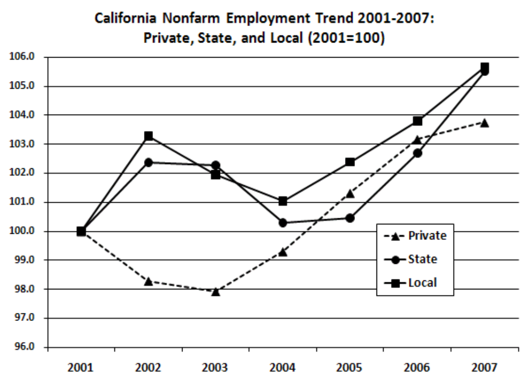
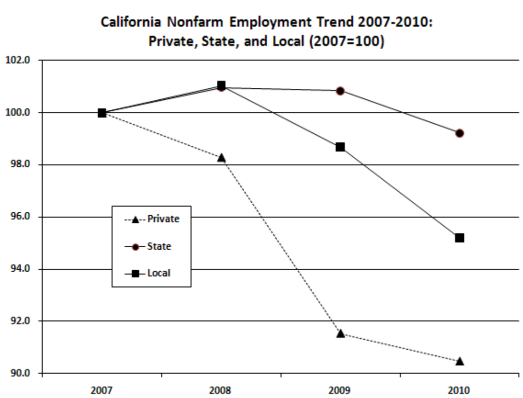
Mitchell's Musings 10-24-11: What You Call It Counts

California was disproportionately hit by both the dot-com bust/recession of the early 2000s and the Great Recession that started in late 2007. The state had a disproportionate share of dot-com firms and a larger housing/mortgage bubble than the typical state. In both cases, the impact on California's public sector brought national attention. In the wake of the dot-com bust and the resulting state budget crisis, California's governor was recalled in 2003. And in the wake of the Great Recession, California end up issuing IOUs instead of paying all its bills during the summer of 2009.

As the two charts below show, in both episodes private sector employment and public sector employment in California reacted to the downturn on different time tables. Private sector employment dropped quickly. Public sector employment *rose* for a time and then dropped with a lag. The drop has been particularly severe in the later downturn.





If we are seeking an explanation for this lagged response, an obvious place to look is in the system of state and local finance. However, rather than get into the specifics of the California state and local fiscal system (or the state's political system of "direct democracy" that allowed the gubernatorial recall), I want instead to consider budgetary accounting terminology. That focus may seem an odd choice, even arcane. Or it may seem to be at best a matter of concern just for one state. But however much California may differ from other states in its fiscal and political institutions, as far as I can tell, it is similar to the rest in its budgetary terminology. And it appears that the terminology used at the state and local level may get in the way of policy makers – particularly elected officials – in making decisions as to how to react to the ups and downs of the business cycle and its fiscal reflections. What I will describe, in summary, is not exclusively a California problem, although I will be using California examples.

If you have ever taken a course in accounting, you will be familiar with the difference between an *income statement* of a firm and its *balance sheet*. The former represents flows over a time period (a year). Essentially, you learn from the income statement how much revenue has flowed into the firm. Subtracting the expenses (the outflow) tells you whether that firm has made a profit (revenues > expenses) or a loss (the reverse). In contrast, a balance sheet is a snapshot at a moment in time (the end of the year). It compares assets and liabilities as of that moment – it is a "stock," not a flow - measurement. A firm whose liabilities are greater than its assets is in trouble.

When we talk about the federal government running a deficit (or a surplus – there have been some as recently as the Clinton administration), we are describing flows. A federal deficit means that less came into the Treasury than went out in the course of a fiscal year. A federal surplus is the result. Now, one might think the same would be true at the state and local level but, unfortunately, that is not the case.

State and local governments typically have a "general fund" that handles regular operating expenses, e.g., paying police and teachers. They also have special funds that are earmarked for particular purposes. Transportation funds may receive gasoline tax revenues, for example, and then use them for road construction and maintenance. The general fund and the special funds look something like household checking accounts. Money flows into them and out of them and there is, at any time, a balance. And that is where things begin to get messy. The funds have three aspects: inflows, outflow, and the balance. The first two are flows. The last is a stock. Hence, there is a possibility of confusing flows and stocks.

Note that the balance in these accounts – which we will refer to henceforth as the "reserve" – is, in essence, the sum of past *net* inflows. If, over some time period, more flows into a fund than goes out, the reserve will rise; if more flows out than flows in, it will fall. So if stocks and flows are mixed up into a single measure, the time dimension can become ambiguous since the reserve implicitly embeds past time periods.

Generally, when a state or local "budget" is discussed, the discussion is focused on the general fund. Because of the stock-flow confusion, the words "surplus" and "deficit" do not necessarily have the federal meaning when they are used at the state and local level. Sometimes, a budget will be described as in surplus or perhaps "balanced" because there is a positive reserve left in the fund. Thus, revenue may be falling short of expenditure and, therefore, the reserve is eroding – but the last penny of the reserve has not yet been drawn down. Describing such a budget as being in surplus or balanced makes it sound healthy. But a falling reserve – headed toward zero – should be flashing danger.

Let me give a concrete example of the problem. California experienced a high-profile electricity crisis in 2001 – the result of a poorly designed deregulation scheme. The big California utilities teetered on bankruptcy and became unable to buy power. As an emergency response, the state stepped in to buy electricity on behalf of the major utilities. Assurances were given to the public that the state would buy the power from its budget "surplus." The only difficulty was that in the federal sense of that word, the state was in deficit. Moreover, it was evident by that point in time that the economy was turning down, thanks to the dot-com bust.

With a colleague of mine at UCLA – the late Werner Z. Hirsch - I wrote an op ed in the Los Angeles Times entitled "Surplus? California is Running a Deficit." It began with the following words:

As California's electricity crisis unfolded, there was much talk about using the state's "surplus" to fend off high energy costs. Indeed, in recent years the surplus has been regarded as the answer to just about any social need in California. There is just one problem, evident in the governor's budget documents but ignored by the public and the Legislature. In the current fiscal year ending June 30, California is running a deficit. And the budget proposals for the next fiscal year similarly project a deficit…

The op ed went on to describe the situation as it then appeared in official documents in more detail. It concluded:

…It is important to stop sugar-coating the state's fiscal situation with talk of a phantom surplus. The governor's budget needs to be revised to take realistic account of the energy crisis, even before May when such corrections traditionally are made. That way, administrators of programs that receive state funds will have a chance to plan for possible cutbacks. The general fund shouldn't be running a deficit now when the money may well be needed later.[1]

The op ed elicited an angry letter to the editor from the state's budget director a few days after it appeared insisting there was a surplus. What he meant was that there was still some reserve left. Yet it was obvious that a state running a deficit at the peak of the cycle when revenue was at a maximum would be in trouble as the downturn progressed. And the inevitable did happen

[1] The full op ed is available at https://docs.google.com/viewer?a=v&pid=explorer&chrome=true&srcid=0BzVLYPK7QI_4MDQwNzMyYWEtMjhhNC00MWUxLWI5YzgtOWUxN2IzMGRhYThj&hl=en_US

– California had a major budget crisis. As the crisis unfolded, it was soon determined that the budget director needed to spend more time with his family (and someone else was appointed). Eventually, thanks to the 2003 recall, the governor also found himself with more family time.

Would better fiscal policy have been made if common-sense terminology had been used? There is no guarantee, of course, that better policy would have been the outcome. But what can be said is that use of terminology that obscured fiscal reality made it more likely that bad outcomes would follow. As it has been said, if you don't know where you are going, it may be hard to get there.

What about the response to a budget crisis, once it has occurred? Again, fuzzy accounting terminology gets in the way of understanding what the options are. Typically in a crisis, the reserve in the general fund becomes negative, a situation analogous to overdrawing a checking account. It is possible to run with a negative reserve through borrowing. Borrowing can be internal – the general fund borrows from the other special funds – or external (borrowing from financial markets). Because of the fuzzy terminology, the goals of getting back to a positive reserve, i.e., making up for past fiscal sins, and of dealing with the current situation become confounded. In effect, the one-year time dimension is lost. Budget proposals made during midyear crisis course corrections are described as "deficits" if they don't make up for past sins *and* finish with a positive reserve by the end of the coming fiscal year. In effect, three years – or more – become the implicit time period of the problem.

At one point in California's budget crisis, the speaker of the assembly and the governor described the state as having remedied a $60 billion deficit in a $100 billion budget. When I posed the idea of fixing a $60 billion deficit *in the common-sense meaning of that term* in a $100 billion budget to an audience of fiscal experts, they laughed. In the common-sense (federal) meaning of the term, there would be no practical way of making such a fix. The problem with the statement was that the $100 billion was a one-year flow and the $60 billion was a correction for the past sins, the current year, and the forthcoming year. And, not surprisingly, the supposed $60 billion fix did not resolve the entire problem.

Suppose California's fiscal dilemma had been reframed as follows.

1) We have a negative reserve in the general fund. How do we finance the negative reserve until we can work our way out of the problem?

2) We need to make a midyear correction in the current year's budget because our assumptions when that budget was enacted were over-optimistic. What can we do in the short run in the current year, given that it is partly over?

3) If we make no changes, the budget next year will be in deficit? Do we try to run a sufficient surplus to bring the reserve back into positive territory? Or will we need a multiyear workout, given the depth of the crisis?

By breaking the $60 billion "deficit" into its true components, we at least have made the options clear – although, again, there is no guarantee of good decision making.

Even at the current time, the stock-flow mix in terminology is California driving policy. Any proposed budget that does not ostensibly produce a positive reserve by June 30, 2012 (the end of the current fiscal year in California) is described as a deficit, even if they are budgets in which revenue > expenditure. That terminology drives the option of a multiyear workout off the agenda. And/or it gives rise to budget "solutions" that appear to meet the June 30 goal but may not do so.

There are still other terminology problems in state and local government accounting. I have used California examples because I am familiar with that state's fiscal history. But the same problem is common in all states and localities. Right now, layoffs in state and local government have been offsetting private job growth. Current terminology tends to delay recognition by state and local governments of downturns; politicians are told that budgets are "balanced" or even in surplus until reserves are exhausted - at which point there is a full-blown crisis. In essence, there is no crisis until there is a severe one. Then politicians are told there are deficits unless there is a complete fix in a short period of time – a large surplus to rebuild the reserve by the end of the fiscal year.

The likely outcome of current terminology is a more erratic pattern of state and local government employment than there needs to be with sharp layoffs just when the labor market needs the reverse.