

PLATINUM | ADVISORS

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TO: Diane Shaw, President, AC Transit Board of Directors

Members of the AC Transit Board of Directors

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FR: Steve Wallauch
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RE: Budget Update

LAO's Fiscal Outlook: The Legislative Analyst's Office (LAO) released two fiscal outlook reports this week. One focusing on the current fiscal year, and another focusing on the 2026-27 fiscal year. In short, the current fiscal year remains in balance with the current revenue gains being offset by cost increases. The coming budget year faces additional budget shortfall potentially reaching \$20 billion, maybe more if the AI bubble bursts. These are "structural deficits" forecast by the LAO, which bases these projections on current laws and policies without predicting or assuming any budgetary changes, such as program cuts, tax and fee increases, or fund shifts.

2025-26 Fiscal Year: The report highlights uncertainties in revenue forecasts, spending estimates, and the fiscal effects of recently passed ballot measures. It is also unknown if the state will meet the goal of implementing \$2.2 billion in operational efficiencies mandated in the 2025-26 budget.

- **Revenues Running Ahead of Broader Economy:** Despite a sluggish labor market and weak consumer spending, income tax revenues have surged due to high-income earners benefiting from stock market gains. Given the potential for volatility in the stock market, the LAO states that revenues could end up above or below projections by as much as \$30 billion. However, this growth is uncertain without broader economic improvements.

Underscoring the precarious outlook, the LAO's report states, "Current stock prices relative to companies' past earnings (a common measure of how "expensive" stocks are) are at levels rivaled only by the transitory booms of 1999 and 2021. Furthermore, a single company (Nvidia) accounts for about one-third of the total gains in the S&P 500 stock index over the last year."

- **2025-26 Budget Roughly Balanced:** The Legislature proactively addressed anticipated budget issues during the 2024-25 budget process, resulting in a small projected deficit of \$2 billion for 2025-26, which is considered roughly balanced. While current income exceeds projections by almost \$6 billion so far this year, the LAO forecasts revenues for the entire fiscal year will exceed projections by only \$7 billion. However, spending on education and all other programs has grown faster than revenues by \$11.5 billion, which results in the \$2 billion deficit for 2025-26.
- **No Capacity for New Commitments:** The state faces significant multiyear operating deficits starting in 2026-27, driven by faster-than-normal spending growth and slower revenue growth. The state faces annual operating deficits beginning in 2026-27 of \$20 billion and growing to about \$30 billion in 2028-29. The LAO points out that the Legislature will need to reduce spending, increase taxes, or use reserves to address future deficits.

2026-27 Fiscal Year: The LAO affirms the widely held outlook that both the California and U.S. economies currently face significant headwinds. Borrowing costs, a key factor in business expansions and major consumer purchases, remain high. New tariffs on imports into the U.S. are creating cost pressures for businesses and consumers. While income taxes have remained strong, for the most part this is due to the AI technology stocks that have pushed the stock market to record highs. These factors combine to create a significant budget challenge for California in 2026-27.

The LAO estimates that the deficit facing the 2026-27 fiscal year totals \$18 billion, which is \$5 billion higher than the June 2025 forecast. There are several factors contributing to this budget problem.

- **Constitutional Spending Requirements:** Revenue improvements are largely offset by increased spending obligations under Proposition 98 (school and community college funding) and Proposition 2 (reserve deposits and debt payments). These requirements consume over \$10 billion of revenue gain.
- **Higher Costs in Other Programs:** Spending across various programs is estimated to increase by about \$6 billion compared to earlier budget act estimates. Key drivers include:
 - **Statewide expenditures:** Higher costs for retiree health care, pension payments, and administrative expenses (\$2.4 billion).
 - **H.R. 1 impacts:** Increased costs for Medi-Cal (\$1 billion) and CalFresh (\$300 million) due to federal policy changes.
 - **Corrections costs:** An additional \$850 million due to budget imbalances and lower-than-expected savings.
 - **Other costs:** Employee compensation changes and health/human services programs add \$1.1 billion.
- **Structural Deficits:** Spending growth continues to outpace revenue growth, leading to annual structural deficits projected to reach \$35 billion starting in 2027-28.

- **Stock Market Risks:** The state's revenue forecast incorporates the risk of a potential stock market downturn fueled by AI-related exuberance, which could lead to weaker income tax collections.
- **Limited Budget Resilience:** The state has already used most of its budget resiliency tools, such as reserves, budgetary borrowing, and temporary fixes, leaving fewer options to address future deficits.

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