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.