Multiyear Budget Forecast

As discussed last week in our publication, *The 2012-13 Budget: Overview of the May Revision*, we are releasing a summary of our multiyear forecast of state General Fund revenues and expenditures below. Consistent with our usual practice, this forecast assumes adoption of all of the Governor’s May Revision revenue and expenditure policy proposals, including his proposed November ballot initiative. Our forecast makes projections about future budgetary conditions based on our independent assessments of the economy, tax receipts, program caseloads, and the achievability of proposed General Fund budgetary changes. The revenue projections included in our May Revision *Overview* publication are used in this forecast.

The discussion below concerns (1) the near-term condition of the General Fund, (2) the potential effects of the Governor’s treatment of Proposition 98 maintenance factor, and (3) possible issues facing the General Fund in later fiscal years.

Near-Term Condition of the General Fund

**2012-13 Budget Problem Is Likely Larger Than the Governor Estimates.** As discussed in last week’s *Overview*, we believe that the state’s 2012-13 budget problem is somewhat larger than the Governor estimates. The two main drivers of this larger budget problem are: (1) our assessment that property tax distributions from former redevelopment agencies (RDAs) will be about $900 million less than the administration assumes over the next 13 months and (2) our forecast of $550 million less in revenues under the Governor’s proposed tax policies in 2011-12 and 2012-13. Our forecast also identified various other differences with the administration’s budget estimates, including the strong likelihood that cap-and-trade auction revenues will be able to offset much less General Fund spending in 2012-13 than the $500 million included in the Governor’s budget estimates. (We discussed this finding in our February 2012 publication, *The 2012-13 Budget: Cap-and-Trade Auction Revenues*.) Due to all of these factors, our projection is that the Governor’s May Revision policies would result in a General Fund deficit of about $1 billion at the end of 2012-13, instead of the $1 billion General Fund reserve projected by the administration.

Our estimate gives the benefit of the doubt to many other administration proposals, notwithstanding the likelihood that some will be challenged in court or otherwise prove difficult to achieve. For instance, our $1 billion year-end deficit estimate assumes that the entire $1.4
billion of RDA liquid assets identified by the administration will be available to reduce state spending for schools in 2012-13. In our *Overview*, we noted the strong possibility that RDA liquid assets could produce much less than this amount of General Fund relief in 2012-13. Also, as noted in our *Overview*, state policy makers should not be surprised if revenues are several billion dollars lower (or higher) than currently estimated during the fiscal year, which also would affect the year-end deficit (or reserve).

**2013-14: Projected Operating Deficit of $1.6 Billion.** In general, the same basic budgetary trends contributing to our deficit forecast in 2012-13 (lower projected revenues and higher projected spending) continue into 2013-14. We forecast $94.9 billion of General Fund revenues and $96.5 billion of expenditures in 2013-14 under the Governor’s May Revision policies. This would result in an operating deficit of $1.6 billion during that fiscal year.

**Future Budgetary Effects of Governor’s Maintenance Factor Treatment**

*LAO Forecasts Lower Revenues Than Administration in Outyears...* As discussed in last week’s *Overview*, we forecast lower General Fund revenues than the administration, particularly in 2014-15 and 2015-16 (the last years of the Department of Finance [DOF] multiyear forecast). In each of those two fiscal years, our revenue forecasts are around $3.5 billion to $4 billion lower than the administration’s.

*...Yet LAO Forecasts Operating Surpluses Under Governor’s Policies Starting in 2014-15.* While our revenue forecasts are lower than the administration’s, our forecast indicates the possibility of operating surpluses under the Governor’s May Revision policies beginning in 2014-15. This is quite counterintuitive, given the fact that the multiyear budget forecast released by DOF on May 14 includes considerably higher General Fund revenues and indicates just a small operating surplus in 2014-15. As discussed below, it appears that this result is caused primarily by the Governor’s Proposition 98 maintenance factor treatment (which we discussed in the May Revision *Overview* last week and in [testimony to the Legislature](#)).

*DOF Multiyear Forecast Assumes Large Maintenance Factor Payment in 2014-15.* Under the Governor’s maintenance factor treatment, the state would make a large maintenance factor payment in 2014-15 under DOF’s multiyear revenue and expenditure forecast. In that fiscal year, DOF projects higher General Fund revenue growth than our office. Specifically, DOF forecasts 10.7 percent growth of General Fund taxes used in the Proposition 98 calculation, while we forecast 8.0 percent growth.

Under both of our revenue forecasts, Proposition 98 funding for schools and community colleges would increase significantly in 2014-15. DOF’s higher projected revenue growth, however, propels Proposition 98 from Test 2 (where it is under our revenue forecast in 2014-15) into a Test 1 scenario (under DOF’s revenue forecast for that fiscal year). In Test 1, the Governor’s maintenance factor treatment becomes particularly important. Because of this maintenance factor treatment, all of DOF’s projected additional year-over-year tax revenue growth above our projections goes to Proposition 98 spending in 2014-15. Accordingly, while General Fund Proposition 98 spending rises by about $4 billion under our forecast in 2014-15 to $43 billion, it rises by about $7 billion under the administration’s forecast to $46 billion. Thus, while our 2014-
15 revenue forecast is $3.9 billion less than the administration’s, our forecasted General Fund spending for Proposition 98 totals $2.9 billion less than the administration’s. After accounting for all other forecasting differences, our forecast indicates a minimal $24 million operating surplus in 2014-15 (meaning that General Fund revenues are forecast to be $24 million higher than expenditures in that fiscal year).

**Effects of 2014-15 Budget Forecasts Continue Into 2015-16.** The effects of the 2014-15 maintenance factor treatment keep the DOF estimates of Proposition 98 spending elevated into later years. The general budgetary trends described above for 2014-15 continue into 2015-16, with our office forecasting $3.7 billion less in revenues and about $3 billion less in state and local Proposition 98 funding than DOF. By this point in our forecast, our office also projects notable strengthening of property tax revenues distributed to school and community college districts both due to the dissolution of RDAs and improvements in the housing market. This strengthening contributes significantly to the forecasted operating surpluses in the later years of our forecast.

In total, we forecast a $385 million General Fund operating surplus in 2015-16 assuming adoption of all of the Governor’s May Revision proposals (including various actions assumed in DOF’s multiyear projections to reduce the so-called “wall” of state budgetary debt).

**New Element of Inflexibility for Future Budgets.** Our forecast assumes adoption of all of the Governor's May Revision revenue and expenditure policies, including an assumption that Proposition 98 maintenance factor is administered according to the administration's May Revision treatment of it. Our two different revenue forecasts, however, produce different Proposition 98 results, even under the same maintenance factor treatment.

The differing LAO and DOF forecasts for 2014-15 and 2015-16 show how the Governor’s proposed maintenance factor treatment could introduce an inflexible and somewhat unpredictable new element into state budgets in the coming years. This could further constrain the flexibility of the state’s elected leaders to prioritize state spending and balance the budget in some years. With state revenues potentially becoming more volatile in the next few years if voters approve higher tax rates for high-income taxpayers, the Governor’s maintenance factor treatment could require very large portions of some future years’ revenue growth to go only to Proposition 98—not to building state reserves or restoring funding to non-Proposition 98 programs.

In previous years, maintenance factor payments ensured that schools received healthy funding growth in strong General Fund years. Under the Governor’s maintenance factor treatment, at a certain point, almost all or all of each additional revenue dollar would be required to be spent on schools. In the administration’s forecast, these factors contribute to Proposition 98’s share of General Fund expenses growing from less than 38 percent in 2011-12 to about 44 percent or higher beginning in 2014-15, with matching decreases in the non-Proposition 98 share of the budget.

**Other Issues Facing the General Fund in Later Years**
**Various Temporary Influences Will Expire Beginning in 2016-17.** The forecast continues to be heavily influenced by several temporary factors. Two of these temporary factors could result in significant budgetary changes, beginning in 2016-17.

First, the temporary sales and use tax increase of the Governor’s proposed tax measure would expire in the middle of 2016-17, followed two years later by expiration of the proposed temporary income tax increase. (Our current revenue estimates for the initiative proposal are near the end of a recent online article released by our office.) As a result, revenue growth during this period is likely to be restrained or, in some years, perhaps even negative.

Second, the state’s economic recovery bonds (ERBs) are likely to be retired sometime in 2016 or 2017. In the first full fiscal year after the “triple flip” provisions related to the ERBs expire, the General Fund will receive over $1.5 billion of net budgetary benefit.

These various effects could influence the Proposition 98 minimum guarantee and General Fund spending in different ways depending on the timing of the triple flip’s end, economic conditions at the time, the method of applying maintenance factor, and other issues.

Currently, our 2016-17 forecast indicates an operating surplus of a few billion dollars under the Governor’s policies. We note that this assumes several years of uninterrupted economic growth, improvement in the housing market, no restoration of any program reductions, no pay raises for state employees not already included in bargaining agreements, very few inflation increases for state-funded programs, investment returns of the California Public Employees' Retirement System consistent with that system's current actuarial assumptions, and no increases in statutorily prescribed rates of state contributions to address teachers’ retirement liabilities.

**Conclusion**

**Near-Term Budget Challenges, but Opportunity to Reduce Future Deficits Substantially.** The Governor’s proposals, taken together, would continue the state’s progress toward ending a long era of structural budget deficits and returning the state to fiscal balance. As always, economic, revenue, and other budgetary results will end up differing from our forecasts—perhaps substantially. Assuming, however, a steady period of economic growth, the state would stand a good chance of achieving budgetary balance within a few years under the Governor’s May Revision proposals. Nevertheless, the Legislature and the Governor still face stiff challenges in crafting a budget package that brings the budget into balance this year. As discussed in our May Revision Overview, we advise the Legislature to focus on both realistic and ongoing budget solutions in order to make as much progress as the Governor proposes in reducing the state’s structural deficits.

**Choice of Maintenance Factor Method May Have Major Influence on Future Budgets.** The choices that the Legislature and the Governor make this year concerning Proposition 98 maintenance factor will set an important precedent for future budgets. Under the Governor’s maintenance factor treatment, in years of sharp revenue growth (due to economic growth, stock market increases, or tax increases), the flexibility of current and future elected leaders to balance
the budget, increase state reserves, and fund non-Proposition 98 programs would be significantly constrained. We advise the Legislature to consider the ramifications of these decisions now.