GAO

State and Local Governments: Persistent Fiscal Challenges Will Likely Emerge within the Next Decade

GAO's State and Local Fiscal Simulations

For over a decade GAO has run long-term simulations showing that absent a change in policy, the combined effects of demographic changes and growing health care costs drive ever-increasing federal deficits and debt levels. The Comptroller General has repeatedly warned that the current fiscal path of the federal government is "imprudent and unsustainable". State and local governments provide an array of services to their residents, and the federal government relies on these governments to assist in the realization of national goals. State and local governments also rely on federal grants to varying extents. These subnational governments may also face fiscal stress. To provide Congress and the public with a broader national context, GAO has developed a fiscal model of the state and local sector.

The GAO state and local model projects the level of receipts and expenditures of the sector in future years based on current and historical spending and revenue patterns. In the "base case" model we assume that the current set of policies in place across federal, state, and local governments remains constant. The primary data source for the model is the National Income and Product Accounts. 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.

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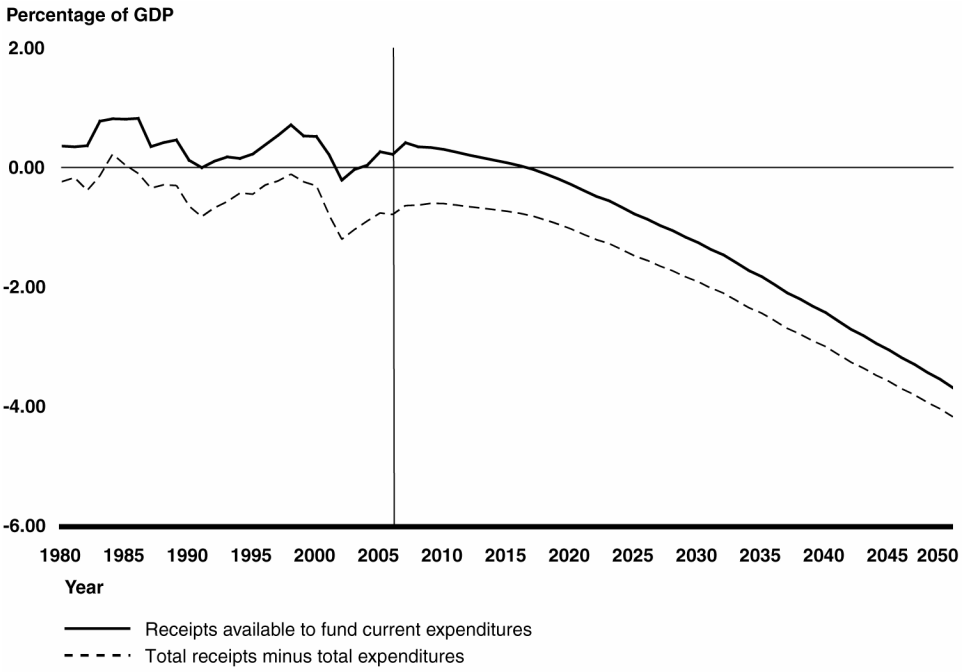
Figure 1: State and Local Receipts Net of Expenditures



Source: GAO analysis.

Note: GDP is Gross Domestic Product.

Our simulations for the state and local government sector indicate that in the absence of policy changes, large and growing fiscal challenges for the sector will begin to emerge within the next few years. Figure 1 shows the gap between receipts and expenditures of the sector. Historical data from 1980 to 2006 are graphed along with our model simulations beginning in 2007 and running through 2050. We measure this gap in two ways. In one case we examine, for a given year, all receipts—including grants from the federal government for infrastructure projects—and all expenditures—including not only operating expenditures but also expenditures on such items as investments in buildings and roads. This provides a balance measure similar to the federal unified budget. While historically, total expenditures have usually exceeded total receipts—and the sector therefore issues debt to cover part of the cost of its capital projects—the simulations suggest that the size of the gap will exceed the historical range starting within the next decade.

Unlike the federal government, most states have some sort of requirement for balancing their operating budgets, which do not include budgeting for longer-term investments. Therefore, we also examine a second case in which we evaluate a balance measure that we call an operating balance. Our definition of the operating balance is receipts available to fund current expenditures minus current expenditures. As shown in figure 1, these receipts usually have exceeded current expenditures.[1] But the simulation suggests that within the next decade current expenditures will outstrip available receipts resulting in a deficit (e.g., a negative operating balance). This deficit—worsening throughout the projection timeframe under an unchanged policy scenario—indicates that state and local governments will need to make tough choices on spending and tax policy to meet their budget requirements and to promote favorable bond ratings.

Fiscal Difficulties for State and Local Sector Are Driven by Rapidly Rising Health Care Costs

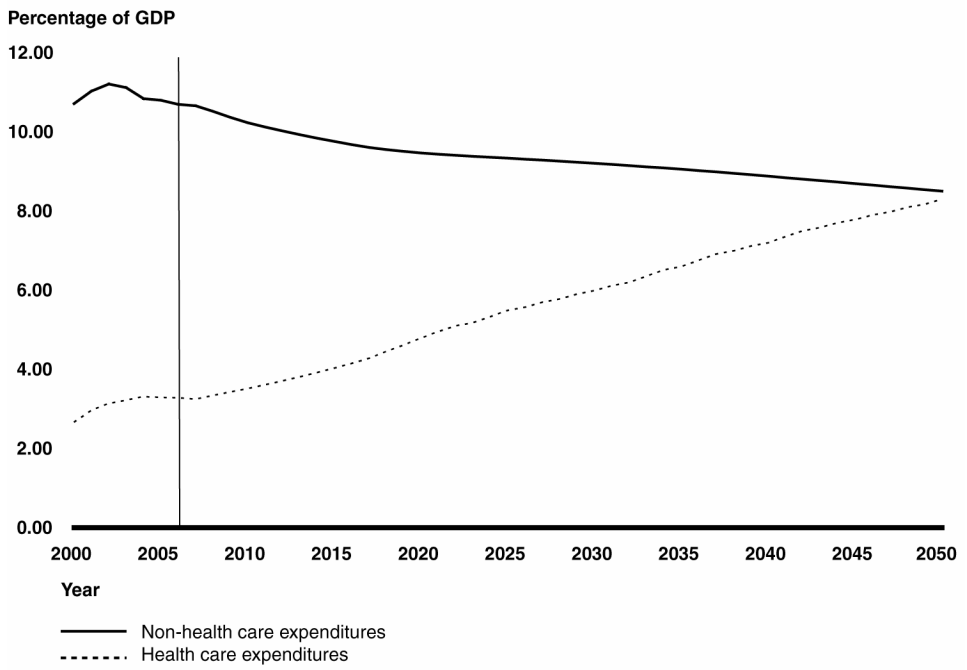
As is true for the federal sector, it is the growth in health-related costs that is a primary driver of the fiscal challenges facing the state and local government sector. In particular, two types of state and local expenditures will likely rise quickly because of escalating medical costs. The first is Medicaid expenditures, and the second is the cost of health insurance for state and local employees and retirees. Conversely, we found that other types of expenditures of state and local governments—such as wages and salaries of state and local workers, pension contributions, and investments in capital goods—are expected to grow slightly less than gross domestic product (GDP). At the same time, most revenue growth is expected to be approximately flat as a percentage of GDP.[2] As such, the projected rise in health-related costs is the root of the fiscal difficulties these simulations suggest will occur. Figure 2 shows our simulations for expenditure growth for health-related and other expenditures.[3]

[1]The explicit definition of our operating balance measure is all receipts, net of funds used for long-term investments, minus current expenditures.

[2]The exception to this is Medicaid grants from the federal government.

[3]Interest 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 merely a reflection of the sustained deficits the model predicts across future years.

Figure 2: Health and Non-Health Expenditures of State and Local Governments



Source: GAO analysis.

Notes: Historical data through 2006, projections from 2007 through 2050. Interest expense is not included in this analysis.

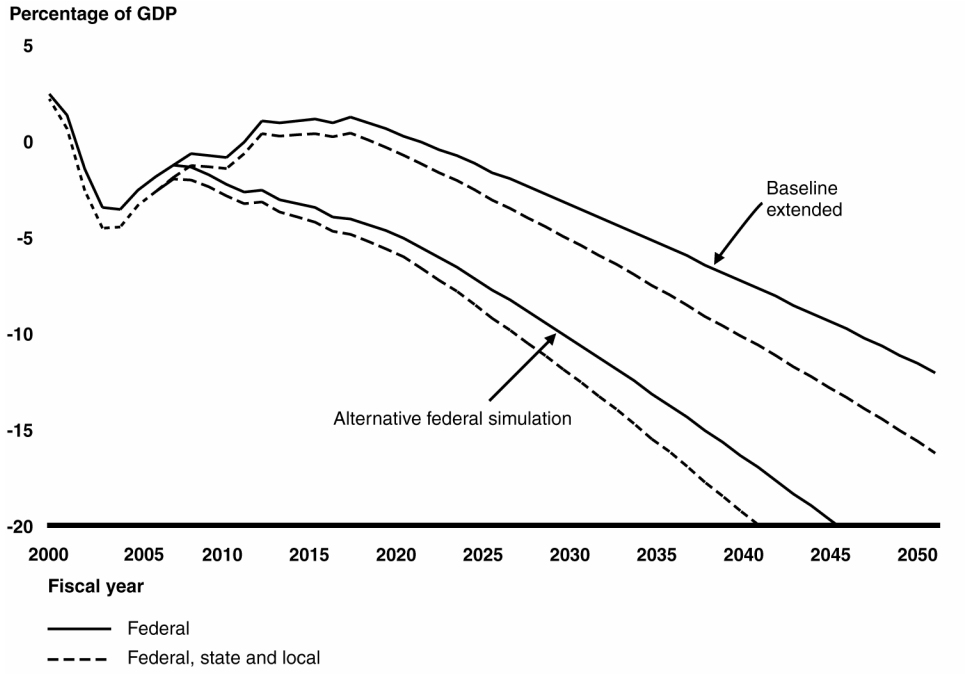
State and Local Fiscal Challenges Add to the Nation's Fiscal Difficulties

Since 1992, GAO has produced long-term simulations of what might happen to federal deficits and debt under various policy scenarios. GAO's most recent long-term federal simulations show ever-larger deficits resulting in a very large and growing federal debt burden over time. Just as in the state and local government sector, the federal fiscal difficulties stem primarily from an expected explosion of health-related expenditures. As we have noted elsewhere, the expected continued rise in health care costs poses a fiscal challenge not just to government budgets, but to American business and society as a whole. In short, the fundamental fiscal problems of the federal government and these subnational governments are similar and are linked. As such, solutions to address these challenges should be considered in tandem.

Figure 3 shows two simulations for the federal fiscal path under alternative assumptions, and overlays the simulated fiscal imbalance of the state and local government sector.[4]

[4]In GAO simulations that combine the fiscal outcomes for all levels of government, the methodology underlying the federal simulations differs slightly from GAO's usual approach. Usually, GAO's federal budget simulations incorporate the negative effect on economic growth of large deficits that divert funds from private investment. In order to combine the federal and state and local budget simulations using a consistent set of economic assumptions, this feedback from deficits to economic growth is removed. With or without feedback, the simulations imply that current fiscal policy is unsustainable over the long term.

Figure 3: Federal and State/Local Surpluses and Deficits as a Share of GDP



Sources: Historical data from the National Income and Product Accounts, and GAO analysis.

Note: Historical data from 2000 through 2006, projections from 2007 through 2050; state and local balance measure is similar to the federal unified budget measure.

For the federal fiscal simulation denoted Baseline, we use Congressional Budget Office (CBO) projections for the next 10 years. Under this scenario, it is assumed that taxes and expenditures over the next 10 years are in line with current law. This means that a variety of tax provisions—mostly tax reductions—that are set to expire are allowed to expire, and that discretionary expenditures of the federal government grow with inflation. After the first 10 years, we use the Social Security and Medicare Trustees' 75-year intermediate ("best") estimates for those programs and CBO's mid-range Medicaid estimates. All other expenditures are held constant as a share of GDP after the first 10 years. Receipts are also held constant as a share of GDP after the first 10 years. Under the alternative federal simulation, we assume that during the next 10 years, expiring tax provisions are extended and that discretionary spending grows with GDP—a faster pace than inflation. After the 10-year timeframe, we assume that action is taken to return revenue to its historical share of GDP plus an additional amount attributable to deferred taxes (i.e., taxes on

withdrawals from retirement accounts). This alternative also incorporates somewhat higher Medicare estimates reflecting a more realistic scenario for physician payments. The overlay of the base case state and local simulation shows that the state and local fiscal situation imposes further burdens on the nation's economy in the next several decades.

Key Assumptions of GAO's State and Local Simulations

The GAO state and local model projects the level of receipts and expenditures of the sector in future years based on current and historical spending and revenue patterns. To develop these long-run simulations, we make projections for each major receipt and expenditure category of the state and local government sector in future years. On the receipt 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, payments 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. 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 the primary model is that the current set of policies in place across state and local governments remains constant.