*

NORTH CAROLINA FISCAL OUTLOOK

1993-2002

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Policy Economics Group
for
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EXECUTIVE SUMMARY

The intent of this report is to provide an overall fiscal outlook of projected General Fund revenues and expenditures for the fiscal period 1993/94 through 2001/02. The report and the financial model used to produce the analysis were prepared by the Policy Economics Group of KPMG Peat Marwick. The financial model is based on the concept that current services will continue at the level provided in the base year, and that expenditures associated with those service levels will be adjusted for inflation. Another approach to projecting the fiscal outlook is what is referred to as the continuation approach, which is more commonly used for shorter projection periods. For purposes of comparing the two approaches, current services and continuation, the financial model was also adjusted to approximate a continuation projection. The distinction between the two approaches is further discussed in the section entitled "Current Services vs. Continuation Budget Concepts." Unless otherwise noted, however, all discussions and tables presented in this report refer to the current services model.

Scope and Methodology

This report provides projections of General Fund revenues and expenditures for fiscal years 1993/94, 1994/95, 1995/96, 1996/97, 1997/98 and 2001/02. The expenditure projections encompass the General Fund current expenditures of 26 state government departments (net of departmental receipts), plus General Fund current expenditures, such as debt service and revenue reimbursements to local governments, that are nondepartmental. The revenue projections cover all General Fund tax and non-tax revenues (excluding departmental receipts), as well as the annual transfers from the Highway Fund and the Highway Trust Fund.

The current services expenditure projections reflect the assumption that the departments will continue to provide the current scope and quality of services (as provided for in the 1992/93 authorized budget) to the populations or "clients" that they serve. It is assumed that the scope of services for most departments will expand in response to the growth in some broad demographic or economic measure, such as total state population or total state employment. However, a special effort was made to determine the factors that drive the workloads of the five departments with the largest expenditures -- Public Education, Human Resources, The University of North Carolina (UNC) System, Community Colleges, and Corrections. The costs of providing most government services are assumed to increase in step with the rate of inflation and the real (inflation-adjusted) salaries of State employees are allowed to keep pace with real wage increases in the private sector. In general, departmental receipts are assumed to grow at the same rate as departmental expenditures.

There are two important exceptions to the basic current services methodology. First, it is assumed that the State-funded portion of Medicaid payments will increase by 20 percent each year. Second, it is assumed that total State payments for health benefits for employees and

retirees will increase at a rate of 17.5 percent per year. These growth rates reflect recent experience in North Carolina.

Two modifications were made to the current services methodology in order to produce expenditure projections that approximate the continuation budget concept used by the State. First, the salaries and non-health benefits of state employees were not adjusted for inflation or for real wage increases. Second, no full-time equivalent (FTE) growth was allowed for the University of North Carolina system or for community colleges.

The projected receipts for most of the revenue items covered in this report are based on the historical relationships between the growth in receipts and the growth in either total State personal income or total State population. However, the projections for the largest single revenue item, the personal income tax, are generated by the Income Tax Simulation Model that the Policy Economics Group recently developed for the Department of Revenue. It is assumed that there will be no discretionary changes to any tax rates or bases in the future, other than ones that are already legislated to phase in or out.

The revenue and expenditure projections produced by the model all rely on DRI/McGraw-Hill's most recent trend economic forecast for the State of North Carolina. That forecast shows total State personal income growing at an annual rate of 6.2 percent from 1992 through 1997 and at an annual rate of 6.5 percent between 1997 and 2001. The annual rates of inflation forecast for those two time periods are 3.1 and 4.8 percent.

In calculating the surpluses/deficits, capital outlays were excluded on the spending side and beginning credit balances were excluded on the revenue side.

Summary of Major Findings

- If all current programs are continued, with no changes in law or policies, rising workloads and other cost pressures, including cost-of-living compensation adjustments, would cause expenditures to grow more rapidly than revenues over the next decade. This "automatic" growth would result in a deficit of \$313 million in fiscal year 1996/97, which represents 3 percent of projected revenues for that year (see Table ES-3). By the year 2001/02 this budget gap would equal 11.6 percent of projected revenues.
- The projections described above (and more fully below) are known as "current services" projections because they are based on the assumption that the existing scope and quality of existing programs will be maintained in the future. The surpluses or deficits that are projected using this approach are considered as "structural" surpluses/deficits because they measure the budgetary impacts of projections of the State's economic and demographic conditions in the absence of any change in the structure of

government programs and policies.

- State spending for Medicaid is assumed to grow, as it has in recent years, at an annual rate of 20 percent. If this growth rate persisted, expenditures for the Medicaid program would rise from a share of 8 percent of total General Fund spending in 1992/93 to 13 percent of total spending in 1996/97 and 20 percent of total spending in 2001/02 (Table ES-2).
- The costs of employee and retiree health benefits are also assumed to grow as they have in the recent past -- at a rate of 17.5 percent each year. This growth would cause expenditures on employee health benefits to rise as a share of total spending from 5 percent in 1992/93 to 7 percent in 1996/97 and to 10 percent in 2001/02 (Table ES-2).
- If in contrast to the current services assumption, salaries of State employees were to be frozen throughout the entire projection period and no spending growth due to increased UNC and community college enrollments were permitted (in accordance with the continuation approach), the State would have surpluses of \$647 million in 1996/97 and \$1,013 million in 2001/02. If the enrollment-related spending increases were allowed, the surpluses in those two years would be reduced to \$552 million and \$741 million (Table ES-4).

Key Factors Affecting Long-Term Fiscal Conditions

General Fund current services budget requirements are projected to grow at an annual rate of 8.0 percent during the period 1992/93 through 1996/97. Over that same period General Fund revenues are projected to grow by only 6.9 percent annually. The gap between the two growth rates becomes larger over the period 1996/97 through 2001/02, as current services expenditures are projected to grow by 9.2 percent per year while revenues grow by 7.5 percent.

Table ES-1 compares the annual growth rates for the principal components of General Fund current services budget with the annual growth rates for General Fund revenues. The two expenditure items whose growth rates sharply outpace the rate of revenue growth are Medicaid and health benefits for state employees and retirees. These extremely high growth rates reflect the nationwide crisis in spiraling health care costs.

Table ES-1
Projected Current Services Growth Rates
For Major Components of North Carolina's
General Fund Appropriations

	Average Annual Growth Rates	
	1992/93 to 1996/97	1996/97 to 2001/02
Total Revenues	6.9%	7.5%
Total Expenditures	8.0%	9.2%
Medicaid	20.0%	20.0%
Health Benefits	17.5%	17.5%
Human Resources (excluding Medicaid)	6.6%	11.2%
Public Education	8.1%	6.4%
UNC System	5.1%	8.8%
Community Colleges	7.4%	8.1%
Corrections	7.9%	7.2%

Source: KPMG Peat Marwick, Policy Economics Group

Appropriations for the Departments of Public Education, Community Colleges, and Corrections are also projected to grow more rapidly than revenues over the period 1992/93 through 1996/97. In addition, workloads in Community Colleges and Corrections are projected to grow more rapidly over that period than the average workload growth of the other departments.

A higher annual rate of inflation is projected for the period 1996/97 through 2001/02 than for the period 1992/93 through 1996/97. These price increases, along with the compounded effects of rapid growth in health benefits, cause the rate of growth in spending by the Departments of Human Resources (excluding Medicaid), Community Colleges, and the University of North Carolina System to accelerate in the latter half of the decade. These acceleration factors are more than offset by declining rates of growth in workloads in the cases of Public Education and Corrections. The annual rate of growth in public school average daily membership is projected to decline from 1.8 percent in the earlier period to 1.2 percent in the later period. The growth in prison population is projected to be frozen after 1994 due to the cap on the number of inmates permitted in existing or planned facilities.

Table ES-2 shows how the composition of General Fund appropriations changes over time due to the variation in growth rates across spending items. As already noted, Medicaid and health benefits rise markedly as a share of total appropriations. The shares for the Departments of Human Resources (excluding Medicaid), Community Colleges and Corrections remain fairly constant. By the end of the decade spending for public schools and for the UNC System would account for smaller shares of total General Fund appropriations than they do currently, if current policies are unchanged.

Current Services vs. Continuation Budget Concepts

The "current services budget" is commonly used as a benchmark for long-term budget planning. Current services projections are designed to show what would happen to revenues and expenditures assuming that current laws, policies, and programs are continued without change. Under this approach, the budget is allowed to grow automatically as the result of the interplay between the fiscal system, on the one hand, and changes in the economic and demographic circumstances of the state, on the other. The resulting projections are "policy neutral" in the sense that no judgments are drawn regarding the merits of current law. This is not, however, the same as saying that there will be no legislative action during the projection period. These "baseline" projections provide a framework for analyzing the budgetary impacts of tax and expenditure policy options.

Current services projections can be used to identify quantitatively the long term "structural" implications of the interplay between a state's economic performance and its budget. Specifically, the task is to determine whether and why the state is facing a potential structural deficit or surplus. A current services "structural deficit (surplus)" is said to exist

Table ES-2
Major Components of North Carolina's
General Fund Appropriations as a Percent
of Total General Fund Appropriations

	1992/93	Projected 1996/97	Projected 2001/02
Medicaid	8%	13%	21%
Health Benefits	5%	7%	10%
Human Resources (excluding Medicaid)	9%	9%	9%
Public Education	43%	43%	38%
UNC System	14%	12%	12%
Community Colleges	5%	5%	5%
Corrections	6%	6%	6%

Source: KPMG Peat Marwick, Policy Economics Group

if, over time, as the state's economy and demography changes, the spending requirements grow automatically faster (slower) than its revenues. Of course, projected structural deficits would become actual deficits only if the state government took no corrective actions in the interim. It is important to remember, therefore, that, whereas the current services projections reported below provide critical information about the magnitude and composition of a state's potential fiscal condition, they should not be interpreted as predictive statements about what actually will occur.

The State of North Carolina employs a somewhat different concept known as the "continuation budget" in order to ensure that mandated expenditures and spending programs that have been endorsed in the past are adequately funded. The continuation budget refers to that portion of the operating budget which maintains the existing authorized level of services, excluding non-recurring or one-time spending items. The amount of spending required for the continuation budget is subtracted from the estimated amount of revenue available for the budget year to arrive at the amount of funding that is available for "expansion" spending. It should be noted that revenue projections are the same for both the current services and continuation budget approaches.

To maintain their continuation level of services, government departments are permitted to increase their spending to allow for 1) the replacement of equipment, 2) increases in the costs of utilities, food, drugs, clothing and medical supplies, 3) increased costs associated with the enrollment or population currently served by public schools, prisons and entitlement programs, 4) increased operating costs associated with newly completed capital investments, and 5) a limited number of receipt-supported increases and a few other spending items. All other spending, including salary increases and non-replacement capital outlays, must be funded out of the expansion budget.

Although the continuation budget concept is a very useful tool for short-term budget policymaking and control, it is not an ideal benchmark for focusing on causes of future fiscal stress. One problem is that the continuation budget provides a very low benchmark over a long time horizon. By not allowing for salary increases or other spending increases that are often approved (such as those for increased college enrollments), a continuation projection may lead decisionmakers to believe that they have a greater range of spending options in the future than is actually the case. For example, the projected continuation spending levels can only be achieved if the legislature makes the policy decision to deny pay increases for an extended period of years. Nevertheless, adjustments were made to the financial model in order to prepare expenditure projections that more closely fit the budget concept traditionally used in North Carolina.

Alternative Current Services Expenditure Projections

In addition to the "Trend" current services projections described in the methodology section, a second set of current services projections were made based on an alternative set of assumptions regarding the growth in health care costs. The intent of this alternative is to show

the sensitivity of the financial model to health care cost. This "Moderate Health Care Increases" scenario differs from the Trend case in two respects:

First, the per-employee cost of health benefits funded by the State is assumed to grow at an annual rate of 15 percent through 1996/97. After 1996/97 these expenditures are assumed to increase in step with the U.S. price index for medical services after 1996/97. In the Trend case, total health benefits costs increase at a rate of 17.5 percent throughout the projection period.

Second, State payments for Medical Assistance are also assumed to grow at an annual rate of 15 percent through 1996/97. After 1996/97 these expenditures are assumed to increase in step with both State population growth and the U.S. price index for medical services after 1996/97. In the Trend case, Medical Assistance payments increase at a rate of 20 percent throughout the projection period.

The projection results for the Trend case and this alternative case are compared in Table ES-3. If the State were able to contain the growth in the costs of these two health-related spending items to the rates specified above, the projected current services budget would have a surplus throughout the projection period. This surplus is projected to reach \$1,049 million in 2001/02. The results of the trend case have been discussed in detail above.

Alternative Continuation Expenditure Projections

In addition to the "Trend" continuation projection, two more sets of continuation projections were made, based on the following alternative definitions of the continuation budget:

Trend Case with FTE-Driven Increases. In contrast to the Trend continuation case, State funding for community colleges and the UNC system is allowed to grow in step with increases in full-time equivalent enrollments.

Moderate Health Care Increases. This case differs from the Trend continuation case in the same manner that the similar alternative under the current services approach differs from the Trend current services case.

The projection results for the Trend continuation case and the two alternative cases are compared in Table ES-4. In the Trend continuation case the State is projected to have a surplus of \$647 million to devote to expansion items in 1996/97. The available surplus is projected to grow to \$1,013 in 2001/02. If the State provided funds to the UNC system and community colleges to support FTE increases, the projected surpluses would be reduced to \$552 million in 1996/97 and \$741 million in 2001/02. If the State contained the growth in the two health care items (and did not support FTE growth), the projected surpluses would be substantially larger: \$941 million in 1996/97 and \$2,308 million in 2001/02.

Table ES-3
North Carolina General Fund Budget Projections
Excluding Capital Expenditures and Prior Balances
Alternative Current Services Cases
(in millions of dollars)

	1993/94	1994/95	1995/96	1996/97	1997/98	2001/02
Trend Case (Current services adjusted for inflation)						
surplus/(deficit)	(43.7)	(49.1)	(123.4)	(313.4)	(523.4)	(1,757.3)
surplus/(deficit) as a % of Total Revenues	-0.5%	-0.5%	-1.2%	-3.0%	-4.6%	-11.6%
Moderate Health Care Increases (See growth assumptions below)						
surplus/(deficit)	5.4	66.1	79.3	3.6	132.5	1,048.7
surplus/(deficit) as a % of Total Revenues	0.1%	0.7%	0.8%	0.0%	1.2%	6.9%

Growth assumptions for moderate health care increases (employee & medical):

93/94 - 96/97 = 15 %

97/98 - 01/02 = 5.4 % (CPI - medical)

Avg. Annual Growth Rates in Underlying Economic/Demographic Factors			
	1992 - 1996	1996 - 2001	1992 - 2001
Population	1.1%	0.9%	1.0%
Personal Income	6.2%	6.4%	6.3%
Consumer Price Index	2.9%	4.7%	3.9%
Employment	2.2%	1.6%	1.8%
Emp. Health Care (trend case)	17.5%	17.5%	17.5%
Medicaid (trend case)	20.0%	20.0%	20.0%

Source: KPMG Peat Marwick, Policy Economics Group

Table ES-4
North Carolina General Fund Budget Projections
Excluding Capital Expenditures and Prior Balances
Alternative Continuation Cases
(in millions of dollars)

	1993/94	1994/95	1995/96	1996/97	1997/98		2001/02
Trend Case (No growth in salaries and no growth in UNC & Comm. College FTE)							
surplus/(deficit)	154.1	368.1	536.8	646.7	790.2		1,012.6
surplus/(deficit) as a % of Total Revenues	1.8%	4.0%	5.4%	6.1%	7.0%		6.7%
With FTE-Driven Increases (Growth allowed in UNC & Comm. College FTE)							
surplus/(deficit)	130.6	329.0	471.0	551.8	664.2		740.6
surplus/(deficit) as a % of Total Revenues	1.5%	3.5%	4.7%	5.2%	5.9%		4.9%
Moderate Health Care Increases (See growth assumptions below)							
surplus/(deficit)	197.4	481.3	728.6	940.5	1,223.2		2,308.2
surplus/(deficit) as a % of Total Revenues	2.3%	5.2%	7.3%	8.9%	10.8%		15.3%

Growth assumptions for moderate
health care increases (employee &
medicaid):

93/94 - 96/97 = 15%

97/98 - 01/02 = 5.4% (CPI - Medical)

Avg. Annual Growth Rates in Underlying Economic/Demographic Factors			
	1992 - 1996	1996 - 2001	1992 - 2001
Population	1.1%	0.9%	1.0%
Personal Income	6.2%	6.4%	6.3%
Consumer Price Index	2.9%	4.7%	3.9%
Employment	2.2%	1.6%	1.8%
Emp. Health Care (trend case)	17.5%	17.5%	17.5%
Medicaid (trend case)	20.0%	20.0%	20.0%

Source: KPMG Peat Marwick, Policy Economics Group

Current Services vs. Continuation Projection Results

Projections for the two current services and the analogous continuation cases are compared in Table ES-5. Projected expenditures in the Trend continuation case are \$1,313 million lower than in the Trend current services case in 1996/97 and \$2,770 million lower in 2001/02. The differences between the current services and continuation versions of the Moderate Health Care Increases case are not quite as large. Health care cost containment saves more money under the current services approach than under the continuation approach because the number of State employees is larger each year under the current services assumptions.

Table ES-5
North Carolina General Fund Budget Projections
Excluding Capital Expenditures and Prior Balances
Under Alternative Assumptions
(in millions of dollars)

	1993/94	1994/95	1995/96	1996/97	1997/98	2001/02
I. CURRENT SERVICES APPROACH						
Trend Case (Current services adjusted for inflation)						
surplus/(deficit)	(43.7)	(49.1)	(123.4)	(313.4)	(523.4)	(1,757.3)
surplus/(deficit) as a % of Total Revenues	-0.5%	-0.5%	-1.2%	-3.0%	-4.6%	-11.6%
Moderate Health Care Increases (See growth assumptions below)						
surplus/(deficit)	5.4	66.1	79.3	3.6	132.5	1,048.7
surplus/(deficit) as a % of Total Revenues	0.1%	0.7%	0.8%	0.0%	1.2%	6.9%
II. APPROXIMATE CONTINUATION APPROACH						
Trend Case (No growth in salaries and no growth in UNC & Comm. College FTE)						
surplus/(deficit)	154.1	368.1	536.8	646.7	790.2	1,012.6
surplus/(deficit) as a % of Total Revenues	1.8%	4.0%	5.4%	6.1%	7.0%	6.7%
Moderate Health Care Increases (See growth assumptions below)						
surplus/(deficit)	197.4	481.3	728.6	940.5	1,223.2	2,308.2
surplus/(deficit) as a % of Total Revenues	2.3%	5.2%	7.3%	8.9%	10.8%	15.3%

Growth assumptions for moderate
health care increases (employee &
medicaid):

93/94 - 96/97 = 15%

97/98 - 01/02 = 5.4% (CPI - Medical)

Avg. Annual Growth Rates in Underlying Economic/Demographic Factors

	1992 - 1996	1996 - 2001	1992 - 2001
Population	1.1%	0.9%	1.0%
Personal Income	6.2%	6.4%	6.3%
Consumer Price Index	2.9%	4.7%	3.9%
Employment	2.2%	1.6%	1.8%
Emp. Health Care (trend case)	17.5%	17.5%	17.5%
Medicaid (trend case)	20.0%	20.0%	20.0%

Source: KPMG Peat Marwick, Policy Economics Group