



What is a “Balanced Budget”?

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Try this multiple choice test.

According to the Comptroller’s *Comprehensive Annual Financial Report* the City of New York ended its 2010-11 fiscal year with:

- a. a \$5 million surplus
- b. a \$282 million deficit
- c. a \$9.6 billion deficit
- d. all of the above

The answer is: d. all of the above.

How can that be? Doesn’t the City, under compulsion of State law, follow the strict standards of Generally Accepted Accounting Principles (GAAP) and balance its budget according to those principles? How can there be multiple versions of what a balanced budget means, and how can two of them indicate the City is running a significant deficit?

The answer to these questions is that multiple versions of a balanced budget standard have arisen because: (a) the State, at the City’s request, has given the City permission to deviate from GAAP in meeting the statutory standard for a balanced budget, and (b) the Governmental Accounting Standards Board (GASB), the body that sets GAAP, has in recent years modified GAAP in ways that set a new and higher benchmark for a balanced budget. The City issues reports disclosing the newly required information, but municipal officials have not adopted it as the basis for defining a balanced budget.

First, consider the old fashioned version of a balanced budget. This is the one incorporated in the initial State law passed in the midst of the 1970s fiscal crisis that mandates a balanced budget. This definition applies to the City's General Fund, the accounts through which most operating expenses are funded. It requires that revenues for the General Fund equal or exceed expenses paid from the General Fund. Simple enough.

Yes, it is pretty straightforward. And since fiscal year 1981 the City has achieved a \$5 million surplus in its General Fund. Keeping the surplus to the consistent and round number of \$5 million typically involved some maneuvers to "roll" money to the next fiscal year, but these practices conformed to GAAP and were widely viewed as prudent because they created a de facto rainy day fund.

A troublesome complication arose in 2007 when the GASB clarified the definition of operating expenses to include expenses related to certain types of pollution remediation such as asbestos removal. The City, and many other local governments, had been treating these costs as capital expenses and paying for them with long-term borrowing. Now they would have to be paid for in the General Fund with current revenues. The new GASB ruling took effect in the City's fiscal year 2009.

Initially the City sought and received a two-year temporary exemption from the GASB rule under state law. The case was made that the City needed the time to identify the specific sums involved in the relevant remediation expenses and to develop the procedures for following the practice in future years. In its January 2010 Financial Plan the City indicated it would begin conforming fully to GAAP and include the relevant remediation expenses as part of its approach to balancing the operating budget for fiscal year 2011.

In June of 2010 the City abruptly reversed itself. As part of a deal with state officials over the State's fiscal year 2011 budget, the City asked for and received a permanent statutory exemption from the GASB rule relating to remediation expenses. Thus, the Comptroller reports a \$5 million surplus for the City's fiscal year 2011 based on the exemption from that rule. If GAAP were strictly applied to the fiscal year 2011 results, the City would have a \$282 million deficit due to the \$287 million in remediation expenses funded with borrowed money. In other words, the City has crafted its own special version of GAAP, and has a surplus only under those rules.

That unique version of GAAP explains the first two answers to the multiple choice question – but what about that whopping \$9.6 billion deficit? This version of a balanced budget is rooted in an evolving perspective on government finances promoted by the GASB over the past decade. This approach recognizes that government finances involve more than the transactions reported in the General Fund. The General Fund is an accounting concept devised to help legislatures keep track of how executives use the money they appropriate and typically cover only appropriated funds. However, governments incur expenses and debts outside the General Fund. The most significant of these are the depreciation of physical assets and the obligation to pay future retirement benefits in addition to pensions to current and former employees. Both types of expenses are recognized in private sector accounting, and GASB has been applying a parallel logic to state and local governments.

The first major step in this direction took effect in fiscal year 2000 when the GASB required as part of GAAP that governments prepare a “Statement of Activities” that reports expenses and revenues beyond those included in the General Fund. The City Comptroller has complied and prepared these annual statements. (See Table 1.) The differences between the accounting approach taken in this report and the traditional fund accounts are extensive, but most relevant for New York City are the requirements to include capital expenses as investments in assets and to reflect use of capital assets through depreciation expenses (or an equivalent). In many ways the new approach is more meaningful to average citizens; it shows the extent to which the overall financial condition of a government has improved or worsened in a given year.

The fiscal year 2000 Statement of Activities showed New York City to have expenses of \$39,561.8 million and revenues of \$38,680.1 million for an operating deficit of \$881.7 million. This included depreciation expenses of \$889.3 million, a non-cash expense that is not included in the General Fund. As shown in Table 1, in four of the five subsequent years the City also had substantial deficits ranging from about \$3.9 billion in the post-September 11 recession fiscal year of 2002 to \$671 million in the better times of fiscal year 2005 and a surplus of \$83 million in fiscal year 2004. The large deficits resulted primarily from the decline in revenues after the terrorist attacks in 2001 and the national recession, but growing depreciation expenses also contributed.

In fiscal year 2006 additional changes to GAAP came into effect that substantially worsened the picture of the City’s financial condition. The new rules required state and local governments to recognize and report the liabilities they incur by promising to pay for retirees’ health insurance (in addition to their cash pensions). This item, known as Other Post-Employment Benefits or OPEB, essentially obliges government employers to identify the current value of the future promises made to workers and to report the current value of those promises as an expense, similar to the treatment of pension benefits.

Because the City of New York provides generous retiree health insurance benefits (requiring no retiree contribution toward basic premium costs and reimbursing for Medicare Part B premiums), the impact on the annual financial results is enormous. In fiscal year 2006, when the accumulated liability was first recognized, the added expense was \$53.3 billion; in subsequent years the annual increment ranged from \$2.3 billion to \$9.4 billion.

In recent years the combination of a drop in revenues due to the recession, large new OPEB expenses, continuing large depreciation expenses and (to a lesser degree) the new remediation expenses has led to repeated large deficits under the new GAPP standard. The amount of red ink grew from \$2.8 billion in fiscal year 2007 to over \$11.7 billion in fiscal year 2010 and was still nearly \$9.6 billion in fiscal year 2011. And that explains the third “correct” figure in the multiple choice test.

Table 1. City of New York, Statement of Activities, Primary Government
Fiscal Years 2000-2011

(dollars in millions)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Expenditures	\$39,562	\$43,027	\$45,539	\$46,606	\$48,335	\$54,899	\$109,782	\$64,056	\$68,742	\$67,357	\$76,052	\$75,949
Revenues	38,680	41,880	41,686	43,579	48,418	54,227	56,081	61,251	62,909	60,336	64,350	66,373
General Revenues	23,773	25,666	23,540	25,729	30,146	33,781	37,133	40,244	39,583	36,283	38,819	41,647
Charge for Services	2,621	2,869	3,001	2,791	3,286	4,143	3,345	3,766	4,094	4,339	4,541	4,236
Grants and Contributions	12,286	13,346	15,145	15,060	14,985	16,303	15,603	17,241	19,232	19,714	20,990	20,489
(Deficit)/Surplus	(882)	(1,148)	(3,852)	(3,026)	83	(671)	(53,701)	(2,805)	(5,833)	(7,021)	(11,702)	(9,577)
Selected Expense Items												
Depreciation	(889)	(1,243)	(1,154)	(2,091)	(1,800)	(2,367)	(2,019)	(1,994)	(2,265)	(2,290)	(2,139)	(2,333)
OPEB							(53,507)	(4,254)	(5,528)	(2,254)	(9,440)	(8,922)
Pollution Remediation										(236)	(455)	(287)

Source: New York City Office of the Comptroller, *Comprehensive Annual Financial Report for the City of New York*, fiscal year 2000 through 2011 editions.

Expenditures and Revenue items from the Statement of Activities on pp. 24-25 in the 2001 edition, p. 28 in the 2002 edition, p. 30 from the 2003 edition, p. 32 in the 2004 edition, p. 30 in the 2005 edition, p. 32 in the 2006 edition, p. 34 in the 2007 edition, p. 34 in the 2008 edition, p. 36 in the 2009 edition, p. 36 in the 2010 edition and p. 36 in the 2011 edition.

Depreciation and OPEB Expense items from Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities on pp. 32-33 in 2001 edition, p. 36 in 2002 edition, p. 38 in 2003 edition, p. 40 in 2004 edition, p. 38 in 2005 edition, p. 40 in 2006 edition, p. 42 in 2007 edition, p. 42 in 2008 edition, p. 44 in 2009 edition, p. 44 in 2010 edition and p. 44 in 2011 edition.

Pollution Remediation Expense item from General Budgetary Fund Highlights on p. 18 in 2009 edition and p. 18 in 2011 edition.

Accessed November 4th, 2011 <http://www.comptroller.nyc.gov/bureaus/bud/all_budget_reports.shtm> In the event figures were updated the most recent figure was used.

Note: Figures are for Primary Government Activities and do not include separately reported component units.

So how should New Yorkers react to the widely varying answers to questions about the City's financial condition? The best approach is to ask ourselves why a balanced budget is important. That is a philosophical, not an accounting, question. For many concerned citizens the reason budgets should be balanced is to avoid imposing harm on future residents, especially the next generation. That is, we should not ask our children to pay out of their future incomes for the services consumed and promises made today. If one accepts this value premise, then the three alternative accounting definitions are not equally acceptable:

- The first definition, yielding a current surplus, makes the least sense. New York City should not have its own unique set of accounting rules, a version that allows what the rest of the world views as an operating expense to be labeled a capital investment and paid for with borrowed funds that our children will repay.
- The second definition would avoid the above mistake, but it is still inadequate. It derives from an old fashioned notion of government accounting that does not align with a more comprehensive approach to government finances. Keeping the General Fund accounts in balance is a worthwhile goal, but it does not address the larger philosophical question behind the concept of a balanced budget.
- The third definition is the one most appropriate for determining whether current residents are imposing a burden on future New Yorkers. If we want to leave the city in better condition at the end of any given year than when that year began, this is the appropriate framework for keeping score.

The implication of these judgments is that New Yorkers should be giving much more attention to the financial results disclosed under the new GAAP rules. The recent record is not good, and serious challenges arise in making improvements to the City's financial condition. It will be hard to move from the current self-deluding standard for a balanced budget to a more meaningful one, but that should be the vision of municipal leaders. When the City first was required to "balance" its budget during the fiscal crisis, it took a period of at least seven years to reach that goal. A similar time frame might be appropriate for recognizing that times have changed and a new standard is needed for local financial management.