



La Follette Policy Report

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Director's Perspective

Restoring Confidence, Economic Growth

With many Americans feeling as though the economic foundations of our society have been deeply shaken, careful policy analysis and management of public resources in responding to the economic recession are of the highest priority. To restore public confidence, our public and private sector leaders must balance the need to develop short-term policies to stimulate economic growth with longer term investments in the economic and social infrastructure of our nation that will reduce the likelihood of another severe recession.

President Obama has identified, in part, health care and education as key priorities for investment and reform, with the expectation that increased spending and greater accountability will enhance the effectiveness and efficiency of these sectors and long-run economic growth. In this context, this issue of the *La Follette Policy Report* offers perspective on the causes of the economic crisis that began in 2007, its ramifications, and on solutions offered to address it.

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Reflections on the Causes and Consequences of the Debt Crisis of 2008

By Menzie Chinn and Jeffrey Frieden

In late 2008, the world's financial system seized up. Billions of dollars worth of financial assets were frozen in place, the value of securities uncertain, and hence the solvency of seemingly rock solid financial institutions in question. By the end of the year, growth rates in the industrial world had gone negative, and even developing country growth had declined sharply.

This economic crisis has forced a re-evaluation of deeply held convictions regarding the proper method of managing economies, including the role of regulation and the ideal degree of openness to foreign trade and capital. It has also forced a re-assessment of economic orthodoxy that touts the self-regulating nature of free market economies.

The precise origin of this breathtaking series of events is difficult to identify. Because the crisis is such an all-encompassing and wide-ranging phenomenon, and observers tend to focus on what they know, most accounts center on one or two factors. Some reductionist arguments identify "greed" as the cause, while others obsess about the 1990s era amendments to the 1977 U.S. Community Reinvestment Act that was designed to encourage banks and other financial institutions to meet the needs of the entire market, including those of people living in poor neighborhoods. They also point to the political power of government-sponsored entities such as Fannie Mae and Freddie Mac, agencies designed to smooth the flow of credit to housing markets.

In our view, such simple, if not simplistic, arguments are wrong. Rather, we view the current episode as a replay of past debt crises, driven by profligate fiscal policies, but made much more virulent by a combination of high leverage, financial innovation, and regulatory disarmament. In this environment, speculation and outright criminal activities thrived; but those are exacerbating, rather than causal, factors.

History Repeats, Again

The United States has borrowed and spent itself into a foreign debt crisis. Between 2001 and 2007, Americans borrowed trillions of dollars from abroad. The federal government borrowed to finance its budget deficit; private individuals and companies borrowed so they could consume and invest beyond their means. While some spending went for physical commodities, including imports, much of the spending was for local goods and services, especially financial services and real estate. The result was a broad-based, but ultimately unsustainable, economic expansion that

drove up the relative price of goods not involved in foreign trade—things like haircuts, taxi rides, and, most important, housing. The key “nontradable” good was housing; that boom eventually became a bubble. And, when that bubble burst, assessments of assets and liabilities across the board became unbalanced.

This disaster is, in our view, merely the most recent example of a “capital flow cycle,” in which foreign capital floods a country, stimulates an economic boom, encourages financial leveraging and risk taking, and eventually culminates in a crash. In broad outlines, the cycle describes the developing-country debt crisis of the early 1980s, the Mexican crisis of 1994, the East Asian crisis of 1997-1998, the Russian and Brazilian and Turkish and Argentine crises of the late 1990s and into 2000-2001—not to speak of the German crisis of the early 1930s or the American crisis of the early 1890s. There are, to be sure, unique features of contemporary events, for the United States is not Argentina, but the broad outlines of the crisis is of a piece with hundreds of similar episodes in the modern international economy.

The United States

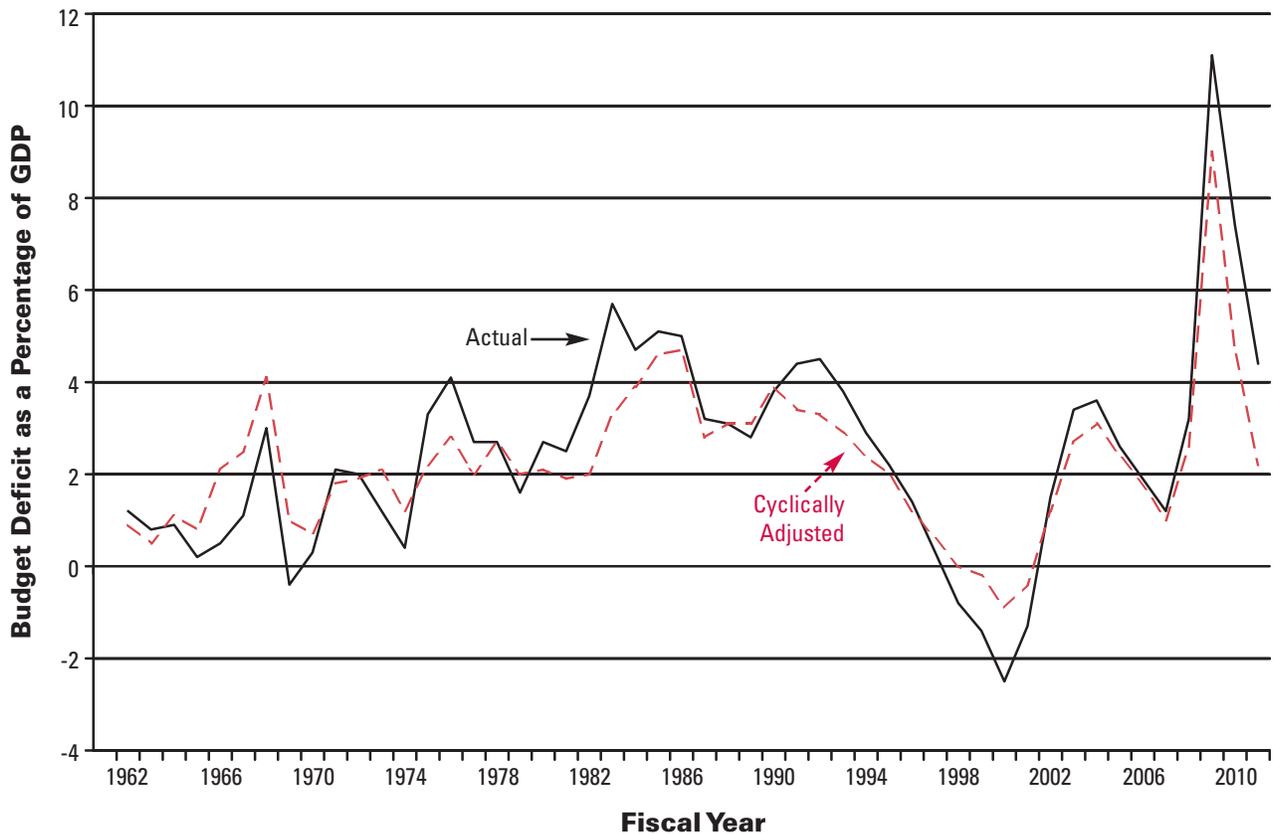
Ten years ago, few observers voiced concern about an impending debt crisis. In fact, the federal government registered substantial budget surpluses in 1999 and 2000, and surpluses were projected for the indefinite future. The recession of 2001, combined with the Bush administration’s tax cuts, quickly erased those surpluses and threw the federal budget into a substantial deficit of 1.5 percent of gross domestic product (GDP) by fiscal year 2002. National security spending after the September 11, 2001, attacks further increased the deficit.

By 2004, the federal budget deficit was more than \$400 billion, the largest in history. As shown in Figure 1, this deficit rivaled those of the Reagan deficits of the early and middle 1980s. The government ran these deficits with ease, for it could borrow just about as much as it wanted internationally. This ready access to capital funds was the new reality of globally integrated financial markets.

The result was a continual rise in America’s foreign debt, expressed as a share of GDP. This is most clearly seen in the size of the country’s current account deficit, the amount the country needs to borrow from the rest of the world to pay

Figure 1. Actual and Cyclically Adjusted Budget Deficits

The cyclically adjusted budget deficit is the deficit that would be incurred if the economy was at full employment.



Source: Congressional Budget Office, *Measuring the Effects of the Business Cycle on the Federal Budget* (June 2009). Note: 2009-11 are projections.

for the excess of its imports over its exports. In other words, a current account deficit means that the country is not covering its current expenses out of current earnings, so that it must borrow the difference from abroad. Between 2001 and 2007, the American current account deficit averaged between \$500 billion and \$1 trillion every year, resulting in a current account deficit equal to an unprecedented 6 percent of GDP in 2006, as Figure 2 shows. For a while, this borrowing failed to manifest itself in a corresponding degree of indebtedness to the rest of the world—largely because the dollar’s value fell over this period (and most of America’s assets abroad are denominated in foreign currency). However, that string of good luck ended in 2008, when America’s net indebtedness to the rest of the world deteriorated substantially (about \$1.3 trillion). This episode demonstrates that, in fact, there is no such thing as a free lunch, no matter how much things appear to change.

Facilitators of American Excess

Two other plausible causes have been forwarded for the current crisis. The first is the “saving glut” on the part of East Asia and the oil exporting countries. The other is an overly loose monetary policy. The first is, we believe, a red herring;

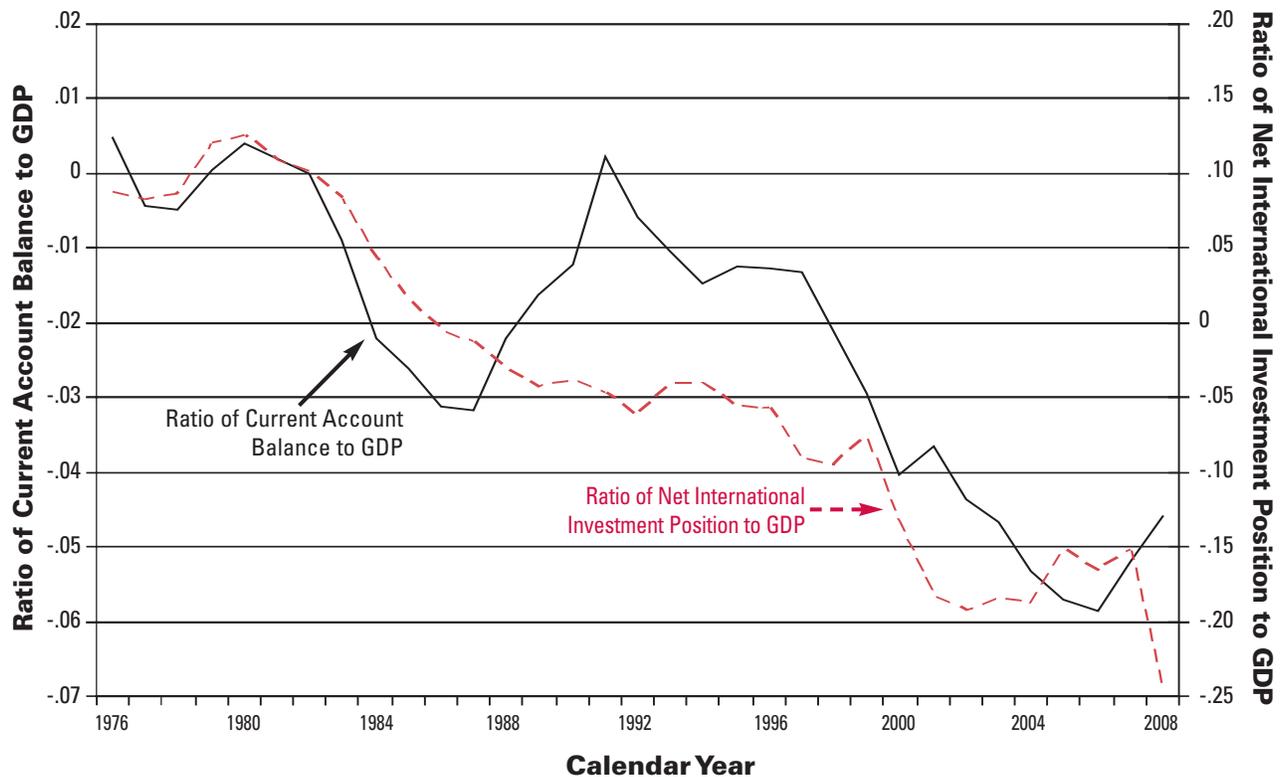
the second bears more blame, but is more of a contributor than a primary instigator.

The saving glut, a term coined by then Federal Reserve Board governor Ben Bernanke in a 2005 speech, argues that the U.S. current account deficit is better viewed as an East Asian capital surplus. Hence, one can think of incipient excess capital being pushed in the direction of America. More recently, several observers, including even the Bush administration in its *2009 Economic Report of the President*, have promoted the view that this capital flow to America is the root cause of the financial crisis of 2008, by inducing risk-taking behavior and the subsequent housing boom.

China is a central character in this drama. In the first decade of the 21st century, China’s saving rate surged even more than its incredibly high rate of investment, so that it too started running large current account surpluses, up to 10 percent of GDP in 2008, according to the International Monetary Fund. The oil exporting countries are also tagged as part of the capital flows to the United States. They were minor players until the oil prices began rising in 2004 and peaking spectacularly in 2008 (before dropping just as precipitously thereafter).

One point highlighted by the development of these

Figure 2. Current Account Balance, Net International Investment Position as Ratios of Gross Domestic Product



International investment position data is for year-end.
 Source: Bureau of Economic Analysis, 2008 International Investment Position release, and 2009 first quarter final GDP release; and authors’ calculations

current account balances is the fact that these capital flows did not arise out of nowhere. Think about the oil exporters. They had such large surpluses because U.S. policy authorities had overstimulated the economy via a mixture of tax cuts, domestic and national defense spending, and lax monetary policy. This drove up demand for petroleum and resulted in the oil exporters' burgeoning trade surpluses. In other words, we think that narratives that place primary blame on the rest of the world for our troubles have the causality mixed up. To a large extent, America created its own misfortunes.

We stress this point because it is necessary to dispense with the view that all this excess saving from the rest of the world was "forced" upon us. The rest of the world's capital flowed to us, in part, because we wanted to borrow, and we wanted to borrow because of the Bush administration's emphasis from 2001 to 2008 on cutting taxes while still spending.

Turning to monetary policy, it is now clear—in retrospect—that the Federal Reserve Board pursued its low interest rate policy for too long. In the wake of the dot-com bust of 2001, the Fed dropped the interbank lending rate (the "Fed Funds rate") quickly—and kept it low for an extended period. By the end of 2002, the Fed's benchmark interest rate was approaching 1 percent, at a time when inflation was between 2 percent and 3 percent a year. Interest rates were kept at this extremely low level through 2004 and only went above 2 percent in early 2005. The long period of interest rates lower than the inflation rate—negative real interest rates—is thought to contribute to the remarkable increase in American borrowing.

Much has been made about the institutional aspects of

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the current crisis. We agree with the view that the presence of a large unregulated financial sector—what is sometimes called the "shadow financial system"—is a critical feature of the crisis. But we view this aspect as an exacerbating factor.

Essentially, the development of an unregulated financial sector has circumvented the entire panoply of banking regulation created in the wake of the Great Depression. This made the financial system vulnerable to traditional "bank panics," or "runs" on the financial system. The abdication of regulatory oversight (particularly in allowing high leverage) in the presence of too many in-

stitutions "too large to fail" meant the buildup of implicit financial liability on the part of the government. In this sense, the buildup of Treasury debt during the Bush administration understated the true liabilities of the government. This is a reality that people are only now coming to understand, as the debt to GDP ratio balloons, from the bank bailout and collapsing tax revenues (a phenomenon that is typical in the wake of financial crises, as Carmen Reinhart, a professor at University of Maryland, and Kenneth Rogoff, a professor at Harvard University and former International Monetary Fund chief economist, have pointed out).

Financial innovation and lack of regulation also play a role in allowing for the buildup of these governmental "contingent liabilities" on the part those institutions "too interconnected to fail." AIG represents the prime example of this phenomenon. AIG's financial products division was heavily involved in the trading of credit default swaps; the insolvency of AIG would have caused a cascade of defaults that would have threatened the entire financial system.

The debt crisis of 2008 would have occurred in the absence of credit default swaps and other exotic financial instruments (such as collateralized debt obligations, the sliced and diced securities based upon other securities backed by mortgages). But these factors greatly magnified the impact of the debt crisis and significantly complicated the policy response to the ensuing events.

Consequences

Not only did Americans borrow from the rest of the world, they borrowed from each other. Consider first households. Gross household debt rose rapidly. Many observers took comfort from the fact that at the same time, household assets—primarily houses and stocks—also rose, so that net assets were rising. As it turns out, household debts have turned out to be much more durable than household assets; and so as asset prices have plunged, individual asset/liability balances have deteriorated.

Consequently, during the foreign borrowing boom of 2001 to 2007, the federal government and households were the biggest borrowers. In a broad sense this is troubling;

By 2004, the federal budget deficit was more than \$400 billion, the largest in history.

certainly, if this had been a developing country, red flags would have gone up, as the pattern of borrowing and spending would have suggested that most of the borrowed funds were going into consumption—which does not add to the future productive capacity of the economy—and not to investment.

Not only did the borrowing by the private sector not go to investing in new technologies, as in the dot com boom, but rather a large portion seemed to go to the financial and real estate sector. The central role of housing in the debt cycle that eventually collapsed into the crisis should not obscure the fact that real estate speculation of this nature is a common and predictable feature of such a capital inflow. The reason is straightforward: money borrowed from abroad has to go somewhere. Some of it is spent on goods that are readily traded across borders, “tradable goods.” Since there are ready foreign substitutes for domestically traded goods, much of this additional demand ends up sucking in imports from the rest of the world.

The run-up in housing prices was more spectacular than the yawning trade deficit but just as predictable. As Americans borrowed \$500 billion to \$1 trillion a year, they spent some of the increased resources on physical commodities that included imports but spent the rest on items not easily traded internationally. Such nontradable goods and services, which have to be consumed where they are produced, experienced rapid price increases because they faced no foreign competition. A universal result of a major capital inflow, then, is increased demand for and rising prices of nontradables, especially housing. And this is precisely what happened in the United States.

The capital inflow led to surging imports and rising home prices, and to a major expansion of financial activity. One reason is that financial services are also, largely, nontradable. It is also the case that much of the money coming into the United States flowed through the domestic financial system. American banks borrowed from abroad—taking deposits from foreigners, borrowing from other banks—in order to re-lend the money at home. Other financial institutions sold foreigners stocks and bonds on behalf of American issuers.

As capital flooded into the United States, imports surged, the housing market soared, and the financial sector boomed. These three results of the borrowing boom are typical of all such foreign debt cycles. Prices of such nontradables as housing rise, prices of tradables stay roughly the

same or fall, while imports rise. The financial, housing, and broader services sectors grow rapidly, while industries competing with imports are troubled.

The rise in housing prices had additional follow-on effects on consumption, contributing to the self-reinforcing nature of the bubble that developed. As housing prices rose, homeowners who regarded the price increases as permanent saw their family wealth rise. For example, a family with a \$200,000 house and a \$100,000 mortgage in 2000 might, by 2006, have a \$300,000 house and the same \$100,000 mortgage, so that its household wealth had increased by \$100,000. While this was “paper wealth,” there was nothing fictitious about it—a similar increase in the price of the family’s stocks would have been just as real. Indeed, the family could—as did millions of Americans—take advantage of newfound wealth to borrow and consume more, taking out a

home equity line of credit against their now more valuable home, which could then be spent on home improvements, new appliances, or vacations. So the housing expansion fed into a broader expansion of consumption, as debt fed housing price increases that, in turn, enabled more debt.

The Long-Term Prospect

We are now witnessing the unwinding of this process of debt accumulation. Households and firms are busily trying to reduce their debt loads, in the face of dimmer prospects for income and profits. For households, savings rates are rising, but at the cost of stagnant consumption. For firms, the reduction of debt load is consistent with a reduced rate of investment in plant and equipment.

In some sense, this process of retrenchment is necessary. For many years, the United States consumed more than it produced. We borrowed and for a while thought that the old rules had been suspended. But now it turns out that we do have to pay back what we have borrowed. The attendant higher saving rate and lower investment rate will lead to a substantial improvement in the current account balance, or in other words, the paying off of our debt.

More broadly, though, this also means that the United States cannot rely upon the driver of growth that has sustained it over the past three decades—namely consumption. But the consequences extend beyond the nation’s border. The world can no longer rely upon the American consumer. Who will take up this role remains to the next big question. ♦

Essentially, the development of an unregulated financial sector has circumvented the entire panoply of banking regulation created in the wake of the Great Depression. The abdication of regulatory oversight in the presence of too many institutions “too large to fail” meant the buildup of implicit financial liability on the part of the government.

What the Stimulus Package Says about President Obama's Plans for Health Care Reform

By Pamela Herd

As the stimulus bill fades into the background of more recent discussions about health care reform, it is useful to look back at the stimulus package to get a sense of the Obama administration's agenda and countervailing forces. The distribution of these dollars reflects the administration's overall health care reform goals, which include expanding access to coverage, controlling health care spending, and improving the quality of care. Responses to this package, however, reflect the challenges of broader health care reform. With health care spending consuming 16.6 percent of gross domestic product, everyone from employers to pharmaceutical companies have vested, and not necessarily aligned, interests in reform. The health care industry alone spends nearly \$1 billion a year lobbying on its own behalf. This lobby has had a huge impact on U.S. health care reform.

The rapid growth of health spending has caused problems for U.S. employers who subsidize employee health insurance, employees who must pay greater shares of the cost, and the federal government, which covers nearly half of health care spending in the United States through Medicare (health insurance for older adults and people with disabilities) and Medicaid (health insurance for poor people). In 2008, total health care spending came to \$2.4 trillion or \$7,800 per person. If spending continues to increase at current rates, the U.S. Department of Health and Human Services projects it will reach \$4.4 trillion by 2018, or 20.3 percent of gross domestic product. We spend about twice as much as other industrialized countries, yet our life expectancy and infant mortality rates lag significantly behind most of these countries. The United States has among the highest rates of medical errors resulting in death, more than triple the rate of the average Organisation for Economic Cooperation and Development member country.

In addition to anxiety about rising costs, concerns exist

about the accessibility of health care. A substantial proportion of the population lacks health insurance. And many others have insufficient health insurance coverage. Many Americans postpone or forgo care, which can lead to more serious conditions that are more expensive to treat, and to financial ruin in the event of catastrophic illness. The Commonwealth Fund reports that in 2005 nearly half of sick adults in the United States reported that they did not access needed health care due to costs. Further, it is estimated that unpaid medical bills are an underlying cause of nearly half of bankruptcies.

This pressing concern about health insurance coverage and access to health care helps explain why such a large part of the stimulus package was devoted to health. Indeed, one of the least controversial components is the \$90 billion—60 percent of the health stimulus spending—devoted to keeping low-income, disabled, and other eligible Americans insured by subsidizing state Medicaid costs. The Kaiser Family Foundation reports that 45 million people younger than 65—including 9 million children—were uninsured in 2007. Of those 45 million, more than eight in 10 come from working families with low incomes who lack employer-based coverage or cannot afford employee premiums. Medicaid, which consumes about 20 percent of state budgets, provides health insurance coverage for 13 percent of all Americans and nearly 30 percent of children younger than 18. But with the recession causing greater budget deficits, rising unemployment, and, consequently, greater demand for the program, states were going to cut Medicaid. The \$90 billion is actually on top of the \$60 billion reauthorization and expansion of the State Children's Health Insurance Program (SCHIP), which is expected to almost double the number of enrollees.

The lack of opposition to this expansion on the part of the health care lobby, in particular, may reflect the extent to which private health insurance companies actually participate in these programs and thus benefit from their expansion. Currently, more than half of Medicaid enrollees are in private managed-care plans, compared to 9 percent in 1991. Further, historians have demonstrated that health insurers ultimately did not fight the creation of Medicaid and Medicare. They did not perceive they could garner large profits from seniors, people with disabilities, or poor people due to

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their significant health problems and limited financial resources. It is the case today, however, that the health insurance lobby has been fighting a new public plan as part of larger health care reform.

The other strategy for keeping Americans covered, a focus on employer-provided health insurance, is more controversial. About 17 percent of the stimulus is devoted to protecting health insurance coverage for those who have lost their jobs due to the recession. While these individuals are eligible to maintain their existing employment-based health insurance coverage through COBRA, they must pay the full premium costs, which in 2008 averaged \$4,704 for a year of single coverage and \$12,680 for family coverage, according to the Kaiser Foundation. Many cannot afford to pay these amounts, especially after having lost their jobs. Consequently, the stimulus money will subsidize 65 percent of premium costs for up to nine months for individuals whose income does not exceed \$125,000 and married couples whose income does not exceed \$250,000.

While the government is providing the subsidy, many employers were unhappy about the measure. They were concerned that it would increase their administrative costs to manage the program. Any attempt at expanding coverage that shifts cost burdens toward employers encounters resistance. Indeed, employers, particularly small-business employers, played a huge role in the failure of the 1994 Clinton health care reforms. Responses to the stimulus reflect the inherent difficulty in expanding coverage in an employer-based health insurance system.

Reducing Health Care Costs

A portion of the stimulus spending is also focused on reducing health care costs, an essential component of President Obama's agenda for broader health care reform. Without effective controls, health care costs are projected to consume more than 20 percent of gross domestic product by 2018.

One widely promoted and popular strategy for reducing costs and improving care is to update the care system so that medical records are stored electronically. Around 17 percent of the health stimulus spending will go to make all medical records electronic by 2014. Many hospitals and health care providers still rely on paper files to maintain patient record systems. Electronic records, however, improve efficiencies, reduce costs, and can be a mechanism to improve care. For example, people with multiple chronic diseases generally see multiple physicians. Electronic records allow each physician access to the patient's full medical files. This leads to fewer medical errors and thus lowers costs. However, even under the best circumstances, policy changes to control costs (such as electronic records) will only affect cost growth over the long run; in fact, in the short run, such measures may increase health care costs.

One of the most controversial portions of the stimulus was also among the smallest, though it is considered to be

one, if not the, key approach to controlling health care costs. The bill devotes about \$1 billion to comparative effectiveness research, which examines the effectiveness of varying treatments for the same health problem. All other industrialized countries employ comparative effectiveness research to help control costs. For example, most new drugs that come on the market are for conditions where there are existing drugs for treatment. But in the United States, these new and expensive drugs are compared to placebos as opposed to the currently accepted drug treatment to test for their effectiveness. Drug and biotech companies, which rely on new innovations to bolster profits, oppose comparative effectiveness research, arguing that it will lead the government to ration care, not just weed out ineffective drugs. Some lawmakers have made clear that they will fight attempts to pursue this cost-control mechanism.

Protection from Lobbying Pressure

Indeed, one of the greatest challenges to controlling health care costs will be how to prevent lobbying groups from pressuring Congress to maintain Medicare and Medicaid spending on treatments, drugs, and supplies that are of questionable efficacy. Earlier this year, President Obama supported a proposal to shift decisions about Medicare payment policies away from Congress and into the hands of a congressional commission called MedPac (Medicare Payment Advisory Commission). MedPac comprises health care experts who issue reports and evaluations of the Medicare program. The logic of shifting the responsibility of managing Medicare payment policies from Congress to MedPac is that MedPac is shielded from lobbying pressure in a way that Congress is not. Because Medicare comprises such a huge portion of overall health care spending, and is often a leader for private health insurance companies in terms of setting payment practice, this move could have a huge impact on overall spending,

The final major element of the health care stimulus spending, a 30 percent increase in the National Institutes of Health (NIH) budget, reflects broad concerns about improving health. But it also reflects the difficulty in predicting health policy reform and politics. Indeed, congressional approval of the entire stimulus bill hinged on this relatively small portion of the stimulus package. Then-Republican Senator Arlen Specter of Pennsylvania demanded the NIH increase to secure his vote for the overall stimulus package, arguing that \$335 billion of government spending on research will lead to a cure for cancer.

All told, the stimulus package addressed immediate health care needs and works toward long-term plans to expand health care access, reduce costs, and improve the quality of care. The measures encapsulated in the stimulus health spending represent a step in the direction of a new, and much needed, approach to health care in the United States, while working to reduce the number of Americans who lose coverage during the recession. ♦

Putting Community Colleges First

By Sara Goldrick-Rab

President Obama visited Macomb Community College in Detroit in July 2009 to announce a proposal for a federal government investment of \$12 billion over 10 years in the nation's community colleges. His goal: produce 5 million more community college graduates by 2020. The American Graduation Initiative is welcome recognition of the important role this educational sector plays in helping the recovery from the economic downturn and in increasing economic equality in future generations. Community colleges provide vital training for workers, especially those who lose jobs in economic change, and they offer a valuable gateway to higher education for many, including lower-income and minority students. A well-funded community college system can help cushion the nation during recession by helping more students earn post-secondary credentials and thus increase their economic security. As President Obama has declared repeatedly during the past year, higher education is nothing less than critical to national economic and social prosperity.

Non-baccalaureate higher education is an especially im-

This article is based on a May 2009 Brookings Institution policy report that was influential in shaping President Obama's agenda for community colleges. The report is titled "Transforming America's Community Colleges: A Federal Policy Proposal to Expand Opportunity and Promote Economic Prosperity," http://www.brookings.edu/~media/Files/rc/reports/2009/0507_community_college_goldrick_rab/0507_community_college_full_report.pdf. Author **Sara Goldrick-Rab** is a faculty affiliate of the La Follette School of Public Affairs and an assistant professor of educational policy studies and sociology at the University of Wisconsin–Madison. She is also a scholar at the Wisconsin Center for the Advancement of Postsecondary Education. She thanks Douglas N. Harris, Christopher Mazzeo, and Gregory Kienzl, her co-authors on the report. La Follette School alum Harris is also a faculty affiliate of the La Follette School and an associate professor of educational policy studies at the University of Wisconsin–Madison. Mazzeo is associate director for policy and outreach at the Consortium on Chicago School Research, while Kienzl is research director of the Institute for Higher Education Policy. Thanks as well to Alan Berube of the Metropolitan Policy Program at the Brookings Institution.

portant contributor to inclusive growth. Many high-demand well-paying jobs require a college credential, though not necessarily a four-year degree. Occupational projections and demographic changes suggest continued growth in labor market opportunities for workers with post-secondary, sub-baccalaureate degrees and certificates. Associate degree holders, in particular, can earn 20 to 30 percent more than workers with only high school diplomas, and certificates in fields like health care yield substantial earnings gains for recipients.

But the Obama administration faces significant challenges in realizing its stated ambition to renew America's status as the world leader in college attainment. Despite decades of progress in expanding *access*, rates of student *success* in higher education attainment are stagnant in the United States. Even as the share of U.S. high school graduates who go on to college skyrocketed by 28 percentage points from 1972 to 1992, the share of those students completing a degree inched upward by only three percentage points, one study finds. As a result, at least 10 developed nations have surpassed the United States in educational attainment, and our nation ranks even lower internationally on measures of cognitive skills, the U.S. Department of Education reports. Stagnation in U.S. degree completion is partly due to dramatic increases in the expenses associated with college-going. The direct costs of college have grown more quickly than inflation and have limited access to college, even among academically able students who are reluctant to accumulate debt. This diminishes economic growth by reducing the skills of the workforce and draining financial resources from other public and private investments. We clearly must find ways to produce more postsecondary credentials while at the same time reducing the average cost per degree and maintaining quality.

Part of the erosion of America's longstanding educational attainment advantage can also be explained by a heavy and growing reliance on community colleges. Only 1 in 10 students entering community college in 2002 completed an associate degree within three years. While these institutions present enormous opportunities for spreading the economic and social benefits of higher education, many two-year colleges face serious financial constraints that dampen their performance and that of their students.

A transformation of the American community college is

needed to renew America's status as the world's leader in college attainment. This long-overdue investment should establish national goals and a related performance measurement system; provide resources to drive college performance toward those goals; stimulate greater innovation in community college policies and practices to enhance the quality of sub-baccalaureate education; and generate data systems that can track student and institutional progress and performance over time.

The Status Quo

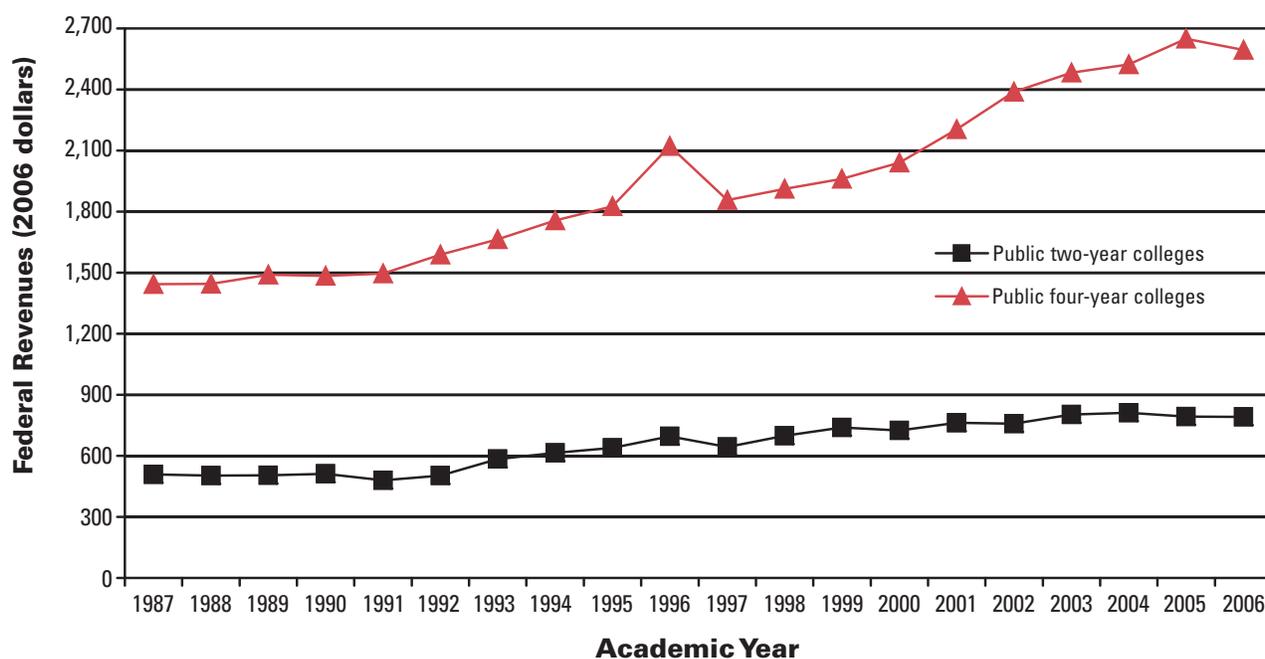
Between 2000-2001 and 2005-2006, total enrollment in the public two-year sector grew by 2.3 million students, more than in any other higher educational sector. The current economic downturn is causing further increases. Community colleges rely on states and localities for the lion's share (nearly 60 percent nationally) of their revenues, making them particularly susceptible to fluctuations in state and local budgets. During a period of relative economic stability (2002 to 2005), community college expenditures per student *decreased* by 6 percent, even as they *increased* by 3 percent at public four-year universities. Federal spending accounts for only about 15 percent of community college revenues (including financial aid). Meanwhile, as Figure 1 illustrates, four-year institutions receive more than three times as much in federal support per full-time-equivalent student (\$2,600) as community colleges (\$790). State and local support levels widen, rather than narrow, this resource gap. Research finds that the resulting "crowding" of students vying for scarce resources

contributes to declining rates of degree completion.

How—not just *how much*—funding is delivered to community colleges matters for outcomes, too. Most state and local funding for community colleges is based on enrollment, rewarding colleges for getting students in the door, but not making sure they succeed. Little of the \$5.6 billion mix of federal student subsidies and categorical grants that supports community colleges aims to improve student or institutional performance. Earlier this year, the president announced a "College Access and Completion Fund" that would include \$2.5 billion over five years for federal-state partnerships to stimulate innovation and learning about how to enhance student success. That fund builds on the idea of "Student Success" grants authorized in the 2008 reauthorization of the Higher Education Act that were designed to assist institutions in offsetting the costs of providing services to help Pell Grant recipients succeed in school. While Congress authorized funds, none have been appropriated for the pilot of the Student Success program.

The myriad challenges community college students face are well-known. For example, many encountered academic difficulties during earlier schooling and face competing demands on their time. Focusing attention on student-directed incentives intended to alter individual behaviors is therefore tempting. Many such efforts are afoot; one notable example is the performance-based scholarship program being studied by MDRC with support from the Bill and Melinda Gates Foundation. These programs aim to alter students' cost-benefit calculations, making college completion more attractive.

Figure 1. Total Federal Revenues Per Full-Time Equivalent Public College Student



Sources: Delta Cost Project 20-year database (2009); author's calculations

But student-focused approaches alone are insufficient for raising community college attainment rates. Such incentives can help bring students “to the table” by, for instance, helping them spend more time on campus. Yet sub-optimal completion rates are bound to persist if colleges are simply ill-equipped to serve them. The economic downturn, together with boosts to Pell Grants in the stimulus package, is sending more students through community college doors than ever before. But many of these institutions are, at the same time, implementing budget-induced layoffs and hiring freezes that will prevent students from accessing the classes and programs they seek. California expects that 250,000 students—a population nearly the size of Madison, Wisconsin—will be essentially locked out of the state’s community colleges this fall. Solving this problem requires investments in colleges, as well as students.

A New Federal Approach

Despite their strong sense of mission to serve students well, community colleges have too little incentive under current policies to focus on student success, rather than inputs and process. As recognized by ambitious initiatives such as the Lumina Foundation-supported *Achieving the Dream*, a “culture of evidence” focused on student achievement and coupled with capacity-building efforts to make success possible can have a rapid and transformative impact. Absorbing the lessons of such initiatives, the federal government must exercise new leadership to significantly transform the potential of community colleges nationwide to help their students, and thus our society, achieve greater prosperity.

The federal government should develop a set of national postsecondary goals and an accompanying performance measurement system for community colleges. While colleges need to focus on their students, colleges also must have broader, clearly defined institutional goals with incentives to match. A performance measurement system would help policymakers, institutions, and students stay focused, and it would ensure that we make the most efficient and effective use of scarce resources. Such a system must reflect the multiple missions that community colleges embrace. These include retraining older workers, awarding associate degrees, and preparing students for transfer to four-year colleges.

The federal government should also require colleges to track their performance. To operationalize real accountability, and to track progress and improvement, the federal government must work with states and local communities to create real-time data systems for tracking individual student outcomes at community colleges and throughout the educational system, and into the labor market. While most states do not have the ability to track student outcomes in this way, a few leading-edge states have created comprehensive data systems. The Florida K-20 Education Data Warehouse includes data on all students in public kindergarten through 12th grade, college, university, and career and technical students, and can

measure student employment and earnings outcomes by connecting to the state’s wage record files. That system and a few others can serve as models for other states, which, through the stimulus package, now have expanded opportunities and obligations to build student-level data systems.

Establishing goals and measuring progress are vital steps for improving attainment levels in the public two-year sector. But new resources are needed to help financially strapped institutions to deliver on those goals. For example, key areas of current need include:

- ◆ **Campus Infrastructure.** Although community colleges have experienced the highest rates of enrollment growth over the past several decades, the number of their campuses has grown more slowly than the number of public and private four-year colleges and universities. Even the many part-time and distance learners served by community colleges need and benefit from investments in classrooms and student support spaces. Federal support for campus infrastructure would help these institutions sidestep state-level battles for scarce capital resources that flagship universities most often win.
- ◆ **Technology.** We cannot educate the workforce of the future in classrooms and buildings that resemble the overgrown high schools of the past. We need to help colleges open online courses and use technology to enhance classroom instruction.
- ◆ **Faculty.** Topping the list of concerns among community college administrators is a severe shortage of faculty in nursing, allied health, science, technology, engineering, and mathematics. Compounding the problem for community colleges is that two-thirds of their faculty members are between the ages of 45 and 64, and the pool of qualified younger applicants with specific in-demand skills may be quite small. As a result, many community colleges rely heavily on part-time adjunct lecturers who have little incentive or opportunity to invest in their own professional development. Nearly two-thirds of community college faculty are part-timers, compared to less than one-fourth of faculty at public four-year colleges. Additional federal resources could help augment the supply and quality of community college instruction in high-demand fields.

To meet these substantial needs, in our May Brookings Institution proposal, my co-authors and I called on the Obama administration to *double* the current level of federal support in community colleges. As current direct federal spending is \$2 billion, this would imply spending another \$2 billion, bringing the total federal expenditures on community colleges (not including student subsidies) to just over \$4 billion. In addition, we recommended that half of the \$2.5 billion Access and Completion Fund (proposed by the president earlier in the year) be targeted to spurring innovation in the two-year sector.

The president’s current proposal meets us more than

halfway. The \$12 billion investment over 10 years would increase direct federal spending on community colleges by 60 percent and represent the greatest investment in public two-year colleges the country has seen in decades.

According to text from the White House and drafts of the proposed legislation from the U.S. House of Representatives, three-fourths of the proposed \$12 billion investment would be funneled into two grant programs to stimulate the adoption of innovative policies and practices to improve the quality of community college education by revitalizing learning, connecting students to real-world job options, and facilitating degree attainment. The other \$3 billion would go to enhance infrastructure and development new online courses. The new federal resources will help financially strapped community colleges to deliver on national postsecondary goals, and they will give the federal government greater influence to demand more out of the two-year-college sector. The additional funds pledged by the Obama administration are a modest commitment relative to the \$60 billion per year the federal government spends on kindergarten-through-12th-grade education, and the \$20 billion per year it spends on public four-year universities.

At the time of this writing (late July), it is not clear whether or how the new resources will be tied to performance. One option, as outlined in the Brookings proposal, is to gradually allocate them according to institutional performance based on key metrics established with the new postsecondary goals and performance measurement system for community colleges. In the program's first year, funds could be based solely on enrollment, with community colleges serving lower-income and minority students receiving proportionally greater resources. In subsequent years, funds could shift toward an eventual 75/25 performance/enrollment allocation. Because they vary widely in the types of students they serve and the level of state and local government support they receive, colleges could qualify for funding by making progress in any or all targeted areas. Additional weighting could be provided to states that gear more of their own funding to improve student outcomes, and matching requirements could be instituted and strengthened as state and local budgets recover from the recession.

Another option, and the one that appears more likely, is to award the new funds via a competitive grant process. This approach would help to ensure that the money goes to states

and institutions prepared to make the best use of it, but also it runs the risk of reducing the participation of community colleges in need of the most support. Those who are not involved in major initiatives with foundations, for example, may be less prepared to submit proposals. Thus, a phased deployment of a competitive process, one that included some planning time and assistance for less-ready colleges, would be advisable.

In Summary

President Obama's call to action on higher education acknowledges a hard truth: As a nation we have lost our more than century-long advantage in postsecondary educational attainment and are at risk of falling farther behind. Stagnating educational achievement threatens our nation's ability to meet critical workforce needs, ensure rising standards of living for future generations, and close the racial and economic gaps that for too long have marred our economy and democracy.

The road to improved higher educational attainment does not run only—or even largely—through the traditional four-year sector, however. The nation's community college system, long on the sidelines in funding and policy debates, now needs to be put first. Yet notwithstanding its great potential, its current track record on student success leaves much to be desired.

President Obama's American Graduation Initiative to invest \$12 billion over 10 years in community colleges addresses the related issues of resource and performance simultaneously, and head-on. If it passes Congress, it will seed a transformative change for America's community colleges—the beginning of a first-ever performance

measurement system and an increase in federal funding to assist those institutions that prove themselves capable of meeting more ambitious goals around student success.

Stronger community colleges will help our nation during recessionary times and speed economy recovery as they become better able to meet demand to retrain workers. A better educated workforce will more readily be able to adapt to the changing economic context. College success counts more than ever. Fully funded and properly executed, the American Graduation Initiative will increase the nation's human capital, improve our collective economic competitiveness, and support a more informed and engaged citizenry that can pass on greater opportunities to future generations. ♦

The federal government should develop national postsecondary goals and an accompanying performance measurement system for community colleges to help policymakers, institutions, and students stay focused. A performance measurement system would ensure that we make the most efficient and effective use of scarce resources.

The Impact of the Economic Crisis on State Governments

By Andrew Reschovsky

Most of the national media coverage about the current economic downturn has focused on policy responses by the president and the Congress, on rising unemployment rates, on the collapse of much of the American automobile industry, and on the growing number of housing foreclosures. With the possible exception of California's budget woes, relatively little attention has been paid to the impact of the recession on state government finances. Across the nation, governors and legislatures have been struggling to make difficult decisions about how to balance state budgets. While many states have completed work on the next fiscal year's budget, few of those decisions' consequences—tax increases and cuts in public services—have yet been felt.

This article explores the severity of the fiscal problems state governments face; the links between the economic downturn and state budget problems; whether state government budget deficits are entirely due to the economic recession; the role federal stimulus money is playing in closing state budget gaps; and steps state governments are taking to address their budget gaps.

The Size of State Budget Gaps

Different budgetary practices across the 50 states make it difficult to measure the exact magnitude of total state government *fiscal gaps*—the difference between the money needed to continue existing state programs and the expected revenue from existing state taxes, fees, and other sources. The National Conference of State Legislatures and the Center on Budget and Policy Priorities, a Washington-based think tank, have been closely monitoring state budgetary conditions and providing timely estimates of the size of state government budgetary gaps. Both organizations report that nearly all

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states face budget gaps that are larger, in absolute terms and relative to the size of their budgets, than at any time since the Great Depression.

States have had to fill budget gaps in excess of \$100 billion for fiscal year 2009 (the year that in most states ended on June 30, 2009). One estimate suggests that, in aggregate, budget gaps will total nearly \$170 billion in fiscal year 2010. With the unemployment rate expected to continue to rise, many states that passed balanced fiscal year 2010 budgets likely will face new budget gaps before the end of the year. In many states, large budget deficits are already anticipated for fiscal year 2011 and beyond.

Unlike the federal government, state governments must balance their budgets. The National Conference of State Legislatures reports that in 33 states, budget gaps exceed 10 percent of those states' general fund budgets, while the Center on Budget and Policy Priorities estimates that, on average, states have to fill gaps that are equal to 24 percent of their budgets. In California, the budget hole is projected to be equal to 58 percent of the state's budget. Although California's fiscal situation is certainly more dire than in other states, closing a budget gap of even half this size is not only politically difficult, but cannot help but create substantial hardships for many state residents. In Wisconsin, which enacts biennial budgets, the budgetary shortfall for fiscal years 2010 and 2011 was \$6.6 billion, an amount equal to nearly a quarter of the state's general fund budget.

How the Recession Affects State Government Fiscal Conditions

Clearly, the impact of the recession on tax revenue is the primary cause of the budget problems states are experiencing. Revenue from the three most important state taxes, the individual income tax, the general sales tax, and corporate income tax have fallen in nearly all states utilizing those taxes. The Rockefeller Institute of Government at the State University of New York, Albany reports that in states utilizing the personal income tax, revenue was 26 percent lower during the first four months of 2009 compared to the same period in 2008. Income tax revenue declined by more than one-third in Michigan and California, states the recession hit

particularly hard. In Wisconsin, the latest revenue forecasts indicate that individual income tax revenues will be 13 percent lower in fiscal year 2010 compared to fiscal year 2008. With no adjustments for inflation, population growth, or legislative changes, income tax revenues during fiscal year 2011 are projected to be 9.4 percent lower than they were in fiscal year 2008.

Revenue from the general sales tax has also fallen in most of the 45 states utilizing that tax. Sales tax revenues were 6.1 percent lower in the last quarter of 2008 than they were in the last quarter of 2007. This reduction in revenue was larger than any inflation-adjusted decline during the past 50 years. Not surprisingly, during a period when corporate profits have declined precipitously, income from the corporate income tax is down sharply in most of the 46 states using the tax.

The recession not only results in less revenue, but in increased demand for some state services. With unemployment rates climbing, welfare caseloads are up in most states. A survey conducted by the National Conference of State Legislatures and the *Wall Street Journal* showed that the biggest increases in caseloads are generally in states with the highest unemployment rates. Although rising caseloads indicate that the welfare system is operating effectively to provide a social safety net for the neediest families, increased state welfare payments add to the challenge states face in balancing their budgets. One recent study concluded that for every one percentage point rise in the national unemployment rate, eligibility for Medicaid and for the State Children's Health Insurance Program (SCHIP) would grow by 1 million persons, an increase that would likely lead to nearly \$1.5 billion in required state spending. Although federal stimulus money will help states meet their growing Medicaid and SCHIP obligations, in many states meeting Medicaid obligations will drain funds from other state programs.

State Fiscal Woes Cannot All Be Blamed on the Recession

Although the recession is clearly a major cause of the budget shortfalls facing most states, some state fiscal problems are home grown. California provides a case in point. Although the state has been hard hit by the recession, its by now notorious fiscal problems are clearly exacerbated by a fiscal system that has been largely defined by the passage of a large number of voter initiatives. Once enacted, these initiatives become part of the state constitution and cannot be reversed without the approval of another referendum calling for their repeal. For example, because the approval of a state budget requires a two-thirds super majority, budgetary compromise

is particularly hard to achieve. Other initiatives restrict the use of state tax dollars by requiring that a minimum percentage of revenue be spent on specific spending categories. Other initiatives tightly restrict how revenue from a particular source can be used. By limiting the legislature's ability to cut spending and restricting its use of revenues, the problem of closing budget gaps becomes much more difficult.

Although Wisconsin's state government is not constrained by voter-enacted restrictions, a number of the state's past budgetary decisions have exacerbated its current fiscal problems. By enacting a set of policies that committed the state to

increased spending while at the same time passing a series of tax cuts, the state has created a situation where the amount of money needed to meet state commitments exceeds the revenue from existing taxes and fees.

The result is what economists call a *structural deficit*. In the mid-1990s, Wisconsin state government promised local school districts that it would pay a larger share of the costs of public education. In addition, in pursuit of a "war on crime," the state lengthened prison sentences and reduced the possibility of parole. Although these policies required additional state spending, the state failed to enact any tax increases. In fact, in subsequent years lawmakers enacted a number of tax cuts. The existence of this long-term fiscal imbalance helps explain why, entering this recession, Wisconsin was one of only five states that had placed no money into a *rainy day* or *budget stabilization fund*—a special fund in which states can hold money for use in stabilizing revenues during economic slowdowns.

According to a recent survey of state budgets, in fiscal year 2006, prior to the start of the recession, the average state held balances from a rainy day fund or as an ending balance of its general fund equal to over 11 percent of general fund expenditures. The impact of the economic downturn is so severe, however, that even states that had large rainy day funds prior to the recession have found them to be insufficient to prevent spending cuts or tax increases. Nevertheless, the economic hardships created by the recession are only made worse in states, like Wisconsin, that failed to accumulate fiscal reserves prior to the economic downturn.

What Role Will Federal Stimulus Funds Play in Closing State Government Fiscal Gaps?

The American Recovery and Reinvestment Act (ARRA), enacted by Congress in February 2009, included approximately \$140 billion in federal aid to state governments. Unlike the federal government, state governments must balance their budgets. To accomplish this, most states raise taxes or cut

A number of states, including Wisconsin, have increased income tax rates on high-income taxpayers. Wisconsin and other states have increased the share of capital gains that is taxed. Several states have increased sales tax rates.

spending. By forcing reductions in consumption of goods and services, both these policies serve to further weaken the economy. By providing state governments with additional resources, the ARRA reduces the spending cuts or tax increases that states would otherwise have to enact, thereby stimulating state economies.

The two major sources of federal stimulus funds for state governments come from an \$87 billion ARRA allocation for additional federal Medicaid funding and a \$48 billion State Fiscal Stabilization Fund that provides states with funds for education. Each state chooses to use its stimulus dollars in different ways. For example, in Wisconsin, as in many other states, increases in Medicaid funding allowed the state government to maintain most Medicaid services while freeing up funds to help close the budget shortfall. Without these federal funds, it is highly likely that the state would have reduced Medicaid funding and restricted health services provided to needy people. Wisconsin used most of its funds from the federal State Fiscal Stabilization Fund to replace cuts in state funding for kindergarten-through-12th-grade education. Even though the final state budget reduced state funding of K-12 education by more than \$147 million (2.7 percent), nearly \$800 million of ARRA funds replaced additional cuts in state education funding. Without these federal funds, it is almost certain that local school districts would have faced much larger cuts in state aid. As the state took steps to limit the ability of local school districts to raise property taxes in response to cuts in state aid, these state aid cuts would have almost certainly translated into large teacher layoffs and declines in educational quality.

Around the country, federal stimulus dollars are playing a significant role in helping states close their budget gaps. However, despite their importance, a study by the Center on Budget and Policy Priorities suggests that on average federal stimulus funds will only fill between 30 and 40 percent of state government budget gaps during fiscal years 2009 through 2011.

How Are States Closing Their Budget Gaps?

The arithmetic of balancing a state budget is in principle quite simple. There are only three options: revenue from state taxes and fees can be increased, spending on state programs can be reduced, or one-time budget gimmicks can be used to advance revenue or delay spending obligations to the next budget year. Given the magnitude of the budget gaps most states need to fill, it is not surprising that states are resorting to all three strategies.

Policymakers often argue that tax increases will do more harm to state economies than spending cuts. Economists, however, point out that, depending on what spending is cut and how revenues are raised, reductions in spending can do more harm to a state's economy than raising taxes.

It will be many months before an exact accounting of how states closed their budget gaps will be possible. As this article is being written in mid-July 2009, several states, including California and Illinois, have yet to enact budgets. It is also likely that at least in some states tax revenue will be below forecasted levels, requiring those states to take additional steps before the end of the fiscal year to balance their budgets.

A recent report by the Center on Budget and Policy Priorities indicates that more than half the states have enacted or are considering revenue increases this year. During the last recession, the most frequent way of raising revenue was by increasing the cigarette excise tax. This time around, increases in income and sales taxes are much more common. A number of states, including Wisconsin, have increased in-

come tax rates on high-income taxpayers. Several states, again including Wisconsin, have increased the share of capital gains that is taxed. Massachusetts raised its sales tax rate by 1.25 percentage points, and California temporarily increased its rate by one percentage point, while other states are increasing sales tax revenues by eliminating selective sales tax exemptions.

For most states, the largest part of their budget gaps are

being closed by cutting state spending. Spending cuts are widespread, and education and health care are hardly immune. According to surveys conducted by the National Conference of State Legislatures, many states have enacted or are considering cuts in the funding of K-12 education. These cuts, which generally take the form of reductions in state aid to local school districts, are likely to lead to spending reductions by local districts. In recent research that Richard Dye, an economist at the University of Illinois's Institute of Government and Public Affairs, and I conducted, we found that in response to reductions in school aid following the 2001 recession, property taxes on average made up for 23 cents of every dollar of real reduction in state education aid. With falling property values in many parts of the country and a rising number of foreclosures, it is unlikely that in this recession local school districts will be able to use the property tax to replace very much of the reductions in state funding.

Most states are also making large cuts in their support of public higher education. In many cases these budget reductions are far too large to be fully offset with revenue from in-

Fiscal problems facing state governments are likely to continue at least into 2013. Although the availability of federal stimulus funds reduced the spending cuts and tax increases needed to balance fiscal year 2009 and 2010 state budgets, that discretionary money will not be available after 2011.

creased tuition. Some states, including Wisconsin, have also legislated salary cuts and/or mandatory furloughs for all state employees, including university faculty and staff. One likely outcome of higher education budget cuts is reduced access to college, especially for students from low-income families. College completion rates are likely to fall and time-to-graduation increase as many students will have to devote more time to earning money to afford college and the number of available courses is likely to drop. Wisconsin's budget included a small increase in student financial aid to cover higher tuition for most students whose family income is below the state median. However, a 5.2 percent reduction in overall state support for the university system more than offset these additional student aid resources.

Reductions in state health care spending for poor people are also widespread, with at least 21 states reducing access of low-income families to health insurance or health care services. In addition, in a similar number of states, spending cuts are reducing access to nursing homes and to specialized health care for elderly and disabled people.

What Does the Future Hold?

One lesson that states learned from the mild recession in 2001 is that improvements in state government finances can lag behind improvements in the general economy. Thus, even though the overall economy was growing in 2003, state government revenues continued to fall. State income and sales tax revenues are closely linked to levels of employment, and during a typical recession, businesses tend to hire back workers only after a recovery is well established.

The current economic downturn is much more severe than the last recession. Although the economy is expected to begin growing in late 2009, a June 2009 forecast by IHS Global Insights Inc. indicates that non-farm employment in the United States won't return to its 2007 level until early 2013. This suggests that the fiscal problems facing state governments are likely to continue at least into 2013. Although the availability of federal stimulus funds reduced the spending cuts and tax increases needed to balance fiscal year 2009 and 2010 state budgets, that discretionary money will not be available after 2011. Unless Congress is willing to provide state governments with a new round of fiscal assistance, the fiscal decisions facing most state governments are likely to be at least as difficult in 2012 and 2013 as they have been this year. How state governments will respond to repeated budget crises is an open question. Will they be willing and able to levy higher taxes on their residents? Or, will public education, health and welfare services for the needy, and the maintenance of physical infrastructure face renewed cuts? ♦



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Director's Perspective *continued from page 1*

An important role for a leading public affairs school is for its faculty and affiliates to be diverse in their interests and abilities to respond to the issues of the day with thoughtful analysis. Here, La Follette School faculty and affiliates examine the pillars of the economy that must be strengthened, including the financial system, health care sector, post-secondary education, and state government finance.

Until now, U.S. consumption has driven the world economy. As a nation and as individuals, Americans borrowed heavily so we could consume more, a pattern of behavior that had become unsustainable by 2008. La Follette School macroeconomist Menzie Chinn and co-author Jeffrey Frieden of Harvard University dissect the causes of the financial crisis and focus attention on this public and private consumption binge. What we are experiencing now is similar to previous crises fueled by the flow of foreign capital into the United States, but reduced regulation, new and untested financial tools, and interest rates kept low for too long a time combined to make this crisis worse than those of the past, both here and abroad.

The economy has reinvigorated debate about health-care policy, and here again the vexing issues are not new. Private insurance companies are not contesting the use of economic stimulus funds to subsidize state Medicaid costs and keep people insured, just as they did not oppose the creation of Medicaid and Medicare in the first place. However, as La Follette School sociologist Pamela Herd writes, employers are again opposing reforms that imply any increases in their costs, just as they did during President Clinton's reform attempt in 1994. In this go-round, employers object to a federal subsidy of premiums individuals and families pay under COBRA, the federal law that allows them to continue group health benefits when they lose their jobs. How health care stakeholders act on the proposals in President Obama's stimulus package for expanding coverage, improving care, and containing costs will have long-term ramifications.

In the education arena, a college credential—a two-year or four-year degree—can go a long way toward assuring that an individual will be economically secure, especially now that more than 40 percent of U.S. jobs are expected to require post-secondary credentials. However, too many people from low-income families struggle to attend and succeed in college. The United States is slipping in the educational attainment ranks compared to other developed nations, and a less skilled workforce is a drag on our economic growth.

One way to reverse this slide and increase our citizenry's earning power is to strengthen community colleges, argues faculty affiliate Sara Goldrick-Rab, an assistant professor of educational policy studies and sociology at the University of Wisconsin–Madison. The two-year college sector has gained in importance in the last 10 years and is essential in providing job-training during economic downturns. She and several co-authors, including La Follette alum Douglas Harris, an associate professor of educational policy studies at UW–Madison, made this argument in a Brookings Institution report discussed in May by a panel that included Cecilia Rouse of the president's Council of Economic Advisors. Two months later, President Obama proposed investing \$12 billion over 10 years in the nation's community colleges. Goldrick-Rab's Policy Report article updates the Brookings report in the wake of the president's July announcement.

At the state level, federal stimulus funds will help offset shortfalls, but most states are finding increases in taxes and/or cuts in spending unavoidable in their efforts to balance budgets, writes La Follette economist Andrew Reschovsky. While state tax revenues have decreased significantly due to the recession, not all of the state budget gaps can be attributed to the economic downturn. Rather, states such as California and Wisconsin pursued policies that compounded their financial problems, explains Reschovsky. The federal stimulus money will only go so far toward helping states ride out the recession. As he notes, state governments lag behind the general economy in their recovery. Without renewed federal aid, states will face tough decisions on cutting services and raising taxes through at least 2013.

Tight state budgets interact with the fiscal implications of proposed health care and higher education policies. A reduction in state health care expenditures could help close fiscal gaps. A more productive workforce should generate increased incomes and tax revenue, and reduce demand for some public services.

Most policy analysts agree that the status quo is untenable. How well proposed reforms will work—and whether we can afford them and make the difficult adjustments necessary for their success—remains to be seen, and will surely depend at least in part on the skills of the next generation of public managers and policy analysts that we are now training in public policy schools.

Carolyn J. Heimel