STATE SPENDING FOR HIGHER EDUCATION IN THE NEXT DECADE

The Battle to Sustain Current Support

By Harold A. Hovey

July 1999

Prepared by
State Policy Research, Inc.
For
The National Center for Public Policy and Higher Education

National Center Report #99-3

Production Management and Editing: Nodine Consulting, nodine@cruzio.com

Contents

Foreword

State Spending for Higher Education in the Next Decade is the second report published by The National Center for Public Policy and Higher Education that explicitly addresses the future financing of higher education. *State Spending,* like its predecessor, *Federal Tax Credits and State Higher Education Policy,* focuses primarily on the states and presents state-by-state data on important trends. The earlier report offered guidance to state leaders on the implications of new federal funding. In contrast, *State Spending* predicts a quite different policy issue: despite the favorable state fiscal environment of the moment, many states will experience significant difficulties in maintaining their current levels of public services over the next decade. And—all too likely—state fiscal difficulties will pose even greater problems for publicly supported colleges and universities.

The National Center was very fortunate to engage Harold A. Hovey to undertake this analysis of the prospects of state support of higher education. Mr. Hovey, president of State Policy Research, Inc., brings unique experience and authoritative expertise to this analysis. Whether or not readers will accept his findings and conclusions, they will assuredly understand why Mr. Hovey's talents are so frequently in demand by states, the federal government and national organizations that seek analytical insight on issues of public finance and public policy.

Using economic assumptions and empirical methods that are widely accepted in the public and private sectors, Mr. Hovey assesses the outlook for state finances and, in the context of the ongoing needs of other major state services, for state support of higher education. Despite the fact that "the last five years have been about as good as it gets in state funding of higher education," he finds that the fiscal circumstances of many states are likely to erode over the next few years. Many states will find it impossible to maintain current public services within existing tax structures. Continuing support for other services will place enormous pressure on higher education budgets. Recently, colleges and universities have done disproportionately well in times of good state budgets and disproportionately poorly in tight budgetary times. In addition, demographic and economic factors in some states will require that higher education actually do *better* than other public sector activities just to maintain current service levels in the future. Directing a greater share of state budgets to higher education would mean reversing trends of the past decade.

If Hovey's analysis is correct, there is much room for discussion and debate about its policy implications. His message is that difficult times are ahead for both states and higher education. In these flush economic times, this is not a message that will be easily accepted by either elected officials or higher education leaders. As Hovey points out, elected officials are likely in good times to assume that the future will be like the immediate past. Higher education leaders are equally vulnerable to overly optimistic assumptions in similar circumstances. History suggests that this short-term tendency for optimism usually prevails over both experience (Remember the recession of the early 1990s?) and even the best long-term analyses. The results: both the states and the colleges and universities are found to be unprepared for cyclical downturns, and unnecessary damage is created by adverse state fiscal circumstances.

This report does not offer recommendations to state or college and university policy leaders, but its implications are clear. Both sets of leaders should realize that permanent tax cuts may have even more severe implications for higher education than for other public services. In addition, higher education budgets that increase the state cost per student in good times usually add to the cost of maintaining services in hard times. And in their current heady financial circumstances, some states may be increasing their higher education expenditures in ways that will increase the difficulty of maintaining essential, core services in the future.

The National Center extends its appreciation to Harold Hovey for this important analysis. The initial draft was reviewed at a symposium on emerging state higher education policy issues convened in early 1999. The symposium was chaired by Robert Atwell, president emeritus of the American Council on Education, and the participants are listed in Appendix E. David Breneman of the University of Virginia and D. Bruce Johnstone of the State University of New York at Buffalo also reviewed early drafts. Our thanks to all of these reviewers.

Patrick M. Callan
President
The National Center for Public Policy and Higher Education

Executive Summary

This fiscal forecast of state and local spending patterns, using the same assumptions that most state legislative bodies employ when developing budgets, finds that even with normal economic growth over the next eight years, the vast majority of states will face significant fiscal deficits. Given past state budget patterns of coping with fiscal deficits and avoiding tax increases, the report concludes that the projected shortfalls will lead to increased scrutiny of higher education in almost all states, and to curtailed spending for public higher education in many states. The bad news is that if economic growth is slower than "normal," if taxes are reduced, *or* if state spending increases for areas outside of higher education, then the outlook for support of public higher education will be even *less* favorable.

The overall forecast for state fiscal health is as follows:

- *The Challenge: Maintaining Current Service Levels.* To maintain current service levels, state and local governments will need to increase spending by about the same percentage as the increase in total personal income of all Americans. This increase in spending will allow for inflation and for constant per-unit services, such as teacher / student ratios.
- *The Problem: Slower Growth in State and Local Revenues.* Unless tax increases are enacted, state and local revenues will not grow as quickly as total personal income. This derives from a well-known problem, largely due to states' reliance on sales taxes and fees: state and local taxes are slow to react to increases in income.
- *The Result: Structural Deficits.* State and local governments will have a structural deficit in funding current service levels. The mismatch averages about 0.5% per year nationwide, but varies depending upon the state. Due to the robust national economy and other reasons, this problem has not been obvious in recent years, but is likely to become more obvious in the next few years.

  Only ten states show structural surpluses. One state has no surplus or deficit, and the remaining 39 are projected to have structural deficits.

IMPACT ON HIGHER EDUCATION

Based on national averages, state spending for higher education will have to increase *faster* than state spending in other areas—just to maintain current services. Whereas total state funding for all services will need to increase by 5% annually to maintain current service levels, state funding for higher education will have to increase by 6%—largely due to enrollment increases. This means that *even if states were not facing structural deficits* in reaching the 5% annual growth in revenues, the percentage of state funding devoted to higher education will need to increase *annually* in order for higher education just to *maintain current services.* Since the percentage of the state budget dedicated to higher education has actually *declined* over the past decade, continuing to fund current service levels for higher education would represent a significant shift in state budget trends. It would also represent a dramatic departure from near-universal statements about priorities for K–12 education in the 1998 campaigns.

Taking the positive view—that is, assuming that higher education were merely to share equally in the fiscal pain of helping states respond to their structural deficits (rather than being singled out for additional cuts, a "balance wheel" function that higher education has served in the past)—then, based on national averages:

- higher education would not see expansion of spending patterns for any program except as financed by reductions in other programs within total higher education spending, *and*
- higher education would share proportionately in spending growth rates that average annually about 0.5% below the total appropriations levels needed to maintain current services.

At the same time that states will be facing structural deficits, they will be:

- seeking to fund new initiatives in many state program areas outside of higher education (see Appendix A),
- confronting the difficulty of cutting current services in these other program areas (see Appendix B), and
- confronting the difficulty of raising taxes (see Appendix C).

Preface

This report is grounded in what budget people do—including forecasting revenues, calculating budgets needed to continue current levels of government services, and dealing with unexpected fluctuations in economic circumstances. Few people find these topics interesting. Many consider them only in order to examine the basis for trends that affect them adversely. This report reflects this reality. The text, designed to be a "quick read," summarizes its conclusions and the reasons for them. The supporting details appear in appendices.

Readers should recognize that two types of forecasts appear in the text without repetitious reminders of how they differ. The forecasts—of revenues from current taxes, spending for current services, and thus shortfalls and fiscal flexibility over the next decade—are built just as revenue and spending forecasts are built for annual government budgets. They are professional forecasts of circumstances beyond the control of decision-makers. Since the estimates reflect a close consensus among professional estimators and a widely accepted methodology, they closely approximate what other professionals would produce if asked to address the same subjects. Such forecasts are never exactly right. They are usually close to right. And, right or not, they are generally considered authoritative.

Forecasts of the responses of decision-makers to predicted fiscal circumstances are another matter. Their empirical base is inherently weaker. There is no close consensus on how to predict political behavior. Actions of participants in the political process can affect outcomes in ways experts are unable to predict as easily as economic and tax collection growth, public school enrollment, and inflation. Forecasts of how decision-makers will respond to the predicted fiscal circumstances are not authoritative; they inherently reflect predictions of what people with power to decide will decide. Their only empirical base is how similarly situated decision-makers, primarily legislators and governors, have made similar decisions when confronted with similar circumstances in the past. This approach makes sense in specifying a baseline of what policy would likely be, given unchanged behavior by participants. But it is only a starting point in considering the range of policy choices available to the participants.

CHAPTER ONE

The Outlook for State Finances

INTRODUCTION

Impact of Fiscal Conditions on Higher Education

State funding for higher education has always been heavily influenced by states' fiscal situations. State elected officials have often viewed support of higher education as more discretionary than funding for many other programs. As a result, changes in state fiscal conditions are often multiplied in their impacts on higher education. When finances are tight, higher education budgets are often cut disproportionately. When financial conditions are good, higher education often receives larger increases than most other programs.

These fiscal responses mean that the outlook for state higher education funding depends critically on the outlook for state finances overall. This chapter addresses that outlook.

Baseline Budget Projections

The approach used in this paper is similar to that used by most legislative bodies when developing and enacting budgets and making fiscal projections—typically called *baseline* or *current service* budgeting. The starting point is current spending and revenues. The projections are based on applying current government policies to predicted future changes in the environment in order to measure the fiscal consequences of continuing those policies.

For revenues, that means predicting the revenues from current taxes, given likely changes in the national and state economies. For spending, it means predicting the workloads, such as the number of children in public schools, that drive spending. The underlying assumption is that decision-makers will be tempted to hold constant their spending for units of workload, such as spending per pupil. But to keep activity constant, such as maintaining the same pupil-teacher ratios and quantities of teaching supplies per pupil, spending must reflect inflation as well as growth in workloads.

The result of such an analysis is a current service, or baseline, budget. Such budgets provide the starting point for formulating governors' budgets and considering legislative budget options. The time period covered by the forecasts is a fiscal year or biennium, depending on the fiscal practices of individual states.

If the projections indicate that revenues from current taxes likely will exceed the spending needed to maintain current services, the government has fiscal flexibility to expand spending further or reduce taxes. If there is a projected shortfall, decision-makers must either raise taxes to finance their current programs or curtail their spending patterns.

Some states and the federal government extend their fiscal projections to longer time periods. They use roughly the same approach—basing expected revenues on predicted economic conditions, and basing spending on predicted changes in price levels and workloads for government programs.

THE ENVIRONMENT FOR STATE FINANCES

Economic Environment

The condition of the nation's economy is the single most critical factor influencing the fiscal condition of state governments. Economic growth brings large gains for state revenues because of impacts on tax bases. For example, in a rapidly expanding economy, rapid growth in incomes brings rapid growth in income tax revenues and rapid growth in purchases brings rapid growth in revenues from sales taxes. Economic growth also affects spending. Large portions of state expenditures are for means-tested safety net programs, such as cash welfare and Medicaid (health care for low-income households). In strong economic times, more people hold jobs and eligibility for safety net programs is reduced. Conversely, in economic downturns, the caseloads in these programs increase as more people become eligible because of low incomes.

For its projections, this paper relies on the baseline economic assumptions used by the U.S. Congress in its budget

From year to year, the performance of the nation's economy seems quite unpredictable. At any given time, there is constant speculation over whether the nation is on the verge of recession or economic "overheating," that is, rapid but unsustainable growth. Over the long run, economic growth is more predictable. Changes in the nation's real (inflation-adjusted) output are driven by the combination of: (1) the number of workers, and (2) their productivity or output per unit of time. Many factors affect productivity, such as technological innovation, education and training of workers, and capital investment. But over multi-year time periods changes in both productivity and the number of workers have proven to be relatively predictable.

For its projections, this paper relies on the baseline economic assumptions used by the U.S. Congress in its budget deliberations. These assumptions are quite similar to those used by those states that make long-term budget projections, as well as to the assumptions underlying forecasts used in business planning in the private sector.

The projections assume that each year of the forecast period will be characterized by about the same rate of economic growth. This is not because those making the forecasts believe that the nation will be free of periods of slow growth or recession alternating with faster-than-normal growth. It simply means that, without exception, those who make long-term projections of government budgets are not confident of their ability to forecast exactly when these periods will begin and end. They are confident, however, that the variations will average out over the projection period to about the rate of economic growth being assumed.

Demographic Environment

Standard demographic projections from the U.S. Census Bureau underlie both the economic and workload projections used in this report.[1]

Federal Policy

Because federal aid finances about a quarter of all state and local spending, the fiscal outlook of state and local governments is highly sensitive to changes in federal funding. These projections assume that federal aid will continue to finance the same percentage of state and local outlays as in the past. State government costs are also sensitive to federal mandates, which are presumed not to undergo major changes.

Political Environment

There are no assumptions about the relative electoral success of major political parties underlying the projections. This can be viewed as either: (1) an assumption that that success will not change in major ways, or (2) an assumption that such changes are insignificant.[2]

Sensitivity to Assumptions

Long-term fiscal projections are sensitive to the assumptions described above. This sensitivity is explored in Appendix D.

Spending Growth Projected to Parallel Personal Income Growth

Total Spending Increases

To maintain their current services, state and local governments will need to increase their spending by about the same percentage as the increase in total personal income of all Americans.

Detailed projections of state and local spending on a state-by-state basis were developed by State Policy Research, Inc., during 1998. The nationwide projections produced an unsurprising result. To maintain their current services, state and local governments will need to increase their spending by about the same percentage as the increase in total personal income of all Americans. Specifically, over the next eight years, an increase of 39.6% in spending will maintain current services while personal income growth is expected to be about 36.5%. Thus, current service spending can be accommodated with a slight rise in the percentage of incomes spent by state and local governments, from about 16.0% to 16.3%.

Having spending for current services so closely tied to personal income makes sense. First, it is reasonable to expect that voters will support adjusting purchases of public services about as fast as incomes grow. The projections imply improvements in purchasing power, as measured by real per capita income gains. To maintain balance between public and private outlays, citizens are likely to want to devote some of this purchasing power to public goods and services. It makes little sense, for example, to spend more on vehicles while not maintaining roads on which to drive them or on security alarm systems without adequate police responses to the resulting alarms.

Second, many of the factors driving personal income increases are also driving increases in the costs of government. Inflation is the best example. Demography offers other examples. A growth in population not only contributes the workers who produce economic growth, but also produces more citizens to be served by governments. Growth in those segments of the population that create high spending needs, such as children in school, is roughly proportional to the growth in the segments creating economic growth, such as those in the 18 to 65 age group.

Differences Among Functions

Within the growth in total spending for current services, there are differences among major government functions. The somewhat higher-than-average growth of the college-age population and trends in college attendance will likely make higher education costs rise more rapidly than the costs of most other programs. Growth in the population over age 65, and particularly in the population over age 85, will tend to force Medicaid costs—a large portion of which pays for nursing home care—to rise more rapidly than total state and local outlays.

REVENUES GROW MORE SLOWLY THAN PERSONAL INCOME

Problem Widely Recognized

While spending for current services will grow at about the same pace as personal income, state and local revenues from existing taxes will not do so. The result is a shortfall in state and local budgets that is almost entirely attributable to the characteristics of state and local tax systems. This problem with current tax systems is well known. It has been the subject of a series of reports from organizations of state and local officials identifying the problem and proposing reforms in state tax systems to reduce if not eliminate it.[3]

While spending for current services will grow at about the same pace as personal income, state and local revenues from existing taxes will not do so.

Causes of the Problem

As economists would put it, the problem with state and local tax systems is their low *elasticity.* To provide revenues adequate to finance current service spending without tax increases, these tax systems would have to have *unit elasticity*—that is, growth in revenues would be proportionate to growth in personal income. For example, a 10% increase in personal incomes would result in a 10% increase in tax revenues. Because of its graduated personal income tax rates, the federal income tax would raise much more than 10% additional revenue for every 10% increase in personal income. To offset this tendency, the federal government adjusts the standard deduction and tax bracket break points for inflation every year. But even with the adjustment, federal income tax revenues grow at a better pace than personal income because: (1) personal income growth enters the income tax base, and (2) additional increments of real income (that is, income adjusted for inflation) are taxed at successively higher marginal income tax rates.

State and local tax systems show the reverse. The main culprit is states' high reliance on sales taxes on goods. As individual incomes rise, people spend a successively smaller portion of incremental income on taxed goods and higher proportions on non-taxed outlays for services. Even without increases in personal income, the share of consumer spending associated with goods tends to decline. Because productivity increases are concentrated in manufacturing, prices of manufactured goods tend to decline while those of services, where productivity has less of an impact, tend to rise. As a result, successively larger portions of incomes go to purchase services.

Low elasticity of state and local tax systems is also associated with high reliance on taxes and fees based on units of purchase (e.g., packages of cigarettes, bottles of alcoholic beverages, gallons of gasoline) rather than on prices. For more complex reasons, business taxes also have less-than-unit elasticity, since smaller portions of economic activity are associated with the types of businesses (corporations engaged in manufacturing) for which state and local tax systems were designed.

These characteristics of state and local tax systems mean that every growth of 10% in personal income is associated with growth of about 9.5% in state and local tax revenues.

The Outlook for Funding Current Services

This mismatch between what would be needed to continue current programs and revenues from current taxes is about 0.5% a year.

Structural Deficits

With revenues growing more slowly than personal income and outlays growing faster, state and local governments have a *structural deficit* in funding current services. This mismatch between what would be needed to continue current programs and revenues from current taxes is about 0.5% a year. That is, to maintain current services, state and local governments nationwide would have to increase taxes by about 0.5%. Alternatively, they could maintain current tax systems and keep budgets balanced by holding spending growth to about 4.5% annually rather than the 5% needed to maintain current services.

Problem Not Obvious in Recent Years:

These structural deficits usually appear when states make long-term projections of their fiscal situations. But they are a marked contrast to the widely publicized surpluses that have been appearing in state budgets in recent years. Why the difference?

1. The nation's economy has been growing faster than its long-term sustainable growth rate, swelling state as well as federal tax collections.
2. Unusual percentages of the economic gains from growth have accrued to economic players with higher-than-average tax rates, namely corporations and high-income households.

3. Federal aid, particularly funding associated with welfare reform, has provided windfall revenues for state governments.
4. Several fortuitous circumstances have benefited state finances, including extraordinary returns on pension fund investments (which cut the amounts required for employer contributions), a rapid decline in welfare caseloads, and unusual moderation in cost increases in health care.
5. Gains from these factors have been concentrated at the state level, without corresponding gains in local government finance. Therefore, surpluses reported by states are not indicative of the combined circumstances of state and local governments discussed in this report.

Interdependence of State and Local Finances

The impact of the combination of stronger state and weaker local finances on support of higher education is not obvious at first blush. Because most higher education money comes from states, strong state finances might suggest a favorable environment for higher education spending, regardless of local situations. In practice, however, local fiscal pressures are rapidly translated into state fiscal pressures. Evidence of this appears in discussions of taxes and tax relief. In many states, there is strong sentiment for reducing reliance on property taxes, such as personal property taxes on motor vehicles and residential property taxes. When states seek to reduce burdens of local property taxes, they do so by replacing all or most of the local revenue losses.

Evidence of the interaction of state and local finances also appears in spending. For example, in the state campaigns of 1998, candidates almost universally stressed increasing state aid for local public schools. Besides whatever impact this might have on how well children are educated, one effect is to reduce reliance on local property taxes for funding of schools. This effect can be viewed as using some state revenue growth to enhance local revenue growth, which is not matching the strong growth seen by states.

The flip side of the better-than-normal state financial conditions will be, as everyone who looks at the subject concludes, an ensuing period when state finances show worse problems than the normal mild structural deficits.

Problem Likely to be Obvious in Next Few Years

The flip side of the better-than-normal state financial conditions will be, as everyone who looks at the subject concludes, an ensuing period when state finances show worse problems than the normal mild structural deficits. There are two basic reasons for this, one behavioral and one economic.

The *behavioral reason* stems from the tendency to assume that the future will be like the immediate past. This is particularly important in state government, which has institutional factors encouraging a short-term outlook. The old adage that elected officials rarely look beyond the next election has an element of truth. Also important is the turnover of legislators—always rapid, but accelerated by the increasing use of term limits. The office of governor also turns over rapidly, with most governors limited to eight years of continuous service.

These factors mean that the average state legislator and governor in 1999 has never held his or her current office except during the period of unbroken prosperity that has lasted since 1992. In this context, there is a tendency to assume that strong tax collection growth will continue unabated and that actual collections will always exceed those predicted by revenue estimators. Revenue estimators themselves are not immune from adjusting their estimating procedures to deal with their recent errors, which have been underestimates.

The last five years have been about as good as it gets in state funding of higher education.

So on top of whatever institutional inability state elected officials inherently have to look beyond the next election, all the behavioral factors at work encourage more optimism about future state finances than projections suggest is merited. Historically, this factor alone has led state officials to over-commit their resources by adopting aggressive tax cuts and spending increases.

The *economic reason* to expect a sharp reversal of state fiscal fortunes lies primarily in the likelihood that past economic patterns will be repeated. If they are, the past eight years of rapid growth will be followed by some years of recession or slow growth with resulting negative impacts on state finances.

Problems would arise even if the nation were to revert to its normal long-term growth pattern of increases of about 2.4% in real (inflation-adjusted) Gross Domestic Product rather than the nearly 4% growth in 1998 and 1999. Such a situation would likely reverse some of the five factors listed on pages 6 and 7 that have contributed to the current strong fiscal positions of the states.

IMPACTS ON HIGHER EDUCATION

The Past

The last five years have been about as good as it gets in state funding of higher education. By all available measures of state government spending, appropriations per full-time equivalent (FTE) student have increased by substantially more than the rate of inflation. Not included in these calculations are the significant developments in state tax policies that have provided special tax treatment for college savings and a variety of tax benefits in some states for outlays for college costs.

This favorable fiscal environment has meant that state elected officials have exerted little pressure for major changes in higher education. With minor exceptions, they have not forced consolidation or closures of institutions, elimination of programs, restrictions on tenure, mandates regarding minimum faculty teaching loads, enrollment caps, and other devices to attempt to force cost reductions. Nor have they squeezed appropriations for public institutions to the point that large tuition increases were required in order for the institutions to match the increases in costs occurring (on a national average basis) at private and public institutions.

In fact, many states have budgeted more favorably for higher education than necessary to match enrollment changes and inflation. Some states have been financing the costs of tuition freezes and a few rollbacks. Many have increased scholarships, particularly in grades 13 and 14. The environment for the establishment of new institutions in rapidly growing states has been favorable, as has the environment for the expansion of offerings at existing institutions.

The national budget projections suggest that this environment will not continue.

The Future

The national budget projections suggest that this environment will not continue.

Even if the national economy and state finances return to *normal growth* patterns without a downturn, higher education will find itself in an environment where merely maintaining current services (through appropriations reflecting inflation and enrollment increases) will be difficult. Specifically, if higher education shared the fiscal pain equally with all other functions, spending growth would be slightly below the amounts needed to maintain current services. Without tax increases, appropriations to higher education each year would be about 0.5% short of the total funding needed for maintaining those services. New initiatives in higher education would require offsetting reductions in the current spending base.

In a normal growth environment, higher education would constantly be on the defensive against those seeking deeper cuts in order to finance tax cuts or new initiatives in other fields, such as elementary and secondary education.

If the long-term pattern of normal growth is preceded by *recession* or *slower-than-normal growth,* higher education would experience even more fiscal pressures, recreating the fiscal environment of 1990 to 1993 and 1984 to 1986.

Table 1

State and Local Surplus or Shortfall as a Percent of Baseline Revenues in Year Eight of Fiscal Projections

Rank	State	Percent
1	Iowa	2.7%
2	Nebraska	1.5
3	North Dakota	0.9
4	Ohio	0.9
5	Kentucky	0.5
6	Connecticut	0.4
7	Michigan	0.4
8	New York	0.3
9	Maine	0.1
10	Minnesota	0.1
11	Massachusetts	0.0
12	Oregon	–0.1
13	Illinois	–0.4
14	Pennsylvania	–1.3
15	West Virginia	–1.4
16	Wisconsin	–1.5
17	Missouri	–1.8
18	Kansas	–1.9
19	Mississippi	–2.0
20	Oklahoma	–2.1
21	Arkansas	–2.3
22	Louisiana	–2.5
23	California	–2.8
24	Rhode Island	–2.9
25	Delaware	–3.0
26	New Jersey	–3.3
27	North Carolina	–3.7
	United States	**–3.8**
28	Utah	–4.3
29	South Carolina	–4.6
30	Vermont	–4.6
31	Alabama	–4.8
32	South Dakota	–5.0
33	Indiana	–5.7
34	Montana	–5.7
35	Georgia	–6.5
36	Washington	–6.7
37	Virginia	–6.8
38	Colorado	–7.0
39	Maryland	–7.1
40	Texas	–7.8
41	New Hampshire	–8.2
42	Florida	–8.8
43	Tennessee	–9.1
44	Arizona	–10.5
45	Wyoming	–10.6
46	New Mexico	–12.0
47	Idaho	–13.2
48	Hawaii	–15.1
49	Alaska	–16.4
50	Nevada	–18.3

Source: State Policy Research, Inc., 1998.

Differences among States

State Situations

Few individual states exhibit the structural deficit of 0.5% a year that is represented by the national average. Both tax systems and spending pressures vary among the states.

Some states rely heavily on personal income taxes with their high elasticity. Others have no personal income tax and rely heavily on sales and excise taxes with quite low elasticity. Some states will see little growth in government workloads, such as those associated with enrollment increases, while others will see faster-than-average growth. Inelastic tax systems and rapid workload growth are frequently found together. Table 1 provides the baseline projections (in year eight) of each state's structural surplus (+) or deficit (–) for state and local governments combined.

Reasons for Differences in Outlook

The reasons for the major differences among the states can be divided into three categories: (1) differences in tax systems, (2) differences in spending needs, and (3) differences in economic growth rates.

Most of the states that have surpluses also have *tax systems* that rely heavily on graduated personal income taxes, which take increasing shares of personal income as inflation and economic growth drive those with more income into higher tax brackets. These states do not rely heavily on sales taxes. Of the ten states showing structural surpluses, ten have personal income taxes and nine use graduated rates. Bottom-ranked states typically do not rely significantly on graduated income taxes. The bottom-ranked states typically rely heavily on sales and excise taxes and / or on revenues from royalties, severance taxes, and other revenues associated with natural resources.

Many of the states with surpluses have few demographic pressures on *spending* because of slow population growth and stable or declining school enrollments. This is a characteristic shared by Iowa, Minnesota, Nebraska and several other top-ranked states. Conversely, many of the states showing the largest structural deficits have been showing substantial increases in enrollments, which are expected to continue.

Steady *economic growth* causes both an increase in revenues, because taxes are collected on a stronger economic base, and an increase in spending needs, because of rising population and enrollments. However, these factors do not necessarily produce balanced growth in spending needs and revenues within individual states. The imbalance becomes particularly notable in states where past economic growth has abruptly slowed. This results in a slowdown in the growth of tax collections without a proportional slowdown in the growth of spending needs (such as when young workers with children are drawn to a state during prosperous times, only to witness an abrupt economic downturn). Hawaii is a good example of this effect.

CHAPTER TWO

Prospects for Funding Higher Education

INTRODUCTION AND SUMMARY

Understanding the State Perspective

It is understandably difficult for someone oriented to a particular government-financed activity—such as higher education, law enforcement, health care, or public schools—to see beyond the needs for government support of that function. The usual approach from such a perspective is to ignore choices and problems associated with other functions, implicitly assuming that those with overall responsibility can and should make the adjustments—in tax levels and funding of other programs—that are necessary to provide appropriate funding for the activity in question. *In this context, the discussion of baseline structural deficits is easily viewed as a problem that must be tolerated, but somehow should be dealt with by those who are supposed to deal with it, specifically those outside higher education.*

Besides, projections like those presented above are dry as dust when compared with the appealing realities of any government function, such as higher education. Compared with such inviting concepts as broadening access and improving quality in higher education, funding current service budgets for health care or law enforcement sounds like a trade-off that somehow should be made in favor of the more attractive alternative.

ANative American saying asserts that you cannot know a person until you have walked in his moccasins. Most readers of this paper have lifelong careers in higher education, without the experience of having served in major elected offices, with no burning desire to do so, and with limited prospects for doing so even if they choose to do so. They haven't and will not walk in the moccasins of elected officials. For a short time, they must settle for a few written words that attempt to convey the perspective of elected officials.

Higher Education Funding Options

Three appendices to this report attempt to convey the perspective of elected officials by examining substantive and political arguments about tax increases and, program-by-program, arguments against cutting and for expanding major programs other than higher education. (Readers are presumed to be familiar with those arguments in relation to higher education.)

The gist of the arguments in each appendix and the basic conclusions flowing from them are summarized below. Chapter One, in projecting mild structural deficits in most states, indicates that there will be a widespread inability to fund current state and local services with current taxes. If higher education were to share proportionally in adjusting to this problem, it would:

- *not* see expansion of spending patterns for any program except as financed by reductions in another program within total higher education spending by states, and
- share proportionately in spending growth rates that average annually about 0.5% below the levels of total appropriations that are needed to maintain current services.

This conclusion could be avoided by two alternatives, both of which the appendices suggest are unlikely. First, state officials might raise taxes, but Appendix C provides many reasons that make this improbable. Second, state officials might favor higher education spending over other areas of spending by providing disproportionate budget cuts in other programs, but Appendix B indicates that this is unlikely.

State officials might, in fact, make the pain suffered by higher education proportionally greater than that of other programs. This would happen if they opted for the new initiatives in other programs described in Appendix A. Or higher education might suffer more than required to close the structural deficits because state officials insist on additional tax cuts.

The environment described in the appendices will make it difficult, particularly in some states, to achieve funding of current services for higher education. With a struggle just to maintain current service spending, increases above that level appear unlikely over any decade-long horizon. Specifically, it is likely that the fiscal environment for higher education in most states in the early 2000s will be significantly worse than it was in the late 1990s.

Specifically, it is likely that the fiscal environment for higher education in most states in the early 2000s will be significantly worse than it was in the late 1990s.

Funding Current Services

Amounts Needed

The baseline projections on which the discussion in Chapter One is based presume that state governments will continue to provide the same level of support for higher education as they have in the past. Specifically, this is defined as increasing funding enough to cover the expected increases in higher education enrollment with constant real (inflation-adjusted) support for full-time equivalent (FTE) students. To do this, state funding would have to cover per-FTE cost increases associated with general inflation and additional cost increases associated with presumed increases in higher education salaries equivalent to increases being experienced in the private sector.[4] The net effect of these factors is that total state support needs to increase by nearly 6% a year in the baseline projections.

Implications of the Baseline for Higher Education Funding

If 6% increases are, in fact, achieved, state support of higher education would closely resemble the patterns now in existence. This, of course, is the intent of current service or baseline budgets.

Specifically, the total costs of higher education would rise about 4% per FTE student. The share of total costs currently paid by the federal government, state and local governments, and tuition would remain as it is today. Higher education tuition would thus be rising slightly faster than inflation, along with the funding from other sources of support for higher education.

Shifting Spending Priorities Toward Higher Education?

National Situation

Over the past decade, the percentage increases in state support for higher education have been smaller than the percentage increases in total state budgets. The baseline projections imply that this situation will need to be reversed. Specifically, annual increases in state appropriations of about 6% would contrast with annual total budget increases of about 5%. They would exceed annual increases in elementary and secondary budgets of just under 5%. To fund the baseline, state elected officials would be in the position of having to defend an apparent priority for higher education spending—as well as defending the apparent other priority implied by the baseline, Medicaid.

This development implies a significant shift in emphasis from what state officials have been doing over the past decade and from the near-universal statements about spending priorities in the 1998 campaigns. Many candidates talked about a priority for spending on education. For most of them this boiled down to K–12 education.

State Situations

Individual states face dissimilar situations because of expected differences in the budget increases needed to maintain current services. These differences are caused by several factors, including projected increases in higher education enrollments and in the workload factors driving other spending. The differences among states are captured in Table 2. The right two columns of the table show the projected increases in total state and local spending needed to maintain current services over eight years, and the spending increases needed for higher education to maintain its current services over the same time frame. The "Annual Average Advantage for Higher Education" is derived by subtracting the growth in all programs from the growth in higher education, and then dividing by eight to give readers a feel for the annual difference.

Based on the national average, spending for higher education would have to increase 1% faster than total state and local spending (the higher education "advantage") if current services are to be maintained for all programs. As Table 2 shows, eleven states can cover current services by providing smaller increases to higher education than to their total budgets. These are primarily southern states that saw rapid growth in the 1960s and 1970s, resulting in enrollment bulges for higher education in the 1990s. In the next decade, higher education enrollments will be stable or declining while other portions of the population, particularly those over age 45, expand rapidly.

In a third of the states, current service spending implies providing for annual growth in higher education funding that exceeds by 2% or more the growth rates in total annual spending.

Table 2

Percentage Change in Spending to Maintain Current Services

Rank	*State*	*Annual Average Advantage for Higher Education*	*Eight-Year Spending Growth Rate* All Programs	Higher Education
1	Vermont	5.3%	41.0%	83.3%
2	Nevada	4.9	75.4	114.8
3	Hawaii	4.3	45.3	79.5
4	New Mexico	3.3	52.2	78.9
5	Arizona	3.3	60.6	86.9
6	South Dakota	3.2	40.2	65.7
7	Wisconsin	3.0	36.9	60.8
8	Florida	2.9	46.3	69.6
9	Minnesota	2.8	38.0	60.3
10	Kansas	2.8	37.2	59.2
11	Washington	2.7	44.9	66.4
12	Connecticut	2.4	31.8	51.1
13	Maryland	2.4	40.5	59.6
14	New Hampshire	2.2	44.5	62.0
15	Iowa	2.1	32.0	48.7
16	Oklahoma	2.1	33.7	50.4
17	Alaska	2.1	43.6	60.3
18	Pennsylvania	1.9	32.5	47.4
19	Montana	1.7	43.1	56.7
20	Colorado	1.7	50.8	64.2
21	California	1.7	38.9	52.3
22	Rhode Island	1.6	33.7	46.8
23	North Dakota	1.5	33.2	45.0
24	Oregon	1.4	43.2	54.8
25	Nebraska	1.4	35.9	47.4
26	Missouri	1.3	36.9	47.5
27	Delaware	1.3	43.8	54.3
28	Louisiana	1.3	33.3	43.7
	United States	**1.0**	**39.5**	**47.7**
29	New York	1.0	32.5	40.5
30	Georgia	0.8	50.0	56.4
31	Massachusetts	0.8	36.1	42.3
32	Texas	0.7	45.5	51.5
33	Idaho	0.6	57.8	62.3
34	Virginia	0.5	41.6	45.7
35	Wyoming	0.3	42.4	44.5
36	Utah	0.1	51.0	52.1
37	Michigan	0.1	31.7	32.6
38	Illinois	0.0	33.4	33.8
39	Tennessee	0.0	45.4	45.4
40	Maine	–0.1	31.3	30.4
41	Ohio	–0.2	32.1	30.5
42	Indiana	–0.2	38.7	36.7
43	New Jersey	–0.5	37.1	33.3
44	Arkansas	–0.5	40.2	36.2
45	South Carolina	–0.5	40.0	36.0
46	Alabama	–0.6	38.9	34.3
47	Kentucky	–0.8	35.4	28.6
48	Mississippi	–0.9	37.4	30.5
49	West Virginia	–0.9	29.4	22.0
50	North Carolina	–1.3	45.9	35.3

Source: Calculated from *The Outlook for State and Local Finances* (Washington, D.C.: National Education Association, 1998), Technical Appendix.

This occurs primarily because those states, particularly those in the Southwest, are now feeling the impacts of higher education enrollment of their rapid growth in the late 1970s and 1980s.[5]

BASELINE IMPLIES TAX INCREASES IN MOST STATES

The Magnitude of the Fiscal Problem

To provide the level of funding for higher education described above, state officials will need to put themselves, in conjunction with local governments, in a position to fully fund their current service budgets. Nationwide this implies tax increases of about 0.5% a year. Afew states would not require tax increases at all, while some others would require tax increases approximating 1% a year.

The baseline projections do not include the impacts of decreases in revenues because of recently legislated tax cuts. Many states have already enacted tax cuts that are being phased in over a period of years. These future cuts will cause budget shortfalls in these states to be larger than the shortfalls presented in the baseline projections. Nor do the baseline projections include the impacts of the many commitments made by individual state elected officials in support of tax cuts that have not yet been enacted.

In combination, these factors suggest that funding the baseline budgets of higher education and other programs implies substantial tax increases. The amounts vary by state. Each state will have somewhat different: (1) baseline budget shortfalls or surpluses, (2) already enacted tax cuts taking effect in future years, and (3) likelihood of enacting additional tax cuts in 1999. Summing these would imply tax increases by state and / or local governments during the early 1990s of as much as 1% a year in many states.

Obviously, state officials are unlikely suddenly to announce that they see a need to start raising taxes just because projections indicate future fiscal problems. Instead, the cyclical patterns that historically have brought about state tax changes reveal that tax increases must appear to be absolutely essential at the time. This dynamic is particularly germane because extraordinary economic circumstances can make state fiscal positions look artificially strong in good times, such as those of the late 1990s. In such an environment, state legislatures tend to expand state spending and cut taxes, while still producing balanced budgets—but only so long as the unusually strong economic circumstances continue.

Fiscal Crises

If extraordinarily good times were followed by normal times, it might be possible for states to make fiscal adjustments in less than a crisis environment. However, extraordinarily good times are usually followed by corrections in the private economy called recessions. When these occur, states are usually caught in a situation where their budgets are grossly out of balance. Often state officials are slow to recognize the onset of recession. Because of the timing of legislative sessions and controversy over appropriate solutions, state legislatures are often slow to enact corrective measures once the problem has been recognized. As a result, the magnitude of corrections to maintain balanced budgets is often 5% or more. That is, the corrections imply a combination of spending cuts and tax increases amounting to 5% or more of total spending, often to be continued in effect for several years.

The crisis environment created by unexpected large budget gaps provides the political environment most conducive to state tax increases. Increases are presented as an alternative to such measures as laying off large numbers of state employees, mid-year cuts in school funding that would cause actions like ending extracurricular activities in public schools, mid-year increases in university and community college tuition, and the like.

Even in such a crisis environment, it isn't obvious that state elected officials will act to avoid these results. Their primary objections are likely to be: (1) concern over rising taxes, and (2) concern over the apparent priority being given to higher education over other competitors for funds.

The underlying question about spending will be whether, at the margin, higher education spending is contributing more than spending at the margin in other programs.

Looking Hard at Higher Education Spending

In the early 2000s, state elected officials will be facing structural deficits yet seeking to fund new initiatives in many programs (Appendix A). They will be confronted with difficulties in raising taxes (Appendix C) and cutting current services in other programs (Appendix B). In this context, at an absolute minimum, they and their budget staffs will be subjecting higher education to more scrutiny than in the recent past.

The underlying question about spending will be whether, at the margin, higher education spending is contributing more than spending at the margin in other programs. This question will be raised in a political dimension with the adverse electoral consequences of cuts in higher education compared with cuts affecting public schools, health care providers, and others active in state politics. The question will be raised in a substantive dimension with the values of improvements in higher education compared with the values of improvements in job training, preschool education, preventive health, and other programs.

One underlying question about financing will be whether raising revenues in the form of budgets that encourage university officials to raise tuition (or cut spending) are less painful than raising revenues in the form of tax increases.

Cross-Cutting Approaches

Historically, elected officials have often found comfort in applying a logic equally to all program budgets. Critics can argue that such approaches ignore the relative merits of spending increases and the costs of spending cuts in each program and thus beg the issues elected officials are supposed to decide. A more positive view of the result is to say that elected officials often simply assume that the relative merits of increases and adverse consequences of cuts are about equal across programs, so adjustments associated with changes in state fiscal circumstances should be in roughly equal proportions.

The across-the-board approaches are particularly likely to be employed in situations where the complete state budget process cannot be used to set new priorities based on changed fiscal circumstances. Those situations arise when governors and / or legislative budget committees are charged with adjusting already enacted budgets to deal with unexpected fiscal difficulties.

Historically, the first signs that state budgets are unbalanced usually come during a period for which the current budget has been set, and thus needs to be trimmed in mid-year or in the midst of a biennium. Some of the across-the-board measures adopted in such circumstances have included:

- Uniform holdbacks of appropriations, called pro-ration in some states, by which spending for each function is constrained to 1% to 5% below amounts appropriated;
- Freezes on new hires and promotions;
- Freezes on purchases of new equipment and renovation projects;
- Elimination or curtailment of hiring of seasonal or temporary workers; and
- Restrictions on travel.

As fiscal difficulties persist, the need to formulate new budgets with less total spending than required to maintain current services appears. Across-the-board approaches are often applied in this situation also. Some examples are:

- Freezing spending by holding appropriations in the new budget to the dollar totals provided in the old;
- Adjusting budgets only for changes in workloads (e.g., FTE student counts), thereby requiring state agencies and grantees to absorb costs of employee pay raises and inflation in costs of utilities and purchases; and
- Across-the-board percentage reductions in total spending from a base of either the costs of maintaining current services or the previous year's budget.

While subject to the criticism that these across-the-board efforts are arbitrary, many elected officials are more comfortable with them than with more policy-oriented and less uniform sharing of fiscal pain among program clients and interest groups advocating various forms of spending. Public higher education in most states has seen these across-the-board policies at work in past periods of fiscal adversity and is likely to see them again in the early 2000s.

While subject to the criticism that these across-the-board efforts are arbitrary, many elected officials are more comfortable with them than with more policy-oriented and less uniform sharing of fiscal pain.

SINGLING OUT HIGHER EDUCATION FOR DISPARATE SPENDING CUTS

Over the past several decades, state budgets for higher education have reflected two major characteristics. First, the percentage of state spending devoted to higher education has been declining. Second, there have been fluctuations in higher education spending, changes that are linked to state fiscal circumstances.

The Balance Wheel Concept

The fluctuations in higher education spending stem from use of higher education as a "balance wheel in state finance."[6] Typically, when state finances are strong, appropriations for higher education have risen disproportionately to appropriations for other functions. But current service budgets in higher education have been cut disproportionately when state fiscal circumstances are weak.

Selection as a balance wheel results from some perceived characteristics of higher education relative to other objects of state spending. First, higher education institutions have separate budgets with reserves of their own and perceived fiscal flexibility to absorb temporary fiscal adversity, unlike state agencies which do not have these features. Second, higher education is perceived as having more flexibility to translate budget changes into employee pay than state agencies, which are bound by statewide pay scales, and local education agencies, which are subject to collective bargaining and multi-year employee contracts. Third, higher education is seen as having more flexibility to vary spending levels (e.g., through changes in courses offered and class sizes) than most programs, which have spending levels that are more fixed. Fourth, in most states, higher education has the ability to maintain and increase spending levels by shifting larger proportions of costs to users by tuition and fee increases.

Temporary Cuts and Permanent Loss of Budget Share

Use of higher education as a balance wheel has probably been an independent factor leading to the reduction in higher education spending as a share of state budgets. Because the starting point for budgeting is the prior year, disproportionate spending constraints on higher education tend to be perpetuated as state financial circumstances improve.

However, there are other reasons why the higher education share of state spending has been declining. One major reason is totally independent of higher education or of current perceptions of higher education. Through the late 1980s and early 1990s factors unique to Medicaid and corrections were causing rapid annual increases in spending for those programs. Because "shares of the budget" is a zero-sum game, their gains had to come at the expense of shares of other programs. Viewing the same phenomenon another way, the baseline costs of those programs rose rapidly because of changes in federal mandates, workload (e.g., prisoners to be confined, parolees to be supervised, and Medicaid clients, particularly those in nursing homes), and cost factors (e.g., increasing complexity and cost of medical procedures). There were no comparable changes in higher education in most states.

Even with these explanations, it appears that higher education is doing worse in capturing growth in state spending that would be expected based on changes in objective circumstances alone.[7] In other words, higher education isn't competing successfully with the attractions of other forms of state spending.

The critical question for many readers is undoubtedly whether these factors will continue to impact state support of higher education in the next decade.

The answer to this question cannot be known with certainty. The author's answer is YES. Absent any evidence of change, the author assumes that elected officials' attitudes toward the substantive and political merits of spending on various programs remains as in the past. With attitudes and decision-making procedures unchanged, and with the impacts of strong and weak state fiscal circumstances on higher education spending well known, forecasting state approaches to higher education spending becomes simply a matter of forecasting the state fiscal circumstances likely to prevail in the next decade.

Given the fiscal environment predicted in this paper for the next decade, *the fiscal outlook for state support of higher education is not good* from the perspective of advocates of increased state spending for higher education. Use of higher education as a balance wheel will continue. Higher education will likely share disproportionately in the adverse consequences of the structural deficits likely to become increasingly apparent in most states.

Given the fiscal environment predicted in this paper for the next decade, the fiscal outlook for state support of higher education is not good.

Put another way, the current relatively generous increases in state support of higher education do not reflect changes in patterns and practices in state budgeting. They only reflect the standard response to extraordinarily strong fiscal conditions. They will disappear when those fiscal conditions disappear.[8] Both will disappear soon.

Could These Conclusions Be Wrong?

The predictions of widespread structural deficits in state and local government throughout the next decade are the cornerstone of the conclusions in this chapter. Those conclusions are based on many factors, some more predictable than others. Appendix D discusses the sensitivity of the conclusions to various predictions and assumptions.

CHAPTER THREE

Fiscal Impacts on Higher Education Policy

CENTRAL FISCAL DECISIONS, IN THEORY

The preceding two chapters deal entirely with purely fiscal decisions of state elected officials. These are decisions from the world of state budget offices and governors, legislative fiscal staffs and legislators, and voters occasionally acting directly on tax and spending measures by initiative and referendum. These decision-makers are treated as though they dealt only with relatively pure fiscal decisions, including:

- The level of taxes and thus spending,
- The allocation of spending among higher education and other major functions, and
- The mechanisms for adjusting spending to unexpected changes in fiscal circumstances.

The major players in these decisions are chairs of appropriating committees, House speakers and Senate presidents, governors, budget directors, legislative fiscal officers, and those interest groups with major effects on overall spending and tax policies. They do not normally have any closer association with higher education than with health care, elementary and secondary education, or other functions.

Of course, fiscal decisions themselves are policy decisions. Furthermore, decisions about budget levels often push detailed policy decisions in particular directions. For example, new programs are more likely to be established in higher education institutions when appropriations exceed costs of maintaining current services. But in the purest view of budgeting, the central fiscal authorities *do not:*

- Determine how the spending totals they set will be allocated within a function, such as by determining divisions between community and institutional mental health, formulas for allocating school aid among school districts, and allocations of higher education funds among levels of instruction, individual institutions, or between scholarships and institutional support.
- Establish policies affecting individual functions except as government-wide policies applicable to all functions, such as civil service pay

schedules, contributions to employee retirement plans, and charges levied by central service units such as state computer utilities.

These limited roles of central fiscal authorities are reflected in the normal assignments of responsibilities in executive branches and legislatures. Within the executive branch, state budget offices play the fiscal role, while departments and independent agencies administer functions and are expected to have dominant influence over questions of policy—so long as they operate within fiscal constraints. In the legislatures, appropriating committees have jurisdiction over budgets. But substantive legislation dealing with policies is assigned to other committees such as those dealing with education and health care.

Central Fiscal Decisions, in Reality

As a practical matter, the divisions between central fiscal authorities and those setting policy for individual state functions is never clear and always controversial.

Ambiguity in roles is inherent in the work of elected officials because their responsibilities include both policies within individual governmental functions and central fiscal decisions. They are under no major pressure to separate their roles and often do not do so; therefore, governors frequently use the process for the development of budgets as their primary mechanism for reviewing and making decisions on major policy initiatives. Many legislatures include substantive legislation in their budget bills. It is quite common for legislators and governors to hold many major decisions of a legislative session for final determination as part of grand compromises that include tax policy, the budget, issues with fiscal impacts such as employee pay raises, money issues within functions such as allocation of school aid among school districts, and issues unrelated to money such as those associated with regulatory policy.

Many state budget staffs, both legislative and executive, and legislators serving on appropriating committees see themselves as having more responsibility for policy than the theory summarized above suggests they should have. They feel responsibility for decisions embodied in “their” products, such as their executive budget and their appropriations bills. Some believe that they cannot separate decisions on how much to spend on particular functions from decisions on how it will be spent. For example, they may support additional spending if used for Activity Abut not for Activity B. In that situation, to achieve their objectives, they must control sub-allocations of appropriations when Activities Aand B are within the same function—as when, for example, both involve higher education spending. Moreover, those in central positions may choose to exercise power simply because they believe they know the right policies and are in a position to use their fiscal power to ensure implementation of the policies they like.

Rightly or wrongly, central fiscal decision-makers have more impact on policy than theory might suggest they should have.

Rightly or wrongly, central fiscal decision-makers have more impact on policy than theory might suggest they should have. That impact varies from state to state and from year to year based on many different factors, including institutional traditions, statutory frameworks, the impact of dominating personalities, and the preferences of current governors and legislative leaders.

Fiscal Decision-Makers Affecting Higher Education Policy

Random Impacts

Some impacts of fiscal decision-makers on higher education policy are nearly random. For example, a powerful appropriations committee chairperson may use his or her position of power to favor appropriations for a particular higher education institution in his or her district. Or the position of power may lead to larger appropriations for some activity, such as medical education, and lesser ones for others. Apowerful budget analyst in an executive or legislative position may influence a variety of policies of interest to him or her, but random events may lead to someone else holding such a position with less or more power to implement policy preferences. This paper has nothing to contribute to the understanding of such situations.

Systematic Perspectives

On some subjects, the impacts of those who draw power from state fiscal processes is not random. It stems from one of two factors, or both:

1. There is a substantial rationale for involvement of central fiscal perspectives in the decision.
2. Central fiscal decision-makers bring a unique perspective to the policy under consideration.

There are many examples where there is a substantial rationale for involvement of central fiscal decision-makers in higher education policy. Each one is controversial, but these are some common ones:

- Policies involving collecting money from the public (e.g., tuition), particularly if state rules allow the collecting agency to supplement spending through using the resulting revenues.

- Policies involving duplication of functions or potential duplication of missions of other agencies, such as providing remedial instruction in higher education.
- Policies with rationales outside of the budgeted function, such as justification of higher education spending based on perceived economic development benefits.

The unique perspectives of those in central fiscal decision-making involve such topics as government-wide approaches to performance measurement and attitudes toward contracting out government functions.

The discussion of individual policies in higher education that constitutes the remainder of this chapter examines the unique policy perspectives commonly found among those dealing primarily with fiscal matters affecting multiple state agencies. The aim is to explain the various perspectives and their impacts on higher education, not to predict the extent to which the perspectives are likely to be implemented.

TAX EXPENDITURES VERSUS SPENDING

In economic terms, there is little difference between supporting an activity through direct grants, which count as state spending, and tax concessions, which count as reductions in revenues. This point is so widely understood that the federal government and some states prepare annual reports on tax expenditures. Like outlays, *tax expenditures* involve allocation of scarce state resources. The amounts and purposes can be calculated by treating the revenue reductions as though they were outlays.

Paying some of the costs of attending higher educational institutions provides an example. Suppose, for example, the intent is to employ additional state resources of $600 per full-time pupil in higher education. One approach would be to give the $600 to the institution providing the education. This would count as an outlay, taking the form of an appropriation to the institution. Another approach would be to allow the subsidy to follow the student by awarding $600 to each eligible student in the form of a voucher or its equivalent, a scholarship which could only be used as partial payment of tuition. This would also count as an outlay, but the appropriation would be to a state scholarship commission. Another approach would be to award the student or person paying the tuition a tax credit of $600. This would not be an outlay, but instead would be a reduction in revenue.

Choices between expenditures and tax expenditures are only theoretically unrelated to other policy choices. As a practical matter, whether the decision is made in a tax context or a spending context also influences other important policies. For example, it is relatively easy to defend distributing institutional subsidies only to public institutions. It is much harder to defend confining tuition tax credits only to those attending public institutions.

Central state decision-makers have recently shown a strong bias toward using tax expenditures rather than spending. For reasons described in Appendix C, many decision-makers wish to make records of reducing taxes. This alone could account for the recent popularity of using tax expenditures in higher education, both at the federal level and in some states.

The impact of both federal and state fiscal conditions on this bias is probably not well understood. When a government is collecting more money than is required to maintain current services, the excess is available for either tax reduction or increased spending. In this situation, but only in this situation, tax expenditures appear to perform double service in public perceptions. On the one hand, they are a reduction in taxes. On the other, they represent added support for the function for which they are provided.

However, when a government is unable or barely able to cover current service spending with current revenues, there are no extra resources available either for added spending or for tax reductions. In such a context, the use of resources for either a tax expenditure or a regular expenditure will require difficult decisions to increase taxes or cut spending in existing programs. No double duty can be performed by a tax expenditure because any tax cut will have to be accompanied by an equal and offsetting tax increase.

In such a context, a different principle of central fiscal authorities applies. Public opinion surveys and the experience of state elected officials suggests that revenue-neutral tax changes are perceived as tax increases. The public clearly sees, and journalists widely publicize, the portion of the revenue-neutral changes that increases revenue. The corresponding reductions are often less clearly perceived and, when perceived, tend to be viewed as promises of politicians to cut taxes that may not be fulfilled.

It follows that the recent emphasis on tax expenditures for higher education may be temporary.

Subsidizing Consumers, Not Providers

Over the past several decades fiscal decision-makers have become increasingly convinced that it is better to provide government support of consumption of any good or service by allocating subsidies to consumers rather than to providers. This approach substitutes decisions by consumers for decisions by government on such topics as which providers prosper and grow, which suffer, and which are eliminated. Adoption of the approach causes massive changes in any field affected by it. Fields most recently affected include the provision of acute medical care (a function most hospitals perform), mental health, and housing.

The impact can most recently be seen in the dramatic changes that have taken place in the operations and ownership of what formerly were public hospitals. There is a potential direct parallel to public higher educational institutions. The response of governments in the United States to people who needed hospital care but could not pay for it was the creation of public hospitals. These hospitals, which included some of the best-known and respected medical facilities in the nation, were typically funded and maintained by local governments, primarily counties.

The major changes in health care are primarily associated with the institution of the Medicaid program, which, in effect, provides open-ended vouchers to those eligible in the form of a Medicaid card which works roughly like a health insurance card. Parallel changes occurred in other government programs such as the provision of health care for veterans and for some members of the armed forces and their dependents. Private (mostly not-for-profit) hospitals were often preferred by these subsidized patients by reason of location, perceived better services, and other reasons. In the many cases where government payments equaled or exceeded costs of treatment, private hospitals aggressively marketed themselves to charity patients. As a result, capacity utilization in public hospitals dropped, costs per patient increased, and for a variety of reasons, the public hospitals were slow to adopt cost-saving measures being adopted in the private sector. Faced with the resulting financial pressures, state and local governments have largely eliminated their public hospitals—closing some, merging others with private institutions, and disposing of others to profit-seeking or not-for-profit corporations.

These results have their critics, but have generally pleased elected officials and their fiscal staffs. Competition is believed to hold costs to below what they would otherwise be. The changes have reduced public employment. Almost by definition, consumers are satisfied as they are experiencing the consequences of their own choices.

Advocates of subsidizing consumers rather than producers are now most publicly apparent in the voucher movement (and pressures for tax credit equivalents of vouchers) in elementary and secondary education. The voucher proposals draw huge controversies, primarily because public education employees perceive the changes as threatening their jobs, a threat those employees have recognized better than their counterparts in public hospitals.

Subsidizing consumers rather than producers in higher education has produced much less visible controversies. However, policy shifts have been substantial, and they can be seen in the details of some programs—such as in shifts of support for teaching in university medical schools. They appear dramatically in the recent adoptions of education saving accounts, tax deductions for tuition, tax credits for tuition, and state-run college savings plans. Most of these programs do not distinguish between private and public institutions as providers of higher education services.

State central decision-makers are moving consistently in many fields toward more support of consumers and less support of providers. The concepts are reflected in the use of tax expenditures rather than outlays for functions such as childcare, care for the elderly, higher education, elementary and secondary education, and job training. They are reflected in changes in financing mental health and daycare services. They are reflected in education plans that seek to increase student choice in attending charter schools or schools outside the district of residence.

To the extent that central decision-makers successfully bring these perspectives to higher education, the results will be a greater emphasis on tax expenditures, a greater emphasis on scholarships, less emphasis on institutional support, and broader participation by private institutions in public support of education of state residents.

How far could such an approach evolve? In higher education, it could evolve to match systems now in existence for other functions, systems in which governments merely buy “slots” that eligible participants use, thereby providing these participants with choice among providers, so long as space is available. Section 8 housing subsidies work this way. Most daycare programs work this way. School voucher plans work this way. Much of job training works this way. So does provision of Medicaid-reimbursed nursing home care.

PUBLIC SUPPORT OF QUALITY

Government typically provides its services at no cost to the consumer or with charges that are highly subsidized with tax revenues. As a result, there is little limit to potential consumer demand and thus to government costs. Meeting all of the resulting demand is impossible, so governments find ways to limit consumption of what they produce.[9]

Acommon mechanism for limiting consumption is to declare only a portion of possible consumers as eligible for the service by some test, such as through the low-income tests required for eligibility for government-paid health care, nursing home services, and housing. But long traditions and public policy arguments suggest that many public services must be offered to all. Examples are services of the police, libraries, public parks, museums, public schools, and public higher educational institutions. Although no one likes to talk about the resulting rationing as a matter of policy, public services in these situations normally do not meet the highest standards of quality in their industry. This drives the portion of demand associated with more affluent and/or highly motivated users into private sector providers.

The results are apparent in many fields. Those seeking the highest levels of security services buy alarm systems and hire private guards. Those seeking the best mental health care see private psychiatrists even though supposedly comparable services are available at public expense. Most parents pay private doctors to vaccinate children, even though vaccination is offered as a public health service. Affluent families go to private theme parks while less affluent ones use public parks. Many people seeking their definition of "the best" for their children send them to private schools and universities.

In general, while aspiring to the best, governments provide most services based on views of meeting minimum standards. In this context, widespread support for using tax dollars to bring some state universities to standards of elite private institutions remains an anomaly of public policy that has not escaped the notice of some central decision-makers.

Rationing by User Charges

Many of the staff members populating central fiscal agencies are trained in economic doctrines that place much more value on user charges for public services than the providers and users of the particular services consider appropriate.

In extreme cases—where benefits of government services accrue almost exclusively to the users of the service—this philosophy suggests either that government should not provide the service at all or, if circumstances dictate that it must, the users be charged the full cost of providing services. This approach has much to do with why state governments, despite federal urging, have never participated with their own tax dollars in subsidized housing, why costs of fish and game programs are covered by license fees, why gas taxes and other user fees cover most highway costs, and why heavy fees are charged for applications for state and local permits to conduct various activities.

This orientation to user charges helps explain why there is often more interest in financing portions of higher education outlays with tuition among budget staffs than among students and higher education professionals.

Avoiding Geographic Distinctions

Statewide elected officials, such as governors, are elected by systems in which a vote anywhere counts as much as a vote anywhere else. Legislators are elected in smaller geographic constituencies but must reach decisions by majorities of representatives of such constituencies. Both systems give elected officials strong reasons to never appear to be anything but even-handed in dealing with different geographic areas within a state.

The resulting pressures in allocation of support among public higher educational institutions is well known. These pressures inherently make it difficult to single out particular institutions, and thus particular places, as unique centers of excellence. Instead, all of the pressures lead to one of two policies. One option is access for nearly all high school graduates to excellent state institutions. This policy leads to the conclusion that such institutions should exist in every population center. The other option is concepts of tiers of excellence, with use of the excellent institutions restricted on some basis other than geography such as the stiff admissions requirements used by the University of California.

Budgeting for "Add-Ons" for Missions Not Directly Related to Higher Education

The basic philosophy of budgeting suggests that appropriations should be budgeted to agencies primarily responsible for identifiable missions. This is a bureaucratic version of the concept of subsidizing consumers rather than providers. It is reflected in practices such as budgeting training of employees in the agency with the employees, rather than in appropriations for particular training providers, such as state universities. The philosophy is incompletely implemented even in this simple case and is even less completely implemented in other more fiscally significant cases.

The best current example is the interaction of economic development and higher education objectives. States are pursing economic development competitively and at great expense. Bidding wars have established the going price of luring one new manufacturing job as a one-time outlay (in tax benefits, cash subsidies, free land, provision of public services such as road connections, and more) in the range of $15,000 to as much as $300,000. With this kind of money at stake, state officials concerned with economic development are willing to exert great pressures on higher education administrators to be responsive to real or imagined concerns of business leaders contemplating expansion or new locations. These business leaders are looking for a higher education presence in the fields that interest them and in close proximity to where they are considering locating facilities. Those locations are often not the ones that would be selected on the basis of higher education criteria alone.

Purity in budgeting spending by higher education institutions to achieve economic development objectives will never be achieved. Economic development professionals will always have an interest in minimizing their apparent costs by ensuring that they appear outside their budgets and in such forms as budgets for higher education and reductions in tax collections. Administrators in higher education (and other fields) will always be motivated to claim benefits from their spending in contributing to state objectives outside educating students, of which economic development is an example.

But at least in the theory of budgeting (as imperfectly pursued by central fiscal staffs), those portions of demands on higher education rationalized by state objectives outside of higher education should be budgeted separately.

Conclusions

The likely impacts of the central fiscal perspectives considered in this chapter are much more difficult to forecast than the likely impacts of state fiscal conditions on state spending for higher education. About all that can be said with certainty is that the constant tensions between perspectives of central fiscal decision-makers and managers of state programs, including higher education, seem likely to continue at about the same levels as in the past.

APPENDIX A

Increasing Spending Outside of Higher Education

INTRODUCTION AND PURPOSE

This is one of two appendices designed to turn the unappealing category of "other programs" (those competing with higher education for state funds) into the appealing realities seen by state elected officials. This appendix deals with proposals to increase spending on other programs above the baseline levels defined in the text of the report. Appendix B focuses on the difficulties of cutting baseline spending in the other programs. Reading these two appendices is not necessary for those who believe that, for political or substantive reasons or both, higher education will have a difficult time competing for funds with other programs.

To expand from their current services base, higher education interests will have to develop proposed uses for additional funds that can compete successfully with the programs described in this appendix.

Those who believe that proposals to increase baseline spending in higher education can, or should, compete successfully with similar proposals in other fields should consider the details of the proposals in other fields found in this appendix. Those who believe that proposals to maintain baseline spending in higher education without tax increases is simply a matter of making easy cuts in other programs should read Appendix B.

The basic approach of this appendix is to canvass each major area of state spending that competes with higher education for state general funds. Within each area, readers will find a brief description of major proposals for new initiatives. Given the baseline budget projections for each state, *there will be no funding for any of these initiatives* in all but a few states. In fact, there would have to be cuts in current service spending in those programs just to avoid tax increases.

In order to maintain current services in most states, higher education must hope that state officials turn down every one of these new initiatives or fund them only by increases in taxes. To expand from their current services base, higher education interests will have to develop proposed uses for additional funds that can compete successfully with the programs described in this appendix.

EDUCATION FROM BIRTH THROUGH GRADE 12

The education situation implied by current services funding of K–12 education is seriously out of synch with expectations for and likely policies concerning public schools.

Regular School Programs

The level of dissatisfaction with public K–12 education is extremely high. While many citizens express satisfaction with the public education being provided to their own children, they share the attitudes of the general public about public schools. At an absolute minimum, this includes the view that American education is performing poorly relative to education in many other countries, a view fortified by comparative international test scores.

Popular across-the-board remedies include smaller class sizes, better teacher qualifications, longer school days, and longer school years. Among elected officials, there is widespread interest in increasing the technology applied in the classroom, such as wiring all schools to the Internet. In parts of the country where teacher salaries are well below the national average, the view is widely accepted that salaries should be increased.

Disadvantaged Children

There are extra concerns associated with the schooling provided to disadvantaged segments of the population, particularly inner-city children. There is widespread recognition of the basic concept that more intensive (and thus expensive) efforts are required to deal with these children than current budgets provide, though little agreement on exactly what should be done.

New Emphasis on Early Childhood

Of even more financial significance is the increasing conviction, particularly among the nation's governors, that education between birth and age 3 or 4 is much more important than had been previously understood. This point is financially significant as there is little state and local funding of any public programs for this age group. The prevailing view among elected officials is that much more can and should be done in this age group (including permitting heavy outlays) so that schooling in later years can be reasonably productive.

Options include moving down the age of entry in public schools to include universal kindergarten for full days and part-day schooling at even earlier ages. In addition, there are many equivalents to the extremely popular Head Start program extending its concepts to earlier ages and more children. For those who are reluctant to see the public education model brought to earlier ages at the potential expense of family-provided training of young children, there are many attractive alternatives, including training parents in better parenting techniques.

School Choice

Asubstantial and, according to opinion surveys, growing segment of the public believes that educational choices should be expanded, particularly in situations such as central cities, where a strong case can be made that the public schools are failing. This has produced support in every legislature for voucher plans, though the concept now affects fewer than 10,000 children through public funding, plus at least an equal number through the increasingly popular programs funded by donations.

This interest in choice is linked with the long-felt unfairness associated with support of low- and middle-income children in parochial schools. Many people accept the view that if those schools meet or exceed the targets for education applied to the public schools, parents who send children to such schools are deserving of some level of support, even if not exactly the amount saved by governments by not having to educate their children in public school systems.

The combination of these two factors is encouraging states to consider expanding voucher plans and tax credits for school expenses, such as those already found in Iowa and Minnesota. These plans are inherently expensive because they entail spending public funds for the over 10% of K–12 pupils now receiving education at no public expense.

The compromise between advocates of choice and those oriented to basic reliance on traditional school models is charter schools. Although in theory these publicly chartered institutions should not cost more money, in practice, budgets for existing public schools are not decreasing enough to offset spending for adding the charter schools.

Special Problems In Some States

On top of these substantial arguments for going beyond current services in the funding of public elementary and secondary education, two closely related expenditures of state governments will likely increase over the next decade, with some states much more affected than others.

Equalization of School Funding. The first issue is known as school finance equalization. With local property taxes being the primary source of support for education in many states, differences in the per-student tax bases of individual districts create: (1) much more spending per pupil in rich districts, given equal tax efforts, or (2) huge differentials in local taxes, as much as five times in some situations, as poor districts seek to match the spending levels (and thus class sizes, teacher salaries, equipment, etc.) of the more affluent ones, or (3) often, combinations of higher taxes and lower spending in the poorer districts. In about half the states, advocates of the poor districts have obtained state supreme court decisions to the effect that state constitutions require some form of equality among districts, so that roughly equal tax rates produce roughly equal education spending per pupil. In all the states, there is sympathy with the argument that state policy should move toward more equality in financial support.

As a practical matter, equalization does not mean *leveling,* which could be accomplished at no state cost by taking from the rich and giving to the poor, thereby forcing the rich districts to reduce their level of spending. Instead, it means *equalizing up:* raising the spending levels of the poorer districts by providing additional state aid.

School Construction and Renovation. Many states face extraordinary challenges in capital outlays for schools. In rapidly growing states, this is a challenge of accommodating rising enrollment. In the Northeast and older areas elsewhere, it means replacing or substantially modernizing existing schools. Everywhere, it means dealing with huge mismatches of school facilities and students. Young couples with school-age children typically turn to newer housing, often remote from central cities and inner suburbs, leaving a shortage of classrooms in the remote areas. At the same time, the population of central cities and inner suburbs is aging, leading to reduced enrollment in schools in those areas, and the closing of many adequate school buildings that are no longer needed.

States are often heavily involved financially in meeting construction needs because the arguments for school finance equalization applied to operating costs can appropriately be applied to costs of school construction as well. Also, state support of local school construction has the same perceived benefit in tax policy as support of operating costs—reducing burdens on the local property tax.

PROBLEMS OF THE AGED

Growth of Aged Population

As is well known, an increasing percentage of the population is over age 65, and over age 85, each year. These numbers will begin to increase even more dramatically as the baby boom (persons born shortly after the end of World War II in 1945) hits age 65, which it will begin to do in 2010. The most widely understood impact of the aging population is the effect on the Social Security system, not a matter of significant state concern,[10] and the burdens on mature adults increasingly being faced with the time demands and costs associated with caring for aging parents. The effects on state finances, while less well known, are also huge.

Providing Care for the Aged

Most Americans reach age 65 with few resources to deal with needs for intensive care that cannot be defined as health care in the traditional sense. These individuals may have mental problems, diseases such as Alzheimer's, and general declines in physical capabilities such as the ability to bathe themselves, to shop, and to clean and maintain their housing. Eventually, significant percentages of them go to nursing homes at annual costs from $40,000 to $100,000 per year. No federal program covers these costs of aging, even for the poorest of the poor. Social Security and income-tested Supplemental Security Income (SSI) benefits cover cash requirements for ordinary living, but not extraordinary costs such as nursing homes and homemaker services. Medicare does not cover nursing home stays, with the minor exception of short stays associated with specific treatments, such as recuperating from operations.

As a result, using a mix of federal and state funds (averaging 57% federal, 43% state), state governments deal with these situations through Medicaid. Medicaid now pays for well over 50% of all nursing home days in the United States. Besides covering nursing home costs of Americans who qualify as low-income when they enter nursing homes, it is common for middle-class Americans to exhaust their savings in a few years of nursing home residence, so they, too, qualify.

States have sought to divert patients from costly nursing homes by offering in-home services, but have not experienced significant savings by providing this service. The reason is understandable. When services are offered, participation is widespread by both the target group, those who would otherwise enter nursing homes, and a group which would never enter such homes but cannot be distinguished from the first group.

Health Care

Rising Costs

Costs of health care are continuing to grow as a percentage of American purchasing power, as measured either by personal income or Gross Domestic Product. The reasons are well beyond the control of state governments.

One principal reason is reduction in mortality among persons with extremely high health care costs. For example, advances in saving newborns mean that a larger number of people are born with serious disabilities that require expensive, lifelong care. Improving care and health practices are prolonging life of those over 55, many of whom develop late-in-life chronic problems such as diabetes, prostate and breast cancer, and circulatory and heart problems. Another reason is the availability of new but expensive forms of treatment such as organ transplants and pharmacological management of AIDS.

Costs Being Shifted to Government

Most households do not have the savings necessary to cover even short hospital stays, so private health insurance is the mainstay of coverage for Americans below age 65. But this insurance has become so expensive for employers that the percentage of Americans who have employer-paid health care is declining. Even where employers provide coverage for their employees, they often provide coverage for families only at prices that cause many working Americans to decline this coverage. As a result, the percentage of under-65 Americans without health care coverage has been rising, even in the past seven years of sustained economic growth characterized by increased job holding. The percentage of the population that is without health insurance is likely to soar in recession.

This situation is widely viewed as unacceptable when it affects pregnant women and young children. As a result, Medicaid now finances over a third of births and associated pre- and post-natal care. This percentage is growing as a result of new state and federal initiatives.

Having no care available for adults who are presented with health emergencies is also viewed as unacceptable. As local officials like to put it, it is intolerable for a 911 emergency run to end with a patient in distress turned away at the emergency room door. As a result, such care is provided on an emergency basis. To the extent they can do so, health care providers and state and local governments cover the costs of this care by establishing eligibility for such programs as Medicaid. Where coverage cannot be established, the health care providers treat the patient at their own expense. But because these charity cases are heavily concentrated in a few providers, such as downtown hospitals, the costs are partially reimbursed by public programs.

Spending to Expand Coverage

Although proposals to approach universal coverage through a national health insurance program were rejected by the U.S. Congress in the mid-1980s, the arguments for expanded coverage are leading to *ad hoc* extensions of coverage. Besides the major expansion of children's coverage mandated by congressional action in 1997, many states have been experimenting with providing health insurance of last resort under a variety of programs.

Fiscal Consequences

Some of the impacts of rising public outlays for health care are reflected in the baseline budget projections described in Chapter One. But many are not. This is particularly true for improved health care for children that is generally believed to be necessary as a part of the extension of public concerns about education to ages zero to four, and filling gaps in providing acute care to low- and middle-income adults.

Low Incomes and the Safety Net

Public officials mostly think that welfare reform has been working. It has, as measured against an objective of cutting the number of households regularly receiving cash assistance while not working. But it has not, as measured against an objective of having Americans with families working at jobs that provide a standard of living viewed by most Americans as adequate. So with little fanfare, the costs per case being incurred after welfare reform are much greater than those before the system was reformed. Those costs are being incurred by supplements to earned income, such as federal and state earned income tax credits, and by providing benefits that supplement wages and salaries. Those benefits include food stamps (mostly federal outlays), Medicaid, daycare, and various forms of emergency assistance.

There are many reasons to argue that state and local outlays for income-tested programs for the poor, particularly the working poor, should increase in impact and thus cost. These programs likely will increase in costs *automatically* anytime the economy slows and low-wage jobs are more difficult to find than they are now.

Apersuasive case can also be made for further expansion. For example, many people believe that improvements in the education of welfare-prone people can provide the key to ending long-term dependency. Welfare reform has generally ended the practice of having large numbers of people receiving cash assistance who also receive training leading to job readiness.

Law Enforcement

Despite recent improvements in public safety as measured by crimes reported to police and crimes reported by victims, crime remains a major concern of voters and public officials. The primary outlays competing with higher education are those associated with sentencing changes designed to keep repeat offenders off the streets. Those changes are having a gradual but substantial impact on the number of inmates in correctional institutions, leading to a continuing increase of about 5% a year in the census of jails and state prisons. Many people argue that this increased incarceration is closely associated with the reduced crime rates.

APPENDIX B

Cutting Spending Outside of Higher Education

INTRODUCTION

This is one of two appendices designed to turn the unappealing category of "other programs" (those that compete with higher education for state funds) into the appealing realities seen by state elected officials. Whereas Appendix A focuses on proposals to increase spending on other programs above the baseline levels (defined in the text of the report), this appendix deals with the difficulties of cutting baseline spending in other programs. Reading these two appendices is not necessary for those who believe that, for political or substantive reasons or both, higher education will have a difficult time competing for funds with other programs.

Those who believe that maintaining baseline spending in higher education without tax increases is simply a matter of making easy cuts in other programs should consider the details found in this appendix. Those who believe that proposals to increase baseline spending in higher education can, or should, compete successfully with similar proposal in other fields should read Appendix A.

PROGRAM ADVOCATES AVOID SUPPORTING PARTICULAR BUDGET CUTS IN OTHER PROGRAMS

Those concerned with maintaining particular programs, such as higher education, have little interest in having "their" program associated with tax increases. For example, higher education proponents will rarely put themselves in a position of advocating that lawmakers increase taxes to fund higher education. Instead, they, like advocates of competing priorities for uses of state dollars, find it much more comfortable to suggest that "their" program be funded by giving it an appropriate priority in spending decisions. This posture is comfortable because it means that they do not have to advocate tax increases or large cuts in any specific other program that might represent a lower priority.

This posture is so comfortable for advocates of particular programs that all advocates of all categories of state spending assume the same posture. This puts elected officials in the position of having little support for tax increases but also no support for cuts in particular programs. That is, those concerned about health care cannot be counted upon to defend low funding for education.

Likewise, those concerned with education will not back attacks on health care spending.

Lawmakers Must Consider Cuts

While interest groups can "sit out" battles over budget priorities, lawmakers cannot. In order to fund even current service spending for higher education without tax increases, lawmakers must find ways to fund less-than-current services in other programs.

For purposes of presentation, these reductions from current service spending needs are called *budget cuts* in this paper. This follows the federal usage, which isn't followed in all states. That is, if a 4% increase in state school aid would be required to cover inflation and enrollment increases, this discussion considers a 3% increase to be a 1% budget cut. Obviously, this is not a cut in the sense of reducing spending below the level of the prior year.

The discussion that follows asks readers to put themselves in the position of state elected officials who are seeking to fund higher education without raising taxes by examining other portions of state budgets for such cuts. While considering these options is probably not what readers want to do, and isn't recommended as what they should do as part of public budget debates, it is what they must do to get a feel for how state elected officials will likely respond to desires to make room in state budgets for increases in higher education.

Cutting Elementary and Secondary Education

Support of K–12 education is the largest single category of state spending, accounting for about a third of all state general fund outlays.[11] Nearly all state spending for K–12 education takes the form of state payments to school districts under a variety of programs. The largest and most expensive of these state spending mechanisms involves aid not earmarked to particular local spending, which is provided under formulas that reflect proxies for school spending needs (e.g., pupil counts) and that reflect the portion of those needs that should be met with local funding, which is a function of the wealth (tax base per pupil) of the districts. Other aid is provided to districts under categorical programs for such purposes as pupil transportation, school construction, special education, and teacher training.

The starting points for discussion of annual budgets for elementary and secondary education reflect several concepts. The most common is that state aid should increase by an amount sufficient to adjust the prior year allocation for enrollment changes and inflation. This is one of the standards guaranteed for elementary and secondary education (and community colleges) under California's constitution. It was made a constitutional requirement under a voter-initiated measure known as Proposition 98. School funding does not enjoy similar constitutional protections in other states, but the concept is widely accepted.

From a tax policy perspective, the concept is appropriate because it maintains spending per pupil, at a minimum, at the amount required to cover inflation. The concept provides that the increases in total costs (to cover inflation and enrollment changes) be split between state governments and individual school districts in the same proportion that the base costs are being split.

If states provide less aid than this, the consequence must be one of two widely disliked alternatives. The first is that total education spending per pupil rises with inflation, but local property taxes pay for a larger share of the increase than of the previous spending level. The second is that spending per pupil does not increase by the inflation rate.

To most readers, providing state aid to cover inflation and enrollment increases probably looks like a reasonable decision on the merits, just as it does to most legislators. Readers not of this view can consider the political implications of not providing at least this level of assistance. Such a cut from current services puts legislators at odds with the strongest group of program advocates in state policy. They represent the combined forces of teachers, parents organized through parent-teacher associations, school administrators, school board members (often major political movers and shakers in their local area), and large numbers of well organized school employees such as janitors, bus drivers, and food service employees.

This group is politically formidable because it does many things that public higher education does very little of or not at all: (1) active lobbying from the grass roots while legislatures are in session; (2) endorsement of candidates; (3) support of endorsed candidates with campaign workers and campaign contributions; and (4) retaliation against perceived opponents by such devices as supporting opponents in primary challenges and general elections.

Cutting Low-Income Health Care

On first blush, Medicaid doesn't sound like an awesome competitor for a share of state spending, particularly in competition with education. While education is an investment for the future, Medicaid is basically a dull operating cost. While education fits nicely with the popular theme of prevention, Medicaid is basically treatment. While education has substantial support in public opinion, Medicaid doesn't fare nearly as well in public opinion polls. While elected officials almost always campaign by saying they will spend more on education, few brag that they will spend more on Medicaid.

Yet Medicaid is a proven successful competitor against higher education in state budget priorities. The share of state budgets going to support higher education declined over the 1990s to make room for rapid increases in state spending on Medicaid. During the mid-1990s, Medicaid displaced higher education as the second most expensive state program, trailing only elementary and secondary education.

Medicaid is a strange competitor for state resources. It shares with another strong competitor, corrections, an almost total lack of interest in expanding the program because it is valuable *per se,* making it much different from state support of local schools, universities, transportation, and other functions in which, other things being equal, more spending is viewed by nearly everyone as socially beneficial. So Medicaid isn't a serious competitor for increases above budget levels defined as *continuation, baseline,* or *current services.*

Finding room for higher education spending does not, however, depend upon a decision as to whether or not to expand Medicaid programs. Rather, the choice concerns: (1) providing the funds to continue the existing Medicaid programs, or (2) cutting Medicaid. Implementing cuts in Medicaid is a much different proposition than resisting increases beyond those required to maintain current programs.

To consider the consequences of cuts in Medicaid, it is important to understand how the money is spent. With variation from state to state, a large portion of the outlays for Medicaid pays for health care for a population that is either over 65 or disabled. Asignificant portion of Medicaid spending for this group pays for residential care in nursing homes and for home health services that are designed to prevent the higher costs of nursing home stays. The rest of the outlays for this group are directed toward those who meet a means (poverty) test and provide for supplements to federal Medicare, supplements that cover about the same things that private "Medigap" insurance covers for most of the over-65 population (i.e., co-payments for services, drugs, and certain other omissions from Medicare coverage).

An important federal rule significantly affects states' ability to cut spending for Medicaid for the aged and disabled. The means tests applied to persons applying for Medicaid must be the same as those for persons already on Medicaid. As a practical matter, this means that to make eligibility more difficult for the aged and the disabled seeking to obtain Medicaid coverage, states would have to define as ineligible some aged and disabled persons now in nursing homes under Medicaid. In plain English—and as the issue would be covered in the media—this means "throwing them out in the street."

The rest of the Medicaid dollar goes to an under 65, not disabled population composed of both adults and children meeting poverty tests that account both for low incomes and few assets. There is essentially no interest in restricting Medicaid access for children. There is widespread public support for the notion that poverty should not stand in the way of adequate medical care. State policies don't always conform to this view on the grounds that able-bodied adults should rely on their own incomes to provide this care, or at least should only have public care in the direst of circumstances.

But this argument obviously doesn't apply to children. So expansion of Medicaid programs for children was the subject of a new federal-state program established by the U.S. Congress in 1997 and is a priority of many elected officials. Cutting back health care for children is extremely difficult for elected officials.

Health care for indigent adults isn't easily reduced either. The expensive portions of the care are typically associated with hospital stays. Denial of treatment by hospitals in urgent care situations, the most expensive portions of the program's cost, is unthinkable to hospital administrators and is illegal under federal and some state laws. Because of fierce competition among hospitals, no individual hospital can cover the costs of that care by raising charges for all other patients.

As a result, some form of public reimbursement will be provided. The only question is who will pay for it. There are two basic choices. The first is to recover the costs of indigent care out of patient charges. This can be accomplished by such mechanisms as taxing delivery of hospital services and using the proceeds to reimburse hospitals with extraordinary charity care burdens, or mandating school-age among the hospitals themselves with the same effect—or combinations of the two. Each of these choices involves no federal subsidies. The other alternative incorporates federal cost sharing through Medicaid. By nearly every imaginable criterion, it is preferable to have the federal cost sharing.

It is also possible to save money in the Medicaid program by reducing reimbursements to health care providers such as hospitals, nursing homes, and physicians. This alternative is, indeed, often pursued by state elected officials. Over the past few years, there has been extensive movement toward coverage of Medicaid clients by managed care to bring savings of fixed price contracting to the program. For the services in which managed care is believed to be less useful (for instance, nursing home care), many states have attempted to cut costs by cutting rates (for example, by decreasing compensation to physicians per visit and to nursing homes per day). As a result, most states now pay Medicaid providers substantially less than the reimbursements available for comparable services from private health insurers, Medicare, and federal reimbursements for care of veterans and military dependents. In many areas, most physicians in key specialties, such as obstetrics, will not accept new Medicaid patients. This puts a practical limit on how much reimbursement rates can be cut.

Besides the substantive problems associated with reductions in Medicaid, there are more substantial political obstacles than higher education readers might imagine. Because the alternative to Medicaid reimbursement is often not denial of care but cross-subsidies from others who pay for care, Medicaid enjoys substantial support from private employers who purchase health insurance, private insurance carriers, and labor unions in environments where health care benefits are part of collective bargaining agreements.

Individual health care providers often have substantial, and surprising, political bases. For example, in many states nursing home operators are major political contributors, and members of hospital boards and physicians have substantial influence with those legislators and governors who are generally viewed as conservatives—and who thereby would not be expected to defend this program for the poor.

Cutting Corrections

Like Medicaid, elected officials do not campaign on the basis of spending more than necessary for corrections. But they also are not interested in spending less than necessary in this area—that is, less than the costs of maintaining current services.

The costs of prisons and the administration of parole programs are largely set by factors not under the effective control of state legislators—and particularly not by those oriented to cutting budgets, for they are normally found on appropriating committees, not on those committees dealing with criminal law and sentencing. In broad overview, corrections workloads (prisoner censuses) are determined by crime levels, the success of law enforcement in catching criminals, conviction rates, and sentences. Legislatures have no direct control over crime rates, they generally seek to maximize rather than minimize the frequency with which crimes end in arrest and conviction, and they have been creating records of lengthening, not shortening, sentences. Also, elected officials, encouraged by a federal program, have been working to ensure that criminals actually serve longer portions of their sentences.

The political costs of not pursuing these policies is viewed as very high. Nearly every state has examples of someone allowed out of prison on parole or work release who has committed some widely publicized, heinous crime. Such examples always provide grounds for criticism of incumbent elected officials for being soft on crime and frequently inspire cutbacks of patterns for granting parole and pardons and for using work release.

CUTTING SAFETY NET PROGRAMS

Besides Medicaid, states pay for many programs designed to assist low-income persons who meet means tests. Cash welfare constitutes only a tiny portion of the total amounts involved. Even before the recent caseload reductions, cash welfare payments were only about 4% of total state spending. Medicaid alone costs about five times as much as cash welfare. The current service budget projections on which this paper is based already presume, as do many state budgets, that the substantial apparent success of welfare reform in reducing cash assistance caseloads will continue. Specifically, welfare costs are projected to increase at about 4% a year, versus 5% for total state budgets and 6% for higher education.

Many of the more expensive aspects of safety net programs are not what most people think of when they talk about welfare. One major example consists of the state and local programs that attempt to deal with child abuse and neglect by supporting placement in other households.

CUTTING ALL OTHER GENERAL FUND PROGRAMS

The primary demands on state baseline budgets—other than higher education— are set by the programs previously described in this appendix. Other programs are smaller in their impacts, but have similar problems associated with cuts in current services. The following paragraphs feature the highlights.

Mental Health and Developmentally Disabled

States continue to maintain residential institutions for a portion of these populations. However, over three decades, states have been responding to the huge expense of institutionalization as well as to changes in thinking about appropriate treatment by de-institutionalization. Large portions of clients in both programs are now found in sheltered workshops, halfway houses, group homes, foster care arrangements, and in private homes with state funding of their unique needs for drugs (often very expensive) and medical care. In community settings like these and in state institutions, cutting current services is largely tantamount to eliminating these services for those now receiving them or rejecting new patients with circumstances comparable to those now being provided care at state expense.

Child Welfare Spending

States pay for substantial child welfare costs over and above those covered by the safety net programs described above. These programs, often run by local agencies at mostly state expense, include investigating child abuse and neglect, collecting child support, and serving *in loco parentus* to thousands of children who are literally wards of the state. These children are found primarily in foster homes and subsidized adoption settings, but a few of the most difficult and expensive cases are in state-run and private institutions. As with mental health, cutting current services is largely tantamount to eliminating these services for those now receiving them or rejecting new children with circumstances comparable to those now being provided care at state expense.

Parks and Recreation

Net state outlays for state parks, museums, and historical sites have declined as a percentage of total state spending even more than have higher education outlays. While the portion of total higher education spending that is defrayed by the users of public institutions (i.e., tuition in the case of higher education) has risen slightly, there has been a much larger increase in the portion of spending for parks and recreation that is defrayed by users (e.g., fees). As would be expected, increasing fees for users has cut the demand for use of state facilities and discouraged construction of additional facilities. The higher user charges have also encouraged private competitors for campgrounds and scenic recreational opportunities.

Regulatory Functions

State governments maintain a variety of regulatory functions dealing with such subjects as air and water pollution, consumer protection laws, licensing of professionals, granting corporate charters, building codes, and the like. While unglamorous, these activities are surprisingly difficult to use as a source of savings by curtailing current services. Because changes in long-standing regulatory frameworks are difficult to accomplish and usually opposed by the regulated professions and industries , budget cuts often simply delay the regulatory processes. Such delays usually create more negative feedback than the small savings seem worth.

Overhead Functions

Most state overhead functions—maintaining personnel systems, building operations, tax collecting, financial processing, auditing, and the offices of the governor and legislative operations—are relatively stable operations that present little pressure for major increases in spending but that are also relatively difficult to cut. Current service spending for these operations are typically cut only in connection with across-the-board spending rollbacks that affect all programs. Such cuts, though dramatic when announced, are often rescinded in part by exceptions and are usually rescinded entirely when the fiscal crises that trigger them are resolved.

CONCLUSION

This discussion of the difficulties of cutting current services in many programs may strike some readers as unduly pessimistic and a rationalization of the status quo. It is certainly subject to that interpretation, but it should be understood as a distillation of how elected officials have reacted to cutting current services, not a statement of how either the author or readers feel those officials should react.

The actual experiences have appeared in many different states in many different forms, yet have led to virtually the same conclusions. For a broad audience, it is best understood by an example of cutting current services at the federal level. As a result of the elections of 1994, Republicans in Congress viewed themselves as having a “Contract with America” that featured downsizing the federal government in general and downsizing domestic social programs in particular, especially some of the vestiges of anti-poverty programs established in the 1960s. President Clinton, while having a different perspective of these programs, enjoyed relatively clear sailing in seeking to reduce national outlays on defense. The national security threats had been greatly diminished, allowing the United States simultaneously to reduce defense spending and maintain a more dominant military position in the world than anytime in several decades.

The political history of the years from 1994 to the present appear to have taught federal elected officials that there is little payoff in cutting current service spending. Both defense and domestic discretionary budgets were expanded in 1998, reflecting decisions by both the President and the Republicans in Congress that the losses of cutting exceeded the gains.

APPENDIX C

Raising Taxes

INTRODUCTION

This is the third of three appendices designed to support the conclusions in the text that alternatives to putting fiscal pressures on higher education are unlikely to be pursued in most states. In the context of structural deficits suggested by the report, Appendix Asuggests that demands for increases (new initiatives) in the current service spending of other functions would put pressure on higher education outlays. Appendix B describes the difficulties of financing higher education by cutting baseline spending in other programs. This appendix covers political, constitutional, and substantive objections to raising taxes to finance either current services or new initiatives in any field, including higher education. Reading it is not necessary for those who already believe that most states are unlikely to increase major taxes for any reason.

Over the three years from 1996 through 1998, state officials made substantial records of reducing tax burdens.

POLITICAL COMMITMENTS TO NO TAX INCREASES

Over the three years from 1996 through 1998, state officials made substantial records of reducing tax burdens. In each of those years, at least half of the states enacted significant tax cuts. In each of those years, those reductions, net of increases in a few states, caused tax collections to be at least half a percent below what they would otherwise have been. These tax cuts, which were unaccompanied by cuts in budgets required to maintain current services, put state elected officials in extremely comfortable positions. They were able to deliver what appeared to be a reduction in the demands that government placed on citizens through taxes. Incumbents were able to campaign for re-election on the basis of sponsorship and / or votes for a variety of highly visible tax cuts.

During the 1990s, cutting taxes became viewed as a clear route to possible electoral successes. To campaign consultants and candidates, individual states provided strong lessons showing the potency of the issue. In 1993, Christy Whitman produced a come-from-behind win in her try to unseat the incumbent governor of New Jersey. Her signature issue was a 30% cut in state income taxes. Her victory caused her campaign theme to be copied by many of the gubernatorial candidates in 1994. They campaigned, many of them successfully, on a platform emphasizing cuts in personal income taxes. Often, they too picked 30% as the appropriate reduction. Nationally, most Republican candidates for U.S. Congress ran for office, with considerable success, by referring to a document called the “Contract for America,” which also specified substantial tax cuts.

The off-year elections of 1997 in the two states that held elections for governor provided a testing ground for political themes to be used by candidates in 1998. New Jersey again provided lessons. Governor Whitman entered the campaign a heavy favorite. She had delivered on her promise to cut income taxes, had avoided spending cuts that alienated any major interest group, and had a scandal-free administration. All this occurred at a time when the New Jersey economy was doing well. Despite all this she barely won re-election against a little-known challenger with substantially less campaign financing. The keys to his success were two signature issues. Both were more in the nature of criticisms of the status quo rather than precise plans to solve problems. The one-line criticisms were that New Jersey had the highest property taxes and the highest auto insurance rates in the nation. Responding to the obvious public response to these themes, Whitman and many legislative candidates made commitments to seek property tax relief if they were re-elected.

There was no incumbent in the Virginia campaign of 1997 because that state limits its governors to serving a single term. One of the candidates made his signature issue the elimination of the “car tax.” The tax is a local personal property tax based on vehicle value that produced annual bills in excess of $500 for many middle-income households. The other candidate initially called the proposal unaffordable and stressed his spending priorities and a modest tax cut plan of his own. As polls indicated the popularity of cutting the car tax, the other candidate reversed ground enough to be able to endorse a large tax cut plan of his own.

The 1998 state campaigns reflected these apparent lessons from 1997; challengers and incumbents alike, legislators and governors alike, included tax cut plans in their platforms. Even governors who were viewed as likely to (and who did) win by huge margins decided to include such promises (e.g., Governor Bush of Texas, Governor Engler of Michigan, and Governor Thompson of Wisconsin). As a result of the 1998 campaigns, there is a widespread environment of state officials who have pledged additional specific tax cuts. Those officials are clearly not going to be attuned to considering tax increases.

Most elected officials, not to mention political consultants, believe that the primary lesson of the 1992 presidential election was this: appearing to make a commitment to avoid tax increases yet later endorsing them was the political kiss of death for President Bush. This conviction fortifies the political wisdom that raising taxes after promising not to do so has much stronger negative effects on voters than raising taxes alone might have.

These lessons mean many state elected officials in the early parts of the next decade will consider their support for tax increases in the context of their own past promises to avoid them. Based on past examples, these officials consider support for tax increase to be political suicide. These career concerns exist over and above substantive reasons for opposition to tax increases—which are substantial themselves.

Concerns about the Size of Government

Besides political concerns associated with raising taxes, a substantial percentage of voters and elected officials believe that government is simply too large and intrusive. Their perspective suggests that many things now done by government could be done equally well or better by private enterprise in a competitive environment or by voluntary organizations. Some people believe that certain activities of governments are better not done at all.

For those with this view, the policy problem is to restrict the size of government at all levels. Proponents of this perspective are realistic in recognizing the difficulty in avoiding government spending that can be financed with current revenues. So they consider the revenues themselves as the problem; they seek to cut into the revenue stream, indirectly getting at the objective of curtailing spending and thus government intrusiveness. As some advocates of this view put it, taxes are the root of the spending tree, so killing the growth of spending means chopping into the root system. The policies of choice for those with this perspective are to obtain tax cuts whenever possible and to prevent any growth in tax revenues brought about through tax increases.

These positions are themselves formidable barriers to tax increases at the state and local level. They have also led to creating constitutional barriers to tax increases in many states.

Mechanisms Barring Tax Increases

In many of the states with the most serious problems of structural deficits, tax systems differ from those of the majority of states because one of the three major tax bases—sales, income, and property—is used much less or not at all. Some of the barriers to adopting the “missing tax” and to expanding use of an underutilized revenue source are built into state constitutions. For example, there are barriers to adoption of income taxes in Florida and Texas, two major states without them. Similar barriers exist to adoption of a sales tax in Oregon and some of the other states without them. Restrictions preventing full use of property taxes, such as large homestead exemptions, are part of the constitutions of many states.

In some states, opponents of tax increases have also built procedural hurdles into the process for enacting tax increases. For example, tax increases of any kind in Colorado, whether by local or state government, require voter approval. Some states have requirements that state and /or local legislative bodies must have larger-than-majority votes to increase taxes.

Many states have also adopted tax and spending limits that have the effect of preventing the spending of tax collections that exceed a stipulated amount. The typical limit relies on a base year and bars spending increases in excess of those required to adjust the base-year spending for inflation and a measure of government workload, such as population. The more generous of the limits restrict the spending growth rate to the rate of growth in personal income.

CONCLUSION

Reaching the baseline funding level for higher education implies tax increases, but is it reasonable to expect that state elected officials will enact such tax increases? The simple answer is "maybe." Historically, state officials have produced tax increases at about the level needed to maintain their current service budgets when circumstances, such as recession, have appeared to make such action necessary. On the other hand, to adopt such increases most elected officials will have to do what they are loathe to do on principle and probably at least a third of them will have to renege on campaign commitments.

Thus, *whether or not state elected officials ultimately conclude that they must raise taxes, they most certainly will not accept this conclusion easily.* Having possible tax increases on the table will set off a cry that all spending should be scrutinized for possible savings, before raising taxes is even considered seriously. This logic is bound to cause much more intensive scrutiny of state spending patterns than was seen anytime in the late 1990s. Higher education cannot avoid at least a share of this scrutiny proportional to its share of funding.

APPENDIX D

Sensitivity Analyses

This appendix discusses the possibilities that the central conclusions of this report are wrong.

PREDICTIONS OF STRUCTURAL DEFICITS

The prediction of widespread structural deficits in state and local government throughout the next decade is the cornerstone of the conclusions in this report. That prediction naturally depends on definitions of what constitutes current service spending, which are discussed in this section. Given the definitions that are common in state budgeting and similar projections, the prediction of structural deficits depends on demographic, economic, and federal budget assumptions.

Demographic Assumptions

The underlying demographic assumptions reflect relatively stable patterns of demographic change. One major variable in the population estimates is immigration. But as indicated below, over time, immigration has somewhat parallel impacts on spending and revenues.

Changes in *longevity* would have major impacts on total government spending. Most of the adverse impact, however, would be concentrated on the federal budget, which bears total responsibility for maintaining safety net income through the Supplemental Security Income program, for preventing poverty in retirement through Social Security, and for providing the bulk of medical care for the aged through Medicare. State and local impacts would be confined primarily to health care spending supplementing Medicare and, most important, to increased nursing home outlays shared by the federal government and the states through Medicaid.

Changes in *birth rates* would not have much impact on state and local spending during the eight-year projection period of the forecasts in this report. The primary impact of children on state and local budgets comes only when they reach school age, so there is about a five-year lead time between birth rate changes and spending impacts.

Economic Assumptions

The predictions assume a long-term rate of *real growth* in the U. S. economy, about 2.4% as measured by the total output of goods and services (Gross Domestic Product or GDP) adjusted by a price index known as the GDP price deflator. Economic growth in excess of the predicted rate is an unmitigated blessing for government finances. It adds to revenues because tax collections are closely related to total economic activity. But it does not add to spending pressures, which are based on such factors as the number of children in school. More rapid growth than previous predictions, more than all other factors combined, accounts for turning the federal deficit into a surplus and for the strong current fiscal position of state governments.

It is possible that national economic growth could continue to exceed what forecasters view as the long-term trend. The fiscal impacts would depend on how the growth came about. Total output can be considered as the product of two factors: (1) total worker hours, and (2) productivity or output per worker-hour. So long as growth resulted from unexpected gains in productivity, there would be unambiguous gains in private living standards and in government revenues. However, such gains would be unprecedented in the nation's economic history. They are increasingly hard to realize because a growing proportion of economic activity is taking form (e.g., beauty care, most health care, and many other forms of personal services) where productivity gains are harder to realize than in manufacturing and construction. If unexpected growth results from a larger percentage of the nation's population working or a lengthening of the work day or work week, the fiscal consequences would also be overwhelmingly favorable. However, output gains that result from immigration of the labor force would not be favorable, as the unanticipated population growth would soon lead to as many sources of additional spending as the added revenues.

To the author and many other observers, the downside risks to assumed economic growth rates seem more serious than the upside risks. Individual forecasters each have their own favorite causes of concern. The author's is the increasing dependence of growth in national output on money from abroad. Currently, Americans are able to spend about $900 per person (including children) per year more than the value of their production because capital inflows from other nations (the reciprocal of a negative balance of trade in goods and services) now equal that amount. Centuries of economic history suggest that other nations will not subsidize the consumption of one nation to that extent indefinitely.

While the projections assume an *inflation rate,* the projections of structural deficits are largely insensitive to assumed rates. Inflation has nearly equal impacts on spending and revenues.

Federal Budget Assumptions

Assumptions about the federal budget affect higher education planning in two ways. First, the assumptions affect presumed federal outlays for higher education made directly in the form of Pell grants and other programs. Second, the assumptions affect presumed state and local outlays for higher education through the impact of federal spending on the fiscal position of state and local governments. With the federal budget supporting nearly 25% of all state and local spending, that fiscal position is now highly sensitive to what happens to future federal aid.

The outlook for federal domestic discretionary spending—the category that includes both direct federal support of higher education and most grants to state and local governments—is mixed.

On the one hand, actions in 1998 suggest this report's assumptions in this area will be easily realized. These projections assume that federal aid to state and local government will simply remain a constant percentage of personal income. The projections of federal surplus—which governed the congressional budget allocations in 1998 and the many decisions in Congress to increase aid programs—suggest that federal officials have both the desire to spend more on domestic discretionary programs and the fiscal capabilities to do so.

On the other hand, the spending caps of the 1997 budget agreement remain in place and both the President and the congressional leaders have indicated that these agreements will not be violated. These caps were not seriously restrictive in 1998, as they were designed to avoid pre-election budget trauma for members of Congress. But they bite heavily in 1999, with consideration of the FY 2000 budget. The caps will require that domestic discretionary outlays be reduced by about $28 billion from the FY 1999 levels. Appropriations needed to maintain federal domestic discretionary spending as a constant share of personal income would need to account for this $28 billion reduction. Similar problems will arise as federal officials consider budgets for FY 2001 and subsequent years.

The conflicting perspectives on future federal spending for domestic discretionary programs create choices that will provide the basis for debates on the federal budget in 1999 and the years beyond. Those debates could result in federal spending in support of state and local spending (and direct federal support of higher education) that could vary substantially, up or down, from the growth assumed in this paper.

Remedies for Structural Deficits

Running Unbalanced Budgets

The financial picture that this report paints for higher education presumes that state and local governments will continue to maintain balanced budgets, as they are required to do by many constitutional provisions and statutes. These laws and the traditions behind them withstood the intense fiscal challenges of the Great Depression (circa 1929 to 1938) and appear likely to withstand the lesser challenges predicted by the projections in this report.

Because of balanced budget requirements, state officials will not allow a structural deficit of the magnitude described in the projections to occur. Instead, in the states where these deficits occur, state officials will deal incrementally with the mismatch between revenues from current taxes and the spending needed to maintain current services—that is, they will respond to projected deficits as they become apparent.

Tax Increases

Although the text of the report does not predict this, the discussion of fiscal pressures on higher education suggests that most of the adjustments will be made by reductions in spending below the level required to maintain current services.

In fact, many adjustments are likely to be made by increasing taxes. Increases are particularly likely in the taxes with the least responsiveness to economic growth—particularly the per-unit taxes on motor fuels, tobacco, and alcoholic beverages. For various reasons, increases in these taxes are not as politically formidable as increases in general taxes. Increases are also more likely in states combining rapid growth and inelastic tax systems, with Texas providing a good example. Reflecting public attitudes toward growth-oriented spending, the willingness of elected officials in those states to raise taxes is substantially greater than is found on average throughout the nation.

For the past two decades, state and local taxes have taken an almost constant percentage of personal income. This means, on balance and over the business cycle, tax increases have predominated over tax cuts enough to overcome the less-than-unit elasticity of state and local tax systems. That pattern may well continue, thereby reducing somewhat the impact of structural deficits on spending in general and higher education spending in particular.

Spending Cuts

The text of the report and Appendix B suggest that all possibilities for providing increases at less-than-current service level requirements have major policy consequences and thus major political consequences. Particularly over the short term, this is not entirely true. In many but not all state and local activities, small structural deficits can be handled by spending constraints with no immediate policy consequences.

Current service budgets presume that major ratios of governmental inputs to governmental outputs will remain constant. Examples of such ratios are faculty members to students in higher education, teachers to students in public schools, caseworkers to clients in social services, police officers and firefighters to population in local governments, and guards to prisoners in corrections. Such ratios can be allowed to inflate somewhat by holding spending increases to slightly below the levels that would be required to maintain them. Of course, there are consequences in each field paralleling the consequences most readers would understand for such ratio changes in public higher education.

Current service budgets also presume that the relationship between the compensation of public sector employees and the compensation of private sector employees will remain constant. As a result, the projections presume the same increase in real (inflation-adjusted) compensation of all workers, which, by definition, is roughly equal to the annual improvements in productivity assumed in the economic projections.

Given the assumptions of this report, this means university faculty members, public school teachers, and other public workers would be seeing annual average increases in purchasing power of about 1.5% a year. In the long run, providing smaller increases in compensation for public sector workers creates no apparent problems. For example, annual pay increases matching inflation would be readily defensible for many elected officials and would cut 1.5% a year from the wages and salary component of state and local outlays. The wage and salary component of state and local spending is so large that an inflation-matching compensation salary policy would, by itself, eliminate (on a national average basis) the structural deficit predicted in this report.

Such a policy is untenable in the long run because the public sector must compete for workers, particularly at the entry level, with the private sector.

Spending Shifts Out of the Public Sector

Nearly all discussions of government spending and taxes presume the same accounting conventions used to prepare and present budgets and fiscal statistics. These exclude those extractions of funds from the public that are “off-budget” in the jurisdiction(s) under consideration, and they often exclude the spending financed by those revenues. Major examples are public university tuition and fees, charges by state toll road authorities, and charges levied for services of public institutions with functions that parallel those of the private sector, including providing hospital services, recreation, electric power, and natural gas.

The projections in this report presume that such charges will finance the same proportion of total spending in each function that they currently finance. For example, if a particular state’s higher education institutions are defraying 33% of their spending through tuition at the beginning of the projection period, then they are presumed to defray 33% at the end as well. This means that the projections presume, for example, tuition increases per student equal to increases in spending per student.

In times of fiscal adversity, such as those forecast for state and local governments in the early years of the next decade, state and local officials often find many ways to shift spending from financing by tax collections to financing by user charges. One example is the tendency to increase tuition to offset the impacts of appropriation freezes on institutions of public higher education.

Achieving Public Purposes by Requiring Private Spending

Government budgets and financial reports are imperfect indicators of the impact of government on the freedom of citizens to control the uses of their resources. By mandating private sector spending, governments can achieve the same objectives as are achieved by public sector spending and taxes. For example, supporting the consumption of low-income individuals is currently accomplished by tax-financed spending for cash welfare payments and subsidized health care.

It is also accomplished by subsidized low rates for phone service. Those rates, often called “lifeline” service, do not fully compensate telecommunications providers for their costs of services. The offsetting extra revenue is collected from all other customers. While the payment of extra costs by the other customers is a government-mandated reduction in consumer purchasing power, it does not count as a tax. While the subsidies to low-income households are government-directed spending, they do not count as spending.

There are constantly growing examples of such devices. Two that have drawn public attention recently are: (1) the extraction of impact outlays from housing and commercial property developers for such purposes as building public streets and roads and constructing public schools, and (2) the funding of a multi-billion dollar federal program to provide telecommunications access to schools through charges built into telephone rates.

MAJOR REALIGNMENTS IN THINKING ABOUT GOVERNMENT ACTIVITIES

The analyses in the text and appendices of this report presume that the attitudes of the public and of elected officials toward government spending and taxes and toward major public programs will remain relatively constant over the projection period. The projection methodology simply applies these constant attitudes to changed circumstances dictated by the economic, demographic, and fiscal environments predicted during the projection period. As summarized at the end of Chapter Two, “With attitudes and decision-making procedures unchanged, and with the impacts of strong and weak state fiscal circumstances on higher education spending well known, forecasting state approaches to higher education spending becomes simply a matter of forecasting the state fiscal circumstances likely to prevail in the next decade.”

The conclusions in this report are thus sensitive to any major changes in attitudes. Several such changes are possible.

Role of Government

One possible change is a major revision in thinking about the role of government and thus its size, scope, and cost. One possibility is that more people will believe that government does too little, much improving the outlook for higher taxes. On the other hand, another possibility is that more people will believe that government does too much, creating an environment for reductions in taxes and spending.

Redefining Baseline Spending

There are areas in which changes in attitudes and resulting changes in policy could substantially redefine baseline spending. Accepting a public obligation to finance fundamental health care would be one such change, with enormous fiscal implications. So would redefinition of the scope of free public education to encompass the education of three and four-year olds and/or grades 13 and

14. Likewise, certain activities now viewed as part of baselines could be defined as outside the traditional responsibilities of government. This has been happening with one major outlay in federal budgets (housing) and one in state budgets (recreation). As these examples suggest, movement in either direction tends to be gradual, almost glacial. As a result, such changes are not built into the assumptions used in this report.

APPENDIX E

Participants:
Symposium on Emerging State Policy Issues

February 1999

Robert Atwell
Symposium Chair
President Emeritus
American Council on Education

Robert Berdahl
Professor Emeritus
College of Education
University of Maryland

Frank Bowen
Consultant
The National Center for Public Policy and Higher Education

Kathy Reeves Bracco
Senior Policy Analyst
The National Center for Public Policy and Higher Education

Patrick Callan
President
The National Center for Public Policy and Higher Education

Ronald Cowell
President
The Education Policy and Leadership Center

David Dill
Professor of Public Policy Analysis and Education
University of North Carolina, Chapel Hill

William Doyle
Research Associate
The National Center for Public Policy and Higher Education

Donna Douglass
Administrative Officer
The National Center for Public Policy and Higher Education

Joni Finney
Vice President
The National Center for Public Policy and Higher Education

Lyman Glenny
Professor Emeritus
University of California, Berkeley

Harold Hovey
President
State Policy Research, Inc.

Dennis Jones
President
National Center for Higher Education Management Systems

Aims McGuinness
Senior Associate
National Center for Higher Education Management Systems

Ann Marcus
Dean
School of Education
New York University

Mario Martinez
Assistant Professor
Department of Education and Management and Development
New Mexico State University

James Mingle
Executive Director
State Higher Education Executive Officers

Kenneth Mortimer
President/Chancellor
University of Hawaii, Manoa

Richard Novak
Director
Public Sector Programs
Association of Governing Boards of Universities and Colleges

William Pickens
Executive Director
California Citizens Commission on Higher Education

Richard Richardson
Professor
Division of Educational Leadership and Policy Studies
Arizona State University

Virginia Smith
President Emerita
Vassar College

Gloria Timmer
Executive Director
National Association of State Budget Officers

William Trombley
Senior Editor
The National Center for Public Policy and Higher Education

Alan Wagner
Principal Administrator
Directorate for Education, Employment, Labour and Social Affairs
Organisation for Economic Co-operation and Development

Richard Wagner
Former Executive Director
Illinois Board of Higher Education

Jane Wellman
Senior Associate
Institute of Higher Education Policy

Judy Zelio
Program Associate, Finance
National Conference of State Legislatures

Endnotes

[1] For more details on assumptions underlying the baseline forecasts, see The Outlook for State and Local Finances (Washington, D.C.: National Education Association, 1998). Some of the workload assumptions are interactive with policies assumed in current policy projections. For example, higher education enrollment is not independent of tuition and access policies. The current service projections presume no change in the percentage of public higher education costs defrayed by tuition payments.

[2] Along line of academic studies shows state tax and spending levels, overall and for individual programs, to be insensitive to political variables such as party control of governors' offices and legislatures.

[3] See for example, Financing State Government in the 1990s (Denver: National Conference of State Legislatures, 1993) and Is the New Global Economy Leaving State-Local Tax Structures Behind? (Washington, D.C.: National League of Cities, 1998). Both of these studies were endorsed by large numbers of organizations of state and local officials.

[4] Because of productivity gains in the economy, private sector wages and salaries rise in real terms. That is, the purchasing power of workers increases, as it historically has. To maintain the alignment of public and private compensation, public sector compensation also must rise somewhat faster than inflation. Specifically, in the projections inflation occurs at about 2.5% and all wages, private and public, rise just over 3.5% annually, providing a real purchasing power increase of about 1%. The real world implication of this is that simply matching inflation and workload increases is not a tenable long-term policy for governments. Good examples of why this is not good policy can be found in Colorado and Washington, both of which have limits on state spending growth tied to the sum of inflation and population growth. Those limits, approved as a result of voter-initiated measures on state ballots, have forced these states into tight budgets and ultimately to return to voters with requests for waivers of the limits. Such requests were on the November 1998 ballots in both states.

[5] These projections obviously depend on the validity of the underlying demo-graphic forecasts, both for higher education enrollment and the other drivers of workloads in government programs. These projections are most reliable for states with large populations and diversified economic bases, and least reliable for states with the reverse, such as Hawaii, Idaho, Vermont, and Wyoming.

[6] Higher education is not unique as a balance wheel. Other institutions with similar characteristics, such as state arts agencies and Medicaid providers, also serve this function. In the case of Medicaid providers, the cuts often take the form of shifting billing cycles, for example, creating large one-time savings by moving from payment within 15 days to payment within 60 days.

[7] To the author, who works daily with data on the budgets of 50 states, this is an empirically based statement. However, because the adjustments associated with (1) the use of higher education as a balance wheel, (2) federal mandates, (3) workload growth,

and (4) uncontrollable cost changes are all difficult to make and controversial, the extent to which higher education's relative unpopularity has been a factor in declining budget shares cannot be easily demonstrated empirically.

[8] This conclusion implies that public K–12 education spending will continue to command strong support among elected officials. This support was strongly in evidence in 1998 in congressional actions on education funding in 1998 and in campaign positions of candidates for state office, despite ample criticism of "throwing money at the problem" aimed at elected officials supporting major spending increases.

[9] The default is that queues form which in and of themselves impose a cost in waiting times. National health services in Canada and Europe are illustrations. Free operations are available to all, but waiting periods for non-emergency procedures are months and sometimes years. Another type of queue arises when insufficient quantities of services are provided to meet demand in particular geographic areas. Many state highway programs have this characteristic.

[10] One of the likely solutions to financing Social Security will come from mandatory coverage of all state and local workers. In a practice dating from the beginnings of Social Security, some states and local governments are exempt from Social Security coverage. Including them will raise their payroll costs by roughly 15% with sizeable fiscal impacts on the affected states and local governments.

[11] The discussion of individual spending categories uses shares of general fund budgets as compiled by the National Association of State Budget Officers in their annual series called State Expenditure Report. In most states, the general fund is the primary component of the state budget and the one usually containing all major outlays for higher education, except capital outlays supported by bond issues. The concept typically excludes from total spending and revenues: (1) trust funds such as those for unemployment compensation; (2) revenues earmarked for particular purposes, such as highways, and the spending of those revenues; and often, (3) large categories of spending not financed by taxes, such as spending financed by university tuition and federal aid.

About the Author

Harold A. Hovey has a lifetime of experience in fiscal policy and in forecasting government expenditures and revenues. Currently, he is president of State Policy Research, Inc., and editor of its twice-monthly newsletters, *State Policy Reports* and *State Budget & Tax News.* Past positions have included director of finance for the State of Ohio, budget director for the State of Illinois, senior fellow for public finance at the National Governors' Association, and head of the Public Policy Economics Division at the Battelle Memorial Institute. He has also worked for the federal government in the Office of the Secretary of Defense and the Office of Management and Budget.

Hovey has published extensively on issues relating to local, state, and federal fiscal policy and management, including two books and many articles and special reports. For over two decades he has consulted with the National Conference of State Legislatures and the National Governors' Association. His federal clients have included the U.S. House Budget Committee, the General Accounting Office, the Office of Management and Budget, the Congressional Budget Office, and the Departments of Education, Health and Human Services, Housing and Urban Development, Transportation, and Treasury. He has also done significant work for a variety of individual states and local governments, and he recently completed a study of state and local structural deficits for the National Education Association.

ABOUT THE NATIONAL CENTER FOR PUBLIC POLICY AND HIGHER EDUCATION

The National Center for Public Policy and Higher Education was established in 1998 to promote opportunity, affordability and quality in American higher education. As an independent, nonprofit, nonpartisan organization, the National Center provides action-oriented analyses of state and federal policies affecting education beyond high school. The National Center receives financial support from national philanthropic organizations; it is not affiliated with any institution of higher education or with any government agency.

The National Center publishes:

- ★ Reports and analyses commissioned by the National Center,
- ★ Reports and analyses written by National Center staff,
- ★ NATIONAL CENTER POLICY REPORTS that are approved for release by the National Center's Board of Directors, and
- ★ *CrossTalk,* a quarterly publication.

Each of the publications listed below is available or forthcoming on the world wide web. Single copies of most of these publications are also available from the San Jose office of the National Center. Please FAX requests to 408-271-2697 and ask for the report by publication number.

San Jose Office: 152 North Third Street, Suite 705, San Jose, California 95112
Telephone: 408-271-2699 • Fax: 408-271-2697
Email: center@highereducation.org • Web site: http://www.highereducation.org

Washington Office: 1001 Connecticut Avenue, NW, Suite 310,
Washington, D.C. 20036
Telephone: 202-822-6720 • Fax: 202-822-6730

Reports and Analyses Published by the National Center

98-1 *Concept Paper: A National Center to Address Higher Education Policy,* by Patrick M. Callan (March 1998). Describes the purposes of The National Center for Public Policy and Higher Education.

98-2 *The Price of Admission: The Growing Importance of Higher Education,* by John Immerwahr (Spring 1998). A national survey of Americans' views on higher education, conducted and reported by Public Agenda.

98-3 *Organizing for Learning: The View from the Governor's Office,* by James B. Hunt Jr., Governor of North Carolina and Chair of the National Center for Public Policy and Higher Education (June 1998). An address to the American Association for Higher Education concerning opportunity in higher education.

98-4 *Tidal Wave II Revisited: AReview of Earlier Enrollment Projections for California Higher Education,* by Gerald C. Hayward, David W. Breneman and Leobardo F. Estrada (September 1998). Finds that earlier forecasts of a surge in higher education enrollments were accurate.

98-5 *The Challenges Facing California Higher Education: AMemorandum to the Next Governor of California,* by David W. Breneman (September 1998). Concludes that the next governor should give serious consideration to exploring a new Master Plan for Higher Education.

98-6 *Federal Tuition Tax Credits and State Higher Education Policy: AGuide for State Policy Makers,* by Kristin D. Conklin (December 1998). Examines the implications of the new federal income tax provisions on students and their families, and makes recommendations for state higher education policy.

98-7 *Higher Education Governance: Balancing Institutional and Market Influences,* by Richard C. Richardson, Jr., Kathy Reeves Bracco, Patrick M. Callan, and Joni E. Finney (November 1998). Describes the structural relationships that affect institutional efficacy in higher education, and argues that effective state policy achieves a balance between institutional and market forces.

98-8 *The Challenges and Opportunities Facing Higher Education: An Agenda for Policy Research,* by Dennis Jones, Peter Ewell, and Aims McGuinness (December 1998). Argues that due to substantial changes in the landscape of postsecondary education, new state-level policy frameworks must be developed and implemented.

99-1 *Taking Responsibility: Leaders'Expectation of Higher Education,* by John Immerwahr (January 1999). Reports the views of those most involved with decision-making about higher education, based on a survey and focus groups conducted by Public Agenda.

99-2 *South Dakota: Developing Policy-Driven Change in Higher Education,* by Mario C. Martinez (June 1999). Describes the processes for change in higher education that government, business and higher education leaders are creating and implementing in South Dakota.

99-3 *State Spending for Higher Education in the Next Decade: The Battle to Sustain Current Support,* by Harold A. Hovey (July 1999). This fiscal forecast of state and local spending patterns finds that the vast majority of states will face significant fiscal deficits over the next eight years, which will in turn lead to increased scrutiny of higher education in almost all states, and to curtailed spending for public higher education in many states.