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## FISCAL EVASION IN STATE BUDGETING

By Eileen Norcross

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States are entering their third fiscal year of a sustained economic and revenue contraction. Tax revenues have been declining since the first quarter of 2009 and are likely to continue their slide through 2012. Between FY 2009 and FY 2012 state budget deficits will total \$300 billion in the states over the next three years.<sup>1</sup> In FY 2011, states face a cumulative budget gap of \$89 billion.<sup>2</sup> Federal stimulus funds will be largely exhausted in the coming fiscal year with state source revenues unlikely to return to their pre-recession levels.<sup>3</sup>

While this recession delivered a severe shock to state economies and revenues, the fiscal crisis in the states developed over decades. States have struggled to recover from economic downturns since the early 1980s. Institutions meant to constrain spending such as Tax and Expenditure Limits (TELs), adopted in the 1970s and 1980s, and constitutional limits on debt have also given rise to evasive practices meant to circumvent these constraints and grow spending beyond a legal or constitutionally established limit. The response to budgetary shortfalls in the states since the 1990s has been to resort to fiscal gamesmanship.

With the most recent recession, the choices made by legislatures and governors to balance the books have come under greater scrutiny. Tax increases, spending cuts, and federal bailout funds have each been critiqued through different economic lenses as either supportive of or detrimental to recovery. There is also concern that many of the tactics used to present balanced budgets amount to gimmickry.<sup>4</sup> And more fundamentally, the long-running use of gimmicks is part of the reason most state budgets are

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<sup>1</sup> National Association of State Budget Officers (NASBO), "The Fiscal Survey of States," Spring 2010.

<sup>2</sup> National Conference of State Legislatures (NCSL), "FY 2011 Budget Status", June 1, 2010. (<http://www.ncsl.org/default.aspx?TabId=19999>)

<sup>3</sup> "The Fiscal Survey of the States-June 2010" The National Association of State Budget Officers (NASBO), 15. (<http://www.nga.org/Files/pdf/FSS1006.PDF>).

<sup>4</sup> See for example, "State Fiscal Gimmicks: a Budgetary Balancing Act" by Katherine Barrett and Richard Greene, *The American Prospect*, February 15, 2010; "Grab Bag of Gimmickry Hides State Deficit" by Nicholas Confessore, *The New York Times*, April 6, 2010; "The States' Stupid Budget Tricks" by Katherine Barrett and Richard Greene, *Governing*, November 2009 (<http://www.governing.com/columns/smart-mgmt/The-States-Stupid-Budget.html>) and "Don't Fall for State Budget Gimmicks" *The Daily Herald Editorial Board*, May 25, 2010. (<http://www.dailyherald.com/story/?id=383160>).

in crisis today.<sup>5</sup> In this discussion, the word “gimmick” has been loosely applied to describe a range of choices including school aid cuts, sales tax holidays, increased borrowing, delayed tax refunds, delayed payments to vendors, and pension deferrals. Yet some of the practices labeled “gimmicks” do not violate any accounting standard or budget rule.

To a great extent, a budget gimmick is in the eye of the beholder. Many of the tactics currently criticized as gimmicks have also been described as “budget shortfall strategies,”<sup>6</sup> and “expedients.”<sup>7</sup> This inconsistent characterization may reflect the inadequacy of government budgeting practice and standards, as well as a general ambivalence over the long-term implications of the accounting choices made in public budgeting. It may also reflect the inadequacy of the word “gimmick” itself. Some of the practices singled out as budget “gimmicks” are a result of a half-century of structural change to state budgets, and the subnational governments’ growing reliance on debt and intergovernmental aid.

The inconsistent identification of poor fiscal practice indicates the lack of a common framework against which to assess the fiscal choices of states. This paper establishes a basic definitional framework that can be used to assess long-running fiscal practices in the states against a standard of fiscal prudence. The aim is to further refine this framework to capture the drivers of the states’ long-running fiscal problems and to offer recommendations for reform.

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<sup>5</sup> It is worth noting that states have faced significant shortfalls in the past, with similar criticisms leveled at state budgeting practices. During the recession of 1991-1992, revenue shortfalls, increased unemployment and welfare applications, put pressure on state budgets, leading to a similar diagnosis, “To some degree, the state’s fiscal problems are of their own making. Some states have been good managers and have saved for a rainy day; others have been unwilling to restrain revenues or to restrain demands for more spending.” See, Susan B. Hansen, “State Fiscal Strategies for the 1990s: Balancing Budgets in a Recession,” *Publius*, Vol. 21, No. 3, *The State of American Federalism*, p. 155.

<sup>6</sup> “Budget Shortfalls: Strategies for Closing Spending and Revenue Gaps,” National Association of Budget Officers, 3<sup>rd</sup> Ed. December 2002. <http://www.nasbo.org/LinkClick.aspx?fileticket=2KMUBWgfJdw%3D&tabid=83>. NASBO noted in 2002 that, “Anemic revenue growth coupled with severe spending pressure is forcing states to replace short-term budget solutions with more creative, innovative and long-term adjustments. Aside from the usual budget balancing tools, states have a wide variety of other tools at their disposal.” These include: spending cuts, tobacco settlement funds, fund transfers, privatization, tax and fee increases, delayed tax cuts, debt finance, delaying payments to vendors, delaying tax refunds, among other measures.

<sup>7</sup> The National Conference of State Legislatures notes, “Fiscal stress, however, can induce governors and legislators to adopt expedients so they can observe the letter, if not the spirit, of balanced budget requirements. Among these are sales of state assets, postponing payments to vendors, reducing payments to pension funds, borrowing from one state fund to finance expenditures from another and “creative” accounting. Such expedients reflect the stress that can arise between legal demands for a balanced budget and political demands for the continuation of state programs without a tax increase. See, Ronald K. Snell, “*State Balanced Budget Requirements*,” National Conference of State Legislatures, updated April 1999 (<http://www.ncsl.org/IssuesResearch/BudgetTax/StateBalancedBudgetRequirements/tabid/12660/Default.aspx>)

## **Gimmickry, Fiscal Evasion and Fiscal Illusion**

Gimmickry can be defined as a practice that intentionally violates an accounting or budgeting standard or a legal requirement meant to ensure fiscal prudence. However, in some cases, the standards or practices themselves may encourage a lack of prudence, or erode the hard budget constraint facing state and local governments, necessary to ensuring a market-preserving federalist system.<sup>8</sup> When the rules or norms that guide budget choices contribute to structural instability or fiscal profligacy, the word gimmickry loses its meaning and it becomes necessary to consider the extent to which the budgeting framework promotes or discourages accuracy in accounting and fiscal prudence.

Budgeting choices identified as gimmickry arise from the fiscal framework. This framework includes accounting standards, budget rules and their enforcement, and the fiscal relationships between the federal, state, and local government.

Routine violation of accounting standards or budget rules can be minimized with better monitoring, tighter controls, and penalties. But where accounting standards, legislative rules, or intergovernmental interventions promote fiscal profligacy by obscuring the cost of spending, the remedies are less obvious.

To reconcile these two concepts—the violation of an accounting or legal standard, and the potential weaknesses of the standards themselves—a new term, “fiscal evasion,” is employed. I define fiscal evasion as any means—an accounting tactic, budgeting rule, or intergovernmental arrangement that conceals the full cost of public spending.<sup>9</sup> When these tactics are employed regularly, or weak rules and

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<sup>8</sup> See, Barry R. Weingast, “The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development,” *Journal of Law, Economics & Organization*, Vol. 11, No. 1 (Apr., 1995), 4-5.

Market-preserving federalism is a type of federalism that limits the degree to which a country’s government can encroach on its markets. It consists of five conditions, including the condition that the lower levels of government in a federalist arrangement face a hard budget constraint, “that is, they have neither the ability to print money nor access to unlimited credit. This condition is not met if the central government bails out the lower one whenever the latter faces fiscal problems.”

<sup>9</sup> The concept of government creating mechanisms to evade limits and rules on spending is developed by James T. Bennett and Thomas DiLorenzo in their seminal work on the rise of Off-Budget Enterprises (OBEs). They find that one outcome of the “tax revolts” of the late 1970s and early 1980s, and the resulting Tax and Expenditure Limits designed to constrain spending, was the increase in the number of OBEs on the local level with the authority to issue debt without voter approval. “Voter preferences for fiscal restraint are often evaded at the local level of government by conducting many public sector activities through off-budget enterprises which are largely beyond the control and scrutiny of citizen-taxpayers.” See, James T. Bennett and Thomas DiLorenzo, “Off-Budget Activities of Local Government: The Bane of the Tax Revolt” *Public Choice*, Vol. 39 No. 3 (1982) p 334.

arrangements dominate budgets, the effect is to institutionalize fiscal deception—convincing lawmakers of a policy’s sustainability and dulling the response of voters by concealing the cost of policy choices.

Fiscal evasion is not meant to supplant the well-developed theory of fiscal illusion, which holds that the methods used to finance government spending may cause taxpayers to perceive spending as less costly than it actually is.<sup>10</sup> An overly complex revenue system, debt finance, and income-tax withholding all give rise to fiscal illusion.<sup>11</sup> Instead, fiscal evasion describes how lawmakers intentionally foster fiscal illusion to present a distorted picture of a government’s true fiscal condition.

Fiscal evasion is undertaken by circumventing statutory or constitutional budget rules, or through the weak design of such rules, by practices that promote fiscal illusion, such as the use of debt and intergovernmental aid to finance policies, and by accounting tactics that rely on data manipulation to present a favorable budgetary picture.

There is a strong incentive in public budgeting at all levels of government to mask the full cost of policies. The agents engaged in fiscal deception do not necessarily bear the consequences of those choices. The costs are passed on to the taxpayer in the present or the future. Politicians reap immediate political reward when they emphasize the benefits of a policy and diminish its costs. Taxpayers share the “same budgetary pathology” of legislators, seeking an increase in spending, a decreased tax burden, and a budgetary surplus.<sup>12</sup>

### **Why Does it Matter?**

The misrepresentation of the cost of policies to taxpayers presents both lawmakers and voters with an inaccurate picture of a government’s fiscal condition as well as the potential taxation necessary to finance policies. Lawmakers budget in a fog which weakens their capacity to make well-informed policy choices. New York State Comptroller Thomas DiNapoli notes, “The state’s real fiscal picture is impossible to pin down.”<sup>13</sup> He notes the long-running and widespread use of gimmickry is so woven into Albany’s

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<sup>10</sup> For a discussion of the development of the theory of fiscal illusion, see, *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice*, by James M. Buchanan, 1967, in *The Collected Works of James Buchanan* vol. 4 Liberty Fund (1999).

<sup>11</sup> Richard E. Wagner, “Revenue Structure, Fiscal Illusion, and Budgetary Choice,” *Public Choice*, Spring 1976.

<sup>12</sup> Cheryl Block, “Budget Gimmicks,” in *Fiscal Challenges: An Interdisciplinary Approach to Budget Policy*, Edited by Elizabeth Garrett, Elizabeth A. Graddy and Howell E. Jackson, pp. 47 (Cambridge University Press, 2008)

<sup>13</sup> “Grab Bag of Gimmickry Hides State Deficit” by Nicholas Confessore, *The New York Times*, April 6, 2010.

budget that it has “essentially rendered the state’s balance sheet immaterial.”<sup>14</sup> This misrepresentation creates a false picture of budgetary balance that obscures the reality of underlying deficits.

When the true cost of spending is obscured, voters may prefer an increase in the amount of resources dedicated to a particular policy or support a policy they might not otherwise if the full cost were obvious. Where budgets are constructed to hide the cost of spending the meaning of voter participation is eroded.

A one-time tactic employed to balance a budget or conceal the cost of a policy choice may generate a climate of fiscal gamesmanship. Short-term fixes may be codified as budget procedures, which in turn help to conceal unsustainable spending policies. Reliance on intergovernmental aid may lead to the expectation of bailouts leading states to budget less prudently or avoid structural budgetary reforms.<sup>15</sup>

### **How States Engage in Fiscal Evasion**

In her assessment of budget gimmickry in the federal government, Cheryl Block identifies three types of gimmicks: games with numbers, timing games, and procedural games. This is a useful framework for identifying tactics that violate or manipulate established accounting or legal standards, and it can be extended to the standards themselves. However, it does not capture the use of mechanisms such as debt that mask the full cost of policies. Further, when considering state (and local) governments in a federalist system, the potential for another kind of evasion emerges—one that exploits intergovernmental transfers.

In order to identify how states avoid presenting the full cost of policies, the next section considers how the state’s budgetary framework gives rise to fiscal evasion. This framework includes a) balanced budget requirements, b) Tax and Expenditure Limits, c) limits on debt, d) accounting practices and definitions, and e) intergovernmental transfers.

#### **a. Balanced Budget Requirements**

All states, except Vermont, operate under either constitutional or statutory balanced budget rules. There are two general types of balanced budget rules. Prospective balanced budget rules require the

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<sup>14</sup> Ibid.

<sup>15</sup> Alexander Fink and Thomas Stratmann, “Institutionalized Bailouts and Fiscal Policy: The Consequences of Soft Budget Constraints,” CESifo Working Paper Series No. 2827, October 28, 2009, Fink and Stratmann note that “States have soft budget constraints when they can expect a bailout by the federal government in the event of a financial crisis. This gives rise to incentives for unsound state fiscal policy.”

proposed or enacted budget be in balance.<sup>16</sup> If revenues are not sufficient to cover proposed spending, a deficit results. One outcome of prospective rules is that it creates an incentive for legislatures to overstate anticipated revenues to permit higher levels of spending. The penalty for this strategy is voter anger associated with deficit spending or future tax increases.<sup>17</sup> Forty-four states require the governor to submit a balanced budget to the legislature, and 37 states require the legislature enact a balanced budget.

A balanced budget rule may also be retrospective, stipulating how a deficit is treated at the end of the fiscal year. Retrospective rules are stronger balanced-budget rules than prospective rules. Seven states allow for deficit carry-over, provided the deficit is accounted for explicitly in the next budget. Thirty-six states prohibit deficit carryover and require the shortfall is addressed in the current fiscal year, either through reduced spending, increased taxation, debt, federal aid, or accounting gimmicks.<sup>18</sup> Empirical evidence suggests constitutional spending limits with no deficit carryover rules in states with elected courts are more effective at controlling spending growth. Seventeen states meet these criteria.<sup>19</sup>

While balanced budget rules may be designed to keep deficit spending in check, they are limited in what portion of the spending they constrain. The National Conference of States Legislatures (NCSL) finds that in 48 states balanced budget rules apply only to operating budgets, or the general fund, which comprises anywhere from 20 to 60 percent of a state's budget. Some states also apply balanced budget rules to other funds. Thirty-eight states extend balanced budget requirements to federal funds and 34 states apply a spending limit to special funds in which taxes are dedicated to specific spending.<sup>20</sup>

NCSL suggests that revenues and expenditures earmarked for federal grants and special funds, such as highway trust funds have little impact on balanced budgets, since "expenditures are controlled by available funds."<sup>21</sup>

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<sup>16</sup> David Primo, *Rules and Restraint: Government Spending and the Design of Institutions*, University of Chicago Press, 2007, 87.

<sup>17</sup> *Ibid.*, p. 88

<sup>18</sup> Robert Krol, "The Role of Fiscal and Political Institutions in Limiting the Size of State Government" *Cato Journal*, Vol 16, No. 3

<sup>19</sup> David Primo, *Rules and Restraint* p. 89

<sup>20</sup> Ronald K. Snell, "State Balanced Budget Requirements: Provisions and Practice," December 2004 (<http://www.ncsl.org/?TabId=12651>)

<sup>21</sup> *Ibid.*

While dedicated funds are meant to be spent on legally specified purposes, funds are fungible. States have shown a willingness to “sweep” trust funds earmarked for specific purposes into the general fund, a practice criticized by New York State’s comptroller as encouraging budgetary instability. In addition, intergovernmental transfers of federal funds to states can stimulate greater state spending, including encouraging states to issue debt in order to support federally-initiated projects.

More importantly, budgetary balance does not imply fiscal prudence, nor does it mean that spending growth is constrained. Budgetary balance simply indicates that revenues are sufficient to cover a desired level of spending. Even though a budget is balanced, it may still be too large relative to the state’s economy. In fact, the definition of a “budget deficit” is often misleading.

For FY 2010, California reported a budget deficit of \$19.1 billion. This estimate represents the difference between current revenues and what the government would like to spend, based on projected budget growth of 14 percent. The deficit represents the legislature’s desire to increase the FY 2009–2010 budget of \$87.3 billion to a budget of \$99.5 billion in FY 2010–2011. If instead, the legislature only increased spending by inflation plus population growth, the budget deficit would fall from \$19.1 billion to \$7 billion.<sup>22</sup>

#### **b. Tax and Expenditure Limits**

The growth in state taxation during from the 1950s and 1970s to fund increased state government spending touched off a wave of tax revolts in the states during the 1970s and 1980s. The culmination of these tax revolts was the passage of Tax and Expenditure Limits (TEs) in many states, meant to curtail taxation and/or spending. TEs vary in what they constrain and in their stringency. The degree to which TEs have been successful in limiting the growth of government is the subject of a vast literature. It is worth noting that there is evidence that lawmakers have undermined the intent of TEs by developing mechanisms to evade imposed spending limits. Wagner and Sobel find that some states adopted budget stabilization funds (BSFs), or rainy day funds, “to circumvent existing expenditure and/or tax limit laws.”<sup>23</sup> Many states have “weakly structured” withdrawal and deposit rules governing their BSFs, allowing lawmakers to access stabilization funds, while bypassing spending limits.<sup>24</sup>

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<sup>22</sup> Cal-Tax Reports, Vol. IV, No. 19, May 24, 2010.

<sup>23</sup> Gary A. Wagner and Russell S. Sobel, “State budget stabilization fund adoption: Preparing for the next recession or circumventing fiscal constraints?” *Public Choice*, Vol. 126 (2006), p. 178

<sup>24</sup> *Ibid*, Wagner and Sobel, “State budget stabilization fund adoption,” 182.



### c. Debt Limits

Thirty-three states constrain spending in capital funds which are typically financed through debt.<sup>25</sup> However, court decisions and voter referendums on borrowing have led to the exclusion of debt-financed expenditures in calculating balanced budget requirements.<sup>26</sup> There is evidence that debt per capita spending is higher in states with weak budget rules.<sup>27</sup>

Until the 20th century, it was generally accepted that prudent fiscal conduct on the part of governments included adopting the same set of financial principles as households. Spending should not exceed income and debt should be kept to a minimum. Debt finance was generally limited to “extraordinary events” such as war and natural disasters.<sup>28</sup> This norm was occasionally violated with state governments borrowing to build canals, turnpikes, and roads, leading to defaults by state and local government.<sup>29</sup> These defaults lead states to pass constitutional restrictions on debt. However, state debt restrictions have not been successful in limiting overall state debt.<sup>30</sup> The use of debt in to finance projects in state and local governments has grown significantly in recent decades.

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<sup>25</sup> National Conference of State Legislatures, “State Balanced Budget Requirements: Provisions and Practice,” by Ronald K. Snell, updated 2004, p.5 (<http://www.ncsl.org/?TabId=12651#t3>).

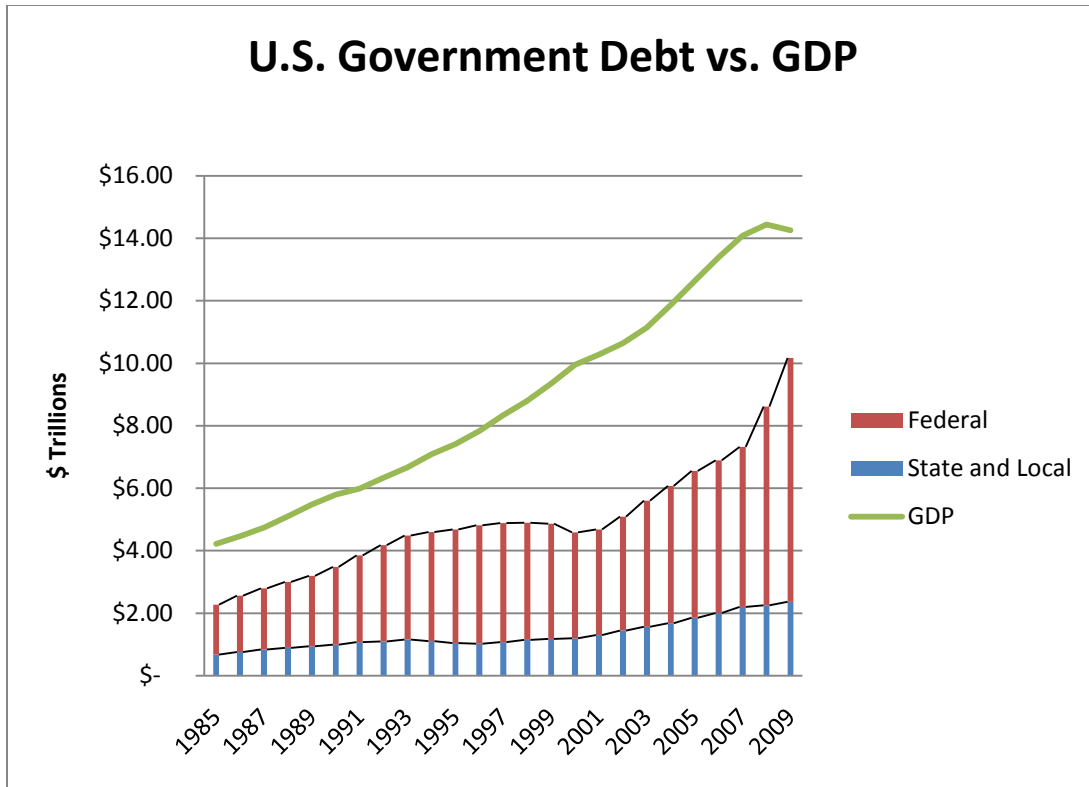
<sup>26</sup> Ibid, p. 5

<sup>27</sup> Robert Krol, “The Role of Fiscal and Political Institutions in Limiting the Size of State Government,” *Cato Journal*, Vol. 16, No. 3.

<sup>28</sup> Eileen Norcross and Frederic Sautet, “Institutions Matter: Can New Jersey Reverse Course?” *Mercatus Center Working Paper No. 09-30*, July 2009 p. 12.

<sup>29</sup> James C. Clingermayer and B. Dan Wood, “Disentangling Patterns of State Debt Finance,” *The American Political Science Review*, Vol. 89, No. 1 (Mar, 1995) 108.

<sup>30</sup> Clingermayer and Wood, “Disentangling Patters of State Debt Finance,” 1995, 109.



States governments issue General Obligation bonds backed by the taxing authority of the state. These bonds come with the legal obligation that the state must pay bondholders. Debt limits generally only cover such “guaranteed debt.” States have gotten around these debt limits by creating off-budget entities (OBEs) such as special authorities with the ability to issue other forms of “non-guaranteed debt”, in particular, revenue bonds.<sup>31</sup> Revenue bonds are backed by revenues generated by the authority, such as tolls or fees. Today, revenue bonds constitute the majority of total state debt.

States are “morally” but not legally obligated to guarantee revenue debt in the event that the issuing authority defaults. In fact, the concept of “moral obligation” debt originates with the off-budget enterprise.<sup>32</sup> As Bennett and DiLorenzo recount, in 1960, Governor Nelson Rockefeller of New York created the Housing Finance Authority (HFA), one of dozens of debt-issuing OBEs established during his tenure. Because HFA’s bonds were based on rental housing revenues, Rockefeller worried that the authority would have difficulty marketing its bonds to investors. To

<sup>31</sup> Beverly S. Bunch, “The Effect of Constitutional Debt Limits on State Government’s Use of Public Authorities,” *Public Choice*, Vol. 68 No. 1-3, January 1991.

<sup>32</sup> James T. Bennett and Thomas J. DiLorenzo, “Underground Government” *Cato Institute*, 1983 p.64

assure investors, bond lawyer, John Mitchell, devised the “moral obligation bond” requiring the issuing authority to create a debt-service reserve fund from bond proceeds. If the agency should default, the legislature would consider replenishing the debt-reserve fund. Since according to New York law the legislature cannot bind future legislatures into appropriating funds, Mitchell reasoned such revenue debt represents a moral but not a legal obligation of the state.

A factor contributing to the rise in the number of OBEs in state and local governments was the imposition of tax and spending limits. OBEs are part of a strategy on the part of politicians “to bypass the wishes of the electorate whenever the voters express a demand for fiscal restraint.”<sup>33</sup> Through the use of OBEs governments move their activities, “off-the-books” or “underground.”<sup>34</sup> It is estimated that OBEs, or “special-district governments” increased three-fold between 1952 and 2007, totaling 37,389 entities.<sup>35</sup>

Between 1990 and 2008, debt issued by special authorities increased 125 percent, while state debt grew by 29 percent and municipal debt increased by 37 percent in real terms. This shift to revenue bonds demonstrates, “an effort by politicians to work around such (debt) rules.”<sup>36</sup>

The Office of the State Comptroller of New York reports that in FY 2010, New York’s \$48.5 billion in total state-funded debt includes \$3.5 billion of General Obligation bonds, and \$45 billion issued by public authorities. As tax revenues continue to fall, dropping 5.6 percent in 2009, revenue bonds which are backed by fees have increased in their appeal to both governments and investors, with prices for revenue bonds rising over the same period.<sup>37</sup>

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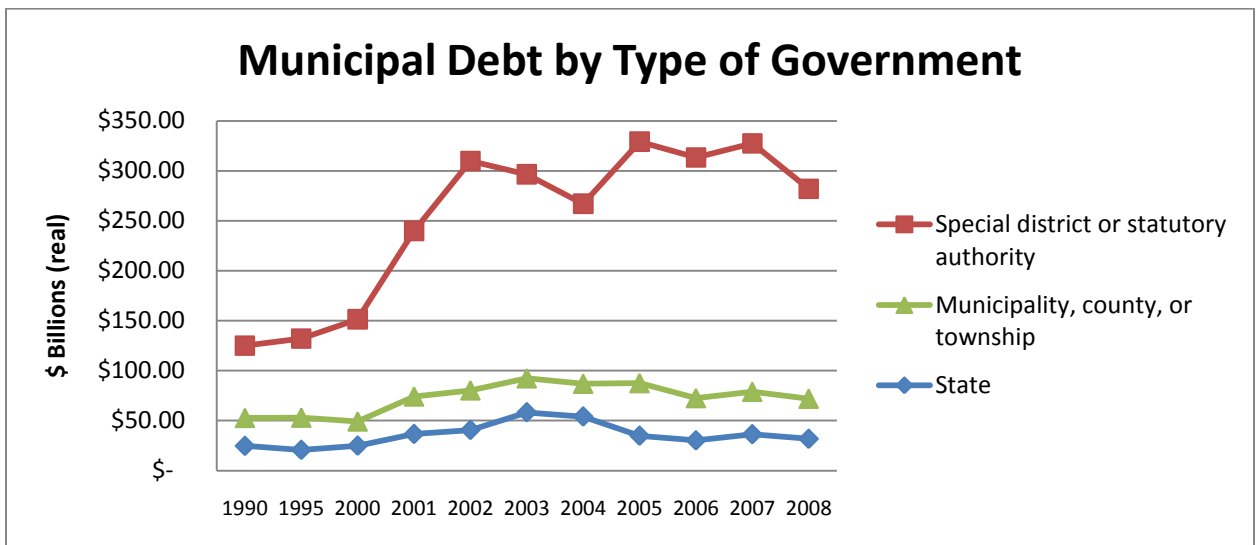
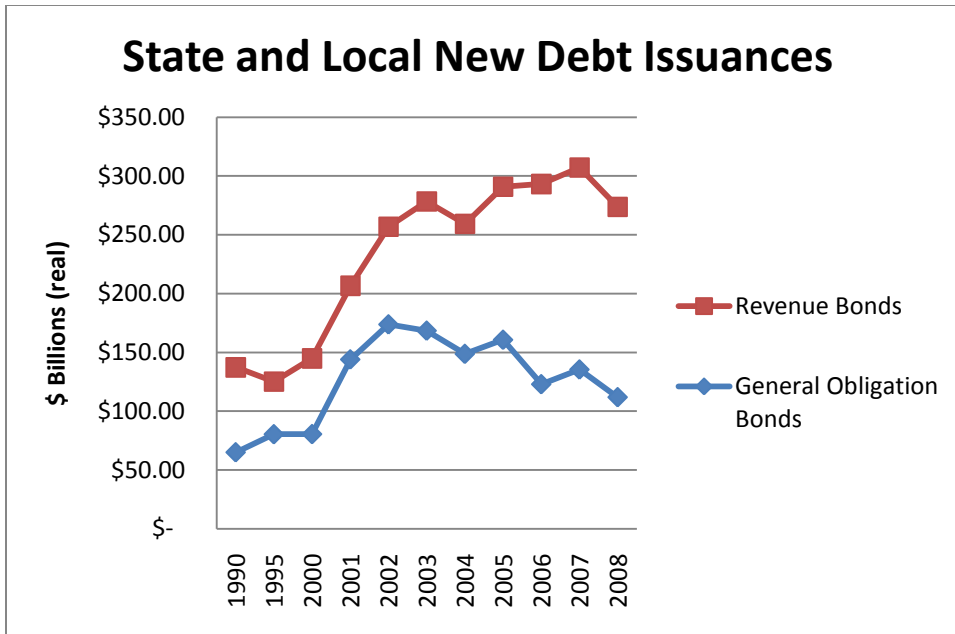
<sup>33</sup> Bennett and DiLorenzo, “Off-budget activities of local government” *Public Choice*, Vol 39, 1982 p.335.

<sup>34</sup> Robert T. Bennett, “The Underground Economy,” In the *Encyclopedia of Public Choice*, 2003 (pp...)

<sup>35</sup> See, Robert T. Bennett the *Underground Economy in the Encyclopedia of Public Choice*, 2003. Number reflects the latest census figures of 2007 ([http://harvester.census.gov/gid/gid\\_07/options.html](http://harvester.census.gov/gid/gid_07/options.html)).

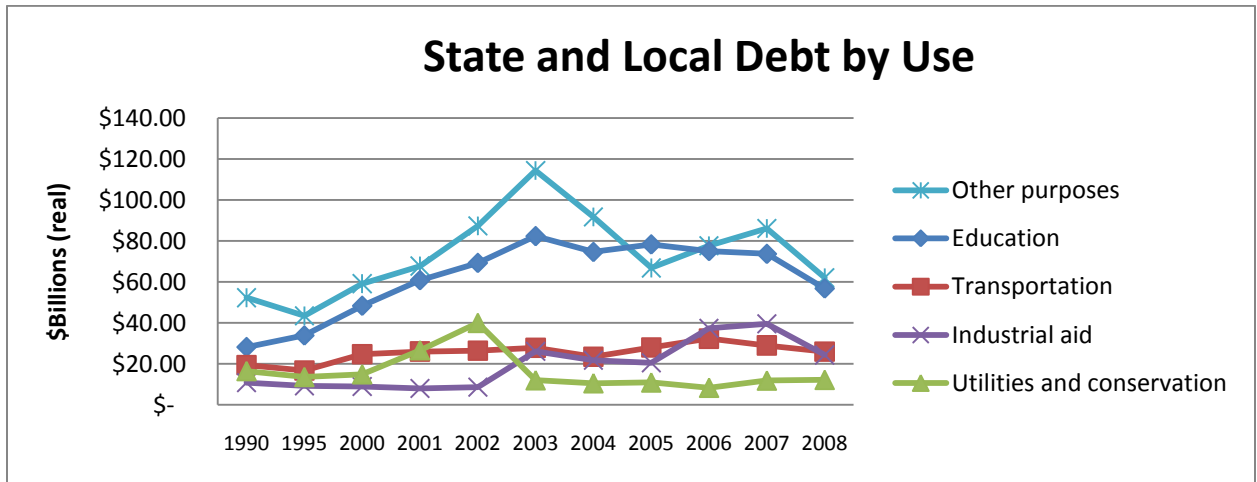
<sup>36</sup> Robert Krol, “The Role of Fiscal and Political Institutions,” *Cato Journal*, 2007, p. 435

<sup>37</sup> In recent months, prices have risen on revenue bonds. California sold \$2.97 billion in revenue bonds in May 2010 backed by fees on electric utility users. See, “Sewer Bonds Beat Muni General Obligation Debt: Chart of the Day,” by Jerry Hart, *Bloomberg.com*, May 10, 2010. (<http://www.bloomberg.com/news/2010-05-10/sewer-bonds-beat-muni-general-obligations-as-taxes-dwindle-chart-of-day.html>)



Debt finance which is typically used to finance capital projects has also increased during a period when governments have adopted a broader definition of capital spending. No longer confined to traditional infrastructure such as bridges and roads, capital spending may include school buildings, stadiums, historic preservation, environmental remediation, or land acquisition. Over time, operating expenses and capital budgets have become blurred “with many claiming that

bricks-and-mortar projects are not the only projects belonging in a capital budget, and therefore eligible for debt financing.”<sup>38</sup>



Other reasons for the increase in state and local borrowing include low interest rates and federal tax treatment of debt.<sup>39</sup> The growth of municipal debt is due in part to the tax exemption given to interest on municipal bonds. The Tax Reform Act of 1986 limited the types and kinds of tax-exempt municipal debt and it imposed limits on the issuance of tax-exempt “private activity bonds” to limit state governments issuing debt for private sector activities such as industrial projects, housing, and economic development.<sup>40</sup> Since then Congress has reversed these restrictions by creating additional forms of tax-favored public debt for private purposes.<sup>41</sup>

Another potential factor stimulating states to issue debt is intergovernmental aid. Clingermeier and Wood find that for each \$1,000 per capita difference between states in intergovernmental aid resulted in a \$78 difference between states in debt growth. That is, states with higher levels of intergovernmental aid, borrow more.<sup>42</sup> Federal aid leads to the formation of coalitions that lobby for

<sup>38</sup> Clingermeier and Wood, “Disentangling Patterns of State and Local Debt,” 1995, 109.

<sup>39</sup> Clingermeier and Wood, “Disentangling Patterns of State and Local Debt,” 1995, 110.

<sup>40</sup> W. Bartley Hildreth and C. Kurt Zorn, “The Evolution of the State and Local Municipal Debt Market over the Past Quarter Century,” *Public Budgeting & Finance*, Vol. 25, Issue 4s, 29 Nov 2005, 129.

<sup>41</sup> Chris Edwards, “State and Local Government Debt is Soaring,” *Tax and Budget Bulletin*, No. 37 July 2006, Cato Institute.

<sup>42</sup> Clingermeier and Wood, “Disentangling Patterns of State and Local Debt,” 1995, 113.

increased spending on federally subsidized projects. To support projects financed with federal transfers, states may choose to issue debt, rather than raise taxes since debt promotes fiscal illusion, making it more difficult for taxpayers to evaluate the full cost of spending proposals.

### **Does Bonding Contribute to Fiscal Instability?**

On June 4, 2010, Connecticut's bond rating was downgraded by Fitch's after the state legislature issued bonds to close next year's projected budget deficit of \$1 billion. The state also borrowed for operating expenses in 1991 and 2003 to close the budget deficits. Since 1987, the state's ratio of debt to general expenditures has increased from 6.2 percent to 10.9 percent in FY 2009, passing the 10 percent threshold that leads bond ratings agencies to potentially issue a downgrade.<sup>43</sup>

Governor Lynch of New Hampshire proposed balancing the state's FY 2010–2011 budget by issuing \$6 billion in "refunding bonds" to lower interest rate payments, \$25 million in University of New Hampshire bonds (backed by a loan from the university), and \$51 million in Debt Service bonds to pay for current debt payments.<sup>44</sup> Issuing debt to pay for the state's debt "has not been done in New Hampshire before," according to Treasury Secretary Cathy Provencher, and "is not something we would want to get into the habit of doing."<sup>45</sup> Currently, New Hampshire's debt represents 7.9 percent of its general expenditures.<sup>46</sup> Since New Hampshire's debt to general expenditures ratio hasn't exceeded 10 percent, the practice of issuing debt to pay for debt has not yet harmed New Hampshire's bond rating. The state's \$44 million in GO debt was rated AA+ by Fitch's in June, 2010.

The practice of borrowing to pay for current spending is generally permitted by state laws and constitutions and it does not violate balanced budget requirements. NCSL notes the practice is rare. However, it is worth noting there is evidence that borrowing to cover revenue shortfalls may lead to a growing reliance on debt to finance current spending.

For example, Illinois' government may borrow up to 15 percent of total appropriations in years with significant revenue declines to cover budgetary shortfalls. Short-term debt must be repaid within a year

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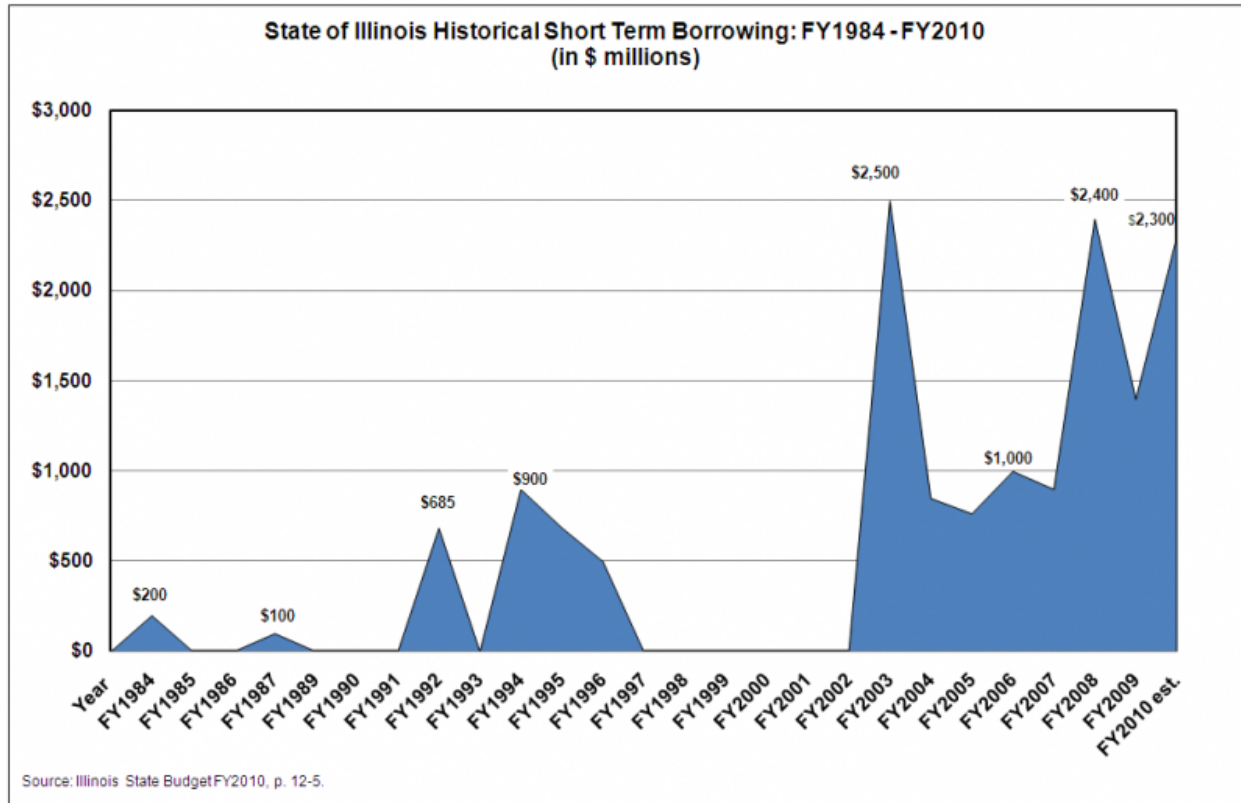
<sup>43</sup> Connecticut General Assembly, Office of Legislative Services, "State Budget, Debt, and Long-Term Obligations," Judith Lohman, October 7, 2009. (<http://www.cga.ct.gov/2009/rpt/2009-R-0341.htm>)

<sup>44</sup> Grant D. Bosse, "Mortgaging the Future: Can New Hampshire borrow its way to a balanced budget?" Bartlett Center for Public Policy, April 2010, 1-2

<sup>45</sup> Ibid, Grant D. Bosse, "Mortgaging the Future", 2

<sup>46</sup> Bosse, "Mortgaging the Future", 3-4.

of issuance. The Civic Foundation finds that Illinois has dramatically increased its reliance on short-term debt since the market downturn of 2002 in order to cover current spending.<sup>47</sup>



Source: Institute for Illinois' Fiscal Sustainability at the Civic Federation, Debt is not a Remedy for State Budget Woes, March 2010, <http://civicfed.org/iifs/blog/debt-not-remedy-state-budget-woes>.

**d. Government Accounting**

States may seek to achieve budgetary balance without resorting to programmatic cuts or tax increases by altering the time horizon of payment. This includes accounting techniques that recognize liabilities at a later date: pushing forward payroll dates, delaying tax refunds, and deferring contributions to pension systems. In addition to avoiding payment in the present, government and actuarial accounting standards have contributed to an incomplete picture of states' outstanding obligations.

<sup>47</sup> Debt is not a Remedy for State Budget Woes, Institute for Illinois' Fiscal Sustainability at the Civic Federation, March 2010. <http://civicfed.org/iifs/blog/debt-not-remedy-state-budget-woes>; and Illinois Fiscal Rehabilitation Plan, Institute for Illinois' Fiscal Sustainability at the Civic Federation, p.48.

## **Pushing Payroll Dates Forward**

To close its two-year deficit of \$41.6 billion, California lawmakers approved ABX4 12. The bill permitted the state to move the payroll date for state employees forward by one day, from June 30th to July 1st, effectively pushing a month of payroll into the next fiscal year. The action reduced California's budget deficit by \$930 million.

This same technique was used to balance Colorado's budget in FY 2003. To close an \$850 million shortfall, SB 03-197 shifted \$134 million in payroll from June 30th to July 1, effectively adding a 13<sup>th</sup> month of payroll to the FY 2004 budget.<sup>48</sup> This measure was not a one-time tactic. It has been employed every year since, most recently to close Colorado's FY 2009 budget gap of \$604 million. Payroll for June 2010 was pushed to July 1st, and recorded for the FY 2011 budget.<sup>49</sup> This exemplifies the tendency for an accounting gimmick to become codified and integrated into established budgetary practice.

Payroll shifts are relatively easy to undertake. Employees do not notice the difference. The effect on state budgets however is to "kick the can forward", compounding the cost of payrolls in future budgets.

## **Delaying Tax Refunds and IOUs**

Another timing game used to balance budgets is to delay tax refunds. To balance their FY 2010 budgets, several states planned to postpone income tax refunds by a few weeks to a few months.<sup>50</sup> California delayed tax refunds in FY 2009 and issued IOUs to vendors.

In addition to delaying tax refunds, in some cases, states may manipulate the terms of awarding tax rebates in order to free up money in the state budget. New Jersey has regularly employed this tactic, changing the eligibility and award amounts governing its property tax relief program to balance the budget.

In 2007, property tax rebates were awarded to all homeowners earning less than \$150,000, an income threshold which had been lowered from \$250,000 in 2006.<sup>51</sup> In 2008, Governor Jon Corzine cancelled

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<sup>48</sup> <http://www.colorado.gov/dpa/dfp/sco/Alerts/125-149/148.pdf>

<sup>49</sup> [http://www.colorado.gov/dpa/dfp/sco/FiscalProcedures/Cur/Chapter\\_I.pdf](http://www.colorado.gov/dpa/dfp/sco/FiscalProcedures/Cur/Chapter_I.pdf). June payroll is reported as an expense for financial reporting purposes in FY 09-10, but it is recorded against the budget in FY 10-11

<sup>50</sup> "Half a Dozen States Delay Tax Refunds," by Michael Cooper, *The New York Times*, June 1, 2010 (<http://www.nytimes.com/2010/06/02/us/02refund.html>)



property-tax rebate checks for all homeowners excepting the elderly and disabled, allowing him to direct \$900 million to balancing the FY 2009 budget. For the FY 2010 budget, the governor restored the property tax rebate program for all eligible homeowners, with checks mailed in October 2009.<sup>52</sup>

This budget balancing tactic has been employed by the executive office for many years. It is an outgrowth of changes made to the state's tax system in 1976, when the New Jersey Supreme Court ordered the legislature to find revenues to supplement the property tax in order to level the spending disparity between wealthy and poor school districts. The state created an income tax and constitutionally dedicated the revenues to a Property Tax Relief Fund (PTRF). The majority of the fund is distributed to school districts as aid, and smaller portions are awarded to municipal governmental aid and to individual homeowners as a property tax rebate. Since the Homestead Rebate program began in 1977,<sup>53</sup> the amount awarded and eligibility for individual homeowner rebates has varied. In some years, the Homestead Rebate was augmented with additional property tax relief programs, and in other years, the Homestead Rebate has been suspended due to declining revenues.

### **Deferring Pension Payments**

Most state and local governments operate defined benefit pension plans for their employees. A defined benefit plan promises the employee a guaranteed benefit upon retirement based on a measure of their final salary, years of service and other factors. To ensure there are sufficient funds to pay these promises, governments must make an annual contribution to the pension fund, known as the Annual Required Contribution (ARC).<sup>54</sup> Many states have contributed less than what is recommended by state actuaries to pension plans and instead applied those revenues to other areas.

The result of pension payment deferrals has been to push the bill forward and to increase the size of the contribution recommended to ensure a well-funded pension system. Colorado paid the full contribution

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<sup>51</sup> <http://wcbstv.com/politics/nj.property.tax.2.1015038.html>

<sup>52</sup> <http://newjersey.realestaterama.com/2009/08/03/governor-corzine-announces-homestead-rebate-checks-averaging-1300-mailed-to-senior-and-disabled-homeowners-and-tenants-ID0280.html>

<sup>53</sup> The Homestead rebate program was instituted to counter the unpopularity of the income tax. A total of \$200 million in rebate checks were mailed to New Jersey homeowners on March 15, 1977. See, "Gov. Byrne personally presents 1<sup>st</sup> homestead rebate check to Mr. and Mrs. John Chambers of Absecon," by Walter H. Waggoner, *The New York Times*, March 16, 1977.

<sup>54</sup> Based on pension accounting standards, the size of pension liabilities has been vastly underestimated. This means that the ARC has also been underestimated. Even if a state makes its full contribution, many state pension systems suffer from a level of underfunding that makes it unlikely they will be able to meet their full obligations to employees. See, "The Crisis in Public Sector Pension Plans: A Blueprint for Reform in New Jersey," by Eileen Norcross and Andrew Biggs, Mercatus Center Working Paper No. 10-31, June 2010.

to the pension system until 2002. But a combination of benefit enhancements made in 1999 and a decline in the growth of pension assets lead to a sudden increase in the amount the state needed to contribute. Between 2002 and 2006, Colorado contributed between 50 and 70 percent of the ARC, amounting to \$2.4 billion in skipped payments which were then folded into future payments. In 2004, the ARC represented 11 percent of state payroll. In 2008 it rose to nearly 18 percent of payroll.<sup>55</sup>

In FY 2008, state pension systems required \$64.4 billion to meet obligations, but only \$54.4 billion was contributed.<sup>56</sup> States contributing less than 70 percent of the ARC over a five year period include Colorado (58 percent), Illinois (60 percent), Kansas (66 percent), Washington (37 percent), Pennsylvania (52 percent) and New Jersey (33 percent).<sup>57</sup>

### **Pension Obligation Bonds**

To make up for pension deferrals, some states have issued bonds to fill the gap. In January 2010, Illinois issued \$3.5 billion in pension obligation bonds to make this year's payment to the pension system. Illinois's unfunded liability is \$77.8 billion (approximately \$6,301 per capita). Lawrence Msall of the Civic Federation notes, "Pension underfunding has grown dramatically over the last decade by almost 300 to 400 percent over the last decade, because the state has used gimmicks . . . it has ignored pension obligations, it has borrowed or had partial pension holidays, and it has just flat out not made the adequate contribution to the pensions."<sup>58</sup>

The practice of issuing pension obligation bonds (POBs) increased in the 1990s and has been concentrated in about 10 states.<sup>59</sup> Illinois is the leader in the practice. In 2003, POBs spiked due to Illinois' issuance of a \$10 billion pension bond.<sup>60</sup> Between 1992 and 2009, states have issued 284 POBs totaling \$43 billion.<sup>61</sup>

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<sup>55</sup> "The Trillion Dollar Gap: Underfunded state retirement systems and the roads to reform," The Pew Center on the States, February 2010, 20. [http://downloads.pewcenteronthestates.org/The\\_Trillion\\_Dollar\\_Gap\\_final.pdf](http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf)

<sup>56</sup> Ibid., "The Trillion Dollar Gap," The Pew Center on the States, 27.

<sup>57</sup> Ibid., "The Trillion Dollar Gap," The Pew Center on the States, 56.

<sup>58</sup> "Shortfall Threatens Illinois Pension System," by David Schaper, *NPR*, March 24, 2010.

<sup>59</sup> The states that have relied extensively on POBs include California (\$14.7 billion), Illinois (\$14.3 billion), Oregon (\$4 billion), New Jersey (\$3.5 billion), Connecticut (\$3 billion), Pennsylvania (\$2.9 billion), Wisconsin, Michigan and Texas. See, Alicia H. Munnell, Thad Calabrese, Ashby Monk and Jean-Pierre Aubry, "Pension Obligation Bonds: Financial Crisis Exposes Risks," Center for State and Local Government Excellence, January 2010.

<sup>60</sup> Alicia H. Munnell, et al. "Pension Obligation Bonds": Financial Crisis Exposes Risks," Center for State and Local Government Excellence, p. 3. Oakland, California issued the first pension obligation bond in 1985, at the time a tax-exempt instrument. The Tax Reform Act of 1986 eliminated the tax exemption to discourage state from using

States have used bonds to make payments to their pension systems in times of fiscal stress and revenue decline, to catch up on deferred payments, and to exploit the actuarial arbitrage opportunity.<sup>62</sup> That is, states are betting that pension investments will grow faster than the cost of borrowing the money.

For example, Connecticut issued a bond of \$2 billion in 2008 with a borrowing cost of 5.88 percent, about 3 percentage points less than the assumed 8.5 percent return on pension asset investments.<sup>63</sup> When the bond was issued, Connecticut stood to pay less in debt service than the state projected it would receive from its pension assets investments.

However, when market returns are less than the cost of financing the debt, the POB becomes a liability, changing the nature of the government's debt from a pension liability to a debt that requires an annual payment to bondholders.<sup>64</sup> As a result of the financial crash of 2008, most POBs issued since 1992 are in the red, making them a revenue drain in state budgets.<sup>65</sup> Interestingly, there is evidence that POBs have tended to be issued by governments in financial stress with substantial outstanding debt.<sup>66</sup>

### 3) Intergovernmental Games

Unlike the federal government, state and local governments face a hard budget constraint. They cannot issue currency, they do not have access to unlimited credit and, most states face a balanced budget requirement. If states tax excessively, a loss of population may result. And at least historically, states cannot expect to be bailed out by the federal government.<sup>67</sup>

The hard budget constraint facing state and local government has been weakened by the dramatic increase in federal grants-in-aid since the 1960s. By providing states and local governments with revenues from the national level of government, states budget under the expectation of federal support which may cause them to budget less prudently or act under the expectation of a bailout.

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"arbitrage bonds". In spite of this, during the boom market of the 1990s, some governments and bankers saw a "potential arbitrage opportunity for taxable POBs" leading to an increase in their issuance.

<sup>61</sup> Allan Beckman, "Pension Obligation Bonds: Are States and Localities Behaving Themselves or Do the Feds Need to Get Involved?" Spring 2010, (<http://www.sog.unc.edu/uncmpa/students/documents/AllanBeckmann.pdf>)

<sup>62</sup> Ibid, Munnell, Calabrese, Monk and Aubry, "Pension Obligation Bonds," 4

<sup>63</sup> Ibid, Munnell, Calabrese, Monk and Aubry, "Pension Obligation Bonds," 3

<sup>64</sup> Ibid, Munnell, Calabrese, Monk and Aubry, "Pension Obligation Bonds," 5

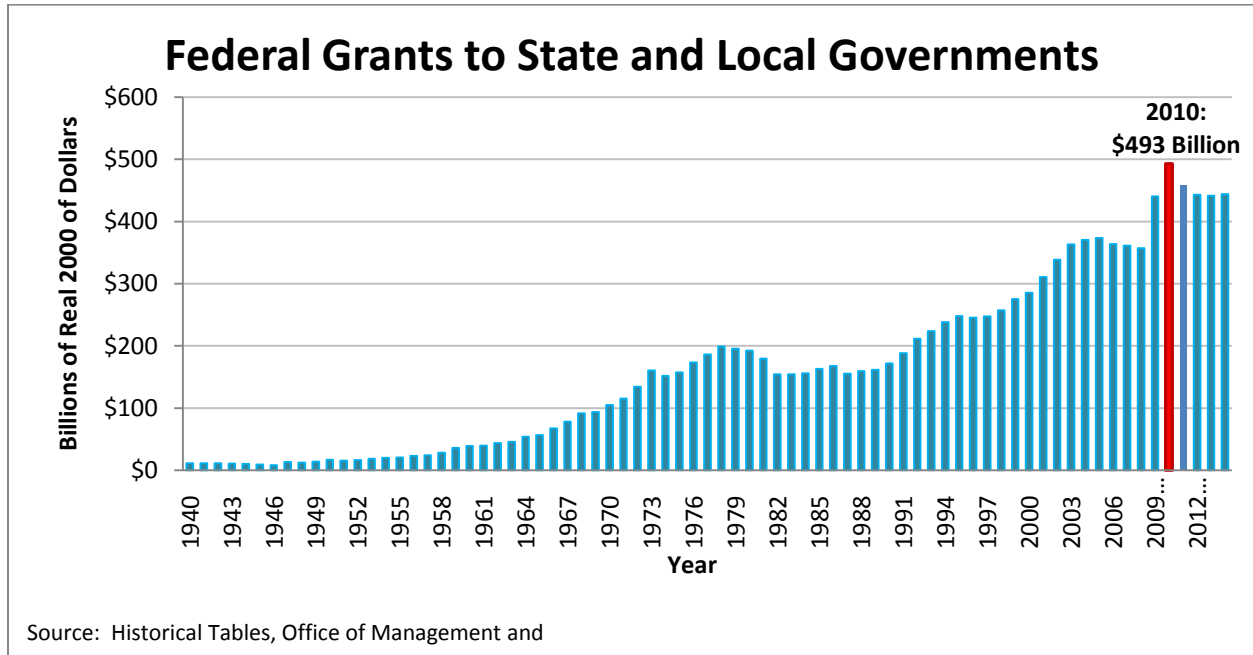
<sup>65</sup> Ibid, Munnell, Calabrese, Monk and Aubry, "Pension Obligation Bonds," 4

<sup>66</sup> Ibid, Munnell, Calabrese, Monk and Aubry, "Pension Obligation Bonds," 6-7

<sup>67</sup> Ronald McKinnon and Thomas Nechyba, "Competition in federal systems: the role of political and financial constraints," in John Ferejohn and Barry R. Weingast, eds., *The New Federalism: Can the States be Trusted?* (Hoover Institutional Press, Stanford, CA) 3-61.

Intergovernmental grants are intended to provide states with access to federal funds to supplement or (at least in theory) replace state revenue. However, intergovernmental grants change the budgeting incentives of state governments causing them to spend more than they would absent the grant. Intergovernmental grants also provide an opportunity for gamesmanship or outright fraud.<sup>68</sup>

Since the 1980s, the number of federal grants to state and local governments has grown by 87.5 percent.<sup>69</sup>



In 1950, federal grants constituted 10.4 percent of state and local expenditures.<sup>70</sup> In FY 2010, federal grants represented one-third of state budgets. Federal grants to state and local governments equaled

<sup>68</sup> A very well-documented example of intergovernmental grant fraud is state government manipulation of Medicaid matching formulas to increase the amount of money the federal government awards to the state in order to operate the program. See, Government Accountability Office, "States use Illusory Approaches to Shift Program Costs to Federal Government, GAO/HEHS-94-133, August 1992, and GAO, "Intergovernmental Transfers Have Facilitated State Financing Schemes," GAO-04-574T, March 18, 2004.

<sup>69</sup> Veronique de Rugy and Stephanie Haeffele-Balch, "The Death of Fiscal Federalism," Mercatus On Policy, No. 75, May 2010.

<sup>70</sup> Charles H. Levine and Paul L. Posner, "The Centralizing Effects of Austerity on the Intergovernmental System," Political Science Quarterly, Volume 96, No. 1 Spring 1981, p. 69.

\$439 billion in FY 2010, an increase of 73 percent since FY 2000,<sup>71</sup> or 18 percent of federal spending in 2009.

In addition to altering the priorities of state and local governments,<sup>72</sup> federal grants to the states stimulate spending at all three levels of government, by “entice[ing] state and local government participation [in federal programs] and increase[ing] their expenditures.” This is true of lump-sum grants<sup>73</sup> as well as matching grants, where costs are shared between the state and federal governments, such as Medicaid.<sup>74</sup>

The intermingling of federal, state, and local revenues adds complexity to the financing of public spending, making it harder for taxpayers to evaluate the cost, promoting fiscal illusion. As noted, federal grants may also stimulate the issuance of state or local debt to help finance projects undertaken with federal dollars.

In addition to awarding grants to the states to operate a wide variety of programs, the federal government has shown that it is willing to explicitly bail states out of fiscal distress twice in the last decade. As noted, bailouts soften the hard budget constraint facing state and local governments and lead to moral hazard, enabling states to avoid structural budgetary reform while increasing spending.

There is evidence that states have failed to undertake structural budgetary reforms or cut spending on the expectation of future federal subsidies. States took more drastic action to close budget deficits during the recession of 1990–1991 than they did during the 2002–2003 recession.<sup>75</sup> In FY 1991–1992, California closed 82 percent of its \$14.3 billion shortfall largely through tax increase and spending cuts. The remainder of the gap, \$2.5 billion, was covered with trust fund sweeps, cost shifts and reductions in reserves.<sup>76</sup> By contrast, in FY 2002–2003, Governor Gray Davis closed half of California’s \$23.6 billion

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<sup>71</sup> Veronique de Rugy and Stefanie Haeffele-Balch, “The Death of Fiscal Federalism” *Mercatus On Policy* No. 75, May 2010

<sup>72</sup> Levine and Posner, “The Centralizing Effects of Austerity on the Intergovernmental System,” p. 68.

<sup>73</sup> See, James R. Hines and Richard H. Thaler, “Anomalies: The Flypaper Effect” *Journal of Economic Perspectives*, Vol.9 No. 4 Fall 1995 pp. 217-226.

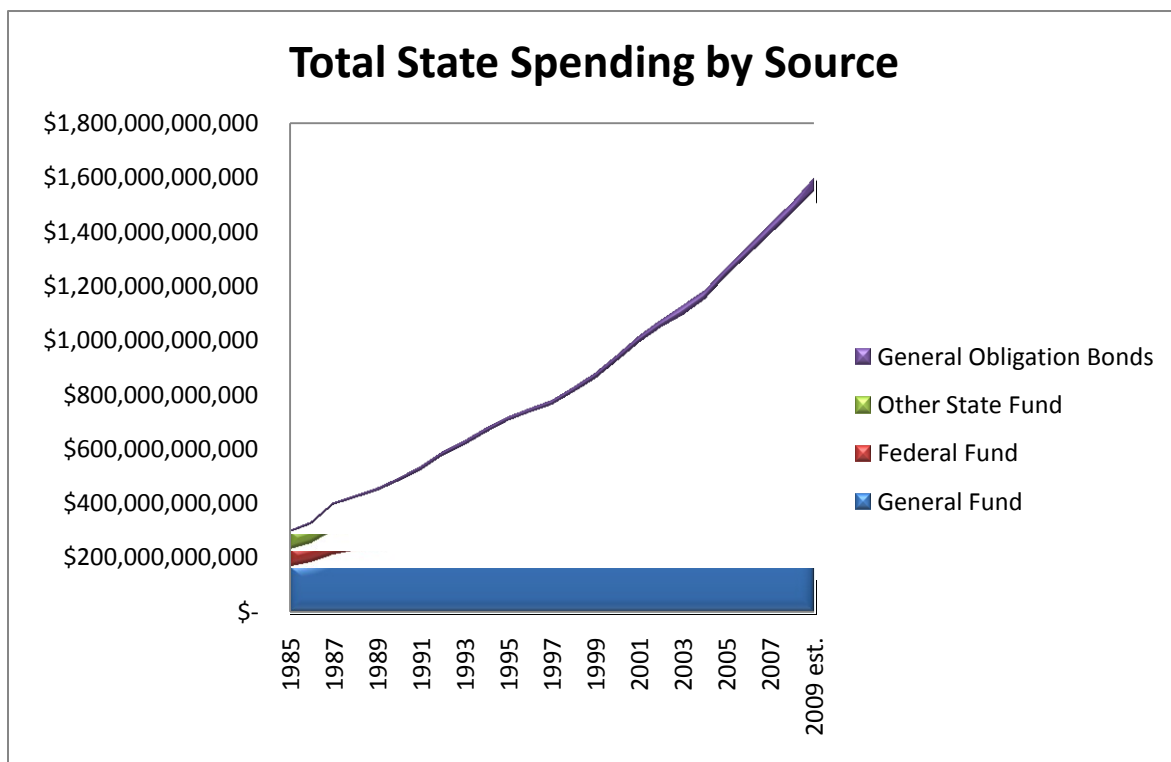
<sup>74</sup> Medicaid is the fastest growing component of state budgets, growing from 12 percent to 21 percent of total state spending between 1990 and 2007, constituting one of the “major elements of federal fiscal support the states.”<sup>74</sup> For every Medicaid dollar granted by the federal governments, depending on the matching rate, states contribute between 0.50 cents and 0.24 cents towards the program.

<sup>75</sup> Steven M. Sheffrin, “State Budget Deficit Dynamics and the California Debacle” *The Journal of Economic Perspectives*, Vol. 18, No. 2 (Spring, 2004) 220.

<sup>76</sup> *Ibid*, Steven M. Sheffrin, “State Budget Deficit Dynamics and the California Debacle”

deficit through borrowing, fund shifts, loans, payment deferrals, and assumed increases in federal funding, while only \$7.5 billion of the deficit was addressed through spending cuts.<sup>77</sup>

In 2003, the Bush administration approved \$20 billion in a state fiscal relief fund to shore up state budget shortfalls that occurred after the market downturn of 2002–2003. Between 2003 and 2008 states increased total spending by 33 percent. During this period states also continued to defer payments to pension systems and increase debt loads. In particular, revenue debt increased by 20 percent between 2003 and 2007. Accounting tactics such as deferring payrolls were in some cases codified into legislation.



The financial crisis of 2008 and the attendant fallout in revenues leaves states with sizeable budget gaps. In October, 2008, Governor Corzine of New Jersey, and Governor Paterson of New York each testified before Congress on the need for federal help to close state budget shortfalls and meet increased demand for Medicaid.<sup>78</sup> Trenton, New Jersey Mayor Douglas H. Palmer made a case for increased

<sup>77</sup> Ibid, 220

<sup>78</sup> See for example, “Statement of the Honorable David A. Paterson, Governor of the State of New York, Testimony before Full Committee of House Committee on Ways and Means, October 29, 2008”

infrastructure spending to stimulate the economy. In February 2009, Congress authorized \$499 billion in grants be used to close budget gaps, cover increased Medicaid spending, as well as spark economic recovery by spending on infrastructure projects. A further \$288 billion was authorized as targeted tax credits.

The spending portion of the American Recovery and Reinvestment Act (ARRA) of 2008 is an infusion to the existing federal grant-in-aid apparatus financed with growing federal debt. The recent growth in federal funds in state budgets is so large that it resulted in greater total state spending in FY 2009, even as general fund and other state spending declined by 3.2 percent.<sup>79</sup> State revenues are not projected to return to their pre-recession levels until 2012. As federal stimulus dollars will have been largely absorbed by state budgets by the close of FY 2011, states will face even larger budget gaps to fill—the result of an increase in spending due to the stimulus, growing Medicaid payments, increasing pension liabilities, and indebtedness.

These recent federal bailouts of state finances are in part a repercussion of the growth of federal spending in state budgets. States have budgeted under altered expectations and weakened fiscal prudence. Although states were told that the increase for Medicaid funding provided in ARRA was a one-time infusion, 28 states built their FY 2011 budget around the expectation that Congress would provide more funding for Medicaid, leading governors in these states to begin lobbying Congress for increased Medicaid funding for the coming year.<sup>80</sup>

## **Recommendations**

The goal of a budget is to present a full and accurate accounting of the cost of public policies. States have employed a range of tactics to avoid presenting that picture over a period of decades. To capture these choices, the term fiscal evasion is defined as a means employed by governments to avoid presenting the full cost of spending, thereby weakening fiscal prudence. This includes the evasion of budgeting rules and debt limits, or the weak design and enforcement of these limits, accounting tactics, and the use of financing methods that promote fiscal illusion such as debt and intergovernmental aid.

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(<http://waysandmeans.house.gov/media/pdf/110/paterson.pdf>). In addition, California Governor Arnold Schwarzenegger wrote a letter to the Treasury Secretary Hank Paulson requesting \$7 billion in bailout funds for the state's budget shortfall. See, State of California, Office of the Governor, Press Release, October 21, 2008 "Governor Schwarzenegger Sends Letter to Congressional Leadership Supporting a Second Economic Stimulus Package," <http://gov.ca.gov/press-release/10859/>

<sup>79</sup> NASBO FY 2008 State Expenditure Report

<sup>80</sup> "Governors ramp up lobbying for federal Medicaid dollars," by Jake Grovum, July 1, 2010, Stateline.org (<http://www.stateline.org/live/details/story?contentId=495458>)

This paper is a first attempt at developing a framework for states to identify budgetary and fiscal choices that have contributed to an incomplete accounting, lessening the ability of states to respond to revenue shocks. This paper presents a brief survey of some of the budgetary choices of legislatures that fit the definition of fiscal evasion; these include how states have applied balanced budget rules, defined deficits, avoided debt restrictions, employed evasive accounting maneuvers, and used intergovernmental aid. There are other practices that are certain to meet the criteria.

There will always be an incentive present in public budgeting to overemphasize the benefits, and de-emphasize the costs of spending proposals. But there are things states can do to minimize the practices discussed in this paper.

- 1) **Defining the Deficit** – Deficits should be measured as the difference between projected revenue and the previous year’s spending plus inflation and population growth. Currently, states offer an inflated deficit figure based on what the state would like to spend. When beginning with an artificially inflated deficit figure, any reductions to this figure are inaccurately presented as “cuts.”
- 2) **Accounting for OBEs** – Off-Budget Enterprises have proliferated over the past forty years, growing to over 37,000 such entities in the United States. OBEs should be considered part of the fiscal responsibilities of state and local governments, and as such they should be subject to the same financial reporting requirements of state governments.
- 3) **Restriction on Debt** – States should require voter approval for debt issued by special authorities and other Off-Budget Enterprises and include that debt under current debt limits.
- 4) **Close loopholes and eliminate codified accounting tricks** – Pushing forward payroll dates, issuing IOUs, pension deferrals, all constitute accounting manipulations that hide the full cost of current spending. Such practices can be minimized through tighter accounting standards.
- 5) **Roll Back Intergovernmental Aid** – The result of the long-running transfer of grants from the federal to the state governments has been to alter the budgetary choices of state governments, while stimulating greater spending, debt finance, and weakening fiscal prudence. While there is little incentive for one state to turn down a federal grant if states are to regain control of their finances and reduce their growing fiscal instability, the intergovernmental aid apparatus must be rolled back. Reform of this apparatus must take place in conjunction with Congress.

## **Conclusion**



Assessing budget gimmickry requires a framework to identify practices that either deliberately or inadvertently obscure the cost of policy choices to both policy makers and voters. In this assessment, the term “budget gimmickry” reveals it is insufficient to describe all of the factors that contribute to a clouded fiscal picture.

Fiscal evasion is instead used to capture both the practices that depart from either an established rule or problems inherent in the rules themselves, in order to systematically identify practices that create a clouded budgetary picture. These practices may encourage fiscal illusion by relying on debt and intergovernmental aid to finance increased spending, or they may employ accounting gimmickry and inaccurate definitions in order to present a particular budgetary picture.

In decrying gimmickry, the implication on the part of budget watchdogs is that governments are budgeting in a way that departs from a norm, a rule, or expectations. But interestingly, many of the tactics labeled gimmicks do not necessarily violate an established rule but flow from the established framework, a terrain that includes budget rules and the relationship among governments in a federalist system. The manipulation of a tax rebate program qualifies as a budgetary sleight-of-hand, yet, it is also a fiscal repercussion of a revenue-replacement scheme embedded in a state constitution, promoted as policy. Issuing bonds to pay for current expenses can be classified as a one-shot revenue source, but the practice is written into state rules, and more interestingly, has been used repeatedly to cover budget shortfalls. The tactics used by states to present a balanced budget by concealing deficits prompts the need for more research into how states have traded fiscal prudence for quick fixes over a period of decades, by reliance on accounting maneuvers, fiscal illusion, and financial arbitrage.