

AGENDA

ASSEMBLY BUDGET SUBCOMMITTEE NO. 2 ON EDUCATION FINANCE

Assembly Member Julia Brownley, Chair

TUESDAY, MARCH 13, 2007
STATE CAPITOL, ROOM 444
10:00 AM

ITEMS TO BE HEARD

ITEM	DESCRIPTION	PAGE
6110	DEPARTMENT OF EDUCATION	2
ISSUE 1	OVERVIEW OF TOTAL EDUCATION FUNDING IN THE GOVERNOR'S BUDGET	2
ISSUE 2	OVERVIEW OF PROPOSITION 98 FUNDING	5
ISSUE 3	FUTURE TEST 1-LEVEL FUNDING AND THE LAO'S RECOMMENDATION TO DEVELOP A ROADMAP FOR THESE FUNDS	15
ISSUE 4	COST-OF-LIVING ADJUSTMENTS	19
ISSUE 5	GROWTH ADJUSTMENTS	20
ISSUE 6	OVERALL K-12 GROWTH TRENDS AND DECLINING ENROLLMENT	22
ISSUE 7	MANDATES	25
ISSUE 8	STATUS OF LAST YEAR'S FUNDING INCREASES	27

ITEMS TO BE HEARD

6110 DEPARTMENT OF EDUCATION**ISSUE 1: OVERVIEW OF TOTAL EDUCATION FUNDING IN THE GOVERNOR'S BUDGET**

The issue for the subcommittee to consider is the Governor's proposed funding level for K-12 education, including all state and federal funds.

BACKGROUND:

Governor's budget. The Governor's budget cites a total funding increase of a little less than \$1.8 billion for K-12 education (a 2.7% increase), including all funds (except for bond funds and state contributions to the State Teachers' Retirement System). The proposed increase and the corresponding fund resources are summarized in the table below. Increases in Proposition 98 funds (state General Fund and local property taxes) account for all of this year's proposed increase, since other K-12 funds are experiencing a decrease relative to last year's level. Proposition 98 funds will be discussed in issue 2 below.

**Governor's Proposed 2007-08 Budget: Total K-12 Funding
(dollars in thousands)**

K-12 Education Budget Summary					
(Dollars in Millions)					
	Actual	Revised	Proposed	Changes From	
	2005-06	2006-07	2007-08	2006-07	
				Amount	Percent
K-12 Proposition 98					
State General Fund	\$34,582	\$36,658	\$36,851	\$193	0.5%
Local property tax revenue	11,959	12,353	13,595	1,242	10.1
Subtotals	(\$46,541)	(\$49,011)	(\$50,446) ^a	(\$1,435)	(2.9%)

Other Funds					
General Fund					
Teacher retirement	\$999	\$876	\$966	\$91	10.4%
Bond payments	1,681	1,857	2,201	345	18.6
Other programs	160	554	413	-140	-25.4
State lottery funds	1,036	1,012	1,012	—	—
Federal funds	6,931	7,113	6,568	-545	-7.7
Other	6,147	6,352	6,948	596	9.4
Subtotals	(\$16,954)	(\$17,763)	(\$18,109)	(\$346)	(1.9%)
Totals	\$63,495	\$66,774	\$68,555	\$1,781	2.7%
K-12 Proposition 98					
Average daily attendance (ADA)	5,964,108	5,940,989	5,917,948	-23,041	-0.4%
Budget amount per ADA	\$7,803	\$8,250	\$8,524 ^b	\$275	3.3%
Totals may not add due to rounding.					
<p>^a Reflects Governor's proposal to fund Home-to-School Transportation (\$627 million) from the Public Transportation Account and rebench the Proposition 98 guarantee downward by a like amount. If the swap were not to occur, the change from 2006-07 would be \$2.1 billion—a 4.2 percent increase.</p> <p>^b Assumes transportation funding swap. If swap were not to occur, the per-pupil rate would be \$8,631, reflecting a 4.6 percent increase over 2006-07.</p>					

Enough to cover growth and COLA but little else. In general, the Governor's proposed budget for K-12 provides modest increases that mostly cover enrollment growth and cost-of-living adjustments, but does not provide increases sufficient to fund major new programs or expansions of existing programs. This is in contrast to the last two years, which saw significant increases in funding for education.

COMMENTS:

Federal funds decreasing. For federal funds, the administration estimates a 7.75% decline in federal funds for education. The Department of Finance states that this estimate is based on the latest information regarding the fiscal year 2007 federal budget, which the federal government is late in passing. The final figures on the federal budget may not be available until later this spring.

Lottery funds. Schools receive lottery funds equal to 34% of lottery sales. They may use most of these funds however they wish, but are required to spend a certain portion on instructional materials. In recent years, lottery funds available for education have increased. At the end of February, the Lottery Commission issued a statement that they would revise their figures for lottery funds available in 2006-07 downward by \$136 million. This is based on slower-than-expected sales in certain lottery products. The Lottery Commission notes that the final funding level in 2006-07 still represents the Lottery's third highest contribution to public education in its history.

ISSUE 2: OVERVIEW OF PROPOSITION 98

The issues for the subcommittee to consider are:

- The Governor's estimate of the minimum Proposition 98 guarantee, his proposals to use Public Transportation Account funds to replace some Proposition 98 expenditures and his corresponding proposal to re-bench the minimum Proposition 98 guarantee funding level.
- The LAO's estimate of overall revenues, its corresponding estimate of the minimum Proposition 98 guarantee and its recommendation regarding the use of Public Transportation Account funds.

BACKGROUND:

Proposition 98 funding refers to state funds and local property taxes that together meet the state's minimum funding requirement for K-12 education and community colleges (under the constitution). Proposition 98 funds account for about 70% of all K-12 funding. For more information, see the "comments" section.

Governor's budget. The Governor's budget proposes a total increase of \$1.8 billion in Proposition 98 funds for K-14 education. This includes an increase of \$1.4 billion for K-12 education and \$380 million for community colleges. This is summarized in the table below:

Proposed Proposition 98 Appropriations (dollars in millions)

	2006-07 revised	2007-08	Change from 2006-07 revised (Proposition 98 only)		Change from 2006-07 revised (including PTA funds)	
			Amount	Percent	Amount	Percent
K-12 Proposition 98 (CDE)	\$49,011	\$50,446	\$1,435	2.9%	\$2,061	4.2%
Community colleges	5,897	6,274	\$380	6.4%	n/a	n/a
Other agencies	115	115	\$0			
Total Proposition 98¹	\$55,022	\$56,835	\$1,813	3.3%	n/a	n/a

General Fund	40,812	41,190	\$378	0.9%	n/a	n/a
Property tax revenues	14,210	15,645	\$1,435	10.1%	n/a	n/a
K-12 Prop. 98 funding per-pupil ¹	\$8,350	\$8,525	\$275	3.3%	\$381	4.6%
Community college funding per FTE	\$5,114	\$5,335	\$220	4.3%	n/a	n/a

¹Figures may not add, due to rounding.

The Governor's proposed budget estimates that the state is in a Test 2 year (strong economy), but assumes that the minimum Proposition 98 guarantee can be re-benched downwards by \$627 million due to the use of public transportation account funds to pay for expenses usually funded with Proposition 98 funds. Assuming this downward re-benched, the Governor's budget meets the Proposition 98 minimum funding level for K-14 education (using the administration's revenues estimates). The administration's estimate of the minimum Proposition 98 funding guarantee for 2007-08 also assumes that the state has to pay \$144 million in maintenance factor that was accrued last year, when the Proposition 98 minimum was in a Test 3 year.

How the Governor proposes to spend the \$1.8 billion increase. The Governor proposes to use most of the \$1.8 billion increase in Proposition 98 funds to fully fund growth and cost-of-living adjustments in K-12 and community colleges. The cost of these adjustments exceeds the \$1.8 billion available, so the Governor proposes reductions to offset the cost. These increases and reductions are summarized in the table below, prepared by the LAO.

Governor's Proposition 98 Expenditure Plan	
2007-08 Governor's Budget	
Baseline Adjustments	
Cost-of-living adjustment	\$2,137.9
Attendance growth	38.2
Subtotal	(\$2,176.2)
Proposed Increases or Reductions	
Home-to-School Transportation	-\$626.8
Child care federal funds shift	269.0

Other K-12 proposals	-29.0
CCC ¹ proposals	28.6
Subtotal	<u>(-\$358.2)</u>
Total	<u>\$1,818.0</u>
Detail may not total due to rounding.	
¹ California Community College.	

Governor's proposed transportation shift. The Governor proposes to add a new funding source for education: Public Transportation Account funds from the State Transportation Fund. These funds are derived from sales tax revenues on gasoline purchased at the pump. The Governor uses \$627 million of these funds to pay for the Home-to-School Transportation Program, a program that is usually funded from Proposition 98 funds and that is provided to districts to help support the cost of their transportation programs (i.e., school busing). However, the Governor does not propose any changes to the existing program, only a change in funding source. The purpose for this funding change is to save General Fund revenue, which would otherwise be used to fulfill the minimum Proposition 98 obligation. (This is one of a handful of proposals intended to close a General Fund deficit caused by expenditures that exceed available General Fund revenues.)

As a result of his proposal to change the funding source of this program, the Governor proposes to shift the minimum required level of state funding for education (the Proposition 98 minimum guarantee) downward by the amount of the funding shift: \$627 million. According to the administration, this downward "re-benching" of the Proposition 98 minimum is proposed in response to downward re-benching that was done in previous years when certain programs were shifted out of Proposition 98 funds because they were not administered by school districts. (state funds must go directly to school districts in order to count towards the state's minimum Proposition 98 obligation.) The effect of the Governor's proposed downward shift in the Proposition 98 guarantee will be a lower spending obligation for education by the state in future years.

The home-to-school transportation program provides funding to 930 districts to purchase and operate school buses for transporting students to and from school. It has been in existence for more than fifteen years. Funds are distributed to school districts based on what they received the prior year (historic levels of funding), and not based on their current costs. Outside of the growth and cost-of-living adjustments to the program, there is no allowance for increasing individual districts' apportionments from the program. Since 1991, funding is split between transportation for the general population, and transportation for severely disabled/orthopedically impaired students. Statewide,

37% of the funds go to transportation programs for the severely disabled/orthopedically impaired students.

Governor's proposed increase in Proposition 98 expenditures for childcare. The Governor's budget proposes to increase Proposition 98 expenditures for childcare programs by \$269 million above growth and COLA. This increase does not reflect an overall increase in funding for childcare, since the increase is offset by reductions in other non-Proposition 98 expenditures. Unlike the Governor's proposal to use public transportation account funds for education, the Governor's childcare proposal does not reflect a change in the way the state funds childcare, since the state has historically funded childcare with a mix of Proposition 98, non-Proposition 98 General Fund and federal funds. The Governor's proposal only increases the proportion of childcare funding made up by Proposition 98. Historically, the proportion of childcare funded by Proposition 98 funds has increased and decreased, with the proportion of Proposition 98 funding for childcare declining in recent years.

Governor's proposal for 2006-07 funds. The Governor's budget assumes some savings in the 2006-07 fiscal year (current year), due to lower-than-expected enrollment in 2006-07. However, in order to meet the Governor's estimate of the minimum Proposition 98 funding guarantee in 2006-07, the Governor proposes to re-appropriate \$72.5 million back to K-14 education in the form of one-time appropriations. The figure below summarizes the Governor's proposal for these 2006-07 funds.

**Governor's proposed one-time expenditures to meet the 2006-07 minimum
Proposition 98 guarantee (\$ in millions)**

Proposed expenditure	Amount
<u>K-12</u>	
Teacher Recruitment and Retention Block Grant for Deciles 1-3 schools (existing program)	\$50.0
EnCorps Teacher Recruitment Program for retired professionals (new program to be administered by CTC)	10.0
Chief Business Officer Training program	2.5
<u>Community Colleges</u>	
Nursing: four regional simulation laboratories	4.0
Nursing: start-up costs for five new nursing programs	5.0
CalPASS	1.0
Total	\$72.5

Governor's proposals from the Proposition 98 reversion account. The Governor also proposes \$186 million in one-time K-12 expenditures from the Proposition 98 reversion account, which is an account made up of unexpended education appropriations from prior years. The table below summarizes the Governor's proposed

K-12 expenditures from this account. Current law requires that the state set aside half of all funds in this account (or \$100 million, whichever is greater) to repair facilities in low-performing schools under the terms of *Elizer Williams v. State of California* lawsuit. Accordingly, the Governor proposes \$100 million for this purpose.

Governor's proposals for Proposition 98 reversion account funds (K-12 only)
(\$ in millions)

Proposed K-12 expenditure	
School Facilities Emergency Repairs in low-performing schools (Williams Settlement – existing program)	\$100
Charter School Facility Grant Program (existing program)	43.9
Childcare – CalWORKs Stage 2 (existing program)	25.7
Teacher Credentialing Block Grant – 2006-07 costs (existing program)	8.8
Individual intervention materials for students who have failed the California High School Exit Exam (existing program)	5.0
Compact for Success – (new college access program)	1.5
Internet-based information management system for low-performing schools (new program)	1.0
Sub-total	\$185.9

CTA settlement funds. In addition to the above, the Governor assumes Proposition 98 funding from last year's CTA settlement, in which the state promised to pay \$2.8 billion to K-12 schools and community colleges over a period of seven years. This payment settles a dispute in which the education community believed that the state had misinterpreted a 2004 state law that suspended the state's minimum funding obligation to education. The dispute centered around the amount of savings the state recuperated as a result of the suspension, with the education community contending that the state's savings should have been limited to \$2 billion, but climbed to a higher level. This settlement would provide \$270 million to the selected schools among the lowest performing 20%, to be used for a variety of uses, the biggest being class size reduction.

LAO's lower General Fund estimates. Due to the availability of more updated data when they produced their Analysis of the Governor's Budget, the LAO has different General Fund revenue estimates than the Governor. Specifically, the LAO estimates General Fund revenues that are \$1.4 billion less than the Governor's estimates. They also estimate that property tax revenues are \$204 million less than that assumed by the Governor, which increases the amount of General Fund that the state must provide toward the minimum Proposition 98 funding level. The result of these differences means a much bleaker financial picture than that assumed by the Governor's budget, in which the state has a year-end reserve (surplus) of \$2.1 billion. The LAO instead estimates that the Governor's budget will lead to a deficit of \$ 726 million.

LAO's different estimates of the minimum Prop. 98 guarantee. The LAO's different General Fund estimates lead to different estimates of the Proposition 98 minimum funding level for K-14 than the Governor. Specifically, the LAO estimates a Prop. 98 guarantee that is \$609 million lower in 2006-07 and \$261 million higher in 2007-08 than the Governor's estimate. This means that under the LAO's revenues, the state could spend \$609 million less in 2006-07, and accrue some savings. The table below summarizes the differences between the Governor's estimate of the Prop. 98 guarantee and the LAO's.

Proposition 98 Under Different Revenue Scenarios		
(In Millions)		
	2006-07a	2007-08b
Proposition 98 Minimum Guarantee		
LAO Forecast	\$54,413	\$57,097
Governor's Budget	55,022	56,835
Differences	-\$609	\$261
General Fund Requirement		
LAO Forecast	\$40,203	\$41,656
Governor's Budget	40,812	41,190
Differences	-\$609	\$466
Local Property Tax Revenues		
LAO Forecast	\$14,210	\$15,441
Governor's Budget	14,210	15,645
Differences	—	-\$204
a Includes required additional appropriation for Proposition 49 after school programs.		
b Assumes proposed reduction of minimum guarantee for transportation funding swap.		

LAO's recommendations regarding the proposed transportation shift. The LAO recommends the rejection of the Governor's proposal to permanently shift the home-to-

school transportation program out of the Prop. 98 guarantee and re-bench the guarantee downward, for three reasons:

- The Public Transportation Account funds are volatile, and may not be sufficient in out years to sustain the home-to-school transportation program.
- The proposed downward re-benching of the Prop. 98 guarantee appears unconstitutional and inconsistent with the aims of Prop. 98 to provide a stable and protected funding source for education.
- The proposed downward re-benching sets a bad precedent because it could lead to future “extractions” of certain programs from Proposition 98 funding, rendering the minimum guarantee meaningless.

LAO’s recommendations regarding achieving savings. Due to its estimates of scarce General Fund resources, and its estimate of the Prop. 98 minimum guarantee for 2006-07 that’s \$609 million lower than the Governor’s, the LAO recommends reducing current-year spending by \$609 million to achieve General Fund savings. Part of the LAO’s proposal to reduce current-year spending includes the use of \$300 million in Public Transportation Account funds to replace Prop. 98 funds for the home-to-school transportation program, but without the re-benching of the minimum Prop. 98 guarantee that the Governor proposes. The remaining \$309 million in savings is from capturing unused funds and rejecting some of the Governor’s one-time proposals in his January 10 budget. This action would also reduce the 2007-08 Prop. 98 minimum by about \$630 million.

COMMENTS:

Background on the Proposition 98 Formula. In 1988, voters approved an amendment to the state constitution that requires the state to provide a minimum amount of funding for K-12 education and community colleges (“K-14 education”). The amendment included a formula to calculate this minimum amount on an annual basis, based on certain economic factors:

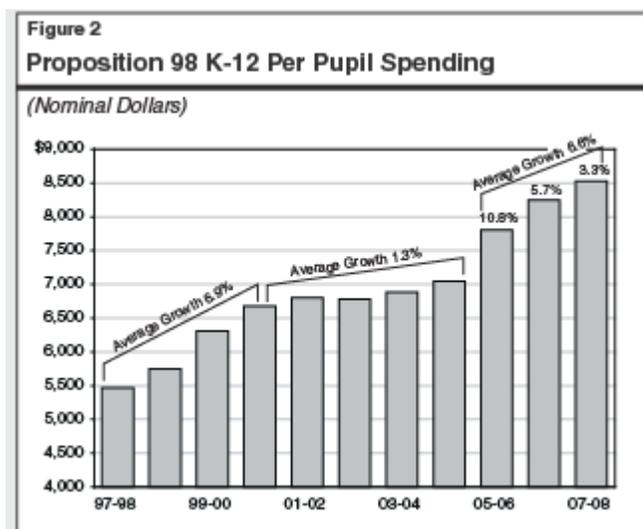
- In general, the formula is intended to ensure that, in the long run, funding for K-14 education grows enough each year to keep pace with a) K-12 enrollment growth and b) the growth in the economy (as measured by per capita personal income) (this is Test 2).
- However, the formula also takes into consideration the state’s finances and its ability to pay, and in years when the state’s revenues don’t grow enough or decline, the state can provide a lower level of funding than the Test 2 funding level (Test 3 years). In Test 3 years, while the state can provide a lower level of funding to education, and accrues a type of debt called a maintenance factor that measures the difference between what it provided and what it would have provided under a Test 2 year. Once revenues rebound, the state must pay back

this debt by getting back to the level of funding that it would have been at if had kept education funding at the Test 2 level and not provided the lower level of funding when its revenues were down. It is important to note that the Proposition 98 formula does not actually consider the amount of General Fund actually available in any given year, but rather considers the year-to-year growth in General Fund as a proxy of the state's ability to pay.

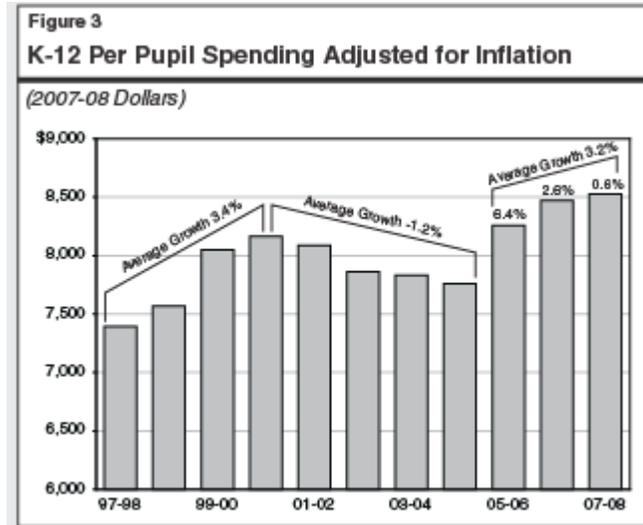
- The Proposition 98 formula is intended to ensure that education receives a minimum percentage of General Fund revenues. To ensure this, the formula requires that the proportion of General Fund spent on education does not go below about 40 percent (Test 1).
- The Proposition 98 formula allows the state to suspend its obligation to provide education funding at the level dictated by the Proposition 98 formula. The state has only suspended the Proposition 98 minimum requirement once, in 2004-05. During that year, the state passed legislation with intent language that the amount of savings from the suspension not to exceed \$2 billion. Due to changes in the Proposition 98 minimum funding level that occurred after the Legislature passed the budget, the amount of savings from the suspension increased beyond the \$2 billion, leading to a lawsuit by the California Teachers Association and others against the Governor, claiming that the state should be required to immediately pay back the amount of savings that exceeded the \$2 billion. CTA settled its lawsuit with the Governor last year when the Legislature approved SB 1133 (Torlakson), which appropriates approximately \$3 billion over seven years for a new program targeted at low-performing schools.

Historically, the Proposition 98 formula has required the state to provide education funding at the test 2 level in most years. Test 1 has only been triggered once, in 1988-89, the year after Proposition 98 was passed. Test 3 has been triggered in five years since the passage of Proposition 98, generally in years when the state's revenues were faltering.

Trends in Proposition 98 funding. The Governor's proposal to increase education funding by \$275 per pupil, or 3.3%, continues the recent growth pattern in education funding. The LAO graph below shows historic funding for education on a per-pupil basis, and demonstrates a fast growth period in the late 1990's, followed by a four-year period of slow growth, followed by growth over the past three years.



Even when these figures are adjusted for inflation, they show substantial increases in recent years, as shown in another LAO figure, below. According to the LAO, per-pupil education spending, even when adjusted for inflation, has increased by approximately 15%.



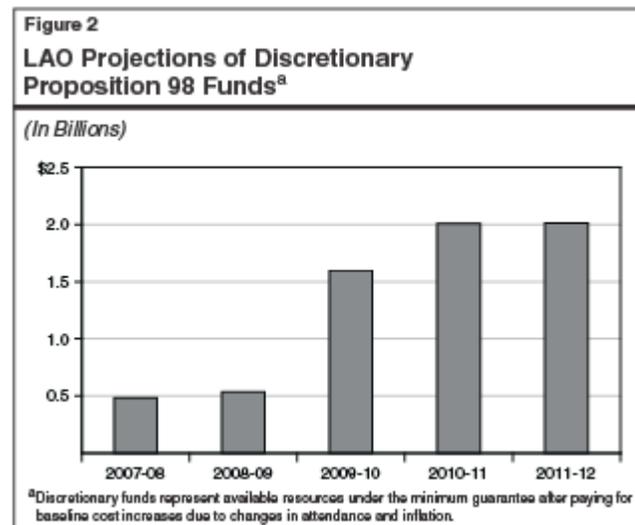
ISSUE 3: FUTURE “TEST 1” LEVEL FUNDING AND THE LAO’S RECOMMENDATION TO DEVELOP A ROADMAP FOR THESE FUNDS

The issue for the subcommittee is the LAO’s estimate of additional funds for education that will be available when the state Proposition 98 formula requires a Test 1 funding level, as well as its recommendation that the Legislature develop a roadmap to plan for the expenditure of these funds.

BACKGROUND:

Test 1 under Proposition 98. Under Test 1 of the Proposition 98 guarantee formula, the minimum funding level for education is set roughly at 40% of all General Fund revenues. The Test 1 formula is only triggered when it yields a higher funding level than either Test 2 or Test 3, and has only been operative once, in the year after the passage of Proposition 98. After that year, the percentage of General Fund spent on education increased above 40%, due to a combination of high growth in K-12 attendance and slow growth in property tax and General Fund revenues. Over the past several years, K-12 attendance has dropped while General Fund and property tax revenues have grown, leading to a steady decrease in the **percentage** (not the amount) of General Fund revenues spent on education.

Test 1 will yield increases in funding for education. Under the Test 1 Proposition 98 calculation, education funding will be based on the growth in the General Fund, regardless of the growth in the K-12 population. Therefore, even when the K-12 population is declining, education funding will be increasing significantly, leading to greater per-pupil funding levels. Under Test 2, any increases in property tax revenues offset the amount of General Fund that the state must provide to schools to meet the minimum Proposition 98 funding level, so that increases in property tax revenues result in savings to the state. Under Test 1, schools will get to “keep” increased property tax revenues, leading to increased funding levels. The LAO estimates that Test 1 may be triggered as early as 2009/10. Beginning that year, the Proposition 98 calculation will yield significant increases in education funding above the costs of funding growth and COLA. (“discretionary funds”). The LAO estimates that cumulative sum of the additional revenues will be more than \$6 billion. The figure below from LAO summarizes the amounts of these discretionary funds over time.



Need for plan/roadmap. The LAO recommends that the Legislature create a long-term roadmap for the use of these funds, for three reasons:

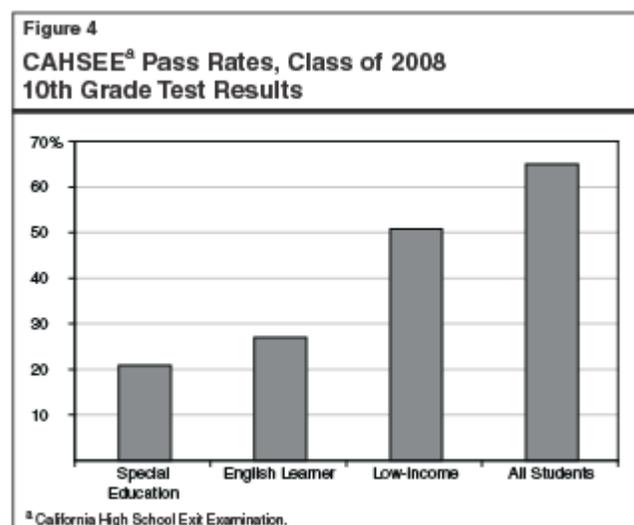
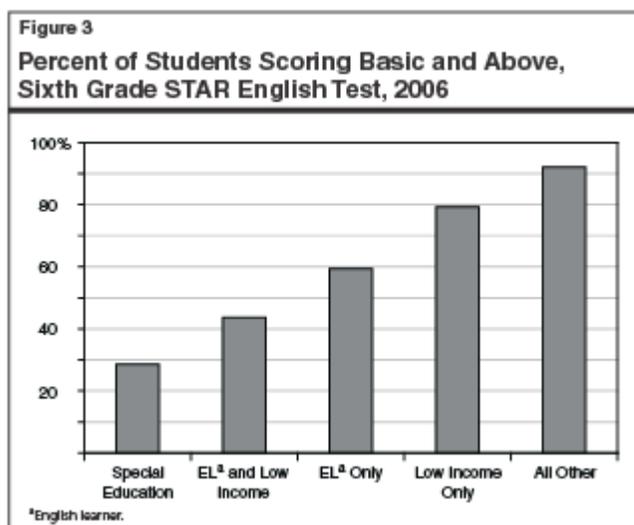
- To create a forum for identifying long-term priorities to address the state's educational goals
- To strengthen the Legislature's role in the budget process, in contrast to the current practice of making major decisions at the time of May Revise and reacting to the Governor's May Revise proposal, and
- To allow school districts and community colleges to adequately plan for the implementation of major initiatives.

LAO's identified criteria for evaluating alternatives for the use of the additional funds. The LAO recommends that the Legislature consider the following criteria in developing a long-term roadmap for the use of these funds:

- Fix problems with current formulas – Many of the state's current funding formulas don't provide equal funds to districts of similar populations. Fixing these formulas often costs money to hold districts harmless from any financial loss as a result of the change in formula.
- Provide flexibility, but learn what works – The state can evaluate programs and identify best practices, but should still allow local innovation and problem-solving and avoid one-size-fits-all solutions.
- Link new funds to improved performance – Create incentives to improve student achievement.

LAO's three expenditure areas under a roadmap. The LAO recommends a focus on two problems in the state's K-12 system: the achievement gap between different types of students and the need for better fiscal solvency in some school districts. On the issue of the achievement gap, the LAO cites significantly lower achievement rates

among English learners, special education students and economically disadvantaged students, as contained in the following charts:



It accordingly recommends that the state invests its \$6 billion above the costs of growth and COLA in the following three areas:

- Early childhood development and preschool – The LAO recommends increased spending for preschool programs for economically disadvantaged children, parenting programs for infants, and promoting a closer working relationship between preschool programs and K-12 districts.
- Programs for under-achieving and high-risk students – The LAO recommends additional funding for existing programs serving these students: special

education, Economic Impact Aid, Alternative High Schools and vocational programs.

- Fiscal Solvency Grants – The LAO recommends providing funds to all school districts to address various fiscal solvency issues, namely the problem some school districts have with unfunded retiree health benefit liabilities. It recommends providing these grants to all districts, regardless of whether they have serious problems or not. Districts that have few unfunded liabilities would be able to spend the block grant funds as they wish. Districts with significant problems would be required to use the funds to address their problems.

COMMENTS:

The LAO will present their analysis at today's hearing. They also recommend that the Legislature create a roadmap for community colleges; this will be discussed at a later hearing.

ISSUE 4: COST OF LIVING ADJUSTMENTS

The issue for the subcommittee to consider is the Governor's proposal to fund the cost-of-living adjustments for K-12 education programs.

BACKGROUND:

Governor's budget. Each year, the budget provides most Proposition 98 programs with a cost-of-living adjustment, or COLA, to reflect the higher costs that schools experience as a result of inflation. Funding for COLA's provides discretionary funds to school districts. The Governor's budget proposes to fully fund the cost-of-living adjustment for both discretionary funds and categorical programs, at 4.04 percent. The total cost of the COLA for all programs is \$1.9 billion: \$1.4 billion for discretionary funds (revenue limits), and a little more than \$500 million for all remaining categorical programs. The proposed COLA rate of 4.04 percent is the administration's estimate of what the final COLA adjustment will be.

The statistic used for the COLA for K-12 and community college programs is based on the gross domestic product deflator for purchases of good and services by state and local governments, for the last three quarters of 2006 and the first quarter of 2007. This factor will be finalized at the end of April, when the federal government releases the cost data for the first quarter of the year. If the final COLA percentage is higher than the Governor's estimate, it could cost hundreds of millions of dollars more to fully fund a COLA for K-12 programs¹. On the other hand, if the final COLA amount ends up being lower than the Governor's estimate, this will free up Proposition 98 resources.

COMMENTS:

The LAO has a similar estimate of the COLA rate, and believes the final COLA rate will be close to the 4.04% assumed by the Governor in his January 10 budget.

¹ For example, in last year's budget, the final COLA percentage went up to 5.92 percent from the Governor's initial estimate of 5.18 percent. This jump ended up costing the state \$355 million more to fully fund a COLA for all K-12 programs.

ISSUE 5: GROWTH ADJUSTMENTS

The issues for the subcommittee to consider are:

- The continuing trend of negative growth in the K-12 education population.
- The Governor's proposal to adjust some categorical programs for this negative growth and to hold other programs harmless.

BACKGROUND:

Overall growth. For the third year in a row, the state is experiencing a decline in the K-12 population. The Governor's budget estimates the statewide decline in average daily attendance at 0.39 percent. Accordingly, for the 2007-08 year his budget reflects a savings of approximately \$110 million in discretionary (revenue limit) funds, due to negative growth. For categorical programs, the Governor's budget reflects a net increase of \$39 million for growth. While there is some savings in growth for categorical programs due to negative statewide growth, this is offset by a) the fact that some categorical programs have statutory formulas different than the statewide population that give them positive growth, and b) the administration's decision to hold some categorical programs harmless from the negative growth. (See "growth for categorical programs, below.)

For the 2006-07 fiscal year (current year), the Governor assumes approximately \$120 million in one-time General Fund savings as a result of average daily attendance being lower than the estimates available at the time the budget was passed. Of these savings, the Governor proposes to redirect approximately \$50 million to non-education programs to help with the overall General Fund shortfall. He uses the remainder of the savings to meet the Proposition 98 minimum funding level for the 2006-07 – these funds are detailed in the table above regarding Proposition 98 one-time expenditures.

Growth for categorical programs. For many categorical programs, there is a statutory formula that requires an annual cost-of-living adjustment. For some categorical programs, the growth factor is based on overall K-12 population changes and sometimes on other growth factors more closely linked to the population served by the program, depending on the individual program. For other categorical programs, there is no statutory growth adjustment. The Governor's budget reflects these differences as different growth rates, in which some programs receive a decrease to reflect the decline, and some programs receive an increase. However, the Governor also proposes to hold some programs harmless from the decline in enrollment by keeping their funding level the same as last year. According to the administration, they chose to hold harmless those programs that were a high priority, were created last year or that received a substantial increase last year. Examples of programs that appear to be held harmless from negative growth adjustments include Supplemental Instruction, the Teacher Credentialing Block Grant, Deferred Maintenance, and the various new programs that were initiated last year.

Effect of negative growth on the Prop. 98 minimum. The overall Proposition 98 minimum guarantee is somewhat affected by the overall reduction in the K-12 population. The terms of the Proposition 98 formula hold total education funding harmless from this decline for the first two years of statewide decline. Since 2007-08 is the third year of statewide decline, it is the first time that the Proposition 98 minimum guarantee reflects a negative growth factor. However, total Proposition 98 funding still increases over last year's minimum funding level due to other factors in the Proposition 98 formula.

COMMENTS:

The LAO estimates the cost of the administration's proposal to hold some categorical programs harmless from negative growth at \$13 million.

The LAO also notes that the Governor's proposal to protect certain programs from negative growth adjustments is **discretionary**. The Legislature could either a) approve the Governor's list, b) choose not to hold these programs harmless from negative growth, or c) select a different list of programs to hold harmless.

ISSUE 6: OVERALL K-12 GROWTH TRENDS AND DECLINING ENROLLMENT

The issues for the subcommittee to consider are:

- The effect of negative statewide growth on individual districts, and the extent to which districts are experiencing declining enrollment.
- State funding under existing law that holds districts harmless for one year from their enrollment declines.

BACKGROUND:

Approximately two-thirds of all state funding for K-12 education is distributed in the form of apportionments, which are continuously appropriated. These funds are discretionary for districts, and are used to fund the general purpose costs of running the schools. They are distributed based on a formula that considers a district's base funding level "per student" and a district's average daily attendance throughout the year. Because school enrollment plays a large part in this formula, districts that are experiencing declining enrollment also experience a proportionate decline in their apportionments, or discretionary funds. Current law holds districts harmless from the decline in their apportionments, by giving districts funds based on the higher of their current- or prior-year attendance.

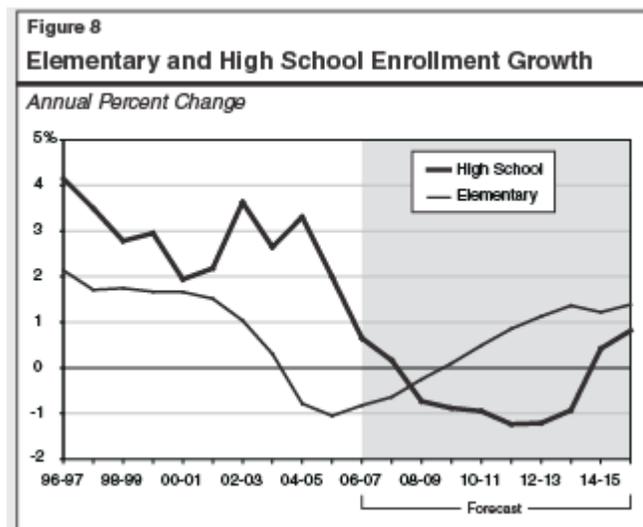
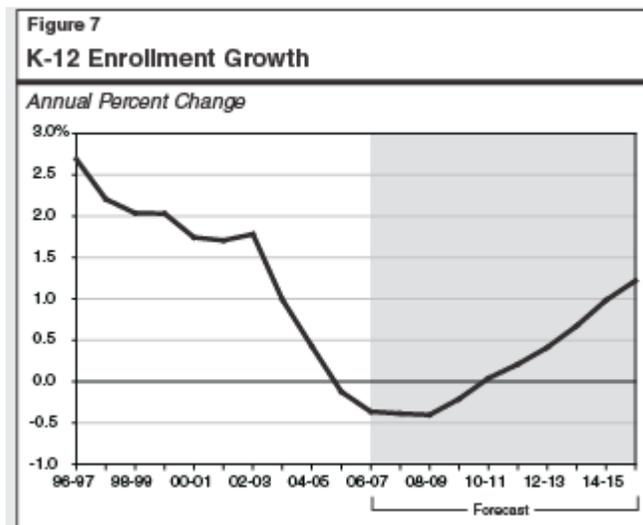
According to CDE, a total of 536 school districts experienced declining enrollment in 2005-06, the latest actual data available. Because K-12 enrollment is expected to continue to decline, the number of districts experiencing declining enrollment may increase in the coming years. The following information contains historical data from CDE and DOF on the number of districts reporting declining enrollment, and the cost of the adjustment under current law of holding districts harmless from their decline.

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08 (estimate)
Statewide growth rate	2.10%	1.75%	0.85%	0.30%	-0.33%	-0.39%	-0.39%
Districts receiving declining enrollment adjustment	329	375	413	439	536	NA *	NA
Difference between prior-year ADA and actual ADA for declining enrollment districts	16,000	19,000	28,000	50,000	78,000	NA	NA
State cost of declining enrollment adjustment	\$75 m.	\$90 m.	\$135 m.	\$246 m.	\$402 m.	\$476 m.	\$501 m.

* NA indicates that the data is not available

Statewide enrollment projections. Although the state is experiencing negative growth in its K-12 population, this trend is expected to reverse itself in three to four years, when the growth rate will become positive again. However, the positive growth is expected to be modest, unlike recent years. The following graphs contain the LAO's K-12

enrollment projections through 2015-16. Note in the second graph that while the LAO expects positive enrollment growth beginning in 2010-11 for the overall population, negative growth in grades 9-12 is expected to continue through 2014-015.



Regional differences. These overall trends reflect statewide totals, but mask regional differences. For example, during the same period covered by the graphs, Los Angeles’ enrollment is expected to decline by a total 12%, while enrollment in Riverside is expected to increase by a total of 34% over the same period.

COMMENTS:

Many districts with declining enrollment cite the difficulty of reducing costs commensurate with their declining revenues. Specifically, they cite fixed costs that are

not easy to reduce to scale (for example, the utility and janitorial costs of operating a school building do not decline if there are 1% fewer students in it). In addition, costs that are scalable, such as staff costs, are still difficult to reduce enough to keep up with falling revenues. For example, when a district must reduce its workforce to reduce costs, it usually drops its most junior staff, who are typically below the district salary average. This action actually increases the average staffing costs.

ISSUE 7: MANDATES

The issue for the subcommittee to consider is the Governor's budget proposal regarding funding for education mandates.

BACKGROUND:

Background. State law requires the state to reimburse school districts and local governments for their costs of implementing state requirements (mandates). School districts and local governments file claims to the state, and the state is required to pay for those claims as long as they fall within certain claiming guidelines that are established by the Commission on State Mandates.

Governor's budget. The Governor's budget does not contain funding for the 2007-08 costs of reimbursing districts for their mandated costs, and therefore proposes to defer these costs until future budgets. This is similar to past practice, in which the state deferred payments until it owed almost \$1 billion in payments to schools. Last year's budget paid off that debt to schools, with \$927 million in one-time funds to pay off prior-year mandate claims. However, last year's budget contained only \$30 million in one-time funds for 2006-07 mandate costs, deferring more than \$100 million in costs to future years. By proposing no new funding for the 2007-08 costs of mandate claims, the Governor is proposing to defer another \$185 million (approximately) in costs to future years (this is for K-12 and community colleges). The state is required to eventually pay all claims, once they are reviewed by the Controller's office, with interest on overdue claims.

In addition, the Governor proposes to continue the suspension of the following mandates, which were also suspended in prior years: School Bus Safety I and II, School Law Enforcement Sexual Harassment Training, County Treasury Withdrawals, and Grand Jury Proceedings.

LAO credit card. The table below summarizes the LAO's estimate of the amount of debt the state has accrued and owes to education, the "education credit card." This debt includes mandate claims that the state has still not paid school districts.

Status of the Education Credit Card Debt			
(In Millions)			
	2005-06	2006-07	2007-08
Deferrals			
K-12	\$1,103.4	\$1,103.4	\$1,103.4

Community college	200.0	200.0	200.0
Mandates			
K-12 ^a	\$900.0	\$275.0	\$435.0
Community college	100.0	90.0	115.0
K-12 Revenue Limits	\$300.0	—	—
Totals	\$2,603.4	\$1,668.4	\$1,853.4
^a Excludes claims that are unlikely to be paid as the result of court decisions or recent determinations by the Commission on State Mandates.			

LAO recommendation. If new funds become available, the LAO recommends that the state dedicate those funds to pay off the “credit card debt” the state has accrued over the years. This includes setting aside ongoing funds for the budget-year cost of mandates, so as not to accrue more debt.

COMMENTS:

Mandate reform. The Governor's budget summary references a proposal by the Governor to simplify and expedite the process by which the state creates guidelines for districts and local governments to file their mandate claims. It is intended to reduce the current time gap between the time a state mandate is approved (via legislation) and the time the state issues claiming guidelines, as well as make it simpler for districts and local governments to file claims. This proposal will be discussed at a future hearing, possibly in conjunction with Assembly Budget Subcommittee No. 4, which considers local government issues.

ISSUE 8: STATUS OF LAST YEAR'S FUNDING INCREASES

The issue for the subcommittee to consider is the status of funding increases in last year's budget.

BACKGROUND:

Increases in last year's budget. Last year's budget contained large increases in Proposition 98 funding to K-14 education. Specifically, it provided increases of:

- \$4.5 billion in ongoing funds – This level funded the Proposition 98 guarantee at what the minimum would be if the state had funded education in 2004-05 at a level that kept the suspension to education at \$2 billion. The following is a breakdown of how this increase was distributed:
 - \$2.6 billion for growth & COLA – This fully funds growth and a COLA rate of 5.92% for revenue limits and categorical programs.
 - \$660 million in increased discretionary funds -- \$350 million was for revenue limit equalization per existing law, where all revenue limits are brought up to the 90th percentile and \$310 million was for revenue limit deficit reduction, which fully pays off the amount the state owes to get revenue limits back to where they'd be had the state not cut them in 2003-04.
 - The remainder was for expansions of existing programs (i.e., Economic Impact Aid, which received a 50% increase over the prior-year funding level) and for new programs (such as the \$105 million Arts and Music Block Grant).
- \$2.5 billion in one-time funds -- Of this amount, \$2 billion was unexpected and came in May Revise as a result of the 2005-06 guarantee going up. About \$230 million of this was Prop. 98 reversion account money (unused funds from prior years), and about \$260 million of it was "settle-up" money, money needed to meet the re-calculated Prop. 98 minimum in prior years.
 - \$927 million for prior-year mandate claims – This completely paid off prior-year mandate claims (however, the budget shorts the 2006-07 claims by about \$100 million, thereby creating new debt). Districts do NOT have to wait until their claims are audited to get their money.
 - \$533 million in school and district discretionary block grants for one-time uses.

- The remainder is for a variety of new one-time block grants, new programs and augmentations to existing programs.

Attachment 1 is a table of the funding increases approved in last year's budget. CDE will provide an update on all of these funds, including the status of any funding distribution.

COMMENTS:

CDE will present their implementation table at today's hearing.