
Los Angeles Times

DWP chief to quit amid funds furor

Brown urges restraint as revenue increases

Insurers under fire as glitches mount

Answers sought in mother's killing

Christie tries to stem traffic scandal fallout

Cartier

Mitchell's Musings 1-13-14: News Reporting Deficit

Daniel J.B. Mitchell

Every once in awhile, there is a news story about a woman who goes into labor sooner than expected and her husband puts her quickly into the family car and drives to the hospital, exceeding the speed limit. So let's consider that decision. The husband could have called 911 and hoped the paramedics would arrive quickly. But that decision might be risky; they might not arrive in time. He could have driven his wife to the hospital but obeyed the speed limit on the way. But that approach might have led to the baby being born in the car, possibly endangering his wife and the baby. Or he could speed to the hospital, risking a car accident along the way or maybe just being stopped by the police, thus delaying the ride to the hospital.

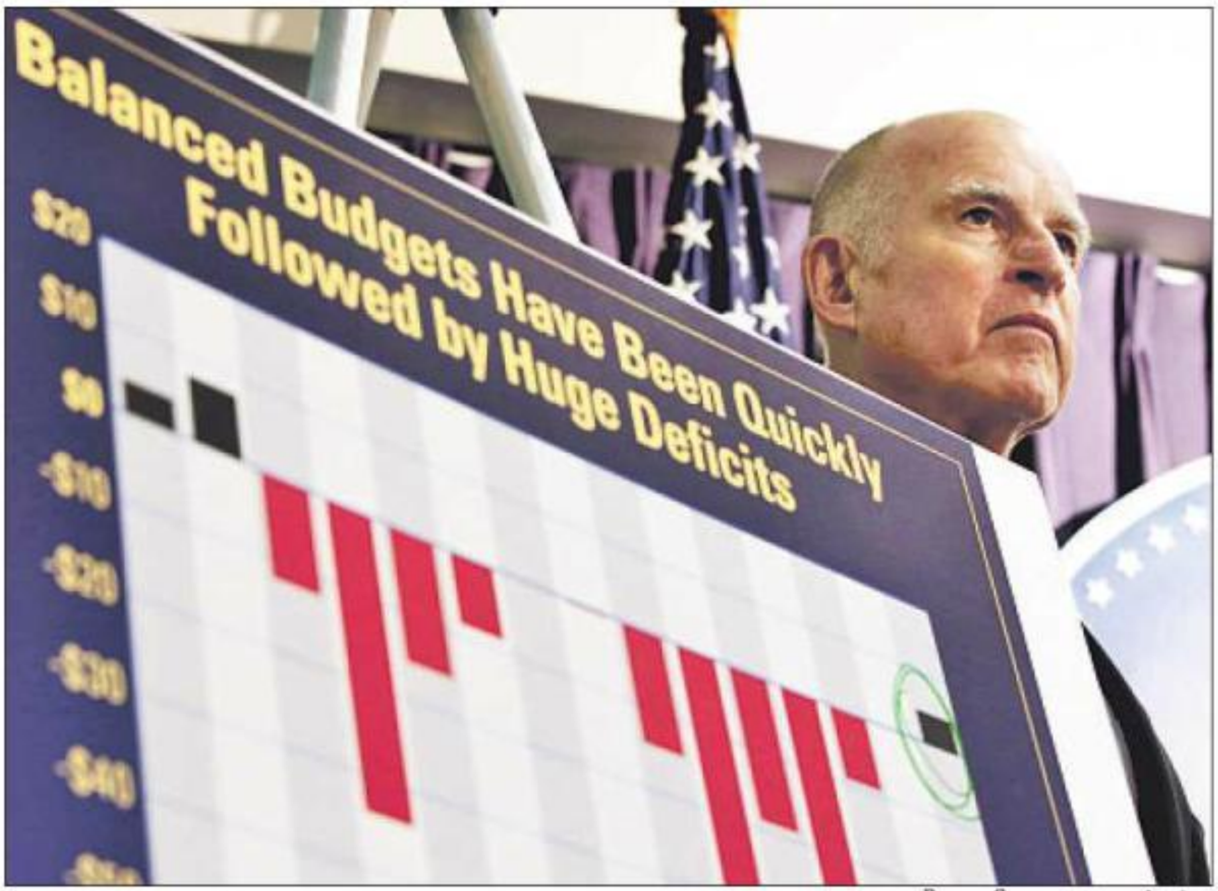
There are pros and cons to each decision. But here is a decision that would not make sense. The husband could decide to speed to the hospital, but also to adjust the speedometer in his car to prevent it from showing he was exceeding the speed limit. That decision makes no sense, since fiddling with the speedometer won't affect the actual speed of the car. Indeed, fiddling with the speedometer could make it difficult for the husband to determine by what margin he was exceeding the speed limit, creating some additional and unnecessary danger. Lack of reliable measurement can be a hazard. And there is a lesson in this allegory for public budgeting. In particular, there is a lesson that might have been applied to the recent unveiling of a budget proposal by California Governor Jerry Brown, which by and large was heralded in the news media without much attention to measurement.

California has had periodic budget crises that mirrored the ups and downs in its economy. In the early 1990s, the state was hard hit by the end of the Cold War and the decline of aerospace. It was argued by the mid-1990s that the state had developed a "structural" deficit which could not be cured in the long term by just ongoing economic growth. But then – for a time – the dot-com boom masked the problem. When that boom turned to bust, the crisis was renewed – this time reflected politically in the recall of then-Governor Gray Davis and his replacement by Arnold Schwarzenegger.

Schwarzenegger borrowed his way out of the immediate problem and, with the help of the housing bubble of the early-to-mid-2000s, he achieved a temporary budgetary quiescence. But the subsequent housing bust and the resulting Great Recession renewed the California state budget crisis. Ultimately, Schwarzenegger left office equally as unpopular as Davis had been at the time of the recall. Schwarzenegger was replaced in the 2010 election by Jerry Brown.

I won't rehash the struggles Brown had with the budget crisis after taking office, but ultimately he persuaded voters to approve tax increases under Proposition 30 in 2012. His recent budget proposal reflects the added tax revenue under Prop 30 plus the tax revenue brought in by the general economic expansion – sluggish though it has been – and by developments in financial markets that bring in capital gains tax revenues.

Brown has positioned himself as the prudent adult in the room who will guard the state treasury against raids by spendthrift legislators. The official budget documentation that was released by his office picks up the themes he has sounded about saving for economic uncertainties through a "rainy day fund," having the state live within its means, paying down debt, etc. News reports generally have reflected positively on his stance. Even statements from the currently marginalized Republican opposition, with some exceptions, have been grudgingly supportive.



ROBERT GAUTHIER Los Angeles Times

GOV. JERRY BROWN discusses his proposed 2014-15 state budget at a news conference in Los Angeles. The $155-billion blueprint includes increased spending, but Brown said the state still needs to live within its means.

The picture above – taken at the media event during which the governor unveiled his new budget plan - appeared on the front page of the *Los Angeles Times*. The chart the governor is showing in the photo is taken directly from his budget summary document (page 8).[1] On the next page is the actual table reproduced from that document. Note that the title refers to "deficits," but the footnote on the table

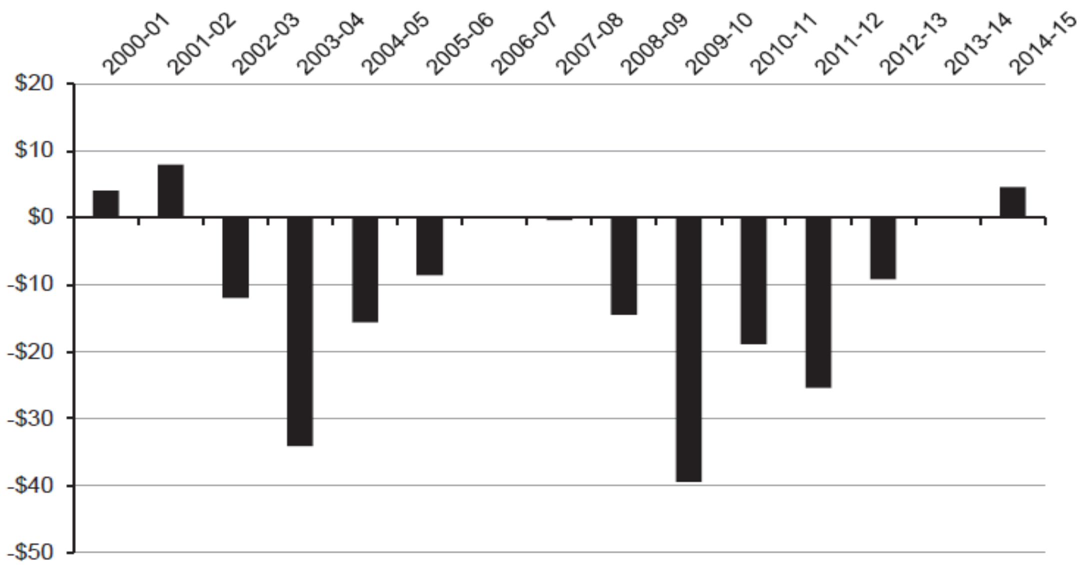
[1] http://www.ebudget.ca.gov/2014-15/pdf/BudgetSummary/FullBudgetSummary.pdf

refers to “shortfalls.” You may think you know what a deficit is, but what exactly is a shortfall? It’s not a term you are likely to find defined in any accounting textbook.

Figure INT-05

Balanced Budgets Have Been Quickly Followed by Huge Deficits[1/]

(Dollars in Billions)



[1/] Budget shortfalls or surplus, measured by the annual Governor's Budget.

You probably think that a deficit means that less money came into the state’s General Fund in a given year than was spent. And, indeed, when folks talk about the federal budget deficit, that concept is what they mean. Now, loosely, you can think of the state spending something like $100 billion or less per year during the period shown on the chart. But look at the deficits – using the common meaning that most people apply to that term (less in than out). If the state actually had really run deficits in that sense of the word, it could not have survived. You can’t fix deficits of $30+ billion in a $10 billion budget – which are shown twice on the chart – as a practical matter. Yet we know that the state, with difficulty and even with some IOUs, did make it through the worst of its budget crisis.

Note that the governor’s chart ends hopefully in what appears to be a “surplus” at the end of the 2014-15 fiscal year. But since it is apparent that “deficit” on the chart doesn’t mean what it seems to mean, isn’t it likely that surplus doesn’t mean what you might think it does?

We started off with a story about a car speeding to the hospital. We’ll come back to that story below but let’s consider another story. Imagine you have a checking account and at the beginning of the year you had $1,000 in that account. During the course of the year, you put your paycheck and other sources of income into the account. And you pay your daily expenses out of the account. Suppose you discover that at the end of the year, there was only $600 in the account. That result can only mean that during the year you spent $400 more than you took in. ($1,000 - $600 = $400.) You thus could be said to have run a deficit – in the common English meaning of that term – of $400. (Whether you had a "shortfall" is unclear, since – as noted - you won't find any definition of shortfall in accounting textbooks.)

The General Fund of California is like the state's checking account. So let's go further into the official budget summary released by the governor and see (page 14) what he expects to be the balance or reserve in the account on July 1, 2014 when the fiscal year 2014-15 begins. *Note that I am not for purposes here questioning the projection; I am using only numbers found in the official document.* According to the document, on July 1, 2014, there will be $4.2 billion in the account. What does the projection say will be there at the *end* of the year, i.e., July 1, 2015? The governor says there will be $1.9 billion there. But he proposes to divert some money into a supplemental rainy day fund to the tune of $1.6 billion. So, in effect, there will be $1.9 billion + $1.6 billion = $3.5 billion in the account at the end of the year. Since the reserve drops from $4.2 billion to $3.5 billion, there must be a deficit projected of $0.7 billion.

Did no reporter at the news conference or afterwards notice that the seeming surplus shown on the chart the governor displayed at the event did not square with the implicit deficit in his official budget summary? Apparently not.

What about paying down the debt? According to the official document, the governor proposes to reduce what he termed the "Wall of Debt" of $25 billion by around $11 billion in 2014-15. So you might think that the $0.7 billion deficit is in some way offset by the reduction in debt. But there is a problem here. If you want to net liabilities against assets – some kind of net worth concept – you have to be consistent and do it at the beginning of the year as well as at the end. And if you do it that way, *prepaying debt leaves your net worth unchanged but does make you less liquid than you would have been*, since you have less cash on hand after the prepayment. Put simply, if you reduce your debt by, say, $11 billion, you will have $11 billion less cash on hand than you would have had by not paying off your debt. In an uncertain world – something the governor emphasizes we live in – you might argue that reducing state liquidity is just what you *don't* want to do. You might suddenly need the cash that you used to prepay debt - and then not have it.

Now let's return to my speeding-to-the-hospital story. The husband was not necessarily wrong to exceed the speed limit to get to the hospital, all things considered. It could have been the best available alternative, exactly what needed to be done. But it would have been foolish to diddle with the speedometer to make it seem cosmetically as if no speeding was occurring. It could even be dangerous. Similarly, we can't say that the budget proposed by Governor Brown is a bad proposal because it runs down reserves in the General Fund. According to the proposal, there are big real expenditure increases in education and transportation. Given the big cuts during the Great Recession and its aftermath, maybe those choices are what should be done by California. But fiddling with the accounting – deficits termed surpluses, reference to vague past "shortfalls" – is not a good choice. When you obscure proper measurement, not knowing what you are doing can be dangerous.