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From: Sharon Gonsalves
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RE: Outlook of the Fiscal Year 2024-2025 Budget

BUDGET DEFICIT CURRENTLY PROJECTED AT \$68 BILLION

The Legislative Analyst's Office (LAO), the Legislature's internal bipartisan policy and budget advisor and researcher, published a [report](#) on December 7 that projected a budget problem of \$68 billion in the upcoming budget in fiscal year (FY) 2024-25, which is up from the \$14 billion that it had projected earlier in the year. The LAO bases its forecast on the [estimate](#) that tax collections will come in \$58 billion lower than expected across FY 2022-23 through FY 2024-25. This projection is based partly on the forecasted decline in FY 2022-23 tax collections of about \$27 billion, as detailed below, a fall of about 25%, and partly on the estimation that revenue growth will remain flat for FY 2023-24 due to corporate and sales tax remaining flat. It is thus estimated that revenue may only return to positive growth in 2024-25 or after. The LAO also noted that the \$68 billion shortfall is comparable in magnitude to the Great Recession and the dotcom slowdown, but that the state is in a far better position to navigate the current challenge than previous ones due to the buildup of rainy-day funds. Legislative analyst Gabriel Petek was quoted in a CalMatters [article](#) stating that "the state is facing a serious budget problem, but not a crisis."

BACKGROUND

Since the Governor's January proposal of the fiscal year 2023-24 budget, it has been anticipated that the state budget would enter a deficit for the foreseeable future. Forecasts assumed that cost-shifts, delays, and cuts would follow as a result, but were complicated by an uncertain domestic economic environment. Although the Administration did not forecast a recession, future budget estimations were made further uncertain by an extension of the tax filing deadline to October, and then to November. By the November deadline, however, it became clear that revenues had not come in at levels at previously expected levels, specifically due to lower high-income and corporate tax payments. These taxes together [account](#) for roughly 75% of all General Fund revenues, and therefore are highly relied upon by the state to fund its services. It had been anticipated that \$42 billion of this revenue would be delayed by the October extension deadline, but only about \$15 billion was received. It was originally assumed that this shortfall would be addressed across FYs 2021-22, 2022-23, and 2023-24.

A budget problem occurs when resources for the upcoming budget are insufficient to cover the costs of currently authorized services. The Administration planned for a certain level of spending based on

projected revenue but now that that revenue is coming in lower than had been expected, that level of spending must be adjusted downwards. The \$68 billion shortfall is thus based on current policy and could change depending on actions taken by the Legislature and Administration in the 2024-25 budget act and any budget trailer bills. About \$17 billion of this total is due to FY 2022-23 Prop 98 funding, and the LAO thus suggests in its report that spending on schools and community colleges may have to come from state reserves as part of cost-shifting measures designed to balance the budget. The state currently has around \$30 billion in reserves and \$91 billion in cash on hand, formally referred to as “unused borrowable reserves”.

The LAO’s report noted the primary reason behind the shortfall is that the state’s economy entered a downturn in 2022 as a result of slowing economic activity caused by rising interest rates, inflation, and stock market declines. The housing market has cooled significantly, with home sales down by about half, and this has had a ripple effect on the economy due to the outsized importance of this market to the state. Reduced overall investment in the economy has followed. The LAO is projecting that this slowdown could continue into next year.

We will have a better handle on what the FY 2024-25 budget will look like and what the Department of Finance (DOF) is forecasting in terms of a deficit and how it plans to address it when Governor Newsom announces his FY 2024-25 budget proposal on January 10. It is important to note that the LAO and DOF often differ on their projections of the budget, as well as on suggested actions to address any challenges. Moreover, the LAO noted in its report that all of its projections remain highly uncertain. Nonetheless, it is likely that delayed spending, cost-shifting, and the introduction of bond measures will all play a role in addressing the budget problem.

LAO PROPOSED SOLUTIONS & POTENTIAL IMPACTS TO LOCAL GOVERNMENTS

The LAO report identified various potential solutions to the looming deficit problem. These solutions include the following: Withdraw Reserves; Reduce Proposition 98 Spending; Reduce Other One-Time Spending; and Other Solutions. A brief description of each strategy is below.

Reducing one-time spending is one of the solutions that has been identified to close the funding gap. The LAO estimates that the state has \$8.6 billion in one-time and temporary spending slated for 2024-25 that can be reduced entirely in order to address the serious budget problem. This includes \$2.2 billion in transportation, \$1.9 billion in natural resources and environment, and \$1.8 billion in various education programs. These reductions could have particular impacts on local grant programs in these topic areas. If this tactic is used, this may have an impact on direct local jurisdiction earmarks.

Regarding withdrawing reserves, the LAO suggests that the state could withdraw up to \$24 billion in General Purpose Reserves to address the budget problem. These funds would come from the \$23 billion in the Budget Stabilization Account (BSA) and \$1 billion in the Safety Net Reserve. The Safety Net Reserve is available to fund program costs in HHS programs, like Medi-Cal, while the BSA can only be accessed in a budget emergency. The LAO forecasts that a fiscal emergency may be available for both 2023-24 and 2024-25 – as of December 11, no declaration of a fiscal emergency has been made. Given that we are entering a pivotal election year, it is likely the administration will exhaust all other mechanisms prior to formally declaring a fiscal emergency. However, if declared, funds from the BSA may be used for any purpose, while funds from the Safety Net Reserve are intended to only be used for existing CalWORKS and Medi-Cal benefits and services. However, Safety Net Reserve Funds may

be used for any purpose if the Legislature so chooses, according to the [California Budget & Policy Center](#). If BSA and Safety Net Reserve funds are ultimately used, they most likely will filter down from state departments to local entities.

Other identified solutions include cost shifts – a tactic where the state moves costs between fund sources or entities. An example includes shifting spending from the General Fund to special funds, or, shifting costs from state to local governments. The state previously used about \$10 billion in cost shifts to address last year’s budget problem, and could elect to use a similar method in the coming year. Besides cost shifts, other proposed solutions from the LAO include temporarily suspending net operating loss (NOL) deductions, cuts to higher education and the judicial branch, and using more of the state’s reauthorized tax on managed care organization.

CHANGE IN SENATE LEADERSHIP

In early December it was announced that President pro Tempore Designee Mike McGuire (D, Healdsburg) will formally replace current pro Tem Toni Atkins (D, San Diego) on February 5. Notably, this will be after the Governor releases his budget proposal, and so it will be interesting to see which actions Senator McGuire takes to address the budget situation on his hands, whereas Senator Atkins enjoyed the benefit of surpluses the last several years. Senator Atkins was quoted in a Politico [article](#) that “Our economy is still good, but what we need to do is be incredibly cautious here. We are in a deficit, and therefore, new programs, new spending — in fact, existing spending — we’re going to have to slow down over time.”

WHAT HAPPENS NEXT?

RPPG continues to monitor the ongoing budget dilemma and will inform clients of updates as they develop. You can expect a major update after the Governor’s January budget proposal is published. In the meantime, please feel free to reach out to RPPG staff with any questions. We will do our best to assist you.