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Arguing over federal aid won't solve state's worsening fiscal crisis

Daniel J.B. Mitchell is professor emeritus of the Anderson School of Management and the School of Public Affairs.

I was reminded of Rodney King's famous phrase, "Can't we all just get along?", uttered after the Los Angeles riots, as an episode of the back-and-forth argument between the California congressional delegation and Governor Schwarzenegger continued. In his budget message of January 8, the governor included a complaint that California was being shortchanged by the federal government, sending more to Washington than it was receiving back. He demanded that the federal government provide almost \$7 billion in aid for the distressed California state budget.

Apparently, in order to get the attention of the powers-that-be in Washington, the governor has reversed his stance on the pending universal health care bill. That bill is similar in broad outline to a state-level bill Governor Schwarzenegger unsuccessfully championed in 2007. Moreover, he had initially been generally supportive of the federal version, unlike almost all Republicans. But in his State of the State address of January 6, the governor denounced the federal bill as potentially costly to California. He challenged the California congressional delegation to vote against it or change it to be favorable to California.

California's two Democratic senators and others in the delegation fired back, stating that Sacramento could not expect more aid from the feds and that they had been doing a good job for the state. They argued, moreover, that the governor's figures on current inflows and outflows from Washington were misstated. So, is there any case for federal aid to California?

There is a case for federal assistance, and it is summed up in two words that no one in an official position in the state can utter: "municipal bonds." California's fiscal position is, in fact, grave. We could spend much time debating who is to blame for the state's budget debacle. But at this point the salient fact is that the budget is wildly out of balance, even with the cuts, tax increases and gimmicks that have been enacted during the past two years. State officials, particularly the treasurer and controller, have been anxious to assure financial markets that a state default on its debt service is very unlikely. Their insistence on that point became particularly strong when a forecasting service in late 2009 predicted an eventual California default.

The treasurer and controller have repeatedly noted that debt service is a relatively small portion of state's general fund revenue, even in the Great Recession. And they are right; the state itself is very unlikely to default. But what about the myriad local counties, cities, school and community college districts that also have debt to service and that are dependent on a flow of funds from Sacramento? To conserve cash for its own needs (including debt service) during a crunch, the state now routinely delays payments it is obligated to make to locals (and others). It finds ways of indirectly raiding their treasuries. One small municipality in California is already in default. Others could follow.

In normal times, the muni-bond market would shrug off a local default as just that, a local problem. For example, even the large Orange County default in the mid-1990s caused only a brief shiver in the market. But we are not now in normal times. The Federal Reserve and the Treasury have found themselves bailing out major financial institutions. Those steps ultimately led to a bottoming out of an economy that was heading for freefall. But the recovery, if that is what we now have, is still quite fragile. Another financial market disturbance could put us back on the downward path.

Do the folks in Washington want to risk a disturbance in yet another financial market? A double-dip recession? No one knows what the consequences would be of a rash of defaults coming out of California localities. And no one should want to find out. So now is the time for the governor, the California congressional delegation and the authorities in Washington to take a deep breath. The time for inflammatory language is over. Aid to California – probably as part of a larger state-and-local assistance plan – is needed.

What form might such aid take? While undoubtedly the governor and many in the legislature would welcome a direct federal cash infusion, there are other options available. The feds could simply offer a form of bond insurance. California has to roll over revenue anticipation notes — short-term securities — at the end of this fiscal year. A federal guarantee could make that process easier. And the feds could put financial conditions on such borrowing guarantees or on outright loans. Indeed, in his budget message, Governor Schwarzenegger included a contingency plan if federal aid did not arrive. The feds could insist on similar triggers and contingencies in the state budget in the event that revenues fell short of forecasts or expenditures exceeded them.

In the wake of the near terrorist bombing of a Detroit-bound airplane, there was much hand-wringing about a failure of federal agencies to “connect the dots,” i.e., the warning signs that something bad might happen. The president, in reviewing a report on the failure, acknowledged that he was ultimately responsible. California already has the lowest bond rating of any state, a warning of financial stress. The governor, however crudely, has delivered another form of warning. The legislative analyst, in reviewing the governor’s budget, has pointed to its downside risk in almost every category. It is now time for the folks in the Obama administration to connect these dots and come to the assistance of the nation’s largest state.