



Fiscal Challenges for State and Federal Governments

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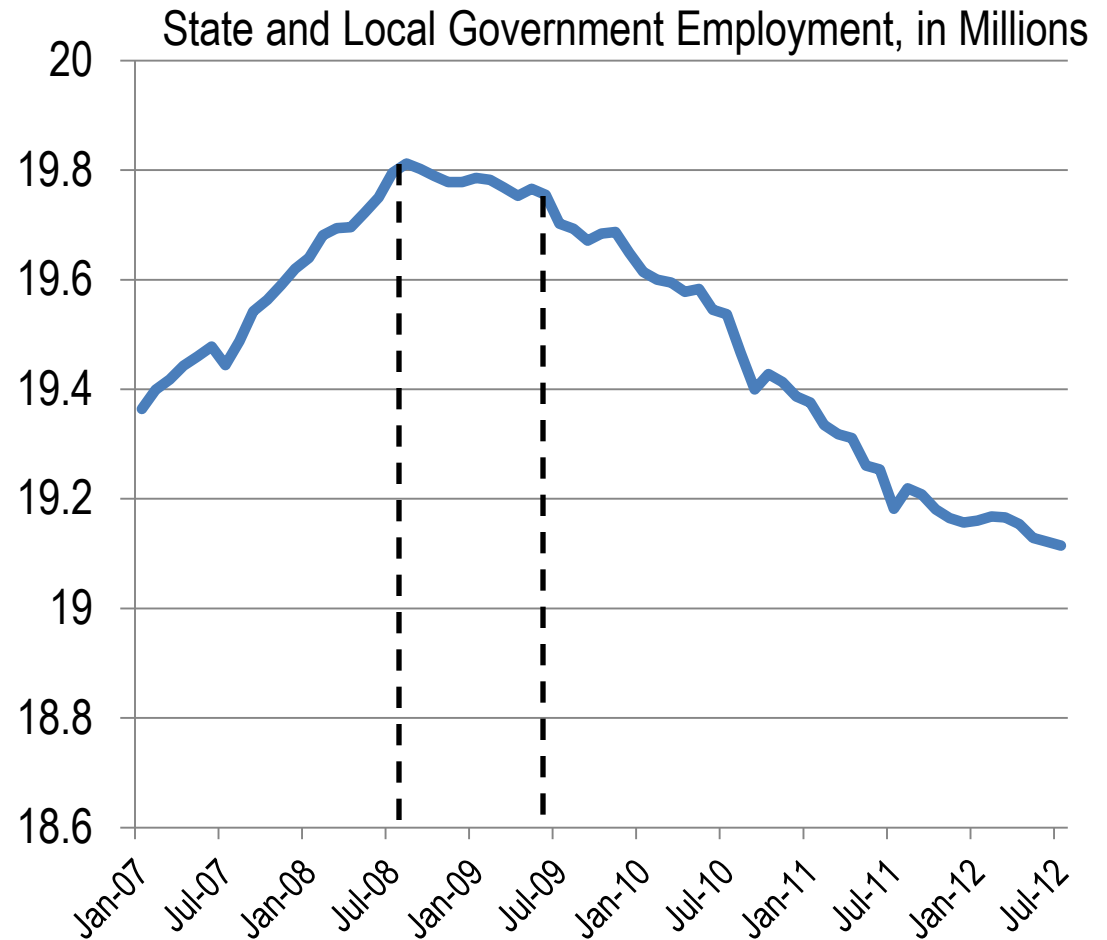
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Agenda

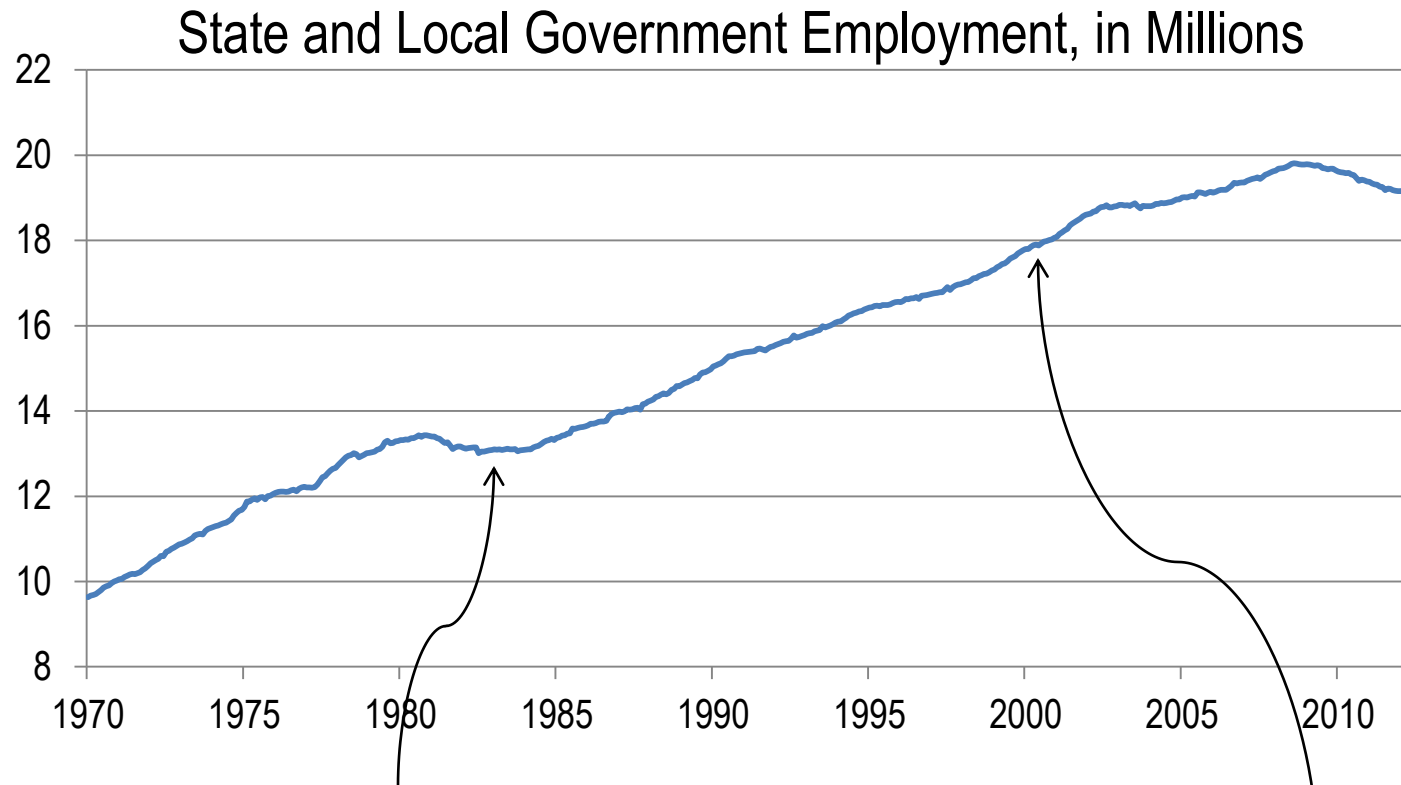
- Fiscal Crisis in State and Local Governments
- Outlook for Federal Budget
- Fiscal Cliff: Impact and Potential Scenarios

State and local government employment during the Great Recession

- Slow decline from Aug-08 to Jun-09
- 600k jobs lost since Jun-09



State and local government employment, the long view



Recession of early 1980s:
300k state and local gov't jobs lost

Recession of early 2000s: State/local
gov't employment continued to grow

Source: Bureau of Labor Statistics: Current Employment Statistics

Great Recession's effect on state and local government tax revenue

- State and local gov'ts expected high rev. growth
- Then revenues shrank in Great Recession
- Some recovery since, but growth still slower than trend

| Time Period | Annual rate of revenue growth* |
|-------------|--------------------------------|
| 1988-2007 | 2.7% |
| 2002-2007 | 4.1% |
| | |
| 2007-2009 | -2.1% |
| 2009-2011 | 0.9% |

*Adjusted for inflation

Great Recession's effect on public pensions

| Fiscal Year* | Investment Returns (including dividends and interest) |
|--------------|--|
| 2008 | -7.9% |
| 2009 | -16.2% |
| 2010 | 11.0% |

*Fiscal year end varies by public plan.

Based on a sample of state and local pension funds assembled by Boston College Center for Retirement Research

Challenges facing Illinois pensions

- ~\$90 billion unfunded liability
 - Funding ratio about 50%
- Chronic underfunding
 - State not make \$28 billion in promised contributions since 1996
- If funded properly, IL's pension would be near 65-70%
 - Near national average of 74%

General challenge for public pensions: Low discount rate

- Lower discount rate → higher pension liabilities
- In the past: “expected rate of return” ~ 8%
- New compromise rules:
 - Expected rate of return for funded liabilities
 - Muni bond yields for unfunded liabilities
 - Will affect underfunded plans the most

Medicaid pressuring state budgets

- About 16% of state expenditures*
 - Great Recession increases enrollees
 - Rising healthcare spending per person
- Healthcare for poor, nursing homes for elderly
 - Covers ~60 million people
- Administered by each state
- Federal government gives matching grants
 - On average, feds pay 55-60%

*% of state general funds. Source: Report of the State Budget Crisis Task Force

Medicaid under Affordable Care Act (ACA)

- Expands coverage to 133% of federal poverty level
- Projected to cover 17 million more people by 2019
 - ~50% of total insurance gains under ACA
- Supreme Court: States may opt out
- Fed. gov't pays for 100% of expansion until 2016, then decreases to 90%
- But 10% of expansion is still a lot
 - Illinois: \$238 million in 2020*

*Source: Department of Healthcare and Family Services, as reported by *Chicago Tribune*, 7/5/2012

Medicaid under the Ryan budget

- Repeal Affordable Care Act
- Convert matching grant into block grant, starting 2013
 - Better incentive for states to control costs
- Savings come from slow growth of block grants
 - Indexed only to inflation and population growth
 - Roughly 3.3% per year
 - Compare: CBO projects 7% annual increases in Medicaid spending
- Saves \$800 billion, but reduces coverage by 14-19 million*

*Savings and coverage estimate does not include impact from ACA repeal. Source: Urban Institute

Why are grants to states vulnerable?

| Program | FFY 2012 federal outlay |
|--|---------------------------------|
| <u>Total Federal Outlays</u> | <u>\$3,795.5 billion</u> |
| <u>“Untouchables”</u> | |
| Defense | \$709.0 billion |
| Social Security | \$772.7 billion |
| Medicare | \$484.5 billion |
| Veterans benefits | \$129.6 billion |
| <u>Total</u> | <u>\$2,320.6 billion</u> |
| | |
| Everything else | \$1,474.9 billion |
| Including: Grants to state and local governments | ---\$612.4 billion |

Source: Report of the State Budget Crisis Task Force

Substantive Medicare reform

- Obama: \$716b in next ten years*
 - Slower growth rate for hospital reimbursement
 - Reduced subsidies for Medicare Advantage
 - Long-run: IPAB keeping growth to GDP + 1.0%**
- Ryan budget:
 - Starting 2023: Vouchers, growing at GDP + 0.5%
 - Reduced costs through competition?
 - Or just gradually shifting costs to patients?

*These savings are used to finance insurance expansion in ACA. Ryan's budget also includes these \$700b in cuts, though he claims that his cuts would be different in some unspecified way.

**Obama's FY 2013 budget calls for reducing this target to GDP + 0.5%

Room to cut defense?

- Should not get credit for savings from committed troop drawdown
- Budget Control Act already cut \$420 billion*
- Hard to squeeze much more
- Romney wants to **INCREASE** defense spending

*This includes cuts to all “security” spending, which also includes (e.g.) the Department of Homeland Security

Republican individual income tax plans

- Mitt Romney
 - Reduce all rates by 20%
(e.g., 35% → 28%)
 - Rate cuts = \$3.42 trillion over ten years*
- Paul Ryan
 - Two brackets: 25% and 10%
 - Rate cuts = \$3.22 trillion over ten years*
- Revenue neutral?
 - Additional economic growth
 - But not identify tax deductions
or exemptions for repeal

All estimates are relative to a current policy baseline.

*This includes the cost of repealing the AMT, which both plans would do

Source: Tax Policy Center

But Obama can't balance the budget just by raising taxes on the rich

- Projected deficit over ten years: \$10 trillion.*
- Repeal Bush Tax Cuts for “Wealthy” **
 - Increase marginal tax rates: \$607 billion over ten years ***
 - Dividends and capital gains: \$242 billion over ten years
- Reduce Value of Deductions **
 - Cap deductions at 28%
 - \$584 billion over ten years
- Total: \$1.4 trillion over ten years

*Source: Congressional Budget Office, Alternative Fiscal Scenario

**Applying to income above \$200,000 (\$250,000 for married couples). Source: FY 2013 Green Book

***This includes various provisions that (e.g.) roll back personal exemptions as income increases—which is essentially identical to a marginal rate increase.

Fiscal cliff—end of 2012

| Program | Decreased spending / increased revenue in 2013 |
|--------------------------------|--|
| Bush tax cuts (2001/2003/2010) | \$145 billion* |
| AMT patch | \$90 billion |
| Sequester | \$65 billion |
| Payroll tax cut | \$90 billion |
| Unemployment Insurance | \$25 billion |
| “Doc Fix” | \$10 billion |
| Affordable Care Act taxes | \$20 billion |
| Various other provisions** | \$30 billion |
| Total | \$475 billion |

*Includes interaction effects of the Bush tax cuts with the AMT patch

**Includes various targeted tax credits, such as the credit for increasing research and experimentation spending.

Source: Congressional Budget Office, Committee for Responsible Federal Budget

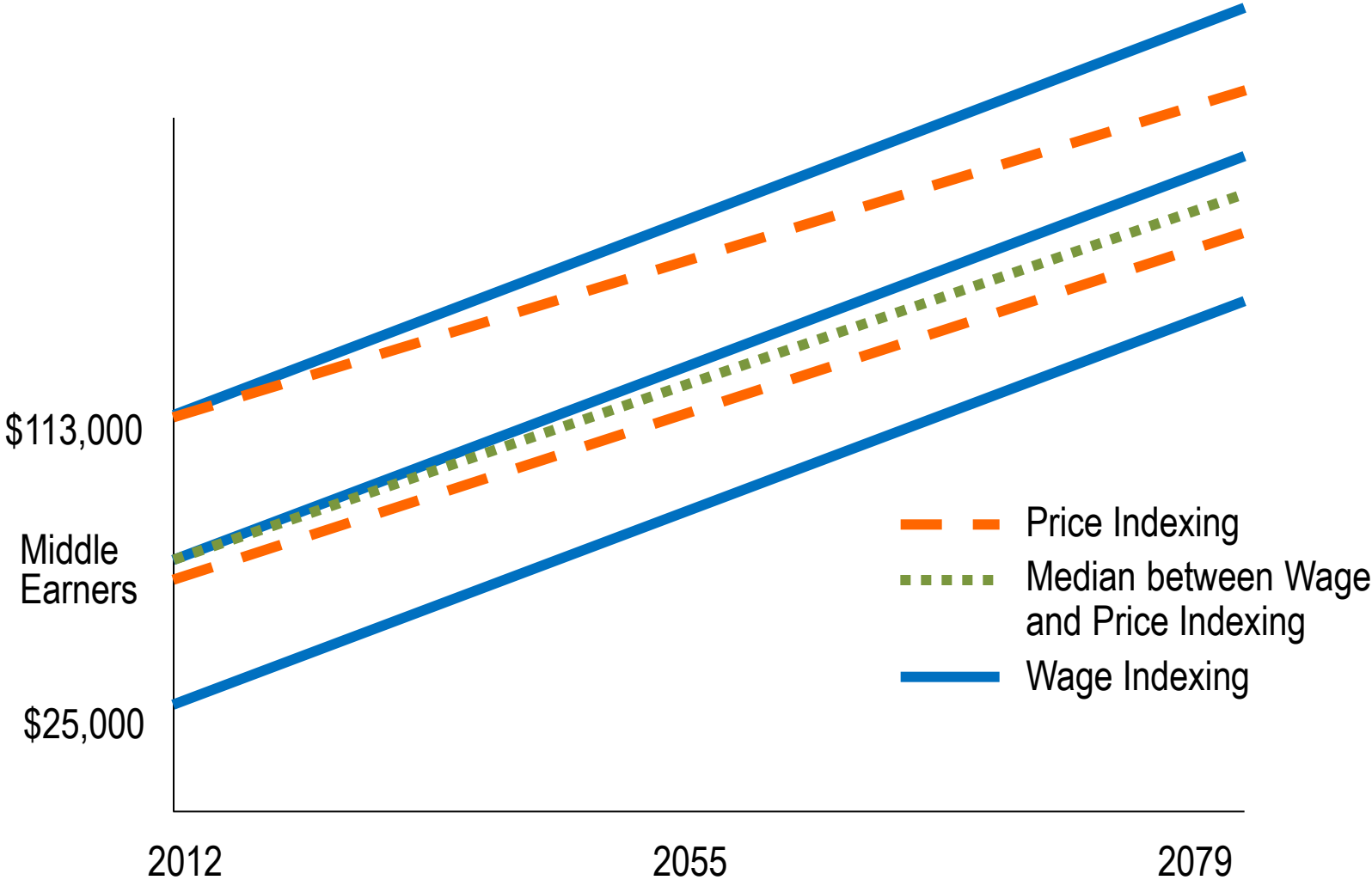
Political realities of fiscal cliff

- Neither Romney nor Obama will be able to avoid
 - Senate will be near 50-50
 - Need 60 votes for closure
- Four main possibilities:
 1. Paralysis: U.S. falls off fiscal cliff for lengthy period
 2. Denial: Congress indefinitely extends measures
 3. Buying time: Congress postpones measures for month or two
 4. Compromise: In the crisis, Congress passes “big deal”

Bipartisan “Big Deal”

- Goal: \$4-\$5 trillion over ten years
- Simpson-Bowles as starting point
- Bipartisan Gang of Eight in Senate
- Strong business support for Big Deal

Social Security shortfalls: A solution



Falling off the cliff, then climbing back on

- Wait until 2013
 - Romney wins, or
 - Obama wins, but GOP refuses to raise taxes on “rich”
- Political spin after falling off cliff
 - Cutting taxes
 - Raising spending
- Drop dead date, February 2013
 - Debt ceiling
 - Won't lift without deal