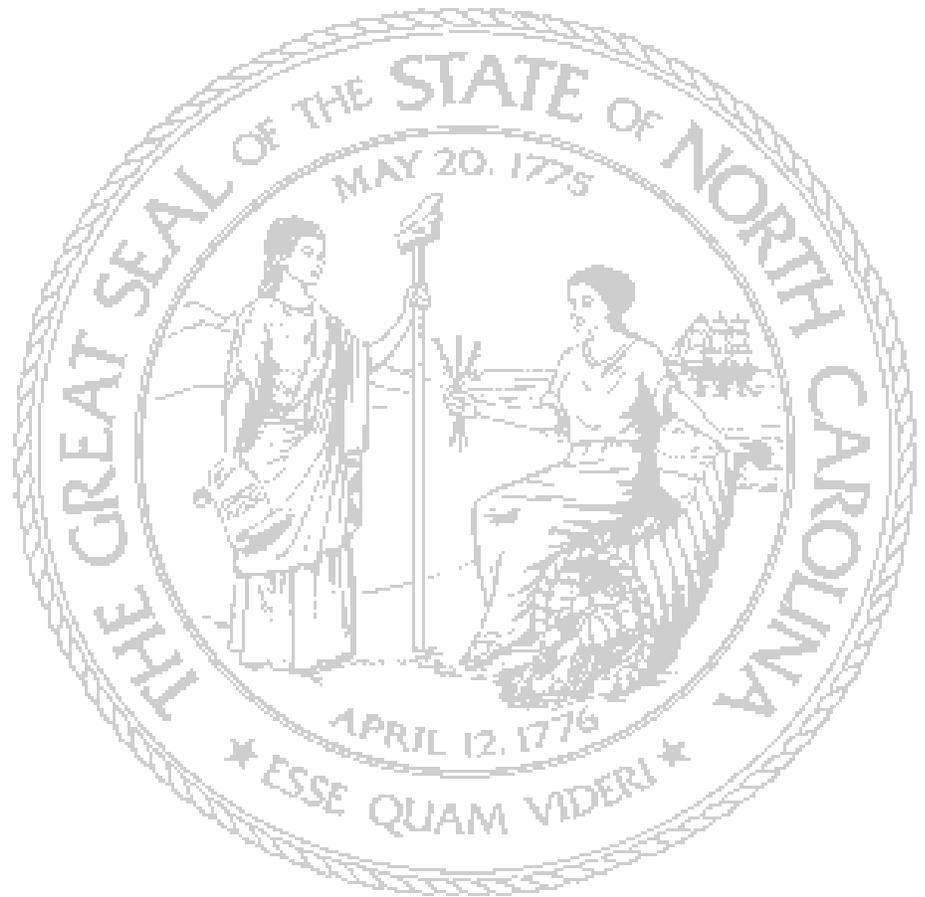


State of North Carolina

***Financial
Highlights
For the
Fiscal
Year 1998***



Edward Renfrow, State Controller

State of North Carolina

Financial Highlights

For the Fiscal Year 1998

Prepared by the North Carolina Office of the State Controller
Edward Renfrow, State Controller
<http://www.state.nc.us/OSC>



I am pleased to present you with the *State of North Carolina Financial Highlights* for the fiscal year ended June 30, 1998. This *popular report* represents our continuing commitment in providing the highest standards of financial management and reporting, as well as fiscal accountability of the resources of the State of North Carolina reporting entity. We hope that you find this report both informative and beneficial and we welcome any questions or comments. If you need additional copies, or have questions about this report, please contact either me or our Statewide Accounting Division staff at (919) 981-5454.

Thank you for your interest in the State of North Carolina.

Sincerely,

A handwritten signature in dark ink that reads "Edward Renfrow". The signature is written in a cursive style.

Edward Renfrow
State Controller
March 22, 1999

Introduction

This popular report, *North Carolina Financial Highlights*, is intended to summarize basic financial information about our State. This information is supported in more detail in the State's Comprehensive Annual Financial Report (CAFR). The CAFR is prepared in accordance with generally accepted accounting principles and is independently audited by the North Carolina Office of the State Auditor. Much of the information in the CAFR is necessarily technical and complex. As a result, the full financial statements and note disclosures may not be as useful to the citizens of the State wishing to gain a more general understanding of the State's finances.

The *popular report* is a report for the people. *North Carolina Financial Highlights* is the product of a coordinated effort on the part of state and local governments to issue simplified financial reports. It is our intent to provide you with information about the State's financial condition, without overwhelming detail and technical accounting terminology. This report contains financial information for the State's fiscal year ended June 30, 1998. The State's fiscal year starts July 1, and ends the following June 30.

State of North Carolina — Financial Highlights — Fiscal Year 1998

Information is presented in this report on both the cash and generally accepted accounting principles (GAAP) basis. Labels have been used to note which basis of accounting is being shown.

The State's complete financial statements, known as the CAFR, can be obtained on the internet at <http://www.state.nc.us/OSC>, by telephone at (919)981-5454, or by writing to the N.C. Office of the State Controller, 3512 Bush Street, Raleigh, N.C. 27609-7509.

State Reporting Entity and Its Services

The State of North Carolina reporting entity includes all of the departments, agencies, boards, commissions and authorities governed and legally controlled by the State's executive, legislative and judicial branches of government.

In addition, the popular report includes financial information for legally separate component units for which the State is financially accountable.

The State's component units are the University of North Carolina system, the State's community colleges, and various proprietary organizations providing specific services to the public and private sector.

The State and its component units provide a broad range of services to its citizens, including

- public education;
- higher education;
- health and human services;
- economic development;
- environment and natural resources;
- public safety, corrections, and regulation;
- transportation;
- agriculture; and
- general government services.

The Economy

1998 Results Demonstrated Continued Growth

- For the seventh straight year, both the national and North Carolina economies grew in 1998.
- Gross State Product, a measure of economic output in the State, rose by over 5% in 1998.
- The State's job market also improved, with over 40,000 net new jobs added to the labor force. The State's unemployment rate fell to 3.5%, and in the State's metropolitan areas, unemployment dropped to under 2.5%.
- Economic growth in North Carolina was widespread across most economic sectors. One exception was the textile and apparel sector, where 11,000 jobs were cut in 1998.
- Inflation and interest rates were helpful to the economy in 1998.
- The improved interest rate situation was helped by a turnaround in federal fiscal affairs. For the first time in twenty-nine years, the unified federal budget ran a surplus. The surplus reduced the need for borrowing by the federal government and reduced the pressure on interest rates.

Potential for Slower Growth in the Near Future

- Financial problems in several foreign countries, including Japan, contributed to sharp declines in the U.S. stock market. Thus, as 1998 came to a close, more and more decision-makers were questioning whether the long economic expansion was about to be overtaken by a recession.
- There are two major issues facing today's economy. One is the financial and economic decline in several foreign countries, including Japan, Russia, South Korea, Indonesia, and Brazil. The other major economic issue is the prospect for faster rising labor costs. For example, labor costs rose an estimated 3.5% in 1998, up from 3.1% in 1997 and 2.8% in 1996. Thus far, improved labor productivity has offset the additional labor costs. But many economists think this fortunate circumstance will not continue.

Outlook for Our Economy

- The outlook is that the economy will indeed grow more slowly in 1999. Nationally, Gross Domestic Product will grow 2.5%, and no net new jobs will be added to the national payrolls.
- In North Carolina, Gross State Product will increase 3.5%, and job growth will be 1.5 %, down from 1998's 2% growth rate.
- Job growth in North Carolina's manufacturing sector is expected to be only 0.6% in 1999.

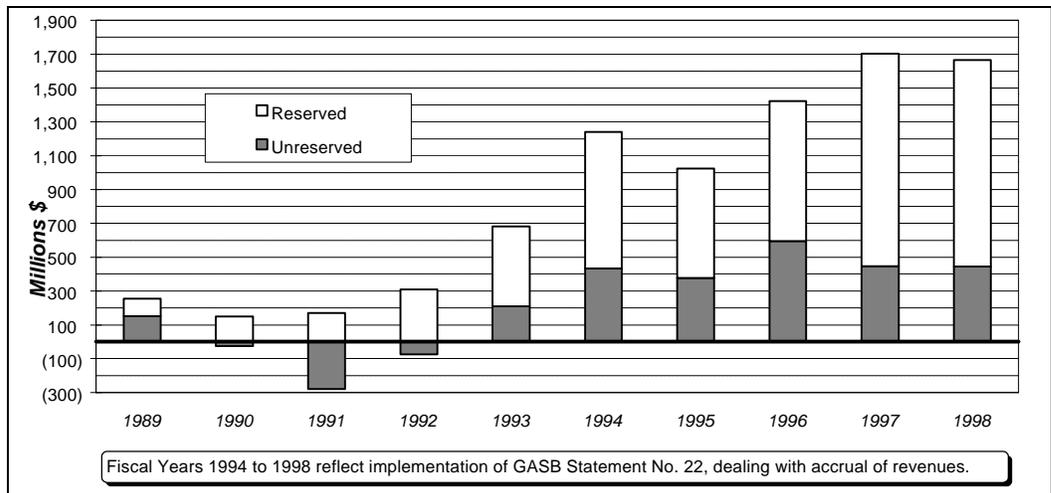
- ❑ The real (inflation-adjusted) value of residential construction in the State rose 14% in 1998, but is forecasted to rise only 5.5% in 1999.
- ❑ Pushed by faster climbing labor costs, the inflation rate is projected to rise to between 2% and 2.5% in 1999, up from 1998's rate of 1.6%. Interest rates will either change little or edge up slightly.
- ❑ An economic slowdown is forecasted for the nation and for North Carolina in 1999. However, North Carolina's economy will move forward in 1999, but at a slower pace.

Source: Dr. Michael L. Walden
November 2, 1998

General Fund GAAP Fund Balance

Although the growth in tax and other revenues once again exceeded expectations this year, which directly contributed to the strong condition of the General Fund, current year outflows and amounts owed to others exceeded dollars collected and owed to the State by \$33.8 million.

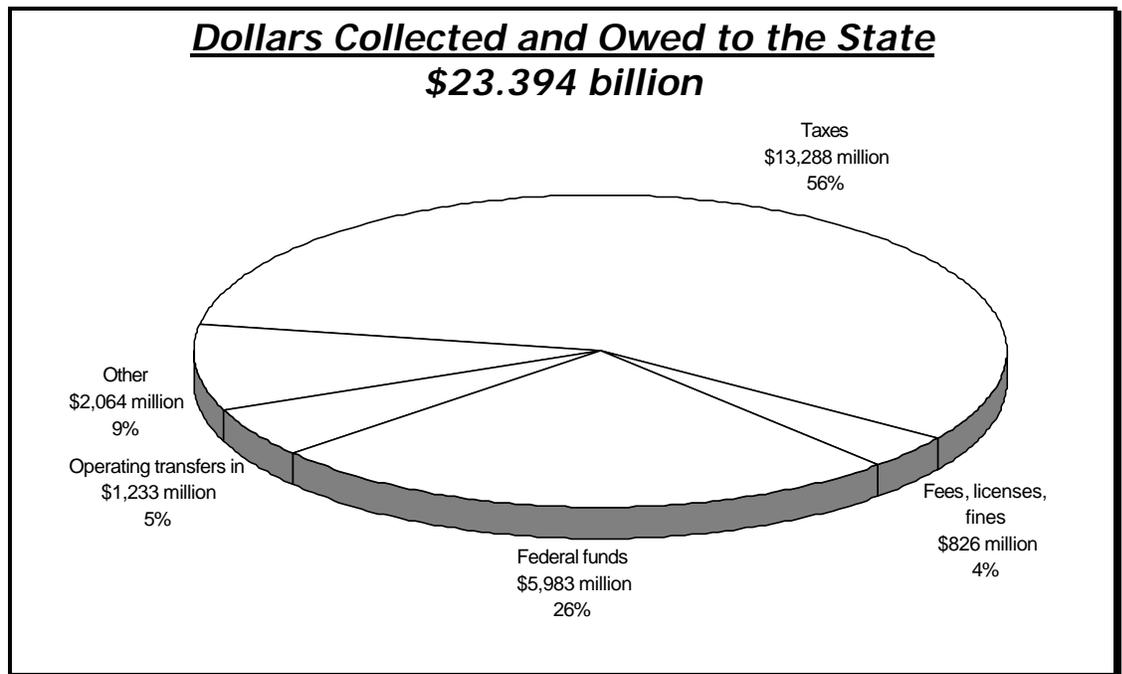
At June 30, 1998 the total fund balance of the General Fund on the modified accrual basis was \$1.665 billion, in comparison to a \$1.704 billion balance at the end of 1997.



Reserved fund balance represents commitments of funds. The reserved portions indicate to the State's management that these monies are not available for discretionary spending.

Unreserved fund balance is what is available to fund future non-recurring needs of the State.

General Governmental Funds - GAAP Basis



Dollars Collected and Owed to the State

Collections and receivables for general governmental functions (General Fund, special revenue funds, and capital projects funds) amounted to \$23.4 billion for the fiscal year ended June 30, 1998, using the modified accrual basis of accounting.

Tax Revenues. Tax revenues increased by \$1.1 billion in 1998, reflecting a continuing favorable economic climate in North Carolina.

Income tax collections increased by \$800.2 million in 1998 to \$7.1 billion, a 12.7% increase over 1997.

Sales tax collections grew by \$138 million in 1998, to \$3.3 billion, a 4.4% increase over 1997.

Highway taxes (gasoline and highway use) were \$1.477 billion in 1998, \$89.9 million more than in 1997.

Federal Funds. Federal funds revenues grew by \$125 million in 1998, up by 2.1% over 1997. Increases in Federal revenues are due to increased Federal program expenditures for which the State is reimbursed.

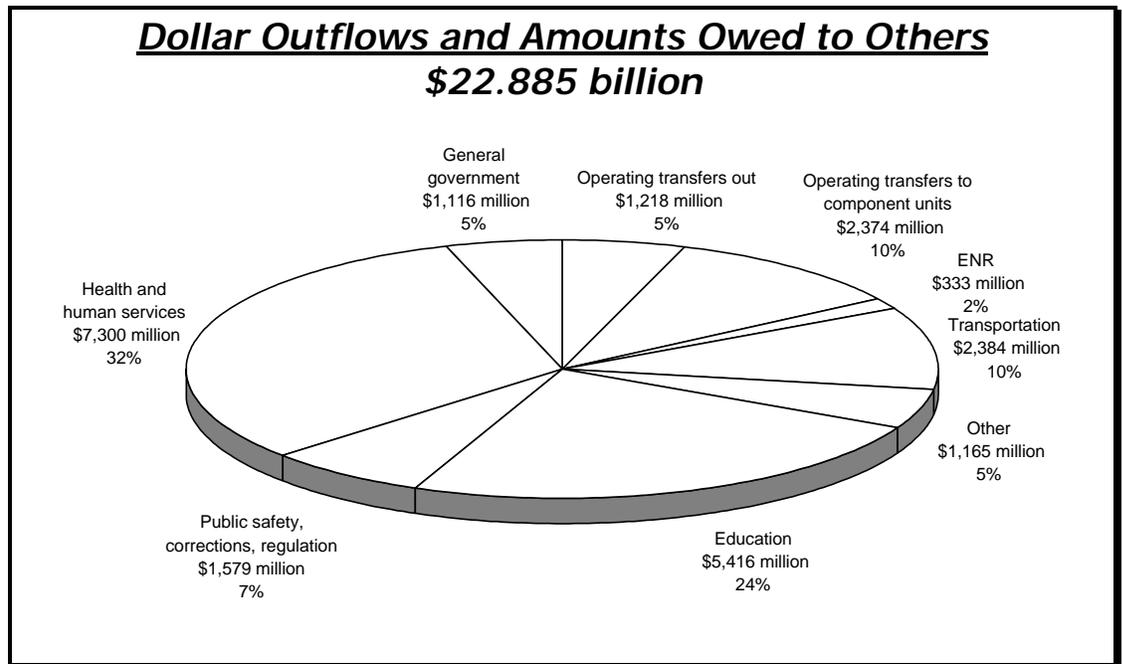
Investment Earnings. Investment earnings reflect an increase of \$121 million in 1998.

Several factors contributed to this increase. In fiscal year 1998, the State implemented a new accounting standard which resulted in fair value accounting for investments, and an investment earnings increase of \$7 million.

Securities lending activity resulted in an increase of \$40 million, while interest earnings on bond proceeds accounted for \$51 million of the investment earnings increase.

General growth in investment earnings accounts for the remaining increase of \$23 million. The growth in 1998 can be directly attributed to the favorable investment climate through June 30, 1998, and the investment management strategies of the State Treasurer.

Dollar Outflows and Amounts Owed to Others



Expenditures and other financing uses for general governmental purposes totaled \$22.9 billion in 1998, using the modified accrual basis of accounting.

Significant changes in outflows and amounts owed to others. The trend of increases in expenditures, an increase of \$1.6 billion for 1998, was directly related to the continued emphasis on education, health and human services, and transportation.

A large portion of the increase in governmental expenditures, *retiree tax judgments*, is the result of the North Carolina Supreme Court ruling in the Bailey case.

On June 9, 1998, representatives of the State and the various retirees involved in the Bailey and Patton cases announced a settlement, which was later approved by the court, in the amount of \$799 million. Of this amount, \$400 million will be disbursed in refunds in fiscal year 1998-99, and \$399 million will be paid in refunds during fiscal year 1999-2000.

Educational expenditures of \$5.4 billion reflected an increase of \$640 million largely because of growth in dollars spent on State administered programs and the increasing costs associated with providing public education. In addition to these expenditures for education, \$1.654 billion is distributed to the University System and \$619.6 million is distributed to the State's community colleges as transfers to component units. Including transfers, total State funding for public education in North Carolina was \$7.7 billion in fiscal year 1998.

Health and human services increased by \$477 million in 1998 (\$143 million when adjusted for reorganization), with this increase largely attributable to the reorganization of the State's public health resources. An offsetting decrease in expenditures of \$335 million occurred in expenditures for environment and natural resources. There was a decrease in spending for 1998 for public safety, corrections, and regulation of \$35 million. This decrease compared to 1997 is the result of decreased emergency assistance payments (hurricane relief) through June 30, 1998.

Transportation expenditures increased in fiscal year 1998 by \$179 million.

Debt service will continue to climb, a \$39 million increase from 1997 to 1998, as the State continues to issue general obligation debt to fund capital projects for education, highways and utilities.

Intangibles Tax Ruling

On February 21, 1996, the U.S. Supreme Court declared North Carolina's intangibles tax unconstitutional.

Subsequently, the State made refunds of intangible taxes paid by all persons who had complied with the provisions for obtaining refunds of unconstitutional taxes. The *Smith* and *Patton* cases were actions aimed principally at recovering intangibles tax refunds for taxpayers who failed to comply with these provisions. On December 4, 1998, the Supreme Court ruled that North Carolina will have to pay refunds to taxpayers who failed to comply with these provisions.

Refunds to these non-protesters will total approximately \$233 million plus interest of approximately \$100 million. Final details of repayment have not been determined.

Year 2000

The Year 2000 issue is the result of shortcomings in many electronic data processing systems and equipment.

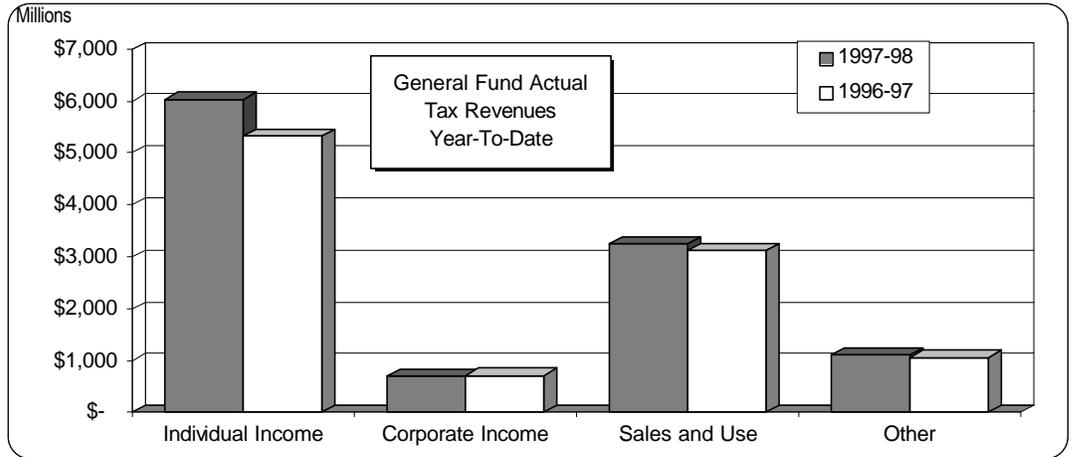
Many systems and equipment, if not corrected, will not be able to distinguish between the Year 2000 and the year 1900.

This may cause the programs or equipment to process information inaccurately or to stop processing data altogether.

In early 1997, the State's Year 2000 Project Team was formed to manage the Year 2000 project from a statewide perspective.

The State is making great efforts to address the mission critical systems potentially affected by the Year 2000.

General Fund Cash Basis Tax Revenues

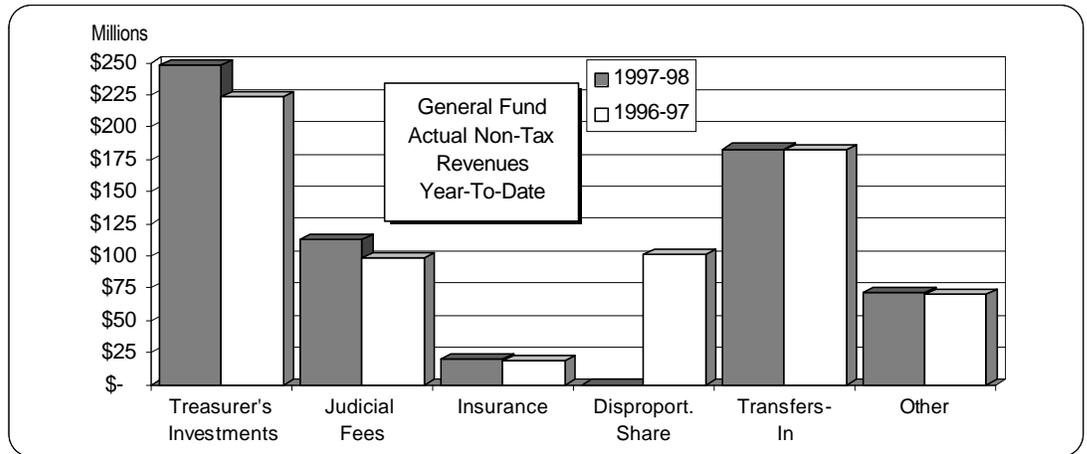


The State's General Fund reflects the efforts of the State to provide for education, health and human services, public safety, regulation, corrections and general government administration.

Monies collected in the General Fund must be authorized to be spent by the General Assembly. Individual income tax, corporate income tax and sales and use tax are the primary sources of income for the State's General Fund.

Primary sources of income will vary from state to state depending on a particular state's tax revenue structure.

General Fund Cash Basis Non-Tax Revenues



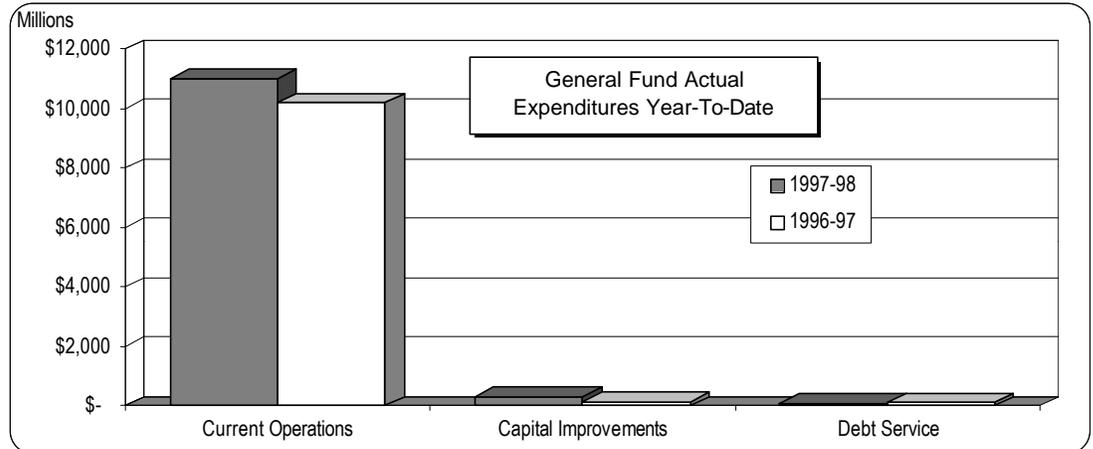
Along with tax revenues, the State collects various fees (judicial, insurance) and other miscellaneous revenues.

Treasurer's investment earnings are the result of the investment of available General Fund cash during the fiscal year.

Disproportionate share receipts are Medicaid payments received by hospitals which serve a disproportionate share of indigent patients

Transfers-in consist primarily of funds reallocated to the General Fund from the Highway Trust Fund.

General Fund Cash Basis Appropriated State Dollars



Examples of current operations expenditures include expenditures for education, health and human services, public safety, regulation, corrections, and general government administration.

Generally each year, a large portion of funding for the infrastructure of the State is funded through capital improvement expenditures from the General Fund.

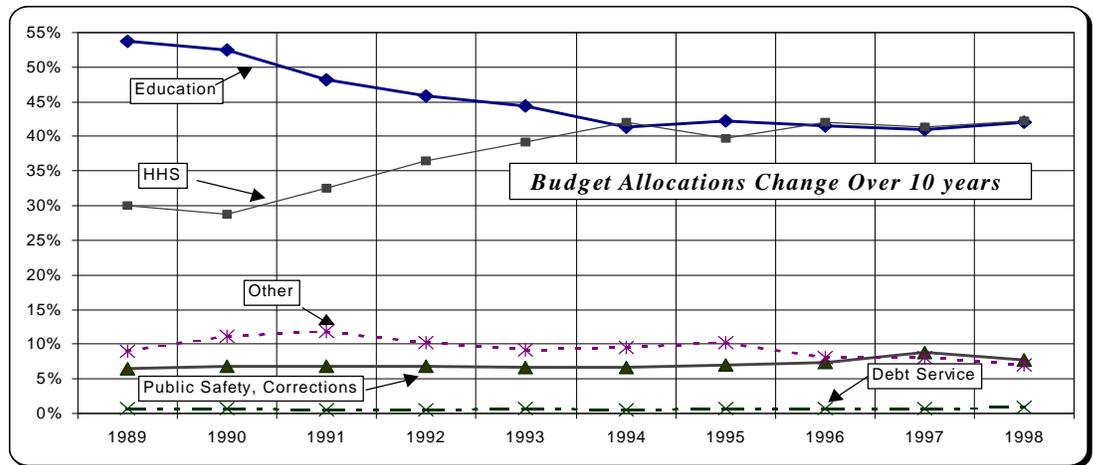
Debt service will begin to grow in proportion to total expenditures as the State issues new general obligation bonds whose funding purpose is the maintenance and construction of infrastructure within the State.

Changes in How Your Dollars are Spent - General Fund Cash Basis

The following chart reflects the changes in budgetary allocations in the General Fund over the last 10 years.

The State's budget, as approved by the General Assembly, typically only addresses State dollars. The revenue and expenditure amounts used to compile the chart below are higher than those referenced during the General Assembly's budget deliberations because of the inclusion of State, federal and local dollars.

Education received 54% of the annual budget (State, federal, and local dollars) in 1989, while funding decreased proportionally to 42% in 1998 when compared to other funding needs. During the same period, the budget allocation for health and human services grew from 30% to just over 42%. The remaining portions of the budget remained relatively the same over the last 10 years.



The primary cause of change in allocations is the result of changes in spending requirements for federal funds in our State.

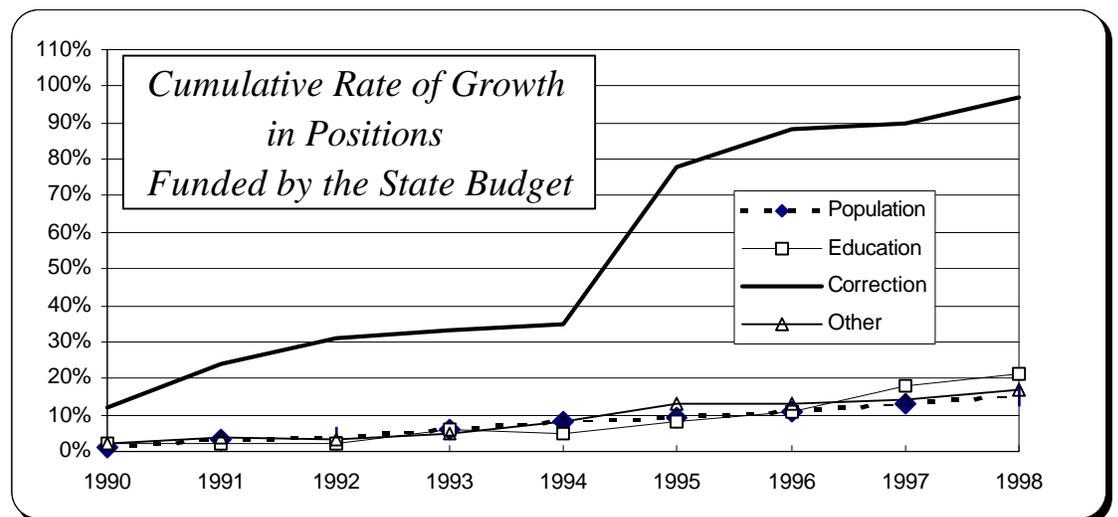
State Government Growth

As the State continues to experience population growth (15%, or 975 thousand people since 1989), the various functions of State government have been and will continue to be affected.

In addition to the pressures of population growth on education, the plan to improve elementary and secondary education in North Carolina has included class size reduction and the addition of teaching assistants. During the last 10 years, 318 new schools, funded by State and local dollars, were constructed in North Carolina. When we provide for the construction of new public schools, we must then fill our new schools with qualified classroom personnel and administrators.

As our population grows, so does the number of criminals that must be supervised in our correctional facilities. In addition, litigation during the late 1980s resulted in additional square footage requirements for inmates, and sentencing laws were strengthened, hence the need for more prison facilities. During fiscal year 1997-98, the State housed approximately 32,000 inmates on a daily basis in 88 State facilities and 5 private facilities.

Most of the position growth in State government during the last 10 years has been in public education, which has increased by 29,313 positions, and corrections which has increased by 9,730 positions.



During the last 10 years, the rate of growth in public education positions (21.3% increase) has exceeded the rate of growth in North Carolina's population (15% increase). During the same period, primarily due to new legal requirements for housing inmates, the rate of growth in correctional positions (110.9% increase) has far and away exceeded North Carolina's population growth.

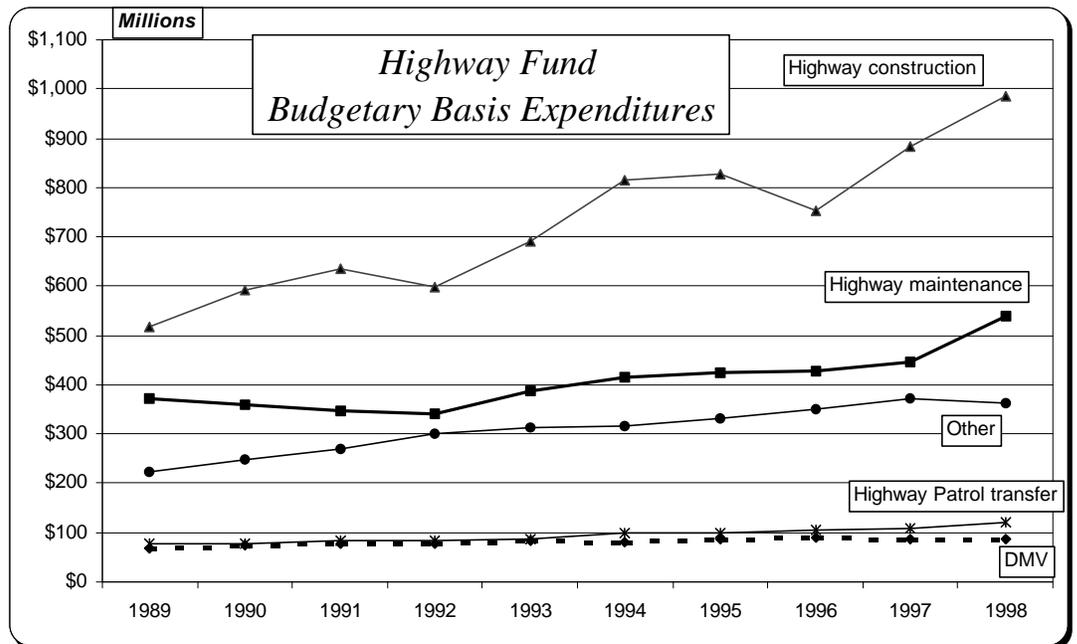
North Carolina's Growth Demands Spending for Transportation Infrastructure

During the last 10 years, the State's highway programs have added in excess of 1,100 miles of highways to our State, or roughly the equivalent of traveling roundtrip from the Town of Manteo on the Atlantic Coast to the Town of Murphy in the Appalachian mountains. With these additions, our State must maintain an estimated 77,856 miles of highway.

Funding for Highway Maintenance and Construction

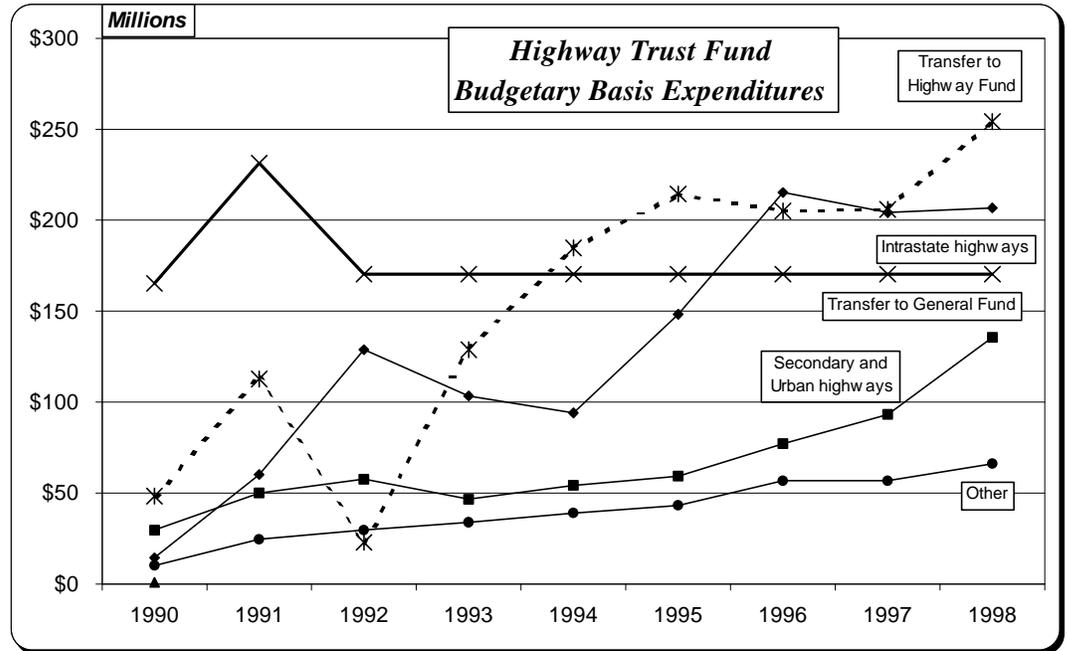
The State's Highway Fund, referred to as a Special Revenue Fund, is funded by specific taxes and fees dedicated to expenditures for the purpose of constructing and maintaining the State's highway system.

The following chart presents information on a budgetary (cash basis) for the Highway Fund.



Highway Trust Fund

The State's Highway Trust Fund, referred to as a Special Revenue Fund, is funded by specific taxes and fees, and is dedicated to expenditures for the purpose of constructing intrastate highway systems and urban loops, with supplements for city streets and secondary roads.



North Carolina's Infrastructure and Capital Improvement Needs Continue to Grow

As stated earlier, the State's population has grown by 15% since 1989. The drawing cards of excellent climate, geography, affordable higher education, and the State's efforts to recruit new industry and jobs have been major contributors.

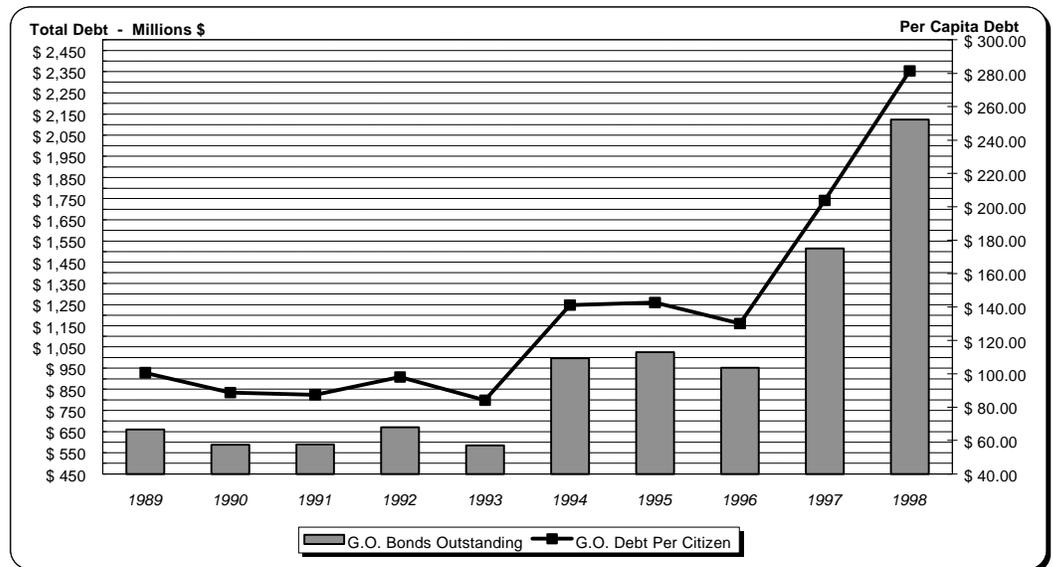
With population growth comes the need to increase and improve the capacities of our infrastructure, i.e., our roads and highways, our public schools, and our clean water.

General Obligation Debt – GAAP Basis

Financial Reputation Allows the State to Borrow at Low Rates

Fiscal Year Ended June 30	General Obligation Debt Per Capita			Ratio of Annual Debt Service To General Expenditures		
	N.C. Population	General Obligation Bonds Outstanding	G.O. Debt per Citizen	Debt Service (Principal and Interest)	Total General Expenditures	Ratio
1998	7,544,360	\$ 2,123,944,000	\$ 281.53	\$ 170,039,000	\$ 19,292,584,000	0.88%
1997	7,431,161	\$ 1,514,477,000	\$ 203.80	\$ 131,249,000	\$ 17,646,075,000	0.74%
1996	7,309,514	\$ 951,082,000	\$ 130.12	\$ 150,741,000	\$ 15,978,166,000	0.94%
1995	7,186,663	\$ 1,025,167,000	\$ 142.65	\$ 141,031,000	\$ 14,755,972,000	0.96%
1994	7,061,823	\$ 996,365,000	\$ 141.09	\$ 123,376,000	\$ 13,333,832,000	0.93%
1993	6,947,724	\$ 584,905,000	\$ 84.19	\$ 124,314,000	\$ 12,870,325,000	0.97%
1992	6,832,621	\$ 670,380,000	\$ 98.11	\$ 114,928,000	\$ 12,078,683,000	0.95%
1991	6,747,962	\$ 590,014,000	\$ 87.44	\$ 106,692,000	\$ 11,366,952,000	0.94%
1990	6,632,448	\$ 588,004,000	\$ 88.66	\$ 110,396,000	\$ 9,999,131,000	1.10%
1989	6,568,810	\$ 660,429,000	\$ 100.54	\$ 110,980,000	\$ 8,891,729,000	1.25%

Total General Obligation Debt and Long-Term Debt Per Capita



If you assume that the additional approved but unissued debt of \$2.6 billion was issued, the general obligation debt would rise from \$2.124 billion to \$4.724 billion. Per citizen debt would rise from \$282 to \$635 per citizen, or 225%.

Source: Population - U.S. Department of Commerce, Bureau of the Census, and N.C. Office of State Budget and Management