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THE FISCAL HEALTH OF THE STATES*

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THE TROUBLED CONDITION of the federal budget has overshadowed the poor fiscal health of the 50 states. State debts are underreported, and state budgets are on an unsustainable long-term path. If current spending patterns continue, the ratio of state debt to output will increase without bound.

While the states have varying levels of officially reported debt, all share two worrisome characteristics: an understatement of unfunded pension liabilities and ever-increasing expenditures, driven primarily by health-care costs.

PENSIONS AND HEALTH-CARE SPENDING

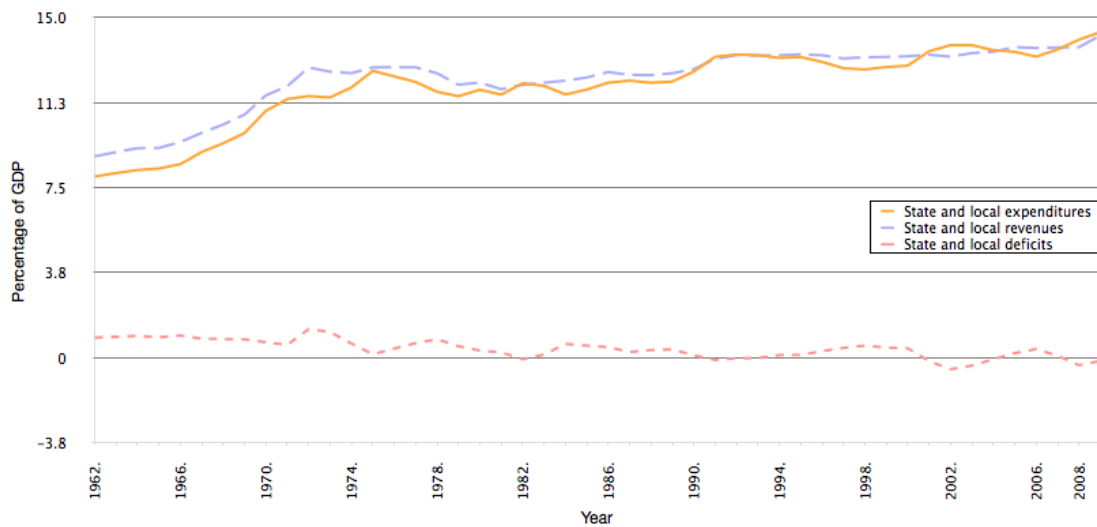
STATES HAVE LARGE, understated implicit debts for unfunded pension liabilities, making their current net debt positions substantially worse than officially reported. And driven by increasing health-care costs, state and local expenditures are growing faster than output. If spending trends continue and tax revenues remain near their historical levels relative to output, all 50 states will reach dangerous ratios of debt-to-GDP, and most will do so within 20 to 30 years.

While it will be politically difficult, states need to slow the growth of health-care expenditures in order to avoid fiscal crisis. Also, the federal government will need to help states by changing some of its programs. It should consider converting Medicaid into block grants to states and then giving states substantial leeway to limit the rate of increase in program costs.

STATE BUDGETS: FACT VS. FICTION

IF STATE GOVERNMENTS' officially reported debt levels were the whole story, then state balance sheets would appear healthy. As figure 1 shows, despite a worrisome half-century-long increase in state expenditures as a share of GDP, the states generally have sufficient financial assets to make their reported sovereign debts appear low. The worst net debt ratio, by this measure, is only 9.6 percent (New York), and the ratios

FIGURE 1: AGGREGATE STATE AND LOCAL EXPENDITURES RELATIVE TO GDP, 1962—2008



Source: *Economic Report of the President* (Washington, DC: Government Printing Office, February 2011)
Produced by Jeffrey Miron

are negative for 18 states (see table 1, column1).¹ Overall, the officially reported net debt of state and local governments is a paltry 1.9 percent of GDP.

But officially reported debts levels are not the whole story. State and local governments have significant “off-balance-sheet” liabilities in the form of pension obligations to state and local employees. These liabilities exceed existing pension-fund balances by substantial amounts. In other words, pension liabilities are understated and represent substantial fiscal imbalances.

The crucial issue, as pointed out by Assistant Professor of Finance Robert Novy-Marx and Associate Professor of Finance Joshua Rauh, is that officially reported pension liabilities assume a risky interest rate (typically about 8 percent, the historical return on stocks) when discounting future payouts.² But that approach is problematic. State and local governments are legally obligated to make those pension payments,³ and standard financial economics requires that future payments that are certain be discounted at a risk-free interest rate, which is much lower than 8 percent. A lower interest rate makes the present values of future liabilities substantially larger.⁴ Novy-Marx and Rauh estimate that measured liabilities exceed officially stated liabilities by roughly \$1.3 trillion.⁵

The first three columns of table 1 show each state’s officially reported debt levels exclusive of pensions, officially reported debt levels inclusive of pensions, and Novy-Marx and Rauh’s corrected debt-level estimates.

These unfunded pension liabilities are only the tip of the iceberg. An assessment of states’ fiscal health must also consider

realistic projections of future state and local expenditures. The results look bleak.

The key trend is that expenditure growth has *consistently* exceeded GDP growth, and this growth drives the projections. State and local expenditures have grown from roughly 8 percent of GDP in 1962 to more than 14 percent in 2008 (see figure 1).⁶ Most of the increase over the last two decades has been due to health care, which now accounts for 18 percent of state and local expenditures.⁷ The trend in spending growth is expected to continue, driven by Medicaid and the subsidies for health-insurance exchanges under the Patient Protection and Affordable Care Act (PPACA) of 2009. The U.S. Government Accountability Office projects aggregate state and local expenditures to increase without bound relative to GDP, driven mainly by these health-care costs.⁸

Column 4 of table 1 summarizes the seriousness of current trends by showing when each state’s indebtedness is projected to reach 90 percent of state GDP.⁹ That is the tipping point where economics Professors Carmen Reinhart and Ken Rogoff conclude that sovereign debt has a strong tendency to retard economic growth.¹⁰ Most states will hit a 90 percent ratio of explicit-plus-implicit debt-to-GDP within two to three decades.¹¹ A state-level fiscal crisis likely won’t happen in the next few years, but the window for taking corrective action is closing.

The case for taking these debt projections to heart is even stronger because they are almost certainly too optimistic. The projections ignore the effects of the recession; economic growth from 2009 through 2011 has been lower than the 1962–2008 rate used in the projections. Structural

TABLE 1: DEBT LEVELS OF THE 50 STATES

| State | Officially Reported Net Debt Level (% of GDP) | | Novy-Marx & Rauh Adjusted Debt Level Incl. Pensions (% of GDP) | Projected Year Debt Level Reaches 90% of GDP |
|----------------|---|----------------|--|--|
| | Excl. Pensions | Incl. Pensions | | |
| Alabama | 1.4 | 9.1 | 20.7 | 2026 |
| Alaska | -93.7 | -95.3 | -82.3 | 2094 |
| Arizona | 0.7 | 2.7 | 14.2 | 2034 |
| Arkansas | -1 | 3.2 | 12.2 | 2041 |
| California | 1.3 | -1.8 | 7.7 | 2029 |
| Colorado | 2.5 | 4.9 | 16.3 | 2061 |
| Connecticut | 6.9 | 12.6 | 23.1 | 2043 |
| Delaware | -0.9 | 0.3 | 6 | 2043 |
| Florida | -0.1 | -0.5 | 6.2 | 2037 |
| Georgia | 1.9 | 2.8 | 11.3 | 2039 |
| Hawaii | 3.3 | 12.6 | 22.7 | 2033 |
| Idaho | -6.9 | -4.5 | 4.3 | 2043 |
| Illinois | 5.9 | 9.2 | 22.1 | 2035 |
| Indiana | 0.8 | 5.8 | 10.6 | 2040 |
| Iowa | -1.4 | 0.2 | 6.9 | 2043 |
| Kansas | 3.6 | 9.6 | 16.8 | 2042 |
| Kentucky | 7.8 | 17 | 28.7 | 2026 |
| Louisiana | -4.3 | -4.5 | 3.9 | 2040 |
| Maine | -1.2 | 6.4 | 17.8 | 2038 |
| Maryland | 2.2 | 3.3 | 10.2 | 2035 |
| Massachusetts | 8.3 | 6.5 | 13.9 | 2056 |
| Michigan | 4.3 | 1.1 | 9 | 2026 |
| Minnesota | 2.1 | 5.6 | 17.2 | 2034 |
| Mississippi | 0.5 | 6.9 | 20.2 | 2032 |
| Missouri | 0.2 | 0.4 | 9.4 | 2039 |
| Montana | -13.1 | -9.2 | 0 | 2049 |
| Nebraska | 1.9 | -0.5 | 3.3 | 2040 |
| Nevada | 4.6 | 7.8 | 16 | 2041 |
| New Hampshire | 2.2 | 7 | 13.8 | 2044 |
| New Jersey | 6.2 | 17.9 | 30 | 2037 |
| New Mexico | -21.5 | -15 | -0.8 | 2030 |
| New York | 9.6 | -3.8 | 4 | 2034 |
| North Carolina | 1.8 | 1.1 | 7.8 | 2054 |
| North Dakota | -19.9 | -18 | -12 | 2070 |
| Ohio | -4.8 | 4.4 | 22.2 | 2040 |
| Oklahoma | -3.7 | 3.3 | 11.4 | 2044 |
| Oregon | 0.9 | 2.5 | 15.8 | 2029 |
| Pennsylvania | 3.1 | 2.3 | 12.2 | 2042 |
| Rhode Island | 4.9 | 14.1 | 28.1 | 2029 |
| South Carolina | 8.3 | 15.9 | 29.1 | 2027 |
| South Dakota | -4.7 | -5.7 | 1.8 | 2040 |
| Tennessee | 5.7 | 5 | 10.2 | 2042 |
| Texas | 0.1 | 0.3 | 6.7 | 2055 |
| Utah | -1.2 | 1.8 | 9.4 | 2049 |
| Vermont | -0.8 | 2.4 | 9.3 | 2042 |
| Virginia | 1.3 | 2.5 | 7.5 | 2042 |
| Washington | 2.6 | 1.6 | 8.8 | 2039 |
| West Virginia | -2.5 | 6.8 | 14.6 | 2042 |
| Wisconsin | 5.2 | 3 | 17.6 | 2028 |
| Wyoming | -36.2 | -35 | -27.8 | 2075 |
| United States | 1.9 | 2.2 | 11.2 | 2038 |

impediments such as mounting federal debt, may slow growth even further. Spending growth may rise even faster than assumed; past projections of government health-care costs have often erred on the low side. Also, growing debt levels will likely increase debt-financing borrowing rates. Moreover, facing its own budgetary strain, the federal government is likely to shift more health-care and other expenditures onto states.

AVOIDING FISCAL MELTDOWN

THE CRUCIAL QUESTION IS: what can states do to avoid fiscal meltdown? Unfortunately, all the options involve substantial political pain, which may cause the necessary actions to be delayed until a crisis occurs. Nevertheless, the way for states to avoid fiscal crisis is to slow the growth of health-care expenditures. This task is difficult since the federal government gives states relatively little freedom to limit Medicaid expenditures—unless a state opts out of the program entirely.

The policy changes that can help states avoid fiscal meltdown, therefore, must come from the federal government. One promising possibility is to convert Medicaid into block grants to states, with each state having substantial leeway to determine exactly who and what is covered under the state plan. The block grant approach is politically viable and can plausibly generate a lower rate of health-care cost increases by leaving states free to adjust their programs in ways that reduce costs without major reductions in health care.

CONCLUSION

STATE GOVERNMENT FINANCES are not on a sustainable path due to rising health-care costs and understated, unfunded pension liabilities. Medicaid expenditures and the subsidies for health-insurance exchanges under the PPACA of 2009 are the key drivers of unsustainable trends in state spending.

Additionally, states have large implicit debts for unfunded pension liabilities, making their current net debt positions substantially worse than official debt statistics indicate. If these spending trends continue and if tax revenues remain near their historic levels relative to output, most states will reach dangerous ratios of debt-to-GDP within 20 to 30 years, and all states face fiscal meltdown in the foreseeable future. Moreover, pressure to reduce federal expenditures may result in a shift of health-care and other expenditures to states, further exacerbating budgetary imbalances. All the options are painful, but unsustainable trends in state budgets should be corrected as soon as possible.

ENDNOTES

*This Mercatus on Policy is a summary of a working paper. See Jeffrey Miron, "The Fiscal Health of U.S. States" (working paper, Mercatus Center at George Mason University, Arlington, VA, 2011).

1. The net asset ratios for several states, especially Alaska, are sufficiently negative to raise concerns about the underlying data. The states with the most extreme numbers are small, however, so their data have minimal impact on the overall assessments.
2. Robert Novy-Marx and Joshua Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?" *Journal of Finance*, forthcoming. See also, Jeffrey R. Brown, Robert Clark, and Joshua Rauh, "The Economics of State and Local Pensions" (working paper no. 16792, National Bureau of Economic Research, Cambridge, MA, 2011).
3. Jeffrey Brown and David Wilcox, "Discounting State and Local Pension Liabilities," *American Economic Review* 99, no. 2 (2009): 538–42.
4. Consider, for example, a benefit payment of \$1,000 that a state owes in 20 years. At a risky interest rate of 8 percent, the state's current liability for that payment is only \$215. At a risk-free interest rate of 2 percent, the liability is \$673.
5. The Pew Center on the States documents a roughly \$1 trillion underfunding of state and local pension and health-care plans in *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform* (Washington, DC: Pew Center on the States, 2010). The Center provides an updated figure of \$1.26 trillion in *The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs* (Washington, DC: Pew Center on the States, 2011). The CBO discusses the different approaches to measuring the underfunding of state and local pension plans in "The Underfunding of State and Local Pensions Plans," Economic and Budget Issue Brief (Washington, DC: CBO, May 2011).
6. Matthew Mitchell, "State Spending Restraint: An Analysis of the Path Not Taken" (working paper, Mercatus Center at George Mason University, Arlington, VA, 2010).
7. The data on health-care expenditures are from the U.S. Census Bureau, <http://www.census.gov/govs/estimate/>. Clicking on the link for a particular state provides excel files with the necessary tables. For the data on state GDP, see the Bureau of Economic Analysis, "GDP by State," news release, June 7, 2011, http://www.bea.gov/newsreleases/regional/gdp_state/gsp_newsrelease.htm.
8. Government Accountability Office, *State and Local Governments: Fiscal Pressures Could Have Implications for Future Delivery of Intergovern-*

mental Programs, GAO Report 10-899 (Washington, DC: GAO, 2010). It uses a methodology similar to that used in the Congressional Budget Office's analyses of the federal, long-term budget outlook. See, for example, Congressional Budget Office, *CBO's 2011 Long-Term Budget Outlook* (Washington, DC: CBO, June 2011).

9. The projections assume that both nominal state GDP and tax revenues grow at 7.2 percent per year, their average growth rate over the period 1962–2008, and that nominal state and local expenditures will grow at 8.5 percent per year, their average growth rate over the same period. The sample starts in 1962 because that is when consistent data on state and local expenditures become readily available. The sample ends in 2008 so that the growth rates are not overly influenced by the recent recession. The assumption that tax revenues remain constant as a percentage of GDP is reasonable for three reasons. First, political opposition to tax increases is likely to continue. Second, raising taxes to reduce debt levels would reduce GDP growth rates, both complicating the calculations and reducing the revenue gains from higher rates. Third, state governments in particular face significant impediments to higher tax rates because many individuals and businesses can avoid them by relocating to other states.
10. Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt," *American Economic Review* 100, no. 2 (May 2010): 573–78.
11. Table 2 also shows projected tipping-point dates under alternative assumptions. Column 2 assumes expenditures grow at a rate 0.5 percentage points slower than the historical average. Column 3 assumes output and tax revenues grow at a rate 0.5 percentage points faster than the historical average. Neither alternative assumption dramatically changes the results. For all states combined, lower expenditure growth delays reaching the 90 percent ratio of debt-to-GDP by only six years; higher output, by only seven.

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