



UNDERSTANDING STATE AND LOCAL HIGHER EDUCATION RESOURCES



Prepared for the

NATIONAL COMMISSION ON FINANCING 21ST CENTURY HIGHER EDUCATION

By: Sandy Baum and Kim Rueben, The Urban Institute



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LETTER FROM THE COMMISSIONERS

The University of Virginia Miller Center created the National Commission on Financing 21st Century Higher Education in 2014 to recommend policy and funding changes to help the nation attain the goal of 60 percent of the labor force with a postsecondary degree or certificate by 2025. This means that 62 million Americans must graduate with a postsecondary degree or credential between 2015 and 2025. At current rates, the United States will produce only 39 million such graduates, leaving a gap of 23 million—a shortfall of more than 2 million per year.

To meet the goal, the nation must maintain high school graduation and college entrance rates at or above 75 percent and 70 percent, respectively—reachable goals close to historical norms. The nation must also *increase* college graduation rates from 40 percent to 60 percent. Increasing the college graduation rate is inherently challenging but made even more so because of major demographic changes. Many of the upcoming college-aged individuals will be people of color or from low-income families, populations that traditionally have needed additional counseling, mentoring, academic support, and financial assistance to successfully enter into and complete higher education. How to increase access and graduation rates and thus equality for these two population groups is the major focus of the commission.

The need to address these issues is also urgent given that other nations are catching up to—and even surpassing—the United States in postsecondary degree- and credential-attainment rates. The United States ranked 13th relative to other Organization for Economic Cooperation and Development countries in 2014 in the percentage of 25- to 34-year-olds with higher education degrees or credentials. The cost of failure in attaining this goal—to the nation in terms of international leadership and to citizens in terms of job creation and income—is too high, and so action is required now.

To learn more about these issues, the commission engaged highly qualified experts to create 10 white papers on different dimensions of the higher education problem. The commission asked all the authors to push the limits of their knowledge and engage in “blue sky” thinking on individual topics. Each paper represents the views of the individual authors, not the commission. Nevertheless, the papers provide a foundation for the recommendations in the final report. In addition, the commission hopes the papers stimulate further discussion and debate about higher education policy and funding.

The 10 papers and the final report focus on answering three primary questions related to reaching the 60 percent goal. First, how do we realign incentives and retarget existing public funding to make the entire system more efficient and to increase graduation rates for students generally and students of color and from low-income families in particular? Second, what are the new, innovative models to deliver postsecondary education that can both lower the cost and increase the productivity of the entire system? Third, what options do federal and state governments and the private sector have for increasing funding for higher education? It is important to stress here that the interest is in the “value proposition” that underlies these three primary questions. The “value proposition” focuses on the national imperative of building a more highly skilled and educated work force not merely a more credentialed one.

The U.S. higher education system is still the envy of the world, but it must become more affordable for the next generation. It must also become more innovative and adaptable, especially in its use of technology, and be more productive with regard to graduation rates. Finally, additional funding must be available from federal, state, and private-sector sources to reach the goal.

NATIONAL COMMISSION ON FINANCING 21ST CENTURY HIGHER EDUCATION

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WHITE PAPERS WRITTEN FOR THE NATIONAL COMMISSION ON FINANCING 21ST CENTURY HIGHER EDUCATION

Paper 1. Crowded Out: The Outlook for State Higher Education Spending

Authors: Dan White and Sarah Crane, Moody's Analytics

Paper 2. Transformations Affecting Postsecondary Education

Author: Jeffrey J. Selingo, Arizona State University and Georgia Institute of Technology

Paper 3. State Higher Education Finance: Best Practices

Authors: Martha Snyder, Brian Fox, and Cristen Moore, HCM Strategists

Paper 4. Financing American Higher Education in the 21st Century: What Can the United States Learn From Other Countries?

Author: D. Bruce Johnstone, professor, Higher and Comparative Education Emeritus, University at Buffalo

Paper 5. State Strategies for Leveraging Employer Investments in Postsecondary Education

Authors: Robert Sheets and Stephen Crawford, George Washington Institute of Public Policy, The George Washington University

Paper 6. Understanding State and Local Higher Education Resources

Authors: Sandy Baum and Kim S. Rueben, Urban Institute

Paper 7. New Directions in Private Financing

Author: Andrew P. Kelly, American Enterprise Institute

Paper 8. Higher Education: Social Impact Bonds and Income Share Agreements

Author: Carlo Salerno, higher education economist/analyst

Paper 9. State Support for Higher Education: How Changing the Distribution of Funds Could Improve College Completion Rates

Author: Bridget Terry Long, Harvard Graduate School of Education

Paper 10. The Federal Role in Financing 21st-Century Higher Education: Effectiveness, Issues, and Alternatives

Author: Gabriel R. Serna, Virginia Polytechnic Institute and State University

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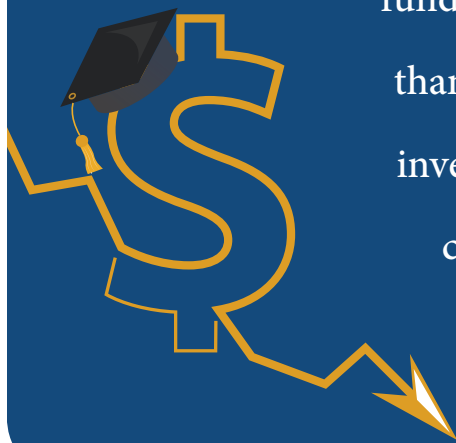
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Executive Summary

The number of students enrolled in public colleges and universities in the United States was 24 percent higher in the fall of 2014 than at the beginning of the 21st century.¹ Yet state and local governments devoted a lower share of their resources to higher education and currently fund a smaller portion of the cost of educating students than they did then. This shift in how we pay for the investment in higher education results more from changing pressures on state budgets than from a deliberate decision to shift responsibility from taxpayers to students and their families.



Although driven by pressures from other spending areas, this decline in higher education funding creates serious problems for the nation's future. The United States needs a more educated population if we are to meet the needs of an increasingly competitive world economy. Strong, stable funding is a prerequisite to supporting the increasing percentage of the population that must earn college credentials to realize financial security.

Finding strategies to reverse this trend requires a clear understanding of the revenue options for state governments and of the alternative potential structures of subsidies for college students. In addition, it requires understanding how we are currently spending our higher education dollars and determining whether part of the solution may be rebalancing resources to increase access and completion for a wider array of students.

To lay the groundwork for a more equitable and efficient funding system, this paper first examines the choice between financing college through general tax revenues and through user fees—called *tuition* in the higher education context. We then focus on how public funds are provided, distinguishing between appropriations for higher education institutions and grant aid awarded directly to students. We review the differences across states in their revenue sources, which may be (1) either a variety of tax structures or

¹ National Center for Education Statistics, "Digest of Education Statistics 2015," Table 303.20, https://nces.ed.gov/programs/digest/d15/tables/dt15_302.20.asp (accessed April 13, 2016).

nontax revenues such as lotteries or (2) either from sources dedicated to higher education or part of general government resources. We examine how these revenue sources have changed over time and how they relate to evolving economic circumstances. Finally, we seek solutions to known funding problems, considering ways in which governments might influence institutional priorities, generate new revenue, and develop strategies to dampen the cyclical variation in funding levels.

Throughout our discussion, we emphasize differences across states in their levels and patterns of higher education funding, tuition levels, and available revenues. This variation, which often reflects historical differences in the structure of higher education and the industrial mix in states, generates considerable inequality in educational opportunities across the nation.

Funding Public Services: User Fees vs. Tax Revenues

Some publicly provided services are funded through general tax revenues. Others are funded either through dedicated taxes, usually related to the service, or through user fees. For example, federal, state, or local revenues support national defense, the judicial system, and fire departments, but gasoline taxes (federal and state) are almost exclusively used to fund transportation. Social Security payroll taxes are earmarked only for that program. Some localities pay for garbage collection out of property tax revenues, while others charge residents based on their use of the service. National parks charge entrance fees, some highways charge tolls, and city swimming pools usually charge for admission.

Often the choice of a financing mechanism is clear. In the case of pure public goods, it is not possible to exclude nonpayers. The government cannot provide national defense only to those individuals who volunteer to support the armed services or spray only the mosquitos surrounding residents who pay a pest control fee. User fees are simply not feasible under these circumstances. Moreover, congestion is not a problem for these public goods. Individuals are no less safe or mosquito free when others also benefit from the service. The number of residents does not affect the cost of spraying.

In other cases, there is a choice. The sanitation department does not have to pick up garbage from the homes of people who choose not to pay a fee—indeed, it takes more labor hours to serve more customers—but there may well be impacts of such a choice on third parties. The neighborhood may suffer if some residents choose to let their trash pile up rather than pay to have it collected. In fact, if trash is not picked up, the cost of mosquito abatement may increase, illustrating the interrelatedness of public services. How governments fund such services is a judgment call, and different communities make different choices about who provides and who pays for trash collection.

The same is true of higher education. The state can charge user fees for public colleges and universities, with *tuition* being just another word for *user fee*. Overall, 30 percent of state and local higher education dollars as reported in Census of Governments data comes from tuition and related charges, an increase from 22 percent in 1983, but with considerable variation across states. User fees allocate the costs of the public service according to individual consumption levels. These fees frequently pay only a portion of the total cost of the service, with tax revenues covering the remainder. Taxpayers who never go to national parks pay less of the cost of maintaining those parks than individuals who choose to vacation there. Likewise, those who do not enroll in public postsecondary institutions pay less of the cost than those who go to college.

What are the relevant arguments for and against user fees in cases where it is possible to exclude nonpayers? A key issue is who benefits. Some advocates of free or low tuition contend that higher education is a public good for which individuals should not have to pay—or at least not have to pay much.² Higher education is *not* a pure public good, however, in the sense that national defense and mosquito control are. It is possible to exclude nonpayers and it is more expensive to educate more students. Moreover, congestion can be an issue in that a crowded campus can detract from the educational experience and may hinder degree completion if required courses are oversubscribed or unavailable.

Moreover, students reap a significant portion of the benefits of higher education personally—both financial and nonfinancial. When individuals go to college, they may well enjoy the activity and the environment. Students will learn and will have experiences that open doors for the rest of their lives. Assuming students complete degrees, they will significantly increase their earning potential.

Higher education is *not* a pure public good, however, in the sense that national defense and mosquito control are.

That said, our society and our economy also benefit when people go to college. People who have a college education tend to earn more than those who do not, but their higher earnings do not reflect the whole of their contribution. Other people who work with college graduates earn higher wages because of the added flexibility, innovation, and productivity of the labor force.³ People who have a college education tend to be more active citizens, their volunteerism and civic activities benefiting those around them.⁴ There are more new products and services for all of us to enjoy because of the contributions of college graduates.⁵ And, as these graduates' earnings increase, tax revenues also increase—especially for the federal government and states dependent on a progressive income tax that taxes those in higher-income brackets at higher rates.

Because there is a public good component of higher education there is a justification for some public support in addition to user fees. It is not an either/or question of public versus private benefits.⁶ Individuals benefit financially and otherwise from postsecondary education, but society gets some fraction of the benefits, as well. The positive externality means that public subsidies of higher education are efficient. The market overproduces

goods and services with negative spillover effects, and it underproduces goods and services with positive externalities. Rational individuals will make their college-going decisions based on their own costs and benefits. They will not be willing to bear the cost of improving society.

² Kenneth Warren and Samir Sonti, "Nobody Should Have to Pay to Go to College," *Chronicle of Higher Education* (December 16, 2015), <http://chronicle.com/article/Nobody-Should-Have-to-Pay-to-Go-to-College/234612> (accessed April 14, 2016); Sarah Hebel, "From Public Good to Private Good: How Higher Education Got to a Tipping Point," *Chronicle of Higher Education* (March 2, 2014), <http://chronicle.com/article/From-Public-Good-to-Private-Good/145061> (accessed April 14, 2016); and Catherine Rampell, "Catherine Rampell: Higher Education Went From Being a Public Good to a Private One," *Washington Post*, May 22, 2014, http://www.washingtonpost.com/opinions/catherine-rampell-higher-education-went-from-being-a-public-good-to-a-private-one/2014/05/22/50263a16-e1bd-11e3-9743-bb9b59cde7b9_story.html (accessed April 14, 2016).

³ Enrico Moretti, "Estimating the Social Return to Higher Education: Evidence From Longitudinal and Repeated Cross-Sectional Data," *Journal of Econometrics* 121 (2004): 175–212, <http://eml.berkeley.edu/~moretti/socret.pdf> (accessed April 14, 2016).

⁴ Sandy Baum, Jennifer Ma, and Kathleen Payea, *Education Pays: The Benefits of Higher Education for Individuals and Society* (New York: The College Board, 2013).

⁵ Sandy Baum and Michael McPherson, "Is Education a Public Good or a Private Good?" *Chronicle of Higher Education* (January 18, 2011), <http://chronicle.com/blogs/innovations/is-education-a-public-good-or-a-private-good/28329> (accessed April 14, 2016).

⁶ Some analysts argue that individuals should pay for their own education out of their future earnings without public subsidy. See George Leef, "College Education Is Not a Public Good," National Association of Scholars Blog, entry posted June 28, 2012, http://www.nas.org/articles/college_education_is_not_a_public_good (accessed April 14, 2016).

The difficult question is not so much whether the cost should be split between students and taxpayers but rather what the appropriate breakdown should be. In other words, it is not difficult to argue for user fees in principle, but it is very difficult to determine how high those fees can be before they represent an abdication of social responsibility. It is also important to remember that students, by definition, bear the significant portion of the cost of education represented by forgone earnings. Students must devote time to education, and they are not financially compensated for that time until it pays off in the form of higher wages. Moreover, tuition increases may prevent some students from enrolling or completing their studies, leading to fewer degrees and diminished benefits for both students and society.

If, however, there are no tuition charges, taxpayers must pay the entire cost of higher education. In exchange for not paying tuition while they are in college, students will have to pay higher taxes later to fund the tuition-free education of future students. Of course, not everyone goes to college, and so some of this funding will come from those who never enroll. In addition, the continuation of such a cycle assumes that graduates will remain in the same state in which they attended college. If graduates move out of that state, they will not support future students in that state, and the benefits of their education will accrue to their new state of residence.

The difficult question is not so much whether the cost should be split between students and taxpayers but rather what the appropriate breakdown should be.

Both user fees and taxpayer funding raise equity concerns. Excluding people who cannot afford to pay for higher education denies them the opportunity to invest in themselves and improve their lives. If we rely on tuition payments, we have to solve that problem. But the taxpayer model is also problematic. Children from low-income families are less likely than their more affluent counterparts to attend college; if they do enroll, they are likely to stay in college for fewer years and

less likely to complete their degrees than their more privileged peers. This reality, combined with the fact that most state and local taxes are not progressive—lower-income households often pay a higher share of their income in taxes than higher-income households—means that a shift away from tuition and toward total reliance on tax revenues could generate effective transfers from lower-income to higher-income residents. If states increase the portion of costs that public funds cover, these funds should come from progressive taxes, such as graduated income taxes, rather than from taxes paid disproportionately by lower-income households.

Regardless of their backgrounds, people who successfully participate in higher education tend to end up in the top ranges of the income distribution. Thus, there is a strong argument for maintaining student contributions to pay for college education as long as mechanisms such as need-based financial aid ensure that low-income students are not excluded and that provisions for loan repayment include income-driven options, protecting borrowers whose higher education does not pay off well financially.

As long as there is tuition and as long as students have to cover living expenses without the benefit of full-time labor market earnings, students from low-income families and adults returning to college to improve their labor market opportunities will face financial barriers to higher education. Some students are fortunate to have families that can pay their tuition and other expenses while they are in school. Expecting these families to provide this support may be equitable and efficient, but targeted subsidies in the form of financial aid are the best way to compensate students who do not have this privilege and to ensure that both they and society reap the benefit of their opportunity for postsecondary success.

In sum, states should fund higher education through a combination of tuition revenues—a form of user fee—and general tax revenues. These tax revenues should be progressive, with the burden falling most heavily on those who have the greatest financial capacity, consistent with the distribution of the benefits of higher education. Moreover, tuition charges should be in the context of sufficient need-based financial aid to prevent tuition from being a barrier to access and insure against unmanageable debt burdens resulting from unexpected post-college financial hardship.

Two Paths To Subsidizing Students

College students benefit from two categories of subsidies: funding to institutions and direct funding to students in the form of grants and tax breaks. Funding to institutions allows colleges and universities to charge tuition prices that do not cover the full cost of education, providing across-the-board subsidies to students. Grants and tax breaks are direct subsidies to students to help them pay the cost of college. Because of this aid, the prices individual students enrolled in the same institutions and programs pay vary considerably depending on their circumstances and characteristics.

Currently, states and localities provide most of their subsidies directly to colleges and universities. In fiscal year 2014, according to the State Higher Education Executive Officers Association, states provided \$77 billion for higher education operations, and local governments provided \$9 billion.⁷ Institutions may use some of these state funds to provide grant aid to students, but direct state grants to students totaled just over \$10 billion that academic year.⁸ In contrast, the federal government focuses on financial aid for individual students, awarding \$46 billion in grants and about \$18 billion in education tax credits and deductions in 2014–2015; postsecondary students also benefited from \$96 billion in federal loans and \$1 billion in Federal Work-Study funding that year. Educational institutions received a total of just \$79 million in direct revenue from the federal government in 2012–2013.⁹

⁷ State Higher Education Executive Officers Association, “SHEF—State Higher Education Finance FY2014,” <http://www.sheeo.org/resources/publications/shef-%E2%80%94state-higher-education-finance-fy14> (accessed April 14, 2016).

⁸ National Association of State Student Grant and Programs (NASSGP), *45th Annual Survey Report on State-Sponsored Financial Aid, 2013–2014 Academic Year*, https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&ved=0ahUKEwj128fs0o7MAhVmhmYMKHXCmCCcQFggrMAI&url=https%3A%2F%2Fwww.nassgap.org%2Fdocument_download.aspx%3FdocumentID%3D1094&usg=AFQjCNE45HLzWY3WExXsYmSapyw57G6Z4A (accessed April 14, 2016).

⁹ Jennifer Ma et al., *Trends in College Pricing 2015* (New York: The College Board, 2016), <http://trends.collegeboard.org/sites/default/files/trends-college-pricing-web-final-508-2.pdf> (accessed April 14, 2016).

Within this general pattern, the specifics vary quite a bit, both across states and over time. Some states provide virtually no direct aid to students, while others award more than \$1,000 per student on average. Overall, state financial aid going directly to students has come to account for an increasing portion of state higher education funding.

Rather than taking the current division of subsidies as a given, however, it is constructive to examine the pros and cons of the different ways to deliver subsidies and consider whether modifications to existing practices might increase educational opportunities.

The data

Over the years, grant aid has grown more rapidly than overall funding, rising to 13 percent of the total in 2013 (Table 1).¹⁰ Between 2003–2004 and 2013–2014, state funding per student in the nation as a whole declined by 14 percent in constant dollars, while state grant aid per student increased by 7 percent. Grant aid grew from 7 percent of total state support in 1993–1994 to 10 percent in 2003–2004 and to 13 percent in 2013–2014.

Academic Year	Grant Expenditures as a Percentage of State Fiscal Support
1993–1994	7%
1998–1999	7%
2003–2004	10%
2008–2009	11%
2013–2014	13%

Table 1: Total State Grant Expenditures as a Percentage of State Fiscal Support for Higher Education Operations

Source: National Association of State Student Grant and Aid Programs, *Annual Survey Reports on State-Sponsored Financial Aid*, 1993–1994, Table 23; 1998–1999, Table 16; 2003–2004, Table 14; 2008–2009, Table 14; 2013–2014, Table 14.

The national figures conceal significant variation across states. In 2013–2014, New Hampshire had no state grant aid, and Alabama and Hawaii allocated less than 1 percent of their higher education funding to grant aid for individual students. In contrast, in South Carolina, state grants—83 percent of which were distributed without regard to the financial circumstances of the recipients—accounted for 40 percent of postsecondary funding, and in Pennsylvania, where all aid is need-based, 28 percent of the funds were in the form of grants.¹¹

¹⁰ National Association of State Student Grant and Aid Programs, *Annual Survey Reports on State-Sponsored Financial Aid*, 1993–1994, Table 23; 1998–1999, Table 16; 2003–2004, Table 14; 2008–2009, Table 14; 2013–2014, Table 14.
¹¹ NASSGP, *45th Annual Survey Report*, Table 14.

As Figure 1 illustrates, the states that have the highest ratios of grant aid to total funding tend to be those that have high levels of grant dollars per student, but some exceptions exist. Pennsylvania, which has the second-highest ratio, ranks 14th in grant aid per student, and Vermont, which has the sixth-highest ratio, ranks 24th. In Wyoming, where subsidies to institutions are relatively high, the ratio is only 4.3 percent, but state grant aid to students is not far below the national average.

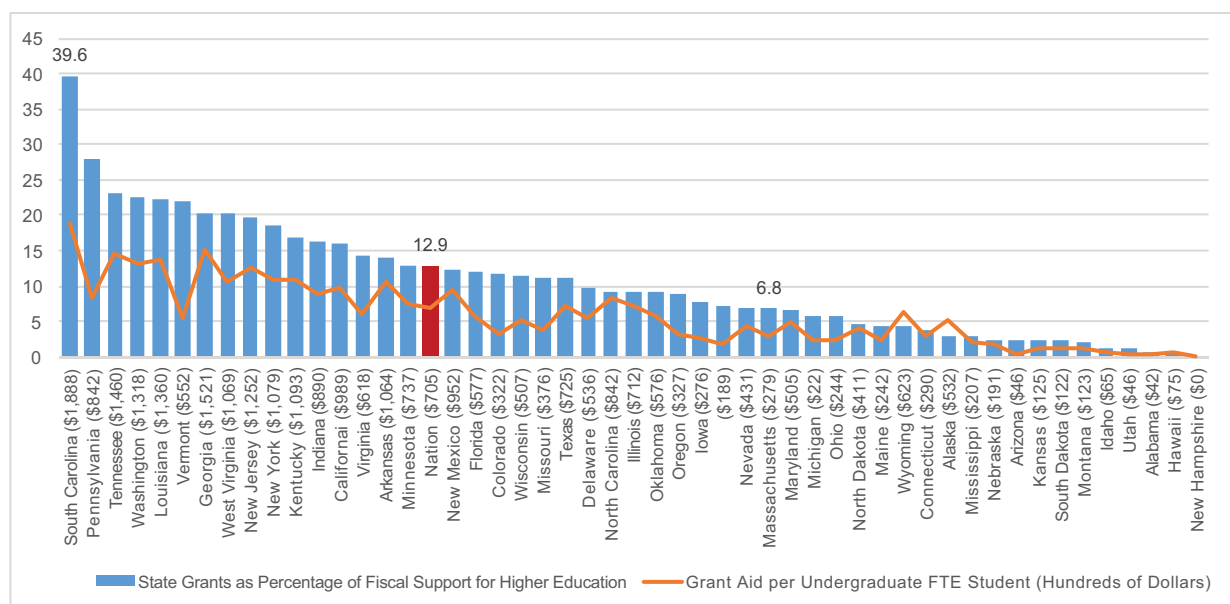


Figure 1: State Grant Expenditures as a Percentage of State Fiscal Support for Higher Education and State Grants Per Full-Time Equivalent Student by State, 2013–2014

Source: National Association of State Student Grant and Aid Programs, *Annual Survey Reports on State-Sponsored Financial Aid*, 2013–2014, Table 12 and Table 14.

Funding students or funding institutions: theory and practice

Despite the attention and concern that high tuition levels engender, economists have long argued that high tuition–high aid models are most promising to ensure a combination of access and quality in public higher education.¹² A central issue is that funding to institutions subsidizes students across the board and allows everyone, including the most affluent students, to pay lower tuition prices.

¹² In favor of high tuition–high aid, see James Garland, “How to Put College Back Within Reach,” *Washington Post*, December 30, 2005, <http://www.washingtonpost.com/wp-dyn/content/article/2005/12/29/AR2005122901312.html> (accessed April 14, 2016); Gary Becker and Richard Posner, “Raising Public College Tuition—Posner,” *The Becker-Posner Blog*, entry posted January 17, 2011, <http://www.becker-posner-blog.com/2011/01/raising-public-college-tuitionposner-.html> (accessed April 14, 2016); Gary Becker, “The Case for Tuition Increases at Public Universities,” *The Becker-Posner Blog*, entry posted January 17, 2011, <http://www.becker-posner-blog.com/2011/01/the-case-for-tuition-increases-at-public-universities-becker.html> (accessed April 14, 2016); Sarah Turner, “Higher Tuition, Higher Aid and the Quest to Improve Opportunities for Low Income Students in Selective, Public Higher Education,” in *What’s Happening to Public Higher Education*, ed. Ronald Ehrenberg (Westport, CT: Greenwood Press for the American Council on Education), 251–274; and Michael McPherson and Morton Schapiro, *The Student Aid Game* (Princeton: Princeton University Press, 1998).

As discussed earlier, college enrollment rates are highest among young people from higher-income backgrounds; low-income students are less likely than others to earn bachelor's and advanced degrees, and earnings correlate strongly with levels of postsecondary education attainment. As a result, these general subsidies likely involve transfers from less to more affluent individuals.¹³

Of course, the structure of state and local revenues is relevant here. In a progressive tax system, high-income taxpayers would bear most of the burden which is consistent with them receiving a disproportionate share of the benefits of higher education funding. State tax systems tend to be regressive, however, with sales taxes that represent a higher share of low-income households' incomes and income taxes that are relatively flat.

Another argument against low tuition as a solution is that this policy is frequently insufficient to make college financially manageable for low-income students. The real cost of going to college includes forgone earnings in addition to tuition, fees, books, and other expenses individuals do not incur unless they are in school. In the absence of those earnings, many students struggle to pay their daily living expenses. For full-time community college students, tuition and fees constitute only about 20 percent of the total budget. Tuition and fees make up about 40 percent of the average budget for four-year public college students living on campus.¹⁴ This reality makes grant aid for low-income students vital, even in a low-tuition environment.

Another relevant issue is the importance of adequate institutional resources to support student success. Low-income students are disproportionately represented in community colleges and broad-access four-year institutions, which tend to be under-resourced relative to research universities, which both receive higher state appropriations and charge higher tuition. Increases in time-to-degree and declines in bachelor's degree completion rates over time appear to be explained largely by institutional resource constraints.¹⁵ If resources are scarce, focusing those resources on the students most in need while charging higher tuition to those who can afford to pay has the potential to improve student outcomes. This would also argue for increasing the share of state aid targeted to institutions that serve more low-income students—the exact opposite of the policy currently found in most states.

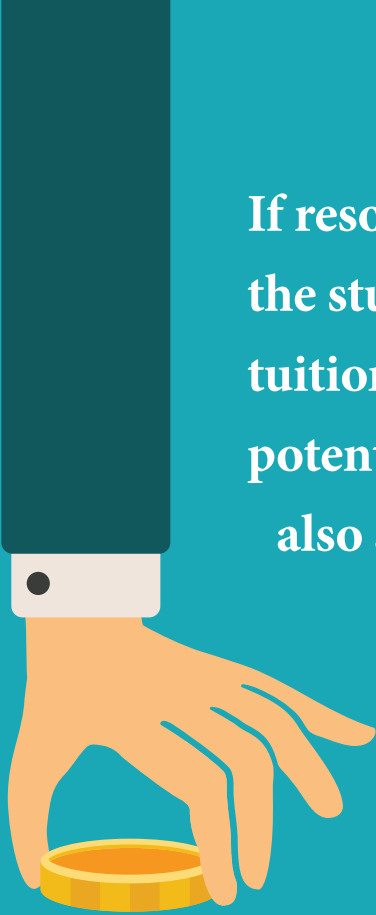
To the extent that the resources available to subsidize public higher education are limited, capacity constraints in public institutions are a concern. The promise of low tuition may induce relatively affluent students to switch from the private nonprofit sector to the public sector. In 2011–2012, 12 percent of all undergraduates (and 21 percent of those from the highest parental income quartile) attended private, nonprofit four-year colleges and universities. If a significant number of these students were to switch to the public sector, institutions could face capacity problems, diminishing the opportunities available to lower-income students.

¹³ Don Francis, "Populist, Not Progressive," *Inside Higher Ed*, <https://www.insidehighered.com/views/2015/09/11/proposals-make-public-college-free-are-regressive-not-progressive-essay> (accessed April 14, 2016); Matt Bruenig, "3 Theses on Higher Education," *Politics*, <http://mattbruenig.com/2013/11/20/3-theses-on-higher-education> (accessed April 14, 2016); and W. Lee Hansen and Burton Weisbrod, "The Distribution of Costs and Direct Benefits of Higher Education: The Case of California," *Journal of Human Resources* 4 no. 2 (Spring 1969): 176–191.

¹⁴ Jennifer Ma et al., *Trends in College Pricing 2015*, Figure 2.

¹⁵ John Bound, Michael Lovenheim, and Sarah Turner, "Why Have College Completion Rates Declined? An Analysis of Changing Student Preparation and Collegiate Resources," *American Economic Journal: Applied Economics* 2 no. 3 (2010): 129–157.

If resources are scarce, focusing those resources on the students most in need while charging higher tuition to those who can afford to pay has the potential to improve student outcomes. This would also argue for increasing the share of state aid targeted to institutions that serve more low-income students—the exact opposite of the policy currently found in most states.



In the mid-1990s, when the income cap on eligibility for the Georgia merit-based HOPE scholarship was lifted, automobile sales increased. Apparently, parents who had saved for college tuition used the money instead to buy their children cars when they attended public universities tuition free.¹⁶ A significant portion of the increase in enrollments at Georgia public universities resulting from the HOPE program was the result of students staying in the state instead of going to out-of-state institutions.¹⁷ With limited capacity, an influx of more affluent students who have other good options crowding less affluent students who do not have other good options out of selective public institutions could be an unintended consequence of significantly lowering prices across the board.

Of course, lower public college tuition would also widen the gap between prices in the public sector and the already much higher prices at for-profit institutions. Without more insight into why so many older and lower-income students choose the for-profit sector, it is difficult to know whether lower sticker prices could redirect them to public institutions. In 2011–2012, while 13 percent of undergraduates attended for-profit institutions, 20 percent of independent students and 10 percent of dependent students from the lowest parental income quartile (compared to 2 percent from the highest quartile) were enrolled in this sector. Since then, overall enrollment in the sector has declined sharply,¹⁸ but it remains true that ensuring opportunities for these students in public colleges and universities is critical to improving educational outcomes.

There are, however, good arguments for using subsidies to institutions to cover a significant percentage of the costs of education at public colleges and universities. One issue is that sticker prices are visible: Financial aid is less transparent and more difficult for students to understand. High published tuition levels are likely to discourage disadvantaged and first-generation students from even applying to college.¹⁹ For many low-income students, grant aid currently covers tuition and fees for public two-year and four-year institutions, but many potential students are unaware of this reality. Many do not take the necessary steps to apply for financial aid or apply to college. Announcing low tuition prices has the potential to increase participation among these vulnerable groups.

Political realities also dictate caution about concentrating subsidies in financial aid programs while allowing tuition rates to rise. High tuition–high aid can too easily turn into high tuition–low aid when state budgets are tight.²⁰ Political forces have also led to a significant portion of the grant aid in a number of states being allocated on the basis of academic achievement rather than financial need. As Figure 2 illustrates, in 2013–2014, six states, including the four states with the highest levels of grant aid per student, took account of financial circumstances in allocating less than a quarter of their aid.²¹ The advantage of grant aid, which allows states to target funds to individual students without

¹⁶ Christopher Cornwell and David Mustard, “Merit-Based Scholarships and Car Sales,” *Education Finance and Policy* 2 no. 2 (2007): 133–151.

¹⁷ Christopher Cornwell, David Mustard, and Deepa Sridhar, “The Enrollment Effects of Merit-Based Financial Aid: Evidence From Georgia’s Hope Program,” *Journal of Labor Economics* 24 no. 4 (2006): 761–786.

¹⁸ According to the National Student Clearinghouse, total enrollment in the for-profit sector declined by 14 percent between fall 2013 and fall 2015; overall postsecondary enrollment fell by 3 percent over this two-year period. See National Student Clearinghouse, *Term Enrollment Estimates: Fall 2015*, <https://nscresearchcenter.org/wp-content/uploads/CurrentTermEnrollment-Fall2015.pdf> (accessed April 14, 2016).

¹⁹ Andrew Kelly, “Nothing but Net: Helping Families Learn the Real Price of College,” *Education Outlook* 10 (December 2011), https://www.aei.org/wp-content/uploads/2011/12/-nothing-but-net-helping-families-learn-the-real-price-of-college_084809849714.pdf (accessed April 14, 2016).

²⁰ Josh Freedman, “How Not to Help the Poor: The Lesson of Soaring College Prices,” *Atlantic*, July 10, 2013, <http://www.theatlantic.com/business/archive/2013/07/how-not-to-help-the-poor-the-lesson-of-soaring-college-prices/277658> (accessed April 14, 2016); and Alexander Holt, “The Higher Ed Arms Race: How the High-Tuition, High-Aid Model Shuts Out Low-Income Students,” *New America* (May 9, 2013), <https://www.newamerica.org/education-policy/the-higher-ed-arms-race-how-the-high-tuition-high-aid-model-shuts-out-low-income-students> (accessed April 14, 2016).

²¹ South Carolina, Georgia, Tennessee, and Louisiana had the highest state grant levels per full-time-equivalent student. They awarded 17 percent,

providing the same subsidies to all, is much less compelling when the targeting is based on student test scores or high school grades rather than ability to pay.

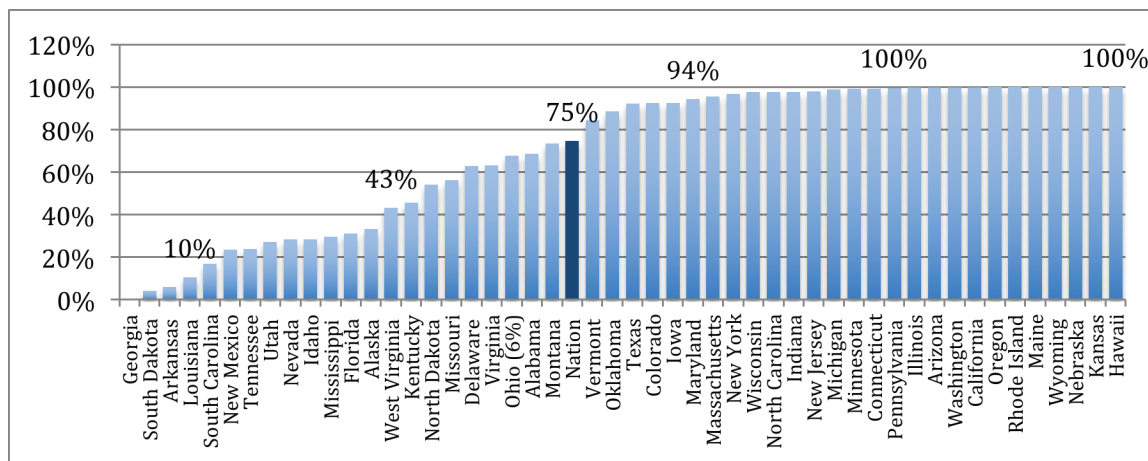


Figure 2: Percentage of State Grant Aid Based at Least Partially on Financial Circumstances by State, 2013–2014

Source: National Association of State Student Grant and Aid Programs, *45th Annual Survey Report on State-Sponsored Financial Aid, 2013-14 Academic Year*, Table 1.

Integrating federal and state roles

In 2014–2015, when states awarded about \$10 billion in grant aid to students, the federal government spent more than \$30 billion on Pell Grants to low- and moderate-income undergraduates and an additional \$16 billion on other grant aid, primarily to support veterans. Federal tax credits and deductions added another \$18 billion in student aid. Even if states were to double their grant funding, the amount would still be quite small relative to the assistance the federal government provides directly to students.

Given this reality and the decline in recent years in state appropriations for higher education institutions, a transfer of existing state funds from institutional subsidies to direct student aid does not seem likely. However, focusing existing state grant aid exclusively on students who have limited financial means—whose probability of enrolling in and succeeding in college could be measurably improved by additional funding—is more feasible. Reallocating existing state grant dollars to more effectively meet this goal could represent real progress.

It would be constructive for a relatively high percentage of incremental state funding to go to need-based financial aid. It is difficult to imagine that growth in state funding in the coming years will be sufficient to generate both declines—or even slower growth—in tuition and fees and the increases in financial aid to low- and moderate-income students required to diminish the financial barriers these student face in accomplishing their postsecondary goals. States could also reallocate existing funds to favor those colleges and universities that serve a larger percentage of low-income students.

0 percent, 24 percent, and 10 percent of their aid, respectively, at least partially on the basis of financial need (NASSGAP, 2015).

The existing diminished level of per-student general funding of public higher education institutions does not in most states leave room for shifts toward student aid, but incremental funds should bolster need-based grant aid rather than focusing only on mitigating tuition increases. Subsidies to institutions should be allocated with the goal of increasing the resources devoted to those students who have the greatest need.

The importance of state funding for both institutional revenues and student aid makes understanding the actual and potential sources of this funding critical. The distribution of the burden across residents in different financial circumstances varies considerably across revenue sources. State income, sales, and property taxes; lottery revenues; and other potential sources of higher education funding have different distributional implications.



State and Local Revenues

In fiscal year (FY) 2013, state and local governments raised \$2.7 trillion, with transfers from the federal government accounting for 21.7 percent of the total. The remaining funds came from own-source revenues, including tuition and other charges and miscellaneous revenues (24.2 percent), sales and excise taxes (18.5 percent), property taxes (16.9 percent), and individual income taxes (12.6 percent).²² It is important to note that tuition does constitute a source of revenue for state governments. As discussed earlier, tuition revenues are a substitute for tax revenues in financing

²² U.S. Census Bureau, “2013 Annual Survey of State and Local Government Finances,” <http://www.census.gov/govs/local> (accessed April 14, 2016).

higher education. The distinction lies in which residents provide the revenues. Because we are interested in state and local sources of funding for higher education, the discussion that follows focuses on own-source general revenues, which exclude intergovernmental revenues. To look beyond tuition sources of funding for higher education, we focus on other fees and charges and the different types of taxes on which states rely.²³

Table 2 provides a breakdown of own-source revenues for all U.S. states and localities. Taxes accounted for 69 percent of total own-source general revenues.

	Taxes					Tuition and Fees	Other Charges and Misc.
	Individual Income	Property	Sales*	Corporate Income	Other		
Millions of Dollars	\$338,471	\$455,442	\$496,439	\$53,039	\$112,107	\$77,285	\$572,991
Percentage	16%	22%	24%	3%	5%	4%	27%
* Includes both general sales tax and selective sales taxes.							

Table 2: State and Local Own-Source General Revenues by Type, FY 2013

Source: U.S. Census Bureau, “2013 Annual Survey of State and Local Government Finances,” <http://www.census.gov/govs/local>.

The national breakdown of state and local own-source general revenues conceals stark differences across states. For example, in 2013:

- Hawaii, Nevada, and Washington derived about 40 percent of state and local general revenue from sales taxes, but five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) collected no general sales tax.²⁴
- New Hampshire drew 44 percent of its combined state and local own-source general revenues from property tax—about twice the national average²⁵—but property taxes provided just 10 percent of own-source general revenue in Alabama and North Dakota.
- California, Connecticut, Maryland, Massachusetts, New York, and Oregon relied on individual income taxes for about a fifth of own-source general revenue, but seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) did not tax any kind of income.²⁶

Table 3 provides a breakdown of state and local revenues by state and type in FY 2013. The share of revenues from individual income tax ranged from 29 percent in Maryland to 0 percent in the no-income-tax states.²⁷

²³ Lotteries, which are a nontax source of revenue often used to finance education, made up 1 percent of all own-source general revenues.

²⁴ All five states levied selective sales taxes, and some Alaskan localities levied a general sales tax.

²⁵ New Hampshire does not have a broad-based income tax or sales tax. The state has a strong tradition of local control, with most general revenues coming from local governments, where property tax is dominant.

²⁶ New Hampshire taxes only interest and dividends, and Tennessee taxes only bond interest and stock dividends.

²⁷ Alaska, Florida, and South Dakota have corporate income taxes but not personal income taxes.

State	Taxes					Tuition and	Other Charges
	Individual Income	Property	Sales	Corporate Income	Other		
Alabama	13%	10%	27%	1%	5%	7%	36%
Alaska	0%	12%	4%	5%	34%	1%	43%
Arizona	10%	20%	33%	2%	3%	5%	27%
Arkansas	17%	13%	34%	3%	3%	4%	26%
California	23%	18%	22%	3%	5%	2%	27%
Colorado	15%	20%	23%	2%	4%	5%	31%
Connecticut	25%	32%	22%	2%	4%	3%	13%
Delaware	16%	11%	7%	4%	21%	9%	32%
District of Columbia	21%	25%	19%	6%	8%	0%	22%
Florida	0%	22%	32%	2%	5%	2%	37%
Georgia	18%	20%	25%	2%	2%	4%	29%
Hawaii	16%	12%	39%	1%	5%	3%	25%
Idaho	17%	19%	23%	3%	5%	4%	30%
Illinois	18%	29%	21%	5%	4%	3%	20%
Indiana	17%	17%	28%	2%	3%	7%	27%
Iowa	16%	21%	19%	2%	4%	5%	32%
Kansas	15%	20%	24%	2%	3%	4%	32%
Kentucky	22%	14%	26%	3%	4%	5%	26%
Louisiana	10%	14%	33%	1%	5%	3%	34%
Maine	18%	30%	21%	2%	5%	3%	21%
Maryland	29%	21%	19%	2%	5%	4%	20%
Massachusetts	25%	27%	15%	4%	4%	4%	21%
Michigan	15%	23%	22%	2%	3%	7%	29%
Minnesota	22%	20%	23%	3%	4%	3%	24%
Mississippi	11%	16%	28%	3%	4%	4%	34%
Missouri	18%	18%	24%	1%	4%	4%	31%
Montana	18%	25%	10%	3%	11%	6%	26%
Nebraska	16%	24%	21%	2%	5%	3%	28%
Nevada	0%	18%	42%	0%	11%	2%	27%
New Hampshire	1%	44%	12%	7%	5%	5%	26%
New Jersey	17%	36%	17%	3%	4%	3%	20%
New Mexico	10%	11%	29%	2%	8%	4%	36%
New York	24%	24%	19%	6%	4%	1%	22%
North Carolina	20%	16%	22%	2%	4%	3%	34%
North Dakota	8%	10%	24%	3%	32%	3%	21%
Ohio	20%	19%	22%	1%	6%	5%	27%

Oklahoma	14%	11%	28%	3%	8%	6%	31%
Oregon	25%	20%	7%	2%	7%	5%	33%
Pennsylvania	18%	21%	22%	3%	6%	5%	25%
Rhode Island	14%	32%	20%	2%	3%	4%	24%
South Carolina	12%	18%	18%	1%	4%	5%	40%
South Dakota	0%	23%	35%	1%	7%	5%	28%
Tennessee	1%	18%	36%	4%	7%	4%	31%
Texas	0%	27%	32%	0%	9%	4%	28%
Utah	17%	17%	22%	2%	3%	8%	31%
Vermont	14%	32%	22%	2%	4%	8%	18%
Virginia	21%	22%	17%	1%	5%	5%	29%
Washington	0%	20%	39%	0%	6%	4%	31%
West Virginia	16%	13%	24%	2%	9%	5%	30%
Wisconsin	19%	27%	20%	2%	3%	4%	24%
Wyoming	0%	20%	17%	0%	17%	2%	44%
United States	16%	22%	24%	3%	5%	4%	27%

Table 3: State and Local Own-Source General Revenues by Type and State, FY 2013

Source: U.S. Census Bureau, “2013 Annual Survey of State and Local Government Finances,” <http://www.census.gov/govs/local>.

The choice of tax structure affects the level of revenues collected, how the tax burden is distributed across residents at different income levels, and how volatile revenues are in response to changes in economic conditions. The incidence of the taxes—who actually bears the burden—varies quite a bit. Both progressive income taxes, which generally exempt the first dollars and often have graduated rate structures, and estate taxes fall disproportionately on higher-income households. Some taxes are proportional across households, but others (e.g., general sales taxes, lotteries, tobacco taxes) are regressive, with states collecting higher percentages of the incomes of low-income than of higher-income residents. Sales taxes tend to be regressive because lower-income households generally spend all their incomes and mostly purchase goods, while those who have higher incomes are more likely to save and when they spend money, are more likely to buy services that are often not subject to general sales taxes. These differences are important when considering the implications of raising taxes to increase public funding of higher education.

The incidence of taxes is not always straightforward. For example, there are open debates about whether property owners or renters actually pay the property taxes on rental units and whether corporate income taxes are borne by consumers of the products produced, owners of a company’s stock, or workers through lower wages.

In general, states that raise a larger share of their revenues through income taxes, especially those with graduated rates, have more progressive tax structures. Currently, California, Maryland, New York, New Jersey, and the District of Columbia have some of the most progressive tax systems, while those reliant

on general and selective sales taxes are more regressive.²⁸ Finally, some states—notably, Alaska, North Dakota, and Texas—raise significant revenues from *severance taxes* (i.e., taxes on natural resources). These taxes are often paid by individuals outside the state, exporting the tax burden to nonresidents.

As noted earlier, state and local governments do have nontax revenues, which include fees and charges for services. College tuition is one component of this revenue category, but there are also fees for local services such as garbage collection, charges for automobile registration and drivers' licenses, and a variety of other user fees. In addition, 42 states have lotteries, and all states but Utah and Hawaii have some sort of legalized gambling. Lottery and other gambling revenues are most likely to be earmarked for higher education. Some states dedicate some or all of their lottery revenues to financial aid for college students, while others use these funds for broader support for higher education. Five southern states (Florida, Georgia, South Carolina, Tennessee, and West Virginia) derive more than 10 percent of their funds for higher education from gambling sources.²⁹ Although gambling, unlike paying most taxes, is voluntary, it is a particularly regressive source of revenue.

Over time, the share of revenues coming from specific sources has varied (Figure 3), in part the result of state actions such as raising or lowering tax rates, but also related to changes in economic activity. More than 16 percent of state and local general revenues came from fees and charges in 2013, up from just below 13 percent in 1983. Nearly 25 percent of the increase in fees and charges as a portion of general revenues came from college tuition and fees. If we exclude fees and charges, state and local revenues as a share of personal income have been relatively stable.

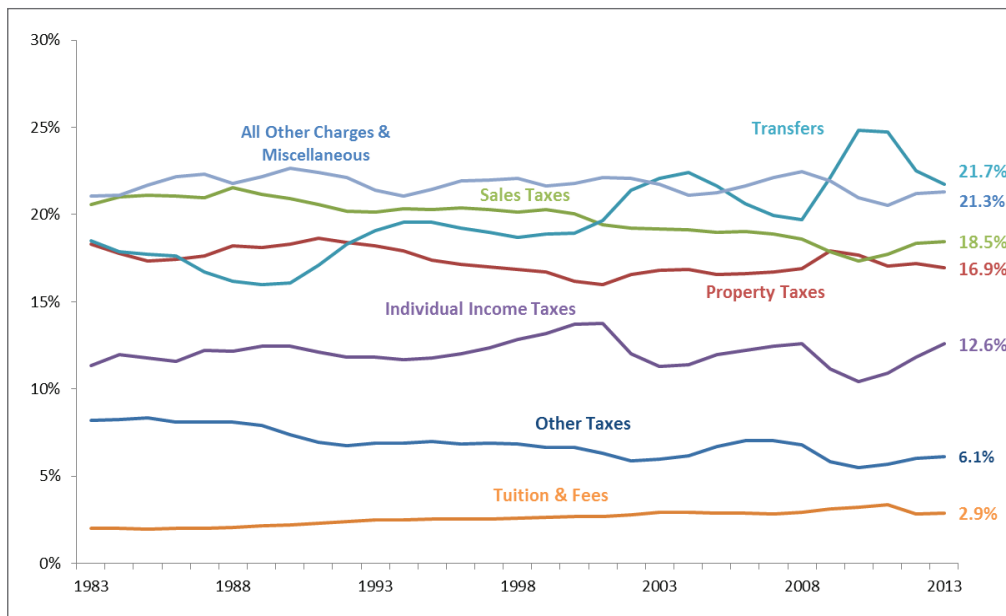


Figure 3: State and Local General Revenues by Category, 1983–2013

Source: U.S. Census Bureau, “2013 Annual Survey of State and Local Government Finances,” <http://www.census.gov/govs/local>.

²⁸ In some instances, especially for states in which a large percentage of economic activity comes from tourism, states often rely more on sales taxes because nonresidents will end up paying them.

²⁹ Arlene Russell, “Dedicated Funding for Higher Education: Alternatives for Tough Economic Times,” *A Higher Education Policy Brief* (Washington, DC: American Association of State Colleges and Universities, 2008), [http://www.aascu.org/uploadedFiles/AASCU/Content/Root/PolicyAndAdvocacy/PolicyPublications/08.decpm\(2\).pdf](http://www.aascu.org/uploadedFiles/AASCU/Content/Root/PolicyAndAdvocacy/PolicyPublications/08.decpm(2).pdf) (accessed April 14, 2016).

Focusing only on tax revenues, general sales taxes have made up close to one-quarter of state and local tax revenues over the past 25 years, but this stability reflects increases in sales tax rates in 38 of the 45 states that have general sales taxes, offsetting an increasing share of consumption involving untaxed transactions. This change results from a combination of increased consumption of services, which are typically not taxed, rather than goods, as well as increased purchases from online retailers.³⁰ States have responded to these changes in several ways. Some have begun expanding sales taxes to cover services, with New Mexico and Hawaii being notable for taxing most services.

Treatment of online sales is more complicated. Under the U.S. Constitution, if a retailer has no physical presence in the online purchaser's state of residence, the retailer is not required to collect state or local sales tax from the consumer (technically called a *nexus requirement*). Many consumers do not realize, however, that in addition to sales taxes, states levy use taxes. Consumers are theoretically subject to use taxes on goods purchased outside their state of residence for consumption in their home state. The use tax rate is the same as the sales tax rate, but few consumers actually pay the tax.

The U.S. Supreme Court (*Quill Corp. v. North Dakota*) ruled that states cannot require remote sellers to collect sales taxes but that Congress can enact new rules. The Marketplace Fairness Act, first proposed in Congress in 2011, would allow states to require remote sellers to collect sales taxes on online purchases state residents make.³¹ The act would require that states simplify their sales taxes to make it easier for out-of-state sellers to collect the tax. This law has failed to pass Congress, despite being proposed annually. If implemented, proponents estimate that the Marketplace Fairness Act would generate about \$20 billion a year in new state tax revenues—a 12 to 15 percent increase from current levels.³²

State and Local Expenditures

State and local taxes and other revenues primarily fund services to individuals. In fiscal year 2013, state and local governments allocated 22 percent of their total direct general spending to elementary and secondary education and another 29 percent to public welfare and health and hospitals.³³ Higher education, which receives most of its funding from states rather than localities, accounts for about 10 percent of spending. These funds include the tuition revenues that colleges and universities collect. The tuition portion of total funds has increased over time, and the nontuition portion of spending on higher education fell to 7 percent of direct general expenditures in 2013.

Over the past 35 years, the composition of state and local spending has changed dramatically (Figure 4). Most notably, increases in Medicaid spending account for significant growth in the public welfare component of the budget.

³⁰ Norton Francis and Frank Sammartino (2015) examine long-term trends in state budgets. See Norton Francis and Frank Sammartino, *Governing With Tight Budgets* (Washington, DC: The Urban Institute, 2015), <http://www.urban.org/research/publication/governing-tight-budgets> (accessed April 14, 2016).

³¹ For more information about the Marketplace Fairness Act and those who support it, go to <http://marketplacefairness.org>.

³² *Ibid.*

³³ Funding for Medicaid falls partly in the public welfare category and partly in the health and hospitals category in the U.S. Census data. To better understand changing state spending on Medicaid, we use the National Association of State Budget Officers (NASBO) 2015 State Expenditure Report, which includes information about Medicaid in its own category. According to NASBO, Medicaid spending went from about 20 percent of state budgets in 1995 to 27.5 percent in 2015, while higher education funding went from 12 percent to 10 percent. Unlike the Census of Governments information, this information excludes any local spending.

Outlays for elementary and secondary education decreased from 24.3 percent of direct general expenditures in 1983 to 23.0 percent in 1994. Following a rise in the late 1990s, this category declined to 21.6 percent of the total by 2013 (the most recent year for which data are available). In contrast, public welfare expenditures increased from 12.7 percent to 19.6 percent over this 30-year period, largely as a result of increases in Medicaid spending.

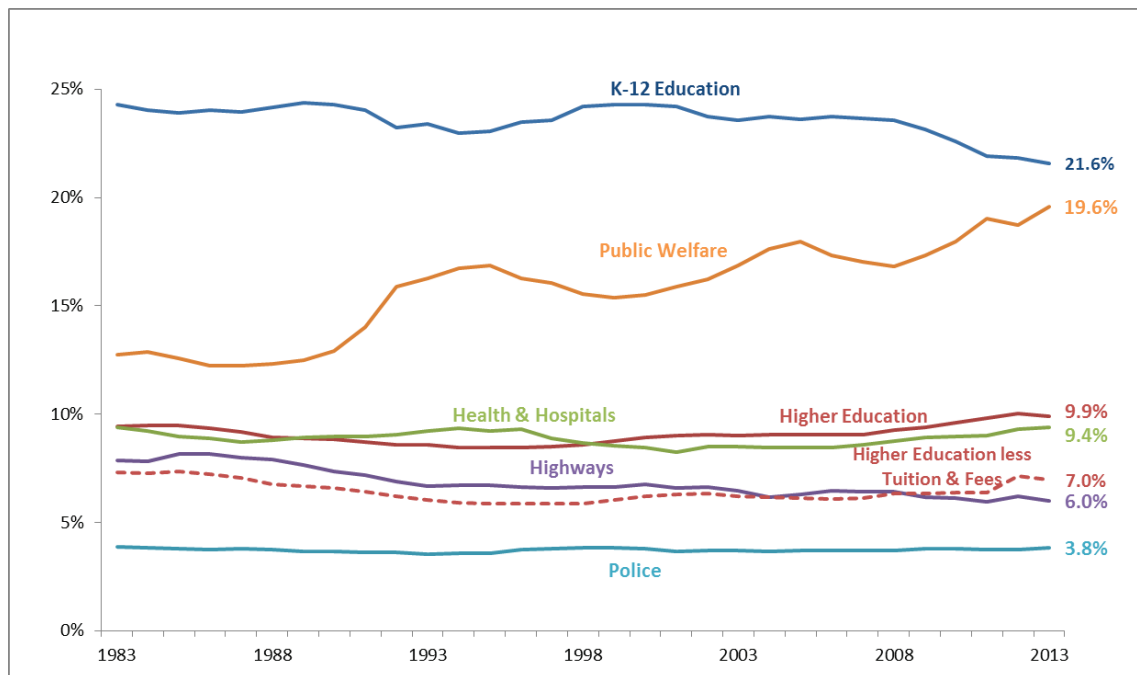


Figure 4: State and Local Direct General Expenditures by Category, 1983–2013

Source: U.S. Census Bureau, “2013 State and Local Government Finances,” <http://www.census.gov/govs/local>.

The remaining budget activities have been far more stable, with annual spending in each category fluctuating by only a few percentage points over the past 30 years. For example, higher education spending (less tuition and fees) accounted for between 5.9 and 7.5 percent of direct general spending each year. The stability of this share is somewhat misleading, however, because a growing share of the population is enrolled in higher education. In 1980, the 12 million postsecondary students in the United States constituted about 5 percent of the population. By 2013–2014, about 6.4 percent of the population—more than 20 million people—were enrolled in colleges and universities.³⁴

³⁴ National Center for Education Statistics, “Digest of Education Statistics 2014,” Table 306.10, https://nces.ed.gov/programs/digest/d14/tables/dt14_306.10.asp (accessed April 14, 2016); and U.S. Census Bureau, “Population Estimates: Historical Data,” <https://www.census.gov/popest/data/historical> (accessed April 14, 2016).

As is the case with revenues, states differ dramatically in the level of their spending by function and in the allocation of funds across functions. For example, in 2013:

- National kindergarten through grade 12 (K–12) per-pupil spending was \$12,380, but the District of Columbia, New York, and New Jersey spent more than \$20,000 per pupil and eight states (Arizona, Idaho, Mississippi, Nevada, North Carolina, Oklahoma, Tennessee, and Utah) spent less than \$9,000 per student.³⁵
- Four states (Colorado, Georgia, Nevada, and Utah) spent less than \$1,150 per capita on public welfare, a broad category that includes cash assistance, medical vendor payments, and administration. In contrast, the District of Columbia spent more than \$4,900 per resident. In four states (Alaska, Minnesota, New York, and Vermont), the total was more than \$2,300 per capita.
- Elementary and secondary education made up 22 percent of spending in the nation, but Hawaii spent 16 percent of its state and local budget on K–12 education and New Jersey spent 29 percent.
- Seventeen percent of Utah's state and local direct general expenditures went to higher education compared with 6 percent in New York (the national average was 10 percent).

Strategies for Increasing Educational Opportunities

Generating new state revenues

Against this background, how can we increase the state and local revenues available to fund postsecondary students and institutions and ensure that taxpayer funds more effectively finance positive educational outcomes? In addition to reallocating existing revenues, states may be able to better fund higher education by raising revenues. Before investigating the range of possibilities, we would note that although we focus exclusively on the imperative of increasing educational opportunity, states face many other pressing priorities. It is not at all clear that the majority of either state legislators or citizens would rank more generous funding of higher education above improvements in elementary and secondary education, health care, housing, or infrastructure, even if they were convinced of the need for added revenues. Nonetheless, it is useful to ask whether raising existing taxes or finding new revenue streams dedicated to public higher education could mitigate underfunding problems.

About one-quarter of state tax revenues are dedicated to specific purposes. Some states earmark more than half of their tax revenues, while others use the strategy sparingly. The majority of states earmark some tax revenues for kindergarten through grade 12 (K–12) or higher education.³⁶

As noted earlier, however, most earmarked taxes are related to the expenditures they fund. Pollution taxes fund environmental clean-up. Both federal and state governments impose taxes on gasoline, primarily to fund transportation infrastructure, but some states have diverted a portion of these funds to support education, Medicaid, debt service, or other spending needs, illustrating that even dedicated funds can be used for other purposes during downturns.³⁷

35 U.S. Census Bureau, "Per Pupil Spending Varies Heavily Across the United States" Press Release, June 2, 2015, <https://www.census.gov/newsroom/press-releases/2015/cb15-98.html> (accessed April 14, 2016).

36 A. Russell, "Dedicated Funding for Higher Education."

37 Damian Paletta, "States Siphon Gas Taxes for Other Uses," *Wall Street Journal*, July 16, 2014.

Thus far, when states have dedicated specific funds to higher education, those funds have come from regressive revenue sources, with the most common funds earmarked for higher education coming from lotteries or other gambling revenue. In addition to the regressive nature of these funds, this money is often used for merit- rather than need-based scholarships, exacerbating distributional problems and limiting the impact on educational opportunities.

Other earmarked funds have included revenues from trusts set up using taxes on natural resources and extraction taxes—fees from oil and natural gas. For example, Montana and Wyoming dedicate a portion of these tax revenues to higher education annual spending, and Texas uses mineral and oil rights revenues to fund higher education capital projects. These funding streams have historically been reliable, but recent downturns in oil prices highlight the risk of basing higher education funds on unrelated activity.

Earmarking **income tax revenues** for higher education would more effectively match the people paying the taxes to the population most likely to benefit. These tax revenues should be progressive, with the burden falling most heavily on those who have the greatest financial capacity, consistent with the distribution of the benefits of higher education.



A potential new source of tax revenues might be **the tax on marijuana sales**, if more states move toward legalization. (For example, in fiscal year [FY] 2015, Colorado raised twice as much revenue from this source as from alcohol taxes.)

If implemented, proponents estimate that the **Marketplace Fairness Act** would generate about \$20 billion a year in new state tax revenues—a 12 to 15 percent increase from current levels.

Earmarking income tax revenues for higher education would more effectively match the people paying the taxes to the population most likely to benefit. Alabama earmarks its income tax to K–12 and higher education; in California, Proposition 98 earmarks a share of general-fund revenue for K–14 education, ensuring more money for community colleges than generally found in other states. Given the highly progressive nature of California’s tax systems (with 50 percent of income tax revenues coming from the top 1 percent of taxpayers),³⁸ this translates into a transfer of revenues from higher-income taxpayers to lower-income potential students. Progressive income taxes tend to

³⁸ Legislative Analyst’s Office, “California’s Major Revenue Sources and Tax Agencies,” <http://www.lao.ca.gov/handouts/localgov/2015/Major-Rev-Sources-Tax-Agencies-022315.pdf> (accessed April 14, 2016).

generate pro-cyclical revenue, however, leaving states cash-strapped at exactly the point when higher education may need more funds because of increases in both demand and financial need.

Another example from California is the recently proposed surcharge on property valued at more than \$3 million to fund numerous programs to help alleviate inequality in the state³⁹. The need-based Cal Grant program for postsecondary students would benefit from this provision.

Overall, however, little of earmarked state funding is currently devoted to higher education. As of 2005, just four states dedicated a specified fraction of a particular revenue stream to higher education. These earmarks are generally not taxes dedicated entirely to higher education but rather portions of general tax revenues. Notably, most earmarked state funding of higher education does not contribute to general institutional funding but to specific undertakings in the sector.⁴⁰

As long as other priorities are also underfunded, it would be both an uphill battle and an uncertain strategy to design a new, dedicated revenue stream for higher education. Of course, tuition revenues already constitute an earmarked source of state revenue for higher education, but the search is for a substitute source of funds.

It is worth noting that a potential new source of tax revenues might be the tax on marijuana sales, if more states move toward legalization. (For example, in fiscal year [FY] 2015, Colorado raised twice as much revenue from this source as from alcohol taxes.)⁴¹ If these revenues were to materialize, however, there would certainly be many competing demands for them. Another resource for new revenues might be increased taxation of online sales. As noted earlier, if Congress chose to act and pass the Marketplace Fairness Act, state sales tax revenues would increase, even if advocates' forecasts overestimate the impact. Both the current paralysis in Washington, D.C., and potential resistance to earmarking these funds for higher education make it unrealistic to count on this revenue source in the foreseeable future.

A broader approach to increasing state revenues might involve either increasing existing tax rates or imposing taxes not currently in use in a particular state. Five states have no general sales tax, and seven states do not have income taxes. It is unlikely that any of these states would impose a new broad-based tax solely dedicated to higher education, but the implementation of a sales or income tax would surely have the potential to significantly increase the state funds available to subsidize students at the same time other priorities also receive more attention.

Evaluating the implementation of a new tax structure or an increase in existing tax rates that would make more generous state subsidies for higher education feasible requires focusing on both the macroeconomic and the distributional implications. As noted in the discussion of tax incidence, sales taxes tend to fall more heavily on lower-income households, while income taxes are generally more progressive. This consideration is critical, particularly given the distribution of higher education's benefits. A major goal of greater funding is to increase participation and success among less privileged residents, but success in this direction is unlikely to change the reality that individuals from the top

³⁹ The proposal had been proposed but not placed on the November 8, 2016 ballot, [https://ballotpedia.org/California_Lifting_Children_and_Families_Out_of_Poverty_Act_Initiative_\(2016\)](https://ballotpedia.org/California_Lifting_Children_and_Families_Out_of_Poverty_Act_Initiative_(2016))

⁴⁰ A. Russell, "Dedicated Funding for Higher Education."

⁴¹ Tanya Basu, "Colorado Raised More Tax Revenue From Marijuana Than From Alcohol," *Time*, September 16, 2015, <http://time.com/4037604/colorado-marijuana-tax-revenue> (accessed April 14, 2016).

half of the income distribution are likely to take greater advantage of higher education and reap more of the benefits. From this perspective, increased income tax revenues from a progressive tax that has graduated rates are most promising.

We should also note that although some states are becoming more reliant on income taxes, others, including Kansas and Ohio, are reducing reliance on income taxes and moving to less progressive tax systems. Arguments in favor of such a change are frequently rooted in the idea of promoting economic growth, but there is little evidence that flatter tax systems actually accomplish this goal.⁴² In practice, the main outcomes of Kansas' tax changes have been budget shortfalls and a shortened school year for K-12 students.

We should also address the question of lottery revenues—the most prevalent nontax source of state funding for higher education outside tuition and fees and the largest source of earmarked funding for higher education. Following the 1964 lead of New Hampshire, most states now have lottery programs. Florida, Georgia, South Carolina, Tennessee, and West Virginia generate more than 10 percent of their higher education funding (including student financial aid) from lottery revenues. The Georgia model of developing a lottery for the purpose of funding merit-based scholarships is the most salient example of this type of funding, but there are many examples of lottery funds being dedicated to need-based financial aid and to general institutional revenues.⁴³

Many studies have confirmed that low-income individuals are significantly more likely than high-income individuals to play the lottery.⁴⁴ The highly regressive nature of this revenue source raises serious question about increasing it if the goal is increasing opportunities for the most vulnerable members of society. This is especially the case in places like Georgia, where the funds are used for merit scholarships that do not consider financial need.

An alternative to increasing revenues is reducing expenditures in other areas to free additional funds for postsecondary education. The most obvious option here is the criminal justice system. State spending on corrections grew rapidly in the 1990s and early 2000s, but from FY 2004 to FY 2013, spending on corrections grew more slowly than most areas of state spending, with public assistance spending—which actually declined—the only exception. Corrections accounted for 7.0 percent of total state spending and 3.5 percent of general-fund spending in FY 2004. Nine years later, this function accounted for 6.8 percent of total and 3.1 percent of general-fund expenditures.⁴⁵ With bipartisan support for reforming the criminal justice system growing across the nation, perhaps declining funding needs could free state dollars for higher education and other areas.

The idea of new taxes devoted exclusively to higher education is not promising, but increased tax revenues from progressive state income taxes or new sources such as taxes on marijuana or online retail sales could increase states' capacity to more generously fund higher education. In addition, some of the funds now spent in areas such as criminal justice might be redirected toward increasing educational opportunities.

⁴² William Gale, Aaron Krupkin, and Kim Rueben, "There Is No Reason to Believe That Tax Cuts Are an Elixir for Economic Growth," *Milken Institute Review* (2015), <http://assets1c.milkeninstitute.org/assets/Publication/MIRReview/PDF/05-12-MR68.pdf> (accessed April 14, 2016).

⁴³ A. Russell, "Dedicated Funding for Higher Education."

⁴⁴ Grace Barnes et al., "Gambling on the Lottery: Socioeconomic Correlates Across the Lifespan," *Journal of Gambling Studies* 27 no. 4 (2011): 575–586.

⁴⁵ Brian Sigriz, "Recent Growth in Corrections Spending Slower Than Most Other Areas of the State Budget," National Association of State Budget Officers, <http://www.nasbo.org/budget-blog/recent-growth-corrections-spending-slower-most-other-areas-state-budget> (accessed April 14, 2016).

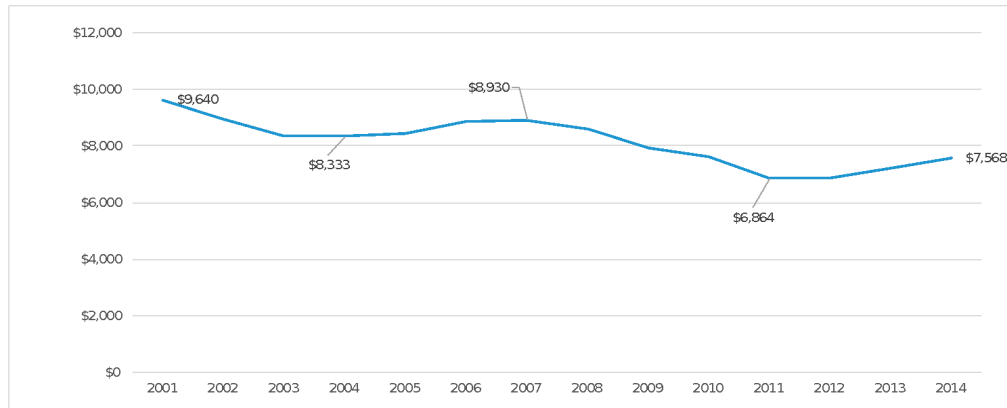
The Inconsistency of Higher Education Funding

The level of funding for public higher education and the decline in state and local funding per student are not the only financial difficulties facing students and institutions. Per-student spending fluctuates dramatically, both because states cut or slow the growth in their appropriations for higher education during weak economic times and because enrollments rise during these same periods as people turn to college to strengthen their unsatisfactory labor market options.

As Figure 5 shows, per-student funding rises and falls in a counter-cyclical pattern. Most recently, this subsidy fell from an average of \$8,930 in the nation as a whole in fiscal year (FY) 2007 to \$6,864 in FY 2011, recovering to \$7,568 in FY 2015. Increases in tuition tend to move in opposite directions, as illustrated in Figure 6.

Figure 5: State Funding per Full-Time-Equivalent Student, FY 2001 to FY 2015

Source: The Urban Institute, “Financing Public Higher Education,”



<http://webapp.urban.org/higher-education>; data from Illinois State University, Grapevine, various publication years for fall 2000 through fall 2014 data; National Center for Education Statistics (NCES), *Digest of Education Statistics*, various publication years for fall 2000 through fall 2013 data; NCES, *Digest of Education Statistics*, 2014, Table 307.10.

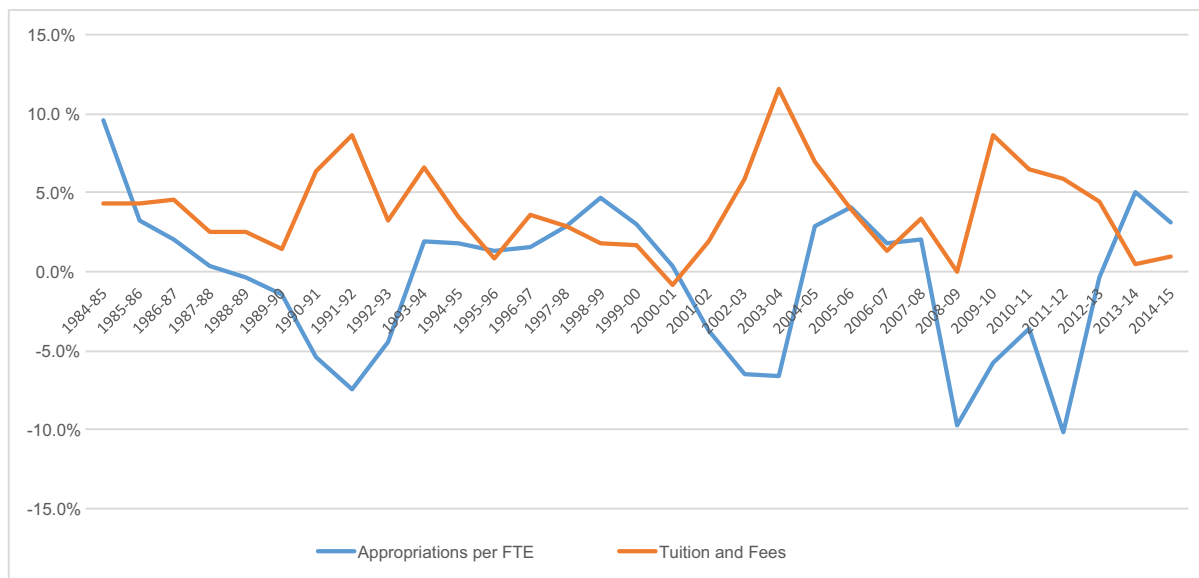


Figure 6: Annual Percentage Change in Inflation-Adjusted Per-Student State Funding for Higher Education and in Tuition and Fees at Public Institutions, 1984–1985 to 2014–2015

Source: Jennifer Ma et al., *Trends in College Pricing 2015*.

The funding fluctuations make it difficult both for institutions and for families to plan. Under current circumstances, institutions must either use their funding or lose it: They do not have the option of accumulating funds in anticipation of future shortfalls. As a result, tuition rates rise fastest during recessions, just as students and families are experiencing declining income and employment and often seeing the value of their assets fall.

Enrollment growth during recessions exacerbates the problem, but states do make significant adjustments to total postsecondary funding in an effort to balance their budgets. Figure 7 shows examples of year-to-year changes in total funding in selected states. It is no surprise, for example, that students in California and Florida faced significant changes in tuition levels and in the opportunities available at their institutions in the wake of the sharp funding cuts in 2010–2011.

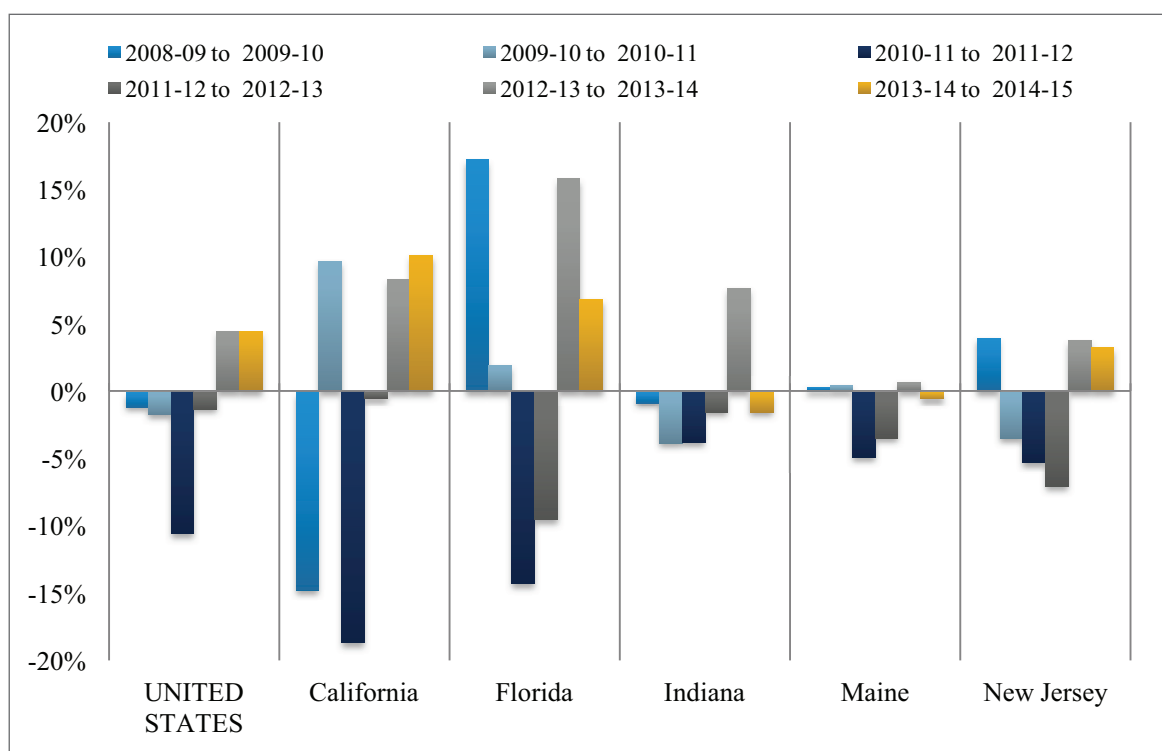


Figure 7: Single-Year Fluctuations in State Funding for Higher Education, Inflation Adjusted, Selected States by Fiscal Years, 2009–2010 to 2014–2015

Source: Sandy Baum and Martha Johnson, *Financing Public Higher Education: The Evolution of State Funding* (Washington, DC: The Urban Institute, 2015), http://www.urban.org/research/publication/financing-public-higher-education-evolution-state-funding/view/full_report.

In contrast to the situation of higher education, in some areas stored up funds meet the expanding need for income support in economic downturns. The unemployment insurance system might serve as a good model for creating state-level “rainy-day funds” for higher education. If a state were to deposit a fraction of appropriated funds in a dedicated fund when the economy is strong, it could withdraw those funds when state revenues decline to supplement funding for colleges and universities. A long-term funding strategy would be a significant improvement over the current year-to-year system.

In 2008, Maryland created a Higher Education Investment Fund to act as a rainy-day fund to help smooth appropriations during recessions. Funded with 6 percent of corporate income tax revenues, ideally funds will be deposited when the economy is doing well and spent during downturns. In 2010, the Legislature linked payouts to tuition increases, limiting tuition growth to the three-year rolling average of increases in state median income, with the fund being used to make up shortfalls. Since the Great Recession, Maryland’s tuition increases have been lower than the national average.⁴⁶ Establishing some sort of stabilization fund is especially important if, as recommended above, states use pro-cyclical taxes to fund higher education. Because demand for college increases during recessions, access to revenues accrued during more stable periods is especially important.

⁴⁶ National Conference of State Legislatures, *Higher Education Appropriations*, <http://www.ncsl.org/research/education/higher-education-appropriations.aspx> (accessed April 14, 2016).

Taxpayer-Funded Incentives for Institutions

States are increasingly focused on influencing the behavior of institutions. Another paper in this series discusses the increasing prevalence of performance-based funding formulas that tie appropriations to outcomes. These funding systems tend to focus on completion rates but may also incorporate student demographics, fields of study, and other metrics.

Of course, the allocation of general appropriations is not the only way state or federal governments can provide financial incentives. Some proposals for reforming the federal student aid system include a fund that would be distributed to institutions based on the number of low-income students who successfully complete their studies. Details of this proposed fund vary, but the basic idea is that institutions require both incentives and resources to provide the services at-risk students need to succeed. Providing financial aid is necessary but insufficient.

In 2008, the Rethinking Student Aid study group proposed that the federal government provide colleges and universities with block grants proportional to the institution's success in helping Pell Grant-eligible students progress beyond the first year of study. For the most part, institutions would have wide discretion in their use of these incentive funds.⁴⁷

In a related effort, the Obama administration's First in the World Program supports the "development, replication, and dissemination of innovative solutions and evidence for what works in addressing persistent and widespread challenges in postsecondary education for students who are at risk for not persisting in and completing postsecondary programs, including, but not limited to, adult learners, working students, part-time students, students from low-income backgrounds, students of color, students with disabilities, and first-generation students."⁴⁸ This model funds a small number of institutions through a competitive process, most with awards in the \$2 million to \$3 million range but some with close to \$10 million. The Rethinking Student Aid proposal and others like it would make the funding an entitlement to any institution that meets the specified requirements.

States could design similar strategies to encourage institutional innovation. The main goals would likely be improving student outcomes and reducing costs. States could either have institutions develop proposals and apply for funding or provide funding over and above regular state appropriations that would focus institutional resources on supporting success among at-risk students.

⁴⁷ Rethinking Student Aid Study Group, *Fulfilling the Commitment: Recommendations for Reforming Federal Student Aid* (Washington, DC: The College Board, 2008), <http://media.collegeboard.com/digitalServices/pdf/advocacy/homeorg/rethinking-student-aid-fulfilling-commitment-recommendations.pdf> (accessed April 14, 2016).

⁴⁸ U.S. Department of Education, "First in the World," <http://www2.ed.gov/programs/fitw/index.html> (accessed April 14, 2016).

Conclusion

State and local governments provide vital funding for public colleges and universities and for state residents enrolled in them. Subsidizing all college students is important in terms of both efficiency and equity. The benefits of higher education accrue both to individual students and to society as a whole. Declines over time in per-student state funding risk diminishing the nation's ability to develop and maintain a skilled, flexible labor force as well as an active and engaged citizenry.

Most important is ensuring that financial barriers do not make higher education inaccessible to students who have limited resources. Because these are the students most likely to be on the margin of college attendance, subsidizing low- and moderate-income students offers the greatest potential to increase educational attainment levels. Moreover, from an equity perspective, these are the students whose opportunities for investing in themselves are most limited and who depend most on the support that lowers the price they pay for college.

It is important to realize, however, that states are facing competing demands for increasingly limited dollars. In this context, states should focus on strategies for increasing higher education funding and for allocating existing funding in the most effective way possible. It is unlikely that a magic bullet will solve the current problems; there are no vast untapped sources of revenue. That said, many states do not take full advantage of income taxes to generate revenues from more affluent residents and do not target their funding to generate the largest possible increases in educational opportunity and attainment.

State funding can go farther in meeting its goals if tuition is recognized as a user fee and if funding is used to generously finance need-based grant aid in addition to providing broad institutional support. Of particular importance is the development of mechanisms to dampen the cycles in higher education funding, replacing the ups and downs of current funding patterns.



We conclude with the following recommendations to policymakers for balancing competing demands for public dollars:

- **There is a role for both tuition and public subsidies.** Tuition payments are both fair and efficient, reflecting the substantial return to education individual students realize in the form of future earnings. At the same time, general subsidies to higher education recognize the fact that society as a whole shares the benefits of a more educated workforce in terms of growth in economic activity and future tax revenues. The challenge lies with finding the optimal balance. The recent shift toward greater reliance on tuition revenues and less reliance on public funding was not purposeful. Increases in tuition must be accompanied by increases in need-based grant aid to prevent tuition increases from reducing educational opportunities for disadvantaged populations.
- To use limited resources most effectively, states should **prioritize funds for students who have the most limited ability to pay** rather than for merit aid, which goes disproportionately to more affluent students.
- **Institutional funding should prioritize colleges that serve low-income students.** These institutions tend to be underfunded, limiting their ability to support success among their students. Providing incentive funds based on the success of low-income students has the potential to increase both the motivation and the capacity of public institutions to further national attainment goals.
- **There is no such thing as free college.** It is important to understand that lower tuition means higher taxes and increases the burden on all taxpayers, including and often primarily lower-income households.
- **Progressive taxes are better sources of funding than regressive taxes.** This distinction is particularly important because the returns to education accrue disproportionately to higher-income individuals. Increased tax revenues and the diversion of some existing state funds from other purposes could strengthen public higher education, but the revenues should come from income taxes or other progressive measures, not from lotteries or other taxes imposing the largest burdens on low-income residents.
- **Tuition increases should be planned in advance** and implemented on a regular basis rather than being greatest during downturns. Basing annual increases on inflation or changes in personal income would be preferable to the current, unpredictable cyclical increases.
- **Stabilization funds** help smooth tuition increases. Longer-term budgeting is generally good practice, and the impact of cyclical tuition increases on access to education is a particular problem.
- **Funds should be used strategically to improve success rates.** Balancing tuition limits with spending on services to help students complete their degree in a timely fashion will make limited available funds go farther. Low prices are not enough. Students must have access to success—not just to postsecondary institutions.