

INTRODUCTION

The 2026 Budget Act largely maintains the May Revision framework, which balances the budget in both the 2026-27 and 2027-28 fiscal years, and significantly reduces the projected structural deficits in 2028-29 and 2029-30. These actions strengthen California's fiscal position in the budget year and beyond, providing a solid foundation to support critical priorities enacted over the past seven years by the Administration and the Legislature. Further, the Budget includes a number of strategic investments, mostly one-time, that are possible in large part because of increased revenue since the 2025 Budget Act.

Over the last seven years, the people of California have endured some of the most difficult challenges in the state's modern history. The global pandemic, severe drought, numerous devastating wildfires, and other extreme weather events; and the Federal Administration's assault on families, affordability, the climate and critical programs; resulted in major impacts on the state budget. After the 2023 winter storms, the tax filing and payment deadline for 99 percent of California taxpayers was delayed until November of 2023, which significantly hindered the state's ability to accurately forecast revenue and make budget decisions that year.

While managing through these events, the Administration and the Legislature made transformative investments in education (both TK-12 and higher education), housing and homelessness, combating the impacts of climate change, increasing access to health care and expanding the state's safety net, bolstering workforce programs, and protecting public safety. The Budget secures these investments while also setting the stage for continued success well into the future.

BALANCING THE BUDGET FOR TWO YEARS

California is required to adopt a balanced budget for the 2026-27 fiscal year, measured by maintaining a positive balance in the state's Special Fund for Economic Uncertainties (SFEU). The 2026 Budget Act goes beyond this requirement, projecting a positive balance in 2026-27 and a positive balance in the SFEU in 2027-28. By doing so, the state is better positioned to manage any changes that may occur, whether in revenues or expenditures.

In responsibly balancing the budget over the next two fiscal years, the 2026 Budget Act includes SFEU balances of \$4.5 billion in 2026-27 and \$403 million in 2027-28. In addition, the Budget projects ongoing structural deficits in the outyears that are less than half those projected in the Governor's Budget, indicating significant progress in rightsizing the state's fiscal position.

To assist in providing for a positive SFEU in 2027-28 and more prudently manage the state's resources, the Budget includes a transfer of \$6.4 billion into the Projected Surplus Temporary Holding Account (Surplus Holding Account) in 2026-27. The Budget allocates these funds from the Surplus Holding Account in the following fiscal year, 2027-28.

Established in 2024, the Surplus Holding Account allows the state to set aside a portion of anticipated surplus funds for allocation in a subsequent fiscal year. The Surplus Holding Account was created to provide fiscal protection against overcommitting projected resources until revenues are realized and expenditures are finalized.

SUPPORTING A SOUND FISCAL STRUCTURE

The 2025 Budget Act included numerous spending reductions that, at the time of enactment, were estimated to result in almost \$12 billion in ongoing savings. Building on this significant action to address ongoing cost pressures, the Budget includes three key revenue proposals that help solidify the state's fiscal structure. These include:

- **Managed Care Organization (MCO) Tax**—The Budget reflects the renewal of a House of Representatives (H.R.) 1 compliant MCO Tax, effective January 1, 2027, increasing revenue by a projected \$575 million in 2026-27, \$2.3 billion in 2027-28 and 2028-29, and \$1.7 billion in 2029-30, to support the Medi-Cal program and maintain targeted rate increases for primary, maternal, and non-specialty mental health care.

- **Business Tax Credit Limitation**—Extends the existing temporary business tax credit limitation of \$5 million per year—initially in place for 2024 through 2026—for an additional three years, from 2027 through 2029. This extension continues to allow elective refundability for 2027 through 2029. Beginning in 2030, the Budget permanently limits the use of business tax credits to the greater of \$5 million or 70 percent of liability. The limitation is projected to increase General Fund revenue by \$1 billion in 2026-27, \$3.3 billion in 2027-28, \$4.7 billion in 2028-29, and \$4.2 billion in 2029-30.
- **Prewritten Software Tax**—Extends the existing sales tax on prewritten software delivered on a tangible medium to electronically delivered prewritten software. This is projected to increase General Fund revenue by \$450 million in 2026-27 and \$900 million in 2027-28 and annually thereafter. Additionally, it is expected to increase local sales tax revenue by \$560 million in 2026-27 and \$1.1 billion in 2027-28 and annually thereafter.

MAINTAINING AND ENHANCING RESERVES

Since the 2014 approval of Proposition 2, the Budget Stabilization Account (BSA), also known as the Rainy Day Fund, has been a key component of budget resiliency, a buffer against revenue volatility, and an insurance policy that has protected core state programs. The Rainy Day Fund receives a deposit of 1.5 percent of General Fund revenue annually, as well as a portion of General Fund revenue derived from capital gains.

Over the last two fiscal years, the state has withdrawn approximately \$12.2 billion from the BSA and suspended deposits into the BSA for the 2024-25 and 2025-26 fiscal years. These actions have allowed the state to take a balanced approach by using a portion of these reserves as one component in closing prior budget shortfalls. Consistent with these actions, the budget continues the suspension of the 2025-26 “true-up.”

As a result of the increase in revenue, the total suspension in 2025-26 is \$5.4 billion. However, the budget includes a \$3.6 billion deposit into the BSA in 2026-27 and a minor “true-up” for the 2024-25 fiscal year. After accounting for these actions, the BSA balance in 2026-27 is \$15.1 billion—an increase of \$3.9 billion compared to the 2025 Budget Act level of \$11.2 billion. In addition, the budget includes \$4.5 billion in the SFEU and \$9.2 billion in the Public School System Stabilization Account—bringing the combined reserves in 2026-27 to \$28.8 billion. When accounting for the balance in the

Surplus Holding Account, the budget sets aside approximately \$35.2 billion for future funding obligations in the 2026-27 fiscal year.

Lastly, the Legislature passed ACA 20, which places an initiative on the November ballot that, if passed by voters, would strengthen the BSA and provide the state with tools to better manage revenue volatility in the future. Specifically, the cap on required deposits into the BSA would rise from 10 percent to 20 percent, additional deposits would be required when revenue from capital gains as a percent of General Fund revenue is above 10 percent, and withdrawals from the BSA and the Surplus Holding Account would count against the Gann limit instead of deposits, which will allow the state to set aside more money during times of significant revenue growth. Provisions requiring certain funds to be used to pay down state debts would be updated to allow for payments against debts, such as the federal Unemployment Insurance loan.