State Fiscal Outlooks from 2005 to 2013: Implications for Higher Education

The material for this article was prepared for NCHEMS by Don Boyd of the Rockefeller Institute of Government at the State University of New York.

Introduction

State and local governments have been working their way out of a severe fiscal crisis precipitated by the national recession of 2001 and the stock market declines of 2000 through 2002. They have drawn down reserve funds, allowed colleges and universities to raise tuition and fees in abnormally large increments, cut spending in some areas, selectively increased taxes, and tapped nonrecurring sources of revenue (such as securitizing tobacco settlement funds). This process is still going on in many states. After states have restored the balance, what will happen? Will new gaps reappear due to a mismatch between underlying revenue and expenditure structures, or will state and local finances boom as in the late 1990s, allowing governments once again to increase spending, cut taxes, and rebuild reserves?

Even if state and local governments close their current budget gaps with regular sources of revenue, instead of relying on gimmicks that provide only temporary relief, the sad conclusion is that most states will face continuing problems in financing current services and will not have sufficient resources to support real increases in spending. Given the fact that state and local governments have substantially increased real per-capita spending in each of the last five decades, this conclusion suggests that citizens will have to either scale back their appetites for government services in the next ten years or support tax increases to finance new growth.
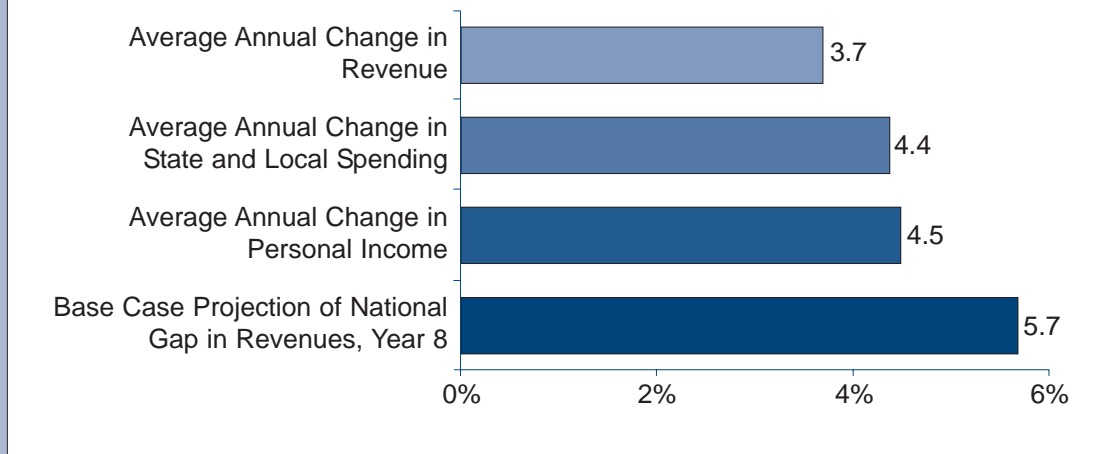
Base Case Projections

To support this conclusion, a set of "Base Case" projections of state revenues and expenditures was constructed. These show that within eight years—assuming state and local governments can bring their budgets back into balance in year one—states still are likely to face substantial gaps. For the nation as a whole, the Base Case budget gap is about 5.7% of revenue. By comparison, personal income, a broad measure of the economy, is projected to grow at an annual average rate of 4.5%. State and local spending needed to maintain current services is projected to grow a bit more slowly than the economy, at an average annual rate of 4.4%. Revenue, by contrast, is projected to grow considerably more slowly than the economy, at an annual average pace of only 3.7% (see **Figure 1**).

Similar projections reveal that every state faces at least a small gap, with 29 of them looking at gaps of 5% or more. While these shortfalls are smaller than those that occurred recently as a result of swift, sharp shifts in the economy and financial markets, they nevertheless suggest that state and local governments will face continuing stress even after this crisis has passed.

There are three main reasons for this condition.

1. Tax revenue will not grow as fast as the economy because:

    a. Economic growth, unlike that of the late 1990s, will not generate major annual surges in capital gains income.

Figure 1
Overall Base Case Projections

Average Annual Change in Revenue	3.7
Average Annual Change in State and Local Spending	4.4
Average Annual Change in Personal Income	4.5
Base Case Projection of National Gap in Revenues, Year 8	5.7

0%   2%   4%   6%

b. Sales tax revenues will decline due to a continuing shift in consumption from goods to lightly taxed services and the difficulty of collecting taxes on Internet-related transactions.

c. Excise taxes will not keep up with overall economic growth.

2. Spending in many states will be increasingly dominated by the need to underwrite Medicaid growth.

3. The federal budget outlook has deteriorated dramatically, resulting in administration proposals to substantially cut grants to state and local governments.

Cuts in federal grants are the main reason why the fiscal outlook for states now shows an average budget shortfall of 5.7% instead of the potential gap of 3.4% reported in an October 2002 analysis done by the Rockefeller Institute of Government.

The Base Case projections also show that income taxes tend to grow more quickly than income. As a result, states that do not have income taxes are more likely to face bigger gaps. Five of the nine states without a comprehensive income tax have projected gaps that place them in the "top 10."

The sections that follow show the results of projections based on a variety of alternative assumptions. All of them indicate that the outlook for states will worsen. And even if states address current deficits using nonrecurring revenue or spending reductions extensively, they will have to address additional cyclical budget gaps due to fluctuations in the economy.

The 50-State Picture

Projections of future budget conditions were developed for each state. These projections start with a balanced budget in the initial year. The projections therefore address the question:

*What would happen to state and local government finances **after** states have addressed their current budget shortfalls?*

This question can be answered only by looking at underlying revenue and spending structures. The fiscal conditions shown are thus **in addition to** the shortfalls that states will face as they continue to work off the effects of the recent fiscal crisis.

Because they examine structural conditions, the analysis does not project actual surpluses or deficits. Instead, it looks at **imbalances** in fiscal conditions.

For some states, the results show potential surpluses. In most, they show probable deficits. In the real world, state and local governments must balance their budgets; and they will generally cut taxes or raise spending if they face potential surpluses. Thus actual budgets eight years from now are likely to be balanced in most states. But the potential surpluses or deficits shown help us understand the pressures state governments face and the kinds of choices they may have to make to maintain balanced budgets.

Projected conditions vary widely across states, depending on economic and demographic forecasts and the revenue and spending structures typical of each state. **Figure 2** shows fiscal shortfalls or surpluses at the end of eight years as a percentage of revenue in year 8, under Base Case assumptions.

All 50 states show potential deficits, ranging from 0.5% of revenue in New Hampshire to 12.9% in Wyoming. Of the 10 states with the largest projected gaps, five do not have an income tax (Nevada, Tennessee, Texas, Washington, and Wyoming). Two of the four states with the next largest potential gaps also do not have income taxes—Florida and South Dakota. Wyoming—one of the few states that has shown a robust economy in recent years—is an anomaly. Its large projected deficit results primarily from its heavy reliance on federal revenue, which is projected to decline an average of 3.3% per year in real per-capita terms. We assume that all states will be affected proportionately by these costs. However, it is possible that federal revenues may be cut in ways that do not fall evenly across states, in which case Wyoming might not be hit as hard as the model projects.

Looking at these projections geographically (see **Figure 3**), it is clear that northeastern states in general fare better than the U.S. as a whole, while southern states fare the worst.

So what does all of this mean for higher education? **Table 1** shows the projected eight-year percentage growth in state higher education expenditures and total

Table 1
Higher Education Advantage After 8 Years

	Annual Average Advantage for Higher Education	8-Year Spending Growth Rate	
		All Programs	*Higher Education*
Nevada	1.2	59.5	74.9
New Jersey	0.6	34.3	40.9
Illinois	0.5	33.5	38.9
Arizona	0.2	55.8	58.0
Michigan	(0.0)	34.3	34.0
Indiana	(0.0)	38.6	38.2
California	(0.1)	46.4	45.7
Connecticut	(0.2)	36.0	33.6
Delaware	(0.3)	37.7	35.1
Colorado	(0.3)	43.5	40.6
Virginia	(0.3)	39.4	36.4
Massachusetts	(0.3)	31.2	27.9
Rhode Island	(0.4)	37.0	32.3
United States	**(0.6)**	**41.1**	**34.4**
New York	(0.7)	35.3	28.6
Florida	(0.6)	49.2	42.5
North Carolina	(0.6)	47.7	40.9
Georgia	(0.6)	51.0	44.1
Utah	(0.6)	47.1	40.1
Pennsylvania	(0.7)	32.3	25.2
Texas	(0.7)	50.3	42.6
Maryland	(0.8)	36.3	28.3
Ohio	(1.0)	34.0	24.1
Tennessee	(1.0)	43.7	33.6
Kentucky	(1.0)	42.3	31.5
Iowa	(1.3)	35.1	22.5
South Carolina	(1.2)	47.4	34.8
Kansas	(1.3)	34.9	21.7
Oregon	(1.3)	46.8	32.9
Missouri	(1.4)	38.1	24.3
West Virginia	(1.6)	34.8	19.0
Nebraska	(1.6)	36.1	20.2
Wisconsin	(1.6)	33.8	17.8
Arkansas	(1.6)	41.5	25.3
Hawaii	(1.6)	37.9	21.4
Minnesota	(1.7)	37.2	20.7
Louisiana	(1.7)	40.0	22.8
Oklahoma	(1.7)	37.2	19.9
Alabama	(1.8)	41.4	23.1
Idaho	(1.7)	48.7	30.4
Washington	(1.7)	46.8	28.5
Mississippi	(1.8)	45.2	26.3
New Hampshire	(2.3)	37.4	15.1
Alaska	(2.4)	44.7	20.5
South Dakota	(2.6)	33.9	9.2
Maine	(2.7)	34.3	8.9
Vermont	(2.7)	32.3	6.7
New Mexico	(2.6)	47.3	20.5
Montana	(3.0)	33.9	5.6
North Dakota	(3.3)	29.7	(0.1)
Wyoming	(3.6)	39.0	4.9

Note: In these numbers, annual average growth takes into account the impact of compound growth. The 1999 report did not take compounding into account, and as a result it would have shown slightly higher differences in annual average growth than shown here.

Figure 2
State and Local Fiscal Surplus (Gap) After 8 Years as Percent of Revenue
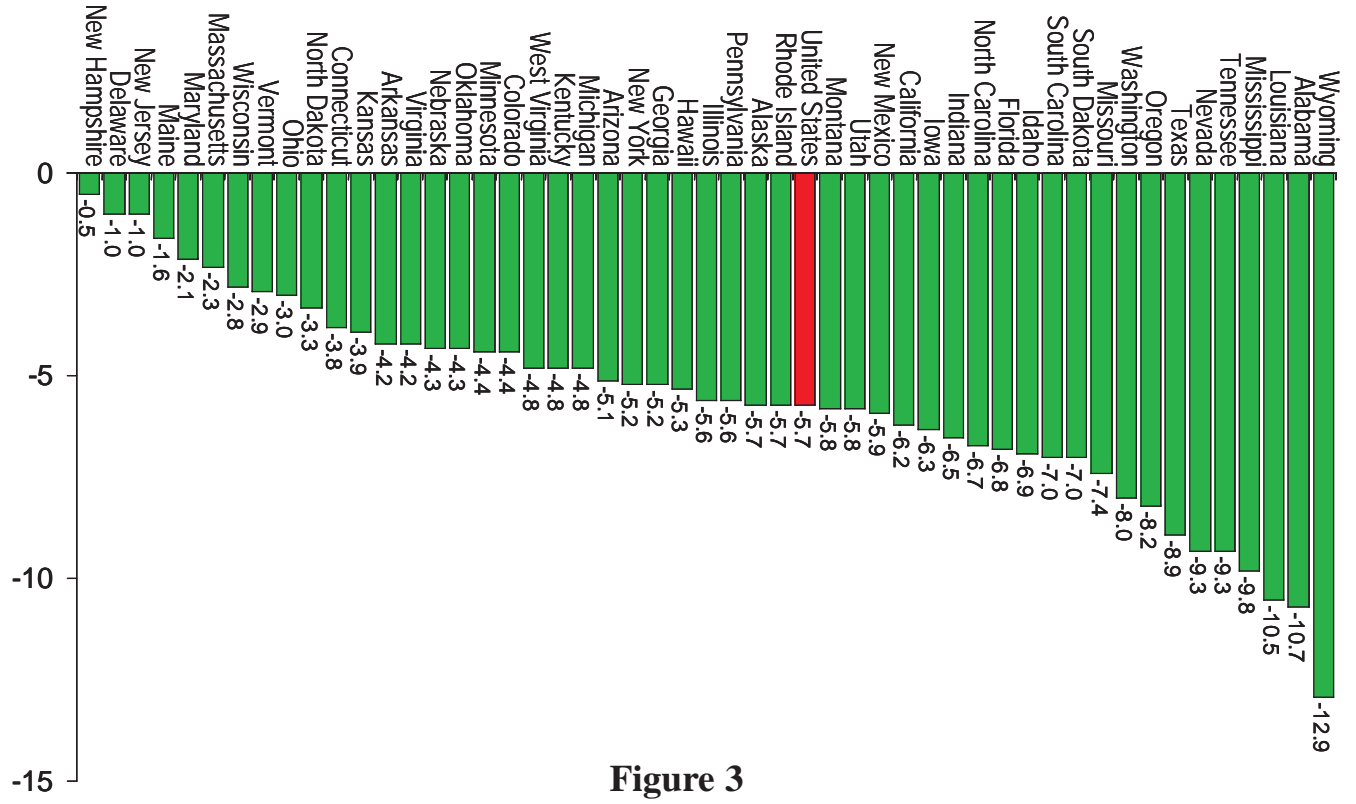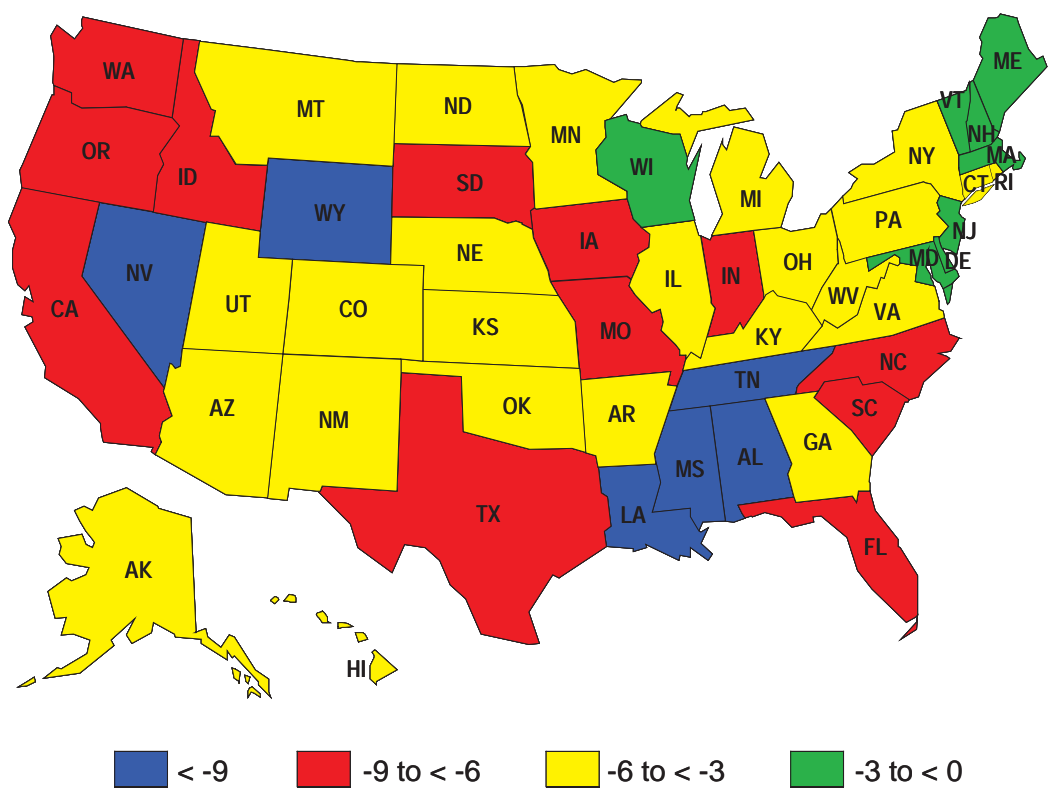

States (left to right): New Hampshire -0.5, Delaware -1.0, New Jersey -1.0, Maine -1.0, Maryland -1.6, Massachusetts -2.1, Wisconsin -2.3, Vermont -2.8, Ohio -2.9, North Dakota -3.0, Connecticut -3.3, Kansas -3.8, Arkansas -3.9, Virginia -4.2, Nebraska -4.2, Oklahoma -4.3, Minnesota -4.3, Colorado -4.4, West Virginia -4.4, Kentucky -4.8, Michigan -4.8, Arizona -4.8, New York -5.1, Georgia -5.2, Hawaii -5.2, Illinois -5.3, Pennsylvania -5.6, Alaska -5.6, Rhode Island -5.7, United States -5.7, Montana -5.7, Utah -5.8, New Mexico -5.8, California -5.9, Iowa -6.2, North Carolina -6.3, Florida -6.3, Idaho -6.5, South Carolina -6.7, Missouri -6.8, Washington -6.9, Oregon -7.0, Texas -7.0, Nevada -7.4, Tennessee -8.0, Mississippi -8.2, Louisiana -8.9, Alabama -9.3, Wyoming -9.3, -9.8, -10.5, -10.7, -12.9

Figure 3
Projected Fiscal Gap After 8 Years as Percent of Revenue

Legend:
- < -9 (blue)
- -9 to < -6 (red)
- -6 to < -3 (yellow)
- -3 to < 0 (green)

state expenditures, together with the extent to which annual average higher education growth compares to growth in total expenditures. In 1999, Hal Hovey called this difference the "higher education advantage." In most states these numbers are negative—that is, higher education expenditures are expected to grow less rapidly than total state and local government spending. The main reason for this is that Medicaid is expected to grow at approximately 8.5% annually, driving up overall state spending considerably.

Table 1 shows that higher education spending for the nation as a whole is projected to grow 34.4% over the eight-year period. This is considerably slower than the 41.1% growth projected for total spending—about 0.6% slower per year. Higher education spending is expected to grow faster than total spending in only four states, at about the same rate in two states, and slower than total spending in 44 states. Thus, in most states, higher education will face strong competition from other state offices and services—claimants who can make a solid case for greater need.

Alternative Scenarios

Changing the assumptions that underlie the Base Case would yield scenarios that show even more fiscal pressure on state and local governments. Is it plausible to assume, for example, that states will not increase real per-pupil spending on elementary and secondary education given recent policies to reduce class sizes, raise standards, raise requirements for teacher qualifications, and reduce social promotion? Each of these is likely to **increase** K-12 spending, and there is ample public support for doing so. In the 1990s, real per-pupil spending in K-12 increased by more than 1% annually. In the 1980s, it increased by approximately 3.3% annually, and in each of the preceding three decades average annual real per-pupil spending on K-12 education increased by more than 2.4%.

Issues like these were taken into account to make alternative sets of projections:

- If state and local governments increase real per-pupil spending in K-12 education by

1.5% annually—instead of none as assumed in the Base Case projections—the average projected shortfall increases from 5.7% to 8.6%, and 45 states would face gaps of 5% or more.

- If states increase **both** real per-pupil elementary **and** secondary education spending and real per-pupil higher education spending by 1%, results are similar, but the distribution differs across states: the average gap is 8.4%, and 44 states would face gaps of 5% or more.

Under other plausible assumptions, though, the outlook might improve slightly.

- If states are able to promptly stem sales tax losses related to Internet commerce, the average gap falls from 5.7% to 4.5%, and only 20 states would face gaps of 5%.

- If growth in Medicaid costs were slowed by one percentage point across the board, the average gap falls from 5.7% to 4.5%, 49 states would face gaps (rather than all 50), and only 21 states would face gaps of 5% or more.

- Finally, if there were no cuts in federal grants to states, the average budget gap falls from 5.7% to 2.7%.

Conclusion

This study demonstrates that all 50 states face potential deficits by 2013. Most states will face continuing difficulties in financing current services within the constraints of existing revenue structures, and will not have the resources to support real increases in spending. If states solve current deficits through the extensive use of one-time revenue or spending reductions—as has happened in some cases—they will have to address continuing cyclical budget gaps in addition to these longer-term gaps. And, in most of them, higher education expenditures are expected to grow less quickly than total state and local government spending. The result is not a pretty picture for public financing of higher education.