

Truth and Integrity in State Budgeting: What is the Reality?

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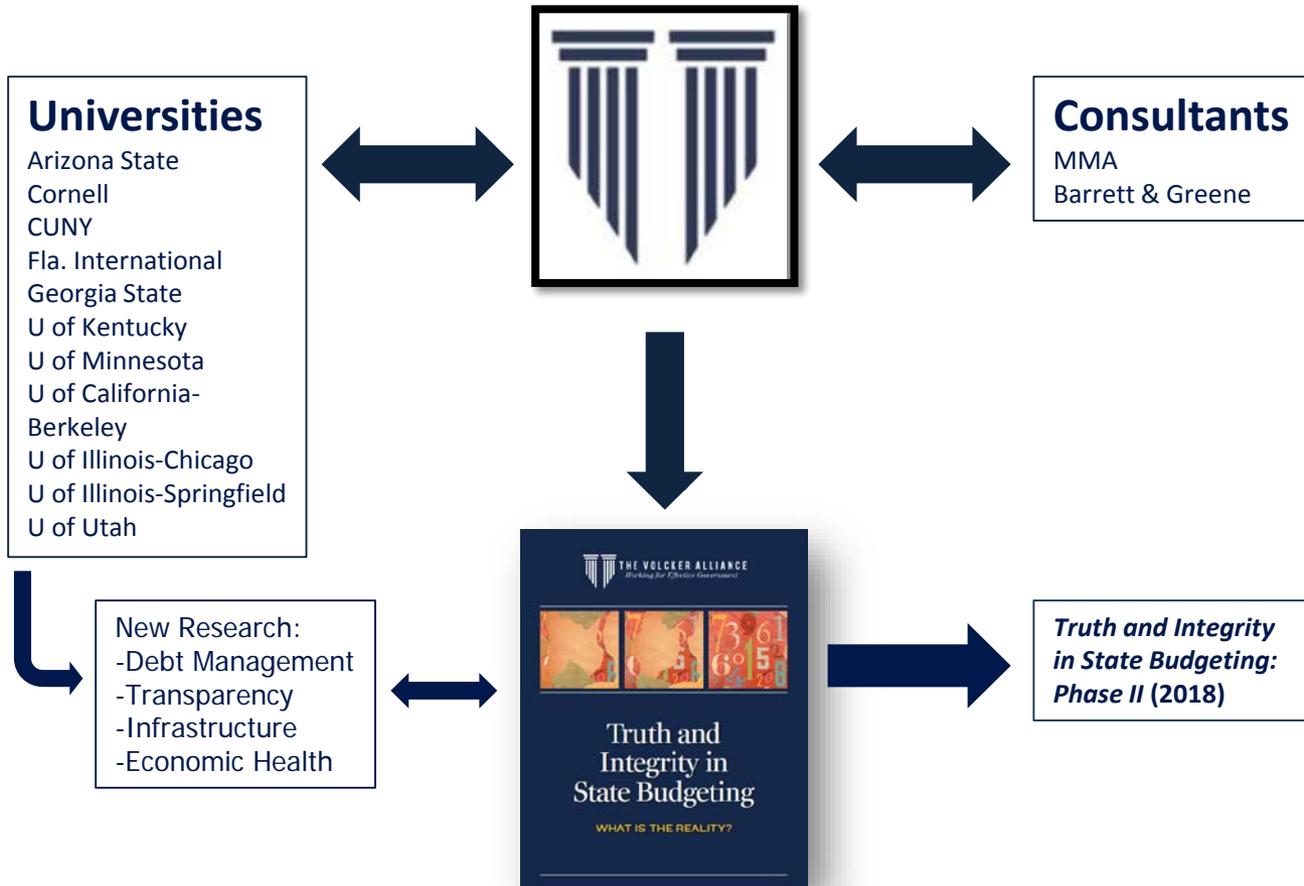
Truth and Integrity in State Budgeting: Objectives

- Identify five key budgeting and financial reporting procedures
- Grade all states' performance in each area
- Propose best practices for states to follow
- Continue evaluations annually in cooperation with university partners
- Help bolster university teaching of public budgeting and finance
- Encourage further university-based research based on Volcker Alliance research and findings

Drivers of Best Budgeting Practices

- When the Volcker Alliance first began examining state fiscal and financial reporting practices in 2014, we were driven by one question: What makes up a balanced budget? That led us in 2015 to report on California, New Jersey, and Virginia, and now, all 50 states.
- Even the nation's third-longest recovery since 1858 has not warded off fiscal crises for some states. Weak revenue growth challenges states' ability to pay bills for infrastructure, Medicaid, education, and public worker pensions and retiree health care. Unpaid obligations in these areas probably exceed the \$2.2 trillion in annual state revenue.
- Cash-based budgeting allows states to push some costs to future generations to keep budgets balanced in accordance with constitutions, statutes, or traditions.
- Best practices for state budgeting cannot successfully bolster fiscal stability and informed policymaking without political will to adopt and apply them for the long term. Establishing and maintaining strong and transparent budget processes and practices is a concern not only for the states themselves but for the entire economy.

The Volcker Alliance Research Network

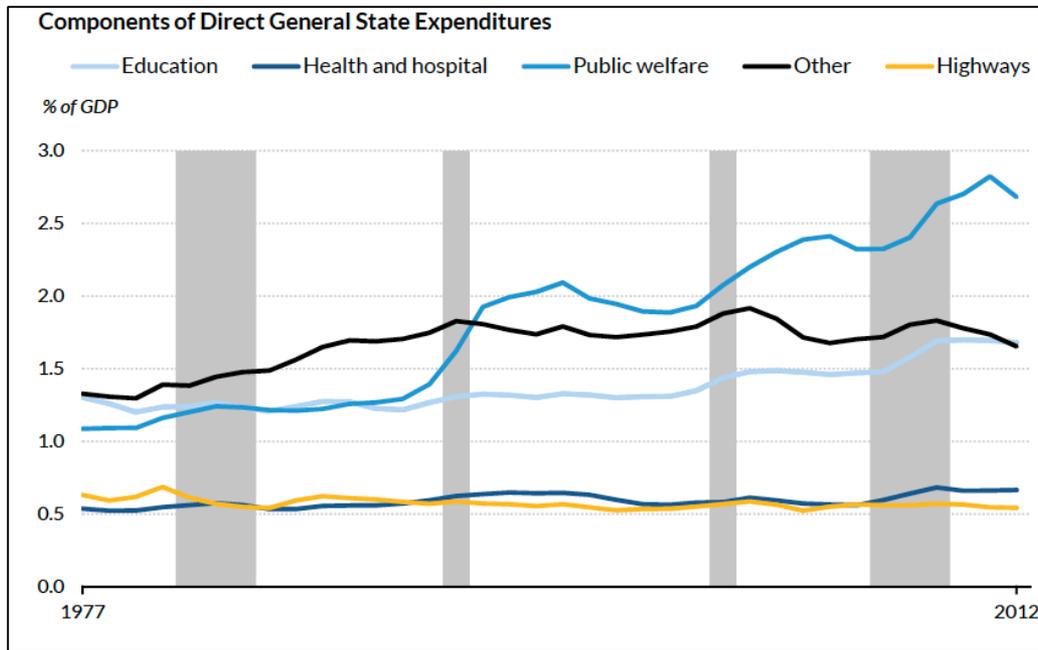


The State Fiscal Framework

- Record US recovery; modest growth (GDP +~2.2%/yr)
- Low inflation (CPI +~2.1%/yr)
- Low unemployment (~4%)
- Slowly rising interest rates (10-year Treasuries @ 2.5% '17, 3.1% '18). Means muni rates may stay low, but tax reform may diminish demand
- Slow revenue growth (~3-3.5%); revenues/GDP ~2005 level of 10%
- Modest spending growth, still < historical 5.5% avg. State infrastructure spending lowest since mid-1990s.
- Budget pressure points: Pensions/OPEB, Medicaid, Infrastructure, K-12
- Likely increases in rainy day fund contributions
- Little enthusiasm for new muni debt (issuance ~\$380b in '17 vs. \$422b in '16), but Harvey/Maria rebuilding may change that

Source: Volcker Alliance, Bloomberg, Rockefeller Institute of Government, MMA, NASBO, Urban Institute

The State Fiscal Squeeze



Source: Urban Institute, from US Census data

5 Budgetary Best Practices & Areas of Inquiry

1 Budget Forecasting

Use a consensus approach to establishing single, binding numbers for revenues and expenditures. Provide long-term estimates. (Example: Washington)

2 Budget Accounting

Pay for expenditures in the same year they are accrued; avoid deferring them. Shift from cash-based accounting to modified accrual accounting techniques used in state/local CAFRs. (Example: NYC)

3 Legacy Costs (Pensions & OPEB)

Consistently make contributions actuaries determine to be necessary. (Example: Wisconsin). While some states may find it a crippling burden to fully cover costs of future benefits and past underfunding, they should consider committing to move toward full funding in the future. OPEB plans should be adequately funded to ensure benefits can be paid when bills come due (Example: Utah)

4 Fiscal Reserve Funds

Enact clear policies for withdrawals from rainy day and other fiscal reserves, as well as rules for replenishing spent funds and tying the size of fund balances to revenue volatility. (Example: Indiana)

5 Transparency

Construct a consolidated budget website (Colorado). Include full disclosure of cost to replace depreciated infrastructure (Examples: Alaska, California).

Key Findings: Best-Graded States

- **Forecasting:** 9 states graded A
- **Maneuvers:** 22 states graded A
- **Legacy Costs:** 8 states graded A
- **Reserve Funds:** 15 states graded A
- **Transparency:** 2 states graded A

BUDGET FORECASTING		LEGACY COSTS	
STATE	GRADE	STATE	GRADE
Connecticut	A	Idaho	A
Florida	A	Iowa	A
Hawaii	A	Nebraska	A
Maryland	A	Oklahoma	A
New York	A	Oregon	A
Rhode Island	A	South Dakota	A
South Carolina	A	Utah	A
Virginia	A	Wisconsin	A
Washington	A		

BUDGET MANEUVERS		RESERVE FUNDS	
STATE	GRADE	STATE	GRADE
California	A	Alaska	A
Delaware	A	Arizona	A
Georgia	A	California	A
Hawaii	A	Hawaii	A
Idaho	A	Idaho	A
Indiana	A	Indiana	A
Iowa	A	Massachusetts	A
Minnesota	A	Michigan	A
Mississippi	A	Minnesota	A
Missouri	A	North Dakota	A
Montana	A	Tennessee	A
Nebraska	A	Texas	A
New Hampshire	A	Utah	A
North Dakota	A	Virginia	A
Oregon	A	Washington	A
South Carolina	A		
South Dakota	A		
Tennessee	A		
Texas	A		
Utah	A		
Vermont	A		

TRANSPARENCY	
STATE	GRADE
Alaska	A
California	A

Key Findings: Lowest-Graded States

- **Forecasting:** 4 states graded **D**
- **Maneuvers:** 6 states graded **D**
- **Legacy Costs:** 9 states graded **D-**
- **Reserve Funds:** 3 states graded **D**
- **Transparency:** 3 states graded **D**

BUDGET FORECASTING	
STATE	GRADE
Alabama	D-
Illinois	D-
Kansas	D-
North Dakota	D-

BUDGET MANEUVERS	
STATE	GRADE
Illinois	D
Kansas	D
New Jersey	D
New York	D
Pennsylvania	D
Virginia	D

LEGACY COSTS	
STATE	GRADE
Hawaii	D-
Illinois	D-
Kansas	D-
Massachusetts	D-
New Jersey	D-
Pennsylvania	D-
Texas	D-
Virginia	D-
Wyoming	D-

RESERVE FUNDS	
STATE	GRADE
Kansas	D
Montana	D
New Mexico	D

TRANSPARENCY	
STATE	GRADE
Alabama	D
Arkansas	D
New Mexico	D

A Note on Methodology

The Volcker Alliance joined with professors and students in public finance and budgeting programs at eleven US universities who answered a standardized set of research questions on budget procedures. University research network gathered data from a variety of sources, interviewed current and former state budget and financial officials, and examined budget documents and financial disclosure filings. Responses to questions were reviewed by faculty advisers at the universities and Alliance consultants and revised, if necessary. Responses were then reviewed and normalized to account for any discrepancies among researchers' findings. The focus on states' adherence to best practices, combined with the normalization process, resulted in a relatively high level of comparability among the fifty states' budgetary performance.

States received a grade ranging from A to D-minus for each of the five budget categories for fiscal 2015, 2016, and 2017. Every state's average category score over the period was used to determine a three-year average grade. Sustained improvement or decline in a state's score over the three fiscal years was used to identify trends in budgetary performance in each category:

Budget Forecasting was graded on five indicators, each representing 20% of the category score. We asked if a state used a consensus revenue forecast; employed a reasonable rationale for revenue growth projections (based on historical revenue and economic growth trends); successfully avoided having to make a negative midyear budget adjustment; and produced multiyear revenue and expenditure forecasts.

Budget Maneuvers was graded on a state's use of one-time actions to create short-term budget fixes. States received 25% of the category grade for each type of one-time budget maneuver they successfully avoided. They included funding recurring expenses with debt; funding recurring expenses with the proceeds of asset sales or by tapping future revenues; deferring a current year's recurring expenditures; and covering general fund expenditures with transfers from other funds.

Legacy Costs was graded on a state's willingness to meet public employee pension and OPEB obligations. Thirty percent of a grade was determined by a state's making its OPEB actuarially required or determined contribution. Seventy percent of the category grade was scored on whether the state made its pension ADC or ARC contribution and on its pension funding ratio as of 2015, which represents the amount of assets available to cover promised benefits.

Reserve Funds was graded on a state's performance on four equally weighted budget indicators: If a state had a reserve fund disbursement policy; existence of a reserve fund replenishment policy; if reserves were tied to historic trends in revenue volatility; whether there was a positive reserve or general fund balance at the beginning of each fiscal year.

Transparency was graded on the extensiveness and usefulness of a state's fiscal disclosure practices. States received 25% of their grade for each of four transparency measures: providing the public with a consolidated budget website; disclosing outstanding debt and debt-service cost tables; providing information on deferred infrastructure maintenance costs; and providing cost estimates for tax expenditures.

Volcker Alliance State Budget Grades and Credit Ratings: How They Are Different

State Grades and Credit Ratings: Budget Forecasting

BUDGET FORECASTING

STATE	GRADE
Connecticut	A
Florida	A
Hawaii	A
Maryland	A
New York	A
Rhode Island	A
South Carolina	A
Virginia	A
Washington	A

A1
Aa1
Aa1
Aaa
Aa1
Aa2
Aaa
Aaa
Aa1

BUDGET FORECASTING

STATE	GRADE
Alabama	D-
Illinois	D
Kansas	D-
North Dakota	D-

Aa1
Baa3
NR
NR

Sources: Volcker Alliance, Moody's Investors Service, Bloomberg

State Grades and Credit Ratings: Budget Maneuvers

BUDGET MANEUVERS

STATE	GRADE
California	A
Delaware	A
Georgia	A
Hawaii	A
Idaho	A
Indiana	A
Iowa	A
Minnesota	A
Mississippi	A
Missouri	A
Montana	A
Nebraska	A
New Hampshire	A
North Dakota	A
Oregon	A
South Carolina	A
South Dakota	A
Tennessee	A
Texas	A
Utah	A
Vermont	A

Aa3
Aaa
Aaa
Aa1
NR
NR
NR
Aa1
Aa2
Aaa
Aa1
NR
Aa1
NR
Aa1
NR
Aaa
NR
Aaa
Aaa
Aaa

BUDGET MANEUVERS

STATE	GRADE
Illinois	D
Kansas	D
New Jersey	D
New York	D
Pennsylvania	D
Virginia	D

Baa3
NR
A3
Aa1
Aa3
Aaa

Sources: Volcker Alliance, Moody's Investors Service, Bloomberg

State Grades and Credit Ratings: Legacy Costs

LEGACY COSTS

STATE	GRADE
Idaho	A
Iowa	A
Nebraska	A
Oklahoma	A
Oregon	A
South Dakota	A
Utah	A
Wisconsin	A

NR
NR
NR
Aa2
Aa1
NR
Aaa
Aa1

LEGACY COSTS

STATE	GRADE
Hawaii	D-
Illinois	D-
Kansas	D-
Massachusetts	D-
New Jersey	D-
Pennsylvania	D-
Texas	D-
Virginia	D-
Wyoming	D-

Aa1
Baa3
NR
Aa1
A3
Aa3
Aaa
Aaa
NR

Source: Volcker Alliance, Moody's Investors Service, Bloomberg

State Grades and Credit Ratings: Reserve Funds

RESERVE FUNDS

STATE	GRADE
Alaska	A
Arizona	A
California	A
Hawaii	A
Idaho	A
Indiana	A
Massachusetts	A
Michigan	A
Minnesota	A
North Dakota	A
Tennessee	A
Texas	A
Utah	A
Virginia	A
Washington	A

Aa
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NR
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 3
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NR
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RESERVE FUNDS

STATE	GRADE
Kansas	D
Montana	D
New Mexico	D

NR
Aa1
Aa1

Sources: Volcker Alliance, Moody's Investors Service, Bloomberg

State Grades and Credit Ratings: Transparency

TRANSPARENCY	
STATE	GRADE
Alaska	A
California	A

Aa3
Aa3

TRANSPARENCY	
STATE	GRADE
Alabama	D
Arkansas	D
New Mexico	D

Aa1
Aa1
Aa1

Sources: Volcker Alliance, Moody's Investors Service, Bloomberg