



June 4, 2020

TO: State Association of County Retirement Systems

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RE: **Legislative Update – June 2020**

May Budget Revision

On May 14, Governor Newsom released his May Revision to his January Budget. In a normal year, the May Revision is a chance for the Governor to fine tune his January proposal based on more up to date revenue estimates for the coming year.

In 2020, the May Revision is all about responding to the economic crisis caused by COVID-19. Between January and May, the state has seen a 22.3% decline in revenue and 4.6 million new unemployment claims filed since mid-March. This drop in revenue combined with higher caseloads for social safety net programs has eviscerated the multi-billion-dollar surplus the Governor anticipated in January.

All of this has led the Legislative Analyst's Office (LAO), a non-partisan advisor to the Legislature, to estimate anywhere from an \$18 to \$31 billion deficit. The Governor's Department of Finance (DOF), is projecting a higher deficit of \$54.3 billion for two reasons. First, the Governor has chosen to calculate the deficit based on his *proposed* expenditures in the January Budget rather than the expenses the state is obligated to pay under current law. Second, the Department of Finance is projecting a \$13 billion increase in caseload for social safety net programs and other expenses related to COVID-19.

The Governor's May Revision would resolve the projected \$54.3 billion deficit with the following solutions:

- 16% from the state's reserves
- 15% from the federal government under the CARES Act
- 15% from cancelling proposals for additional spending from the January budget
- 19% from internal borrowing from special funds
- 26% "triggered cuts" as described below
- 8% from revenue gained by limiting the use of net operating losses and tax credits

We have several observations about the above plan.

May Revise Spreads the Use of Reserves Across Several Budget Years

The state has \$16.2 billion in its “Rainy Day Fund” and several billion more in additional reserves including social safety net and Proposition 98 (school funding) reserves. Collectively, the Governor is planning to use only \$8.8 billion of our reserves in the current budget year. The Governor is proposing to use the remainder of the state’s reserves to bridge gaps in the next two budget years.

May Revise Relies on Several One Time Solutions

The use of state reserves, one-time appropriations from the federal government, and borrowing from state special funds are all one-time solutions. This means that in future budget years California will still be confronting a significant structural deficit as revenues continue to fall below expenses. The size of this ongoing deficit will depend on the strength of the economy. The May Revise projects that this deficit could be higher than \$16 billion in future budget years.

Federal Funding or Cuts

The biggest solution proposed by the Governor involves cuts to funding that will be triggered if the federal government does not provide funding to states before the new fiscal year starts on July 1. During a recent press conference, Governor Newsom appealed directly to President Trump to support Speaker Pelosi’s “HEROES Act.” The \$3 trillion stimulus proposal would fill in multi-billion-dollar gaps in the state’s budget.

If the “HEROES Act” or other federal support is not forthcoming, the May Revise includes billions of triggered cuts. The brunt of these cuts, \$6.5 billion, fall on K-12 funding. More than a billion in additional cuts would come to UC’s, CSU’s, and the state’s community college system. Collectively billions more are proposed for social safety net programs, state parks, and court systems. Finally, the Governor has proposed a 10% pay cut for state employees if federal relief is not forthcoming. This cut would result in \$2.8 billion in savings.

Legislative Response

The trigger cuts in the May Revise have quickly become a thorny issue for the Governor and the Legislature. If federal relief does not materialize to stop all or some of these cuts, they will have to choose whether they let the cuts happen, or attempt to avoid them by imposing new taxes or spending reserves faster than the Governor plans to. Some progressive Democrats in the Legislature have already balked at the prospect of the cuts which hit programs that are very important to their core constituencies. If the federal government does not intervene to provide funding, the Governor and the Legislature would have a very short window of time between the beginning of July and the end of August to find alternatives to avoid the cuts. Unless those alternatives included long term solutions, the budget would experience larger structural issues in the coming years.

The Assembly met as a “Committee of the Whole” last week, a procedure which allows all Assemblymembers to meet but take testimony from outside witnesses. The meeting allowed Assemblymembers to review the Governor’s budget and provide feedback and criticism. The proposed trigger cuts drew bipartisan criticism. Some members argued that if enacted the cuts would be devastating to California’s most vulnerable populations. Others pointed out that the budget was too reliant on the Federal government, meaning that a structural deficit would persist in future years when funding dries up.

The Senate took things a step further last week and adopted their own alternative to the Governor’s May Revise. The Senate plan is similar to the Governor’s but makes a number of adjustments to the trigger cuts. First, the Senate’s cuts are not “triggered” until October 1. From there, most of the Senate’s cuts are not cuts at all, but increased reliance on reserves, internal borrowing, and deferred payments. If passed by the Legislature and signed by the Governor, the Senate Budget would leave a lasting structural deficit and fewer reserves for future years.

On June 3, the Senate and Assembly then formally announced that they have agreed upon a budget deal that is substantially similar to the Senate deal described above. The next step is to come to an agreement with the Governor by June 15, the constitutional deadline to pass a balanced budget.

With tax filing deadlines delayed, the state will not have a complete picture of revenue shortfalls until after July 15. Given that, it is likely that the Legislature and Governor will revisit the budget in July and August.