Mitchell's Musings 8-27-12: Park at the Governor's Risk

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I have mused before on fiscal data practices in state and local government. The public sector since the Great Recession has been under strain, a fact that invites examination of the public budgeting process. My July 16th musing, for example, referenced the bankruptcy of the City of San Bernardino, California, an event that garnered national attention. I suggested in that musing that state and local data practices can contribute to situations in which those responsible for budget policy have only a partial idea of what is happening within their jurisdictions. In the San Bernardino case, although there were originally statements in the news media suggesting criminal conduct, no such allegations have been substantiated. But obviously, something went wrong in that city.

City officials – particularly elected officials - may have made bad decisions in the San Bernardino case. But bad policy by itself is not criminal. And, of course, there is no guarantee that even with good data available to decision-makers, those who receive that information will govern wisely. On the other hand, good data – particularly if presented in consistent and illuminating formats - should increase the odds of making good decisions. I argued in the earlier musing that the widespread use of fuzzy public accounting practices in describing such basic concepts as surpluses and deficits can obscure looming challenges.

The San Bernardino case received national attention because the bankruptcy there along with bankruptcies of some other California municipalities, were viewed as possible harbingers of similar events in other cities - including cities outside California. But we now have another unfortunate fiscal development in California, this time involving the state parks system. The parks problem is more confined to the state in terms of media attention than was San Bernardino. But as in the San Bernardino case, the parks problem may also have lessons for the public sector more generally.

By way of background, California has had well-publicized state budget problems for years. The state has had what analysts term a "structural deficit" going back to the 1990s and to the end of the Cold War's infusion of growth-stimulating federal military spending. The California structural problem has been masked on two occasions, first by the dot-com boom/bubble (late 1990s) and then by the housing boom/bubble (mid-2000s). But it inevitably reappears with a vengeance when the bubbles burst. California was particularly hard hit by the Great Recession and its budget has been in chronic crisis since that time.

Jerry Brown was elected governor of California in 2010 on a pledge of dealing with the budget but not raising taxes without a vote of the people. For his first budget (applying to fiscal year 2011-12 – beginning July 1, 2011), he spent almost six months trying to persuade GOP legislators to give him the two-thirds vote needed to put a temporary tax measure on the November 2011 ballot. His efforts at persuasion failed. Ultimately the legislature simply assumed about $4 billion of phantom extra revenue that produced a state budget balanced on paper – a budget which under California's constitution could be passed with a simple majority – but which was not balanced in reality.

There are two routes to obtaining a vote of the people in California. The legislature can put propositions on the ballot, the route tried unsuccessfully by Brown in 2011. Alternatively, under the state's system of direct democracy, the initiative process (petitions with sufficient voter signatures) can be used. So when it came to proposing a new budget for 2012-13, Brown went the petition route and ignored the GOP legislators. That approach has now resulted in a proposition scheduled for the November 2012 ballot that would raise income and sales taxes on a temporary basis. Details of the state budget and on how that initiative was placed on the ballot are interesting but not relevant to this musing.

The key point now is that the governor needs to persuade voters in November that the state needs more money. So far, polls indicate that a slim majority of the electorate would vote for his tax initiative. But folk wisdom among state politicos is that before a campaign surrounding a controversial initiative gets underway, the initiative should poll 60% or more favorable. Support tends to slip as negative campaigning occurs so a 10% cushion of initial support is needed to ensure a majority by Election Day. In short, absent that cushion, Brown has a sales job ahead of him.

As part of the ongoing California budget crisis, the state has repeatedly threatened to close a list of state parks and even scheduled various closures. As those threats developed, various local public and private interests have raised external funds to keep particular parks open. On the other hand, an initiative on the ballot in 2010 for an added motor vehicle fee – effectively a tax – earmarked for parks was rejected by voters. Thus, it appeared that only external fundraising could save the various parks on the closure list.

Just as the campaigning was beginning for and against the governor's November tax initiative, a newspaper discovered that the California Department of Parks and Recreation had $54 million in funds on reserve that seemed to be "hidden." There are conflicting stories about who knew about the money and when, but so far the head of the Department has resigned and the second in command has been fired. Unlike the San Bernardino case, there may have been some misappropriation of funds involving the parks which could entail criminal charges. Those outsiders who with considerable effort raised money to keep the parks open were obviously incensed to learn that Department money might have been available for that purpose all along.

The fallout from the parks scandal has been fourfold. First, opponents of the governor's tax have seized on the idea that the state has hidden money and therefore additional taxes are unnecessary. The parks scandal is in the millions of dollars while the state's overall budget problem is in the billions. But in the public mind, millions vs. billions is a distinction that is not always made. Second, the news media are now busy investigating the Department of Parks and Recreation looking for other or related misbehavior.

Third, the parks scandal has turned attention to the practice of having funds outside the general fund, typically earmarked for particular purposes, since the hidden money appears to have resided in one such fund. The state has hundreds of such funds, some very small and some quite large. And the practice of having a general fund as an operating budget and then a host of satellite other earmarked funds is a widespread state and local practice. Fourth, the issue of fuzzy accounting in the public sector has re-emerged.

The political embarrassment for the governor caused by the existence of seemingly-hidden parks money is obvious and I won't say more about that matter. But it is the other elements of fallout I want to discuss. There is a mix of investigations about faulty management information and about incentives for perverse managerial behavior.

It is not clear at this point how hidden the $54 million was. As noted, it was sitting in accounts outside the general fund for the Department. Even if the now-resigned department head knew of the money – still uncertain – there were others in the hierarchy all the way up to the governor who evidently didn't know. So there is a problem with the state information system that is obvious. Those who should have known didn't. Having accounts outside the general fund is surely part of the story. But there seems to be still more.

The state controller issues monthly and annual reports on cash flows into and out of the various funds of the state including the general fund. Yet it is not possible – apparently – to reconcile the cash statements with the budget approved by the legislature and estimated as the year progresses by the Department of Finance (which reports to the governor). All that can be found when one searches for a reconciliation are vague footnotes about accrual vs. cash accounting. In principle, if accrual vs. cash was all that was involved, reconciliation should be possible. In theory, accrual accounting is supposed to provide a clearer picture of underlying budget trends than the vagaries of cash flows. But accrual, as it is actually applied by the state, is as fuzzy as the concepts of surpluses and deficits. Given the system in place, managers of departments may not be able to attain a clear understanding of how to connect what the legislature thinks it has given them with what they actually have on hand.

It appears that along with hidden funds outside the general fund, there were also surprise discoveries of extra money left over in the general fund for the Department. Because of "use it or lose it" practices for such monies, there was a perverse incentive for managers to find ways of using up the "excess" before it disappeared at the end of the fiscal year. Apparently, some of the uses may not have been legitimate. However, even if the uses were entirely legal, they clearly were of low priority. There was bound to be trouble in a system in which managers don't have real-time information about what is available and about how what is available relates to what they think they have been allocated by the legislature. And now that trouble has arrived.

Let's put aside the issue of whether some of the uses inspired by "use it or lose it" were legal. It is rational for managers at the departmental level to respond to incentives, even if those incentives are perverse. There isn't a perfect solution for correcting such incentives. In principle, you want managers to use money in ways the legislature intended and you don't want to create incentives to hoard. So just solving the "use it or lose it" problem by saying departments could keep anything they don't spend by the end of the year – one "solution" - would also raise issues.

All incentives in organizations (public or private) – whether those incentives are intended or just built inadvertently into the administrative structure – are imperfect. That is why we have supervisors and supervision. Supervision sometimes must override micro-level (mis)incentives. But effective supervision requires accurate and timely budgetary information presented in consistent and illuminating formats. That is the most basic lesson of California's current parks scandal. I suspect that state and local governments outside California, as well as within the state, could benefit from that lesson.