FitchRatings

Public Finance
Tax-Supported
U.S.A.

State of California

Ratings

Long Term Issuer Default Rating	AA

New Issues

$1,200,000 General Obligation Various Purpose Refunding Bonds, Series 2022	AA
$1,300,000,000 General Obligation Various Purpose Bonds, Series 2022	AA

Rating Outlook

Stable

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (May 2021)

Related Research

Fitch Rates California's $2.5 Billion GO Bonds 'AA'; Outlook Stable (August 2022)

New Issue Summary

Sale Date: Negotiated sale on September 8, 2022

Series: $1.3 billion various purpose general obligation (GO) bonds and $1.1 billion various purpose GO refunding bonds

Purpose: The bonds will finance or refinance voter-approved capital projects or other voter-approved projects and pay down commercial paper (CP). The bonds will also refund outstanding GO bonds of the state for debt service savings and refund outstanding variable-rate GO bonds to effect a favorable reorganization of the debt structure of the state.

Security: GO bonds are GOs, for which the state pledges its full faith and credit, subject to the prior application of moneys to the support of public education.

California's 'AA' Issuer Default Ratings (IDR) and GO bond rating incorporate the state's large and diverse economy, which supports strong, albeit cyclical, revenue growth prospects, a solid ability to manage expenses through the economic cycle and a moderate level of long-term liabilities. Strong fiscal management, institutionalized across administrations and demonstrated through build-up of the budgetary stabilization account and elimination of past budgetary borrowing, allows the state to better withstand economic and revenue cyclicality.

Economic Resource Base: California's economy is unmatched among U.S. states in size and diversity, leading to consistent overall growth despite a considerable presence of the more cyclical information technology industry. Population and employment growth rates approximate U.S. averages over time, with relatively high levels of immigration partially offsetting domestic outmigration. Growth in California's economy between the Great Recession and the recent pandemic-related recession was among the strongest of the states. Fitch Ratings expects California's post-pandemic growth to return to this trend.

Key Rating Drivers

Revenue Framework: 'aaa': Tax revenues are dominated by personal income taxes, which are economically sensitive, particularly those related to capital gains. Long-term growth prospects for revenues are strong, driven by the state's robust economic fundamentals. The state retains the independent legal ability to raise taxes, subject to a legislative super-majority voting requirement.

Expenditure Framework: 'aa': California has a solid ability to reduce spending throughout the economic cycle, although its flexibility is somewhat more restricted than most states due to constitutional requirements for funding education and voter initiatives that limit state discretion. However, Proposition 98 school funding requirements also decline relatively quickly when revenues decline, acting as a form of automatic stabilizer during a downturn.

Long-Term Liability Burden: 'aa': Long-term liabilities, while above the median for U.S. states, remain a moderate burden on the resource base. The state is addressing its pension liabilities with some benefit reforms and supplemental contributions and implemented a long-term plan to increase contributions to the teachers' system, among other changes to improve funding.

Operating Performance: 'aa': The state's strong budget management during the extended period of economic expansion and revenue growth following the Great Recession allowed the state to materially improve its financial position and enhance its ability to address future fiscal challenges. The state eliminated budgetary liabilities, built a rainy day fund, enacted on-time, structurally balanced budgets and generally used a prudent approach to managing demands for additional spending. All of these efforts contribute to greater resilience to cyclical economic changes.

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Rating Sensitivities

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

- A material increase in the state's financial resilience and ability to absorb volatility in revenues.
- Continued actions to maintain long-term liabilities consistently below 10% of personal income and support pension sustainability.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

- A change in fiscal approach regarding maintaining structural budgetary balance over time that leads to a reduction in budgetary resilience.

Current Developments

Economic Update

California's labor market recovery has slightly lagged the national pace through most of the post-pandemic recovery period, although the pace has picked up in recent months. Nonfarm payrolls declined by about 15.4% at the pandemic's start (from February 2020 to April 2020), slightly higher than the national decline of 15%. California has regained 94% of the payroll employment declines versus 98% for the U.S.

Headline unemployment in June of 4.2% exceeded the U.S.'s (3.6%) and state's median (3.3%) for that month. Growth in the California's labor force has improved in recent months. The state's employment to population ratio (a measure of labor force utilization) as of June 2022 was 59.5%, which is still below its pre-pandemic level but now matches the national rate.

California Budget Update

The enacted budget for fiscal 2023 reflects the continued economic and revenue rebound from the pandemic and continues the state's policy of prudently allocating higher available revenue to maintain budgetary resilience while also increasing programmatic spending. The state estimates fiscal 2022 revenues were $51.7 billion (28%) higher than the June 2021 enacted budget estimate, with revenues well above pre-pandemic levels.

The state attributes the strong revenue performance to a number of factors, including underlying economic growth with the state having passed its pre-pandemic GDP level in the first quarter of 2021 and the continued strength of earnings and stock market performance that benefit higher-wage taxpayers. It also reflects the impact of inflation on sales and income tax revenues as they are not inflation-adjusted. General fund revenues, prior to transfers, are forecast to decline to $223 billion in fiscal 2023.

As has been the state's practice, the budget takes a fairly conservative approach to using higher available revenue by limiting growth in ongoing spending, rebuilding reserves, and paying down long-term liabilities. Fitch considers this approach to be prudent given the risk of slower economic growth, which may be evident in July 2022 revenues that were below estimate. The enacted budget adds to the rainy day fund (Budget Stabilization Account [BSA]), bringing its total to over $23 billion, which is considered full funding at 10% of general fund revenues, and allocates $13.9 billion to other operating reserves.

The budget applies 93% of the discretionary surplus (the surplus not required to be spent on education due to proposition 98) to one-time expenditures focused on direct relief to taxpayers, investments in infrastructure, and Covid-19 related emergency spending. The budget applies $4.9 billion in one-time funds over a multi-year period to refund $1.7 billion in callable GO bonds and to substitute $3.2 billion in expected appropriation-backed debt issuance with pay-as-you-go financing.

It applies $3.4 billion in supplemental payments to reduce retirement liabilities (required under Proposition 2 and above the actuarial requirement) in fiscal 2023 with an additional $7.5 billion projected over the next three years.

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AA	Affirmed	Stable	8/26/22
AA	Upgraded	Stable	8/16/19
AA–	Upgraded	Stable	8/12/16
A+	Upgraded	Stable	2/25/15
A	Upgraded	Stable	8/5/13
A–	Affirmed	Positive	3/4/13
A–	Revised	Stable	4/5/10
BBB	Affirmed	Stable	8/26/09
BBB	Downgraded	Negative[a]	7/6/09
A–	Downgraded	Negative[a]	6/25/09
A	Affirmed	Negative	5/29/09
A	Downgraded	Stable	3/19/09
A+	Affirmed	Negative[a]	1/14/08
A+	Upgraded	Stable	6/9/06
A	Affirmed	Positive	4/13/06
A	Upgraded	—	7/14/05
A–	Upgraded	—	9/7/04
BBB	Affirmed	—	8/9/04
BBB	Downgraded	Negative[a]	12/18/03
A	Downgraded	Negative[a]	12/20/02
AA	Affirmed	Negative[a]	4/18/01
AA	Upgraded	—	2/16/00
AA–	Upgraded	—	10/2/97
A+	Upgraded	—	2/26/96
A	Downgraded	—	7/15/94
AA	Assigned	—	9/25/92

[a]Rating Watch.

While most additional spending is one-time in nature, the budget also provides $498 million for ongoing employee compensation, health care, and retiree health care prefunding costs as well as other compensation changes, including some one-time bonuses.

Federal Aid Continues to Support State Operations

The state is receiving $27 billion in direct American Rescue Plan Act (ARPA) aid, with local governments receiving an additional $16 billion. Uses of these funds include addressing public health issues, housing shortages and homelessness, support for energy and water suppliers that are owed utility payments in arrears, grants to small businesses, emergency financial aid to college students, and education and training for displaced workers. A portion will be used to replace up to $17.2 billion that the state calculates as lost revenue.

Given strong revenue performance and the state's focus on avoiding use of one-time revenues for ongoing programs, Fitch expects the state to maintain structural balance in its budget as the impact of federal stimulus programs recedes.

Credit Profile

Revenue Framework

General fund revenues are derived primarily from personal income tax (PIT) and sales and use tax (SUT); roughly 62% of general fund revenues are expected to come from the PIT and another 15% from the SUT. The PIT is structured with progressive rates, with capital gains a significant and notably volatile component. The state has implemented mechanisms in recent years to cap the effect of volatility on the general fund, with capital gains-related tax revenues above 8% of general fund revenues not needed to fund Proposition 98 education spending allocated to the BSA and debt repayment. SUT is levied on goods but not services at a combined state and local uniform rate of 7.5%.

Strong economic fundamentals are the basis for a revenue profile that is likely to grow at or above Fitch's expectation for national economic growth over time. California's tax revenues, adjusted to exclude the estimated effect of tax policy changes, grew during the economic expansion that preceded the coronavirus-related downturn at a pace that approximated national GDP growth.

While not a legal limitation on the state's independent revenue control, a super-majority legislative vote to raise tax revenues is a requirement.

Expenditure Framework

General fund spending is focused on education and health and human social services (primarily for Medi-Cal, the state's Medicaid program), as is typical of most states. Education, both for primary schools and higher education institutions, comprises almost half of state general fund spending, with K-14 education (including community colleges) having a constitutional first claim on revenues and local schools having a separate constitutional formulaic minimum funding requirement under Proposition 98.

California has a relatively generous approach to providing health and social services to vulnerable and at-risk state residents and, as state tax revenues grew in recent years, expanded programs to address needs in homelessness, anti-poverty programs, early childhood and health care. Fitch expects spending to be somewhat above expected revenue growth over time, in the absence of policy action, driven by health and social services, particularly Medi-Cal. The fiscal challenge of Medicaid is common to all U.S. states, and the nature of the program as well as federal government rules limit states' options in managing the pace of spending growth. Federal action to revise Medicaid's fundamental programmatic and financial structure does not appear to be a near-term priority of the current federal administration or congressional leadership. As with all federal programs, Medicaid remains subject to regulatory changes that could affect various aspects of the program.

Most education appropriations fall under Proposition 98, a constitutional requirement with a complex formula that links spending to longer-term trends in state personal income and revenue. As such, education spending is relatively inflexible in terms of both annual spending and the multiyear effects of the funding formula. However, Proposition 98 generally also results in lower required spending when revenue declines, providing somewhat of an automatic counter in the event of cyclical revenue changes, and shifting fiscal challenges to the school district level. Beyond education spending, the state retains considerable ability to reduce or defer spending. Carrying costs for long-term liabilities are above average for a state but remain low as a percentage of the budget.

Long-Term Liability Burden

Long-term liabilities are a moderate burden on resources with nearly all of the state's direct debt consisting of GO bonds issued under voter authorizations or lease obligations for public facilities.

As of Fitch's November 2021 report "State Liability Burdens Shrink in Fiscal 2020," California's combined burden of debt and Fitch-adjusted net pension liabilities equaled 8% of personal income, above the 4.7% median for U.S. states. Pension obligations relate primarily to state workers in the California Public Employees Retirement System (CalPERS) and a share of the obligation for K-12 teachers in the California State Teachers Retirement System (CalSTRS). Fitch's measure of long-term liabilities assumes a standard 6% return assumption for pensions.

The state and the pension systems have pursued various reforms in recent years to improve their long-term sustainability, although these changes will continue to drive contributions higher in coming years. In 2012, the state adopted a broad package of benefit reductions and contribution increases that affected most state and local systems. Annual savings were very low in the early years but are expected to grow considerably over time with employee turnover.

Full actuarial contributions to CalPERS are legally required, but not to CalSTRS, which had led to persistent underfunding of the latter. The state addressed the CalSTRS contribution shortfalls with legislation enacted in June 2014 that gradually increased contribution requirements, in particular from school districts, and granted the CalSTRS board limited discretion to raise employer contribution rates to amortize the liability over 30 years. Since then, further contribution increases are being triggered by plan actions to lower their investment return assumptions to 7% at both systems (and even lower at CalPERS) and shorten the amortization period to 20 years at CalPERS.

As part of the fiscal 2018 budget, the state deposited $6 billion to CalPERS as a supplemental payment to its budgeted actuarial contribution. The source of funds for the supplemental payment was a loan of non-general fund cash balances to pension participating funds. The loan raised net funding for CalPERS, saving the state an estimated $6 billion in contributions over 20 years, net of principal and interest on the loan, by the state's estimate. The loan is being repaid over 12 years from general and non-general fund resources, including debt repayment funds under Proposition 2, a 2014 voter initiative that prioritized the reduction of state liabilities, including unfunded pensions.

Recent budgets have provided supplemental contributions to the retirement funds. The fiscal 2022 budget included $1.9 billion for CalPERS and $410 million for CalSTRS, using available Proposition 2 funds. The fiscal 2023 budget makes an even more sizable supplemental contribution of $2.9 billion to CalPERS. These are excess contributions, rather than loans, and are intended to reduce employer contribution rates for the state, school districts, and other participants and provide savings over time.

The state reported $92 billion in net other post-employment benefit liabilities as of June 30, 2020, provided mostly through multiple bargaining unit plans. Prefunding to date ($5.2 billion) has been minimal.

Operating Performance

The state's financial resilience reflects steps taken since the fiscal crisis of 2008–2009 to materially improve its ability to address economic and revenue cyclicality, including the passage of a constitutional amendment in November 2014 that strengthened the funding mechanism of the BSA and the accumulation of other reserves.

The BSA reached $16.1 billion (11% of general fund revenues) in fiscal 2020. The fiscal 2021 enacted budget assumed use of approximately half of the BSA, reducing it to $8.3 billion, although the actual draw on the BSA was lower and offset by contributions based on the strong rebound in tax revenues. The BSA is expected to reach $23.2 billion in fiscal 2023, 10% of projected revenues. With BSA funding at the constitutional maximum, the state expects to dedicate $465 million for infrastructure investments in 2022–2023.

The state also maintains three other reserves: the Special Fund for Economic Uncertainties (SFEU), the Safety Net Reserve Fund, and the Public School System Stabilization Account (PSSSA). The SFEU is available for any purpose during the fiscal year, including unexpected disaster costs. Its $1.3 billion balance was appropriated in March 2020 to support the state's coronavirus mitigation efforts. Similarly, half of the $900 million balance in the safety net reserve was transferred to the general fund to support safety net programs in fiscal 2021, although it has been restored to $900 million as of the fiscal 2022 budget. The PSSSA was created as part of Proposition 2 as a rainy-day fund designed to address volatility in Proposition 98 school funding, with the goal of limiting reductions in education spending when revenues decline. The $377 million deposit in fiscal 2020, which was generated in part from strong capital gains collections in fiscal 2019, was the first such deposit into the PSSSA. The fiscal 2021 budget fully utilized the balance in the PSSSA; however, given significant growth in capital gains and overall general fund revenue growth, deposits in each of fiscal years 2021, 2022, and 2023 are expected to bring the total to $9.5 billion.

A key element of ongoing flexibility has been the elimination of residual budgetary borrowing that had accumulated as the state worked to balance the budget over the two prior recessions. At its peak, budgetary borrowing totaled approximately $35 billion, including outstanding debt in Economic Recovery Bonds (ERBs), payment deferrals to schools and local governments, payroll shifts between fiscal years and interfund borrowing. Having eliminated the final pieces of budgetary borrowing in the fiscal 2020 budget, the fiscal 2021 budget again used budget deferrals to schools and community colleges as a budget balancing mechanism. The fiscal 2022 budget paid down these deferrals fully, more quickly than was assumed when the fiscal 2021 budget was enacted.

Cash balances, including borrowable resources outside the general fund, have risen substantially and the state has not borrowed from external sources for cash flow purposes since fiscal 2015.

Although vulnerabilities in financial operations remain, including from the cyclical nature of its revenue base and the limitations imposed by voter initiatives, the reforms over the last decade better position the state to manage cyclicality. The state has consistently adopted budgets on a timely basis in recent years, benefiting from the change to require a simple majority to enact a budget. Budgets have continued to prioritize shoring up finances, including through prudent control of spending and budgetary debt repayment. The state's disciplined approach to limiting spending growth and voter approval in 2012 of PIT and SUT rate increases have enabled the state to move to structural budget balance, repay billions in past budgetary borrowing and begin to address long-term liabilities.

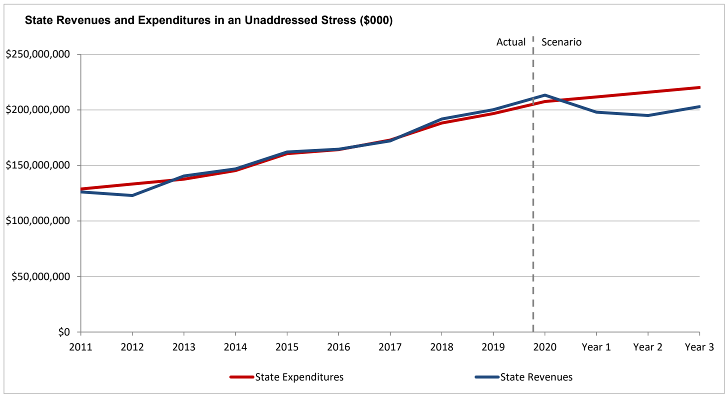
ESG Considerations

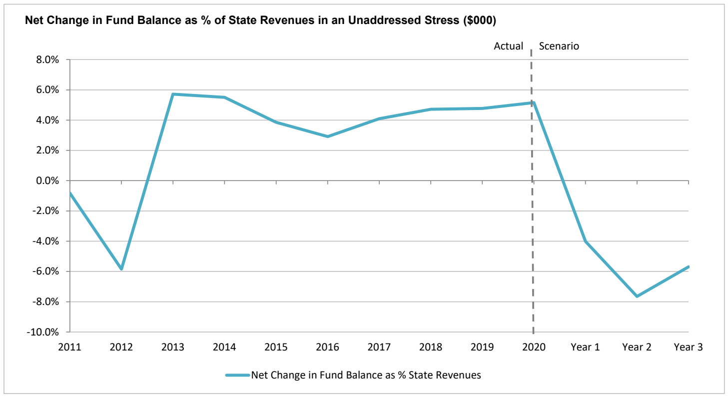
Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

California, State of (CA)

Scenario Analysis

Ver 36





Analyst Interpretation of Scenario Results

California has taken steps in recent years to materially improve its ability to address economic and revenue cyclicality. Notable improvements since the fiscal crisis of 2008-2009 include a voter-improved change that allows simple majority budget approval, significantly reducing the risk of budget impasses that had plagued the state; various cash flow management tools that contribute to enhanced liquidity; and the passage of a constitutional amendment in November 2014 that strengthens the funding mechanism of the BSA and provides the state with additional means to manage revenue cyclicality. Fitch believes these changes make it less likely that the state would experience a liquidity crisis similar to that of the Great Recession, as it was in part caused by limited cash balances, the inability to enact a timely budget and resulting inability to borrow for cash flow purposes.

Scenario Parameters:			Year 1	Year 2	Year 3
GDP Assumption (% Change)			(1.0%)	0.5%	2.0%
Expenditure Assumption (% Change)			2.0%	2.0%	2.0%
Revenue Output (% Change)	*Minimum Y1 Stress:* -1%	*Case Used:* **Moderate**	(7.2%)	(1.5%)	4.1%

Revenues, Expenditures, and Net Change in Fund Balance	Actuals										Scenario Output		
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Year 1	Year 2	Year 3
Expenditures													
Total Expenditures	197,961,600	195,574,612	202,104,695	218,348,798	248,386,929	255,285,348	268,537,692	281,084,427	296,613,878	356,503,475	363,633,545	370,906,215	378,324,340
% Change in Total Expenditures	3.8%	(1.2%)	3.3%	8.0%	13.8%	2.8%	5.2%	4.7%	5.5%	20.2%	2.0%	2.0%	2.0%
State Expenditures	128,800,684	133,338,941	137,685,887	145,348,198	160,646,262	164,215,595	172,827,908	188,179,958	196,746,128	207,551,825	211,702,862	215,936,919	220,255,657
% Change in State Expenditures	15.5%	3.5%	3.3%	5.6%	10.5%	2.2%	5.2%	8.9%	4.6%	5.5%	2.0%	2.0%	2.0%
Revenues													
Total Revenues	195,337,050	185,207,198	204,903,861	219,871,196	249,923,439	255,725,275	267,887,275	284,738,891	300,105,844	362,238,899	349,934,256	349,953,419	361,078,110
% Change in Total Revenues	1.3%	(5.2%)	10.6%	7.3%	13.7%	2.3%	4.8%	6.3%	5.4%	20.7%	(3.4%)	0.0%	3.2%
Federal Revenues	69,160,916	62,235,671	64,418,808	73,000,600	87,740,667	91,069,753	95,709,784	92,904,469	99,867,750	148,951,650	151,930,683	154,969,297	158,068,683
% Change in Federal Revenues	(12.7%)	(10.0%)	3.5%	13.3%	20.2%	3.8%	5.1%	(2.9%)	7.5%	49.1%	2.0%	2.0%	2.0%
State Revenues	126,176,134	122,971,527	140,485,053	146,870,596	162,182,772	164,655,522	172,177,491	191,834,422	200,238,094	213,287,249	198,003,573	194,984,122	203,009,428
% Change in State Revenues	11.0%	(2.5%)	14.2%	4.5%	10.4%	1.5%	4.6%	11.4%	4.4%	6.5%	(7.2%)	(1.5%)	4.1%
Excess of Revenues Over Expenditures	(2,624,550)	(10,367,414)	2,799,166	1,522,398	1,536,510	439,927	(650,417)	3,654,464	3,491,966	5,735,424	(13,699,288)	(20,952,796)	(17,246,229)
Total Other Financing Sources	1,600,205	3,178,484	5,231,506	6,560,044	4,715,645	4,358,647	7,693,525	5,392,268	6,069,288	5,256,790	5,754,104	6,033,195	5,701,129
Net Change in Fund Balance	(1,024,345)	(7,188,930)	8,030,672	8,082,442	6,252,155	4,798,574	7,043,108	9,046,732	9,561,254	10,992,214	(7,945,185)	(14,919,601)	(11,545,101)
% Total Expenditures	(0.5%)	(3.7%)	4.0%	3.7%	2.5%	1.9%	2.6%	3.2%	3.2%	3.1%	(2.2%)	(4.0%)	(3.1%)
% State Expenditures	(0.8%)	(5.4%)	5.8%	5.6%	3.9%	2.9%	4.1%	4.8%	4.9%	5.3%	(3.8%)	(6.9%)	(5.2%)
% Total Revenues	(0.5%)	(3.9%)	3.9%	3.7%	2.5%	1.9%	2.6%	3.2%	3.2%	3.0%	(2.3%)	(4.3%)	(3.2%)
% State Revenues	(0.8%)	(5.8%)	5.7%	5.5%	3.9%	2.9%	4.1%	4.7%	4.8%	5.2%	(4.0%)	(7.7%)	(5.7%)

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's scenario analysis assumes the GDP and expenditure growth sequence shown in the 'Scenario Parameters' section. For further details, please see Fitch's US Tax-Supported Rating Criteria.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.