

The State Fiscal Crisis And Higher Education

The Hechinger Institute on
Education and the Media

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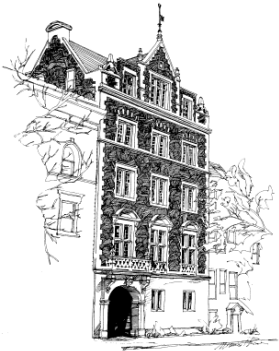
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Higher Ed.: 3rd Largest State Spending Area

State Government Spending in Fiscal Year 2002

Category:	Expenditures in \$ Billions			Category as % of Budget			Federal Funds as % of Total Funds
	State Funds	Federal Funds	Total	State Funds	Federal Funds	Total	
Elementary and secondary education	207.4	27.8	235.3	26%	10%	22%	12%
Medicaid	94.5	126.8	221.3	12%	43%	21%	57%
Higher education	106.1	14.7	120.9	14%	5%	11%	12%
Transportation	68.1	27.4	95.4	9%	9%	9%	29%
Corrections	38.8	0.9	39.6	5%	0%	4%	2%
Public assistance	12.6	10.8	23.4	2%	4%	2%	46%
Other	257.9	84.1	342.0	33%	29%	32%	25%
Total	785.4	292.5	1,077.9	100%	100%	100%	27%

Notes: (1) Much of "state" spending is from tuition funds, (2) amounts are estimates of 2002 actuals

Source: State Expenditure Report 2001, National Association of State Budget Officers, Summer 2002

Higher Education And Fiscal Crises

- A relatively large target
- Flexible funding – states often can make cuts while another party decides consequences (e.g., tuition hikes)
- Unlike Medicaid (#2 spending area):
 - not an entitlement
 - cutting state spending does not lead to large cuts in federal reimbursement
- Does not appear to have as much citizen support as K-12 education (#1 spending area)

The Current Crisis: Two-Pronged

This crisis has roots in two related problems:

- *Bursting bubble* - undoing of unsustainable trends of late 1990s
exacerbated by
- *Cyclical downturn*

Major Sources Of Risk In Typical State Budget

- **Tax revenue is volatile**, especially PIT, sales tax:
 - Taxes: 55% of state revenue
 - Income tax: 37% of taxes
 - Sales tax: 32% of taxes
- **Medicaid - far more volatile** than other state spending
 - *Large*: 21% of state all-funds budget, 12% of “own funds”
 - *Economically sensitive*: 1% pt. unemployment rate ↑ could cause \$2.7B spending ↑ (Holahan/Garrett, Urban Inst.)
 - *An entitlement*
 - *Hard to cut* – federal reimbursement; care standards

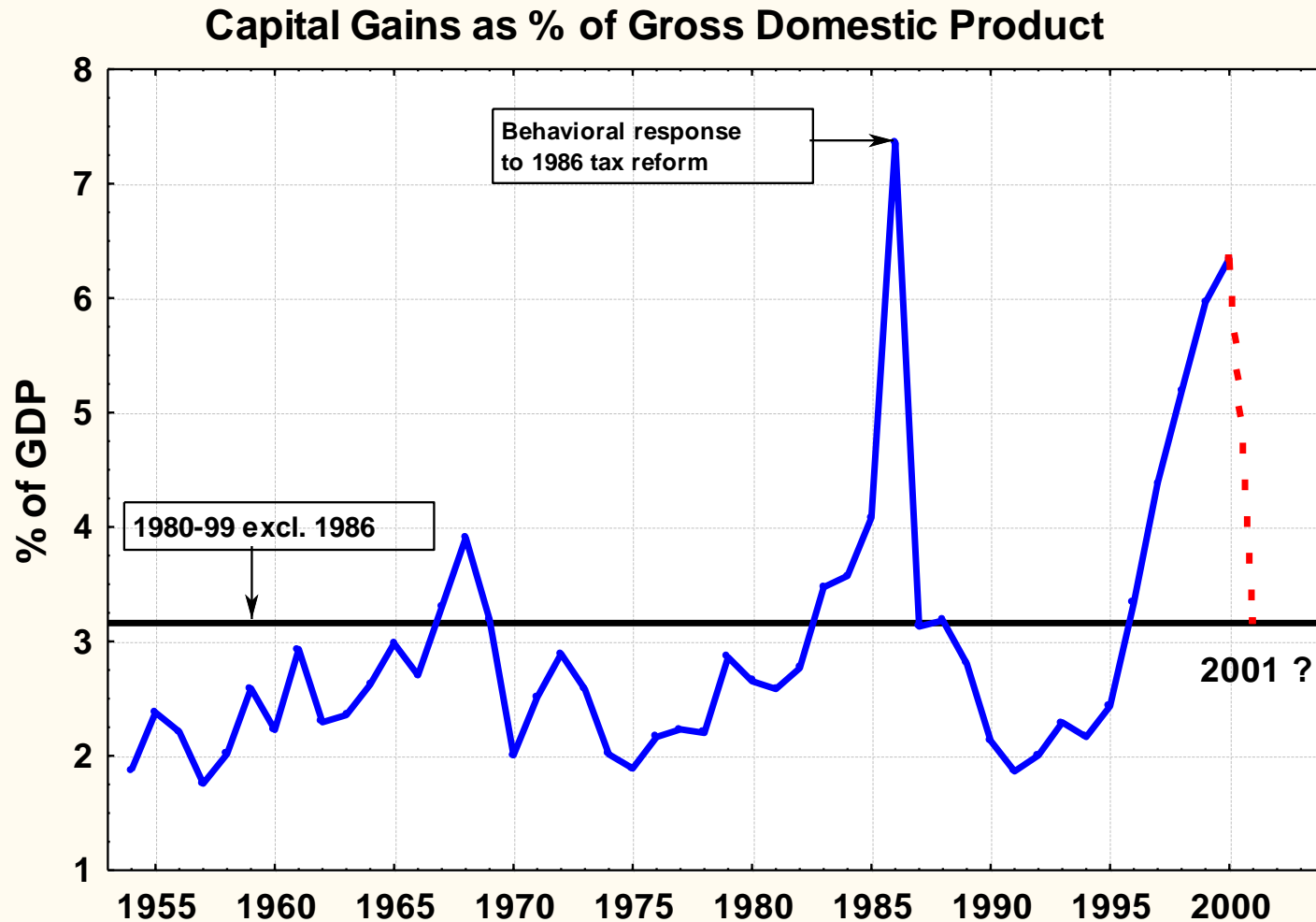
These are averages - state fiscal structures vary greatly

RECAP: 3 biggest risks - income tax, sales tax, Medicaid

Bubble Bursting: Many Favorable Trends of Late 1990s Now Stalled Or Reversing...

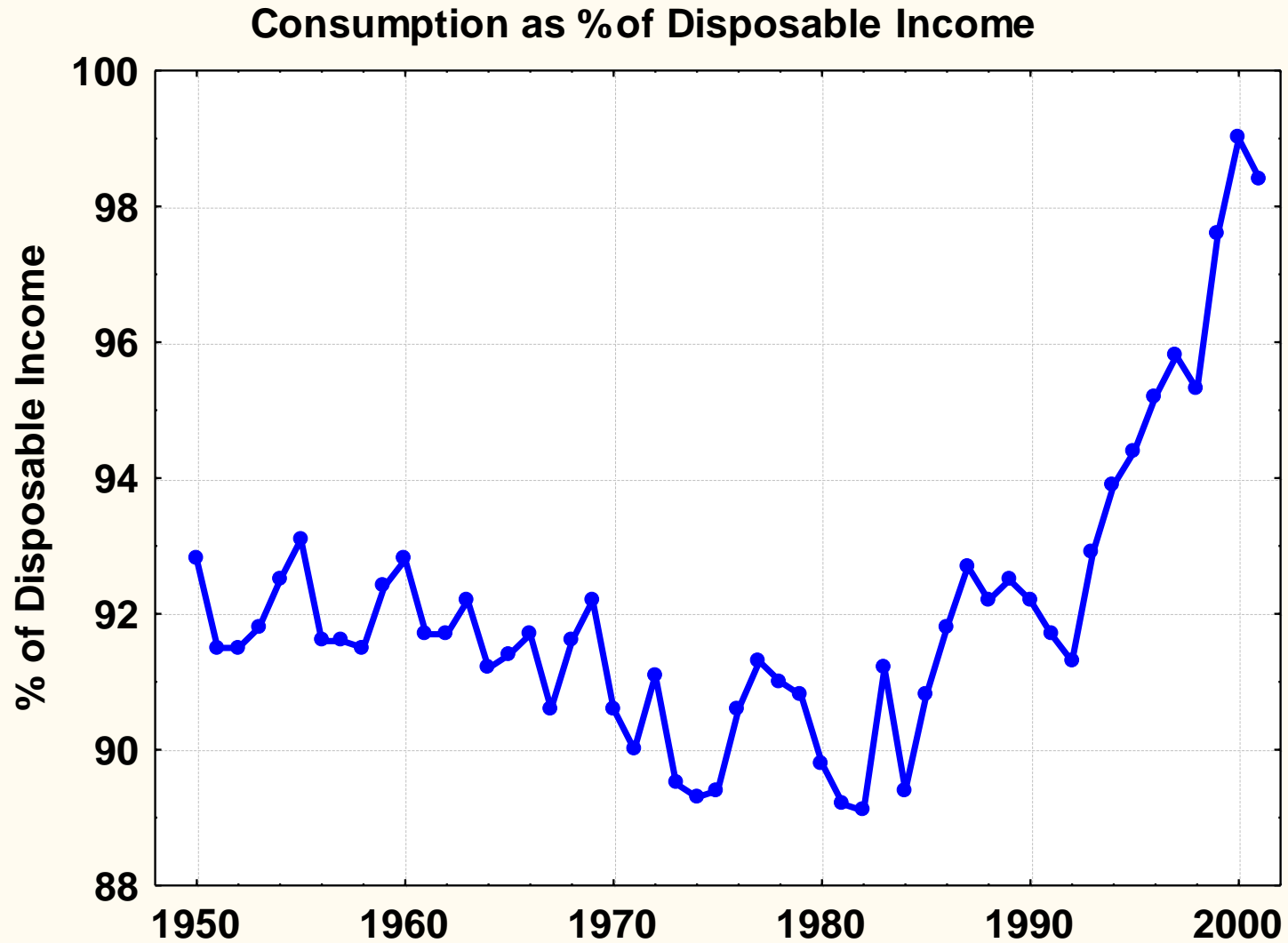
- ***Economy*** - growth in late 1990s consistently was higher than forecasted
- ***Financial markets, capital gains surged*** (27% average annual growth 1994 to 2000, quadrupling)
- ***Consumption soared*** (savings rate plummeted) and sales tax benefited
- ***Medicaid*** growth came to a halt
- ***Welfare windfall*** - caseloads fell, new block grant did not → “surplus” for states

Capital Gains Finally Dropped Like A Stone in 2001 – Worse to Come?



SOURCE: Internal Revenue Service, Statistics of Income Branch

Will Surging Consumption, Which Boosted Sales Taxes, Also Fall?



Tax Revenue, Once Booming, Is Now Crashing

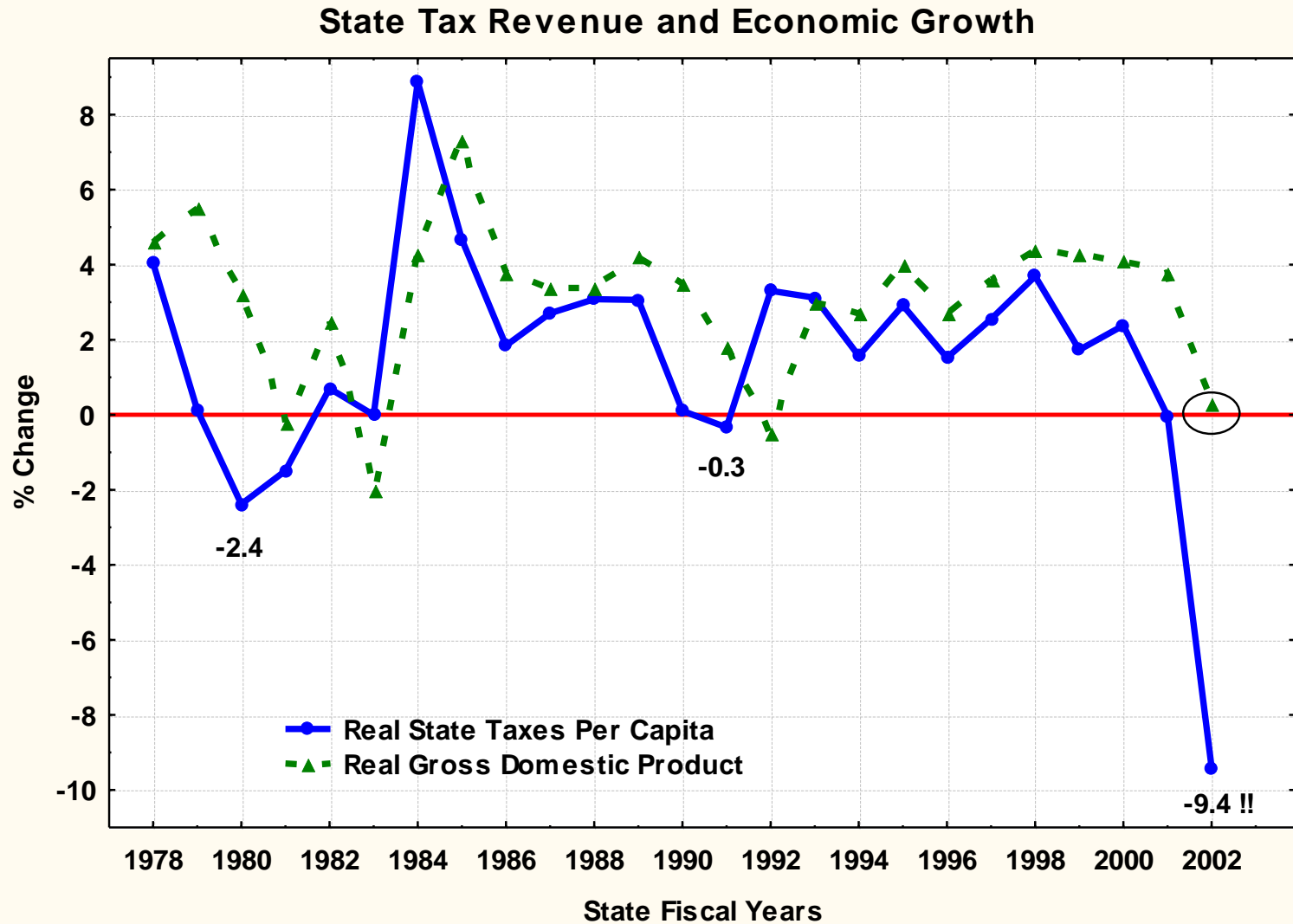
% Growth in State Tax Revenue

	Average: FY 1995 to FY 2000	FY 2001	FY 2002
Personal income tax	9.1	7.0	(12.0)
Sales tax	5.7	2.9	0.4
Other taxes	3.8	1.2	(5.8)
Total taxes	6.2	3.8	(6.3)

NOTE: Not adjusted for legislative actions. States cut taxes for every FY from FY 1996 through FY 2000, plus a little for FY 2001

SOURCES: U.S. Bureau of the Census, Rockefeller Institute

A Mild Recession But A Severe Fiscal Crisis



SOURCES: Bureau of the Census, Bureau of Economic Analysis, Rockefeller Institute of Government

Revenue Crash Is Widespread

- Most Recent Quarter -

Percentage Change in State Tax Revenue April-June 2002 vs. Same Quarter in 2001 *Adjusted for Legislation*

	Personal Income Tax	Sales Tax	Corporate Income Tax	Total Taxes
Far West	(37.4)	(0.8)	0.6	(21.9)
New England	(26.9)	2.7	(9.8)	(15.7)
Mid Atlantic	(21.8)	0.7	(41.1)	(14.8)
United States	(22.7)	0.1	(15.1)	(11.8)
Plains	(13.1)	(1.9)	(13.2)	(9.4)
Rocky Mountain	(14.8)	(0.8)	(26.6)	(8.8)
Great Lakes	(11.6)	(0.1)	(9.9)	(6.3)
Southwest	(11.2)	(2.3)	(20.7)	(6.2)
Southeast	(12.4)	2.1	(9.2)	(4.6)

Source: Rockefeller Institute of Government

Medicaid Cost Pressures

- FY 2001: overall growth accelerated to 10.9%; exceeded budget in 31 states
- FY 2002: estimated growth of 13%; 36 states exceeded original budget
- Growth surge driven by:
 - increases in prescription drug costs (now approximating 20% annually)
 - enrollment increases
 - increasing costs of long-term care
 - (plus efforts to maximize federal reimbursement)

SOURCES: Kaiser Commission/HMA survey,
National Conference of State Legislatures

Problems Large and Widespread

- FY 2002 budget gaps in 43 states, FY 2003 gaps in 40+
- Aggregate FY 2003 gap was at least \$49 billion [revised]
- 14 states had FY 2003 gaps of 10% or more of budget
AK, AZ, CA, IA, KS
MA, MN, MO, NJ, NY
NC, OR, RI, VA

SOURCE: NCSL

State Responses

- **Fund balances:** drawn down in 42 states in 2002 - from \$32 billion to \$18 billion; further declines in 2003
- **Special funds:** At least 23 states tapped capital, highway, other funds; 16+ used tobacco settlement money
- **Spending cuts:** At least 26 states cut 2003 spending plans: higher education (*at least* 16 states), corrections (14), and Medicaid (12) – with Medicaid cost containment planned in many states
- **Tax increases:**
 - $\geq 1\%$ in 16+ states, for \$6.7 billion, 40% of \$ was cigarette taxes
 - a few large broad-based tax increases – KS, IN, MA, NJ, TN – but these were exceptions, not the rule

CAUTION: tax and spending changes not always as large as they sound

SOURCE: mostly NCSL

Higher Education Responses

- Cuts in higher education were quite common:
 - per NCSL, 19 cut higher ed. in 2002, and 16 cut in 2003, more than any other major spending area
 - AASCU suggests cuts were even more common, occurring in 24 states
- Approximately 40 states raised tuition, or were poised to do so
 - Many increases in 5-10% range – more than double the rate of inflation
 - Some were much greater
- Cuts in higher education agencies were common

SOURCES: NCSL and AASCU

Multi-Year Implications of State Responses to Fiscal Crisis

- Revenue declines were too sharp and sudden for policymaking process to keep up
- Spending cuts and tax increases were not sufficient to close gaps
- States understandably take easiest actions first – fund balances, off-budget funds, defer spending, accelerate revenue
- **Result: states rolled problems forward** – “solutions” in many states include actions that postpone significant part of problem to the future, or that exacerbate future problems

Fund Balances Used Early, Tax Increases Continue During Recoveries

State Actions In Two Recent Recessions

Action as % of Expenditures

State Fiscal Year	Fund Balance Change	Revenue Enactments	Real Year-Over-Year Spending Change
<i>1980-82 Recession</i>			
1981	(4.6)	0.3	6.1
1982	(1.5)	2.4	(1.1)
1983	(1.4)	2.3	(6.3)
1984	2.3	6.0	3.3
1985	1.4	0.5	4.6
<i>1990-91 Recession</i>			
1990	(1.4)	1.8	2.1
1991	(2.3)	3.7	0.7
1992	0.7	5.1	1.9
1993	2.4	1.0	0.6
1994	0.9	0.9	2.3

Source: National Association of State Budget Officers,
Fiscal Survey of the States

Short-Term Outlook: BIG problems in FY 2003, 2004

- Economy, stock markets weaker than expected
- Tax collections deteriorating further, some shortfalls already
- Medicaid projections may be too optimistic: appropriations assume only 4.8% growth! (Kaiser/HMA Survey)
- FY 2003 “solutions” pushed problems into post-election 2004

Mid-Term Outlook: Continuing Pressure

- PIT: huge loss of income in top brackets means slower growth than in late 1990s (absent miraculous market recoveries)
- Sales tax - 3 negatives:
 - slower consumer spending growth
 - continuing shift to consumption of lightly taxed services
 - difficulty collecting tax on Internet/mail order sales
- Accelerating spending pressures in Medicaid (9+% growth), continued pressure on K-12 and higher education spending

Conclusion

Several years of
hard choices ahead