LITTLE HOOVER COMMISSION

STATE FISCAL CONDITION REPORT

MARCH 1995

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State Fiscal Condition Report

March 1995

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Executive Summary

The Little Hoover Commission has examined California's fiscal condition in light of the current two-year budget agreement, which relies on $10 billion in external borrowing and a trigger mechanism to make automatic cuts if resources do not materialize to pay back loans. Based on research and public testimony, the Commission is issuing this report to sound an alarm that deteriorating credit ratings, the size of short-term borrowings and reliance upon bank guarantees place serious external restraints on the State's financial condition.

The problem: While California's budgets appear to be in balance each year when they are adopted, the State has incurred a large structural deficit which has led to difficulty in financing its annual cash needs. In less than a decade, the State has gone from an entity that borrowed because it could make money on investing the proceeds to an entity that is caught in a vicious cycle of short-term borrowing to pay off loans related to a structural deficit. In July 1994, California borrowed $7 billion, the largest municipal financing ever sought anywhere in the nation. Although the State's faltering economy is improving, there may be refinancing difficulties despite a trigger mechanism that is poised over the budget to slash spending. This is due to reliance on short-term financing in record amounts, the possibility of more than $4 billion in adverse court rulings on previous cost-cutting budgetary decisions; and reliance on receiving almost $1 billion from the federal government in reimbursement for services to illegal immigrants.

The State's spending and borrowing practices have a distinct real-world effect that is reflected in the State's credit rating. The State has gone from having top ratings to seeing only two states in the nation with worse ratings. Its last short-term bond offering had a rating (MIG3) only marginally better than that assigned to junk bonds. The ratings not only mean that the State spends millions of dollars more in higher interest charges to borrow money but they also are a dismal signal to businesses, which avoid investing or expanding in states that may need to tax their way out of financial problems.

The solution: Policy makers must concentrate on the steps that will bring both the spending and cash flow budgets into balance and pursue a course that will restore California's tarnished credit rating. These include:

- Crafting a budget that is based on reasonable and sustainable estimates of revenues, federal reimbursements and debt obligations.

- Focusing on a realistic cash flow plan to complement the budget plan.

- Cutting programs as deeply as necessary to end the 1995-96 fiscal year in a balanced position.

- Adopting long-term plans, budgets and policies that California's budgets will be balanced in reality, not through financial maneuvers. It is poor public policy to rely on automatic triggers, to divert funds clearly earmarked for special purposes and to allow either the financial markets or the need for bank guarantees to dictate the State's future.

The State can continue to put together new and innovative ways to package debt. Or it can find a way to live within its means and eliminate its structural deficits. The Commission advises that policy makers choose the latter course.

State of California

LITTLE HOOVER COMMISSION

March 29, 1995

The Honorable Pete Wilson
Governor of California

The Honorable Bill Lockyer
President Pro Tempore of the Senate
and Members of the Senate

The Honorable Kenneth L. Maddy
Senate Republican Leader

The Honorable Willie Brown Jr.
Speaker of the Assembly
and Members of the Assembly

The Honorable James Brulte
Assembly Republican Leader

Dear Governor and Members of the Legislature:

For several years, California has borrowed money to stay afloat -- and then borrowed again when certain of those loans came due. At a personal level, such actions would be viewed as irresponsibly living beyond one's means and flirting with financial ruin. When a state does it, the consequences are no less grave -- and in fact are more so, since millions of lives may be affected.

The Little Hoover Commission has examined the State's actions in crafting the 1994-95 budget agreement, actually an unconventional two-year plan for $10 billion in external financing and a trigger mechanism to slash state spending if revenues do not materialize to repay the loans. The plan included the largest financing effort ever undertaken by any state or local government in the history of the nation's financial marketplace -- and was almost double any previous external borrowing by the State.[1]

Because of the magnitude and unusual nature of the budget elements, the Commission reviewed California's fiscal condition, the context for its actions, the reaction of the financial markets and the implications for the long-term future of the State.

We found that policy makers met the State's short-term financing problems with creativity but with little success in dealing with the structural deficit created in prior years or other long-term policy considerations. Tough budget choices were made over the past four years during the deepest recession California has seen since the Great Depression, but a structural deficit that may be as high as $6 billion to $8 billion continues to exist. It is the Commission's position that a clarion call must be sounded strongly against the pattern of rolling over short-term debt to fund long-term structural deficits. Otherwise, California will join the ranks of governments -- like New York two decades ago -- that lived dangerously and lost.

Milton Marks Commission on California State Government Organization and Economy

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provisions are more circuitous. The Constitution requires the Governor to offer the Legislature a budget that matches expenditures to revenues. The Legislature is responsible for maintaining a prudent reserve. And no debt in excess of $300,000 is to be incurred without a vote of the people.[2]

The debt limit has been defined by the courts to mean the State cannot borrow more than $300,000 without voter authorization except in two cases: The State can issue notes (Revenue Anticipation Notes -- RANs) through the Treasurer's Office to help even out cash flow and pay bills as long as the notes are redeemed within the same fiscal year. When there is an unanticipated shortfall of funding at the end of a fiscal year, the State can issue warrants (Revenue Anticipation Warrants -- RAWs) through the Controller's Office that will be repaid within the next fiscal year. In both cases, state officials must certify that there is a reasonable expectation that funding will exist to pay off the notes and warrants when they become due.[3]

The financial marketplace: Certifying the ability to repay is important from a legal and a marketing perspective. The notes and warrants would find few buyers if doubt existed that the money and interest would be repaid. In addition, the assurance greatly affects both the ability to borrow and the cost to the borrower, particularly when the amounts are as large as those required by the State.

To further enhance the attractiveness of the notes and warrants, banks may guarantee that the money will be repaid in case the State defaults. Although the banks charge a fee for providing the guarantee, the overall package can represent a cost savings if the guarantee allows a lower interest rate to be paid.

A key factor in the ability of the State to market debt instruments is the financial rating that is intended to tell potential buyers whether their investment is extremely safe, moderately safe or risky. Extremely safe investments in general pay lower interest rates and therefore are less costly from the borrower's perspective. Higher interest rates and therefore larger costs are associated with risky investments.

Through the late 80s, California had the highest possible financial rating (AAA or Aaa, depending on the system used by the service). By 1992, the effects of the recession and the State's budgetary responses had pushed the ratings down to AA, A+ and Aa. Shortly after the two-year budget agreement described below was costly than the interest rate for the enhanced notes plus the bank consortium fee.)

- The issuance of $3 billion in RANs on August 3, 1994 to be redeemed on June 28, 1995. The issuance of another $3 billion in RANs in August 1995 to be repaid before the end of that fiscal year.

- A check-and-balance process for pulling a "trigger" if the State's year-end cash position was going to be worse than expected in November 1994 (the so-called first trigger) and October 1995 (the so-called second trigger). The Controller makes the assessment, which is double-checked by the Legislative Analyst. The trigger requires the Governor and the Legislature to take immediate action to address the shortfall, or across-the-board cuts on all programs not constitutionally protected will take place.

The trigger was an important element of the package because of the uncertainty -- some would say the unlikelihood -- of the State receiving the federal funding to the extent it was assumed in the budgets. In addition, long-range revenue forecasts are tricky under the best of circumstances and often may be adopted in a rosy form for budgets.

The Attorney General's Office, which issues legal opinions that are a prerequisite for selling the notes, had advised the Treasurer early in the budget process that any external borrowing plan had to include a realistic repayment method. In testimony to the Commission, the Controller said that, given the uncertain revenue picture (particularly the probability that most of the $3.6 billion in federal funds would not be received), the trigger was necessary for him to certify that there was a reasonable expectation of repaying the RAWs (whose issuance made the repayment of the RANs possible). While the bank consortium told the Commission it did not require the trigger as a condition for providing the credit enhancement, it did require some mechanism for lessening the chances that the State would default.[5]

Avoiding the trigger: The first trigger was avoided on November 15, 1994, when the Controller certified that the State's cash position had not worsened but had actually improved -- despite the State only receiving $33 million of the first year's anticipated $763 million in federal funding.[6] With the recovering economy providing

The impact of the recession on the state budget can be seen in the following chart, which shows total revenues and total expenditures for the past six years:

Chart 1
GENERAL FUND REVENUES AND EXPENDITURES
1988-1994 (in billions of dollars)

Year	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94
Total Revenues	37.01	39.08	**39.94**	42.22	41.03	40.15
Total Expenses	36.18	39.82	**41.94**	44.44	40.92	39.32
Difference	.84	-.73	**-1.99**	-2.21	.11	.84

Source: State Controller's Annual Report

As the highlighted area of the chart shows, the 1990-91 budget reflected the impact of the nascent recession, with revenues almost flat from the year before and expenses growing unchecked. Spending outstripped funding by almost $2 billion. Recognizing the dilemma they faced, policy makers approached the 1991-92 budget with a combination of tax increases and selective budget cuts to tackle a $14 billion gap between the anticipated unenhanced revenues and the caseload-driven increases in expenditures. Revenues rose but despite the budget cuts, expenses continued to increase dramatically. The result fell $2.21 billion short of a balanced budget.

Off-budget items: While the recession continued to erode revenues in 1992-93 and 1993-94, policy makers relentlessly pushed spending down even as caseloads were increasing. Some of the cutbacks were achieved by one-time -- and in some cases, questionable -- actions, such as deferring state worker pension contributions, accelerating tax collection and "loaning" schools almost $2 billion in funding that was not reflected in the budget. Other cuts, such as trimming welfare benefits and using cigarette taxes for general health care, had short life spans because of court reversals. (The Legislative Analyst has estimated that these adverse court rulings, which are subject to appeal, threaten to place a $4.1 billion burden on future budgets. These include rulings that call into question the school loans, the pension contribution deferral and welfare cuts.)[8] The largest savings came from two actions: the elimination of the some point due to a raise or seasonal overtime, or it may decline for some amount of time because of unpaid leave or cutbacks in hours. Expenditures come in fits and starts: There are the regular monthly obligations, like the mortgage and utilities, and then there are the occasional large sums, like property taxes, insurance, holiday gift-giving or emergencies. On a month-to-month basis, it is not unusual to have revenues and expenditures that are not in sync with each other. And simply having a budget that says at the end of the year that all of the bills will be paid does little good if this month's paycheck is gone but the property tax bill is due.

Similarly, the State's budget reflects assumed annualized revenues and expenses. But much of the revenue arrives in the spring when taxes flow in -- and some even arrives after the budget year has ended. The outgo may be fairly steady, except when an earthquake strikes or a lump-sum pension payment is due or a court hands the State an unexpected liability. In addition, while the budget always presumes a clean slate at the beginning of the fiscal year, the cash management side of the ledger knows that a deficit soaks up cash that cannot be spent elsewhere.

The State has many of the same tactics at hand to deal with the mountains and valleys of cash management that a family does. A responsible family may set aside money in separate funds for special purposes: a Santa Saver account for Christmas, mad money under the mattress for a vacation trip and a regular savings account for emergencies. And when a bill comes at the wrong time, the family may borrow from one fund to cover another, and then replace the funds at a later date. Or the family may use a short-term loan to tide it over, knowing the income will be there when the loan is due.

California, for many years, was able to satisfy its cash management needs by surpluses or borrowing internally from the special funds that it has set aside. In fact, when it began borrowing externally in 1982, it did so because it could borrow the money cheaply and invest it at a higher rate of return. But in 1988, according to the Treasurer's Office, California began to market notes from need rather than financial advantage. By 1992, the State was borrowing money to pay back loans as they came due. The chart on the following page illustrates the State's borrowing practices in escalating amounts from 1988 through the anticipated levels for 1996:

As the chart on the previous page indicates, the State's borrowing has become more frequent and for longer periods. Where the bars overlap, new funding needed to be borrowed before the previous loans could be retired. For instance, in the 1991-92 fiscal year $4.1 billion in notes were issued on August 15, 1991 with varying maturity dates, the earliest of which was March 3, 1992. On March 3, 1992 a new note for $2 billion was issued with a due date of June 30, 1992. Then just days before that due date, warrants in the amount of $475 million were issued with a due date of July 24, 1992.

To put this practice into more familiar terms, one can use a credit-card analogy. A person who learns he is inheriting $10,000 might use his American Express card to buy a new houseful of furniture. However, when the American Express bill arrives, he discovers that the probate process will hold up the inheritance for at least six months. He then uses his Mastercard to pay off the American Express bill and begins paying a high rate of interest. The plot thickens when the long-awaited bequest turns out to be only $2,000. He applies to a crotchety uncle for bailout funds and in the meantime continues to juggle the debt by paying the Mastercard bill with a Visa card and then the Visa bill with the Mastercard. The cost -- and the anxiety -- mounts.

Similarly, the State's costs have risen as its debt load has increased and its financial ratings have declined. The chart on the following page tracks the State's borrowing for General Fund purposes from both internal and external sources:

extent California is viewed as weak financially, businesses will be reluctant to expand or invest because of concern that the problems will be solved through higher taxes and fees.

The Future

The growing crescendo of the State's budgetary problems and cash management practices has not gone unnoticed. The media writes about them, policy makers bemoan them, fiscal analysts despair over them. Solutions so far have run to coping with -- rather than solving -- the problem, usually with an emphasis on getting through the present budget year.

In mid-1993, a year before the present debt-heavy, two-year budget arrangement was created, the California Debt Advisory Commission conducted a hearing about the then-"cash crisis." Experts including bond counsel and rating service analysts were asked about financing solutions and, in general, offered four untested routes that were felt to require legislative action and court validation. They were:

- ***An extended RAN:*** Rather than limiting the external financing to one year, a note could be issued for two years. The reasoning ran that the courts have found RANs not to be debts because they will be paid with revenues anticipated within a short period of time. Since the courts have never defined "short period," a two-year RAN might be found to be constitutional.

- ***Asset-transfer lease financing:*** Basically, state property would be mortgaged and the State would make lease payments to retire the mortgage. The courts have recognized such arrangements as not falling under the constitutional debt limit.

- ***Formation of a separate entity:*** A method used by both New York and Louisiana, this skirts the debt limit by having a new body handle the financing of the deficit, with payments to be made through the "discretionary" action of the Legislature in appropriating funds from future budgets.

- ***Obligations imposed by law:*** Under this theory, a separate entity is created to issue notes to cover the cost of services that the State is required to provide by the federal government, such as health, government with fiscal responsibility. Their response to policy makers actions will come next August, analysts told the Commission, when the State seeks to market its next RAN. A RAN that is larger than the planned $3 billion would be cause for alarm, as would any sign that the new RAN payoff would require floating yet another RAW.

To break the vicious cycle, policy makers must take several steps:

- They must craft a budget that is based on real numbers, including reasonable estimates of revenues, federal reimbursements and debt obligations.

- They need a realistic cash flow plan to complement the budget plan.

- They must cut programs as deeply as necessary to end the 1995-96 fiscal year in a balanced position.

- And they must adopt long-term policies that both ensure the growth of the State and provide for a surplus to meet unanticipated cash contigencies.

The fulfillment of these goals should result in a return to AAA and MIG1 ratings -- and it is the ratings that will serve as a barometer that indicates whether change is real or merely rhetoric.

Short-term borrowing has worked successfully for the State to date -- but the strategy has been costly and, as Mexico has found, the result can be devastating when the markets decide they will no longer take a seat at the table. California can continue to put together new and innovative ways to package debt. Or it can find a way to live within its means and eliminate its structural deficits. The Commission advises that policy makers promptly choose the latter course.

Sincerely,

Richard Terzian
Chairman

Appendix & Endnotes

APPENDIX

Witnesses Appearing at the Little Hoover Commission
State Fiscal Condition Public Hearings

December 7, 1994, Sacramento

Gray Davis
State Controller

Manny Mateo
State Treasurer's Office

Anthony J. Taddey
BA Securities, Inc.

Assemblyman Phil Isenberg

Tim Gage
Assembly Ways & Means Committee

Steve Larson
Senate Budget & Fiscal Review Committee

December 8, 1994, Sacramento

Elizabeth Hill
Legislative Analyst

Renee Boicourt
Moody's Investor Service

Steven Zimmermann
Standard & Poor's

Claire Cohen
Fitch Investors Service

J. Clark Kelso
McGeorge Law School

Rebecca K. Taylor
California Taxpayers Association

A. Alan Post
California Citizens Budget Commission

William B. Baker and John O. Wilson
California Business-Higher Education Forum

February 27, 1995, Sacramento

Steve Olsen
Department of Finance

ENDNOTES

1. Anthony J. Taddey, Managing Director, BA Securities Inc., testimony to Little Hoover Commission, December 7, 1994.

2. California Constitution, Article IV, Section 12 (a); Article XIII B, Section 5; and Article XVI, Section 1.

3. Floyd D. Shimomura, Senior Assistant Attorney General, letter to the Director of the Department of Finance, June 13, 1994.

4. Testimony to Little Hoover Commission on December 8, 1994 from Renee Boicourt, Moody's Investor Service; Steven Zimmermann, Standard & Poor's; and Claire Cohen, Fitch Investor Service.

5. State Controller Gray Davis and Anthony J. Taddey, Managing Director, BA Securities Inc., in testimony to Little Hoover Commission, December 7, 1994.

6. State Controller Gray Davis, letter to Governor and Legislature, November 15, 1994.

7. *Cal-Tax News,* April 1, 1994.

8. "An Overview of the 1995-96 Governor's Budget," Legislative Analyst, January 20, 1995.

9. State Treasurer's Office, January 17, 1995 memo to Little Hoover Commission.

10. State Controller's Office, January 17, 1995 memo to Little Hoover Commission.

LITTLE HOOVER COMMISSION FACT SHEET

The Little Hoover Commission, formally known as the Milton Marks Commission on California State Government Organization and Economy, is an independent state oversight agency that was created in 1962. The Commission's mission is to investigate state government operations and -- through reports, and recommendations and legislative proposals -- promote efficiency, economy and improved service.

By statute, the Commission is a balanced bipartisan board composed of five citizen members appointed by the Governor, four citizen members appointed by the Legislature, two Senators and two Assembly members.

The Commission holds hearings on topics that come to its attention from citizens, legislators and other sources. But the hearings are only a small part of a long and thorough process:

* Two or three months of preliminary investigations and preparations come before a hearing is conducted.

* Hearings are constructed in such a way to explore identified issues and raise new areas for investigation.

* Two to six months of intensive fieldwork is undertaken before a report -- including findings and recommendations -- is written, adopted and released.

* Legislation to implement recommendations is sponsored and lobbied through the legislative system.

* New hearings are held and progress reports issued in the years following the initial report until the Commission's recommendations have been enacted or its concerns have been addressed.

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