

LAO 
75
YEARS OF
SERVICE

Economic and Budget Update



Presented to:

**Association of California School
Administrators: Business Services
Council**

February 22, 2023

Legislative Analyst's Office

Overview of the Governor's Budget

Changes in the State Budget Since June 2022

➤ **State Revenue Estimates Are Down**

- Compared with June 2022 estimates, General Fund tax revenues are down \$17.4 billion across 2021-22, 2022-23, and 2023-24.
- Driven by weakness in certain parts of the economy.

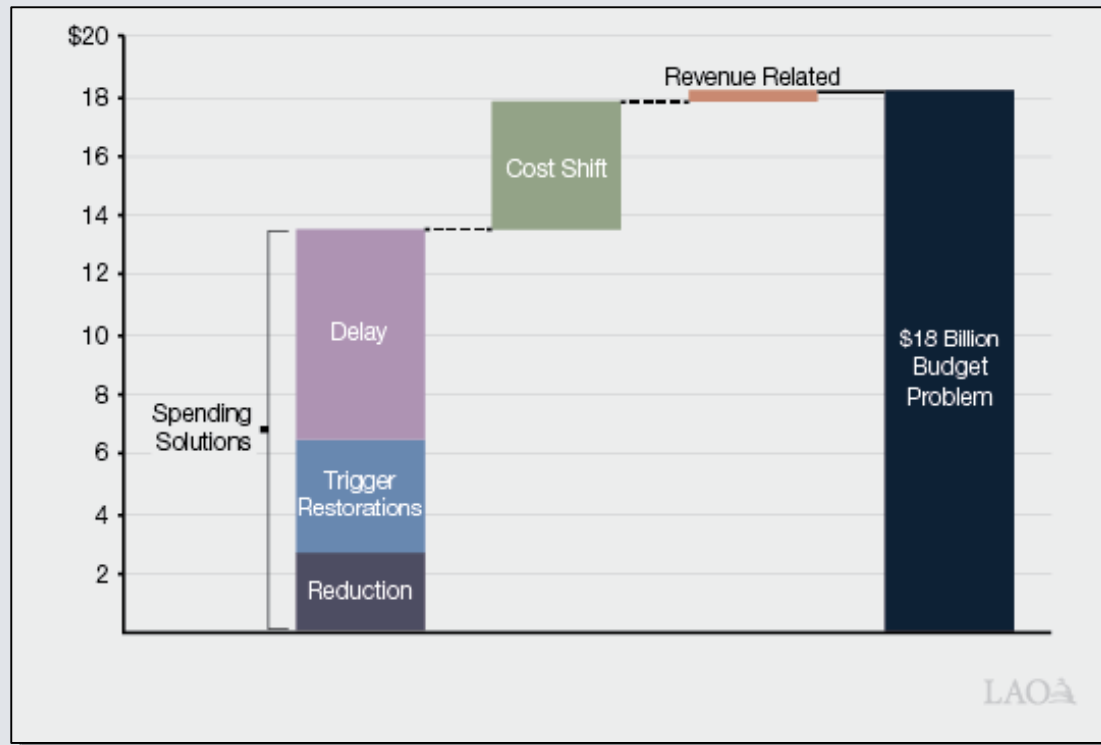
➤ **Various Baseline Spending Adjustments**

- Lower required spending on schools under Proposition 98.
- Updated information on timing and amounts of federal funding.
- Revised estimates of caseload for various state programs.

➤ **Governor's Budget Addresses \$18 Billion Shortfall**

Governor's Plan for Addressing the Budget Shortfall

In Billions



Governor's Plan Would Retain \$27 Billion in State Reserves

Governor's Budget Estimates, in Millions

	2021-22 Revised	2022-23 Revised	2023-24 Proposed
Prior-year fund balance	\$41,102	\$52,713	\$21,521
Revenues and transfers	233,891	208,883	210,174
Expenditures	222,280	240,076	223,614
Ending fund balance	\$52,713	\$21,521	\$8,081
Encumbrances	4,276	4,276	4,276
SFEU balance	48,437	17,245	3,805
Reserves			
BSA	\$19,867	\$21,487	\$22,398
SFEU	48,437	17,245	3,805
Safety net	900	900	900
Total Reserves	\$69,204	\$39,632	\$27,103

BSA = Budget Stabilization Account and SFEU = Special Fund for Economic Uncertainties.

Assessing the Governor's Budget

➤ **Revenues Likely Lower Than the Budget Anticipates**

- We think the state has about an 80 percent chance of receiving less revenue than the budget anticipates.
- Recommend Legislature start planning for larger budget problem.

➤ **Preserving State Reserves Is Prudent Starting Point**

- Reserves might be needed if revenue deteriorates significantly.

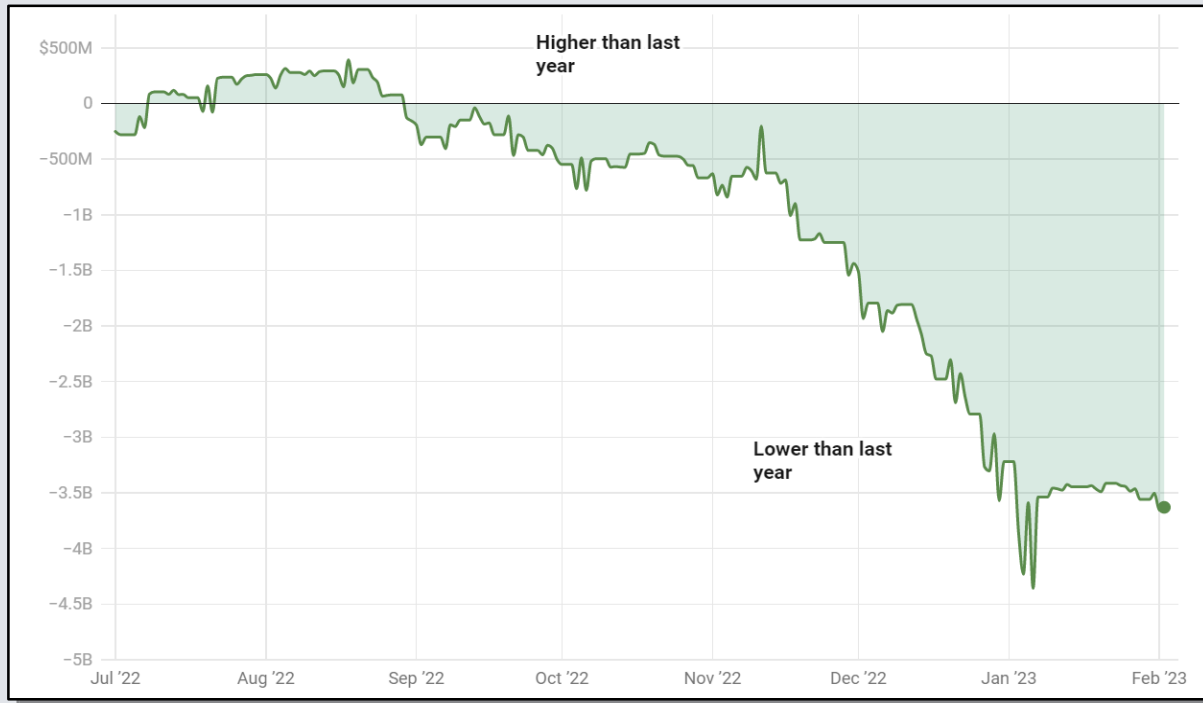
➤ **Future Deficits From \$4 Billion to \$9 Billion Annually**

- Means more changes would be needed to balance future budgets.
- State has several options, but further spending reductions likely.

LAO Revenue Outlook

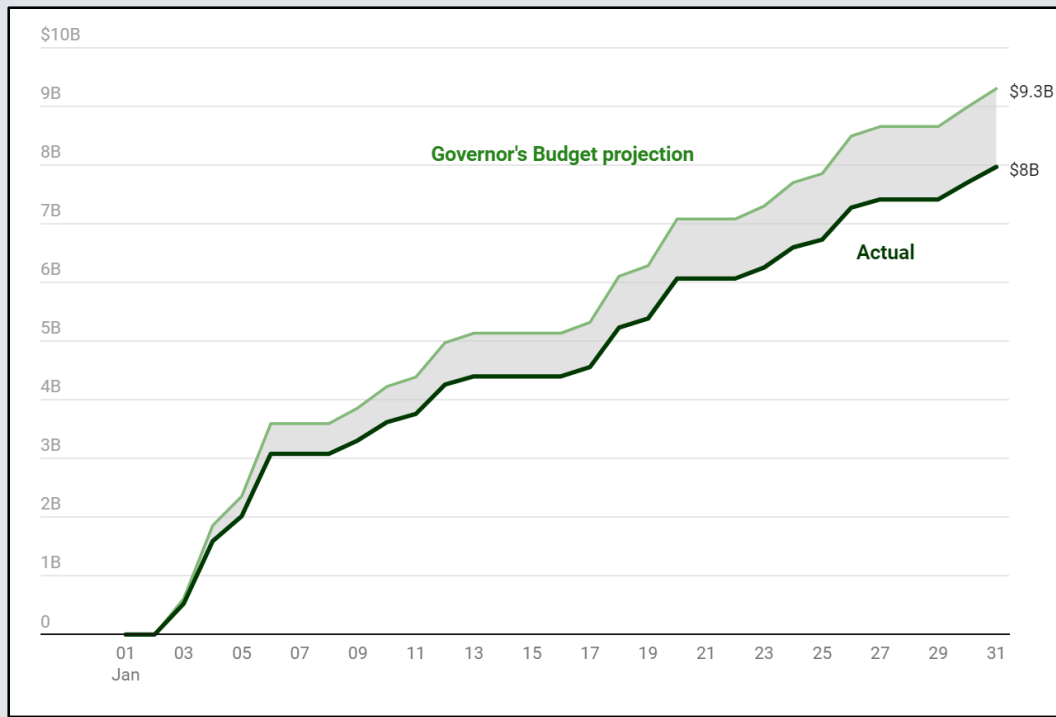
California Income Tax Withholding Is Trailing Last Year

Cumulative Income Tax Withholding for 2022-23



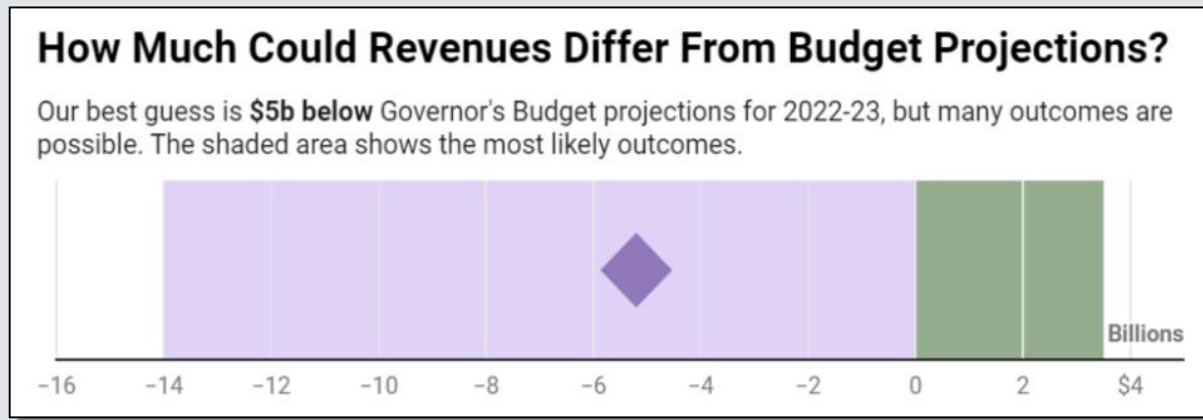
January Withholding Came in Below Governor's Budget Estimate

Cumulative January Withholding, in Billions



General Fund Revenue Likely Below the Estimates in the Governor's Budget

➤ Revenue Likely \$5 Billion Lower in 2022-23:

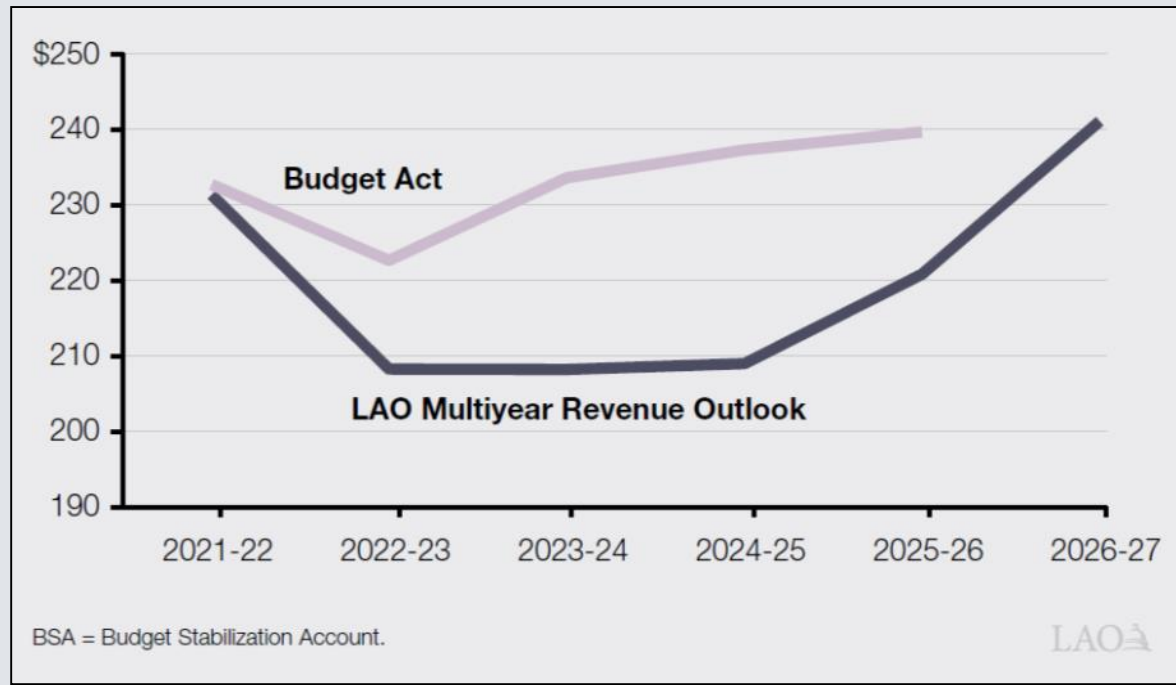


➤ Revenue Also Likely \$5 Billion Lower in 2023-24

➤ Total Difference of \$10 Billion Across Both Years

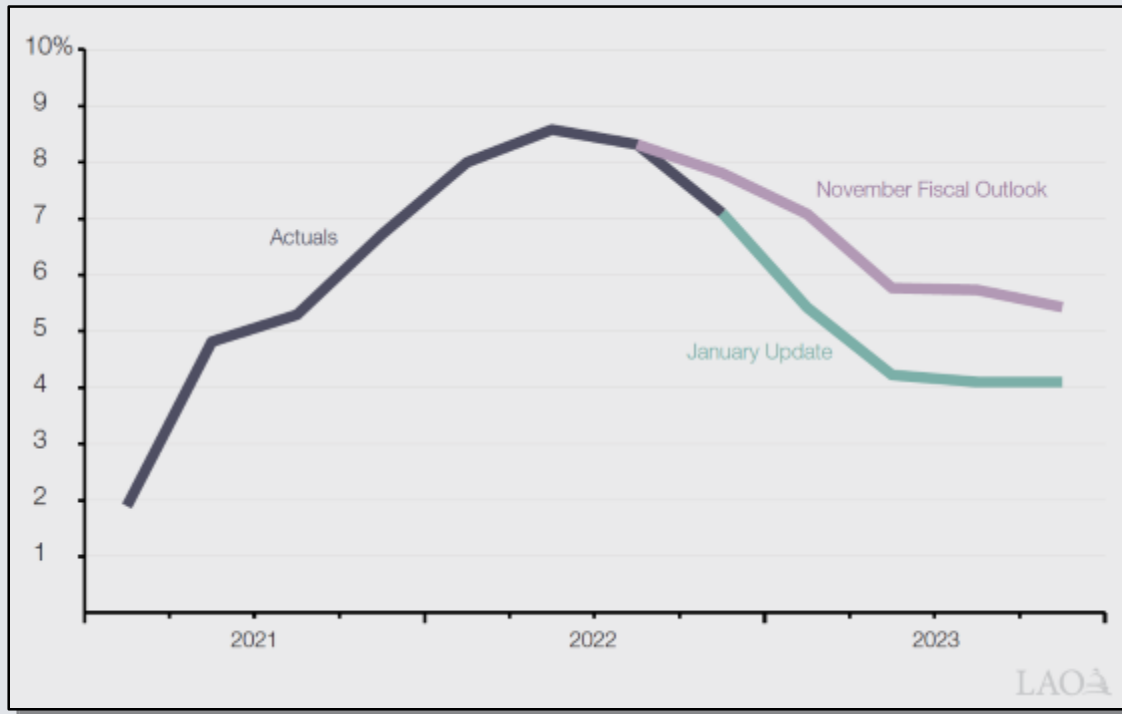
General Fund Revenues Expected to Decline, Stabilize, Then Grow

General Fund Revenue Estimates, in Billions



Inflation Expected to Moderate

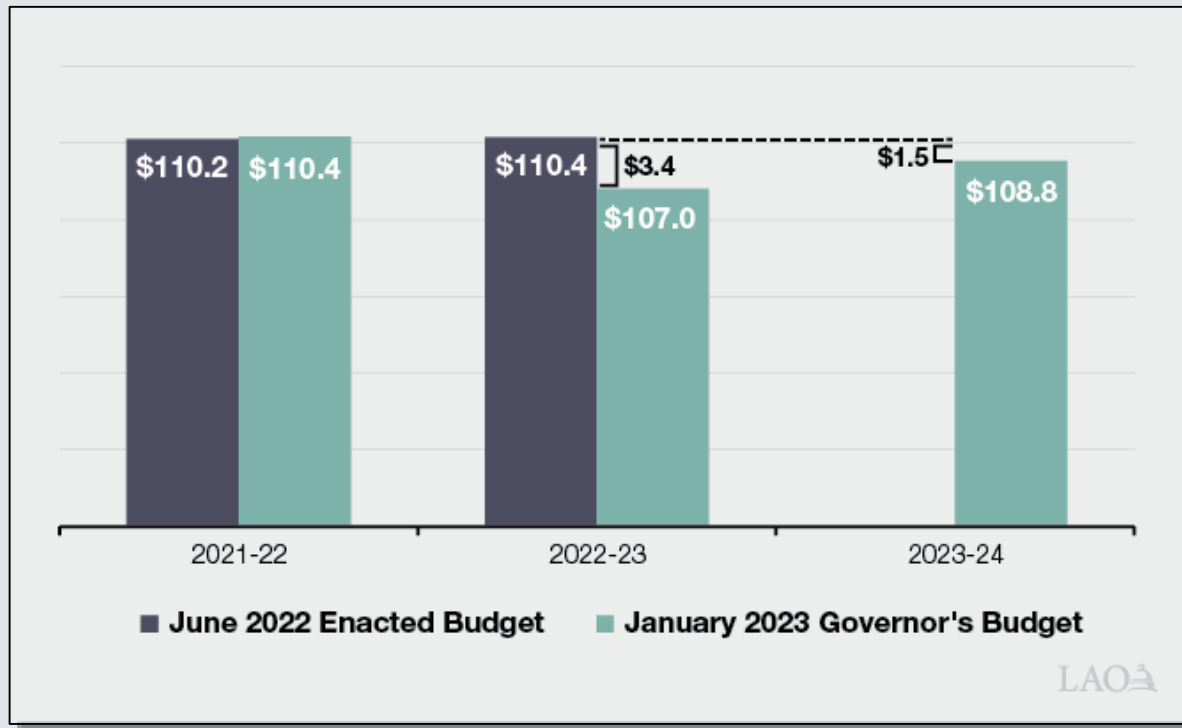
Year-Over-Year Inflation (Consumer Price Index)



The Proposition 98 Guarantee

Proposition 98 Guarantee Revised Down Under Governor's Budget

In Billions



Understanding Changes in the Proposition 98 Guarantee

- **Formulas in the State Constitution Determine the Guarantee**
 - Three “tests” linked to various economic and demographic factors.
 - The operative test in 2022-23 and 2023-24 is Test 1, which sets the guarantee equal to a minimum percentage of General Fund revenue.
- **Factors Influencing the Guarantee in Test 1 Years:**
 - Most significant: General Fund revenue—the guarantee increases or decreases about 40 cents for each dollar of higher or lower revenue.
 - Also significant: property tax revenue—guarantee increases or decreases dollar-for-dollar based on property tax changes.
 - Changes in student attendance do not affect the guarantee.

Proposition 98 Reserve

➤ **Established by Proposition 2 (2014)**

- Separate from state's main rainy day fund (also part of Proposition 2).
- State made first deposit in 2020-21.

➤ **Reserve Controlled by Formulas**

- Formulas require deposits and withdrawals under certain conditions.
- State can make discretionary withdrawals if Governor declares a budget emergency (based on certain types of disasters or weakness in state revenue).

➤ **Withdrawals Only Available to Supplement the Guarantee**

Proposition 98 Reserve, Cont.

- **Under Governor's Budget, Reserve Has \$8.5 Billion Balance**
 - Includes \$7 billion related to deposits in 2020-21 and 2021-22.
 - Includes \$1.5 billion related to deposits in 2022-23 and 2023-24.
- **Reserve Provides Cushion for K-14 Programs**
 - Lower revenues and a lower guarantee could free-up funding automatically by eliminating deposits or requiring automatic withdrawals.
 - If the guarantee drops, this freed-up funding would lessen the likelihood of program reductions or payment deferrals.

Governor's Plan for K-12 Education

Baseline Adjustments Free-Up Funding

- **Costs for Local Control Funding Formula (LCFF) Are Down**
 - State overestimated costs for LCFF in the June 2022 budget.
 - Phase-out of pre-pandemic attendance levels in the three-year rolling average calculation reduces costs.
- **One-Time Costs Are Expiring**
 - 2022-23 budget used \$2.8 billion in ongoing funds for one-time grants.
 - The costs of these grants end in 2023-24, freeing-up the underlying funds for other school purposes.
- **Lower Required Deposits Into Proposition 98 Reserve**

Governor's Plan for K-12 Schools Has Three Main Components

➤ **Ongoing Increases of \$6 Billion**

- Mainly to fund 8.13 percent statutory cost-of-living adjustment (COLA).
- New “equity multiplier” proposal (\$300 million ongoing).

➤ **One-Time Proposals Totaling \$376 Million**

- \$250 million for reading specialists and literacy coaches.
- \$100 million for cultural enrichment activities for high school seniors.

➤ **One Reduction to an Existing Program of \$1.2 Billion**

- Reduces funding for the Arts, Music, and Instructional Materials Discretionary Block Grant from more than \$3.6 billion to \$2.5 billion.

Equity Multiplier Proposal

- **New \$300 Million Ongoing Allocation**
- **Funds Allocated for High-Poverty School Sites**
 - At least 90 percent of students eligible for free meals at elementary and middle schools and at least 85 percent eligible at high schools.
 - Eligible school sites receive funding based on the number of eligible students enrolled, with minimum award of \$50,000.
 - Funds must be used “for services and supports that directly benefit school sites” and must not supplant existing LCFF funding.
- **Related Changes to Oversight and Support Systems**

One-Time Proposals

➤ **\$250 Million for Reading Specialists Grant Program**

- Augments funding provided in the June 2022 budget plan.
- Funds available to (1) develop school literacy programs, (2) hire and train reading specialists and literacy coaches, and/or (3) develop and implement interventions for students needing targeted support.

➤ **\$100 Million for Arts and Cultural Enrichment**

- Provides funding for students in Grade 12 during 2023-24 school year to participate in culturally enriching experiences (such as visits to theaters, museums, and art galleries).
- Fund allocations based on a 11th grade enrollment in 2022-23.

Implementing Proposition 28

- **Creates New Ongoing Program to Fund Arts Instruction**
 - Initial amount would be \$941 million in 2023-24.
 - Program would grow in tandem with other K-12 funding.
 - Measure allocates 70 percent of funding based on total prior-year enrollment and 30 percent based on share of low-income students.
 - Requirements for staffing, local plans, and non-supplanting uses.
- **Increases the Proposition 98 Guarantee**
 - Does not reduce funding for other K-12 programs.
 - Effectively, costs are covered by reducing non-education spending.

Assessing the Governor's K-12 Plan

Assessing the Plan for K-12 Schools

➤ Positive Aspects

- Main focus is core programs, not too many new initiatives.
- Saves Proposition 98 Reserve for tighter fiscal times.

➤ Concerns

- Relies on \$1.4 billion in one-time funds to pay for ongoing LCFF costs.
 - Creates a deficit in the education budget the following year.
 - Compounds budget risks to programs if guarantee is lower than anticipated.
- Midyear reduction to Arts, Music, and Instructional Materials Discretionary Block Grant likely disruptive for districts.

Recommended Changes

➤ **Avoid Creating Deficit in Proposition 98 Budget**

- Adjust spending to avoid relying on one-time funds for ongoing costs.
- Would better position the state to address drops in the guarantee.
- Also would reduce need for midyear reductions to discretionary grant.

➤ **Reject Governor's Larger Proposals for New Programs**

- Not strong justification for some of the Governor's proposed new programs, especially in tighter fiscal times.
- Rejecting proposals would yield mix of ongoing and one-time savings.
- Would ease pressure on existing programs.

Additional Options for Ongoing Savings

➤ Consider Funding Lower COLA Rate

- Each 0.5 percent change in COLA rate equates to about \$400 million.
- For illustration: assuming the state (1) wants to avoid relying on one-time funds, and (2) makes no other changes to the Governor's budget, it could cover a 6.4 percent COLA.
- If the guarantee drops, the state might need to fund lower COLA.

➤ Consider Reductions to Existing Programs

- Could modify Expanded Learning Opportunities Program to account for the lower levels of participation observed during initial implementation.
- Could modify State Preschool to align funding with current contracts.

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