
RECOMMENDATIONS

RECOMMENDATIONS TO ELECTED OFFICIALS

REVIEW BALANCED BUDGET REQUIREMENTS

State governors and legislatures should review the intent of balanced budget requirements. They should then determine if those intentions are being honored or if loopholes have been found that frustrate the object of balanced budget requirements. If the intentions are not being met, legislatures need to change the balanced budget statutes to compel the adoption of truly balanced budgets.

To achieve truly balanced budgets, to prevent financial difficulties and to improve public accountability, we recommend including verbiage in balanced budget statutes similar to the following:

The Governor shall not propose expenses and the General Assembly shall not enact any expense appropriations that exceed the revenues estimated to be earned during the budgeted period. The State budget shall be prepared on the basis of revenue and expense measurement concepts that are in concert with full accrual basis of accounting. All expenses expected to be incurred within the budgeted period shall be included. These expenses shall include, but are not limited to, ordinary operating costs and the increases/decreases in the actuarially accrued liabilities for employees' pension and other post-employment benefits.

DEMISTIFY BALANCED BUDGET MYTHS

The goal of most state budget processes is to reach balance. At the end of each year's budget process, numerous news stories and governmental press releases highlight the gubernatorial and legislative proclamations that they have enacted a "balanced" budget. Such declarations leave citizens believing that state governments have not had to go into debt to cover expenses. After all, **balanced** budget requirements exist so that state governments live within their means. To most citizens, this means the state's budgeted bills are expected to be covered by revenues the state estimates it will collect.

Unfortunately what the public is led to believe is not the true condition as it exists. The state budget, while claiming to be "balanced" is not. In a later recommendation we suggest that the budgeting and accounting standards that permits these balanced budget claims be revoked. Until these changes come, we also recommend that it becomes the duty of legislators, governors, treasurers, comptrollers and their staff to let citizens know that even though budgets are ostensibly balanced, the states are going further and further into debt.

The public must be told the truth. The term “balanced budget” is a misnomer. We recommend that before a “balanced” budget is adopted, the public should be informed of the following:

- The amount of the state bills that will be incurred, but not paid during the budgeted year;
- The amount the proposed budget’s policies will increase the state debt, including the money required to be borrowed to balance the budget on a cash basis;
- The amount of the increases in the pension and other post-employment benefits promised;
- The one-time revenue transactions that will be entered into, including the funds that will be transferred from dedicated or trust funds; and
- The annual fiscal deficit that is forecasted if the proposed budget is passed.

INCLUDE ALL EXPENSES IN BUDGET CALCULATIONS

State balanced budget requirements exist to foster governmental accountability and sustainability. To make informed public policy choices, decision makers, including the public, need a more complete picture of the state’s fiscal position than the current cash basis budget calculations can provide. Additional information needs to be taken into account; i.e. the future obligations of the state, including costs and revenues as they accrue regardless of when they must be paid.

Accordingly, states need a new kind of budget discipline that would confront the actuarial exposures created by promises of future benefits and other liabilities that are currently off-budget and off-balance sheet.^{xlvi} We recommend the budget calculations include full accrual basis measurements of all liabilities and obligations.

Full accrual budgeting would provide the information needed because it recognizes all expenses incurred during the period, including the cost incurred for pension and other post-employment benefits. Accrual accounting more accurately reflects economic realities which would provide citizens with the information necessary to determine if their elected officials are living up to their responsibilities by reporting the full consequences of their fiscal behavior.

We are **not** recommending the elimination of cash budget calculations. We are recommending that the cash budget calculations be augmented with full accrual budget calculations. Cash budgeting is integral to maintain control over spending and to ensure compliance with appropriation laws. Cash measures are effective for cash management purposes, including identifying borrowing needs. But, as longer term commitments have come to dominate state tax and spending decisions, such cash measurements have become less meaningful and should no longer be the principal indicator of state fiscal affairs.

EMPHASIZE FISCAL DEFICITS

Over the years, the use of the cash budgeting technique has allowed governors and legislators to obligate future taxpayers without much effect on current budgets. This has been an “easy” method to manage state finances because it allows the government to spend currently but to shift actual payment into the future.

One effect of moving to a full accrual system of budgeting and accounting would be to expose the effect of those habitual cash budgeting decisions. Such an accounting change would immediately recognize—and place on the balance sheets—the long-term liabilities that are the economic result of entitlements, pensions and other benefits that have been legislated and promised over the years.

Regardless of whether the states move to a more accurate accrual accounting system, we recommend each state calculate its deficit or surplus, using the full accrual accounting method, and report that number each year as its “fiscal” surplus or deficit.⁵ The basis of the fiscal deficit calculation should be the GASB’s version of accrual basis of accounting, except that the actuarially determined costs of post-employment benefits would be fully reported.

Using Illinois’ situation as an example, Table 1 presents two methods for calculating a state’s fiscal deficit:

- The first method calculates the fiscal deficit by subtracting the off-balance sheet post-employment benefit liabilities from the state’s net assets.
- Another way to calculate the fiscal deficit is to start with the state’s assets then subtract the total liabilities, add back the net pension obligation then subtract the actuarial accrued liabilities for pensions and other post-employment benefits.

Table 1	
The State of Illinois	
Fiscal Deficit Calculations	
June 30, 2007	
<u>Governmental Activities</u>	<u>(in millions)</u>
Total Net Assets	\$ (20,402)
Off Balance Sheet Liabilities	
Pension	\$ (25,086)
Other Post Employment Benefits	\$ (24,200)
Fiscal Deficit	\$ (69,688)
Total Assets	\$ 30,840
Total Liabilities	(51,242)
Add back Net Pension Obligation included in liabilities	17,091
Unfunded Actuarial Accrued Liabilities	
Pension Systems	(42,177)
Other Post Employment Benefits	(24,200)
Fiscal Deficit	\$ (69,688)

The forecasted fiscal deficit would be an estimate of the financial effect of budget policies. Actuaries should be utilized to determine the increase or decrease of the unfunded actuarial accrued liabilities of pension and other post-employment benefits.

An annual fiscal deficit should be calculated and compared with the cash basis surplus/deficit. The forecasted annual fiscal deficit would be the difference between the beginning forecasted fiscal deficit and the ending forecasted fiscal deficit.

⁵ To simplify this discussion we will use the term “fiscal deficit”.

Most countries, who utilize accrual budgeting, are able to include both the cash and accrual basis budget calculations by issuing forecasted budget documents. The Forecasted Operating Statement, which would detail the annual fiscal deficit, is prepared on the full accrual basis.^{xlvii} Most of the countries, who utilize similar full accrual budgeting, also include a Forecasted Balance Sheet in their budget documents. This statement estimates the assets and liabilities of the government and takes into account the long term financial impact of proposed policy decisions. The Forecasted Balance Sheet would include the Fiscal Deficit. Budget documents also include the Forecasted Statement of Cash Flow, which assist in determining borrowing needs.

To expose the state government to a greater degree of public scrutiny and accountability, the citizens and their elected representatives must be informed of the current and long term financial consequences of the spending and revenue decisions included in the budget. The inclusion of both cash basis and full accrual basis budget calculations would provide information about these consequences. Including fiscal deficit amounts, calculated under the full accrual budget method, is necessary because states are now engaged in the business of making long term promises.

By producing the fiscal deficit calculations, legislators and the public would be able to determine the long term consequences of the policies that will be adopted with the passage of the budget. Incorporating these types of full accrual measurements into the states' budget processes will improve incentives to address the longer-term implications of current decisions by better reflecting year-to-year changes in states' assets and liabilities. As reported in the "Other Findings" section, accounting changes of this sort **do** result in policy changes.

PROVIDE SUPPORT AND RESOURCES TO ACCELERATE CAFR PREPARATION

We recommend legislators and governors provide the support and resources needed to accelerate the preparation of the CAFR so it is available during each state's most important decision making process—the budget. Legislators and governors should educate themselves about the important information included in the financial report, including the truer liabilities for pension and other post-employment benefits.