

JUNE 6, 2024

# **The 2024-25 Budget: LAO Assessment of the Governor's May Revision**

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PRESENTED TO:

League of California Cities



LEGISLATIVE ANALYST'S OFFICE

# The Budget Problem

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***What Is a Budget Problem?*** A budget problem—also called a deficit—arises when resources for the upcoming budget are insufficient to cover the costs of currently authorized services.

***How Big Is the Budget Problem?*** The Governor cites a budget problem of \$27 billion. Under our estimates, the administration addressed a larger deficit than this—\$55 billion. This difference is largely due to differences in two areas:

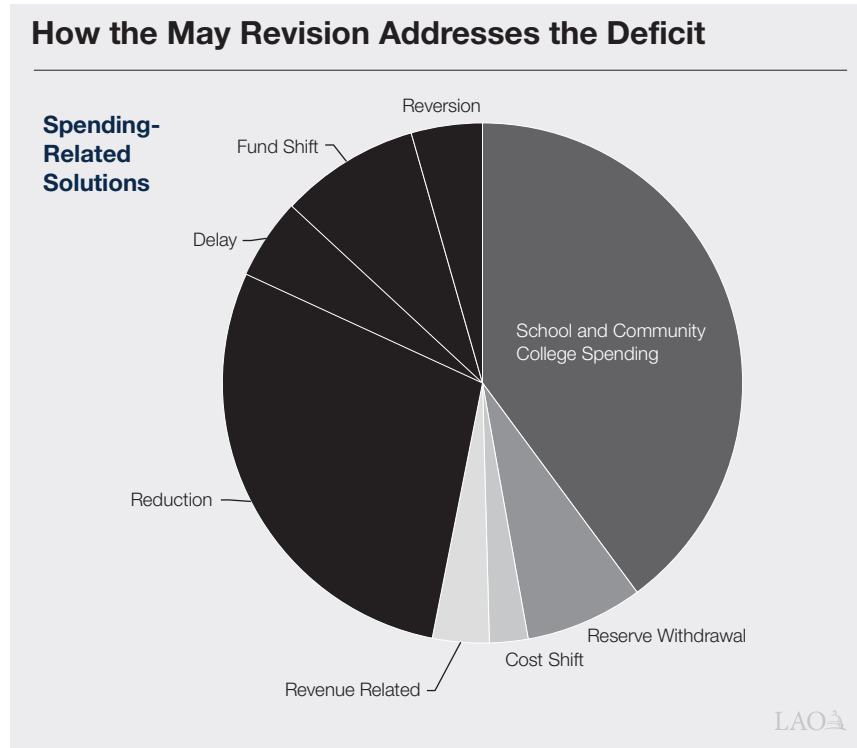
- ***Schools and Community Colleges.*** Our calculation of the budget problem assumes \$22 billion in higher baseline spending on schools and community colleges. This difference mainly relates to our treatment of changes in the minimum spending requirement established by Proposition 98 (1988).
- ***Other Solutions.*** Across the rest of the budget, we also count about \$6 billion in other budget actions as solutions that the administration counts as baseline changes.

***Similar Assessment of the State's Fiscal Condition.*** Together, these scoring differences account for the roughly \$27 billion difference in our office's accounting of the budget problem and the administration's scoring. While we would maintain that our approach more accurately reflects current law, these scoring differences do not reflect substantive differences in state's fiscal position.



# How Does the Governor Propose Addressing the Deficit?

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***Spending-Related Solutions Make Up Majority of May Revision Proposals.*** Spending-related solutions (including both school and community college spending and other spending) total \$48 billion and represent nearly 90 percent of the total solutions. Spending-related solutions include reductions, fund shifts, delays, and reversions. In addition, the May Revision includes \$4 billion in reserve withdrawals, \$1 billion in cost shifts, and about \$2 billion in revenue-related solutions.



# Spending-Related Solutions

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## Schools and Community Colleges

**Schools and Community Colleges.** The May Revision includes several actions to mitigate the effects of lower Proposition 98 spending on schools. The primary actions are: (1) reserve withdrawals, (2) cost shifts, and (3) repurposing of unspent/unused funds. These actions also free up funding for a few smaller augmentations.

## All Other

**Spending-Related Reductions.** More colloquially, these are spending cuts. The May Revision includes \$16 billion in spending-related reductions.

- **One-Time Reductions.** The May Revision eliminates or reduces over \$11 billion in one-time or temporary spending.
- **Ongoing Reductions.** The May Revision also includes about \$5 billion in ongoing spending reductions in 2024-25, which grow to roughly \$8 billion over time.

**Fund Shifts.** Fund shifts are budget solutions that use other fund sources—for example, special funds—to pay for a cost typically incurred by the General Fund. We estimate the May Revision includes \$5 billion in fund shifts.

**Delays.** We define a delay as an expenditure reduction that occurs in the budget window (2022-23 through 2024-25), but has an associated expenditure increase in a future year of the multiyear window (2025-26 through 2027-28). Nearly \$3 billion of the May Revision spending-related solutions are delays.

**Reversions.** We estimate the May Revision includes about \$2 billion in reversions.



## Other Solutions

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**Reserves.** The Governor proposes withdrawing about \$3 billion from the Budget Stabilization Account (BSA) and \$900 million from the Safety Net Reserve. While the May Revision would withdraw the entirety of the Safety Net Reserve balance, it maintains over \$19 billion in the BSA. The May Revision also assume the state withdraws all of the reserves specified for schools and community colleges—almost \$10 billion.

**Cost Shifts.** The May Revision includes about \$1 billion in cost shifts.

**Revenue.** We estimate the May Revision includes about \$2 billion in revenue-related solutions. The largest revenue solution is a proposal to not allow businesses with more than \$1 million in income to claim net operating loss (NOL) deductions on their taxes in 2025, 2026, and 2027.



# The Budget Condition

## General Fund Condition Summary

(In Millions)

|                         | 2022-23<br>Revised | 2023-24<br>Revised | 2024-25<br>Proposed |
|-------------------------|--------------------|--------------------|---------------------|
| Prior-year fund balance | \$63,631           | \$46,260           | \$9,727             |
| Revenues and transfers  | 178,544            | 189,354            | 205,249             |
| Expenditures            | 195,915            | 225,888            | 200,974             |
| Ending fund balance     | <b>\$46,260</b>    | <b>\$9,727</b>     | <b>\$14,001</b>     |
| Encumbrances            | \$10,569           | \$10,569           | \$10,569            |
| <b>SFEU Balance</b>     | <b>\$35,691</b>    | <b>-\$842</b>      | <b>\$3,432</b>      |
| <b>Reserves</b>         |                    |                    |                     |
| BSA                     | \$21,708           | \$22,555           | \$19,429            |
| SFEU                    | 35,691             | -842               | 3,432               |
| Safety net              | 900                | 900                | —                   |
| <b>Total Reserves</b>   | <b>\$58,299</b>    | <b>\$22,613</b>    | <b>\$22,861</b>     |

SFEU = Special Fund for Economic Uncertainties and BSA = Budget Stabilization Account.

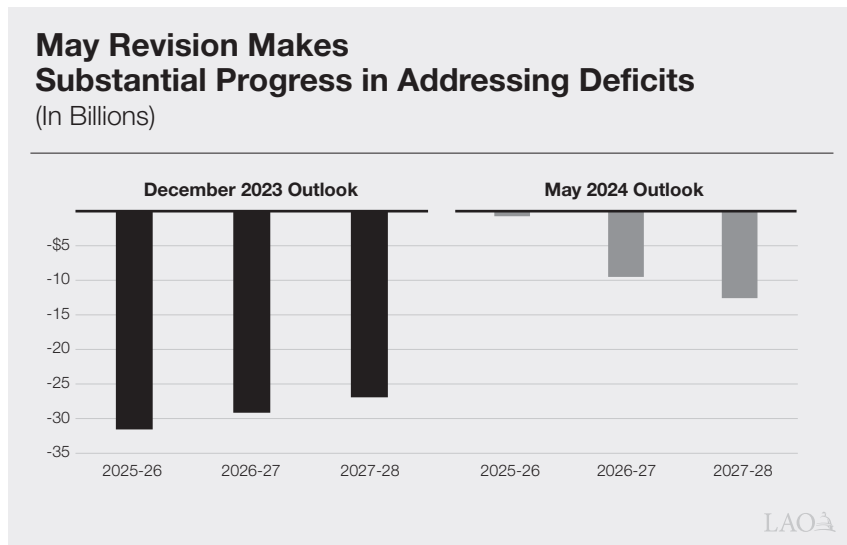


## Assessing the Governor's Approach

***Proposed Budget Structure Puts State on Better Fiscal Footing.*** The May Revision would improve the fiscal position of the state in a few ways. Specifically:

- ***Reducing Reliance on Reserves Preserves a Tool Likely Needed in the Future.***
- ***Reducing More One-Time and Temporary Spending Allows the State to Maintain Other Budget Tools.***
- ***Proposing to Save Excess Revenue in the Future Prudent.***

***By Making Significant Progress Toward Structural Balance Ultimately, Approach Makes It More Likely the State Can Maintain Core Services in the Future.***



## Next Steps for the Legislature

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***How Does the Legislature Want to Address School and Community College Funding?*** One key question for the Legislature is deciding how to address prior-year funding for schools and community colleges. The May Revision continues to rely on a funding maneuver that would contribute to the structural budget shortfall in future years.

***How to Balance Trade-Offs When Reducing Ongoing Spending?*** Each of these decisions involve trade-offs, and some represent reductions to core service levels. Although the administration's focus for ongoing reductions tends to be on newer programs and program expansions, there could be longer-standing programs that the Legislature wishes to revisit.

***Do Any Proposals Raise Serious Concerns?*** While structurally the Governor has taken a prudent approach, some specific proposals raise concerns for our office. (Rejecting or reducing either of these solutions or any others would require finding equivalent alternatives in dollar-for-dollar terms.)

- ***Suspension of NOL Deduction Would Lead to a Less Equitable Tax System.***
- ***Unallocated State Operations Reductions Unlikely to Yield Assumed Savings.***

***Is the Legislature Comfortable With the Downside Risk to Revenues?*** Our revenue forecast is somewhat below the May Revision across the budget window. As such, we think it is more likely than not that revenues ultimately will come in below the May Revision. That being said, we think the administration's estimates are a reasonable basis for building the state budget. Doing so, however, would create a somewhat heightened risk that the state will face additional shortfalls next year. On the other hand, using the May Revision estimates would diminish the risk of overshooting on budget reductions now.

