Exhibit 37

United States Government Accountability Office

GAO

Report to the Congress

March 2010

STATE AND LOCAL GOVERNMENTS' FISCAL OUTLOOK

March 2010 Update

GAO-10-358

March 2010

STATE AND LOCAL GOVERNMENTS' FISCAL OUTLOOK

March 2010 Update

GAO Accountability · Integrity · Reliability

Highlights

Highlights of GAO-10-358 , a report to the Congress

Why GAO Did This Study

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 show that, like the federal government, the state and local government sector faces persistent and long-term fiscal pressures.

Using the Bureau of Economic Analysis's National Income and Product Accounts (NIPA) as the primary data source, GAO's model projects the level of receipts and expenditures for the sector until 2060 based on current and historical spending and revenue patterns. GAO assumes the current set of policies in place across federal, state, and local governments remains constant. This update incorporates NIPA data including increased federal grant funding made available to the sector through the American Recovery and Reinvestment Act of 2009. The model simulates the long-term fiscal outlook for the state and local sector as a whole and, while the model incorporates the Congressional Budget Office's economic projections, adjustments are made to capture the budgetary effects of 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 http://www.gao.gov/special.pubs/longterm/.

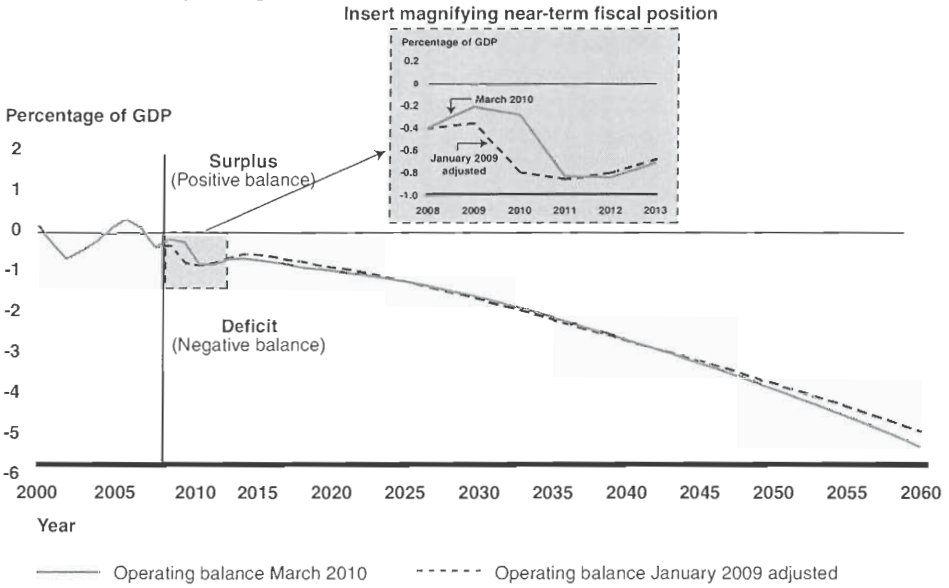
View GAO-10-358 or key components. For more information, contact Stanley J. Czerwinski at (202) 512-6806 or czerwinskis@gao.gov or Thomas J. McCool at (202) 512-2700 or mccoolt@gao.gov.

What GAO Found

The state and local government sector continues to face near- and long-term fiscal challenges which grow over time. Although the sector's near-term operating balance remains negative, increases in federal grants-in-aid—largely from the Recovery Act—alleviated some near-term pressure. As shown in the insert to the figure below, the March 2010 operating balance measure (including 2009 Recovery Act funds) shows an improvement compared to the January 2009 simulation. In the near-term, the sector's fiscal position can be attributed to several factors, including steep revenue declines.

GAO projects that the sector's long-term fiscal position will steadily decline through 2060 absent any policy changes, as shown in figure 1. The decline in the sector's operating balance is primarily driven by rising health care costs. The fiscal challenges confronting the state and local sector add to the nation's overall fiscal difficulties. Because most state and local governments are required to balance their operating budgets, the declining fiscal conditions shown in GAO's simulations suggest the fiscal pressures the sector faces and the extent to which these governments will need to make substantial policy changes to avoid growing imbalances.

State and Local Operating Balance Measure, as a Percentage of Gross Domestic Product



Source: GAO simulations, updated March 2010 and January 2009 adjusted.

Notes: The operating balance is a measure of the sector's ability to cover its current expenditures out of current receipts. Historical data are from the Bureau of Economic Analysis's NIPA accounts from 1980 to 2008. Data in 2009 are GAO estimates aligned with published data where available. GAO simulations are from 2010 to 2060, using many Congressional Budget Office projections and assumptions, particularly for the next 10 years. Simulations are based on current policy.

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United States Government Accountability Office
Washington, DC 20548

March 2, 2010

Report to the Congress

Fiscal sustainability presents a national challenge shared by all levels of government. Recent economic events and state and local government efforts to maintain balance during the current recession have called attention to the immediate challenges facing these governments. The recession has substantially reduced states' and local governments' combined tax revenues. These immediate challenges exist alongside daunting long-term fiscal challenges for all levels of government.

For almost two decades, 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.[1] Under the authority of the Comptroller General, GAO began publishing long-term fiscal simulations for the state and local government sector in 2007. This report updates GAO's state and local fiscal model for the purposes of (1) analyzing the near-term effects of the recent economic downturn on the sector and (2) assessing the long-term outlook of the sector and identifying the key drivers of this outlook.

Using the U.S. Bureau of Economic Analysis's National Income and Product Accounts (NIPA) as the primary data source, our model projects the level of receipts and expenditures for the sector until 2060 based on current and historical spending and revenue patterns. We assume the current set of policies in place across federal, state, and local governments remains constant. This update incorporates NIPA data including increased federal grant funding made available to the sector through the American Recovery and Reinvestment Act of 2009 (Recovery Act). The model simulates the long-term fiscal outlook for the state and local sector as a whole and, while the model incorporates the Congressional Budget Office's economic projections, adjustments are made to capture the budgetary effects of 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. Also, the model does

[1]See GAO, *The Federal Government's Long-Term Fiscal Outlook: January 2010 Update*, GAO-10-468SP (Washington, D.C.: March 2010). This and related products can be found at http://www.gao.gov/special.pubs/longterm/.

not identify whether the state or local government sector faces greater challenges. For additional information on the model's key assumptions, see Appendix I.

In summary, this March 2010 update to our model shows that the state and local government sector continues to face near-term budget and long-term fiscal challenges which grow over time. Although the sector's near-term operating balance remains negative, increases in federal grants-in-aid—largely from the Recovery Act—alleviated some near-term pressure. In the near-term, declines in the sector's fiscal position are attributable to several factors, including steep revenue declines.

In the long-term, we project that the fiscal position will steadily decline through 2060 absent any policy changes. The decline in the sector's operating balance is primarily driven by rising health care costs. The fiscal challenges confronting the state and local sector add to the nation's overall fiscal difficulties. Because 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 foreshadow the extent to which these governments will need to make substantial policy changes and other adjustments to avoid growing fiscal imbalances.

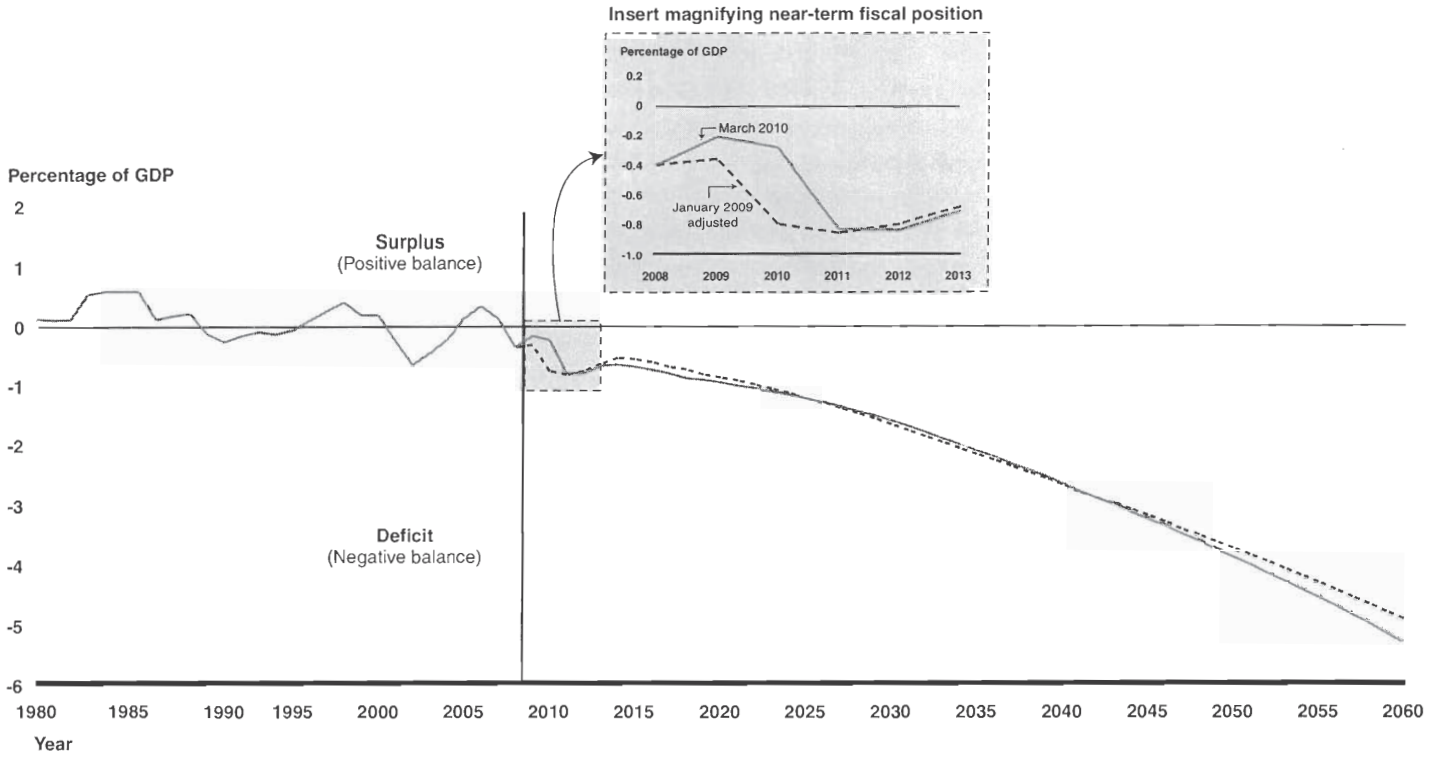
Infusion of Recovery Act Funds Helped State and Local Governments Address Budget Gaps in the Near-Term

This March 2010 update to our model shows that the state and local government sector faces near-term declines in its operating balance (figure 1).[2] These declines in the sector's fiscal position are attributable to several factors, including a reduction in projected tax receipts. An increase in federal grants-in-aid—largely from the Recovery Act—has helped state and local governments address fiscal challenges in the near-term.[3] As shown in the insert to the figure below, the March 2010 operating balance measure (which includes the 2009 Recovery Act funds) shows an improvement compared to the January 2009 simulation.

[2]In figure 1, we use the term "January 2009 Adjusted" to refer to the results of our model published in GAO, Update of State and Local Government Fiscal Pressures, GAO-09-320R (Washington, D.C.: Jan. 26, 2009), which we adjusted to reflect the effect of reduced oil prices on the sector's expenditures. "March 2010" refers to the results of our most recent simulation, published in this report. See table 1 for a description of adjustments made to our simulations since the January 2009 report.

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

Figure 1: State and Local Operating Balance Measure, as a Percentage of Gross Domestic Product[a]



Operating balance March 2010

Operating balance January 2009 adjusted

Source: GAO simulations, updated March 2010 and January 2009 adjusted.

Notes: Historical data are from the Bureau of Economic Analysis's National Income and Product Accounts from 1980 to 2008. Data in 2009 are GAO estimates aligned with published data where available. GAO simulations are from 2010 to 2060, using many Congressional Budget Office projections and assumptions, particularly for the next 10 years. Simulations are based on current policy.

[a]Data for this and other figures in this report can be downloaded at http://www.gao.gov/special.pubs/longterm/data.html.

The model uses the operating balance as a measure of fiscal balance for the sector for each year until 2060.[4] As illustrated in figure 1, the operating balance generally was positive in the past except during and after recent

[4]The operating balance is a measure of the sector's ability to cover its current expenditures out of current receipts.

recessions. This suggests that, in the aggregate, the sector had been able to cover its expenses with incoming receipts.

The model results in near-term projected deficits, even after the inclusion of updated NIPA data which reflect Recovery Act grant funds received by state and local governments.[5] Specifically, the model estimates operating deficits for the state and local sector of about $39 billion for 2010 and $124 billion for 2011. The cumulative two-year projected operating deficit is estimated to total approximately $163 billion for 2010 and 2011.[6] These results confirm our recent finding that while states' near-term revenue shortfalls have been cushioned by the temporary infusion of Recovery Act funds, states will continue to be fiscally stressed.[7]

One of the factors contributing to the model's projected near-term deficits is the sector's decline in some tax receipt categories, as illustrated in figure 2. Total tax receipts for the sector declined from about 9.25 percent of GDP in 2008 to 8.80 percent of GDP in 2009. We project a slight increase in total tax receipts to 8.82 percent of GDP in 2010.[8] Personal income tax receipts declined from about 2.3 percent of GDP in 2008 to 1.9 percent in 2009. We project that these receipts will increase as a share of GDP beginning in 2009. As a percentage of GDP, state and local personal income tax declines exceeded revenue shifts from sales and property tax.

[5]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, thus resulting in a near-term or cyclical operating deficit.

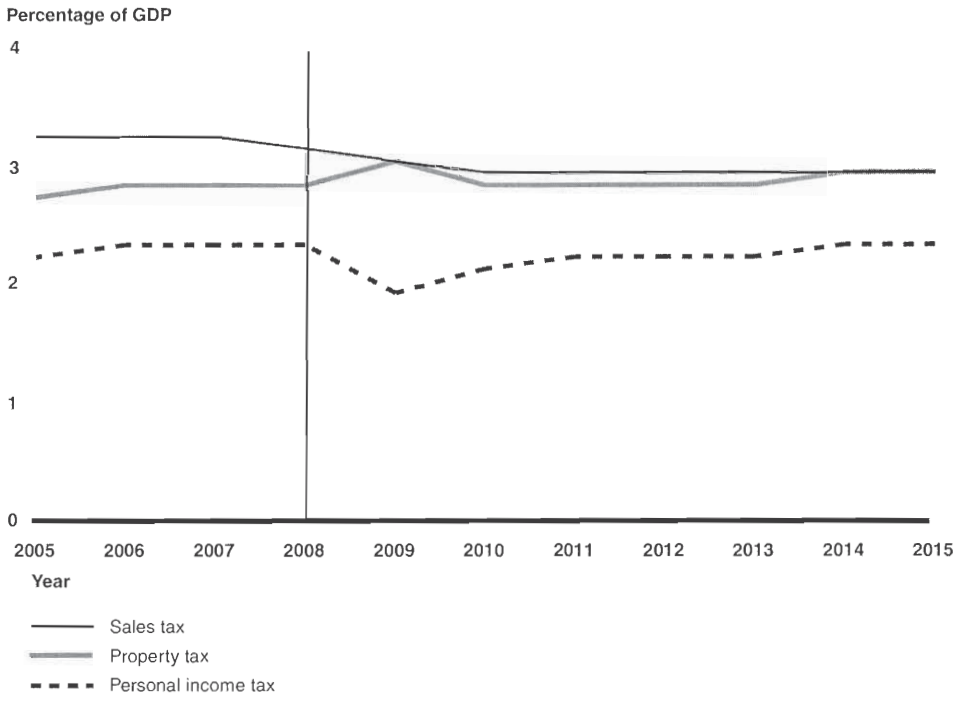
[6]These estimates do not attempt to assume forthcoming policy actions by federal, state or local governments and are based on analysis of historical data. Actual amounts will reflect policy actions taken by state and local governments to balance their budgets. Years are calendar years.

[7]See GAO, *Recovery Act: Status of States' and Localities' Use of Funds and Efforts to Ensure Accountability*, GAO-10-231 (Washington, D.C.: Dec. 10, 2009); and GAO, *Recovery Act: Funds Continue to Provide Fiscal Relief to States and Localities, While Accountability and Reporting Challenges Need to Be Fully Addressed*, GAO-09-1016 (Washington, D.C.: Sept. 23, 2009). See also National Governors Association and National Association of State Budget Officers, *The Fiscal Survey of States* (Washington, D.C.: Dec. 2009); National Association of Counties, *How are Counties Doing? An Economic Status Survey* (Washington, D.C.: Nov. 2009); and National League of Cities, *Research Brief on America's Cities, City Fiscal Conditions in 2009* (Washington, D.C.: Sept. 2009).

[8]We use historical data from BEA NIPA from 1980 to 2008. Data in 2009 are GAO estimates based on data available through the third quarter of 2009. GAO projections are from 2010 to 2060.

Property tax receipts as a percentage of GDP increased from about 2.8 percent in 2008 to about 3.0 percent in 2009. While property taxes increased as a percentage of GDP, property tax receipts increased just 2.7 percent—from about $411 billion in 2008 to $422 billion in 2009, the lowest annual increase since 1995. In addition, GDP decreased 1.3 percent—from about $14.4 trillion to about $14.3 trillion during the same period. We project that property tax receipts will continue to be about 3.0 percent of GDP through 2015.

Figure 2: State and Local Government Taxes, as a Percentage of Gross Domestic Product



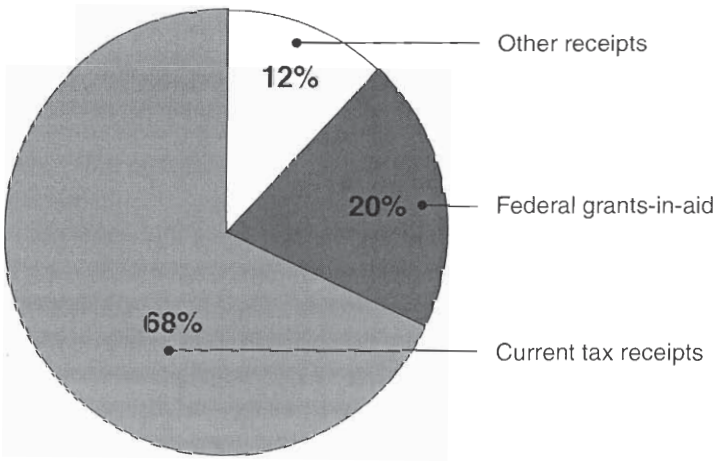
Source: GAO simulations, updated March 2010.

Notes: Historical data are from the Bureau of Economic Analysis's National Income and Product Accounts from 1980 to 2008. Data in 2009 are GAO estimates aligned with published data where available. GAO simulations are from 2010 to 2060, using many Congressional Budget Office projections and assumptions, particularly for the next 10 years. Simulations are based on current policy.

The state and local government sector's receipts in 2008 totaled almost $2 trillion. As illustrated in figure 3, 68 percent—or about $1.3 trillion in 2008—of the sector's receipts are comprised of tax receipts, including personal income, sales, and property taxes. Federal grants-in-aid comprise

the second largest source of receipts for the sector, providing about $392 billion to the sector. In 2008, the sector had about $246 billion in other receipts, including income on assets and contributions for government insurance.

Figure 3: State and Local Government Current Receipts by Category, 2008



Source: GAO analysis of NIPA data.

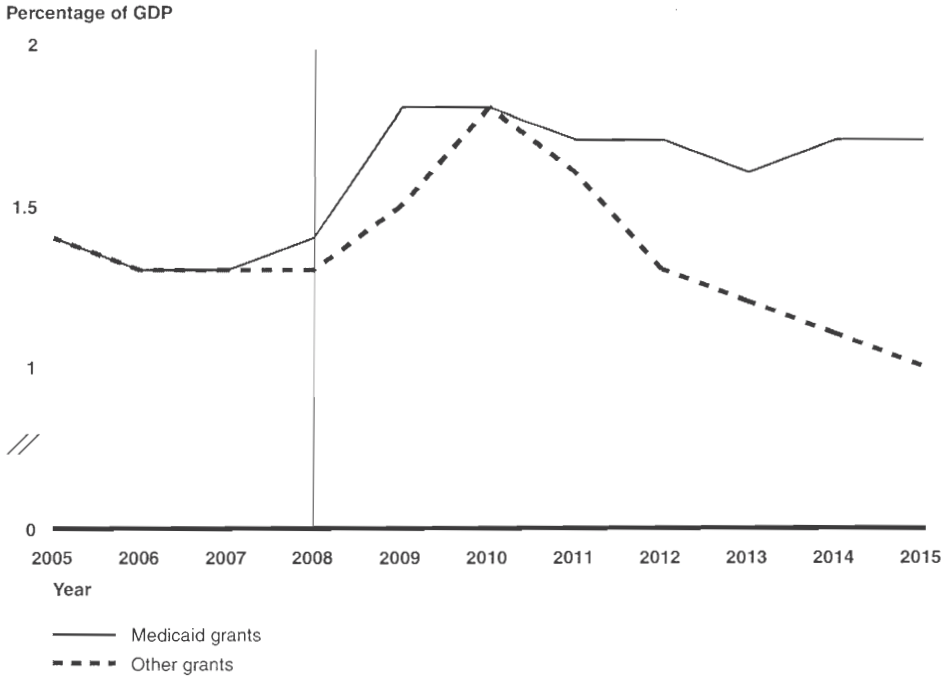
Notes: Other receipts includes income on assets, contributions for government insurance, surplus from government enterprises, and transfer receipts from businesses and persons.

In the near-term, federal grants-in-aid—which in 2009 included funding from the Recovery Act—helped offset the sector's tax receipt declines. Medicaid and other federal grants are projected to grow as a share of GDP through 2010 (figure 4).[9] After 2010, the model projects that as a percentage of GDP, Medicaid grants will decline through 2012 and then begin to increase. Other federal grants—including those for education, highways, weatherization, housing, and other programs—are projected to

[9]Medicaid is a joint federal-state program that finances health care for certain categories of low-income individuals, including children, families, persons with disabilities, and persons who are elderly. The federal government provides assistance to states (known as the Federal Medical Assistance Percentage, or FMAP) for Medicaid services according to a formula based on each state's per capita income in relation to the national average per capita income. Under the Recovery Act, states are eligible for an increased FMAP for expenditures that states make in providing services to their Medicaid populations. The Recovery Act provides eligible states with this increased FMAP for 27 months between October 1, 2008, and December 31, 2010.

decline as a percentage of GDP after 2010, consistent with CBO's assumptions.

Figure 4: State and Local Government Grants, as a Percentage of Gross Domestic Product



Source: GAO simulations, updated March 2010.

Note: Historical data are from the Bureau of Economic Analysis's National Income and Product Accounts from 1980 to 2008. Data in 2009 are GAO estimates aligned with published data where available. GAO simulations are from 2010 to 2060, using many Congressional Budget Office projections and assumptions, particularly for the next 10 years. Simulations are based on current policy.

State and Local Sector Continues to Face Long-Term Fiscal Challenges Driven by Growing Health Care Costs

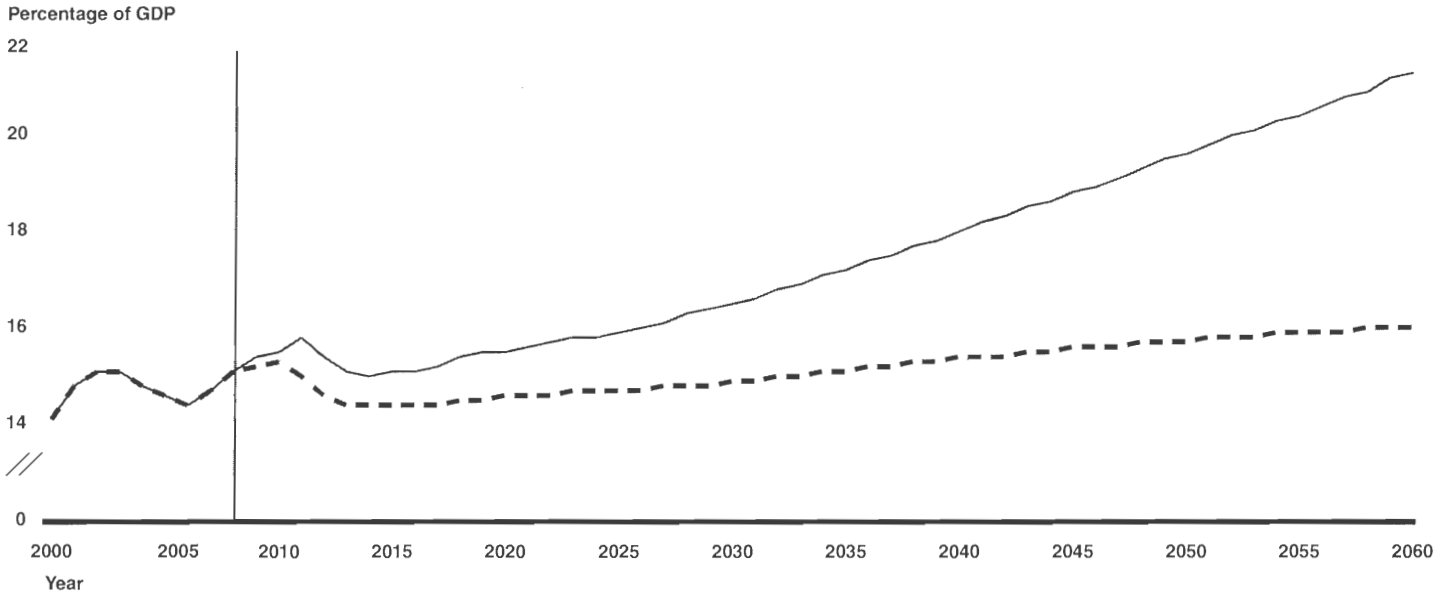
The fiscal challenges confronting the state and local sector add to the nation's overall fiscal difficulties. As we have reported in previous model updates, and as shown in figure 1 above, the sector faces growing long-term fiscal challenges.[10] We project that the fiscal position of the sector will steadily decline through 2060 absent any policy changes.[11] The decline in the sector's operating balance is primarily driven by rising health care costs. Because 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 foreshadow the extent to which these governments will need to make substantial policy changes to avoid growing fiscal imbalances.

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 prevent operating deficits (or negative operating balances). As shown in figure 5, we calculated that closing the fiscal gap would require action to be taken today and maintained for each and every year going forward equivalent to a 12.3 percent reduction in state and local government current expenditures. Closing the fiscal gap through revenue increases would require action of a similar magnitude through increased state and local tax receipts.

[10]The most recent prior update is GAO, *Update of State and Local Fiscal Pressures*, GAO-09-320R (Washington, D.C.: Jan. 26, 2009). See also GAO, *State and Local Fiscal Challenges: Rising Health Care Costs Drive Long-term and Immediate Pressures*, GAO-09-210T (Washington, D.C.: Nov. 19, 2008).

[11]The explicit definition of our operating balance measure is all receipts, excluding funds used for long-term investments, minus current expenditures. To develop 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 exclude capital-related expenditures from spending.

Figure 5: Extent of State and Local Government Action Required to Maintain Balance (State and Local Expenditures, as a Percentage of Gross Domestic Product)



Source: GAO simulations, updated March 2010.

Note: Historical data are from the Bureau of Economic Analysis's National Income and Product Accounts from 1980 to 2008. Data in 2009 are GAO estimates aligned with published data where available. GAO simulations are from 2010 to 2060, using many Congressional Budget Office projections and assumptions, particularly for the next 10 years. Simulations are based on current policy. 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.

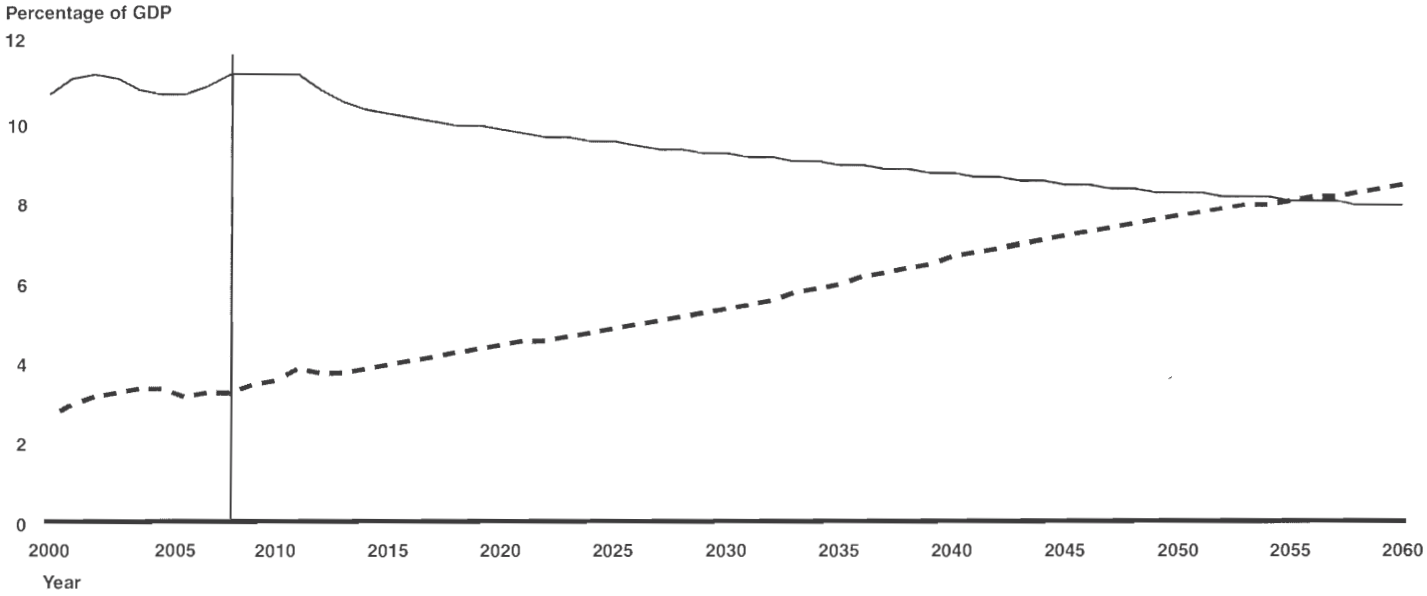
The primary driver of fiscal challenges for the state and local government sector continues to be the growth in health-related costs. Specifically, state and local expenditures on Medicaid and the cost of health insurance for state and local retirees and employees are projected to grow more than

GDP.[12] The model also projects that the sector's health-related costs will be about 3.5 percent of GDP in 2010 and 3.8 percent of GDP in 2011. In contrast, we found that other types of state and local government expenditures—including wages and salaries of state and local workers and investments in capital goods—are expected to grow slightly less than GDP. We also found that revenue growth, excluding Medicaid grants from the federal government, is projected to be relatively flat as a percentage of GDP. As such, the projected rise in health-related costs is the root of the fiscal difficulties these simulations suggest will occur. Our simulations for health-related and other expenditures are shown in figure 6.[13]

[12]One of the most central assumptions we must make to estimate the pay-as-you-go health expenditures for employees and retirees in future years is the cost growth of health care. The extent to which the per-person cost of health care is expected to grow beyond GDP per capita is called the "excess cost factor." We estimate the excess cost factor using unpublished data from the Centers for Medicare & Medicaid Services' (CMS) Office of the Actuary. Between 2008 and 2009, CMS reduced its assumption for average annual excess cost growth during 2010-2080 from 1.3 percent to 0.8 percent, which we incorporated into our model. This reduced the growth in our Medicaid and employee and retiree health spending projections from our January 2009 simulation.

[13]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 6: Health and Non-Health Expenditures of State and Local Governments, as a Percentage of Gross Domestic Product



Source: GAO simulations, updated March 2010.

Note: Historical data are from the Bureau of Economic Analysis's National Income and Product Accounts from 1980 to 2008. Data in 2009 are GAO estimates aligned with published data where available. GAO simulations are from 2010 to 2060, using many Congressional Budget Office projections and assumptions, particularly for the next 10 years. Simulations are based on current policy.

Recent declines in pension asset values stemming from the current recession could also affect the sector's long-term fiscal position. The sector experienced a decline in pension asset values of 27.6 percent—from $3.2 trillion at the end of 2007 to $2.3 trillion at the end of 2008. Our March 2009 estimate of the sector's required contribution rate rose to 9.9 percent of the sector's wages, which is higher than the sector's actual 8.3 percent of wages contributed in 2008. While governments can postpone increasing the annual contribution rate, postponing action could increase the rate needed to fully fund pensions. In addition to declines in pension asset values and the challenge of fully funding pension benefits, state and local

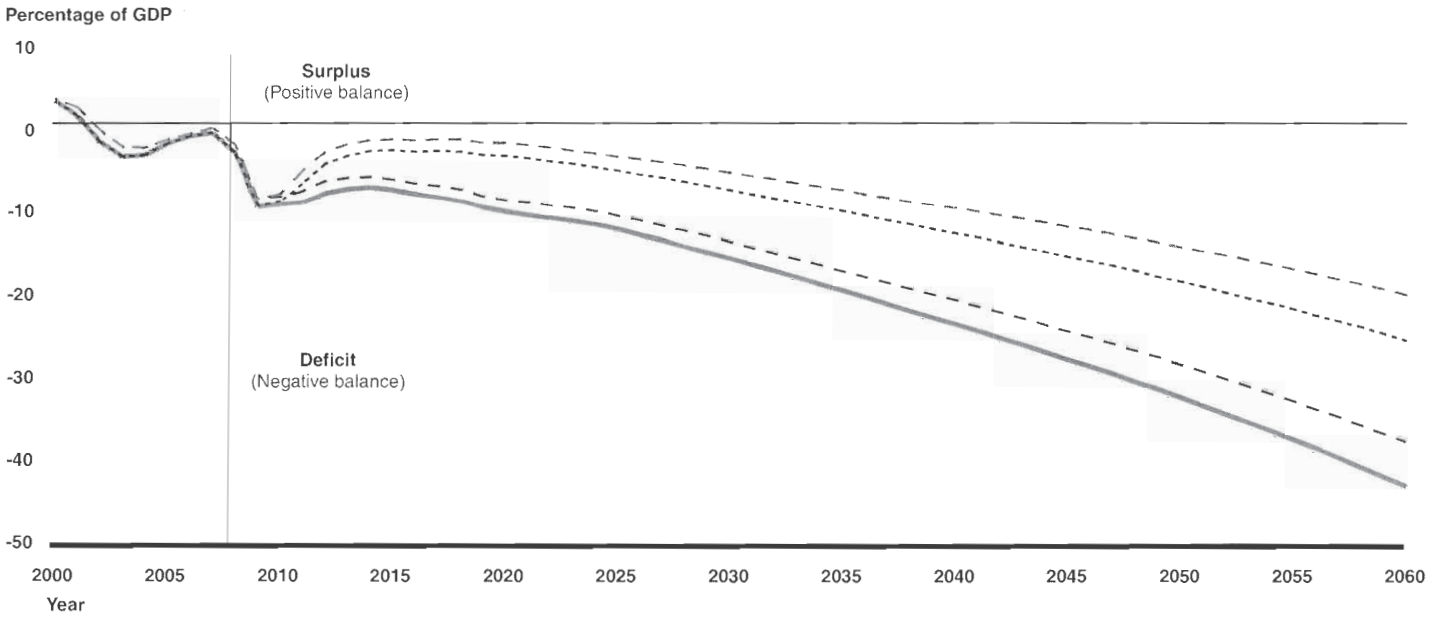
governments also face challenges funding their liabilities for other public employee benefits (which are primarily retiree health benefits).[14]

Similar to these state and local model findings, our most recent long-term federal model simulations continue to show health spending as one of the key drivers of long-term, unsustainable structural deficits.[15] As we, the CBO, and others have previously reported, the continued rise in health care costs poses challenges to not only the budgets of federal, state, and local governments, but also to American businesses, families, and societies as a whole. Figure 7 shows two simulations for the federal fiscal path under alternative assumptions and overlays the simulated fiscal imbalance of the state and local government sector. The overlay of the state and local government model's simulations in both the baseline and alternative scenarios shows that state and local governments' fiscal challenges impose further fiscal challenges on the nation's economy in the next several decades.

[14]See GAO, *State and Local Government Retiree Health Benefits: Liabilities Are Largely Unfunded, but Some Governments Are Taking Action*, GAO-10-61 (Washington, D.C.: Nov. 30, 2009). Most state and local governments pay for employee and retiree health insurance on a pay-as-you-go basis—that is, these benefits are generally not prefunded. To estimate expenditures for employee and retiree health insurance in future years, we assume that the same percentage of employees and retirees of state and local governments will be enrolled in health insurance through their previous employer as we observe were enrolled in 2005. The Agency for Healthcare Research and Quality updated its Medical Expenditure Panel Survey (MEPS) data in the fall of 2009 covering the period through 2008, which we have incorporated into this update.

[15]GAO-10-468SP

Figure 7: Federal and State/Local Surpluses and Deficits, as a Percentage of Gross Domestic Product



Source: Historical data from NIPA and GAO analysis.

Note: Historical data are from the Bureau of Economic Analysis's National Income and Product Accounts from 1980 to 2008. Data in 2009 are GAO estimates aligned with published data where available. GAO simulations are from 2010 to 2060, using many Congressional Budget Office projections and assumptions, particularly for the next 10 years. The state and local balance measure is similar to the federal unified budget measure. The baseline simulation uses CBO projections and assumes that taxes and expenditures during the next 10 years are in line with current law. The alternative simulation assumes expiring tax provisions are extended and that discretionary spending grows with GDP.

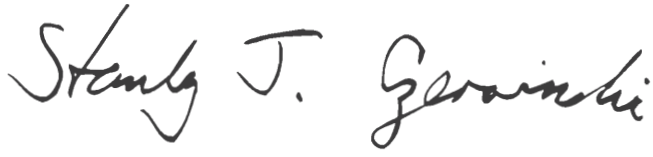
Our federal baseline simulation uses CBO projections for the next 10 years and assumes that taxes and expenditures during this time period are in line with current law. For example, we assume that a variety of federal tax provisions—mostly tax reductions—that are set to expire are allowed to expire, 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 estimates for those programs and CBO's mid-range Medicaid estimates. All other expenditures, as well as receipts, are held constant as a share of GDP after the first 10 years.

Our alternative federal simulation assumes that during the next 10 years, expiring tax provisions are extended and that federal 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. The alternative simulation also incorporates somewhat higher Medicare estimates reflecting historical trends that physician payments are not reduced as specified under current law.

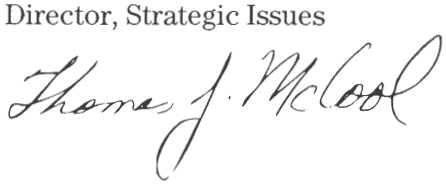
We conducted our work for this model update from August 2009 to March 2010 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our 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.

We are sending copies of this report to interested congressional committees. The report is part of a body of work on the long-term fiscal challenge and is available free of charge at http://www.gao.gov/special.pubs/longterm/.

If you or your staffs have any questions about this report, please contact Stanley J. Czerwinski at (202) 512-6806 or czerwinskis@gao.gov or Thomas J. McCool at (202) 512-2700 or mccoolt@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.



Stanley J. Czerwinski
Director, Strategic Issues



Thomas J. McCool
Director, Center for Economics

Appendix I: Scope and Methodology

To answer our two reporting objectives, we incorporated updated data into and analyzed output from GAO's State and Local Fiscal Model. While the model's key data sources and assumptions are summarized below, a detailed explanation of the model's methodology is available in Appendices 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).

Using the National Income and Product Accounts prepared by the U.S. Bureau of Economic Analysis as a primary data source, our state and local model projects the level of receipts and expenditures for the sector in future years based on current and historical spending and revenue patterns.[1] 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. We project the growth in each category of receipts and expenditures using CBO's economic assumptions whenever possible.[2] 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. 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. Our model assumes current policies remain in place. Since our last simulation in January 2009, we have made several adjustments to the model in light of recent economic events, as summarized in table 1.

[1]The model incorporates data available after BEA's comprehensive revision of the NIPA in July 2009.

[2]In Congressional Budget Office, *CBO's Economic Forecasting Record: 2009 Update* (Washington, D.C.: July 2009), CBO warns that the uncertainty inherent in its current forecasts exceeds the historical average because the current degree of economic dislocation exceeds that of any previous period in the past half-century.

Table 1: Modifications to Assumptions for March 2010 Update

Variable	Previous assumptions	Updated assumptions
State and local consumption excluding employee compensation and capital consumption—or "other consumption" (GSLCO)	Other consumption expenditures grow with population plus inflation. In our January 2009 simulations, we adjusted the projected 2008 value of this variable upward because energy price increases raised other consumption expenditures far more than the growth of population plus inflation.	In 2009, oil prices fell greatly, and the level of other consumption expenditures was below the level our standard assumption implies. In 2010 we increased this spending category to its 2000-2007 average as a share of GDP. Thereafter, we let other consumption expenditures grow with population plus inflation as per our standard assumption. In figure 1, we adjusted the January 2009 simulation (now labeled January 2009 adjusted) to incorporate the same assumptions for this spending category. Specifically, we used the same percentage of GDP for other consumption in the January 2009 adjusted simulation as we are using in the March 2010 simulation. This adjustment for years 2008, 2009, and 2010 removes the over-prediction of other consumption caused by our assumption in January 2009 that the 2008 historical peak in consumption expenditures was permanent rather than temporary.
Total state and local government retirement fund assets (L1TOTALFA)	In previous updates, we used 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.[a]	Because asset values can exhibit substantial volatility, governments typically use smoothed asset values in their pension funding calculations. Accordingly, in this update, we use the average value of pension fund assets over the previous five years to calculate the contribution rate needed to fully fund pensions. Even though this smoothing somewhat dampens the effect of the recent drop in asset values, that drop still raises our estimate of the required contribution rate significantly from previous estimates.
Medium and long-term municipal securities outstanding (DBTGSLLT)	The model's estimate of state and local governments' issuance of medium- and long-term debt depends on the difference between capital acquisitions and federal investment grants, municipal bond rates, and a first-order autoregressive error term, which adjusts the current year's estimate by some portion of the amount by which the equation over- or under-estimated the previous year's value.	Because an anomalously low amount of debt was issued in 2008, the year before the first projection year, the model under-predicted the change in debt in the early projection years. This overstated the model's estimate for the operating deficit because it implies a greater portion of general revenues must be used to finance investment rather than operating expenditures.[b] To address this issue, we now generate projections for debt issuance by excluding the autoregressive error term, which produces debt issuance values closer to general historical trends.
Employment cost indexes for private wages and salaries (JECIWSP) and state and local government wages and salaries (JECISTLC)	Our standard assumption is that both private wages and salaries and state and local government wages and salaries grow at the rate CBO assumes for the employment cost index in the final years of its ten-year economic projections.	We used a wage growth assumption of 3.1 percent, which is 0.1 percent higher than CBO's 3.0 percent assumption, to offset the 0.1 percent increase in CBO's GDP price inflation assumption from 1.7 percent in August 2009 to 1.8 percent in January 2010. If we had used CBO's wage growth assumption, wages would decline as a share of GDP when compared with our previous projections, which is inconsistent with our projections' unchanged rates of real GDP growth.

Variable	Previous assumptions	Updated assumptions
Total state and local government employment (EGSLALL)	Our standard assumption is that state and local government employment grows at the same rate as total population. We obtain data from NIPA to estimate this variable.	Because 2009 data on total employment was not available from NIPA at the time of our analysis, we used data from the Bureau of Labor Statistic's Current Employment Statistics program to estimate the sector's 2009 employment level. Also, we chose not to use our standard assumption because the economy was in recession during 2009. Instead, we estimated a non-recessionary employment level for 2010 by multiplying the average share of total population during the 2001-2009 period by 2010's projection population. After 2010, we assume the employment level grows with total population.
Rate on AAA-rated municipal bonds (RMMUNIBB20)	In previous models, we used the rate on Moody's AAA-rated municipal bonds (RMMUNIAAA) as the interest rate to derive the effective rate on the sector's credit market debt (RATEOWED). Our standard approach to project the AAA-rated municipal bond rate 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 over-predicts the last historical value.	To align our methods with other major sources, we now use the Bond Buyer GO 20-Bond Municipal Bond Index as our data source and adjusted our relationships for RATEOWED accordingly. 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.
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.	At the time of our March 2010 update, CBO 's NIPA-consistent values for federal grants were not available. To estimate federal investment and other federal grants, we multiplied the January 2010 GDP projection with an estimate of each variable's respective share of GDP derived from CBO's most recently available projections.
State personal income tax receipts (TXPGSTATE)	We simulate future state personal income tax receipts by estimating the long-run responsiveness, or elasticity, of receipts to taxable personal income. The long-run elasticity estimate depicts the extent to which tax receipts grow in response to income growth but does not capture their short-run reaction to changes in income over the business cycle.	We assumed a delay in adjustment that kept receipts one-tenth of one percent of GDP below the long run level in 2010. In 2011, we let state personal tax receipts return to their long run level.
General sales tax receipts (TXIMGSLSGEN)	We estimated the long-term responsiveness of our measure of the sales tax base to aggregate wage and salary income. Given projections of aggregate income, this elasticity provides a future path for the sales tax base.	Because this long-run relationship does not capture cyclical adjustments well, we adjusted the 2010 level downward by a tenth of a percent of GDP so that the category of which it is a part is the same share of GDP as IHS Global Insight projections in 2010.

Variable	Previous assumptions	Updated assumptions
Property tax receipts (TXIMGSLPROP)	Property tax receipts are assumed to grow with our projections of the property tax base. In turn, property tax base projections are based on our estimate of the relationship between real GDP and the real market value of real estate owned by both the household sector and the nonfarm, nonfinancial business sector.	Because our standard assumption does not adequately capture shorter term developments—particularly in recent years—we set property taxes in 2010 equal to their 2.8 percent average share of GDP during the non-recessionary years from 2002 through 2008. Thereafter, we let receipts grow from this level according to the long run relationship.

Source: GAO analysis.

Note: See Appendices 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) for a description of all assumptions made in the state and local model. Appendix V in GAO-08-317 provides a list of all model variables and definitions.

[a]Other elements include employment growth, beneficiary growth, wage growth, inflation, mortality, the real rate of return, and the employees' own contributions.

[b]In developing the operating balance measure, we subtract an estimate of general funds used to finance longer-term projects—such as investments in equipment and roads—from total receipts since these funds would not be available to cover current expenses. The estimate of general funds used for investment equals total investment minus the sum of federal grants and the change in debt.

Appendix II: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Staff Acknowledgments

In addition to the contacts listed above, Richard Krashevski and Michelle Sager (Assistant Directors), Shannon Finnegan (Analyst-in-Charge), Andrew Ching, and Kathleen Padulchik made significant contributions to this report.

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Exhibit 38

United States Government Accountability Office

GAO

Report to the Ranking Member, Committee on the Budget, House of Representatives

July 2010

STATE AND LOCAL GOVERNMENTS

Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs

GAO-10-899

July 2010

STATE AND LOCAL GOVERNMENTS

Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs

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Highlights

Highlights of GAO-10-899, a report to the Ranking Member, Committee on the Budget, House of Representatives

Why GAO Did This Study

State and local governments work in partnership with the federal government to implement numerous intergovernmental programs. Fiscal pressures for state and local governments may exist when spending is expected to outpace revenues for the long term. GAO was asked to examine (1) the long-term fiscal pressures facing state and local governments and historical spending and revenue trends, (2) spending and revenue trends to identify patterns among states, and (3) what is known about the implications of these fiscal pressures for federal policies.

Using aggregate data from the Bureau of Economic Analysis's National Income and Product Accounts, this analysis draws on results from the March 2010 update to GAO's state and local government fiscal model. GAO's model uses historical data to simulate expenditures and revenues for the sector for the next 50 years. Data from the U.S. Census Bureau are used to analyze patterns of state and local government expenditures and revenues among the states from 1977 to 2007, the most recent 30-year period for which these data were available. A review of GAO and other reports synthesizes what is known about the implications of these long-term fiscal pressures for future federal policies.

GAO does not make recommendations in this report.

View GAO-10-899 or key components. For more information, contact Stanley J. Czerwinski, (202) 512-6806, czerwinskis@gao.gov.

What GAO Found

Understanding patterns in state and local government expenditures and revenues is crucial for identifying and analyzing potential future fiscal pressures for the sector. The March 2010 update to GAO's state and local fiscal model updates simulations that state and local governments' long-term fiscal position will steadily decline through 2060 absent policy changes. The primary driver of the fiscal pressure confronting the state and local sector is the continued growth in health-related costs. Over the last 30 years, health care spending has increased as a share of state and local spending, growing from 12 percent of overall state and local expenditures in 1978 to 20 percent in 2008. While the temporary infusion of funds from the American Recovery and Reinvestment Act of 2009 helped cushion near-term revenue shortfalls, states will continue to be fiscally stressed.

The rates of growth in expenditures and revenues varied among the states during the past 30 years, both overall and within specific categories. Current expenditures grew faster than own-source revenues in almost all states between 1977 and 2007. Average annual growth rates of state and local government expenditures and revenues varied substantially by category and among states. For example, public welfare (which includes Medicaid) was one of the fastest growing expenditure categories. In the aggregate, inflation-adjusted spending on public welfare grew at an average annual rate of 5.3 percent per year and growth rates in individual states ranged from 2.3 percent to 10.9 percent. The growth of intergovernmental revenue from the federal government (grants) also varied among the states. State and local current expenditures grew faster than federal grant revenues in more than half of the states. Despite these trends, the sector in the aggregate usually remained in surplus during this 30-year period. The sector avoided operating deficits, in part because of federal grant growth, and in part because, from 1995 to 2007, the sector increasingly financed capital purchases by issuing debt, rather than with revenues, which left more revenues available to pay for current expenditures. However, if the overall trend of state and local government expenditure growth in excess of revenue growth persists, this growth will put increasing pressure on state and local governments going forward.

All levels of government face long-term fiscal challenges which could affect future federal funding of intergovernmental programs, as well as the potential capacity of state and local governments to help fund and implement these programs. The interconnectedness which defines intergovernmental programs requires that officials at all levels of government remain aware of and ready to respond to fiscal pressures. These pressures have implications for a wide range of federal, state, and local programs, policies, and activities, and include costs associated with health care, physical infrastructure, state and local employee pensions and retiree health benefits, and education, among other areas. Actions to address the nation's long-term fiscal outlook will be needed at all government levels in coming years and the challenges cannot be adequately met by shifting burdens from one level of government to another.

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Abbreviations

Recovery Act	American Recovery and Reinvestment Act of 2009
CAFR	comprehensive annual financial report
CBO	Congressional Budget Office
CHIP	Children's Health Insurance Program
CMS	Centers for Medicare & Medicaid Services
GDP	gross domestic product
LEA	local educational agencies
NASBO	National Association of State Budget Officers
NGA	National Governors Association
NIPA	National Income and Product Accounts
OPEB	other postemployment benefits
PPACA	Patient Protection and Affordable Care Act
SSI	Supplemental Security Income
TANF	Temporary Assistance for Needy Families

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

July 30, 2010

The Honorable Paul Ryan
Ranking Member
Committee on the Budget
House of Representatives

Dear Mr. Ryan:

State and local governments work in partnership with the federal government to implement numerous intergovernmental programs. All levels of government face long-term fiscal challenges, which threaten both the prospect for continued federal contributions to the funding of these programs as well as the potential capacity of state and local governments to help fund and implement these programs.

You asked us to provide information and analysis on the fiscal challenges facing state and local governments. In response to your request, we examined (1) the fiscal pressures facing state and local governments during the next several decades and the past expenditure and revenue trends that influence these pressures, (2) state and local government expenditure and revenue trends to identify patterns among states, and (3) what is known about the implications of long-term state and local government fiscal pressures for current and future federal policies.

To characterize and quantify the long-term fiscal outlook for the state and local government sector over the next 50 years, we drew information from the March 2010 update to our state and local government fiscal model.[1] To describe long-term trends in state and local government revenues and expenditures, we examined data from the National Income and Product Accounts (NIPA) over the past 30 years. In addition, we reviewed our prior reports and those of others to identify what is known about these trends and factors that affect them. To examine state and local government expenditure and revenue patterns among the states, we examined U.S. Census Bureau data for the past 30 years. We also reviewed our prior reports, as well as reports from the National Association of State Budget Officers (NASBO), the National Conference of State Legislatures, and

[1]GAO, *State and Local Governments' Fiscal Outlook: March 2010 Update*, GAO-10-358 (Washington, D.C.: Mar. 2, 2010).

others to understand state variation in fiscal pressures, revenue and spending patterns, and factors that affect them, including any shifts resulting from the recent recession. To identify what is known about the implications of these long-term fiscal pressures for federal policies, we reviewed our prior reports and reports by think tanks and associations representing state and local government officials. We assessed the reliability of the data we used for this review and determined that they were sufficiently reliable for our purposes. Appendix I provides additional details about the scope and methodology of our review, including certain limitations concerning the data that were available for our purposes.

We conducted our work from February 2010 to July 2010 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.

Background

Similar to our prior work on federal fiscal exposures, this report notes that state and local fiscal pressures can be thought of broadly and highlights trends in and simulations for state and local spending and revenue patterns that may expose the federal government to future spending or otherwise have implications for implementation of federal programs.[2] This review of state and local governments' fiscal pressures is not necessarily representative of all fiscal pressures facing state and local governments.[3] This review provides a perspective on the issues facing these governments and how these pressures could affect federal programs and policies. States and localities face fiscal pressures when, taken as a whole, spending is expected to outpace revenues, based on current policies. Growth in individual categories of spending, absent corresponding revenue growth or decreases in other spending, can be a source of fiscal pressures. Similarly, fiscal pressures may arise from revenue trends that do not keep pace with overall spending. Growth in individual spending categories or a decline in individual revenue categories alone does not constitute a fiscal pressure.

[2]See GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

[3]For example, the scope of the review does not include tax expenditures or pressures specific to individual state or local governments.

Changes in the makeup of state and local government services and revenues may be choices that reflect economic or demographic changes or a change in public preferences. Fiscal pressures can result from spending growth or revenue declines that are not the direct result of current state and local policy choices, but instead reflect automatic spending growth (for example in response to population shifts or an increase in the number of people eligible for government programs) or declines in revenue due to changes in the economy (e.g., increases in internet sales, which affect states' ability to capture sales tax). Individual expenditure categories can also face fiscal pressures; (e.g., employee pension funds experiencing growth rates below the rates assumed in budget forecasts which then become underfunded liabilities).

This work is primarily focused on long-term pressures, but the state and local government sector can also face short-term fiscal pressures that can arise from unexpected developments—such as a natural disaster or a recession—that cause substantial increases in spending or reductions in revenue. The recession that began in December 2007 caused significant immediate fiscal pressures in the form of reduced tax revenues and increased demand for certain programs, including Medicaid and unemployment benefits. Because this report focuses primarily on long-term pressures and some of the state and local data on government spending were only available through 2007, the effects of this recession are not included in the statistical analysis of variation among the states.

To address fiscal pressures and comply with balanced budget requirements, state and local governments may offset increased costs in one program by making cuts to other programs, but they may have less flexibility to adjust certain types of spending.[4] For example, state and local government employee pension benefits are often defined in state law or local ordinances or charters and, in that sense, pension benefits for current retirees are largely protected from states' or localities' responses to fiscal pressures. On the other hand, retiree health benefits for those employees may not have the same level of legal protection. Spending on programs such as street paving may have no legal protection, but instead be an implicit commitment grounded in the public's expectations for the provision of government services. Flexibility to adjust revenues may also

[4]Most states have some sort of requirement to balance operating budgets. Projects with longer time frames are typically budgeted separately from the operating budgets and financed by a combination of current receipts, federal grants, and the issuance of debt.

be constrained explicitly (e.g., caps on tax increases), or implicitly, (e.g., tax increases can be politically unpopular). The obligation of state and local governments to repay their long-term debt also varies, and a substantial portion of that debt has limited claims on the assets and revenues of state and local governments. About 60 percent of total state and local long-term debt outstanding is in the category of revenue bonds secured by a specific revenue-generating entity and provide no recourse to any other governmental assets or revenues in the event of default.[5] In contrast to revenue bonds, general obligation bonds, which comprise about 40 percent of total state and local long-term debt outstanding, have payment of principal and interest secured by the full faith and credit of the issuer.[6]

State and Local Governments Face Increasing Fiscal Challenges in the Next 50 Years

State and Local Fiscal Model Simulations Show Sector Facing Long-Term Fiscal Challenges

Our March 2010 state and local fiscal model updates simulations showing that state and local governments' long-term fiscal position will steadily decline through 2060 absent policy changes (see fig. 1).[7] Our updated simulations for the state and local sector's operating balance measure estimate operating deficits of about $39 billion for 2010 and $124 billion for 2011. These results confirm our recent finding that while states' near-

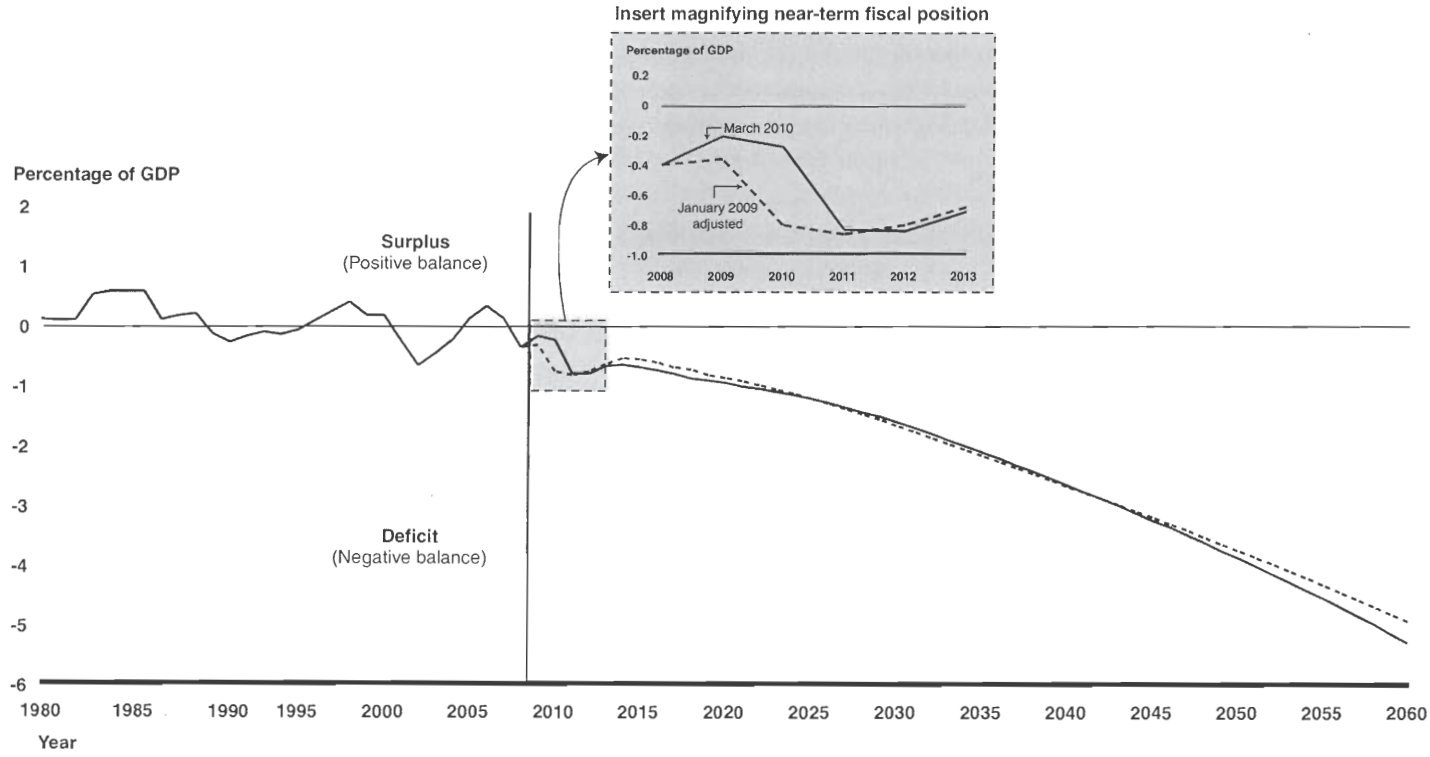
[5]The percentage composition of debt outstanding by type of debt is U.S. Census Bureau data for fiscal year 2004, the last year in which these data were collected. Some revenue bonds finance public projects including toll roads and water and sewage treatment facilities. Others provide loans for private purposes—the states and localities essentially act as a conduit for reduced-rate financing of private projects and the debt has no claim on state and local revenues and assets. Such private purpose debt has been a fast-growing category over the past 30 years.

[6]Although secured by the full faith and credit of the issuer, general obligation bonds are not necessarily less risky than revenue bonds of the same issuer. Under certain conditions, the bond rating on an issuer's general obligation bonds could be lower than the rating on its revenue bonds.

[7]GAO-10-358.

term revenue shortfalls have been cushioned by the temporary infusion of American Recovery and Reinvestment Act of 2009 (Recovery Act)[8] funds, as shown in the insert within figure 1, states will continue to be fiscally stressed.[9]

Figure 1: State and Local Government Operating Budget Balance, as a Percentage of GDP



Source: GAO simulations, updated March 2010 and January 2009 adjusted.

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

[9]See GAO, *Recovery Act: One Year Later, States' and Localities' Uses of Funds and Opportunities to Strengthen Accountability*, GAO-10-437 (Washington, D.C.: Mar. 3, 2010).

Notes: Historical data are from the Bureau of Economic Analysis's National Income and Product Accounts from 1980 to 2008. Data in 2009 are GAO estimates aligned with published data where available. GAO simulations are from 2010 to 2060, using many Congressional Budget Office (CBO) projections and assumptions, particularly for the next 10 years. Simulations are based on current policy. The term "January 2009 Adjusted" refers to the results of our model published in GAO, *Update of State and Local Government Fiscal Pressures*, GAO-09-320R (Washington, D.C.: Jan. 26, 2009), which we adjusted to reflect the effect of reduced oil prices on the sector's expenditures. "March 2010" refers to the results of our most recent simulation. As shown in the insert, the March 2010 operating balance shows an improvement compared to the January 2009 simulation. An increase in grants-in-aid—largely from the Recovery Act—helped state and local governments improve the aggregate operating balance in the near-term.

[a]Data for this and other figures in this report can be downloaded at http://www.gao.gov/special.pubs/longterm/data.html.

These simulations suggest the fiscal pressures the sector faces and the extent to which these governments will need to make substantial policy changes to avoid growing imbalances. The size of these simulated deficits and state and local government balanced budget requirements imply the need for these governments to take action to reduce state and local government current expenditures, increase revenues, or do both in order to maintain balance. One way of measuring the long-term challenges faced by the 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 prevent operating deficits (or negative operating balances).[10] Our simulations showed the present value of the fiscal gap over the period 2009 to 2058 was $9.9 trillion, or 2 percent of gross domestic product (GDP). We calculated that closing the fiscal gap over the next 50 years would require action to be taken today and maintained for each and every year going forward equivalent to a 12.3 percent reduction in state and local government current expenditures. Closing the fiscal gap through revenue increases would require action of a similar magnitude through increased state and local revenues. It is important to note that these estimates do not attempt to assume forthcoming policy actions by federal, state, or local

[10]Even though state and local governments regularly make changes in tax laws and expenditures, the model essentially holds current policy in place and analyzes the fiscal future for the sector as if those policies were maintained because it would be highly speculative to make any assumptions about future policy adjustments. The fiscal gap measure for our state and local fiscal model differs slightly from the fiscal gap measure used for our federal model. In our federal fiscal model, the fiscal gap represents the difference, or gap, between revenue and spending that would need to be closed in order to achieve a specified debt level (e.g., today's debt to GDP ratio). For the state and local model, the fiscal gap is the amount of spending reduction or tax increase needed to prevent operating deficits (or negative operating balances).

governments and are based on analysis of historical data. Actual amounts will reflect policy actions taken by state and local governments to balance their budgets.

The primary driver of the fiscal pressure confronting the state and local sector is the continued growth in health-related costs. State and local expenditures on Medicaid and the cost of health insurance for state and local retirees are expected to grow more than GDP. The health care cost growth assumptions in our model's simulations[11] do not include adjustments in response to the March 2010 passage of the Patient Protection and Affordable Care Act (PPACA).[12] Precisely how the act will affect state costs is not yet clear and will likely vary among the states. CMS estimates that while the federal government will be responsible for the vast majority of increases in Medicaid expenditures over the next 10 years, state and local governments will also experience some increases. Some analysts predict state costs will likely increase most where Medicaid eligibility requirements provided less coverage than that required by PPACA. A portion of these additional costs to states will likely be offset by lower charity care costs.[13]

Historical Data Show Aggregate Shifts in State and Local Expenditures, Revenues, and Intergovernmental Grants

Over the last 30 years, health care spending has increased as a share of state and local spending, growing from 12 percent of overall state and local expenditures in 1978 to 20 percent in 2008 (see fig. 2).[14] Trends in expenditures for other non-health categories of state and local government spending reflect some fluctuations in the federal role in some of these

[11]Our health care cost growth assumptions rely on the excess cost factor (i.e., the extent to which the per-person cost of health care is expected to grow beyond GDP per capita) estimated by the Centers for Medicare & Medicaid Services' (CMS) Office of the Actuary.

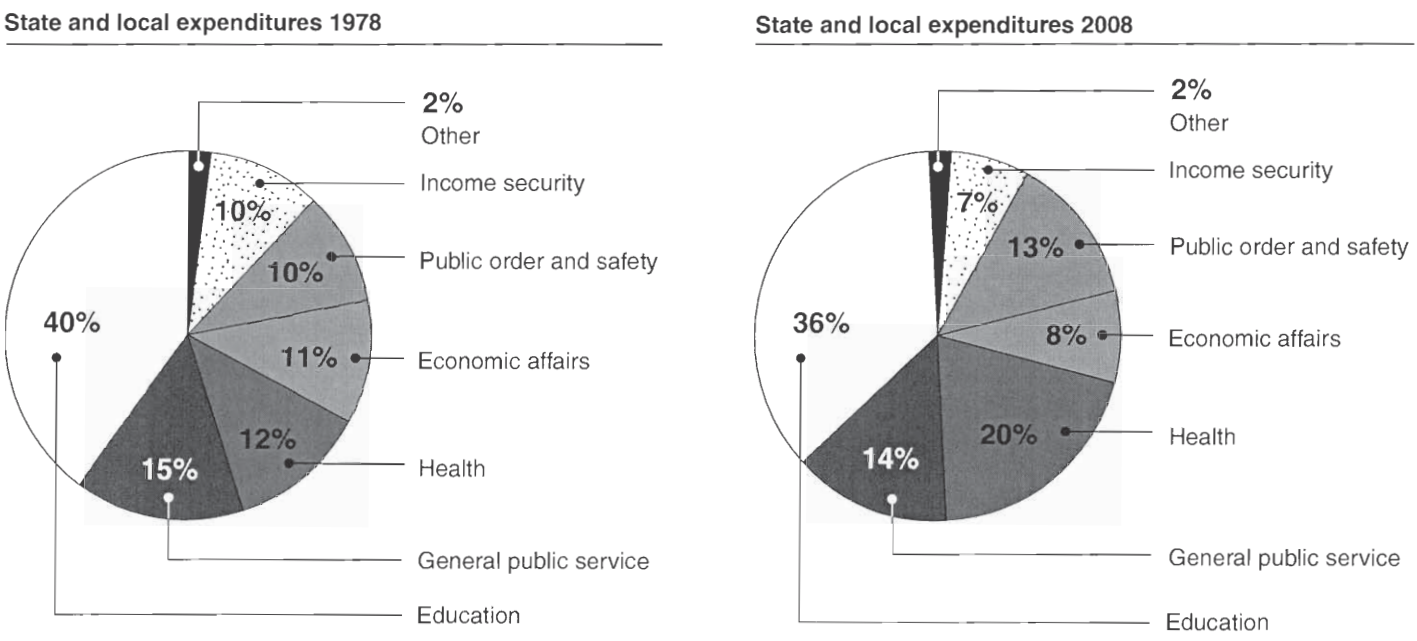
[12]We will continue to consult with CBO analysts to understand long-term assumptions revised in response to enactment of health care reform legislation. The next update of the state and local sector model will incorporate any changes to health care cost growth assumptions made in response to enactment of the PPACA. The Trustees of the Social Security and Medicare trust funds have delayed release of their 2010 report to incorporate the anticipated impact of the health care legislation on the Trustees' projections.

[13]PPACA will qualify more people for health insurance coverage through their jobs, new health insurance exchanges, or Medicaid. As a result, the need for free care should decline. However, charity care will continue to exist as some individuals will still not qualify for health insurance under PPACA.

[14]NIPA data from 1978 to 2008 are the most recent available 30 years of data for all data categories.

functions. For example, shifts in social welfare spending reflect federal policy changes to the Temporary Assistance for Needy Families program (TANF, previously known as Aid to Families with Dependent Children) in the mid-1990s. With the creation of TANF, the number of families who received cash assistance fell significantly, from an average of 4.8 million just prior to the creation of TANF to 1.7 million in 2008. State and local expenditures on income security programs, including welfare spending, declined from 10 percent of overall state and local expenditures in 1978 to 7 percent in 2008. Education spending also declined as a share of all state and local government spending, from 40 percent in 1978 to 36 percent in 2008. However, inflation-adjusted spending on education increased over this time period, so this decline in education spending as a share of all state and local government spending largely reflects shifts resulting from faster growth in spending on health care.

Figure 2: State and Local Expenditures, by Category, 1978 and 2008



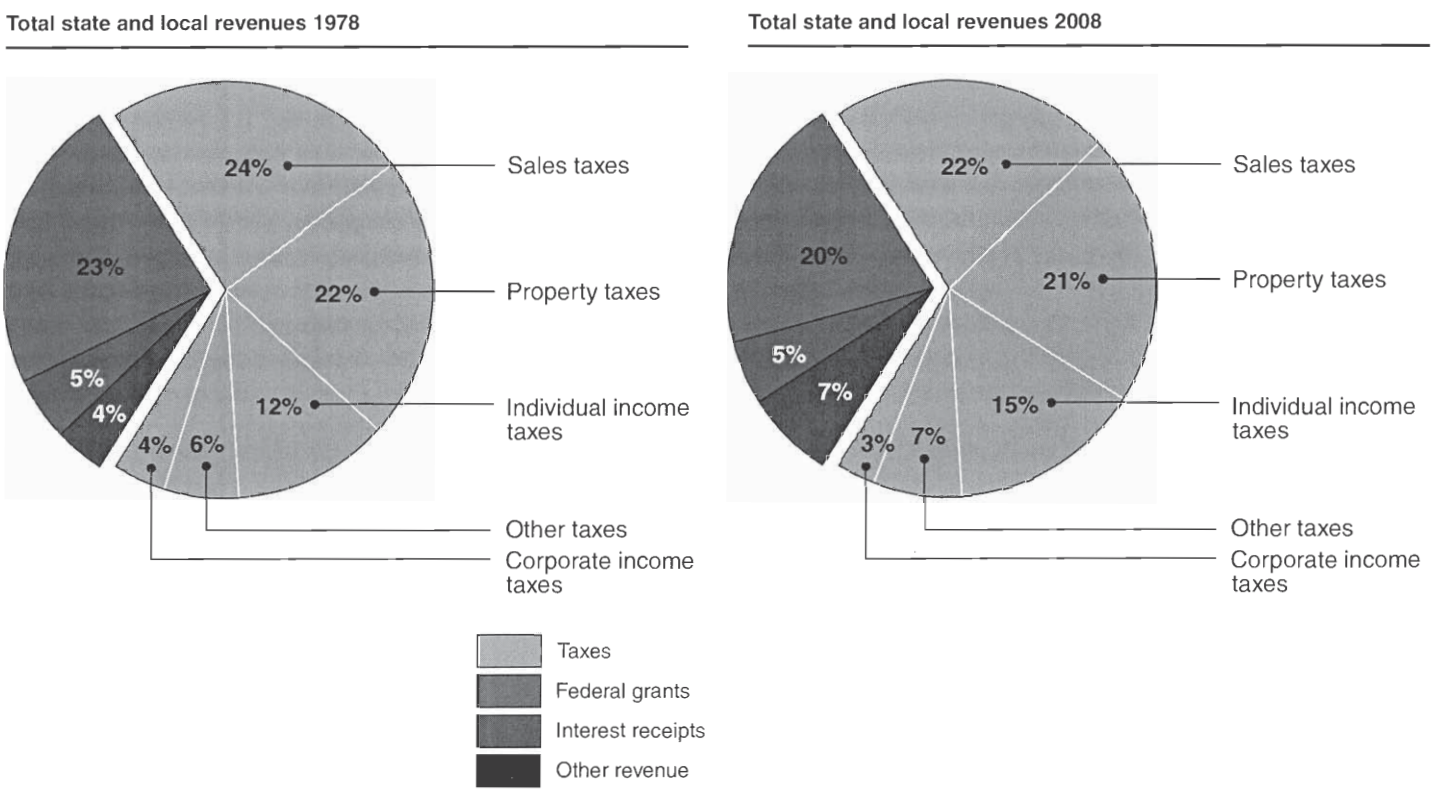
Source: GAO analysis of historical data from the Bureau of Economic Analysis's National Income and Product Accounts.

Note: The Other category includes Housing and Community Services and Recreation and Culture. Economic affairs include transportation, space, agriculture, and natural resources. Health includes Medicaid. General public service includes interest payments and tax collection and financial management services. Income security includes disability, welfare, and social services. State and local government pension contributions are considered part of employee compensation and accounted for within the categories.

State and local government revenues increased from $786 billion in 1978 to more than $2 trillion in 2008.[15] About $1.4 trillion—or 68 percent—of the sector's receipts are comprised of tax receipts, including personal income, sales, and property taxes. Federal grants comprise the second largest source of receipts for the sector, providing about $399 billion to the sector in 2008. The sector had about $251 billion in other receipts in 2008, including fees, income on assets, and contributions for government insurance. Revenue streams from different sources (i.e., taxes, federal grants, and other) have been relatively stable as a percent of GDP over the past 30 years, with some short-term fluctuations and recent declines due to the recession. States' current tax receipts held relatively steady and ranged from 8 to 10 percent of GDP between 1978 and 2008. Total tax receipts were 68 percent of aggregate state and local government revenues in both 1978 and 2008 (see fig. 3). Other receipts also held relatively steady during the period of analysis at 1 to 2 percent of GDP.

[15]Revenue figures are in constant 2009 dollars unless otherwise noted.

Figure 3: State and Local Revenues, by Type, 1978 and 2008



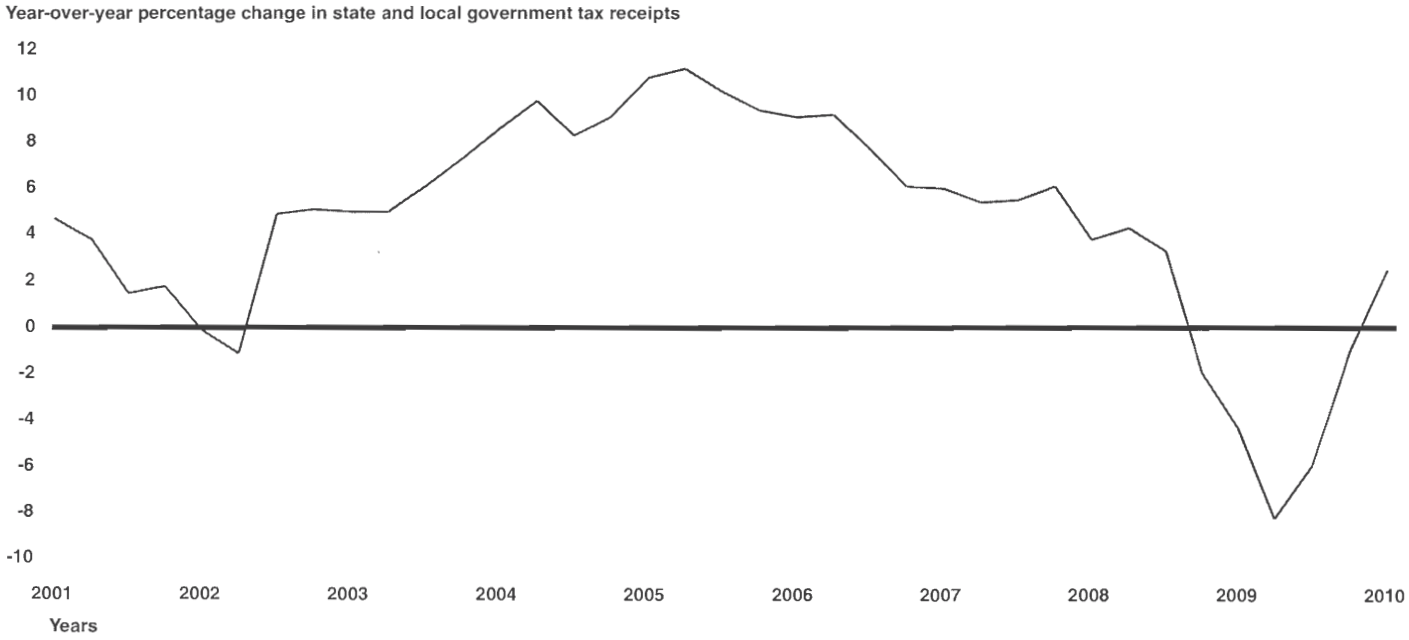
Source: GAO analysis of historical data from the Bureau of Economic Analysis's National Income and Product Accounts.

Note: Federal grants as a percentage of state and local revenues declined from 23 percent in 1978 to 14 percent in 1988 and then gradually increased to 20 percent in 2008.

Growth in state government tax revenue slowed around the start of the recession that began in December 2007 (see fig. 4). State and local current tax receipts declined for four consecutive quarters, starting in the third quarter of 2008. State tax collections totaled $715.2 billion in fiscal year 2009, down 8.6 percent from the $782.1 billion collected in fiscal year 2008. The National Governors Association (NGA) and NASBO reported in June that the severe national recession has drastically reduced tax revenues due to significant declines in sales, personal income, and corporate income tax

collections.[16] NGA and NASBO also reported that as state revenue collections historically lag behind any national economic recovery, state revenues will likely remain sluggish throughout fiscal years 2011 and 2012. In the first quarter of calendar year 2010, state tax revenues were higher than in the same period in 2009. This positive news is tempered by the small size of the projected growth rates in many states.

Figure 4: State and Local Government Tax Revenues Experienced Serious Recent Decline



Source: GAO analysis of data from the Bureau of Economic Analysis's National Income and Product Accounts.

Some of these revenue losses were offset by increased federal funding provided by the infusion of Recovery Act funds discussed below. However, states continued to take actions to address revenues in fiscal years 2009 and 2010. Actions taken by state and local governments to close their budget gaps included raising fees, laying off employees, across-the-board cuts to state programs, and drawing on states' rainy day or reserve

[16]National Governors Association and the National Association of State Budget Officers, *The Fiscal Survey of States* (Washington, D.C.: June 2010).

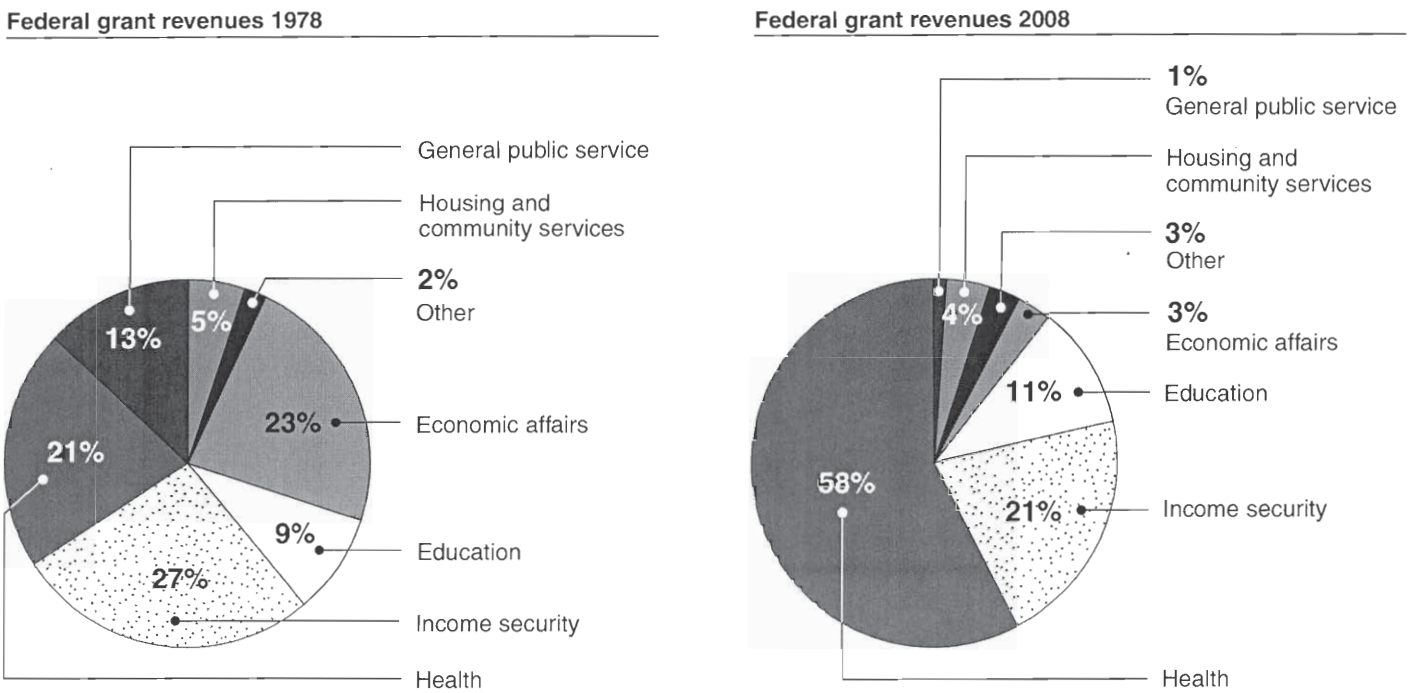
funds.[17] States also reduced state aid to localities, a budget-balancing strategy that shifts the fiscal pressure from the state to local governments.

Federal grants were a relatively consistent proportion of the state and local sector's total revenue over the past 30 years. Federal grants ranged from 2 to 3 percent of GDP during this time, increasing from $179 billion in 1978 to $399 billion in 2008.[18] Health care grants have increased as a share of federal grants to state and local governments. Health care grants (including Medicaid) grew from 21 percent of federal funds provided to the sector in 1978 to 58 percent in 2008 (see fig. 5). Non-health care federal grants include funds for education, housing, income security, and other functions that are administered by multiple levels of government and community-based organizations.

[17]National Governors Association and the National Association of State Budget Officers, *The Fiscal Survey of the States* (Washington, D.C.: December 2009).

[18]Federal grant figures are in constant 2009 dollars unless otherwise noted.

Figure 5: Federal Grants to State and Local Governments



Source: GAO analysis of historical data from the Bureau of Economic Analysis's National Income and Product Accounts.

Note: Medicaid grants comprised 90 percent of health grants in 2008. 'Other' includes national defense, public order and safety, and recreation and culture.

More recent data for 2009 reflect substantial increases in federal grants—largely from the Recovery Act. The largest categories of Recovery Act funding for state and local governments include Medicaid (Federal Medical Assistance Percentage), education (State Fiscal Stabilization Fund), and transportation (highways and transit).[19] Actual federal outlays to states and localities under the Recovery Act totaled approximately $137.1 billion through July 9, 2010. Outlays in health and education and training constituted 88 percent of total Recovery Act outlays to states and localities in fiscal year 2009. These Recovery Act funds were used by states and localities to fund a range of programs and services and thereby helped to partially address budget gaps. However, state and local officials

[19]GAO, *Recovery Act: States' and Localities' Uses of Funds and Actions Needed to Address Implementation Challenges and Bolster Accountability*, GAO-10-604 (Washington, D.C.: May 26, 2010).

reported that they continued to take actions to further address existing budget shortfalls.[20]

State and Local Spending and Revenue Trends Varied Among the States for the Past 30 Years

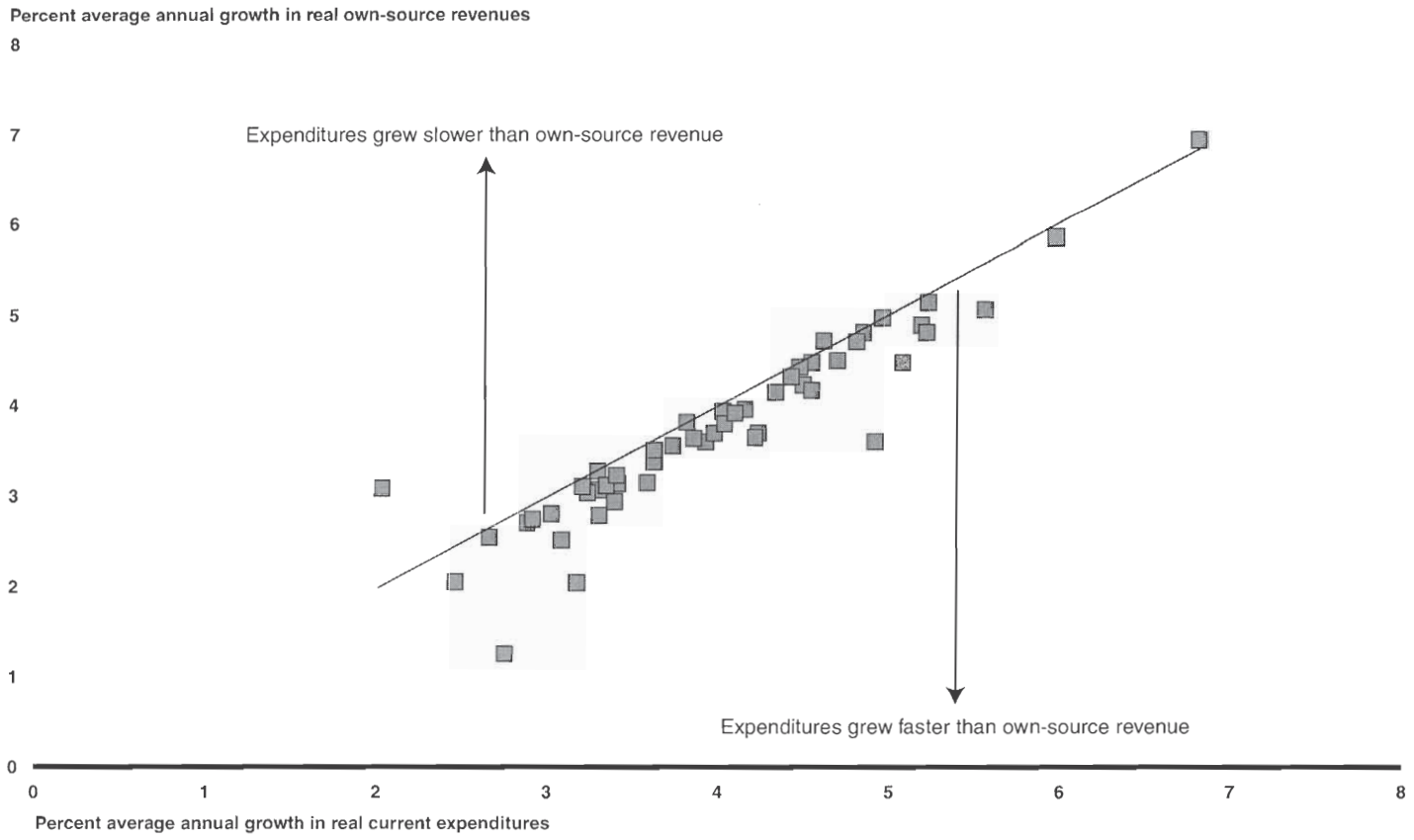
The rates of growth in expenditures and revenues varied among the states during the past 30 years, both overall and within specific categories of expenditures and revenues. State and local government total general expenditures (capital and current) grew slightly faster than total general revenues—both own-source and federal grant revenues—in most states during the period from 1977 to 2007. In addition, state and local government current expenditures grew faster than own-source revenues in almost all states between 1977 and 2007 (see fig. 6).[21] The state and local sector as a whole generally avoided operating deficits despite current spending growing faster than own-source revenues in part because the growth in federal grants for the purpose of funding current spending somewhat exceeded the growth in current spending. In addition, from 1995 to 2007, the sector increasingly financed capital purchases by issuing debt, rather than with revenues, which left more revenues available to pay for current expenditures. As a result, the sector usually remained in surplus during this time period, as illustrated above in figure 1, and states increased their reserves between 2000 and 2006.[22] However, if the overall trend of expenditure growth in excess of revenue growth persists; state and local government expenditure growth will put increasing pressure on state and local governments going forward.

[20]GAO-10-604.

[21]Throughout this section, the term "state" refers to the 50 states and the District of Columbia. Our analysis of state-level expenditure, revenue, and debt trends relies on data from the U.S. Census Bureau, which includes state and local government data, by state. At the time we conducted our analysis, the most recent year for which state-level data on state and local government finances were available from the U.S. Census Bureau, *Annual Survey of State and Local Government Finances* and *Census of Governments* was 2007. In mid-July 2010, the U.S. Census Bureau released *Annual Survey of State and Local Government Finances* data for 2008. We determined that the U.S. Census Bureau data were the best available for purposes of this review of state and local spending and revenue trends and patterns among states. However, there are several limitations to the data, due in part to definitional differences among the states, such as those of coverage (what constitutes a government entity) or measurement (cash vs. accrual accounting). Given these limitations, the data cannot be used as financial statements, to measure a government's fiscal condition, or to calculate a surplus or deficit. All growth rates cited in the section are annual average inflation-adjusted growth rates unless otherwise noted.

[22]Although states and many local governments maintain reserve or rainy day funds, the current recession resulted in depleted reserves for many states.

Figure 6: Current Expenditures Grew Faster than Own-Source Revenues from 1977 to 2007 in Almost All States



Source: GAO analysis of U.S. Census Bureau data.

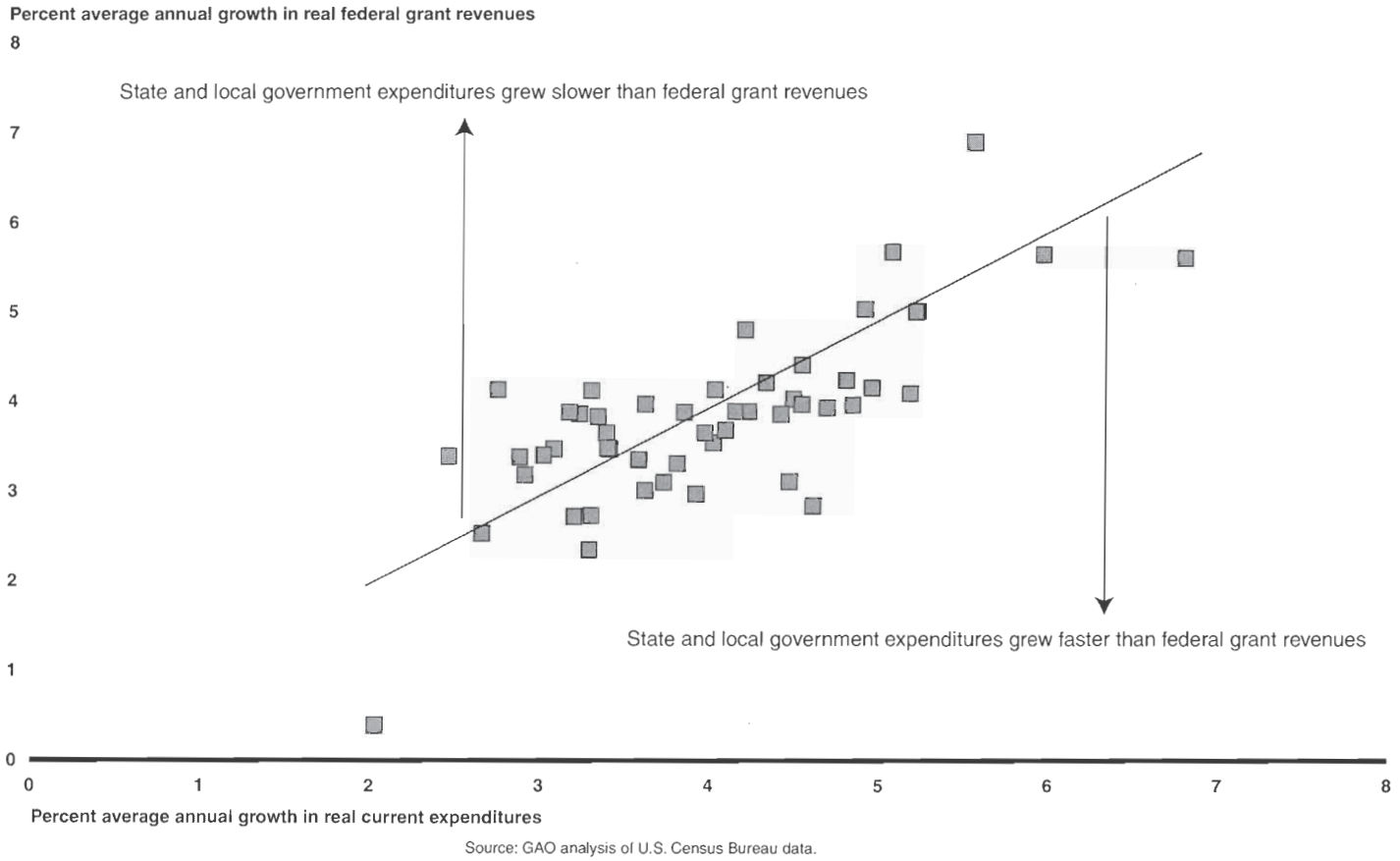
Note: Expenditure growth is the average annual percent change in the real current expenditure of state and local governments between 1977 and 2007, excluding 2001 and 2003, years for which state-level data were not available. Own-source revenue growth is the average annual percent change in real own-source revenue collected by state and local governments. Each point on the figure shows the combination of expenditure growth and own-source revenue growth for a state. The diagonal line identifies the possible combinations of expenditure and revenue growth for which the two growth rates are equal.

The growth of intergovernmental revenue from the federal government (federal grants) was mixed. State and local current expenditures grew faster than federal grant revenues in more than half of the states (see fig. 7).[23] Such growth means that, in those states, federal funding supported a

[23]Throughout this section, the term "state" refers to the 50 states and the District of Columbia.

decreasing share of state and local government current spending over this time period. State and local current expenditures grew more slowly than federal grant revenues in the other states between 1977 and 2007. States with faster growth in expenditures generally also had faster growth in federal grant revenues but this pattern also included variation among states. Some states that had similar expenditure growth rates had federal grant revenue growth rates that differed by more than 1 percentage point. The growth of federal grant revenues relative to the growth of own-source revenues was also mixed. In about half of states, federal grant revenues grew slower than own-source revenues and in the other half, states' federal grant revenues grew faster than own-source revenues during the past three decades.

Figure 7: State and Local Current Expenditures Grew Faster than Federal Grant Revenues from 1977 to 2007 in Most States



Source: GAO analysis of U.S. Census Bureau data.

Note: Expenditure growth is the average annual percent change in real state and local government general current expenditures between 1977 and 2007, excluding 2001 and 2003, years for which state-level data were not available. Growth in intergovernmental revenue (grants) from the federal government is the average annual percent change in real intergovernmental revenue. Each point on the figure shows the combination of expenditure growth and federal intergovernmental revenue growth for a state. The diagonal line identifies the possible combinations of expenditure growth and federal intergovernmental revenue growth for which the two growth rates are equal.

For the state and local government sector in the aggregate, federal grants grew as a share of state and local current expenditures from 1977 to 2007 for three of the four types of spending that we assessed—health and hospitals, education, and public welfare (which includes Medicaid spending).[24] Variation also existed among states and categories. Federal grants for health and hospitals showed the greatest overall increase relative to state and local current expenditures on health and hospitals. For the state and local government sector as a whole, federal grants for health and hospitals grew at an annual rate of 6.4 percent, 2.4 percentage points faster than the 4.0 percent growth in state and local government spending on health and hospitals (table 1). Growth rates within this category varied considerably among states—in more than two-thirds of the states, federal funds were an increasing share of state and local spending on health and hospitals. Federal grants for education grew at an annual rate of 3.8 percent, 0.3 percentage points faster than the 3.5 percent growth in state and local governments' current expenditures for education. Federal education grant funding grew faster than state and local governments' education expenditure growth in more than half of the states. Federal grants for public welfare grew at an average annual rate of 6.1 percent, 0.8 percentage points faster than the 5.3 percent growth in state and local governments' public welfare spending. Only for housing and community development did sector-wide spending grow faster than related federal grant revenues.[25] In the aggregate, federal grants for housing and community development grew at an average annual rate of 5.3

[24]We focused on these four categories because the analogous expenditure categories in the NIPA data experienced large growth rates between 1977 and 2007 and/or were of significant size. Health and hospitals includes federal aid for health programs and care of veterans in state hospitals, including construction of facilities. Education includes federal aid for the Head Start program; school nutrition and milk programs; and institutions of higher education for education or research and development programs. Public welfare includes federal aid for categorical programs—Supplementary Security Income, Temporary Assistance for Needy Families (TANF), medical assistance programs (Medicaid); other welfare services, and related administration.

[25]Housing and community development includes federal aid for public housing; rent subsidy programs; and rural, urban, and community development.

percent, 0.6 percentage points less than the 5.9 percent growth in state and local spending on housing and community development.

Table 1: Growth in State and Local Government Current Expenditures Relative to Federal Grant Funding, by Category, 1977-2007

	Federal grant funding average annual growth rate 1977-2007 (%)			State and local government current expenditures average annual growth rate 1977-2007 (%)				
Selected functional categories	U.S.	Min.	Max.	U.S.	Min.	Max.	Number of states in which federal grant revenues grew faster than state and local government current expenditures	Number of states in which federal grant revenues grew slower than state and local government current expenditures
Health and hospitals	6.4	1.2	9.4	4.0	-0.4	7.2	43	8
Education	3.8	0.8	6.2	3.5	1.9	6.7	31	20
Public welfare	6.1	3.3	15.7	5.3	2.3	10.9	38	13
Housing and community development	5.3	-0.6	13.2	5.9	0.8	14.2	14	37

Source: GAO analysis of U.S. Census Bureau data.

Note: The data are for 1977 to 2007, excluding 2001 and 2003, years for which data were not available.

Variations in spending, revenue, and debt patterns among and within states over time reinforce the challenge of designing a federal response to recent trends or in anticipation of future trends. We examined these variations in selected categories of expenditures and revenues, which are described in table 2.

Table 2: Selected Categories of Expenditures and Revenues

Total General Expenditures – All expenditures except those classified as utility, liquor store, or social insurance trust expenditures; comprised of:

- **Capital Outlays** – Includes construction of buildings; purchase of land, equipment, and buildings; and payments on capital leases.
- **Current Expenditures** – Consists of current operations, assistance and subsidies, and intergovernmental expenditure, including the following categories:
  - Corrections – Includes correctional activities and residential facilities for the detention of adults and juveniles awaiting trial or convicted.
  - Elementary and Secondary Education – The operation, maintenance, and construction of public schools and facilities for elementary and secondary education, vocational-technical education, and other educational institutions except those for higher education.
  - Health and Hospitals – Includes services for the conservation and improvement of public health and expenditures related to a government's own hospitals and for the provision of care in other hospitals.
  - Public Welfare – Includes federal programs—Medicaid, Supplementary Security Income, and TANF; other welfare services, and related administration.
  - Salaries and Wages – Includes all functional categories and activities of the government and dependent agencies, including liquor stores and utilities. Because liquor stores and utilities are included, part of total salaries and wages are not included in current expenditures. Salaries and wages of state and local government employees are also accounted for in the sector (e.g., education) for which the employees work.
  - Interest on the General Debt – amounts paid for the use of borrowed monies paid by all funds of the government, except those on utility debt.

Employee and retiree health benefits and government pension contributions on behalf of current employees – accounted for in the sector (e.g., education) for which the employees work.

Total General Revenue – All revenue except that classified as utility, liquor store, or social insurance trust revenue; comprised of:

- **Taxes** – Includes property, general sales and gross receipts, individual income, and corporate income taxes, as well as other taxes.
- **Current Charges and Miscellaneous Revenue** – Includes amounts received from the public for fees, rents and sales, income of commercial enterprises, interest earnings, and all other general revenue that is not accounted for in the tax or federal grants categories.
- **Federal Grants** – Revenues received directly from the federal government, including grants, shared taxes, certain payments-in-lieu of taxes, and reimbursements. This category excludes certain revenues from the federal government, including payments that are passed-through to individuals (e.g., certain veteran's benefits) and payments for utility services.

Own-Source Revenue = Taxes + Current Charges and Miscellaneous Revenue

Source: U.S. Census Bureau, Government Finance and Employment Classification Manual.

To examine these variations, we assessed selected categories of expenditures, revenues, and debt using three measures.

1. To get a sense of the relative proportion represented by each category in each state, we calculated (a) selected expenditure categories as shares of general current expenditures in 2007, (b) selected revenue categories as shares of general revenues in 2007, and (c) long- and short-term debt as shares of total revenues in 2007.

2. To assess how fast each category grew between 1977 and 2007 in each state, we calculated the growth rate for each selected expenditure, revenue, and debt category.
3. To compare the growth in these categories relative to growth in each state's resources, we compared the growth rate for each selected expenditure, revenue, and debt category to the growth rate in total state personal income between 1977 and 2007. We chose total personal income as a proxy for each state's resources or fiscal capacity.[26] For example, when expenditures in a state are growing faster than personal income, the share of the state's resources that are dedicated to state and local government services is growing. Over the long run, such growth could create a fiscal pressure. This analysis also identified the number of states where growth in a category was (a) greater than total personal income growth for that state or (b) less than total personal income growth for that state.

State and Local Government Expenditure Growth Patterns Reflect Variations Among States in Expenditures by Type and Over Time

State and local government expenditure growth rates varied substantially by category among states (see table 3). Between 1977 and 2007, general expenditures for the state and local government sector increased at an average rate of 4.0 percent per year and ranged from a minimum of 2.2 percent to a maximum of 6.8 percent in individual states. Current expenditures and capital outlays by the state and local government sector displayed a similar pattern, but with a wider range of growth rates for individual states.[27] State and local government expenditures varied in

[26]We previously reported that personal income is an incomplete measure of state resources because it excludes some sources of income potentially subject to state taxation, such as corporate income produced within the state, but not received by state residents (see GAO, *Medicaid Formula: Differences in Funding Ability among States Often Are Widened*, GAO-03-620 (Washington, D.C.: July 10, 2003)). We recently reported that total taxable resources, as reported by the Department of the Treasury, is a more comprehensive measure of state financing ability than personal income (see GAO, *Vocational Rehabilitation Funding Formula: Options for Improving Equity in State Grants and Considerations for Performance Incentives*, GAO-09-798 (Washington, D.C.: Sept. 30, 2009)). We did not use total taxable resources as the measure of state fiscal capacity in this analysis because the Department of the Treasury only began calculating it in the 1980s and therefore it was not available for the full period of our analysis. We also did not use GDP-by-state as the measure of states' fiscal capacity because the calculation of GDP-by-state changed in 1997 such that the data before and after that year are not comparable.

[27]Because depreciation costs are not included in the current expenditure data, to the extent that state and local governments do not maintain their capital stock, the data do not reflect total current costs. According to data from the Bureau of Economic Analysis National Income and Product Accounts, in 2008 the total aggregate value of current-cost depreciation of state and local government fixed assets (including equipment, highways, water systems, and other structures) was $189 billion. Insofar as maintenance of public facilities is deferred, an increase in future fiscal pressures is possible.

terms of the shares of expenditures represented by different categories of spending both among states and over time within states. We examined state and local government expenditures for four spending categories—corrections, elementary and secondary education, health and hospitals, and public welfare[28]—as well as categories for salaries and wages and interest on the general debt.

Table 3: State and Local Government Expenditure Patterns, 1977-2007

	Share of general current expenditure in 2007 (%):			Average annual growth rate 1977-2007 (%):		
	U.S.	Min.	Max.	U.S.	Min.	Max.
Total general expenditure	—	—	—	4.0	2.2	6.8
Total general expenditure by character:						
Capital outlay	—	—	—	3.7	0.5	6.6
Current expenditure	—	—	—	4.0	2.0	6.8
General current expenditure by selected functional category:						
Corrections	3.3	1.8	4.6	6.7	0.6	10.0
Elementary & secondary education	23.7	17.7	30.6	3.5	1.6	6.7
Health & hospitals	9.3	2.6	17.5	4.0	-0.4	7.2
Public welfare	19.6	12.5	30.6	5.3	2.3	10.9
General current expenditure by selected category:						
Total salaries and wages	38.5	29.0	48.7	2.9	0.4	5.5
Interest on general debt	4.7	1.8	8.0	3.7	-1.2	7.4

Source: GAO analysis of U.S. Census Bureau data.

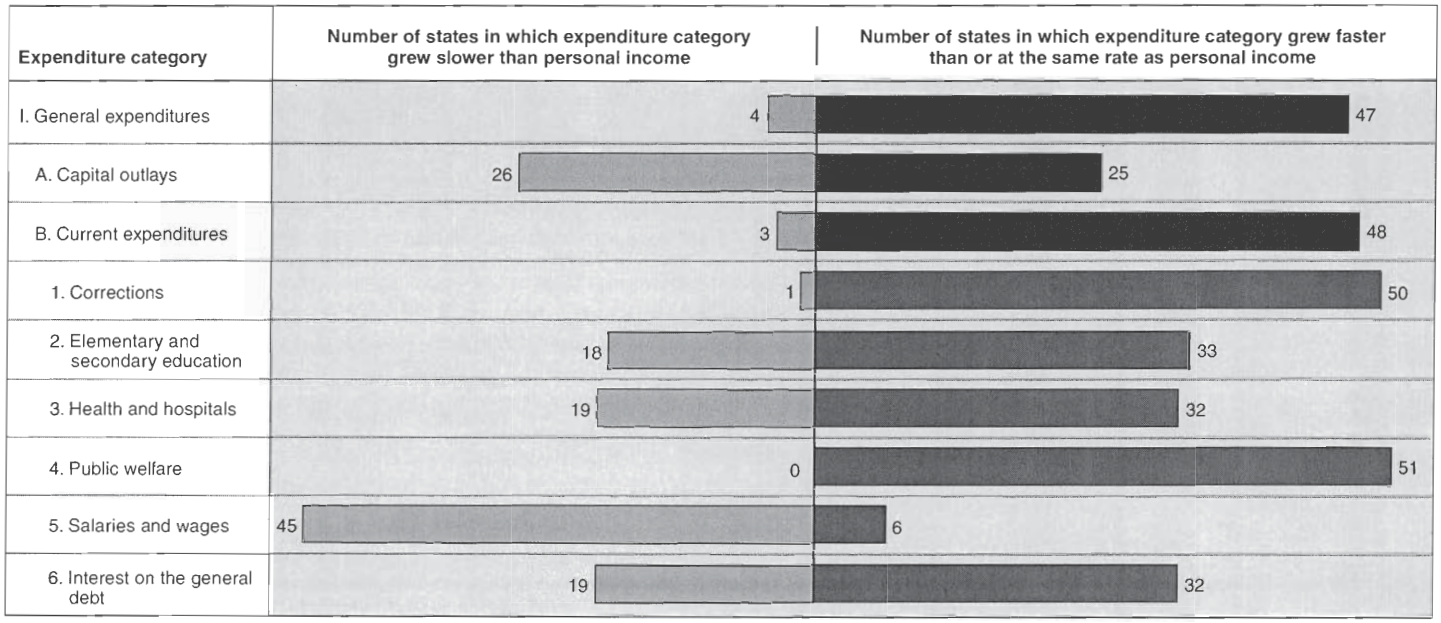
Note: The data are for 1977 to 2007, excluding 2001 and 2003, years for which data were not available. "U.S." indicates the value for the aggregate state and local government sector for all 50 states and the District of Columbia. "Min." and "Max." indicate the minimum and maximum values, respectively, for all 50 states and the District of Columbia. Growth rates are average annual growth rates of expenditures measured in constant 2009 dollars.

Variation across states in personal income growth, a proxy for a state's fiscal capacity growth, also likely contributed to differences among states

[28]We identified expenditure categories which could lead to fiscal pressures based on size or growth rates identified using NIPA data. We then used data from the U.S. Census Bureau to assess state-level trends from 1977 to 2007 for these and other selected expenditure categories.

in expenditure growth.[29] Between 1977 and 2007, personal income in the United States grew at an annual rate of 3.3 percent with a range of 1.7 percent to 6.6 percent for individual states. In most states, both general expenditures and current expenditures grew faster than personal income between 1977 and 2007 (see fig. 8). At the same time, the number of states for which state and local government expenditures grew faster than personal income varied among key categories.

Figure 8: State and Local Government Expenditure Growth Relative to State Personal Income Growth, 1977-2007



Source: GAO analysis of U.S. Census Bureau data.

Notes: The data are for 1977 to 2007, excluding 2001 and 2003, years for which data were not available. States includes all 50 states and the District of Columbia. Growth rates are average annual growth rates of expenditures measured in constant 2009 dollars.

Corrections: Corrections expenditures grew at a rate of 6.7 percent—the fastest growing expenditure category during the time period we assessed. All states experienced growth in this type of expenditure and growth rates ranged from 0.6 percent to 10.0 percent in individual states. Virtually every state experienced a growth rate faster than the growth in total personal

[29]Other variations, such as population changes and policy choices, also contributed to differences among states.

income. However, corrections spending only represented 3.3 percent of current expenditures for state and local governments in 2007.

Education: Spending on elementary and secondary education increased in all states between 1977 and 2007. However, almost all states experienced declines in these expenditures as a percent of current expenditures because other expenditure categories grew faster. Over the same period, spending on elementary and secondary education grew faster than personal income in almost two-thirds of states. In the aggregate, spending on elementary and secondary education made up 23.7 percent of state and local government current expenditures in 2007, making it the largest functional expenditure category.

Health and hospitals: Expenditures on health and hospitals grew at an average rate of 4.0 percent per year for the state and local government sector as a whole between 1977 and 2007. Over the same period, growth rates in some states were as high as 7.2 percent, and inflation-adjusted spending on this category increased in virtually all states. Spending on health and hospitals grew faster than personal income in almost two-thirds of states. State and local governments as a whole allocated 9.3 percent of current expenditures to health and hospitals in 2007, with individual states allocating between 2.6 and 17.5 percent.

Public welfare: Spending on public welfare, including Medicaid, grew at a rate of 5.3 percent between 1977 and 2007. Growth rates for public welfare expenditures during the same period ranged from 2.3 to 10.9 percent in individual states. Spending on public welfare by state and local governments grew faster than personal income in all states between 1977 and 2007. Aggregate public welfare expenditure by the state and local government sector grew from 15.2 to 19.6 percent of current expenditures during the same period. In 2007, public welfare made up between 12.5 and 30.6 percent of current expenditures in individual states.

Salaries and wages: State and local government spending on salaries and wages grew at an average annual rate of 2.9 percent between 1977 and 2007 and growth ranged from 0.4 percent to 5.5 percent for individual states during this time period. Spending on total salaries and wages grew slower than personal income in almost all states. Overall, state and local government spending on salaries and wages dropped from 53.5 percent of current expenditures in 1977 to 38.5 percent in 2007. Total salaries and wages overlaps with sector-specific functional expenditure categories (e.g. education, public welfare, corrections, etc.), and is thus not considered a separate functional category.

Interest on the general debt:[30] Expenditures on interest on the general debt increased in almost all states between 1977 and 2007, with average annual growth rates that varied from a low of -1.2 percent to a high of 7.4 percent. Almost two-thirds of states experienced growth greater than the growth in total personal income. Spending for interest on the general debt varied substantially within and among the states between 1977 and 2007. On average in the United States, states spent 4.7 percent of current expenditures on interest on general debt in 2007, but this ranged from a low of 1.8 percent to a high of 8.0 percent.

State and Local Government Revenue Growth Patterns Reflect Variations among States in Revenue Shares by Type and Over Time

Although state and local government revenues grew slower than expenditures in most states between 1977 and 2007, revenue growth rates varied substantially among states during this period. Revenues grew at an average annual rate of 3.8 percent and ranged from 1.7 to 6.7 percent for individual states. States experienced varying growth rates for individual revenue categories and each relied on the various types of revenues to a different extent (see table 4). Own-source revenue made up a stable fraction of revenue collected by the state and local government sector, measuring 78.1 percent in 1977 and 79.9 percent in 2007. However, in individual states, own-source revenue ranged from 58.9 to 86.4 percent of state and local government revenue in 2007. Own-source revenue grew at an annual rate of 3.8 percent for the sector, but grew at rates from 1.3 to 6.9 percent in individual states.

[30]Spending on interest on the general debt is also affected by past decisions about capital spending as well as issuance of private purpose debt. The U.S. Census Bureau began collecting data on private purpose debt—interest payments for which are included in the interest on the general debt category—in 1988. Interest payments for private purpose debt have grown rapidly since that time and use of private purpose debt is more extensive in some states than others.

Table 4: State and Local Government Revenue Patterns, 1977-2007

	Share of general revenue in 2007 (%)			Average annual growth rate 1977-2007 (%)		
	U.S.	Min.	Max.	U.S.	Min.	Max.
General revenue	—	—	—	3.8	1.7	6.7
General revenue by source:						
Federal grants	20.1	13.6	41.1	3.9	0.4	6.9
Own-source revenue	79.9	58.9	86.4	3.8	1.3	6.9
Total charges & misc. revenue	25.2	15.7	42.3	4.8	1.6	7.1
Total taxes	54.8	36.7	69.3	3.4	-0.4	6.9
Tax revenue by selected tax:						
Property taxes	16.5	6.2	34.1	3.2	0.3	6.8
General sales taxes	12.9	1.4	26.1	3.8	-0.8	7.8
Individual income taxes	12.4	0.7	24.6	4.3	1.8	14.6

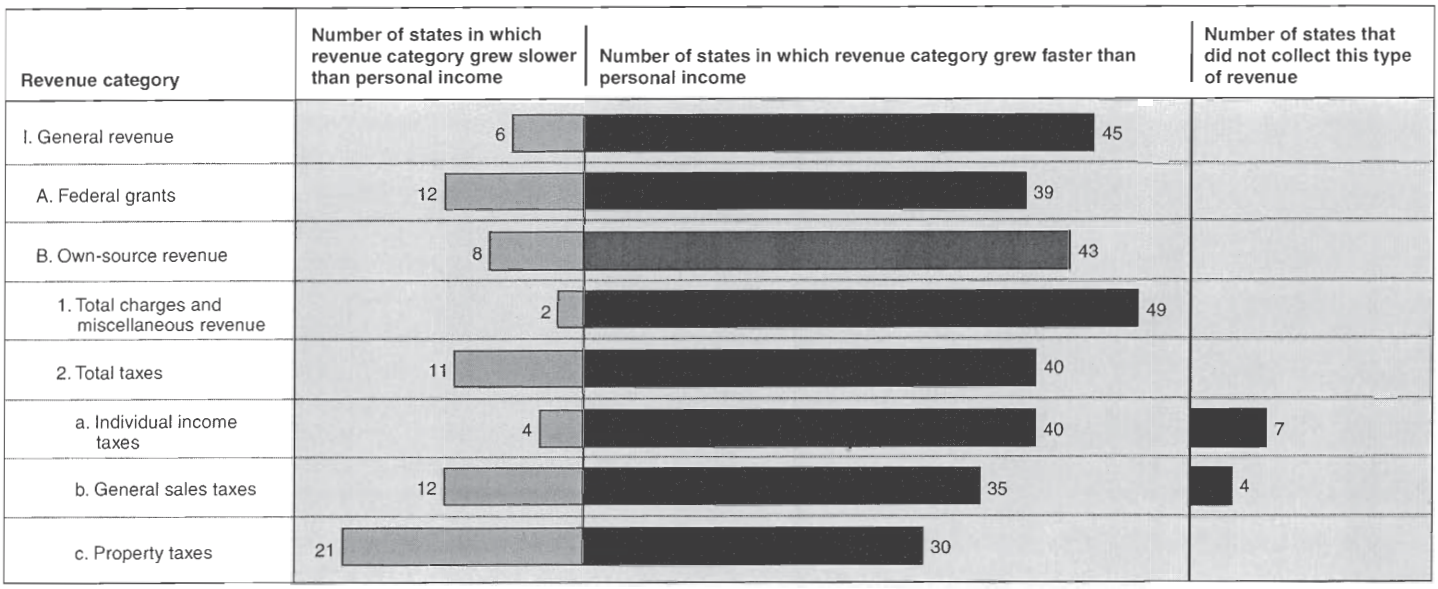
Source: GAO calculations based on U.S. Census Bureau data.

Notes: "U.S." indicates the value for the aggregate state and local government sector for all 50 states and the District of Columbia. "Min." and "Max." indicate the minimum and maximum values, respectively, for all 50 states and the District of Columbia, except in the categories general sales tax and individual income tax, for which we excluded states that did not charge that category of tax. Growth rates are average annual growth rates of revenues measured in constant 2009 dollars.

As with expenditure growth, variation across states in personal income growth, a proxy for fiscal capacity growth, also likely contributed to variation across states in revenue growth. [31] In most states, revenue grew faster than personal income between 1977 and 2007 (see fig. 9). Most of the components of revenue also grew faster than personal income in most states over the same period.

[31]Other variations, such as population changes and policy choices, also contributed to differences among states.

Figure 9: State and Local Government Revenue Growth Relative to State Personal Income Growth, 1977-2007



Source: GAO analysis of U.S. Census Bureau data.

Notes: The data are for 1977 to 2007, excluding 2001 and 2003, years for which data were not available.

Total taxes: Tax revenues grew in almost all states between 1977 and 2007, with growth rates as high as 6.9 percent annually. These changes in tax revenues reflect both policy changes (e.g., changes in income tax rates) and economic changes (e.g., changes in population or total taxable personal income). Most state and local government tax revenues stem from three types of taxes—individual income taxes, general sales taxes, and property taxes. While more than two-thirds of the states experienced growth in total taxes greater than the growth in personal income between 1977 and 2007, almost all states also experienced declines in total taxes as a percent of general revenue because other revenue categories (i.e., federal grants and total charges and miscellaneous revenue) grew faster. For the state and local government sector in the aggregate, total taxes made up 54.8 percent of revenue in 2007. The share of revenue collected as taxes in individual states ranged from about 37 to about 69 percent. For the state and local government sector, property taxes as a share of revenue declined between 1977 and 2007, while individual income taxes increased and general sales taxes remained relatively stable.

Individual income taxes: Individual income taxes emerged as the fastest growing tax category, growing at an annual rate of 4.3 percent. Receipts in

states that collected individual income taxes ranged from 0.7 percent to 24.6 percent of revenue collected in 2007. For the sector in the aggregate, individual income tax revenues made up 12.4 percent of revenue in 2007. Individual income taxes made up more than 20 percent of state revenues in a few states while 7 states had no broad-based income tax during this period of analysis. Individual income taxes grew faster than personal income in more than two-thirds of the states.

Sales taxes: General sales taxes grew an average of 3.8 percent per year for all states between 1977 and 2007. Sales tax growth ranged from -0.8 percent to 7.8 percent in individual states. Four states did not have a general sales tax during the period of analysis and sales tax revenues constituted more than 20 percent of state and local government revenues in a few states. Sales tax revenues grew faster than personal income in more than two-thirds of the states during this period.

Property taxes: Of the three major categories of taxes, growth in property tax revenues showed the least amount of variation among the states and grew an average of 3.2 percent per year with growth rates ranging from 0.3 to 6.8 percent in individual states. For the sector in the aggregate, property taxes made up 16.5 percent of revenue in 2007. Property taxes ranged from 6.2 to 34.1 percent of revenue collected in individual states in 2007. A majority of states experienced property tax growth greater than the growth in personal income.

Total charges and miscellaneous revenue: This category emerged as the fastest growing overall revenue category, with an aggregate annual growth rate of 4.8 percent. All states experienced growth in this category while almost all states experienced growth relative to personal income. These growth rates indicate that, on the whole, state and local governments are increasingly relying on charges and miscellaneous revenue to finance their programs and services. For the state and local government sector in the aggregate, total charges and miscellaneous revenue comprised 25.2 percent of revenues in 2007.

Federal grants: In the aggregate, federal grant revenues also grew faster than tax revenue, at an average annual rate of 3.9 percent. Growth rates of federal grant revenue for individual states varied between 0.4 and 6.9 percent. Federal grants to the state and local government sector represented 20.1 percent of revenues in 2007, slightly less than the 21.9 percent they contributed in 1977. Federal grants made up between 13.6 and 41.1 percent of revenues for state and local governments in individual

states in 2007. More than two thirds of the states experienced growth in federal grant revenue greater than growth in personal income.

Growth in State and Local Government Debt Varied Considerably Across States

Between 1977 and 2007, total state and local government debt grew at an annual rate of 4.2 percent, driven largely by long-term debt, which grew at an annual rate of 4.3 percent. A major portion of long-term debt is private purpose and utility debt, which have a limited claim on state and local revenue and assets in the event of default.[32] According to National Income and Product Accounts data, there has been a long-term downward trend in aggregate state and local government sector net savings over the past 30 years. Short-term debt increased over this period at a rate of 0.2 percent in the United States. Short-term debt equaled approximately 1 percent of total state and local government revenue in 2007.[33] States varied significantly with respect to trends in debt. For example, a few states experienced declines in levels of long-term debt, while two-thirds of the states experienced growth greater than the growth in personal income over that period. More than two-thirds of the states experienced real declines in short-term debt, while a small number of states had real dollar increases in the level of short-term debt of more than 15 percent.

Fiscal Pressures Could Affect Delivery of Intergovernmental Programs

Given the nature of the partnership among levels of government in providing services to the public and the economic interrelationships among levels of government, understanding patterns in state and local government expenditures and revenues is crucial for identifying and analyzing potential fiscal pressures for the sector. The federal government partners with state and local governments to achieve national priorities through implementation of a variety of programs. Such programs range from Medicaid, a joint federal-state program that finances health care for certain categories of low-income individuals, to disaster recovery, where the federal government provides significant financial assistance after major disasters, but state and local governments play the lead role in disaster recovery. The interconnectedness which defines

[32]The issuing government pays interest on private purpose debts from general revenues and is reimbursed in the exact amount by the private entity. Such reimbursements are interest earned (a component of general revenue) for the issuing government.

[33]We calculate debt as a percent of total revenue to compare the size of debt to the size of state and local governments' resources. This comparison does not indicate the amount of this debt that has a claim on general revenues.

intergovernmental programs requires that all levels of government remain aware of and ready to respond to fiscal pressures. Such awareness and readiness to respond must also acknowledge the array of assumptions used to develop simulations identifying potential future pressures.

State and Local Fiscal Pressures Have Implications for Federal Programs and Policies

Since many federal programs are implemented with state and local governments, fiscal pressures confronting the sector could affect implementation of federal programs and policies. The persistent long-term pressures outlined earlier in this report may require states and localities to fundamentally reassess their spending and revenue policies. The emergence of the recent cyclical downturn has hastened the need for action and increased the sense of urgency for state and local governments. In our work involving oversight of Recovery Act funds, we found that many states have reported significant declines in the number of management and oversight staff—limiting states' ability to ensure proper implementation and management of Recovery Act programs. These recent findings reinforce the expectation that states may not be able to provide current levels of services for federally funded programs they administer if budget actions such as layoffs and furloughs of state employees continue. These challenges have implications for a wide range of federal, state, and local programs, policies, and activities.

The following discussion of state and local fiscal pressures provides additional context for understanding the potential implications for future federal policies to supplement the analysis of expenditure and revenue data which identified the existence of and variation in these pressures.

Health Care Programs

The fiscal pressure created by the growth in health care expenditures discussed earlier in this report is combined with the anticipated December 31, 2010 end of increased Medicaid funding for states provided through the Recovery Act. States' approaches to preparing for the end of Recovery Act funding vary, depending on budget gaps and governments' balanced-budget requirements. According to a recent report by the National Conference of State Legislatures, 30 states built into their proposed or enacted fiscal year 2011 budgets an assumption that Congress would extend increased Medicaid funding.[34] In addition to this near-term pressure, it is not entirely clear how states' Medicaid expenditures will be

[34]National Conference of State Legislatures, *FMAP Extension and the Impact on States* (Denver, Colo.: Apr. 29, 2010).

affected by the Patient Protection and Affordable Care Act over the long term. CBO estimated the cost of health care reform efforts over the 2010-2019 period as well as the effects on the deficit in the decade beginning in 2020. However, CBO has also noted the imprecision of these calculations because of the great degree of uncertainty associated with the estimates. CBO has not extrapolated estimates further into the future because the uncertainties surrounding them are magnified even more. Looking forward, states have concerns about the long-term sustainability of their Medicaid programs.

Physical Infrastructure

In addition to the known fiscal challenges and uncertainty regarding future health care expenditures, the nation's physical infrastructure is under strain. Estimates of the costs to repair, replace, or upgrade aging infrastructure so that it can safely, efficiently, and reliably meet current demands, as well as expand capacity to meet increasing demands, top hundreds of billions of dollars. Addressing these challenges is complicated by the breadth of the nation's physical infrastructure—including aviation, highway, transit, rail, water, and dam infrastructure—which is owned, funded, and operated by all levels of government and the private sector. In this environment, the infrastructure improvements that all levels of government want will compete for scarce resources and may exceed what the nation can afford. Accordingly, decisions about the appropriate level of distribution and spending on infrastructure are both difficult and enormously important.

State and Local Employee Pensions

State and local governments also face fiscal pressures from pensions offered to employees. Declines in pension asset values stemming from the recent recession affect the sector's long-term fiscal position. The state and local government sector experienced a decline in pension asset values of 27.6 percent—from $3.2 trillion at the end of 2007 to $2.3 trillion at the end of 2008. The contribution rate required for the sector to fund the plans on an actuarial basis increased to 9.9 percent of the sector's wages, according to our March 2009 estimate, which is higher than the actual 2008 contribution rate of 8.3 percent.[35] In 2008 we reported that the percentage of the 65 large public pension plans we analyzed that had a funded ratio (actuarial value of assets divided by actuarial accrued liabilities) of 80 percent or better decreased steadily from about 90 percent in 2000 to 58

[35]GAO-10-358.

percent in 2006.[36] More recent studies by others found that aggregate state and local pension funding levels continued to decline in 2008 and are expected to decline significantly in 2009 and over the next few years as the full effect of the recent financial crisis is realized. Consistent with our prior work, these studies found wide variation in funding levels among plans. For example, the Pew Center on the States found that in 2008, 12 state pension funds had funded ratios above 90 percent and 8 had funded ratios less than 65 percent. Low funded ratios will eventually require action by state and local governments to improve funding and may shift costs to future generations. While reducing benefits could improve funding requirements, state and local governments may not be able to do so for existing employees due to guarantees by state constitutions or contracts. Improving funding may require increased contributions. Many governments have often contributed less than the amount needed to improve or maintain funded ratios. Low contributions raise concerns about the future funded status of these plans.

State and Local Retiree Health Benefits

State and local governments also face fiscal pressure from other postemployment benefits (OPEB), the largest of which is typically retiree health benefits. Accounting standards issued by the Governmental Accounting Standards Board in 2004 require governments to account for the costs of OPEB as employees earn the benefits and as costs are accrued, rather than when the benefits are paid or provided. Because state and local governments have historically funded retiree health benefits when paid or provided rather than when the benefits are earned, much of their OPEB liability is unfunded, raising concerns about the fiscal pressures state and local governments face in the coming decades. In a 2009 review, we found that the total unfunded OPEB liability reported in states and the largest local governments' comprehensive annual financial reports (CAFR) exceeded $530 billion.[37] We reported that spending on state and local government retirees' health benefits is expected to more

[36]GAO, *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits*, GAO-08-223 (Washington, D.C.: Jan. 29, 2008).

[37]GAO, *State and Local Government Retiree Health Benefits: Liabilities Are Largely Unfunded, but Some Governments are Taking Action*, GAO-10-61 (Washington, D.C.: Nov. 30, 2009). The total for unfunded OPEB liabilities is likely higher than $530 billion because GAO reviewed OPEB data in CAFRs for the 50 states and 39 largest local governments but not data for all local governments or additional data reported in separate financial reports. Also, the CAFRs we reviewed report data that predate the market downturn, as asset values have declined. Additionally, OPEB valuations are extremely sensitive to assumptions about the health care cost inflation rate and discount rate.

than double as a share of total operating revenues by 2050, from 0.9 percent to 2.1 percent. The Pew Center on the States published similar findings on OPEB obligations and found that state governments' OPEB liability in fiscal year 2008 was $587 billion to pay for current and future benefits, with only $32 billion of that amount pre-funded.[38] Low funded ratios will eventually require action by state and local governments to close the gap between promised benefits and dedicated resources and may shift costs to future generations. Similar to state and local employee pensions, while reducing benefits could improve funding, state and local governments may not be able to do so for existing employees without changing current guarantees in contracts. In the absence of such changes, improving funding may require increased contributions.

Education

The federal government also has an interest in investing in the education of children to establish a well-educated and skilled workforce that will enhance U.S. competitiveness in the global marketplace. As we have previously reported, the federal government accounts for about 9 percent of the total investment in K-12 education, with state and local sources covering the rest.[39] The federal government provided an estimated $166.9 billion over the 3-year period from fiscal years 2006-2008—for an average of $55.6 billion per year—to administer 151 different federal K-12 and early childhood education programs. In addition to these funds, the Recovery Act provided about $85 billion in discretionary funding for 14 existing and 3 new K-12 and early childhood education programs. Some of these funds can also be used for postsecondary education and noneducation purposes. Even with the influx of Recovery Act funds, the budget condition of local educational agencies (LEA) across the country is mixed, with some still facing large budget cuts. The budgetary picture for LEAs ranges widely across states. The budget pressures facing LEAs contribute to a fiscal pressure with long-term implications for our nation's workforce and competitiveness depending on how these pressures are addressed.

[38]The Pew Center on the States, *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform* (Washington, D.C.: February 2010).

[39]GAO, *Federal Education Funding: Overview of K-12 and Early Childhood Education Programs*, GAO-10-51 (Washington, D.C.: Jan. 27, 2010). For the purposes of that study, we defined K-12 and early childhood education programs as programs that focus primarily on K-12 or early childhood education, have objectives whose emphasis is enhancing learning through school activities and curricula, and for which K-12 or early childhood students or teachers are the main beneficiaries. This definition excludes food nutrition and infrastructure programs.

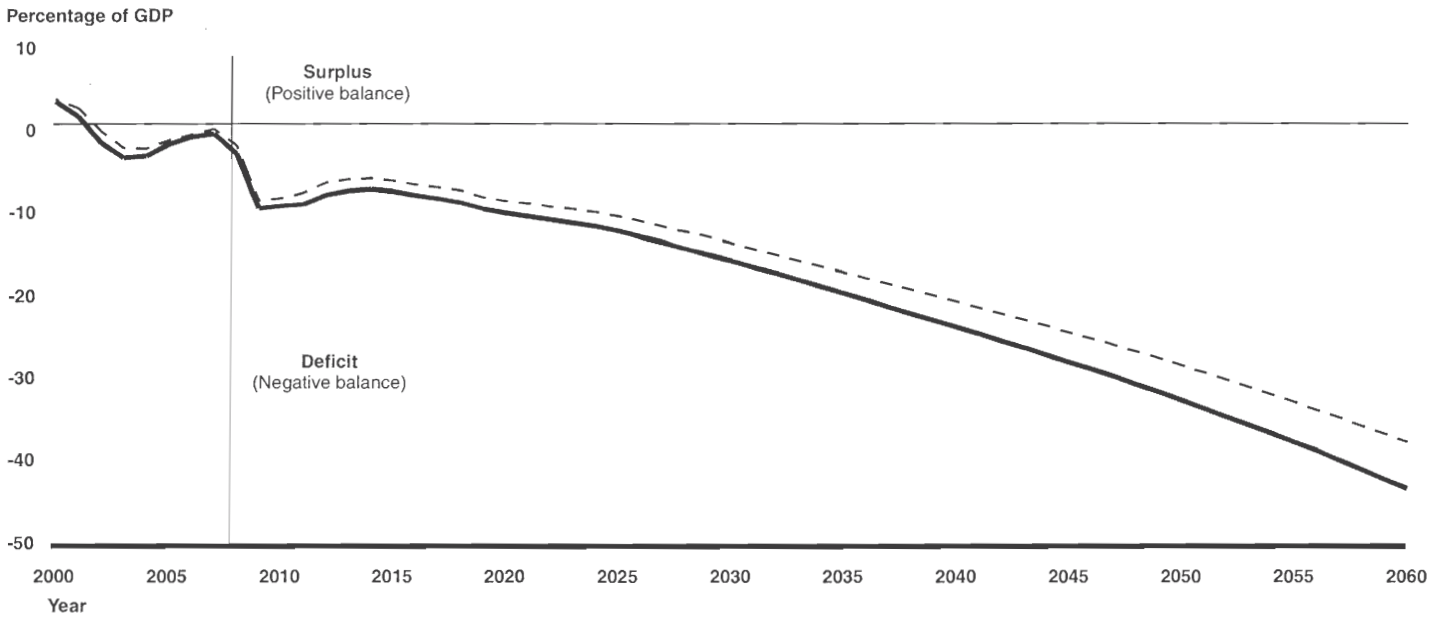
Federal Fiscal Pressures Have Implications for Future Assistance to State and Local Governments

As we have previously reported, state and local governments are not alone in facing a broad array of daunting fiscal pressures. As the federal government confronts its own long-term and growing fiscal challenges, its ability to continue to provide growing intergovernmental revenue could be constrained. These federal fiscal pressures are also likely to influence future federal policies to provide countercyclical federal fiscal assistance.

Beyond the recent recession, state and local governments' continued and growing fiscal challenges will add to the nation's overall fiscal difficulties. Figure 10 shows simulations for the federal fiscal path under alternative assumptions and overlays the simulated fiscal imbalance of the state and local government sector.[40] The overlay of the state and local government model's simulations with our federal fiscal model shows that state and local governments' fiscal challenges impose further fiscal challenges on the nation's economy in the next several decades. Countercyclical federal assistance provided by the Recovery Act and other federal programs to address the recent recession will not alleviate the long-term structural fiscal challenges facing state and local governments. The combined long-term fiscal challenges for all levels of government further complicate the process of sorting out competing demands for federal funds and other fiscal resources.

[40]See GAO, *The Federal Government's Long-Term Fiscal Outlook: January 2010 Update*, GAO-10-468SP (Washington, D.C.: March 2010). This and related products can be found at http://www.gao.gov/special.pubs/longterm/. GAO's "Baseline Extended" simulation follows CBO's January 2010 baseline estimates for the first 10 years and then simply holds revenue and spending other than large entitlement programs constant as a share of GDP. The "Alternative" simulation is based on historical trends and policy preferences. Discretionary spending grows with GDP rather than inflation during the first 10 years, Medicare physician payment rates are not reduced as in CBO's baseline, all tax provisions are extended to 2020, and the alternative minimum tax exemption amount is indexed to inflation through 2020; revenues are then brought back to their historical level.

Figure 10: Federal and State/Local Surpluses and Deficits, as a Percentage of GDP



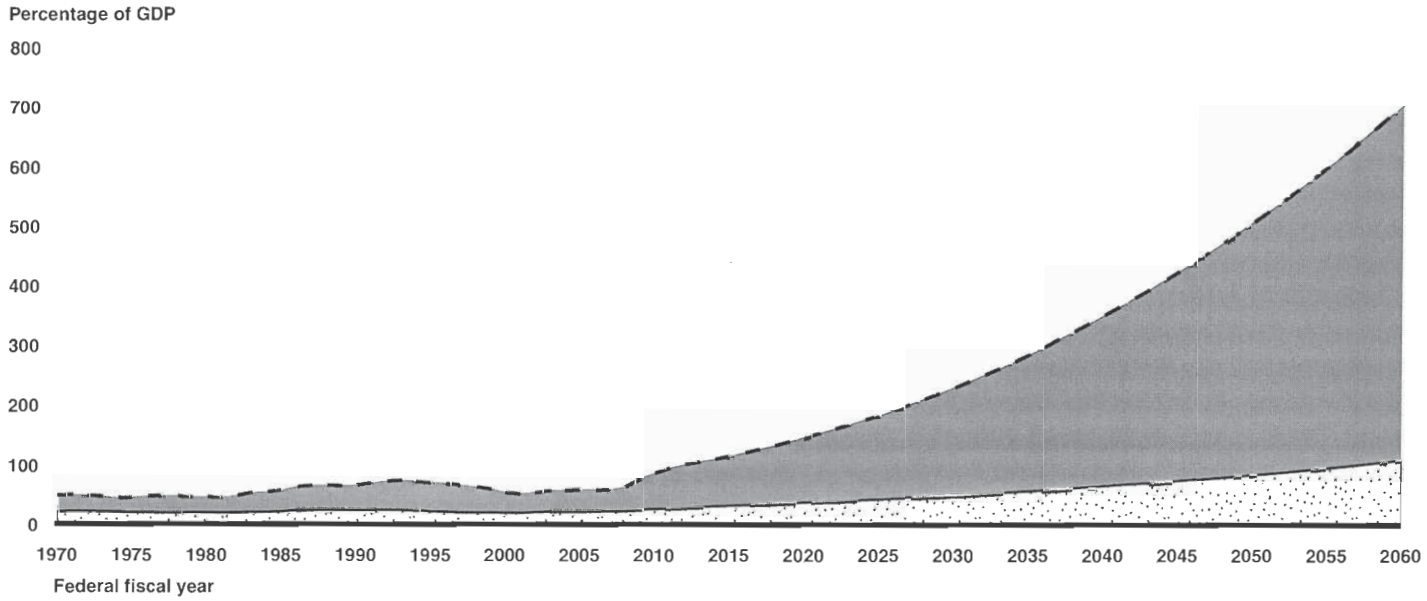
Source: Historical data from NIPA and GAO analysis.

Note: Historical data are from the Bureau of Economic Analysis National Income and Product Accounts from 1980 to 2008. Data in 2009 are GAO estimates aligned with published data where available. GAO simulations are from 2010 to 2060, using many CBO projections and assumptions, particularly for the next 10 years. The state and local balance measure is similar to the federal unified budget measure. The simulation assumes expiring tax provisions are extended and that discretionary spending grows with GDP.

As we have previously reported, our long-term simulations also show that absent policy changes, the federal government faces an unsustainable growth in debt, as debt held by the public as a share of GDP could exceed the historical high reached in the aftermath of World War II by 2020. Figure 11 also shows a measure of the increased burden facing state and local governments. Because state and local governments are generally prohibited from using debt to finance operating deficits, state and local debt will not actually increase as shown in this figure. However, the figure is an indicator of the cumulative growing pressure on their budgets and their economies. The simulations suggest that federal debt could exceed 100 percent of GDP by 2019 and reach 200 percent of GDP by 2032. At some point, such a growing debt burden becomes unsustainable and some

combination of increased interest rates,[41] higher inflation, or the dollar's depreciation could force action to reduce federal deficits.

Figure 11: Federal Debt and State and Local Debt and Simulated Cumulative Shortfalls as a Percentage of GDP



Source: GAO.

Note: Historical values for federal debt are from Historical Tables, Budget of the United States Government, Fiscal Year 2011. Historical values for state and local government debt are from the Federal Reserve Board's Flow of Funds Accounts. Simulated values are from our most recent fiscal outlook reports (The Federal Government's Long-Term Fiscal Outlook: January 2010 Update, GAO-10-468SP (Washington, D.C.: March 2010) and State and Local Governments' Fiscal Outlook: March 2010 Update, GAO-10-358, (Washington, D.C.: Mar. 2, 2010)). Combined debt sums the debt of the two sectors of government without adjusting for one sector's holdings of securities issued by the other sector. Unlike most state and local debt, U.S. Treasury securities are secured by the full faith and credit of the issuing government.

In addition, many of the long-term fiscal challenges the nation faces, including health care cost growth and the aging population, have already begun to affect the federal budget—in some cases sooner than previously

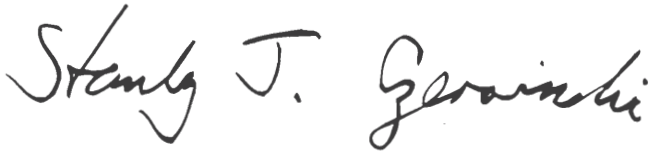
[41]A government's bond rating affects its cost of borrowing money by affecting the interest rate it must pay to lenders. Debt levels are one of the factors that affect bond ratings. Declines in state reserve funds could also increase a state's borrowing costs.

estimated—and the pressures only grow in the coming decade. For example, Social Security cash surpluses have served to reduce the unified budget deficit. However, CBO recently estimated that due to current economic conditions the program will run small temporary cash deficits for the next 4 years and then, similar to the Trustees' estimates, run persistent cash deficits beginning in 2016. The fluctuation and eventual disappearance of the Social Security cash surplus will put additional pressure on the rest of the federal budget. Given these fiscal conditions, it is likely the federal government could find the trade-off between providing countercyclical assistance to states during future periods of economic downturn and addressing long-term federal fiscal challenges more and more pronounced over time.

Recent events have further exacerbated fiscal challenges for all levels of government. Although the economy is fragile, there is wide agreement on the need to begin to change the long-term fiscal path without slowing the recovery because the magnitude of the changes needed grows with time. While the drivers of the long-term fiscal outlook have not changed, the sense of urgency has. Actions to address the nation's long-term fiscal outlook will be needed at all government levels in coming years and the challenges cannot simply be shifted from one level of government to another.

As we agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 14 days from the date of this letter. The report will be available at no charge on GAO's Web site at http://www.gao.gov. If you or your staff have any questions about this letter, please contact me at (202) 512-6806 or czerwinskis@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.

Sincerely yours,



Stanley J. Czerwinski
Director, Strategic Issues

Appendix I: Scope & Methodology

We examined the fiscal challenges facing state and local governments. Specifically, we examined (1) the fiscal pressures facing state and local governments during the next several decades and the past expenditure and revenue trends that influence these pressures, (2) state and local government expenditure and revenue trends to identify patterns among states, and (3) what is known about the implications of long-term state and local government fiscal pressures for current and future federal policies.

To characterize and quantify the long-term fiscal outlook for the state and local government sector over the next 50 years, we drew information from the March 2010 update to our state and local government fiscal model.[1] Specifically, we present simulations of the state and local sectors' operating budget balance as a percentage of gross domestic product (GDP) and an estimate of the fiscal gap—the amount of spending reduction or tax increase needed to prevent operating deficits (or negative operating balances). To develop these long-run scenarios, we simulate each major receipt and expenditure category of the state and local government sector in future years using the Bureau of Economic Analysis's National Income and Product Accounts (NIPA) as our primary data source. We simulate the growth in each category of receipts and expenditures using the Congressional Budget Office's (CBO) economic assumptions whenever possible.[2] 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. For example, because 2009 data on total employment were not available from NIPA at the time of our analysis, we used data from the Bureau of Labor Statistic's Current Employment Statistics program to estimate the sector's 2009 employment level.

To describe long-term trends in state and local government revenues and expenditures, we examined NIPA data over the past 30 years.[3] We analyzed changes in the shares of state and local expenditure, revenue, and federal

[1]GAO, *State and Local Governments' Fiscal Outlook: March 2010 Update*, GAO-10-358 (Washington, D.C.: Mar. 2, 2010). This report and related products can be found at http://www.gao.gov/special.pubs/longterm/.

[2]In its *CBO's Economic Forecasting Record: 2009 Update* (Washington, D.C.: July 2009), CBO warns that the uncertainty inherent in its current forecasts exceeds the historical average because the current degree of economic dislocation exceeds that of any previous period in the past half-century.

[3]NIPA data from 1978 to 2008 are the most recent available 30 years of data for all data categories.

grant categories as a percent of total expenditures, revenues, and federal grants respectively from 1978 to 2008. We also examined inflation-adjusted growth in expenditure and revenue categories as a percent of GDP. In addition, we provide information on the effect of the recent recession on state and local government tax revenues using NIPA data (2001 through the first quarter of 2010) to show declines in recent years. We also reviewed our prior reports and those of others to identify what is known about these trends and factors that affect them.

To examine trends in state and local government expenditure and revenue patterns among the states, we used U.S. Census Bureau government finance data and GDP price index data from NIPA to calculate inflation-adjusted values of selected expenditure and revenue categories for each state (including the District of Columbia) and for the U.S. for 1977-2007, excluding 2001 and 2003 because data were not available in those years.[4] Data for 1977, 1982, 1987, 1992, 1997, 2002, and 2007 are based on the U.S. Census Bureau, *Census of Governments*, which surveys all state and local governments in the United States. Data for the other years are based on the *Annual Survey of Government Finances*. In these years, local government finance statistics are based in part on a sample of local governments in the United States. We determined that the U.S. Census Bureau data were the best available data for the purpose of examining variation in trends among the states. We previously reported that this data comprises the most comprehensive and consistent set of data on this subject.[5] We assessed the reliability of the data we used for this review and determined that they were sufficiently reliable for our purposes. However, due in part to definitional differences among the states, such as those of coverage (what constitutes a government entity) or measurement (cash vs. accrual accounting) the data cannot be used as financial statements, to measure a government's fiscal condition, or to calculate a surplus or deficit.

We examined patterns between state and local revenue growth and growth in overall state and local spending using data from the U.S. Census Bureau. For each state and the District of Columbia, we plotted the average annual growth rate in real own-source revenues against the average annual

[4]U.S. Census Bureau data from 1977 to 2007 are the most recent available 30 years of data for all data categories.

[5]GAO, *State and Local Finances: Some Jurisdictions Confronted by Short- and Long-Term Problems*, GAO/HRD-94-1 (Washington, D.C.: Oct. 6, 1993).

growth in real current expenditures from 1977 to 2007. We then counted the number of states in which spending grew faster, slower, and at the same rate as own-source revenues. We analyzed growth in current expenditures against growth in federal grant revenues and total general expenditures against total general revenues using the same approach. To examine the extent to which federal grants supported selected categories of state and local government spending, we compared average annual growth in federal grants from 1977 to 2007 using U.S. Census Bureau data for four expenditure categories—health and hospitals, education, public welfare, and housing and community development[6]—to the growth in those expenditure categories over the same time period. We also tabulated the number of states in which federal grant revenues grew faster than current expenditures, and the number of states in which federal grants grew slower than current expenditures.

To identify categories of spending that could influence fiscal pressures, we analyzed NIPA data on aggregate expenditures by category. Specifically, we selected for further analysis spending categories for which there were at least $100 billion in expenditures in 2008, and which, as a percent of GDP, experienced a positive annual growth rate between 1978 and 2008. We also included 'Corrections' because it had the highest growth rate of all categories, and is identified in the literature as a growing expense for some states. We then selected analogous categories in the U.S. Census Bureau data to analyze expenditure trends by category and state. To examine state and local government spending for personnel, we added 'total salaries and wages' to our list of expenditure categories.

To examine variation among the states, we examined the state and local government finances using three measures:

To get a sense of the relative proportion represented by each category in each state and for the United States, we calculated (a) selected expenditure categories as shares of general current expenditures in 2007, (b) selected revenue categories as shares of general revenues in 2007, and (c) long- and short-term debt as shares of total revenues in 2007.

To assess how fast each category grew between 1977 and 2007 in each state, we calculated the average annual growth rate for each selected

[6]We chose these expenditure categories based on our expenditure analysis and on the availability of U.S. Census Bureau federal grant data by category.

expenditure, revenue, and debt category using regression analysis. For each expenditure and revenue growth rate calculation, we identified the U.S. average growth rate and the minimum and maximum growth rates across the states.

Because changes in the levels of expenditures and revenues can be affected by changes in state fiscal capacity—such as increased tax revenues due to population growth—we compared the average annual growth rate for each category of spending, revenues, and debt to the average annual growth rate in state personal income. To compare the growth in these categories relative to growth in each state's resources, we compared the growth rate for each selected expenditure, revenue, and debt category to the growth rate in total state personal income between 1977 and 2007. We chose total personal income as a proxy for each state's resources or fiscal capacity. When expenditures in a state are growing faster than personal income, the share of the state's resources that are dedicated to state and local government services is growing. Over the long run, such growth could create a fiscal pressure. This analysis also identified the number of states where growth in a category was (a) greater than total personal income growth for that state or (b) less than total personal income growth for that state.

We used state personal income as a proxy for state fiscal capacity even though we previously reported that personal income is an incomplete measure of state resources because it excludes some sources of income potentially subject to state taxation, such as corporate income produced within the state, but not received by state residents.[7] We recently reported that total taxable resources, as reported by the Department of the Treasury, is a more comprehensive measure of state financing ability than personal income.[8] We did not use total taxable resources as the measure of state fiscal capacity in this analysis because the Department of the Treasury only began calculating it in the 1980s and therefore it was not available for the full period of our analysis. We also did not use GDP-by-state as the measure of states' fiscal capacity because the calculation of

[7]GAO, *Medicaid Formula: Differences in Funding Ability among States Often Are Widened*, GAO-03-620 (Washington, D.C.: July 10, 2003).

[8]GAO, *Vocational Rehabilitation Funding Formula: Options for Improving Equity in State Grants and Considerations for Performance Incentives*, GAO-09-798 (Washington, D.C.: Sept. 30, 2009).

GDP-by-state changed in 1997 such that the data before and after that year are not comparable.

To provide additional context for understanding the fiscal pressures facing state and local governments and the potential implications for federal programs and policies, we reviewed our prior reports and reports of think tanks, including the Pew Center on the States and the Nelson A. Rockefeller Institute of Government, and associations representing state and local government officials, including the National Governors Association, the National Association of State Budget Officers, and the National Conference of State Legislatures. We did not fully analyze every pressure nor identify the full range of possible federal policy implications.

To show the combined long-term fiscal challenges for all levels of government, we draw on simulations developed in our most recent update to the federal fiscal model for combined federal, state, and local surpluses and deficits as a percentage of GDP. We also simulate federal debt, state and local debt, and cumulative shortfalls as a percentage of GDP. We obtained historical values for federal debt from Historical Tables, Budget of the United States Government, Fiscal Year 2011 and historical values for state and local government debt from the Federal Reserve Board's Flow of Funds Accounts. Simulated values are from our most recent fiscal outlook reports.[9]

We conducted our work from February 2010 to July 2010 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.

[9]GAO, *The Federal Government's Long-Term Fiscal Outlook: January 2010 Update*, GAO-10-468SP (Washington, D.C.: March 2010) and GAO-10-358.

Appendix II: GAO Contact and Staff Acknowledgments

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Staff Acknowledgments

Michelle Sager (Assistant Director), Keya Chateauneuf, Andrew Ching, Susan Etzel, Shannon Finnegan, Richard Krashevski, Courtney LaFountain, and Max Sawicky also made key contributions to this report.

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