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**Agreement on state budget evades House, Senate**  
 For Many American States, It's Like the Recession Never Ended  
 Agencies predict dire effects if state budget not passed  
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# Truth and Integrity in State Budgeting

**LESSONS FROM THREE STATES**

INITIAL REPORT OF THE  
 TRUTH AND INTEGRITY IN GOVERNMENT  
 FINANCE PROJECT





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NEW YORK • 2015



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This report is the product of the Volcker Alliance Project on Truth and Integrity in Government Finance. It is an important goal of the Alliance to produce reports that contain ideas, proposals, and recommendations based on independent research and analysis supporting constructive solutions for dealing in new ways with persistent governance problems. To stimulate this process and maintain project independence to make such conclusions and recommendations as they deem to be appropriate, these Alliance projects are commissioned to proceed without the requirement of approval of their conclusions and recommendations by the board of directors collectively or by individual members of the board of directors.



## ABOUT THE ALLIANCE

THE VOLCKER ALLIANCE was launched in 2013 by former Federal Reserve Board Chairman Paul A. Volcker to address the challenge of effective execution of public policies and to help rebuild public trust in government. The nonpartisan Alliance works toward that broad objective by partnering with other organizations—academic, business, governmental, and public interest.

The Alliance aims to be a catalyst for change—encouraging our public and educational institutions to give sustained attention to excellence in the execution of public policies at the federal, state, and local level in the United States and abroad. Our efforts will be reflected in meaningful research, well-supported proposals for action, and initiatives that ultimately produce better outcomes and accountability. We will work closely with the professional schools preparing people for public service and other organizations, always in the interest of restoring trust and pride in the way our public institutions implement policy.

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## PREFACE

WHEN I STARTED THE VOLCKER ALLIANCE in 2013, I intended that the organization be a catalyst for change. The palpable erosion of trust in our democratic institutions of government demands a response. Part of that response should be sustained attention by our educational institutions and by the public generally to the need for excellence in the execution of agreed public policies in every part of our federal system.

A particular area in which we want to make an impact is the public understanding of the budgetary pressures and financial reporting in America's states—in US Supreme Court Justice Brandeis's familiar phrase, the nation's "laboratory" of democracy.

In this report we return to some of the themes and places that my colleague and Volcker Alliance board member Richard Ravitch and I have explored over the past few years in the State Budget Crisis Task Force. If anything, state finances and reporting practices have continued to deteriorate in many locations.

Many US states remain under heavy pressure, as the task force reported. Overall, their tax revenues, adjusted for inflation, have barely recovered from their prerecession peaks.

The continued fiscal stress is tempting states to continue, and even intensify, budgeting and accounting practices that obscure their true financial position, shift current costs onto future generations, and push off the need to make hard choices on spending priorities and revenue practices.

This report, by its nature, is exploratory. It reviews budgeting and financial reporting practices in only three states, chosen somewhat arbitrarily for their varied experience. On that basis, it sets out a preliminary set of reporting principles to better assure the clarity and integrity of state financial practices.

The intent is to extend the analysis to all 50 states, providing a firm basis for "grading" the performance of individual states with respect to the integrity and clarity of their financial reporting. To that end, we will invite interested officials, independent experts, and educators to review this preliminary report and test its approach and conclusions.

This report and project benefited from the vision and insight of Mr. Ravitch. The work has been carried forward under the capable direction of William Glasgall, our state and local project director.

PAUL A. VOLCKER

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## EXECUTIVE SUMMARY

EVEN AS THE REVENUE OF STATE GOVERNMENTS in the United States recovers from the longest economic downturn since the 1930s, many states continue to balance their budgets using accounting and other practices that obscure rather than clarify spending choices. These practices make budget trade-offs indecipherable, lead to poorly informed policy-making, pass current government costs on to future generations, and limit future spending options. Further, they weaken the fiscal capacity of states to support the cities and counties that depend on their aid.

In 49 states, “balanced budgets” are required by constitution or by statute; Vermont, the sole exception, follows the practice of its peers. In truth, however, there is no common definition of a balanced budget, and many states resort to short-term sleight of hand to make it appear that spending does not exceed revenue. The techniques include shifting the timing of receipts and expenditures across fiscal years; borrowing long term to fund current expenditures; employing nonrecurring revenue sources to cover recurring costs; and delaying funding of public worker pension obligations and other postemployment benefits (OPEB), principally retiree health care.

While these actions temporarily solve budget-balancing challenges, they add to the bills someone eventually has to pay. Yet few states include information about these long-term spending obligations in the budgets that governors propose and state legislatures debate. This precludes accurate, informed consideration of policy trade-offs.

When budgets are balanced using accounting and other short-term and obscure fixes, the long-term consequences require a continual search for plugs to fill gaps in future budget cycles. The never-ending sense of crisis leads to stop-and-go funding of vital programs and stifles the need for serious discussions about policy. It also leaves states vulnerable when economic downturns occur and allows long-term obligations to mount.

This report builds on the work of the State Budget Crisis Task Force, chaired by Volcker Alliance founder Paul A. Volcker and board member Richard Ravitch, from 2011 to 2014. In sounding the alarm, the task force warned that the cash-based budgeting practices most states and municipalities use facilitate “gimmicks and short-term measures that obscure actual financial conditions.”

In this report, we revisited in more detail three states (California, New Jersey, and Virginia) of the six in the original study to learn if their budgetary practices were responding



to the revenue growth provided by a recovering economy. The good news is that California has adopted a number of improved budgeting practices. That has helped the state win four upgrades of its general obligation from Moody's Investors Service, Standard & Poor's, and Fitch Ratings since 2013. Virginia, which has a history of more-careful budget management practices, has enacted substantial pension reforms but has struggled with underperforming revenues. In New Jersey, large gaps remain in pension and other programs.

A primary aim of this preliminary study is to lay the groundwork for a common approach toward responsible budget practices in all 50 states. A continuing comparative analysis should provide a framework for a scorecard with respect to budgeting and financing practices. By shining a spotlight on opaque and confusing practices and by identifying more-appropriate approaches, we hope to provide incentives for officials to clarify financial issues and encourage debate on basic policy choices. We hope to engage academic institutions in this effort by tapping their scholarly expertise, encouraging research on more-effective budgeting practices, and preparing more students for work in government budgeting at all levels.

We invite and encourage governors, budget officers, and legislators to commit to work with us in developing useful approaches toward effective financial policies. Recent experience demonstrates the need. Mounting fiscal stress in Illinois, the bankruptcy of Detroit, and the impending financial crisis in Puerto Rico all indicate the relevance of the initiative that the Alliance has undertaken.

## I. INTRODUCTION

EVEN AS THE REVENUE OF STATE GOVERNMENTS in the United States recovers from the longest economic downturn since the 1930s, many states continue to balance their budgets using accounting and other practices that obscure rather than clarify spending choices. These practices make budget trade-offs indecipherable, lead to poorly informed policy-making, pass current government costs on to future generations, and limit future spending options. Further, they weaken the fiscal capacity of states to support the cities and counties that depend on their aid.

In 49 states, “balanced budgets” are required by constitution or by statute; Vermont, the sole exception, follows the practice of its peers.<sup>1</sup> In truth, however, there is no common definition of a balanced budget, and many states resort to short-term budget sleight of hand to make it appear that spending does not exceed revenue. The techniques include shifting the timing of receipts and expenditures across fiscal years;<sup>2</sup> borrowing long term to fund current expenditures; employing nonrecurring revenue sources to cover recurring costs; and delaying funding of public worker pension obligations and other postemployment benefits (OPEB), principally retiree health care.

While these actions temporarily solve budget-balancing challenges, they add to the bills someone eventually has to pay. Yet few states include information about long-term spending obligations in the budget documents that governors propose and state legislatures debate. This precludes accurate, informed consideration of policy trade-offs.

When budgets are balanced using accounting and other short-term and obscure fixes, the long-term consequences require a continual search for plugs to fill gaps in future budget cycles. The never-ending sense of fiscal crisis leads to stop-and-go funding of vital programs and stifles the need for serious discussions about policy practices. It also leaves states vulnerable when economic downturns occur and allows long-term obligations to mount year in and year out. Even states with the highest credit ratings are susceptible.

The issue is long-standing and bipartisan, with Democratic and Republican governors and legislators sharing the blame for deferring tough fiscal decisions. In this environment, it is no wonder that fiscal concerns have become common for many citizens. In 2013, almost four years after the end of the recession, 60 percent of Americans polled by the Pew Research Center acknowledged that their state faced very or fairly serious budget problems. And while 57 percent said they had a favorable opinion of state government, the total was down sharply

from a record high of 77 percent in 2001.<sup>3</sup>

This report builds on the work of the State Budget Crisis Task Force, chaired by Volcker Alliance founder Paul A. Volcker and board member Richard Ravitch, from 2011 to 2014. In sounding the alarm, the task force warned that the cash-based budgeting practices most states and municipalities use facilitate “gimmicks and short-term measures that obscure actual financial conditions” that would be more accurately depicted using the modified accrual accounting techniques already required for the governments’ comprehensive annual financial report (CAFR).<sup>4</sup> These reports contain the audited annual financial statements, which all states produce, based on accounting and reporting standards promulgated by the Governmental Accounting Standards Board. The Volcker Alliance is sounding that alarm again, with an even more rigorous review of budgeting practices in three states to show that the danger of future fiscal fire has hardly subsided.

In this report, we revisited in more detail three states (California, New Jersey, and Virginia) of the six in the original study to learn if their budgetary practices were responding to the revenue growth provided by a recovering economy. The good news is that California has adopted a number of better budgeting practices. That has helped the state win four credit-rating upgrades for its general obligation bonds from Moody’s Investors Service, Standard & Poor’s, and Fitch Ratings since 2013. Virginia, which has a history of more-careful budget management practices, has enacted substantial pension reforms but has struggled with underperforming revenues. In New Jersey, large gaps remain in pension and other programs.

A primary aim of this preliminary study is to lay the groundwork for a common approach and checklist to help foster more-responsible budget practices in all 50 states. A continuing comparative analysis should provide a framework for a scorecard with respect to budgeting and financing practices. By shining a spotlight on opaque and confusing practices and by identifying more-appropriate approaches, we hope to provide incentives for officials to clarify financial issues and encourage debate on basic policy choices. We hope to engage academic institutions in this effort by tapping their scholarly expertise, encouraging research on more-effective budgeting practices, and preparing more students for work in government budgeting at all levels.

We invite and encourage governors, budget officers, and legislators to commit to work with us in developing useful approaches toward effective financial policies. Recent experience demonstrates the need. Mounting fiscal stress in Illinois, the bankruptcy of Detroit, and the

impending financial crisis in Puerto Rico should all indicate the relevance of the initiative the Alliance has undertaken.

Although our initial focus is on improving the integrity of state budgets, similar principles apply to local governments. While the structure of governments varies, they all engage in an annual or a biennial budget exercise to match planned spending and available resources. State budgets built upon wishful thinking and short-term fixes serve only as poor examples for the many municipalities similarly struggling to balance budgets and compensate for problematic past practices.

By shining a spotlight on current practices and identifying more-appropriate as well as problematic ones, we hope to make it more difficult for elected officials to make expedient moves that obfuscate in the short term and impose long-term costs that fall especially hard on younger citizens. Until that goal is realized, states, counties, cities, and their residents will continue to fall victim to fiscal processes that are unfair, costly, and misleading at best, and deeply corrosive at worst.

#### A PRELIMINARY BUDGET REPORT CARD: How the States Are Trending

● Followed best practices ● Needs improvement ● Followed practices to be avoided NA Fiscal 2015 yearend data not available

BUDGET PRACTICE	CALIFORNIA			NEW JERSEY			VIRGINIA		
	2013	2014	2015	2013	2014	2015	2013	2014	2015
Used consensus revenue forecasts	●	●	●	●	●	●	●	●	●
Adequately funded annual pension contribution that actuaries say is required	●	●	●	●	●	●	●	●	●
Provided advance funding of other postemployment benefits (OPEB) obligation*	●	●	●	●	●	●	●	●	●
Increased rainy day fund balance as economy recovered**	●	●	NA	●	●	NA	●	●	NA
Provided easy online access to budget and necessary supplemental data	●	●	●	●	●	●	●	●	●
Avoided delaying payments to third parties to reduce general fund deficit or address liquidity issues	●	●	●	●	●	●	●	●	●
Avoided moving future revenue into current fiscal year or current expenses into next fiscal year	●	●	●	●	●	●	●	●	●
Avoided selling assets to raise cash for general fund or address liquidity issues	●	●	●	●	●	●	●	●	●

\* Principally retiree health care \*\* California funds include Special Fund for Economic Uncertainties, Reserve for Liquidation of Encumbrances, and Budget Stabilization Account. New Jersey made no rainy day fund contributions in fiscal 2013-15 because state failed to meet revenue threshold, which excludes personal income taxes. **SOURCE:** Survey of material practices in state budget and financial reports.

## Report Organization and Study Approach

**THIS REPORT STARTS** with a discussion of key budget and financial reporting concepts. It then details the criteria we used to assess the three states' budgets and explains why they were chosen. Summaries of the budget and key budget-related financial reporting practices in the three states and recommendations follow.

To prepare our report, the Alliance turned to former state budget and legislative officials, academic institutions, and experts on municipal finance to help us develop the initial set of criteria for reviewing state budget practices. A small team of experts then reviewed the enacted budgets of the three states for fiscal 2013, 2014, and 2015, plus CAFRs. They returned to state financial and legislative officials for clarification, when necessary, and referred to research on budgeting practices by the Pew Charitable Trusts, Center on Budget and Policy Priorities, Nelson A. Rockefeller Institute of Government, National Association of State Budget Officers, and National Association of State Retirement Administrators, among others. As the research proceeded and new issues came to light, the team reviewed and revised the criteria.

We propose these criteria as a checklist of responsible practices all states should adopt and of irresponsible ones they should resist. The Alliance welcomes comments and suggestions on the criteria, as well as on ways to encourage state adoption of better budgeting practices and to make dysfunctional maneuvers more difficult. We also welcome allies eager to press elected state officials and candidates to commit to improving the integrity of their state budget.

## II. THE NEED FOR TRUTH AND INTEGRITY IN STATE BUDGETS

FOR ANY STATE, THE BUDGET is of critical importance. It is the core vehicle used by the executive and legislative branches to debate and decide how much of a state's limited resources to spend on roads, education, economic development, social services, and other needs. The budget is the primary means to compel decisions about spending priorities within the boundaries of available revenue. It is both a planning and a control document that should ensure that governments don't spend beyond their means. Budget documents that are readily accessible, easily understood, and devoid of smoke-and-mirrors balancing tricks serve the needed control function and support the required—albeit difficult—honest, democratic debate about trade-offs between spending and revenue-raising.

In 30 states, the budget is a one-year document. In the remaining 20, it covers two years, although some provide for substantial revisions after the first year.<sup>5</sup>

Whether the spending plans are annual or biennial, finalizing a budget involves many steps, some of which may occur simultaneously. The role and involvement of the legislature and executive differ from state to state, particularly in the smaller details. Generally, however, the governor's budget office starts working with individual agencies in the fall—following the typical July 1 commencement of the fiscal year—refining requests and assembling the budget. It is presented to the legislature for consideration in the next year's session and lays out proposed spending against estimated revenue.

Legislatures review a governor's budget and vote on appropriations bills before passage, making adjustments that vary in their depth and breadth. Finally, the budget goes back to the governor for signature. As with any other piece of legislation, if the chief executive disagrees with legislative changes, the governor can negotiate with lawmakers before signing the measure or can veto the budget. In some states, such as New Jersey, a governor can reject individual budget items with a so-called line-item veto. At that point, the legislature can alter the document or vote to override the veto, though an override usually requires a supermajority.<sup>6</sup>

The requirement for balanced state budgets generally refers to ensuring that the annual operating, or general fund, budget does not exceed estimated annual revenue. Money for the general fund can be supplied by personal and corporate income and sales taxes, estate taxes, state levies on property, legal judgments, and various fees. The general fund does not typically include federal grants, tuition at state colleges and universities, or special

purpose levies, such as motor fuel taxes earmarked for highways. The revenue and spending associated with such areas can be uncovered in a number of places, including a state's annual report. For example, state lotteries are often found under the rubric of "proprietary funds," which comprise areas in which the state collects dollars from sources other than taxes to fund specific activities.

The general fund covers appropriations for state operating expenses. Those typically include K-12 and higher education; health and human services; prisons; public safety; transportation; environmental protection and services; economic development; and support of local government. Some of the proposed expenditures are wholly discretionary, such as those for salaries and expenses of the economic development and environmental protection departments. Other budgeted annual operating expenditures are determined by prior commitment or requirement. These include commitments to repay borrowed funds and associated interest, and payments required by court settlement, citizen-mandated referendum, or state-adopted legislation.

As a result of the recession, between 2008 and 2010, states' general fund revenues dropped by a total of \$77.6 billion, or 11.6 percent.<sup>7</sup> At the same time, demand for state-funded services rose as people lost jobs and their incomes declined. Enrollment for families, pregnant women, and children in Medicaid—the jointly funded, federal-state health care program for lower-income residents—jumped 9.1 percent in 2009 and 8.3 percent in 2010.<sup>8</sup> Although the federal government temporarily eased the pain through an \$830 billion stimulus program begun in 2009,<sup>9</sup> much of that money was targeted at creating jobs and promoting economic growth rather than at direct budget relief. States still confronted budget gaps totaling \$230 billion from fiscal 2009 to 2011.<sup>10</sup>

It's unlikely that states will be able to count on more generous federal funding anytime soon. This creates issues for a bevy of programs heavily supported by the federal government, including transportation and housing. If states want to continue to deliver such services at current levels, every dollar not provided by the federal government must be found elsewhere—either by raising taxes or by cutting services, including a number of other programs financed by the general fund. The Mercatus Center of George Mason University estimates that federal spending accounted for 30 percent of total state expenditures in fiscal 2014, down slightly from the stimulus period and somewhat higher than in the early 2000s. But the expansion of Medicaid means federal spending is increasingly focused on health care.<sup>11</sup> With Congress set on reducing discretionary spending, federal grants to states for expen-

ditures not related to health care actually declined 20.6 percent in real terms from 2010 to 2015, according to Mercatus.<sup>12</sup>

To be sure, when states face temporary and unexpected financial difficulties, some short-term budget maneuvering may be unavoidable. But cyclical shortfalls are different than structural deficits, and states must address flawed budgeting practices that exacerbate such deficits. This is an enduring concern. For example, as long ago as 2002, Fitch recommended that finance officers of local governments adopt practices such as multiyear forecasting, debt-affordability policies and reviews, and policies regarding nonrecurring revenue.<sup>13</sup>

Thirty-two states have capital budgets that are separate from their general fund budgets, although 19 exclude proposed funding for transportation. Capital budgets are used principally to propose and determine spending choices for buildings, infrastructure, and other items whose useful life extends beyond a budget year.<sup>14</sup>

States usually sell bonds to pay for items included in the capital budget, matching debt maturities to the useful life of the capital asset being funded. Using debt to finance capital projects is reasonable: Because future citizens will use the assets, it is appropriate that they contribute to repaying bonds or loans. The annual debt service to pay the principal and interest on those bonds is included in the operating, or general fund, budget. But because state budgets generally use a form of cash accounting, they may include only the current year or biennium's outlay to cover long-term obligations such as pensions and retiree health care or to replace infrastructure such as highways, bridges, and buildings.

Budgets that don't contain accruals for the future cost of such obligations are unable to support informed discussion and decision making by policymakers and other stakeholders. It is noteworthy that New York City has not repeated its near-bankruptcy in 1975: That year, the state legislature required the city to balance its budgets using accrual methods recommended by Generally Accepted Accounting Principles, which are promulgated by the Governmental Accounting Standards Board (GASB) for state and local accounting and financial reporting.<sup>15</sup> The requirement was enshrined in the City Charter following a 2005 ballot proposal.<sup>16</sup>

Even for municipalities adopting modified accrual accounting for budgets, the way present-value costs of future obligations are calculated remains subject to debate. No single standard is used to evaluate the replacement cost of highways and bridges, for example. In the area of public worker pensions, GASB's guidelines, used since 1996, allowed considerable leeway in calculating a state or locality's liability for employer contributions, including how future benefit payments are discounted to their present value.<sup>17</sup> While recommendations



that began taking effect in 2014 limit public pension plans' choices of discount rates and how benefits can be calculated over a worker's time on the job, states and municipalities are still not under a single uniform standard. Nor will the recommendations specify funding levels; the GASB board regards that as "a policy decision for elected officials to make as part of the government budget approval process."<sup>18</sup>

## Criteria Used to Assess State Budgets

**IN REVIEWING THE BUDGETS** of the three states, we started with several basic questions:

- Were recurring general fund expenditures matched with recurring revenue, or were recurring expenditures covered by one-time revenue sources, such as transfers from other funds, loans, or bond proceeds?
- What process did states use to estimate their general fund revenue; were the estimates reasonable when the budget was introduced and when it was passed?
- Did the states fully fund prior long-term commitments made for public worker pensions and health care, as well as for education, transportation, and other areas?

We then screened enacted general fund budgets and supplementary documents for key elements, including:

- Optimistic financial forecasting—aggressive assumptions on revenue performance or expense reductions without credible rationale;
- Reliance on borrowed money or payment-deferring debt structures, including deficit financing, delaying payments of tax refunds or on bills owed to private sector contractors or nonprofit service providers, accelerating revenue or postponing expenditures, and using capital appreciation bonds or other back-loaded debt structures;
- Use of nonrecurring revenue, including asset sales, and other one-time fixes;
- Pension funding history, including trends in the funded ratio, per capita unfunded liabilities, the amount the government contributes each year and how that corresponds to funding recommendations provided by actuaries;
- Funding of public workers' other postemployment benefits (OPEB), typically retiree health costs, as well as trends in per capita unfunded liabilities and liability as a percentage of revenue;
- Policies and practices related to rainy day funds and year-end balances;
- Trends in state public education funding; and
- Disinvestment in infrastructure, including where possible the states' reported statistical metrics on infrastructure conditions.

## Many Pensions, Many Standards

**WHILE THE GOVERNMENTAL** Accounting Standards Board (GASB) provides recommendations for public employee pension funds' reporting, comparing liabilities between states is difficult because they are based on actuarial assumptions and calculation methods that differ from one plan to another.

To project the total amount pension systems will owe retirees over time, actuaries derive assumptions based on their understanding of the economy and employment trends' and provide recommendations to pension boards on such factors as the lifespan of retirees, inflation rate, and salary increases. Other items affecting the calculation of liabilities include the amortization period; the method used for allocating cost over time; and the so-called smoothing period, which has allowed major gains and losses in investment performance to be absorbed gradually.<sup>19</sup> This information helps states decide what to contribute to pensions annually, keeping up with what retirees have earned each year and providing additional funding for a portion of any unfunded liability that has developed over time.

The actuarial assumption that has received the most attention over the past 15 years is the investment return. Any change in this assumption has a substantial impact on the calculation of liabilities. For example, when Utah shifted to a 7.75 percent from an 8 percent assumption in 2008, its funding level dropped to 95 percent from 101 percent. If it had raised the investment rate assumption to 8.5 percent, the funding level would have risen to 113 percent.<sup>20</sup> Of the three states studied by the Volcker Alliance, the Virginia Retirement System assumes a 7 percent rate of return. New Jersey's public employee and teachers' systems use a 7.9 percent rate of return; and both the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) use 7.5 percent. A number of independent experts have questioned whether the pensions' assumptions are higher than justified by existing circumstances and future probabilities.<sup>21</sup>

These and other calculations need to be considered when looking at the plan's calculations of its unfunded liabilities. At the end of 2013, the state portion of the New Jersey pension system was 54 percent funded;<sup>22</sup> the Virginia Retirement System was 65 percent funded.<sup>23</sup> In California, the public employee portion of CalPERS was 75 percent funded,<sup>24</sup> while CalSTRS was 67 percent funded.<sup>25</sup>

### III. THE AGENDA FOR BUDGET REFORM

THE VOLCKER ALLIANCE'S INQUIRY led us to these findings and resulting recommendations, comprising a checklist to improve the quality and transparency of state budgeting:

***Complete budgetary information, including how balance was achieved and whether one-time revenue sources were tapped, should be easier to find and interpret.***

Although a great deal of fiscal and financial data are available on the Internet, much of it can be difficult to find and interpret. Seeking out truth in budgeting and finance requires tapping a number of sources, including multiple documents produced by the budget office, treasurer, and legislative analysts, as well as direct contacts with a variety of state-employed and external researchers. Even then, a state finance expert might have to interpret the uncovered information. In our examination, we found that California provided the most easily accessible information, largely because of the nonpartisan, clear reports prepared by the Legislative Analyst's Office.<sup>26</sup> But in all three states, it was difficult to trace the number of transfers into the general fund from various special funds, such as those supporting transportation projects or energy programs, and to follow changes that occurred after the budget was passed, such as deferrals of spending obligations for pension funding. For the latter, we needed to scrutinize separate state retirement system documents.

***Short-term revenue forecasts should be transparent and supportable by historic growth trends. Past projections should be assessed for accuracy to help improve forecasting methods.***

Budgets are built on a projection of revenue and expenditures. If revenue estimates are too optimistic, a budget that appears balanced will fall short as actual collections trail expectations. States should track and report the accuracy of their projections, work with other states to refine their forecasting methodology, and establish expert advisory teams to review forecasting techniques and recommend needed improvements so that governments can better plan several years ahead.

While consensus revenue estimating cannot guarantee accurate forecasts, the Rockefeller Institute of Government and the Pew Charitable Trusts cite the advantage of the governor, lawmakers, and other parties' reaching agreement on a single estimate.<sup>27</sup> Transparent projections using multiple inputs open to public scrutiny, such as the system Virginia uses, could remove revenue estimates from politics and allow leaders to focus more attention on

allocating available resources where they are most needed.

In addition, fiscal notes establishing the projected cost of legislation should be reviewed carefully to make sure that revenue and spending are estimated accurately and that those estimates are incorporated into budgets. Budgets should also include revenue and spending estimates for at least the next three fiscal years.

Twenty-eight states have adopted a formal consensus estimating procedure involving the legislative and executive branches that typically leads to agreement on a number to be used for projected revenue.<sup>28</sup> Many states, Virginia among them, also include input from advisory groups made up of economists or business leaders to help inform forecasts.

While states differ on whether the governor must use the agreed-on figure in forming the budget or whether it becomes a binding cap on final spending, the perils of a less transparent revenue forecasting process are apparent. For example, New Jersey is one of only 22 states that don't formally rely on reaching consensus to estimate revenue. Instead, the executive branch has the authority to set the revenue figure, and the state's projections in fiscal 2013 and 2014 tended to anticipate more revenue than proved to be the case. In fiscal 2014, New Jersey had a revenue shortfall of \$1.3 billion compared with the projection in the Appropriations Act,<sup>29</sup> partly because it failed to accurately gauge the long-term impact of taxpayers' taking capital gains at the end of 2012 in response to an impending increase in federal tax rates on January 1, 2013. While the gains led to a surge in state tax receipts in 2013, New Jersey was among several states erroneously assuming the revenue increase would be repeated in future years.<sup>30</sup>

No revenue forecasting technique is immune to surprise. Virginia, which is bound by statute to use a consensus forecast, nonetheless also misjudged the impact of the same federal tax-rate change and came up \$350 million short of expectations.

***Recurring costs should be paid with recurring revenue.***

While states may need to tap rainy day funds or seek other short-term solutions during economic downturns, the use of nonrecurring resources to cover recurring costs should be avoided. States shouldn't balance general fund budgets with proceeds from debt or asset sales, extraordinary legal settlements, or other one-time fixes – such as transfers or loans from funds dedicated to specific purposes. They should follow consistent policies for revenue and expense management so that future revenue cannot be shifted routinely into the current fiscal year (or expenses pushed out to the next one) to cover an unbalanced budget. States

should also avoid delaying bill payments beyond the normal schedule to make current-year spending appear lower.

All three states studied by the Volcker Alliance have to varying degrees relied on one-time revenue to balance recurring general fund expenditures. While a strong economic recovery and budget reforms have helped curb California's use of one-time solutions, in past years officials brought future revenue forward into the current year and pushed spending out into future years to help balance the budget; used nongeneral fund resources to support general fund spending; and changed accounting methods for Medi-Cal, the state's version of Medicaid, to achieve a windfall to cover a budgetary gap.

Meanwhile, New Jersey has relied on a variety of one-time maneuvers to balance general fund budgets for the three years studied, including sweeping funds out of accounts earmarked for specific purposes, such as the Clean Energy Program. It has accelerated revenue from future budget years, including front-loading payments for a 15-year contract signed with a private sector company to manage the state lottery. It has drained rainy day fund reserves; delayed property tax rebates; and, to achieve a cash infusion, restructured a bond issue backed by proceeds of the 1997 Master Tobacco Settlement with states.

In Virginia, officials have accelerated sales tax collections to help balance the budget and to a modest extent have transferred balances from dedicated accounts to support the general fund.

***The proceeds of borrowings should not be used to cover operating expenses.***

Operating budgets should not be funded with the sale of bonds or other forms of debt that provide immediate cash but move the cost of debt service to future years. Even if states are prohibited from using borrowing to cover operating costs, there are ways to get around that prohibition, including shifting money from one fund to another. Governments shouldn't directly or indirectly treat the proceeds of debt sales as revenue.

Most state and local governments use forms of cash accounting that have let officials treat the proceeds of debt sales as revenue in determining the balance of various government funds. While states tend to prohibit the sale of general obligation bonds to provide funds for operating costs, the budgets of New Jersey and California have been bolstered by debt in past years. Both states have borrowed substantially against money associated with the Master Tobacco Settlement, which was intended to pay a set sum for years. As a result, that money will not be available in the future to cover spending.

Both have also refinanced debt to get cash to cover current bills. California is one of seven states allowed to carry over a deficit to the next year.<sup>31</sup> During the first decade of the 2000s, voters permitted the state to sell up to \$15 billion in bonds to cover past gaps. The bonds—plus other borrowed money and budgetary deferrals—led California to build what Governor Jerry Brown named a “wall of debt,” which reached \$34.7 billion in 2011 and was still \$24.9 billion at the end of fiscal 2013.

***States should move away from strictly cash budgeting and toward the type of accounting, used in their audited comprehensive annual financial reports, that shows the true present value of future spending obligations.***

The use of cash-based fund accounting methods by most states and localities creates the temptation as well as the capacity to shift the costs of today’s services onto coming generations by ignoring future spending for which taxpayers are already obligated. For example, Virginia, California, and New Jersey have failed to make their recommended contribution, as determined by actuaries, for full funding of public employee pension systems. Yet the states’ enacted budgets show only the amount governors and legislators chose to appropriate for each fiscal year or biennium studied. In addition, New Jersey and California, particularly, have amassed billions of dollars in obligations for public workers’ retirement health care benefits. Virginia has a smaller long-term obligation and has set aside more funding to cover future costs.

The three states have substantial deferred long-term infrastructure maintenance needs that are not reflected in their budgets, and California and New Jersey have failed to reflect the cost of future obligations for K-12 spending required under statutes or judicial orders.

***States must build rainy day funds to safeguard essential services during economic downturns. The size of the funds should be adjusted for revenue volatility, and they should be replenished consistently after they are tapped.***

Revenue volatility is a growing budget problem for states. A 2014 analysis of US Census tax data by the Rockefeller Institute showed that volatility had increased in 42 states between 2000 and 2013.<sup>32</sup> This has complicated forecasting how much cash governments will take in during a fiscal year, and suggests a need for bolstering rainy day funds and accounting for revenue volatility when calculating adequate balances. Yet New Jersey has exhausted its rainy day fund, leaving itself vulnerable to revenue declines in any future economic downturn.

California’s reserve funds have been inadequate to protect the state from cuts in services during downturns. From fiscal 2009 through fiscal 2012, its two reserve funds were completely empty. Voters approved rules in November 2014 to enlarge budgetary cushions and establish procedures for both deposits and withdrawals. But reserves are still low. About \$1.6 billion was shifted to the budget reserve in June—still only 1.5 percent of general fund revenue.

Virginia has solid policies regarding reserves and the goal of building its revenue stabilization fund to 15 percent of expenditures. But since the recession, the commonwealth has not been able to increase reserves anywhere near that goal. For the 2014–16 biennium, about \$1.55 billion was provided as a cushion for the \$36.4 billion budget, but the revenue shortfall was about \$2.4 billion, as reported by the governor’s budget director at the end of calendar 2014.<sup>33</sup> Filling that gap required draining still more resources from the rainy day fund.

**THREE STATES IN FOCUS**

	<b>CALIFORNIA</b>	<b>NEW JERSEY</b>	<b>VIRGINIA</b>
Capital	Sacramento	Trenton	Richmond
Governor/Party	Jerry Brown/D	Chris Christie/R	Terry McAuliffe/D
Population	38.3 million	8.9 million	8.9 million
Unemployment rate (March 2015)	6.5%	6.5%	4.8%
Real gross state product, 2013 (in 2009 dollars)	\$2.1 trillion	\$0.5 trillion	\$0.4 trillion
Gain in Philadelphia Fed state coincident index since recession	20%	10.8%	5.5%
Percentage of roads in poor condition	34%	35%	6%
Moody’s state general obligation bond rating (as of May 21, 2015)	Aa3	A2	Aaa
Average annual change in general fund revenue growth, 2011–13	5.7%	1.0%	1.0%
Unfunded pension liability, 2013	\$130.1 billion	\$37.3 billion	\$28.4 billion
Unfunded pension liability per capita, 2013	\$3,394	\$4,191	\$3,436
Unfunded OPEB liability, 2013*	\$64.6 billion	\$53.0 billion	\$5.4 billion
Unfunded OPEB liability per capita, 2013	\$1,685	\$5,955	\$649
Income tax as percentage of total tax revenue, 2014	55.7%	48.3%	61.3%
Sales tax as percentage of total tax revenue, 2014	36.2%	43.0%	32.0%

\* OPEB = Other postemployment benefits, principally public worker retiree health care. **SOURCES** Municipal Market Analytics survey of state financial data, Bloomberg terminal, Moody’s Investors Service, US Bureau of Labor Statistics, *Governing Magazine*, US Census, Federal Reserve Bank of Philadelphia, American Society of Civil Engineers.



## IV. STATE REPORTS

### CALIFORNIA

ONCE TIED WITH Illinois for America's lowest state general obligation credit rating, California now stands out as a budget reformer. Since 2013, its general obligation bond debt has garnered multiple upgrades from Moody's, S&P, and Fitch.<sup>34</sup>

Until recently, the state employed a wide array of moves to achieve short-term budget relief via a significant amount of public debt, spending deferrals, and other obligations. Since 2010, when Democrat Jerry Brown was elected governor after winning the office twice in the 1970s, the budget approval process has been changed. It has changed to a legislative majority vote versus two-thirds approval for passage—and taxes have been raised, although some of the increases are temporary. The state won voter approval for additional improvements, including strengthening budget reserves, pension funding, and long-term debt reduction, as well as requiring revenue and expenditure forecasts from the executive branch that extend for three years beyond the upcoming budget year.<sup>35</sup> It has also taken steps to improve teachers' pension funding, though this is being accomplished in part by pushing the costs from the state to local school districts.

Risks remain for California. The state is still saddled with \$94.5 billion in bond debt supported by tax revenue, and it has amassed another \$195 billion in unfunded promises to pay pension and other retiree benefits. Its revenue remains highly dependent on capital gains taxes, which means the state is hostage to the vagaries of the stock and real estate markets. Further, California has a \$64.6 billion shortfall in deferred infrastructure maintenance, according to the California Five-Year Infrastructure Plan of 2014.<sup>36</sup> It remains too early to tell if the state's fiscal culture has changed permanently or if California will revert to its previous tactics in the next economic or stock market downturn.

#### **Budget Practices Overview**

California's finances have historically been among the most volatile of any state, and its leaders have often resorted to a wide assortment of budget maneuvers to maintain balance during economic downturns. Recognizing that such actions created enormous long-term liabilities, Governor Brown and legislators have made a commitment to improve budget stability and fiscal sustainability in a state that leads all 50 in population and ranks as the world's eighth-

largest economy.<sup>37</sup> Some of the notable actions include:

- Voter approval in 2010 of Proposition 25, which reduced the legislative vote requirement for approval of the budget from two-thirds to majority.<sup>38</sup> This change has helped the state pass five consecutive on-time budgets, versus its previous history of chronically late budgets built on short-term spending solutions and inadequate spending restraint.
- Voter approval in 2012 of Propositions 30 and 39, which increased recurring revenue to fund ongoing expenditures. Proposition 30 temporarily increased the personal income tax for seven years and sales tax rates for four years to raise an estimated \$6 billion annually from fiscal 2012–13 through 2016–17.<sup>39</sup> Proposition 39 changed the method of calculating some corporations' income taxes to raise an estimated \$1 billion annually.<sup>40</sup>
- Voter approval in 2014 of Proposition 2, aimed at stabilizing the state's rainy day fund. Mandates include using unusually large capital gains tax revenue to build up reserves; diverting general fund revenue toward paying down retirement obligations and debt; providing multiyear budget forecasts; and establishing a special reserve for education funding, the Public School System Stabilization Account.<sup>41</sup>

These reforms were enacted as California's economy and revenue were rebounding. By the first quarter of 2014, revenue was up more than 5 percent from its peak in the third quarter of 2006. The gains continued into the year, with revenue for the first five months running 3.6 percent ahead of the administration's forecast.<sup>42</sup> The state's actions, combined with economic growth, have allowed California to use fewer budget maneuvers over the past three years and to incorporate significant ongoing spending reductions instead of relying on one-time solutions. California closed fiscal 2013 with a general fund surplus of \$234 million—its first positive year-end balance since 2008.<sup>43</sup> With a \$107 billion budget approved for fiscal 2015, the Legislative Analyst's Office projects the fiscal year will end with a total of \$2.1 billion in the state's two budget reserves: the Special Fund for Economic Uncertainties and its traditional rainy day fund, the Budget Stabilization Account.<sup>44</sup>

The recovery and renewed focus on fiscal reforms have allowed California to attack its “wall of debt,” Governor Brown's term for the borrowings, deferrals, and budgetary obligations accumulated over the previous decade as a result of budget solutions that pushed costs out to future years. Aided by an improving economy, the state has made progress in reducing these obligations from \$34.7 billion at the end of fiscal 2011 to \$24.9 billion at the end of fiscal 2014.<sup>45</sup> California expects to slash that amount to \$4.7 billion by the end of fiscal 2017,

an 86.4 percent reduction from 2011.<sup>46</sup>

A key benefit from this reduction is the flexibility that will come from California’s having debt available during the next budget downturn to help address future shortfalls. This kind of countercyclical effort can help a state stay on a relatively even keel.

Moody’s Investors Service has raised its general obligation credit rating for California by four levels since 2009, to Aa3, taking it out of a tie with Illinois for the lowest-ranked state.<sup>47</sup> Despite significant budgetary improvements over the last few years, however, California still faces a number of challenges and risks—particularly its tendency to overspend during boom years. Additionally, the full expiration of higher taxes in 2018 under Proposition 30 poses a budgetary hazard. A failure to control spending to align with recurring revenue—which will be difficult unless the taxes under Proposition 30 are extended—might undermine the fiscal improvements the state has realized over the past few years.

### Revenue Forecasting

Unlike Virginia and 27 other states, California does not use a revenue estimate based on a consensus of the governor’s office, legislators, and outside experts. Its forecasting begins with an estimate of general fund revenue based on a projection of national economic activity prepared by an independent company. The national forecast is used to develop an outlook for similar indicators for California. After the forecasts of major national and California economic indicators are finalized, revenue estimates are generated using models created and maintained by the state Department of Finance, which develops and periodically updates the estimates used in the governor’s budget

### CALIFORNIA’S ECONOMY

CAPITAL  
**Sacramento**

GOVERNOR/PARTY  
**Jerry Brown/Democrat**

POPULATION

**38.3**  
Million

UNEMPLOYMENT RATE  
(MARCH 2015)

**6.5%**

REAL GROSS STATE PRODUCT,  
2013 (IN 2009 DOLLARS)

**\$2.1**  
Trillion

GAIN IN PHILADELPHIA FED  
STATE COINCIDENT INDEX  
SINCE RECESSION\*

**20%**

PERCENTAGE OF ROADS IN  
POOR CONDITION

**34%**

MOODY’S STATE GENERAL  
OBLIGATION BOND RATING  
(AS OF MAY 21, 2015)

**Aa3**

\* Through April 30, 2015. Includes nonfarm payroll employment, average manufacturing hours worked, and real wage and salary disbursements.

**SOURCES** Municipal Market Analytics survey of state financial data, Bloomberg terminal, Moody’s Investors Service, US Bureau of Labor Statistics, *Governing Magazine*, US Census, Federal Reserve Bank of Philadelphia, American Society of Civil Engineers.

proposals. The California Legislature subsequently prepares revenue estimates as part of its Annual Budget Act. After reviewing this proposal, the governor signs or vetoes the annual budget. When the legislature disagrees with the governor, a closure deal—occurring at the end of the process—provides a compromise on the budget act revenue forecast.

Research has shown that revenue forecast errors for the state’s general fund appear to be largest during recessions.<sup>48</sup> Forecasting state revenue accurately is uniquely challenging in California because of a highly progressive income tax with returns that fluctuate through economic cycles. With its taxes heavily influenced by the Silicon Valley technology industry and stock market cycles, California depends greatly on the income taxes paid by high-net-worth residents. A reliance on capital gains and equity option-related profits has helped make California tax revenue the fourth-most volatile among the 50 states, at 132 percent of the national average, according to the Pew Charitable Trusts. Pew estimates that the state’s revenue stream was 70 percent more volatile than the US average from fiscal 1995 through 2013.<sup>49</sup>

In fiscal 2015, 67 percent of California’s estimated general fund revenue came from the personal income tax, of which \$10.8 billion, or 9.4 percent, was connected to capital gains.<sup>50</sup> Recently released data from the state Franchise Tax Board show that the wealthiest 1 percent of Californians paid 50.6 percent of the state income tax in 2012, compared with 41.1 percent in 2011.<sup>51</sup> The dependence on wealthy taxpayers became even more pronounced after the 2012 passage of Proposition 30, which raised the state’s top marginal income tax rate from 10.3 percent to 13.3 percent, the highest in the nation.<sup>52</sup>

### **Use of Borrowed Money**

The California Constitution prohibits using general obligation bonds to finance state budget deficits. Voters must approve general obligation bonds, while the legislature authorizes lease revenue bonds, which the Treasurer’s office defines as long-term borrowings for public improvements such as state office buildings, universities, and prisons.<sup>53</sup> Special fund and self-liquidating general obligation bonds are primarily secured by specific revenue, and the general fund is not expected to pay the debt service. California does not employ scoop-and-toss refinancing structures—in which issuers refund debt maturing in the immediate future (the scoop) with bonds that may come due many years later (the toss), thus pushing the cost of current obligations (and the services and benefits of those obligations) onto future taxpayers.<sup>54</sup>

While California cannot sell bonds to cover general fund deficits, it has historically

borrowed and transferred money from other funds. But the state's leadership has taken important steps to manage cash flow in a way that avoids short-term actions that might exacerbate future problems.

### **Reliance on Other Nonrecurring Sources**

Over a number of years, the state implemented shortsighted budgetary solutions by deferring certain required payments using tax payment accelerations. As part of the fiscal 2015 budget projection, Governor Brown estimated that the state had an accumulated \$24.9 billion in budgetary borrowing or deferred obligations as of June 30, 2014. These include Proposition 98 payments to schools and Medi-Cal (the state's Medicaid program) reimbursements. The state has also deferred its Proposition 4 required cost reimbursement to local governments for new programs or services.

The state has obscured its budget problems further by changing the accounting for various programs from an accrual basis (in which expenses are recorded when they're incurred) to a cash basis (in which they're recorded when they are paid). Changing Medi-Cal to a cash basis in the early to mid-2000s allowed the state to reduce spending by delaying certain payments until the next year and helped achieve temporary budgetary balance. Although this device has not been used in a decade, the legacy remains. According to the Legislative Analyst's Office, the cost of returning Medi-Cal to an accrual basis of accounting was \$2 billion as of fiscal 2013.<sup>55</sup>

Additionally, in recent history—but before the period of this study—the state delayed payments to employees; increased amounts withheld from many public and private sector workers' paychecks, primarily to accelerate \$1.6 billion in additional personal income tax (PIT) revenue; and accelerated the estimated payment schedule for PIT and corporation tax revenue to the first half of the calendar year from the second, thereby artificially inflating general fund revenue. (See box on page 27.)

### **Status of Pension and OPEB Funding**

California is carrying a total of \$131.1 billion in unfunded pension liabilities and \$64.6 billion in unfunded retiree health benefits for state workers, teachers, and local school administrative personnel. The combined amounts equal more than 9 percent of the state's \$2.1 trillion economy, a burden of about \$5,100 per resident.

The two main state pension systems are the California Public Employees' Retirement

System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). The former provides retirement benefits for 1.7 million public employees, retirees, and families; the latter administers retirement programs for 868,000 current, former, and retired teachers and administrators.

As of June 30, 2013, the public employee portion of CalPERS was about 75 percent funded,<sup>56</sup> while CalSTRS had set aside only 67 percent of the assets needed to pay promised benefits.<sup>57</sup> Wilshire Consulting estimates that the funding ratio for state pension plans nationwide was 75 percent in 2013, up from 72 percent in 2012.<sup>58</sup> (In 2014, the funding ratio estimate rose to 80 percent.<sup>59</sup>) In general, California has contributed the annual amount that actuaries calculate is needed to achieve full funding over time for CalPERS. That isn't the case with CalSTRS, whose contributions are set through statutes that dictate the percentage of payroll employers must pay each year. That these rates have lagged actuarial recommendations significantly contributed to an unfunded actuarial obligation of \$73.7 billion through June 2013.

Paying the full annual contribution recommended by actuaries doesn't guarantee that full funding will be achieved, partly because the calculations are based on projections about the economy or mortality rates that could prove inaccurate. Although CalPERS fully funds the annual contribution, it still has an unfunded liability of \$64.6 billion. For example, the actuarial liability grew in the 2008–10 period, when CalPERS and other funds took major investment losses.

To deal with the CalSTRS problem, Governor Brown in 2014 signed legislation aimed at improving its funding. The law increased member, employer, and state contributions, which state actuaries project will fully fund the plan within 32 years. Contributions would increase annually, reaching more than \$5 billion. Total contributions from the state, school districts, and teachers equal 19.3 percent of teacher payroll and will rise eventually to 35.7 percent,<sup>60</sup> paid for largely by the districts. With Proposition 13 limiting the ability to boost property taxes, school districts will probably need other revenue sources to meet the added cost of funding pensions under the new law unless investment returns grow far faster than expected.

The state also provides other postemployment benefits (OPEB), primarily health care, to more than 1.3 million annuitants of its retirement systems. In accordance with the California Government Code, the state generally must pay 100 percent of annuitants' health insurance cost, plus 90 percent of the premium for family members. Partly as a result of this generosity, unfunded liabilities for retiree health care benefits pose long-term financial issues. As of June

30, 2013, California’s unfunded OPEB liability was \$64.6 billion. That is equivalent to about \$1,700 per capita, 68 percent above the median for all 50 states.<sup>61</sup>

### Rainy Day Fund Policy and Use

Governor Brown has made rebuilding state fiscal reserves drained during the recession one of his top priorities. California has traditionally had two reserve funds: the Special Fund for Economic Uncertainties and the Budget Stabilization Account. Like many other states, California has underfunded such reserves, and high spending requirements for schools have made it difficult for the state to build reserves at all. The result: Reserves have generally been insufficient to protect the state in bad times. Indeed, from 2008–09 through 2011–12, the state’s combined reserves were completely unfunded.

Reflecting California’s commitment to fiscal sustainability, Proposition 2—a constitutional amendment passed by voters in November 2014 following legislative approval—tightens rules for making deposits to and withdrawals from the Budget Stabilization Account. It requires the state to set aside capital gains tax proceeds that exceed 8 percent of general fund revenue, doubles the current maximum size of the account to 10 percent of revenue from 5 percent, requires supplemental payments to retire debt, and limits withdrawals to ensure that the state does not rely unduly on the fund at the start of a downturn.<sup>62</sup> The legislation mandates that once reserves are fully funded, the excess can be used only for retiring debt (such as reducing unfunded liabilities for public pensions) or for emergencies.

### CALIFORNIA'S FINANCES

AVERAGE ANNUAL CHANGE  
IN GENERAL FUND REVENUE  
GROWTH, 2011–13

**5.7%**

UNFUNDED PENSION  
LIABILITY, 2013

**\$130.1**  
Billion

UNFUNDED PENSION LIABILITY  
PER CAPITA, 2013

**\$3,394**

UNFUNDED OPEB LIABILITY,  
2013\*

**\$64.6**  
Billion

UNFUNDED OPEB LIABILITY  
PER CAPITA, 2013

**\$1,685**

INCOME TAX AS PERCENTAGE  
OF TOTAL TAX REVENUE, 2014

**55.7%**

SALES TAX AS PERCENTAGE OF  
TOTAL TAX REVENUE, 2014

**36.2%**

\* OPEB = Other postemployment benefits, principally public worker retiree health care.

**SOURCES** Municipal Market Analytics survey of state financial data, Bloomberg terminal, Moody's Investors Service, US Bureau of Labor Statistics, *Governing Magazine*, US Census, Federal Reserve Bank of Philadelphia, American Society of Civil Engineers.

### **Educational Funding Trend**

Following voter approval in 1979 of Proposition 13, which limited local property taxes, Californians passed Proposition 98 in 1988. This shifted the state's education funding to a mix of state aid from general fund and local property levies. Proposition 98 guarantees K-14 and K-12 schools and community colleges a minimum annual funding amount that's set via a complex formula linked to the economy and number of students.<sup>63</sup> Yet the response of governors and legislators to past budget gaps resulted in California's amassing an \$11.5 billion shortfall for its K-12 commitments by the end of 2012–13.<sup>64</sup>

With its school spending down 3.2 percent, California is one of 30 states providing less money for education now than it provided before the recession, according to the Center on Budget and Policy Priorities.<sup>65</sup> Proposition 98 typically consumes about 43 percent of general fund tax revenue and a somewhat higher percentage of new revenue.<sup>66</sup> The Proposition 98 minimum-funding guarantee will rise to \$66.5 billion for 2016–17, compared with \$47.3 billion for 2011–12, a jump of more than \$19 billion in the five-year period. Proposition 2, passed in November 2014, was intended in part to alleviate the recurrence of accumulated Proposition 98 deferrals by creating a separate reserve fund, the Public School System Stabilization Account, financed from tax revenue related to capital gains.

The unique Proposition 98 formula could cause budgetary imbalances again in the future. By formula, California school funding rises with revenue. Current tax collections are booming and will likely exceed estimates by billions, which could dramatically increase Proposition 98 spending. While the challenges are modest compared with previous budget crises, the governor will need to balance growing school outlays with other budgetary considerations, including the requirements of Proposition 2.

### **Deferred Maintenance Trend**

According to the 2013 report from the American Society of Civil Engineers on the state of US infrastructure, 11.1 percent of the bridges in California are considered structurally deficient and 16.8 percent are considered functionally obsolete; 34 percent of its major roads are in poor condition.<sup>67</sup>

Governor Brown recently released California's first Five-Year Infrastructure Plan since 2008, with deferred maintenance needs totaling \$64.6 billion. Transportation represents by far the largest share (\$59 billion) of that.<sup>68</sup> According to the infrastructure plan:

“Caltrans' current annual budget of \$412 million available for maintenance priorities —



such as patching, thin overlays, joint and bearing repairs on bridges, and minor repairs to drainage systems—is well under the estimated \$928 million in annual needs. The \$2.3 billion in the State Highway Operation and Protection Program available annually for repair work—such as replacement of pavement and culverts and reinforcement of overpasses and bridges—is insufficient to address the estimated \$8.2 billion in annual need.”<sup>69</sup>

## Deficits and Debt in the Golden State

**DESPITE CONSERVATIVE REGULATIONS**, California has historically resorted to using debt and deficit borrowing to balance budget shortfalls. Though not taking place within the time period covered by this report, these events are worth noting:

- In 2003, California issued two tobacco settlement bonds that produced \$4.75 billion in proceeds that were transferred to the general fund. The bonds were refunded in 2005 and 2007 to generate an additional \$1.78 billion for the budget. The state has committed to investors that the governor will ask the legislature for a general fund appropriation if tobacco settlement revenue is insufficient to pay debt service.<sup>70</sup> Given the uncertainty of future tobacco industry revenue and payments to the state, the agreement—known as a covenant—introduces potential risks to future budgets.
- In 2004, Proposition 57 authorized the state to sell up to \$15 billion in Economic Recovery Bonds to finance past budget deficits.<sup>71</sup> About three-quarters of the bonds were issued in 2004, and some were issued in 2008. Repayment is secured by a pledge of revenue from a 2004 increase of one-quarter cent in the sales and use tax. In addition, as voter-approved general obligation bonds, the debt is secured by the state's full faith and credit and payable from the general fund in the event the dedicated sales and use tax revenue is insufficient to repay the obligations.
- The state has issued IOUs, called revenue anticipation warrants, payable in the next fiscal year. California issued the warrants to bridge emergency cash shortages in 1992, 1993, 1994, 2002, and 2003.<sup>72</sup> It also issued \$2.6 billion of the IOUs in 2009 to pay businesses, local governments, and tax filers due refunds after legislators failed to pass a budget by the beginning of the fiscal year and the general fund ran short of cash to pay bills.<sup>73</sup>
- California has used loans from special funds to help close general fund budget shortfalls, generating one-time savings that avoided spending cuts or revenue increases of an amount equal to the loans.

## NEW JERSEY

WHILE CALIFORNIA HAS TAKEN aggressive measures to get its fiscal house in order, New Jersey is still seeking lasting solutions. The Garden State's budget practices under both Republican and Democratic administrations dating back at least to the 1990s have produced repeated structural imbalances and deterioration in fiscal flexibility and credit quality; rating agencies have downgraded its general obligation bonds nine times since 2010.<sup>74</sup> The budget process is centralized in the governor's office, and chief executives wield significant power through a constitutional requirement that gives them the job of certifying state revenue.

To produce a balanced budget, New Jersey has counted on shifting resources intended for other programs to the general fund and has increased its reliance on borrowing. It does not issue multiyear budget forecasts, and repeated optimistic revenue estimates have resulted in midyear adjustments that are not subject to the usual legislative budgeting process. Against this backdrop, the need to catch up with the state's \$90 billion in unfunded pension and other retirement liabilities weighs heavily on spending decisions. Unless it is reversed by a state court, the 2014 decision by Republican Governor Chris Christie to block a pension-funding schedule agreed to with the legislature means retirement liabilities will keep rising. That will lead eventually to cuts in existing programs, including education and infrastructure investment, unless new revenue can be raised or pension costs reduced.

### Budget Practices Overview

New Jersey's recurring revenue has failed to keep pace with expenditures. As a result, the state has relied on a series of maneuvers to achieve balance in a general operating budget originally totaling \$32.5 billion in appropriations for fiscal 2015.<sup>75</sup> According to a Rutgers University forecast in May 2014, the state's economic expansion has trailed that of neighboring states and the nation, limiting revenue. Rutgers attributes this to a number of factors, including the high cost of living and doing business in the state and slower population growth.<sup>76</sup> New Jersey has the largest per capita property tax collections in the nation<sup>77</sup> and ranks second in overall tax burden,<sup>78</sup> making revenue increases politically difficult. With many New Jerseyans working in neighboring New York and Pennsylvania, residents also pay an average of \$2,000 per capita in taxes on income earned in other states, according to the Tax Foundation.<sup>79</sup>

As of May 2015, concerns that New Jersey's high tax burden and difficulties enacting reforms of public worker pensions and retiree health care benefits have left the state with a

Moody's general obligation credit rating of A2, the second-lowest of any state, after Illinois.

### **Revenue Forecasting**

Unlike 28 other states, New Jersey does not use a consensus of forecasts from the governor's office, legislative leaders, and outside experts to build an estimate of revenue to include in the general fund budget. Instead, the governor's proposed budget includes the chief executive's estimate of resources available for the upcoming fiscal year. The Office of Legislative Services provides a separate revenue forecast. While both are reviewed by the legislature—which can adjust the projections—the governor has the final say because his or her certification of state revenue is required as part of the final Appropriations Act.

While revenue for the current year was projected to be \$200 million over the governor's initial estimate when the fiscal 2015 budget was enacted, overly optimistic revenue assumptions in New Jersey were the norm in the previous two of the three fiscal years we studied. Growing expenditures and fewer opportunities for maneuvers may have prompted the use of aggressive assumptions. While the legislature can cut the revenue forecast, any reduction must have corresponding program cuts.

### **Use of Borrowed Money**

New Jersey is prohibited from using bond proceeds as revenue for budgeting purposes by a 2004 New Jersey Supreme Court ruling, *Lance v. McGreevey*.<sup>80</sup> The state has relied on other forms of borrowing to achieve budgetary balance, however. They include using bond premiums as a revenue source and relying on planned as well as unplanned refinancing activity to generate near-term savings.

These actions insert risk into the state's budget and, ultimately, its ability to fund future needs. Though debt restructuring can sometimes generate real savings, it also can be another way to transfer current costs to future generations. The real value of debt restructuring depends on the interest rate environment and on bonds available to be refunded. Like many municipal issuers, New Jersey has sold securities bearing coupons that are above market levels, say 5 percent, when similarly rated bonds of like maturities are yielding less. Investors typically pay more than face value for such securities, and an issuer, such as New Jersey's Transportation Trust Fund Authority, uses the premium as revenue for the current fiscal year.<sup>81</sup> Such use of bond premiums costs the state more in ongoing interest payments than would have been required if a bond were issued at par, or face value.

The state’s declining liquidity has contributed to accelerated issuance of tax and revenue anticipation notes. In fiscal year 2015, a sale took place on the first day, July 1.<sup>82</sup>

### Reliance on Other Nonrecurring Sources

Large fund transfers or diversions and asset sales have been used to shore up New Jersey’s general fund budget. The fund’s balance—basically the amount of cash the state has available at the end of the fiscal year for day-to-day operations—has been declining because it has been used to support the budget. The balance dropped from \$804 million<sup>83</sup> at the beginning of fiscal 2011 to an estimated \$300 million<sup>84</sup> at the end of fiscal 2014, according to the National Association of State Budget Officers.

The Government Finance Officers Association recommends that governments of all sizes maintain balances of “no less than two months of regular general fund operating revenue or regular general fund operating expenditures,” or 16.7 percent.<sup>85</sup> New Jersey’s reduction of its fund balance to less than 1 percent of general fund revenue leaves the state little flexibility to address revenue underperformance or unanticipated expenditures. For fiscal 2015, the state originally budgeted a modest increase in the general fund balance to \$388 million.

For several years, New Jersey has relied on the transfer to the general fund of a portion of the balances of the Clean Energy Program, a separate fund financed by utility ratepayers and intended to promote energy efficiency and the use of renewable sources. Since 2008, the transfers have ranged from \$10 million in earlier years to highs of over \$250 million in 2012 and 2014.<sup>86</sup>

The state has also tapped the New Jersey Turnpike Authority, an agency supported by toll revenue. An annual

## NEW JERSEY'S ECONOMY

CAPITAL  
**Trenton**

GOVERNOR/PARTY  
**Chris Christie/Republican**

POPULATION  
**8.9**  
Million

UNEMPLOYMENT RATE  
(MARCH 2015)  
**6.5%**

REAL GROSS STATE PRODUCT,  
2013 (IN 2009 DOLLARS)  
**\$0.5**  
Trillion

GAIN IN PHILADELPHIA FED  
STATE COINCIDENT INDEX  
SINCE RECESSION\*  
**10.8%**

PERCENTAGE OF ROADS IN  
POOR CONDITION  
**35%**

MOODY'S STATE GENERAL  
OBLIGATION BOND RATING  
(AS OF MAY 21, 2015)  
**A2**

\* Through April 30, 2015. Includes nonfarm payroll employment, average manufacturing hours worked, and real wage and salary adjustments.

**SOURCES** Municipal Market Analytics survey of state financial data, Bloomberg terminal, Moody's Investors Service, US Bureau of Labor Statistics, *Governing Magazine*, US Census, Federal Reserve Bank of Philadelphia, American Society of Civil Engineers.

amount of \$295 million—representing most of the payments made by the authority to the state under a \$1.465 billion funding agreement in 2011—is being diverted to the general fund and away from the Transportation Trust Fund. The cash was intended to pay debt service on Transportation Trust Fund bonds or to finance capital projects, but the state has used it to reduce general fund expenditures for New Jersey Transit, its mass transit agency. Consequently, the Transportation Trust Fund has been forced to borrow rather than increase the pay-as-you-go portion of the capital plan.

In addition, \$1.8 billion from the Port Authority of New York and New Jersey, originally earmarked for building the Access to the Region’s Core rail tunnel project connecting the two states, was redeployed to support specific state transportation projects after Governor Christie canceled the tunnel. These funds will be exhausted in 2016. The potential need to replace both sources of funds exposes future budgets to uncertainty and risk.

In fiscal 2013, the state entered into a 15-year contract with Northstar New Jersey Lottery Group to manage its lottery and received an “accelerated” upfront payment of \$120 million for the general fund.<sup>87</sup> To help close a midyear budget gap, the state in 2014 also sold revenue it was owed under the 1997 Master Settlement Agreement between tobacco producers and states. In exchange for an upfront payment from bond investors of \$92 million, the state gave up an estimated \$400 million in settlement revenue between fiscal 2017 and fiscal 2023.<sup>88</sup> The state needs to address the loss of that money in future budgets.

The state has also inconsistently managed the timing of revenue collection and spending. In 2013, for example, New Jersey pushed payment of \$395 million in property tax rebates across fiscal years, from May to August, to help close a budget gap. In addition, the state has generated cash infusions by making occasional offers to taxpayers to pay overdue balances without penalties. The latest, from September 17 through November 17, 2014, was estimated to bring in \$75 million.<sup>89</sup>

### **Status of Pension and OPEB Funding**

For decades, governors of both parties have balanced New Jersey budgets by declining to put aside the amount of money actuaries say is necessary, on an annual basis, to ensure that the state will be capable of covering future promised benefits. Underfunding of New Jersey’s other postemployment benefits (OPEB), primarily retiree health care, amounts to \$53 billion, or \$5,955 per capita. The 2013 unfunded liability for the state portion of the New Jersey pension system was about \$37 billion, giving it enough assets to cover only 54 percent of promised

benefits.<sup>90</sup> That is equivalent to \$4,191 per person, versus a national median in 2012 of \$2,962.<sup>91</sup> Wilshire Consulting estimates that the funding ratio for state pension plans nationwide was 75 percent in 2013, up from 72 percent in 2012.<sup>92</sup> (By 2014, the estimate of the funding ratio had risen to 80 percent.<sup>93</sup>)

New Jersey's performance in annual pension funding is poor compared with other states. While most states fund more than 90 percent of their actuarially determined contribution, New Jersey contributed only 28 percent in fiscal 2013.<sup>94</sup> In 2011, pension reforms suspended cost-of-living adjustments, increased employee contributions, and extended the retirement age to 65 from 62 for individuals enrolled on or after June 28, 2011. In exchange, Governor Christie and the Democratic-controlled legislature agreed to raise payments to the pension system to achieve full funding of the annual contribution by 2018, at the time estimated to be about \$5 billion.

Despite reforms in 2011, the revenue shortfalls that materialized toward the end of fiscal 2014 led the state to cut its pension payments to the system to \$696 million. This reduced payment covered only normal costs, which are pension benefits earned by employees in that year without regard to money owed because of accumulated unfunded liabilities. The governor's decision in 2014 to override the deal through executive action means retirement liabilities will keep rising even faster than anticipated in 2011. That will likely lead to major cuts in other programs unless significant new revenue can be raised, investment returns increase dramatically, or pension costs fall sharply.

The state took the same approach in 2015 and reduced the budgeted payment for pensions to \$681 million from \$2.25 billion, but its failure to contribute the

**NEW JERSEY'S FINANCES**

 AVERAGE ANNUAL CHANGE  
IN GENERAL FUND REVENUE,  
2011-13

**1.0%**

 UNFUNDED PENSION  
LIABILITY, 2013

**\$37.3**

Billion

 UNFUNDED PENSION LIABILITY  
PER CAPITA, 2013

**\$4,191**

 UNFUNDED OPEB LIABILITY,  
2013\*

**\$53.0**

Billion

 UNFUNDED OPEB LIABILITY  
PER CAPITA, 2013

**\$5,955**

 INCOME TAX AS PERCENTAGE  
OF TOTAL TAX REVENUE, 2014

**48.3%**

 SALES TAX AS PERCENTAGE OF  
TOTAL TAX REVENUE, 2014

**43.0%**

\* OPEB = Other postemployment benefits, principally public worker retiree health care.

**SOURCES** Municipal Market Analytics survey of state financial data, Bloomberg terminal, Moody's Investors Service, US Bureau of Labor Statistics, *Governing Magazine*, US Census, Federal Reserve Bank of Philadelphia, American Society of Civil Engineers.

full amount for fiscal 2015 required under the pension reform legislation is the subject of a lawsuit before the New Jersey Supreme Court. These further deferrals will make it even more difficult for future budgets to accommodate needed pension payments. If the state had budgeted to pay its full actuarial contribution in fiscal 2015, the payment would consume 12 percent of general fund revenue; its original budgeted pension contribution amounted to only about 2.1 percent.

OPEB liabilities, which are far greater than the pension gap, now exceed \$50 billion. A lack of advance funding of OPEB obligations is typical in most states, but New Jersey has the country's second-highest OPEB liability as a percentage of revenue, according to Moody's.<sup>95</sup> This discrepancy is due in part to the state's contributing large sums to pay for teacher retiree health benefits, an obligation many other states leave to local governments and school districts. Like most states and cities, New Jersey has not set aside reserves for its long-term retiree health costs and funds the benefits on a pay-as-you go basis. About \$1.7 billion, or about 5 percent of general fund revenue, was budgeted in fiscal 2015 for retiree health benefits. Making the roughly \$5 billion<sup>96</sup> actuarially recommended contribution in 2014 would have consumed about 15 percent of the general fund budget.

### **Rainy Day Fund Policy and Use**

New Jersey has a rainy day fund, the Surplus Revenue Fund, and a policy to deposit into it 50 percent of collections above whatever revenue the governor certifies for the fiscal year in the annual Appropriations Act, excluding personal income tax revenue. The fund is accessible to cover revenue shortfalls or to respond to an emergency.<sup>97</sup> However, for the past several years, the fund's balance has been \$0.

### **Educational Funding Trend**

State spending on K-12 education accounts for about 40 percent of the budget and has risen by about 4 percent to 6 percent annually over the past few years. According to US Census data, New Jersey is among the top five states in terms of spending per pupil. But even that high level falls short by about \$1 billion for fiscal 2015 of the required amount under the State Funding Reform Act—enacted in 2008 to provide for a fair and equitable education for all students.<sup>98</sup> The gap between actual expenditures on K-12 and the required funding level would be a danger to future budgets if the state were ordered to increase funding to come closer to the required amount, as has happened in the past. In 2011, a New Jersey Supreme



Court ruling that the state had failed to uphold its constitutional requirement to adequately fund certain school districts resulted in an increase in K-12 funding for that year.

### **Deferred Maintenance Trend**

The 2013 report from the American Society of Civil Engineers on the state of US infrastructure found that 35 percent of New Jersey's roads are in poor condition, and more than a third of its bridges are structurally deficient or functionally obsolete.<sup>99</sup>

New Jersey maintains a seven-year estimate of capital spending needs and is one of only 18 states to include its capital budget in the operating budget, according to the National Association of State Budget Officers.<sup>100</sup> According to the New Jersey Commission on Capital Budgeting and Planning—the central agency responsible for short- and long-range capital planning—in fiscal 2013–15, capital requests were received for between \$2.5 billion and \$3.5 billion each year. Forty percent to 50 percent of the requests were provided for in the budget.

## VIRGINIA

VIRGINIA HAS A LONG-STANDING and well-deserved reputation for strong budget practices that in large part reflects a budgetary process that is more administrative than political.

While the Virginia Constitution makes the governor the only state chief executive limited to a single term of four years, the state looks beyond the period when estimating the fiscal outlook. The commonwealth has a robust process for consensus revenue estimating that by law provides forecasts for six-year periods. The forecasts are based on input from the Joint Advisory Board of Economists, a statutorily established panel that includes the state finance secretary, representatives of both houses of the legislature, and outside economists; and from the Governor's Advisory Council on Revenue Estimates, another statutory group composed of the governor, and legislative and business leaders.<sup>101</sup>

Despite the state's strong revenue-forecasting requirement, both Democratic Governor Terry McAuliffe's administration, which took office in January 2014, as well as that of his Republican predecessor, Governor Bob McDonnell, were slow to react to warnings that Virginia would face severe pressure from federal spending cuts stemming from budget sequestration. Since the state's economy is heavily dependent on US government spending, revenue declines resulting from federal reductions threaten to drain much of Virginia's rainy day fund as it grapples with the challenge of an underfunded pension system.

### **Budget Practices Overview**

Virginia's conservative fiscal management has made it one of only eight states to receive top, AAA credit grades from Moody's, Standard & Poor's, and Fitch.<sup>102</sup> Professional budget and finance officials in Virginia tend to last through multiple administrations, while governors are barred by the state constitution from serving a second consecutive four-year term and thus have relatively limited influence over the biennial budget cycle. Highlights of the cycle include six-year strategic planning for revenue and capital spending, repeated revenue reestimation, statutory constraints on borrowing, and an actively employed rainy day fund. Although the revenue picture has recently improved, a surprise late-year shortfall in fiscal 2014 tax receipts and a projected gap in the fiscal 2015–16 budget engendered the use of some one-time solutions.

## Revenue Forecasting

Virginia's revenue assumptions and methodologies are subject to periodic review by a volunteer state board of professional economists, and actual revenue estimates are reviewed by a consensus group of executive and legislative political leadership. While the practice does not guarantee more-accurate forecasts, its wide range of inputs allows political leaders to focus more on the debate about expenditures than on a debate about the level of revenue.

Virginia law requires that governors present a forecast of economic activity each fall, with additional reviews of revenue midway through the fiscal biennium.<sup>103</sup> In fiscal 2013 and 2014, initial revenue setting appeared reasonable, despite an unexpected \$350 million shortfall in nonwithholding income taxes beginning in May 2014. As was the case in New Jersey, this stemmed from the state's misinterpreting the permanence of increases in capital gains tax revenue realized when President George W. Bush's tax cuts expired in December 2012.<sup>104</sup>

The gap was easily managed within the year by carrying forward a budget cushion of \$500 million in unspent revenue. However, either because it was late in the budget process or because the governor was unwilling to reestimate revenue by year-end, the fiscal 2015–16 biennial budget was not adjusted downward for \$1.55 billion in diminished revenue expectations (\$950 million in 2015 and \$600 million in 2016). Still, the so-called money committees—House Appropriations and Senate Finance—subsequently adjusted appropriations to address the expected shortfall. Their actions included zeroing out most discretionary spending increases and preparing to tap the Revenue Stabilization Fund, the state's rainy day fund, if needed.

More recently, revenue increases have alleviated some of the pressure on Virginia's budget. For the first eight months of fiscal 2015, tax collections rose 6.6 percent, well ahead of the General Assembly's revised estimate of 4.7 percent.<sup>105</sup> Earlier estimates had projected revenue growth of 3.1 percent for both fiscal 2015 and 2016.<sup>106</sup>

## Use of Borrowed Money

Virginia's top credit rating imposes a powerful discipline on policymakers. Although the state is allowed to borrow to smooth out peaks and valleys in cash flow, it has not done so in the last three budget years. In any event, total borrowing is limited by how much the state has received in the last three years from income and sales taxes. Virginia avoids using bond premiums for its general fund; leaders instead use the proceeds to reduce borrowing.

### Reliance on Other Nonrecurring Sources

Virginia implemented an accelerated sales tax program in 2009 that obligates many businesses to prepay a year of expected levies. While the commonwealth narrowed the universe of businesses required to prepay through fiscal 2013 and 2014, it temporarily reversed the scheduled reduction to help patch the fiscal 2015–16 budget.

The state also allows for transferring costs from one fiscal year to the next within the biennium. For example, the fiscal 2015–16 budget paid \$12 million toward an \$80 million transportation project in fiscal 2015 and the remaining \$68 million in fiscal 2016, rather than spread the cost evenly over two years. Among other minor one-time solutions, Virginia transferred \$30 million from the highway maintenance fund to the general fund—the reverse of how money typically has flowed.

### Status of Pension and OPEB Funding

The state has been aggressive in reforming its public pension liabilities, which are administered by the Virginia Retirement System. The pension is underfunded compared with other states, with actuarial assets only 65 percent of liabilities in fiscal 2013—the legacy of years of underfunding. Wilshire Consulting estimates that the funding ratio for state pension plans nationwide was 75 percent in 2013, up from 72 percent in 2012.<sup>107</sup> (By, 2014, the estimate of the funding ratio had risen to 80 percent.<sup>108</sup>)

Virginia has launched three major pension reform programs in the past five years. The first reform, in 2010, created Plan 1 and Plan 2. The latter was for new employees, who for the first time were required to pay a portion (5 percent) of their salary toward the pension and who receive less generous cost-of-living adjustments and have longer vesting periods.

#### VIRGINIA'S ECONOMY

CAPITAL  
**Richmond**

GOVERNOR/PARTY  
**Terry McAuliffe/Democrat**

POPULATION

**8.3**  
Million

UNEMPLOYMENT RATE  
(MARCH 2015)

**4.8%**

REAL GROSS STATE PRODUCT,  
2013 (IN 2009 DOLLARS)

**\$0.4**  
Trillion

GAIN IN PHILADELPHIA FED  
STATE COINCIDENT INDEX  
SINCE RECESSION\*

**5.5%**

PERCENTAGE OF ROADS IN  
POOR CONDITION

**6%**

MOODY'S STATE GENERAL  
OBLIGATION BOND RATING  
(AS OF MAY 21, 2015)

**Aaa**

\* Through April 30, 2015. Includes nonfarm payroll employment, average manufacturing hours worked, and real wage and salary disbursements.

**SOURCES** Municipal Market Analytics survey of state financial data, Bloomberg terminal, Moody's Investors Service, US Bureau of Labor Statistics, *Governing Magazine*, US Census, Federal Reserve Bank of Philadelphia, American Society of Civil Engineers.

The second, in 2012, further cut COLAs for Plan 2 employees. In 2013, the third reform created Plan 3. Aimed at new employees or those opting in, it has a hybrid structure that combines a smaller defined-benefit approach with a defined-contribution plan, similar to a 401(k), that does not guarantee a specific return.<sup>109</sup> While Virginia has historically not paid the full amount that actuaries recommend for the annual contribution, it is moving toward full annual funding. The General Assembly has put itself on a schedule to increase funding each year until it hits 100 percent of the recommended contribution in fiscal 2019.<sup>110</sup> The commonwealth's budget accelerated the schedule in fiscal 2014 and held to its advanced funding level in the 2015 budget, even though that added \$150 million to the projected budget gap. With the revenue picture improving this year, additional pension funding was also added to the upcoming biennial budget.<sup>111</sup>

Unlike most states and municipalities, Virginia has statutory language that requires the funding of 90 percent of the annual recommended contribution for other postemployment benefits (OPEB). Its OPEB unfunded liability is modest—particularly when measured against California or New Jersey's. Virginia's unfunded OPEB liability is \$649 per capita, versus a 50-state median of \$1,023.<sup>112</sup>

### **Rainy Day Fund Policy and Use**

Virginia's rainy day fund, the Revenue Stabilization Fund (RSF), can be readily drawn down if there is enough of a shortfall in revenue. The unexpected emergence of a budget gap for fiscal 2015–16 forced the money committees to assume that 75 percent of the fund would be drained over the next two years—a plan that accords with the fund's purpose as well as with the Virginia Code and Constitution, and the Appropriations Act.

The commonwealth has a well-defined policy for deposits into and withdrawals from the RSF. The fund balance cannot exceed 15 percent of sales and income taxes; a constitutional amendment in 2011 revised that from 10 percent in acknowledgement of revenue volatility during the financial crisis. The constitution requires that the RSF receive half of any revenue growth over expectations (assuming that revenue is growing faster than recent averages), with a statutory mandate on top of that when growth is particularly rapid. (This secondary mandate can and has been waived as situations demand, as in fiscal 2014.) If spending exceeds revenue by 2 percent, draws are permitted but for only half of the gap, and the corpus of the fund cannot be drawn down by more than 50 percent.

The RSF peaked at \$1.2 billion in fiscal 2007, on the eve of the US recession; funding fell to \$679 million in fiscal 2014.

### Educational Funding Trend

Virginia provides generally lower educational resources than other states.<sup>113</sup> K-12 expenditures represent about 30 percent of general fund outlays each year, for a per pupil rate of \$5,030 in fiscal 2015, up from \$4,546 in 2012. Education spending has been rising faster than inflation, with a 5.7 percent hike in fiscal 2013, 2.5 percent in 2014, and 4 percent in 2015.

### Deferred Maintenance Trend

Virginia divides infrastructure spending into capital assets (principally buildings), transportation, and water. Since fiscal 2009, most deferred maintenance funding for structures has come from proceeds of bonds sold by the Virginia Public Building Authority and Virginia College Building Authority, a change from the practice of cash funding from the general fund. In 2009, the Auditor of Public Accounts identified \$3.3 billion in deferred maintenance of state buildings, more than twice the amount recorded four years earlier.<sup>114</sup> Plans to regularly update that number were shelved in the aftermath of the recession.

According to the 2013 American Society of Civil Engineers report on the state of US infrastructure, 6 percent of Virginia's roads are in poor condition, and 26 percent of its bridges are either structurally deficient or functionally obsolete.<sup>115</sup> Virginia broke with low-tax, project-underfunding practices for transportation in fiscal 2013 with the passage of HB 2313. The law is projected to raise \$6 billion over five years through increases in state and regional sales taxes (in Northern Virginia and Hampton Roads), and a restructuring of the state motor fuel tax from per gallon to a percentage of each sale.<sup>116</sup>

#### VIRGINIA'S FINANCES

AVERAGE ANNUAL CHANGE  
IN GENERAL FUND REVENUE,  
2011-13

**1.0%**

UNFUNDED PENSION LIABILITY  
PER CAPITA, 2013

**\$3,436**

UNFUNDED OPEB LIABILITY,  
2013\*

**\$5.4**  
Billion

UNFUNDED PENSION  
LIABILITY, 2013

**\$28.4**  
Billion

UNFUNDED OPEB LIABILITY  
PER CAPITA, 2013

**\$649**

INCOME TAX AS PERCENTAGE  
OF TOTAL TAX REVENUE, 2014

**61.3%**

SALES TAX AS PERCENTAGE OF  
TOTAL TAX REVENUE, 2014

**32.0%**

\* OPEB = Other postemployment benefits, principally public worker retiree health care.

**SOURCES** Municipal Market Analytics survey of state financial data, Bloomberg terminal, Moody's Investors Service, US Bureau of Labor Statistics, *Governing Magazine*, US Census, Federal Reserve Bank of Philadelphia, American Society of Civil Engineers.

## Investigating State Budgets: A Complex Task

**TO INVESTIGATE THE DETAILS** of a state's budget, researchers must go to more than the primary document passed by the legislature and signed by the governor. In the three states we studied, our path took us to various departments and agencies, as well as to the municipal bond market's regulator, to find the necessary legislative analyses, cash flow figures, historical documents, and financial disclosures. In no state could we find a digital hub that would take us to all the data needed to fully investigate the numbers. Here are some of the sources we tapped in the three states:

### California

The California Budget website (<http://www.ebudget.ca.gov>) is useful for the budget itself; archives of budget-related documents are available in the Historical Documents section.

The state Department of Finance (<http://www.dof.ca.gov>) provides information on the state budget process and history. It's also the home of the state's 2015 Five-Year Infrastructure Plan. That is critical in assessing the percentage of capital spending requests that were funded and other needs that were deferred. The department also publishes the Monthly Finance Bulletin, an economic update and cash report useful for determining whether the state's revenues are on track with forecasts.

The California State Treasurer's website (<http://www.treasurer.ca.gov>) provides significant information. But the state's monthly debt report and details on borrowings that may affect budgets reside on the Treasury Public Finance Division's website (<http://www.buycaliforniabonds.com>).

The Legislative Analyst's Office (<http://www.lao.ca.gov>), a nonpartisan agency with a staff of 43 analysts, provides analyses of the state budget, as well as fiscal and policy advice to the legislature. The information is vital to putting budgets into context.

The Municipal Security Rulemaking Board's EMMA (Electronic Municipal Market Access) disclosure website (<http://www.emma.msrb.org>) offers state municipal bond offering statements, comprehensive annual financial reports, updates to the state's financial and demographic information, and disclosures of events affecting investors.

We needed to consult state and retirement system CAFRs to assess the funding ratios, annual required contributions, and actual state contributions for public employee pension and

retiree health care benefits (known as other postemployment benefits).

## **New Jersey**

The New Jersey Department of the Treasury website (<http://www.state.nj.us/treasury>) provides information on the budget, but we also needed to consult the state constitution and statutes related to the budgeting process and rainy day fund policies.

Documents presented to the legislature's annual budget hearings supplied vital insights about the implications of the numbers on various state departments. These include testimony by state officials and independent analyses of departmental budgets by the legislature's Office of Legislative Services (<http://www.njleg.state.nj.us/legislativepub/ols.asp>).

The New Jersey Transportation Trust Fund Authority's financial documents, including yearly financial plans and financial statements posted to its website (<http://www.state.nj.us/tffa>), are important to understanding the relationship of the general fund budget to the flow of money among state transportation agencies.

State retirement system actuarial reports and information included in comprehensive annual financial reports and official statements are needed to assess public worker pension and other retiree benefit funding ratios and state contributions.

The New Jersey Department of Education's website (<http://www.state.nj.us/education>) provided state education formula funding requirements so we could better understand shortfalls.

The state's capital improvement plan (<http://www.state.nj.us/transportation/capital/cpd>) is necessary to assess the percentage of capital spending requests actually funded in the general fund budget and what decisions may have been deferred.

The Bloomberg terminal is helpful for tracking data on the state's use of short-term notes.

## **Virginia**

The governor's initial budget proposal is at the Virginia Department of Planning and Budget website (<https://www.dpb.virginia.gov>). An enacted version of the budget with comparisons to the governor's proposal is available at <http://leg2.state.va.us/MoneyWeb.NSF/sb2015>, the website of Virginia's Legislative Information System. Subsequent budget adjustments can be found in presentations on the websites of the so-called money committees: the House Appropriations



Committee (<http://hac.state.va.us>) and Senate Finance Committee (<http://sfc.virginia.gov>).

Virginia's Joint Legislative Audit and Review Commission (<http://jlarc.virginia.gov>) provides current budget review material and data on trends in state spending over time.

The website of the state Secretary of Finance (<https://finance.virginia.gov>) offers monthly reviews of revenue collections as well as its presentations to the money committees, including revenue forecasts that come from the combined efforts of the Joint Advisory Board of Economists and the Governor's Advisory Council on Revenue Estimates.

The Virginia Auditor of Public Accounts (<http://www.apa.virginia.gov>) provides regular updates on the size of the state's Revenue Stabilization Fund and related calculations.

The Municipal Securities Rulemaking Board's EMMA website contains state bond offering documents, comprehensive annual financial reports, regular updates to the state's financial and demographic information, and event disclosures.

Financial and actuarial reports posted on the Virginia Retirement System website (<http://www.varetire.org>), plus regular reports by the Joint Legislative Audit and Review Commission, are necessary to obtain information on funding of public worker pensions and other retirement benefits.

## GLOSSARY

*Following are definitions of some of the terms used in this report, compiled from online glossaries published by the Lincoln Institute of Land Policy (LILP), Municipal Securities Rulemaking Board (MSRB), National Association of State Budget Officers (NASBO), and National Association of State Retirement Administrators (NASRA).*

**Comprehensive annual financial report (CAFR)**—MSRB defines this as a report meeting recommendations of standards set by the Governmental Accounting Standards Board that includes a state or municipality’s audited financial statements for the fiscal year as well as other information.

**General fund**—NASBO defines this as the main fund for financing a state or locality’s operations.

**Governmental Accounting Standards Board (GASB)**—The MSRB defines this as the body that sets standards for financial accounting and reporting practices by states and municipalities.

**Modified accrual basis of accounting**—According to LILP, this is a method of accounting that recognizes revenues in the accounting period in which they become available and measurable.

**Other postemployment benefits (OPEB)**—The MSRB defines this as future liabilities incurred by certain governmental entities for benefits other than pensions, such as medical care, owed to retired public employees.

**Rainy day fund**—NASBO defines this as reserves that governments can tap to balance the budget or respond to unforeseen circumstances.

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