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Fitch: California Revenue Shortfall Consistent with Historical Volatility

Fitch Ratings-New York/San Francisco-25 May 2023: California's deteriorating revenue forecast reflects the high sensitivity of the state's tax revenues to changing economic conditions, which is a fundamental characteristic of its credit profile, says Fitch Ratings. California (Issuer Default Rating 'AA'/Stable) benefits from strong financial resilience and prudent fiscal management since the 2008-2009 Great Recession. Fitch anticipates the state will respond to the lower available tax revenues with sustainable actions that support ongoing structural budget balance.

The May Revision to Governor Newsom's fiscal 2024 budget proposal assumes revenues will be $31.5 billion lower for fiscal years 2022-2024 than was assumed when the fiscal 2023 budget was enacted in June 2022. Fiscal 2023 general fund revenues, prior to transfers, are forecast to be $16.7 billion (7.5%) lower than the June 2022 estimate and down 7.7% yoy. Forecast fiscal 2024 general fund revenues of $206.6 billion, prior to transfers and solutions, are $26.8 billion (11.5%) lower than the June 2022 estimate but still well above pre-pandemic fiscal 2019 levels of $144.5 billion.

The lower revenue forecast is driven largely by weakness in the personal income tax (PIT), with slowing economic conditions and technical factors playing important roles. The PIT is highly sensitive to economic changes, and the forecast reflects slower economic growth after the very rapid pace of growth immediately following the pandemic recession. The governor's economic assumptions assume a stronger rebound in national GDP growth than does Fitch's economic outlook, leaving the state's revenue forecast susceptible to downside risk. Additionally, the state Legislative Analyst Office's (LAO) assessment of the May Revise suggests a more pessimistic outlook with the fiscal 2022-2024 forecast an additional $11 billion below the Governor's estimate.

California's pass-through entity (PTE) elective tax and the deferral of tax deadlines in a number of counties add uncertainty. The PTE elective tax allows business owners to work around the federal cap on state and local tax deductions by combining corporate income tax payments and personal income tax credits. The department of finance (DOF) estimates nearly 10% of general fund revenues before transfers from fiscal 2022-2024 will be PTE elective tax payments. The mix of payments and credits with unpredictable timing complicates revenue forecasting.

Following severe winter storms, the state deferred tax deadlines for individuals and businesses in 55 counties, representing 99% of the state's population, from April to October 2023. The state estimates the deferral will shift $40 billion of its tax revenue from the current into the next fiscal year, while acknowledging the difficulty in crafting an estimate given the lack of clarity on potential taxpayer behaviour. Fitch considers the state's liquidity cushion ($109 billion including $91 billion in borrowable resources as of April 30, 2023) more than adequate to address cash flow implications.

The May Revision addresses the lower revenue forecast by tapping resilience built into the fiscal 2023 and previous budgets without dipping into the budget stabilization account (BSA) or taking deep cuts to ongoing spending. Prior budgets enhanced resilience by reducing budgetary and other debt, limiting growth in ongoing spending, applying non-recurring revenues to one-time spending including for capital investment rather than debt issuance, placing revenue triggers on new programs, and building reserves.

The bulk of the Governor's proposed budget balancing actions involve some form of spending reduction, including funding delays, reduced one-time spending, spending shifts from the general fund to other funds, and trigger reductions that can be restored if the revenue picture improves. The Governor is also proposing to renew and increase a managed care organization tax that is expected to raise $3.4 billion. The May Revise includes a modest withdrawal of $450 million of the $900 million balance Safety Net Reserve but does not touch the larger $22.3 billion BSA, and adds to the Public School System Stabilization Account, bringing its total to 10.7 billion, leaving these reserves available to address further revenue deterioration.

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