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Authors

Hirsch, Werner Z
Mitchell, Daniel J.B.

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MAKING CALIFORNIA'S STATE BUDGET MORE USER-FRIENDLY AND TRANSPARENT

Werner Z. Hirsch, UCLA Professor Emeritus

**Daniel J.B. Mitchell, Ho-su Wu Professor at the UCLA Anderson School of Management
And Department of Policy Studies, School of Public Policy and Social Research**

This chapter inquires into the nature of California's state budget and its budgeting activity. The focus is on these two defining elements of governance with a view to improving decision making by public (and private) policy makers and administrators so they can better carry out their missions. As shortcomings of the present budget documents and of budgeting are identified, recommendations toward improvement are offered.

Budget and budgeting are important instruments for intelligent fiscal decisions, i.e., raising money from households, firms and other sources and spending the receipts to provide services and meet earlier financial obligations. States raise revenue by levying taxes, imposing user fees, and by earning interest on state funds. In addition, they obtain funds in the form of federal transfer payments, i.e., subventions for specific programs, and through bond floatations. Spending involves payments made by the state for goods and services (including labor), transfers to local governments, other transfer payments, and interest on state debt. State debt, in turn, represents the outcome of prior decisions regarding spending, revenue, and borrowing.

Viewed in this way, a state's budget and budgeting may seem nothing more than dry accounting, of little interest to anyone except technicians and bookkeepers. In fact, the state budget acts as a cue for state and local decision makers, as well as for the financial community from which the state borrows. Priorities for the state are expressed in the budget. The budget is a political document expressing the public will, mediated through elected and appointed officials, interest groups, and the media in a complex way.

If decision makers in state and local agencies are led to believe that the state is flush with resources, they may increase their own spending targets, i.e., go further down their priority lists. An unclear budgetary picture, in short, can lead to inappropriate decision making in the short term. In some circumstances, such inappropriate decisions can lead to painful reversals later on if the expected resources anticipated in the budget do not materialize.

Much of California's infrastructure, broadly defined, depends on the condition of the state budget. Infrastructure includes such tangibles as roads and water supply facilities. With the electricity crisis of 2000 that was triggered by deregulation, power generation capacity must be included as part of public infrastructure. But infrastructure also includes intangibles such as educational and public health services. Over the long term, California's capacity for economic growth depends on such infrastructure.

Major Elements of State Budgeting

Budgeting by state governments gives expression to decisions about the provision of services and ways to finance them. Efficiency, distributional fairness, and financial soundness are important considerations. However, the pursuit of macroeconomic objectives, such as fostering

national economic growth and avoidance of recession and inflation, is left to the federal government.

Efficiency

By *efficiency*, we mean obtaining the best “bang for the buck.” That is, given a dollar of expenditure, what is the most effective use for that money? One way to think about efficiency is in the context of a cost/benefit analysis of alternative expenditures. Efficiency considerations also extend to taxation. Some taxes may have an especially distorting effect on resource utilization. For example, it has been argued that local dependence on sales tax revenue leads to zoning decisions that artificially favor shopping malls over manufacturing facilities. Obviously, efficient taxation and spending is a very important topic. But we do not deal with efficiency considerations in this chapter.

Distributional Fairness

While major responsibility for income redistribution rests with the federal government, the raising of funds and the spending of them for specific undertakings have redistributional effects. Therefore, states must seriously consider these impacts as they engage in planning and budgeting. But as with efficiency, we do not take up this issue in what follows.

Financial Soundness

As noted above, in this chapter we will be mainly concerned with the third aspect of California’s budget and budgeting: *financial soundness*. If the State of California wants to access financial markets for borrowing, as it certainly will, it must provide assurance to potential creditors. Lenders are not directly concerned with the efficiency with which California spends its money, nor with any countercyclical effects state fiscal policy may have. The state’s creditors simply want to be assured that they will get their money back, both principal and interest, on the promised time schedule.

There is a great difference between the federal and state government in assuring lenders that financial obligations will be met. The federal government has the power to create money, it can run a large deficit and accumulate a large debt load without raising concern over early bankruptcy. U.S. Treasury securities are considered the most riskless form of debt – government or private - by investors for that reason.

In contrast, state governments cannot run large deficits and accumulate large debt loads without raising the specter of an ultimate inability to repay. Thus, the ability of the state government to adopt a countercyclical fiscal policy, especially during a recession, is very limited. As an example, during the recessions (and after) of the early 1980s and early 1990s, the federal government ran deficits as a proportion of gross domestic product of 3% or more for several years without sparking concern about a Treasury default.¹ But California during those same recessions found itself in financial difficulties. If California’s state government deliberately followed a policy of long-term deficits, it would quickly exhaust the willingness of the financial community to lend. Even for one year, if California tried to run a budget deficit on the order of 3% of gross state product (roughly \$40 billion), a grave financial crisis would occur.²

Table 1 illustrates how commercial bond rating services have tended to downgrade California state debt during periods in which budget difficulties have occurred. These periods of distress occurred in the early 1980s, 1990s, and 2000s, i.e., about once every ten years. Such downgradings – for magnitudes of deficit far less than 3% of gross state product – impede state borrowing at favorable interest rates. Interest rates necessary to entice creditors rise as the ratings drop and perceptions of risk increase. At some point, lenders may be reluctant to provide resources at any interest rate. Thus, the scope for state countercyclical fiscal policy is very limited.

Ultimately, lenders have to assess California's willingness to undertake necessary fiscal decisions that will avert a default on its state debt. Are the state's elected officials willing and able to raise taxes and/or cut spending to the degree necessary to meet financial obligations? Such an assessment is inherently a combination of hard number analysis and subjective judgment.

In theory, taxing and spending decisions can always be made by California policy makers to repay state creditors on time. But sometimes political leaders are unwilling to make such decisions. Thus, when Orange County found itself in difficulties in 1994 due to unwise financial speculation with County funds, local officials and voters chose bankruptcy rather than tax increases. Orange County could have averted default. But it *chose* not to do so to the disadvantage of its creditors.

What factors do lenders consider in judging the riskiness of lending money to California or any state or local government? Generally, if in spite of federal transfers the state runs large deficits (expenditures in excess of revenue), lenders will become increasingly concerned. Large deficits – whether of a government or a household – mean that existing assets must be run down and/or debt must increase. Reduced assets mean there is less of a reserve to service debt obligations. Increased debt implies more burdensome debt service. Both are negative indicators and suggest more risk of default.

Particularly disturbing to lenders will be evidence of a “structural” deficit, i.e., a deficit that is not the result of a temporary business cycle dip. If the state is running a deficit at a business cycle peak, the deficit is likely to worsen if and when the economy moves into recession. Concerns about a structural deficit can be offset for a time if the state has on hand a substantial financial reserve. But multiyear deficits must eventually eat up that reserve, as it is used to meet the gap between revenue and expenditure.

However, even the concept of a structural deficit requires some judgment. State officials might acknowledge a deficit but argue that some portion of the expenditures are for “one-time” purposes rather than for ongoing commitments. The contention is that one-time uses are more easily discontinued if resources should dry up. Of course, the line between one-time expenditures and ongoing expenditures can be fuzzy. If the so-called one-time expenditures are not cut in periods of financial difficulty, lenders will begin to suspect that the political commitment to service debt is weak. Bond ratings will decline and interest rates the state must pay will rise.

Apart from structural (and other) deficits, lenders will be influenced by the existing debt load of the state and the proportion of state revenue that must go for interest and debt service. A large debt and debt-service load will suggest a greater risk of default. Again, a subjective element is involved in deciding how much debt is too much.³ And not all securities issued by the state are

of equal riskiness. As Chart 1 shows, state revenue inflows and outflows during the course of a year do not coincide. Because of these imbalances in the timing of receipts and expenditures, the Treasurer issues short-term “revenue anticipation notes” (RANS) when cash is needed temporarily within a fiscal year. The risk of these notes need not be high when the cash to repay will soon arrive. But during budget crises, the state may issue “revenue anticipation warrants” (RAWs) that in effect borrow this year in anticipation of revenue in the next year. A warrant issued in the context of a budget crisis is clearly more risky than a routine borrowing within a fiscal year to deal with the timing of cash flows.⁴

Some long-term debt, for example, in the form of revenue bonds, is tied to particular capital projects, e.g., university dormitories. Default risk on such debt is more a function of the particular project and the revenue it generates rather than of the general financial condition of the state. Basically, lenders must assess each securities issue with regard to the risk and potential for default.

The Structure of California’s Budget

California’s state budget is divided between the “general fund” and various special funds. The official budget for fiscal year 2001-2002 (beginning July 1, 2001) involved projected expenditures of \$100.1 billion of which \$78.8 billion are part of the general fund and \$21.3 billion come from special funds. Another \$3.2 billion in expenditures was planned for other bond funds. Revenue going to special funds such as transportation is in principle earmarked for a single purpose, whereas revenue to the general fund can be used for a range of public purposes. In theory, therefore, the general fund is the source of discretionary spending whereas the special funds are earmarked and in principle limited in use. Charts 2A-B and 3A-B show the projected division of expenditures for the total state budget in 2001-2002 and for the general fund alone. As can be seen, K-12 education is the largest single element of state expenditures. Income and sales taxes are the largest sources of revenue. The precise percentages vary depending on whether the general fund alone or whether all funds are included. In fact, the boundary line between the general fund and the special funds is fuzzy. So, too, is the concept of discretionary use.

Various mandates and entitlements effectively earmark a large proportion of the expenditures from the general fund. The most important of these are the requirements of Proposition 98, passed by the voters in 1988. This complex law requires that a certain percentage of general fund revenue – determined by formula but on the order of 40% - be used for K-14 educational purposes.⁵ Some state funding comes from the federal government and is used for designated objectives. Such funding must be used for the entitlement programs specified by the federal government. In addition, some expenditures are ultimately determined by caseload. For example, if more people are sent to prison, corrections expenditures will increase. On the other hand, mandates such as Proposition 98 could be changed through the political process. Voters could amend or even repeal Proposition 98. Thus, even mandatory expenditures could be seen as discretionary under some scenarios, however unlikely these may be.⁶

Moreover, despite the official accounting division, the resource-availability line between seemingly-earmarked special funds and the general fund is not sharp. Under some circumstances, revenue for a special fund can be diverted to the general fund. From the viewpoint of the financial community, the ability of the state to move monies into the general fund could be seen as a positive factor in assessing the riskiness of potential loans to the general fund. The more flexibility the state has in meeting its financial obligations, the more likely it is that those obligations will be met.

However, such flexibility might reduce efficiency if necessary projects that depend on seemingly-earmarked user fees are underfunded.⁷

Budget Estimates

When the California state legislature passes – and the governor signs – the state budget, detailed specifications of revenues and expenditures are included. Although not required by law, the budget is generally expected to be “balanced” but the concept of balance is loose. Despite the common-sense meaning of the term, “balance” does not mean revenue = expenditures in actual California budgetary practice. It means instead that expected “resources” – which can include drawing down reserves as well as revenue – will cover expected expenditures. The specified revenues and expenditures in the budget bill passed by the Legislature are estimates and projections. Expenditures and revenues may not turn out to match what was specified in the official budget. The budget may turn out to be unbalanced, even measured against the loose definition of balance that is actually applied.

Thus, when the budget for fiscal 2000-2001 was adopted in June 2000, general fund revenue was estimated to be \$73.9 billion and expenditure was \$78.8 billion. Despite the fact that expenditures exceeded revenues, the budget was deemed to be in balance because there were reserves from prior years available to be drawn down. In January 2001, the estimates of revenue and expenditure projected for 2000-2001 were \$76.9 billion and \$79.7 billion, respectively. After that fiscal year ended, revenue was reported to be \$78.0 billion and expenditures were \$80.1 billion. Both estimated revenues and expenditures rose as new data came in. What was expected to happen initially did not quite happen after the fact. And the imbalance of expenditure relative to revenue was officially deemed to be in balance due to the presence of accumulated reserves.

Table 2 illustrates the uncertain nature of budget projections. When the budget for the fiscal year 2000-2001 was enacted in June 2000, it was estimated that this budget – although in deficit – would leave a general fund balance at the end of the fiscal year (June 30, 2001) of about \$2.9 billion. By early January 2001, half way through the new fiscal year, the end-of-year balance estimate was raised to \$6.6 billion. And by the time the next year’s budget was signed in July 2001, the balance for June 30, 2001 (by then in the past) was estimated to have been \$7.1 billion. In short, the deficit turned out to be less than expected. Even more interesting is that as late as July 2001, the fund balance as of June 30, 2000 (13 months earlier) continued to be revised. It was estimated when the 2000-2001 budget was signed to be \$7.8 billion. But that estimate rose to \$9.1 billion over the course of the year.

Tax revenue is primarily derived from sources that are sensitive to the condition of the California economy. If times are good and consumption is high, there will be more revenue from sales taxes than otherwise. If times are bad and layoffs and unemployment are up, personal income taxes will be reduced. Some taxpayers will lose their jobs or not have opportunities to work overtime. Sluggish economic activity will hurt profits and thus collections from corporate income taxes. Similarly, if times are bad, certain kinds of welfare-related expenditures may increase.⁸

While the linkage between economic developments and the status of the budget is clear, the actual budget process involves making a forecast of what those economic developments will be. Then budget forecasters must estimate precisely how the assumed developments will affect revenue

and expenditure. In fact, the historical record suggests that – after the fact - state budget forecasters underestimate revenues in good times and overestimate them in bad times. As Chart 4 shows, actual general fund revenues exceeded the original estimates of revenues in the late 1970s, late 1980s, and late 1990s (good times). But overestimates of revenues occurred in the early 1980s and 1990s (bad times). There seems to be some tendency for revenue expectations to lag reality on both the up and down sides of the economic cycle.

Forecasting general fund expenditures poses a problem, too, as depicted on Chart 5. In the late 1970s, as will be noted below, voter passage of Proposition 13 led to the assumption by the state of certain local funding responsibilities under A.B. 8. State expenditures soared well beyond initial projections. Hard times eventually seemed to produce cuts relative to anticipated expenditures as in the early 1980s and early 1990s. The prosperous 1990s, in contrast, seemed to produce unanticipated growth in expenditures.

Generally, state expenditures rose relative to state personal income during the 1960s and 1970s. Prop 13 caused a spike up in state expenditures to bail out local jurisdictions, especially school districts. Thereafter, the taxpayer revolt and the recession of the early 1980s squeezed state spending relative to personal income until the booming 1990s. As show on Chart 6, by fiscal year 2000-2001, state general fund expenditures relative to personal income were back to the peak caused by Prop 13 two decades earlier.

Since the state budget bill projects general fund revenues and expenditures, it implicitly projects the resulting surplus or deficit (revenue minus expenditure). State budgetary forecasters underestimated the surplus in the late 1970s, as Chart 7 shows. Proposition 13 caused a large overestimate. Overestimates continued during the bad times of the early 1980s. Hard times in the early 1990s again produced overestimates. But the boom of the late 1990s, like that of the pre-Prop 13 late 1970s, produced underestimates of the surplus.

California-Specific Factors

The condition of the California state budget is not simply a function of the national business cycle. There are always influences that are unique to California. As already noted, in June 1978, voters passed Proposition 13 that sharply curtailed local property taxes. State government came to the rescue and provided make-up funding for local authorities such as school districts.

When the national economy turned down in the early 1980s, the state was thus saddled with both the business cycle effect *and* the new obligations it acquired as a legacy of Prop 13 and the passage of Prop 98. The state's general fund deficit reached 11% of revenue in 1980-1981, leading to an eventual budget crisis. At the peak of the crisis, there were threats that the state would pay its employees in warrants (IOUs) that might or might not have been redeemable for cash at face value.

The early 1990s saw a similar development of a California-specific problem. While the U.S. economy experienced a mild recession, California was hit with a marked decline of its aerospace and military-related industries thanks to the end of the Cold War. Economic distress was also intensified in the state by a slump in construction activity thanks to overbuilding of office space in the 1980s. These special California factors caused a general fund deficit of about 5% of revenue in fiscal year 1990-1991.

Finally, the early 2000s saw both a slowdown in the U.S. economy and the special factor in California of the electricity crisis.⁹ Thanks to a flawed deregulation plan for the electricity market, two of the three major utilities in the state amassed large debts. Pacific Gas and Electric filed for bankruptcy in early April 2001, while Southern California Edison teetered on the edge of bankruptcy and began negotiating with the Governor and Legislature for debt relief. The state had to step in to buy electric power for the utilities starting in January 2001, using general fund revenue. Again, a business cycle effect – the national economic slowdown - was compounded with a California-specific factor, producing a potential state budget crisis.

Adding to the budget uncertainty in the early 2000s was the dependency that state revenue had developed on stock market-related capital gains. Rising share prices - and stock options offered to employees in the dot-com/high-tech sector – produced a state tax windfall. The size of the windfall was enhanced by the fact that individuals with major capital gains tend to be in the top income tax bracket. But the steep stock market slump that began in 2000 subsequently put that windfall in peril. California has a particular vulnerability to this effect because of the disproportionate share of dot-coms and high-tech firms in its economy.

Finally, the terrorist attacks on the U.S. on September 11, 2001 created additional uncertainties for California, even though the attacks occurred elsewhere. Major negative impacts were immediately experienced in travel-related industries such as airlines, aircraft manufacturing, and tourism. At this writing, it is unclear how long the negative impact of the attacks on the national and state economies – as well as the stock market - will last. Tax revenues for the state could be affected adversely due to layoffs, declining profits, and reduced sales. In addition, the state may have to undertake costly measures to protect public security. And disturbances in financial markets related to the attacks could affect the state's ability to float bonds and obtain credit.

The moral of these three episodes of budget strains – the early 1980s, 1990s, and 2000s – is that sound fiscal planning and budgeting involves consideration of more than general economic projections. Even a perfect year-ahead estimate of the national business cycle would not necessarily permit a fully-accurate projection of state revenues and expenditures. There is always the potential for a California-specific influence on the budget's receipts and expenditures.

The Budget Process

California's budgetary enactment process for a given fiscal year is supposed to be completed before the start of that year, i.e., before July 1. In January, the Governor submits a proposed budget to the Legislature. Preparation of this proposal involves consultation with the various state agencies covered by the budget and the making of economic projections by the Department of Finance. Once the budget bill is submitted, however, the Legislature has its own apparatus for analyzing the proposal and making projections. In particular, the Legislative Analyst Office (LAO) can provide an independent assessment.

The state Assembly and Senate must ultimately agree on a common budget bill that both houses can adopt. According to the California constitution, budget enactment by the Legislature is supposed to occur by June 15. Thereafter, the Governor is supposed to sign the budget bill by June

30, just before the fiscal year to which the budget applies begins. The Governor, in signing the overall bill, has the power to delete some expenditures in order to meet budgetary objectives.

There are, however, no substantive penalties for missing the constitutional deadlines. During the twenty-five fiscal years from 1977-1978 to 2001-2002, the budget has been signed after June 30 sixteen times. It has been over two weeks late ten times. And it has been over a month late four times.

The fact that under the state constitution, a two-thirds vote is required in both houses of the Legislature can result in delays in budget enactment. A minority can withhold votes until, for example, particular pet spending or taxation issues are addressed. In periods when difficult fiscal decisions need to be made, the actual budget signing may thus be delayed substantially while deals are cut until the necessary votes are obtained. The budget for fiscal year 2001-2002 was not signed by the Governor until July 26, 2001. A Democratic Governor and Democratic control of both legislative houses could not produce the required two thirds vote until there had been protracted negotiations with individual Republican legislators.

When there is no signed budget at the beginning of the fiscal year, payments to suppliers and certain employees of the state government may be delayed by the State Controller, although most state functions continue. Even when signed by the Governor, the budget is not quite final. Typically, a variety of follow-on trailer bills are enacted that can alter the initially-adopted plan. Prior to the submission of the next budget, the state Department of Finance summarizes all of the modifications to that point in a "Change Book." (The Change Book for 2000-2001 ran 949 pages!) In addition, some state agencies – especially those running entitlement programs – may find that they are spending (or have spent) more than their appropriation during the course of the year. "Deficiency" bills must be enacted retroactively to cover these excess expenditures. Such deficiencies are typically less than 1% of expenditures but have reached as high as 1¾%.

Even after the Legislature has finished with a given year's budget and has passed whatever bills are needed to cover deficiencies, amendments to the historical record continue to accrue. The historical record of these after-the-fact changes since the mid-1970s suggests that the adjustments are more likely to add to the surplus than subtract from it, i.e., they do not appear to be corrections of random mis-estimates.¹⁰ But in earlier years, it appears that the reverse must have been true and that surpluses must have been systematically overestimated.¹¹

The Importance of Budget Semantics and Presentation

In early 2001, as the California electricity crisis developed, there was much talk about using the state "surplus" to deal with the problem. The authors of this chapter wrote an Op Ed piece in the *Los Angeles Times* pointing out that there was no "surplus" but rather a deficit.¹² A week later, a letter to the editor by the director of the state's Department of Finance asserted that no such deficit existed. "California is not running a deficit," the letter declared.¹³ The charge that there was a state deficit was "flatly untrue," according to the letter. How could there be a dispute over whether there was a deficit or not? After all, the Op Ed article simply cited data drawn from the Department of Finance's own website.

The answer is that California has tended to use fuzzy semantics in describing its budget situation. Of course, other states may also use such fuzzy semantics, but that problem does not make budget analysis any clearer for California. Most Americans are aware of the long-running debate over the federal government's budget and the degree to which it should run a surplus or deficit. Thus, Californians might assume that their own state uses the same broad concepts as the federal government in describing its fiscal affairs. In particular, they might assume that a surplus in any one year is a condition in which revenue exceeds expenditure. And they might assume that a deficit occurs when expenditure exceeds revenue. These are the basic federal definitions that correspond in general to usage in private-sector accounting.

There is much to be said for the proposition that California should utilize the same basic terminology that is used at the federal level. That common-sense usage is what most people - lay persons and experts - understand. But unfortunately, budget-speak in California often differs from federal terminology in practice. And the problem is compounded by the format of the tabular summaries of the budget found in various public documents.

Stocks vs. Flows

It is common practice to distinguish between stocks and flows in accounting. Stock accounting is essentially a financial snapshot at a moment in time. For example, as of the end of a fiscal year, what are the assets and what are the liabilities of a person, firm, or government? For a corporation, such a snapshot accounting statement is known as a "balance sheet." Thus, at the end of calendar year 2000, IBM reportedly had assets valued at \$88.3 billion and liabilities of \$67.7 billion. The excess of assets over liabilities, known as "stockholder equity," was \$20.6 billion.¹⁴

The assets and liabilities that exist at a moment in time represent the accumulation (flow) of such assets and liabilities over the past. That is, ultimately, the flows over the past add up – or should add up – to the stocks at the present. Thus, during the course of 2000, IBM had revenue (in)flows of \$88.4 billion and cost and expense (out)flows of \$76.9 billion, leaving the firm a net before-tax income (profit) flow of \$11.5 billion. The (out)flow of taxes on those profits absorbed \$3.4 billion, so that IBM had an after-tax flow of profits of \$8.1 billion. IBM paid out most of this flow through dividends and share repurchases in 2000, leaving a net increase of \$0.1 billion in stockholder equity from the end of 1999 until the end of 2000. Put another way, what IBM accumulated in stockholder equity during 2000 was the difference between what flowed into the firm (sales, etc.) and what flowed out (payments to suppliers, wages, payments to shareholders and lenders, etc.).¹⁵

But it is not necessary to use the billions of dollars that flow into and out of large corporations such as IBM to illustrate the basic point. Consider a simple household example. Suppose Sally had \$1,000 in net assets at the beginning of a given year. Suppose further that during the course of the year her earnings from all sources were \$19,400 and her expenditures were \$20,000. Then she should have only \$400 in net assets at the end of the year. ($\$19,400 - \$20,000 = -\$600$; $\$1,000 - \$600 = \$400$) She would have had to finance her "deficit" by some combination of running down her past assets or borrowing.

In federal budget parlance, an excess of government receipts relative to expenditures is called a "surplus." The opposite – as in the household example above - is a "deficit." Typically,

government, firms, and households (if they keep budgets), present their flow accounts on an annual basis. Of course, the length of time it took the Earth to travel once around the Sun is an arbitrary interval for bookkeeping purposes. But that interval does account for important seasonal effects, e.g., outside construction activity is higher in summer than in winter, retail sales are boosted by the Christmas season, etc.

California, unfortunately, has deviated in practice from the simple, understandable terminology of the household example. Suppose that, in that example, the net assets Sally had at the beginning of the year consisted of a savings account of \$1,000. Supposed she financed her excess of expenditures (\$20,000) over receipts (\$19,400) by drawing down savings her account by \$600. In California's budgetary process, Sally's obviously unbalanced budget for the year is considered as "balanced" because the \$600 withdrawal is treated as if it were revenue. Indeed, in California *de facto* terminology, the remaining funds in Sally's savings account might even be described by some observers as a \$400 "surplus."

Linguistic Ambiguity

At various locations, the official website of the California Department of Finance defines "surplus" in stock terms as "the excess of assets (or resources) of a fund over its liabilities." But it notes that "surplus" – defined in this fashion – "is an outdated and often misused term." At one point in a question and answer section of the website, an excess of revenue over expenditure is described as an "operating surplus."¹⁶ "Deficit" is not defined on the website, although it might reasonably be supposed that whatever a surplus is, a deficit must be the opposite.

The problem with such linguistic ambiguity is obvious. It is not sustainable for Sally with her \$19,400 income to run a \$600 deficit indefinitely. She can do so for less than two years and then her savings will be gone. After that, Sally will have to go into debt. To do that, she will have to find a lender who will trust her to repay her loan. But a potential creditor will not be sanguine about lending to someone who routinely spends more than she earns. Using "balance" to describe her \$600 excess of expenditure over income - simply because Sally had initially had enough in her savings account to cover her deficit - is misleading. The term "balance" might even lead Sally to think that her financial situation was in order. Even more so, use of the word "surplus" to describe her remaining \$600 applies a very positive word to a negative situation. In any event, it seems unlikely that a diligent lender would be fooled by such fuzzy language, even if Sally were.

Yet it was precisely this fuzzy terminology that allowed the state budget director to declare that, contrary to our Op Ed article, California had no deficit when it in fact had one. And fiscal year 2000-2001 was hardly the first time that fuzzy terminology had been applied to the state's budget picture. During earlier budget crises, for example, borrowing had been used ostensibly to "balance" the budget, in effect taking revenue from a future year through revenue anticipation warrants and dragging it – in an accounting sense – into the prior year. Such soft accounting occurred in fiscal 1992-1993. At that point, however, the word "deficit" was openly used and the bond issue and repayment arrangement was described as part of a "Deficit Retirement Plan."

Presentation

The display of budget data in a particular format can convey an impression of the budgetary situation, just as can terminology. Table 3 uses what appears to be the standard California format to present budget summaries. This format is utilized repeatedly in documents of the Department of Finance as well as the Legislative Analyst Office. Note that although surpluses and deficits (defined as revenue – expenditure) could be derived from the various versions of the fiscal year 2001-2002 budget shown on the table, the actual surplus/deficit does not appear. What does appear is the sum of projected revenues and transfers (flow) and the assumed fund balance (stock) that is described as “Total Resources.” From these total resources (and not revenue and transfers) expenditures are subtracted, in all cases leading to a positive bottom line, the projected fund balance at the end of fiscal year 2001-2002. In each version of the budget, although the bottom line varies, it is always positive, conveying the impression of a surplus.

We would like to propose an alternative format that (to the best of our knowledge) has not been used in official documents of the State of California, and that is presented as Table 4. Note that the surplus or deficit is easily derived from this alternative format and shown as revenue and transfers minus expenditures and, equivalently, the change in the fund balance over the course of the year. The alternative format of Table 4 also makes clear the distinction between stocks and flows. And it reconciles the two concepts.

The official budget presentation, with its bottom line as the fund balance, might suggest to a reader – perhaps even a legislator – that the balance is in fact sitting in a vault, available for use. However, the budget is in fact on an accrual basis. Because of the timing of revenues and expenditures, the fund balance at the beginning or end of a fiscal year is not the same as cash actually on hand. (For example, tax liabilities may be accrued in a given fiscal year but not necessarily paid during that year.) The State Controller provides a statement on a cash basis that Table 5 compares with the accrual basis for fiscal year 2000-2001. Note that on a cash basis (July 1, 2000-June 30, 2001), the reported deficit was larger by \$3 billion than the accrual deficit. And there was substantially less cash on hand reported than the accrued fund balance (\$3.4 billion vs. \$7.1 billion).

In fact, a \$4.3 billion bond issue was floated by the Treasurer – an advance on a \$12-13 billion bond issue planned for later in the year to reimburse the state for electricity purchases.¹⁷ Thus, it appears that the drain of electricity spending had exhausted the cash reserves of the state’s general fund by the end of fiscal 2000-2001. However, all of this is supposition since the state does not routinely provide an annual reconciliation of its cash and accrual budgets.

Budgetary reviews published by the Legislative Analyst Office (LAO) typically place the key figures on revenues, expenditures, and fund balances at the beginning of the document, albeit in the official format that obscures surplus/deficit calculations. In contrast, reviews published by the Governor’s office and the Department of Finance typically place that information at the end. Thus, in the official 92-page summary of the fiscal year 2001-2002 budget published in early August 2001, readers will not find the general fund budget summary until page 91. There is a summary of national and state economic trends, followed by estimates of revenue (but not transfers), a section on tax relief, and then a long section on expenditures. It would be more

informative and user-friendly if the Department of Finance were to follow the LAO presentation style of putting the key budget summary up front in all official budgetary documents.

Valuation

Apart from confusion over stocks and flows, questions of valuation also arise in budget methodology. All enacted budget estimates of revenue and expenditure are uncertain. As uncertainty increases, however, it becomes necessary to flag the risks entailed. At some point, it is legitimate to question whether an uncertain stream of future dollars can be used to offset already-expended (and therefore certain) dollars on a one-to-one basis. As noted earlier, California began using general fund revenue to buy electricity for its utilities in early 2001. About \$6.8 billion was spent (with certainty!) on electricity by the state during the first 6 months of 2001. The utilities collected revenue from their customers for that electricity (and for electricity generated by the utilities themselves and certain other power suppliers). But the state received only \$1.5 billion during those 6 months from the utilities, about 64% of what the utilities collected from customers. So \$5.2 billion that the state had expended for electricity was unpaid by the utilities to the state.¹⁸ The state didn't record these unreimbursed expenditures for electricity in its accounting for the 2000-2001 fiscal year.¹⁹ Its rationale for this omission was that the state would eventually collect the money either from the utilities or from ratepayers through a bond issue.

Yet one of the utilities was officially bankrupt and one was teetering on bankruptcy. Moreover, there were legal barriers related to the bankruptcy and political barriers within the legislature to floating the electricity bonds. Surely a dollar owed by a bankrupt or near bankrupt utility and a dollar dependent on an uncertain loan is worth less than a dollar already spent. While it is not easy to put these considerations on a simple table, their existence was an essential part of California's state budgetary picture as of mid-2001. But that aspect of the budget was not readily apparent from official documents.

Terminology and Presentation Has Consequences

We do not wish to imply that a single accounting number, even if based on semantics consistent with usage at the federal and corporate levels, can capture all aspects of California's budget situation. And we do not wish to imply that California is uniquely remiss in its accounting practices. The federal government has been known to "adjust" its accounts to depict a more favorable outcome. In August 2001, for example, it was suddenly announced by the federal Office of Management and Budget that an accounting change would free up over \$4 billion in payroll tax revenue. This "added" revenue avoided (temporarily) political charges of tapping Social Security to cover federal expenditures. And, of course, private firms have sometimes admitted to misstating their accounts to curry favor with stockholders or to paper over internal problems. Ultimately, there is no perfect accounting system and certainly none that cannot be manipulated. But the best long-term public policy for California is to depict the state budget as clearly and consistently as possible. Transparency – including a presentation style that allows easy and obvious calculation of surpluses and deficits - should be the goal. Complicating factors that are not readily captured in numerical presentations – such as the electricity situation in 2001 – should be prominently flagged.

Presumably, big institutional lenders in assessing the risk of California financial obligations can see through accounting semantics and presentation opaqueness. Presumably, experts at bond rating services can also make an assessment independent of such semantics and opaqueness. It is

not so clear, however, that the general public will understand the condition of the budget if it is described as being in balance or even in surplus when a deficit is occurring and is likely to occur again the next year. It is not evident that journalists will understand the budget if surpluses are reported when there are deficits. Even agencies financed by the state may misunderstand the budget situation under such conditions. Indeed, members of the Legislature – who operate in a world of term limits – may have trouble comprehending the nuances of the budget they are asked to approve if confusing language is used. Budget confusion may extend to administrators and decision makers in local agencies and governments. As noted at the outset, if the state budget situation is depicted in sanguine terms, such administrators may not feel constrained to limit their spending or to plan for adverse contingencies. But in a worst case scenario, budget cuts might have to be made in mid-year. Enactment of a budget at the beginning of a fiscal year does not guarantee that a mid-course correction will not become necessary. As a matter of fact, in fiscal year 2000-2001, seventeen states had to make budget cuts during the year.²⁰

A mid-course cut – even if unlikely - would inevitably be more painful and inefficient in the use of resources once programmatic commitments are already in place. Administrators and decision makers therefore should know that they need a “Plan B” to deal with such an unpleasant possibility. Private citizens insure their homes against fire without expecting their homes to burn down. The insurance premium they pay represents the cost of offsetting a remote, but very unfortunate eventuality. For program administrators and decision makers, having a Plan B in place is a form of insurance. The more difficult they perceive the state’s budget situation to be, the more seriously they will undertake prudent planning. Thus, state budget semantics and format should provide a more transparent assessment of that situation.

Recommendations

In our review, we have not undertaken an analysis of the efficiency with which California spends state dollars or imposes taxes. That is an important topic but not within the scope of our analysis. We have not viewed state fiscal policy as playing an important counter-cyclical role. It has very limited scope for doing so. Our emphasis in this chapter has been on financial soundness.

Our most broad-based recommendation is that California’s state budget documents should be transparent and user-friendly. More is entailed in meeting that goal than simply putting official reports and numbers on the Internet, a task that the State of California performs well. User friendliness and transparency will be much enhanced if the following recommendations are adopted:

- State budget reports must use budgetary semantics that correspond to federal practice. Terms such as “deficit” and “surplus” should be applied only to flow concepts (revenue – expenditure).
- Where stocks are reported (assets and liabilities at a moment in time), appropriate terminology such as “fund balance” or “reserves” should be used exclusively. “Surplus” in an inappropriate term for a positive fund balance.
- Budgetary summary tables should enable readers to determine quickly whether the state budget is in surplus or deficit and the level of the fund balance at the beginning and end

of the fiscal year. Budgetary tables should be reported in a format that clearly depicts the connection between stock and flow concepts.

- Cash statements relating to the state budget should be reconciled with accrual statements.

Apart from these issues of presentation and format, our analysis of California's state budgetary process suggests that more timely updates are needed. It is necessary to go beyond a budget proposal in January followed by a May revision. The historical evidence suggests that budget forecasters have tended to underestimate the impact of economic fluctuations on revenue. Negative budgetary surprises lead in practice to unanticipated cuts in proposed expenditures. Positive surprises lead to the reverse. Both types of surprises lead to inefficient resource use.

The core problem is that it is difficult – if not impossible - to forecast with precision 12-18 months ahead under normal conditions. Non-economic events, such as the terrorist attacks of September 11, 2001, can not be forecast at all but such occurrences can have economic consequences. Even a perfect forecast of the national economy would not necessarily capture California-specific factors. Such factors can cause the state's economy to deviate from national trends. The California budget process may therefore require more frequent formal review and publication than current practice permits. There needs to be an early warning system that alerts the Legislature and departments and agencies of the State (including its public institutions of higher education) to new developments. A process of regular update meetings with state and local policy makers, stakeholders, and outside economic analysts would be useful. Particularly during periods of economic uncertainty, there needs to be a contingent form of budgeting, i.e., What would happen if the budget had to be trimmed by, say, 3%. 5%, etc.?

Finally, given the inevitable uncertainties in the budget, maintenance of a large “rainy-day” fund balance is appropriate. California's income tax is highly progressive so that tax revenues are very sensitive to the economic conditions of relatively high income individuals. Good Times bring an onrush of receipts that quickly disappear in Hard Times. Structural deficits, i.e., situations in which expenditures exceed revenues even at the business cycle peak, should be avoided, even if some expenditures are nominally of the “one-time” variety. Although so-called one-time expenditures may be easier than others to discontinue, the money spent on one-time purposes is nonetheless gone and unavailable for future use in emergencies or Hard Times.

The tendency that developed in 2000 to move into deficit at the cyclical peak - whether due to pressures to spend more or to provide tax refunds – needs to be resisted in the future. For this purpose, it would be appropriate for the legislature to enact a requirement that during the upward phase of the business cycle, the rainy-day fund balance should not be less than a stipulated percentage, e.g., 5%, of the year's general fund revenues.²¹ This provision would not only assure a rainy-day fund of an appropriate size but also rein in the state's tendency to overspend in good economic years.

Table 1: California General Obligation Credit Ratings

Date/Rating Service	Rating
Fitch ¹	
4/01	AA ²
2/00	AA
10/97	AA-
2/96	A+
7/94	A
9/92	AA
2/92	AA+
7/86	AAA
10/82	AA
Prior 1982	AAA
Moody's Investors Services ³	
5/01	Aa3
9/00	Aa2
10/98	Aa3
7/94	A1
7/92	Aa
2/92	Aa1
10/89	Aaa
4/80	Aa
9/72	Aaa
11/40	Aa
1/38	A
Standard & Poor's (S&P) ⁴	
6/01	A+ ⁵
4/01	A+
1/01	AA ⁶
9/00	AA
8/99	AA-
7/96	A+
7/94	A
7/92	A+
12/91	AA
7/86	AAA
2/85	AA+
1/83	AA
1/80	AA+
5/68	AAA

Source: California Treasurer's office:
<http://www.treasurer.ca.gov/ratings/history.htm>

¹ Fitch ratings follow the same pattern as S&P. See footnote 3 below.

² Fitch has a negative credit watch notation on California general obligation bonds not insured with private agencies such as FSA, MBIA, or FGIC.

³ The highest Moody's rating is Aaa followed by Aa and A. Numerical grades are added for ratings from Aa and below with 1 being the best in the grade and 3 the worst.

⁴ The highest S&P rating is AAA followed by AA and A. Ratings from AA and below can be modified by + or - to show best and worst within the grade.

⁵ Negative credit watch removed.

⁶ Negative credit watch issued.

Table 2

Estimate of General Fund Balance as of
June 30, 2001 and June 30, 2000
Reported at Different Times
(thousands of dollars)

	General Fund Balance: June 30, 2001	General Fund Balance: June 30, 2000
Governor's Budget July 2001	\$7,055	\$9,139
Conference Bill LAO, June 26, 2001	6,935	*
Assembly Bill LAO, June 3, 2001	7,205	*
Senate Bill LAO, June 3, 2001	7,222	*
Governor's Revision May 2001	6,645	8,848
Governor's Budget January 10, 2001	6,557	9,366
Governor's Budget June 2001	2,873	7,827

*Not reported.

Note: LAO = Legislative Analyst Office.

Source: California Legislative Analyst Office, California Department of Finance. Documents available through <http://www.lao.ca.gov>; <http://www.dof.ca.gov>.

Table 3

Presentation of General Fund
Budget Data in "Official" Format: Fiscal Year 2001-2002
(thousands of dollars)

	Governor's January Proposal	Governor's May Revision	Senate Bill	Assembly Bill	Conference Bill	Governor's "Final" Version
A) Fund Balance At Beginning of Year 7/1/01	\$6,557	\$6,645	\$7,222	\$7,205	\$6,935	\$7,055
B) Revenue and Transfers	79,434	74,842	76,079	75,777	75,158	75,105
C) Total Resources (A+B)	85,991	81,487	83,301	82,982	82,093	82,160
D) Expenditures	82,853	79,676	80,061	80,399	79,089	78,763
E) Fund Balance at End of Year 6/30/02 (C-D)	3,138	1,811	3,240	2,583	3,004	3,397

Source: See Table 2.

Table 4

Presentation of General Fund
Budget Data in Recommended Alternative Format: Fiscal Year 2001-2002
(thousands of dollars)

	Governor's January Proposal	Governor's May Revision	Senate Bill	Assembly Bill	Conference Bill	Governor's "Final" Version
A) Revenue and Transfers	\$79,434	\$74,842	\$76,079	\$75,777	\$75,158	\$75,105
B) Expenditures	82,853	79,676	80,061	80,399	79,089	78,763
C) Surplus [+] or Deficit [-] (A-B)	-3,419	-4,834	-3,982	-4,622	-3,925	-3,658
D) Fund Balance At Beginning of Year 7/1/01	\$6,557	\$6,645	\$7,222	\$7,205	\$6,935	\$7,055
E) Fund Balance at End of Year 6/30/02	3,138	1,811	3,240	2,583	3,004	3,397
F) Surplus (+) or Deficit (-) (D-E)	-3,419	-4,834	-3,982	-4,622	-3,925	-3,658

Source: See Table 2.

Table 5

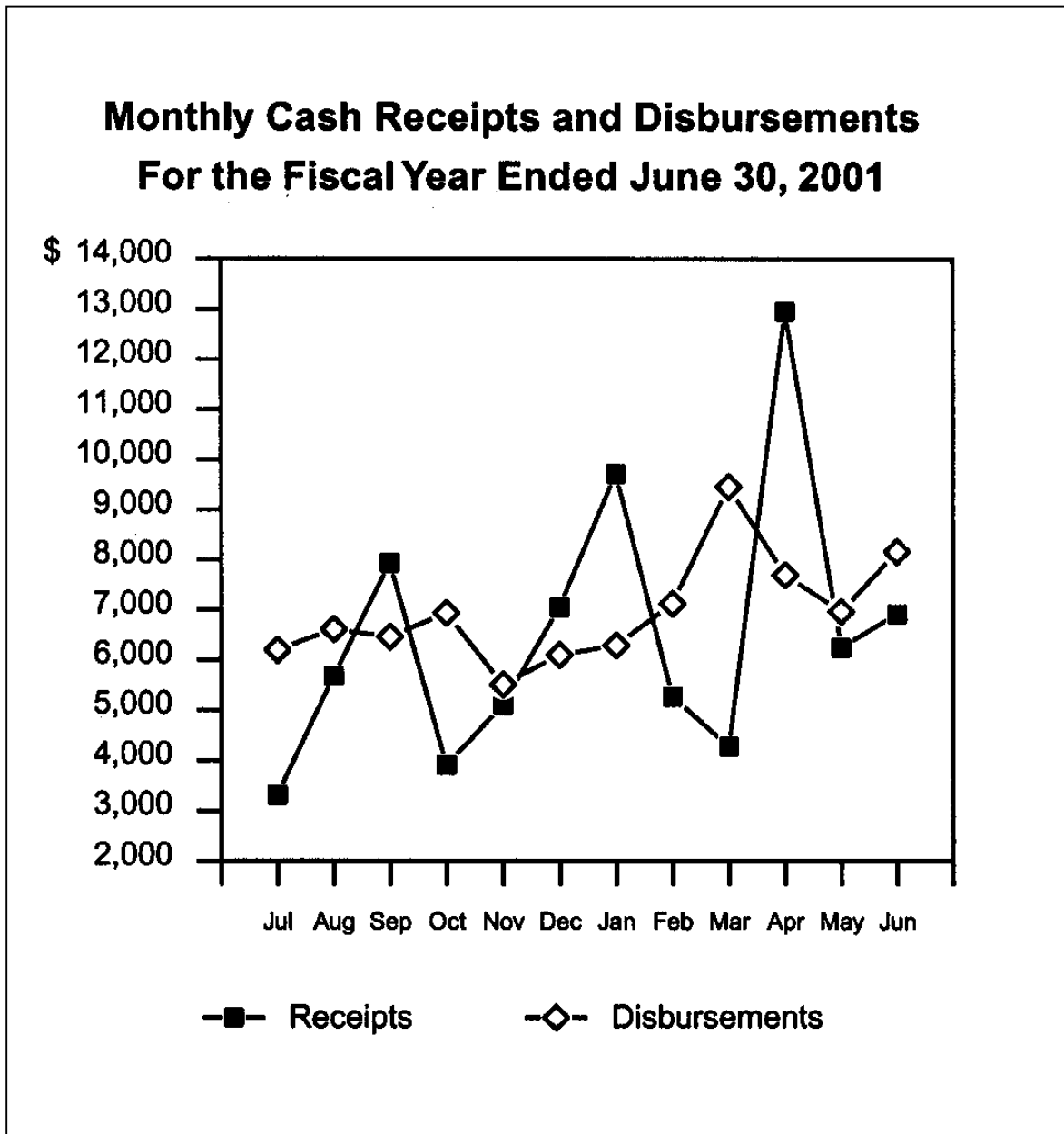
General Fund Accrual Budget vs. Cash Budget
for Fiscal 2000-2001
(thousands of dollars)

	Governor's Estimate as of July 2001	Controller's Cash Estimate as of July 2001
A) Revenue and Transfers	\$78,003	\$78,330*
B) Expenditures	80,087	83,467
C) Surplus [+] or Deficit [-] (A-B)	-2,084	-5,137
D) Fund Balance At Beginning of Year 7/1/00	\$9,139	\$8,531
E) Fund Balance at End of Year 6/30/01	7,055	3,394
F) Surplus (+) or Deficit (-) (D-E)	-2,084	-5,137

*Includes "nonrevenue receipts," chiefly transfers from other funds to the General Fund.

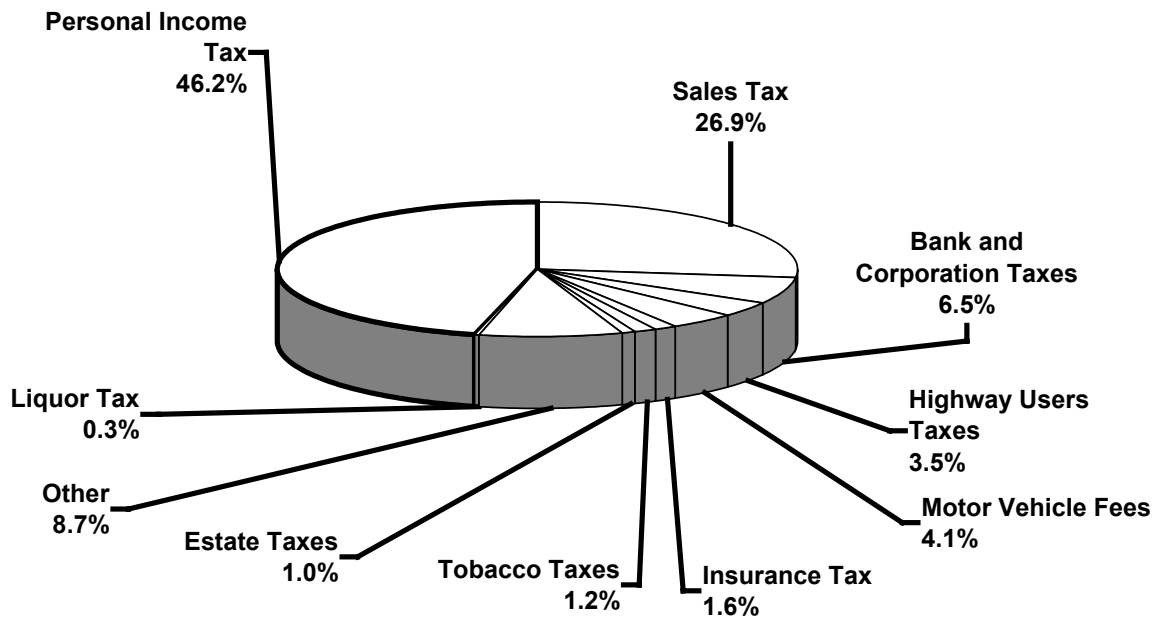
Source: California Department of Finance, *California State Budget Summary 2001-02*, August 1, 2001, available at http://www.dof.ca.gov/HTML/BUD_DOCS/Bud_link.htm;
California State Controller, *General Fund Cash Basis Report*, July 10, 2001, available at <http://www.sco.ca.gov/ard/genfun/genfun01.htm>.

Chart 1

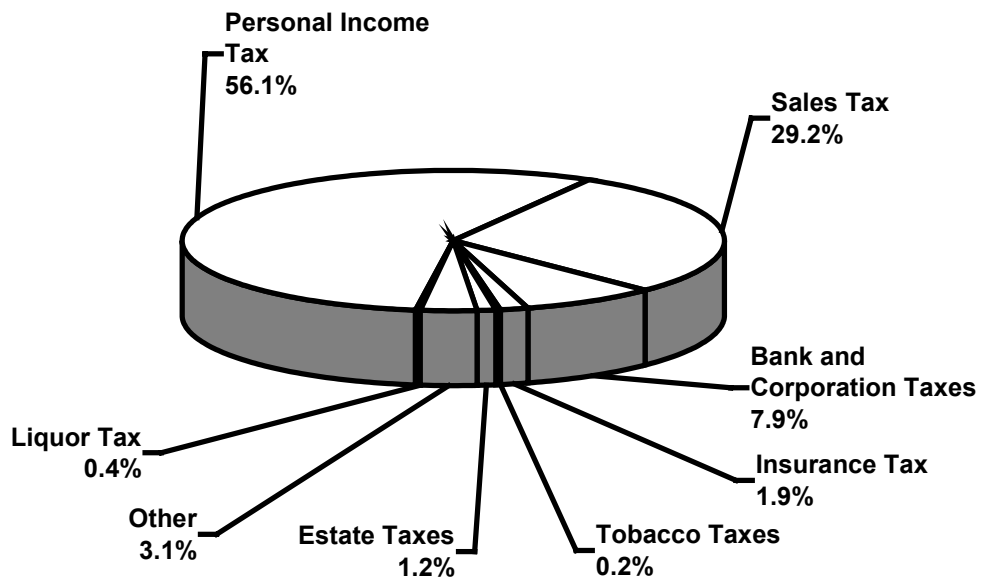


Source: California State Controller, *General Fund Cash Basis Report*, July 10, 2001.

**Chart 2A: California State Budget: FY 2001-2002
Total Revenues and Transfers**

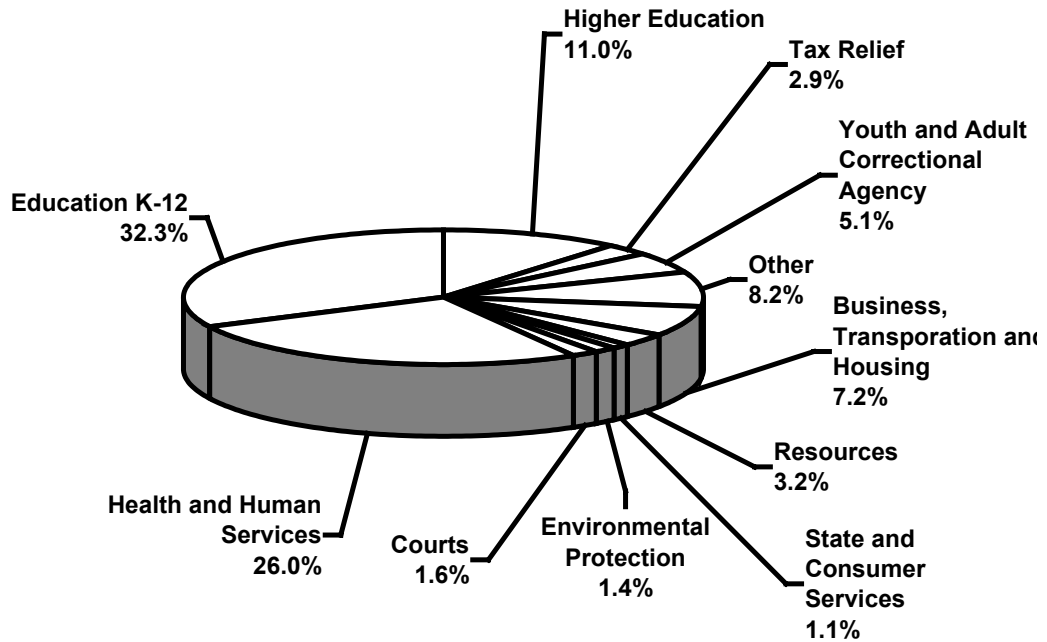


**Chart 2B: California State Budget: FY 2001-2002
General Fund Revenues and Transfers**

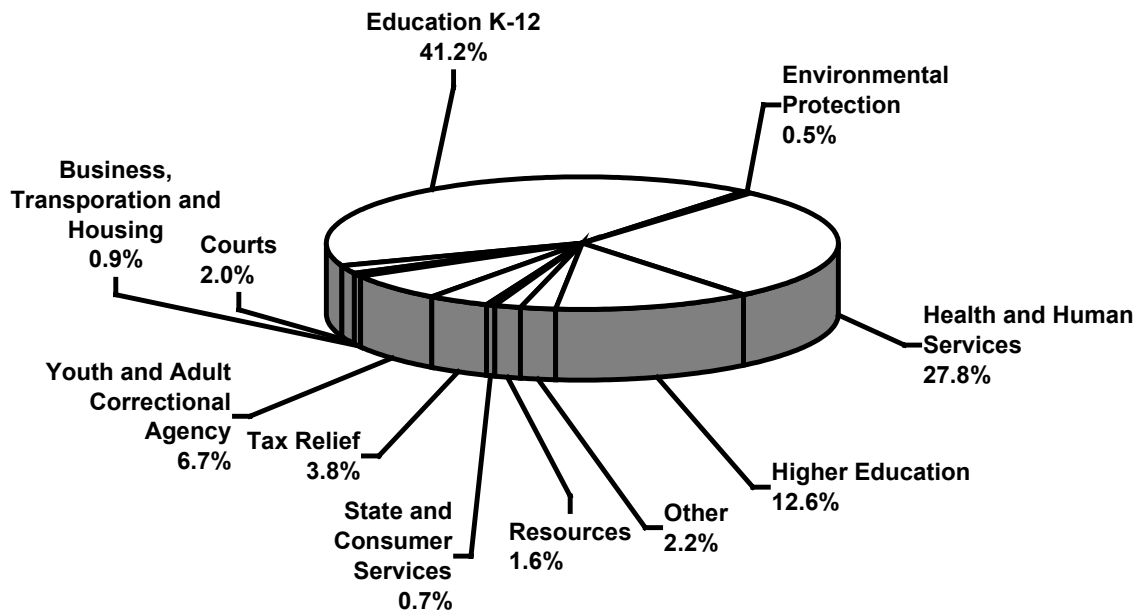


Source: California Department of Finance, *State Budget Summary*, August 1, 2001.

**Chart 3A: California State Budget: FY 2001-2002
Total Expenditures:
General, Special, and Selected Bond Funds**

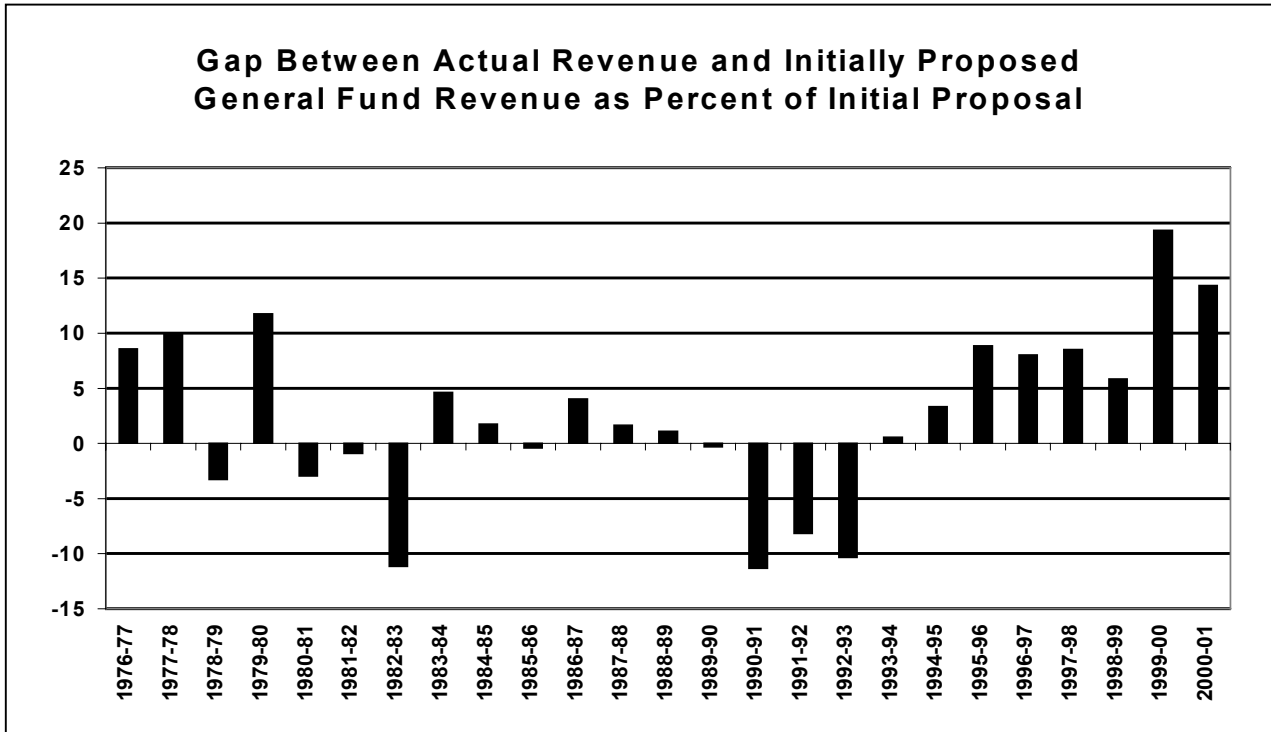


**Chart 3B: California State Budget: FY 2001-2002
General Fund Expenditures**



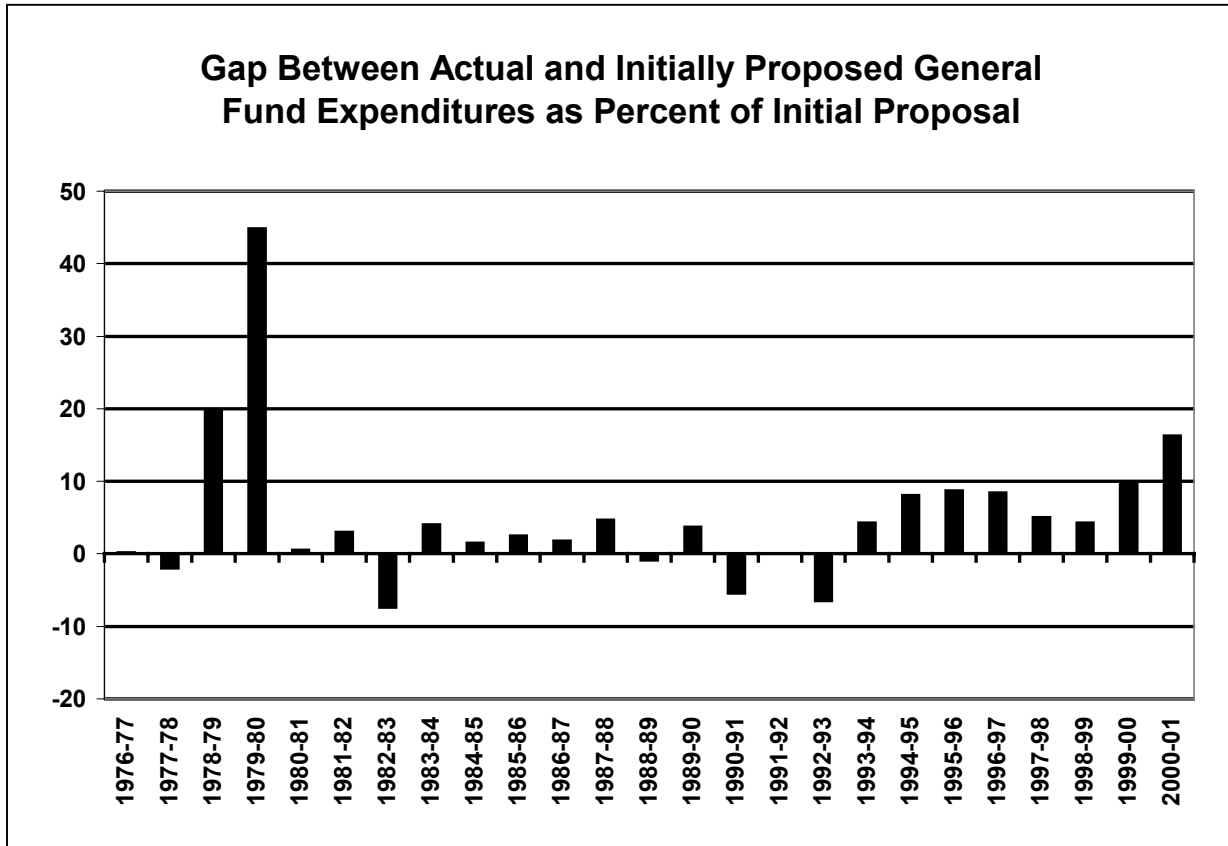
Source: California Department of Finance, *State Budget Summary*, August 1, 2001.

Chart 4



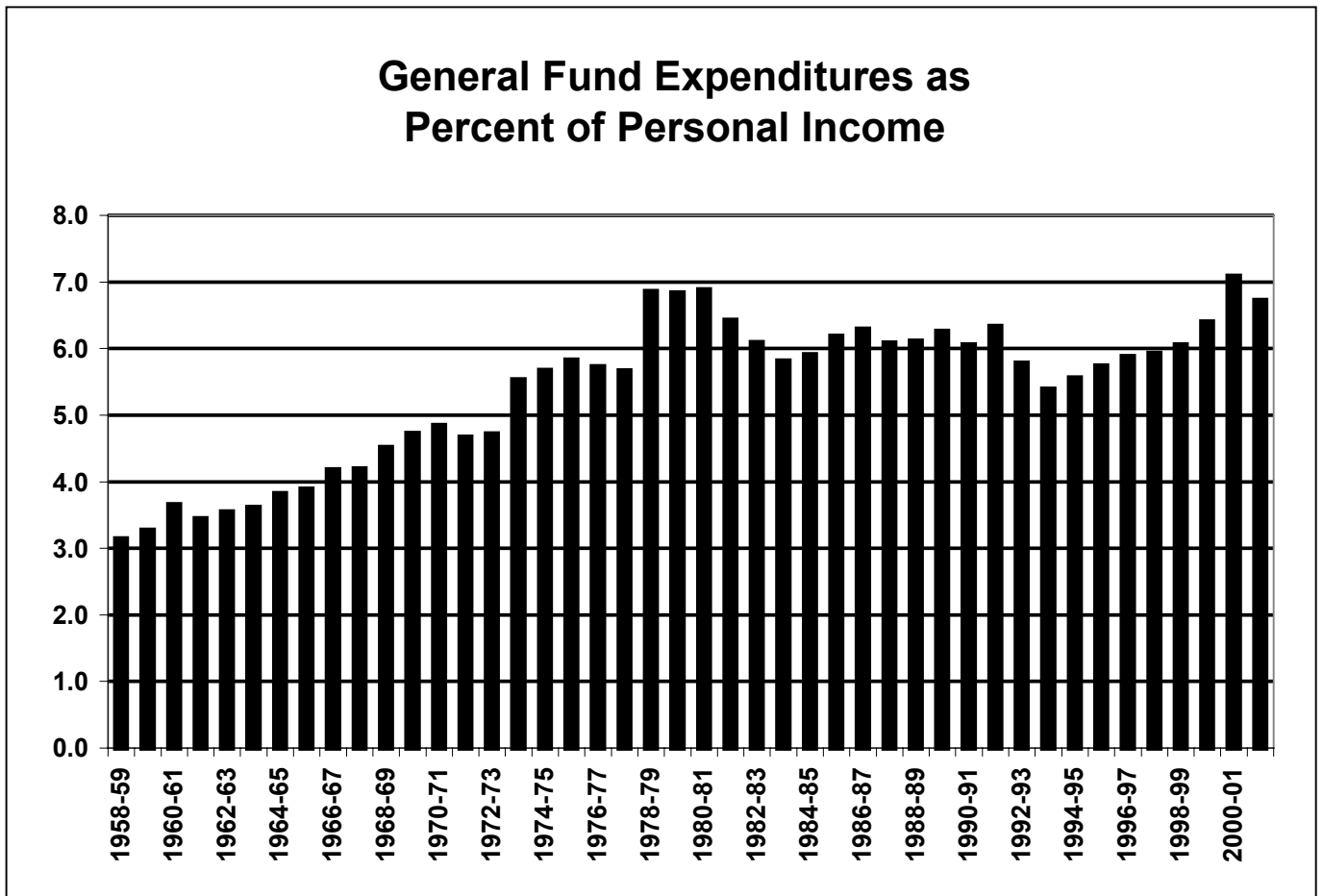
Source: California Department of Finance, historical data available through http://www.dof.ca.gov/HTML/BUD_DOCS/question.htm.

Chart 5



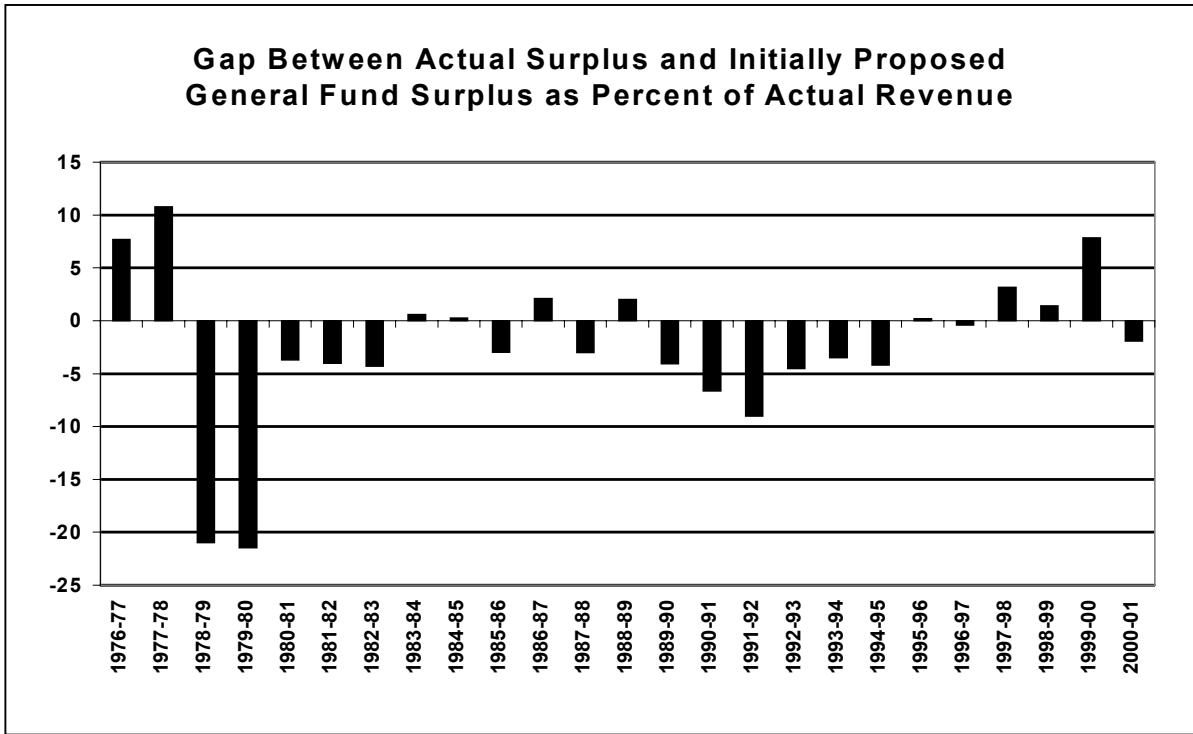
Source: California Department of Finance, historical data available through http://www.dof.ca.gov/HTML/BUD_DOCS/question.htm.

Chart 6



Source: Expenditure data from California Department of Finance, available through http://www.dof.ca.gov/HTML/BUD_DOCS/question.htm; personal income data from U.S. Department of Commerce, Bureau of Economic Analysis, <http://www.bea.doc.gov/bea/regional/sqpi/>

Chart 7



Source: California Department of Finance, historical data available through http://www.dof.ca.gov/HTML/BUD_DOCS/question.htm.

Footnotes

¹ The on-budget and off-budget federal government deficit exceeded 3% of GDP during fiscal 1982-1988 and again during 1990-1993.

² There was an attempt by the state government to stimulate the construction industry in the recession of the early 1990s by accelerating certain bond-financed capital expenditures. But the increment was too small to have had much impact.

³ California State Treasurer, Smart Investments, June 1999. Available at <http://www.treasurer.ca.gov/publications/publications.htm>.

⁴ Prior to the use of RAWs in the early 1990s, they had not been utilized since the Great Depression.

⁵ Proposition 98's complicated formulas tend to inhibit reductions in spending on K-14 during periods of recession when revenues fall.

⁶ For more on state budget history, see Eileen A. Roush and Philip J. Romero, "Surrendering Sovereignty to Sacramento: State-Local Fiscal Relations During the 1990s" in Daniel J.B. Mitchell and Patricia Nomura, eds., *California Policy Options 2000* (Los Angeles: UCLA School of Public Policy and UCLA Anderson Forecast, 2000), pp. 27-44.

⁷ For example, a transfer of funds from the 911 emergency telephone account (financed by a phone bill tax) to the General Fund reduces the ability to enhance 911 service.

⁸ But as will be noted below, *overall* expenditures tend to be cut in bad times.

⁹ At this writing, it is unknown whether the economic slowdown will reach the threshold of an official "recession."

¹⁰ One suggestion we have received is that these adjustments in part represent returns to the general fund of appropriated monies that agencies did not spend. Agencies may be reluctant to report that they did not spend all of their resources for fear of receiving smaller allocations in the future. Note, however, the finding reported in the next footnote.

¹¹ If one starts from the general fund balance in the mid-1970s (beginning of the cleaned-up historical record) and works backwards to estimate the fund balance in prior years, the results are implausible. Each year's prior fund balance should be the next year's beginning balance minus the reported surplus during the year. Under this logic, if the balance was truly \$905 million under Governor Jerry Brown in 1975-1976, working backwards suggests that under Governor Earl Warren in 1945-1946, it must have been -\$1 billion! Since Warren prided himself on building up a rainy day fund during the prosperity of World War II, and since state revenues were only \$364 million at the time, reported surpluses between 1945-1946 and 1975-1976 must be systematically overstated. For the historical data, go to http://www.dof.ca.gov/HTML/BUD_DOCS/question.htm and click on Charts A and A-1.

¹² Werner Z. Hirsch and Daniel J.B. Mitchell, "Surplus? California is Running a Deficit," *Los Angeles Times*, February 12, 2001, p. B7.

¹³ Letter from Tim Gage, State Director of Finance, *Los Angeles Times*, February 23, 2001, p. B8.

¹⁴ Data taken from the IBM Annual Report for 2000, available at http://www.ibm.com/annualreport/2000/fnc1/3_0_fnc1_index.html.

¹⁵ In using an example from a large corporation, we do not intend to imply that corporate accounting practices give a completely accurate view of a firm's financial condition. We are simply pointing to the stocks vs. flows concept.

¹⁶ <http://www.dof.ca.gov/FISA/BAG/dofgloss.htm>; http://www.dof.ca.gov/HTML/BUD_DOCS/question.htm.

¹⁷ The plan at this writing is to finance the bond repayment through a surcharge on electricity bills. That is, consumers are ultimately to be charged for the electricity purchases the state undertook.

¹⁸ This unpaid debt may have helped Southern California Edison avoid bankruptcy during that period; it evidently did not provide a sufficient cushion to keep Pacific Gas and Electric out of bankruptcy. Stories in the business press during the summer of 2001 that the outlook was brightening for the two utilities may also have reflected the unpaid electricity debt.

¹⁹ Data taken from memo from the Department of Water Resources of August 10, 2001 to the California Public Utilities Commission. Exhibit A, Table A-8, shows cash receipts by the Department of Water Resources from the three private utilities. Table A-1 shows total expenditures by the Department as its accumulated "fund balance." Table A-2 shows revenue collected from customers by the three utilities. It should be noted that the presentation of data relating the electricity crisis has tended to be opaque. A report from the Controller indicates that \$5.9 billion was transferred from the General Fund to purchase electricity during the first six months of calendar 2001. Another \$302 million was transferred from the Special Fund for Economic Uncertainties, for a total of \$6.2 billion. (California State Controller, *General Fund Cash Basis Report*, July 10, 2001, p. 8, note 4.) Exactly how this figure relates to the larger \$6.8 billion figure reported by the Department of Water Resources is unclear.

²⁰ John Harwood, "Tighter State Budgets May Mean Closer Governor's Races," *Wall Street Journal*, August 7, 2001, p. A16.

²¹ In fiscal year 2001-2002, the average cash reserve of all states was reported to be more than 6% of general fund expenditures, down from almost 12% in fiscal 1999-2000. See Will Pinkston, "Attacks Raise Likelihood of Higher State Taxes," *Wall Street Journal*, September 21, 2001, p. A2.