

Bond Case Briefs

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WSJ: More Detroits Are on the Way.

Even as pension bombs tick, cities and states still borrow far beyond their means.

The most significant step taken after New York City's near-bankruptcy in 1975 was to curb creative-accounting practices. How was that accomplished? Through a state requirement that the city balance its budget in accordance with generally accepted accounting principles. The city has not had a fiscal crisis since.

So it's not surprising that since the city's new mayor, [Bill de Blasio](#), released his first budget last week, there's been intense public debate involving the comptrollers of both the city and the state about whether the deferral of payments contractually due city employees was properly accounted for. Between the scrutiny of the press, civic organizations and public officials, the city's record of 30 years without a fiscal crisis is likely to last.

Sadly, no other local government chose to follow the example of New York City, a choice that has led to chronic shortfalls. Earlier this year, former Federal Reserve Chairman Paul Volcker and I released the "Final Report of the State Budget Crisis Task Force" after nearly three years of study and analysis. The report sought to understand whether the states' current fiscal problems were cyclical—caused by the financial collapse of 2008 and likely to abate with economic recovery—or whether they were structural, the result of long-term revenue and spending imbalances. The report's main finding is that in most states and cities the problems are structural and the crisis is deepening. The crisis has many elements but a few stand out. First, contributions to employee pension funds are often well below the levels needed to ensure the payment of the benefits that are contractually or constitutionally guaranteed, let alone those that past trustees and legislatures added on a discretionary basis. Sometimes the contributions are not made at all for years at a time. Everyone with a role in determining these contribution levels has an incentive to keep them as low as possible. Politicians don't like to raise taxes to meet future obligations, while public unions would rather take the long-term risk of underfunding rather than face immediate layoffs or benefit reductions.

The largest single expenditure in most state budgets is for Medicaid. Unfortunately, health-care costs have been rising faster than either inflation or state and local tax revenues, and most economists believe they will rise even faster in the next few years.

But the most critical piece of the states' fiscal dilemma is that they are borrowing to cover their operating deficits. They do this directly—by issuing debt securities—but also indirectly. Some states, like New York, make contributions to their pension systems in promissory notes rather than cash. States and cities also sell assets and treat the proceeds as operating revenues, in effect selling off the family silver to stay afloat.

In 2009 Arizona sold its capitol buildings for more than \$700 million. In 2008 Chicago leased its parking meters for 75 years for nearly \$1.2 billion. In 1991 New York sold Attica Prison for \$200

million to itself through a bond issuance, providing a temporary revenue boost but costing taxpayers far more in the long run in interest. While state constitutions contain various balanced-budget clauses, they generally don't define revenues or prevent such creative accounting.

The consequences of our state and municipal fiscal crises are plain: We are drastically underinvesting in physical infrastructure—roads, bridges, ports, etc.—the necessary underpinning of future growth. Just as important, we are also underinvesting in human infrastructure, most notably our children's ability to compete. No one is satisfied with the output of our educational system, yet states spent over half a billion dollars less on prekindergarten education last year than they had the year before.

Permitting states and municipalities to continue these practices will result—indeed, has already begun to result—in harmful service cuts and a failure to fund promises made to creditors, public employees and the beneficiaries of essential public services, including elderly people without minimal levels of financial support. What this means is we can expect to see more Detroit's. Last July the Motor City filed the country's largest municipal bankruptcy after racking up \$18 billion in promises it could no longer afford to keep.

Meanwhile, the federal government is facing understandable pressure to rein in spending and reduce deficits. One proposal is to reduce health-care spending by raising the age of Medicare eligibility to 67 from 65. Yet this would greatly increase the spending burden on state and local governments currently obligated to fund health care for some 19 million retirees until they are eligible for Medicare. Worse, we can only guess the scale of such impact since there is currently no mechanism in the federal government that properly measures the effects of federal proposals on the states.

No one seriously argues that when credit markets won't allow more state or local government borrowing, Washington should write checks to get them through their crises. Even if an administration proposed such a Band-Aid, it would be politically impossible for Congress to approve it. Yet if the number of cities and states in extreme distress were to grow significantly, the political pressure to do something would increase inexorably. The ultimate cost would be staggering.

It is time for the federal government to take the steps needed to avoid the social and financial crisis that must be expected if nothing changes. Washington now provides almost 30% of what the states spend annually and already imposes many mandates on states and localities in return for its largess. The federal government could condition its continued financial support on states and local governments adopting budget systems that would require recurring expenses to be matched by current revenues.

The political difficulty involved in such a step will be far less than the pain that will result if states and localities are not forced to move toward a responsible system of accrual budgeting. One thing is clear: Continuing to use cash budgeting practices that allow states and cities to inflate revenues, defer costs and multiply the burdens on future generations is the worst option.

By

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May 15, 2014 6:46 p.m. ET

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