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Fitch: Governor Brown's Final Budget Proposal Points to Sustainable Path for California.

Fitch Ratings-New York-25 January 2018: The fiscal 2019 California state budget proposed by Governor Brown appears prudent, in Fitch Ratings' view, and an enacted budget with similar priorities would bode well for continued fiscal stability in light of the state's volatile tax structure and the inevitability of a future economic downturn. While the budget would invest in many of the governor's priorities, it also continues his policy of restraining growth in ongoing spending while paying down long-term liabilities and funding the rainy day fund. This approach has contributed to improved fiscal stability and resilience and has led Fitch to upgrade the state's Issuer Default Rating three times since 2013, most recently to 'AA-/Stable.

Fitch's assessment of the state's credit quality assumes a continuation of the strong budget management the state has demonstrated through this extended period of economic recovery and expansion; the governor's proposed budget is consistent with this assumption. The 'AA-' rating also recognizes California's large and diverse economy, solid ability to manage expenses through the economic cycle and moderate level of liabilities, although California's flexibility is somewhat more restricted than is true for most states due to its constitutional requirement for funding education and voter initiatives that limit policymakers' discretion. Going forward, Fitch will continue to assess the extent to which these strong management practices have become institutionalized and not limited to a particular governor's approach.

The governor's budget proposal, which fully funds both the rainy-day reserve and the school funding formula ahead of schedule, is based on a revenue forecast of modest growth that reflects the continued expansion of the California economy tempered by the risk that the current economic expansion has passed its peak and that federal tax reform (not included in the revenue forecast due to timing) could have a negative impact on state revenues.

Rainy Day Reserve Fully Funded

The governor is proposing to set aside \$5 billion from fiscal 2019 revenues in the state's rainy day fund (the Budget Stabilization Account), \$3.5 billion above what would be required by law. This would bring the balance to \$13.5 billion, reaching 100% of the target of 10% of tax revenues detailed in Proposition 2, which established the fund. A fully funded rainy day fund provides the state with strong gap-closing capacity and would help it to weather a downturn in the economy while maintaining adequate financial flexibility, in contrast to prior economic downturns. Pursuant to Proposition 2, once the rainy day fund is fully funded, "excess revenues" will be set aside to address the state's considerable infrastructure needs.

In addition to the rainy day fund, the budget maintains approximately \$2.3 billion in the state's Fund for Economic Uncertainty, which can be tapped for unexpected events such as natural disasters. The state used \$43 million from this fund for costs related to the recent wildfires. The governor's budget proposal would backfill approximately \$48 million in local property taxes in affected areas from the general fund. Budgetary borrowing, which peaked at approximately \$35 billion in fiscal 2011, will be further reduced to \$1.1 billion from \$2.2 billion by the end of fiscal 2019 as the state repays special

funds, uses one-time funds to “settle-up” prior year Proposition 98 obligations, and repays transportation loans.

Reasonable Assumptions for Revenue Growth

The proposed general fund budget assumes 4.5% growth in revenues over the current fiscal year to \$135 billion and estimates that current year revenues will exceed budget by \$1.4 billion (1%) and total \$127.3 billion, driven by strong wage withholding and capital gains. The 4.5% growth rate is below the average growth rate experienced by the state since emerging from the recession, taking into account various changes in tax law related to personal income and sales taxes. Much of the increase in revenue will be automatically allocated to K-14 education under Proposition 98 but will also support increased spending for Medi-Cal (California’s Medicaid program), higher education, programs that counteract poverty and climate change, and infrastructure.

Medicaid Spending Stable

Medi-Cal is the state’s single-largest all-funds expenditure and the second-largest general fund expenditure after education. The state expects to spend \$101.5 billion on Medi-Cal, including state and federal funds. The budget does not propose significant programmatic changes although increasing state revenues have allowed the restoration of program reductions taken during the great recession and increases in the state’s portion of the cost for optional Medicaid expansion under the Affordable Care Act. The Proposition 56 increase in cigarette taxes is expected to generate \$1.3 billion in fiscal 2019, which, after mandated transfers, will support supplemental payments and provider rate increases as well as partially covering costs of caseload growth.

Big Boost to School Funding/Future Funding More Modest

The proposed budget boosts Proposition 98 (school funding formula) K-12 funding by \$3.8 billion (5.1%) compared to the fiscal 2018 budget, including full implementation of the Local Control Funding Formula (LCFF; enacted in 2013) two years earlier than originally projected. Proposition 98 funding includes \$1.8 billion in discretionary one-time funding to settle up prior-year obligations. If districts use these funds one time rather than for funding ongoing programs, the downside risk of recession could be partially mitigated. The boost in funding for fiscal 2019 may alleviate some of the budget pressure being felt by school districts, many of which may need to make budget cuts in fiscal 2019 in order to maintain fiscal balance.

The proposed budget is consistent with Fitch’s expectations that once the LCFF target funding level has been reached, annual increases to K-12 funding will generally be for cost of living adjustments (COLA). Individual district’s revenues will depend on the COLA and relative increases/decreases in average daily attendance.

Community College Proposal

The governor is proposing a shift in incentives for community colleges (CCD) that will focus funding on outcomes (such as for certificates and degrees) and serving low-income students, rather than solely on the number of full time equivalent students (FTES). Base grants (approximately 50% of funding) would be based on FTES, with supplemental grants (25%) for low-income students and incentive grants (25%) for the number of degrees and certificates granted. For fiscal 2019, districts would receive at least the funding received in fiscal 2018 with adjustments made thereafter. If a new funding formula alters Fitch’s expectations for revenue growth, there could be a positive or negative credit impact. If implemented in the final budget, Fitch will analyze its impact on its CCD portfolio.

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