Our Nation’s Governors—Walking a Tightrope Without a Net

BY: EDWARD J. MAZUR, MBA, CPA

Governor—the Toughest Job in America

This is not a fun time to be a governor. Our nation’s governors and legislators have been tested by several factors: dropping state revenues beginning in 2007, the near collapse of the financial markets in 2008, the Great Recession of 2009–2010 and the jobless recovery of 2010–2011. The continuing work of keeping state budgets in balance has required enormous leadership, courage and decisiveness. It has also required governors to speak with their fellow citizens and explain—with both candor and compassion—why changes have been necessary and why maintaining a strong sense of community is more important than ever as citizens adjust to cuts in state programs and services.
To What Extent are the States Financially Dependent on the Federal Government?

The short answer is that the states are significantly dependent on the federal government. For three selected states, Figure 1 illustrates the total direct and indirect federal resource flows into the states. The percentage of total state revenues that come directly from the federal government range from 27 to 32 percent. The Compendium of Government Finances report of the U.S. Census Bureau illustrates that average direct federal payments to state governments amount to 29 percent of total state revenues.

Figure 2 illustrates how these total direct and indirect federal revenues range from 21 percent of Real GDP for North Carolina to 37 percent of Real GDP for Virginia. Figure 2 also illustrates the indirect economic impact of the federal government associated with its ownership or lease of millions of square feet of buildings and the presence of military establishments.

Understanding the extent of state/federal financial dependency is a key beginning point in establishing a knowledgeable capacity to exert shared leadership. Fortunately, through a forward-thinking project, the Governments Division of the U.S. Census Bureau is examining a cooperative project that would include several data sources to establish an automated and time-efficient mechanism through which states can access and download key measures of intergovernmental financial dependency. Although financial ties between the federal government and the states form an important point of focus, it is how these connections affect the programmatic, service-related, research, economic and other activities at the state level that is equally important to understand. In 2005, GAO published a report titled, 21st Century Challenges—Reexamining the Base of the Federal Government. Six years later it still raises profound questions...

Yet, as the 2011 fiscal year closes this summer for many states, the challenge goes on. The National Association of State Budget Officers (NASBO) reports slow revenue growth, Medicaid enrollment increases, continued uncertainty with health care reform and many state balances near historic lows.

And if these near-term challenges were not enough, the U.S. Government Accountability Office’s (GAO) ongoing study of the long-term fiscal challenges of state and local governments suggests a difficult fiscal future requiring even more leadership from governors:

...we (GAO) project that the fiscal position (of state and local governments) will steadily decline through 2060 absent any policy changes... the declining fiscal conditions... foreshadow the extent to which these governments will need to make substantial policy changes and other adjustments to avoid growing fiscal imbalances.

“The primary driver of fiscal challenges for the state and local government sector continues to be the growth in health-related costs. Specifically, state and local expenditures on Medicaid and the cost of health insurance for state and local retirees and employees are projected to grow more than GDP.”

One more set of circumstances—perhaps the most difficult of all—require governors to exert leadership. That is the need—borne of severe fiscal distress—to reshape our federal government. The current and future fiscal condition of the states is so intertwined with the fiscal condition of the federal government as to demand shared leadership by the nation’s governors.

Figure 1

<table>
<thead>
<tr>
<th>Key Dependency Measurements</th>
<th>VA 2008</th>
<th>NC 2008</th>
<th>FL 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Federal Revenues to State (billions) (VA 2009)</td>
<td>$10.8</td>
<td>$15.0</td>
<td>$24.5</td>
</tr>
<tr>
<td>Percentage of Total State Revenues—All Sources</td>
<td>26.9%</td>
<td>31.8%</td>
<td>28%</td>
</tr>
<tr>
<td>Direct Federal Grants to Local governments (billions)</td>
<td>$1.1</td>
<td>$2.2</td>
<td>$3.9</td>
</tr>
<tr>
<td>Federal Purchases from State Businesses (billions)</td>
<td>$53.9</td>
<td>$5.8</td>
<td>$16.6</td>
</tr>
<tr>
<td>Federal Payments to Individuals—wages, pensions, S.S., Medicare (billions)</td>
<td>$53.9</td>
<td>$47.6</td>
<td>$110.7</td>
</tr>
<tr>
<td>Total Direct and Indirect Federal Flows (billions)</td>
<td>$119.7</td>
<td>$70.6</td>
<td>$155.7</td>
</tr>
</tbody>
</table>

Figure 2

<table>
<thead>
<tr>
<th>Key Dependency Measurements</th>
<th>VA 2008</th>
<th>NC 2008</th>
<th>FL 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP by State Inflation Adjusted to 2000 (billions)</td>
<td>$324.5</td>
<td>$329.4</td>
<td>$603.5</td>
</tr>
<tr>
<td>Total Federal Flows as % of Gross State Product</td>
<td>36.9%</td>
<td>21.4%</td>
<td>25.8%</td>
</tr>
<tr>
<td>Federal Leased/Owned Buildings (millions sq/ft) As of March 2010</td>
<td>27.3</td>
<td>3.7</td>
<td>10.4</td>
</tr>
<tr>
<td>Military Facilities (9/30/08)</td>
<td>148</td>
<td>123</td>
<td>235</td>
</tr>
<tr>
<td>Military Facilities—Present Replacement Value (9/30/08, billions)</td>
<td>$37.6</td>
<td>$20.4</td>
<td>$23.4</td>
</tr>
<tr>
<td>Military Facilities—Military and Civilian Personnel (9/30/08, thousands)</td>
<td>205.8</td>
<td>147.2</td>
<td>91.2</td>
</tr>
</tbody>
</table>
regarding which activities of the federal government relate most to its core constitutional mission. It provides guidance on how an objective review might be conducted of 12 areas of federal involvement. A reading of the report will likely lead to the conclusion that virtually all 12 areas of current and significant federal responsibility result in some involvement by state and local governments. The activities of the three levels of government are intertwined—fiscally, programmatically and on a human scale—through efforts of the nation’s citizens who, after all, do not bear the label “federal,” “state” or “local.”

A Case for Shared Leadership by Governors in Reshaping the Federal Government

The federal government, to put it bluntly, is broke. For most everyone in the U.S. that is not news. However, the trajectory and severity of this condition has gathered such momentum that a negative impact on the states is now unavoidable.

As illustrated in Figure 3, every authoritative source of objective and rigorous analyses makes the assertion that the federal government is fiscally unsustainable. This assessment, in certain cases, has been put forward for many years. The difference today is that the federal government is no longer considered unsustainable only “in the long run” but is beginning to experience sustainability problems in the near term. For example, Social Security outflows are now exceeding annual collections from payroll taxes, an event that until very recently was predicted to occur years into the future.

As described in more detail in the sidebar, the size and extent of the federal government’s fiscal imbalance is so great that it can only be adequately addressed through a conscious, significant and disciplined reshaping of federal activities. As this reshaping occurs, it is difficult to imagine how the states and individual citizens can be shielded from making significant sacrifices. However, citizens can be assisted through this transition and the capacity of state governments to serve can be sustained if our nation’s governors exert effective shared leadership with the administration and Congress.

Figure 3

How Many Ways Can You Say Unsustainable?

From the 2010 Financial Report of the United States Government:

“…under current policies and the assumptions used in this report, the debt-to-GDP ratio will continually increase over the next 75 years and beyond, which means current policies are not sustainable.”

—Supplemental Information Section

“These projections show continual increases in debt as a percentage of GDP, meaning fiscal policy is unsustainable over the long term.”

—Report of Acting Comptroller General of the United States

From the GAO’s Long-Term Fiscal Outlook, GAO-11-201SP, November 15, 2010:

“The timing of the debt buildup varies depending on the assumptions used, but the overall picture is the same: the federal government is on an unsustainable fiscal path.”

From the Congressional Budget Office’s The Budget and Economic Outlook, August 2010:

“Putting the nation on a sustainable fiscal course will require policymakers to restrain the growth of spending substantially, raise revenues significantly above their average percentage of GDP of the past 40 years, or adopt some combination of those approaches.”

From The National Commission of Fiscal Responsibility and Reform’s The Moment of Truth, December 2010:

“Our nation is on an unsustainable fiscal path. Spending is rising and revenues are falling short, requiring the government to borrow huge sums each year to make up the difference.”

Figure 4

Reshaping the Federal Government

Key Reference Materials:


The Benefits of Shared Leadership

Shared leadership by governors in reshaping the federal government can benefit the entire nation, individual states and all citizens in at least three ways:

First, governors can help Congress and the administration make better decisions. Informed by a more detailed understanding of the many ways in which states are financially dependent on federal revenue streams, the nation’s governors must be at the table when decisions are made to adjust federal spending and revenue programs. In addition, their hands-on experience in making tough choices should be invaluable to federal elected officials.

Second, the ability of the governors to interpret the potential effects of recommended changes and to communicate with citizens could make an immense difference in the way in which sacrifices are accepted by the American public.

Third, as the federal government is reshaped and its various programs reduced in scope or eliminated, it is the governors—through state colleges and universities—who can be most effective in protecting that foundational knowledge needed to protect the nation and sustain its ability to recover and rebuild. America may go many years before it again puts a person in space in a U.S.-made vehicle, but we never want to lose knowledge of where to pick up the task and move America forward again in manned space exploration. As research grants are cut or eliminated, the status and place at which work was stopped must be documented and preserved. It will be the governors—more than weakened or eliminated federal departments, agencies or programs—that will, through personal leadership and the goodwill and efforts of their citizens, protect America’s “seed corn” for future generations.

Recommendations for Executing Effective Shared Leadership

It is vital that the unsustainable fiscal condition of the federal government not result in a sudden and uncontrolled stop, such as what might occur if a key current holder of publicly held Treasury securities decides not to roll over their holdings or to sit out a series of major Treasury bond sales. To support a principled fact-based approach to shared leadership, it is recommended that the following actions be undertaken by our nation’s governors:

• Assign to the state budget office the responsibility to read, digest, interpret and report back on the potential state and citizen-level impact of each recommendation presented in the report of the National Commission on Fiscal Responsibility and Reform issued in December 2010 under the title,
Figure 5

Debt Held by the Public and Net Interest

![Graph showing Debt Held by the Public and Net Interest between 2005 and 2021.](source: Congressional Budget Office February 18, 2011)

Figure 6

Analysis of Federal Liabilities, Intragovernmental Debt and Social Insurance Obligations


<table>
<thead>
<tr>
<th></th>
<th>$ Billions</th>
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<tbody>
<tr>
<td><strong>2010</strong></td>
<td><strong>2009</strong></td>
</tr>
<tr>
<td><strong>Federal Liabilities:</strong></td>
<td></td>
</tr>
<tr>
<td>Publicly-held Debt</td>
<td>$9,060*</td>
</tr>
<tr>
<td>Federal Employee &amp; VA Benefits</td>
<td>5,720</td>
</tr>
<tr>
<td>Other</td>
<td>1,576</td>
</tr>
<tr>
<td><strong>Intragovernmental Debt</strong>—Owed to Social Security, Medicare/Other Trust Funds</td>
<td>4,577</td>
</tr>
<tr>
<td><strong>Federal Social Insurance Obligations</strong></td>
<td></td>
</tr>
<tr>
<td>Social Security</td>
<td>7,947</td>
</tr>
<tr>
<td>Medicare—Parts A, B &amp; D</td>
<td>22,813</td>
</tr>
<tr>
<td>Other</td>
<td>97</td>
</tr>
<tr>
<td><strong>Total Liabilities, Intragovernmental Debt &amp; SI Obligations</strong></td>
<td><strong>51,790</strong></td>
</tr>
<tr>
<td><strong>Current-dollar GDP 3rd qtr 2010, 4th qtr 2009 (Source: BEA)</strong></td>
<td><strong>14,750</strong></td>
</tr>
<tr>
<td><strong>Liabilities and Obligations as % GDP</strong></td>
<td>351%</td>
</tr>
</tbody>
</table>

* 62% of 2010 GDP  ** 53% of 2009 GDP

Moment of Truth. And further, to conduct the same efforts in regard to other nonpartisan studies, listed in Figure 4, whose recommendations are among those being considered by Congress and the administration.

- Assign to state congressional liaison personnel the responsibility to identify and report on the establishment and progress of individual federal legislative proposals that are intended to implement the recommendations of the National Commission and related studies.

- Assign to the state’s economists the responsibility to continually assess, and report upon, the impact on state revenues and federal grants and contributions from enacted legislation centered on reshaping the federal government.

- Convene a day-long, state-level town meeting to consider the recommendations of the National Commission and related studies. It is suggested that participation in such a meeting be comprised of other statewide elected officials; state cabinet-level appointees and deputies; the state auditor, comptroller, treasurer and tax commissioner; senior legislative leadership, money committee chairs and related legislative staff; elected and appointed representatives of local government; state economic development leaders; representatives of the business community; and presidents of state colleges and universities. The meeting can begin with a brief review of the fiscal condition of the federal government and key measures of intergovernmental financial dependency for the state and selected local governments. The bulk of the meeting would be in the format of a facilitated workshop comprised of small group discussions of the various published recommendations for reshaping the federal government. Summary notes of shared observations and identified alternatives could be taken—without attribution—and later summarized.

- The last segment of the meeting would consist of a concise review of all of the recommendations discussed throughout
the day. During this recap, the participants would be able to vote their preferences regarding each recommendation, with anonymity, using an electronic keypad and supporting technology that would permit a big-screen presentation of the consolidated results on virtually an instantaneous basis.4

• Request that the state comptroller issue a separate annual report on intergovernmental financial dependency, or to include related information within the audited comprehensive annual financial report. Such reporting, by way of example, might include:5
  - The amount of federal funds flowing into the coffers of the state, and the percentage of total state revenues that represents.
  - A summary of major federal departments providing federal funds, and the amounts of such funds received by major state programs.
  - The percentage of expenses funded by federal dollars for major programs.
  - The number and placement of state employees funded by federal dollars.
  - Changes in enacted federal legislation with reported current year and known future year fiscal impacts.
  - The amount of federal dollars flowing directly to local governments, disbursed in payment for goods and services procured from state businesses, and disbursed as payments to citizens within the state for Social Security, civilian and military pay and benefits, and Medicare payments.
  - Statistics on federal ownership or lease of civilian facilities, and the number, replacement value and employment levels of military facilities within the state.
  - Excerpts on the reported, audited financial condition of the federal government.
  - Share information and leadership with fellow governors.

The Capacity of the Federal Government to Borrow is Limited—in Both Amount and Time

One of the greater dangers facing our country today is the continued belief that the federal government can go on borrowing at the levels projected by the U.S. Office of Management and Budget or the Congressional Budget Office (CBO). Figure 5, prepared by the CBO early in 2011, illustrates a projected trajectory in federal publicly held debt growing from a reported total of $9.06 trillion at September 30, 2010, to approximately $14 trillion by the end of FY 2015, and on to approximately $18.0 trillion by the end of FY 2021.

Now here is the question that no one seems to be posing publicly: Where is the money going to come from to purchase all of those additional Treasury securities? Is there any reliable source of rigorous analysis that is attempting to address that question? Not as far as this author can determine.

An ever-steepening growth curve for federal debt seems to ignore a fundamental truth, which is that there is a legitimate future need for every dollar of outstanding U.S. publicly held debt. Every dollar now in the form of Treasury securities will ultimately be redeemed to provide retirement income, pay for retiree health insurance, cover the cost of college tuition and fees, fund critical infrastructure, address losses from natural disasters, and fund a whole host of other needs. And, these needs are not just those of Americans; they are the needs of the Chinese, Japanese and all the citizens of the globe who hold debt of the U.S. government.

Unfortunately, publicly held debt outstanding, which represented 62 percent of the U.S. Gross Domestic Product at September 30, 2010, is not the only factor contributing to the unsustainable fiscal condition of the federal government. Today the federal government has other very important debts and obligations, most of which did not exist in 1946 when publicly held debt to GDP reached the previous high of 109 percent.

For example, by the close of FY 2010, the government had accumulated borrowings from the Social Security and Medicare Trust Funds totaling $4.5 trillion. At the close of FY 2010, liabilities for federal civilian and veterans’ pension and other benefits were reported at $5.7 trillion. As illustrated by Figure 6, if you lump together all liabilities of the federal government as they appear on its balance sheet, with the intragovernmental borrowings from the Social Security and Medicare “trust funds” and the present value of all future benefit payments to current and future participants in Social Security and Medicare—reported at $30.9 trillion—they total $51.8 trillion, which is 351 percent of 2010 GDP.

Unless the promises of the federal government are altered by law, interest on publicly held debt, civilian and military retirement benefits, intragovernmental debt and social services obligations will all have to be addressed by the same productive capacity of the nation. It is not unreasonable, at this juncture in our history, to ask if these various liabilities and obligations can be honored and, if they cannot, how governors and the citizens of their states will adjust.
On a Tightrope without a Net

Governors, together with their legislative colleagues, will continue to bear tremendous burdens and responsibilities for keeping their states solvent. State revenues are still volatile as the world claws itself back from the debacle in the financial markets and resulting recession. Managing and balancing the long-term retiree obligations of states will require continued attention. And, the reduction and elimination of federal programs, and the explicit or implicit devolution of certain federal responsibilities, will provide additional challenges to the states. During this transition, it is likely that no safety net will be provided by the federal government, as suggested by the following statements:

“We have no expectation or intention to get involved in state and local finance.” The states “should not expect loans from the Fed.”


“I think most of the solutions for state government will have to come from state government.”


“If we bail out one state, then all of the debt of all of the states ... is almost explicitly put on the books of the federal government.” “There seems to be some sort of implicit belief that these are federally backed. They’re not.”


Governors will be able to draw support and encouragement from their fellow governors, and strength and confidence from the results of their own leadership. Most important, it is hoped, they will be supported by the appreciation and respect of their fellow citizens for having risen to the occasion and exerted shared leadership in guiding the federal government toward a sustainable fiscal future.
We've been providing our clients with honest, accurate, objective results since 1981. We think that the most valuable service we can provide to our clients is the truth. That's why we ask hard questions. And that's how we deliver real answers. Some people call that tough. We call it a job well done.

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