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Fairy Tale Ending For Government Deficits

By: Todd Ganos – February 15, 2013

Some might recall the story of the grasshopper and the ant. In the Spring and Summer, the ant worked hard at tending its garden. The grasshopper laughed at the ant for not enjoying the weather and living it up. In the Fall, the ant worked hard at harvesting its garden. The grasshopper laughed at the ant because food was plenty. As Winter set in, the ant was prepared but the grasshopper was not.

With this story in mind, the State of California requires its political subdivisions to maintain a revenue reserve fund. The State understands that while expenditures tend to be consistent, tax revenues – for example, from sales tax – are often cyclical. In times of plenty, the political subdivisions are to put excess revenues in the fund. In times of lean, the funds are there to cover any deficit.

While the State of California requires its political subdivisions to maintain a revenue reserve fund, its legislature has repeatedly failed to approve proposed legislation requiring the State itself to maintain such a fund.

The reality is that State revenues vary with the stock market. As the market moves up and taxable investors realize gains, tax revenues increase. As the market moves down and taxable investors realize losses, tax revenues decrease. This is also the case for the Federal government and other states that impose an income tax.

During the technology bubble of the late 1990s, the Federal budget turned a surplus. The states were flush with cash. But, rather than apply the wisdom of the ant, the State of California followed the ways of the grasshopper. Rather than save the excess revenues, the catch phrase was "spend, baby, spend." Budgetary projections were premised on a continuation of these realized gains. In 2003, the non-partisan Cato Institute warned that California would like face a budget crisis if the State did not adjust its spending growth. Of course, we all know what happened next.

Recently, the Administration announced that higher tax revenues in late 2012 have closed the budget deficit gap by about $110 billion. (Keep in mind, we need $800 billion.) In one calendar quarter! We are on our way! Let's not kid ourselves. These higher tax revenues were in all likelihood from realized gains as there was a rush to have gains taxed at the 15 percent Federal rate as opposed to the impending 20 percent Federal rate. Let's be real.

In his series of books starting with "Good to Great," noted management scholar and author Jim Collins discusses a number of factors that distinguishes successful companies. One of those factors in consistency of execution. For example, a great company will resist the temptation to expand R&D expenses during times of plenty. Instead, it will put excess revenues aside so it can sustain R&D efforts during difficult times. Great companies understand the story of the grasshopper and the ant and they live by it. Perhaps our elected leaders need to revisit their childhood and reread the story.