

OUR CHALLENGE

North Carolina, like every other state, is facing serious structural problems with the foundation of government. Like damage to the foundation of a home, these problems will not go away by themselves and cannot be fixed cosmetically. They demand that we find—and fix—the causes.

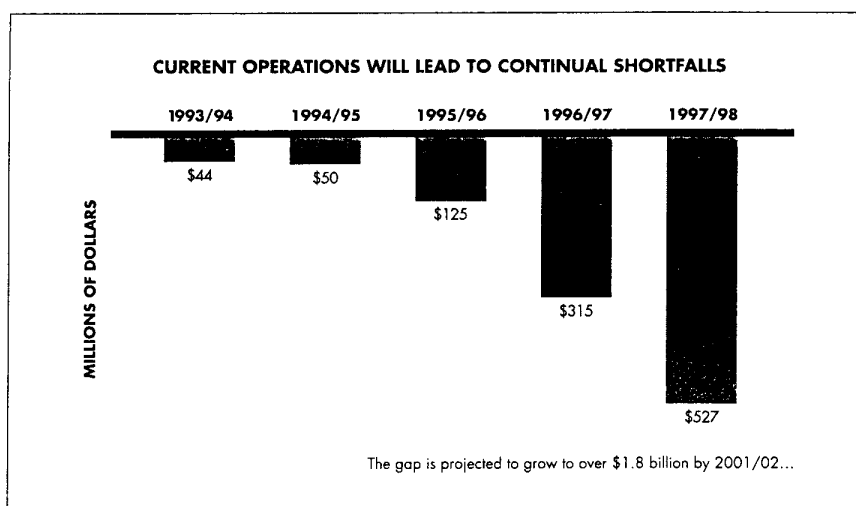
Signs of the problem first appeared in fiscal year 1989-1990, when the State's General Fund revenues fell short of projections by over \$500 million. Then in 1991, the General Assembly faced a projected \$1.2 billion gap for fiscal year 1992—the largest budget shortfall since the Depression.

In the last three years the General Assembly has had to take extraordinary measures to balance the budget as required by the State Constitution. Demonstrating prudent fiscal management, the General Assembly cut spending, restricted hiring, deferred capital projects, drew down reserves, and increased taxes.

These actions resolved the crisis of 1992, but did not solve the underlying problem: at the current rates of revenue and expenditure growth, the State's General Fund will experience continual shortfalls into the year 2000. Equally

"It has been quite a year for trying to find the money to pay the bills."

Fred Talton
State Controller



These problems will not go away by themselves and cannot be fixed cosmetically.

(EXHIBIT 1)

Source: Financial Model prepared for GPAC by KPMG Peat Marwick

important, there will be limited "new" monies available for investments in education, transportation, health care or other programs important to the State's future.

We are facing what's known as a "structural budget imbalance." This means that the lines of revenues and expenditures have crossed, and the natural rebound of the economy will not realign them. As the fiscal projection model developed for the Government Performance Audit Committee indicates, if we continue to operate the State in the future as we have in the past, we will not have the funds we need for education, health care, law enforcement and other basic services.

The structural budget imbalance is not the fault of anything North Carolina did or did not do in recent years. In fact, the State has earned its reputation as one of the most well managed states in the nation. However, North Carolina is facing three national trends:

1. Slower growth in revenue
2. Increasing spending pressures
3. Constant change

Like most other states, the problem was not of our making, but the challenge is ours to deal with. If we don't change the way we do business, the State will be unable to keep up with rising costs, and will need to reduce the quality or quantity of our services, raise our tax burden—or both.

TREND 1: *Slower Growth In Revenue*

After a decade of tremendous growth, which enabled the State to increase spending without major tax increases, North Carolina is now facing limited revenues to meet pressing program needs. Growth in the State's revenues has slowed as a result of changes in our economy and population:

A slowdown in the national economy. A prolonged recession was created by a slowdown in spending by companies and consumers paying off debt incurred in the 1980s, and by tighter credit policies resulting from the savings and loan crisis. The recession resulted in reduced State tax revenues in the short term.

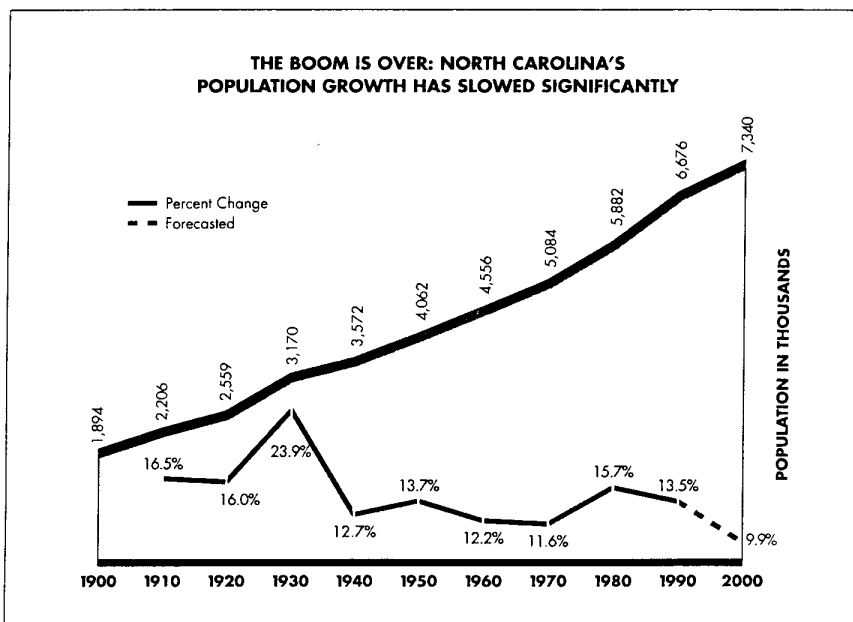
A slower recovery. Recovery from the recession is expected to be slower than that of earlier economic downturns. A slower recovery will reduce State tax revenues in the long term. Our fiscal model projects an average annual increase in North Carolina real personal income of 2.4%, a substantially lower rate of growth than that of previous economic recovery periods. This is significant because personal income taxes and sales taxes provide almost 80% of General Fund revenues. If personal income is growing slower, people have less disposable income with which to purchase goods and services; sales tax revenue slows as well.

Reduced federal assistance. As Congress struggles with the national recession and the federal deficit, North Carolina can expect decreases in

*"If you take a look
at the revenue
trends of this
State, and
compare those to
the expenditure
trends, you will
see a collision
course down the
road."*

Harlan Boyles
State Treasurer

**The structural
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(EXHIBIT 2)

Source: U.S. Department of Commerce, Bureau of the Census

As Congress struggles with the national recession and the federal deficit, North Carolina can expect decreases in federal funding.

federal funding available to support vital State services and programs. From 1981-82 to 1989-90, the federal share of programs the State is responsible for providing dropped from 21% to 16%. The federal government is likely to make further inroads on jointly-shared tax bases, resulting in increased and competing demands on these revenue sources.

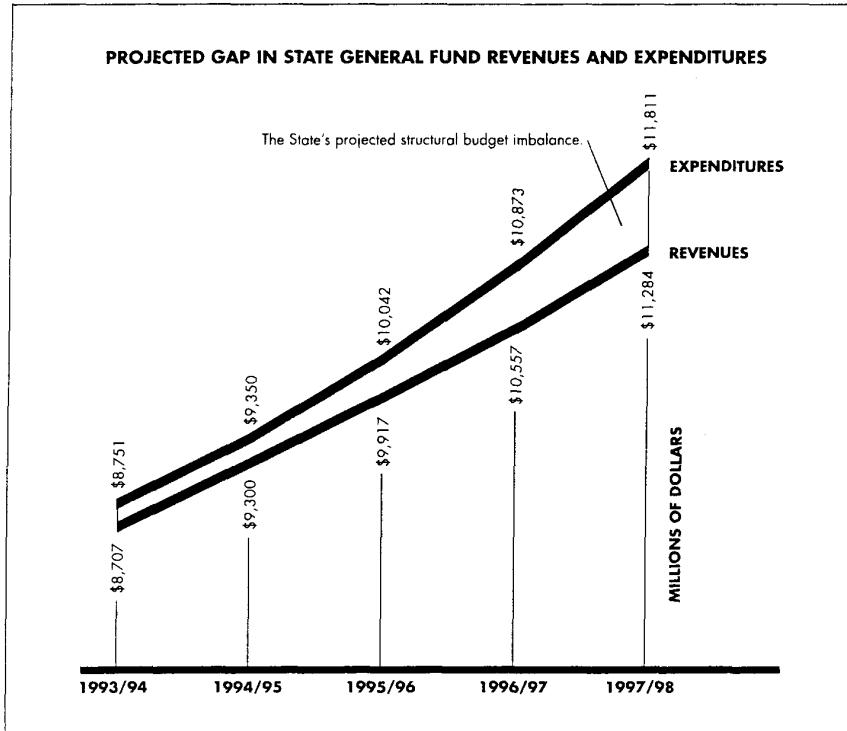
Slower growth in the working age population. Projections show North Carolina's labor force growing by 10% in the 1990s, compared to 24% in the 1970s and 16% in the 1980s. The 18- to 34-year-old group is expected to decline by 140,000. This group accounts for nearly all entry-level labor force growth and most first purchases of housing and other major items.

TREND 2: Increasing Spending Pressures

While revenues are declining, spending pressures are climbing. Unless we significantly increase taxes or severely reduce spending, the State's General Fund revenues will not keep pace with expenditures required by our *current* programs. In other words, we will have a shortfall even without adding new initiatives to respond to emerging needs.

Many of these costs are outside the State's control:

Runaway Medicaid costs. Medicaid costs are out of control, in North Carolina and every other state. Expenditures for Medicaid increased 340% from 1981-82 to 1991-92, but more relevant, are projected to increase an estimated 20% annually during the next decade. The projections do not



(EXHIBIT 3)

Source: Financial Model prepared for GPAC by KPMG Peat Marwick

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reflect changes in federal regulations which could increase the burden to states unless some form of national health insurance is introduced.

Prison overcrowding. The State is operating under a federal court order to reduce prison overcrowding. Since the initial settlement in 1987, the General Assembly has authorized \$187.7 million in State funding for construction of prison facilities. An additional \$200 million was approved by voters in 1990. Operating costs for new prison space are enormous: the cost of operating the expansion funded by the \$200 million alone is estimated at \$67 million a year.

Growth in the number of school age children. After peaking in 1976 and flattening out in the 1980s, the number of public school students will rise again in the 1990s. By the year 2000, enrollment is projected to increase by 140,000 students—or 2,300 additional bus loads per day. At today's costs, these 140,000 students will add roughly \$400 million to the State's budget.

Investments in elementary and secondary education. North Carolina is more than halfway through the Basic Education Program (BEP), a major effort to improve K-12 education. The program required expenditures of \$491 million from fiscal year 1984-85 to 1991-92. BEP calls for additional, new funding of \$348 million through 1994-95. A percentage of these costs are for new teaching, counseling and other positions, which are reoccurring, not one-time costs.

"We can't do anything else on the deficit if we can't cut the monster of spiraling health care costs."

President
Bill Clinton

Requirements of the University of North Carolina (UNC) system. The University's enrollment grew 24% over the past 10 years, and UNC is projecting continued enrollment growth of 21% for the next decade. Adding to UNC funding requirements are projected building renovation and replacement costs of \$541 million.

Changing skill needs. The Commission on the Future of the North Carolina Community College System identified an emerging "skills gap," in which the skills needed to seek and hold jobs in new technical industries are not being taught in the State. The Commission estimates that training North Carolina's workforce in these new skills will require an additional \$135 million per year.

Aging of the State's population. The State's population is projected to shift in the 1990s, with an increase in the number of residents over age 64. The number of residents over age 85 is expected to rise by roughly 70%. Because of their greater need for assistance, this age group has a high demand for costly social services.

TREND 3: *Constant Change*

The State is experiencing a major transformation, similar to the transformation of our society from agrarian to industrial, as we move from the industrial age into the age of information. The emerging role of women in the workforce, the increased mobility of our residents within and outside of the State, the emergence of new health care, social service, and even corrections systems are merely illustrations of a society in flux.

What makes these changes different from those of the past is the speed at which they are occurring. When we say the world is changing, we mean weekly, daily, hourly...and it's only going to get faster.

Our ability to store, access and manipulate information is changing the way we do everything else, from materials engineering to biotechnology, from health care to public education. Improvements in information technology provide—and require—a level of efficiency, productivity and accountability that was unthinkable just a few years ago. This technology is more than a tool: it's a mechanism of cultural change.

What do we mean by cultural change? Deep-seated changes that will change how we think about things, how we do things, what skills we need, and how we are measured. This change is pushing us to:

- Invent new approaches to solving problems
- Empower people to respond to change
- Become lifelong students
- Take risks

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Smart Strategies For Tough Times

Like many families who have added up their budgets and found the resources lacking, the State of North Carolina is going to have to make fundamental changes in the way it does things. Our challenge is to change the culture of State government, to ensure that we make every dollar—and every action—count.

That's why the North Carolina Government Performance Audit Committee was formed. With this report, our Committee begins the process of setting the State's agenda for the 1990s and beyond.

OUR OPPORTUNITY

North Carolina has a long record of success in responding to the challenges of the past. The State's ability to envision new possibilities, tackle tough decisions, take leadership positions and manage our fiscal affairs has created an excellent starting point for change.

Building On A History Of Success

Among our many achievements, the State:

Assumed responsibility during the Depression. When the Great Depression of 1929 abruptly ended a period of prosperity, the State budget was reduced by one-third, State employees' salaries were cut by 20-25% and the price of cotton, tobacco and other crops dropped dramatically. The North Carolina General Assembly reacted in a positive and strategic way, taking responsibility for roads, public schools, prisons and other vital functions local jurisdictions were unable to maintain. As a result, the State was one of the first to return to normalcy after the Depression.

Anticipated a high technology future. North Carolina has earned a national reputation as a leader in technology as a result of the vision and cooperation of the State's business and industry, public and private universities, and government leaders. In the 1950s, that vision led to the creation of Research Triangle Park, now a 6,700-acre park housing 50 high technology research organizations and employing more than 30,000 people with an annual payroll of more than \$1 billion.

In the 1980s, farsighted government initiatives resulted in the creation of other models of public-private partnership, such as the Microelectronics Center of North Carolina, focusing on microelectronics, communications and

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"There isn't much that Washington can do to solve our problems. The action is on the State and local level today."

Jane Smith
Patterson
Vice Chancellor,
UNC-Wilmington

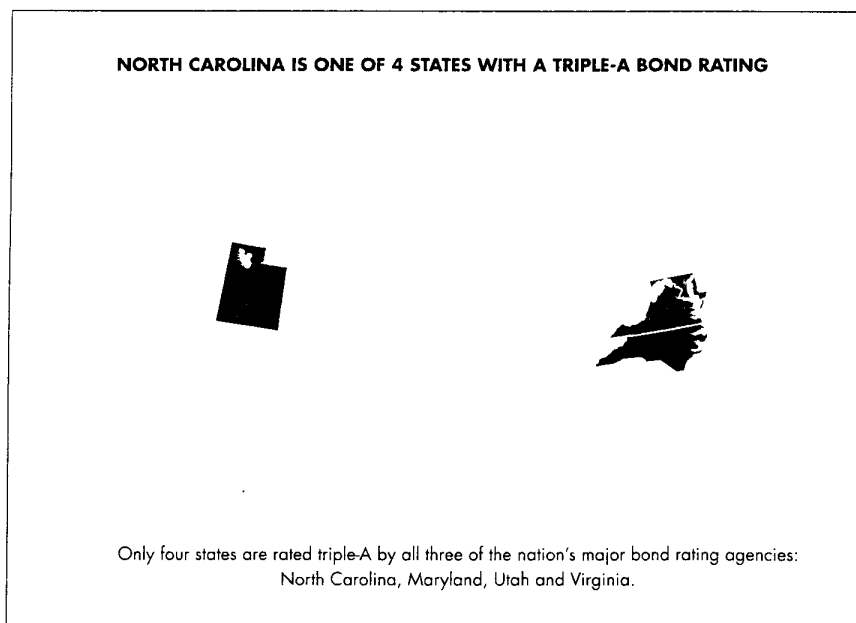
supercomputing, now one of five national testbeds in high speed telecommunications technology; and the North Carolina Biotechnology Center, the first state-based biotechnology center in the nation.

Put educational reforms in place. Realizing the need to make radical changes in North Carolina's educational system, the General Assembly took major action in the 1980s. The Basic Education Plan (BEP), approved in 1984 and funded in 1985, provided additional resources to public schools in the form of teachers, aides and other professional personnel. The School Improvement and Accountability Act of 1989 (popularly known as Senate Bill 2) added flexibility for individual school districts. A new teacher salary schedule was also established in 1981, setting teachers' salaries on the basis of degrees completed and years of experience.

Managed fiscal affairs in a prudent fashion. North Carolina has built a well-deserved reputation for sound fiscal management. Today it is one of only four states given a triple-A bond rating by all three national rating agencies. Standard & Poors' affirmation of the State's triple-A rating in 1992 reflects

"The 1991 General Assembly dealt with North Carolina's budget crisis in a responsible and farsighted way. We are in far better condition than most other states."

Governor
James B. Hunt



**North Carolina
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management.**

(EXHIBIT 4)

Source: Fiscal Research Division, North Carolina General Assembly

the discipline displayed in fiscal plans adopted by the General Assembly in 1991 and demonstrated in earlier economic downturns. Other measures of fiscal responsibility include the State's debt rate, one of the lowest in the nation, and its accuracy in revenue estimates. North Carolina was one of the few states east of the Mississippi with revenue either on target or exceeding the forecast in 1991-92.

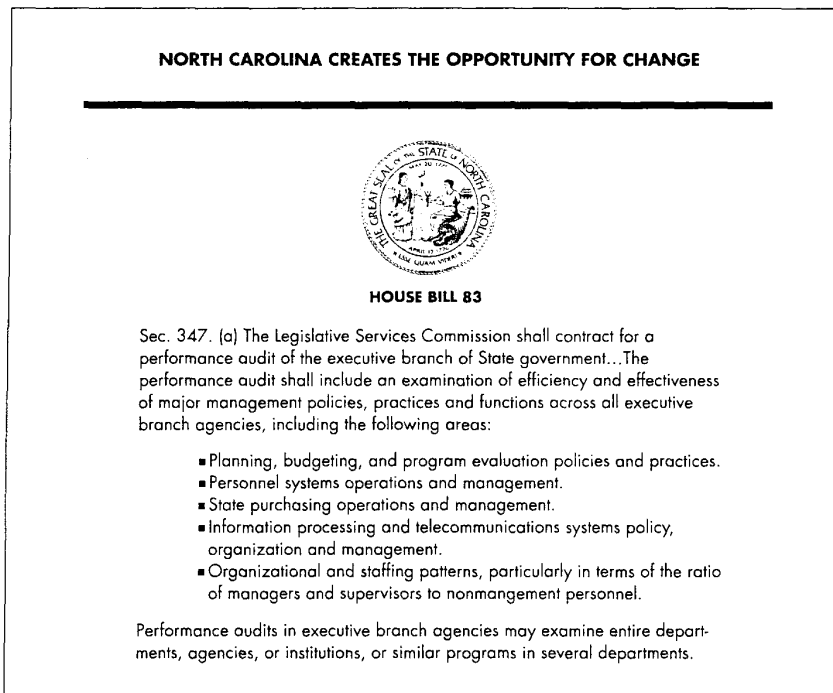
Laying The Groundwork For Long-term Change

The General Assembly's foresight was evident once more in 1991, when it adopted budget reform legislation to address North Carolina's fiscal management over the long term. Among other things, the legislation:

- Required 5-year projections of operating costs for all proposed legislation
- Required 20-year projections of operating costs for capital projects
- Restricted the growth of the total number of State employees
- Limited the growth of the operating budget
- Established a permanent "rainy day" fund
- Mandated a performance audit of State operations

"It's already been shown to us that we're going to have to make serious changes."

Senator
Marc Basnight
President Pro
Tempore of the
North Carolina
Senate



(EXHIBIT 5)

To oversee this comprehensive audit, the General Assembly created the Government Performance Audit Committee, co-chaired by the Speaker of the House of Representatives and the President Pro Tempore of the Senate, and consisting of 27 members from the private and public sectors. We were asked to:

- Put aside "business as usual" assumptions
- Rethink the way government operates
- Develop strategies to improve the quality of State services

Our Committee was asked to put aside business as usual and to rethink the way government operates.

- Find and recommend opportunities to restructure, reallocate or reform service delivery systems
- Recommend better management practices
- Set priorities for future State spending

The General Assembly instructed the Committee to carry out our activities in two ways: 1) A study of the major management functions that support the activities of virtually every State department, program and activity; and 2) Detailed investigations of specific issues that, in the opinion of the Committee, could have an impact on improving services, reducing costs or both.

From the beginning, the work of the Government Performance Audit Committee has attracted State and national interest. Its establishment was one of the reasons cited by Standard and Poors for maintaining the State's triple-A rating. And, as the first attempt by a State legislature to use this strategy to examine and plan for its fiscal future, our Committee is already serving as a model for other states.

From October 1991 to February 1993, the Government Performance Audit Committee investigated the processes and programs of the State, with the assistance of a team directed by the national firm of KPMG Peat Marwick. A complete listing of the Peat Marwick team and its primary subcontractors is included as an appendix to the report.

Over the last year the Committee has collected detailed data from all three branches of government; interviewed hundreds of State officials, employees and citizens; surveyed thousands of State employees; and solicited comparative information from other states and organizations. This is our report to the members of the General Assembly and the citizens of North Carolina.

*"You have to
choose. That's
what government
is about."*

Representative
Daniel T. Blue, Jr.
Speaker of the
North Carolina
House of
Representatives