Truth and Integrity in State Budgeting: The Art of Consensus Revenue Forecasting

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Testimony on Senate Concurrent Resolution No. 132

Prepared for the New Jersey Senate Budget and Appropriations Committee
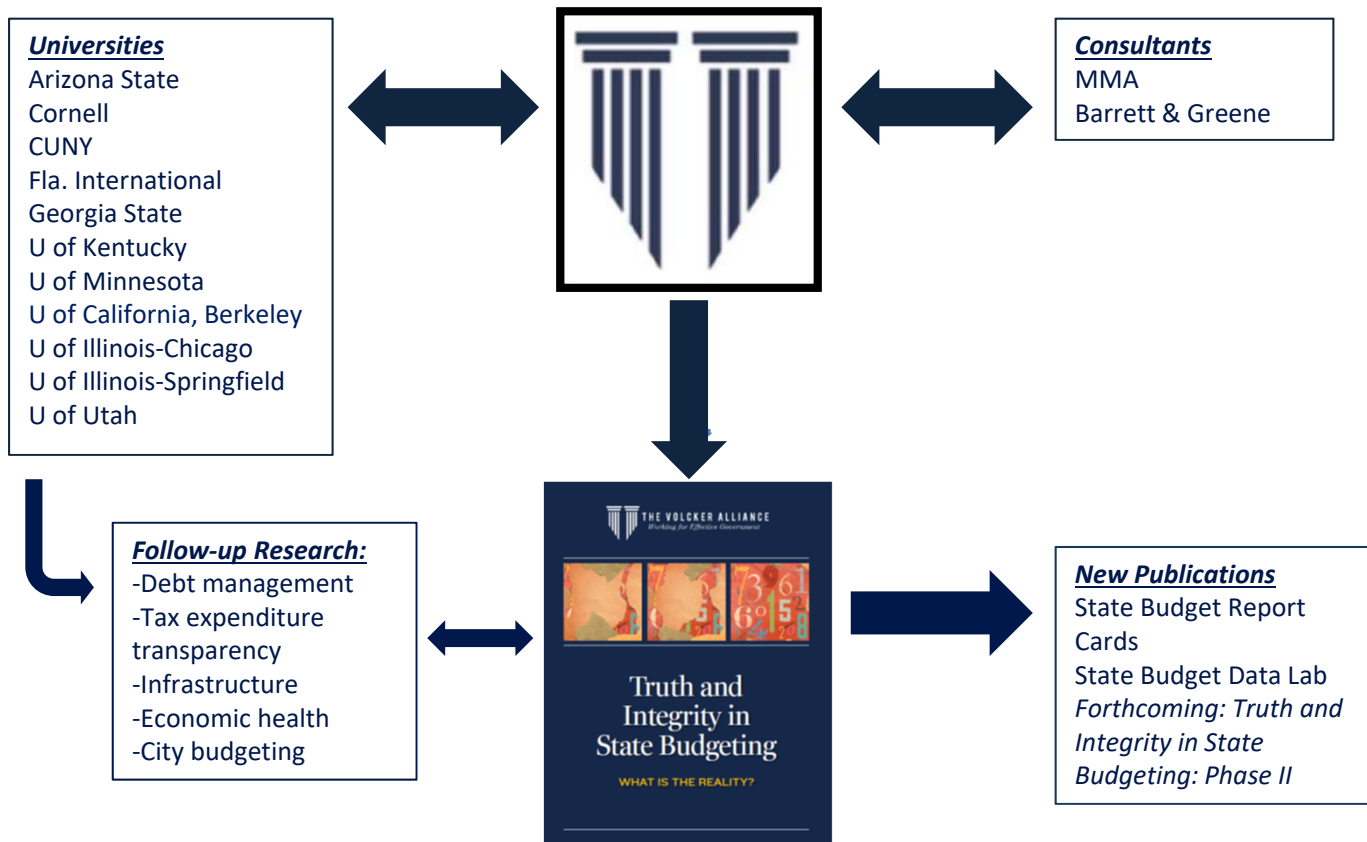
Trenton, New Jersey

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Revenue Forecasting in the Garden State

"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." –Truth and Integrity in State Budgeting: Lessons from Three States (2015)

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Truth and Integrity in State Budgeting: Objectives

- Identify five key budgeting and financial reporting procedures
- Grade all states' performance in each area
- Propose best practices for states to follow
- Continue evaluations annually in cooperation with university partners
- Help bolster university teaching of public budgeting and finance
- Encourage further university-based research based on Volcker Alliance research and findings

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The Volcker Alliance Research Network

Universities
Arizona State
Cornell
CUNY
Fla. International
Georgia State
U of Kentucky
U of Minnesota
U of California, Berkeley
U of Illinois-Chicago
U of Illinois-Springfield
U of Utah

Consultants
MMA
Barrett & Greene

Follow-up Research:
-Debt management
-Tax expenditure transparency
-Infrastructure
-Economic health
-City budgeting

Truth and Integrity in State Budgeting
WHAT IS THE REALITY?

New Publications
State Budget Report Cards
State Budget Data Lab
Forthcoming: Truth and Integrity in State Budgeting: Phase II

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Truth & Integrity Research Questions & Best Practices

❶ **Budget Forecasting**
Use a consensus approach to establishing single, binding numbers for revenues and expenditures. Provide long-term estimates. (Example: Washington)

❷ **Budget Accounting**
Pay for expenditures in the same year they are accrued; avoid deferring them. Shift from cash-based accounting to modified accrual accounting techniques used in state/local CAFRs. (Example: NYC)

❸ **Legacy Costs (Pensions & OPEB)**
Consistently make contributions actuaries determine to be necessary. (Example: Wisconsin). While some states may find it a crippling burden to fully cover costs of future benefits and past underfunding, they should consider committing to move toward full funding in the future. OPEB plans should be adequately funded to ensure benefits can be paid when bills come due (Example: Utah)

❹ **Fiscal Reserve Funds**
Enact clear policies for withdrawals from rainy day and other fiscal reserves, as well as rules for replenishing spent funds and tying the size of fund balances to revenue volatility. (Example: Indiana)

❺ **Transparency**
Construct a consolidated budget website (Colorado). Include full disclosure of cost to replace depreciated infrastructure (Examples: Alaska, California).

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I. Budget Grades

Best-Graded States

- **Forecasting:** 9 states graded **A**

- **Maneuvers:** 22 states graded **A**

- **Legacy Costs:** 8 states graded **A**

- **Reserve Funds:** 15 states graded **A**

- **Transparency:** 2 states graded **A**

BUDGET FORECASTING

STATE	GRADE
Connecticut	A
Florida	A
Hawaii	A
Maryland	A
New York	A
Rhode Island	A
South Carolina	A
Virginia	A
Washington	A

BUDGET MANEUVERS

STATE	GRADE
California	A
Delaware	A
Georgia	A
Hawaii	A
Idaho	A
Indiana	A
Iowa	A
Minnesota	A
Mississippi	A
Missouri	A
Montana	A
Nebraska	A
New Hampshire	A
North Dakota	A
Oregon	A
South Carolina	A
South Dakota	A
Tennessee	A
Texas	A
Utah	A
Vermont	A

LEGACY COSTS

STATE	GRADE
Idaho	A
Iowa	A
Nebraska	A
Oklahoma	A
Oregon	A
South Dakota	A
Utah	A
Wisconsin	A

RESERVE FUNDS

STATE	GRADE
Alaska	A
Arizona	A
California	A
Hawaii	A
Idaho	A
Indiana	A
Massachusetts	A
Michigan	A
Minnesota	A
North Dakota	A
Tennessee	A
Texas	A
Utah	A
Virginia	A
Washington	A

TRANSPARENCY

STATE	GRADE
Alaska	A
California	A

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Worst-Graded States

- **Forecasting:** 4 states graded **D**

- **Maneuvers:** 6 states graded **D**

- **Legacy Costs:** 9 states graded **D-**

- **Reserve Funds:** 3 states graded **D**

- **Transparency:** 3 states graded **D**

BUDGET FORECASTING

STATE	GRADE
Alabama	D-
Illinois	D-
Kansas	D-
North Dakota	D-

BUDGET MANEUVERS

STATE	GRADE
Illinois	D
Kansas	D
New Jersey	D
New York	D
Pennsylvania	D
Virginia	D

LEGACY COSTS

STATE	GRADE
Hawaii	D-
Illinois	D-
Kansas	D-
Massachusetts	D-
New Jersey	D-
Pennsylvania	D-
Texas	D-
Virginia	D-
Wyoming	D-

RESERVE FUNDS

STATE	GRADE
Kansas	D
Montana	D
New Mexico	D

TRANSPARENCY

STATE	GRADE
Alabama	D
Arkansas	D
New Mexico	D

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New Jersey Budget Grades

NEW JERSEY Budget Report Card

NEW JERSEY WAS ONE OF NINE STATES given a D-minus average, the lowest possible grade, by the Volcker Alliance for its handling of pension and other postretirement obligations for fiscal 2015 through 2017. It was also one of nine states with an overall D for budget forecasting and six states with an overall D for using budgetary maneuvers to achieve balance.

The New Jersey grade for legacy costs, which includes public worker pensions and other postemployment benefits, primarily health care, reflects its longtime inability to fund either program in line with actuarial recommendations. The state had only 38 percent of the assets needed to meet obligations—it tied with Kentucky for the lowest funding level—and its $135.7 billion in unfunded pension liabilities was second only to California's $174.1 billion.

Burdened as it is with retirement funding obligations, it is of little surprise that New Jersey also scored poorly in budget maneuvers, the second of five budgetary categories the Alliance evaluated. Such one-time actions included transfers from the New Jersey Turnpike Authority and the Clean Energy Fund to the general fund and the use of expected revenue from pending legal settlements for budget-balancing purposes.

The state's D in budget forecasting reflects a failure to create multiyear expenditure and revenue forecasts to help it prepare for financial challenges. New Jersey fared better in the reserves and transparency categories, winning average B grades for the period. As with forty-seven other states, New Jersey's transparency grade speaks to the absence of disclosure of deferred infrastructure replacement costs. Only Alaska and California publish such estimates.

MID-ATLANTIC STATES SIDE BY SIDE: Three-Year Average Grades, 2015–17

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

NOTE: States are grouped by US Census Bureau divisions.

Average grades are based on annual numerical scores. For more information, download Truth and Integrity in State Budgeting: What Is the Reality? at https://www.volckeralliance.org/publications/truth-and-integrity-state-budgeting-what-is-the-reality.

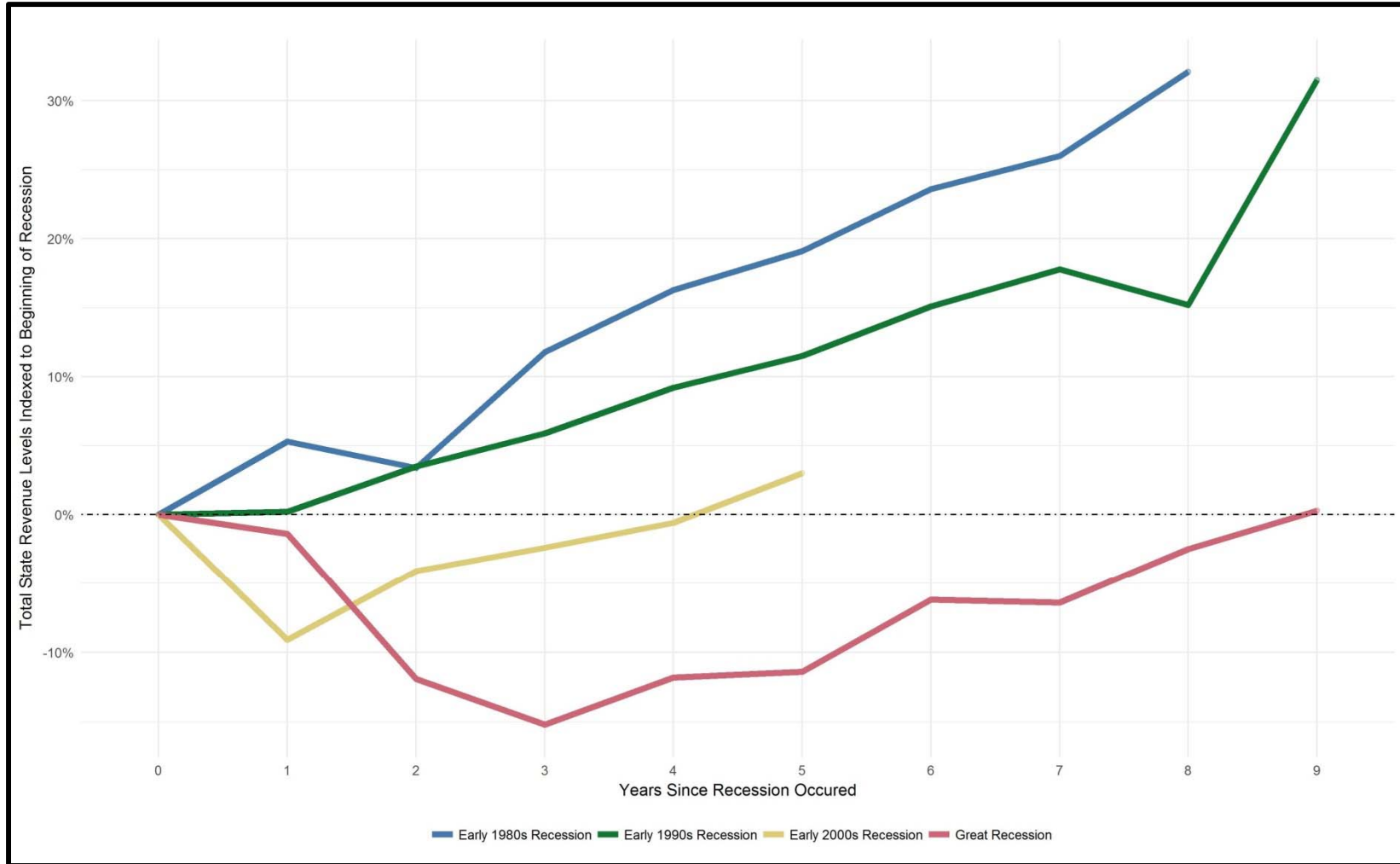© 2018 VOLCKER ALLIANCE INC.

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New Jersey Budget Indicators

II. Revenue Forecasting Challenges

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State Revenue Lagging Past Recoveries

Source: Gabriel Petek, S&P Global; NASBO

Medicaid, Debt Service, Pensions, OPEB Stressing Budgets

NJ=30%+

% of operating expenditures

GF-Medicaid Exp % of Operating Expenditures
Actual OPEB Payment as a % of Operating Expenditures
Debt service as a % of Operating Expenditures
Pension Contributions as a % of Operating Expenditures

Source: Gabriel Petek, S&P Global, NASBO
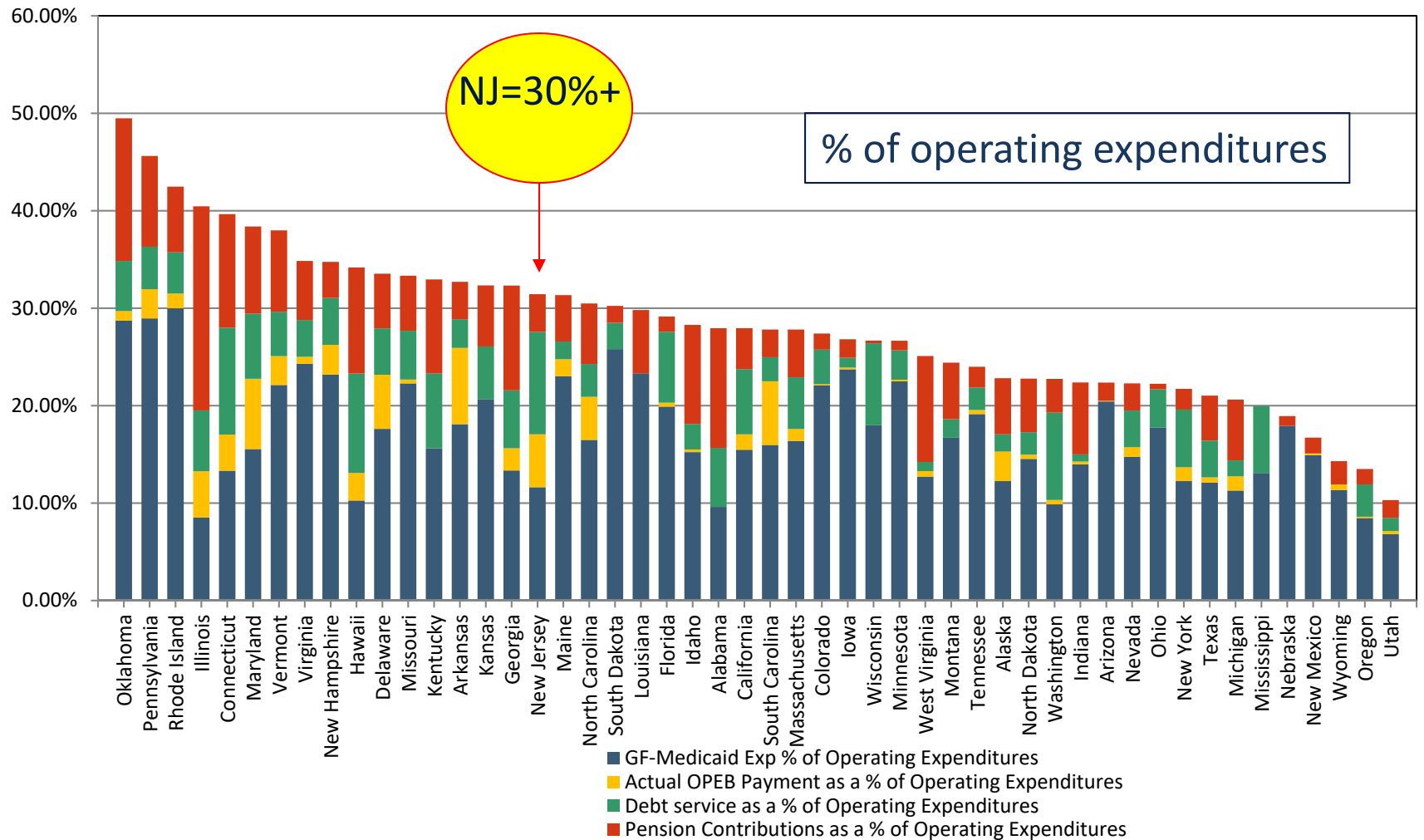
State Revenue Becoming More Volatile than GDP
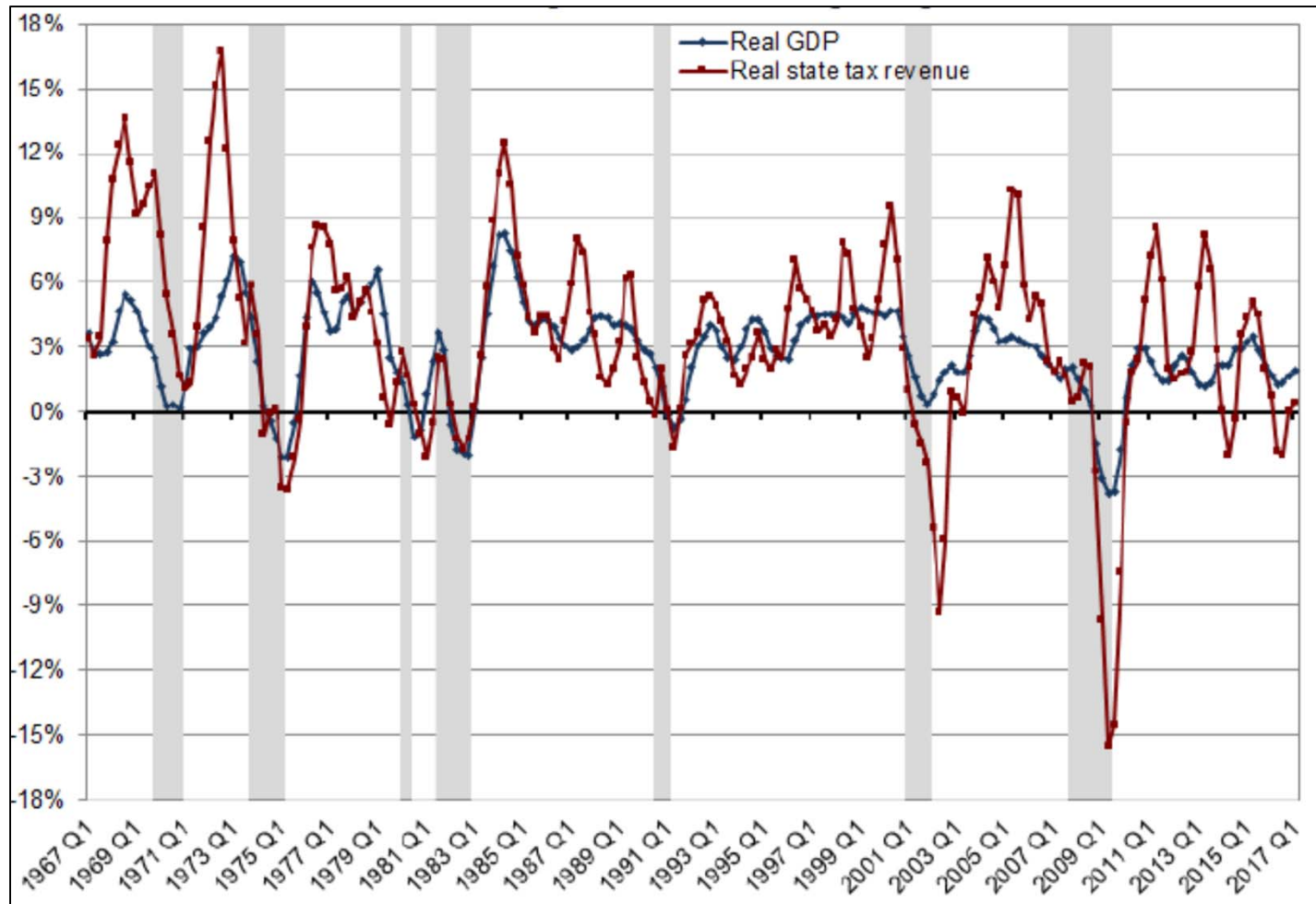
Source: Boyd & Dadayan, Rockefeller Institute, from US Census and BEA data

III. Consensus Revenue Forecasting Advantages

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Consensus vs. Single-Source Revenue Estimates

States Using Consensus Revenue Forecasting	3-year Average Budget Forecasting Grade	States not using Consensus Revenue Forecasting	3-year Average Budget Forecasting Grade
Connecticut	A	Alabama	D-
Delaware	B	Alaska	B
Florida	A	Arizona	B
Hawaii	A	Arkansas	D
Indiana	C	California	B
Iowa	C	Colorado	C
Kansas	D-	Georgia	C
Kentucky	B	Idaho	D
Louisiana	C	Illinois	D-
Maine	B	Minnesota	B
Maryland	A	Montana	D
Massachusetts	C	New Hampshire	D
Michigan	B	New Jersey	D
Mississippi	C	North Dakota	D-
Missouri	D	Ohio	D
Nebraska	B	Oregon	C
Nevada	C	Pennsylvania	B
New Mexico	C	South Dakota	B
New York	A	Texas	D
North Carolina	C	West Virginia	C
Oklahoma	B	Wisconsin	D
Rhode Island	A		
South Carolina	A		
Tennessee	C		
Utah	C		
Vermont	C		
Virginia	A		
Washington	A		
Wyoming	B		
Total States	**29**	**Total States**	**21**
Total Combined Average Grade	**B**	**Total Combined Average Grade**	**C**
Total Grades of A	9	Total Grades of A	0
Total Grades of B	7	Total Grades of B	6
Total Grades of C	11	Total Grades of C	4
Total Grades of D	1	Total Grades of D	8
Total Grades of D-	1	Total Grades of D-	3
Budget Forecasting 3-Year U.S. Average	**B**		

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Why Use Consensus Revenue Estimates?

- Consensus revenue forecasts are inclusive by nature, typically created by a group of contributors, often involving both parties of the legislature; the executive branch; and, sometimes, outside economic experts.
- Consensus revenue estimates may allow states to avoid producing budgets with parts predicated on a variety of different estimates—one from the legislature, for example, and another from the governor's office.
- A consensus forecast may make it easier for policymakers to concentrate on expenditures, rather than arguing about whether the forecast was politically driven.
- Consensus estimates give policymakers an opportunity to spot risks and opportunities that a single input may miss.
- While consensus revenue forecasts are not necessarily more accurate than ones produced by the executive budget office, the process is likely to go more smoothly when all the parties involved in forming a budget agree on a single revenue figure.
- Consensus estimates, especially if they are revised periodically during the fiscal year or biennium, may reduce the likelihood of having to convene a special legislative session to address revenue shortfalls.
- Consensus forecasts may reduce the need or temptation to tap one-time revenue sources to fund continuing expenditures.

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Three Best Practice States:
Florida, Virginia, and Washington

All three states are among only nine winning average A grades for budget forecasting from 2015 through 2017. The other six are Connecticut, Hawaii, Maryland, New York, Rhode Island, and South Carolina. All nine use consensus revenue forecasting, although each state's system is unique.

FLORIDA (annual budget) relies on the work of the Revenue Estimating Conference, which has met twice in 2018. Estimates are based on input from the governor's office, the Senate and House of Representatives, and the Department of Revenue. The principal members, three from the legislature and one from the governor's office, must all concur in order to have to have a state forecast. The process is intended to ensure that multiple contributors determine a single revenue number on which to build a budget, leaving more time to debate spending priorities.

VIRGINIA (biennial budget) revenue assumptions and methodologies are subject to periodic review by a volunteer state board of professional economists. Actual revenue estimates are reviewed by a consensus group of executive and legislative political leadership. Virginia law requires that governors present a forecast of economic activity each fall, with additional reviews of revenue midway through the fiscal biennium. The so-called money committees—House Appropriations and Senate Finance—can adjust appropriations to address any expected revenue shortfalls.

WASHINGTON (biennial budget) relies on the Economic and Revenue Forecast Council, which includes representatives of the legislative and executive branches, as well as the state treasurer. Four times a year, the organization adopts a bipartisan revenue review, which is then used to build the state's operating budget.

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Revenue Misses Happen!

NEW JERSEY While revenue for fiscal 2015 was projected to be $200 million over the governor's initial estimate when the 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.

VIRGINIA law requires that governors present a forecast of economic activity each fall, with additional reviews of revenue midway through the fiscal biennium. In fiscal 2013 and 2014, revenue setting initially appeared reasonable, despite an unexpected $350 million shortfall in non-withholding income taxes beginning in May 2014. 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. The gap was 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 House Appropriations and Senate Finance committees 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.

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Pennsylvania Consensus Revenue Forecasting Bill

Memo from Pennsylvania State Representative Seth Grove accompanying House Bill 2013:

To improve the state's economic forecasting, I am introducing legislation establishing a <u>Joint Revenue Forecasting Committee</u>. The Committee shall consist of the following members:

- Secretary of Revenue
- Secretary of the Budget
- The Majority Appropriations Chairs of the Senate and House
- The Minority Appropriations Chairs of the Senate and House
- One Member of the public appointed by the Governor
- One Member of the public appointed by the President Pro-Tempore of the Senate
- One Member of the public appointed by the Speaker of the House
- One Member of the public appointed by the Minority Leader of the Senate
- One member of the public appointed by the Minority Leader of the House
- The Director of the Independent Fiscal Office who will serve as an ex-officio member

The Committee will be staffed by the Department of Revenue and is charged with forming a joint estimate for the Commonwealth's General Fund by December 16th and May 15th of every year. The estimate must be approved by 11 members to ensure a nonpartisan estimate is approved by the Committee. Should the Committee fail to have 11 members approve of the revenue estimate, the Governor and General Assembly shall use a revenue estimate provided by the Independent Fiscal Office. The committee may revise an official estimate under the same process requiring an 11 vote majority.

Should the estimate approved by the committee have an error rate of three percent or more between estimated revenues and collected revenues, the committee shall develop a new model for forecasting revenue collections.

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Notes on Volcker Alliance Research

Robert Chislett, Program Fellow at the Volcker Alliance, contributed to the research for this testimony.

For its national survey of state budgeting practices, the Volcker Alliance joined with professors and students in public finance and budgeting programs at eleven US universities who answered a standardized set of research questions on budget procedures. University research network gathered data from a variety of sources, interviewed current and former state budget and financial officials, and examined budget documents and financial disclosure filings. Responses to questions were reviewed by faculty advisers at the universities and Alliance consultants and revised, if necessary. Responses were then reviewed and normalized to account for any discrepancies among researchers' findings. The focus on states' adherence to best practices, combined with the normalization process, resulted in a relatively high level of comparability among the fifty states' budgetary performance.

States received a grade ranging from A to D-minus for each of the five budget categories for fiscal 2015, 2016, and 2017. Every state's average category score over the period was used to determine a three-year average grade. Sustained improvement or decline in a state's score over the three fiscal years was used to identify trends in budgetary performance in each category:

Budget Forecasting was graded on five indicators, each representing 20% of the category score. We asked if a state used a consensus revenue forecast; employed a reasonable rationale for revenue growth projections (based on historical revenue and economic growth trends); successfully avoided having to make a negative midyear budget adjustment; and produced multiyear revenue and expenditure forecasts.

Budget Maneuvers was graded on a state's use of one-time actions to create short-term budget fixes. States received 25% of the category grade for each type of one-time budget maneuver they successfully avoided. They included funding recurring expenses with debt; funding recurring expenses with the proceeds of asset sales or by tapping future revenues; deferring a current year's recurring expenditures; and covering general fund expenditures with transfers from other funds.

Legacy Costs was graded on a state's willingness to meet public employee pension and OPEB obligations. Thirty percent of a grade was determined by a state's making its OPEB actuarially required or determined contribution. Seventy percent of the category grade was scored on whether the state made its pension ADC or ARC contribution and on its pension funding ratio as of 2015, which represents the amount of assets available to cover promised benefits.

Reserve Funds was graded on a state's performance on four equally weighted budget indicators: If a state had a reserve fund disbursement policy; existence of a reserve fund replenishment policy; if reserves were tied to historic trends in revenue volatility; whether there was a positive reserve or general fund balance at the beginning of each fiscal year.

Transparency was graded on the extensiveness and usefulness of a state's fiscal disclosure practices. States received 25% of their grade for each of four transparency measures: providing the public with a consolidated budget website; disclosing outstanding debt and debt-service cost tables; providing information on deferred infrastructure maintenance costs; and providing cost estimates for tax expenditures.

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