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Grading State Budget Practices at a Turbulent Time.

The Volcker Alliance's latest state budget report cards come as the pandemic has tested public finances and as historic sums of federal aid flow toward states and localities.

It's been a rollercoaster for state budgets over the past year. When the coronavirus outbreak hit the U.S. last March, it led to a round of dire revenue forecasts, in many cases revised upwards as tax revenues turned out better than expected. Still, states faced significant unplanned costs tied to the pandemic response and some, especially those with economies linked tightly to sectors like tourism and oil and gas production, have struggled with serious shortfalls.

Then, the largely mixed picture for state budgets brightened early last month when President Biden signed a massive coronavirus relief bill into law that included about $360 billion in state and local recovery funds, including nearly $200 billion earmarked for states and the District of Columbia. And now, the White House and Democrats in Congress are backing a $2 trillion infrastructure bill that could send even more federal money gushing to the state and local level.

It's in this context that the Volcker Alliance, a good government group, this week released its latest edition of *Truth and Integrity in State Budgeting*, a 162-page report that includes in-depth report cards grading how each state manages its finances. The Alliance has been scrutinizing state budgeting practices with reports like this since 2015 and this year's report, like the one issued last February, just before the U.S. covid outbreak, catalogs many overall improvements.

Some of the strides states made during the years leading up to the pandemic—during the longest economic growth cycle dating back to the 1850s—left them better equipped to deal with the Covid-19 crisis. This is especially true when it comes to budget reserves.

In the decade after the Great Recession, states beefed up their so-called rainy day funds, and some established new policies to guide how they are used. The accounts held a record $79 billion by 2019, according to the Volcker report. The report notes that in fiscal years 2020 and 2021, as the virus battered the economy, at least 21 states tapped the funds to close budget gaps.

"While no one could have foreseen the immense economic and fiscal stresses caused by Covid-19, actions taken by many states during recent boom times left them better prepared than they would have been only a few years earlier," William Glasgall, the alliance's senior vice president and director of state and local initiatives, said in a statement.

"The report analyzes the budgetary foundation states laid in the five years prior to the pandemic, which directly impacted how well-equipped states were to deal with the fiscal crisis," he added.

Volcker grades states in different areas on a A to D-minus scale. In the reserve funds category, its latest report notes that 17 states received A averages for fiscal years 2015 through 2019 and just two states, Illinois, known for its chronic budget problems, and Kansas averaged Ds.

In addition to evaluating savings, Volcker grades states in four other areas.

One is budget forecasting, which looks at how states estimate revenues and spending. Another is budget maneuvers, or one-time moves to cover recurring costs. Then there's a "legacy costs" category that looks at how well states are meeting pension and retiree health care obligations. And, lastly, budget transparency, which digs into issues around the disclosure of budget information, including debt, tax breaks and deferred infrastructure maintenance.

When looking at the grades for fiscal 2015 to 2019, for each of the five areas that the report evaluates, all five categories saw improvement and three had B averages. In two areas—budget forecasting and legacy costs—the average grade was a C.

With budget forecasting, the report says that grades were held back by a lack of estimates prepared jointly by governors and legislators, and also by a limited number of states issuing longer-term projections. "A one-year estimate does little to reveal structural deficits that may burden subsequent budgets," the report cautions. Only 10 states averaged A grades in this category, while eight scored Ds and three—Alabama, Missouri and North Dakota—checked in with D-minuses.

Legacy costs, both pensions and retiree health care, hang heavy over some state budgets. One major contributor to this problem over the years has been state lawmakers approving pension benefits for public employees, but then failing to set aside adequate funding to cover the costs. Another issue is states using unrealistic estimates for what the returns will be on pension fund investments—those investment earnings help to cover benefit payments.

The Volcker report highlights $1.3 trillion in unfunded pension liabilities states have stacked up. The figure is a projection of how short states will be on what they owe to retirees in future years, based on current pension funding levels. In addition, the report notes over $600 billion in obligations for "other postemployment benefits," which mainly consist of retiree health care.

On the upside, the research finds that the number of states making their full recommended contributions to public pensions rose to 39 states, from 33 between fiscal 2015 and 2019. Even so, 33 states had an average mark of C or below in this category.

The report points to a number of other issues as well.

For instance, how states failing to disclose deferred maintenance costs for infrastructure can be a transparency issue. Deferred maintenance on public infrastructure is around $1 trillion, according to a figure cited in the report. Only five states, Alaska, California, Hawaii, Illinois and Tennessee provided data on these costs as of 2019, the report says.

Volcker also takes the position that it would be easier for states to balance their budgets transparently if they adopted what's known as "modified accrual" accounting, instead of a "cash-based" method.

The cash option doesn't count budget expenses until a bill is paid, instead of at the time when expenses are incurred. Cash accounting opens the door for lawmakers to balance budgets by simply pushing off the timeframe when costs will be paid, while committing the state to spending in the meantime.

Route Fifty

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