STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

California Initiates Budget Process Amid Rising Stock Market Volatility

Primary Credit Analyst:
Gabriel J Petek, CFA, San Francisco (1) 415-371-5042; gabriel.petek@standardandpoors.com

Secondary Contact:
David G Hitchcock, New York (1) 212-438-2022; david.hitchcock@standardandpoors.com

Table Of Contents

California Initiates Budget Process Amid Rising Stock Market Volatility

A sharp increase in stock market volatility provided the backdrop for the Jan. 7 release of California Governor Jerry Brown's fiscal 2017 budget proposal. For several years, the bull market for equities has generated above-average capital gains, turbocharging personal income tax revenue receipts. Revenues in fiscal 2016 continue to run well ahead of what the budget anticipated upon its enactment. But stock market corrections are as inevitable as they are unpredictable, and when they strike, history suggests state revenues will follow stock prices lower. Similar to the equity markets, the broader economic recovery, now in its seventh year, has already outlasted most expansions. Standard & Poor's Ratings Services forecasts another year of economic growth and modest stock market appreciation, but we cannot rule out the possibility that financial markets and the economy have peaked.

At the same time, some of the institutional shackles on state spending are falling away. For the past several years, California was required by its constitution to allocate much of any revenue growth to education in order to close a funding gap (referred to as the "maintenance factor") that peaked at $10.6 billion in 2012. In the course of complying with this requirement, lawmakers shrewdly appropriated most of the funds for one-time purposes, insisting that they count toward the retirement of $10.4 billion in deferred school aid payments. Beyond education, much of the growth in general fund spending since 2011 has similarly been limited to one-time outlays for debt repayment and to capitalize the state's budget reserves. Managing the state's multiple-year revenue rebound in this manner has contributed to California's improved credit rating throughout the past several years.

Overview

- California's revenues remain prone to cyclicality;
- Policymakers will have increased discretion over spending policy in fiscal 2017;
- Despite fiscal recovery, state's fiscal condition remains precarious and linked to stock market performance;
- Large new spending commitments now could undermine state's capacity to withstand weaker conditions in the future.

In addition to absorbing much of the state's incremental revenue growth and helping facilitate its debt repayment, the constitutional requirements also crowded out room in the budget for all but a few new spending commitments. This had the effect of holding the state's expenditure base to a lower trajectory than earlier fiscal projections. Whereas the previous multiple-year fiscal projections showed large annual deficits, more recent forecasts have depicted structural alignment, thanks in large part to the lowered spending base. But now the maintenance factor is gone and the deferrals have been reversed. Consequently, lawmakers begin budget negotiations with more open-ended discretion over general fund spending. This gives rise to the potential that the state could ramp up its recurring spending commitments just as its revenue trends reach a plateau—or worse, begin to falter, thereby putting the state's fiscal alignment in jeopardy.

Spending Proposal Identifies Additional Resources Largely As One-Time

Despite the obligations that have been retired, many of California's appropriations remain governed by legal requirements. Constitutional funding formulas dictate minimum spending on kindergarten through community college education (Proposition 98), debt repayment, and deposits into the state budget reserve. In addition, some spending growth is necessary simply to maintain current programs and service levels. Nevertheless, discretionary resources were shown in the budget proposal to have increased by more than enough to cover these cost increases. Most significantly, the Department of Finance (DOF) raised its revenue forecast by $5.9 billion (across the three-year forecast horizon spanning fiscals 2015 through 2017 and before accounting for transfers to the budget stabilization account). The DOF also lowered its estimate of non-Proposition 98 spending in fiscal 2015 and increased its projected fiscal 2017 beginning balance, both of which free up budget capacity. Finally, the budget recognizes $1.1 billion in potential new tax revenue, pending the legislature's approval of a revised managed care organization (MCO) tax on health insurance plans. Putting these together and net of the amount existing policies and legally required funding formulas will absorb, the Legislative Analyst's Office (LAO) has identified a total of roughly $7 billion in discretionary resources for fiscal 2017.

Most of the additional budget capacity, however, including the downward revision to prior-year spending and the higher than expected beginning balance, amount to one-time resources. The upwardly revised revenue forecast comprises the main source of additional resources. But much of the anticipated incremental tax revenue depends upon difficult-to-forecast capital gains, most of which are also arguably one-time receipts. Furthermore, 60% of the additional revenue in the forecast accrues to fiscal 2016. Any revenue from fiscal 2016 appropriated to finance fiscal 2017 expenditures is inherently a nonrecurring source of funding. In short, we view a significant majority of what the LAO identified as discretionary resources in the budget as nonrecurring. From a structural standpoint, therefore, California's fiscal alignment affords considerably less capacity for new ongoing spending initiatives than its current-year bottom line might suggest.

The governor's fiscal 2017 budget proposal acknowledges this and dedicates a majority of the discretionary resources to fund one-time outlays. We believe this approach helps preserve the state's structural budget alignment, which is a key to its improved credit quality. In particular, the governor recommends a supplemental deposit to the budget stabilization account (BSA), some infrastructure-related appropriations, and allowing the traditional budget reserve to grow. According to the LAO, more than 70% of the discretionary resource capacity goes toward these one-time purposes under the governor's plan while only 11% would fund commitments that either are or could become recurring. (For now, the $1.1 billion in revenue from the revised MCO tax is uncommitted and held in a special fund in the governor's budget proposal.)

By the end of fiscal 2017 the state's combined budget reserves would grow to a higher level than in recent memory, at $10.2 billion or 8.4% of expenditures under the governor's proposal. Still, reserve balances would fall short of the $12.4 billion the DOF projects in capital gains related tax revenue, implying that a precipitous stock market decline could strain the state's fiscal position.

Table 1

California -- Selected Financial Statistics

(Mil. $)

	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017
Begining fund balance*	(5,019)	(2,282)	(826)	2,264	5,356	3,699	5,172
Revenues and transfers	93,489	87,071	99,915	102,675	111,318	117,537	120,633
Expenditures	91,549	86,404	96,562	99,838	112,974	116,065	122,609
Operating position§	1,940	667	3,353	2,837	(1,656)	1,472	(1,976)
SFEU	(3,797)	(2,233)	1,573	4,130	2,733	4,206	2,230
BSA	NA	NA	NA	NA	1,606	4,455	8,011
BSA plus SFEU	(3,797)	(2,233)	1,573	4,130	4,339	8,661	10,241
BSA plus fund balance share of expenditures (%)	(4.15)	(2.58)	1.63	4.14	3.84	7.46	8.35

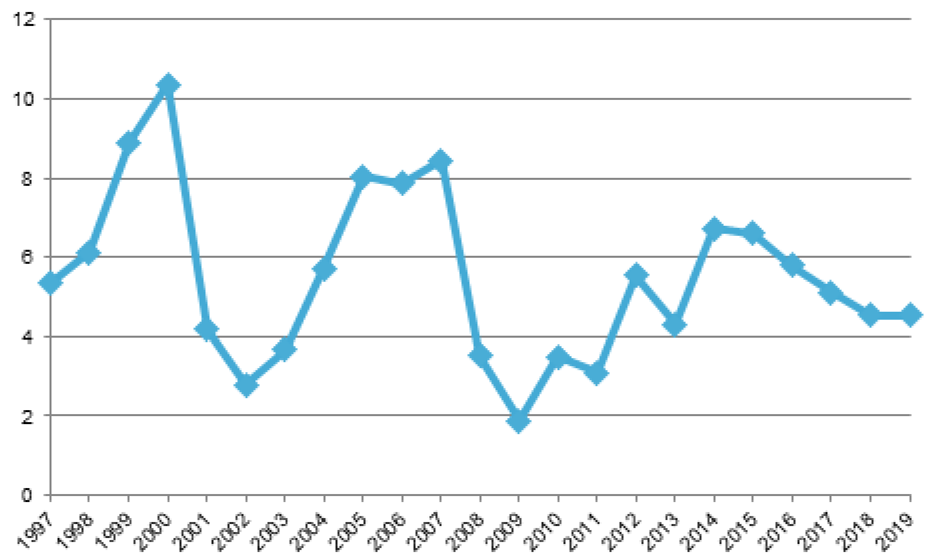
Note: Budgetary basis of accounting. *Restated for any prior-year adjustment. §Negative operating positions in fiscal 2015 and 2017 reflect revenue reduction for transfer to BSA. BSA--Budget stabilization account. N/A--Not applicable. SFEU--Special fund for economic uncertainties.

Revenue Forecast Assumes More Gradual Equity Market Appreciation Ahead

In a now familiar pattern, general fund revenues this fiscal year have surpassed the budget forecast. Collections through November were $664 million, or 1.8% higher than the budget assumption. Tax receipts appear to have been especially strong in December. Partial revenue data from LAO indicate that personal income taxes alone ended the first half of the fiscal year almost $1.5 billion, or 9.7%, above budget. In early January, the DOF revised its fiscal 2016 revenue forecast higher by $3.5 billion, or 3.0%. And, relative to its earlier projection, the DOF also raised its revenue forecast for fiscal 2017 by $2.4 billion, or 1.9%.

Both the above-budget collections and upwardly revised forecasts reflect the effects of surging capital gains income in 2014 and 2015. Strong stock market performance fueled a 63% jump in capital gains income to $130 billion in 2014 and the DOF estimates that it reached an all-time high of $135 billion in 2015. Capital gains income now represents an estimated 5.8% of total personal income in the state, which is above the long-term average (although they remain well-below the 10.4% of personal income they accounted for in 2000) (see chart).

Capital Gains As Percent Of Personal Income In California



Source: California Department of Finance

Looking forward, the DOF assumes that the S&P 500 will increase by about 2% in 2016 followed by similar gains for several years thereafter. But even with a flatter stock market in 2015 and the expectation of more modest increases in the years ahead, the DOF anticipates that earlier bull market performance will continue to yield above-average capital gains income through 2017. By 2018, the DOF expects capital gains will subside to the historically normal 4.5% of personal income, both because by then taxpayers will have realized most prior gains, and the rate rate of stock market appreciation will have slowed.

Budgeting With The Risk Of Recession In Mind

Although higher revenues have aided the state's fiscal recovery, we previously have detailed our view that the state's current fiscal alignment owed more to a lower general fund spending trajectory (see "Budgeting With Revenues Growing Means California Must Confront Its Past," published Jan. 28, 2015). Constitutional mandates notwithstanding, lawmakers had the option to chart a different course during the past several years. For instance, they could have adopted more bullish revenue forecasts in the recent budgets thereby enabling them to more aggressively restore services and add programs. It's possible that by now--some five years later--the state's expenditure baseline would have grown to be several billion dollars higher than its present level. In that case, the state's fiscal condition would currently be less capable of withstanding an economic slowdown.

The same logic applies to the future. Given the sensitivity of California's revenue base to economic and financial market fluctuations—and considering the duration of the current expansion—the governor's budget proposal explicitly acknowledged the possibility of a recession. According to the DOF's estimates, a moderate economic downturn in fiscal 2018 accompanied by a 25% stock market correction could cost the general fund $20 billion in annual revenue. Without corrective measures, the general fund operating reserve would deteriorate to a negative $29 billion by fiscal 2020. And that's assuming that this year, the legislature agrees to the governor's preference of committing $4.3 billion in discretionary resources to one-time purposes. If, on the other hand, the state were to appropriate its discretionary resources to recurring commitments, the deficit would be considerably larger at an estimated $43 billion according to DOF modeling.

Table 2

Baseline General Fund Multiyear Forecast At Fiscal 2017 Budget Proposal

(Mil. $)

	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020
Prior-year balance	5,356	3,699	5,172	3,196	3,805	1,914
Revenue (net of transfers to BSA)	111,318	117,537	120,633	126,841	127,305	131,138
Expenditures	112,974	116,065	122,609	126,232	129,196	133,985
Operating balance	(1,656)	1,472	(1,976)	609	(1,891)	(2,847)
SFEU plus BSA	4,339	8,661	10,241	12,134	11,242	9,386
Reserve share of expenditures (%)	3.8	7.5	8.4	9.6	8.7	7.0

BSA--Budget stabilization account. SFEU--Special fund for economic uncertainties. Negative operating position includes effect of deposits to BSA and debt repayment under Proposition 2. For instance, in fiscal 2017 the operating position would be positive $1.1 billion not including these transfers.

In our view, the future direction of California's credit quality is closely linked to its ability to maintain balanced fiscal operations. Even without a recession, the escalating schedule for pension contributions and rapidly growing unfunded liability for retiree health care already account for an increasing share of future budget capacity. The stronger revenue performance and much improved budgetary position of recent years therefore belie somewhat how fragile California's fiscal balance remains. In sobering fashion, recent stock market declines only help underscore this reality.

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.