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Fitch: California 2024 Budget Proposal Benefits from Prior Budgetary Actions

Fitch Ratings-New York/San Francisco-25 January 2023: California is well-positioned to address weaker revenue performance both in the current fiscal year 2023 and in the upcoming fiscal 2024, says Fitch Ratings.

California Governor Newsom's executive budget proposal for fiscal 2024 addresses lower than anticipated revenues by tapping resilience built into the fiscal 2023 and previous budgets without dipping into the rainy day fund (the budget stabilization account) or taking deep cuts to spending. The state now projects fiscal 2023 general fund revenues, prior to transfers, will be $12 billion (5.5%) lower than the June 2022 enacted budget estimate and down 5.6% yoy. General fund revenues are forecast to be essentially flat to fiscal 2023 at $209.7 billion in fiscal 2024, $23.7 billion (10.2%) lower than the June 2022 estimate, but still well above pre-pandemic levels.

The lower revenue forecast is driven largely by weakness in the personal income tax (PIT) that began to be evident at the start of fiscal 2023 in both withholding and estimated payments cash receipts. Lower withholding and capital gains are expected to be the main drivers of lower PIT revenues in the forecast. The PIT is highly sensitive to changes in the economy and the forecast reflects slower economic growth after the very rapid pace of growth immediately following the pandemic recession. The economic assumptions underlying the governor's budget proposal assume slightly stronger growth than does Fitch's economic outlook for the U.S., with the state assuming 0.9% real national GDP growth in 2023 versus Fitch's outlook of 0.2%. Fitch anticipates a mild recession beginning in 2Q23 while the governor's economic forecast anticipates slower economic growth, but no recession, leaving the state's revenue forecast susceptible to downside risk.

Balancing Actions

Prior enacted budgets enhanced financial resilience that will allow the state to address the current moderate slowdown. These budgets reduced budgetary and other debt, limited growth in on-going spending, applied non-recurring revenues to one-time spending including for capital investment rather than debt issuance, placed revenue triggers on new programs, and built reserves.

The bulk of the budget balancing actions proposed by the governor involve some form of spending reduction rather than revenue enhancement and are focused on funding delays, reductions and pullbacks, and trigger reductions that can be restored if the revenue picture improves. The budget also eliminates $3 billion that was available but not allocated in the fiscal 2023 budget to address potential inflation costs, withdraws a proposal to retire $1.7 billion in general obligation bonds using cash, shifts anticipated cash funding of capital projects to lease revenue bond issuance, and eliminates supplemental deposits to the budget stabilization account and other reserves.

The budget proposal continues programmatic spending that was funded in the fiscal 2023 budget, although in some cases funding is delayed or subject to trigger reductions. This includes initiatives in climate resilience, child care investments, transitional kindergarten, universal school meals, higher education investments and expanding health care access. The budget continues a multi-year investment in various state-wide infrastructure projects and housing development to address homelessness and affordability. The budget also maintains the accelerated paydown of state retirement liabilities as required by Proposition 2, with $1.9 billion in additional payments in fiscal 2024.

Fitch anticipates the details of the enacted budget will vary from the governor's plan, which will be updated in May to reflect any changes in the economy. If the economic situation deteriorates, the governor may propose additional program reductions as well as use of the budget stabilization fund, which is fully funded at $21.5 billion as of fiscal 2023 (10.2% of fiscal 2023 revenues). It is Fitch's expectation that the state will continue to make decisions that support a structurally balanced budget and that it will take the steps necessary to align expenditures with revenues as the revenue outlook develops.

Contact:

Karen Krop
Senior Director
+1-212-908-0661
Fitch Ratings, Inc.
300 West 57th Street
New York, NY 10019

Bryan Quevedo
Director
+1 415-732-7576

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com