BBVA Research Flash

U.S.

California's Revenue Shortfall Will Trigger Further Cuts

- **$3.7 billion projected revenue shortfall in FY 2011-2012**
- **$13 billion+ deficit now expected heading into the next fiscal year**
- **The current budget establishes automatic spending cuts up to $2.5 bn this year**
- **Legislators must act to ensure long-term fiscal sustainability**

California's fiscal situation further deteriorated according to recently released reports. Yesterday, the California Legislative Analyst's Office (LAO) released a revised fiscal outlook that projects a revenue shortfall of $3.7bn for the current fiscal year that will lead to an expected $13 billion deficit heading into FY2013. Earlier this week, the state Controller reported that July-October revenues missed projections by $1.5bn, transfers to local governments exceeded the baseline by $1.8bn and state government expenditures were slightly under budget. The controller's lower revenue projection is primarily due reduced personal income tax revenue – which comprise nearly 2/3 of total general fund revenues – but lower corporate and sales tax revenues were also partly to blame. The total projected $3.7 billion revenue shortfall arose as a result of an overly optimistic revenue forecast in the FY12 budget. Due to strong tax collections in early 2011, the Governor raised the FY12 revenue projection by $4bn in June to help close a $26 billion deficit. However, these revenues are unlikely to materialize and thus further budget cuts are imminent. With falling revenues, rising retirement program costs, unfunded pension liabilities and debt service costs, California's fiscal situation is dire.

The first consequence of the revenue shortfall will be automatic spending cuts to state education and health expenditures. The FY12 budget included a two-tier trigger mechanism for spending cuts if revenue shortfalls were to exceed $1 or $2 billion. These cuts could amount to anywhere between $600 million (Tier I) to $2.5 billion (Tier I & II), but given the magnitude of the projected shortfall, it is likely that the cuts will approach the upper limit. California universities and K-14 education will bear the brunt of the reductions.

On the plus side, however, California's private sector employment growth is strengthening, and government sector layoffs have eased in recent months. Although the residential construction and real-estate sectors will not rebound sharply, specialized manufacturing sectors and the concentration of high-tech companies is propelling the state forward. As the private sector expands, income tax collections will strengthen; however, higher income tax revenues alone do not put California on a sustainable path.

Over the next five years, budget pressures will intensify. In 2006, California's retirement plan costs totaled near $3.6 billion per year but are projected to nearly double by 2016, as more retirees and ballooning healthcare costs add stress. In addition to higher costs, California's pension has been underfunded since 2003, and the LAO estimates that an additional $4 billion per year would be needed immediately to fully fund the obligations. Another line item with rising costs is debt service. California's long-term borrowing has climbed precipitously in recent years, and principal and interest debt service will rise from around $3 billion per year in 2006 to more than $7.3 billion by 2016. The debt-service-ratio will climb to its highest point in 30 years to 7% during this time, and thus the share of debt-service and retirement costs in revenues will approximately double from 2006 to around 14%.

In conclusion, to resolve its severe fiscal challenges, California must now shy away from short-term fixes that gloss over structural problems and turn to long-term solutions. For example, Proposition 98, which establishes minimum guaranteed funding for education based on realized revenues, may need to be addressed to increase budget flexibility to accommodate the state's other obligations such as entitlements and debt-service. Although historically low municipal bond yields are enabling the state to borrow and manage its cash flow at a minimal cost, budget pressures remain. If long-term fiscal sustainability is not ensured, the state's borrowing costs will climb.

Bottom line: The latest California LAO revenue forecast predicts a nearly $4 billion shortfall for this fiscal year. At this magnitude, between $2.0-2.5 billion of automatic spending cuts are triggered. These cuts will first impact K-14 and university education. The state legislature and Governor must now address a projected $13bn deficit for FY13 and create long-term solutions that recognize structural changes in the state's spending. Similarly, high projected federal deficits demand a long-term solution from policymakers to put the U.S. on a sustainable fiscal path.