

Planning for Tomorrow: Challenges States Face in Forecasting Long-Term

Expenditures

Policy Bite

Nationally, 30 states publish long-term expenditure forecasts, while the remaining 20 exhibit variation in their financial planning practices. This research examines the challenges states face as they produce their forecasts. First, a review of academic papers, technical reports, and other relevant materials inform a state typology to account for characteristics associated with expenditure forecasting challenges. Then, interviews with officials from states representing each of the eight clusters in the typology inform the research findings. Findings from the interviews indicate that:

- Caseload driven budget components, specifically Medicaid, are associated with more forecasting challenges.
- The use of simplified forecasting approaches, rather than more sophisticated techniques, are perceived by some states as creating challenges.
- In terms of spending frequency, for some states, the challenge revolves around differentiating between one-time versus ongoing spending, which is often a discretionary decision and may require evaluative judgement.
- For some, communicating the nature of forecasting to stakeholders is complicated. In other instances, communication is identified as a challenge in the context of using a current services model or differentiating between one-time versus ongoing spending.
- Preserving institutional knowledge and maintaining information currency is also identified as challenging.

Research Brief

The Government Finance Research Center at the University of Illinois Chicago offers a qualitative analysis of the challenges that states face in producing long-term expenditure forecasts, as commissioned by The Pew Charitable Trusts.

Nationally, 30 states publish these forecasts, while the remaining 20 exhibit variation in their longer-term financial planning practices. The research, which relies on collecting information through interviews, begins with a state typology to account for characteristics associated with expenditure forecasting challenges. The typology uses variables anchored in a review of academic papers, technical reports, and other relevant materials, to produce eight clusters of states named after the challenges that are most prominent within the grouping (Figure 1).

Then, interviews with a state representative from each of the eight groupings inform the research findings. The interviewees represent state offices responsible for forecasting, which names' generally include a mention of *Budget, Finance, Planning*, and/or *Management*.

Figure 1. Geographical Representation of the Eight Typology Clusters



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In designing semi-structured interview questions, the researchers focus on forecasting challenges associated with: (1) the process, (2) budget components, (3) policy changes, (4) spending frequency, (5) economic conditions, (6) structural changes to the economy, and (7) structural balance. Questions about the process also focus on the use of current services as a forecasting baseline, or in other words, forecasting expenditures while assuming the current level of service provision will be maintained.

Consistently across states, the most challenging aspect of long-term expenditure forecasting is the uncertainty introduced by Medicaid. This challenge is a function of the magnitude and nature (e.g., real-time payments, complex cost structure) of expenditures. For example, in 2021, state governments spent roughly \$796 billion or 26.8% of total expenditures on social insurance programs (Figure 2), rendering this category the largest spending component in state budgets. This spending forecast is further complicated by the shared fiduciary responsibility with the Federal government, as well as the unpredictability of healthcare costs and financial status of providers. Generally, larger expenditure categories and caseload driven forecasts are considered more challenging. As such, one of the main underpinnings of long-term expenditure forecasting is demographic changes.

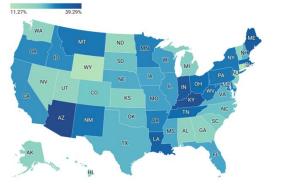


Figure 2. Share of Expenditures Spent on Social Insurance Programs

Some states describe the use of simplistic forecasting approaches as a challenge. For the most part, the expenditure forecasting process is anchored in historical trends. In fact, most offices receive forecasting of some budget components from other specialized governmental departments. Therefore, policy changes, economic conditions, and/or structural changes to the economy are not typically incorporated into forecasts until they materialize. Other procedural challenges relate to flexibility in forecasting methodologies used, validity of assumptions, and statutory restrictions. For the most part, however, states did not express challenges associated with the current methods or data used. In terms of spending frequency, for some states the challenge revolves around differentiating between onetime versus ongoing spending, which is often a discretionary decision and may require evaluative judgement. Most states that publish their forecasts begin with their current services baseline, an approach following recommended best practices. Partially as a result, for example, most states did not communicate that pension or debt service expenditures posed significant challenges to their forecasting process.

Communication also emerges as a challenge. For some, communicating the nature of forecasting to stakeholders is complicated, specifically explaining the role that unknown factors can play in invalidating a forecast, and the varying level of knowledge across stakeholders regarding statutory requirements. For example, in aligning their forecasts with structural balance goals, states are often governed by statutes.

One additional theme emerging from the interviews focuses on preserving and expanding institutional knowledge, specifically how to preserve institutional information and remain current with new advances.

Going forward, a partnership focused on producing best practices and common standards that can leverage the existing prevalent culture of collaboration across states could alleviate some of the challenges that states face. Critically, statutory hurdles would need to be considered before more sophisticated modeling techniques, or other changes to forecasting processes, in line with best practices, could be adopted.

Moreover, an initiative that provides targeted training to stakeholders, with an emphasis on reaching legislators and the press, could address many of the communication challenges described in this research. This initiative might have the added benefit of indirectly facilitating the adoption of best practices as it can help increase interest and visibility of long-term expenditure forecasts.

Finally, a centralized database of resources could provide key support to states as they tackle unexpected expenditure forecasting challenges. This database can preserve past knowledge and provide a platform to keep states up-to-date with curated information regarding new skills, insights, techniques, and other relevant information.

Read the full report <u>HERE</u>.

The **Government Finance Research Center** at the University of Illinois Chicago shapes and informs public policy and scholarly discourse on government and public finance by identifying, planning, and executing research, providing reports and informed analyses, delivering educational opportunities and technical training, and offering inclusive venues to convene national and local discussion on fiscal and governance issues.