Bond Case Briefs

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The 7 Deadly Sins of Public Finance.

There's no sure-fire way to get fiscal policy right. But there are a few simple ways to get it disastrously wrong.

This is part of the ongoing Finance 101 series that breaks down the basics of public finance for public officials.

The temptation of the quick fiscal fix has seduced just about every lawmaker at one time or another. Scraping pennies together to balance the budget? Perhaps skipping a contribution to the public employee pension plan is the best way to get through the year. Can't afford to pay for building maintenance? Push some of it off into the following year's liabilities. Governments have been using these and other money-shuffling tricks since balanced budgets and municipal financing were invented. But in the aftermath of the Great Recession, short-sighted gimmicks like these became more common as governments looked for any solution to combat dwindling revenues. Revenue is back up now in most places, but some of the fiscal trickery has hardened into common practice.

"If it happens for a year or two in a down economy, that's understandable," says Tom Kozlik, an analyst with the finance firm Janney Montgomery Scott. "In 2009 and 2010, you didn't want that to be the time you raise taxes. But, as an analyst, if I'm looking at a situation where the same things are happening pre- and post-recession, then it's a significant problem."

What follows is Governing's list of the most tempting financial schemes that can severely weaken a government's fiscal future when practiced as a matter of course. Although the consequences aren't necessarily lethal, those that make heavy use of these 7 Sins of Public Finance find that they only succeed in digging deeper financial holes.

1. Balancing the Budget with One-Time Fixes

States and many cities have a legal obligation to balance their budgets each year. But there are all sorts of tricky maneuvers that can place a government in technical compliance with that rule. Shifting payments into the next fiscal year, for example, can instantly take the problem off the current books. But it serves only to make the following year's budgeting that much more difficult. Borrowing money for operating costs, another common tactic, may be even more dangerous. It adds to the public's long-term debt without creating any related future public benefit.

Bad Choice
One of the most perilous quick fixes is the practice of taking costs out of one fund and transferring them to another. New York did that in 1992, when it balanced its general fund budget by taking the state's historic canal system and moving it to the Thruway Authority. The canal system, which includes the Erie Canal, has traditionally been a financial albatross — it costs up to $90 million to run each year but generates only a few million dollars in revenue. The deficiencies are highlighted every time the Thruway raises its tolls, particularly during a stretch in the 2000s when it raised tolls four out of five years to cover the canal system. The problem is that New York never solved the real issue — the canals are simply draining a different fund. "You're creating the illusion that things are

in balance but you haven't actually changed any of the financial facts," says Peter Hutchinson, a state and local government consultant for Accenture. "In the case of the Thruway Authority, the issues with the Erie Canal didn't go away."

Better Choice
DeKalb County, Ga., was downgraded by rating agencies in 2012 after years of transferring money from one fund to bail out another in an effort to meet operating costs. The result was an overall deficit that never seemed to go away. Finally officials in DeKalb took a painful but responsible step. They raised taxes, cut expenses (including a reduction in staff) and added to cash reserves. The county also imposed new controls on fund transfers. By the 2014 fiscal year, DeKalb had stopped cash-flow borrowing and its credit outlook was raised to positive.

2. Ignoring the Long-Term Consequences of a Deal

Few governments have a long-term financial plan and even fewer have multiyear budgets. Many don't even require a fiscal analysis of proposed legislation. That's made it possible for some, facing immediate demands for wage increases, to buy off public employee constituencies by increasing retirement benefits at an unsustainable long-term cost. Other governments have been wooed by the prospect of privatizing assets as a way to get quick cash, a move that some have called the governmental version of an unwise payday loan.

Bad Choice
In 2008, Chicago accepted a one-time fee of a little more than $1 billion in exchange for giving up control of its 36,000 parking meters for 75 years. The public outcry started almost immediately as the new private owners pushed through a substantial increase in parking rates. A report by an inspector general brought in to assess the consequences estimated that the process used to award the deal cost the city $974 million, and that the amount charged to the private purchaser should have been much higher.

Better Choice
Chicago learned a lesson. Five years later, Mayor Rahm Emanuel, elected in 2011, halted a possible deal to privatize Chicago's Midway International Airport. Citing the problems with the city's parking deal, he insisted that an airport privatization arrangement share revenue with the city and demanded a Travelers' Bill of Rights to cap parking costs and food prices. The demands were enough to scare off the potential investors, almost certainly a benefit to the city in the long run.

3. Taking on Too Much

One of the reasons privatizing assets has become alluring to governments is because many of them have been burned by taking on more public investments than they could handle. This frequently involves development projects funded by municipal bonds. If a project's tax revenues don't deliver, governments have to pay the difference to bondholders out of their general fund budgets — a promise that becomes an embarrassing burden for some that can ill afford the actual risk. "It's a question of scale," says Julie Beglin, vice president of Moody's Investors Service local government team. "Is the scale affordable for the government if the project doesn't go well?"

Bad Choice
In 1996, Hamilton County, Ohio, got voters to approve a sales tax increase to help pay for two new Cincinnati sports stadiums by offering them a property tax break. But the stadiums, which cost more than $1 billion, never generated the downtown business that local officials had hoped to see. As the county found the stadium debt financing eating up an increasing share of its budget, it repealed the property tax break, then raised taxes. It sold off a hospital and refinanced the stadium debt. But the

annual stadium costs — $30 million in 2008 — keep rising. In 2014, the county is projected to put as much as $50 million toward its two stadiums.

Better Choice
By contrast, the development of a downtown sports arena in Washington, D.C., in the mid-1990s has been heralded as the starting point of a hugely successful revitalization of the center of that city. The arena was privately developed; the city provided the land and infrastructure in what was then a barren and oft-times dangerous part of town. Now the area is home to retail, restaurants and hotels that churn out millions in annual tax revenue. The city is attempting to apply the same concept today with a major league soccer stadium after local officials refused to take on the main responsibility for developing the project.

4. Misapplying a Temporary Windfall

This is the sin that many governments commit when it seems like the good times will never end. Every economic boom is followed by a bust, but elected officials are often tempted to spend money as if that weren't true, using one-time surpluses in especially good years to cover recurring expenses that they will have to meet in the bad years. When the downturn comes, the money to meet these expenses isn't there. "State and local officials get into this over and over again," says Steve Dahl, a consultant for Deloitte. "They make very generous decisions at the top of a bull market run instead of recognizing where they are in the economic cycle."

Bad Choice
In the early 2000s, California reacted to its booming economy by granting pay raises and increased benefits to public employees, including some benefits that were awarded retroactively. Thanks to that decision and to the stock market crash later in the decade, the state and its localities have seen their entitlement bills multiply. In the first 10 years of this century, the state's pension contribution mushroomed from $611 million to $3.5 billion. Had pensions been left alone, today's bills would not be nearly as high.

Better Choice
Meanwhile, in Southern California's Riverside County, the Eastern Municipal Water District was using its skyrocketing revenues from connection fees during the boom to pay only for one-time expenses. It expanded wastewater treatment plants and water storage facilities, and improved its recycled water program. "So, when everything went bust, their expenses were very affordable as they hadn't incurred debt," notes Suzanne Finnegan, chief credit officer of Build America Mutual. "It's ironic sometimes that when you really need the discipline is when things are going well."

5. Shortchanging Pension Obligations

The most serious threat to some government pension plans has been a chronic unwillingness by lawmakers to contribute what is necessary to keep the plans fully funded. To be sure, many governments skipped or pared down payments into pension plans during the recession. But some places did that for years prior to the downturn and continue to do it today. The longer they delay, the larger the long-term liability becomes.

Bad Choice
Over the last decade, New Jersey's public employee pension system has gone from a fully funded enterprise to a roughly $56 billion unfunded liability. The financial crisis certainly played a part. But the situation in New Jersey is worse than in most other places mainly because the state wasn't making its full pension payments even before the crisis began. In 2011, lawmakers passed a new pension law that legally spared the state a portion of its annual payments into the fund. It also gave

New Jersey seven years before it had to start making its full contributions. “In other words,” says Howard Cure, director of bond credit research at Evercore Wealth Management, “rather than continue to fully fund the pension, they used it as an excuse. Now they’re back to the same hole.” This year, in response to that hole, Gov. Chris Christie retroactively changed the pension funding formula to allow the state to contribute $94 million less in order to help balance the 2014 budget. Now, thanks to the formula change, the state is slated to put a total of $900 million less into the fund by the time it’s required to start making its full payments. The likely outcome is that the unfunded liability will continue to grow.

Better Choice
Lexington, Ky., had a similar problem with habitually shortchanging its pension plan. But in 2012, it put together a pension task force made up of city officials and public employee union representatives, guided by an outside financial consulting firm. The result was a new agreement that guarantees Lexington will increase its annual contribution to the pension fund to $20 million from $11 million. In return, employees agreed to an older retirement age and increased paycheck deductions.

6. Making Unrealistic Projections About Rate of Return

Every budget or financial planning document has to start with some assumptions about the rate of interest that will be earned on an invested portfolio. It’s tempting — too tempting sometimes — to stretch those assumptions beyond what sensible economics can justify. Some pension funds still base their total liabilities owed on an expected annual investment return of more than 8 percent, a figure that affects the formula used in figuring out how much governments should contribute each year. “That means they’re targeting a pension funding level that’s lower than what most people might consider prudent,” says Donald Fuerst, a senior pension fellow at the American Academy of Actuaries. Similarly, a budget that expects too much from a volatile revenue stream like the sales tax can be burned in any given year if the economy hits the skids.

Bad Choice
In 2012, Rockland County, N.Y., faced a $40 million budget deficit and was hit with a credit rating downgrade to one step above junk status. In its downgrade action, Standard & Poor’s cited the county’s “vulnerable” management practices based on overly optimistic budgeting. The following year, the county based one-fifth of its revenue returns on sales tax receipts — and expected a 4 percent increase in those returns when consumer spending growth had been far slower. The financial practices prompted the state to step in, demanding that county officials scale back their estimates and develop a realistic financial plan to escape Rockland’s deficit woes, which had mounted to $125 million by 2014.

Better Choice
Many states that assumed at least an 8 percent return on investment from their pension funds have since reduced their expectations. New York state’s public pension funds, for example, lowered their target return rate to 7.5 percent from 8 percent in 2010 (in addition to other changes in actuarial assumptions concerning career duration, salaries and life expectancy). This had the effect of increasing the unfunded liability (and thus, the state’s required contribution) but it was more in line with the fund’s financial realities. Starting this year, pension funds throughout the country will have to follow new accounting rules that include a lower assumed rate of return on their unfunded liabilities.

7. Ignoring Financial Checks and Balances

Don’t lose track of the money you have. It seems like the most obvious advice in the world. But in government finance and fund accounting, where there are many different ways to count the same revenue, weak financial controls can lead to serious dollar losses. Governments can lose track of how much money they actually owe one of their special funds. Or lax internal monitoring can result in poor financial choices not getting flagged until it's far too late.

Bad Choice
Earlier this year, a legislative audit criticized Idaho Treasurer Ron Crane for acting on investments without the guidance of others. At issue were $31 million worth of mortgage-backed securities that Crane transferred from the Local Government Investment Pool to the state's Idle Pool in order to protect the credit rating of the local pool. (Both pools are vehicles for storing government cash that isn't needed immediately.) Later, Crane took $31 million in cash from the Idle Pool and put it back in the local one. The problem cited by the audit was that while the securities had a face value of $31 million, their market value was only $19 million as the move was made during the depths of the recession. The audit concluded that the treasurer's office overrode internal controls meant to contain financial risks, resulting in inappropriate transfers that cost at least $10 million in "a disproportionate share of investment losses."

Better Choice
A number of organizations have published best practice guides that help governments limit their vulnerability to financial reporting problems. The Government Finance Officers Association recommends that reporting systems incorporate an antifraud program and that financial managers periodically evaluate internal control procedures to ensure they are still working as envisioned. The Association of Local Government Auditors recommends that, at a minimum, governments have an ethics policy, established performance measures and an audit committee. State governments also cite best practices for their local governments to follow. Vermont, for example, has fact sheets available to localities offering advice on financial management of fixed assets, cash receipts and accounts receivable.

BY LIZ FARMER | JUNE 2014