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Commentary

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How to Deal with California's Budget Problem

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The governor and the legislature face an enormous challenge as state revenues continue to fall precipitously. While the budget could have been better managed over the last decade (for which I bear some responsibility), this revenue decline dwarfs any reasonably sized rainy-day fund that might have been established as a defense against a downturn.

So, what to do?

The most immediate task, as outlined to the budget conference committee, is to deal with the state's cash crisis. In order to get the state's cash flow borrowing to a manageable level, the legislature needs to make immediate spending reductions. However, they shouldn't attempt to address the entire budget problem in the next few weeks.

Why not?

The budget process is fundamentally flawed. We budget on a year-by-year basis. In the midst of budget crises, proposals for program reforms, almost no matter how sensible, that yield out-year savings but don't help the budget year are routinely tossed aside in favor of short-term fixes. Program reforms that require lead time to realize savings get short shrift.

The budget problem presents an opportunity to revamp programs so that critical services can be delivered more effectively and at lower cost. But making these changes

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requires thoughtful discussion on the part of the legislature, the administration, program advocates, and others. While some of these conversations may be completed in a few weeks, others will take more time. And implementing program changes will require lead time as well, meaning that even under the best of circumstances program reforms will yield only partial savings in 2009–2010.

That's why the legislative analyst told the budget conference committee that their immediate task was to deal with Phase 2—identifying reductions to reduce the state's cash borrowing demand. (Phase 1 was the February budget agreement.) Having done this, they should turn their attention to the development of more substantial program changes that could yield long-term savings—Phase 3.

In effect, the legislature and the governor need to put together a workout plan. They need to provide Californians with a roadmap as to how the budget will be brought into balance by the end of 2010–2011. One way of doing this would be to establish spending targets by major program area and assign task forces the responsibility of coming back with program reforms that meet those targets.

This will give them the opportunity to make changes that might otherwise be dismissed if they deal solely with 2009–2010. As part of the effort, they should look closely at the current allocation of program and financing responsibilities between the state and local government. Earlier program realignment efforts provide a good model of how to engage this conversation.

Targeting the end of 2010–2011 to bring the budget into balance fits with the likely timeframe for repaying the revenue anticipation warrants, or RAWs, the state will likely have to sell in order to manage cash flow. RAWs are a cash management tool the courts have consistently said are a permissible means of managing cash flow over two fiscal years. Investors need to see a credible plan for repayment of that borrowing if they are going to be willing to lend money to the state. The state is far more likely to be able to develop such a plan if 2010–2011 is the target.

There are limits, however, to how much of the budget problem can be addressed in 2010–2011. The first I've already mentioned—cash flow borrowing demand needs to be reduced immediately with large spending reductions. Second, the budget is significantly out of balance in 2010–2011 even if the governor's proposals are adopted. But in order to address the 2010–2011 budget, why not use the lead time available to finish balancing this year's budget and next year's at the same time.