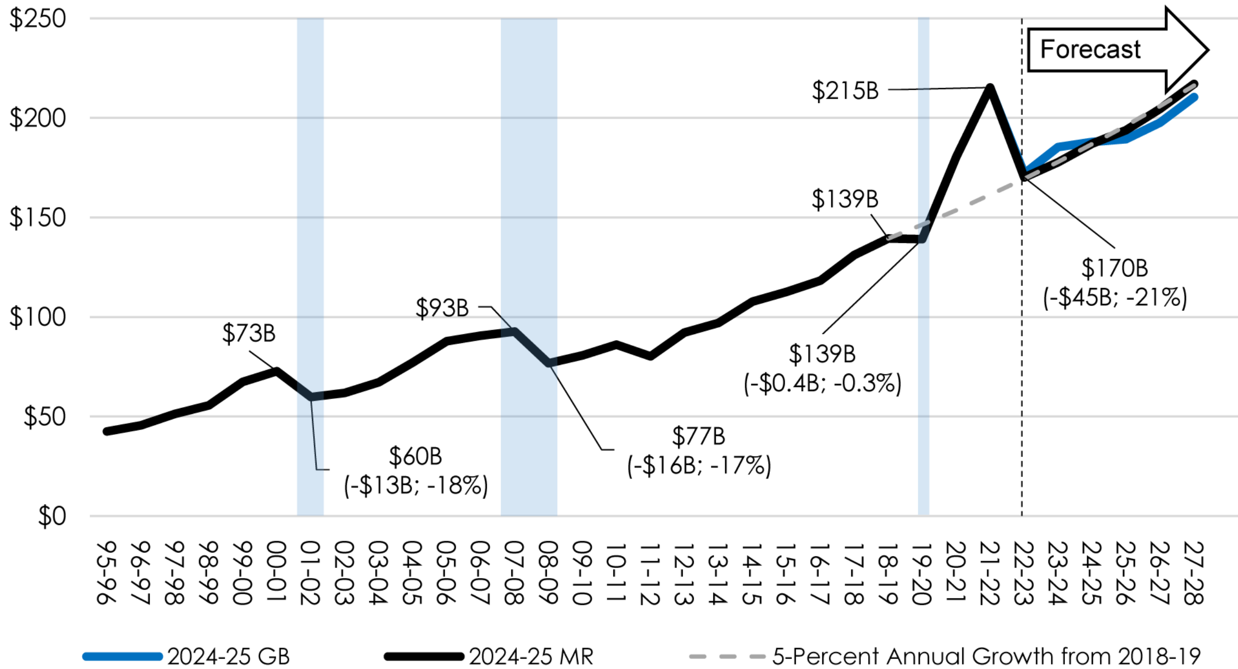
INTRODUCTION

This year's May Revision puts the state on a long-term, fiscally responsible path that protects vital programs assisting millions of Californians. Although the economy remains strong and revenue volatility has stabilized after the tumultuous COVID-19 Pandemic, the May Revision addresses anticipated shortfalls in both the 2024-25 and 2025-26 fiscal years. This multiyear focus presents a balanced approach that results in positive operating reserves in the 2024-25 and 2025-26 fiscal years—transforming a cumulative two-year deficit into an operating reserve surplus. To achieve this outcome, the May Revision includes significant spending cuts to government operations, reductions to programs and pauses of new investments. Despite these necessary cuts, reductions, and pauses, the May Revision maintains current service levels for key health care, social services and other critical programs.

Emerging from the pandemic, the state's economy has been resilient but has behaved in ways that have defied traditional forecasts and historical precedent. During this time California has experienced significant revenue volatility—seeing unprecedented revenue growth that was quickly followed by a sharp and deep correction back toward historical trends. This volatility resulted in the 2021 and 2022 Budget Acts reflecting higher growth assumptions, which created a misalignment between expenditures and revenues in the last two fiscal years that will continue unless corrective action is taken. Despite this volatility and the resulting need to take corrective actions, revenues in the coming fiscal year are forecasted to be higher than pre-pandemic levels in 2018-19 and reflect a level consistent with a more typical annual growth pattern of five percent (see the Big Three Revenue—personal income, corporation, and sales tax—figure below).

Big Three Revenues
(Dollars in Billions)



Projected revenue figures exclude the impact of tax policy proposals and solutions.
Shaded bars indicate previous U.S. recessions.
Source: California Department of Finance, 2024-25 May Revision Forecast.

At last year's May Revision, significant uncertainty clouded the state's revenue forecast, driven by the unprecedented Internal Revenue Service (IRS) tax filing and payment postponement—affecting 99 percent of California taxpayers—that delayed critical cash receipts for more than half a year. With the revenue picture now clearer for the 2022 and 2023 tax years, actions must be taken to bring the budget's expenditures and revenues into alignment—an essential step so programs and services that Californians rely upon can be protected. Without action, these programs and services will be at risk of more consequential reductions in the coming years.

In response, the May Revision includes budgetary solutions that address the near-term budget shortfall for 2024-25 and result in a positive operating reserve in 2025-26. Without question, difficult decisions are required to accomplish this. However, these decisions are necessary to stabilize California's financial plan. Without them, significant shortfalls are projected to persist.

HOW WE GOT HERE

Following the stock market run-up through the end of 2021, asset prices dropped in 2022, with the S&P 500 declining by 19 percent and the NASDAQ Composite Index—concentrated in stocks in technology companies that are a California mainstay—declining by 33 percent. As a result, the state's Big Three General Fund revenue sources—personal income, sales, and corporation taxes—declined by 21 percent in 2022-23 after increasing by a remarkable 55 percent from 2019-20 to 2021-22. While the stock market rebounded and recovered nearly all of its losses by the end of 2023, cash receipts for the year remained weak, due in part to increased capital loss carryovers originating from the asset market declines in 2022. New tax data for 2022 show capital loss carryovers grew by 62 percent in 2022, exceeding the 58 percent increase in 2008 during the Great Recession.

Due to the revenue spike from 2019-20 to 2021-22, the Budget Acts of 2021 and 2022 were based on forecasts that projected substantially greater revenues in the last two fiscal years than occurred.

To illustrate:

- The 2022 Budget Act projected that Big Three revenues would be $210 billion in 2022-23 and $220.9 billion in 2023-24.
- As of the May Revision forecast, 2022-23 revenues, excluding solutions and policy proposals, are now estimated at $170.1 billion and 2023-24 revenues are at $177.7 billion.
- This is a difference of $83.1 billion between the 2022 Budget Act projection for the 2022-23 and 2023-24 fiscal years and what has materialized based on the latest projections.

Big Three Revenue Forecast Comparison
2022 Budget Act vs. 2024 May Revision
(Dollars in Billions)

Fiscal Year	2022-23	2023-24	2024-25	2025-26
2022 Budget Act	$210.0	$220.9	$230.6	$232.2
2024 May Revision	$170.1	$177.7	$187.0	$193.8
Difference	-$39.9	-$43.2	-$43.6	-$38.4

The total difference across the four fiscal years is a negative $165.1 billion.

THE BUDGET PROBLEM

The 2023 Budget Act addressed a budget shortfall of approximately $32 billion. As previously noted, significant uncertainty surrounded the revenue forecast due to the IRS tax filing and payment delay. Once additional tax receipts for 2022 were received in late November 2023, it was clear that 2022 revenues were weaker than projected when the 2023 Budget Act was adopted. As a result, the Governor's Budget projected an additional budget shortfall of $37.9 billion.

Since then, 2023 tax year cash receipts have been weaker than expected. In addition, inflation has been slower to cool, defying earlier expectations. As a result, interest rates have remained higher to longer than expected. Compared to January's revenue forecast, the May Revision revenue forecast reflects a decrease of $10.5 billion in the Big Three revenues, excluding solutions and policy proposals, through the 2024-25 fiscal year—with personal income tax lower by $2.4 billion, corporation tax lower by $5.8 billion, and sales tax lower by $2.3 billion.

The May Revision estimates that the budget shortfall has grown by approximately $7 billion. Combined with the Governor's Budget, the budget shortfall for the 2024-25 fiscal year is approximately $44.9 billion. However, after accounting for the early action budget package that included $17.3 billion of solutions, the remaining budget problem is approximately $27.6 billion.

Budget Problem at the May Revision

Governor's Budget	$37.9 billion
Shortfall Since Governor's Budget	$7.0 billion
Early Action Budget Package	-$17.3 billion
Remaining Budget Problem	**$27.6 billion**

The Governor's Budget reflected a negative operating reserve balance in the 2025-26 fiscal year of $33.1 billion. Such levels of negative reserves in budget out-years are not manageable and put state investments at further risk, particularly ongoing programs and services. The May Revision addresses the 2025-26 shortfall and reflects positive operating reserve balances in both the 2024-25 and 2025-26 fiscal years.

EARLY ACTION BUDGET PACKAGE

Recognizing the importance of addressing the shortfall ahead of schedule, the Legislature passed an early action budget package in April that reduced the size of the budget shortfall by approximately $17.3 billion (Chapter 9, Statutes of 2024 (AB 106)). This package was comprised primarily of solutions included in the Governor's Budget, and also accounted for the use of $12.2 billion from the Budget Stabilization Account (BSA).

BUDGET RESERVES AND SOLUTIONS

USE OF RESERVES

The scope of the current shortfall presents the conditions for which the BSA was designed—mitigating volatility in revenues, specifically from fluctuations in capital gains.

To help address this volatility, capital gains tax revenues that exceed eight percent of total general fund revenues are deposited into the BSA. The BSA is structured to capture revenue from capital gains during market upswings to mitigate the impact of market—and corresponding revenue—downswings on the state budget.

California experienced this type of swing in revenue from capital gains in 2021 when capital gains realizations spiked to an all-time high of $349 billion. Conversely, the May Revision forecast projects that capital gains realizations fell to approximately $156 billion in 2022 and $137 billion in 2023.

While challenging, the current shortfall is more manageable because of the state's foresight in building the combined budgetary reserves to a record level in 2023. Withdrawals 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 more harmful cuts in programs that are essential to the well-being of Californians throughout the state.

The May Revision maintains the Governor's Budget withdrawal of approximately $12.2 billion from the BSA, as well as $900 million from the Safety Net Reserve. However, the May Revision spreads the use of the BSA withdrawal over two fiscal years, utilizing $3.3 billion in the 2024-25 fiscal year and $8.9 billion in the 2025-26 fiscal year. This action will assist in balancing the budget through the 2025-26 fiscal year.

In addition, the May Revision includes withdrawals from the Public School System Stabilization Account of approximately $8.4 billion to maintain predictable support for local educational agencies and community college districts.

By spreading the use of reserves over two fiscal years, total budget reserves in the coming fiscal year will remain substantial at $22.8 billion. This includes $19.4 billion in the BSA and $3.4 billion in the Special Fund for Economic Uncertainties.

SOLUTIONS

In January, the Governor's Budget proposed to close the estimated $37.9 billion shortfall through the following mix of balanced solutions:

Governor's Budget 2024-25 Solutions

Category	Amount
Reserves	$13.1 billion
Reductions	$8.5 billion
Revenue/Borrowing	$5.7 billion
Delays	$5.1 billion
Fund Shifts	$3.4 billion
Deferrals	$2.1 billion
Total	**$37.9 billion**

As mentioned above, the early action budget package addressed $17.3 billion of the budget problem. Accounting for the increased budget problem of $7 billion and erosions of Governor's Budget solutions of $1.2 billion, the May Revision includes $8.2 billion of additional solutions. The following is a breakdown of solutions by category that net to address the $8.2 billion incremental increase in the 2024-25 fiscal year budget problem at the May Revision.

Additional May Revision 2024-25
Solutions and Adjustments

Category	Amount
Reserves*	- $8.9 billion
Reductions	$10.7 billion
Revenue/Borrowing	$2.0 billion
Delays	$520 million
Fund Shifts	$3.9 billion
Total	**$8.2 billion**

*Reflects the spreading of the proposed BSA withdrawal in the Governor's Budget of $12.2 billion over two fiscal years: $3.3 billion in 2024-25 and $8.9 billion in 2025-26.

The May Revision also ensures that there is a positive operating reserve in the 2025-26 fiscal year. The solutions to address the 2025-26 fiscal year budget problem total $28.4 billion and are listed by category below:

May Revision 2025-26
Solutions and Adjustments

Category	Amount
Reserves	$8.9 billion
Reductions	$14.6 billion
Revenue/Borrowing	$7.4 billion
Pauses/Delays*	-$1.1 billion
Fund Shifts	$743 million
Deferrals*	- $2.1 billion
Total	**$28.4 billion**

*Reflects delays and deferrals proposed in the Governor's Budget.

Some of the new solutions at the May Revision are:

- **Reductions.** The May Revision reduces funding for various items in addition to the reductions made in the Governor's Budget. Significant solutions in this category include:
    - **Middle Class Scholarship Program**—Reduce $510 million ongoing General Fund support for the Middle Class Scholarship program. Combined with a technical adjustment, $100 million ongoing support for this program would remain.
    - **California Preschool, Transitional Kindergarten and Full-Day Kindergarten Facilities Grant Program**—Pull back a planned 2025-26 General Fund investment of $550 million that would have supported the California Preschool, Transitional Kindergarten, and Full-Day Kindergarten Program. Such an investment could be considered for inclusion in education facilities bond proposals being contemplated by the Legislature.
    - **Children and Youth Behavioral Health Initiative**—A reduction of one-time $72.3 million General Fund in 2023-24, $348.6 million General Fund in 2024-25, and $5 million General Fund in 2025-26 for school-linked health partnerships and capacity grants for higher education institutions, behavioral health services and supports platform, evidence-based and community-defined grants, public education and change campaign, and youth suicide reporting and crisis response pilot.
    - **California Department of Corrections and Rehabilitation Housing Unit Deactivations**—An ongoing reduction of $80.6 million General Fund to reflect the deactivation of 46 housing units across 13 prisons, totaling approximately 4,600 beds.
    - **Ongoing Reductions to State Operations**—A reduction to state operations by approximately 7.95 percent beginning in 2024-25 to nearly all department budgets. The planned reduction involves all categories, including personnel, operating costs, and contracting. The Department of Finance will work with agencies and departments in the fall on the appropriate budget reductions.
- **Revenue/Internal Borrowing.** The May Revision includes additional and adjusted support from revenue sources and borrows internally from special funds. Significant solutions in this category include:
    - **Net Operating Loss (NOL) Suspension and Limit Credit to $5 Million**—The Governor's Budget NOL suspension proposal is modified to begin in 2025-26 and include an opportunity to trigger the suspension off if revenues improve, resulting

in $900 million revenue gain ($558 million net of Proposition 98) in 2024-25 and $5.5 billion ($3.4 billion net of Proposition 98) in 2025-26.

- **Additional Managed Care Organization (MCO) Tax (Medicare Revenue)**—Increase the MCO Tax to achieve additional net state benefit of $689.9 million in 2024-25, $950 million in 2025-26, and $1.3 billion in 2026-27 by including health plan Medicare revenue in the total revenue limit calculation, which increases the allowable size of the tax.

- **Delays and Pauses.** The May Revision minimizes the use of delays to avoid both increased future obligations and potential shortfalls, and some delays proposed in the Governor's Budget have been changed to reductions. There are limited exceptions in which funding is spread over a multiyear period. These include:
  - **Broadband Last Mile**—Delay $200 million from 2025-26 to 2027-28.
  - **Child Care Slot Expansion Pause at Current Level**—Approximately,119,000 slots have been added; a pause at the current level until fiscal conditions allow for resuming the expansion will result in a revenue gain of $489 million in 2024-25 and $951 million in 2025-26.
- **Fund Shifts.** The May Revision shifts certain expenditures from the General Fund to other funds in addition to those shifted in the Governor's Budget. Significant solutions in this category include:
  - **Capitol Annex Projects**—Shift $450 million in 2024-25 and $250 million in 2025-26 from cash to bonds.
  - **Cap and Trade Fund Shifts**—A number of General Fund commitments are shifted into the Greenhouse Gas Reduction Fund, with a focus on equity programs, priorities to help meet climate goals, and programs that support greenhouse gas reductions for a total shift of $1.7 billion in 2024-25.

2022 TRIGGER

The 2022 Budget Act included a trigger that anticipated expenditures for certain programs would be included in the 2024 Budget Act if the Department of Finance first determined that estimated General Fund resources reflected in the 2024 May Revision could support such ongoing increases over the multiyear forecast. Given the negative multiyear projections, the following investments that were part of this trigger are not included in the May Revision:

- Union Membership Dues Tax Credit
- Medi-Cal Share of Cost Reform
- Continuous Medi-Cal Coverage for Children Aged 0 through 4
- Child Support Pass-Through to Currently Assisted CalWORKs Families
- California State Student Aid Commission – Cal Grant Reform Act
- California Community College Cal Grant Expansion Program
- Victim Compensation Program

PRIOR BUDGET SAFEGUARDS WORKING AS PLANNED

The May Revision fortifies California's fiscal foundation by more closely aligning projected expenditures with the state's revenue forecast. While difficult reductions and pullbacks of funding are required to accomplish this, they are proposed in a manner intended to protect nearly all of the state's core programs and services.

Specifically, the May Revision relies upon the following budget resiliency measures and other tools to provide for a balanced budget in 2024-25 and 2025-26:

- **Budget Stabilization Account**—Prudent use of the BSA to stabilize the budget during a period of revenue decline.
- **Reductions of One-time Spending**—While the budget shortfall necessitates some ongoing solutions, the May Revision maximizes the pullback of one-time spending, which prevents far deeper reductions to ongoing programs.
- **Trigger Mechanism**—By including a trigger mechanism in the 2022 Budget Act instead of automatic spending increases on new programs, state expenditures did not grow further in the 2024-25 fiscal year and beyond.

Difficult decisions regarding spending reductions are necessary to create a path for long-term fiscal sustainability. Making these decisions now will significantly reduce the risk of more difficult decisions in the months and years ahead that could have substantial effects on core state programs and services.

SAVING MORE DURING FUTURE UPWARD SWINGS IN REVENUE

As the Governor's Budget stated in January, the Administration and the Legislature should explore legislation 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. This includes amendments to Proposition 2 (2014) to allow increased deposits into the BSA.

The May Revision proposes additional legislation that would require the state to set aside a portion of anticipated surplus funds to be allocated in a subsequent budget act. This will ensure that the state does not commit certain amounts of future anticipated revenues until such revenues have been realized. This proposal does not replace the need to explore changes to Proposition 2; rather, it provides an additional tool to manage future revenue volatility.