

AGENDA

ASSEMBLY BUDGET SUBCOMMITTEE NO. 2 ON EDUCATION FINANCE

Assembly Member Susan Bonilla, Chair

TUESDAY, MARCH 6, 2012
9:00 AM - STATE CAPITOL ROOM 444

OVERVIEW OF THE GOVERNOR'S 2012-13 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 2012-13 BUDGET PROPOSALS: PROPOSITION 98 FUNDING

Nick Schweizer, Department of Finance

Edgar Cabral, Legislative Analyst's Office

Erin Gabel, Department of Education

ITEMS TO BE HEARD

6110 DEPARTMENT OF EDUCATION

ISSUE 1: 2012-13 GOVERNOR'S BUDGET PROPOSAL: PROPOSITION 98 FUNDING

The issue for the Subcommittee to consider is the Proposition 98 funding level for the 2012-13 Fiscal Year.

PANELISTS

- Department of Finance
- Legislative Analyst's Office
- California Department of Education

Proposition 98 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 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. Assuming passage of the Governor's initiative proposal, "Test 1" governs both the 2011-12 and 2012-13 Fiscal Years (FY).

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. 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.

- **Maintenance Factor.** 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. According to the LAO, the state is currently carrying an outstanding maintenance factor balance of \$10.8 billion.

- **Suspension.** 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.

Declining revenues and the impact on education funding. In most States, public schools receive the largest portion of their funds from local tax dollars. By contrast, the California public school system is supported predominantly with state funds. As a result, when state general funds decline, education funding is largely at risk for decline. Since the national recession began in 2008, California has grappled with a decline in state revenue that in turn has largely impacted state funding for education.

As the chart below shows, per pupil programmatic funding has declined since 2007-08 with the largest reductions year-over-year occurring in 2009-10 and 2011-12. The decline in 2011-12 is largely because federal stimulus dollars that helped bridge the gap in prior years are now spent. If the Governor's initiative fails, schools will see the largest decline in funding since the start of the recession.

K-12 "Programmatic" Funding^a							
<i>(Dollars In Millions Unless Otherwise Specified)</i>							
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2012-13
	Final	Final	Final	Final	Revised	Proposed	With Trigger
Programmatic Funding							
K-12 ongoing funding ^b	\$48,883	\$43,215	\$40,717	\$43,017	\$42,254	\$47,341	\$42,243
Payment deferrals		2,904	1,679	1,719	2,064	-1,565	
Settle-up payments		1,101		267			
Public Transportation Account	99	619					
Freed-up restricted reserves ^c		1,100	1,100				
ARRA funding ^c		1,192	3,575	1,192			
Federal education jobs funding ^c				421	781		
Totals	\$48,982	\$50,130	\$47,070	\$46,616	\$45,099	\$45,776	\$42,243
Per-Pupil Programmatic Funding (in dollars)							
K-12 attendance	5,947,812	5,957,790	5,933,768	5,947,368	5,950,041	5,970,775	5,970,775
Per-pupil funding	\$8,235	\$8,414	\$7,933	\$7,838	\$7,580	\$7,667	\$7,075
Year-to-year percent change		2.2%	-5.7%	-1.2%	-3.3%	1.1%	-6.7%
Percent change from 2007-08		2.2%	-3.7%	-4.8%	-8.0%	-6.9%	-14.1%
a Excludes federal funds not associated with stimulus packages, lottery, and various other local funding sources.							
b Includes ongoing Proposition 98 funding, Proposition 98 accounting adjustments, and funding for the Quality Education Investment Act.							
c Reflects LAO estimates of funds spent in each year.							

While economic recovery appears to be on the horizon, K-14 education continues to grapple with limited resources. Schools are owed forgone COLAs totaling roughly \$9 billion. Roughly 22 percent of state funding currently comes to schools late due to deferrals (30 percent of K-12 Proposition 98 General Fund payments are late).

PROPOSITION 98 AND THE GOVERNOR'S TAX INITIATIVE PROPOSAL

The Governor's 2012-13 Budget assumes passage of his November ballot initiative, which proposes a temporary increase to the Personal Income Tax (PIT) and Sales and Use Tax (SUT). The Administration estimates that their measure would generate \$6.9 billion over two years. The Governor accrues \$2.2 billion of these revenues to 2011-12 and attributes \$4.7 billion to 2012-13.

2011-12 Adjustments. The 2011-12 Budget Act provided a total Proposition 98 funding level of \$48.7 billion. The Governor's Budget proposes a revised funding level of \$47.6 billion. This nearly \$1 billion decline is due to \$436 million in trigger cuts taken in December 2011 and \$588 million in savings from lower than estimated student growth funding.

Assuming passage of the Governor's tax initiative, the minimum guarantee for 2011-12 would rise to \$48.3 billion, an increase of \$661 million. The Governor's Budget does not propose to appropriate this funding in the current year but instead assumes this funding will be provided to schools as a future "settle-up" payment¹.

2012-13 Adjustments. For 2012-13, the Governor's Budget provides a minimum guarantee of \$52.5 billion. This level of funding assumes approval of the Governor's tax measure as well as a series of base funding level adjustments. Roughly, \$2 billion of the increase in the minimum guarantee is attributable to the tax initiative. The remaining increase is due to several adjustments or "rebenching" of the guarantee.

Rebenching adjustments. The Governor's Budget proposes a number of modifications to Proposition 98 calculations, also known as "rebenching". According to the LAO, this practice has occurred in prior years to prevent certain state actions from having unintended consequences on the Proposition 98 minimum guarantee. For example, in 1993-94, the state required cities and counties to shift \$2.6 billion in property tax revenues to schools and community colleges to achieve state General Fund savings. To ensure that the shift in revenue provided state savings, the State rebenched the Proposition 98 calculation so the additional property tax revenue would not increase the minimum guarantee.

According to the LAO, prior to 2011-12, the State had rebenched for a number of local property shifts using a methodology known as the 1986-87 approach. Under this approach, when shifting property taxes to or away from schools, the State rebenches the Proposition 98 calculation by determining the percent change in school property tax revenues due to the shift and then applying that same percent change back to school property tax revenues in 1986-87. This rebenching approach increases or decreases the State's General Fund obligation in response to the property tax change assuming

¹ A settle-up obligation is created when the minimum guarantee goes up after the budget has been enacted (the difference is deemed settle up)

the shift had been implemented the year prior to the enactment of Proposition 98. While the local and state shares of Proposition 98 funding are affected, the intent of the rebenching is to leave the minimum guarantee itself unaffected. This approach, however, can result in unexpected fiscal effects. Using this approach, a \$2 billion shift in property tax revenues to schools, for example, might only provide \$1.5 billion General Fund savings. This is because the share of the Proposition 98 obligation covered by local property taxes has changed over time. In 1986–87, local property tax revenues represented a smaller share of Proposition 98 funding than today. When the shift is applied to property tax revenues in 1986–87, the shift therefore reduces the General Fund obligation by a smaller amount than one might expect.

The Governor's Budget assumes the following "rebenching" adjustments:

- 1) Child Care Funding Shift. The 2011-12 budget provided a \$1.134 billion decrease in the minimum guarantee to reflect the shift of funding for most child care programs from Proposition 98 General Fund to non-98 General Fund. When the state made this shift in 2011-12, it was based on the current value of the shift. The Governor proposes to instead rebench the 2011-12 funding shift based upon the 1986-87 costs for child care programs. This adjustment increases the minimum guarantee by an additional \$298 million in 2012-13, compared to the 2011-12 Budget Act.
- 2) Mental Health Shift. The 2011-12 Budget Act provided an increase of \$221.8 million in Proposition 98 funding to reflect a shift in responsibility for the provision of educationally related mental health services for students with disabilities from counties to K-12 schools. Similar to the child care funding, the shift was based on the current value of the shift. The Governor proposes to rebench this 2011-12 funding shift based upon the 1986-87 costs for these mental health programs. This change reduces the minimum guarantee by \$197 million in 2011-12.

In addition, the Governor proposes an additional adjustment of \$98.6 million for special education mental health services in 2012-13 to cover costs funded in 2011-12 out of Proposition 63 funds, ensuring the guarantee is fully adjusted for the program. This change increases the minimum guarantee by \$5 million in 2012-13.

- 3) Redevelopment Agencies (RDAs). The 2011–12 budget package included two bills related to dissolution of redevelopment agencies that would have required remittance payments and property taxes to be redirected from dissolved redevelopment agencies to schools. When the bills were enacted, it was estimated that these payments would provide a total of \$1.7 billion to schools in 2011–12 and \$400 million each year thereafter. The state rebenched the Proposition 98 calculation to achieve \$1.7 billion in state General Fund savings from the remittance payments in 2011–12, with schools receiving no increase in their total Proposition 98 funding. Moving forward, the \$400 million was to have been in addition to Proposition 98 appropriations (no rebenching was to occur).

A recent California Supreme Court decision on last year's legislation resulted in the elimination of RDAs and a different allocation of related property tax revenue to schools and community colleges. Due to the court decision, estimated

revenues for schools and community colleges dropped from \$1.7 billion to \$1.1 billion in 2011-12. The Governor's Budget proposes to continue \$1.1 billion in offsetting local property taxes in 2012-13 due to the elimination of RDAs and rebench this adjustment based on 1986-87 property taxes. This adjustment increases the minimum guarantee by in 2011-12 by \$267 million. The Governor's budget also proposes to rebench the minimum guarantee for these revenues in 2012-13 and the next several years (as redevelopment-agency debt is retired), ensuring ongoing General Fund savings as a result of the elimination of redevelopment agencies.

- 4) Gas Tax Swap. The Governor's Budget proposes to eliminate existing provisions that require the state to rebench for the "gas tax swap" adopted by the Legislature in 2011, reducing the minimum guarantee by \$596 million. The gas tax swap eliminated the sales tax on gasoline (previously included in the Proposition 98 calculation) and replaced it with an increase in the excise tax on gasoline (excluded from the Proposition 98 calculation). Absent a rebenching, the minimum guarantee would have decreased due to the loss of gas tax revenues.

Proposition 98 spending mostly dedicated to paying down deferrals. While the Governor's Budget provides an increase of \$4.9 billion to Proposition 98 over the 2011-12 Budget Act funding level, programmatic spending remains flat. This is because the Governor dedicates most of the year-to-year increase to backfilling one-time solutions from 2011-12 and paying down existing K-14 deferrals.

The State has relied heavily on deferring Proposition 98 payments as a way to achieve budgetary savings in difficult fiscal times. According to the LAO, 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. In the current year, a total of \$10.4 billion in Proposition 98 payments are being paid late (roughly 21 percent of total Proposition 98 support).

The length of deferrals have also increased over time. Initial deferrals were only a few weeks. The state now defers payments as long as nine months (with the longest deferral stretched from January to October). 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.

Governor's Proposal. Of the \$4.9 billion increase to Proposition 98, \$2.4 billion is used to backfill one-time solutions (largely deferrals) for 2011-12 and \$1.8 billion is used to pay down additional deferrals. According to the LAO, the proposal generally reduces late payments in the months that currently have the largest share of payments deferred, thereby providing roughly the same amount of state funding each month from February through June. (The Administration also assumes the state will need to rely once again on intra-year deferrals to achieve savings in certain months when the state is cash poor, including the start of the fiscal year.)

Other Proposition 98 spending proposals. Below are the other notable spending proposals. The LAO will provide a chart to the Subcommittee on these specific spending proposals:

- **Growth adjustments.** The Governor's Budget provides \$158.2 million for revenue limits to reflect projected K-12 student population growth. The budget proposes to provide \$12.2 million for special education growth. Charter school categorical programs are provided an increase of \$56.6 million. A small increase of \$588,000 is provided for preschool slots.
- **Program reductions and eliminations.** The Governor's Budget contains a few program reductions and eliminations, including reductions in preschool funding, savings from choosing not to initiate the Transitional Kindergarten (TK) program, and the elimination of the Early Mental Health Initiative. All of these issues will be discussed in more detail at later hearing dates.
- **Changes to the January spending plan.** Under the Governor's January proposal, the Home to School Transportation program was proposed to be eliminated. The Administration has changed their proposal and would now fund the program for one year at a cost of \$540 million. The Administration also proposes to hold districts harmless under their weighted pupil formula proposal for one year at a cost of \$90 million dollars. The Administration paid for these adjustments by lowering the deferral pay down from \$2.4 billion to \$1.8 billion.

No COLA Funding. Current law requires that a COLA be applied annually to revenue limits and most K-12 categorical programs in order to reflect the higher costs that schools face due to inflation. The statutory K-12 COLA is based on an index that measures changes in costs experienced by state and local governments. School districts generally use COLAs to provide annual increases to employee salaries and address cost increases for local operating expenses, including employee benefits, utilities, materials, and supplies.

Due to the state budget crisis, the state has not provided COLAs in recent years. Deficit factors have been established in these years to keep track of the foregone COLA for revenue limit programs, so revenue limit funding could eventually be restored to previous base levels. The Legislature is not required to create a deficit factor for revenue limits when no COLA is provided; however, the Legislature has adopted the practice of establishing deficit factors for revenue limit programs -- based upon statutory COLA rates -- when COLA has not been provided.

For 2012-13, the statutory COLA for K-12 programs is 3.17 percent or a cost of \$1.24 billion. The Governor does not propose to provide COLA to any programs in 2012-13 but does intend to establish a deficit factor to account for foregone COLAs in the budget year and prior years.

PROPOSITION 98 AND THE GOVERNOR'S BACK UP PLAN

Mid-year Trigger Reductions. If the Governor's tax measure is not adopted, the budget contains a total of \$5.4 billion in trigger reductions. Of these reductions, \$4.8 billion (nearly 90 percent) would be reduced from schools and community colleges. In terms of programmatic spending cuts, K-12 general purpose funding is proposed to be reduced by \$2.76 billion and community colleges would need to cut spending by \$292 million. The Administration has not yet proposed specific language on how these trigger reductions would occur. Below is more detail on how the reductions would occur:

- **Baseline revenue drop.** Proposition 98 drops by \$2.4 billion due to the loss of the new tax revenues. The Governor proposes to rescind buying down roughly \$1.8 billion in K-14 inter-year deferrals (\$1.6 billion for school districts and \$218 million for CCC apportionments). The remaining \$400 million gap would need to be bridged with programmatic reductions.
- **Debt Service Shift.** The Governor proposes to shift debt service on school bonds inside Proposition 98. Historically, debt service has been funded outside of Proposition 98. The Governor's Budget proposes to shift the cost, \$2.6 billion, into Proposition 98. However, when calculations are done to "rebench" or adjust the Proposition 98 base per 1986-87 formulas, the minimum guarantee only goes up by \$200 million. This is because in 1986-87 debt service was relatively low. Rebenching in this manner allows the Governor to shift \$2.6 billion in costs into Proposition 98 with minimal effect on the minimum guarantee. As a result of this cost shift, schools must make programmatic reductions of \$2.4 billion, which the Governor equates to eliminating three weeks of instruction from the school year.

Realignment sales tax revenue excluded. The 2011-12 budget package removed \$5.1 billion in sales tax revenues from the Proposition 98 calculation to reflect the redirection of specific state sales tax revenues to local realignment. As a result, these sales tax funds were excluded from the Proposition 98 calculation in 2011-12 and reduced the minimum funding guarantee by \$2.1 billion. Per AB 114 (Committee on Budget), Chapter 43, Statutes of 2011, these sales tax exclusion provisions are operative beginning in 2011-12, only if: (1) these changes are authorized via ballot measures prior to November 17, 2012; and, (2) new funding is provided for K-12 schools and community colleges equal to the amount that would have otherwise been provided if specified sales tax revenues were General Fund. If these conditions are not met, sales tax funds that would have been provided to Proposition 98 in 2011-12 prior to this shift would have to be calculated and repaid to K-12 schools and community colleges -- over a five year period beginning in 2012-13. In subsequent fiscal years, these sales tax revenues would be included in the calculation of the minimum guarantee. This issue is currently being litigated.

The Governor's contingency package would not count the realignment-related sales tax revenue toward the Proposition 98 minimum guarantee. According to the LAO, this treatment of the realignment revenues is risky. If the revenues were to count toward the guarantee, the guarantee would increase roughly \$1.7 billion (from \$50.3 billion to \$52 billion) and the Governor's contingency plan would need to be modified. This could be done by suspending the guarantee to achieve the same level of savings proposed or the state could fund the higher Proposition 98 minimum guarantee and implement \$1.7 billion in trigger reductions in other areas of the state budget.

PROPOSITION 98: WALL OF DEBT

According to the Governor's Budget summary, the state's current budget problem is "exacerbated by an unprecedented level of debts, deferrals, and budgetary obligations." The Governor's "wall of debt" identifies \$33 billion in total outstanding budgetary borrowing. According to the Department of Finance, this includes \$17.4 billion in Proposition 98 related funding obligations.

Governor's Budget -- Outstanding Budgetary Borrowing (Dollars in Billions)	
Deferred payments to K-12 schools and community colleges	10.4
Unpaid state mandate costs to K-12 schools and community colleges	3.6
Underfunding of Proposition 98:	3.4
-Proposition 98 Settle-Up	(1.9)
-Quality Education Investment Act	(1.1)
-Emergency Repair Program	(0.5)
Total K-14 Education	\$17.4

Source: Department of Finance

In addition to the obligations above, the LAO would include the obligation to restore revenue limit deficit factors, maintenance factor, debt service and pension benefits. It should be noted that in some cases the State can retire two or more obligations at the same time. For example, the State can retire maintenance factor obligations by spending the required extra monies on deferral, mandate, and revenue limit obligations. Settle-up obligations also can be retired at the same time as these three other obligations. The LAO will provide a comprehensive chart to the Subcommittee displaying all outstanding obligations. Below is a description of some of the major obligations:

- **K-14 Inter-Year Payment Deferrals.** As previously discussed in this agenda, the State has relied heavily on inter-year deferrals to achieve budget solution. As a result, ongoing Proposition 98 payment deferrals totaled \$10.4 billion for K-12 schools and community colleges in 2011-12. The Governor proposes to reduce K-14 deferrals by \$1.8 billion in 2012-13, reducing total inter-year deferrals to \$8.6 billion.
- **K-14 Education Mandate Backlog.** The Department of Finance estimates that the state's backlog of unpaid, K-14 mandate claims totaled \$3.6 billion at the end of 2011-12. These unfunded balances resulted in part from the practice of deferring annual mandate payments as a means of achieving budget savings.

The courts have clarified that K-12 schools and community colleges must fully fund, suspend, or eliminate mandates, so the state can no longer defer mandate payments. The Governor proposes a number of reforms to the K-14 education mandate system beginning in 2012-13. This proposal will be discussed in detail at a subsequent hearing.

- Quality Education Investment Act (QEIA). The Governor's Budget includes \$450 million in General Funds to support the QEIA program in 2012-13, which originated with a \$2.8 billion Proposition 98 "settlement" agreement in 2006-07. Of this amount, \$402 million is provided to schools and \$48 million is provided to community colleges. Per statute, the State will be required to make payments through 2014-15 in order to pay off \$1.1 billion in remaining funds owed per the settlement agreement.
- Emergency Repair Program. In 2004, the State settled the *Williams v. California* case, a class-action lawsuit filed on behalf of public school students. In response to the settlement, the Legislature created the Emergency Repair Program (ERP), which provides grants for critical health and safety repairs in certain low-performing schools. Per statute, the State is required to provide a total of \$800 million over the life of ERP to meet the requirements of the settlement. The State has appropriated \$343 million for the program to date, leaving \$457 million in remaining funds owed for ERP. In recent years, full funding for the program has been suspended due to budget shortfalls. The Governor proposes \$12.3 million in one-time Proposition 98 reversion funds for ERP in 2012-13.
- Revenue Limit Deficit Factor Obligations. Revenue limits provide the primary form of general purpose (discretionary) funding for K-12 local agencies -- school districts and county offices of education. Revenue limits are funded through both property taxes, and state General Fund and allocated on the basis of student enrollment, as measured by average daily attendance (ADA). Funds are continuously appropriated by statutes that continue base funding, adjusted by cost-of-living adjustments (COLAs). As discussed previously in this agenda, the state has not provided a COLA to revenue limits in recent years due to insufficient funds but has established a statutory deficit factor to keep track of what would have otherwise been provided. The Governor's Budget reflects deficit factors of 21.666 percent for school districts and 22.497 percent for county offices in 2012-13. It would cost the State approximately \$9 billion to eliminate these deficit factors and fully restore revenue limit base funding and statutory COLAs to K-12 local agencies.
- Maintenance Factor. As discussed at the beginning of the agenda, maintenance factor is created under Proposition 98 when the State provides less funding to education, generally due to sluggish General Fund revenue growth. A constitutional formula is used to determine when and how much maintenance factor is to be paid. The State is currently carrying a maintenance factor of \$10.6 billion.

Governor's Proposal. The Governor proposes to retire five of the obligations totaling over \$17 billion with a multi-year plan. The Administration plans to retire the deferral and mandate obligations (roughly \$14 billion) using natural growth in the Proposition 98 minimum guarantee. The remaining obligations would require non-Proposition 98 General Fund monies to retire. The Governor's plan would pay off these obligations in installments over a four-year period, beginning in 2012–13. For most obligations, payments are not spread evenly over the period. For example, the Governor proposes making a very large (almost \$5 billion) deferral pay down in 2014–15 and a very large (almost \$3 billion) mandate payment in 2015–16.

PROPOSITION 98: IMPACT OF BALLOT INITIATIVES

As discussed throughout this agenda, the Governor's Budget plan for Proposition 98 is largely predicated on the passage of his November ballot initiative. Currently there are several initiatives circulating along with the Governor's initiative, though none have officially qualified for the ballot at this stage. The LAO will provide the Subcommittee with a brief overview of the status of the initiatives circulating that could affect education funding.

LAO COMMENTS ON THE GOVERNOR'S BUDGET

The Legislative Analyst's Office offers the following considerations for the Legislature with regard to the Governor's Budget and Proposition 98:

- **Recommend Consistency in Rebenching Approach.** The LAO has no major concerns with the Governor's proposal to eliminate the rebenching for the gas tax swap. Given the state has not historically made adjustments to the minimum guarantee for increases or decreases in existing tax rates, the LAO does not think a compelling reason exists for making an adjustment for this one specific tax change. Regarding the Governor's other rebenching proposals; the LAO is concerned by the lack of consistency in the rebenching approach across years. In particular, they are concerned that frequent changes in the approach can result in arbitrary changes to the Proposition 98 minimum guarantee from year to year and allow otherwise technical calculations to be used as a way to meet other objectives.
- **Serious Policy Concerns With Debt Service Proposal.** According to the LAO, from a policy perspective, counting debt service payments to the guarantee is problematic. This is because the size of annual debt service payments is significantly more volatile than the annual changes in the Proposition 98 minimum guarantee. Whereas debt service payments are linked with the timing of voter-approved bond measures and state bond sales, the minimum guarantee is linked with changes in student attendance and growth in the economy or state revenues. Since the enactment of Proposition 98 in 1988, had debt service payments been counted toward the minimum guarantee, they would have equated to as much as 5.1 percent and as little as 0.5 percent of Proposition 98 spending. That is, in some years, particularly after a new bond measure passed, debt service payments could increase notably, potentially requiring Proposition

98 programmatic cuts to make room for the higher payments. In other years, debt service payments could decrease notably, potentially resulting in the need to make big Proposition 98 programmatic increases. In both cases, what otherwise would have been relatively stable school and community college operations will be partly driven by bond-related factors rather than an assessment of operational needs. Absent a clear, compelling policy rationale, the LAO questions why the State would want to change its longstanding education facility funding practices, particularly when the change results in a significant reduction in funding for school and community college operations.

- **Prioritizing Deferral Pay Downs Reasonable, Particularly Given Uncertainty of Revenues.** If the state has additional Proposition 98 resources to spend in 2012–13, the LAO recommends the Legislature take the Governor's approach and retire some existing K–14 payment deferrals rather than provide K–14 program augmentations. This would help mitigate the existing cash management problems that many school districts and community colleges face as a result of the State's late payments. In addition, given the uncertainty of the Governor's revenue proposals, setting aside additional Proposition 98 funding from the ballot measure for paying down deferrals could be less disruptive to districts than earmarking the monies for programmatic funding increases. That is, if the Governor's proposed ballot measure is rejected by voters, it will be easier for school districts and community colleges to retain existing short-term borrowing options than to make midyear programmatic reductions.
- **Multi-year “wall of debt” plan.** The Governor's Budget package contains a multiyear plan for retiring certain school and community college obligations. The LAO thinks building such a plan is prudent budgeting practice. Though they believe the Governor's multiyear proposal is a solid starting point, they have several suggestions for modification should the Legislature choose to adopt such a plan.
 - The LAO recommends scheduling payments over a longer time period. By extending the payment period just one year (through 2016–17), for instance, the LAO suggests the Legislature could build a more realistic plan that more likely could be implemented on schedule. For example, if deferral payments were spread evenly over a five-year period (2012–13 through 2016–17), the State would be scheduled to pay \$2 billion in 2014–15 rather than almost \$5 billion scheduled for payment under the Governor's plan. Spreading out payments evenly over a longer time period would increase the likelihood the State could afford to make the annual associated payments.
 - Designate Settle-Up Funds for Mandates or Deferrals. Because the state may use settle-up payments for any one-time purpose, the LAO recommends using them to help retire other outstanding Proposition 98 obligations, with the two best candidates being K–14 mandates and K–14 payment deferrals. In prior years, the State has used this approach—scheduling out settle-up payments over a number of years and using them to pay down the K–14 mandate backlog. Given the K–14 mandate

backlog (\$3.5 billion) exceeds the State's existing settle-up obligation (\$2.5 billion), settle-up could be used solely for this purpose. The state, however, also could use the funds to pay down existing K-14 deferrals. Somewhat different districts would benefit from the two approaches. If used for mandates, the funds would be allocated to roughly one-third of districts—typically midsize to large districts. If used for deferrals, the funds would be allocated across most districts but would provide particular benefit to districts that rely heavily on state payments (often linked with lower property wealth districts).

- Reduce State Costs by Recognizing and Redirecting Certain Program Savings. QEIA schools that fail to meet five program requirements are to have funding terminated beginning in 2012-13. Based upon preliminary information, program costs could be about \$140 million less beginning in 2012-13. The State could use any freed-up QEIA funding to first retire Emergency Repair Program (ERP) costs, which are related to the *Williams* settlement. The QEIA and ERP programs are designed for similar types of schools (those performing low on the Academic Performance Index). Though the State has designated statutorily that Proposition 98 Reversion Account funding be used for ERP, a statutory change could be made to use the freed-up QEIA funds to accelerate ERP payments.

STAFF COMMENTS

Given that, the level of funding provided under Proposition 98 is driven by state revenues, it is important to have the most up to date information before taking action on program funding under Proposition 98. The LAO estimates in their *Economic and Revenue Update*, that General Fund revenue will be \$3 billion less than the Administration's estimates for 2011-12 and \$3.5 billion less for 2012-13. Given this uncertainty, the LAO recommends, and staff agrees, that major Proposition 98 decisions should not be finalized until updated May revenue estimates are available.