# Bond Case Briefs

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## Fitch Ratings: Strong Economy Continues to Propel California's Budget

Fitch Ratings-New York-20 May 2019: The updated budget proposal for fiscal 2020, released by Governor Newsom in his "May Revise," continues to build budgetary resilience, while also increasing spending on education and social welfare programs, says Fitch Ratings. The budget revision takes advantage of strong revenue collections in the current fiscal 2019 and a $1.7 billion increase in the forecast for fiscal 2020, as compared to the January budget proposal, propelled by continued strength in the California economy that is driving higher personal and corporate income tax collections. The budget focuses on sustainability of program expansions through use of one-time spending, continues to pay down long-term liabilities, and funds the rainy day fund. The approach taken in the revised budget appears prudent, in Fitch's 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.

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. California's 'AA-' Issuer Default Rating also recognizes its 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 most states due to its constitutional requirement for funding education and voter initiatives that limit policymakers' discretion.

Reasonable Assumptions for Revenue Growth

The governor's budget proposal 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. It also accommodates the expectation of slower out-year revenue growth by allowing certain program expansions to sunset; this should help to maintain structural budgetary balance.

The proposed general fund budget assumes 3.4% growth in revenues over the current fiscal year to $147.8 billion and estimates that current year revenues will exceed the forecast upon which the fiscal 2019 budget was enacted by $34.6 billion (3.3%) and total $142.9 billion, driven by strong capital gains and corporate income tax collections. The 3.4% growth rate for fiscal 2020 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 homelessness, climate change, infrastructure, and paying down liabilities.

Building Budget Resiliency

The governor's revised budget proposal allocates $15 billion to building budgetary resiliency by adding to reserves and paying down unfunded pension liabilities, debt, and deferrals, an increase of $1.4 billion over the January proposal. The governor is proposing to set aside $2.2 billion from fiscal 2020 revenues in the state's rainy day fund (the Budget Stabilization Account), $1.2 billion more than initially proposed in January. This would bring the balance to $16.5 billion, reaching 100% of the target of 10% of tax revenues as originally detailed in Proposition 2, which established the fund. The governor has offered a new interpretation of Proposition 2 that does not count previous supplemental contributions toward the required funding level, potentially raising the deposits to the rainy day fund. A fully funded rainy day fund supports the state's very strong gap-closing capacity and would help it to weather a downturn in the economy, while maintaining financial flexibility, in contrast to prior economic downturns.

In addition to the rainy day fund, the governor continues to propose adding $700 million to the Safety Net Reserve that was initially funded at $200 million in the fiscal 2019 budget, but lowering the balance in the Special Fund for Economic Uncertainties to $1.645 billion from just under $2 billion, for a net increase of $537 million in discretionary reserves. The revised budget proposal makes the first ever deposit ($389 million) into the Public School System Stabilization Account, as required by Proposition 2. This reserve is intended to offset volatility in school funding in the event of a downturn.

Governor Newsom's application of excess revenues to one-time supplemental spending in fiscal 2019 to pay down long-term liabilities and eliminate remaining budgetary deferrals bodes well for a continued balanced approach to budgeting under the new administration. This practice also provides flexibility to maintain balanced operations if revenue growth expectations are not realized. At its peak, the state's budgetary borrowing totalled approximately $35 billion, including outstanding debt in the form of the Economic Recovery Bonds, payment deferrals to schools and local governments, payroll shifts between fiscal years and interfund borrowing. The governor's budget proposal for fiscal 2020 eliminates the final pieces of budgetary borrowing, allowing the state to direct revenues generated from Proposition 2 to other long-term liabilities, including for pensions and other post-employment benefits.

Longer term budget sustainability also is provided by the application of surplus revenues to one-time spending, including supplemental contributions to the retirement funds: $3 billion for CalPERS and $2.3 billion to CalSTRS as supplemental appropriations in the current year plus $1.1 billion for CalSTRS proposed for fiscal 2020. These are intended both to reduce employer contribution rates and to provide savings over time. Other one-time spending focuses primarily on education and housing, with facilities for all-day kindergarten, expanded childcare facilities, and a variety of grants and incentives designed to address housing production and homelessness.

The revised budget would increase ongoing spending by $3.4 billion, approximately $500 million more than proposed in January and higher than in recent budgets. However, as the out-year revenue forecast is slightly more pessimistic than was the case in January, the governor is proposing sunsets to several categories of program expenditures in order to avoid emergence of a structural deficit.

Adjustments to Spending Proposals

The governor is not making major changes to the spending proposed in the January budget, although there are several adjustments. Of note is an increase in state support for programs to address homelessness, with the governor proposing $1 billion in spending, including $650 million allocated to local governments for emergency aid. The revision also increases the health and human services budget request by $1.1 billion over the January proposal. Other more modest changes include, slowing the creation of additional pre-school slots, a priority highlighted in the budget, recognizing both longer implementation time and the possibility of slower revenue growth.

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