

Intelligent Money

Current thinking from Haven Financial Advisors

The Fiscal Crisis in California



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Special Notes of Interest:

Obesity-related health spending reaches \$147 billion annually, double what it was a decade ago, according to a recent study published in the *Journal of Health Affairs*

The second quarter earnings season has thus far exceeded expectations. Positive earnings surprises outnumber negative surprises by better than 4 to 1.

California's financial problems have been front and center in the media of late. This month, its credit rating was cut to the low end of investment grade. Facing insolvency, Governor Schwarzenegger and legislators have undertaken drastic action - selling off state assets, cutting the state's university budget by 20 per cent and releasing 27,000 inmates from prison. Already the state has given mandatory furloughs of three days a month to its 243,000 state employees.

What is the impact on California's crisis on the rest of the nation? What about the state's municipal bondholders? Will Washington DC have to bail out the nation's largest state? This edition of the newsletter will examine these questions and try to provide some helpful guidance.

Current State of Affairs

California now carries the lowest credit rating of the fifty states. In the current fiscal year of 2009-2010, its budget deficit was expected to be \$24 to \$28 billion. This is what prompted the recent marathon session of the state legislature. The state's general fund budget is about \$100 billion. The prospective deficit was large both in absolute and in relative terms.

As recently as Fiscal 1998-99, the state's budget was in balance. A number of reasons have been put forth to explain the state's ensuing misfortune. All have some merit.

The state's tax structure is a contributory factor. Voters approved proposition 13 some 30 years ago placing severe limits on property tax increases. Consequently, the state has come to rely more and more on its rather large income tax. Unlike property taxes, income tax receipts tend to follow a boom and bust cycle along with the economy. During the good times, political pressure is applied by the state's powerful special interests to ramp up benefits. During bad times, there is less wiggle room to reduce expenditures as revenues plummet.

Case in point: California's state legislature passed SB 400 in 1999 that increased the pensions of state police officers by 50%! The same bill substantially upgraded the pensions and survivor benefits of other state employee. Now, ten years later, the governor tried

unsuccessfully to roll pension benefits to pre 1999 levels back for new hires.

The state's constitution has been an impediment to fiscal responsibility. One problem is the requirement that a two-thirds vote of the California legislature is needed to pass the state's budget and tax increases. There are only a handful of states that require a supermajority.

Another problem with California law is the reliance on ballot initiatives to amend its constitution or statutes. These have become ubiquitous in recent years and are typically referred to as "propositions". Not surprisingly, the popular vote has consistently supported an expansion of services without a commensurate increase in taxes. Direct democracy sounds good in theory but its practice invites deficit spending.

On July 20th, lawmakers approved a budget plan that should close the deficit this fiscal year. It includes spending cuts amounting to 60% of the deficit with the balance financed with short term debt. While some of the cuts were accomplished with accounting gimmicks, most of the state's residents will be impacted by either a reduction in services or an increase in user fees.

California's Municipal Bonds

For municipal bondholders, the events of the past several months have raised troubling questions. Could the state of California default on its debt and what would the spillover effects on local California bonds be?

The good news is that California's bondholders are actually senior creditors. Proposition 98, passed in 1988, mandated that the state allocate 40 percent of its general fund to public elementary and high schools as well as community colleges. Roughly another 5% of education spending is also guaranteed by the state's constitution. This commitment is senior to the claims of bondholders.

However, the state's bondholders are next in line. Today payments to those bondholders account for another 5% of the general fund as there are about \$59 billion outstanding. Below the bondholders



are the state's employees, contractors, pension contributions. Some very key stakeholders must suffer before the state fails to pay its debt service.

Unlike corporations or municipalities, the states cannot file for bankruptcy in an attempt to reorganize their debt obligations. Moreover, California needs continuous unfettered access to the credit markets to fund ongoing infrastructure projects and to cover short term seasonal cash flows.

What about the spillover effect on local issuers of tax-exempt bonds within California? Different local jurisdictions have varying levels of reliance on state funding. School districts and counties are among the most dependent. Most general obligation bonds are secured by local property taxes – a source of revenue that is comparatively stable. While municipalities can declare bankruptcy, they have been loathe to do. The relevant precedents indicate that bondholders are made whole regardless of the financial woe of the local issuer. Orange County CA filed for bankruptcy in 1994 but did not miss any bond payments. The City of Vallejo CA filed for bankruptcy more recently but has thus far continued to service its debt.

In fact, the default rates nationwide for municipal bonds are extremely low. According to Moody's, the default rate has averaged 0.01% per year since 1970. The average recovery rate for defaulted muni bonds was 60% compared to 40% for corporate bonds. And even during the Great Depression, the average annual default rate was 1.8%, with 97% of the defaulted principal eventually recovered.

There are additional risk factors today. Unfunded pension liabilities and infrastructure projects place

a greater strain on state and local governments. However, most tax-exempt bonds are fairly senior in the credit structure of the issuer. And access to credit is essential for any public enterprise.

Bond markets have long memories. Any government defaulting on its debt would lose access to the capital markets for years. And, even then, the credit rating of its next issue would be so low that heightened borrowing costs would swamp any short term relief offered by reneging on payments in a time of crisis.

A Federal Bailout?

Governor Schwarzenegger has spent a good deal of time in Washington DC in 2009. There has been speculation that the Federal Government will bail out its largest state. In fact, Washington DC has already gone a long way to shore up the state and local bond markets. Of the nearly \$800 billion federal stimulus money authorized in February 2009, about \$135 billion was earmarked for the municipal bond issuers. The state of California has received at least \$6 billion in direct transfers from Washington under the stimulus.

That same stimulus package authorized municipal issuers to issue "Build America Bonds" (BABs) to repair infrastructure. The federally taxable bonds offer a subsidy to issuers of 35 percent on their interest costs. Effectively, this program opens up municipal finance to potential investors that are already tax-exempt – thereby adding a new set of lenders to troubled local borrowers.

Federal tax dollars are hard at work today in supporting the finances of municipal issuers. But that is different from an explicit bailout of a sovereign state. No state has defaulted in modern times. It's hard to imagine the consequences of default in today's credit markets.

One major consideration of any effort directed towards California is the potential domino effect on other state governments. California is hardly alone. A report from the National Conference on State Legislatures says that, collectively, states faced \$142.6 billion in deficits for the 2009-10 fiscal year and many already are seeing signs that the total could grow.

There is a moral hazard to any federal bailout of California. Where does it stop? Wouldn't every state and municipality cut corners to deliver services to its constituents if it knew that the Federal Reserve would print the money to rescue it? California may facing similar travails a year from now. It will be interesting to see what measures, if any, Washington DC offers.

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