Mitchell's Musings 7/16/12: False or Just Misleading?

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California has experienced four municipal bankruptcies since the Great Recession: Vallejo (population 116,000 and now out of bankruptcy), Stockton (300,000), Mammoth Lakes (7,400),[1] and now San Bernardino (210,000). As news reporters descended on each, tales of unwise decisions by city authorities emerged. But while unwise decisions can lead to bankruptcy, some degree of underlying fiscal distress is often in the background. When there is money flowing into city coffers, past mistakes can often be covered over. There is the old Warren Buffett adage: *"Only when the tide goes out do you discover who's been swimming naked."* San Bernardino is in the heart of southern California's foreclosure belt so the tide definitely ran out for it.


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California City Under Investigation Drained Reserve Funds

By James Nash - Jul 13, 2012 6:57 AM PT

9 COMMENTS QUEUE

Law enforcement officials are investigating possible crimes in San Bernardino's city government, which almost drained special funds to prop up its budget.

The near-bankrupt state of the community of 209,000 east of Los Angeles came to light when a new finance director discovered that previous officials shifted money for workers-compensation and liability insurance to the general fund, said Andrea Travis- Miller, interim city manager.

The headlines around the San Bernardino bankruptcy hint at someone fiddling with the municipal accounts and even suggest some kind of criminal behavior, as can be seen on the left. However, so far no specific criminal behavior has been identified.

I have no inside information on what happened in San Bernardino. But it wouldn't surprise me if the supposed deceitful accounting turns out to be – at least in part - a natural product of the way in which sub-national public entities keep their books. In other words, the city council may well have been given "honest" reports in the years leading up to the bankruptcy and yet not understood where finances were heading thanks to normal public accounting methodology. It may turn out that San Bernardino's bookkeeping was no worse than that of other cities' but that, at the same time, the bookkeeping was a cause of the bankruptcy. How can that be?

Let's start with some basics of public sector account at the state and local level. Typically, a government entity will have a "general fund" as the operating account. A city will pay for such ongoing services as police and fire from that account. It likely will have other funds earmarked for special purposes outside

[1] Mammoth Lakes is a small ski resort and is the one of the four cities whose problems seem to involve factors apart from the general economy.

the general fund, often for capital projects. Usually, when you hear about a state or local budget, it is the general fund that is being discussed.

The various funds are viewed in public accounting – including the general fund – as analogous to a household's checking account. You don't want your checks to bounce and as long as there is enough money in your account to cover the checks, you can pay your bills. So in a sense, as long as checks are not bouncing, things are "all right." But note that you might be able for a time to replenish your checking account if it runs low by tapping your savings account or selling or depleting other assets. You might be able to borrow from some source. These methods will prevent your checks from bouncing but borrowing for current expenditures and/or running down your savings probably means you are in for trouble if you don't take some corrective action. What seems "all right" is not sustainable.

If the account in question was your personal checking account, you probably would spot the problem. But suppose you are a member of a city council or a state legislature and the account in question is the general fund. In normal English parlance, if a government is taking in less in taxes and fees than it is spending on goods and services, we would say it is in "deficit." If the reverse is true, we would say it is in "surplus." And if taxes and fees just match spending, we would say our account is in "balance." In fact, at the federal level, that is what we do.

If you are a council member or a state legislator and you are told by your finance staff that you have a "deficit," therefore, you would probably think that your fiscal condition is problematic and take some corrective action. You might not insist that the corrective action occur entirely in one fiscal year if you have some reserves or ways to borrow to ease the adjustment and the option to resolve the problem through a multi-year solution. But you definitely need to grasp the situation as being unsustainable to determine a) whether a corrective action is needed and b) over what time frame that action should occur.

Suppose, however, that your finance staff told you that you had a "surplus" or that your accounts were "balanced" even though in fact your general fund was being steadily drawn down. You might think your fiscal affairs were under control until you suddenly ran out of money. It would not surprise me if the San Bernardino situation turns out to be something like that scenario rather than criminal obfuscation. News reports suggest that some staff gave the council warnings of problems. But that message could have been lost if the accounting terminology suggested things were ok or under control.

Why might you be told that you were in surplus or at least in balance even though you were in fact in deficit under the common parlance meaning of those terms? Basically, state and local accounting tends to confuse stocks (your reserves or savings or net debt at a moment in time) and flows (taxes, fees, spending over a period such as a fiscal year). And it may treat borrowing or drawing down reserves or sales of assets as a form of revenue. If borrowing is treated as revenue for descriptive purposes, there really can be no deficit. If having any reserve on hand – even if small and dwindling - is called a "surplus," then you will be told you are in surplus until the last penny in your account disappears and you can't pay your bills. Such terminology, unfortunately, is common in public finance at the state and local level and elected officials can easily be confused.

Again, I have no direct knowledge of what went on in San Bernardino. But if the accounting staff treated borrowing as revenue (including borrowing from internal funds outside the general fund) or if staff described have any money in the general fund as a "surplus" or a situation of "balance," elected officials might truly have been surprised when one day there was not enough on hand to meet payroll. Yet because such stock/flow confusions and lack of clear definitions are common practice, there may have been no intent by anyone to deceive, let alone criminal behavior.

We'll see what transpires as audits and post mortems are conducted in San Bernardino. Possibly there was deliberate deception or even misappropriation of funds. But the basic message applies. In periods when - in Buffett's words - the economic tide is low (as will be the case for years in the U.S. if current forecasts are to be believed), elected officials need to have accounting with clear normative terminology. When they hear the word "deficit" it should mean that inflows from true revenue sources (not borrowing or running down reserves or selling assets) are less than spending and that some corrective action is warranted. When they hear the word "surplus," it should mean (and only mean) that true revenues exceed spending. (And it should not mean that there is still some money in the account, even though true revenues are falling short of spending.)

There is no guarantee that elected officials will make good decisions when they are given meaningful information conveyed by common-parlance terminology. But good decisions are hard to make in the face of misleading information.