

STATE AND LOCAL GOVERNMENTS' FISCAL OUTLOOK

April 2013 Update

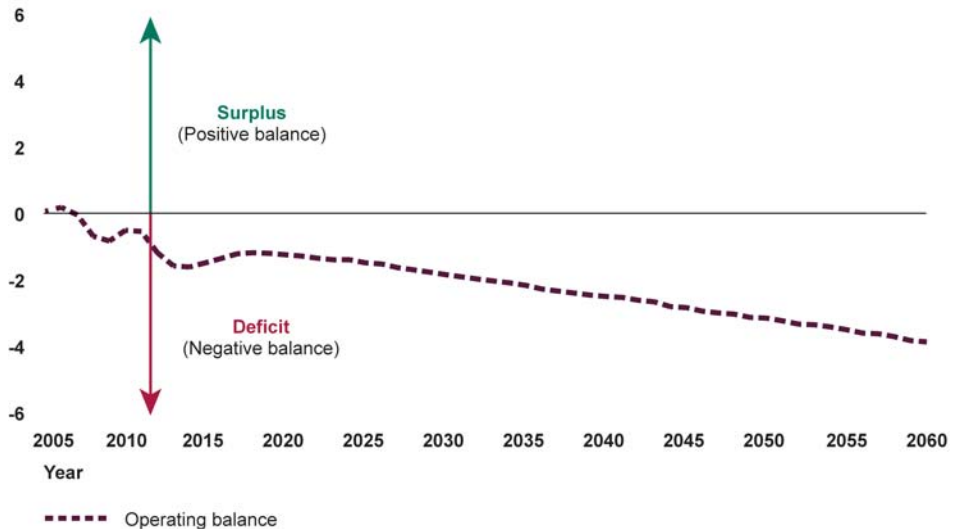
GAO's State and Local Fiscal Simulations

Fiscal sustainability presents a national challenge shared by all levels of government. Since 2007, GAO has published long-term fiscal simulations for the state and local government sector. These simulations have consistently shown that, like the federal government, the state and local sector faces persistent and long-term fiscal pressures and, absent any policy changes, would face an increasing gap between receipts and expenditures in future years.

Using the Bureau of Economic Analysis's (BEA) National Income and Product Accounts (NIPA) as the primary data source, GAO's model shows the level of receipts and expenditures for the sector until 2060 based on current and historical spending and revenue patterns. The model assumes that the current set of policies in place across state and local government remains constant to show their impact on future fiscal outcomes. The model simulates the long-term fiscal outlook for the state and local sector and incorporates the Congressional Budget Office's (CBO) economic projections. These projections capture near-term cyclical swings in the economy. Because the model covers the sector in the aggregate, the fiscal outcomes for individual states and localities cannot be captured. This product is part of a body of work on the nation's long-term fiscal challenges. Related products can be found at www.gao.gov/special.pubs/longterm/. For more information, contact Stanley J. Czerwinski at (202) 512-6806 or czerwinski@gao.gov or Thomas J. McCool at (202) 512-2700 or mccoolt@gao.gov.

The state and local government sector continues to face near-term and long-term fiscal challenges which add to the nation's overall fiscal challenges. As shown in figure 1, the state and local sector faces a gap between revenue and spending and long-term fiscal challenges that grow over time. The model's simulation shows that the fiscal position of the sector will steadily decline through 2060 absent any policy changes.¹

Figure 1: State and Local Operating Balance Measure, as a Percentage of Gross Domestic Product (GDP)
Percentage of GDP



Source: GAO simulations, updated April 2013.

Notes: Historical data are from BEA's National Income and Product Accounts. Data in 2012 are GAO estimates aligned with published data where available. GAO's simulations are from 2013 to 2060, using many CBO projections and assumptions, particularly for the next 10 years.

The operating balance is a measure of the sector's ability to cover its current expenditures out of current receipts. The operating balance measure is all receipts, excluding funds used for long-term investments, minus current expenditures. To develop this measure, GAO subtracts funds used to finance longer-term projects—such as investments in buildings and roads—from receipts since these funds would not be available to cover current expenses. Similarly, GAO excludes capital-related expenditures from spending. While most states have requirements related to balancing their budgets, deficits might arise because of unanticipated events such as recessions. These cyclical deficits can occur because the planned annual revenues are not generated at the expected rate, demand for services exceeds planned expenditures, or both, resulting in a near-term or cyclical operating deficit. States have tapped fiscal reserves to cope with revenue shortfalls during recent recessions, as indicated by their reported total balances, which are comprised of general fund ending balances and amounts in state budget stabilization "rainy day" funds. Figure 1 depicts the state and local operating balance only, and does not include fiscal reserves or other budget measures used to cope with revenue shortfalls.

¹The simulation assumes that the tax structure is unchanged in the future and that the provision of real government services per capita remains relatively constant.

In the near-term, the state and local government sector has seen an increase in tax receipts following the decline during 2008 and into 2009. Specifically, from the second quarter of 2009 to the third quarter of 2012, total tax receipts, increased more than 12 percent in nominal dollars, returning to prerecession levels of early 2008. Income and sales taxes accounted for most of the growth, increasing more than 22 percent and just over 14 percent in nominal dollars, respectively, during the same period. However, property tax receipts grew at a slower rate, increasing less than 2 percent from the third quarter of 2011 to the third quarter of 2012, as real estate values remained depressed. In nominal dollar terms, total tax receipts have returned to their prerecession highs following declines that started in 2008, and slowly increasing tax receipts are a sign of improvement in the state and local sector's fiscal situation. However, as a percentage of gross domestic product (GDP), our model estimates that total tax revenues for the sector, in the long term, will remain below the 2007 historical high through 2060 due to the projected modest growth in receipts. In addition, as most outlays from the American Recovery and Reinvestment Act of 2009 (Recovery Act) have already occurred, the state and local government sector will continue to adjust to a reduced level of federal assistance from that provided by the Recovery Act.² While this April 2013 update to our model incorporates these near-term changes for both revenues and expenditures, it focuses primarily on the long-term fiscal outlook for state and local governments as a sector.

In the long term, the decline in the sector's operating balance is primarily driven by the rising health-related costs of state and local expenditures on Medicaid and the cost of health care compensation for state and local government employees and retirees. Since most state and local governments are required to balance their operating budgets, the declining fiscal conditions shown in our simulations continue to suggest that the sector would need to make substantial policy changes to avoid growing fiscal imbalances in the future. That is, absent any intervention or policy changes, state and local governments would face an increasing gap between receipts and expenditures in the coming years.

² Pub. L. No. 111-5, 123 Stat. 115 (Feb. 17, 2009).

Substantial Policy Changes Required in the State and Local Government Sector to Maintain Fiscal Balance over the Long Term

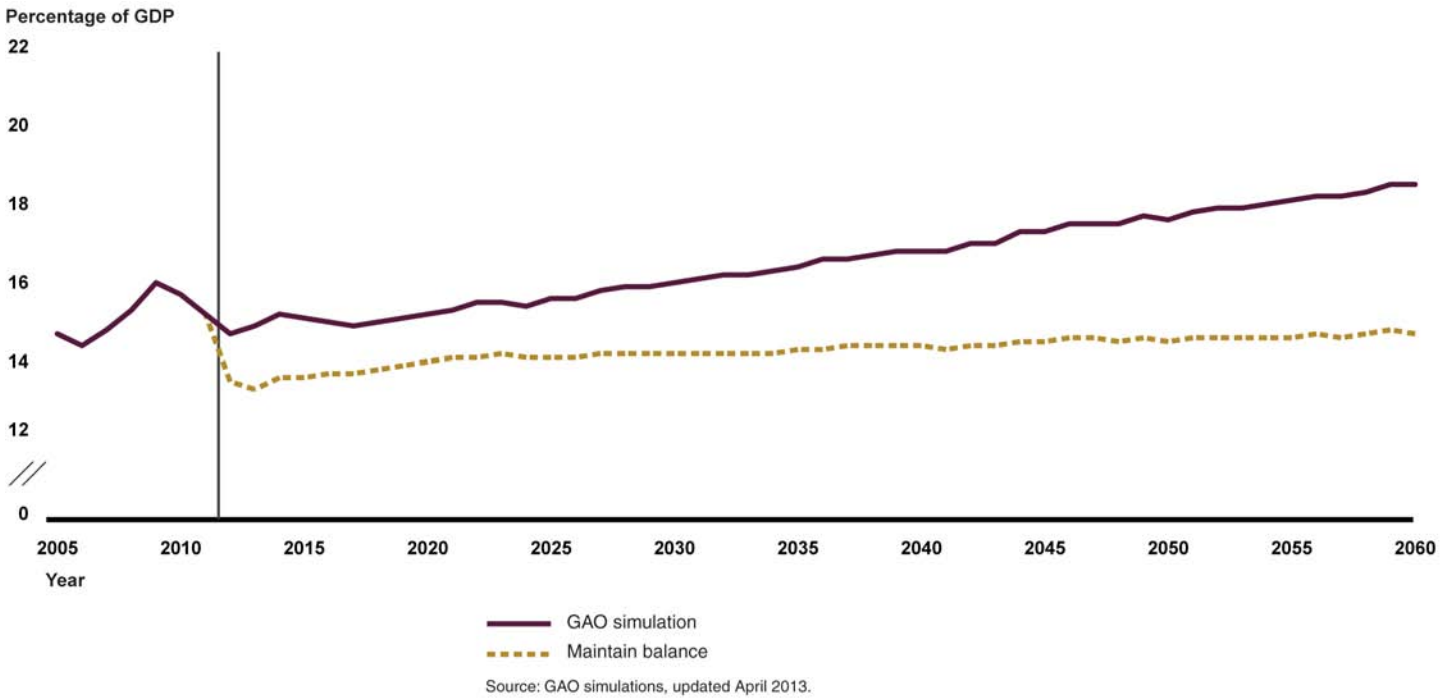
One way of measuring the long-term fiscal challenges faced by the state and local government sector is through a measure known as the “fiscal gap.”³ The fiscal gap is an estimate of the action needed today and maintained for each year to achieve fiscal balance over the next 50 years. We measured the gap as the amount of the spending reductions or tax increases needed to prevent operating deficits (or negative operating balances). As shown in figure 2, under our simulation, expenditures rise considerably as a percentage of GDP over the simulation time frame.⁴ In contrast, maintaining balance solely through spending restraint would require holding expenditure growth to a much lower rate than the simulation, which assumes that current policies will remain constant. We calculated that closing the fiscal gap would require action to be taken today and maintained for each year equivalent to a 14.2 percent reduction in the state and local government sector’s current expenditures. Closing the fiscal gap solely through a revenue increase would require action on that side of similar magnitude. More likely, closing the fiscal gap would involve some combination of both expenditure reductions and revenue increases.⁵

³ The fiscal gap for the state and local model is calculated for the years 2014 to 2063. We also calculated the fiscal gap for our federal model for fiscal years 2013 through 2087—see GAO, *The Federal Government’s Long-Term Fiscal Outlook, Spring 2013 Update*, GAO-13-481SP, (Washington, D.C.: Apr. 11, 2013). However, the fiscal target in the state and local gap calculation is an annual balanced operating budget, while the fiscal target in the federal model’s fiscal gap calculation is a specified debt level at the end of the federal model’s 75 year simulation period.

⁴ As noted earlier, in our simulation, we assumed that the tax structure does not change in the future and that the provision of real government services per capita remains roughly constant.

⁵ The “maintain balance” spending path shown in figure 2 is only illustrative. Our model assumes no economic effects from closing the state and local fiscal gap. Because abrupt spending declines or tax increases would likely have negative effects on both state and local governments and the economy as a whole, the adjustments needed to achieve fiscal balance would likely need to be adopted gradually.

Figure 2: State and Local Government Action Required to Maintain Balance (Expenditures, as a Percentage of Gross Domestic Product—GDP)



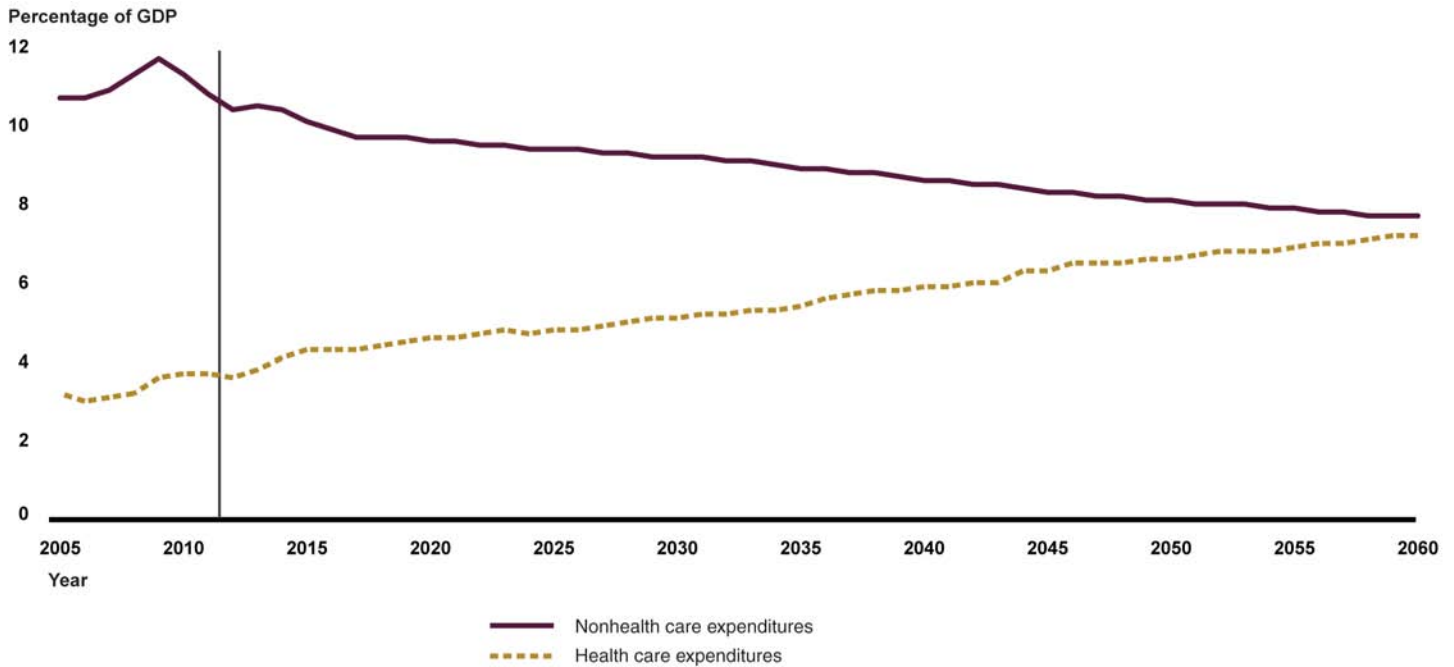
Note: Historical data are from the Bureau of Economic Analysis's (BEA) National Income and Product Accounts (NIPA). Data in 2012 are our estimates aligned with published data where available. Our simulations are from 2013 to 2060, using many CBO projections and assumptions, particularly for the next 10 years.

State and Local Governments Continue to Face Long-Term Fiscal Challenges from Estimated Growth in Health-Related Costs

The primary driver of fiscal challenges for the state and local government sector in the long term continues to be the projected growth in health-related costs. Specifically, state and local expenditures on Medicaid and the cost of health care compensation for state and local government employees and retirees are projected to grow more than GDP.⁶ The model's simulations show that the sector's health-related costs will be about 3.8 percent of GDP in 2013 and 7.2 percent of GDP in 2060. In contrast, our model shows that other types of state and local government expenditures—such as wages and salaries of state and local workers—are expected to decline as a percentage of GDP. The model projects that the sector's non-health-related costs will be about 10.5 percent of GDP in 2013 and about 7.7 percent of GDP in 2060. Our simulations for health-related and other expenditures are shown in figure 3.

⁶ The health-related cost growth assumption in our model includes adjustments in response to the March 2010 passage of the Patient Protection and Affordable Care Act (PPACA). Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010). Our model assumes health care excess cost growth of about 0.8 percent, which is based on national health care expenditure projections consistent with the Medicare Board of Trustees 2012 report's intermediate assumptions.

Figure 3: Health and Nonhealth Expenditures of State and Local Governments, as a Percentage of Gross Domestic Product (GDP)



Source: GAO simulations, updated April 2013.

Note: Historical data are from the Bureau of Economic Analysis's (BEA) National Income and Product Accounts (NIPA). Data in 2011 are our estimates aligned with published data where available. Our simulations are from 2013 to 2060, using many CBO projections and assumptions, particularly for the next 10 years.

With regard to revenue growth over the long term, our simulations show that, excluding Medicaid grants from the federal government, state and local sector revenues, which include non-Medicaid federal grants, are projected to decrease as a percentage of GDP. In addition, while our model projects that property tax receipts will gradually increase from 2.86 percent of GDP in 2013 to 3 percent around 2060, state and local property tax revenues will not reach their 2009 peak level of 3.09 percent of GDP until sometime after 2060. This reflects the general downward trend in real estate values and property tax assessments in recent years.

Declines in state and local pension asset values stemming from the 2007 to 2009 economic recession could also affect the sector's long-term fiscal position. Pension asset values increased by almost 22 percent, from \$2.3 trillion at the end of 2008 to \$2.8 trillion at the end of 2011. However, as of 2011, values have not recovered to match or exceed the 2007 value of \$3.2 trillion. Furthermore, pension asset values varied throughout 2011, ending the year approximately \$82 billion below the fourth quarter 2010

value. In our prior work, we reported that while most state and local government pension plans have assets sufficient to cover benefit payments to retirees for a decade or more, plans have experienced a growing gap between assets and liabilities.⁷ In response to this gap, state and local governments are taking steps to manage their pension obligations, including reducing benefits and increasing member contributions.⁸

The Extent to Which the Patient Protection and Affordable Care Act and Budget Control Act Could Affect State and Local Government Fiscal Outlook is Uncertain

The effect of the Patient Protection and Affordable Care Act (PPACA) on the long-term state and local fiscal outlook is uncertain and may depend on the states' implementation of the act and the future rate of health care cost growth.⁹ PPACA provides for states to expand Medicaid coverage for millions of lower income individuals and create health insurance exchanges where eligible individuals can qualify for federal subsidies to purchase private health insurance coverage by January 1, 2014.¹⁰ Following the U.S. Supreme Court's ruling on the Medicaid expansion requirements of PPACA, states have the option of deciding whether to expand Medicaid coverage to newly eligible populations.¹¹ CBO noted that, given that there are both financial incentives and disincentives to states participating in the Medicaid expansion, what states will decide to do regarding the expansion under PPACA is highly uncertain. Though the

⁷ Our most recent prior model update is GAO, *State and Local Governments' Fiscal Outlook: April 2012 Update*, GAO-12-523SP, (Washington, D.C.: Apr. 2, 2012).

⁸ GAO, *State and Local Government Pension Plans: Economic Downturn Spurs Efforts to Address Costs and Sustainability*, GAO-12-322 (Washington, D.C.: Mar. 2, 2012).

⁹ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010).

¹⁰ Exchanges may be established and operated by a state itself as a "state-based exchange." Where a state is unable or unwilling to establish and operate an exchange, PPACA requires HHS to establish a "federally facilitated exchange" in that state. Exchanges may only offer coverage through qualified health plans, which must meet certain certification-related requirements.

¹¹ PPACA provides for states to expand Medicaid coverage to non-pregnant individuals under age 65 who have household incomes that do not exceed 133 percent of the federal poverty level beginning no later than January 1, 2014. States will receive an increased federal match for this population, starting at 100 percent in 2014, gradually decreasing to 90 percent in 2020. 42 U.S.C. §§1396a(a)(10)(A)(i)(VIII), 1396d(y). Under PPACA, as enacted, states were required to cover this expansion population as a mandatory population. A failure by a state to cover mandatory populations may result in a termination of federal Medicaid matching funds for the entire program. However, the U.S. Supreme Court subsequently ruled that states that choose not to expand Medicaid eligibility to these newly eligible individuals are not subject to this potential penalty and instead will forgo only the enhanced federal matching funds associated with covering this population. See *National Federation of Independent Business, et al., v. Sebelius, Sec. of Health and Human Services, et al.*, 132 S. Ct. 2566 (U.S., June 28, 2012).

federal government will cover a large share of the costs of the Medicaid expansion, states would ultimately have to bear some costs during a period when their budgets are already under pressure. While some of the uncertainty surrounding PPACA is related to the implementation of the act, there is also uncertainty about the future underlying rate of health care cost growth.¹² Future enrollment patterns for Medicaid and qualified health plans are also less clear due both to the uncertainty about future policy changes and to other factors such as income growth that affect individuals' eligibility.

State and local governments may also be affected by certain deficit reduction measures enacted under the Budget Control Act of 2011, (BCA).¹³ BCA established limits on discretionary budget authority for fiscal years 2012 through 2021.¹⁴ It also included automatic enforcement procedures that will reduce both discretionary and mandatory spending because lawmakers did not enact legislation originating from the Joint Select Committee on Deficit Reduction that would lower projected deficits by \$1.2 trillion. The American Taxpayer Relief Act reduced the size of these automatic spending reductions scheduled for 2013 to roughly \$85 billion and delayed their effect until March 2013. In 2013, these reductions will be accomplished through across-the-board spending reductions known as sequestration. The degree to which BCA and sequestration will affect the intergovernmental transfer relationship between the federal government and the state and local government sector is uncertain. To the extent possible, our simulations account for sequestration by incorporating CBO grant projections. These projections have been adjusted for the BCA's deficit reduction measures.

¹² For further information on the future underlying rate of health care cost growth, see GAO, *Patient Protection And Affordable Care Act: Effect on Long-Term Federal Budget Outlook Largely Depends on Whether Cost Containment Sustained*, GAO-13-281, (Washington, D.C.: Jan. 31, 2013).

¹³ Pub. L. No. 112-25, 125 Stat. 240 (Aug. 2, 2011).

¹⁴ Pub. L. No. 112-25, § 101, 125 Stat. 240, 241 (Aug. 2, 2011).

Assumptions Used in Our 2012 State and Local Model Simulations

This update uses NIPA data prepared by BEA as a primary data source. Our state and local model simulates the level of receipts and expenditures for the sector in future years based on current and historical spending and revenue patterns.¹⁵ To develop these long-run simulations, we make simulations for each major receipt and expenditure category of the state and local government sector in future years.¹⁶ We simulate growth in each category of receipts and expenditures using CBO's economic assumptions wherever possible.¹⁷ In several cases we were not able to obtain existing projections and needed to develop our own assumptions about the likely future growth path of certain receipts or expenditures. Overall, our model assumes current policies remain in place.

Consistent with the assumptions used by the Centers for Medicare & Medicaid Services' Office of the Actuary in projecting health care expenditures, we removed the effects of productivity adjustments and other cost-containment mechanisms for Medicare from our estimates of excess cost growth affecting Medicaid and CHIP. This approach is also consistent with the fall 2012 update of our federal model. In prior updates, our excess cost growth assumption, while based on growth for the U.S. health sector as a whole, was affected by productivity adjustments and other cost-containment mechanisms for Medicare. Excess cost growth now averages 0.8 percentage points between 2023 and the end of our projection period.

In addition, we made projections on a pay-as-you-go basis for the health care costs for state and local employees and retirees in each year through 2060. To simulate health care compensation costs, we used estimates from BEA as a starting value of the sector's health care expenditures on behalf of employees and retirees.

The model's key data sources and modifications to assumptions that are discussed in this section of the report, as well as other modifications, are

¹⁵ The model incorporates data available after BEA's comprehensive revision of NIPA in July 2009 and its annual revision of NIPA in July 2012.

¹⁶ Key categories of receipts for state and local governments include several types of taxes (personal income, sales, property, and corporate), income on assets owned by the sector, and grants from the federal government. Categories of expenditures include wages and salaries of state and local employees, health insurance costs, pension costs, payments of social benefits (e.g., Medicaid and unemployment), depreciation expenses on state and local capital stock, interest payments on state and local financial debt, and other expenditures of the sector.

¹⁷ See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023* (Washington, D.C.: February 2013).

summarized in table 1. A detailed explanation of the model’s methodology is available in apps. I–IV of GAO, State and Local Governments: *Growing Fiscal Challenges Will Emerge during the Next 10 Years*, GAO-08-317 (Washington, D.C.: January 2008).

Table 1: Modifications to Assumptions for April 2013 Update

Variable	Original assumption	Updated assumption
Bond Buyer GO 20-Bond Municipal Bond Index (RMMUNIBB20)	Our standard approach for the Bond Buyer GO-20 Bond Municipal Bond Index has been to use an estimated relationship between that rate and the 10-year Treasury yield, with an adjustment for the amount by which the relationship under- or overpredicts the last historical value.	Because municipal bond rates were unusually high relative to Treasury yields in the year preceding our projections, our standard assumption results in what appears to be excessively high projections for the municipal bond rate. We added an adjustment factor that gradually brings the municipal bond rate below the 10-year Treasury note rate.
Medium and Long Term Debt (DBTGSLLT)	Changes in medium- and long-term municipal debt are mostly linked to capital expenditures (including land) and their financing. Some combination of tax receipts, federal investment grants, and debt can be used to finance state and local government investment. Accordingly, a relationship was estimated in which the change in the municipal bond rate explains how much debt is used to finance the gap between investment spending and federal investment grants.	Our updated relationship shows an increase in the relationship between municipal bond rate and debt used to finance the gap between investment spending and federal investment grants, from 0.068 in our 2012 report to 0.081 in this update.
Short Term Debt (DBTGSLST)	The model includes an econometric equation linking short-term debt to net saving. The equation indicates that short-term debt issuance is inversely related to the sector’s net saving, which implies that past deficits were financed in part by short-term borrowing.	Our updated estimate shows a decrease in the inverse relationship between short-term debt and net savings, from -0.238 in our 2012 report to -0.217 in this update.

Real Estate Asset (REST_ALT)	Based on data for the market value of real estate, obtained from the sectors' balance sheets in the Federal Reserve Board's flow of funds accounts, we estimated that the long-run responsiveness, or elasticity, of property values to GDP is 1.06.	Our estimated relationship between real-estate market value and GDP is used to estimate the future property tax base. Property tax grows with the property tax base in our model. The updated estimate showed a decrease in the elasticity between the property tax base and GDP, from 1.06 in our 2012 report to 1.04 in this update.
Federal investment grants (IGRANTCBO) and federal non-Medicaid grants or other federal grants (GFAIDSLO)	We assume that federal investment grants grow at the same rate as CBO's projections for federal capital transfers for the first 10 years. We project other federal grants by subtracting CBO's Medicaid grant projections from CBO's total grants for current expenditures. For both federal investment and other federal grants, we assume that grants grow with inflation plus population growth after the first 10 years.	To estimate federal investment grants and other federal grants, we multiply CBO's January 2013 GDP projection by an estimate of each variable's annual share of GDP derived from CBO's most recently available NIPA-based budget projections. After the 10th year we assume investment grants grow with population plus inflation.
Total state and local government retirement fund assets (L1TOTALFA)	Our original assumption was to use the last year-end historical value of pension fund assets, along with other elements, to calculate the contribution that governments must make to fully fund employee pension benefits.	Because asset values can exhibit substantial volatility, governments typically smoothed asset values in their pension funding calculations. Accordingly, since our March 2010 update, we use the average value of pension fund assets over the previous 5 years to calculate the contribution rate needed to fully fund pensions.

Source: GAO.

We conducted our work for this model update from November 2012 to April 2013 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions.

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Related GAO Products

This product is part of a body of work on the long-term fiscal challenges. Related products are listed below and can be found at www.gao.gov/special.pubs/longterm/longtermproducts.html.

State and Local Governments' Fiscal Outlook: April 2012 Update. GAO-12-523SP. Washington, D.C.: April 2, 2012.

State and Local Government Pension Plans: Economic Downturn Spurs Efforts to Address Costs and Sustainability. GAO-12-322. Washington, D.C.: March 2, 2012.

State and Local Governments' Fiscal Outlook: April 2011 Update. GAO-11-495SP. Washington, D.C.: April 6, 2011.

State and Local Governments: Knowledge of Past Recessions Can Inform Future Federal Fiscal Assistance. GAO-11-401. Washington, D.C.: March 31, 2011.

State and Local Government Pension Plans: Governance Practices and Long-term Investment Strategies Have Evolved Gradually as Plans Take on Increased Investment Risk. GAO-10-754. Washington, D.C.: August 24, 2010.

State and Local Governments: Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs. GAO-10-899. Washington, D.C.: July 30, 2010.

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State and Local Fiscal Challenges: Rising Health Care Costs Drive Long-term and Immediate Pressures. GAO-09-210T. Washington, D.C.: November 19, 2008.

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State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits. GAO-08-223. Washington, D.C.: January 29, 2008.

State and Local Governments: Growing Fiscal Challenges Will Emerge during the Next 10 Years. GAO-08-317. Washington, D.C.: January 22, 2008.

State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade. GAO-07-1080SP. Washington, D.C.: July 18, 2007.

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