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# Bad to Worse

*California's budget mess will grow only deeper, no matter who becomes the governor*

**By ERIC J. SAVITZ**

**SO HERE'S A QUESTION** for the 135 Californians vying to take over as the Golden State's governor: Are you all insane?

On Oct. 7, California voters will decide whether or not to boot Gov. Gray Davis out of office, and if he's voted out, who should replace him. On Oct. 8, someone will face the monumental task of cleaning up the ugly mess that passes for a budget in the largest state in the union. And the disturbing fact is, no matter who wins, this situation is going to get worse -- possibly far worse -- before it gets better.

**Table:** We Left Out the Other 132 Plans[1]

California's credit ratings, as judged by Moody's, Standard & Poor's and Fitch, already rank below all 49 of the other states. And none of three bond-rating firms expects California's credit situation to improve in the foreseeable future. S&P, perhaps the most bearish of the rating agencies, in July dropped the state to a triple-B rating, the first time any state has had a rating that low since Massachusetts in 1989. Moody's, which says the credit outlook for the state remains negative, warned recently that the state faces a "sizable structural budget gap," and that California "will have substantial difficulty closing this gap in the next budget cycle."

True, after months of intense squabbling, Gov. Davis and the state legislature over the summer cobbled together a budget for the June 2004 fiscal year. But the state's budget problems were less cured than papered over. Someone still needs to actually fix things. Accomplishing that Herculean task will almost certainly involve some extremely unpopular decisions, however. The fact is, Californians are going to get smacked in the pocketbook before this is all over, and investors could well feel the fallout.

Despite what you might think, California's budget woes have little to do with its well-publicized energy shortage. And while the candidates for governor keep jawboning about the economy, the state actually is performing about on par with the rest of the country in job creation and economic output.

Ramin Talaie/Bloomberg News

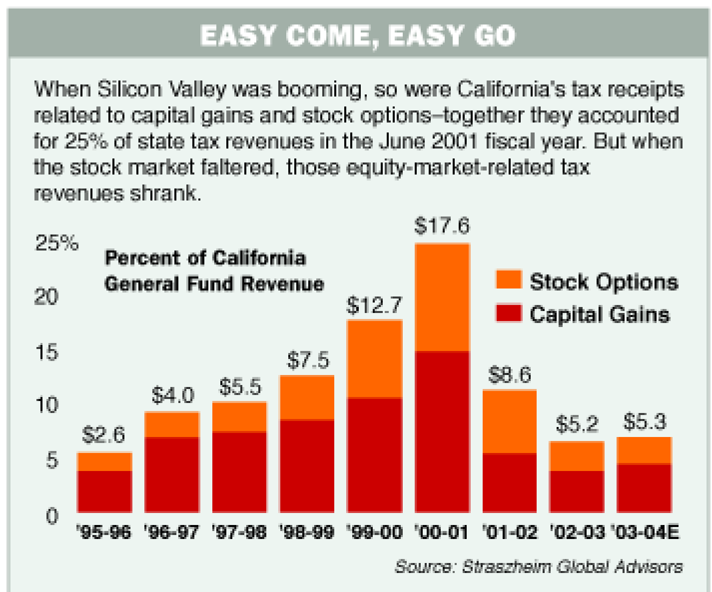
Arnold Schwarzenegger

The Bay Area economy does remain in a funk; metropolitan San Jose has lost nearly one fifth of its jobs since the peak of the bubble years. But that weakness is being offset by strength in other areas, such as San Diego, the "Inland Empire" east of Los Angeles and the Central Valley agricultural region.

The state government's real problem is a deceptively simple one: Lacking impulse control, California's leaders keep trying to spend more than they have. "The idea that the budget problems have arisen due to the recession is phony," says Donald Straszheim, a former Merrill Lynch economist who now runs his own advisory firm in Santa Monica. "California's budget problems are made in Sacramento."

Here's the dilemma. In the bubble years, when the stock market was flying, the state received a massive windfall from taxes on capital gains and the exercise of stock options. At the peak, in fiscal 2001, equity-market-related revenue reached $17.6 billion, representing roughly a quarter of that year's state tax receipts. In response, the state ratcheted up the budget, adding thousands of employees and new programs: State employment rose 13.6% from 1997 to 2001, more than twice the rate of population increase, according to Straszheim. "They spent the windfall like it was an ongoing revenue stream," he says.

When the tech-stock bubble popped, revenues from equity-related sources plunged -- the projected total for this year is $5.3 billion. That's left Sacramento scrambling to close the gap.




The Davis administration managed to piece a budget together for the June 2004 fiscal year, but just barely. Overall, the state will spend just shy of $99 billion this year; take out self-funded projects, and you still have $71 billion in projected outlays from the general fund, down about $7 billion from fiscal 2002. To make the numbers work, the state pulled out all stops, including a number of one-time-only measures. The budget includes an anticipated $2.2 billion in new federal funds, for instance, which aren't expected to be available in future years. And the state booked $930 million in savings from a shift in the accounting method used by the Medi-Cal health-care program from an accrual to a cash basis.

Other elements of the budget are highly speculative. For instance, the plan anticipates $1.1 billion in reduced employee compensation costs, equal to a 10% drop in salaries, which it hopes to achieve through yet-to-be detailed union concessions and job cuts. The budget includes $680 million in revenue from the restructuring of the state's gaming compacts with Indian tribes -- but most tribes have many years remaining on their current compacts with the state, and few have yet shown any interest in increasing the state's take. The budget also anticipates a 4.9% rise in personal income in fiscal 2004, a forecast that could turn out to be optimistic if the recovery falters.

What's not in the budget are any new taxes, with the exception of the restoration of the state's much-hated vehicle- licensing fee, generating about $4 billion in revenue. And that one is coming under fire from all of the leading candidates to replace Davis as governor. Says Straszheim: "They basically punted the hard budget decisions into fiscal 2005."

Part of what ails California are underlying structural issues. State law requires a two-thirds majority approval for any budget -- California is one of just three states that require a super-majority to pass a budget. The provision is problematic in a state legislature where ideological

AP Photo/Rich Pedroncelli

Cruz Bustamante

animosity runs high, and it's hard to imagine conditions improving after the recall vote, no matter who wins.

Some observers contend the problem is compounded by a lack of seasoned state legislators. That's the result of term limits -- state Assembly members are limited to six years, while state Senate members can serve only eight years. Meanwhile, gerrymandering of many districts has left few truly competitive seats. Also contributing to the situation is California's ballot-initiative process, which has created funding mandates that reduce budget flexibility.

Since the legislature rejected attempts by Gov. Davis to include some new tax measures, the budget drafters opted for a fiscal 2004 borrowing spree. In total, the state plans to issue $18 billion in bonds and notes in the current fiscal year. In the first step in that process, the state last week priced $2.3 billion in tobacco bonds, secured by a portion of California's share of the big cigarette-liability settlement. The state also wants to sell $1.9 billion in bonds to cover its fiscal 2004 contribution to the state employees' pension system; $10.7 billion in "fiscal recovery bonds," backed by sales tax receipts; and $3 billion in revenue- anticipation notes, used to smooth out the lumpiness of state income-tax receipts.

To sell the tobacco bonds, the state pledged to make up the difference if revenues from the settlement come up short. That puts California, which has been one of the most vocal anti-smoking states in the country, in a strange position: To the extent that it's successful in reducing cigarette sales, it hurts itself financially, and in effect aligns its financial interest with the tobacco industry's. Combine that with the fact that the state won't be using those funds specifically for health care or anti-smoking problems, and the arrangement is making a lot of people mad. Officials at both the American Heart Association and the American Cancer Society last week said they were studying whether they had legal grounds to challenge the latest bond issue.

More concretely, California suffered a setback on another planned bond offering last week, when a state court in Sacramento barred the issuance of $1.9 billion in pension-obligation bonds, which were supposed to cover the state's fiscal 2004 pension contribution. Opposition was led by the Howard Jarvis Taxpayers Association, which claimed the bonds would violate a provision in the state constitution that bars California from borrowing more than $300,000 to cover routine expenses without voter approval. If the ruling stands, the budget will have a new $1.9 billion hole.

AP Photo/Damian Dovarganes

Tom McClintock

The state had expected to finish the year with a surplus of a bit more than $2 billion, which would mean it could get away without making any major budget modifications. Certainly, the court action triggered no new moves from the rating agencies. But there will be ramifications. For one thing, that surplus was going to be rolled into the fiscal 2005 budget, which means an anticipated $8 billion shortfall for the next fiscal year would now stand at $10 billion. And the state would have no room for further shortfalls.

And one could be developing. The Pacific Legal Foundation, a conservative Sacramento advocacy group, last week finally filed a previously threatened lawsuit in state court in Sacramento seeking to block the planned sale of $10.7 billion in sales-tax-backed deficit-reduction bonds. The suit alleges that the bonds violate the state constitution on two grounds: one, that California can't issue long-term bonds without first receiving voter approval, and two, that the bonds violate the constitutional provision barring borrowing for general operating expenses.

The state went through astonishing gyrations in its effort to design a security that would both meet the state's constitutional requirements and find investor interest. To pay off the bonds, the state devised a complex scheme known as the "triple flip": To pay back the bonds, the state plans to substitute a 0.5% state sales tax for an identical levy that otherwise would have gone to local governments. Then, to make the municipalities whole, the state is shifting funds from public schools and community colleges; the school funding is supposed to be replaced with cash from the state's general fund.

What happens if the challenge is upheld? "If those bonds can't be sold, it would be a much more immediate and significant problem," says Michael Cohen, an analyst with the Legislative Analyst's Office, a nonpartisan arm of the California legislature. "We'd be in unprecedented territory. It's a little hard to speculate on what would happen, but certainly there would be a huge hole in our budget."

Most observers consider it highly unlikely that California will default. David Hitchcock, a credit analyst at S&P, says the risk of the state's rating dropping below investment grade is small, and would require a "cash crisis," which shouldn't happen if the state can access the capital markets. For now, in fact, investors seem remarkably sanguine about the state's budget crunch, with California's general-obligation bonds, rated only triple-B by S&P, trading just four-tenths of a percentage point above comparable triple-A bonds.

Even if California can sell bonds, however, there will be more trouble coming early next year, when the governor, whoever it is, introduces a budget plan for 2005. "They ought to cut the ratings again," snaps Straszheim. "There's no state in the country that is anywhere close to having the kind of budget problems that California has. They deserve to be the lowest rated. It's a unique mess."

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