COVID-19 and California's Evolving Fiscal Outlook

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Emergence of the novel coronavirus (COVID-19) is a public health emergency. Earlier this week the Legislature provided the administration additional resources and authority to ensure the state can effectively respond. Similarly, there is a marshaling of resources occurring at the federal level that should offer support to the economy and the state's fiscal situation. Our office intends to collate and report on the federal fiscal response as information becomes available. The economic uncertainty caused by this emergency will significantly affect California's near-term fiscal outlook. That said, the state goes into this period on strong fiscal footing with significant budget reserves. These reserves could help the state respond to the emergency and, if necessary, help address budget shortfalls once the extent of fiscal fallout from the economic effect of the virus is known.

The last couple of weeks and days have seen a sharp pullback in financial markets and economic activity. Earlier revenue estimates now clearly require downward revision, though it is premature to say by how much. While our office will provide updated economic and fiscal analyses as more information becomes available, this could take a few months. Regardless of the ultimate revenue estimates, the Legislature almost certainly will have to reassess its policy priorities for the upcoming year. Below, we offer some initial observations on the recent volatility in financial markets, palpably sharp reduction in economic activity, and the state's fiscal position at the outset of this episode.

Volatile Financial Markets Indicate Lower Capital Gains-Related Tax Revenue

Taxes on capital gains are a significant source of state revenue. Even in "normal" times, capital gains income is difficult to forecast because it correlates with stock market performance. The Governor's budget projected tax revenues from capital gains income of about $30 billion across 2019-20 and 2020-21. This estimate assumed that the average price level for the S&P 500 stock index would remain relatively flat from late 2019 through the first half of 2020, with gradual price appreciation thereafter. Similar to our November *Fiscal Outlook*, the Governor's budget acknowledged that a market correction represented a significant downside risk to the forecast. Although we do not know how the market will perform going forward, the recent price drops give us tangible information about one way in which COVID-19 could affect California's budget.

Prior to the COVID-19-related declines, equity markets had outperformed Department of Finance assumptions in December and January. As a result, even after the recent drops, the S&P 500 stock index average daily closing price through mid-March remained above the Governor's budget assumption (3,120). At its March 17 closing price level (2,529), however, the market is now well below the budget assumption. Therefore, absent a more rapid recovery than has occurred in any modern market downturn of this severity, it appears likely that the average price level will wind up lower than the budget assumption. A preliminary analysis conducted by our office indicates a very high likelihood that tax revenues from capital gains income will be several billion dollars lower than what the Governor's budget assumed.

COVID-19 Response Abruptly Brings Economic Activity to a Halt…

With regard to the broader economy, the odds of a recession have increased substantially within a short period of time. The suddenness of the pullback in activity across wide swaths of the economy—and especially the various service sectors—is particularly problematic. The abrupt and nearly across-the-board curtailment of spending that is now underway sets it apart from previous downturns. Newly released economic forecasts from several financial services firms have downgraded to near zero or negative their forecasts of second quarter real Gross Domestic Product growth. Beyond the consensus view—that the pandemic introduces a negative economic shock—the various forecasts exhibit a wide range of potential outcomes, reflecting the unprecedented nature of recent events.

In a relatively optimistic scenario, the economy would experience a sharp but comparatively short-lived downturn lasting one or two months. Aided by monetary and (federal) fiscal stimulus, broad-based demand would rebound, contributing to a V-shaped recovery, in which activity rebounds nearly as quickly as it fell. In a more pessimistic scenario, economic activity would remain depressed for longer, compounded by dislocated supply chains and reduced lending caused by elevated risk aversion in credit markets. Whatever emerges as the economic path forward is likely contingent on the course of the virus itself and, relatedly, the extent and duration of its effects on consumer activity. Given that many key economic indicators are reported on a monthly basis and often with a lag, however, it is premature for our office to form any concrete estimates of economic activity.

The type of contraction the state, national, and global economies experience will have implications for revenue collections in the coming years. While the stock market provides some real-time information on how capital gains revenues might be affected, overall personal income and corporation tax revenues will depend highly on the type of recession and recovery the state experiences.

…But California's Strong Fiscal Position Is a Key Advantage

If there is any silver lining, it is found in the condition of California's budget, which entered 2020 on strong footing. Throughout the economic expansion, policymakers maintained a focus on enhancing fiscal resilience by adding significantly to the state's budget reserves. While the Governor's January budget proposed a total reserve level of around $20 billion for June 2021, the adjusted level after the recent declines in the stock market likely will be several billion dollars lower. These reserves are not the only tool at the Legislature's disposal, however. In recent years, because the state has accelerated the pay down of debt, maintained a multiyear balanced budget, and holds a significant cash cushion, California is better prepared to weather the public health crisis and unfolding economic downturn.

Budget Conversation Changes Amid Diminished Fiscal Capacity

Notwithstanding the state's strong budget situation, the timing of the COVID-19 outbreak—during the period between the release of the Governor's budget and the May Revision—presents logistical challenges. Volatile financial markets and the rapidly changing economic picture, as well as the aforementioned lag in receiving current economic data, inject major uncertainty into the May revenue estimating process and budget wrap up. The extended tax filing due date—while justified—will further complicate the task of developing revised revenue estimates both for the current year and the 2020-21 fiscal year. Given that it will take time to appraise the ultimate effects on the state, the Legislature may need to take incremental steps—like adopting a workload budget in the nearer term—to buy time beyond its constitutional deadline to pass the budget (June 15) to assess the state's ultimate fiscal capacity.

After addressing immediate emergency funding needs, the Legislature likely will turn its attention to aiding the state's recovery from the public health and economic effects of COVID-19. Out of necessity, the Legislature may have to prioritize assistance to adversely affected small businesses, nonprofit agencies, and individuals. Furthermore, it is now plausible that these efforts will have to take place with the state facing a budget problem in 2020-21.