Mitchell's Musing 7-14-14: The California State Budget: Will a Rainy Day Fund Fix It?

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The Great Recession caused fiscal distress to most state and local governments. Any time the economy turns down, tax revenue will also fall. If the downturn is large, the drop in revenue will also be large, although the magnitude of the drop will vary with the type of taxes on which the government in question depends.

California, as the largest state in the nation, received substantial national attention as it went through its most recent budget crisis. The state had a prior budget crisis in the early 2000s as a result of the downturn then and the bursting of the dot-com bubble. One consequence of that episode was the replacement of Governor Gray Davis in the early part of his second term by recall. Movie celebrity Arnold Schwarzenegger took his place, promising to fix what ailed Sacramento. Schwarzenegger, because of his movie star status, attracted even more attention to California's fiscal woes than might otherwise have been the case.

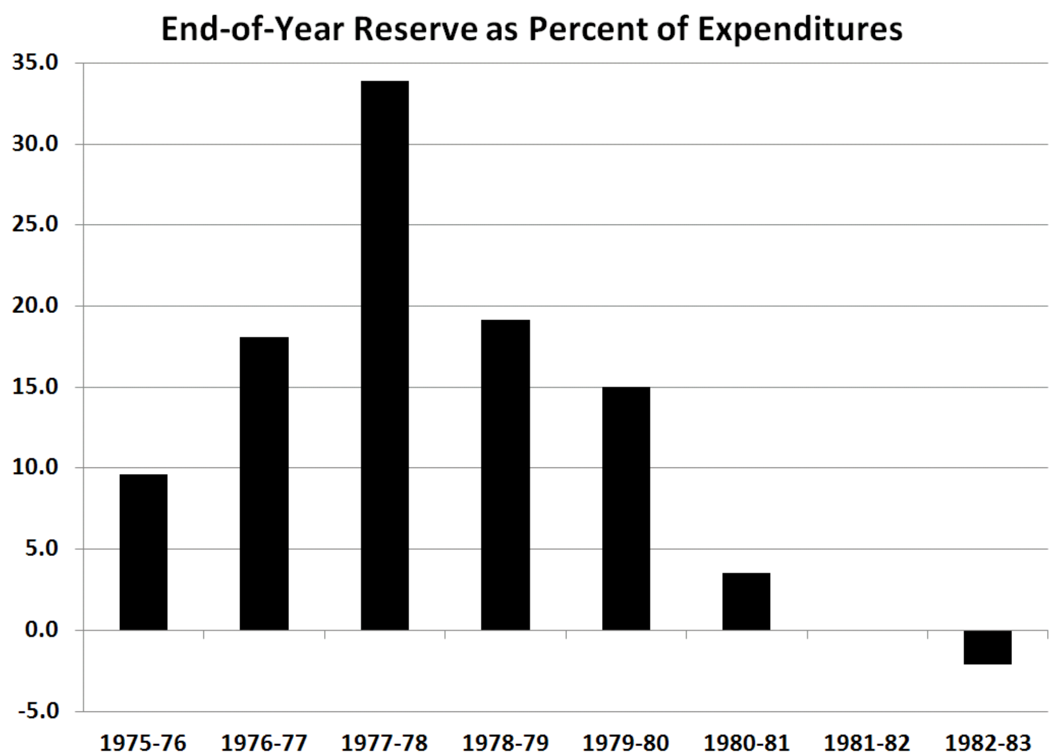
In the end, however, Schwarzenegger's two terms – which ended during the budget crisis that followed the Great Recession – left him equally unpopular as Davis was when he was recalled. Schwarzenegger was followed as governor by Jerry Brown in the general election of 2010; Brown had been governor for two terms during the 1970s and early 1980s. In his earlier iteration, Brown had been an eclectic, "new age" governor who saw himself as a fiscal conservative. His view in his earlier iteration (and in his second coming) focused on building up a healthy reserve in the state's General Fund to cushion against future downturns.

Now a state or local government can save for a rainy day simply by spending less than it takes in. Such a policy will increase the General Fund reserve, a *de facto* rainy day fund. However, this time around, Brown wants voters in the upcoming general election to approve a formula-driven rainy day fund beyond the official reserve. One could argue that no such fund is needed since the dollars that would be accumulated could just as well accumulate with the conventional reserve. Moreover, the voters over the years have approved other formulas, notably Prop 98 in the late 1980s which drives K-14 spending. There is a case to be made that there are already more than enough formulas in California budgeting.

However, let's put that argument aside and assume that a) Brown himself will be re-elected this fall and that b) his rainy day fund ballot proposition will be approved. Both outcomes seem very likely. The popularity of the governor is a function of a voter sense that things – primarily the budget - are being taken care of in Sacramento in an orderly process. Right now, despite various administrative issues for which Brown could be criticized, all seems well regarding the budget. Moreover, Republicans in the state have marginalized themselves to the point that whatever shortcomings there may be in Brown governance, their voice is not being heard except among party loyalists.

As for the rainy day fund proposition, since Brown is popular and Brown says he endorses the concept, voters will almost assuredly approve it despite concerns among policy wonks about too much formula-driven budgeting. In any event, assuming Brown's re-election and approval of his rainy day fund, is California out of the woods? The answer, unfortunately, is that it wouldn't take much of a future downturn to upset the state budget. Thus, the economic pain of public sector layoffs and cuts to education, social programs, etc., could easily be revisited.

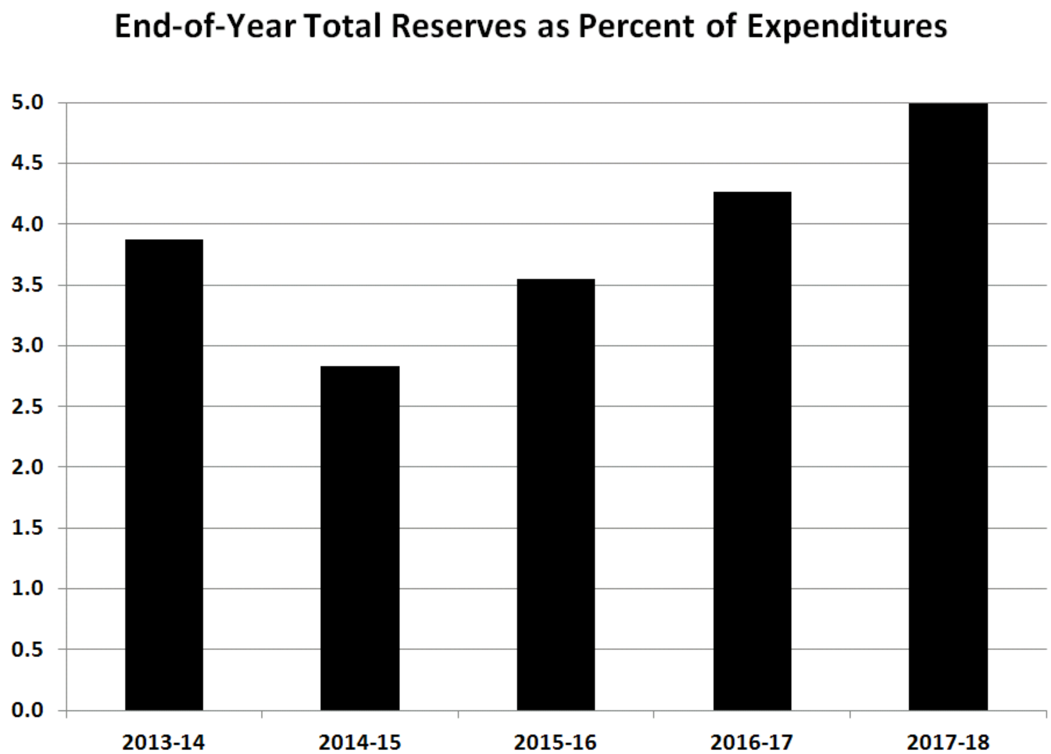
Let's first look back at Brown's first iteration as governor. As the figure below shows, under Brown the reserve in the General Fund back then built up to almost a third of the state budget. But then came the combination of Proposition 13 of 1978, which drastically cut and capped local property taxes, and a period of recession in the early 1980s. Due to Prop 13, the state had to bail out local governments, especially school districts. It initially could do so, thanks to Brown's *de facto* rainy day fund. But then recession hit, further depleting the reserve.



Even if we start with fiscal year 1979-80, when the reserve was about 15% of the budget, the reserve had disappeared into negative territory in a couple of years. In short, a rainy day fund can be depleted very fast and can only be a short-term cushion.

It's unlikely that California will see a reserve of a third of the budget, or even 15%, any time soon. How much can be expected under the Brown plan. Official budget projections going out to 2017-18, *which assume no recession*, are shown on the figure on the next page. Historical precedent suggests that such continuous linear grown is unlikely (but not impossible). However, the figure shows that total reserves (regular reserve plus rainy day fund) under that scenario will rise to 5% of the budget. It wouldn't take much of a setback to blow out 5%.

Note also that total reserves as a percent of the budget actually dip during the current fiscal year (2014-15). So although reserves remain positive, the official estimates have them dropping as a percent of the budget – and in absolute terms. That is, the projection for this year is that spending will exceed revenue. Only in subsequent years do total reserves begin to increase.



There is a *caveat*. Brown's strategy with the legislature is to insist on conservative estimates of revenue during budget making to constrain spending. When the now-concluded 2013-14 budget was enacted, it assumed over $5 billion less in revenue than actually appeared. Possibly, there will be another positive revenue "surprise" during the current year. Even so, however, the projections above forecast a much more moderate level of reserves by 2017-18 than Brown had accumulated during his first iteration as governor. And we know how rapidly those funds disappeared.

The lesson is that, as a practical matter, rainy day funds of the magnitude currently being sought might buy a single year for an adjustment, assuming significant budget cuts were made during that year. If you are thinking of a rainy day fund as an umbrella over the budget, it is a leaky umbrella at best. The fact that the current fiscal year's official figures forecast what in normal parlance would be called a deficit (income < outgo) is also not encouraging. As recalled Governor Davis can attest, a deficit at the peak is dangerous. Things can only get worse. Of course, no one knows for sure if 2014-15 will be a peak. But what if it is?

Hate to rain on your parade.