INTRODUCTION

California begins 2025 in a stronger fiscal position than it has in recent years. The combination of extreme revenue volatility and an unprecedented federal tax filing delay contributed to significant budget shortfalls over the past two years. Last year, the Governor proposed a multi-year approach that closed not only the estimated shortfall for the 2024-25 fiscal year, but for the 2025-26 fiscal year as well. While passage of this budget framework represents significant progress, the state's current fiscal outlook underscores the need for continued vigilance to strengthen budget resiliency and fiscal stability even further.

As such, the state's ongoing commitments must continue to be examined over the coming months and necessary adjustments will be proposed at the May Revision, when a clearer view of state's finances emerges. Meanwhile, this Governor's Budget further supports vital initiatives that improve the lives of millions of Californians—in education and health care, as well as housing and homelessness—while enhancing economic development and supporting public safety. For example, through implementation of the Master Plan for Career Education, this Budget makes it easier for Californians to receive college credit for their real-world experience and creates more pathways to fulfilling careers in California. The Budget also reflects full implementation of universal transitional kindergarten, increased funding for universal school meals, and implementation grants will be fully disbursed in 2025-26 to support the community school model at more than 2,000 public schools. Also, since 2021, through California Jobs First, the state has leveraged federal and private funds, investing in 13 regions across the state to create quality jobs and bolster resilience to climate and global challenges. And the Budget recognizes the importance of keeping Californians safe by maintaining an investment of approximately $1.6 billion since 2022-23—including $283.6 million in 2025-26—to support state and local public safety efforts.

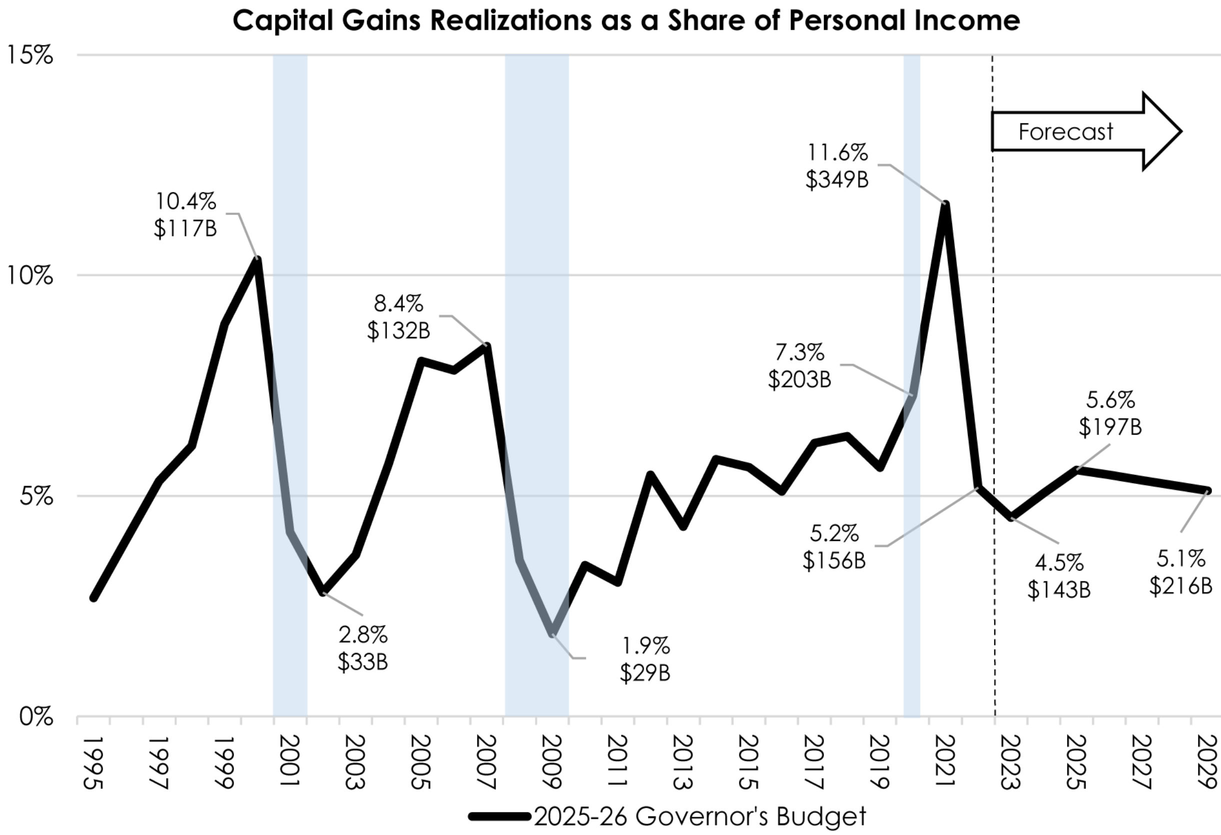
OUTLOOK AND RISKS

The economy has generally performed better than projected in the 2024 Budget Act, leading to an upgrade to the forecast in the near term and modest upward revisions in the long term. The stronger-than-anticipated performance of the economy, stock market, and cash receipts, combined with an improved economic outlook, have all contributed to the upgraded revenue forecast, with General Fund revenues before accounting for transfers and tax policy proposals projected to be higher by approximately $16.5 billion in the three-year budget window.

California's budget is largely dependent on personal income tax, a volatile source of revenue that adds risk to the forecast. Capital gains realizations as a share of personal income reached a record high of 11.6 percent in 2021, exceeding 2007's pre-Recession peak of 8.4 percent and more than a full percentage point higher than 2000's previous record of 10.4 percent. As shown in the figure below, capital gains realizations reverted to 5.2 percent of personal income in 2022 following its 2021 peak and are forecast to decline to 4.5 percent in 2023. This represents a peak-to-trough decline of 59 percent from 2021 to 2023. The Budget projects capital gains realizations to reach 5.6 percent of personal income in 2025 before gradually moderating to 5 percent of personal income by 2030.

The amount of General Fund capital gains revenue can vary greatly over time and from year to year. For instance, capital gains contributed $14.4 billion to the General Fund in 2019, increased significantly to $36 billion in 2021—the highest amount ever—and are estimated to decrease to $14 billion for 2023.

While the Budget forecast does not reflect a recession, it does recognize several risk factors that could negatively affect the economy and state revenues. These factors include stock market and asset price volatility and declines—particularly those affecting high-income earners—as well as geopolitical instability. And although the Budget is balanced and provides for significant reserves in the coming fiscal year, it anticipates shortfalls in subsequent fiscal years that are driven by expenditures exceeding revenues. The state has made progress in reducing these shortfalls; however, additional decisions may be necessary at the May Revision to maintain a balanced budget, not only in the coming year, but also on an ongoing basis.



Shaded bars indicate previous U.S. recessions.
Source: California Department of Finance, 2025-26 Governor's Budget Forecast.

An additional risk in 2025 comes from stated policy changes by the incoming federal administration that could negatively impact California's economy—especially in the areas of international trade and immigration, as well as in health care. Immigration policies and tariffs of the scale and scope proposed would be highly inflationary and result in labor shortages and higher prices of internationally traded goods, which would subsequently constrain economic output. Higher inflation would in turn lead the Federal Reserve to engage in more restrictive monetary policy, further dampening economic and revenue growth. Potential federal actions create substantial fiscal uncertainty for California particularly given the federal-state funding relationship in major health care programs such as Medi-Cal and the health insurance exchange.

RESERVES

Since the passage of Proposition 2 in 2014, the state has built historic levels of reserves that have served as a buffer to volatility in the state's revenue structure. The Budget Stabilization Account (BSA), also known as the Rainy Day Fund, receives 1.5 percent of General Fund tax revenue as well as a portion of General Fund revenues derived from capital gains, recognizing that revenue from taxes on capital gains can substantially compound revenue volatility. To provide for a balanced budget over two fiscal years, the 2024 Budget Act assumed withdrawals from the BSA of approximately $5.1 billion in 2024-25 and $7.1 billion in 2025-26. Spreading the allowable withdrawal for 2024-25 over two years enabled the state to take a more balanced approach to addressing last year's budget shortfall while prudently managing the use of the reserve. The Governor's Budget maintains the planned withdrawal of approximately $7.1 billion from the BSA.

Accounting for withdrawals, the Budget reflects total reserve balances of approximately $17 billion at the end of 2025-26. This includes $10.9 billion in the BSA, $4.5 billion in the Special Fund for Economic Uncertainties (SFEU), and $1.5 billion in the Public School System Stabilization Account.

ADDRESSING REVENUE VOLATILITY AND INCREASING BUDGET RESILIENCY

As discussed, the current deposit requirements for the BSA 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 declines during downturns. Since that time, however, the state has effectively been constrained in its ability to set even more revenue aside during upswings. This is because of the interaction between Proposition 2's cap on mandatory deposits of 10 percent of General Fund revenues and Proposition 4's (passed in 1979) State Appropriations Limit.

Under current law, a deposit into a state savings account is effectively counted as an expenditure and is therefore not exempt from the State Appropriations Limit. In recent years, strong growth in state revenues has outpaced the growth in the constitutional calculation that sets the appropriations limit. Unintentionally but effectively, this created a cap on how much the state could set aside in reserve accounts during the state's recent revenue surpluses. This impeded the state's ability to make additional deposits that would have created even greater budget resiliency by building the state's reserves to a level sufficient to address the revenue correction that the state experienced.

To remove the cap on deposits to the Rainy Day Fund and increase budget resiliency, the Budget proposes statutory changes to allow the state to save even more during economic upswings, enhancing the state's ability to protect vital programs and services during future downturns. Specifically, the Budget proposes to increase the mandatory deposit level in the BSA from the current 10 percent to 20 percent of General Fund revenues and exempt deposits into the BSA from the State Appropriations Limit.

The state has taken steps in recent budgets to manage the revenue swings since the COVID-19 Pandemic, including reductions, deferrals, and delays to important programs. The experience of recent years has demonstrated the need for additional reforms to enable the state to smooth out its revenue by increasing reserves during fiscal upturns. This will better position the state to weather future revenue volatility and protect the essential programs and services upon which Californians rely.