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California Governor's Fiscal 2015 May Budget Revision Proposal Highlights Good News

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NEW YORK (Standard & Poor's) May 22, 2014--Gov. Edmund G. Brown's May revision of his fiscal 2015 executive budget proposal is continued good news for California's credit quality (general obligation rating: A/Positive). State income tax collections remain robust compared to the current fiscal 2014 budget, and will leave the state with a fiscal year-end 2014 general fund balance $1.9 billion higher than the originally enacted 2014 budget going into fiscal 2015. This is in contrast to some states that have recently indicated softness in their personal income taxes against budget. Revenue projections could prove conservative: The state legislative analyst's office (LAO) projects significantly more general fund revenue in fiscal 2015 ($2.2 billion) than the state department of finance does, primarily due to higher projected capital gains tax.

The state legislature recently voted to put the governor's stiffened rainy day fund requirement proposal before voters in November, a development that could have potential long-term positive credit implications (see "The Challenge Of Establishing A State Budget Reserve: The California Example," published May 6, 2014, on RatingsDirect). The governor projects that the rainy day fund would increase to $4.6 billion in fiscal 2018, or 3.8% of projected 2018 expenditures, from $1.6 billion at fiscal year-end 2015, or 1.5% of proposed 2015 expenditures. If voters pass it, the new requirement could eventually lift the maximum size of the rainy day fund to 10% of revenues, and limit government discretion when to add or withdraw from the fund. As part of the rainy day fund agreement with the legislature, the state would also pay down $3 billion of additional debt in three years. Standard & Poor's Ratings Services believes California's use of excess revenue for a one-time debt

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payment is prudent in light of the temporary nature of Proposition 30 increases in sales and income tax rates.

The governor's May budget revision would also increase funding to the chronically underfunded California state teachers' retirement system (CalSTRS), addressing a growing unfunded liability whose full responsibility has not been clearly defined between the state, teachers, and school districts.

The governor's revised fiscal 2015 budget proposal draws down general fund balances by $2.4 billion, or 2.2% of proposed expenditures. However, the state believes this would otherwise have a $4.4 billion fiscal 2015 surplus without policy choices implementing one-time budget items, such as a $1.6 billion retirement of economic recovery bonds eliminating deferred payments to schools and community colleges, and accelerated loan repayments for transportation and cap and trade accounted for as a reduction in revenue. The May revision increases estimated cumulative net revenues by $2.4 billion for the three fiscal years from 2013 through 2015 over the governor's January proposal.

SOME CREDIT CONCERNS PERSIST

However, we believe certain credit concerns remain. The May revision proposes a drawdown in the combined balances of the general and rainy day fund reserves during fiscal 2015, even if largely the result of one-time expenditures. Combined general fund reserves and rainy day fund balances would decline to $2.1 billion from $2.9 billion, or to 2.0% of proposed general fund budgeted expenditures, a level we still see as low in view of the state's historically cyclical revenues. The state's temporary income tax surcharge, which would need a voter referendum to extend, expires at the end of fiscal 2018. As a result of the surcharge, California's dependence on the top 1% of taxpayers, and their capital gains, has temporarily increased, making revenue projections inherently less certain. The budget revision estimates the temporary surcharge will produce about $6 billion of additional personal income tax in fiscal 2015, or about 6% of general fund revenue.

Furthermore, the revision estimates that much of the higher-than-budgeted balances realized in fiscal 2014 are largely due to a one-time bump from higher annual bonus payments and previous shifts in federal tax policy. The LAO projects even higher capital gains tax than the state department of finance projects--$3 billion above the state's estimate--resulting in about $2.2 billion higher of net general fund revenues than the state's forecast when combined with the LAO's lower estimates for other revenues. In some years, California's final enacted budget has used the higher of either the state department of finance's or the LAO's revenue projections.

The May revision also projects a significant increase in the state's Medicaid population to 11.5 million in fiscal 2015, pushing coverage to an estimated 30% of the state's population, from 7.9 million before the passage of the federal Affordable Care Act (ACA). Although the federal government picks up the cost of optional ACA expansion, the state still has to fund 50% of the cost for the estimated 800,000 new individuals entering Medi-Cal under currently existing Medicaid rules as a result of increased publicity. The revision projects this will result in a significant $2.4 billion rise in state general fund costs over two years ($1.2 billion more than the governor's executive budget proposal released in January). Total fiscal 2015 health and human services spending would rise 2.7%, to $29.6 billion, from fiscal 2014.

Although the May revision proposes a significant fix to CalSTRS' unfunded pension liabilities, the state has still not begun to address its large $64.6 billion unfunded other postemployment benefit costs, primarily retiree medical care.

OTHER CHANGES TO THE PROPOSED BUDGET

The 2015 budget revision also assumes higher costs for the employees' retirement system due to longer life expectancy and retirement rate assumptions (for revised extra $342.7 million state general fund contribution), additional costs related to a severe drought, additional money to reimburse localities for unfunded mandate claims, and extra trial court funding. The May revision reduces debt service costs by $112.7 million compared with the January budget proposal due to lower interest rates and bond refunding savings.

As part of the proposed payment of more than $11 billion of internal and external debt in fiscal 2015, California would retire the remaining $3.9 billion of economic recovery bonds, and would pay down all of the governor's identified $34.7 billion "Wall of Debt" from fiscal 2011 by fiscal 2018, when the income tax surcharge expires.

TEACHER PENSION FUNDING

Standard & Poor's state rating criteria incorporate annual pension funding policy, with an emphasis on fully funding actuarial annually required contributions (ARC) (see "USPF Criteria: State Ratings Methodology," Jan. 3, 2011). California fully funds its ARC on its Employees' Retirement System (CalPERS). However, combined state and school district annual contributions to CalSTRS are set by statutory law and have been less than ARC for some time. As a result, CalSTRS was only 67% funded in its defined benefit program on an actuarial basis as of a June 30, 2012 actuarial date (the result of a $70.5 billion unfunded actuarial liability), and CalSTRS actuaries have projected CalSTRS will run short of assets in 33 years without funding changes.

The governor has proposed shoring up CalSTRS with increased contributions that the state projects will fully fund the system in about 30 years, although not with a specific requirement to fund the ARC. Under the governor's proposal, California would provide an extra $73.2 million to fund CalSTRS in fiscal 2015, with state contributions increasing over three years to fund benefits at an earlier level that was in effect before 1998, before benefits were raised and then rolled back as of 2012 for new employees.

State contributions to CalSTRS would rise to 6.3% in 2017; as well, the state would continue to pay 2.5% of payroll for a supplemental inflation protection program, from approximately 3% of payroll in fiscal 2014. The state proposes teacher contributions would rise to 10.25% of pay over three years from 8%, and school district contributions would rise over seven years to 19.1% from 8.25%--a substantial increase for school districts that we believe might create some political opposition. Total contributions from the state, teachers, and school districts would eventually rise to 35.7% from 19.3% of payroll today.

K-14 EDUCATION FUNDING

Proposition 98 K-14 education funding is largely unchanged in the May budget revision, increasing by $242 million during 2013-2015 from the January budget proposal, but down $700 million in fiscal 2015, to $60.9 billion. State fiscal 2015 general fund K-12 expenditures would be $44.7 billion, a 4.3% increase from fiscal 2014. Local school districts will benefit from the governor's proposed payment of remaining interyear prior funding deferrals. The rainy day fund proposal could also aid schools by funding a separate Proposition 98 reserve that could help even out swings in state funding. However, school districts may also have to increase retirement system contributions under the governor's new retirement system proposal (as described above). If the LAO's projection of higher property taxes is realized, the LAO estimates savings to the state would be no more than several hundred million dollars, as the extra revenues would be required for education purposes.

HIGHER-EDUCATION FUNDING

The May revision does not significantly change higher education funding from the January budget proposal. This is relatively good news for higher education: Under the governor's projection, the University of California and California State University would receive a 20% increase in general fund appropriations over four years through fiscal 2017, while students would benefit from a resident tuition freeze. Total state general fund higher education funding would be $12.5 billion in fiscal 2015, a 9.9% increase from fiscal 2014.

PRISONS

In February, the state obtained a two-year extension to meet a court-ordered capacity population cap of 137.5%. Based on the May revision, proposed Corrections and Rehabilitation general fund spending in fiscal 2015 would be $9.6 billion, a 2.9% increase from fiscal 2014.

RAINY DAY FUND

The proposed rainy day fund would require deposits whenever capital gains exceed 8% of general fund tax revenues (they are projected at 9.8% in fiscal 2015). In addition, California would set aside 1.5% of annual general fund revenue each year, with a cap on the size of the rainy day fund at 10% of revenues. The state could withdraw funds only for a disaster or if spending remains at or below the highest level of spending from the past three years. The maximum amount it could withdraw in the first year of a recession would be limited to one half of the fund's balance. Other requirements include a separate Proposition 98 K-14 school spending reserve, a requirement that California use half of each year's deposits for the next 15 years for supplemental debt payments or other long-term liabilities), and a requirement for a multiyear budget forecast (see "The Challenge Of Establishing A State Budget Reserve: The California Example" for more details).

If voters reject the stronger rainy day fund requirement in November, it would not affect fiscal 2015. The state's existing rainy day fund requirement, which we consider relatively weak and has not been funded in recent years, would then remain in effect.

THE RATING OUTLOOK IS POSITIVE

Our positive rating outlook reflects improved state finances, the prospect for an improved rainy day fund requirement, and improving general fund liquidity (see "Understanding California's Fiscal Recovery" published Jan. 14, 2014, for a prior discussion on the interaction between financial improvement and state liquidity). Expenditure cuts, the improved economy, and the temporary tax surcharge have lifted California's credit prospects. We will continue to monitor performance against budget in fiscal years 2014 and 2015; as well, we'll follow the result of the November referendum on the new rainy day fund proposal, looking at potential long-term structural improvement. California has made good progress, in our view, in working down its backlog of budgetary debts. However, we believe there remains pressure in the legislature to restore programmatic spending, despite significant remaining budgetary debts, large unfunded OPEB and pension liabilities, deferred maintenance, and infrastructure needs. Should the state adopt the LAO's or another higher revenue forecast for the purposes of increasing ongoing spending, it could endanger our current positive rating outlook.

RELATED CRITERIA AND RESEARCH

Related Criteria

USPF Criteria: State Ratings Methodology, Jan. 3, 2011

Related Research

- The Challenge Of Establishing A State Budget Reserve: The California Example, May 6, 2014
- Understanding California's Fiscal Recovery, Jan. 14, 2014