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The Solari Report

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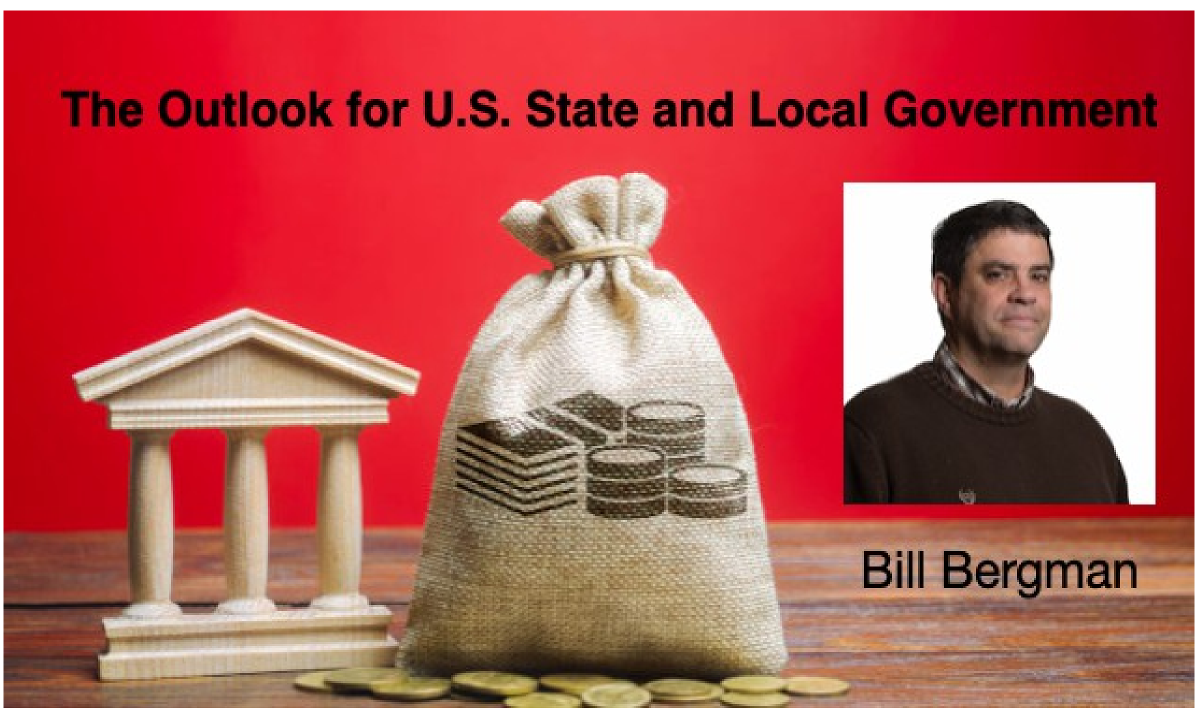
The Outlook for US State and Local Government with Bill Bergman



Summary: This week on The Solari Report, economist Bill Bergman, Research Director of **Truth in Accounting**, joins me for discussion of Truth in Accounting's new report **The Financial State of the States 2020**.

Not that long ago, most U.S. citizens could take state and local government stability for granted. No more. Understanding your state and local jurisdictions and their finances is becoming more and more important, a message that has been brought home many times during the events of 2020. Jurisdictional risk is real and growing with each passing month.

One important aspect is the financial soundness and management of your state or province. Truth in Accounting's new report on state finances is an excellent source for U.S. citizens to understand quickly where their state stands. Looking to move? Make sure you move to a state that is in sound financial condition. The implications for property values, future taxes, essential services, public safety, and law and order can be profound. All across the United States and the world, homeowners are having the value of their properties devastated by failures of local law enforcement or poor governmental financial management, resulting in rising property taxes and deteriorating municipal services.

While Truth in Accounting's work and this report focus on America's fifty states, the report offers ideas relevant to citizens throughout the developed world about how to analyze the finances, debt, and contingent liabilities of their local jurisdictions.

Bio: Bill Bergman serves as Truth in Accounting's Director of Research. He leads question formation, idea development and application of research initiatives. Bill delivers our daily "Morning Call" newsletter every morning to a growing and appreciative audience of influential subscribers. He leads and oversees the development of Truth in Accounting's databases. Bill also leads our federal projects. Bill has written more than 400 articles at "Bill's Blog."

Bill teaches finance courses at Loyola University Chicago. He has more than 30 years of financial market experience, including thirteen years as an economist and policy analyst at the Federal Reserve

Bank of Chicago. Bill earned an M.B.A. and an M.A. in public policy from the University of Chicago in 1990.

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Catherine Austin Fitts: Ladies and gentlemen, it is a pleasure to welcome back to *The Solari Report* one of my favorite persons in the world of finance and accounting. I want to give you a full introduction, but I also want to tell you, first and foremost, that it is really hard to find very smart, very honest money people who you can trust. I'm about to bring back one of them.

Bill Bergman is the research director and a leading light at *Truth in Accounting*, which is a very important organization. If you haven't discovered it, I hope that you do from this presentation. He also teaches at Loyola University in Chicago. He had a distinguished career – as did my mother – at the Federal Reserve. He was, unfortunately, too good at his job. He stepped into a very similar kind of situation as I did. He was bringing transparency where it wasn't desired, and he left the Fed and went to another great organization, American Institute for Economic Research, and then another organization whose services I have used for many years, *Morning Star*.

He has a really strong background on the academic side and the public side and the private side. So, he has a very well-rounded background.

Bill Bergman, thank you for joining us on *The Solari Report*, and congratulations on your new report on state governments. I will describe it this way: It's delicious.

Bill Bergman: Maybe I won't eat it after our conversation, but thank you very much for the thoughts, Catherine. It's great to be with you again. I still remember our first conversation back in 2004 or so. Time is 'flying', but time is money, and we all have to try to catch up.

Fitts: As I remember, when you were leaving the Fed and you wanted to know what you should do or where you should go. I said, "Just dive right back in." Isn't that what I said?

Bergman: I more or less did in choosing to go somewhere, and I went to the American Institute for Economic Research. That was my first job after leaving the Fed for about a year after their summer fellowship program. It's a unique place, started in the early 1930's by E.C. Harwood on the heels of the government's activities, among other places in the gold markets. It was a special place with one of the greatest libraries I've ever seen. If you care about money and banking and old material, they have all of these wonderful old books and reports in hard copy. It was just a fabulous place.

Fitts: I've had the previous president on *Solari*, and I often recommend their books.

Bergman: Yes, they have a good set of books for people who care about, not only their own finances, but the financial trends in the country as a whole.

Fitts: Let's dive in. Tell us about your new report. It's one that I want everyone in the United States to know about and to access.

Bergman: Thank you That is our flagship report annually. It's the first report that got Sheila Weinberg started on *Truth in Accounting*, which she started in 2002. She was concerned and initially exercised, more or less, on the Federal government's financial reporting and the condition of the Federal government, but then people in her 'neck of the woods' started tugging at her elbow and said, "You should probably take a look at the state of Illinois."

One thing led to another after that initial impetus, and Sheila and her colleague, Shawn Cruce, did some heroic work after, not only Illinois, but getting all 50 states' balance sheets – and I'm talking about the state government's balance sheets – on a framework that she thought was far superior than what the governmental Accounting Standards Board was requiring. The balance sheets, we've learned in financial markets in the private sector, are the dangers of off-balance sheet debt accumulation. Well, that was happening in spades in state and local governments throughout the country. The pension debt was effectively off the balance sheet along with another big number, and that was the retiree health care benefits that were promised.

Fitts: My recollection in just looking at the pew studies is that this is the worst; the healthcare is far and away the worst.

Bergman: It's big. At least in the current data, it's not as big as pensions, but it is also more uncertain. Maybe in that sense, the assumptions that go into the present values for those liabilities are even more uncertain than the pension plans. It's a big number. That is the main point, and resolving this will be difficult.

Some states are better than others, and that is what we have learned in our financial State of the States review. Among other things, we have 50 states on a consistent framework across the states. You can learn lessons from the good states and not just point out the bad ones.

In our latest review, at least for 2019-that is the latest fiscal year we have available- that is another thing that we can talk about. Overall, we saw some modest improvement from the year before. The trouble is that was in a fiscal year that started at least six months before the latest pandemic lockdown crisis. So, all we have is a picture of the latest that we have available. The modest improvement this year has been erased. It's going to take time to learn about that.

Thinking about those overall results, on average across the 50 states, the one thing that is somewhat disheartening – or even scary – is that there has been little improvement over the last decade on average despite the fact that the 2009 data, which is the first data that we have, was in the middle of the worst financial and economic crisis since the Great Depression.

Fitts: If you've had this much of an uptrend – which some people would call a bubble – and you haven't taken advantage of that to put your house in order, what are things going to look like when we are in a recession or worse?

Bergman: Yes, we should have been improving, and we weren't, on average across the states. Some of them, including my home state, were actually deteriorating in that timeframe despite the favorable economic and financial environment. You called it possibly a 'bubble'. I'm afraid that could be what the Fed did after the financial crisis. That's a little scary.

Fitts: One of the reasons I value this report and what you do and why I wanted you to come on is that I keep trying to stress to all of our subscribers that you must do due diligence on the places you choose to live. You are subject to risk in services or taxes or other ways – directly and indirectly – if your state is not financially sound.

Early in your report you defined the top five 'sunshine states' and top five 'sinkhole states'. So, you had the best five and the worst five, and I think that there are some real lessons to be learned by looking at those.

Why don't you introduce your top five sunshine states and your top five sinkhole states?

Bergman: Regarding the sunshine states, – the ones to learn from as a general rule –the idea that they aren't just lucky, most of them anyway. We will talk about some of them. The sunshine states include Alaska and Wyoming, which have had a tailwind from energy markets over the last few decades. We learned a lesson in 2015 that oil prices don't always climb to 'Heaven', and the energy-intensive states are likely to face growing challenges, including Texas and Louisiana in the years ahead.

Among our sunshine states, the ones to learn from – and I like to define it more broadly, not only the ones who have been lucky from the oil market developments, the long-term ones anyway – are states such as Utah, Idaho, Iowa, Nebraska, and Tennessee. These are states that are not just lucky, but they consistently do a good job of keeping their accrual revenues (not their cash-based accounting) ahead of total accrual expenses. They truly balance their budgets. That is the discipline that leads to a healthy and sustainable governmental posture, as opposed to the states that don't.

Fitts: I have to stop you for a moment and brag on Tennessee because, of course, I live in Tennessee. I've lived in Tennessee since 2000, and I know how hard they work at this, and I know how hard it is.

They are not a wealthy state. They are not rolling in oil revenues or anything else, but if you look at the discipline – both at the county and the state level – it's unbelievable. I moved there from New York and Washington D.C., and seeing a state which is that strict and conservative, many people thought we were 'fuddy-duddies'. It's somewhat like the 'revenge of the Methodists'. It is deeply conservative, but it has really stood the test of time; that is the only thing that I can say.

Bergman: It's hard to resist the temptations. What we are talking about are entities. They are governments, and they have something that is special compared to a local drugstore or a local sporting goods store; they have the power to tax. That power to tax is a tempting thing. You feel like you are in charge of your revenues, and it's hard to resist the temptation to spend beyond that power. But the states that do are the ones that are actually doing a good job of a responsible stewardship for their citizens.

Having said that, Tennessee is not universally in good shape.

Fitts: You didn't give them an A; they got a B.

Bergman: They are up there, but Nashville is not. That is the story lately; Nashville has been the problem child within Tennessee.

Fitts: I recently saw an email that said Nashville was going to raise property taxes 34%. I don't know if it's true or not, but I said, "Whoa!"

Bergman: Nashville has had a wake-up call. They were subject to the same types of political and special interest group pressures that infected other states that are in bad shape underneath the surface. Tennessee, the state, has done a responsible job of exerting greater authority over Nashville's finances in the last few years.

Fitts: One of the things that I really noted when I was looking at your five sunshine states: I did a study many years ago of the sovereign wealth funds, and Alaska is the only state in the union that has done the equivalent of a sovereign wealth fund. Most sovereign wealth funds are when commodity producers have boom-bust commodity cycles. So, what they do is build up the wealth fund in the boom cycles so that they can manage through the bust cycles.

I don't know as much about North Dakota because I looked at Alaska in connection with the sovereign wealth funds. But if you then look at Texas and Louisiana, you say, "Norway could do it. What's your excuse?"

Bergman: Texas has more of a reputation than it deserves on this score – both directly from building a sovereign wealth fund versus indirectly from the tailwind from energy prices that Texas had for a long time. Texas should be in much better shape than it is compared to Wyoming, North Dakota, South Dakota, but it's not. That's a sign, too, that I'm afraid we are going to have some more exciting stories out of Texas in the coming years.

Fitts: I can tell you North Dakota's secret is twofold – in addition to the oil, of course. One is they have a state bank, and two, their legislature is part-time, not full-time, and they only meet once every other year.

Bergman: I hope they don't have too much to manage. The state bank idea is very interesting, and we can talk about that at some length. I consider the hands of a state bank in Illinois or the hands of the city of Chicago as a frightening prospect. So, I don't know if that is a solution for Illinois.

Fitts: I know much about New Jersey. When I was turning to the sinkhole states, I was the underwriter for the New Jersey turnpike, for the Garden State Parkway, and junior manager on the New Jersey turnpike. To me, it's all *Soprano*-country, and I know plenty about it. It just goes to show you that corruption does not make for a well-managed state.

Bergman: As a general rule, both illegal and legal corruption and the ways in which special interest groups can manipulate legally public policy for their selfish interest at the expense of the general citizen is the driving force behind the tendency to overspend and not save for the future if the average Joe and

Jane are paying the price down the road. That is the thing that we need to guard, and that is why we need to do our due diligence for understanding our local places.

Fitts: I look at New Jersey and all the wealth and the rich land and the ports and the resources, and I look at Illinois and Connecticut, and I just shake my head.

I haven't been looking deeply into municipal credits for many years, but whenever I look at them, I just shake my head. How could it have gotten that bad?

Bergman: The dollar amounts are staggering. For instance, the city of Chicago and the state of Illinois and New York City are dramatically in debt. I'm afraid that part of the reason they got so bad is that they benefitted in the short run from false advertising in the accounting statements they provided and the communications they provided. The Governmental Accounting Standards Board (GASB) has fixed those to some degree in recent years with the recognition of Other Postemployment Benefits (OPEB)and pension, but their current position is the product of decades of mismanagement and effectively spending beyond their means, which was enabled, in part, to bondholders.

You asked about bankruptcy and what that looks like. I'm afraid bondholders helped enable the 'kick the can' down the road environment, which New Jersey, Illinois, and Chicago were able to 'feed the beast' as long as they did.

We are talking now about the accounting for budgets as opposed to the financial reporting. That is something that will be a hot issue in the next year or two with GASB's financial reporting model project, which is a longer story. But the budget accounting has long relied on, more or less, deceptive cash-based accounting principles for the funds accounts that are provided by governments.

Chicago claims to balance its budget according to state law every year. If they do, then how did it get into such a 'deep hole'? I asked the question of one of the colleagues of the former financial committee city council chair, Ed Burke, who is now under scrutiny for a corruption investigation, "How do you claim to balance the budget when your accrual revenue is lower than your accrual expenses every year?"

He was almost proud in his response. He said, "We have access to the capital markets. We borrow the money."

In fact, they think about borrowing proceeds as a form of revenue.

That is the environment within which you build up your balance sheet and you grow in the short run with long-term consequences. They tell us that they balance the budget, but they are running up the credit card in order to 'balance the budget'. It's almost like an oxymoron.

That is why we believe that the budget accounting and the funds accounting at the GASB need to be revised and changed.

Fitts: At the same time, one of the things that we've seen is a real breakdown in the rating process and in the accountability of creditors. The creditors, especially the mutual fund system, has just decided, "Okay, we have to put money out, and we are not going to worry about what could happen five years from now. It's not a next year problem."

So, there is a 'kicking of the can' by both the rating agencies and the bond market, which is very scary.

For ten years I worked as an individual investment advisor, and I would look at some of the people's holdings and I would think, "Why in the world do you own this?"

What I realized is that if you looked at the ratings, it appeared okay if you didn't know any better. So, I think that the system has been very 'kick-the-can-ish' across the board, and I don't know what the rating agencies are doing.

I was really struck by page 19 of your report. You pointed out that California has yet, as of the end of August, to produce financial statements for 2019. Well, why would anybody let them go into the bond market under such a situation? That is shocking to me.

Bergman: If you are in the private sector and don't produce financial statements, what happens to you?

Fitts: You get delisted; you can't go into the market.

Bergman: Your CEO is 'out of there'. But that is not the case with governments. Governments are above that – at least in the short run. The maelstrom may be there down the road for a few of these people.

With the rating agencies and the bonds, there is a debate about how much the cost of resolving the 2008-2009 crisis was for the taxpayer. Some people say, "Oh, they paid back the loans. It's okay."

I'm afraid that one of the understated and possibly overwhelming costs that is not in that accounting is the fact that the world saw the bailouts and said, "Hey, they can do that again," and we didn't see the moral hazard of the resolution, but we see that today.

The special interest groups attached to governments – not only the bondholders – have an unholy alliance with organized labor and other special interest groups that are attached to the governments. They point to the bailouts in 2008-2009 and say, "You are just bailing out Wall Street. Why can't you just bail out us?"

That is why we let ourselves get into this hole; they are looking for a bailout today.

Fitts: There are two other things that are happening here that I want to get your thoughts on. One is currency debasement because the Feds can literally print money, and the states can't. If the states could float their own currency, they would be in much better shape if it was properly managed. That is a big 'if'.

With the Feds constantly debasing the currency, and the states keeping much of their balances in dollars, they and their citizens are getting drained.

Bergman: Let's look first at the Federal government and its confidence in its ability to print money. The Federal government's balance sheet has roughly $4 trillion in assets, $24 trillion in liabilities, and those are understated in our view. Four minus 24 gives you a 'big hole', but the language introducing the balance sheet includes the following two "comforting" sentences, "There are, however, significant resources available to the government beyond the assets presented in these balance sheets. They include the governments, sovereign powers to tax, and to set monetary policy."

In other words, we should feel okay about our government; it is going to be okay because it can: A) Take our money away, and, B) Inflate the value of the dollar away.

Fitts: It can also seize our property. When I was on the Board of the Gold Anti-Trust Action Committee, they wrote a letter to the Treasury saying, "Do you reserve the right to seize and confiscate gold?"

The Treasury wrote back and said, "No, we reserve the right to confiscate everything."

Bergman: Oh my gosh! The lesson of 1933, which you are very aware of, is that gold seizure possibility. I'm thinking out loud here, but what if we have a world where bitcoin and other cryptocurrencies become more widely accepted? Is it possible that government asserts this power to seize valuable things?

Fitts: I would point out that when they confiscated gold at that juncture – and I would also point out that they only got what you had at the bank – it was a portion of personal savings. Now it's IRAs and 401(k)s. That's where I get nervous. And I don't think they have just to seize it; they can play all sorts of games like all of a sudden, you have to buy Treasurys, or, "Oops! Now it's an annuity."

Bergman: And now we get into an arena that is a fascinating one. Speaking of watching and doing due diligence on your government, you have to also watch the constitutional law issues for the relative authority of the executive branch versus the Congress. When they do this kind of thing, it tends to be exercised through the executive branch under national emergency authorities and whether or not we have an active and willing judiciary and/or Congress to stand up to those extraordinary situations. That's 'Crisis Management for Citizens 101'.

Fitts: Let me bring up another subject. I think one of the reasons the states are struggling is that the Feds are constantly giving out grants and infrastructure money and other money that look like it's budget-positive until you have to maintain the stuff, and then it goes to budget-negative. So, I think we are seeing many projects being done that are fees for our friends that aren't justified by the private economy.

Chuck Marohn at *Strong Towns* has done a lot of work to show that dynamic. I know you are familiar with this, and it is exactly what I ran into when I worked in the government. It's, what I would call, 'negative return on investment' money, and it came with massive amounts of rules.

I had a bit of a squabble in my town. I'm trying to stop them from putting in a walking path. There is nobody who is going to use it, and there are only three people who walk. One is me, and the other is a colleague, and we are both happy to walk on the road; we don't want a walking path. So, pouring concrete all over the lovely town commons – and this is a town that has worked for decades to save reserve funds, so they are very well-managed – is going to spend an unbelievable amount of funds doing the match for this walking path. I think that we could do it cheaper if we just paid 100% and did it ourselves.

The matching funds came with five pages of rules and regulations of the different laws that they had to apply. If I had taken my attorneys and tried to figure out what it really meant, it would have cost me $100,000 to figure out what we were liable for.

All I know is that by the time they decided they wanted to audit and investigate us, they had us 'over a barrel'. But if you consider what we knew we were supposed to do, it was very, very expensive.

That was going to be the world's most expensive walking path. It's 'the gift that keeps on giving'.

Bergman: It's a gift for somebody. Somebody wants it, and somebody is getting paid. That is part of the program. The complicated laws are feasts for lawyers who have to administer the system.

When we look across the 50 states, for instance, there is a remarkable correlation if you look at the condition of state and local governments' finances and the actual number of lawyers per capita in that area. You see a very distinct correlation. Lawyer-intensive places tend to be in worse shape.

Fitts: I do believe is, if you look at the employment statistics, one of the things that have happened is while corporations have been re-engineering and cutting out labor and downsizing, if anything, government employment has trended up slightly. So, we have never seen the same kind of re-engineering on the government side. My fear is that this is coming.

Bergman: It's how you define the 'public sector' and 'public sector employment'. The formal government statistics that were given that distinguished between government employees and private sector employees, shows there are many people in the 'private sector' who are effectively working on the government contracts or the government 'dime'. The government is bigger than we think.

Fitts: When I first got to HUD in my area, I looked at all the big programs that I was doing – FHA mortgage insurance and Section 8 subsidy. When we started those programs, \$0.70 on the dollar went into a local neighborhood. By the time I found them, \$0.29 on the dollar went into the local neighborhood, and everything was Federal, state, and local bureaucracy or intermediaries and not-for-profits and contractors. Everybody was 'feasting' on it except for the recipients. It was extraordinary.

Bergman: That is the lesson from the public choice school of economics. Government tends to be coopted by well-organized special interest groups, and so-called 'public services' that are provided for the public are actually coopted and captured by special interest groups that use them for their own benefit at the expense of the average citizen.

Fitts: One of the things that I've always believed is that if you could make government finances understandable and accessible to the citizenry who are paying taxes into those entities, you could get much more accountability. One of the reasons I love this report and encourage everybody to go to the *Truth in Accounting* website and download it (you can find it on the homepage) is that this report makes it so easy. It's really well-written, and it's very accessible.

You go through why it is so important to have good financials and good financial reporting, and it's an easy read. You do it really well.

Bergman: Thank you. It's not easy to make things easy in this 'neck of the woods', but that is what drove Sheila to develop this framework. Her passion was helping citizens and enabling them to understand. In order to do that, and to do it on a consistent framework across the 50 states in a relatively simple way, is what drove her to develop this report.

Fitts: If you look at this report and then meet with any of your state legislators, you are in a position to have an intelligent conversation with them about what they are doing and why they are doing it and why aren't they doing a better job.

I have a dear friend who is very involved with their city council in California. As soon as I read page 19, I sent it to him and said, "You had better start 'yapping' at people. This is not acceptable."

Bergman: One way to use the report along those lines – and I'm just thinking out loud and reacting to you – is there are interesting stories about next-door neighbors throughout the 50 states. Kentucky and Tennessee are like night and day. Kentucky is more or less a disaster, and here (Illinois), is right next door to Tennessee. Why are two very close places so very different?

You can learn lessons from each other about what to avoid or what to do. Conversely, Illinois and Indiana are like that, too. Illinois has a long border with Indiana, and Indiana has been responsibly and carefully run.

Having said that, there are Republican places out there, too, that aren't necessarily run well. Historically, Texas was thought to be the paragon of Republican and fiscal conservativism virtue, but I'm afraid that things have been moving in another direction.

Fitts: I could tell you stories from HUD because they were the paragon of stealing the most money out of the Federal coffers.

Bergman: And the S&L crisis and all of that. Texas has some bad history for sure.

Fitts: The percentage of the losses at the RTC that were attributable to Texas and their 'pals' in Colorado; we were losing massive amounts of money at the FHA fund when I first got there. What I discovered was that we were making a profit in eight regents and losing money in two regents that was more than the profit we were making in the eight. Of course, it was Texas and Colorado.

Your report ends with the 2019 financials, all except California, which has not produced theirs yet. You mention that the results of the different economic events of 2020 are going to produce very significant deficits.

I saw a report about a month ago from *Kiplinger* saying that it was going to add $500 billion to the net deficit of the states. You had a number that was about $396 billion.

Bergman: Yes, I made that number; that is a story all by itself.

As soon as you start trying to get specific like that, you have to step back. That is why we developed an acronym for our guess at the shortfall from revenues. We call it a 'SLEG'; it's a Sloppy Logically Educated Guess.

At the end of the day when you try to do something like that, you realize what you are assuming about the future and what you know about the future and how uncertain it is. Another part of that equation is the fact that state and local governments think of the Federal government as a source of revenue, too, and the possibility of a bailout is not part of our $397 billion – depending on which party is saying what. The uncertainty about Federal government intervention right now is very high leading to the current election environment, which is incredibly intense.

Fitts: One of my favorite quotes is from the German Finance Minister at the 2018 G20 meeting in China who said, "The debt growth model is over. There are no reforms that aren't real reforms," which means, "We can't borrow our way out of this; we have to cut. We have to change."

I think that is where we are. So as I look at the 50 states, we are talking, not just about the change of significant loss of revenues or hits to expenses in 2020, but if you look at the extent to which small business have been wiped out and incomes have been destroyed, if you look at 2021, 2022, or 2022; I saw a chart that said that 49% of the small businesses in San Francisco are expected to be closed or shut down or bankrupted in 2020.

How does a municipality adjust when its accruals for pension funds and healthcare cannot get cut very much?

Bergman: I'm afraid that is part of the incentive and motivation for many state and local governments – not all of them – to rely on Uncle Sam. In turn, many people think that the Federal government's authority to borrow and print money is a resource. We're not at the day yet when they stop showing up to buy Treasurys.

Fitts: We saw the announcement that the deficit this year is now up to $3.1 trillion. I don't know if you saw that headline.

Bergman: Yes, I did. Possibly, the real one is even bigger when you consider the unfunded Social Security and Medicare, but that is another story.

One of the lines about bankruptcy is: How did you go bankrupt? "Slowly, and then suddenly."

I'm afraid at the Federal government level, I don't want to be a 'scared rabbit', but we should be careful of abusing that possibility.

Fitts: We face the issue of: 'What does bankruptcy look like?' at both the Federal and state level. In one sense, the Federal government can't go bankrupt because it can always print.

If I could print money off my computer in 'Catherine dollars', I can always pay my creditors because I just have to print money to pay them. But what that means is the dollars I print are – at some point if you go up that S-curve – very worthless.

Bergman: That is a form of bankruptcy; it's a form of default.

I teach money and banking at Loyola, and I love to tell the students the story of this old Jesuit monk, Juan de Mariana, from the 1500's. This fellow wrote a rant against inflation at the time – the way in which the king would debauch the currency by taking the gold content and silver content out.

He wrote this rant against inflation, and he also wrote an argument about when it is ethically justified to kill the king, but his rant about inflation is the one that got him into more trouble than the argument for killing the king.

Fitts: Let's face it: Jesus got crucified because he threw the central bankers out of the temple, right?

Bergman: We are laughing, but this is serious 'stuff'.

Fitts: Jesus on the cross in the front of the church is basically a subliminal message to the youths saying, "If you mess with our money, here is what we are going to do to you."

Let's talk about what bankruptcy looks like at the state level. First of all, there is a serious question as to whether states would be allowed to go bankrupt. So if they run out of money, what we are talking about is preserving tax revenues for the bond holders and slashing services to the 'bone', or raising taxes or both. Or, they could literally confiscate property.

Bergman: The states also have an incentive. 'Push will come to shove' first in trying to get money from the Federal government in order to forestall this process. When we get to that 'push' versus 'come to shove', we are going to see – as we are seeing today – the migration trends very significantly directly correlated. As you were talking about, as citizens, we should be looking at our governments. Well, the governments that are in bad shape are seeing exit. The 'lab rats' are escaping, and that is going to be a source of competitive pressure.

Fitts: I wanted to ask you about that because you, of course, are in Illinois. John Titus always joins me on *Money & Markets*. He has been joining me for the last couple of months, and he left and went to Indiana. He moved out of Chicago, which he loves. Of course, we have many subscribers who report leaving California and San Francisco.

To what extent are people migrating out of these states?

Bergman: They are doing it because of the prospect of higher taxes and what they see as government services. This is not just a higher income phenomenon; lower income people who depend on government services have seen pressures on those services. And the property taxes for people in Chicago on the west side and the south side relative to the value of their property, has made living in Chicago a less attractive proposition.

Fitts: Right, and property values have gotten hit quite hard.

Bergman: They have, especially in the south side and the west side of Chicago. The migration trends are real, and that will help the day of reckoning come sooner rather than later.

Fitts: I will tell everybody listening or reading this, that if you are thinking of moving to a location in the United States, this is a must-read report – and not only for you. If you have a family member, a relative, a friend, or a colleague who is moving, they have to do due diligence on their state and their local jurisdiction. We are coming into a world where the jurisdiction matters a great deal. I think that is why for anybody who is moving in the United States, this report is an incredible blessing. It dramatically lowers the time that it takes to do due diligence on a state.

Bergman: Thank you very much. That is what we try to provide, along with our companion website called *Data-Z*. You can do charts based on all this data. Look up our *Data-Z* website, too.

Fitts: It's great!

One of my concerns is that when you strip services and try to 'claw in' more money for taxes, then you start with, what I call, the 'piratization'.
Bergman: I thought that was a typo when you sent that to me.

Fitts: No, no, that's not a typo.

Bergman: Then I realized, "Oh, no. That's what she really means."

Fitts: 'Privatization' is when the liabilities and assets transfer at market values. 'Piratization' is what really happens in most cases when they decide to play this game.

Bergman: As the downward spiral begins and people can see it, the incentives are to be the first one to the 'lifeboat'. Financially, that can be described as what is happening, not only with bond holders, but with creditors like banks, as well as the pension funds and trying to cement your authority and seniority within the overall resolutions.

You asked what bankruptcy looks like. Well, you tend to see a competitive process among various forms of creditors trying to get seniority in creative ways, which includes things like pension obligation bonds. One way to try to gamble for resurrection right now for some of these states and cities is to issue bonds and then put the money in the pension funds. Then 'poof', you have a good pension fund. But guess what? That is a way to elevate the position of the people in the pension plan at the potential expense of the taxpayers in the jurisdiction.

Fitts: Although I have to tell you that with interest rates this low, it is tempting. Interest rates are so low that it's tempting.

Bergman: Maybe it's a little too tempting! There is no such thing as a 'free lunch'. Maybe the rates are low for a reason.

Fitts: Absolutely. So, take us through the next year with the incredible pressures coming from all the different things happening. What do you think is going to impact the average American vis-à-vis their state?

Do you reside in Illinois?
Bergman: I reside in the southwest suburbs of Chicago.

Fitts: So, what do you and your family do to protect yourself from this? What do you do? What should the person listening or reading this who lives in the

United States do to protect themselves in terms of their state financial risk?

Bergman: I know what I think, but if you talk about my family, they think something else. I would like to move, but my wife and her family are all within a mile.

My main point here is that we all have our individual circumstances. I can't recommend any avenue for any one person, depending on their own preferences. But I advocate that what citizens, in general, should have been doing 20 years ago was to be taking a more active interest in the affairs of their local governments and their finances and being aware of the trends and educating themselves on those trends. To the extent that you can, be an active participant in a force for good financially in your environment.

Fitts: In the state and local area, you absolutely can. If you look at how much time we all spend on Presidential elections, if we just took half of that and spent it on our state and local jurisdiction, what a difference it would make! It would be unbelievable.

Bergman: I live next door to a great grade school. That is one possible solution that Illinois may have in the future is privatizing education. I looked at my grade school's district's financial report, and I might have been one of . 0001% of the people in the district to do that, and it was a little frightening. They have been borrowing money, and the interest expense for an elementary school district ballooned in the last ten years in a period of declining interest rates.

They were spending more money than they took in, and they were borrowing to make up the difference. The degree of interest expense was large, although I don't have the exact number; the main point is to take an active interest in the local finances in general. That includes school districts, not just the City of Chicago.

Fitts: Absolutely. I know that this isn't your 'spin', but I'll do the *Solari* 'spin' right now. People always say to me, "What can I do politically about something that my state or local area is doing?"

I always say, "Dive into their finances."

They say, "This isn't about finances."

I say, "Yes, but that is where you are going to get them."

What you need is political leverage. The way to get political leverage is to go through the finances and look at whether or not they are following the laws and the rules and managing the finances responsibly. If you look at the political problems that people have, usually those political problems show up where they're not managing things responsibly.

Bergman: Yes, it's good to be aware of who is following the law or not. That brings up another issue regarding the tendency for the states that are lawyered up to be in worse shape financially.

I would encourage you to look at your local municipal code. I looked at the State of Illinois Municipal Code on the internet, and I started scrolling down. Then I realized that it would take about 10-15 minutes to get to the bottom of the page. It was the longest document I think I've ever seen in this job, which is another sign that the extent to which places that tend to be lawyered up are not in good financial shape. Individual lawyers, per se, are not bad things; they can be great things.

Mancur Olson, the great public choice school economics person, did some great work looking at the role of lawyers in economic growth, and one of his main cautionary notes is that when you see many lawyers, it is a sign of other forces that aren't necessarily good for you.

Fitts: China has plenty of engineers, and we have many lawyers. That's not necessarily a good thing.

Let's talk about some of the reforms that you recommend in the report. What are some of your recommendations that somebody can pick up when they are visiting or talking to their state or local representatives?

Bergman: Two of our recommendations have been achieved in practice. One is the recognition of the pension liability and the OPEB liability. At least they are there. However, there is still work to do in the world of financial reporting.

One thing that we are currently working on is the Governmental Accounting Standards Board, which is undergoing a financial reporting model initiative. This would effectively cement the short-term view's cash-based accounting as a way to account for these governmental funds. This would in turn, effect the budgets of the state and local governments that are not in the control of the Governmental Accounting Standards Board.

Encouraging your local government to consider budgeting and not to think about borrowing proceeds as revenue in the budgeting process is another thing you can do. Do your best to inculcate an accrual accounting, not a cash-based accounting framework, that recognizes expenses. Try to make sure that those Comprehensive Annual Financial Reports (CAFRs) are reliable and the statement of activities (the income statement) are reliable.

We can give a refresher if you want on how to look at these things, but the statement of activities does have a bottom line that is relatively reliable, and that is the 'all accrual revenue' minus 'all accrual expenses', which leads to the change in net position. Try to enforce an environment in your state and local government that actually keeps that number neutral or positive as opposed to 'kicking the can' down the road.

One of the solutions in the short run for the financially-pressed places these days is planning to spend less money on putting it into the pension plan. That is a way to reduce your 'expenditures', but that is one way to have your expenses on an accrual basis actually go up because you didn't reduce them.

The accrual accounting method is very important, and I would encourage people to learn about the differences between accrual and cash-based accounting as a way to interpret claims. For instance, the City of Nashville claims to balance its budget every year, but they use the funds accounting – which they state represents the difference between all assets and liabilities. That's not true on an accrual accounting basis. That is why Nashville got into their current situation.

Fitts: That's how people get into trouble. If you looked at the FHA, that is how FHA and all the insurance fraud got into serious, serious trouble.

Bergman: It's by not recognizing losses when they happen.

Fitts: We did a huge amount of reforms in the Bush Administration to get all the credit programs on an accrual basis. So, when they decided to start playing games again, they just started lying about all of the assumptions.

Bergman: There is a parallel story from the savings and loan crisis. One of my favorite people is a man named Ed Kane at Boston College. He's the person who coined the term 'Zombie Bank'. Ed decried the way in which the regulatory accounting principles that were crafted by the regulators and the big thrifts actually made insolvent thrifts look solvent when they weren't. They had an incentive then to gamble for resurrection.

In our public pension plans, shortly we are developing a zombie index for Halloween to identify the states that are the most at risk of potentially gambling their way out of their pension problems with higher risk portfolios. I'm afraid that the same types of incentives that we are facing today in Illinois are the same ones that we didn't learn the lessons from in the S&L crisis back in the 1980's.

Fitts: And I would also say that we did a big report on pension funds in 2017, and from what I saw, if you look at how they were trying to get yield, they were putting money with private equity firms who were doing things that were destroying their long-term economy. So, you have these private equity firms 'juicing' their yields by very destructive things that make money fast but ultimately drive down the GNP of a place. I think that the bigger one is not in the pension game.

I spend more and more time – and this is what happened to me as an investment advisor – focused on how government policies are causing children to become not economically productive. When I was an investment advisor, I dealt with a lot of vaccine injury and some vaccine death, and the poisoning in the food, the pesticides, the GMO foods, and things that really caused children's health to deteriorate.

The current statistics are that 54% of American children have a chronic disease. We just had a wonderful pediatrician on *The Solari Report* who said that it is 70% because so many families can't afford the testing to establish that they have chronic diseases. Bobby Kennedy now says that their IQ points have fallen seven points.

It's a combination of things; it's a cocktail. But when you allow government policies to produce an entire population who is unable to compete globally, and if you take seven points from their IQ against the Chinese, they are toast.

These are things that have a much longer-term impact, but they will ultimately come back around and hit everything from Federal, state, and local finances, to family wealth and on and on and on.

Bergman: Our children are inheriting our Earth now, and unfortunately, what we've bequeathed them federally and in many state and local jurisdictions isn't what children had 50 years ago in some ways. I'm thinking about infrastructure now, just reacting to you. One of the critical things that should or should not be in government but is, is the management of the water supply. The infrastructure for water distribution is something we learned about in Flint. Hopefully, Flint is only an anomaly, but it is still a risk given that the state and local governments that are in trouble may have difficulty funding infrastructure maintenance in the future. That will be a risk to the health of the water supply and the children drinking it today.

Fitts: The whole economy, including the private economy, 'dances on the platform' created by all sorts of regulatory and facilities functions of the government. If the government doesn't work optimally, ultimately it will come back and get all of us one way or another – including the big corporations. That is why I've been appalled at the extent to which they are happy to disinvest in the governmental infrastructure and let it deteriorate to the degree they have.

Bergman: I've been depressed that the business community and the business leaders in Chicago allowed the finances to get where they are. You would think that a relatively sophisticated financial place like Connecticut, with the home of the insurance industry and/or the accounting community, would do better with their finances. Why did the financial communities in Chicago and Connecticut allow these jurisdictions to get to the position that they are in? The civic leaders weren't leading in a way that would have been good for them.

Fitts: I was booted out of Washington and you were booted out of the Fed for being financially responsible. So, you know why they didn't do it.

Bergman: Hopefully, we can learn a lesson, not only from you and me, but in general, the importance of respecting integrity and fighting corruption in government. We all have a shared interest in that in the United States.

Fitts: If anybody in the economist profession has stood up, it's been you.

So, tell us what's next for *Truth in Accounting,* and what you are up to for the next year, how we find you, and how we find your work.

Bergman: We are still plugging away. We're at www.TruthInAccounting.org. That is our main website.

I produce a daily newsletter called *Morning Call,* which has roughly 800 or 900 people a day addicted to the distribution. I try to scour the world every morning for the best stories that I can find – the most intriguing ones, anyway – about government finance.

Fitts: I think that you did a great conversation and covered Mark Skidmore's reports.

Bergman: Yes, on the Defense Department.

Fitts: He has a new report on the Thrift Savings Plan, and it's a 'doozy'. I don't know if you've seen it yet.

Bergman: Not yet. I'll google it.

Fitts: I'll send it to you.

Bergman: Thank you. We also have this *Data-Z* website that I recommend.

Fitts: It's great! Give us your URL again.

Bergman: It's www.TruthInAccounting.org.

Fitts: There is a great place in this world for people of integrity, and you are proof.

Bergman: I hope so. I think that an important component of integrity is humility and the extent to which you can't necessarily recommend what is good for all. But our government needs more of that and not less of that. So, thank you for your kind words.

Fitts: Bill Bergman, thank you for joining me on *The Solari Report*. Give us the name of the state report again so that everyone can find it.

Bergman: *The Financial State of the States*. It's at www.TruthInAccounting.com by Sheila Weinberg, our CEO. If you google that, you will find the report rather quickly.

Fitts: Thanks again. Have a great day.

Bergman: You too, Catherine, and it is great to be with you again.