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Fitch: Improved Revenue Outlook Supports California's Budget

Fitch Ratings-New York-21 January 2021: California Governor Newsom's executive budget proposal for fiscal 2022 benefits from better than anticipated tax collections, as compared to the deep declines assumed in the enacted fiscal 2021 budget, says Fitch Ratings. The proposed budget also prudently allocates higher available revenue to addressing the pandemic while also rebuilding budgetary resilience.

The state now projects fiscal 2021 revenues will be $28 billion (22.5%) higher than the June 2020 enacted budget estimate, essentially matching the pre-pandemic forecast. General fund revenues, prior to transfers, are forecast to further increase 5.2% to $161.6 billion in fiscal 2022, $39 billion (32%) higher than the June 2020 estimate.

The state attributes the improved revenue performance to the unusual nature of the coronavirus-related downturn, in which higher-wage taxpayers have both been protected from job losses and have benefitted from the strong stock market. This has allowed the state's progressive personal income tax structure and taxing of capital gains to generate the higher than anticipated tax revenue. It also reflects a less severe economic downturn than was assumed in the fiscal 2021 budget. The economic assumptions underlying the governor's budget proposal align with Fitch's economic outlook for the U.S., with the state assuming 3.1% real national GDP growth in 2021. However, California's relatively volatile tax structure leaves it vulnerable to wide swings in economic activity.

FISCAL 2021 SUPPLEMENTAL ACTIONS

The governor is requesting early action on several items intended to provide immediate relief to individuals and small businesses considered to be disproportionately affected by the pandemic. These one-time actions include $2.4 billion to provide $600 payments to low-income workers, $575 million for grants to small businesses and small non-profit cultural institutions, and additional targeted relief for other industries, including restaurants and personal services. However, the budget was developed prior to enactment of the December federal stimulus bill, and legislative action is likely to take recent and expected federal actions into account.

The budget also requests immediate action to provide $2 billion in incentives to schools to re-open as early as February and accelerates repayment of deferrals that were incorporated into the fiscal 2021 budget. Education funding will automatically significantly increase due to the requirements of Proposition 98 in both the current year and the budget year.

SUSTAINABLE BUDGET ACTIONS

As has been the state's practice, the governor takes a fairly conservative approach to using increased revenue by limiting growth in ongoing spending, rebuilding reserves, and paying down long-term liabilities. The executive budget begins to restore the $7.8 billion draw on the rainy day fund, known as the Budget Stabilization Account (BSA), that helped balance the fiscal 2021 budget. It also provides $2 billion to continue programs that otherwise would sunset during the coming fiscal year, applies $3 billion in supplemental payments to reduce retirement liabilities (required under Proposition 2 and above the actuarial requirement), and provides limited additional funding for various policy initiatives.

The proposed budget adds $7.2 billion to the BSA across fiscal years 2021 and 2022, bringing the balance to $15.6 billion, or 9.6% of revenues. In contrast to prior economic downturns when the state's reserves were limited, the BSA helped address the anticipated revenue gap as the pandemic unfolded and continues to provide flexibility to address revenue volatility. The budget also allocates $6.3 billion to other operating reserves.

Fitch anticipates details of the enacted budget will vary from the governor's plan, which will be updated in May to reflect federal actions and any changes in the economy. But, as in recent years, the general approach of limited recurring spending growth, focus on one-time actions, and restoring resilience will likely carry through.

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