**Statement by Controller John Chiang at the Senate and Assembly Joint Convention**
**December 8, 2008**

Mr. Pro Tem, Madame Speaker, and distinguished members of the Legislature, let me first commend you for convening this joint session to address the dire financial circumstance that threatens the current and future solvency of our state.

Make no mistake, a delay in action would be catastrophic. As unpalatable as tax increases or further program cuts may appear, neither is as toxic to the State's fiscal health as doing nothing.

Failure to act threatens our ability to respond to natural disasters, our ability to provide life preserving care to the elderly and the ill, and our ability to protect our communities from crime.

If we are to avert sure disaster, together we must set aside blame, proceed with speed, pursue practical solutions, and, most importantly, summon the political courage to make the decisions necessary to protect the programs and services that Californians depend on every day.

Before I speak to the State's cash flow problem, and why attacking the $28 billion deficit is needed to stave off an immediate shut down of public services, let me begin with a critical distinction between "budgeting" and "cash available."

As you know, the "budget" refers to the financial plan based on estimated revenues and disbursements for a fiscal year. This plan and its projections are a primary responsibility of the Department of Finance.

"Cash" refers to what is actually in the State Treasury on a day-to-day and month-to-month basis. Monitoring the amount of cash available to meet the State's financial obligations is the core responsibility of my office.

Part of that responsibility is to address the monthly cash "gaps" we see throughout the year when revenue collections are lower than payments. This is both routine and expected: Most of the State's expenses come during the first part of the year, while much of its revenues are collected in the final quarter. To smooth those gaps, we use a combination of internal and external borrowing, and also work to maintain at least a $2.5 billion cash cushion.

We borrow internally from 600 of the State's 1,100 special funds to minimize the costs associated with external borrowing. The total amount available from this type of borrowing is approximately $18 billion. As of November 30, there were only $4 billion remaining – and by March there will be nothing left to borrow from these funds.

We borrow from several large funds that support public goals like oil spill prevention, beverage container recycling, and air pollution control. But State law prohibits borrowing from 500 other funds including CalPERS and CalSTRS, and other protected accounts such as the Local Agency Investment Fund.

Internal borrowing is short-term – just like external borrowing – and it must be repaid in a manner that will not interfere with the operations of the special funds.

When internal borrowing cannot suffice, we can also look to Wall Street in a normal market to smooth out cash flow. Short term external borrowing is achieved through a Revenue Anticipation Note – or a RAN – which must be repaid by the end of the fiscal year. RANs are used to bridge the cash gaps between what comes in and what goes out.

In the past 25 years, RANs have been issued every year but one. The Treasurer's Office has issued RANs ranging from $1 billion in 1999 to $12.5 billion in 2002. My office determines the amount of RANs needed, and the Treasurer's office then sells them. This is made possible when budgets are balanced and the markets are functioning, but we know that this year is different.

Under normal conditions, we have a balanced budget for the year and we are able to manage shortfalls with internal borrowing and RANs. This year we needed a $7 billion RAN, but due to the severely weakened condition of the State's finances coupled with the global financial crisis, only $5 billion was sold. That left a $2 billion cash gap.

Now, compounding our problems, the global financial crisis has continued to erode revenues. The size of the revenue shortfall for the remainder of the fiscal year was most recently estimated at $7.8 billion by the Legislative Analyst, and at $9.7 billion by the Department of Finance. My office's economists think even $9.7 billion may be an understatement.

My office tested the latest cash flows associated with this $9.7 billion deterioration, and what we found was a clear threat to the State's ability to pay all of its bills starting this Spring.

By February, we will only have $882 million in cash on-hand. By March, we will have exhausted our general and borrowable funds and run more than $1.9 billion in the red. If revenues continue to deteriorate, this number will only grow.

My office is about to issue a report showing November revenues were down even further than expected. In the past four weeks that we have argued about the budget, our problem grew by as much as $500 million above and beyond the $9.7 billion loss projected a few weeks ago.

The responsible course of action is to solve the $28 billion problem for the combined current and budget years. Solid budget solutions have a cascading effect. If we address the budget shortfalls now, we tackle much of next year's problems as well. Left unaddressed, current year shortfalls compound in the following year.

It would also be a mistake to think our problem is only the $1.9 billion cash crunch in March. Addressing this Spring's cash problem alone would be like burning the furniture to heat the house. And while March poses a real challenge, here are four reasons why this Summer looks much worse.

First, July and August are usually low in revenue and high in expenditures. For example, in July 2007, we collected $4.1 billion and spent $10.3 – that is a $6 billion dollar gap and is typical of the gap that we see as the fiscal year opens.

Second, there will be no cash balance or borrowable funds to carry over to the new fiscal year. In other words, we will begin the fiscal year with our cupboards bare.

Third, special fund revenues could follow general fund revenues and turn downward with this economy. The more special fund revenues deteriorate, the smaller our pool of borrowable funds becomes.

And finally, state law requires that borrowing from internal funds cannot interfere with the operations of the funds. If the special funds need cash and the State's general fund cannot provide that cash, there will be a liquidity crisis in the Pooled Money Investment Account that could significantly impact the special funds from which we borrow.

These four facts are red flags that demand immediate legislative action. The problems we face are real, and the only true solution is to address the $28 billion budget problem.

Without a budget solution, my office has few choices to deal with the immediate cash crisis. None of these options are in our best interest, nor do they offer any guarantees. But I will go through them individually for you today while explaining the pitfalls and complexities that each presents.

The first is to try to "cash-manage" the problem. I have directed my staff to determine the exact date we will run out of cash, how many days we will be in the red, what payments are due, what payments have statutory due-dates, which payments can be moved, and what the penalties and interest are for moving those payments.

This fact finding will determine if there is flexibility in the payment schedule to buy us a few days for a limited amount of dollars.

This is nothing more than a Band-Aid. The crisis we face this spring and summer is of such magnitude and duration that it cannot be adequately addressed by this type of triage.

The next option is a Revenue Anticipation Warrant – or a RAW – which is another form of external borrowing. But unlike a RAN, it can cross fiscal years, it does not require a budget, it has only been used in fiscal emergencies, and it is extremely expensive.

My office ventured to put a RAW together as a financial backstop this summer. We were able to line up $5 billion, but the financing would have cost taxpayers more than half a billion. This came when we saw only symptoms of a credit crunch – before it became a worldwide credit and liquidity pandemic.

Now, my financial team includes some of the most experienced advisors in California, who have put together nearly every RAW in the State's history. But even they warn that market access is terribly difficult, and we may not be able to find lenders willing to take a leap of faith.

The bottom line is selling RAWs may well be impractical if not impossible.

The last option is issuing Registered Warrants – or IOUs. They bear interest and are issued to replace regular warrants when there is not enough cash available to pay the State's obligations. IOUs are rarely issued – only once since the Great Depression has California used them.

There is no reason to believe an IOU is a viable option. It sends the wrong message to our creditors by showing that we cannot pay our bills. And their use is limited – litigation already bars IOUs for most state payments. I have directed my legal staff to review what IOUs can and cannot pay, but we already know they cannot be used to pay salaries of employees covered by the Fair Labor Standards Act. Nor can they go towards schools, debt service, or federal payments like Medi-Cal.

There is no prohibition against using these for vendor payments, income tax refunds or the salaries of judges, elected officials and their appointees.

But there is another catch to issuing IOUs – if one is used, all revenues received afterwards must go to pay back the IOU before any standard payments can be made. State law already determines the priority for many payments. But the IOU repayment could jeopardize that order by putting non-priority payments ahead of priority payments. This could put the State in serious legal and financial trouble, and frustrate our ability to manage cash.

Failure is not an option here. Without coming together to address our budget problem, we will create a financial catastrophe from which it would take years to recover.

Failing to enact a responsible, long-term solution to this financial crisis could mean liquidated damages, federal penalties, and exposing our state to expensive litigation when it can least afford it.

You would see a chain reaction far worse than new taxes or program cuts. It would endanger local governments, schools, small businesses, nursing homes and hospitals. We would pass our financial problems on to millions of Californians by deepening and prolonging the current recession.

We cannot waste time arguing about how we got here today. We only have time to quickly come together and pursue solutions and make the tough decisions that will protect our future.