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# Missouri's Budget Crisis: The Impact of the Structural Budget Deficit on Public Education

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MNEA White Paper

Revised July 2004

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## Abstract

The central policy issue confronting the state of Missouri is the resolution of the structural deficit between essential general revenue expenditures and available revenue receipts.

Hancock revenue limits, state tax cuts and economic slowdown have contributed to a flattening of state revenues over the last five years.

The shortage of general revenue funds has created a growing crisis in education funding. The effects of that funding crisis are now visible. Additional attacks on education funding sources have emerged recently.

The state's budgeting process needs an overhaul, including both a significant infusion of revenues and a new process to mandate savings for budget stabilization purposes. Advocates for public education must play a pivotal role if such vital reforms are to occur.

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## **The 1990s: Hancock revenue limits, tax refunds and tax cuts**

It seems long ago, but during the late 1990s Missouri's state general revenue was so plentiful that the so-called Hancock Amendment (Article X of the Missouri Constitution) triggered refunds to taxpayers from 1995 to 1999. During those years, \$971.7 million was refunded to taxpayers as required by the Constitution.

During this time of abundant revenue, key decisions were made that impact current funding. The state sales tax on food was reduced by about three-fourths. Corporations were given tax credits and other tax breaks to stimulate job growth. The tax deduction for individuals and families was increased. All told, approximately \$750 million in long-term revenue sources were eliminated by the state legislature. The capital-gains taxes paid on record-high investment income in the 1990s came to be seen as a permanent source of income and filled part of the gap left by eliminating the tax on food as well as other tax reductions.

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## **The new millennium: economic downturn adds to shortfall**

The state and national economies slowed in 2000 and the events of Sept. 11, 2001, exacerbated that trend. Thousands of Missouri jobs were lost—over 70,000 during 2001 and 2002, according to the Department of Economic Development. By 2002, capital gains were replaced by capital losses and people were taking deductions for these losses on their federal and state income taxes. The capital gains once counted on for state revenue disappeared, and the millions in state tax cuts further cut revenues. State revenues flattened and remained flat from 1999 to 2003.

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## **Holden's first term: cut, cut and cut again**

The first signs of economic problems surfaced in 2000, and the state's budget dilemma became evident soon after. Gov. Bob Holden, upon taking office, was forced to act quickly to curtail state spending. State workers didn't receive a pay raise for the first three years of Holden's term. Significant cuts have been made to all state agencies. Cuts to higher education have forced Missouri's institutions to raise tuition. The result is that Missouri ranks second in the nation in tuition hikes in the last two years, a dubious distinction. Elementary and secondary education was the last state department to be cut, beginning in 2003. Missouri became the last state among all adjoining states to cut K-12 spending.

In January 2003, Holden asked the legislature to consider numerous proposals for increasing revenue. The governor proposed using tobacco settlement money, closing numerous corporate loopholes to fund schools and using the "Rainy Day Fund". The legislative leadership rejected those options, insisting that the state had a "spending problem, not a revenue problem."

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The General Assembly's leaders were unwilling to deal with the gap between spending and revenues and make the tough cuts their position warranted. In spring of 2003, however, the legislature got a partial reprieve. The federal government's tax cut, while reducing state revenue about \$100 million per year in the long run and causing federal deficits to skyrocket, included some one-time money for the states. Missouri received about \$400 million, which was quickly applied to the FY 2004 budget deficit. That \$400 million was not enough.

In late April 2003, updated budget projections indicated that anticipated state revenue was significantly below the spending called for in the budget. The state deficit was estimated to be \$240 million, in spite of the additional federal money. Even after calling a special session and making two vetoes, Gov. Holden was presented yet again with a budget which would likely not be balanced, based upon revenue estimates agreed to by both the governor and Senate. Holden was left to solve the problem of balancing an overspent budget. The governor is required to balance the budget and—since other agencies had already suffered significant cuts—Holden withheld \$200 million from elementary and secondary education and \$40 million from higher education.

Fortunately, revenues for fiscal year 2004 exceeded all projections. Gov. Holden was able to release all the withheld funds once revenue receipts and other key developments made it clear that the state would have sufficient revenue to fund the expenditures authorized in the FY 2004 budget.

## **General revenue expenditures are “hard to cut”**

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Most programs receiving general revenue funds, other than K-12 education, were severely cut in 2001 and 2002. After all those cuts, the state still faces a structural budget deficit of about \$650 million for FY 2005 (July 1, 2004, to June 30, 2005—or next school year). A structural deficit is a continuing gap between expenditures and revenues received to cover those expenditures. This deficit will be hard to eliminate: there are only bad choices when cutting another \$650 million from Missouri's general revenue expenditures.

For example, Missouri spends about \$1.4 billion in general revenue on the Department of Social Services (DOSS). So, reducing state funding for DOSS could eliminate the general revenue structural budget deficit. The trouble is that cuts to state social-services spending also take with them about four times that amount in federal matching funds. A reduction of \$650 million in state funding for DOSS could represent a net reduction of over \$2 billion in spending on the neediest Missouri citizens.

Aside from being just plain wrong and politically untenable, such cuts can't actually be made simply by reducing budget amounts. Medicaid expenditures, a huge portion of DOSS spending,

are an entitlement. (If you meet federal guidelines, the state must serve you to get federal dollars.) Those expenses can only be cut by legislation to remove or limit eligibility for that entitlement, not by a simple reduction in an appropriations bill. House Republicans supported a bill in 2004 (HB 1566) that would have made many Medicaid services “subject to appropriations” and would have reduced eligibility for some services. The bill met strong opposition from many influential groups in 2004, including MNEA, and was defeated; most cuts to Medicaid were restored by the Senate and maintained in budget conference. Beyond DOSS, half of what’s left to cut is state spending on K-12 and higher education. The remainder includes funding for operating state prisons and mental health services.

### **A glimpse of where we are now**

Between \$200 million and \$300 million in new revenues are needed each year just to balance the budget at the previous year’s levels and meet mandatory increases such as Medicaid payments and early-childhood special-education costs. The Consensus Revenue Estimate (CRE) for FY 2004 was finally agreed to in early May 2004 at \$6287 million. This number exceeded both the house and senate revenue estimates and the governor’s estimate for this year.

FY 2005 K-12 spending was raised back to roughly FY 2003 appropriations levels prior to withholding. However, this year’s spending is again propped up by one-time funds and transfers, rather than ongoing revenues, and maintains a structural imbalance of roughly \$650 million for yet another year.

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### **The full scope of the problem**

Even after several years of harsh cuts, Missouri still faces a long-term structural budget deficit of roughly \$650 million in general revenue. This structural deficit is being temporarily offset by transfers of tobacco settlement and other funds and by the use of dwindling one-time funds. Most, if not all, of this deficit can be traced to a decade of ill-advised state and federal tax cuts which have reduced the state’s general revenue by about \$1 billion per year. A key measure of tax effort—net general revenue as a percentage of total personal income—reached a 20-year low in FY 2004, falling from a peak of 4.5 percent in 1996 to only 3.5 percent in 2004.

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On top of the revenue needed to balance the budget, at least an additional \$610 million is needed to fully fund the foundation formula in FY 2005, and even that level of funding is estimated to be about \$900 million short of adequate to meet state and federal accountability requirements. As a result of not keeping pace with education funding needs, the state is once again the defendant in a school funding lawsuit which is likely to result in a court mandate for increased funding and improved equity and adequacy of funding for public schools.

MNEA believes that increasing revenues is a better and more humane approach than balancing the budget with cuts alone. The Association will continue to make support for increased revenues a high priority.

## **A closer look at the school funding crisis**

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Missouri's public schools have made significant progress since passage of Senate Bill 380, "The Outstanding Schools Act," in 1993. Unfortunately, much of this progress is being undone or is in peril. The revised school aid formula and increased funding were required to respond to Judge Kinder's decision that the State of Missouri violated the Missouri constitution by inequitably and inadequately funding public schools. The significant increases in education funding through the 1990s came from a broad array of sources: gaming revenues (about \$200 million), SB 380 taxes (about \$400 million), desegregation savings (transfer of about \$340 in existing court-ordered payments) and other general revenue (at least \$300 million).

The structural budget deficit has caused the school funding formula to be under-funded, beginning modestly in FY 2002 (by \$21 million), zooming to \$364 million in FY 2004 and increasing to at least \$610 million in FY 2005. The effects of this under-funding are already keenly felt. The Department of Elementary and Secondary Education estimates the state suffered a net loss of about 1400 total education staff this year compared to last year. About 1200 of those losses were certified staff positions, including many teachers.

Across the state, successful programs such as alternative education programs are being shut down. The state's graduation rate increased during the last decade, but will likely start to decline due to these program cuts. This year's under-funding of about \$364 million will have the greatest impact on low-spending districts most dependent upon state aid. The status of funding equity across the state will be as negative this year as when Missouri lost the Kinder decision in 1993.

The state is again being sued on the basis of inequitable and inadequate funding. The Committee for Educational Equality—supported by MNEA and hundreds of Missouri school districts—filed suit on Jan. 6, 2004. Both Kansas and Arkansas have recently lost similar court cases.

The Missouri legislature established a study committee to analyze the problem, make recommendations and report to the General Assembly during February 2004. The Joint Interim Committee is considering a recommendation for a long-term shift to a "student need-based" system, rather than a tax-rate driven formula.

MNEA, along with other state education, business and philanthropic groups, funded the first-ever study of education-funding adequacy for the state of Missouri. Conducted under the supervision of nationally recognized expert John Augenblick, the study presents an example of a "student need-based" system with adequate funding to meet state and federal accountability

requirements. The options aren't cheap: state costs compared to full funding of the current formula could range from \$700 million to \$1.5 billion, depending upon how local tax revenues are treated.

The new school-finance litigation has significant implications for state budgeting for years to come. The likely outcome of a court mandate to improve school funding equity and adequacy will almost surely require a significant increase in appropriations of general revenue for schools. While equity can be improved by legal standards, either with or without a funding increase, adequacy generally cannot.

Moreover, the political obstacles to passing a "zero-sum" approach—which involves taking from some districts and giving to others—are enormous and probably insurmountable. Other general revenue expenditures, as we have seen, are "hard to cut", both legally and politically. Thus, the need for a significant increase in state general revenue appears inescapable, despite the current legislative leadership's distaste for such action.

### **New threats to education funding**

The shortage of general revenue has created budget problems for all state agencies, local governments and the entities they serve. In response to these budget problems, new efforts are being made by various interests to re-direct existing state and local resources away from public schools to other uses.

One such proposal would re-direct state highway funds and motor vehicle sales-tax revenues currently used for road-related general revenue expenditures to road and bridge expenditures. This "diversion" will require scarce general-revenue funds to be reassigned to cover these expenses. This proposal is essentially a tax increase for road and bridge building at the expense of education and other general-revenue programs, since a significant portion of the reassigned funds would likely come from reductions in K-12 education and Medicaid spending. The impact of this proposal would be to eventually transfer about \$190 million annually out of general revenue. Signatures have been collected on an initiative petition and, as of this writing, are being verified by county officials. This proposal is expected to be on the Nov. 2, 2004, ballot.

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Several threats to local school property-tax revenues have emerged within the last two years. Owners of significant amounts of business personal property (i.e. equipment, rather than buildings) have begun to successfully challenge existing assessments of such property based upon installed value and depreciation. In a great many cases, the assessments have been radically reduced to an amount based upon an auction or salvage value—even in the case of recently installed, fully functional equipment—on the tenuous basis that there is essentially "no market" for the sale of such proprietary and specialized equipment. Legislation to correct this undervaluation and restore the long-accepted practice of value-in-use assessment is vital to protecting local school revenues in districts with such property, but the legislation has not yet been enacted.

Another popular proposal, which threatens to reduce local school revenues, is the so-called “homestead exemption.” This proposal usually seeks to cap growth in the assessed value of a personal residence. Such a measure, adopted in SB730 in 2004, caps residential tax liability increases for income-qualified elderly or disabled owners. The bill requires state appropriation for reimbursement of losses by political subdivisions in order to allow the capping of property taxes for eligible owners.

Finally, county assessors—struggling to maintain operating funds after reductions in county general revenue and state reimbursement have taken their toll—won approval in 2004 to increase the share of local school revenues they receive to conduct their assessments. The effect on school revenues is limited to \$100,000 for first class counties and \$50,000 for other counties, for a total impact of about \$3 million per year statewide.

The cumulative impact of these efforts is to further reduce school foundation formula funding and local school revenues, thereby reducing the ability of districts to offer quality education programs and creating new pressure for local school tax increases.

## **Problems with budgeting process**

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Recent experience in Missouri highlights several significant drawbacks to the existing budgeting process. First, policy-makers don't know the actual revenues upon which they set budgets until the end of the budget year, over 12 months after the budget bills are passed. Thus, they must use a guess, and these guesses can be significantly in error if unanticipated changes in income or sales take place during a year.

Second, the governor and General Assembly have competing interests when it comes to revenue projections and spending authority. The General Assembly desires to appear magnanimous to its constituents in support of favored programs, while the governor seeks spending authority that, at most, will not exceed a cautious and reasonable estimate of expected revenue. The effects of these competing interests are at their worst when partisan interests are involved. Stakeholders, including public schools, become political footballs in this competition.

Third, the state must eventually resolve the large structural deficit created by the state tax cuts of the late 1990s and worsened by the recent economic slowdown. The deficit is currently about \$650 million plus increases for educational adequacy and other deferred state needs.

Finally, there is no effective process for the state to save for budget stabilization purposes. Unlike the federal government, Missouri can't borrow or deficit spend in bad times without voter approval.

Progress is crucial. At a minimum, any solution should provide:

1. A significant increase in state revenues to close the structural budget deficit and adequately fund education and other deferred state needs, preferably via a progressive tax increase such as a tiered state income tax, and
2. Some new structure to stabilize state general-revenue budgeting and create a substantial and usable budget-stabilization fund. Some or all excess revenues received in growth years should be dedicated to this fund, with a limited portion available to appropriate to maintain spending during declining revenue periods without extraordinary approval requirements such as a supermajority vote.

### **The role for MNEA and other advocates for public education**

Missouri NEA and other public education advocates must provide statewide leadership in returning Missouri to a climate supportive of public education. The Association's agenda (safe schools, adequate funding, quality teachers and respect and support for staff) is well focused to guide the public in embracing that supportive attitude. A unified voice on behalf of public education is needed to counteract the effects of right-wing issue framing on issues such as tax cuts that force spending cuts on education and social services; the notions of "failing" schools, vouchers and tax-credit schemes; weakening certification standards; and thinking of kids as "goods" and teachers as factory workers.

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Elected officials and other political leaders need our help in framing the debate and shifting the focus back to the longstanding tradition of broad support for public education. Public education advocates can help by:

1. lobbying to help legislators understand these vital issues,
2. promoting public awareness through letters to the editor and other public expressions of support that create a positive climate for teachers and students,
3. grassroots efforts to educate the people of Missouri about what's important for children and public education, and
4. supporting pro-public education candidates for public office in the 2004 election cycle.

In conclusion, the key issue facing the state remains the structural budget deficit. The crisis in education funding is one result of that structural deficit. A long-term solution is needed to provide both stable and adequate revenues.

You can be part of MNEA's leadership in building a broad base of support for public education.



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