March 15, 2012

Director of Research and Technical Activities, Project 13-3
Governmental Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

By Email

Dear Mr. Bean,

Thank you for the opportunity to comment on the Preliminary Views on Economic Condition Reporting: Financial Projections.

Our comments are attached.

Sincerely,

Elizabeth C. McNichol,
Senior Fellow,
State Fiscal Project, CBPP
Comments on the Preliminary Views of the Governmental Accounting Standards Board on major issues relating to Economic Condition Reporting: Financial Projections.

Overview

The Center on Budget and Policy Priorities supports the requirements of GASB’s Preliminary View dated November 29, 2011 entitled Economic Condition Reporting: Financial Projections. Two main components of this requirement -- a current services spending projection and a revenue projection -- particularly will improve the quality of financial information available to policymakers during budget and tax policy debates.

As we discuss in a recent paper, current service spending projections provide the necessary data, when combined with a revenue projection, to understand the ongoing structural balance of the budget. Too often, states and localities adopt budgets that provide only temporary balance, achieved with one-time maneuvers that may mask decisions that will be costly in the out-years. Multi-year projections are needed to shed light on these practices. Whether a state or locality’s revenues will remain adequate to fund existing programs over time is a critical indicator of the fiscal condition of states and localities. The reporting requirements included in this preliminary view would provide the information analysts need to determine if this structural budget balance exists.

The Center’s responses to the questions included in this Preliminary View follow.

1. The Board’s preliminary view is that there are five components of information that are necessary to assist users in assessing a governmental entity’s fiscal sustainability (Chapter 3, paragraph 2). Component 1—Projections of the total cash inflows and major individual cash inflows, in dollars and as a percentage of total cash inflows, with explanations of the known causes of fluctuations in cash inflows (Chapter 3, paragraphs 4–9)

Component 2—Projections of the total cash outflows and major individual cash outflows, in dollars and as a percentage of total cash outflows, with explanations of the known causes of fluctuations in cash outflows (Chapter 3, paragraphs 10–14)

Component 3—Projections of the total financial obligations and major individual financial obligations, including bonds, pensions, other postemployment benefits, and long-term contracts, with explanations of the known causes of fluctuations in financial obligations (Chapter 3, paragraphs 15–20)

Component 4—Projections of annual debt service payments (principal and interest) (Chapter 3, paragraphs 21–23)

Component 5—Narrative discussion of the major intergovernmental service interdependencies that exist and the nature of those service interdependencies (Chapter 3, paragraphs 24–26).

Do you agree with this view? Why or why not?

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Fiscal sustainability depends on both the balance between revenues and spending each budget year and how easy or difficult it will be for the government to sustain that balance. Taken together, components 1 and 2 indicate whether a state or locality’s revenues will be an adequate source of funding for the services the government has chosen to provide into the future.

When states and localities face budget shortfalls, part of the problem is cyclical – in other words, related to the economic cycle – and part of the problem is structural – that is, related to the mix of revenues and spending adopted by the government. Cyclical shortfalls exist because state revenues decline when the economy experiences a downturn, but the need for public services does not. Because most states are required to balance their budgets even during recessions, the decline in revenues often leads to cuts in public services.

While cyclical deficits have taken front stage in recent years, analysts long have recognized that many or most states and localities also face a structural deficit – a chronic inability of state revenues to grow apace with economic growth and hence keep up with the cost of government. When a state has a structural deficit, its normal growth of revenues is insufficient to finance the normal growth of expenditures year after year. As a result, the state faces gaps between estimated revenues and expenditures even in normal economic times. The existence of sizable structural gaps is a key sign of fiscal instability.

No research has definitively determined how many states and localities have structural deficits, but three separate 50-state studies found that most states do have this problem to some degree. Though these studies differed in their assumptions, techniques, and results, each of the three found that more than two-thirds of states face structural deficits. But these studies were one-time efforts, based on limited data, and appear to have had little impact on state policy decisions. Requiring states and localities to prepare careful projections of revenues and spending would reveal these kinds of structural gaps where they exist in much greater detail, on an ongoing basis.

For these reasons, we strongly agree that the projections required by Components 1 and 2 are critical for determining the fiscal condition of states and localities. In addition, the narrative on interdependencies required by Component 5 is very relevant to fiscal sustainability.

Component 2 should be stronger to include projections of future service obligations:
In paragraph 14 of Chapter 3, the P.V. states that reporting entities will not be required to develop

2 The term normal growth of expenditures generally refers to the amount it would cost the state to continue providing the existing level of programs and services. (This is often called a continuation budget or a current services budget.) Even if no programs or services are improved, costs generally rise from year to year because inflation pushes up the costs of purchased goods and services, because states must provide their employees with reasonable increases in wages and benefits in order compete with the private sector, and because the populations that require services may be growing. In addition to normal growth in spending, states sometimes face increased costs over which they have little control, such as natural disasters and new federal mandates. The term normal growth of revenues means the revenue level that would occur in the absence of any changes in tax rates or in what is taxable. For taxes such as income taxes and sales taxes, this means the normal change in such revenues that occurs as a result of economic growth. For other taxes and revenue sources, such as cigarette taxes or lottery revenues, it may reflect changes in population or per-capita consumption.

3 See for example studies by Hal Hovey, a state policy expert consulting with the National Education Association; Don Boyd of the Rockefeller Institute of SUNY, Albany; and economists at Boston University and the Department of Commerce. NEED FULL CITES
information related to the need and demand for public services when making the required projections. Leaving out this information could result in an entirely misleading picture of state spending obligations, and hence could render the entire exercise much less meaningful, quite unnecessarily. For example, it might preclude a state or locality from taking into account expected changes in the caseloads of programs – even when those changes result from routine and predictable increases or decreases in the number of people eligible for Medicaid or the number of school-age children. Information on projected changes in the caseloads of major programs – at least those that are already regularly prepared – should be used as part of the estimation of future cashflows.

We are not convinced that Components 3 and 4 are essential. They do represent a substantial new reporting burden on governmental entities. In contrast with the information in Components 1 and 2, which represents a very important new contribution to a clear portrait of state financial health, the information required in Components 3 and 4 relate to parts of the budget – pensions and retiree health plans in particular – for which there are already calculations being made of future liabilities and future assets. Moreover, for the purposes of determining the future financial condition of a state or local budget, the most important information needed about pensions is the amount that the government must spend on its pension and OPEB contributions. If this is large, it will already be included in the cashflows that must be reported under Components 1 and 2. Given the amount of attention currently being paid through GASB processes to the accounting of pensions and retiree health benefits, a two-step process would work better with the next step being revisiting the projections required of pension plans and entities responsible for funding OPEB.

The same concern about the necessity of the information required about debt service applies. But these projections already generally exist so it would be easier for states and localities to include this information.

2. The Board’s preliminary view is that financial projections should be (a) based on current policy, (b) informed by historical information, and (c) adjusted for known events and conditions that affect the projection periods. Current policy includes policy changes that have been formally adopted by the end of the reporting period but that will not be effective until future periods (Chapter 4, paragraphs 2–7). Do you agree with this view? Why or why not?

We agree that in order to get an accurate picture of the fiscal outlook for a state or locality, it is very important that the impact of policy changes that have been adopted but that are not yet in effect be included in the projections as the P. V. states. The projections would be unrealistic if they did not include the effect of changes that have been adopted.

To the extent possible, it would also be important for state and localities to note major relevant policy changes that cannot be included in the projections because they occur after the end of the fiscal year but are known before the CAFR is finalized.

3. The Board’s preliminary view is that inflows and outflows should be projected on a cash basis of accounting, and financial obligations should be projected on an accrual basis of accounting (Chapter 4, paragraphs 8–12). Do you agree with this view? Why or why not?
We agree that inflows and outflows should be projected using cash accounting matches as this is how states and localities typically prepare their budgets.

For financial obligations, the accrual basis makes sense. However, as stated earlier, we feel that it is not necessary to require state and localities to project financial obligations beyond existing requirements.

4. The Board’s preliminary view is that the identification and development of assumptions for making financial projections should be guided by a principles-based approach. Such an approach would set forth principles that require assumptions to be based on relevant historical information, as well as events and conditions that have occurred and affect the projection periods. Furthermore, these assumptions should be (a) consistent with each other (where appropriate) and with the information used as the basis for the assumptions and (b) comprehensive by considering significant trends, events, and conditions (Chapter 4, paragraphs 13–16). Do you agree with this view? Why or why not?

These criteria make sense, on the condition that (as noted in Chapter 4, paragraph 17) the assumptions are clearly described so that it is possible to determine how they affect the projections. This is an essential element of accountability and transparency in making these projections, and will make it possible to compare one state or locality to another.

5. The Board’s preliminary view is that annual financial projections should be made for a minimum of five individual years beyond the reporting period for the purpose of external reporting (Chapter 4, paragraphs 19–23). Do you agree with this view? Why or why not?

A minimum of five years is a reasonable length for these projections. This would allow an estimation of the impact of policy changes that may be phased in over subsequent budget cycles.

6. The Board’s preliminary view is that all of the components of fiscal sustainability information are essential for placing the basic financial statements and notes to the basic financial statements in an operational or economic context and therefore should be required and communicated as required supplementary information (Chapter 5, paragraphs 7–12). Do you agree with this view? Why or why not?

For the reasons we discuss above, we agree that the information required in Components 1, 2, and 5 are essential to determining the fiscal condition of a state or locality. We disagree concerning Components 3 and 4. We think that the information in Components 3 and 4 is not essential because it would only be relevant if the costs are significant, in which case they would be included in Component 2.

7. The Board’s preliminary view is that all governmental entities should be required to report financial projections and related narrative discussions (Chapter 5, paragraphs 13 and 14). Do you agree with this view? Why or why not?

We agree that all governmental entities should be covered by these requirements.
8. Do you believe that a phase-in period for implementing the reporting requirements for financial projections and related narrative discussions would be appropriate (for example, requiring governmental entities over certain dollar thresholds to implement first)? If so, what phase-in criteria would you recommend (Chapter 5, paragraph 14)?

A phase-in period makes sense – perhaps the schedule used for GASB 45 could be used.

Pre-tests or dry runs for governments of various sizes would be good idea, if such tests have not already been done.