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Fitch: Strong Revenues Propel California Budget; Uncertainty Heightened in Forecast

Fitch Ratings-San Francisco/New York-31 May 2022: The updated budget proposal for fiscal 2023, released by Governor Newsom in his "May Revise", reflects the continued economic and revenue rebound from the pandemic and continues the state's policy of prudently allocating higher available revenue to maintaining budgetary resilience while also increasing programmatic spending, says Fitch Ratings.

The state now projects fiscal 2022 revenues will be $41 billion (23%) higher than the June 2021 enacted budget estimate, with revenues well above pre-pandemic levels. General fund revenues, prior to transfers, are forecast to remain flat at $223 billion in fiscal 2023, but $25 billion (13%) higher than the estimate used in the Governor's January 2022 budget proposal. This exceptional growth, especially in the current year, comes despite the war in Ukraine and related economic sanctions on Russia, as well as ongoing supply chain disruptions, all of which contribute to the tempering of growth in the outyear revenue forecast.

The state attributes the strong revenue performance to a number of factors, including underlying economic growth with the state having passed its pre-pandemic GDP level in the first quarter of 2021 and the continued strength of earnings and stock market performance that benefit higher-wage taxpayers. It also reflects the impact of inflation on sales and income tax revenues as they are not inflation-adjusted.

While the forecast pre-dates the recent stock market retraction and incorporates record high capital gains in the current year, it assumes stock market growth will be weaker through the forecast period, accompanied by a decline in capital gains realizations and lower related taxes. The requirement to transfer capital gains-related tax revenues above 8% of general fund revenues not needed to fund Proposition 98 education spending to the budget stabilization fund and to debt repayment dampens the impact of capital gains volatility on general fund operations.

Although the state's economic outlook assumes continued growth and recovery, it has been slightly downgraded relative to its earlier forecast due to the greater economic uncertainty. The economic assumptions underlying the governor's "May Revise" are in line with Fitch's economic outlook for the U.S., with the state assuming 3% real national GDP growth in 2022.

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 revised budget proposal adds to the rainy day fund (Budget Stabilization Fund, BSA), bringing its total to over $23 billion, which is considered full funding at 10% of revenues and allocates $10.4 billion to other operating reserves.

The proposal assumes that 94% of the $49 billion discretionary surplus (the surplus not required to be spent on education due to proposition 98) will be applied to one-time expenditures focused on direct relief to taxpayers, investments in infrastructure, and COVID-related emergency spending.

The budget also proposes using $6.2 billion in one-time funds to refund general obligation bonds and substituting up to $2.7 billion in expected appropriation-backed debt issuance with pay-as-you-go financing. It applies $3.9 billion in supplemental payments to reduce retirement liabilities (required under Proposition 2 and above the actuarial requirement).

The budget as initially proposed in January and revised in May provided approximately a $3 billion increase in ongoing spending, including to expand access to healthcare, address extreme weather, invest in public safety, and combat homelessness. Even with these increases, the multi-year forecast, which incorporates an added inflation adjustment beginning in 2023-2024, is structurally balanced.

Fitch anticipates details of the enacted budget will vary from the governor's plan; 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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