FITCH: CALIFORNIA BUDGET PROPOSAL CONTINUES PATH OF FISCAL RESTRAINT

Fitch Ratings-New York-12 January 2016: Last week, Governor Brown of California released his proposed budget for fiscal year 2016-2017, which will begin July 1, 2016. The budget proposal is based on robust revenue growth that reflects the continued expansion of the California economy, according to Fitch Ratings. The governor continues his policy of restraining growth in on-going spending while paying down long term liabilities and funding the rainy day fund (the Budget Stabilization Account or BSA). This approach has contributed to improved fiscal stability and has led Fitch to upgrade the state's general obligation (GO) bond rating (rated 'A+' by Fitch) twice in the past three years. Fitch believes the approach taken in the budget proposal is prudent and bodes well for continued fiscal stability in light of the state's volatile revenue stream and the possibility of future economic downturn.

The governor is proposing to set aside $3.6 billion in the state's rainy day fund, $2 billion above what would be required by law. This would bring the balance to $8 billion by the end of fiscal 2017, approximately 2/3 of the target 10% of tax revenues detailed in Proposition 2. Budgetary borrowing would also be reduced from $3.9 billion to $2.5 billion by the end of fiscal 2017, as the state repays special funds, uses one-time funds to 'settle-up' prior year Proposition 98 obligations, and repays transportation loans.

The budget proposal for the state's General Fund assumes 3% growth in revenues over the current fiscal year to $125.1 billion, before transfers including to the BSA. The state is also now estimating that current year fiscal 2016 revenues will exceed budget forecast by $3.5 billion (3%) and total $121.5 billion, also prior to transfers including to the BSA. Much of the increase in revenue will be automatically allocated to K-14 education under Proposition 98 but will also support increased spending for Medicaid and higher education. Rather than expanding on-going programs, the governor is proposing an allocation of $2 billion to non-recurring spending for deferred maintenance and state facilities renovations and replacement, in addition to the $2 billion allocated to the rainy day fund. California is estimating that its share of the optional expansion of Medicaid under the Affordable Care Act will total $740 million in fiscal 2017, as a small portion of costs that were fully covered by the federal government for the first three years of implementation are partially shifted to the state. The governor's proposed revisions to the managed health care tax, which is estimated to generate approximately $1 billion, would compensate for this growing expense.

The budget proposal appears prudent in terms of restraining spending growth in favor of retaining flexibility for future economic weakness. The budget assumes solid economic growth in both fiscal 2016 and 2017, but notes the potential for a future downturn as well as risks associated with slower global growth or a stock market correction. As is the case in the current fiscal year, the state does not anticipate the need to issue cash flow notes in fiscal 2017.

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--'Fitch Rates $209MM Calif. Public Works Board Bonds 'A' Outlook Stable' (Oct. 19, 2015);
--'Fitch Rates California's $1.9B GOs 'A+'; Outlook Stable' (Aug. 19, 2015).