What Happens When California Defaults?

by Bill Watkins 12/16/2009

The California Legislative Analyst's Office recently reported that the State faces a $21 billion shortfall in the current as well as the next fiscal year. That's a problem, a really big problem. My young son would say it was a ginormous problem. In fact, it may be an insurmountable problem.

Our governor and legislature used every trick in their books when they created the most recent budget. They even resorted to mandatory interest-free loans from the taxpayers. Now, they have no idea where to go. The Democrats have declared that they will not allow budget cuts. The Republicans will not allow tax increases. They have probably run out of smoke and mirrors, although their ability to engage in budget gimmickry is enough to make an Enron accountant blush. No one is considering raising revenues by increasing economic activity.

In my opinion, California is now more likely to default than it is to not default. It is not a certainty, but it is a possibility that is increasingly likely.

Then what?

Ideally, we'd see a court-supervised, orderly bankruptcy similar to what we see when a company defaults. All creditors, including direct lenders, vendors, employees, pensioners, and more would share in the losses based on established precedent and law. Perhaps salaries would be reduced. Some programs could see significant changes. This is distressing, but it is better than other options.

Unfortunately, a formal bankruptcy is not the likely scenario. There is no provision for it in the law. Consequently, absent framework and rules of bankruptcy, the eventual default is likely to be very messy, contentious and political.

Other states have defaulted. Nine states defaulted on credit obligations in the 1840s. Most of those states eventually repaid all of their creditors (see William E. English "Understanding the Costs of Sovereign Default: U.S. State Debts in the 1840s," *American Economic Review*, vol. 86 (March 1996), pp. 259-75.) Unfortunately, the examples in the 1840s are not much help in anticipating the impacts of a modern default. Circumstances are different, and things have changed, a lot.

We're left with the question: what happens when California defaults?

The worst case would be the mother of all financial crises. According to the California State Treasurer's office, California has over $68 billion in public debt, but the *Sacramento Bee's* Dan Walters has tried to count total California public debt, including that of local municipalities, and his total reaches $500 billion. Whatever the amount, the impact of default could be larger than the debt amount would imply. Other states – New York, Illinois, New Jersey, for example – are in almost as bad shape as California, and they could follow California's example. The realization that a state could default would shock markets every bit as much as when Lehman Brothers failed. Given the precarious state of our economy and the financial sector, another fiscal crisis would be disastrous, with impacts far beyond California's borders.

What would a California default look like? In a sense, we've already seen California default, when that state issued vouchers. If any company tried that, they would be in bankruptcy court in days. Issuing vouchers didn't trigger a California crisis because banks were willing to honor the vouchers. If banks refuse to honor the vouchers next time, employees and vendors won't be paid, and state operations will come to a halt. This could happen if our legislature locks up and is unable to act on the current $21 billion problem.

Another possible California scenario is that the State will try to sell or roll over some debt, and no one buys it. Already, we've seen California officials surprised with the interest rates they have had to pay. What happens if no one buys California's debt? We saw last September what happens when lenders refuse to lend to large creditors.

If we continue on the current path, the worst case is also the more likely case. Bad news keeps dribbling out. One day we find we are paying 30-percent-higher-than-anticipated interest on a bond issue. A few days later, we find the budget shortfall is billions of dollars higher than projected just a short time ago. Every month brings new bad news. The risk that one of those news events triggers a crisis grows with every news event.

Given California's recent history, it is difficult to believe that the people with the authority and responsibility for California's finances can act responsibly, but that is what we need. Responsible action would be creating a gimmick-free budget that places California finances on a sustainable path, and provides an environment that allows for opportunity and job creation. But, sadly, Sacramento probably cannot draft an honest balanced budget, and will thus need to plan for California's eventual default. They need to work with Federal Government and Federal Reserve Bank officials to insure a coordinated plan to limit damage to financial markets. That plan needs to be ready to release when markets go crazy, which is exactly what could happen when participants realize that default is possible. It could be needed sooner than they think.

Bill Watkins is a professor at California Lutheran University and runs the Center for Economic Research and Forecasting, which can be found at clucerf.org.