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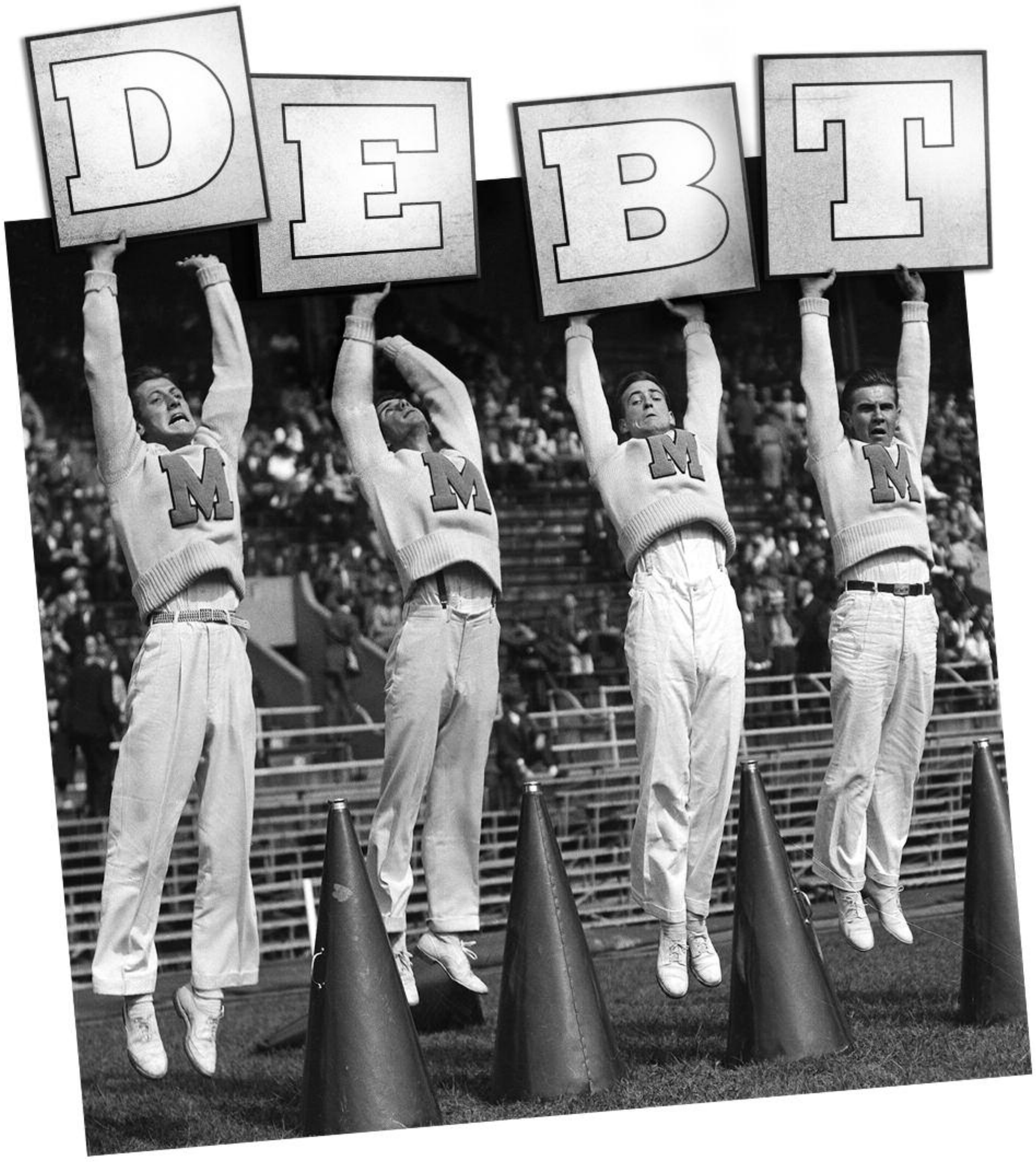
More on the Cost of College …



Campus of dreams:
Bill it, and they will come?

The cost of higher education has risen steadily for decades, but so have the benefits. Is the value proposition being challenged by increasing debt loads and a severe recession?

By RONALD A. WIRTZ
Editor

Jennifer Weil is a person with a lot on her plate.

A first-year graduate student at Minnesota State University-Moorhead, she's studying counseling and student affairs. She's also state chair of the Minnesota State University Student Association, and she works in the academic affairs office as a graduate assistant.

Immediately out of high school she attended the state university in St. Cloud, Minn., but left after one year after getting married and then starting a family. She returned to college several years later in the belief that having a degree would better provide for her two boys. That decision was a prescient one after her marriage ended in divorce. A mother with two small boys, Weil fits in motherhood, classes and an estimated 40 hours of work per week.

If that feels like a heavy load for one person, she's got a financial burden to match, coming out of her undergraduate studies with $42,000 in debt—about twice the level of the average four-year graduate; much of

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439%

Average college tuition and fees have risen by 439 percent (in current dollars) since the early 1980s, outpacing medical care inflation by almost 200 percentage points, and triple the rise in median family income.

Campus from page 1

the debt difference for Weil came from private student loans to pay for day care while tending to class and work.

So you might say that Weil has a unique perspective on the college experience—and particularly its costs—having firsthand experience and as the voice of students statewide.

"It's ridiculously expensive," said Weil. Among her peers, Weil said her level of debt "is fairly common."

For Weil, her debt means different choices, both now and in the future. She has always worked at least part-time to help pay for school—from being a Mary Kay beauty consultant to various gigs in student government and now the Student Association. But working during college is a fact of life for many students.

"Almost everybody I know has at least one job. Students have to work significantly more hours a week just to pay for tuition." And despite all that work while in school, Weil understands it will take still more work after graduation to pay off her debt, requiring further sacrifices. For example, she said, "because of the number of years it'll take to pay that [debt] off, I'll have to wait to purchase a house. It's very difficult."

Weil might not exactly be the poster student for college today, but she represents part of the growing angst over the rising cost of higher education. According to the annual Measuring Up report by the National Center for Public Policy and Higher Education, average college tuition and fees have risen by 439 percent (in current dollars) since the early 1980s, outpacing medical care inflation by almost 200 percentage points, and triple the rise in median family income.

Families are worried about the cost of college. Weil said she helped at a booth at the Minnesota State Fair sponsored by the Minnesota System of Colleges and Universities (MnSCU) in late August. Cost, she said, "was a huge topic for families" because parents have been laid off and investment portfolios have shrunk. "The money that was set aside or planned for [for college] is gone now. People feel the crunch of the economy," Weil said.

College has never been cheap, exactly; but its cost used to be heavily subsidized for students. Over time, costs have risen steadily, and a larger portion of that growing bill has been laid on students and families. For the first time in history, tuition this year at the University of Minnesota is expected to contribute more revenue to the operating budget than state funding. South Dakota State University crossed that threshold two years ago.

This trend didn't come quickly or by surprise. It's the result of many colliding factors, from fickle state support to rising enrollments to escalating higher education expenditures—each of which is similarly driven by a variety of factors.

Over time, a mentality has evolved that college is too expensive. For the better part of two decades, university officials, policy wonks, students and their families have criticized the slow evolution of a higher-tuition, higher-aid model as unsustainable.

But its dogged survival has demonstrated the opposite, as students streamed through college doors because they saw a favorable value proposition: Go to school, maybe have to take out a few loans, but graduate and get a much better job earning a lot more money than without a degree. Tuition's also not as expensive as it often looks, thanks to a lot of grant aid in myriad forms. (For an analysis of the value proposition of college education, see the December 2005 *Region* magazine, also published by the Minneapolis Fed, at minneapolisfed.org.)

Enter the recession. While recessions are nothing new, and college enrollment typically grows during such events, the scale of this recession has sent a shock through consumers and intensified much of the existing cost tensions between higher education systems and their customers.

As in other areas of consumer spending, this recession will likely test the implicit assumption that (net) tuition and student debt can rise with little consequence to enrollment or higher education generally. Already, even amid growing enrollments, there are signs of subtle shifts in choice. What remains unknown is whether college preferences will reset along traditional lines once the recession is over and job growth resumes, or if the higher education model is in for a more fundamental shake-up.

The good old days

You have to go back a few decades to see how higher education got to this position. In virtually every way, higher education was a smaller, simpler endeavor. A narrower slice of (only) young people attended college, and the cost of attendance was kept artificially low through state appropriations to colleges. Slowly but steadily, the system evolved: More students started going to college, and state and higher education budgets both got swamped by additional spending priorities. The cost to go to college rose progressively higher as a result, and an increasing share was passed on to students.

As costs climbed, students sought more financial aid to fill the gap between the expense of college and their savings and work income. And many were successful in finding grant money to help buy down the cost of tuition. An array of grant programs has meant that net tuition (after grants are subtracted) has gone up less steeply; in fact, according to the College Board figures, net tuition has gone down at two-year colleges this decade. But it's risen by 32 percent at four-year public universities.

Comparable net tuition and fee figures over time were not available among all district states, and they likely vary widely because published tuition and grant levels, and their change over time, differ significantly across states and institution types. For example, published tuition rates at two-year schools run 20 percent to 90 percent higher in district states compared with the national average. In much of the district, net tuition and fees are higher: For the 2007 school year, net tuition and fees at Minnesota's public two-year colleges were 194 percent higher than the national average, and they were 85 percent higher at the state's four-year universities, according to information from the Minnesota Office of Higher Education.

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One of the Minneapolis Fed's congressionally mandated responsibilities is to gather information on the Ninth District economy. The *fedgazette* is published bimonthly to share that information with the district, which includes Montana, North and South Dakota, Minnesota, northwestern Wisconsin and the Upper Peninsula of Michigan.

The opinions expressed in the *fedgazette* are expressly those of the authors or of attributed sources and are not intended to represent a formal position of this bank or the Federal Reserve System.

At the same time, many students are either not eligible for or cannot find grant aid, and in general, the supply of grant money has not kept pace with the rise in tuition. So students have increasingly sought loans to finance college, and average debt of graduates has risen substantially. (For a detailed discussion of these historical trends in the Ninth District, see companion article on page 8.)

Fast forward to today. Even in recession, higher education institutions have had difficulty reining in tuition. At the University of Minnesota and MnSCU schools (the latter comprised of seven universities and 25 two-year colleges), tuition for the current school year was upped by 7.5 percent and 5 percent, respectively. Thanks to federal stimulus funds, those rates were subsidized down to 3 percent and 2.8 percent. (See Chart 1 for changes in tuition this decade.)

With rapidly rising costs and higher debt, you might think that enrollments would eventually suffer, as consumers vote with their pocketbooks. So far this decade, it's been exactly the opposite. Higher education enrollment on a full-time-equivalent (FTE) basis has risen over the past decade in all district states (see Chart 2). This is most likely due to the well-established fact that college-educated workers earn appreciably higher wages; it's also complemented by a demographic bulge as kids of the millennium generation (babies of baby boomers) have grown to college age during this period and by college participation rates that have continued to inch their way up, though much more slowly than in the 1970s and '80s.

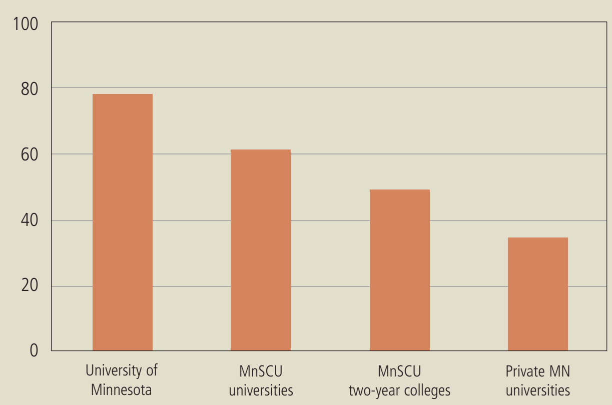
Enrollment growth has generally been strongest among two-year colleges, but four-year institutions have swelled as well, public and private. Official enrollments for this fall were not yet available at the time of this research, but anecdotes and past experience suggest it will be a seam buster.

Among Wisconsin's technical colleges, "realistic" growth of FTEs this year is 10 percent, according to Morna Foy, vice president with the Wisconsin Technical College System. She added that growth "could be much higher," given that half of the state's 16 technical colleges are expecting increases of at least 15 percent this fall. Last year saw an FTE rise of 5 percent.

CHART 1

Tuition costs rising

Percent change in tuition and fees, FY2000–FY2009, 2008 dollars

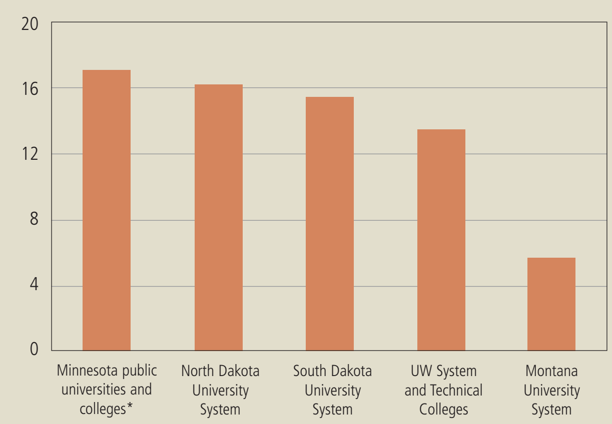


Source: Minnesota Office of Higher Education

CHART 2

Student growth spurt

Percent change in full-time-equivalent students, 2000–08



*Minnesota data are head counts; FTE figures were available only through 2005.
Sources: University and/or state higher education offices in each state

Four-year universities do not expect to match that growth, but many are expecting higher-than-average enrollment this year. Brad Eldredge, director of institutional research for the Montana University System (MUS), said via e-mail that it was too early to confirm this fall's enrollment, but added that "our sense from preliminary numbers is that enrollment growth will be strong." Preliminary figures from the University of Montana-Missoula estimated a 5 percent increase over last year's enrollment—which was itself a record.

Credit for the enrollment surge, according to Foy, Eldredge and other higher education officials across the district, is given almost universally to the recession. As one source put it, "It's a socially acceptable form of unemployment" as young adults and unemployed workers seek better skills in hopes of becoming more marketable in the future job market. It's even attractive to employed workers interested in greater job security or flexibility, knowing that they could be next in the unemployment line.

Of course, the recession comes with an ugly side for students and higher education institutions alike. For example, parents still fund a significant portion of college costs, and when one or both lose a job, it strains their ability to afford tuition out of savings or income. The same goes for students; over the past decade and a half, and particularly in this recession, teenagers and other young adults have had a rough go of it in the job market, which means they also do not have much savings or regular income to pay for college. Such circumstances imply that student debt is likely to continue climbing, possibly steeply.

Adding salt to this wound is the fact that, even before the recession, incomes had not kept pace with college costs, and prices for other basic student needs also have outpaced inflation by a large mar-

Continued on page 4

Ultimately, the cost of higher education will be justified—or not—based on whether it retains its historic value proposition:

Live better.

Earn more.

Go to college.

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gin. According to the College Board, average room and board costs have increased by 23 percent above inflation during the past decade. From fiscal year 2004 to 2008, tuition and fees at the University of Wisconsin-La Crosse rose by 17 percent, housing costs rose by 12 percent, and the most popular meal plan rose by more than 7 percent, according to this year's UW System Fact Book. (All figures are adjusted for inflation.)

A helping hand (into debt)

For existing and prospective students, the challenge for many is finding the necessary means to pay for college. Getting a firm handle on the extent of financial need in the district today is tricky for two reasons. First, state-specific data on financial need—the number of aid applications, amounts requested and approved, and the financial gap between approved aid and demonstrated need—typically lags at least a year.

Second, compounding the matter is the fact that financial aid packages are based on the previous year's income. So even last year, some sources said, financial aid trends didn't appear dramatically different because aid packages were based on student and family income from 2007, when the economy was still upright.

"If there was an acceleration (of financial need) in 2008–09, we didn't see it very clearly," said Greg Stringer, a senior vice president at Great Lakes Educational Loan Services, a federally designated guarantor for student loans in Minnesota, South Dakota and Wisconsin. Headquartered in Madison, Wis., the company services loans for more than 2 million borrowers and holds loan guarantees on nearly $51 billion under the Federal Family Education Loan Program, one of the major federal student loan programs.

Stringer and other sources said they are seeing more signs of financial need today. He ticked off a number of reasons—higher joblessness, tighter credit standards from banks for credit cards and home equity loans, and higher tuition and other costs—that were are all leaving their mark. "Put it all into the mix, and it seems intuitive that demand would be up."

Lois Larson, director or financial aid at Century College, a two-year community college in White Bear Lake, Minn., said the school had as many applications for aid on file this past August as "we had all of last year for three terms—fall, spring and summer."

Eldredge said that MUS was also seeing an increase in requests for financial aid; the number at the state's flagship University of Montana "is up significantly," and students were demonstrating greater need. Those local events mirror national trends: According to a September survey of 500 financial aid offices by the National Association of Student Financial Aid Administrators, 61 percent reported that financial aid applications were up 10 percent or more.

Financial aid flavor: Rocky road

Though financial aid takes on different forms and comes from a variety of sources, it all boils down to a fairly simple template: grants and loans. The federal government is the single largest provider of both, particularly loans. But states, institutions and private interests also provide a lot of financial aid—in fact, much more grant aid on a cumulative basis than the federal government.

But not all aid is equally palatable, Stringer pointed out. "There is a free-money flavor and a debt flavor, and one of those flavors doesn't taste very good."

As is always the case, there is never enough free money to go around, and rising demand for financial aid means even more competition for finite grant resources. A total of 35,000 students in Wisconsin's 16 technical colleges received need-based grants from the Wisconsin Higher Education Grant program, but more than 15,000 got shut out when funding ran out. That's more than double last year's number of unserved applicants, according to Foy.

Still, students manage to find the financial resources necessary to enroll, as evidenced by enrollment growth. Eldredge, from MUS, said students are able to find aid, "but often that aid is in the form of student loans. … [That's] the only aid that doesn't run out." He added that early projections showed student loan volume this year was up between 5 percent and 10 percent.

A September report by the U.S. Department of Education estimated that the total value of federal student loans grew by 13 percent last year and will do so by another 6 percent this year, to almost $92 billion. However, it offered no geographic breakdown on loan demand.

Higher enrollments are driving some of that federal loan growth. But the recession has also shut down other credit sources. For example, the recession and the concomitant slump in housing have cut deeply into home equity, which had been a small but growing source of financing for college. And the shake-up in financial markets also has banks and other for-profit lenders beating a hasty retreat from the private student loan market, which had been the fastest growing segment of student aid.

Bring your checkbook, or else?

While many complain about the rising use of student loans—whatever their source—the alternative might be worse. Without debt financing, millions of students simply wouldn't be able to afford college.

But higher costs and the growing use of debt financing have also heightened anxiety over college access for low- and modest-income households. High tuition and fees are "more and more of a challenge for those households with limited income," said David Chicoine, president of South Dakota State University in Brookings. "If we were all rich, there's not a problem."

But the current focus on low-income access might not be as intuitive as you think.

According to the National Center for Education Statistics, the gap between students from low-income families (those in the bottom 20 percent of family income) and their higher-income peers narrowed from 1972 to 2006, but differences remain. Still, the rate at which low-income high school graduates enroll in two- or four-year colleges by the following October has risen steadily, even this decade (see Chart 3 on page 6). In fact, it's the middle- and high-income high school graduates who have seen their college matriculation rate plateau.

One likely reason for improvement among low-income students is the continued availability of aid—grants and subsidized loans—for those who can demonstrate need (see article on page 8 for more discussion). Chicoine said that access for low-income students "might be better than those that are just above that (need) line" who must finance their college attendance via student loans. "If the student has the ability and preparation to get to college, we can put together a package" to get him or her in the doors, he said.

A potentially larger obstacle for many is not their respective wealth (or lack thereof), but their willingness to take on debt to get an education. That's because debt is often "something (students) have worked to avoid," said Chicoine, even if that means eschewing low-cost federal loans and ultimately "choosing not to go to school based on debt."

That's particularly the case for first-generation college students, who often get their views on debt from their more conservative parents. The matter is exacerbated when parents and students look at sticker prices for tuition—a price that few students pay because of widespread tuition discounting and scholarships. "What needs to be discussed is not gross cost but the net cost" after various sources of financial aid are applied, said Stringer, from Great Lakes. "A lot of people see the gross price, and they are horrified."

Many students also drop out when they can no longer pay for college out of their own pocket. Some take a semester or two off, hoping to save up enough money to pay for a return down the road. But research shows that many never go back.

While there is some utility—even trendiness—to frugality today, an absolute stance against debt can be counterproductive for a young person. "There are levels of debt that are affordable. If you're going to be a school teacher, there's a (total debt) number out there" to help you figure out what program is the best fit, Stringer said.

Tell that to the bill collector

But that view also competes with a rising din of anecdotes from students who didn't pay much attention to debt levels and their career choices.

Whether student debt is manageable depends on a person's income after graduation. Despite a plethora of stories about what seems to be excessive student debt, the college wage premium suggests that student loan debt generally must be manageable—if maybe unpalatable—for the majority of borrowers. Were it not, students would most certainly start making different decisions.

At the same time, surprisingly few data are available on the net financial burden of student debt. Figures for average debt are widely accessible, but that likely hides a significant amount of variation—and possibly shifting choices—among career paths.

It's not that educational institutions are uninterested in such matters. "We definitely try to track it. We're asking, but the other side is (students) need to respond" to income surveys they receive, said Gavin Leach, vice president of finance administration for Northern Michigan University in Marquette.

Loan defaults can offer some insight on debt management. National default rates on federal student loans, for example, are on the rise, at 6.7 percent for 2007, the most recent figures available from the U.S. Department of Education. That's up significantly from 4.6 percent in 2005.

But it's not all bad news. The rate among most district institutions, for example, is considerably lower (though also rising); statewide rates in the district run between a low of 2.3 percent (Montana) and a high of 3.8 percent (South Dakota). Rates nationwide were also much higher two decades ago, peaking at 22 percent in 1990. Those have come down significantly, thanks mostly to changes in federal lending programs that gave borrowers greater repayment flexibility.

Still, more financial trouble appears to be brewing. Stringer, from Great Lakes, said his organization has seen "a sharp increase in the number of delinquencies and defaults this year." But students also have more leeway in repaying education loans compared with other consumer loans. With student loans, Stringer said, "there are lots of temporary release valves that allow loan payments to be put into suspension while things work themselves out." A new income-based repayment option was also introduced this summer that caps loan repayments at 15 percent of discretionary income.

What, me worry?

As students and their families scramble to finance college, institutions face their own challenges that will likely add still more pressure to higher education costs.

Higher education institutions generally have high fixed costs, thanks to a huge assortment of programs, mostly tenured faculty and expansive facilities. As a result, they depend on reliable streams of (increasing) revenue. But some of those streams might not run as fast as they have in the past. For example, though state appropriations to higher education this decade have been generally modest, even meager in some places, they will nonetheless be under constant threat for the foreseeable future in many states—including Minnesota and Wisconsin—that are staring at huge structural budget deficits.

Or consider university endowments. Many schools receive significant contributions from them, but the collapse of financial markets last year put a serious dent in many endowments. The district's largest endowments rest at the University of Minnesota Foundation ($1.4 billion) and the University of Wisconsin Foundation ($2.3 billion). Each grew greatly in recent years, and their universities benefited richly: In 2008, foundation disbursements to the University of Minnesota were almost $100 million, a 21 percent increase over 2007. The Wisconsin Foundation did that one better, distributing $203 million to UW-Madison last year.

Whether or not universities can count on similar contributions is likely being reevaluated in light of a disastrous investment year. The UW Foundation assets dropped by 23 percent in 2008, with losses of almost $600 million. (The U of M Foundation has not reported investment results for the second half of 2008 and early 2009). Such endowment pain is widespread. UW-Superior, with about 2,300 students, reportedly awarded $100,000 less this year in endowed scholarships due to investment losses.

Institutions have also been receiving significantly more revenue from research contracts over time. That fund-

Continued on page 6

True or false:
College is expensive

Whether students are making different choices today about college—where to go, how to pay for it and so on—because of financing issues is an obscure, moving target, especially in an immediate sense. For starters, long-term trends tend to bend slowly, exacerbated by data lags that veil the effect of the recession on students' enrollment and financial aid choices.

For what they're worth, anecdotes are easy to come by. With the help of student leadership at several universities, the *fedgazette* conducted an (unscientific) online survey with students at a handful of universities in the district. The survey inquired about the cost of college and the use of financial aid in its many forms, including grants, loans and parental support. Close to 1,500 responses were received from students at four universities (three in Minnesota, one in North Dakota), including hundreds of additional comments to each of the survey's questions.

Anecdotally, the findings broadly confirm many long-term trends in higher education seen in the data, while adding some student perspective to a variety of issues discussed in *fedgazette* articles.

- Many students were receiving government grants and private scholarships. But a larger portion of students were borrowing to pay for college, and they were borrowing more than in previous years.
- Financial aid was getting harder to obtain. The application process was burdensome, students were hoping for more grant aid, existing federal loan caps did not always provide for enough funding, and private loans were tougher to find and more expensive.
- Less financial support appeared to be coming from home, partly because of recessionary pressures. Students said the "scoring" process for federal loan eligibility compounded the problem because it weighted parental income too much (particularly in cases where parents offered no assistance) and could not be adjusted to consider recent financial events in a household, such as a job loss.
- A large majority of students were working to help pay for college.
- Many said that the cost of college has made them reconsider the college they attended, or whether they could stay in college or attend part-time versus full-time. Some were also considering changing their lifestyle to help pay for college.

Survey results including comments—which cannot necessarily be considered representative of the overall student population because of possible sampling bias—are available online at minneapolisfed.org.

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ing might hold out; even if it does, however, it's not likely to relieve student costs because such revenue is typically dedicated to noninstructional types of expenditures, such as research staff, equipment and project administration.

With these revenue challenges, there will be growing pressure to have students fund more of their own instructional costs via tuition and fees, which means colleges and universities will also depend on strong enrollment. This isn't a problem for the time being—in fact, many institutions are more likely overcrowded—but it might be down the road, because the pull of higher education during recession is expected to wane with economic recovery.

Colleges and universities also are watching two demographic shifts roll through high schools, particularly in slow-growth states like those in the district: First, a steady decline in the number of high school graduates; second, an ethnic shift among those who graduate.

North Dakota has already had a glimpse of the high school future: The number of high school graduates there dropped by almost 10 percent from 2004 to 2008. It's projected to fall another 15 percent by 2016, the largest drop among district states (see Chart 4). But the trend hits high schools in every district state. That will have a trickle-up effect on all colleges and universities.

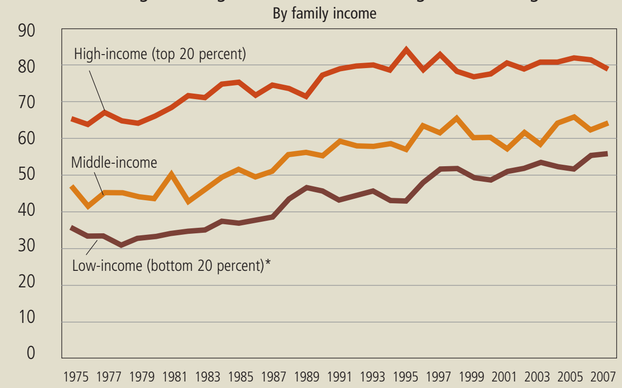
"I've never seen (a decline), certainly not to this degree," said David Laird, recently retired, but at the time of the interview, president of Minnesota Private Colleges and Universities. "The decline in Minnesota is almost entirely in white, middle- and upper-class students,"—in other words, the traditional bread and butter of higher education, particularly for private colleges. Most future enrollment growth will come from ethnic populations that are traditionally underrepresented in college and culturally tend to be more debt averse than their white counterparts—a potentially serious obstacle given the role of student loans in financing college today.

And … what?

Students and institutions alike are also staring wide-eyed into the worst job market for graduates in decades. Anecdotes on the matter are rife, but consider a handful of surveys by the National Association of Colleges and Employers, an industry group connecting career service professionals at nearly 2,000 colleges and universities nationwide with thousands of staffing professionals.

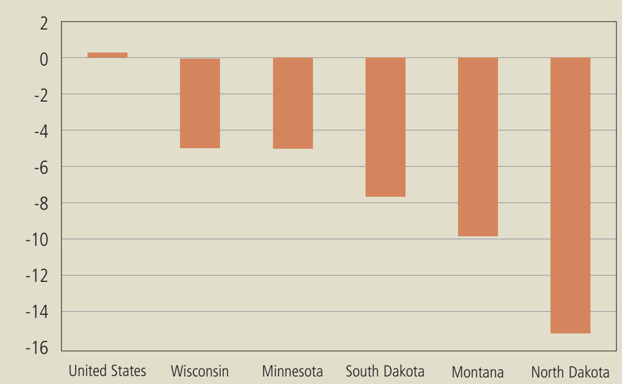
An absolute stance against debt can be counterprductive for a young person.

CHART 3
College dream (on?)
Percent of high school graduates enrolled in college the following October
By family income



* Three-year moving average due to small sample size
Source: National Center for Education Statistics, U.S. Department of Education

CHART 4
Student pipeline running dry
Percent change in projected high school graduates, 2009–16



Source: National Center for Education Statistics, U.S. Department of Education

Last spring, a NACE survey found that two-thirds of the class of 2009 were worried about their job prospects. It turns out they had good reason: Employers expected to hire 22 percent fewer new grads than from the previous year. Last May, NACE reported that just 20 percent of grads who had applied for jobs had been hired, down from 26 percent and 49 percent the previous two years; the percentage of grads even applying for jobs has also dropped each of the past two years. Then this fall, it reported that graduates who did find jobs saw their starting wages fall by 1.2 percent over the 2008 class. Finally, 55 percent of college career centers reported budget cuts for the coming year, and only 5 percent saw increases despite a potentially huge increase in demand for their services.

In the district, it appears to be much the same. A survey released in September by the St. Cloud State University Career Center found that 16 percent of respondents planned to decrease graduate hiring, up from 7 percent a year earlier. Employment markets are not expected to rebound quickly: The Minneapolis Fed's July forecast predicts that total nonfarm employment will decline further in 2010 in Minnesota, Wisconsin, South Dakota and the Upper Peninsula of Michigan, while Montana and North Dakota will have below-average (but positive) job growth.

Add up all of these colliding factors—higher costs, higher debts and an unsettling employment outlook for students; higher expenditures, a shifting client base and constrained revenue streams for institutions—and you've got the proverbial irresistible force and immovable object. Will students become more price sensitive? Is the current anxiety on both sides short lived, a figment of the economic times?

Time will tell, but chatter over college costs is getting louder. Steven Schuetz, vice president for admission and financial aid at Ripon College, a private school in Ripon, Wis., outlined much of the problem facing higher education, especially on the upper end. "Already, we are finding that all institutions need to justify their increases, and those above inflation are harder and harder to justify to families even though the cost of doing business is going higher. At the higher end of the tuition scale, we will have to eventually ask ourselves, 'Are we worth $50,000 a year?'"

VALUE

Taking on debt to earn a degree is a good, rational decision. The evidence of the value proposition is pretty robust.

But students are looking at different options. For example, online enrollments are growing fast. While most colleges and universities offer online courses, there appears to be significant leakage to private online colleges. In 2008, fall head count at Minnesota's two online universities (Walden and Capella) increased by 17 percent over the previous year, to 60,000 students.

Among traditional institutions, two-year colleges have seen easily the largest enrollment surge. Some of this is likely a function of rising job dislocation and career retraining, which technical and community colleges specialize in. But even before the recession, two-year colleges were out-polling four-year institutions. In Montana, two-year colleges saw enrollment from 1998 to 2008 grow by 25 percent, compared with an increase of just 6 percent for the university system as a whole and 5 percent for the state flagships, Montana State University-Bozeman and the University of Montana-Missoula. This fall, Montana Tech reported an 11 percent increase in its head count.

Larson, from Century College in Minnesota, said the choice of a two-year college makes affordable sense in today's economic environment. "Think about it for a second. A student loan at this time nicely covers half-time enrollment costs at a two-year college, and then the rest is sent to the student for living expenses. If you are hungry, going back to college can be a short-term fix as well as a long-term goal. I think all [higher ed institutions] will see an increase in applicants. But the increase in enrollment will pass down the food chain to lower-cost colleges, at least for now."

"My instinct is that yes, families are becoming more cost-conscious, at least on the margins, not wholesale. It's not dismissing the idea of college but changing what you want to do," said Stringer, from Great Lakes. That might mean choosing an in-state public university because "they can't send Johnny or Judy across the country to an Ivy League school anymore."

Chicoine, from SDSU, believes schools like SDSU might be the destination of prodigal students—those who transfer from expensive out-of-state or private institutions when families can no longer rationalize the expense. Laird, from Minnesota's private colleges, said more students were looking at premier public universities like UW-Madison as a lower-cost alternative.

New and improved! Great value!

Educational institutions are also taking a fresh look at how to deliver services. For example, the UW System is exploring the possibility of accelerated three-year baccalaureate degrees. In an attempt to tackle skyrocketing textbook prices, half of the system's four-year campuses have implemented rental programs. The system has also considered additional fees for high-cost fields that also offer higher salaries, like engineering.

In the midst of budget pressures, some institutions are even looking downright businesslike. Facing state appropriation reductions, the University of Minnesota was staring at $90 million in budget reductions and reallocations this year. The Board of Regents took the unprecedented step of cutting more than 1,200 jobs—including 220 faculty positions.

Elsewhere, faculty are having to swallow hard to avoid what's behind door number two. Earlier this year, the unions representing the MnSCU's 32 institutions agreed to a two-year salary freeze. At the Montana University System, tuition was kept constant at all campuses for the 2007–2008 biennium. It will remain flat over the coming two years at most campuses, and will rise by 3 percent annually only at MSU-Bozeman and UM-Missoula. Eldredge called this level of tuition stability "unprecedented."

Opinions varied as to whether actions by students and institutions are the first steps in a new direction for higher education or a necessary reaction for muddling through the recession.

"My sense is that there is going to be a softening [of price sensitivity by students] once the economy recovers," Chicoine said. He and others pointed out that the world needs more—not less—skilled labor in the future, and that means a university classroom seat will continue to be a finite resource, particularly if state and federal funding remains scarce. Regardless, higher education needs to be seen "as an investment, and not a current expenditure … [because] there is no substitute for human capital" for long-term economic growth, Chicoine said.

That doesn't necessarily mean that college costs can resume their ascent once the economy recovers. A few sources believed there is an as-yet-unknown cost point at which the return on a college degree is no longer obvious and students will start making different choices.

"I don't know where the [affordability] line is, but it's out there where families will change their horizons on a more permanent basis," said Stringer.

College degree: Earning its keep

Ultimately, the cost of higher education will be justified—or not—based on whether it retains its historic value proposition: Go to college. Earn more. Live better.

Of course much of that value proposition depends on who's paying, and that's not always straightforward because research has shown that both the individual and society as a whole benefit from the human capital growth that occurs through higher education. But there is no clear line demonstrating how much each party needs to pony up for its share of the benefits.

"I don't know if there is a theoretical balance" between the public and private share of higher education investment, said Chicoine. If that's true—and there's virtually no research that even takes a stab at a hypothetical equilibrium—then students and higher education systems will have to continue feeling their way along the cost ladder.

Chicoine pointed out that college students "make decisions all the time" based on their understanding of costs and benefits. Average student debt at the university rose from $14,200 at the start of the decade to $20,800 in the 2008 school year. At the same time, median wages for workers in South Dakota with four or more years of college were about 60 percent higher in 2006 than for those with a high school diploma, according to figures compiled by the Federal Reserve Bank of Minneapolis. So taking on some debt to earn a degree, Chicoine said, "is a good, rational decision. The evidence of the value proposition is pretty robust."

Some might think that the cost issue is more pressing for private institutions with higher tuition and fee costs. But that depends on how you interpret value. Average debt is higher for graduates of these institutions. But four- and six-year graduation rates from Minnesota's private four-year schools are significantly higher than those of public universities in the state (including the University of Minnesota), and entry into the workplace a year after graduation is also much higher. That means private college grads start earning their wage premium earlier and begin paying off their debt sooner.

But Laird, representing Minnesota's private colleges, also acknowledged that all schools are on a slippery cost slope considering the economic conditions today, and have to be part of the solution. "Could institutions behave differently? If they had some necessity or benefit, sure," said Laird. "These institutions are not incapable of making very dramatic changes when necessary, or when there are incentives to do so." f

College finance 101:
A history lesson

The evolution of a high-tuition, high-aid model

By RONALD A. WIRTZ
Editor

OK, class, time for a refresher course on how college got steadily more expensive over the past few decades. Here's the cheat sheet: more students, higher spending, not-high-enough public appropriations and easy credit.

None of this is particularly tricky, or even new. College tuition and fees, for example, have plotted a steady course upward (see Chart 1). No state, indeed virtually no institution, has escaped the simple fact that tuition and fees for college have skyrocketed beyond almost any other major consumer good.

Higher education officials are often quick to point out that state appropriations have not kept pace with the cost of higher education, which fuels tuition and fee increases. Technically, that's correct.

But it's also a half-truth. State appropriations have risen, though more slowly in most states this decade, thanks to bookend recessions. Still, since the late 1970s, almost all district states saw inflation-adjusted increases in state appropriations of at least 26 percent, with South Dakota topping the list at a 50 percent increase.

The exception is Wisconsin, where state appropriations grew a paltry 1.5 percent over this period. However, Wisconsin is also one of a few states where technical colleges are supported by local property tax levies. In fiscal year 2009, tax levies brought in more than $700 million in local appropriations to the state's 16 technical colleges; that's an increase of 24 percent in constant dollars since 2000.

There are other caveats, as well. For example, cumulative state appropriations to higher education include direct funding to institutions, but also state-run grant and loan programs for students. Direct funding for individual institutions, therefore, likely reflects a different trend slope. Equally important, adjusted on a full-time-equivalent student basis, state appropriations look more modest of late, given enrollment increases in the district, and have seen a real decline over the past decade in Minnesota and Wisconsin.

Advocates also argue that higher education has become a lower state priority by default, evidenced by the fact that higher education accounts for a steadily declining share of state budgets and that state appropriations make up a declining share of higher ed budgets. For example, state appropriations made up about one-third of the fiscal year 2000 budget for the University of Wisconsin System, which comprises 13 four-year universities (including UW-Madison) and 14 two-year colleges; by 2008, state appropriations had slid below one-quarter of the budget, according to the system's most recent Fact Book.

That might give the impression that higher education is living on a financial shoestring. If that's the case, it's a pretty thick string, because total revenue has risen progressively in higher education. The UW System has kept costs down better than most. Yet total real revenue grew by 11 percent, to $3.9 billion, from 2000 to 2008. Most of the new money comes from just a few sources. For example, student-based revenue in the UW System jumped by 45 percent (inflation-adjusted) to almost $900 million, derived from both higher enrollment and rising tuition. The system also managed to pull in an additional $400 million over this period from gifts, grants and contracts, over half of it from federal sources and much of that for research.

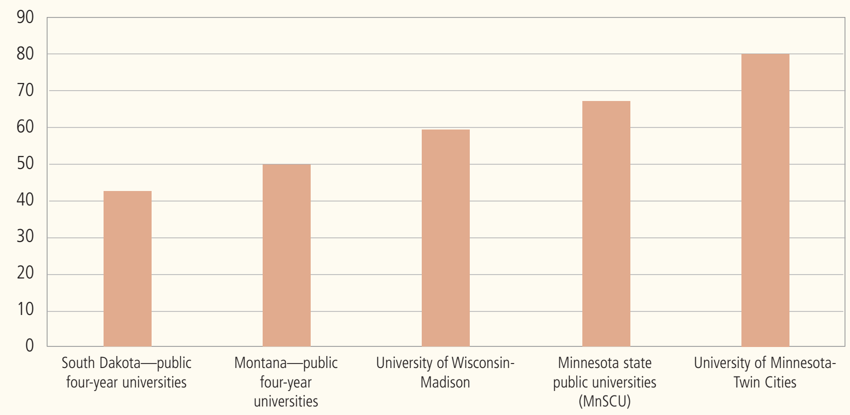
What has resulted is a public higher education model increasingly funded by sources other than state appropriations—namely, students, research contracts and even alumni donation campaigns. Figures from State Higher Education Executive Officers show that public appropriations have been sluggish for much of this decade, while tuition revenue has increased significantly.

Even factoring in rising enrollments, total education revenues per full-time student have outpaced inflation in all district states—significantly in some cases (see Chart 2). Montana has held the lid most tightly on tuition levels of late, the result of recent tuition freezes coupled with higher state appropriations.

CHART 1

Tuition up at district schools

Percent change in in-state undergraduate tuition and fees, FY2000–FY2009, 2008 dollars

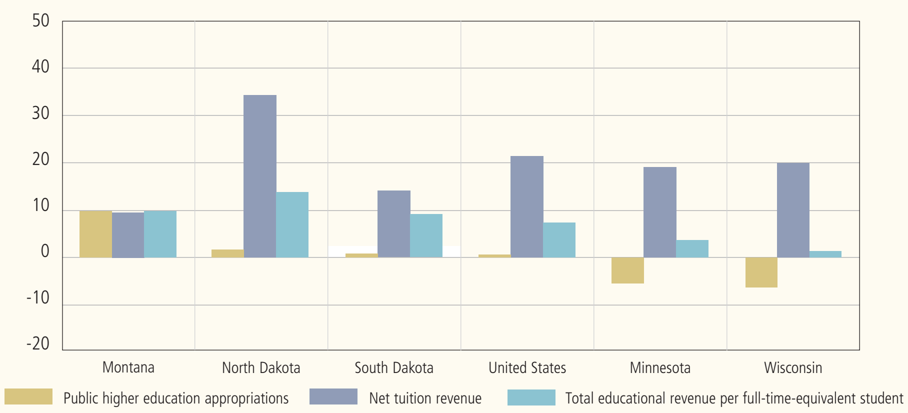


*South Dakota figure based on simple average of six universities.
Sources: University systems in each state

CHART 2

Tuition revenue rising strongly, even by FTE

Percent change in higher education revenues, FY2003–FY2008, 2008 dollars



Source: "State Higher Education Finance, FY2008," State Higher Education Executive Officers, 2009

Spare a few (thousand) bucks?

Students are dealing with higher costs by seeking more financial aid. In the 2008 school year, students received $143 billion in financial aid, a real increase of 84 percent since 1998, according to the College Board.

The rate at which students seek and receive financial aid varies widely by institution type and even by state. For example, since 1995, at least 80 percent of students in South Dakota's six public universities have received financial aid, and that figure has inched even higher. That's well above the national average, currently at 66 percent.

Financial aid demand tends to be lower in the other district states, but all have moved much higher in recent years. In the UW System, the percentage of enrollees receiving any financial aid jumped from 37 percent in 1989 to 66 percent last year.

All of those figures hide still more variation among borrowers in terms of their propensity to seek aid, from what sources and for how much. Though there are exceptions, students attending public two-year schools generally seek less financial aid. They also receive less grant money and take out fewer and smaller student loans because these schools cost less to attend. Financial aid requests and amounts tend to increase at public four-year universities, and levels go higher still for those attending private universities. This typology holds fairly well among institution types, but can vary significantly across states.

Most of the attention regarding financial aid goes to the widely publicized—and criticized—fact that students are becoming increasingly dependent on loans to finance their college education. In 2007, college goers in Minnesota received $2.3 billion in financial aid, more than double the (adjusted) amount in 1997. Loans, most of which

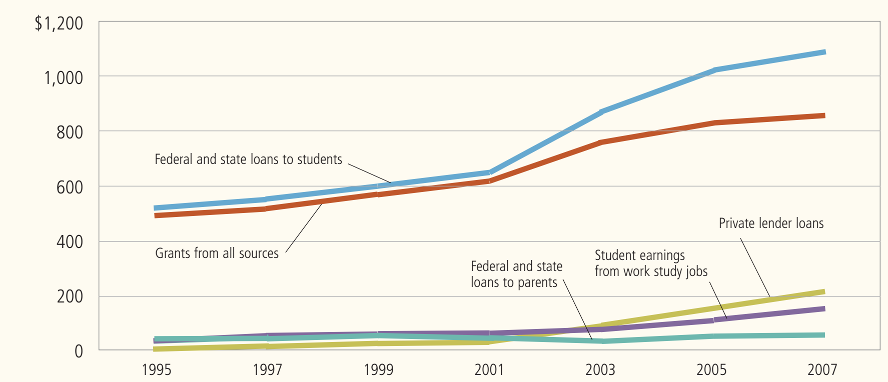


CHART 3
Cash, check or charge?
Financial aid to Minnesota college students, FY1995–FY2007, millions of 2008 dollars
Source: Minnesota Office of Higher Education

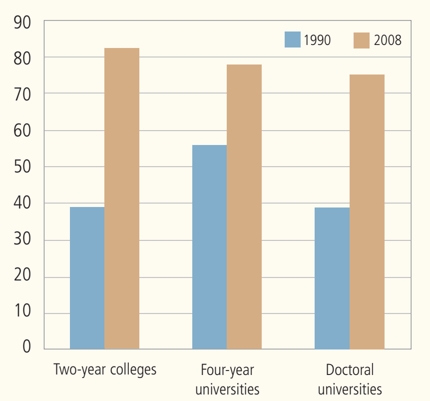


CHART 4
Everybody's doing it
Percent of North Dakota students taking out loans
Source: North Dakota University System

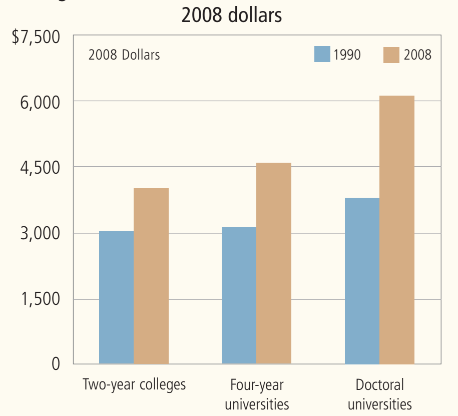


CHART 5
Get big, or go home
Average size of annual loan to North Dakota students, 2008 dollars
Source: North Dakota University System

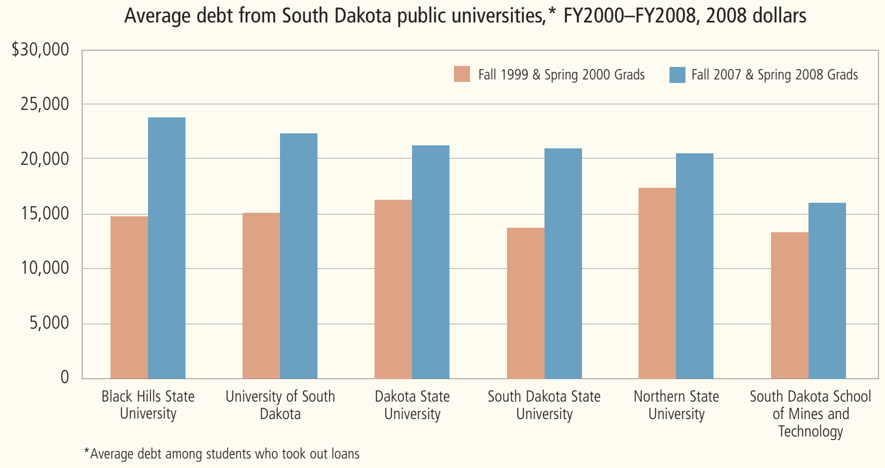


CHART 6
Average debt rising
Average debt from South Dakota public universities,* FY2000–FY2008, 2008 dollars
*Average debt among students who took out loans
Source: South Dakota Board of Regents Fact Books, fiscal years 2001 and 2009

come from the federal government, make up the largest portion of the growth (see Chart 3). Breakneck growth in private loans (more than 7,600 percent) over this period has also contributed to the increasing prominence of loans as a source of funding.

Financial aid debates typically focus on a perceived lack of grant aid, based on the fact that the most visible grant program, the federal Pell grant, has persistently shrunk as a percentage of average tuition. (Since 1973, the annual maximum Pell grant has failed to increase even in nominal dollars 14 times, according to the U.S. Department of Education.) But like much else in this debate, it depends on how you read the data. It's true that grant aid hasn't generally kept pace with the cost of tuition, which is why student loans are on the rise. But it's inaccurate to say that grant aid has pulled a disappearing act.

What many don't recognize is that grant aid has many spigots, including traditional federal and state need-based programs, employer funding, private scholarships and institutional grants, the last of which is the single largest pot of money to help students afford college.

Most of these spigots have been pouring out much more—not less—money over time. From 1997 to 2007, inflation-adjusted grant aid to Minnesota students grew by 74 percent. Institutional grants and tuition discounts accounted for almost half of all grant aid in 2007, at about $417 million, with the other half made up of federal, state and private grant aid.

Institutional aid is doled out in many forms and programs. For example, at the University of Minnesota, the Founders Free Program promises grant and gift assistance equal to tuition and required fees for any state resident who has been admitted as a first-time, full-time student, completes the Federal Application for Financial Student Aid and is eligible for a Pell grant (which indicates financial need, though a student does not necessarily have to be low-income). Started in 2005 and fully implemented last year, the program provides free tuition for nearly 5,000 students—12 percent of undergrads there—according to the university.

Grant aid is likely to continue improving, at least in the short term. Maximum Pell grant awards have risen in each of the past three years, from $4,050 to $5,350 for the current school year. That has meant big bucks for students. With rising enrollment, higher grant amounts and the fact that more students are qualifying for grants courtesy of the recession, it's estimated that total Pell grants to Minnesota college students will go from about $250 million in the 2008 school year to almost $400 million this school year, according to Department of Education estimates.

In September, the House of Representatives passed a bill that upped the maximum grant again next year to $5,500 and ties the grant max to the cost of living index, plus 1 percent annually, which is expected to push the max to $6,900 by 2019. The Senate was expected to take up the matter by the end of October (after *fedgazette* deadlines).

Once you factor in grant aid from its multiple sources (institutional, federal, state and private), net tuition costs look much different. Nationwide from fiscal years 2000 to 2009, net tuition costs after grant aid actually fell for two-year schools, though it rose by 17 percent for four-year private schools and by 32 percent for four-year public schools (inflation-adjusted), according to the College Board.

Those figures hide a lot of variation among students in different states because tuition rates fluctuate widely, as does the availability of grant aid. For example, unlike most states, South Dakota has never had a state-based grant program, which is likely one reason for its higher dependence on loan aid. Only about 25 cents of every financial aid dollar for a South Dakota student is grant aid (mostly from federal and institutional sources), compared with 40 cents for Minnesota peers. Much of the gap is due to a Minnesota grant aid program (not to be confused with state appropriations, which go to institutions) that disbursed more than $150 million to students in 2008.

Despite these increases in grant aid, more students at all levels of higher education are borrowing money, and the loan amounts are increasing. Students at two-year colleges in North Dakota were more than twice as likely to take out a student loan in 2008 as they were in 1990 (see Charts 4 and 5). The average loan has increased by about 30 percent (inflation-adjusted) during this period; however, all of that increase has occurred since 2004, according to data from the state university system.

Loan + loan = car payment

The growing propensity for and size of student loans has logically caused debt to balloon for Ninth District students.

In the UW System, average debt of resident undergraduates who completed a bachelor's degree and who borrowed while in college hit $22,400 in 2008, according to system figures. That's an 85 percent real increase from 1989. In the 2007 graduating class from Minnesota public universities, 77 percent carried student loans averaging $23,600, according to the Minnesota Office of Higher Education. Their monthly payment over 10 years was $270.

But state averages gloss over differing debt levels among even fairly similar institutions. Among South Dakota's six universities, for example, both average debt and growth of debt over time have varied widely (see Chart 6).

Despite the surge in borrowing, not all students go into debt for college. Nationwide a little over half of those graduating with associate degrees in 2007–08 did so with no debt; 34 percent of those leaving with baccalaureates did likewise, and two-thirds of all graduates at all levels left with less than $20,000 in debt. But all of those figures are worsening from a student-finance standpoint.

The uniqueness of U.S. higher education, including institutions in the Ninth District, is that it is not a unified system; rather, it has evolved and expanded into a multitude of programs—public and private, profit and nonprofit—of various length, quality and price points. As one source put it, "It's available to everyone, if you can figure out how to [pay for] access." f

SOUTH DAKOTA

Don't bet against it

Nationwide, state-sanctioned gambling (which does not include tribal casinos) saw a revenue decline of 2.6 percent last year, the first decline on record for at least three decades, according to a report by the Nelson A. Rockefeller Institute. South Dakota saw a slightly larger drop of 3.8 percent.

South Dakota is one of only 12 states in the country that allows casino gambling outside of tribal casinos, though revenues are small in size, at about $8 million. Still, it was also one of only three states that saw growth in (nontribal) casino revenues, with an increase of about 1 percent. On the flip side, the state saw state lottery revenue drop more than 4 percent to $118 million.

South Dakota currently ranks seventh highest in gambling revenue per resident, at $230. Some of that money might be leaking across the southern border, however. A planned casino in neighboring Iowa recently upped its own ante when it decided to increase the size of its project, boosting its cost from $90 million to $110 million.

Have work, will pay

Various national surveys have put South Dakota residents among the best at their ability to stay current with financial obligations.

For example, TransUnion, a credit analysis firm, said the state had the lowest home mortgage delinquency rate in the country in the second quarter of this year and the second-lowest rate for credit card delinquency. In both cases, national rates were roughly double those of South Dakota. The state is also in the bottom third for car loan defaults. The Mortgage Bankers Association ranked South Dakota 50th (lowest) for both foreclosures and missed payments.

Much of that is likely due to the fact that more people are working in South Dakota.

Though its unemployment rate jumped from 4.5 percent to 4.9 percent in August, that's half the national rate and continues to be one of the lowest in the country. Unlike most states, South Dakota also saw median household wages grow last year. At 2 percent, that wage growth was good for fifth best.

—Ronald A. Wirtz

Quiet summer at the lake

Demand has cooled for vacation homes in the district

By JOE MAHON
Staff Writer

The cabin market on Lake Superior's North Shore has gone south. Typically, this scenic area of Minnesota is a strong market for vacation properties, but since 2007 real estate activity has slowed markedly. In and around the resort town of Grand Marais, the number of properties sold fell by nearly half in 2008 compared with the year before, according to the Cook County assessor's office. This year is expected to be about the same as last.

"It is bleak this year, just bleak," said Vicki Wenz, owner of Gunflint Realty in Grand Marais.

As goes the primary-home market, so goes activity in vacation real estate. From 2002 to 2006, sales, construction and prices of all housing rose steeply, contributing to economic expansion in the middle of this decade. Then the tide turned in 2007, with the supply of homes for sale outpacing demand, leading to falling prices and rising numbers of foreclosures. Sales of weekend cabins and second homes suffered along with real estate in general, and the current recession has further lessened demand for a place in the country.

Nationwide, the second-home market fared worse than the overall housing market last year; a survey of investment and vacation-home buyers by the National Association of Realtors (NAR) showed that vacation-home sales fell by almost a third, more than twice the percentage point drop in sales of primary residences.

A similar pattern appears to hold in the Ninth District; vacation areas have seen a more dramatic drop in property sales than the region's overall housing market (see chart on page 11). Sales of existing homes in the Midwest fell 15 percent in 2008 from a year earlier, according to the NAR. In contrast, the number of home sales in the northern Black Hills in South Dakota fell 20 percent during the same period, according to the Multiple Listing Service (MLS), which real estate agents use to track local markets. In northern Wisconsin, sales plummeted almost 36 percent.

National numbers for this year are unavailable, but there's evidence in the district that the vacation-home market remains depressed. For example, in lake-studded northern Wisconsin, a popular destination for vacationers from the Twin Cities and Chicago, the number of homes sold in the first half of the year was down 22 percent from the same period in 2008. Median sales prices in the area also fell year over year.

This continuing slump stands in contrast to trends in the primary-housing market in recent months. Nationwide, and in many district markets, housing sales have risen from 2008 levels as buyers took advantage of lower prices and federal first-time buyer incentives. Will vacation-home sales show a similar bump this year? Maybe not; buyers of second homes face constraints not found in the primary-housing market.

For example, a vacation home is more of a luxury than a necessity. A decline in housing prices as well as stock values has reduced household wealth, making people less inclined to indulge their urge to get away. The erosion of household wealth, combined with other factors, has also made financing a second home more difficult.

While vacation properties are still selling in some market segments, the overall second-home market in the district likely faces a long, slow road back to prerecession levels.

A lot for sale

Across the district, market segments that appeal to those with moderate incomes have shown more signs of life this summer than pricier retreats.

In the Brainerd lakes area of Minnesota, a popular resort destination within two hours' drive of the Twin Cities, both sales and prices for high-end properties have fallen over the past two years. As of midsummer, about 300 homes were listed on the exclusive Whitefish chain of lakes, but there were only 15 sales for the year, according to the MLS. Average time on the market for these lake homes increased 70 percent from last year. "What we've seen is a big dry-up in the $500,000 to $1 million range," said Jim Eisler, a broker at Edina Realty's office in Brainerd.

Today, sales of moderately priced properties, although below the pace of a few years ago, are far outpacing those at the high end. "There's still a robust market for vacation homes in the $250,000 to $325,000 range," Eisler said. Moreover, falling prices for vacation homes have opened up new possibilities for buyers in the Brainerd area. During the boom, $250,000 to $325,000 would buy property in the woods, but not on the lake. Now buyers in that price range can expect to move up to a lakefront lot or small house.

Chris McGrath, owner of Woodland Realty in Hayward, Wis., told a similar story—prices of vacation property are falling, and buyers with more modest means are driving the market. The Hayward lakes area in the northwestern part of the state attracts primarily moderate-income tourists and cabin owners from the Twin Cities.

This year's real estate season—late spring and early summer—started slowly, McGrath said, continuing the pattern of last year, when sales were down 37 percent from peak levels two years earlier. But toward the end of July, he saw an influx of people pursuing deals on a lake cabin or lot. "I think we're starting to see buyers and sellers agree more on prices," McGrath said. On average, property sellers this year were settling for about 10 percent less than their initial asking price, he said—a marked discount from 2006.

Michigan's Upper Peninsula is another moderately priced market that has weathered the housing storm fairly well. Despite Michigan's economic woes, home sales in the U.P. have been relatively stable, if slow. Last year, sales of homes, including vacation properties, fell by less than 13 percent year over year in the region, according to the Michigan Association of Realtors—a big drop, but not as large as the decreases in many other markets.

The overall housing market in the U.P. didn't experience a surge earlier in this decade, so when the recession hit, sales and prices didn't fall as far. Even in the boom years of 2005 and 2006, sales grew by less than 10 percent a year and annual price increases were in the low single digits—a snail's pace compared with nationwide increases at that time.

Have I got a log cabin for you

In western Montana, much of the run-up in sales and valuations before the recession was driven by wealthy out-of-state residents buying luxury log homes. Since the housing slump and financial crisis, this exclusive market has taken a beating.

At the start of the residential downturn, second-home sales activity in the region showed no signs of slackening. "Sellers here were overoptimistic that we would continue to be sheltered," said Misty Retz, a real estate agent at Glacier Sotheby's International Realty in Whitefish, which specializes in luxury properties with an average price of about $1 million.

But the slowdown was just delayed in Montana; loss of wealth due to falling real estate and stock portfolio values has taken its toll. In Whitefish and the surrounding Flathead Valley, for example, sales have fallen drastically since 2005. The number of sales in the Flathead peaked in 2005 at about 4,300, according to the MLS. In 2007, there were fewer than 3,000 sales, and in 2008, sales dropped to less than half their peak level.

Dollar volume of transactions has fallen by an even higher percentage, because prices are also down. MLS closing prices last summer were running anywhere from 25 percent to 50 percent below list prices.

Retz said the Flathead Valley is fortunate not to be seeing as many foreclosures as other areas of the country, because wealthy owners can afford to hold onto their mountain retreats. "But that also means they can afford to take a loss and go somewhere else where real estate is undervalued," she said. Eager sellers looking to unload their Montana chalet in exchange for a condo in Florida or a villa in Italy have driven down market values.

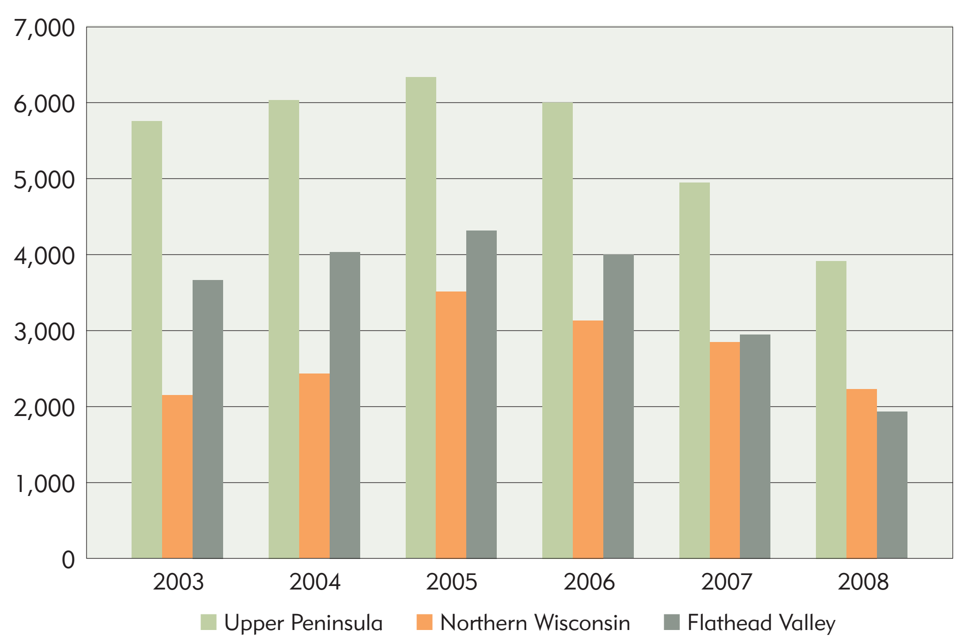
Show me the money

With prices falling for all types of vacation property, deals abound in the district. But financing a home away from home is harder than in the past, thanks to troubles in the residential housing market. Getting a loan to buy a cabin is a challenge in the U.P., said Kelli Konrad, a real estate agent in Munising. "It's tougher getting things financed; there's a lot more hoops you've got to jump through."

The NAR survey showed an increase last year in the proportion of buyers paying cash for vacation properties, but few people can afford to finance such a purchase solely with cash.

Home sales in vacation areas down sharply from peaks

Total home sales



Sources: Northwestern Montana Association of Realtors, Michigan Association of Realtors, Wisconsin Realtors Association

Second-home financing has felt the impact of the same factors that have tightened the screws on borrowers in the primary-home market (see the January 2009 *fedgazette* for details). Mortgage lenders are requiring bigger down payments and more documentation, and charging borrowers with less-than-sterling credit higher interest rates. Turmoil in markets for bundling and selling mortgage debt has made it tough to secure anything other than a traditional 30-year fixed-rate loan.

Prospective second-home buyers face additional hurdles, not the least being a decline in net worth because of the overall drop in home values. House-poor compared to years past, many people are having trouble mustering sufficient equity to qualify for a cabin loan. Buyers get no help from the federal $8,000 tax credit for first-time home buyers that took effect at the beginning of this year; introduced to buoy home sales, the credit doesn't apply to vacation homes.

See you next summer—maybe

How quickly vacation-home sales pick up depends on the outlook for the regional and national economies. The problem is that no one's sure what course and trajectory the recovery will take after a lengthy recession. Since any vacation property is a luxury, market recovery will require growing incomes and assurance that values won't keep falling. A rebound in values for primary residences would help restore household wealth and buyer confidence.

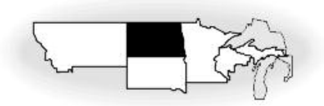
A market resurgence in the Brainerd area is a ways off, Eisler believes. Given the pace of sales and the number of homes on the market, "we've got another 18 to 24 months before everything's cleaned up here," he said.

In Hayward, McGrath expressed optimism, noting that the Twin Cities area is expected to come out of the recession with a lower unemployment rate than the average for metro areas nationwide. He was hoping for a surge in sales this fall and winter to offset a slow spring. Although sales in his area have fallen nearly 40 percent over the past two years, median sale prices are down only 6 percent, he said. That leaves room for more discounting that may entice more prospective buyers to enter the market.

In western Montana, Retz said that the apparent willingness of wealthy vacation-home owners to accept losses on sales may keep valuations depressed through next year, even if economic recovery is robust.

At this juncture, predictions about the future of the second-home market in the district are highly speculative. However, McGrath is certain about one thing: "On a large scale, we need the recession to continue on its merry way out." f

NORTH DAKOTA



Economic un-development

Comparatively speaking, lots of things are going right for North Dakota, particularly in its capital city. But the recent announcement of Bobcat closing its Bismarck manufacturing facility has laid bare an economic development effort that has stumbled.

Bobcat was the lone firm at the Northern Plains Commerce Centre, a 243-acre industrial park built by the city for $15 million, mostly from an economic development fund supported by sales tax revenue, according to local reports. The hope was that the project would create a hub where freight is loaded from railcar to truck or vice versa.

The facility is also close to the airport. Bobcat had been manufacturing heavy construction equipment in Bismarck since the 1970s, but was the NPCC's first tenant when it moved there in 2006. Shovel-ready construction sites are available with direct and indirect rail access.

In April, plans for a $20 million sunflower crushing plant at the NPCC were also announced. But financial issues cropped up, and those plans were put on hold in late August. Had the plant been built, it would have qualified for a five-year full income tax exemption.

Press the button for pull tab

The state of North Dakota is considering a change to gambling regulations that would streamline complex regulations and tax rates and would allow charitable organizations to offer electronic pull tabs to replace the paper ones now widely used.

A possible move to electronic pull tabs is being considered because they are easier to manage and audit. The state's judiciary committee is currently studying this and other possible changes, but the final report is not due until next fall. Any recommendations would have to be approved by lawmakers.

Outside of tribal casinos, all gambling is operated by and on behalf of charities. Last year, gamblers in the state spent $144 million on the paper-pulling game, or more than half of all charitable wagers. Despite obvious efficiencies, the switch to electronic pull tabs is not a slam dunk. Two decades ago, the Legislature approved laws allowing charities to offer electronic gambling, but the matter was soundly defeated in a special election.

—Ronald A. Wirtz

No patient turned away

Community health centers have expanded their presence in the district by offering basic medical care for everyone

By PHIL DAVIES
Senior Writer

Montana's Flathead Valley attracts well-heeled tourists, vacationers and retirees from around the country. Tony enclaves of log homes dot the outskirts of Kalispell, a city of 20,000 that is a gateway to Glacier National Park. But not everybody in the valley is wealthy; many people can't afford regular medical care at a private doctor's office. For years, those residents have forgone care or ended up in a hospital emergency room when struck by accident or serious illness. Since 2008, such patients have had someplace else to go when they get sick: a clinic in Kalispell that treats everybody, regardless of ability to pay.

The Flathead Community Health Center provides basic medical services such as physical exams, X-rays, immunizations and tooth fillings. Sixty percent of the clinic's patients have incomes below the federal poverty level, and 70 percent have no health insurance. Such patients pay fees on a sliding scale calibrated to family size and income. Minimum fees are $10 for a medical visit, $20 for a dental appointment.

A medical underclass—low-wage workers in hotels, restaurants and other seasonal, tourism-oriented businesses—has long existed in the region. But economic hardship over the past two years has increased the need for the center, said Executive Director Wendy Doely. "[Flathead County] has suffered a lot during the economic downturn," she said, noting that the county had the third-highest unemployment rate in the state in July because of layoffs in the lumber, construction and service industries. Along with their jobs, many clinic patients have lost their health insurance coverage.

The opening of Kalispell's community health center is part of a dramatic expansion of CHCs nationwide and in the Ninth District during this decade. Formally called federally qualified health centers (FQHCs), these nonprofit clinics provide primary care for underserved populations—people with little or no health insurance, or limited access to medical care.

Supported by federal grants and state money—some of it in the form of increased funding for public health insurance programs—the number of patients treated nationwide at CHCs increased 65 percent between 2000 and 2007, to over 16 million annually. Federal government figures show that the community health network has grown at an even faster pace in the district, both in patients served and territory covered. In Minnesota, Wisconsin, Montana and the Dakotas, the number of patients seen by health centers each year nearly doubled between 2000 and 2008. Including the Upper Peninsula of Michigan, 22 new CHC organizations have formed in the district in this decade—an increase of 60 percent.

Many community health centers are located in low-income neighborhoods in cities such as Minneapolis, Fargo, N.D., and Billings, Mont. But they've also taken root in much smaller communities—Cook, Minn.; Faith, S.D.; Iron River, Wis. A number of CHC organizations have expanded their operations over the past 10 years, opening satellite clinics in surrounding towns and adding services such as dental care, on-site drug prescriptions and mental health counseling. Some health centers specialize in treating migrant workers, at-risk schoolchildren or the homeless.

This year, health centers got a shot in the arm from federal economic stimulus funding aimed at strengthening a health care system safety net frayed by economic troubles. (The Flathead CHC received $1.5 million in stimulus grants last spring.) Legislation enacted by Congress last year and several health care bills generating intense debate at the Capitol this fall call for further national expansion of CHCs, although a federal budget deficit and opposition to a major overhaul of health care may derail those plans.

Community health centers have garnered staunch government support because they're seen as cost-effective providers of health care. They operate on a different model than the one followed by most private medical practices, focusing on basic, everyday care by teams of doctors who earn salaries, not fees for each service performed. By providing preventive care to patients who would otherwise receive less care or forgo it altogether, CHCs aim to keep them healthier, potentially avoiding expensive medical bills down the road.

"By having a health center, you catch people with medical problems in the early stages," said Dr. Jon Berg, medical director of Valley Community Health Centers, a trio of clinics in northeastern North Dakota. "You treat them, and they avoid going to the emergency room."

Policymakers desperately want to find a way to improve access to health care while curbing its increasing costs. The growing number of people receiving care from CHCs shows that they do improve access, at least for a segment of society that has little recourse under the current system. But ongoing research on treatment costs has yet to prove that further expansion of health centers in the district would reduce the overall cost of health care.

Clinics of last resort

The tug-of-war in Congress over reshaping the nation's health care system has highlighted the fact that many people either can't afford or don't have ready access to medical care. The U.S. Census Bureau estimates that 46 million people in the United States lacked health insurance in 2008—about 15 percent of the population. (In district states, the proportion of uninsured ranged from 8.5 percent in Minnesota to 16 percent in Montana.)

Those figures don't count people with public health insurance, such as Medicaid or Medicare, who have difficulty getting treatment because of the federal government's relatively low reimbursement rates for those programs. And in some rural areas, even those with private insurance may not have easy access to health care, because of local shortages of primary care physicians and dentists. Berg and one other doctor at Valley Community are the only physicians practicing in the small towns of Northwood and Larimore, N.D.

It was this unmet need for basic health care that President George W. Bush addressed by pushing for a major expansion of community health centers, created in the 1960s to improve medical care in inner cities. During the Bush administration, Congress doubled federal funding for health centers to more than $2 billion a year, leading to a rapid increase in the number of clinics and patients served.

To qualify for grants from the Health Resources and Services Administration (HRSA), health centers must show that they're meeting an unsatisfied local need for primary care. They must also operate as nonprofits and accept all patients, charging on a sliding fee scale for those at or below 200 percent of federal poverty guidelines.

Nationally and in the district, the number of patients treated by CHCs has risen in tandem with revenue increases from HRSA dollars and Medicaid, which provides health care coverage for the poor. But district states differ in the degree to which these respective sources of funding have driven growth in health center capacity (see Charts 1 and 2).

Montana and the Dakotas have seen big increases in Section 330 grants in this decade, according to data tracked by HRSA's Bureau of Primary Health Care. In Montana, HRSA funding surged from $5 million in 2000 to about $15 million seven years later. During that time, the number of HRSA grantees in the state increased from seven to 15, and the number of patients seen annually more than doubled to almost 85,000 (see Chart 3).

New clinics such as the Flathead center were sorely needed even before the recession, noted Mary Beth Frideres, deputy director of the Montana Primary Care Association in Helena, an organization that promotes CHC development. The state has historically had a large proportion of low-income residents as well as a big helping of uninsured. The Census estimated in 2004 that over a third of Montanans had incomes under twice the federal poverty level, the target population for CHCs.

Said Frideres: "The people who don't have insurance, the people who make little money—they're the ones who are going to come to a place where they're not going to get a huge bill and be unable to pay it. That's what community health centers are about."

In 2000, North Dakota had just one health center, in Fargo; $17 million in grants since then has helped launch five CHC organizations and 47 clinics serving about 26,000 patients. However, between 2004 and 2008, inflation-adjusted HRSA funding in the state and in South Dakota declined because many communities have had trouble qualifying for new health centers and satellites in the face of fierce national competition for federal funding.

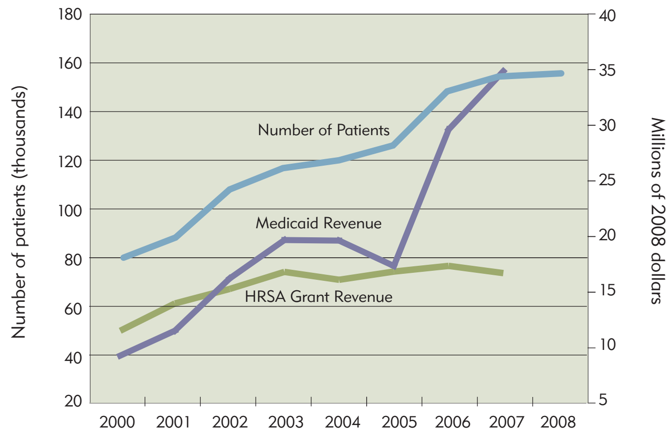
In Minnesota and Wisconsin, patient growth has had more to do with increasing Medicaid revenue at established centers than HRSA grants for new clinics. These states have gained proportionately fewer new delivery sites than Montana and the Dakotas because their demographics—relatively high incomes and

Continued on page 14

CHART 1

Medicaid funding drives patient growth in Minnesota ...

Minnesota community health center patients and funding sources*



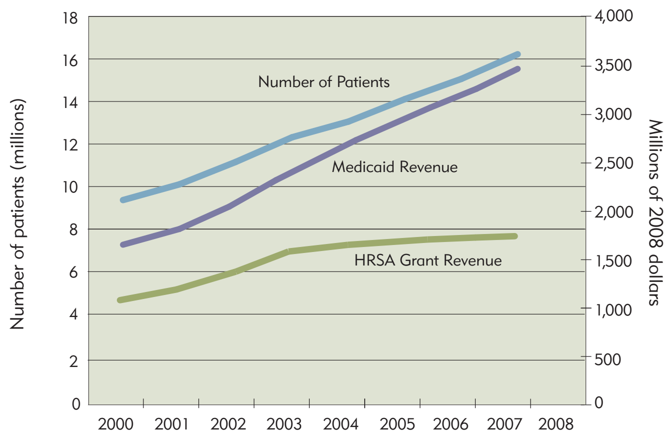
*Not including patients of one CHC in the state that treats the uninsured and receives enhanced reimbursement for public health insurance, but doesn't get HRSA grants.

Source: U.S. Department of Health and Human Services, Bureau of Primary Health Care, Uniform Data System reports

CHART 2

... and in the nation

U.S. community health center patients and funding sources*



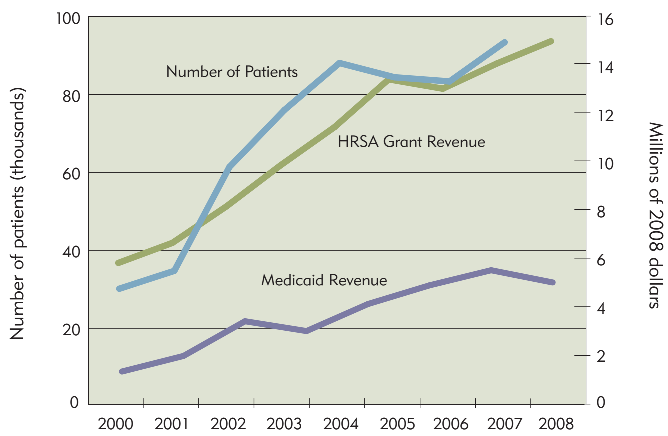
*Not including patients of CHCs that treat the uninsured and receive enhanced reimbursement for public health insurance, but don't get HRSA grants. There are about 100 such "FQHC look-alikes" nationwide.

Source: U.S. Department of Health and Human Services, Bureau of Primary Health Care, Uniform Data System reports

CHART 3

In Montana, HRSA grants drive patient growth

Montana community health center patients and funding sources*



*Not including patients of one CHC in the state that treats the uninsured and receives enhanced reimbursement for public health insurance, but doesn't get HRSA grants.

Source: U.S. Department of Health and Human Services, Bureau of Primary Health Care, Uniform Data System reports

Health Centers from page 13

rates of insurance coverage—handicap communities in the national competition for startup grants. Since 2000, Wisconsin has gained only three HRSA grantees, for a total of 16.

But CHCs in Minnesota and Wisconsin have drawn large numbers of low-income patients enrolled in Medicaid and state health insurance programs. Health centers are disposed to accept patients enrolled in these public plans because the government—recognizing the financial strains under which CHCs operate—reimburses them for treatment at a higher rate than private clinics and physicians receive. (Medicare services for seniors and the disabled are also reimbursed at a higher rate.)

Relatively high income ceilings for Medicaid coverage in Minnesota and Wisconsin make it easier for residents to qualify for the federal/state program—avoiding paying for care out of their own pockets—than those of other states with stricter requirements. In Minnesota, CHC patient revenue from Medicaid has increased at a much faster pace than HRSA grant funding. Between 2000 and 2007, Section 330 funding increased 46 percent, adjusted for inflation. During the same period, Medicaid funding almost quadrupled in real dollars.

In addition, expanded eligibility in the past five years for state health insurance programs—MinnesotaCare in Minnesota, BadgerCare in Wisconsin—has encouraged more low-income adults to get treatment at CHCs.

Health centers have attracted billions of dollars in government funding over the years because they're widely viewed as effective health care providers that save the health care system billions more in the long run.

Just the basics, doc

Health centers have attracted billions of dollars in government funding over the years because they're widely viewed as effective health care providers that save the health care system billions more in the long run. The National Association of Community Health Centers and other proponents claim that CHCs more than recoup their operating costs by efficiently delivering primary care to people who would otherwise do without.

Certainly the health center model seems promising as a way to reduce overall health care expenditures. A number of studies have shown that health centers provide primary care that is typically as good and in some cases superior to that provided by private doctors' offices and clinics. Little reliable data exist on comparative costs of care—whether CHCs achieve the same health outcomes for less money than private primary providers. But efficiency is inherent in the health center model, which emphasizes basic care by salaried doctors and nurses who often collaborate on diagnosis and treatment.

Typically, private practitioners earn fees for each service performed—an MRI, a hip replacement, a root canal. This fee-for-service system fosters a powerful incentive for medical providers to perform more treatments and tests—a major driver of escalating health care costs. "You get what you pay for," said Berg of Valley Community Health Centers. "If you're paying for more tests and procedures, that's what you'll get."

Putting health center providers on salary eliminates this incentive. At Valley Community, doctors earn productivity incentives, but the extra pay—up to 5 percent of annual salary—is for seeing more patients, not carrying out more procedures, Berg said.

Ironclad protection against litigious patients also reduces the urge for doctors to order tests of questionable value, just in case. Health center staff enjoy the same immunity from malpractice lawsuits as federal employees; the U.S. government acts as their primary insurer. Liability protection also saves CHCs millions of dollars a year in private insurance premiums. (The downside of such protection is that it may result in less than the optimum amount of testing, harming patients and increasing legal costs.)

Advocates of health centers say that they achieve their greatest health care cost savings by treating the medical problems of underserved populations before they become more serious—and expensive. It's well established that timely preventive care reduces costly trips to hospitals and emergency rooms (the costliest form of care in the health system) by patients suffering from chronic maladies such as heart disease, diabetes and asthma. In the case of low-income or geographically isolated patients, CHCs often provide the only means of such vital intervention, said Dr. Ann O'Malley, a senior health researcher at the Center for Studying Health System Change, a health care think tank based in Washington, D.C.

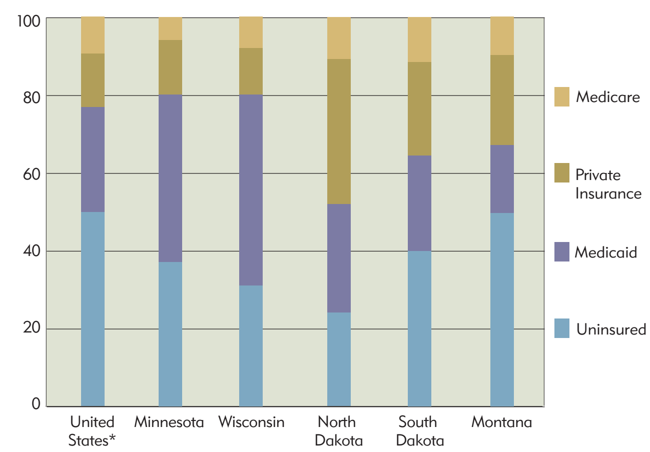
"Community health centers are very good at providing access to patients, and we know that good access to primary care helps avoid certain types of hospitalizations for certain types of conditions," she said.

However, empirical studies that purport to show the salutary influence of health centers on "downstream" illness and medical costs are tricky to interpret. For example, in studies that found that health center patients incur lower total health care costs (including treatment at hospitals and drug prescriptions) than non-CHC users, it's unclear whether the savings are due to better preventive care or simply more limited care.

The national recession has further strained the resources of CHCs. A number of health centers in the district have reported increased traffic over the past year as people who were once covered by employer-sponsored health insurance search for other medical options.

CHART 4 **Health coverage of CHC patients varies by state**

Percent of total community health center patients, 2008



* 2007 data

Source: U.S. Department of Health and Human Services, Bureau of Primary Health Care, Uniform Data System reports

A forthcoming research brief by the Robert Graham Center, a primary care research group affiliated with the American Academy of Family Physicians, found that average annual medical spending for patients who rely on CHCs for most of their care was 12 percent lower than for people who are seen mostly by private primary care doctors. But there's a crucial difference between the two patient groups: If you're a CHC patient with no private insurance, you're going to have a hard time getting referred to a specialist outside the clinic for a complex or life-threatening condition.

If health center patients had equal access to the expensive services of surgeons, cardiologists and other specialists, their total medical costs could equal or exceed those of the private primary care patients.

Also, comparative cost studies don't capture the full costs of health center care, which include HRSA grants to pay for treatment of the uninsured and malpractice jury awards or settlements paid by federal taxpayers on behalf of CHC practitioners. The real cost to society of health center care may be higher—or lower—than estimates based on average household medical expenditures.

Carry that weight

Health centers' mandate to treat all patients is a heavy burden, because revenues often fail to cover the cost of caring for the uninsured. A large proportion of CHC patients have no health coverage of any kind, public or private. In Minnesota, 37 percent of health center patients had no health insurance last year, according to HRSA data. In Montana, more than half of CHC patients had no coverage in 2008 (see Chart 4). Those figures are even higher at clinics in low-income urban neighborhoods or on American Indian reservations.

Some CHC patients have private insurance, but it affords little protection against sickness and mishap. In North Dakota, for example, many farmers and small-business owners carry insurance deductibles of $5,000 or more, said Scot Graff, CEO of the Community Health Care Association of the Dakotas. "It's not health insurance; it's catastrophic, save-the-farm insurance," he said. "Functionally, they're uninsured for primary care."

Federal grants are supposed to cover the cost of treating the uninsured, but a clinic's Section 330 funding doesn't necessarily increase when more uninsured patients come in the door. Funds to expand service capacity at existing health centers are hard to come by.

In Minnesota, the costs of treating

uninsured patients have outstripped increases in HRSA funding for years, according to data compiled by the Minnesota Association of Community Health Centers. Last year CHCs in the state spent $32 million caring for the uninsured, but received only $17 million in HRSA grants. Sliding scale fees don't make up the difference; the portion of costs covered by patient fees has dropped by half since 2001.

Patients covered by comprehensive private insurance subsidize the uninsured—a practice called cost shifting. But the chunk of CHC patients with private insurance is fairly small—about 22 percent in Montana, 13 percent in Wisconsin. And patients with solid health plans are even scarcer at clinics serving large numbers of poor or minority patients. West Side Community Health Services, a CHC with 18 sites in Minnesota, was forced to close a clinic in south Minneapolis three years ago when the number of uninsured patients became overwhelming. "We can sustain a significant percentage of uninsured, but that's not unlimited," said Terry Hart, interim executive director of the health center.

To fill budget gaps, CHCs depend on state and local government grants, and charitable contributions from foundations and corporations. Health centers throughout the district have benefited from nonfederal support, but such funding varies from state to state. For example, Minnesota CHCs received $18 million in state and local government funding in 2007—slightly more than they received in HRSA grants. In contrast, CHCs in North Dakota gleaned only $25,000 from that source—a tiny fraction of over $3 million in Section 330 funding received that year.

The national recession has further strained the resources of CHCs. A number of health centers in the district have reported increased traffic over the past year as people who were once covered by employer-sponsored health insurance search for other medical options. "There's a lot of pressure being put on all parts of the health care system right now," said Stephanie Harrison, executive director of the Wisconsin Primary Health Care Association. "You see people who are using [hospital] emergency departments, you see people who are using health centers more vigorously, and a lot of that is because these folks have lost their jobs."

Harrison—and several other sources at CHC organizations—said that demand is especially high for dental services, because many low-income people lack dental insurance and few private dentists accept Medicaid or state insurance plans. Moreover, dentists are thin on the ground in rural areas of the district such as northwestern Wisconsin, the Upper Peninsula and eastern Montana.

Earlier this year, besieged health centers got some relief from economic stimulus funding. The American Recovery and Reinvestment Act (ARRA) authorized $2 billion to pay not only for new health centers but also for expanded services and facility upgrades at existing clinics. In addition to a long-sought $1.3 million grant to cover uninsured patients, the Flathead CHC received $241,000 in capital improvement funding. Doely said that the clinic plans to spend the money on medical and dental equipment, an electronic records system and upgrades to phone systems, signage and building security.

Horizon Health Care, a CHC serving 10 small communities spread across South Dakota, was awarded $1.1 million in ARRA funding to buy new X-ray equipment, expand its telemedicine capability and hire extra staff, including a full-time family nurse practitioner.

Rx for rising costs?

Another wave of health center expansion may sweep across the nation and the district under enacted or proposed federal legislation. In reauthorizing the CHC program last year, Congress called for a 60 percent increase in funding through 2012. And this fall, amid a vigorous debate over revamping the health care system, lawmakers envisioned a greater role for health centers. An early version of one House bill would create dedicated funding for CHCs and boost nationwide HRSA funding to more than $8 billion annually over the next 10 years.

Other proposals being considered as part of health care reform would expand Medicaid eligibility and subsidize the cost of private insurance, encouraging more low-income people to come into health centers (or seek care at private doctors' offices and clinics).

Health center advocates in the district are optimistic that the political winds are blowing in their direction. "The community health care model is cost-effective, quality primary care," said Frideres of the Montana Primary Care Association. "You can't beat it. So I think there's going to be even more need for community health centers." Graff speculated that increased funding for CHCs might help mid-sized cities in the Dakotas such as Minot and Aberdeen secure HRSA grants to open health centers.

But prospects for more health centers and satellites depend on appropriations from Congress to fund CHC initiatives, and at the moment money is tight in Washington. For the 2010 fiscal year, the Obama administration has proposed no funding increases for health centers.

Supporters of health centers as part of the solution to rising health care costs point to estimates of how much money would be saved under proposed health care legislation. A recent study by researchers at The George Washington University calculated that under one health care reform scenario, doubling CHC capacity would save the U.S. health care system $37 billion annually by 2019.

That impressive figure is questionable, because it uses the same methodology as the Robert Graham Center study, extrapolating from average figures on lower total cost of care for CHC patients. If health care system legislation extended private health insurance coverage to low-income health center patients, they might use more specialist care, raising the treatment costs of CHC users.

But the study's conclusion that investing in community health centers can "bend the curve" of future health expenditures raises the question of how much money might be saved if more people—those with well-paying jobs and private insurance in addition to the medically underserved—went to CHCs for their basic medical needs.

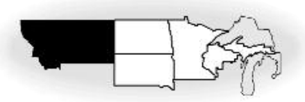
Broadening the health center model to cover the general population appears unlikely in the near term. Current and proposed health center legislation focuses on catching people who slip through the cracks of the health care system, not extending public medicine to the middle class. But it might make sense to take certain elements of the CHC approach, such as salaried doctors and collaborative care, and apply them to other health care settings.

"There are certainly lessons that the rest of the health care system can learn from community health centers in terms of their organization, their facility in dealing with a vulnerable, low-income population, their use of teams," said O'Malley of the Center for Studying Health System Change.

She noted that some private health organizations such as Mayo Clinic in Rochester, Minn., and Kaiser Permanente, a managed care organization in California, already employ salaried physicians and take a team approach to diagnosis and treatment. Not coincidentally, these institutions are also leaders in keeping a lid on health costs; Mayo's Medicare spending per patient is among the lowest in the country.

Community health centers use the term "medical home" to describe their hands-on, one-stop-shopping treatment model. Berg, an unabashed champion of CHCs, sees that approach as one way to maintain quality of care while curbing seemingly inexorable increases in health care costs. "The patient-centered medical home—that whole idea is the thrust we want to achieve, and it's an idea that would well play across the country," he said.

MONTANA



Rx for high drug costs?

Trying to rein in escalating costs in its employee health plan, state government has harnessed the power of prices to nudge beneficiaries toward the least costly drug for their ills. Under a new prescription drug plan, effective Jan. 1 for 32,000 people covered by state health insurance, drugs are "graded" according to their health benefits and cost effectiveness. Patients who choose expensive name-brand drugs that do the same thing as cheaper alternatives must contribute a co-pay. Those who order medications without "significant clinical value," such as the erectile-dysfunction drug Viagra, pay full price.

Since last year, prescription drug claims to the state's health plan have increased 30 percent, mostly due to higher drug prices. State health officials hope that the grading system, developed with input from large Montana self-insured employers such as First Interstate Bank and NorthWestern Energy, can reduce those costs. They estimate savings of $6.3 million in 2010, which are already reflected in next year's premiums.

The state University System, whose health plan covers 18,000 employees, is slated to start the drug program next July. Private employers who helped develop the plan had not yet decided whether to adopt it themselves.

Stalking the $2,000 wolf

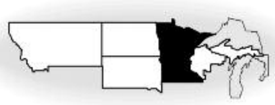
No matter how many wolves are killed during the state's inaugural hunt for the animals, the money is in the bag. During the first two weeks of September, hunters bought almost 8,800 licenses, generating $167,000 in revenue for Montana Fish, Wildlife and Parks.

The withdrawal of federal protection for wolves in Montana and Idaho earlier this year cleared the way for state-supervised hunts this fall. Montana's season began Sept. 15.

Wildlife officials may opt to spend the license money on wolf management, formerly the domain of the federal government. This year, the state will receive less money than last to manage wolves under federal contract, and a further drop is expected in 2010. Researching and monitoring wolves is an expensive business in the northern Rockies, where wolves were reintroduced in the mid-1990s. Last year, the U.S. Fish and Wildlife Service spent about $3.4 million on wolf management in the region. That works out to more than $2,000 per wolf.

—Phil Davies

MINNESOTA



Silicon Elk's Club

Give me a biosciences home, where the elk roam.

That very plan is on the drawing board near Pine Island, where Silicon Valley venture capitalist Peter Bianco has promised to raise up to $1 billion to convert an elk farm into a biosciences incubator. The location is about an hour south of the Twin Cities and just north of Rochester, and the effort expects to leverage proximity to major health care and medical device firms and significant research already taking place at the Mayo Clinic and University of Minnesota.

The development is targeted for a 2,300-acre site, where the master plan envisions a mix of biotechnology businesses, commercial and office space, and residential development. Work is already being done; in September, the city approved plans for the first phase of the park. The state has pledged $15 million for site improvement.

In an ironic twist—for both the eventual development of the site and its intention as a biosciences research hub—elk on the farm were found to have chronic wasting disease earlier this year, and federal sharpshooters had to eliminate the entire herd of about 700 in September.

A job, any job

Despite the fact that Minnesota's unemployment rate fell in both July and August, the state's job market is back on its heels. In July, the state saw its first increase in jobs in some time. Though unemployment dropped again in August (by one-tenth of a percentage point), the decrease was a result of 6,200 individuals dropping out of the labor force and no longer being counted.

A September state report showed about 31,000 job vacancies in the second quarter of this year—40 percent lower than the level a year ago. That might still sound like a lot, but it means that there are just 1.2 job openings for every 100 filled jobs; there are also some 250,000 jobless workers fighting for those openings—or about 8 workers for every spot.

The state got some decent news about its manufacturing sector. A monthly report of supply managers by Creighton University showed Minnesota's index was above 50 (a signal of growth) for both August and September.

—Ronald A. Wirtz

Patch job: Repairing the unemployment safety net

State unemployment insurance funds are facing big challenges that could have long-term consequences for employers and workers

By MIKE MEYERS
Contributing Writer

In the next couple of years, the longest, deepest slide in the job market in a generation will force states to borrow billions of dollars across much of the Ninth Federal Reserve District.

The scramble for more money is the latest chapter in the employment compact between states and workers that dates to the Great Depression. When workers lose their jobs through no fault of their own, employer-financed unemployment insurance (UI) helps pay the bills during the search for work.

But as the ranks of the jobless—and the time spent looking for work—have swelled, the funds that pay UI benefits are scraping bottom in many states, including those in the Ninth District. When this happens, states must borrow from the federal government to keep paying benefits—Minnesota and South Dakota have already done so, and Wisconsin is not far behind. As part of the deal, states are required to offer more generous benefits—a politically popular move with financial consequences that states have only begun to tally.

Replenishing depleted UI trust funds and repaying loans from the federal government will take years. The problem will threaten to push state legislatures to raise UI premiums for employers, reduce jobless benefits or both. Either way, the moves will have real, if hard-to-measure, consequences for job growth and incomes in the region.

Check, please

UI benefits routinely extend for only 26 weeks, on the theory that six months is plenty of time for a displaced worker to seek and find a new job. But this recession has challenged both workers and the UI programs designed to help them through a rough spot. Jobless claims are much higher, workers are staying on UI much longer and UI funds are getting depleted (more on each of these trends in a bit).

So earlier this year, as part of the Obama administration's economic stimulus plan, Congress approved extensions and supplemental benefits that required states to make more of the jobless eligible for UI, and for a longer period.

For instance, Minnesota in the spring received $130 million in federal dollars to boost the state's UI fund. Meanwhile, federal emergency unemployment compensation benefits are set to provide an additional $390 million in benefits in Minnesota through the end of the year—a cost being picked up by the federal government via the stimulus bill. State and federal governments have split the tab in the past.

With added federal dollars, states can pay up to 79 weeks of unemployment checks. In addition, Congress has provided a federal supplement of $25 per claim per week to state UI programs.

The millions and billions in jobless benefits, paid out by states small and large, absorb shocks that would make an economic reversal all the more painful in their absence. "People take those benefits and put them right back into the economy. Normally, the money is spent on food, shelter and the mortgage," said Roy Mulvaney, Montana's UI administrator. "Those benefits are helping sustain a lot of the businesses that are out there."

Under the UI hood

State UI funds are financed by employer-paid taxes. Each state is free to set the UI tax rate and how much of an employee's pay is subject to the tax.

In 2009, Minnesota employers subject to the UI tax pay on gross wages up to $26,000. The rates vary, based on whether employers have a history of layoffs. A new employer, in an industry where job cuts are rare, pays a tax of about 2.3 percent on the taxable wage base. In Wisconsin, only the first $12,000 is subject to IU taxes, which top out at 3.4 percent for new employers.

Rates for more established employers can go much higher—up to 9.3 percent in Minnesota. But these rates are harder to compare because layoff histories play a different role in determining rates in each state.

Disparities among states also exist for UI benefits. In Minnesota, standard weekly UI benefits are capped at $566—

about $200 more than in Wisconsin. Only about one in eight workers in Minnesota qualifies for the top benefit, which is based on pay and work history. Still, it was enough to pull the average weekly UI benefit in Minnesota last July to $363—27 percent higher than in Wisconsin.

With this UI architecture of costs and benefits in place, rumbles in the labor market have shaken UI funds across the Ninth District.

At the close of November 2007, the last month before the start of the current recession, Minnesota paid 38,465 continuing claims, a figure that rose to more than 131,000 by April 2009 (see Chart 1). By early August, it had come down to about 98,000. South Dakota claims and their benefits reached "unprecedented" levels, according to Don Kattke, director of South Dakota's UI division. Claims were just 1,400 in November 2007, but spiked to more than 8,000 last April before pulling back to about 5,400 by early August.

Compounding the problem for UI funds is that the jobless are receiving UI benefits for longer periods. So far this year, the average duration of unemployment in Minnesota swelled to near 22 weeks, up from 18 weeks last year and 14 weeks in 2007.

More are also breaching the previous UI benefits standard of 26 weeks. At the end of July, more than 13,300 Minnesotans had done so—a huge increase from the 5,200 in July of last year. So-called final payments more than tripled in Wisconsin, North Dakota and Montana from July 2008 to July 2009. Among district states, only in Michigan, where final claims for standard benefits have remained elevated for years—a measure of the state's persistent high unemployment rate—did final claims drop slightly over the same period.

Breaking the piggy bank

Although continuing claims have moderated of late, the elevated number of jobless claims and elongated duration of claims means UI funds in many states are hitting bottom, or will be soon, because states are paying out far more in claims than they are taking in from UI premiums.

In July, for example, the Minnesota UI fund paid out more than $1.3 billion in benefits, but took in $900 million in deposits. Wisconsin's UI fund is unraveling even more quickly. It paid nearly $1.7 million in UI benefits in July, more than double the $733,000 in deposits, as the state has been battered particularly hard by the current recession. Initial UI claims this year through the end of August came to 773,000—far higher than the 317,000 in Minnesota during the same period (see Chart 2).

Why would Wisconsin, a state with about the same population as Minnesota, record towering UI claims? Officials in both states pointed to industry mix (e.g., more manufacturing in Wisconsin) and higher claims in hard-hit industries (like manufacturing), along with a higher propensity in Wisconsin for filing UI claims, which is partly due to broader eligibility for initial claims there.

The good news for UI programs is that continuing claims are declining. In July, Minnesota's unemployment rate declined to 8.1 percent, after the state added 10,300 jobs. But this was the first job gain in 11 months, while the number of continuing claims peaked several months earlier. So it's unclear whether the easing of claims is the result of the jobless exhausting benefits or finding enough work to no longer qualify for checks. Complicating matters is the fact that forecasters—including those at the Federal Reserve Bank of Minneapolis—are expecting slow job growth into 2010, so UI rolls are unlikely to decline quickly, especially given newly extended benefits.

In the short run, UI payments counterbalance some of the financial travails of layoffs numbering in the millions nationwide and the hundreds of thousands across the Ninth District. That's doing the job Congress intended when jobless insurance programs were introduced three quarters of a century ago.

But burdens on UI coffers are likely to continue across the district, and despite the stimulus money, many states have to borrow additional funds from the federal government to continue paying claims. For the first time ever, South Dakota expects to borrow $6.7 million from the federal government this year, and $91 million next year, to pay jobless claims, according to Kattke.

Wisconsin expects to take out $1 billion in federal fund loans to make up for 2009 state UI fund deficits (see Chart 3). More likely will be needed next year, although Wisconsin officials haven't yet offered estimates. In the aftermath of the 2001 recession, Wisconsin avoided federal borrowing to keep its UI fund solvent.

Minnesota projects the state's current UI shortfall will require $1.8 billion in federal borrowing—a debt that could take years to repay.

Only North Dakota and Montana expect to avoid borrowing to pay unemployment benefits this year and next. North Dakota can thank oil and gas drilling, in part, for avoiding the fate of many of its neighbors. Montana, without a big share of jobs in manufacturing and construction—two industries hard hit in the downturn—also expects to emerge with its UI fund intact (see Chart 4).

"These last few years, we've had record-low benefit payments," said Darren Brostrom director of North Dakota's UI Job Service. "The (slumping) economy hit us when we were in a very good position. … We had enough money to weather any additional benefits that we had to pay."

Free kitten, anyone?

Going forward, states are faced with the prospect of replenishing their own UI funds while repaying federal loans. For some, this will not be daunting. By the second half of next year, South Dakota UI officials expect to pay off

Continued on page 18

CHART 1

A steeper UI roller coaster

Continued unemployment insurance claims

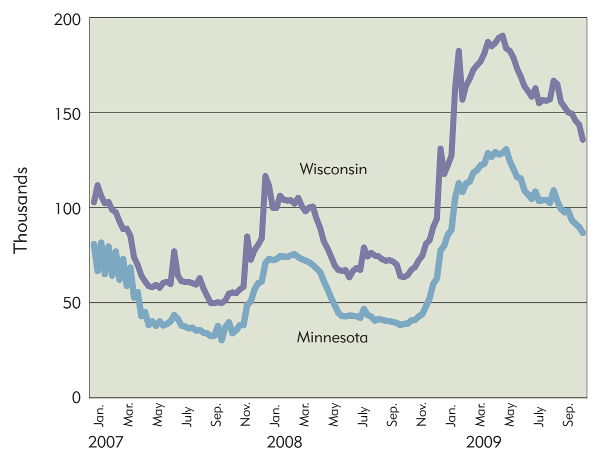
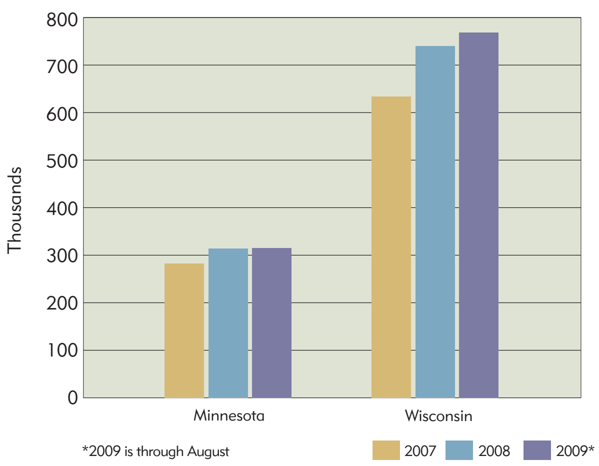


CHART 2

2009 claims a record

Initial unemployment insurance claims

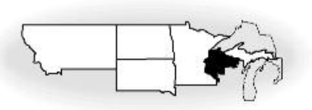


*2009 is through August

2007 2008 2009*

Source: Employment and Training Administration, U.S. Department of Labor

WISCONSIN



Newest big export: Pain

Wisconsin's economy is taking it on the chin from virtually all directions. Late September figures from the U.S. Census Bureau showed that international buyers are piling on—or off, as it were—as exports for the first half of the year were down by almost 22 percent over the same period a year earlier. Exports nationwide dropped by 24 percent.

The state's largest export sector is industrial machinery—ranging from mining shovels to armored vehicles—which dropped by 24 percent, but virtually no sector was untouched. In terms of the state's largest export markets, most destinations save for China saw significant declines.

Before the dip, Wisconsin exports had been on a tear. Exports dipped in the final quarter of 2008, but still managed a full-year record, topping $20 billion, roughly double 2003 levels.

A sick program

Wisconsin is getting a firsthand lesson on the controversies of health care policy. The U.S. Census Bureau showed that the state has one of the lowest rates of uninsured people in the country, at 9 percent. Part of the reason is that the state has one of the broadest public health programs for poor people, called BadgerCare Plus, which recently expanded eligibility for some poor families without children.

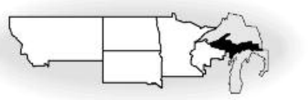
The new program saw a deluge of applicants—37,000 just from its start-up in mid-June to early August, according to local news reports. Applications are processed by private firms via state contract, and the program developed such a large backlog of applicants that the state suspended new applications in early October. The backlog also pushed the state to announce this fall that it would require—for the first time—competitive bids from firms administering BadgerCare.

Officials are hoping this and other measures might save the program $600 million over two years, or 5 percent of program expenditures.

Physicians apparently are not crazy about the state-level program, at least indirectly. A survey of in-state doctors last summer found that 54 percent supported national health insurance. Support was even higher—at 67 percent—among primary physicians, who have much more contact with public health care programs than heath care specialists.

—Ronald A. Wirtz

UPPER PENINSULA



Swap meet: Sheepskin for a building

A unique scholarship opportunity has been developed at an Upper Peninsula school, thanks to a real estate deal.

Finlandia University, located on the northern tip of the U.P. in Hancock, was reportedly looking for land or facilities to expand. At the same time, the local school district had excess facilities.

Administrators for the university and school district then developed a win-win proposal: The school district handed over a classroom facility that was no longer needed, as well as an athletic field, and the university agreed to admit any qualified graduate of the local high school, for at least the next 12 years, for free.

The university, founded in 1896 by Finnish immigrants during the copper boom in the region, is raising money to rehab the building in an effort to expand enrollment in health sciences and athletic programs. Local students who benefit from the deal will be required to donate any federal and state grant money they receive in financial aid, according to local news reports.

Clean up your mess … later

A considerable amount of attention is being paid to the environmental health of the Great Lakes. Action, on the other hand, appears to be in shorter supply.

A September progress report on cleanup of 43 "areas of concern" throughout the Great Lakes found that work was moving so slowly that completion would take 77 years.

Most of the AOC sites in the so-called Great Lakes Binational Toxic Strategy were identified in the 1980s. Four of the sites are in the Upper Peninsula, and several others are near its Wisconsin, Minnesota and Canadian borders. Among them is Torch Lake, on the northern tip of the U.P., which made the list in 1987 after fish with tumors of unknown origin were discovered. Also on the list is Deer Lake/Carp River, near Marquette, where concentrations of mercury were found in 1981, leading to a state ban on fish consumption.

To date, only three sites—two in Canada and one in the United States—have been fully remediated and taken off the list.

—Ronald A. Wirtz

UI from page 17

nearly $16 million in federal liabilities.

States like Minnesota and Wisconsin won't be as fortunate. In the aftermath of the 2001 recession, Minnesota borrowed more than $400 million to keep the state UI fund solvent. Repayment of federal loans stretched into 2005.

"If it took two or three years last time, I presume it will take far longer this time," said John Berglund, Minnesota's UI financing specialist.

Lee Nelson, chief attorney for the Minnesota Department of Employment and Economic Development (DEED), said projections made last spring soon will be revised, probably upward. But as of the end of August, he said the agency UI fund projections were daunting: "We're going to be carrying a $1 billion deficit balance for at least three years."

Exactly how federal loans will be repaid remains an open question in Minnesota and Wisconsin. Minnesota officials so far have identified no fewer than 17 strategies for raising revenues without changing the fundamentals of the UI system.

Businesses feel the UI pain

Almost regardless of how states choose to deal with these fiscal issues, the breaking of UI piggy banks, federal borrowing and changes to UI benefits as a condition of federal help will have a lingering effect on businesses and their hiring decisions for some time.

UI tax rates, for example, are likely headed north, particularly for those that have laid off workers, thanks to the way UI rates are set in many states: The companies that shed the most workers in hard times pay higher premiums in good times—what's known in the industry as the experience rating. For example, since the tapped-out Minnesota UI fund soon will be supplemented by big federal loans, employers across the state will see higher premiums in the years ahead even if their payrolls remain stable. But the use of experience ratings means that UI tax rates and resulting premiums will be higher still—possibly significantly—for companies that have shed workers.

As a solution to refilling UI coffers and repaying federal loans, states are also considering changes to existing formulas that dictate how much employers pay in UI premiums. For example, the experience rating might be widened or otherwise changed to alter how employers share UI costs.

Another option is to lift the ceiling on the amount of pay subject to taxation. Minnesota taxes only the first $26,000. Wisconsin taxes the first $12,000; Michigan, $9,000; North Dakota, $23,700; South Dakota, $9,500 and Montana, $25,100.

Or states can do as South Dakota did earlier this year to quickly address its UI underfunding: It imposed a special assessment of $150 per employee to shore up the state's UI fund. The special charge, amounting to $36 million, was added to the $26 million South Dakota also expects to collect in routine employer payments this year.

Yet another maneuver, likely to be popular in an election year, would be to let the federal government raise its UI levy temporarily to help states repay their loans. Currently, if a state is slow in repaying a UI trust fund debt, the federal government temporarily can add to the annual $56 levy per employee that firms pay when a state trust fund is in the black.

What role higher premiums will play in future hiring decisions is tough to predict. Higher employment costs would suggest reduced hiring, but not right away, because higher rates are phased in. Minnesota's premium formula takes into account four years of payroll history. Layoffs in 2009 won't be reflected in premiums until 2012 or later.

Another outcome of higher UI premiums, particularly in a slack job market, would be a dampening effect on wages, as employers merely pass the cost of higher UI premiums along to workers in the form of lower wages. "It might not be dampening hiring if we assumed all of the costs are not imposed on employers," said John Budd, a professor of human resources at the University of Minnesota's Carlson School of Management. "Essentially, workers are bearing the cost of their own insurance."

To a large Minnesota company paying wages far above the $26,000 taxable wage base, a premium increase of several hundred dollars probably won't be a key element in choosing whether to add workers. For an employer with lower-paid workers in seasonal industries, from landscaping to construction, the cost could be more noteworthy, however.

"Is [a UI premium increase] the straw that breaks the camel's back? The answer almost always is no," Berglund said. "Our impact on corporate taxes is not significant."

Although the current recession is no run-of-the-mill downturn, past increases in UI premiums have not wrecked post-recession job recoveries. For example, after the recessions of the early 1980s, with job losses comparable to the latest downturn, Minnesota and other states shored up their UI funds with a host of changes. In the end, employers wound up paying more to guard against future shortfalls, and Minnesota nonetheless outperformed the nation in job growth over the next two decades.

But how businesses react this time around is anyone's guess. Ultimately, it will depend on how long the downturn lasts, and the strength of any ensuing recovery. The outlook keeps changing, almost week to week.

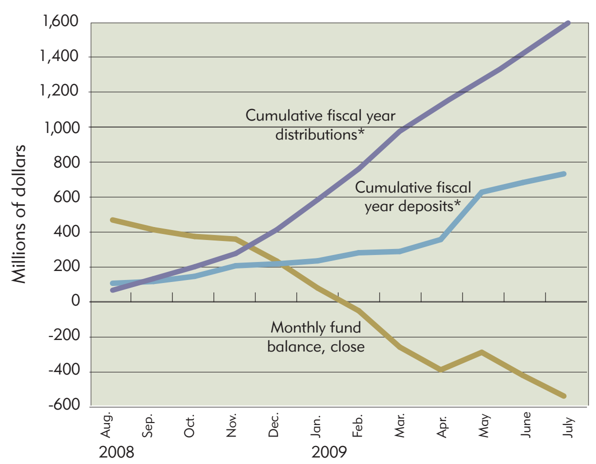
In mid-August, Minnesota estimated that the state's UI fund shortfall would peak at $2 billion. But by the end of the month, a sunnier economic job market prediction by the forecasting firm Global Insight prodded DEED to lower its expected peak debt to $1.8 billion.

"Let's hope the next recession is far, far away," said Nelson, at DEED. ■

CHART 3

The path to insolvency

Wisconsin's unemployment insurance fund



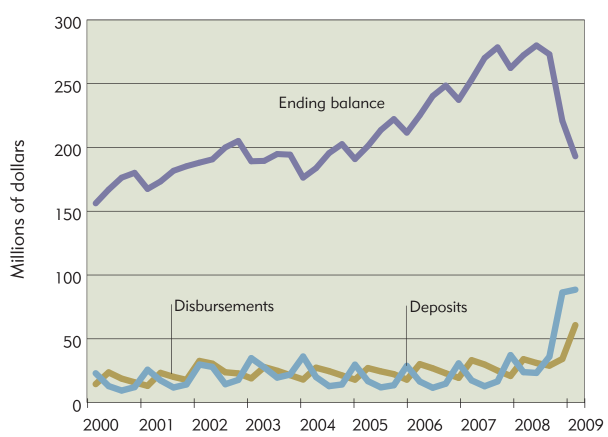
* Excludes transfers

Source: Wisconsin Department of Workforce Development

CHART 4

Montana's UI fund dropping, but healthier

Montana's unemployment insurance fund



Source: Unemployment Insurance Division, Montana Department of Labor and Industry

Per capita income picks up in western district states

By WONHO CHUNG
Research Assistant

ROB GRUNEWALD
Associate Economist

After spending years toward the bottom of state per capita personal income rankings, Montana and the Dakotas are climbing the income ladder, thanks to strong economies.

In 1990, North Dakota and South Dakota ranked 39th and 38th, respectively; by 2008, they ranked 20th and 26th. Montana's ranking went from 47th in 1995 to 38th in 2008. At the same time, Minnesota's state ranking rose during the 1990s, but has held steady since 2000. Wisconsin's per capita income ranking dropped from 23rd in 1990 to 27th in 2008 (see chart).

While the economic downturn has affected Montana and the Dakotas, these states have weathered the recession relatively well compared with the nation. Minnesota and Wisconsin largely followed national trends during the economic downturn.

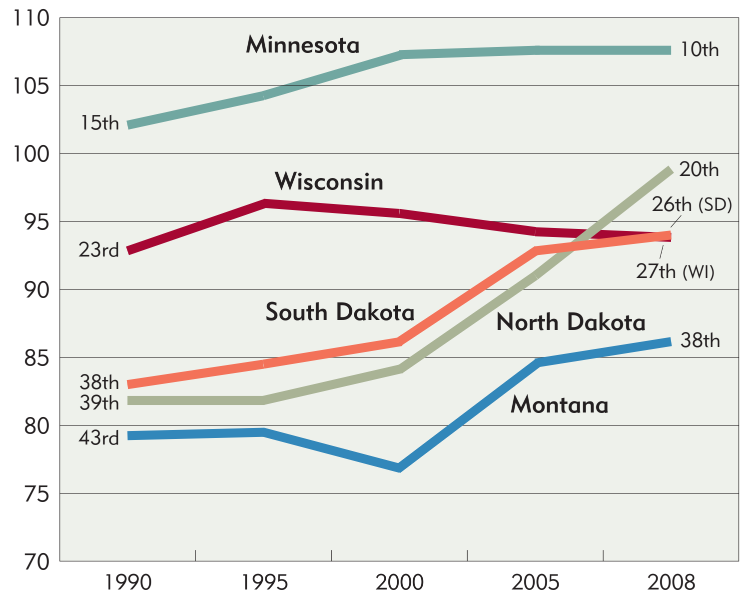
The superior performance in Montana and the Dakotas appears to be attributable to their heavier dependence on natural-resource-based industries in comparison with other states. Agriculture, mining, oil drilling and forest products have seen strong, if volatile, growth during this decade. Income from these sectors represented 13 percent of total state personal income in North Dakota, 6 percent in South Dakota and 4 percent in Montana in 2008, while representing only 2 percent nationally. As income from these sectors began to expand, so did per capita income.

Agricultural conditions were relatively robust during the past few years, which had an outsized effect on income in these three states. Adjusted for inflation, average national net farm income during the most recent five years (2004–2008) was $73.8 billion, much higher than the average of $54.6 billion for the previous 25 years (1979–2003). Meanwhile, oil production exploded in the Williston Basin, a vast area that straddles North Dakota and Montana. The number of drilling rigs in North Dakota increased from six in July 2000 to 13 in July 2008; Montana saw a jump from 14 rigs to 69. Oil prices soared from $30 to over $100 per barrel during the same period, which increased revenue dramatically.

Mining production also picked up as metal prices increased. Broad measures of metal prices about tripled between July 2003 and July 2006 and remained at high levels until the middle of 2008. While forest products industries showed strong growth during the first half of this decade, the sector has been a drag on natural resources since 2007, but not enough to counterbalance the success in other areas.

Income on the rise in Montana and the Dakotas

Per capita personal income as a percent of U.S. per capita personal income and state rank in 1990 and 2008



Source: Bureau of Economic Analysis

While per capita income has climbed out of the basement in Montana and the Dakotas, this is not the first time these states have claimed relatively high levels of per capita income. Back in 1950 when farm income was strong, Montana and North Dakota ranked 12th and 28th, respectively. If overall strength in agriculture, mining, oil drilling and forest products holds up during the post-recession recovery, these states' per capita income rankings could remain relatively higher. Yet most investors and workers in these industries know that history does have a way of repeating itself.

District Voices

What effect has the expiration of the federal C.A.R.S., or cash for clunkers, program had on your operations?

We're a pre-owned (vehicle) dealership. … We actually sold, I believe, in the last two or three months while cash for clunkers was going on, more cars than we would have sold without it. But as far as after the fact now that it's done, the faucet is shut off. … [T]hose people who were in the market or who may not have been in the market for maybe six or eight months ahead of time, that drew everybody out and about and the people who were going to buy cars in the next six months or a year just decided to do it then. So I don't know what that's going to entail for the next six months.

Casey Sol, Manager
Drive One Today—Eau Claire, Wis.

[A]t this point, we're pretty well established in the community. A lot of people know that Newgate uses (old) cars for training young adults who want to get into mechanics or auto body and provides (donated) cars to low-income single moms. … [S]o we didn't have the impact (on donated cars) because of our size that I know cash for clunkers had on smaller nonprofits. … I'm sure that we lost cars that didn't get donated because they were crushed instead.

Ron Severson, Executive Director
Newgate Education Center—
Minneapolis, Minn.

Well, according to the dealerships … September started off pretty slow for new cars. I don't know exactly how it's going to end, but according to everything I heard while I was out in the dealerships, new car sales were pretty light beginning of September. … August, of course, was excellent.

Teri Everson, Director of Field Services
South Dakota Automobile Dealers
Association—Sioux Falls, S.D.

[T]raditionally, we'll stock anywhere from 80 to 100 cars, and our inventory has been depleted to just a fraction of that. And to go out and replace the used cars right now, what it has done is driven the used car prices up so far that they're very close to a new car price. I think the fallout that we're seeing right now is just adjusting to the market conditions. We still have the same amount of people coming through the door. I don't think we sold ahead or anything like that. But fulfilling their needs with inventory is probably our biggest issue right now.

Terry Packer, Sales Manager
Halbinsel Volkswagen-Mazda-Suzuki-Isuzu—
Escanaba, Mich.

Our sales are back to … the April-May type sales we were having. June and July in the Dakotas are the best months to sell, so those numbers … were up. August numbers obviously were up, but our September sales numbers and early in October are much like our last spring sales numbers. [W]e're actually … very close to the numbers we want to hit, which is equivalent to last year, which was a tremendous sales year for us.

Justin Theel, Owner/General Manager
Cedric Theel Toyota Scion—Bismarck, N.D.

I think that car sales have slowed down. But I have no figures to back it up other than I know inventory is low. You can drive by any car lot and it's pretty bare. … I think those that were going to purchase at this time probably did it. If they had the type of trade that could be done, they probably did it during the cash for clunkers.

Marilyn Olsen, Executive Vice President
Montana Automobile Dealers Association—
Helena, Mont.

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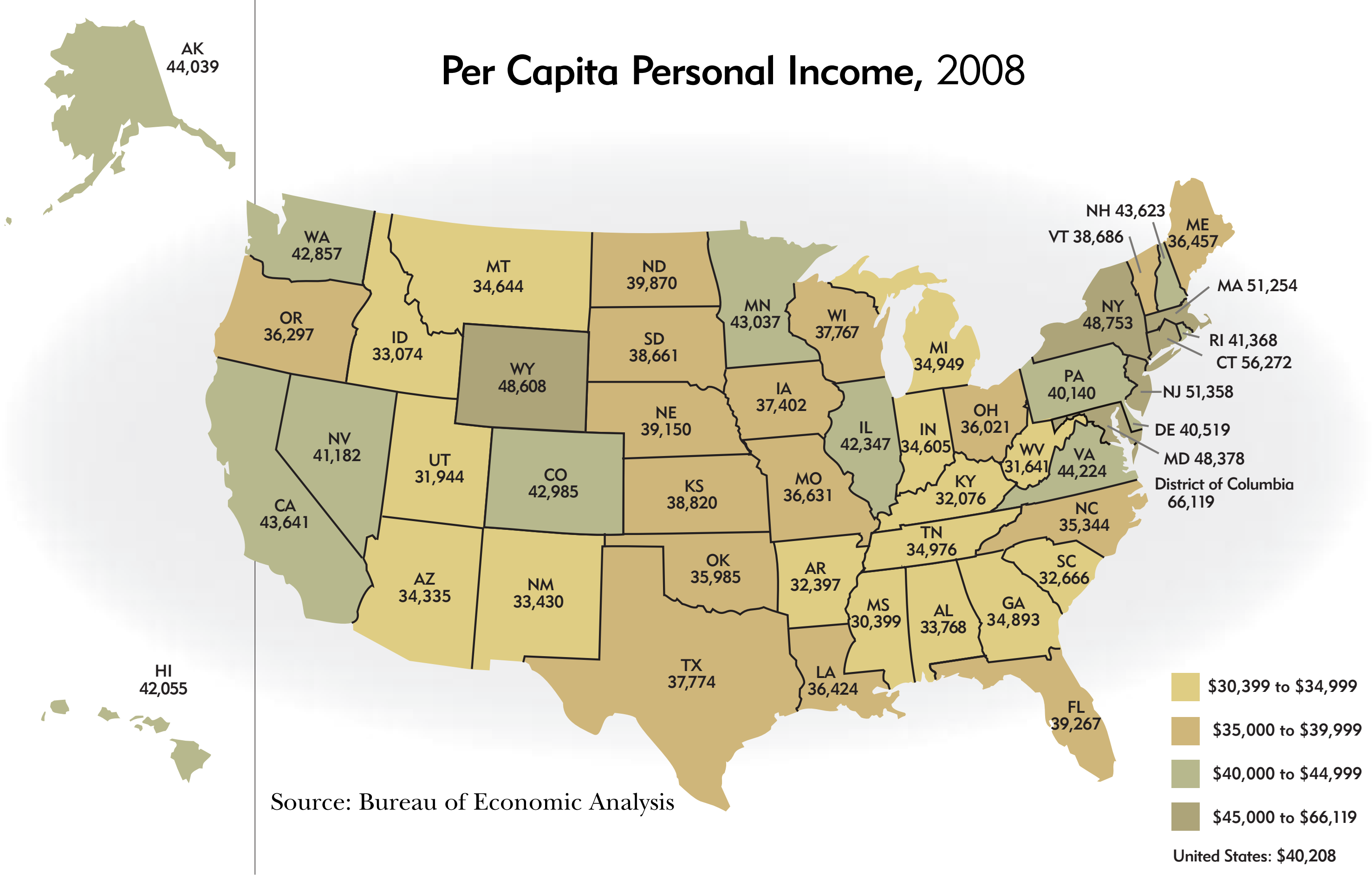
Per Capita Personal Income, 2008



Source: Bureau of Economic Analysis