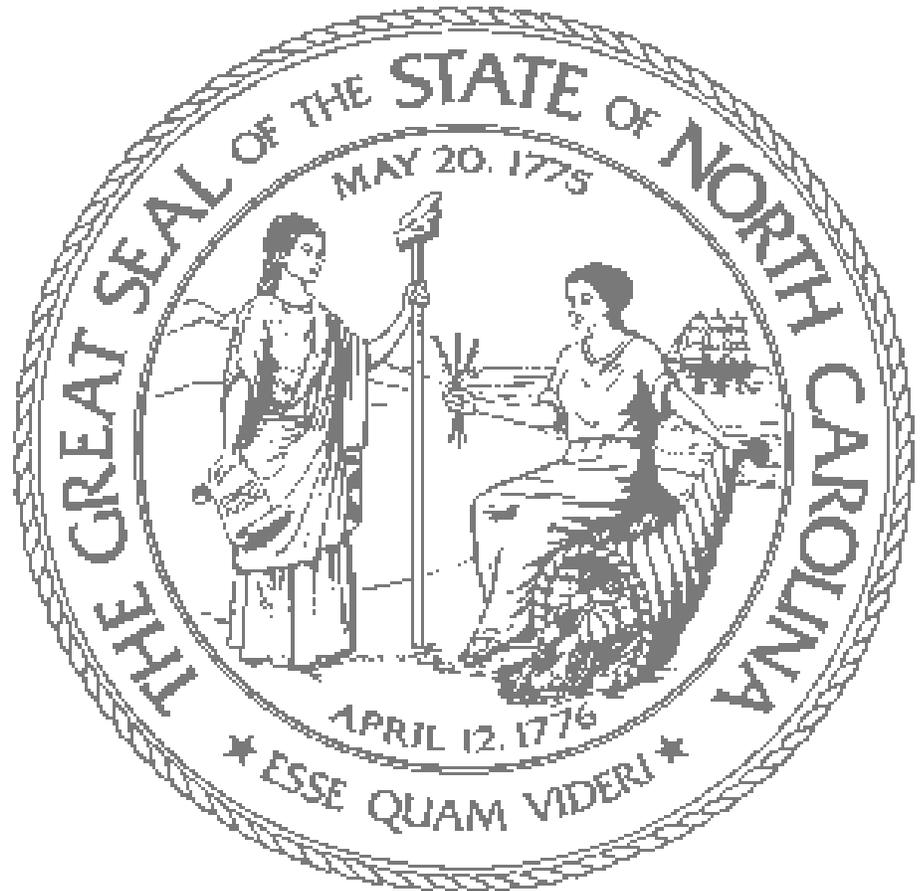


North Carolina

*Financial
Highlights
Fiscal Year
2001*



Robert L. Powell, State Controller

North Carolina Office of the State Controller

<http://www.osc.state.nc.us>

North Carolina — *Financial Highlights* — Fiscal Year 2001

Prepared by the North Carolina Office of the State Controller
Robert L. Powell, State Controller
<http://www.osc.state.nc.us>



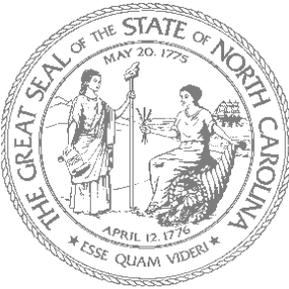
I am pleased to present you with the ***North Carolina Financial Highlights*** for the fiscal year ended June 30, 2001. This ***popular report*** represents our continuing commitment in providing the highest standards of financial management and reporting, as well as fiscal accountability of the resources 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 black ink that reads "Robert L. Powell". The signature is written in a cursive, flowing style.

Robert L. Powell
State Controller
December 20, 2001



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. Our report provides information on our general, special revenue and capital projects funds (*governmental funds*), and certain selected statistical information cited in our CAFR. Coverage of legally separate, but related organizations is limited to university and community colleges and is at a very high level.

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, 2001. The State's fiscal year starts July 1, and ends the following June 30.

Information is presented in this report on the basis of generally accepted accounting principles (GAAP).

This popular report and the State's complete financial statements, known as the CAFR, can be obtained on the internet at <http://www.osc.state.nc.us>, by telephone at (919) 981-5454, or by writing to the N.C. Office of the State Controller, 1410 MAIL SERVICE CENTER, Raleigh, N.C. 27699-1410.

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 other 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.



Museum of Life & Science, Durham

The Economy

The North Carolina outlook depends on two conflicting features of the State's economy. First, continued diversification means that the State's prospects are more in line with the national fortunes as outlined earlier. At the same time, our economy remains more dependent on traditional manufacturing industries and thus is more cyclical than the U.S. This leads to steeper downturns and stronger recoveries.

The diversification of the State's economy during the last four decades can be best illustrated by the fact that in 1970, 46% of the workforce was employed in manufacturing. Today the share is down to 18%, and the trend has accelerated in recent years. In addition, the proportion of manufacturing workers employed in textile, apparel, furniture, and tobacco has dropped from 63% in 1970 to 34% in 2000.

The adjustment within manufacturing has been helpful in alleviating the damage from the movement of traditional manufacturers to Mexico and other overseas locations. At the same time, the collapse of the technology-related firms during this recession is having a larger impact than in previous downturns.

The best example of this latter effect is the rise in the unemployment rate in Catawba County from 2.2% in July 2000 to 7.2% in the same month this year. The Catawba Valley area, home to major fiber optic production facilities, has been hammered during the last year due to excess capacity problems in the telecommunication sector.

The continued diversification of the state's economy is essential to the well-being of North Carolinians in the near-term. However, North Carolina still has 18% of employment in manufacturing, versus 12% for the nation as a whole. This is the main reason why our statewide unemployment rate of 5.2% is now above the national average (4.9%). For most of the 1990's, our rate was consistently a point or so below the U.S.

There may be a silver lining to the cyclical nature of the North Carolina economy: our recoveries tend to be stronger than other states. For example, during the first two years of the recovery from the 1981-82 recession, the income of the State's residents ("personal income") grew 33% faster than the U.S. In the same period following the 1990-91 recession, our economy rose 46% faster. In fact, our combined growth rate for 1992 and 1993 was the fifth highest in the U.S. It is very possible that if the nation experiences a strong economic recovery in 2002 and North Carolina follows the traditional pattern, we could have a very improved situation by the middle of next year.

A specific North Carolina trend that we need to watch is the slowing employment gains in the financial group (finance, insurance, real estate) and in services in recent years. From 1995-98, high growth in these sectors (over 8% during one quarter) offset the long-term decline in traditional North Carolina manufacturing industries.

However, in 1999 the impact of mergers and consolidations in banking and health care led to a sharp drop in the rate of growth of non-manufacturing employment. What we do not know at this time is whether this trend will continue once the overall economy begins a recovery.

The single most important state economic factor for the State budget is wage and salary payments. This source of income makes up 74.8% of taxable income in North Carolina. Expressed another way, about 40% of the General Fund revenue base is tied to net withholding payments (gross payments less refunds) and withholding is directly related to wage payments.

For the 1995-99 period, wages and salaries paid by employers grew at an average annual rate of 7.5%. Even during 2000, the rate of increase amounted to 7.2%. The reason for the stability through 2000 was the fact that average pay rates were still increasing at a rate of almost 4%, and employment changes always lag changes in the overall economy. Thus, unemployment did not begin to accelerate until late in the downturn.

A review of Employment Security Commission data indicates that the employment slowdown has begun. For the first quarter of 2001, wage and salary growth dropped to 4.9%. Based on withholding tax receipts, we think that the rate of increase for the second quarter was 3.8% and 2.6% for the third quarter.

Slower wage and salary growth is due partly to smaller increases in employment. For example, nonagricultural employment in North Carolina was 1.9% higher in July 2000 than for the same month the prior year. Tentative data for July 2001 indicates that the increase slowed to .3%. This report does not include data from start-up firms. However, even if an adjustment is made for this factor, net job growth in the state is no higher than 1.1%. A more serious problem is the fact that average weekly hours worked in manufacturing has declined from almost 41 hours in July 2000 to 39 hours this year, a 4.4% reduction.

Since sales tax collections amount to another 25% of the revenue base, the drop in retail sales activity in the State is important. The measure used by the General Assembly's Fiscal Research Division is gross state and local sales tax collections prior to refunds to local government and nonprofits. Throughout 2000, consumer spending was a stabilizing force in the overall economy, even as corporate profits and stock prices took a nosedive. As recently as the first quarter of 2000, sales tax receipts were growing at a 3.4% annual rate.

The bottom dropped out of consumer spending during the Spring. For the April-July period, taxable sales fell at a 2.2% annual rate. In August, receipts were up .6% due to the \$600 federal tax rebates. If the events of September 11 had not taken place, we might have continued to experience modest positive growth in retail sales as the remainder of the refund checks were distributed.

Now we are facing a different situation. In September, state and local sales tax collections fell at a 3.8% annual rate. In October, the rate of decline was 1.4%. Data for these two months captures the August 16 – October 15 sales period for large merchants and August 1 –

September 30 for smaller vendors. The data clearly indicates the impact of the events since September 11 on consumer confidence and shopping activity.

During the last downturn, tight monetary policy and the elimination of incentives caused car and light truck registrations in North Carolina to fall from 433,477 units in the 1987-88 fiscal year to 405,776 in 1988-89 and then to 360,929 in 1989-90. When the Gulf War recession hit, sales dropped another 17% to 299,757.

This time around, consumer spending has been a stabilizing force, as reflected in stronger-than-expected auto sales. For example, vehicle registrations peaked at a record level of 493,778 during the 1999-2000 fiscal year. Part of this strength was gains to investors from the roaring stock market and the exercise of stock options. For 2000-01, the level of sales dropped 7% to 459,300 units, a modest decline for an economic downturn. To counter the effects of September 11, manufacturers are now offering zero percent financing. Nationwide, this has pushed sales back to the highest level in recent years.

— *Economic analysis prepared by David Crotts*
Fiscal Research Division
North Carolina General Assembly
November 1, 2001



University of North Carolina at Chapel Hill

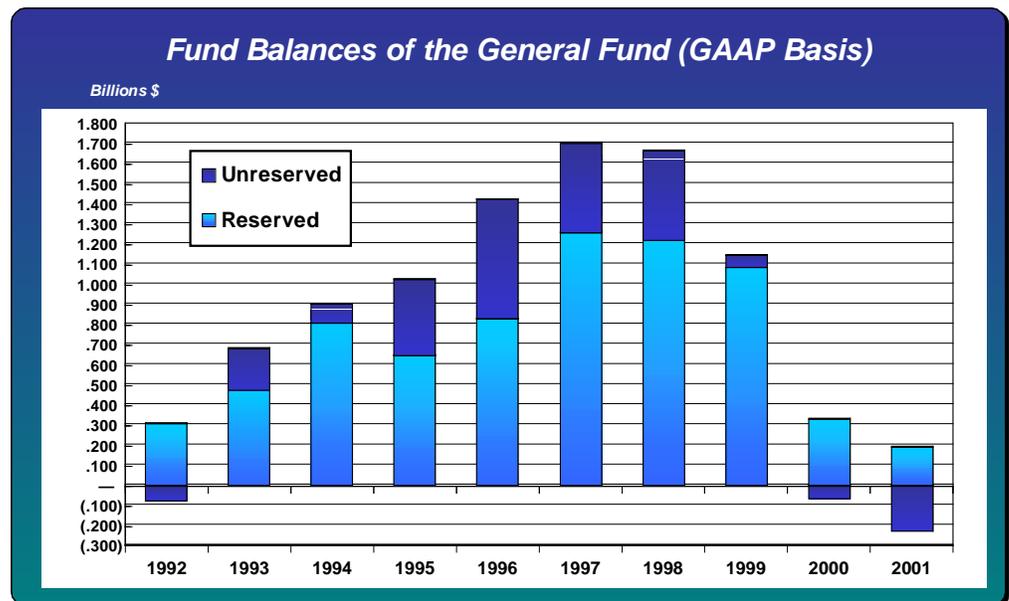
General Fund GAAP Fund Balance

The fund balance of the General Fund declined by \$298.1 million in 2001. Expenditures and transfers out exceeded revenues and transfers in by \$239 million. Total assets at June 30, 2001, were \$4.513 billion, with total liabilities at \$4.545 billion. Tax refunds payable were \$951 million in 2001, as compared to \$1.0129 billion in 2000.

Fiscal year 2000 tax refunds payable includes \$100 million of individual income tax refunds deferred for payment to fiscal year 2000-2001 due to processing delays, and \$20 million in corporate income tax refunds delayed to balance the General Fund budget on a cash basis.

In an average year, taxpayer refunds as a percent of gross cash collections approximate 13.5% for individual income tax; just over 8% for corporate income tax; and 5.5% for sales and use tax. These rates of overcollection are the result of the State's tax policies, tax withholding and estimating tables, and in some cases, the desire of the taxpayer to receive a refund at the end of the tax year.

At June 30, 2001, total fund balance of the General Fund on the modified accrual basis was a negative \$32.4 million, in comparison to a \$265.7 million balance at the end of 2000. The following chart illustrates the fund balances on the modified accrual (GAAP) basis of the General Fund for the last ten fiscal years.



The State's unreserved fund balance designations in the General Fund represent tentative plans for use in a future period. The State's internal governing body (*General Assembly*) establishes restrictions on the use of these assets which are reported as fund balance designations. Fund balance designations in the General Fund are established based on the amount of reserves available as measured on the budgetary basis of accounting and authorized carryforwards for continuing General Fund programs. These designations totaled \$608.971 million. As shown in the table below, the unreserved fund balance available to be designated was a negative \$224.922 million on a modified accrual basis (dollars in thousands):

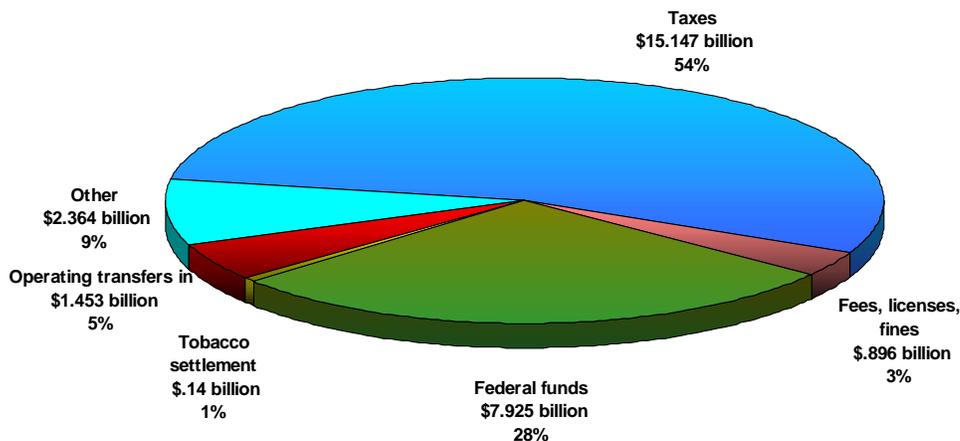
Unreserved Designated Fund Balance	General Fund
Disaster relief.....	\$ 448,608
Educational programs.....	77,918
Other purposes.....	25,159
Public safety, corrections, and regulation programs.....	22,749
Health and human services programs.....	22,415
General government programs.....	7,553
Economic development programs.....	3,399
Disproportionate share.....	1,170
Total designations.....	\$ 608,971
Unreserved fund balance.....	\$ (224,922)

Restrictions in the form of reserves of \$192.5 million, exceeded total fund balance of negative \$32.4 million, resulting in a negative \$224.9 million unreserved fund balance. The State's liabilities to creditors and restrictions/designations of fund balance (equity) exceed the State's assets as determined by generally accepted accounting principles by a total of \$833.9 million.



NC Zoological Park, Asheboro

General Governmental Funds - GAAP Basis ***Dollars Collected and Owed to the State*** ***\$27.925 billion***



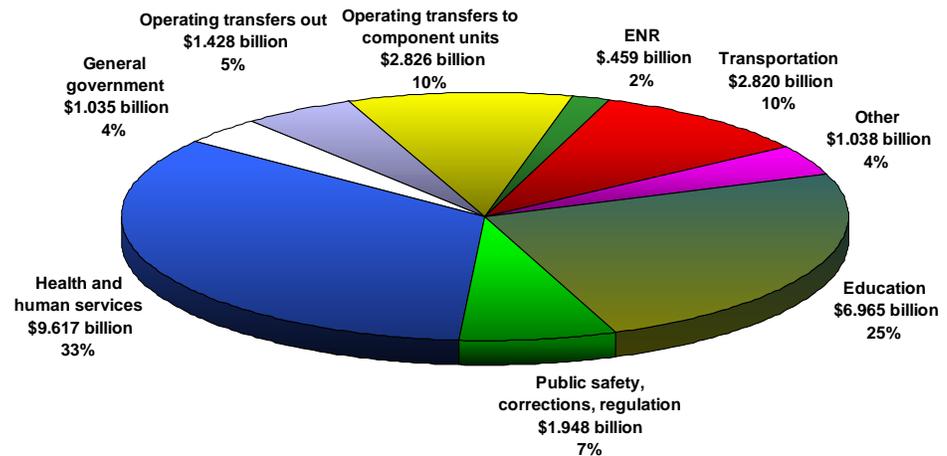
Tax Revenues. Tax revenues increased by \$578 million in 2001 to \$15.147 billion, a 4% increase over 2000. Individual income tax collections in the General Fund increased by \$508 million in 2001 to \$7.6 billion, a 7.16% increase over 2000. Sales tax collections in the General Fund grew by \$68 million in 2001 to \$3.43 billion, a 2.03% increase over 2000, compared to a .57% increase from 1999 to 2000. Highway taxes were \$1.705 billion in fiscal year 2001, \$111.2 million, or 6.98% more than in 2000.

Federal Funds. Federal funds revenues grew by \$672 million in 2001 to \$7.925 billion, up by 9.3% over 2000. Increases in Federal revenues are due to increased Federal program expenditures for which the State is reimbursed.

Investment Earnings. Investment earnings of \$488 million reflect a decrease of \$13 million in 2001 from the previous year. Investment earnings include realized/unrealized gains and/or losses, and distributed and accrued interest on cash and investments.

Tobacco Settlement. The State recognized tobacco settlement revenue of \$140.272 million in fiscal year 2001 in the General Fund. Of this amount, \$70.136 million was transferred to the Golden LEAF (*component unit*), with \$35.068 million transferred to the Health and Wellness Trust Fund (*special revenue fund*) and \$35.068 million transferred to the Tobacco Trust Fund (*special revenue fund*).

General Governmental Funds - GAAP Basis ***Dollar Outflows and Amounts Owed to Others*** ***\$28.136 billion***



Significant changes in expenditures. The trend of increases in expenditures, an increase of \$1.214 billion for 2001, was directly related to the continued emphasis on education (\$290 million increase) and health and human services (\$1.2 billion increase). General government expenditures decreased by \$195 million, or 15.9%. The largest part of this decrease relates to a decrease in expenditures for employer pension contributions of \$129 million.

Educational expenditures (K-12) increased by \$290 million largely because of enrollment growth, increased teacher compensation, increases in the number of teaching positions, and the general increase in dollars spent on State administered programs and costs associated with providing public education. Health and human services increased by \$1.2 billion or 14.4% in 2001. This large increase can be attributed to the increased costs of health care and increased numbers of eligible program beneficiaries related to Medicaid.

Transportation expenditures increased in fiscal year 2001 by \$221 million to \$2.82 billion, or 8.5%. During fiscal year 2000-2001, 162 miles of roads were added to the State highway system, which now consists of 78,245 miles of roads. As the State continues to add road miles to accommodate economic growth, road maintenance requirements will force transportation expenditures to increase.

Debt service increased \$16 million from 2000 to 2001 and will continue to climb as the State continues to issue general obligation debt to fund capital projects for education, highways and utilities.

Major Issues

Tax Increases. On September 26, 2001, Governor Easley signed the Current Operations and Capital Improvements Appropriations Act of 2001 (State budget). The newly enacted State budget includes General Fund appropriations of \$14.4 billion for fiscal year 2001-2002, and \$14.8 billion for fiscal year 2002-2003. Actual General Fund appropriation expenditures for fiscal year 2000-2001 were \$13.45 billion.

The General Fund budget for fiscal year 2002 included several tax increases. The State sales tax was increased by a half-cent from 4% to 4.5%. The State hopes to generate an additional \$246.3 million in General Fund revenue for the fiscal year 2002. This increase was effective October 16, 2001, and will expire July 1, 2003. Effective July 1, 2003, the provisions for local government tax reimbursements will be repealed, and local governments will have the optional authority to impose an additional half-cent sales tax. Local governments opting to increase sales tax by a half-cent will be held harmless by the State up to the amount that they would have received during fiscal year 2002-2003 if the statutory provisions related to local government tax reimbursements had not been repealed.

Effective for the tax years January 1, 2001 through December 31, 2003, the highest individual income tax rate will rise from 7.75% to 8.25%, generating an estimated \$125.5 million for the fiscal year 2002. Effective December 1, 2001, a 6% sales tax will be imposed on liquor sold in ABC stores. Effective January 1, 2002, the State will levy a telephone tax on out-of-state long-distance calls. The \$1,500 cap on sales tax on cars will be eliminated effective October 1, 2001. Of these tax increases, the increased state sales tax and income tax increase are expected to generate the largest increase in General Fund revenues.

State Health Plan. The State Health Plan provides comprehensive major medical care for employees and retirees of the State and its participating component units, and it allows for optional coverage of employee and retirees' dependents. This care is also extended to employees and retirees of the Local Education Agencies (LEAs), which are not part of the State's reporting entity. Coverage is self-funded by contributions to the State Health Plan (the Plan), a proprietary component unit of the State. Contributions for employee and retiree coverage are made by the State, its participating component units, and LEAs. Contributions for dependent coverage are made by employees and retirees. Coverage is also extended to certain individuals as an other postemployment benefit. The Plan pays most expenses that are medically necessary and eligible for coverage based on usual, customary and reasonable allowances. Claims are subject to specified annual deductible and copayment requirements.

The Plan disallows claims in excess of a lifetime maximum of \$2 million (*\$5 million effective July 1, 2001*).

As of June 30, 2001, the State Health Plan reflected negative retained earnings of \$159.67 million, with an operating loss of \$212 million for the fiscal year. Insurance premium revenues were \$930.48 million (*\$167.15 million increase from fiscal year 2000*), while claims and benefits expenses were \$1.127 billion (*\$310.55 million increase from fiscal year 2000*).

As of July 1, 2001, an estimated \$240 to \$300 million of cost savings for the State Health Plan were implemented in the form of increased insurance premiums, reduction of benefits to employees and dependents, and in the form of cuts in payments to providers. The State Health Plan pays 100% of the health insurance premium for employees and retirees, but employees and retirees must pay for optional family or dependent coverage. Effective October 1, 2001, the insurance premium for dependent coverage rose by 30%.

Historically, the State's health benefits package has been a key component of an overall compensation package enabling the State to hire and retain quality personnel.

Tobacco Settlement. In 1998, North Carolina, along with forty-five other states, signed the Master Settlement Agreement (MSA) with the nation's largest tobacco companies to settle existing and potential claims of the states for damages arising from the use of the companies' tobacco products. The amount that North Carolina will actually receive from this settlement remains uncertain, but projections are that the State will receive approximately \$4.6 billion through the year 2025.

In 1999, the State approved legislation to implement the terms of the MSA in North Carolina. The State created a nonprofit corporation, Golden LEAF (*Long-term Economic Advancement Foundation*), to distribute 50 percent of the settlement funds received by the State of North Carolina. The legislation directed that these funds be used for the purposes of providing economic impact assistance to economically affected or tobacco-dependent regions of North Carolina. Golden LEAF supports programs such as education assistance, job training, employment assistance, alternative crop research, economic hardship assistance, public works, industrial recruiting, health and human services, and community assistance. The Golden LEAF's share of the settlement funds are being put in an endowment that will generate earnings to fund grants. Golden LEAF may also use a portion of the principal to fund grants in the future. During the fiscal year ended June 30, 2001, Golden LEAF awarded \$5.1 million in grants to 34 organizations. At June 30, 2001, Golden LEAF had an unreserved fund balance of \$167.1 million.

In 2000, the State enacted legislation that established the Health and Wellness Trust Fund and the Tobacco Trust Fund. Each fund will receive 25 percent of the tobacco settlement payments. The purpose of the Health and Wellness Trust Fund is to finance programs and initiatives to improve the health and wellness of the people of North Carolina. The State is planning to spend a substantial portion of the Health and Wellness Trust Fund money over the next two to three years on a prescription drug plan for the elderly, a plan the Governor strongly supports. In addition, some of the money is likely to be spent on anti-smoking efforts. North Carolina has the third-highest rate of adult tobacco use in the nation. The primary purpose of the Tobacco Trust Fund is to compensate the tobacco-related segment of North Carolina's economy for the economic hardship it is expected to experience as a result of the MSA. At June 30, 2001, the Health and Wellness Trust Fund and the Tobacco Trust Fund had unreserved fund balances of \$73.8 million and \$85.6 million, respectively.

Hurricane Floyd. Hurricane Floyd passed through the eastern portion of North Carolina in September 1999. Hurricane and tropical force winds, torrential rains, and flooding left one-third of North Carolina suffering from an unprecedented natural disaster. The record-high floodwaters of Hurricane Floyd forced thousands of people from their homes. Many citizens lost homes, farms, and businesses. On December 16, 1999, the General Assembly held a special session for the purpose of setting aside \$836.6 million of funds for recovery from damage caused by the winds, rain, and flooding of Hurricane Floyd. At June 30, 2001, the State's General Fund (budgetary basis) held \$448.6 million in reserve for disaster relief (Hurricane Floyd, Fall 1999, and Hurricane Fran, Fall 1996).

General Obligation Debt. In November 2000, the State's voters approved \$3.1 billion of University and Community College general obligation bonds. The \$3.1 billion is projected to be issued over the six-year period beginning in fiscal year 2000-01, with repayments scheduled for fiscal year 2001-02 through fiscal year 2024-25. Total debt service for all of the State's outstanding general obligation debt is projected to be at its highest in fiscal year 2006-07, at \$722 million (*assuming no additional voter approved debt in subsequent years*). At June 30, 2001, the State's outstanding general obligation debt totaled \$3.039 billion, with an additional \$4.37 billion approved and unissued at June 30, 2001. Outstanding general obligation debt is projected to peak at \$6.043 billion for fiscal year 2005-06.



Edenton, NC

The amount of authorized, but unissued bonds was \$4.37 billion as of June 30, 2001.

**Bonds Unissued — Total Authorized, Issued, and Unissued
June 30, 2001**

(Expressed in Thousands)

<i>Authorized:</i>	<u>Date</u>	<u>School Construction</u>	<u>Higher Education</u>	<u>Highway Construction</u>	<u>Clean Water</u>	<u>Natural Gas</u>	<u>Total</u>
School Construction	11/5/96	\$ 1,800,000	\$ —	\$ —	\$ —	\$ —	\$ 1,800,000
Highway Construction	11/5/96	—	—	950,000	—	—	950,000
Clean Water	11/3/98	—	—	—	800,000	—	800,000
Natural Gas	11/3/98	—	—	—	—	200,000	200,000
University/Community College	11/7/00	—	3,100,000	—	—	—	3,100,000
Total Authorized		<u>1,800,000</u>	<u>3,100,000</u>	<u>950,000</u>	<u>800,000</u>	<u>200,000</u>	<u>6,850,000</u>
Issued:							
Public School Building Series 1997A	3/1/97	450,000	—	—	—	—	450,000
Highway Bonds, Series 1997A	11/1/97	—	—	250,000	—	—	250,000
Public School Building Series 1998A	4/1/98	450,000	—	—	—	—	450,000
Public School Building Series 1999	4/1/99	450,000	—	—	—	—	450,000
Public Improvement, Series 1999A	9/1/99	—	—	—	172,400	5,000	177,400
Public Improvement, Series 1999B	9/1/99	—	—	—	—	20,000	20,000
Public Improvement, Series 1999C	10/1/99	—	—	—	2,600	—	2,600
Public Improvement, Series 2000A	9/1/00	295,000	—	—	—	5,000	300,000
Public Improvement, Series 2001A	3/1/01	100,000	250,000	—	30,000	—	380,000
Total Issued		<u>1,745,000</u>	<u>250,000</u>	<u>250,000</u>	<u>205,000</u>	<u>30,000</u>	<u>2,480,000</u>
Bonds Unissued — June 30, 2001		<u>\$ 55,000</u>	<u>\$ 2,850,000</u>	<u>\$ 700,000</u>	<u>\$ 595,000</u>	<u>\$ 170,000</u>	<u>\$ 4,370,000</u>

Construction and Other Commitments. At June 30, 2001, the State had commitments of \$1,597.7 million for construction of highway facilities. Of this amount, \$1,185.9 million relates to the Highway Fund, and \$411.8 million relates to the Highway Trust Fund. The other commitments for construction and improvements of State government facilities totaled \$444.4 million (including \$393.1 million for the Department of Environment and Natural Resources, \$12.4 million for the Department of Correction, and \$11.5 million for the Department of Public Instruction). At June 30, 2001, the University of North Carolina system (component unit) had outstanding construction commitments of \$392.4 million (including \$121.7 million for

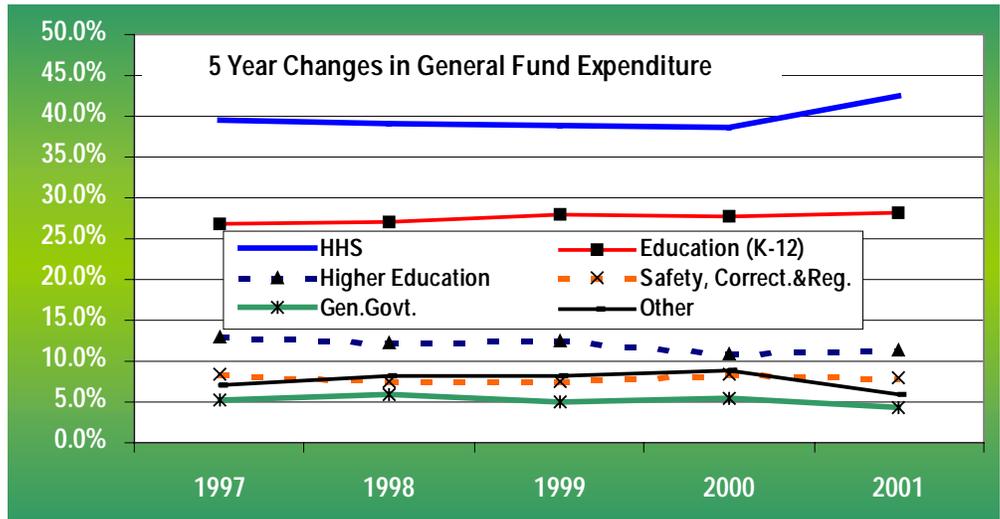
University of North Carolina - Chapel Hill, \$61.6 million for East Carolina University, and \$37.2 million for UNC Hospitals).

Leandro et al v. State of North Carolina and State Board of Education — Right to a Sound Basic Education. Leandro et al v. State of North Carolina and State Board of Education — Right to a Sound Basic Education. In 1994, students and boards of education in five counties in the State filed suit in Superior Court requesting a declaration that the public education system of North Carolina, including its system of funding, violates the State constitution by failing to provide adequate or substantially equal educational opportunities, by denying due process of law, and by violating various statutes relating to public education. Five other school boards and students therein intervened, alleging claims for relief on the basis of the high proportion of at-risk and high-cost students in their counties' systems.

The suit is similar to a number of suits in other states, some of which resulted in holdings that the respective systems of public education funding were unconstitutional under the applicable state law. The State filed a motion to dismiss, which was denied. On appeal the North Carolina Supreme Court upheld the present funding system against the claim that it unlawfully discriminated against low wealth counties but remanded the case for trial on the claim for relief based on the Court's conclusion that the constitution guarantees every child the opportunity to obtain a sound basic education. Trial on the claim of one plaintiff-county was held in the fall of 1999. On October 26, 2000, the trial court, in Section Two of a projected three-part ruling, concluded that at-risk children in North Carolina are constitutionally entitled to such pre-kindergarten educational programs as may be necessary to prepare them for higher levels of education and the "sound basic education" mandated by the Supreme Court. On March 26, 2001, the Court issued Section Three of the three-part ruling, in which the judge ordered all parties to investigate certain school systems to determine why they are succeeding without additional funding. The State filed a Notice of Appeal to the Court of Appeals, which resulted in the Court's decision to re-open the trial and call additional witnesses. That proceeding took place in the fall of 2001. The result of this last proceeding is unknown at this time; however, the cost of future programs which the Court may order could exceed \$100 million. The State is involved in numerous other claims and legal proceedings, many of which normally recur in governmental operations.

Changes in How Your Dollars are Spent

The following chart reflects very little shift in funding in the General Fund over the last five years. The data below is derived from the State’s CAFR and includes accrual adjustments.



The expenditure allocation for health and human services increased from 39.6% in 1997 to 42.4% in 2001. A significant increase in the health and human services budget allocation occurred from fiscal year 2000 to 2001, with expenditures growing by \$1.2 billion or 14.4%. Offsetting decreases in budget allocation occurred in general government, tax judgements, and public safety expenditures (disaster relief). Education (K-12) received 28.2% of the total expenditures and uses (State, federal, and local dollars) in 2001 compared to 26.8% in 1997. Dollars allocated to higher education declined from 12.9% in 1997 to 11.3% in 2001, primarily due to a change in accounting for community college tuition in fiscal year 2000.

The primary cause of change in expenditure allocations is the result of changes in spending requirements for federal funds in our State. In recent years, court case settlements and natural disasters have had a significant impact on spending.

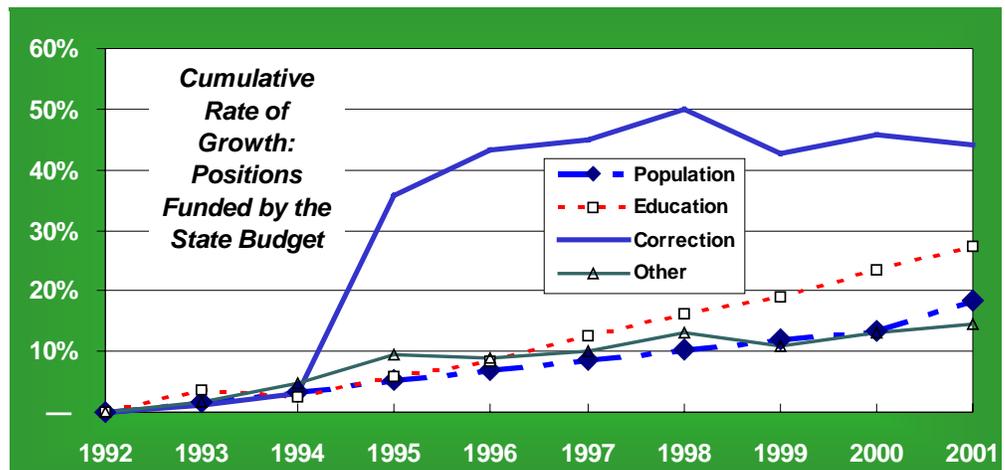
- HHS = Health and human services;
- Education (K-12) = Department of Public Instruction
- Higher Education = UNC system and community colleges
- Safety, Correct. & Reg. = Public safety, corrections, and regulation
- Gen. Govt. = General Government

State Government Growth

As the State continues to experience population growth (18%, or 1,253,704 people since 1992), 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. For the 2000-2001 school year, there were 2,112 public schools and 90 charter schools 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 1980's resulted in additional square footage requirements for inmates, and sentencing laws were strengthened, hence the need for more prison facilities. During fiscal year 2000-2001, the State housed approximately 31,899 inmates on a daily basis, with 23,299 entering the prison system and 22,806 exiting the prison system.



Most of the position growth in State government during the last 10 years has been in public education, which has increased by 31,776 positions, and corrections which has increased by 5,825 positions.

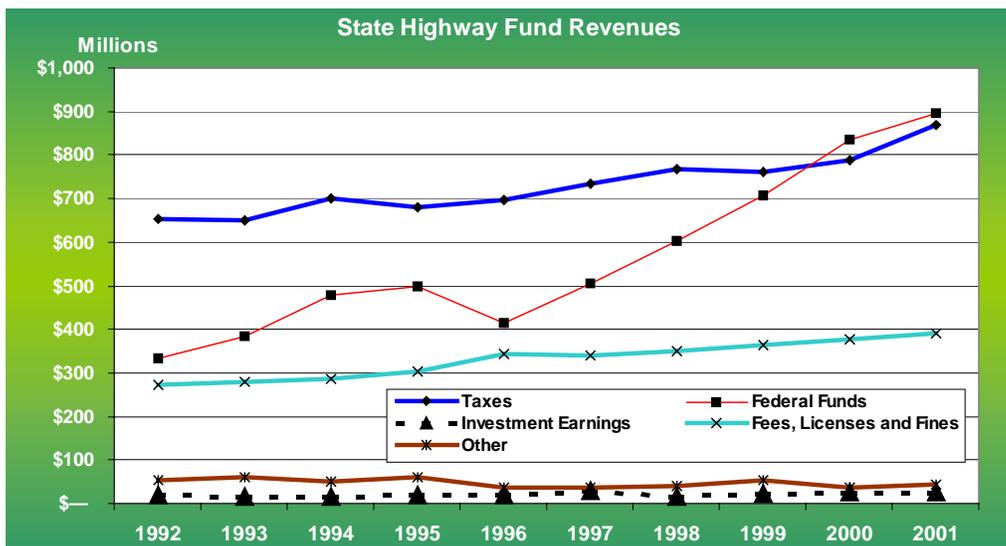
During the last 10 years, the rate of growth in public education (K-12) positions (27.33% increase) has exceeded the rate of growth in North Carolina's population (18% increase). During the same period, primarily due to new legal requirements for housing inmates, the rate of growth in correctional positions (44.21% 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 1,090 miles of roadways 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 78,245 miles of roadway.

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 for the Highway Fund.

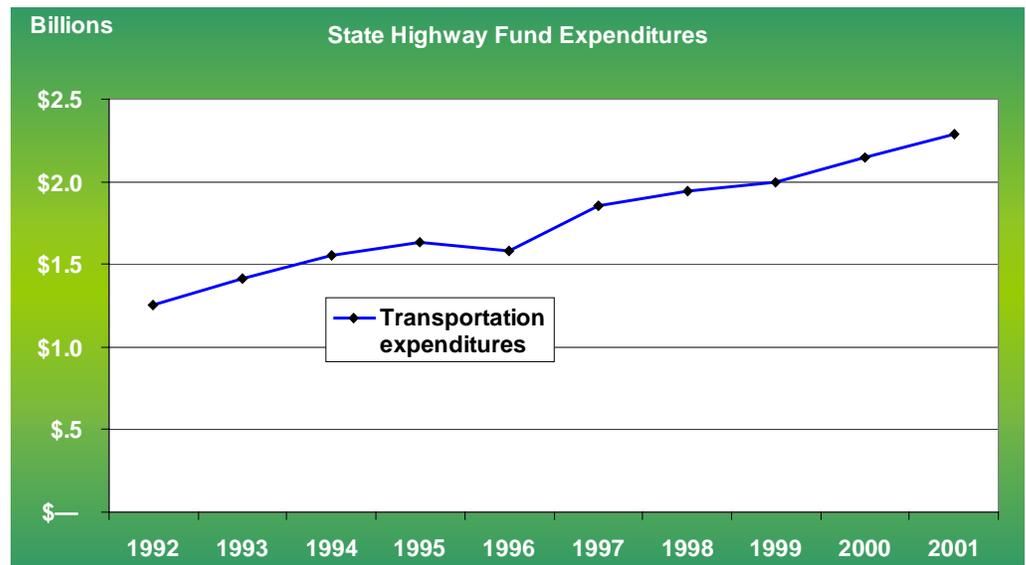


The Department of Transportation is required to survey and report on the condition of the State highway system.

The North Carolina Department of Transportation develops a statewide annual maintenance program for the State highway system, which is subject to the approval of the North Carolina Board of Transportation and takes into consideration the general maintenance needs, special maintenance needs, vehicular traffic, and other factors deemed pertinent. A detailed assessment is conducted of the State's pavements, structures, and roadway features. The methodologies used in the survey and assessment are based on acceptable practices used in other state transportation departments across the country.

In a high growth State such as North Carolina, the trend of increasing lane miles and increased traffic on existing roads, along with general deterioration from the elements, are at the heart of the road maintenance issue.

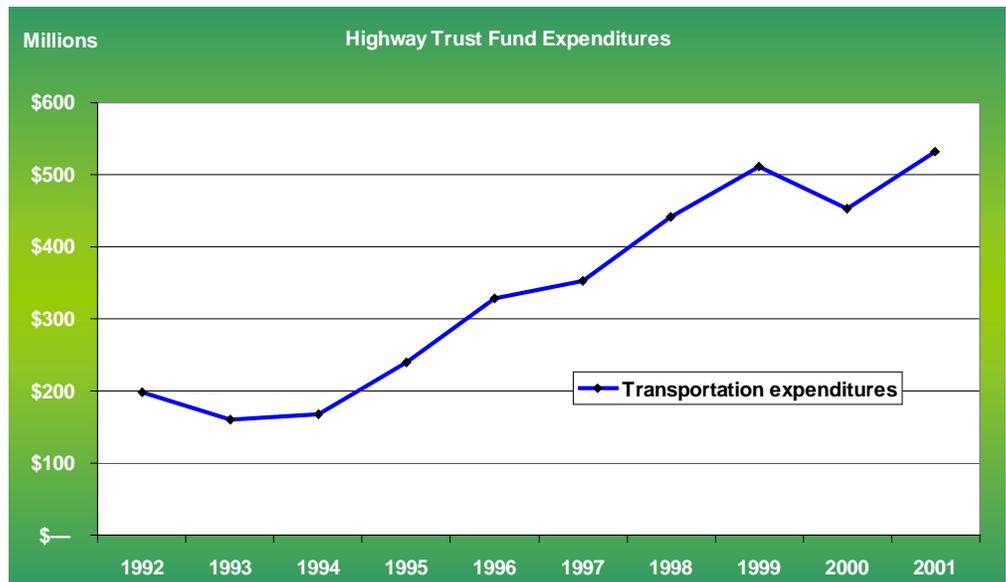
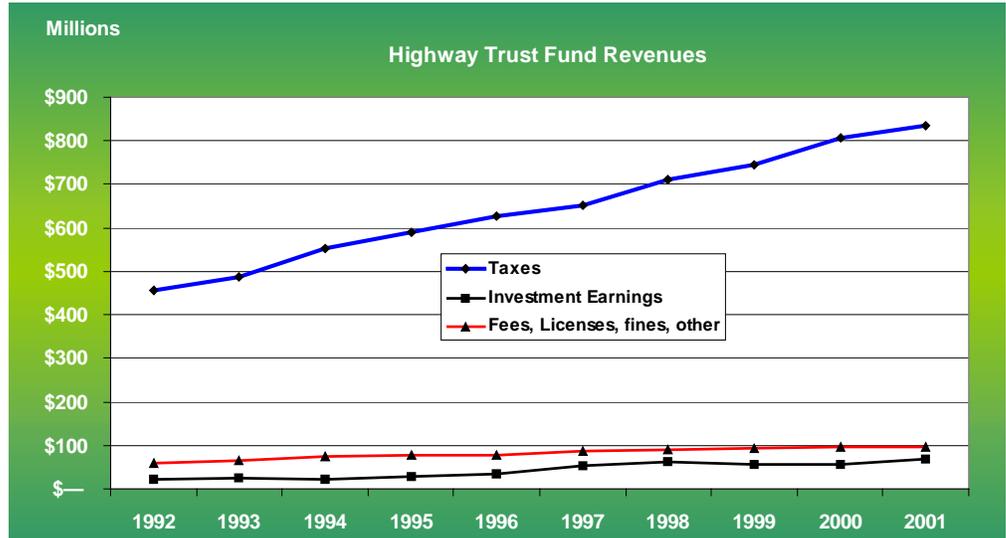
The most current assessment report highlights that while road maintenance funding has increased over the last decade, the increase in funding has not kept pace with inflation. According to the December 2000 report, \$500.2 million is needed to fund routine maintenance and to provide for an acceptable level of transportation service in North Carolina. According to the report, it would take an additional \$214.4 million (\$21.4 million per year) over the next 10 years to eliminate the current road maintenance backlog, with an additional \$75.6 million (\$7.56 million per year) needed over the next 10 years to eliminate the contract resurfacing backlog. The annual cost of resurfacing the State's primary, secondary, and urban road systems is \$221.4 million.



The estimated total maintenance needs, including backlogs, ranges from \$785.6 million in fiscal year 2001-2002, to \$1.116 billion in fiscal year 2009-2010 (averaging \$935.72 million per year). For the year ended June 30, 2001, \$531.4 million was spent on road maintenance. The approved State budget included \$578.6 million of road maintenance funding for fiscal year 2001-2002.

North Carolina — Financial Highlights — Fiscal Year 2001

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.



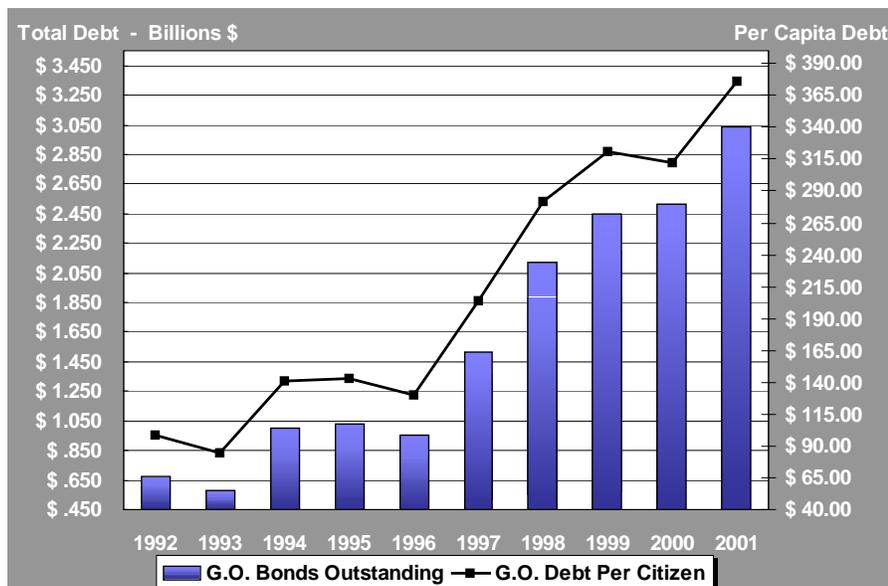
North Carolina's Infrastructure and Capital Improvement Needs Continue to Grow

As stated earlier, the State's population has grown by 18% since 1992. 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, public schools, universities, community colleges, and clean water.

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
2001	8,085,484	\$ 3,038,693,000	\$ 375.82	\$281,463,000	\$23,883,482,000	1.18%
2000	8,049,313	\$ 2,509,986,000	\$ 311.83	\$264,877,000	\$22,721,905,000	1.17%
1999	7,647,934	\$ 2,451,973,000	\$ 320.61	\$227,630,000	\$20,744,877,000	1.10%
1998	7,545,735	\$ 2,123,944,000	\$ 281.48	\$170,039,000	\$19,292,584,000	0.88%
1997	7,428,579	\$ 1,514,477,000	\$ 203.87	\$131,249,000	\$17,646,075,000	0.74%
1996	7,307,565	\$ 951,082,000	\$ 130.15	\$150,741,000	\$15,978,166,000	0.94%
1995	7,185,327	\$ 1,025,167,000	\$ 142.68	\$141,031,000	\$14,755,972,000	0.96%
1994	7,060,881	\$ 996,365,000	\$ 141.11	\$123,376,000	\$13,333,832,000	0.93%
1993	6,947,216	\$ 584,905,000	\$ 84.19	\$124,314,000	\$12,870,325,000	0.97%
1992	6,831,780	\$ 670,380,000	\$ 98.13	\$114,928,000	\$12,078,683,000	0.95%

Total General Obligation Debt and Long-Term Debt Per Capita



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

Award for Outstanding Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) has given an Award for Outstanding Achievement in Popular Annual Financial Reporting to the State of North Carolina for its Popular Annual Financial Report for the fiscal year ended June 30, 2000. The Award for Outstanding Achievement in Popular Annual Financial Reporting is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government popular reports.

In order to receive an Award for Outstanding Achievement in Popular Annual Financial Reporting, a government unit must publish a Popular Annual Financial Report, whose contents conform to program standards of creativity, presentation, understandability and reader appeal. An Award for Outstanding Achievement in Popular Annual Financial Reporting is valid for a period of one year only. We believe our current report continues to conform to the Popular Annual Financial Reporting requirements, and we are submitting it to GFOA.

Award for Outstanding Achievement in Popular Annual Financial Reporting

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**STATE OF
NORTH CAROLINA**

For the fiscal year ending
June 30, 2000



Imelda Greve
President

Jeffrey L. Esser
Executive Director