State of the states:
Desperate times or is this status quo?

Grant Thornton LLP

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Why would we need an integrated toolset?

- GOOD QUESTION!
- Easy answer – fiscal sustainability
- First, let's understand the topic we will discuss
- What is it? What does it mean?

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Fiscal sustainability

"Fiscal sustainability" is the extent to which patterns of government spending do not undermine the capability of the government to continue to spend to achieve its public purposes.

People see things this way:

- Continuing and growing deficits are a sign that fiscal sustainability is going down;
- Continuing and growing increases in the national debt are a sign that fiscal sustainability is going down; and
- An increasing debt-to-GDP ratio is a sign that fiscal sustainability is going down.

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Is there a sustainability issue/problem?

- Think in terms of the U.S. government
- Debt limit increased (what is your share?)
- Are we (the USA) sustainable?
- Downgrade by Standard & Poors
- High unemployment
- Slow economic growth
- Entitlement programs (Social Security, Medicare)

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How long does it take a government to borrow itself into a fiscally sustainable position? …an informal survey:

- Is the USA fiscally sustainable?
- Social Security?
- Medicare/Medicaid?
- Will federal funds to states and local governments be impacted?
- Are state and local governments fiscally sustainable?
- Do balanced budget requirements improve it?

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Major pressures on state and local governments:

- OPEB
- Pensions
- Debt

- What is a balanced budget?

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Additional discussion topics

- What's the problem, anyway?
- 2011 CFO Survey
- Tools to respond to fiscal sustainability issues
- Challenges

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What's the problem?

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What's the problem?

State and local governments and public agencies face extraordinary fiscal crises

- The myriad of problems that they face range from operational management to spiraling healthcare and pension costs to declining tax bases
- Local citizens expect government service but have little desire to pay for it
- Federal budget cuts have reduced funding to state and local governments

Public discussion of municipal and government agency default is on the rise

- Historic default rates for muni bonds is about 0.25%
- Cities and States have recently cancelled $3 billion of new bond issuances, more than 10% of the $24.4 billion pipeline, for fear of low demand
- The Federally subsidized Build America Bond program has ended
- The looming $25 billion budget deficit in California is and need to finance $14 billion in the near term is rattling bond markets.

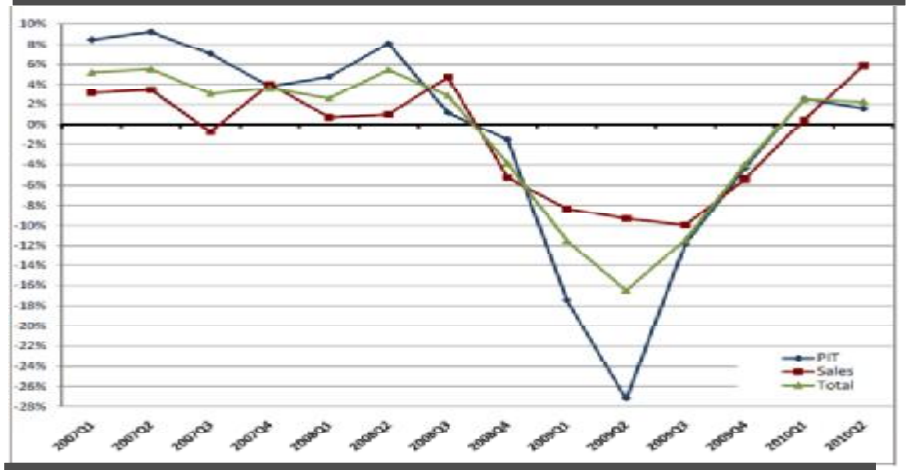
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The state of the States

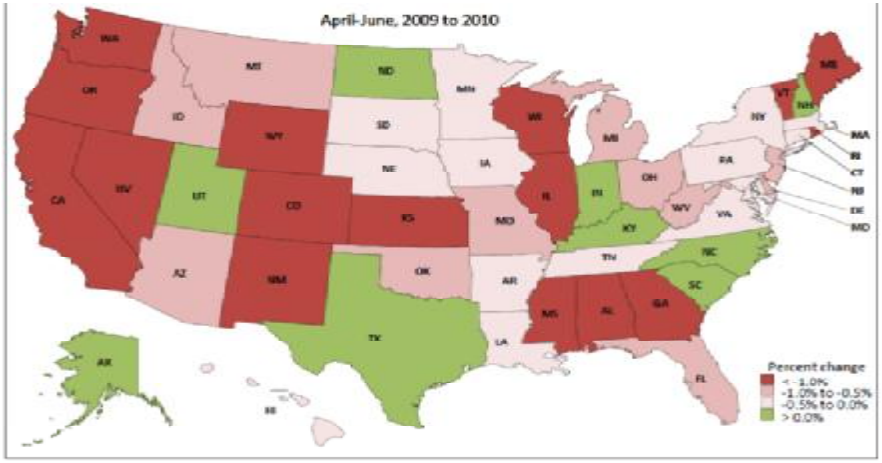
Context

- The Center on Budget and Policy Priorities estimates aggregate state budget gaps of:
  - **$180 billion for 2011**
  - **$118 billion for 2012.**
- Employment continues to be a challenge

% Change in State tax Collections versus Year Ago



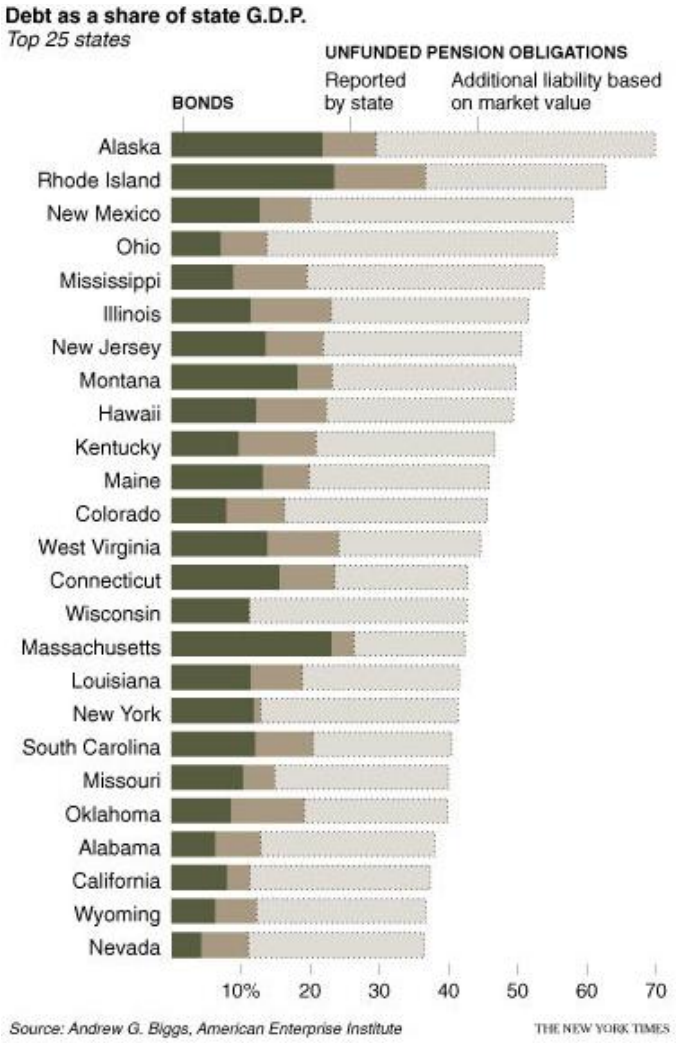
Employment Declined in 41 States in the 2nd Quarter of 2010



Source: "State Revenue Flash Report – State Tax Revenues are Slowly Rebounding," Dadayan and Boyd

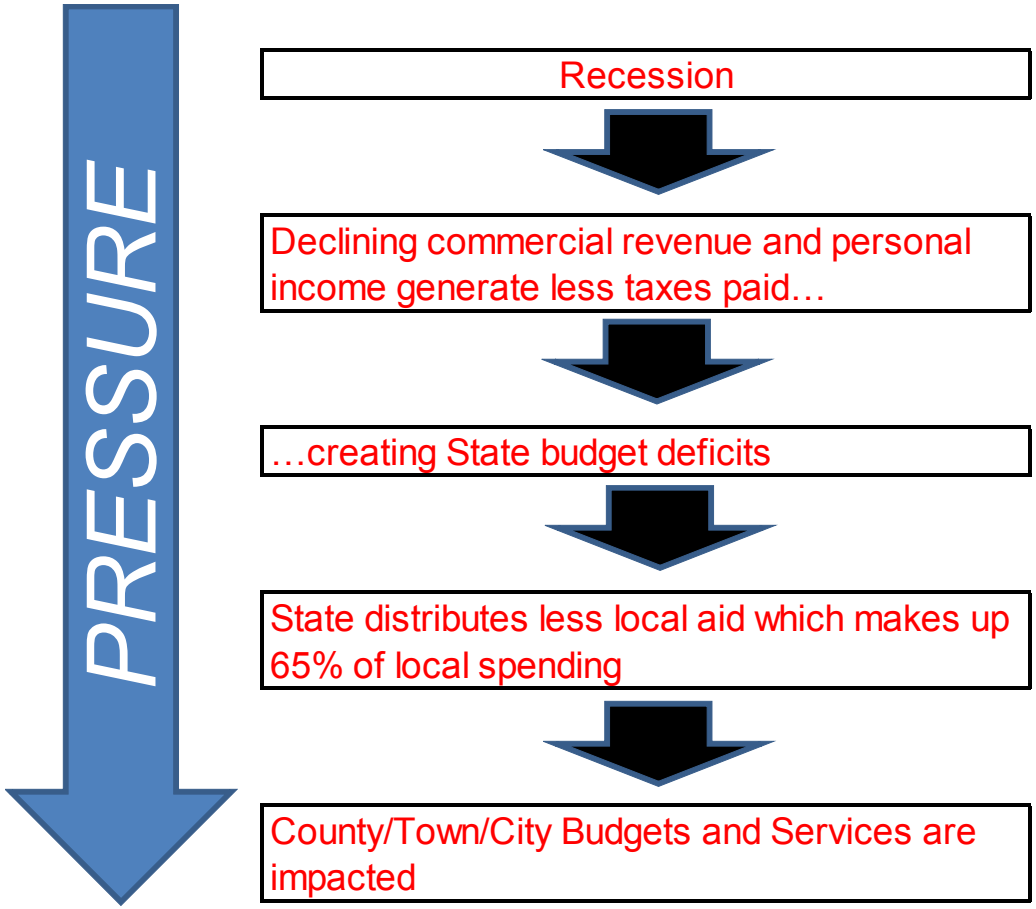
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State debt and pension liabilities



- States' total debt, as a percentage of their respective GDP is shown left
- Explicit debts in the form of bonds outstanding may look manageable (dark gray bar)
- Unfunded pension obligations are not fully recognized in the marketplace
- States utilize accepted actuarial methods that depend on reinvestment assumptions to determine unfunded liability (medium gray bar)
- Additional liability based on market value of pension assets tells a more alarming story (light gray bar)
- There is no PBGC or equivalent to back-stop state public pension funds

Impact of macro economic trends on municipal budgets



Source: J.P. Morgan Chase

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Municipal budget shortfalls and responses

- According to the National League of Cities ("NLC"), the municipal sector likely faces a combined, estimated shortfall of anywhere from **$56 billion to $83 billion from 2010-2012.**

- Leading causes for this shortfall is the impact of the economic recession on municipal revenue collection
  - **Sales tax** and **income tax collections have been declining**
  - Nationwide, **housing values are down approximately 10% since 2007**, which eventually will translate into residential property tax revenue declines for cities – the brunt of which will hit in 2011 and 2012.
  - At the same time, **ongoing and increased demands from residents for municipal services and increasing municipal costs – especially health care -** will make it difficult for city leaders to offset revenue shortfalls through spending cuts alone

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Who is affected?

Governments	Government agencies	Creditors

• States
• Counties
• Municipalities
	• Public Authorities
	  • Transit
	  • Health
	  • Waste
	  • Water
	• Hospitals
	• School districts
	• Toll roads/bridges
		• Public bond holders
		  • Pension funds
		  • Mutual funds
		  • Asset managers
		  • Bond trustees
		• Credit insurers

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What is the magnitude?

Fragmented state and local government sector

Units of government	Number
States	50
Counties	3,034
Municipalities (city, town, village)	19,429
Townships	16,504
School districts	13,506
Special purpose districts (fire, utility, police, etc.)	35,502

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Examples of municipal fiscal distress nationwide

- **Augusta, Maine:** Mid-year budget shortfall and decreasing budget for next fiscal year, resulting in layoffs, reductions in police and fire overtime and reductions in services.
- **Baltimore, Maryland:** $127 million shortfall, likely resulting in a next round of layoffs /furloughs having already eliminated more than 500 positions.
- **Bossier City, Louisiana:** $6.5 million deficit in the city's $50.3 million budget, resulting in a proposed elimination of 117 out of 897 positions, including 80 police and fire positions.
- **Boston, Massachusetts:** $130 million shortfall, resulting in layoffs of more than 500 municipal employees.
- **Chicago, Illinois**: $20 billion underfunded pension liability
- **Cleveland, Ohio:** $23 million shortfall, and the city estimates that for every $1 million about 20 general city employees or 12 police and firefighters would have to be laid off.
- **Columbia, Missouri:** $4 million budget shortfall in 2009-2010, covered through cutbacks in personnel and programs.
- **Dallas, Texas:** $190 million budget shortfall, 637 full-time positions to be eliminated, including 347 layoffs, and cuts to street repairs, libraries and senior services.

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Examples of municipal fiscal distress nationwide

- **Denver, Colorado:** $120 million shortfall, resulting in layoffs of 80 positions and early retirement of 322 city workers.
- **Dover, Delaware:** Budget decrease of $10.5 million from last year, covered by requiring all city employees to take 12 unpaid furlough days and the deferral of capital improvements.
- **East Providence, Rhode Island:** Reduced city positions by 55, including 16 in the police department and 28 in the fire department.
- **Harrisburg, Pennsylvania**: city has retained bankruptcy counsel and is contemplating a Chapter 9 filing
- **Little Rock, Arkansas:** $2.8 million shortfall**,** resulting in $200,000 cut in police services and $450,000 in fire services.
- **Los Angeles, California:** $98 million shortfall in 2009-2010, $408 shortfall in 2010-2011, and predicting total shortfall near $1 billion by 2013; the city has already removed 2,400 positions from the city payroll through early retirement, furloughs and other workforce reductions.
- **Philadelphia, Pennsylvania :** city facing $145 million deficit in 2011 that is being closed with a one-time property tax increase
- **Sacramento, California:** General fund revenues declined by $15 million, resulting in eliminating funding for 387 positions.
- **San Francisco, California :** $436 million shortfall and expecting $80-100 million more due to declining revenue collections and state cuts; mayor asked city departments for 25 percent cuts.
- **Seattle, Washington:** $72 million budget shortfall, resulting in the elimination of 310 positions and the city using $25.4 million of a $30.6 million fiscal stabilization (“rainy day”) fund.

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Examples beyond states and municipalities

- **Counties**
  - Nassau County Interim Finance Authority
  - Jefferson County, Alabama
- **Infrastructure**
  - Municipal transit agencies
    - New York MTA
    - New Jersey Transit
    - Minneapolis Metro Council
    - San Francisco BART
    - Chicago Transit Authority
  - Santa Rosa Bridge Authority
  - MetroLinx – Toronto
- **Municipal healthcare**
  - Boston Medical Center
- **Public school districts & state universities**

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About the surveys
Risk management
Predictive & statiscal analytics
Budget cuts
Debt management
Benefits



STATE CFO SURVEY DISCUSSION TOPICS

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About the survey

- Sponsored by AGA, supported by NASACT, conducted by Grant Thornton LLP in Spring 2011
- Two surveys: overall and state-specific
- 1,385 respondents
  - 152 federal executives, CFOs & deputy CFOs (in person)
  - 38 state executives, comptrollers & treasurers (in person & online)
  - 1,157 AGA members, including 393 from state government (online)
  - 38 Government of Canada CFOs & deputy CFO executives

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Risk management



Is risk management (RM) adequate in your entity?

- ü *Yes*
- ü *Mixed*
- ü *No*
- ü *Don't know*

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Risk management

Opinions on adequacy of enterprise RM in their entities

Response	Executives		
	U.S. federal	U.S. state	Canada ministries
Yes	50%	71%	78%
Mixed	16%	4%	3%
No	28%	25%	20%
Don't know	6%	0%	0%

- **Yes:** Risk committees of senior executives & SMEs aligned with balance sheet; top support by CFO & other leaders
- **Mixed:** Limited, unstructured risk analysis
- **No:** Reactive, not serious about RM

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Risk management: integration with internal controls (IC)



How satisfied are you with the integration of RM & IC in your entity?

1. *Very dissatisfied*
2. *Somewhat dissatisfied*
3. *Neutral*
4. *Somewhat satisfied*
5. *Very satisfied*

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Risk management: integration with internal controls

Satisfaction with integration of RM & IC

(1 = very dissatisfied, 5 = very satisfied)

Government/position	Mean score
Federal executives	3.1
State executives	3.5
Federal managers	3.5
State managers	3.6
Local/regional managers	3.5

Observations:

- IC is *only* formal RM method in some entities
- Stovepipes make integration difficult
- IC & RM are better integrated at the business line level because each line is so different. Leaders conscientious about integration.

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Risk management: what gets tracked & how

Top 5 functions monitored

1. Preparing annual audited financial statement reports & undergoing audits of them.
2. Budgetary issues (formulating & tracking)
3. Financial process improvements (including their efficiency & performance)
4. Providing information for decision making, including financial reports other than annual financial statements
5. Risks & internal controls

Top RM tools & methods

1. Internal controls
2. None (respondents say their financial organizations use no such tools)
3. Statistical analysis (sampling; flux, trend & root cause analysis)
4. Audits (including internal & external audits)
5. Financial reporting (not necessarily for annual audited financial statements)

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Risk management: staff skills

Executives: does your financial staff have the right RM skills?

Government/position	Yes	No
Federal executives	68%	32%
State executives	96%	4%

Yes: We have a formal RM approach & train people to use it
Yes: Strong skills in financial management (FM) but weak in other support & operations functions
No: Concerned with the RM talent at senior management levels
No: Training is severely lacking

"Hard to get non-financial managers to focus on risk management"

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Risk management: budget cut risks & benefits

Risks

- Do less with less, not more with less
- Cuts to skill building; IT investment; pay freezes & attrition
- IT won't keep up with transaction growth or make up for staff cuts
- Harder to get ahead of the risk curve & mitigate risk
- Less focus on managing risk, oversight & internal controls
- Worst time to try to stand up new RM capabilities

Benefits

- Could force government be more risk-based in operations management
- Could drive priorities, better data & analytics
- Will Increase CFO status if they sell & drive RM to
  - Mitigate risk of running out of money
  - Avoid spending too much on low ROI items

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Predictive & statistical analytics



Are you aware of predictive & statistical analytics in your entity?

- ü *Yes*
- ü *No*

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Predictive & statistical analytics: tools

- Sampling techniques
- Dashboards, balanced scorecards
- Predictive modeling
- Trend analysis
- "Homegrown" applications
  - Mostly spreadsheets
  - For finding anomalies
- Cost tracking & analysis
- GPS analysis
  - Track claims
  - Predict overpayments & fraudulent payments
- Business Intelligence software
  - Data mining
  - Data warehouses
  - Typically, use COTS ERP SW
- Uncertainty (Monte Carlo)
- Regression
- Monitoring problem report logs

Most entities in early stages of using these tools; many do not use them at all

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Predictive & statistical analytics: ability to use tools

Executives' satisfaction with use of analytics in their entities

Level of satisfaction	Financial areas	Non financial areas
Satisfied	28%	32%
Mixed feelings	36%	19%
Not satisfied	35%	49%

- Most executives would like to see more analytic prowess
- Some waiting to automate or to get better data, but others think they do not have to wait
- Executives give their staffs a 2.7 score out of 5 on analytic skills

Most people are good at compiling data, not using it for predictive or statistical analysis

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Predictive & statistical analytics: how to help non-financial types to use analytics

- Strive to integrate financial & non-financial analytics
  - Build financial analytics skills around operations needs
  - Use financial indicators to help find operations problems & risks
  - Get involved in non-financial analytics – bring financial table tools to the table
- Join operations improvement teams
- Make analytics easy to understand

- Help operations managers answer legislator/central agency questions using analytics
- Set up disciplined process for capturing & integrating timely, realistic cost estimating & monitoring
- Help non-financial managers explain requirements in both fiscal & operations terms

Don't just tell – sell. Look for headline issues in the CFO's analytic sweet spot.

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Effect of budget cuts



What are/will be the effect of budget cuts in your entity:

A. *Less production*
B. *More errors*
C. *Less support to programs*
D. *Personnel turnover*
E. *Chance to show value*

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Effect of budget cuts: effect on…

Innovation

- Low-cost innovation often tapped out by now (e.g., BPR, streamlining)
- Less/no money for higher cost innovation (e.g., IT)

Loss of funds

- State & local governments may lose federal funds because of poor reporting, compliance
- Loss of budgetary control
- Transfer of financial work to non-financial areas with no training

Audits & auditors

- Calls for more audits cannot be met without more personnel
- Less accuracy & detail

Little impact short-term, more mid-term,

long-term the dam may burst

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Effect of budget cuts: dealing with financial management budget cuts

Transactions & reporting

- Reengineer & automate transaction & reporting processes
- Use more charge & purchase cards
- Keep everything visible
- Communicate more with other functions & with operations

Set priorities

- Focus on medium to high risks
- Avoid unnecessary reports, especially if not required by statute
- Central agencies must take the lead in consolidating duplicative reports & compliance activities
- Get independent advice on methods of reducing unneeded work, then train inhouse staff to use those methods

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Effect of budget cuts: dealing with financial management budget cuts

Standardizing

- Standardizing financial processes & data across government saves time & money
- Will lead to more consolidation, economies of scale & true COTS financial software…
- …but also get better at using non-standard data – meta-data solutions can help

Consolidating & sourcing

- If it will save money or improve service at the same cost, then consolidate financial, budget & related offices
- Build a solid business case for consolidating, insourcing or outsourcing

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Effect of budget cuts: dealing with financial management budget cuts

Evolve toward evaluation

- CFOs must spend more time on programmatic issues looking at ROI
- Help to evaluate program efficiency
- To do this, financial managers *must* understand missions & programs

Basic blocking & tackling

- Basic accounting done well is an important boost to how governments spend their money
- Tracking & reprogramming funds, helping avoid improper payments, sound financial stewardship – all build confidence in a government's numbers

CFOs have the hard, cold facts about funding. Leaders ask for facts, but are often unhappy with what they hear.

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Special state government issues

What state financial executives think of 2 critical issues:

- *debt management*
- *employee benefits*



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State debt management

- State financial executives have an average satisfaction rating of of 3.6 out of 5 for how the governments manage debt – about a C+
- Suggestions for improvement:
  - Funding current operations with long term debt is a serious problem
  - More centralization of debt issuance & management, statewide policies
  - Less political & more institutional control
  - More transparency

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State employee benefits: retirement

- State financial executives have an average satisfaction rating of of 4.0 out of 5 for how the governments manage retirement benefits – about a B
- Suggestions for improvement:
  - Broaden investment options to get higher interest rates & returns
  - Have one umbrella advisory group for all plans
  - More transparency about funding long-term pension obligations & of changing benefit levels

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State employee benefits: health insurance

- From a **financial perspective**, state financial executives have an average satisfaction rating of of 3.0 out of 5 for their governments' employee health benefits systems – about a C.
- Raising performance in this area will depend more on larger-scale societal, political & cultural factors rather than any discrete thing that state governments can do, say several executives. This includes changing how the nation delivers health care & controls related costs.

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Conclusion

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Transforming Government
Answering some basic questions

- When & why was it created?
- Have conditions changed, and have we adapted?
- How are we measuring success, and are we achieving desired outcomes?
- Are there multiple programs, and if so are they working in an integrated manner?
- Are we using the experience of others (e.g., countries, states) to replicate success and avoid mistakes?
- Can we afford and sustain it in its present form?

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Limits to the Current Approach to Fiscal and Operational Planning and Management

- Too much of our fiscal planning is budget focused instead of outcome based (i.e., how much do we get instead of what do we need to accomplish)
- Much of our planning is based on historical vs. prospective data (did any of us plan for the recession 5 years ago?)
- Traditional approaches such as fair-sharing “haircuts” or 5-10-20 percent drills proved to be inadequate in meeting savings targets while retaining viable programs and services
- Exposed an absence of available, consistent, and reliable planning data (both financial and operational) that provides insight into cost and performance drivers that are essential to making reductions

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Funding Prioritization

- To optimize use of limited funding, government managers must prioritize which activities and services are most important in meeting mission and strategic goals (i.e., priority-based budgeting)
- Managers must also assess the degree to which performance degrades with reduction in resources (i.e. cost-performance tradeoff)
- Key activities and services should get high priority in funding to maintain or meet performance targets (to the extent possible)
- Non-essential activities and services should 1) get less priority in resource allocation, 2) be considered for reduction or elimination, and 3) have loosening of performance targets

We need tools and techniques that quantify the cost-performance tradeoff associated with mandated budget reductions

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Questions?



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