THE STATE OF THE STATES 2012

EXECUTIVE SUMMARY

A Citizen's Guide To the State of The States

www.thestatesproject.org

PRODUCED BY

John F. Kennedy School of Government
HARVARD UNIVERSITY
INSTITUTE OF POLITICS

AEF
AMERICAN EDUCATION FOUNDATION

Fels Institute of Government
UNIVERSITY *of* PENNSYLVANIA

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OVERVIEW

By virtue of Article 10 of the U.S. Constitution, American states have the lion's share of domestic responsibilities for our citizens. Our states and cities — not the federal government — are in charge of educating our children, policing our streets, building our schools, maintaining our roads, and caring for our poor, unemployed, and sick. State and local governments spend $2.5 trillion annually and employ over 19 million workers, or 15% of total national employment.

The Great Recession of 2008 and subsequent years of stagnant economic growth have brought our states to a near critical condition. As state tax revenue fell, states across the country saw mass layoffs of workers, from teachers to police officers to judiciary employees. Nevertheless, the demand for public services continued to increase. A stagnant economy increased the number of Americans dependent upon unemployment compensation and Medicaid. Health care costs swelled and educational resources were stretched to fit shrinking budgets. Infrastructure, including government buildings, schools, roads, and bridges, deteriorated with little funding left for repair. In 2009, the federal government stepped in with much needed stimulus for the states. But those funds have now expired, leaving states with current deficits to fill, despite a gradually improving national economy.

Our states' long-term fiscal obligations pose another set of challenges. States are responsible for the pensions and health care of current and retired government workers, but for decades, states have underestimated the true cost of these programs. As a result, nearly every state in the nation carries huge future liabilities, estimated at anywhere between $1 trillion and $4 trillion, depending on how those liabilities are measured. These liabilities coupled with large state debts that have accumulated from years of over borrowing, paint a harrowing fiscal picture.

STATE & LOCAL GOVERNMENTS OWE OVER $7 TRILLION IN LIABILITIES

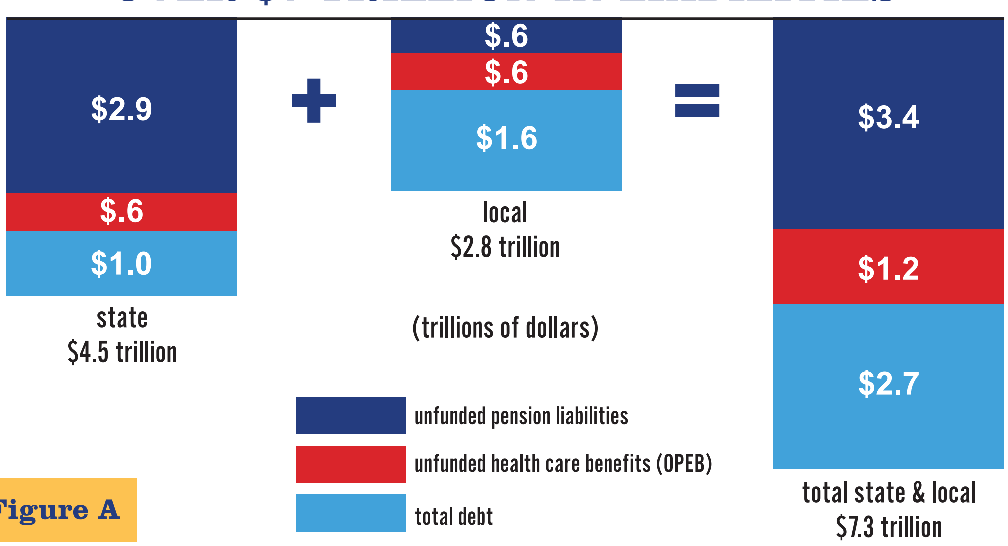

Figure A

{ executive summary }

According to what we believe are the most accurate estimates, states owe a total of $4.5 trillion in debt, comprised of $2.9 trillion in unfunded pension fund debt, $627 billion in unfunded health care benefits,[1] and $1 trillion in state borrowing (including general obligation bonds, special obligation bonds, notes payable, and etc.).[2] If we make similar assumptions for local governments, we come up with a total debt of $2.8 trillion, comprised of $1.6 trillion in local borrowing, $587 billion for unfunded pensions, and roughly $600 billion for unfunded health care benefits. Taken together, states and localities, have an estimated $7.3 trillion in debt, which is just under half of the total national debt, but far less known or talked about. In addition, more than half of this state and local debt is not reported on the financial statements of these entities.

In this, our first year, the States Project examined the finances of four states for FY 2011: Massachusetts, New Jersey, New York, and Pennsylvania. Every state across the country has reacted to these tough economic conditions differently, but there are patterns that cross state lines. Five major trends emerged from our analysis that were of particular concern:

1. The recovery from the Great Recession has been longer and slower than any recovery in the postwar period and has exposed structural weaknesses in state economies that need attention now.
2. Medicaid costs have escalated due to increased enrollment and rising heath care costs, threatening to “crowd out” other state priorities like education and infrastructure.
3. Pensions and health benefits for government workers are not properly valued or funded, resulting in huge unfunded liabilities for states.
4. Federal grants to states are headed for the chopping block as the federal government deals with its own budget deficits and debt.
5. States do not account to citizens in ways that are transparent, timely, or accessible.

1 Our estimations of unfunded liabilities come from independent economists, who have made modifications to state and local actuarial estimates of liabilities. We believe these independent estimates best reflect the true economic condition of states’ unfunded liabilities. State OPEB obligation as calculated by Susan K. Urahn, "The Widening the Gap Update." The Pew Center on the States, published June 20, 2012. [http://www.pewstates.org/uploadedFiles/PCS _ Assets/2012/Pew _ Pensions _ Update.pdf]. Local OPEB obligations extrapolated from 2009 GAO data, and estimated by Paul Volcker and Richard Ravitch: The State Budget Crisis Task Force (footnote #93). [http://www.statebudgetcrisis.org/]. State pension fund liabilities as calculated by Andrew G. Biggs, "The Market Valuation of Public-Sector Pension Deficits." American Enterprise Institute, published April 2010. [http://www.aei.org/article/economics/retirement/ the-market-value-of-public-sector-pension-deficits/]. Local pension fund liabilities calculated by Joshua Rauh and Robert Novy-Marks: The Crisis in Local Government Pensions. [http://www.stanford.edu/~rauh/].

2 We define state borrowing as total debt defined by the U.S. Census Bureau, Government of Finance and Employment, Classification Manual (2006), Chapter 6 and reported in the U.S. Census Bureau’s State and Local Finances by Level of Government, estimates for 2010. [http://www.census.gov/govs/estimate/].

1. The recovery from the Great Recession has been longer and slower than any recovery in the postwar period and has exposed structural weaknesses in state economies that need attention now.

The U.S. economy has experienced a slower recovery from the recent economic downturn than from other recessions in the postwar era. Employment has been slow to recover, as have personal incomes, corporate profits, and tax revenue.

State governments — responsible for administering the bulk of our social safety net programs, such as Medicaid, unemployment insurance, and public assistance — have been hit particularly hard, as they try to deliver services to more needy citizens with fewer state dollars. Estimates for FY 2012 indicate that the state tax base had still not recovered to pre-2008 levels. In addition, federal funding to states, which had cushioned the blow of the Great Recession, has ended, leaving states with big deficits to shore up and tough decisions to make.

UNEMPLOYMENT RATE, JULY 2012

NATIONAL AVERAGE: 8.3%

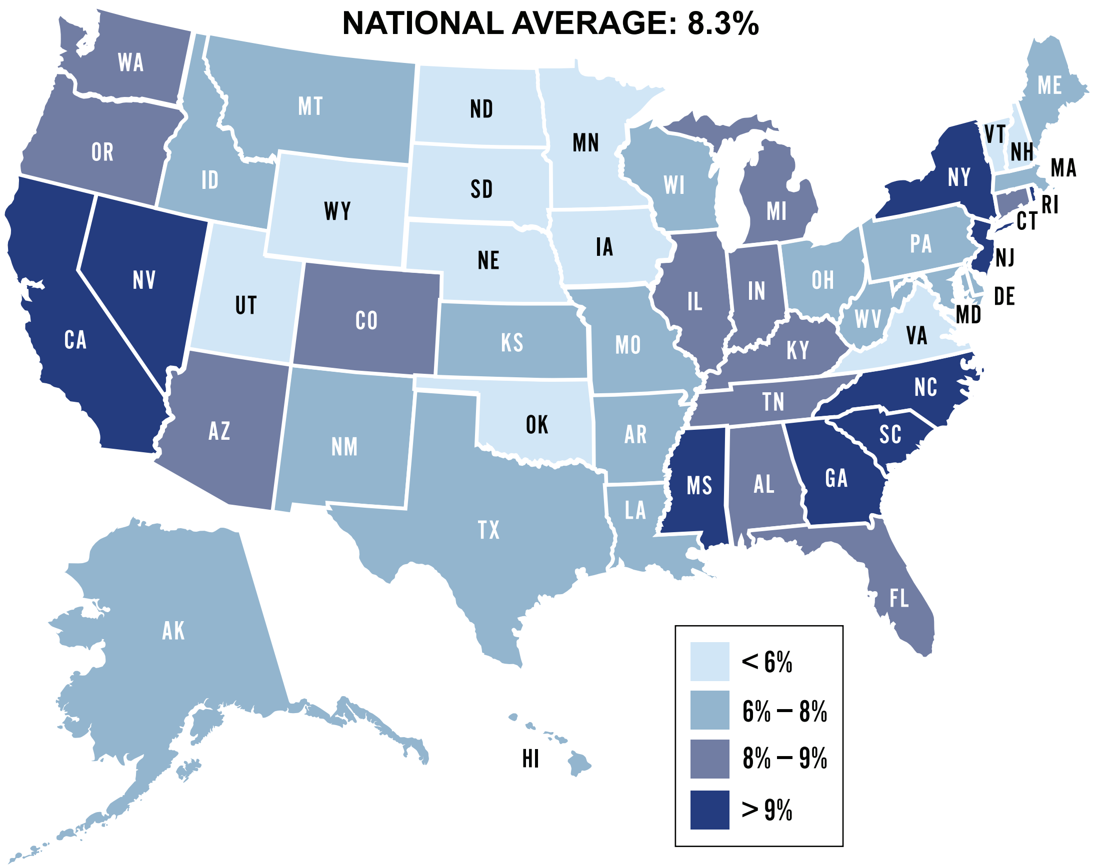

Figure 1 SOURCE: BUREAU OF LABOR STATISTICS, RATES FOR JULY 2012. RATES ARE AS A PERCENTAGE OF THE LABOR FORCE. DATA REFER TO PLACE OF RESIDENCE.

RISING AND PERSISTENT UNEMPLOYMENT

- National unemployment peaked at around 10% in early 2009. Since then, the decline has been slow and uneven, spiking again in 2009 and 2010. By August 2012, the unemployment rate had declined to 8.3%, still well above the 4% to 5% unemployment rates seen in the mid-2000s.

- Underemployment (i.e. people who take part-time work because they cannot find full-time work) is 15% nationwide as of August 2012. In some states, like California, Nevada, and Rhode Island, underemployment is around 20%.[3]

- The longer people are out of the workforce the more likely it is they will lose relevant skills or become discouraged. Because unemployment and underemployment has been more persistent than in past recoveries, there is a growing risk that the long-term unemployed will become permanently marginalized from the workforce.[4]

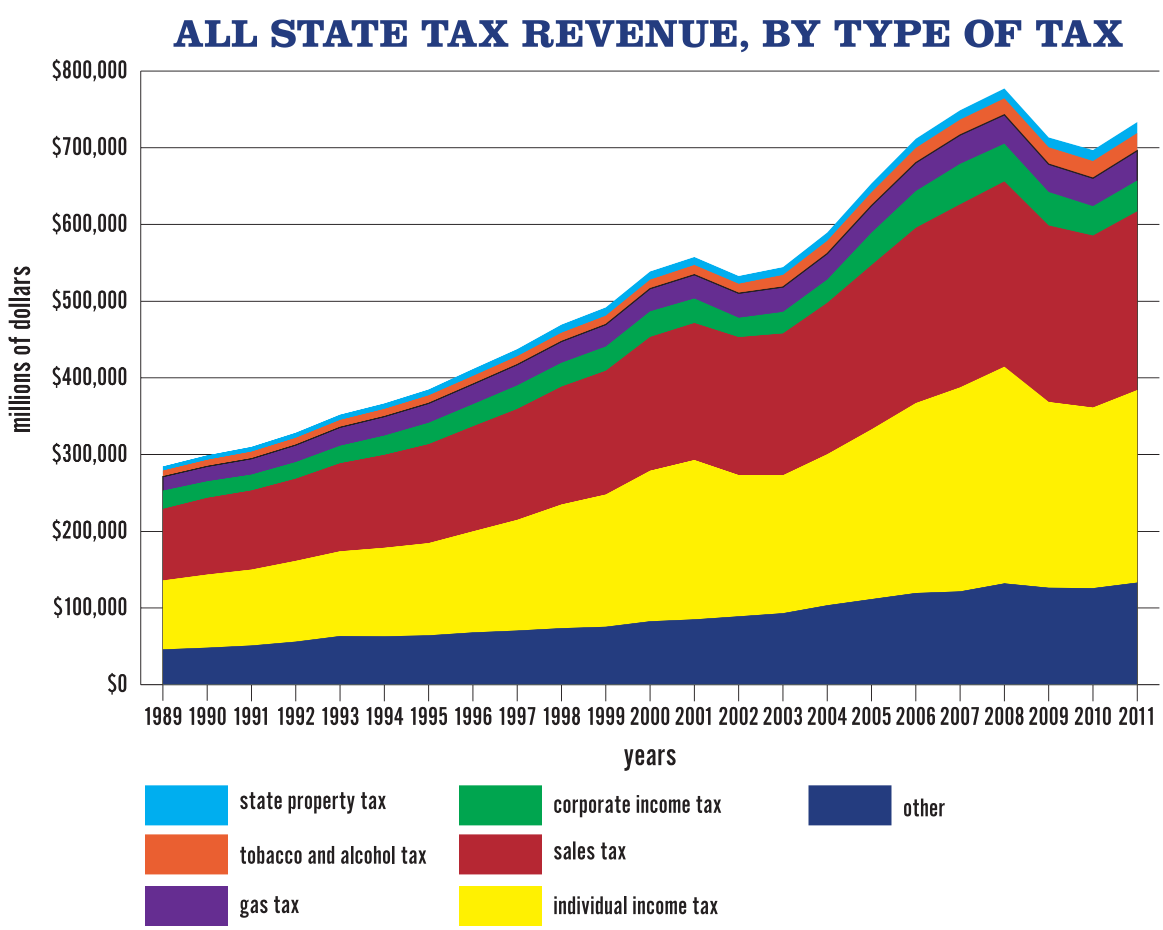

Figure 2 SOURCE: U.S. CENSUS BUREAU. QUARTERLY SUMMARY OF STATE & LOCAL TAXES

3 U.S. Bureau of Labor statistics. Underemployment measured as total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers. [http://data.bls.gov/cgi-bin/print.pl/lau/stalt.htm].

4 OECD Publishing. "Waiting for the Recovery: OECD Labour Markets in the Wake of the Crisis."

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FALLING TAX REVENUE

- State receipts fell across all major revenue streams during the recession and have yet to recover. Personal income, corporate, and sales taxes were lower in FY 2011 by 11%, 18%, and 4%, respectively, than in FY 2008.[5]

- Corporate taxes have decreased, as states have lowered rates and offered tax breaks to create an attractive business environment. In FY 1989, corporate taxes made up 8.4% of overall state revenue. By FY 2011, that number had fallen to 5.4%.[6]

THE INCREASING COST OF THE PUBLIC SAFETY NET

- Since the recession, more citizens have dropped into lower income tax brackets and became qualified for unemployment insurance, public assistance, and Medicaid.

- Two hundred percent increases from just five years ago in state spending on unemployment compensation are common across states.

- Medicaid, the health insurance program for low-income Americans, saw big increases in enrollment because of the recession. Medicaid enrollment rose by 8.1% in FY 2010, 5.4% in FY 2011, and 3.8% in FY 2012.[7]

- In FY 2012, states were forced to dramatically increase Medicaid spending by an average of 28.7%, largely to replace temporary federal stimulus funds that expired in June 2011.[8]

THE END OF FEDERAL STIMULUS FUNDS

- States received more than $150 billion from the federal stimulus package of 2009, primarily through higher Medicaid reimbursement rates and the creation of a "State Fiscal Stabilization Fund" that provided education funding.[9]

- Federal stimulus funds largely ended in 2012, before state tax revenue had recovered. As a result, forty-two states faced budget deficits in FY 2012 and thirty-one states have projected (and in most cases now have closed) budget gaps totaling $55 billion for FY 2013.[10]

5 Calculated from data provided by the U.S. Census Bureau, Quarterly Summary of State & Local Taxes.
6 Ibid.
7 National Governors Association and National Association of State Budget Officers. "The Fiscal Survey of States, Fall 2011." November 2011.
8 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
9 Recovery.gov. "Tracking the Money."
10 "States Continue to Feel Recessions Impact." Center on Budget Policy and Priorities. June 27, 2012.

2. Medicaid costs have escalated due to increased enrollment and rising health care costs, threatening to "crowd out" other state priorities like education and infrastructure.

RISING HEALTH CARE COSTS AND EXPANSION OF MEDICAID

- Nearly one out of every five dollars spent in the U.S. goes towards health care. For more than a decade, health spending has risen faster than any other sector of the economy.[11]

- High and persistent unemployment have put more citizens on Medicaid rolls. Since June 2007, an additional 10 million people nationwide enrolled in Medicaid, over half of whom were children.[12] In 2012, 20% of Americans use Medicaid.

MEDICAID AS A PERCENTAGE OF TOTAL STATE EXPENDITURES, 2010

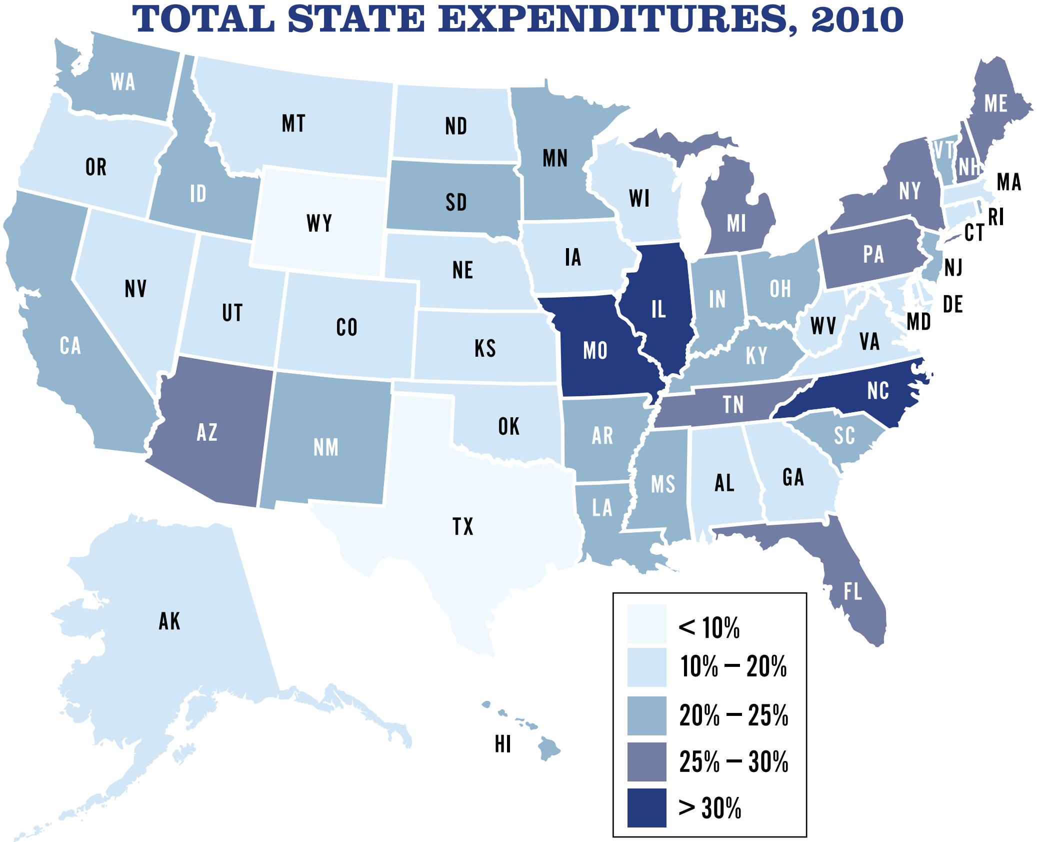

Figure 3 SOURCE: THE KAISER FAMILY FOUNDATION. WWW.STATEHEALTHFACTS.ORG

11 Ibid.
12 "Medicaid Enrollment: June 2011 Data Snapshot." Kaiser Commission on Medicaid Facts. June 2012.

- Higher enrollment translates into higher costs. The Medicaid program accounted for 22% of all state expenditures in FY 2009, but is estimated to account for 24% in FY 2011.[13]

- Total spending for Medicaid in this decade (2011-2020) will increase by an average of 8.1% per year assuming full implementation of the Affordable Care Act (ACA) as it is now, or 6.6% excluding the effects of the ACA.[14]

MEDICAID CROWDS OUT OTHER SPENDING

- Economists call attention to the "crowding out" effect of Medicaid spending. If states must spend more money on Medicaid, they have less money to spend on other important areas of the budget, like education or infrastructure.

- **K-12 Education:** Medicaid recently surpassed K-12 education as the largest category of state spending when all funds, including federal funds, are considered. Medicaid appears likely to claim a growing share of state resources. A reduction in education spending at the state level means that municipalities must chip in more to cover education costs by increasing property taxes. School funding based on local tax revenue may disadvantage low-income communities, as the same tax rate in a low-income community will raise fewer funds than in a high-income community.

MEDICAID SURPASSES K-12 SPENDING AS A PERCENTAGE OF STATE BUDGETS

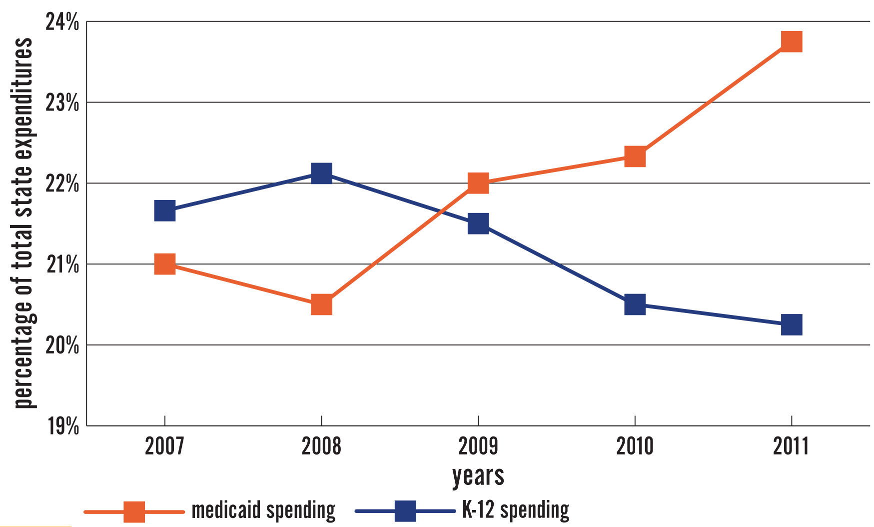

Figure 4 SOURCE: NATIONAL ASSOCIATION OF STATE BUDGET OFFICERS (NASBO), STATE EXPENDITURE REPORT, 2010.

13 "Medicaid Cost Containment: Recent Proposals and Trends." The National Association of State Budget Officers. [http://www.nasbo.org/publications-data/issue-briefs/medicaid-cost-containment-recent-proposals-and-trends-0].
14 Office of the Actuary, Centers for Medicare and Medicaid Services. 2011 Actuarial Report on the Financial Outlook for Medicaid. March 16, 2012.

- **Higher Education:** Public colleges and universities have also seen reductions in state support and have instead raised funds by increasing tuition. As a result student debt is on the rise. Reductions in higher education spending has occurred despite rising college enrollment and a widely-accepted understanding that higher education plays an important role in growing economies, national competitiveness, reducing the unemployment rate, and long-term personal wealth. The unemployment rate for those who have a bachelor's degree or higher — at just 4% — is half the national average and one-third of the unemployment rate for those who never graduated from high school.[15]

- **Infrastructure:** Despite the federal stimulus, public construction spending, including state, federal and local projects, has been on a staggered decline since early 2009, down 20% in FY 2012.[16]

THE EXPANSION OF MEDICAID AND THE AFFORDABLE CARE ACT

- With the expansion of Medicaid, under the ACA, the numbers of enrollees are expected to increase 27% by 2019, with total cost increasing 13%.[17]

FEDERAL GOVERNMENT WILL BEAR NEARLY ALL MEDICAID EXPANSION COSTS OVER 2014-2022

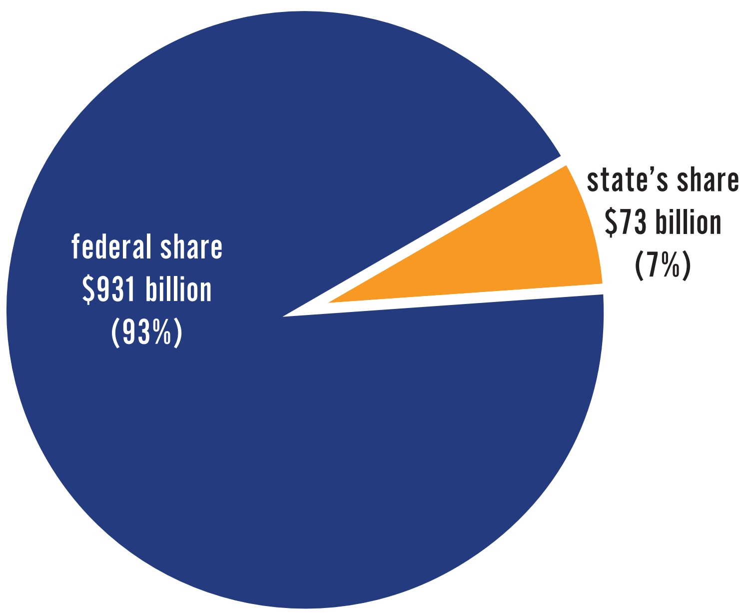

Figure 5 SOURCE: CENTER ON BUDGET AND POLICY PRIORITIES ANALYSIS OF THE CONGRESSIONAL BUDGET OFFICE, MARCH 2012 BASELINE

15 Unemployment rates from the Bureau of Labor Statistics for August 2012.
16 U.S. Department of Commerce; U.S. Census Bureau.
17 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].

- The federal government will pick up 100% of the cost of covering citizens made newly eligible for Medicaid for the first three years (2014-2016) and no less than 90% on a permanent basis.

- Critics worry that the federal government, while generous in the early years of the program, might have to cut funding in subsequent years to meet its own budget obligations. That could leave states holding the bag with a greater number of Medicaid recipients and less federal funding to cover costs.

MEDICAID REFORM

- The aggressiveness and inventiveness of Medicaid reform varied from state to state, however reform measures include: transferring more services to the private sector, containing enrollment, moving patients from fee-for-service to managed-care delivery systems, establishing spending caps, and eliminating fraud.

- States are limited in reforming Medicaid by strict federal guidelines.[18] Many governors are currently lobbying the federal government for more control over their state Medicaid programs.

- Medicaid reform is often blocked by provider groups, who resist reductions in provider rates and changes in delivery systems and who may use litigation to prevent or delay reform.

3. Pensions and health benefits for government workers are not properly valued or funded, resulting in huge unfunded liabilities for states.

As part of their compensation, state workers, ranging from clerks to police officers, receive pensions from the state. State pension systems have come under fire for being poorly funded. The Great Recession, which reduced the investment earnings of these funds, has aggravated the problem.

Pension funds hold huge future liabilities, threatening both the long-term viability of the pension system and the budgets of states responsible for paying out benefits. According to their actuaries, state pensions are underfunded by over $1 trillion. However, if private-sector accounting standards are applied (i.e. using a lower discount rate to value investment returns), unfunded liabilities could be as much as $3 trillion nationwide.[19]

UNDERFUNDING OF PENSIONS

- Most public employees contribute to their own retirement funds, as does the state government through its general funds. Those funds are then invested with the goal of earning investment income to support the fund.

18 Ibid.
19 Rauh, Joshua. "Pensions in Peril." Kellogg Insight. [http://insight.kellogg.northwestern.edu/index.php/kellogg/article/pensions_in_peril].

- In theory, pensions should be funded in advance to ensure that sufficient funds are available upon workers' retirement.

- In practice, however, such prefunding has been dangerously inadequate. The states in the most dire situations are Ohio, New Mexico, Mississippi, Kentucky, Rhode Island, Hawaii, South Carolina, New Jersey, and Illinois, all of which have unfunded liabilities greater than 13% of their Gross State Product.[20]

UNDERFUNDING HEALTH CARE BENEFITS

- In addition to pensions, most state and local governments have promised substantial retirement health care benefits to their workforces, also referred to as other post-employment benefits (OPEB).

- Health care liabilities are rarely pre-funded, and are often underreported or not reported at all. According to their actuaries, the total state liability for these health care benefits is $600 billion. If local governments (which have many more employees than do states) are included, the number is closer to $1 trillion.

UNFUNDED LIABILITIES: PENSIONS & OPEB OBLIGATIONS

TEN BEST STATES				TEN WORST STATES			
Rank	State	%GSP	(In Thousands)	Rank	State	%GSP	(In Thousands)
1	Indiana	13.26%	$34,138,998	41	West Virginia	34.28%	$21,344,541
2	North Dakota	13.32%	$4,212,440	42	Mississippi	34.67%	$32,953,427
3	Tennessee	13.34%	$32,259,493	43	Alabama	34.75%	$58,503,809
4	Florida	14.13%	$103,050,955	44	Kentucky	35.23%	$54,457,754
5	Virginia	14.31%	$58,157,373	45	Illinois	38.06%	$236,364,439
6	South Dakota	15.61%	$6,052,651	46	New Mexico	41.97%	$31,222,662
7	Iowa	15.99%	$21,804,426	47	Alaska	43.72%	$20,402,227
8	Utah	16.88%	$19,024,129	48	New Jersey	45.20%	$216,241,387
9	Washington	17.47%	$58,743,651	49	Ohio	46.60%	$217,169,878
10	Arizona	17.99%	$45,712,189	50	Hawaii	49.54%	$32,540,878

SOURCE: PENSION LIABILITIES FROM ANDREW BIGGS. "PUBLIC SECTOR PENSIONS: HOW WELL FUNDED ARE THEY REALLY?" STATE BUDGET SOLUTIONS. JULY 2012. OPEB CALCULATIONS FROM SUSAN K. URAHN "THE WIDENING THE GAP UPDATE." THE PEW CENTER ON THE STATES. JUNE 20, 2012

REFORM AND PROSPECTS FOR REFORM

- To address these huge pension shortfalls, states will need to increase the retirement age for public workers, decrease cost of living adjustments (COLAs), increase the employee contributions, and up the amount that states pay into these funds from general funds.

20 Calculations based on the work of Robert Novy-Marx and Joshua D. Rauh. "Public Pension Promises: How Big are They and What are They Worth?" Journal of Finance. [http://papers.ssrn.com/sol3/papers.cfm?abstract _ id=1352608].

- Public employee unions are highly resistant to such changes and have launched legal challenges in many states to block reform. The legal protections given to public employees vary by state.

- It is easier to cut spending for current workers than for retirees, whose contracts have been in place for decades and are protected under contract law as well as many state constitutions.

4. Federal grants to states are headed for the chopping block as the federal government deals with its own budget deficit.

In September of 2012, the U.S. debt stood at just over $16 trillion. The projected budget deficit for FY 2012 is $1.1 trillion.[21] For years, our government officials have passed the problem of deficits off to future generations. Watching nations near bankruptcy in Europe in the recent years, as well as suffering a U.S. credit downgrade in August 2011, has likely sobered policy makers into understanding they must deal with our deficits now.

Last year, unable to compromise on balancing the U.S. Budget, Republicans and Democrats agreed to what is popularly described as a "fiscal cliff," in which each side will face an unacceptable reality if they fail to act by the end of 2012: $1.2 trillion in automatic spending cuts over 10 years, starting January 1, 2013. These cuts would be divided between nondefense programs (which Democrats care deeply about protecting, like Medicare) and defense projects (which Republicans care deeply about protecting). In addition, the agreement calls for the sunset of the Bush-era tax cuts. If Congress does not come up with an alternative plan to shave $1.2 trillion in spending over the next ten years, the "fiscal cliff" reductions would be enacted by default. If that happens, the CBO predicts a 4% reduction in economic output due to the swift and draconian nature of those cuts. Analysts say that level of economic shock could put us into another recession.[22] The idea behind the fiscal cliff was to get policy makers to act by the end of 2012 — or else.

THE FISCAL CLIFF AND STATE BUDGETS

- If past is prologue, lawmakers may try to avoid big cuts to the most politically protected programs – Social Security, Medicare, and defense. Together these programs take up over half of the national budget.[23] In addition, Republicans will likely attempt to block tax increases, limiting the prospect of raising revenues to close the budget deficit.

- Once all mandatory spending (spending mandated by legislation like Social Security, Medicare, interest on the debt, and block grants to Medicaid) is removed from the equation, then a relatively small portion of the national budget — less than 30% — is left to debate.[24]

21 FY 2012 Historical Tables. Budget of the U.S. Government. Office of Management and Budget. [http://www.budget.gov].
22 Beard, Rebecca. "Fear of Year-End Fiscal Stalemate May Be Having Effect Now." New York Times. July 11, 2012.
23 Ibid.
24 The Center on Budget and Policy Priorities. Policy Basics. August 13, 2012. [http://www.cbpp.org/cms/index.cfm?fa=view&id=1258].

• Contained in that 30% of the national budget are many of the block grants to states, which help support K-12 education, colleges and universities, unemployment compensation, public housing, school lunch programs, and infrastructure. While grants to states make up only 16% of federal outlays as a whole, they make up more than 40% of this discretionary portion of the budget — and therefore are more likely targets for budget cuts.[25]

DISCRETIONARY VERSUS MANDATORY SPENDING

• Medicaid is the largest category of federal grants by far at $265 billion in FY 2011, accounting for almost 43% of all federal grants.[26] Medicaid is considered mandatory spending, as it is dictated by legislation.

• Education (including K-12 and higher education) takes up another 17% of federal grants, while infrastructure and physical capital grants account for 16%. These categories are considered discretionary spending.

FEDERAL GRANTS TO STATE & LOCAL GOVERNMENTS BY CATEGORY

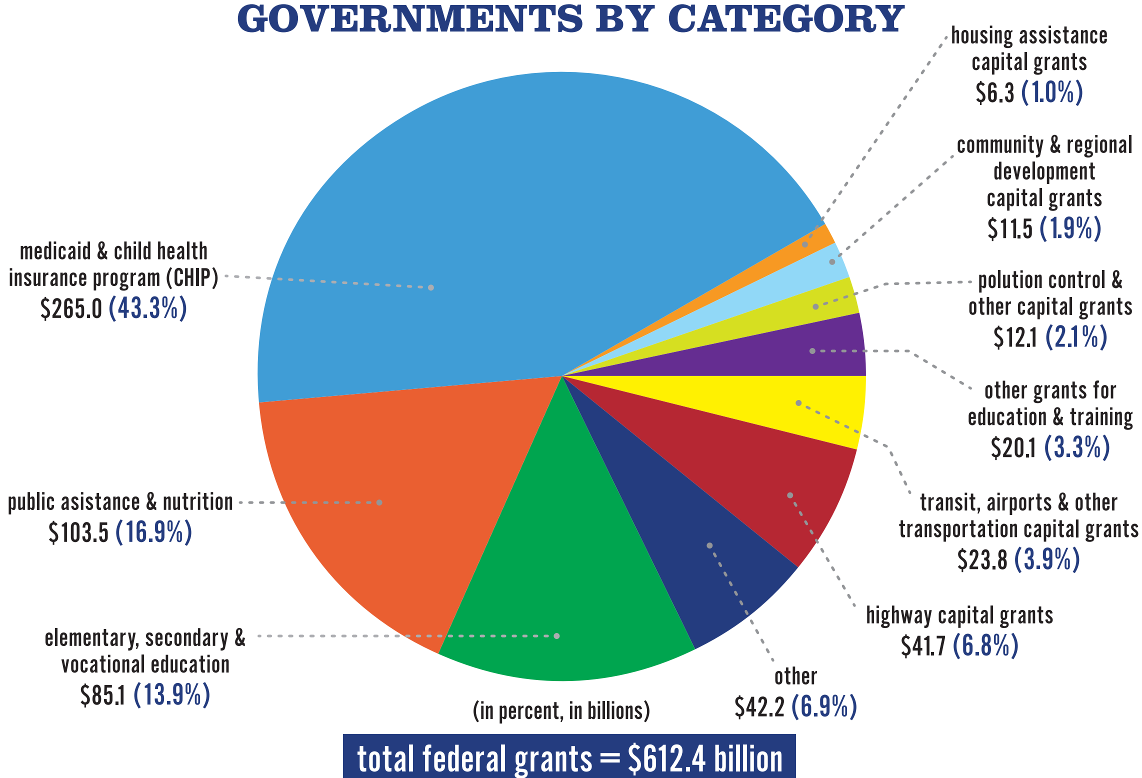

Figure 6 SOURCE: OFFICE OF MANAGEMENT AND BUDGET

25 Ibid.
26 Grants include those made to Medicaid and the related Child Health Insurance Program (CHIP), estimated at $265 billion in 2012. Office of Management and Budget.

- CBO Projections indicate that Medicaid will continue to take a growing share of federal grant money, leaving fewer funds available for education, infrastructure, and income assistance. Discretionary spending for education, transportation, and housing will shrink by 35% between FY 2012 and FY 2022. Selected income security programs, primarily those benefiting children, will decline by 35% for the same period. Conversely, federal spending for Medicaid and CHIP will increase by 47% in those years.[27]

REDUCED GRANTS FOR CITY GOVERNMENTS

- The reductions in federal block grants to states may be passed onto municipalities, which then, in turn, receive less in block grants from their respective states.

- State aid to local governments, which represents the largest source of revenues for municipalities at 34% of budgets, is falling and will likely continue to decrease, given recent budget cutting efforts at the state level.[28]

- In order to balance their budgets, local governments will likely have to cut spending on K-12 education, as most states have done in the last two years, as well as on infrastructure, and other basic services for citizens.

5. States do not account to citizens in ways that are transparent, timely or accessible.

UNTIMELY REPORTING

- Each state produces a Comprehensive Annual Financial Report (CAFR), an annual report of expenditures, revenues, assets, and liabilities. CAFRs typically give the most thorough account of the state's finances for the past year.

- From the time that the fiscal year ends (June 30th for most states), it can take as long as six months or more to publish the CAFR. By contrast, the SEC requires large corporations to issue their annual reports within 60 days of the end of the fiscal year. Similarly, the federal government requires its agencies to publish their financial statements in 45 days.[29]

- By the time CAFRs are released, the state government will already have passed a budget for the interim year and would be submitting budget proposals to be debated for the year thereafter. Thus, state officials do not have adequate information about past expenditures and revenues to help plan for the future.

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27 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
28 Welber, Peter. "Understanding complexities in the municipal bond market." The Washington Business Journal. September 5, 2012. [http://www.bizjournals.com/washington/blog/2012/09/understanding-complexities-in-the.html?page=all].
29 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].

CASH VERSUS ACCRUAL ACCOUNTING

- Nearly all major U.S. Corporations use accrual accounting rather than cash accounting to produce income statements and balance sheets. The federal government also provides accrual accounting measures in its statement of activities and balance sheet. States, however, use a form of cash accounting.

- In cash accounting receipts are recorded during the period they are received, and the expenses in the period in which they are actually paid. In accrual accounting economic events are recognized by matching revenues to expenses at the time in which the transaction occurs rather than when payment is made (or received). This method allows the current cash inflows or outflows to be combined with future expected cash inflows or outflows to give a more accurate picture of an entity's current financial condition. Accrual accounting adds a longer-term focus to the state's "financial picture" by providing information on the future consequences of today's policy decisions, operations, and events.

- Because states do not use accrual accounting, CAFRs do not provide reliable information on states' unfunded liabilities for the pensions or health benefits of government workers. Estimates of unfunded liabilities are often provided by the actuaries of the plans themselves, however the data is never presented in the balance sheet which would provide a more complete picture of the states' future liabilities as set against its current financial position.

BALANCING BUDGETS WITH ACCOUNTING TRICKS

Unlike the federal government, most states are not permitted to run deficits due to balanced budget provisions in their constitutions. However, states often spend more than they take in through revenues but are still able to "balance" their budgets by manipulating their accounting procedures.

- **States can deny or delay certain payments until subsequent years.** For example, in 2009-2010, New York balanced its budget by delaying income tax refund payments until the following year.

- **Because a "deficit" is often an ill-defined concept in state budgeting, many states can simply raise debt to cover their deficits.** New York and New Jersey have raised high-levels of debt through the component units of their government (like transit authorities). This debt does not legally have to be reported in the balance sheet. This allows states to finance spending without increasing state debt as reported in the CAFR.

- **States can redirect state funds meant for other uses.** New York has moved funds from their legally dedicated purpose to other projects, like transferring $264 million meant for environmental protection programs and wireless network improvements.[30]

30 Walsh, Mary Williams; Cooper, Michael. "Gloomy Forecasts for States, Even if Economy Rebounds." [http://www.nytimes.com/2012/07/18/us/in-report-on-states-finances-a-grim-long-term-forecast.html? _ r=1&ref=business]. July 17, 2012.

- **States can securitize future revenue streams.**[31] New York securitized tobacco settlement revenue to generate approximately $4.2 billion, which the state used to close budget gaps in the early 2000s.[32]

RECOMMENDATIONS

Persistent unemployment, a result of a slow national recovery, has translated into less state tax revenue and a surge in the costs of Medicaid and unemployment insurance. Medicaid, in particular, has crowded out spending on other state priorities like K-12 education, higher education, and infrastructure. Further, the Great Recession has exacerbated the underfunding of the health care and pension systems for government workers, which carry trillions of dollars in liabilities nationwide. Lastly, inaccurate and untimely accounting practices have masked the true picture of the states' deficit spending and debt accumulation and fail to offer the transparency needed to solve these impending issues.

If our states are to weather these storms, the States Project puts forth the following recommendations:

1. States must move towards accrual accounting and away from cash accounting. Accrual accounting better reflects the true liabilities that states face and makes it more difficult for states to obscure deficit spending.

2. States should provide financial reports in a timely and transparent fashion. Accounting principals should be standardized across states and made accessible to policymakers as well as citizens.

3. States must reduce Medicaid costs. While supporting the public safety net is an important priority, states must balance this need with other objectives, such as supporting education and infrastructure.

4. States must tackle persistent unemployment by supporting education on all levels, giving our citizens the skills necessary to compete in a 21st century job market.

5. Federal, state, and local governments must create formal dialogues on budgeting — none currently exist. Most pressingly, we must assess how the budget-cutting efforts of Washington will affect states and localities and how we might mitigate some of the harshest cuts at the local level.

Our states' challenges are often made more difficult by the infighting of our political parties, which sometimes obscure underlying truths for political advantage. In order to create solutions rather than distractions, it is up to us to become educated voters who can understand the nuances of these difficult problems and find reasonable solutions. ★

31 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
32 Ibid at 60.

For more information on how to get involved,
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