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Daniel Weintraub: A rainy day reserve that is both smart and possible

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California's budget rollercoaster is more than just an annoyance to the green eyeshades who track state spending and taxes deep inside the government. The volatile nature of the state's revenue mix, combined with spending formulas that are locked into law, pose a serious problem for the schools our kids attend, the doctors and hospitals who care for the poor, and the cities and counties that provide our public services.

In good times, tax receipts surge and programs are flush with money, able to meet their needs and even expand, sometimes automatically. But in bad times, as revenues flatten or even shrink, those same agencies are forced to curtail the programs and services they offer. Schools lay off teachers, hospitals see fewer patients, and cities pinch police departments, park maintenance and libraries.

The worst such cycle in recent history occurred during the dot-com boom and bust at the end of the 1990s and the beginning of this decade. But the housing boom and the resurgence of the stock market in the middle of the decade, and the current slump, have had a similar effect.

Gov. Arnold Schwarzenegger has tried to deal with the problem. In 2004, he persuaded the voters to create a rainy-day reserve and a balanced budget amendment that he said would sock away money in good times that the state could use later when revenues ran short.

But his own experience since then has shown that the measure, Proposition 58, was insufficient. It did not set aside enough tax revenue while the economy was hopping, and it allowed Schwarzenegger and the Legislature to tap into the reserve for short-term needs rather than hold the money back for the inevitable economic slowdown.

The result is a multibillion-dollar deficit and pressure to raise taxes. But the state cannot raise taxes every time the economy slows. It must find a better way to manage its money through good times and bad.

Now the governor is asking the Legislature to create another reserve that he says would do a better job of shaving the peaks and filling the valleys in the state's revenue flows. He would limit spending growth each year to the average revenue growth of the previous 10 years, and allow automatic, across-the-board cuts in spending if revenues fall short of projections after the Legislature passes a budget.

Schwarzenegger's new proposal is better than his last one. But it, too, is flawed. If adopted while the state still had a gap between its tax receipts and spending, Schwarzenegger's plan could freeze that shortfall in place by preventing the state from spending new revenue. And in the next economic downturn, revenues and spending could fall, but when the economy began growing again, services might never catch up with their previous levels because the new, higher revenues would be sequestered.

His proposal for automatic cuts in bad times – if lawmakers fail to act by a pre-set deadline – is not only unnecessary but has virtually no chance of winning approval in the Legislature.

The Legislature's independent analyst, Elizabeth Hill, has suggested an alternative to the governor's proposal that would be an improvement over the status quo and might also be able to win support from lawmakers, whose votes Schwarzenegger would need to move his idea forward.

Rather than tying the budget and the reserve to an average of annual revenue growth, Hill suggests requiring the state to set aside tax receipts that come in above projected levels for the year. This would preserve the Legislature's discretion during the normal budget-writing time while preventing lawmakers and governors from spending surpluses from an "April surprise" – the big surges in tax returns that have been known to flood the treasury in good times. She would also raise the ceiling on the rainy day reserve to 10 percent of the general fund.

The analyst has urged the Legislature to reject Schwarzenegger's call for automatic budget cuts in bad times because the proposal would simply use a new formula to combat the problems caused by all the existing ones. Instead, she urges lawmakers to re-examine more than a dozen mandates adopted by voters and earlier Legislatures that push spending up automatically or reserve particular pots of tax dollars for special programs.

Those mandates are politically popular, or they wouldn't exist in the first place. Special formulas drive spending on schools, transportation, mental health programs and tobacco-use prevention. Altering any one of them, or all of them, would be a gargantuan political battle.

Hill's recommendations on the budget reserve, however, are solid and doable. Republicans who want to shrink the size of government would rather have a true spending limit, but that does not seem likely in California's current political climate. Democrats who believe in bigger government don't like the idea of setting aside money when the economy surges. But the destructive effect of the state's boom and bust cycles on programs and the constituents who depend on them should show liberal lawmakers that moderation would be an improvement.

If Schwarzenegger were to adopt Hill's proposal as his own, it might actually have a chance of passing in the Legislature as part of a larger budget-balancing solution.
