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A One-Two Punch in the Budget

■ Economy: Tech dive and energy crisis hurt bond ratings again. Analysts say it's likely to get worse.

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A perfect storm is brewing over California: A downturn in the state's prized high-tech economy has coincided with a costly energy crisis, leaving a once-bountiful state budget a shambles.

The cascade of tax revenues from stock options that caused the budget to balloon in recent years has begun to dry up as the New Economy falters. At the same time, the energy crisis is forcing the state to spend billions buying electricity to avoid crippling mass blackouts.

The latest bad news came Tuesday, when Moody's Investors Service became the second major credit rating firm to downgrade $25 billion in state bonds, sounding an alarm over the "increasing financial risks associated with the continuing energy crisis."

The downgrades not only add millions to the state's borrowing costs, including projects in the next state budget, they further complicate a troubled plan to float a record $13.4 billion in bonds to repay state coffers for electricity purchases.

The move by Moody's came one day after Gov. Gray Davis announced that he was dipping into the state's emergency reserve fund to finance a pared-down budget for the fiscal year that begins in July. Already, a statewide sales tax holiday has been canceled and $300 million in aid to local governments has been deleted from the budget.

The spiraling events contributed to a financial picture that looks increasingly bleak, according to analysts. With the long, hot summer looming, it only figures to get worse, potentially developing into the worst fiscal crisis the state has faced since the economic recession of the early 1990s.

"It's almost a Kafkaesque situation we find ourselves in," said state Treasurer Phil Angelides. "California is the leading edge of the national economy, which is the leading world economy. We have to take these current problems with a grain of salt. But without a doubt, these downgrades are a black mark that threatens to harm the state's reputation."

After years of worrying about little more than how best to spend surplus billions, Gov. Gray Davis is now faced with his first tough budget battle. And his initial response--draining emergency reserves rather than slashing government spending--has raised eyebrows in Sacramento and on Wall Street.

Despite a pervasive aura of negativity, however, veteran state budget officials profess optimism.

"Clearly, the revenue outlook has deteriorated," said Elizabeth Hill, the state's nonpartisan legislative analyst. But compared to the budget deficits of the past decade, Hill said, the current situation is still within control.

"Most of us have lived though the $14-billion budget shortfall," she said, referring to the 1990-91 budget season, when then-Gov. Pete Wilson was forced to slash programs. "So we have seen us overcome serious economic problems in the past."

Experts on the outside, however, were taking a more negative view. In explaining its downgrade, Moody's said it was particularly concerned that California had recently backed out on a $4-billion loan to reimburse the budget for electricity purchases until bonds could be floated, and that the bond sale had been delayed until August.

It was also concerned about the general decline in the state and national economies, and Davis' plan to maintain only a minimal $1-billion reserve, the firm said. Moody's action came less than a month after Standard & Poor's lowered its rating on California bonds two notches.

The downgrade registered virtually no response on Wall Street on Tuesday, in part because many bond traders and analysts have already reacted to California's energy woes and actually expected a harsher action from Moody's. The firm lowered the rating on $19.8 billion of general obligation bonds from AA2 to AA3. The ratings on $5.7 billion in lease revenue bonds was dropped from AA3 to A1.

In general, the lower the rating, the higher the interest the state must pay those who buy its bonds. Thus, the downgrade threatens to increase the price tag for state projects, such as $400 million in higher education bonds Davis had proposed in his new budget.

"If anything, the market was surprised that Moody's was so kind," said Bob Gore, a managing director and bond trader at Crowell Weedon & Co. in Los Angeles. "I thought they'd take [the state] down to at least a single-A."

But it sparked a heated round of finger-pointing in Sacramento, with Davis and other Democrats accusing Republicans of causing the state's credit rating to slip by blocking the loan deal last week.

The GOP legislators attempted to force Davis into a new strategy on the energy crisis by holding up a bill needed to secure the loan and sell the bonds. But Davis refused and the Democratic-led Legislature passed a majority-only bill instead.

"Last week, when Republican legislators decided to play politics and block a vote on revenue bonds, I warned that their actions could have serious consequences," Davis said in a statement Tuesday. "Today, the seeds of Republican obstructionism are bearing their ugly fruit."

Republicans, in turn, blamed the downgrade on Davis, calling it a denunciation of his entire plan to finance a way out of the energy crisis.

"Last I heard we were the minority here," said Assemblyman George Runner (R-Lancaster), the GOP's budget point man in the lower house. "He's holding us awfully accountable for what I believe he has gotten the state into."

Political differences over how to overcome California's financial problems are sure to color debate over the next budget. But Angelides and others hold out hope for a bipartisan solution. Angelides said he spoke with Runner on Tuesday and left encouraged. But the current climate is ugly, he conceded.

"We're at a place now where we've had a great thing going for a decade. The mark of a great team is one that comes together when times are tough. Unfortunately, we are showing some of the characteristics of a losing team."

Already, there are signs lawmakers plan to do what Davis did not--further pare down the budget to meet the state's unpleasant new economic realities. Hill, a respected voice among leaders in both parties, has already written legislators respected voice among leaders in both parties, has already written legislators suggesting they take an ax to Davis' spending plan.

But others maintain that the outlook isn't as bleak as Wall Street credit rating agencies and other critics believe. Ted Gibson, the state's chief economist, acknowledged that the state is in a precarious position, but said it still boasts m one of the nation's highest rates of growth and employment.

"The situation is manageable," Gibson said. "None of these things help--the delay in the bonds is going to cost us money. But the state is in a strong cash position. The economy, in the context of the rest of the United States, is still doing pretty darn well. Once we get these [energy] bonds sold, the picture will be considerably brighter."

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Times staff writer Julie Tamaki contributed to this story.