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California Credit Quality Expected to Benefit from Election Day Tax Hike; Long-Term Outlook More Clouded

Voters in California approved Proposition 30 last Tuesday, raising sales and income taxes in support of Governor Jerry Brown's budget plan. The State of California expects to collect an additional $6.8 billion annually as a result. Prop. 30 raised the state sales tax one-quarter percent, to 7.5% from 7.25%, and raised income taxes on those making more than $250,000. California will now have by far the highest income tax rates in the U.S., as tax rates jump to 10.3% on income over $250,000, 11.3% over $300,000, 12.3% over $500,000 and 13.3% on income over $1,000,000.

The passage of Prop. 30 is a significant short-term positive for municipal investors in California for multiple reasons. By generating the revenues needed to support the Governor's FY2013 budget, passage will avoid substantial mid-year state spending cuts that would otherwise have been necessary. The state's credit quality is now much more stable in the near-term, as revenues will now be more closely in line with state budget expenditures. Although no rating actions have resulted yet, the rating agencies have made positive comments about the effects of Prop. 30's passage on the state's credit quality. California is currently the lowest rated state by S&P (current ratings A1/A-/A-, outlooks stable/positive/stable by Moody's, S&P and Fitch, respectively), and many market participants expect S&P will now upgrade California later this year. As a result, California state bonds have already seen improved price action in the days since the election, according to Bloomberg.

The biggest beneficiaries of increased state revenues may be local school districts, as mid-year state budget cuts would have come in large part from state spending on K-12 education and higher education. While some districts remain well-positioned to weather such cuts, many more were expected to have had serious negative credit consequences if the state made significant mid-year spending cuts. California's community colleges and universities were also in jeopardy of having state funding levels slashed if Prop. 30 did not pass. With its passage, state education spending levels will not have to be cut mid-year, providing much-needed stability to California local education issuers.

From an investor perspective, we expect demand for California tax-exempt bonds to continue to be very strong, regardless of the budget rumblings in Washington, D.C. At the new marginal tax rates, high-tax bracket investors will be even more highly incentivized to seek investments that have in-state tax advantages. For an investor with taxable income above $250,000 buying a bond yielding 3%, the benefit of buying state-tax-exempt bonds ranges from at least 47 basis points (bps, or 0.47%) to as much as 70 bps (0.70%) on a tax-equivalent yield basis.

Over the long term, the more significant Election Day outcome for California may be the election of a super-majority of Democrats in the California Legislature. California is one of the few states that require a supermajority vote in the Legislature to pass new tax increases. As a result, the state's Legislature has had a very difficult time passing budgets in years in which revenues failed to grow as fast as expenditure demands, with Republicans in the Legislature generally standing against any increases in state and local tax rates. As a result, California's financial position and credit quality have tended to follow a boom-and-bust pattern in which strong economic growth fuels rapid revenue increases and improves credit quality. In recessions, revenues fell off rapidly, creating gaping budget holes and bitter Legislative battles over how to balance budgets. Often, the result has been deficit borrowing and cash flow crunches that lowered state credit quality.

With the new political balance in Sacramento, there is some potential that the Legislature will aggressively move to make changes to certain tax limitations in the state, most notably California's Proposition 13 limit on increases in local property taxes. While it is far too early to tell what course California will follow in the coming years, a rapid expansion of state and local taxes to support significant increases in structural expenditures could set the state up for long-term budget problems that are even greater than those currently facing the state and its local governments. In the near- to intermediate-term, if the economy continues to grow, expanding tax revenues could help stabilize California's budget position and lead to improved credit quality not only for the state, but also for local issuers that depend on property taxes for much of their revenues. Over the long-term, tax policies that stifle job creation and economic growth and substantially increase the already-high cost of living in the state could have dire long-term effects on the economy and budget of California and its municipalities.

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