



Investment Insights

State of the State: California

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Overview

The state of California has remained strong and resilient, and it is well positioned to navigate any potential economic slowdown.

Prudent fiscal management has allowed California to maintain robust budget reserves that could provide a cushion against slowing economic growth.

We highlight the University of California, which offers a highly durable credit profile, supported by its scale, diversified revenues, and significant liquidity.

State overview

The Golden State has maintained a financial position that is robust and resilient overall. Having encountered economic challenges in the past, the state has implemented various measures to prepare for a potential economic slowdown, positioning itself to effectively manage such conditions.

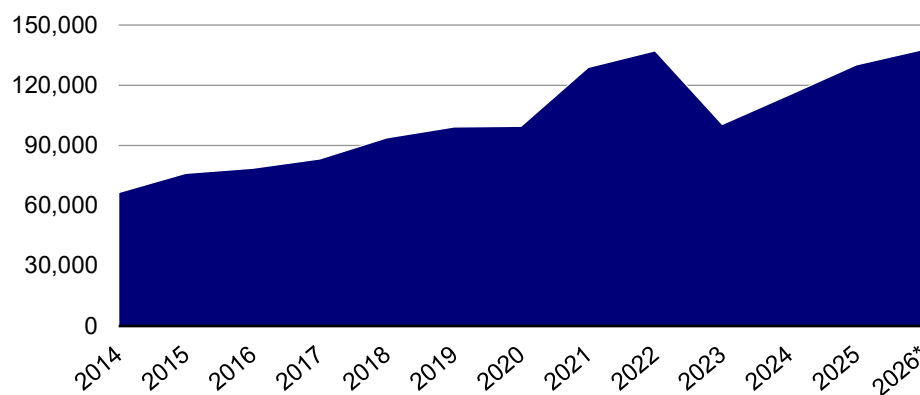
California's tax revenue relies heavily on a small segment of high-income earners, whose personal income taxes have been bolstered by previous periods of economic and market growth. Voters in California have also contributed to increased revenue by approving temporary income tax rates targeting these high earners. Since 2012, a combined top income tax rate of 13.3%, including surcharges on incomes exceeding \$1 million, has been in place.¹ Furthermore, state officials have taken a prudent approach to revenue growth forecasts by building reserves, reducing liabilities, and limiting new ongoing expenditures. Voters have supported these efforts by authorizing greater flexibility in the budget process and later approving the creation of additional budget reserves funded by surplus capital gains tax revenues.

Fiscal update: California general fund revenue (\$millions)

	FY 2025	% of Total
Personal income tax revenues	130,178	59.6%
Sales and use tax revenues	38,353	17.6%
Corporate tax revenues	41,338	18.9%
Other revenues	8,637	4.0%
Total general fund revenues	218,506	100.0%

Excludes transfers
Source: California Governors Budget 2026/27

Annual personal income tax revenue (\$millions)



*Estimated
Source: Prior California State Budgets through FY 2024; California Governors Budget 2026/27

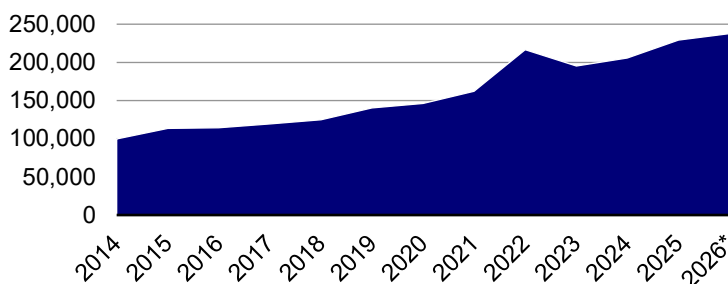
For the first time since Fiscal Year (FY) 2024, California has been able to achieve a roughly balanced budget for FY 2027 without having to tap into the budget stabilization account. In fact, the state will deposit \$3 billion into the budget stabilization account this fiscal year, bringing the account balance to \$14.4 billion. For FY 2025, California expects to have generated a general fund surplus of \$3.1 billion, an improvement from the estimated \$7 billion deficit in the FY 2026 state budget act. This change reflects more than \$42 billion in additional general fund revenue over the next three-year budget window, which is driven by higher cash receipts, stronger stock market levels that support personal income tax collections, and an improved economic outlook.² The general fund balance rose to \$56 billion in FY 2025, or roughly 24% of expenditures. Total general fund revenues for FY 2025 were the second highest on record and only \$5 billion behind FY 2022. Year over year, the increase was driven largely by a \$15 billion rise in personal income tax revenues, up 13% to \$130 billion.² Because personal income tax includes stock-based compensation, a meaningful share of these revenues depends on financial market performance and individual taxpayers' investment decisions. Historically, that has made these revenues difficult to project and budget for.

As in other states, California has experienced cost pressures from high inflation since early 2021. The governor's office projects a 3.3% increase in revenues for FY 2026, alongside a 3.7% rise in expenditures. There is the possibility of higher revenues, especially for personal income taxes. This will depend, however, on volatility in the equity markets.

California's reserve levels are positioned to help mitigate the impact of any deficits in future years. Despite planned reserve usage during the fiscal year, reserves at year end are expected to total \$53 billion, representing 22% of estimated expenditures.² The state continues to maintain strong liquidity across multiple areas. The California State Controller reported cash and internal borrowable resources of more than \$108 billion, as of January 31, 2026, down 1.7% year over year. This drop is primarily due to a decrease in the budget stabilization account.³

Fiscal update: California general fund expenditures (\$millions)

	FY 2025	% of Total
Education	110,233	48.1%
Health & Human services	73,227	31.9%
Public safety/Corrections	13,869	6.1%
Other expenses	31,902	13.9%
Total expenditures	229,231	100.0%



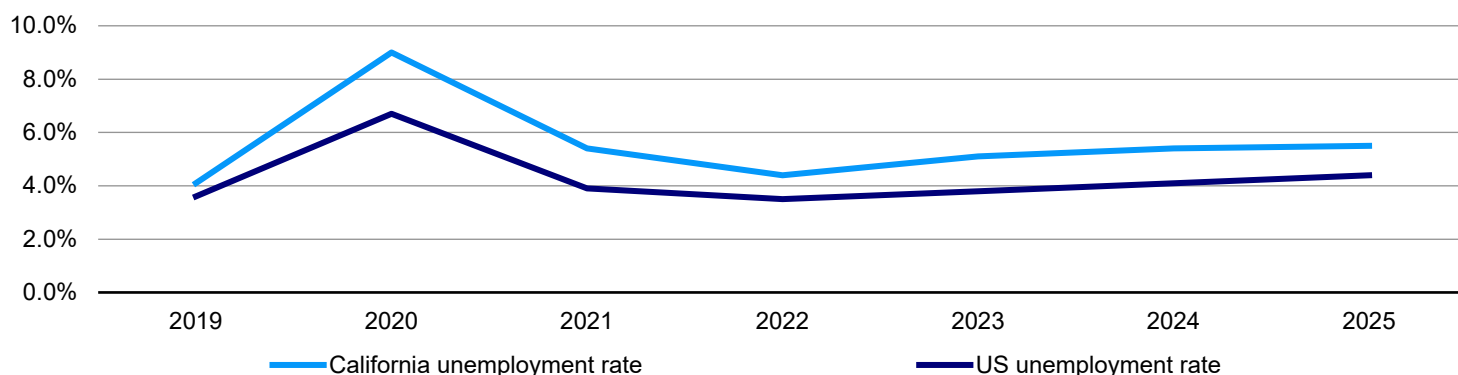
*Estimated
Source: California Governor's Budget 2026/27.

Economic update

California has a massive and diverse economy that plays a major role in driving US economic growth. It has the largest gross state product, accounting for 14.4% of national gross domestic product.¹ In 2025, real gross state product grew by 2.5%, outpacing the national real gross domestic product growth rate of 2.1%.⁴ The state is also the most populous in the US, with an estimated population of 39.4 million people.⁵

Income levels in California have typically exceeded the US levels. In 2024, the state's median household income was \$100,149, 23% higher than average US per capita family income.⁵ Despite this, California's unemployment rate has consistently been higher than the US average, even in periods of economic growth. The state unemployment rate rose slightly in 2025, ending the year at 5.5%, above the national unemployment rate of 4.4%.⁶

California vs. national unemployment rate (seasonally adjusted)



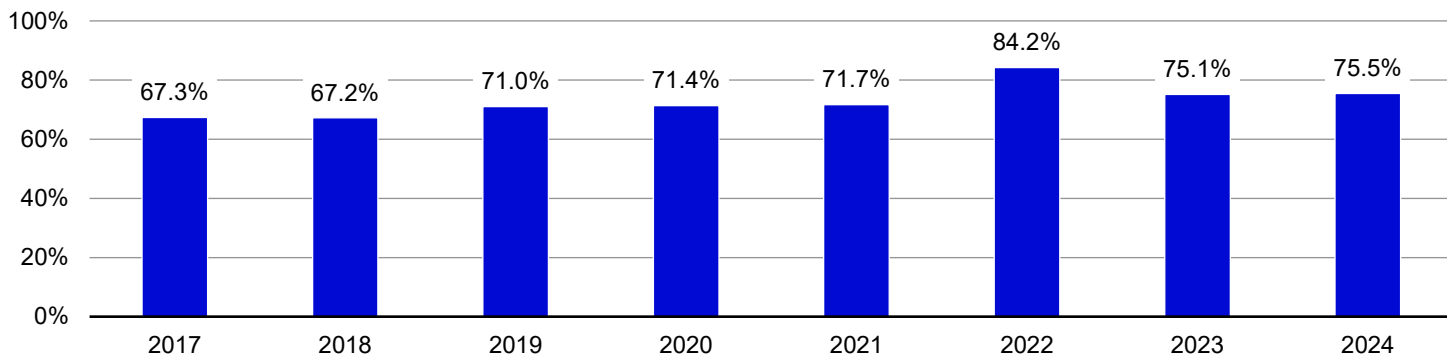
Source: US Bureau of Labor Statistics, as of December 31, 2025.

California pension funding

The state maintains two major defined pension plans, the California Public Employees' Retirement System (CalPERS) and the California Teachers' Retirement System (CalSTRS). The combined funding ratio of both retirement systems decreased to 75.5% in FY 2024.⁶

California has been making extra pension payments, and the proposed FY 2027 budget includes a \$2.5 billion supplemental one-time contribution.² Future pension funding levels could be impacted by reductions in supplemental contributions and lower investment returns.

State pension funding levels



Source: Merrit Research Services through 2024. Latest data available.

Natural disasters

California has recently experienced extensive periods of drought, leading to severe wildfires. Most recently, the Madre fire in July 2025, which burned over 80,000 acres and the Palisades fire in January 2025 that destroyed more than 23,000 acres. While these wildfires do pose risks to local communities and governments, they have had a relatively small impact on the state's economy. The Madre fire only destroyed one structure compared with the nearly 8,000 structures destroyed or damaged in the Palisades fire despite burning far more acres. Further, we believe that insurance proceeds and other federal support will be material in the process of rebuilding in Los Angeles. Given California's history of managing natural disasters, we believe the state will be able to navigate these recent wildfires through effective fiscal policy. Los Angeles has also already started the process of rebuilding, with more than 3,000 permits having been issued as of January 2026. The parcels are mainly being sold to small and midsize real estate investors and developers. According to S&P, Los Angeles County accounts for 21% of California's total personal income tax collections, 28% of corporate taxes, and 32% of the pass-through entity tax, based on 2022 collections.⁸

Issuer spotlight: California state general obligation bond ratings

Moody's: Aa2 / Stable outlook

Moody's has rated the state of California's general obligation bonds Aa2 since its last upgrade in October 2019. On March 30, 2026, Moody's affirmed its rating and outlook at stable. Moody's rating and outlook balance the state's large economic base, healthy liquidity, and satisfactory level of budget reserves against a highly volatile revenue structure and constraints to operating flexibility.

Standard & Poor's: AA- / Stable outlook

Standard & Poor's (S&P) has maintained a rating of AA- on the state of California's general obligation bonds since its last upgrade in July 2015. On March 30, 2026, S&P affirmed its rating and outlook, having revised its outlook to stable from positive in December 2023. The downward outlook revision was based on weaker-than-estimated revenue collections; however, the outlook is stable due to the state's strong fiscal position and tools to manage through this uncertain time. S&P's rating incorporates strong economic metrics, healthy reserves, and moderate debt ratios that together help to offset the state's volatile revenues, high housing costs and minimal prefunding of retiree benefits.

Fitch: AA / Stable outlook

Fitch has rated the state of California's general obligation bonds AA since its last upgrade in August 2019 and affirmed its rating and stable outlook on March 31, 2026. Fitch's stable outlook reflects the state's large and diverse economy, which supports strong revenue growth prospects, the ability to manage expenditures, and moderate levels of debt and pension liabilities. The state's strong fiscal management has helped build reserves that mitigate impacts from economic and revenue cycles.

Issuer spotlight: University of California

Moody's: Aa2 / Stable outlook since 06/26/2024

Standard & Poor's: AA / Stable outlook since 02/10/2026

Fitch: AA / Stable outlook since 12/02/2025

The University of California, or UC, is one of the largest public university systems in the country. It includes 10 campuses across California, plus a graduate health sciences campus in San Francisco. The system also includes six medical schools, five academic medical centers, affiliated hospitals, professional schools, and a statewide agriculture and natural resources division. In addition, UC helps manage national laboratories for the US Department of Energy.⁹ Its scale and breadth support a broad revenue base, a well-known academic brand, and a statewide public mission that together help underpin its strong high-grade credit profile.

UC also benefits from very strong student demand, especially at flagship campuses such as UCLA, UC Berkeley, and UC San Diego. That demand has helped support enrollment growth across the system, which in turn has helped tuition revenue remain healthy even though tuition increases have been relatively modest.¹⁰ UC is also a leading research institution, bringing in \$8.7 billion in annual research grants,¹⁰ which adds another important source of revenue and strengthens its national and global standing. While UC's large medical center operations can add earnings volatility, we view this as manageable, as the added revenues and cash flow help offset operating and capital risks over time.

Another key strength is UC's balance sheet. In fiscal 2025, the system reported more than \$50 billion of total cash and investments,¹¹ giving it meaningful flexibility to handle operating volatility, fund capital projects, and manage long-term obligations. Those obligations include roughly \$40 billion of total debt¹² and approximately \$32 billion of combined pension and non-pension retirement liabilities.¹⁰ Looking ahead, UC faces substantial capital investment needs, estimated at nearly \$30 billion through 2030, focused on seismic compliance, medical centers, and housing.¹¹ A large portion of that spending is likely to be financed with debt, which would raise leverage somewhat, but we believe it remains manageable in the context of UC's scale, liquidity, and market position.

Why we like the credit

The University of California continues to show strong and dependable credit quality, in our view, backed by experienced leadership, a globally respected academic brand, a wide mix of revenue sources, and very strong liquidity. Fiscal 2025 marked another solid year for the system, with revenues rising 9% to \$60.7 billion¹⁰ and more than \$50 billion of available funds and resources,¹³ highlighting UC's ability to navigate a challenging environment for both higher education and healthcare. Revenue growth was driven mainly by medical center operations, research activity, and tuition, while state support and net tuition levels were relatively flat. Looking ahead, while UC's long-term strengths remain firmly in place, additional borrowing to help fund capital projects could limit near-term credit improvement, even as the overall financial profile remains strong. Importantly, UC's scale, deep liquidity, and enduring demand for its academic and healthcare offerings position the system well to continue navigating future challenges while maintaining strong credit quality.

1. State of California General Obligation Bonds Official statement, dated October 30, 2025
2. California Department of Finance, Governor's Budget, dated January 9, 2026
3. California State Controller, dated February 10, 2026
4. Federal Reserve Economic Data, as of December 31, 2025
5. US Census Bureau, as of December 31, 2025
6. US Bureau of Labor Statistics, as of December 31, 2025
7. Merritt Research Services, as of June 30, 2024
8. S&P Global Ratings, dated March 3, 2025
9. The Regents of the University of California General Revenue Bonds Official Statement, dated February 25, 2026
10. University of California, as of June 30, 2025
11. Moody's, dated December 8, 2025
12. S&P Global Ratings, dated February 10, 2026
13. Fitch, dated February 18, 2026

About risk

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. The values of junk bonds fluctuate more than those of high-quality bonds and can decline significantly over short time periods.

All fixed income securities are subject to two types of risk: credit risk and interest rate risk. Credit risk refers to the possibility that the issuer of a security will be unable to make interest payments and/or repay the principal on its debt. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Municipal bonds are issued by state and local government agencies to finance public projects and services. They typically pay interest that is tax-free in their state of issuance. Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. NR indicates the debtor was not rated and should not be interpreted as indicating low quality.

For more information on Standard and Poor's rating methodology, please visit www.standardandpoors.com and select 'Understanding Credit Ratings' under 'About Ratings' on the homepage.

For more information on Moody's rating methodology, please visit <https://ratings.moody's.io/ratings> and select 'Rating Methodologies' on the homepage.

For more information on Fitch Ratings rating methodology, please visit www.fitchratings.com and select 'Criteria' under 'Resources' on the homepage. Then select 'Rating Definitions' under 'Resources' on the 'Contents' menu.

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