THE LONG VIEW OF STATE BUDGETING

Accrual accounting is a big-picture way of ensuring state governments are living within their means.

BY JULIE LAYS
Unlike the federal government, states balance their budgets every year—it’s required for all of them except Vermont. But a different story sometimes emerges in states’ own financial reports, which look more comprehensively at revenue and spending and how the money is managed.

These financial reports show that between fiscal years 2003 and 2017, most states amassed sufficient revenue to cover their expenses. The typical state’s revenue, composed primarily of taxes and federal grants, totaled 102.1 percent of its total bills over those 15 years. That’s pretty good, considering the Great Recession and two economic recoveries occurred during that time.

That’s the median, however, of all states’ revenue and expenses, and it obscures how widely states’ situations can vary. While 40 states collected more than enough revenue to cover expenses during that period, 10 had negative balances. Those states carried forward deferred expenses for previously provided services, such as the annual cost of public employee retirement benefits. Such moves push off to future taxpayers some of the costs of operating government and providing services, which can jeopardize a state’s long-term fiscal flexibility.

### Diagnosing Fiscal Health

State budgets generally track cash as it is received and paid out. But there’s a way to capture all of a state’s financial activities (excluding those of some legally separate organizations, such as economic development authorities or some universities). It’s called “accrual accounting,” and it offers a different perspective on state finances.

Accrual accounting attributes revenue to the year it is earned, regardless of when it is received, and expenses to the year incurred, even if some bills are partially or wholly deferred. This method captures deficits that can be papered over in the budgeting process, even when balance requirements are met by such means as accelerating tax collections or postponing payments.

This long-term view also produces data that are more comparable state to state. Examining aggregate revenue as a share of aggregate expenses transcends temporary ups and downs that states experience over the years, as it allows surplus funds collected in flush years to balance out shortfalls in other years.

### Key Financial Reports

Researchers for The Pew Charitable Trusts’ Fiscal 50 project, which tracks and analyzes key fiscal and economic trends, used accrual accounting techniques to get a longer-term view of all 50 states’ financial health than can be seen in annual or biennial budgets.

The group’s analysis was drawn from audited, comprehensive annual financial reports that have included accrual information since 2002. The reports broaden the scope of reporting beyond state budgets to capture all financial activity under the state government umbrella, including revenue and spending from related activities, such as utilities and state lotteries.

All states must file these standardized reports, but they are used mostly by credit rating agencies and other public financial analysts.

The Pew researchers used the FY 2003-17 time frame to get a perspective that was both long-term and relevant to current decision-makers—the ones who must consider whether to increase revenue or cut expenses when state finances are out of balance. Accounting for funds as the financial reports do is like a family reconciling whether it earned enough income over 12 months to cover not just cash expenditures but also credit card bills and car or home loan debts.

A state whose annual income falls short generally turns to a mix of reserves, debt, and deferred payments on its loans to get by. Conversely, when state income surpasses expenses, the surplus can be directed toward nonrecurring purposes, including paying down obligations, bolstering reserves or expanding services.

### Chronic Deficits Cause Concern

Like families, states can withstand periodic deficits without endangering their long-term fiscal health. Chronic shortfalls, however, may indicate a serious structural deficit requiring changes in policy.

A negative fiscal balance is one indication of a structural deficit, but there is no consensus on how to determine when policy changes are needed. Some states, for example, diagnose structural deficits by comparing cash-based recurring general fund revenue to recurring expenditures under normal economic conditions. However, such data are not available for all 50 states.

### What Did Pew Find?

Among the findings of the Fiscal 50 analysis for fiscal 2003-17:

- States with the largest accumulated surpluses were Alaska (135.9 percent of expenses incurred), Wyoming (126.1 percent), North Dakota (120.8 percent), Utah (110.3 percent) and Montana (109.8 percent). These resource-rich states use some of the large surpluses they acquire in boom years to help alleviate shortfalls when oil or mining revenue declines.
- Two states’ long-term balances improved from negative to positive. With the addition of fiscal 2017 results and after seven consecutive years of surpluses, Michigan’s revenue edged up to 100.5 percent of its expenses. New Mexico’s revenue also reached 100.5 percent of expenses, thanks to a surplus in fiscal 2017.
- Two states had deficits every year: New Jersey had the largest long-term imbalance, with revenue able to cover only 91.3 percent of aggregate expenses, followed by Illinois at 93.8 percent.
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Eight more states had symptoms of a structural deficit: Massachusetts (96.1 percent), Hawaii and Connecticut (both 96.9 percent), Kentucky (98.3 percent), California and Maryland (both 98.8 percent), New York (98.9 percent), and Delaware (99.5 percent). All but California and Delaware experienced deficits in at least 10 of the 15 years.

In fiscal 2017, Delaware had its largest deficit in eight years, pulling its long-term fiscal balance into negative territory. It was the only state to move from positive to negative during the period studied.

**Year-by-Year Trends**

Looking at states’ balances year by year, shortfalls mainly occurred during and immediately after the economic downturns of 2001 and 2007-09, suggesting that most states’ challenges were temporary. For example, all but Louisiana, Montana, North Dakota, and West Virginia ran deficits in 2009, the nadir of the Great Recession.

As the nation’s economic recovery took hold, most states balanced their books and have stayed in the black since 2011. In fiscal 2016 and ’17, however, more than a dozen states ran deficits. One reason was stagnant tax revenue growth, which through the second quarter of 2017 had its weakest two-year stretch—outside of a recession—in at least 30 years. Throughout much of 2016 and ’17, tax collections were stymied in some states by sagging energy and crop prices, and more widely by the slow growth of wages and a migration of consumer spending toward services and online purchases that were less likely to be taxed.

Among the 10 states with gaps between aggregate revenue and expenses between 2003 and 2017, a year-by-year breakdown shows that only California has turned a corner and reported surpluses for the past five fiscal years.

It’s important to note that just because a state raised enough revenue over time to cover total expenses does not necessarily mean it paid every bill. North Dakota brought in surpluses in nearly each year studied, for example, but frequently fell behind on annual contributions to its pension system, electing to use the money for other purposes. So, accrual accounting gauges states’ wherewithal but does not reconcile whether revenue was used to cover specific expenses. Collecting more revenue than expenses over the long term is just one of the conditions needed to achieve fiscal balance. Further insights can be gleaned from examining states’ debt and long-term obligations.

After years of slow progress, lawmakers are seeing a more promising economic and fiscal environment in 2019. Still, not all states have fully recovered from the shocks of the Great Recession more than a decade ago. Some face vexing constraints: inherited shortfalls in funding for public employees’ pension and retiree health care benefits; recurring deficits between annual state revenue and expenses; and weak population growth, which can affect economic prospects and revenue collections.

Accrual accounting can help provide the long-term perspective these states need to get a true picture of their fiscal health.

Julie Lays is the editor of State Legislatures magazine. This article is based on research by The Pew Charitable Trusts. The report is available at pewtrusts.org/fiscal50.