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August 2023

# California is better positioned to weather an economic downturn

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*The State of California started 2022 with 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 began to prefund pensions. The state is better prepared to face the economic impacts of a potential recession.*

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*California passed budgets on time over the last 12 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)** 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 toward state pensions and retiree health costs. Debt repayment would be 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 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 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 improved 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 rating upgrades in 2019 to Aa2 by Moody's Investors Service, AA- by Standard and Poor's and AA by Fitch Ratings.

> *The state's General Fund posted a $45.6 billion net surplus in FY21.*

## 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 1,400 separate funds to borrow for cash flow needs totaling $97.6 billion as of 30 June 2023. 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 FY23-24. 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).

## CHALLENGES LED TO A 2023 BUDGET DEFICIT

The state of California failed to file its annual report for FY22 by the 31 March 2023 continuing disclosure deadline. The delay, according to the previous state controller, Betty Yee, is a result of "the cumulative impact of delays in the completion of Annual Comprehensive Financial Reports for the three previous fiscal years, which was due to a large number of State Departments transitioning from several separate legacy accounting systems to a new statewide account, budget, cash management and procurement information technology system, contributing to delays in the state departments providing information to the state controller necessary for the preparation of the Annual Comprehensive Financial Report for such years."

The FY21 report was released 23 March 2023 and contains the most recent audited financials available for the state of California, therefore this paper references the FY21 numbers. The state controller expects a significant delay in the issuance of the State's Annual Comprehensive Financial Report for FYE 30 June 2022, beyond 31 March 2023.

The state's General Fund posted a $45.6 billion net surplus in FY21, equal to 23.2% of General Fund revenues. Strong economic conditions helped California achieve the surplus, given that 96.7% of General Fund revenue is derived from the state's largest three taxes: personal income taxes, sales and use taxes and corporation taxes. In addition, California received federal pandemic related aid, but this aid is held outside the General Fund in a separate Federal Fund. General Fund tax revenues came in $41.1 billion or 26.3% ahead of prior year and 43% higher than estimates. Expenditures came in at $7.9 billion or 5.7% higher than FY20, but 9.3% higher than budget.

As the start of the 2023 fiscal year began, risks to California's economic and revenue outlook, identified in the 2022-23 Budget Act, have been realized: continued high inflation, multiple federal reserve bank 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. As a result, FY23-24 General Fund Revenues are down $25.9 billion over the prior year's revised estimates, which is a very different revenue picture than last year.

These challenges have led to an estimated $31.7 billion budget deficit appearing in FY23-24. This lies in stark contrast to surpluses of $73 billion in FY21, $100 billion in FY22 and $49 billion in FY23. The state plans to address the deficit through fund shifts; spending reductions and pullbacks of previously approved spending; funding delays; revenue and internal borrowing; and trigger reductions.

The budget does not include a drawn on reserves. Total reserves are $37.8 billion, which includes $22.3 billion in budget stabilization account (BSA) (rainy day fund), $10.7 billion in public school system stabilization account (education reserve); $3.8 billion in the special funds for economic uncertainty and $900 million in the safety net reserve (protect safety net services during economic downturn).

Maintaining reserves is important, given the uncertain revenue forecasting for this budget. Because of strong winter storms, a disaster declaration was declared for 55 of 58 counties comprising over 99% of California's tax filers, extending income tax filing deadlines from 15 April to 16 October 2023. It's estimated that $42 billion in anticipated revenues will not come until October. The state may look to use reserves if revenues underperform budget.

## WHERE IS THE STATE TODAY?

Preliminary numbers show that state receipts are on par with budget estimates in the FY22-23 budget. According to the state controller's *Fiscal Year-to-Date 30 June 2023 State Cash Report*,

> *The estimated $31.7 billion budget deficit lies in stark contrast to surpluses in recent years.*

total General Fund revenues came in $860.5 million or 0.5% ahead of the FY23 governor's budget but down $71.6 billion or 29.1% below FYTD 30 June 2022.

The year-over-year underperformance is due to the decline in two of the three largest tax revenue categories. Personal income taxes and corporate income taxes came in below the prior year by 34.1% and 32.9%, respectively. The personal income tax loss was due to the state's progressive income tax structure that is more heavily weighted toward high-wage earners who rely heavily on capital gains taxes. Those taxes have underperformed given the decline in the stock market. FYTD 30 June 2023 expenditures came in under budget by $10.8 billion or 4.2%.

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

In September 2012, the California Public Employees' Pension Reform Act (PEPRA) eliminated contribution holidays and retroactive benefit increases, while prohibiting air time, increasing current employee contributions, lowering defined benefit formulas and placing compensation limits on CalPERS members.

The state has also made additional supplemental pension contributions to both CalPERS and CalSTRS, in addition to the required contributions during strong operating years. Additionally, AB1469 was passed on 24 June 2014, intended to eliminate the CalSTRS unfunded liability by 2046 by requiring increasing contributions each year. CalPERS funded ratio (amount of assets on hand to pay for obligations) was 80.7% for FY21, up over prior year's 70.6%. The improvement is due in part to a 21.3% investment return in FY21.

CalSTRS funded ratio was 73% for FY21, up from 67% the prior fiscal year. Fixed costs, including debt service, plus pension and retirement health care (other post-employment benefit or OPEB) contributions are 5.4% of total governmental fund expenditures in FY21, down over prior year's 9%. When compared to other states, California is on par with New York's 5.3% but favorable compared to New Jersey's 13.2%, Connecticut's 22% and Illinois' 16.3%.

## CALIFORNIA'S ECONOMY IS LARGE AND DIVERSE

California's $3.6 trillion economy is the largest in the nation. It accounts for nearly 14% 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 the first quarter of 2023 (seasonally adjusted annualized basis) after a 2.4% increase in fourth quarter 2022 and an 0.4% increase in 2022. California's real GDP was 5.3% above its pre-pandemic level (fourth quarter 2019) as of the first quarter of 2023.

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 4.2% as of February 2020 (pre-pandemic), peaking at 16% by April 2020 and now sits at 4.6% as of June 2023. 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.

California recovered 101% of the 2.7 million jobs lost in March and April 2020 between May 2020 and June 2023. This is just above the nation's recovery of 100% of the 22 million jobs lost.

## CALIFORNIA IS AN ACTIVE ISSUER OF MUNICIPAL DEBT

California is the second largest issuer of new municipal debt out of all fifty states, after New York. California's issuance totaled $46.98 billion in 2022, according to The Bond Buyer. This accounts for 12% of 2022 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.

## THE DEBT LOAD IS LARGE BUT MANAGEABLE

The state of California has the nation's largest amount of tax-supported debt outstanding at $84.4 billion in 2020 (most recent data available), according to Moody's. However, on a per capita basis, the state's debt burden is eleventh highest out of all 50 states at $2,144 versus the Moody's median of $1,039. On a personal income basis, California was sixteenth highest in the nation, at 3.0% versus Moody's median of 1.9%.

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. Moody's median of 2.0%. California's debt ratio is likely to increase over the next few years, as the state has approximately $29 billion of GO bonds authorized but unissued and approximately $5.8 billion of authorized and unissued lease revenue bonds as of 01 Jan 2023. Despite the high debt load, total debt service on the state's bonded debt is manageable and accounts for 2.7% of total governmental funds as of FY21.

## STATE CHALLENGES STEM FROM THREE FACTORS

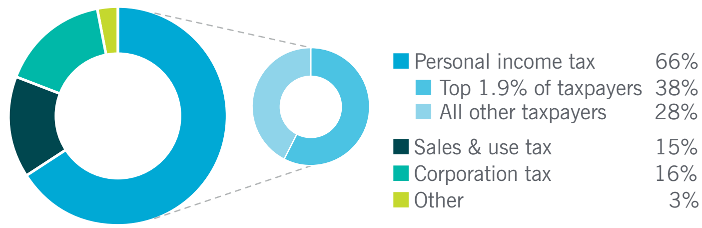
Many of the state's fiscal challenges can be directly linked to three main sources: inflexible expenditures, structural governance problems and a volatile and concentrated revenue mix. The previous weakening of California's credit was sparked by the economic recession, but these inherent risks exacerbated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

**Inflexible expenditures.** The state 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 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 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 66% in FY21. California's income tax 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 1.9% of California taxpayers paid approximately 57.1% of total personal income tax in tax year 2020.

### Figure 1: California's revenues are highly concentrated




Data source: State of California Comprehensive Annual Financial Report, Fiscal Year End 30 Jun 2021 and the California Franchise Tax Board, Personal Income Tax Annual Report 2021

### 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 1994-2021.

Therefore, about 38% of the state's General Fund revenue depends on 1.9% of taxpayers (Figure 1). In addition to being a concentrated revenue mix, the state's primary 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 revenues stream, accounted for 15% of General Fund revenues for FY21. These factors have resulted in wide and sudden financial and credit swings.

## 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.

## 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 it 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

### Sources

State of California, Comprehensive Annual Financial Report, Fiscal Year Ended 30 Jun 2021; California State Budget 2020-21, Gavin Newsom, Governor State of California, 29 Jun 2020; California State Budget 2023-24, Gavin Newsom, Governor State of California, 27 Jun 2023; Bureau of Labor Statistics; The BondBuyer; California Department of Finance, Finance Bulletin, July 2023; California state controller, Monthly Statement of General Fund Cash Receipts and Disbursements, July 2023; California Franchise Tax Board, Personal Income Annual Reports, 2021; State of California Various Purpose General Obligation & Refunding Bonds Official Statement, dated 05 Apr 2023; Moody's Investors Service, Medians-State debt rose 2.5% in 2020, spurred by pandemic-linked borrowing, 14 Jun 2021; Fast Facts About CalPERS Investment and Pension Funding, February 2023, www.news.calpers.ca.gov; CalSTRS Fast Facts, Fiscal Year Ended 30 Jun 2022.

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