LAO

The 2024-25 Budget:

The Governor's Proposition 98 Funding Maneuver

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SUMMARY

In this brief, we evaluate the Governor's novel proposal to allow schools to keep $8 billion of cash disbursements above the minimum requirement without recognizing the budgetary impact of those payments. We first provide some background information on how the state's budget and cash positions differ as well as some basic information about school finance. We then describe this proposed funding maneuver. Finally, we assess the proposal and provide our recommendation on it. (The administration very recently released the trailer bill language associated with this proposal. We did not receive this language in time to review it for this analysis. However, this analysis reflects our best understanding of the proposal, which was confirmed by the administration. We will provide additional analyses as necessary as we review the proposed statutory language.)

Bottom Line. This proposed maneuver is bad fiscal policy. It sets a problematic precedent for the state and creates a binding obligation that will worsen out-year deficits and require more difficult decisions in the future. The state could maintain school and community college spending in a number of other ways. We strongly recommend that the Legislature reject the administration's proposal.

BACKGROUND

State Fiscal Basics

The Legislature Plans the State's Budget and the Administration Manages the State's Cash. Through the annual budget process, the Legislature creates a plan for General Fund spending based on its resources available (most notably, projected revenues). This is the state's *budget*. After this plan is put into law, the executive branch executes it on a *cash* basis. That is, on a daily basis, the state's tax agencies collect revenues, the State Controller pays the state's bills, and the State Treasurer invests any of the state's cash that is currently unused. We have described how the state's cash management system works in earlier publications, including: *Managing California's Cash* and *An Update on the State's Cash Management Situation*.

Budget Position Is Currently Weak. After a couple years of surpluses, the state faced a deficit last year and continues to face deficits now and into future years. We estimate the administration addressed a $58 billion budget problem in the Governor's budget. Despite this significant deficit, there is a good chance that the administration's revenue projections are too low and the state will face an even larger budget problem in May. Further, under both our and the administration's forecasts, the state will need to solve large deficits in future years—averaging around $30 billion each year for the next three years.

State's Cash Position Is Currently Very Strong. Despite this weak budget position, the state's cash position is currently very strong. Even though revenue projections have declined substantially, the administration projects the General Fund would still have a small cash surplus at the end of the current year. Further, under the same projections, the state would end this year with nearly $100 billion in unused borrowable resources (balances in other state funds). These funds would be available to cover any cash deficits that could occur in subsequent months.

Why Is There a Difference? The reason that the state's budget and cash positions have diverged is, in large part, due to undistributed funds. While all of the monies in the State Treasury are committed in some sense—usually to an expenditure or reserve, including an ending fund balance—some of those funds have not yet been *disbursed*. There are many reasons why this can occur. Currently, for example, the state: (1) has sizeable balances in its reserve accounts, including the Budget Stabilization Account and Proposition 98 Reserve; (2) has many special funds that are carrying large balances; and (3) has allocated large sums to expenditures that take years to disburse, like infrastructure projects. That said, if the state's budget position remains weak, the state's cash position will erode as well.

School and Community College Funding (Proposition 98)

State Constitution Establishes a Minimum Funding Level for Schools and Community Colleges. The California Constitution sets a minimum annual funding requirement for schools and community colleges (otherwise known as Proposition 98 [1988]). Each year's minimum funding requirement is established using a set of formulas. The state meets this requirement through a combination of General Fund spending and local property tax revenue. Under these formulas, General Fund spending on K-14 education tends to increase when revenues grow and decrease when revenues decline.

Minimum Funding Level for K-14 Education Has Declined Substantially for 2022-23. Typically, the budget process does not involve large changes in revenue in the prior year (in this case, 2022-23). This is because prior-year taxes usually have been filed and associated revenues collected by April of any given year. Due to the state conforming to federal tax filing extensions, however, the Legislature only gained a complete picture of 2022-23 tax collections late in 2023—after the fiscal year already ended. Those data showed a severe revenue decline, with total income tax collections down 25 percent. A decline of this magnitude is unprecedented for the prior fiscal year. It also results in an unprecedented prior-year reduction to the minimum funding requirement for schools and community colleges.

General Fund Payments to Schools Significantly Above Revised Proposition 98 Requirement for 2022-23. Throughout 2022-23, the State Controller distributed funds to schools and community colleges based on program expenditure levels the state initially approved in June 2022 and later modified in June 2023. These expenditure levels aligned with the estimates of the minimum funding requirement at the time the state approved them. As a result of the state's revenue decline for that year, however, these disbursements now exceed the revised estimate of the minimum requirement by approximately $8 billion. The state would need to take legislative action to revise these payments in light of the lower minimum requirement.

GOVERNOR'S PROPOSAL

Governor's Budget Proposes Not Recognizing the Expenditures Above the Minimum Requirement, Despite Allowing Schools to Keep the Funding. The Governor's budget proposes no changes to the funds that have already been distributed for 2022-23 on a cash basis—that is, those payments would not be offset or recouped and K-14 districts would not be expected to make any changes in their local budgets. At the same time, however, in order to score budgetary savings, the Governor proposes to delay recognizing these payments in its budget documents. In essence, this maneuver generates short-term budgetary savings by creating a misalignment between the state's cash position and its budget.

Expenditure Would "Accrue" to the Future Instead. The Governor's budget does not address the misalignment between the state's cash and budget positions until future years. Starting in 2025-26, the administration would recognize the budgetary costs in increments of $1.6 billion annually for five years. The payments would be scored outside of the state's Proposition 98 requirements, meaning they would add to the state's projected deficits in those years. These payments would bring the state's cash and budget documents back into alignment.

LAO ASSESSMENT

Creates a New Type of Budget Solution: Effectively an Interest-Free Loan From the State's Cash Resources. Under this proposed maneuver, the state would generate budget savings by not recognizing a budgetary expenditure, despite the fact that the cash has gone out the door. Although it is not technically a loan, the best way to conceptually understand this proposal is that the state would make an interest-free loan to itself using its own cash resources. In short: the unacknowledged $8 billion in cash disbursements in 2022-23 create an outstanding "principal" due from the state's cash resources. The state would make "repayments" on this principle balance beginning in 2025-26 as it acknowledges the cash disbursement on a budgetary basis. In total, the repayments would equal the principal such that there would be no interest payments. While the state does sometimes shift costs between time periods as a type budget solution—as is the case with deferrals—this specific maneuver is unprecedented.

Obfuscates Budget's True Condition. We have major concerns about this proposal from a transparency perspective. The proposal would create a new budgetary obligation on the state that is virtually invisible in budget and cash documents as currently produced by the Department of Finance and State Controller. Further, although this maneuver is clearly a proposal that requires legislative approval, the administration treats it as an "automatic" change in its depiction of the state's budget condition. This has the effect of: (1) reducing the size of the budget problem on paper, and (2) obscuring the proposed solution in the documents presented to the Legislature as part of the Governor's budget. (We explained this dynamic further in our report: *The 2024-25 Budget: Overview of the Governor's Budget*.)

Creates Binding Obligation That Magnifies Structural Deficit, Likely Requiring More Cuts to Other Programs in the Future. The repayments on this maneuver would represent a new, binding obligation on the state. (Although the precise timing of these repayments would be up to the Legislature, the payments would have to occur eventually. Therefore, this proposal is fundamentally different than other kinds of spending delays proposed by the administration.) The state currently faces deficits of around $30 billion per year for the next few years. Given that the state will need to deploy most of its budget tools to address this year's deficit, these future budget problems are likely going to require even more difficult decisions, including ongoing cuts to state programs and/or revenue increases. The future payments on this maneuver would exacerbate these problems, likely requiring the Legislature to make even more difficult decisions as soon as next year. Moreover, the cost of this maneuver would be outside of funding for schools and community colleges. All other state General Fund programs would bear these costs.

Sets a Problematic Precedent. While borrowing to finance a year-end deficit is unconstitutional, the state is permitted to shift its own funds and costs—that is, to internally borrow—to balance the budget. Such cost shifts include, for example, budgetary deferrals (for example, the payroll deferral) and special fund loans. Similar to this proposed maneuver, these tools create long-term obligations in exchange for short-term budgetary relief and some do so by creating discrepancies between cash and budget documents. However, this particular maneuver is new and sets a problematic precedent. It would likely create an expectation that the state would continue to use maneuvers like this to pay for spending in the presence of budget deficits. Even more concerning, in effect, the state's cash position represents the only upper bound to which the state could use a maneuver like this. As long as there is sufficient cash in the treasury, the state could defer the recognition of almost any amount of budgetary expenditure. Eventually, however, the bill comes due—the state cannot defer incurred costs forever. At that time, like under this proposal, the Legislature likely would have to make other spending cuts to repay the "loans."

LAO RECOMMENDATION

Strongly Recommend Rejecting Governor's Proposal. This proposed maneuver is bad fiscal policy, sets a problematic precedent, and creates a binding obligation on the state that will worsen out-year deficits and require more difficult decisions. We strongly recommend that the Legislature reject the proposal. In our report, *The 2024-25 Budget: Proposition 98 K-12 Education Analysis*, we set forward some alternative options that would allow the state to maintain school funding while achieving budgetary savings in 2022-23, but without the problematic downsides of this specific proposal.

LAO PUBLICATIONS

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

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