Debt and Deception: How States Avoid Making Hard Fiscal Decisions

Government borrowing occurs whenever the government forgives control over some future flow of resources or benefits in order to acquire resources for current use. Based on this definition, the authors identify several ways that state governments borrow, which include widely recognized forms of debt as well as types of actions that are less transparent. Case studies for Connecticut, Illinois, and New York document the large amounts of future commitments that these states have taken on to cover operating deficits over the last decade. The authors conclude by evaluating the usefulness of current financial statements for assessing the amount of borrowing that states have done to support current services and suggest areas for which additional information is needed.

Borrowing to support current operating deficits raises concerns about intergenerational equity because its forces future generations to pay for benefits provided to the current generation and undermines a government’s ability to meet future obligations (Mikesell 2011). Because individual state governments have a limited role to play in macroeconomic stabilization, such borrowing is difficult to justify, particularly at a time when demographic pressures are expected to put considerable strain on future state budgets. For these reasons, many states have constitutional and/or statutory provisions designed to limit the use of debt to the financing of capital projects and to prohibit borrowing to cover operating expenditures (Leonard 2004).

It is well known, however, that states employ many types of budget gimmicks to satisfy budget-balancing requirements (Briffault 1996; Peterson 2003). Some of these gimmicks effectively free up resources to cover current operating expenditures in exchange for taking on future resource commitments. One result is that the extent to which state governments borrow to finance current operating expenditures is poorly understood. Three related factors obscure what is known about this type of borrowing. First, many of the actions or gimmicks that state governments undertake to balance annual budgets are not typically conceptualized as borrowing. Second, the extent and timing of future spending commitments created by many of these actions are difficult to measure. Third, government financial statements do not effectively aggregate the extent of long-term commitments that states make.

To encourage more transparency about the extent to which some states borrow to support operating expenditures, we do three things in this article. First, we develop a definition of borrowing that includes official debt issues but also other actions that have similar economic implications and identify some of the most common ways that states borrow to support current services. This definition and catalogue can help guide analysts as they try to assess the fiscal policy of particular states. Second, we detail the forms of borrowing that have been used in three states—Connecticut, Illinois, and New York. The inadequacy of financial statements for fully capturing long-term liabilities makes it difficult to say whether these states are typical. Nonetheless, these case studies demonstrate that disguised forms of borrowing are used extensively to support operating expenditures in some states, such that typical measures of debt in these states are very misleading. Given the size of the unfunded pension and other postemployment benefits (OPEB) liabilities that have been documented in national studies (Pew Center on the States 2010, 2011)—which is an important form of disguised borrowing—and the fiscal pressures in a number of states (NASBO 2011), it is unlikely that Connecticut, Illinois, New York are unique. Third, we discuss the difficulty of developing comprehensive measures of state government borrowing that can be compared across time and states. Given the potentially significant implications of disguised borrowing for intergenerational equity and fiscal sustainability, we discuss steps that can be taken to make the magnitude and consequences of state government borrowing more transparent during budget development.

Toward a Definition of Borrowing
A narrow definition of borrowing focuses on entering into legal contracts to make future payments

in exchange for funding that can be used currently. Such contracts traditionally come in the form of bonds but also may include instruments such as certificates of participation and lease-purchase agreements. There are, however, a host of other actions that do not necessarily fit this narrow definition but are economically similar to borrowing. Using a broader definition, government borrowing occurs whenever the government forgoes control over some future flow of resources or benefits in order to acquire resources for current use. Any actions that commit the government to give up resources in the future raise the same questions about intergenerational equity and have similar implications for a government’s ability to meet future financial and service obligations as borrowing in the narrower sense. Within this broader definition, different forms of borrowing can be distinguished along three dimensions—certainty, measurability, and transparency.

Certainty refers to the likelihood that the government will have to forgo future resources. Because the government is more likely to have to forgo future resources if it can be forced, through judicial proceedings, to make monetary payments or to provide service, the certainty of debt is influenced by legal enforceability. However, other factors can also influence certainty. For instance, deferring capital maintenance is unlikely to create legally enforceable obligations to make future payments, but it is virtually certain to cause the government and its citizens to forgo future resources, either because the benefits provided by the capital facilities will be diminished or because the government will have to make expenditures to replace or renovate those facilities sooner.

Measurability refers to the feasibility of valuing either the amount of resources obtained for current use or the amount of future resources that the government has committed to forgo. Uncertainty about the amount or timing of future commitments can undermine measurability. Also, the data needed to estimate future costs might or might not be collected. For instance, for governments that lack well-developed asset management systems, it is difficult to estimate the extent, let alone the future costs, of deferred maintenance.

Finally, transparency refers to the extent to which an action is widely recognized as committing future resources and the extent to which those commitments are considered in public deliberations. Lack of certainty and measurability can undermine transparency, but so can other factors. For instance, borrowing through “off-budget” transactions or actions that are reported in budget and financial statements in ways that are difficult to assess will undermine transparency.

Forms of borrowing that are widely recognized as debt rate high on certainty, measurability, and transparency. Bond holders, for instance, enjoy many legal protections—for example, the amount they are to be paid and on what dates are specified precisely in bond agreements—and history suggests that governments are extremely likely to make payments as scheduled. Issuing general obligation bonds often requires approval by voters and thus is a highly visible form of borrowing. Revenue bonds, certificates of participation, and lease-purchase agreements are often less visible than general obligation bonds, but decisions to use bonds to finance operating deficits typically receive ample media attention (Briffault 1996). The future commitments created by the other forms of borrowing may be less enforceable, involve more uncertainty, or be less measurable than the commitments created by more narrow forms of debt.

Underfunding long-term obligations. The large majority of state government employees are covered under defined-benefit pension plans, where employees are guaranteed a certain level of benefits in retirement if they meet plan requirements (Norcross and Briggs 2010). A pension system is considered fully funded if the accumulated employer contributions (plus any required contributions from the employees) are adequate to cover the present value of benefits that the system expects to pay to current employees and beneficiaries. Funding status varies from year to year based on changes in the value of the assets in the retirement fund portfolio and changes in the actuarially accrued liabilities of the plan as new employees are added and others leave or retire. Failure to fully fund a pension system for government employees increases the demands on future resources. Because pension benefits are a form of deferred compensation, underfunding pension plans amounts to committing future resources to finance services in the current period.

Many states have constitutional provisions or statutes that provide explicit guarantees that pension liabilities will be met in full (Brown and Wilcox 2009; Hansen 2010), which means that pension obligations are as legally enforceable as any government commitment. The total amount of future obligations is subject to uncertainty related to turnover rates, future wages, retirement ages, mortality rates, and inflation. Beyond these uncertainties about future payment demands, there are important questions about the discount rate to use in calculating the present value of future payments. Because of this issue, any measure of the extent to which accrued pension liabilities are underfunded is controversial. Recent estimates of pension system funding indicate that, in aggregate, between 37 percent and 84 percent of state government pension system liabilities are covered by pension system assets. Thus, while underfunded pension liabilities are a form of debt that rates high on legal enforceability and pension underfunding is receiving increasing attention (Pew Center on the States 2010), measurement is challenging.

Similarly, unfunded OPEB, most notably retiree health care, might be considered a form of borrowing. Retiree health care often is not a contractual obligation in the same way as pension benefits and payments on bonds, although there is significant variation across states (National Conference on Public Employee Retirement Systems n.d.). In addition to the uncertain factors that influence pension obligations, future retiree health care costs depend on changes in the cost of health care and future health care needs. Thus, unfunded OPEB may be less certain and measurable than pension obligations. Beginning in 2008, state governments have been required to estimate the magnitude of their OPEB liabilities, which has served to increase the visibility of this form of borrowing.
of economic benefits that they provide. When a government sells an asset, it forgoes that future flow of benefits and receives in return resources for current use. In some cases, an asset has more value in the hands of a private owner than it would provide under the control of the government, which may justify the sale. Government assets may be sold, however, for the primary purpose of avoiding an operating deficit. A clear case would be if the government sells an office building, uses the proceeds of the sale to cover current expenditures, and then leases the space in the office building from its new owner. The certainty and measurability of obligations created by such a maneuver would depend on the terms of the leasing arrangement.

**Deferred payments.** Paying bills in the following fiscal year for obligations incurred in the current fiscal year can help meet legal requirements to have the state budget balanced on a cash basis. If paid in the following fiscal year, such delayed payments do not have long-term implications. However, states can continually defer payments so that backlogs of payments emerge. Policies related to interest owed on delayed payments and their legal enforceability may be uncertain, but otherwise these debts are legally enforceable and easy to measure. However, intentions about how long this debt will be carried are often unknown, reducing public scrutiny of decisions to defer payments.

**Debt structuring and refinancing.** Decisions about debt structuring and refinancing are typically made to reduce future debt service payments. However, debt structuring and refinancing decisions can also be made to help close current-year budget deficits without longer-term benefits. In these cases, governments reduce current debt service payments by extending the length of debt maturities, deferring principal payments, and/or capitalizing interest payments, thereby increasing the commitment of future resources. Any increase in future commitments created by a restructuring are as certain and legally enforceable as other bond issues. Also, many states have laws requiring that each restructuring decrease the net present value of future payments, and these requirements bring some scrutiny to restructurings by finance officials (Wood 2008).

The value of future cash payments, however, depends on the choice of a discount rate, a decision that can be controversial, and the details of the structuring and refinancing analysis are largely left to specialists, reducing transparency.

**Deferral of capital maintenance.** When the government chooses not to invest in the maintenance of assets, the flow of future benefits from the asset is reduced. In the future, the government will either have to devote economic resources to refurbish the asset or forgo the benefits that the asset provides. In either case, a burden is born in the future in order to free up resources for current use. As discussed earlier, deferred maintenance does not create legal obligations to make payments, but some impact on future resources is virtually certain. Capital asset management, however, involves trade-offs between investing in routine maintenance, major repair/ refurbishment, and replacement, which complicates estimation of the level of deferred maintenance. Recent changes to government accounting standards require states to value their capital stock and recognize depreciation of the capital stock as an expense. This requirement may lead to advances in the measurement of deferred maintenance and has the potential to improve transparency, but the impacts of deferred maintenance remain difficult to measure.

**Sale of government assets.** Assets derive value from the future flow of economic benefits that they provide. When a government sells an asset, it forgoes that future flow of benefits and receives in return resources for current use. In some cases, an asset has more value in the hands of a private owner than it would provide under the control of the government, which may justify the sale. Government assets may be sold, however, for the primary purpose of avoiding an operating deficit. A clear case would be if the government sells an office building, uses the proceeds of the sale to cover current expenditures, and then leases the space in the office building from its new owner. The certainty and measurability of obligations created by such a maneuver would depend on the terms of the leasing arrangement.

**Fund sweeps.** State governments often transfer money from other funds to cover general fund deficits. If the government has a legal obligation to make transfers from the general fund back into the other fund at some point, then such transfers can be viewed as a form of borrowing. Another example would be if the proceeds from long-term borrowing are used to replenish special revenue funds that are swept into the general fund. In this case, fund transfers may be used to disguise the fact that the state is increasing its borrowing in order to cover operating deficits. The legal enforceability and certainty of future obligations created by fund sweeps depend on the particular regulations and purposes of the fund involved, and thus it is difficult to categorize in any general way. However, the New York State Office of the State Comptroller (2010b) has argued that relying on a large number of fund transfers to meet budget balancing requirements obscures the true economic implications of fiscal policy choices.

**Case Studies in Three States**

We now turn to specific case studies to illustrate how extensively states can rely on these types of fiscal maneuvers. Each case study details borrowing over the last decade that appears to be motivated by the need to cover operating deficits.

**Connecticut**

The state of Connecticut has made use of both official debt issues and disguised borrowing to cover operating deficits in recent years.

**Long-term debt.** Connecticut issued $916 million in economic recovery notes (ERNs) to close the fiscal year (FY) 2009 cash basis deficit (Business Wire 2010), which were sold with an $80.5 million premium, creating additional costs throughout the life of the note (State of Connecticut 2009). Prior deficit borrowing included a total of about $321 million of ERNs to finance the FY 2002 and 2003 deficits (Business Wire 2004; COFA 2009b, 9). The total debt outstanding for operating purposes in FY 2010 was approximately $3.3 billion, which represents $917 per capita, 1.7 percent of state personal income, and 19.2 percent of total debt outstanding (see table 1).

**Pensions and OPEB.** Connecticut’s public pension plans are significantly underfunded. The Pew Center on the States (2011) estimated that in 2009, Connecticut had funded about 53 percent of its pension obligations. Since 2000, the state’s unfunded pension liability has grown by about $14 billion, to more than $21 billion by FY 2010, and it is now higher than total debt outstanding. In relative terms, the unfunded pension liability represents $5,895 per capita and 10.8 percent of personal income (table 1). A study by...
In 2009, more than half of the interfund loans ($533 million) were and 2009) and repays the funds at a later date when times get better. The state's general fund regularly use of interfund borrowing and transfers to address cash short falls resulting from fiscal imbalances. The state's general fund regularly borrows from other funds during tough economic times (2002–3 and 2009) and repays the funds at a later date when times get better. In 2009, more than half of the interfund loans ($533 million) were from restricted grants and accounts (COSC 2009, 87), which are restricted for specific purposes by the federal government or other entities. In addition, about $281 million was borrowed from “other governmental funds,” including the state capital and special revenue funds (COSC 2009, 87). The state also sweeps balances out of other funds and into the general fund with no expectation that the general fund will pay them back. In some cases, the fund sweeps result in reduced spending in those other funds during out-years. Transfers into the general fund also increased during the state's previous financial difficulties.

Delayed payments. The current biennial budget contains provisions that delay the timing of state payments to nursing homes by moving $58 million of payments from June 2011 to July 2011 (COFA n.d.).

### Illinois

The state of Illinois had budget deficits every year during the period from FY 2002 to FY 2010, including $6.3 billion for the general funds in FY 2010. A substantial portion of the deficit ($3.7 billion) was carried over from FY 2009 (State of Illinois 2011, 7). In addition to carrying deficits into future years, Illinois has been utilizing long-term debt and other types of budget mechanisms that shift the burden of financing current operations to future taxpayers.

**Long-term debt.** Illinois has been a heavy user of long-term debt to pay for pension contributions or to decrease the unfunded pension liability, including issuance of $10 billion in taxable 30-year pension obligation bonds in FY 2003, $3.466 billion in general obligation bonds in FY 2010, and $3.7 billion in general obligation bonds in FY 2011 (State of Illinois 2010, 52–53; see also Burr 2011). In FY 2011, the state also created a separate public authority that issued $1.5 billion in tobacco revenue bonds to help address the state’s budget shortfall (Seymour 2010). As of March 2011, Illinois had a total of about $17.8 billion in debt outstanding that was associated with bonds used to finance operating costs or to decrease the state’s unfunded pension liabilities. This is equivalent to almost $1,389 per capita, about 3.3 percent of personal income, and 74.4 percent of state tax-supported state debt outstanding as of the end of FY 2009 (table 1).

In addition to using long-term debt to finance operating costs, Governor Rod Blagojevich’s administration (2001 to January 2009) was criticized for structuring debt to put a larger financial burden on the out-years, including practices such as deferring and back loading principal payments, extending the bond maturities from 25 to 30 years, capitalizing interest, and deferring debt service through refinancing (Luby 2009). For example, the debt service schedule for the $10 billion pension obligation bonds did not include any principal payments during the first four years of its term (CGFA 2010a, 55).

**Pensions and OPEB.** Despite the borrowing to support the pension system mentioned in the previous paragraph, as of the end of FY 2009, Illinois had unfunded accrued pension liabilities of $62 billion and had funded only 51 percent of its pension liabilities—the lowest funding rate among all of the states (Pew Center on the States 2011, 3). The unfunded liability is equivalent to $4,829 per capita, 11.5 percent of personal income, and more than 2.5 times the amount of tax-supported state debt outstanding at the end of

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**Table 1 Types of Long-Term Borrowing for Operating Purposes**

<table>
<thead>
<tr>
<th>Description</th>
<th>Connecticut</th>
<th>Illinois</th>
<th>New York</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt for operating purposes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per capita</td>
<td>$917</td>
<td>$1,389</td>
<td>$506</td>
</tr>
<tr>
<td>Percent of personal income</td>
<td>1.7%</td>
<td>3.3%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Percent of outstanding debt</td>
<td>19.2%</td>
<td>74.4%</td>
<td>16.0%</td>
</tr>
<tr>
<td>Unfunded state pension liability</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per capita</td>
<td>$5,895</td>
<td>$4,829</td>
<td>$67</td>
</tr>
<tr>
<td>Percent of personal income</td>
<td>10.8%</td>
<td>11.5%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Percent of outstanding debt</td>
<td>123.3%</td>
<td>258.6%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Unfunded state OPEB liability</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Per capita</td>
<td>$7,280</td>
<td>$2,114</td>
<td>$2,838</td>
</tr>
<tr>
<td>Percent of personal income</td>
<td>13.4%</td>
<td>5.0%</td>
<td>6.1%</td>
</tr>
<tr>
<td>Percent of outstanding debt</td>
<td>152.2%</td>
<td>113.2%</td>
<td>89.8%</td>
</tr>
</tbody>
</table>

Notes: Personal income is for the 2009 calendar year, derived from information produced by the U.S. Bureau of Economic Analysis (2010). Population is based on the 2010 Census of Population as reported by the U.S. Census Bureau (2011). Total debt outstanding is total net tax supported debt in FY 2009 as reported in Moody’s (2010).

* Connecticut’s long-term debt for noncapital purposes includes $2.276 billion in pension bonds and $917 million in deficit funding bonds with an $80 million premium. Connecticut unfunded pension and OPEB liabilities are based on estimates by the Pew Center on the States (2010).

* Illinois’s long-term debt for noncapital purposes includes $16.3 billion in pension bonds and $1.5 billion in tobacco settlement revenues bonds outstanding as of March 2011. The tobacco bonds were issued by a public authority but are included here because the bond proceeds were used to address the budget shortfall in the general fund. To remain consistent with the other two states, total debt outstanding is total net tax supported debt in FY 2009 as reported in Moody’s (2010). The unfunded pension and OPEB liabilities are as of FY 2009. The pension unfunded liabilities are based on estimates from the Pew Center on the States (2011, 3), and the OPEB unfunded liabilities were obtained from Illinois’s Comprehensive Annual Financial Report (IOSC 2010b, 122).

* Estimates of borrowing for noncapital purposes are from NYOSC (2010a, 2010b). Pension underfunding is based on borrowing by local governments and state agencies to lower their pension contributions. Unfunded OPEB liabilities used in the analysis are those estimated at the beginning of FY 2009 as reported in New York’s Comprehensive Annual Financial Report (NYOSC 2009).
FY 2009 (table 1). Illinois had an estimated $27.1 billion in OPEB unfunded accrued liabilities as of the end of FY 2009 (IOSC 2010b, 122), which is equivalent to 5 percent of personal income and $2,114 per capita.7 Unfunded pension liabilities have continued to grow in the last decade despite legislation in 1995 to force adequate contributions.8

**Delays in paying bills.** Reflecting the fiscal challenges associated with the recession, Illinois had a backlog of approximately $6.4 billion in unpaid bills and fund transfers at the end of FY 2010 (compared to $4.0 billion in FY 2009), which represented 23.8 percent of general funds revenue (State of Illinois 2011, 7). As of the end of FY 2010, the delay in paying vendors was 153 working days (IOSC 2010a, 1), compared to a delay of only seven days at the end of FY 2008 (IOSC 2009, 1). Given the state’s long delays, unpaid bills represent “involuntary loans” to the state. The state also has been delaying the release of some state-appropriated funds to nonprofit organizations, public universities, school districts, and local governments.

**Short-term debt.** Historically, Illinois has used short-term debt to address cash flow needs within a fiscal year; however, during the past three years, the state has issued short-term debt under a constitutional provision for “failures of revenue.”9 This includes the three years, the state has issued short-term debt under a

**Fund sweeps, interfund borrowing, and moving expenditures to other funds.** Illinois has utilized various types of interfund transfers, interfund borrowing, and moving expenditures to other funds to help decrease the budget deficit in the general funds. The amount of transfers peaked in FY 2004 at $522 million but also reached $287 million in FY 2010 (CGFA 2010b, 213). The FY 2011 budget authorized interfund borrowing, which was expected to total around $1.0 billion or 3.3 percent of total revenues for the general funds (State of Illinois 2011, 21). The borrowed funds are subject to a 1 percent interest rate and must be repaid within 18 months (CGFA 2010b, 183).

In FY 2010, the state moved about $1.8 billion in Medicaid costs from the General Revenue Fund to the Healthcare Provider Relief Fund and Tobacco Settlement Recovery Fund. This lowered the amount of expenditures reported in the general fund and allowed the state to utilize cash from other funds to pay for these Medicaid costs (IOSC 2010a, 2). The $1.8 billion figure is equivalent to about 6.6 percent of the estimated FY 2010 total revenues for the general funds.

**Selling of state assets.** The state of Illinois has looked to its large assets as a way to generate revenue to cover operational costs. In 2003, the legislature approved the sale of the James R. Thompson Center, a large state office building in Chicago, with the intent that the state would then lease space in the building. However, the Illinois Office of the Attorney General (2004) ruled that the mortgage loan agreement was state debt that had not been approved by the necessary three-fifths majority of both the house and senate. In 2007, the state sold part of its student loan portfolio ($3.1 billion) and used the net proceeds to finance state aid to students (IOSC 2008, 9).

**Deferral of capital needs.** Illinois did not have a major capital program during the period from FY 2000 through FY 2009 (CGFA 2010a, 9). This pushed the costs of financing capital maintenance, replacement, and expansion needs to future years. With the passage of a new $31 billion capital program in FY 2010, the state has started to address some of these capital needs.

**New York**

New York has also been running a large structural deficit for over a decade and has consistently resorted to borrowing of various kinds to meet budget balancing requirements.

**Long-term debt.** New York State is a heavy user of long-term debt, with debt per capita more than three times the median for U.S. states (Moody’s 2010). The New York Office of the State Comptroller (NYOSC) has estimated for FY 2010 that “New York’s current debt portfolio includes nearly $9.8 billion in bonds used to finance operating expenses and deficits, 16 percent of all State-Funded debt” (2010a, 3). One example is the issuance by a state authority of $4.6 billion in tobacco bonds in FY 2004 to finance a portion of the budget deficits occurring in fiscal years 2003, 2004, and 2005 (NYOSC 2005a). The issuance of debt for operating purposes has occurred despite the passage of the Debt Reform Act of 2000, which restricted the use of state-financed debt to capital improvements (see http://www.budget.ny.gov/investor/bond/IntroDebtReformStatute.pdf). State government has been able to elude these limits through “massive loopholes in the law” with regard to what is classified as state-financed debt (NYOSC 2005a).

The state also refinanced more than $16 billion in long-term bonds in the last decade, with many refundings involving deferred principal payments leading to “higher debt service costs … well into the future” (NYOSC 2005a, 61; 2005b, 43–44).

**Pensions and OPEB.** New York State’s pension system has been cited in national reports as one of the few in the country that is fully funded (Pew Center on the States 2010; Public Fund Survey 2009). The large stock market losses since 2008 have severely reduced the assets of the retirement system, resulting in rapid growth in the contribution rate from state agencies, from below 1 percent of payroll in 2000 to 12 percent in FY 2011 and an estimated 24 percent by FY 2015 (Lyman 2010). In response to this increase, the state legislature has twice passed legislation allowing local governments and state agencies to contribute at rates below those required for actuarial balance and to amortize the gap in their contributions over 10 years (at a 5 percent interest rate). The state amortized more than $600 million in retirement payments due in FY 2005 and 2006 and has estimated that it may amortize close to $4 billion from FY 2011 to 2015 (New York State and Local Retirement System 2006; NYSDOB 2010b).

New York was estimated to have an OPEB liability of more than $55 billion in FY 2009 (NYOSC 2009), which is 89.8 percent of net tax supported debt outstanding in FY 2009 (table 1). To meet this obligation, the state should have contributed $3.3 billion in
FY 2009 to cover current liabilities to retirees and to amortize the unfunded future liabilities. Instead, the state contributed less than $1 billion.

**Fund sweeps.** New York has also used an array of one-time revenue sources or fiscal gimmicks to balance its budgets, which are estimated by the NYOSC to have totaled close to $30 billion in the last decade (NYOSC various years). New York has a complicated fund accounting system with hundreds of funds besides the general fund. The comptroller has argued that the complexity of New York’s fund structure has helped it disguise its structural deficit (NYOSC 2010b).

Over the last decade, the state has swept close to $6 billion from other state funds into the general fund, including $1 billion in FY 2009 (NYOSC various years). In addition, a substantial amount of money has been transferred from state public authorities, such as the New York State Power Authority (NYPA). Although for most fund sweeps, it is difficult to find information on whether there is an obligation of repayment, many of the transfers from public authorities appear to create obligations to make payments or forgo benefits in the future. For example, in 2009–10, the state transferred $215 million from the NYPA into the general fund, which was reserved “to pay for the disposal of waste at a federal repository. It is anticipated that NYPA will need these funds in several years” (NYSDOB 2010b, 17).

**Reduction in pay-as-you-go capital finance.** New York State government has financed a significant share of its capital expenditures using current revenue either from state sources or federal sources (pay-as-you-go or “paygo” financing). The NYOSC has argued that the state has partially financed deficits over the last decade by reducing the use of paygo (NYOSC 2010a). While it is difficult to estimate trends in paygo because of significant volatility, paygo as a percentage of state-funded capital spending has dropped from more than 40 percent in 1980s to between 35 percent and 40 percent for most of the 1990s to less than 36 percent for most of the last decade. If 40 percent paygo is taken as a standard that represents how much past generations have devoted to the funding of long-lived assets, then the state has issued an additional $4.1 billion in long-term debt since FY 2001, which represents 6.8 percent of total state-funded debt outstanding and $212 per capita.10 One example is the Environmental Protection Fund, which was created in 1993 as a “dedicated pay-as-you-go source of funding for environmental capital programs, financed primarily with the Real Estate Transfer Tax” (NYOSC 2010b, 5). Since FY 2000, almost $900 million has been swept from this fund into the general fund, with about 40 percent of this balance replaced with proceeds from long-term revenue bonds issued by the Environmental Facilities Corporation.

**Deferred payments.** A common strategy that New York State has used to help balance the budget over the last decade is to delay payments or accelerate tax revenues. Delayed payments or accelerated revenue provided $3.2 billion in nonrecurring revenue sources from FY 2003 to FY 2010 (NYOSC various years). Examples include the delay of one of the payment cycles for Medicaid and accelerating of payments of business taxes.

**Developing Summary Measures of Debt Burdens**

The preceding case studies demonstrate that the states of Connecticut, Illinois, and New York have undertaken extensive future commitments in recent years in order to cover operating deficits. All three states have issued substantial amounts of long-term debt for operating purposes. Connecticut and Illinois are estimated to have significantly underfunded their pension systems, and none of the states has set aside assets to cover what may be substantial OPEB liabilities over the next several decades. Long-term liabilities associated with underfunded pensions, OPEB, and borrowing for operating purposes appear to be at least as large, if not several times larger, than total debt outstanding to fund capital projects (table 1).

While simple summary measures of long-term liabilities, as presented in table 1, highlight the magnitude of the problem, they are not an adequate summary of borrowing for operating purposes, for a couple of reasons. First, they do not include all of the forms of disguised borrowing discussed in this article, such as deferred maintenance, fund sweeps, and delayed payments. There also are judgment issues in defining and measuring these indicators, such as what assumptions to use in estimating unfunded pension and OPEB liabilities or how to treat decreases in paygo financing to address operating deficits. Moreover, these measures provide only a snapshot of long-term liabilities at one point in time. Of equal importance for assessing recent fiscal policy are measures of the increase in future obligations taxpayers have taken on to support current services.

Recent changes to government accounting standards require states to produce government-wide financial statements using an accrual basis of accounting. These statements have the potential to provide useful indicators of how much state governments borrow to cover operating deficits. For instance, one comprehensive measure of borrowing to fund current services would be the present value of future commitments that a state has taken on compared to the amount that it has spent on investments that are expected to provide benefits into the future. One approximation of that amount could be changes in a state government’s net assets over time. Each year, state governments prepare a financial statement called the statement of net assets that shows the value of assets (what a government owns), liabilities (what the government owes), and net assets (assets minus liabilities). If a state engages in borrowing for operating purposes through the issuance of long-term debt to address budget shortfalls, uses debt refinancing to shift debt service payments into the future, defers capital maintenance, or accumulates a large amount of unpaid bills, there should be a decline in the state’s net assets.

However, there are limitations to utilizing a decrease in net assets as an indicator of the extent to which a state government utilizes borrowing to fund operations. Although explaining the intricacies of governmental accounting and financial reporting is beyond the scope of this article, there are three main limitations:

1. Some borrowing used to support capital investment may result in a decrease in the state’s net assets. For instance, in Connecticut and Illinois, the state has issued bonds to help finance capital projects for local school districts or general-purpose governments, which increases state liabilities with no corresponding increase in state capital assets. The issue in this example is that government-wide financial statements do not adequately capture the financial interrelationships between state and local governments.
2. Some of the borrowing mechanisms identified in this article will not result in a decrease in the net assets reported on the state's government-wide financial statement. For example, a decrease in the value of capital assets should reflect depreciation caused by deferred maintenance. However, some states, such as New York, claim to maintain general government capital assets at current service levels and thus value capital assets at undepreciated, historical cost. In other words, New York State claims for purposes of estimating the value of its capital assets that it does not defer any maintenance. Given recent criticism over capital planning practices and the condition of the New York's infrastructure, this assumption seems questionable (NYOSC 2010e). With regard to long-term liabilities, such as pension liabilities and OPEB, the statement of net assets does not record the full value of the unfunded liability. Instead, information on the total unfunded liability would have to be extracted from the notes to the financial statements in the comprehensive annual financial report for the state government or state pension systems.

3. As discussed earlier, unfunded pension or OPEB liabilities can be difficult to measure because they are based on several risky assumptions about demographics, health costs, and market valuation of pension assets. Because states may modify these assumptions over time, changes in unfunded liabilities may reflect state policy changes with regard to funding these liabilities rather than changes in the net assets themselves. There are also significant measurement challenges associated with assigning a dollar value to capital asset depreciation.

Thus, although the adoption of government-wide financial statements over the last decade has the potential to improve the transparency of state government financing, the measures of changes in net assets presently available on financial statements capture only imperfectly the broader concept of borrowing presented in this article. Government accounting standard-setting bodies both in the United States and abroad are in the process of considering the introduction of additional information into financial statements to help with the measurement of fiscal sustainability (FASAB 2009; GASB 2009; IFAC 2009). The broader concept of borrowing presented in this article could be used as a framework for evaluating changes to existing financial statements to improve their utility for assessing fiscal sustainability and intergenerational equity.

Even with continued modifications of financial statements to facilitate measuring fiscal sustainability, there still needs to be the analytic capacity within the fiscal units and watchdog agencies in state governments to collect, evaluate, and synthesize financial information into measures of fiscal sustainability. This needs to occur as part of the budgetary decision-making process, as well as in the financial reporting that documents the impact of decisions. Such capacity would allow analysis of individual proposals before government budget decisions are made and would provide the institutional knowledge and memory that would allow meaningful aggregation of the outstanding government commitments that have been taken on to address operating budget deficits.

Official debt measures are certainly not an accurate indicator of how much borrowing states have done, and they do not tell us how much of this borrowing is done to cover operating deficits. Unfortunately more comprehensive measures of borrowing are not readily available. If state governments are going to accurately assess the impacts of budgetary decisions on long-run fiscal sustainability, then improvements in both financial information and analytic capacity are necessary. A good place to start is developing comprehensive and accurate measures of state borrowing.

Notes

1. The large difference is attributable to the method used to calculate the liabilities and assets, with the higher estimate (Pew Center on the States 2010; Public Fund Survey 2009) based on conventional valuation methods presently used by state pension systems and the lower estimate (Novy-Marx and Rauh 2009) based on a financial economics methodology (Rizzo 2009).

2. Capitalized interest allows the bond issuer to reduce current interest payments by including it in the bond sale—effectively paying for current interest over the life of the bond. Capitalized interest is common for revenue bonds, as a facility might not generate revenue to pay interest until it is built. There is no obvious reason why interest would be capitalized for general obligation bonds—other than to defer interest payments.

3. Another example of selling an asset is the issuance of tobacco bonds, in which a state receives bond proceeds up front and pledges to use the receipt of future master settlement agreement funds from tobacco companies to pay debt service. In essence, the state has sold an asset—the rights to the future receipt of tobacco settlement revenues. In this article, this type of borrowing is listed under long-term debt, but it also could be listed under the sale of an asset.

4. The state had not made $100 million of scheduled pension payments in FY 2010 pursuant to an agreement with labor unions, and it expected to miss another $100 million in FY 2011 (Business Wire 2010, 2; COFA 2010, 3, 6). This adds further deferrals to a pension contribution schedule that is already significantly back-loaded.

5. It is estimated that there will be $58 million of these fund sweeps in the state's FY 2010 deficit mitigation plan on top of the budgeted $57 million of sweeps in FY 2010 and $45 million in FY 2011 (COFA 2010, 15; 2009a, 36).

6. In Illinois, the general funds include the General Revenue Fund, Education Assistance Fund, Common School Fund, and General Revenue–Common School Special Account Fund.

7. In FY 2010, the state passed legislation that changed the pension provisions for employees hired on or after January 1, 2011 (State of Illinois 2010, 54).

8. In 1995, Illinois passed a statute that required funding at a fixed percentage of payroll to reach a funding level of 90 percent by FY 2045. However, the statutory funding requirements are significantly less than the actuarially required contribution amounts (IOSC 2010b, 119).


10. The information on capital spending and financing sources, including debt and paygo, are based on information reported in the annual Enacted Budget: Capital Program and Financing Plan developed by the New York State Division of the Budget (various years).
Debt and Deception: How States Avoid Making Hard Fiscal Decisions


