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Fitch Ratings: California Municipalities Brace for Next Downturn

Fitch Ratings-San Francisco-23 January 2019: California credits, specifically the state, counties and cities and school districts, are all better prepared to manage through the next economic downturn; however, some school districts throughout the state may feel its effects more acutely, according to a new Fitch Ratings report.

California school districts face a challenging budget environment during the next recession due to what Fitch Senior Director Karen Ribble describes as “scheduled teacher pension contribution increases, limited to no control over revenues, relatively low reserves compared to elevated revenue volatility due to reliance on volatile state funding.”

School district reserves are higher than in fiscal 2008, which will help to some extent. Also important to consider is that California school districts have essentially no ability to raise revenue without voter approval.

Conversely, most Fitch-rated California counties appear to be the most well-positioned out of the three local governments to weather cyclical declines while maintaining financial flexibility. For one, counties have the least volatile revenues. Much of it comes from relatively stable property tax revenues and counter-cyclical intergovernmental revenues instead of more cyclical revenue streams like sales taxes and transient occupancy taxes. However, cities are also well-positioned. “California cities and counties will likely trim service levels, negotiate labor concessions and temporarily curtail discretionary spending so its expenditures are more closely better aligned with temporary lower revenues,” said Ribble.

The state as a whole is very susceptible to revenue volatility since it is reliant on two economically sensitive revenues (personal income taxes and sales and use taxes). Additional risk exists because California contains some of the more overvalued housing markets in the nation. On the positive side, California has paid back the debt it borrowed during the last two recessions and has a rainy day fund that will equal 10% of revenues by the end of fiscal 2019. These excess funds will help mitigate revenue volatility.

Drilling down into the ratings themselves, Fitch expects the vast majority of them to remain stable throughout a moderate downturn since the expected stresses have been factored into the ratings. Only unforeseen policy decisions or an unusually long and/or severe economic downturn would result in rating changes.

“How Prepared Are California Credits for the Next Recession?” is available at www.fitchratings.com.

Contact:

Karen Ribble
Senior Director
+1-415-732-5611

Fitch Ratings, Inc., 650 California Street
San Francisco, CA 94108

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email:
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com