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Improving transparency and accountability in state budgeting

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On December 7, 2015, the Volcker Alliance, the Institute of Government and Public Affairs at the University of Illinois, and the Federal Reserve Bank of Chicago held a conference examining ways to increase transparency and accountability in state (and local) budgeting. Based on research presented at the conference, the main speakers recommended budgetary principles and practices that, if adopted, would improve public understanding of the true nature, cost, and consequences of states' tax policies and spending commitments.

The agenda and other details of the conference, Transparency and Accountability in State Budgeting: Challenges for Illinois and Other States, are available at https://www.chicagofed.org/events/2015/transparency-and-accountability-in-state-budgeting.

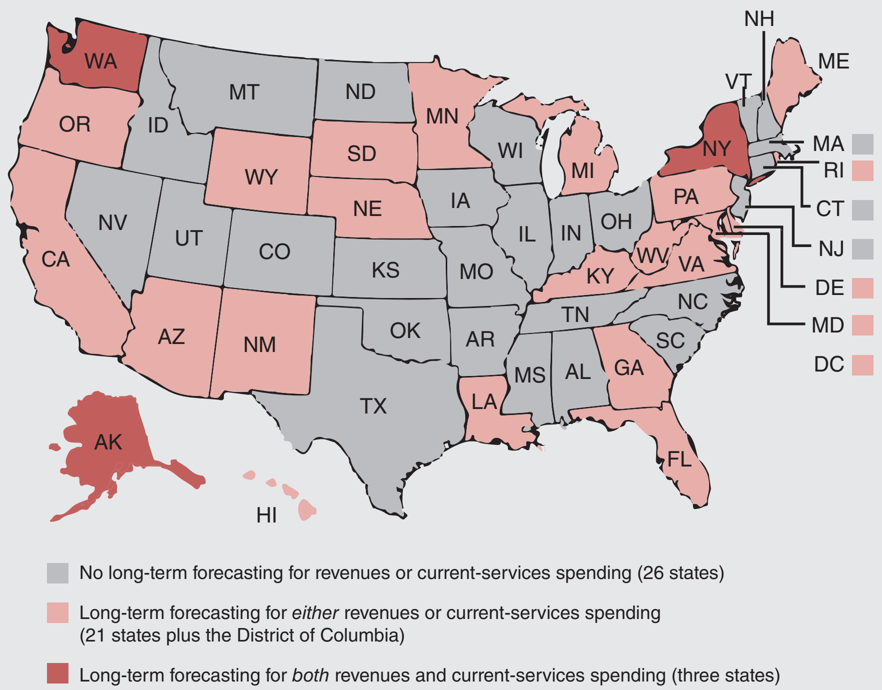
The recent bankruptcies of Detroit and some other cities, as well as the fiscal problems now facing Illinois and Chicago, have shown that governments can slip into extreme financial distress without sufficient advance notice to prevent it. Confusing budgeting and accounting practices, which obscured the actual amounts of tax revenues available or the true costs of government programs, contributed to these fiscal calamities. Little can be done to reverse the effects of past decisions made by states and localities to spend more than was coming in. However, improved budgeting and accounting practices could clarify the need to make tough choices about cutting spending or raising taxes sooner rather than later, so that current fiscal problems are not exacerbated. The conference—which focused on the results of two recent research papers—was devoted to identifying these very practices.

Best practices for budgetary transparency

Katherine Barrett and Richard Greene (Volcker Alliance) presented the first paper, which was based chiefly on a literature review and interviews with numerous budget officers and public finance experts.[1] They began by discussing their six general principles for good budgeting:

- Policies governing the processes and presentation of the budget should be clearly stated. (This applies to policies concerning the use of reserves, such as rainy day funds—which should feature explicit procedures for withdrawals and contributions.)
- The budget document should communicate the key fiscal and policy decisions that were made, as well as the current and emerging issues surrounding them and the trade-offs involved.
- Revenue and expenditure information should be presented in a consistent format so that changes from one fiscal year to the next can be easily compared.
- Budgets should provide long-term trend data to demonstrate how changes over time in a state's demographics, economic conditions, and finances affect current budgeting decisions.
- Budget items need to be defined consistently. For instance, capital spending budgets should clearly delineate between maintenance of infrastructure and major modification (or construction) of it.

1. Long-term budget forecasting practices of states



NOTES: Long-term forecasting means projecting for at least four fiscal years. See reference in note 2 for further details.
SOURCE: Center on Budget and Policy Priorities analysis of state budgets.

- The budget should report the accuracy of past projections for revenues and spending.

In addition to adopting these principles, Barrett and Greene stressed that specific steps need to be taken by a state to ensure that its budget presents a clear view of both current and future fiscal conditions. The speakers provided the following ten recommendations to help prevent a state from misrepresenting its fiscal position.

- Disclose and clearly explain one-time actions and their impact on future budgets. States occasionally make one-time transfers from special funds dedicated to specific programs or use one-time revenues (e.g., from asset sales) to balance their budgets. There is a clear risk if such actions are being used to cover recurring expenses in a state's budget.
- Provide multiyear forecasts of recurring revenues and expenditures (as well as other factors potentially affecting either). That is, states should furnish long-term projections of revenues and spending (including state contributions to Medicaid), along with estimates of the impacts of inflation and changes in the state tax code (if any). Figure 1 shows the long-term forecasting practices of the 50 states and the District of Columbia.[2]
- Disclose and clearly explain the effects of delayed spending. For instance, some states have chosen to delay making statutory payments to pension funds in times of fiscal stress. If a state does this, the delayed payment needs to be reported in the budget and the additional costs it will place on future budgets must be explained.
- Determine and disclose deferred maintenance on infrastructure. Fiscal stress can cause states to postpone or skip maintenance on roads, bridges, buildings, and other physical assets. States need to assess the condition of their infrastructure and report any backlog in maintenance.
- Calculate and disclose revenues lost from tax expenditure programs. It is important for states to report the revenues lost through tax exclusions, exemptions, deductions, or credits, whether they are for individuals or businesses, in a specific fiscal year.
- Include current, historical, and trend information on government debt. Debt ratios comparing the outstanding debt of a state to a variety of fiscal measures (e.g., its revenues or assets) should be made readily available. These ratios should be reported over many years so that trends can be identified. Additionally, these data should be used to help identify a state's debt capacity so that too much debt is not taken on and the state's credit rating is not jeopardized.
- Explain how state fiscal actions affect local governments. Local governments are often highly dependent on the state for funding (e.g., through revenue transfers, tax sharing, and aid programs). When changes to state support occur, the impact on municipalities needs to be identified and clearly communicated.
- Compare actual funding for education to the goals set by legislatures, voters, and court decisions. For example, states under fiscal stress often fail to meet the funding targets for K–12 education set by statutory formulas. If such shortfalls are occurring, they should be disclosed. This is not commonly done in most budgets.
- Improve disclosure of tax revenue volatility. Recent research has shown state revenues have become more volatile. This is particularly true for personal income tax revenues, mostly because of dramatic year-to-year changes in investment income (i.e., income from capital gains, interest, and dividends). Understanding revenue volatility can help states determine appropriate levels of budget reserves and prevent them from committing to long-term programs based on unusually good revenue years.
- Track and share progress toward achieving fiscal goals. For example, states may have set targets for increasing their reserve funds or paying off pension debt. Budgets should reflect what progress is being made to meet such goals.

To close, Barrett and Greene said that they hope this set of recommendations will serve as a catalyst for officials to increase the quantity and the quality of their budget disclosures to political leaders, advocacy groups, and the public—which should lead to better choices about how to allocate the resources of the state.

Considering Illinois's fiscal situation

Richard Dye (Institute of Government and Public Affairs at the University of Illinois) presented the second paper—a policy brief on Illinois's current budgetary practices and ways to improve them.[3] Dye said that Illinois's fiscal crisis has been decades in the making as the state has consistently spent more than sustainable revenues should permit over much of this time. He contended this pattern of "buying now and paying later" was both facilitated and disguised by faulty procedural and reporting practices for the budget. To reform these practices, Dye argued that those responsible for Illinois's budget should follow the four fundamental principles laid out in his paper. Most of them were quite similar to Barrett and Greene's recommendations for increasing budgetary transparency.

The first principle advocated by Dye was to use advance multiyear budget planning. Unfortunately, he noted, the State of Illinois does not currently do comprehensive multiyear projections of *both* revenues and current-services expenditures. (Limited efforts have been made to provide such projections for three fiscal years.) Furthermore, unlike many other states, Illinois does not have a consensus revenue forecasting system for combining competing revenue projections.[4] Another complication is that Illinois does not routinely analyze major legislation's impact on future expenses and revenues—in contrast to the vast majority of other states. Illinois also lacks an annually updated capital spending plan (to fund infrastructure projects, which usually take multiple years to complete). Absent this, it is difficult to assess whether appropriate investments are being made in state infrastructure assets. Finally, Illinois relies on cash-basis accounting for budget preparation. As such, it recognizes expenses only when they are paid, not when they are incurred. Dye said most of these deficiencies could be addressed by refining or expanding the state's budgetary projection efforts—e.g., by increasing the revenue projection period to five years or more, initiating projections for current-services spending, and crafting a capital spending plan. While switching to full accrual accounting from cash-basis accounting may not be feasible, Dye said Illinois should at least supplement the budget with information on significant changes in liabilities or assets.[5]

Dye's second principle was to ensure the sustainability of both revenues and expenditures. Budgets should not shift payments for current services on to future taxpayers. In other words, current services should be paid for with current dollars. Furthermore, one-time revenues (e.g., from casino license sales or asset sales) should be clearly identified in budgets and should not be presented as funding sources for ongoing programs.

In cases where state employee compensation is deferred for current labor services, appropriate financial reserves need to be set aside to protect future taxpayers from having to shoulder that burden, Dye said. Illinois fails to put aside adequate resources for either pensions or other post-employment benefits (OPEB), such as retiree health care coverage. In the case of pensions, Illinois has not funded them at the actuarially required contribution (ARC)[6] level for decades. Because of this, as of June 30, 2014, the combined pension underfunding of the five state-financed retirement systems was $111.2 billion—and pension plan assets covered only 39.3% of this liability. In regard to OPEB, the most recent estimation of the underfunding for retiree health care benefits alone was $34.5 billion. Illinois has a history of borrowing to pay down these liabilities, Dye noted; for instance, pension obligation bonds have been issued to cover annual pension contributions, but doing so reduces the state's ability to issue debt to support other expenditures—e.g., for infrastructure improvements (which the state has tended to defer).

The third principle Dye recommended was to build in budgetary flexibility to deal with unanticipated events (e.g., economic shocks). Fluctuations in both revenues and expenditures will occur, and sometimes they may be quite dramatic. Reserve funds need to be accumulated during good times, so they can be expended during bad times. As Dye pointed out, Illinois has no true rainy day fund. The state created the Budget Stabilization Fund in 2000 but has never made adequate deposits to it; since its inception, this reserve fund has ranged from 0% to 1% of general fund revenues.

Dye's fourth—and perhaps most vital—principle was to make the budget report more transparent. Illinois policymakers tend to focus on the state's four general funds (which make up less than half of the state's annual budget). Budgeting should reflect total state revenues and spending—and not just those that flow through the general funds. Dye said that the state should develop a broad-based (all-funds) approach to generating the annual budget report. Moreover, budget categories should be established and then maintained year to year (any changes to the categories should be

Charles L. Evans, *President*; Daniel G. Sullivan, *Executive Vice President and Director of Research*; David Marshall, *Senior Vice President and Associate Director of Research*; Spencer Krane, *Senior Vice President and Senior Research Advisor*; Daniel Aaronson, *Vice President, microeconomic policy research*; Jonas D. M. Fisher, *Vice President, macroeconomic policy research*; Robert Cox, *Vice President, markets team*; Anna L. Paulson, *Vice President, finance team*; William A. Testa, *Vice President, regional programs, and Economics Editor*; Helen Koshy and Han Y. Choi, *Editors*; Julia Baker, *Production Editor*; Sheila A. Mangler, *Editorial Assistant*.

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clearly explained); this way revenue and spending trends can be spotted over time. These reforms to Illinois's budgeting process would help identify fund transfers. Relatedly, while Illinois has detailed budgetary information accessible through the comptroller's website, these data's clarity, timeliness, and cross-year consistency must be improved, according to Dye.

Commentary on budgetary reform and related matters

Four other conference participants offered their perspectives on the two papers and related matters. Lisa Washburn (Municipal Market Analytics Inc.) said that better budget rules based on the principles in the papers might be necessary because poor credit ratings for municipal bonds have often failed to impose fiscal discipline on states. She explained that the credit ratings are designed to gauge the default risk associated with a state debt offering. Even when state finances are badly run, the default risk on state bonds is very low. This is because many states give priority to bondholders over their other creditors when it comes to repayment. Moreover, Washburn explained that the yield spreads between relatively higher-risk state bond offerings and low-risk ones are often not large enough to capture the public's attention.

Brian Sigritz (National Association of State Budget Officers) said that state governments have been identifying sources of fiscal stress that emerged after the Great Recession and trying to address them. In particular, many states have pursued pension reforms that reduce future costs by trimming cost-of-living increases, lowering benefit levels, and extending the retirement age. States have also had to make larger contributions to pension funds in an effort to prevent the growth of unfunded balances.

Jamey Dunn (*Illinois Issues* magazine and WUIS radio in Springfield, IL) argued that Illinois has had a long history of avoiding making tough fiscal choices. At the time of the conference, she noted that Illinois had already gone five months into the current fiscal year without passing a budget. She said that the political culture of the state is currently very adversarial, making it difficult for discussions about both the immediate budget and future solutions to occur. She also commented that reporting on fiscal issues can often be difficult given their complexity and that few journalists are allowed to cover the subject full time.

Richard Mattoon (Federal Reserve Bank of Chicago) commented that the proposed reforms to the budget rules in both papers seemed very reasonable and appropriate, yet states have been reluctant to adopt them. He argued that this reluctance might be due to an incentive problem: Officials holding public office are not likely to gain a political advantage by supporting better budget and accounting rules because these improvements would likely make the policies they were elected to implement more difficult to realize. Even without this problem, some entity would have to impose these enhanced rules on state governments, but at this point no entity has either the authority or interest to do so. That said, formally adopting specific economic or budgetary triggers for making certain fiscal moves—e.g., withdrawals from rainy day funds—could circumvent these political concerns.

Conclusion

As demonstrated by the two papers presented at the conference, there is no shortage of ideas for improving budgetary rules and procedures for state and local governments. But developing, implementing, and enforcing better rules and procedures will be challenging. To avoid exacerbating the budget problems facing many states and localities today, it is imperative that this challenge be met sooner rather than later.

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[1] Katherine Barrett and Richard Greene, 2015, "Beyond the basics: Best practices in state budget transparency," Volcker Alliance, working paper, December, available at https://www.volckeralliance.org/sites/default/files/attachments/Beyond%20the%20Basics%20-%20The%20Volcker%20Alliance.pdf.

[2] Elizabeth McNichol, Iris Lav, and Michael Leachman, 2015, "Better state budget planning can help build healthier economies," Center on Budget and Policy Priorities, report, October 15, available at http://www.cbpp.org/sites/default/files/atoms/files/10-15-15sfplookingahead.pdf (as cited in Barrett and Greene, 2015).

[3] Richard Dye, David Merriman, and Andrew Crosby, 2015, "Improving budgetary practices in Illinois," Institute of Government and Public Affairs at the University of Illinois, Fiscal Futures Project, policy brief, December 7, available at http://igpa.uillinois.edu/system/files/Improving-Budget-Practices-in-Illinois.pdf.

[4] A consensus revenue forecasting system combines estimates from multiple sources, usually representing the executive and legislative branches, in a manner agreed upon in advance by all parties responsible for the budget; thus, it tends to reduce political gridlock (McNichol, Lav, and Leachman, 2015).

[5] For instance, the forecasting commission of Illinois's legislature has recently begun providing projections for changes in unfunded pension liabilities, according to Dye, Merriman, and Crosby (2015, p. 6).

[6] The ARC is the sum of the "normal cost" (defined as the change in future liabilities resulting from the current year of service of existing employees) and the "amortized cost" (defined as the annual payment needed to eliminate any pension underfunding over a period of 30 years or fewer).