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ON THE CHOPPING BLOCK

Rising State Pension Costs Lead to Cuts in Higher Education

Daniel DiSalvo
Manhattan Institute

Jeffrey Kucik
City College of New York-CUNY

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About the Authors

Daniel DiSalvo is a senior fellow at the Manhattan Institute and an associate professor of political science at the Colin Powell School of the City College of New York–CUNY. His research focuses on American political parties, elections, labor unions, and state government. DiSalvo is the author of *Engines of Change: Party Factions in American Politics, 1868–2010* (2012) and *Government Against Itself: Public Union Power and Its Consequences* (2014). He writes frequently for scholarly and popular publications, including *National Affairs, City Journal, American Interest, Commentary, Weekly Standard, Los Angeles Times, New York Daily News,* and *New York Post.* DiSalvo is coeditor of *The Forum: A Journal of Applied Research in Contemporary Politics.* He holds a Ph.D. in politics from the University of Virginia.

Jeffrey Kucik is an assistant professor of political science at the Colin Powell School of the City College of New York-CUNY. He also serves as director of CCNY's master's degree program in international relations. Kucik was previously a fellow at Princeton University and a lecturer in international political economy and director of the MSc program in international public policy at University College London. He researches topics in international trade, political economy, and global security. Kucik holds a Ph.D. in political science from Emory University.

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Executive Summary

America's public colleges and universities have long served as engines of upward mobility, intellectual innovation, and economic growth. But these critical institutions are increasingly under financial stress. From 2000 to 2016, public universities lost 25% of their state funding per student. During the same period, tuition and student debt skyrocketed.

Spending on public-worker pensions is driving these budget cuts. In the wake of the Great Recession, all 50 states enacted pension reforms of some kind. Unfortunately, these reforms didn't go nearly far enough, and pension debt has continued to rise steadily since 2008. Forced to adhere to balanced-budget requirements, many state governments have been confronted with tough fiscal choices. One choice that nearly every state has made is to cut funding for higher education.

Over the past several years, total state expenditures have increased, on average, across the U.S., and pension expenditures (and liabilities) have increased the most—by an average of 61% between 2008 and 2015. But states decreased per-student higher-education spending by an average of 22.4% over the same period, while tuition increased by 12%. State funding for higher education is nearly $10 billion (adjusted for inflation) below what it was in 2008.

Squeezing higher education to fund pensions is not a trend confined to red states; the trends are similar in states governed by Democrats. As a result, states are confronted with a choice between generations: students and retirees. This report argues for rebalancing. States should reprioritize pension reform in order to boost higher education, for the good of younger Americans—particularly those from families of modest means—and for the good of the nation's future economic health.

ON THE CHOPPING BLOCK

Rising State Pension Costs Lead to Cuts in Higher Education

Introduction

Years before the onset of the Great Recession, many states underfunded their pension plans, either because of unsound accounting practices, overly generous benefits packages, or failure to dedicate sufficient funds up-front. The stock market crash of 2008 led to a sharp devaluation in pension fund assets, ultimately totaling about $1 trillion in losses.[1] The result of persistent underfunding was a net deficit across all states of about $4 trillion, or one-third of total U.S. GDP.[2] Today, state and local public-sector pensions rank just below the federal entitlements of Medicare, Medicaid, and Social Security as America's most pressing fiscal challenge.

Over the past five years, states have enacted reforms that many hoped would address the problem.[3] Yet pension spending continues to trend upward. Since state reforms mainly targeted new hires, rather than existing employees or current retirees, it will take decades for these reforms to produce cost savings.

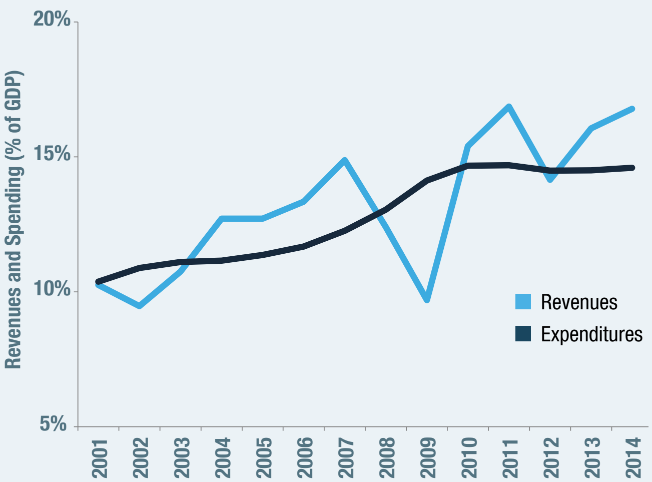
States have only three basic options to deal with rising costs: raise taxes, cut spending, or borrow more. To varying degrees, states have tried all three, with mixed success. Revenues are up in most states, but so are expenditures. **Figure 1** shows that, notwithstanding the dip in revenues around the Great Recession, total state revenue and spending across the U.S. has grown steadily. But increased revenues have not been enough to cover states' fiscal priorities. The result is the "crowding out" of certain policy areas—chief among them, higher education—as states are forced to cut spending in other areas to cover expanding pension obligations.[4]

At one time, public colleges and universities could reliably count on government funding. But since the 1980s, as state spending on higher education has consistently declined, students, parents, the federal government, and higher-education institutions have increasingly borne the financial burden. Tuition hikes have significantly outpaced growth in median incomes.[5] Students have taken on more debt. Colleges and universities have adjusted by increasing fund-raising efforts and drawing upon their endowments.

Since 2008, spending on Medicaid, elementary and secondary education, and protective services has increased. Higher education is the only large area of state spending that has experienced comprehensive cuts.

FIGURE 1.

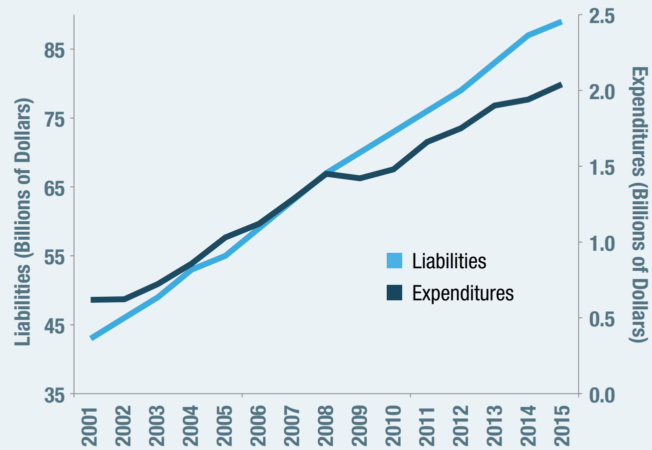
Total State Revenues and Expenditures, 2001–14



Source: US Census Bureau Annual Survey of State Government Finances

FIGURE 2.

Average State Pension Liabilities and Expenditures, 2001–15



Source: Center for Retirement Research at Boston College's Public Plans Data

The Higher-Education Landscape

There are some 2,056 public colleges or universities (including community colleges) in the United States.[6] These institutions served 13.2 million students in 2014, compared with the 2.8 million students enrolled in the 1,675 private nonprofit colleges and universities that year.[7]

In 2016–17, the average cost of tuition and fees was $9,650 for state residents attending public universities and $24,930 for out-of-state residents, while the average tuition at private nonprofit colleges was $33,480. Public colleges and universities serve more students from lower-income groups than those who attend private nonprofit institutions.[8] For example, 81% of students at the University of California–Irvine came from households whose income was in the lowest 20% of the income distribution (less than $21,884 in 2016).[9] Public institutions have traditionally served as the conveyor belt to the middle and upper classes. By way of contrast, 38 elite private nonprofit institutions—including Washington University in St. Louis, Middlebury College, Bucknell University, and Tufts University—had more students hailing from households in the top 1% of the income scale (greater than $630,000) than the lower 60% (less than $65,000).[10] Many private institutions, in effect, serve as finishing schools for the well-to-do.

Rising Pension Costs

Public-sector pensions have increased dramatically in recent years (**Figure 2**). At the same time, expenditures have grown threefold as more public-sector employees—promised benefits decades ago—have begun to retire. Indeed, the rate at which public employees are retiring is increasing faster than that of retirees in general.[11]

Figure 3 shows each state's total pension expenditures and liabilities in 2008 and 2015, as well as the changes in both categories. The top 10 states whose expenditures grew the most—including Pennsylvania, Illinois, and New York—all more than doubled their expenditures on pensions. Total combined liabilities increased by 41% in those same 10 states—9% higher than the national average.

Previous generosity is a key driver of today's fiscal pressures. Two main factors are at play. First, public pension plans typically offer defined benefits, as opposed to defined contributions, which are common in the private sector. Defined-benefit plans lock state governments into providing predetermined income replacement, regardless of their current fiscal health.[12]

Second, beginning around 1975, many state pension plans began to expand. Stock market gains in the 1990s created widespread belief that the money that state governments invested then would grow to cover future

FIGURE 3.

State Pension Expenditures and Liabilities, 2008–15, in Millions

State	2008		2015		Percent Change	
	Expenditures	Liabilities	Expenditures	Liabilities	Expenditures	Liabilities
Alabama	1,060	40,000	1,150	46,000	8%	15%
Alaska	294	14,000	2,930	20,000	897%	43%
Arizona	1,100	44,000	1,650	62,000	50%	41%
Arkansas	524	20,000	672	9,300	28%	-54%
California	14,300	630,000	14,200	890,000	-1%	41%
Colorado	1,250	61,000	1,380	73,000	10%	20%
Connecticut	3,270	43,000	2,320	55,000	-29%	28%
Delaware	102	6,500	178	9,100	75%	40%
Florida	2,830	130,000	2,520	170,000	-11%	31%
Georgia	1,340	76,000	1,970	100,000	47%	32%
Hawaii	489	17,000	—	23,000	—	35%
Idaho	274	11,000	321	15,000	17%	36%
Illinois	3,370	190,000	8,950	290,000	166%	53%
Indiana	1,110	32,000	1,590	41,000	43%	28%
Iowa	432	27,000	737	36,000	71%	33%
Kansas	396	19,000	676	25,000	71%	32%
Kentucky	811	43,000	1,520	59,000	87%	37%
Louisiana	1,450	43,000	1,640	57,000	13%	33%
Maine	318	14,000	342	15,000	8%	7%
Maryland	1,060	50,000	1,830	66,000	73%	32%
Massachusetts	1,510	61,000	—	78,000	—	28%
Michigan	1,640	81,000	3,050	98,000	86%	21%
Minnesota	761	59,000	1,560	96,000	105%	63%
Mississippi	617	29,000	950	40,000	54%	38%
Missouri	1,130	55,000	1,520	68,000	35%	24%
Montana	154	8,600	265	12,000	72%	40%
Nebraska	148	9,000	213	13,000	44%	44%
Nevada	1,170	30,000	1,430	46,000	22%	53%
New Hampshire	181	7,800	332	12,000	83%	54%
New Jersey	2,070	120,000	2,550	140,000	23%	17%
New Mexico	583	27,000	712	37,000	22%	37%
New York	10,200	370,000	18,100	480,000	77%	30%
North Carolina	649	70,000	1,670	90,000	157%	29%
North Dakota	59	4,100	143	6,500	143%	59%
Ohio	2,800	190,000	3,840	230,000	37%	21%
Oklahoma	873	29,000	1,070	32,000	23%	10%
Oregon	797	55,000	936	76,000	17%	38%
Pennsylvania	1,450	120,000	3,940	150,000	172%	25%
Rhode Island	370	12,000	418	12,000	13%	0%
South Carolina	888	40,000	1,190	50,000	34%	25%
South Dakota	90	7,000	219	10,000	144%	43%
Tennessee	929	36,000	707	45,000	-24%	25%
Texas	3,640	190,000	4,410	270,000	21%	42%
Utah	617	21,000	954	28,000	55%	33%
Vermont	80	3,400	56	5,000	-30%	47%
Virginia	1,320	65,000	2,170	87,000	64%	34%
Washington	646	27,000	958	55,000	48%	104%
West Virginia	499	13,000	681	16,000	36%	23%
Wisconsin	677	82,000	1,040	97,000	54%	18%
Wyoming	88	6,200	145	8,400	64%	35%
				Average Change	61%	33%

Source: Center for Retirement Research at Boston College's Public Plans Data

liabilities.[13] At the same time, population growth and politically active public-sector unions encouraged further generosity, including lowering retirement ages and relaxing vesting requirements.[14] According to Robert L. Clark and his fellow economists, the amount that a typical worker with 30 years on the job would receive in retirement increased by about 10% between 1975 and 2000.[15]

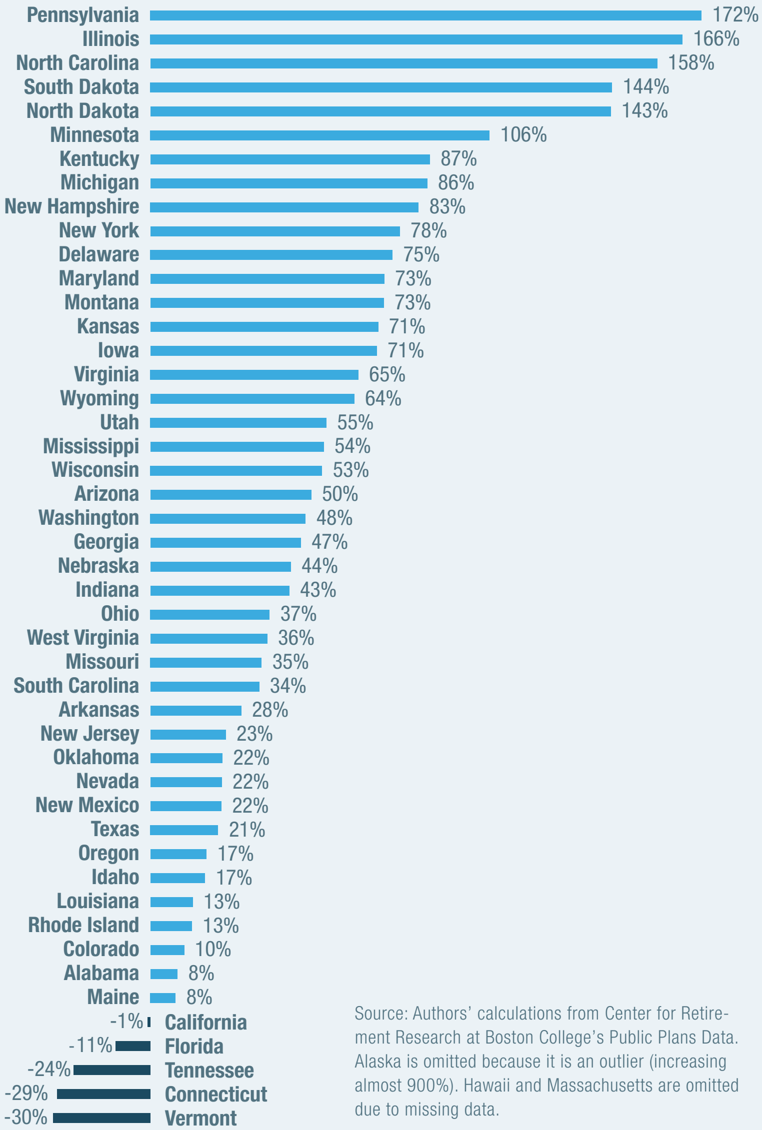
Today, states are in the difficult position of having to pay for benefits that they promised a generation ago. Since 2005, the average number of beneficiaries per state has grown from 500,000 to 1.5 million.[16] Total active employees, by contrast, have remained roughly constant. At the same time, assets that performed so well in the past suffered tremendous setbacks in the fall of 2008. States were left with less overall revenue and lower returns on their investments during a period in which demand began to swell. In short, the fiscal foundations of public pensions are far weaker today than in the past, while demographic pressures have increased.

States took various steps to deal with this problem. Many increased their investments in riskier asset classes. Public pensions typically assume 7%–8% rates of return, incentivizing boards and money managers to place money into higher-yield, riskier investments.[17] Across the U.S., 60% of public-pension-plan assets are invested in equities.[18]

Some states have moved away from defined-benefit pensions. Between 1997 and 2011, four states stopped offering defined benefits for new employees (Alaska, Michigan, Nebraska, and Utah). Other states now provide optional defined-contribution plans (including Colorado, Florida, Montana, North Dakota, Ohio, and South Carolina). Still others have begun offering hybrid plans that combine features of defined-benefit and defined-contribution plans. Since defined-contribution

FIGURE 4.

Change in State Pension Expenditures, 2008–15



Source: Authors' calculations from Center for Retirement Research at Boston College's Public Plans Data. Alaska is omitted because it is an outlier (increasing almost 900%). Hawaii and Massachusetts are omitted due to missing data.

pensions generally shift costs and risks from the employer to the employee, public-sector unions hotly contested the change.

Despite the changes, public-pension reforms will have only a limited impact on state finances for years to come. From 2008 to 2015, state pension expenditures increased on average by almost 40% (**Figure 4**).

Higher-Education Funding Trends

Public two- and four-year colleges depend on state appropriations for the majority of their costs.[19] However, state funding has been declining (**Figure 5**). Penn State University's David A. Tandberg notes that state expenditures on higher education declined by 37% from 1974 to 2001. In 1974, public higher education received 9.4% of general fund expenditures. In 2001, that percentage dropped to 5.9%.[20] By 2015, it was down to 4.3%.

Evaporating state funding has had significant consequences for public colleges and universities. Years of reduced spending have diminished students' experiences by forcing faculty reductions, limiting course offerings, and significantly increasing class sizes.[21] Tenured or tenure-track full-time professors are now the exception; part-time instructors are the norm.[22] Studies also suggest that declining state support leads public universities to seek out wealthier out-of-state students who can pay higher tuition, which, in turn, drives down the number of low-income and minority students.[23]

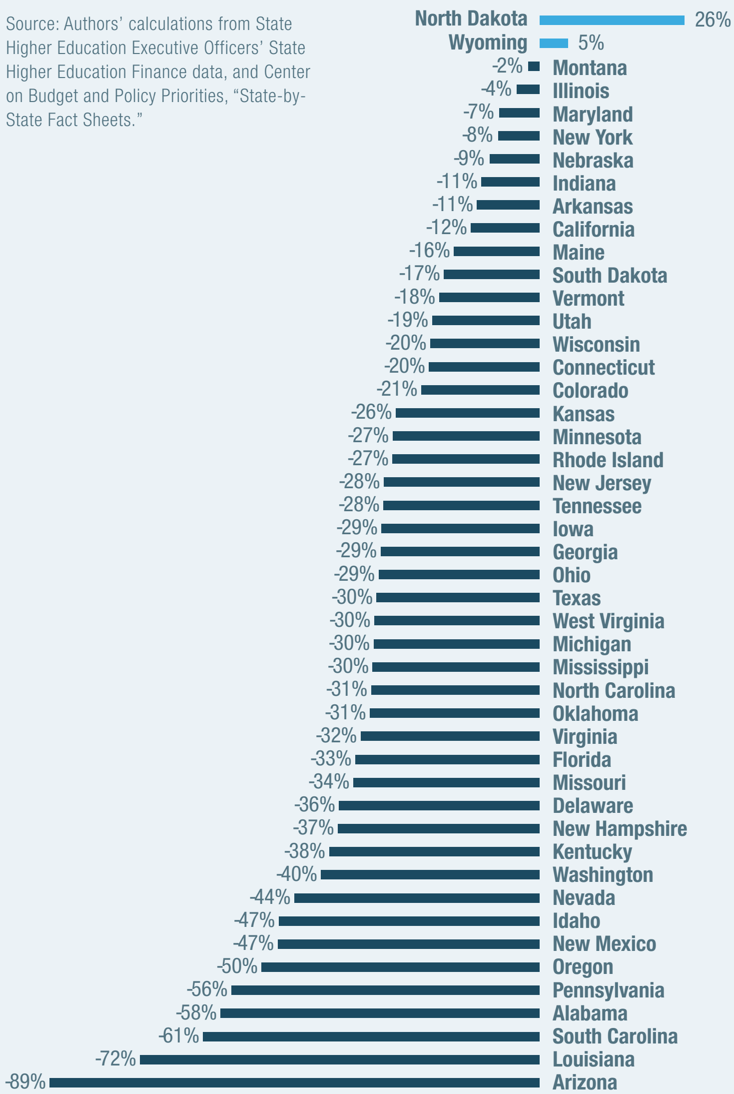
Just as important, the erosion of state support has led many schools to hike tuition. From 2008 to 2016, average annual tuition rose by $2,333 nationally, or 33% (**Figure 6**). As a percentage of colleges' and universities' total revenue, tuition increased over that period from 17% to 25%.[24] That means that half of states now receive more financial support from tuition dollars than from state or local funding. Not surprisingly, New Hampshire, whose state university system has the nation's highest average sticker price, has the lowest the level of state support, while Wyoming's, which has the lowest sticker price, has one of the highest levels of state funding.[25]

Most troubling, tuition increases now far outpace growth in median incomes. This disadvantages lower-income students, and it means that higher education is prohibitively expensive without financial aid. During the 2013–14 academic year, students in the U.S. took out about $100 billion in loans, 90% of which came from the federal government.[26] This is part of a wider trend: in recent decades, more students are borrowing to pay for college and are borrowing larger amounts.[27]

FIGURE 5.

Change in State Higher-Education Expenditures per Student, 2008–15

Source: Authors' calculations from State Higher Education Executive Officers' State Higher Education Finance data, and Center on Budget and Policy Priorities, "State-by-State Fact Sheets."



Pensions and Higher Education Collide

The two trends that we explain above—ever-rising pensions and ever-depleting funding for higher education—are inextricably linked.[28] Over the period of our study, every major budget item has increased, on average, except higher education. **Figure 7** depicts spending changes calculated in two ways. The top picture is the percentage change in total nationwide spending in major budget areas. In 2008, states spent a combined $72 billion on pensions. In 2014, that number rose to $97 billion. At the same time, total nationwide spending on higher education fell from $80 billion to $77 billion.

The bottom half of Figure 7 shows the average amount that each state's spending changed across the same categories. Some states, such as Minnesota and Pennsylvania, more than doubled their pension expenditures, while others increased theirs significantly less. The average per-state increase in pension expenditures was 47%.

Figure 7 illustrates how, calculated either way, spending on pensions has increased more, as a percentage, than any other area. By contrast, higher education is the only category in which spending has contracted. States are paying less for higher education so that they can avoid tax increases or other spending cuts.

Why Are Pensions So Difficult to Cut?

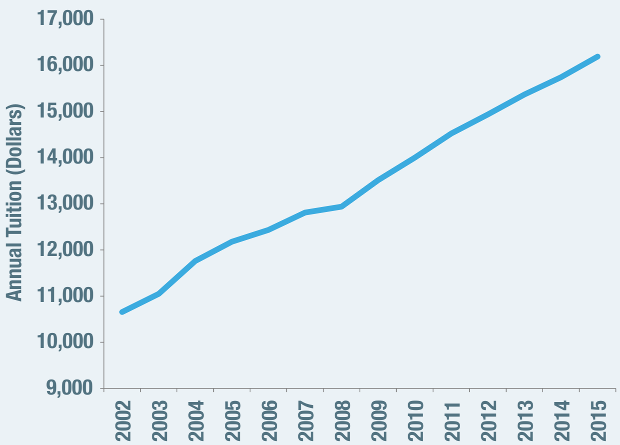
First, pension allocations are made largely on the basis of a formula. While some states may choose to short their fund by not making the annual required contribution as defined by actuaries, states must contribute to their pension funds. States must also allocate revenues on a pay-as-you-go basis for other post-employment benefits for retired public workers, which consist mostly of health-care coverage. (These other liabilities have also been rising rapidly.)[29]

Second, pensions have strong legal protections, some of which are even enshrined in state constitutions.[30] Then there is the U.S. Constitution: public-sector unions would likely appeal any cutbacks to the federal government as a violation of the property-rights provisions of the Fifth and Fourteenth Amendments or the contracts clause (Article 1, Section 10). The result is that altering benefit levels for existing employees or those already retired is difficult, if not impossible.

Third, many state programs are protected by powerful interest groups, and perhaps no interest group is more powerful than public-sector unions: they relentlessly advocate for generous pensions and other employee benefits.

FIGURE 6.

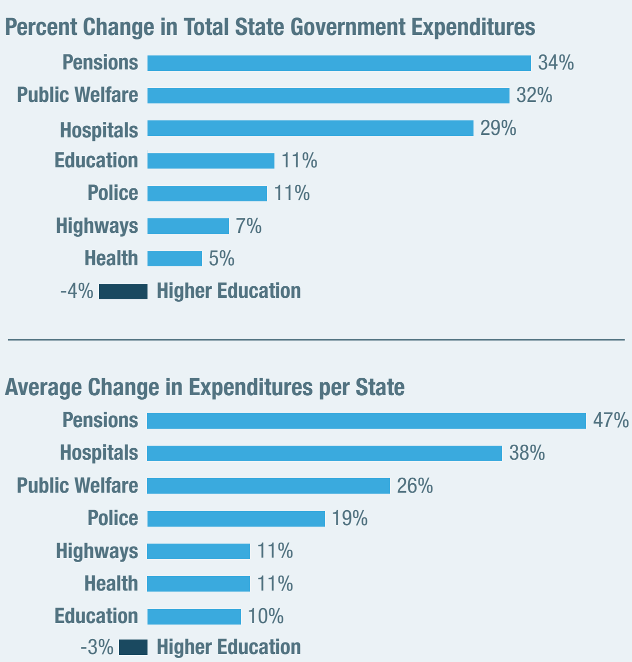
Average Tuition for Public Higher-Education Institutions, 2001–15



Source: National Center for Education Statistics

FIGURE 7.

Change in State Expenditures by Category, 2008–14



Source: Authors' calculations. US Census Bureau Annual Survey of State Government Finances, Center for Retirement Research at Boston College Public Plans Data. The top figure shows the percentage change, by category, in total spending across the United States. The bottom figure shows the average change in spending, by category, per state.

Taken together, these three facts mean that states are in a difficult legal and political position when attempting to rein in pension costs.

By contrast, none of these three conditions apply to higher education. Its funding is not set by a legally fortified formula, and the possibility of shifting costs to the federal government implicitly incentivizes states to reduce higher-education spending. Since the 1990s, federal aid per student has risen from roughly $2,000 to $6,000 in loans; $1,000 to $3,000 in grants; and $0 to $1,000 in tax credits.[31]

Moreover, higher-education spending does not enjoy strong legal protections. No contracts with public colleges and universities mirror those between government employers and their workers. While some state constitutions mandate far more policy items than the federal constitution, there is little in most state constitutions that explicitly protects higher-education spending.[32]

In contrast with pensions, few powerful interest groups are advocating on behalf of public higher education. The unions representing university faculty and staff lack the clout of other public-sector unions. Most faculty unions are in large public university systems in some 15 states, with New York and California accounting for nearly half of the U.S. total. Even in such locales, faculty unions aren't much of a force. The reason is that more than half of those faculty members are part-time employees, and another fifth are full-time but non–tenure track.[33] Those without a long-term stake in their jobs have less motivation to be politically engaged. Nationwide, fewer than 400,000 faculty are covered by collective bargaining contracts, while America's two K–12 teachers' unions claim a combined 4.6 million members. The small membership of higher-education unions limits the resources available for political activity.[34]

Thus, higher education is a ripe target for state politicians. Many of the costs can be shifted onto other constituencies and the negative effects of the cuts pushed into the future. The universities and colleges themselves can be pressured to raise more money and draw on their endowments. Colleges and universities can increase prices because students are shielded from the full cost of their education. Tuition hikes don't pinch middle-class parents if the real price (in contradistinction to the sticker price) remains relatively flat, thanks to increased private fund-raising or the use of endowment funds. For instance, in 2012 only 25% of students paid the sticker price at a four-year college; in 1990, 56% did.[35] Even if students must pay more, those payments can be deferred into the future by taking out federally subsidized loans.

In light of these political incentives, it is not surprising that Democrats as well as Republicans have pressed for—or acquiesced to—cuts in higher-education funding. Almost all states are spending less today on higher education than they did before the recession.[36]

Consider some examples. In the wake of the Great Recession, California, a state dominated by Democrats, made some of the steepest cuts in higher education.[37] On the other hand, in 2015, Republican governors in Arizona, Louisiana, and Wisconsin—and Connecticut's Democratic governor—proposed higher-education cuts to the tune of $547 million.[38] In 2016, New York's Democratic governor, Andrew Cuomo, proposed cutting state support for the City University of New York by $485 million.[39] Cuomo also rolled out a tuition "free" plan for families making less than $125,000, but the number of strings attached make it hard for students to qualify and the small amount of money budgeted for the program ($168 million) suggests that this plan will do little to alter the landscape of higher education in New York State.

Conclusion: Widening the Rungs on the Upward Mobility Ladder

The biggest losers from state cuts to higher education are students from low-income backgrounds. Historically, public colleges and universities have been the primary avenue of upward mobility for poor and lower-middle-class students. As data from the Equality of Opportunity Project show, "the City University of New York system propelled almost six times as many low-income students into the middle class and beyond as all eight Ivy League campuses, plus Duke, M.I.T., Stanford and Chicago, combined."[40] Yet systems like CUNY are struggling as a result of cuts in Albany.

Overall, states are currently failing to strike the right balance between the past and the future; a rebalancing is in order. Crucial to this rebalancing is to further reform state pension plans. Steps that legislators might take include moving toward defined-contribution plans, introducing hybrid plans, or, more controversially, changing the terms of defined-benefit plans for current employees who are not yet vested. Serious change will not happen without a protracted political struggle. But without pension reforms, states will be unable to create the conditions that enable present and future generations of young men and women to move up the mobility ladder and contribute to the nation's prosperity.

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32 Most state constitutions have language that requires the establishment of public universities and dictates aspects of their governance structure. Only

four state constitutions mention setting up a dedicated fund to support higher education. A few states also have language suggesting a guarantee of educational loan repayment, making adequate financial appropriations, and the location of institutions. Midwestern Higher Education Compact, "State Constitutional Provisions and Higher Education Governance," Policy Report, May 2013, p. 4. See also John Dinan, *The American State Constitutional Tradition* (Lawrence: University Press of Kansas, 2006).

[33] "Forum: The Future of Faculty Unions," *Chronicle of Higher Education*, July 24, 2011.

[34] Ronald G. Ehrenberg et al., "Collective Bargaining in American Higher Education," in Ehrenberg, ed., *Governing Academia* (Ithaca, N.Y.: Cornell University Press, 2004).

[35] Akers and Chingos, *Game of Loans*, p. 50.

[36] Robert Hiltonsmith and Tamara Draut, "The Great Cost Shift Continues: State Higher Education Funding After the Recession," Demos, Mar. 21, 2014.

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[39] Ellen Weller, "Cutting CUNY," *Inside Higher Ed*, Mar. 11, 2016.

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REPORT 39

Abstract

America's public colleges and universities have long served as engines of upward mobility, intellectual innovation, and economic growth. But these critical institutions are increasingly under financial stress. From 2000 to 2016, public universities lost 25% of their state funding per student. During the same period, tuition and student debt skyrocketed.

Spending on public-worker pensions is driving these budget cuts. In the wake of the Great Recession, all 50 states enacted pension reforms of some kind. Unfortunately, these reforms didn't go nearly far enough, and pension debt has continued to rise steadily since 2008.

Over the past several years, total state expenditures have increased, on average, across the U.S., and pension expenditures (and liabilities) have increased the most—by an average of 61% between 2008 and 2015. But states decreased per-student higher-education spending by an average of 22.4% over the same period. State funding for higher education is nearly $10 billion (adjusted for inflation) below what it was in 2008.

Squeezing higher education to fund pensions is not a trend confined to red states; the trends are similar in states governed by Democrats. As a result, states are confronted with a choice between generations: students and retirees. This report argues for rebalancing. States should reprioritize pension reform in order to boost higher education, for the good of younger Americans—particularly those from families of modest means—and for the good of the nation's future economic health.

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