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An Update on California's Fiscal Picture for Muni-Bond Investors.

Revenue collections have been outperforming forecasts, while credit fundamentals for key California municipal bond sectors continue to improve.

While recent headlines about California have focused on office vacancies and homelessness, state revenues have been quietly outperforming budgetary forecasts for the past several months. Tax collections through the first four months of the current fiscal year are \$5.25 billion above expectations, tracking 11% ahead of forecast.

Cutting through the budgetary noise of the pandemic period, state revenues thus far in fiscal 2025 (ending June 30) have grown at a 6.4% compounded annual growth rate over the last five years, above the 6.1% annual growth experienced in the five years leading up to the pandemic.¹ Based on a July 2024 report from the California Department of Finance, revenues totaled roughly \$209 billion in fiscal 2024.

Surging stock prices, especially for the largest California-based tech companies, and optimism for the potential of artificial intelligence have helped drive large increases in compensation for California residents. In the first quarter of calendar 2024, total pay grew at a 17% annualized rate, one of the highest quarterly growth rates observed in the past 40 years.² These gains are translating into strong growth in personal income tax collections, which typically account for about two-thirds of the state's revenue.

The picture is improving from the expense side as well, with the state budgeting for a second consecutive year of expenditure declines in fiscal 2025—down 5.2% to \$211 billion from the \$223 billion budgeted for fiscal 2024. Part of the decline represents a return to normalcy following the extraordinary one-time spending of federal relief grants in prior years, and part is due to belt-tightening measures passed through an agreement between the governor and the legislature in June. Both drivers of spending reductions demonstrate the state's commitment to long-term fiscal sustainability.

Favorable Credit Fundamentals

Local municipal credit in California is in historically strong shape as well. Coffers remain full as the billions in federal relief awarded during the pandemic are still being carefully spent, and recurring revenues continue to rise. Property taxes, the largest revenue source for California cities and counties, are insulated from fluctuations in market values by a decades-old state law known as Proposition 13. The experience of San Francisco during the global financial crisis highlights just how insulated this revenue source is—while median home prices fell by 20% between 2007 and 2011, the city's property tax revenues were up 23% over that period.³

We think healthcare systems in California will benefit greatly from a permanent extension of the Managed Care Organization (MCO) tax that was approved by voters on the November 2024 ballot. This tax generates between \$7-8 billion annually, which will now be restricted solely for Medi-Cal

expenses and other health programs.⁴

Conditions for California water utilities have improved dramatically over the last 18 months as well. High levels of precipitation and snow accumulation in the Sierra Nevada mountains have refilled state reservoirs, the largest of which is currently sitting at 111% of its historical average.⁵

Impact of Federal Tax and Policy Developments

Tax cut extensions and deregulation, two hallmarks of president-elect Trump's campaign and previous administration, stand to benefit a state economy fueled in large part by high-income earners and large tech companies. Trump's proposed removal of the State and Local Tax (SALT) deduction cap would disproportionately benefit California residents, given how high the state's top income tax rates are.⁶

While, in theory, higher tariffs on Chinese goods would hurt container volumes at the West Coast ports that handle them, in practice, we saw volumes decline only marginally the last time tariffs were imposed—a cumulative 2.7% decline at the Port of Los Angeles between 2018, when the first tariffs were announced, and 2020.⁷ Volumes did not decline as much as expected as importers were able to pass higher prices on to consumers.

Looking ahead to 2025, we expect to see a continued uptick in bond issuance driven by large bond authorizations approved by voters in November 2024: \$10 billion for construction and modernization of public education facilities and \$10 billion for various water, energy, and environmental projects.⁸ This increased bond issuance at the state level could also result in more school district and water utility debt issuance as those downstream entities accelerate their capital plans to take advantage of cheap state loans and/or grants.

These issuances will give investors in California municipal bonds plenty of opportunities to generate tax-free income backed by high-grade issuers with strong and improving credit fundamentals.

1 California Department of Finance, Finance Bulletin, November 2024.

2 "The 2025–26 Budget: California's Fiscal Outlook," California Legislative Analyst's Office, November 20, 2024.

3 Source: Metropolitan Transportation Corp. (Bay Area, Calif.) via Zillow.

4 "Proposition 35," California Legislative Analyst's Office, November 5, 2024.

5 "Current Conditions: Major Water Supply Reservoirs," California Department of Water Resources, December 3, 2024.

6 Howard Gleckman, "Repealing the SALT Cap Would Overwhelmingly Benefit Those With High Incomes," Tax Policy Center, Urban Institute and Brookings Institution, September 24, 2024.

7 "Monthly Container Statistics," The Port of Los Angeles, October 2024.

8 "Unofficial Election Results," California Secretary of State, November 5, 2024

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