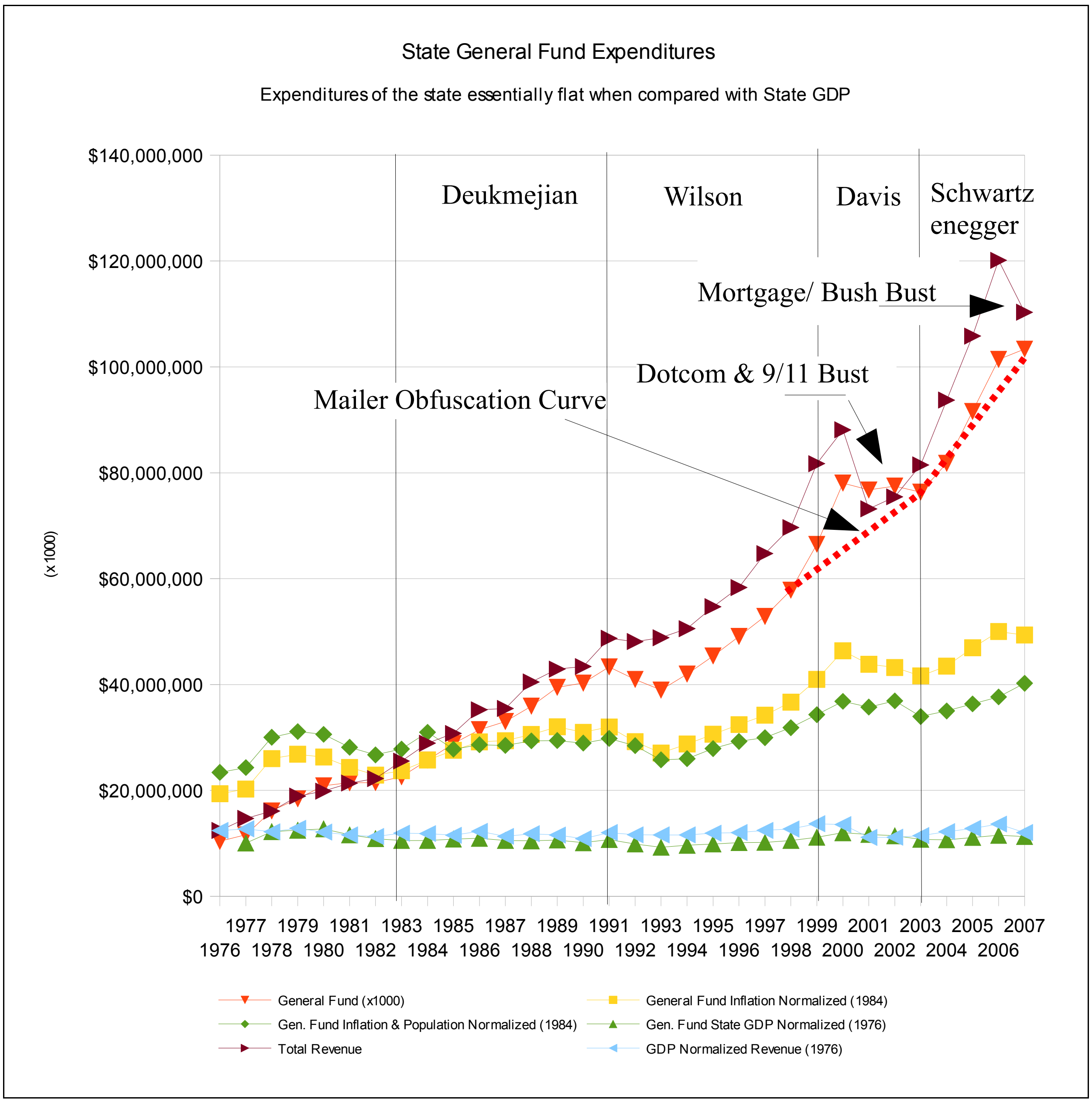
Does the State have a "Spending Problem" and not a "Revenue Problem?"

by Raymond Lutz, 2008-02-03 (V4)

Unfortunately, this is mostly partisan positioning, and the truth is that the state has both a spending problem AND a revenue problem, but this time around the dip in revenue is the primary culprit. We keep hearing from Governor Schwarzenegger and the Republicans that the "Democrats are at fault" for the spending problem of the state. In a mailer, they say:

- State Spending is Out of Control
- In the last ten years, spending has increased at an alarming rate – up 87%.
- Much of this spending occurred under Governor Gray Davis and a Democrat controlled Legislature.
- To pay for their wasteful spending and mismanagement of your tax dollars, Democrats want to raise taxes... Recently suggesting a $9 billion tax increase.

The mailer shows a chart with three data points, at 1998-99, 2002-03, and 2007-08 to show a linear increase in expenditures. This is obfuscation, not openness. Take a look at the chart below, which shows the facts of the situation.



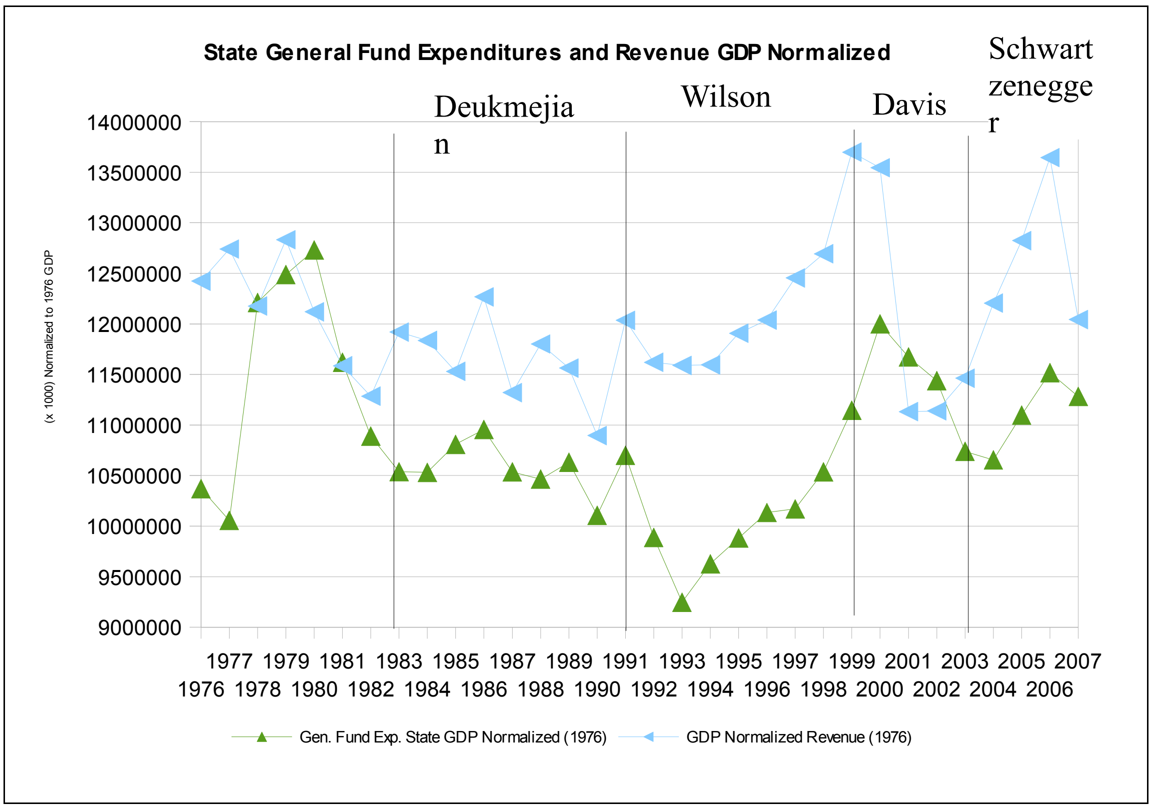
The total expenditures with no adjustments for inflation or population are shown with (red) upside-down triangles and the revenue is shown in red right-pointing triangles. (You can't compare these directly due to the nature of the funds they area allocated to.)

We first notice that the mailer skips the flat region in raw expenditures from 2000 to 2003, which was during the Gray Davis administration, and saw the largest increases under Pete Wilson, from 1991 to 1999. Davis actually did quite well in responding to the sharp decline in revenues by cutting expenditures in real dollars from year to year. His response was so good, he should have won an award. Instead, he was recalled.

The first step to make sense of these plots is to adjust the figures for INFLATION and POPULATION. when you do so, you find that the increase is not nearly as alarming as the mailer would have you believe. Adjusting for state inflation only, we have the (yellow) squares, and if you also adjust for population, the green diamonds. Indeed, the increase is on-par with other states in terms of higher costs that are due to energy costs increases and an increase in productivity of our workforce.

But it does not end there. It turns out that the INFLATION RATE is a manufactured number, and is specifically suited to calculating the cost of living for a family based on a market basket of goods. The trouble is that running a state is not like running a family. Sure, many families work for state and local governments, and those payments should use the conventional CPI. However, other aspects of state operation are more sensitive to the cost of energy and other variables that are not weighted correctly in the conventional CPI. For example, 15% of all energy used in the state is used for one thing: moving water around. When you add the operation of firefighting equipment, law enforcement, and the like, you wind up with a much higher reliance on energy, just like any business will need different weights than a family. Therefore, the CPI is really quite poor at estimating increasing costs on state operations.

To eliminate the pesky calculation of inflation and operating costs, the expenditures of the state can be compared with the STATE GROSS DOMESTIC PRODUCT. The SGDP is a figure that is, once again, not easy to derive and is developed by taking a portion of the US GDP. What is good about the number is that it is affected by true inflation just like expenditures and also rises according to underlying costs. Therefore, we can normalize expenditures and revenue based on the change in the State GDP. You find that expenditures are essentially flat (within a range of variation) for the entire 30 year study period and run about 7.5% of the SGDP. We need to blow these curves up to see any variation at all, and we can see the same boom-bust cycles, but this time against the backdrop of the actual cost of doing much more business (Higher state GDP.)



A key observation to make is that, when compared with our huge state economy, we are really not that far from putting our budget into line, and we should. And, it is interesting that with all this evidence and clear changes in the economy that signal a decline in revenues, that the “Spending Problem” chant continues. Spending is certainly a problem, but it is no worse than it has been in the 1980s and 90s when compared with the State GDP.

Appropriate and fair taxes will help our state to balance its budget and avoid cranking up the ever-increasing debt load, now growing without bound. Diligent spending cuts (and eliminating per-diem during budget impasses) must also be part of our strategy.

--Ray Lutz

Notes:
1. State Expenditures are with regard to the GENERAL FUND only and were obtained from the CA Department of Finance, http://www.dof.ca.gov/
2. CPI figures are from the CA Department of Industrial Relations, http://www.dir.ca.gov/
3. Population figures from US Department of Commerce, Bureau of the Census, http://www.census.gov/
4. State GDP from U.S. Dept of Commerce – Bureau of Economic Analysis http://www.bea.gov
5. Revenue from the CA Department of Finance, http://www.dof.ca.gov/