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California Budget Solutions May Weaken Fiscal Resilience in Outyears

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Fitch Ratings-New York-05 February 2024: The magnitude and timing of California's revenue shortfall, despite ongoing economic expansion, is leading the state to consider budgetary responses that could reduce its resilience to future downturns and limit rating upside, Fitch Ratings says. We anticipate a budget consistent with the executive proposal should allow the state to retain very strong gap-closing capacity, supporting the 'AA'/Outlook Stable Issuer Default Rating. Fitch acknowledges the enacted budget may look materially different and will continue to assess the state's ability to align its core spending with anticipated slower, more normal revenue growth, the scope of non-recurring balancing actions, and the extent to which it uses economic growth to rebuild budget resilience.

California adopted a fiscal 2024 budget without key fiscal 2023 data, and actual results have fallen short, complicating the state's budget situation. California did not finalize its fiscal 2023 (YE June 30) revenue collections until after Nov. 16, the final extended income tax filing deadline for tax year 2022, after the conclusion of fiscal 2023 and adoption of the fiscal 2024 budget. Fiscal 2023 revenues prior to transfers fell well short of the estimate used in the 2024 enacted budget (down $25.2 billion, or 12%), which set the baseline for the fiscal 2024 revenue estimate.

The forecast for fiscal 2024 has been revised $10.3 billion (5%) below its enacted level to $195.9 billion, but this is still an 8.2% yoy increase. Revenues for fiscal 2025 are forecast to rise a modest 2.8% to $201.4 billion, based on an economic forecast that is largely in line with Fitch’s December 2023 Global Economic Outlook. Even with these adjustments, forecast revenues for fiscal 2025 remain almost 40% above the pre-pandemic level, representing a rapid CAGR of 5.7% over six years.

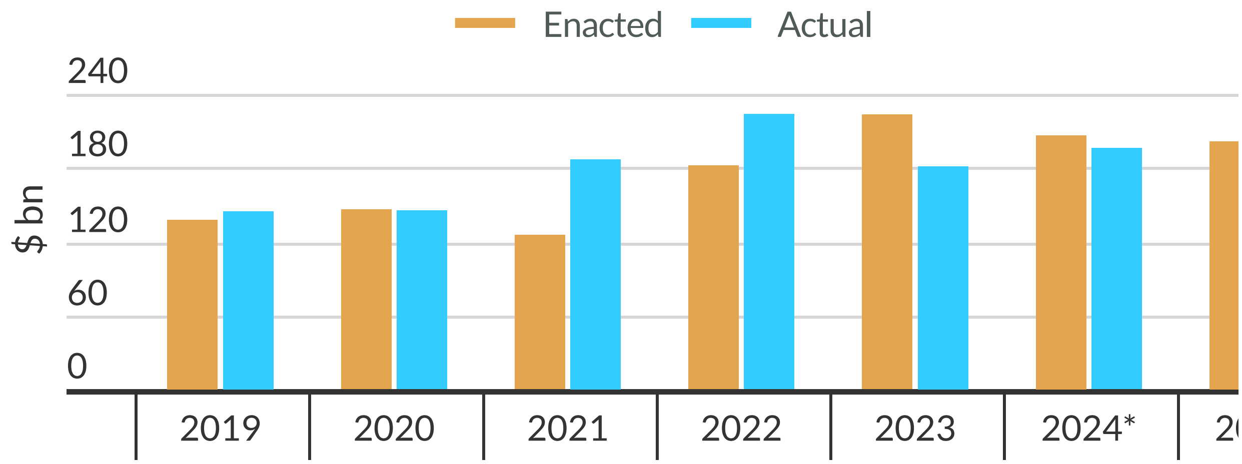
Although the state recognized revenue uncertainty in adopting its fiscal 2024 budget without key fiscal 2023 data, compensatory measures were insufficient to address an unexpectedly large revenue shortfall. Governor Newsom's fiscal 2025 budget closes the gap across the three-year budget window (fiscal years 2023, 2024, 2025) through a combination of structural and temporary budget adjustments, a number of which are more typically used in a downturn.

The most significant of these is drawing more than half of the rainy-day fund ($12.2 billion) in fiscal 2025. California's remaining reserves ($18.4 billion) would still support very strong gap-closing capacity. The budget would shift one pay period from fiscal 2024 to fiscal 2025, deferring $1.6 billion in spending, defer $499 million in payments to the state university systems, and use $1.3 billion of Proposition 2 debt repayment funding to make its regular pension contribution. Employing such non-recurring measures is unusual in a slower, but still growing economy, and reflects the magnitude of the revenue gap and its mid-fiscal year timing. California's fiscal resilience remains strong under the executive budget, but rating headroom would narrow.

The budget also utilizes compensatory measures built into the state's fiscal plan. The executive budget addresses the fiscal 2023 shortfall with a draw on unallocated balances and reduced education spending that is partially offset with a draw on the Proposition 98 reserve. A portion of the proposed $8.5 billion in budget reductions are from one-time spending commitments made when there were significant surpluses. The executive budget also delays $5.1 billion in planned spending to beyond the budget window, some of which may cause budget stress in outyears. The budget proposal relies more on expenditure reductions than revenue solutions, although the state expects to capture an additional $3.8 billion from the Managed Care Organization (MCO) tax for Medi-Cal that was put into place this year.

California Revenues Returning to Trend

2022 Revenue Collections Provide Buffer for Lower Recent Collections



*2024 actual is a revised estimate as of the 2025 budget proposal. 2025 indicates Governor's budget.
Source: Fitch Ratings

Contacts:

Karen Krop
Senior Director, U.S. Public Finance
+1 212 908 0661
karen.krop@fitchratings.com
Fitch Ratings, Inc.
Hearst Tower
300 W. 57th Street
New York, NY 10019

Sarah Repucci
Senior Director, Fitch Wire
Credit Policy - Research
+1 212 908 0726
sarah.repucci@fitchratings.com

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email:

sandro.scenga@thefitchgroup.com

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