Lesson 4 Appendix: State and City Budget and Financial Reporting

Lesson Overview

Understanding the financial standing of state governments is not easy. Balanced budgets don't have to balance and reading financial reports can feel like reading in a foreign language. This lesson breaks down the political language and process of state budgeting and reporting that allow state policy makers to profess balanced budgets, while borrowing money at the same time. In the accompanying activity students use Data-Z, an online tool that aggregates state financial data to compare the financial situation of their state with 3 other states and make a prescription to improve the fiscal health of their state.

Key Terms & Economic Concepts

Accrual Accounting	Decision Making	Opportunity Cost
Budget	Deficit	Trade-offs
Cash Accounting	Fiscal Policy	
Debt	Interest	

Content Standards

Voluntary National Content Standards in Economics

CONTENT STANDARD 20

Federal government budgetary policy and the Federal Reserve System's monetary policy influence the overall levels of employment, output, and prices.

Benchmark 5: When the government runs a budget deficit, it must borrow from individuals, corporations, or financial institutions to finance that deficit.

Materials

- Data-Z State Data Comparison Tool: https://www.data-z.org/
- Mobile device or computer (1 per student)
- Handout 1: States' Fiscal Health Check-Up

- Optional: *Lesson 4 Appendix* ***Essential Understandings***, if assigned as a student reading (1 copy per student)

Activity: The Fiscal Health of States

Procedures

1. Use the Lesson 4 Appendix **Essential Understandings** to introduce students to state budgets and financial reporting.
2. ALTERNATIVE: Assign the Lesson 4 Appendix **Essential Understandings** as a student reading the day before running the **Lesson 4 Activity: The Fiscal Health of States**
3. Give students a copy of **Handout 1**: States' Fiscal Health Check-Up
4. Ask them to compare the fiscal health of 4 states at https://www.data-z.org/. Their choice of states should include a state that ranks in the top 5, a state that ranks in the bottom 5, and their own state.
5. Debrief Questions
    a. Did the fiscal health of the states you examined, improve or worsen from the previous year? Why? *(Answers will vary.)*
    b. Why might a state want to run a deficit? *(They may want to invest in infrastructure, provide disaster relief, etc.)*
    c. What kinds of things are financed by state borrowing? How does it compare to federal borrowing? *(Much of state government borrowing is used to finance infrastructure, whereas the federal government borrowing is largely used to pay for current consumption. Spending on infrastructure is an investment, in that it can result in greater productivity and economic growth in the future.)*
    d. Is the opportunity cost question "to spend or not to spend," or is it a question of "where to spend?" *(It depends on who you ask. Fiscally conservative people are more likely to see the alternatives in terms of spending or not spending (meaning lower tax obligations for current and future citizens. Others may see the alternatives in terms of spending in one area vs spending in another.)*
    e. What recommendations would you give to improve your state's fiscal health? *(Answers will vary.)*

Resources

Bergman, Bill. “State Budgets: The Good and the Bad.” Foundation for Teaching Economics, 2020, www.fte.org

“Data-Z.” Data-Z, Truth in Accounting, www.data-z.org. Accessed 20 Apr. 2021.

Lesson 4 Appendix: Essential Understandings

Like Federal Government financial reporting, city and state government must have budgets and financial reports that are kept and made available to the public. For the most part these reports are similar to federal reports in that budgets project future expenditures and revenues and the financial reports show net positions of activity and assets and liabilities.

However, there are a few key differences between federal and state and local finances that are not only cause for looking at them a little differently, but also the root of practices that some people feel allow state and city officials to be less transparent in the reporting.

State Budgets

Currently 49 of the 50 states have a "balanced budget" requirement in their state law. Given this, a simple question might be—if states balance their budgets every year, how could so many of them have accumulated so much debt? A short answer to a sometimes long story is that states and cities can balance their budgets using borrowed money as revenue and not counting all expenses if cash is not going out in the current period. This is not the story of all states and cities, but unfortunately it is the story of many of them.

State and local budgets will provide projections on anticipated expenses to run all aspects of the respective state or city. These expenses will generally include items that range from low income housing assistance to youth athletic programs and street repairs.

It is important to note that they also include payments to be made to pension and retirement benefit plans for state and local employees. Herein lies one of the concerns of state and city budgeting because what is planned or projected to be paid into the pension and benefit plans may not be the amounts necessary to "fund" the future benefits to be paid from those programs. The "budget" will only include the actual cash amount to be paid to the retirement program in the upcoming year, when the accrued, or long-term expense is anticipated to be much larger.

Using **cash budgeting** rather than **accrual based budgeting** will understate the long-term expense for the state or city. Thus on a cash expense budget basis the budget is balanced while if it were on an accrual basis the budget could show a significant deficit.

The budgeted, or projected, revenue sources will include things such as sales tax, property tax, certain fees, and grants from the federal government or other entities. All of these sources show up under "General Revenues." But what if the budgeted expenses are greater than the anticipated revenues? Accounting standards allow projected borrowing to be included in General Revenues. Thus, a city might plan to borrow $100,000, (from a bank, a bond issue, etc.) and show that as revenue, then spend $90,000 of that and be left with a $10,000 "surplus" in the budget. All while they went $100,000 in debt.

Lesson 4 Appendix: Essential Understandings

Below is a real world example from the state of Indiana's 2021 published budget plan. On the following chart under projected revenues the last three entries are all sources of borrowing that they anticipate using. These total $6,574 million which is being counted in the General Revenue total.

The anticipated expenses are listed on the lower half of the chart and when those expenses are subtracted from the revenues there is a projected $87 million "surplus" in the budget. All while the state of Indiana assumes an additional $6,574 million of debt.

GENERAL FUNDS - BUDGET PLAN FY 2021
Expenditures, Revenues/Resources, and Resulting Estimated Surplus
{Amounts per Legislative Staffs and GOMB}
$ in millions

Revenues/Resources	
Revenue Source	**FY 2021 Estimate [May-2020]**
Personal Income Taxes (Net):	$18,352
Corporate Income Taxes (Net):	$2,122
Sales Tax (Net):	$7,453
All Other State Sources:	$3,252
Transfers In:	$1,558
Federal Sources:	$3,684
Interfund Borrowing:	$300
Federal Stabilization/Municipal Liquidity Facility	$5,000
P.A. 101-8 Revenues/Section 7.6 GO Bond Borrowing	$1,274
Total Revenues:	**$42,995**

Borrowing $6,574

Expenditures	
Purpose	**FY 2021 Amount**
K-12 Education:	$8,896
Higher Education:	$1,943
Pensions:	$8,624
Human Services:	$7,077
Healthcare:	$8,014
Group Insurance:	$1,922
Government Services:	$1,570
Public Safety:	$1,910
Economic Development:	$81
Environment and Culture:	$61
Debt Service:	$1,709
Short Term Borrowing/Treasurer Borrowing Repay	$1,738
Statutory Transfers Out:	$425
Lapsed Appropriations:	-$1,062
Subtotal	**$42,908**
Fiscal Year Estimated "Surplus":	**$87**

State Financial Reports

State and local governments produce "Comprehensive Annual Financial Reports" (CAFRs). These reports, like federal reports include two main end-of-year financial statements, the Statement of Activities (like the private sector **income statement**) and the Statement of Net position (like the private sector **balance sheet**). Each statement arrives at a plus or minus net position, the expenses compared to revenues or assets compared to liabilities.

State and local "Statements of Activity" will include expense categories like, public safety, public works, health and welfare, economic development, and interest. There are often "off-setting" amounts which can be fees or charges for service and grants that are deducted from the expense categories.

The revenue section of the Statement of Activity, which is usually the bottom half of the statement, will include, "General Revenues." General Revenues will be made up of taxes, property and sales for cities and income and gasoline, sales and property for states. Borrowed funds will not be listed as revenues on the Statement of Activity. When the expenses are subtracted from the general revenues we get the positive or negative result of the year's activity - the Net Position for the year's activity. Per the state of Indiana's 2021 budget plan we could expect a Statement of Activity that will show a loss of $6,487 million. Where does that loss, or negative position show up?—on the "Statement of Net Position."

The Statement of Net Position (or private sector balance sheet) states the assets minus liabilities that lead to a positive or negative net position. Remember that the Statement of Activities is for activity over a period of time and the Statement of Net Position reflects a point in time, such as the end of a fiscal year. The top half of the Statement of Net Position includes various categories of assets, such as cash, investments, various types of receivables and capital assets like land, infrastructure, and construction in progress.

The bottom half of the Statement of Net Position lists Liabilities which are subtracted from the Assets to determine a Net Position of **deficit** or **surplus** at that point in time.

In the liabilities section you will see the same sorts of things that you would see on a private sector balance sheet—accounts payable, interest payable, and other payables. On most state or city balance sheets you will see a section of Long-term liabilities which include bonded debts and employee benefit program obligations. Just who those obligations are owed to can usually be found in a footnote to the statement. Any borrowing or indebtedness that a state or city has incurred to meet expenses or fund pension or retirement programs will be listed as a liability.

Following is the Statement of Net Position for the state of Indiana for 2019. You can see that the state has very significant liabilities on the bottom line of the statement (bottom of second page). Notice the number in parentheses. On financial statements, a number in parentheses means the number is negative.

State of Illinois

Statement of Net Position

June 30, 2019 (Expressed in Thousands)

	Primary Government			
	Governmental Activities	**Business-type Activities**	**Total**	**Component Units**
ASSETS				
Cash equity with State Treasurer	$ 9,717,447	$ 287,931	$ 10,005,378	$ 1,025,365
Cash and cash equivalents	293,165	50,357	343,522	1,752,468
Deposits held by federal government		2,118,168	2,118,168	
Securities lending collateral of State Treasurer	2,805,582	69,639	2,875,221	5,247
Investments	44,469	1,064,964	1,109,433	3,032,152
Receivables, net:				
Taxes	2,357,078	339,761	2,696,839	
Intergovernmental	3,132,091	28,545	3,160,636	230,577
Other	955,850	204,356	1,160,206	749,321
Internal balances	105,698	(105,698)	-	
Due from fiduciary funds	25,970	445	26,415	
Due from component units	491,196	8,277	499,473	23,034
Due from primary government				1,507,703
Inventories	137,138		137,138	43,935
Prepaid expenses	7,620	507	8,127	75,061
Unamortized bond insurance costs	11,318		11,318	7,485
Loans and notes receivable, net	50,932	1,303,785	1,354,717	1,268,070
Restricted assets:				
Cash equity with State Treasurer	1,230,957		1,230,957	205,465
Cash and cash equivalents	186,026	10,906	196,932	610,887
Investments	13,019		13,019	5,549,892
Intergovernmental receivables	4,398		4,398	
Other receivables	164,215	32,993	197,208	106,473
Loans and notes receivable, net		3,454,797	3,454,797	18,394
Other assets	42,495		42,495	6,868
Derivative instrument				14
Other assets	16,999		16,999	72,090
Capital assets not being depreciated	4,213,781		4,213,781	2,706,823
Capital assets being depreciated, net	18,172,514	3,247	18,175,761	13,027,261
Total assets	44,179,958	8,872,980	53,052,938	32,024,585
DEFERRED OUTFLOWS OF RESOURCES				
Deferred outflows of resources - accumulated decrease in fair value of derivatives				115,035
Deferred outflows of resources - unamortized deferred amounts on bond refundings	74,689		74,689	95,597
Deferred outflows of resources - unamortized deferred amounts on certificates of participation refundings				4,929
Deferred outflows of resources - pensions	17,740,434	43,095	17,783,529	133,156
Deferred outflows of resources - OPEB	1,156,206	6,044	1,162,250	104,618
Total deferred outflows of resources	18,971,329	49,139	19,020,468	453,335

State of Illinois

Statement of Net Position

June 30, 2019 (Expressed in Thousands)

	Primary Government			
	Governmental Activities	**Business-type Activities**	**Total**	**Component Units**
LIABILITIES				
Accounts payable and accrued liabilities	9,664,879	212,604	9,877,483	1,377,687
Intergovernmental payables	4,215,151	6,376	4,221,527	45,085
Due to fiduciary funds	1,179,344		1,179,344	
Due to component units	367,569	1,140,165	1,507,734	23,034
Due to primary government				493,865
Unearned revenue	1,335,094	33,513	1,368,607	471,002
Obligations under security lending of State Treasurer	2,805,582	69,639	2,875,221	5,247
Assets held for others				211,802
Short-term notes payable		93,357	93,357	11,577
Derivative instrument - liability				116,266
Other liabilities				16,111
Long-term obligations:				
Due within one year	3,381,311	172,606	3,553,917	624,650
Due subsequent to one year	222,334,566	1,661,110	223,995,676	14,644,697
Total liabilities	245,283,496	3,389,370	248,672,866	18,041,023
DEFERRED INFLOWS OF RESOURCES				
Deferred inflows of resources - loan origination points				1,350
Deferred inflows of resources - accumulated increase in fair value of derivatives				156
Deferred inflows of resources - unamortized deferred amounts on bond refundings	27,652	28,971	56,623	93
Deferred inflows of resources - service concession arrangements				30,705
Deferred inflows of resources - irrevocable split-interest agreements				20,007
Deferred inflows of resources - pensions	4,254,473	50,892	4,305,365	54,378
Deferred inflows of resources - OPEB	6,665,489	64,863	6,730,352	581,412
Total deferred inflows of resources	10,947,614	144,726	11,092,340	688,101
NET POSITION				
Net investment in capital assets	16,161,889	3,210	16,165,099	6,924,659
Restricted for:				
Debt service	2,037,737	27,672	2,065,409	493,390
Capital grants/projects	842,582		842,582	177,974
Repayment of loan from component unit		3,210,137	3,210,137	
Unemployment compensation benefits		2,467,322	2,467,322	
Municipal lending		632,412	632,412	
Education	4,369	47,117	51,486	
Employment and economic development	197,845		197,845	
Health and social services	295,273		295,273	
Public protection and justice	56,059		56,059	
Environment and business regulation	173,756		173,756	
Transportation	47,399		47,399	
Other purposes	594,144		594,144	
Funds held as permanent investments:				
Nonexpendable purposes	51,793		51,793	1,849,228
Expendable purposes	3,991		3,991	3,222,267
Unrestricted	(213,546,660)	(999,847)	(214,546,507)	1,081,278
Total net position	$ (193,079,823)	$ 5,388,0[illegible]3	$(187,691,800)	$ 13,748,796

For most states and cities the Long-term liabilities are by far the largest portion of all liabilities reported. This has not always been the case, and in fact, it is only in recent years that most of the Long-term liabilities of states and cities have been reported on the Net Position statement. In 2015 accounting standards were changed so that these Long-term liabilities had to be listed. First, the pension liabilities in 2015 and then medical retirement benefits in 2017. Prior to that change in accounting standards leaving these liabilities off of the net position statement made the position look far more positive than it was and supported claims of “balanced budgets” even when there were massive unreported liabilities.

It you choose to examine the Statement of Net Position for a number of states and cities over the years of 2014-2018 you will see that for most the long-term liabilities increased dramatically in 2015 and again in 2017—not because real debt increased, but because state and local governments now had to report those obligations as debt.

In examining those same statements, usually in the footnotes, you can find the amount of the Long-term debt that is for pensions, healthcare and other postemployment benefits and the portion that is for bonded dept. You will find in the case of most states and cities the liabilities of pension, healthcare and post-employment benefits will be close to or greater than the bonded portion of the debt.

If the net position is negative then that is an amount that will need to be paid in the future by the taxpayers. So the decisions of the current state and city governments to operate in a negative position put the burden on the taxpayers into the future, often many years after the state and city officials are out of office or retired.

An example of a city with massive long-term retirement benefit liabilities is Chicago at over $28 billion. How did they get in this position? A third element of the financial reports can shed some light on that. There is an unaudited section at the end of most annual reports called “Statistical Information.” This statistical information is presented in a table that covers a number of years and tracks the deficit position of a state or city. The bottom line here will tell us if the net position each year is continuing to get worse or better. Again, to pick on Chicago their net position has been negative every year since 2009 while claiming to have balanced budgets throughout that time.

At some point the long-term liabilities can put a state or city literally at risk for becoming insolvent, or going bankrupt. If their liability position has become too bad they will not find a lender or lenders willing to extend credit to the state or city and they will be in a default position on their retirement and bond obligations. When this happens cities often turn to the state for help and states, who cannot legally go “bankrupt”, will look to the federal government or the Federal Reserve Bank for help.

While states cannot legally go bankrupt, they can default on debt. The best (and only) example of this is Arkansas in 1933. In the midst of the Great Depression they found themselves unable to make payments on their highway bonds. The bondholders sued and the state had to restructure and prioritize their debt. Some bondholders lost their money. Defaulting on debt means the institution will have to pay higher interest rates to borrow money in the future as lenders will see the loans as riskier.

In March of 2020, amidst the COVID Pandemic, the Federal Reserve Bank of the United States announced that for the first time in its history, it would enter the municipal bond market. So effectively, states and local governments can now borrow at lower interest rates because the Federal Reserve Bank is willing to buy city and state debt.

Conclusion

To summarize, the two biggest concerns about state and city finances are that they can balance projected and actual budgets with borrowed funds (revenues) and they can chose to pay less into retirement accounts (cash expense) than those programs need on an annual basis (accrued expenditures) to be funded for future retirements. The 2015 and 2017 changes in accounting practices have forced states and cities to produce financial statements with a much clearer understanding of liabilities but they have not done anything to move away from counting borrowed funds as general revenues in the budgeting process.

There are organizations dedicated to tracking, monitoring and analyzing state and city financial practices. Two of those are the Volcker Alliance and Truth in Accounting. Both have websites where you can see reports and compare state and city financial performance.

Sources

Bergman, Bill. "State Budgets: The Good and the Bad." Foundation for Teaching Economics, 2020, www.fte.org

Commission on Government Forecasting & Accountability; Illinois General Assembly. *State of Illinois Budget Summary Fiscal Year 2021*. https://cgfa.ilga.gov/Upload/FY2021BudgetSummary.pdf

Ergungor, O. Emre, 2016. "Sovereign Default in the US," Federal Reserve Bank of Cleveland Working Paper, no. 16-09

Mendoza, Susana A. (2019). *State of Illinois Comprehensive Annual Financial Report 2019.* https://illinoiscomptroller.gov/financial-data/find-a-report/comprehensive-reporting/comprehensive-annual-financial-report/fiscal-year-2019/

Handout 1: States' Fiscal Health Check-Up

Directions:

Compare the fiscal health of 4 states at https://www.data-z.org/. Include a state that ranks in the top 5, a state that ranks in the bottom 5, and your state. Fill in the table below with your findings.

	Your State: ______________	**"Top 5" State:** ______________	**"Bottom 5" State:** ______________	**Other state:** ______________
Assets available to pay bills				
Total Bills				
Each Taxpayer's share of debt (-) or surplus (+)				
Ranking out of 50				
How does this year's debt or surplus compare to years past? Is there a trend?				
What is an interesting fact you learned about this state's fiscal health?				

What recommendations would you give your state to improve its fiscal health?