# California State Assembly

# Agenda

## Assembly Budget Subcommittee No. 3
## on Education Finance

**Assemblymember David Alvarez, Chair**

**Tuesday, February 27, 2024**
**9:00 A.M. – State Capitol, Rm 447**

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**Public Comment will be taken in person after the completion of all panels and any discussion from the Members of the committees.**

# Items To Be Heard

## 6100 California Department of Education
## Proposition 98: All Agencies

### Issue 1: Proposition 98 Guarantee Overview & Rebench Proposals

This issue will cover the Proposition 98 guarantee, as projected in the Governor's Budget, for the 2022-23, 2023-24, and 2024-25 Budget years. This issue will also cover the Governor's Budget proposals to calculate Universal Transitional Kindergarten (UTK) enrollment and meet the requirements of Proposition 28, as they impact the Proposition 98 guarantee.

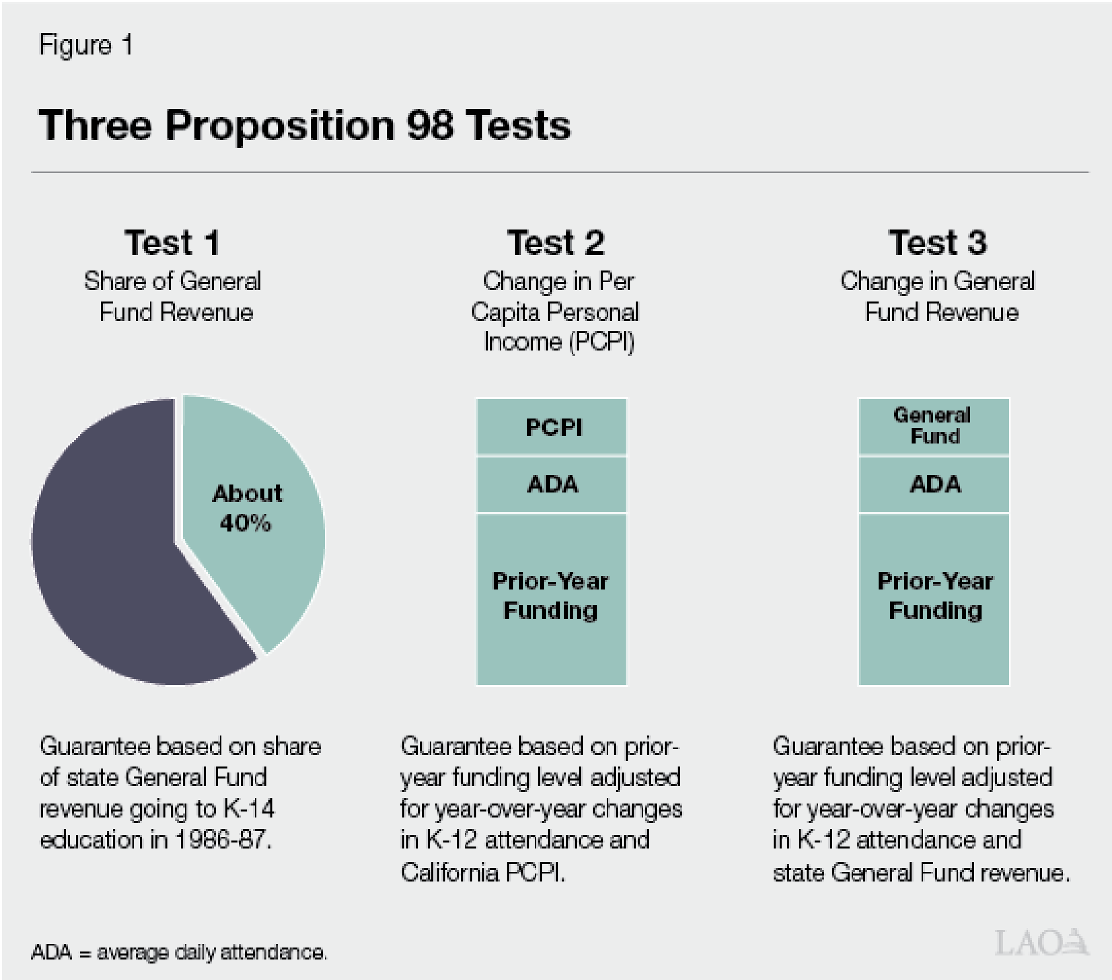
### Panel

- Alex Shoap, Department of Finance
- Kenneth Kapphahn, Legislative Analyst's Office

### Background

The California Constitution sets forth three main tests for calculating the Proposition 98 minimum guarantee. Each test takes into account certain inputs, including General Fund revenue, per capita personal income, and student attendance (LAO Figure 1 below). Test 1 links school funding to a minimum share of General Fund revenue, whereas Test 2 and Test 3 build upon the amount of funding provided the previous year. The Constitution sets forth rules for comparing the tests, with one of the tests becoming operative and used for calculating the minimum guarantee that year. Although the state can provide more funding than required, it usually funds at or near the guarantee. With a two-thirds vote of each house of the Legislature, the state can suspend the guarantee and provide less funding than the formulas require that year. The guarantee consists of state General Fund and local property tax revenue.

The state makes an initial estimate of the guarantee when it enacts the annual budget, but this estimate typically changes as the state updates the relevant Proposition 98 inputs. Specifically, the state recalculates the guarantee at the end of the year based on revised estimates of these inputs, followed by a second recalculation at the end of the following year. When the guarantee exceeds the initial budget estimate, the state must make a one-time payment to "settle up" for the difference. If the guarantee drops, the state can reduce spending to the lower guarantee. After making these revisions, the state finalizes its calculation of the guarantee through an annual process called "certification." Certification involves the publication of the underlying Proposition 98 inputs and a period of public review. The most recently certified year is 2021-22.




## Rebenching the Proposition 98 Guarantee

Modifications to the Proposition 98 guarantee calculations under either of the three “tests” are commonly known as a “rebench.” The state constitution is silent on whether the Proposition 98 minimum guarantee can be adjusted to account for policy changes, but a rebench has been adopted in prior years to prevent certain state actions from having unintended consequences on the Proposition 98 minimum guarantee. In prior rebench budget actions, the state adjusted the total Guarantee for the single fiscal year value of the shift, thereby ensuring that it achieved an associated dollar–for–dollar impact. For example, the removal of child care programs from the Proposition 98 calculation resulted in a $1.1 billion reduction in the guarantee, and the shift of responsibility for student mental health services from counties to school districts resulted in a $222 million increase in the guarantee.

The 2021-22 Budget agreement included shared Administrative and Legislative intent to rebench the Proposition 98 guarantee to accommodate the growth of ADA for Universal Transitional Kindergarten (UTK). This agreement and statutory timeline would add new UTK enrollment in Budget years 2022-23, 2023-24, 2024-25, and 2025-26. The intent is that the Proposition 98 guarantee would be rebenched in each year of statutory UTK enrollment growth, to reflect the actual costs of the new grade's ADA. The intent of the agreement is to create adequate room inside the guarantee in each year TK enrollment is required to expand in statute, and then adjust for actual enrollment changes.

The 2023-24 Budget agreement also included shared Administrative and Legislative intent to rebench the Proposition 98 guarantee for nearly one billion dollars in new arts funding, as required by Proposition 28.

## Governor's 2024-25 Budget

The Governor's Budget revises the state's projected Proposition 98 guarantee of $107.36 billion in the 2022-23 fiscal year, down to $98.3 billion. The Governor's Budget revises the state's projected Proposition 98 guarantee of $ 108.3 billion in the current year, down to $105.6 billion. Both the 2022-23 and 2023-24 Budget years remain in a Test One calculation.

For 2024-25, the Governor's January Budget provides a total of $109.1 billion for Proposition 98 funding, $1.6 billion above the Test One guarantee level, for state preschool, TK-12 public education, and community colleges. $630 million reflects the Administration's TK enrollment projections in 2024-25. The January Budget also assumes the rebenching of Proposition 98 in 2024-25 for the inclusion of over $930 in annual arts education funding, as authorized by the voters in 2022 through Proposition 28.

The Governor's budget proposes to reduce General Fund spending on schools to align with the lower January estimates of the minimum guarantee. The budget implements these reductions primarily through cost shifts and other one-time solutions that would not have any immediate effect on school district budgets.

This downward revision is the largest reduction to the guarantee in a prior year since the passage of Proposition 98 in 1988. By contrast, previous downward revisions to the prior-year guarantee have never been larger than a couple hundred million dollars.

### Comparing June 2022 and June 2023 Proposition 98 Estimates

*(In Millions)*

| | 2022-23 | | | 2023-24 | | |
|---|---|---|---|---|---|---|
| | June 2022 Enacted | June 2023 Revised | Change | June 2023 Enacted | Change From 2022-23 Revised | Change From 2022-23 Enacted |
| **Minimum Guarantee** | | | | | | |
| General Fund | $82,312 | $78,117 | -$4,195 | $77,457 | -$660 | -$4,855 |
| Local property tax | 28,042 | 29,241 | 1,199 | 30,854 | 1,613 | 2,812 |
| **Totals** | **$110,354** | **$107,359** | **-$2,995** | **$108,312** | **$953** | **-$2,042** |
| **Funding by Segment** | | | | | | |
| K-12 schools | $95,524 | $93,241 | -$2,283 | $94,953 | $1,712 | -$571 |
| Community colleges | 12,606 | 12,331 | -275 | 12,456 | 125 | -150 |
| Reserve deposit | 2,224 | 1,787 | -437 | 903 | -885 | -1,322 |

**Source: LAO**

The Administration is estimating moderate growth in property tax revenue. The January Budget estimates assessed values will grow 5.1 percent in 2023-24 and 4.7 percent in 2024-25. This growth assumption is somewhat below the historical average of about 5.5 percent. The administration also anticipates that some smaller property tax components will grow more slowly. Accounting for all of these factors, the overall increase in local property tax revenue is about 4 percent in each year.

Under the administration's multiyear forecast, the Proposition 98 guarantee would grow to $111.9 billion in 2025-26, an increase of $2.8 billion (2.6 percent) from the 2024-25 level. This relatively small increase builds upon underlying assumptions of minimal growth in General Fund revenue (0.5 percent) and moderate growth in property tax revenue (4.3 percent). Approximately $1.1 billion of this increase in the guarantee is attributable to an adjustment for TK.

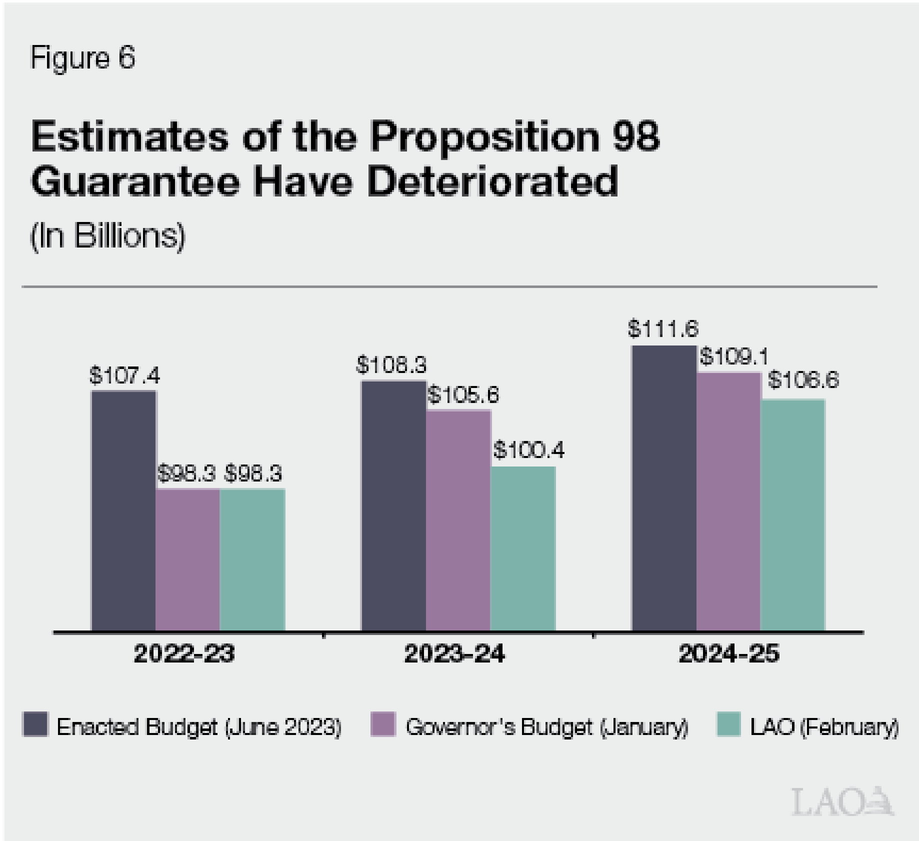
## LAO Comments

***State Tax Collections Through January Have Been Weak.*** Whereas the Governor's budget anticipates a relatively strong rebound in General Fund revenue for 2023-24, state tax collections through January point to continuing weakness. Tax receipts from regular income tax withholding (the largest portion of the personal income tax) came in $1 billion (11 percent) below the estimates in the Governor's budget. Receipts from the quarterly estimated payments (the other major contributor to personal income tax revenue) were even worse, coming in $3 billion (27 percent) below the Governor's budget estimate. The state experienced additional weakness in its two other major revenue sources, with corporation tax payments significantly below projections and sales tax revenue slightly below projections. Consistent with these trends, economic indicators that are important for state revenue collections also have remained weak. For example, investment in California startups and technology companies remains depressed, and relatively few California companies are going public (selling stock to public investors for the first time).

***Our February General Fund Revenue Estimates Are Well Below the Governor's Budget Level.*** Based on the recent tax collection data, we see a high level of downside risk to the revenue estimates in the Governor's budget. Specifically, our updated estimate of General Fund revenue (released in February) is $15.3 billion lower than the administration anticipates in 2023-24 and $8.4 billion lower in 2024-25. (Across both years, these estimates are $8.4 billion lower than the estimates from our December outlook.) As Figure 4 shows, uncertainty remains for both years and final tax receipts could be higher or lower than we anticipate. Despite this uncertainty, our assessment of the most plausible scenarios (represented by the shaded area in the figure) indicates a low probability that revenues approach the levels in the Governor's budget.

***Our Local Property Tax Estimates Are Slightly Above the Governor's Budget Level.*** Whereas our estimates of General Fund revenue are well below the levels in the Governor's budget, our estimates of property tax revenue are somewhat higher. Specifically, the estimates from our December outlook are $590 million higher in 2023-24 and $682 million higher in 2024-25. Approximately one-third of this difference is due to our higher estimates of growth in assessed property values, another one-third is due to our higher estimates of supplemental taxes (taxes levied on properties sold during the year), and the remaining one-third is due to various differences in several smaller property tax components. Preliminary data suggest that property tax revenues are tracking closer to our higher estimates. Most notably, recent data from the Board of Equalization show that assessed property values grew nearly 6.7 percent in 2023-24, compared with the estimate of 5.1 percent in the Governor's budget.

***Our Estimates of the Guarantee Are $7.7 Billion Below the Governor's Budget Level.*** In Test 1 years like 2023-24 and 2024-25, changes in General Fund revenue and local property tax revenue both have direct effects on the Proposition 98 guarantee. Specifically, our lower General Fund revenue estimates reduce the guarantee by nearly 40 cents for each dollar of lower revenue. Increases in local property tax, however, increase the Proposition 98 guarantee on a dollar-for-dollar basis. Accounting for our February estimates of General Fund revenue and our December 2023 estimates of local property revenue, we estimate the Proposition 98 guarantee is $7.7 billion lower than the Governor's budget level over the period. Specifically, our estimates are $5.2 billion lower in 2023-24 and $2.5 billion lower in 2024-25 (Figure 5). For 2022-23, our estimates are unchanged from the Governor's budget level. As Figure 6 shows, our estimates of the guarantee represent even steeper reductions when measured against the levels the state anticipated in June 2023.




### Staff Comments

The prior year, current year, and Budget Year Proposition 98 funding levels and relevant proposals will be considered as part of the Final Budget guarantee estimate, and so no action will be recommended until after the May Revision.

The prior year revenues and guarantee formula impacts are known: the January Budget estimates a $9.05 billion reduction to the Test One calculation, as rebenched, compared to the enacted 2022-23 Budget Act.

**Protect Priorities.** The final Budget deal created a one-time spending buffer inside the 2022-23 Proposition 98 guarantee of over $3 billion, and a multi-year one-time spending package of over $15 billion. While the January Budget does not propose eliminating or delaying most of these one-time expenditures, the estimated $8 billion one-time shortfall will require a re-prioritization of investments over the multi-year budget forecast. The Assembly's commitment to protect ongoing classroom funding may require a reexamination of all one-time appropriations.

**Rebenching in a Recession.** The final UTK rebench in any budget year is intended to reflect actual enrollment growth. The Administration estimates that the full price tag for new enrollment will be approximately $3 billion through 2025-26. Recent budgets have enjoyed both General

Fund and Proposition 98 growth and surplus: as economic growth slows, the availability of General Fund for the rebench may come at a steep cost to programs funded outside the Proposition 98 guarantee. According to DOF, the annual variance in rebenching could range from $50 million to $200 million a year, based on factors like volatile post-pandemic ADA and UTK uptake rates.

**The Rebench Split.** According to DOF, the Governor's Budget proposes to maintain the Proposition 98 split between TK-12 schools and community colleges at 89.07% for TK-12 and 10.93% for community colleges across the budget window. Funding for other education agencies, adult education, adults in correctional facilities, and the K-12 adults in correctional facilities is taken off the top before computing this split.

Because the cost of expanded TK and Proposition 28 arts funding is unique to TK-12 schools, the reason for making this rebench subject to a split with community colleges is unclear.

**Early & Accelerated UTK Plans.** According to California Department of Education (CDE) surveys, many large LEAs planned to accelerate their new TK enrollment in the current year, including Long Beach, Los Angeles, San Diego, and Fresno USDs. These LEAs are offering TK enrollment to children younger than the statutory expansion timelines. While these younger students do not earn ADA in the Budget Year, they may impact near-term enrollment counts, and thus rebench calculations, dramatically. CDE should have an update on UTK enrollment for the current year later this spring.

**<u>Suggested Questions:</u>**

- What is the total revenue drop necessary to exit Test 1 in the current year? Budget Year?
- If the TK rebench is intended to accommodate TK enrollment growth, why is the funding subject to a split with Community Colleges?
- If the Prop 28 rebench is intended to accommodate TK-12 arts funding growth, why is the funding subject to a split with Community Colleges?
- What is the estimated 2023-23 enrollment growth from LEAs for Early TK?
- With economic softening, what is risk of over-estimating the rebench and ratio needs in the Budget Year?

**Staff Recommendation:** Hold Open.

## Issue 2: Public School System Stabilization Account Overview & Proposals

This issue will cover the Public School System Stabilization Account (PSSSA) contributions and proposed withdrawals in the January Budget, as projected for the 2022-23, 2023-24, and 2024-25 Budget years.

## Panel

- Alex Shoap, Department of Finance
- Kenneth Kapphahn, Legislative Analyst's Office

## Background

Proposition 2 (2014) established the PSSSA or “Prop 98 Rainy Day fund”, a constitutional reserve account within Proposition 98. The purpose of this reserve is to set aside some Proposition 98 funding in relatively strong fiscal times to mitigate funding reductions during economic downturns. The PSSSA can grow to a maximum of 10% of the Proposition 98 guarantee in the Budget Year. A deposit to the PSSSA was first triggered in the 2019-20 budget.

The 2021-22 budget plan triggered a statutory cap on school district reserves in the 2022-23 fiscal year. The local cap applies the year after the balance in the PSSSA reserve exceeds 3 percent of the Proposition 98 funding allocated to TK-12 schools. The cap prohibits medium and large districts—those with more than 2,500 students—from holding general purpose reserves that exceed 10 percent of their annual expenditures. Districts can respond to the cap by designating their reserves for specific purposes, seeking exemptions from their county offices of education (COEs), or spending down their reserves. When the local reserve cap went into effect in 2022-23, the LAO estimated that approximately 265 LEAs statewide would be impacted, and that districts held a total of $21 billion in reserves.

Under the enacted 2023-24 Budget**,** the state deposited a total of $7.5 billion into this account across the 2021-22 through 2023-24 period—an increase of $1.3 billion compared with the estimates made in June 2022. These deposits brought the total balance in the reserve to $10.8 billion in 2023-24—10 percent of the Proposition 98 guarantee. As long as the balance remains at this 10 percent threshold, the constitutional formulas do not require additional deposits. The balance in the Prop 98 Rainy Day Fund also makes the statutory cap on local school district reserves operative for another year.

The Constitution provides two reserve withdrawal options. The first requires the state to withdraw funds from the reserve if the guarantee is below the prior-year funding level, as adjusted for student attendance and inflation. The amount withdrawn equals the difference between the prior-year adjusted level and the actual guarantee, up to the full balance in the reserve. If the Governor declares a budget emergency, the Legislature may withdraw any amount from the reserve or suspend required deposits. Unlike other state reserve accounts, the Proposition 98 Reserve is available only to supplement the funding schools and community colleges receive under Proposition 98.

## Governor's 2024-25 Budget

The January Budget now estimates the state is required to make a reduced contribution of $8.8 billion through the Budget year.

The Governor's Budget further proposes a $4.9 billion discretionary withdrawal to cover ongoing LCFF school spending that would otherwise exceed the minimum guarantee in the current and Budget years. The Budget would use $2.8 billion for the Local Control Funding Formula (LCFF) in 2023-24 and $2.1 billion for LCFF in 2024-25. Under the January Budget revenue forecast, these withdrawals would leave $3.9 billion in the reserve for future use. This PSSSA balance continues to exceed the threshold triggering the cap on local school district reserves.

## LAO Comments

***Discretionary Reserve Withdrawal Is Warranted—if Used as a Solution for 2022-23.*** Discretionary withdrawals from the Proposition 98 Reserve are contingent upon the Governor declaring a budget emergency and the Legislature enacting a law authorizing the withdrawal. Although the Governor has not yet declared a budget emergency, the proposal for a withdrawal signals the Governor is open to using reserves as a solution. We share the Governor's view that a reserve withdrawal is warranted, but have concerns about the way the budget would use these funds. Reserves generally provide the greatest benefit for the state budget—and for schools—when the state is facing a large, unexpected shortfall and would need to adopt disruptive alternatives if it did not withdraw reserves. The significant drop in the guarantee in 2022-23 meets all of these conditions. The Governor's budget, however, would use reserves to cover costs in 2023-24 and 2024-25, including to free-up funding for spending increases. Using reserve withdrawals to support new spending seems contrary to the core purpose of the reserve—protecting existing programs—and diminishes an important tool that could mitigate the prior-year shortfall. In addition, the estimate of the Proposition 98 guarantee is higher in 2024-25, making the case for reserve withdrawals that year less compelling.

***Formulas Could Require Withdrawal of Remaining Reserve Balance.*** The constitutional formulas governing the Proposition 98 Reserve generally require withdrawals when the Proposition 98 guarantee is growing slowly relative to changes in inflation and student attendance. Whereas the Governor's budget anticipates relatively strong growth in the guarantee from 2022-23 to 2023-24, our estimate of the guarantee in 2023-24 reflects notably weaker growth. Assuming the state uses a discretionary withdrawal to cover at least a portion of the drop in 2022-23, the constitutional formulas likely would require the state to withdraw the remaining balance in 2023-24. Whereas the Governor's budget has $3.9 billion remaining in the reserve, the state under our estimates would have to allocate this amount for programs.

***Use Reserve Withdrawal to Address 2022-23 Shortfall.*** We recommend building a budget that (1) contains a discretionary reserve withdrawal and (2) directs the entire withdrawal toward addressing the shortfall in 2022-23. Using reserves in this way would help the state accommodate the drop in the prior-year guarantee without resorting to reductions in school programs. In contrast to the Governor's funding maneuver, this alternative works within an existing legal framework, avoids setting a troubling fiscal precedent, and does not worsen future budget deficits. To the extent the state is required to withdraw any funds that remain in the reserve after covering the shortfall in 2022-23, we recommend directing those funds toward existing program costs that would otherwise exceed the guarantee in 2023-24. Using the reserve withdrawals in this way would help the state balance its budget with fewer disruptive changes for schools.

## Staff Comments

**It's Raining.** As intended, the Prop 98 Rainy Day Fund availability, and robust local reserves are available to support reductions to ongoing Proposition 98 growth in the current year, through the Budget Year, even under the LAO's further projected economic downturn.

The issue at hand is how to handle the one-time, historic drop in 2022-23 revenues due to a lack of revenue data. Should the Legislature consider further dipping into the PSSSA to address the one-time shortfall? Conversely, should the Legislature take actions to ensure some Rainy Day funding remains available to protect prior year, ongoing commitments in 2024-25 and 2025-26? Is full COLA in the Budget Year and out years worthy of reserve funding, if the Guarantee is insufficient?

**What About Deferrals?** While Proposition 98 deferrals were not a popular recession maneuver, the availability of local reserves may moderate many LEAs needs to rely on borrowing, should a minor June to July deferral become necessary to support current year or Budget Year spending.

**Suggested Questions:**

- Is it appropriate to fund new ongoing cost increases with Rainy Day funds, as proposed in the January Budget for 2024-25?
- How are LEAs responding to the local reserves cap, triggered for the 2023-24 fiscal year?

**Staff Recommendation:** Hold Open.

## Issue 3: Proposition 98 Accruals & Accounting Proposal

This issue will cover the Governor's Budget proposal to fund the estimated $8 billion shortfall in Proposition 98 funding for the 2022-23 Budget Year, compared to the enacted Budget.

## Panel

- Alex Shoap, Department of Finance
- Kenneth Kapphahn, Legislative Analyst's Office

## Background

Throughout 2022-23, the State Controller distributed funds to schools and community colleges based on program expenditure levels the state initially approved in June 2022 and later modified in June 2023. These expenditure levels aligned with the estimates of the minimum Proposition 98 funding requirement at the time the state approved them. As a result of the state's revenue decline for that year, however, these disbursements now exceed the revised estimate of the minimum requirement by approximately $8 billion. If the state does not want to fund the 2022-23 Proposition 98 guarantee higher than the combined Test One calculation and rebench commitments, the state would need to take legislative action to revise these payments.

This prior year cash shortfall, compared to the enacted and allocated Proposition 98 Budget, is a historic first for the state to grapple.

### Governor's 2024-25 Budget

The Governor's budget proposes no changes to the funds that have already been distributed for 2022-23 on a cash basis—that is, those payments would not be offset or recouped, no one-time or ongoing programs would face reductions, and K-14 districts would not be expected to make any changes in their local budgets. At the same time, however, in order to score budgetary savings, the Governor proposes to delay recognizing these General Fund payments in its budget documents.

Starting in 2025-26, the administration would recognize the 2022-23 General Fund budgetary costs in increments of $1.6 billion annually for five years. The payments would be scored outside of the state's Proposition 98 requirements, meaning they would add to the state's projected deficits in those years.

## LAO Comments

Despite the weak budget position, the state's cash position is currently very strong. Even though revenue projections have declined substantially, the administration projects the General Fund would still have a small cash surplus at the end of the current year. Further, under the same projections, the state would end this year with nearly $100 billion in unused borrowable resources (balances in other state funds). These funds would be available to cover any cash deficits that could occur in subsequent months.

The reason that the state's budget and cash positions have diverged is, in large part, due to undistributed funds. While all of the monies in the State Treasury are committed in some sense—usually to an expenditure or reserve, including an ending fund balance—some of those funds have not yet been *disbursed*.

***Creates a New Type of Budget Solution: Effectively an Interest-Free Loan From the State's Cash Resources.*** Under this proposed maneuver, the state would generate budget savings by not recognizing a budgetary expenditure, despite the fact that the cash has gone out the door. Although it is not technically a loan, the best way to conceptually understand this proposal is that the state would make an interest-free loan to itself using its own cash resources. In short: the unacknowledged $8 billion in cash disbursements in 2022-23 create an outstanding "principal" due from the state's cash resources. The state would make "repayments" on this principle balance beginning in 2025-26 as it acknowledges the cash disbursement on a budgetary basis. In total, the repayments would equal the principal such that there would be no interest payments. While the state does sometimes shift costs between time periods as a type budget solution—as is the case with deferrals—this specific maneuver is unprecedented.

***Obfuscates Budget's True Condition.*** We have major concerns about this proposal from a transparency perspective. The proposal would create a new budgetary obligation on the state that is virtually invisible in budget and cash documents as currently produced by the Department of Finance and State Controller. Further, although this maneuver is clearly a proposal that requires legislative approval, the administration treats it as an "automatic" change in its depiction of the state's budget condition. This has the effect of: (1) reducing the size of the budget problem on paper, and (2) obscuring the proposed solution in the documents presented to the Legislature as part of the Governor's budget. (We explained this dynamic further in our report: *The 2024-25 Budget: Overview of the Governor's Budget*.)

***Creates Binding Obligation That Magnifies Structural Deficit, Likely Requiring More Cuts to Other Programs in the Future.*** The repayments on this maneuver would represent a new, binding obligation on the state. (Although the precise timing of these repayments would be up to the Legislature, the payments would have to occur eventually. Therefore, this proposal is fundamentally different than other kinds of spending delays proposed by the administration.) The state currently faces deficits of around $30 billion per year for the next few years. Given that the state will need to deploy most of its budget tools to address this year's deficit, these future budget problems are likely going to require even more difficult decisions, including ongoing cuts to state programs and/or revenue increases. The future payments on this maneuver would exacerbate these problems, likely requiring the Legislature to make even more difficult decisions as soon as next year. Moreover, the cost of this maneuver would be outside of funding for schools and community colleges. All other state General Fund programs would bear these costs.

***Sets a Problematic Precedent.*** While borrowing to finance a year-end deficit is unconstitutional, the state is permitted to shift its own funds and costs—that is, to internally borrow—to balance the budget. Such cost shifts include, for example, budgetary deferrals (for example, the payroll deferral) and special fund loans. Similar to this proposed maneuver, these tools create long-term obligations in exchange for short-term budgetary relief and some do so by creating discrepancies between cash and budget documents. However, this particular maneuver is new and sets a problematic precedent. It would likely create an expectation that the state would continue to use maneuvers like this to pay for spending in the presence of budget deficits. Even more concerning, in effect, the state's cash position represents the only upper bound to which the state could use a maneuver like this. As long as there is sufficient cash in the treasury, the state could defer the recognition of almost any amount of budgetary expenditure. Eventually, however, the bill comes due—the state cannot defer incurred costs forever. At that time, like under this proposal, the Legislature likely would have to make other spending cuts to repay the "loans."

***Strongly Recommend Rejecting Governor's Proposal.*** This proposed maneuver is bad fiscal policy, sets a problematic precedent, and creates a binding obligation on the state that will worsen out-year deficits and require more difficult decisions. We strongly recommend that the Legislature reject the proposal. In our report, *The 2024-25 Budget: Proposition 98 and K-12 Education*, we set forward some alternative options that would allow the state to maintain school funding while achieving budgetary savings in 2022-23, but without the problematic downsides of this specific proposal.

## Estimate of Unallocated One-Time Grants

*LAO Estimates (In Millions)*

| Program | Amount available |
|---|---|
| Community schools | $2,594 |
| Green school bus grants (first round) | 500 |
| Golden State Pathways Program | 475 |
| Teacher and counselor residency grants | 330 |
| National board certification grants | 205 |
| Inclusive Early Education Expansion Program | 163 |
| Dual enrollment access | 122 |
| Other | 108 |
| **Totals** | **$4,495** |

### Staff Comments

The Administration's proposal to hold schools harmless from any appropriation reductions in the prior year, current year, or ongoing Budget Year projections is the most generous recessionary proposal on record.

While the Administration's proposal directly ties the $8 billion general fund maneuver to backfilling the Local Control Funding Formula's continuous appropriation, there are billions in one-time program funds built into the 2021-22 and 2022-23 Budget Years. These one-time investments were built into those Budget years precisely due to the perceived volatility of revenues at the time, and caution around on-going investments.

**It's Raining.** The Prop 98 Rainy Day Fund availability, and robust local reserves are available to support reductions to ongoing Proposition 98 growth through the Budget Year, even under the LAO's further projected economic downturn. The issue at hand is how to handle the one-time, historic drop in 2022-23 revenues due to a lack of revenue data.

The LAO will detail various prior year recessionary responses and alternatives for the subcommittee, as part of this hearing.

## Suggested Questions:

- How would the Administration propose to handle supplemental payments in years where the Proposition 98 guarantee calculation is not in Test One?
- Are there any future budget/revenue scenerios where the Administration would pause payments to the General Fund? If so, what?
- Are there consequences to the proposed delay in cash availability for the General Fund, as proposed?
- What are the possible consequences to a further delay in cash availability for the General Fund, if a repayment where not possible in a future year?
- What is the value, of the $8 billion in 2022-23 education appropriations, as proposed for protection, compared to the out-year pressures for the General Fund?
- What is the total amount of one-time spending in the final 2021-22 and 2022-23 Budget Acts? Of this total one-time spending, how much is not yet allocated to LEAs?
- What further reversions are anticipated from the 2021-22 and 2022-23 Budget Acts that may mitigate the shortfall?

**Staff Recommendation:** Hold Open.

## Issue 4: Local Control Funding Formula & COLA

This panel will provide an overview of the Local Control Funding Formula (LCFF) for public schools, and Governor's Budget proposals for cost of living adjustments to the Formula and categorical programs.

## Panel

- Katie Lagomarsino, Department of Finance
- Michael Alferes, Legislative Analyst's Office

## Background

The bulk of funding for school districts and county offices of education for general operations is provided through the Local Control Funding Formula (LCFF) and is distributed based on the numbers of students served and certain student characteristics, including grade, income, and home language. The state first fully funded the LCFF in 2018-19 and has annually adjusted the LCFF base grant amounts by a cost-of-living adjustment (COLA).

The LCFF is based on student average daily attendance (ADA). The state allocates LCFF funding to school districts and charter schools based on their ADA—the average number of students in class each day throughout the school year. The 2022-23 Budget Act adjusted this historical calculation for non-charter LEAs: the state credits school districts with their ADA in the current year, prior year, or the average of three prior years, whichever is higher.

Please see Attachment A for a comprehensive LAO overview of the Local Control Funding Formula.

Statute requires a Cost-of-Living Adjustment (COLA) for LCFF. The COLA rate is based on a price index published by the federal government. This index reflects changes in the cost of goods and services purchased by state and local governments across the country. State law provides an automatic COLA for LCFF unless the constitutionally required Proposition 98 funding level is insufficient to cover the associated costs. In these cases, the law reduces the COLA rate to fit within the available funding. The state applies the COLA to LCFF by increasing the grade span base rates, necessary small schools rates, and the transitional kindergarten staffing adjustment. These rate increases also result in proportional increases to the grade span adjustments and supplemental and concentration grants, since the value of these components are funded as a percentage of the base grant.

Recent Budget Acts have made notable changes to the Local Control Funding Formula:

1) Statute now includes a new requirement that districts track their unspent supplemental and concentration grant funding and use the funding to increase or improve services for English Learning/Low Income (EL/LI) students in future years.

2) The concentration grant rate was increased from 55 percent to 65 percent of the base grant, with a requirement that the associated increase in funding must be used by school districts to increase the number of staff that provide direct services to students in schools where more than 55 percent of students are EL/LI.

3) The 2022-23 and 2023-24 Budget Acts increased the LCFF base grants by a total of 21.8%.

4) For the purpose of allocating funding under the LCFF, the state credits school districts with their attendance in the current year, previous year, or average of the three previous years (whichever is highest).

5) Beginning in 2022-23, school districts and county offices of education (COEs) are reimbursed for 60 percent of eligible transportation expenditures they reported in the previous year.

6) The 2023-24 Budget Act created the Equity Multiplier, with $300 million ongoing Proposition 98 funding for school sites with high instability rates, and new accountability provisions for LEAs receiving Equity Multiplier funds. Oversight of this new funding will be covered in a later hearing.

## Governor’s 2024-25 Budget

**Reduces LCFF Costs by $1.2 Billion From Lower Attendance.** Due to large decreases in attendance over the past few years, approximately 80 percent of school districts currently are receiving funding based on their three-year average. Most of these districts will experience funding declines in 2024-25 as their higher attendance levels from earlier years continue phasing out of their average. The Governor’s budget estimates this phaseout will reduce LCFF statewide by $2 billion (2.6 percent). Partially offsetting this reduction, the budget estimates an LCFF increase of $796 million related to the expansion of TK. This increase consists of $635 million for base, supplemental, and concentration grant funding generated by students who are newly eligible in 2024-25 and $161 million to support lower staffing ratios for these students. Accounting for the attendance phaseout and the expansion of TK, the overall reduction in LCFF costs is $1.2 billion.

**Provides a 0.76 Percent Statutory Cost-of-Living Adjustment (COLA).** For 2024-25, the administration estimates the statutory COLA rate is 0.76 percent. (This rate is relatively low by historical standards, likely reflecting decreases in energy prices that have occurred since the summer of 2022.) The Governor's budget provides an ongoing increase of $628 million to cover the associated cost for K-12 programs—$564 million for LCFF and $64 million for various categorical programs.

**LAO Comments**

***LCFF Cost Estimates Likely Too High.*** Separate from our assessment of the COLA, we think the baseline estimates of LCFF costs in the Governor's budget are likely too high. Our latest estimates are about $1.8 billion lower—$690 million lower in 2023-24 and $1.1 billion lower in 2024-25. The largest contributing factor is our treatment of TK. Although our underlying attendance estimates are similar, the Governor's budget scores the LCFF costs for these newly eligible students immediately. If a district receives funding based on its average attendance over the past three years, however, the full effect of this additional attendance will not materialize for several years. Given that most districts are funded this way, we anticipate that TK expansion will have only modest effects on LCFF costs in 2023-24 and 2024-25.

***Reject Statutory COLA Increase.*** We recommend zeroing out the COLA for the upcoming year. Rejecting the COLA would reduce the ongoing shortfall by $628 million and help the state avoid committing to an ongoing spending level it would have difficulty maintaining in the future. An additional consideration is that a zero COLA for 2024-25 would follow several years of very large funding increases for LCFF. Between 2019-20 and 2023-24, the state increased LCFF funding rates per student by nearly 30 percent.

***Plan for Lower Attendance-Related Costs.*** We recommend the Legislature (1) plan to adopt lower LCFF cost estimates than Governor's budget anticipates for 2023-24 and 2024-25 and (2) use updated data that will be released within the next few weeks to calibrate its estimates. Related to these recommendations, we recommend ensuring these estimates account for the interaction between the expansion of TK and the three-year rolling average attendance calculation. Under our latest estimates, the overall cost of LCFF would be $1.8 billion lower across 2023-24 and 2024-25. The updated data, however, easily could change these estimates by several hundred million dollars in each year. Adopting lower LCFF cost estimates would reduce the size of the budget problem the Legislature needs to address.

***Explore Changes to Ongoing Programs That Could Generate Additional Savings.*** If the Legislature were to revisit some recent program expansions, it could likely find ways of achieving its core objectives in less costly ways. The ongoing savings the state identifies through this process would help the state address the current shortfall and ease future budget pressure.

***TK Staffing Add-On ($505 Million).*** In 2022-23, the state began providing additional funding based on TK attendance. (This is in addition to funding the state already provided for these students through LCFF.) To receive this funding, districts must maintain an average of 1 adult for every 12 students in TK classrooms at each school site. Beginning in 2025-26, districts must maintain an average of 1 adult for every 10 students. Our understanding is that the existing rates were calculated based on an assumption that TK classrooms would have 20 students, aligning with the policy to have 1 adult for every 10 students. The Legislature could modify the rates to align with the current ratio. If the Legislature were to fund based on the assumption that TK classrooms have 24 students (consistent with a 1-to-12 ratio), it would result in savings of about $100 million. Next year, the Legislature could assess its fiscal situation and determine whether higher staffing ratios and associated rates could be covered within its ongoing Proposition 98 funding levels.

***Consider Reducing Funding Streams That Are Based on Antiquated Factors.*** Another way the Legislature could obtain ongoing savings is by revisiting three LCFF add-ons that provide additional funding for certain districts based on historical factors. Unlike the core components of the formula, these add-ons are not based on the number of students districts currently enroll or the needs and characteristics of those students. Instead, they provide additional funding based primarily on the size of certain programs districts operated decades ago. Eliminating or scaling back these add-ons would reduce historical funding inequities among districts, simplify the LCFF, and provide ongoing savings. If the Legislature were concerned that eliminating these add-ons immediately would be disruptive for district budgets, it could provide for a gradual phaseout. Below, we profile these three add-ons (the parenthetical amounts indicate expenditures in 2023-24):

- ***Targeted Instructional Improvement Block Grants ($855 Million).*** This add-on provides additional funding for school districts that (1) operated desegregation programs during the 1980s, and/or (2) benefited from general-purpose grants intended to equalize district funding levels during the 1990s. The add-on is a fixed amount and unrelated to whether a district currently operates a desegregation program or the level of funding the district receives relative to other districts.

- ***Minimum State Aid ($356 Million).*** This add-on provides additional funding for school districts and COEs with high levels of local property tax revenue per student. The add-on amount is based on the level of state funding the district or COE received prior to the LCFF and is unrelated to the programs it currently operates or the characteristics of its students.

- ***Economic Recovery Targets ($61 Million).*** The state created this add-on to ensure all districts would receive at least as much funding under the LCFF as they would have received if the state had retained its former funding system and increased it for the statutory COLA. Over the past decade, the state has provided multiple LCFF increases beyond the statutory

COLA. Based on these increases, all districts are likely receiving more funding than they would have received under the former system, adjusted for COLA.

## Staff Comments

**Ongoing ADA crisis.** While the impacts on students from chronic absenteeism will be covered in a future hearing, the fiscal impacts of ongoing absenteeism are also enormous. Statewide absence rates are hovering over 20%, compared to the 5% average pre-pandemic.

The Budget Year LCFF and COLA funding levels and relevant proposals will be considered as part of the Final Budget guarantee estimate.

**Suggested Questions:**

- How are recent changes to the LCFF being evaluated?
- How are recent historic increases to the LCFF base grants translating into salary scale increases for the educator workforce?

**Staff Recommendation:** Hold Open.

## Issue 5: State of School Fiscal Health (Information Only)

The Fiscal Crisis and Management Assistance Team (FCMAT) is California's public resource to monitor and guide Local Education Agency fiscal health. This hearing will provide FCMAT's annual address to update the Assembly on the state of school fiscal health.

## Panel

- Michael Fine, FCMAT

## Background

AB 1200 (Chapter 1213, Statutes of 1991) created an early warning system to help local educational agencies (LEAs) avoid fiscal crisis, such as bankruptcy or the need for an emergency loan from the state. AB 1200 expanded the role of county offices of education (COEs) in monitoring school districts and requires that they intervene, under certain circumstances, to ensure districts can meet their financial obligations. AB 1200 also created the Fiscal Crisis and Management Assistance Team (FCMAT), recognizing the need for a statewide resource to help monitoring agencies in providing fiscal and management guidance.

FCMAT's work is divided into six categories:

**Management Assistance** (EC 42127.8(d)(1)) for K12 and community colleges. The work is focused on preventive measures and solving LEA-specific issues at the lowest level before they grow. A significant portion of management assistance is requested by the LEA and supported on a fee for service model. A smaller portion of management assistance is performed under the automatic triggers and is limited to Fiscal Health Risk Analysis studies supported by state appropriations. Management assistance can include interventions driven by fiscal distress. All management assistance work culminates in a written report posted on the FCMAT website.

**Professional Learning (includes Product Development)** (EC 42127.8(d)(2) – (4)) for K12 and community colleges. Training is provided directly by FCMAT and in collaboration with private partners. Training provided directly by FCMAT is provided free of charge to LEA personnel. Professional learning includes traditional training sessions (i.e., fiscal oversight training), year-long programs (i.e., CBO Mentor Program), the provision of application-based tools (i.e., LCFF calculators and Projection-Pro), and manuals and guides. Professional Learning is a key element of FCMAT's focus on preventive measures; ensuring the most qualified personnel with the right training and tools are in positions such as CBO.

**AB 139 Reviews** (EC 1241.5) for fraud, misappropriation of funds and other illegal fiscal practices in school districts and charter schools. While statute does not designate FCMAT as the provider of AB 139 reviews, the budget does make an annual appropriation to FCMAT to reimburse county superintendents for the work. FCMAT provides nearly one-hundred percent of the AB 139 reviews.

**Fiscal Crisis** (EC 41320 – 41329) includes numerous aspects of assisting and evaluating school districts in fiscal crisis. This work can best be summarized as work in various stages of fiscal crisis leading to receivership including pre-receivership activities, receivership activities, comprehensive reports, identifying and vetting trustee/administrator candidates and providing general counsel.

**California School Information Services (CSIS)** (EC 49080) is a service of FCMAT. CSIS work includes an annual scope of work in partnership with CDE for the California Longitudinal Pupil Achievement Data System (CALPADS) and product development, maintenance and operations for the Standardized Account Code Structure (SACS) System Replacement Project. CSIS plays an integral role in the new Cradle-to-Career Data System (C2C) Governing Board, with the CSIS's chief operating officer serving as the C2C board chair. CSIS developed and maintains the Ed-Data.org website, and provides technical support for the internal operations of both FCMAT and, under contract to, the California Collaborative for Educational Excellence (CCEE).

**Other** includes the overall governance and leadership of the organization (EC 42127.8), interface with state and private partners, internal accounting and planning. This includes the annual J90 reporting (Salary and Benefit Schedule for the Certificated Bargaining Unit) capturing information from 80% of school districts and county offices of education covering 95.6% of non-charter ADA. Further, the "other" category includes FCMAT's role with the Education Audit Appeals Panel (EAAP) (EC 14502.1, 41344 and 41344.1).

Total FCMAT and CSIS full-time staff capacity stands at 86.5, all funded through the Proposition 98 guarantee to the Kern County Office of Education.

FCMAT publishes an annual report each fall summarizing the activities of the prior fiscal year and providing other relevant information about the organization: Annual Report 2022-23 final.pdf (fcmat.org)

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Fiscal Crisis and Management Assistance Team (FCMAT), recognizing the need for a statewide resource to help monitoring agencies in providing fiscal and management guidance.

There are several defined "fiscal crises" that can interventions in a district: a disapproved budget, a qualified or negative interim report or recent actions by a district that could lead to not meeting its financial obligations. The interim reports must include a certification of whether or not the LEA is able to meet its financial obligations. The certifications are classified as positive, qualified, or negative.

- A positive certification is assigned when the district will meet its financial obligations for the current and two subsequent fiscal years.

- A qualified certification is assigned when the district may not meet its financial obligations for the current or two subsequent fiscal years.

- A negative certification is assigned when a district will be unable to meet its financial obligations for the remainder of the current year or for the subsequent fiscal year.

FCMAT has recently completed three Extraordinary Audits that are available on their website:

- Inspire Charter Schools (https://www.fcmat.org/PublicationsReports/inspire-charter-schools-final-report.pdf): Eight operating charters from the now closed Inspire Charter network. Recommended disallowance and recapture of “Track A” ADA clearly generated by summer school programming.

- Ezequiel Tafoya Alvarado Academy (ETAA) (Madera COE) (https://www.fcmat.org/PublicationsReports/Madera-COE-final-report.pdf): Misappropriation of funds for personal gain by former charter school’s executive director. Federal law enforcement prepared to file charges.

- Stockton USD (https://www.fcmat.org/PublicationsReports/sjcoe-stockton-usd-final-report.pdf): Illegal fiscal practices regarding improper multi-million-dollar procurement using ESSER funds, and Political Reform Act discrepancies.

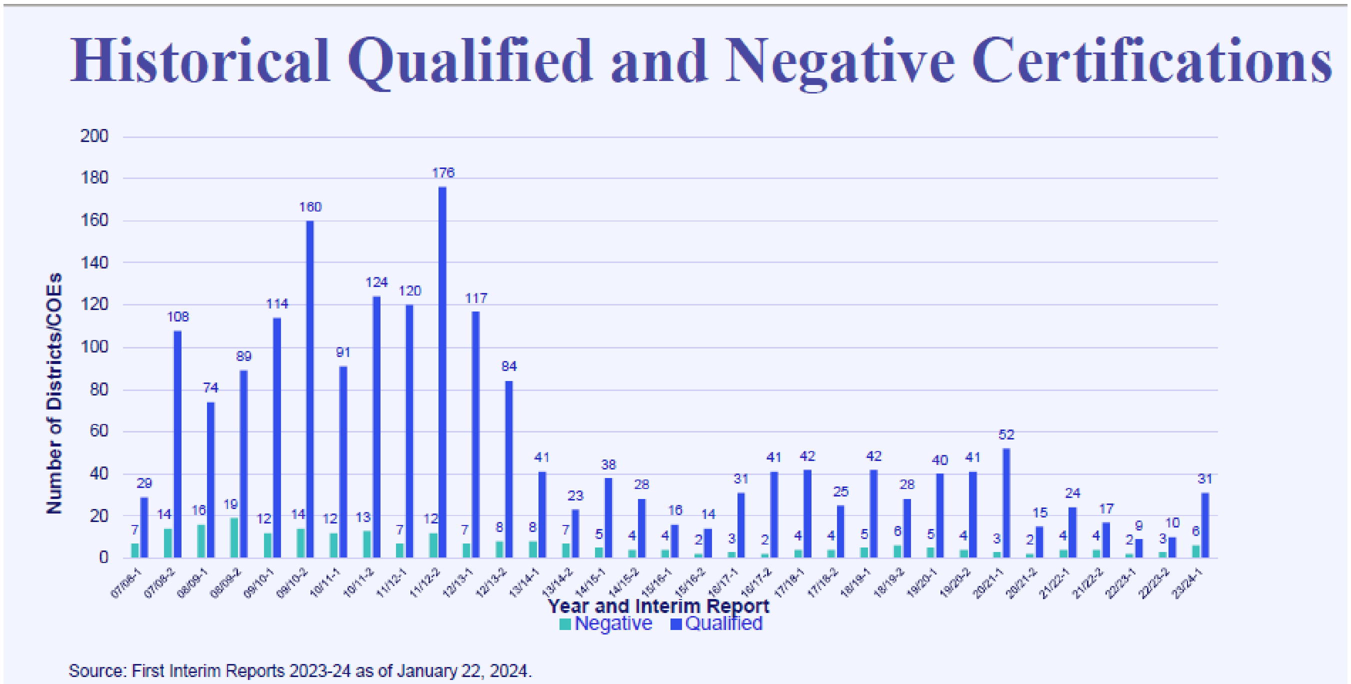
## State of School Fiscal Health

FCMAT will provide more details in this hearing, however they have already provided preliminary information, as of the first interim report:

- 31 school districts received a qualified certification, a three-fold increase from the same reporting period last year.

- Six school districts have been assigned a negative certification:
  - Calaveras Unified School District
  - Green Point Elementary School District
  - Happy Camp Elementary School District
  - Junction Unified School District
  - Live Oak Elementary School District
  - Oak Run Union Elementary School District

- And additional six LEAs are anticipated to have a "lack of going concern" designation, and no LEAs have a disapproved budget.




Source: FCMAT

## Emergency Loans

In most cases, the assistance provided by county offices of education and FCMAT is sufficient to pull LEAs out of immediate financial trouble. The option of last resort for LEAs that have insufficient funds is to request an emergency loan from the state. This is often the result of years of deficit spending and budgetary issues.

An emergency loan can be provided by the state through a legislative appropriation. Accepting a state loan is not without consequence, however. The county superintendent assumes all legal rights, duties, and powers of the district governing board and an administrator is appointed to the district. Several conditions must be met before control is returned to the district. State loans are typically set up for repayment over 20 years and county control remains over the school district until the loan is fully repaid. The state loan is sized to accommodate the anticipated shortfall in cash that the district will need during the life of the loan in order to meet its obligations. In addition, all of the costs of ensuring a fiscal recovery are the responsibility of the district and are added to the amount of the state loan. Therefore, a state loan will be much larger than what the district would otherwise need to borrow locally if it had been able to solve its own fiscal crisis.

Since 1991, the state has provided nine districts with emergency loans. Inglewood Unified School District is the most recent LEA to receive emergency apportionments in 2012. Since 2019 Inglewood Unified School District and Oakland Unified School District have received additional state apportionments through AB1840 (2018). Oakland USD required a $10 million AB1840 additional apportionment in the 2021-22 Budget, and is continuing to struggle with forecasted deficits, despite robust one-time funds.

No new LEAs are recommended for state assistance at this time.

FCMAT will present on current solvency trends, including:

- Local LEA reserves generally higher than in Great Recession (22% vs 8% for USDs).
- Employer contribution rates to CalSTRS and CalPERS increasing.
- Inflationary pressures on cost side.
- Move away from prior three-year average ADA to traditional greater of CY/PY.
- Low to more normal COLAs moving forward (<4.5%-5%).
- Declining enrollment and continued low average daily attendance yields.
- Spend down of one-time pandemic-related funds.
- Slowing state revenues in near term years.
- Significant increase in liability claims against LEAs as AB 218 deadline approached; this has not been quantified as to impacts on LEA fiscal stability, but risk pools are being impacted.

## Staff Comments

It is unknown at this time whether LEAs have adequately updated their enrollment projections in the current year, Budget Year, and the out-years, for both steep enrollment declines and new UTK enrollment. It is also unclear whether LEAs have recalibrated their Budget-year and out-year planning for the billions in one-time, multi-year funding packages adopted in the 2021-22 and 2022-23 Budget Acts.

According to FCMAT, many LEAs are struggling with how to transition from one-time federal and state funds to ongoing plans, including use of Expanded Learning, UTK, and other new 21-22 and 22-23 Budget Act programs. FCMAT has also expressed concerns that one-time federal and state funds from prior Budget years are masking systemic LEA problems, including declining enrollments and attendance.

It is notable that five out of six of the LEAs with a negative certification are very small school districts, struggling with total enrollments under 50 students.

**Staff Recommendation:** Information Only.