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For the Committee on Finance,
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STATE AND LOCAL FISCAL CHALLENGES

Rising Health Care Costs Drive Long-term and Immediate Pressures

Statement of Stanley J. Czerwinski, Director
Strategic Issues



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Highlights

Highlights of [GAO-09-210T](#), a Statement for the Record for the Committee on Finance, U.S. Senate

Why GAO Did This Study

GAO was asked to provide its views on projected trends in health care costs and their effect on the long-term outlook for state and local governments in the context of the current economic environment. This statement addresses three key points: (1) the state and local government sector's long-term fiscal challenges; (2) rapidly rising health care costs which drive the sector's long-term fiscal difficulties, and (3) the considerations involved in targeting supplemental funds to states through the Medicaid program during economic downturns.

To provide Congress and the public with a broader perspective on our nation's fiscal outlook, GAO previously developed a fiscal model of the state and local sector. This model enables GAO to simulate fiscal outcomes for the sector in the aggregate for several decades into the future. GAO first published the findings from the state and local fiscal model in 2007. This statement includes August 2008 data to update the simulations.

This Committee and others also asked GAO to analyze strategies to help states address increased Medicaid expenditures during economic downturns. GAO simulated the provision of such supplemental assistance to states. As we previously reported, the simulation model adjusts the amount of funding states would receive based on changes in unemployment and spending on Medicaid services.

To view the full product, including the scope and methodology, click on [GAO-09-210T](#). For more information, contact Stanley J. Czerwinski, (202) 512-6806, Czerwinskis@gao.gov.

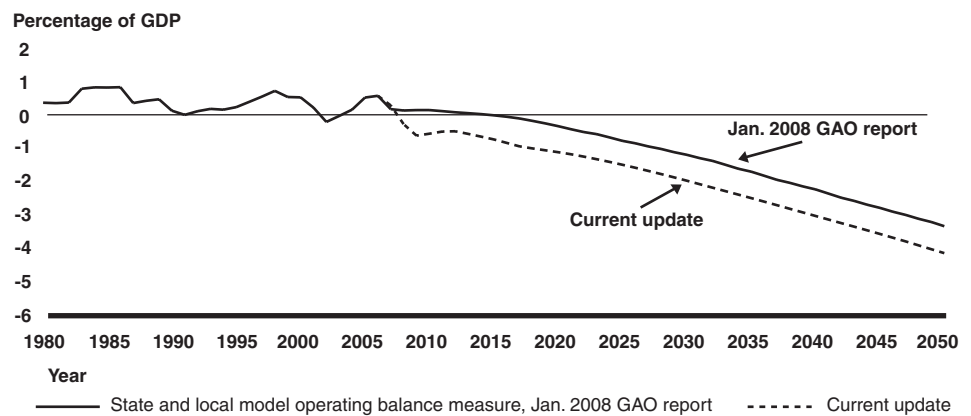
STATE AND LOCAL FISCAL CHALLENGES

Rising Health Care Costs Drive Long-term and Immediate Pressures

What GAO Found

Rapidly rising health care costs are not simply a federal budget problem. Growth in health-related spending also drives the fiscal challenges facing state and local governments. The magnitude of these challenges presents long-term sustainability challenges for all levels of government. The current financial sector turmoil and broader economic conditions add to fiscal and budgetary challenges for these governments as they attempt to remain in balance. States and localities are facing increased demand for services during a period of declining revenues and reduced access to capital. In the midst of these challenges, the federal government continues to rely on this sector for delivery of services such as Medicaid, the joint federal-state health care financing program for certain categories of low-income individuals.

Our model shows that in the aggregate the state and local government sector faces growing fiscal challenges. Incorporation of August 2008 data shows that the position of the sector has worsened since our January 2008 report.



Source: Historical data from National Income and Product Accounts. Historical data from 1980 – 2007. GAO projections from 2008 – 2050 using many CBO projections and assumptions, particularly for the next 10 years. Jan. 2008 GAO Report is GAO-08-317.

The long-term outlook presented by our state and local model is exacerbated by current economic conditions. During economic downturns, states can experience difficulties financing programs such as Medicaid. Downturns result in rising unemployment, which can increase the number of individuals eligible for Medicaid, and declining tax revenues, which can decrease revenue available to fund coverage of additional enrollees. GAO's simulation model to help states respond to these circumstances is based on assumptions under which the existing Medicaid formula would remain unchanged and add a new, separate assistance formula that would operate only during times of economic downturn. Considerations involved in such a strategy could include:

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

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to provide this statement for the record for today's hearing that discusses our observations on health care costs and their relationship to long-term state and local government fiscal conditions in the context of the current economic environment. Our economic perspective on health care costs draws on historical data, simulations, and analysis of policy options to reveal daunting challenges in need of intergovernmental solutions. As Acting Comptroller General Gene Dodaro testified before this committee in June, the nation's long-term fiscal outlook is driven primarily by rising health care costs and known demographic trends.¹

Rapidly rising health care costs are not simply a federal budget problem. Growth in health-related spending also drives the long-term fiscal challenges facing state and local governments. The magnitude of these pressures presents vexing long-term sustainability challenges for all levels of government. The current turmoil in the financial sector adds to the immediate fiscal and budgetary challenges for these governments as they attempt to remain in balance in a rapidly changing and uncertain budget environment. States and localities are facing increased demand for services during a period of declining revenues and reduced access to capital. In the midst of these challenges, the federal government continues to rely on this sector for delivery of services such as Medicaid, the joint federal-state health care financing program that covers medical costs for certain categories of low-income individuals.

This statement addresses a few key points:

- the state and local government sector's long-term fiscal challenges,
- the rapidly rising health care costs which drive the sector's long-term fiscal difficulties, and
- the immediate considerations involved in targeting supplemental funds to states through the Medicaid program during economic downturns.

This statement is based on our previous work on intergovernmental fiscal issues, including reports and testimony on state and local government fiscal challenges, our nation's long-term fiscal challenges, and approaches to providing federal fiscal assistance through Medicaid. We conducted this

¹GAO, *Long-Term Fiscal Outlook: Long-Term Federal Fiscal Challenge Driven Primarily by Health Care*. [GAO-08-912T](#) (Washington, D.C.: June 17, 2008)

performance audit in November 2008 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.

The State and Local Government Sector Faces Increasing Fiscal Challenges

Fiscal sustainability presents a national challenge shared by all levels of government. The federal government and state and local governments share in the responsibility of fulfilling important national goals, and these subnational governments rely on the federal government for a significant portion of their revenues. To provide Congress and the public with a broader perspective on our nation's fiscal outlook, we developed a fiscal model of the state and local sector. This model enables us to simulate fiscal outcomes for the entire state and local government sector in the aggregate for several decades into the future. Our state and local fiscal model projects the level of receipts and expenditures for the sector in future years based on current and historical spending and revenue patterns.² This model complements GAO's long-term fiscal simulations of federal deficits and debt levels under varying policy assumptions.³ We

²To develop the long-run state and local model simulations, we make projections for each major receipt and expenditure category of the state and local government sector. On the receipts side, 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, payment of social benefits (e.g., Medicaid and unemployment), depreciation expense on state and local capital stock, interest payments on state and local financial debt, and other expenditures of the sector. The primary data source for the model is the National Income and Product Accounts (NIPA). The timeframe for the simulations parallels that of our federal fiscal model—the simulations extend until 2050. The state and local model examines the aggregate fiscal outcomes for the sector and does not examine the condition of any individual state or local government.

³GAO, *The Nation's Long-Term Fiscal Outlook: September 2008 Update*, [GAO-09-94R](#) (Washington, D.C.: Nov. 2008).

have published long-term federal fiscal simulations since 1992. We first published the findings from our state and local fiscal model in 2007.⁴

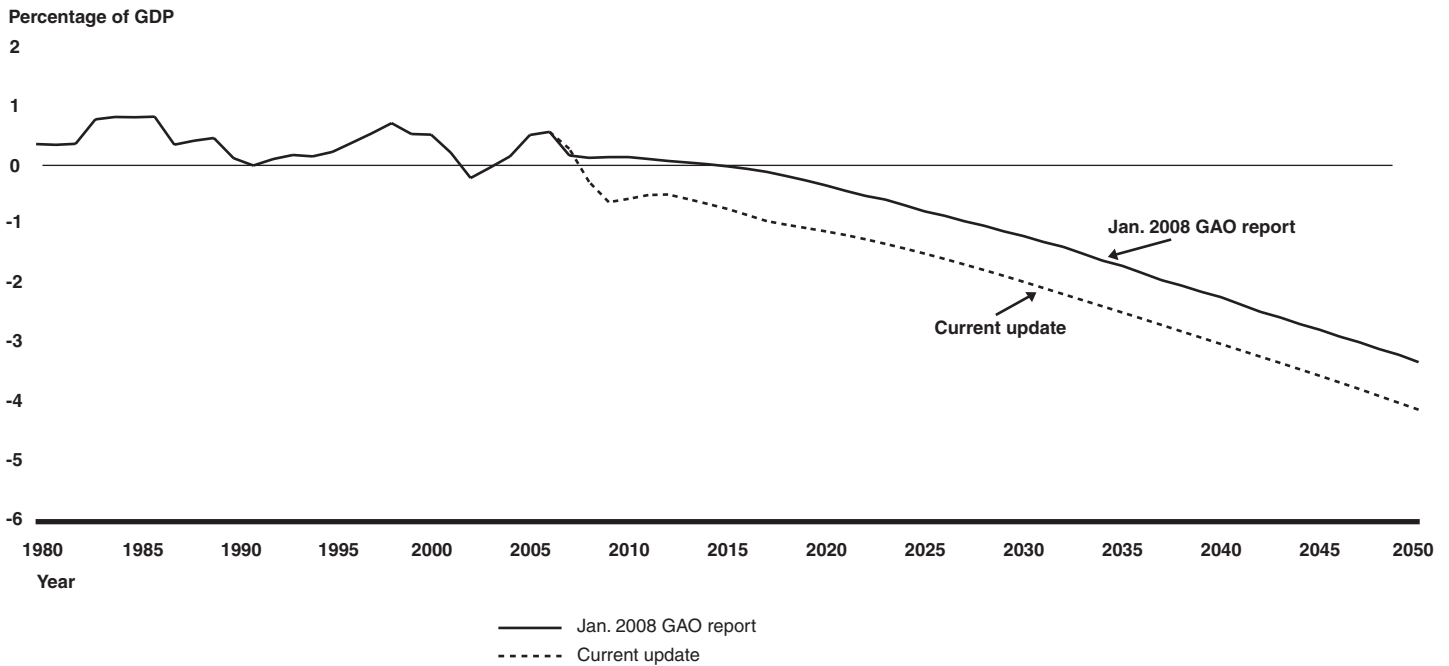
Our model shows that the state and local government sector faces growing fiscal challenges. The model includes a measure of fiscal balance for the state and local government sector for each year until 2050. The operating balance net of funds for capital expenditures is a measure of the ability of the sector to cover its current expenditures out of current receipts.⁵ The operating balance measure has historically been positive most of the time, ranging from about zero to about 1 percent of gross domestic product (GDP). Thus, the sector usually has been able to cover its current expenses with incoming receipts.

Our January 2008 report showed that this measure of fiscal balance was likely to remain within the historical range in the next few years, but would begin to decline thereafter and fall below the historical range within a decade. That is, the model suggested the state and local government sector would face increasing fiscal stress in just a few years. We recently updated the model to incorporate current data available as of August 2008. As shown in Figure 1, these more recent results show that the sector has begun to head out of balance.

⁴GAO, *State and Local Governments: Growing Fiscal Challenges Will Emerge during the Next 10 Years*, [GAO-08-317](#) (Washington, D.C.: Jan. 22, 2008), and *State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade*, [GAO-07-1080SP](#) (Washington, D.C.: July 18, 2007).

⁵In developing this measure we subtract funds used to finance longer-term projects—such as investments in buildings and roads—from receipts since these funds would not be available to cover current expenses. Similarly, we excluded capital-related expenditures from spending.

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



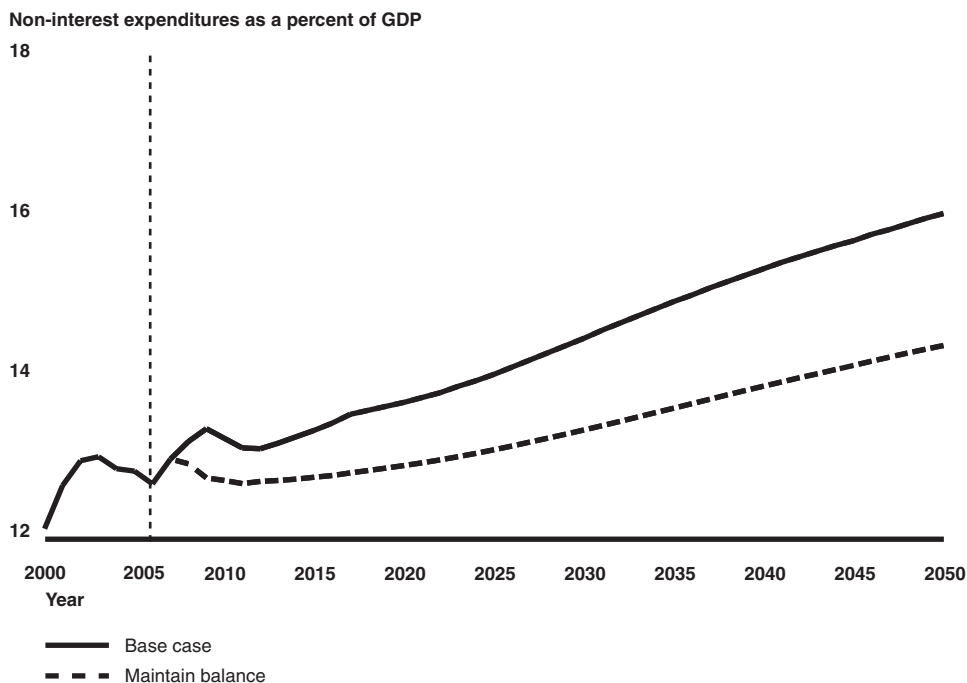
Source: Historical data from National Income and Product Accounts. Historical data from 1980 – 2007. GAO projections from 2008 – 2050 using many CBO projections and assumptions, particularly for the next 10 years. Jan. 2008 GAO Report is GAO-08-317.

These results suggest that the sector is currently in an operating deficit. Our simulations show an operating balance measure well below the historical range and continuing to fall throughout the remainder of the simulation timeframe.

Since most state and local governments are required to balance their operating budgets, the declining fiscal conditions shown in our simulations suggest the fiscal pressures the sector faces and are a foreshadowing of the extent to which these governments will need to make substantial policy changes to avoid growing fiscal imbalances. That is, absent policy changes, state and local governments would face an increasing gap between receipts and expenditures in the coming years. One way of measuring the long-term challenges faced by the state and local sector is through a measure known as the “fiscal gap.” The fiscal gap is an estimate of the action needed today and maintained for each and every year to achieve fiscal balance over a certain period. We measured

the gap as the amount of spending reduction or tax increase needed to maintain debt as a share of GDP at or below today's ratio.⁶ As shown in figure 2, we calculated that closing the fiscal gap would require action today equal to a 7.6 percent reduction in state and local government current expenditures. Closing the fiscal gap through revenue increases would require action of the same magnitude to increase state and local tax receipts.

Figure 2: Extent of State and Local Action Required to Maintain Balance (State and Local Expenditures, as a Percentage of GDP)



Source: Historical data from National Income and Product Accounts.

Note: Historical data are from 2000-2007. Projections are from 2008-2050. In the "base case" model we assume that the tax structure is not changed in the future and that the provision of real government services per capita remains roughly constant. That is, a basic assumption of our model is that the current set of policies in place across state and local government remains constant.

⁶Fiscal gap is calculated for the years 2008 to 2057.

Rapidly Rising Health Costs Drive Long-term State and Local Sector Fiscal Difficulties

Growth in health-related costs serves as the primary driver of the fiscal challenges facing the state and local sector over the long term. Medicaid is a key component of their health-related costs. CBO's projections show federal Medicaid grants to states per recipient rising substantially more than GDP per capita in the coming years.⁷ Since Medicaid is a federal and state program with federal Medicaid grants based on a matching formula, these estimates indicate that expenditures for Medicaid by state governments will rise quickly as well. We also estimated future expenditures for health insurance for state and local employees and retirees. Specifically, we assumed that the excess cost factor—the growth in these health care costs per capita above GDP per capita—will average 2.0 percentage points per year through 2035 and then begin to decline, reaching 1.0 percent by 2050.⁸ The result is a rapidly growing burden from health-related activities in state and local budgets. Our simulations show that other types of state and local government expenditures—such as wages and salaries of state and local workers, pension contributions, and investments in infrastructure—are expected to grow slightly less than GDP. At the same time, most revenue growth is expected to be approximately flat as a percentage of GDP.⁹ The projected rise in health-related costs is the root of the long-term fiscal difficulties these simulations suggest will occur. Figure 3 shows our simulations for expenditure growth for state and local government health-related and other expenditures.¹⁰

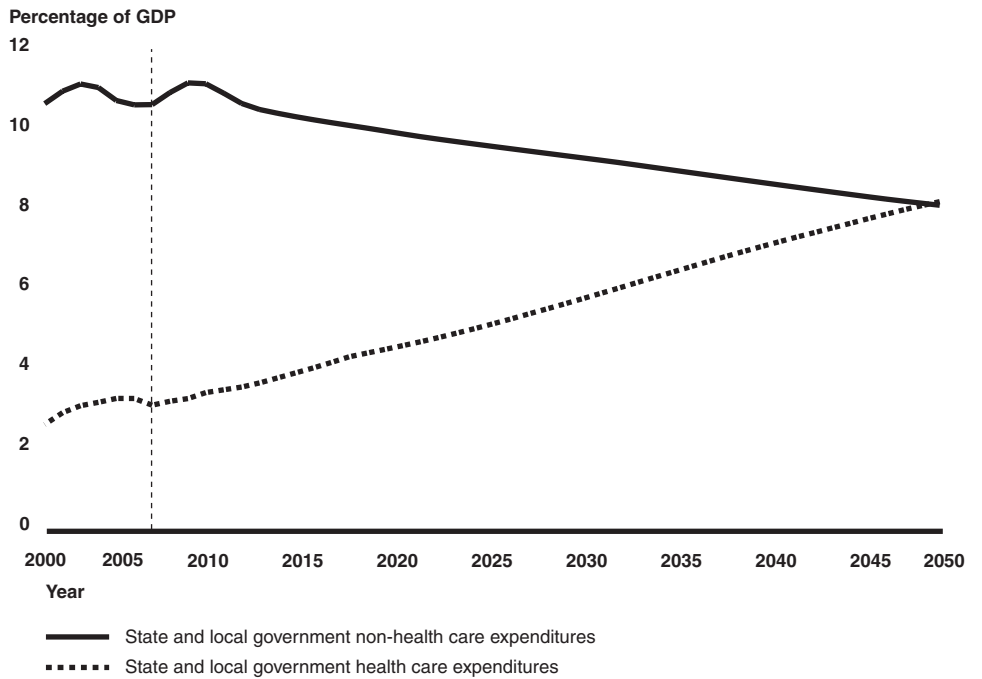
⁷For Medicaid, our cost growth projections align with CBO's most recent budget baseline for the first 10 years. Thereafter, we project Medicaid grants by combining the Center for Medicare and Medicaid Services' 2008 excess cost growth assumption for national health expenditures with CBO's Dec. 2007 long-term projection for Medicaid assuming zero excess cost growth.

⁸We developed estimates of cost growth for health insurance based on research and discussions with experts.

⁹The exception to this is Medicaid grants from the federal government.

¹⁰Interest payments that these governments will need to pay on their outstanding debt will also likely be a rising expense for the sector in the future. Rising interest costs are a reflection of the sustained deficits the model predicts across future years.

Figure 3: State and Local Government Expenditures, as a Percentage of GDP



Source: Historical data from National Income and Product Accounts. Historical data from 2000 – 2007, projections from 2008 – 2050.
Note: Health care expenditures include health care benefits for employees and retirees and medical spending on behalf of other individuals, such as Medicaid and the State Children’s Health Insurance Program (CHIP). Non-health care expenditures include all expenditures with the exception of health care and interest payments.

On the receipt side, our model suggests that most of these tax receipts will show modest growth in the future—and some are projected to experience a modest decline—relative to GDP.¹¹ We found that state personal income taxes show a small rise relative to GDP in coming years. This likely reflects that some state governments have a small degree of progressivity in their income tax structures. Sales taxes of the sector are expected to experience a slight decline as a percentage of GDP in the coming years, reflecting trends in the sector’s tax base. While historical data indicate that property taxes—which are mostly levied by local governments—could rise slightly as a share of GDP in the future, recent events in the housing market suggest that the long-term outlook for property tax revenue could

¹¹Percentages of each category of state and local tax receipts in 2007 were approximately: sales, 33; property, 30; personal income, 24; corporate, 5; and other, 9.

also shift downward. These differential tax growth projections indicate that any given jurisdiction's tax revenue prospects are uniquely tied to the composition of taxes it imposes.

The only source of revenue expected to grow rapidly under current policy is federal grants to state governments for Medicaid. That is, we assume that current policy remains in place and the shares of Medicaid expenditures borne by the federal government and the states remain unchanged.¹² Since Medicaid is a matching formula grant program, the projected escalation in federal Medicaid grants simply reflects expected increased Medicaid expenditures that will be shared by state governments. These long-term simulations do not attempt to assume how recent actions to stabilize the financial system and economy will be incorporated into the federal budget estimates in January 2009.

Considerations for Targeting Supplemental Funds to States through the Medicaid Program during Economic Downturns

The outlook presented by our state and local model is exacerbated by current economic conditions. During economic downturns, states can experience difficulties financing programs such as Medicaid. Economic downturns result in rising unemployment, which can lead to increases in the number of individuals who are eligible for Medicaid coverage, and in declining tax revenues, which can lead to less available revenue with which to fund coverage of additional enrollees. For example, during the most recent period of economic downturn prior to 2008, Medicaid enrollment rose 8.6 percent between 2001 and 2002, which was largely attributed to states' increases in unemployment. During this same time period, state tax revenues fell 7.5 percent. According to the Kaiser Commission on Medicaid and the Uninsured, in 2008, most states have made policy changes aimed at controlling Medicaid costs.¹³

Recognizing the complex combination of factors affecting states during economic downturns—increased unemployment, declining state revenues, and increased downturn-related Medicaid costs—this Committee and several others asked us to assist them as they considered a legislative

¹²Because CBO's baseline adjusts discretionary spending, such as non-Medicaid grants to state and local governments, only for inflation, our projections for these grants decline as a share of GDP over the next 10 years—the timeframe of CBO's projections. Beyond that, we grow these expenditures at the rate of population growth plus inflation.

¹³Kaiser Commission on Medicaid and the Uninsured. *Headed for a Crunch: An Update on Medicaid Spending, Coverage and Policy Heading into an Economic Downturn* (The Henry J. Kaiser Family Foundation, Sept. 2008).

response that would help states cope with Medicaid cost increases.¹⁴ In response to this request, our 2006 report on Medicaid and economic downturns explored the design considerations and possible effects of targeting supplemental assistance to states when they are most affected by a downturn.¹⁵ We constructed a simulation model that adjusts the amount of funding a state could receive on the basis of each state's percentage increase in unemployment and per person spending on Medicaid services. Such a supplemental assistance strategy would leave the existing Medicaid formula unchanged and add a new, separate assistance formula that would operate only during times of economic downturn and use variables and a distribution mechanism that differ from those used for calculating matching rates. This concept is embodied in the health reform plan released by Chairman Baucus last week.¹⁶

Using data from the past three recessions, we simulated the provision of such targeted supplemental assistance to states. To determine the amount of supplemental federal assistance needed to help states address increased Medicaid expenditures during a downturn, we relied on research that estimated a relationship between changes in unemployment and changes in Medicaid spending.¹⁷ Our model incorporated a retrospective assessment which involved assessing the increase in each state's unemployment rate for a particular quarter compared to the same quarter of the previous year. Our simulation included an economic trigger turned on when 23 or more states had an increase in the unemployment rate of 10 percent or more compared to the unemployment rate that existed for the same quarter 1 year earlier (such as a given state's unemployment rate

¹⁴The bipartisan group of Senators requesting this work included Senators Bingaman, Collins, Nelson, Rockefeller, and Smith.

¹⁵GAO, *Medicaid: Strategies to Help States Address Increased Expenditures during Economic Downturns*, [GAO-07-97](#) (Washington, D.C.: Oct. 18, 2006).

¹⁶U.S. Senator Max Baucus, *Call to Action: Health Reform 2009* (Washington, D.C.: Nov. 12, 2008).

¹⁷Stan Dorn, Barbara Markham Smith, and Bowen Garrett, *Medicaid Responsiveness, Health Coverage, and Economic Resilience: A Preliminary Analysis*, Prepared for the Health Policy Institute of the Joint Center for Political and Economic Studies (Washington, D.C.: Joint Center for Political and Economic Studies, Sept. 27, 2005). For our model, we used Dorn et al.'s estimates to derive an average increase in Medicaid expenditures per additional unemployed person of \$300, which could be adjusted over time by inflation and changes in demographics of the Medicaid population.

increasing from 5 percent to 5.5 percent).¹⁸ We chose these two threshold values—23 or more states and increased unemployment of 10 percent or more—to work in tandem to ensure that the national economy had entered a downturn and that the majority of states were not yet in recovery from the downturn.¹⁹ These parameters were based on our quantitative analysis of prior recessions.²⁰ As shown in figure 4, for the 1990-1991 downturn, 6 quarters of assistance would have been provided beginning with the third quarter of 1991 and ending after the fourth quarter of 1992.²¹

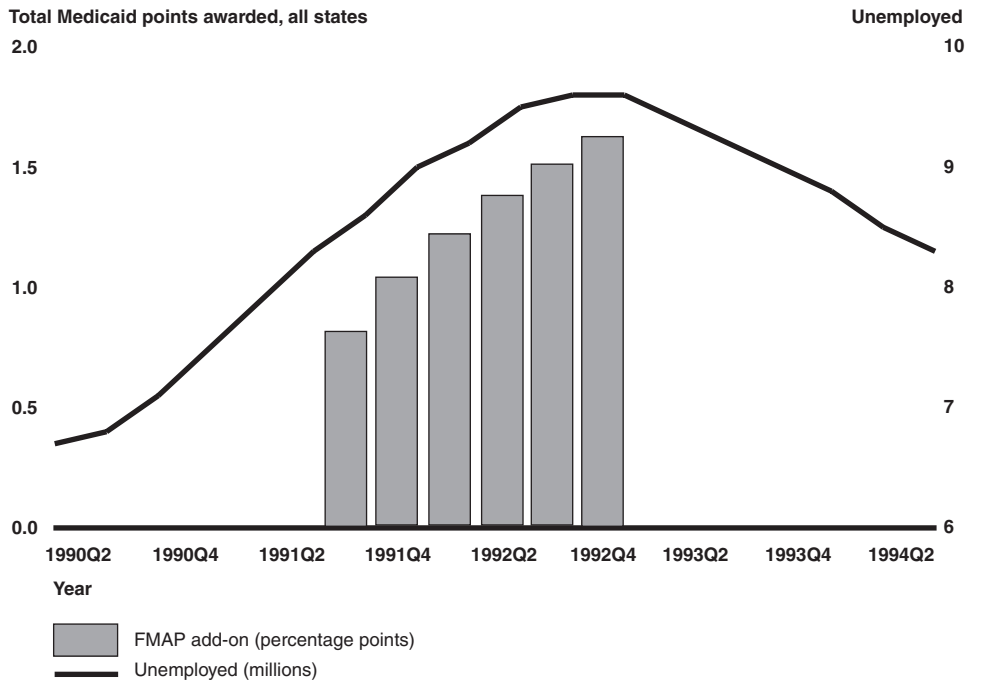
¹⁸This is an increase of 10 percent compared to the unemployment rate of the same quarter in the previous year and not a 10 percentage point change in unemployment rates (such as from 5 percent unemployment to 15 percent).

¹⁹We chose both numbers based on a review of states' unemployment rates over the past three recessions and determined that these levels would have provided considerable certainty that the economic slowdown was nationwide.

²⁰We chose these threshold values based on evidence which indicated that 23 states experiencing a 10 percent or more increase in unemployment provided considerable certainty that an economic slowdown had extended nationwide and that at least 23 states had not yet entered a recovery. These parameters could be adjusted up or down to tighten or loosen the threshold for providing supplemental assistance. The use of unemployment as an indicator also reflects research establishing a connection between increased unemployment and Medicaid enrollment.

²¹This reflects a slight variation from our 2006 report based on a reduction in the administrative lag to make payments.

Figure 4: Simulation Model's Supplemental Medicaid Assistance Compared to States' Unemployment Increases



Source: U.S. Dept. of Labor, Bureau of Labor Statistics and GAO-07-97.

Note: Unemployment data are expressed in millions and represent a twelve-month rolling average calculated for each quarter. The Federal Medical Assistance Percentage (FMAP) add-on amount is the average of all states' percentage point increases in their FMAPs calculated using the prototype formula simulation described in Appendix II of [GAO-07-97](#).

Analysis of recent unemployment data indicate that such a strategy would already be triggered based on changes in unemployment for 2007 and 2008. In other words, current data confirm the economic pressures currently facing the states.

Considerations involved in such a strategy include:

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

Any potential legislative response would need to be considered within the context of broader health care and fiscal challenges—including continually rising health care costs, a growing elderly population, and Medicare and Medicaid’s increasing share of the federal budget. Additional criteria could be established to accomplish other policy objectives, such as controlling federal spending by limiting the number of quarters of payments or stopping payments after predetermined spending caps are reached.

Conclusions

The federal government depends on states and localities to provide critical services including health care for low-income populations. States and localities depend on the federal government to help fund these services. As the largest share of federal grant funding and a large and growing share of state budgets, Medicaid is a critical component of this intergovernmental partnership. The long-term structural fiscal challenges facing the state and local sector further complicate the provision of Medicaid services. These challenges are exacerbated during periods of economic downturn when increased unemployment leads to increased eligibility for the Medicaid program. The current economic downturn presents additional challenges as states struggle to meet the needs of eligible residents in the midst of a credit crisis. Our work on the long-term fiscal outlook for state and local governments and strategies for providing Medicaid-related fiscal assistance is intended to offer the Committee a useful starting point for considering strategic evidence-based approaches to addressing these daunting intergovernmental fiscal issues.

GAO Contact and Staff Acknowledgments

For information about this statement for the record, please contact Stanley J. Czerwinski, Director, Strategic Issues, at (202) 512-6806 or czerwinski@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony and related products include: Kathryn G. Allen, Director, Quality and Continuous Improvement; Thomas J. McCool, Director, Center for Economics; Amy Abramowitz, Meghana Acharya, Romonda McKinney Bumpus, Robert Dinkelmeyer, Greg Dybalski, Nancy Fasciano, Jerry Fastrup, Carol Henn, Richard Krashevski, Summer Lingard, James McTigue, Donna Miller, Elizabeth T. Morrison, Michelle Sager, Michael Springer, Jeremy Schwartz, Melissa Wolf, and Carolyn L. Yocom.

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