AGENDA

ASSEMBLY BUDGET SUBCOMMITTEE NO. 2
ON EDUCATION FINANCE

Assemblymember Susan Bonilla, Chair

TUESDAY, MARCH 5, 2013

9:00 AM - STATE CAPITOL ROOM 444

OVERVIEW OF THE GOVERNOR'S 2013-14 PROPOSITION 98 FUNDING PROPOSAL

I. OPENING REMARKS

Assembly Member Susan Bonilla, Chair

Committee Members

II. BUDGET PERSPECTIVES

Tom Torlakson, Superintendent of Public Instruction

III. GOVERNOR'S 2013-14 BUDGET PROPOSALS: PROPOSITION 98 FUNDING

Thomas Todd, Department of Finance

Edgar Cabral, Legislative Analyst's Office

Erin Gabel, Department of Education

ITEMS TO BE HEARD

6110 DEPARTMENT OF EDUCATION

ISSUE 1: 2013-14 GOVERNOR'S BUDGET PROPOSAL: PROPOSITION 98 FUNDING

The issue for the Subcommittee to consider is the Proposition 98 funding level for the 2013-14 Fiscal Year.

PANELISTS

- Thomas Todd, Department of Finance
- Edgar Cabral, Legislative Analyst's Office
- Erin Gabel, Department of Education

BACKGROUND

Proposition 98 is a 1988 ballot initiative that amended the California constitution to establish a minimum annual funding level for K-12 education and Community Colleges (K-14 education). This funding formula is intended to provide K-14 education with a guaranteed funding source that generally grows each year with the economy and the number of students attending. Community Colleges receive roughly an 11 percent share of total Proposition 98 funding. The guaranteed funding is provided through a combination of state General Fund and local property tax revenues and is more commonly referred to as the "minimum guarantee." The State has the option of funding at the designated minimum guarantee, over-appropriating to provide funding above the guarantee, or "suspending" the guarantee to provide any level of funding the Legislature deems appropriate.

There are three formulas or "Tests" that, based on various inputs, determine the minimum level of funding required under Proposition 98. The 2012-13 Fiscal Year is a "Test 1" year. "Test 3" is expected to apply to the 2013-14 Fiscal Year.

Three Formulas ("Tests") Used to Determine K-14 Funding

Test 1—Share of General Fund. Provides roughly 40 percent of General Fund revenues to K-14 education. This minimum requirement must be met each year.

Test 2—Growth in Per Capita Personal Income. The Proposition 98 requirement is determined by growth in the economy (as measured by per capita personal income) and K-12 attendance. Applies in years when state General Fund growth is relatively healthy and formula yields more than under Test 1.

Test 3—Growth in General Fund Revenues. Adjusts prior-year funding for changes in attendance and per capita General Fund revenues. Generally, this test is operative when General Fund revenues grow more slowly than per capita personal income.

The underlying premise of Proposition 98 is to guarantee that per pupil funding keep pace with the cost of living (Test 2). In times of slow economic growth, when the State cannot provide the Test 2 level of funding, the State keeps track of this long term funding commitment and eventually restores Proposition 98 to what it otherwise would have been had education funding grown with the economy. This outstanding obligation is called "maintenance factor." Formulas under Proposition 98 dictate when and how much maintenance factor is restored in a given year. Maintenance factor for 2013-14 is projected to be $9 billion.

As noted above, the Proposition 98 formula also allows the Legislature to provide less than the formulas require. This is achieved through a two-third's vote to suspend the State's obligation to provide education funding at the level dictated by the Proposition 98 formula. The Legislature has only invoked suspension on a few occasions. The most recent suspension was invoked under the 2010-11 Budget Act.

Overall Proposition 98 Funding. Since the national recession began in 2008, California has grappled with a decline in state revenues that in turn has negatively impacted state funding for education. However, with the passage of the Schools and Local Public Safety Protection Act of 2012 (Proposition 30), schools were spared from billions of dollars in mid-year trigger reductions and a reinvestment in California schools is on the horizon.

The Governor's Budget estimates a Proposition 98 minimum guarantee of $56.2 billion for 2013-14. This funding level is $2.7 billion above the current year funding level and represents a 5 percent increase year-over-year. Proposition 98 funding growth is greater for community colleges (10 percent) than for K-12 education (4 percent), however, about half of the additional increase for the community colleges is related to the Governor's proposal to restructure adult education.

Proposition 98 Funding (Dollars in Millions)					
				Change from 2012-13	
	2011-12 Actual	2012-13 Revised	2013-14 Proposed	Amount	Percent
Preschool	$368	$481	$481	$0	0%
K-12 Education					
General fund	29,368	33,406	36,084	2,679	8%
Local property tax revenue	11,963	13,777	13,160	-618	-4%
Subtotals	41,331	47,183	49,244	2,061	4%
California Community Colleges					
General fund	3,279	3,543	4,226	683	19%
Local property tax revenue	1,974	2,256	2,171	-85	-4%
Subtotals	5,253	5,799	6,397	597	10%
Other Agencies	83	78	79	1	1%
Totals	**$47,035**	**$53,541**	**$56,200**	**$2,659**	**5%**
General Fund	33,097	37,507	40,870	3,362	9%
Local property tax revenue	13,937	16,034	15,331	-703	-4%

Source: Legislative Analyst's Office

Other technical adjustments. The Governor's Budget includes technical adjustments in the current year to account for the updated estimates of the Proposition 98 minimum guarantee for 2012-13. The Administration estimates the revised Proposition 98 minimum guarantee for 2012-13 is $53.5 billion—down $54 million from the budget act estimate. Proposition 98 spending, however, is estimated to be $163 million above the minimum guarantee. To bring spending down to the 2012-13 minimum guarantee, the Governor proposes to reclassify $163 million in Proposition 98 funds as non-98 General Fund and uses those funds to meet the *CTA v. Schwarzenegger* obligations.

The Governor's calculation of the Proposition 98 minimum guarantee also includes revenue raised by Proposition 39, passed by voters in November 2012. The Administration projects that Proposition 39 will increase state revenue by $440 million in 2012-13 and $900 million in 2013-14. According to the LAO, the Governor's budget includes all revenue raised by Proposition 39 in Proposition 98 calculations, which has the effect of increasing the minimum guarantee by $426 million in 2012-13 and an additional $94 million (for a total increase of $520 million) in 2013-14. The Subcommittee will have a more extensive hearing on Proposition 39 funding at a later date.

Growth and COLA. The Governor's Budget proposes a 1.65 percent cost–of–living adjustment for only a few K–12 categorical programs: $60.2 million for special education, $2.5 million for child nutrition and $74,000 for California American Indian education centers. These programs are not proposed to be included in the Governor's new funding formula.

The Governor's budget proposes to provide $3 million for K–12 growth (a 0.10 percent increase) but assumes no increase in funded enrollment levels at the community colleges.

Programmatic Per Pupil Funding. According to the LAO, under the Governor's budget, Proposition 98 programmatic per–student funding for schools is $7,929—an increase of $360 (5 percent) from the revised current–year level. For community colleges, Proposition 98 programmatic per–student funding is $5,969—an increase of $522 (10 percent) from the revised current–year level.

Major Proposition 98 Spending Proposals. The Governor's Budget proposes to spend the increase in ongoing Proposition 98 funding on a mix of debt repayment and programmatic funding increases. The Subcommittee will examine most of these proposals in greater detail through subsequent hearings.

Major K-12 Proposals:

- Provides $1.8 billion to retire some existing inter-year deferrals
- Provides $1.6 billion towards funding a new Local Control Funding Formula
- Provides $400.5 million for energy-efficiency projects pursuant to Proposition 39
- Provides $100 million increase to the mandate block grant for the addition of the Graduation Requirement and Behavioral Intervention Plan (BIP) mandates.

Major CCC Proposal:

- Provides $300 million for restructuring Adult Education.
- Provides $197 million in discretionary funding allocated based on the Chancellor's priorities
- Provides $179 million to retire existing deferrals
- Provides $49.5 million for energy-efficiency projects pursuant to Proposition 39
- Provides $16.9 million for a new CCC technology initiative

The chart below outlines the specific changes to ongoing spending proposed by the Governor.

Proposition 98 Spending Changes (In Millions)	
2012–13 Revised Spending	**$53,541**
Technical Changes	
Make technical adjustments	$148
Fund K–12 categorical growth	49
Fund K–12 revenue limit growth	3
Adjust for prior–year deferral payments	–2,225
Subtotal	(–$2,025)
K–12 Policy Changes	
Pay down deferrals	$1,765
Transition to new funding formula	1,630
Allocate money for energy–related projects	401
Add two programs to mandate block grant[a]	100
Provide COLA for certain programs[b]	63
Swap one–time funds	–17
Subtotal	**($3,941)**
CCC Policy Changes	
Create new adult education categorical program	$300
Increase funding for apportionments	197
Pay down deferrals	179
Allocate money for energy–related projects	50
Fund new technology initiative	17
Subtotal	($742)
Total Changes	**$2,659**
2013–14 Proposed Spending	**$56,200**

[a] Graduation Requirements and Behavioral Intervention Plans.
b Applies to special education, child nutrition, California American Indian Education Centers, and American Indian Early Childhood Education Program.
COLA = cost–of–living adujustment.

Source: LAO

<u>One-time funds</u>. The Governor's budget includes a total of $27 million in one-time funds. Specifically, the Governor proposes to use $10.4 million in one-time funding for some ongoing Special Education expenses, $9.7 million to support California School Information Services (CSIS) activities, and $9.7 million in one-time Proposition 98 reversion account funds for the Emergency Repair Program (ERP).

With regard to ERP, as part of the *Williams* settlement, the state agreed to provide certain schools with $800 million for emergency facility repairs. The state has paid a total of $338 million for the ERP obligation thus far. The state has not provided funding for this program since 2008-09.

Outstanding education funding obligations. The state has endured tough fiscal times over the last several years and as a result has built up several one-time funding obligations owed to schools. The largest obligation is related to deferrals or late payments to schools. The following chart describes each obligation and the amount owed.

Outstanding One–Time School and Community College Obligations

(In Millions)

Obligation	Description	Amount Outstanding[a]
Payment deferrals	State has deferred certain school and community college payments from one fiscal year to the subsequent fiscal year, thereby achieving one–time state savings.	$8,205
Mandates	State must reimburse school and community college districts for performing certain state–mandated activities. State deferred payments seven consecutive years (2003–04 through 2009–10).	4,014
Emergency Repair Program	As part of the *Williams* settlement, state agreed to provide certain schools with $800 million for emergency facility repairs.	452
Quality Education Investment Act	Associated with a Proposition 98 suspension in 2004–05 and *Schwazenneger v. CTA*, the state agreed to provide an additional $2.7 billion to schools and community colleges over a multiyear period.	247

[a] As of year–end 2012–13.

Source: LAO

Additional obligation - Proposition 98 Settle-Up. In addition to the obligations discussed above, the state has $1.7 billion in outstanding one–time Proposition 98 obligations known as “settle–up” obligations. A settle–up obligation is created when the minimum guarantee increases midyear and the state does not make an additional payment within that fiscal year to meet the higher guarantee. The state’s existing settle–up obligations were created as a result of underfunding in 2006–07 ($212 million), 2009–10 ($1.2 billion), 2010-11 ($2.5 million), and 2011–12 ($251 million). Settle–up funds can be used for any educational purpose, including paying off other state one–time obligations, such as deferrals and mandates. The Governor’s budget does not propose to provide any funding for settle-up obligations in 2013-14.

Governor's multiyear plan for paying education obligations. The Governor lays out a multi-year plan for paying off the state's one-time obligations in the area of education. The largest obligation is the payment deferrals, which will be covered in greater detail later in this agenda. The Governor also proposes to provide $247 million on top of the minimum guarantee in 2014–15 for the Quality Education and Investment Act and an additional $452 million on top of the minimum guarantee in 2016–17 for the Emergency Repair Program. These payments would fully retire the state's statutory obligation for both programs. In 2016–17, the Governor also proposes to make a $1.7 billion payment to retire the state's existing settle–up obligations. These funds would be allocated to school districts and community colleges to reduce the mandate backlog. (A backlog of roughly $2.3 billion would remain.)

While the Governor intends to pay these obligations as outlined in the following chart, the only issue that requires Legislative action this year is the Governor's 2013-14 budget proposal to retire $1.9 billion in payment deferrals.

Governor's Multiyear Plan for Paying Education One–Time Obligations

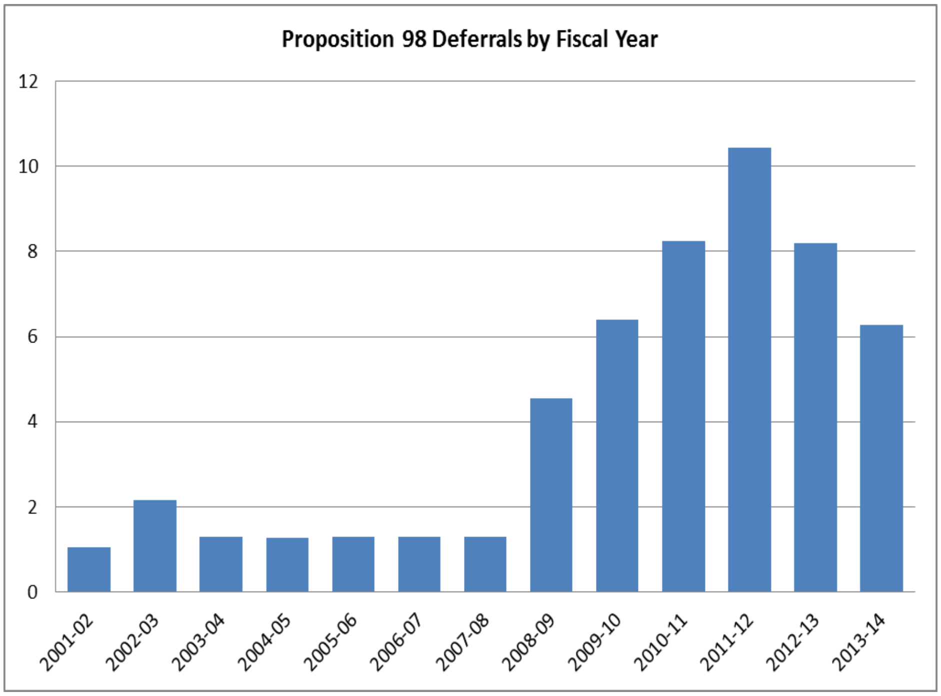
(In Millions)

Obligation	Paid Within Annual Proposition 98 Appropriation?	2013–14	2014–15	2015–16	2016–17	Total Payments Over Period[a]
Payment deferrals	Yes	$1,950	$2,986	$3,137	$132	$8,205
Mandates	No	—	—	—	1,666	1,666
Emergency Repair Program	No	—	—	—	452	452
Quality Education Investment Act	No	—	247	—	—	247
Fiscal–Year Totals		**$1,950**	**$3,233**	**$3,137**	**$2,250**	**$10,570**

[a] By the end of the period, all obligations would be retired, except for mandates, which would have $2.3 billion in still outstanding obligations.

Source: LAO

<u>Background on Deferrals.</u> The State has relied heavily on deferring Proposition 98 payments as a way to achieve budgetary savings in difficult fiscal times. The first Proposition 98 deferrals were adopted in the middle of 2001–02, when $1.1 billion in K–12 payments were deferred from late June 2002 to early July 2002. This delay, while only a few weeks, allowed the state to achieve one–time savings by reducing Proposition 98 General Fund spending in 2001–02 without making programmatic reductions. Schools continued to operate a larger program using cash reserves. In 2008–09, facing an even larger budgetary shortfall, the state delayed $3.2 billion in Proposition 98 payments to achieve one–time General Fund savings. (To address the 2008–09 budget shortfall, the State also made $2 billion in midyear Proposition 98 programmatic reductions). The State adopted additional deferrals in 2009-10 ($1.8 billion), 2010–11 ($1.8 billion), and 2011–12 ($2.2 billion) to achieve one–time savings and avoid further programmatic reductions. By 2011-12, a total of $10.4 billion in Proposition 98 payments were paid late (roughly 21 percent of total Proposition 98 support). The following chart illustrates the use of deferrals over time.



Source: LAO

The length of deferrals also increased over time. Initial deferrals were only a few weeks. The state now defers payments over several months. These delays place a larger cash management burden on school districts. To access cash, districts can use existing budget reserves or special funds (although drawing down reserves also results in a loss of earned interest). If internal resources are insufficient, districts can try to borrow from private lenders, their County Office of Education (COE), or their County Treasurer. If districts borrow from other agencies, they are responsible for covering all transaction and interest costs.

Starting in 2008, district cash management was compounded when the state began to also defer payments to schools inside the fiscal year. These "intra-year" deferrals were used to help ease state cash flow but left districts with an increased pressure to borrow funds. According to the Department of Finance, as of December 2012, all "intra-year" deferrals have been repaid and no future intra-year cash management deferrals are anticipated.

<u>Paying down inter-year deferrals.</u> The state began the process of retiring "inter-year" deferrals in the 2012-13 Budget Act by providing a total of $2.2 billion ($2.1 billion for K-12 schools and $160 million for community colleges) to reduce this obligation. This funding was contingent upon the passage of Proposition 30. By providing this one-time payment in 2012-13, the state "freed up" $2.2 billion in the budget year for ongoing expenditures within Proposition 98.

The Governor's 2013-14 Budget proposes to continue to pay down K-14 inter-year deferrals by dedicating $1.9 billion for this purpose ($1.8 billion for K-12 and $179 million for community colleges). These payments would reduce the amount of outstanding deferrals to $6.3 billion.

Proposition 98 Adjustments for Property Tax Shifts. According to the LAO, over the past two decades, the state has made numerous shifts in the allocation of property taxes among cities, counties, special districts, school districts, and community college districts. In some years, these shifts can unintentionally increase or decrease the Proposition 98 minimum guarantee. To ensure that these shifts have no effect on the total amount of funding schools and colleges receive, the state adjusts or "rebenches" the Proposition 98 minimum guarantee.

As a result of legislation adopted in 2011, redevelopment agencies (RDAs) were dissolved on February 1, 2012. In most cases, the city or county that created the RDA is managing its dissolution as a successor agency. The successor agencies are required to use tax revenues previously provided to RDAs to continue to pay the former RDA's outstanding financial obligations. After these obligations are paid, the remaining revenues—known as residual RDA revenues—are distributed based on existing property tax allocation laws to cities, counties, special districts, schools, and colleges. Successor agencies also are required to allocate former RDA cash assets to local agencies serving the area. When all RDA debts have been repaid, tax increment revenues no longer will be separated from other property tax revenues and instead will be distributed to local agencies using existing property tax allocations. Once all shifts have been completed, schools and community colleges are expected to receive a total of roughly $2.5 billion in additional property tax revenues.

The Governor's budget reduces the RDA estimates assumed in the 2012-13 Budget Act. As the chart below shows, for 2012-13, RDA related revenues decreased by $1.1 billion. For 2013-14, RDA related revenue estimates are decreased by $494 million.

Lower Estimates of Redevelopment–Related Transfers to Schools and Colleges

(In Millions)

	2012–13 Budget Act	***2013–14 Governor's Budget***	**Difference**
2011–12			
Ongoing residual	$113	$147	$34
Cash assets	—	—	—
Totals	**$113**	**$147**	**$34**
2012–13			
Ongoing residual	$1,676	$784	–$893
Cash assets	1,479	1,302	–177
Totals	**$3,155**	**$2,086**	**–$1,070**
2013–14			
Ongoing residual	$1,011	$559	–$452
Cash assets	600	558	–42
Totals	**$1,611**	**$1,117**	**–$494**
Totals Through 2013–14			
Ongoing residual	$2,800	$1,490	–$1,310
Cash assets	2,079	1,860	–219
Totals	**$4,879**	**$3,350**	**–$1,529**

Source: LAO

The Governor's budget is inconsistent with regard to rebenching adjustments related to RDA revenues. The LAO recommends the Legislature update its rebenching, as needed, to account for the increase in revenues transferred to schools.

LAO Recommendations on Overall Proposition 98 Proposal. According to the LAO, over the next several years, as state General Fund revenue growth results in additional Proposition 98 resources, the Legislature will want to weigh the trade–offs between building up ongoing base support and retiring outstanding one–time obligations. The LAO believes the Governor's approach is generally balanced and reasonable. Using such an approach would allow the state to retire most school and community college obligations by 2016–17—prior to the expiration of Proposition 30's personal income tax increases—while also dedicating a substantial portion of Proposition 98 funding for ongoing programs.

Further, the LAO notes that General Fund revenue estimates could be subject to significant swings over the next several years, largely due to volatility in the earnings of high–income taxpayers. These changes in General Fund revenues can result in significant midyear changes to the Proposition 98 minimum guarantee. Over the next several years, if the state receives unanticipated revenues that increase the minimum guarantee midyear, the LAO recommends the Legislature dedicate these additional resources to accelerating the pay down of its one–time education obligations.

STAFF COMMENTS/QUESTIONS

The level of Proposition 98 funding is driven by the growth or decline in the economy. General Fund revenues for 2012-13 and 2013-14 continue to fluctuate. The Subcommittee should have the most updated revenue information prior to considering a specific Proposition 98 spending plan. Updated revenue estimates are available in May when the Governor releases his revised budget. Staff recommends the Subcommittee hold all major Proposition 98 actions open until after the release of the Governor's May Revision.

Suggested Questions:

1) What does the Governor’s Proposition 98 funding increase mean for K-12 schools and community colleges in 2013-14 in terms of programmatic spending?
2) What is the Governor’s rationale for dedicating roughly half of new expenditures for reducing deferrals in 2013-14? Can the Administration or LAO explain how the deferral schedule is proposed to change under the Governor's budget?
3) Tax collections finished January roughly $5 billion above the Administration's projections. Where did we end with February revenues? What is the likelihood that these increased revenues will hold? What is the potential effect of revenue increases in the current year and budget year on the Proposition 98 funding level? How would a decline in revenues affect Proposition 98 in 2012-13 and 2013-14?
4) According to the LAO, the Administration updates the rebenching adjustment to reflect the revised estimates of one-time RDA liquid assets but does not update the adjustment to account for revised estimates of ongoing residual property tax revenues. Why did the Administration take this approach? What is the impact on schools if the adjustment is updated per the LAO recommendation?

Staff Recommendation: Hold Proposition 98 Funding Level Open Pending May Revision