State Budgets:
The Good and the Bad

A foundational paper for high school economics classes
prepared for the Foundation for Teaching Economics

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In “Financial Reporting by Governments in the United States,” I stressed that budgets are one thing, and audited financial statements are another thing. “There are words, and there are deeds,” the old saying goes.

Budgets are a type of financial report, and so are annual financial reports. But budgets look forward, while the financial statements included in annual financial reports relate to a period just ended. Those statements are audited, and they are based on results, not plans or intentions. Budgets can provide important accountability devices, at least in theory. In practice, however, they can also become unreliable, if not tools of deception.

In the United States, 49 of the 50 states have “balanced budget” requirements. A simple question or two arises -- if states balance their budgets every year, how could so many of them have accumulated so much debt? Why did their debts grow so much faster than their economies? If you balance your budget, you don’t spend more than you take in, right? Then why do so many states regularly report accrual expenses that exceed revenue, and borrow to help make up the difference?

A short answer to the long and sometimes-depressing story below is that states (and cities) can balance their budgets using “political math.” Accounting standards enable untruthful budgeting practices like treating borrowing proceeds as revenue, and not counting real expenses if cash isn’t going out the door immediately.

Not all states (or cities) are alike, however. There are good lessons out there, as well. .

This paper will introduce the financial reports and accounting standards for state and local governments, and then dive into accounting and other issues of concern to students, teachers, and citizens and taxpayers more generally. It will lay the basis for the development of a series of exercises and projects for high school classrooms. Topics that will be covered include:

- State and Local Government Financial Reports
- State and Local Government Accounting Issues
- Case Study 1: The City of Chicago
- Case Study 2: New York City
- 50 State Review -- Budget Practices
- 50 State Review -- Some Results in Financial Statements
- Perspective From the Public Choice School of Economics

State and Local Government Financial Reports

In order to evaluate budgets in light of results, let's start with how to read the results.

Every year, state and local governments produce "Comprehensive Annual Financial Reports" (CAFRs). These reports include audited financial statements. The two main end-of-year financial statements are the government versions for an income statement and a balance sheet. As in the private sector, the income statement reflects performance over a period of time, and the balance sheet theoretically reflects (or "portrays," a better word, see below) financial condition at a point in time.

For municipal (state and local) governments, the income statement is called the Statement of Activities. The balance sheet is called the Statement of Net Position. Both of these statements are structured, as in the private sector, on an "A minus B leads to left-over C" basis. For example, in the Statement of Net Position, assets minus liabilities basically equals net position.

Here's a picture of the Statement of Activities in the latest annual financial report for the City of Indianapolis. Fortunately, it is all on one page, unlike the presentation of many other large cities. Unfortunately, that makes it hard to see here, but you can zoom in on it, and I will explain how it is presented right below the picture.

CITY OF INDIANAPOLIS
(A Component Unit of the Consolidated City of Indianapolis - Marion County)
Statement of Activities
Year ended December 31, 2018
(In thousands)

Functions/Programs	Expenses	Program revenues: Charges for services	Program revenues: Operating grants and contributions	Program revenues: Capital grants and contributions	Net (expense) revenue and changes in net position: Primary Government Governmental activities	Net (expense) revenue and changes in net position: Component Unit Indianapolis Housing Agency
Governmental activities:						
General government	$ 36,351	$ 18,857	$ 7,223	$ —	$ (10,271)	$ —
Public safety	436,687	32,110	61,826	48	(342,703)	—
Public works	222,011	57,340	60,186	11,215	(93,270)	—
Health and welfare	11,594	94	7,263	—	(4,237)	—
Cultural and recreation	30,423	3,583	1,258	952	(24,630)	—
Urban redevelopment and housing	23,302	2,224	12,433	—	(8,645)	—
Economic development and assistance	52,671	961	837	—	(50,873)	—
Interest	49,159	—	—	—	(49,159)	—
Total governmental activities	$ 862,198	$ 115,169	$ 151,026	$ 12,215	(583,788)	—
Component Unit						
Indianapolis Housing Agency	$ 80,814	$ 10,237	$ 65,597	$ 4,947		(33)
Total component units	$ 80,814	$ 10,237	$ 65,597	$ 4,947		(33)
General revenues:						
Taxes:						
Property taxes					315,230	—
Wheel taxes					15,354	—
Local income taxes					237,319	—
Other taxes					23,159	—
Grants and contributions not restricted to specific programs					12,439	—
Investment earnings not restricted to specific programs					16,302	—
Miscellaneous					29,269	1,651
Total general revenues					649,072	1,651
Change in net position					65,284	1,618
Net position (deficit) – beginning of year, as previously reported					(157,303)	174,948
Change in accounting principle					(34,953)	
Net position (deficit), beginning of year, as restatement					(192,256)	174,948
Net position (deficit) – ending					$ (126,972)	$ 176,566

Like all income statements, there is a top half and a bottom half. Subtracting the bottom half from the top half leads to a bottom line. Unlike private sector income statements, however, municipal (state and local) government income statements start with expenses, and then subtract revenues! This raises some philosophical questions about the role of government in the economy, but let's hold off on that for now.

In the top half of the statement, you can see expenses allocated into certain categories, like "public safety," "public works" and "health and welfare," along with "interest." The naming of those categories leads to other postponable philosophical questions. For now, note that Indianapolis reports expenses for governmental activities as well as an entity deemed to be a component unit, leading to total expenses of $862.2 million and $80.8 million, respectively.

To the right of that first "expenses" column, you see another way in which the Statement of Activities differs from private sector income statements. For each expense category, there are offsetting "revenue-like" amounts that are deducted from expenses to lead to the "net expenses" to the right of the top section, before general revenues are deducted in the bottom section.

Those revenue-like amounts in the top section are in three categories of “program revenues” -- “charges for services,” “operating grants and contributions,” and “capital grants and contributions.” These categories reflect the fact that municipal governments earn money from fees and other direct charges for their services, and that they also get money in the door from other governments, including the federal government, for different expense categories. Once these amounts are deducted from expenses, the statement gets to the right-hand side column(s) titled “Net (expense) revenue and changes in net position.”

In the top half of the statement, those right-hand side amounts are net expenses, but in the bottom half of the Statement of Activities you see the crucial third part of the equation -- general revenues. These are basically taxes -- in Indianapolis’ case, you can see that property and income taxes are the largest components of general revenue.

At the very bottom, you see the bottom line (see, this isn’t that hard!). The bottom line is titled “Net Position (Deficit) -- Ending.” This links the result in the Statement of Activities (the income statement) to the balance sheet, which will be described next. To get to the net position, the Statement of Activities “bottom line” amount is the “Change in Net Position,” which arrives after you subtract general revenue from net expenses.

If the change in net position is positive, the ending net position rose (improved) from the beginning of the period to the end of the period. If it was negative, the net position fell. For Indianapolis, you can see that general revenues exceeded net expenses for the city as well as its component unit. For the city, the change in net position was roughly $65 million. This is a sign that Indianapolis really “walked the talk,” in balancing expenses with revenue, and didn’t spend more than it took in for the latest fiscal year.

Now, let’s look at the balance sheet -- “the Statement of Net Position.” This time, the government statement follows the basic pattern of the balance sheet in the private sector -- assets minus liabilities lead to net position. For municipal governments, however, there are some complicated complicating factors we are going to introduce as well.

The top half of Indianapolis’ Statement of Net Position is below. It goes two pages long.

CITY OF INDIANAPOLIS
(A Component Unit of the Consolidated City of Indianapolis - Marion County)
Statement of Net Position
December 31, 2018
(In thousands)

	Primary Government	Component Unit
	Governmental activities	Indianapolis Housing Agency
ASSETS AND DEFERRED OUTFLOWS OF RESOURCES		
Assets:		
Equity in pooled cash	$ 40,393	$ 7,680
Cash and investments with fiscal agents	200,316	25,420
Investments	480,653	—
Property taxes receivable	7,948	—
Accounts receivable, less allowance for uncollectibles	33,931	811
Due from federal and state governments	8,072	554
Due from other governments	170	—
Other assets	—	1,402
Long-term receivables, less allowance for uncollectibles	28,238	9,091
Restricted assets	—	3,795
Net pension asset	19,856	—
Capital assets:		
Land	67,884	20,755
Infrastructure, net of accumulated depreciation	845,639	—
Other capital assets, net of accumulated depreciation	359,603	140,044
Construction in progress	279,321	5,708
Total assets	2,372,024	215,260
Deferred outflows of resources - OPEB	230	—
Deferred outflows of resources - pensions	66,381	559
Deferred outflows of resources - deferred losses on refundings	13,662	—
Total deferred outflows of resources	80,273	559
Total assets and deferred outflows of resources	2,452,297	215,819

(Continued)

In the top half, you can see the various categories of assets, including cash, investments, various types of receivables, and capital assets like land, infrastructure, and construction in progress. Further down in the top half, you see something you don't normally see in a balance sheet, a set of "deferred outflow" accounts. These accounts are part of that complicated complicating factors story I just hinted at. Let's just note for now that they aren't very big, in Indianapolis' case, anyway. "Deferred Outflows of Resources" were about $80 million at the end of 2018, less than five percent of the top half of the balance sheet.

But it will be important to remember that the top half of the Statement of Net Position isn't titled simply "Assets" -- it is titled "Assets and Deferred Outflows of Resources." For other municipal governments, including troubled places like the State of Illinois and the City of Chicago, those deferred outflows get a) much bigger, and b) more controversial.

Here's the "bottom half" of Indianapolis' Statement of Net Position. It leads with a section titled "Liabilities and Deferred Inflows of Resources," which are deducted from the "Assets and Deferred Outflows of Resources" to arrive at the "Net Position (Deficit)" section at the bottom.

	Primary Government	Component Unit
	Governmental activities	Indianapolis Housing Agency
LIABILITIES AND DEFERRED INFLOWS OF RESOURCES		
Liabilities:		
Accounts payable and other current liabilities	$ 113,209	$ 3,566
Accrued interest payable	14,538	—
Unearned revenue	11,915	201
Customer deposits	—	256
Other liabilities	—	2,443
Long-term liabilities:		—
Due within one year	153,120	9,858
Due in more than one year	2,193,685	22,289
Total liabilities	2,486,467	38,613
Deferred inflows of resources - OPEB	13,622	—
Deferred inflows of resources - pensions	62,380	640
Deferred inflows of resources - parking meter concession agreement	16,800	—
Total deferred inflows of resources	92,802	640
Total liabilities and deferred inflows of resources	2,579,269	39,253
NET POSITION (DEFICIT)		
Net investment in capital assets	706,470	149,499
Restricted for:		
Capital projects	29,475	—
Debt service	23,831	—
Section 8 vouchers and VASH	—	6
Reserves and escrow	—	2,109
Programs	—	12,220
Other purposes by grantors	23,222	—
Other purposes by contributor – nonexpendable	362	—
Statutory restrictions	87,959	—
Unrestricted (deficit)	(998,291)	12,732
Total net position (deficit)	$ (126,972)	$ 176,566

Here you can see liabilities like those that appear in private sector balance sheets, like accounts payable, interest payable, and unearned revenue. But in Indianaopolis' case, like most municipal governments, long-term liabilities are by far the largest class of liabilities. Long-term liabilities include things like bonded debt and employee retirement benefit obligations, and you can find the breakdown for how much is owed, and to whom, in the footnotes to the financial statements.

That hasn't always been the case, however, for state and local governments.

For decades, government accounting standards didn't treat pension or retiree health care benefit obligations as debt on the balance sheet! These now-massive amounts only arrived beginning in 2015. By not including these debts as liabilities, government statements of net position falsely inflated the bottom line. This practice formed one element of the equation explaining how government officials could claim "balance budgets" while running up the credit cards on their citizens and taxpayers, a topic we will develop more thoroughly below.

Here's a look at Note 12 to Indianapolis' financial statements, titled "Long-Term Liabilities." It shows the beginning balance for various forms of long-term debt, additions and deductions to those amounts during the year, their ending balance, and the share of the ending balance that is due in the next year.

12. Long-Term Liabilities

A. Changes in Long-Term Liabilities

The following is a summary of changes in long-term liabilities for the City's governmental activities and for its discretely presented component unit, the Housing Agency, for the year ended December 31, 2018:

	Balance, January 1, 2018 (as restated)	Additions	Reductions	Balance, December 31, 2018	Due within One Year
Governmental Activities:					
Bonds payable:					
General obligation bonds payable	$ 128,450	$ —	$ 10,490	$ 117,960	$ 15,395
Tax increment bonds payable	583,141	36,819	38,319	581,641	40,807
Revenue bonds payable	295,000	30,000	3,245	321,755	8,045
Unamortized amounts:					
Premiums	64,614	4,217	6,530	62,301	—
Total bonds payable	1,071,205	71,036	58,584	1,083,657	64,247
Notes payable and certificates of participation	119,288	76,434	29,646	166,076	70,781
Capital leases payable	9,659	4,972	2,449	12,182	423
Net pension liabilities	896,740	1,139	72,899	824,980	—
Postemployment benefit liability	223,265	20,749	22,861	221,153	—
Compensated absences	38,626	31,354	31,223	38,757	17,669
Total governmental activities	$ 2,358,783	$ 205,684	$ 217,662	$ 2,346,805	$ 153,120
Discretely Presented Component Unit - Housing Agency:					
Notes payable	$ 19,131	$ 7,726	$ 1,225	$ 25,632	$ 9,612
Due to other governmental units	1,524		65	1,459	65
FSS escrow	1,126	646	909	863	158
Net pension liability	5,176	677	1,900	3,953	—
Compensated absences	281	25	66	240	23
Total discretely presented component unit	$ 27,238	$ 9,074	$ 4,165	$ 32,147	$ 9,858

Indianapolis reported $2.4 billion (those dollar amounts are in thousands) in long-term liabilities at the end of 2018. About half of that was in bonds payable, while the other half was in "net pension liabilities" and "postemployment benefits liability." In other words, the present value of pension and retiree health care benefit obligations was as big as the city's bonded debt.

The roughly $2.4 billion in long-term liabilities totalled in that footnote relate to, and help inform, the Statement of Net Position's simple presentation of long-term liabilities. One could argue that the actual balance sheet, which is already two pages long in this case, could benefit from more detail within the largest amount for liabilities, and not bury it down in the footnotes.

For Indianapolis, note that long-term liabilities added to other short-term debts lead to $2.5 billion. From there, liabilities and deferred inflows of resources are added together, and then subtracted from “assets and deferred outflows of resources” to arrive at the bottom-line “Total Net Position (Deficit).” For Indianapolis (the city, not including the component unit), the net position amounted to a negative $127 million. Viewing Indianapolis as a whole, and melding the city with its reported component unit (which is what we do for state and local governments, at Truth in Accounting), the net position was roughly flat, at a positive $50 million.

It should be noted, however, that there are two components to net position -- “restricted” and “unrestricted.” Some of the assets included in the net position calculation are restricted by law or contract to specific claims on the government. Subtracting those amounts leads to the “unrestricted” net position amount, which is probably the best indicator of the overall financial health of the enterprise. If that amount is negative, it is an amount that future taxpayers and/or citizens are on the hook for. That unrestricted net position provides a scorecard for “balanced budget” claims. Government’s that truly balance their budget don’t kick the can down the road for future constituents, and don’t accumulate large negative unrestricted net positions

Let’s take a sneak peek at the City of Chicago, to briefly compare Chicago to Indianapolis and introduce more fundamental topics to be developed below. We will look at Chicago’s footnote for long-term liabilities, and at the bottom half of its “Statement of Net Position.”

Here’s Chicago’s “long-term obligations” footnote:

10) **Long-term Obligations**

a) **Long-term Debt** activity for the year ended December 31, 2018 was as follows (in thousands):

	Balance January 1, 2018	Additions	Reductions	Balance December 31, 2018	Amounts Due within One Year
Governmental activities:					
Bonds and notes payable:					
General obligation and other debt	$ 9,609,424	$ -	$ 1,635,272	$ 7,974,152	$ 107,863
Line of Credit (LOC)	77,203	233,627	77,203	233,627	-
Total General Obligation Debt, other debt and LOC	9,686,627	233,627	1,712,475	8,207,779	107,863
Tax increment	27,925	-	7,980	19,945	3,750
Revenue	254,224	-	4,295	249,929	4,515
STSC	743,735	1,292,700	-	2,036,435	-
	10,712,511	1,526,327	1,724,750	10,514,088	116,128
Add unamortized premium/(discount)	88,675	110,062	40,439	158,298	-
Add accretion of capital appreciation bonds	315,863	29,175	21,553	323,485	22,293
Total bonds, notes and certificates payable	11,117,049	1,665,564	1,786,742	10,995,871	138,421
Other liabilities:					
Net pension liability	25,058,993	1,702,599	-	26,761,592	-
Other postemployment benefits obligation*	746,321	-	61,689	684,632	-
Pollution remediation	35,044	9,371	-	44,415	-
Claims and judgments	1,012,756	220,434	200,805	1,032,385	125,697
Total other liabilities	26,853,114	1,932,404	262,494	28,523,024	125,697
Total governmental activities	$ 37,970,163	$ 3,597,968	$ 2,049,236	$ 39,518,895	$ 264,118

Chicago's population is about three times as big as Indianapolis/Merion County, but at roughly $40 billion, it reports long-term liabilities more than fifteen times the amount reported by Indianapolis. For Chicago, at $11 billion, bonds payable are about 10 times as large as for Indianapolis. At $28 billion, Chicago's retirement benefit liabilities are about 20 times as high as for Indianapolis!

Here's a look at the net position section for Chicago's latest Statement of Net Position.

NET POSITION			
Net Investment in Capital Assets	(332,211)	4,298,879	3,966,668
Restricted for:			
Capital Projects	416,037	257,815	673,852
Debt Service	621,315	15,900	637,215
Special Taxing Areas	1,471,732	-	1,471,732
Passenger Facility Charges	-	231,621	231,621
Contractual Use Agreement	-	190,867	190,867
Airport General Fund	-	137,216	137,216
Customer Facility Charges	-	42,267	42,267
Other Purposes	-	60,854	60,854
Unrestricted (Deficit)	(32,304,567)	(4,472,398)	(36,776,965)
Total Net (Deficit)/Position	$ (30,127,694)	$ 763,021	$ (29,364,673)

In Chicago's case, the first column is for "government activities," the second column is for "business-type activities," and the third column is the total for "government-wide activities." In contrast to Indianapolis, which had a roughly-flat overall net position in 2018, and a $1 billion deficit in unrestricted net position, Chicago reported a nearly $30 billion overall net deficit in 2018, and an unrestricted net deficit of $37 billion.

Ouch. How did Chicago get there?

A much longer story to be developed below, but for now, this question introduces the third main element of the audited annual financial report to look at, when pressed for time and asked about the financial performance of state and local governments. We've briefly looked at the Statement of Activities and the Statement of Net Position, and a third thing to key in on resides in an unaudited section at the end of the annual report, called "Statistical Information."

The first table included in that section for Indianapolis is titled "Net Position by Component." It shows the development of the net position over the last 10 years. Here's what it looks like in Indianapolis' latest annual financial report:

CITY OF INDIANAPOLIS
Net Position by Component
Schedule 1
Last Ten Fiscal Years
(Accrual basis of accounting)
(In thousands)

	Fiscal Year									
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Governmental activities:										
Net investment in capital assets	$ 920,186	$ 961,358	$ 605,824	$ 621,413	$ 682,291	$ 604,736	$ 618,860	$ 658,793	$ 682,445	$ 706,470
Restricted	214,479	209,948	188,976	124,511	122,379	171,863	177,408	180,615	176,332	164,849
Unrestricted (deficit)	(416,849)	(534,850)	(274,303)	(337,574)	(441,977)	(505,392)	(1,141,617)	(980,497)	(1,016,080)	(998,291)
Total governmental activities net position (deficit)	$ 717,816	$ 636,456	$ 520,497	$ 408,350	$ 362,693	$ 271,207	$ (345,349)	$ (141,089)	$ (157,303)	$ (126,972)

The thing to focus on (with reader glasses and/or a magnifying glass, if necessary) is the unrestricted (deficit) line, which relates to the same element of the Statement of Net Position. You can see that for Indianapolis, the unrestricted amount stayed roughly flat from 2009 to 2014, consistent with "truly" balanced budgets keeping expenses in line with revenues, and not borrowing to make up the difference.

From 2014 to 2015, however, Indianapolis' unrestricted deficit more than doubled, to more than $1.1 billion (negative)! What happened? That wasn't a bad year for the economy.

The answer is that Indianapolis' financial condition didn't really deteriorate that much from 2014 to 2015. The "deterioration" happened because, in 2015, state and local governments finally had to report pension debt on their balance sheet!

After 2015, Indianapolis' unrestricted net position stayed roughly flat again, despite the fact that a couple of years after 2015, state and local governments had to add "OPEB" (Other Post-Employment Benefit) debts (principally retiree health care benefits) to their balance sheet as well.

In light of these accounting changes, then, Indianapolis appears to have effectively balanced its budget, in the sense that the management of budget intentions led to responsible outcomes, and avoided pushing the cost of past government activities on to future citizens and taxpayers.

How about the City of Chicago? How does that "Net Position by Component" table look, compared to Indianapolis? In Chicago's latest annual financial report, the table is at once easier and harder to read, compared to the table for Indianapolis. It is easier because the numbers are in a bigger font. But it is harder, because it breaks up the table and presents it on two pages.

Here it (they) is (are):

Table 1
CITY OF CHICAGO
NET POSITION BY COMPONENT
Last Ten Fiscal Years Ended December 31, 2018
(Amounts are in Thousands of Dollars)

	2009 (1)	2010	2011	2012
Governmental Activities:				
Net Investment in Capital Assets	$ 251,103	$ (324,284)	$ (299,859)	$ (215,961)
Restricted	3,735,128	3,611,533	1,596,408	1,908,516
Unrestricted (deficit)	(5,840,026)	(6,582,562)	(5,691,215)	(7,537,057)
Total governmental activities, net position	$ (1,853,795)	$ (3,295,313)	$ (4,394,666)	$ (5,844,502)
Business-type activities:				
Net Investment in Capital Assets	$ 2,286,658	$ 2,365,522	$ 2,451,787	$ 2,388,310
Restricted	821,909	790,881	874,837	982,517
Unrestricted	(1,541,136)	(1,431,859)	(1,541,515)	(1,354,572)
Total business type activities, net position	$ 1,567,431	$ 1,724,544	$ 1,785,109	$ 2,016,255
Primary Government:				
Net Investment in Capital Assets	$ 2,537,761	$ 2,041,238	$ 2,151,928	$ 2,172,349
Restricted	4,557,037	4,402,414	2,471,245	2,891,033
Unrestricted	(7,381,162)	(8,014,421)	(7,232,730)	(8,891,629)
Total primary government, net position	$ (286,364)	$ (1,570,769)	$ (2,609,557)	$ (3,828,247)

2013	2014	2015 (2)	2016	2017	2018
$ (242,862)	$ 28,744	$ (292,432)	$ (65,466)	$ (551,074)	$ (332,211)
1,940,911	1,491,995	1,519,914	2,269,517	2,416,071	2,509,084
(9,120,377)	(10,564,064)	(25,263,289)	(29,676,310)	(30,579,844)	(32,304,567)
$ (7,422,328)	$ (9,043,325)	$ (24,035,807)	$ (27,472,259)	$ (28,714,847)	$ (30,127,694)
$ 2,446,242	$ 2,713,825	$ 2,892,548	$ 3,373,063	$ 3,866,056	$ 4,298,879
883,758	978,972	1,042,980	879,934	868,021	936,540
(1,278,777)	(1,185,755)	(3,731,167)	(4,210,657)	(4,387,321)	(4,472,398)
$ 2,051,223	$ 2,507,042	$ 204,361	$ 42,340	$ 346,756	$ 763,021
$ 2,203,380	$ 2,742,569	$ 2,600,116	$ 3,307,597	$ 3,314,982	$ 3,966,668
2,824,669	2,470,967	2,562,894	3,149,451	3,284,092	3,445,624
(10,399,154)	(11,749,819)	(28,994,456)	(33,886,967)	(34,967,165)	(36,776,965)
$ (5,371,105)	$ (6,536,283)	$ (23,831,446)	$ (27,429,919)	$ (28,368,091)	$ (29,364,673)

For our purposes here, two items to focus on in the table(s) above are the bottom two line items -- for the total primary government net position (the very bottom line item) and the next line above it -- the unrestricted net position (deficit).

In contrast to Indianapolis, where the unrestricted position remained basically flat from 2009 to 2014, the unrestricted deficit for Chicago “rose” from a deficit of $7.4 billion in 2009 to $11.7 billion in 2014, an annual deterioration of nearly $1 billion in a city that *claims to balance its budget every year, according to state law!*

After 2014, in Chicago, the hammer dropped. In 2015, the unrestricted net deficit nearly tripled, falling $17 billion in a single year with the long-delayed arrival of massive pension debts on the balance sheet. As noted above with Indianapolis, Chicago’s net position didn’t “really” deteriorate that much in 2015, it was mainly due to an accounting change.

But note for now that Chicago’s unrestricted net position continued to deteriorate after 2015, all while city leaders claimed “balanced budgets” (see below). In fact, the deterioration in its net position actually accelerated.

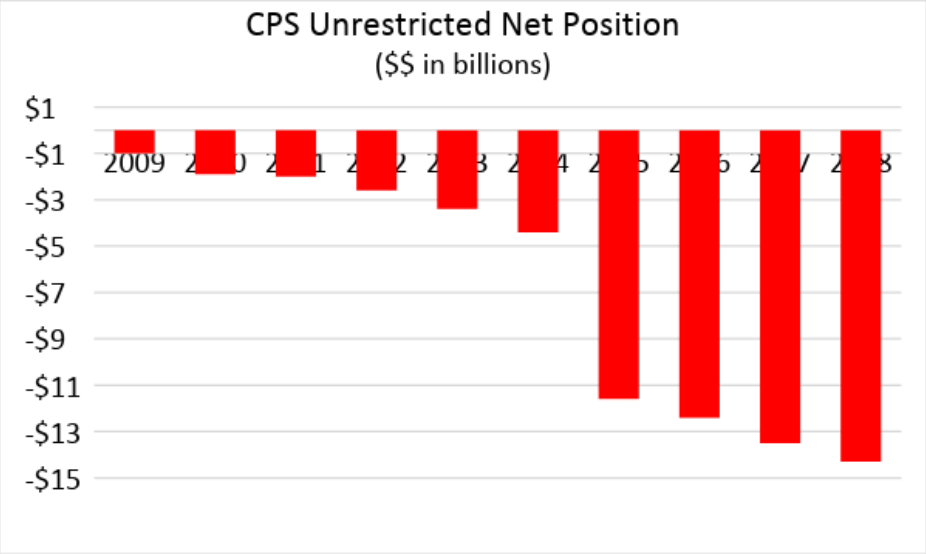
Parenthetically, it is worthy to note that not all cities are alike in how they present what is or isn’t “city” government in their CAFRs. The City of Chicago, for example, does not

consolidate the Chicago Public Schools (CPS) in its “government-wide” financial statements, while New York City does include the city school system. This is one fly in the ointment for making apples-to-apples comparisons, but I make this point now for another reason to question cash-based “funds” accounting.

Back in early 2019, the CPS released their own Comprehensive Annual Financial Report. The CPS CAFR is structured just like the CAFR for the State of Illinois, City of Chicago, or other state and local government entities. It includes a Statement of Net Position, Statement of Activities, and various funds accounting statements like the ones I just described.

When the 2019 CAFR for CPS came out, a hard-copy version of an article in the local media was headlined “CPS Finishes Year With Surplus as CTU Talks Get Going.” Chicago Sun-Times education reporter Mitchell Armentrout wrote that CPS administrators “offered some rare positive news,” as the year ended with $324 million “left over in CPS’s general operating fund.” Armentrout included favorable impressions offered by the CPS controller, the Chicago Teachers Union president, and the president of the Chicago Board of Education.

As we’ve noted, however, in a world where borrowing proceeds can serve as “revenue” for funds accounting purposes, general fund “surpluses” aren’t necessarily good news. Here’s what CPS’s unrestricted net position looked like in the years leading up to, and including, the year with that “rare positive news.”



Granted, that swan dive in 2015 didn't "really happen," as CPS like other state and local government entities began to reflect pension liabilities. But the net position was deteriorating, consistently, in the decade before the "rare positive news."

So, what have we learned so far? This section of the paper introduced four elements in the audited annual financial statements that can be used to measure the results from state and local government budgeting practices. They were the Statement of Activities, the Statement of Net Position, the "Long-Term Liabilities" footnote for the Statement of Net Position, and the "Net Position By Component" section of the "Statistical Section." All four of these elements are present, and available, in the Comprehensive Annual Financial Reports (CAFRs) required for all state and local governments.

State and Local Government Accounting Issues

While CAFRs are better than budgets, state and local government financial reports are not to be mistaken for "truth." It depends on how you count. Two plus two may always equal four, but if you are adding two "debts" to two other "debts" without counting other debts that should be counted as debts, your "accurate bottom line" (four) may not truthfully represent total debt.

In recent years, the standards have improved, but changing the yardsticks revealed truths that should have been more evident earlier. The regime change also made it harder for the average citizen to interpret trends in financial statements.

In some important ways, the recent "improvement" in municipal accounting remains incomplete. The continuing afflictions relate more directly to understanding the differences between budget accounting and the financial reporting in the Comprehensive Annual Financial Reports (CAFRs).

With the recent changes to accounting standards for employee retirement benefits, the Governmental Accounting Standards Board (GASB) has valuably oriented the foundations for the Statement of Activities and the Statement of Net Position in more truthful "accrual-based" vs. "cash-based" accounting principles. Accrual accounting does not focus on the timing on cash inflows and outflows, when measuring revenues and expenses. Cash is important to watch, to be sure, but a myopic view of cash (and/or 'financial resources', see below) trends as "results" can ignore the accrual of real expenses (and debts).

Longer story short, for years, many state and local governments have effectively "balanced the budget" by planning to run up the credit cards. And while the GASB has improved the truthfulness of the results indicated in the Statement of Activities and Statement of Net Position, the standards relating to subsidiary "funds" accounts (like the "general fund") remain on unreliable cash-based, not accrual-based, accounting principles. Those funds accounts are also reported in the CAFRs, and many state and local governments gear their budgets to the funds accounts, often the general fund, not the overall results in the Statement of Activities or Statement of Net Position.

Consider the State of Illinois. In the 2018 CAFR, below the main financial statements, two other important statements are next -- the "Balance Sheet - Governmental Funds" and the "Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds." The "governmental funds" include three main funds, and the "general fund" is the biggest one and the one we will focus on for now.

Here is the "Balance Sheet -- Governmental Funds." Note the irony that we are now getting a balance sheet soon after seeing another one, in the more-reliable "Statement of Net Position."

Have you ever heard warnings about organizations that keep "two sets of books?"

State of Illinois

Balance Sheet - Governmental Funds

June 30, 2018 (Expressed in Thousands)

	General Fund	Road Fund	Other Nonmajor Funds	Total Governmental Funds
ASSETS				
Cash equity with State Treasurer	$ 2,022,385	$ 755,743	$ 7,276,877	$ 10,055,005
Cash and cash equivalents	7,322	25,090	361,951	394,363
Securities lending collateral of State Treasurer	2,645,893	259,089	1,071,932	3,976,914
Investments			55,988	55,988
Receivables, net:				
Taxes	1,845,437		526,445	2,371,882
Intergovernmental	2,284,410	172,820	830,093	3,287,323
Other	607,500	12,017	641,570	1,261,087
Due from other funds	290,414	73,441	770,893	1,134,748
Due from component units	8,321	91,718	336,138	436,177
Inventories	22,401	51,521	47,607	121,529
Loans and notes receivable, net	5,547	55	50,843	56,445
Other assets	15,000		41,842	56,842
Total assets	9,754,630	1,441,494	12,012,179	23,208,303
DEFERRED OUTFLOWS OF RESOURCES				
Deferred outflows of resources - intra-entity transfers of future revenues			505,078	505,078
Total deferred outflows of resources			505,078	505,078
Total assets and deferred outflows of resources	$ 9,754,630	$ 1,441,494	$ 12,517,257	$ 23,713,381
LIABILITIES				
Accounts payable and accrued liabilities	$ 5,748,478	$ 268,301	$ 722,303	$ 6,739,082
Intergovernmental payables	2,568,867	110,408	1,882,350	4,561,625
Due to other funds	4,160,138	233,779	489,790	4,883,707
Due to component units	116,841	147,770	68,915	333,526
Unearned revenue	850,997	13,115	337,819	1,201,931
Obligations under securities lending of State Treasurer	2,645,893	259,089	1,071,932	3,976,914
Matured portion of long-term liabilities	20,710	218		20,928
Total liabilities	16,111,924	1,032,680	4,573,109	21,717,713
DEFERRED INFLOWS OF RESOURCES				
Deferred inflows of resources - unavailable revenue	1,405,999	21,053	795,762	2,222,814
Deferred inflows of resources - intra-entity transfers of future revenues			505,078	505,078
Total deferred inflows of resources	1,405,999	21,053	1,300,840	2,727,892
FUND BALANCES (DEFICITS)				
Nonspendable - long-term portion of loans and notes receivable	5,547			5,547
Nonspendable - inventories	22,401	51,521	47,607	121,529
Nonspendable - endowments and similar funds			50,834	50,834
Restricted	89,798	24,430	4,291,964	4,406,192
Committed	1,923,096	311,810	3,120,311	5,355,217
Unassigned	(9,804,135)		(867,408)	(10,671,543)
Total fund balances (deficits)	(7,763,293)	387,761	6,643,308	(732,224)
Total liabilities, deferred inflows of resources and fund balances (deficits)	$ 9,754,630	$ 1,441,494	$ 12,517,257	$ 23,713,381

In 2018, Illinois reported a fund balance (deficit) of ($7.8 billion) in the general fund, but a deficit of “only” $700 million for governmental funds total (note for now that the $700 government-wide deficit pales in comparison to the $211 billion in unrestricted net position reported on Illinois’ overall Statement of Net Position.) Those fund balance amounts are at the end of the year, and the next table shows how things changed during the year, to get to those end-of-year amounts.

State of Illinois

Statement of Revenues, Expenditures and Changes in Fund Balances - Governmental Funds

For the Year Ended June 30, 2018 (Expressed in Thousands)

	General Fund	Road Fund	Other Nonmajor Funds	Total Governmental Funds
REVENUES				
Income taxes	$ 19,899,284		$ 2,487,137	$ 22,386,421
Sales taxes	8,155,648		3,695,035	11,850,683
Motor fuel taxes		$ 307,127	1,015,265	1,322,392
Public utility taxes	940,909		473,593	1,414,502
Riverboat taxes			469,363	469,363
Medical providers assessment taxes	1,586,240			1,586,240
Other taxes	2,415,942		496,053	2,911,995
Federal government	13,597,331	1,318,455	8,398,568	23,314,354
Licenses and fees	619,611	945,186	1,202,409	2,767,206
Interest and other investment income	68,046	9,335	40,825	118,206
Other	1,003,886	135,056	954,288	2,093,230
Total revenues	48,286,897	2,715,159	19,232,536	70,234,592
EXPENDITURES				
Current:				
Health and social services	23,184,588		5,650,927	28,835,515
Education	17,497,294		2,679,050	20,176,344
General government	2,047,019	396	484,319	2,531,734
Employment and economic development	133,870		636,836	770,706
Transportation	558,448	1,885,245	714,565	3,158,258
Public protection and justice	2,785,855		588,424	3,374,279
Environment and business regulation	162,894		590,550	753,444
Debt service:				
Principal	3,055	291	2,333,761	2,337,107
Interest	500	277	1,611,661	1,612,438
Capital outlays	54,147	609,751	701,708	1,365,606
Intergovernmental			5,917,915	5,917,915
Total expenditures	46,427,670	2,495,960	21,909,716	70,833,346
Excess (deficiency) of revenues over (under) expenditures	1,859,227	219,199	(2,677,180)	(598,754)
OTHER SOURCES (USES) OF FINANCIAL RESOURCES				
General obligation bonds issued	6,000,000		1,250,000	7,250,000
Premiums on general obligation bonds issued	502,402		57,268	559,670
Revenue refunding bonds issued			670,965	670,965
Premiums on revenue refunding bonds issued			90,805	90,805
Transfers-in	2,168,549	1,110	4,830,495	7,000,154
Transfers-out	(3,684,913)	(589,270)	(1,977,191)	(6,251,374)
Payments to refunded bond escrow agent			(756,954)	(756,954)
Capital lease financing	3,089	174	6,020	9,283
Net other sources (uses) of financial resources	4,989,127	(587,986)	4,171,408	8,572,549
Net change in fund balances	6,848,354	(368,787)	1,494,228	7,973,795
Fund balances (deficits), July 1, 2017	(14,611,613)	768,691	5,122,672	(8,720,250)
Increase (decrease) for changes in inventories	(34)	(12,143)	26,408	14,231
FUND BALANCES (DEFICITS), JUNE 30, 2018	$ (7,763,293)	$ 387,761	$ 6,643,308	$ (732,224)

This statement is in an “income statement” format, subtracting expenditures (note: “expenditures” are not “expenses”) from revenues. But there is another interesting section below the expenditures section, titled “Other Sources (Uses) of Financial Resources.”

In 2018, the State of Illinois reported $88.3 billion in total “revenue” for its general fund, including $20 billion in income taxes, $13.6 billion in “federal government revenue,” and $8.2 billion in sales taxes. Illinois reported $46.4 billion of “expenditures” in the general fund, so “revenue” apparently exceeded “expenditures,” at least in the general fund. But

further down, we see that next section about sources and uses of other financial resources. In 2018, in the general fund, we see that Illinois found another $5 billion in net “financial resources,” leading to a $6.8 billion improvement in the overall general fund balance.

Adding other funds to the general fund, you get to the overall “Governmental Funds” amounts over there on the right of this statement. The consolidated funds didn’t fare as well as the general fund, apparently, as total revenues were modestly (about $600 million) below expenditures. Like the general fund, however the overall governmental funds increased significantly during the year, after considering other sources and uses of financial resources. And the overall governmental funds balance improved markedly, apparently, a beginning-of-year deficit of $8.7 billion to a deficit of only $700 million.

Did Illinois “balance its budget” in 2018?

It depends on how you count.

We will examine Illinois more closely below. For now, consider that the apparent improvement in Illinois’ funds balances arrived importantly with borrowing proceeds, and that the difference between expenditures and revenues in the funds accounts was dramatically lower than the difference between expenses and revenues in the more accrual-accounting-based Statement of Activities.

Truth in Accounting has long called for “F.A.C.T. Based Budgeting.” Developed by Truth in Accounting’s CEO and founder Sheila Weinberg, the “F.A.C.T.” in the proposal stands for “Full Accrual Accounting and Techniques.” These principles would constrain practices like treating borrowing proceeds as revenue, and paying less-than-actuarially sound amounts into pension plans to keep “expenditures” below actual accrual expenses. These changes would require further changes to GASB accounting standards. Those standards help grease the wheels for government funds accounting to show “results” in line with less-than-truthful budgeting communications.

Case Study 1: The City of Chicago

On October 15, 2014, the Office of the Mayor of the City of Chicago issued a press release titled “Mayor Emanuel Presents Balanced 2015 Budget to City Council.” The press release featured some quotes from the Mayor:

> “To balance our budget for the past three years without any increase in property, sales or gas taxes was only possible by changing the way Chicago does its business,” Mayor Emanuel said. “We have reduced our structural deficit by making city government smaller, smarter, and simpler.”

These claims were issued four months before Emanuel’s reelection in early 2015, and were repeated in the local media. How did they square with results -- in those past three years he was referring to, as well as in fiscal 2015, the year to which that budget applied?

In Chicago, the mayor develops a budget proposal, and submits it to the City Council. The final budget must be approved in the City Council before the end of the year, and it relates to the following year, based on appropriations and anticipated inflows. That is the first wrinkle in comparing budgets to results. Budgets aren’t the reality for the period they anticipate -- they are projections, and plans, for what ends being reality.

In the 2014 CAFR for the City of Chicago, table 4A in the Statistical Section provides a first answer to determining how accurate Mayor Emanuel’s claim was. This table, titled “Changes in Fund Balances -- Governmental Funds,” shows that revenue fell short of “expenditures” by $764 million in 2011, $750 million in 2012, $751 million in 2013, and $1.1 billion in 2014, the year in which he made that claim. The bottom of that table shows that Chicago issued about $3.2 billion in new debt in those four years, helping cushion the decline in fund balances.

But debt proceeds aren’t revenue, at least in the private sector, and it gets worse.

On Chicago’s Statement of Activities, total reported expenses steadily rose from $6.8 billion in 2011 to $7.4 billion in 2014. Over the same time frame, general revenue (mainly taxes) also rose, from $4.0 billion to $4.3 billion. This isn’t consistent with a government getting “smaller, smarter and simpler,” but the deeper problem deals with the *difference* between expenses and revenue on the Statement of Activities. From 2011 to 2014, the change in net position (recall that is calculated as net expenses less general revenues) clocked in at $1.0 billion (negative) in 2011, $1.2 billion (negative) in 2012, $1.1 billion (negative) in 2013, and $1.2 billion (negative) in 2014 -- a cumulative $4.5 billion in four years leading up to Emanuel’s “balanced budget” claim.

Then in 2015, after Emanuel’s re-election, the bottom fell out. Chicago (like all other state and local governments) began to reflect its pension liabilities on the balance sheet. Chicago’s overall net position fell from $6.5 billion (negative) in 2014 to $23.8 billion

(negative) in 2015. And on the Statement of Activities, the (negative) change in net position ballooned from $1.2 billion in 2014 to $5.4 billion (negative) in 2015. Chicago changed the assumptions for its estimate for its pension debt, after an Illinois Supreme Court decision ruled changes to Chicago's pension plan unconstitutional, and had to reflect those changes in assumptions in the income statement.

How truthful was Emanuel? If budgets are more about painting pictures than revealing reality, he wasn't necessarily untruthful. He really balanced the budget. Trouble is, the budget didn't reveal or reflect the reality of Chicago's deteriorating financial condition.

As noted above, Chicago claims to balance its budget "according to state law." And the Illinois Constitution provides what is called a "balanced budget" requirement for the state itself. But here are some of the words in that constitutional provision (to be found in the "Article VIII-Finance" section).

> "The Governor shall prepare and submit to the General Assembly, at a time prescribed by law, a State budget for the ensuing fiscal year. … Proposed expenditures shall not exceed funds estimated to be available for the fiscal year as shown in the budget."

If you read those words carefully, in light of the argument being developed in this paper, you can see a red flag or two. The budget is to be prepared and submitted, but for the ensuing year. The requirement is framed in terms of "expenditures," not "expenses." And to "proposed" expenditures, which are not to exceed "funds estimated to be available … as shown in the budget."

Those funds "estimated to be available" are not current funds, and they can include funds made available by plans to borrow more money.

In turn, that constitutional provision reads:

> "The General Assembly by law shall make appropriations for all expenditures of public funds by the State. Appropriations for a fiscal year shall not exceed funds estimated by the General Assembly to be available during that year."

Here the General Assembly is "constrained" by the same malleable language.

This is the broader legal environment framing the regular failure of the State of Illinois, and the City of Chicago, to keep accrual expenses in line with or below revenues.

Chicago is only one of thousands of city governments. But it offers a powerful cautionary note, and an example why accrual-based budgeting can provide a step in the right direction.

Note that I just referred to “accrual-based budgeting,” not “GAAP-based budgeting.” “GAAP” stands “generally accepted accounting principles,” which are set for state and local governments by GASB. The next example, New York City, offers cautionary notes that “GAAP-based budgeting” may not necessarily provide a step in the right direction.

Case Study 2: New York City

Back in 1975, New York City was near bankruptcy. After a flurry of state, federal and private sector initiatives, reforms were imposed. One of them is still cited as a source of strength in New York City’s budgeting process, and a good example for other state and local governments. It is called “GAAP-based budgeting.”

In September 1975, the State of New York enacted a law titled the “Financial Emergency Act of The City of New York.” This legislation created a new state “Financial Control Board” that oversaw New York City (NYC) financial operations. Among other oversight and enforcement authorities, NYC was subject to new “balanced budget” requirements, including budgets balanced “in accordance with generally accepted accounting principles.” And in 2005, those provisions were amended to include:

> “Requirement to end the year with a GAAP-basis balanced budgeted (the Charter previously only required adoption of a balanced budget), with no provision for an operating deficit of any size …”

So here we have a tougher benchmark, it would appear. It didn’t just apply to budgets established at the beginning of the year, it applied to year-end “results.” At least, to “results” in the budget.

New York City leaders have long cited these practices as evidence of learning the lessons from the 1975 near-bankruptcy, and a source of continuing discipline in city financial management today. Consider the comments by New York City’s comptroller Scott Stringer, in a city report titled “Measuring New York City’s Budgetary Cushion” from August 2015:

> “New York City however, is required to balance its operating budget according to generally accepted accounting principles (GAAP) which mandates that revenues in a given year must equal or exceed expenditures in the General Fund in that year … While all governments in the country practice GAAP accounting, New York City is the only major government in the country subject to GAAP budgeting”

And in delivering his 2018 budget, New York City Mayor Bill de Blasio said “This is the thirty-eighth consecutive budget which is balanced under Generally Accepted Accounting Principles (GAAP).”

But as we have learned, expenditures aren’t necessarily expenses. And a positive or improving balance in the General Fund isn’t necessarily improvement in a government’s overall financial condition.

From 2010 to 2019, a period that marked by a recovery from the worst financial and economic crisis since (at least) the Great Depression, and a recovery in a city central to that crisis, the change in net position reported for New York City’s Statement of Net Position was negative (a deficit) in eight of those ten years. The total change in net position, which started in a negative position at the beginning of that decade, was another negative $37 billion -- in a city that claims to balance its budget under “GAAP based budgeting.”

Because fund accounting is driven by GAAP, “GAAP budgeting” may help explain how government officials can regularly claim to balance their budgets, even while spending regularly runs ahead of revenue in their accrual accounting results.

50 State Review -- Budget Practices

The State of New York, the State of Illinois, New York City and the City of Chicago all have large governments. And these four entities are each in relatively bad financial shape. But now, we step back and look at a bigger picture, comparing budget practices (and results) across all 50 state governments in the United States.

As we’ve noted, 49 of the 50 states have some form of balanced budget requirement, either in the state constitution or in laws enacted under those fundamental charters. All

50 states are not alike, however, in the wording of those legal requirements. They vary, in other words, in how binding or effective they are.

This paper will not conduct an original analysis of the text and impact of those requirements. It will, however, explore and report on the results of an annual review of budgeting practices across the 50 states that is conducted by the Volcker Alliance. In turn, we will review those assessments in light of economic, demographic and financial characteristics for the states.

Paul Volcker, former Chairman of the Federal Reserve Board of Governors, started the nonprofit Volcker Alliance in 2013, with a state mission "to advance effective management of government to achieve results that matter to citizens." Among other projects, leaders there have issued regular state budget analysis reports titled "Truth and Integrity in State Budgeting." The most recent report, issued two months ago, was subtitled "The Balancing Act."

For its overall framework, the Volcker Alliance analyzes five budget practices areas that it calls "budget forecasting," "budget maneuvers," "legacy costs," "reserve funds," and "budget transparency."

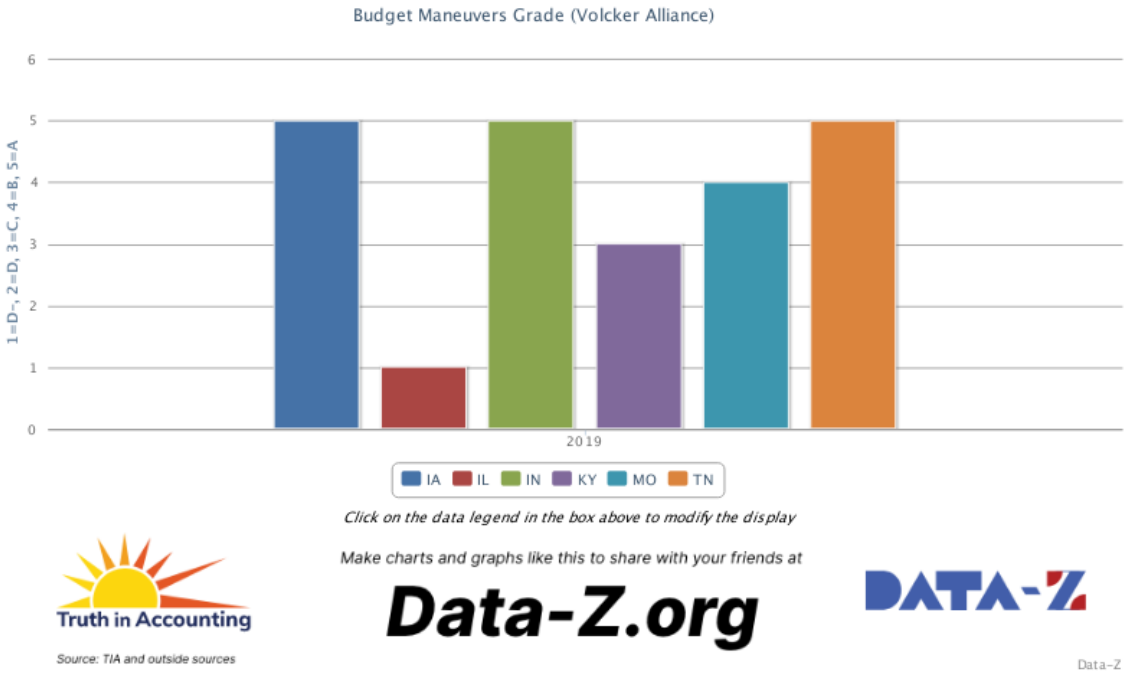
> **Budget forecasting.** Whether and how states anticipate future revenue and expenses.
>
> **Budget maneuvers.** Whether and how often states rely on one-time and/or special sources to "balance budgets."
>
> **Legacy costs.** How well states are funding the accumulation of retiree benefit obligations.
>
> **Reserve funds.** Whether and how well states manage any "reserves" or "rainy day" funds.
>
> **Budget transparency.** How well states disclose budget information to their citizens, with an interesting and important emphasis on assessments of disclosure of costs for deferred infrastructure maintenance.

Truth in Accounting gathers and tracks the grades the Volcker Alliance assigns the 50 states in these five categories, along with hundreds of other financial, economic and

demographic indicators, in its "Data-Z" facility. This website provides free charting tools and, for subscribers, access to speadsheets with historical data for all of these indicators.

For a quick introduction to that charting tool, using Volcker Alliance grades to compare some neighboring states, follow the following steps:

1) Go to the Data-Z website.
2) Hover over the "Charts" tab at the top of the front page, and select "Create Your Own State Chart."
3) In "Step 1: Select Your States," select Illinois, Indiana, Iowa, Kentucky, Missouri and Tennessee.
4) In "Step 2: Select Your Time Series," scroll down to "State Financial Data" and select the "Budget Maneuvers Grade (Volcker Alliance)" from the "Other" section at the bottom.
5) In "Step 3: Select Years," Chose "2019."
6) Click "Generate Chart." This is the chart that should appear, like the one below.

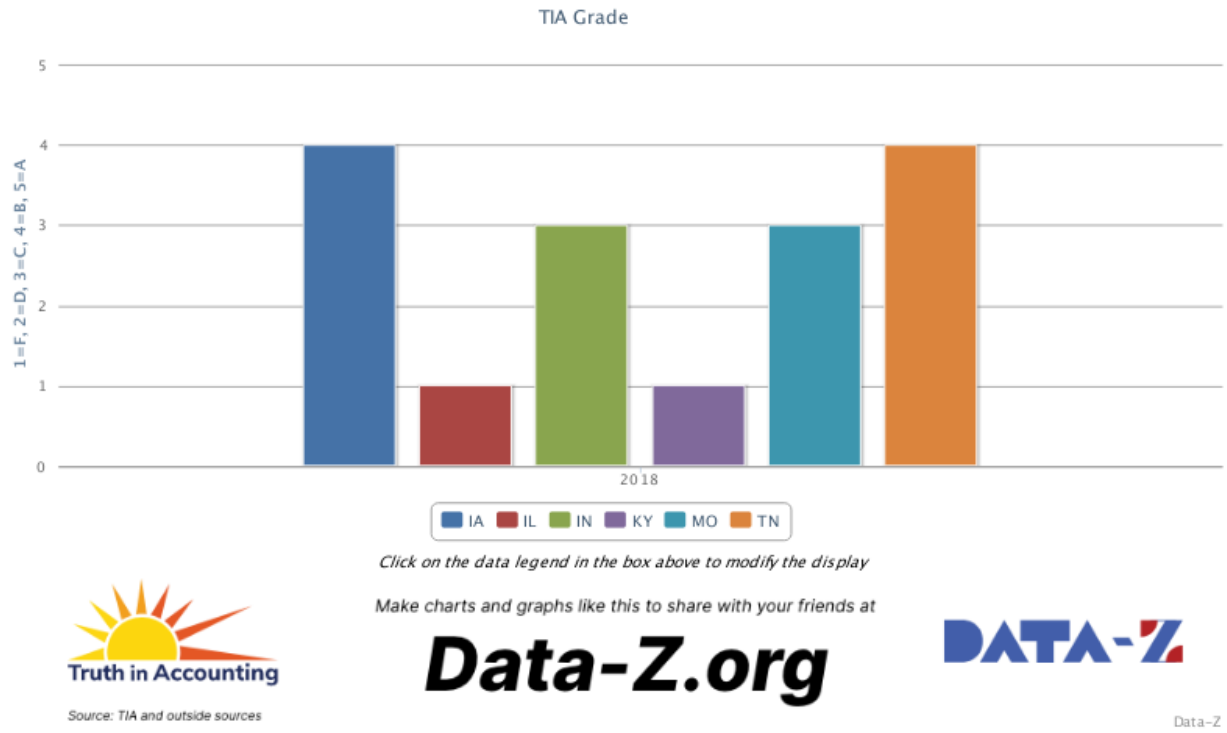


The Volcker Alliance grades the states on those five budgeting practices, with grades ranging from A to D- (the lowest). For those six states in the chart, Illinois graded the

lowest in the 2019 analysis, while neighbors Indiana, Iowa and Tennessee all ranking at the top with grades of A.

The Volcker Alliance does not issue overall “budget” grades for the states, but it does include state “report cards” with their grades on each of those five elements, allowing comparisons across states.

Truth in Accounting has also been issuing grades for the states, based not on their budgeting practices but their overall financial condition (the results), and since 2015. Here’s a look at Truth in Accounting’s grades for those six states that are graded on their “budget maneuvers” in the chart above.



Pretty consistent with the pattern in the grades for budget maneuvers, Illinois ranks the lowest, getting the lowest grade on its financial condition (along with Kentucky) among those six states. And Iowa and Tennessee rank the highest, followed by Indiana and Missouri.

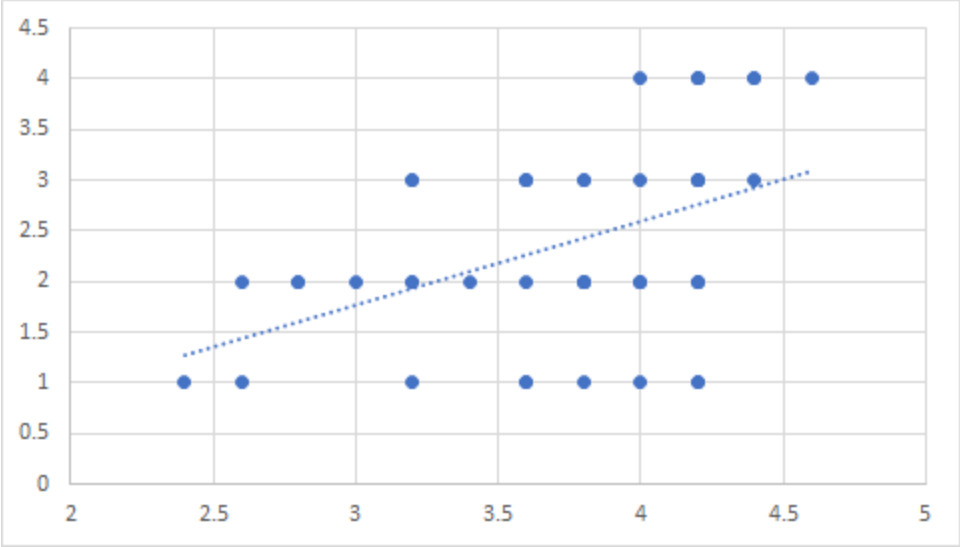
Here we have a hint that a) states that do well on “budget maneuvers” as graded by the Volcker Alliance tend to have better financial conditions, as measured by Truth in Accounting, and more importantly b) that Truth in Accounting’s Data-Z website provides

a rich set of tools for analyzing the context for state (and local and federal) government financial conditions.

For high school economics classes, these tools can introduce statistical analysis topics like correlation and regression analysis, and bring them to life in interesting if not exciting ways.

Here's one example, again focusing on the Volcker Alliance budget grades. With the data download feature at Data-Z, we can download all five of those grade elements, and then begin to explore the relationships between "the words" (the budgets) and "the deeds" (results, as indicated by Truth in Accounting's grades).

Here's a look at a scatter plot comparing the states on the simple average for the five Volcker Alliance budget element grades (on the bottom or "x-axis") together with their grades from Truth in Accounting on their financial condition (Alaska, Wyoming, and North Dakota, special energy cases, are excluded from the picture). The loose but general tendency is -- states that budget well, according to the Volcker Alliance, tend to be in better financial condition, as graded by Truth in Accounting.



Which of those five elements have the strongest correlation with state financial condition, and which have the weakest correlation? Here they are, ranked from highest to lowest correlation:

Volcker Element	Correlation with TIA Grade
Legacy costs	0.61
Budget maneuvers	0.46
Reserve funds	0.16
Budget forecasting	-0.16
Transparency	-0.30

The two strongest, or most significant, correlations deal with how well states fund retiree benefits, and whether and how the state engages in special budget maneuvers to artificially balance the budget. Interestingly, the Volcker Alliance grades for reserve funds is insignificantly related to state financial conditions, consistent with skepticism that reserve funds may not be as important as they are sometimes stressed in the media, given how small they are relative to overall debt obligations. Another interesting result is that there are actually negative correlations, albeit not especially significant ones, for the Volcker Alliance "budget forecasting" and "transparency" assessments with TIA grades.

Here's a look at the top ten and bottom ten states on their average Volcker Alliance grades for all five of those elements. They are ranked on the Volcker Alliance average grade, but also reported next to the state is Truth in Accounting's "Taxpayer Burden" measure of state financial condition, to be discussed below.

Top 10

1	Utah	$5,300
2	Tennessee	$2,800
3	South Dakota	$2,800
4	Oklahoma	-$1,200
5	West Virginia	-$8,300
6	Washington	-$7,400

7	Oregon	$1,600
8	North Carolina	-$1,300
9	Nebraska	$2,000
10	Minnesota	-$200

Bottom 10

1	Illinois	-$52,600
2	Kansas	-$7,000
3	New Jersey	-$65,100
4	Ohio	-$6,600
5	Pennsylvania	-$17,100
6	New Hampshire	-$5,000
7	Alabama	-$12,000
8	Arkansas	-$2,300
9	Massachusetts	-$31,200
10	Missouri	-$4,300

The top 10 Volcker Alliance grade states have an average Taxpayer Burden of $390, compared to the average of $20,320 for the bottom 10 states. The top 10 states are actually evenly split between states with Taxpayer Surpluses and Taxpayer Burdens, while all 10 of those bottom 10 Volcker Alliance states have taxpayer burdens.

It should be recognized that TIA grades are based on financial conditions that are the product of financial practices that have been years, if not decades, in the making. The comparisons above are related to Volcker Alliance assessments for a single year, the latest one (2018) for which state financial data are available for TIA to grade for all the states. With the dawning realization of how severe the retirement benefit and related

debt crisis has become, some states could well be improving their budgeting practices, compared to the past.

Let's briefly look at another way to assess the outcomes of state budgeting practices, and whether states truly "walk the talk" in their budget-balancing.

Fifty State Review -- Results in Financial Statements

In the Data-Z website facility, Truth in Accounting gathers a wide range of financial information, from audited financial statements in CAFRs as well as other sources. For the CAFR data, we carefully collect different sources of revenue and expenses from the Statement of Activities, for all 50 states as well as the 75 largest cities in the country. We also collect revenue, expense, and net expense totals, and track "net revenue" (general revenue less net expenses, of the "change in net position" going back annually to 2005.

As discussed above, states that are truly walking the talk and balancing their budget in practice, not just in theory, end up more-or-less consistently reporting net expenses in line with or below general revenue. In a complicated world, this leads to a relatively easy and valuable way to track states (and cities). We can download the "net revenue" reported in Data-Z for each state going back to 2005, and construct (in a spreadsheet) a simple "if-then" statement -- in the period at issue, is net revenue negative or positive? If positive, general revenue exceeded net expenses, indicating the government did the deeds, not just the words.

Here's a table showing 47 states (except Alaska, North Dakota, and Wyoming) allocated into seven buckets, based on their frequency of having general revenues at or above net expenses annually from 2005 to 2019. The "buckets" are ranked from top to bottom with the states most frequently "balancing their budgets" in practice at the top, running down to the bottom of the list. The "BB FREQ" column is the percent of the 14 years that general revenue exceeded net expenses. The "TIA TB" is the average "Taxpayer Burden" measure of overall financial condition, as measured by Truth in Accounting. The "VA GRADE" column is the average grade for those states' budgeting practices, as given by the Volcker Alliance. The "# STATES" column is the number of states in each category.

"BB" FREQ	TIA TB	VA GRADE	# STATES
100%	-$1,400	4.1	3
93%	-$1,654	3.8	13
86%	-$8,730	4.0	10
79%	-$3,417	3.6	6
64% to 71%	-$15,280	3.6	5
50% to 57%	-$22,950	3.9	6
14% to 43%	-$50,175	3.0	4

There is a strong relationship between “walking the talk,” at least on the Statement of Activities, and state financial conditions, as measured by Truth in Accounting. The average per-taxpayer burden clearly worsens, significantly, as you move down the list in terms of frequency. There is also a tendency, albeit less clear-cut, for states with more frequent positive “net revenue” results to earn higher grades from the Volcker Alliance, but as we noted above the Volcker Alliance grades are only for a single recent year.

The 16 states in the top two categories in the “balanced budget frequency” table above are Utah, Maine, Montana, Arkansas, Florida, Idaho, Iowa, Missouri, Nebraska, Nevada, North Carolina, Ohio, South Dakota, Tennessee, Texas, and Virginia.

The 4 states at the bottom of the list are New Jersey, Illinois, Massachusetts, and Connecticut. Just above them, in the next-worst category, are six more states -- Louisiana, Kentucky, Hawaii, Delaware, New York, and Maryland. These 10 states have accumulated markedly higher Taxpayer Burdens than the other states, posing consequences for future citizens and taxpayers that face the prospect of paying for past shortfalls in fiscal responsibility.

States that truly “balance the budget” tend to be in better shape than the ones that don’t. This observation opens the door into considering what other factors might be associated with state government financial conditions, from either a “causation” or “consequence” perspective. This opens the door into high school economics classrooms for the practical application of economic reasoning, and an introduction to the fundamentals of econometrics.

One always has to caution that “correlation is not causation,” but here are six tendencies that help explain how governments vary in their financial conditions. The data for these factors have all been collected in Truth in Accounting’s Data-Z website:

Balanced Budget Frequency: States that regularly keep net expenses in line with or below general revenue tend to be in better financial condition than those that don't.

Medicaid Enrollment Share of Population: States with higher shares of the total population enrolled in Medicaid tend to be in worse financial condition.

Government Employment Unionization. States with higher shares of the government workforce covered by collective bargaining agreements tend to be in worse financial condition -- curiously, in important part because employee retirement benefit obligations are so poorly funded.

Gerrymandering. There are a variety of ways in which strategic political districting can be mathematically measured, and the tendency is, states with more gerrymandering tend to be in worse shape, financially.

Lawyers per 10,000 Residents. States with more "active and resident" lawyers on per capita basis tend to be in worse shape, financially.

Age of the State. Older states tend to be in worse shape, financially, than younger states.

These six tendencies open the door to potentially energetic inquiry and/or debate, and they also underscore my recommendation to introduce high school students to the "public choice school of economics" below. For now, however, here are six more tendencies that can be asserted to be in the area of "consequences" of state government financial conditions.

Migration Trends. There is a strong tendency here. States that measure up well on Truth in Accounting's Taxpayer Burden are showing stronger inmigration, while states in poor financial condition are witnessing higher net outmigration in recent years.

Recovery in Housing Prices Since 2009. Consistent with population and migration trends, states in better financial condition tend to have posted better recoveries in housing markets since the 2007-2009 housing and financial meltdown.
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Economic Growth. States with relatively good finances have been experiencing better economic growth in recent years. There is some "chicken-or-the-egg" uncertainty in this and other "consequence" tendencies, as state finances are helped by economic growth. But the financial conditions measured in TIA's Taxpayer Burden are the product of long-term financial management practices, much more so than recent economic growth.

Nonprofits Reporting Late Payment Issues. The Urban Institute has conducted past surveys of nonprofits that contract with state and local governments to provide social services to the poor and needy. States in bad financial condition also tend to be states that rank poorly on nonprofit concern for the timeliness of government payments for their services. This tendency underscores how government financial conditions for citizens more broadly, not just taxpayers. So does the next tendency.

Doctors Accepting New Medicaid Patients. Studies show that financially troubled states tend to have a significantly lower share of doctors accepting new Medicaid patients.

Trust in Government. In perhaps the most interesting, sad, and compelling "consequence" tendency of all, the results in Gallup polls of trust in state government clearly indicate that states in poor financial condition, and the ones that don't truly "balance the budget," rank more poorly on trust in state government.

Perspective From the Public Choice School of Economics

In this paper, I developed a framework for evaluating budgets in light of results. I identified states with relatively good results, and those that persistently failed to live up to the spirit of "balanced budget" requirements. I also briefly introduced you (and over time, your students) to Truth in Accounting's Data-Z website, which can be used to compare, contrast, and analyze state (and city) governments. This introduction can lay the basis for a series of future papers, and the development of exercises and group projects for the classroom.

Stepping back for a moment, let's briefly reflect on a question. Why do budgets get so much attention, compared to government annual financial reports? For example, at the federal level, major newspapers regularly spill a lot of ink on the budget of the U.S.

government, when it is proposed as well as developed over time. But when the latest annual financial report of the US government arrived in early March, about six weeks ago, it arrived to deafening silence. No major newspaper reported on the results.

The same tendency holds in state and local governments. Why?

An important part of the answer lies in a fascinating area of economics -- the public choice school of economics. This field starts with some of the basic assumptions in economics about human behavior, including an assumption that people tend to be “rational” in the sense they are self-interested, and try to make themselves better off. From there, public choice theory provides perspective for how special interest group organization can be easier for some groups more than others, and how well-organized groups work to promote their own interests in “public” policy, potentially making themselves better off at the expense of the general welfare.

And then, more ominously, public choice theory suggests we take off the blinders when we consider the motivations of government leaders. Perhaps they are self-interested, like the rest of us, and are not especially motivated to enhance a difficult-to-define “general welfare.” In a world like this, the prediction of public choice theory is that well-organized special interest groups tend to prevail in public policy, as self-interested government officials are more easily swayed to their goals than public-spirited ones.

What might this have to do with the widespread awareness and reporting on budgets, compared to government financial results? Budgets and related public communication from government officials have too-frequently been driven by well-organized groups “seeking rents” from government activity, with consequences for the overall public purse.

We all have a common interest in the condition of that public purse, but our individual stake in the matter is diffused among many of us. Well-organized interest groups also care about that public purse, but they can be driven by the higher per-capita consequences of drawing on that purse for their own needs.

Budgets are where the action is because they are the vehicles through which government spending arises. Many more people care about government spending, and getting the proceeds, than the number of people who really care about government *accounting* for its spending.

We persist in these tendencies at our peril, with potentially more severe consequences for young people in high school classrooms.

The general welfare is at risk. Educating young people about government accounting and financial reporting can help defend it.