

**University of North Carolina Board of Governors
Committee on Public Affairs
Friday, March 19, 2004
9:00 a.m.**

Executive Conference Room

AGENDA

1. Approval of February 13, 2004 minutes* (Attachment A)

2. Fiscal Outlook for the 2004 – Legislative Session*
(Attachment B)

James Johnson
Director of the
Fiscal Research Division
N.C. General Assembly

3. 2004 State Agenda * (Attachment C)

4. Report on Congressional Delegation meetings

5. Other

* Materials attached

DRAFT

**Minutes of the Committee on Public Affairs
UNC Board of Governors
February 13, 2004**

The following committee members were present:

Jim Babb, Chair
Brent Barringer
Anne Cates
Dudley Flood
Peter Hans
Charles Mercer
Estelle Sanders

The following other Board members, staff, and others were present:

Ed Broadwell	J.B. Milliken	Joni Worthington	Russ Lea
Bert Collins	Leslie Winner	Ken Grogan	Bobby Kanoy
Robert Warwick	Jeff Davies	Erin Culbreth	Bob Kennel
Irvin Aldridge	Mark Fleming	Terry Feravich	Shelby Strothers
Gladys Robinson	Laura Foxx	Ellen Klingler	George Briggs
Willie Gilchrist	Kimrey Rhinehardt	Vickie McNeil	Charlotte Todd
			Amanda Devore

Chairman Babb called the meeting to order.

1. Ms. Cates moved, seconded by Dr. Flood, that the minutes of the meeting of January 9, 2004, be approved. The motion carried.
2. 2004 Federal Agenda - Chairman Babb stated that a copy of the 2004 Federal agenda was being provided for informational purposes. The Board would consider that item later in the day.
3. Committee consideration of State Agenda - Mr. Babb briefly explained the process for the development of the Board of Governors' State Legislative Agenda. He noted that the process begins with a request for items from the Chancellors, and that the response has been significant. Mr. Babb said that the goal was to review the legislative proposals submitted this year by the campuses, affiliates, and Office of the President, and adopt a recommendation to the Board of Governors. He asked the Committee to consider one additional proposal submitted by the UNC Association of Student Governments: a proposal to allow a student vote on the UNC Board of Governors. He then called on Amanda Devore, UNC Association of Student Governments representative, to review the student government proposal. Discussion of this item followed.

A motion was made and seconded to add to the 2004 State Legislative Agenda the UNC Association of Student Governments proposal for a student vote on the UNC Board of Governors. The motion passed.

Vice President Milliken and other staff reviewed with the Committee the proposed Legislative Agenda. Considerable discussion was held.

A motion was made and seconded for the Public Affairs Committee to approve the 2004 State Legislative Agenda and to recommend it to the Board of Governors for approval. The motion passed.

4. Bob Kennel, Executive Director, Council of UNC Alumni Association Presidents, distributed a letter from the Association to North Carolina's political leadership for use in the state's economic development efforts.

Mark Fleming, Associate Vice President, State Governmental Relations, provided a brief legislative update.

There being no further business the meeting was adjourned.



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March 4, 2004

MEMORANDUM

TO: Appropriations and Finance Chairs

FROM: Dave Crotts
Fiscal Research Division

SUBJECT: Revenue Update

The Revenue Collection "Tug of War" Continues

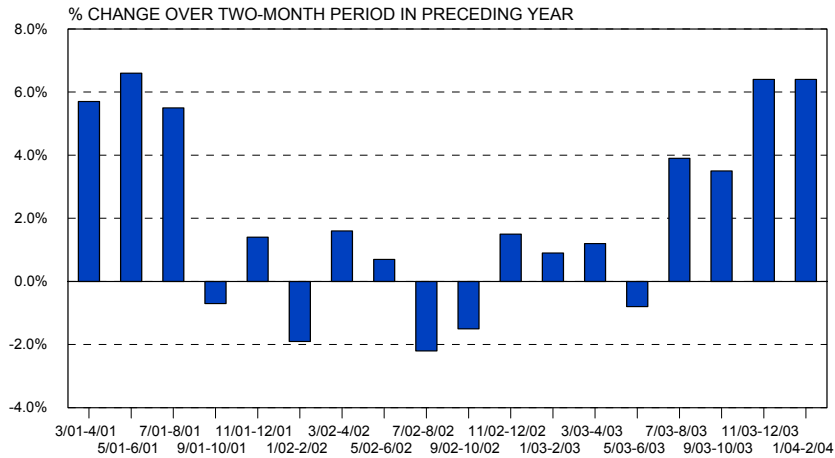
Monthly revenue collections continue to reflect a contrast between economy-based taxes that exceed budget expectations and the lagging impact of the 2000 stock market crash on the income tax. The latter effect occurs through depressed estimated tax payments and tax due collections that are the result of carryforward losses that will be reported on 2003 tax returns.

Let's talk about the good news first. If we combine January and February tax collections, withholding taxes paid by the largest employers (84% of total withholding) were up 6.4%. This is surprising given the continued weak performance of the job market. There are a couple of explanations.

First, on a statewide basis the reported employment growth numbers may be understating the true situation. The reported growth for January 2004, compared to last January, was only .4%. However, we think the real improvement in jobs may be 1.0-1.5%. This difference is not unusual during an economic recovery. The reason is that the job numbers reported in the media do not take into account positions created by start-up firms. This disparity will be corrected next January when the Employment Security "benchmarks" the 2003 and 2004 numbers based on actual unemployment insurance reports from employers.

Other factors pushing up withholding tax payments include the decision by many employers to stretch the workweek and pay raises (3.0-3.5%).

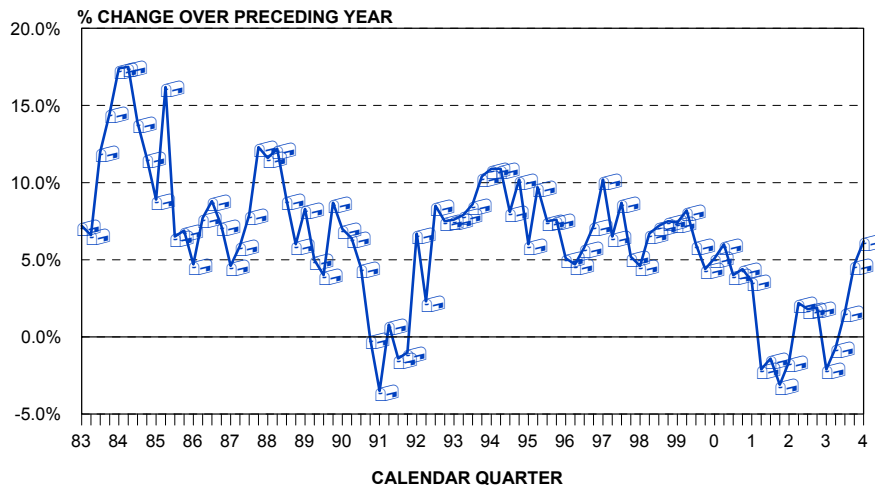
WITHHOLDING TAX RECEIPTS FROM LARGE EMPLOYERS



Notes: Two month periods are used to smooth out monthly volatility.

Gross state and local sales tax receipts for January plus February were 6.2% higher than the same period last year. This means that retail sales are expanding even though the federal tax rebates ran out last August. The continued improvement in this tax is due to gains in wage payments and the 40% rise in equity prices since last March. Improving stock values not only provide a “wealth effect” but also make consumers and business owners feel more confident about the future.

GROSS STATE AND LOCAL SALES TAX COLLECTIONS



NOTE: Data has been adjusted for tax law changes. The most recent data point represents January and February only.

The strength of the economic recovery has led to a \$52 million surplus in withholding and sales tax collections. On the other side of the coin, we have a \$28 million shortfall from the other tax and non-tax schedules. This nets down to a \$24 million revenue surplus through February.

The major tax collection problem has to do with the continued decline in quarterly estimated tax payments by high-income individuals and other taxpayers with significant non-wage income. Our hope had been that the run-up in stock prices would cause the final estimated payment for 2003 to improve substantially from the 6% decline for the first three quarters (April, June, September payments). The final check sometimes represents a reconciliation payment if a taxpayer has unexpected income late in the tax year and wants to avoid an underpayment penalty. Unfortunately, these checks were still down 4% for the final payment.

The best explanation is that carryforward losses from the market crash are offsetting gains coming from the recent run-up in stock prices. In addition, if a taxpayer does not have sufficient gains to offset all of his losses, up to \$3,000 can be offset against ordinary income (wages and salaries for example). Discussions with forecasters in other states indicate that the backlog of carryover losses is the largest since the bear market of 1973-74. During that cycle, net capital gains were depressed for a number of years.

In addition, preliminary data suggests that mutual fund distributions were down 30-40% in 2003, due mostly to carryforward losses. This could mean that total net capital gains (including bonds and real estate) for 2003 could be 5-10% lower than 2002 instead of rising 5-10% based on the improving market.

The contrast between the acceleration in economy-based tax collections and lagging non-withholding income tax receipts may continue. The key period is April-June due to the bunching of final income tax payments for the 2003 tax year (due April 15) and the two estimated tax payments for the 2004 tax year (due April 15 and June 15).

At this point, it is hard to predict the outcome of this tug of war. Both the Fiscal Research Division and the state budget office feel that the best point estimate continues to be the budget projection adopted by the Appropriations Committees last June. A range estimate would be \$75 million on either side of this number. This range is much smaller than in past years because capital gains have fallen so much that the base is smaller.

There is one possibility that offers some hope for the April-June period. Suppose an investor did well enough in the markets in 2003 that he has capital gains even after factoring in carryforward losses. In this case, the investor can avoid the state

underpayment penalty if estimated income tax payments during 2003 were at least 100% of the prior year's actual liability. In a good year, this "safe harbor" provision means that the increased tax bill is paid on April 15 with the tax return instead of being sent in on January 15. Unfortunately, there is no way to know whether this is happening.

Difficult Budget Choices Remain

It is tempting to think that with improving revenues there will be enough money to cover the usual budget needs with resources left over for new initiatives. This is not the case. During the typical economic recovery, there are three sources of new budget availability. So far none of the sources offer any help for the 2004-05 budget.

1. Current Year Revenues

In prior business cycles, the economic recovery turned out to be much stronger than the cautious forecast adopted during the heart of a recession. This created a "current year" revenue surplus that provides one-time budget availability two ways: the carryover of the year-end credit balance; and, the additional recurring availability via the bump up in the revenue forecast base.

So far the economy-based taxes are providing the normal surplus. The problem is that large carryforward losses on 2003 income tax returns could offset those gains, thereby eliminating the typical current year revenue surplus.

2. Growth Rate for Upcoming Budget Year

Since 1975, the General Assembly has adopted a tentative two-year budget during the odd-numbered years with the understanding that the second-year budget will be adjusted the following year based on updated economic conditions and other factors. If fiscal conditions improve, key items such as pay raises, education initiatives, and higher education enrollment are addressed through an adjustment to the second-year budget.

This strategy has worked well in the past. The reason is that during the long session, a modest, tentative revenue growth rate is adopted for the second year of the biennium. This estimate reflected budget strategy as much as forecasting science since it is understood that the second-year numbers will be revised. In many long sessions, a second-year growth rate of only 2% or 3% was selected in order to simply cover the requirements for public school enrollment and Medicaid. In these situations, the hope was that economic conditions would allow for an upgrade the next year.

During the 2003 session, the difficulty of balancing the budget for both years led to the use of a middle of the road revenue growth estimate of 5.5% for the second year of the biennium. The source of the forecast was the Governor's budget plan sent over as part of the biennial budget.

It is unlikely that there will be a justification for raising this estimate. For one thing, continued low inflation will shave withholding and sales tax growth by at least one percentage point from the typical pattern. In addition, the record backlog of carryforward losses from the stock market crash could continue to depress capital gains reported on 2004 tax returns. Finally, North Carolina's dependence on manufacturing may mean that job growth in the state during this recovery will not lead the nation as it has in previous recoveries and displaced workers may be forced to accept a lower-paying job.

3. Declining Budget Requirements

The third way in which an economic recovery leads to an improving budget situation is through lower-than-expected growth of major General Fund spending items that are tied to the unemployment situation. The best examples include Medicaid utilization and community college enrollment. The surplus occurs when the spending levels for the current year come in below the authorized budget level and the growth rate for the upcoming budget year is reduced. To date, there is no evidence that the actual spending requirements for these two items will be below the budget forecast for the biennium.

Interest Rate Outlook

One of the reasons that economists feel that the current economic recovery is sustainable has to do with the prospects for interest rates. The graphs on the next page show that rates are the lowest in over four decades.

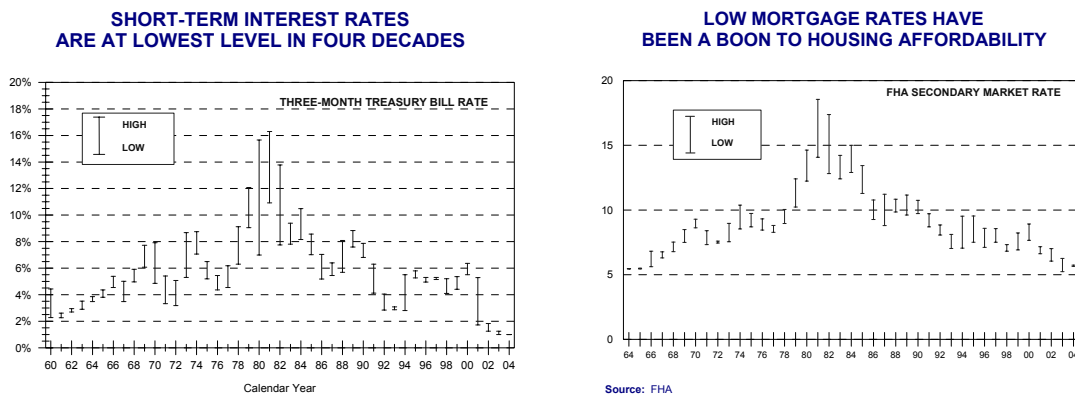
Forecasting future interest rates is always hazardous given world events and the normal difficulty of reading the minds of Federal Reserve officials. In fact, in the financial markets "Fed watching" is an art form. This is due to vague statements made by Fed officials and the hard-fought independence of the Fed.

This cycle may be different. In recent months, Chairman Greenspan has gone to great lengths to make it clear that the Fed will not raise rates until well into the recovery. In my mind, there are a lot of reasons for this change.

First is the prolonged loss of jobs to overseas locations and the weak recovery in employment. This plays into the desire of the Bush Administration and leaders on Capitol Hill to make sure the economy is clicking in November. The Fed is not immune to this line of thinking. Even though there are a number of cases where monetary authorities have raised rates just prior to a major election, we do not think it is likely this time.

Another factor is that core inflation remains restrained, even though energy prices are continuing to rise. The other is the fact that if this truly is Greenspan's last term, we think that the smartest way to preserve a favorable legacy is to make sure the Fed does not choke off a recovery as it did in 1984.

For these reasons we think that the first rate hikes will not take place until very late in 2004 or early 2005.



Conclusion

General Fund revenue collections that are tied to the economy continue to exceed the budget target. However, the potential for large carryforward losses on 2003 income tax returns means that the modest revenue surplus through February may be wiped out during the remaining months of 2003-04. In addition, the biennial budget adopted last session already contains a healthy 5.5% economic growth estimate for 2004-05.

Absent the prospect of a budget surplus (when compared to the 2003-05 budget plan), there are no resources available to fund the \$500-800 million of typical high priority gubernatorial and legislative initiatives. Examples include pay raises for teachers and state employees, performance bonuses for teachers, higher education enrollment increases, repairs/renovations, rainy day fund restoration, and Medicaid inflation increases.

On the bright side, North Carolina is not facing the \$1.3-1.5 billion continuation budget shortfall it had to deal with during the last two sessions. This budget gap was over \$2 billion when high priority issues were added.

2004 Short Session Non-Budget Legislative Initiatives

HIGHEST PRIORITY

Finance

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| 1 | Bond Project Modifications
Campus Requests | <p>The following projects listed in Chapter 3 of the 2000 Session Laws and authorized by voter referendum in November 2000 have been recommended for scope modifications by the campuses. These suggested changes are consistent with the initial intent of the listed projects. However, these alterations are due to changed conditions or discovery of a more efficient means to accomplish the same end result.</p> <p>1a) <u>NC A&T</u>. Cancellation of Central Cooling Plant Phase I (\$9,430,700) and transfer to a New School of Education.</p> <p>1b) <u>UNCW</u>. Reduce the scope of Alderman Hall Classroom Building (-\$2,204,652) and Kenan Auditorium (-\$1,173,325). Apply the reduced funds (\$3,377,977) to King Hall Classroom Building, Hinton James Hall Classroom Building and Kenan Hall Classroom Building.</p> <p>1c) <u>FSU</u>. Alter the scope of Comprehensive Renovation and Conversion of Spaulding for Public Safety Facilities (\$1,420,845) to reflect occupancy of the complete facility by Student Health Services and student counseling.</p> <p>1d) <u>FSU</u>. Transfer unused funds (\$300,000) from William Collins Building Renovation to a renovation of the Mitchell Building. The Mitchell Building will house the Public Safety Facilities.</p> <p>1e) <u>NCSU</u>. Change scope of Harrelson Hall Higher Education Bond Project from a renovation to a replacement project. A replacement classroom facility will be constructed to meet the current needs of the campus (\$13,608,500)</p> <p>1f) <u>UNC-CH</u>. Alter the scope of a project for constructing a stand-alone community health building to allow the campus to add space to the Medical Science Research Building and renovate space within that building. The programmatic scope of the project is unchanged and savings would be transferred to other health affairs related bond projects.</p> |
| 2 | Special Obligation Bonds For Acquisition of Equipment and Renovation or Repair of Existing Facilities | Amend GS 116 and GS 116D to provide low-cost financing for major equipment purchases and repairs and renovations to facilities for smaller-scale projects that are not considered to be Capital Improvement projects. |
| 3 | Authority For One-Time Expenditures | Amend GS 116-30.2(b) to authorize NC School of Science and Mathematics to carry over 2 ½% of its general fund appropriations for one time expenditures. |
| 4 | Contributions To Parental Savings Trust Fund Tax Deductible. | Amend GS 105-134.6 & GS 116-209.25 to allow taxpayers who make contributions to the Parental Savings Trust Fund to deduct all, or a portion of, their total contributions in calculating NC taxable income for any given tax year beginning in 2004. |

- 5 Retain Proceeds From Sale of Chancellor's Residence Allow for a one-time exemption from GS 146-30 to allow FSU and NCSA to retain the proceeds from the sale of the existing chancellor's residence and apply the proceeds toward the cost of a new residence.

Management & Administration

- 6 UNC Internal Mediation Documents Seek to protect documents and discussion generated by UNC internal mediation from discovery in litigation and/or use at trial; and to clarify that a mediator preparing a mediation settlement agreement is not engaged in the practice of law.
- 7 Need-based Nursing Scholarship Loan Program Permit the State Education Assistance Authority to administer the Need-based Nursing Scholarship Loan Program consistent with the process by which it administers other need-based scholarship loans. This recommendation is a result of a performance audit report from the Office of the State Auditor.

Academic Affairs

- 8 Military Tuition Amend the NC Military Tuition Statutes (GS 116-143.3)
- a) Add "abiding in this state" to relevant sentences of GS 116-143.3 (b1) and (b2)
 - b) Work to improve military tuition benefits for active duty members of the armed services abiding in the state.
 - c) **Grandfather in-state tuition for dependents of active military personnel upon permanent reassignment outside of the state. Such dependents would retain in-state tuition rate for the remainder of any degree program in which they are enrolled at the time of transfer.**
 - d) **Grandfather in-state tuition for active duty transferees upon permanent reassignment outside of the state. Such personnel would retain in-state tuition rate for the remainder of any degree program in which they are enrolled at the time of transfer out of the state.**

Human Resources

- 9 Amend N.C. Disability Income Plan Repeal changes to G.S. 135 legislation enacted last session that rewrote the definitions of disability under the N.C. Disability Income Plan.

Governance

- 10 Dual Office Holding Eliminate the prohibition against spouses of members of the Board of Governors' and of members of Boards of Trustees' being employees or officers of the State, so long as the spouse is not an officer or employee of UNC, for BOG members, or of the relevant campus, for BOT members.

PRIORITY

Finance

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| 11 | Lead-Time For Acquisition Of Real Property | The acquisition of real property valued \$25,000 or greater by the UNC System requires approval by the respective Board of Trustees, UNC Board of Governors, Jt. Commission on Governmental Operations (Gov. Ops) and the Council of State. Only Gov. Ops does not have a regular, year round meeting time thereby creating delays. It is recommended that GS 146-22 be rewritten in a manner requiring the purchase of land by reporting to Gov. Ops thirty (30) days prior to the sale. |
| 12 | Construction Specifications | Modify GS 133-3 to allow campuses of the University to establish campus standards for building components by conducting public evaluation and selection processes and thereafter specifying said components by brand when writing construction specifications. |
| 13 | NC Rehabilitation Pilot Building Code | Adoption of the NC Rehabilitation Pilot Building Code as the NC Existing Building Code. |

Human Resources

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| 14 | Paid Time Off Program | Amend GS 126 to allow a Paid Time Off program to State and University employees. If not enacted, allow the University to offer a Paid Time Off program to employees. A Paid Time Off program merges all the kinds of leave instead of keeping track of annual leave, sick leave, etc. separately. |
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2005 Long Session Non-Budget Legislative Initiatives

Finance

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| 15 | Revenue Anticipation Notes | Permit use of revenue anticipation notes to borrow money for the purpose of paying expenses budgeted or incurred for the current fiscal year in anticipation of the receipt of revenues estimated to be realized during such fiscal year. |
| 16 | Property Insurance Program | Seek exemption from the NC Department of Insurance's State Property Fire Insurance Fund and establish our own property insurance program. |
| 17 | Amend Contract Requirements | Abolish the requirement to only allow for 3-year contracts without prior written permission from the State Purchasing Officer. |

Human Resources

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| 18 | University Personnel System | Provide the authority for the University of North Carolina to create a separate university personnel system that would better reflect the needs of a multi-campus, multi-mission, higher education system. |
| 19 | Optional State Retirement Program | <ul style="list-style-type: none"> a) Allow all EPA employees who were never given an opportunity a one-time option to switch from TSERS to ORP. These are employees who were actively employed prior to August 1, 2003. b) Decrease vesting period for the ORP to one year. |

Academic Affairs

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| 20 | Tuition Status of Undocumented NC High School Graduates | If the federal DREAM act passes, which will return to the states the right to decide the tuition status of undocumented students who graduate from state high schools, UNC should support legislation to study and make recommendations concerning resident tuition status for undocumented students who graduate from NC high schools. |
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Endorsement

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| 21 | Student Representative on BOG to Vote | Endorse the passage of a bill to allow the student member on the BOG to have a vote. |
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