

CONCLUSION

Lessons Learned and Challenges Ahead

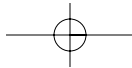
If we have learned anything from this history of the budget, it is that the budget encompasses a lot more than a series of spending priorities. The state does not spend its money on the budget per se; rather, the budget is a tool that makes it possible to fund the state's real priorities. With this point in mind, we want to conclude by looking more closely at the two areas driving state spending – education and healthcare.

Lesson One: Budget Reform Must Be Accompanied by Education and Healthcare Reform

Taken together, education and healthcare consume 81.2 percent of the state's budget. For FY2006, education spending comprised 56.7 percent of the operating budget while healthcare comprised 24.5 percent. Given these current trends, proposals to curb state spending will only be successful if they are linked to concrete efforts to streamline the public education and healthcare systems.

It is no exaggeration to say that education policy has dominated the debate regarding spending and taxation over the past 20 years. In 1984, James Martin became only the second Republican in the twentieth century to be elected governor. Martin won election, and re-election, by running on a platform that combined fiscal discipline with education reform. In so doing, Martin was able to defuse Democrat accusations that he was anti-education. Governor Jim Hunt likewise sought to secure his legacy as an education governor by launching and continually expanding Smart Start and also implementing the \$1 billion, four-year Excellent Schools Act. Not unlike Hunt, Governor Mike Easley won two terms as governor by promoting class size reduction, as well as his More at Four pre-kindergarten program. It is important to note that these education programs were expanded even while other programs were cut – and even during the 2001-2003 recession.

Now that education has become such an entrenched part of the budget, policymakers are increasingly looking to expand healthcare. Perhaps most important in this respect is the massive expansion of Medicaid coverage and spending currently underway in North Carolina. Using the FY2006 budget as a baseline, at the current rate of growth the Division of Medical Assistance, which oversees Medicaid (as well as NC Health Choice for Children), will consume 80 percent of the DHHS budget by 2012.



The recent increase in Medicaid spending is a foreshadowing of a demographic revolution currently underway in the United States. In short, America is aging. According to the U.S. Census Bureau: "The U.S. population age 65 and over is expected to double in size within the next 25 years. By 2030, almost 1-out-of-5 Americans – some 72 million people – will be 65 years or older. The age group 85 and older is now the fastest growing segment of the U.S. population."¹

At the same time, the native U.S. population growth rate has been below the replacement level of 2.1 births per childbearing woman for several years – due, in part, to an increase in the prevalence of contraception and abortion. In 2002, the U.S. birth rate reached a record low and since then has grown at an average of only 1 percent per year.²

According to demographers, we are also facing the retirement of 78 million baby boomers. Only 40 million persons, age 25 to 34, will be replacing these retirees; and of these, only 23 million are college educated – "a group 10 percent smaller than 10 years ago." If these trends continue, experts predict that "by 2012, the work force will be losing more than two workers for every one it gains."³

In North Carolina, the median age for the population as a whole is projected to reach 38.2 in 2030. The elderly (65 and over) population is also growing rapidly, going from 969,000 in 2000 to 2.15 million by 2030. As a result of this "Gray Revolution," healthcare spending will start to crowd out other priorities, including education. Older people demand different goods and services than do younger people. Thus even as the state spends more and more on education, the need for new education spending – measured in terms of the needs of the population as a whole – is declining. According to figures taken from the State Demographics unit, the projected percentage of the population that is of school age (5-18) is slowly falling. Between 2000 and 2029, this group is expected to decrease from 19.1 percent to 17.9 percent of the population.⁴

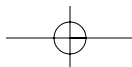
But although North Carolina is aging, the state's demographic trends differ somewhat from the rest of the country. North Carolina's population is growing more rapidly than is the U.S. average. In 2006, North Carolina's population growth rate was 2.12 percent: 1.14 percent higher than the U.S. average. North Carolina is also a net in-migration state, having gained 337,883 persons from other states

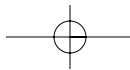
¹U.S. Census Bureau, "Dramatic Changes in U.S. Aging Highlighted in New Census, NIH Report: Impact of Baby Boomers Anticipated," press release, March 9, 2006; available from http://www.census.gov/PressRelease/www/releases/archives/aging_population/006544.html.

²United States Department of Health and Human Services, "U.S. Birth Rate Reaches Record Low: Births to Teens Continue 12-Year Decline; Cesarean Deliveries Reach All-Time High," press release, June 25, 2003; available from <http://www.hhs.gov/news/press/2003pres/20030625.html>.

³Haya El Nasser, "Mid-sized cities get hip to attract young professionals," *USA Today*, October 10, 2003, Nation Section; available from http://www.usatoday.com/news/nation/2003-10-10-cities-cover_x.htm. See also Shaila Dewan, "Cities Compete in Hipness Battle to Attract Young," *New York Times*, November 25, 2006, U.S. Section; available from <http://www.nytimes.com/2006/11/25/us/25young.html?ex=1322110800&en=4872177bf4c9dfa1&ei=5090>.

⁴North Carolina State Demographics, County/State Projections, County/State Population Projections, Statewide Trends, "Past and Expected Trends"; available from <http://demog.state.nc.us/demog/extrends.html>.

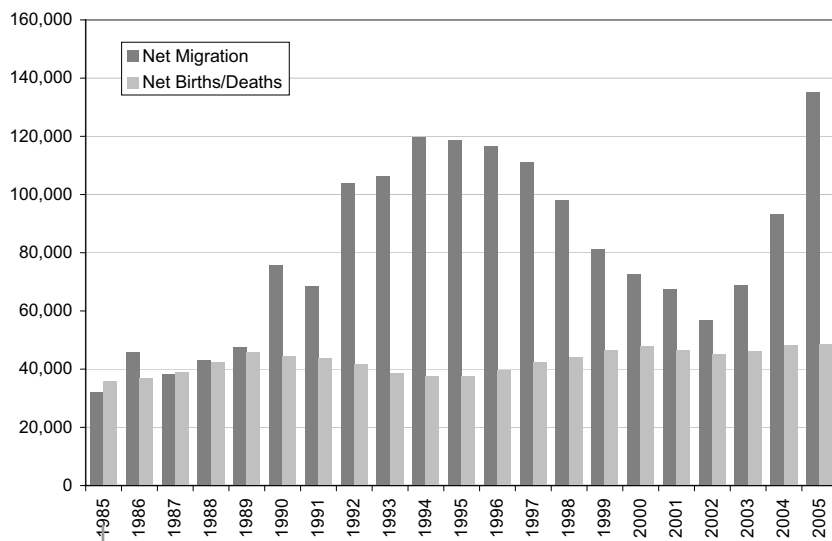




between 1995-2000 (latest data available), with the majority of new residents coming from New York, Florida and California. In fact, the only states that North Carolina is losing population to are in the Southeast – namely, South Carolina, Georgia and Tennessee. This decline could have something to do with the fact that North Carolina’s overall tax burden of 10.5 percent is higher than South Carolina’s (10.2 percent), Georgia’s (10.4 percent), and Tennessee’s (8.6 percent).⁵

While it may seem comforting to know that North Carolina’s population is growing even as the rest of the country’s population is shrinking, this divergence

Reasons for N.C. Population Growth: 1985-2005



is not without its problems. To begin with, we have already seen that by 2016 federal funds are projected to overtake state tax revenues as North Carolina’s single largest revenue source (see Q & A: 8). A large part of this contribution is for Medicaid, with the federal government subsidizing

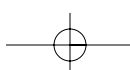
approximately 60 percent of the cost and the state and counties covering the rest. Thus if the federal government is forced to cut Medicaid entitlements, the state will probably have to do so as well.

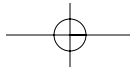
In addition, much of North Carolina’s population growth is being fueled by illegal immigration. Reports Rick Martinez of the Carolina Journal, “During the 1990s, North Carolina had the fastest growing Hispanic population of any state in the nation.” From 1990 to 2000, the state’s Hispanic population increased 393 percent.⁶ Currently, more than one-half million Hispanics reside in North Carolina, an estimated 65 percent of whom are in the United States illegally.

Most illegal immigrants hold low-wage jobs that translate into low tax revenue per capita. If this is work that needs to be done, the fact remains that many illegal immigrants lack the education and skills necessary to excel in today’s economy. Moreover, as Martinez observes: “The majority of taxes paid by illegals accrue to

⁵North Carolina State Demographics, “Annual North Carolina Population Growth” available from <http://demog.state.nc.us/>.

⁶Rick Martinez, “Immigration Hits ‘Critical Mass’ in NC,” *Carolina Journal Online*, December 12, 2005; available from http://www.carolinajournal.com/exclusives/display_exclusive.html?id=2983.





the federal government, while many public services they consume, such as education, are mostly funded by state and local government.⁷

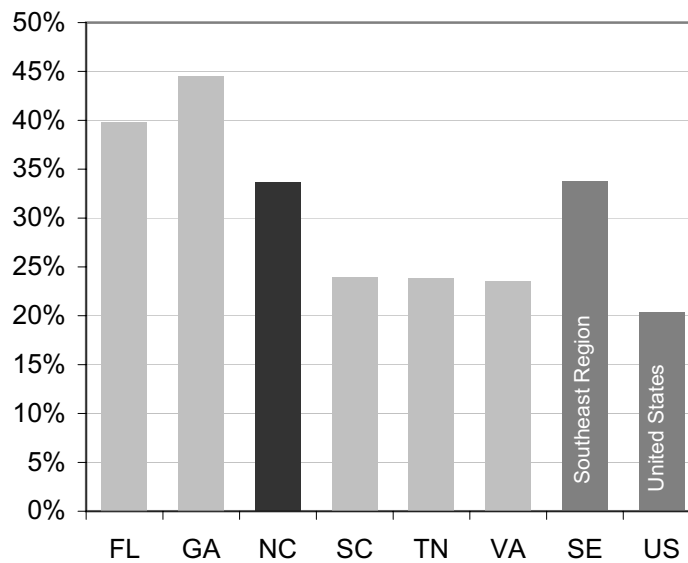
Yet even at the federal level, illegal immigrants consume more in services than they contribute in taxes. Confirms a 2004 study by the Center for Immigration Studies: "Households headed by illegal aliens imposed more than \$26.3 billion in costs on the federal government in 2002 and paid only \$16 billion in taxes, creating a net fiscal deficit of almost \$10.4 billion, or \$2,700 per illegal household."⁸

At the state level, illegal immigration has had the greatest impact on the educational system, where children who are either illegal aliens themselves or are the children of illegal aliens generally cost more to educate than children who are native speakers. Data from the U.S.

Department of Education indicates that in 2004 alone North Carolina paid an estimated \$771.1 million to educate children who are either illegal aliens themselves or are the children of illegal aliens.⁹ This figure comprises 13 percent of the \$6.16 billion public education (K-12) budget for FY2005. By comparison, North Carolina's entire Hispanic population equals 6.4 percent of the state's total population.¹⁰

What all this means is that as the rest of the country begins to divert education spending to healthcare, North Carolina will be pressed to sustain, if not increase, already high levels of spending in both areas. While part of the state's population growth will lead to an increase in tax revenue (for the reasons discussed in the Executive Summary) the people of North Carolina will also be forced to find better and more efficient ways to fund education and healthcare.

Southeast Population Growth: 1990-2006

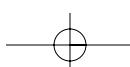


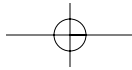
⁷Ibid.

⁸Center for Immigration Studies, Steven A. Camarota, "The High Cost of Cheap Labor: Illegal Immigration and the Federal Budget," Executive Summary, August 2004; available from <http://www.cis.org/articles/2004/fiscalexec.html>.

⁹Federation for American Immigration Reform, Jack Martin, "Breaking the Piggy Bank: How Illegal Immigration is Sending Schools Into the Red" (Washington, D.C., Federation for American Immigration Reform, 2005); available from http://www.fairus.org/site/PageServer?pagename=research_researchf6ad.

¹⁰U.S. Census Bureau, "State & County QuickFacts: North Carolina"; available from <http://quickfacts.census.gov/qfd/states/37000.html>.





Federal Reserve Chairman Ben Bernanke recently testified before the U.S. Senate Budget Committee on how the graying of the U.S. population will force the government to change its spending priorities:

We are experiencing what seems likely to be the calm before the storm. In particular, spending on entitlement programs will begin to climb quickly during the next decade. In fiscal 2006, federal spending for Social Security, Medicare, and Medicaid together totaled about 40 percent of federal expenditures, or roughly 8-1/2 percent of GDP. In the most recent long-term projections prepared by the Congressional Budget Office (CBO), these outlays are projected to increase to 10-1/2 percent of GDP by 2015, an increase of about 2 percentage points of GDP in less than a decade. By 2030, according to the CBO, they will reach about 15 percent of GDP. As I will discuss, these rising entitlement obligations will put enormous pressure on the federal budget in coming years.

The large projected increases in future entitlement spending have two principal sources. First, like many other industrial countries, the United States has entered what is likely to be a long period of demographic transition, the result both of the reduction in fertility that followed the post-World War II baby boom and of ongoing increases in life expectancy. ...

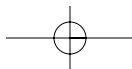
Although the retirement of the baby boomers will be an important milestone in the demographic transition – the oldest baby boomers will be eligible for Social Security benefits starting next year – the change in the nation's demographic structure is not just a temporary phenomenon related to the large relative size of the baby-boom generation. Rather, if the U.S. fertility rate remains close to current levels and life expectancies continue to rise, as demographers generally expect, the U.S. population will continue to grow older, even after the baby-boom generation has passed from the scene. If current law is maintained, that aging of the U.S. population will lead to sustained increases in federal entitlement spending on programs that benefit older Americans, such as Social Security and Medicare.

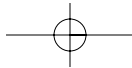
The second cause of rising entitlement spending is the expected continued increase in medical costs per beneficiary. Projections of future medical costs are fraught with uncertainty, but history suggests that – without significant changes in policy – these costs are likely to continue to rise more quickly than incomes, at least for the foreseeable future. Together with the aging of the population, ongoing increases in medical costs will lead to a rapid expansion of Medicare and Medicaid expenditures. ...

According to the CBO projection that I have been discussing, interest payments on the government's debt will reach 4-1/2 percent of GDP in 2030, nearly three times their current size relative to national output. Under this scenario, the ratio of federal debt held by the public to GDP would climb from 37 percent currently to roughly 100 percent in 2030 and would continue to grow exponentially after that. ... Ultimately, this expansion of debt would spark a fiscal crisis, which could be addressed only by very sharp spending cuts or tax increases, or both. ...

The prospect of growing fiscal imbalances and their economic consequences also raises essential questions of intergenerational fairness. As I have noted, because of increasing life expectancy and the decline in fertility, the number of retirees that each worker will have to support in the future – either directly or indirectly through taxes paid to support government programs – will rise significantly. To the extent that federal budgetary policies inhibit capital formation and increase our net liabilities to foreigners, future generations of Americans will bear a growing burden of the debt and experience slower growth in per-capita incomes than would otherwise have been the case.

Board of Governors of the Federal Reserve System, Ben S. Bernanke, "Long-term fiscal challenges facing the United States," (Testimony of Chairman Ben S. Bernanke presented before the Committee on the Budget, U.S. Senate, Washington, D.C., January 18, 2007); available from <http://www.federalreserve.gov/boarddocs/testimony/2007/20070118/default.htm>.





What is needed is fundamental reform. Inevitably these reforms will have to incorporate free market based alternatives. For one reason, this is because more and more North Carolinians are beginning to see that private and semi-private solutions – such as homeschooling and charter schools, not to mention private healthcare – are simply better than the public alternatives. Even more certain is that the state simply will be unable to increase education and healthcare spending at current trends without at the same time raising taxes to unacceptably high levels and also compromising quality. In spite of an infusion of billions of dollars of new funding over the past 20 years, North Carolina's public school system, as the Leandro v. State decisions suggest, is failing to "prepare students to participate and compete in the society in which they live and work." As for healthcare, the failure of universal healthcare in countries like Sweden and Canada (cf. the 2005 Chaoulli v. Quebec case) should be enough (but admittedly has not done so yet) to lay to rest claims that a government-run healthcare system is a good idea.

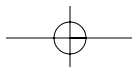
Lesson Two: In the Event of a Budget Surplus, Cut Taxes

Our study of the budget brings out other lessons legislators would be wise to consider. These lessons become clear once we examine the events (detailed in our Timeline) preceding the three shifts in legislative control over the past 20 years: 1994, 1998 and 2002 (interpreting 2004 not so much as a shift in power, but a confirmation by the electorate that Republicans had already lost control of the House when Michael Decker switched parties). At the state level, each of these power shifts can be linked to voter discontent over the state budget. During the 1994 short session, North Carolinians watched as the Legislature blew through a \$1.2 billion surplus. As in previous years, much of the money was spent on raises for teachers and state employees. No significant tax cuts, if any at all, were passed that year. In response, voters embraced the Republican "New Contract for the People of North Carolina" which promised to reduce taxes, implement a Taxpayer Protection Act, and prohibit unfunded state mandates. Seeing the writing on the wall, Governor Hunt subsequently proposed the largest tax reduction package (\$483 million) in state history.

Lesson Three: Play Nice (and Be Patient)

From 1995 to 1998, Republicans in the House fought hard to reduce taxes, winning a repeal of the regressive food sales tax, as well as the inheritance tax, during the 1998 short session. The House also succeeded in pushing through a limited welfare reform program. In spite of delivering tax cuts to the people of North Carolina for three consecutive years, Republicans lost their majority in the House during the 1998 election.

At least in part, the Republicans fell from power because the Democrat Senate was able to make it appear that the House was obstructing the budget process.



With the 1997 session having lasted 212 days and the 1998 session drifting into October, voters were weary of what was perceived as partisan bickering. The message: voters do want tax cuts, they do want welfare reform; but not at any price. In the end, Americans – and perhaps, even more so, North Carolinians – are an optimistic and hopeful people who want to believe that everyone, regardless of their political views, should be able just to get along.

Lesson Four: In the Event of a Deficit, Cut Spending

In 2002, voters returned Republicans back into power in the House. While some citizens, no doubt, were unhappy that taxes (sales, income, and others) were raised in 2001 and 2002, still more were displeased over Governor Easley's mishandling of the budget crisis. The problem was not really that the state raised taxes, but that even after raising taxes the governor and the General Assembly were unable to prevent a \$2 billion shortfall for 2003. Even accounting for the effects of the economic recession, the massive size of the shortfall indicated to many voters that government spending had careened out of control.

In the end, we would like to say that resolving the state's ongoing budget crisis is simply a matter of following one basic truism: applying the same rules to the state budget that each person generally applies to his own budget. This would entail cutting costs whenever possible, being fair to all parties (even present and future taxpayers), and not spending money that is not actually available. Unless our legislators suddenly turn into angels, however, this is not going to happen. What is even more necessary, and far more realistic, is for each citizen to start to treat his own money as if it were his own. After all, if we as taxpayers do not care how the Legislature is spending our money, why should they? Our final lesson, then, is this: Pay Attention. It's Your Money.

J.T.T.

