August 22, 2019

Truth and Integrity in State Budgeting: Preventing the Next Fiscal Crisis

Prepared by:

William Glasgall

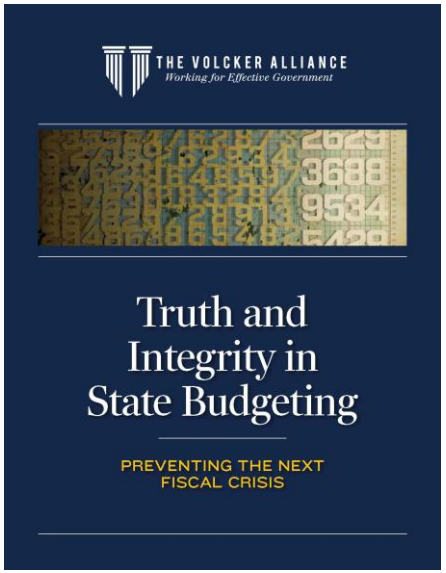
About The Volcker Alliance

The Volcker Alliance was launched in 2013 by former Federal Reserve Board Chairman Paul A. Volcker, who served in the federal government for almost 30 years.

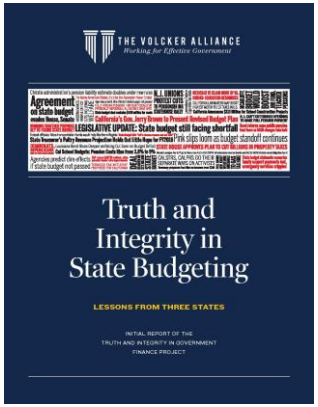
The mission of the Volcker Alliance is to advance effective management of government to achieve results that matter to citizens.

The History of Truth and Integrity in State Budgeting

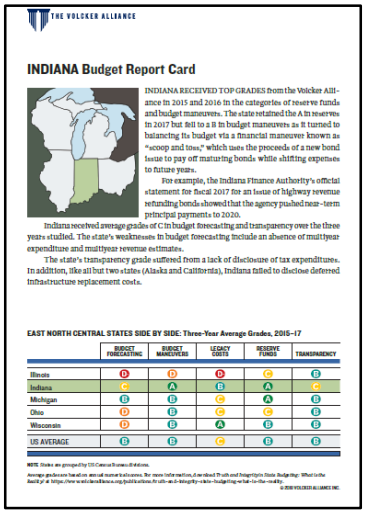
State Budgets



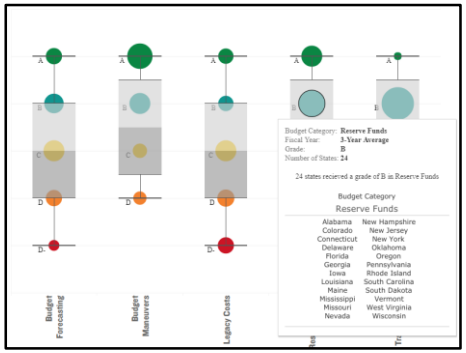
2018



2015

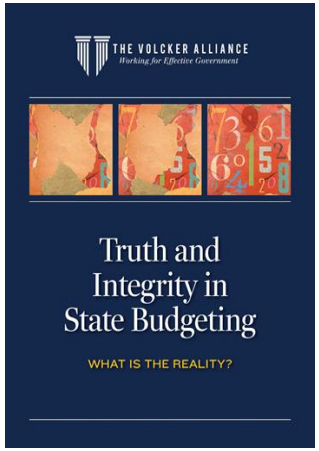


Report Cards



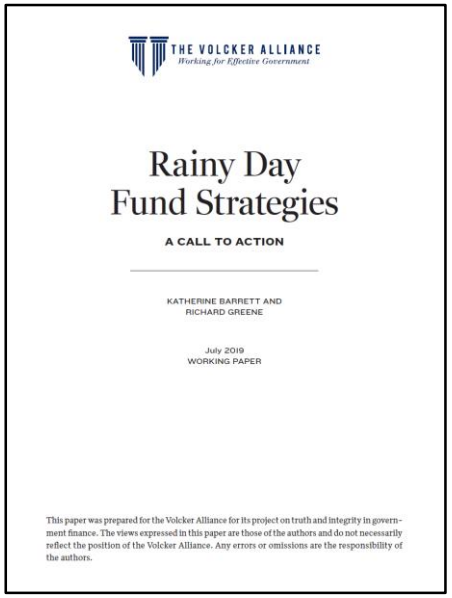
State Data Lab

2019



2017

State Budget Sources



NEW: Rainy Day Fund Strategies

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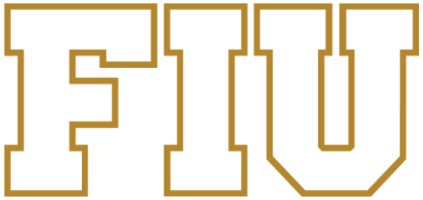
State Budget Research Network



The Results

The Results

2019 Fiscal Framework for States

- **Longest GDP expansion since 1858...but cooling.** Economists surveyed by Bloomberg in August see 35% chance of recession in next 12 months, up from 31% in July, 25% in February, 15% in July ’18. Warning flags: Slower jobs and global growth; trade war; inverse US yield curve; Philly Fed state leading index rising fairly steadily but at slowest rate since 9/2010, about where it was before recession began in ‘07.
  Sources: Volcker Alliance, Federal Reserve Bank of Philadelphia, Bloomberg

- **Fatter budgets for states.** FY ‘19 state general fund spending +5.8%, fastest since 2007 and around 5.6% long-term average. May states posted surplus, boosted rainy day funds and other reserves. FY ’20 projected general fund spending +4% with most of gain going for K-12 and higher education. Rainy day funds near record high.
  Source: Volcker Alliance, NASBO

The Results

2020 Budget Risks for States

- **Federal budget uncertainty:** Budget gap ~5% of GDP. Despite recent budget deal, federal discretionary spending reductions affecting states still a possibility.
  Sources: Volcker Alliance, Bloomberg

- **State budget pressure points.** Volcker Alliance 3-year Legacy Cost grade trend rising for 2nd year, but 2/3 of states still experiencing pension/OPEB stress. Legacy Costs battling debt service, Medicaid, infrastructure, K-12, Rainy Day Funds for resources. Infrastructure deferred maintenance cost may be at least $1 trillion.
  Source: Volcker Alliance

The Results

2020 Budget Risks for States

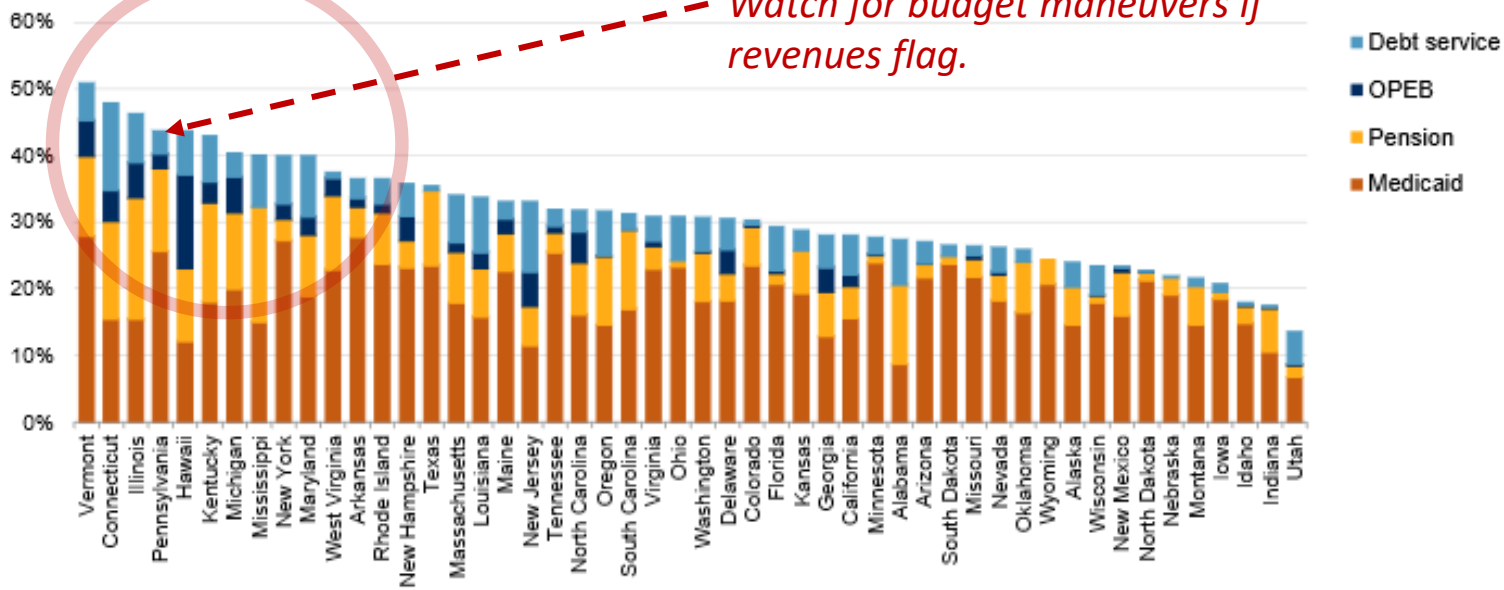
- **Record-low bond yields but muni issuance is no panacea.** Est. 2019 muni sales ~ $350b vs. $325b in ’18, $410 b in ‘17. New-money issuance may be best in 8 years, yet states & localities wary of cost of borrowing for new projects, preferring to add to reserves, bolster existing programs.

Source: Volcker Alliance, Bloomberg, Municipal Market Analytics issuance estimates

Fixed Costs: Biggest Risk for States?

Combined Medicaid, Debt Service, Pension And OPEB Contributions
Share Of General Fund Expenditures
Mandatory expenditures can reduce fiscal flexibility

PA ~ 40% -- Is this sustainable? Watch for budget maneuvers if revenues flag.



Source: S&P Global Ratings' survey of state budgets, adjusted for biennial budgets where applicable.
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"Absent any policy changes by state and local governments, revenues are likely to be insufficient to maintain the Sector's capacity to provide services at levels consistent with current policies during the next 50 years." – US Government Accountability Office, December 2018

How the Volcker Alliance Grades States

States received average FY 2016-18 grades of A to D-minus, plus annual grades for each year, in five areas:

1. **Budget forecasting**–how and whether states estimate revenues and expenditures for the coming fiscal year and the long term;

2. **Budget maneuvers**—dependence on one-time revenues to offset recurring expenditures;

3. **Legacy costs**—how well states fund promises made to public employees for pensions and retiree health care;

4. **Reserve funds**—the condition of general fund reserves and rainy day funds as well as rules governing their use and replenishment;

5. **Budget transparency**—disclosure of budget information, including debt, tax expenditures, estimated cost of deferred infrastructure maintenance.

Five State Budget Principles

Our evaluation of state budgets is guided by these best practices

- **Budget forecasting**–States should use a consensus approach to establish single, binding estimates for revenues and expenditures. States should also make predictions about revenues and expenditures for more than one following fiscal year.

- **Budget maneuvers**—States should pay for expenditures with recurring revenue earned in the same year.

- **Legacy costs**—States should consistently make the contributions for pension and retiree health care plans that actuaries determine to be necessary.

Five State Budget Principles

Our evaluation of state budgets is guided by these best practices

- **Reserve funds**—States should enact clear policies for deposits into and withdrawals from rainy day and other reserves.

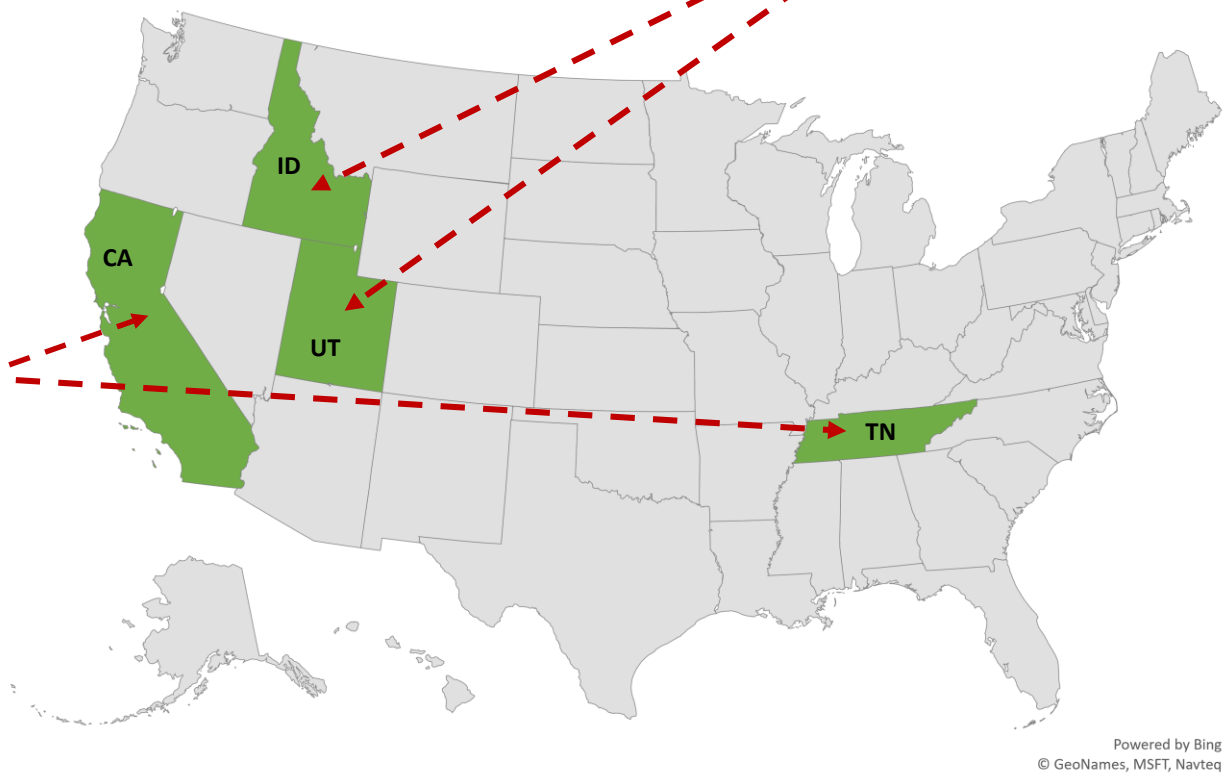
- **Budget transparency**—States should provide the data that public officials, advocacy groups, and citizens need to thoroughly understand budgets. These budgetary disclosures should include the costs of debt, deferred infrastructure maintenance, and tax expenditures.

Most 3-Yr Average A Grades, FY 2016-18

California, Idaho, Tennessee, and Utah Are the Only States With Three A Grades Apiece

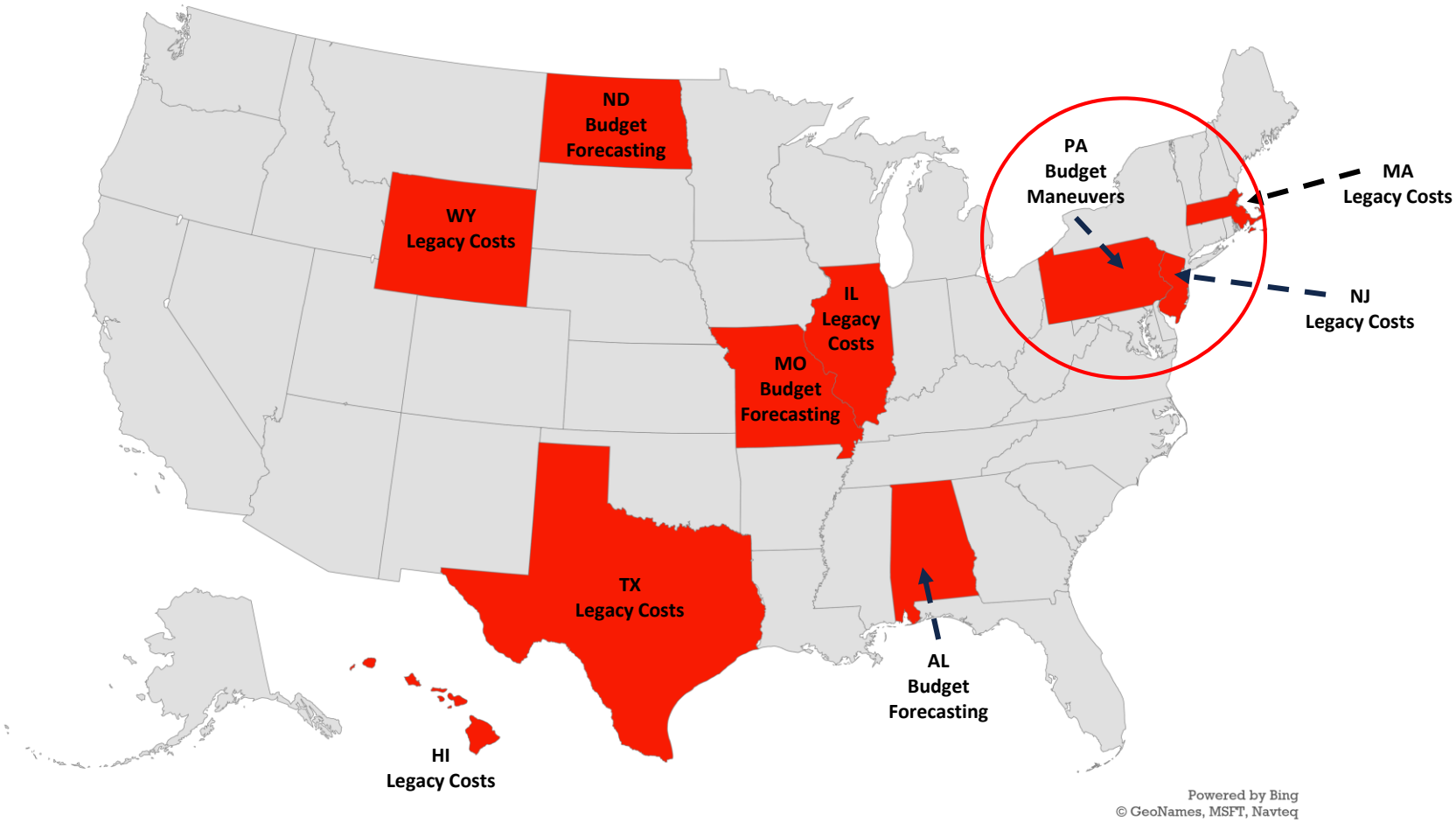
Categories: Budget Maneuvers, Legacy Costs, Reserve Funds

Categories: Budget Maneuvers, Reserve Funds, Transparency



States With Average D- Grades, FY 2016-18

Legacy Costs Weigh Down 6 States, 4 Trail in Other Categories



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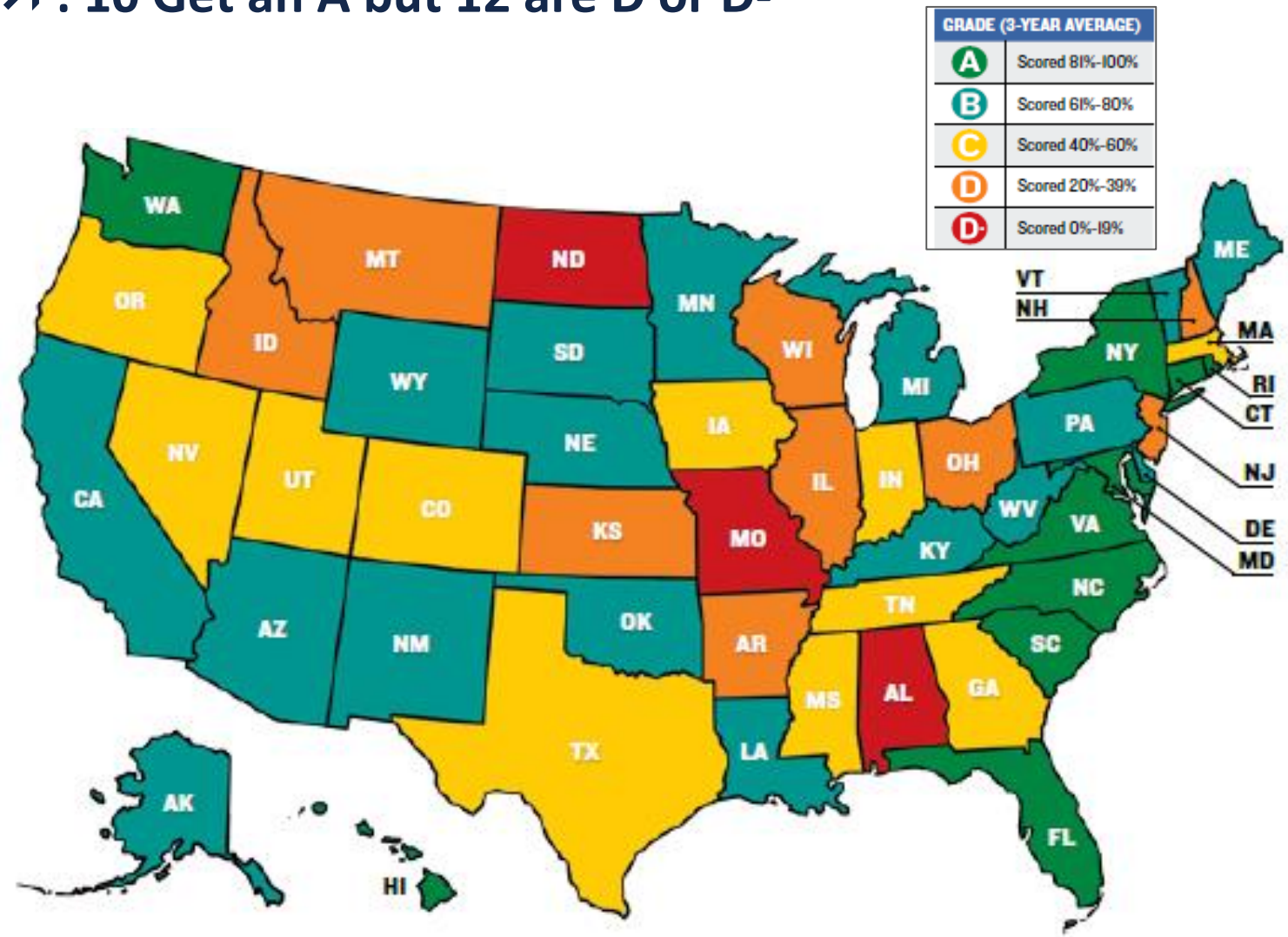
Budget Forecasting Average Grades, FY 2016-18

Trend ↗ : 10 Get an A but 12 are D or D-



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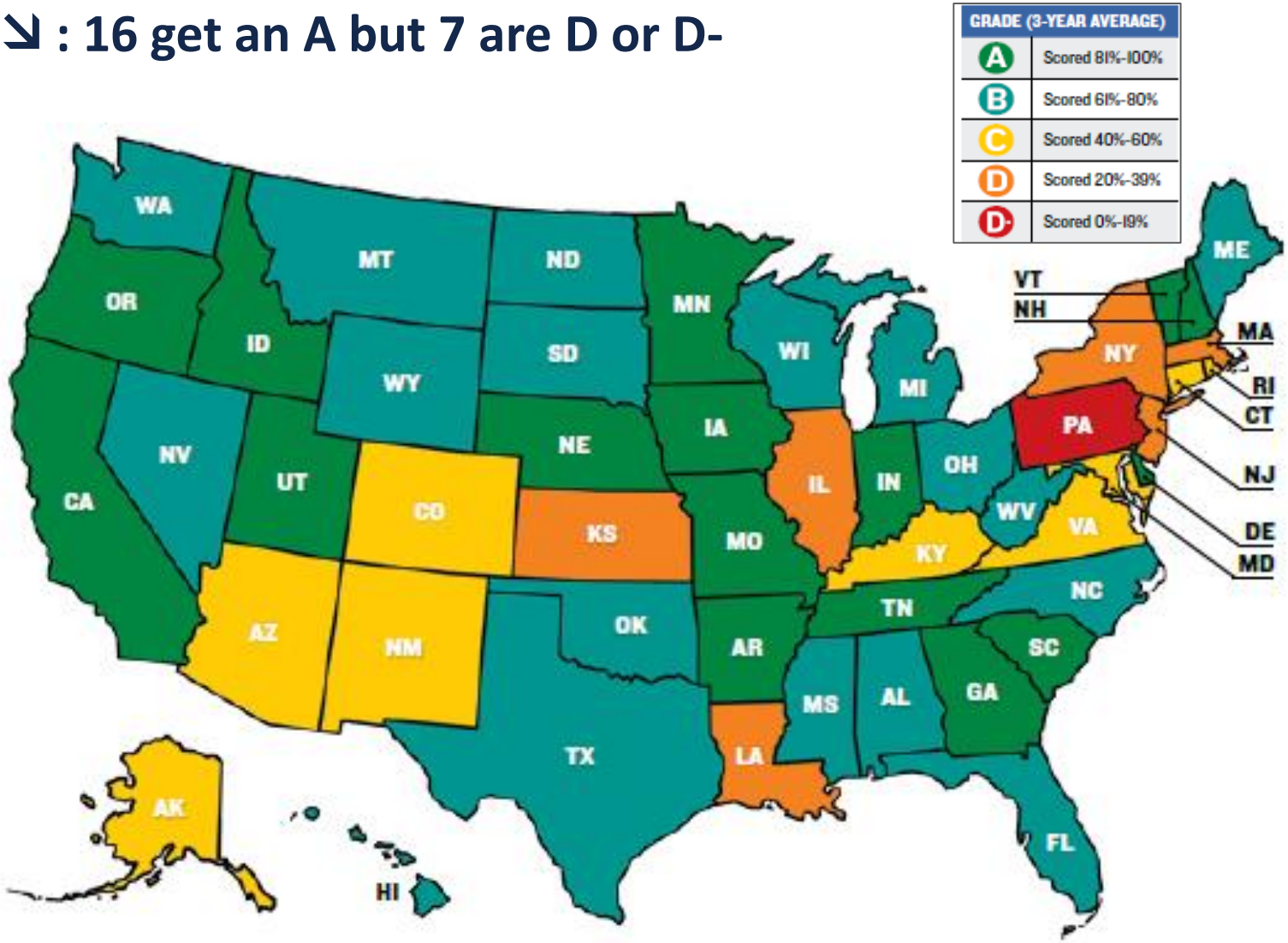
Budget Maneuvers Average Grades, FY 2016-18

Trend ↘ : 16 get an A but 7 are D or D-



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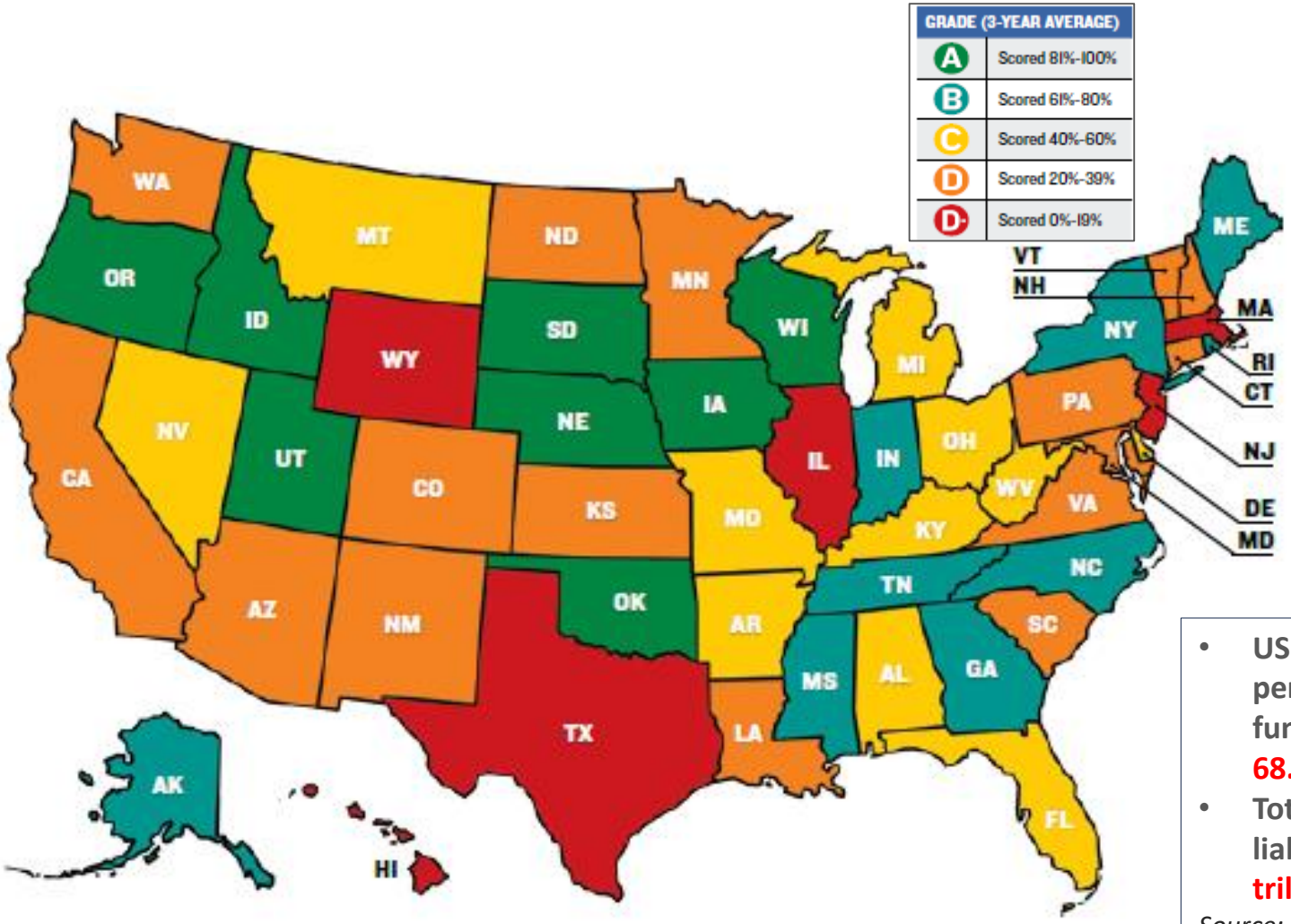
Legacy Cost Average Grades, FY 2016-18

Trend ↗ : Only 8 get an A; 33 are C or Worse and 6 are D-



- US total state pension plan funding level: **68.6%**
- Total unfunded liability: **$1.35 trillion**

Source: Bloomberg

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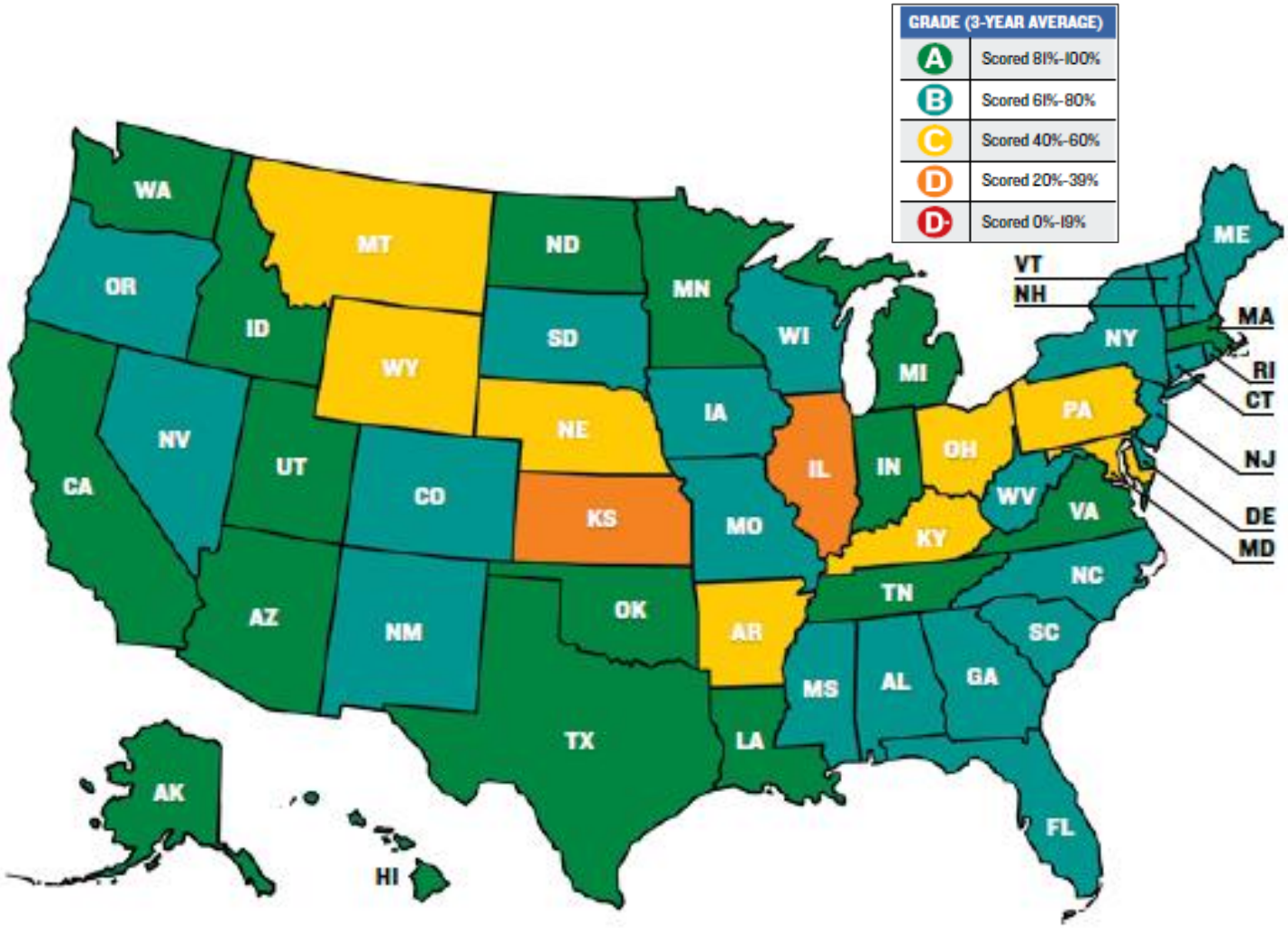
Reserve Funds Average Grades, FY 2016-18

Trend ↗ : 17 get an A, only 10 graded C or worse



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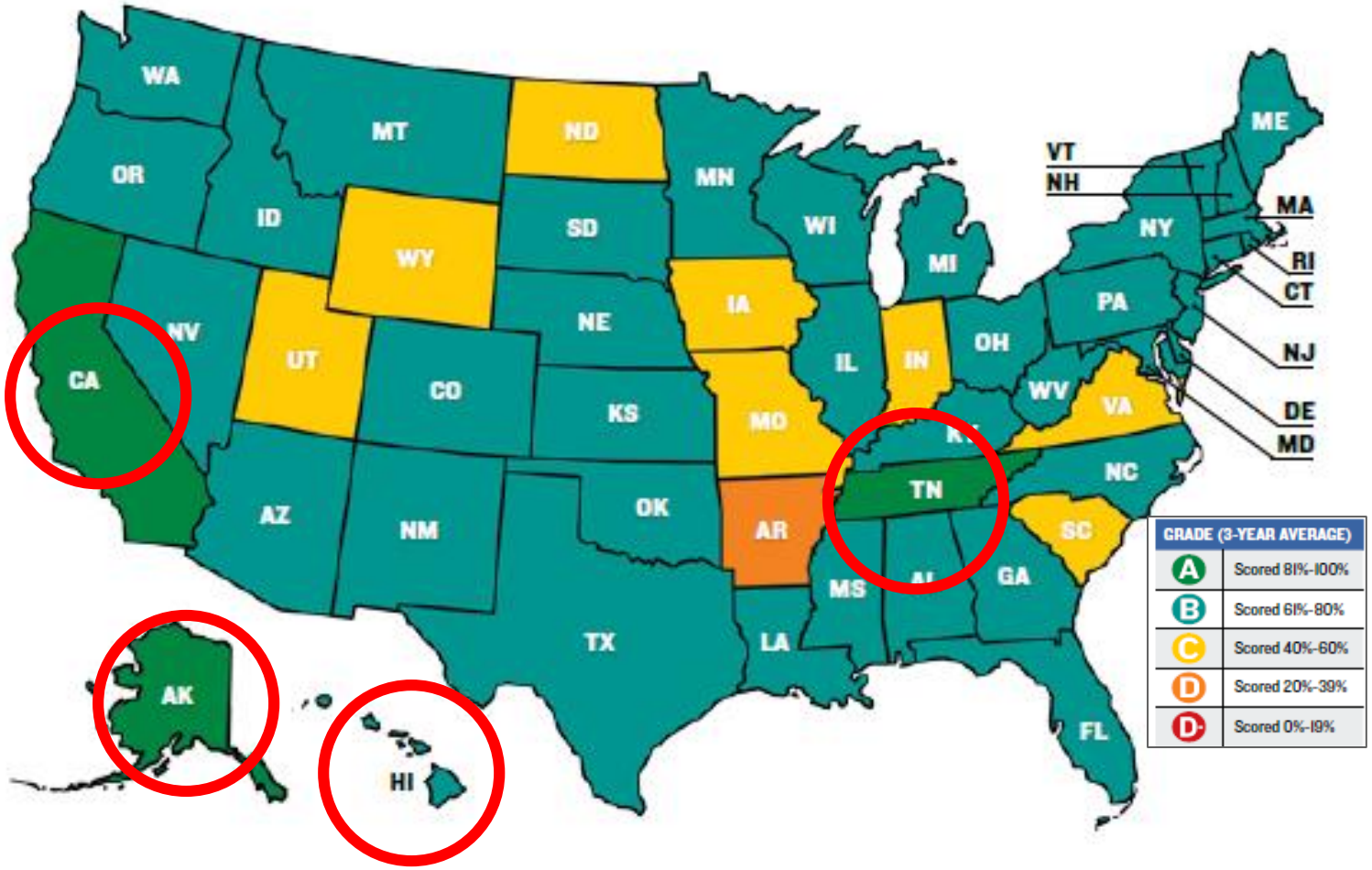
Transparency Average Grades, FY 2016-18 (2)

Infrastructure: Only 4 states disclosed deferred maintenance cost in budgetary documents or equivalent



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Case Study: Pennsylvania Budget FY 2016-18

Pennsylvania, in general, scored better than neighbors. Grade levels align roughly with the Commonwealth's general obligation credit ratings (Aa3/A+/A+), which fall between New York (Aa1/AA+/AA+) and New Jersey (A3/A-/A-). 2017-19 budget grades likely to be unchanged.

MID-ATLANTIC STATES SIDE BY SIDE: Three-Year Average Grades, 2016-18

	BUDGET FORECASTING	BUDGET MANEUVERS	LEGACY COSTS	RESERVE FUNDS	TRANSPARENCY
New Jersey	D	D	D-	B	B
New York	A	D	B	B	B
Pennsylvania	B	D-	D	C	B
US AVERAGE	C	B	C	B	B

Case Study: Pennsylvania Budget FY 2016-18

Budget Strengths:
Forecasting; making pension ARC; reserve fund policies.
Budget Weaknesses:
Lack of consensus forecasting; frequent budget maneuvers; pension/OPEB underfunding; low reserve balances; lack of infrastructure deferred maintenance disclosure.

PENNSYLVANIA Budget Report Card

BUDGET FORECASTING	2016	2017	2018
CATEGORY GRADE	B	B	B
Consensus Revenue Forecasts	✗	✗	✗
Multiyear Expenditure Forecasts	✓	✓	✓
Multiyear Revenue Forecasts	✓	✓	✓
Revenue Growth Projections	✓	✓	✓
	3-YEAR AVERAGE B		3-YEAR TREND —

BUDGET MANEUVERS	2016	2017	2018
CATEGORY GRADE	D	D-	D
Deferring Recurring Expenditures	✗	✗	✗
Revenue and Cost Shifting	✗	✗	✗
Funding Recurring Expenditures with Debt	✓	✗	✗
Using Asset Sales and Up-Front Revenues	✗	✗	✗
	3-YEAR AVERAGE D-		3-YEAR TREND ↘

LEGACY COSTS	2016	2017	2018
CATEGORY GRADE	D-	D	D
Public Employee OPEB Funding	✗	✗	✗
Public Employee Pension Funding	✗	✓	✓
Public Employee Pension Funded Ratio*	53%	55%	55%
	3-YEAR AVERAGE D		3-YEAR TREND ↗

RESERVE FUNDS	2016	2017	2018
CATEGORY GRADE	B	C	C
Positive Reserve or General Fund Balance	✓	✗	✗
Reserve Funds Disbursement Policy	✓	✓	✓
Reserve Funds Replenishment Policy	✓	✓	✓
Reserves Tied to Revenue Volatility	✗	✗	✗
	3-YEAR AVERAGE C		3-YEAR TREND ↘

TRANSPARENCY	2016	2017	2018
CATEGORY GRADE	B	B	B
Consolidated Budget Website	✓	✓	✓
Provides Debt Tables	✓	✓	✓
Discloses Deferred Infrastructure Replacement Costs	✗	✗	✗
Discloses Tax Expenditures	✓	✓	✓
	3-YEAR AVERAGE B		3-YEAR TREND —

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Five Takeaways

What the findings mean for policymakers, citizens, and investors

- **Budget forecasting**–With a US average grade of C, many states should improve how they estimate revenues and expenditures. Investors and taxpayers should prepare for surprises if the economy cools.

- **Budget maneuvers**–Average B grade reflects economic recovery, but one-time actions to balance budgets remain ubiquitous. If economy slows, use of maneuvers may increase, threatening fiscal sustainability.

- **Legacy costs**—Average C grade indicates almost two-thirds of states are struggling to meet obligations for public worker pension and retirement health care. These costs, along with Medicaid and debt service, will continue to squeeze spending on education, infrastructure, public safety.

- **Reserve funds—**Average B grades show rainy day funds and budgetary reserves on the mend. But reserves need to be adjusted for revenue volatility, especially in resource and steeply progressive income tax states. Those with healthy reserves may withstand future commodity price swings or recessions better than others with little cushion.

- **Budget transparency**—Average US grade is B, but 46 states fail to provide budgetary data on deferred infrastructure maintenance costs. These are unmet obligations that threaten state economies and are being passed to future generations to meet. Tax expenditure disclosure also needs to improve beyond current budgetary and GASB Statement 77 reports.

Questions?

Contact Information

The Volcker Alliance

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