THE CENTER FOR STATE AND LOCAL FINANCE

OCTOBER 9, 2018

Budget Maneuvers in the Southern States

Part of *Balancing the Budget in the Southern States*

Alex Hathaway
Jesseca Lightbourne

Georgia State University
ANDREW YOUNG SCHOOL
CENTER FOR STATE & LOCAL FINANCE

Balancing the Budget in the Southern States — This six-report series is based on the Volcker Alliance's Truth and Integrity in Government Finance project results as well as additional research conducted by the Center for State and Local Finance.

Special thanks to The Volcker Alliance for its research support and permission to use the data in this analysis. We also appreciate the comments of Ken Heaghney and W. Bartley Hildreth.

Table of Contents

Introduction

Unlike the federal government, all U.S. states must pass balanced budgets, where planned expenditures do not exceed expected revenue collections.[1] A balanced budget requirement serves as a monitoring mechanism to constrain spending and ensure current services are funded by current taxpayers. Maintaining budgetary balance requires states to adapt to fluctuations in revenues or expenditures through various approaches, such as cutting agency spending or raising taxes. Although spending cuts and tax hikes can be politically difficult choices, they are relatively transparent actions. In contrast, states may also resort to other budget manipulation approaches like using bond proceeds for general fund operating costs.

These budget manipulation techniques, which we refer to as one-time budget maneuvers, are less transparent to the public than spending cuts and tax hikes and potentially push off costs onto future generations of taxpayers. States may use one-time budget maneuvers for several reasons, such as in response to economic shocks. These unpredictable events, such as natural disasters or recessions, can dramatically affect state revenues and expenditures, and states can struggle to maintain structural balance. In such cases, states may consider using maneuvers despite the potential drawbacks because they can provide quick solutions to budget problems without drastic cuts to programs and services. In other instances, states facing structural deficits, with recurring expenditures exceeding recurring revenues, may resort to budget maneuvers in place of politically challenging decisions.

In this report, we look at several one-time budget maneuvers used recently in the 16 states within the U.S. Census Bureau's southern region: Alabama, Arkansas, Delaware, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia and West Virginia. The research covers fiscal year (FY) 2015 through FY 2018 and draws on questions from the Volcker Alliance's Truth and Integrity in Government Finance project, which evaluates state budgeting and financial management for best practices and the transparent use of funds. The maneuvers discussed in this report include a variety of actions such as using borrowed funds to cover recurring expenditures, refinancing bonds to push off costs to the future, taking upfront revenues and deferring payments to agencies. The following sections look at the complications that arise from using budget maneuvers and the recent maneuvers employed in the South.

Drawbacks of Budget Maneuvers

The major budget maneuvers discussed in this report create the appearance of a balanced general fund budget at the expense of opening holes in future budgets. For example, the use of debt for recurring expenditures is problematic because debt, primarily in the form of bonds, is often paid back over several decades. The long repayment schedule raises issues of intergenerational equity. In effect, supporting

[1] Vermont does not have a balanced budget requirement but traditionally enacts a balanced budget.

recurring or operating expenditures — such as Medicaid, K-12 education or police salaries — with bonded debt results in future taxpayers bearing the costs of these programs and salaries without benefitting from the services provided. Furthermore, future debt service occupies a share of general funds that future generations could use for other purposes.

Debt-related maneuvers can pose a risk to states' credit ratings as well because rating agencies identify the accumulation of debt to fund recurring expenditures as an indicator of financial instability. Higher credit ratings can translate into lower borrowing costs for states, and investors value a high credit rating because it demonstrates a state's ability to meet its financial obligations (Pew 2017). West Virginia is a good example of how lower ratings can hinder a state. In February 2017, Moody's Investors Service downgraded West Virginia's general obligation debt rating, adversely affecting $394 million in outstanding debt. The rating agency explained that the downgrade from Aa1 to Aa2 was the result of the "multi-year trend of growing structural imbalance between annual expenditures and available resources" (Lannom 2017). Although the state has used revenue generators, reduced expenditures and transferred reserve funds to close its budget gaps, the revenues continue to lag behind estimates, and West Virginia expects the structural imbalance to continue into FY 2022.

Finally, budget maneuvers also take the form of shifting expenditures or revenues across fiscal years, which both create future budget issues. States commonly delay payments to a program or agency, such as a Medicaid payment or employee payroll, from the end of June to the beginning of July for accounting purposes, but these short-term deferrals do not have lasting budgetary effects. Longer delays in payments, however, can mean the state pays a larger amount in the future. In a similar way, taking revenues like sales taxes early gives the state additional funds in the present but reduces sales tax collections as a fund source in the future. Like debt-related revenue sources, these one-time maneuvers give the appearance of a balanced budget in the present, but the future problems they create are often not evident to the public.

Budget Maneuvers in the South

This section introduces the budget maneuver research questions based on the Volcker Alliance project. It then provides an overview of the results in the South from FY 2015 to FY 2018. Finally, we analyze each budget maneuver using state-specific examples.

RESEARCH QUESTIONS

Five research questions from the Volcker Alliance project inform the major budget maneuvers examined in the South. Three questions deal with the use of bonds and two with shifting revenues or expenditures.

- Did the state use bond proceeds for recurring expenditures?
- Did the state refinance bonds with scoop and toss techniques to raise funds for recurring expenditures?
- Did the state divert bond premiums (or other upfront cash flows generated during sales of bonds or other financial transactions) into the general fund?

- Did the state use upfront revenues or proceeds to fund recurring expenditures?
- Did the state defer recurring expenditures, excluding those for capital projects, into the future?

OVERVIEW OF MANEUVER USE IN THE SOUTH

During the research window, most of the budget maneuvers were used at least once in every year (Table 1). No more than three instances of a maneuver were seen in any one year across the 16 states, and overall, few southern states engaged in the maneuvers. For example, only Maryland diverted bond premiums, though the state did so in each year. Similarly, Virginia is the only state that used an upfront revenues mechanism in each year.

Table 1. Southern States Using One-Time Budget Maneuvers, FY 2015-18

	NUMBER OF STATES			
BUDGET MANEUVERS	FY 2015	FY 2016	FY 2017	FY 2018
Using bond proceeds for recurring expenditures	0	0	1	1
Refinancing bonds with scoop and toss techniques to raise funds for recurring expenditures	1	1	2	1
Diverting bond premiums (or other upfront cash flows generated during sales of bonds or other financial transactions) into the general fund	1	1	1	1
Using upfront revenues or proceeds to fund recurring expenditures	1	1	1	1
Deferring recurring expenditures, excluding those for capital projects, into future year(s)	2	3	1	1

Source: Volcker Alliance research results; FY 2018 results are preliminary. (Note: Results may differ slightly from Volcker Alliance results because of definitional changes in this report.)

Of the 16 southern states, the following eight did not use any of these one-time budget maneuvers to balance their budgets during the research window: Arkansas, Delaware, Florida, Georgia, Mississippi, North Carolina, South Carolina and Tennessee. Twelve states avoided maneuvers in FY 2015, but one of these 12 states, Texas, engaged in budget maneuvers to address deficits in FY 2016, deferring payments to cover Medicaid expenses that resulted in a hole of between $1.3 billion and $1.6 billion in state funds (Garrett 2016). In FY 2017, 11 states avoided maneuvers, increasing to 12 states in FY 2018. Table 2 lists the states that did not use any of the one-time budget maneuvers examined in this report to balance their budgets from FY 2015 to FY 2018.

Note that when the nation experiences fiscal stress, such as during the Great Recession, a rise in budget maneuvers by states is expected. However, FY 2015-18 was a period of economic expansion, and states were less likely to engage in one-time budget maneuvers (Bureau of Economic Analysis 2018). The states relying on budget maneuvers in this expansionary period may have had difficulty maintaining reserves, which could exacerbate budget imbalances during the next economic downturn.

Table 2. Southern States That Avoided Using One-Time Maneuvers, FY 2015-18

FY 2015 (12)	FY 2016 (11)	FY 2017 (11)	FY 2018 (12)
Alabama	Alabama	Arkansas	Arkansas
Arkansas	Arkansas	Delaware	Delaware
Delaware	Delaware	Florida	Florida
Florida	Florida	Georgia	Georgia
Georgia	Georgia	Kentucky	Kentucky
Louisiana	Mississippi	Mississippi	Louisiana
Mississippi	North Carolina	North Carolina	Mississippi
North Carolina	Oklahoma	Oklahoma	North Carolina
Oklahoma	South Carolina	South Carolina	South Carolina
South Carolina	Tennessee	Tennessee	Tennessee
Tennessee	West Virginia	Texas	Texas
Texas			West Virginia

Source: Volcker Alliance research results; FY 2018 results are preliminary. (Note: Results may differ slightly from Volcker Alliance results because of definitional changes in this report.)

Although states use budget maneuvers for a variety of reasons, the budget cycle is often a contributing factor. Four of the 16 southern states — Kentucky, North Carolina, Texas and Virginia — use biennial budgeting, in which a government adopts a two-year operating budget every other year. This distinction in budget planning is noteworthy because states with biennial budgets are subject to greater revenue volatility. Biennial-budget states adjust revenue and expenditure projections less often than states with annual budgeting processes and, therefore, may be more likely to resort to budget maneuvers. Although most biennial-budget states pass budget amendments in the interim years, the National Conference of State Legislatures observed that several states recently shifted from biennial to annual budgeting to better monitor budget growth, address complications and adjust to revenue volatility, notably Arkansas in 2009 and Oregon in 2011 (Snell 2011). Table 3 shows the southern states' budget cycles. Of the biennial budgeting states, only North Carolina avoided one-time budget maneuvers every year of the research window.

Table 3: Budget Cycles of the Southern States, FY 2018

BUDGET CYCLE	STATE
Annual	Alabama, Arkansas, Delaware, Florida, Georgia, Louisiana, Maryland, Mississippi, Oklahoma, South Carolina, Tennessee, West Virginia
Biennial	Kentucky, North Carolina, Texas, Virginia

Source: Volcker Alliance research results, FY 2018

ANALYSIS OF ONE-TIME BUDGET MANEUVERS

Bond Proceeds

Funding recurring costs with debt is problematic because bond proceeds are not a recurring revenue source. Moreover, as discussed previously, paying for recurring expenditures with debt poses issues for future budgets when the debt is repaid with interest and raises questions about intergenerational equity as future taxpayers pay for today's services. During the research window, only Alabama used borrowed funds to cover recurring expenditures directly.

In December 2016, Alabama issued nearly $548 million in taxable revenue bonds, all of which funded recurring program costs or repaid accounts from which the state had previously borrowed. Alabama used $120 million from the bond issuance to fund increases to the state's Medicaid program in FY 2017 and FY 2018. Because the state used a one-time funding source to pay for recurring expenditures, Alabama must find another source of funds to maintain its increased Medicaid spending in future years. Other proceeds from the December 2016 bond issuance backfilled its rainy day fund with $162 million, after the state previously borrowed from it for general operations. Alabama must now repay, with interest, the bond-supported portion of its Medicaid costs and rainy day fund.

Scoop and Toss

Scoop and toss is a bond refinancing strategy in which a state issues new bonds to pay off old bonds and, in the process, extends the repayment schedule or backloads out-year payments to alleviate near-term budgetary pressure. Extending the repayment schedule and creating onerous out-year payments leave future taxpayers shouldering the burden of repaying old debt. Furthermore, scoop and toss is one of the least transparent budget maneuvers because the Official Statements, which describes the issued bonds, do not directly identify this refinancing technique.

States traditionally refinanced bonds to take advantage of lower interest rates, saving the state money in the long term. However, some refinancing techniques like scoop and toss cost the state more money in the long term or created burdensome repayment schedules. With the passage of the Tax Cuts and Jobs Act of 2017, Congress eliminated advance refunding (more than 90 days before the bonds are due to be paid) of municipal bonds. This change may reduce some future instances of scoop and toss. However, within the 90-day window, bonds can still be refunded and paid with a new debt issuance.

Three southern states have recently used scoop and toss refinancing: Louisiana, Oklahoma and West Virginia (Table 4). Louisiana is an interesting example because the state attempted to remain transparent in its bond issuance, clearly remarking that the funds were needed to alleviate budgetary pressure. According to the Official Statement, "[The new bonds] shall be structured to achieve maximum cash flow savings in Fiscal Year 2015-16, and any additional cash flow savings to be applied in Fiscal Year 2016-17, all for the purpose of assisting in eliminating the Fiscal Year 2015-2016 and Fiscal Year 2016-2017 deficits" (State of Louisiana 2016). Louisiana's bond issues refinanced numerous bonds set to mature in 2016 through 2021, but the payment on the principal for the new refunding bonds will not begin until 2022. Additionally, the new bonds fund the interest payments for various other outstanding bonds.

Table 4. Scoop and Toss Refinancing, FY 2015-18

FISCAL YEAR	STATES USING MANEUVER
2015	West Virginia
2016	Louisiana
2017	Louisiana, West Virginia
2018	Oklahoma

Source: Volcker Alliance research results

Bond Premiums

Bond premiums are the excess funds collected when bonds trade above their face value. Typically, states use premiums to pay for capital projects or reduce debt service, but states sometimes reroute the premiums to pay for recurring expenses. In the South, Maryland diverted bond premiums as a budget maneuver to offset budget deficits in all years of the research window. General obligation debt service in Maryland is typically supported by a portion of property taxes, which are allocated to the Annuity Bond Fund (ABF). However, the ABF has been insufficient to cover debt service in recent years. In 2014, the state appropriated general funds to cover deficits in this account, but in FY 2015-18, Maryland deposited bond premiums into the ABF to defray the general fund appropriations required to cover debt service (Maryland Department of Legislative Services 2016). In FY 2015, Maryland estimated it would receive $108 million in bond premiums and appropriated an additional $140 million in general funds to the ABF. Actual bond premiums came in $35 million more than estimated, and in response to a mid-year shortfall in FY 2015, the state reduced the general fund appropriation to the ABF by $22 million (Deschenaux 2015).

Upfront Revenues

States can collect future revenues early from companies to pay for expenditures in the current fiscal year. While states often shift funds across fiscal years for accounting purposes, this report focuses on substantial movements due to fiscal stress that result in future financial issues. Virginia is the only southern state to use this budget maneuver to balance its budget from FY 2015 to FY 2018. To mitigate the effects of the Great Recession in 2010, the Virginia General Assembly implemented the accelerated sales tax (AST). The AST requires businesses whose revenues exceed a specified threshold to prepay their estimated June taxes.[2] Businesses normally pay June taxes in July, but under the AST, June taxes are paid in June at the same time May taxes are paid (Virginia Department of Taxation 2017). Moreover, the state adjusts the threshold level in direct response to fiscal stress, lowering the threshold and increasing the number of businesses prepaying taxes to shift more money into the current year.

Although Virginia anticipated using this maneuver only during the Great Recession, the state has faced difficulties in unwinding the tax (Table 5). The prepayment maneuver shifts revenues across fiscal years,

[2] The prepay estimate is calculated as 90 percent of the sales tax paid in the previous June.

opening a budget gap in sales tax revenues in the latter year because businesses have substantially fewer taxes to pay that June. The state, then, must wait for the economic situation to improve enough that it can cope with lower revenues in the latter fiscal year, or the state must continue accelerating payments from future years, which Virginia has done since FY 2010. For instance, the AST added $223.8 million to FY 2010 from additional revenue collected from companies with taxable sales and purchases above $1 million (Virginia Comptroller 2010). Since 2010, the state has raised and lowered the threshold depending on revenue needs. In FY 2014, the threshold increased to $48.5 million, as the state attempted to unwind the tax. However, anticipated fiscal stress in FY 2015 led the general assembly to lower the threshold significantly for FY 2015, down to $2.5 million, to increase the number of companies required to prepay taxes. Virginia maintained the $2.5 million threshold through FY 2017 and shifted $210.6 million into the last month of FY 2017 (Virginia Comptroller 2017). The FY 2018 threshold was increased to $4 million.

Table 5. Virginia's Accelerated Sales Tax Threshold, FY 2010-18

PAYMENT DUE IN JUNE OF	APPLIED TO COMPANIES WITH TAXABLE SALES/PURCHASES OF
2010	$1 million or more
2011	$5.4 million or more
2012	$26 million or more
2013	$26 million or more
2014	$48.5 million or more
2015	$2.5 million or more
2016	$2.5 million or more
2017	$2.5 million or more
2018	$4 million or more

Source: Virginia Department of Taxation 2017. Guidelines for the Accelerated Sales Tax Payment.

Deferring Expenditures

As a budget maneuver, deferring payments into future years allows states to claim a balanced budget by reducing the expenditures in a given year, even though the following years will see increased expenditures from the deferral. As with upfront revenues, deferrals across fiscal years often occur for accounting purposes and are seen regularly in many states, such as Louisiana delaying Medicaid payments from the end of the fiscal year in June to the beginning of July. In this report, however, we focus on lasting maneuvers that potentially affect the future position of the state. During the research window, three states made noteworthy deferrals: Kentucky, Virginia and Maryland (Table 6).

Kentucky and Virginia have underfunded their annual pension obligations for many years to address current-year budgetary pressure, resulting in future liability growth. Both states have made steps to curb this deferral of expenditures, however, and by FY 2018 both states had begun contributing virtually 100 percent of the full pension requirements to all state pension funds.

Additionally, Virginia deposits $40 million annually for debt service on Route 58 transportation bonds. In FY 2015, in anticipation of a shortfall, the state reduced the FY 2015 payment to $28 million by increasing the FY 2016 payment to make up the difference. Unlike the June to July accounting shifts, this maneuver had the potential to create a challenging increase in future expenditures.

Maryland has also deferred payments in response to fiscal stress, adjusting its Medicaid Deficit Assessment. This assessment was imposed on hospitals during the Great Recession to assist with Medicaid payments. In FY 2016, the state began incrementally reducing the assessment by $25 million every year. Due to budgetary problems in FY 2018, however, the state postponed the scheduled $25 million reduction and raised subsequent fiscal year reductions to $35 million. Although Maryland attempted to balance the assessment reduction with future increases, the $35 million future reductions may be more burdensome on future resources. Like the Virginia example, if Maryland faces further budgetary pressure in the near future, the state may have difficulty paying the deferred expenditure.

Table 6. Deferring Expenditures, FY 2015-18

FISCAL YEAR	STATES USING MANEUVER
2015	Kentucky, Virginia
2016	Kentucky, Texas, Virginia
2017	Virginia
2018	Maryland

Source: Volcker Alliance research results
(Note: Results may differ slightly from Volcker Alliance results because of definitional changes in this report.)

Conclusions

Balancing the budget can be difficult, yet states are responsible for finding solutions to maintain structural balance. Some one-time budget maneuvers contribute only to the appearance of a balanced budget and cloud transparency, providing short-term relief and creating future fiscal troubles. These maneuvers are especially problematic when used during times of economic expansion. This report looks at the negative consequences of some of the major, one-time budget maneuvers used in the South. The southern states used relatively few maneuvers during the research window, with most maneuvers occurring only once or twice in a given year. Through these examples, however, states can learn to recognize the potential problems with one-time solutions and follow good budget management practices to prevent the need to consider these options.

References

Bureau of Economic Analysis. 2018, Aug. 29. Gross domestic product: Second quarter 2018 (second estimate; Corporate profits: Second quarter 2018 (preliminary estimate). U.S. Department of Commerce, BEA No. 18-43. Retrieved from www.bea.gov/data/gdp/gross-domestic-product.

Deschenaux, Warren G. 2014, April 11. 90 day report, a review of the 2014 legislative session. Maryland Department of Legislative Services. Retrieved from mgaleg.maryland.gov/pubs/legislegal/2014rs-90-day-report.pdf.

Deschenaux, Warren G. 2015, April 11. 90 day report, a review of the 2015 legislative session. Maryland Department of Legislative Services. Retrieved from mgaleg.maryland.gov/Pubs/legislegal/2015rs-90-day-report.pdf.

Garrett, Robert. 2016, Sept. Texas braces for budget cuts as economy, Medicaid, spending decisions collide. *Dallas News*. Retrieved from www.dallasnews.com/news/texas-legislature/2016/09/01/texas-braces-budget-cuts-economy-medicaid-spending-decisions-collide.

Lannom, Andrea. 2017, Feb. 21. Moody's downgrades West Virginia bond rating. *Register-Herald*. Retrieved from www.register-herald.com/news/moody-s-downgrades-west-virginia-bond-rating/article_06bb25a0-f888-11e6-90ec-b7e32a5d7072.html.

Maryland Department of Legislative Services. 2016. Analysis of the FY2017 Maryland executive budget: X00A00 public debt. Retrieved from mgaleg.maryland.gov/pubs/budgetfiscal/2017fy-budget-docs-operating-x00a00-public-debt.pdf.

The Pew Charitable Trusts (Pew). 2017, May. Rainy day funds and state credit ratings: How well-designed policies and timely use can protect against downgrades. Retrieved from www.pewtrusts.org/~/media/assets/2017/05/statesfiscalhealth_creditratingsreport.pdf.

Snell, Ron. 2011, April. State experiences with annual and biennial budgeting. National Conference of State Legislatures. Retrieved from www.ncsl.org/research/fiscal-policy/state-experiences-with-annual-and-biennial-budgeti.aspx.

State of Louisiana. 2016, April 21. Official statement, general obligation refunding bonds, series 2016-B and 2016-C. Retrieved from emma.msrb.org/EP929954-EP721984-EP1123824.pdf.

Virginia Comptroller. 2010, Aug. 13. General fund preliminary (unaudited) annual report. Retrieved from www.doa.virginia.gov/Financial_Reporting/Preliminary_Reports/2010_Preliminary_Report.pdf.

Virginia Comptroller. 2017, Aug. 15. General fund preliminary (unaudited) annual report. Retrieved from www.doa.virginia.gov/reports/Preliminary_Reports/2017_Preliminary_Report.pdf.

Virginia Department of Taxation. 2017, May 3. Guidelines for the accelerated sales tax payment. Retrieved from tax.virginia.gov/sites/default/files/inline-files/2017-accelerated-sales-tax-guidelines.pdf.

Virginia General Assembly. 2016, June 9. Capital outlay, 2016 session summary. Retrieved from budget.lis.virginia.gov/sessionreport/2016/1/1800/.

About the Authors

Alex Hathaway is a research associate with the Center for State and Local Finance and the Fiscal Research Center, specializing in fiscal health. He is the principal investigator on the center's multi-state evaluation of budgeting and financial management practices for the Volcker Alliance's Truth and Integrity in Government Finance project. Hathaway is also a key contributor to the center's education policy research, currently evaluating outcome measures of later-age degree recipients in University System of Georgia institutions. He holds a master's degree in public policy from Georgia State University, a professional doctorate in chiropractic medicine from Life University, and bachelor's degrees from the University of Georgia. His other research interests include healthcare systems and finance, aging policy and program evaluation.

Jesseca Lightbourne has written articles for journals such as Public Administration Review and technical reports for the Kinder Institute for Urban Research at Rice University. She earned a doctorate degree in public administration and management from the University of North Texas. Her research interests include the effect natural disasters have on state and local economies, tax reform, state and local fiscal policy, and other topics. She also has taught financial aspects of government, intergovernmental relations, and public policy analysis at the University of North Texas.

About the Center for State and Local Finance

The Center for State and Local Finance's (CSLF) mission is to develop the people and ideas for next generation public finance by bringing together the Andrew Young School's nationally-ranked faculty and the broader public finance community. CSLF conducts innovative, nonpartisan research on tax policy and reform, budget and financial management, education finance, and economic development and urban policy. Additionally, it provides premier executive education in public finance for state and local finance officials and works with local and state partners on technical assistance projects on fiscal and economic policy.

CSLF maintains a position of neutrality on public policy issues. However, in order to protect their academic freedom, authors may express a wide range of viewpoints in CSLF's publications. The research, interpretations or conclusions in CSLF publications should be understood to be solely those of the author(s).

For more information on the Center for State and Local Finance, visit our website at: cslf.gsu.edu.