

LAO 

Executive Summary

Why Do Budget Problem Estimates Differ? A budget problem is inherent in a point-in-time estimate that reflects information available at the time of development, forecasts of future revenues and spending, and assumptions about the extent to which changes in costs are due to current policies (that is, whether or not they are baseline changes). When changes in costs do not occur automatically under current policies, economists use budget solutions or adjustments. We take this approach in order to provide the Legislature visibility into the full scope of the administration's choices.

What Is Our Estimate of the Budget Problem Under the Governor's Budget? We estimate the administration solved a budget problem of \$58 billion. Our estimate of the Governor's budget deficit is larger than the administration's estimate (\$38 billion) largely due to differences in what we consider to be baseline changes. The largest of these changes impacts schools and community colleges. Specifically, the administration defines a \$15 billion reduction in school and community college spending relative to the enacted level in 2023 as a baseline change.

How Does the Governor Propose to Solve the Budget Problem? The Governor's budget solutions focus on spending. Spending-related solutions (including both school and community college spending and other spending) total \$41 billion and represent nearly three-quarters of the total solutions. In addition, the Governor's budget includes \$13 billion in reserve funds, which represent nearly one-quarter of the total; \$4 billion in cost shifts; and about \$400 million in revenue-related solutions.

Assessing the Governor's Approach. The Governor's budget revenue projection is \$15 billion

HOW DOES THE GOVERNOR PROPOSE ADDRESSING THE BUDGET PROBLEM?

Figure 2 summarizes the budget solutions that this section describes in detail. The Governor's budget solutions focus on spending. Spending-related solutions (including both school and community college spending and other spending) total \$41 billion and represent nearly three-quarters of the total solutions. In addition, the Governor's budget includes \$13 billion in reserve fundraiser, which represent nearly one-quarter of the total; \$4 billion in cost shifts; and about \$400 million in revenue

he s a e o eres ima es p ake in a ne program or as a ro ine ma er in programs here spending is ncer ain d e o fac ors like caseload. When ac al s a e cos s are belo b dge ed amo n s, a re ersion occ rs af er a period of ime picall , hree ears. The re ersion re rns he nspen f nds o he General F nd. In his ear's b dge , he Go ernor proposes accelera ing some re ersions ha o ld ha e o her ise occ rred in he f re and proposes proac i el re er ing cer ain f nds ha o her ise are con in o sl appropria ed (hich has he effec of reali ing sa ings from he nspen f nds ha o ld no o her ise occ r). While no all of hese amo n s represen lo er s a e spending o er he long erm, he do res l in sa ings oda a a cos in he f re. As a res l , e co n hem as spending-rela ed sol ions. We es ima e he proposed b dge incl des abo \$3 billion in re ersions.

School and Community College Spending

\$15 Billion in Lower Spending on Schools and Community Colleges. The California Cons i ion se s a minim m ann al f nding req iremen for schools and comm ni colleges (o her ise kno n as Proposi ion 98 [1988]). The s a e mee s his req iremen thro gh a combina ion of General F nd spending and local proper a re en e. De o he large decline in General F nd re en es, he cons i ionall req ired General F nd spending le el is do n \$15.2 billion rela i e o he es ima es in he J ne b dge . The Go ernor proposes o red ce school and comm ni college spending o his lo er le el (e describe he specific red c ions in he ne sec ion).

Reserve Withdrawals

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Revenue-Related Solutions

We estimate the Governor's budget includes about \$400 million in revenue-related solutions. For example, the Governor proposes narrowing

businesses' ability to deduct their charitable contributions from their current income. This would generate about \$300 million in additional revenue in 2024-25.

BUDGET CONDITION

In this section, we describe the overall condition of the General Fund budget after accounting for the Governor's budget proposals and solutions. We also describe the condition of the school and community college budget.

General Fund Budget

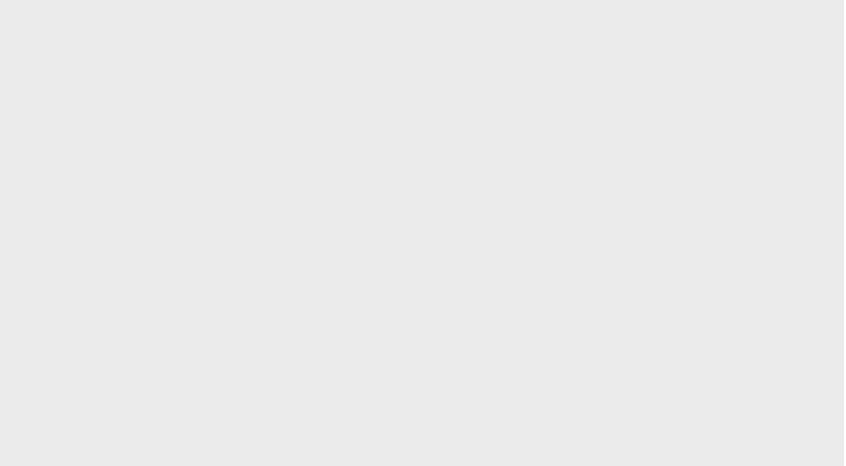
Figure 3 shows the General Fund condition based on the Governor's proposals and using the administration's estimates and assumptions.

Under Governor's Budget, Reserves Would Total \$14.5 Billion by End of 2024-25. Under the Governor's budget, general purpose reserves would total \$14.5 billion by the end of 2024-25. (In addition, the state would have \$3.9 billion in the Proposition 98 Reserve, available only for school and community college programs.) The remaining balance of the BSA—\$11 billion—would likely be available to address a budget problem near the end of the fiscal year.

Administration Plans for Significant Future Budget Deficits. The Governor's budget includes estimates of multi-year revenues and spending. Under the administration's projections, the state faces operating deficits of \$37 billion in 2025-26, \$30 billion in 2026-27, and \$28 billion in 2027-28. (As shown in **Figure 4**, these deficits are very similar to or

Figure 3

General Fund Condition Summary (In Millions)



December projections of the budget's position although estimates were based on current law and policy, not the Governor's budget proposals.) Although these former deficits are smaller than the current one, they are still quite significant. Moreover, the state is likely to face these deficits in other options such as one-time spending reductions and reserves. As such, former deficits are likely to require more difficult decisions, like ongoing spending cuts and revenue increases.

School and Community College Budget

Funding for Schools and Community Colleges Down \$14.3 Billion Over Budget Window.

Compared with the estimates included in the June 2023 budget plan, the administration estimates the constitutional minimum funding level for schools and community colleges is down \$14.3 billion over the 2022-23 through 2024-25 period. This downward revision consists of a \$15.2 billion reduction in required General Fund spending, partially offset by a \$903 million increase in local property revenue. Most of the reduction \$9.1 billion is attributable to 2022-23, with the remainder divided about evenly between 2023-24 and 2024-25. The Governor proposes to red-define the lower constitutional level through a combination of spending reductions and discretionary reductions from the Proposition 98 Reserve. These reductions also free up funding for a few smaller augmentations.

Assumes \$8 Billion in Lower Spending in 2022-23. The budget proposes to reduce General

Fund spending on school and community college programs in 2022-23 by \$8 billion. The budget does not specify how the state will implement this reduction, but indicates the state will make the reduction in a way that avoids impacting school and community college budgets. We also understand that as part of this action, the state would make supplemental payments totaling \$8 billion over a five-year period (from 2025-26 through 2029-30). (Separate from this proposal, the budget scores \$1.1 billion in lower baseline spending in 2022-23.)

Proposes Discretionary Withdrawal From Proposition 98 Reserve. The Proposition 98 Reserve is a state-wide reserve account for school and community college funding. The Governor proposes to make a discretionary withdrawal of \$5.7 billion from this account to help cover costs for existing school and community college programs in 2023-24 and 2024-25. After accounting for the discretionary withdrawal and a few other automatic adjustments, the remaining balance in the reserve would be \$3.9 billion.

Funds Augmentations in a Few Areas. The most notable ongoing augmentation is a 0.76 percent salary cost-of-living adjustments (COLA) for existing school and community college programs. The most notable one-time proposal is \$500 million for a second round of grant funding for zero-emission school buses. The budget also proposes smaller increases related to education workforce, education technology, and community college nursing programs.

ASSESSING THE GOVERNOR'S APPROACH

Revenues Optimistic but Plausible.

relationship between stock price gains and share repurchases is complex. And, not all similar stock market rallies can have significant different impacts on share repurchases.

Reserve Withdrawals Generally Reasonable.

Plan for Lower Revenues. Because we will be much closer to resolving the question of how much (if at all) revenues will rebound in the current fiscal year. While many options are possible, our assessment of the current evidence suggests the resolution of this question likely will result in the administration requesting down their revenues estimates in May. Should this occur, it would necessitate additional budget solutions. We advise the Legislature to begin to consider now those solutions could be.

Maintain Similar Reserve Withdrawal. We advise the Legislature to set no more in reserves than proposed by the Governor's current proposal, about half of general-purpose reserves. Given the state is likely to continue to face significant budget problems in the coming years, depleting reserves now would make reductions to ongoing programs and/or ongoing revenue increases more likely.

Develop Plan for School and Community College Funding. Given the lack of clarity in the Governor's proposal, the Legislature may want to develop a position plan for addressing school and community college funding. As we describe in our **Fiscal Outlook**, the Legislature could see the existing balance in the Proposition 98 Reserve to help cover spending above the constitutional minimum in 2022-23. This approach would allow the state to reduce spending in 2022-23 with no immediate effect on schools and community colleges.

Maximize One-Time Spending Reductions. The Governor's budget includes \$26 billion in spending-related solutions (excluding school and community college solutions). While the Governor's budget likely reflects pulling back most recent approved one-time and temporary spending, we are still assessing whether any additional such appropriations remain. To the extent we do, we recommend the Legislature assess whether additional pullbacks could be achieved, including in the current year. Maximizing one-time spending reductions allows the Legislature to minimize the use of other budget tools like reserves that likely will be needed in future years. To ensure these one-time savings can be realized, the Legislature may wish to consider early action on current-year appropriations.

Apply High Bar for Any Discretionary Proposals and Contain Ongoing Service Level. The Governor's budget includes roughly \$2 billion in discretionary proposals for 2024-25. To balance the budget, these discretionary proposals require additional reductions to already approved expenditures. Consequently, we recommend the Legislature set a higher threshold for approving these new proposals. Specifically, the Legislature would need to view these new proposals as preferable to already approved spending. We also recommend the Legislature avoid growing the ongoing service level by assessing whether to continue approved, but not implemented, programs.