Fiscal Update

LAO Fiscal Outlook Update: A Strong COLA, but a Troubling State Budget Outlook

The Legislative Analyst's Office (LAO) has released its 2027-28 Fiscal Outlook. The near-term news for community colleges is good, but the state's longer-term budget picture is serious and warrants caution as we plan. Three themes stand out: a projected 7.88% COLA that may not be fully funded, a state budget that remains structurally overextended, and reserves that are not sufficient to withstand a major downturn.

1. A 7.88% COLA is projected, but it may not be fully funded

The LAO projects a 7.88% statutory COLA for 2027-28 and estimates that the Proposition 98 guarantee will be about $4 billion higher over the three-year budget window than assumed in the 2026 Budget Act. However, approximately $1.4 billion in additional ongoing Proposition 98 funding, combined with roughly $4 billion that becomes available as prior one-time commitments expire, would cover only about three-quarters of the estimated cost of the COLA. A required withdrawal from the Proposition 98 Rainy Day Fund could provide one-time resources to help, but the LAO cautions that using one-time funds for ongoing costs could make programs more vulnerable if revenues decline. The outlook also assumes the Legislature will use Proposition 2 authority to address approximately $3.9 billion in outstanding Proposition 98 settle-up obligations.

2. The state remains structurally overextended

Despite near-record revenues, the LAO projects a $2 billion operating deficit in 2027-28, growing to more than $15 billion annually in later years under its baseline forecast. Ongoing expenditures exceed ongoing revenues, and the recent revenue gains have not solved that underlying problem. Much of the growth comes from exceptionally strong stock market performance, particularly gains tied to AI-related companies, which may not be sustainable.

Figure 1: Projected multi-year state deficits. This graph shows that even with higher-than-expected revenues, California faces recurring operating deficits every year. It reinforces the LAO's conclusion that spending commitments have grown beyond what ongoing revenues can sustainably support.

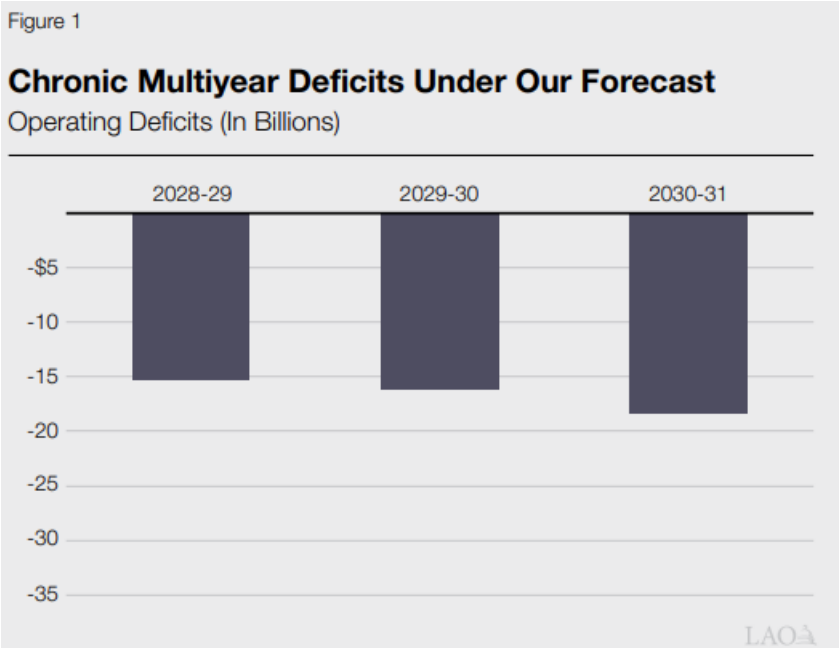
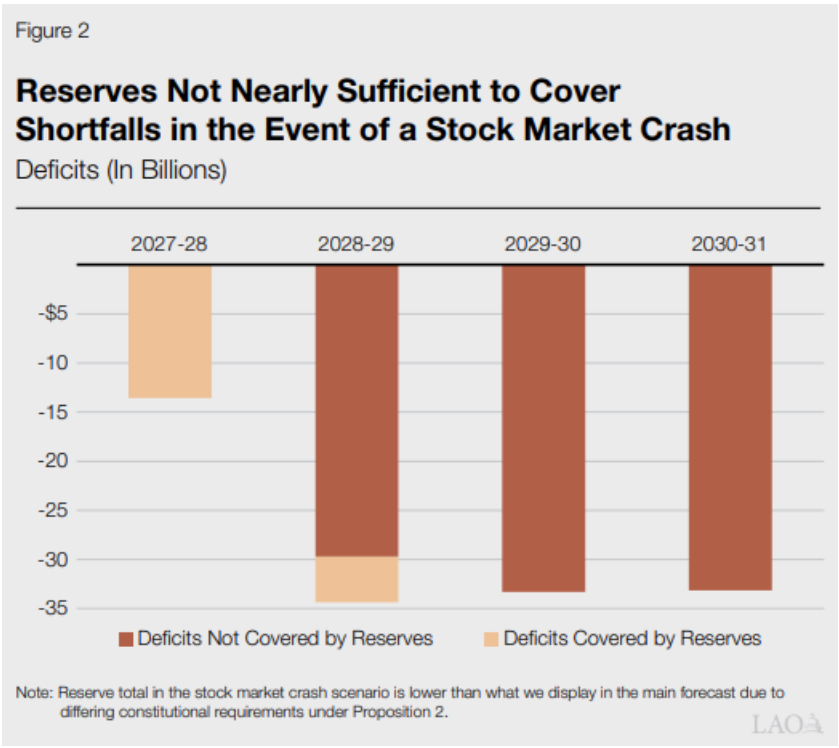


Figure 2. Reserves are not sufficient to absorb a major downturn

The LAO also tests how exposed the budget is to a stock market correction. It is not predicting a recession; the scenario illustrates California's reliance on high-income taxpayers whose incomes track financial markets.



Appendix 1, Figure 1 and 2: Baseline revenues versus a stock market crash scenario. Under the crash scenario, cumulative revenue losses exceed $130 billion over the forecast period, driven largely by declines in personal income tax revenues from capital gains and investment income.

Appendix 1, Figure 1

Fiscal Outlook Revenue Forecast

(In Billions)

	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31
Personal income tax	$148.4	$158.5	$141.0	$149.8	$159.3	$169.4
Corporation tax	45.0	45.8	46.8	49.0	50.0	49.3
Sales tax	34.9	36.6	38.8	40.6	41.9	44.0
Total "Big Three" Revenue	**$228.4**	**$240.9**	**$226.6**	**$239.4**	**$251.1**	**$262.6**
Other revenues	$11.8	$11.0	$11.3	$10.6	$10.8	$10.8
Total Revenues	**$240.2**	**$251.9**	**$237.9**	**$250.0**	**$261.9**	**$273.4**

Appendix 1, Figure 2

Stock Market Crash Revenue Scenario

(In Billions)

	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31
Personal income tax	$148.4	$150.4	$112.3	$114.8	$127.4	$141.4
Corporation tax	45.0	45.8	46.8	49.0	50.0	49.3
Sales tax	34.9	36.6	38.8	40.6	41.9	44.0
Total "Big Three" Revenue	**$228.4**	**$232.8**	**$197.9**	**$204.4**	**$219.2**	**$234.6**
Other revenues	$11.8	$11.0	$11.3	$10.6	$10.8	$10.8
Total Revenues	**$240.2**	**$243.8**	**$209.2**	**$214.9**	**$230.0**	**$245.4**

Note: The crash scenario is applied to personal income tax revenues.

Bottom line for community colleges

The near-term funding picture is favorable, including a projected 7.88% COLA and increased Proposition 98 resources, but the longer-term risks for our system are significant. **With available resources covering only about three-quarters of the COLA**, **the state's reliance on one-time funding to support ongoing programs will have a negative impact**: when those one-time resources run out, the ongoing obligations remain, leaving programs exposed to future revenue declines. At the same time, the state remains structurally overextended, and as policymakers work to develop solutions to close projected deficits that grow to more than $15 billion annually, community colleges should be prepared for the possibility of reduced funding or deferrals affecting our system. The LAO recommends conservative revenue assumptions, stronger reserves, paying down obligations, and avoiding new ongoing commitments supported by temporary revenues. We should welcome the near-term gains while planning conservatively for a more difficult budget environment ahead.