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It’s Time for Truth in State and Local Government Finances.

Imagine your business could treat borrowings as revenues, avoid cost recognition by not paying expenses and report less debt than actually owed.

Fortunately, accounting for private-sector enterprises doesn’t enable such activities. But accounting for state and local governments does, and with big consequences.

The Financial Accounting Standards Board (FASB), which governs financial reporting by private-sector enterprises, requires accrual accounting and truthful reporting of liabilities. Under FASB, borrowings aren’t revenues, costs must be accrued whether or not paid, revenues are recognized as earned, and retirement liabilities can’t be understated. But the Governmental Accounting Standards Board (GASB), which governs financial reporting by state and local governments, doesn’t impose accrual accounting and permits aggressive assumptions for valuing retirement obligations. As a result, state and local officials aren’t prevented from reporting balanced budgets, and sometimes even surpluses, that would pass the test of traditional accounting methods.

For example, Chicago used proceeds from the sale of 75 years of parking meter revenues to plug a single year’s budget shortfall; last year California’s budget ignored more than half of the actuarial costs of insurance subsidies provided retired state employees (adding to $85 billion of liabilities already accumulated from non-recognition of previous such costs). And pension costs that today are crowding out state and local services all across the country would’ve been identified more than a decade ago as addressable threats to government budgets but for GASB rules permitting public pension funds to underreport the real size of pension promises.

Today, state and local governments are using GASB’s permissive rules to report unfunded pension liabilities at just one quarter of the $4 trillion the same liabilities are valued by the Federal Reserve’s Financial Accounts of the United States.

Budgets enabled by GASB’s permissiveness can produce painful consequences. For example, despite record tax revenues and a 30 percent income tax increase, the school district serving Sacramento is laying off teachers because money is being diverted to past retirement promises whose true size and underfunded nature had been hidden by GASB’s permissive rules. Under FASB-type rules, those costs would’ve been made visible when incurred, in time to act on them and well before they started crushing classroom budgets.

The key to reforming GASB lies in its chair, who is the only full-time GASB board member. At FASB, all board members serve full time and are required to sever connections with firms or institutions they served before joining FASB’s board. But GASB board members other than the chair are part time and may be employed by other organizations, including state and local governments. As a result, at GASB it has been much easier for the regulated to control their regulator. But that can change if GASB’s next chair is a reformer and independent of state and local governments.

GASB’s chair is selected by the 18 trustees of the not-for-profit Financial Accounting Foundation (FAF) — Charles Noski is the chairman and Diane Rubin is the vice chair. Later this year they will

appoint a new chair for a seven-year term. They have the sole power to install a reform-oriented GASB chair who is independent of state and local governments. Some state and local governments will resist such a voice, but just as private-sector firms are not given a veto over the FASB officials who regulate their accounting, neither should state and local governments.

The federal government has a strong interest in GASB requiring state and local governments to account truthfully for their financial activities because states provide the lion's share of domestic services, including public education, public safety and infrastructure. The next recession will expose those state and local governments that have used GASB's permissive rules to cover up deep financial problems, potentially forcing the federal government to step in to finance core public services.

State and local governments spend more than $3 trillion per year, compensate nearly 20 million public employees, and provide the vast majority of domestic government services to more than 325 million Americans. GASB's rules permit state and local government financial statements to bury facts that eventually produce devastating consequences for critical public services and taxpayers. FAF trustees should select a reform-minded GASB chair who is independent of state and local governments.

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