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POLICY MATTERS

States' Finances Strong Today, But Big Tests Loom

Context

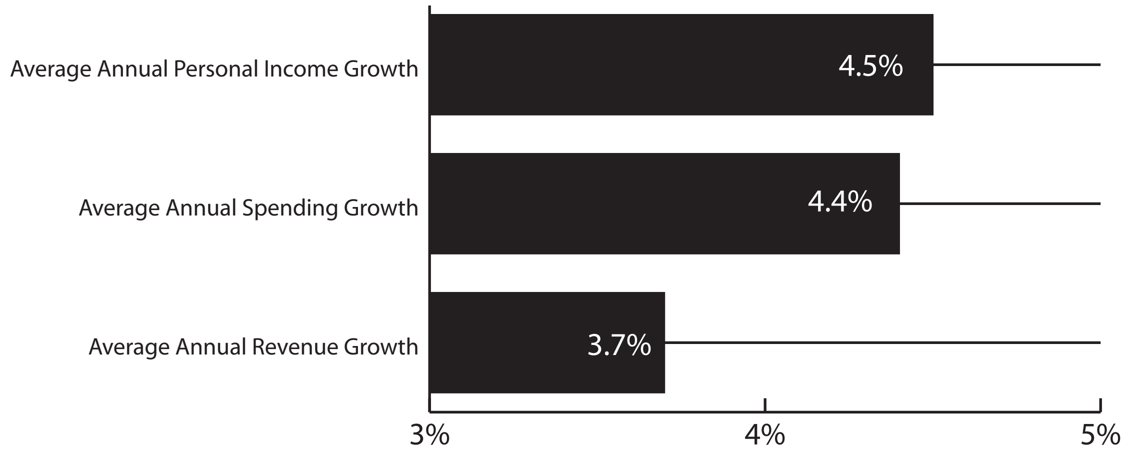
Over the past two years, the big headline in state capitals has been the return of strong revenues and expanding budgets. After a spate of mid-year spending cuts, layoffs, and tax/fee hikes, states are once again boosting spending and even putting tax cuts on the table, illustrating the boom/bust cycle of state fiscal conditions. Looking ahead, though, governors and legislators face a potent combination of internal and external forces that will test their ability to maintain and expand services such as higher education. Campus and system leaders and policymakers need to understand and carefully monitor these factors so that they can anticipate the potentially difficult choices ahead.

Observations

1. Concerns linger about the efficiency and productivity of states' tax systems, especially given current and expected spending demands. According to the Rockefeller Institute of Government, growth in state tax revenue is likely to lag the expected economic growth rate over the next decade due to a slowdown in capital gains collections, as well as a shift in consumption to lightly taxed or untaxed goods and services (including those purchased online). Specifically, the Institute expects that state revenues will grow at a slower rate than spending from 2005 to 2013. [see Figure] Data from the National Association of State Budget Officers (NASBO) underscore the likelihood of continued spending pressures, pegging average annual growth in state expenditures over the past three decades at 6.4 percent per year.

2. The aging of the population and continued escalation of health care costs will increasingly squeeze states on several fronts. Most significant and obvious in this respect is Medicaid, which continues to exceed budget writers' targets despite recent efforts by governors to revamp services and contain costs. NASBO reports that nearly half the states (22) experienced Medicaid shortfalls in Fiscal Year 2004 (FY04) and that more than half the states (26) anticipated shortfalls for Fiscal Year 2005 (FY05). Moreover, the Kaiser Commission on Medicaid and the Uninsured pegged Medicaid spending growth at 7.5 percent for FY05 and projects annual increases at that level or higher for the next several years.

Projections of Key State-Local Fiscal Indicators, 2005–2013



Source: Rockefeller Institute of Government, Fiscal Studies Program

A graying workforce poses another challenge for the states, in particular the funding of pensions for public sector employees. A recent analysis by the Standard and Poor's Corporation found that states' funding of their current and future pension obligations fell from 100 percent (full funding) in the late 1990s to 84 percent in 2004, a gap totaling $284 billion. States with seriously underfunded pension systems (some as low as 44 percent of obligations) are especially at risk, as they may be hit with rising liabilities at a time when programs such as Medicaid are already squeezing state revenues. This could spell bad news for "discretionary" services such as higher education because a significant amount of general fund revenues could be siphoned off for pension bailouts.

3. Prospects for federal grants-in-aid have dimmed considerably in the face of rising deficits and competing domestic and international priorities. According to the Center on Budget and Policy Priorities, nearly half of the proposed reduction in domestic discretionary spending in the President's Fiscal Year 2007 (FY07) budget ($7.5 billion of $16 billion) falls in the area of aid to states (health care, education, housing, law enforcement, etc.). Given the interest of the administration and congressional Republicans in extending the 2001 package of federal tax cuts and the mounting cost of the military's engagement in the Middle East, it is reasonable to expect that aid from Washington, D.C. will not keep up with service demands in the states. This will force governors and legislators to consider additional state funding, program reductions, or a combination of the two. Again, the likely upshot for higher education is an increasing squeeze on state funding.

4. Political forces also may have a tightening effect on state revenues. Tax cuts represent one area of interest. Enacted state revenue increases have dropped from $9.6 billion in FY04 to $2.5 billion in Fiscal Year 2006, with 14 states approving net tax/fee reductions in FY06 (up from just two in FY04). This trend is likely to continue in FY07, with overall net change perhaps re-entering negative territory for the first time in five years. These cuts, while politically popular, also will limit states' options in the face of rising service demands, federal funding reductions, and the ever-present possibility of an economic downturn.

Also gaining traction in a number of states are stringent tax and expenditure limitations (TELs), modeled after Colorado's Taxpayer Bill of Rights (TABOR). While more than half the states (31) already have some form of revenue or spending limit, TABOR represents the most restrictive form, capping both taxes and expenditures. The National Conference of State Legislatures (NCSL) reports that to date, 11 states have debated the implementation or expansion of a TEL, with potential ballot initiatives in two of these states (Ohio and Oregon). For higher education, Colorado's experience with TABOR is instructive—state funding for colleges and universities declined by 20 percent from Fiscal Year 2001 to Fiscal Year 2006 (the largest drop in the nation). While proponents and opponents of stricter TELs debate their long-term implications, it is clear that adopting them further limits states' options for squaring means and ends.

Conclusion

The old saying "timing is everything" applies especially well to states' fiscal decisions and prospects in the years ahead. Governors and legislators currently have an opportunity in a healthy economic climate to size up potentially threatening factors and make appropriate adjustments in policy. If state leaders do not take advantage of this opportunity, one or more of the forces cited here could easily emerge as a serious challenge to satisfying the mandate of a balanced budget. Even more sobering is the prospect of these pressures emerging in the midst of a sudden economic retreat, a scenario made more plausible in light of Hurricanes Katrina and Rita. The bottom line: the signs are pointing to more difficult times for state budget writers, and policymakers and higher education leaders should work together to develop scenarios and possible solutions that reflect proactive strategy rather than reactive crisis management.

Resources

Center on Budget and Policy Priorities. The Center on Budget and Policy Priorities is one of the nation's premier policy organizations working at the federal and state levels on fiscal policy and public programs that affect low- and moderate-income families and individuals. The Center conducts research and analysis to inform public debates over proposed budget and tax policies and to help ensure that the needs of low-income families and individuals are considered in these debates. It also develops policy options to alleviate poverty, particularly among working families. **cbpp.org**

Grapevine. Housed at the Center for the Study of Education Policy at Illinois State University, this resource includes current and historical trend data on state higher education appropriations. **coe.ilstu.edu/grapevine**

National Association of State Budget Officers. This organization publishes two primary resources on state fiscal conditions—the State Expenditure Report (annual) and the Fiscal Survey of the States (bi-annual). **nasbo.org**

National Conference of State Legislatures. NCSL's Education Committee follows a wide range of P-20 state policy developments and its Fiscal Affairs Division publishes regular updates on state budget developments and an annual assessment of state budget and tax actions. **ncsl.org**

The NCHEMS Information Center for State Higher Education Policymaking and Analysis. The Center provides state policymakers and analysts timely and accurate data and information that are useful in making sound higher education policy decisions. The Center is a comprehensive "one-stop-shop" for state-level higher education data and information and a leader in coordinating activities and securing funds for the collection of missing data and information that are crucial for higher education policy analysis. **higheredinfo.org**

Rockefeller Institute of Government, Fiscal Studies Program. Housed at the State University of New York-Albany, the institute tracks state revenue collections on a quarterly basis (State Revenue Report) and issues other reports on topics related to state finance. **rockinst.org**

State Higher Education Executive Officers (SHEEO). SHEEO publishes State Higher Education Finance, an annual look at state higher education spending on a per-student basis. SHEEO also compiles 50-state data on tuition/fee policies and other finance-related areas. **sheeo.org**

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