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# California: resilient despite a changing budget picture



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*California capitalized on its previous economic expansion by growing reserves to historic levels. Since the last recession, it has repaid billions of dollars in budgetary borrowings, debt and deferrals; deposited surplus revenues into a rainy day fund; paid down other post-employment benefits (OPEB) and begun to prefund pensions. The state is better prepared to face the fiscal impacts of a slowing economy.*



*California passed budgets on time over the last 13 years and **built its rainy day fund.***

## INSTITUTIONALIZED CHANGES HELPED STRENGTHEN THE STATE'S CREDIT PROFILE

Aside from general economic resurgence, the state's credit profile improved with the following positive institutionalized changes:

**Proposition 25 (2010)** reduced the voting requirement to pass a budget in the California legislature from a super majority (two-thirds) to a simple majority (more than 50%) and would dock lawmakers' pay when the budget is late, incentivizing on-time budget passages.

**Proposition 2 (2014)** put in place a more stringent rainy day fund aimed at smoothing out the state's revenue volatility by requiring 1.5% of General Fund revenues plus any capital gains taxes that exceed 8% of General Fund revenues be deposited in the budget stabilization account (the "rainy day fund"). These funds must be used to repay the state's budgetary borrowing and make excess payments toward state pensions and retiree health costs. Debt repayment is required through 2029, at which time the debt repayments become optional.

**Proposition 30 (2012) and Proposition 55 (2016)** Proposition 30 temporarily increased sales taxes by 0.25% to 7.5% from 01 Jan 2013 to 31 Dec 2016, and personal income taxes by 3% to 13.3% for the top tax bracket from 2012 to 2018. Passed in 2016, Proposition 55 extended the personal income tax portion of Proposition 30 for 12 additional years (through 2030).

These changes helped the state pass budgets on time over the last 13 years and build its rainy day fund while also paying down its debts and liabilities. Since the Great Recession, the state has capitalized on the economic recovery and taken steps to prepare itself for the next economic recession.

The enactment of Proposition 2 has allowed the state to build its total reserves from unfunded in 2009 to a projected \$22.3 billion, which is at its constitutional maximum of 10% of General Fund revenues for fiscal year (FY) 2023. These actions have better prepared the state to handle a recession and earned it rating upgrades in 2019 to Aa2 by Moody's Investors Service, AA- by Standard and Poor's and AA by Fitch Ratings.

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### **CASH MANAGEMENT TOOLS ARE AVAILABLE**

In addition to the measures taken to balance the budget, California has many tools available to help manage any cash flow disruptions. The state can access more than 800 of its 1,500 separate funds to borrow for cash flow needs totaling \$102.2 billion as of 31 May 2024. It can also issue revenue anticipation notes (RANs) or revenue anticipation warrants (RAWs) in order to finance cash flow needs.

RANs are typically used to smooth out the timing difference between when revenues are collected and when bills are due. RAWs are issued in the absence of a budget. California has not issued RANs since FY15 and there are no plans to issue RANs through FY24-25. The state historically relied heavily on RANs to manage cash flows, so the lack of issuance demonstrates the state's improved financial health. And if needed, the state can issue registered warrants (or IOUs), which it did back in 2009.

However, the state is no longer allowed to issue long-term debt to fund operating deficits with the passage of Prop. 58 (2004).

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### **CHALLENGES LED TO BUDGET DEFICITS**

The state's General Fund posted an \$8.0 billion surplus in FY22<sup>1</sup> but a net General Fund deficit of -\$93.3 million after transfers out. General Fund reserves ended at \$74.05 billion, equal to 37.2% of General Fund revenues for FY22. Personal Income taxes saw a 5% decline from the prior year with sales and use taxes and corporation taxes offsetting the decline with 12.6% and 11.5% growth, respectively. Total General Fund tax revenues came in \$2.1 billion or 1.1% ahead of the prior year. Expenditures came in at \$44.7 billion, or 30.6% higher than FY21.

As FY23 began, risks to California's economic and revenue outlook, identified in the 2022-23 Budget Act, were realized: continued high inflation, multiple Fed interest rate increases and further stock market declines. Declines in the stock market and market-based compensation have an outsized effect on the state's revenue picture since the state relies heavily on personal income taxes and it has a progressive income tax structure.

The FY24-25 budget shortfalls are due to two main factors: a decline in income tax collections and delayed tax receipts following the 2023 winter storms. The 2022 decline in the equity market resulted in the state collecting less in income taxes than projected. And while the stock market bounced back by late 2023, the state collected less tax revenue due to the "capital loss carryover," which allows losses from previous years to offset capital gains or ordinary income in subsequent years, to reduce an individual's overall tax liability. The winter storms resulted in the IRS extending tax filing deadlines for 99% of all California taxpayers. This made it difficult to forecast revenues accurately.

These challenges led to an estimated \$31.7 billion budget deficit appearing in FY23-24 and now a \$46.8 billion deficit in FY24-25 and \$30 billion deficit in FY25-26. This lies in stark contrast to

estimated surpluses of \$73 billion in FY21, \$100 billion in FY22 and \$49 billion in FY23. The state's enacted Budget Act of 2024 solves for anticipated shortfalls in both 2024-25 and 2025-26 fiscal years. The state is solving two years of budget deficits in a single budget year to achieve an operating reserve surplus. Solutions to address the deficits include reserve draws, spending reductions, additional revenue sources, internal borrowing, funding delays and deferrals.

The remaining reserves after the \$6 billion budgeted draw in FY25 are projected to total \$22.2 billion, or 10% of General Fund expenditures. This includes \$17.6 billion in the budget stabilization account (BSA) (rainy day fund); \$1.05 billion in the public school system stabilization account (education reserve); and \$3.5 billion in the special funds for economic uncertainty. Remaining reserves at the end of FY26 after a projected draw of \$9 billion would total an estimated \$13.1 billion, or 6.0% of GF expenditures: \$10.5 billion in BSA, \$1.5 billion in the Special Fund for Economic Uncertainties and Prop. 98 reserves of \$1.05 billion.

## WHERE DO THE STATE'S FINANCES STAND TODAY?

Preliminary numbers show that state receipts are on par with budget estimates in the FY23-24 budget. According to the state controller's Fiscal Year-to-Date 30 June 2024 State Cash Report, total General Fund revenues came in \$3.1 billion or 1.5% ahead of the FY24 governor's budget and up \$40.6 billion or 24.3% above FYTD 30 Jun 2023. The year-over-year overperformance is due to the increase in two of the three largest tax revenue categories.

Personal income taxes and corporate income taxes came in above the prior year by 27.7% and 38.3%, respectively. FYTD 30 Jun 2024 expenditures came in just below budget by \$2.98 billion or (1.4%). Large swings in income tax collections are not out of the ordinary for the state and highlight the importance of recent measures governing reserve policies.

## PENSION FUNDING HAS IMPROVED

California sponsors two retirement systems: the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). The state has favorably made some progress to address its unfunded pension liabilities.

In September 2012, the California Public Employees' Pension Reform Act (PEPRA) eliminated contribution holidays and retroactive benefit increases, while prohibiting airtime (ability to buy extra years of service to count toward their pension benefits), increased current employee contributions, lowered defined benefit formulas and placed compensation limits on CalPERS members. These changes, now in place for over a decade, have improved funding levels.

A law passed in 2014, intended to eliminate the CalSTRS unfunded liability by 2046, requires increasing contributions each year. The state has also made additional supplemental pension contributions to both CalPERS and CalSTRS, above the required contributions during strong operating years. CalPERS funded ratio (amount of assets on hand to pay for obligations) was an estimated 72% for FY23, up over the prior year's 70.9%. CalSTRS funded ratio was 74.4% for FY22, up from 73% the prior fiscal year.

The state's total fixed costs, including debt service, pension contributions and retirement health care (other post-employment benefit or OPEB) contributions were 7.5% of total governmental fund expenditures in FY22, up over the prior year's 5.4%. When compared to other states, California fixed costs are slightly higher than New York's 6.0% but favorable compared to New Jersey's 13.1%, Connecticut's 23% and Illinois' 16.3%.



*State receipts are on par with budget estimates in the FY23-24 budget.*

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## **CALIFORNIA'S ECONOMY IS LARGE AND DIVERSE**

California's \$3.23 trillion economy is the largest in the nation. It accounts for nearly 14.4% of U.S. GDP, and on a standalone basis would be the fifth largest in the world, according to the International Monetary Fund (IMF). The state's real GDP grew by 1.2% in 2023, compared to the nation's 2.5% increase over the prior year.

California's economy is diverse and generally mirrors the nation's economy with major components in high tech, trade, entertainment, manufacturing and tourism. Though the economy's employment composition is similar to the U.S. overall, the state's unemployment rate was 5.2% as of June 2024, exceeding the nation's 4.1% during the same period. Mining and logging, trade, professional services, construction, education and health services, leisure and hospitality, and government sectors saw the largest job gains from June 2023 to June 2024. Areas of the economy contracting from June 2023 to June 2024 include manufacturing, information technology and financial services.

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## **CALIFORNIA IS AN ACTIVE ISSUER OF MUNICIPAL DEBT**

California is the second largest issuer of new municipal debt out of all fifty states, after Texas. State issuance totaled \$53.9 billion in 2023, according to The Bond Buyer. This accounts for 14.3% of 2023 issuance nationwide. The state issues two types of debt: general obligation (GO) and annual appropriation (lease revenue).

California state GO bonds are rated Aa2 by Moody's, AA- by Standard and Poor's and AA by Fitch Ratings. GO debt must be voter approved in a general election prior to issuance. Debt service payments enjoy a priority payment status from moneys in the General Fund, second only to payments to the public school system and public institutions of higher education. Lease payments that support various lease and appropriation bonds are also considered priority payments, but are lower on the list of priorities.

Under California law, GO debt service payments are considered a continuous appropriation, which means they get paid with or without a formal appropriation by the legislature or an enacted budget. Though not as strong, appropriation bonds are also continuously appropriated with prior approval from the Department of Finance, indicating that sufficient funds are available for payment of debt service.

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## **THE DEBT LOAD IS LARGE BUT MANAGEABLE**

The state of California has the nation's largest amount of tax-supported debt outstanding at \$96 billion in 2022 (most recent data available), according to Moody's. However, on a per capita basis, the state's debt burden is twelfth highest out of all 50 states at \$2,460 versus the Moody's median of \$1,178. On a personal income basis, California was fifteenth highest in the nation, at 3.2% versus the Moody's median of 2.2%.

Net tax-supported debt in relation to the size of the state's economy ranked it sixteenth, at 2.7% of state gross domestic product, vs. the Moody's median of 2.0%. California's debt ratio is likely to increase over the next few years, as the state has approximately \$23.7 billion of GO bonds authorized but unissued and approximately \$6.5 billion of authorized and unissued lease revenue bonds as of 01 Jan 2024. Despite the high debt load, total debt service on the state's bonded debt is manageable and accounts for 3.9% of total governmental funds as of FY22.

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## **STATE CHALLENGES STEM FROM THREE FACTORS**

Many of the state's fiscal challenges can be directly linked to three main sources: inflexible expenditures, structural governance problems and a volatile and concentrated revenue mix. Previous weakening of California's credit more than a decade ago was sparked by an economic recession but these inherent risks exacerbated the state's challenges and limited the state's ability to react to the weakening revenue.

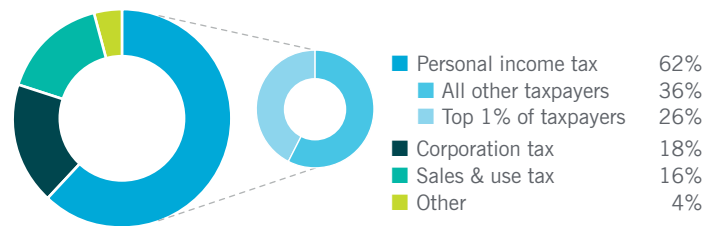
**Inflexible expenditures.** The state initiative system often dictates policy and reduces its expenditure flexibility. Many initiatives constrict revenue but increase or maintain expenditures. For example, Proposition 98 calls for approximately 40% of the state’s General Fund to go toward education, and in the process reduces GO debt service from first to second position in priority of payments. In addition, Proposition 13 limits property taxes and effectively shifts local expenses to the state.

**Structural governance problems.** For years, the state has dealt with structural governance problems such as its highly polarized political environment often causing bipartisan gridlock and budget stalemates. Also, the state requires a two-thirds majority vote of the Legislature to raise taxes. Some progress was made when the state lowered the threshold of approval to pass the budget to just a simple majority. Prior to 2010, a two-thirds majority was required to pass a budget.

**A volatile and concentrated revenue mix.** Personal income taxes are the largest component of General Fund revenues, accounting for 62% in FY22. California’s income tax rate structure is steep (rates range from 1% to 13.3%), thus a small number of taxpayers pay a large share of tax revenues. The Franchise Tax Board (California’s tax collection agency) indicates that the top 1.1% of California taxpayers paid approximately 41% of total personal income tax in tax year 2021. Therefore, about 26% of the state’s General Fund revenue depends on 1.1% of taxpayers (Figure 1). In addition to its having an extremely concentrated revenue mix, the state’s primary tax sources are also highly economically sensitive (Figure 2).

This concentration in an economically sensitive revenue stream means equity market declines can quickly impact the state’s finances. Additionally, sales taxes, another economically sensitive revenue stream, accounted for 16% of General Fund revenues in FY22. These factors have resulted in wide and sudden revenue, financial and credit swings.

**Figure 1: California’s revenues are highly concentrated**



Data source: State of California Comprehensive Annual Financial Report, Fiscal Year End 30 Jun 2022 and the California Franchise Tax Board, Personal Income Tax Annual Report 2022

**Figure 2: Primary tax sources are highly economically sensitive**

*Percent change in revenue from prior year*



Data source: State of California Comprehensive Annual Financial Reports 1994-2022.

**A NUMBER OF CREDIT SAFEGUARDS ARE IN PLACE**

Despite the state’s inherent risks, a number of safeguards ensure timely payment of GO bond debt service:

- GO bonds are secured by the full faith and credit of the fifth largest economy in the world.
- Debt service is a priority payment from the General Fund, second only to support for the public school system and public institutions of higher education.
- The state of California is not authorized to file Chapter 9 bankruptcy and cannot cease to exist.



- GO debt must be approved prior to issuance by the citizens of California in a general election, obligating the citizens for repayment.
- The appropriation to pay debt service on state GO bonds, as set forth in the enabling Bond Acts, cannot be repealed until the principal and interest on the bonds has been fully paid. Debt service on the bonds is a continuous appropriation under the state constitution, meaning there is no need for appropriation from the legislature to pay.

These provisions give bondholders a certain sense of security that debt service will be made.

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## **LOOKING FORWARD: WEATHERING THE CHALLENGES**

Structural governance changes have helped streamline decisions and improve California's fiscal position. As a consequence, the state is better positioned to deal with the challenges presented by the pandemic and any future recession. The state has successfully weathered recessionary challenges historically and is expected to continue to do so going forward.

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#### Endnotes

1 The state of California failed to file its annual report for FY23 by the 31 Mar 2024 continuing disclosure deadline. The delay is a result of the state transitioning from several separate legacy accounting systems to a new statewide accounting system. The FY22 report was released 15 Mar 2024 and contains the most recent audited financials available for the state of California, therefore this paper references the FY22 numbers.

#### Sources

Ability to service long-term liabilities and fixed costs improves, Moody's Investors Service, September 26, 2023; State of California Franchise Tax Board, Personal Income Annual Reports, 2022, Tax Year 2021; State of California Various Purpose General Obligation Bonds Official Statement, dated April 11, 2024; State of California, Comprehensive Annual Financial Report, Fiscal Year Ended 30 June 2022; Bureau of Labor Statistics, Economy at a Glance; Bureau of Economic Analysis; The Bond Buyer; California Department of Finance, Finance Bulletin, June 2024; California State Controller, Monthly State of General Fund Cash Receipts and Disbursements, June 2024; Fast Facts About CalPERS Investment and Pension Funding; California Public Employees' Retirement System, 2023 Annual Review of Funding Levels and Risks, November 2023; CalSTRS Fast Facts, Fiscal Year Ended 30 June, 2023; 2024 Budget Agreement Fact Sheet; Senate Budget and Fiscal Review Committee, 2024-25 Budget, Key Highlights, June 22, 2024; California State Budget 2024-25, Gavin Newsom, Governor, State of California, June 26, 2024; California Employment Development Department, California Gained 22,500 Nonfarm Payroll Jobs in June 2024.

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