THE NATIONAL CENTER FOR PUBLIC POLICY AND HIGHER EDUCATION

Policy Alert

February 2006

KEY FINDINGS …

- Continuing financial pressure on state legislatures to limit appropriations for higher education will affect all 50 states through 2013.
- Even starting with balanced budgets, all states face fiscal imbalances that will make it impossible to maintain current public service levels.
- The result for higher education will be increased competition for what resources remain, intensified by greater growth in demand for state services other than higher education.
- For all states, the projection for the next eight years is continued fiscal stress.

This *Policy Alert* updates a 1999 report by Harold Hovey, *State Spending for Higher Education in the Next Decade: The Battle to Sustain Current Support*, and two earlier *Policy Alerts*: *State Shortfalls Projected Despite Current Fiscal Prosperity* (February 2000) and *State Shortfalls Projected Throughout the Decade* (February 2003), all available at www.highereducation.org.

Projections for this *Policy Alert* were developed for the National Center for Higher Education Management Systems by the Rockefeller Institute of Government, updating a 2002 Institute analysis. Find both studies, as well as more detailed state-by-state data, at www.higheredinfo.org.

For more information on states' projected budget deficits, see Federal Funds Information for States, "Another Take on State Structural Deficits" (May 2005, Volume 23, Issue 10).

STATE SHORTFALLS PROJECTED TO CONTINUE DESPITE ECONOMIC GAINS

Long-Term Prospects for Higher Education No Brighter

By Dennis Jones

Although most state budgets for 2006 have improved, the long-term prognosis for state finances is poor, according to an analysis by the National Center for Higher Education Management Systems (NCHEMS).

The analysis projects state spending and revenues for eight years, from 2005 to 2013, and concludes that ***all*** states face potential budget deficits that will serve to limit the funding of higher education.

"The rapidly escalating costs of Medicaid, more than anything else, explain why total state and local spending is projected to grow faster than spending for higher education."

In a similar study conducted in 2002—at the height of the states' fiscal crises—44 out of 50 states indicated budget shortfalls that would create continuing pressure on legislatures to limit appropriations to higher education.

In contrast, the update outlined here comes at a time of brightened economic prospects. By 2005, the budget outlook was hopeful: short-term fixes (e.g., tapping reserves, reducing spending, allowing extraordinary increases in tuition, using nonrecurring sources of revenue), and rebounding tax revenues had eased the fiscal crisis in many states.

The question was: "What will happen after states restore financial equilibrium?" Would state and local finances return to the prosperity of the late 1990s, allowing state governments to increase spending, reduce taxes, and build reserves? Or would new gaps appear due to a disparity between underlying revenue structures and expenditure patterns?

SOMBER FISCAL OUTLOOK

The findings indicate that even as many state and local governments close their current budget deficits with regular sources of revenue (and not short-term fixes), all 50 states will face a gap between projected revenue growth and the projected cost of public services. Additionally, projected state revenues will not support real increases in spending.

Since state and local governments have substantially increased real per-capita spending in each of the last five decades, this conclusion suggests that ***either:***

- ★ State residents would have to scale back their appetite for government services.

or:

- ★ State residents would have to accept tax increases to finance new growth.

The study also finds, in 46 states, growth in demand for other services (such as K–12 education, social services, corrections, and Medicaid) will be greater than growth in demand for higher education. The rapidly escalating costs of Medicaid, more than anything else, explain why total state and local spending is projected to grow faster than spending for higher education. (Only in Nevada, New Jersey, Illinois, and Arizona are higher education's requirements expected to grow more rapidly than the needs of other state and local programs.) Continuing support for these other services will place enormous pressure on higher education budgets.

PROJECTIONS

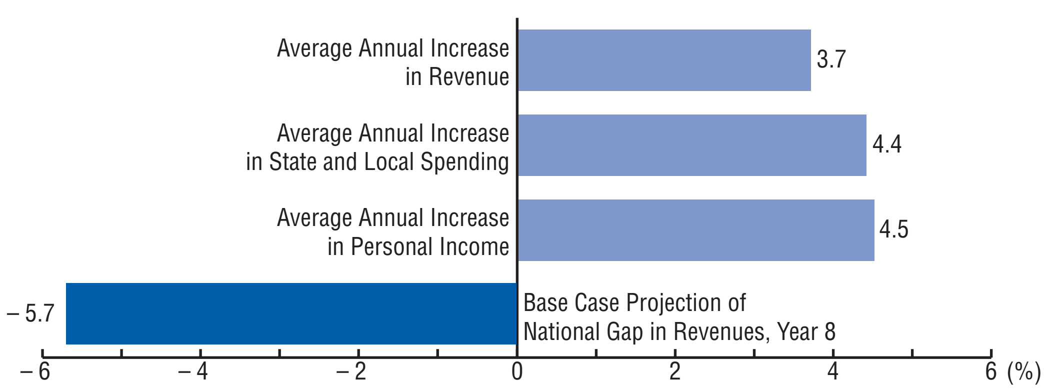
These conclusions are drawn from Base Case eight-year projections of likely revenues and expenditures required in each state to maintain current public service levels (1) given current revenue structures, (2) given conservative estimates of expenditures, and (3) projecting average, or "normal," state economic conditions. Assuming state and local governments balance their budgets in year one, states are still likely to face substantial gaps between revenues and the resources required to maintain current service levels into the next decade. Despite generally improved fiscal conditions, long-term projections call for structural budget deficits in every state.

THE NATIONAL PICTURE—SLOWED GROWTH

For the nation as a whole, the projections indicate that state revenues will be 5.7% lower than the level required to maintain current services.

- ★ Personal income, a broad measure of the economy, is projected to grow at an average annual rate of 4.5%.
- ★ State and local spending needed to maintain current services is projected to grow ***a bit more slowly*** than the economy, at an average annual rate of 4.4%.
- ★ Revenue, by contrast, is projected to grow ***considerably more slowly*** than the economy, at an average annual pace of only 3.7% (see Figure 1).

Figure 1.
Factors Incorporated in Developing Base Case 8-Year Projections (2005–2013)



Source: Donald Boyd, *State Fiscal Outlooks from 2005 to 2013: Implications for Higher Education* (Boulder, CO: NCHEMS, 2005).

THE STATE-LEVEL PICTURE—CONTINUING FISCAL STRESS

State-level projections indicate that every state faces at least a small gap, with 29 states looking at gaps of 5% or more. Recent economic gains and increases in state tax revenue make shortfalls in many states less than those that occurred in 2001 and 2002. The projections nevertheless suggest that state and local governments will face continuing fiscal stress.

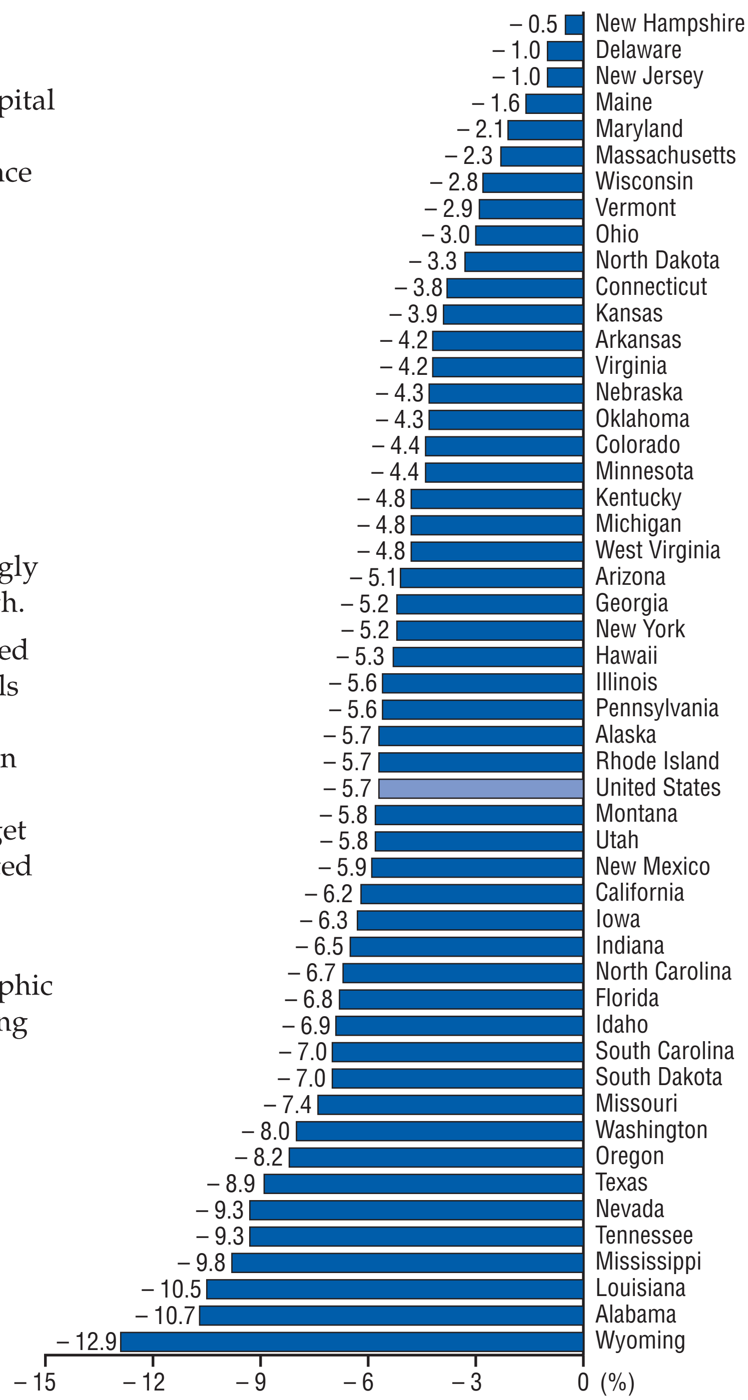
There are three main reasons for this condition.

1. ***Tax revenue*** will not grow as fast as the economy because:
   a. Economic growth is not projected to generate major annual surges in capital gains income. Stock markets unlikely to repeat the extraordinary performance of the late 1990s call for more modest growth assumptions.
   b. Sales tax revenues will decline due to the steady shift in consumption from goods to lightly taxed services, and the difficulty of collecting taxes on Internet-related transactions.
   c. Excise taxes will not keep pace with overall economic growth.
2. ***Spending*** in many states will be increasingly dominated by the cost of Medicaid growth.
3. ***The federal budget*** outlook has deteriorated dramatically, resulting in federal proposals to substantially cut state and local grants. The reduction in federal grants is the main reason why the fiscal outlook for states currently shows a potential average budget shortfall of 5.7% instead of 3.4% as reported in the 2002 analysis.

Projected conditions vary widely across states, depending on economic and demographic forecasts and the typical revenue and spending structures of each state. Figure 2 shows projected state and local deficits as a percentage of revenues in year eight (2013).

(continued on page 4)

Figure 2.
Projected State and Local Deficits after 8 Years, Calculated as Percentage of Revenue



Source: Donald Boyd, *State Fiscal Outlooks from 2005 to 2013: Implications for Higher Education* (Boulder, CO: NCHEMS, 2005).

50-STATE PROJECTIONS

Base Case projections of future budget conditions were developed for each state. In developing these projections, the study examined each state's revenue and spending structures and assumed, as a starting point, a balanced budget* in year one, i.e., after state and local governments address their current cyclical—or short-term—budget shortfalls. Thus the projected fiscal conditions are in addition to the shortfalls states will face as they continue to work off the effects of the 2001 recession.

Because they examine structural conditions, the analyses do not project actual surpluses or deficits. Instead, they look at fiscal imbalances (gaps between revenue and spending).

Actual state budgets in the year 2013 are likely to be balanced. But the projected imbalances shed light on the extent of pressure states are likely to face and the difficult choices they may have to make to maintain balanced budgets.

* By law, most states must balance their budgets at regular intervals. States either cut services or raise taxes if they encounter revenue shortfalls, and generally increase spending or cut taxes if they run a surplus.

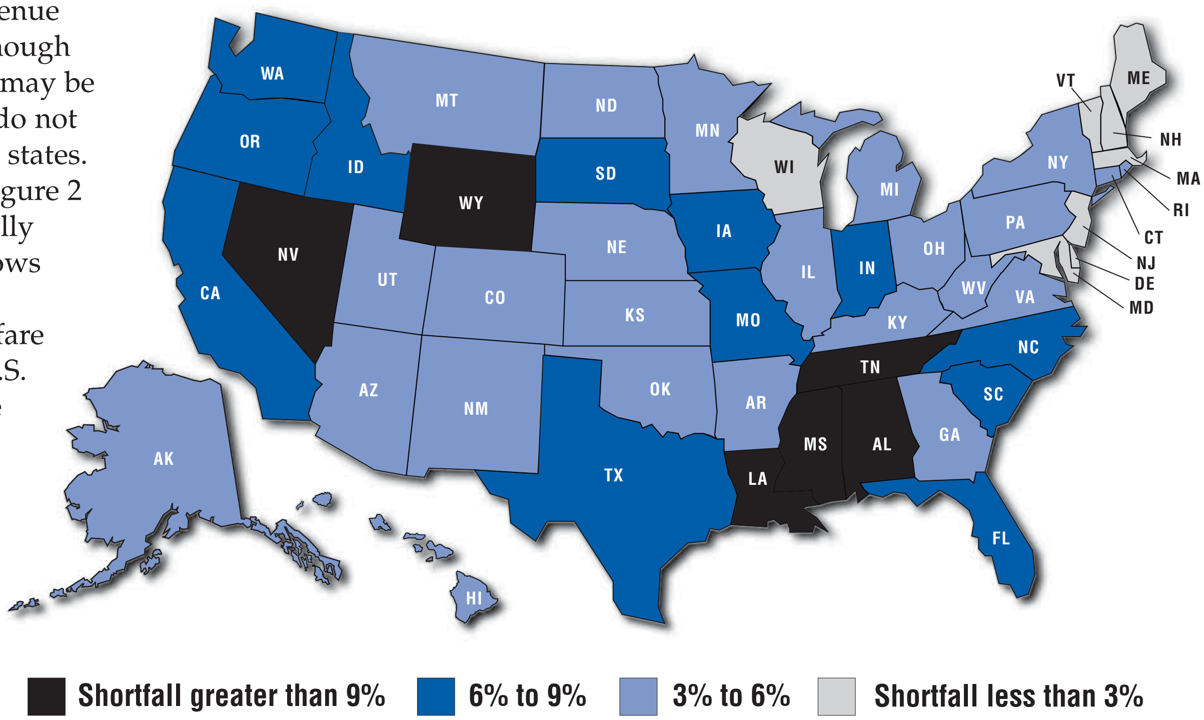
THE STATE-LEVEL PICTURE *(continued from page 3)*

All 50 states show potential revenue deficits, ranging from 0.5% in New Hampshire to 12.9% in Wyoming. Of the 10 states with the largest projected deficits, five (Nevada, Tennessee, Texas, Washington, and Wyoming) do not have an income tax. Of the four states with the next largest potential deficits, two (Florida and South Dakota) also do not have an income tax.

Wyoming, the state with the largest projected deficit, is an anomaly. One of the few states that has shown a robust economy in recent years, its large projected deficit results primarily from its heavy reliance on federal revenues, which are projected to decline an average of 3.3% per year in real per-capita terms.

The model assumes that all states will absorb these reductions in revenue proportionally, though federal revenues may be cut in ways that do not fall evenly across states. Displaying the Figure 2 data geographically (see Figure 3) shows that northeastern states in general fare better than the U.S. as a whole, while southern states fare worst.

Figure 3.
States' Projected Fiscal Shortfalls after 8 Years, Calculated as Percentage of Revenue



Source: Donald Boyd, *State Fiscal Outlooks from 2005 to 2013: Implications for Higher Education* (Boulder, CO: NCHEMS, 2005).

ALTERNATE SCENARIOS PROJECT DEEPER DEFICITS ... OR BRIGHTER PROSPECTS

Changing some of the Base Case projections' key assumptions would yield scenarios showing even more fiscal pressure on state and local governments.

It is reasonable to assume, for instance, that ample public support exists for increasing spending on K–12 education, given recent policies to raise standards, reduce class sizes, and raise requirements for teacher qualifications. The track record supports this assumption: in the 1990s, real per-pupil spending in K–12 increased by more than 1% annually; in the 1980s, it increased by approximately 3.3% annually; and in the preceding three decades, it increased on average by more than 2.4% annually.

"The reduction in federal grants is the main reason why the fiscal outlook for states currently shows a potential average budget shortfall of 5.7% instead of 3.4%..."

Deeper Deficits ...

These alternate sets of projections would paint a gloomier picture of the state fiscal environment:

- ★ If state and local governments increase real per-pupil spending in K–12 education by 1.5% annually—instead of none as assumed in the Base Case projections—45 states would face deficits of 5% or more, and the average projected shortfall increases from 5.7% to 8.6%.
- ★ If states increase spending in both K–12 education and higher education by 1%, results are similar, but the distribution differs across states: 44 states would face deficits of 5% or more, and the average shortfall is 8.4%.

Brighter Prospects ...

Under other plausible assumptions, fiscal prospects could improve:

- ★ If states were able to promptly stem sales tax losses related to Internet commerce, the average deficit falls from 5.7% to 4.5%, and only 20 states would face deficits of 5% or more.
- ★ If growth in Medicaid costs were slowed by 1% across the board, the average deficit falls from 5.7% to 4.5%, 49 states (rather than all 50) would face deficits, and only 21 would face deficits of 5% or more.
- ★ If there were no cuts in federal grants to states, the average budget deficit falls from 5.7% to 2.7%. This result highlights the interconnectedness of federal and state budgets and demonstrates the sensitivity of state budgets to federal actions.

CONCLUSION

This study concludes that despite recent economic gains, all 50 states face potential budget deficits by the year 2013.

- ★ States will face continuing difficulties in financing current services within the constraints of existing revenue structures, and will not have the resources to support real increases in spending.
- ★ If states solve current deficits through the extensive use of one-time revenue enhancements or spending reductions, then they will have to address continuing cyclical budget shortfalls in addition to these longer-term deficits.
- ★ For most states, it is difficult to see a future for higher education that recreates the prosperity of the late 1990s. Colleges and universities—and the students who enroll in them—are more likely to face continued financial strain.

Dennis Jones is president of the National Center for Higher Education Management Systems.

THE NATIONAL CENTER FOR PUBLIC POLICY AND HIGHER EDUCATION

The National Center for Public Policy and Higher Education promotes public policies that enhance Americans' opportunities to pursue and achieve high-quality higher education. Established in 1998, the National Center is an independent, nonprofit, nonpartisan organization. It is not associated with any institution of higher education, with any political party, or with any government agency.

The *Policy Alert* series is supported by grants to the National Center by The Atlantic Philanthropies and The Pew Charitable Trusts. The statements and views expressed in this report, however, do not necessarily reflect those of the funders, and are solely the responsibility of the author and the National Center for Public Policy and Higher Education.

152 North Third Street, Suite 705, San Jose, CA 95112. Telephone: 408-271-2699. FAX: 408-271-2697. www.highereducation.org