



State and Local Fiscal Challenges

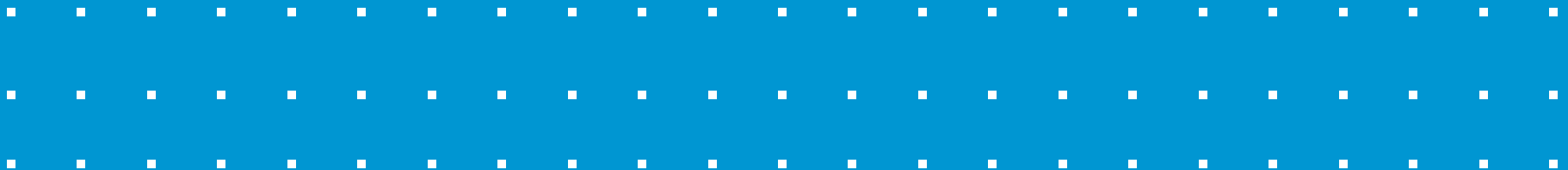
Tracy Gordon

National Intergovernmental Audit Forum

US Government Accountability Office

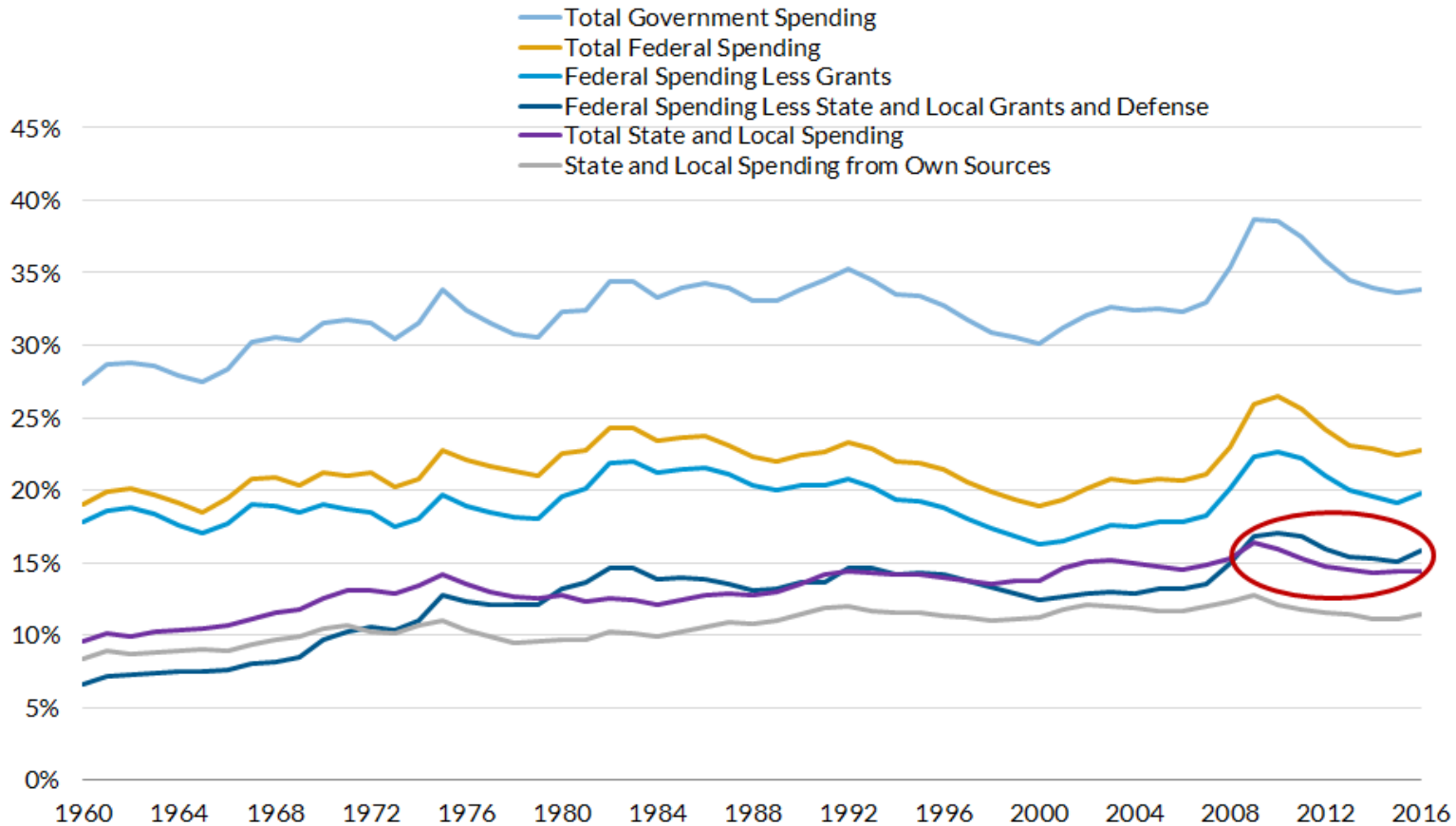
Washington, DC

July 18, 2017



States and Localities Deliver Much of What Americans Think of as “Government”

Spending by Level of Government
Percent of GDP



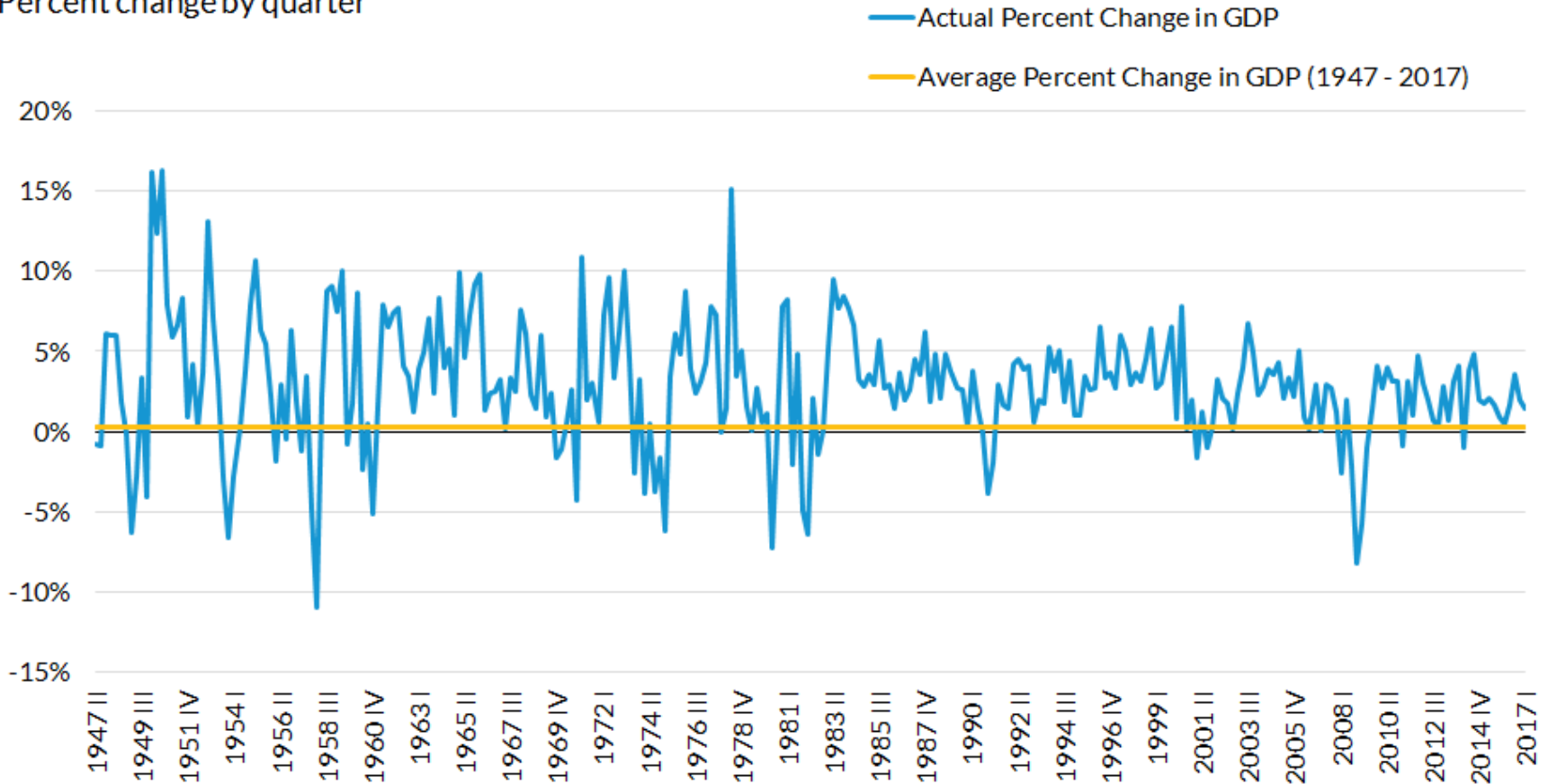
Source: Bureau of Economic Analysis

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They Help Drive US Economy

State and Local Contribution to Percent Change in Real GDP

Percent change by quarter



Source: Bureau of Economic Analysis

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They Are Vital to US Communities

<u>Rank</u>	<u>Industry</u>
1	State and local government
2	Health care
3	Retail
4	Accommodation and food services
5	Educational services
6	Manufacturing

Source: US Bureau of Labor Statistics (2017)

2013 Pew Report

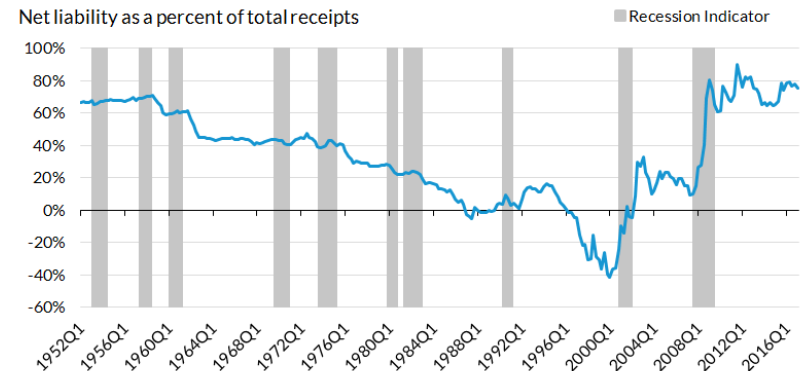
- Americans tend to trust states and localities more than the federal government
- More Americans hold favorable views of local (63%) and state governments (57%) than federal government (28%)

Source: Pew Research Center (2013)

But, They Face Serious Fiscal Challenges

- Total unfunded pension liabilities = 75% of annual receipts. Adding outstanding debt (although this funds assets) elevates liabilities-to-receipts ratio to ~ 200% of a year's revenue
- There is considerable variation among states. Annual pension, retiree health care, and debt service payments > 25% of revenues in Illinois, New Jersey, Connecticut, Hawaii, and Kentucky
- Concerns about “service insolvency” or crowding out of services that attract people and jobs, such as investments in infrastructure and K-12 education

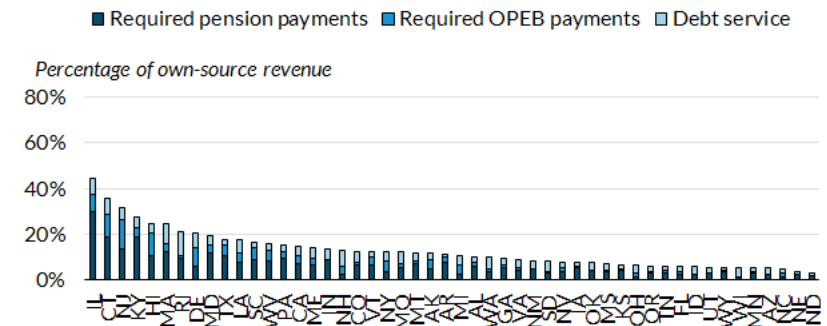
State and Local Employee Defined Benefit Pension Funds



Source: Federal Reserve Board, Financial Accounts of the United States, US Bureau of Economic Analysis, and NBER recession indicators

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Annual State Budget Burden of Long-Term Costs



Source: Center for Retirement Research at Boston College, 2016

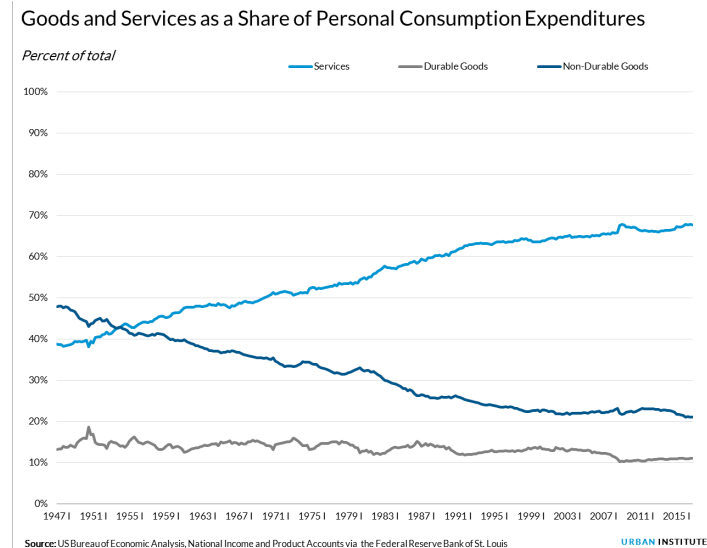
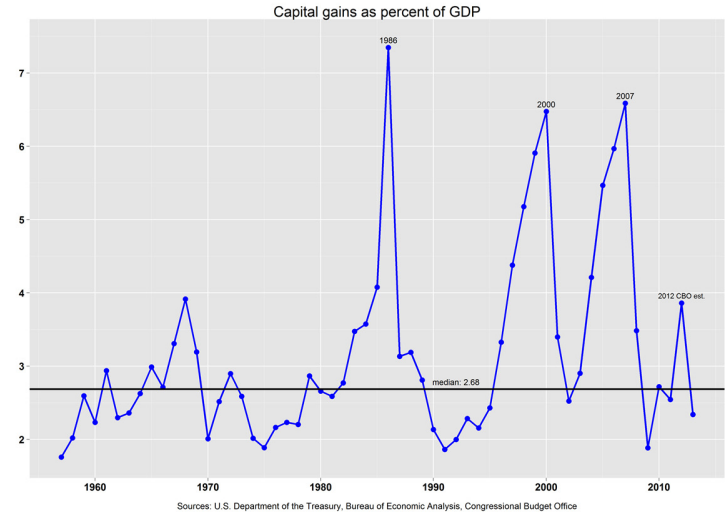
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“Every decade or so the state and local government sector begins to behave strangely”

- Edward M. Gramlich, 1991

Why Does the State and Local Sector Get into Trouble?

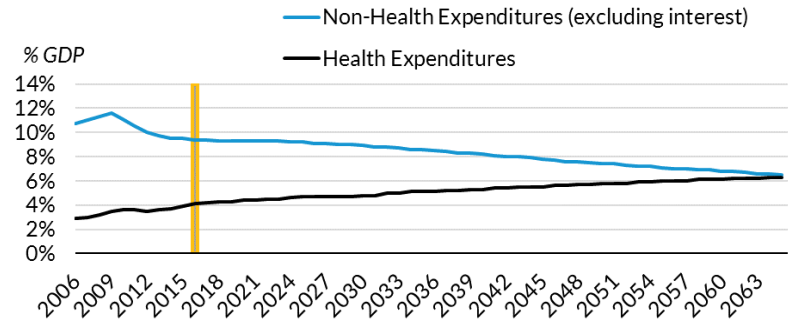
- **States are increasingly reliant on volatile income tax collections** In states like CA, NY, ID, OR, NJ high capital gains interact with a high personal income tax to create revenue instability
- **States are seeing their sales tax base shrink** Services are largely exempt from taxation (except in HI, NM) and states have a hard time collecting owed taxes on online and remote sales



Why Does the State and Local Sector Get into Trouble?

- **Rising health care costs and aging populations are pressuring budgets**
Medicaid has been growing at 2x rate of state taxes for the past decade
- **Inadequate information and incentives** Outcomes of government can be hard to measure. Voters and other stakeholders may be disengaged or uninformed, focused on inputs vs. outputs

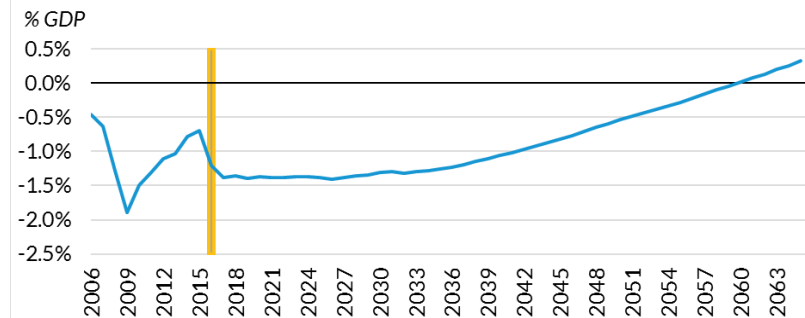
State and Local Health and Non-Health Expenditures



Source: Government Accountability Office, 2016 Fiscal Outlook
Note: Bar indicates the beginning of the forecasted data

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State and Local Government Operating Balance



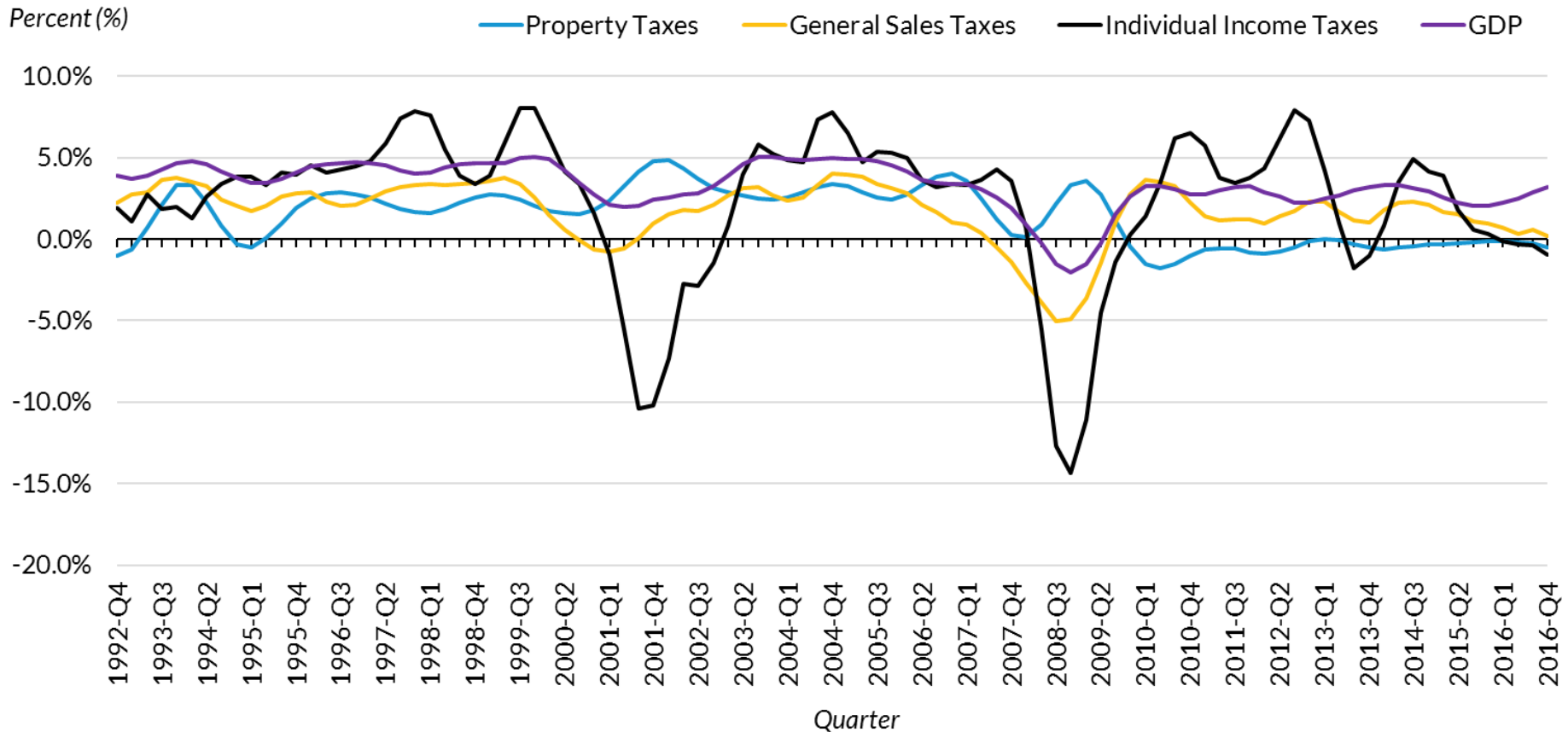
Source: Government Accountability Office, 2016 Fiscal Outlook
Note: Bar indicates the beginning of the forecasted data

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Great Recession Hit States & Localities Hard

State and Local Government Revenue

Four-quarter moving average of year-over-year percent change

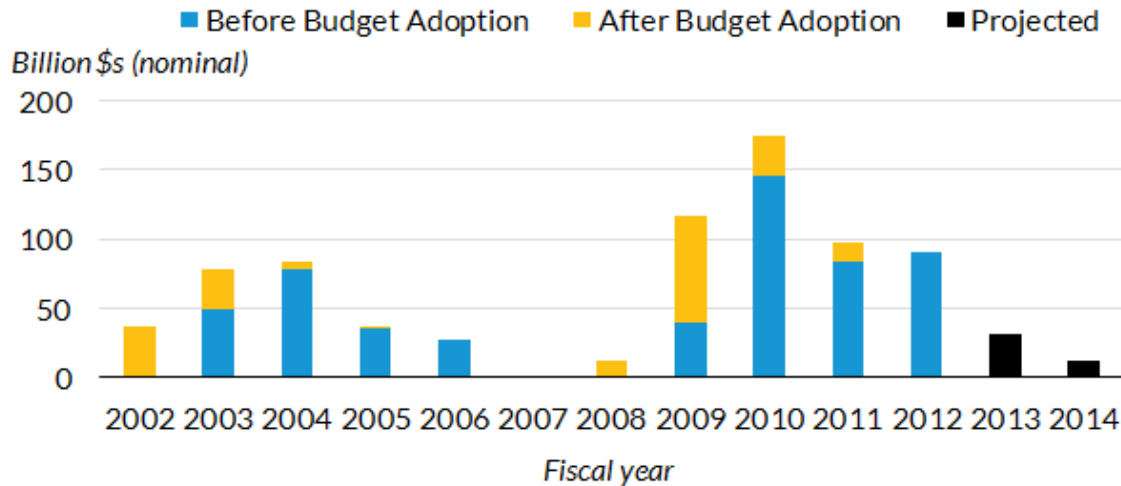


Source: Bureau of Economic Analysis: National Product and Income Accounts

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Many States Faced Budget Shortfalls

State Budget Gaps



Source: NCSL survey of legislative fiscal offices, 2011 and prior years. **URBANINSTITUTE**

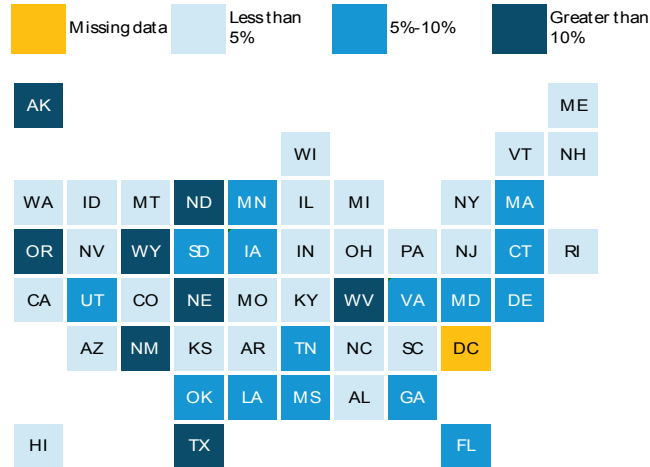
Projected Budget Gaps as a Percent of State General Fund

States	Mid-year FY			
	2009	FY2010	FY2011	FY2012
Alabama	12.7	N/A	8.3	13.9
Alaska	6.8	N/A	N/A	-
Arizona	15.9	29.8	36.5	11.5
Arkansas	N/A	3.2	N/A	-
California	13.6	25.6	20.7	29.3
Colorado	7.7	4.9	21.5	13.8
Connecticut	10.1	23.1	28.8	18.0
Delaware	6.2	15.3	11.4	6.3
District of Columbia	6.3	10.4	1.7	5.2
Florida	9.0	22.6	19.5	14.9
Georgia	10.3	14.5	25.4	7.9
Hawaii	4.0	11.9	11.8	8.2
Idaho	7.4	13.9	3.5	3.9
Illinois	15.1	16.4	40.4	14.6
Indiana	8.0	N/A	9.4	2.0
Iowa	2.1	12.2	20.3	3.5
Kansas	2.9	16.7	9.1	8.8
Kentucky	4.9	N/A	9.1	9.1
Louisiana	3.7	21.7	12.9	20.7
Maine	4.6	5.8	34.7	16.1
Maryland	4.6	12.5	15.3	10.7
Massachusetts	8.4	11.0	8.6	5.7
Michigan	0.9	6.9	9.3	5.9
Minnesota	3.8	18.3	25.0	23.6
Mississippi	3.4	1.7	15.9	14.1
Missouri	3.8	N/A	9.4	9.1
Montana	N/A	N/A	N/A	-
Nebraska	N/A	4.3	9.7	9.2
Nevada	7.3	30.0	54.5	45.2
New Hampshire	160.0	N/A	27.2	N/A
New Jersey	11.1	21.6	38.2	37.4
New Mexico	7.5	N/A	6.1	8.3
New York	3.0	24.3	15.9	18.7
North Carolina	9.3	15.3	30.6	12.7
North Dakota	N/A	N/A	N/A	-
Ohio	4.2	7.1	11.0	11.0
Oklahoma	N/A	9.2	13.7	9.4
Oregon	6.6	N/A	32.4	25.0
Pennsylvania	8.1	N/A	16.2	16.4
Rhode Island	11.4	13.7	13.4	11.3
South Carolina	12.7	10.5	26.1	17.4
South Dakota	2.2	2.7	8.8	10.9
Tennessee	7.8	6.3	9.4	N/A
Texas	N/A	7.6	10.8	31.5
Utah	10.4	12.1	14.7	8.2
Vermont	6.7	20.8	31.3	16.3
Virginia	6.7	10.4	8.5	13.1
Washington	3.4	18.2	22.5	16.2
West Virginia	N/A	2.1	3.6	-
Wisconsin	4.2	18.4	23.9	12.8
Wyoming	N/A	N/A	10.3	-

Sources: The Wall Street Journal, Nelson A. Rockefeller Institute of Government, the Center on Budget and Policy Priorities
Notes: "N/A" = data is not available.

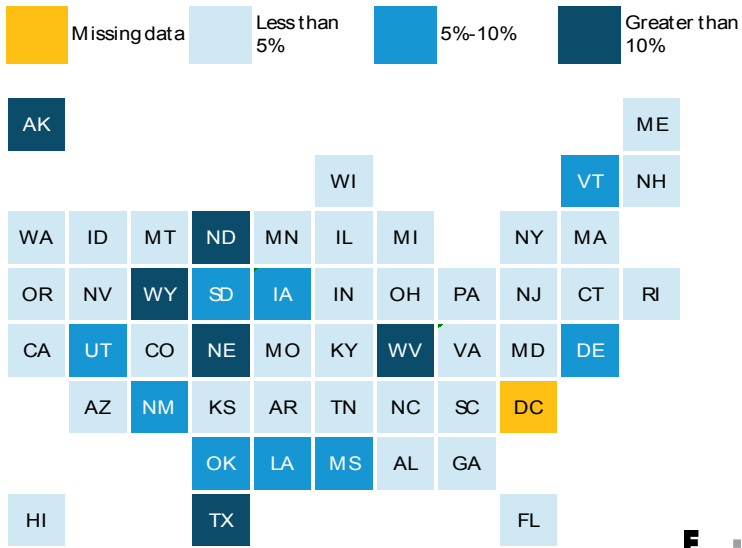
Rainy Day Funds Helped But Not Enough

2008 State Rainy Day Funds as a Percent of General Fund Revenue

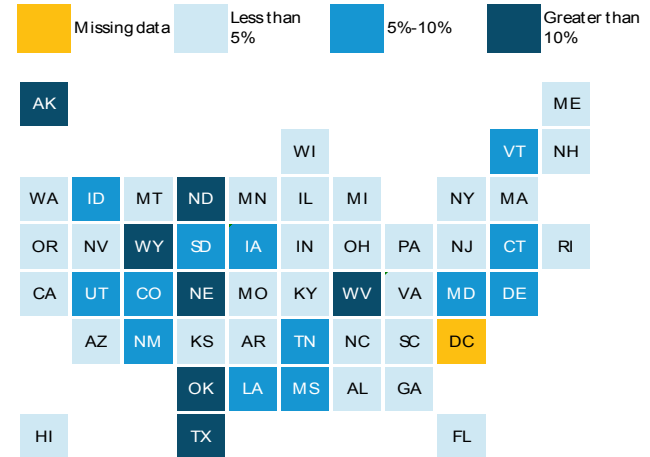


Source: NASBO State Expenditure Reports

2010 State Rainy Day Funds as a Percent of General Fund Revenue

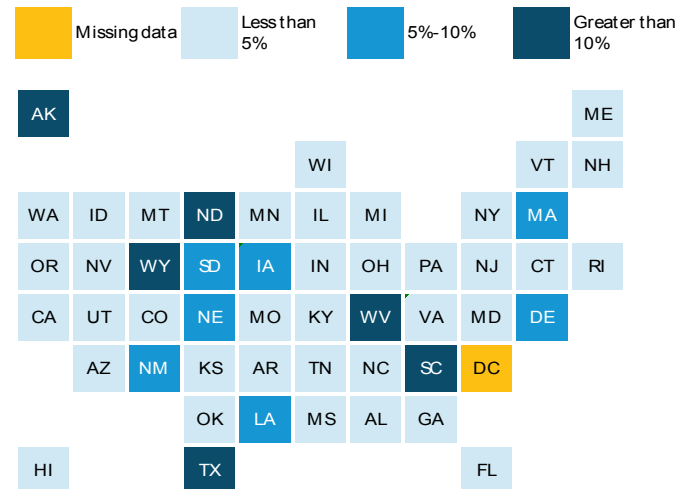


2009 State Rainy Day Funds as a Percent of General Fund Revenue



Source: NASBO State Expenditure Reports

2011 State Rainy Day Funds as a Percent of General Fund Revenue



Source: NASBO State Expenditure Reports

Recovery Act Directed Considerable Sums to State and Local Government

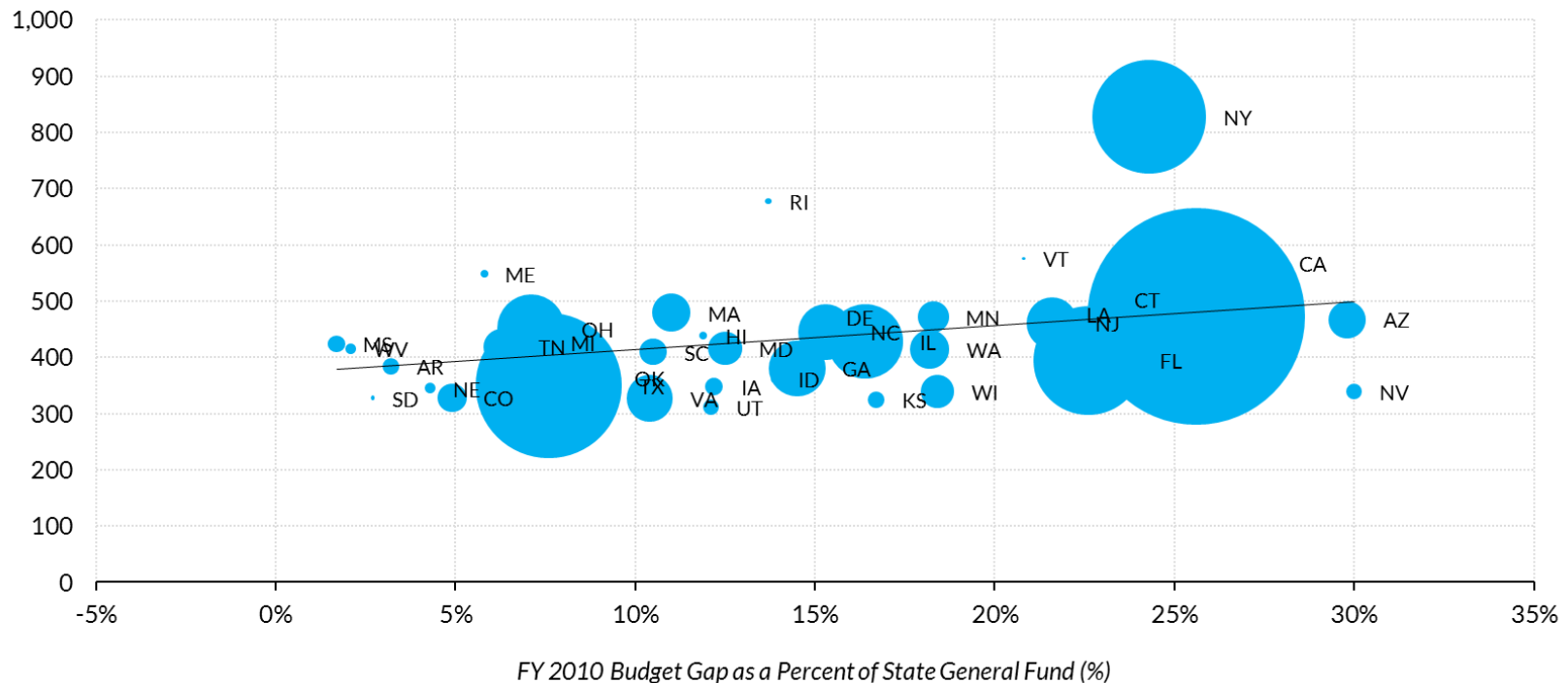
	2009	2010	2011	2012	2013	2014	2015-	Total
<i>Flexible fiscal relief</i>								
State Fiscal Relief (Medicaid FMAP)	33.9	43.9	11.8	0.1	0.0	0.0	0.3	90.0
State Fiscal Stabilization Fund	6.5	28.4	16.1	2.4	0.3	0.0	0.0	53.6
<i>Other non-infrastructure purposes</i>								
Education (beyond SFSF)	2.0	13.3	11.8	1.6	0.2	0.0	0.0	28.9
Economic recovery payments, TANF, and child support	14.9	2.1	0.7	0.2	0.0	0.0	0.0	18.0
Unemployment compensation	17.0	20.5	0.5	0.3	0.1	0.1	0.8	39.2
State and local law enforcement	0.4	0.8	0.6	0.4	0.6	0.0	0.0	2.8
<i>Infrastructure</i>								
Highway construction & other transportation	5.0	9.4	8.8	7.0	6.1	5.4	6.4	48.1
Clean water drinking water revolving fund	0.2	1.4	1.8	1.2	0.6	0.3	0.3	5.8
Public housing capital fund	0.1	1.2	1.2	0.8	0.6	0.0	0.0	4.0
Total	80.0	121.0	53.2	14.0	8.4	6.0	7.7	290.4

Recovery Act Fiscal Relief Was Well Targeted

ARRA State Fiscal Relief vs. FY 2010 Projected Budget Gaps

By state, weighted by state population (2009)

State Aid Per Capita (\$)



Source: Will Straw, "The Nationwide Allocation of Recovery Funding: An Interactive Map on the Final House-Senate Compromise" Center for American Progress based on data from federal agencies. Available at: <http://www.americanprogress.org/issues/economy/news/2009/02/13/5631/the-nationwide-allocation-of-recovery-funding/>

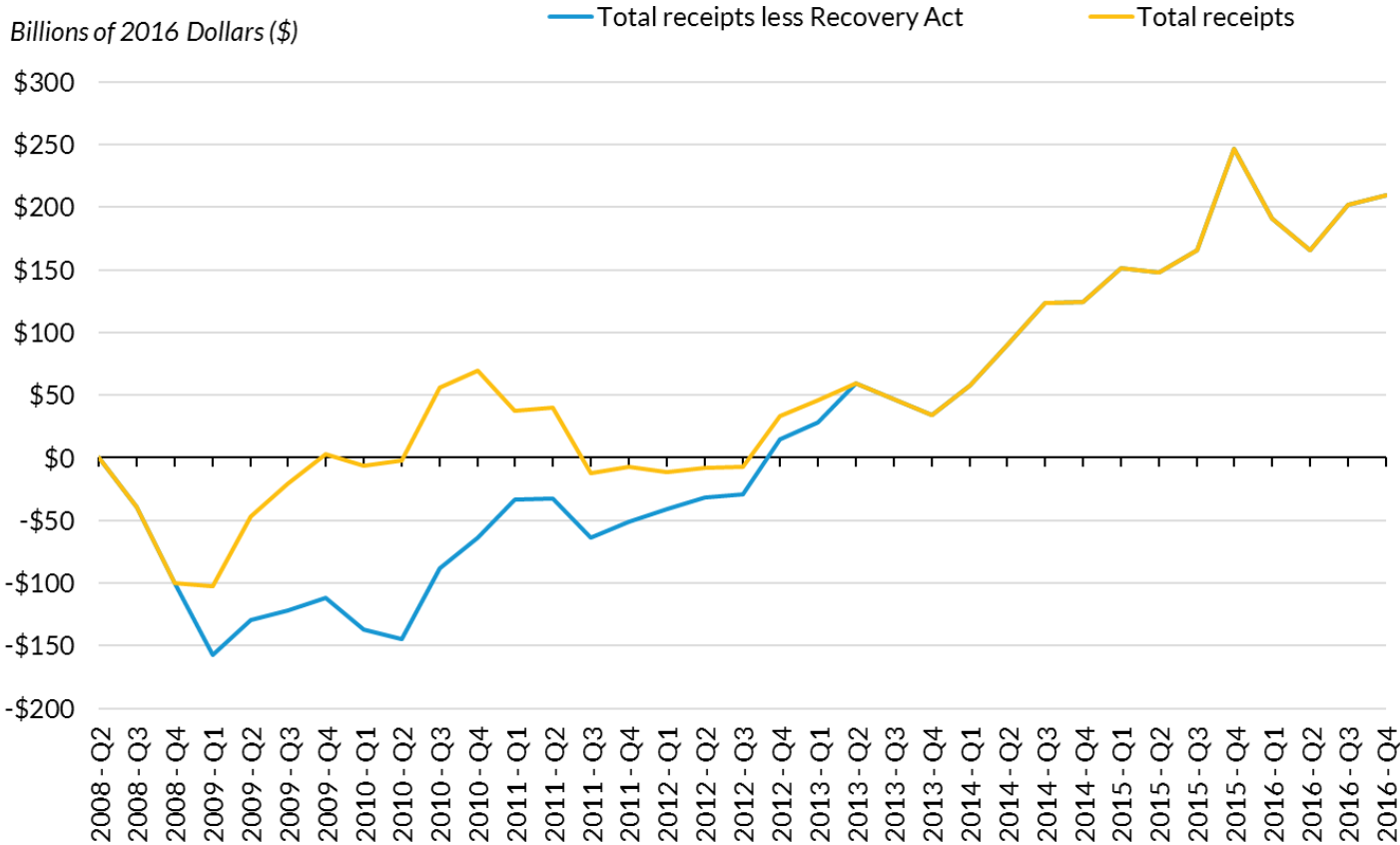
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But It Did Not Make Up for Revenue Shortfall

Change in State and Local Government Revenues

Indexed to 2008 (Q2) = \$0

Billions of 2016 Dollars (\$)



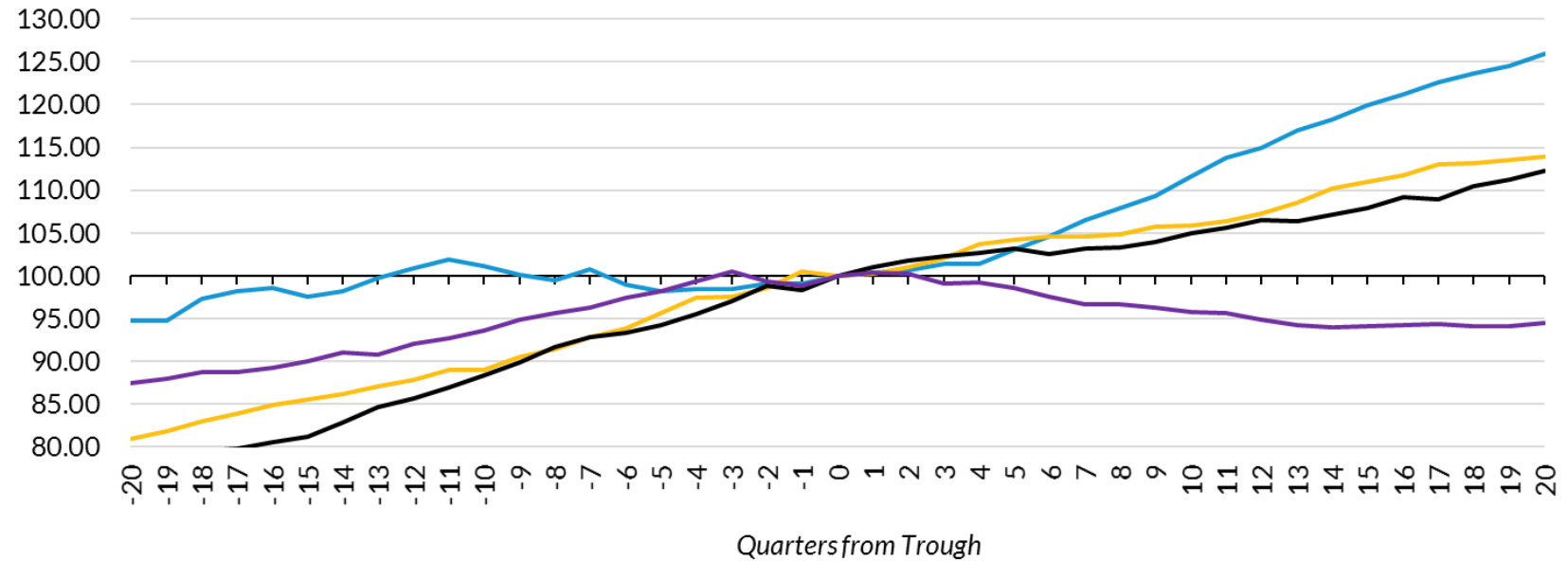
Source: BEA National Income and Product Accounts, Table 3.3: State and Local Government Current Receipts and Expenditures: Quarterly

This Recession Really WAS Different

Real State and Local Government Purchases

Government purchases for the last four recessions

Index (Business Cycle Trough = 100)

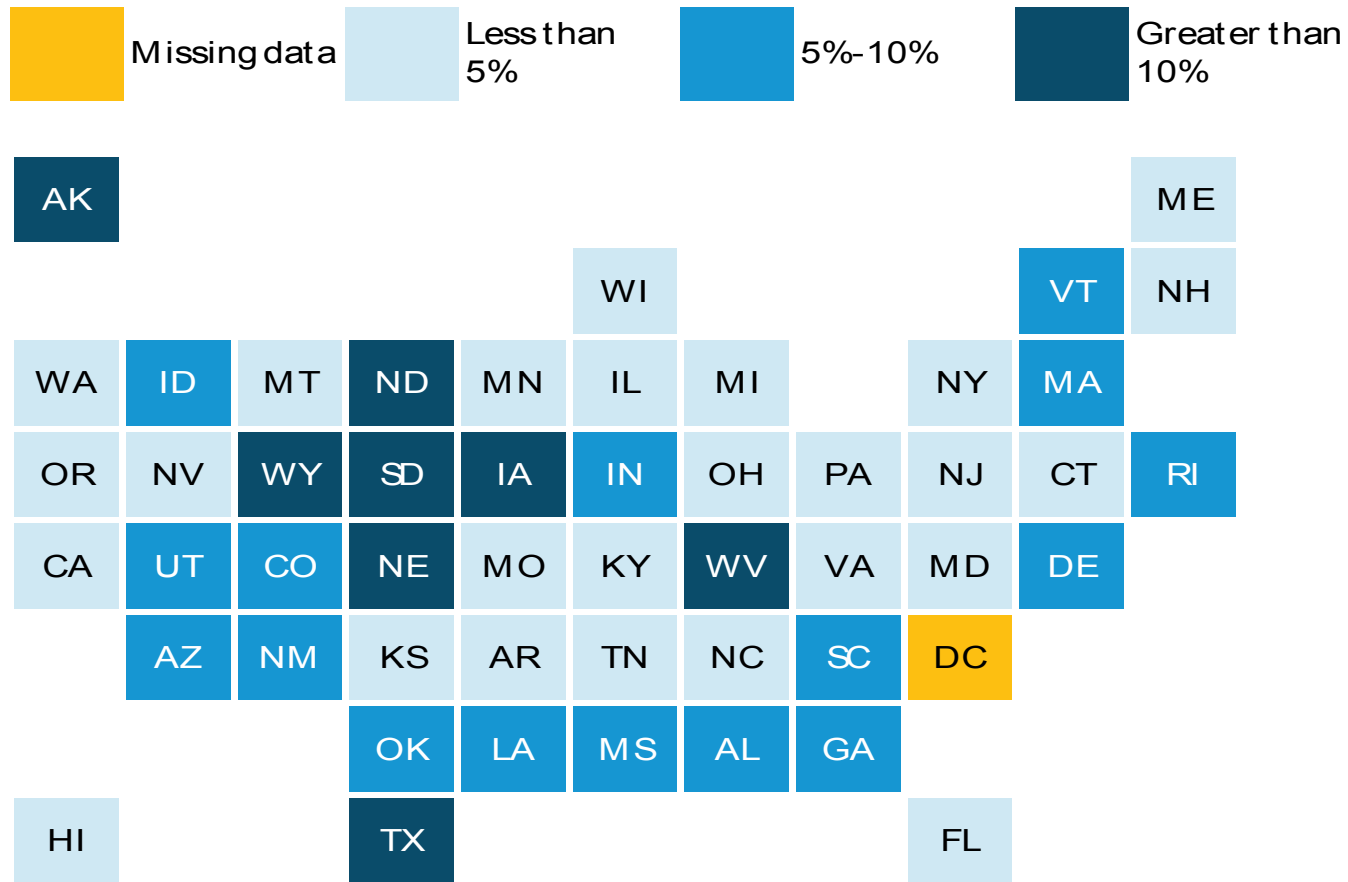


Source: Bureau of Economic Analysis, National Income and Product Accounts; Bureau of Labor Statistics; National Bureau of Economic Analysis

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Rainy Day Funds in Better Shape

2015 State Rainy Day Funds as a Percent of General Fund Revenue



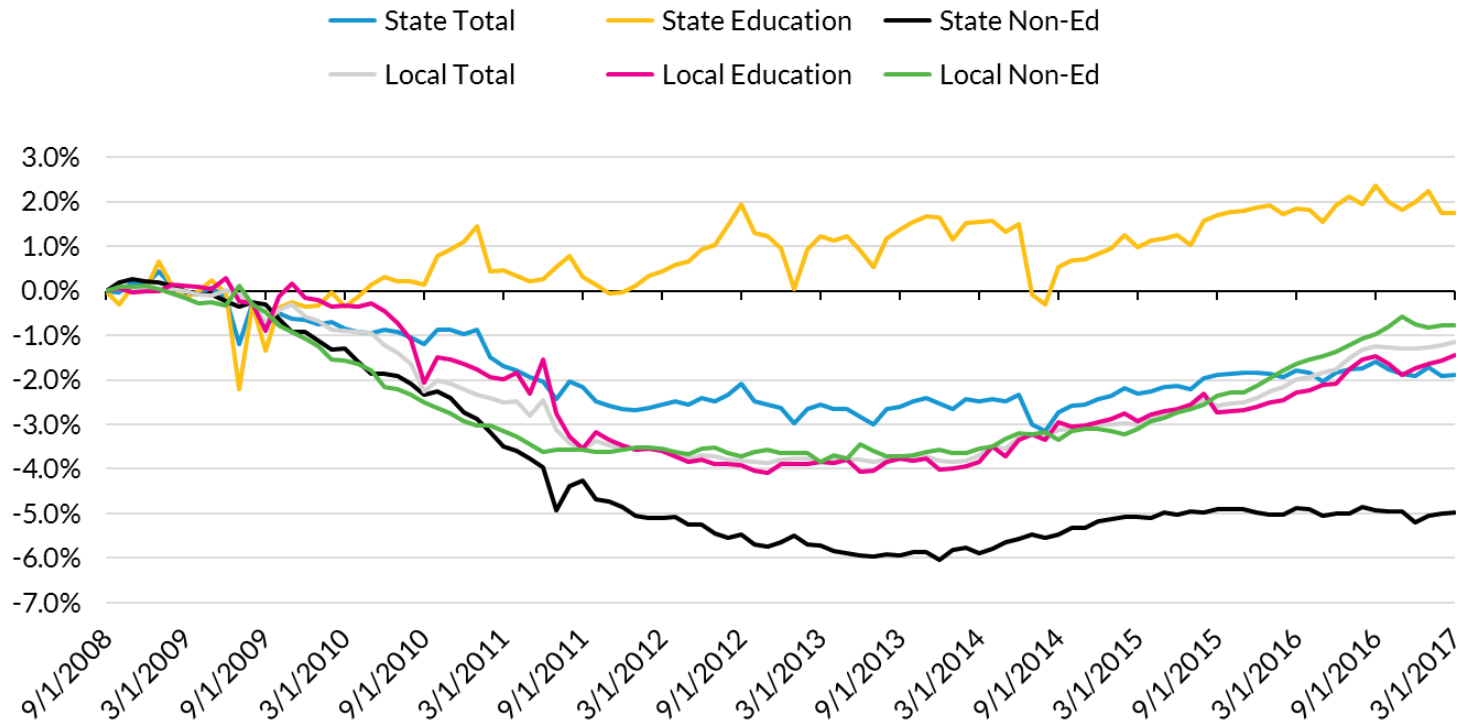
Source: NASBO State Expenditure Reports

State and Local Employment Remains Depressed

State and Local Government Employment

Cumulative monthly job loss by sector indexed to August 2008

Percent (%)



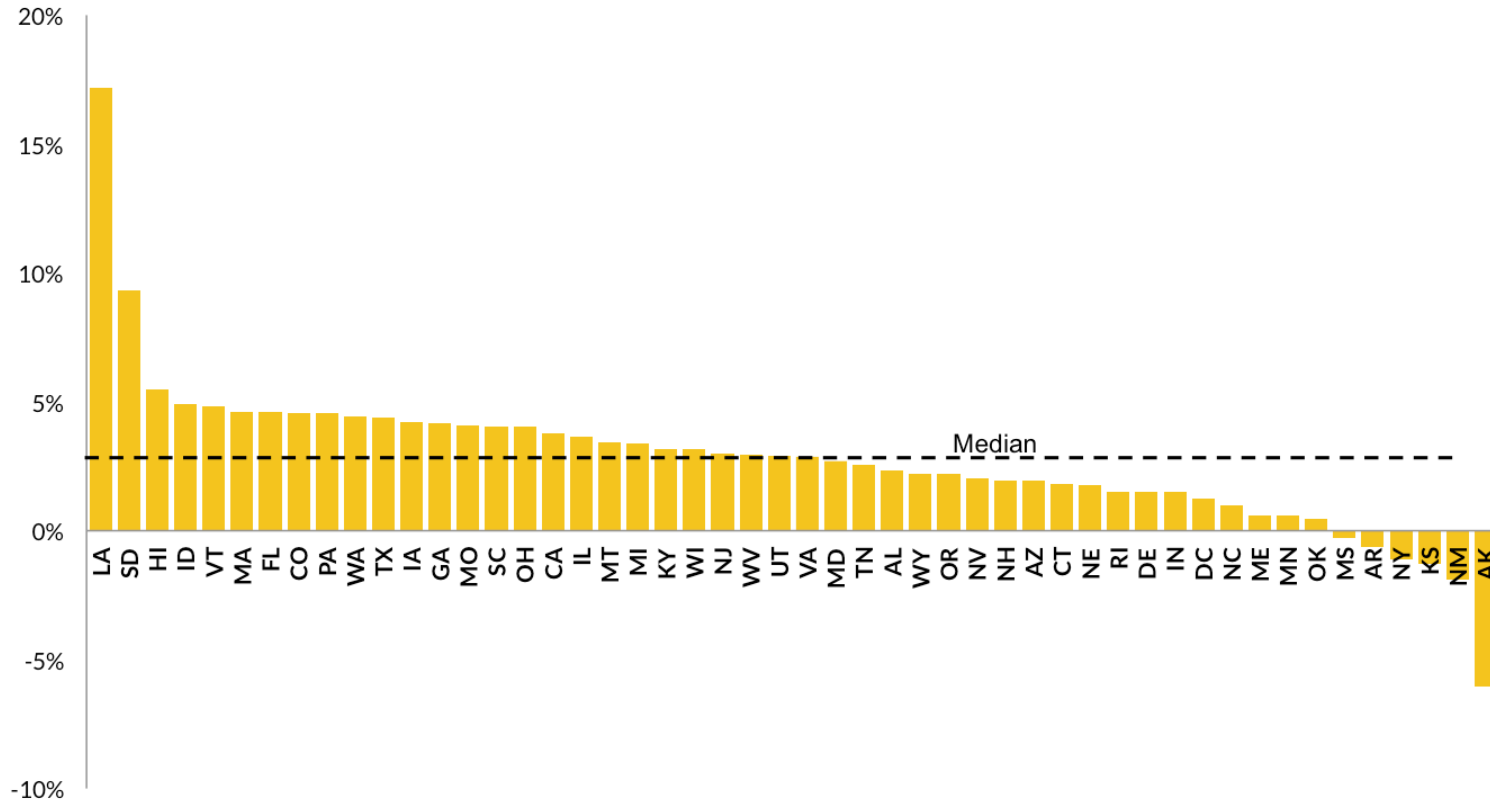
Source: US Bureau of Labor Statistics, Current Employment Statistics

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Weak Revenue Growth Is Expected to Continue

FIGURE 1

State General Fund Revenue Growth
Fiscal Year 2017



Source: State agency revenue reports compiled by author. North Dakota excluded.

What's Next?

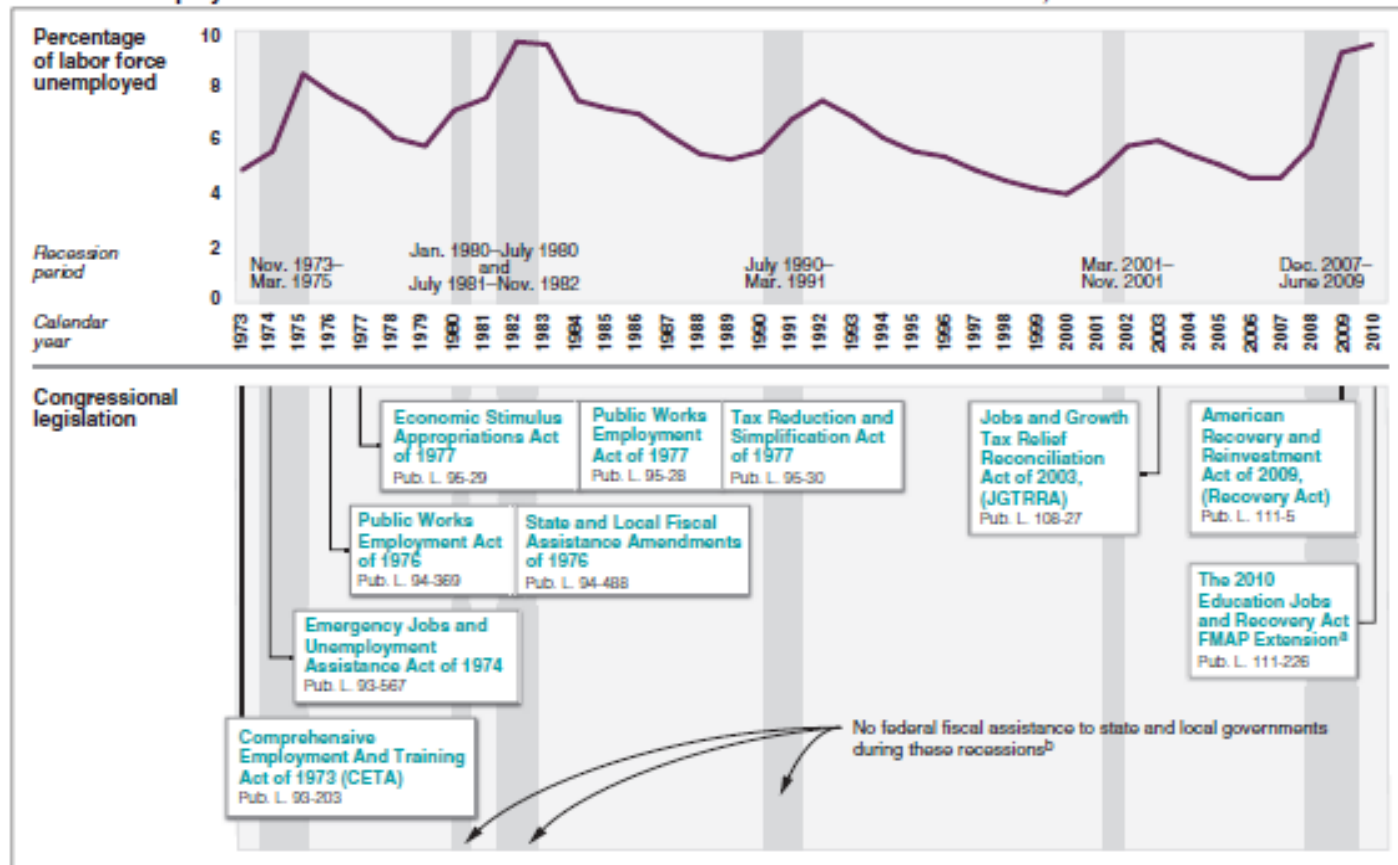
Economic Shocks Increasingly Regional and Not Highly or Even Positively Correlated

Metro Area and National Business-Cycle Correspondence: February 1990 - June 2015					
Number of months with economies:					
	Both in expansion	Both in recession	National in expansion, MSA in recession	MSA in expansion, national in recession	Match (%)
Chicago	256	30	15	4	93.77
Philadelphia	265	18	6	16	92.79
New York	246	28	25	6	89.84
Miami	245	26	26	8	88.85
Boston	242	27	29	7	88.2
Los Angeles	235	34	36	0	88.2
Las Vegas	248	18	23	16	87.21
Houston	241	17	30	17	84.59
Detroit	204	34	67	0	78.03

Source: Arias, Maria, A., Charles S. Gascon, and David E. Rapach. 2016. "Metro Business Cycles." *Journal of Urban Economics*.
 Notes: MSA=metropolitan statistical area. National business-cycle phases use peak and trough dates from NBER. MSA business-cycle phases use peak and trough dates identified by Arias et al. The last column indicates the percentage of all months February 1990 through June 2015 where the national and MSA economies were in sync.

Recurring Proposals for Countercyclical Fiscal Assistance to States and Localities

National Unemployment Rate and Federal Fiscal Assistance to State and Local Governments, 1973 to 2010



Sources: GAO analysis of BLS and NBER data, federal fiscal assistance public laws, and pertinent legislative history.

^aPub. L. No. 111-226 has no official title, so we refer to this act as The 2010 Education Jobs and Recovery Act FMAP Extension.

^bOther forms of federal assistance were provided, but these approaches did not focus on fiscal assistance to state and local governments.

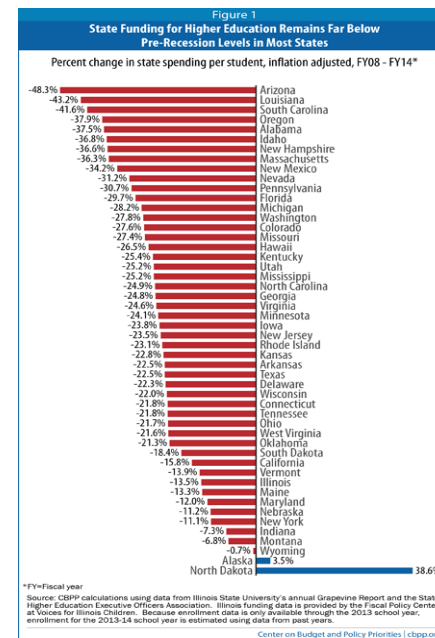
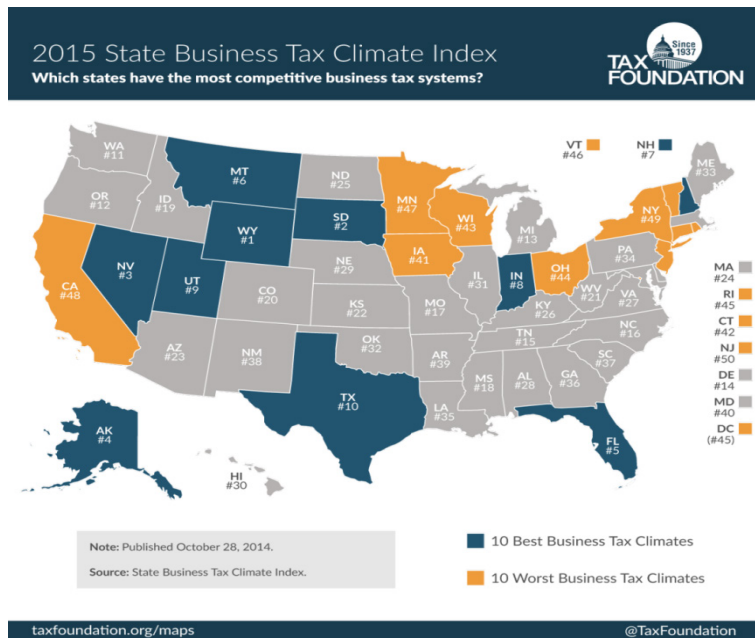
Federal Policy Seems to be Moving in Opposite Direction

- “Skinny budget” cuts to non-defense discretionary spending to fund defense spending
- ACA repeal and replace would include Medicaid per capita caps with block grant option
- President Trump and Congressional Republicans have also expressed support for block granting SNAP
- More broadly, federal/state and local tensions over immigration, environmental, and criminal justice policy
- But also Treasury’s Office of State and Local Finance, OMB’s Community Solutions Council (lessons from Detroit, Puerto Rico, usaspending.gov, etc.)

What to Do?

Know Your Budgets, Focus on Tradeoffs

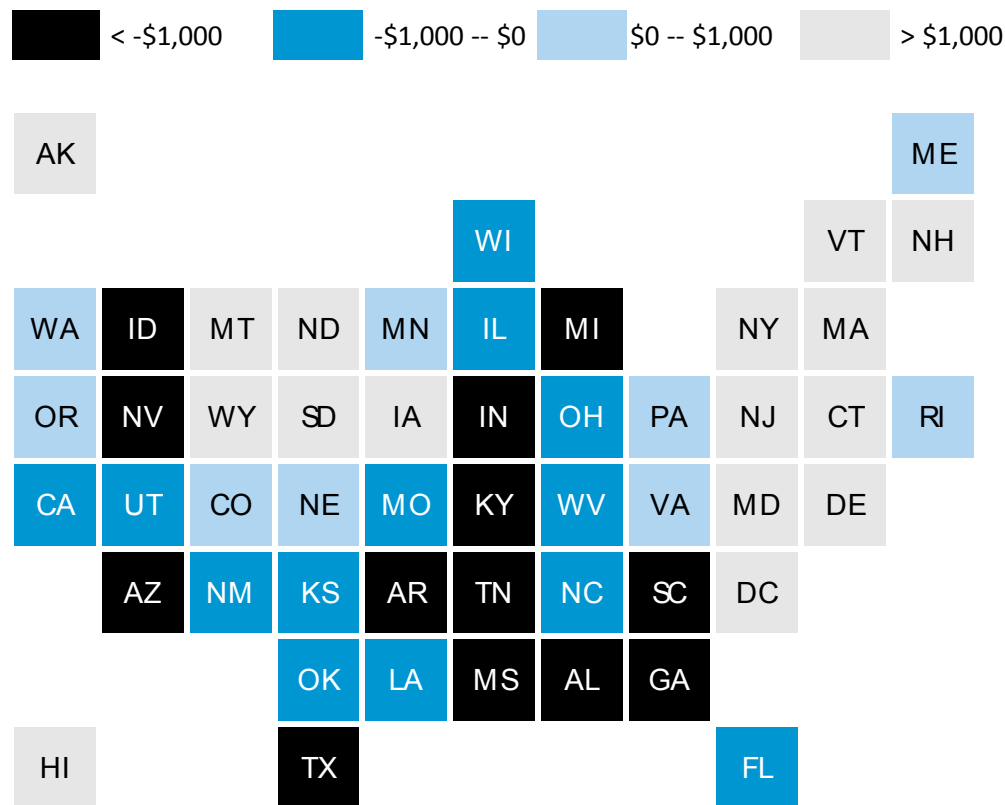
- Per capita comparisons are a flawed metric, ignore differences in geography, income, demographics, costs
- More broadly, they fail to capture *policy choices* vs. *background conditions*



Tools to Solve These Problems

- **Fiscal Capacity** Multiplies US average tax rate or fee assessment for each major revenue source by state base to obtain *revenue capacity*
- Multiplies US average per capita spending by state population, adjusts for demographics and costs to get *expenditure need*
- Takes difference as *fiscal gap at capacity* and compares to federal grants

Gap at Capacity After Transfers



Source: Urban Institute calculations

Note: Gap at capacity after transfers equals a state's revenue capacity plus federal transfers minus expenditure need.

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Tools to Solve These Problems

- **What everyone should know about their state's budget** (actually state & local spending combined)

<http://apps.urban.org/features/what-drives-state-spending/>

- E.g., States with few school-aged kids (demographics) and high private school enrollments (takeup 2) often spend a lot on public schools (NJ, NY, MA, RI, DC). Why? High salaries (payroll) and other costs (non-payroll)

FIGURE 1
State Spending Drivers Excerpt: K-12 education
sorted by payroll per capita



About one out of every five dollars that state and local governments spend (from their own and federal funds) goes to elementary and secondary education. Education is also tremendously popular with voters, consistently ranking as their top spending priority in opinion polls. This section delves into how states compare on spending for public schools, including money spent on administration, school lunch programs, counseling services, and student transportation.

spending per capita = demographics × take-up rate × take-up rate 2 × unit per recipient × (payroll + nonpayroll)

	demographics	take-up rate	take-up rate 2	unit per recipient	payroll	nonpayroll
1 DC	52	1	51	44	1	1
2 AK	15	23	24	6	12	3
3 WY	29	19	2	2	22	15
4 NY	43	17	44	8	6	2
5 NJ	31	10	38	10	2	13
6 CT	30	15	23	15	7	18
7 VT	48	52	19	1	24	44
8 MA	44	34	35	14	11	17
9 RI	46	51	39	27	5	7
10 NH	41	a	28	3	23	34
11 NE	9	32	43	9	29	27
12 MD	34	46	47	23	4	21
13 DE	38	42	48	41	13	4
14 OH	25	25	46	30	19	10
15 IL	15	11	32	32	14	20
16 IA	22	43	18	16	30	25
17 LA	17	4	50	25	45	8
18 PA	42	47	49	26	15	12
19 MN	18	40	34	43	3	24

States whose governments spend the most per capita on K-12 education are not necessarily home to the most students. Take New Jersey, New York, Massachusetts, Rhode Island, and DC. All have relatively few school-age children (demographics) and low rates of public school attendance (take-up). But they have high payroll and other costs. The result is high spending despite fewer kids. Some states also employ a lot of teachers and other personnel per student (units per recipient), adding to the overall tab for public K-12 education.

Source: Excerpt from SLFI State Spending Drivers Webtool, 2017.

Demo, documentation and data depot on web site contain all kinds of info – try it out!