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LAO Warns of Continued Cash Flow Problems in Fiscal 2009-10

While acknowledging the progress made with February's enactment of the 2009-10 Budget, the ability to draw down some federal stimulus funds, and recent successful bond sales, a new publication by the state's nonpartisan Legislative Analyst (LAO) warns that California faces major cash flow problems this summer and fall. Without additional Budget solutions or the ability to borrow unprecedented amounts from the short-term credit markets, the LAO warns that the state will not be able to pay many of its bills on time for much of the next fiscal year.

Magnitude of Problem

The state regularly faces cash flow deficits in the first half of the fiscal year and cash flow surpluses in the second half of the fiscal year, and routinely borrows internally and externally to address the imbalance between receipts and disbursements.

We reported extensively on the cash flow problem attributable to weak revenues and the severe credit crisis that surfaced in late 2008 and continued into 2009, and caused funding for K-14 facilities projects to be frozen. While the current-year problem has eased, the expected fiscal year-end cash cushion on June 30, 2009, will be much lower than in prior years. (In fact, it would have been zero had the Legislature not authorized additional special fund internal borrowing.)

With an expected five consecutive months of monthly cash flow deficits starting in July, the Administration forecast in March that the state might need to borrow \$13 billion from investors to pay all of its currently budgeted bills on time and to maintain its target minimum cash cushion. Based on developments since March, the LAO says the state might need to borrow \$17 billion in 2009-10. Moreover, should voters reject Propositions 1C, 1D, and 1F on the May 19 ballot, the state's need to borrow could reach a whopping \$23 billion. That magnitude of short-term borrowing may be impossible and even if possible, would come at a high interest cost.

Timing

Prompt legislative action will be necessary-by late June or early July at the latest-if the state is going to be able to borrow the funds needed to pay its bills in a timely fashion. If there is a long Budget stalemate-as many people are predicting-more Californians could be impacted by delayed payments.

Options

The LAO recommends the Legislature take prompt actions to reduce the state's short-term borrowing need to under \$10 billion for 2009-10, and identifies two options to do that:

- Additional actions to increase revenues or decrease expenditures-either General Fund or special funds available for cash flow borrowing
- Additional actions to delay scheduled payments to schools or accelerate the receipt of revenues from

the General Fund or special funds available for borrowing

Although the state should first focus on addressing the Budget deficit, the LAO notes that balancing the Budget alone may not solve the state's cash flow difficulties, and that actions to defer payments or accelerate state receipts may also be needed. The LAO suggests that federal stimulus funds may help school districts and other governmental entities cope with additional payment delays. Other options mentioned by the LAO include accelerating issuance of Lottery securitization bonds and so-called trigger legislation that would require the state to reduce expenditures or increase revenues if cash flow projections showed that timely payment of Revenue Anticipation Warrants (RAWs) was threatened. This would provide assurances to investors of timely RAW repayment, and might make it easier to sell RAWs.

The LAO notes that the State Treasurer is exploring the potential for federal assistance, which could include a federal guarantee of the state's RAWs and RANs (Revenue Anticipation Notes), but recommends that the state be cautious about accepting more help from the federal government due to the strings that might be attached.

Implications for K-14 Education

The State Constitution provides K-14 education some insulation against delays in payments by designating K-14 education as a priority spending program. However, this provision does not provide unlimited protection against deferrals, which have been part of the K-14 budget landscape since 2003-04 and were expanded significantly in 2008-09. The recommendations provided by the LAO suggest that K-14 education is better able to sustain additional deferrals as a result of the federal stimulus funding being provided. However, it is also the case that current deferrals have reached such a magnitude that there has been a dramatic increase in the number of local educational agencies and community colleges that have had to rely on internal and external borrowing.

Given the magnitude of the potential cash shortfall faced by the state, the LAO's suggestion to increase K-14 deferrals would be a dramatic expansion to an already significant level of existing deferrals. Any expansion to existing deferrals would prove costly to K-14 education in the form of delayed services and/or increased borrowing costs. And, to the extent that California does not balance its Budget, any external borrowing will be expensive and will further exacerbate the Budget shortfall, increasing the pressure to reduce Proposition 98 funding to the level of the minimum guarantee. Finally, we'll want to closely monitor any "trigger" legislation to assure that funding for K-14 education is protected from automatic cuts.

-Deborah Harmon

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