The 2022-23 Budget:

Overview of the Governor's Budget

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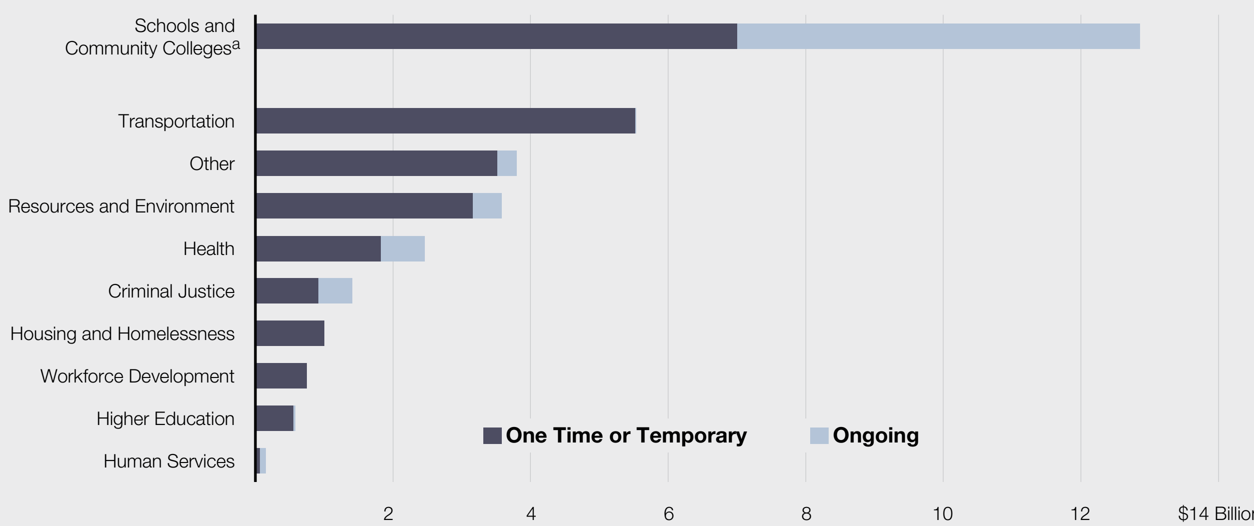
Executive Summary

Budget Structure

How Much in Discretionary Resources Does the Governor Allocate? We estimate the Governor had a $29 billion surplus to allocate in the 2022-23 budget process. The Governor proposes spending about 60 percent of discretionary resources, or $17.3 billion, on a one-time or temporary basis for a variety of programmatic expansions. The Governor also proposes using $6.2 billion to reduce revenues and $2 billion for ongoing spending increases. (These ongoing proposals would increase to $5.2 billion by 2025-26.) In addition, the Governor's budget allocates nearly $13 billion in discretionary spending for schools and community colleges (which we exclude from the surplus because these amounts are constitutionally required). The figure below displays the major budgetary decisions that the Governor made in allocating state discretionary funds.

Major Discretionary Spending Choices in 2022-23 Governor's Budget

Nearly $13 Billion in School and Community Colleges Spending;
$19 Billion in General Fund Discretionary Spending Choices



[a] Includes General Fund and local property tax revenue.
Note: Bridge funding for homelessness included in the "Health" section.

How Does the Governor Address the State Appropriations Limit (SAL) Requirement? The SAL limits how the Legislature can use revenues that exceed a specific threshold. The Governor's budget shows excess revenues of $2.6 billion across 2020-21 and 2021-22. The Governor's budget does not include a proposal to address these excess revenues, but the administration states it plans to put forward a plan to address these requirements at the May Revision. In 2022-23, the Governor's budget reflects $5.7 billion in room—meaning appropriations subject to the limit are under the limit by this amount in this year. This room in part reflects $12.5 billion in proposals for revenue reductions and SAL exclusions.

Overall Comments

Multiyear Revenue Projections Are Reasonable, but New Spending Proposals Exceed Administration's Estimates of the Budget's Capacity. Whereas we often noted previously that the administration's multiyear revenue estimates appear to be fairly cautious, we characterize this year's estimates as a middle of the road among potential outcomes. Despite these improved revenues, the administration's multiyear estimates reflect negative balances in the Special Fund for Economic Uncertainties (SFEU) in 2023-24 (and throughout the rest of their forecast) due to proposed spending exceeding estimated resources. By planning to have a negative balance in the SFEU, the administration assumes that next year revenues will be higher than anticipated, costs will be lower than anticipated, taxes will be increased, or reductions will be required. While multiyear revenue and expenditure forecasts are imprecise, committing to spending above anticipated resources carries considerable risk.

Strongly Consider Building More Reserves. The reserve for schools and community colleges has increased from zero in 2019-20 to nearly $10 billion—or nearly 10 percent of their funding—under the Governor's estimates in 2022-23. The state's other budget reserves, however, have not increased as a share of other General Fund spending and, in fact, are significantly below the pre-pandemic share. Given this, we recommend the Legislature consider building general purpose reserves above the level currently proposed by the Governor.

SAL Remains Important Consideration. The SAL will continue to constrain the Legislature's choices in the upcoming budget process. Deferring plans to meet the SAL's requirement further decreases the Legislature's flexibility. We encourage the Legislature to develop a plan for how it wishes to meet the requirement across 2020-21 and 2021-22. For the budget year, as the Legislature considers the Governor's budget proposals, those proposals that currently count as excludable expenditures—such as spending on capital outlay—for the most part can only be reallocated to other SAL-related purposes, such as tax reductions or an alternative excluded expenditure.

Focus on Ensuring Success of Recent Initiatives. We recommend the Legislature dedicate the early part of the budget process to overseeing the implementation of last year's significant augmentations. This information could inform the Legislature's approach to allocating this year's surplus. For instance, if departments face challenges with administrative capacity, the Legislature could consider whether additional staffing is warranted. Moreover, given the scale of last year's commitments, we suggest the Legislature be cautious in creating additional new programs as well as expanding the scope of existing programs.

Consider Longer-Term COVID-19 Planning. The Governor's budget includes additional spending for COVID-19-related expenditures like testing and vaccination and an intent to modify the state's COVID-19 sick leave policies. It largely does not include, however, the extension of program flexibilities and temporary supports provided in last year's budget. In part, this likely reflects that the Governor's budget was developed before Omicron became the prevailing COVID-19 variant in California. As the Legislature starts its deliberations on the budget, we recommend considering whether any program flexibilities—like remote assessments for human services programs—or temporary supports—like targeted cash assistance—are warranted. Moreover, as COVID-19 likely will remain a public health and economic challenge in future years, we recommend the Legislature closely consider the extent to which the Governor's proposals properly prepare the state for this reality.

INTRODUCTION

On January 10, 2022, Governor Newsom presented his proposed state budget to the Legislature. In this report, we provide a brief summary of the proposed budget based on our initial review. In the coming weeks, we will analyze the plan in more detail and release several additional budget analyses.

The objective of this report is to summarize the Governor's budget structure and major proposals for the Legislature, including any themes that emerged as we conducted our preliminary review. We also provide our initial assessment of the structure of the budget—including how the Governor proposes addressing the state's constitutional State Appropriations Limit (SAL) requirements—and raise issues for legislative consideration on the major budget proposals. Appendix 1 provides definitions for some key terms used in this report.

HOW MUCH IN DISCRETIONARY RESOURCES DID THE GOVERNOR ALLOCATE?

BUDGET CONDITION

Figure 1 shows the General Fund condition based on the Governor's proposals and using the administration's estimates and assumptions.

General Purpose Reserves Reach Nearly $25 Billion. The bottom of Figure 1 shows general purpose reserves planned for the end of 2022-23 under the administration's estimates and assumptions. Under the Governor's proposed budget, the state would end 2022-23 with nearly $25 billion in general purpose reserves. This represents an increase of $4.2 billion over the enacted reserve level of $20.7 billion in 2021-22. The increase is the result of three factors:

- ***Deposit of $1.6 Billion in BSA for 2022-23.*** Proposition 2 (2014) requires the Legislature to set aside monies each year in the state's constitutional reserve, the Budget Stabilization Account (BSA). Generally, these reserve deposits are higher when the state collects more revenues, especially revenues from capital gains taxes. Under the administration's revenue estimates, the state's 2022-23 BSA requirement totals $3.9 billion. However, the BSA also would reach a threshold level, requiring the state to spend $2.4 billion of this total on infrastructure. The box on the next page describes this infrastructure spending requirement in more detail.

Figure 1

General Fund Condition Summary

(In Millions)

	2020-21 Revised	2021-22 Revised	2022-23 Proposed
Prior-year fund balance	$6,332	$37,011	$23,651
Revenues and transfers	194,132	196,669	195,718
Expenditures	163,453	210,030	213,127
Ending fund balance	$37,011	$23,651	$6,242
Encumbrances	3,175	3,175	3,175
SFEU balance	**33,836**	**20,476**	**3,067**
Reserves			
BSA	$14,287	$19,303	$20,868
SFEU	33,836	20,476	3,067
Safety net	900	900	900
Total Reserves	**$49,023**	**$40,679**	**$24,835**

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

- ***$3.5 Billion in Reserve Deposit Adjustments.*** Proposition 2 also requires the state to revise, or "true up," BSA deposits for the two preceding fiscal years based on updated revenue estimates. Under the administration's assumptions, the state would need to make $3.5 billion in true-up deposits to the BSA for 2020-21 and 2021-22, primarily due to higher estimates of capital gains revenues.
- ***Decrease in the Discretionary Reserve Balance of Nearly $1 Billion.*** The state's main discretionary reserve is called the Special Fund for Economic Uncertainties (SFEU). The 2021-22 budget package enacted a discretionary reserve balance of nearly $4 billion and the Governor proposes a year-end balance of $3.1 billion in that reserve—a reduction of nearly $1 billion.

Proposition 98 Reserve Reaches Nearly $10 Billion. In addition, the Proposition 98 Reserve, which is dedicated to school and community college spending, would reach nearly $10 billion under the Governor's budget. We do not include this reserve in general purpose reserves because withdrawals supplement the constitutional minimum spending level for K-14 education and therefore do not help the state address future budget problems. However, this reserve does benefit schools because it mitigates the funding reductions that occur when the constitutional minimum drops.

GENERAL FUND SURPLUS

We Estimate the Governor Allocated a Surplus of $29 Billion. We estimate the Governor had a $29 billion surplus to allocate in the 2022-23 budget process. This is somewhat larger than the $21 billion discretionary General Fund surplus identified by the administration. Both our office and the administration estimate the budget "surplus" by tallying up the amount of discretionary spending, excluding spending on K-14 education, and revenue reductions in the budget. Both of our offices define discretionary spending as new spending not required under law or to maintain current service levels. In a number of areas, however, our office and the administration differ on whether a specific proposal is discretionary or not. For example, our office considers the $3.5 billion proposal for transportation infrastructure discretionary because those funds have reverted to the General Fund, but the administration proposes reallocating them. The administration, however, considers this proposal part of its baseline. (The Governor's budget also refers to a total surplus of nearly $46 billion, which includes constitutional requirements under Proposition 98 and Proposition 2. We discuss the discretionary spending choices within Proposition 98 in the next section. We do not typically consider Proposition 2 requirements to be part of the surplus.)

Infrastructure Spending Requirement Under Proposition 2 in 2022-23

Proposition 2 Requires Infrastructure Spending After Budget Stabilization Account (BSA) Reaches Threshold Level. Under Proposition 2 (2014), the state is required each year to set aside funds for reserves, debt payments, and—potentially—infrastructure. In particular, the state must deposit funds into the BSA until its constitutional deposits reach 10 percent of General Fund tax revenue. Once the BSA reaches this threshold, required deposits that would bring the fund above 10 percent of General Fund taxes instead must be spent on infrastructure.

Governor's Budget Anticipates State Reaches This Threshold in 2022-23. Under the administration's revenue estimates, the state would reach the 10 percent threshold in 2022-23. As a result, under these estimates, the state is required to spend $2.4 billion on infrastructure in 2022-23. The Governor's budget does not allocate these funds to specific proposals. Rather—given the magnitude of capital outlay proposals in the budget—the administration notes it has fulfilled this constitutional requirement. (As a result, for the purposes of our surplus calculation described in the next section, we must treat this $2.4 billion in spending on capital outlay as part of the surplus, although we would not ordinarily define a constitutional requirement in this way.)

Comparison to LAO November Outlook. In our *Fiscal Outlook* released in November 2021, our office anticipated the state would have a surplus of $31 billion, slightly higher than the surplus allocated in the Governor's budget. This relatively small difference reflects many moving—and offsetting—factors across the budget. Specifically, relative to our outlook, the administration's estimates include:

- ***$10.5 Billion in Lower Revenues.*** Setting aside policy changes, federal funding scored as revenues, and reserve deposits, the administration's baseline revenue are $10.5 billion lower than our November estimates across 2020-21, 2021-22, and 2022-23. This primarily is due to our differing estimates of corporation tax revenues, particularly in the current year.
- ***$6.5 Billion in Lower School and Community College Spending.*** Reflecting these lower revenue estimates—and including policy changes in the Governor's budget—the administration's estimates of constitutionally required General Fund spending on K-14 education is about $6.5 billion lower than our November estimates. This largely offsets the revenue reduction described above.
- ***$2 Billion in Lower Other Spending.*** Across the rest of the budget, the administration's estimate of spending is lower than ours by $2 billion. This is the result of many differences in our estimates, both higher and lower. For example, as described in the nearby box, the administration assumes the state's spending on COVID-19 emergency response will be higher. However, the administration also estimates baseline costs in a variety of other program areas—such as In-Home Supportive Services and the California State Teachers' Retirement System—will be lower than what we estimated.

Surplus Excludes Last Year's Budget Agreements. There were a number of multiyear budget commitments agreed to last year. Based on our initial assessment, the Governor's budget reflects these commitments. These allocations are not reflected in our surplus calculation. For example, they include:

- ***Climate Resilience Package.*** The 2021-22 budget agreement included $3.7 billion from the General Fund over three years for a variety of activities to respond to the impacts of climate change—such as extreme heat and sea-level rise—including $2.1 billion in 2022-23, which is included in the Governor's proposal, consistent with the budget agreement between the Governor and the Legislature
- ***Student Housing.*** The 2021-22 budget agreement included $2 billion General Fund over three years—including $750 million in 2022-23—for grants to increase affordable student housing at the three public higher education segments.

COVID-19 Emergency Response Spending Update

The administration estimates direct COVID-19 expenditures are $3.2 billion in 2021-22 ($1.4 billion higher than budget act assumptions) and $1.3 billion in 2022-23. Both of these estimates are higher than our November assumptions. (Direct COVID-19 expenditures include testing, contact tracing, vaccine distribution and administration, and hospital and medical surge.) The administration requests the Legislature take immediate or early action to approve the additional 2021-22 funding, of which $1.2 billion is for the California Department of Public Health (CDPH) and $206 million is for the California Department of Corrections and Rehabilitation (CDCR). Of the 2022-23 total, $761 million is estimated for CDPH, $425 million for CDCR, and $65 million for the Department of State Hospitals. The administration continues to assume that many of these costs will be federally reimbursable. For example, the Federal Emergency Management Agency will continue to reimburse eligible COVID-19 costs at the increased rate of 100 percent through April 1, 2022.

- ***Sustainable Agriculture Package.*** The 2021-22 budget agreement included a total of $1.1 billion from several fund sources over two years for various proposals related to agriculture. This included $417 million from the General Fund in 2022-23, which is included in the Governor's proposal, consistent with the budget agreement between the Governor and the Legislature.
- ***Middle Class Scholarship Program.*** The 2021-22 budget agreement included significant statutory changes that revamped this program, significantly increasing its future cost. The Governor's 2022-23 budget contains $515 million ongoing General Fund to launch the revamped program.
- ***Foundational Support for Public Health.*** The 2021-22 budget agreement included $300 million ongoing General Fund beginning in 2022-23 for state and local public health staffing and general support. The Governor's 2022-23 budget provides a proposed spending plan for the funding, directing $200 million to local health jurisdictions and retaining $100 million for state operations.

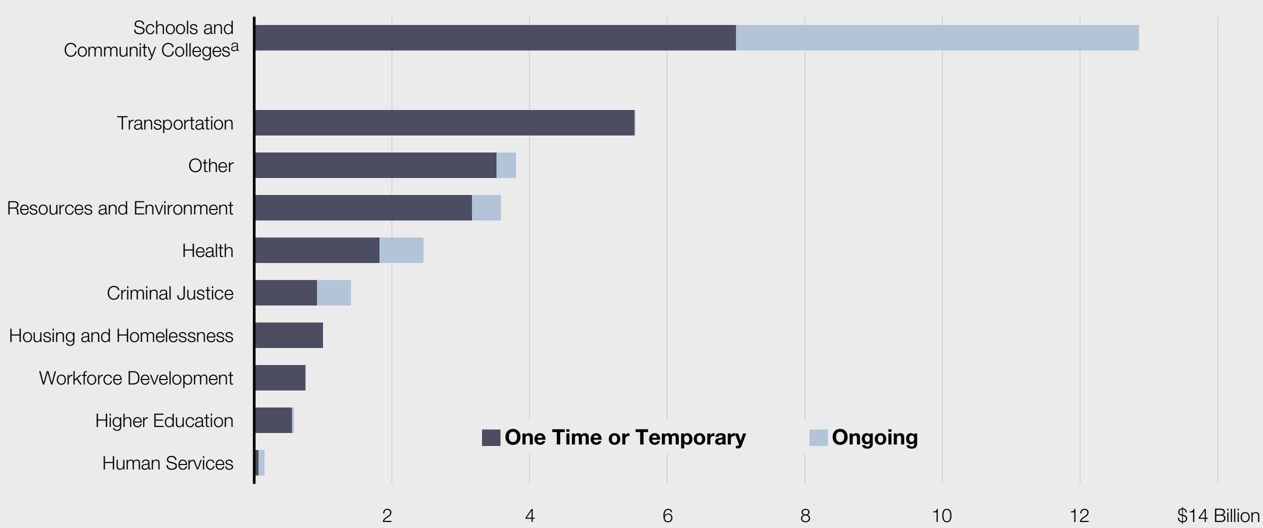
HOW DID THE GOVERNOR ALLOCATE THE DISCRETIONARY RESOURCES?

Figure 2 displays the major budgetary decisions that the Governor made in allocating state discretionary funds. It includes: (1) the General Fund surplus and (2) discretionary school and community college spending choices. The remainder of this section discusses the major components of each of these funding amounts. (Later sections describe the major proposals.) As the figure shows, schools and community colleges would receive the largest spending allocations. We also provide more program-level information in Appendix 2. (Appendix 2 only is available for the online version of this report.)

Figure 2

Major Discretionary Spending Choices in 2022-23 Governor's Budget

Nearly $13 Billion in School and Community Colleges Spending;
$19 Billion in General Fund Discretionary Spending Choices



[a] Includes General Fund and local property tax revenue.

Note: Bridge funding for homelessness included in the "Health" section.

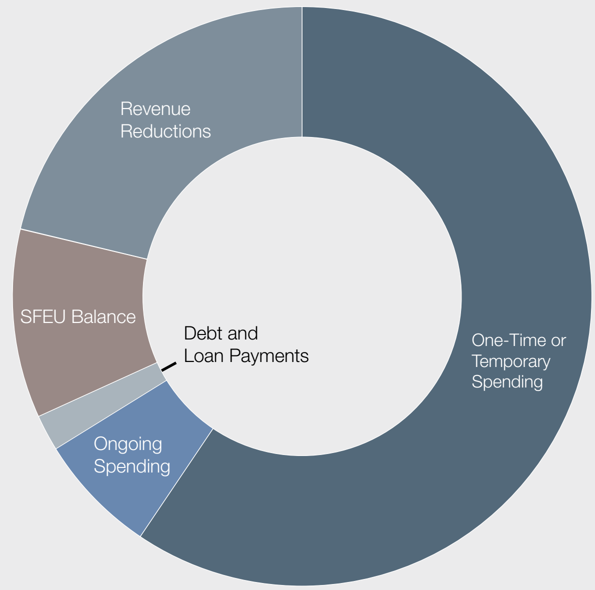
GENERAL FUND CHOICES

How the Governor Allocates the Surplus. Figure 3 shows how the Governor proposes the Legislature allocate the $29 billion surplus. Specifically, the Governor proposes allocating:

- ***$17.3 Billion to One-Time or Temporary Spending.*** The Governor proposes spending about 60 percent of discretionary resources, or $17.3 billion, on a one-time or temporary basis for a variety of programmatic expansions. (We define temporary to mean three years or fewer.)
- ***$6.2 Billion to Revenue Reductions.*** The Governor proposes using $6.2 billion, about 20 percent of the surplus, to reduce revenues. Most of this total, $5.5 billion, would be allocated to end, one year early, temporary limits on the ability of businesses to use net operating loss (NOL) deductions and tax credits to reduce their tax payments.
- ***$3.1 Billion to the SFEU Balance.*** The Governor proposes the Legislature enact a year-end balance in the SFEU of $3.1 billion. The Legislature can choose to set the SFEU balance at any level above zero. However, recent budgets have enacted SFEU balances around $2 billion to $4 billion, which the state uses to cover costs for unanticipated expenditures.
- ***$2 Billion to Ongoing Spending Increases.*** The Governor's spending proposals include $2 billion in ongoing spending, slightly less than 10 percent of the surplus. That said, under the administration's estimates, the ongoing costs of the Governor's budget proposals would grow significantly over time, totaling $5.2 billion by 2025-26.
- ***$590 Million to Repay Debts and Liabilities.*** In addition to $4 billion in constitutionally required debt payments, the Governor proposes the Legislature use $590 million in discretionary resources to repay state debts and liabilities. Specifically, these funds would be used to repay some special fund loans made in 2020-21.

Figure 3

How the Governor Allocates a $29 Billion Surplus



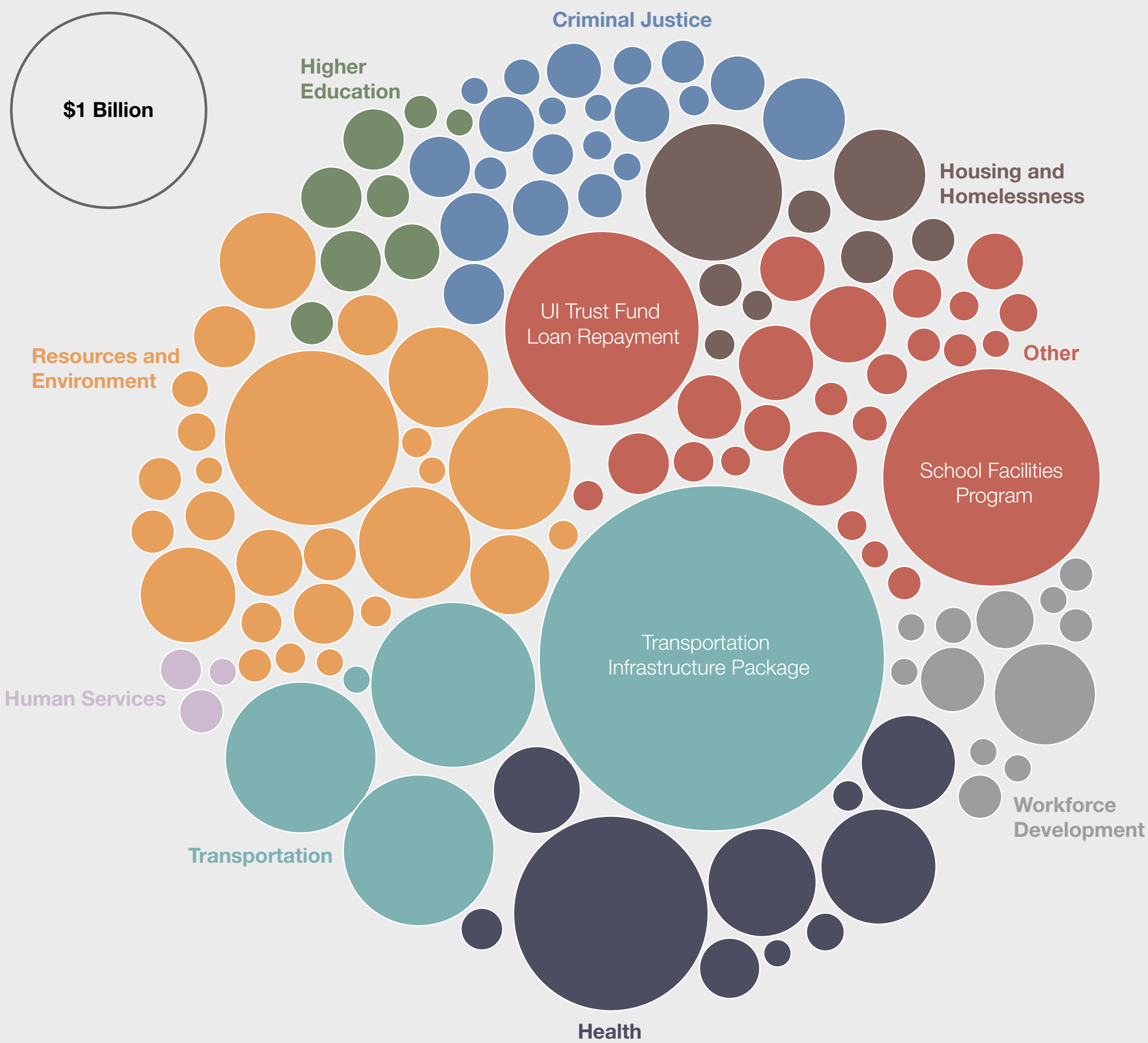
SFEU = Special Fund for Economic Uncertainties.

How the Governor Allocates the Surplus by Program Area. Figure 4 on the next page, shows how the $19 billion in one-time, temporary, and ongoing spending proposals are distributed across major program areas. The largest proposals include: $3.5 billion for a transportation infrastructure package, $1.3 billion in funding for school facilities, $1 billion to repay the unemployment insurance trust fund loan in 2022-23, and $1 billion to provide funding for bridge housing through the Behavioral Health Continuum Infrastructure Program.

Figure 4

Discretionary General Fund Spending Choices in the 2022-23 Governor's Budget

$19 Billion in One-Time, Temporary, and Ongoing Budget Proposals



Note: Bridge funding for homelessness included in the "Health" section. Excludes proposals below $20 million.
UI = Unemployment Insurance.

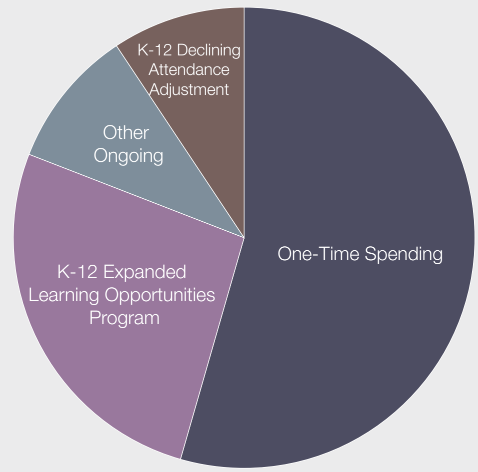
SCHOOLS AND COMMUNITY COLLEGES CHOICES

The State Constitution sets a minimum annual funding requirement for schools and community colleges. After setting aside funding for statutory cost-of-living adjustments (COLAs) and other planned program expansions, the Governor's budget includes nearly $13 billion in discretionary spending proposals to meet the constitutionally required funding level for schools and community colleges. As **Figure 5** shows, the Governor proposes allocating $7 billion of this total for one-time activities, $3.4 billion ongoing for the Expanded Learning Opportunities Program, $1.2 billion ongoing for a new funding adjustment for school districts with declining attendance, and $1.3 billion for other ongoing increases.

Figure 5

Governor's Major Spending Choices for Schools and Community Colleges

$13 Billion



HOW DOES THE GOVERNOR ADDRESS THE SAL REQUIREMENTS?

The SAL limits how the Legislature can use revenues that exceed a specific threshold. In particular, under these constitutional requirements, each year the state must compare the appropriations limit to appropriations subject to the limit. As shown in Step 1 of **Figure 6** on the next page, this year's limit is calculated by adjusting last year's limit for a growth factor that includes economic and population growth. As shown in Step 2, appropriations subject to the limit are determined by taking all proceeds of taxes and subtracting excluded spending. In Step 3, the state compares appropriations subject to the limit to the limit itself. If appropriations subject to the limit are less than the limit, there is "room." If appropriations subject to the limit exceed the limit (on net) over any two-year period, there are excess revenues.

As the figure shows, there are essentially two different ways that the state can meet its constitutional requirements under the SAL. The state can preemptively lower appropriations subject to the limit. It can do this by either lowering tax revenues or spending more money for purposes excluded from the SAL. These exclusions include: subventions to local governments, capital outlay projects, debt service, federal and court mandates, and certain kinds of emergency spending. Alternatively, the state can address excess revenues (shown in Step 3). Under this alternative, the state must split the excess between additional school and community college payments and taxpayer rebates. (For more information about the SAL, see our report, *The State Appropriations Limit.*)

Prior Year (2020-21) and Current Year (2021-22)

Estimates and Proposals. In 2020-21, the Governor's budget reflects nearly $19 billion in "negative room," meaning appropriations subject to the limit exceed the limit itself by this amount in this year. In 2021-22, the Governor's budget reflects $16.4 billion in room—meaning appropriations subject to the limit are under the limit by this amount in this year. This estimate includes about $6.3 billion in revenue and spending proposals which meet SAL requirements and therefore lower appropriations subject to the limit. The exclusions include: $4.3 billion for a transportation infrastructure package, $1.4 billion for green school buses (Proposition 98), and $450 million for school kitchen upgrades (Proposition 98).

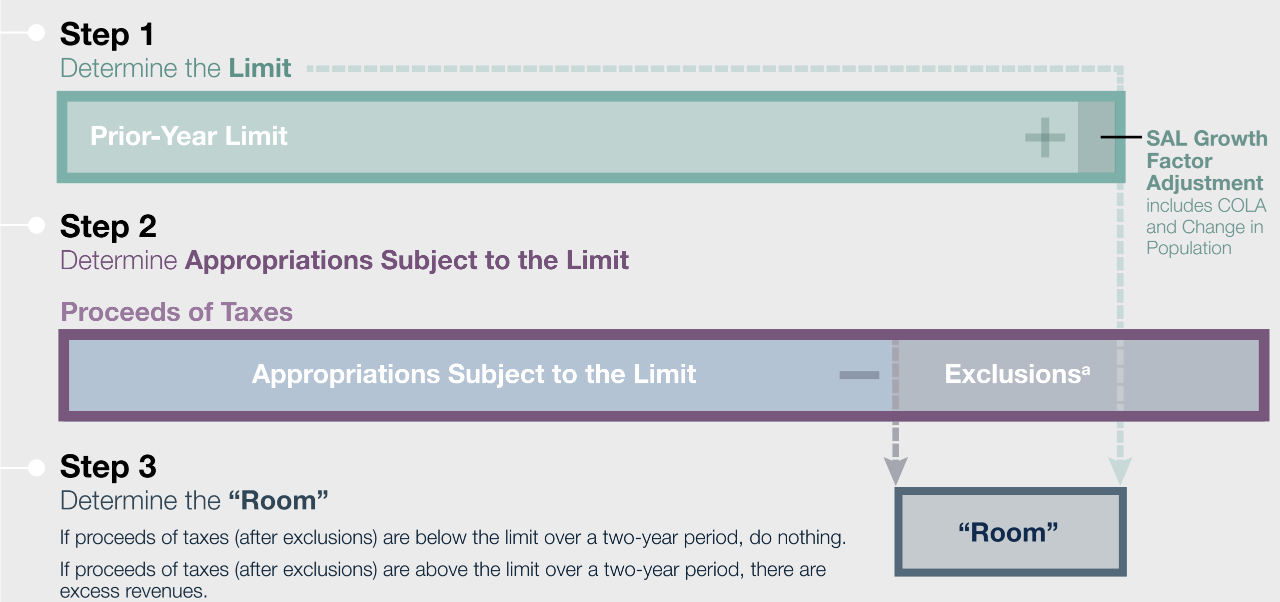
Excess Revenues of $2.6 Billion. As shown in Figure 7, on net, across the two years, the Governor's budget shows excess revenues of $2.6 billion. The Governor's budget does not include a proposal to address these excess revenues, but the administration states it plans to put forward a plan to address these requirements at the May Revision. Importantly, this requirement could change substantially between now and May. Nonetheless, the Legislature currently can choose to address this requirement with any of the three choices described earlier—lowering tax revenues, splitting excess revenues between school payments and taxpayer rebates, or spending more on excluded purposes.

Budget Year (2022-23)

Estimates and Proposals. In 2022-23, the Governor's budget reflects $5.7 billion in room—meaning appropriations subject to the limit are under the limit by this amount in this year. As shown in Figure 7, this estimate includes about $12.5 billion in proposals that either reduce revenues or appropriations subject to the limit (thereby meeting SAL requirements). On the revenue side, the Governor's budget includes $5.5 billion to restore net operating losses and business credits and various other tax credits, which reduce SAL revenues by a total of $6 billion. On the spending side, the Governor's budget includes $6.5 billion in discretionary SAL-related exclusions. The largest of these are: $1.3 billion in funding for the School Facilities Aid Program, $1.2 billion for various transportation projects, and $545 million for clean energy and building decarbonization.

Figure 6

How the State Appropriations Limit (SAL) Works



[a] Exclusions are appropriations that are not counted towards the state appropriations limit. For example, spending on capital outlay is excluded.

COLA = cost-of-living adjustment.

The Surplus and the SAL

The Governor's budget allocates a surplus of $29 billion across a variety of programs. As shown in Figure 8, these proposals include $16.9 billion in discretionary proposals across 2021-22 and 2022-23—both revenue and spending—that address SAL requirements. (These figures exclude school and community college spending, which is not part of the surplus.) The remainder of the surplus—$12.1 billion—is proposed for purposes not excluded from the SAL, including $8.5 billion in spending-related proposals, the $3.1 billion balance of the SFEU, and about $600 million to repay special fund loans. Broadly speaking, to maintain appropriations below the limit in 2022-23, any excluded spending (or tax reductions) proposals rejected by the Legislature must be repurposed for an expenditure that also meets SAL requirements (in particular, excluded spending or tax reductions). Conversely, the Legislature has flexibility to reallocate the proposals that are not excluded from the SAL to any of its priorities. Consequently, within the Governor's budget framework, the Legislature's flexibility over roughly half of the surplus is restricted.

Figure 7

SAL Estimates and Proposals in the 2022-23 Governor's Budget

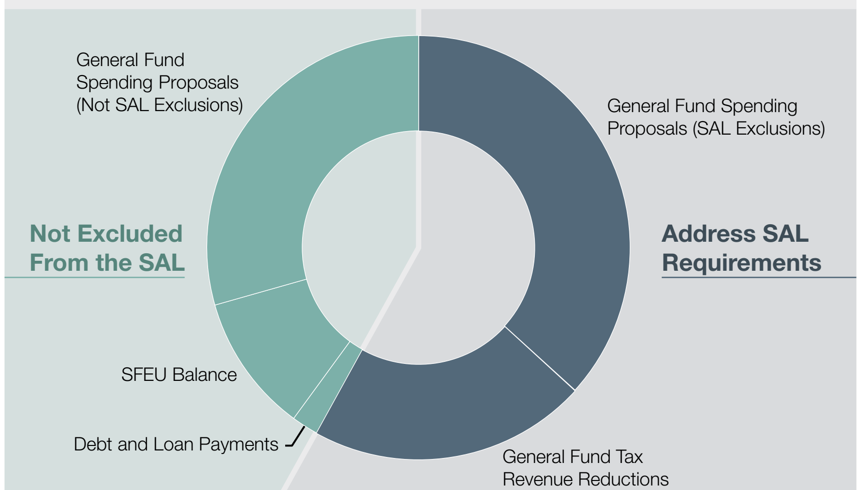
(In Millions)

	2020-21	2021-22	2022-23
SAL Revenues and Transfers			
Baseline revenues	$215,221	$224,037	$233,124
Proposals (revenue reductions)	—	-130	-6,006
Totals	**$215,221**	**$223,907**	**$227,118**
Exclusions			
Baseline expenditures	-$80,266	-$108,322	-$94,970
Proposals (SAL exclusions)	-97	-6,282	-6,473
Totals	**-$80,363**	**-$114,604**	**-$101,443**
Appropriations Subject to the Limit	$134,858	$109,303	$125,675
Limit	115,860	125,695	131,365
Room/Negative Room	**-$18,998**	**$16,392**	**$5,690**
Excess Revenues?	**-2,606**		**—**[a]

[a] Future budgets will determine whether there will be excess revenues across 2022-23 and 2023-24.

Figure 8

Surplus Includes Nearly $17 Billion in Discretionary Proposals That Address SAL Requirements.



Note: Figure excludes discretionary proposals that meet SAL requirements within Proposition 98.
SAL = State Appropriations Limit and SFEU = Special Fund for Economic Uncertainties.

WHAT ARE THE MAJOR BUDGET PROPOSALS?

TAXES

Business Tax Reductions

Lifts Temporary Limits on Business Tax Provisions. The Governor's budget proposes to end, one year early, temporary limits on the ability of businesses to use NOL deductions and tax credits to reduce their tax payments. These limits were put in place for three years at the onset of the pandemic as a solution to an anticipated $54 billion budget problem. Lifting the NOL deduction and credit limits will reduce tax revenues by an estimated $5.5 billion in 2022-23 and then, over following years, increase revenues by several hundred million dollars per year.

LAO Comment: Ending NOL and Credit Limits Early Is Reasonable. The state's actual revenue situation improved significantly faster than the state anticipated when it adopted the temporary limits on NOL deductions and credits. These business tax provisions were enacted to address an anticipated budget problem, not to raise revenue for new state spending. Lifting the limits one year early would be reasonable given the significantly improved revenue outlook.

Conform to Federal Tax Treatment of Federal Economic Relief. The Governor's budget proposes to exempt certain federal pandemic-related grants from taxation. In late 2020 and early 2021, the federal government created two new grant programs, the Shuttered Venue Operators Grant (SVOG) and the Restaurant Revitalization Fund (RRF), to provide additional fiscal relief to businesses that were especially impacted by the pandemic. These grants are not taxable under federal law. Under current state law, however, both grants are taxable. This proposal would conform state law to the federal law, exempting the grants from taxation. This change would reduce state tax revenues by about $500 million over several years.

LAO Comment: Proposal Consistent With Previous Legislative Action. Chapter 17 of 2021 (AB 80, Burke) conformed state law with federal tax treatment of most other federal pandemic-related economic relief programs. Conforming to the federal tax treatment of the SVOG and RRF grants would be consistent with that previous action.

New Business Tax Incentives. The budget includes proposals for two new business tax credit programs:

- ***Climate Change Research and Development (R&D) Credit.*** This new credit would be available to companies headquartered in California that are spending on R&D activities related to mitigating climate change. The administration intends for the new R&D credit to reduce revenues by about $250 million per year for three years.
- ***Green Energy Technology Credit.*** The Governor's Office of Business and Economic Development (GO-Biz) would allocate tax credits to companies that are developing green energy technologies. Credit recipients would be required to share future profits with the state. GO-Biz would allocate $100 million in credits per year for three years.

LAO Comment: Effective Incentives Require Thoughtful Design and Timing. Business tax incentives must be carefully designed to be effective. Some past business incentives have been ineffective and provided large windfall benefits to businesses for actions they already had decided to take. In light of this, should the Legislature move forward with the Governor's proposals, we recommend including elements that guard against such windfalls—such as basing the tax credit on future, incremental changes in business investment and requiring data collection and evaluation.

Managed Care Organization (MCO) Tax

No Proposal to Renew MCO Tax, Allowing for Its Expiration. For many years and following multiple renewals, the state has imposed a tax on MCOs and used the revenues to offset General Fund costs in Medi-Cal. The current MCO tax is scheduled to expire in December 2022. By not proposing to renew the MCO tax, the Governor's budget would allow it to expire, raising General Fund costs in Medi-Cal by $1.6 billion or more annually beginning in 2023-24. The administration has shared that the scheduled reprocurement of Medi-Cal MCO contracts and anticipated volatility in the Medi-Cal caseload present challenges for renewing the MCO tax. While we agree that both factors present important challenges, we think that careful structuring of a renewed MCO tax potentially could overcome such barriers. Given the importance of the MCO tax as a reliable funding source for Medi-Cal, we recommend the Legislature explore the feasibility and trade-offs of renewing the MCO tax as part of its budget deliberations.

SCHOOLS AND COMMUNITY COLLEGES

Nearly $18 Billion in New Spending Proposals. Proposition 98 (1988) establishes a minimum annual funding level for schools and community colleges commonly known as the minimum guarantee. Due to increases in the minimum guarantee over the 2020-21 through 2022-23 period (see nearby box), the state has $17.7 billion available for new spending on K-14 programs. The Governor's budget proposes to allocate this funding for an array of existing programs and more than a dozen new initiatives.

Changes in the Proposition 98 Guarantee Under Governor's Budget

Substantial Upward Revisions to Estimates of the Minimum Guarantee. The state calculates the minimum guarantee each year using formulas in the State Constitution. The guarantee encompasses state General Fund revenue as well as local property tax revenue. Compared with the estimates in the June 2021 budget plan, the administration revises its estimates of the guarantee up $2.5 billion (2.7 percent) in 2020-21 and $5.3 billion (5.7 percent) in 2021-22. For 2022-23, the guarantee is up $8.2 billion (8.8 percent) relative to the 2021-22 enacted budget level. These increases—combined with nearly $1.6 billion freed up from the expiration of various one-time Proposition 98 costs—make $17.7 billion available for new commitments. Most of the increases in the guarantee are due to state General Fund revenue being significantly above previous estimates. For 2022-23, the higher guarantee also reflects growth in local property tax revenue and an adjustment to "rebench" the guarantee for the expansion of Transitional Kindergarten. Total Proposition 98 funding for schools and community colleges in 2022-23 is $102 billion—$73.1 billion from state General Fund and $28.9 billion from local property tax revenue.

Significant Deposits Into the Proposition 98 Reserve. Proposition 2 (2014) established the Proposition 98 Reserve and set forth rules requiring deposits and withdrawals under certain conditions. Generally, the state is required to deposit Proposition 98 funding into the account when revenue from capital gains is relatively strong and the minimum guarantee is growing faster than per capita personal income. The state is required to withdraw mandatory deposits from the Proposition 98 Reserve if the minimum guarantee is not growing quickly enough to support the prior-year funding level, as adjusted for student attendance and inflation. These withdrawals are provided in addition to the minimum guarantee and can be allocated by the Legislature for any school or community college programs. (The state also can make optional deposits and withdrawals.) The June 2021 budget estimated the state would be required to make deposits totaling $4.5 billion across 2020-21 and 2021-22. Under the Governor's budget, the required deposits in those years increase to nearly $6.7 billion and the state makes an additional $3.1 billion deposit in 2022-23. By 2022-23, the cumulative balance would be more than $9.7 billion—nearly 10 percent of the total Proposition 98 funding allocated to schools and community colleges that year. Once the balance reaches 10 percent, additional deposits are no longer required.

Of the total, nearly $10.6 billion is for ongoing augmentations and nearly $7.2 billion is for one-time activities. Most of the larger proposals fall into four main areas:

- ***$5.3 Billion Ongoing for Previous Commitments.*** The Governor's budget provides funding to implement several program expansions agreed upon in the June 2021 budget plan. The largest augmentation is $3.4 billion to accelerate the implementation of the Expanded Learning Opportunities Program, which funds summer and before/after school programs. The budget allocates another $1.9 billion to expand Transitional Kindergarten, provide school meals for all students, reduce staffing ratios in Transitional Kindergarten classrooms, implement State Preschool rate increases, and cover community college financial aid expansions.
- ***$4.1 Billion Ongoing for COLAs and Attendance Changes.*** The Governor's budget funds a 5.33 percent COLA for the primary K-14 funding formulas and several categorical programs. For schools, the budget anticipates a 2.19 percent decline in funded attendance but proposes to offset this decline with a new funding adjustment for districts with declining attendance. This adjustment would credit districts with their average attendance over the previous three years if it exceeds their current- and prior-year attendance. For community colleges, the budget funds enrollment growth of 0.5 percent and proposes a new minimum funding level beginning in 2025-26. This proposal would provide all colleges with at least as much funding as they received under certain calculations in 2024-25—regardless of the number of students they serve in the future. The budget provides nearly $3.7 billion for schools and $487 million for community colleges to cover these adjustments and proposals.
- ***$2.3 Billion One Time for Infrastructure.*** The Governor's budget proposes $1.5 billion to replace diesel school buses with electric buses. It also provides $450 million to upgrade school kitchen infrastructure and $388 million for deferred maintenance and instructional equipment at the community colleges. Separate from these allocations, the budget also proposes to provide $2.2 billion in non-Proposition 98 General Fund for the School Facilities Aid Program ($1.3 billion in 2022-23 and $925 million in 2023-24). Under the Governor's budget, these infrastructure proposals count as exclusions from the SAL.
- ***$1.5 Billion One Time for College and Career Pathways.*** The budget proposes $1.5 billion to develop college and career pathways for high school students interested in technology, health care, education, and climate-related fields. The funds would be available over four years to support local partnerships involving schools, colleges, universities, employers, and other community organizations.

LAO Comment: School and Community College Budget Likely Prepared for a Mild Recession. Under the Governor's budget, the balance in the Proposition 98 Reserve would reach $9.7 billion by the end of 2022-23 (see box). If the Proposition 98 guarantee were to drop, the Legislature would be able to withdraw this amount to maintain funding for programs. (In some cases, the constitutional formulas would require withdrawals.) In addition, the budget contains a one-time cushion of more than $4 billion in 2022-23. This cushion consists of the one-time spending and reserve deposit specifically attributable to 2022-23. The expiration of these allocations the following year creates a buffer that helps insulate ongoing programs from future drops in the guarantee. Based on the reserve balance and one-time cushion, we think the state likely could weather a relatively mild recession without resorting to significant cuts or payment deferrals for school and community college programs.

LAO Comment: Some Major Ongoing Augmentations for Schools Seem Reasonable. All of the major ongoing increases for K-12 schools relate to previous commitments or involve additional funding for longstanding programs. Although we are still reviewing the details, these proposals generally appear reasonable and align with previous cost estimates. The Governor's proposal to accelerate the Expanded Learning Opportunities

Program could give districts more certainty about their funding levels and potentially improve local planning. For the community colleges, some of the Governor's ongoing spending proposals might be worth revisiting. For example, the Governor proposes a major expansion of the Part-Time Faculty Health Insurance program (increasing the existing $490,000 allocation by $200 million), without a clear explanation of how this augmentation works in concert with the Governor's other proposals to expand health care coverage and reduce associated costs. We anticipate having more comments on these proposals in the coming months.

LAO Recommendation: Fund Fewer of the One-Time Proposals. School and community college districts are currently navigating several issues that will affect their ability to implement new programs next year. Specifically, districts face (1) ongoing cost pressures related to higher inflation and pension rate increases, (2) challenges maintaining continuity of operations due to the effects of the pandemic on students and staff, and (3) elevated uncertainty over future enrollment trends and program participation levels. In addition, districts are in the midst of implementing many new programs and requirements included in the June 2021 budget plan. Due to these issues, we think districts have relatively limited capacity to implement additional programs in 2022-23. We are concerned that the Governor's budget contains so many proposals that districts will be unable to implement them all effectively. Accordingly, we recommend the Legislature fund fewer new activities than the Governor proposes. In some cases, the Legislature could consider providing a smaller amount or delaying implementation. The Legislature could use the funding it frees up from funding fewer proposals to address district cost pressures (such as rising pension costs), or it could set this funding aside in the Proposition 98 Reserve for future allocation.

LAO Recommendation: Prioritize Proposals That Address Clearly Defined Problems. As the Legislature evaluates the Proposition 98 budget, we encourage it to prioritize proposals that (1) clearly identify underlying problems and (2) explain why existing programs are unable to address those problems. For example, the Governor's proposal to provide funding for community college deferred maintenance addresses a longstanding maintenance backlog resulting from chronic underfunding. Addressing the backlog would improve learning conditions for students and reduce costs in the future. On the other hand, the proposal to provide $1.5 billion for college and career pathways appears to have similar goals as several existing programs. We recommend the Legislature avoid creating a new program until it receives evidence that these existing programs are insufficient to support college and career pathways in the targeted areas. Prioritizing proposals using this approach would increase the likelihood that state funding results in long-term improvements and avoid fragmenting existing efforts to improve services and outcomes for students.

UNIVERSITIES

Governor Establishes Multiyear Compacts With the Universities. The Governor's budget increases ongoing General Fund for the California State University (CSU) and the University of California (UC) by a total of $775 million. Much of the new spending is linked to the Governor's recently announced compacts with CSU and UC. The largest components of the compacts are 5 percent annual General Fund base increases over the next five years (through 2026-27). Whereas the Governor provides funding for approximately 3 percent resident undergraduate enrollment growth for CSU and UC in 2022-23, the administration's expectation is that the segments increase resident undergraduate enrollment by approximately 1 percent annually over the subsequent four years using a portion of their base increases. Regarding tuition levels, the Governor's budget assumes no increase at CSU in 2022-23. In contrast, the Governor's compact with UC assumes the university implements the Board of Regents-approved tuition plan. This tuition plan generally pegs annual tuition increases to inflation, applies annual increases to all academic graduate students, and uses a cohort model in applying higher charges to incoming undergraduate students (with charges held flat for continuing undergraduate students).

Compacts Contain Many Expectations for the Universities. In tandem with providing ongoing base augmentations, the Governor sets forth a total of 40 associated expectations for the universities (22 for CSU and 18 for UC). These expectations focus on student access, overall student outcomes, equity in student outcomes, college affordability, intersegmental collaboration, workforce preparedness, and online education. Some of the expectations (for example, improving graduation rates and closing equity gaps) build off goals the segments already had established. Other expectations (for example, improving the affordability of student housing and instructional materials) reflect priorities driven by the administration. Regarding accountability, the Department of Finance indicates that the administration reserves discretion to propose smaller future base increases were a segment not to demonstrate progress in meeting its expectations.

LAO Comment: Three Key Concerns With Governor's Compact. Historically, several governors have established multiyear compacts with CSU and UC. The Legislature has been wary of these compacts for three reasons—all of which apply to the new compacts. First, the Governor and universities agreed to these compacts without legislative input. Though the Legislature likely shares some of the Governor's interests (for example, to improve student outcomes and close equity gaps), its interests likely diverge at least in part (for example, the Legislature might prefer other outyear enrollment targets). Second, much like previous compacts, the Governor's multiyear funding plan establishes arbitrary future base increases regardless of underlying cost drivers. Even the Governor's proposed base increases for 2022-23 are not linked to specific cost increases for personnel, equipment, and other operating expenses—the core building blocks of any university budget. Third, enforcement of the compact is unclear. For example, the Governor has not explained how he plans to determine if the segments have made sufficient progress toward meeting their expectations and to what extent he would reduce funding were one or more of the expectations not met. The lack of these key details hampers the Legislature's ability to hold the universities and the Governor accountable for delivering on the compact promises.

LAO Comment: Legislature Has Better Budget and Planning Options for the Universities. Instead of focusing on the Governor's compacts, we encourage the Legislature to think about its spending priorities and the universities' underlying cost drivers, then fund CSU and UC accordingly. Importantly, the Legislature can couple this more standard budget approach with meaningful long-term planning. For example, state law already requires CSU and UC to submit annual performance reports. If interested, the Legislature could work with the administration and segments to establish specific performance benchmarks over the next five years, linked with appropriate repercussions. In some cases, repercussions likely would not be solely fiscal. For example, if a segment failed to close a student equity gap as planned, it could be required to report on the strategies it had implemented to date, how it would change those strategies moving forward, and how it would reallocate existing resources.

WORKFORCE DEVELOPMENT

Proposes Many New Workforce Training Programs. The Governor's budget allocates over $2 billion in discretionary General Fund (plus additional funding under Proposition 98) for more than 20 new, one-time workforce training proposals. These include proposals for several new training programs in clean energy fields, as well as new and expanded training programs to recruit and train teachers, social workers, nurses, community health workers, and behavioral health workers, among others. The broad aim of these proposals is to recruit and train more workers in fields that are growing or in demand. Many of the proposals also would seek to increase diversity within existing occupations.

LAO Comment: Can So Many New Efforts Be Effectively Launched at Once? The sheer number of new proposals to plan, implement, and administer may make it difficult for the agencies to carry out the programs effectively. This is especially true in light of recent program roll-outs. Specifically, these new proposals would be in addition to the more than 20 workforce items funded as part of the 2021-22 budget.

LAO Comment: How Do the Proposals Work Together to Meet Clear Goals? Despite seeming overlap of many of the proposed and recently created programs, the administration has not shown how the myriad individual proposals work together to meet an overarching goal and avoid duplicating efforts. Further, given the number of state and local agencies that would be involved in administering the proposals, carefully considering how these agencies would coordinate and complement each other will be important.

LAO Comment: Understanding Underlying Issues Is Key to Moving Forward and Crafting Solutions. Before wading into the Governor's workforce development package, we encourage the Legislature to consider what problems it wishes to solve by allocating additional funds to workforce development efforts. Are individuals facing barriers to enrolling in existing state-funded training programs? If so, why do those barriers exist, and why have they not already been removed? Once the most recent COVID-19 surge subsides, will several now-pressing workforce issues dissipate? Is the aim of the programs to help individual workers improve their career prospects, to increase the number of workers in a particular field, or both? If the aim is to increase the number of workers in a field, how will the state determine which fields need additional workers and how many? Further, is lack of workforce training the main impediment to increasing the number of workers in these fields? In addition to training and recruitment, the number of workers in a field also is affected by the job's working conditions, salary, benefits, upward ladder, and perceived prestige. The clear role of these other factors raises questions as to whether training efforts can effectively lead more workers to pursue these jobs.

CLIMATE CHANGE

Key Climate Change-Related Proposals. The Governor's budget includes numerous proposals related to climate change, some of which are presented as packages. This is in addition to full inclusion of 2022-23 funding that was agreed to by the Legislature and the Governor as part of the 2021-22 budget for different packages of proposals related to climate resilience, zero-emission vehicles (ZEVs), and drought. For example, the proposed budget includes $2.1 billion that was part of a Climate Resilience package. Some of the key new climate-change proposals and packages include:

- ***ZEV Package.*** The 2021-22 budget agreement included a total of $3.9 billion over three years for various programs to support ZEVs. The Governor's budget includes $660 million General Fund in 2022-23 consistent with this agreement. In addition, the budget proposes a total of $6.1 billion over five years—$2.7 billion in 2022-23 and $3.4 billion in subsequent years—in additional funding for ZEV-related programs. This total includes $3.5 billion from the General Fund (non-Proposition 98), $1.5 billion in Proposition 98 General Fund, $676 million from the Greenhouse Gas Reduction Fund (GGRF), and $383 million in federal funds.
- ***Energy Package.*** The Governor proposes a total of roughly $2 billion over two years ($938 million in 2022-23 and $1.1 billion in 2023-24), almost entirely from the General Fund, for various proposals related to clean energy and building decarbonization. Some of the funding would go to programs that the Governor proposed in his 2021 May Revision, but that were not adopted as part of the 2021-22 budget.
- ***Wildfire Resilience Package.*** The Governor proposes $800 million from the General Fund over two years—$400 million in 2022-23 and 2023-24—to implement various efforts to improve forest health and make communities more resilient to future wildfires. This is in addition to $200 million annually from GGRF, which is already continuously appropriated from 2022-23 through 2028-29 as part of the 2021-22 budget package.
- ***Drought Package.*** The Governor proposes $750 million one-time General Fund for a variety of activities to respond to current drought conditions and build the state's resilience to weather future dry years. This amount includes (1) $180 million for water conservation programs, (2) $145 million to

address communities experiencing water supply shortages, (3) $250 million to set aside as unspecified "contingency" funding the Governor would propose for specific drought response allocations later in the budget process, and (4) $175 million for various other drought-related activities. These funds are in addition to $880 million General Fund proposed for water and drought-related activities in 2022-23 consistent with the 2021-22 budget agreement that included a total of $4.6 billion across three years.

- ***Wildfire Suppression Proposals.*** The Governor's budget provides augmentations for various proposals related to fire suppression. Some of the major fire protection-related proposals include: (1) $400 million ongoing General Fund to improve the health and wellness of California Department of Forestry and Fire Protection (CalFire) firefighters; (2) $190 million General Fund in 2022-23, along with some outyear funding, for equipment such as helicopters and fire engines; (3) $175 million in 2022-23 ($120 million in General Fund and $55 million in lease revenue bonds) for CalFire capital outlay projects, and (4) $69 million General Fund in 2022-23, increasing to $81 million ongoing, to increase the availability of year-round fire crews.

In addition to the proposals identified above, the Governor's budget includes numerous other proposals across a wide range of policy areas—such as education, workforce development, and transportation—to which the Governor draws a nexus to climate change.

LAO Comment: Integrating Climate Change Considerations Across Policy Areas Makes Sense. The Governor's focus on considering climate change response activities across a wide range of areas of the budget—not just natural resources and environmental protection—has great merit. California is already experiencing significant impacts from climate change, such as more severe droughts and wildfires, and higher temperatures. As the climate continues to warm, these impacts are expected to grow. They are also expected to be widespread, affecting different policy areas such as housing, transportation, health, workforce, and education. For the state to adequately respond to these large and widespread impacts, climate change considerations will need to be integrated across policy areas.

LAO Comment: Legislative Considerations in Reviewing Climate Change Proposals. As the Legislature evaluates the myriad climate change-related proposals and packages across the budget, there are many different issues to consider. These considerations include (1) how to prioritize funding between programs that address the effects of climate change and those that reduce greenhouse gas emissions that contribute to climate change; (2) whether the specific proposals are likely to be the most cost-effective set of policies and programs to meet the Legislature's climate change goals, particularly given the significant amount of funding provided in the current year for similar activities; (3) to what extent the proposals have benefits in addition to addressing climate change impacts (such as, for example, reducing pollution or expanding housing); (4) how the benefits of the programs are distributed among different populations (such as vulnerable and low-income communities); (5) to what extent administering departments and grantees—particularly those that have received significant funding in recent budgets—have capacity to implement the new proposed or expanded programs; and (6) whether one-time, multiyear, or ongoing funding is most appropriate given the nature of the proposed activity.

INFRASTRUCTURE

Key Infrastructure Proposals. The Governor's budget includes numerous proposals to spend significant amounts of funding on infrastructure. Some of the proposed funding continues projects and initiatives previously approved or agreed to by the Legislature, whereas others would support new projects and initiatives. These proposals span multiple policy areas, including transportation, education, energy, and water, and would be supported by the General Fund and other fund sources. The Governor's major infrastructure proposals include:

- ***Transportation.*** The Governor's budget proposes a total of $4.9 billion from the General Fund—$3.3 billion in 2021-22 and $1.6 billion in 2022-23—to support various transportation projects, including transit and intercity rail, active transportation, and climate adaptation. (We note that the $3.3 billion proposed for the current year reflects funds that were approved in the *2021-22 Budget Act* but eventually reverted to the General Fund as subsequent legislation to allocate the funding was not enacted in the time line required.) In addition, the Governor's budget includes $1.8 billion in 2021-22 and $1.9 billion 2022-23 in new federal transportation funds that the state is expected to receive through formula-based transportation programs as part of the Federal Infrastructure Investment and Jobs Act (IIJA) that was enacted in November 2021.
- ***Port Infrastructure and Goods Movement.*** The Governor's budget proposes $1.2 billion from the General Fund—$600 million in 2022-23 and 2023-24—for projects that improve the movement of goods on rail and roadways that serve ports, including railyard expansions and new bridges.
- ***School Facilities.*** As discussed earlier in this report, the Governor proposes one-time General Fund support—$1.3 billion in 2022-23 and $925 million in 2023-24—to support new school construction and modernization projects.

In addition to the proposals identified above, the Governor's budget includes numerous other infrastructure proposals. For example, the climate-related packages discussed earlier in this report includes funding for infrastructure projects, such as infrastructure to support ZEVs. We also note that the Governor continues to request $4.2 billion in Proposition 1A bond funds for the state's high-speed rail project.

LAO Comment: Legislative Considerations in Reviewing Infrastructure Proposals. Given the various needs of and demands on the state's aging infrastructure, as well as local facilities, allocating one-time resources to infrastructure projects has merit. In reviewing the Governor's various proposals, the Legislature will want to consider various issues. First, it will be important to consider whether the proposed infrastructure projects are aligned with the Legislature's highest priorities and how the intended benefits of projects are distributed across different communities. Second, the Legislature will want to consider whether the specific projects proposed and their anticipated time line will meet the identified needs. For example, it is unclear on the extent to which the proposed funding for port infrastructure will address the current supply chain issues in a timely manner.

Third, the Governor's proposals should be assessed in context of the billions of dollars in federal funds that the state is anticipated to receive over the next five years from IIJA. While the proposed budget includes some initial allocations of IIJA funds for transportation and ZEV infrastructure, the budget does not include the significant amounts of additional funding expected in the next several months, as federal agencies award competitive grants and remaining funding guidelines are finalized. As a result, it will be important to consider how state funding can best complement federal funds, particularly in the areas of water, energy, and transportation, where significant amounts of funding are anticipated, but not yet allocated. Fourth, the Legislature will want to consider the extent to which state and local agencies have the capacity to administer funding and implement projects, given the influx of funding at the federal and state levels.

Finally, as a result of the SAL, the Legislature has limited flexibility to reallocate these proposals to other purposes. In particular, for the majority of the Governor's infrastructure-related proposals, the Legislature could only reallocate those funds to another SAL-related purpose, such as more spending to respond to COVID-19, different types of capital outlay, tax reductions or tax payments, and additional school payments.

HEALTH CARE AND PUBLIC HEALTH

Proposals to Address Health Care Access and Affordability. The Governor's budget includes a number of proposals aimed at improving health care access and affordability. The two largest proposals are to expand comprehensive Medi-Cal Coverage to all income-eligible undocumented immigrants and commit to addressing the affordability of health care through Covered California programs. We describe these proposals in more detail below. In addition, the Governor reintroduces his earlier proposal to establish an Office of Health Care Affordability and proposes efforts to lower the cost of insulin.

- ***Expand Comprehensive Medi-Cal Coverage to All Income-Eligible Undocumented Immigrants.*** Historically, undocumented immigrants who were income-eligible for Medi-Cal only qualified for coverage for their emergency- and pregnancy-related services. Over the last several years, and in a number of steps, the Legislature has expanded comprehensive Medi-Cal coverage to all income-eligible undocumented immigrants who are under the age of 26 or over the age of 49. The Governor proposes to expand comprehensive Medi-Cal coverage to all income-eligible undocumented immigrants aged 26 through 49 (the remaining population not currently eligible for comprehensive Medi-Cal coverage) beginning no earlier than January 1, 2024. The administration estimates this would cost \$819.3 million (\$613.5 million General Fund) in 2023-24, increasing to \$2.7 billion (\$2.2 billion General Fund) annually at full implementation, which the administration is anticipating will begin in several years. We currently are evaluating the reasonableness of the administration's cost estimates. The Legislature also might want to consider whether it agrees with the proposed, extended implementation time frame, which is longer than for previous expansion proposals.
- ***Signals Commitment to Improving Affordability in Covered California.*** The Governor signals a commitment to working with the Legislature and other stakeholders on options to improve affordability and access to health care coverage through California's health insurance marketplace, known as the California Health Benefit Exchange (Covered California). These options would utilize a \$333.4 million reserve fund established through the 2021-22 budget package for future health affordability programs operated by Covered California. This funding was made available after enhanced federal premium subsidies (authorized through 2022) effectively replaced state premium subsidies and resulted in savings to the state. A key consideration when determining what affordability options to adopt will be whether pending federal legislation will extend federal premium subsidies beyond 2022. To the extent the federal premium subsidies continue, the Legislature might want to explore options such as cost-sharing assistance to reduce out-of-pocket costs. On the other hand, if the federal premium subsidies expire, the Legislature might want to reestablish a state premium subsidy program.

One-Time Funding to Provide Increased Provider Payments. The Governor proposes \$400 million in one-time spending (\$200 million General Fund and \$200 million federal funds) in 2022-23 on payments to Medi-Cal managed care plans and their contracted providers to promote health equity and improve outcomes in the areas of children's preventive services, maternal health, and mental health and substance use disorder treatment. The goals of the initiative include, for example, the closing of racial and ethnic disparities in child immunizations, prenatal care, and child delivery via cesarean section. In evaluating this proposal, the Legislature might wish to explore whether targeted provider payments would address health equity or improve outcomes as opposed to other types of interventions. Moreover, we suggest asking the administration whether one-time funding would be sufficient to address these long-standing disparities.

Foundational Support for Core State and Local Public Health Functions. The 2021-22 budget agreement included a commitment to provide \$300 million ongoing General Fund beginning in 2022-23 for public health "infrastructure"—the workforce, training, data and information technology systems, partnerships, and other resources needed to successfully carry out core public health functions. Pursuant to this agreement, and informed by a stakeholder workgroup, the 2022-23 budget proposal includes a spending plan for the \$300 million in foundational public health funding. The spending plan includes \$100 million for California Department of Public Health (CDPH) state operations, largely for workforce development, recruitment, and training (\$57.9 million) and emergency preparedness and response ($27.6 million). The remaining $200 million would be allocated to the state's 61 local health jurisdictions (LHJs) (58 counties and 3 cities), with funding allocated based in part on each LHJ's population share, level of poverty, and racial/ethnic make-up. CDPH would require that 70 percent of an LHJ's funding allocation be used for staffing. Each LHJ would be required to submit its own public health spending plan for its funding allocation by July 1, 2023 and every three years after that. The plans would include metrics by which an LHJs' progress could be assessed.

LAO Comment: Spending Plan Has Merit, Ongoing Oversight Will Be Essential. The COVID-19 pandemic exposed weaknesses in state and local public health systems—in staffing levels, expertise, lab capacity, and flexibility. Public health systems previously have been funded largely with categorical sources of funding—federal grants and state special funds—or one-time General Fund for specific purposes. The agreement reached in the 2021-22 budget negotiations between the Legislature and Governor to increase General Fund support significantly for public health systems beginning in 2022-23 thus represents an opportunity for CDPH and LHJs to rethink their operations, organization, staffing models, and capabilities. The proposed spending plan describes overarching goals for use of the funding, while the department notes that many of the specific implementation details would be worked out through planning over the coming year or longer. The Legislature may wish to request additional information about how the current spending plan provisions tie to the findings from its legislatively required pandemic response review that was intended to identify gaps and problems in the public health system. (A stakeholder workgroup was convened for this review.) In addition, in light of the latitude requested by the administration for use of this funding, particularly in the near term, we suggest the Legislature require a regular annual update on the use of the $300 million funding with release of the Governor's budget. The annual update could include, for example, information about spending decisions, hiring status of additional staff supported by this funding, LHJ progress in meeting plan objectives, and findings from evaluations about the use of this funding.

HOUSING AND HOMELESSNESS

Homelessness Package Proposes to Focus on Near-Team Needs. The Governor proposes $2 billion in one-time General Fund over two years intended to address near-term homelessness needs while previously authorized funding for long-term housing solutions are implemented. Specifically, the budget proposes $1.5 billion to the Department of Health Care Services' Behavioral Health Continuum Infrastructure Program for housing support for people with behavioral health needs. Many details of this proposal are still under development. Additionally, the Governor proposes $500 million for the Encampment Resolution Grants Program in 2022-23 administered by the California Interagency Council on Homelessness to provide targeted grants to local governments to rehouse individuals living in encampments.

Housing Development Package Primarily Expands Existing Programs. The Governor proposes $1 billion in one-time General Fund over two years to expand housing development. Specifically, the budget proposes $500 million for infill housing development, $300 million for the Affordable Housing and Sustainable Communities Program, $100 million to build housing on excess state sites, and $100 million to repurpose existing commercial buildings for housing. While most of these efforts already are underway as a result of prior-year budget actions, the budget proposal represents an increased level of funding for them. The administration notes the climate benefit of these proposals as these programs support more dense housing development.

Affordable Housing Package Primarily Expands Existing State Programs. The Governor proposes $1 billion in one-time General Fund over two years for affordable housing development. The budget largely expands existing state programs related to affordable housing. Specifically, the budget proposes $500 million for tax credits to builders of rental housing affordable to low-income households, $200 million for mixed-income housing, $200 million to preserve affordable housing units, and $100 million to preserve affordable mobile homes.

LAO Comments. In total, the proposed budget includes $2 billion in housing-related proposals and $2 billion in homelessness-related proposals. While a significant amount for these purposes, the proposed resources reflect a reduction from the $16 billion in new spending in 2021-22. While this reduction may be appropriate given capacity constraints to allocate additional funding, housing and homelessness remain one of the state's most significant challenges. Similar to recent years, while the Governor's budget reflects his commitment to addressing homelessness and housing affordability by once again proposing significant state resources toward these issues, the Governor's response continues to focus on one-time, rather than on-going, funding. In considering the Governor's proposals, some of our preliminary questions and comments include:

- ***How Is the Proposal Informed by Prior Housing and Homelessness Actions?*** In many cases, the state recently authorized significant funding for housing and homelessness programs the Governor now proposes for additional augmentation. Prior to authorizing additional funding for these efforts, the Legislature may wish to ask (1) have the previously authorized funds been spent, (2) how have previously authorized funds been used, (3) what are the demonstrated program successes and/or are there opportunities for improving these programs, (4) how will the proposed additional funding complement existing efforts, and (5) how will outcomes be measured and assessed? Finally, while relying on existing programs helps to expedite release of funding compared to establishing new programs, do these existing programs have capacity to absorb the proposed funding?
- ***Are Prior-Year Programs Sufficiently Supported?*** The Governor's budget does not increase support for the infrastructure investments—such as Homekey and the Community Care Expansion—from prior years. Prior to authorizing increased funding for the activities proposed in the 2022-23 budget, ensuring that the housing and homelessness efforts authorized in the prior budget are adequately supported and can be maintained over time will be important. (For instance, we have raised whether local governments need additional support to establish services and supports for Homekey properties especially over the long term.)
- ***Bridge Funding May Make Sense but Forthcoming Details Will Be Important.*** The Governor indicates the homelessness funding proposed in the 2022-23 budget is intended to address near-term needs while previously funded long-term housing solutions come online. While this seems like a reasonable strategy, whether the short-term options proposed by the administration are most effective, especially in the context of what the state already has invested towards housing and homelessness infrastructure, is unclear. Some key questions include: (1) to what extent is the Governor's proposal focused on behavioral health infrastructure versus longer-term housing solutions; (2) given the scope of the state's homelessness challenge, is one-time bridge funding sufficient or are longer-term resources necessary to provide assistance until more permanent housing is available; (3) what would happen to resources once permanent housing comes online; and (4) how would the funding support transitioning individuals into permanent housing? Finally, the focus of the proposal—whether for behavioral health or broader homelessness-related services—should determine which state entity should oversee the program. Currently, many state entities are tasked with different homelessness responsibilities, so ensuring programs are properly suited to a department's mission is important.

OVERALL LAO COMMENTS

Budget Condition

Multiyear Revenue Projections Are Reasonable. Consistent with our *Fiscal Outlook* forecast, the Governor's budget reflects a dramatic upward adjustment to revenues. Despite this, the administration's revenue estimates remain meaningfully below our *Fiscal Outlook* for 2021-22. While there is a reasonable possibility 2021-22 revenues could end up as the administration assumes, we think there is a better than two-thirds chance that revenues come in higher. In the budget year and beyond, the administration's estimates are very close to our *Fiscal Outlook*. Whereas we often noted previously that the administration's multiyear revenue estimates appear to be fairly cautious, we would characterize this year's estimates as a middle of the road among potential outcomes. Middle of the road assumptions are an entirely reasonable foundation for a spending plan. That being said, relative to recent budgets built around more cautious revenue assumptions, building a spending plan around middle of the road revenues calls for allocating additional resources to plan for future budget shortfalls.

New Spending Proposals Exceed Administration's Estimates of the Budget's Capacity in Future Years. The administration's multiyear estimates reflect negative balances in the SFEU in 2023-24 (and throughout the rest of their forecast) due to proposed spending exceeding estimated resources. While the administration is not required by law to plan for future positive balances in the SFEU beyond the budget year, doing so is prudent. A positive SFEU balance generally reflects a budget that is balanced. In contrast, by planning to have a negative balance in the SFEU, the administration assumes that next year revenues will be higher than anticipated, costs will be lower than anticipated, taxes will be increased, or reductions will be required. While multiyear revenue and expenditure forecasts are imprecise, committing to spending above anticipated resources carries considerable risk.

Reserves

Consider Reserves in Two Categories. The state's constitutional formulas essentially divide the budget into two parts. The first part generally is more flexible and is used to pay for health care, human services, universities, corrections, and many other program areas. The second is restricted under the rules of Proposition 98 and can only be spent on schools and community colleges. As such, budget reserves should be thought of in two categories: those which must supplement school and community college funding (the Proposition 98 Reserve) and those which generally can supplement spending on any purpose (namely, the BSA, SFEU, and Safety Net Reserve).

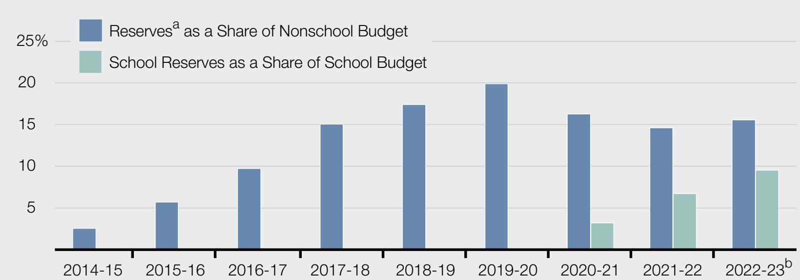
General Purpose Reserves Remain Below Pre-Pandemic Levels. The Proposition 98 Reserve has increased from zero in 2019-20 to nearly $10 billion—or nearly 10 percent of school and community college funding—under the Governor's estimates in 2022-23. The state's other budget reserves, however, have not increased commensurately with other General Fund spending. Figure 9 shows this dynamic. In particular, after reserves reached a high of nearly 20 percent of nonschool spending in 2019-20, they dipped in 2020-21 and 2021-22, following historic revenue growth that was allocated to a variety of spending programs. Under the Governor's budget, these reserves as a share of nonschool spending would reach 15.5 percent by the end of 2022-23, still significantly below the pre-pandemic level.

Strongly Consider Building More Reserves. Given these dynamics, we think more general purpose reserves are warranted. While we and the administration have acknowledged the trade-off

Figure 9

Since the Pandemic, School Reserves Have Grown as a Share of Its Budget While Other Reserves Have Not

(Actuals)



[a] Includes Budget Stabilization Account and Safety Net Reserve. Excludes Special Fund for Economic Uncertainties (SFEU) because this graphic shows actual, rather than enacted, levels. Actual levels of SFEU can vary widely depending on revenue fluctuations.

[b] Proposed.

Note: We define the nonschool budget as General Fund expenditures excluding Proposition 98. The school budget is defined as the minimum guarantee (which includes both General Fund and local property tax revenues).

between building reserves and the state's ability to meet its SAL requirements (because reserve deposits are not excluded spending), the budget has the capacity to make additional reserve deposits. In particular, the Governor proposes $8.5 billion in spending that is not excluded from the SAL. We recommend the Legislature repurpose a portion of this funding for building more general purpose reserves. Moreover, if the Legislature adopts an otherwise similar level of spending as the administration, additional reserves are warranted given the risks posed by this approach.

SAL

Develop Plan for Meeting Current-Year SAL Requirement. The Governor's budget identifies a $2.6 billion SAL requirement across 2020-21 and 2021-22, but defers action on this requirement until the May Revision. Moreover, our revenue estimates suggest that it will grow. The Legislature can meet the requirement in three ways: (1) lower tax revenues, (2) split the excess revenues between additional school and community college district spending and taxpayer rebates, and (3) appropriate more money for purposes excluded from the SAL. Excluded spending includes, most notably, spending on infrastructure and/or on statewide emergencies, such as for COVID-19. We encourage the Legislature to develop a plan for how it wishes to meet the requirement across 2020-21 and 2021-22. Deferring plans to meet the SAL requirement decreases the Legislature's flexibility. For instance, assuming revenues continue to exceed budget act estimates, if the Legislature wishes to address a portion of the requirement by lowering taxes, early action likely would be needed. Waiting to take such action could eliminate this option for the Legislature.

SAL Will Continue to Constrain the Legislature's Flexibility to Allocate the Surplus in Budget Year. For the budget year, the Governor's budget currently reflects $5.7 billion in room under the limit. However, this room, under the Governor's proposal, reflects about $12.5 billion in SAL-related exclusions included in the Governor's discretionary General Fund proposals. This means that the SAL will continue to constrain the Legislature's flexibility to allocate the General Fund surplus during the upcoming budget process. In particular, as the Legislature considers the Governor's budget proposals, those proposals that currently count as excludable expenditures—such as spending on capital outlay—for the most part can only be repurposed for other SAL-related purposes, such as tax reductions or an alternative excluded expenditure.

Spending Proposals

Devote Attention to Overseeing Recent Augmentations. We recommend the Legislature dedicate the early part of the budget process to overseeing the implementation of last year's significant augmentations. Specifically, we recommend the Legislature ask the administration and affected departments to provide implementation updates, including progress made to date in: establishing the programs, distributing associated funding, and collecting performance results. The updates also should identify any implementation barriers departments have overcome and any barriers that still exist. This information could inform the Legislature's approach to allocating this year's surplus. For instance, if departments face challenges with administrative capacity, the Legislature could consider whether additional staffing is warranted. If programs are oversubscribed, the Legislature also could consider providing additional funding this year. Alternatively, if programs remain in the early stages of implementation, are undersubscribed, or show other signs that program modifications might be needed, then the Legislature could address those issues as part of the budget.

Assess Capacity for and Alignment of New Programs and Proposals. The Governor's budget reflects a mix of additional spending on existing programs, expanding the scope (and funding for) existing programs, and new initiatives. Given the scale of last year's commitments, we suggest the Legislature be cautious in creating additional new programs as well as expanding the scope of existing programs. In planning its budget, we suggest the Legislature assess departments' ability to roll out recent initiatives in a timely and effective manner to inform whether new programs could be implemented—or existing programs could be expanded—at this time. To the extent that departments have faced challenges in rolling out new programs, the Legislature could focus on ensuring the success of recently enacted augmentations and take more time to fully develop any new program proposals to ensure they can address the identified problems. We also suggest the Legislature consider whether new proposals or expansions would complement recent efforts or be duplicative.

Consider Longer-Term COVID-19 Planning. The Governor's budget includes additional spending for COVID-19-related expenditures like testing and vaccination and an intent to modify the state's COVID-19 sick leave policies. It largely does not include, however, the extension of program flexibilities and temporary supports provided in last year's budget. In part, this likely reflects that the Governor's budget was developed before Omicron became the prevailing COVID-19 variant in California. As the Legislature starts its deliberations on the budget, we recommend considering whether any program flexibilities—like remote assessments for human services programs—or temporary supports—like targeted cash assistance—are warranted. Moreover, as COVID-19 likely will remain a public health and economic challenge in future years, we recommend the Legislature closely consider the extent to which the Governor's proposals properly prepare the state for this reality.

APPENDIX 1

Below, we provide a definition of some of the key terms used in this report.

Surplus. The Governor's January budget is the starting point for legislative deliberation. Ultimately, the Legislature will make its own determination about how to allocate funds available in the upcoming budget process. One of the goals of this report is to estimate for the Legislature how much capacity the budget has to make those allocations under the Governor's estimates of revenues. Assuming the proposed budget is balanced, we answer this question by assessing the size of the General Fund surplus. A surplus occurs when revenues exceed spending under current law and policy. Our estimate of the surplus excludes discretionary resources available within the Proposition 98 (1988) minimum guarantee because the State Constitution requires those funds to be spent on schools and community colleges. Similarly, we typically do not include the reserve, debt, and infrastructure requirements of Proposition 2 (2014).

Discretionary General Fund Spending. We define discretionary spending as General Fund spending not authorized under current law and policy. Current law and policies include, for example, constitutional requirements, and other baseline costs, such as increases (or decreases) in costs to cover caseload or price increases. Put another way, discretionary spending is the Governor's new spending proposals that allocate the General Fund surplus.

Discretionary Spending on Schools and Community Colleges. The State Constitution sets a minimum annual funding requirement for schools and community colleges (the Proposition 98 minimum guarantee). Because this funding requirement is constitutional, we do not consider it part of the General Fund surplus. However, after accounting for current law and planned program expansions, the Legislature has choices about how to allocate the remaining funding within K-14 education. We refer to these spending choices as discretionary spending on schools and community colleges.

APPENDIX 2

Note: In the online version of this report, we plan to include a series of Appendix tables that have detailed information on the discretionary choices in the *2022-23 Governor's Budget*.

LAO PUBLICATIONS

This report was prepared by Ann Hollingshead, with contributions from analysts across the office, and reviewed by Carolyn Chu and Anthony Simbol. 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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