

Lost in Translation

Precisely defining financial terms would help Californians understand what's at stake in budget debate.

By DANIEL J.B. MITCHELL

BUSINESS leaders often bemoan the fact that government is not run like a business. Of course, businesses are not democracies and most people would resist living under a government run like a business. However, there is one place where we would all benefit if California's state government emulated business practice: basic budget accounting.

As the state's fiscal crisis worsens — and it will — you will be seeing references in the media to budgetary “deficits,” “short-falls,” “gaps” and “holes.” You will also find that these terms are rarely defined — even by the state government officials who use them, from the governor on down. Although the numbers associated with these terms are always in the billions of dollars, the amounts vary dramatically from one telling to the next.

When I ask business people what they think it means when someone says that the California state budget is in deficit, they almost always respond that it means the state is spending more than it is collecting in revenue. In business terms, they are thinking of in-and-out flows of funds, the kinds of flows found on corporate income statements.

But in California's budget discourse, sometimes words like “deficit” don't refer to the inflows and outflows, but instead refer to stocks.

Let's step back and recall that in business accounting, there's a differentiation between stocks and flows. Stocks refer to what you have at a moment in time, such as assets or liabilities. The balance sheet is a compilation of stock measures, i.e., all assets and all liabilities as of a given date.

By contrast, flows occur over time. The change in inventory over a time period such as a year, for example, is a flow. The income statement is a compilation of flow measures; what happened over the course of a period of time such as a fiscal year.

If I had \$1,000 in the bank at the beginning of the year — a

stock measure — and I netted all the deposits and withdrawals made during the year (flows) — I should arrive at my balance at the end of the year. So if my balance at the end of the year is \$700, it must be the case that outflows exceeded inflows during the year by \$300. I ran a deficit of \$300.

Of course, I have a problem if I continue year after year with my outflows exceeding my inflows. But sometimes, in California budget-speak, I would be said to have a “surplus” of \$700. Sometimes I might be described as having a balanced budget because I still had a reserve left to draw down. Sometimes I might be described as having a deficit because my outflows exceeded my inflows.

What's more, unlike corporate income statements that refer to a fixed time unit — typically a year — deficits, shortfalls, gaps and holes in California budget-speak may refer to more than one year. Sometimes, deficit refers to past debt accumulation (a stock concept) plus this year's difference between revenue and expenditure plus next year's difference between revenue and expenditure.

What can such a mix of flows and stocks with uncertain time dimension possibly mean? How can such a figure help make a good decision?

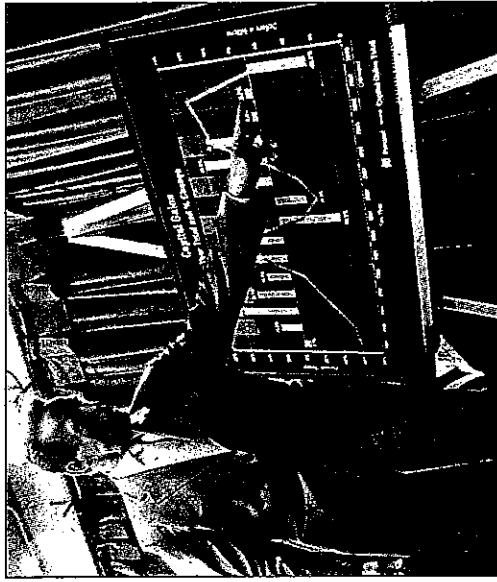
Of course, any accounting framework can be gamed and abused. We all remember Enron's cooking of the books. But undefined accounting has no standards at all.

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So a good first step in addressing California's current budget crisis would be to define fiscal terms precisely. A deficit or surplus should refer — and refer *only* — to the difference between revenues and expenditures in a single year. And particularly on the revenue side, a basic definition is needed.

Obvious sources of state revenue are taxes, user fees, grants received from the federal government, and interest earned on state funds. These are receipts analogous to sales on a business income statement. But unlike business accounting, borrowing — external and internal — and sales of state assets are sometimes treated as a type of revenue in California budgeting. That is bad practice. If borrowing were revenue, even the federal government could be said to have a balanced budget.

A much overused phrase of late is “transparency.” In regards to one dimension of transparency, putting all its basic budget



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documents on the Web for public inspection, California gets a grade of “A.” But making lots of tables and charts readily available is not truly transparent if the underlying concepts behind the numbers are fuzzy. On business-consistent use of basic accounting definitions, California gets a “D.”

There is no way to prove that with well-defined business accounting principles, public officials in California would make better budgetary decisions than they seem to have made so far. But it seems improbable that good decisions can be made without such basic principles.

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