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California is better positioned to weather the economic downturn

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The state of California has historic levels of reserves. 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 prefunded pensions. The state is better prepared to deal with the economic impacts of the recession triggered by the coronavirus pandemic.

California passed budgets on time over the last 11 years and build 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 (50%) and would dock lawmakers' pay when the budget is late, incentivizing on-time budget passage.

Proposition 2 (2014) is 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") and be used to repay the state's budgetary borrowing and make excess payments towards state pensions and retiree health costs.

Proposition 30 and Proposition 55 (2012). Proposition 30 temporarily increased sales taxes by 0.25% to 7.5% from 1 January 2013 to 31 December 2016, and personal income taxes by 3% to 13.3% for the top tax bracket from 2012 to 2018. Passed in

2016, Proposition 55 extends the personal income tax portion of Proposition 30 for 12 additional years (through 2030).

Because of these changes, the state has been able to pass budgets on time over the last 11 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 improved economic recovery and taken steps to prepare itself for the inevitable economic recession.

The enactment of Proposition 2 has allowed the state to build its total reserves from unfunded in 2009 to $17 billion, or 12% of general fund revenues by fiscal year (FY) 2020. As a result, these actions have better prepared the state to handle the recession and earned rating upgrades to 'Aa2' by Moody's Investors Service, 'AA-' by Standard and Poor's, and 'AA' by Fitch Ratings.

Prior to COVID-19, the state had a record level of reserves and had eliminated its budgetary borrowing.

WORKING TO FILL THE BUDGET GAP

Prior to COVID-19, the state's budget and economic picture looked solid. Unemployment was 3.9% as of February 2020. The state had a record level of reserves and had eliminated its budgetary borrowing that it used historically to balance the budget. It was making supplemental payments to fund its pensions and began to prefund its OPEB liabilities. Revenues were trending above projections and in January 2020, the governor's budget was forecasting a $5.6 billion surplus.

Then in March 2020, the COVID-19 pandemic hit. State revenues declined, temporarily, from recent historic highs due to business closures caused by the virus and expenditures increased to manage and mitigate COVID-19. When the 2020 Budget Act was enacted in June 2020, the legislature had to solve for a $54 billion deficit or ~40% of general fund spending for fiscal year (FY) 2021 reflecting a projected decline in income and increased costs related to dealing with COVID-19. The deficit is large but not as large as deficits faced in the Great Recession on a percent of budget basis. California faced an estimated $41 billion deficit or 45% of the budget in 2008 and $60 billion deficit or 58% of the budget in 2009. The state unfortunately has seen deficits such as these before and was successful in navigating through the challenges.

To fill the gap for FY2021, the state drew down a portion of its reserves, borrowed from internal funds they refilled over the last decade, deferred money to K-14 education, suspended program expansions from prior years' budgets and relied on federal CARES Act funding. The state has relied upon many of these actions in previous recessions to balance the budget.

CASH MANAGEMENT TOOLS ARE AVAILABLE

In addition to the measures taken to balance the current budget, California has many tools available to help manage any cash flow disruptions. The state can access more than 700 of its 1,300 separate funds to borrow for cash flow needs totaling $48 billion as of December 2020. It can also issue revenue anticipation notes (RANs) or revenue anticipation warrants (RAWs) in order to finance cash flow needs.

RANs are typically utilized 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 for FY21. The state historically relied heavily on RANs to manage cash flows; the subsequent 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. The state, however, is no longer allowed to issue long-term debt to fund operating deficits with the passage of Prop. 58 in 2004.

WHERE IS THE STATE TODAY?

Despite the expected decline in revenues due to the pandemic, tax collections for the first six months of FY21 have tracked better than budgeted. The state controller reported that its three largest tax sources (personal income taxes, sales taxes and corporate income taxes) between July and December 2020 were 26.5% ($18.5 billion) ahead of the 2020 budget act assumptions for FY21.

The personal income tax outperformance was due to the state's progressive income tax structure, which is more heavily weighted toward high-wage earners who generally have not lost as many jobs from the pandemic versus blue-collar workers. Additionally, the stock market was higher than was anticipated when the budget was approved. Consumer spending dropped briefly in the spring, and has since rebounded within 10% of pre-pandemic levels as of October 2020 according to the Legislative Analyst Office.

On 8 Jan 2021, Governor Gavin Newsom presented his 2021-2022 budget totaling $227.2 billion. The general fund budget proposal totals $164.5 billion, up 5.5% over the prior year's revised budget and includes a $15 billion windfall due to a budget overcorrection last year given the extraordinary uncertainty caused by the COVID-19 pandemic.

Governor Newsom's current budget forecasts the state to end FY22 with $18.8 billion in total reserves, an increase of $7.5 billion over the last year's enacted level. Spending of the windfall is largely geared towards one time or temporary disbursements on housing and homelessness and additional discretionary COVID-19 aid; depositing money in the special fund for economic uncertainty; expanding tax incentives for builders and small businesses and tax refunds to low income residents; and repaying special loans made in FY21 and additional payment to CalPERS. Additionally, the proposed budget includes funds to pay down K-14 deferrals made last fiscal year and to help reopen schools. A revised budget will come in May with lawmakers' approval required by June 15.

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A large and diverse economy

California's $3.1 trillion economy is the largest in the nation. It accounts for 14.6% of the 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 2.6% in 2019, compared to 2.3% for the U.S. as a whole, according to the U.S. Bureau of Economic Analysis.

California's economy is diverse and generally mirrors the nation's economy with major components in high tech, trade, entertainment, manufacturing and tourism. The recession resulting from the pandemic increased the state's unemployment rate from 3.9% as of February 2020 (pre-pandemic), peaking at 16.4% by April and May 2020 and sits at 8.2% as of November 2020. Leisure and hospitality sectors saw the largest job losses. But some parts of the economy, after initial declines, began to bounce back and stabilize including sales of single family homes, and construction activity.

A large and active issuer of municipal debt

California is the nation's largest issuer of new municipal debt, with issuance totaling $69.2 billion in 2020, according to *The Bond Buyer*. This accounts for 14.6% of 2020 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. GO debt of the state must be voter approved by the citizens of the state of California in a general election prior to issuance. Debt service payments on all state GO bonds 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, general obligation debt service payments are considered a "continuous appropriation" which means that 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.

A large but manageable debt load

The state of California has the largest amount of tax-supported debt outstanding in the nation at $84.8 billion in 2019, according to Moody's. However, on a per capita basis, the state's debt burden is the twelfth highest of all 50 states at $2,147 versus the Moody's median of $1,071. When comparing it on a personal income basis, California was fifteenth highest in the nation, at 3.2% versus Moody's median of 2%. Net tax-supported debt in relation to the size of the state's economy ranked it sixteenth at 2.7% of state GDP, vs. Moody's median of 1.9%.

California's debt ratio is likely to increase over the next few years, as the state has approximately $31.9 billion of general obligation bonds authorized but unissued and approximately $7.6 billion of authorized and unissued lease revenue bonds as of 1 Jul 2020. Despite the high debt load, total debt service on the state's bonded debt is manageable and accounts for 4.9% of total governmental funds as of FY19.

STATE CHALLENGES STEM FROM THREE FACTORS

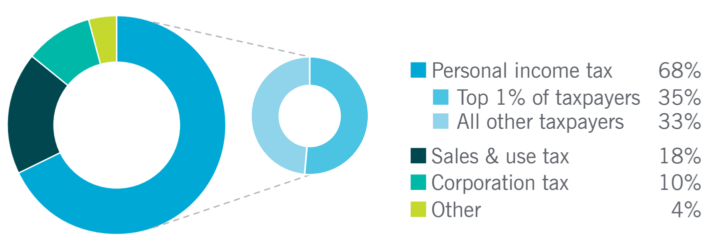
Many of the state's fiscal challenges can be directly linked to three main sources: inflexible expenditures, structural governance problems and a volatile and concentrated revenue mix. The previous weakening of California's credit was sparked by the economic recession, but these inherent risks exacerbated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

Inflexible expenditures. The state is constrained by its inflexible expenditures driven by its initiative system, which often dictates policy and reduces its expenditure flexibility. Many initiatives constrict revenue but increase or maintain expenditures. For example, Proposition 98 calls for 40% of the state's general fund to go towards 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. It used to be a two thirds majority to pass a budget, but the passage of Proposition 25 changed the requirement to a simple majority as of November 2010.

A volatile and concentrated revenue mix. Personal income taxes are the largest component of general fund revenues, accounting for 68% of general fund revenues for FY19. California's income tax structure is steep (with rates ranging from 1% to 13.3%), thus a small number of taxpayers pay a large share of tax revenues. The Franchise Board (California's tax collection agency) indicates that the top 1.4% of California taxpayers paid approximately 51% of total personal income tax in tax year 2017. That means 35% of general fund revenue depends on 1% of taxpayers.

Figure 1: California's revenues are highly concentrated



Data source: State of California, Comprehensive Annual Financial Report, Fiscal Year End 30 June 2019 and the California Franchise Tax Board.

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, 1994-2019.

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 revenues stream, accounted for 18% of general fund revenues for FY19. These factors can result in wide and sudden financial and credit swings, as has occurred in the past.

A NUMBER OF CREDIT SAFEGUARDS ARE IN PLACE

Despite the state's inherent risks, it has a number of safeguards to ensure timely payment of GO bond debt service. These provisions give bondholders a certain sense of security that debt service will be made.

- GO bonds are secured by the full faith and credit of the fifth largest economy in the world.
- GO bond debt service has been identified as 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.

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-induced recession. The state's outlook is uncertain. Coronavirus caseloads are fluctuating, and it is uncertain when vaccines and better treatment plans will become more widely available and whether additional federal aid will be forthcoming. However, the state has successfully weathered recessionary challenges historically, and is expected to continue to do so going forward.

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Endnotes

Sources

State of California, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2019; California State Budget 2020-21, Gavin Newsom, Governor State of California, June 29, 2020; Governor's Budget Summary 2021-2022, Gavin Newsom, Governor State of California; The 2021-22 Budget: Overview of the Governor's Budget, Legislative Analyst Office, January 2021; The 2021-22 Budget: California's Fiscal Outlook, Legislative Analyst Office, November 18, 2020; Bureau of Labor Statistics; The BondBuyer; California Department of Finance, Finance Bulletin, December 2020; California State Controller, Monthly Statement of General Fund Cash Receipts and Disbursements, December 2020; California Franchise Tax Board; State of California Variable Rate General Obligation Bonds, Series 2020A Official Statement, dated November 10, 2020.

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