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Education Outlook

K–12 Budget Picture: Lean Years Ahead

By Frederick M. Hess and Whitney Downs

While educators are eager to forget the financial woes of the past two years and return to the familiar routine of steady budget increases, the fiscal outlook for America's fourteen thousand school districts is bleak—not just for next year, but for a half decade or more. This calls for a new mindset among educators and an unfamiliar, sometimes-uncomfortable commitment to productivity and cost-effectiveness.[1]

On the first day of school in San Jose, California, Lorrie Davis scrambled at the last minute to find a ride for her daughter. No one from the school district had notified her that budget cuts meant bus services for nearly three hundred special-needs students would not start until a few weeks after school began.[2] In Charlotte, North Carolina, budget cuts mean students have to shell out $50 to $100 to play middle or high school sports.[3] Parents of elementary school students in Moody, Alabama, and Nevada, Texas, were surprised to find garbage bags, Clorox wipes, and other classroom cleaning supplies on their children's recommended back-to-school lists—a trend that Barbara Chester, president of the National Association of Elementary School Principals, says is due to limited funds. "Some of the things that have been historically provided by schools, we're not able to provide at this point," Chester said.

If Chester and school officials across the country think things are bumpy now, they will certainly want to buckle their seatbelts going forward. The alarming truth is that, as bad as the current situation seems, there is little daylight ahead as we look to the next five years—which makes it all the more worrisome that educators are relying on haphazard tactics, like erratically cutting bus services or asking parents to supply paper towels, to deal with the budget crunch. This *Outlook* will explain why the bleak situation is unlikely to brighten anytime soon and suggest a more comprehensive reform strategy, including reevaluating cost structures and addressing systemic inefficiencies.

It Is Time for Blunt Truths

Despite all the recent talks of teacher firings and harsh cuts, education has actually had it easy thus far. Mike Antonucci of the Education Intelligence Agency reports that, according to the Department of Education's own data, school-district staff

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Key points in this *Outlook*:

K–12 education administrators can no longer rely on steadily increasing budgets:

- Property-tax revenues are falling after the housing bubble burst;
- Most stimulus funds will dry up after this school year; and
- State budgets are increasingly pinched by Medicaid and public-pension obligations.

Piecemeal budget cuts will not suffice. Districts must consider fundamentally new ways to boost productivity and cost-effectiveness.

actually increased by 2.3 percent nationally over the course of the "Great Recession."[4] And, while state government employment has declined 1.9 percent since December 2007, state education jobs are up 2.1 percent. Private-sector jobs fell 6.8 percent in that time; local education employment, on the other hand, declined by just 0.9 percent.[5]

Unfortunately, national education leaders have too rarely spoken candidly with educators, parents, and reformers about where matters stand. In fact, Secretary of Education Arne Duncan touted August's $10 billion "Edujobs" bill by saying, "Today's historic vote means school officials won't need to make those tough calls."[6] Duncan has said that while "we want people to be responsible to be efficient," the public should understand that many districts have been cutting for years and have already cut "through . . . fat, through flesh, and into bone."[7] But Duncan's claims are misleading. The National Center for Education Statistics reports that, nationally, per-pupil spending increased 16 percent from 2000 to 2007.[8] Indeed, nominal per-pupil spending rose every year between World War II and 2007.[9]

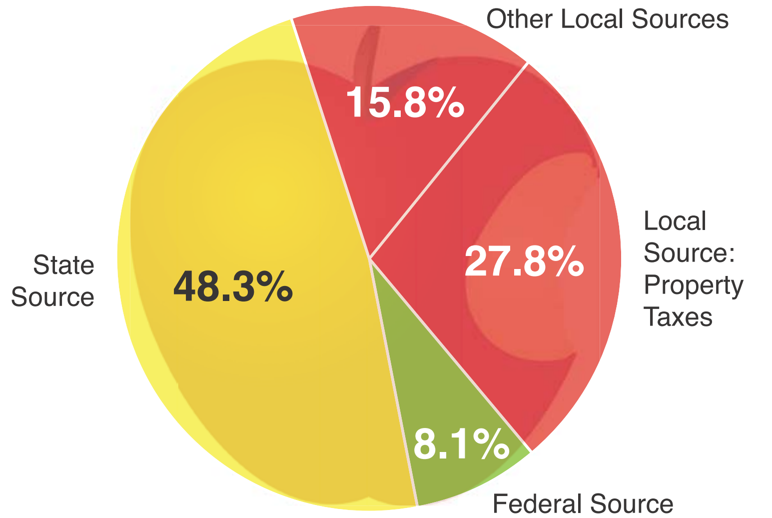
For example, despite a net decrease in total enrollment, the Houston Independent School District increased spending by 15 percent from 2006 to 2008.[10] School spending in New York grew from $16,195 per pupil in 2007 to $17,929 in 2009.[11] And the operating budget for the Chicago Public Schools has increased 14.6 percent (or $680 million) from 2008 to 2010 in the teeth of the recession—despite flat enrollment.[12] Many districts simply have not yet adjusted to the tougher times.

Unfortunately, they will have to face reality soon. The Center on Budget and Policy Priorities recently estimated that state budget gaps are likely to exceed $140 billion in fiscal year (FY) 2011, even after taking into account the $40 billion in leftover federal stimulus dollars. Thirty-nine states have already projected an additional $102 billion in shortfalls for FY 2012; the states may see a combined $260 billion in budget shortfalls over the next two fiscal years.[13] The National Governors Association puts the estimated budget gap for 2009–2012 at $297 billion.[14] These gaps are significant because state dollars account for 48.3 percent of K–12 education funding (see the figure). Meanwhile, analysts predict that unemployment will remain above 8 percent into 2012 and above 6 percent through 2015.[15] And, while the worst of the recession may be over, Nobel prize–winning economist Joseph Stiglitz cautions, "This is an anemic recovery . . . and is likely to remain anemic."[16]

State tax revenue in the first quarter of 2010 was down 10.9 percent compared to two years ago and is expected to continue slipping into 2011.[17] State sales, personal-income, and corporate tax collections, which account for 80 percent of the general-fund revenue (revenue not allocated by law to a specific fund or purpose), are expected to be 8.4 percent lower in FY 2011 than in FY 2008.[18] In June, the National Association of State Budget Officers (NASBO) noted, "Fiscal 2010 presented the most difficult challenge for states' financial management since the Great Depression."[19] And NASBO's executive director, Scott Pattison, has warned, "There are so many issues that go way beyond the current downturn. . . . This is an awful time for states fiscally, but they're even more worried about 2011, 2012, 2013, 2014."[20] This is partly because, as a recent Rockefeller Institute report observed, "fiscal recovery for the states historically lags behind a national economic turnaround."[21]

These macroconditions are made even worse for K–12 schooling by a series of impending state budget pressures: lagging property-tax revenues, increasing Medicaid enrollment, underfunded pension obligations, and the expiration of federal bailouts.

Distribution of Public K–12 School Revenue, 2007–2008



Source: U.S. Bureau of the Census, *Public Education Finances, 2008* (Washington, DC, June 2010), available at www2.census.gov/govs/school/08f33pub.pdf (accessed November 1, 2010).

Lags in Property-Tax Revenue

Aside from state spending, property-tax revenue is the lifeblood of K–12 education, accounting for 95 percent of the tax revenue for independent school districts.[22] At 27.8 percent of total K–12 revenue in 2007–2008 (on average), property taxes exceed all other local and federal sources of revenue combined (see the figure).[23] In some states, including Illinois, New Jersey, Nebraska, and New Hampshire, that number is even higher, with property-tax collections accounting for more than half of revenue.[24] Property taxes have made up a steadily growing percentage of revenue since 2000, reaching 36 percent in 2010.[25]

Property-tax revenues soared as the real estate bubble grew in the first half of the decade, growing 50 percent faster from 2001 to 2005 than from 1996 to 2000.[26] Byron Lutz has found, however, that it takes a full three years for a change in real estate prices to influence property-tax revenues due to poorly administered assessment systems and the backward-looking nature of assessments (for example, taxes this year are based on the value of property last year).[27] The S&P/Case-Shiller index of the national housing market places the peak of the "boom" at mid-July 2006, with residential property only bottoming in 2010.[28] Meanwhile, experts project that commercial real estate is unlikely to bottom until 2011. The nature of lagged valuations means that property-tax collections are likely to face downward pressure at least through 2013 or 2014.

A recent report by the Rockefeller Institute found that a dip in property-tax collections in the first quarter of 2010 marked the first dip in property-tax revenues since the start of the recession.[29] Florida, one of the earliest victims of a burst housing bubble, saw a 6.9 percent statewide decline in real property taxes levied from 2008 to 2009, resulting in a $1.1 billion loss of revenue.[30] And that is only the start of things.

Those hoping to boost tax rates to offset declining valuations should anticipate a surprising degree of political backlash from voters whose homes have lost value.[31] In April, New Jersey voters rejected over half of the local school districts' budgets due in large part to property-tax hikes contained in many of them.[32] Mayor Richard Daley of Chicago recently ruled out raising property taxes as a way to plug the city's budget hole.[33] In Milwaukee, Mayor Tom Barrett opposed property-tax hikes for the first time since taking office in 2004.[34]

Indeed, some states have adopted regulations or tax caps to limit the amount of property taxes residents will pay in future years. Indiana collected $24.6 million less in local property-tax revenues this year due to newly enacted caps.[35] In New Jersey, Governor Chris Christie signed into law a 2.5 percent cap on property-tax increases, while proposing to trim aid to schools by $820 million and to municipalities by $445 million.[36] Other states, such as New York and Nevada, have seen property-tax-cap proposals gain substantial support. Clearly, school districts must stop relying on ever-increasing property taxes to finance their operations.

Underfunded Pensions

States also have to wrestle with huge, looming pension imbalances. The Pew Center on the States reports that at the end of FY 2008, there was a $1 trillion gap between the $2.35 trillion states and local governments had set aside for employees' retirement benefits and the $3.35 trillion price tag of those promises.[37] This estimate does not take into account the 25 percent decline in pension coffers since that time. In a June 2010 white paper, economists Andrew G. Biggs of AEI and Eileen Norcross argue that if public pensions were subjected to the kind of evaluation required of private-sector pensions, the gap would be as large as $3 trillion.[38]

State and local pension obligations have skyrocketed by a whopping 135 percent since 2000. Over the same time period, the states with fully funded pension systems have dropped from over half to just four.[39] Retiree health care and other nonpension benefits pose similar challenges. The Pew Center estimates that states have a $587 billion total liability in current and promised benefits, with just $32 billion of that amount funded as of FY 2008.[40] Economist Joshua Rauh of Northwestern University predicted in May 2010 that four states—Illinois, New Jersey, Connecticut, and Indiana—will empty their pension funds before the end of the coming decade.[41] The need to address this shortfall and fulfill existing obligations will pressure school budgets for the foreseeable future.

The Growing Obligations of Medicaid

Among budget experts, Medicaid is seen as the largest potential threat to state fiscal solvency.[42] Though many states tried to cut Medicaid costs last year by dropping services, these steps—along with $87 billion in federal stimulus aid—were completely offset by enrollment growth.[43] A Kaiser Commission study published earlier this year found that Medicaid spending increased 7.9 percent nationally during FY 2009.[44]

One quarter of state spending, or $152 billion in FY 2008, goes to Medicaid obligations. This figure is projected to rise in 2014 and beyond as health care reform takes full effect.[45] The Congressional Budget Office (CBO) projects that health care reform will boost state Medicaid enrollment by at least 16 million between 2014 and 2019.[46] In addition to the legislated increase in Medicaid enrollment, the aging of the baby-boomer generation is also projected to cause entitlement spending to swell. The CBO reports that "aging is the more important factor over the next 25 years or so. . . . [It] accounts for about 64 percent of the projected growth in spending on the major entitlements by 2035."[47]

Many of the costs associated with the implementation of health care reform will come before 2014, as states attempt to update their computer and infrastructure systems. One state budget officer said there is "a prevailing state of 'cognitive fiscal dissonance,' where states are trying to meet Medicaid budget reduction targets while at the same time putting in place new staff and funding to get started on health care reform implementation."[48]

The End of Stimulus Dollars

In February, forty-two governors signed a letter imploring Congress to extend federal Medicaid assistance that was originally set to expire at the end of 2010.[49] Even when extension looked unlikely, thirty states assumed it would occur while attempting to balance their FY 2011 budgets.[50] In total, stimulus dollars were used to plug between 30 and 40 percent of states' 2009 and 2010 budget gaps.[51]

Stimulus dollars propped up K–12 education with a direct grant of $77 billion to be used in 2009 and 2010. This included $40 billion in "state stabilization" funds to be used to "help avert education cuts."[52] Overall, the Department of Education has estimated that stimulus dollars funded a total of 312,000 education jobs.[53] Combined with the 161,000 positions supposedly funded under the Edujobs bill, this suggests that hundreds of thousands of education jobs are underwritten by dollars set to expire at the end of the 2011–12 school year.[54]

Furthermore, though stimulus dollars helped districts deal with funding shortfalls, the American Association of School Administrators reports that a vast majority of superintendents (87 percent) said the stimulus dollars did not make up for the loss of local and state revenues.[55] Thirteen states have already drained their "rainy day" reserve accounts, and forty-one used at least some of these funds to balance their budgets in 2009 and 2010.[56] With additional federal bailout dollars looking highly unlikely in the new Congress, states will have to find other ways to replace the stimulus dollars.

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The Impact on Education Funding

States have tried to address shortfalls in various ways. Some have raised taxes, instituted hiring and pay freezes, mandated furlough days for state employees, reduced police and fire protection, released nonviolent felons early from state prisons, and closed state parks. For the first time on record, states' overall spending shrank for two consecutive years, by 4.8 percent in FY 2009 and 4 percent in FY 2010.[57] A recent survey of school administrators found nearly 80 percent of respondents reporting budget cuts for 2010–11, with one-third reporting budget cuts greater than 10 percent.[58]

Through all this, governors have tried to shield K–12 education from the deepest cuts. Many states, including Tennessee, Utah, North Dakota, Pennsylvania, New Hampshire, and Connecticut, proposed no cuts to K–12 education funding in their FY 2011 budgets.[59] Consider the actions taken by three of the states with the largest percentage of FY 2011 shortfalls.[60] In Illinois, the budgets of the Department of Healthcare and Family Services and the Department of Human Services were cut by 6.6 percent, or $791 million, while K–12 education budgets were cut only two-thirds as much. Arizona voters passed a 1 percent increase in the state sales tax, which went exclusively to preventing $551 million in education cuts. Nevada enacted across-the-board cuts of 10 percent for every department except education, which was cut by less than 7 percent. If education remains relatively protected from cuts, it will likely be toward the back of the line for new funding when state budgets improve; governors and state legislators may first try to restore deep cuts to other departments.

Many wonder what will happen to state budgets next year, when state budget deficits are projected to be at least as bad as they are this year. Unfortunately, the Department of Education does not seem to have answers. When a reporter asked Duncan about 2011–12, he said, "[W]e really wanted to avoid a huge catastrophe this year. . . . [W]e're hopeful we'll be in a much better spot next year."[61]

What Now?

Michigan House speaker Andy Dillon has sensibly encouraged states to view the harsh economic conditions as an opportunity to pursue fiscal and budgetary reform, explaining, "We have to do what General Motors did to itself. . . . It wasn't until [General Motors] hit the wall that the real structural changes happened. We have a small window of opportunity to make structural, long-term changes to state government to avoid hitting a similar wall. That time is now."[62]

States can either step up and heed this advice, or hope against hope that the federal bailout window remains open for years to come—a plan that looks increasingly unlikely with the new, more right-leaning Congress. A better plan is for states, districts, and schools to take to heart the lessons of *Stretching the School Dollar* and start to prepare themselves for a spate of leaner years. Fortunately, there are a wealth of ways that educational leaders can control spending by tightening up operations, rethinking staffing, and using technology smartly. They will not only save money but also, more importantly, boost cost-effectiveness and transform schools and districts into more effective organizations.

The Council of Great City Schools, the nation's primary coalition of large-city districts, has launched a Performance Measurement and Benchmarking Project that allows urban school systems to compare their operational and financial efficiency against that of their peers. In the first few years of the project, districts have saved millions by improving the efficiency of their custodians, bus fleets, procurement operations, and use of electricity. University of Washington scholar Marguerite Roza has shown how districts can use unit-cost analyses of programs and practices to identify savings.[63] In one district, for example, cheerleading cost the district $1,348 per cheerleader. The problem: cheerleading was offered as a class, requiring a salaried teacher. The superintendent shifted cheerleading to after-school status, saving tens of thousands of dollars without eliminating any opportunities.

Boosting productivity, though, requires grappling with the cost of teaching. Teacher salaries and benefits amount to half or more of district spending. The most promising way to control costs without slashing services is to get more value out of each employee. While American schools have been in a multidecade push for class-size reduction—cutting student-teacher ratios from 23:1 in the early 1970s to about 15:1 today—this massive increase in staffing has shown no evidence of academic benefits. While smaller classes are attractive in the abstract, the need to hire more bodies dilutes teacher quality. Indeed, some high-performing countries, like South Korea and Singapore, have some middle school and high school classes with forty or more students per classroom. Increasing aggregate student-teacher ratios by about two students, from 15:1 to 17:1, could cut district spending on salary and benefits by nearly 10 percent.

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Another key to trimming costs is making better use of technology. Education analyst John Chubb has calculated that integrating online instruction into the school day—by having elementary students work online for one hour, middle school students for two hours, and high school students for three hours—could cut spending by perhaps 8 percent (or more than $700 per student) in the typical district.[64]

There are many ways to sensibly address educational costs while promoting cost-effective schooling. In addition to the above, simple measures like reining in benefits and negotiating more disciplined collective bargaining agreements can make a huge difference. Many educational advocates, including the U.S. secretary of education, have implied that difficult measures are not necessary because things will get better soon. Unfortunately, the truth is that, generally speaking, they will not—and states and districts would do well to look ahead with no illusions and a cool resolve to act.

Notes

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