

Fiscal Sustainability Research and Resources

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1. Introduction

[HB 715](#) directs the Legislative Finance Committee to study long-term budget stabilization and financial modernization with emphasis on risk analysis. As part of this effort the Legislative Fiscal Division has surveyed existing studies and research efforts that have a similar focus: both from governmental/practitioner sources and academic sources. In general, studies of this type are referred to as “fiscal sustainability” studies. The idea behind such studies is to examine the projected change in both government revenues and expenditures for a given jurisdiction (country, state, city, etc.) over a given period of future years. The LFC HB 715 study projects Montana’s state and local revenues and expenditures 10 years into the future.

Fiscal sustainability studies can highlight strengths and weaknesses in a jurisdiction’s fiscal practices. Projection, while uncertain, may permit jurisdictions to respond to anticipated fiscal vulnerabilities before serious fiscal difficulties emerge. For example, changing demographics in a jurisdiction may lead policymakers to shift to a different tax regime in order to capture the necessary level of revenues to ensure fiscal sustainability: future revenues should be sufficient to fund future expenditures.

This document focuses on fiscal sustainability studies that have already been completed by other entities. While these studies may not be directly comparable to Montana in every dimension they offer valuable information in several areas. First, existing examinations of fiscal sustainability can inform the HB 715 project by specifying the scope of projects of this type. What variables and areas of focus should a fiscal sustainability study contain? Second, some of these studies, specifically those conducted by governmental organizations like the Government Accountability Office (GAO), can inform the data sources and methodology used in the HB 715 study. Finally, existing studies provide useful examples for the communication and organization of results and key findings.

As indicated previously, fiscal sustainability studies can be divided by the type of entity that authored the report: academic researchers and governmental/practitioner researchers. The remainder of this review summarizes findings from a number of fiscal sustainability studies in each of these research group types.

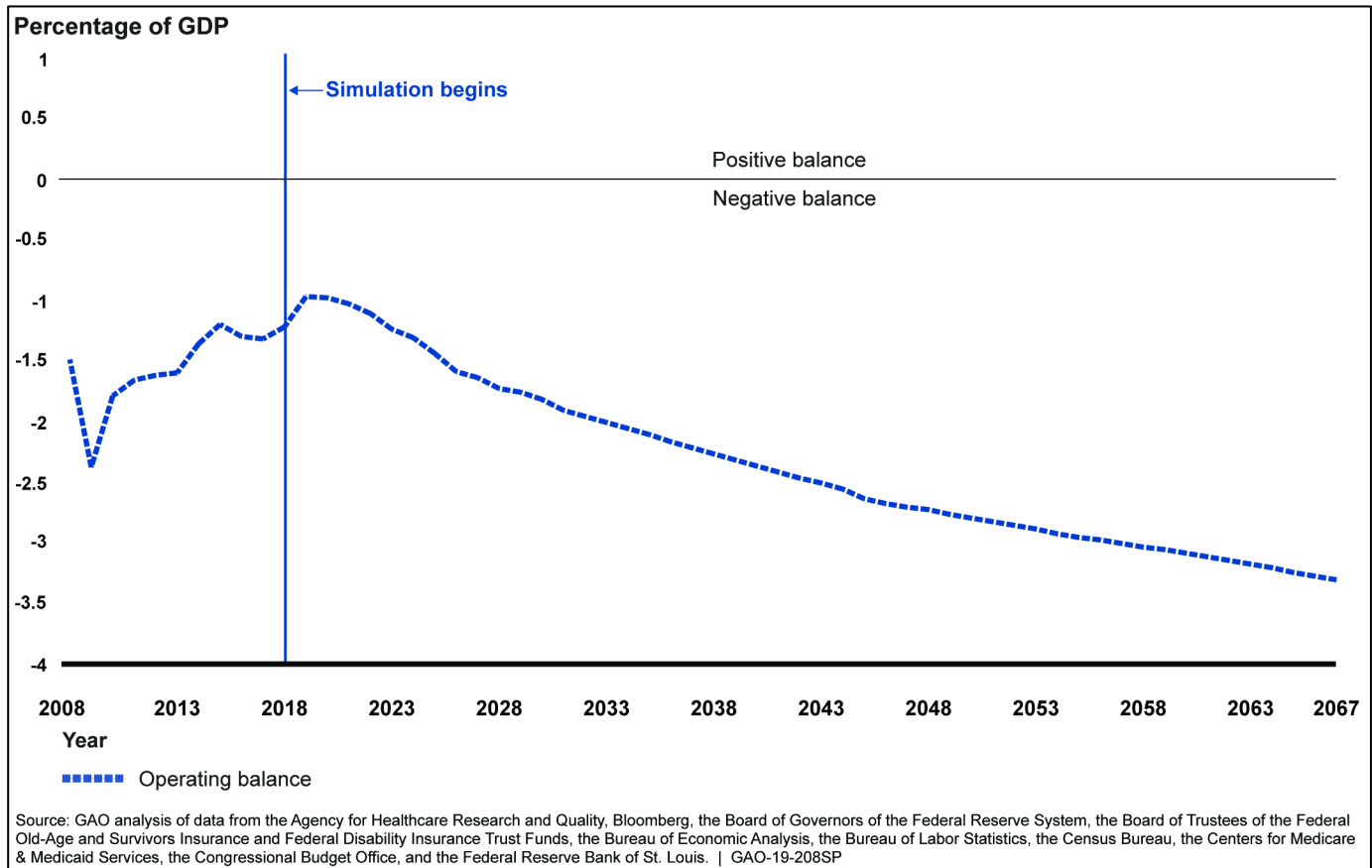
2. Public Sector Research

2.1 Government Accountability Office’s [“State and Local Governments’ Fiscal Outlook”](#) Series

The GAO has conducted an annual series of fiscal sustainability studies for state and local governments since 2007. This series discusses state and local finances in the aggregate (there is no data on individual states or local jurisdictions) and projects revenues and expenditures 50 years into the future, as opposed to the 10-year projection in the HB 715 project. This GAO product is similar to the Federal Fiscal Outlook series they have produced beginning in 1992.

This series uses Bureau of Economic Analysis National Income and Product Accounts (NIPA) data, a dataset that is to a large degree based on Census Bureau data utilized in the LFC HB 715 study. In general, the GAO series expresses expenditures and revenues as a percentage of gross domestic product (GDP), as in the graph below.

Figure 1 - State and Local Government Sector Operating Balance 2008-2067



GAO indicates that since beginning this series in 2007 their findings have “consistently shown that the sector [state and local governments] faces long-term fiscal pressures.” While virtually all states face some sort of balanced-budget requirement, the long-run projection for state and local finances indicates an expanding deficit in the aggregate.

The study develops the concept of a “fiscal gap,” which is an estimate of actions (revenue increases and/or expenditure reductions) that must be taken in the present and continued throughout the period covered by the model in order to achieve fiscal balance over the simulation. GAO estimates that the current aggregate fiscal gap for all state and local governments is 14.7% of expenditures, or 2.4% of GDP. That is, states and local governments would need to make a current 14.7% expenditure cut (or revenue increase, or some combination thereof) and maintain that reduction in order to be in fiscal balance 50 years in the future.

The most recent report in this series ties the projected expanding negative balance for state and local governments largely to increased health care expenditures. The GAO model projects both Medicaid and state employee health expenditures to grow significantly over the next 50 years: from 4.1% of GDP in 2018 to 6.3% of GDP in 2067. The study also discusses state and local employee pensions and suggests that many jurisdictions will need to manage their pension obligations by reducing benefits or increasing employee contributions.

2.2. [Connecticut Commission on Fiscal Stability and Economic Growth Final Report](#) (2018)

A 2017 Connecticut statute created a Commission on Fiscal Stability and Economic Growth in that state to “develop and recommend policies to achieve state government fiscal stability and promote

economic growth and competitiveness within the state.” The commission issued a report in March 2018. While a large portion of the report focuses on business and tax climate, it does include findings on short and medium-term fiscal sustainability. Connecticut faces large and growing budget deficits (projected at \$3 billion in FY 2021 and \$3.5 billion in FY 2022. Additionally, the report projects that the gap between non-discretionary, or fixed general fund expenditures and discretionary general fund expenditures will continue to expand: entitlement spending will consume a majority of general fund expenditures going forward in Connecticut. Finally, the report emphasizes concerns with Connecticut’s pension liabilities (including the assumed 7.5% rate of return) and debt service.

2.3. Pew Fiscal 50: [State Trends and Analysis](#)

The Pew Charitable Trusts maintains the Fiscal 50: State Trends and Analysis series, which has a number of visualizations on various measures of state revenues, expenditures, fiscal policy, and demographics. This series of variables does not project forward in time, but shows a trend over some range of past years or a recent year. This is a useful resource for comparing Montana to other states on variables such as state personal income, unfunded liabilities, tax revenue volatility, and other salient measures.

2.4. Urban Institute: [Sustainable Budgeting in the States](#)

A 2017 report from the Urban Institute (Sustainable Budgeting in the States) provides some useful findings on the impact of certain budgeting practices on fiscal outcomes and fiscal sustainability. The authors assess the academic evidence on the impact of various fiscal institutions: balanced budget requirements, budget stabilization funds, annual vs. biennial budgeting, consensus revenue estimation, and several others.

3. Academic Research

3.1 (Chapman 2008): [State and Local Fiscal Sustainability: The Challenges](#)

Chapman (2008) is a relatively early examination of state and local fiscal sustainability. The author summarizes trends in state and local revenues and expenditures before a discussion on three types of external fiscal pressures that may impact state and local governments. Cyclical pressures are tied to the business cycle and/or revenue cycle, and can impact states by not only putting downward pressure on revenues but also through increasing demands for certain public services. Structural pressures include broad economic and social trends: shifting demographics, consumption increasingly favoring services over goods, and e-commerce are all types of structural pressures. Chapman discusses Medicaid, pensions, and infrastructure as three policy areas that are particularly likely to place pressure on state fiscal health. Two of these areas (infrastructure and Medicaid) have a critical intergenerational component, in which states depend on federal grants to offer both discretionary and non-discretionary services. The author concludes by asserting that state and local governments will face increasing uncertainty in the future and must undertake reforms in order to achieve fiscal stability in the long term.

3.2. Ward and Dadayan (2009): [State and Local Finance: Increasing Focus on Fiscal Sustainability](#)

The authors write about the possibility that the GASB (Governmental Accounting Standards Board) become involved in assessing fiscal sustainability. They suggest a need for a clear definition of fiscal sustainability, which they describe as “the ability of governments to meet existing spending commitments with existing resources.” After describing the recent trends in state and local finance the authors also describe several changes that they think could impact state and local fiscal sustainability in the future. These potential developments include federal changes to Medicaid, a national health care reform (this article is pre-ACA), decreasing intergovernmental transfers from the federal government, and an increased ability for states to raise revenues through expanded taxation tools.

3.3. Rose (2010): [Institutions and Fiscal Sustainability](#)

Rose (2010) is a summary of academic findings focused on how various rules, procedures, and institutions impact state and local fiscal sustainability. Research indicates “rainy day funds” with meaningful deposit and access rules seem to enhance fiscal sustainability, as do “no-carry-over” balanced budget rules. There is mixed evidence on the impact of debt limits and tax and expenditure limits on fiscal sustainability. Rose finds that some ballot measures that limit taxation and spending can reduce the growth of government. Finally, there is evidence that term limits increase spending when lawmakers avoid difficult decisions, primarily as a result shortened time horizons, and increase the power of special interest groups.

3.4. Plummer and Patton (2015): [Using Financial Statements to Provide Evidence on the Fiscal Sustainability of the States](#)

The authors use government-wide financial statements (*Statement of Net Assets*) to assess state fiscal sustainability. They create a measure of state fiscal health which they term “adjusted total net assets (AdjTNA).” Pensions and OPEB (other post-employment benefits – in particular healthcare) are an important part of their calculation for AdjTNA. Most states had negative values on AdjTNA, but MT was positive (for fiscal year 2008) along with several other states, many of which are similar to Montana (Alaska, Idaho, North Dakota, New Mexico, South Dakota, Tennessee, Utah, and Wyoming). The average AdjTNA is about 140% of a state’s total annual tax revenues, meaning that most states face significant future liabilities, generally in the form of unfunded pension liabilities.

3.5. Gorina et al (2017): [Local Fiscal Distress: Measurement and Prediction](#)

The authors focus on fiscal health in local jurisdictions, a research area that had received renewed interest since the Great Recession led to many fiscal crises in local jurisdictions. They develop a model of fiscal distress prediction that incorporates comprehensive annual financial reports, budgets, and media coverage. Their findings indicate that local fiscal health is largely dependent on fiscal reserves, debt level, and revenue composition.

3.6. Zhao and Coyne (2017): [Walking a Tightrope: Are U.S. State and Local Governments on a Fiscally Sustainable Path?](#)

The authors develop a new measure of state and local fiscal sustainability which they refer to as the “trend gap.” It removes the short-term impact of the business cycle when considering long-run fiscal health. This study argues the nationwide trend gap has been driven larger over the past three decades by expenditures tied to education, social services, income support, and pensions. The authors predict a growth in the “trend gap” through 2026 if significant policy changes do not occur.

4. Conclusions and Implications of Existing Resources for Montana's HB 715 Study

All relevant sources assessed for this review exhibit a general consensus that in the aggregate, the state and local fiscal situation is not sustainable. States and local jurisdictions will either need to raise revenues, reduce expenditures, or some combination of the two if they wish to offer their current level of services in the long-term. All relevant sources agree that the most significant contributors to this negative outlook are health costs (Medicaid, employee health, and retiree health) and pensions. Additionally, several of these studies mention the shift from discretionary spending (infrastructure, economic development, etc.) to non-discretionary, or entitlement spending.

This negative outlook is compounded by other factors that complicate the process of finding a solution. First, many policymakers and stakeholders have relatively short time horizons. The majority of states have annual budgeting process, and even biennial budgets tend not to consider fiscal health beyond a two-year period. This can make addressing long-run problems, such as pension health, politically and practically difficult. Second, states and local governments face hard budget constraints when compared to national governments. State and local jurisdictions cannot print currency and have a limited ability to borrow and/or high borrowing costs. State and local jurisdictions, on average, have meaningful balanced budget rules, which can create additional pressure during the "bottom" of a business or revenue cycle.

Reviewing existing state and local fiscal sustainability resources is beneficial to Montana's HB 715 study in several ways. First, a review of this type helps establish project scope, variables of interest, assumptions, and areas of focus. Second, a review of existing studies helps inform Montana's efforts by providing information on data sources and methodology. Finally, existing similar studies provide guidance on information display and the communication of key findings. While Montana's HB 715 study has some truly unique features, including local fiscal sustainability interaction and a great level of detail, surveying existing studies is a critical early step in enhancing our understanding of fiscal sustainability in Montana.