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United States Government Accountability Office
Washington, DC 20548

January 26, 2009

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

Subject: *Update of State and Local Government Fiscal Pressures*

You asked us to provide information on (1) the fiscal pressures facing state and local governments and (2) principles to consider in determining how to effectively target and time temporary assistance to states, especially for Medicaid. This information is intended to inform ongoing congressional deliberations regarding fiscal relief to state and local governments as a component of an economic recovery initiative to respond to the current recession.

We have developed a model that enables us to simulate fiscal outcomes of the state and local sector in the aggregate for several decades into the future. The model is not designed to highlight the fiscal position of individual states. Rather, the model projects the level of aggregate receipts and expenditures of the state and local sector in future years based on current and historical spending and revenue patterns. We first published the findings from our state and local fiscal model in 2007.[1] A January 2008 report provided a detailed methodology for how we constructed the model.[2] For a November 19, 2008, Senate Committee on Finance hearing, we provided a statement which included updated model results based on August 2008 National Income and Product Account (NIPA) data from the Bureau of Economic Analysis.[3] The findings from the model discussed in this letter include data released in the Congressional Budget Office's (CBO) *Budget and Economic Outlook* on January 8, 2009.

State and Local Sector Faces Immediate and Long-term Fiscal Pressures Exacerbated by the Current Recession

Recent updates to the data in our model demonstrate that the long-term fiscal challenges faced by the state and local government sector are exacerbated by the current recession. The

[1]GAO, *State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade*, GAO-07-1080SP (Washington, D.C.: July 18, 2007).
[2]GAO, *State and Local Governments: Growing Fiscal Challenges Will Emerge during the Next 10 Years*, GAO-08-317 (Washington, D.C.: Jan. 22, 2008).
[3]GAO, *State and Local Fiscal Challenges: Rising Health Care Costs Drive Long-term and Immediate Pressures*, GAO-09-210T (Washington, D.C.: Nov. 19, 2008).

magnitude of these challenges affects all levels of government. State and local governments work in partnership with the federal government to implement numerous federal programs, many of which experience increased demand during a period of economic downturn.[4] However, it should be kept in mind that legislative action in order to provide temporary fiscal assistance to respond to the immediate pressures of the recession would also need to be considered within the context of the long-term fiscal outlook. Importantly, countercyclical federal assistance to address the current recession will not alleviate the long-term structural fiscal challenges facing state and local governments.

Our model includes a measure of fiscal balance for the state and local government sector for each year until 2057. The operating balance net of funds for capital expenditures is a measure of the ability of the sector to cover its *current* expenditures out of *current* receipts.[5] The operating balance measure has historically been positive most of the time, ranging from about zero to about 1 percent of gross domestic product (GDP). Thus, in the aggregate, the sector generally has been able to cover its current expenses with incoming receipts, although our model, in July 2007, initially suggested that the sector would face increasing fiscal stress in just a few years.[6] More recent simulations suggest that the onset of the sector's fiscal stress has accelerated.

Our incorporation of the January 2009 CBO projections shows an operating deficit for the sector. Specifically, the update to our model depicts reduced receipts because of lower GDP, as projected by CBO.[7] Our model simulates operating deficits of about $131 billion for 2009 and about $181 billion for 2010. The cumulative 2-year projected operating deficit totals approximately $312 billion. The current results represent a significant deterioration from our November 2008 update, as shown in figure 1. In November, our model depicted an operating deficit in the $100-$200 billion range, consistent with estimates reported by the National Conference of State Legislatures, the National Governors Association, the Urban Institute, and others. Our simulations show the operating balance remaining well below the historical range throughout the simulation time frame.[8]

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[4]For example, economic downturns result in rising unemployment, which can lead to increases in the number of individuals who are eligible for Medicaid coverage. During the economic downturn that occurred between 2001 and 2002, Medicaid enrollment rose 8.6 percent, an increase that was largely attributed to states' increases in unemployment. During this same time period, tax revenues fell 7.5 percent.

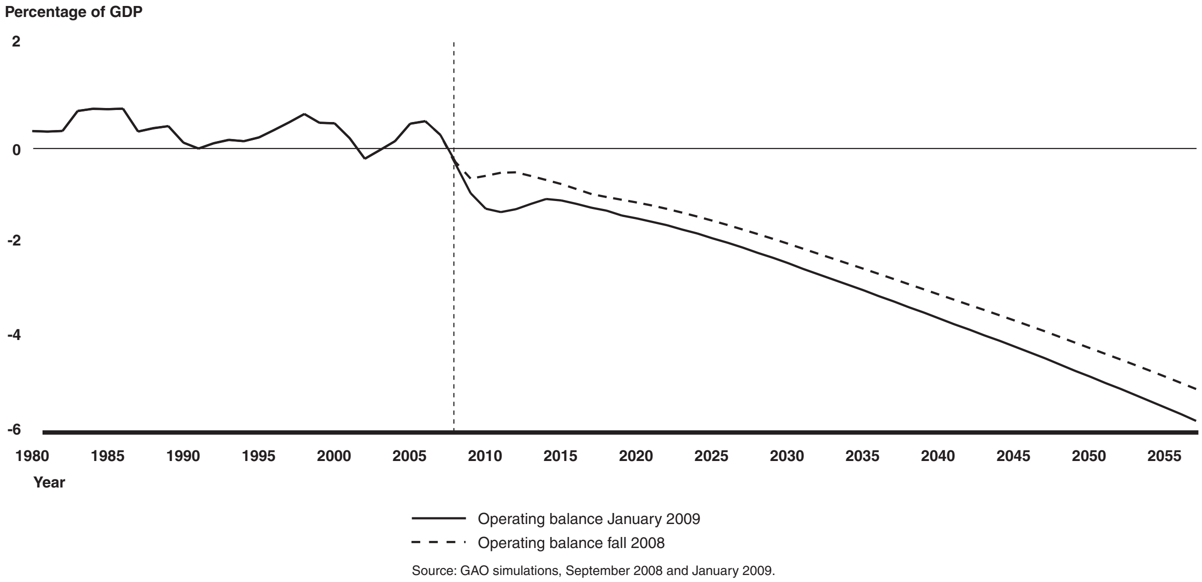
[5]In developing this measure we subtract funds used to finance longer-term projects—such as investments in buildings and roads—from receipts since these funds would be unavailable to cover current expenses. Similarly, we excluded capital-related expenditures from spending.

[6]See GAO-07-1080SP and GAO-08-317. Our model's operating balance measure reflects the sector's historical outcomes and potential fiscal future rather than precise predictions of projected deficits and surpluses.

[7]The projections of lower revenues are derived by applying long-term averages to short-term changes in GDP and may understate the effect of the downturn on revenues. Expenditure estimates in our model are based primarily on assumptions regarding the growth in population and inflation and are less affected by the short-term effects of the business cycle. Our simulations do not reflect yet-to-be-determined fiscal stimulus or actions state and local governments will take to balance their operating budgets during the next 2 years.

[8]Even though we know that these governments regularly make changes in tax laws and expenditures, the model essentially holds current policy in place and analyzes the fiscal future for the sector as if those policies were maintained because it would be highly speculative to make any assumptions about future policy adjustments.

Figure 1: State and Local Model Operating Balance Measure, as a Percentage of GDP



Note: GDP is Gross Domestic Product. Historical data are from the National Income and Product Accounts from 1980 to 2007. GAO simulations are from 2008 to 2057, using many CBO projections and assumptions, particularly for the next 10 years.

Since most state and local governments are required to balance their operating budgets, the declining fiscal conditions shown in our simulations suggest that, without intervention, these governments would need to make substantial policy changes to avoid growing fiscal imbalances. That is, absent any intervention or policy changes, state and local governments would face an increasing gap between receipts and expenditures in the coming years. Any combination of state and local government revenue increases or spending cuts to address the operating deficit is complicated by the current recession. The recession contributes to declining state and local revenues in the midst of increased demand for state and local services, many of which are provided to disadvantaged populations. Recent financial market turmoil places additional limitations on attempts to address this imbalance as state and local governments face increased borrowing costs and reduced access to capital.

Consideration of State Fiscal Relief Requires Attention to Targeting and Timing of Temporary Assistance

Recent economic events have also renewed interest in our work on state fiscal relief, especially our 2006 report on strategies to help states address increased Medicaid expenditures during economic downturns.[9] In 2003, Congress, in response to the 2001 recession, provided $10 billion to the states through a temporary across-the-board increase in federal Medicaid funding.[10] Our 2006 report noted that states' recession-induced Medicaid expenditure growth resulting from enrollment increases could have been addressed with approximately $4.2 billion if the parameters in our report had been available to target and

[9]See GAO, *Medicaid: Strategies to Help States Address Increased Expenditures during Economic Downturns*, GAO-07-97 (Washington, D.C.: Oct. 18, 2006). See also GAO, *Federal Assistance: Temporary State Fiscal Relief*, GAO-04-736R (Washington, D.C.: May 7, 2004). Medicaid is a joint federal-state health financing program that covers medical costs for certain categories of low-income individuals.

[10]Following the 2001 recession, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003, which provided $10 billion in fiscal relief through a temporary increase in federal Medicaid funding and $10 billion in general assistance divided among the states on a per-capita basis.

time assistance according to how severely and when states were affected by the 2001 recession. See enclosure 1 for a more detailed description of our approach and methodology, as excerpted from our 2006 report.

The principles outlined in our 2006 report for targeting and timing supplemental federal assistance for Medicaid apply to the current debate regarding supplemental Medicaid funding and general fiscal relief to state and local governments in response to the current recession. As described in our 2006 report, supplemental federal assistance for Medicaid could be targeted to states based on their increased unemployment rates. Using our approach, such assistance would be triggered on and off based on agreed-upon thresholds reflecting states' percentage increases in unemployment compared to a base quarter. Analysis of recent unemployment data indicates that, based on this strategy, fiscal relief would already have been triggered based on states' changes in unemployment for 2007 and 2008. Congress could choose from a number of unemployment-based thresholds to trigger or taper off such temporary assistance as the recession winds down. The concept of targeted supplemental federal Medicaid assistance is embodied in the health reform plan released by Chairman Baucus in November.[11]

We used unemployment as the key variable for targeting Medicaid-related assistance because it is (1) generally accepted as an indicator of increased Medicaid enrollment resulting from an economic downturn, (2) not easily influenced by outside sources or state policy choices and thus is less subject to manipulation, and (3) a reliable indicator collected in a consistent manner from all 50 states. The intent of this approach targets supplemental federal assistance to states relative to the depth and duration of each state's downturn as well as increased Medicaid expenditures while also reflecting congressional policy choices.[12]

In summary, considerations involved in developing any strategy for federal fiscal relief include

- targeting assistance according to the extent of each state's downturn,
- timing assistance so that it is delivered as soon as it is needed,
- temporarily increasing federal funding so that it turns off when states' economic circumstances improve sufficiently, and
- triggering mechanisms so the starting and ending points of assistance respond to indicators of states' economic distress.

We conducted this review in January 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We are sending copies of this letter to interested congressional committees. We will also make copies available to others upon request. In addition, the letter will be available at no charge on GAO's Web site at http://www.gao.gov.

[11]U.S. Senator Max Baucus, *Call to Action: Health Reform 2009* (Washington, D.C.: Nov. 12, 2008).
[12]This approach does not attempt to address the effects on states' Medicaid programs of either downturn-related revenue declines or any expenditure increases beyond those stemming from caseload growth caused by rising unemployment.

If you or your staff has any questions about this letter, please contact Stanley J. Czerwinski, Director, Strategic Issues, who can be reached at (202) 512-6806 or czerwinskis@gao.gov, or Thomas J. McCool, Director, Center for Economics, who can be reached at (202) 512-2700 or mccoolt@gao.gov.

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Enclosures

GAO's Approach to Helping States with Increased Expenditures during Economic Downturns[13]

During economic downturns, states can experience difficulties financing programs such as Medicaid, a joint federal-state health financing program that covers medical costs for certain categories of low-income individuals. Economic downturns result in rising unemployment, which can lead to increases in the number of individuals who are eligible for Medicaid coverage, and in declining tax revenues, which can lead to less available revenue with which to fund coverage of additional enrollees.

Recognizing the complex combination of factors affecting states during economic downturns—increased unemployment, declining state revenues, and increased downturn-related Medicaid costs—policy makers and others have considered the possibility of establishing a legislative response that would help states better cope with Medicaid cost increases. Any potential legislative response would need to be considered within the context of broader health care and fiscal challenges.

We explored the design considerations and possible effects of a strategy aimed at helping states with their share of Medicaid expenditures during an economic downturn by targeting supplemental funds to specific states on the basis of the relative depth and duration of their economic downturns (as measured by changes in their unemployment rates) as well as the extent to which their Medicaid costs are likely to increase during a downturn. To determine the amount of supplemental federal assistance needed to help states address increased Medicaid expenditures during a downturn, we relied on research that estimated a relationship between changes in unemployment and changes in Medicaid spending while holding constant other factors that influence Medicaid spending.[14] To determine the amount of federal assistance that would be provided based on this strategy, our model incorporated a retrospective assessment, which would involve assessing the increase in each state's unemployment rate for a particular quarter compared to the same quarter of the previous year.

We used unemployment as the key variable because it reflects the potential for increases in Medicaid enrollment as a result of an economic downturn. Although other indicators of economic downturn are widely reported and important in other contexts, experts consider increases in unemployment to be an indicator of the likely increase in Medicaid enrollments of adults and children. To simulate how supplemental assistance could be provided, we used Bureau of Labor Statistics unemployment data by state.

Our simulation model targets funds to states in proportion to the relative size of the states' Medicaid programs for the nonelderly. The purpose of this targeted approach is to adjust

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[13]Excerpts from GAO, *Medicaid: Strategies to Help States Address Increased Expenditures during Economic Downturns*, GAO-07-97 (Washington, D.C.: Oct. 18, 2006).

[14]Stan Dorn, Barbara Markham Smith, and Bowen Garrett, *Medicaid Responsiveness, Health Coverage, and Economic Resilience: A Preliminary Analysis*, Prepared for the Health Policy Institute of the Joint Center for Political and Economic Studies (Washington, D.C.: Joint Center for Political and Economic Studies, Sept. 27, 2005). More recent analyses include John Holahan and A. Bowen Garrett, *Rising Unemployment, Medicaid and the Uninsured*, Prepared by The Urban Institute for the Kaiser Commission on Medicaid and the Uninsured (Washington, D.C.: Kaiser Commission on Medicaid and the Uninsured, Jan. 2009); and Stan Dorn, A. Bowen Garrett, John Holahan, and Aimee Williams, *Medicaid, SCHIP and Economic Downturn: Policy Challenges and Policy Responses*, Prepared by The Urban Institute for the Kaiser Commission on Medicaid and the Uninsured (Washington, D.C.: Kaiser Commission on Medicaid and the Uninsured, April 2008).

each state's funding increase in proportion to the product of 1) each state's increase in the number of unemployed compared to a base quarter and 2) a Medicaid spending index intended to adjust the number of unemployed for the relative size of states' Medicaid programs for the nonelderly.

The first factor is intended to gauge the impact of the economic downturn on Medicaid enrollment in the state. The second factor is intended to adjust the number of unemployed for the relative cost of state Medicaid programs. Two states with an equal increase in the number of unemployed could have very different increases in Medicaid expenditures, depending on their rate of Medicaid spending. The Medicaid index is calculated for each state as its average Medicaid spending per nonelderly poor person relative to the national average. Thus, a state whose Medicaid spending per nonelderly person in poverty was equal to the national average would have an index value equal to one (1.00). CMS spending data are used to approximate each state's Medicaid spending for the cyclically sensitive population. Census Bureau data provide an estimate of adults and children in poverty, who are the potential beneficiaries of such Medicaid spending. The Medicaid index varies widely among the states because of differing Medicaid program characteristics and funding efforts.

GAO Contacts and Staff Acknowledgments

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