
LEGAL REQUIREMENTS AND BUDGET MANIPULATIONS

ALL STATES EXCEPT VERMONT REQUIRE A BALANCED BUDGET

Since state governments cannot infinitely expand their credit, issue currency or tax excessively, their ability to spend is finite. To avert future financial difficulties and to enhance accountability, states have balanced budgets requirements in their constitutions and/or laws. Our study found all states, except Vermont, have such requirements.

These balanced budget requirements have both short and long-term objectives. In the near term, these requirements force governors and legislatures to determine the amount of taxes that must be raised to cover the costs of governmental policies and actions.^{xxxi} In theory, these requirements foster governmental accountability because politicians are allowed to spend only the amount taxpayers are willing to pay. Former U.S. Treasury economist, Francis X. Cavanaugh, said it best: “Politicians should not have the pleasure of spending (getting votes) without the pain of taxing (losing votes).” Mr. Cavanaugh highlighted that “we need that accountability to ensure that spending is justified and that the taxpayers are willing to pay for it.”^{xxxii}

The GASB believes that laws requiring balanced budgets prevent the current generation of citizens from shifting the burden of paying for current-year services to future-year taxpayers – namely, our children and grandchildren. The GASB deems this concept, known as “*inter-period equity*,” to be a significant part of accountability and fundamental to public administration.^{xxxiii} Inter-period equity is indeed a significant part of accountability because it reduces incumbent’s ability to promise voters future benefits without having an impact on budget calculations.

THE MAJORITY OF STATES REPORT THEIR BUDGETS ARE *NOT* BALANCED

Our study found that the majority of states report that their budgets are *not* balanced. Our review of the state numbers revealed that during the fiscal years 2005-2007:

- Two states reported that their budgets were balanced for each of the three years;
- Ten states reported budget surpluses for each of the three years;
- Twenty six states reported budget deficits for each of the three years;
- Another nine states reported budgetary basis deficits for one or more of the three years;
- The annual budget bills adopted by California, Arizona and Arkansas do not include revenues; therefore, only expenditures are presented on the Budgetary Comparison Schedules. This makes it impossible to determine whether their budgets were balanced.

Each state’s budget surplus or deficit can be found in the “Roll of States” section of this document. Within each state’s data schedule is a “Budgetary Basis” column. A positive amount on the net transaction line represents a surplus and a negative amount represents a deficit. These numbers were obtained from each state’s original budget, if available, as reported on their Budgetary Comparison Schedule. This Schedule is part of the Required Supplementary Information included in the financial section of the CAFR.

STATE BUDGETS ARE PREPARED ON A CASH BASIS

State budgets are calculated using the cash basis method. The cash basis method of preparing budgets allows governors and legislators to focus only on expected cash flows in the coming fiscal year and to simply ignore previously created obligations that will have to be paid in future years.

Initially, cash basis budgeting may have worked for governments, because they were only responsible for paying current benefits and services. For most government activities, the time between the occurrences of the underlying transaction resulting in a government liability and the cash outlay necessary to liquidate the liability was relatively short. Therefore, cash-based measurement generally provided both adequate information and control. But as governments have taken on long term commitments, such as public employee pensions and retirement health care, cash basis budgeting no longer tracks a government's ultimate costs.^{xxxiv}

State governments, like any business, engage in transactions that will affect future accounting periods. It is desirable to recognize these future obligations as they accrue over time. As we will discuss in greater detail later in this Study, cash basis budgeting does not adequately consider liabilities incurred during the budget period. Therefore, the long term consequences of past and current spending decisions are not included in the budget process.

One obvious example of transactions with future consequences would be pension obligations. A part of the compensation earned by employees during a fiscal year is the present value of a portion of their post-employment benefits. Employees earn the right to receive these benefits by working now, but they will not collect these benefits until they retire. Since no cash is due to the worker currently, cash basis budgeting ignores the effects of this and other accruing liabilities. This is an evident deficiency because the obligation is a real, but unrecorded, liability.

WAYS BALANCED BUDGET REQUIREMENTS ARE CIRCUMVENTED

Balanced budget requirements are intended to maintain fiscal sustainability and public accountability, but these intentions are being circumvented. The Institute found governments circumvent the intent of balanced budget requirements by:

- Using word games that defy the plain intent of constitutions and statutes as well as the very meaning of words;
- Manipulating revenues through falsely inflating or favorably shifting them into earlier periods; and
- Manipulating expenses by ignoring vendor bills and shifting current expenses into later periods.

WORD GAMES

CONVENIENT DEFINITIONS

The actual wording of balanced budget requirements varies dramatically from state to state. In the data section of this Study we include each state's balance budget requirements which sometimes touch both the state constitution and statutory laws. To obtain balance, most requirements mandate that expenditures (or appropriations) should not exceed revenues.

For most states, the wording of the balanced budget requirement is not specific about what "revenues" should include. This leaves elected officials with many options about the types of cash inflows that can be used in the budget calculation. For example:

- The constitution of New York requires the budget should include, "... **moneys** and revenues sufficient to meet such proposed expenditures."
- The Illinois constitution requires that proposed expenditures shall not exceed **funds estimated to be available** for the fiscal year as shown in the budget.
- The balanced budget laws of Nevada and Oklahoma call for proposed expenditures not to exceed anticipated revenues and "**other means of financing**".
- New Mexico's law include "an estimate of state expenditures and **proposals for funding them.**"

RE-CHARACTERIZING DEBT TO BE THE SAME AS REVENUES

The cash basis, used to calculate budgets, report long-term debt issued to finance current operating expenditures, as operating inflow rather than as a fund liability. In essence, the state budgets report loan proceeds as "revenues".

The Institute found that governors and legislatures routinely use borrowed funds to "balance" state budgets. One egregious example occurred in 2003 when Illinois issued general obligation bonds and used more than \$2 billion of the borrowings to pay for current pension contributions. Functionally, the state borrowed money repayable by future taxpayers to pay the current service costs of its employees. This is **exactly** contrary to the goal of accountability intended by balanced budget requirements, because it shifted that year's obligation onto future taxpayers. Yet accounting rules for budgets allowed the governor and legislature to regard the \$2 billion of borrowed money to be "funds available" to spend elsewhere in the budget.

Like Illinois, other states often include loan proceeds as "revenue". The California 2009 budget includes a provision that would borrow from future lottery earnings. This type of borrowing will have to be approved by voters through a special referendum in the spring of 2009. If voters disapprove, then the politicians have threatened drastic cuts in government services and benefits.^{xxxv}

FUNDS SWEEPING

Other examples of this disingenuous practice of identifying "revenues" were evident during the Illinois 2009 budget debate. During the process of adopting the budget, the governor admonished the state House of Representatives for failing to recognize two "new revenue sources". One of the governor's "revenue sources" was the proposed transfer of \$530 million from the state trust funds to its general fund. This is akin to a person transferring money from his savings account to his checking account and claiming he made money. We found evidence that this practice called "funds sweeping" is also used in other states. This funds sweeping can be undertaken because the Illinois

balanced budget requirements mandate that only six funds must be balanced, including the general fund. Therefore if non-budgeted funds, such as trust funds, have balances, the extra cash can be shifted to balance the six “budgeted funds”.

USING ACCRUALS WHEN THEY ARE BENEFICIAL

The Illinois governor’s second “revenue source” was to be a part of the refinancing of state debt. His plan was to refinance some of the pension debt at a lower rate which would mean lower **future** interest payments. The governor felt that the difference between the new interest payments and the higher, old interest payments should be handled as a “revenue source” which could be spent today, even though the difference in interest payments avoided would occur over the next 20 years. In other words, the governor was willing to budget “revenues” that would accrue in the future at the same time he was unwilling to recognize **costs** accruing in the future. This is like someone claiming they made money when they refinanced their credit cards. We determined other states also use such refinancing transactions to increase budget revenues.

CLAIMING BALANCED BUDGETS WHILE RUNNING “STRUCTURAL DEFICITS”

Another word game played by government officials is to say that their budgets are balanced and in the next sentence say that the state is running a “*structural deficit*”. A structural deficit is defined as, “...a condition in which the revenues produced by a state’s tax system ... are insufficient to maintain existing levels of services.”^{xxxvi} This deficit happens because there is a fundamental mismatch between the revenues generated by a state tax structure and the revenues required to fund ongoing, essential public services.

In the short-term this happens because current bills for ongoing public services are not paid.^{xxxvii} Long-term structural deficits exist because current revenues generated are not sufficient to fund expenses as incurred. Often, state employee post-employment benefit commitments are not recognized or the elected officials chose to divert funds for other programs rather than fund these commitments.

REVENUE MANIPULATIONS

ONE-TIME CASH INFUSIONS

As the current economic downturn creates large budget holes, many cities and states are considering the sale or leasing of fixed assets to generate one-time cash infusions that can be spent right away. Recently Elizabeth Lynam, a state policy expert with the Citizens Budget Commission, correctly said “One gets a little concerned when ‘selling off state assets’ and ‘budget deficits’ get mentioned in the same sentence.”^{xxxviii} These assets include real estate, lotteries, toll roads and student loan portfolios. The sale or lease of these assets can bring in large amounts of upfront cash that can be used to fill the large budget holes.

There are positive aspects of the sale and lease of revenue producing or unused assets which include:

- The lump-sum payments received from these types of transactions can be used to pay current bills;
- The moving of assets from public to private ownership may increase the government's real estate tax base; and
- Assets held in private hands may be subject to sales and income taxes.

The sale and lease of long term revenue producing assets introduces several concerns. First is the question of the nature of the transaction and the price that purchasers or lessees offer. The public sector is often unprepared to negotiate with the business people involved in these transactions. The private sector individuals who negotiate these deals may stand to make large profits.

The second concern is one of inter-period equity. When a state sells or leases an asset, it essentially collects all future net revenues immediately. While the transaction's proceeds can be used to balance the current budget, it takes away future revenue streams. Current elected officials taxpayers receiving current benefit from the sale of the assets, while future taxpayers may need to pay additional taxes to off-set the revenues that would have been received from the assets.

States must also ensure that the transactions recognize the full value of the assets, including direct and indirect benefits that the property provides.^{xxxix} For example, there may be unused land around a state prison, but it is providing a nice buffer zone between the prison and the surrounding communities.

QUESTIONS ABOUT THE VALUE OF ASSETS BEING SOLD OR LEASED

Presumably, the state is able to determine the net present value of the asset and sets this as its "floor price". Such transactions only occur if there is a perceived benefit to both parties. When the potential buyer offers more than the value that the state perceives, the buyer must be thinking that they can generate more money under their management. In some cases the buyer or lessee of state assets may believe they can generate more money from assets, such as toll ways and lotteries, by operating them more efficiently than does the state or by increasing revenue. For example the buyer of a toll way system may consider raising toll fees or the buyer of the state lottery may work to lure new customers. That naturally begs the question of why the state could not do the same thing. A good example occurred recently in Chicago where the right to operate the parking meters was sold to investors. Immediately the new owners doubled the parking fees. Why didn't the city do this, itself?

SALE LEASE-BACK ACCOUNTING HAZARD

Another source of one-time revenue is the selling of state assets and then leasing those assets back. This allows governments to record proceeds from the sales of assets as current revenues, while cash basis budgeting allows them to disregard the future payments for renting back the same assets. Such transactions have had the effect of dramatically improving the budget deficit while increasing future governmental expenditures in the form of lease payments.

TOBACCO SETTLEMENT SECURITIZATION

Another opportunity for states to receive a large lump sum payment is the securitization of tobacco settlement revenue. To cope with deficits, some states have "securitized" the stream of revenue that they had expected to receive from the national tobacco settlement. In other words, states sold the right to future tobacco settlement payments. The tobacco settlement requires annual payments to states in perpetuity, but estimates of the settlement total value often assume income for the years 1998 through 2025. Securitizing even a portion of this total revenue has resulted in billions of dollars in "current revenue" being generated. The sale or lease of state assets and the securitization of future tobacco settlement payments can be expensive transactions to complete, involving fees for investment bankers, brokers, accountants, and lawyers.

USE OF SALES PROCEEDS QUESTIONS

A large cash sale of state-owned assets can create significant temptation to use the proceeds to fund immediate needs. These transactions may have to be decided during the tremulous budget process, so there may be little time to consider all of the consequences and issues surrounding the decisions. States considering the sale of assets need to establish criteria and strategies to make sure that these transactions are for the long-term good of the governmental entity, not done just to fill short-term cash needs. And determining the market value of the asset is often difficult.

Accountants warn their clients that it is not wise to sell long-term assets to fund short term needs. During a budget process politicians, whose horizon may be limited by the next election, might think only of the immediate resources needed for short-term budget relief rather than the government long-term needs.^{x1} All aspects of the sale of the asset must be considered, including whether the government will need the asset in the future. Even though governments need resources during economic downturns, but this may not be the time to get the best price for the assets.

EXPENSE MANIPULATIONS

TRUE EMPLOYEE RETIREMENT COST NOT REPORTED

Because state budgets are calculated using cash-based measures, only the pension contributions paid to the plans are included in state budgets. The budgets only include the pension contributions legislators decide they want to pay in conjunction with all the other taxing and spending considerations. State pension contributions usually have nothing to do with the amount of retirement benefits earned by the workers during the budget period. Consequently a state budget calculation may not recognize billions of dollars of retirement costs incurred each year, yet the state budget is deemed balanced even though current revenue is not set aside to adequately fund these promises.

In state budget calculations other post-employment benefits, including health care, are usually accounted for on the pay-as-you-go basis. In other words, these benefits are not pre-funded and the cost incurred is not included in the budget. The amount included in the budget is the cash paid out for current retirees' benefits.

NOT PAYING BILLS

To maintain control over spending, state and local governments originally maintained separate bank accounts for various types of expenditures. Once a bank account balance reached zero, spending for that purpose had to stop. Unfortunately, government officials learned that they could get around this control by switching money from one bank account to another. They also determined they could simply postpone paying bills.^{xli}

State balanced budget requirements were then enacted to stop such practices. Regrettably, cash basis budgeting still allows government officials to delay the payment of vendor bills and to defer compensation costs, such as pension and other retirement benefits. For example, the state of Illinois routinely delays Medicaid payments to healthcare providers. Each year the budget appears balanced on a cash basis even though the state does not provide sufficient funding for the Medicaid program.^{xliii} In November 2008 Illinois Comptroller Daniel Hynes said that the state had an “unprecedented bill backlog of nearly \$4 billion.” The ability to defer such payments has created huge budget holes that will need filling in future years.

GAAP SURPLUSES DO NOT TELL THE TRUE STORY

To our surprise our Study found only four states had a negative GAAP basis ending balance for FYE 2007: Connecticut, Illinois, Massachusetts and New Jersey. All of the other forty six other states reported positive GAAP basis ending balances. In other words, their audited Balance Sheets reported that the states had Net Assets or that they had more assets than liabilities. Our concern is that this is giving states and their citizens a false indication of the states’ financial conditions. Most readers of state financial reports are unaware that the Balance Sheet liabilities only represent a small portion of the state’s actuarially determined post-employment liabilities. Truer amounts of unfunded pension liabilities are buried deep in the state CAFR and the liabilities for the states employees’ healthcare and other retirement benefits are usually not disclosed.

In Rhode Island, for example, the audited CAFR reported that the state had Net Assets totaling almost one billion dollars. The state’s actuarially determined unfunded pension liability is found deep in the CAFR on page 121. Two problems exist with this information. The first is that even though the CAFR was for fiscal year ending June 30, 2007, the most recent actuarial valuation was done on June 30, 2006. The second problem is that the state’s three retirement systems are listed separately. To determine the state’s total unfunded pension liability the annual report reader needs to add the three amounts together. If this pension liability is subtracted from the reported Net Assets, then Rhode Island had a financial hole of almost \$4 billion. We assume decision makers would make different decisions if they understood that the state had an accumulated deficit of \$4 billion versus having Net Assets of \$1 billion. If the liability for post-employment health care and benefits were calculated and reported on the state’s Statement of Net Assets, then the Rhode Islands’ financial hole would be even deeper. The Management’s Discussion and Analysis for Rhode Island, included in their June 30, 2007 CAFR, stated that the unfunded liability for post-employment benefits other than pensions equaled \$696 million as of June 30, 2005.