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U.S.

## Why Are States So Strapped for Cash? There Are Two Big Reasons

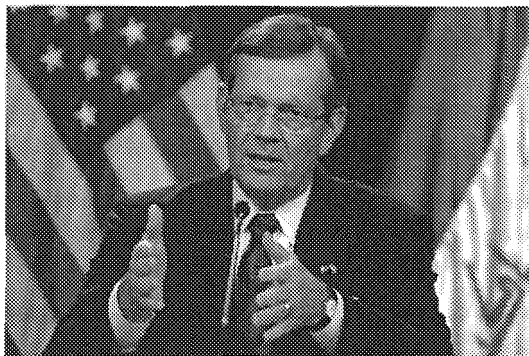
The proportion of state and local tax revenues dedicated to Medicaid and public pensions is the highest since the 1960s

*By Cezary Podkul and Heather Gillers*

March 28, 2018 12:45 p.m. ET

The only speaker standing between state budget officers and the opening cocktail hour at a Washington conference was the U.S. Secretary of Health and Human Services. What he said left no one in a celebratory mood.

Medicaid costs, said then-Secretary Michael Leavitt, were projected to grow so fast that within 10 years they would “crowd out virtually every other category of spending.” State spending on higher education, infrastructure and safety, he predicted, would all get squeezed.



In 2008, then Health and Human Services Secretary Michael Leavitt predicted Medicaid costs would “crowd out virtually every other category of spending” for states within 10 years. PHOTO: ALI ABBAS/EPA/SHUTTERSTOCK

Nearly 10 years after that October 2008 speech, Mr. Leavitt’s prediction—part of HHS’s first-ever annual projection of Medicaid’s costs—is looking prescient.

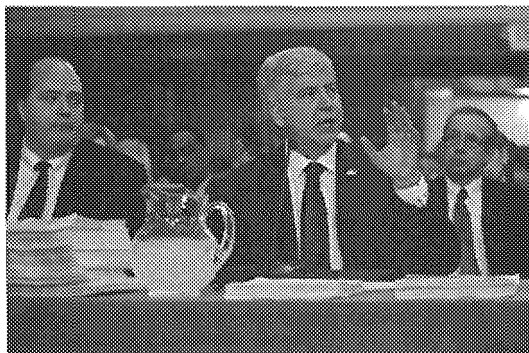
As state and local officials prepare their next budgets, many are finding that spending decisions have already been made for them by two must-fund line items that barely mattered when baby boomers such as Mr. Leavitt were growing up: Medicaid, the state-federal health insurance program for the poor and disabled, and public-employee health and retirement costs.

These days, they consume about one out of every five tax dollars collected by state and local governments. That is the highest share since Medicaid was created in 1965. Postretirement health benefits, which are harder to quantify, add to that burden and have cumulatively cost states more than \$100 billion since 2008, according to government financial disclosures compiled by Merritt Research Services.

Those costs are outpacing growth in tax revenue year after year. In 2016, state and local governments collected about \$136 billion more in taxes than they did in 2008, adjusting for inflation. Two-thirds of those additional dollars went to fund pensions and Medicaid, according to a Wall Street Journal analysis of Commerce Department spending data.

"The more we stare at the data, the more we realize all roads lead back to Medicaid and pensions," says Dan White, a director at Moody's Analytics who has studied the issue.

The resulting revenue squeeze is making it harder for governments to pay for core services such as education, infrastructure, police and fire protection.



Michigan Gov. Rick Snyder, center, tapped John Nixon, left, to run the state's budget. PHOTO: AL GOLDIS/ASSOCIATED PRESS

It also is fueling bitter state budget battles. Twenty-two states faced budget shortfalls in 2017. Ten couldn't agree on a new budget before the start of their next fiscal year. Illinois's credit rating was downgraded nearly to junk status.

To save money, states are sending less aid to cities. Many cities, in turn, are increasing fees and fines on everything from garbage collection to parking tickets. Others, such as Hartford, Conn., have teetered on the brink of bankruptcy.

The cash crunch is likely to get worse. Federal actuaries predict that Medicaid's annual cost, which was \$595 billion in 2017, will exceed \$1 trillion in 2026. States and many localities pay about 38% of that tab. The remainder is covered by the federal government.

Policy makers in Washington have talked about revamping entitlement programs such as Medicaid, but so far their efforts have gained little traction. That leaves it up to states to try to contain spending—and make do with less.

Nearly 70 million Americans, about one-fifth of the population, depend on Medicaid for health coverage, including more than 28 million children. The biggest financial beneficiaries are the disabled, the elderly and poor working-age adults.

Medicaid costs have transformed state budgets. In 1964, states' top three spending items were education, highways and public welfare, according to data from the Council of State Governments. As of 2014, public welfare, which includes Medicaid, had moved into the No. 2 position.

"Governments are spending less on what they want so they can spend more on what they must spend," says Don Boyd, a senior research fellow at Rockefeller College in Albany, N.Y. "There's been a lot of crowding out."

Public-employee pensions are legally protected in most states. With Medicaid, states can set criteria for coverage, but then must pay for anyone who qualifies.

"Whatever that bill is, you have to cover it," says John Nixon, a former state budget director for Utah. In 2010, Michigan Gov. Rick Snyder tapped him to run that state's budget. At the time, Michigan was spending about \$1.5 billion more than it collected, Mr. Nixon says. The governor wanted to close the gap and boost funding for the state's underfunded pension and retiree health plans, among other priorities.

Mr. Nixon couldn't touch Medicaid, which then took up almost a quarter of Michigan's general fund. So he and lawmakers looked for savings elsewhere as they wrote the state's 2012 budget. Eventually, they agreed to cut \$222 million from higher education, \$452 million from K-12 education and \$105 million from statutory tax revenue sharing with Michigan cities. Mr. Snyder, a Republican, said "tough decisions" were necessary to close Michigan's fiscal gap.

State and local governments nationwide shed 286,000 employees from 2008 to 2016, shrinking to 19.4 million, according to the U.S. Census Bureau's public-employment survey.

Over the past two years, Mississippi closed 10 of its 95 county health clinics, eliminating 153 positions and two inpatient drug-treatment centers. Nonprofit drug-treatment providers also lost funding.

"We have an opioid crisis going on," says Amy Turner, who runs a nonprofit drug-treatment center near Biloxi. Mississippi cut Ms. Turner's grant for treating female drug addicts by 33%.

Nationwide, state spending on higher education and local tax revenue sharing, adjusting for inflation, have both declined since 2008, according to the Journal's analysis. So has state and local spending for infrastructure.

For college students, shrinking state higher-education budgets mean paying more to attend public universities. In 1980, 48 of 50 states funded their college budgets mostly through annual appropriations of tax revenues, not from tuition. By 2017, that was true in just 20 states, as tuition had become the larger funding source in 28 states, according to data from the State Higher Education Executive Officers' Association.

"For the first time in our nation's history, we are at the cusp of college students and their families paying the majority of college costs," Robert Anderson, the group's president, testified at congressional hearing in February.

For cities, the budget squeeze means they must rely less on state aid to balance their books. The Lincoln Institute of Land Policy, which tracks the budgets of 150 U.S. cities, found that 85 received less state aid in 2015 than they did in 2005. In 54 cities, aid declined by more than 10%.

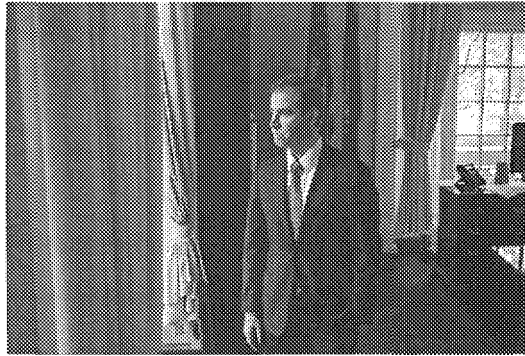
Last summer, a legislative standoff over Connecticut's debt and pension costs delayed the state budget and froze aid to municipalities. In the state's capital, Hartford, Mayor Luke Bronin warned he would seek bankruptcy protection if the city didn't receive additional aid from the state.

The aid finally arrived when lawmakers reached a budget deal in October. To find money for Hartford, lawmakers took aid away from other cities, prompting some towns to shelve infrastructure projects and consider tax increases.

"State and local governments made big commitments, particularly on pensions and retiree health care, but didn't adequately fund those liabilities," says Mr. Bronin, a Democrat.

Connecticut has just 31.7% of what it needs to pay its employees' future retirement benefits, according to state financial reports. A fund for teachers has 52.3%. Together, that adds up to more than \$37 billion in unfunded pension liabilities, or about \$10,300 per Connecticut resident.

Connecticut's unfunded pension liabilities resulted from nearly 40 years of politicians making promises about benefits without adequately funding them, according to a 2015 study by the Center for Retirement Research at Boston College.



Hartford Mayor Luke Bronin warned he would seek bankruptcy protection for the city if it didn't receive additional aid from the state. PHOTO: MICHELLE MCLOUGHLIN FOR THE WALL STREET JOURNAL.

After the long bull market of the 1990s, seemingly flush with cash, Pennsylvania, California, New Jersey and many other states sweetened retirement benefits. In 2008, stock markets plunged and those promises became harder to fund. To balance budgets, many governments skimmed on annual pension contributions. The average funding level of large public pensions dropped from 100% in 2001 to 72% in 2016, according to the Public Plans Database, which tracks 170 large public plans.

Cost was an afterthought when Medicaid was enacted in 1965 under President Lyndon Johnson, who championed free health care for the poor and elderly as part of his "Great Society" program. "I'll go a hundred million or a billion on health or education," Johnson told his vice president in a March 1965 phone call, according to a recording in his presidential library. "I'll spend the goddamn money. I may cut back some tanks, but not on health."

The Medicaid legislation didn't levy taxes to pay for the program. Most states copied that approach, tapping general funds as the main revenue source and sharing some costs with local governments.

Cost wasn't a problem in the 1960s, when health care wasn't as sophisticated. "People used to go to the hospital to die back then," said Joseph Califano, who served as President Johnson's chief domestic policy aide in 1965. As treatments and longevity improved, many states also expanded Medicaid eligibility. Enrollment and costs rose.

Since 1967, the state and local share of Medicaid has grown at a compound annual rate of about 7%, exceeding the 3% annual growth in their tax revenues, adjusting for inflation, according to the Journal's calculations.

The math can overwhelm states when they hit a rough patch in tax growth. Declining tax revenue is what led to Michigan's budget cuts in 2011.

Today, the state is doing better. It has a "rainy day" fund of \$889 million and is gradually increasing transportation, higher-education and K-12 funding. Michigan even expanded Medicaid under the Affordable Care Act, bringing health coverage to an additional 675,000 adults through federal matching funds that President Donald Trump wants to scale back.

John Walsh, the state budget director, says Medicaid expansion has been "physically healthy for the individuals and financially healthy for the state," since it helps lower Michigan's uncompensated health-care costs. One out of every four Michiganders now benefits from Medicaid.

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President Lyndon Johnson explains the importance of funding health care and education in a March 6, 1965, phone call to president, Hubert Humphrey.

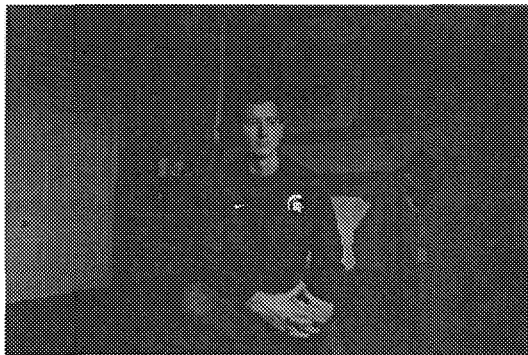
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Source: LBJ Presidential Library

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The financial picture is bleaker for many Michigan cities, including East Lansing, home of Michigan State University. Since 2009, annual state funding for the city and the school has fallen by about 17% each, adjusting for inflation. To offset the cuts, the university has increased tuition repeatedly. The city, which is struggling with almost \$125 million in unfunded pension and retiree health-care liabilities, has been cutting services because state law caps property tax increases.



Things came to a head last summer when East Lansing asked MSU to pony up \$100 million over 20 years to help shore up the city's underfunded pension plan. The alternative, the city said, was asking voters to approve a 1% income tax that would hit university employees and working students.

After negotiations went nowhere, the city brought the income-tax proposal before voters in a referendum last November.

Undergraduate student body president Lorenzo Santaviecca, 21 years old, said the measure would take away from his generation. "We are getting the short end of the stick because of commitments that were made years ago," he said.

