

# Bond Case Briefs

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## California Inequality During Outbreak Drives Its Budget Windfall.

- **State expects \$15 billion surplus as pandemic hits poor harder**
- **Reliance on rich for revenue may backfire as firms leave state**

California's budget is benefiting from the disproportionate impact of the coronavirus outbreak that's thrown lower-income employees out of work and onto the streets while highly paid residents who can work remotely are snapping up new homes to ride out the pandemic.

The state, with a progressive tax system that rakes in more revenue when the income of the highest earners rises, expects to collect a record amount from capital gains as wealthy residents reap the rewards of a booming stock market. California has taken in more in sales-tax receipts year to date than it did over the same period last year as people shop online for everything from groceries to \$275 pajamas.

California's reliance on the fortunes of the rich, which led to multi-billion dollar deficits in the past, is allowing it to now project a \$15 billion surplus after officials had previously girded for a \$54 billion two-year shortfall. As Covid-19 infected more than 3 million people and killed almost 35,000 in California, officials there, as in other states now scaling back their initial dire forecasts, failed to estimate the extent of the success of the top 1% amid the pandemic.

"Everything is pointed up for the state of California right now," said Jennifer Johnston, director of research for Franklin Templeton Fixed Income's municipal bond team. "This recessionary period has not impacted high wealth earners. And the state is highly reliant on them for cash revenue. They're generally still employed, they haven't seen the layoffs like we've seen among low income."

California, which levies a top rate of 13.3% on income, is home to more billionaires than any other U.S. state, according to the Bloomberg Billionaires Index ranking of the world's wealthiest 500 people. Nearly half of the state's personal income tax collections come from the top 1% of earners.

Meanwhile, nearly half a million leisure and hospitality jobs in California have been lost year to date, while the typically higher-paying financial activities sector added 4,300 positions over the same period, another sign of the uneven recovery. A survey released in December from the Public Policy Institute of California showed that about 40% households with annual incomes of under \$40,000 reduced work hours or pay in the last 12 months, with a similar share forced to cut back on food.

The state's finances are likely to be buttressed even more as the new Biden administration pushes a \$1.9 trillion Covid relief package that could send more federal aid to the Golden State. That could allow Governor Gavin Newsom and lawmakers to redirect state tax money toward those most in need.

Newsom has proposed tapping the surplus for \$600 checks to 4 million low-income Californians. He also wants to spend \$1.75 billion on housing and homelessness programs and \$2 billion to help schools open for in-person education more quickly.

But the state's flush treasury obscures a disturbing trend: high-profile companies such as HP Inc. and billionaires such as Elon Musk are leaving the state. While businesses and people have for years departed the Golden State for lower-tax locations, the pandemic and the potential of remote work continuing in the future raises concerns that the exodus could speed up and pose a risk to the vibrancy of the world's fifth-largest economy. Indeed, despite the surplus, the state still sees deficits ahead.

"The fact that the state is still running a budget surplus this year reduces the urgency to solve some of these longer-term problems," said Scott Anderson, Bank of the West's chief economist. "I do think the economic pain could grow, the longer they delay these sorts of adjustments. And there could be a bit of a snowball effect."

When asked during his recent budget briefing what he can do to prevent more companies and billionaires from leaving the state, Newsom noted the success of recent initial public offerings of companies based there. He pointed to his proposed budget allocations to education and business grants when pressed.

"The state is still this remarkable, remarkable home to more dreamers and doers than any other part of the globe," the first-term Democrat and businessman said. "There's no state on planet Earth that I'd rather do business in than the state of California."

But for some Democratic lawmakers, more needs to be done to help those hurt most by the pandemic after years of growing inequality. Several members of the Assembly have introduced a bill that would raise the corporate tax rate on certain companies for a dedicated funding stream for homelessness services.

As the pandemic bears down more heavily on lower-income residents, lawmakers will have to make difficult decisions while balancing the budget with deficits projected in the future, said Howard Cure, head of municipal research at Evercore Wealth Management.

"The long-term negative effects of the pandemic, it's going to last for a while," he said. "How willing are you to put in additional monies above the formulas to help all these schools districts make up for it or provide more Internet access or housing needs to help poor people, even though they're not contributing that much proportionately to the state's budget?"

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