A NEW FUNDING PARADIGM FOR HIGHER EDUCATION

Session One

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The state fiscal landscape has changed dramatically in recent years. Undermined by the impacts of an 18-month recession—often dubbed the Great Recession—state budgets faltered. With revenue collections actually falling in most states, funding for many programs, including higher education, was cut. Always a target during economic downturns, higher education is now facing an entirely new funding crisis wrought by record state budget gaps and forecasts of anemic revenue growth. Although recently improving revenue performance could mitigate the funding squeeze, the environment for state higher education support might be permanently and unalterably different from the past.

Indeed, funding for all areas of state government is evolving, out of necessity. State spending is likely to grow more slowly than in past decades, with some areas, like higher education, possibly falling as a funding priority. More than ever, therefore, public higher education institutions and state officials will need to work together to ensure improved access and performance.

The State Budget Crisis in Perspective

Even before the Great Recession began in December 2007, many states were experiencing budget problems. Feeling the collapse of the residential real estate market earlier than others, states like Arizona, California, Florida and Nevada, were the tip of the proverbial iceberg. As the effects of the recession hit with full force, states across the nation saw revenue performance collapse. Every major tax source was affected to some extent. According to the Rockefeller Institute of Government, the personal income tax—a key revenue source in 41 states—fell the most (see figure 1).

![Figure 1: Year-Over-Year Percent Real Change in Major Taxes](source: The Nelson A. Rockefeller Institute of Government, State Revenue Report, August 30, 2010)
As job losses mounted and consumer spending fell, sales tax receipts in the 45 states levying the tax also declined. Other sources, from business taxes to real estate transfer taxes, also stumbled. The impact was far reaching: Every state except North Dakota saw year-over-year revenues fall. This occurred despite three-quarters of the states raising taxes at some point during the recession.¹

These declining revenues generated massive state budget gaps. From FY 2008 through the initial forecast for FY 2011, states faced and largely resolved a cumulative gap exceeding $400 billion (see figure 2). Although the recession officially ended in June 2009, many states continue to forecast budget gaps in FY 2012, FY 2013 and beyond.²

![Figure 2: State Budget Gaps FY 2002-FY 2013 (projected)](source: NCSL survey of state legislative fiscal offices, various years.)

Despite many looming challenges (discussed later in this paper), state lawmakers are starting to see some positive news on the revenue side of the ledger. In some states this means that the rate of revenue decline has slowed, but in others, nominal growth is occurring in one or more tax categories. With nearly every state forecasting improvement in FY 2011, it increasingly appears

¹ NCSL State Tax Actions, various years.
² NCSL, State Budget Update; July 2010 (Preliminary Report).
that FY 2010 was the trough for state collections. While this long-awaited news is welcome, it must be considered in the context of a bigger revenue picture. Specifically, it is important to consider how far revenues fell and when they are projected to return to their pre-recession levels.

Most states saw general fund revenue collections peak in FY 2008. Some of the key exceptions were Michigan (FY 2000), New York (FY 2006) and Arizona, Florida, Nevada, Oregon and South Carolina (FY 2007). Based on current law—that is to say absent any tax changes—state revenues have a long way to go before they return to pre-recession levels.

Twenty-eight states currently have projections for when general fund revenues will return to peak levels. As shown in figure 3, forecasters in three states (New Hampshire, Oregon and Texas) expect the rebound to occur in the current fiscal year. Eight others put the date as FY 2012 and another eight are looking at FY 2013. Estimators in four states (Florida, Georgia, Idaho and North Carolina) expect revenues to recover in FY 2014. Another four states (Arizona, Maine, Montana and New Mexico) do not foresee a return until FY 2015. At the far end of the projection spectrum is California, where officials do not expect revenues to hit pre-recession levels until FY 2016.

![Figure 3: Projected Return to Peak Revenue Collections](image)

Note: 20 states do not have return-to-peak forecasts.
Source: NCSL survey of state legislative fiscal offices, Summer 2010.

The good news about improving revenue performance is obviously tempered by the length of time it will take before collections return to their peak levels. Exacerbating this concern is the phase out of federal stimulus funds from the American Recovery and Reinvestment Act (ARRA) of 2009. These funds will largely disappear by FY 2012. State officials do not see revenue performance recovering strongly enough to replace these lost funds. In fact, many state officials

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3 NCSL Fiscal Brief: Projected Revenue Growth in FY 2011 and Beyond.
report the end of ARRA money is contributing to projected budget gaps in the coming years. Higher education budgets are feeling the impact as well.

According to preliminary figures, at least $5.3 billion in ARRA funds went to higher education in fiscal years 2009 and 2010. In addition to these funds, the Recovery Act provided $16 billion in funding for student aid: $15.5 billion for Pell grants and $500 million for work study programs. With these extra federal funds scheduled to expire soon, higher education institutions face additional challenges. Not only are they losing general support, funding for financial aid programs to help cushion rising tuition levels is ebbing. It is unlikely that state revenue growth will be able to make up the difference for several years, if ever. With federal deficits expected to be high for years to come and state resources scarce, it is likely that future growth for general operations and financial aid will be limited at best.

The Evolving Landscape for Higher Education Funding

Although state higher education funding has increased over time, its share of state funds has decreased somewhat in recent years. The percentage of total state funds devoted to higher education over the last 15 years averaged 10.6 percent, peaking at 11.4 percent in FY 2000—the height of the dot com boom—and falling to a low of 10 percent in the economically troubled recovery year of FY 2010. Considering only general funds (money from revenue sources like state sales and income taxes), the share of general funds devoted to public universities averaged 12.2 percent over the last 15 years. Higher education’s share of general funds peaked at 13.1 percent in FY 1998. It was 11.3 percent in FY 2009 and 11.9 percent in fiscal FY 2010.

Higher education is in stiff competition for state funds and its share of the budget has been affected by significant funding increases for large and high priority budget items like health care programs, especially Medicaid. General fund spending for Medicaid increased from 14.4 percent of the state budget in FY 2000 to 15.4 percent in FY 2010. K-12 education, which often is protected during economic downturns, actually saw a decline from 35.7 percent of the budget in FY 2000 to 35.3 percent in FY 2010.

As the chart below shows, some parts of state general fund budgets increased faster than funds for state higher education.

![Figure 4: Percentage Growth in Spending Categories Between FY 2000 & FY 2010 (General Funds)](chart.png)

Sources: NASBO 2001 and 2009 State Expenditure Reports
on. In 10 years, funding for K-12 education increased by 30.7 percent and funds for Medicaid grew by 35.6 percent. Funds for higher education rose by 23.2 percent. Overall general funds increased by 32 percent over this period. Although the share of state funds devoted to higher education has decreased, it is important to note that the overall amount spent on higher education has increased. States spent $58.1 billion FY 2000, and this amount increased to $71.6 billion in FY 2010. All areas of state budgets have seen increased funding over the last 10 years. K-12 education saw an increase of $211.9 billion in FY 2010 from $162.1 billion in 2000. Funding for Medicaid grew from $67.9 billion in FY 2000 to $92.1 billion in FY 2010.

Funding for public higher education has been volatile over time. States usually are generous to higher education in good fiscal periods, only to cut significantly during severe revenue downturns. In fact, state funding to higher education experiences outright declines during recessionary periods. For instance, state spending for higher education was nearly $62 billion in FY 2002, but dropped slightly to $61.6 billion in FY 2003 and was down to roughly $60 billion in FY 2004. Affected again by the latest recession, state higher education spending is estimated to total $71.6 billion in FY 2010, down from $74.8 billion in FY 2008. Recession periods have led to an unfortunate—and almost unique—cycle of state funding for higher education. A long time budget director in Ohio and Illinois, the late Hal Hovey provided analysis in the 1990s about this volatile cycle in state budgeting. According to Hovey, states use higher education as a “balance wheel” during economic downturns. Essentially, states cut higher education funding in bad fiscal times (allowing significant tuition increases to make up for the reductions) but then dramatically increase higher education spending when state revenues rebound. A group convened by the National Center for Public Policy in Higher Education (NCPPHE) put it more starkly when they said in a 2009 statement, states “follow past patterns of responding to revenue shortfalls by shifting the financial burden [of higher education] to students and their families and by shutting out undergraduate students. Even when growth returns, states will still face structural budget deficits.”

More recently additional data on this issue of cyclical funding for higher education has been analyzed by William Doyle of Vanderbilt University and Jennifer Delaney of the University of Illinois at Urbana-Champaign. They analyzed data on state support for higher education between 1979 and 2007 and demonstrated the volatility in higher education funding. Echoing Hovey’s point, they write, “When state revenues are low, higher education is an attractive option for heavy cuts because it has the ability to collect fees for its services (an ability lacking in most other state spending categories). When states revenues are high, higher education is a politically attractive area on which to spend money.” This past recession has been no different with

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declines in state support for higher education (along with significant cuts to nearly all parts of state budgets) and increases in tuition.

**Key Concerns Looking Ahead**

Will the historical pattern of higher education funding hold true this time around? It is impossible to consider this question without looking at the bigger state fiscal picture and the pressures on state budgets. As already noted, two key concerns are the length of time before revenues rebound and how to replace receding federal stimulus funds. Lawmakers also face other, equally compelling, claims on limited state resources.

*Some Broad Issues.* Recessions generate new spending demands as more people become eligible for safety net programs like Medicaid and Temporary Assistance to Needy Families. Even programs like these have not been immune to budget cuts as lawmakers have attempted to close massive budget gaps.

Another concern is the impact of further budget cuts on state programs. Higher education funding is certainly an example. Many lawmakers are concerned that more cuts—which are likely given looming budget gaps—will ultimately undermine programs so dramatically that they will lose their effectiveness or ability to reach intended recipients.

Unfunded pension liabilities and other retiree costs are yet another growing pressure point in state budgets. Recognizing that these unfunded obligations are significant and needed to be addressed, many states began chipping away at the liabilities when revenue performance was strong. But the recession’s impact on state revenues has all but ended these efforts.

*The Feasibility of Raising Taxes or Other Revenues.* Three-quarters of the states raised taxes since 2008. Now that the recession is over and collections are starting to pick up, it will be increasingly difficult to raise taxes again—even though many states still face large budget gaps. Some believe that tax increases will undermine a fledging recovery or simply are not needed. This will concentrate gap-closing actions on the spending side of the budget.

*The Competition for Scarce Resources.* With the prospects of further tax increases low and anemic revenue performance high, state revenues will remain tight for the foreseeable future. The competition for these limited resources will continue to be fierce, with programs that have other sources of revenue—higher education, for instance—likely to lose priority in allocation decisions.

*The Impact of Voter-Approved Ballot Measures.* Nearly half the states allow the initiative or referendum process. Voters in 21 states considered passage of several significant fiscal ballot measures in November 2010. Several of the measures that passed will necessitate new gap-closing decisions in the short term. Others impose new or higher spending commitments without providing new sources of funding. These are important developments because they underscore
the influence of the electorate in making major state fiscal policy decisions, in some instances overturning delicately negotiated legislative-executive decisions.

Federal Actions Affecting States. States are affected by federal fiscal policy decisions because they receive federal aid and often tie their tax provisions to the federal code. But there is a heightened potential for state impacts as federal officials focus renewed attention on addressing the federal deficit. The National Commission on Fiscal Responsibility and Reform is scheduled to release its initial report on Dec. 1. State lawmakers are bracing for recommendations from the Commission—or in the President’s February budget submission—that could adversely affect state budgets.

What’s Ahead for State Higher Education Funding?

If the funding environment for higher education is evolving into something new—and evidence suggests it is—what does that mean for the future of public higher education and the relationship between states and public higher education institutions? What opportunities for reform and streamlining does a new funding environment encourage?

With the fiscal situation so dire for states going forward, the higher education funding model is unsustainable. The states’ ability to be generous to higher education in times of economic growth may recede. Even with a stronger economy and a better fiscal situation for states, the increased demand for funds—for unfunded pension liabilities, health care, corrections and other parts of the state budget—will make it difficult for recent higher education cuts to be restored. Indeed, stepping back to view state budgets in a larger context, many state budget experts anticipate “a new normal” of state spending growth that will be much lower than what states were accustomed to in the past.

On a nominal basis, state spending growth has averaged 5.5 percent annually over the last few decades. Economic forecasts for slower growth—the new normal—make this scenario unlikely to continue. Average spending growth may actually be closer to 3 percent to 4 percent on a nominal basis, in line with slower national economic growth. Consequently, even if states want to be generous to higher education, they may not be able to be. With resources even scarcer, lawmakers are going to be asking administrators tough questions about state-supported programs and this will include higher education. State officials will be reluctant to provide funding increases unless they know how the money will be spent and that there will be an improvement in program performance.

Some of the questions finance officials will be asking are:

- How can higher education be more efficient?
- How can increased funding be tied to increased performance?

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- Can duplicate or similar programs be consolidated?
- Are there too many public higher education institutions in the state?
- Are senior higher education employees adding value?
- Are all degree programs at each school necessary?

State officials, for example, will be less patient with universities that have empty classrooms for significant portions of the day, or that cannot accommodate all of the students who want a particular course. State officials also will be less patient with institutional duplication. Too often, each separate institution within a public university system wants to do what its peers are doing, leading to extensive duplication. When the institutions are able to complement each other rather than duplicate, funds can be allocated more efficiently. Increases in appropriations for the institutions will need to lead to increased performance in some way.

Tuition at universities has increased roughly 2 percent to 3 percent faster than the rate of inflation over at least the last decade. Granted, in some cases universities are simply replacing lost state dollars, but state officials still want to understand whether this is always necessary and when institutions should seek to be significantly more efficient. One major concern among state officials was raised by a recent study that found that much of the new incoming revenue to institutions was not necessarily spent on educating students or producing degrees. As Jane Wellman with the Delta Project states, “the funding problem in American higher education is as much about focus and priority as it is about revenue.”\(^9\) She and others propose a serious commitment among state and education policy leaders to set goals, align spending with those goals, improve degree productivity and improve public accountability. Goals need to be based on the public’s needs not necessarily on the interests of individual public institutions.

Funding has rarely been tied directly to results and performance in the case of higher education but the scarce resource environment at the state, and ultimately at the federal level, may cause this to change. More and more officials are focusing on the importance of accountability. There will be opportunities in the states to adopt different approaches to this dilemma and in fact there are some examples to examine. Mississippi, for example, is working to align spending with set goals. The University of Maryland has embarked on an efficiency initiative that has many successes so far. There are many other state examples of seeking to improve institutional performance and ensure the money is being spent wisely.

The bottom line is: Money will be tight for all areas of state government. The ability of states to fund higher education at previous growth rates may be limited and in many states not possible. The old pattern of making up for significant cuts with generous increases to higher education when good times return may no longer be possible. With resources so scarce, state officials will increasingly expect improved efficiency and funding tied to outcomes and results. Working with

university systems, state officials can improve the situation by determining ways to provide more predictable revenue to higher education. At the same time, public university officials will need to understand and acknowledge the “new normal,” and determine ways to improve efficiency and performance.