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S&P: Kansas' Proposed Midyear Budget Adjustments and Recent Court Ruling on Education Could Hamper Structural Budget Balance.

NEW YORK (Standard & Poor's) Jan. 9, 2015—Standard & Poor's Ratings Services believes two recent credit developments for the State of Kansas — a lower court ruling that could require substantially higher education funding if upheld on appeal, and the state's projection of a substantial fiscal 2015 shortfall — raise additional obstacles for Kansas to achieve structural budget balance in fiscal 2016 and potentially beyond. In this respect, the extent of the state's movement toward structural budget alignment in fiscal

2016 will be an important component in our view of Kansas' future credit quality.

The lower court ruling on education could require the state to spend more than \$500 million extra per year, beyond the \$129 million of increased education funding the Kansas Supreme Court required the state to spend in fiscal 2015. We do not see an immediate impact from the new court ruling, as it will likely be appealed to the state supreme court. In our opinion, however, the ruling adds uncertainty to future years' budgets.

Kansas also released a new forecast that projects a negative \$280 million general fund budget balance at the end of fiscal 2015, or a negative 4% of budgeted expenditures, absent corrective action. This is in contrast to the adopted 2015 budget, which forecasts a positive 6% ending balance and also assumed that fiscal 2014 would end with a large 11.6% balance; instead the state's preliminary estimate is that fiscal 2014 ended with a lower balance equal to 6% of 2014 expenditures, or \$380 million.

The projected negative ending balance for fiscal 2015 has prompted Governor Sam Brownback to propose an offsetting \$280 million of midyear corrective actions that would eliminate the projected general fund deficit position, although still leave the state with essentially no general fund balance at the end of the year. The bulk of the governor's proposed midyear adjustments, involving fund transfers and other measures, will require legislative approval when the legislature reconvenes Jan. 12.

In our view, the proposed budget adjustments, if enacted, would result in a state general fund balance position broadly consistent with our expectation in August 2014, when we lowered our rating on Kansas to 'AA' from 'AA+' and assigned a negative outlook, although it would appear that the state's structural imbalance has grown. We had earlier expected a marginal fiscal year-end 2015 balance due to large shortfalls in the April 2014 income tax collections that were not reflected in the adopted fiscal 2015 state budget.

Kansas' current revenue forecast now incorporates the earlier April shortfall, resulting in a lower beginning balance that carries forward into a lower year-end balance. However, the state's structural imbalance appears to have grown further due to increased education and Medicaid spending. Although the proposed midyear corrective actions could eliminate a year-end deficit position, they do not appear to significantly address the mismatch between recurring revenues and

expenditures.

The governor's \$280 million proposed midyear adjustments include: \$201 million of one-time transfers from other funds, the delay of a scheduled increase in pension funding (\$41 million), savings from a bond refinancing (\$3 million), delays in a hospital expansion (\$5 million), reduced transfers out for capital construction (\$5 million), and 4% spending reductions for many state agencies.

Although Kansas will likely make adjustments to bring its general fund balance back to a marginally positive level at fiscal year-end 2015, we remain concerned about the one-time nature of most of the budget fixes, and the large fund balance drawdown on a budgetary accounting basis. (On a generally accepted accounting principles [GAAP] basis the fund balance is lower — the recent release of the state's fiscal 2014 GAAP financial statement shows a fiscal year-end 2014 general fund balance of only \$2.5 million.) We believe the state will have enough working cash to operate using its other internally borrowable funds. However, the large reduction of the fund balance in the past two years during a period of economic recovery indicates credit stress, in our opinion, and contributes to our negative rating outlook. Kansas reduced its top individual income tax rate to 4.6% from 4.8% in fiscal 2015, and has another reduction in the top rate scheduled in fiscal 2018 to 3.9%. State credit quality could be affected to the extent tax reductions are not paired with ongoing spending cuts, absent significant economic growth.

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