

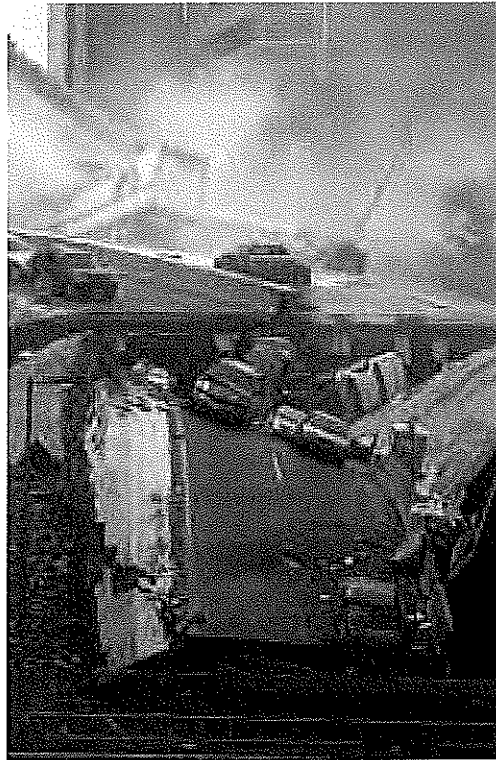


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CASE 11.1 DANGEROUS STRATAGEMS



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In three-fourths of the states, the treasurer or chief financial officer (CFO) is elected by citizens in statewide elections. In some states, such as New York and Texas, the comptroller is elected and performs many of the functions of the CFO. About two-thirds of local governments have an official with the title "financial officer," "financial director," or a similar title implying broad duties. Financial wizardry is not a CFO's primary calling; but when governors or mayors find their budgets unbalanced, they turn to the CFO for possible stratagems. For the past few years, politicians in far too many cities and states—not to speak of Washington, DC—have tended to rely on nine dangerous stratagems:

1. *Delay maintenance and replacement of assets—and rely on hope.* On August 1, 2007, the I-35W bridge across the Mississippi River in Minneapolis collapsed suddenly, killing 13 people. Seven months later, a federal commission said that just to maintain and upgrade surface transportation in the United States would cost \$225 billion a year for the next 50 years. Ensuring safe and dependable roads, bridges and transportation systems, as well as water systems, sewage treatment plants, dams and even schools also requires long-term planning. Unfortunately, most politicians prefer quick fixes.
2. *Sell assets.* In economic hard times, it is popular to sell land, buildings, or surplus assets.

California's real estate is one of its greatest assets and selling off state property, according to the governor's office, would raise over \$1 billion. Specifically, Governor Schwarzenegger proposed the sale of seven state-owned properties to help get his budget in balance including: San Quentin State Prison, the Cow Palace, Del Mar Fairgrounds, Orange County Fairgrounds, Ventura County Fairgrounds, and the Los Angeles Coliseum. Schwarzenegger's proposal was rather straightforward compared to that of Governor Eliot Spitzer in New York, who wanted to securitize, or sell off, part of *future* state lottery proceeds.

3. *Lease rather than buy equipment.* Say the U.S. Air Force needs 100 Boeing 767 aircrafts to use as aerial refueling tankers. Buying them outright would cost about \$20 billion and add appreciably to this year's deficit. Therefore, for political reasons, Congress and the president might prefer to lease them over a 12-year period. The budget would take far less of a hit each year, even though total cost would be higher than if the Air Force had bought the planes.
4. *Rob Peter to pay Paul.* Most budgets are made up of multiple accounts. The account that gets the most attention is called the general fund. When that general fund gets in trouble, politicians start considering *off budget funds* as resources to be tapped. New York helped balance its budget in 1992 by transferring the cost of running the Erie Canal from the general fund ("on budget") to the Thruway Authority ("off budget"). Similarly, in 2003, Massachusetts transferred management of a convention center and a parking garage (both "on budget") to the state pension fund ("off budget") to show a savings of \$175 million.
5. *Nickel and dime employees.* The response to budget problems is often symbolic. David Osborne and Peter Hutchinson write: "Leaders order coffee pots unplugged, travel budgets slashed, and consultants banned. To save energy, they force workers to endure hotter offices in summer and colder offices in winter. Some even outlaw potted plants. In Missouri last year, the governor ordered that every other light bulb in government buildings be unscrewed."
6. *Make across-the-board cuts rather than targeted cuts.* In 2008, Governor Schwarzenegger proposed cutting California's budget across the board by 10 percent, meaning that every state agency from police to health to the arts would receive a 10 percent reduction in its annual budget. Less drastically, that same year, Iowa Governor Chet Culver announced a 1.5 percent across-the-board cut and said education and Medicare "won't escape unscathed." The popularity of broad-brush, across-the-board cost-cutting is easy to understand: It is a way to avoid making difficult, uncomfortable political choices.
7. *Fudge the numbers.* A budget is really just a forecast, a necessary statement of expected revenues and expenses. But every budget is based on assumptions, and CFOs can make it look better or worse simply by changing those assumptions. If they expect 1000 new students to enroll in their schools but assume (for budget purposes) only 900, they have reduced the basis for their estimate of new expenses by 10 percent. Ronald Reagan's approach in 1982 was a classic example of making the budget "work" by fudging the numbers. To justify large tax cuts, his budget director, David Stockman, forecast 5 percent growth for 1982. Theoretically, this would help create a \$28 billion surplus by 1986. As it turned out, the gross national product fell by 2 percent that year—and the largest deficits since World War II soon followed. The Obama White House presented its own rosy scenario with the fiscal year 2010 budget. It expected economic growth in 2009 to decline by only 1.2 percent, whereas the non-partisan Congressional Budget Office assumed a 3 percent decline. Quite a difference.
8. *Borrow.* Even when the general fund is legally prohibited from being in debt, governments find ways to borrow. The chief way states and local governments borrow is by issuing bonds. California has proven that the politics of borrowing works for both Republicans and Democrats. In 2003, the legislature finally passed a \$99 billion budget with \$10.7 billion of borrowing—which was probably unconstitutional. After voter removed (recall) Democratic Governor Gray Davis from office, the new Republican governor, Schwarzenegger, immediately endorsed borrowing \$1.5 billion more as part of his "budget balancing"

plan. Meanwhile, on the East Coast, New Jersey faced a \$3.5 billion shortfall and had accumulated a \$32 billion debt. Governor John Corzine therefore proposed increasing fees on toll roads and issuing up to \$38 billion in bonds against future toll revenues.

Although issuing bonds is the chief way for a state to borrow, Schwarzenegger would later try another way, namely, invoking a law that lets the state demand loans of 8 percent of property tax revenue from cities, counties, and special districts. Under this law, the state must repay the municipalities with interest within three years. So, he requested \$2 billion, displeasing local officials up and down the state and in effect, kicking the can down the road three years.

9. *Use accounting gimmicks.* Accounting offers many temptations to politicians who might have made a read-my-lips pledge of "no new taxes." Since we cannot consider all the gimmicks, we note here just four: manipulating the timing of expenditures and receipts, requesting funds after budget approval, making false assumptions, and making dubious promises.

Our first example involves pretending or even requiring that money you expect to receive next year will actually come in this year or pretending that expenses planned for this year will be made, technically, next year. For example, states tell school districts that are expecting a school-aid payment in May (this fiscal year) that they will get it in July (next fiscal year), thus making this year's expenses look smaller. At the same time, they tell retailers who normally submit their June sales tax receipts in July (next fiscal year) to do so in June, thus making this year's revenue look larger. In Massachusetts, Governor Deval Patrick proposed counting about \$900 million in proceeds from license fees of new casinos that the legislature had not even authorized.

Prudent presidents and governors recognize that natural disasters happen and allow for them in their budgets. Others simply assume none will occur, lower their spending request to the legislature accordingly, and then blithely ask the legislature for supplemental funding two months later, when the flooding or whatever occurs. This works well for wars, too.

Another accounting gimmick used to make deficit projection look smaller involves the alternative minimum tax (AMT) enacted in 1969 to prevent the wealthy from using tax shelters to avoid paying any income tax. Although it was intended to hit the wealthy taxpayer, it was not indexed for inflation. That fact has meant that it could affect millions of middle-class taxpayers. If they pay it, the government would get billions of dollars more in tax revenues, which is what past budgets have falsely assumed. But it would also probably mean a taxpayer revolt. So each year the White House and Congress agree to patch the alternative tax for inflation and the extra revenues never materialize.

Finally, we come to a relatively new gimmick: PAYGO (pay-as-you-go). Here's how it works: The president promises that "Congress can only spend a dollar if it saves a dollar elsewhere." Thus, PAYGO, provides politicians with convenient talking points and taxpayers with a false sense of security on budget reform. From 1991 through 2002, PAYGO existed as a statute and was brought back in 2007. But it never worked because Congress severely limited the amount of the budget to which it applied and, in those cases when it did apply, conveniently voted waivers.

Case Questions

1. Identify the weaknesses in each strategy. (Hint: How do you think the bond rating agencies reacted to California's 2003 budget?)
2. Which strategies are the most dangerous? Least? Why?
3. Provide a recent example of each strategy.

Case References

David A. Stockman, *The Triumph of Politics: The inside Story of the Reagan Revolution* (New York: Harper and Row, 1986); David Osborne and Peter Hutchinson, *The Price of Government* (New York: Basic Books, 2004); Jackie Calmes, "Obama Bans Gimmicks, and Deficits Will Rise," *New York Times*, February 20, 2009; Keith B. Richburg, "Governors Seek Remedies for Shortfalls," *Washington Post*, January 13, 2008; Stu Wu and Bobby White, "California Cities Irked by Borrowing Plan," *Wall Street Journal*, May 22, 2009; and <http://gov.ca.gov/FactSheet/12305>.



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