State of California – Unexpected Abundance

Sheila R. May, CFA, Principal, Director, Municipal Bond Research

A little over a year ago, in the face of countless uncertainties triggered by the pandemic, the State of California along with many governments across the U.S., reworked its budget plan and prepared for a dramatic decline in tax revenues. Of the variety of recession scenarios offered by the states, nearly all proved to be overly pessimistic.

In May 2020, California anticipated General Fund revenues for fiscal 2021 (July 1, 2020 to June 30, 2021) would total $130 billion, a drop of nearly 7% or more than $9.0 billion from the then current 2020 year. In its most recent comprehensive revenue forecast, based on 10 months of actual results, the state expects to close the cycle with over $182 billion of General Fund collections, more than $50 billion (40%) above estimates drafted a year earlier. The remarkable result has been driven by the robust performance of the state's "Big 3 Taxes," personal income, sales and corporate taxes. Although not yet finalized, fiscal 2021 is projected to end with General Fund balances and reserves in excess of $42.0 billion, representing more than 25% of the year's expenditures.

Many of the drivers of the outstanding growth have been national in scope, while other factors are somewhat unique to California. As mentioned in prior comments, the pandemic's impact on employment disproportionately affected low-wage workers, while higher-wage earners, responsible for the vast majority of personal income tax receipts, remained largely employed. Unprecedented federal stimulus in the form of direct payments and enhanced unemployment benefits buoyed incomes and spurred consumer spending, supporting both personal income and sales taxes. Following some initial volatility at the outset of the pandemic, equity markets posted outstanding results in 2020, boosting capital gains taxes, particularly for high wealth states, including California. More specific to the Golden State, the technology sector thrived during the pandemic, resulting in higher salaries, larger corporate profits, and elevated shareholder values. Additionally, legislators temporarily revised rules to limit the use of prior-year losses and other credits, thereby increasing corporate tax payments to the state.

Along with the tax windfalls experienced across the country, government entities have been the beneficiaries of significant levels of federal assistance. State officials estimate over $600 billion has been injected into the California economy since March 2020 through six separate federal authorizations. The most recent stimulus bill, the American Rescue Plan Act, provides $27 billion of direct aid to the state, another $14.7 billion for cities and counties, and an additional $15.4 billion for K-12 education. Similar to many of its peers, California is flush with cash at the start of the current 2022 fiscal year. The challenge for all legislators will be the prudent allocation of this once-in-a-generation surplus. Deliberations across state capitals will continue for the next several months, yet we expect these funds to be viewed as non-recurring and as such, directed towards one-time outlays versus annual operating expenses. In California, the surplus funds are expected to be disbursed to a variety of investments, including broadband infrastructure, affordable housing, workforce development and climate change resiliency.

A wrinkle in an otherwise positive outlook is the upcoming September election to unseat Governor Newsom, an effort initiated by organizers at odds with his handling of the pandemic, among other objections. The Public Policy Institute of California reports that a poll conducted in May indicated the majority of likely voters oppose the recall. In the event there is a change in leadership, Democrats still hold a super-majority in the legislature, leaving a low probability of significant shifts in policies and priorities, including fiscal management.

The federal government's herculean response to the pandemic has left California with an enviable quandary that was unimaginable a year ago. It is our expectation that the Golden State will demonstrate fiscal prudence in the allocation of its substantial resources by balancing investments in its economic future with debt retirement and the maintenance of appropriate reserves.

Fiscal 2021 General Fund Revenue Estimates (FYE 6/30, $000,000)

	20-May Estimate	21-May Estimate	$ Change	% Change
Personal Income Tax	76,841	124,151	47,310	61.6%
Sales & Use Tax	20,613	27,936	7,323	35.5%
Corporation Tax	16,577	20,120	3,543	21.4%
"Big 3 Taxes" Total	**114,031**	**172,207**	**58,176**	**51.0%**
Total Revenues (before transfers)	129,611	182,164	52,553	40.5%
Big Three as % of Total Revenues	***88.0%***	***94.5%***		

Source: State of California May Revision Fiscal Years 2021 & 2022