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Fitch: California Retains Ample Tools to Address Deep Revenue Shortfall

Fitch Ratings-New York-14 December 2023: The state of California has the fiscal capacity to address an emerging revenue shortfall, estimated at \$58 billion over three years by the state's Legislative Analyst Office (LAO), says Fitch Ratings. California is much better positioned than the last time it faced a similarly deep revenue decline during the Global Financial Crisis (GFC), and Fitch anticipates the state will take steps to close the budget gap while maintaining very strong financial resilience.

While the estimated revenue decline is significant, California's general fund revenues increased by \$78 billion (54%) between fiscal 2020 and fiscal 2022, without a concurrent increase in ongoing spending. Furthermore, institutional changes made by the state during and following the GFC, such as improved liquidity management and simple majority approval of the budget, materially improved its ability to address economic and revenue cyclicalities.

As Fitch previously noted, the state's fiscal 2024 budget included an uncertain revenue forecast due to the deferral of the final personal income tax and corporation tax filing deadline from April to November 2023. At the time of budget enactment in June 2023, the state estimated the delayed receipt of \$42 billion of fiscal 2023 tax revenue. It is now becoming evident that tax receipts were well below estimate, although the detailed reconciliation of tax revenues between the two fiscal years has not been released.

The LAO attributes \$26 billion of the revenue gap to fiscal 2023 (FYE June 30), with the balance divided approximately evenly over the current year (fiscal 2024) and the next budget year (fiscal 2025). The state Department of Finance will formally revise its revenue forecast prior to release of the governor's fiscal 2025 budget proposal in January. Fitch anticipates the governor will address the prior year and current year gaps in his budget proposal for fiscal 2025 through a mix of spending cuts and reserve draws. Fitch will assess the sustainability of budget solutions for fiscal 2025 following its release. The current 'AA' Issuer Default Rating assumes the state will maintain reserves that are robust compared to past practice to provide a cushion in case of further economic weakening.

In total, the state holds \$37.8 billion in dedicated reserves. It seems likely that the state will apply a significant portion, if not all, of its special fund for economic uncertainty (SFEU) to closing the prior year gap. The SFEU held \$3.3 billion as of the end of fiscal 2023. Another source of gap closing capacity is the state's rainy day fund, the Budget Stabilization Account (BSA), which contains \$22 billion, or 10% of state revenues. Both funds were built up through a combination of revenue surpluses and structural budget changes that mandated deposits.

The state has other gap closing measures available on the expenditure side. The enacted budget for fiscal 2024 incorporated one-time or temporary spending that can be delayed or curtailed in light of lower revenues, estimated by the LAO at \$8.6 billion. Further, the state's school funding requirements under Prop 98 also decline relatively quickly when revenues decline, acting as a form

of automatic stabilizer during a downturn. The LAO estimates the state's Prop 98 school spending will be \$4.3 billion lower than previously estimated over the three-year budget window. Since the state is funding schools in excess of the minimum constitutional requirement, California could theoretically reduce school spending by up to another \$16.7 billion for a total \$21 billion cut and still be within its Prop 98 guarantee. Fitch considers such a drastic reduction in school aid highly unlikely. Instead, the state could combine reductions in education spending with draws on its \$8.1 billion Prop 98 reserve.