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March 2020

# INTERGOVERNMENTAL ISSUES

## Key Trends and Issues Regarding State and Local Sector Finances

# GAO Highlights

Highlights of [GAO-20-437](#), a report to congressional requesters

## Why GAO Did This Study

State and local governments work together with the federal government to deliver a broad range of public services. GAO's prior work has shown that the state and local government sector will likely face fiscal pressures during the next 50 years due to a gap between spending and revenues. The fiscal sustainability of the state and local government sector is essential to effectively implement intergovernmental programs.

GAO was asked to review recent trends in state and local government expenditures and revenues, fiscal pressures for state and local governments with intergovernmental implications, and the implications of federal policy for these pressures. This report (1) examines trends in state and local government expenditures and revenues during the past two decades; and (2) synthesizes expert views regarding the effects of federal policy on state and local government fiscal conditions.

GAO analyzed data from the Bureau of Economic Analysis National Income and Product Accounts, the U.S. Census Bureau and the National Association of State Budget Officers.

GAO also interviewed a nongeneralizable sample of experts from organizations that represent state and local governments, professionals who provide financial and credit risk information (credit rating agencies), and researchers from think tanks to better understand how federal policies affect state and local government fiscal conditions.

View [GAO-20-437](#). For more information, contact Michelle Sager at (202) 512-6806 or [sagem@gao.gov](mailto:sagem@gao.gov).

March 2020

## INTERGOVERNMENTAL ISSUES

### Key Trends and Issues Regarding State and Local Sector Finances

#### What GAO Found

During the past two decades, the state and local government sector experienced overall growth in spending and revenue. Specifically, inflation-adjusted spending increased from about \$1.7 trillion in 1998 to about \$2.8 trillion in 2018. Health spending accounted for the largest increase. Inflation-adjusted revenues increased from about \$1.6 trillion in 1998 to about \$2.6 trillion in 2018. Taxes comprised the largest revenue category.

From 1997 to 2017, state and local government expenditures and revenues grew faster than state gross domestic product in most states. On average, growth in expenditures outpaced growth in revenues by 0.3 percentage points per year during the period. Increases in public welfare spending drove spending growth (spending largely for states' share of Medicaid), while federal grants and user charges drove revenue growth.

#### State and Local Government Expenditures and Revenues Grew Faster Than State Gross Domestic Product (GDP) in Most States from 1997 to 2017

	U.S. average annual growth rate (%)	Number of states with growth exceeding state GDP growth	Number of states with growth slower than state GDP growth
Expenditures	2.8	43	8
Revenues	2.5	35	16
State GDP	2.3	—	—

Source: GAO analysis of U.S. Census Bureau and Bureau of Economic Analysis data. | GAO 20-437

Note: "U.S." indicates the aggregate value for the state and local government sector across all 50 states and the District of Columbia. For each state and the District of Columbia, we compared average annual compound growth in real (inflation-adjusted) expenditures or revenues, as appropriate, to average annual compound growth in inflation-adjusted state GDP.

Experts identified a range of issues facing state and local governments that could affect the sector's fiscal condition. Those most frequently mentioned included:

**Health care.** Experts expressed concerns regarding their ability to meet future Medicaid enrollment demands in an economic downturn.

**Federal budget uncertainty.** Uncertainty in the future of federal assistance as well as the timing of federal appropriations, including federal government shutdowns, affected state and local governments' program planning.

**Physical infrastructure.** Aging infrastructure costs and uncertainty in federal funding sources placed pressure on the sector to identify alternative revenue sources for transportation projects.

**Tax policy.** Provisions of the law known as the Tax Cuts and Jobs Act had varied effects on the sector, but most experts agreed it is still too early to assess the act's full effects on state and local government revenues.

**Natural disasters.** Experts acknowledged the important contribution of federal financial support for disaster response and recovery and noted some states' mitigation efforts to address the increasing frequency and cost of disasters. Credit rating firms are considering the effects of climate change in their credit analyses of state and local governments.

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### Abbreviations

BEA	Bureau of Economic Analysis
Bureau	Census Bureau
CMS	Centers for Medicare & Medicaid Services
DRRA	Disaster Recovery Reform Act of 2018
FPL	Federal Poverty Level
GDP	gross domestic product
HCERA	Health Care and Education Reconciliation Act of 2010
NASBO	National Association of State Budget Officers
NCSL	National Conference of State Legislatures
NIPA	National Income and Product Accounts
PPACA	Patient Protection and Affordable Care Act
SALT	State and Local Taxes
TCJA	Tax Cuts and Jobs Act

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March 23, 2020

The Honorable Jim Jordan  
House of Representatives

The Honorable Gary Palmer  
House of Representatives

State and local governments work together with the federal government to deliver a broad range of public services. Federal funds for government programs implemented in partnership with states and localities support health care, education, public safety, infrastructure, and other policy goals. Successful implementation of federal policy goals in these areas is therefore contingent on state and local governments' fiscal stability. Consequently, the fiscal health of state and local governments is an issue of critical interest to federal policymakers.

You asked us to provide information on and analyze trends in state and local government expenditures and revenues, fiscal pressures facing state and local governments, and the implications of federal policy actions on state and local governments' fiscal health.<sup>1</sup> This report (1) examines recent trends in state and local government expenditures and revenues; and (2) synthesizes expert views regarding the effects of federal policy on state and local government fiscal conditions.

To describe recent trends in state and local government expenditures and revenues, we analyzed aggregate data on state and local expenditures and revenues using inflation-adjusted data from the Bureau of Economic Analysis's (BEA) National Income and Product Accounts and the U.S. Census Bureau (Bureau) during a 20-year period—which includes periods of economic growth and two recessionary periods. For purposes of this review, we determined that the BEA National Income and Product Accounts and Bureau data were sufficiently reliable for our analysis of trends in state and local government expenditures and revenues. Our data reliability assessment included reviewing relevant documentation, interviewing knowledgeable BEA and Bureau officials, and reviewing the data to identify obvious errors or outliers. We also reviewed our prior reports and those of other organizations examining state and local

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<sup>1</sup>Representative Jordan's March 2019 co-request was in his role as Ranking Member of the House Committee on Oversight and Reform.

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government fiscal conditions to identify what is known about these trends and factors that may influence them.

As part of our analysis of state and local government expenditure and revenue trends, we examined state rainy day funds to better understand how states prepare for future economic downturns. To do this, we analyzed data from the National Association of State Budget Officers (NASBO) on state rainy day fund balances and general fund expenditures. We found the NASBO data to be sufficiently reliable for our analysis of state rainy day funds.

This review is not necessarily representative of all fiscal pressures facing state and local governments. For example, the scope of the review does not include tax expenditures or pressures specific to individual state or local governments.

To obtain expert views regarding the effects of federal policy on state and local government fiscal conditions, we conducted a series of structured interviews with a nongeneralizable sample of individuals from 17 organizations with recognized expertise in state and local budgeting and finance, economics, public policy, and intergovernmental issues. We identified three categories of experts and selected individuals within each category. They included: (1) individuals from organizations representing state and local government officials; (2) providers of financial and credit risk information, such as credit rating agencies; and (3) researchers from think tanks with expertise in state and local government finance, including taxes, budgeting, and intergovernmental relations.

To select experts within each category, we reviewed publicly available work and professional affiliations, as well as other criteria to determine their relative expertise related to state and local government fiscal and intergovernmental issues. Appendix I includes additional detail about the scope and methodology of the review, including a list of the organizations represented by the experts we interviewed and how we analyzed the information they shared with us.

We conducted this performance audit from January 2019 to March 2020 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.

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## Background

State and local governments rely on a range of revenue sources to support their activities, including federal grants, user charges, and taxes. The share of revenue generated from different types of state and local taxes and user charges—also referred to as own-source revenue—varies by state or local government. State and local governments face fiscal pressures when, taken as a whole, spending exceeds revenues. Fiscal pressures may reflect growth in selected expenditure categories without corresponding revenue growth or other spending reductions.

To alleviate fiscal pressures and comply with balanced budget requirements, state and local governments may seek to reduce spending, increase revenues, or both. For example, state and local governments may offset increased costs in one program by making cuts to other programs where they have more flexibility to adjust certain types of spending. Alternatively, if their ability to adjust spending is limited, they may seek additional revenue by increasing existing taxes or user charges or imposing new ones. For example, some programs may have spending that is defined or required in state law and must be funded annually, regardless of broader economic circumstances.<sup>2</sup> Other spending may not be subject to legal or other requirements and is thus subject to decisions influenced by current fiscal pressures.

Changes in the makeup of state and local government services, spending, and revenues may reflect economic or demographic changes, a change in spending priorities, or changes in federal policy. Fiscal pressures can result from spending growth or revenue declines that are not the direct result of current state and local policy choices. These choices may instead reflect automatic spending growth (for example, in response to population shifts or an increase in the number of people eligible for government programs) or declines in revenue due to changes in the economy (for example, a shift from goods to services without a corresponding shift in the tax base). Individual expenditure categories can also face fiscal pressures. For example, employee pension funds can experience investment returns below the rates of return assumed in budget forecasts, which can then become underfunded liabilities.

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<sup>2</sup>Most states have some sort of requirement to balance operating budgets. In some states, the governor is required to submit a balanced budget, while in other states, the legislature is required to enact a balanced budget.

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## State and Local Governments Experienced Overall Growth in Expenditures and Revenues during the Past 20 Years

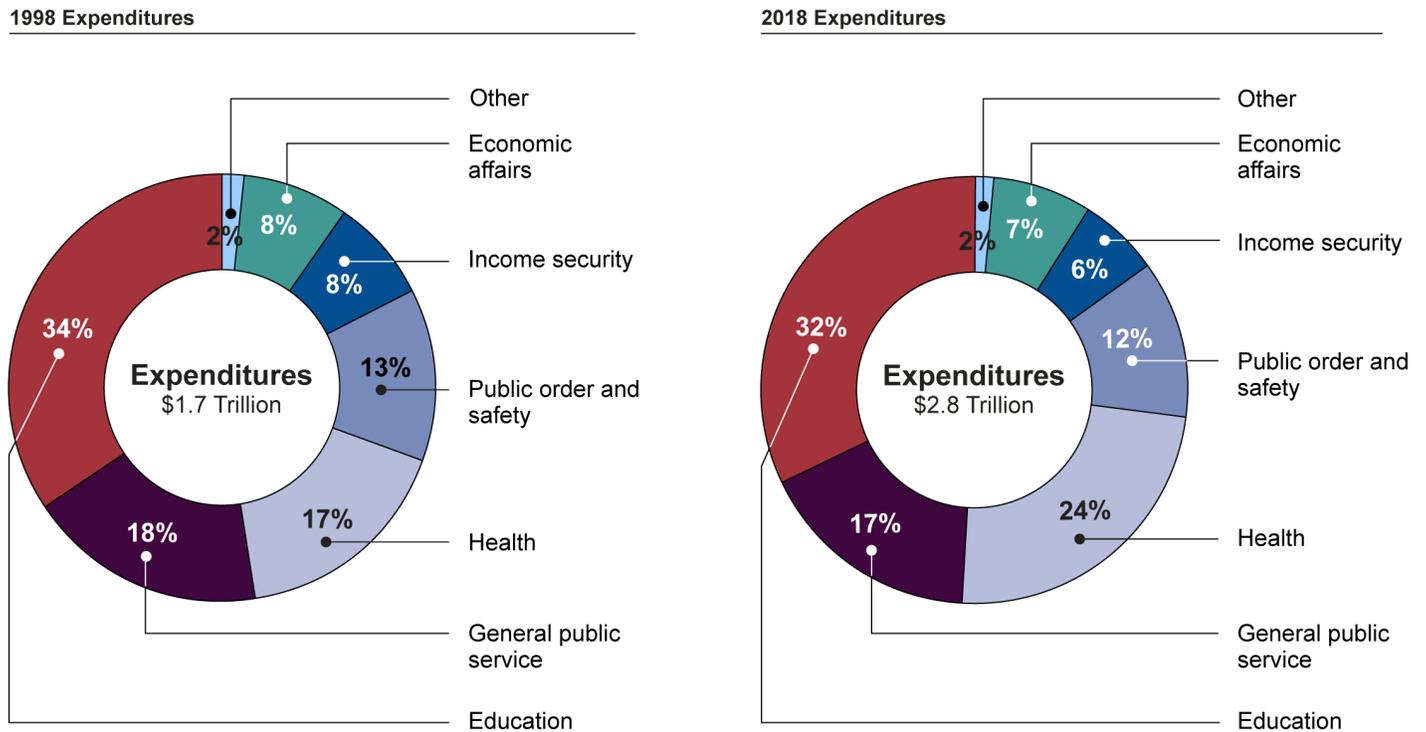
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### State and Local Government Expenditures and Revenues Increased in Most Categories from 1998 to 2018

From 1998 to 2018, state and local government expenditures increased from about \$1.7 trillion in 1998 to about \$2.8 trillion in 2018. Figure 1 shows that most state and local government expenditure categories experienced slight shifts during this period. While some categories declined as a share of total spending, inflation-adjusted spending increased in all expenditure categories. Health expenditures reflected the largest increase in inflation-adjusted spending, increasing from \$288 billion in 1998 to \$670 billion in 2018. As a share of total expenditures, health spending increased by 7 percentage points, from 17 percent in 1998 to 24 percent in 2018.

Inflation-adjusted spending on education—the largest share of state and local expenditures—increased by more than \$300 billion from 1998 to 2018. However, as a share of total spending, education expenditures decreased by 2 percentage points during the period, in large part, because of the sizable growth in health expenditures during this time period.

**Figure 1: State and Local Government Expenditures, by Category, 1998 and 2018**



Source: GAO analysis of Bureau of Economic Analysis's National Income and Product Accounts data. | GAO-20-437

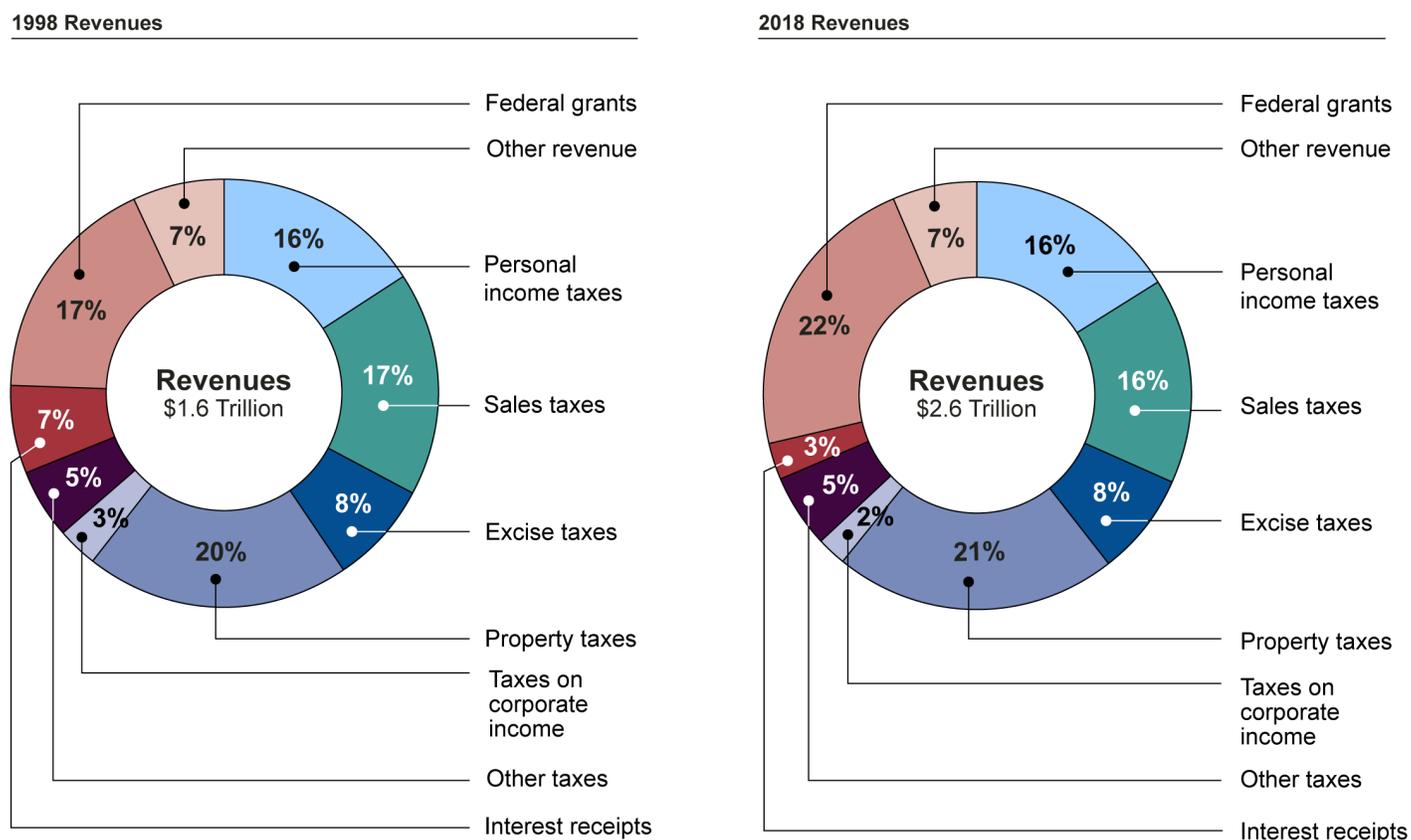
Note: The other category combines recreation, culture and housing, and community services. General public service includes spending for executive and legislative services, tax collection and financial management services, and other services. Public order and safety includes police, fire, courts, and prison services. Economic affairs includes transportation (highways, air, water, transit, and railroads), space, and other economic affairs (general economic and labor affairs, agriculture, energy, natural resources, postal services, and other services). Health includes the gross output of providing health care services minus the revenues received as hospital charges and other health charges. Education includes elementary and secondary education, higher education, libraries, and other services. Income security includes disability, welfare and social services, unemployment, and other services. Employee compensation costs (e.g., employers' pension contribution costs and wages and salaries) are included across all the expenditure categories. Dollar values are adjusted for inflation and expressed in 2017 dollars.

From 1998 to 2018, state and local government revenues increased from about \$1.6 trillion in 1998 to about \$2.6 trillion in 2018 (see figure 2). In every year between 1998 and 2018, state and local government taxes (i.e., personal income, sales, excise, property, corporate, and other taxes) comprised the largest category of receipts for the sector, providing about \$1.8 trillion or 69 percent of total revenues in 2018.<sup>3</sup> With the exception of

<sup>3</sup>Other taxes include other income taxes and taxes on production and imports.

interest receipts, all revenue categories increased in inflation-adjusted dollars from 1998 to 2018. Interest receipts decreased from \$108 billion or 7 percent of total revenues in 1998 to \$72 billion or 3 percent of total revenues in 2018.

**Figure 2: State and Local Government Revenues, by Category, 1998 and 2018**



Source: GAO analysis of Bureau of Economic Analysis's National Income and Product Accounts data. | GAO-20-437

Note: The other revenue category includes contributions for government social insurance, dividends, rents and royalties, transfer receipts from businesses, persons, and current surplus of government enterprises. Other taxes include other income taxes and taxes on production and imports. Interest receipts include general government monetary interest, imputed interest, and social insurance interest. Monetary interest includes interest from interest-bearing deposits and accounts, interest on investments, and funds held for construction and other purposes. Imputed interest includes services provided by banks and other financial institutions that do not reflect the entire cost of the service. Dollar values are adjusted for inflation and expressed in 2017 dollars.

Federal grants comprised the second largest category of state and local government revenues in both 1998 and 2018 (see figure 2). As a share of

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total revenues, federal grants increased from \$288 billion or 17 percent of total revenues in 1998 to \$569 billion or 22 percent in 2018, an increase of \$281 billion or 5 percentage points.<sup>4</sup>

Figure 3 provides a more detailed breakdown of federal grants to state and local governments from 1998 to 2018. Compared to other grant categories, health grants reflected the only increase in state and local government federal grants, increasing from 53 percent in 1998 to 70 percent in 2018.<sup>5</sup> Most of this growth occurred after 2010, following the enactment of the Patient Protection and Affordable Care Act (PPACA), which offered federal Medicaid funding for states choosing to expand their programs to low-income adults.<sup>6</sup> As a share of total federal grants, income security grants reflected the largest decrease—from 26 percent in 1998 to 17 percent in 2018.<sup>7</sup> However, income security grants increased in inflation-adjusted dollars, from \$75 billion in 1998 to \$96 billion in 2018. The decline in income security grants, as a share of total federal grants, reflects shifts in federal grants to state and local governments resulting from faster growth in health grants during the 20-year time period.

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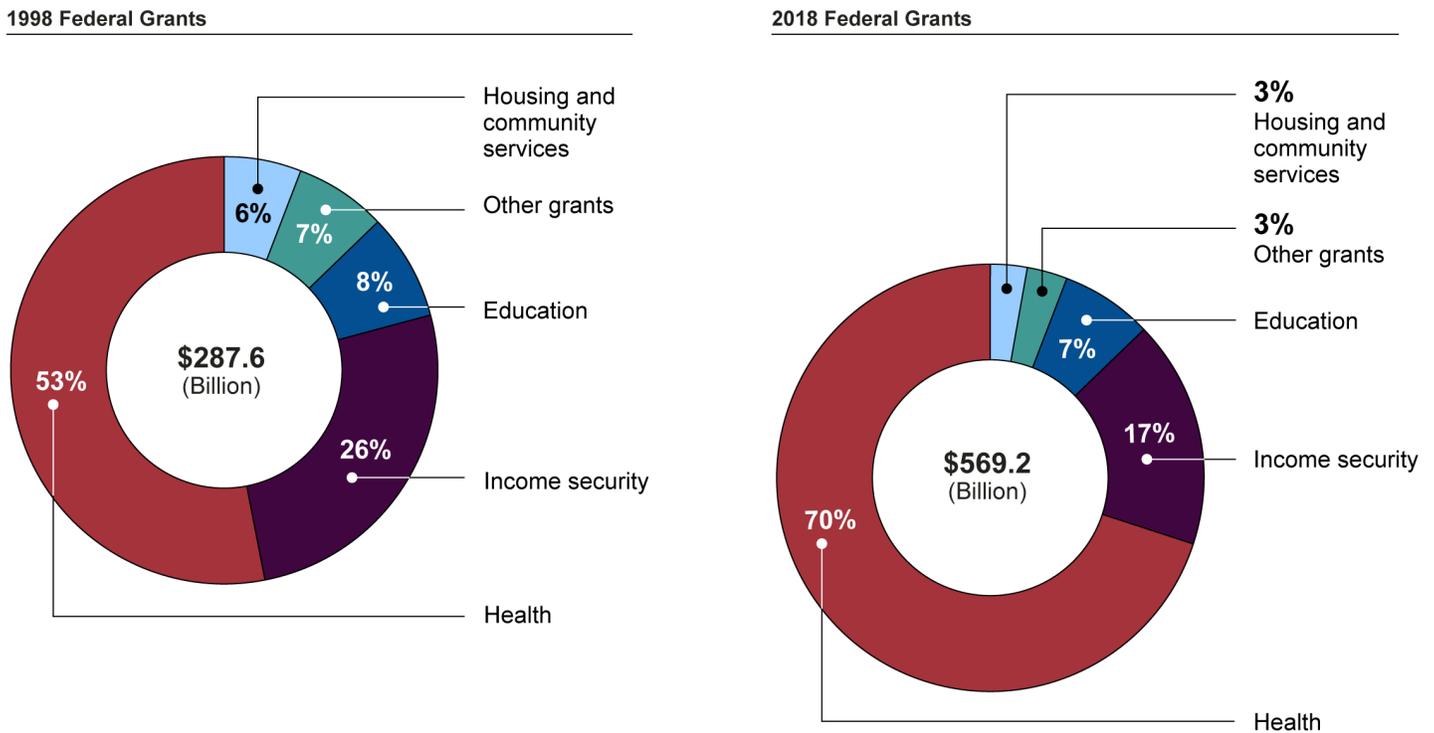
<sup>4</sup>Other sources, such as the Office of Management and Budget's government-wide summary data in the *Budget of the U.S. Government's Analytical Perspectives*, provide information on federal grants. Amounts shown for federal grants to state and local governments may vary depending on factors such as the time period shown.

<sup>5</sup>Medicaid grants accounted for about 95 percent of health grants in both 1998 and 2018.

<sup>6</sup>Pub. L. No. 111-148, 124 Stat. 119 (2010), as amended by the Health Care and Education Reconciliation Act of 2010 (HCERA), Pub. L. No. 111-152, 124 Stat. 1029 (2010). For purposes of this report, references to PPACA include the amendments made by HCERA. PPACA gave states the option to expand their Medicaid programs by covering nearly all adults with incomes at or below 133 percent of the federal poverty level (FPL) beginning January 1, 2014. PPACA also provides for a 5 percent disregard when calculating income for determining Medicaid eligibility, which effectively increases income eligibility from 133 percent of FPL to 138 percent of FPL. PPACA also permitted an early expansion option, whereby states could expand eligibility for this population, or a subset of this population, starting on April 1, 2010. States choosing to expand their programs receive a higher federal matching rate for these Medicaid expansion enrollees. As of January 2020, 36 states and the District of Columbia have implemented expansion under PPACA.

<sup>7</sup>Income security grants include those related to disability, welfare and social services, unemployment, and other services.

**Figure 3: Federal Health Grants Reflected the Only Increase in State and Local Government Grants from 1998 to 2018**



Source: GAO analysis of Bureau of Economic Analysis's National Income and Product Accounts data. | GAO-20-437

Note: Other grants includes those for general public service, economic affairs, national defense, public order and safety, and recreation and culture. Dollar values are adjusted for inflation and expressed in 2017 dollars.

### State and Local Government Expenditures and Revenues Grew Faster Than State Gross Domestic Product and Varied by Type

In most states, growth in both state and local government expenditures and revenues exceeded growth in state gross domestic product (GDP) from 1997 to 2017.<sup>8</sup> As shown in table 1, growth in expenditures equaled or exceeded growth in state GDP in each of the 5-year periods from 1997 to 2017. Revenues grew faster than state GDP, on average, during the 20-year period, though they grew somewhat slower than state GDP from 2008 to 2012. Table 1 also shows that state and local government

<sup>8</sup>In this report, we compared average annual compound growth in state and local government expenditures or revenues to average annual compound growth in GDP-by-state (which we refer to as state GDP throughout this report). State GDP is the measure of the market value of all final goods and services produced in a state in a particular period of time. To analyze trends in state and local government revenues and expenditures across states, we used the Bureau's government finance data and GDP price index data from BEA to calculate inflation-adjusted values of selected expenditure and revenue categories for each state and the District of Columbia.

expenditures, revenues, and state GDP all experienced more robust growth during the first half of the 20-year period (1997 to 2007) than in the second half of the period (2008 to 2017).

**Table 1: State and Local Government Expenditures and Revenues Exceeded State Gross Domestic Product (GDP) Growth in the Majority of States from 1997 to 2017**

	Overall growth 1997-2017			Five-year growth patterns (%)			
	U.S. average annual growth rate (%)	Number of states where growth exceeded state GDP growth	Number of states where growth was slower than state GDP growth	1997-2002	2003-2007	2008-2012	2013-2017
General expenditures <sup>a</sup>	2.8	43	8	4.9	3.4	0.8	2.1
General revenues <sup>b</sup>	2.5	35	16	3.5	4.2	0.6	1.7
State GDP	2.3	—	—	3.4	3.4	0.8	1.6

Source: GAO analysis of U.S. Census Bureau and Bureau of Economic Analysis data. | GAO-20-437

<sup>a</sup>General expenditures refer to all expenditures except those classified as utility, liquor stores, and employee-retirement or insurance trust.

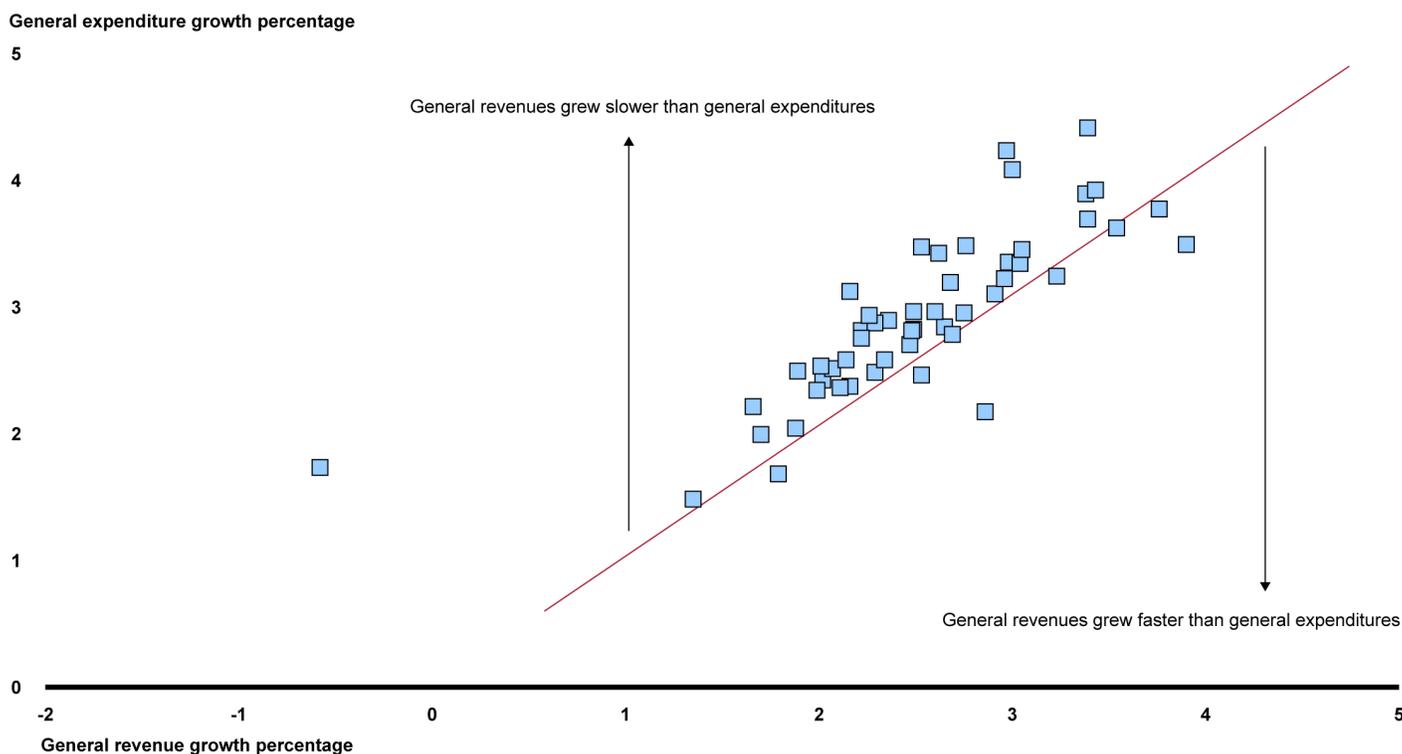
<sup>b</sup>General revenues refer to all revenues except those classified as utility, liquor stores, and insurance trust.

Note: Data are for 1997 to 2017. Values for 2001 and 2003 were estimated because data were not available. "U.S." indicates the aggregate value for the state and local government sector across all 50 states and the District of Columbia. For each state and the District of Columbia, we compared average annual compound growth in inflation-adjusted expenditures or revenues, as appropriate, to average annual compound growth in inflation-adjusted state GDP.

On average, growth in state and local government expenditures outpaced growth in state and local government revenues by about 0.3 percentage points per year. As shown in figure 4, expenditures grew faster than revenues in 43 states from 1997 to 2017. We have previously reported on state and local government expenditure growth trending in excess of revenue growth and its implications for increasing state and local government fiscal pressures. For example, our most recent simulations suggest that the state and local government sector could continue to face a gap between expenditures and revenues during the next 50 years. Because many state and local governments are required to balance their operating budgets, they will most likely need to make policy changes

involving some combination of reduced spending and increased revenue.<sup>9</sup>

**Figure 4: General Revenues Grew Slower than General Expenditures in Most States, 1997 to 2017**



Sources: GAO analysis of U.S. Census Bureau and Bureau of Economic Analysis data. | GAO-20-437

Note: General expenditure growth is average annual compound growth, from 1997 to 2017, in inflation-adjusted general expenditures made by state and local governments. General revenue growth is average annual compound growth, from 1997 to 2017, in inflation-adjusted general revenues collected by state and local governments. Each point on the figure shows the combination of expenditure and revenue growth for a particular state. The diagonal line identifies points where inflation-adjusted expenditures and inflation-adjusted revenues grew at the same rate.

<sup>9</sup>We developed a fiscal model of the state and local government sector, which we first reported on in 2007 and have regularly updated since. Our simulations assume that the current set of policies in place across state and local governments remain relatively constant to show a simulated long-term outlook. For our most recent update, see GAO, *State and Local Governments' Fiscal Outlook: 2019 Update*, [GAO-20-269SP](#) (Washington, D.C.: Dec. 19, 2019).

Most Types of Expenditures Grew among States, with Public Welfare Spending Showing the Fastest Growth

Spending in most expenditure categories grew faster than or at the same rate as state GDP in a majority of states from 1997 to 2017 (see table 2). State and local government expenditures, as a whole, grew at an average annual rate of 2.8 percent from 1997 to 2017 and faster than state GDP in 43 states. Public welfare spending showed the fastest growth among all state and local government expenditure categories, growing at an average annual rate of 4.9 percent per year during the period.<sup>10</sup>

**Table 2: State and Local Government Expenditure Growth Relative to State Gross Domestic Product (GDP) Growth, 1997 to 2017**

	U.S. average annual growth rate (%)	Minimum (%)	Maximum (%)	Number of states where growth exceeded state GDP growth	Number of states where growth was slower than state GDP growth
<b>Total general expenditures<sup>a</sup></b>	2.8	1.4	4.3	43	8
Education services <sup>b</sup>	2.6	0.9	5.6	36	15
Public welfare <sup>c</sup>	4.9	0.4	7.5	49	2
Hospitals and health <sup>d</sup>	2.6	-2.8	7.8	29	22
Transportation <sup>e</sup>	2.1	-1.4	7.2	20	31
Public safety <sup>f</sup>	2.5	0.7	4.9	34	17
Environment and housing <sup>g</sup>	2.3	0.3	6.4	24	27
Government administration <sup>h</sup>	2.1	-0.3	4.2	18	33
<b>Other selected expenditures</b>					
Interest on debt <sup>i</sup>	-0.1	-5.1	2.5	3	48
Insurance benefits and repayments <sup>j</sup>	3.9	-1.5	6.0	47	4
Salaries and wages <sup>k</sup>	1.8	0.1	2.9	5	46

Source: GAO analysis of U.S. Census Bureau data. | GAO-20-437

Note: Data are for 1997 to 2017. "U.S." indicates aggregate expenditures for the state and local government sector across all 50 states and the District of Columbia. For each state and the District of Columbia, we compared average annual compound growth in inflation-adjusted expenditures to average annual compound growth in inflation-adjusted state GDP. "Minimum" and "maximum" indicate, respectively, the lowest and highest rates of growth across all 50 states and the District of Columbia.

<sup>a</sup>General expenditures refer to all expenditures except those classified as utility, liquor stores, and employee-retirement or insurance trust.

<sup>b</sup>Education services includes all education and library functions, including schools, colleges, and other educational institutions.

<sup>10</sup>We used the Bureau's categories of state and local government expenditures and revenues in analyzing and presenting spending and revenue data in this report. For example, the Bureau categorizes Medicaid and Temporary Assistance for Needy Families as public welfare programs.

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<sup>c</sup>Public welfare includes cash assistance paid directly to needy persons under such programs as Medicaid, Old Age Assistance, Temporary Assistance for Needy Families, and other programs.

<sup>d</sup>Hospitals and health includes outpatient health services, such as public health and financing, construction, acquisition, maintenance or operations of hospitals.

<sup>e</sup>Transportation includes highways, air transportation, parking facilities, water transport and terminals, and transit subsidies.

<sup>f</sup>Public safety includes police protection, fire protection, corrections, and protective inspection and regulation.

<sup>g</sup>Environmental and housing includes functions related to natural resources, parks and recreation, housing and community development, sewerage, and solid waste management.

<sup>h</sup>Government administration includes government financial administration and administrative functions, such as judicial and legal functions and personnel administration.

<sup>i</sup>Interest on debt includes payments for borrowed money by all funds of the government, except for utility debt.

<sup>j</sup>Insurance benefits and repayments includes social insurance payments to beneficiaries, employee retirement annuities and other benefits, and withdrawals of insurance or employee-retirement contributions.

<sup>k</sup>Salaries and wages includes amounts expended for compensation of employees.

**Public welfare.** Public welfare—which includes Medicaid and welfare programs, such as Temporary Assistance to Needy Families—grew faster than all other spending categories from 1997 to 2017. Public welfare grew faster than state GDP in all but two states at an average annual rate of 4.9 percent during the period. The Centers for Medicare & Medicaid Services (CMS) Office of the Actuary projected that Medicaid spending would grow at an average rate of 5.7 percent per year, from fiscal years 2017 to 2026, with projected Medicaid expenditures reaching more than \$1 trillion by fiscal year 2026.<sup>11</sup> Since Medicaid is a matching formula grant program, the projected growth rate reflects expected increased Medicaid expenditures that will be shared by state governments. Furthermore, our long-term simulations of the state and local government sector’s fiscal outlook have shown that health expenditures are expected to continue to increase faster than the economy during the next 50 years.<sup>12</sup>

**Hospitals and health.** Expenditures on hospitals and health—which include state and local government spending on public health and hospitals, but not Medicaid—grew at an average rate of 2.6 percent per year from 1997 to 2017. Across all states, average annual growth in

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<sup>11</sup>The Department of Health and Human Services, Centers for Medicare & Medicaid Services (CMS), Office of the Actuary, *2017 Actuarial Report on the Financial Outlook for Medicaid*, (Washington, D.C.: 2018). In this report, the CMS Chief Actuary stated that projections of health care costs are inherently uncertain. In particular, Medicaid projections are uncertain because enrollment and costs are very sensitive to economic conditions.

<sup>12</sup>[GAO-20-269SP](#).

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spending on hospitals and health ranged from -2.8 percent per year to 7.8 percent per year, reflecting the largest spread of any spending category. Further, growth in spending on hospitals and health was not distributed evenly across this range. In eight states, hospital and health expenditures grew at an average annual rate of less than 1 percent, while the average annual growth rate exceeded 3 percent in 20 states.

**Education services.** Spending on education services (i.e., schools, colleges, other educational institutions, educational programs for adults, veterans, and other special classes) grew at an average rate of 2.6 percent per year and faster than state GDP in 36 states from 1997 to 2017. This average annual growth rate reflects faster growth of 4.1 percent per year, on average, from 1997 to 2007 and slower growth of 0.7 percent per year, on average, from 2008 to 2017. During the second half of the 20-year period, from 2008 to 2017, spending on education services grew more slowly than state GDP in 39 states.

**Public safety.** Spending on public safety, which includes state and local government services, such as police, fire protection, and corrections, grew in all states at an average rate of 2.5 percent per year from 1997 to 2017. In 34 states, public safety spending grew faster than state GDP during the period. Further, public safety expenditures grew faster than 3 percent in 13 states and slower than 1 percent in three states during the same period.

**Transportation.** Spending on transportation grew at an average annual rate between -1.4 percent and 7.2 percent from 1997 to 2017. In 35 states, transportation spending grew between 1 percent and 3 percent per year, on average, during this period. Transportation spending grew slower than 1 percent per year on average in seven states, while in nine states, transportation spending grew faster than 3 percent, on average, per year.

**Environment and housing.** Expenditures on environment and housing, which include functions related to natural resources and housing and community development programs, grew, on average, at a rate equal to state GDP from 1997 to 2017 and ranged from a low of 0.3 percent to a high of 6.4 percent. Environment and housing spending exceeded state GDP growth in 24 states, while these expenditures grew more slowly than state GDP in 27 states. From 1997 to 2007, environment and housing spending grew at an average rate of 4.3 percent per year. From 2008 to 2017, this spending category grew at an average annual rate of .03 percent.

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**Government administration.** Government administration includes functions related to managing the government’s day-to-day work, such as financial administration, judicial and legal costs, and central staff services and personnel agencies. Spending in this category grew slightly slower than state GDP at an average rate of 2.1 percent per year from 1997 to 2017. Government administration spending grew faster from 1997 to 2007 (at an average rate of 3.6 percent per year) than from 2008 to 2017 (at an average rate of 0.4 percent per year).

**Other selected expenditures.** Interest on debt spending (i.e., all spending on borrowed money except utility debt) grew slower than state GDP in 48 states, while annual growth ranged from -5.1 to 2.5 percent across states. From 2008 to 2017, spending on debt interest decreased by an average annual rate of 2.1 percent from 2008 to 2017. Insurance benefits and repayment expenditures, which include retirement benefits, was the fastest growing category of selected expenditures. Average annual growth in interest paid to finance debt equaled -0.1 percent. Salaries and wages for state and local government employees grew slower than state GDP in 46 states and slower than 1 percent per year in seven states.

Growth in the Sector’s  
Revenues Driven by Federal  
Grants and User Charges

General revenues, as a whole, grew faster than state GDP in 35 states from 1997 to 2017 with the fastest growth in federal grants (3.5 percent per year) and user charges (3.1 percent per year). Table 3 shows state and local government revenue broken down into two larger categories: (1) federal grants, which include all federal fiscal aid to state and local governments; and (2) own-source revenue, which includes all general revenue state and local governments generate from their own sources, such as taxes and user charges.

**Table 3: State and Local Government Revenue Growth Relative to State Gross Domestic Product (GDP) Growth, 1997 to 2017**

	U.S. average annual growth rate (%)	Minimum (%)	Maximum (%)	Number of states where growth exceeded state GDP growth	Number of states where growth was slower than state GDP growth
<b>General revenue<sup>a</sup></b>	2.5	-0.6	3.9	35	16
<b>Federal grants<sup>b</sup></b>	3.5	2.1	7.2	45	6
<b>Own-source revenue<sup>c</sup></b>	2.2	-1.7	3.9	25	26
<b>Total taxes</b>	2.1	-0.7	4.0	15	36
Property <sup>d</sup>	2.6	-0.3	4.5	36	15
Sales <sup>e</sup>	2.0	-0.6	4.1	19	28
Excise <sup>f</sup>	2.1	-1.1	5.3	22	29
Individual income <sup>g</sup>	2.0	-0.8	4.7	18	26
Corporate income <sup>h</sup>	-0.2	-8.1	4.7	7	40
Other <sup>i</sup>	1.7	-4.1	9.5	22	29
User charges <sup>j</sup>	3.1	0.9	6.2	40	11
<b>Miscellaneous revenue<sup>k</sup></b>	1.2	-3.3	5.3	9	42

Source: GAO analysis of U.S. Census Bureau data. | GAO-20-437

Note: Data are for 1997 to 2017. "U.S." indicates aggregate revenues for the state and local government sector across all 50 states and the District of Columbia. For each state and the District of Columbia, we compared average annual compound growth in inflation-adjusted revenues to average annual compound growth in inflation-adjusted state GDP. "Minimum" and "maximum" indicate, respectively, the lowest and highest rates of growth across all 50 states and the District of Columbia.

<sup>a</sup>General revenue. All revenues except those classified as utility, liquor stores, and insurance trust.

<sup>b</sup>Federal grants. Amounts received from the federal government as fiscal aid in the form of shared revenues and grants-in-aid, as reimbursements for the performance of general government functions and specific services for the paying government (e.g., care of prisoners or contractual research), or in lieu of taxes. This category excludes amounts received from other governments for the sale of property, commodities, and utility services.

<sup>c</sup>Own-source revenue. All general revenue generated from own-sources, such as taxes, user fees, and interest earnings.

<sup>d</sup>Property taxes. Taxes imposed on ownership of property, as measured by its value.

<sup>e</sup>Sales taxes. Taxes on sales or gross receipts, applicable with only specified exceptions to all types of goods and services, or all gross income. Sales taxes are not levied in five states: Alaska, Delaware, Montana, New Hampshire, and Oregon. While Alaska does not levy a state sales tax, the state allows local governments to levy a sales tax on goods and services. As a result, for purposes of our analysis, we counted Alaska as a state that levies a sales tax.

<sup>f</sup>Excise taxes. Taxes imposed on sales of particular commodities or services or gross receipts of particular businesses.

<sup>g</sup>Individual income taxes. Taxes imposed on individuals, measured by net income and taxes imposed on special types of income, such as interest on dividends, and income from intangibles. Income taxes are not levied in seven states: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

<sup>h</sup>Corporate income taxes. Taxes imposed on the net income of corporations and unincorporated businesses. These taxes are not levied in six states: Nevada, Ohio, South Dakota, Texas, Washington, and Wyoming. While Ohio and South Dakota do not levy a corporate income tax, these

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states collect revenue on financial institutions. Therefore, for purposes of our analysis, we counted both Ohio and South Dakota as states that levy a corporate income tax.

<sup>i</sup>Other taxes. Taxes on various licenses such as those for alcoholic beverages, amusement, corporations, hunting and fishing, motor vehicle operators, public utilities, occupancy, and businesses.

<sup>j</sup>User charges. Amounts received from the public for specific services benefiting the person charged, and from the sales of commodities and services, except liquor store sales.

<sup>k</sup>Miscellaneous. Revenue from special assessments, sale of property, interest earnings, fines and forfeits, rents, royalties, donations from private sources, and net lottery revenues.

In the following section, we discuss trends in selected revenue categories identified in table 3. These selected revenue categories—federal grants, user charges, and property taxes—represent the three largest categories of revenue for the state and local government sector.<sup>13</sup>

**Federal grants.** Federal grants were the fastest growing source of revenue for the sector from 1997 to 2017, growing in every state and faster than state GDP in 45 states at an average annual rate of 3.5 percent. During the same period, state and local governments' own-source revenue (i.e., taxes and user charges) grew at an average rate of 2.2 percent per year and ranged from -1.7 percent to 3.9 percent per year. However, state and local governments' own-source revenue grew faster than state GDP in about half of the states. At the same time, this revenue growth varied among grant categories and across states.

**User charges.** State and local government user charges comprised the second fastest growing revenue category for the sector from 1997 to 2017. User charges grew faster than state GDP in 40 states, at an average rate of 3.1 percent per year. In addition, user charges grew in every state, at an average rate between 0.9 percent and 6.2 percent per year.

**Total taxes.** State and local government taxes, the largest category of own-source revenue, grew slower than state GDP from 1997 to 2017.<sup>14</sup> Specifically, state and local government total tax revenues grew at a rate of about 2.1 percent per year, on average. As shown below, for the three major tax categories—property, sales, and individual income—growth varied overall and across states.

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<sup>13</sup>The following revenue categories—miscellaneous revenue, excise, corporate, income, and other taxes—each represented between 2 and 8 percent of total state and local government revenue in 2017.

<sup>14</sup>Own-source revenue excludes funding from federal grants.

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**Property taxes.** Property taxes were the fastest growing category for the sector—growing in nearly all states at an average rate of 2.6 percent per year from 1997 to 2017. Property taxes grew faster than state GDP in 36 states and faster than 3 percent per year in 17 states. Property taxes drove own-source revenue growth during this time period. Compared to other tax revenue categories, property taxes have been a relatively stable revenue source for local governments.<sup>15</sup> In addition, property taxes grew at an average rate of 1.4 percent per year from 2008 to 2012, while both sales and income taxes showed negative growth during the period.<sup>16</sup>

**Sales taxes.** Sales taxes grew at an average rate of 2 percent per year from 1997 to 2017, ranging from a low of -0.6 percent to a high of 4.1 percent. Revenue from sales taxes grew slower than state GDP in 28 states and slower than 1 percent per year in six states. Slower sales tax growth could reflect a shrinking sales tax base for state and local governments. Many states do not levy a tax on services—which represents more than two-thirds of all consumption. These states must therefore raise sales tax revenue from a smaller base.

**Individual income taxes.** From 1997 to 2017, growth in individual income taxes showed greater variation across states and over time than either property or sales taxes. Similar to the growth in sales taxes, individual income taxes grew at an average rate of 2 percent per year, but reflected a wider range of growth from 1997 to 2017. Individual income taxes grew slower than state GDP in 26 states and slower than 1 percent per year in six states. From 2008 to 2017, growth in individual income taxes slowed to an average rate of 0.3 percent per year—representing a more than 3-percentage-point slower growth rate compared to the period from 1997 to 2007.

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<sup>15</sup>Although property taxes are primarily a local government revenue source, states largely control the conditions under which they are administered. Property tax limits generally are enacted by states and cover an entire state. Some states have statutory limits enacted by legislatures, while others have constitutional limits, which generally require approval by voters.

<sup>16</sup>Tax revenues do not always follow the economic cycle. This is because changes in property values do not necessarily accompany changes in personal and corporate income or economic output. In addition, unlike other taxes, property taxes are not sensitive to taxpayers' incomes and local governments can adjust property tax rates to maintain a stable stream of revenues even if property values decline during an economic cycle.

Table 4 shows that public welfare grants to state and local governments—which include Medicaid—grew faster than state GDP in 47 states. Public welfare grants grew faster than 3 percent per year in 45 states from 1997 to 2017. During this period, public welfare grants grew in all states at an average rate of 4.6 percent per year, ranging from 1.8 percent to 9.5 percent per year. Grant funding for education and highways grew faster than state GDP at an average annual rate of 2.6 percent and 2.4 percent, respectively. Although a relatively small share of federal grants, natural resources grants had the largest average annual growth rate—4.9 percent—and grew faster than state GDP in 37 states from 1997 to 2017.

**Table 4: Growth in Federal Grant Funding by Selected Categories, 1997 to 2017**

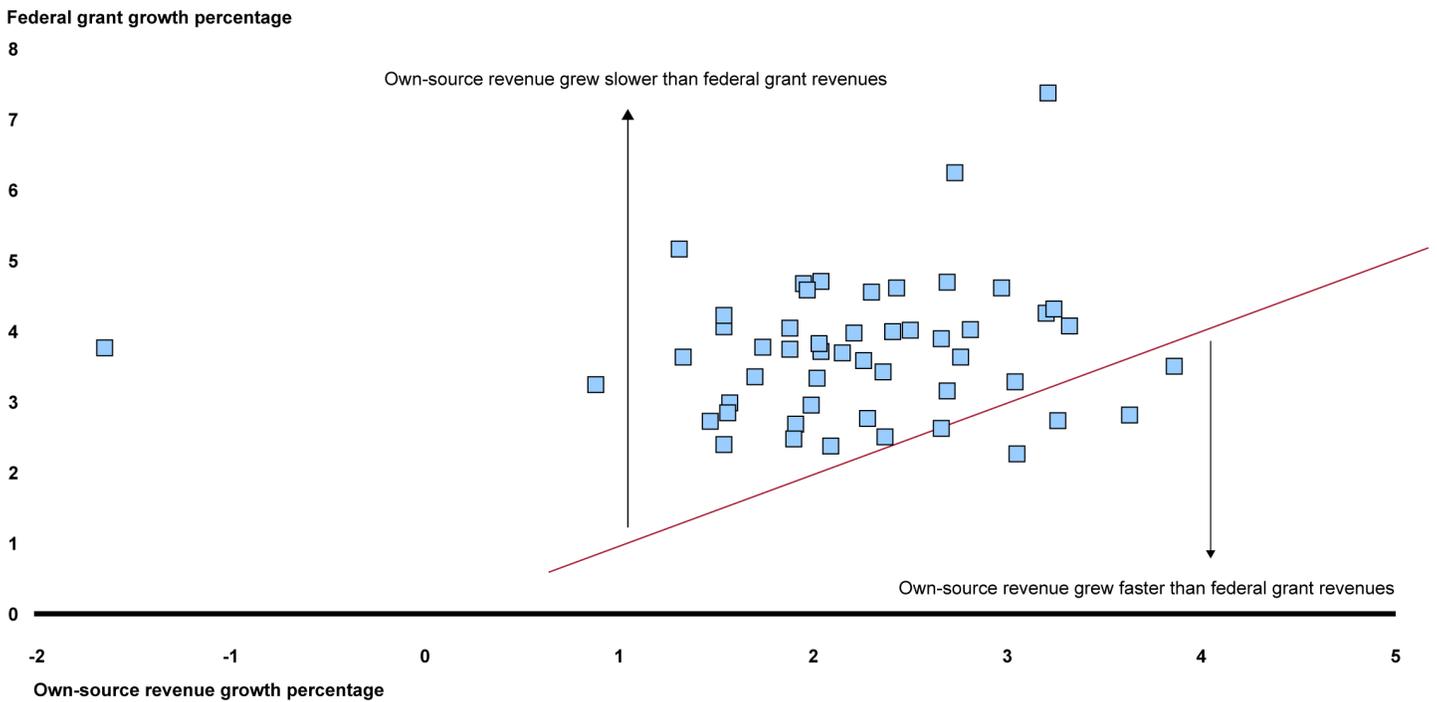
	U.S. average annual growth rate (%)	Minimum (%)	Maximum (%)	Number of states where growth was faster than state GDP growth	Number of states where growth was slower than state GDP growth
Education	2.6	-2.1	6.0	38	13
Health and hospitals	2.1	-11.8	11.9	23	28
Highways	2.4	-4.5	15.8	30	21
Housing and community development	2.1	-2.6	8.4	25	26
Natural resources	4.9	-3.4	22.0	37	13
Public welfare	4.6	1.8	9.5	47	4

Source: GAO analysis of U.S. Census Bureau data. | GAO 20-437

Note: Data are for 1997 to 2017. "U.S." indicates aggregate federal grants to the state and local government sector across all 50 states and the District of Columbia. For each state and the District of Columbia, we compared average annual compound growth in inflation-adjusted federal grants to average annual compound growth in inflation-adjusted state GDP. "Minimum" and "maximum" indicate, respectively, the lowest and highest rates of growth across all 50 states and the District of Columbia.

Federal grants grew faster than own-source revenue overall and in a majority of states from 1997 to 2017. Figure 5 compares the rate of growth in own-source revenue to the rate of growth in federal grant revenue during the period. Figure 5 shows that, for the majority of states, revenue from federal grants grew faster than own-source revenue.

**Figure 5: Federal Grant Revenues Grew Faster than Own-Source Revenue in Most States, 1997 to 2017**



Sources: GAO analysis of U.S. Census Bureau and Bureau of Economic Analysis data. | GAO-20-437

Note: Growth in federal grant funding is average annual compound growth, from 1997 to 2017, in inflation-adjusted federal grants to state and local governments. Own-source revenue growth is average annual compound growth, from 1997 to 2017, in all other inflation-adjusted revenues collected by state and local governments. Each point on the figure represents a combination of growth in own-source revenue and growth in grant revenue from the federal government for a particular state. The diagonal line identifies points where inflation-adjusted federal grants to states and inflation-adjusted own-source revenue collected by states grew at the same rate.

### State Rainy Day Fund Balances Fluctuated During the Past 20 Years and Experienced Consistent Growth Since 2010

State rainy day fund balances fluctuated as a median percentage of general fund expenditures from 1998 to 2018 and experienced consistent increases since 2010.<sup>17</sup> Rainy day funds include state budget stabilization or reserve funds that state governments may use to supplement general fund spending during a revenue downturn or other unanticipated shortfall. Every state has some type of rainy day fund, though deposit and withdrawal rules vary considerably.<sup>18</sup>

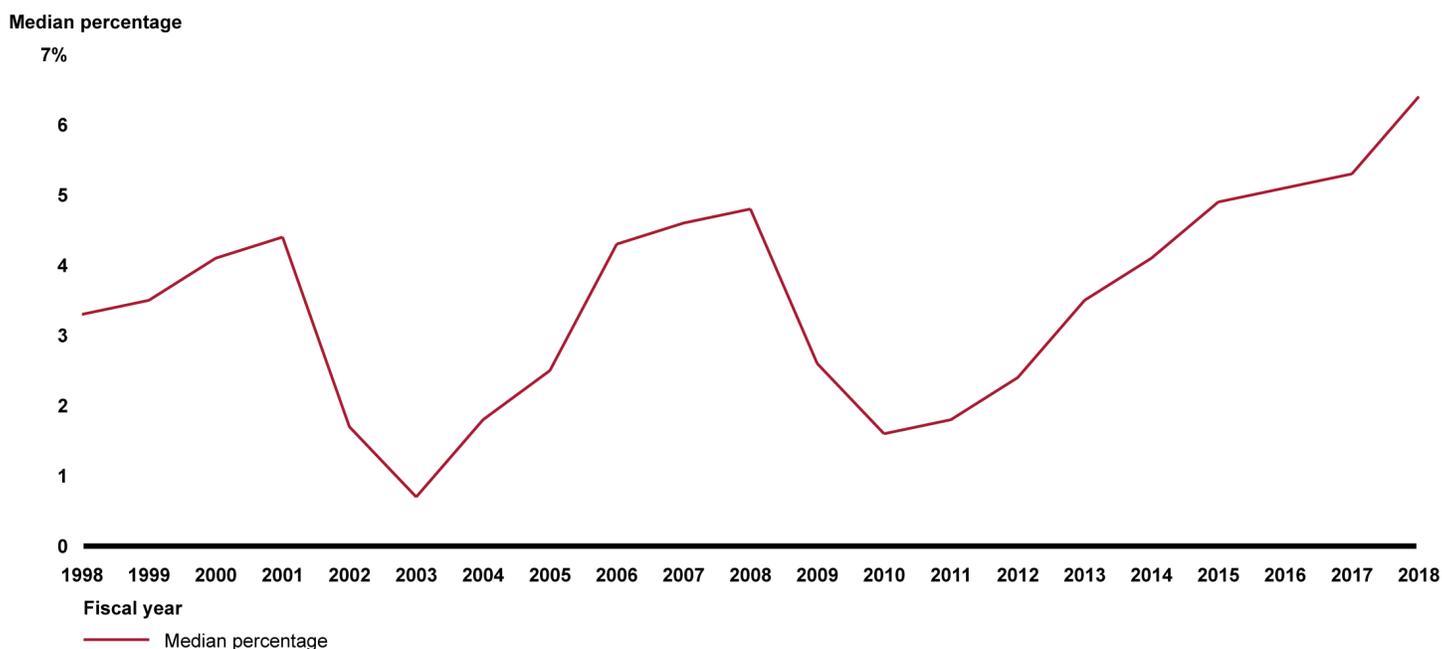
<sup>17</sup>A state's general fund refers to its operating budget.

<sup>18</sup>States have different requirements for reserve funds that determine the specific rules for use of those funds, including limits on the fund size, how deposits into the fund are made, and how funds are withdrawn.

Robust rainy day fund balances alone do not necessarily indicate strong fiscal positions, but they are one of the primary mechanisms available to states to offset a budget gap, along with spending reductions or tax increases. However, these funds will not necessarily relieve longer-term structural fiscal pressures.

Median state rainy day fund balances as a percentage of total general fund expenditures increased to their highest level in the last 20 years in 2018. Figure 6 shows that states' median rainy day fund balances increased from 1.6 percent of general fund expenditures in 2010 to 6.4 percent in 2018. Further, the median balance of state rainy day funds declined significantly after each of the last two recessions, while states gradually restored their balances each time.

**Figure 6: Median State Rainy Day Fund Balances as a Percentage of Total General Fund Expenditures, 1998 to 2018**

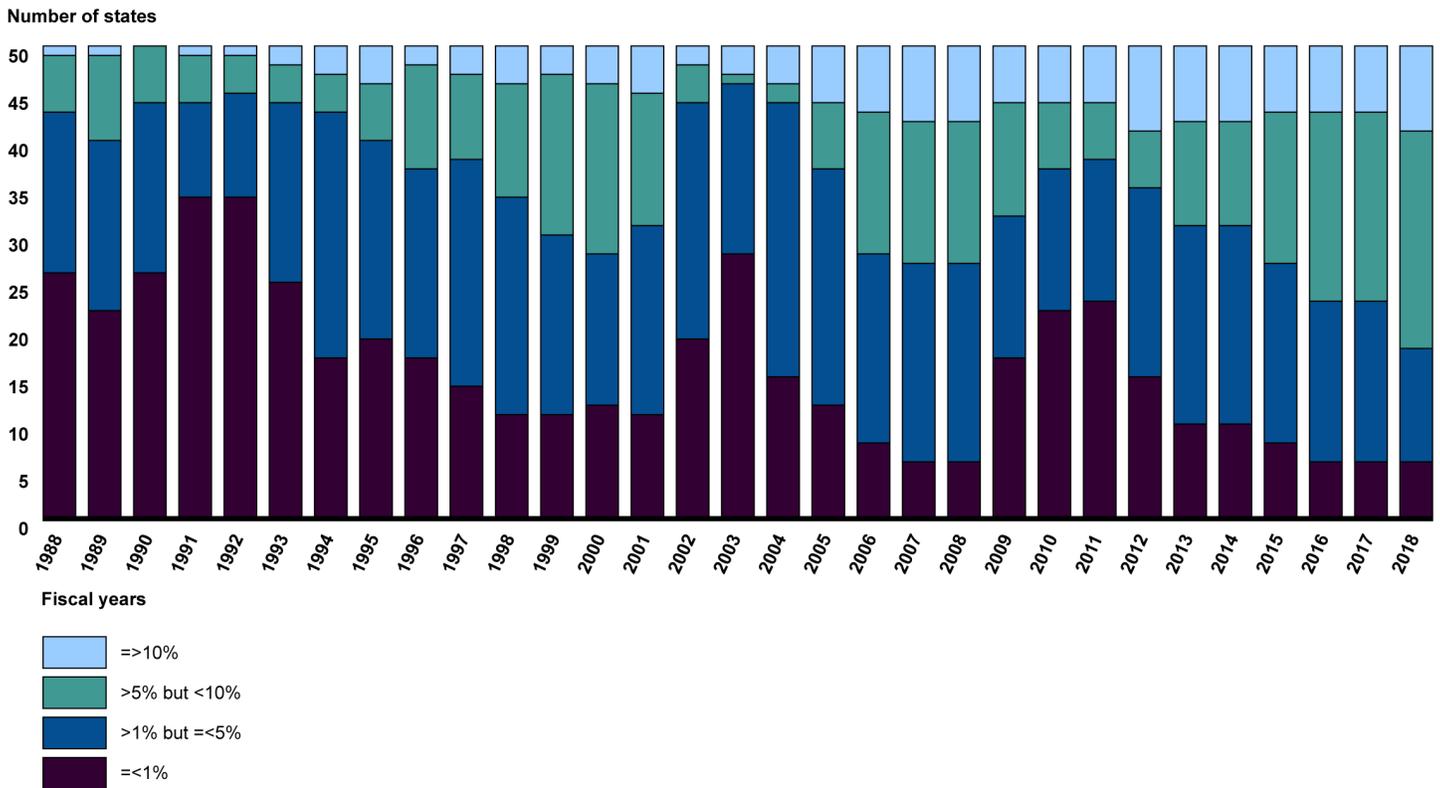


Source: GAO analysis of National Association of State Budget Officers data. | GAO-20-437

From 2016 to 2018, the majority of states maintained rainy day fund balances in excess of 5 percent of their general fund expenditures. The number of states with rainy day fund balances that exceeded 5 percent of their general fund expenditures doubled from 1998 to 2018, from 16 states in 1998 to 32 states in 2018 (see figure 7). Specifically, nearly half of the states maintained rainy day fund balances greater than 5 percent

and less than 10 percent of their general fund expenditures in 2018. Six states had rainy day fund balances equal to 1 percent or less of their general fund expenditures, down from 11 states in 1998.

**Figure 7: State Rainy Day Fund Balances as a Percentage of Total General Fund Expenditures, 1998 to 2018**



Source: GAO analysis of National Association of State Budget Officers data. | GAO - 20 - 437

## Experts Identified Federal Policies and Other Considerations That Affect State and Local Governments' Fiscal Conditions

Experts we interviewed identified a range of federal policies and other considerations that could affect the fiscal condition of state and local governments. While there are other issues that affect the state and local sector's fiscal condition, this section focuses on the issues that emerged most frequently during the interviews related to the effects of federal policies on the sector's fiscal condition, and the fiscal pressures facing states and localities that could require a federal policy response to ensure effective delivery of federal programs implemented by these

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governments. Those issues include: health care, federal budget uncertainty, physical infrastructure, tax policy, and natural disasters.<sup>19</sup>

**Health care.** Most experts agreed that health care costs and, in particular, Medicaid, have placed fiscal stress on state and local governments. A number of experts expressed concerns about the long-term sustainability of Medicaid and the states' ability to meet future demand, given current demographic trends and expectations for escalating enrollment. As we discussed earlier, Medicaid has been the fastest growing category of state spending and, based on our simulations, is expected to rise faster than GDP during the next 50 years.<sup>20</sup>

Some experts noted that growth in Medicaid affects states' fiscal conditions as it has become a larger portion of states' budgets. They pointed out that even though states have experienced a recent leveling off in Medicaid enrollment, states have also experienced a faster rate of growth in spending. Two experts attributed this growth largely to the aged and disabled enrollment groups that account for a larger share of program spending.

A number of experts said that states that expanded their Medicaid programs have seen the largest increases in enrollment—driven by adults who are newly eligible for the program. CMS's Office of the Actuary projected that Medicaid enrollment is expected to grow by as many as 13.3 million newly eligible adults by 2026—as additional states may expand their Medicaid programs to cover certain low-income adults under the Patient Protection and Affordable Care Act (PPACA).<sup>21</sup> The Congressional Budget Office also reported that Medicaid spending increased 36 percent from fiscal years 2015 to 2019, largely because of state Medicaid expansions.<sup>22</sup> As of January 2020, 36 states and the

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<sup>19</sup>The issues we present do not reflect the order with which experts raised these issues.

<sup>20</sup>[GAO-20-269SP](#).

<sup>21</sup>The Department of Health and Human Services, Centers for Medicare & Medicaid Services (CMS), Office of the Actuary, *2017 Actuarial Report on the Financial Outlook for Medicaid*, (Washington, D.C.: 2018). In this report, the CMS Chief Actuary stated that projections of health care costs are inherently uncertain. In particular, Medicaid projections are uncertain because enrollment and costs are very sensitive to economic conditions.

<sup>22</sup>As noted earlier, under PPACA, states have the option to expand their Medicaid programs to cover nearly all adults under 65 with incomes up to 133 percent of the federal poverty level.

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District of Columbia expanded eligibility for their Medicaid programs under PPACA.

Some experts noted that, while enrollment has grown for the expansion states, the federal government bears responsibility for a large portion of the costs. Specifically, the federal government reimbursed 100 percent of the costs of the expanded population beginning in 2014. The federal reimbursement then decreased to 94 percent in 2018, and to 90 percent in 2020. One expert told us that states had the benefit of anticipating the decrease in funding and the corresponding increase in the state share of the costs.

At the same time, a number of experts generally agreed that states are not financially positioned to meet the future demands of Medicaid during a recession or economic downturn, given projected increases in enrollment. In particular, experts pointed to the costs of recession-related Medicaid enrollment increases and the resulting fiscal pressures this would place on federal and state governments to fund Medicaid obligations. One expert shared concerns related to the uncertainty of federal funding should a recession occur.

Two experts also pointed to the pressures local governments, and more specifically, county governments, face from implementation of certain federal health care policies. Specifically, these experts pointed to the health care costs that county governments must incur as a result of local jails housing pretrial inmates who have medical needs and require treatment. Federal law prohibits the use of federal health benefits by inmates who are pending trial.<sup>23</sup> Thus, to the extent that an inmate cannot afford to pay the costs of health care services, counties must assume the related health care expenses for providing the necessary treatment for the inmate without reimbursement for those expenses.

**Federal budget uncertainty.** A number of experts told us that states continue to grapple with uncertainty stemming from unpredictability in the amount of federal assistance and timing of federal appropriations—including continuing resolutions and federal government shutdowns—and effects on states' ability to plan and implement programs.

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<sup>23</sup>Federal law generally prohibits states from obtaining federal Medicaid matching funds for health care services provided to inmates of public institutions during their period of incarceration.

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Some experts raised concerns related to the federal government's current fiscal condition and the potential effects on state and local governments. Specifically, experts noted that states are aware of the federal government's current fiscal condition—including federal debt and deficit levels—and the level of support the federal government may or may not choose to provide in the event of an economic downturn or recession, as it has during past recessions. In light of the uncertainty, some states have engaged in “stress tests” of their own budgets using various revenue and expenditure scenarios to determine if they are in sufficient fiscal health to weather a mild-to-severe recession.

Moody's Analytics reported in 2019 that, based on the results of stress tests it performed on all fifty states, 28 states have the level of cash reserves necessary to manage a moderate recession without having to raise taxes or cut spending.<sup>24</sup> Some experts further noted that state and local governments that have not been able to strengthen their cash reserves could undergo more severe fiscal stress in an economic downturn and require a greater level of assistance.

Some experts also raised concerns related to the effects of federal government shutdowns and continuing resolutions on state and local governments and their ability to plan for and implement federally-funded programs. In all but 4 of the last 42 years, Congress has passed continuing resolutions to keep government services in operation until an agreement is reached on final appropriations bills. In some years, when new appropriations or a continuing resolution have not been enacted on time, this lapse in appropriations—or funding gap—caused the government to partially shut down, which halted some activities at federal agencies until appropriations were passed.

A number of experts told us that interruptions in appropriations and subsequent delays in federal grants caused by shutdowns, for example, may require states to spend additional unbudgeted funds to ensure continuity of services in certain federally-funded programs, such as food and nutrition and transportation. According to one expert, not all state or local governments are in a position to access those funds in a timely manner. Furthermore, one expert noted the impacts of continuing resolutions on local governments by compressing the time available for federal grant applications. As a result, some applicants (e.g., cities or

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<sup>24</sup>In conducting these stress tests, Moody's Analytics estimated the amount of fiscal stress likely to be applied to state budgets under different recession scenarios and compared that stress to the amount of funds that states have set aside in reserves.

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other localities) may not apply or miss deadlines for certain federal grant programs.

We and others have reported on the effects of government shutdowns and its impact on some states. For example, we reported on the partial shutdown of the federal government in October 2013, which lasted for a period of 16 days due to a lapse in appropriations.<sup>25</sup> Our report showed that even if a state wanted to use its funds to continue services for a federally-funded program, it might not have had sufficient liquid assets to do so quickly.

At that time, at least 12 states publicly reported that funding for certain grant programs was only confirmed through October, meaning the funding may not have been available if the shutdown had continued into November. Some of these states expected to discontinue certain federally-funded programs or services if the shutdown had extended into November, while others expressed uncertainty regarding how they would have proceeded if the shutdown had been longer.

**Physical infrastructure.** Physical infrastructure at the state and local government level includes a broad range of systems—including highways, mass transit, rail, water, and sewer systems. A number of experts pointed to concerns related to an aging infrastructure and the fiscal pressures that infrastructure demands place on state and local governments. The cost of repairing and upgrading the nation’s surface transportation infrastructure to meet current and future demands is estimated in the hundreds of billions of dollars.<sup>26</sup> Further, our 2017 report noted that estimates from the Environmental Protection Agency put drinking water and wastewater infrastructure needs at approximately \$655 billion nationwide during the next 20 years.<sup>27</sup>

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<sup>25</sup>For additional information, see GAO, *2013 Government Shutdown: Three Departments Reported Varying Degrees of Impacts on Operations, Grants, and Contracts*, [GAO-15-86](#) (Washington, D.C.: Oct. 15, 2014).

<sup>26</sup>For additional information, see GAO, *High-Risk Series: Substantial Efforts Needed to Achieve Greater Progress on High-Risk Areas*, [GAO-19-157SP](#) (Washington, D.C.: Mar. 6, 2019).

<sup>27</sup>For additional information, see GAO, *Drinking Water and Wastewater Infrastructure: Information on Identified Needs, Planning for Future Conditions, and Coordination of Project Funding*, [GAO-17-559](#) (Washington, D.C.: Sept. 20, 2017).

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State and local governments own a large portion of the nation's physical infrastructure, while the federal government provides support to the sector in the form of grants, bonds, and loans. Funds made available from the Highway Trust Fund are distributed to states in the form of grants for eligible projects. The federal government also supports additional infrastructure spending through tax-exempt or tax-credit bonds, which provide a tax exclusion or tax credit to owners of municipal bonds issued by state and local governments.<sup>28</sup> Further, through various loan programs, such as the Transportation Infrastructure Finance and Innovation Act program, the government supports project financing.<sup>29</sup> State and local governments also generate revenues for transportation projects through their own sources including user fees and taxes.

A number of experts shared concerns about the future of federal funding for state and local surface transportation needs. One expert acknowledged the benefits of highway grant programs provided through the Fixing America's Surface Transportation Act. However, this expert also recognized that the act is set to expire in 2020 and its future, along with other sources of federal funding through the Highway Trust Fund, remains uncertain.<sup>30</sup> We have also reported that traditional federal funding sources for surface transportation, such as the Highway Trust Fund, are eroding and the federal government lacks a long-term sustainable strategy for funding surface transportation.<sup>31</sup>

Moreover, experts noted that physical infrastructure needs represent only one among many competing priorities for state and local government spending. One expert expressed concern that the availability of state and local discretionary spending on infrastructure needs and maintenance will increasingly be affected by growing pressures from other mandatory spending categories, such as Medicaid.

Many states have looked to modify or enhance other sources of revenue, such as the gas tax, to help meet highway transportation costs. According to the National Conference of State Legislatures (NCSL), since 2013, 31

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<sup>28</sup>For example, with a tax-exempt bond, the federal government exempts income from the interest earned on these bonds from federal income tax. With a tax-credit bond, state and local governments issue debt that provides a federal tax credit or a federal payment to the issuer or bondholder.

<sup>29</sup>23 U.S.C. §§ 601–610.

<sup>30</sup>Pub. L. No. 114-94, 129 Stat. 1312, 1614 (2015).

<sup>31</sup>[GAO-19-157SP](#).

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states and the District of Columbia have enacted legislation that will or may increase their motor fuel tax to support surface transportation costs. Even so, two experts raised concerns about the viability of the gas tax as a reliable revenue source since gasoline consumption has declined. Further, NCSL reported that many states have received federal funding to study and pilot user-based alternative mechanisms through the Surface Transportation System Funding Alternative Program.

We and others have also reported that some states have recognized the need for an alternative funding mechanism to meet future revenue demands. Some options that states have considered or implemented include tying gas tax rates to inflation or population, taxes based on the price of fuel, and taxing miles traveled instead of gas purchased—also referred to as mileage-based user fees.<sup>32</sup>

Further, experts pointed to the lack of a clearly articulated federal highway infrastructure policy and the implications for state and local governments. For example, one expert noted that states need the ability to plan multiyear programs for large-scale transportation projects and that an open dialogue about federal program implementation or renewal with all three levels of government could help state and local governments better plan for the future. This expert added that the uncertainty that state and local governments experience could be reduced if the federal government could better inform and communicate with state and local governments regarding legislative policy developments and was willing to engage in conversations with state and local governments.

**Tax policy.** Experts discussed selected provisions of the law commonly known as the Tax Cuts and Jobs Act (TCJA) and other tax-related issues that could exacerbate or help ease fiscal pressures for state and local governments. Enacted in December 2017, TCJA included significant changes to corporate and individual tax law, with implications for state and local government tax collections.<sup>33</sup> In particular, for individual taxpayers, for tax years 2018 through 2025, tax rates were lowered for nearly all income levels, some deductions from taxable income were changed (personal exemptions were eliminated, while the standard

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<sup>32</sup>For additional information, see GAO, *Highway Trust Fund: Pilot Program Could Help Determine Viability of Mileage Fees for Certain Vehicles*, [GAO-13-77](#) (Washington, D.C., Dec. 13, 2012).

<sup>33</sup>Pub. L. No. 115-97, 131 Stat. 2054 (2017).

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deduction was increased), and certain credits, such as the child tax credit, were expanded.

A number of experts agreed that with just over 2 years since its passage, it is still too early to fully assess the effect of TCJA's provisions on state and local government revenues. States are continuing to incorporate some of the provisions of TCJA into their own tax codes. Some states have adopted the federal definition of taxable income as a starting point for state tax calculations, while other states use the federal definition of adjusted gross income as a starting point. The choices states make regarding their linkage to these definitions have implications for their state tax revenues.

Further, because TCJA placed a \$10,000 annual cap on the federal deduction for taxpayers' state and local taxes (SALT) from taxable income beginning on January 1, 2018, some high-income taxpayers prepaid their personal income and property taxes to take advantage of the uncapped SALT deduction in 2017.<sup>34</sup> As a result, some states experienced an increase in revenues in late 2017. According to S&P Global Ratings, the imposition of SALT caps incentivized many taxpayers to accelerate their income tax payments into December 2017, but consequently made December 2018 tax payments look smaller by comparison. It also further reduced December 2018 payments by lessening the incentive for many taxpayers to make early income tax payments.

Most experts raised the TCJA's elimination of advance refunding for tax-exempt municipal bonds as a potential source of fiscal stress for the state and local government sector. State and local governments use these tax-exempt bonds to finance a broad range of projects and activities, including public infrastructure. Prior to its elimination, the provision allowed state and local governments to take advantage of favorable interest rates to reduce borrowing costs, restructure debt, and free up resources for other projects or investments. A number of experts explained that the elimination of the provision could result in increasing project costs—ultimately increasing infrastructure and debt costs over time.

Some experts highlighted overall concerns about states' eroding sales tax base. For example, the country has transitioned to a more service-based

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<sup>34</sup>26 U.S.C. § 164(b)(6).

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economy, due to changes in consumption. As services have begun to represent a larger and growing share of GDP, there has been an erosion of states' sales tax bases.

In contrast, a number of experts pointed to the outcome of the U.S. Supreme Court's ruling in *South Dakota v. Wayfair, Inc.* and its potential for stimulating growth in sales tax revenue.<sup>35</sup> The Court in *South Dakota v. Wayfair, Inc.* held that states could require out-of-state sellers to collect and remit sales taxes on purchases made from those out-of-state sellers, even if the seller does not have a substantial physical presence in the taxing state. A number of experts noted that remote sales taxes will likely increase state and local sales tax revenues, but that states are still realizing the effects of the ruling on their revenues.<sup>36</sup>

Following the U.S. Supreme Court's decision, numerous states that levy a sales tax and the District of Columbia have taken some kind of action to enforce remote sales tax collections. According to NCSL, as of January 2020, 43 states and the District of Columbia currently require remote sales tax collection. Some states have taken legislative action to change their state laws in response to the outcome of the *Wayfair* case, while some collection efforts have been led by departments of revenue if statutory authority was already provided. However, it is too soon to determine the full effects of the *Wayfair* case on states' sales tax revenue.

**Natural disasters.** A number of experts pointed to the increasing fiscal pressure that state and local governments are under and will continue to face, given the increasing frequency, severity, and cost of natural disasters. We and others have reported on the increasing trend in the number of natural disasters and related costs. For example, in 2018 alone, there were 14 weather and climate disaster events with losses exceeding \$1 billion each across the United States with total costs of at least \$91 billion, according to the National Oceanic and Atmospheric

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<sup>35</sup>*South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).

<sup>36</sup>In 2017, we reported that states could realize between an estimated \$8.5 billion and \$13.4 billion in additional state sales tax revenue across all states if all sellers were required to collect taxes on all remote sales at current rates. For additional information, see GAO, *Sales Taxes: States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs*, [GAO-18-114](#) (Washington, D.C.: Nov. 16, 2017).

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Administration.<sup>37</sup> Further, disaster costs are projected to increase as extreme weather events become more frequent and intense because of climate change as observed and projected by the U.S. Global Change Research Program and the National Academies.

A number of experts acknowledged that the federal government plays a critical role in providing disaster assistance to state and local governments and stressed the need for continued financial support. Some experts discussed the importance of federal assistance since states may need to pay for immediate disaster costs, such as debris removal, out of current expenditures and may not have the funds available to cover those costs. Local governments in particular are generally the first responders in the event of a disaster, often times using their own personnel and funding in these circumstances.

Some experts noted that these localities and communities may lack the available cash reserves needed for disaster response-related resources, such as public safety overtime and other types of public assistance. One expert underscored the federal government's role as an economic stabilizer in providing assistance to local governments during disasters.

Given the increase in federal disaster spending, we and others have underscored the importance of finding ways to address the growing costs of natural disasters, citing investment in mitigation as one approach. Some experts we interviewed also pointed to the importance of states' adoption of mitigation strategies as a way to help states and localities reduce the environmental and fiscal effects of natural disasters. For example, the Pew Charitable Trusts reported in 2020 that a number of states and localities are looking to invest in infrastructure projects that will help mitigate the potential effects of disasters before they occur.

For example, according to Pew Charitable Trusts, one state plans to limit development and move residents out of areas most prone to flooding, while improving infrastructure in communities on higher ground that are likely to receive displaced populations from neighboring towns. Another state plans to invest its federal funds in flood control, removing homes from high-risk areas and helping local governments pay for projects. Further, one locality plans to spend \$500 million on infrastructure

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<sup>37</sup>NOAA National Centers for Environmental Information, U.S. Billion-Dollar Weather and Climate Disasters (2019). See also <https://www.ncdc.noaa.gov/billions/time-series>, accessed June 3, 2019.

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upgrades over the next few years, after its residents voted to authorize a bond to address flooding and other concerns.

Further, one expert stressed the importance of the Disaster Recovery Reform Act of 2018 (DRRA) in developing state and local mitigation programs, in addition to strengthening federal, state, and local relationships in disaster response and recovery efforts.<sup>38</sup> Among other things, the act increases the federal investment in predisaster mitigation, increases reimbursement caps for state and local governments on a range of disaster costs, and allows state and local governments to administer housing assistance grants. We reported in 2019 that it is too early to tell what effect implementation of DRRA will have on state and local resilience.<sup>39</sup>

In addition, economic literature we reviewed highlighted the potential long-term implications of natural disasters and climate change on state and local governments' municipal bond ratings. For example, credit rating firms—Fitch Ratings, Moody's Investors Service, and S&P Global Ratings—indicated that they are considering the effects of climate change in their credit analyses of state and local governments. Specifically, S&P Global Ratings has identified risk factors related to the environment, among other credit risk factors, such as extreme weather events and flooding that can affect an issuer's ability to meet full and timely debt service.<sup>40</sup>

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We are sending copies of this report to the appropriate congressional committees and other interested parties. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

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<sup>38</sup>Pub. L. No. 115-254, div. D, 132 Stat. 3186, 3438-70 (2018). The law created a federal funding stream known as BRIC (Building Resilient Infrastructure and Communities) by setting aside up to 6 percent of estimated disaster expenses. The funds will be available to state, local, tribal, and territorial entities on a competitive basis for use on mitigation and resilience projects before a disaster strikes.

<sup>39</sup>See GAO, *Climate Change: Opportunities to Reduce Federal Fiscal Exposure*, [GAO-19-625T](#) (Washington, D.C.: June 11, 2019).

<sup>40</sup>All three agencies indicated that their methodologies for assessing state and local governments do not explicitly address climate change as a credit risk. For example, Moody's Investors Service indicated that the challenges that climate change pose are captured in its analysis of credit factors, such as economic strength and diversity, capital asset management, fiscal strength and governance, among others.

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If you or your staff members have any questions about this report, please contact me at (202) 512-6806 or [sagerm@gao.gov](mailto:sagerm@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix II.

A handwritten signature in black ink that reads "Michelle Sager". The signature is written in a cursive, flowing style.

Michelle Sager  
Director, Strategic Issues

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# Appendix I: Objectives, Scope, and Methodology

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This report examines fiscal pressures for state and local governments. Specifically, the objectives of our review were to (1) examine recent trends in state and local government expenditures and revenues; and (2) synthesize expert views regarding the effect of federal policy on state and local government fiscal pressures.

To describe recent trends in state and local government expenditures and revenues, we analyzed categories of aggregate data on state and local expenditures and revenues using inflation-adjusted data from the Bureau of Economic Analysis's (BEA) National Income and Product Accounts (NIPA) from 1998 to 2018.<sup>1</sup> We analyzed changes in the shares of state and local expenditures and revenues as a percent of total expenditures and revenues respectively from 1998 to 2018. We determined that the NIPA data were the most recent available data for the purpose of examining aggregate state and local government revenue and expenditure trends. The NIPA data do not always match state and local government budget data due to methodological differences between how BEA calculates NIPA data and how state and local governments compute their budget data. We also reviewed our prior reports and those of others to identify what is known about these trends and the factors that affect them.

To analyze trends in state and local government revenues and expenditures among states, we used the U.S. Census Bureau (Bureau) government finance data and gross domestic product (GDP) price index data from BEA to calculate inflation-adjusted values of selected expenditure and revenue categories for each state (including the District of Columbia) and for the United States for 1997 to 2017.<sup>2</sup> Data for 1997, 2002, 2007, 2012, and 2017 are based on the Bureau's *Census of Governments*, which surveys all state and local governments in the United States. Data for the other years are based on the Bureau's *Annual Survey of Government Finances*. In these years, local government finance statistics are based in part on a sample of local governments in the United States. We determined that the Bureau's data were the most comprehensive for the purpose of examining trends in state and local

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<sup>1</sup>National Income and Product Accounts data from 1998 to 2018 were the most recent 20 years of data for all data categories.

<sup>2</sup>Census Bureau data from 1997 to 2017 were the most recent 20 years of data available for all data categories.

government expenditures and revenues.<sup>3</sup> However, due in part to definitional differences among the states, such as those of coverage (what constitutes a government entity) or measurement (cash or accrual accounting), the data cannot be used as financial statements to measure a government's fiscal condition or to calculate a surplus or deficit. We assessed the reliability of the data we used for this analysis and determined that BEA NIPA and the Bureau's data were sufficiently reliable for our purposes. Our data reliability assessment included reviewing relevant documentation, interviewing knowledgeable BEA and Bureau officials, and reviewing the data to identify obvious errors or outliers.

We examined patterns between state and local government revenue growth and growth in overall state and local government spending using data from the Bureau. For each state and the District of Columbia, we assessed how fast each expenditure and revenue category grew between 1997 and 2017 and calculated the average annualized growth rate based on year-to-year changes for each selected expenditure and revenue category. For each expenditure and revenue growth rate calculation, we identified the U.S. average annualized growth rate and the minimum and maximum growth rates across states.

Because changes in the levels of expenditure and revenue categories can be affected by changes in state fiscal capacity—such as increased tax revenues due to population growth—we compared the average annual compound growth rate for each category of spending and revenues to the average annual compound growth rate in state gross domestic product (GDP). We chose state GDP as a proxy for each state's resources or fiscal capacity. We determined state GDP to be the most appropriate representation of a state's total resources or fiscal capacity. To compare the growth in these categories relative to growth in each state's resources, we compared the growth rate for each selected expenditure and revenue category to the growth rate in each state's GDP resources from 1997 to 2017. When expenditures in a state are growing faster than GDP, the share of the state's resources that are dedicated to state and local government services is growing. Over the long run, such growth could create a fiscal pressure. This analysis also identified the

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<sup>3</sup>GAO, *State and Local Governments: Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs*, [GAO-10-899](#) (Washington, D.C.: July 30, 2010).

number of states where growth in a category was (1) greater than GDP for that state or (2) less than GDP for that state.

We also examined patterns between state and local revenue growth and growth in state and local spending and federal grants using data from the Bureau. For each state and the District of Columbia, we plotted the average annual growth rate in general revenues against the average annual growth rate in general expenditures from 1997 to 2017. We then counted the number of states in which spending grew faster, slower, and at the same rate as general revenues. We also analyzed growth in own-source revenues against growth in federal grant revenues using the same approach. We then counted the number of states in which own-source revenue grew faster, slower, and at the same rate as federal grants.

To identify expenditure categories in the Bureau's data, we selected all of the Bureau's general expenditure categories. We included other expenditure categories, such as *interest on debt and salaries and wages* to document their low growth rates. We included *insurance benefits and repayments* because of its high growth rate and its inclusion of pension benefits, which experts identified as a growing expense in some states.

As part of our analysis of trends in state and local government expenditures, we analyzed data from the National Association of State Budget Officers (NASBO) on state rainy day fund balances and general fund expenditures. NASBO's *Fiscal Survey of States* surveys state budget officers in 50 states on general fund receipts, expenditures, annual tax and revenue changes, and balance data, which includes rainy day fund balances. We calculated state rainy day fund balances as a percentage of state general fund expenditures among states from 1998 to 2018. We then plotted the median state rainy day fund balances for each year from 1998 to 2018. We assessed the reliability of the data we used for this analysis and determined that NASBO's data were sufficiently reliable for our purposes. Our data reliability assessment included reviewing relevant documentation and consulting knowledgeable officials about the data.

To obtain expert views regarding the effect of federal policy on state and local government fiscal pressures, we conducted a series of structured interviews by telephone or in person with a nongeneralizable sample of individuals representing organizations with recognized expertise in state and local budgeting and finance economics, public policy, and intergovernmental issues. To select these experts, we reviewed their published or other publicly available work, professional affiliations, or

recommendations by other experts. These considerations informed whether the experts we selected would be knowledgeable or have expertise related to state and local government fiscal and intergovernmental issues. We identified three categories of experts and selected individuals within each category. These three categories included: (1) officials representing state and local government organizations; (2) providers of financial and credit risk information, such as credit rating agencies; and (3) researchers representing think tanks with expertise in state and local government finance, including taxes, budgeting, and intergovernmental relations. We spoke with representatives from the following 17 organizations as part of our structured interviews:

1. The Council of State Governments
2. Federal Funds Information for States
3. Fitch Ratings
4. International City/County Management Association
5. Moody's Analytics
6. National Association of Counties
7. National Association of State Auditors, Comptrollers, and Treasurers
8. National Association of State Budget Officers
9. National Conference of State Legislatures
10. National Governors Association
11. National League of Cities
12. Pew Charitable Trusts
13. S&P Global Ratings
14. Tax Foundation
15. Urban-Brookings Tax Policy Center
16. The United States Conference of Mayors
17. Volcker Alliance

The results from the structured interviews are not generalizable and represent the opinions of the individuals from the 17 organizations we interviewed. However, we took steps to obtain opinions from experts with different types of expertise and perspectives. For each question in the structured interview, we coded, organized, and analyzed the responses to

develop common themes among the responses, based on the issues that emerged most frequently. We use the terms “a number of,” “some,” and “most” to describe the number of experts who responded on a particular issue. We defined “a number of” or “some” as three or more experts and “most” as nine or more experts. To provide context on these themes and supplement our understanding of this information, we reviewed related research, literature from those interviewed and other organizations, including ourselves, and included relevant examples as appropriate.

We conducted this performance audit from January 2019 to March 2020 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.

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# Appendix II: GAO Contact and Staff Acknowledgments

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## GAO Contact

Michelle Sager, (202) 512-6806 or [sagerm@gao.gov](mailto:sagerm@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, Brenda Rabinowitz (Assistant Director), Keith O'Brien (Analyst-in-Charge), Colin Ashwood, and Dylan Stagner made key contributions to this report. David Dornisch, J. Andrew Howard, Courtney LaFountain, Silda Nikaj, Robert Robinson, Ardith Spence, and Frank Todisco also provided support.

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