What the GAO Predicts for States and Localities' Future

BY: Mike Maciag | June 28, 2013

The economy may be rebounding, but the long-term outlook for governments is bleak. A recent report by the Government Accountability Office (GAO) finds a widening gap between projected revenues and expenses for years to come.

States and localities will record operating balances with an aggregate deficit of 1.6 percent of gross domestic product (GDP) this year. Absent any reforms, this deficit will balloon to 2.7 percent within 30 years. To close the fiscal gap, governments would need to trim current expenditures by 14.2 percent and maintain that spending level as a share of GDP in future budgets.

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While states and localities face several short-term fiscal hurdles -- namely pension shortfalls and declining property tax revenues -- narrowing the gap will prove even more difficult in the decades to follow. "The longer we wait, the bigger the problem becomes and the harder it will be to solve," says Stanley Czerwinski, director of the GAO group that authored the report.

The GAO based its projections on a model simulating more than 100 equations comparing projected expenses and revenues, factoring in the Congressional Budget Office's economic growth estimates. It accounts only for current policies, so future adjustments to tax codes, pensions and other changes will sway the model's trend line. Here is a summary of a few key drivers of fiscal pressures for the coming years.

Health Expenses

Not surprisingly, the report cites rising health costs as the top fiscal challenge over the long haul. Medicaid expenditures, along with health insurance costs for public employees and retirees, are expected to rise sharply. Accordingly, the GAO projects state and local governments' total health-related costs to climb from the current 3.8 percent of GDP to 7.2 percent of GDP by 2060, while non-health costs will decline from 10.5 percent to 7.7 percent of GDP over the same time period. "Long term, it's not a revenue or expenditure issue," says Czerwinski. "It's a health-care issue."

So far, about half the states have opted to expand Medicaid coverage under the Affordable Care Act (ACA), for which the federal government will initially cover all costs. States' funding share will gradually rise to 10 percent by 2020. But with some ambiguity surrounding implementation of the legislation and not knowing how health costs will fluctuate, the report concluded that the net effects of ACA were not yet known.

Federal Funding

Federal spending cuts could worsen matters for states and localities. Across-the-board federal cuts stemming from sequestration left Medicaid and most other programs states administer largely unscathed. However, Marcia Howard, executive director of the nonpartisan Federal Funds Information for States, said the uncertainty of sequestration has made it hard for states to know where they stand.

Additionally, federal funding, which accounts for about a third of total state revenues, has remained mostly stagnant outside of Medicaid and some education programs. Still, Howard is optimistic that states will overcome potential hurdles. "States have proven incredibly adept at responding to the recession through budget cuts or tax increases," she says.

Pension Reforms

Many states enacted sweeping reforms to shore up their pension systems. A recent survey of human resources representatives from the Center for State and Local Government Excellence found that 44 percent implemented changes to retirement benefits over the past year, of which 29 percent had increased current employee contributions. Pension costs will further climb in the coming years as baby boomers get set to retire. The stock market, of course, will also affect retirement systems' rate of return.

Property Taxes

Many of the nation's largest cities lean heavily on property taxes for much of their revenue. In Boston, for example, it is two-thirds of total revenue; in Baltimore, it's nearly half. The bursting of the housing bubble meant that localities either took a hit or were forced to raise their tax rates. What's more, the effect of reduced home values varies, and some localities have longer reassessment cycles.

Tax Bases

On the revenue side, eroding tax bases "buried" states, says Don Boyd, a senior fellow at the Rockefeller Institute of Government.

The economy has slowly shifted from goods to services, which governments traditionally are reluctant to collect taxes on. Furthermore, Internet sales are growing, but states and localities are missing out on that revenue. If the proposed Marketplace Fairness Act navigates its way through Congress, however, most online retailers will finally begin collecting sales tax on transactions, boosting revenues.

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Although tax receipts are nearing pre-recession levels in terms of nominal dollars, they still haven't returned to where they were as a percentage of GDP. It goes without saying that tax bases and other long-term fiscal pressures all hinge, to a certain extent, on the national economy. Regardless, states and localities must act. "They need to tackle these programs bit by bit, year after year," Boyd says. "Governments don't have the luxury of waiting 10 years."