The 2023-24 Budget:

Multiyear Assessment

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Summary

Budget Problem Likely Larger in May. Due to a deteriorating revenue picture relative to expectations from June 2022, both our office and the administration anticipate the state faces a budget problem in 2023-24. Although the Governor's budget revenue estimates are reasonable, they are likely a bit too high. In particular, using recent revenue collections and economic data, we estimate there is a two-in-three chance that state revenues will be lower than the Governor's budget estimates for 2022-23 and 2023-24. Our best estimate is that revenues for these two years will be roughly $10 billion lower—implying a larger budget problem by about $7 billion. (Many other factors also will affect the actual size of the budget problem.) That said, after adjusting for inflation, anticipated revenues for 2023-24 still would remain about 20 percent higher than before the pandemic.

Governor's Budget Likely Unaffordable in Future Years. Under the administration's projections, the state faces operating deficits of $9 billion in 2024-25, $9 billion in 2025-26, and $4 billion in 2026-27. Because of the state's constitutional spending requirements, revenues would need to be higher by *more* than these amounts for the state to be able to afford the spending level currently proposed. For example, to eliminate the operating deficit in 2024-25, revenues would need to be roughly $20 billion higher than the Governor's budget projection. Our analysis suggests this level of revenue is quite unlikely—there is only a one-in-five chance the state can afford that spending level.

Baseline Budget More Likely to Be Affordable in Coming Years. By contrast, the chances the state will collect enough revenue to cover the "baseline budget" are much higher. (We define the baseline budget as the spending level after removing reserves deposits and all one-time and temporary spending currently authorized or planned under Governor's budget.) Specifically, there are even chances (one in two) that revenues would be sufficient for the state to pay for all of its baseline programs.

Why We Advise Holding Off on Using Reserves for Now. The main benefit of reserves is that they help the state to maintain its core spending over the long term, despite the state's volatile revenue structure. Although state revenues are moderating from a historic peak, they are not yet consistent with recessionary levels. Using reserves now to maintain the recent spending peak would mean the state would have less reserves available to pay for its core services if revenues declined further or in the event of a recession. Consequently, we recommend the Legislature hold off using reserves unless revenues decline by more than the $10 billion identified in this report. Revenue declines beyond $10 billion would reflect levels below historical averages and could impact the state's core spending level. As a result, if revenue losses go beyond an additional $10 billion through 2023-24, we think using reserves would be warranted.

Alternatives for Addressing the Budget Problem. Instead of making withdrawals from reserves, there are a variety of other actions the Legislature can take to address the additional shortfalls we have identified in the report. In particular, the Legislature could consider: (1) suspending deposits into the state's rainy-day fund (although this would require action by the Governor); (2) reducing more one-time and temporary spending; (3) shifting more costs than currently proposed by the Governor; and/or (4) increasing revenues, for example, on a temporary basis.

INTRODUCTION

The state has faced four recessions in the last three decades. Three of those—the recession in the early 1990s, the dot-com bust in the early 2000s, and the Great Recession—resulted in large revenue shortfalls and ensuing multiyear deficits, even for some years after each recession ended. The most recent COVID-19 induced recession was acute, but short-lived. Ultimately, unlike with previous downturns, state revenues did not decline in response. In fact, the immediate aftermath of this recession was marked by robust revenue growth. As a result, in the last two years, the state saw historic budget surpluses—including $47 billion in 2021-22 and $55 billion in 2022-23.

Although the state faces a budget problem this year, anticipated revenue shortfalls this year do not yet reflect a recession. Rather, revenues have declined relative to their recent peaks due to Federal Reserve actions taken to cool an overheated economy. We do, however, think there is a heightened risk of this cooldown progressing to a recession. As a result, planning for further revenue declines would be prudent. Moreover, the multiyear budget is out of balance under the Governor's proposals. This means the state is more likely to face budget problems over the next few years if the Governor's budget is adopted.

This situation makes legislative choices about budget solutions this year particularly pertinent. In particular, solutions used this year will affect the availability of options in a future year, should a recession occur. In that event, revenues would decline an additional $30 billion to $50 billion compared to the estimates presented here.

This brief provides our current assessment of the scale of the coming budget problems under the Governor's budget proposals. We also provide our guidance to the Legislature about how to address these shortfalls given current economic conditions.

FUTURE SHORTFALLS VERY LIKELY

Budget Problem Likely Larger in May

Budget Problem Emerged Due to Lower-Than-Expected Revenues. Due to a deteriorating revenue picture relative to expectations from June 2022, both our office and the administration anticipate the state faces a budget problem in 2023-24. In particular, under our estimates, the Governor's budget faced an $18 billion budget problem. This deficit is occurring primarily because the state's June 2022 revenue projections—although reasonable at the time—were too high. The main reason for these lower projections is action by Federal Reserve, which repeatedly increased interest rates with the aim of cooling the economy and, in turn, slowing inflation.

Governor's Budget Revenue Estimates Likely Too High for 2022-23 and 2023-24. Although the Governor's budget revenue estimates are reasonable—particularly when the administration put together its estimates in late December—they are likely still a bit too high. In particular, using recent revenue collections and economic data, we estimate there is a two-in-three chance that state revenues will be lower than the Governor's budget estimates for 2022-23 and 2023-24. Based on current information, our best estimate is that revenues for these two years will be roughly $10 billion lower.

Budget Problem Likely About $7 Billion Higher—Requiring Additional Solutions. If the Governor's May Revision revenues are lower by $10 billion, the budget problem would be about $7 billion larger, necessitating an equal amount of additional budget solutions. (This estimate of the budget problem accounts only for formula-driven changes in constitutional spending on schools and community colleges, but not other spending estimates, such as differences in caseload, federal funding, or other constitutional formulas, whose effects can be very unpredictable.

The actual estimate of the budget problem in May will be higher or lower depending on administration revenue projections and these other estimates.) Although our estimate of the budget problem is larger than the one addressed by the Governor's budget, we would still characterize it as manageable, as discussed in further detail below.

Governor's Proposed Trigger Restorations Unlikely to Materialize. To address the estimated $18 billion budget problem at Governor's budget, the administration proposed nearly $14 billion in spending-related solutions. Of these spending reductions, the Governor proposes making nearly one-third—or nearly $4 billion—subject to trigger restoration language. Under this proposed language, program spending that otherwise would have occurred in 2023-24 would not be allocated as part of the June budget act. However, if in January 2024 the administration estimates there are sufficient resources available to fund these expenditures, those programs would be restored halfway through the fiscal year. Given we anticipate an even larger budget problem than estimated by the Governor, we find it unlikely—specifically, a one-in-five chance—that these trigger restorations can be afforded in 2023-24.

Governor's Budget Likely Unaffordable in Coming Years

The administration projects the multiyear condition of the budget under the Governor's revenues and spending levels. Under those projections, the state faces operating deficits of $9 billion in 2024-25, $9 billion in 2025-26, and $4 billion in 2026-27. Because of the state's constitutional spending requirements, revenues would need to be higher by *more* than these amounts for the state to be able to afford the spending level currently proposed.

One-in-Five Chance the State Will Be Able to Afford Multiyear Spending Levels. While both our and the administration's forecasts suggest the state faces operating deficits, revenues could differ substantially from these estimates. **Figure 1** displays the distribution of most likely revenue outcomes over the multiyear (in grey). As seen in the figure, the revenues required to balance the budget (in red) are considerably above the most likely scenario in all but 2026-27. For example, to eliminate the operating deficit in 2024-25, revenues would need to be roughly $20 billion higher than the Governor's budget projection. Our analysis suggests this level of revenue is quite unlikely—there is only a one-in-five chance the state can afford that spending level. (The box on the next page explains how we conduct this analysis.) For reference, the Governor's budget assumes a revenue level that is somewhat higher than our main forecast through 2023-24 and somewhat lower in the out-years.

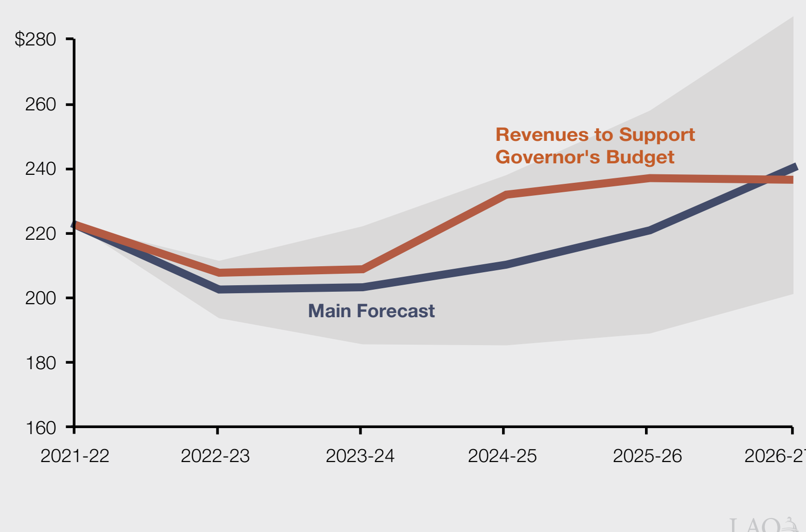
Figure 1

Governor's Budget Likely Unaffordable in Coming Years
(In Billions)

The **Main Forecast** shows revenue estimates we think have even odds of being too high or too low.

The **Revenues to Support Governor's Budget** shows the amount of revenue needed to afford the Governor's Budget.

The grey shaded area shows the range of most likely revenue outcomes.



How Did We Construct This Analysis?

Our analysis starts by estimating how much revenues ultimately could differ from our *Fiscal Outlook* multiyear revenue forecast (with updated current-year estimates) based on the state's historical experience. (Our *Fiscal Outlook* revenues are our best estimate of the revenue assumption that has even odds of being too high or too low.) We then look at where in this range of potential revenue outcomes the Governor's proposed level of spending falls. This allows us to assess how likely it is that revenues could be high enough to support the proposed spending. Specifically, we assess how often in the past revenues experienced a positive deviation large enough to meet or exceed the proposed level of spending (adjusted for constitutional, formula-driven spending).

Even Chances Revenues Will Be Sufficient to Maintain "Baseline" Budget. We also assessed the likelihood the state will collect enough revenue to maintain "baseline spending" over the multiyear period. (For the purposes of this analysis, we define the state's baseline budget as the ongoing program spending level after removing all one-time and temporary spending the administration estimates is currently authorized or planned under Governor's budget. For the purposes of this analysis, we also assumed the state would suspend its annual deposits into the state's constitutional reserve.) As shown in **Figure 2**, using the likely range of plausible revenue outcomes, we find the chances the state can afford the baseline budget are roughly even. Specifically, there are even chances (one in two) that revenues would be sufficient for the state to pay for all of its baseline programs. As we have outlined before, relying on a revenue estimate that presents even chances of a surplus and a deficit helps the state avoid making commitments it cannot sustain while also not foregoing program expansions that likely can be supported.

Figure 2

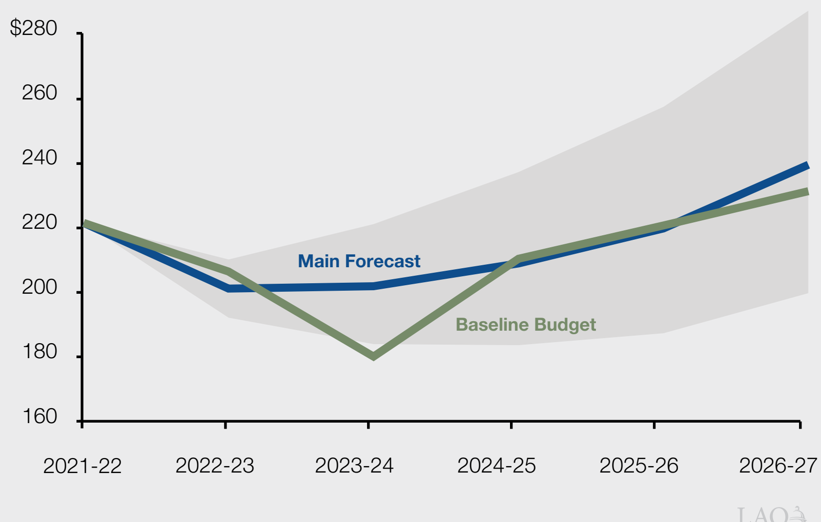
Baseline Budget More Likely to Be Affordable in Coming Years

(In Billions)

The **Main Forecast** shows revenue estimates we think have even odds of being too high or too low.

The **Baseline Budget** shows state spending after removing all one-time and temporary spending in the Governor's budget.

The grey shaded area shows the range of most likely revenue outcomes.



ADDRESSING THE SHORTFALLS

As we discussed above, the state is likely to face a larger budget problem in May and additional shortfalls in the out-years. These shortfalls would represent additional budget problems that the Legislature would have to address with a combination of actions. While the state's main tool for addressing a budget problem is its reserves, for reasons we describe below, we do not advise the Legislature use reserves to address the shortfall at this time. Instead, we suggest the state use a combination of other actions, which include: spending reductions, revenue increases, and cost shifts. In this section, we discuss our guidance for the Legislature as it addresses the additional budget problems likely to materialize this year and, possibly, in future years. We begin with our guidance regarding reserves specifically and then turn to the state's other options.

Why We Advise Holding Off on Using Reserves for Now

As we discussed in the previous section, we expect the revenue shortfall to be larger in May by around $10 billion. (This would imply a larger budget problem of around $7 billion.) Nonetheless, we still advise the Legislature to hold off on using reserves to cover that larger budget problem. If revenue losses go beyond that additional $10 billion, using reserves would be warranted. We explain our reasoning in this section.

Reserves Are a Key Tool to Address Revenue Volatility… As our office has discussed extensively in past reports, California's General Fund tax revenues are relatively volatile. State revenues tend to grow when the economy is expanding and shrink during periods of downturns or when financial market conditions are tightening. In the last couple of decades, the state has faced a choice about how to prevent that volatility from resulting in large cuts to programmatic spending. The state could reform the underlying tax structure to make it less volatile, which nearly certainly would involve reducing tax rates for higher-income earners. Or, the state could address volatility by building reserves—funds that can be saved during upswings and spent during downturns. Over many years, lawmakers and voters have clearly signaled a preference for using reserves to maintain program stability.

…And Maintain Core Spending. While there is more than one reasonable way to define core spending, we define it as the amount of ongoing spending that can be supported over the long term in the context of an inherently volatile revenue structure. (What programs the Legislature prioritizes as core spending depends on its priorities.) In any given year, the core spending level might be above or below the amount of revenue received, depending on whether the state is experiencing a surge or downturn in revenues. Over the long-term, the state can avoid cuts to core spending by setting aside money in reserves when revenues are peaking and spending those amounts during downturns. In other words, given the volatility in the state's revenues, reserves are the state's key tool for avoiding cuts to core spending.

Even With Revenue Declines, Spending Remains Above Historically Recent Peaks. Since around 2020, the state has seen historic surges in revenues—and ensuing historically large surpluses and spending levels. However, while revenues are moderating from the recent peak, they are still above average historical levels. For example, even after adjusting for inflation, anticipated revenues for 2023-24 remain about 20 percent higher than before the pandemic. Moreover, the Governor's proposed spending level—as a share of the economy shown in Figure 3 on the next page—remains above peaks from the early and mid-2000s. None of these levels—both on the revenue and spending side—are consistent with shortfalls seen during recessions.

Because Recent Budgets Focused on One-Time and Temporary Spending, Ongoing Spending Level Is Still Sustainable. Recognizing that recent rapid revenue growth was unsustainable, the Legislature focused recent surpluses on one-time and temporary spending, allocating tens of billions of dollars to these purposes. By limiting expansions to ongoing programs, the Legislature kept ongoing government services roughly in line with underlying revenue trends. One way to measure this is the probability analysis we presented earlier. Under that analysis, the state has roughly even chances of collecting sufficient revenue to maintain its baseline spending level through the multiyear.

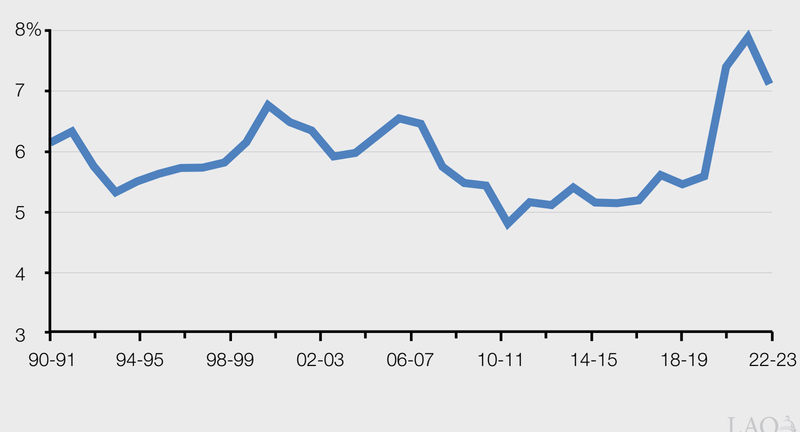
This signals that lawmakers have committed to an ongoing spending level that is sustainable—that is, in line with core spending—but spending above that base is less so.

Using Reserves Now Would Maintain Spending Peak, but Eliminate a Tool for Future Shortfalls. The main benefit of reserves is that they help the state to maintain its core spending over the long term, despite the state's volatile revenue structure. The state's revenue and spending are moderating from a historic peak, and are not yet consistent with recessionary levels. There is about a 50-50 chance the state can afford its ongoing spending level. Using reserves now to maintain the recent spending peak would mean the state would have less reserves available to pay for its core services if revenues declined further or in the event of a recession. Consequently, we recommend the Legislature hold off using reserves unless revenues decline by more than the $10 billion identified in this report. Revenue declines beyond $10 billion would reflect levels below historical averages and could impact the state's core spending level. If revenue losses go beyond an additional $10 billion for the budget window, however, we think using reserves would be warranted.

Figure 3

Despite Decline, General Fund Spending Would Still Remain Above Peaks

General Fund Spending as a Share of State Personal Income



Alternatives for Addressing the Additional Budget Problem

Instead of making withdrawals from reserves, this section outlines alternatives for addressing the budget shortfalls that would arise from an additional $10 billion in revenue shortfalls.

Suspend Budget Stabilization Account (BSA) Deposits. Although we do not think reserve withdrawals are merited at this time, we think suspending the otherwise constitutionally required BSA deposits is warranted. As is the case with making BSA withdrawals, suspending BSA deposits would require that the Governor to declare a budget emergency.

Reduce Additional One-Time and Temporary Spending. After accounting for proposed budget solutions, the administration estimates the state has $15.2 billion in one-time or temporary spending scheduled for 2023-24, $9.3 billion in 2024-25, and $6 billion in 2025-26. These are amounts that seemed affordable in June 2022, but that no longer appears to be the case. The state can solve essentially all of the currently estimated budget problems by suspending deposits into the BSA and reducing this spending. (This would include eliminating the spending currently proposed for delay.) If the Legislature wished, it could make some of these reductions subject to automatic trigger restoration if the state collects more revenue than currently anticipated.

Increase Costs Shifts and/or Revenues. Rather than using spending reductions alone, the Legislature could use other solutions to address the budget problem while still avoiding using reserves—at least for a continued manageable budget problem. First, the state could shift more costs than the $4.3 billion currently proposed by Governor. (We expect to release an analysis on these cost shifts, with additional options for the Legislature, in the coming weeks.) Second, the Legislature could consider increasing revenues, for example, on a temporary basis to cover the interim shortfalls.

LAO PUBLICATIONS

This report was prepared by Ann Hollingshead and reviewed by Carolyn Chu. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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