CHAPTER ONE

1

Government and How It Works

"Every gun that is made, every warship launched, every rocket fired signifies in the final sense, a theft from those who hunger and are not fed, those who are cold and are not clothed. This world in arms is not spending money alone. It is spending the sweat of its laborers, the genius of its scientists, and the hopes of its children. This is not a way of life at all in any true sense. Under the clouds of war, it is humanity hanging on a cross of iron."

—Dwight D. Eisenhower

Topics:

National Government
State Government
Local Government
Agencies
Public Authorities
Public-Private Partnerships

Key questions:

Can government forms regulate morality?
What are political agents looking to do?
What are the forms of government?
Where are the best observation points in these entities to identify the risks they face?

THIS CHAPTER WILL INTRODUCE the reader to various operational and organizational aspects of government. It spells out how and why government functions the way it does, from a fiscal perspective, setting the foundation for the ultimate exploration of the potential for government fraud and mismanagement. The examination of the cash flow that migrates into and out of the various governmental units is key. Prime examples of activities that can create opportunities for mismanagement and fraud are: the strong centralization of activity in the federal government, the significant financial transfers between the federal and state governments, and the direct fiscal effect of state government on the municipal (local) level. These types of intergovernmental transactions should be subjected to strict professional scrutiny.

We will examine the key forms of government encountered in American society, the role each level of government plays in our lives, and its effects on our wallets. We will examine the primary sources of government revenue, spending, and capital infrastructure, and how government borrowing funds its long-term existence. The reason it is important to analyze the forms of government is that it establishes the environment in which the public entity must operate and leads to developing a better understanding of abnormal or deviant behavior. A key element in understanding why fraud happens is to understand the perspectives within which people operate in order to develop the appropriate systems and structures to prevent fraud and mismanagement.

One thing we are going to ask you to consider throughout this and all the chapters, is how the moral standards and structural practices of a public entity form and the behavior of the people who are involved in the process. We then ask you to think about how would you observe and verbalize your findings. When you are in the field, you need to actually develop creative ways to generate an opportunity to examine these people from two perspectives, exploring both their visual cues (how are their bodies reacting?) and verbalization (supportable/believable), preferably unexcitingly. Watching the trusted parties' visual cues and verbalization with respect to their actions will potentially generate warning signs requiring further reexamination.

This examination does not necessarily have to result in finding fraud. Nervous people may be nervous because they are not comfortable speaking in public. This thinking helps in designing systems and structures as you identify weaknesses that may need something as simple as training or support to make the nervous party comfortable. A solid approach is to watch people in action and monitor them as they speak. Remember to always document your findings.

Understanding the basics of the governmental structures and operations and the various types of governmental levels and entities is one of the key elements in developing an understanding of how potential misstatement and fraud can exist in the overall governmental structures. We look to explore the mechanisms that create and maintain the power of political entities and how these entities interact with the general public and each other. A particular emphasis is placed on public agencies and tiers of authority. A thorough understanding of the hierarchy in any organization is imperative in following the flow of money and who enables access to cash resources. By examining the behavior surrounding the flow of money we begin to develop the necessary insight needed to institute the proper levels of internal control. It all starts by ensuring the correct ethical behaviors are in place. Remember the "Tone at the Top."

Governmental entities serve many functions in society. Knowing who the potential enablers and detractors are and their personality behavior is important in building systems and structures around them that lead to accountability and mitigate fraud and mismanagement.

TYPES AND FORMS OF LOCAL GOVERNMENT: AN EXAMPLE FROM NEW JERSEY

Government comes in many forms. Even at the local level, there are significant variations in the structures and operations in which people function. Each of the structures has its own inherent quirks, power structures, and process requirements. Therefore, an understanding of the broad variations gives insight into who has their hands on the levers of power, poised to push for good and/or corrupt purposes.

In New Jersey, there is a staggering number of municipalities per capita—565 for a population of 8.9 million. Right next door, to the east, is New York

City, one massive municipality of 8.2 million residents in the state of New York that is run by a singular governing body.

The types of local government, according to the New Jersey League of Municipalities, are borough, township, city, town, and village.

Each of the 565 varying types of municipalities in New Jersey is run according to one of 12 forms of government: Borough, Township, City, Town, Village, Commission, Council-Manager Act of 1923, OMCL Mayor-Council Plan, OMCL Council-Manager Plan, OMCL Small Municipality Plan, OMCL Mayor-Council-Administrator Plan, and Special Charters.

The first five forms are associated with a particular type of municipality. Each of these five types has a unique form of government historically associated with it. The next seven forms are "optional" forms of government available for adoption, with the exception of the OMCL Small Municipality Plan (which is available only to municipalities with a population of under 12,000), by all 565 municipalities.[1]

Government attempts to organize itself into various segments much like ants form eusocial colonies. It's within the concept of grouping communities where the conflict often arises, as smaller communities have different needs than larger. In explaining the decision making, or voting power, of different forms of municipal government, terms like "strong mayor–weak council" and "strong council–weak mayor" are often bandied about. At the end of the day, it's a form of division that is often created by one interest, not in agreement, with another. Unlike the ant colony that builds its lifestyle around the family unit and operates in a highly organized structure with defined roles, the governmental unit often finds itself with conflicting self-interests and roles that are not always clearly defined and with the overriding power in the hands of a few.

Think of it this way: Strong and weak are opposites, and, while they attract one another, they often create control conflicts. There's the stronger politically connected individual versus the weaker. There are the rich versus the poor. The rich feel they pay their fair share of taxes, and the poor think the rich do not pay enough. In order to develop sound systems and structure, there is a need to understand all interests involved.

New Jersey has 565 municipalities that are, in turn, run under the umbrella of 21 county governments. To further break down the myriad of New Jersey public agencies, the New Jersey Office of the State Comptroller identifies 55 state authorities, 205 local commissions[2] and authorities,[3] and 604 school districts,[4] not to mention the organizations that cluster under the state government itself. All of these entities were created to serve a population of 8.9 million people. Based on this data there is one public entity for every 6,160 people in the state.

The typical fraudster loves all this hierarchy and bureaucracy, as it has a high distraction potential. The fraudster knows how to sift through duplications and unearth what's buried in the past. Only through a meticulous cost analysis will New Jersey stop being crowned the king of property taxes, according to WalletHub.com. The more taxes or revenue the public entity receives, the more value exchange opportunity. The fraudster needs to be able to convert value to cash and remain undetected. When the public entity has greater cash flow (value), the risk for fraud and mismanagement opportunities becomes available to the trusted people who have access to that value. As long as the cash flow and revenues keep coming in, they are likely to remain undetected and fly under the radar.

Let's for a moment think about a hedge fund that is leveraged. As long as the money comes in and can provide a satisfactory return and remain liquid, there is no outrage or interest. It is not until there is no money to satisfy the existing obligations that people begin to question the funds management.

The need to raise taxes, borrow, and find quick-fix solutions are red flags and require a higher level of skepticism—just like the hedge fund that outperforms other, similar funds. These types of comparisons are useful. Comparing governmental units and looking for such red flags can mitigate fraud and mismanagement in government.

The economy and social well-being of the citizenry are further conflicting interests with the taxing of personal income or paying of *user* fees such as highway and bridge tolls, parking fees, or park entry fees. The conflict arises because people who are not users may subsidize people needing the service. Taxes involve a similar conflict in that people who work harder feel they are taxed too much, and the money is given to people who do not work as hard or use the system. This causes the hardworking person to question whether to continue to work hard or to learn ways to avoid the system. In general, people will do what they perceive is fair. The Laffer curve,[5] named after Arthur Laffer, is a supply-side economic theory in which taxes affect revenue in two ways: mathematically and economically. We will add that people will follow rules and pay as long as they feel that it's fair.

Figure 1.1 applies some of the Laffer curve thinking. It assumes the public entity has a zero tax and this generates no revenue. People will not work for no pay. There are conflicting interests between raising the tax rate to generate revenue and who pays for the services. The mathematic and economic

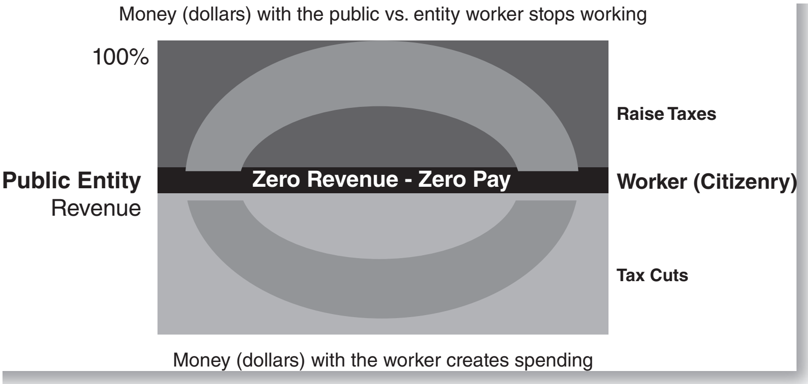

FIGURE 1.1 Circular Laffer curve

variables are in conflict. The Laffer curve suggests that, as the public entity raises taxes (fees) from low levels, tax (fees) revenue collected by the public entity also increases. The Laffer curve also shows that as tax rates increase to a certain point, people will begin not working as hard or not working at all, thereby reducing tax revenue. Eventually, if tax rates (fees) reach 100 percent, then all people will probably choose not to work, because everything they earn will go to the public entity. If the fees become too high, the users will stop using.

So, as we move forward with government policy, one has to ask the hard question: Just how much money should the government raise and how many services should they provide? With the burdensome debt structure public entities face, and the need for the creation of multiple funds to satisfy these debts, you have the potential breeding environment for fraud to remain undetected. Both conditions offer the needed distraction that fraudsters look for to perpetrate a scheme to breach the process for their own gain. Subsidies, grants, and aid are all distractions that enable the movement of funds and are areas that need behavior examination and audit personality testing.

Let's take Enron as an example of the case of having multiple funds and the ability to transfer and move money between funds. Andrew Fastow, chief financial officer of Enron, was a genius in his ability to set up related-party entities to move losing assets off the books. Remember the POP: Fastow had the perspective, occupation, and position to perpetrate a fraud.

Let's take funds and interactions related to government authorities—state, local, school boards, and so on. Taxes are allocated across these entities, and fees are utilized (allocated) across various public entities. All these entities afford the fraudster the opportunity to divert, distract, and divide. More important, they provide the means to gain access to the needed value to exchange for the fraudster's own benefit.

When there are competing self-interests such as when the government raises taxes, leading to a reduction in the household or firm income, and thus a reduction in consumer consumption of household goods and industry spending on labor and capital, this is clearly a divisive act and causes conflict. The competing perspective is that the government knows what's best and needs your tax dollars to fulfill the greater good, which can often be also interpreted as rewarding political donors and supporters. The taxpayers' thinking is, "Why are you spending and requiring me to pay more for your interests?" Thus, the tax function alters the channels of spending and creates alterative demand scenarios that would not occur if the households and firms purchased goods from the market based upon their individual choices. The key word is *choice*. Once choice is eliminated, you have conflict.

Just how do the choices of government impact particular spending and consumption patterns? We can examine a basic service that is generally seen as a public good provided typically by a government agency or authority and in many cases receiving a public subsidy. We will look at a mass transit system such as a municipal bus service or heavy rail system that goes by various names around the world: metro, subway, the "T," the underground, and such.

POLITICS, PUBLIC OPERATIONS, AND LOSS

In the private sector, we examine costs for the entity and also the potential revenue. By comparing the functional form of these two measures, one can establish the point at which the firm covers its costs and thus produces a profit. These parallel relationships formulate a correlation that can be analyzed and assist management in critical decisions.

In terms of costs, it is common to find a certain amount of fixed costs and some additional amount of costs that vary as production increases or decreases. In a general model, we would specify the amount of fixed costs and also the variable costs per unit. It would be common to find public goods having a high amount of fixed costs, with limited additional variable costs for each additional unit of production. One could examine a service such as mass transit—where we have a very high level of fixed costs to deploy and operate the system on a daily basis, and the additional cost of adding another rider is very low. With massive stations, railroad cars, buses, operations costs, and a huge capital stock—none of which is really tied to the level of ridership on a given day—we can see that we are going to add variable costs at a slow rate for each additional rider, but we have to reach a high level of ridership to cover all of our fixed costs.

In our example, we make these assumptions:

- Fixed costs are $100 million per year.
- Variable costs are $3 per rider.
- Demand will be around 33 million riders per year.

Putting a fare structure in place and calculating total revenue as the ridership times the fare per rider produces the general estimate of the break-even point. If we examine existing demand, we find that pricing the rides at about $6 per ride will produce about 33 million rides, and at that point we can solve for the break-even point—which is 33.3 million rides annually priced at $6 per ride. There is where the baseline water mark would be established if this was a profit-making firm in a competitive market. Figure 1.2 illustrates this point.

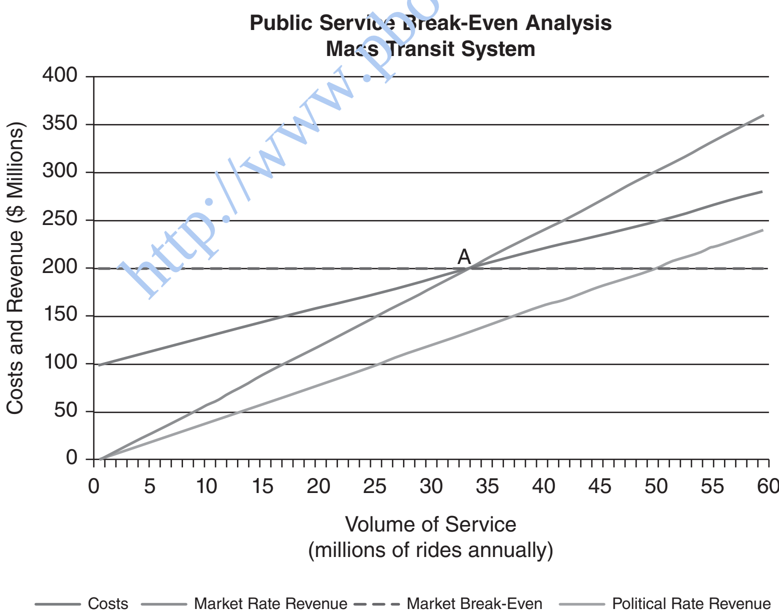

FIGURE 1.2 Break-even analysis for mass transit with market-based fare

The agency produces at Point A and breaks even on costs at $200 million annually and provides 33.3 million rides. If ridership exceeds that level then the entity has a profit, and if ridership is below that level then the entity loses money and requires a subsidy—or it will have to increase the fares to cover costs.

But this is a public service. Being a public service, the politicians may want to establish rates for the service that are below the operating and break-even costs. This causes two problems. First, by lowering the price, we create additional demand for the service—as the price is lower than the true cost of delivery—and that encourages consumption. Take as an example what would occur with ice cream consumption on a hot day if we lowered the price: excess consumption. Second, the low price causes a structural loss for the public authority, which is then forced to seek a subsidy to provide that service.

Now you have politics in play. The elected officials see that there is political value in keeping the fare low, as that creates a concentrated group of beneficiaries (transit riders) who then will work to maintain that pricing structure. This situation may very well be sustained for a considerable period, as the transit users and elected officials may work in coordination to use the tax system to provide ongoing subsidies for the entity. They may also attempt various short-term patches to the finances of the entity to continue the service as long as possible.

In our scenario, we posit a fare that is $4 per ride based upon the desires of the elected officials to offer a cheap ride, for political expediency. This price is maintained as long as the governmental sector can provide a subsidy to cover the cost. In our example, ridership would have to increase to 100 million riders annually to have the transit agency break even. This may not occur, as there may not be demand for that many rides at $4 per ride. Thus, the actual ridership may settle into some interim range—say, 60 million rides annually—and the agency will suffer a $40 million per year loss ($280 million in costs and $240 million in revenue).

Figure 1.3 provides an illustration of this point. Ridership would have to be at Point B for the entity to break even with a $4 fare. The agency would now have a total cost of $400 million and revenues to match. However, it is likely that ridership will fall somewhere between Points A and B and thus some degree of subsidy will be required. Further, it is possible that additional investment may be required to provide more than 33.3 million rides, and that may alter the cost curve as we increase the volume of service.

One way to measure transportation cost efficiency is by gaining an understanding of the term *load factor*. Think of the load factor as a way to measure how crowded a public transit vehicle must be before additional service needs

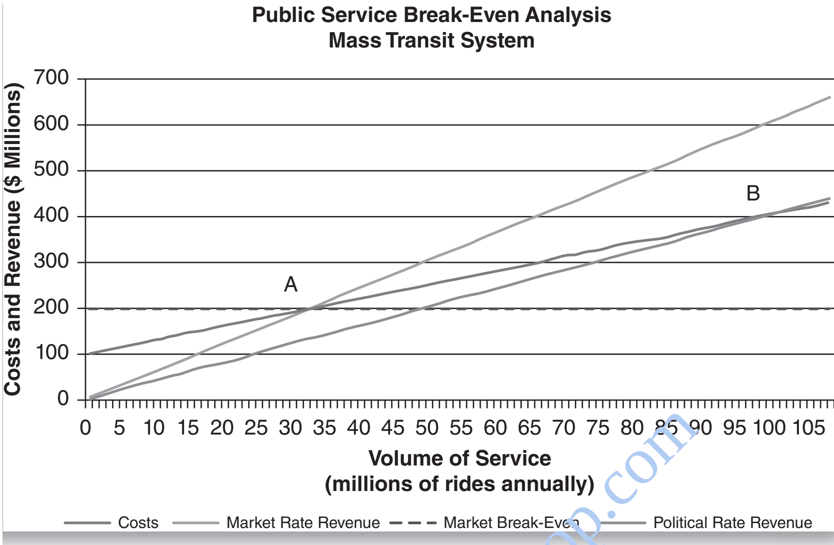

FIGURE 1.3 Break-even analysis for mass transit with discounted fare

to be added. "The industry standard load factor for crowding is 1.25. In other words, in a low-floor 40 foot bus that has 38 seats, the bus will be described as crowded if more than 48 people are on board (38 seats + (38 · 0.25)) = 48."[6]

In the public entity we have subsidized service revenue and unsubsidized cost with respect to the services being performed by the public entity. The tipping point is north or south of the break-even costs. Developing an understanding of the tolerable level of dollars for the provided services by the public users and/or subsidizers is an important tool in making the necessary management decisions. In New York City, this exact scenario is currently being played out. The Metropolitan Transportation Authority (MTA) is the largest mass transit system in terms of ridership in the United States; with a transit fare set at about 58 percent of costs and over 7.8 million rides per day inside New York City alone, the MTA loses over $10 million a day operating its system, or $2.7 billion each year. Part of this gap is covered via dedicated taxes that subsidize transit services as well as tolls on bridges and tunnels that are set above the cost of the service. This has also been sustained by the agency over time by borrowing additional funds to close this gap and to fund capital expenditures; as a result, the MTA has now accumulated $36 billion in debt that consumes 17 percent of revenue to fund on an annual basis.

Size and complexity are potential complexities that the fraudster uses to generate access to value and remain undetected. Government budgets allow for surplus, carry forward and over to future periods. Expenditures are not accrued in some instances and liabilities are not always exact, as we use estimates that require judgment. These people's responsibilities need to be closely analyzed if we are to prevent fraud and mismanagement.

Whenever people are left unchecked, there is fraud risk exposure. When the budget the public entity puts forth does not materially impact a taxpayer or user, no one checks. As the economic or cash flow contracts, these same taxpayers and users become interested. No interest, no outrage. The larger the base, the longer the materiality impact will take to reach the taxpayer and user. Size and complexity offer more cash flow and a means to keep oiling the squeaky wheel when someone asks questions. What often happens is that the public entity throws more money their way to shut down the inquiry. Events such as Superstorm Sandy and the subprime lending crisis create increased budgetary spending. That increased budgetary spending generates financial scrutiny that cannot be shut down by simply throwing money at the inquirers, thus exposing the Fraud as a result of the increased financial scrutiny.

The public entity needs to understand the costs of the service and a simple break-even analysis that leads to the determination of the tipping point at which the public will no longer tolerate the level of dollars for the service being provided. "Life, liberty, happiness" are the foundation of the Declaration of Independence. For many public entities, the three magic words are "supply, demand, and price." In any transaction between a provider and a user, the price of the good or service is determined by supply and demand. Therefore, supply and demand are in turn determined by the conditions which people will accept and operate within. Subsidy is a provocative decision on the part of a government as it changes the economic decisions and relative competitiveness of a region because it twists the economic incentives of the region—with certain services subsidized and others taxed to provide these same services. In the realm of policy, subsidy has assumed an almost mythic value, and political leaders are quick to assume that all subsidies are good. We caution the reader to consider carefully what services and goods to subsidize, as the role of government in setting the table for commerce is very important. In New York City, the massive success of the transit system has created a corresponding massive need for subsidy (Figure 1.4)—and the current elected officials are struggling to find revenue sources to fill the gap in funding.

Having a myriad of government entities creates a morass of officials performing similar, even duplicate, functions. With so many separate bureaucracies at work, there ends up being a massive duplication of effort in

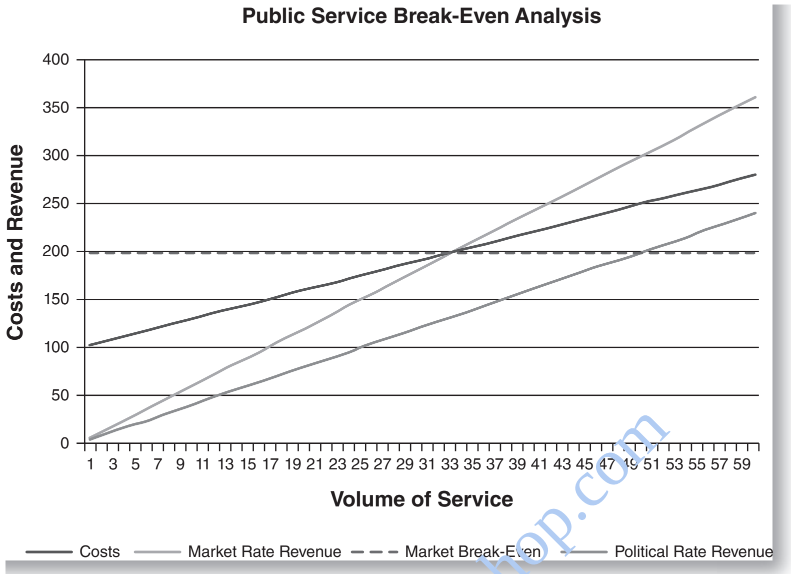

FIGURE 1.4 Break-even analysis for mass transit with subsidy

performing the same simple task, such as buying a garbage truck. It also creates the need for a web of consultants, legal advisors, and contract workers, some of whom have a vested interest in maintaining the status quo, because doing so bears the potential for maximizing their income via the system.

Benjamin Franklin said, "In this world nothing can be said to be certain, except death and taxes." Most Americans' largest financial burden is taxes. The country, as a whole, doesn't earn enough money to pay its total tax bill for the year until April 15, tax day. The varying states' taxing rates and methods makes it even worse. *The more revenue there is, the more debt that can be incurred. That alone fuels a greater potential for fraud and mismanagement.* The more revenue that is available, the greater the cash flow available to the entity, and this affords the fraudster the ability to create transfers and other expenditures while remaining undetected. Without money, there is no value to gain access to. Cash flow needs to be examined closely and the level of trust surrounding the cash flow needs to be examined closely. So understanding the various forms of government gives greater insight into potential enablers and detractors. By examining the enablers' and detractors' behavior that is deviant or abnormal, you're creating a solid defense for the individual taxpayers' and users' wallet in the end.

In most areas of the United States, individuals and firms operate in a world of distinct forms of government. The United States has three primary areas of government: federal, or centralized; state, or a subdivision of federal; and local, or a subdivision of state. At the local level, there is a further subdivision into county and municipal forms of government, as highlighted in the New Jersey example.

These forms of government provide an imbedded structure of operations and supervision designed to protect societal interests, but are also ripe for abuse at the hands of the unethical.

GLOBAL FORMS OF GOVERNMENT

With international trade or commerce, various government structures in foreign countries are encountered. While these forms of government are not in the average American's realm of experience, their functional structures have, in many cases, been in place for centuries. The key is to learn how often one person can influence others to gain control. We feel examining the various forms of government will assist the examiner in developing additional soft skill perspectives beyond the normal accounting methodologies and standards.

Any system built on absolute control creates the opportunity for override, so fastidious scrutiny is needed to keep it in check. In an **absolute monarchy** form of government, also referred to as absolutism, the monarch rules without restriction, laws, constitutions, or legally organized opposition.

Similarly, in a **dictatorship,** the ruler or a small clique has absolute power and operates without being restricted by a constitution or laws. Cliques should be closely examined for the makeup of the people in control. While defining forms of government, one can speculate how fraud and mismanagement can potentially come into play. For instance, terms like "absolute" or "the implication of no rules" imply that there is no structural guard to keep fraud and mismanagement at bay.

Dictators will often resort to force or fraud to gain tyrannical political power, which they will maintain through the use of intimidation, terror, and the suppression of basic civil liberties. Dictators are masters at employing techniques like the use of mass propaganda in order to sustain their public support. The point is to understand how to create absolute power by understanding the language and applying it in your review. Is there intimidation or suppression of the controls and procedures within the process? Is there bias or misleading information surrounding the process? If these are present, then further examination is necessary.

In a **constitutional monarchy,** the government is guided by a constitution whereby the monarchy's rights, duties, and responsibilities are written laws or established by custom. This operates on the assumption that the constitution will not be circumvented. What makes any constitution secure is communicating what the exact responsibilities and duties are and having systems in place to enforce them. The emphasis needs to be on ensuring that the people understand these responsibilities and know where the potential overriding authority lies, as well as the consequences for failure to adhere to the established laws.

In an emirate form of government, a sultanate is given the supreme power. The ruler of a Muslim state is an emir. The emir, ruling as an absolute monarch, may have absolute overlord or sovereign authority with constitutionally limited authority. Again, the effective system focuses on the absolute power and the specific limits that are in place. In the monarchy form of government, the supreme power is in the hands of a monarch who reigns over a state or territory. This is usually for his/her lifetime and is an established right through heredity. It's a form of nepotism, or entitlement. Nepotism is when favor is granted by those with power or influence to family or friends, typically by giving them a prestigious job. Again, with no term limits people are left in authority for long time periods. Without a change in leadership, a sense of entitlement begins, along with a full understanding of the power and what is needed to remain in power and continue to satisfy the interests of those in power.

The monarch is a supreme ruler—such as a king, queen, or prince—with constitutionally limited authority. Where is the person who enforces the limited power? What systems are in place to enforce these restrictions? These are some of the questions that need to be addressed with respect to safeguarding the resources.

In an oligarchy form of government, the control is exercised by a small group of individuals whose authority is generally based on their wealth or power. Oligopolies, as they are referred to in the market, occur when a few companies control the market. The cable companies are good examples of this. This sort of control by an entity can result in various forms of collusion, reducing competition and hiking prices for consumers. There is the possibility for similar outcomes in government organizations with oligarchical control. In government, it's called horse trading when both sides expect equal concessions in order to give one side the advantage. The idiom "You scratch my back and I'll scratch yours" comes to mind.

In a **parliamentary monarchy,** an established state is headed by a monarch who is **not actively involved in policy** formation or implementation but, rather, acts in a **ceremonial capacity.** The governmental leadership in the parliamentary system is carried out by a cabinet and headed by a prime minister, premier, or chancellor drawn from a legislature (parliament). Again, the focus is on the required duties and responsibilities, as it is with any position of control.

It is interesting to note the complex role that a monarch has in a parliamentary monarchy. In the case of the United Kingdom, the queen has specific ceremonial roles and also has the right of consultation with the elected government. Specifically, she has the right to be consulted, the right to encourage, and the right to warn. Essentially the queen provides a very high level of supervision of governmental activities. She is also asked to approve laws through what is called royal assent. While this is granted in the vast number of cases, it still has some impact on policy. These rights, while seemingly minimal in terms of power over elected officials, can, in fact, have persuasive impact on public policy and governmental actions. For instance, if the queen asks to delay action or review a particular law, it sends a strong message about her concern with the actions of the government. In that situation, the elected officials may find themselves in a pitched public debate with a beloved and respected monarch with 60-plus years of public service and deep institutional knowledge of her country. This is the type of fight that most elected officials will quickly lose interest in pursuing in most cases.

In contrast with the role of the queen, the actions of the president of the United States are generally viewed as political and partisan as opposed to the queen's role, which is viewed as objective and informed. This discussion brings to the reader an understanding of the core role of effective management and supervision in creating a sensible government. It is not that the queen is that involved on a day-to-day basis, but she could be the 800-pound (really, an 80,000-pound) friendly gorilla at any moment. It creates a need for internal vigilance and careful thought in establishing governmental policies and practices.

The presidential form of government is one in which the executive branch exists separately from a legislature. The term in U.S. government is the executive (president) and the legislative arms (the House of Representatives and the Senate). The problem is that the executive branch is typically not accountable to the legislative branch. Lots of negotiation between the two branches, with often conflicting interests, occurs, and, as with any negotiation, there is the potential for backroom dealing.

Gaining an understanding of the approval process in any organization or authority is key in identifying where the value is exposed. In the U.S. presidential form, the executive does not have to agree or have the support of the legislative branch. Therein a perfect setting for conflicting interest is established. It is in such a setting that the opportunity for fraud and mismanagement can percolate.

A president coming through a political process commonly has the support of only roughly a third of the people voting, based upon the electoral process—as Table 1.1 illustrates. No president has been elected in the past two decades with even 30 percent of the total vote—with the exception of Barack Obama, who just squeaked by that rate in 2008—and he could not repeat that performance in 2012. As such, his moral suasion is limited, and there may be very vocal opposition to his opinions and positions. Also, the president lacks the long institutional memory that would add credence to his opinions.

In a **communist** government, the **state plans** and controls the economy and a single authoritarian leader often rules or a particular party holds power. The state plans the controls for the economy via the role of central planner. The core of this concept is that the state knows better than its people in terms of public policy, and the population needs to follow the central planner's directives. There are mandated state controls that are imposed, which eliminates or limits private ownership of property or capital. Are these controls applied evenly or is a nepotism effect precipitated? Are all concerns addressed or is this one-size-fits-all thinking? The goal in this form of government is to create a classless society, so all goods are equally shared by the people. In a **Marxist**

TABLE 1.1 Presidential Voting Rates, 1988 to 2012

Election Year	Winner's Share of Popular Vote	Total Vote Turnout	Total % of Americans Who Voted for President Elect
1988	53.4%	50.2%	26.8%
1992	43.0%	55.2%	23.8%
1996	49.2%	49.1%	24.2%
2000	47.9%	51.3%	24.6%
2004	50.7%	55.3%	28.0%
2008	52.9%	57.5%	30.4%
2012	51.1%	57.5%	29.4%

government, the political, economic, and social principles were developed by the nineteenth-century economist Karl Marx. A quote that comes from the *Communist Manifesto*, published in 1848, says, "Workers of the world, unite!" Marx viewed the world from the struggling workers' perspective and their interests, which contrast with those of capitalist business. Marx's perspective was that these conflicting interests would incite class warfare within the society.

It is important to consider that Marx was writing in the 1840s in England and his perspective was based in part on the abuses that the newly emerging manufacturing sector was heaping on the workers: child labor, unsafe work practices, and generally difficult working conditions in the new factory economy. How his critiques have influenced capitalist and mixed economies as well as communist or socialist economies over the past two centuries is still the subject of heated debate. Suffice it to say that his critiques shaped social policy and labor standards in capitalist economies. These same changes have impacted communist countries, which are, in fact, just a form of authoritarianism or oligarchy.

The common notion in the 1840s in England was that the workers would always be taken advantage of by the business owners; a balance of power that could be established, in part, through the use of labor unions and governmental sanctions was not possible. Again, conflicting interests rear themselves as the driving force behind conflict. No matter what the public entity or form of government, this is the area that bears the forbidden fruit, and, accordingly, the appropriate controls and oversight are necessary.

In the Marxist-**Leninist** government, communism was expanded by Vladimir Lenin from the doctrines of Karl Marx. Lenin saw a policy of extending a country's power and influence through diplomacy or military force being the final stage of capitalism. Lenin shifted the focus from the workers' struggle to the developed versus underdeveloped countries. For us fraud examiners, the focus remains on examining the competing interests. The main distinction between a developing country and one that is underdeveloped is that a developing country has an industrial base and capital. There is a lot of truth in the title verse "Money makes the world go 'round" from the musical *Cabaret*. Where there is money, there are competing forces. Where there are competing forces, self-interests are not in balance.

Maoist theory and practice followed Marxism-Leninism. It was developed in China by Mao Tse-tung. The policy stated that a **continuous revolution** was necessary for leaders of a communist state to communicate with their people. A revolution is forcible overthrowing of a government, because people are demanding change. Hostile takeovers come to mind, where two sides are in disagreement with one side determining the only solution is to advance their interest by gaining full control. The word *forcible* in the world of handling the risks of fraud and mismanagement cannot replace the sound concept of keeping balance. The way to keep balance is to have ethical people in power who are well-trained, communicative, and transparent, steering clear of any hint of a conflict of interest. There is no need for absolute control or overthrowing if the systems are maintained with balance amongst all those concerned.

The public servant needs to operate like a fish in a bowl, always visible to the public he or she serves, never using force to get the message across. All force does is create animosity and mistrust. First, understanding why the need for force may develop is critical in creating a way to resolve these potential conflicts before the boiling point is reached.

In the **socialist** form of government, the planning, producing, and distributing of goods is controlled by the central government. The thinking in this form of government is that such central control of government will lead to fairer, more equitable distribution of property and labor. History, however, shows that this form of government has resulted in dictatorships over workers, establishing a ruling elite. Again, this idea of concentrating all the power in the hands of the few, left unchecked, can lead to fraud and mismanagement. As some see it, socialism has crept into many of our existing elected forms of government, with the governmental entities taking on various aspects of social policy and economic control. In the United States, for instance, there is an ongoing debate about the role of various public programs and their limitations on free enterprise. From farm subsidies to Obamacare to unemployment policy, the U.S. government continues to vacillate between more and less socialist-centric policies. European and other developed countries around the world have settled on socialism for many public matters, such as health care, child care, and worker standards.

The old proverb "Give a man a fish and you feed him for a day; teach a man to fish and you feed him for a lifetime" invokes a proactive perspective. Governments that teach people life skills that enable them to break free from reliance on public assistance and/or entitlements, such as nepotism, leads to cost-effectiveness and efficiency. The theory: The better trained the employee, the more efficient. Continual training is a critical ingredient in the recipe for prevention of fraud and mismanagement. The better-trained employee closes the loophole through which fraud and mismanagement can seep. Since he or she met the first hurdle in the battle, he or she recognizes it exists.

Confederacy is a union made by forming a compact or treaty between states, provinces, or territories that creates a central government with limited powers. The forming entities retain supreme authority over all matters, except those delegated to the centralized governmental unit.

In a **constitutional** government, the operations are based on an authoritative document (constitution) that sets forth the system of fundamental laws and principles. This lays out the operating nature, functions, and limits of that established governmental unit. A federal form of government (federation) is one in which the sovereign power is formally divided—usually by means of a constitutional writing that is established by a central authority and a number of constituent regions, or states, colonies, or provinces so that each region retains some management oversight over its internal affairs. The confederacy form differs in that the central government exerts influence not only on the individuals but on the regional unit as well. Understand the responsibilities and powers with which these individuals have been entrusted.

Democracy is a form of government in which the supreme power is retained by the people, but it is usually exercised indirectly through a system of representation and delegated authority that is periodically renewed. In a constitutional democracy form of government, the sovereign power of the people is spelled out in a governing constitution. In a **Democratic republic**, the power rests in the body of the citizenry, which is entitled to vote for officers and representatives who answer to it. In a **federal republic**, the powers of the central government are limited by the states, colonies, or provinces and maintain a certain degree of self-governing. The sovereign power remains with the voters who chose their governmental representatives. In a republic form of government, the people elect representatives to vote for them on legislation.

Parliamentary democracy is a political system in which the legislature (parliament) selects the government: a prime minister, premier, or chancellor and cabinet ministers. This form of government is largely based on the strength of the party in an election. In this form of government, both the people and the parliament can hold the governmental representative accountable. The parliamentary governing body is an executive branch that comprises a cabinet and its leader. That leader is a prime minister, premier, or chancellor who is nominated to the position by a legislature or parliament. The leader is held accountable to the cabinet. This type of government can be dissolved and shut down at will by the parliament (legislature) by means of a no-confidence vote or the leader of the cabinet.

Ecclesiastical is a form of government administrated by a church. In a **theocratic** form of government, a deity is recognized as the ruler. The deity's laws are interpreted by ecclesiastical authorities (bishops, mullahs, etc.). The government is subject to religious authority. Religious fraud through power manipulation can exist in both civil and criminal cases. This is a distinct diversion from the U.S. Constitution, in which church and state are separate. In a theocracy, the religious rules of a particular group are then applied as de facto laws. This opens the door for a tremendous amount of power to reside with religious officials, as they apply their religious opinion as the law of the land. The fraud can be carried out in the name of a religion or within a religion. The fraud can be a result of false claims being made such as something being kosher that really is not.

A great example of this kind of theocracy was the governorship of Brigham Young, president of the Church of Jesus Christ of Latter Day Saints, or the Mormon Church, from 1847 to his death in 1877, in what was known as the Utah Territory. Brigham Young was appointed territorial governor by President Millard Fillmore in 1851 and he served until 1858. Young had strong control over both the Mormon Church and the Utah Territory. In his capacity with both, he had great latitude in his dealings with the federal government as well as the Native Americans and travelers in the region. Much controversy surrounds this period and the actions of Young with respect to pioneers on the Oregon Trail that may never be fully understood. What is known, though, is that a series of incidents occurred in which travelers were harassed and killed due to their non-Mormon status. It was, however, clear, that Young had strong control over the Utah militia and various regional public safety organizations. History dictates that he used these government entities to promote his vision of a Utah territory that was firmly under the control of him and his church. Finally, after an extended period of hostility with the U.S. government, he was replaced by non-Mormon Alfred Cumming, of Georgia. The intent with the replacement was to minimize the control of the Mormon Church on territorial government. Power left unchecked, creates the ability to centralize self-interests and separation from the interest as a whole. It is these types of segregations in specific groups that create territorial power players who then develop overriding control and division. Proper levels of skepticism and questioning create that necessary balance. Where these potential centralized power players are meant, we will use a more familiar term, *power broker*. Power brokers are people who exist to influence people to vote towards a particular elected official or referendum in exchange for political and/or their own financial benefits.

When it comes to tax fraud or money laundering, the problem is that religion can become a communication inhibitor and offer the fraudster cover. Religion is often cloaked in altruistic appeals to higher beings. Who's going to question God's leaders? Those appeals and/or surrenders to a supreme heavenly power often give way to people, or believers, shedding their guard and exposing their vulnerabilities. The other problem is that affinity groups, like religions, share common interests. The knowledge of those common interests in itself is a convenient, powerful hook to reel people into the fold.

Affinity fraud is a common component of various investment scams, such as a Ponzi scheme,[7] as identifiable groups are at the core. Various religious or ethnic communities, the elderly, or professional groups are commonly coerced or played in such a confidence scheme. The fraudsters who promote affinity scams frequently pretend to be active members of the group. They enlist respected **enablers**, vital members of the community or the religious leaders from within the group. They ask these enablers to spread the word about the scheme so it convinces those people that it is a legitimate and worthwhile investment. This technique actually can help conceal the fraud, as there may be strong social pressures to avoid affinity conflict; even if the fraud is detected, affinity group members may be resistant to exposing the fraud, as it may incite shame on valued leaders or the group as a whole. Also, given the economic damage that exposure may bring to the members of the group, there may be a desire to ride the wave and, hopefully, jump off before a scandal ensues. The result: less engagement and visibility in putting a stop to the fraud.

Let's change the term from fraudster to lobbyist, or someone who is attempting to influence decisions made by officials in a government for a specific concern. Examine why there is such a strong lobbying effort for or against a decision. Measure the economic benefits to those lobbying the interest versus the general public. This creates outside-the-numbers thinking and awareness that is necessary to establish proper controls. You now have the unsuspected 800-pound friendly gorilla monitoring. Taking into account the interests of the lobbying party versus the public reaffirms that the value is identified at the point of conflict. With any conflict, one party wants more than the other. Otherwise, there would be balance, settlement, and no conflict. Where there are groupings of people with common interests, skepticism must be present to create balance, rather than the development of one-dimensional thinking.

In an **authoritarian** government, state authority is imposed on many aspects of citizens' lives. Some central authority has the sole right to make and enforce laws or sanctions. The authoritarian form of government can be created under some delegated authority over a small component of governmental action or with the expansive power of an authoritarian government, such as North Korea. By delegating authority to an entity, without election, the government gives wide enough latitude in the operation of these entities, as they are not subject to external review or control. This can be done on a very limited basis. For instance, imagine if the power of overseeing traffic violation trials was granted to an arm of the Department of Motor Vehicles. In theory, the administrative law judge who might be hearing a case on a moving violation offense is actually an employee of the state Department of Motor Vehicles, where appeals of his or her decision are heard by a panel at the same agency. In many other cases involving the use of an administrative law judge, that judge may have been a former lawyer of the agency for which she/he works. This relationship between the judge and the agency for which he or she works may spur a lack of objectivity in the judicial process.

Enforcing speed limits, building code compliance, and tax payment are all examples of masked authoritarian thinking. If you don't pay taxes or if you fail to abide by a speed limit, there are the consequences of being fined and/or imprisoned. While we have separated the government forms, every one of them has to have an authoritative (rule-based) form, in one way or another, to maintain order. It is critical that the people subject to these rules find them fair. Another key element is that the control mechanisms remain transparent and open to interpretation with the appropriate flexibilities. The proper oversight of these same entities needs to include we emphasize reasonable checks and balances over the powers delegated to the entity. Notice the use of the word *reasonable,* since there is no absolute, sure-fire solution to stop fraud and mismanagement. It's a continual work in process.

The **totalitarian** form of government seeks to subordinate the individual to the state by controlling not only all political and economic matters, but also the attitudes, values, and beliefs of its population. The fraudster finds ways to control their surroundings and to develop enablers and detractors. Allowing this thinking does not work in managing fraud risk, as any locked or controlled environment is static and, with enough planning, can be overridden. In the authoritarion type of government the opposite is true.

In an **anarchic** form of government, there is no authority. This is a result of having no system or structure in place. The lack of structure is an impetus to law and disorder. Where no systems and structure exist, or where they do exist but are not monitored, the environment breeds potential for fraud and mismanagement. Fraudsters love to leave things unreconciled, in disarray and in a confused state. This all comes about when the proper levels of control and oversight are not put into place.

Countries such as Haiti and Somalia have government systems that have bordered on anarchy at certain points in time. At those times, government functions essentially ceased and the society fell into disarray. A common outcome is that essential government activities may then fall to nongovernmental organizations (NGOs), such as Doctors Without Borders, the United Nations, or UNICEF.

The intent of this discussion was not to expound upon a comprehensive list of all government forms, as there are forms of government at the local level in New Jersey to draw upon in the initial example. Reviewing these government form definitions creates an awareness of who is ultimately responsible, what the approval abilities of any given government are, and their core policy missions and objectives. Think of these as the perspectives/purpose of the government or public entity being examined in detail to understand the complex linkages and interrelated parties. The emphasis here is on the importance of the accountant, or an examining party, in gaining the correct understanding of the government and how it operates as a means to the end of preventing fraud and mismanagement.

Heaping more divisionalized[8] structure, such as authorities, special-purpose districts, and public-private partnerships on top of the already overriding structures of federal, state, and local government, creates the distraction that provides a fertile growing site for fraud and mismanagement, inadvertent or not. All of these entities have various powers that are delegated to them by some form of government charter or authorization, which can often conflict. For instance, given the structure of the U.S. Constitution, unless the federal government retains a right or role, then that role is ceded to the state government or, ultimately, the people. Counties, cities, and other local forms of government are creatures of the states, and, as such, their particular charters or legislative authorization limits their authority. Therefore, we find that a multilayered governmental structure is found in most regions of the United States. The bulk of these entities have revenue, fee or taxing of residents, workers or firms such as taxing itself, or fee-charging, bonding, and other spending via individual financial practices. These myriad separate entities create an ideal environment in which conflicting interests develop and can lead to the necessary divisiveness needed to enable fraud and mismanagement.

REVENUE FUNCTIONS WITHIN GOVERNMENTAL AND PUBLIC ENTITIES

In terms of understanding the role that these various governmental agencies play in our society and their ultimate potential for fraud and abuse, it is useful to examine and understand their revenue functions and funding (bonding) capability. No matter what form the governmental or public entity takes, it needs revenue sources to operate. Greed needs sources of fuel like money and power. There also needs to be a strong understanding of the leadership structure and any governmental protections afforded to the decision makers, specifically with respect to the abilities to override, veto, or circumvent the intended purpose to expose the potential opportunities for fraud and mismanagement. Greed needs to position itself by gaining access to value. From the perspective of fiscal discipline, the detachment of the supervision of a particular entity from legal or political oversight creates significant opportunity for mission creep, politicization of policy decisions, diversion of resources to pet projects, and an overall lack of responsiveness to needs outside of the organization. These pet projects are often created by divided interests or those that stand to benefit from public funding in some way. They typically look to find ways to circumvent the public interest, encourage red tape entanglement, and create the necessary distractions so that the special interest is fueled with the financing. These projects need to be held to the highest level of transparency if fraud and abuse are to be prevented. One method to increase supervision is the requirement of a referendum or some other voting initiative in order to approve the funds for a project.

For example, in the past, if a school budget referendum failed in New Jersey or the spending plan was not approved in the school elections, formerly held in April, the budget did not go back to the voters, but instead was sent for revision and approval to the municipal governing body to cut. What would then generally happen is that the board of education members would **lobby** the municipal government, with the help of teachers and parents (enablers), and this would lead to few if any cuts actually being made.

Now board elections are held in November in New Jersey, and as long as the board stays within a 2 percent levy cap in budget spending, the budget is automatically approved and there is no referendum. The past procedure came with the types of external pressures that are often outside the scope of a traditional financial analysis and need to be examined. It is these types of overrides that prevent the ultimate checks and balances (the vote) from occurring and undercut the role of the voters in creating accountability in the governmental organizations. The idea of appointed commissioners, elected officials, and other policy makers overriding the direct will of the people is no different than overriding the internal controls that ensure the credibility of the financial numbers. Vetoing represents the ability to override. Any override should be allowed to take place only when accompanied by the proper level of support. Management needs to have systems and structures in place to ensure transparency and accountability, as there are often conflicting views.

Sometimes entities are shared between states. Then a real question arises as to who has ultimate control and authority when beyond state borders. Without proper supervision and voter interest and awareness, government agencies can divert from their core mission and charter. Incredible as it may seem, this actually can and does happen for a variety of reasons. For instance, in the case of bi-state agencies, such as bi-state bridge operating authorities, which are agencies that have a federal charter to operate between states, we find that the federal government in 1987 repealed the oversight provision from federal law. This action, though, did not ensure that the individual states had the proper legislative oversight for the same agencies (GAO Report). This essentially left these agencies as sovereign entities in their realm of operation, answerable to no one and subject to their own whim as the only control action.

In most governmental roles, the oversight of government activities is done at the hands of elected officials. Elected officials, or politicians, serve at the will of the voters who elect them to office. The form of government, its responsibilities, and supervising authorities are key elements in understanding the potential for risk that can be created. While there is a lot of literature available in the field of political science that examines what motivates elected officials, a healthy understanding of the daily life of an elected official should be examined along with that politician's access to the government resources as well as that of his or her constituents. This is necessary to create a healthy level of skepticism that must be introduced to understand the meaning of Lord Acton's dictum "Absolute power corrupts absolutely." It is these often conflicting behavior signs that should generate red flags if the proper 800-pound friendly gorillas are monitoring.

For ease of discussion, let's assume that elected officials make decisions in light of the political desire to retain their office, or what those who examine matters in forensic accounting term *self-interest analyzing*. As such, we would expect them to make decisions that are politically expedient, or decisions that make most voters happy as opposed to unhappy. Other motivations—such as altruism, honesty, fairness, personal legacy, quest for higher office, desire for additional political power, desire to punish a political enemy or rival—are catalysts to various forms of corruption and government fraud. It is the study of these often-conflicting self-interested parties and motivations that provide the necessary information to develop systems and structures to improve government efficiency and prevent fraud. The more the public watches the actions that motivate and surround these trusted public servants, the greater the chance of preventing them from making bad choices.

In the case of public agencies, public authorities, and special-purpose districts, the **oversight** may be provided by appointed directors or supervisors with a significant bureaucratic layer protecting sitting directors from public scrutiny or control. Usually, these directors or supervisors are appointed by elected officials and serve for a given fixed term. Examining the relationships between these elected officials and the appointed party is a simple tool for preventing potential collusion or bias from occurring in the established system and structure.

The proper ethical tone needs to be established from the start by these parties. These same parties need to avoid bad choices by making decisions that have integrity, are independent, and are objective. Starting any process with a clear bias or special interest is setting a bad standard of practice. Unfortunately, our existing systems are rife with examples of appointees who lack objectivity. In fact, it is almost a requirement that appointees have some "special" connection with the elected official who appoints them to a particular commission. Further, it is commonly found that these directors have some link via prior government or private-sector service in the field of interest. Just examine the rotating door of the U.S. Treasury, the Federal Reserve, and Goldman Sachs to see this sort of potential for conflict of interest played out on a regular basis. Or you could just say "any one of a number of major investment banking firms."

Once appointed, there is generally a recall provision for these director-type positions. These positions may also be subject to political oversight. In practice, the elected officials often find it expedient to allow a significant amount of autonomy for these directors and to use this separation of power for political gain, thus claiming a lack of political control for unpopular decisions made by the authority or agency.

Another example of an entity that does not have a lot of voter or elected official control is the Federal Reserve System. The Federal Reserve Board functions with a high level of autonomy from the U.S. government due to its board structure[9] whereby the seven directors are appointed for a 14-year term on a rotating basis—one every two years. As such, the president of the United States has very limited control over the board and its policies, since directors, by law, may serve only one full term. Theoretically, the president, with just cause, can remove a director. But, based on our research, this has never been done. This high level of autonomy has come under fire in recent years, with the Reserve Board being sued over a lack of transparency in its financial dealings during the 2008 financial crisis.

Recently, Bloomberg Business[10] reported that more than half of Americans want the Federal Reserve abolished. Congress established the Federal Reserve Board in 1913 to promote national monetary goals and policy for the good of the people. This focus on national interest was intended to be promoted by its makeup of seven board members and 12 reserve bank presidents.

However, without independent audit and supervision, as well as a much more diversified brain trust, it appears that the over 50 percent of American people may be right to be concerned.

Entities with concentrated control, supervision, and policy are areas where the skepticism and systems and structures need to have a high level of accountability. The Federal Reserve Transparency Act of 2015 directs the Comptroller General (GAO) to complete, within 12 months of its enactment, an audit of the Board of Governors of the Federal Reserve System (Federal Reserve Board) and of the Federal Reserve Banks, and submit to congress, within 90 days of audit completion, a detailed report of audit findings and conclusions. Without this type of transparency and full disclosure rules in place to govern the Fed's monetary policy decision making, it is likely that the American taxpayers could continue to be on the hook for trillions in bailouts and loan defaults, as history has shown.

At the end of the day, there is generally some form of government sanction and control for these various agencies. The elected officials, or directors, at the helm advance the operational aspects of their mission. Government entities pass laws or rules. They set regulations over various aspects of society, which often have various inherent self-interests. They confirm treaties, regulate commerce, subsidize certain activities, contract for certain services, and allocate resources. In this book, the financial and revenue aspects of government activity are explored. So discussion of the rule/law-making aspect of government is limited and focus homes in more on the basics of government finance.

THE FEDERAL GOVERNMENT

"A wise and frugal Government, which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities."[11]

—Thomas Jefferson, founding father, principal author of the Declaration of Independence, and third president

Since the time Jefferson was president, the federal government has had a role in protecting one interest over another. There need to be assurances that government creates a balance between the interested parties that are paying and those receiving. The federal government's role in providing goods, services, and regulatory oversight is broad and pervasive in modern American society. Either by a direct provision of services or funding via federal programs—like Social Security and national defense—or by funding through state or local entities for national programs (highway funding and mass transit systems, for example), the federal government is a major component of governmental activity and, thus, the national economy. In many cases there is a high degree of fiscal federalism in federal spending. This is where funds are transferred to the states or local governments to provide either specified services or as a block, or comprehensive grant, with broad spending latitude at the local level. Funds collected at the federal level are disbursed back to state and local governments to administer federal programs or promote local programs consistent with federal goals. These funds may be made available as an unconditional transfer to the local government. In this instance, no real requirements are placed on the receiving government. A second method would be to pass through the funding on a conditional basis. In this instance, the receiving government is given a set of requirements and conditions that must be agreed to in exchange for the funding. An example is the New Jersey Department of Environmental Protection's Green Acres Program funding. A municipality is granted or loaned funds, at low interest, in order to preserve land for passive or active recreation. That funding is contingent upon an agreement with the municipality that the land must be preserved forever. No development may encroach upon the deeded property.

For instance, while the president will submit a budget proposal to Congress, Congress ultimately has the so-called power of the purse. The executive and legislative branches control the federal budget, with the budget proposal coming from the executive branch (president and White House), with final funding decisions made by the U.S. House of Representatives and the U.S. Senate. Final approval of the federal budget is subject to presidential veto. But that provides limited oversight on the overall spending package. The primary sources of funding for the federal government's budget are derived from a number of fees and taxes. The primary source is the federal personal income tax and the federal corporate income tax. In addition, receipts from special retirement contributions, such as Social Security and other excise taxes, or taxes on specific goods such as fuel taxes, provide over 95 percent of federal receipts.

TABLE 1.2 Federal Government Revenue Sources—1990 and 2011

Source of revenue	1990	2011 (Est.)	1990%	2011%
Individual income taxes	466.9	956.0	45%	44%
Corporation income taxes	93.5	198.4	9%	9%
Social insurance and retirement receipts	380.0	806.8	37%	37%
Excise taxes	35.3	74.1	3%	3%
Other	56.2	138.4	5%	6%
Total federal receipts	1,032.0	2,173.7	100%	100%

Table 1.2 provides an overview of the split of revenue sources by area in 1990 and 2011. The relative pattern of funding by source has remained very stable over the past 20 years. Tax and fee types and revenue policy are discussed in detail in Chapter 2.

A further confounding issue is the matter of federal spending—which has generally exceeded federal revenue sources. Figure 1.5 provides a perspective on the overall level of spending at the national level in the United States. You can see that the level of federal revenue collection has tended to fluctuate with the level of economic activity and thus has weakened in recessions and strengthened during economic booms. Federal spending has a quite different structural pattern, with strong growth in spending, averaging 5.57 percent per year from

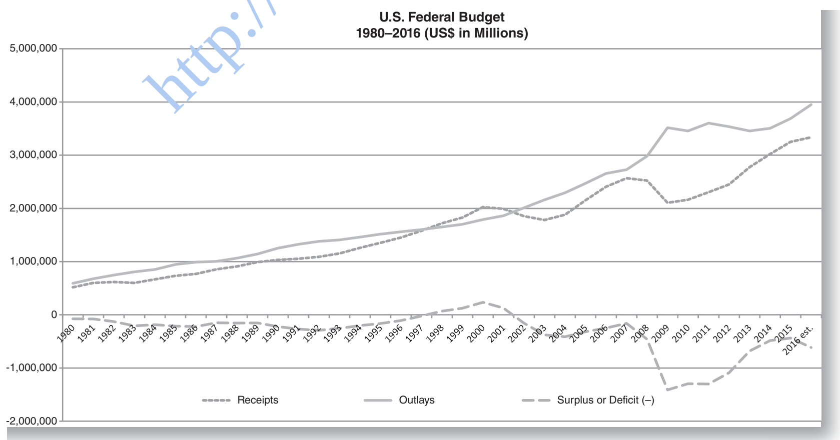

FIGURE 1.5 U.S. Federal Budget Receipts, Outlays, and Surplus/Deficit

1990 to 2010. That was caused by spending increases in statutory programs and a general bias toward overspending on the part of government officials. The net result is a general revenue shortfall in the federal budget that is funded through additional borrowing to attempt to cure the structural deficits. A structural deficit occurs when a country, state, municipality, or other entity posts a deficit. Expenditures greater than revenues equals deficit, regardless of how the economy is doing.

We will continually explore the anomalies that are encountered, the importance of planning for unexpected events, and how to avoid unanticipated expenditures. It is imperative in the establishment of any financially sound system that the assumptions used to determine revenues and government spending be constantly monitored and improved upon. It is the failure to have fail-safe practices in place in the event of a specific type of fiscal collapse that responds in a way that will cause harm. Failing to have well-established, reasonable reserves for the unexpected and future obligations, opens the floodgates of fiscal imbalance that can lead to mismanagement and fraud.

The more confusion caused by events like 9/11 and the subprime lending crisis, the more opportunities there are for potential mismanagement and fraud. Table 1.3 and Figure 1.5 for receipts, outlays, and surplus or deficit support the idea that revenue follows changes in events, whether they are positive, like the advancements in the economy or the technology boom, or negative, like the unprecedented real estate property appreciations prior to the subprime lending financial crisis. The oversight needs to be in place with rising positive advances as well as with negative declines. There is an imminent need to apply conservative and well-documented assumptions. That means lower revenue estimates must be made to lower higher costs in fiscal projections.

Inadequate monitoring of the necessary internal controls surrounding the various revenues continually slaps the taxpaying American with higher taxes. Those taxes and hidden, or ineffectively communicated, fees and/or other revenues feed the growing revenue needs of government to meet its established polices and agenda. The $1.032 trillion of inflation-adjusted receipts equals $1.776 trillion,[12] leaving a gap of $397 billion (2,174 less the 1,776), which represents 38.6 percent or an average of 3.5 percent (38.6/11) per year above the inflation-adjusted amount. Is it potential mismanagement or fraud? There is a need to develop systems and structures that provide accountability and transparencies to the average constituent. Table 1.3 provides an overview of the U.S. Federal Government receipts, outlays, and surplus or deficit from 1980 to 2016.

TABLE 1.3 Summary of Receipts, Outlays, and Surpluses or Deficits: 1980 to 2016

Year	Receipts	Outlays	Surplus or Deficit (−)
1980	517,112	590,941	−73,830
1981	599,272	678,241	−78,968
1982	617,766	745,743	−127,977
1983	600,562	808,364	−207,802
1984	666,438	851,805	−185,367
1985	734,037	946,344	−212,308
1986	769,155	990,382	−221,227
1987	854,287	1,004,017	−149,730
1988	909,238	1,064,416	−155,178
1989	991,104	1,143,743	−152,639
1990	1,031,958	1,252,993	−221,036
1991	1,054,988	1,324,226	−269,238
1992	1,091,208	1,381,529	−290,321
1993	1,154,334	1,409,386	−255,051
1994	1,258,566	1,461,752	−203,186
1995	1,351,790	1,515,742	−163,952
1996	1,453,053	1,560,484	−107,431
1997	1,579,232	1,601,116	−21,884
1998	1,721,728	1,652,458	69,270
1999	1,827,452	1,701,842	125,610
2000	2,025,191	1,788,950	236,241
2001	1,991,082	1,862,846	128,236
2002	1,853,136	2,010,894	−157,758
2003	1,782,314	2,159,899	−377,585
2004	1,880,114	2,292,841	−412,727
2005	2,153,611	2,471,957	−318,346
2006	2,406,869	2,655,050	−248,181
2007	2,567,985	2,728,686	−160,701
2008	2,523,991	2,982,544	−458,553
2009	2,104,989	3,517,677	−1,412,688
2010	2,162,706	3,457,079	−1,294,373
2011	2,303,466	3,603,056	−1,299,590
2012	2,449,988	3,536,951	−1,086,963
2013	2,775,103	3,454,647	−679,544
2014	3,021,487	3,506,114	−484,627
2015	3,249,886	3,688,292	−438,406
2016 est.	3,335,502	3,951,307	−615,805

Short term deficits in government budgets may occur due to unforeseen random events (storms, earthquakes and such), but it appears that the Federal deficit is based on normal spending patterns that are ongoing, exceed existing revenue sources and not unforeseen in any way.

Figures 1.6, 1.7, and 1.8 provide some quick reference points to monitor with respect to why the Federal Reserve needs to continue to print money and the federal government needs to continue to deficit spend (government spending in excess of revenue that are funded through borrowing rather than taxation). Both actions occur when there is a lack of accountability. These

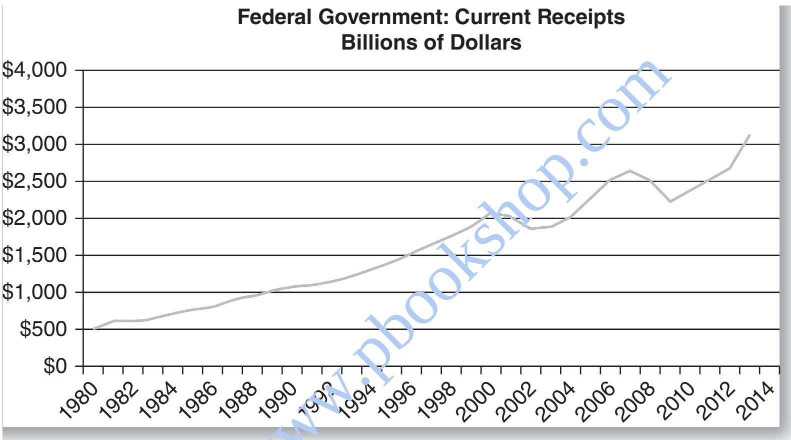

FIGURE 1.6 Federal government: current receipts

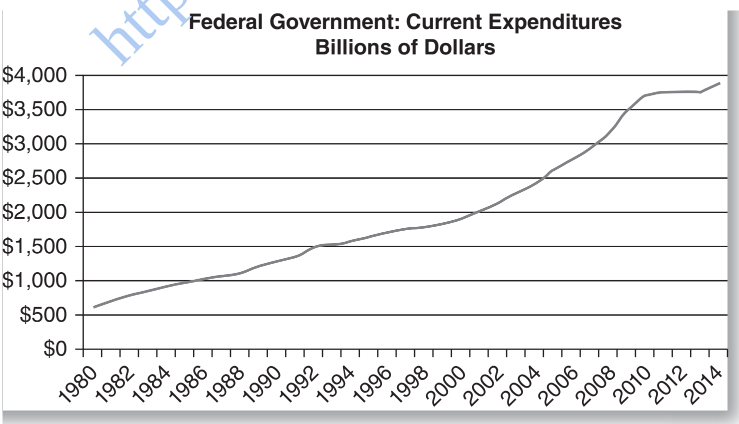

FIGURE 1.7 Federal government: current expenditures

offer those 10,000-foot general information views. The details are discussed as the potential areas where fraud and mismanagement can come into play are revealed.

Figure 1.6 illustrates how the receipt of money is an area where there is a need for monitoring and oversight. The revenues continue to grow, yet we continue to borrow and operate in deficit. The deficit is a result of outlays exceeding receipts.

Figure 1.8 provides a concise picture of the general net budgetary deficit conditions since 1980. Please note the location of the zero point on the graph—located toward the top of the graph. With the vast bulk of federal budgets over the past 30 years having a strong budget shortfall—26 of 30—only four had a surplus.

Thinking needs to be expanded in this area of spending from past and present expenditure focus to what is due in the future. Given the off-balance-sheet liabilities that can exist, such as pension and sick-time liabilities in the public entity, it is becoming necessary to monitor the working capital base needed to fund all past, present, and future spending to enable the government and public entity to remain an ongoing concern.

Figure 1.8 shows how allowing the public entity to operate in deficit breeds fraud and mismanagement. With a deficit you once again afford the fraudster a means to distract attention and assign blame. There is no money available, so the only solution is to raise taxes or fees. The people for whom you are raising taxes and/or fees have no say and, if they do, the next answer is bankruptcy. Bankruptcy is the great equalizer—who is going to pursue an entity that is bankrupt, as there are no funds?

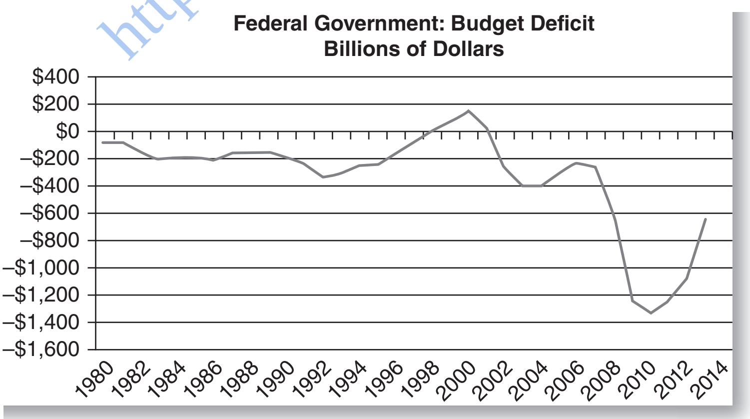

FIGURE 1.8 Federal government: budget deficit

The allowance (reserve) accounting concept is the idea whereby the public entity sets, or allocates, sums of money to be reserved for a specific purpose like collectability issues and or some other purpose that is based on someone's judgment. If the fraudster over- or underallocates, there are impacts to the budget and the opportunity becomes available to convert value for the fraudster's own benefit. Examine any reserves or allocations closely, especially those across related public entities.

Overspending is spending more than the expected or allotted amount, which enables fraud and mismanagement to occur. The entity should not be allowed to spend more than a line item and cover that budget deficit by transfer or other means. That deficiency should be required to be made up in the next budgetary period. While these entities have these systems in place, they are not preventive in terms of why the overspending occurred and what actions are being put in place to prevent reoccurrence. Proactive systems would monitor at the point the budget is overexpending and not wait till the year-end to correct.

If the money needs to come from somewhere else, the place it was taken from in the current year was either overbudgeted or needs to be adjusted in future periods. This type of one-shot adjustment at a specific period like year-end defeats the whole purpose of budgeting, which is to have people stay within their means and be accountable. If it is an extraordinary or unusual event that caused the over-expending, it should be documented and serve as the basis for adjustment in future periods. The people involved in the budget should be required to document the overage and/or surplus in the account. Only with sound budgeting and monitoring can the public entity prevent fraud and mismanagement. This simple exercise of correcting and monitoring spending and revenue shortfalls, if they exist, is a tool that is necessary to ensure that sound systems and structures are in place

This pattern of structural shortfalls in annual budgets leads to an accumulation of debt or shortfalls in funds needed by the U.S. federal government. Debt is one way the government can develop the needed working capital. The governmental or public entity simply issues bonds and notes. The federal government has generally favorable borrowing conditions that allows it to raise significant amounts of cash via the issuing of bonds that are well received by investors in the financial markets. Over time, the historical shortfalls lead to a structural national debt that now tops $18 trillion.

Figure 1.9 provides a perspective on the national debt from 1950. The national debt was at roughly $1 trillion in 1980. Even as late as 1986, the national debt was in the range of $2 trillion. Since 1986, the national debt has risen to $6 trillion in 2006 and now sits in the range of $18 trillion (2015).

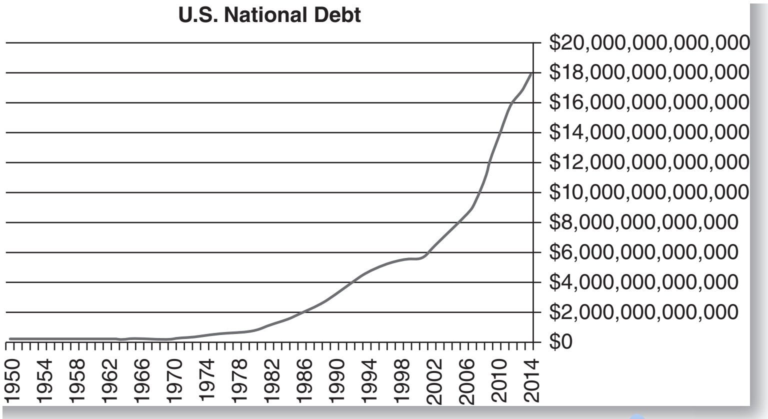

FIGURE 1.9 U.S. national debt

This year's estimated budget shortfall ($1.2 trillion for Fiscal Year 2015) is expected to compound this problem.

Debt can be manipulated, as it is debt and liability on a balance sheet; it is that debt that is sold or a transaction that is created to shift the debt so it can become a revenue source. Any organization using long-term borrowing as a means to fund operation shortfalls should be flagged and closely examined.

There are two types of governmental securities: nonmarketable securities such as savings bonds, various series (A, B, EE, etc.) bonds, and private shares, and marketable securities, such as Treasury bills and bonds that can be purchased and resold to the public. The nonmarketable securities, such as savings bonds, must be held until maturity and can't be resold to another party. Typically, these types of governmental securities are viewed as risk-free assets, since the actual return equals the expected return. Risk in any asset is viewed as the difference between the actual returns and the expected return. This makes the government security attractive to people who are averse to the risks associated with the stock market or other volatile investments. This creates a pool of money available to fund government debt. It is the ability of the public entity to borrow that creates opportunities for deficit spending and/or reallocation of funds for other purposes than the ones established by the government form.

Table 1.4 gives an overview of the funding categories of the national debt. Roughly one-third of the debt is held by government entities in nonmarketable securities—essentially IOUs from the federal government to other "trust funds," such as Social Security and federal pensions. The other two-thirds is held in tradable securities, with a significant portion held in bills and notes. Those bills and notes have a maturity of less than 10 years.

TABLE 1.4 Structure of the U.S. National Debt, January 2015

Marketable Securities		
Bills	$1,412,887	7.8%
Notes	$8,239,915	45.6%
Bonds	$1,589,165	8.8%
Treasury inflation-protected	$1,063,727	5.9%
Floating-rate notes	$163,991	0.9%
Federal financing band	$13,612	0.1%
Total marketable securities	**$12,483,297**	**69.0%**
Nonmarketable securities		
Domestic series	$29,995	0.2%
Foreign series	$264	0.0%
State and local government series	$113,684	0.6%
U.S. state savings	$175,638	1.0%
Government account series	$5,277,355	29.2%
Hope bonds	$494	0.0%
Other	$1,567	0.0%
Total nonmarketable securities	**$5,598,997**	**31.0%**
Grand total	**$18,082,294**	**100.0%**

Source: U.S. Treasury,
http://www.treasurydirect.gov/govt/reports/pd/mspd/2015/opds112015.pdf

Foreign governments and other international entities hold $6.1 trillion of the national debt. This is roughly one-third of the total debt outstanding. Obviously, these foreign owners and sovereign governments expect to have this value returned to them at some point in the future—and will also expect ongoing interest payments from our government to compensate them for lending us these funds.

Studying the people in an organization and their self-interested behaviors is important and forms the basis for developing sound systems and structures. Are these people risk averse or risk takers? How much debt has accumulated under their control? Understanding the reasons for the debt, matching the debt to the purpose, and making sure the financial information supports the debt are important design features in the system and structure that needs to be developed. Auditors tend to rely on management's (the politicians and the government employees) oversight of the internal controls with a historical verification perspective. A simple example of this issue is the entity's balance sheet, which shows the financial position of the government for a snapshot period at a given date. What this means is that it is expected to remain stagnant until the next update, which is often not as frequent as necessary to provide the entities with an accurate picture of the current financial position. This may be due to the varying timing of the receipt of revenues and other transactional events that occur in unsystematic ways. Given the significant lag in transactional events, opportunity for exposure to fraudulent activity exists during the intervals between those fiscal snapshots. Knowing the public entity's ability to pay debt and ensuring that all obligations are reflected, whether or not due for payment in the current period, is critical in the development of long-term cash flow planning to satisfy capital needs.

Fiscal Discipline

National governments differ from state and local governments in that the ability of the national government to borrow money extensively, or tax via inflation by printing money (seigniorage),[13] provides the national government with significantly more fiscal flexibility. This flexibility has been demonstrated in recent years, as the U.S. national debt has increased dramatically while the federal government has not faced any major fiscal constraints from outside forces. Rather, the only real limitation has arisen from internal political unrest that came from the politicization of the debt ceiling for the federal government. While it's rare, ratings companies do sometimes report downgrading the U.S. debt rating. The most recent downgrade transpired in 2011, when Standard & Poor's took the U.S. bond credit rating from AAA to AA+. This change appeared to have little impact on borrowing ability or interest costs for the U.S. government. The point is that the U.S. Treasury remains just as safe as it was before the downgrade. The downgrade was apparently a response to the federal government increasing the debt ceiling. The federal government is giving the arrogant perception that it is too big to fail, and therefore the downgrade is symbolic in that it recognizes the fact that there is no one to bail out the federal government (unlike the federal government's bail out of AIG and other banking institutions).

The downgrade does in fact reflect a deteriorating financial condition and should not be taken lightly. Downgrades often lead to higher interest rate borrowing costs and can impede the ability to raise funds through future bond issues. These financial indicators need to be closely examined.

Understanding this flexibility in borrowing also exposes a potential to the system. Financial entities may attempt to get the national government to function as a backstop "lender of last resort" to preserve institutions. By having the ability to expand its borrowing volume with little impact on bond rating creates the illusion that this backstop is low cost or free. Private entities may then attempt to leverage against these public resources.

Understanding arbitrage is critical in identifying and/or preventing fraud and mismanagement. Arbitrage is the simultaneous purchasing and selling of an asset in order to profit from a difference in the price that occurs between two or more participants. The term *tulip mania* refers to a large economic bubble, or tulip, that occurs when asset prices deviate from their intrinsic value. The term came into play when tulips were being sold at prices significantly above the tangible value as a result of the expectations and demands associated with these tulips. So what happens when the tulip bursts? Who was crazier, the tulip lover who refused to sell for a small fortune or the one who was willing to splurge?[14] Typically, it is the government that is called in to bail us out of a financial crisis related to speculative bubbles and uncollateralized optimism. So is it these often external influences that exist outside the public entity that need to be watched and monitored before the actual burst takes place. This creates proactive forces that prevent the misuse of debt to enable fraud and mismanagement.

These leveraging-type actions, such as using credit without tangible collateral, are available to government. If left unchecked, they pose significant financial risks and create opportunities for fraud and mismanagement. Basically, the Federal Reserve and the government can purchase an asset by paying on account, like in the margining of a stock, by making a small down payment and borrowing the rest. This type of leveraging fails to collateralize and create tangible deliverables but, rather, relies on intangible or intrinsic ones. It is a breeding ground for financial crisis and structural imbalance in our financial system. It requires significant oversight to manage unsustainable growth spurts that are perceived to occur, giving the false perception of continuing indefinitely. The old adage "If it seems too good to be true, it probably is" comes to mind.

Structure of Federal Debt

Government spending policies set the scale of the national debt and programs and the revenue tools used to fund current and capital operations. Sound fiscal policy dictates that debt be used to support capital expenditures and that current revenue should fund current expenditures. Borrowing to fund current expenditures is not considered fiscally responsible. However, at the federal government level, this is common practice.

A second consideration is the term structure of the debt, where, in a fiscally responsible organization, one would suggest that the length of term on the debt should match to some degree the length of life span of the asset purchased. As such, for long-term capital investment, a long-term structure is rational and, for short-lived assets, or current expenditures, should be funded with a shorter repayment term. Proper fiscal planning would dictate that a debt be funded with a structure of payments that will allow the debt to be retired with a reasonable and affordable payment. Obviously, one can take on such a high level of debt that it is unlikely to be paid off in the term that is the basis of the spending, as is the case with the federal government. In such a case, it is logical to see funding terms that reflect the estimated time to amortize the debt.

In a February 2015 U.S. Treasury briefing, the Treasury Borrowing Advisory Committee reported that the weighted-average maturity of the U.S. debt portfolio in 2015 had increased to 68 months, from a low of 49 months in 2008. This new ratio compares favorably to our historical pattern of weighted-average debt maturity being in the 60- to 70-month range from 1985–2004. However, they also reported that 67 percent of the U.S. debt portfolio was maturing within five years and only 13 percent had maturity greater than 10 years. This is in sharp contrast to peer countries of the United States, such as the United Kingdom, where 34 percent of the debt will mature within five years and 46 percent had a maturity greater than 10 years. It is obvious that the U.S. federal government has a structure of borrowing that is not in line with the long-term financing of this debt, and that exposes the U.S. government to refinancing risk. As stated in the Treasury briefing, the U.S. debt situation is concerning, considering that "near term rollover risk is higher than other major government bond issuers."[15]

Given that the national debt now sits at a multi-trillion-dollar level and the federal government continues to run budgetary shortfalls, it seems that the appropriate term structure of the national debt would be funded in the 30- to 50-year range. This would raise the annual costs of funding the debt by forcing reduction through required amortization of principal but would limit the exposure of the government to interest rate spikes that could drive the cost of the debt even higher. The existing national debt is currently funded with a relatively short-term structure—with 67 percent of the debt requiring refinancing within five years, according to the February 2015 U.S. Treasury Borrowing Advisory Committee reporting as cited in footnote 20 of the report. It is this type of balloon financing structure that requires refunding of debt prior to payoff. This is no different than if a homeowner had a note that was ballooning (maturing) in five years. One major concern in balloon-type financing is the potential risk caused by interest rates going up—where the borrower is at risk for not being able to meet these higher costs. Government is subject to the same types of risks. The U.S. Department of Treasury knows this is a matter of concern. Affordable ways of funding the national debt have been explored. In February 2015, the Treasury Borrowing Advisory Committee reviewed the opportunity to increase the weighted-average maturity of the national debt, due to the current market conditions. The reality is that long-term borrowing rates are currently not much higher than short-term rates.

Yet, based upon the existing term structure of interest rates, as shown in Figure 1.10, if the U.S. Treasury tried to shift the maturity date on the national debt, a rather significant increase in borrowing costs would follow. However, doing so would provide a more sustainable and prudent funding base for the national debt. In general, it is anticipated that longer-term rates will be somewhat higher than short- and medium-term rates. This is due to the fact that lenders are taking on more risk to lend for an extended period of time. This difference in interest rates would impact the cost of borrowing if there is an increase in the terms of the loan or bond. For example, if the funding was just shifted for the one- to five-year maturity segment of publicly held debt ($8.2 trillion in January 2015, or 45.6 percent of the national debt) to 20-year average maturity, the cost of borrowing for the public segment of this one category would rise from $85 billion a year to $197 billion. That's an increase of $112 billion each year. By not implementing this funding change, there is a saving on current expenditures for borrowing costs. But Americans could face a spike in costs in future years if the cost of borrowing goes higher.

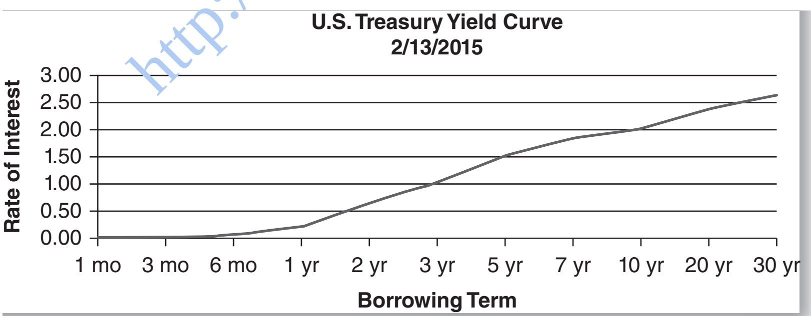

FIGURE 1.10 U.S. Treasury yield curve, 2/13/2015
Source: http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield

Focusing on maturity risk—not only in terms of matching the assets and liability maturities but also with regard to the governmental inflows and outflows of cash—is critical in preventing potential fraud and mismanagement. A debt of $18 trillion was not incurred overnight. Only with reasonable maturity matching can a long-term solution be developed to address the huge debt problem many governmental units face.

STATE GOVERNMENTS

State governments provide many useful functions that, in some cases, are rooted in the colonial charters granted prior to the Revolutionary War. Given the depth of these roots in the history of the United States, there is some variation in the organizational structure and practices by state. We will attempt to provide a basic overview of state government and the various financial practices that are generally observed across the United States. Organizational structures and practices may vary by state and region.

State governments, in general, are organized with an elected governor, or head of the executive branch, and two legislative bodies—typically an assembly and a senate. There are, however, some U.S. states that have unicameral forms of government that are operated under the umbrella of one legislative chamber. Unlike the federal government, both state assembly and senate bodies are representative of population, as opposed to the U.S. Senate, in which each state is represented by two senators regardless of population. These three groups—executive (governor), assembly, and senate—formulate a state budget and spending/taxation plan for the particular state.

States vary in terms of their particular laws and taxes, as they have varying competing interests and goals. For instance, states like Delaware function as tax havens, with favorable corporate taxes. Others, such as Alaska or Kansas, may favor certain industries, such as farming, mining, and petroleum. Therefore, our discussion here is a general one and limited in applicability to any given state. In terms of financial resources, the state governments generally rely on income taxes, sales taxes, excises taxes, and fees as primary sources of revenue. These funding sources may be dedicated for special purposes or poured into the general fund. In the United States, there is significant interest in special-purpose funds, as opposed to general fund sources. With that comes an overriding focus on taxes as dedicated from users for particular purposes. This is in sharp contrast to the European model, where there is limited ability to segregate revenue for special purposes and most revenue pours into the general fund.

Once the revenue has been collected, there is an allocation process in which political powers-that-be decide on the allocation of resources. In the case of the general fund, the political discussion can be intense, where various pet projects and special interests are duking it out for the same fixed pool of funds. For dedicated sources of funding, even those provisions are not absolute. State legislators are experts at breaking open "lockboxes" that contain dedicated funds. Finally, the state governments generally have a bonding capability that can be used to finance revenue shortfalls.

State bonding capability is not unlimited and is tied to revenue sources that are dedicated to repaying the bonds. Bonds are not a revenue source. They are a source of cash flow, but they need to be considered as a revenue-smoothing tool to provide for uneven spending patterns on government projects.

State-level borrowing is limited, to some degree, by state statute. These limits can be set by the state constitution or by legislative act. In a number of states, the limit is set based upon a percentage of the value of all property in the state. Other states limit the level of spending on debt service (the amount paid for principal and interest on borrowing annually), which effectively caps the debt level for a given bond rating. Some states have no expressed cap on debt but have historical patterns of borrowing that function as general guidelines for debt issuance. Some states limit borrowing to some ratio of the total general fund revenue and/or may limit the term of borrowing to some maximum number of years. Finally, certain states require voter referendum to issue debt. As we can see, there is considerable variation in the levels allowed, authority for issuing, management, and maturity of state debt.

The level of debt is also capped from a functional perspective based upon the lenders and the bond rating appetite. Given that the rate of interest charged is based upon the overall state bond rating and the financing duration, you can see that as a government gets further in debt, the cost of borrowing tends to increase. Correspondingly, as the financial future of the state seems brighter and revenues improve, the cost of borrowing falls. States have to manage this relationship in a complex and dynamic way, balancing borrowing costs and bond volume against their natural aversion to raising taxes or fees.

As illustrated in Figure 1.11, as the quality of bonds declines, the cost of borrowing goes up—across all maturities. If an entity has a AAA rating from Moody's or S&P, one would expect to pay 1.65 percent for 10-year notes, 2.45 percent for 20-year bonds, and 2.60 percent for 30-year bonds. As quality declines, the rates increase. As an entity adds to the total outstanding debt or

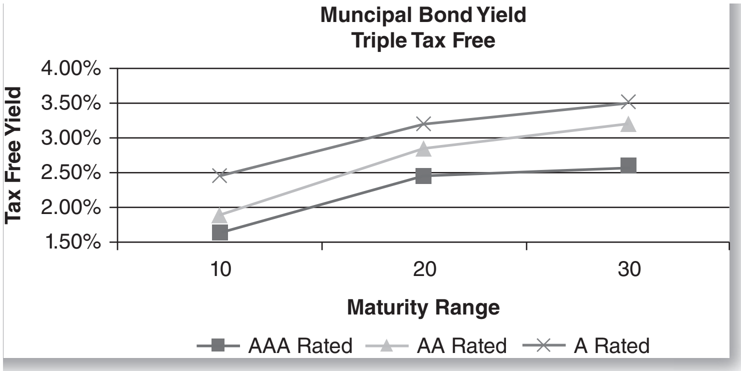

FIGURE 1.11 Municipal bond yield, triple tax free

the revenue sources decline, the bond rating will decline due to the concern about ability to pay. This then adds to the financial burden of holding an existing level of debt. That, in turn, curtails the ability to issue further bonds if the revenue pool is fixed. This relationship functions as a built-in limiter on government entities and caps their issuance of additional debt. For a fixed 20-year debt of $100 million, the cost of borrowing goes from $2.45 million annually for AAA-rated securities to $3.20 million annually for A-rated securities—a 30.6 percent difference in the cost of borrowing. Please note: These costs examined here are only for the best categories of borrowing—the "A" quality; there are lower grades of bonds such as B rating all the way down to D, with similar breakdowns inside each group. Thus, even at the high investment grade level there is considerable variation in borrowing rates and this may be even greater in lower-grade issues.

LOCAL GOVERNMENTS

"All politics is local," as former Speaker of the U.S. House of Representatives Tip O'Neill was known to be fond of saying. Local government provides many key services and goods to local communities that are in many cases poorly understood by local voters. Local government can be grouped into county and local municipal government. Counties, in many cases, are rooted in the colonial period with the establishment of many dating back to the mid-seventeenth century on the East Coast of the United States. County government may be organized under a board of elected "freeholders," who supervise local county-level spending. Cities or towns have various terms for their leaders. *Mayor* is a common title for the top official, with *aldermen, council members, commissioners,* and *committee members* being the titles of some of the legislative body members. The various forms of government were listed earlier in this chapter. There are various forms of authority, including those in which executive power lies within a committee, for example, most schools in New Jersey operate independently from Municipal or county government. Thus, looking at the ethical tone at the top of these public entities and who has access to the resources, whether it be goods and/or services or value created by these goods and services, is important in any structure, especially on the local level.

Local municipal government comes in many organizational forms, usually in step with any given municipality's size. There are cities, boroughs, townships, villages, and hamlets within larger municipalities. In addition, there may be independent school, transportation, water, sewage, and other boards for local needs. In some cases, the city government overlays the county government and is coterminous—such as in San Francisco, which is both a county and a city. In New York, the city government overlays five counties and assumes most county functions under the city government. In the case of functional boards, such as transportation, these entities may function across county and municipal boundaries and serve and tax across the region.

The role and scope of local government have been hotly debated in the past 100 years in the United States. Local government suffers as the last in a great line of government entities that, in many cases, have rule-making authority. In general, municipal governments are creatures of the state. This means that local governments are many time subjected to comply with additional federal and state laws and agency policies. A simple example is environmental regulation, for which the federal, state, and even county government can promulgate rules that must be implemented by local government. Examples of such environmental regulation are recycling, water quality, leaf composting, and storm-water runoff. The local government may be charged with implementation and the accompanying cost to implement various regulations without discussion or power to refuse. As such, the local government may be "crammed down" on with what is known as an unfunded mandate.

Further, the types of services provided by local government vary considerably across the nation and even within states. Hospitals, public health facilities, libraries, museums, mass transit systems, courts, roads, drainage systems, parks, police, firefighters, ambulance services, recreation, schools, building regulations, public housing, public open space, recycling, pools, beaches, and many more things fall within the possible range of local public services provided in any given town.

Selecting that mix of services to provide and also the funding mix of revenue tools to provide for long-term support of these systems is an ongoing discussion in most municipalities. What is deemed "necessary" and "critical" is the basis of many public debates and exposes the conflicting interests. Suffice it to say, many "necessary" expenditures are not all that necessary and many "critical" services are not always of a true crisis nature. It is common to see mission creep and scope issues crop up in local political debate. Typically, the management of local government will continue to see expanded roles for their organization that are far broader than their true mission. Every public service typically requires capital investment and training for staff. Be it a tactical assault team for the police, expanded firefighting skills, training and/or equipment, a new sport, or even an additional language class offered at the local high school, each expands the role of government and typically incurs costs. Most bureaucrats are resistant to reducing their functional roles to accommodate change. This leads to more, not less or stable, capital and operations costs—more roads, more sports, more equipment. All told, costs of municipal services end up rising. Visit your local or county government and suggest abandoning anything—a road repaving, a wanted tennis court … whatever. Experience the process. It's not easy.

Considerable power rests at the local level, with many key planning and functional issues left to the local governments. With funding issues, more and more responsibilities will be initiated by the federal and state entities, as they divest themselves of the funding responsibilities that are often attached to these policy mandates. In particular, the determination of land use matters at a local level is of critical interest in terms of power and corruption. Major private projects see their most significant political support or opposition at the local level. Surprising to many, major private projects, such as the building of a shopping mall, may have very little federal or state oversight, leaving the supervision and policy decisions to the local government. Interestingly, some of these decisions may be optimal for a given local government, but may impose significant direct public costs or external burdens on other local, state, or even federal entities.

Yet local governments' elected officials and bureaucrats may lack sophistication or the scale of operation to hire experts in all areas. So they may rely on the skills of hired consultants, local knowledge, or past practice to choose a course of action. This creates a political operating environment that can be a prime breeding ground for corrupt practices. In the best-case scenario, the local government makes a wise choice based on good counsel from prudent providers or staff. In the worst-case scenario, the local government relies on poor advice and information in rendering a decision and/or relies on a corrupt provider to guide the entity.

PUBLIC AGENCIES

Public agencies are typically authorized by national, state, or local governments with some statutory responsibilities that leave them somewhat detached from the elected officials in terms of day-to-day operations. A public agency is defined as "the government of the United States; the government of a state or political subdivision thereof; any agency of the United States, a state, or a political subdivision of a state; or any interstate governmental agency."[16] A **public agency** is typically affiliated with a local branch of state, county, local (municipal), or federal government. A **private agency**, which is usually a state-licensed entity, either nonprofit or for-profit, serves as an agent to a government entity. An example is the private inspection facilities in New Jersey that perform car inspection services.

Public agencies are typically chartered to provide some limited service or supervision that is specified in the organizing documents. These agencies can also have powers delegated to them by federal or state statute, and must operate within the scope of particular laws and enforcement provisions. These entities then usually operate under an appointed director, typically appointed by the president of the United States for federal agencies. The Senate, in some cases, may confirm the director. Once appointed, the director and administrators may have broad latitude in decision making and policy actions, with limited recourse by elected officials to discipline the agency or remove the director. Finally, the agency may have rule-making authority, which essentially gives it the power to make regulations. Those regulations have the teeth of actual laws and, as such, the agency can then enforce rules with legal authority.

The reason for separation of elected officials from agency control is an interesting and complex matter. Some agencies are established to remove the day-to-day operations of critical government functions from the highly politically charged environment of the statehouse, town hall, or capitol. Issues such as national security may guide us to seek the assistance of a structure such as the Central Intelligence Agency (CIA). By operating as a separate agency, the

CIA director can exert considerable control and operational guidance over the organization without seeking direct approval from the president or Congress. The need to remove the agency from political entanglements in policy may also guide us toward an agency structure. Independent watchdog agencies such as the Federal Trade Commission (FTC), the Environmental Protection Agency (EPA), and the Securities and Exchange Commission (SEC) may be organized as independent agencies, in part, to insulate the rule-making and enforcement activities from the political sphere of government. As further protection from political interference, for federal government agencies that are considered regulatory in nature such as the FTC or SEC, it is policy that their agency heads can be removed from office only with good cause. In agencies that are not considered regulatory, such as the EPA, the director serves at the will of the president.

One key control measure over an agency is the question of funding. A government agency may have a high degree of autonomy in terms of daily action, but it still needs to obtain funding for operations and capital projects. This generally requires interaction with elected officials and offers some degree of operational control over the agency, as there is generally interest on the part of the director to obtain requested funding. This gives rise to the public budget hearing that occurs in many cases, with elected officials grilling directors and agency staff over policy and operational decisions.

Agencies responsible for taxation and fee-based operations have considerably more latitude in terms of their interaction with elected officials. If the revenue created by their taxes or fees is sufficient to fund all or part of agency operations, then the agency may well have the economic power to avoid serious supervision and control by elected officials. For instance, the General Services Administration (GSA) of the federal government functions as the "government landlord" through the Public Building Service (PBS) arm of GSA for federal buildings. Federal agencies that occupy GSA properties pay rental fees to the PBS and that revenue is then used to pay for the building operations and capital improvements. In addition, the GSA operates the federal vehicle pool of 210,000 vehicles, with individual agencies paying for the use of these vehicles.

It is important to consider that the agency does not have to have a net income (known as profit in the private sector) to benefit from revenue and fees. Generally, an agency with significant revenues and cash flows can divert a segment of that revenue to fund particular projects that may be politically unpopular and difficult to fund through a budget allocation from the elected officials. By taking advantage of an internal revenue stream, one may be able to create a larger shortfall in a politically strong area (say, the GSA vehicle pool—a real no-brainer for the elected officials in terms of funding) while funding the controversial project without recourse to the general budgetary allocation.

At agencies with a high degree of financial independence and strong agency statutory authority, the level of independence from oversight may be astounding. This autonomy may be most easily shown by the chair and board of the Federal Reserve System (Fed), as stated in their own policy.

"The Federal Reserve Act requires the Federal Reserve Board to submit written reports to Congress containing discussions of the conduct of monetary policy and economic developments and prospects for the future." This report, dubbed the *Monetary Policy Report,*[17] "is submitted semiannually to the Senate Committee on Banking, Housing and Urban Affairs and to the House Committee on Financial Services, along with testimony from the Federal Reserve Board Chair."

This requirement is achieved by reporting twice a year to these committees. However, the Fed operating policies are largely independent of any political discussion, as the Federal Reserve does not seek funding from Congress. It actually pays a net dividend from Federal Reserve bank operations to the U.S. Treasury as a residual payment after all Federal Reserve System costs are paid. In 2012, this amounted to $88.9 billion paid to the U.S. Treasury. Thus, any significant expenditure deemed necessary by the Fed board or regional banks is deducted prior to this transfer. This simple fact may explain the generally informative, but emotionally detached, presentation made by the Fed chair to Congress. He or she is well aware that her agency has little to no risk in terms of budget or practice due to the testimony given. The head of an agency without revenue powers knows full well that his or her answers may subject his or her agency to political retribution through the budget process.

PUBLIC AUTHORITIES

The Office of the New York State Comptroller defines "public authorities" as corporate instruments of the state created by the legislature to further public interests. These entities develop, operate, and maintain some of New York's most critical infrastructure, including roads, bridges, and schools.[18] Public authorities are typically authorized by nation, state, or local authority and are usually chartered to provide some limited service or role in a given region. Federal authorities are chartered by the federal government and include authorities such as the Tennessee Valley Authority—an electric power, waterway, and economic development entity. State authorities include many mass transportation authorities, airport operators, turnpike authorities, power systems, water systems, sewage systems, and the like. Local governments may band together and seek state charter for local authorities as needed. They may also provide separate boards to supervise particular government entities, such as housing authorities.

An authority is a completely separate branch of government with no operational ties to the organization from which it is created. It is different than an agency in two key respects: It may have a budget that is separate from the authorizing entity, and it may have the ability to issue its own debt. The New York State Comptroller's office[19] defines the differences between state agencies and authorities as follows:

> Unlike traditional State agencies, many authorities conduct business outside of the typical oversight and accountability requirements for operations including, but not limited to, employment practices, contracts and procurement procedures, and financial reporting.

Key aspects of all of these public authority entities are that they are typically run by a charter (compact) and that they have a board of directors, a chairperson, and executive management. Included in the charter is, in most cases, the authority to charge fees and provide for the issuing of bonds, usually with some range of cap on the amount of bonds issued. The bonding limits set boundaries on the activities of these entities and protect the chartered entity from unlimited activities or scale with respect to the authority. The role and scope of authorities is considerable, and governments across the United States have ceded considerable amounts of government function and power to public authorities.

In December 2014, the comptroller of the State of New York reported that there were 1,180 public authorities in New York State alone with a wide range of power and issues related to policy and supervision delegated to these entities. This growth in authorities in the state is dramatic. It started with the first, the Port Authority of New York and New Jersey, in 1921, and saw an average increase of 12.67 authorities per year over the following 93-year span. These authorities employed 153,502 people and collected $59.8 billion in revenue in 2012.

Public authorities have a number of odd characteristics that make them similar to government in some aspects and private corporations in other ways. Generally, they have some form of financial and activity reporting but may claim exemption from various forms of government oversight. Further, their unique status may in fact preclude the public from pursuing the entity in court under unclear statutes and various aspects of government sovereignty. In some cases, federal and state law is ambiguous, or even silent, with respect to public authorities.

GOVERNMENT VIA CONCESSIONS, FRANCHISES, AND CONTRACT WORK

This is not an actual form of government, but in fact consists of private entities that act under the governmental umbrella to provide goods and services. These arrangements are authorizations for work that occur under all of the forms of government previously specified. Government does not function only through its standing agencies and departments. Government, in many cases, hires outside private corporations and firms to provide government services. These private firms may be hired in a number of ways to serve public needs, including straight billing of fees for service, standing contracts that are renewed regularly via resolution, and ongoing concession. All of these modes of purchase or lease have limitations and challenges for the governmental entity, and proper standards of practice need to be applied in the contracting process. Appropriate performance standards and enforcement provisions need to be included in the contract. In addition, the governmental entity needs to be prepared and equipped to hold the contract provider accountable as needed to maintain compliance. Failure to include these clauses or failure to act in situations of nonperformance exposes the governmental entity to additional risk.

Some of the classic forms of government corruption involve the use of private contract abuse to funnel money from government sources to politically connected private-sector firms. A classic example of this is the Tweed Courthouse in New York City, which was constructed in the 1870s using various corrupt and connected firms. Costs rose from an initial estimate of $250,000 to a final cost of more than $12 million ($200 million in today's dollars), and construction dragged on for 20 years, from 1861 to 1881. The key reason for these overruns was the extensive graft and kickbacks that were paid to individuals connected to William Magear "Boss" Tweed of Tammany Hall—the local party boss.

Another more recent phenomenon is the migration of public ownership into private entities that function under government license or franchise. These entities are given a contract to provide some form of service or operation under the auspices of the franchising governmental entity. For example, in some states and also in European countries, toll roads have been transferred or created by private entities that have been given some franchise agreement. The control over the entity is limited and is largely dictated through the contract terms of the operating agreement.

Are these governmental entities or private enterprises? A number of interesting questions arise. Given their government sanction and contract, it could easily be argued that their activities should be subject to public scrutiny and public bidding laws. The problem occurs when the controls break down and public interest is not there. Given that they function under sanction of the government, it should be determined whether or not the service provided is exclusive to the selected firm and other firms are excluded from the market. These authorities that tend to "float under the radar" bear less accountability.

Oversight and proper contract design is the key to a successful concession contract. These concession contracts have many detailed terms and have to be negotiated with an eye to detail and with clear objectives. Contracts can be deficient in key details and also potentially can undervalue the asset leased. For example, in 2008, the city of Chicago sold a concession to operate parking meters in downtown Chicago. The concession agreement was for a term of 75 years, and the concessionaire was the same firm that leased a number of the public parking garages in Chicago. This contract was subject to an investigation by Chicago's Office of the Inspector General in 2009. The report found that Chicago had been paid roughly 46 percent less for the lease of the asset than the full value of $2.13 billion.

Perhaps some of the lessons to learn with regard to private concessions may come from outside the United States. European governments have a long history of providing public services through concession agreements. In many countries, the history and framework of Roman law discourages the use of a quasi-governmental agency such as a public authority that would be standard practice in the United States. Projects are undertaken via either the public sector (true government) or the private sector (private company). The European governments have also developed laws and standards of practice to ensure contract compliance and protection of the public. In particular, governments may place constraints on the length of concession contracts, impose limitations on increases in prices for concession services, and set operational quality standards. We explore these practices in later chapters.

PUBLIC-PRIVATE PARTNERSHIPS

A partnership is an organization in which two or more entities manage and operate a project. Both are equally responsible for the debts incurred by the project. This business relationship is between a private-sector company and a governmental agency for the purpose of completing a project that will serve the greater good of the public. Public-private partnerships (also known as PPP, P3, or P^3) can be used to finance, build, and operate projects for things such as public transportation, parks, and convention centers. Financing a project through a public-private partnership can allow a project to be completed sooner or make it more financially feasible.

This PPP concept is currently all the rage in Washington and in various state capitals. This model of providing public services relies on a private-sector firm to organize and perform the work under contract with the governmental entity. The form and relationship can be complex, with various portions of the work provided by the private sector and with various roles for government incorporated into the project.

PPP infrastructure-type projects can be grouped into four broad categories as identified by the World Bank: management and operating contracts, leases, concessions, and joint ventures. Using these general forms, government can contract to have a private entity perform a given management service, can lease or otherwise transfer the operations of a government asset to a private operator, or can partially or fully divest itself of ownership of a government asset.

Typical examples of divesting or joint ventures would be a government selling or leasing a noncore asset that can be operated as a private entity through the use of fee revenue or some sort of government payments. In many areas, the government has built a utility service—such as electricity, water, or sanitary sewers. The government can maintain these assets through the use of public funds—or in some cases can decide that it is optimal to lease or outright sell the asset to a private operator. This operator then has a contract to provide a given level of service or it may fall under additional regulation—such as public utility service law—that controls its prices and service levels. This may be important for government entities that have limitations on their capital spending and bond issuance. Thus, by transferring the asset to a private owner, selling a part ownership in the project, or leasing out the assets, they can then tap into the ability of the private partner to borrow and invest in the asset.

The most basic form of concession is privatization of an existing public asset—such as a toll road or electrical grid. This is called a *Brownfield* project—as the project has been constructed and is in place and operating. This type of project is very attractive to private investors if the terms of the lease are reasonable, because they are purchasing or leasing what is known as a going concern. A going concern has a known volume of sales and usage, a known cost structure, and known operating conditions. As such, the potential private leaser of the property is better able to evaluate the expected cash flows and capital needs—and this gives greater value to the project.

As an alternative, governments can grant concessions to construct new facilities or assets. These types of contracts are known as *Greenfield* projects—as these assets are being built on a “green field” (i.e., one that has not previously been built on). Given that the asset is not yet in place, operating conditions, costs, and revenues are much less established. Further, the costs of construction are unknown and the potential exists to have significant cost overruns or delays in the project. As such, private leaseholders are going to discount the value of the project to account for this risk and will generally negotiate for more favorable terms in the lease contract to protect the private firm from unforeseen outcomes. These could include government financing of the project, government guarantees, and progress payments for meeting certain construction milestones.

In all of these models of PPP, the government sector has to perform a careful analysis of the value components that are being transferred to the private sector. In many cases, governments look to transfer assets in a poor state of repair, as that is the situation that motivated them to consider privatization—a desire to avoid the significant capital investment to upgrade existing facilities. In those cases, the contract terms will be reflective of the poor asset conditions. If the government is leasing an asset in a good state of repair and one with a strong revenue stream, then the value of the lease in terms of payments to the government should be high. It is very important to be aware that the terms and conditions that are specified in the contract will be subject to minute analysis by the private-sector partner—and they will expect to hold the government to all the terms of the lease. Further, one should expect that the private leaseholder will try to take all liberties allowed in the contract to minimize costs and maximize cash flow to the private operator.

Be aware that private-sector experts are more than willing to work in the service of government and public organizations. However, private firms participate based upon the desire for revenue and ultimately, profit. As such, projects need to provide a good level of projected return if one wishes to engage the help of private firms. PPPs are not a magic solution to revenue or cost issues in the provision of government services, but they offer alternative methods of project delivery and operations.

One of the more interesting forms of PPP is known as DBOM in the world of transportation and public infrastructure. **DBOM** stands for **Design, Build, Operate, and Maintain**. In this model of PPP, the private operator receives a contract to bring a capital project from the design phase all the way through the operation and maintenance of the project for a period of time. In traditional contracting for a capital project, a single firm under government contract may complete the design, and then the project is publically bid for construction. After completion of the project, the asset is turned over to the government entity for operations and maintenance. In a DBOM contract, the government issues a contract with general performance goals for a system. It allows contractors to bid for the whole package of designing the system in detail, building it, and then operating and maintaining it for a fixed period. In return, the private owners would receive revenue from the project and/or a series of payments for the construction and services provided. The operating and maintenance contract has a limited period of service and after completion of that period the asset is generally turned over to the government entity for a new contract to be reformed or for municipal or other potential operating purposes.

As an example of this concept, in 1996, New Jersey Transit contracted to construct a new light rail system in Hudson and Bergen counties in the state of New Jersey. This system, called the Hudson–Bergen Light Rail System (HBLR), opened in 2000. As opposed to the traditional method of providing rail transit services with agency-owned assets and operations, the HBLR was built using a DBOM contract, with the firm 21st Century Rail being awarded a contract to construct and operate the system for a period of 15 years from the start of operations. The private operator was then responsible for the staffing, operations, and other maintenance costs for the system during this contract period. This allows significant flexibility in terms of operating and staffing practice as compared to traditional government operations.

Overall, this method of project delivery is seen as one that provides the correct set of incentives for the private contracting firm, if the contract terms are well-defined. Given that the designer of the project is the same entity that will build and operate the project, cost and design decisions should be made that reflect the overall long-term cost of delivering the service. For instance, cutting corners and doing shoddy work on a component of the project—say, a bridge section on the line—would represent a significant financial risk to the DBOM contractor. That's because the failure of the bridge or significant repair costs would be borne by the DBOM contactor. In sharp contrast, if a contract is just a construction contract, the private contractor has little incentive to ensure that the project components will be in good working order past a relatively short warranty period (generally one to five years). Also, the DBOM contractor has incentive to expend more effort on design aspects and selecting materials that will have long life and minimal maintenance needs, as the contractor will be operating the system for that extended period. Finally, the DBOM contactor has incentive to deliver the project in a timely manner so that operation and maintenance payments can be procured.

In contrast, some traditional government contracts have been subject to significant cost overruns and long-delayed project delivery. For example, the Wollman Rink ice skating rink in New York City was a textbook case of project delay, in which, starting in 1980, a projected two-and-a-half-year renovation of the facility stretched to six years with no end in sight. Finally, real estate developer Donald Trump stepped forward in 1986, and under his firm's supervision and construction management, the renovation was completed in three months. Another example is the famous Central Artery/Tunnel Project, also known as "The Big Dig" in Boston. This initial project cost was estimated at $2.8 billion, with a construction period estimated to run from 1991 to 1998. The project was finally completed in 2007, after 16 years under construction and at a total cost of $14.6 billion. New York City's East Side Access project, a new transit link in Manhattan, was initiated in 2006, with an estimated $6.3 billion in costs and a forecasted completion date of 2013. Current projections from the project sponsor, New York's Metropolitan Transportation Authority, are for a 2023 completion date, with a total cost of $10.178 billion. These are examples of traditional governmental contracting practices that have gone awry and why PPP contracts are viewed in many cases as better project management practice as well as control risk for the government entity.

One key advantage that PPP projects can offer to the public sector is project administration and cost control. Current practice in public contracts relies on the lowest qualified bidder to provide the service. This can result in somewhat less efficient or experienced bidders winning the contract. Meeting the minimum bid criteria and offering the lowest price does not ensure quality work. By using a PPP contract, the PPP contract winner can negotiate a price with a given qualified contractor and manage costs through an ongoing relationship with the contractor. Given that no long-term relationships can be formed in the public competitive bid process, there is little social pressure to perform well and no real penalty for poor performance, outside of the contract penalties and warranties that often do not carry significant contractual consequences. Companies such as Macquarie Bank of Australia, which have multiple PPP contracts, can develop ongoing relationships with construction, maintenance, and financial companies.

Another advantage is that the contract terms can shift some of the risk for cost overruns to the private contractor and provide incentives for early delivery and cost control. By specifying the contract payment schedule and various targets for construction and system performance, the governmental entity can provide incentives for the PPP constructor or operator to achieve certain outcomes and project goals. In public-sector administration, it is rare to find significant penalty clauses or benefits for project management and success. With the ownership and administration tied to government service, who would be the valid payer if a bureaucrat failed to achieve project goals? Would Nevada be forced to pay Nevada a project penalty if a highway project ran over in terms of cost or was not delivered on time? With a proper PPP contract, the governmental entity can place rewards and penalty clauses that can potentially increase or reduce profit for the PPP contractor. Most contracts routinely include liquidated damage clauses in the bid specs. These terms can provide incentive to manage costs and also promote on-time or early project delivery. The impact can be dramatic. According to the American Association of State Highway and Transportation Officials (AASHTO), the Hudson–Bergen Light Rail was completed for $2.2 billion on budget and with a project time savings estimated at eight years, as compared to a traditional multiple contract design/bid/award/construct process.[20]

There has been a long history of private assets providing contracted services for public benefit. The electric company, water supply entities, sewer authorities, and telecommunications companies are, in many cases, private entities that provide key regional infrastructure. In some cases, these same services may be provided by government entities. Privatization offers governmental units the opportunity to lease (in most cases a lease is used as opposed to outright sale) a public asset to a private operator in exchange for a single lump sum or a series of structured payments.

These leases can be for a considerable period of time and may include price escalation clauses that increase the value of the lease. A prominent example of this type of contract was the lease of the Chicago Skyway to a private concern led by Macquarie Bank of Australia and Cintra transportation systems of Spain. Cintra S.A. is one of the largest private developers of transport infrastructure in the world. Its full name is Cintra Concesiones de Infraestructuras de Transporte. Cintra is one the largest private toll operators in the United States. The City of Chicago leased a municipally owned toll highway to this private concern for a period of 99 years. The lease terms included favorable allowances for toll increases as well as terms and conditions for road operations. In exchange, the City of Chicago received a one-time payment of $1.83 billion in 2006. The private concern is responsible for maintenance and operation of the roadway and in exchange keeps all toll and other revenue.

One key advantage of PPP is the opportunity for the private entity to bond against future fee increases. In traditional agency or authority funding models, bond purchasers will generally allow an agency to bond against future revenue generated by existing fees but are resistant to additional bonding against the planned increases in these same fees. Fearing that the agency in question will lose the political will to increase fees as scheduled in future periods, bond purchasers and bond rating agencies are reluctant to approve lending against any future of the value of future fee increases to be bonded against in the current period. This allows a greater front-end payment and thus can be an inducement to government entities to lease assets and achieve the maximum short-term payout, which can be disposed of in various ways by the current elected officials. As this process essentially delivers the value of future fees into the hands of today's politicians, one must consider the various aspects of public finance in these decisions.

Clearly, this form of lease allows a government entity to capitalize on the value of a publicly owned asset and obtain a potential cash windfall. However, it is very important to carefully negotiate the terms of a long-term lease, as any errors or omissions in the lease will typically require additional cash payments or other compensation to the concessionaire to correct these errors. Also, the level and frequency of price changes need to be considered carefully. Granting an exclusive operating agreement to a private firm can create incentive to price-gouge. The Europeans have a more conservative view on privatization contracts, with French and Spanish road concessions generally containing lower price escalation clauses and shorter lease terms. These factors reduce both the risk of contract error and also the lump-sum cash value of these leases. Finally, given the move toward lump-sum payments for these concessions, one must be concerned that the elected officials who are the stewards of these public funds will develop a long-term strategy for their use. Utilizing a lump-sum payment from a concession agreement to satisfy a short-term budget need is not prudent. Unfortunately, if history teaches us anything, we find that elected officials have a very difficult time planning for long-term capital management.

One of Cintra's biggest public-private partnerships involved a 75-year lease infrastructure deal for the Indiana Toll Road in 2006. Cintra and minority partner Macquarie of Australia paid $3.85 billion to Indiana to operate the 157-mile roadway.[21] The leases allowed Cintra to collect the toll revenue through the year 2081. The problem with the agreement in Indiana was that it allowed the toll rates to more than double from $14 to $32 within the first five years, calling for a 2 to 3% inflationary adjustment for the remaining 70 years. Toll rates are indexed to the rate of inflation.

Overall, PPPs offer many interesting alternative methods of project finance and project delivery for elected officials to consider. The problem is it offers immediate, onetime cash fixing and also removes the responsibility for maintaining and repairing the existing infrastructure from the government entity but it also may place significant costs on facility users. With various risks and components of value, we caution their broad use and application without careful evaluation of contract terms and project specifications. A careful transparent cost study with proper projections and with high levels of professional skepticism is a must. Unfortunately, given the value at risk, it is difficult for government entities to hire competent and objective valuation experts to negotiate the deal for the public entity. This is due in part to the extensive specialization of valuation consultants on the "buy" side of the market, where the larger paychecks for valuation consultation are in the hands of the purchaser (leaser) of public assets. Finally, any PPP project should be carefully evaluated for market power and the creation of de facto monopolies by the granting of an exclusive government contract for a given service.

CONCLUSION

As we have seen, there are myriad forms of organizations that can provide government or public services in our society. The various roles and forms of service provision need to be carefully explored by elected officials and policy makers. The behavior that surrounds these public-entity forms is critical in formulating a plan to mitigate fraud and mismanagement.

There is considerable pressure to expand the role of government and add costs and services based on political pressure. The problem is that people do not want to pay for these services. These expansions may seem on the surface to be benign, but may in fact cause structural cost increases for the government entity, and require the application of a high level of skepticism.

Careful consideration of the method and cost structure of each form of government service should be examined and decisions should be driven in large part by long-term costs and the ability to provide the service effectively. Clearly documented, well-defined language along with the properly trained people and controls surrounding the authorization process are essential.

All governmental entities should consider whether or not a service or expenditure is clearly a government matter or could be performed more effectively or provided more efficiently as a private expenditure. Government should be cognizant of the particular line of business and what is involved. Should the United States have the Export-Import Bank of the United States (Ex-Im), which is the official export credit agency? The Ex-Im is an independent, self-sustaining executive branch agency with a mission of supporting American jobs by facilitating the export of U.S. goods and services. The salient issue is whether or not government should perform a function itself or outsource it to others. The authors remind the reader that many individuals in the private sector would love to have their personal expenditures shifted to the government; only with prudent practice and sound judgment can proper balance be maintained between public and private costs. Any government intervention or partnership should never lead to the creation of monopolistic or oligopolistic precedents. It should not inhibit market entry by limiting open market participation and/or steering to political or related-interest parties, either. Utilities, cable companies, and sports authorities that create limited markets are arenas in which the potential for fraud and mismanagement thrives. Free market and skeptical oversight are critical in ensuring that a proper ethical tenor thrives.

In conclusion, the exact public-entity forms and responsibilities vary considerably across states and regions in the United States and in other countries. Regardless of the form, the behavior needs to be examined for any deviant or abnormal patterns. The sheer number, variety, and overlapping nature of public entities makes the job of ensuring accountability and preventing fraud in the public sector a challenging task. While this may prevent people from identifying silver bullets, a general approach can be developed and applied in any one of the scenarios described in this chapter. Well-trained independent public servants working within well-developed compacts (constitutions, charters) that clearly define responsibilities and duties and have a no-tolerance-for-override policy, ensure transparency, and have the public's support are what create adequate controls and balance. It is a well-developed system and structure with the proper ethical tone that ensures the mitigation of fraud and mismanagement.

NOTES

1. http://www.njslom.org/types.html.
2. http: //www.nj.gov/comptroller/news/docs/authoritiescommission.pdf.
3. Readers with a strong interest in governmental entities are advised to read the enabling statues that create these organizations. Naming and the definitions of these entities are somewhat subjective.
4. http://www.state.nj.us/education/data/fact.htm.
5. http://www.laffercenter.com/the-laffer-center-2/the-laffer-curve/.
6. http://publictransport.about.com/od/Transit_Planning/a/Load-Factor-Low-Floor-Vehicles-Need-A-Lower-One.htm.

7. A Ponzi scheme is a fraudulent investment operation where an individual or organization is paid returns from new investors' capital, rather than from profit earned by the investments.
8. Divisionalized organizational structure is that the divisions can act with a high degree of autonomy to address specific issues by the power (authority) they have been given.
9. The Federal Reserve Act establishes both 14-year terms for members of the board and four-year terms for the chair and adds: "each member shall hold office for a term of fourteen years from the expiration of the term of his predecessor, **unless sooner removed for cause** by the President."
10. http://www.bloomberg.com/news/articles/2010-12-09/more-than-half-of-americans-want-fed-reined-in-or-abolished.
11. Thomas Jefferson, http://www.brainyquote.com/quotes/quotes/t/thomasjeff130495.html#EbhxrksstgU0eGeK.99.
12. http://data.bls.gov/cgi-bin/cpicalc.pl The inflation number utilized the U.S. Bureau of Labor Statistics Inflationary calculator.
13. Seigniorage is the difference between the value of money and the cost to produce it. If it costs the U.S. government $0.05 to produce a $1 bill, the seigniorage is $0.95, or the difference between the two amounts.
14. http://www.businessweek.com/2000/00_17/b3678084.htm.
15. http://www.treasury.gov/resource-center/data-chart-center/quarterly-refunding/Documents/February2015TBACCharge1.pdf.
16. Fact Sheet #7, U.S. Department of Labor, www.dol.gov/whd/regs/ … /whdfs7.pdf.
17. http://www.federalreserve.gov/monetarypolicy/mpr_default.htm, accessed 1/22/2015.
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21. http://www.landlinemag.com/Story.aspx?StoryID=24861#.V2gaH_nF-fg.