INTRODUCTION

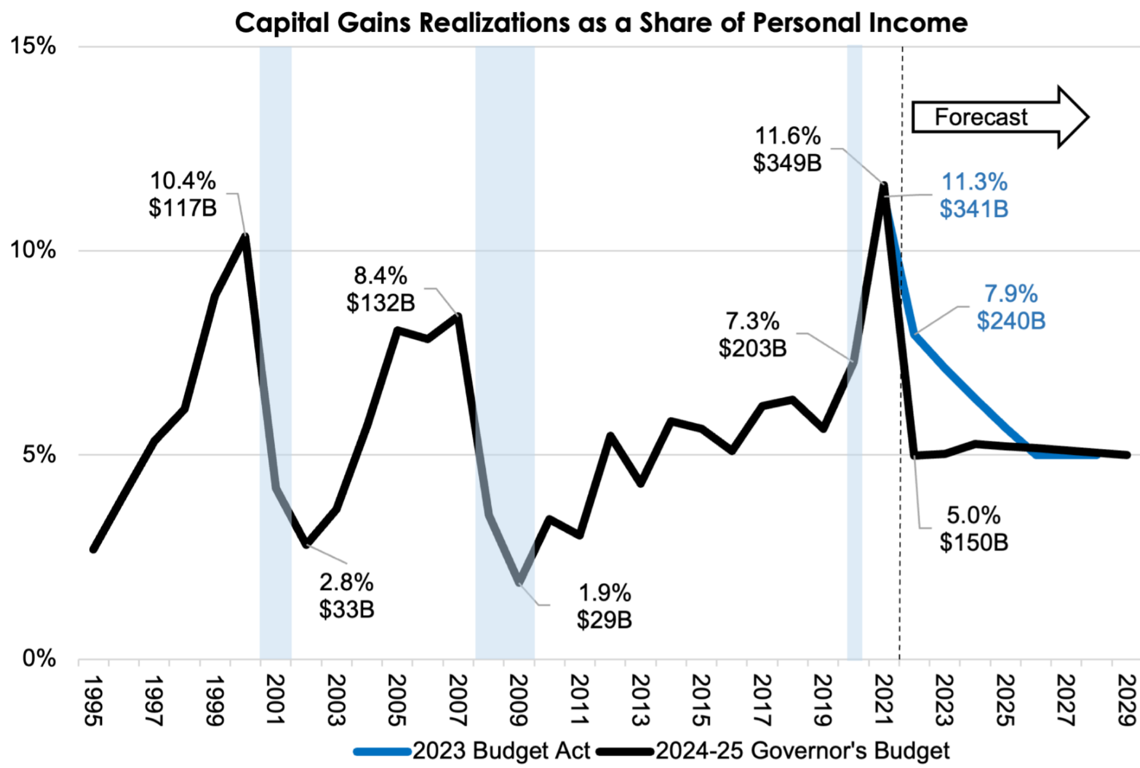
Even as the state faces a shortfall, California continues to expand access to high-quality education, healthcare, and opportunities for innovation and growth—fulfilling promises made while responsibly managing finances into the future. This budget maintains the state's fiscal stability using some of the money saved in historic budget reserves and responsibly closes the shortfall. This balanced budget will allow California to continue to drive important public policy, protect the services Californians depend on most, and support a private sector whose innovation is unmatched anywhere in the world.

The budget shortfall facing lawmakers in 2024—estimated at $37.9 billion—is rooted in two separate but related developments during the past two years—the substantial decline in the stock market that drove down revenues in 2022 and the unprecedented delay in critical income tax collections. Normally, the bulk of cash data relating to the prior tax year is available by April, leading to a revised May budget informed by actual cash collections. Last year, due to federal tax deadline delays and California's subsequent conformity, the majority of the state's revenues did not arrive until October and November. That means the correction that would have come as part of last year's May Revision is instead being made in this January budget.

The Governor's proposed budgets in January and May 2023 warned of this increased uncertainty, and in June, the state passed a budget that planned accordingly, setting aside record reserves of just under $38 billion. Now, the state faces a budget that must solve for last year's shortfall while adjusting state spending to ensure continued fiscal stability for years to come.

STEEP MARKET DROP AFTER RECORD RUN-UP

Revenues showed unprecedented strength in the two fiscal years following the COVID-19 Recession, as stock market growth outpaced the slower overall economic recovery. Fueling this growth were capital gains realizations, which have a sizable impact on California revenues. These increased to a record-high $349 billion in 2021—a 72 percent increase from 2020—representing a record 11.6 percent share of personal income, following a 40 percent increase from 2019 to 2020.

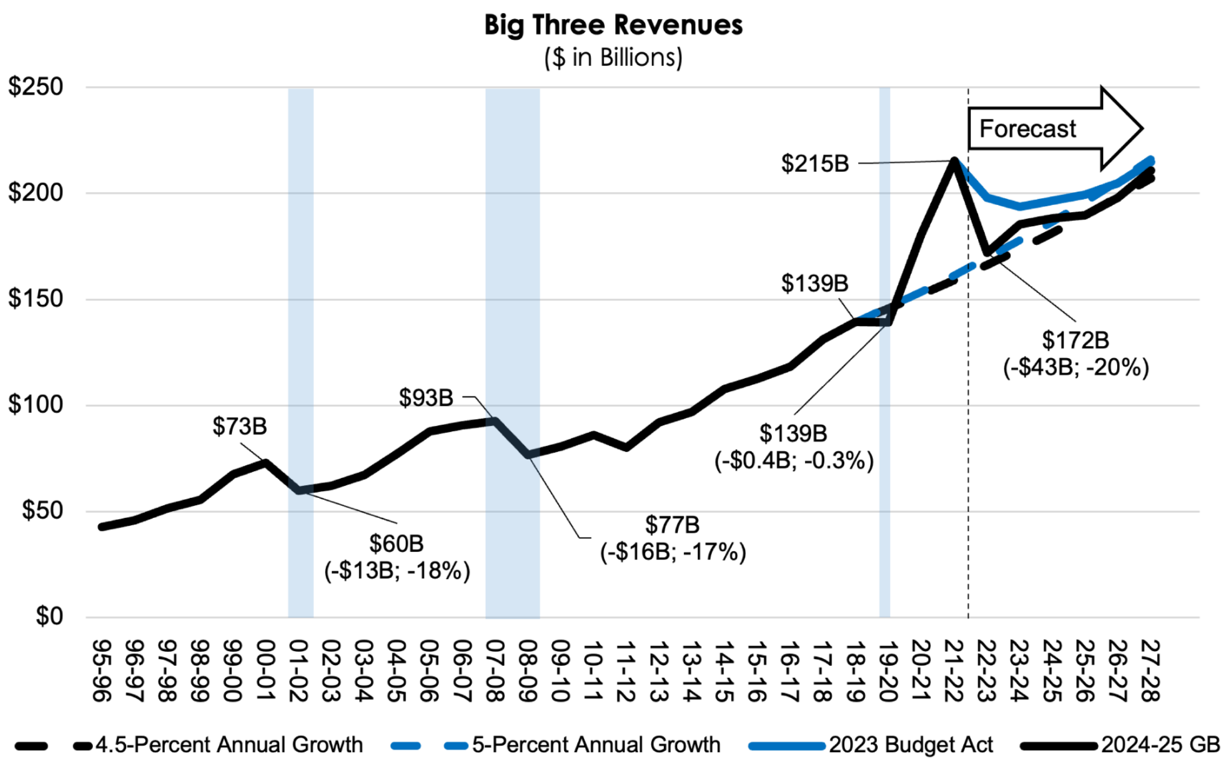


Shaded bars indicate previous U.S. recessions.
Source: California Department of Finance, 2024-25 Governor's Budget Forecast.

As the markets grew, so did state revenues. Over two fiscal years, from 2019-20 to 2021-22, the state's "Big Three" General Fund revenue sources—personal income, sales, and corporation taxes—grew by 55 percent. By comparison, the other two recent periods of comparable growth were the two years before the 2000-01 revenue peak, which saw growth of 31 percent prior to the Dot-Com Bust, and 31 percent from 2003-04 to 2005-06 before the Great Recession.

The stock market run-up through the end of 2021 led to the tax revenue surge that ended in 2022. The S&P 500 Index, which tracks the country's 500 leading companies, declined by 19 percent in 2022. Over the same period, the NASDAQ Composite Index, which measures more than 2,500 stocks concentrated in technology companies that are a California mainstay—declined by 33 percent. These represent the most substantial annual declines in these key indices since the onset of the Great Recession in 2008, and a correction from strong prior market performance, a tightened monetary policy by the Federal Reserve Board that drove interest rates upward, and the expectation of a recession that never materialized.

Despite the downward revision in 2022, 2022-23 revenues are estimated to still be 23 percent higher than pre-pandemic levels in 2018-19. Furthermore, the Big Three revenues are projected to revert to levels consistent with a normal revenue growth trajectory, absent the COVID-19 surge and subsequent correction.



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Source: California Department of Finance, 2024-25 Governor's Budget Forecast.

CONCENTRATION OF HIGH-INCOME EARNERS HEIGHTENED REVENUE IMPACT OF MARKET DROP

The 2022 market decline had an outsized impact on state revenues, since an extremely small share of California taxpayers are responsible for a large share of state revenues. Personal income tax represents roughly two-thirds of all General Fund revenues, and just one percent of California's total tax returns—180,000—were responsible for half of all personal income tax paid by residents in 2021—or $62.9 billion. This small share of Californians earns a significant proportion of their income from stock-based compensation and capital gains, making their income—and the tax revenue it generates—significantly more volatile and subject to swings in the financial markets as opposed to changes in the overall economy.

2023's Unprecedented Tax Filing Delay Masked Full Scope of Revenue Drop

With reliable tax filing deadlines, the degree of the revenue drop associated with the 2022 market declines would have become evident as tax receipts were received in the spring. However, due to federal disaster declarations resulting from severe winter storms, the Internal Revenue Service announced that taxpayers in declared counties could delay filing their federal tax returns—first until October 16, and subsequently to November 16. This delay, to which the state conformed for filing purposes, occurred in 55 of the state's 58 counties, comprising 99 percent of all California taxpayers, and affected tax collections that were due as early as January 2023. While past filing delays of several weeks have been manageable, never before had the state's revenue forecasters been confronted with a delay of up to 10 months in receiving critical tax and revenue data—a challenge compounded by the fact that the past several years have also included global financial and economic instability. The COVID-19 Pandemic led to unprecedented economic impacts through 2022. Global supply chains were disrupted, inflation reached record highs, Gross Domestic Product (GDP) contracted at levels unseen since the Great Depression. Beginning in 2023, economic and financial conditions have started to normalize.

Based on the limited data available in the spring of 2023, the enacted 2023-24 budget reflected a decline in the revenue forecast from January. However, because of the unprecedented tax filing and payment delay, the full scope of the estimated revenue decline was unclear until all the delayed tax returns and payments were received by the extended November 16 deadline, which was only two months before the 2024 budget must be proposed to the Legislature. Once processed, personal income tax and corporation tax receipts through November were $25.7 billion—22 percent—lower than projected at Budget Act. This factor alone is a significant reason why the budget forecasts of the Big Three General Fund revenue sources through 2024-25 have decreased by approximately $42.9 billion as compared to the 2023 Budget Act, before accounting for budget solutions.

Had the filing delay not been in place, most of the revenue drop would have been reflected in lower tax receipts before the May Revision and incorporated into the 2023 Budget Act projections. This would have resulted in a larger budget gap in 2023, additional solutions to close it, and a smaller shortfall for 2024 than what is now faced.

Lastly, the filing delay resulted in an abbreviated timeline to prepare the Budget. As such, the Administration will continue to assess whether additional corrective actions are necessary during the development of the May Revision.

IMPROVED CONDITIONS, BUT RISKS REMAIN

The stock market rose throughout 2023 and made up most of its losses from 2022, with the S&P 500 increasing by 24 percent in 2023, and the NASDAQ increasing by 43 percent. California's GDP has also remained strong in 2023, averaging 3.9 percent annualized growth through the first three quarters compared to a contraction of 2.2 percent over the same period in 2022. The stock market recovery and improved economic growth support the budget forecast assumptions that revenue growth will resume in 2023-24 following the steep correction in 2022-23, with potential upside through 2024-25 if the markets continue to outperform the forecast. In addition, the Federal Reserve has indicated it intends to cut interest rates throughout 2024, which may stimulate real estate transactions and other sectors of California’s economy.

However, several risk factors could negatively impact the economy going forward. For instance, a significant financial shock from tightening financial conditions, stock market and asset price volatility and declines, and geopolitical turmoil are all issues that pose a risk to ongoing economic and revenue growth.

BUDGET RESERVES AND BALANCED SOLUTIONS

While closing a shortfall of $37.9 billion poses a substantial challenge for lawmakers, it is more manageable because of the state’s foresight in building the combined budgetary reserves to a record level in 2023. A withdrawal from the Budget Stabilization Account (BSA) is a significant and appropriate component of the budget’s balanced solutions. As its title suggests, a withdrawal from the BSA will help the state maintain fiscal stability, continue its ongoing efforts to address priority issues, such as homelessness and combatting the effects of climate change, and avoid harmful cuts in programs that are essential to the well-being of Californians throughout the state.

Even after the proposed withdrawals, total budget reserves in the coming fiscal year will remain substantial at $18.4 billion. This includes $11.1 billion in the BSA, $3.9 billion in the Public School System Stabilization Account (PSSSA), and $3.4 billion in the Special Fund for Economic Uncertainties.

The Budget incorporates the following balanced combination of measures to close the shortfall in the budget year:

- **Reserves—$13.1 billion.** The budget draws upon funds from the state's reserves. Significant solutions in this category include:
  - Withdrawal from Mandatory BSA Balance and Transfer Suspension ($10.4 billion),
  - Withdrawal from Discretionary BSA Balance ($1.8 billion), and
  - Withdrawal from the Safety Net Reserve ($900 million).
- **Reductions—$8.5 billion.** The budget reduces funding for various items. Significant solutions in this category include:
  - Various Climate Reductions ($2.9 billion),
  - Various Housing Program Reductions ($1.2 billion),
  - State Vacant Position Funding Sweep ($762.5 million),
  - School Facilities Aid Program ($500 million),
  - Student Housing Revolving Loan Fund Program ($494 million),
  - Legislative Requests ($350 million),
  - University of California Los Angeles Institute of Immunology and Immunotherapy ($300 million), and
  - Middle Class Scholarship Program ($289 million).
- **Revenue/Internal Borrowing—$5.7 billion.** The budget includes support from revenue sources and borrows internally from special funds. Significant solutions in this category include:
  - Increasing the Managed Care Organization Tax Support for Medi-Cal ($3.8 billion) and
  - Conforming to Tax Cuts and Jobs Act Net Operating Loss Limitation ($300 million).

- **Delays—$5.1 billion.** The budget delays funding for multiple items and spreads it across the three-year period, beginning in 2025-26, without reducing the total amount of funding through this period. Significant solutions in this category include:
  - Transit and Intercity Rail Capital Program ($1 billion),
  - Full Implementation of DDS Service Provider Rate Reform ($613 million),
  - Preschool, Transitional Kindergarten and Full-Day Kindergarten Facilities Grant Program ($550 million),
  - Clean Energy Reliability Investment Plan ($400 million),
  - Behavioral Health Bridge Housing Program ($235 million), and
  - Vulnerable Community Toxic Clean Up ($175 million).
- **Fund Shifts—$3.4 billion.** The budget shifts certain expenditures from the General Fund to other funds. Significant solutions in this category include:
  - Various shifts to the Greenhouse Gas Reduction Fund ($1.8 billion),
  - State plans retirement contribution reductions using Prop 2 Debt Repayment Funding ($1.3 billion), and
  - Unemployment Insurance Interest Payment ($100 million).
- **Deferrals—$2.1 billion.** The budget defers specific obligations to the 2025-26 fiscal year. Significant solutions in this category include:
  - June to July Payroll Deferral ($1.6 billion) and
  - University of California and California State University Deferrals ($499 million).

In addition to the solutions listed above that address the $37.9 billion gap, the Budget includes withdrawals from the PSSSA of $5.7 billion to maintain support for Local Educational Agencies and Community College Districts.

LIFTING THE LIMITS ON DEPOSITS TO BUDGET RESERVES

Proposition 2, passed by the voters in 2014, made changes to require 1.5 percent of General Fund tax revenue and a portion of General Fund revenues derived from capital gains to be set aside in reserves and used to pay down debt. The current deposit requirements for the BSA, or Rainy-Day Fund, were established in recognition of the volatility in capital gains revenue and to allow the state to set aside funds during stock market upswings to mitigate the impact of revenue drops during downturns. However, the state has been constrained in its ability to save during upswings due to Proposition 2's cap on mandatory deposits of 10 percent of General Fund revenues combined with the State Appropriations Limit.

The State Appropriations Limit, also known as the "Gann Limit," was enacted by the voters in 1979 to cap the amount of revenues from the proceeds of taxes that the state can appropriate in a given fiscal year. However, under current law, a deposit in the state savings account is effectively counted as an expenditure. Deposits into the state's reserve accounts are not exempt from the State Appropriations Limit and must count as appropriations subject to the limit. In recent years, strong growth in state revenues has outpaced the growth in the constitutional calculation that set the appropriations limit. This inadvertently, but effectively, created a cap on how much the state could set aside in reserves during the state's recent revenue surpluses, impeding the state's ability to make additional deposits that would have created even greater budget resiliency.

While both voter-approved initiatives promote fiscal prudence and long-term stability in state finance, their interaction has unintentionally eroded the effectiveness of both measures. The Administration and the Legislature should explore changes to law to allow the state to save more during economic upswings, enhancing the state's ability to protect vital programs and services during future budget downturns.