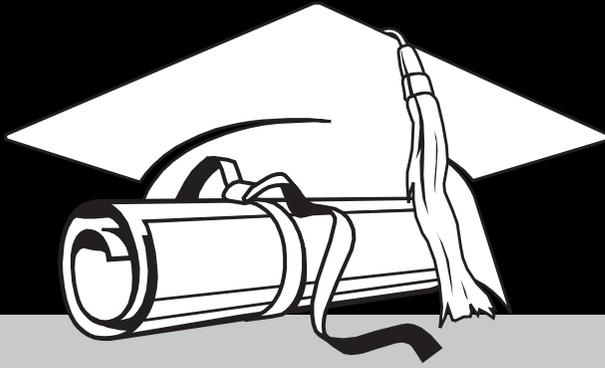


# EDUCATION



**LAO**   
65 YEARS OF SERVICE

2006-07 Analysis



# MAJOR ISSUES

## *Education*

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### **Minimize Impact of Proposition 98 on Structural Gap**

- The Governor's budget proposes to increase Proposition 98 expenditures by \$4.3 billion in 2006-07 compared to the revised 2005-06 spending level. The administration's proposal for the budget year exceeds the minimum spending requirement under Proposition 98 by \$2.1 billion.
- We recommend the Legislature fund Proposition 98 at the level needed to fully fund base program costs in the budget year. While this would result in \$1 billion less in K-14 spending than the Governor's budget, it would still provide an increase of \$3.3 billion over the current year. If the Legislature chooses to spend above this level, we offer two options that permit additional spending on K-14 education while reducing the impact on the state's future fiscal condition (see page E-27).



### **Create a Fiscal Solvency Block Grant**

- Districts face a variety of fiscal challenges, including low general purpose reserves, internal borrowing, declining enrollment, and costs of retiree health benefits.
- If the Legislature chooses to fund schools at the level of Proposition 98 spending proposed in the *2006-07 Governor's Budget*, we recommend the Legislature redirect \$411.7 million proposed for new programs to establish a new fiscal solvency block grant (see page E-56)



### **Simplify the K-12 Mandates Process**

- The Governor's budget proposes \$133.6 million from the General Fund to pay the costs of K-14 education mandates in 2006-07 (about three-quarters of expected claims). We recommend the Legislature fully fund these costs. We also

recommend trailer bill language that would simplify the mandate claims process and make mandate funding more predictable for both the state and districts (see page E-76).



### **Fund Anticipated Higher Education Enrollment Costs**

- The Governor's budget funds 2.5 percent enrollment growth at the University of California (UC) and the California State University (CSU), and 3 percent enrollment growth at the California Community Colleges (CCC). These rates are at odds with the administration's own enrollment projections.
- We recommend that the Legislature instead provide the three segments with funding for somewhat lower growth rates based on population projections and modest increases in participation rates (see pages E-186 and E-256).
- For UC and CSU, we also recommend the Legislature adopt a new marginal cost formula that better accounts for the cost of educating additional students (see page E-200).



### **Reject "Fee Buyout" Proposal**

- The Governor's budget proposes \$130 million to "buy out" planned fee increases at UC and CSU. The budget neither explains the need for these funds nor how they would be used. The budget also would commit additional funds to CCC in lieu of a fee increase.
- We recommend the Legislature instead determine each segment's overall needs and then determine how new costs should be shared between the state and students (see page E-225).



### **Restructure How State Administers Financial Aid Programs**

- Given various concerns about state coordination and management of financial aid programs, we recommend the Legislature authorize a single agency, with one board and Executive Director, to administer both state grant and federal loan programs.
- We recommend the agency be structured as a nonprofit public benefit corporation, subject to stronger accountability requirements (see page E-277).

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# OVERVIEW

## Education

The Governor's budget proposes \$63 billion in operational spending from state, local, and federal sources for K-12 schools for 2006-07. This is an increase of \$3.8 billion, or 6.5 percent, from estimated expenditures in the current year. The budget also includes a total of \$34.4 billion in state, local, and federal sources for higher education. This is an increase of \$1.5 billion, or 4.5 percent, from estimated expenditures in the current year.

Figure 1 shows support for K-12 and higher education for three years. It shows that spending on education will reach over \$97 billion in 2006-07 from all sources (not including capital outlay-related spending).

**Figure 1**

### **K-12 and Higher Education Operational Spending**

*(Dollars in Millions)*

	Actual 2004-05	Estimated 2005-06	Proposed 2006-07	Change From 2005-06	
				Amount	Percent
K-12 <sup>a</sup>	\$56,447	\$58,891	\$62,739	\$3,848	6.5%
Higher education <sup>b</sup>	31,316	33,019	34,487	1,468	4.4
<b>Totals</b>	<b>\$87,763</b>	<b>\$91,910</b>	<b>\$97,226</b>	<b>\$5,316</b>	<b>5.8%</b>

<sup>a</sup> Includes spending from state, local and federal funds. Excludes debt service for general obligation bonds and local debt service.

<sup>b</sup> Includes spending from state, local and federal funds and student fee revenue. Excludes debt service for general obligation bonds. For community colleges, also excludes spending from funds maintained in local budgets.

## FUNDING PER STUDENT

The Proposition 98 request for K-12 in 2006-07 represents \$8,030 per student, as measured by average daily attendance (ADA). Proposed spending from all funding sources (excluding capital outlay-related spending) totals about \$10,417 per ADA.

The Proposition 98 budget request for California Community Colleges (CCC) represents about \$4,859 per full-time equivalent (FTE) student. When other state funds and student fee revenue are also considered, CCC will receive about \$5,382 per FTE student. This compares to proposed total funding (General Fund and student fees) of \$23,900 for each FTE student at the University of California (UC) and \$11,506 for each FTE student at the California State University (CSU).

## PROPOSITION 98

California voters enacted Proposition 98 in 1988 as an amendment to the State Constitution. The measure, which was later amended by Proposition 111, establishes a minimum funding level for K-12 schools and CCC. A small amount of annual Proposition 98 funding provides support for direct educational services provided by other agencies, such as the state's schools for the deaf and blind and the California Youth Authority. Proposition 98 funding constitutes around three-fourths of total K-12 funding and about two-thirds of total CCC funding.

The minimum funding levels are determined by one of three specific formulas. Figure 2 briefly explains the workings of Proposition 98, its "tests," and other major funding provisions. The five major factors involved in the calculation of the Proposition 98 tests are: (1) General Fund revenues, (2) state population, (3) personal income, (4) local property taxes, and (5) K-12 ADA. A key determinant of the formula is the *change* in personal income and revenues from one year to the next.

### Proposition 98 Allocations

Figure 3 (see page 10) displays the budget's proposed allocations of Proposition 98 funding for K-12 schools and CCC. The budget proposes only technical adjustments to the current-year spending level of \$50 billion, and increases funding to \$54.3 billion for Proposition 98 in 2006-07 (an increase of \$4.3 billion). This includes \$1.7 billion beyond what is required by the Proposition 98 minimum guarantee, plus \$426 million to fund Proposition 49 after school programs. Most of the increase in proposed Proposition 98 spending is supported by General Fund revenues (\$4.1 billion). This

is due primarily to the conclusion of a two-year arrangement under which local governments annually transferred \$1.3 billion in local property taxes to schools. The end of those transfers requires the General Fund to backfill the loss in revenue. Proposition 98 funding issues are discussed in more detail in the “Proposition 98 Priorities” section of this chapter.

**Figure 2****Proposition 98 Basics**

- ✓ **Over time, K-14 funding increases to account for growth in K-12 attendance and growth in the economy.**
- ✓ **There Are Three Formulas (“Tests”) That Determine K-14 Funding.**

The test used to determine overall funding in a given budget year depends on how the economy and General Fund revenues grow from year to year.

  - **Test 1—Share of General Fund.** Provides around 41 percent of General Fund revenues. While not applicable since 1988-89, this test may begin to determine the minimum guarantee near the end of the decade.
  - **Test 2—Growth in Per Capita Personal Income.** Increases prior-year funding by growth in attendance and per capita personal income. Generally, this test is operative in years with normal to strong General Fund revenue growth.
  - **Test 3—Growth in General Fund Revenues.** Increases prior-year funding by growth in attendance and per capita General Fund revenues. Generally, this test is operative when General Fund revenues fall or grow slowly.
- ✓ **Legislature Can Suspend Proposition 98.** With a two-thirds vote, the Legislature can suspend the guarantee for one year and provide any level of K-14 funding.
- ✓ **Mechanism Exists to Ensure Growth With Economy and Attendance.** When Test 3 or suspension occurs, the state creates a funding gap called maintenance factor. Proposition 98 contains a mechanism to accelerate spending to restore maintenance factor and close the gap in future years.

### Figure 3 Governor's Proposed Proposition 98 Funding

(Dollars in Millions)

	2005-06		2006-07 Proposed	Change From 2005-06 Revised	
	Budget Act	Revised <sup>a</sup>		Amount	Percent
<b>K-12 Proposition 98</b>					
General Fund	\$33,071	\$32,792	\$36,403	\$3,611	11.0%
Local property tax revenue	11,573	11,845	11,963	118	1.0
Subtotals <sup>b</sup>	(\$44,644)	(\$44,637)	(\$48,366)	(\$3,729)	(8.4%)
<b>CCC Proposition 98</b>					
General Fund	\$3,413	\$3,412	\$3,949	\$537	15.7%
Local property tax revenue	1,804	1,830	1,899	69	3.8
Subtotals <sup>b</sup>	(\$5,217)	(\$5,242)	(\$5,848)	(\$606)	(11.6%)
<b>Total Proposition 98<sup>c</sup></b>					
General Fund	\$36,591	\$36,311	\$40,455	\$4,144	11.4%
Local property tax revenue <sup>d</sup>	13,377	13,675	13,862	187	1.4
<b>Totals<sup>b</sup></b>	<b>\$49,968</b>	<b>\$49,986</b>	<b>\$54,318</b>	<b>\$4,332</b>	<b>8.7%</b>

<sup>a</sup> These dollar amounts reflect appropriations made to date or proposed by the Governor in the current year.

<sup>b</sup> Detail may not total due to rounding.

<sup>c</sup> Total Proposition 98 also includes around \$105 million in funding that goes to other state agencies for educational purposes.

<sup>d</sup> The two-year diversion of property tax revenues from local governments to schools ends after 2005-06, reducing growth in property tax revenues for the budget year.

## ENROLLMENT FUNDING

The Governor's budget funds a 0.21 percent increase in K-12 enrollment, a level which is considerably lower than annual enrollment growth during the last decade. The K-12 enrollment is expected to grow even more slowly in coming years, as the children of the baby boomers move out of their K-12 years. Community college enrollment is funded for 3 percent growth in 2006-07, which is considerably above the expected adult population growth rate of 1.74 percent. In addition, the Governor's budget funds enrollment increases of 2.5 percent at UC and CSU.

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## SETTING EDUCATION PRIORITIES FOR 2006-07

In this chapter, we evaluate the proposed budget for K-12 and higher education, including proposed funding increases and reductions, budget/policy reforms, fund shifts and fee increases, and projected enrollment levels. The ongoing structural gap between state revenues and expenditures makes it all the more important for the Legislature to reassess program effectiveness and funding levels. In both K-12 and higher education, we provide the Legislature with alternative approaches to the budget's proposal.

***K-14 Priorities.*** The Governor's proposed Proposition 98 spending increase of \$4.3 billion is sufficient to adjust K-14 funding programs for the increase in student attendance and the cost of living, as well as provide \$1.4 billion for new and expanded programs. The additional discretionary spending proposed in the budget results in more K-14 funding than is required under Proposition 98. Because this higher level of spending increases the state's structural budget gap in 2007-08 and beyond, the budget raises the issue of whether the administration's funding level could be sustained in the future. We identify several alternative budget strategies the Legislature could adopt to reduce the impact of Proposition 98 on the state's financial condition. We also identify several key areas of the K-14 budget where we recommend a different approach than that taken in the Governor's budget. These include the seven new categorical programs included in the K-12 budget, funding for mandated programs, the federal program for migrant students, and the implementation of Proposition 49 after-school programs. We also address concerns about the current fiscal condition of school districts.

***Higher Education Priorities.*** The Governor's budget presents the Legislature with three major issues in higher education: enrollment growth, student fees, and CCC equalization. The Governor's budget proposal offers little rationale to justify its enrollment funding increases which significantly exceed projected growth in the college-age population. In addition, neither CSU nor CCC enrollment has met the level of growth funded in recent annual budgets. In the "Higher Education" portion of this chapter, we recommend different enrollment targets, funding levels, and related budget language changes for the segments.

The Governor's budget proposes no student fee increases for 2006-07. Instead, the Governor proposes that all increased higher education costs should be funded with additional state funds. We discuss how educational costs can be allocated between students and the state in a way that preserves access and allows families to plan for future educational expenses.

The Governor's budget proposes \$130 million as a final installment to complete the effort, begun in 2004-05, to equalize per-student funding

among community college districts. We discuss this augmentation, as well as the need for changes in CCC funding allocation practices that otherwise would erode the state's equalization efforts.

## PROPOSITION 98 UPDATE

*Our updated economic and revenue forecasts lead us to project different Proposition 98 outcomes than the Governor. Specifically, we estimate a somewhat higher Proposition 98 minimum guarantee for both the current and budget years. We also discuss various issues related to Proposition 98, including an update on the outstanding maintenance factor and our recommendation that the Legislature enact trailer bill language to rebench the Test 1 factor. Finally, based on updated economic data, we estimate that the K-12 cost-of-living adjustment (COLA) will be higher than the Governor's projection—5.8 percent instead of 5.2 percent. Funding COLAs at this level could lead to additional state costs of around \$300 million.*

### GOVERNOR'S BUDGET

The Governor's budget includes only minor adjustments to overall prior-year and current-year Proposition 98 funding levels. Figure 1 (see next page) shows changes in Proposition 98 K-14 spending from 2005-06 Budget Act levels. The figure also shows changes in support for Proposition 98 from the General Fund and local property tax revenues.

#### Prior-Year Adjustments

*Spending Increases by \$75 Million Due Mainly to Declining Enrollment.* For 2004-05, overall Proposition 98 spending increased by a total of \$75 million above the level assumed in the 2005-06 Budget Act, to a total of \$47 billion. This increase in costs is the net result of two main factors—a decrease in the K-12 attendance growth rate, and an increase in the cost of the declining enrollment provision. Specifically, the actual attendance growth rate for 2004-05 was 0.36 percent—slightly lower than the 0.52 percent previously assumed. This results in savings. However, the cost assumptions for the state's declining enrollment funding mechanism were significantly underestimated. Statute allows school districts to claim the higher of the prior-year's attendance level or the current-year's

attendance level when determining revenue limit funding. Due to technical budgeting reasons, the costs of the declining enrollment provision were underestimated by \$115 million. (We discuss the costs related to the declining enrollment adjustment in greater detail in the "Revenue Limits" section of this chapter.) In combination, the savings from having less students and the costs of funding declining enrollment result in net additional spending of \$75 million. Because local property tax revenues increased by an additional \$89 million for 2004-05, General Fund spending was decreased by \$14 million.

**Figure 1**  
**Changes in Proposition 98 Funding**  
**From 2005-06 Budget Act**

(In Millions)

	2004-05	2005-06
<b>Total Proposition 98</b>		
2005-06 Budget Act	\$46,941	\$49,968
2006-07 Governor's Budget	47,016	49,986
<b>Differences</b>	<b>\$75</b>	<b>\$18</b>
<b>General Fund Share</b>		
2005-06 Budget Act	\$34,009	\$36,591
2006-07 Governor's Budget	33,995	36,311
<b>Differences</b>	<b>-\$14</b>	<b>-\$280</b>
<b>Local Property Tax Share</b>		
2005-06 Budget Act	\$12,932	\$13,377
2006-07 Governor's Budget	13,021	13,675
<b>Differences</b>	<b>\$89</b>	<b>\$298</b>

### Current-Year Adjustments

The Governor's budget proposes roughly the same spending level for Proposition 98 in 2005-06 as what was assumed in the budget act—it increases slightly by \$18 million. Estimates for revenues from local property taxes increase by \$298 million, resulting in estimated General Fund savings of \$280 million.

*Spending Still Above the Proposition 98 Guarantee, but by Less Than Was Assumed in the Budget Act.* When the 2005-06 budget was adopted, the budget assumed Proposition 98 spending would be \$741 million above the minimum guarantee. While the overall spending level has remained

about the same, additional General Fund revenues have increased the minimum guarantee for the current year. Under the Governor's assumed revenues, the 2005-06 spending level is now roughly \$265 million above the minimum guarantee.

### **Budget-Year Estimates**

As discussed in the "Overview" section of this chapter, the Governor's budget proposes a spending level of \$54.3 billion for Proposition 98 in 2006-07. This is a \$4.3 billion, or 8.7 percent, increase over revised current-year spending. Based on the administration's revenue estimates, this would provide \$1.7 billion more than required by the minimum guarantee, plus \$426 million for after school programs as required by Proposition 49.

## **LEGISLATIVE ANALYST'S OFFICE (LAO) FORECAST**

Due to the timing of the budget's release, the Governor had to develop his budget before data from the end of 2005 was made available. We benefit from receiving economic information on the final quarter of 2005, as well as revenues from year-end tax payments. Based on this data, our updated economic and revenue forecasts indicate that General Fund revenues will be significantly higher in 2005-06 and 2006-07 compared to the administration's estimates. (Throughout this chapter we use the term "General Fund revenues" to refer to revenues received from taxes—the revenues used in the Proposition 98 calculation. These differ slightly from overall General Fund revenues.) These alternate projections result in somewhat different outcomes for Proposition 98, as shown in Figure 2 (see next page). Below, we discuss our estimates for Proposition 98 in the current and budget years.

***State Owes \$200 Million More to Education in Current Year Due to Increase in Minimum Guarantee.*** Our forecast projects General Fund tax revenues will be \$1.2 billion higher than the administration's estimates for 2005-06. Because the Proposition 98 calculation requires that a portion of these revenues go to fund K-14 education, we project the minimum guarantee is actually about \$465 million higher than what is estimated in the Governor's budget. However, because the Governor's current-year spending is \$265 million above the minimum guarantee, our higher revenue estimates will only require the state to spend an additional \$200 million in the current year to meet the minimum guarantee (as shown in Figure 2). Because of uncertainty in projecting General Fund revenues—discussed in detail below—we suggest the Legislature wait to address its funding obligation in the current year until the May Revision.

**Figure 2**  
**Proposition 98 Funding**  
**Under Different Revenue Scenarios**

(In Millions)

	2005-06	2006-07
<b>Governor's Budget Revenues</b>		
Governor's Proposed Funding Level	\$49,986	\$54,318
Minimum Guarantee	49,721	52,645 <sup>a</sup>
<b>Differences</b>	<b>\$265</b>	<b>\$1,673</b>
<b>LAO Revenues</b>		
Governor's Proposed Funding Level	\$49,986	\$54,318
Minimum Guarantee	50,186	52,760 <sup>a</sup>
<b>Differences</b>	<b>-\$200</b>	<b>\$1,558</b>

<sup>a</sup> Includes \$426 million funding for after school programs, as required by Proposition 49.

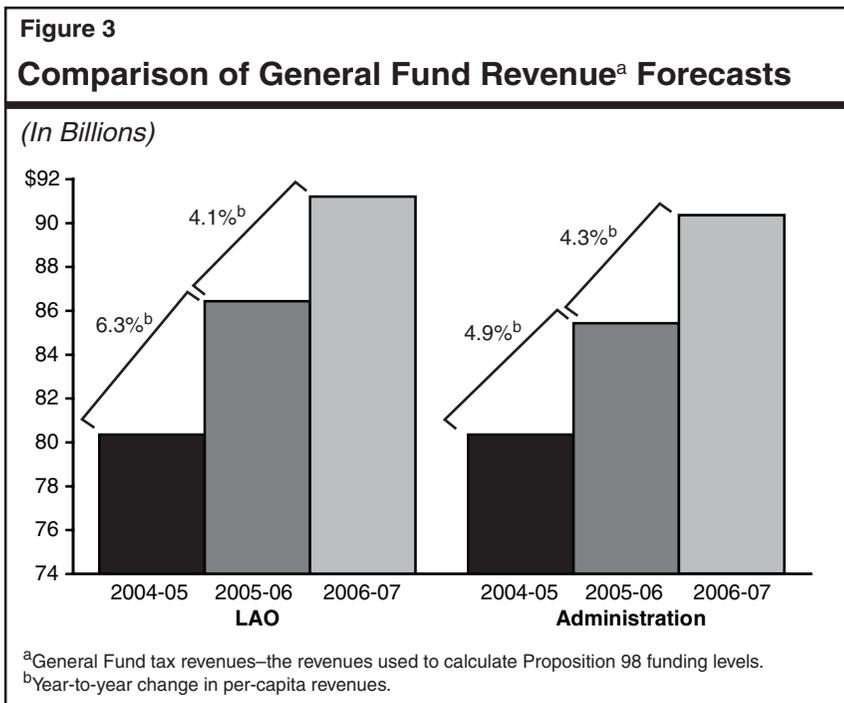
### Budget-Year Estimates

*Forecast Projects a Similar Minimum Guarantee.* Under our revenue forecast, the required spending level for Proposition 98 in 2006-07 is almost the same as the level projected by the Governor—\$52.8 billion as compared to \$52.6 billion. Our minimum guarantee is slightly more—\$115 million—than the Governor's. Both estimates include the \$426 million required for Proposition 49 after school programs. Because the guarantee is slightly higher under our forecast, maintaining the Governor's spending level—\$54.3 billion—would exceed the minimum guarantee by \$1.6 billion, slightly less than the Governor's estimate of \$1.7 billion.

*Almost \$1 Billion More Revenue but Similar Guarantee in 2006-07?* Our Proposition 98 forecast provides an unintuitive outcome. Compared to the Governor, we project the state will receive around \$1 billion more in revenue in the budget year, yet estimate that the minimum guarantee is only \$115 million more. It would seem that significantly higher revenues should lead to significantly higher funding for education, especially given our projection that budget-year funding will be growing off a base funding level that is \$200 million higher in 2005-06. There are two primary reasons this is not the case. First, we project a slightly lower growth rate for per-capita personal income for 2006-07—3.4 percent instead of 3.6 percent. This lower growth rate partially offsets the effect of our higher 2005-06 base.

Second, although our revenue forecast is considerably higher, our year-to-year revenue growth rate is similar. Proposition 98 drives off the

year-to-year *growth* in General Fund per-capita revenues, not the actual *amount* of revenues. Figure 3 shows that our revenue forecast is \$1.2 billion higher than the administration's in 2005-06, leading to a significantly higher per-capita growth rate from 2004-05—6.3 percent compared to 4.9 percent. As discussed, this raises the 2005-06 minimum guarantee above the Governor's estimates by \$465 million. For 2006-07, our revenues are around \$1 billion above the administration's. Because the magnitude of this increase is close to that of the increase we project for 2005-06, our forecast and the administration's forecast result in relatively comparable growth rates off of our respective estimates for the current year—4.1 percent compared to 4.3 percent. Similar year-to-year growth rates lead to similar Proposition 98 guarantees.



Thus, even though our forecast has the state receiving around \$2.2 billion more total revenues than the administration in the current and budget years combined, K-14 education would only be entitled to \$315 million in additional funding—\$200 million in 2005-06 and \$115 million in 2006-07. (This amount would have been \$265 million higher had the Governor's 2005-06 spending level not already exceeded estimates for the minimum guarantee.) This surprising outcome illustrates how strongly the Proposition 98 funding model is influenced by year-to-year changes in General

Fund revenues. That is, it is more than just how *much* revenue the state receives that determines the K-14 funding level, but also *when* that revenue is received.

***Difficulty Predicting Revenues Leads to Uncertainty for Proposition 98.*** As discussed in *The 2006-07 Budget: Perspectives and Issues (P&I)*, there is a high degree of uncertainty regarding where the state's economy is headed in the budget year and beyond. In the *P&I*, we also discuss uncertainties regarding the timing of future collections and refunds resulting from the 2004-05 tax amnesty program. These questions about the future make it difficult for forecasters to accurately project the General Fund revenues that drive the Proposition 98 formulas. Given that Proposition 98 is so dependent on year-to-year revenue changes, the specificity of these yearly projections matter a great deal. As such, the increasing degree of uncertainty in forecasters' revenue estimates may make estimating and planning for Proposition 98 increasingly uncertain as well. Since revenue estimates will likely change multiple times over the course of a fiscal year, the Legislature should anticipate ongoing adjustments to required Proposition 98 spending levels. In cases where the minimum guarantee is estimated to increase, such as 2005-06, the Legislature may wish to wait for updated projections in May before providing additional funding.

## TECHNICAL PROPOSITION 98 ISSUES

There are a number of technical issues related to Proposition 98 which the Legislature will face in the budget year. These include (1) questions related to the Proposition 98 suspension in 2004-05, (2) restoration of maintenance factor, (3) making adjustments to the Test 1 factor as a result of changes in the allocation of local property tax revenues, and (4) determining and meeting "settle-up" obligations from prior years when the Proposition 98 guarantee was not fully funded. Below, we discuss these issues in greater detail.

### Suspension and the Chapter 213 Target

In 2004-05, the state suspended the Proposition 98 guarantee. The legislation authorizing the suspension—Chapter 213, Statutes of 2004 (SB 1101, Committee on Budget and Fiscal Review)—established a target funding level for K-14 education that was \$2 billion lower than the amount called for by the guarantee. We refer to this spending level—\$2 billion below the minimum guarantee—as the Chapter 213 target. Over the course of the 2004-05 fiscal year, an improving economy resulted in the state receiving significantly more revenues than were projected when the *2004-05 Budget Act* was enacted. This increase in revenues would have resulted in

a substantial increase to the K-14 minimum guarantee had the state not suspended Proposition 98. Specifically, the minimum guarantee would have increased an additional \$1.7 billion above what was estimated at the time of the budget act. Correspondingly, the amount of savings the state realized from the suspension also increased by an additional \$1.7 billion above the Chapter 213 target level, for a total of \$3.7 billion.

As discussed below, the Governor proposes to appropriate \$1.7 billion above the Proposition 98 minimum guarantee in 2006-07 to restore K-14 funding to roughly the Chapter 213 target level.

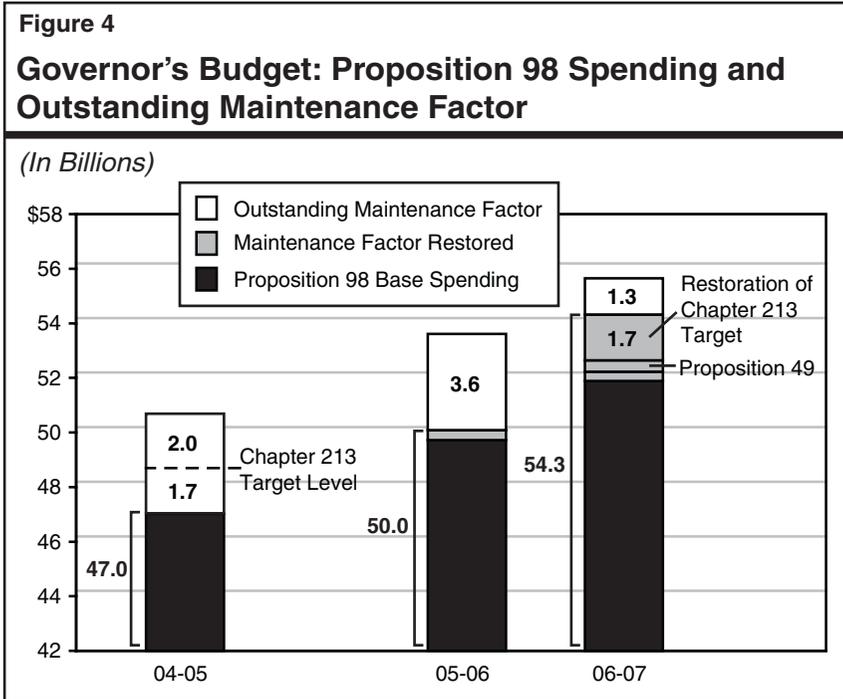
## Maintenance Factor

Over the long run, Proposition 98 has historically grown annually by attendance and growth in the economy (Test 2). At certain times—in Test 3 or suspension years—the state has provided less growth in K-14 funding than under the Test 2 formula. The gap between the Test 2 level and the actual funding provided is called the maintenance factor. The maintenance factor is tracked over time, and Proposition 98 contains a mechanism to accelerate K-14 spending in future years to restore the maintenance factor to the ongoing funding base. In addition, if the state decides to fund above the minimum guarantee, maintenance factor is restored. The suspension of Proposition 98 in 2004-05 created \$3.7 billion in maintenance factor obligation. The Governor's budget proposal would restore a small portion of this outstanding maintenance factor to the ongoing Proposition 98 base in 2005-06, and restore an even larger share in 2006-07. Figure 4 (see next page) shows Proposition 98 spending, the amount of maintenance factor restored under the Governor's budget, and the outstanding maintenance factor.

***Some Maintenance Factor Restoration in the Current Year.*** As discussed, the Governor proposes to provide \$265 million above the minimum guarantee in 2005-06. This "overappropriation" would restore a small portion of the outstanding maintenance factor (as shown in Figure 4). Our higher revenue estimates would require an additional \$203 million in maintenance factor payments in the current year, for a total of \$468 million (not shown in the figure).

***Governor Proposes to Restore Funding to Chapter 213 Target Level in 2006-07.*** As discussed above, the Governor proposes to spend a total of \$54.3 billion for Proposition 98 in 2006-07. Under the Governor's revenue forecast, the minimum guarantee for 2006-07 is \$52.2 billion, including a \$334 million maintenance factor restoration required by the Proposition 98 formula. Thus, as shown in Figure 4, the proposed level of funding would restore a total of \$2.4 billion of outstanding maintenance factor to the ongoing Proposition 98 base in 2006-07—\$334 million required restoration, \$1.7 billion as a discretionary appropriation above the minimum guaran-

tee, and \$426 million in required Proposition 49 funding. (See nearby box for a discussion of how Proposition 49 interacts with maintenance factor obligations.) The Governor proposes to provide the \$1.7 billion above the guarantee in order to restore the funding schools would have received in 2004-05 had the state met the Chapter 213 target in that year.



According to the administration’s revenue estimates, spending at the proposed level would leave \$1.3 billion in maintenance factor outstanding at the close of 2006-07. Because our revenue estimates project an additional \$200 million in maintenance factor payments in 2005-06 and a slightly higher minimum guarantee in 2006-07, we estimate that spending at the Governor’s level in the budget year would leave slightly less maintenance factor outstanding—\$1.2 billion.

**Rebenching the Test 1 Factor**

*We recommend the Legislature enact trailer bill legislation to clarify how the administration should rebench the Proposition 98 Test 1 factor to reflect the effect of changes in the allocation of local property tax revenues.*

### **Proposition 49 Pays Off Maintenance Factor Obligation**

Proposition 49 requires the state to provide an additional \$426 million to fund after school programs starting in 2006-07. The funding mechanism in Proposition 49 requires the state to first meet the Proposition 98 minimum guarantee for the year in which the measure takes effect, and then provide an additional \$426 million. Because of the specific statutory language of this requirement, both the Legislative Analyst's Office and Department of Finance interpret the measure such that the additional after school funding would count as restoring Proposition 98 "maintenance factor." (Some in the education community disagree with this interpretation and believe the Proposition 49 funding should not score as maintenance factor restoration.)

The Test 1 factor requires that Proposition 98 receive a minimum fixed percentage of General Fund revenues. When Proposition 98 was passed by voters in 1988, the Test 1 factor was set at 40.7 percent—that is, spending on K-14 education had to make up at least 40.7 percent of overall General Fund revenues. As directed by the initiative language approved by voters, this was intended to mirror the proportion of General Fund spending provided to K-14 education in 1986-87. To date, Test 1 has been operative only in 1988-89, the first year after Proposition 98 was passed by voters. However, based on the Governor's proposed level of spending and our estimates for revenues, attendance, and local property taxes in the future, we project that Test 1 may become operative again as early as 2008-09.

*Test 1 Factor Adjusted in 1992-93 and 1993-94 Due to Changing Allocations of Property Tax Revenues.* In 1992-93 and 1993-94, the state shifted a portion of property tax revenues which had previously gone to local governments to instead fund K-12 schools and community colleges. These were known as "educational revenue augmentation funds," or ERAF shifts. Because local revenues were now covering a greater share of K-14 funding, the Test 1 General Fund requirement was adjusted downward, from 40.7 percent to 34.6 percent. Had this Test 1 "rebenching" not occurred, the state would have had to provide schools 40.7 percent of the General Fund *plus* the higher local property tax revenues (including ERAF). This would have resulted in K-14 education receiving funding that significantly exceeded what schools would have received had the ERAF shifts not occurred. Thus, the rebenching allowed overall school funding requirements to remain unchanged by the ERAF shifts—all that changed was the proportion contributed by each funding source.

**Additional Local Property Tax Shifts.** In 2004-05, the state made additional permanent property tax shifts between schools and local governments, only this time funds were shifted in the other direction. Specifically, the state provided local governments with additional property tax revenues in exchange for reductions in (1) vehicle license fee (VLF) revenues through the VLF “swap,” and (2) sales tax revenues that the state designated as the payment source for the deficit-financing bonds passed by the voters in March 2004. The additional property tax revenues provided to local government resulted in less property tax revenues being available for schools. So, the state provided schools additional General Fund revenues to backfill the reallocated property tax revenues.

Figure 5 shows that starting in 2004-05, the state transferred a net of \$3.9 billion in local property taxes from schools to local governments. These transfers increase to \$6.8 billion in 2006-07, due primarily to the end of a two-year agreement under which local governments transferred \$1.3 billion annually in property taxes to schools. The \$6.8 billion in transfers to local governments is backfilled by the state providing additional General Fund revenues for Proposition 98.

**Figure 5**

**Transfers of Local Property Tax Revenues  
From Schools to Local Governments**

(In Millions)

	2004-05	2005-06 <sup>a</sup>	2006-07	2007-08
Vehicle License Fee (VLF) backfill	\$4,075	\$5,209	\$5,419	\$5,853
“Triple flip” <sup>b</sup>	1,136	1,208	1,426	1,503
Two-year savings from local government agreement	-1,300	-1,300	—	—
<b>Totals</b>	<b>\$3,911</b>	<b>\$5,117</b>	<b>\$6,845</b>	<b>\$7,356</b>

<sup>a</sup> The total for the VLF backfill includes a one-time \$318 million payment to cities and counties to settle up the state’s 2004-05 obligation. Similarly, the triple flip payment for 2005-06 includes a one-time reduction of \$173 million because the state’s payment to cities and counties in 2004-05 was too high.

<sup>b</sup> The state dedicates a one-quarter cent portion of sales tax revenues that previously went to cities and counties to finance the deficit-financing bonds authorized by Proposition 57. In exchange, cities and counties receive an equivalent amount of property tax revenues that previously went to schools, and schools receive additional General Fund revenues instead of local property tax revenues. These shifts are commonly referred to as the triple flip.

**LAO and Department of Finance (DOF) Differ on How to Adjust the Test 1 Factor.** As a result of the property tax shifts described above, the Test 1 factor must be adjusted again. While both DOF and our office agree

that an adjustment to the Test 1 factor is necessary, we disagree on how that adjustment should be made. Under the DOF methodology, the Test 1 factor would be adjusted to roughly 41 percent. Using our methodology, we estimate a Test 1 factor of around 41.6 percent.

While a 0.6 percent difference seems pretty close, the effect on the minimum guarantee under Test 1 would vary by over half a billion dollars. Since Test 1 may be operative in the near future, we believe that the Legislature should address this issue. We recommend the Legislature enact trailer bill language to clarify how the administration should rebench the Test 1 factor, and recommend that the methodology used provide schools with a level of resources comparable to what they would have received had the local government transfers not occurred.

### **State Owes Proposition 98 Settle-Up for Past Years**

Statute requires DOF, the California Department of Education (CDE), and the California Community Colleges (CCC) to jointly certify the Proposition 98 calculation and funding level nine months after the end of a fiscal year. If the minimum guarantee calculation requires the state to provide more funding in a specific year, the Legislature can either appropriate those funds, or within 90 days the Controller must allocate the funds to K-12 schools and CCC. This statutory requirement was only met in the first year Proposition 98 was operative. Proposition 98 funding levels were again certified in the mid-1990s through the enactment of legislation to settle the *CTA v. Gould* lawsuit. Since 1994-95, the state has not certified the Proposition 98 calculation.

Chapter 216, Statutes of 2004 (SB 1108, Committee on Budget and Fiscal Review), included language intended to determine finalized Proposition 98 required funding levels for fiscal years 1995-96 through 2003-04. Specifically, the legislation required the Superintendent of Public Instruction and Director of Finance to jointly determine by January 1, 2006, the outstanding balances—settle-up obligations—of the Proposition 98 minimum funding obligation for the nine years in question. Figure 6 (see next page) summarizes these “determinations.” In total, CDE and DOF estimate the state owes schools \$1.4 billion to meet the minimum guarantee for past years.

Chapter 216 also continuously appropriates \$150 million annually beginning in the 2006-07 fiscal year for the purposes of repaying settle-up obligations. (Because \$17 million was “prepaid” in 2005-06, only \$133 million is provided for this purpose in the Governor’s budget.) Chapter 216 states that, unless the Legislature directs it for another purpose, settle-up funding is to be used to repay schools and community colleges for the costs of prior-year mandates.

**Figure 6****Outstanding Settle-Up Owed for Proposition 98***(In Millions)*

1995-96	1996-97	2002-03	2003-04	Total <sup>a</sup>
\$76.3	\$165.9	\$540.8	\$617.6	<b>\$1,400.6</b>

<sup>a</sup> The Governor proposes to pay schools \$133 million in settle-up payments in 2006-07, reducing the outstanding obligation to \$1.3 billion.

**COST-OF-LIVING ADJUSTMENT (COLA)**

Each year, the budget provides most Proposition 98 programs with a COLA, or an increase in funding to reflect the higher costs schools experience due to inflation. Some programs receive this adjustment through statute, and others are typically provided with a discretionary COLA in the annual budget act. The K-12 COLA (also used for community college programs) is based on the gross domestic product deflator for purchases of good and services by state and local governments (GDP<sub>SL</sub>). For 2006-07, the K-12 COLA will be based on GDP<sub>SL</sub> growth rates from the final three quarters of 2005 and the first quarter of 2006.

**Budget-Year COLA Expected to Be Higher Than Governor's Estimates.** Based on the two quarters of GDP<sub>SL</sub> data available at the time the budget was developed, the administration estimated a 5.2 percent COLA and the budget provided corresponding adjustments to K-14 programs. The Governor's budget provided approximately \$2.6 billion in Proposition 98 funding to support COLAs for K-14 education. Recently released fourth quarter 2005 data indicates that the actual COLA factor may be even higher—around 5.8 percent. We estimate funding a 5.8 percent COLA would cost just over \$300 million more than the level currently funded in the Governor's budget, for a total of \$2.9 billion. Figure 7 provides a breakdown of these additional costs. The COLA factor will be finalized at the end of April, when the federal government releases the cost data for the first quarter of 2006.

**Why Is the COLA Rate So High?** As shown in Figure 8 (see page 26), the projected budget-year COLA of 5.8 percent is considerably higher than K-12 COLAs have been in recent years, and substantially higher than other COLAs provided in the state budget. (For a detailed discussion of COLAs, see "Perspectives on State Expenditures" in "Part IV" of our companion document, the *P&I*). The figure also displays the historical and projected

growth rates for the primary inputs to the overall GDP SL—general government employee compensation, gross investments (which include construction and building costs), and nondurable goods (which include costs for oil and gas). General compensation, including salaries and benefits, has grown moderately over the last few years, ranging from 3.6 percent to 4.6 percent annually. Until recently, the cost of gross investment and nondurable goods had grown slowly. As shown in the figure, however, 2006-07 estimates for these two factors appear significantly higher than they have been in prior years. This is primarily due to substantial increases in the costs of energy and construction, in part resulting from the hurricanes in the fall of 2005. Although first quarter 2006 data are not yet available, the high growth rates for nondurable goods and gross investments during the first three data periods indicate a higher-than-usual K-12 COLA rate for the budget year.

<b>Figure 7</b>	
<b>Increased Cost of Funding 5.8 Percent Cost-of-Living Adjustment (COLA)<sup>a</sup></b>	
<i>(In Millions)</i>	
K-12 Revenue limits	\$202.2
K-12 Categorical programs	71.1
Community colleges	33.6
<b>Total</b>	<b>\$306.9</b>
<sup>a</sup> Compared to a 5.2 percent COLA, as provided in the Governor's budget.	

**2006-07 COLA Rate May Be Higher Than Schools' Actual Costs of Inflation.** The cost factors that school districts face may be different than those reflected in the GDP SL. For schools, employee compensation accounts for a vast majority of operating expenditures—typically between 80 percent and 90 percent. In contrast, compensation makes up around 57 percent of the GDP SL. Conversely, the GDP SL weighs cost increases for energy and construction more heavily than the weights reflected in K-14 operating budgets. (Construction expenditures are typically supported by bond funds and developer fees rather than Proposition 98, and have an alternative COLA mechanism.) As shown in Figure 8, employee compensation costs are only projected to increase at a rate of 3.8 percent

in 2006-07—significantly less than the 5.8 percent COLA schools are expected to receive. This indicates that overall K-14 costs may grow more slowly than the K-12 COLA. Thus, providing a 5.8 percent COLA to all applicable Proposition 98 programs may overcompensate schools for the costs they actually face. However, as shown in Figure 8, there have been several years when the costs of inflation for employee compensation were actually higher than was reflected in the K-12 COLA rate. In those years, schools had to absorb the additional compensation costs without corresponding COLA funding from the state. Because the state did not provide additional COLA funds in years where the K-12 COLA rate may not have provided sufficient funding to help schools meet their actual costs of inflation, it may be unfair for the state to provide less than the actual K-12 COLA rate in 2006-07, even if it overestimates schools' actual rate of inflation for the budget year.

**Figure 8**

### **Rates for K-12 Cost-of-Living Adjustment (COLA) And COLA Factors**

*2002-03 Through 2006-07*

	2002-03	2003-04	2004-05	2005-06	2006-07 Estimate <sup>a</sup>
<b>K-12 COLA</b>	2.0%	1.9%	2.4%	4.2%	5.8%
<b>K-12 COLA Factors</b>					
Nondurable Goods—including oil and gas	-3.5%	3.6%	4.5%	12.1%	14.0%
Gross Investment—including construction	1.9	1.9	1.3	3.7	5.8
General Government Employee Compensation	4.1	4.6	4.4	3.6	3.8

<sup>a</sup> Projected based on three quarters of 2005 data and estimates for first quarter of 2006.

## PROPOSITION 98 PRIORITIES

*The Governor's budget proposes to spend \$1.7 billion more in 2006-07 for K-12 education and community colleges than the administration's estimate of the Proposition 98 minimum guarantee. If approved, this increase would widen the state's structural spending gap in 2007-08 and beyond, and raises the issue of whether the state would be able to sustain the budget's proposed overall level of General Fund expenditures in the future.*

### GOVERNOR PROPOSES SIGNIFICANT NEW RESOURCES

The Governor's budget proposes to increase Proposition 98 expenditures by \$4.3 billion in 2006-07 compared to the revised 2005-06 spending level. This increase is sufficient to adjust K-14 funding programs for the growth in student attendance and the cost of living and provide a \$1.4 billion increase for new and expanded programs.

Figure 1 (see next page) displays the major funding increases proposed in the budget for 2006-07. As the figure shows, increases in baseline costs consume \$2.9 billion of the new funds. A projected 5.2 percent cost-of-living adjustment (COLA) accounts for most of this increase (\$2.6 billion). Growth in attendance in K-12 education (0.2 percent) and the community colleges (3 percent) adds another \$305 million. The budget also includes \$134 million for K-14 state-mandated programs in the budget year. This represents the first time funding has been included in the Governor's budget for the ongoing cost of education mandates since 2002-03. The amount included in the budget would support about three-quarters of likely claims in 2006-07.

The budget plan also proposes \$1.4 billion for a variety of new or expanded K-14 programs. Implementing the requirements of Proposition 49 accounts for \$426 million. The initiative requires the state to expand existing after school programs for K-8 students by a specific amount starting in 2006-07. An additional \$406 million in revenue limits is proposed to equalize K-12 general purpose funding levels (\$200 million) and restore

past-year reductions in revenue limits (\$206 million). For the community colleges, the budget proposes funding for equalization (\$130 million) and several smaller funding increases totaling \$60 million. Finally, the budget proposes to spend almost \$400 million for a number of new K-12 categorical programs, including programs to help attract and retain teachers in low-performing schools (\$100 million) and an arts and music block grant (\$100 million).

<b>Figure 1</b>	
<b>Proposition 98 Expenditure Plan</b>	
<b>2006-07 Governor's Budget</b>	
<i>(In Millions)</i>	
<b>Baseline Adjustments</b>	
Cost-of-living adjustment	\$2,566.8
Attendance	304.9
Mandates	133.6
Other	-96.9
Subtotal	(\$2,910.7)
<b>New or Expanded Programs</b>	
Proposition 49 after school	\$426.2
K-12 revenue limit increases	406.2
CCC <sup>a</sup> equalization	130.0
Recruitment and retention	100.0
Arts and music	100.0
Other CCC proposals	60.1
Other K-12 proposals	198.2
Subtotal	(\$1,420.3)
<b>Total</b>	<b>\$4,311.0</b>
Details may not add due to rounding.	
<sup>a</sup> California Community Colleges.	

By appropriating more than Proposition 98 requires for 2006-07, the Governor's budget would restore K-14 funding roughly to the funding target set in Chapter 213, Statutes of 2004 (SB 1101, Committee on Budget and Fiscal Review). This act suspended the Proposition 98 minimum funding guarantee for 2004-05 by about \$2 billion and provided a target spending amount if revenues increased. Although General Fund revenues in 2004-05

were significantly higher than originally estimated, Proposition 98 expenditures in both 2004-05 and 2005-06 fell short of the target.

### **Minimum Guarantee Insufficient to Maintain Base Program**

The proposal to provide more than the minimum Proposition 98 funding level is significant for another reason—a portion of these additional funds supports baseline program costs of providing growth and inflation adjustments and restoring funding for ongoing K-14 mandates. As Figure 1 indicates, these baseline adjustments account for \$2.6 billion of the budget-year increase in spending. The administration's revenue forecast, however, would result in an increase in the minimum guarantee of only \$2.4 billion. This would leave schools and community colleges at least \$200 million short of a fully funded base budget. The Legislature has two basic choices for fully funding base K-14 programs—redirecting a portion of the existing Proposition 98 budget or appropriating more than the minimum guarantee.

Our revenue forecast reduces the difference between the minimum guarantee and the baseline K-14 budget for 2006-07. As we discuss in the previous write-up, our projection of General Fund revenues in the budget year translates into a minimum guarantee that is \$115 million higher than proposed in the budget. Our estimate, therefore, reduces, but does not eliminate, the amount of spending above the minimum guarantee needed to fully fund the base budget for K-12 and community colleges.

## **STATE STILL EXPOSED TO SIGNIFICANT FISCAL THREATS**

It is important for the Legislature to consider the Governor's Proposition 98 proposal in the context of the administration's overall General Fund spending plan. Viewed from this perspective, the increase in total spending proposed by the *2006-07 Governor's Budget* raises the issue of whether the higher level of expenditures—including funding for education—could be sustained in 2007-08 and beyond.

As we discuss in *The 2006-07 Budget: Perspectives and Issues (P&I)*, we think the Governor's budget proposal misses an opportunity to achieve a better long-term balance between expenditures and ongoing revenues. There are three factors underlying our concerns. First, while the administration's 2006-07 budget is balanced, we estimate that the state still has a structural budget gap—the difference between the cost of programs and the level of ongoing revenues—of several billions of dollars. This suggests that, under the administration's plan, the state would be unable to sustain the proposed level of spending without some combination of budget reductions or additional tax revenues in future years.

Second, in addition to the structural budget gap, other fiscal challenges require attention. For example, the State Teachers' Retirement System estimates that annual appropriations into the fund fall about \$1 billion short of the amount to fully fund the projected level of benefits for retirees over the long run. In addition, the state needs to begin addressing its liability for retiree health benefits. In our discussion of this issue in the *P&I*, we estimate the state's liability for these benefits is likely in the range of \$40 billion to \$70 billion.

Third, we are concerned that the extraordinary increases in General Fund revenues experienced recently may not be sustainable in the future. Our long-term forecast assumes steady economic growth of about 6 percent annually. The near-term economic outlook, however, is mixed. Because General Fund revenues are quite sensitive to changes in these conditions, a small reduction in economic growth could add several billions of dollars to the state's budget gap. With virtually no General Fund reserve projected at the end of 2006-07, the Governor's budget would leave the state with little fiscal flexibility to adjust to the lower revenues.

### **K-14 Funding Is Linked to State's Fortunes**

The fiscal health of the state is important to K-14 education. When times are good, state spending on schools and community colleges results in new and expanded programs and extra base increases. When the economy—and state revenues—slow, the state tends to cut categorical programs and inflation adjustments. While Proposition 98 was initially proposed by the education community to stabilize state funding, the level of support provided by the state is heavily influenced by changes in state revenues, particularly during economic slowdowns.

There are ways the state could mitigate the fiscal stress to K-14 education when General Fund revenues slow. For example, the state could use a portion of new General Fund revenues generated in good economic times to establish a healthy reserve that could protect state programs when revenues slow or fall during economic downturns. A healthy reserve could allow the state to supplement the Proposition 98 minimum guarantee and minimize funding reductions to schools and community colleges. Alternatively, the state also could establish a Proposition 98 reserve that would create a cushion *within* the minimum guarantee to protect against slow economic times. Without some type of significant "rainy day" reserve, the Legislature has few options—other than program reductions or tax increases—to help schools and colleges weather tough economic times.

How the state chooses to spend—or cut—Proposition 98 resources also influences the amount of flexibility local education agencies have to accommodate spending reductions. Typically, the state determines how

new K-14 spending is allocated among the many state funding programs as part of the annual budget process. Depending on the nature of new or expanded activities approved by the Legislature, the funds are often spent on programs that are difficult to reverse during times of spending reductions. As a consequence, districts must find other sources of funds to substitute for the state's budget cuts, thereby triggering disproportionately large program cuts at the local level when the economy slows.

An example of this pattern occurred only a few years ago. Large increases in Proposition 98 spending in 1999-00 and 2000-01 were followed by funding cuts in 2002-03 and 2003-04. During 2000-01, the budget distributed much of the increase as general purpose funding to K-12 districts, although then-Governor Davis made it clear that the increase was intended to support increased teacher salaries. Many districts complied with the Governor's wishes, and, as a result, wage increases of 8 percent to 10 percent were common across the state.

The budget reductions made by the state in 2002-03 and 2003-04 did not reverse the wage commitments of the early 2000s, however. At the local level, wage "roll-backs" were rare, which required districts instead to reduce the level of educational services beyond what was required by the state reductions. Districts also used budget strategies such as deficit spending and borrowing from restricted funds. As we discuss later in this chapter, district finances have not fully recovered from the recent economic slowdown.

The fiscal fate of K-14 education is tied to the state's financial health. The experience over the past six or seven years suggests that the state's good intentions can sometimes result in very difficult fiscal situations for local educational agencies. In our view, therefore, it is critical that the Legislature recognize the volatile nature of the state's revenue base and take the steps needed to increase the likelihood that new spending provided in the budget year can be sustained in 2007-08 and beyond. The Legislature could lessen the impact of a slowdown in revenues on programs by creating a substantial General Fund reserve. Similarly, an annual Proposition 98 reserve could cushion the impact during an economic slowdown on K-14 education.

## **MINIMIZE IMPACT OF PROPOSITION 98 ON STRUCTURAL GAP**

*We recommend the Legislature reject all proposals for new K-14 programs and fund Proposition 98 at the level needed to fully fund base program costs in the budget year. While this would result in \$1 billion less in K-14 spending than the Governor's budget, it would still provide an increase of \$3.3 billion over the current year.*

The weakness of the state's fiscal health suggests that the Legislature should get the state's financial "house" in order before approving large increases in spending for new programs. In addition, proposed funding augmentations could actually weaken school district and community college financial health if those increases cannot be sustained in the future. Because many districts base local wage increases on the level of general purpose funds provided to the districts, a significant portion of the \$406 million proposed for revenue limit deficit factor and equalization could be used for that purpose. If the General Fund condition cannot sustain the proposed level of Proposition 98 spending in 2007-08, districts could be left in a similar position as in the early 2000s—facing slowing or reduced Proposition 98 funding levels, but with less fiscal flexibility to accommodate those cuts. As a result, we believe the current situation calls for a different approach to Proposition 98 funding than proposed by the Governor.

Instead, we recommend the Legislature increase K-14 funding to provide a fully funded base budget for existing programs. This entails providing growth and inflation increases and fully funding those parts of the school and community college budget that are not adequately addressed.

Figure 2 displays our recommended spending increases for 2006-07. Our estimate of the amount required to fully fund the K-14 base totals \$3.3 billion, or \$359 million more than the base augmentations proposed by the Governor. There are three main differences that account for our higher estimate. First, as discussed earlier in this chapter, recent economic data indicates that the statutory COLA will be larger than projected by Department of Finance. Specifically, we estimate a 5.8 percent K-14 COLA, up from the 5.2 percent adjustment proposed in the budget. This accounts for \$307 million of the difference.

Second, we increased funding for growth in K-14 attendance by \$13 million, which is the net result of two adjustments. We added \$75 million to reflect our higher estimate of the cost of the declining enrollment adjustment. Based on the 0.2 percent increase in K-12 attendance growth anticipated by the administration, the budget understates the growth in costs of the one-year hold harmless payments provided to districts experiencing declines in student attendance. Our proposal also reduces community college growth by \$62 million to reflect our projections of enrollment growth rather than a higher level proposed by the administration.

Third, we added funding for two programs to more fully reflect the state's financial commitments to districts. We added \$39.4 million to fully fund K-12 state-mandated local programs in 2006-07. The Governor's budget only partially funds these expenses. We also recommend approval of

the \$20 million increase in funding for remedial instruction for students who have failed the California High School Exit Examination. Because of the importance of the test to students, the new funds give districts additional resources to help students who have failed the test.

**Figure 2**

### 2006-07 Proposition 98 Baseline Adjustments Governor's Budget and LAO Alternative

(Dollars in Millions)

	Governor's Budget	LAO Alternative	Difference	
			Amount	Percent
<b>Baseline Adjustments</b>				
Cost of living adjustment	\$2,566.8	\$2,873.7	\$306.9	12.0%
Attendance	310.0	323.0	13.0	5.4
Mandates	133.6	173.0	39.4	29.5
Other	-96.9	-96.9	—	—
Subtotals	\$2,910.7	\$3,270.0	\$359.3	12.3%
CAHSEE <sup>a</sup> remediation	20.0	20.0	—	—
<b>Totals</b>	<b>\$2,930.7</b>	<b>\$3,290.0</b>	<b>\$ 359.3</b>	<b>12.3%</b>

<sup>a</sup> California High School Exit Examination.

We would not recommend funding for any other proposals for new or increased spending. This would save the state \$1 billion relative to the Governor's budget. It also would reduce the state's structural budget gap in 2007-08 by about the same amount. While we recognize the desire to use available funds to improve local education programs, we do not believe state finances are sufficiently strong to guarantee that a large infusion of new funding could be sustained in future years. A more modest K-14 budget in 2006-07 could work to the advantage of local education agencies in the future if, for example, the state used the savings to increase the size of its General Fund reserve.

Moreover, our recommendation would still provide more than \$3.3 billion in new resources to schools and colleges. Almost all of this increase results from the large increase in the inflation index used for K-14 education. As discussed earlier in this chapter, the 5.8 percent COLA probably overstates the actual inflation in K-14 costs in California. Large increases in energy and construction costs are responsible for the significant jump in the index. The portion of the inflation index for state and local govern-

ment purchases shows only a 3.8 percent increases in wages and benefits. Since local education agencies spend most operating funds on wages and benefits, the budget-year COLA would likely provide a measure of new discretionary funds for districts and colleges.

If, on the other hand, the Legislature wants to provide a total level of Proposition 98 spending similar to the amount proposed in the budget, we recommend that the Legislature consider two alternatives to the Governor's proposed allocation of funds. The first alternative would provide additional one-time funds to local education agencies above the baseline budget level. The second option would provide additional ongoing funds but targeted at improving school district financial conditions. We discuss each of these options below.

## OPTION 1: SUPPLEMENT BASE WITH ONE-TIME FUNDS

*If the Legislature desires to provide K-14 resources at levels consistent with the Governor's budget, we recommend the Legislature spend \$1 billion on a one-time basis to reduce the state's K-14 "credit card" debt.*

In addition to the state's structural budget gap and other financial threats, the state has essentially "borrowed" from school districts and community colleges during the recent economic slowdown. The state has two types of outstanding commitments to Proposition 98. First, the state owes \$1.4 billion in Proposition 98 "settle-up" payments, primarily as the result of the final determination of the minimum guarantee in 2002-03 and 2003-04. While state law requires paying these one-time settle-up balances within one year after the end of the fiscal year, only a relatively small amount of this obligation has been retired. As part of the 2004-05 budget agreement, the state enacted legislation specifying that this obligation would be paid over a ten-year period starting in 2006-07. The budget's proposal for \$133 million in one-time spending to retire past mandates represents the 2006-07 payment for settle-up.

The second type of obligation the state owes to K-14 education is *internal* to Proposition 98. We have called this the "education credit card," because the districts and community colleges incurred costs for certain programs that were not fully funded during the fiscal year in which services were provided. Figure 3 displays the balance on the credit card from 2003-04 through 2005-06 and our estimate of the amount owed in 2006-07. Funding deferrals—shifting payments for services provided during the budget year to the next fiscal year—account for \$1.3 billion. Another \$1.2 billion stems from the fact that the budget has omitted payments in past years for the ongoing costs of mandated local programs. In addition, state law

promises to repay K-12 districts “deficit factor,” which represents foregone inflation adjustments to revenue limits in 2003-04. The Governor’s proposal to spend \$200 million to pay off a portion of deficit factor would reduce this outstanding obligation to only \$100 million in 2006-07.

<b>Figure 3</b>				
<b>Status of the Education Credit Card Under the Governor’s Budget Proposal</b>				
<i>(In Millions)</i>				
	<b>2003-04</b>	<b>2004-05</b>	<b>2005-06</b>	<b>2006-07</b>
<b>Deferrals</b>				
K-12	\$1,097	\$1,083	\$1,103	\$1,103
Community colleges	200	200	200	200
<b>Mandates</b>				
K-12	\$946	\$1,096	\$1,234	\$1,110
Community colleges	55	73	91	109
K-12 revenue limit deficit	883	646	300	100
<b>Totals</b>	<b>\$3,181</b>	<b>\$3,098</b>	<b>\$2,928</b>	<b>\$2,623</b>

The amount owed to K-14 education has slowly declined throughout this period. In 2006-07, however, the state still owes \$2.6 billion. The reduction in the balance over time results from repaying revenue limit deficit factor and one-time payments for past mandates. In addition, the budget proposal to partially fund the ongoing cost of mandates also avoids a large increase in the amount owed to K-14 in the budget year.

### **Pay Off Mandates, Reduce Structural Gap**

To a large extent, the higher Proposition 98 funding level proposed in 2006-07 is supported by *one-time funds* reflected in the higher ending balance from the current fiscal year. Because of higher-than-expected revenues in 2004-05 and 2005-06, the administration forecasts that the state will enter the 2006-07 budget with a \$6.5 billion reserve. Because this entering reserve is one-time in nature, spending those funds on ongoing augmentations and new programs is not fiscally prudent. If the Legislature wants to use some of these one-time funds to provide additional resources to K-14 education, we would suggest addressing one-time issues in K-14 education.

The existence of the credit card and the outstanding settle-up obligations present the Legislature with an option for providing the same level of K-14 education resources as the Governor's budget in a way that does not widen the structural budget gap in 2007-08 and beyond. Specifically, the Legislature could appropriate \$1 billion in one-time funds to retire most of the state's liability for unpaid mandate claims.

There would be three benefits to this approach. First, one-time payments would retire most of the K-14 settle-up obligations. Because the \$1.4 billion in these obligations were scheduled to be paid off over the next ten years, paying them off early would reduce the state's debt obligations for future years. Thus, compared to the Governor's budget, this option allows the Legislature to provide the same amount to K-14 education in 2006-07 while *reducing* the state's structural gap in future years.

Second, using one-time funds to retire the state's obligation for past mandate costs also would reduce the K-14 credit card balance. The credit card represents a way the state has maintained program while cutting expenditures during slow economic times. If the credit card is not repaid before the next economic slowdown, the state will have much less flexibility to respond to revenue shortfalls. For this reason, we believe the state needs to address existing deferrals and unpaid mandate claims. Directing \$1 billion in one-time funds to satisfy a portion of these claims would virtually eliminate this component of the credit card.

Third, a large infusion of one-time funds to school districts would help them address pressing financial issues. As discussed later in this chapter, many school districts find themselves on shaky financial ground, due to the lingering effects of the recent economic slowdown and declining student attendance. In addition, many districts—like the state—must address the problems presented by unfunded liabilities for retiree health benefits. Using \$1 billion to pay for past mandate claims would give K-12 districts a source of unrestricted one-time funds to address these fiscal issues.

Our assessment of the state's fiscal health suggests that this is not the time for major budget augmentations. The Legislature can, however, provide additional support for K-14 education by addressing past Proposition 98 settle-up obligations, which represent one of the "off-book" budgetary borrowing mechanisms used by the state during the recession. While this does not reflect our recommended legislative action, it does represent a reasonable compromise between a desire to increase support for education and the need to improve the condition of state finances.

## OPTION 2: TARGET NEW FUNDS AT HIGHEST LOCAL NEEDS

*We recommend that, if the Legislature wants to provide a higher ongoing level of Proposition 98 expenditures similar to the amount proposed in the 2006-07 budget, it (1) eliminate new after school funding and place the repeal of Proposition 49 before the voters, (2) commit new K-12 discretionary funds for a fiscal solvency block grant, and (3) approve community college funding to achieve the Legislature's equalization goal.*

If the Legislature desires to fund Proposition 98 at a level similar to that proposed in the Governor's budget, it faces the issue of whether the administration's specific spending proposals for the use of discretionary funds meet the needs of schools and community colleges in the state. As discussed above, we estimate that the Governor's proposed Proposition 98 spending level results in about \$1.4 billion in discretionary augmentations.

### Address K-12 Fiscal Issues

In K-12, the budget would spend these discretionary funds to expand after school programs as required by Proposition 49 and create seven new K-12 categorical programs—each relatively small and targeted at specific state objectives. We continue to recommend repeal of Proposition 49 because it reduces the state's flexibility to establish spending priorities and expands services at a time when the state faces a long-term spending gap. In addition, existing state and federal after school funds are going unused. Later in this chapter, we also recommend that the Legislature disapprove funding for all of the seven new categorical programs because they represent a further splintering of K-12 funding at a time when the state has just consolidated categorical funding into block grants. In addition, the seven programs have basic policy problems and contain virtually no planning, reporting, evaluation, or accountability components.

We do not believe the Governor's uses of discretionary funds address the most pressing issues facing K-12 districts. Specifically, weak district financial conditions left over from the recent economic slowdown, loss of funding due to declining enrollment, and the need to begin budgeting for retiree health care costs present fiscal challenges that many districts will be unable to meet satisfactorily. In the short-term, statewide data show increasing numbers of districts in very poor financial shape. Over the long-run, retiree health costs represent an ongoing fiscal threat that, if not addressed, could force districts to seek state assistance.

Figure 4 (see next page) summarizes our recommendations for the proposed uses of ongoing funds for K-12 education. To help districts address these fiscal issues, we recommend the Legislature reject the new program

proposals included in the Governor's budget. Instead, we recommend the Legislature (1) eliminate from the budget new funds proposed for after school programs and (2) devote the remaining discretionary funds available to adequately fund baseline increases for K-12 education and our proposed fiscal solvency block grant. The block grant would provide a flexible source of funding that districts could use to improve their fiscal health, adjust district operations to reflect lower student attendance, and begin the process of setting aside funds needed to pay for future retiree health care costs. While the block grant may not result in short-term dividends to the quality of many local educational programs, in the long run, we think the returns to restoring the fiscal health of districts are significant. We discuss our block grant approach later in this chapter.

**Figure 4**

### **LAO Recommendations for the Use of 2006-07 Discretionary Funds in K-12**

*(In Millions)*

	<b>Amount</b>
<b>Deny Governor's Proposals</b>	
Proposition 49 after school	\$426.2
K-12 revenue limit increases	406.2
Recruitment and retention	100.0
Arts and music	100.0
Physical education	85.0
Beginning teacher support	65.0
Digital classroom grants	25.0
Fresh Start	18.2
Subtotal	\$1,225.6
<b>LAO Proposed Uses of Funds</b>	
Reduce Proposition 98 spending	\$426.2
Fiscal solvency block grant	411.7
K-12 Baseline increases	387.7
Subtotal	\$1,225.6

### **Achieve California Community Colleges (CCC) Equalization Targets**

Compared to K-12 school districts, community colleges have more flexibility in adjusting to state budget changes. For example, in response to state budget reductions in 2003-04, many colleges reduced the number of courses they offered or focused their course offerings in less costly

disciplines. In addition, while many colleges offer retiree health benefits and therefore face long-term cost pressures similar to K-12 schools, outstanding liabilities for community colleges may be somewhat less because some colleges have set aside funds for these retiree health expenses. As a result, community college districts appear to be in better financial shape than school districts.

We have therefore taken a different approach for community colleges. Specifically, as we describe in the “California Community Colleges” section later in this chapter, we believe completing ongoing efforts to equalize CCC apportionments would be a top priority for discretionary spending on the community colleges. The Governor proposes \$130 million for this purpose. We recommend that any new spending on CCC equalization be accompanied by legislation that changes how future apportionment funding is allocated among the community colleges. This is because the existing program-based funding method would erode the state’s equalization efforts over time.

In addition, we suggest that the Legislature more closely monitor the issue of retiree health benefits at community colleges in order to determine whether additional state action is needed to ensure community colleges are addressing the associated long-term financial issues. Specifically, we recommend that the Legislature require the Chancellor’s office to provide data on the outstanding obligations in the various districts, and to report on steps that the system and districts are taking with regard to this issue.





# INTRODUCTION

## *K-12 Education*

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**T**he budget proposes to provide a \$3.7 billion (8.4 percent) increase in K-12 Proposition 98 funding from the 2005-06 level. Compared to the revised current-year level, the proposed 2006-07 funding would provide \$1.7 billion more than required by the Proposition 98 minimum guarantee plus \$426 million for after school programs as required by Proposition 49. The new funding is used to fully fund attendance growth and provide a cost-of-living adjustment, provide K-12 schools with additional revenue limit general purpose funds, and create several new K-12 categorical programs. Schools would receive \$8,030 per pupil, or 8.1 percent more than revised per pupil expenditures in the current year.

### **Overview of K-12 Education Spending**

Figure 1 (see next page) displays all significant funding sources for K-12 education for 2004-05 through 2006-07. As the figure shows, Proposition 98 funding constitutes over 70 percent of overall K-12 funding. Proposition 98 funding for K-12 increases \$3.7 billion (8.4 percent) from the 2005-06 level. This increase is supported mainly by the General Fund (\$3.6 billion). Growth in local property tax revenues for Proposition 98 is only \$118 million (1 percent) in 2006-07. This is primarily due to transfers of local property taxes to local governments, as discussed below. Other funding for K-12 increases by a combined \$379 million (2.2 percent).

*Local Government Deals Require Higher General Fund Support for Proposition 98.* The K-12 share of Proposition 98 supported by the General Fund has increased from 67 percent in 2003-04 to 75 percent, or \$3.6 billion, in the proposed budget. The main cause of the increased General Fund share is related to state-level decisions affecting the allocation of local property tax revenues. Property tax revenues were redirected from schools to local governments, requiring additional General Fund revenues to serve as a “backfill.” See the “Proposition 98 Update” section of this chapter for a more detailed discussion of these developments.

## Figure 1 K-12 Education Budget Summary

(Dollars in Millions)

	Actual 2004-05	Revised 2005-06	Proposed 2006-07	Changes From 2005-06	
				Amount	Percent
<b>K-12 Proposition 98</b>					
State General Fund	\$30,863	\$32,792	\$36,403	\$3,611	11.0%
Local property tax revenue	11,265	11,845	11,963	118	1.0
Subtotals, K-12 Proposition 98	(\$42,128)	(\$44,637)	(\$48,366)	(\$3,729)	(8.4%)
<b>Other Funds</b>					
General Fund					
Teacher retirement	\$1,050	\$999	\$997	-\$2	-0.2%
Bond payments	1,608	1,731	1,991	260	15.0
Other programs	779	550	623	73	13.3
State lottery funds	810	1,022	1,022	—	—
Other state programs	110	125	146	21	16.8
Federal funds	7,483	7,456	7,469	13	0.2
Local funds	5,587	5,602	5,616	14	0.2
Subtotals, other funds	(\$17,427)	(\$17,485)	(\$17,864)	(\$379)	(2.2%)
<b>Totals</b>	<b>\$59,555</b>	<b>\$62,122</b>	<b>\$66,230</b>	<b>\$4,108</b>	<b>6.6%</b>
<b>K-12 Proposition 98</b>					
Average daily attendance (ADA)	5,982,372	6,010,454	6,023,040	12,586	0.2%
Amount per ADA	\$7,042	\$7,427	\$8,030	\$604	8.1

Totals may not add due to rounding.

*Proposed Increases in Non-Proposition 98 Spending.* The budget proposes to increase non-Proposition 98 funding for K-12 by \$379 million in 2006-07. The key changes include:

- *School Bond Debt Service—Increase of \$260 Million.* The budget's increase in debt service on school bonds reflects recent investments the state has made in school construction and renovation through Proposition 1A (1998), Proposition 47 (2002), and Proposition 55 (2004).
- *State Lottery—Revenues Increase (\$212 Million).* The 2005-06 Budget Act assumed K-12 education would receive \$810 million in revenue from the California Lottery—similar to level of revenue projected received in the prior year. The administration reports that updated information from the Lottery Commission indicates

2005-06 K-12 revenues will exceed \$1 billion due to higher-than-anticipated sales, an increase of \$212 million over projected 2004-05 amounts. The Governor's budget estimates this higher level of lottery revenue will continue in 2006-07.

- **Federal Funding Increases of \$13 Million.** The Governor's budget, finalized prior to passage of the federal 2006 budget (October 2005 to September 2006), assumed an increase of \$13 million in federal funding in 2006-07. We now have early estimates of the year-to-year change in federal funding which indicate that federal funding for California education will decrease in 2006-07. Thus, the Governor has likely overbudgeted federal funds. The Department of Finance (DOF) traditionally reflects these revisions in the May Revision.

### Per-Pupil Spending Grows by \$604 in 2006-07

The Governor's budget provides an additional \$604 per pupil in Proposition 98 funding, an 8.1 percent increase from the current year. Figure 2 (see next page) shows per-pupil spending in dollars over the last decade. (The numbers are in "nominal" dollars—that is, not adjusted for the effects of inflation.) The figure shows three distinct trends—a fast growth period in the late 1990s, a slow growth period between 2000-01 and 2004-05, and significant increases in the current and budget years. Spending per pupil increased in each year of this period.

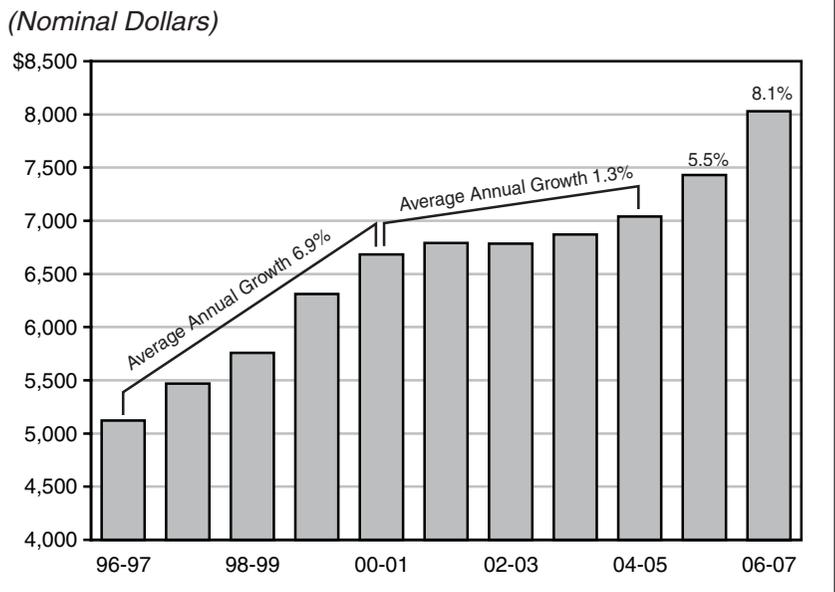
Figure 3 (see next page) adjusts per-pupil spending for inflation. While K-12 spending still shows rapid growth in the late 1990s, between 2000-01 and 2004-05 it did not keep pace with rising costs, declining, on average, 1.9 percent per year. This trend began to change in 2005-06. Building on the slight increase provided in the current year, the Governor's proposal would grow per-pupil spending an additional 4.8 percent. Looking at changes over the last decade, spending (in inflation-adjusted terms) has increased by approximately \$946 per pupil (17 percent).

### Major K-12 Funding Changes

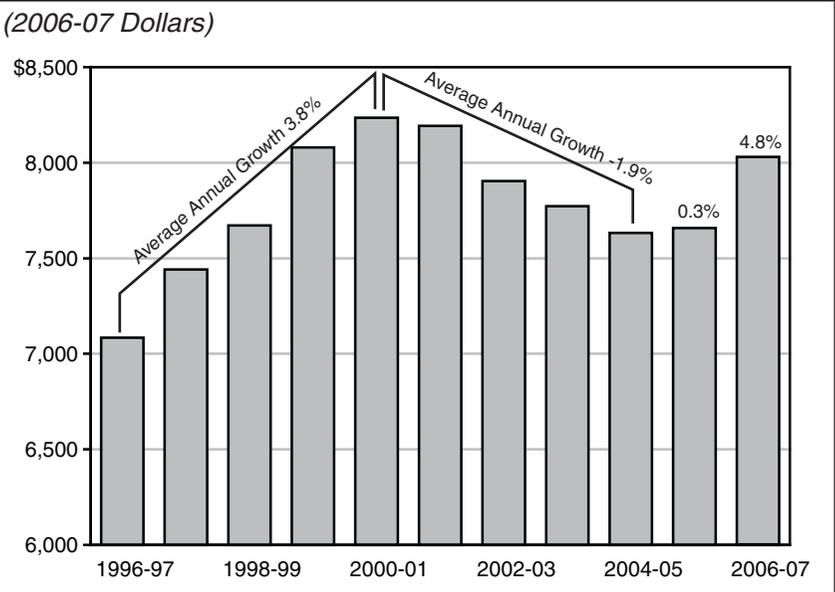
Figure 4 (see page 45) displays the major K-12 funding changes from the 2005-06 revised budget. In 2006-07, the Governor's budget proposes \$3.7 billion in new Proposition 98 K-12 expenditures for the following purposes.

- **Revenue Limit Growth and Cost-of-Living Adjustments (COLAs)—\$1.7 Billion.** The Governor fully funds 0.2 percent enrollment growth in revenue limits (\$54 million), and a 5.2 percent COLA (\$1.7 billion).

**Figure 2**  
**Proposition 98 K-12 Per Pupil Spending**



**Figure 3**  
**K-12 Per Pupil Spending Adjusted for Inflation**



## Figure 4 Major K-12 Proposition 98 Changes

(In Millions)

2005-06 Revised K-12 Spending Level	\$44,637
<b>Revenue Limit</b>	
Cost-of-living adjustments (COLAs)	\$1,689.3
Growth	54.3
Declining enrollment adjustment	13.2
PERS/UI <sup>a</sup>	-136.0
Deficit factor reduction (including basic aid)	206.2
Equalization	200.0
Subtotal	(\$2,027.0)
<b>Categorical Programs</b>	
COLAs	\$594.1
Growth	88.6
Proposition 49 after school programs	426.2
Mandates	133.6
Recruitment and Retention—low performing schools <sup>b</sup>	100.0
Arts and music block grant	100.0
Physical education	85.0
Expand beginning teacher program	65.0
Digital classroom grants	25.0
Restore categoricals funded with one-time funds	23.2
Other	60.5
Subtotal	(\$1,700.9)
<b>Total Changes</b>	<b>\$3,727.9</b>
<b>2006-07 Proposed</b>	<b>\$48,366.4</b>

<sup>a</sup> Public Employees' Retirement System/Unemployment Insurance.

<sup>b</sup> The 2005-06 Budget provided \$49.5 million in one-time funds for the recruitment and retention of teachers in low performing schools. In 2006-07 the Governor proposes to increase the funding level to \$100 million and to fund the program with ongoing funds.

- Deficit Factor Reduction—\$206 Million.** In 2003-04, the state did not provide a COLA (1.8 percent), creating an obligation to restore the reduction at some point in the future. That obligation is referred to as the “deficit factor.” Over the last two years the state has been restoring those funds. The budget provides \$205 million to restore roughly two-thirds of the outstanding deficit factor, reducing it from around 0.9 percent to around 0.3 percent for school districts and 0.1 percent for county offices of education. It also provides

about \$1 million to eliminate the corresponding categorical program reduction for basic aid districts.

- **Revenue Limit Equalization—\$200 Million.** The Governor proposes \$200 million to reduce historical inequities in general purpose spending.
- **Categorical Growth and COLAs—\$683 Million.** The Governor fully funds growth and COLAs for categorical programs.
- **Proposition 49—\$426 Million.** The proposed budget includes \$426 million to fully fund Proposition 49 after school programs. (In addition to these Proposition 98 funds, the budget provides \$2 million to the California Department of Education for administration and evaluation.)
- **New and Expanded Programs—\$375 Million.** The Governor proposes \$375 million to create or expand categorical programs, including: grants for low performing schools (\$100 million), school art grants (\$100 million), physical education (\$85 million), teacher training (\$65 million), and education technology (\$25 million).
- **Mandates—\$133 Million.** The budget proposal includes \$133 million to reimburse schools for a significant portion of the ongoing costs of mandates. (In addition, the budget provides \$152 million in one-time funds to partially pay for mandate claims from prior years.)

### Proposition 98 Spending by Major Program

Figure 5 shows Proposition 98 spending for major K-12 programs. The budget provides \$34 billion for revenue limits, \$3.4 billion for special education, and almost \$1.8 billion for K-3 class size reduction (CSR). The figure also shows that the budget proposal includes a significant increase in funding for after school programs (resulting from the “trigger” of Proposition 49) and for mandates.

### Enrollment Trends

Enrollment growth significantly shapes the Legislature’s annual K-12 budget and policy decisions. When enrollment grows slowly, for example, fewer resources are needed to meet statutory funding obligations for revenue limits and K-12 education categorical programs. This leaves more General Fund resources available for other budget priorities both within K-12 education and outside it. Conversely, when enrollment grows rapidly (as it did in the 1990s), the state must dedicate a larger share of the budget

to education. In light of the important implications of enrollment growth, we describe below two major trends in the K-12 student population.

**Figure 5**  
**Major K-12 Education Programs**  
**Funded by Proposition 98**

*(Dollars in Millions)*

	Revised 2005-06 <sup>a</sup>	Proposed 2006-07 <sup>a</sup>	Change	
			Amount	Percent
<b>Revenue Limits</b>				
General Fund	\$20,539.7	\$22,469.1	\$1,929.3	9.4%
Local property tax	11,493.5	11,593.9	100.4	0.9
Subtotals	(\$32,033.3)	(\$34,063.0)	(\$2,029.7)	(6.3%)
<b>Categorical Programs</b>				
Special education <sup>b</sup>	\$3,241.9	\$3,415.6	\$173.7	5.4%
K-3 class size reduction	1,676.3	1,751.1	74.9	4.5
Child development and care	1,220.9	1,261.5	40.6	3.3
Targeted Instructional Improvement Block Grant	976.3	1,029.0	52.7	5.4
Adult education	648.0	698.6	50.6	7.8
Economic Impact Aid	586.9	648.1	61.3	10.4
Home-to-school transportation	568.8	599.5	30.7	5.4
After School Education and Safety Program	121.6	547.8	426.2	350.7
Regional Occupation Centers and Programs	420.7	454.4	33.7	8.0
School and Library Improvement Block Grant	422.4	445.2	22.8	5.4
Instructional Materials Block Grant	361.0	401.5	40.6	11.2
Mandated supplemental instruction (summer school)	354.8	374.0	19.2	5.4
Deferred Maintenance	267.9	268.5	0.6	0.2
Professional Development Block Grant	249.3	262.8	13.5	5.4
Public School Accountability Act	249.2	249.2	—	—
Mandates	— <sup>c</sup>	133.6	133.5	—
Other	1,258.3	1,763.0	504.8	40.1
Deferrals and other adjustments	-20.1	—	20.1	—
Subtotals	(\$12,603.9)	(\$14,303.4)	(\$1,699.5)	(13.5%)
<b>Totals</b>	<b>\$44,637.2</b>	<b>\$48,366.4</b>	<b>\$3,729.2</b>	<b>8.4%</b>

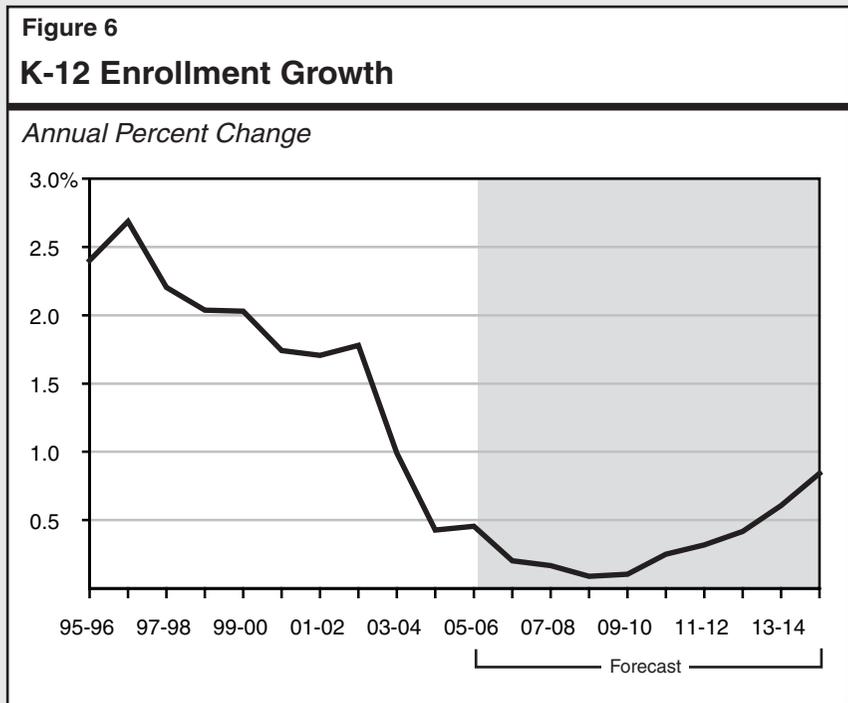
<sup>a</sup> Amounts adjusted for deferrals. We count funds toward the fiscal year in which school districts programmatically commit the resources. The deferrals mean, however, that the districts technically do not receive the funds until the beginning of the next fiscal year.

<sup>b</sup> Special education includes both General Fund and local property tax revenues.

<sup>c</sup> Less than \$100,000.

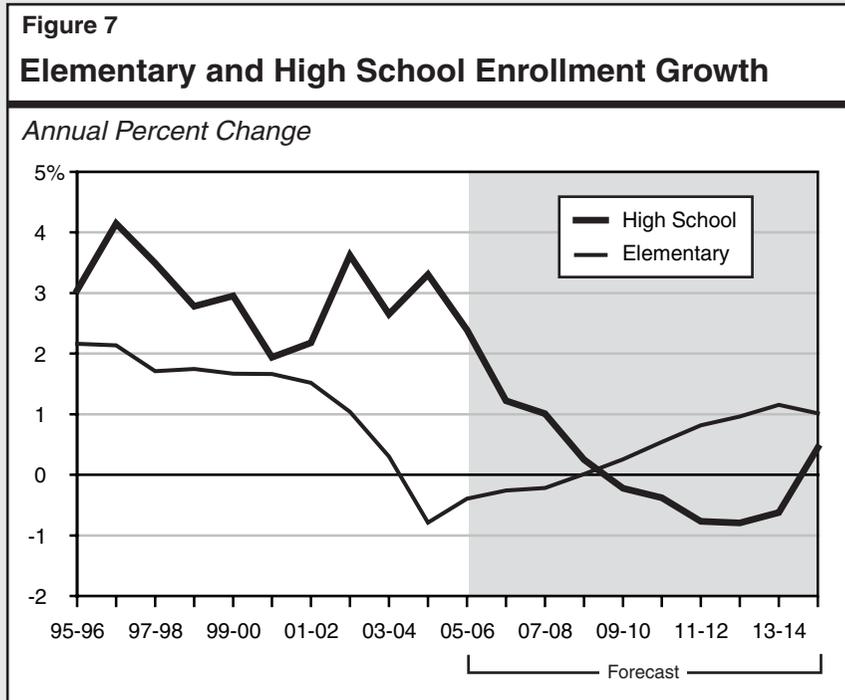
The enrollment numbers used in this section are from DOF's Demographic Research Unit and reflect aggregate, statewide enrollment. While the enrollment trends described here will likely differ from those in any given school district, they reflect the overall patterns the state is likely to see in the near future.

***K-12 Enrollment Growth to Slow Significantly.*** K-12 enrollment is projected to increase by about 0.2 percent in 2006-07, bringing total enrollment to 6.3 million students. Figure 6 shows how enrollment growth has steadily slowed since the mid-1990s. The figure also indicates that K-12 enrollment growth will continue to slow until 2009-10, when it will turn upward.



***Divergent Trends in Elementary and High School Enrollment.*** Figure 7 shows that the steady decline in K-12 enrollment growth masks two distinct trends in elementary (grades K-8) and high school (grades 9 through 12) enrollment. Elementary school enrollment growth has slowed since 1996-97, with actual declines in recent years. In contrast, high school enrollment growth had been growing rapidly, with a 3.3 percent increase in 2004-05. Beginning in 2005-06, however, high school enrollment growth also began to slow. This trend is expected to continue, with actual declines

projected beginning in 2009-10. Between 2008-09 and 2014-15, high school enrollment will fall by almost 47,000 students.



**Budget and Policy Implications.** These enrollment trends have significant budgetary and policy implications for issues such as CSR, teacher demand, and facilities investment. A few of the major implications include:

- An increase of 1 percent in K-12 enrollment requires an increase of approximately \$480 million to maintain annual K-12 expenditures per pupil.
- As enrollment growth slows, a smaller share of the state's new revenues will be consumed by costs associated with funding additional pupils. The Legislature will then have the option of devoting these revenues to increasing per-pupil spending or to other budget priorities.
- In the near term, programs aimed at elementary grades (such as K-3 CSR) will face reduced cost pressures related to enrollment. Programs aimed at high school grades will face increased cost pressures. This could present cost challenges for many unified school

districts because per-pupil costs of educating high school students tend to be higher than for elementary school students.

- Because of declining enrollment provisions in state law, more school districts—especially elementary school districts—will benefit from the one-year hold harmless provision in current law, increasing state costs per pupil. The declining enrollment adjustment cost the state \$242 million in 2004-05, compared to only \$74 million in 2001-02.
- Despite the general downward trend in enrollment growth, significant variation is expected to occur across counties. For example, between 2004-05 and 2014-15, Los Angeles' enrollment is expected to decline by around 162,000 students (a 10 percent decline), whereas Riverside's enrollment is expected to increase by over 132,000 students (a 35 percent increase).
- Slowing enrollment growth will likely affect the uses of new capital outlay bond funding. Fewer students indicates a decreasing statewide need for new construction dollars, and suggests that an increasing proportion of bond funding should instead be directed towards upgrades and modernization of existing school facilities.
- The percent of Hispanic students will continue to increase. In 1995-96, 39 percent of students were Hispanic. By 2013-14, 54 percent will be Hispanic. Since many of these students will be English learners, the state will need to increase its focus on the language development skills of this group.

# BUDGET ISSUES

## *K-12 Education*

### NEW CATEGORICAL PROGRAMS

The Governor's budget contains almost \$400 million in new ongoing funding for seven categorical programs. These seven programs span the categorical spectrum—teacher recruitment and retention, beginning teacher support, veteran teacher support, art, music, physical education, computers, fruits, and vegetables. Figure 1 (see next page) lists the seven programs and their associated purposes. Figure 2 (see page 53) shows the amount the Governor's budget provides for each program and describes how the funding would be allocated. Of the seven programs, two were funded with one-time monies in the current year. The remaining five would be brand new programs.

#### **New Categorical Programs Not Critical**

*We recommend rejecting these seven proposals because they: (1) do not address the major fiscal issues facing the state or school districts; (2) take a step backwards for categorical reform; (3) have basic policy flaws; and (4) contain virtually no planning, reporting, evaluation, or accountability components.*

*Focus on Narrow Issues While Leaving Major Issues Unaddressed.* Despite the potential appeal of new art, music, physical education, teacher, computer, and nutrition programs, these proposals would result in substantial new ongoing spending commitments while leaving major underlying school issues unaddressed. As discussed earlier in this chapter, both the state and many school districts remain in shaky financial condition. The state faces both a significant structural budget gap in 2007-08 and billions of dollars in other obligations. At the district level, fiscal conditions also remain uncertain, especially given problems of unfunded retiree health

benefits and/or declining student attendance. In this environment, we think available resources should be used for addressing state and local fiscal problems rather than establishing numerous new programs with ongoing spending commitments.

We therefore recommend the Legislature deny the administration's plan to fund seven new categorical programs. If the Legislature desires to maintain ongoing Proposition 98 spending at the level identified in the Governor's budget, we recommend redirecting funds proposed for the new programs to a fiscal solvency block grant that would assist districts in addressing their fiscal problems. We discuss this recommendation in the next write-up.

**Figure 1**

**Governor's Budget Funds  
Seven New Ongoing Categorical Programs**

New Programs	Proposed Activities
Teacher Recruitment and Retention <sup>a,b</sup>	Recruitment and retention incentives at low performing schools, including recognition pay, differential pay, signing bonuses, housing/relocation subsidies, and staff development.
Art and Music	Standards-aligned art and music initiatives, including hiring additional staff; purchasing materials, books, supplies, and equipment; and staff development.
Teacher Support <sup>a</sup>	Third year of support for beginning teachers in low performing schools and a voluntary year of support for veteran teachers new to these schools.
Physical Education	Standards-aligned physical education initiatives, including hiring additional staff, purchasing equipment, and staff development.
Physical Education Teachers	Additional credentialed physical education teachers.
Digital Classroom	One-time grants for purchasing computer hardware and software and providing staff development.
Fresh Start <sup>b</sup>	Additional fruits and vegetables in school breakfasts.

<sup>a</sup> Targeted to schools ranking in the bottom three deciles of the Academic Performance Index.

<sup>b</sup> These programs funded with one-time monies in current year.

**Figure 2**  
**Almost \$400 Million Provided in New Ongoing Spending**

New Programs	Funding (In Millions)	Allocation Method
Teacher Recruitment and Retention	\$100.0	\$50 per pupil. <sup>a</sup>
Art and Music	100.0	\$20 per pupil (K-8 schools only). <sup>a</sup>
Teacher Support	65.0	\$3,865 for each third-year teacher and \$1,933 for each veteran teacher.
Physical Education	60.0	\$12 per pupil (K-8 schools only). <sup>a</sup>
Physical Education Teachers	25.0	\$25,000 grant per school (1,000 K-8 schools). <sup>b</sup>
Digital Classroom	25.0	\$3,000 grant per classroom. <sup>c</sup>
Fresh Start	18.2	\$.10 per meal.
<b>Total Funding</b>	<b>\$393.2</b>	

<sup>a</sup> Small schools would receive minimum grants of \$3,000 or \$5,000 depending on the number of students they serve.

<sup>b</sup> Schools grouped by size, type, and geographic location and then randomly selected within each group.

<sup>c</sup> Funds divided across 11 regions based on K-12 enrollment. Within each region, districts grouped by size and type. From each group, districts selected randomly until all funds allocated.

*Step Backwards for Categorical Reform.* The Governor and Legislature recently undertook categorical reform by enacting Chapter 871, Statutes of 2004 (AB 825, Firebaugh). Section 1 of the act stated the Legislature's intent to "address the continuing concerns regarding the fragmentation of supplementary funding sources and the need for flexibility." Despite these concerns, the Governor's budget funds 63 categorical programs. This is the same number of programs the state funded in 2004-05—the year *prior* to reform. School districts therefore would face the same number of restrictions and have about the same amount of their funding tied to categorical programs as they did prior to reform.

*Devil in the Details.* These proposals also have some basic flaws. For some proposals, the problem being tackled is not well-defined or documented. For example, the new art, music, and physical education programs are predicated on the belief that the number of associated course offerings in elementary and middle schools has been drastically reduced in recent years. The data for middle schools, however, show that the number of art

and music courses has stayed virtually constant since 2001-02 and the number of physical education courses has increased slightly. Similarly, the physical education teacher incentive program seems to presume that schools are facing a shortage of qualified physical education teachers. Physical education, however, is not one of California's officially designated teacher shortage areas.

For some programs, the proposed solution also raises concerns. For example, the teacher support proposal would require fully credentialed beginning teachers in low-performing schools to participate in a third year of the Beginning Teacher Support and Assessment (BTSA) program. Many low-performing schools, however, have relatively high percentages of new teachers with emergency permits or intern credentials. These teachers currently are not allowed to participate in BTSA—meaning the proposed solution would not target the teachers likely to be experiencing some of the greatest challenges. Similarly, given that the problem being addressed with the digital classroom program is not well-defined, purchasing computer hardware or software might not be the most needed or effective solution. In addition, certain proposed solutions are not well integrated. For example, the digital classroom proposal is not well integrated with the K-12 High Speed Network nor are the school-day physical education proposals well coordinated with the existing after-school program.

***Virtually No Planning, Reporting, Evaluation, or Accountability.***

The primary reason the state creates categorical programs is to ensure that a specified amount of funding goes directly toward addressing specified problems. This is why categorical programs typically require local spending plans, contain restrictions against using new funds to supplant existing funds, direct schools to report certain expenditure and outcome data, and authorize independent statewide evaluations.

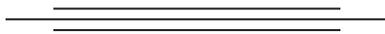
As shown in Figure 3, the Governor's budget proposals contain almost none of these standard safeguards. The exception is the Fresh Start program, which is the only program already authorized in statute. Of the remaining six programs, none requires data to be reported to the state and none has an evaluation component. Only two programs require school districts to develop a local spending plan and only one program has a supplanting restriction. Thus, for most of the programs, school districts are not required to: spend more for these activities than they are currently spending, think about how they might better use their resources, or report their activities to the state. The state therefore would have virtually no data or assessment information to determine if the specified investments were worthwhile.

**Figure 3**  
**Lack of Accountability Safeguards**

New Programs	Requirements:				
	Local Spending Plan	Funds to Supplement <sup>a</sup>	Expenditure Data <sup>b</sup>	Outcome Data <sup>b</sup>	Evaluation
Teacher Recruitment and Retention	Yes	No	No	No	No
Art and Music	No	No	No	No	No
Teacher Support	No	No	No	No	No
Physical Education	No	No	No	No	No
Physical Education Teachers	No	Yes	No	No	No
Digital Classroom	Yes	No	No	No	No
Fresh Start	No	Yes	Yes	Yes	Yes

<sup>a</sup> Refers to requirement that new funds supplement rather than supplant existing funds.  
<sup>b</sup> Refers to requirement that these data be collected and reported to the state.

In conclusion, we recommend the Legislature not fund seven new ongoing categorical programs at a time when the state budget faces a significant structural imbalance and school districts face serious underlying fiscal issues, such as retiree health costs and declining enrollment. Instead, we recommend the Legislature apply the associated \$400 million toward addressing the state’s fiscal issues. Alternatively, if the Legislature decides to provide the \$400 million for education, then we suggest using the funds to help districts cope with a variety of fiscal challenges.



## SCHOOL DISTRICT FINANCIAL CONDITION

In our *Analysis of the 2005-06 Budget Bill*, we discussed the range of fiscal issues facing school districts. These included low general purpose reserves, internal borrowing from self-insurance funds, and falling state revenues due to declining enrollment. We also discussed the long-term challenge created by new accounting requirements on retiree health benefits. The financial health of districts has not improved significantly, and may have even worsened somewhat, over the past year.

In this section, we deepen our discussion of the impact of the new accounting requirements on K-12 school districts and reiterate our recommendations for ensuring that districts address retiree health liabilities. We also provide the Legislature with an option to help improve district financial conditions through a fiscal solvency block grant, which would give districts flexible funds to address the broad range of fiscal problems encountered locally.

### RETIREE HEALTH BENEFIT LIABILITIES

In 2004, the national Governmental Accounting Standards Board (GASB) issued a new policy requiring state and local governments, including local educational agencies, to account for retiree health benefits in a manner similar to other pension costs. This new policy, which will be implemented over the next three years, will highlight a major new fiscal challenge for many school districts and county offices of education. In this section, we recommend several steps the Legislature could take to encourage districts to address this challenge. We also discuss how the new GASB policy affects the state's retirement costs and the costs of local governments in *The 2006-07 Budget: Perspectives and Issues (P&I)*.

***GASB Policy Treats Retiree Health Benefits More Like Pension Benefits.*** The new GASB policy encourages districts to budget for retiree health care costs in a manner similar to the way pension systems operate. The pension systems calculate the *normal cost* of pension benefits, or the average annual amount that must be deposited in the pension fund during

an employee's working life to fully cover the cost of pensions during the employee's retirement. The estimate can change over time based on several factors, including higher or lower returns on the funds' investments and changes in life expectancies.

The new GASB rule attempts to treat retiree health benefits in a similar fashion. It would require districts to identify the normal cost of the retirement benefits to current employees. Because schools generally have not set aside funds for these benefits in past years, the new rule also requires districts to identify the total *unfunded liability* for retiree health benefits that the district has promised to current employees and retirees for service in previous years. In other words, this liability represents employee benefits already earned, but which have not been paid for.

### **California Department of Education (CDE) Survey Incomplete, But Reveals Large Liabilities**

In our *2005-06 Analysis*, we discussed the large liabilities of two districts in California that had completed an actuarial study of retiree health benefit costs. Los Angeles Unified School District (LAUSD) estimated its liability for likely future costs over 30 years at \$5 billion. Fresno Unified School District pegged its liability at \$1.1 billion. Both districts have identified the significant fiscal threat posed by these liabilities. For instance, LAUSD would have to add \$500 million in annual outlays—or about 8 percent of its overall budget—for the next 30 years to pay off its unfunded liabilities and adequately budget for the normal cost of benefits to current employees.

Statewide data on the extent of the problem were not available last year. The CDE, however, agreed to ask districts to report their estimated liability as part of a fall 2005 survey of employee benefits. Unfortunately, the data collected by CDE are incomplete. About 20 percent of districts did not respond to the CDE survey and, of those that did report, most could not identify an estimate of current liabilities. Therefore, the results do not allow a comprehensive assessment of district liabilities in this area.

The survey does provide additional insight into the financial challenge posed by retiree health benefits. Of all districts in the state, about 60 percent (623) responded that some amount of retiree health benefits are provided. Of these, 102 districts reported cumulative liabilities of \$3 billion (LAUSD did not report its estimate). The other 521 districts did not include an estimate of the district's liability for the benefits.

Figure 1 displays selected data from the CDE survey. For this figure, we converted district's reported unfunded liabilities into per-pupil figures to allow a comparison among districts of the financial burden districts face.

Districts that provide lifetime health benefits generally have the highest liabilities. Fresno Unified reported \$13,624 per student in benefit liabilities, the highest per-pupil liability reported by any district. While the liability for this group averages \$4,075 per pupil, only about one-half of the 76 districts that provide lifetime benefits reported their estimated liability.

**Figure 1**

### **Estimated K-12 Retiree Health Benefits Unfunded Liabilities**

*(Dollars Per Student Enrollment)*

Benefit	Number of Districts	Per-Pupil Liabilities <sup>a</sup>		
		High	Average	Low
Lifetime	76	\$13,624	\$4,075	\$84
Over age 65, not lifetime	116	5,144	1,706	61
Up to age 65	431	5,061	2,668	5

<sup>a</sup> These estimates are based on a subset of districts that provide the given benefit.

The per-pupil liabilities for districts in the other two categories—districts that provide retiree health benefits up to age 65 and districts that end benefits at some point above age 65—are significantly lower. The group that ends benefits to retirees at some point above age 65 has a lower average cost than those that stop benefits at 65. This surprising result may be the result of the survey's under-reporting problem, which is especially severe for districts in the up to 65 group.

Another interesting finding of the survey is the relatively large number of districts reporting relatively small liabilities for retiree health benefits. As Figure 1 shows, the "low" districts in all three categories report per-pupil liabilities of less than \$100. Among the 42 districts that reported their liability for lifetime benefits, 11 districts estimated costs at less than \$500 per student. There are at least three situations where this is possible. These districts could have set-aside a portion of the funds needed to pay for future retiree costs, developed agreements with local employee unions to share the cost of these benefits, or recently granted these benefits to employees (giving little time for unfunded benefits to build into a large liability). From what we have learned about retiree benefits in school districts, it seems unlikely however, that these situations exist in many districts.

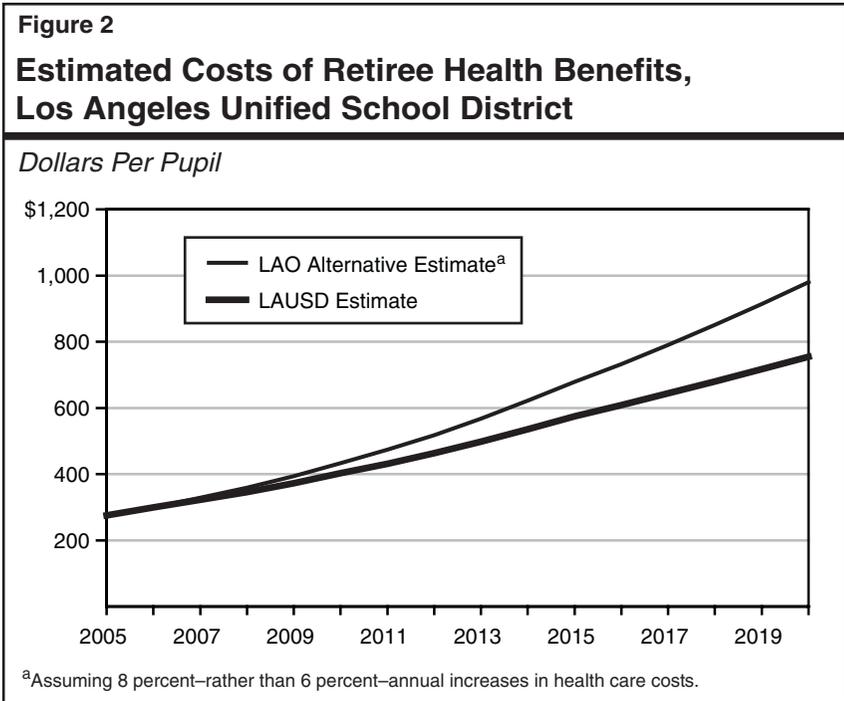
The survey data suggests that district unfunded liabilities for retiree health care costs differ substantially. The majority of districts offer some form of subsidized retiree health care. Districts with the most substantial benefits face the largest outstanding liabilities. A large number report small liabilities for these benefits. The data provide a first glimpse of the liabilities over a broad range of districts, yet they also raise questions about the reliability of the figures. While it is possible that a closer examination would validate these estimates, the low cost estimates for these generally expensive benefits makes us concerned about the accuracy of the district figures.

### **Why Retiree Benefits Is an Important State Issue**

For districts with large unfunded liabilities, retiree health benefits pose a major financial threat. Not only do many districts have large unfunded liabilities, but their failure to pay annual normal costs means these liabilities are growing. In the long run, this problem may become so severe that districts eventually will seek financial assistance from the state. Some districts may even require emergency loans due to this problem.

As we discuss in more detail in the *P&I* piece, we believe public entities should begin prefunding benefits. This means moving from a “pay-as-you-go” approach to paying for retiree health benefits as they are earned. Prefunding involves payment of normal costs each year plus an annual amount necessary to pay off any unfunded liability over a given number of years. For districts with significant liabilities, full prefunding would require a significant redirection of internal resources. The average district that provides lifetime benefits currently faces liabilities for retiree health benefits of about \$4,000 per student. To fund this amount over 30 years, a district would have to set aside roughly \$400 per student each year. This represents about 8 percent of general purpose funds districts receive in state funds and local property taxes. Fully funding both the normal cost and a share of unfunded liabilities by redirecting existing district revenues would significantly affect the quality of education offered by districts.

Continuing to operate on a pay-as-you-go basis, however, would only make the problem more difficult to address in the future. Figure 2 (see next page) displays the estimated per-pupil cost of retiree health benefits for LAUSD over the next 15 years. Under the LAUSD estimate, the costs for retiree health benefits on a pay-as-you-go basis will more than double in the next ten years, increasing from \$275 per student to \$575 per pupil. By 2020, the district’s estimate shows costs reaching \$755 per student.



These costs, however, could be even higher. The LAUSD estimate assumes long-term medical inflation of 6 percent a year, which is a reasonable projection of health care inflation. Actual premiums for health care, however, have tended to increase faster than health care inflation because the quality of health care—and the amount of health care services consumed—also increases each year. To illustrate the sensitivity of these projections to different assumptions, we estimated LAUSD’s costs for health care assuming 8 percent growth (see Figure 2). Under this alternative, district out-of-pocket costs reach \$680 per student in 2015, more than \$100 per student more than the district’s projection and about \$400 per student more than it currently spends. By 2020, our projection pegs the annual cost at almost \$1,000 per student—an increase of 250 percent from its current level of spending.

Under this alternative scenario, retiree health benefits could absorb roughly 30 percent of all new general purpose funds received by the district over the next 15 years.

## Districts Need to Address Liabilities

*We recommend enactment of legislation to require county offices of education and school districts to develop a plan for addressing long-term liabilities for retiree health benefits.*

Districts do not currently have strong incentives to address the retiree health benefit funding problem. The increase in out-of-pocket costs from year-to-year does not signal an immediate fiscal crisis in most districts. Setting aside funds for prefunding retiree benefits would only make balancing local spending priorities more difficult in the near term. The new GASB policy may prod districts to address the problem—either through public pressure or possible negative impacts on a district’s bond rating and costs of borrowing.

The state, however, has an incentive to encourage districts to focus on this problem because, at some point, districts are likely to seek financial assistance for these costs from the state—perhaps at the same time it is addressing its own liabilities for state employees and retirees. Early attention may allow some districts to avoid serious future financial problems. Therefore, we recommend the Legislature take two steps to address this problem. Below, we recommend establishing a “fiscal solvency” block grant that would provide a source of funds to assist districts in meeting current fiscal challenges, including retiree health benefits. Before providing financial assistance to districts, however, it is essential that the state require districts to develop a plan for addressing the issues presented by the new GASB policy. Specifically, we reiterate the recommendations from our *2005-06 Analysis* (see page E-47) that would require districts providing retiree health benefits to develop a long-term financing plan for these costs. The plan has three elements:

- *Require districts to provide a copy of actuarial studies required under the new GASB policy to the county office of education.* Under the GASB policy, districts would be required to assess retiree benefit liabilities over the next three years. The largest districts would be required to complete the study by 2007-08. The policy also requires districts to update these studies every three years.
- *Direct districts to provide the county office with a plan for addressing retiree health benefit liabilities.* Our proposal would give districts one year after completing the actuarial study to forward a financing plan to the county office. Districts could address their liabilities in several ways, including prefunding benefits, or restructuring or eliminating benefits for new employees.
- *Modify AB 1200 to require county offices to review whether district budgets are consistent with their long-term financing*

*plan.* Under the AB 1200 fiscal review process, county offices are charged with reviewing district budgets and assisting districts that experience fiscal difficulties. Our proposal would add a review to determine whether district budgets adequately address health benefits costs as described in each district's long-term plan.

### **Negotiate a Plan to Use Federal Funds for Retiree Costs**

*We recommend enactment of the trailer bill language to direct the California Department of Education to work with the federal government to develop a template that would guide district development of comprehensive plans for addressing unfunded retiree health benefits. We also recommend the Legislature enact trailer bill language to allow districts to use state categorical program funds as part of a comprehensive plan for addressing retiree health liabilities.*

It is our understanding that most school districts are paying for the cost of retiree benefits entirely with their own general purpose funds. Federal regulations permit local governments to use federal funds to pay for a share of the cost of those benefits, including past unfunded liabilities. While details on these regulations are not available, it appears that districts, as part of a comprehensive plan for addressing retiree liabilities, could charge current federal programs for the portion of the liabilities for employees who were paid from federal funds in the past. This would be another tool to help districts address unfunded retiree health liabilities.

The Legislature can help districts take advantage of this flexibility. Specifically, we recommend that the Legislature direct CDE to negotiate with the federal government a "template" that outlines the specific requirements districts would have to meet to use current federal funds for the unfunded retiree health liabilities of employees paid with federal funds in the past. Rather than require each district to negotiate separately with the federal government, establishing a template for the required comprehensive plan would help districts take advantage of this flexibility. There are several critical elements of a template that would be of concern to both the federal government and districts, including the length of the plan, limits on the proportion of federal funds that may be used to pay for benefits earned in past years, and documentation requirements for determining the proportion of a district's unfunded liability that may be paid for with federal funds. While the federal government may insist on approving each district plan, a template would facilitate the development of district plans that conform with the federal requirements, and help districts use this tool for addressing unfunded liabilities for retiree health benefits.

The Legislature also could extend the same type of flexibility created in federal regulations to apply to *state* categorical programs. It is not clear

that state law allows the same flexibility with state categorical funds as the federal regulations provide. This can result in districts using their general purpose dollars to pay for the unfunded retiree liabilities of employees supported by categorical state funds.

**Adopt Trailer Bill Language.** To give districts additional tools for addressing unfunded retiree health benefits, we recommend the Legislature adopt trailer bill language directing CDE to work with the federal government to develop a template that would guide district development of comprehensive plans for addressing unfunded retiree health benefits. We also recommend that this language allow districts to use state categorical program funds as part of a comprehensive plan for addressing these unfunded liabilities. As part of this trailer bill language, we recommend requiring CDE to adopt regulations before districts would be permitted to use this flexibility. This would allow public review of the new flexibility provisions and afford an opportunity to assess their impact on state categorical programs.

## CREATE A FISCAL SOLVENCY BLOCK GRANT

*We recommend the Legislature redirect \$411.7 million in Proposition 98 funds to a block grant that would provide districts and county offices of education with a source of funding to address the fiscal challenges they currently face.*

In our 2005-06 Analysis we discussed a number of fiscal threats districts face. During the first part of the decade, state funding cuts created hard financial choices for districts. In response, many districts employed financial practices such as spending their general fund reserves, borrowing from self-insurance funds, and using one-time funds for ongoing expenses. While these practices may have helped districts weather short-run funding shortfalls, over the long run, it is important to eliminate internal borrowing and deficit spending, and restore fund balances to appropriate levels.

### District Financial Woes Continue

Since last year, however, the fiscal status of districts has not improved significantly. In fact, district finances may even have deteriorated somewhat. The number of districts identified in fiscal trouble, for instance, increased in 2004-05. Under the AB 1200 process, county offices certify the financial condition of districts each year. Districts certified in “negative” financial condition are those that currently cannot meet their financial obligations over the next three years. A “qualified” certification signals significant financial concerns that may cause a district to be unable to meet its financial obligations in the future. In spring 2003-04, 45 districts

were certified as negative (9 districts) or qualified (36 districts). In spring 2004-05, that figure jumped to 61 districts (14 negative and 47 qualified).

According to the state's Fiscal Crisis and Management Assistance Team (FCMAT), the increase results from the lingering fiscal consequences of the recent recession combined with declining enrollment. Because most state funding is allocated based on attendance, declines in the number of students enrolled in districts reduces district revenues. As discussed later in this chapter, the number of districts experiencing declining enrollment increased each year from 2001-02 through 2004-05, affecting more than 40 percent of all K-12 districts in 2004-05.

The Department of Finance's (DOF) long-term enrollment projections suggest this trend will continue. Over the period from 2005-06 through 2009-10, DOF projections show total statewide enrollment gains of less than 1 percent, and declines in 30 of the state's 58 counties, including Los Angeles, San Francisco, Alameda, and Orange. Because this forecast is based on county-level demographic changes, DOF does not issue district-level projections. The implication for K-12 education, however, is that the fiscal pressures created by declining enrollment represent a continuing challenge for the future.

Looming on the horizon is the threat posed by retiree health benefits. As discussed above, 60 percent of districts report providing these benefits for some period of their employees' retirement. Survey data on this issue shows that a significant number of districts face accrued liabilities for these benefits of more than \$4,000 a student. Given the weak district financial condition and other fiscal demands on districts, such as higher utility costs and employee wage increases, it seems unlikely that most districts will have the fiscal flexibility to make serious inroads towards resolving the retiree health issue in the near term.

### **Improve Incentives, Insist on Local Solutions**

In the past, we have been reluctant to suggest that the Legislature address financial issues that, at their roots, result from local policy, administrative, or fiscal practices. Instead, we have counseled the Legislature to address the *incentives* that cause local problems that are not in the long-term interests of students, the overall health of the K-12 system, or the state. Once the incentive problems are fixed, we think districts are in a better position than the state to find good solutions to locally created problems.

We think this perspective applies to the financial issues facing districts. For the most part, past district action (or inaction) created current problems, and the state should not attempt to craft specific solutions to those problems. Districts differ in the extent to which they have been

willing to address these issues. The FCMAT reports that most districts are making the hard choices to make ends meet. Thus, in general, we think the state should avoid trying to “fine tune” state law in response to local fiscal problems.

The issue of retiree benefits, however, presents a new challenge for the majority of districts. As noted above, districts lack a strong incentive for resolving this issue. Therefore, the question facing the state is how to encourage all districts to address their financial problems without the state becoming so involved in the solution that it assumes responsibility for the problem in the long run.

For retiree health benefits, the first step is to require districts to develop long-term plans for reducing liabilities for current and past benefits granted to employees as we recommend above. This recommendation is designed to balance the state’s interest in ensuring districts begin addressing this issue while maintaining local accountability for solutions.

If the Legislature adopts our recommendation on retiree health benefits, the need for further state intervention boils down to a question of whether districts have the financial flexibility to address these issues. The answer to this question requires a judgment about whether, given all the demands placed on local administrators and school boards, districts realistically can address all of the fiscal threats facing them. In general, we think they can—and most districts do. On the issue of retiree benefits, however, the size of the problem is simply too large to expect districts to resolve this issue without additional state action.

We are also wary of developing a state response that penalizes those districts that have made the hard choices needed to resolve their fiscal problems. Many districts are closing schools as a response to declining enrollment, for example. While closing schools upsets parents and community members, the action demonstrates that districts recognize the need to realign district operations—and reduce base spending—in line with the decline in enrollment. Thus, any state action to help districts with their financial problems should not penalize districts that have already addressed these issues.

## **A Solution That Rewards Good Financial Practices**

Earlier in the chapter, we recommend the Legislature reject the Governor’s proposals for new programs on the basis that the state faces many of the same fiscal issues as school districts. If the Legislature chooses to fund schools at the level of Proposition 98 funds identified in the *2006-07 Governor’s Budget*, however, we recommend the Legislature use the

\$411.7 million proposed for new programs and other augmentations to the base budget instead to establish a new fiscal solvency block grant.

The block grant would provide flexible funding that would be available to address the variety of fiscal challenges facing districts. Under our proposal, block grant funds would be provided on a per-pupil basis to districts and county offices. Districts would submit plans for the use of these funds to the county office of education, which would review and approve plans that meet the specific requirements of the block grant. County offices would submit similar plans to CDE for approval. For districts or counties that face none of the challenges discussed above, the block grant funds would be free of any restrictions. Recognizing that, in the long run, districts and county offices would need predictability of funding in order to address long-term financial issues, our proposal would add the block grant funds into revenue limits after five years.

Our plan also contains specific priorities over the use of the block grant funds:

- **Step 1: Make Ongoing Budget “Whole.”** First call on the funds would require districts to use block grant funds to correct certain “holes” in district budgets—specific ongoing costs that district budgets do not adequately fund.
- **Step 2: Declining Enrollment Costs.** Districts could use one-half of the funds that remained after meeting Step 1 for any short-term costs created by declining enrollments. By the end of the five-year period, however, districts would be required to dedicate these funds towards reducing their liability for long-term retiree health benefits.
- **Step 3: Unfunded Retiree Health of Benefits.** Districts would be required to use the other one-half of funds remaining after Step 1 to begin reducing any retiree health benefit liability.

We discuss the block grant priorities in greater detail below.

**Internal Borrowing and the “Normal” Cost of Retiree Benefits.** Our proposal would first require districts to use block grant funds to restore internal fund balances (such as self-insurance funds for workers’ compensation) and set aside funds for the normal cost of retiree health costs of current employees. Self-insurance funds provide a source of funding that adequately supports the costs of anticipated claims that, if left unbudgeted, have to be paid from a district’s general purpose reserve. Borrowing from these internal funds is a way districts can circumvent the state’s AB 1200 guidelines for general purpose reserve balances. Therefore, requiring districts to use block grant funds to repay internal fund borrowing would

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place districts on a sounder financial footing and reinforce the importance of adequate district general purpose reserves.

Setting aside funding equal to the normal cost of retiree health benefits would begin the process of appropriately budgeting for these benefits. The normal cost of these benefits is the amount that should be set aside each year to pay for the future benefits of current employees when they retire. Under existing practice, district liabilities grow each year when they do not set aside the normal cost of these benefits. Using block grant funds for this purpose is designed to cap unfunded liabilities at their current level.

***Declining Enrollment.*** For districts with large unfunded benefit liabilities, setting aside funds for the normal cost of benefits probably would consume the entire block grant. Districts with smaller liabilities may have block grant funds left over. Under our proposal, one-half of any remaining funds could be used for short-term costs of declining enrollment. In general, districts need to restructure district operations in line with enrollment declines. Recognizing that declining enrollment will affect districts for at least the next five years, our proposal would permit districts to use a portion of the block grant funds to smooth the transition to a lower enrollment environment over that time. In general, we suggest that districts use these funds for short-term transitional costs, rather than to offset the need for permanent operational changes. Indeed, we would hope that districts would develop long-term plans for addressing the issues presented by declining enrollment in order to use the flexibility provided by the block grant most strategically.

***Accrued Liability for Retiree Health Benefits.*** The remaining block grant funds would be used to address unfunded retiree health liabilities.

For districts that do not offer retiree health benefits or have adjusted to the impacts of declining enrollment, our plan would allow districts to use the block grant for any general purpose. We would also suggest one final feature for the block grant, which would allow districts to waive the fiscal solvency block grant priorities during a fiscal emergency, with the approval of the county office of education and the Superintendent of Public Instruction. We think the Legislature should provide some flexibility for districts who find themselves in dire fiscal straights. We would suggest limiting this option to a district that is unable to meet its financial obligations in the next year and likely to seek a loan from the state under AB 1200. With these limitations and a close review by the county office and the SPI, we think the block grant could provide some needed flexibility in exceptional situations.

The block grant would give districts a five-year period to address pressing fiscal issues while also keeping responsibility at the local level for

specific solutions. By using the flexibility provided in the proposed block grant strategically, we think most districts could fill existing budgetary holes, address declining enrollment, and begin setting aside funds for past retiree health care obligations. Our proposal also rewards districts that have dealt with these fiscal issues, as the block grant in these districts could be used for any local priority. While our proposal represents a significant investment of state funds, we think the block grant would pay dividends for many years in the future.



## REVENUE LIMITS

The largest source of school district revenues comes in the form of revenue limits. Revenue limits provide general purpose funds—money districts may use at local discretion for the support of local programs. In 2006-07, the budget proposes \$33.4 billion from local property taxes and the General Fund for school district revenue limits, an increase of \$2 billion from the revised 2005-06 budget.

This increase in school district revenue limit funding contains several significant adjustments in 2006-07, including:

- \$1.7 billion to fund a 5.2 percent cost-of-living adjustment (COLA) (\$1.7 billion) and a 0.2 percent anticipated increase in the number of K-12 students (\$46 million).
- \$200 million to equalize school district revenue limits.
- \$200 million for “deficit factor” reduction, which would restore foregone COLAs from a prior year.
- \$129 million in savings due to a reduction in costs for Unemployment Insurance (\$111 million) and Public Employees’ Retirement System (PERS) contributions (\$17 million).

Below, we discuss several features of the Governor’s revenue limit proposal: the funding provided for COLA and deficit factor reduction, the adjustment provided to districts with declining enrollment, and funding for equalization.

### REDIRECT FUNDING FOR DEFICIT FACTOR TO COLA

*We recommend the Legislature redirect the proposed \$206 million for deficit factor reduction to pay for the increased costs of a higher COLA.*

The deficit factor payment restores a portion of the foregone COLA to revenue limits that the state could not afford to provide to schools in

the 2003-04 budget. Over the last two years the state has restored a base reduction to revenue limits and a portion of the foregone COLA. The proposed \$200 million in funding would restore roughly two-thirds of the outstanding deficit factor, leaving approximately \$100 million to restore in future years. (The budget provides an additional \$6 million to reduce the revenue limit deficit factor for county offices of education and corresponding categorical program reductions for basic aid districts.)

As discussed in the “Proposition 98 Update” section at the beginning of this chapter, recently released data indicate that the factor used to calculate COLA for K-12 programs will be significantly higher than the rate assumed in the Governor’s budget—around 5.8 percent instead of 5.2 percent. (The actual COLA amount will be known in April.) A higher COLA will result in higher overall costs for revenue limits. Assuming a COLA factor of 5.8 percent, we estimate the cost of fully funding the COLA for K-12 apportionments (school districts and county offices of education) will be around \$202 million higher than budgeted. This would require a total of \$1.9 billion for revenue limit COLA costs.

We recommend the Legislature redirect the \$206 million proposed for restoring deficit factor to instead fully fund the anticipated needs of the base program resulting from higher COLA costs.

## **INCREASE FUNDING FOR DECLINING ENROLLMENT ADJUSTMENT**

*We recommend the Legislature score an additional \$75 million to fund the costs of the declining enrollment adjustment to continuously appropriated revenue limits.*

Generally, revenue limit funding is provided to a district at a per-pupil funding rate multiplied by the average daily attendance (ADA) in the district for that fiscal year. Under current law, school districts that experience a decline in student population in a given year may instead opt to be funded based on the number of students they served in the prior year. This one-year “hold harmless” provision is intended to provide a temporary financial cushion to districts as they adjust to serving fewer students and, correspondingly, receiving less revenue from the state.

The Governor’s budget includes a total of \$268 million to fund the declining enrollment adjustment in 2006-07. This represents a \$26 million increase from 2004-05, which is the most recent actual data available. The budget-year estimate assumes the same rate and cost of declines as in 2004-05, adjusted by the 2005-06 and 2006-07 COLAs.

In the past, the Department of Finance (DOF) did not specifically identify the costs of funding the declining enrollment adjustment in its annual revenue limit estimates. Since statewide student population was growing rapidly, the costs of the declining enrollment adjustments were minor, and DOF was able to make technical adjustments when actual data were available. However, demographic changes in the K-12 population over the past several years have led to an increasing number of districts experiencing declines in their student populations and using the adjustment.

Figure 1 shows selected data on K-12 attendance growth and the cost of the declining enrollment adjustment. As the figure shows, the growth rate in statewide student population fell each year from 2001-02 through 2004-05. At the same time, the cost of the declining enrollment adjustment more than tripled from 2001-02 to 2004-05, increasing the state's cost of the declining enrollment adjustment from \$74 million to \$242 million. In 2004-05, the last year actual data are available, the \$242 million provided to 438 school districts was to help them adjust to a decline of 49,000 students compared to the prior year. The students that are funded but not actually in the district are commonly referred to as "phantom" ADA.

**Figure 1**

**State K-12 Attendance Growth and  
The Declining Enrollment Adjustment**

	2001-02	2002-03	2003-04	2004-05	Revised 2005-06	Proposed 2006-07
Statewide growth rate	2.1%	1.7%	0.9%	0.4%	0.5%	0.2%
Districts receiving adjustment	327	375	412	438	— <sup>a</sup>	— <sup>a</sup>
"Phantom" ADA <sup>b</sup> funded <sup>c</sup>	16,000	20,000	29,000	49,000	49,000	49,000
<b>Cost of declining enrollment (in millions)</b>	<b>\$74</b>	<b>\$93</b>	<b>\$137</b>	<b>\$242</b>	<b>\$255</b>	<b>\$268</b>
<sup>a</sup> Unknown. <sup>b</sup> Average daily attendance. <sup>c</sup> Difference between level at which districts are funded (based on prior year) and the number of students they are actually serving.						

*Governor's Budget Underestimates Cost of Declining Enrollment Adjustment.* Because of these changing dynamics, DOF recently included estimates for this adjustment in its annual budget projections. Our analysis indicates the Governor's budget underestimates the cost of this adjustment in 2006-07. The DOF's current methodology is to increase the past-year

cost of the adjustment by COLAs. However, using this methodology for the 2004-05 budget underestimated the cost of the adjustment by about \$115 million.

We believe DOF's methodology similarly underestimates the cost of the adjustment in the budget year. Because the Governor's budget projects almost no attendance growth in 2006-07, we think the cost of declining enrollment will be significantly higher in the budget year.

***Cost Will Depend on District-Level Trends.*** Projecting revenue limit costs is an especially difficult task in a low-growth environment. Accurately projecting costs requires an understanding of which districts are growing and which are declining, and the reasons behind the divergent trends. Using the statewide aggregate attendance growth rate worked fine in times of rapid growth, but when growth rates are down, it can mask the interaction between different trends occurring in growing and declining districts. In the current environment of rapidly slowing statewide growth, the DOF methodology of budgeting for the declining enrollment adjustment based solely on prior-year funding levels has not proven to be very effective at predicting costs. We believe a better approach is to study statewide and local growth patterns and, to the extent possible, make an estimate based on anticipated trends.

***Cost of Adjustment Requires Additional Funding.*** We estimate the declining enrollment adjustment will cost \$343 million in 2006-07, or \$75 million more than proposed in the budget. Our projection is based on the most current district-level attendance data available, as well as DOF's long-term enrollment projections. We think the fact that attendance growth is projected to decrease from 0.5 percent in the current year to 0.2 percent in the budget year indicates that both the number of districts experiencing declining enrollment and the size of the attendance decline will be greater than in 2004-05 and 2005-06. Additionally, DOF's county-level enrollment projections for the budget year project negative net growth rates in almost half the state's counties, including the three largest.

Given the way the state funds revenue limits (they are continuously appropriated), the actual costs of the declining enrollment adjustment in 2006-07 eventually will have to be paid. Consequently, it is important for the Legislature to have the best estimates of this General Fund obligation going into the fiscal year. Therefore, we recommend the Legislature score an additional \$75 million to reflect the likely costs of the declining enrollment provision.

Despite the one-year adjustment the state currently provides, districts report significant difficulties adjusting to shrinking student populations. In the "Fiscal Solvency" section of this chapter, we discuss these concerns and suggest additional support the state could provide.

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## REDIRECT EQUALIZATION FUNDING TO FISCAL SOLVENCY BLOCK GRANT

*We recommend the Legislature redirect the proposed \$200 million for equalization to address the serious fiscal solvency issues faced by many districts in the state. If the Legislature chooses to fund equalization, we recommend allocating the funds based on a formula that consolidates revenue limit “add-on” programs into base revenue limits.*

The Governor’s budget proposes \$200 million to make progress towards establishing more uniform district base revenue limits. In past years, we have argued in favor of equalizing revenue limits for two reasons. First, equalization funding provides general purpose funds that districts can use to meet local needs. Second, we are not aware of any analysis showing that historical differences in revenue limit funding levels reflect different local needs for general purpose funds.

However, given the difficult fiscal situations currently faced by many districts in the state (including those that would not qualify to receive equalization funding), we recommend the Legislature delay equalizing revenue limits to future years. We believe these funds would be more effective if targeted specifically at addressing school district fiscal solvency issues. We discuss this proposal in further detail in the “Fiscal Solvency” section of this chapter.

If the Legislature chooses to provide funding in the budget for equalization, we would recommend using a different formula for distributing the funds. In the next section we describe: (1) how the Governor’s approach would not address all the existing inequities in general purpose funding and (2) our recommendation to improve the equalization methodology.

### **Including Add-On Programs Would Lead to More Uniform Funding Levels**

School districts currently receive funding through both a “base” revenue limit and various revenue limit “add-on” programs. Past legislative efforts to address historical inequities in district funding have focused on the base revenue limit. This is also the case with the Governor’s current proposal. As a result, the budget proposal misses an opportunity to simplify the revenue limit system and create a more uniform distribution of funds to districts.

As discussed in our *Analysis of the 2004-05 Budget Bill* (please see page E-88), the majority of revenue limit add-on programs provide general purpose funds to all or virtually all school districts in the state, and therefore

are in essence a part of the state's base K-12 program. Because some districts receive large amounts through the add-on programs while other districts receive little, these revenue limit add-ons create further disparities in general purpose funding. So even if the state fully equalized base revenue limits, inequities in total general purpose funds would continue.

Figure 2 describes the four primary general purpose revenue limit add-on programs and displays the average per-pupil amounts large unified districts received for these programs and for base revenue limits in 2004-05. The data do not represent actual figures for any one district. Instead, they represent the average per-pupil amounts distributed to all large unified districts through the various adjustments in the revenue limit calculation. In addition to these averages, the figure also shows the highest and

<b>Figure 2</b>				
<b>Variance in Revenue Limit Add-On Programs</b>				
<b>Large Unified School Districts</b>				
<i>2004-05</i>				
<i>(Dollars Per Average Daily Attendance)</i>				
<b>Program</b>	<b>Description</b>	<b>Amount</b>		
		<b>Highest</b>	<b>Average</b>	<b>Lowest</b>
<b>Base Revenue Limit</b>	Pay for the basic costs of educating a student.	\$6,789	\$4,797	\$4,657
<b>Add-On Programs</b>				
Meals for Needy Pupils	Replace property tax revenues approved by voters prior to Proposition 13.	\$608	\$24	\$0
SB 813 Incentive Programs	Increase the length of the school day and school year, increase minimum teacher salaries.	402	227	176
Unemployment Insurance (UI)	District UI costs in excess of 1975-76 UI costs.	50	28	4
PERS <sup>a</sup> Reduction	Reduce district funding based on the current district contribution for PERS employees.	0	-23	-67
<sup>a</sup> Public Employees' Retirement System.				

lowest amounts large unified districts actually received for base revenue limits and each adjustment in 2004-05. The range in base revenue limits is about \$2,100 per pupil between the highest- and lowest-funded large unified districts. As shown in the figure, the add-on programs can provide hundreds of dollars of funding increases to some districts, while providing other districts with very little. This variance increases the disparity in general purpose funding levels above and beyond the range that exists among base revenue limits.

***Consolidate Add-Ons Into Base Revenue Limits, Then Equalize.***

The budget proposal would help equalize base revenue limits, but ignores large differences in add-on funding that, in effect, would continue even after the equalization targets were reached. Therefore, if the Legislature pursues equalization we recommend it revise the current revenue limit formula by folding the four add-on programs displayed in Figure 2 into the base grant. (We would also recommend including an additional set of interdistrict adjustments that provide general purpose funding to six school districts.) This would allow the Legislature to equalize the amount of general purpose funds districts actually receive, not just the amount represented by the base revenue limit. Over the long run, this would result in a more uniform distribution of funds to districts and simplify the revenue limit calculation.

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## MANDATES

The Governor's budget proposes \$133.6 million from the General Fund to pay for the costs of state-mandated local programs in K-12 education and community colleges in 2006-07. The proposed budget recognizes 42 mandates affecting the K-12 and community college systems. Of these, 39 mandates apply to K-12 districts and county offices of education requiring a wide range of instructional, fiscal, and safety activities.

The budget proposal represents the first time funding for ongoing mandates has been included in the Governor's budget since 2001-02. In the intervening four years, the state has "deferred" mandate payments, which means that funding will be provided at some unspecified future time. Even though payments have been deferred, school districts have been required to perform the mandated activities.

The proposed \$133.6 million in ongoing funds would not fully fund expected district and community college claims in 2006-07. The Department of Finance (DOF) estimates likely claims of \$173.6 million in the budget year. As a result, the proposed level of funding would fund about three-fourths of expected mandate costs.

In addition to the ongoing funds, the budget proposes to allocate \$151 million in one-time funding to reimburse school districts and county offices of education for mandate claims from past years. These funds would retire outstanding claims from the late 1990s, when mandate claims outstripped the amount appropriated in the annual budget act. To date, we estimate the state owes districts approximately \$1.2 billion for unpaid mandate costs through 2005-06.

From our review of these budget proposals, we have identified four issues:

- The amount proposed in the budget bill for mandates falls short of fully funding ongoing mandate costs. In addition, the budget bill does not list the specific mandates that are funded in 2006-07.

- The mandates claims process could be streamlined and simplified by reimbursing districts on a per-pupil basis for all K-12 mandates.
- Recent action by the Commission on State Mandates (CSM) on the Standardized Testing and Reporting (STAR) mandate raises issues about how the state should address local implementation costs of this program.
- Funding for state truancy mandates could be used more effectively by transforming these programs into a categorical program aimed at reducing truancy and dropouts.

We discuss these issues below, after first reviewing newly identified mandates in the Governor's budget.

## NEWLY IDENTIFIED MANDATE REVIEW

*We recommend the Legislature approve four new K-12 education mandates adopted by the Commission on State Mandates in 2005.*

Chapter 1124, Statutes of 2002 (AB 3000, Committee on Budget), requires the Legislative Analyst's Office to review each mandate included in CSM's annual report of newly identified mandates. In compliance with this requirement, this analysis reviews four new education mandates. Figure 1 (see next page) displays the new mandates and the costs associated with each. The CSM identifies total district costs of \$10.8 million for the four mandates through 2005-06. This estimate is based on actual district claims through either 2002-03 or 2003-04. The DOF identifies expected claims for these four mandates in 2006-07 of \$17.3 million.

As Figure 1 displays, the annual cost of three of the four mandates is less than \$50,000. However, these estimates are based on the claims of an extremely small number of districts. For instance, only one district submitted a claim for the Teacher Incentive Program in 2003-04. If more districts claim for these mandates in the future—something that usually occurs after a new mandate is approved—statewide costs are likely to increase.

Figure 1 also shows the DOF estimate of \$17.3 million for the 2006-07 Pupil Promotion and Retention mandate in 2006-07. This estimate is higher than the \$9 million CSM identified in total costs for the years 1997-98 through 2004-05. The DOF estimate is based on past-year data, when district claims were significantly higher than more-recent claims. For instance, 2003-04 claims for this mandate total \$3.1 million. Accordingly, the DOF estimate for this mandate probably is too high.

<b>Figure 1</b>			
<b>New Mandates Approved by The Commission on State Mandates in 2005</b>			
<i>(In Millions)</i>			
<b>Mandate</b>	<b>Requirement</b>	<b>Accrued Costs Through 2005-06</b>	<b>Estimated Cost in 2006-07<sup>a</sup></b>
Pupil Promotion and Retention	Provide academic instruction to students at risk of failure.	\$10.4	\$17.3
Differential Pay and Reemployment	Implement policies for employees who exhaust sick leave.	0.2	__b
Teacher Incentive Program	Administer state awards for earning national teaching certification.	0.1	__b
AIDS Prevention Instruction II	Plan and conduct in-service training for teachers.	0.1 <sup>b</sup>	__b
<b>Totals</b>		<b>\$10.8</b>	<b>\$17.3</b>
<sup>a</sup> Department of Finance estimate. <sup>b</sup> Less than \$50,000.			

Our review of the CSM decision on the new mandates did not identify any issues with the commission's determination of mandated costs. In fact, we commend the commission staff for uncovering significant errors in district claims for the Pupil Promotion mandate, which resulted in the lower level of recent claims for that mandate. The Governor's budget signals the administration's approval by including the new mandates in its 2006-07 funding plan. We recommend the Legislature approve these four mandates.

## FULLY FUND ONGOING MANDATE COSTS

*We recommend the Legislature augment by \$28.2 million the amount included in the budget for K-12 state-mandated local programs in order to fully fund likely costs for these activities in the budget year. We also recommend the Legislature amend the budget bill to list the specific mandates that the 2006-07 appropriation is intended to cover.*

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Of the \$173.6 million identified by DOF for 2006-07 K-12 and community college mandates, \$161.8 million is associated with K-12 mandates (plus an additional \$4 million in mandates related to the Public Employees' Retirement System [PERS] for school and community college employees). This estimate excludes funding for several mandates that have been eliminated or suspended by the Legislature. The estimate also assumes no budget-year costs for STAR and the School Accountability Report Card mandates because of recent decisions by the CSM.

The proposed budget bill departs from the past practices of displaying the individual K-12 mandates that are funded in the budget as well as those that have been suspended or eliminated. The DOF advises that the list is specified in the Governor's budget document, and that a similar list in the budget bill is unnecessary.

Overall, our review indicates that DOF's cost estimate is reasonable (even though our estimates for individual mandates differ somewhat). Our estimate of total mandate costs, which is based on more recent data than was available to DOF, suggests the costs are about \$15 million lower. According to the State Controller's Office (SCO), however, the number of districts claiming mandate reimbursement has declined in the past few years since no funding was available in the budget. Once ongoing funds are appropriated, claims are likely to increase. On net, then, we think the DOF estimate represents a reasonable estimate of what might be claimed.

The Governor's budget would partially fund the \$161.8 million in estimated K-12 claims, as only \$133.6 million is included in the budget. We have previously recommended that the Legislature restore ongoing funding for mandates because it represents part of the base K-12 budget. Failure to fully fund these costs is a form of borrowing from school districts. It is important to address these "holes" in the budget and end this type of borrowing.

We recommend the Legislature increase the 2006-07 appropriation by \$28.2 million and fully fund the \$161.8 million in expected mandate claims. As we note earlier in the chapter, we believe that fully funding the K-12 base budget warrants a much higher priority for state funds than new programs. By addressing this issue, the Legislature would end the recent practice of borrowing from school districts for these activities and fix a significant problem with the K-12 budget.

We also recommend the Legislature amend the budget bill to list: (1) the specific mandates funded, (2) the amount allocated for each mandate, and (3) those mandates suspended in 2006-07. This list is important for the Legislature and for school districts. For the Legislature, the list serves to explain the significant expenditure of state funds that is proposed in the budget. For school districts, the list provides critical information

on which mandates are funded in the budget. By listing suspended mandates, the language also serves notice to districts that these activities are not required in the budget year.

## **CREATE NEW MANDATE BLOCK GRANT**

*We recommend the Legislature create an Educational Mandate Block Grant that would streamline and simplify the financing of K-12 mandate programs and improve the distribution of mandate reimbursements to districts.*

Lack of funding for K-12 mandates is only one of the problems encountered by the state and school districts in the mandate reimbursement system. In fact, mandates may be one of the more contentious fiscal issues in K-12 finance. In addition to the lack of ongoing funding for education mandates, we have identified the following problems with the system.

### **Mandates Often Not the Most Effective Financing Mechanism**

We generally advise the Legislature to avoid using state mandates to achieve state policy goals. We make this recommendation for several reasons. First, categorical programs or other approaches usually provide the state with a greater ability to accomplish its policy goal. The mandate process affords little opportunity for the state to assess the outcomes of the mandate or hold local governments accountable for meeting specific goals. Second, categorical programs give the state greater control in determining the funding that is provided in support of a state policy or program. Since state mandate costs are determined by local mandate claims, the state loses control over the statewide cost of the mandate. Finally, categorical or other approaches allow the state to distribute funds to those areas with the greatest need. With mandates, district claims are based on local costs of complying with the mandate, not necessarily need.

### **A Lengthy and Legalistic Process for Identifying New Mandates**

The current CSM process operates in a quasi-judicial fashion, in which the commission's decisions are based primarily on case law and written briefs submitted by state agencies and school districts. This structure was intended to create a fair process for both the state and local governments that established a clear record documenting the commission's decisions.

The CSM process, however, lacks a strong "mediation" process that courts commonly use to encourage plaintiffs and defendants to find a negotiated settlement to a dispute. As a result, commissioners must choose among the various arguments introduced into the record. For complex

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mandates, this often asks the commissioners, who are not program experts, to make important decisions on limited information submitted by DOF and districts. These comments should not be interpreted as criticism of the CSM and its staff, who try hard to be thorough and fair. The current process, however, does little to encourage the state and school districts to craft an “out-of-court” settlement that better balances the interests of both sides.

The process also takes years to complete. It currently takes more than five years for the CSM to approve a new mandate for state funding. During this process, districts must incur costs to implement the mandate while at the same time guessing what types of costs will be reimbursed by the state. For the state, the length of the process for new mandates results in a buildup of costs that come due at the completion of the CSM process. This is the first time the Legislature is informed about the size of the costs associated with a new mandate. In the case of the School Bus Safety II mandate, the accrued costs reached several hundreds of millions of dollars—far more than originally anticipated. At that point, however, the state usually has limited options for reducing past costs.

### **A Claiming Process That Requires Significant State and Local Administrative Effort**

State mandate laws allow local governments to claim for costs caused by a new state requirement. The amount claimed by districts can differ significantly depending on the administrative effort made to maximize state mandate funding. School district accounting practices usually are not designed with the idea of accurately capturing these costs. As a result, districts must expend a significant effort to identify the amount of funding to which they are entitled. Even with that effort, district officials indicate they sometimes claim only for costs that are more easily identified, and therefore they believe that claims are less than the actual cost of administering mandated activities.

Small districts are especially affected by this problem. These districts lack the specialized staff for administering mandated programs and identifying additional costs that are common in larger districts. Data from SCO suggests that many small districts fail to make claims for most mandate reimbursements. Only about half of all districts apply for reimbursement for most mandates. Because districts can submit mandate claims as part of a county office of education claim, it is uncertain how many districts actually are reimbursed for each mandate. From our review of past claims, however, we think it’s likely that many small districts receive little or no mandate funding.

The claiming process also results in significant state costs. The SCO develops claim forms, answers district inquiries about specific mandates, receives annual claims for district reimbursements, submits local claims to a “desk audit” review, and distributes state funds to reimburse districts. With 1,000 school districts eligible to claim for 39 mandates, this administrative effort is substantial.

### **Audit Process Increases Friction Between Districts and the State**

The SCO audits school districts to verify local claims for mandate reimbursements. Since January 2003, when SCO was given staff to conduct field audits of local government mandates, the office has conducted audits in 27 school districts. The audits were the state’s response to concerns that local government mandate claims exceeded the level of allowable costs. The SCO audits have disallowed a significant amount of local claims. For instance, SCO auditors disallowed \$32.7 million in 2001-02 claims to date, which represents 18 percent of the \$185.4 million in district claims. In total, SCO has disallowed \$177 million in claims for the years through 2001-02. According to SCO, a majority of disallowed costs result from the lack of supporting documentation for the claim.

Audit findings have angered some district officials, who claim that the audit standards used by SCO require a greater level of documentation than in the past. In addition, large districts believe they are targeted for audits because their relatively large claims offer a greater likelihood of large audit reductions.

Friction over state audits reflects the different perspectives of the state and school districts over mandated programs—and the problems that mandates present to both sides. For the state, the lack of control over the cost of mandates raises concerns that districts will inflate their claims to increase local revenues. From that perspective, audits are a reasonable way to address that issue. For districts, because of the administrative effort needed to accurately capture the incremental cost of implementation, many districts believe their claims do not represent the full cost of mandated activities. As a result, districts see state audit findings over supporting documentation as an attempt to further reduce the proportion of local costs covered by the state.

### **An Education Mandate Block Grant**

The existing mandate reimbursement process does not serve either the state or school districts well. From the state’s perspective, mandates often represent an inefficient way to accomplish state policy goals, and the open-ended nature of the current reimbursement process generates an understandable concern about the reasonableness of local cost claims.

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New mandates take years to process, which can result in the buildup of unexpectedly large local claims. The cost of maintaining the state infrastructure for mandates also is considerable.

From a district perspective, payments for mandates often fall short of actual costs. Districts have no guarantees about the amount the state will provide for new mandates until the CSM process is complete, which usually takes at least five years. State audits reduce reimbursements further, often because local documentation is incomplete.

To address these issues, we recommend the Legislature adopt a new K-12 mandate reimbursement process that offers solutions to many of the problems cited above. Specifically, we recommend the Legislature establish a mandate block grant that would provide a set amount of district reimbursement that would cover all existing K-12 mandates. Because the State Constitution requires paying local governments for their actual costs of complying with state mandates, our block grant would give districts the option of continuing to submit claims for each individual mandate or accepting the block grant amount as adequate reimbursement for all 39 K-12 mandates. Our proposal also includes an alternative process for including the costs of new mandates in the block grant. Specifics of our proposal are discussed below.

***Distribute Ongoing Mandate Reimbursements in a Per-Pupil Block Grant.*** Rather than require districts to separately claim for each mandate, we recommend providing a per-pupil block grant that would compensate districts for the costs of implementing all K-12 mandates. Our proposal would free districts from having to account for the individual cost of each mandate. This also would ensure that all districts, including small districts, would receive some reimbursement for their efforts. Based on the DOF estimate of full funding of 2006-07 mandate costs, districts would receive about \$27 per student in mandate reimbursement. If the Legislature adopts our recommendation below to transform two truancy mandates into a categorical grant program, this amount would drop to about \$24 per pupil. Our recommendation also would keep \$4 million outside of the block grant to pay for the two PERS mandates.

***No Audits of Claims Covered by Block Grant Funding.*** By accepting funding from the block grant, districts would waive their right to claim for individual mandates. These districts also would not be subject to financial audits for costs covered by funds from the mandate block grant. Districts that continue to submit individual claims for mandates, however, could be audited. In addition, districts accepting the block grant would be reviewed periodically to ensure they carry out the mandated activities.

***Incorporating New Mandates Into the Block Grant.*** In future years, we think the costs of many new mandates could be “rolled into” the man-

date block grant. This would work, however, only for those mandates for which a unit cost could be established—that is, a cost that can be measured in dollars per student. To facilitate this, we think the Legislature should explore a “shortcut” around the CSM process for identifying new mandates in order to give both the state and school districts earlier information about the scope and cost of new mandates. As discussed above, we think creating opportunities to find a negotiated settlement of mandates and their associated costs could result in outcomes that both the state and districts find reasonable. The Legislature’s budget process could provide a venue for such negotiations. For instance, the Legislature could direct DOF to submit as part of the budget each year a proposed increase to reflect new mandates. During budget hearings, districts would comment on the DOF proposal, and the Legislature would approve a per-pupil reimbursement rate it found reasonable as part of the annual budget act.

*Summary.* Our proposed solution to the problems of the existing K-12 mandate process attempts to address both the state and local perspective. Districts deserve reasonable compensation for mandated costs, and the process should not be so complex that this goal is frustrated. Our block grant would greatly simplify the mandate process for districts and provide an assured amount of reimbursement each year for those costs.

The block grant approach also has several advantages for the state. A block grant would reduce the state’s costs of processing and auditing district mandate claims. If most districts accepted per-pupil funding for mandates, our proposal also would result in more predictable state budget costs for these activities. Finally, our proposal also would create more immediate feedback on the cost of newly created mandates—provide the Legislature an opportunity to shape the implementation, and the associated long-term costs—of new state directives.

## REVISIT THE STAR MANDATE

*We recommend the Legislature enact legislation to establish a “reasonable reimbursement methodology” for the Standardized Testing and Reporting (STAR) mandate and provide an additional \$11.2 million in ongoing funds and appropriate \$104.5 million in one-time funds proposed in the budget for past mandate costs to retire all outstanding STAR mandate obligations.*

The 2006-07 budget assumes no costs for the STAR mandate in the budget year. According to DOF, the proposal reflects the recent CSM decision that substantially reduces the STAR activities for which school districts may claim. The DOF believes that reimbursement provided through the

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state's assessment budget for local STAR administrative costs is sufficient to pay for all claimable mandated costs.

**Background.** The STAR program includes three different tests. The California Standards Tests (CSTs) assess student knowledge of the state content standards in mathematics, English, history, and science. A "norm-referenced" test is given to students in grades three and seven in English and mathematics. The third test assesses language and mathematics skills in Spanish, and is administered to English-learner students under certain conditions.

In our *Analysis of the 2004-05 Budget Bill*, we identified a number of issues related to the STAR mandate. Specifically, we found that the CSM decision on STAR failed to recognize the fact that the program allowed the state to comply with federal assessment mandates included in the No Child Left Behind (NCLB) act. We also noted the large increases in federal funding provided through NCLB that was intended to pay for the act's new requirements. In response to our recommendation, trailer bill language was enacted to direct the CSM to review the STAR mandate in light of federal testing requirements in place at the time STAR was enacted. The commission's review resulted in the following findings:

- ***Only the Norm-Referenced Portion of STAR Is a Reimbursable Mandate.*** The CSM review dramatically scaled back the number of STAR activities that district may claim as mandated. The commission found mandated costs only for administrative costs associated with the norm-referenced test given in grades three and seven.
- ***CST Is Not a Reimbursable Mandate.*** No activities were identified for the CSTs because districts had failed to submit a new mandate claim when these tests were enacted in state law. Since no new test claim was submitted by districts before the statutory deadline (which is one year after enactment of the new requirement), districts appear to have missed their opportunity to obtain reimbursement for these costs.
- ***Primary Language (in Spanish) Test Is Not a Mandate.*** No mandated activities were identified for the testing of English-learner students because such testing is required by federal law and past court findings.
- ***Commission Did Not Review Prior STAR Claims.*** The CSM's findings do not apply to STAR claims prior to 2004-05. The commission found that the statutory language guiding its review did not authorize a review of these issues for previous years. As a result, the CSM did not review the issue of federal requirements or other

issues relating to the STAR mandate for these past years. District claims for the program through 2004-05 total \$220 million.

### **A Proposal to Settle All STAR Claims**

The commission's STAR findings leave important issues unanswered. First, its decision did not address the issue of the interaction between state and federal testing requirements for past years or for the CSTs. In our view, the decision does not help the Legislature untangle the complex interaction of state and federal mandates for this program.

Second, we have concerns with the possible outcomes for both the state and districts. By not reviewing past-year STAR issues, the Legislature faces the possibility of paying for STAR costs that, in our view, were mandated by federal law. If federally required, the state would be relieved of a significant portion of the \$220 million in prior-year claims. Because districts failed to submit a test claim for the CSTs, they will be unable to receive compensation for the administration of CSTs that are not required by federal law. Districts had assumed that these costs would be covered as part of the STAR mandate.

The DOF also has taken steps to not pay districts for the administrative costs of the CSTs in the years prior to 2004-05. Because the CSM decision excludes the CSTs as a reimbursable mandate, DOF has requested SCO to deny claims for CST administrative costs from all district claims for STAR, including 2003-04 and prior years. Because district claims are not sufficiently detailed to permit SCO to comply with this request, the administration's action likely will create more controversy and delay.

We believe the Legislature could improve on these outcomes. The STAR tests comprise the centerpiece of the state's assessment system. The results of the tests are used by parents, teachers, and administrators for school and district performance measures in the state's accountability programs and for state policy purposes. Given the value of the data from STAR, establishing a system of cost reimbursement that is fair to both the state and districts is in the state's long-term interest.

For this reason, we have developed a proposal that would address both the past-year STAR claims as well as establish a higher ongoing reimbursement rate that would be distributed to districts through the testing item in the budget bill. Underlying our proposal is the assumption that the state would not pay for those activities that also are mandated under federal law. As a result, our proposal would relieve the state of *a portion* of the STAR mandate costs.

Specifically, we recommend the enactment of legislation to establish a "reasonable reimbursement methodology" (RRM) for past and future

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state-mandated STAR costs. Section 17518.5 of the Government Code allows the state to establish an RRM as a way of developing a payment formula that simplifies the claiming process and provides a level of funding that fully satisfies the actual costs of a majority of claimants. Using this provision of state law, we think the Legislature can establish a simple formula to reimburse districts for past and future STAR activities that are not required under federal law.

Our proposed methodology generates a reimbursement level for each year STAR has been administered based on average district claims for the STAR mandate and the proportion of tests that state law, but not federal law, requires for students in each grade. We calculated this level as follows:

- First, we converted average district STAR claims into a per-pupil testing cost. This per-pupil amount represents the total district cost of STAR testing each student.
- Second, our formula determines the proportion of tests that are required only by state law. By multiplying this proportion and the per-pupil total costs, we calculate the proportion of total costs in each grade our formula would cover. For example, since federal law does not require testing in second grade, our methodology would reimburse districts for the full per-pupil cost of testing for all second grade students. For third grade, the state would pay for only one-third of the total cost because federal law mandates two (CSTs in mathematics and English language arts) of the three tests administered in this grade (the norm-referenced test is not a federal mandate).

Our model generates lower levels of reimbursement than claimed by districts for prior years. Specifically, it generates costs of \$104.5 million, slightly less than half of the amount claimed by districts. For the budget year, our model generates an additional \$11.2 million in mandate costs above the level already included in the STAR budget item.

We think this represents a fair trade for both districts and the state. Our proposal recognizes that testing in California is driven, in part, by federal mandates—and under state law, schools are not guaranteed reimbursement for federal mandates. Districts are compensated for these costs as part of the \$1.8 billion in support provided through the federal act each year. It also recognizes that districts do incur costs that reasonably should be funded by the state as a mandated local activity. Finally, it recognizes the critical role of the STAR tests by placing state support for the administration of the program on a solid long-term basis.

For these reasons, we recommend enactment of legislation to implement the following package. This would retire pending past claims against the state for the STAR mandate and cover current costs.

- ***Additional Ongoing Funding (\$11.2 Million)***. Consistent with the methodology outlined above, this additional funding would pay for the portion of the STAR assessment that is mandated exclusively by state law. This funding would be on top of the \$12 million provided in item 6110-113-0001, and would only be provided to those districts participating in the settlement. In future years, this funding would be folded into the STAR appropriation item.
- ***One-Time Funding to Settle Up Past Years (\$104.5 Million)***. Second, we recommend the Legislature amend trailer bill language and appropriate \$104.5 million in support of our proposed STAR mandate settlement for the years 1997-98 through 2004-05. This would use the bulk of the \$151 million in funds proposed in the budget for prior-year mandates. The remaining \$46.5 million would remain available to retire mandate obligations from the late 1990s, as proposed by the administration.

Our proposal represents a middle ground between DOF's assertion that the state should deny reimbursement for any CST costs and districts' belief that the state is responsible for all administrative costs associated with STAR. For the state, our proposal would build a solid administrative foundation under this program, which represents the state's most important testing program. Our proposal also recognizes that state testing requirements exceed those contained in federal law and attempts to compensate districts fairly, rather than take advantage of the districts' failure to submit a test claim for the CSTs and avoid these payments.

For districts, our proposal structures a long-term settlement of both past and future mandates that recognizes that K-12 testing policy is driven, in part, by federal law. Districts receive substantial amounts of federal funding—\$1.8 billion in 2005-06—in program and administrative support through NCLB, and it is reasonable to ask districts to use these funds for federally required testing. Because the DOFs request to SCO signals a possibility that districts may receive almost no STAR reimbursements for past year claims, we think districts have a strong incentive to settle this issue.

## **CREATE A NEW TRUANCY PROGRAM**

*We recommend the Legislature adopt trailer bill language to eliminate two existing truancy mandates and appropriate the \$16.9 million in funding currently allocated for these mandates for a*

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*new truancy grant program. This would increase effectiveness of funds targeted at reducing truancy and the number of students dropping out of school.*

Two of the 39 mandates affecting K-12 education target the problem of truancy—students who are absent from school or classes without permission at least three times during a school year. State law creates a variety of tools for educators to address truant students, including suspension of a student’s drivers license, referral to a School Attendance Review Board, or requiring a student to perform up to 40 hours of community service. The two state-mandated local programs are created by requirements to notify or meet with parents of students who are truant. Specifically, state law requires:

- **Notification of Truancy.** Schools are required to notify parents of truant students by mail or other reasonable method. The DOF estimates 2006-07 claims for this mandate total \$9.8 million. Districts will receive an estimated \$15.40 for each notification made pursuant to this mandate.
- **Habitual Truant.** Students who are absent from school or class five or more times in a year are considered “habitual” truants, and schools are required to “make every effort” to meet with the parents of habitual truants. The DOF estimates 2006-07 costs for this mandate at \$7.2 million.

## **Problems With the Mandate Approach to Truancy**

Truancy is an important issue, for several reasons. State law requires students under the age of 18 to attend school each day. Students who are not in school are also more likely to commit crimes or engage in other negative behaviors such as drug use.

Students who are not in school also are not learning. Research shows that truancy is a sign of disengagement from schoolwork—that students are losing the commitment to succeed in school, usually because they are failing in their coursework. As we discussed in our 2005 report *Improving High School: A Strategic Approach*, research shows that dropping out of school is the final step in a student’s disengagement from school. Thus, effective interventions to reduce truancy and keep students engaged in their studies can help reduce dropout rates.

California’s dropout rate is high. In our report, we estimate that about 30 percent of entering high school freshmen fail to graduate from high school four years later. Available attendance and graduation data do not permit a precise calculation of the dropout rate, so the figure may be somewhat higher or lower than our estimate. Clearly, however, the state’s

dropout rate is too high. For that reason, the state needs to ensure that funds provided for local truancy programs encourage districts to focus on reducing the number of truant students and, ultimately, reducing the number of dropouts.

Our review indicates that state funds currently used to pay local claims for the two truancy mandates could be used to greater effect. We have identified three problems that reduce the effectiveness of the state's current investment in addressing truancy and dropout rates. We discuss these problems below.

***Mandate Can Create the Wrong Incentives.*** The Notification of Truancy mandate provides \$15.40 in reimbursement each time a district notifies parents of a truant student. This unit cost approach to district reimbursement of this mandate establishes a simple, widely accepted, method of paying district mandate costs.

The unit cost approach, however, also encourages districts to maximize the number of parent contacts under the mandate each year in order to maximize state funding. While it could be argued that more information to parents about attendance problems with their students is always a good thing, the unit cost approach of the truancy notification can lead to absurd results. For instance, if a student skips an entire week of class, the student would be judged a truant three times during the week—and a district could receive \$46 for notifying the parents of the three trancies. If the notices are sent by mail, none of the notices is likely to reach the parents until after the entire week of missed classes. While notifying parents of attendance problems is an important element of a truancy program, we question in this example the effectiveness of sending three letters.

Districts sometimes take this approach as a way of maximizing state funding. We discussed this mandate with one district official who uses this mandate as a “revenue source.” That is, since the cost to the district of sending notification letters is significantly less than the state reimbursement rate, the district sends as many parent notifications as possible in order to maximize district claims under the mandate. According to the district official, the additional revenue was used to pay for district school safety programs—not truancy or dropout programs. Thus, the unit cost approach for this mandate creates incentives for districts to maximize notifications without actually reducing the number of trancies.

***Despite Requirements, District Implementation Is Uneven.*** While state law requires all districts to follow state truancy laws, district claims suggest that implementation of the two mandates differs significantly across the state. One large urban district, for example, claimed about \$8,500 in 2002-03, which translates into 620 notices. The district's reported dropout rate in that year was 6.9 percent, which means that 1,300 high school

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students dropped out of school. Thus, since each student who drops out also is truant, it appears that this district did not implement the truancy mandates as state law requires. On the other hand, a small suburban district also claimed about \$8,500 for the Notification of Parents mandate. Yet, in 2002-03, the district reported no dropouts. Because it is a small district (4,300 enrollments), it seems clear that the level of implementation in this district is much greater than the large urban district.

*Funds Are Not Necessarily Targeted to Districts With the Biggest Problem.* The unevenness of claims also indicates another problem—funding for truancy programs is not targeted to districts that have the most severe truancy problems. As noted above, the large urban district received \$8,500 (0.1 percent of the state total) for the Notification of Parents mandate despite the fact the district enrolls more than 57,000 students (0.9 percent of the state's total).

At the other end of the spectrum, a large suburban high school district claimed \$260,000 for the Notification of Parents mandate. This claim translates into more than 19,000 notifications. The district is relatively large, serving about 38,000 high school students. As a high school district, it could be expected to have higher truancy rates than a unified district, which serves grades K-12. The high school district's claim, however, was the third highest in the state—much larger than its size would suggest.

## **Establish a New Truancy Grant Program**

In summary, while the two truancy mandates appear to promote a policy of increasing parental involvement in the area of truancy, the mandates create the wrong incentives for districts and implementation falls far short of a uniform statewide program. In addition, while research suggests that educators and parents must work together to address the needs of students who are disengaging in schools, it does not suggest that a formal notification process is among the more effective approaches. Instead, direct teacher contacts with parents generally is considered to be more effective.

Given these problems, we think a more direct and flexible state approach to addressing truancy would help districts create more effective truancy programs. Therefore, we recommend the Legislature adopt trailer bill language to eliminate the two truancy mandates and establish a new truancy grant program. The program would provide the same level of funds in the form of a grant program for local truancy prevention that districts could use to (1) identify students whose attendance suggests they are at risk of dropping out of high school or in danger of falling significantly behind in their classes, (2) contact students' parents, and (3) develop a plan to address the educational or other issues that create a barrier to

the students' progress in school. While there is no perfect way to distribute funds for this purpose, our proposal would allocate the \$16.9 million based on the number of students who drop out in each district annually. While this data currently is not considered reliable, the quality of the data will improve over the next several years as the state's new student-level database is implemented.

Districts currently have strong incentives for addressing truancy problems because most state funding is based on attendance. Thus, we think they have reason to continue contacting parents when students are absent from class without permission. Districts also have an incentive for reducing dropout rates, as this data is used as part of the federal NCLB accountability system. Building on these incentives, the state could increase the impact of funding currently spent on truancy reduction by focusing state support on activities that can directly help reduce the number of dropouts in the state rather than on procedural mechanisms that are of limited effectiveness.



## AFTER SCHOOL PROGRAMS AND PROPOSITION 49

As approved by voters in 2002, Proposition 49 requires the state to increase funding for the After School Education and Safety (ASES) program beginning in 2006-07 (based on a complicated trigger calculation). The initiative requires an increase of \$426 million from the \$122 million currently provided for ASES, for a total funding level of \$548 million (there is also roughly \$2 million used for California Department of Education (CDE) administration and evaluation costs). These additional funds are provided for the program “on top of” the state’s Proposition 98 minimum funding guarantee (referred to as an “overappropriation”). Proposition 49 also converts after school program funding to a “continuous appropriation” (that is, no annual legislative action is needed to appropriate funds).

### **Background on Current Program**

Both the ASES program and a related federal program—the 21<sup>st</sup> Century Community Learning Centers (21<sup>st</sup> Century)—provide competitive grants to elementary and middle schools primarily for after school services to students between the hours of 3 p.m. and 6 p.m. The program provides both an academic component and an educational enrichment component. The academic component generally consists of tutoring and/or homework assistance in core academic subjects. The enrichment component generally involves physical activities, art, or other general recreation activities.

Under ASES, schools are reimbursed at a rate of \$5 per student, per day. The initiative establishes caps on grants to participating schools, which vary depending on when a school entered the program, and whether one-half of the students in the school are eligible for a free or reduced cost meal. Under Proposition 49 all schools would be effectively guaranteed a grant—\$50,000 for an elementary school and \$75,000 for a middle school—regardless of the size of the school. Schools are required to provide 50 cents in local match for each state dollar provided. If the annual appropriation is insufficient to fund all grant applications, priority

is given to schools with more than one-half of their students eligible for the federal free or reduced-price lunch program.

From our review of the Governor's proposal for implementing Proposition 49, we have identified the following issues:

- The state's fiscal condition makes implementation of Proposition 49 a lower priority.
- There are several implementation issues that may only be resolved by further action of the voters.
- While the Governor's program and fiscal proposals would improve after school programs in a number of ways, we question whether the changes would give districts flexibility to meet local needs for these services.

We discuss these issues below.

## RECOMMEND LEGISLATURE REPEAL PROPOSITION 49

*We continue to recommend the Legislature enact legislation placing before the voters a repeal of Proposition 49 because (1) it triggers an autopilot augmentation even though the state is facing a structural budget gap of billions of dollars, (2) the additional spending on after school programs is a lower budget priority than protecting districts' base education program, and (3) existing state and federal after school funds are going unused.*

In the 2005-06 Analysis, we recommended the Legislature repeal Proposition 49. We continue that position, recommending that the Legislature place the repeal of Proposition 49 before the voters on the June 2006 ballot for the following reasons: (1) it triggers badly timed autopilot spending, (2) the program is a lower priority than other K-12 needs, (3) the program may crowd out K-12 spending on higher priority programs, and (4) Proposition 49 funds are not likely to be spent in a timely manner.

**Autopilot Spending Badly Timed.** Proposition 49's intent was to give after school programs the first call on additional General Fund revenues. Since its passage, the fiscal environment has changed significantly—with the state struggling through several consecutive years of budget difficulties. The state continues to face a significant budget problem with a multibillion dollar structural budget gap for the near future. Moreover, the autopilot formula that triggers Proposition 49 creates additional spending obligations without the Legislature and Governor being able to assess the merits of the augmentation compared to other budget priorities.

**Lower K-12 Education Priority.** In previous sections, we have discussed the fiscal problems that school districts face over the near future to maintain their base education programs. From our perspective, maintaining the base program is a higher priority than expanding after school funding. We think this is particularly the case given that some school districts are struggling with basic solvency issues. For example, providing extra after school funding for Oakland Unified will not help the district improve its local budget to get out of state receivership, and in fact may make its fiscal situation worse (for example, if Oakland used local funds to meet the Proposition 49 matching requirements). If the state wants to provide additional funds to schools, we think providing funding to address basic solvency issues or pay down the education credit card would be a higher priority.

**Proposition 49 May “Crowd Out” Spending for Other, Higher Priority K-12 Programs.** The finance mechanism in Proposition 49 requires the state to fund Proposition 49 as an appropriation in excess of the Proposition 98 minimum guarantee. Under the Legislative Analyst’s Office (LAO) and the Department of Finance (DOF) reading of the measure (discussed in detail later in this analysis), these additional funds would restore Proposition 98 “maintenance factor,” that, absent the measure, would be restored to K-14 education in future years. What may appear to be a technical matter, has a practical effect. It means that, in the near future, the funding for Proposition 49 will likely come at the expense of other K-14 spending priorities, not non-Proposition 98 General Fund priorities. Similarly, while some in the education community disagree with this interpretation, it is our view that Proposition 49 expenditures will count toward the Proposition 98 minimum under Test 1. We forecast the state transitioning to a Test 1 minimum guarantee starting as early as 2008-09. Under Test 1, K-14 education will receive a specific percentage of General Fund revenues, and Proposition 49 funds will count toward that spending level. Once this transition occurs, Proposition 49 funding would come at the expense of other K-14 priorities.

**Proposition 49 Funding Not Likely to Be Spent in a Timely Manner.** The state has had a difficult time spending ASES funds as well as federal after school funding in a timely fashion. The state program reverts around \$30 million out of \$122 million each year because of problems with the reimbursement process and budget and contracting delays. (We discuss these problems in detail below.) The federal after school program has had a worse usage rate. While the Legislature took some steps in the 2005 session to improve the usage of funding, a large amount of the Proposition 49 augmentation would likely go unused, particularly in the near term. We are also concerned that a large portion of the funds would be used inefficiently in early years of the program’s implementation.

In summary, because of the autopilot nature of the trigger, the impact that this appropriation could have on the budget problem, the relatively lower priority of after school programs compared to schools' base education program, and the small likelihood funding actually would be spent in the near term, we continue to recommend the Legislature enact legislation placing before the voters a repeal of Proposition 49. Absent a full repeal of Proposition 49, the Legislature could place a measure before the voters to either delay implementation until the state has balanced its structural budget gap or phase in the program over several years.

## **THE LEGISLATURE FACES LEGAL CONSTRAINTS AND UNCERTAINTIES**

*We recommend the Legislature seek legal advice on the extent to which it can statutorily alter the provisions of Proposition 49.*

If the Legislature chooses not to repeal Proposition 49, it will still face various legal issues regarding the program's implementation. Specifically, since Proposition 49 was passed by the voters, there are restrictions on the type of changes that can be made to its provisions without returning the measure to the voters for clarification. Second, there are differences of opinion on how Proposition 49 interacts with the Proposition 98 minimum guarantee.

### **What Changes Can the Legislature Make Without Going Back to the Voters?**

The administration proposes numerous changes to the ASES program and provisions of Proposition 49 to attempt to address some of the problems with the current program. (We discuss these changes in detail in the next section of this write-up.) It is unclear, however, whether the Legislature can make these changes through statute, or whether they would have to be approved by voters.

*Some Program Elements Can Only Be Changed With Voter Approval.* The initiative prohibits legislative amendments to key portions of the measure. The Legislature would need to seek voter approval if it wanted to: (1) delay program implementation, (2) change the amount of funds provided (including those related to the "no supplanting" provisions), or (3) change the provisions guiding how the initiative interacts with the requirements of Proposition 98. Some have questioned, for example, the administration's interpretation of the Proposition 98 portions of the measure. If the Legislature wanted to clarify the impact that this

measure would have on the Proposition 98 calculation, it would have to submit changes to the voters.

The initiative also prohibits using ASES funds to supplant existing funds, and the Legislature is barred from amending this portion of the act. Yet the Governor's budget proposal appears to use Proposition 49 funds to supplant other monies. Specifically, the administration proposes to allow elementary and middle schools currently supported by federal 21<sup>st</sup> Century funds to transfer into ASES. This proposal would free up 21<sup>st</sup> Century funds that the administration redirects to high school after school programs to help assist students in passing the high school exit exam. We think that this is a clever way of addressing a current state need. It would appear, however, that the Legislature would need to go back to the voters to implement this part of the Governor's proposal.

**What "Furthers the Purpose" of ASES Programs?** The remainder of the Proposition 49 requirements can be amended by a majority vote of the Legislature to further the purpose of the program. But, exactly what qualifies as furthering the purpose of the measure is in the eye of the beholder. For example:

- **Increasing Reimbursement Rate and Grant Caps.** Proposition 49 contains specific funding rates and grant caps. The administration proposes to increase both the reimbursement rates and the grant caps. Some may argue that increasing the per-pupil reimbursement rate and grant caps furthers the purpose of the measure, and for those schools that receive a grant this is certainly true. However, such a change would lead to fewer schools receiving grants. If you are a school that got squeezed out because of the higher grant caps, then from your school's viewpoint, the change would not further the purpose of the measure.
- **Reducing Local Match Requirements.** The administration proposes to reduce the local matching requirement. While this reduction may make policy sense to reduce barriers for schools accessing this funding, some may question whether it furthers the purpose of the measure. Some taxpayers may have voted for this measure because they thought that the state was going to get a good return on the state's investment because state funds were going to leverage private and foundation funds to help support this program. For these taxpayers, having the state fund a higher share of the program's costs may not further the purposes of the measure.

While both of these proposed changes may make the program more effective from the state's viewpoint, they represent significant departures

on key program elements that were approved by voters. For this reason, we recommend the Legislature seek legal advice on the matter.

### **Clarify the Interaction With Proposition 98 and How the State Should Treat Unused Funds**

The Proposition 49 trigger mechanism requires the state to provide an additional \$426 million after the state has fully met its Proposition 98 minimum guarantee. The measure is clear that these new funds become part of the Proposition 98 base in future years. As discussed earlier, both LAO and DOF read these requirements as counting toward the restoration of Proposition 98 maintenance factor in 2006-07. The maintenance factor is an obligation that the state created in 2004-05 when the Legislature suspended the Proposition 98 minimum guarantee. When Proposition 98 was suspended, a maintenance factor was created that is the difference between the required minimum guarantee for that year and the actual spending level. In future years, this maintenance factor is restored in years of strong General Fund growth or when the state appropriates above the minimum guarantee.

Since Proposition 49 requires appropriations above the minimum guarantee, these appropriations restore a part of the outstanding maintenance factor. So, in effect the Proposition 49 funds will reduce the Proposition 98 obligations for future years. Some in the education community, however, believe that LAO and DOF's reading is counter to the intent of Proposition 49. The Legislature may want to clarify this issue, either through statute or by taking the issue back to voters.

*What Happens to Proposition 49 Funds That Are Not Spent?* Depending on how the Legislature chooses to implement Proposition 49, the program could result in hundreds of millions of dollars going unspent. As discussed above, the current ASES program reverts about a quarter of its funds annually (these funds are sent to the Proposition 98 Reversion Account). From past experience, as new cohorts were created under either the state or federal after school program, over one-half of the new funds generally went unused in the first year. Since Proposition 49 does not address what should occur with unused after school funds, it will be up to the Legislature to determine how to treat them. We see three options for ASES funds:

- *Funds Revert to the Proposition 98 Reversion Account.* Under this option, the funds not spent on after school programs would end up in the Reversion Account. Under current law, one-half of these funds would be set aside for emergency facilities repairs under the *William's* court settlement. The remainder could be used

for one-time activities for any K-14 program (such as reimbursing school districts for past mandated activities).

- ***Funds Return to the General Fund.*** Under this option, unused funds would return to the General Fund. The main K-12 program that has a continuous appropriation is school revenue limits. For revenue limits the General Fund appropriation does not occur until the school district “earns” the funding by serving a student. So, no funds for revenue limits are ever reverted to the Proposition 98 Reversion Account; instead, they are effectively not appropriated until the funds are earned. If this logic were applied to Proposition 49, then unearned after school funds would be returned to the General Fund, and would not become part of Proposition 98 until the program fully ramped up.
- ***Funds Are Set Aside for Future After School Activities.*** Under this option, any unused Proposition 49 funds would stay with the program and be set aside for future one-time spending on after school activities. Such activities could include one-time grants for things like facilities improvements, equipment and supplies, or professional development for providers.

How the Legislature decides to handle these issues could affect other changes it decides to make to the program.

## **A FRAMEWORK FOR EVALUATING COMPETING AFTER SCHOOL PROPOSALS**

In this section, we provide a framework for the Legislature in evaluating the Governor’s proposal for after school programs (both ASES and the 21<sup>st</sup> Century). We then provide a summary of our concerns with the proposal.

### **Governor’s Proposal Makes Significant Program Changes**

As of this writing, the Governor’s proposed changes to the Proposition 49 initiative language, ASES program, and 21<sup>st</sup> Century program had not yet been submitted to the Legislature, so we are unable to comment on the details of the Governor’s proposal. The following reflects our understanding of the key components of the proposal based on information shared by DOF:

- ***Changes From Reimbursement to Direct Grant Funding.*** The proposal would provide schools with a specific dollar grant at the

start of the year, instead of reimbursing schools at a rate of \$5 per student, per day based on strict attendance rules.

- ***Increases Grant Caps.*** The grant caps would be increased from \$50,000 (elementary) and \$75,000 (middle school) to \$112,500 and \$150,000, respectively. If not all the grant funds were used, then large schools could receive larger grants.
- ***Would Reduce Grants in Future Years if Not Enough Students Served.*** While the grants would not be based on attendance, the schools would report attendance data. If a school was not serving enough students to justify the size of their grant after two years, the grant would be reduced for future years.
- ***Reduces the Match Requirement.*** The proposal would reduce the local match requirement from a 50 percent local match for each state dollar to 33 percent.
- ***Streamlines Application and Fund Distribution Process.*** The application process would be simplified and available online, and CDE would be required to distribute the funds in a timely fashion.
- ***Grandfathers in 21<sup>st</sup> Century Schools.*** Any elementary or middle school currently participating in the federal 21<sup>st</sup> Century after school program would be eligible for ASES funding in 2006-07. Schools would want to make this transition because the federal grants are only good for five years, and ASES grants are renewable indefinitely.
- ***Redirects 21<sup>st</sup> Century After School Funds to High School.*** The freed up funds from the grandfathering schools into ASES would be redirected to the high school program to assist high school students in preparing for the high school exit exam.
- ***Focuses More on Academics and Less on Other Activities.*** The proposal would require schools to focus more attention on assisting students in core academic subject areas.

Some of the changes proposed by the Governor would significantly improve ASES and 21<sup>st</sup> Century programs. However, Proposition 49 places restrictions on how, and for what purposes, the initiative can be changed. Below, we provide a framework for evaluating whether the Governor's proposal would improve the after school program.

## Balancing Competing Policy Goals

Given that Proposition 49 resources are fixed, the Legislature will either explicitly or implicitly determine a balance of several potentially competing policy trade-offs. Proposition 49 has two main goals—keeping students safe after school and improving student academic outcomes. The cost structure of achieving these two goals differs significantly. As discussed below, supervising students after school is cheaper than providing a program that improves academic achievement. The Legislature will determine through its policy and finance structure for these programs the balance between serving more students in a low-cost enrichment program, and supporting the academic needs of the students served. In addition, there is a similar tension between providing a program that is universal versus a targeted program that focuses on the schools with the greatest need.

*Safety Versus Improving Academic Outcomes.* One of the primary goals of the state's after school program is to keep students out of harm's way in the early afternoon hours (3 p.m. to 6 p.m.). These three hours are peak hours for students either committing crimes or being the victims of crime. In addition, supervising students during these hours may reduce student exposure to drugs and alcohol. Because many parents are working during these hours, after school programs can play a role in helping keep students safe. The funding rate structure of the current ASES program may be sufficient to meet the costs of providing adult supervision between 3 p.m. and 6 p.m. So, if the legislative goal for this program is to provide as many students as possible with a safe after school setting, keeping reimbursement rates low would help the Legislature achieve that goal.

*Improving Academic Outcomes More Costly.* If, on the other hand, the primary goal of the program is to improve academic outcomes, then the current reimbursement rate may be significantly underfunded. While the current program can provide students a time during the day to work on homework or engage in other recreational activities, the funding level is not sufficient to provide significant academic support for students. Providing the small group settings to give struggling students an opportunity to have direct assistance or instruction from a trained adult is much more costly. Currently, the state reimburses supplemental instruction (summer or after school academic instruction) at a rate of \$3.87 per pupil, per hour. This program generally supports a teacher for every 25 to 30 students. To help struggling students meet the high expectations that the state has set may take more intensive adult-student interaction.

If all the new resources from Proposition 49 were invested in an intensive academically focused program with a low student-to-teacher ratio, the per-pupil cost of such a program would require the state or schools to target funds to needier students. If the Legislature wants to focus Propo-

sition 49 resources to improve academic outcomes, then it may want to either significantly increase the reimbursement rate or allow the funds to be mixed with other school resources like supplemental instruction funds. Figure 1, illustrates this trade-off between higher reimbursement rates (higher quality program) and the number of students that can be served with the combined \$548 million that Proposition 49 and the current state program would provide in 2006-07. It shows that twice as many students could be served at the \$5 rate specifically included in the measure.

<b>Figure 1</b>		
<b>How the Proposition 49 Reimbursement Rate Effects The Number of Students Served</b>		
<b>Funding rate</b>	<b>Maximum Students Served</b>	<b>Percent of K-8 Students served</b>
\$5.00	608,661	14%
7.50	405,774	9
10.00	304,331	7

*Universal or Targeted Grants?* A second decision the Legislature will face is whether to provide grants to all schools (universal) or target schools based on need. This issue is primarily determined by how high the grant caps are set. Under the terms of the initiative, all schools would receive at least a grant of \$50,000 (elementary) or \$75,000 (middle school). In contrast, because of its larger proposed grants, the Governor's proposal would limit participation to around 60 percent of schools.

Figure 2 shows that there are four different after school funding models which could be used to implement Proposition 49 depending on how the Legislature sets reimbursement rates and grant caps. For example, if the Legislature sets a low reimbursement rate and a low grant cap, then all schools will be able to participate in the program, and each program would serve a moderate number of students. Because the reimbursement rate will be low, these programs would likely address basic safety concerns, but probably not be academically focused. If the Legislature keeps a low reimbursement rate, but sets a high grant cap, then the Legislature may want to target these grants to schools serving low income students in order to use the more limited number of grants in areas of the state where after school programs are most needed. While not all schools could participate, the larger grants would allow schools to serve a large proportion of their students.

**Figure 2**  
**Proposition 49: Funding Models and Policy Tradeoffs**

Grant Cap	Reimbursement Rate	
	Low	High
Low	Small safety program at all schools.	Small academic/safety program at most schools.
High	Fewer safety programs, but proportional to school size.	Academic/safety programs at fewer schools.

### Assessing the Governor's Proposal

The current ASES program provides a low grant cap and a low reimbursement rate. This type of program would provide all schools in the state with small grants, and each school would be able to offer a program to around 50 students in an elementary school and 70 students in a middle school. For large urban schools, which are sometimes quite large, Proposition 49 grants would allow a small portion of the school's enrollment to participate. The current program would force schools to focus largely on the student safety portion of the program, because the reimbursement rate is too low to provide a program that can focus on academic achievement.

The Governor's approach would increase both the grant cap and the reimbursement rate modestly. We estimate this program would allow roughly 60 percent of schools to participate in the program, and offer a program that would serve up to 70 students per day (elementary) or 95 students (middle school). This would still be a small proportion of a school's enrollment in many urban districts. For example, for Gage Middle School in Los Angeles Unified School District serving 95 of the school's 3,900 students would only serve 2.4 percent of the students in the school. On the other hand, in some areas of the state, the funding would provide a slot for every student in the school.

The administration's proposal requires schools to make significant academic progress as a result of participation in this program. However, the proposal has not made the case for how the proposed funding rates will support an after school program focused on academic improvement. The slightly higher funding rate may allow schools to hire some additional

staff, but in our view, would not likely result in the improved academic outcomes the administration is expecting.

In conclusion, expansion of the current program would provide a small program at any interested school in the state. It is not likely to improve student achievement, and may only serve a small proportion of students in large urban schools. In contrast, the Governor's proposal would provide a somewhat richer program, serving more students on each school site, but would not be available to all schools and would only serve a small portion of students on large urban school campuses. This approach is also not likely to improve student achievement.

### **Other Program Considerations**

Parts of the Governor's proposal make improvements in the current program. Below, we discuss the problems with the current program and how the Governor's proposal addresses these concerns.

***Program Underutilizes Funds.*** The current ASES program reverts around 25 percent of the appropriated funds annually. During periods when the program was expanding, the rate of unused funds was much higher (often over 50 percent). This unused funding results from two main factors—the reimbursement system, and budget and contracting delays. The system of allocating all of the funding through grants, but then requiring schools to earn the grants through a daily reimbursement system results in many schools not fully earning their grants. Delays in enacting the state budget combined with CDE contracting delays has resulted in grant funds not being available until after the start of the school year. These delays have been even longer for new cohorts, taking into springtime before contracts are in place.

The Governor's proposal solves this problem by (1) converting the funding system into a direct grant, and (2) requiring CDE to contract out the funds within a specific time period after enactment of the budget. This approach, however, is likely to result in large amounts of funds being used inefficiently in the start-up phases of the program. Basically, schools will receive funding yet may not have the program in place to serve the students.

***Grant Process May Discourage Many Applicants.*** Currently, there are several factors that could discourage many schools from applying for after school grants including: low funding rate, no transportation funding, time consuming application process, local match requirements, and required partnerships with law enforcement. The proposal increases the funding rate, attempts to streamline the application process, and lowers the matching requirement. However, the proposal may still not go far enough in these areas to encourage participation.

***Current Governance Provides Little Oversight.*** The direct grant approach may lead to little state or local oversight. While CDE is charged with administering the grant program, departmental staff may not do the type of oversight that would ensure that the state is investing in quality programs. Because of the number of grants, CDE may not be able to do more than fiscal and compliance oversight. This means that staff spend little time investigating the quality of programs or closing poorly run programs. While a district or county office of education is required to be a partner in an ASES grant, the program often is administered by an external provider using external staff. Thus, the current finance and governance structure leads to little state oversight. This structure remains under the Governor's proposal.

***Restricted Ability to Carry Over Funds Across Fiscal Years.*** Under ASES, schools are restricted from carrying funds over from one year to the next without direct permission from CDE. Given that grantees often do not receive funding until after the school year has begun, restrictions on carry over reduce the ability of schools to manage their cash flow. This is likely to be more difficult for schools on a year-round calendar. The proposal makes no changes in this area.

In summary, the current program has numerous problems as discussed above. The Governor's proposal successfully addresses some of these problems, but creates others. In the last section, we provide an alternative approach to using the expanded amount of after school funds.

## **AN ALTERNATIVE APPROACH TO REFORMING PROPOSITION 49**

***If the Legislature decides not to repeal Proposition 49, we recommend it enact legislation placing before the voters a package that significantly revamps the after school program described in the initiative. Instead of uniform school grants, we recommend distributing the after school funds to districts based on a weighted-pupil formula. This approach would reflect differential needs across districts, but would provide districts the flexibility to make the trade-offs between the number of students served and the academic richness of the program.***

In the previous section, we described problems and trade-offs with both ASES and the Governor's proposal. Both programs virtually ignore factors such as school size or needs in the distribution of funds. The Governor's proposed reimbursement rates would provide a safe after school setting, but may be insufficient to address the academic goals of the program. Under both current law and the Governor's proposal, districts

would have little choice about how to target funds within the district or the balance in the local program between academics and safety. Below, we provide an alternative approach that provides funds directly to school districts and allows the districts to determine the priority for after school funds in their community. Our approach would also allow schools to better integrate their after school programs with other programs focused on similar goals.

### **Specifics of the LAO Proposal**

We recommend the Legislature amend the ASES program to transform the program from a school level competitive grant program to a formula-driven district level grant. Because school districts face different challenges depending on the students they serve, we recommend distributing the funds on a weighted per-pupil basis. A weighted pupil formula simply distributes funds based on the number of students in each district. The formula, however, also provides a district a larger grant based on the number of certain types of students—such as low-income, English learner or special education students—attending schools in each district. In addition, the proposal would provide flexibility for small school districts to provide them additional resources in a way that those districts could actually use.

Our proposed district grants would increase local flexibility over the use of after-school funds while also addressing other problems with the existing program. Specifically, our approach would:

- ***Allow Districts to Determine the Trade-off Between Academic Achievement and Basic Student Safety.*** We believe that districts are in a better position than the state to determine local needs and balance the trade-off between addressing student safety needs and meeting academic achievement goals. In some districts, safety may be the primary concern, and for those communities, schools could provide relatively inexpensive programs focusing on education enrichment activities, art programs, or physical activities. On the other hand, some districts may want to use this program as part of its strategic approach to improving academic achievement at only a specific set of high need schools or focusing on the students with the greatest needs at each school. Neither the current program nor the Governor's proposal would provide a district with this type of flexibility.
- ***Districts Would Be Accountable for Effective Local Programs.*** By allocating the funds to districts, the state puts districts in charge of administering and taking ownership of the program. Because districts have flexibility in shaping the program, they are in a

position to reallocate funds away from schools that are not using the funds effectively, or assisting struggling schools on improving their after school program. Neither the districts nor CDE provides this oversight role in the current approach.

- ***Encourage Schools to Integrate the After School Program into a Broader School Improvement Strategy.*** Our proposal would eliminate the current prohibition on integrating after school programs with other school programs. This would allow school districts to fold after school funding in with other funding sources like supplemental instruction, Title I, Title III, Economic Impact Aid, and school safety funds to develop quality programs that are integrated and support a comprehensive school reform strategy. While such integration may not be necessary for districts focusing on their school safety needs, this flexibility to integrate after school funds with other district resources is important if the district wants to focus on improving academics.
- ***Target Funding to Areas With Greatest Needs.*** We suggest distributing the funds to districts based not only on the total number of students, but also on the number of students that are poor, English learners, and/or special education. Because these populations often face more difficult academic barriers, and are more likely to face after school safety risks, we think the state would want to target more of the after school resources at these districts.

In the past, we have recommended consolidating categorical programs into more flexible block grants as a way of avoiding the types of distributional and programmatic problems such as those contained in Proposition 49. Our proposal would resolve these problems by transforming the ASES program into a formula-driven grant that is provided to participating school districts based on a weighted pupil formula. Because our proposal would make major changes to the program, it would be necessary for the Legislature to place a measure before the voters to implement it. It would make sense to do this soon, before the program is implemented and the various problems become more difficult to resolve. In addition, as discussed earlier in this section, there are *numerous* other fiscal and legal issues that may require voter approval to change. As such, we think the Legislature should not consider voter approval as a barrier to making needed program revisions.



## CHILD CARE

California's subsidized child care system is primarily administered through the California Department of Education (CDE) and the Department of Social Services (DSS). A limited amount of child care is also provided through the California Community Colleges. Figure 1 summarizes the funding levels and estimated enrollment for each of the state's various child care programs as proposed by the *2006-07 Governor's Budget*. As the figure shows, the budget proposes about \$2.9 billion (\$1.5 billion General Fund) for the state's child care programs. (This does not include about \$712 million for after school programs.) This is a decrease of about \$56 million from the estimated current-year level of funding for these programs, primarily due to caseload reduction in the California Work Opportunity and Responsibility to Kids (CalWORKs) program.

About \$1.4 billion (48 percent) of total child care funding is estimated to be spent on child care for current or former CalWORKs recipients. Virtually all of the remainder is spent on child care for non-CalWORKs low-income families. The total proposed spending level will fund child care for approximately 448,500 children statewide in the budget year.

Families receive subsidized child care in one of two ways: either by (1) receiving vouchers from county welfare departments or Alternative Payment (AP) program providers, or (2) being assigned space in child care or preschool centers under contract with CDE.

### **Eligibility Depends Upon Family Income and CalWORKs Participation**

CalWORKs and non-CalWORKs families have differential access to child care in the current system. While CalWORKs families are guaranteed access to child care, eligible non-CalWORKs families are not guaranteed access, are often subject to waiting lists, and many never receive subsidized care, depending on their income.

**Figure 1**  
**California Child Care Programs**

2006-07  
(Dollars in Millions)

Program	State Control <sup>a</sup>	Estimated Enrollment	Governor's Budget
<b>CalWORKs<sup>b</sup></b>			
Stage 1 <sup>c</sup>	DSS	63,000	\$507.9
Stage 2 <sup>c</sup>	CDE	82,000	555.4
Community colleges (Stage 2)	CCC	2,000	15.0
Stage 3 <sup>d</sup>	CDE	54,000	339.5
Subtotals		(201,000)	(\$1,417.8)
<b>Non-CalWORKs<sup>b, d</sup></b>			
General child care	CDE	91,000	\$680.7
Alternative payment programs	CDE	34,000	219.9
Preschool	CDE	104,000	347.3
Other	CDE	18,500	282.3
Subtotals	CDE	(247,500)	(\$1,530.2)
<b>Totals—All Programs</b>	<b>CDE</b>	<b>448,500</b>	<b>\$2,948.0</b>
<sup>a</sup> Department of Social Services, California Department of Education, and California Community Colleges. <sup>b</sup> California Work Opportunity and Responsibility to Kids. <sup>c</sup> Includes holdback of reserve funding which will be allocated during 2006-07 based on actual need. <sup>d</sup> Does not include after school care, which has a budget of \$712 million and is estimated to provide care for 527,200 school-aged children.			

*CalWORKs Guarantees Families Child Care.* State law requires that adequate child care be available to CalWORKs recipients receiving cash aid in order to meet their program participation requirements (a combination of work and/or training activities). If child care is not available, then the recipient does not have to participate in CalWORKs activities for the required number of hours until child care becomes available. The CalWORKs child care is delivered in three stages:

- **Stage 1.** Stage 1 is administered by county welfare departments (CWDs) and begins when a participant enters the CalWORKs program. While some CWDs oversee Stage 1 themselves, 32 contract with AP providers to administer Stage 1. In this stage, CWDs or APs refer families to resource and referral agencies to assist them

with finding child care providers. The CWDs or APs then pay providers directly for child care services.

- **Stage 2.** The CWDs transfer families to Stage 2 when the county determines that participants' situations become "stable." In some counties, this means that a recipient has a welfare-to-work plan or employment, and has a child care arrangement that allows the recipient to fulfill his or her CalWORKs obligations. In other counties, stable means that the recipient is off aid altogether. Stage 2 is administered by CDE through a voucher-based program. Participants can stay in Stage 2 while they are in CalWORKs and for two years after the family stops receiving a CalWORKs grant.
- **Stage 3.** In order to provide continuing child care for former CalWORKs recipients who reach the end of their two-year time limit in Stage 2, the Legislature created Stage 3 in 1997. Recipients timing out of Stage 2 are eligible for Stage 3 if they have been unable to find other subsidized child care. Assuming funding is available, former CalWORKs recipients may receive Stage 3 child care as long as their income remains below 75 percent of the state median-income level and their children are below age 13.

***Non-CalWORKs Families Receive Child Care If Space Is Available.*** Non-CalWORKs child care programs (primarily administered by CDE) are open to all low-income families at little or no cost to the family. Access to these programs is based on space availability and income eligibility. Because there are more eligible low-income families than available child care slots, waiting lists are common. As a result, many non-CalWORKs families are unable to access child care.

## STEPS TOWARD LINKING REIMBURSEMENT TO QUALITY

In the *2005-06 Analysis*, we recommended the Legislature reform the state's reimbursement system in child care to move toward a system that provides higher reimbursement rates for higher quality care. Specifically, we recommend that the state move toward a policy of tying reimbursement rates to a provider's level of training, education, and other factors. This strategy (1) attempts to promote what research suggests are the characteristics of high quality care and (2) better reflects the cost of providing care. Below, we describe the current reimbursement system, and problems with that system. Then we make a series of recommendations which would begin to address some of the more disconcerting issues with the current system.

In the nearby box (see next page), we provide a list of the child care terms and corresponding definitions used throughout the remainder of this write-up.

## **Two Types of Service Models—Vouchers and Direct State Contracts**

Currently, the state provides child care through two main mechanisms: vouchers and direct contracts with child care centers.

*Most Families Receive Child Care Through a Voucher System.* The CalWORKs families in any of the three stages of child care usually receive a voucher from CWD or AP. In addition, the state provides vouchers to working poor families through APs. The combined programs provide about 250,000 children with child care vouchers. The AP or CWD assists families in finding available child care in the family's community, typically placing families in one of three settings—licensed centers, licensed family child care homes (FCCHs), and license-exempt care. The licensed programs must adhere to requirements of Title 22 of the California Code of Regulations, which are developed by DSS' Community Care Licensing Division. These programs are often referred to as Title 22 programs. Currently, Title 22 centers and FCCH providers are reimbursed up to a maximum rate (or ceiling) of the 85<sup>th</sup> percentile of the rates charged by private market providers in the area offering the same type of child care. The 85<sup>th</sup> percentile is determined by the Regional Market Rate's (RMR) survey of public and private child care providers that determines the cost of child care in specific regions of the state. License-exempt care providers are reimbursed up to 90 percent of the FCCHs maximum rate (85<sup>th</sup> percentile). The relatively high reimbursement level of the vouchers for subsidized care reflects an attempt to ensure that low-income families can receive similar levels of child care service as wealthier families in the same region.

*CDE Contracts Directly With Child Care and Preschool Centers.* For child care and preschool, CDE contracts directly with 850 different agencies through approximately 2,100 different contracts. These providers are reimbursed with the Standard Reimbursement Rate, \$31.59 per full day of enrollment (proposed 2006-07 rate). These providers must adhere to the requirements of Title 5 of the California Code of Regulations and are generally referred to as Title 5 providers.

Figure 2 (see page E-113) shows the major care types (and associated regulations) offered through voucher providers and CDE contractors for preschool-aged children. Moving from the left-hand side of Figure 2 to the right, the requirements to provide the specific type of child care become more difficult to meet and suggest a higher level of quality.

## **Child Care Terminology**

### **Types of Providers**

*Voucher Providers.* Providers who serve the California Work Opportunity and Responsibility to Kids (CalWORKs) and non-CalWORKs families who receive vouchers for child care.

- *License-Exempt.* Relatives or friends without a license for providing child care.
- *Title 22 Family Child Care Homes (FCCHs).* Licensed providers caring for a small number of children typically in their own homes.
- *Title 22 Centers.* Licensed child care centers.

*California Department of Education (CDE) Contractors/Title 5 Providers.* Providers who contract directly with CDE to provide child care and preschool for primarily non-CalWORKs working poor families.

- *Title 5 FCCHs.* Licensed providers caring for a small number of children typically in their own homes. These FCCHs have not only obtained a license, but also meet CDE standards.
- *Title 5 Centers, Including Preschool.* Licensed centers that also meet CDE standards.

### **Other Terms**

- *Alternative Payment (AP) Program.* The CDE-administered voucher program for non-CalWORK working poor families.
- *Standard Reimbursement Rate (SRR).* The per-child rate paid to Title 5 providers that contract with CDE.
- *Regional Market Rate (RMR).* Regionally based market rates used to determine reimbursements to voucher providers.
- *Maximum Rate.* The rate ceiling for voucher providers. If they serve private pay clients, providers receive reimbursements equal to their private pay rates, up to the maximum rate. If they do not serve private pay clients, providers are reimbursed at the maximum rate.
- *FCCH Maximum Rate.* The 85<sup>th</sup> percentile of the maximum rate paid to Title 22 FCCHs. Serves as the basis for the license-exempt care rates.

**Figure 2**  
**Subsidized Child Care Providers**  
**Safety and Educational Requirements**

*Current Law of Preschool-Aged Children*

	Voucher Providers			CDE Contractors
	License-Exempt Providers	Title 22 FCCHs	Title 22 Centers	Title 5 Providers Including Preschool
<b>Provider/teacher education and training</b>	None.	None.	Child Development Associate Credential or 12 units in ECE/CD.	Child Development Teacher Permit (24 units of ECE/CD plus 16 general education units).
<b>Provider health and safety training</b>	Criminal background check required (except relatives). Self-certification of health and safety standards.	15 hours of health and safety training. Staff and volunteers are fingerprinted.	Staff and volunteers fingerprinted and subject to health and safety standards.	Staff and volunteers fingerprinted and subject to health and safety standards.
<b>Required ratios</b>	None.	1:6 adult-child ratio.	1:12 teacher-child ratio or 1 teacher and 1 aide for 15 children.	1:24 teacher child and 1:8 adult-child ratio.
<b>Accountability, monitoring, and oversight</b>	None.	Unannounced visits every five years or more frequently under special circumstances.	Unannounced visits every five years or more frequently under special circumstances.	Onsite reviews every three years. Annual outcome reports, audits, and program information.

<sup>a</sup> FCCHs = family child care homes; CDE = California Department of Education; and ECE/CD = Early Childhood Education/Child Development.

The minimum standards for child care offered through the voucher, especially those for license-exempt providers, are generally lower than the standards for Title 5 providers contracted with CDE. For example, license-exempt providers, who are typically relatives, friends, or neighbors of the family needing child care, are *not* required to have any training or adhere to adult-to-child ratios (though they may only care for children from one other family besides their own). The Title 22 FCCH providers are required to meet minimal health and safety standards, adhere to an adult-to-child ratio, and require a site visit every five years for licensure. Title 22 centers

require providers to have some college-level education. The Title 5 providers require a Child Development Teacher Permit, which is issued by the California Commission on Teacher Credentialing. In addition, they have annual program outcome reports and are required to have onsite reviews every three years.

The effort to provide parents with a variety of child care options that make it easier for low income parents to work, can result in tension with efforts to provide age-appropriate development and early learning to children served through child care. For example, some families may choose license-exempt care for reasons of convenience and availability. (Many centers and FCCHs have shortages of infant care slots and/or do not operate during nontraditional work hours.) Also, certain regions, especially rural areas, tend to have limited center-based and FCCH providers. At the same time, as we discuss below, placing children in exempt care may result in the children not receiving the learning and development opportunities to which their peers in center-based care and, to some extent, FCCHs have access.

### **Problems with the Current Reimbursement System**

*Research Suggests Quality Differences by Care Type.* Recent academic studies investigating the relative benefits of different child care types in existing settings provide evidence that center-based programs offer a higher quality of care relative to FCCHs and license-exempt care. Exposure to the higher quality care appears to have significant positive cognitive effects on young children. Particularly important factors in the quality of care are (1) provider education and training, and (2) the stability of the environment (such as staff turnover).

A look at our current child care system suggests that many children are served in a child care environment associated with lower quality as discussed below.

*One-Half of Children in Lowest Quality Care.* In the state's voucher programs, close to one-half (48 percent) of the children are cared for by license-exempt providers. While the percentage of children enrolled in license-exempt care is highest in Stage 1 (60 percent), the percentage in license-exempt care remains close to 50 percent through Stages 2 and 3. Data from CDE for Stages 2 and 3 and AP show that among the children cared for by licensed providers, less than one-third are enrolled in center-based care.

*Centers May Provide More Stability.* Stability of care is often problematic when parents must rely on license-exempt providers. Data from Alameda County showing a two-thirds turnover rate among exempt

providers in the span of one year suggest that lack of stability may be a significant problem in license-exempt care.

*Fiscal Incentives Weighted Toward Lowest Quality Care.* As discussed above, Title 5 providers have the highest standards. Yet, in some counties, providers with lower standards are paid at *higher* reimbursement rates than Title 5 providers. Figure 3 compares 2005-06 child care reimbursement rates for Title 22 centers with the Title 5 centers in the 15 largest counties. In all of these counties, the Title 22 center rate ceiling exceeds the Title 5 provider rate between \$2 and \$344 per child per month (0.3 percent to 52 percent higher). This occurs because the market rates—which drive voucher payments—are much higher in many parts of the state than the state’s standardized reimbursement rate. Given the higher program requirements of Title 5 providers (as summarized in Figure 2), it seems counterintuitive that their reimbursement rates would be lower than the Title 22 programs.

**Figure 3**

**Reimbursement Rate Gap Between Title 22 Centers and Title 5 Providers<sup>a</sup>**

*(Dollars Per Month for Full-Time Care)*

County	Title 22 Center Ceiling	Title 5 Rate	Reimbursement Gap
San Mateo	\$1,002	\$658	\$344
Santa Clara	1,002	658	344
San Francisco	974	658	316
Alameda	859	658	201
Orange	832	658	174
Contra Costa	830	658	172
Ventura	755	658	97
San Diego	755	658	97
Los Angeles	744	658	86
Sacramento	686	658	28
Riverside	684	658	26
San Joaquin	680	658	22
San Bernardino	676	658	18
Kern	674	658	16
Fresno	661	658	2

<sup>a</sup> Fifteen largest counties shown.

## Increase Funding for Higher Quality Programs

*We recommend the Legislature increase the reimbursement rates for Title 5 providers in “high-cost” counties by redirecting savings from several policy changes recommended below.*

In the 2005-06 Analysis, we recommended moving to a tiered reimbursement system providing higher reimbursement for higher quality and integrating Title 5 providers into the new system. While we still think that is the right way to go in the long run, below we provide a set of recommendations that will move the state in that direction. A first step in that transition is to begin to increase the reimbursement rate for Title 5 providers in “high-cost” counties. (We define high cost counties as those whose RMR for Title 22 centers is above the state Title 5 reimbursement rate. There are currently 36 such counties including those listed in Figure 3.) As discussed above, Title 22—and some license exempt—providers are earning more than the Title 5 centers that face higher quality standards and a higher cost structure (resulting from the higher teacher educational requirements). In order to stay within the funding level for child care provided by the Governor’s budget, we make several recommendation shown in Figure 4 redirecting savings from several policy changes to increase the Title 5 reimbursement rate.

### Figure 4

#### LAO Recommendations to Increase Reimbursement Rate for High Quality Child Care

- ✓ Increase the reimbursement rate for Title 5 child care providers in high-cost counties.
- ✓ Implement the following recommendations to fund a Title 5 provider rate increase:
  - Redirect child care growth funding (\$14.8 million).
  - Limit license-exempt funding to 90 percent of the Title 5 reimbursement rate in high-cost counties.
  - Require centers to provide the state a similar sibling discount as given to private-paying customers.
  - Adopt a sliding scale cost-of-living adjustment (COLA), providing a higher COLA in high-cost counties, and lower COLA in low-cost counties.

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## **Redirect Child Care Growth Funding**

*We recommend the Legislature redirect \$14.8 million in child care growth funding to provide for a higher reimbursement rate for Title 5 providers in high-cost counties.*

The Governor's budget provides \$14.8 million for 1.1 percent growth in child care. These funds would provide around 4,500 new child care slots in the budget year depending on the results of the new RMR Survey (discussed below). While expanding the number of child care slots is important to maintain access for the working poor, continuing access to high quality child care is a competing policy goal. Given other initiatives to expand the offering of child care, after school and preschool in the coming year, we believe that these growth funds could be used more effectively to address the Title 5 provider rate issue. This investment would help correct incentive problems with the current reimbursement system.

## **Limit License Exempt Reimbursement Rate**

*We recommend limiting the license-exempt reimbursement rate to the lesser of 90 percent of the regional market rate or 90 percent of the Title 5 reimbursement rate.*

Under current law, license-exempt providers are reimbursed 90 percent of the FCCH rate maximums. In some higher-cost counties, the license-exempt reimbursement rate is higher than the Title 5 center reimbursement rate. Since the Title 5 providers must meet the highest quality standards, and the license-exempt providers are subject to the lowest quality standards, the current rates provide a fiscal incentive for lower quality. To begin to correct this inequity, we recommend adding an additional restriction to the license-exempt rate to ensure that the exempt rate can not exceed 90 percent of the Title 5 reimbursement rate. We will work with the Department of Social Services to estimate the level of savings that this recommendation would generate and report to the Legislature at budget subcommittee hearings.

## **Create a State Level Sibling Discount**

*We recommend the Legislature require child care centers offering private pay customers a sibling discount to provide the state a similar discount for any family with more than one child in the same care center.*

In the child care field, it is an industry standard that child care centers offer families a sibling discount if that family has more than one child in the center. However, the state does not receive such a discount for the slots it purchases either through the voucher program or the Title

5 centers. It does not seem appropriate that centers effectively charge the state a higher rate than nonsubsidized families. These subsidies are often as high as 10 percent. We recommend the Legislature enact legislation to require child care providers to provide the state with a similar sibling discount as the center provides to private pay customers. Through this recommendation, state child care costs would mirror the cost of child care for nonsubsidized families. Savings from this recommendation could be redirected to increasing the Title 5 provider reimbursement rate in high cost counties. We will work with DSS to estimate the savings this recommendation would generate, and report at budget hearings.

### **Adopt a Sliding Scale COLA for General Child Care and State Preschool**

*We recommend providing an above average cost-of-living adjustment (COLA) to Title 5 providers in high-cost counties and a below average COLA in lower-cost counties.*

The Governor's budget provides roughly \$51.8 million for a 5.2 percent cost-of-living adjustment (COLA) for Title 5 providers through the General Child Care and State Preschool programs. This amount provides all centers with an equal COLA of roughly \$32 per child per month. However, child care centers face differential costs depending upon location. Since Title 5 centers are competing for quality staff with private and Title 22 child care centers in their area, the costs structure of a Title 5 center in a low-cost county is likely to be less than in a high cost county. The Legislature could provide a differential COLA (higher COLA in a high cost county and lower COLA in a low cost county) to move the reimbursement rate for Title 5 centers to more closely reflect local costs. Since the state has data on the cost of child care for each county in the state, such an adjustment could be easily made. For example, if the Legislature provided a 3 percent COLA in lower-cost counties, the Legislature could provide a 6 percent COLA in the higher-cost counties. We have proposed a similar approach to help equalize general purpose funding for school districts. Depending on the difference between COLAs, the state could make a little or a lot of progress toward transitioning the Title 5 funding rates to mirror the local RMRs. We recommend the Legislature provide Title 5 providers a differential COLA, providing a higher COLA in high-cost areas, and a lower COLA in low-cost areas.

### **If Proposition 49 Implemented in 2006-07— Child Care Savings Likely**

*We find that the state will likely have child care savings if the state implements Proposition 49's after school program expansion in 2006-07.*

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*These savings will result in child care program savings, Proposition 98 savings, or could be redirected to serve additional students.*

In the previous section, we recommend repealing Proposition 49—the after school program expansion. However, if Proposition 49 is implemented starting in the 2006-07, DOF estimates that an additional 230,000 students will be provided after school programs between the hours of 3 p.m. and 6 p.m. We would expect that some of the 230,000 students would be in families currently receiving subsidized child care. This is because statute gives children currently in state subsidized child care preferential access in the after school program. To the extent that some children currently receiving subsidized care may either no longer need that care, or may need less hours of care, there would be child care savings. It will be difficult to determine the level of child care savings that may occur as a result of Proposition 49 implementation. The state's child care programs will treat these savings differently, absent legislative direction. For Stage 1 child care, savings would be available for future social services costs. For Stage 2 and Stage 3 child care, savings would result in Proposition 98 carry-over funds, which are typically used to fund child care in the subsequent fiscal year. For State Preschool, General Child Care and AP programs, the savings would be redirected to serving other children from working poor families in the budget year.

### **New RMR Survey Awaits Administration Approval**

*We recommend the Legislature direct the California Department of Education to use the new Regional Market Rate survey results to develop a set of sub-regions within counties to balance the efficiency benefits of having multiple reimbursement rates in counties with the administrative burden that multiple rates create.*

Federal law requires states to establish a child care funding system that reimburses child care costs at a rate that reflects the cost of child care in that community. To meet this requirement, the CDE contracts every couple of years to conduct a survey of the costs of child care across the state. The intent of this process is to ensure the reimbursement rate reflects the cost of child care in that community. Specifically, it ensures that low-income families can access most child care provided in their community, while at the same time not providing too high of a reimbursement rate, which could crowd out nonsubsidized working poor families. Federal regulations suggest that states provide a reimbursement rate that allows subsidized families to access at least 70 percent of child care services in a community. California, however, has decided to set its maximum reimbursement rate high enough that families can access 85 percent of child care services provided in a community. The federal government also tasks the state to determine boundaries for what area defines a community. Since costs of

child care vary dramatically across the state, how the lines separating communities are drawn can be important in determining the reimbursement rates for a community. This issue of how to define a community has led to a delay in the process of updating 2005-06 rates. Below, we describe the historic approach to setting the regional market rates, the new methodology, problems with the new methodology, and the current CDE proposal. Finally we suggest a middle ground approach to establishing new rates.

***Historically, Reimbursement Rates Set for Each County.*** Historically, the state has relied mainly on county boundaries to define a community, resulting in one reimbursement rate for each county. The state has made exceptions in a couple of counties, dividing them into sub-regions to address dramatic cost differences. For example, in Yolo County the cost of care in the university town of Davis was significantly higher than the cost in the remainder of the county. Aggregating to the county level in Yolo County would mean that reimbursement rates would not be high enough to access child care in Davis, and would likely be higher than necessary to access quality care in rest of the county. So, on an exception basis for two counties—Yolo and Ventura—sub-county reimbursement rates were established.

There have been technical problems with the historic approach. First, the studies in the past have had relatively low response rates. The lower the response rate, the less accurate the rate will be. In addition, for some counties the sample size was too small because not enough providers were available to ensure that the reimbursement rates accurately reflected the costs in that county.

***New Methodology Provides Zip Code Level Rates.*** The CDE contracted with an independent research firm for a new RMR survey methodology. The new methodology addressed problems in the historic RMR survey approach. By reducing nonresponse rates and using a sophisticated new method of grouping providers based on demographic variables, the approach can provide a more accurate estimate of market costs of child care in particular communities. The new survey provides cost information for the cost of child care for each zip code in the state based on the underlying demographics of the communities.

***The New Methodology Has Some Technical and Administrative Issues.*** After looking at the reimbursement rates that the new methodology generated, there were some zip codes for which the new methodology is problematic. For example, the new approach is problematic for centers in the downtown San Francisco area. This is because the new method is based largely on demographics of the residents in a zip code, and downtown San Francisco does not have many residents. Thus, the reimbursement rate does not accurately reflect the child care costs that families working in this area would face. We think that rates for areas like these would need to be addressed on an ad hoc basis.

The new methodology may also create too many reimbursement rates for a region or county, leading to excess administrative burden. For example, in Los Angeles County there would be 13 different rates for pre-school aged children in child care centers and 22 different rate for FCCHs. Even for a small county like Yolo County, there would be four different rates for child care centers and ten different rates for FCCHs. There may be some administrative burden to ensure that the centers and FCCHs are each reimbursed at the correct rates.

***Upward and Downward Rate Adjustments.*** Under the new methodology some low-cost neighborhoods would experience reductions in child care reimbursement rates while some higher-cost neighborhoods would experience rate increases. For example, in Alameda County, the lowland neighborhoods around Oakland would have lower rates under the new methodology than the county average rate under the existing system. Conversely, hillside neighborhoods above Oakland would tend to have higher reimbursement rates.

***The RMR Survey Remains in Limbo.*** Because of concerns about sub-county rate changes, the CDE has sought approval from the Department of Finance (DOF) to aggregate the new methodology to the county level. The DOF has reviewed the CDE proposal and has requested additional information on statistical issues and the impact that the CDE proposed rates would have in counties that face differential costs across the county. Because the survey has not been conducted in several years, some providers operating at their regional market rate ceiling have not had a rate adjustment during this time period.

***Finding Common Ground with Multiple Rates in Counties.*** While the new methodology may have generated too many reimbursement rates in a county, the CDE proposal (one rate per county) would continue to result in access problems in high cost communities, while providing too high rates in other counties. There may be a compromise between these two approaches. For example, if CDE limited the number of reimbursement rates in a county to no more than three to five different rates for Title 22 centers, and six to ten different rates for FCCH homes, it would reduce the administrative burden while still providing a more accurate reimbursement system that reflected the cost of care in specific communities. We recommend the Legislature direct the CDE to use the new RMR survey results to develop and implement a set of sub-regions within counties to balance the efficiency benefits of having multiple reimbursement rates in a county with the administrative burden that multiple rates create.

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## ECONOMIC IMPACT AID

*We find that the Economic Impact Aid (EIA) funding formula is outdated, results in district allocations that appear arbitrary and unpredictable, and has recently become unworkable. We recommend the Legislature revise the EIA formula so that (1) district allocations are predictable and meet local needs for serving both poor and English learner students and (2) calculations are based on reliable data. To the extent the Legislature wishes to fund Proposition 98 at the Governor's proposed level, we recommend redirecting some funding in the budget to help ease districts' transition to a revised formula.*

The 2006-07 Governor's Budget provides \$648 million for the Economic Impact Aid (EIA) program. This funding level represents a \$61.3 million, or 10.4 percent increase above the current year.

The EIA program funds school districts to provide compensatory education services to low-performing and English learner (EL) pupils. School districts use this funding for a variety of purposes, including: (1) extra assistance to low-achieving pupils, (2) supplemental instruction services to EL students, (3) training to teachers who instruct EL students, and (4) supplementary materials.

In our *Analysis of the 2004-05 Budget Bill*, we identified several problems with the formula used to distribute EIA funding. To address these issues, the Legislature passed legislation in 2004-05 (SB 1645, Escutia), and adopted budget bill language in 2005-06 to conduct a study of the EIA program and investigate options for a new formula. The Governor vetoed both proposals. In each veto message he directed a working group—consisting of the Department of Finance, the Office of the Secretary for Education, the California Department of Education (CDE), and our office—to develop options for restructuring the EIA formula. While some initial meetings have taken place, neither the administration nor CDE has actively engaged in the working group process, and no progress has been made towards reforming the formula.

The issues we raised about the EIA formula two years ago are still concerns, and a new problem in obtaining one of the primary data inputs

used for the EIA calculation has made the need for reform even more urgent. Below, we discuss five problems with the current EIA formula, and present issues and options for the Legislature to consider in improving the formula.

## The EIA Formula Is Outdated and Problematic

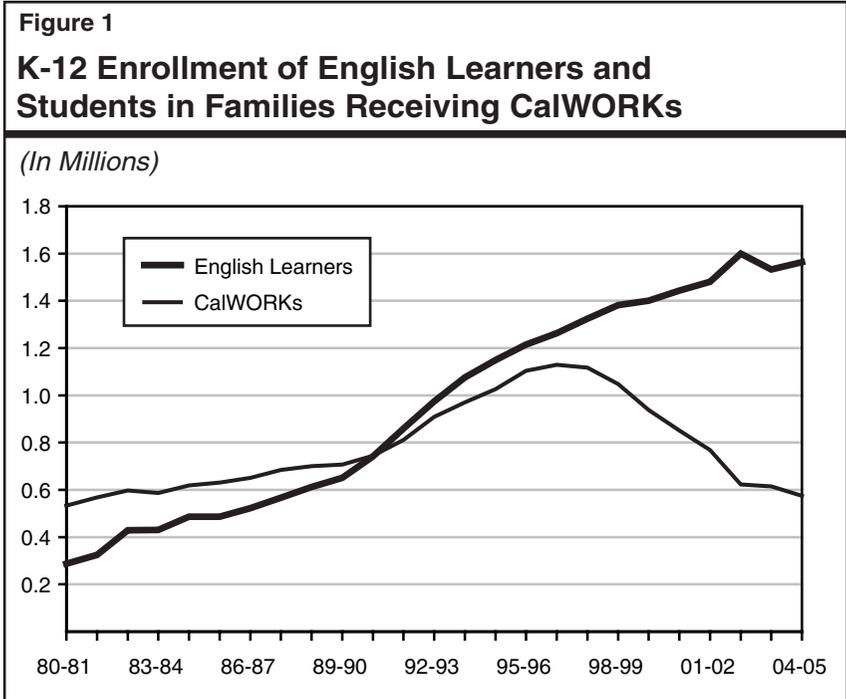
Districts' EIA allocations are calculated using a complex formula based on the number of EL and economically disadvantaged students enrolled in each district. The primary data inputs are district enrollment of (1) EL students, as measured by an annual language census, and (2) students from families below the poverty level receiving California Work Opportunity and Responsibility to Kids (CalWORKs) grants. Poverty data from the 1990 Census also factors into the formula. Under the current formula, poverty is by far the most important factor in determining a district's allocation.

Our analysis indicates the following problems with the current EIA funding formula.

***Formula Does Not Reflect Current School Demographics.*** The EIA funding mechanism has been in existence for more than 25 years. During this time, the state's demographics and the needs of the student population have changed dramatically. Figure 1 (see next page) displays the trends for ELs and CalWORKs students over the past 25 years. As the figure shows, in 1980-81 there were almost twice as many children in CalWORKs as ELs. In contrast, by 2004-05 there were two and one-half times as many ELs as CalWORKs children.

The EIA formula, however, has not been updated to reflect these changing dynamics. Despite the increase in EL students and districts' need for EL funding, poverty is still by far the most important factor in determining a district's EIA funding allocation. As a result, districts with large numbers of poor students receive far more funding than districts with large numbers of EL students.

***Heavy Emphasis on Poverty Skews Per-Pupil Payments.*** A close look at EIA allocations for two districts of similar size illustrates the formula's heavy emphasis on poverty. Figure 2 (see next page) displays the EIA allocations and the number of EL and CalWORKs students in Oakland and Santa Ana Unified School Districts. In 2004-05, Oakland received \$389 for each EL and CalWORKs student in the district based on about 29,000 in the two groups. Santa Ana received \$236 for each based on about 45,000 in the two groups. As a result, Oakland received about \$660,000 more than Santa Ana, despite having 16,000 fewer targeted students. This sort of discrepancy raises fundamental questions about the adequacy of the current EIA formula.



**Figure 2**  
**Economic Impact Aid (EIA) Allocations**  
*Oakland and Santa Ana Unified School Districts 2004-05*

	Oakland	Santa Ana
English learner students	16,730	40,282
CalWORKs <sup>a</sup> students	12,267	4,677
<b>Total students</b>	<b>28,997</b>	<b>44,959</b>
<b>EIA Funding</b>		
Totals (in millions)	\$11.3	\$10.6
Per pupil	389	236

<sup>a</sup> California Work Opportunity and Responsibility to Kids.

***District Allocations Appear Arbitrary and Unpredictable.*** The current EIA formula is extremely complex. This complexity results in district allocations that are hard to understand based on underlying district demographics. Two districts with almost identical numbers of both EL and CalWORKs students can receive very different amounts of EIA funds. For instance, Sausalito Elementary School District receives \$778 for each of the 83 CalWORKs and EL students in the district (66 and 17, respectively). Chawanakee Joint Unified receives only \$373 for each of the 81 students in the two groups (67 and 14, respectively). Given that the number of students needing extra assistance in these two districts are almost identical, the widely differing amounts seem hard to justify.

Additionally, the EIA formula creates unpredictable results from year-to-year, leading to counterintuitive scenarios where districts can receive funding *increases* when their number of EL and CalWORKs students declines, and *decreases* when they experience an increase in the number of students in the two groups. This lack of predictability can complicate districts' annual planning efforts.

***CalWORKs Counts May No Longer Be a Good Measure of Poverty.*** Between 1996 and 2002, the counts of CalWORKs students used in the EIA calculation declined by 45 percent. In contrast, the number of California households whose income was below the federal poverty level declined by 25 percent. The sharp decline in CalWORKs participation rates may not mirror the actual decline in the number of children living in poverty, but rather may reflect other factors, such as changes in CalWORKs program requirements. Thus, using CalWORKs for the EIA formula may not reflect actual district needs for serving poor students. This conclusion is supported by the fact that other measures show significantly higher rates of poverty among K-12 children (as discussed in further detail below).

***Change in Data Availability Makes Current Formula Unworkable.*** Until recently, CDE relied on the Department of Social Services (DSS) to provide it with child-specific counts of children in families below the poverty level receiving CalWORKs assistance. The CDE then used this information to derive district-level CalWORKs student counts, one of the primary inputs for the EIA formula. Beginning in December 2004, however, DSS stopped providing CDE with child-specific CalWORKs data. According to DSS, these changes were in response to concerns about the security of confidential data. Without access to this data, CDE is unable to use the current formula to calculate district EIA funding. The CDE handled this issue in the current year by reusing prior-year CalWORKs data for a second consecutive year. This is not a viable long-term solution. It would be inappropriate to use this outdated data for a third time in 2006-07. We believe this problem should be addressed in the budget year.

## Legislature Has Several Options for Addressing CalWORKs Data Issues

There are three main paths the Legislature could take to address the CalWORKs data availability problem. It could: (1) try to resolve data issues with DSS to make CalWORKs data available again, (2) eliminate the need for CalWORKs data by using a different measure of poverty in the EIA formula, or (3) remove the poverty measure from the formula altogether and make EIA a program for EL students. Below, we discuss some advantages and disadvantages of each approach.

**Option 1: Try to Resolve Data Issues With DSS.** The Legislature could investigate the feasibility of requiring DSS to revise its procedures so that CDE has access to the CalWORKs data necessary to compute EIA funding levels. The CDE has been working with DSS for the past year trying to resolve this issue and has determined it is not possible to obtain the necessary data using alternate methods. It is possible, but not certain, that statutory language directing DSS to collect and provide the data could address some of the problems. However, even if DSS can ultimately provide the data, this solution would not address the remaining concern that CalWORKs counts may not accurately reflect the actual number of poor children in a district.

**Option 2: Use a Different Measure of Poverty.** To address both the availability and accuracy concerns related to CalWORKs data, the Legislature could choose to use a different indicator of poverty for the EIA calculation. We believe there are three alternate data sources the Legislature could consider. Under a new formula, these data could also be used in combination.

- **Title I, Part A:** Using biannually updated Census data, the federal government allocates funding for this supplemental program based on counts of poor, neglected, delinquent, and foster children. Since this data is used to distribute \$1.8 billion in federal Title I funds, districts are generally familiar with the data, and have some comfort level with using it as a measure of poverty. Since the data is collected at the federal level, it can not be manipulated by local decision-making. There have been some concerns raised that the Census may undercount poor children in remote rural areas of the state, but as long as the state maintains a minimum EIA grant size, this may not be a significant problem.
- **Free or Reduced Price Meals (FRPM):** Schools report the number of students who qualify (based on family income) *and* enroll to receive federally subsidized meals at school. The FRPM counts do not include those students who qualify but elect not to participate in the program. Moreover, participation in FRPM is skewed toward

elementary grades, so economically disadvantaged high school students are likely under-represented in these counts.

- **Parental Education Level:** For purposes of the federal school accountability program, CDE combines the number of pupils for whom neither parent has completed high school, in conjunction with FRPM participation data, to determine whether the student is socioeconomically disadvantaged. (A low education level is considered an indicator for low-income status.) These data can be problematic in that they are self-reported (in some cases by students, not parents), and are only collected for children in grades 2 through 11.

There are advantages and disadvantages to each of these alternate data sources. Furthermore, because they define “poverty” in different ways, they can result in dramatically different counts of “poor students” within the same district. Figure 3 illustrates examples of these differences, displaying CalWORKs, FRPM, and Title I participation counts within a sample of districts. (Parental education data was not available for this analysis.)

<b>Figure 1</b>			
<b>Participation Rates in Programs Serving Economically Disadvantaged Students</b>			
<i>(As Percent of Total Enrollment, 2004-05)</i>			
<b>District</b>	<b>CalWORKs<sup>a</sup></b>	<b>FRPM<sup>a</sup></b>	<b>Title I, Part A</b>
Coachella Valley Joint Unified	9%	86%	39%
Capistrano Unified	1	15	7
Oakland Unified	25	68	34
Los Angeles Unified	14	77	32
<b>Totals Statewide</b>	<b>9%</b>	<b>49%</b>	<b>19%</b>

<sup>a</sup> CalWORKs= California Work Opportunity and Responsibility to Kids, FRPM= Free and Reduced Price Meal program.

The figure shows that in Coachella Valley Joint Unified, a rural school district, the participation rate for CalWORKs is almost ten times less than for FRPM and four times less than for Title I. This significant discrepancy is also evidenced in Capistrano Unified, a suburban district with relatively low levels of poverty. Statewide totals for each program indicate FRPM and Title I participation rates are significantly higher than CalWORKs.

Additionally, the figure shows there can be different trends among the data even between similar districts. Oakland and Los Angeles Unified School Districts are both large urban districts with relatively the same number of poor children as defined by Title I; however, Oakland has a higher participation rate in CalWORKs and Los Angeles has a higher participation rate in FRPM.

These examples reiterate that CalWORKs may not be reflective of the actual number of students living in poverty. The data from the sample districts also highlight that because of the considerable differences among student counts, switching from CalWORKs to an alternate measure of poverty would result in a redistribution of EIA funding across the state.

***Option 3: Remove Poverty Measure From EIA Formula.*** A different solution for the CalWORKs data problems would be to eliminate the poverty factor from the EIA formula altogether, and base allocations solely on counts of EL students. Districts report they use around 85 percent of EIA funds on EL services, so the Legislature could opt to transform EIA into an EL program. To understand why the districts direct most of the EIA funds for EL students, it is necessary to look at resources available from other sources. The federal government provides around \$1.8 billion to the state for base Title I grants targeting poor students, and around \$275 million for Title III targeting EL students. Given the significantly higher funding for economically disadvantaged students, it makes sense that many districts direct their EIA funds mainly toward serving EL students. Considering EIA in combination with funds from other sources, it may make sense to distribute EIA funds based on EL counts. However, relying solely on EL counts would substantially change the EIA funding distribution and may not recognize the multiplicative difficulty of serving EL students who are also poor.

## **Simplify Formula and Provide Funding to Ease Transition**

The aforementioned problems obtaining CalWORKs data mean that action will likely be needed to address the EIA funding formula in this year's budget discussions. We recommend the Legislature use this opportunity to undertake a comprehensive reform of the formula, to address both the data availability issue and the numerous other problems we have discussed. In undertaking this revision, we think there are three major issues that are essential to address.

We believe the new EIA formula should be (1) predictable from year-to-year so districts can plan ahead; (2) transparent, so districts and the public understand the rationale behind the funding levels; and (3) calculated using a dependable data source so the formula will remain consistent from year to year.

In addition to the option of replacing or removing CalWORKs as the poverty indicator, the Legislature could also consider various other reforms. We summarize these options for revising the EIA formula in Figure 4 and describe them in further detail below.

**Figure 4**

**LAO Options for Revising Economic Impact Aid Formula**

- ✓ Replace or remove CalWORKs from the formula.
- ✓ Align with other programs that serve the same populations.
- ✓ Reconsider weight of poverty versus English learner status.
- ✓ Allocate funds through a combination of grant types.
- ✓ Provide transitional funding.

*Align EIA With Other Programs.* There are several other programs that provide supplemental funding to help schools serve economically disadvantaged students (including the federal Title I, Part A program and the state Targeted Instructional Improvement Block Grant) and EL students (including the federal Title III and the state English Learner Acquisition programs). The Legislature may want the revised EIA formula to in some way account for the funding districts receive from these other programs, reconstituting EIA as a component of a larger, coordinated funding package designed to help serve needy students.

*Reconsider Formula's Data Inputs and Weights.* As discussed, the Legislature has several options for replacing CalWORKs as the measure of poverty in the EIA formula, including eliminating the poverty factor from the calculation altogether. We recommend the Legislature also reconsider the "weight," or importance of the two primary EIA factors—EL and poverty status. The Legislature may want to consider changing the weights in the new formula so that poverty is not so heavily weighted, especially given that the EL population has increased significantly since the program was created and districts report using the majority of EIA funds for EL services. Adjusting these funding weights could also be part of the process of aligning EIA with other programs, as discussed above.

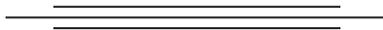
*Distribute Funds Through Combination of Grant Types.* The current EIA formula is structured around three elements: (1) per-pupil grants,

under which every district receives a set amount per targeted student, (2) concentration grants, which provide additional funding to districts with a large proportion of poor and EL students, and (3) minimum grants, which provide a minimum level of funding to districts with small numbers of eligible pupils so they have sufficient resources to operate a program. We recommend the Legislature consider maintaining this multi-grant structure, which ensures that districts receive a level of funding that is proportional to the needs of the targeted population.

***Provide Transitional Funding.*** Revising the EIA formula will likely affect the statewide distribution of funds across districts. As such, we recommend the Legislature provide some ongoing funds to hold districts' funding levels harmless and help ease the transition to the new formula. For instance, the Governor's budget is already proposing to provide a 10.4 percent year-to-year increase in statewide EIA funding. This would provide some additional funds beyond statutory growth and cost-of-living adjustments that could be directed to help ease the transition for districts whose funding levels would decline under the revised formula. These funds could also be redirected from savings we have identified elsewhere in Proposition 98 spending (see, for example, the "Instructional Materials" section of this chapter).

## **Conclusion**

We believe the Legislature needs to take some action to address the EIA/CalWORKs data issues in the budget year. The time is right, however, for comprehensive reform of the EIA formula. Our office will provide the Legislature with several options during budget hearings, using the guidelines outlined above.



## SPECIAL EDUCATION

In 2004-05, 682,000 students age 22 and under were enrolled in special education programs in California, accounting for about 11 percent of K-12 students. Special education is administered through a regional planning system consisting of Special Education Local Plan Areas (SELPA). There are currently 116 SELPAs.

Figure 1 displays the amounts proposed for special education in 2005-06 and 2006-07. The Governor’s budget proposes total expenditures of \$4.4 billion for special education in 2006-07, an increase of \$188 million, or 4.5 percent. Under this proposal, General Fund support for special education would increase by \$156 million, or 5.4 percent. The budget proposes sufficient funding to accommodate growth in the student population (0.2 percent) and a cost-of-living adjustment (COLA) (5.2 percent) on the portion of the special education budget funded from the General Fund and local property taxes. The budget does not fully fund the cost of growth and COLA on the federal fund portion of the budget (discussed in more detail below). The budget also provides \$5.6 million in base technical adjustments to address changes in attendance and local property tax

<b>Figure 1</b>				
<b>Special Education Funding</b>				
<i>(Dollars in Millions)</i>				
	Revised 2005-06	Proposed 2006-07	Change	
			Amount	Percent
General Fund	\$2,890.0	\$3046.3	\$156.3	5.4%
Local property taxes	351.8	369.2	17.4	4.9
Federal funds	970.4	984.2	13.8	1.4
<b>Totals</b>	<b>\$4,212.3</b>	<b>\$4,399.7</b>	<b>\$187.5</b>	<b>4.5%</b>
Detail may not total due to rounding.				

revenue estimates. In addition, the budget would continue in 2006-07 a \$52.6 million appropriation of discretionary funds that was added in the 2005-06 Budget Act.

## FULLY FUND THE BASE SPECIAL EDUCATION BUDGET

*We recommend the Legislature redirect virtually all of the \$52.6 million in one-time discretionary funds to pay for technical adjustments to the base special education budget and fully fund growth and inflation adjustments on the federal portion of the program.*

The 2005-06 Budget Act contains two new provisions that alter the development of the budget-year funding proposal for special education. First, state law no longer guarantees funding for growth and COLA increases on the prior-year level of federal funds. Instead, the amount provided for these cost increases is subject to the annual increase in federal funds. The Legislature may supplement this increase as part of the annual budget if the increase in federal funds is less than the amount needed for growth and COLA.

Second, the current-year budget includes \$52.6 million that is allocated to SELPAs for one-time purposes. These are not one-time funds—they are ongoing funds that are part of the base special education budget. The budget act, however, distributes these funds on a one-time basis, which allows the Legislature to reconsider the use of these funds as part of the 2006-07 budget process. Provisional language in the proposed budget bill places a priority on the use of these funds for helping special education students pass the California High School Exit Examination.

The \$52.6 million in discretionary funds also is accompanied by a “balancer” provision, which specifies that first call on the funds is to pay for any shortfalls in the special education budget. This can happen if federal or local property tax funds are lower than estimated in the annual budget. Thus, the balancer provision provides significant protection to SELPAs by ensuring the availability of additional funds in the event of a shortfall. As a result, however, the amount of one-time discretionary funds distributed to SELPAs could be less than \$52.6 million if there are funding shortfalls.

We have identified two major fiscal issues in the proposed 2006-07 special education budget. First, the budget overstates the amount of discretionary funds that will be available in the budget year due to technical errors in the development of the budget-year proposal. Second, the budget does not propose to provide growth and inflation adjustments to the federally funded portion of the budget. Below, we discuss these issues in greater detail.

## Technical Issues Involve 2004-05 and 2005-06 Revisions

As part of the development of the 2006-07 *Governor's Budget*, the Department of Finance (DOF) revised the estimate of 2004-05 and 2005-06 special education spending in order to calculate its estimate of special education costs for the budget year. Our review indicates that DOF made several technical errors in determining these prior- and current-year adjustments. To correct these technical errors, we recommend the Legislature make the following adjustments to the proposed budget.

***Higher Base Costs Will Reduce One-Time Discretionary Grants in 2005-06.*** As discussed above, the \$52.6 million current-year appropriation for one-time purposes is the balancer for expected costs in 2005-06. The DOF's revised estimate of special education spending in 2005-06 does not reflect the automatic adjustment to the discretionary appropriation. Our estimate of the current-year special education budget indicates that costs are \$7.6 million higher than assumed in the budget act, and that local property tax revenues are \$11.1 million lower (based on DOF estimates). Thus, 2005-06 will have an estimated \$18.8 million shortfall. Our combined figure is higher than DOF's because of technical errors in 2004-05 special education costs, and growth and COLA adjustments in 2005-06. Because of the balancer provision, the amount of the one-time grants will fall from \$52.6 million to \$33.8 million in the current year.

***Higher Base Costs Continue Into 2006-07.*** The effect of the two technical adjustments discussed in the previous section will carry forward to 2006-07. In fact, these adjustments (\$18.8 million) will grow slightly in 2006-07 because growth and COLA is applied to them. Adding \$700,000 for these adjustments, a total of \$19.5 million is needed to fully fund the base program in 2006-07. This is in contrast to the \$5.6 million base adjustment included in the Governor's budget. We recommend the Legislature redirect \$19.5 million in 2006-07 from the combined discretionary funds to pay for these special education technical adjustments.

## Fully Fund Growth and COLA on Federal Funds

The budget projects a \$13.8 million increase in the federal special education grant, which translates into a 1.4 percent increase for this portion of the program. No additional funds are included to provide a full growth and COLA adjustment on the federally funded portion of the program. Providing a full growth and COLA increase would cost \$52.3 million, or \$38.6 million more than is included in the Governor's budget.

Prior to 2005-06, state law required full growth and inflation adjustments on the federally funded portion of the special education program. In 2005-06, this statutory guarantee was deleted. The elimination of the state's guarantee was a response to a federal amendment that disallowed

the use of federal funds to pay for *state-guaranteed* growth and inflation adjustments on the state or *federal* portion of the program. Under the new federal law, federal funds may be used to provide these adjustments on the federal portion of the program—so long as state law does not guarantee such increases. The state’s response in 2005-06 was to eliminate the guarantee in state law, thereby freeing the state to use any increase in federal funds for growth and inflation increases on the federal portion of the program.

In our view, the elimination of the state guarantee places the issue of a full growth and inflation adjustment into the budget process, where the cost of providing a full adjustment must compete with other uses of available Proposition 98 funds. The DOF provides two reasons for not proposing a full adjustment in 2006-07. First, DOF believes the change in state law means that maintaining the spending power of the federal grant is a federal—not state—responsibility. The DOF notes that the state does not use state funds to provide a full growth and COLA adjustment for any other federal education program. Second, DOF believes SELPAs would be able to use funding provided through the one-time discretionary grants to pay for costs associated with growth and inflation.

We disagree with the DOF rationale. Providing a full adjustment is a priority because it would maintain the integrity of the special education funding model that was created by Chapter 854, Statutes of 1997, (AB 602, Poochigian and Davis). The special education funding model provides a grant of funds to SELPAs based on the overall number of K-12 students attending school in each SELPA. The model includes local property taxes and federal funds in determining the amount of total special education funds provided to SELPAs. Failure to fully adjust the federally funded portion of the model for the effects of growth and inflation would slowly erode the purchasing power of the AB 602 grants. We are concerned that, over time, this loss of purchasing power could undermine the funding model.

We also believe that SELPAs would not be able to use the discretionary funds to pay for costs associated with growth and COLA. The provisional language clearly directs SELPAs to use the discretionary funds for “one-time purposes.” Since growth and COLA costs are ongoing base expenditures, the language would preclude SELPAs from using the discretionary funds to pay for such costs.

Therefore, we recommend the Legislature supplement the additional federal funds with \$38.6 million to provide a full growth and inflation adjustment on the federally funded portion of the program. We think the Legislature should place a high priority on maintaining the existing funding model as it provides for a simple, relatively fair method of allocating funds for special education. The \$38.6 million in growth and COLA

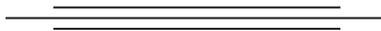
costs combined with the \$19.5 million in base technical adjustments is roughly the same amount proposed in the budget for the discretionary grants (\$52.6 million) and the base technical adjustments (\$5.6 million). We recommend redirecting funding from these two sources to pay for the growth and COLA costs.

Because of last-minute changes in the federal budget (federal fiscal year October 2005 to September 2006) applying across-the-board reductions to federal programs, it appears likely that the federal special education grant will be lower than projected in the Governor's budget. In that event, we recommend the Legislature redirect sufficient Proposition 98 funds to ensure full growth and COLA increases on AB 602 grants.

### **No New Proposal for Mental Health Services**

In signing the *2005-06 Budget Act*, the Governor directed the Department of Mental Health (DMH) to convene a working group to develop a proposal for revamping the existing program that supports mental health services for special education students. This program currently operates as a state-mandated local program. The Governor charged DMH with developing a proposal to convert the program into a categorical funding program.

The DMH budget for 2006-07 does not include such a proposal. Instead, the DOF advises that DMH will convene a working group with the goal of submitting a proposal to the Legislature later this spring. Please see our discussion of this issue in *The 2006-07 Budget: Perspectives and Issues*.



## FACILITIES EMERGENCY REPAIR PROGRAM

*The current structure of the Emergency Repair Program (ERP) makes it difficult for districts to apply for funds and provides incentives for districts to avoid addressing facility problems until they become real emergencies. We recommend the Legislature enact legislation to grant the ERP funds directly to districts with low performing schools to address facility needs identified by their facilities needs assessments, and maintain \$50 million at the state level to provide districts with loans for pressing emergency repair needs.*

In August 2004, the state settled out of court with the plaintiffs of the *Williams v. California* lawsuit. The lawsuit concerned three aspects of K-12 education: instructional materials, teacher qualifications, and facilities. The settlement obliges schools to take steps to ensure (1) all students have sufficient textbooks and materials; (2) teachers have appropriate qualifications for their assignments; and (3) facilities are clean, safe, and maintained in good repair. Most of the requirements imposed by the settlement focus on schools that scored in deciles 1 through 3 on the 2003 Academic Performance Index (the bottom 30 percent of schools based on achievement).

Chapter 899, Statutes of 2004 (SB 6, Alpert), part of the legislative package implementing the *Williams* settlement, created two new facilities programs. The first, known as the School Facilities Needs Assessment Program (SFNAP), provided funding to districts to conduct needs assessments of facilities at their deciles 1 through 3 schools. The 2003-04 budget provided \$25 million for the SFNAP. These assessments were to be completed by December 31, 2005. The second program, the facilities Emergency Repair Program (ERP), established a procedure whereby districts can apply to the state for supplemental funding to address emergency facility repair needs at their deciles 1 through 3 schools. The law defines emergency repairs as repairs to address conditions that pose a threat to the health and safety of students or staff.

The *Williams* settlement requires the state to contribute the greater of \$100 million or one-half the balance of the Proposition 98 Reversion

Account to the ERP each year, until the program has been provided a total of \$800 million. (This is separate from the \$25 million provided for the SFNAP.) In 2005-06, the state provided \$206 million for ERP to meet this requirement. The Governor's budget proposes an additional \$107 million in 2006-07. However, it is likely this amount will increase before the final budget is passed, as typically additional unexpended funds from prior years are identified and transferred into the Reversion Account during the second half of the fiscal year.

Despite substantial state investment in the program, almost none of the funds provided for the ERP have yet been allocated to districts. Below, we discuss problems with the current structure of the program, as well as recommendations for promoting timely and efficient distribution of the funds.

### **Program Structure Makes It Difficult for Districts To Apply for Funding**

Of the \$206 million currently available for the program, so far less than \$1 million has been distributed to districts—the remaining balance is held in a state account. The large balance of unexpended funds is primarily due to the fact that very few districts have applied for ERP funds. According to informal district reports, the lack of applications does not indicate a lack of emergency facility needs, but rather results from other issues, including:

- ***Fears That Projects Will Not Be Approved.*** The ERP is structured such that a district must pay for and undertake the emergency repairs *before* it applies to the state for funding. If the application for the completed work is approved, the state will reimburse the district for the costs of the repairs. If the application is denied, the district will be stuck having borne the full costs of the project. Currently, there is no preapproval process. Districts report being reluctant to undertake emergency repair projects given the uncertainty over whether they will be reimbursed after the work is completed.
- ***Cash Flow.*** Many districts, especially small ones, do not have funds available to “front” the costs of the repairs while they wait for reimbursement from the state—especially given the uncertainty of whether reimbursement will come at all.
- ***Workload.*** Many district maintenance departments report they cannot afford the extra staff time necessary to complete the detailed ERP applications and gather the required documentation.

- **Confusion.** Districts are unsure about the application process and what types of projects qualify, and report they have received conflicting information about how the program operates.

While the state can certainly improve efforts to educate districts on the ERP application process, we believe the program's current structure will continue to make it difficult for many districts to access ERP funds. Without preapproval for reimbursement, districts' reluctance to front funding and undertake projects will continue. This requirement makes the program especially difficult for districts that are small or do not have excess funds available. Furthermore, the involved nature of the ERP application will continue to disadvantage districts without the staff and resources to complete reimbursement claims. For these reasons, we have concerns that the majority of funding provided for the ERP in the budget year and future years will continue to go unexpended, and that funding applications that *are* submitted and approved will not necessarily originate from the districts with the most emergency facility needs but rather those that had the least difficulty navigating the system.

### **Program Creates Bad Incentives**

We think an additional problem with the current ERP structure is that it rewards districts that avoid taking proactive measures to address their facility needs. A district that has a well planned preventative maintenance system in place and uses its deferred maintenance and routine restricted maintenance funds to address repair and replacement needs on a regular basis will have fewer emergency repair needs. As such, these districts will not be eligible to receive as much ERP funding. In contrast, districts that do not manage their facility funding well or fail to address facility needs in a proactive manner will have many emergency needs, and thus be eligible for more supplemental ERP funding from the state.

Not only does this system reward poor facilities management with additional state funds, it also creates incentives for districts to ignore problematic facility conditions at deciles 1 through 3 schools. For example, if a district knows one of its deciles 1 through 3 schools has an old and temperamental boiler, it might choose to spend its maintenance funds at other district schools instead, knowing that once the boiler problem becomes an emergency it can turn to the state for funding rather than having to use its own maintenance funds to repair or replace the equipment.

## Remove Bad Incentives and Get Funding out to Districts— Modify Funding Distribution System

We recommend a two pronged approach to the problems noted above, as summarized in Figure 1. First, we recommend that most of the ERP funding be distributed directly to districts as grants to address needs identified through the SFNAP. Second, we recommend the creation of a loan program to help districts with new emergencies that may occur in the future.

**Figure 1**

### **LAO Recommendations for Legislation to Improve The Emergency Repair Program (ERP)**

- ✓ **Fix Identified Needs Through Direct Grants**
  - Send ERP funding directly to districts in annual grants based on average daily attendance at each of their deciles 1 through 3 schools.
  - Require that districts spend ERP funds on maintenance needs identified in the School Facilities Needs Assessments Program.
  
- ✓ **Address New Emergencies Through Loan Program**
  - Maintain \$50 million in the state ERP account as a revolving fund to serve ongoing district needs.
  - Provide funds from this account to districts that request additional financial assistance to address pressing emergency facility needs at deciles 1 through 3 schools.
  - If requested by the district, provide funding up-front, before project work has begun, or as reimbursement.
  - Require districts to pay back funds over three years, interest free, through reductions in future ERP or deferred maintenance allocations.

*Grant Program.* We recommend the Legislature address the existing problems with the ERP by enacting legislation to eliminate the application and reimbursement process and instead send annual grants directly to districts based on average daily attendance at their deciles 1 through 3 schools. Districts would be required to use these funds on facility needs identified by the SFNAP assessments. This will ensure that items identified in the needs assessments are addressed in a more timely fashion. Local school boards would be required to develop a priority system to determine which of these needs would be addressed first. If a district is able to address all of the needs identified in the SFNAP assessments with

existing resources, then it could either use the ERP funds for other facility needs at the decile 1 through 3 schools, or create a sinking fund to set the funds aside for future needs at these schools.

**Loan Program.** We also recommend maintaining \$50 million in the state ERP account to establish an emergency loan program. This program would be structured as a revolving fund and would assist districts in addressing any facility emergencies at decile 1 through 3 schools. Districts could access these funds either through a reimbursement or preauthorization process.

The program would require districts to repay these loans over a three-year period, paying the ERP account back out of future ERP or deferred maintenance allocations. Structuring the program as a loan instead of a grant reduces districts' incentives to let conditions exacerbate and try to redirect repair costs to the state. However, offering the loans up-front—that is, before project work has begun—and interest-free for a period of three years would encourage districts that have true emergency needs to seek necessary assistance. We recommend this loan program continue even after the full \$800 million for the ERP has been allocated. This would ensure that districts with emergency facility needs at their low-performing schools continue to get assistance when needed.

For 2006-07, district ERP grants would total at least \$262 million—\$155 million (the current ERP account balance minus the \$50 million set-aside) plus \$107 million or whatever amount is ultimately provided in the budget year.

We believe our proposed solution would meet the *Williams* settlement's intention to provide districts with additional resources to address facility needs at low-performing schools. While this proposal would provide funding to all deciles 1 through 3 schools in the state rather than focusing on those schools with the most dire facility needs, we believe some needy districts may actually get *more* funds under our proposal than under the existing system. This is because, as discussed, the current program structure makes it difficult for many districts to even apply for the funds. Under our system, *all* needy districts would get at least some ERP funding, and districts with several deciles 1 through 3 schools would get a greater share than those with fewer low-performing schools. Moreover, we believe our proposal would remove both (1) barriers preventing districts from accessing the funds, as well as (2) incentives for districts to take advantage of the system by ignoring poor conditions at deciles 1 through 3 schools until the state will pay for them.

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## FEDERAL FUNDS

The Governor's budget includes \$7.1 billion in federal funds for education. Of this amount, \$7 billion is provided for various local assistance programs and \$152 million is designated for state operations. The Governor's budget reflects a \$12 million, or 0.2 percent, increase in federal funding over the current year. The Governor's budget, however, does not reflect the enacted federal 2005-06 budget, which the state programs into its 2006-07 budget. This is because the federal budget was passed too late to be included. The administration will reflect the final federal budget in the *May Revision*.

***Federal Funds Will Be Less than Expected.*** The enacted federal 2005-06 budget significantly cuts funding for five education programs whereas it maintains funding for most other programs at approximately their current-year levels. While state allocations have not officially been determined, preliminary estimates have been released. For the five programs with significant cuts, Figure 1 compares current- and budget-year funding levels.

**Figure 1**  
**Federal Budget Significantly Reduces**  
**Funding for Certain Programs**

*(Dollars in Millions)*

	State Allocation		Change	
	2005-06	2006-07 <sup>a</sup>	Amount	Percent
Comprehensive School Reform	\$27.7	—	-\$27.7	-100%
Innovative programs	24.7	\$12.3	-12.4	-50
Even Start	27.7	11.9	-15.8	-57
Education Technology	65.6	35.1	-30.5	-46
Safe and Drug Free Schools	52.7	41.5	-11.2	-21

<sup>a</sup> Reflects preliminary estimates.

Below, we discuss the Governor's budget proposal to use federal carryover for certain low-performing schools. In the next section of this chapter, we discuss in more detail the state's implementation of the federal Migrant Education Program (MEP).

## FEDERAL CARRYOVER PROPOSAL

The Governor's budget proposes to use \$82 million in federal carryover funding on "a one-time basis to increase the capacity of schools and districts identified as program improvement." Under the federal No Child Left Behind Act of 2001 (NCLB), schools and school districts are designated as Program Improvement (PI) if they do not meet minimum student achievement goals for two consecutive years. These goals are known as Adequate Yearly Progress. The NCLB delineates certain annual interventions for PI schools and districts. In the current school year, 1,722 schools, or 30 percent of all Title I schools, are classified as PI schools.

The Governor's budget-year proposal is almost exactly the same as the 2005-06 May Revision proposal. The Legislature rejected that proposal and instead continued appropriating carryover funds for their existing purposes, consistent with federal program requirements. The Governor vetoed these funds in an attempt to engage the Legislature in a more detailed discussion of his original proposal.

The Governor's budget-year proposal relies on carryover funding from four federal programs. Figure 2 identifies these programs and their associated carryover amounts. Budget bill language makes expenditure of these carryover funds contingent on a spending plan developed by the California Department of Education (CDE) and approved by the Department of Finance (DOF).

### Reject All but One Component of Governor's Carryover Proposal

*We recommend the Legislature reject all of the Governor's carryover proposals except for the Title I, Basic Program proposal. Although we think that proposal is reasonable in that it would transfer unused funds to the most struggling schools, the transfer likely would require federal approval. We therefore recommend the Legislature direct the California Department of Education to seek federal approval for making such a transfer.*

We have specific concerns with the Governor's carryover proposals for MEP, Comprehensive School Reform (CSR) program, and Title I, Program Improvement, which we discuss below. We believe that the Governor's general proposal to redirect carryover funding from Title I, Basic Program

to PI schools and districts is reasonable, but it would likely require federal approval. We discuss this issue in the last section.

**Reject MEP Carryover Proposal.** Although the Governor’s budget contains language requiring MEP funds to be expended consistent with federal requirements and existing local and regional plans, it would target \$19 million in carryover funds only to PI schools and districts—and it would do so for undefined one-time purposes. Currently, PI schools serve only about 30 percent of the state’s migrant students. Thus, the vast majority of migrant students would not benefit from the Governor’s proposal. We therefore recommend rejecting it.

<b>Figure 2</b>	
<b>Summary of Federal Carryover Funds</b>	
<i>(In Millions)</i>	
<b>Program</b>	<b>Carryover Amount</b>
<b>Title I:</b>	
Basic program	\$24.3
Program Improvement	22.3
Subtotal—Title I	(\$46.6)
<b>Migrant Education</b>	19.2
<b>Comprehensive School Reform</b>	16.2
<b>Total</b>	<b>\$81.9</b>

**Use MEP Carryover to Build Better System.** In our February 2006 report (*Improving Services for Migrant Students*) and our “Migrant Education” write-up in the next section of this chapter, we recommend using carryover funds to help implement a comprehensive package of reforms that would fundamentally restructure how the state delivers services to migrant students. Specifically, we recommend using a small amount of carryover funding (up to \$4 million) to build a better migrant student data system and all remaining carryover funding to ease the transition to a better student-aligned service system.

**Reject CSR Carryover Proposal.** As with the MEP proposal, the Governor’s budget designates CSR carryover (\$16 million) for one-time interventions at PI schools and school districts. All CSR funds, however, already are targeted to PI schools to implement existing multiyear reform

plans. In contrast, the Governor's proposal contains no plan—neither identifying how the carryover funds would be allocated among PI schools nor designating how they would be used. We therefore recommend rejecting it.

***Use Carryover to Cover Third-Year Grants for Existing CSR Cohorts.*** Instead, we recommend the Legislature use carryover funding to continue implementing the existing multiyear plans. In 2004-05, the Legislature authorized two new CSR cohorts. Cohort 4 contains 52 school districts serving 84 schools, and cohort 5 contains 12 districts serving 58 schools. The first three CSR cohorts received grants for a three-year period. Cohort 4 and cohort 5, which had their applications approved about two years ago and were funded in 2004-05 and 2005-06, have been operating on the assumption their grants also would be renewed for a third year. The CDE estimates it would cost \$30 million to provide these third-year grants (\$15.1 million for cohort 4 and \$14.9 million for cohort 5). We recommend the Legislature use the \$16 million in CSR carryover funds to provide these grants. It either could prorate the grants amounts downward to ensure all existing grantees were covered or consider an augmentation (using likely carryover from other state and/or federal intervention programs) to fund the full cost.

***Reject PI Carryover Proposal.*** As with the MEP and CSR carryover proposals, the Governor's budget designates the PI carryover (\$22 million) for one-time interventions at PI schools and districts. Currently, PI funds already support legislatively determined intervention activities for struggling schools and districts. Specifically, these statutorily authorized interventions include a county office of education support network, funding for School Assistance and Intervention Teams (SAIT), and grants to PI districts or districts with large numbers of PI schools. As mentioned above, the Governor's budget lacks an allocation and spending plan, so its effects on PI schools and districts are unknown. Moreover, as we discuss in more detail below, linking the PI carryover funds to carryover funds generated by other programs might result in the state needing federal approval. Were this to be the case, distribution of the PI carryover funds might be delayed. For these reasons, we recommend the Legislature reject the proposal.

***Redirecting Funds From Title I, Basic Program Is Reasonable, but Likely Would Require Federal Approval.*** The Governor's general proposal to target \$24 million in Title I, Basic Program carryover funds to struggling PI schools and districts is reasonable, but the administration has yet to provide any details on how these funds would be used. (In addition, by the time of the 2006-07 May Revision, the amount of identified Title I carryover likely will be roughly double the current estimate.) Title I, Basic Program grants currently are distributed to school districts

using a formula that is based on counts of Title I students. Historically, carryover funds are distributed using the same formula. The CDE could seek approval from the federal government to target these basic grants to PI schools and districts. The federal government likely would be receptive to such a request because it helps support the policy goals of NCLB. Moreover, California already has shown its commitment to assist struggling schools—spending approximately \$250 million of General Fund (Proposition 98) annually for this purpose.

*Direct CDE to Seek Federal Approval to Transfer Title I, Basic Program Carryover to Title I, Program Improvement.* Accordingly, we recommend the Legislature direct the CDE to seek federal approval to transfer Title I, Basic Program carryover annually to Title I, Program Improvement. By transferring the funds to this program, the state can use the funds to build upon its current efforts—such as expanding the county office of education support network, SAIT for failing schools, and grants to PI districts or districts with large numbers of PI schools. In addition, since PI funds are appropriated in the annual budget act, the Legislature would be involved in making associated allocation decisions—instead of deferring to a CDE plan approved by DOF under which the Legislature would not have a role.

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## MIGRANT EDUCATION

*In February 2006, our office published a report entitled **Improving Services for Migrant Students**. In this report, we recommend the Legislature implement a comprehensive package of reforms designed to improve the state's Migrant Education Program. Specifically, we recommend a number of modifications related to the program's: (1) funding and service model, (2) data system, and (3) carryover funding process. We also identify funding available to help in implementing these changes. We think this package of reforms would help the state better target resources and better serve migrant students throughout the state. Below, we summarize the major findings and recommendations from our report.*

### BACKGROUND

The Migrant Education Program (MEP), created by the federal government in 1966, is intended to address the educational needs of highly mobile children whose family members are employed doing seasonal agricultural work. The program provides supplemental services to support the core academic program children receive during the regular school day.

The MEP is funded almost entirely by federal funds. In 2005-06, California received a total of \$127 million in federal funds for the MEP, the bulk of which is allocated to the MEP centers (described below). The federal government grants broad flexibility to states on how to implement MEP supplemental services. Figure 1 summarizes the services provided by California's MEP and identifies how much of the state's federal grant is currently being spent on each of these services.

**Program Based on Regional System.** Migrant education services are provided by 23 MEP centers located across California. Fourteen of these centers provide regional services to multiple school districts and are run out of county offices of education (COEs). Some of these regional centers provide services to migrant students in more than one county. The remaining nine centers are operated by "direct-funded" school districts that serve

**Figure 1****Migrant Education Services and Spending**

	Percent of Total State Expenditures
<p>✓ <b>Instructional Services, Regular School Year.</b> Typical Migrant Education Program (MEP) expenditures include: hiring additional teachers, tutors and aides for the regular school day and after school programs; purchasing supplemental curriculum and materials; developing and distributing a statewide independent study program; hiring counselors and offering academic counseling programs; and administering preschool programs for migrant students ages 3-5. Various instructional services are also provided to students in nontraditional settings/venues who have not yet completed high school.</p>	64%
<p>✓ <b>Administrative Services.</b> The MEP has various direct and indirect administrative costs at the state and local levels.</p>	14
<p>✓ <b>Instructional Services, Summer School.</b> The MEP runs supplemental academic, enrichment, and leadership programs for migrant students during summer and intersession breaks.</p>	7
<p>✓ <b>Student Identification and Data Collection.</b> The program identifies and “recruits” eligible students in a variety of venues. In addition, MEP staff are responsible for entering basic information on each enrolled student into a statewide migrant student database.</p>	7
<p>✓ <b>Health Services.</b> The MEP often helps migrant families obtain various social and health services by arranging health screenings, offering health awareness workshops, and referring migrant students to health providers.</p>	3
<p>✓ <b>Parent Participation.</b> The MEP offers various activities for parents of migrant children, including: English as a second language, GED, and parenting skills classes; leadership institutes and seminars; and opportunities to participate in MEP parent advisory councils at the school, district, regional, and state levels.</p>	2
<p>✓ <b>Staff Development.</b> The program provides training for staff who work with migrant students.</p>	1

only the students in their own districts. Figure 2 (see next page) shows the number of districts and students served by each center as well as the centers’ 2005-06 funding allotments. As shown in the figure, MEP centers vary dramatically in size, with one center responsible for providing services to almost 36,000 children in 191 school districts and another center serving just over 100 students in a one-school school district. The selection

of MEP centers has not been strategic, but rather has evolved over time based on requests to the California Department of Education (CDE) from individual districts and COEs.

**Figure 2**  
**Migrant Education Program Centers**  
**Vary Significantly in Size**

2005-06

Service Provider	Number Districts Served <sup>a</sup>	Number Migrant Students Enrolled <sup>b</sup>	Percent Statewide Migrant Students <sup>b</sup>	Total Center Funding
<b>Regional Centers<sup>c</sup></b>				
Butte	191	35,675	11%	\$12,637,876
Fresno	29	30,949	9	10,115,926
Monterey	18	30,087	9	9,478,956
Kern	33	29,476	9	10,281,111
Tulare	54	23,572	7	8,143,708
Santa Clara	54	22,675	7	7,497,415
San Joaquin	25	21,960	7	7,669,352
Merced	51	20,882	6	6,940,980
Los Angeles	51	20,276	6	6,659,884
San Diego	54	16,812	5	5,475,465
Imperial	15	12,987	4	3,902,440
Ventura	13	12,953	4	3,667,101
Santa Barbara	25	8,667	3	2,447,095
Riverside	12	6,573	2	1,883,324
<b>School District Centers</b>				
Pajaro Valley Unified	1	14,801	4	4,622,998
Bakersfield City Elementary	1	8,995	3	2,379,938
Santa Maria-Bonita	1	3,949	1	1,343,140
San Jose Unified	1	2,353	1	619,107
Delano Joint Union High	1	2,004	1	589,282
Lindsay Unified	1	1,837	1	645,825
Oxnard Elementary	1	1,381	__d	331,980
Lost Hills Union	1	905	__d	361,665
Semitropic	1	112	__d	29,724
	634	329,881	100%	\$107,724,292
<p><sup>a</sup> Data from 2004-05, provided by statewide migrant student database. Count only includes districts with migrant students.</p> <p><sup>b</sup> Enrollment for regular school year. Centers report separate counts for number of migrant students served during summer or intersession.</p> <p><sup>c</sup> Operated out of county offices of education. The regional center may serve districts in more than one county.</p> <p><sup>d</sup> Less than 1 percent.</p>				

*Service Model Differs Across Regions.* The 14 regional centers can choose to distribute funding to local districts to run their own district-based programs or keep funding at the COE and offer MEP services at the regional level. Most use a mixture of these two approaches, with the specific distribution varying significantly across regions. For example, one regional center reports that it distributes almost 90 percent of its regional funding directly to local districts to provide their own migrant student services, while another regional center distributes only 7 percent to local districts. The nine direct-funded district centers use their funding to run their own district-based migrant student services, and they do not rely on any other (district or county) MEP center.

## FUNDING MODEL

### Concerns With the Current Funding Model

We think there are four primary problems with the current migrant education funding model and formula, as described below.

*Disconnect Between Who Is Funded and Who Is Accountable.* For all but the nine school district MEP centers, the current model results in a disconnect between funding and accountability. The state has a comprehensive standards-based accountability system intended to hold schools and districts accountable for student achievement. In contrast, no accountability system holds COEs responsible for migrant student performance or for the effectiveness of their MEP services. The state program is currently structured such that, in most cases, resources and responsibility for migrant student services lie with COEs, whereas accountability for outcomes lies with districts.

*Lack of Coordination Between MEP Services and Other Programs.* In many cases, little coordination exists between the services migrant students receive at school and the supplemental services they receive through their regional MEP center. In some school districts, staff are largely unaware of the services being provided to their migrant students through the COE-based regional center. Furthermore, regional centers do not have access to many of the other supplemental funds and programs that are available to serve many migrant students—such as Title I, Part A and Title III federal funds. They therefore have limited opportunities to leverage and coordinate different resources—even though the program is intended to encourage pooling resources for a coordinated complement of student services.

*Funding Formula Does Not Reflect Statutory Program Priorities.* The CDE distributes funding to centers using a formula that is based on

certain characteristics of migrant students. The particular characteristics selected by CDE administrators do not reflect the MEP priorities outlined in state and federal law. For example, state law places greater priority on school-age as opposed to preschool-age children, and federal law stipulates that “priority for service” be accorded to (1) students whose education has been interrupted during the *current* school year and (2) students who are failing or are most at risk of failing to meet state content and performance standards. While the MEP may be following federal law by serving these targeted students, there is a disconnect between these identified priorities and the methodology by which CDE allocates funding for the program.

***Funding Formula Does Not Encourage Broad Participation.*** The current formula CDE uses to allocate the majority of MEP funds is based on the number of migrant students who are *eligible* to receive MEP services in the regular school year, as opposed to the number of migrant students a center *actually* serves. Thus, MEP centers have a strong fiscal incentive to *identify* eligible migrant students, but no fiscal incentive to ensure they actually receive MEP services.

## **Revise Funding Model to Improve Quality of Services and Enhance Accountability**

***We recommend the Legislature revise the migrant education funding model to send the majority of funds directly to school districts rather than regional centers. We recommend, however, maintaining some funds at county offices of education for certain regional activities and some funds at the California Department of Education for certain statewide activities.***

The majority of other U.S. states—including Texas, Florida and Arizona (which have relatively large migrant populations)—have structured their state migrant education programs around a *district-level* funding and service model. Currently, California follows this model in only nine districts. Implementing this structure statewide likely would result in more effective migrant student services.

As shown in Figure 3, we suggest that 70 percent of the annual federal grant be allocated to districts using a revised weighted student formula based on district counts of migrant students. This would result in all districts receiving funding directly from the state, similar to the nine existing direct-funded districts. Districts would then have primary responsibility for providing supplemental instructional services to their migrant students. We recommend the remaining 30 percent of MEP funds be allocated to COE-based regional centers (15 percent) and CDE (15 percent). (We developed this specific funding split—70 percent district, 15 percent county, 15 percent state—by aligning responsibilities under the new system with

current spending patterns.) Because state law currently establishes regional centers as the “primary method for the delivery of services to migrant students,” our suggested modifications to the MEP funding model would require statutory change.

**Figure 3**  
**Restructuring Migrant Education Program (MEP) Funding Model**  
*(Percent of Federal MEP Grant)*

	<b>Current System</b>	<b>LAO Recommendation</b>
School districts	9% <sup>a</sup>	70%
Regional support centers	76 <sup>b</sup>	15
Statewide initiatives	15	15
<b>Totals</b>	<b>100%</b>	<b>100%</b>

<sup>a</sup> Reflects funding provided to school districts that are currently designated as MEP centers. Does not include funding passed through to some school districts by county office of education (COE) regional centers.

<sup>b</sup> The COEs provide a portion of this funding to local districts, but statewide data on these pass-throughs are not available. Different regions report passing through anywhere between 7 percent and 90 percent of their funding to local districts.

*Shift to Districts Would Help Overcome Existing Problems.* Shifting the majority of MEP funding away from COE-based regional centers and providing it directly to school districts would streamline the system—providing districts with both the resources and the responsibility to serve migrant students and improve their academic achievement. Districts not only know the content of the instruction migrant students are receiving during the regular school day, but they have the state assessment data to identify individual students’ academic needs. Therefore, they are better positioned to develop supplemental instruction for migrant students that aligns with and supports the students’ broader instructional program. In addition, districts have greater options for meeting the federal requirement to coordinate migrant student services with other student services. Because districts have access to and control over school facilities, transportation, and schedules, and oversee many other educational programs, they are more easily able to pool other funding sources together with MEP funds. Finally, transitioning to a district-based funding and service model also would allow the state to use the existing statewide accountability system to monitor migrant student outcomes, hold districts responsible for pro-

viding effective supplemental services, and identify districts in need of intervention assistance.

***Regional Centers Can Complement District Services.*** Although we think most MEP funding can be best used by distributing it directly to districts, we recommend about 15 percent of the federal grant be retained for regional centers and services. Certain MEP services, highlighted in Figure 4, likely would be more cost effective if delivered at the regional level. In particular, regional centers likely are better positioned to provide services that occur off school-site or are not directly related to K-12 education. During the transition to the new funding and service model, we think regional support services should be maintained within the COEs that already have MEP knowledge and experience. After the initial transition, MEP regional support responsibilities and funding could be expanded to some additional COEs, especially to those areas, such as Sonoma and Napa, currently serving large migrant populations. This would ensure regional support was readily accessible to districts throughout the state.

**Figure 4**

**Migrant Education Services Regional Centers  
Could Provide Under New Service Model**

- ✓ Services for out-of-school youth and preschool children.
- ✓ Identification and recruitment of eligible migrant students in venues outside of the regular school setting.
- ✓ Student health screenings and referrals.
- ✓ Technical assistance and professional development for teachers and administrators.
- ✓ Special regional events, such as seminars or institutes for migrant students and parents.

***Maintain Regional Capacity While Increasing Local Flexibility.*** To allow for maximum local flexibility, under the new system districts should be permitted to use their MEP grants to purchase services from their regional center. (Districts with very small populations of migrant students would likely find it more cost effective either to form consortia with other

neighboring districts or purchase the majority of MEP services from their regional center.) The state, however, would need to clearly establish what level of support regional centers would provide using their state grant and which MEP services they could offer to districts on a user-fee basis.

*Some Statewide Initiatives Should Be Maintained.* Currently, CDE maintains about 15 percent of federal MEP funds at the state level. One percent of the grant is used for statewide program administration and the other 14 percent is used for various program activities that are organized at the state level. These activities include: the MiniCorps migrant student tutoring program; a statewide independent study curriculum (the Portable Assisted Study Sequence, or PASS program); the migrant preschool program; and the statewide migrant student information network (MSIN). To ensure some consistency in MEP services across the state, we recommend maintaining the current practice of funding these activities.

### **Revise Funding Model to Reflect Program Priorities**

*We recommend the Legislature direct the California Department of Education to (1) revise the per-pupil funding formula so that it emphasizes federal and state program priorities and (2) report back on proposed revisions once it has completed its statewide needs assessment.*

State law should align with federal law regarding which migrant students receive priority for service, and these priorities should be reflected in the state's funding formula. Additionally, districts should be provided with fiscal incentives to ensure they are meeting the needs of all migrant students. The basis for funding allocations therefore should incorporate both counts of *eligible* migrant students as well as students who actually *participate* in the MEP.

Toward these ends, we recommend the Legislature direct CDE to develop a new per-pupil funding formula. This revision process should be a part of the comprehensive needs assessment CDE is currently conducting for the MEP. We recommend the Legislature direct CDE to report back by October 31, 2006 regarding the revised formula and other program changes resulting from the needs assessment. (This report should be provided in conjunction with an update on the migrant student database and development of a transition plan, as discussed further below.) The revised formula could become operative in 2007-08.

## MIGRANT EDUCATION DATA SYSTEM

### Concerns with the Current Data System

We think there are several problems with the current migrant student database, known as the MSIN.

***Current Database Provides Limited Benefit.*** Currently, the state contracts with two companies to maintain the MSIN, a database of migrant student information. Although one of the primary goals of the MEP is to reduce the educational disruption experienced by migrant students when they move, the current migrant education information system is only capable of providing the receiving MEP center with very limited information, such as where a student is moving from and how long he or she has been classified as a migrant student. Furthermore, access to the database is restricted primarily to MEP center staff. In the 14 COE-based regional centers, this means even the limited migrant student information contained in the system is largely unavailable to district and school-level staff. Consequently, with each move, migrant students essentially start their educational program anew, with the receiving school district knowing little to nothing about their needs or the MEP services they had been receiving. (This is not an issue in the nine district-based MEP centers.)

***Disconnect Between Data Systems.*** The CDE is currently working to try to incorporate individual migrant students' California School Information Services (CSIS) numbers and state assessment data into the MSIN; however, it has not yet identified an efficient ongoing process for inputting and updating these data elements. This is largely due to the disconnect that often exists between the school districts, where students' CSIS numbers and assessment data are maintained, and the COE-based regional centers, where the MSIN is accessed and updated.

***Regional Centers Are Developing Their Own Data Systems.*** All of the MEP centers currently collect data on migrant students beyond what is maintained in the MSIN. Each of the centers collects and maintains this information in a different format. Moreover, when the student moves, this information is typically not shared. Many of the centers are responding to the limitations of the MSIN by spending a portion of their local grants to build their own databases to collect and maintain more comprehensive information on migrant students. These efforts are not being coordinated at the state level, and the individual databases are not being designed to share or transfer information across regions or districts.

## Enhancing Data System Could Improve Program Effectiveness

*We recommend expanding the state's migrant education data system to include more data elements. We also recommend providing district and school personnel access to the enhanced system. We recommend setting aside up to \$4 million in carryover funds for this purpose.*

Collecting consistent information on migrant students and sharing it across the state would ease students' transitions when they move to new schools as well as help create more coordinated statewide MEP services. This in turn would help meet the program goal of minimizing disruptions in migrant students' educational programs.

*Statewide System More Cost Effective.* A statewide solution would be considerably more cost effective and beneficial to the state than 23 different information systems. In building an enhanced system, the state has several options it could pursue.

- *Expand State's Current Database.* The state could opt to work within the framework of the current MSIN and simply expand it to include more data elements. (The CDE has recently requested authorization to pursue this option as a temporary solution.)
- *Piggy-Back on Statewide Student Data System Efforts.* It may be possible for the CSIS system to encompass additional data fields and functionalities regarding migrant students that would eliminate the need for a separate data system.
- *Join Existing Interstate Network.* Currently, ten states participate in the New Generation System, a comprehensive migrant student database that maintains and shares information when students move across state lines. The state of Washington also has a well-regarded migrant student information system. California could opt into one of these established networks.
- *Develop New Database.* The state could develop an entirely new database from scratch. (The CDE has indicated it may pursue this option in the future.)

We recommend the Legislature direct CDE to investigate the most feasible approach and report back on its progress by October 31, 2006.

*Statewide System Should Include Various Enhancements.* Regardless of which of the above options the state decides to pursue, we believe that the migrant student database should encompass various features, as listed in Figure 5 (see next page).

**Figure 5****Desired Features of an Enhanced Migrant Student Database**

- ✓ Capable of interfacing with and uploading information from the California Longitudinal Pupil Achievement Data System and the California School Information Services System to avoid duplication of effort.
- ✓ Can be accessed and updated by school and district personnel who work with migrant students on a daily basis.
- ✓ Compliant with new federal requirements that state migrant databases contain: (1) student achievement data, (2) immunization records, and (3) high school course credits.
- ✓ Contains optional fields for staff to input additional migrant student information, such as participation in bilingual education, and health issues that have been identified or are being treated (such as dental or vision needs).
- ✓ Standardized across state so information can be shared immediately and easily when students move.

## CARRYOVER FUNDS

The MEP typically expends around 95 percent of its annual federal grant, generating about \$6 million in carryover funds each year. Currently, however, sizeable carryover remains from prior years (approximately \$20 million, as of CDE's most recent estimate). This accumulation of MEP carryover funds is primarily due to a fiscal calendar change that occurred in 2003.

### Use Carryover Funds to Build Better System

*We recommend the Legislature use (1) up to \$4 million in carryover funds to enhance the migrant student database and (2) the remainder of the carryover funds to help transition to a district-based service model. Toward this end, we recommend the Legislature direct the California Department of Education to develop a transition plan and an associated spending plan and report back by October 31, 2006.*

The 2006-07 Governor's Budget proposal appropriates \$19 million in MEP carryover funding (recently updated by CDE to \$20 million) to serve migrant students attending schools classified as Program Improvement (PI) schools based on data from 2003-04. (Under the federal school accountability system, schools that do not meet student performance goals for two or more consecutive years are classified as PI.) We have concerns with restricting the use of carryover funding in this way because only about 30 percent of the state's migrant student population attends PI schools. The remaining students either attend non-PI schools or do not attend a traditional K-12 school (including preschool-age students and out-of-school youth). Thus, the majority of the state's migrant students would not benefit from the Governor's proposed use of carryover funds.

Based on our review of the program, we suggest the Legislature instead spend existing carryover funds on critical statewide initiatives that would benefit all migrant students. Specifically, we recommend using up to \$4 million to improve the migrant student database, as described above, and using the remainder (approximately \$16 million) to assist in the transition to a district-centered system.

***Plan Needed for Transition to District-Based Service Model.*** If the state chooses to revise the MEP funding and service model to focus on school districts instead of regional centers, the current system would undergo a significant transition. Under our proposal, existing MEP centers would receive one-time funds to ease the transition to the district-centered service and funding model. These funds essentially would allow for a more gradual transfer of student programs from the existing MEP centers to the districts themselves. Existing MEP centers also could use the transitional funding to provide training and technical assistance, as well as transfer services and staff to the district level.

We recommend the Legislature direct CDE to develop a timeline and plan for transitioning to this new service model. The plan should include a proposal for allocating and using one-time transitional funds. The CDE should report back to Legislature by October 31, 2006 regarding this plan. (As noted earlier, this report should also include a description of the revised weighted pupil allocation formula, results from the comprehensive needs assessment process, and an update on the best option for enhancing the migrant student database.)

### **Authorize Limited Local Carryover Authority**

*We recommend the Legislature adopt budget bill language that would allow up to 5 percent of annual migrant education funding to carry over at the local level.*

We recommend the Legislature adopt budget bill language allowing local service providers to carry over up to 5 percent of their MEP grant each year, with any additional carryover above this level designated for specific legislative priorities. Given that the state expects local agencies to be fiscally responsible and not exceed their annual budget allocations, districts and regional centers tend to budget somewhat conservatively and typically do not spend all of their MEP grants. A further technical budgeting challenge arises because a significant portion of MEP services are offered during the summer, which straddles the state's fiscal year. Authorizing a small amount of carryover would address these problems and create better incentives to use local funds prudently.

## CONCLUSION

As discussed here and in greater detail in our report, *Improving Services for Migrant Students*, we think the state should adopt a package of reforms designed to enhance services for migrant students. Figure 6 summarizes our recommendations. We recommend coupling these changes with various fiscal actions that would direct one-time carryover funds toward building a better system and easing the transition process. Whether in combination or pursued separately, we think these reforms would lead to: better coordination among MEP services, students' core academic programs, and other education programs; a greater ability to hold districts accountable for migrant student performance; better incentives to serve all migrant students; a more useful and cost-effective solution to sharing student information; and, perhaps most importantly, less educational disruption for migrant students.

**Figure 6****Summary of LAO Migrant Education Program Recommendations**

- ✓ **Revise Funding Model**
  - Revise the migrant education funding model to send 70 percent of funds directly to school districts, 15 percent to county office of education-based regional centers, and 15 percent to the California Department of Education (CDE) for statewide activities.
  - Direct CDE to revise the per-pupil funding formula to emphasize federal and state priorities.
- ✓ **Enhance Migrant Student Database**
  - Expand the state's migrant education data system to include more data elements.
  - Provide district and school personnel access to the enhanced system.
- ✓ **Use Carryover Funds to Build Better System**
  - Use up to \$4 million in carryover funds to enhance the migrant student database.
  - Use remaining carryover funds (around \$16 million) to help transition to a district-based funding and service model.
  - Authorize up to 5 percent of annual migrant education funding to carry over at the local level.
- ✓ **Require Report to Legislature**
  - Direct CDE to report back to the Legislature by October 31, 2006 regarding its progress in implementing changes to the program.

## OTHER ISSUES

### TEST THE IMPACT OF A CAHSEE BLOCK GRANT

*We recommend the Legislature adopt trailer bill language that would allow up to ten districts to test comprehensive approaches to assisting students to pass the California High School Exit Examination.*

The California High School Exit Examination (CAHSEE) was enacted in 1999 and requires students to pass both the English language arts and mathematics portions of the test as a condition of graduating from high school. As enacted, students in the class of 2004 were the first to be required to pass CAHSEE. In 2001, legislation was passed to delay the required passage of the test to graduate until the class of 2006. Thus, this year's seniors are the first class required to pass CAHSEE to graduate from high school.

The Governor's budget proposes \$40 million in support of local efforts to help students pass CAHSEE in 2006-07. This amount would double the \$20 million provided for this purpose in the current year. State law directs the California Department of Education (CDE) to distribute funds first to schools with the highest proportion of students who have failed both parts of the test. In the budget year, districts would receive up to \$631 for each eligible student. The Education Code gives districts wide latitude in the use of these funds. It requires only that districts use funds to supplement existing services and administer a diagnostic assessment to identify each student's area of academic strengths and weaknesses. Given the number of eleventh and twelfth grade students trying to pass the test, we believe the increase in this flexible funding is reasonable.

The \$40 million builds on the existing grades 7 through 12 supplemental instruction program, which has as its mission ensuring that students pass CAHSEE. The budget bill includes \$177 million for this program in 2006-07. State law allows schools to provide supplemental instruction before or after school, during the summer, or on Saturday so long as the instruction is in addition to the regular school day. Districts receive \$3.87

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per student for each hour of instruction. This amount is sufficient to support a class of one teacher with about 25 to 30 students.

### **Many Factors Affecting Student Success on CAHSEE**

The CDE maintains a contract with an external evaluator to assess the quality of the test, passing rates, and the impact of the CAHSEE requirement on dropout and graduation rates. The department hired the Human Resources Research Organization (HumRRO) to fulfill this directive. Its most recent report, published September 30, 2005, explores a number of local factors that affect student success.

The HumRRO reports identifies ways the state can make supplemental instruction more effective. Specifically, the findings suggest that the state's supplemental instruction program for students in grades 7 through 12 is too narrow in its approach to helping lower performing students. The current funding program does not (1) provide the flexibility schools need to establish programs that address the specific needs of students or (2) encourage schools to integrate the test's academic requirements into the design and operation of core academic programs. Because of the importance of the test to students, we think the Legislature should consider other program structures for providing additional academic assistance.

***Student Motivation and Parental Support.*** The report's survey of teachers reveals that 59 percent of teachers cited low student motivation as a primary impediment to student learning. For students in remedial classes, 70 percent of teachers cited student engagement as a core issue. While teachers often tried in various ways to enlist parents in the effort to help students pass the test, they did not find those efforts effective.

The grades 7 through 12 supplemental instruction program does not directly address student motivation. Weak student engagement complicates the financing of local supplemental programs, however, because districts are reimbursed based on the number of student hours of attendance. Weak motivation results in low class attendance—a concern also raised by teachers in the HumRRO report. Since supplemental instruction funding is based on attendance, districts find it difficult to afford small remedial classes using only funds provided through the state funding formula.

***Classes Too Broadly Focused.*** About a quarter of teachers and administrators surveyed by HumRRO reported that supplemental instruction services were not helping students as they had hoped. According to these educators, the primary cause of this problem is that current classes are too broadly focused, and are unable to meet the needs of students with more significant academic problems. Several groups of students—includ-

ing English Learners and students with very low academic skills—were identified as being particularly affected by this problem.

We have identified two possible sources of this problem. First, as discussed above, districts may be unable to afford creating smaller, more focused classes because of the hourly reimbursement formula used by the program. Needing up to 30 students to pay for one teacher, schools simply may have too few students with a particular academic need to create more specialized classes. Second, teachers in the supplemental program may have little information about the needs of the individuals in the class. This is a common problem in categorical programs—the supplemental services funded by the program are not merged into the regular academic program. While the regular classroom teacher may have a clear picture of a student’s needs, that information is not communicated to the teacher of the supplemental program.

***Teacher Experience and Credentials.*** The report finds that students are more likely to pass the mathematics portion of the test in tenth grade if they had a credentialed mathematics teacher. More than one-half of all high schools reported using noncredentialed mathematics teachers. In English language arts, students were more likely to pass the test if they had a teacher with five or more years of teaching experience. These findings emphasize the need for good teachers in the supplemental programs. The reimbursement formula of the state’s supplemental instructional program, however, provides little district flexibility to induce more-effective teachers to provide supplemental instruction. As discussed above, the current formula creates several hurdles for establishing small, focused classes. Thus, the current formula does not appear to give districts the option of offering the best teachers a higher compensation rate to teach these supplemental classes.

***Articulation Between Middle and High Schools.*** The HumRRO found that strong articulation—joint planning on student placement, curriculum, and instructional issues—between high schools and their feeder schools is associated with higher pass rates. The report found, however, that about 20 percent of high schools surveyed do no articulation and about one-half do joint planning only in some cases. The issue of articulation is important because students are expected to develop most of the knowledge and skills tested on CAHSEE by the end of middle schools. Teachers reported to HumRRO that one-third of students arrive in high school without the prerequisite skills in mathematics (29 percent) and English (39 percent) needed to pass the test. Articulation can help improve the effectiveness of middle schools by giving teachers time to identify curricular areas that need greater attention or develop instructional units and local assessments in areas tested by CAHSEE.

A more systematic approach to articulation also could affect the grade 7 through 12 supplemental instructional programs in two ways. First, by making core instructional services aligned with the skills needed to pass CAHSEE, articulation could reduce the need for supplemental remedial classes in high school. Second, high school administrators also could help improve the responsiveness of middle school supplemental instruction in helping students gain the skills needed to pass the test by identifying the areas that commonly give students the greatest difficulties.

### **Test Different Approaches**

The CAHSEE represents an important part of the state's accountability system because it is increasing the focus on high school students who lack fundamental mathematics and English skills. Given the importance of CAHSEE to students—and the importance of an educated populace to our society and economy—we think the state needs to explore other approaches that more effectively support schools in this area. One way to develop new approaches is to allow a small number of district flexibility to try promising ideas for helping struggling students. Pilots have several benefits—they allow the state to test the most promising of the new approaches, are relatively easy to evaluate, and do not disrupt the flow of program services for all other districts.

For these reasons, we recommend the Legislature adopt trailer bill language that would allow up to ten districts to use supplemental instruction funds as part of a comprehensive approach to assisting students to pass CAHSEE. Our proposal would give participating districts more flexibility over the use of supplemental instruction funds. The pilots would be funded through the existing grades 7 through 12 supplemental instruction program. Rather than claim these funds based on student-hours of attendance, however, a participating district would receive the amount it claimed for supplemental instruction in 2005-06 plus an adjustment for growth and inflation. These funds would comprise a block grant that would be available to support a wide variety of school and district activities to help students pass CAHSEE. In addition to the block grant funds, schools would remain eligible for a share of the \$40 million proposed for students who have already failed the test. These funds are sufficiently flexible that pilot districts would be able to merge these additional funds into the comprehensive pilot program.

Under our pilot approach, CDE would evaluate district proposals and select up to ten of the most promising models. We suggest that evaluation criteria of district pilot proposals focus on the overall district program to increase CAHSEE pass rates. Evaluation criteria could include (1) improving supplemental instruction's connection to each student's core academic

classes, (2) engaging parents in supporting their children to pass the test, (3) addressing articulation and planning between the high schools and middle schools in a district, and (4) increasing the impact of existing core classes in meeting the needs of students.

We also recommend requiring participating districts to match the supplemental instruction funds with Title 1 or Economic Impact Aid funds. These programs also are designed to meet the needs of lower performing students, and by adding these resources to the supplemental instruction funds, the pilots would reinforce the need to integrate supplemental instruction into the districts' programs and ensure that support for the pilot adequately addressed the needs of both middle and high school students.

Finally, we also suggest requiring CDE to evaluate the pilot programs. We think the pilots would need at least three years to establish the merits of this approach. Because it would take at least a year to solicit and choose districts who volunteer for the pilot program, no evaluation funds would be needed in the budget year. However, we think about \$200,000 a year would provide sufficient funding for a good evaluation. (The evaluation could be financed from federal funds.).

## INSTRUCTIONAL MATERIALS

*We recommend the Legislature eliminate the \$40 million augmentation in Proposition 98 funds for instructional materials. This recommendation takes into account the large increase in instructional materials funding schools will receive from State Lottery funds.*

The Governor's budget proposes almost \$402 million in Proposition 98 funding for the instructional materials block grant, a roughly \$40 million or 11 percent increase over the level provided in the current year. K-12 schools also receive funding from the State Lottery—an estimated \$190 million in both the current and budget year—allocated for instructional materials.

*Instructional Materials Receives Large and Unexpected Funding Increases in 2004-05 and 2005-06.* As shown in Figure 1, funding for instructional materials increased by 66 percent in 2004-05, due to augmentations in both the block grant program and lottery funds. Total funding for instructional materials is projected to increase an additional 14 percent in 2005-06, to a total of around \$550 million.

Most of this current-year funding increase is from lottery funds. Proposition 20, passed by the voters in 2000, requires that 50 percent of the growth in lottery revenues be directed toward the purchase of instructional materials for K-12 school districts and community colleges.

Based on information provided by the California Lottery Commission, the administration estimates that lottery revenues for education will increase by just over \$100 million in 2005-06. Schools and community colleges can expect to receive half of this increase for instructional materials, equating to a \$40 million increase for K-12 education. The Governor's budget assumes this funding level will continue in 2006-07. So, over the two years (2005-06 and 2006-07), schools will receive around \$80 million of unexpected funds for instructional materials. This is coupled with a higher-than-anticipated increase of \$35 million in lottery funds for 2004-05. Projections for lottery revenues were much lower when the Legislature made its 2005-06 budget decisions. Thus, the 2006-07 budget is the first opportunity for the state to reassess schools' material needs after this recent lottery windfall.

**Figure 1**  
**Instructional Materials Funding**

*(Dollars in Millions)*

	2003-04	2004-05	2005-06	2006-07
Instructional Materials Block Grant	\$175	\$333	\$361	\$402
Lottery funds for Instructional materials	115	150	190 <sup>a</sup>	190 <sup>a</sup>
<b>Totals</b>	<b>\$290</b>	<b>\$483<sup>b</sup></b>	<b>\$551</b>	<b>\$592</b>
<b>Year-to-year change</b>	—	<b>66%</b>	<b>14%</b>	<b>7%</b>

<sup>a</sup> LAO estimates based on lottery revenue projections.  
<sup>b</sup> In addition to the figure shown here, \$168 million in one-time funding was provided in this year.

*Eliminate Budget-Year Augmentation.* Given that the instructional materials program has received significant increases in the past two years, we believe further augmentation in 2006-07 is unnecessary. We recommend the Legislature reject the Governor's proposed instructional materials augmentation of roughly \$40 million and reduce the Proposition 98 appropriation by this amount. Because the Governor's budget spends above the Proposition 98 guarantee, this would score as savings to the state. If the Legislature chooses instead to redirect these funds to other Proposition 98 purposes, we offer in the "Economic Impact Aid" section of this chapter a possible use of these savings.



# INTRODUCTION

## *Higher Education*

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**T**he Governor's budget proposes a \$997 million General Fund augmentation for higher education in 2006-07. This represents a 10.3 percent increase from the revised 2005-06 amount. The Governor's proposal assumes no student fee increases at any of the three segments. It does, however, provide additional General Fund support to the University of California and the California State University in lieu of specified fee increases. The budget funds cost-of-living adjustments and enrollment growth at the three public higher education segments, as well as increased costs of the Cal Grant program.

### **Total Higher Education Budget Proposal**

As Figure 1 (see next page) shows, the 2006-07 budget proposal provides a total of \$34.4 billion from all sources for higher education. This amount is \$1.5 billion, or 4.5 percent, more than the Governor's revised current-year proposal. The total includes funding for the University of California (UC), the California State University (CSU), the California Community Colleges (CCC), Hastings College of the Law, the California Student Aid Commission, and the California Postsecondary Education Commission. Funded activities include instruction, research, and related functions, as well as other activities, such as providing medical care at UC hospitals and managing three major U.S. Department of Energy laboratories. The Governor's current-year estimates include a variety of mainly technical adjustments.

### **Major Funding Sources**

The 2006-07 budget proposal provides \$10.7 billion from the General Fund for higher education. This amount is \$997 million, or 10.3 percent, more than proposed current-year funding. The budget also projects that local property taxes will contribute \$1.9 billion for CCC in 2006-07, which reflects an increase of \$70 million, or 3.8 percent, from the revised current-year amount. (The figure masks an underlying growth in property tax revenues of 11 percent. The 3.8 percent growth reflects the end, in 2005-06, of the two-year property tax shift from local governments to schools.)

## Figure 1 Governor's 2006-07 Higher Education Budget Proposal

(Dollars in Millions)

	2005-06	2006-07	Change	Percent
<b>UC</b>				
General Fund	\$2,842.4	\$3,049.2	\$206.7	7.3%
Fee revenue	1,957.6	1,999.9	42.3	2.2
Subtotals	(\$4,800.0)	(\$5,049.1)	(\$249.1)	(5.2%)
All other funds	\$14,599.9	\$14,993.6	\$393.7	2.7%
<b>Totals</b>	<b>\$19,400.0</b>	<b>\$20,042.7</b>	<b>\$642.7</b>	<b>3.3%</b>
<b>CSU</b>				
General Fund	\$2,597.5	\$2,775.8	\$178.3	6.9%
Fee revenue	1,205.3	1,231.3	26.0	2.2
Subtotals	(\$3,802.7)	(\$4,007.1)	(\$204.3)	(5.4%)
All other funds	\$2,198.9	\$2,190.5	-\$8.4	-0.4%
<b>Totals</b>	<b>\$6,001.7</b>	<b>\$6,197.6</b>	<b>\$196.0</b>	<b>3.3%</b>
<b>CCC</b>				
General Fund <sup>a</sup>	\$3,457.2	\$3,958.1	\$500.9	14.5%
Local property tax	1,829.7	1,899.3	69.6	3.8
Fee revenue	347.9	358.4	10.4	3.0
Subtotals	(\$5,634.9)	(\$6,215.8)	(\$581.0)	(10.3%)
All other funds <sup>b</sup>	\$272.2	\$260.9	-\$11.3	-4.2%
<b>Totals</b>	<b>\$5,907.0</b>	<b>\$6,476.7</b>	<b>\$569.7</b>	<b>9.6%</b>
<b>CSAC</b>				
General Fund	\$752.5	\$861.6	\$109.2	14.5%
All other funds	817.5	768.4	-49.0	-6.0
<b>Totals</b>	<b>\$1,569.9</b>	<b>\$1,630.0</b>	<b>\$60.1</b>	<b>3.8%</b>
<b>Other</b>				
General Fund	\$10.4	\$12.2	\$1.8	17.3%
Fee revenue	26.3	26.4	0.1	0.4
All other funds	21.2	17.8	-3.4	-16.0
<b>Totals</b>	<b>\$57.9</b>	<b>\$56.4</b>	<b>-\$1.5</b>	<b>-2.6%</b>
<b>Grand Totals</b>				
General Fund	\$9,659.9	\$10,656.9	\$997.0	10.3%
Fee revenue	3,537.2	3,616.0	78.9	2.2
Local property tax	1,829.7	1,899.3	69.6	3.8
All other funds	17,909.7	18,231.2	321.5	1.8
<sup>a</sup> Excludes teachers' retirement funds and bond payments. <sup>b</sup> Excludes other funds maintained in local budgets.				

Student fee revenue at all the public higher education segments accounts for \$3.6 billion of proposed expenditures. This is \$78.9 million, or 2.2 percent, greater than student fee revenue in the current year. This increase is primarily due to assumed enrollment growth at all three segments. (The Governor assumes no increase in student fee levels at any of the segments.) The budget also includes \$18.2 billion in other funds, which is an increase of \$322 million, or 1.8 percent. About \$16 billion of this amount constitutes nonstate revenue—including federal funding and private contributions to the universities. The remainder is made up of various state revenues, including lottery and tobacco funds. In addition to the amounts reflected in Figure 1, local community colleges are projected to receive an additional \$2 billion from locally budgeted resources. (These funds are identified in the “California Community Colleges” section of this chapter.)

### **Funding by Segment**

For UC, the budget proposes General Fund appropriations of \$3 billion, which is \$207 million, or 7.3 percent, more than the proposed current-year estimate. The other major source of funding for UC’s educational programs is student fee revenue. This is projected to total \$2 billion in 2006-07, which is 2.2 percent above the current-year estimate. When General Fund and fee revenue are combined, UC’s budget would increase by 5.2 percent.

For CSU, the budget proposes \$2.8 billion in General Fund support, which is an increase of \$178 million, or 6.9 percent, from the revised current-year level. Fee revenue would increase by \$26 million, or 2.2 percent, to \$1.2 billion. Total General Fund and fee revenue combined would increase by 5.4 percent.

For CCC, the Governor’s budget proposes \$4 billion in General Fund support, which is \$501 million, or 14.5 percent, above the current-year amount. Local property tax revenue (the second largest source of CCC funding) would increase by 3.8 percent, to \$1.9 billion. Fee revenue would provide an additional \$358 million, reflecting an increase of \$10.4 million, or 3 percent. Combined, these three sources of district apportionments (General Fund support, property taxes, and fee revenue) would amount to \$6.2 billion, which reflects an increase of \$581 million, or 10.3 percent.

### **Major Cost Drivers for Higher Education**

Annual base adjustments for higher education funding generally arise from three major factors: (1) enrollment growth, (2) inflation, and (3) student fee levels. Specifically, these factors influence costs in the following ways:

**Enrollment Growth.** For UC and CSU, the state uses a “marginal cost” formula that estimates the added cost imposed by enrolling one additional full-time equivalent student. This estimate includes instructional costs (such as faculty salaries and teaching assistants), related educational costs (such as instructional materials and libraries), administrative costs, and student services. Because faculty (particularly at UC) spend part of their time performing noninstructional activities such as research, the marginal cost formula “buys” part of these other activities with each additional student enrolled. A similar approach is used for funding enrollment growth at community college, although there are technical differences in how funding is calculated. (For 2006-07, the Governor proposes changes to marginal cost funding, as we discuss in the “UC and CSU Enrollment Growth and Funding” section of this chapter.)

**Inflation.** Higher education costs rise with general price increases. For example, inflation increases the costs of supplies, utilities, and services that are purchased by campuses. In addition, inflation creates pressure to provide cost-of-living adjustments to maintain the buying power of faculty and staff salaries.

**Student Fees.** Student fees comprise a portion of total revenue available to the segments. When fees are increased, this creates new revenue that either can substitute for General Fund revenue (thus creating General Fund savings) or increase total funding for the higher education segments. Either way, fee increases reduce the level of General Fund support required to provide a given level of services.

## **Major Budget Changes**

The Governor’s higher education budget proposal results primarily from base increases (somewhat higher than inflation), enrollment increases, and increased financial aid costs. Figure 2 shows the major General Fund budget changes proposed by the Governor for the three segments.

**Enrollment Growth.** The Governor proposes enrollment increases from budgeted levels of 2.5 percent at UC and CSU, and 3 percent at CCC. Figure 3 (see page E-172) shows enrollment changes at the three segments. We discuss proposed enrollment levels in more detail later in this chapter.

Figure 2

## Higher Education Proposed Major General Fund Changes

<b>University of California</b>	<b>Requested:</b> <b>Increase:</b>	<b>\$3 billion</b> <b>\$207 million (+7.3%)</b>
<p><b>Base Augmentations:</b> Provides \$80.5 million for a 3 percent base funding increase, plus an additional \$75 million for a further base augmentation in lieu of a student fee increase. Combined, these two augmentations increase the university's base General Fund support by 5.8 percent.</p> <p><b>Enrollment Growth:</b> Provides \$52 million for 2.5 percent enrollment growth, which is sufficient to fund 5,149 additional full-time equivalent (FTE) students.</p> <p><b>Outreach Reductions:</b> Eliminates \$17.3 million in state funding for outreach programs.</p>		
<b>California State University</b>	<b>Requested:</b> <b>Increase:</b>	<b>\$2.8 billion</b> <b>\$178 million (+6.9%)</b>
<p><b>Base Augmentations:</b> Provides \$75.8 million for a 3 percent base funding increase, plus an additional \$54.4 million for a further base augmentation in lieu of a student fee increase. Combined, these two augmentations increase the university's base General Fund support by 5.2 percent.</p> <p><b>Enrollment Growth:</b> Provides \$57.7 million for 2.5 percent enrollment growth, which is sufficient to fund 8,490 additional FTE students. (This estimate reflects a proposed reduction in the number of units defining an FTE graduate student.)</p> <p><b>Outreach Reductions:</b> Eliminates \$7 million in state funding for outreach programs.</p>		
<b>California Community Colleges</b>	<b>Requested:</b> <b>Increase:</b>	<b>\$4 billion</b> <b>\$501 million (+14.5%)</b>
<p><b>Cost-of-Living Adjustments (COLAs):</b> Provides \$280 million for a COLA of 5.18 percent for apportionments and selected categorical programs.</p> <p><b>Enrollment Growth:</b> Provides \$154 million for 3 percent enrollment growth (about 35,000 FTE students) as well as growth in selected categorical programs.</p> <p><b>Other Augmentations:</b> Provides a final installment of \$130 million to achieve the statutory equalization target for all districts. Also provides an additional \$30 million for workforce development programs and an additional \$9.6 million for services to disabled students.</p>		

### Figure 3 Higher Education Enrollment

#### Full-Time Equivalent (FTE) Students

	Actual 2004-05	Budgeted 2005-06	Proposed 2006-07	Change	
				Amount	Percent
<b>University of California</b>					
Undergraduate	155,342	159,730	163,534	3,804	2.4%
Graduate	32,596	33,860	35,005	1,145	3.4
Health sciences	13,465	12,386	12,586	200	1.6
<b>UC Totals</b>	<b>201,403</b>	<b>205,976</b>	<b>211,125<sup>a</sup></b>	<b>5,149</b>	<b>2.5%</b>
<b>California State University</b>					
Undergraduate	274,940	284,252	291,359	7,107	2.5%
Graduate/postbaccalaureate	46,398	47,971	49,170	1,199	2.5
<b>CSU Totals</b>	<b>321,338</b>	<b>332,223</b>	<b>340,529<sup>b</sup></b>	<b>8,306</b>	<b>2.5%</b>
<b>California Community Colleges</b>					
	1,123,910	1,168,417	1,203,469	35,052	3.0%
<b>Hastings College of the Law</b>					
	1,268	1,250	1,250	—	—
<b>Grand Totals</b>	<b>1,647,919</b>	<b>1,707,866</b>	<b>1,756,373</b>	<b>48,507</b>	<b>2.8%</b>

<sup>a</sup> For comparability with the current year, this amount does not reflect an increase in UC's nursing program (as required under Chapter 592, Statutes of 2005 [SB 73, Committee on Budget and Fiscal Review]). The Governor's budget identifies a total of 211,255 FTE students.

<sup>b</sup> For comparability with the current year, this amount does not reflect an increase in CSU's nursing program (as required under Chapter 592) and the Governor's redefinition of a full-time CSU graduate student. The Governor's budget identifies a total of 348,262 FTE students.

*Student Fees.* For all three segments, the Governor proposes no increases in student fees. (See Figure 4 for the current fee levels at the segments.) As noted earlier, the Governor proposes to provide UC and CSU with General Fund augmentations in lieu of fee increases the segments had adopted for 2006-07. While no such fee “buyout” is formally proposed for CCC, implicitly a fee increase equal to CCC’s inflation adjustment is “bought out.” We discuss student fees in more detail later in this chapter.

**Figure 4****Annual Education Fees for Full-Time Resident Students<sup>a</sup>**

	<b>Actual 2004-05</b>	<b>Actual 2005-06</b>	<b>Proposed<sup>b</sup> 2006-07</b>
<b>University of California<sup>c</sup></b>			
Undergraduate	\$5,684	\$6,141	\$6,141
Graduate	6,269	6,897	6,897
<b>Hastings College of the Law</b>	\$18,750	\$19,725	\$19,725
<b>California State University</b>			
Undergraduate	\$2,334	\$2,520	\$2,520
Teacher Education	2,706	2,922	2,922
Graduate	2,820	3,102	3,102
<b>California Community Colleges</b>	\$780	\$780	\$780

<sup>a</sup> Fees shown do not include campus-based fees.

<sup>b</sup> Governor proposes that 2006-07 fees remain unchanged from 2005-06 levels.

<sup>c</sup> The University of California charges special fee rates for 12 professional programs, such as medicine and nursing. We describe these fee rates in the "Student Fees" section of this chapter.

*Student Financial Aid.* The Governor proposes \$51 million in additional funding for Cal Grants. About \$39 million of this amount would fund increased participation in the Cal Grant program, and \$12 million would restore an earlier reduction in Cal Grant awards for needy students attending private institutions. The Governor's budget provides another \$51 million to backfill a reduction in grant support from the Student Loan Operating Fund (SLOF). For 2006-07, the Governor is proposing no transfer of monies from SLOF to the Cal Grant program. We discuss these augmentations in the "California Student Aid Commission" write-up of this chapter.



# BUDGET ISSUES

*Education*

## INTERSEGMENTAL: PROTECTING LEGISLATIVE PRIORITIES IN HIGHER EDUCATION

The Governor's budget for the University of California (UC) and the California State University (CSU) generally follows a six-year agreement he developed with the segments in spring 2004. This "compact" (which is not in statute and which has not been acted on by the Legislature) lays out specific annual increases in enrollment, student fees, and base funding, among others.

The Legislature has expressed its general higher education priorities in the *Master Plan for Higher Education*, as well as various statutory provisions. However, there is no clear link between the funding priorities specified in the compact and higher education needs under the *Master Plan*. The Legislature has the opportunity to reflect its priorities through appropriations in the annual budget act. In this writeup we (1) outline the basic choices the Legislature faces each year with regard to the higher education budget and (2) offer our specific recommendations on these key issues.

### **Higher Education Budget—Key Choices**

Although the state's higher education budget involves billions of dollars of expenditures and a variety of interrelated issues, the Legislature's budgetary choices can be considered in a methodical and straightforward manner. Below, we outline the three basic steps in the Legislature's decision making process.

**Adjust Base Budgets.** In any given year, funding contained in a segment's base budget may need to be adjusted to account for one-time costs or anomalies. For example, if the base budget contained funds for expected enrollment growth that never materialized, it could be appropriate to reduce that segment's enrollment funding to match actual experience. Similarly, the inclusion of funds for a one-time purpose (such as start-up costs for a new campus) would normally be backed out of a segment's base budget for the following year.

**Determine New Higher Education Costs the Budget Should Accommodate.** Given the state's current fiscal circumstances, we believe that first priority for budget increases should be given to those new costs that are necessary to maintain existing services. The largest costs in this area typically include enrollment growth and inflationary adjustments. After addressing these base issues, the Legislature then typically considers proposals for program expansions or new programs. The sum of these various changes results in new costs to each higher education segment or agency.

**Determine How Costs Should Be Covered.** After making decisions about the total budget for each segment, the Legislature then has to decide how these costs are to be covered by various funding sources. In general, education-related programs at the three higher education segments are funded with a combination of state General Fund support and student fee revenue. These funds are essentially interchangeable. The key decision for the Legislature in this area is: What share of total costs should students (and their families) bear?

## Specific LAO Recommendations

Based on the approach described above, we recommend the Legislature address specific components of the Governor's budget proposal as follows:

**Fund Expected Levels of Enrollment Growth.** The Governor's compact calls for UC and CSU's funded enrollment to grow by 2.5 percent each year through 2011. This ignores changes in population growth, participation rates, and other factors that affect enrollment. Indeed, the Governor's Department of Finance projects that enrollment will grow by a much smaller percentage in 2006-07. In the "UC and CSU Enrollment Growth and Funding" section later in this chapter, we recommend the Legislature fund 2 percent enrollment growth for each segment in 2006-07.

**Fund Cost Increases Caused by Inflation.** The Governor's compact calls for UC and CSU's base budgets to increase by predetermined percentages each year without regard for actual inflationary effects. As we

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estimate that inflation will cause costs to increase about 3.3 percent in 2006-07, we recommend that level of increase for the two segments in the budget year.

**Reject Concept of Fee “Buyout.”** The Governor’s compact calls for fee increases at UC and CSU of 8 percent for undergraduate students and 10 percent for graduate students. The UC Regents and CSU Trustees have already approved those increases for 2006-07. Now, however, the Governor’s budget proposal calls for those increases to be reversed, and proposes a General Fund augmentation of \$130 million to make up for (or “buy out”) the additional fee revenue that would have been collected.

The notion of a fee buyout makes no sense under the budget approach we have recommended above. In effect, the Governor proposes an unallocated General Fund increase that is not tied to any identified need. The only reason the fee buyout is set at \$130 million is because that is the amount of money that would have been raised by the particular fee increases originally envisioned by the Governor’s compact. If the Governor’s compact had envisioned larger fee increases, the buyout would cost more; if the Governor’s compact had envisioned smaller fee increases, the buyout would cost less.

As suggested above, we think decisions about the level of higher education funding and the shares of costs borne by the state and students should be addressed as two separate questions. Whatever the amount of new higher education costs, the Legislature will need to decide what share of these costs should be borne by the state and by students. As we discuss later in this chapter, we recommend that the share of costs borne by students remain at its current level. This would require modest fee increases at UC and CSU (although they would be less than half of the fee levels called for in the compact). But even if the Legislature desired not to increase student fees (and thus to allow students’ share of cost to decline), this would not require a fee buyout. Instead, it would simply leave a larger share of identified cost increases to be covered by state General Fund support, or the Legislature could take steps to reduce or eliminate other cost increases.

**Redirect General Fund Savings.** We estimate that the Legislature could free up about \$145 million in General Fund support (relative to the Governor’s budget) by funding the needs we have identified for UC and CSU rather than the somewhat arbitrary amounts generated by the Governor’s compact. These savings would be available for the Legislature to address other important priorities not addressed in the Governor’s budget. For example, the Legislature could apply these savings toward the state’s structural budget deficit (which we estimate to be about \$6 billion under the Governor’s budget proposal). The Legislature could also use

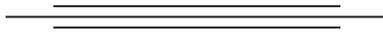
this funding to address unfunded priorities in other areas of the budget. If the Legislature wished to redirect these General Fund savings within the higher education budget, it could consider various options, such as:

- ***Expand Cal Grant Programs.*** The Legislature could expand access for financially needy students by augmenting funding for certain aspects of the Cal Grant programs. For example, in the California Student Aid Commission section of this chapter, we recommend the Legislature adopt a policy that aligns the value of Cal Grants for needy students at private colleges with the subsidy the state provides to needy students at public universities. While the Legislature could gradually increase the private Cal Grant in line with such a policy, we estimate that fully implementing such a policy in 2006-07 would cost about \$11 million more than the amount provided in the Governor's budget. As another example, the Legislature could expand the Competitive Cal Grant program, for which demand far exceeds the number of authorized awards. In 2005-06, for example, more than 135,000 eligible applicants competed for the state's 22,500 new Competitive Cal Grants—meaning only 1 in 6 qualified financially needy applicants received an award. We estimate that doubling the number of new awards would cost about \$62 million.
- ***Implement College Preparation Block Grant.*** The Governor's budget does not include state funding for outreach programs at UC and CSU. We note that the Legislature has generally been supportive of the need for such programs, although it has also expressed concerns about the effectiveness of particular outreach programs. To address both of these concerns, the Legislature could establish a college preparation block grant targeted at K-12 school districts with low college participation rates. Districts would have the flexibility to use these funds to enact their own programs, or to contract with an external provider, in an effort to better prepare their students for college based on local needs. We have described this type of approach in our *Analysis of the 2004-05 Budget Bill* (please see pages E-176 through E-178). Given that the Governor's proposal would delete about \$24 million from UC and CSU's outreach programs, the Legislature might consider restoring a portion of that amount for a college opportunity block grant. We believe this block grant approach focused on students in K-12 districts would be better able to achieve desired results than the existing university-focused approach.

## **What About the Budget for Community Colleges?**

Although it constitutes a vital part of the state's system of higher education, the California Community Colleges (CCC) are excluded from the Governor's higher education compact. Many of the budgeting decisions the Legislature faces for UC and CSU, however, are affected by and will affect CCC. For example, funding for enrollment growth at one segment can affect enrollment demand at another segment due to student transfers between CCC and the universities.

In general, we recommend the Legislature take a similar approach to CCC's budget as it takes to UC and CSU's budgets. For example, the interaction of fees and General Fund support for all three segments is functionally similar, despite technical differences. At the same time, most funding for CCC is subject to Proposition 98, and thus augmentations and reductions to CCC's budget will affect total Proposition 98 spending by the state. For this reason, we discuss priorities for CCC funding within the "Crosscutting" section, "Proposition 98 Priorities."



## INTERSEGMENTAL: UC AND CSU ENROLLMENT GROWTH AND FUNDING

*The Governor's budget proposes \$110 million to fund 2.5 percent enrollment growth at the University of California (UC) and the California State University (CSU). This amount would provide \$10,103 in General Fund support for each additional student at UC and \$6,792 for each additional student at CSU. (The proposed budget also provides \$149 million for a 3 percent enrollment increase at the California Community Colleges.) In this write-up, we (1) review recent enrollment trends at UC and CSU, (2) analyze the Governor's proposed enrollment growth and funding rates for 2006-07, and (3) recommend alternatives to those rates.*

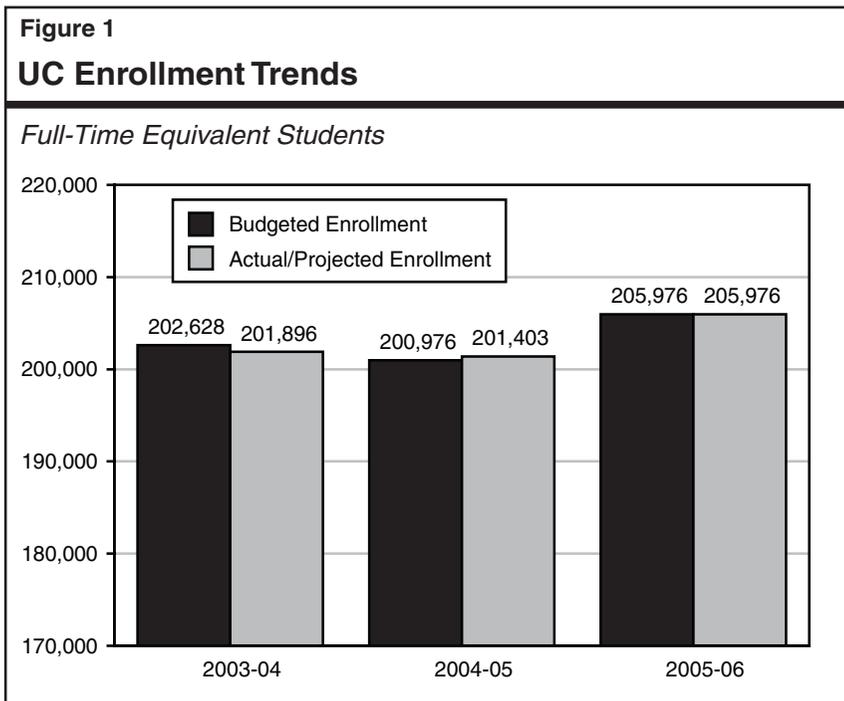
### RECENT ENROLLMENT TRENDS

The Legislature provides funding in the annual budget act to support specific enrollment levels at each segment. Typically, this includes funding for enrollment growth. Because the number of eligible students enrolling at the segments cannot be predicted with complete accuracy, in any given year the University of California (UC) and the California State University (CSU) typically serve slightly more or less full-time equivalent (FTE) students than budgeted. Recently, however, actual enrollment has deviated more significantly from funded levels. In recognition of this disconnect between the number of students funded at each segment and the number of students actually enrolled, the Legislature adopted provisional language as part of the annual budget acts for 2004-05 and 2005-06 to ensure that UC and CSU use enrollment funding only for enrollment. Specifically, the language requires that the segments report in the spring on whether they met their enrollment target for that year. The language specifies that enrollment totals shall not include FTE students in non-state supported

summer instruction programs. If a segment does not meet its goal, the Director of the Department of Finance (DOF) is to revert to the General Fund the total amount of enrollment funding associated with the unmet enrollment. As we discuss below, \$15.5 million in enrollment funding provided to CSU in 2004-05 reverted to the General Fund last year.

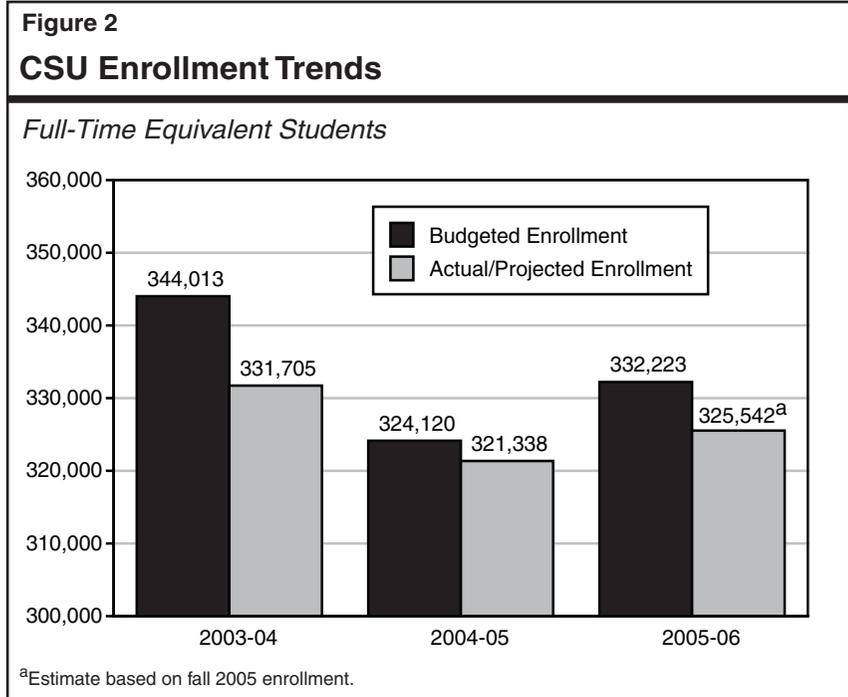
### UC Has Generally Met Enrollment Targets

As indicated in Figure 1, UC enrolled roughly 400 *more* FTE students in 2004-05 than it was budgeted to serve for that year. For the current year, the 2005-06 Budget Act provides \$379 million to UC to enroll 5,000 additional FTE students above the 2004-05 funded enrollment level, for a total of 205,976 FTE students (excluding students in non-state supported summer instruction programs). As of January 2006, the university estimates that it will meet this current-year enrollment target. The 2005-06 Budget Act requires UC to report to the Legislature by March 15, 2006 on whether in fact it met the target.



## CSU Has Not Been Meeting Enrollment Targets

As shown in Figure 2, CSU has not met its budgeted enrollment targets in the previous two years (2003-04 and 2004-05). In other words, the state provided funding for more students than the university enrolled. Based on recent trends and preliminary data, CSU appears unlikely to meet its 2005-06 enrollment target as well.



***Did Not Meet 2003-04 Enrollment Target; \$81 Million Redirected to Other CSU Programs.*** As we discussed in our *Analysis of the 2004-05 Budget Bill*, CSU enrolled about 12,000 fewer FTE students than it was funded to serve in 2003-04. Instead, the university redirected about \$81 million of enrollment growth funding to essentially “backfill” budget reductions approved by the Legislature in other program areas. In effect, CSU campuses reduced spring 2004 admissions in order to help “free up” enrollment funds.

***Did Not Meet 2004-05 Enrollment Target; \$15.5 Million Reverted to General Fund.*** In recognition that CSU shifted some of its enrollment funding to backfill base budget reductions in 2003-04, the 2004-05 budget essentially “rebenched” CSU’s enrollment level downward to 324,120 FTE students. This amount was roughly 20,000 FTE students *fewer* than

the number of students funded the year before. (In fact, the enrollment target was less than the number of students actually served in 2003-04.) Although the enrollment target was lowered, CSU retained the associated enrollment funding from the prior year in its base budget for 2004-05, thus permanently backfilling the earlier General Fund reductions.

Despite the downward rebenching of CSU's enrollment target, the university again fell short of its 2004-05 enrollment target by about 2,800 FTE students (see Figure 2). The university states that the reasons for this shortfall include:

- **Increased Degree Conferrals.** From 2002-03 to 2003-04, the number of students that received a CSU degree—bachelor's, master's, or joint doctoral—increased sharply by about 5,877 students or 8 percent (from 76,755 to 82,592 students). The university states that this increase, most of which occurred in the spring, significantly reduced the number of students campuses assumed would continue in fall 2004.
- **Decreased Demand for Teacher Preparation.** From fall 2003 to fall 2004, the number of postbaccalaureate students enrolled in CSU teacher preparation programs decreased by 1,717 FTE students (from 14,746 to 13,029 FTE students). The university asserts that this decrease occurred in part due to the (1) softening of the market for elementary school teachers in California because of K-12 budget constraints and (2) elimination of state-funded teacher recruitment programs.

As required under provisional language in the *2004-05 Budget Act*, the funding associated with CSU's unmet enrollment target (\$15.5 million) reverted to the General Fund on a one-time basis. This funding was restored to CSU's base budget for 2005-06, thus providing a second opportunity and expectation to enroll the associated 2,800 FTE students.

**Unlikely to Meet 2005-06 Enrollment Target.** For the current year, the *2005-06 Budget Act* provided \$50.8 million to CSU to enroll about 8,100 additional FTE students above the 2004-05 funded enrollment level, for a total of 332,223 FTE students. (This total is about 11,000 more FTE students than it actually enrolled in 2004-05, as shown in Figure 2.)

According to the Chancellor's Office, the estimated enrollment for fall 2005 is 325,542 FTE students. This is 6,681 FTE students below the university's current-year enrollment target of 332,223 FTE students. Although CSU's final enrollment numbers for 2005-06 will not be known until May 1, 2006, the fall estimate does suggest that CSU is unlikely to meet its enrollment target. Moreover, the university could end up serving fewer students than it did two years ago (2003-04), despite continued

annual increases in enrollment funding. In a later section, we propose permanently adjusting CSU's base budget if it does not meet its 2005-06 enrollment target.

## GOVERNOR'S BUDGET PROPOSAL

The budget requests a total of \$110 million in General Fund support to increase enrollment at UC and CSU. The \$110 million total consists of:

**UC (\$52 Million).** The Governor's budget provides \$52 million to UC for 2.5 percent enrollment growth (or 5,149 FTE students) above current-year budgeted enrollment. (This assumes a marginal General Fund cost of \$10,103 per additional student.) The budget also assumes UC will enroll an additional 130 FTE students in its entry-level master's nursing program, as required under Chapter 592, Statutes of 2005 (SB 73, Committee on Budget and Fiscal Review). This results in a budget-year total enrollment target for UC of 211,255 FTE students.

**CSU (\$57.7 Million).** The Governor proposes to change the definition of a full-time graduate student load at CSU from 15 units to 12 units, which would be consistent with current practice at UC and most other higher education institutions. Under this new definition, CSU's 29,543 graduate FTE students (excluding postbaccalaureates) budgeted for the current year is redefined as 36,929 FTE students. As a result, the proposed budget "rebases" CSU's current-year budgeted total enrollment from 332,223 to 339,609 FTE students. Building upon this rebased current-year enrollment, the Governor's budget for 2006-07 provides \$57.7 million to CSU for 2.5 percent enrollment growth or 8,490 FTE students. (This assumes a marginal General Fund cost of \$6,792 per additional student.) The budget also assumes CSU will enroll an additional 163 FTE students in its entry-level master's nursing program, as required under Chapter 592. This results in a proposed budget-year total enrollment target for CSU of 348,262 FTE students.

For the California Community Colleges (CCC), the Governor's budget includes \$149 million (Proposition 98) for 3 percent enrollment growth (or 35,052 FTE students) above current-year budgeted enrollment. This is considerably higher than the statutory growth rate of 1.74 percent. This results in a budget-year enrollment target for CCC of 1,203,469 FTE students. (We further discuss enrollment at CCC, which is funded somewhat differently from UC and CSU, in the "California Community Colleges" write-up of this chapter.)

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## DETERMINING ENROLLMENT GROWTH FUNDING FOR 2006-07

One of the principal factors influencing the state's higher education costs is the number of students enrolled at the three public higher education segments. Typically, the Legislature and Governor provide funding each year for a particular level of enrollment growth at each of the state's public higher education segments. This funding is based upon a per-student funding rate multiplied by the expected number of additional FTE students. For example, the Governor's budget proposes a per-student funding rate of \$10,103 for 5,149 additional students at UC, at a total cost of \$52 million.

As noted earlier, the proposed budget includes a total of \$110 million for 2.5 percent enrollment growth at UC and CSU. In reviewing the Governor's enrollment growth funding proposal, the Legislature must determine the following:

- How much enrollment growth (or additional students) to fund at UC and CSU for 2006-07.
- How much General Fund support to provide the segments for each additional student (commonly known as the "marginal cost").

Below, we examine each of these issues and make recommendations concerning the Governor's enrollment funding proposals.

### HOW MUCH ENROLLMENT GROWTH SHOULD BE FUNDED?

Determining the amount of additional enrollment to fund each year can be difficult. Unlike enrollment in compulsory programs such as elementary and secondary school, which corresponds almost exclusively with changes in the school-age population, enrollment in higher education responds to a variety of factors. Some of these factors, such as population growth, are beyond the control of the state. Others, such as higher education funding levels and fees, stem directly from state policy choices. As a result, enrollment projections must consider the interaction of demographic changes and state policies that influence enrollment demand.

There are two main factors influencing enrollment growth in higher education:

- **Population Growth.** Other things being equal, an increase in the state's college-age population causes a proportionate increase in those who are eligible to attend each segment. Population growth, therefore, is a major factor driving increases in college enrollment.

Most enrollment projections begin with estimates of growth in the student “pool” (18- to-24-year old population) which for the rest of the decade is expected to range from 1.2 percent to 2.6 percent annually.

- **Participation Rates.** For any subgroup of the general population, the percentage of individuals who are enrolled in college is that subgroup’s college participation rate. California’s participation rates are among the highest in the nation. Specifically, California ranks fourth in college enrollment among 18- to 24-year olds, and first among 25- to 49-year olds. However, predicting future participation rates is difficult because students’ interest in attending college is influenced by a number of factors (including student fee levels, availability of financial aid, and the availability and attractiveness of other postsecondary options).

## **Provide 2 Percent Enrollment Growth**

*Based on our demographic projections, we recommend the Legislature fund budgeted enrollment growth of 2 percent for the University of California and the California State University. Our proposal should allow the segments to easily accommodate enrollment growth next year due to increases in population, as well as modest increases in college participation.*

If college participation rates remain constant for all categories of students next year, we project that enrollment at UC and CSU will grow by roughly 1.4 percent from 2005-06 to 2006-07. (See accompanying text box for a description of the demographics-based methodology we employ to estimate future higher education levels.) Since this projection is driven solely by projected population growth, it serves as a starting point for considering how much enrollment to fund in 2006-07. In other words, the Legislature can evaluate how various related budget and policy choices could change enrollment compared to this baseline. We note that DOF’s Demographics Unit also develops baseline enrollment projections using demographically based projections of growth in the number of high school graduates and in the adult population. However, unlike our model, DOF also assumes changes in college participation rates. As a result, DOF projects that in the budget year (2006-07), enrollment at UC and CSU will grow by about 1.6 percent, which is still significantly *less* than the 2.5 percent budgeted enrollment growth rate proposed by the Governor.

Over the years, the Legislature has taken deliberate policy actions (such as funding student outreach programs and expanding the availability of financial aid) in an effort to increase college participation rates. Consistent with these actions, the state has provided funding for enrollment growth

in some of those years that significantly exceeded changes in the college-age population. In view of the Legislature's interest in increasing college participation, we recommend funding 2 percent enrollment growth at UC and CSU for the budget year. This is about 40 percent higher than our estimate of population-driven enrollment growth, and therefore should allow the segments to easily accommodate enrollment growth next year, due to increases in population, as well as modest increases in college participation.

Accordingly, we recommend that the Legislature reduce the Governor's proposed enrollment growth for UC and CSU from 2.5 percent to 2 percent. (In the next section on per-student funding rates, we discuss the General Fund savings associated with reducing the Governor's proposed growth rate.)

### **LAO Higher Education Enrollment Projections**

In our demographically driven model, we calculate the ethnic, gender, and age makeup of each segment's student population, and then project separate growth rates for each group based on statewide demographic data. For example, we estimate a distinct growth rate for Asian females between 18 and 24 years of age, and calculate the resulting additional higher education enrollment this group would contribute assuming constant participation rates. When all student groups' projected growth rates are aggregated together, we project that demographically-driven enrollment at the University of California and the California State University will grow annually between 1.4 percent and 1.8 percent from 2006-07 through 2010-11. In terms of the budget year (2006-07), we project enrollment growth of roughly 1.4 percent at the two university segments.

In addition to underlying demographics, enrollment growth is affected by participation rates—that is, the proportion of eligible students who actually attend the segments. Participation rates are difficult to project because they can be affected by a variety of factors—state enrollment policies, the job market, and changes in the financial situation of students and their families. We have assumed that California's participation rates will remain constant. This is because the state's rates have been relatively flat over recent years, and we are not aware of any evidence supporting alternative assumptions. We do acknowledge that participation rates could change to the extent that the Legislature makes various policy choices affecting higher education. As such, our projections provide a baseline reflecting underlying population trends.

## **Adjust CSU's Base Budget to Reflect Actual Enrollment**

*If the California State University (CSU) does not meet its current-year (2005-06) enrollment target, we recommend the Legislature remove the unused enrollment funding from CSU's base budget for 2006-07.*

As part of the 2005-06 Budget Act, the Legislature adopted provisional language requiring CSU to provide a preliminary report to the Legislature by March 15, 2006, and a final report by May 1, 2006, on whether it met its enrollment target. If CSU does not meet this goal, the Director of DOF is required to revert to the General Fund by May 15, 2006, the amount of enrollment funding associated with the share of the enrollment goal that was not met. However, the budget language requires only that such a reversion be on a one-time basis and apply only to 2005-06 (as was the case with the enrollment funds that were reverted in 2004-05). This means that any enrollment funding not used for enrollment in 2005-06 would return to the base in 2006-07, thus providing "room" for CSU to increase enrollment more than 2.5 percent beyond its current-year level. To put it another way, CSU would have funding in the budget year to accommodate some enrollment growth even without any new growth funding.

As we discussed in an earlier section, recent enrollment trends and data on fall 2005 enrollments suggest that CSU may not meet its current-year enrollment target of 332,223 FTE students. This would trigger a current-year reversion of unused growth funding. If this happens, we recommend the Legislature reduce CSU's budget for 2006-07 by an equal amount (which could range in the tens of millions of dollars). This would also require rebenching CSU's budgeted enrollment levels to reflect the number of FTE students actually enrolled in 2005-06. This would set up more realistic enrollment expectations for CSU and reduce the ongoing disconnect between enrollment funding and actual enrollment. Moreover, the Legislature could use the freed up funds to address other priorities in the budget year, including addressing the state's budget problem. Once we review CSU's enrollment report this spring, we will advise the Legislature during budget hearings as to any specific actions we recommend.

## **Ensuring Enrollment Targets Are Met**

*We recommend the Legislature modify provisional language relating to enrollment targets for both the University of California and the California State University, in order to protect its priority to increase state-supported higher education enrollment.*

The proposed budget bill for 2006-07 includes provisions that specify enrollment targets for both UC and CSU, which are based on (1) the Governor's proposed 2.5 percent enrollment growth, (2) a redefinition of CSU graduate FTE students, and (3) a statutorily required increase in

nursing students. The provisions require that the amount of enrollment funding associated with any enrollment shortfall revert to the General Fund. Unlike the language adopted in 2005-06, however, the Governor's proposed new language does not specify that the enrollment targets and the segments' enrollment reports must exclude students in non-state supported summer instruction programs. Since these programs do not receive enrollment growth funding from the state, past practice has been to exclude these students from state enrollment targets. (We discuss this issue further in the "Year-Round Operations at UC and CSU" write-up later in this chapter.)

In view of the above, we recommend modifying the proposed budget bill language to exclude non-state supported summer students from the enrollment target. This would ensure that enrollment growth funding was used strictly to increase the number of students enrolled at the segments. We further recommend clarifying that CSU's enrollment target reflects a rebasing of graduate FTE students, as proposed by the Governor. The modified language below also assumes our proposed 2 percent enrollment growth and an increase in nursing students (as required under Chapter 592). Specifically, for UC we recommend the Legislature modify Provision 13 of Item 6440-001-0001 to read:

The amount appropriated in Schedule (1) includes funding for the University of California (UC) to enroll a total of 210,226 full-time equivalent (FTE) students (excluding summer students for which campuses only received funding in 2005-06 to buy down their summer fees). The Legislature expects the UC to enroll this number of FTE students during the 2006-07 academic year. The UC shall report to the Legislature by March 15, 2007, on whether it has met the 2006-07 enrollment goal. For purposes of this provision, enrollment totals shall not include FTE summer students for which campuses only received funding to buy down their summer fees. If the UC does not meet its enrollment goal, the Director of Finance shall revert to the General Fund by April 1, 2007, the total amount of enrollment funding associated with the share of the enrollment goal that was not met.

Similarly, for CSU we also recommend modifying Provision 7 of Item 6610-001-0001 as follows:

The amount appropriated in Schedule (1) includes funding for the California State University to enroll a total of 346,564 full-time equivalent (FTE) students (excluding summer students for which campuses only received funding in 2005-06 to buy down their summer fees), based on a graduate student FTE unit load of 12 units per term. The Legislature expects the university to enroll this number of FTE students during the 2006-07 academic year. The university shall provide a preliminary report to the Legislature by March 15, 2007, and a final report by May 1, 2007, on whether it has met the 2006-07 enrollment goal. For purposes of this provision, enrollment totals shall not include FTE summer students

for which campuses only received funding to buy down their summer fees. If the university does not meet its enrollment goal, the Director of Finance shall revert to the General Fund by May 15, 2007, the total amount of enrollment funding associated with the share of the enrollment goal that was not met.

## **HOW MUCH GENERAL FUND SUPPORT SHOULD BE PROVIDED FOR EACH ADDITIONAL STUDENT?**

In addition to deciding the number of additional FTE students to fund in 2006-07, the Legislature must also determine the *amount* of funding to provide for each additional FTE student at UC and CSU. Given past practice, this funding level would be based on the marginal cost imposed by each additional student for additional faculty, teaching assistants (TAs), equipment and various support services. The marginal cost is less than the average cost because it reflects what are called “economies of scale”—that is, it excludes certain fixed costs (such as central administration) which may change very little as new students are added to an existing campus. The marginal costs of a UC and CSU education are funded from the state General Fund and student fee revenue. (A similar, but distinct, approach is used for funding enrollment growth at community colleges.)

As part of the 2005-06 budget package, the Legislature adopted language directing our office and DOF to jointly convene a working group to review the current marginal cost methodology for funding new enrollments at UC and CSU and to provide recommendations that would be considered for the 2006-07 budget. The working group met throughout the summer and fall, but was unable to reach consensus on specific modifications to the current methodology for the budget year, as envisioned by the Legislature. As we discuss below, the Governor’s budget proposes an entirely new marginal cost methodology that was independently developed outside of the working group. Based on his proposed methodology, which differs significantly from the current one, the Governor’s budget provides \$10,103 in General Fund support for each additional student at UC and \$6,792 for each additional student at CSU. In this section, we analyze the Governor’s proposed methodology and recommend an alternative approach.

### ***Development of Current Marginal Cost Methodology***

For many years, the state has funded enrollment growth at UC and CSU based on the marginal cost of instruction. However, the formula used to calculate the marginal cost has evolved over the years. (The nearby text box provides a timeline of key state actions pertaining to marginal cost funding.) In general, the state has sought to simplify the way it funds enrollment

growth and more accurately reflect costs. As we discuss below, the state has moved from utilizing a large number of complex funding formulas for each segment to a more simplified approach for calculating enrollment funding that is more consistent across the two university segments.

## **UC and CSU Used Different Methodologies Before 1992**

From 1960 through 1992, CSU's enrollment growth funding was determined by using a separate marginal cost rate for each type of enrollment category (for example, lower-division lecture courses). In other words, the different marginal cost formulas took into account education levels—lower division, upper division, and graduate school—and “instructional modes” (including lecture, seminar, laboratories, and independent study). Each year, CSU determined the number of additional academic-related positions needed in the budget year (based on specific student-faculty ratios) to meet its enrollment target. These data were used to derive the separate marginal cost rates. Unlike the current methodology, the marginal cost formula before 1992 did not account for costs related to student services and institutional support. The state made funding adjustments to these budget rates independent of enrollment funding decisions.

### **Chronology of Marginal Cost Funding**

- Pre-1992:** The University of California (UC) and the California State University (CSU) use different methodologies to calculate marginal cost of instruction.
- 1992:** Legislature and Governor suspend marginal cost funding practices for UC and CSU and do not provide funding specifically for enrollment growth.
- 1994:** Legislature expresses intent to return to use of marginal cost funding and requests review of 1991-92 marginal cost formulas.
- 1995:** The Legislative Analyst's Office (LAO), Department of Finance (DOF), UC, and CSU jointly develop new marginal cost methodology.
- 1996:** New marginal cost methodology is first implemented in 1996-97 budget.
- 2005:** Legislature directs LAO and DOF to jointly convene a working group to review current marginal cost methodology and recommend possible modifications for 2006-07.

Similar to CSU, annual enrollment growth funding provided to UC before 1992 was based on the particular mix of new students, with different groups of students funded at different rates. However, UC's methodology for determining the marginal cost of each student was much less complex than CSU's methodology and did not require different rates based on modes of instruction. The university calculated separate funding rates for undergraduate students, graduate students, and for each program in the health sciences based on an associated student-faculty ratio. For example, the marginal cost of hiring faculty for new undergraduate students was estimated by dividing the average faculty salary and benefits by 17.48 FTE students (the undergraduate student-faculty ratio). Each marginal cost formula also estimated the increased costs of library support due to enrolling additional students. As was the practice for CSU, however, UC's marginal cost formulas did not account for costs related to student services and institutional support.

### ***Legislature Called for New Methodology in 1990s***

Beginning in 1992-93, the Legislature and Governor suspended the above marginal cost funding practices for UC and CSU. While the state did provide base budget increases to the universities, it did not provide funding specifically for enrollment growth during that time. In the *Supplemental Report of the 1994 Budget Act*, the Legislature stated its intent that, beginning in the 1996-97 budget, the state would return to the use of marginal cost as the basis for funding enrollment growth. Specifically, the language required representatives from our office, UC, CSU, and DOF to review the 1991-92 marginal cost formulas and propose improvements that could be used in developing the 1996-97 budget.

Overall, the 1995 working group identified two major issues related to the 1991-92 marginal cost calculations. First, the data used in the calculations were out of date and did not accurately reflect actual costs. In addition, there was inconsistency between segments in the methods used to fund enrollment growth (such as the allocation of student fees toward the marginal cost). At the same time, the 1995 working group observed that many parts of the 1991-92 marginal cost calculations remained valid. These included: (1) determining the marginal cost for the budget year based on current-year costs and (2) setting the additional cost of hiring faculty to serve additional students at entry-level, rather than average, salaries.

***Compromise Methodology Adopted for 1996-97.*** After a series of negotiations, the four agencies developed a new methodology for estimating the amount of funding needed to support each additional FTE student at each segment. This new methodology reflected a compromise that all parties agreed should be the basis for funding future enrollment growth.

The methodology was first implemented in 1996-97 and has generally been used to calculate enrollment funding since that time. Some of the key features of this methodology include:

- **Single Marginal Cost Formula for Each Segment.** Enrollment growth funding is no longer based on differential funding formulas by education level and academic program. Instead, each university segment uses one formula to calculate a single marginal cost that reflects the costs of all the system's education levels and academic programs. For instance, a single student-faculty ratio helps determine the faculty costs associated with each additional student (regardless of education level). Thus, the state currently provides a different per-student funding rate depending only on which higher education segment that student attends.
- **Marginal Cost for Additional Program Areas.** The 1995 working group concluded that the marginal cost formula should include additional cost components beyond salaries for faculty, TAs, and other academic support personnel. As a result, the current formula takes into account the marginal costs for eight program areas—faculty salary, faculty benefits, TAs, academic support, instructional support, student services, institutional support, and instructional equipment. These program costs are based on current-year funding and enrollment levels, and then discounted to adjust for fixed costs that typically are not affected by year-to-year changes in enrollment.
- **Student Fee Revenue Adjustments.** In addition, the working group agreed that both the General Fund and student fee revenue should contribute toward the total marginal cost. This reflects a long-standing practice that students and the state share in the cost of education. It also acknowledges that fee revenue is used for general purposes—the same as General Fund revenue. Therefore, under the methodology, a portion of the student fee revenue that UC and CSU anticipate from the additional students is subtracted from the total marginal cost in order to determine how much General Fund support is needed from the state for each additional FTE student.

## ***Legislature Requests Marginal Cost Review for 2006-07***

In adopting the 2005-06 budget, the Legislature called for a review of the marginal cost methodology that was developed in 1995. Specifically, the *Supplemental Report of the 2005 Budget Act* directed our office and DOF to jointly convene a working group, including representatives from UC and

CSU, to (1) review the current process for determining the marginal cost of each additional FTE student and (2) examine possible modifications to that methodology for the 2006-07 budget. The intent was that the working group would recommend a new methodology that all parties agreed should be the basis for funding enrollment growth, as was done in 1995.

*Working Group Met, but Could Not Reach Compromise.* In response to the Legislature's directive, our office and DOF worked collaboratively this past summer and fall to improve the formulas for calculating the marginal cost of instruction. For example, together we developed a series of principles to guide the discussion. Figure 3 outlines these principles. As the figure shows, many of these principles are features of the current methodology. In addition, we met with UC and CSU to solicit their input and needed data.

**Figure 3**

### **Guiding Principles for Marginal Cost Funding**

- ✓ **Exclude Fixed Costs.** The current approach of determining the average cost of individual program areas, and then discounting certain areas to adjust for fixed costs, makes sense.
- ✓ **Comparability.** To the extent possible, we should have comparable formulas for the University of California (UC) and the California State University (CSU).
- ✓ **Growth-Related Costs.** Include only costs that change with enrollment growth.
- ✓ **Facts-Based.** Calculations should be based on factual data.
- ✓ **Student Fees Should Contribute.** A portion of student fee revenue that UC and CSU anticipate from the additional students should be subtracted from the total marginal cost in order to determine how much General Fund support is needed from the state for each additional student.
- ✓ **Data Accessibility.** All parties (UC, CSU, Department of Finance, and the Legislative Analyst's Office) should have access to the data necessary to independently calculate the marginal cost in a given year and reach the same conclusion.

Despite the above efforts, our office and DOF were not able to reach a compromise on a new marginal cost methodology, as envisioned by the Legislature. Moreover, DOF independently developed a new formula for calculating the marginal cost of an additional student, which is used in the Governor's budget proposal for 2006-07. As a result, the proposed methodology neither reflects a compromise nor can be construed as a product of the working group. Below, we review the Governor's proposed methodology and recommend an alternative approach.

## ***Governor Proposes New Marginal Cost Methodology***

The Governor's budget for 2006-07 proposes a new marginal cost methodology for funding enrollment growth at UC and CSU, which differs significantly from the agreed-upon marginal cost methodology developed in 1995. Major features of the Governor's proposed methodology include:

- ***Calculates Only General Fund Contribution.*** As mentioned above, the current methodology calculates a total marginal cost, and then subtracts from this cost the fee revenue UC and CSU anticipate from each additional student, in order to determine how much General Fund support is needed from the state. In contrast, the Governor's methodology attempts to isolate the amount of General Fund spent on each program area affected by changes in enrollment in order to determine the General Fund cost of each additional FTE student. Thus, the proposed methodology makes arbitrary assumptions about the distribution of General Fund support at each segment, which may over estimate the level of such support that actually funds certain programs.
- ***Assumes Average Faculty Costs.*** Based on a fixed student-faculty ratio (as adopted in the budget act), the current methodology calculates the cost of hiring a new assistant professor (in other words, entry-level faculty) to serve a specified number of new students. The Governor's proposal departs from this practice and bases the faculty costs for each additional student on the salaries paid to professors of *all* levels.
- ***Modifies Marginal Cost Components.*** Rather than discount each program cost by a particular percentage to adjust for fixed costs, the Governor excludes the specific activities under each program area that typically are not affected by year-to-year changes in enrollment. For example, the Governor excludes funding museums and galleries from the marginal cost of academic support. In addi-

tion, the proposed methodology adds operations and maintenance services as a new cost component.

- ***Changes Definition of Full-Time CSU Graduate Student Load.*** Currently, a graduate student FTE unit load at CSU is recognized in the marginal cost formula as 15 units per term. The Governor proposes to change this definition to 12 units.
- ***Excludes UC Health Science Students.*** The current methodology includes UC health science students in calculating the marginal cost of each program area, except for instructional support. The Governor proposes to exclude such students from the entire marginal cost calculation.
- ***Adjusts for Base Increases Assumed in Governor's Compact.*** The current marginal cost methodology is based only on current-year expenditures and, therefore, does not account for any funding changes proposed for the budget year. The Governor, however, calculates a General Fund marginal cost for each segment using current-year data, and then adjusts that cost by the base increase specified in his compact with UC and CSU (3 percent for 2006-07). This adjusted amount would be used to fund enrollment growth in 2006-07 and increase each subsequent year based on the Governor's compact. For example, for 2007-08, the 2006-07 marginal cost would be adjusted by the base increase called for in 2007-08, under the Governor's compact. In other words, a new marginal cost rate would *not* be calculated each year based on the current expenditure data and legislative priorities.

Based on the Governor's new marginal cost methodology, the proposed budget provides \$10,103 in General Fund support for each additional student at UC and \$6,792 for each additional student at CSU. In comparison, we estimate that the methodology developed in 1995 would call for a UC marginal General Fund cost of \$8,087 and a CSU marginal General Fund cost of \$5,597. (See Figure 4 for a detailed description of the marginal cost calculations based on the 1995 agreed-upon methodology.) Thus, the Governor's proposal reflects an increase in the per-FTE student funding rates at the two segments of roughly 25 percent—\$2,016 for UC and \$1,195 for CSU—from the rates required under the current methodology. In terms of total enrollment growth funding, the Governor's budget provides roughly \$10 million more to each segment than called for by the current methodology (based on an assumed enrollment growth of 2.5 percent). In the following section, we raise concerns about the Governor's proposed marginal cost methodology.

<b>Figure 4</b>		
<b>2006-07 Marginal Cost Calculations</b>		
<i>(Based on Current Methodology)</i>		
<b>Basic Cost Components</b>	<b>Marginal Cost Per FTE<sup>a</sup> Student</b>	
	<b>UC</b>	<b>CSU</b>
Faculty salary	\$2,932	\$2,418
Faculty benefits	670	889
Teaching assistants salary	676	282
Instructional equipment	461	129
Instructional support	3,879	771
Academic support	676	1,221
Student services	1,137	844
Institutional support	992	1,009
<b>Totals</b>	<b>\$11,423</b>	<b>\$7,563</b>
Less student fee revenue	-\$3,336	-\$1,966
<b>State Funding Per Student</b>	<b>\$8,087</b>	<b>\$5,597</b>
<sup>a</sup> Full-time equivalent.		

## Concerns With Governor's Proposal

Although we believe some of the changes in the Governor's proposed marginal cost methodology merit legislative consideration (such as redefining a full-time CSU graduate student load), many of them raise serious concerns (such as assuming average faculty costs). This is because the Governor's methodology represents a significant departure from the underlying rationale behind the 1995 agreed-upon methodology. We also believe the Governor's proposal is not aligned to the guiding principles developed during our marginal cost discussions with DOF this past summer and fall. Figure 5 (see next page) summarizes our concerns, which we discuss in further detail below.

### Ignores Contribution of Student Fees

In adopting the current marginal cost methodology in 1995, the Legislature recognized that both General Fund and student fee revenue together fund the marginal cost of serving an additional FTE student. After a total marginal cost is calculated, the fee revenue UC and CSU anticipate collecting from each additional student gets subtracted from this cost, in order to determine the state's share. Thus, the current methodology acknowledges that because General Fund and fee revenue are "fungible"

resources used for general purposes, it is difficult—and unnecessary—to determine how much of specific program costs are borne by the General Fund as opposed to student fee revenue. For example, CSU reports that both fund sources—General Fund and fee revenue—are deposited in one account, which is used to fund a variety of activities. As a result, CSU's and the Governor's budget displays only reflect the combined total General Fund and fee revenue allocated to a particular program.

**Figure 5**

**Governor's Proposed Marginal Cost Methodology:  
A Step in the Wrong Direction**

- ✓  ***Ignores Contribution of Student Fees.*** The proposed methodology does not account for new student fee revenue—resulting from fee increases—available to support a greater share of the marginal cost of instruction. In addition, the methodology does not recognize that General Fund and fee revenue are “fungible” resources that support the total marginal cost.
- ✓  ***Over Budgets Certain Costs.*** The Governor's proposal assumes faculty costs at the University of California (UC) and the California State University will increase on the average (rather than on the margin) with each additional full-time equivalent student. The proposal also over budgets other program costs, because it does not appropriately adjust the costs for health science students at UC.
- ✓  ***Limits Legislative Budgetary Discretion.*** The methodology assumes that the Legislature will approve the annual base adjustments contained in the Governor's compact each year. Moreover, it “shields” the marginal cost from future legislative policy decisions (such as possible changes to student-faculty ratios or the share of education cost paid by students).

Unlike the current marginal cost methodology, the Governor's proposal does not account for new student fee revenue resulting from fee increases. Since the methodology calculates only General Fund contributions, it ignores the availability of fee revenue to account for a greater share of the marginal cost of instruction. For example, the Governor's proposal would in effect allow UC and CSU to use revenue from fee increases for whatever they deem worthwhile. Rather, we believe that the Legislature should continue to consider new fee revenue as available to meet legislatively determined needs of the segments.

## **Over Budgets Certain Costs**

The Governor's proposed methodology includes the faculty costs associated with all professor levels—assistant professor, associate professor, and (full) professor. In effect, this assumes that a cohort of faculty hired at each segment because of enrollment growth will reflect the make-up of existing faculty at that segment, in terms of level or classification. However, data provided to us by the segments indicate that most new professors are in fact hired at the assistant professor level and thus receive a lower salary than the average of existing faculty. For example, UC hired a total of 505 new faculty members in 2003-04. Of this amount, 67 percent were hired at the assistant professor level. The CSU reports that 85 percent of the 393 faculty members the university hired in fall 2004 were assistant professors. In view of the above, we find that the Governor's marginal cost proposal over budgets the marginal cost of hiring additional faculty.

The proposed methodology also over budgets other program costs. Unlike the current methodology, the Governor's proposal attempts to exclude health science students from UC's entire marginal cost calculation. In other words, the proposed methodology for UC is intended to calculate the marginal cost of an additional nonhealth science student. Specifically, in calculating a per-student cost for each program area (such as academic support and operation and maintenance services), the methodology excludes the number of health science students currently enrolled at UC from the base students. However, the proposed methodology does not appropriately exclude all of the funding spent on health science students in each program area. As a result, the proposed methodology for UC over estimates the marginal cost of an additional nonhealth science student.

## **Limits Legislative Budgetary Discretion**

According to DOF staff, under the Governor's methodology, the marginal General Fund cost would be adjusted each year according to the base budget increase called for in his compact with UC and CSU for that particular year. Thus, the 2006-07 marginal cost would serve as a baseline for future years—meaning there would be no recalculation each year based on recent expenditure and enrollment data. We find that such an approach significantly limits the impact of the Legislature's actions to adopt alternative budget and policy proposals based on its own priorities. For example, the proposed methodology assumes that the Legislature will approve the annual base adjustments contained in the Governor's compact. Moreover, the methodology essentially "shields" the marginal cost from future legislative policy decisions. For example, the Legislature in the future may want to (1) increase or decrease the student-faculty ratio at the segments, (2) increase the share of education cost paid by students, or (3) institute a more differential funding system (such as by education level).

## **LAO Marginal Cost Recommendations**

Given our concerns about the Governor's proposed marginal cost methodology, we recommend below an alternative approach that we believe better preserves legislative prerogatives and builds upon the existing methodology. We further recommend that the Legislature fund enrollment growth at UC and CSU in the 2006-07 budget based on our proposed methodology.

### **Refine Current Marginal Cost Methodology**

*We recommend the Legislature revise the current marginal cost methodology, in order to more effectively fund the increased costs associated with enrollment growth. Specifically, we recommend (1) excluding unrelated costs, (2) reflecting actual costs for faculty and teaching assistants, (3) including operation and maintenance costs, (4) redefining a full-time equivalent graduate student at the California State University, and (5) adjusting the total marginal cost by the average fee revenue collected per student.*

Based on our review of marginal cost funding, we recommend the Legislature reject the Governor's proposal for an entirely new marginal cost methodology. Rather, we continue to support the underlying basis of the current marginal cost methodology (as developed in 1995)—that is, determining a total marginal cost based on current-year expenditures and “backing out” a student fee component to determine the state's share. We have, however, identified individual components of the current methodology that could be improved in order to more appropriately fund the increased costs associated with enrollment growth.

Our proposed improvements reflect legislative attempts over the years to (1) simplify the way the state funds enrollment growth, (2) more accurately account for costs, and (3) provide greater consistency across segments. In developing our recommendations, we also sought to advance the guiding principles outlined in Figure 3, such as ensuring that the marginal cost calculations are based on factual data. Our proposed changes also incorporate some of the suggestions made by the segments during the marginal cost working group discussions and in their budget requests to the Governor (such as including costs for operation and maintenance services). Specifically, we recommend the Legislature adopt a marginal cost methodology that:

- Excludes activities whose costs are essentially unaffected by additional students.

- Adjusts the faculty and TA components of the marginal cost formula to better reflect actual costs.
- Includes the marginal cost of operation and maintenance services.
- Changes the definition of a full-time CSU graduate student load from 15 units per term to 12 units, as proposed by the Governor.
- Accurately accounts for available student fee revenue by adjusting the marginal cost based on the average systemwide fee revenue collected for each additional FTE student.

***Exclude Costs for Specific Activities.*** Under the current methodology, the marginal cost for each program area (such as institutional support) is calculated by first determining the average cost based on current-year funding and enrollment levels, and then discounting that amount by a particular percentage to adjust for fixed costs that typically are not affected by year-to-year changes in enrollment. For example, the current discount factor for institutional support at UC is 50 percent. The different discount percentages contained in the current methodology for each segment were essentially negotiated as part of the 1995 working group. Since there is obviously no one correct discount factor, the current percentages are somewhat arbitrary.

Rather than continue to use or modify the current discount percentages, we propose eliminating entire activities under each program area whose costs increase very little with additional students. In other words, simply exclude activities that primarily reflect fixed costs. Such an approach was discussed by the recent working group and is very similar to how the Governor's methodology adjusts for fixed costs. In fact, our proposal would exclude the same activities as the Governor. For example, we exclude from academic support funding for (1) museums and galleries, (2) ancillary support, and (3) academic personnel development. We believe that this change to the current methodology would more accurately reflect the marginal cost of each additional student.

***Adjust Faculty and TA Components to Better Reflect Actual Costs.*** The expenditure and enrollment data used to calculate the marginal cost of hiring additional faculty and TAs should reflect actual costs. In developing the current marginal cost methodology, the 1995 working group observed that the additional cost of hiring faculty to serve additional students should be set at entry-level, rather than average, salaries. Thus, the current methodology calls for the faculty salary to be based on each university's published salary of an assistant professor (step 3), which currently is \$54,828 at UC and \$45,696 at CSU. According to the segments, they typically have to pay new assistant professors more than the published

salaries, in order to hire their first-choice candidate. As a result, both segments have proposed in their budget requests to increase the faculty salary component of the marginal cost. We believe that such a change is reasonable, but that the salary component should still reflect the level of the recently hired professors.

As discussed earlier, most of the new professors at UC and CSU continue to be hired at the assistant professor level. We therefore recommend that the marginal cost be based on the average annual salary paid to all new assistant professors (regardless of step) that were hired in 2004-05 and adjusted for the base budget increase approved in the *2005-06 Budget Act*, which was 3 percent. (Since UC was unable to provide the average salary of new assistant professors in 2004-05, we used an adjusted 2003-04 average salary.) This approach results in a faculty salary cost of \$69,576 for UC and \$58,262 for CSU.

We further propose that the above faculty salaries for 2006-07 be the base amounts in the marginal cost calculation for future years. For each year after 2006-07, the faculty salary in the marginal cost formula would be the prior-year marginal cost salary adjusted for the segments' current-year base budget increase (as approved in the enacted budget for that year). For example, the faculty salary for the 2007-08 marginal cost would be the salary used in the 2006-07 marginal cost formula adjusted by the base budget increase approved for each segment in the *2006-07 Budget Act*.

Another key component of the current marginal cost methodology is an underlying assumption that the annual salary of a TA at CSU is roughly 50 percent of an entering faculty member's salary and benefits cost, which currently translates to an annual full-time TA salary of \$30,226. According to the CSU Chancellor's Office, however, the average salary for a full-time TA is only \$10,133 (about 16 percent of an entering faculty member's salary and benefits). This means that the state is currently over budgeting the marginal cost of hiring additional TAs at CSU. We, therefore, recommend that the current marginal cost formula for CSU be revised to use the average annual TA salary at the university (\$10,133). This would be consistent with how the state budgets for additional TAs at UC.

In addition to the salary of a full-time TA, the current methodology also assumes a fixed student-TA ratio of 44:1 at UC and 107:1 at CSU to determine the marginal cost of a TA per FTE student. We believe these ratios are significantly low and do not accurately reflect the current make-up of students and TAs. For example, the student-TA ratio currently used for CSU is essentially based on "headcounts" rather than FTE students and TAs. In addition, UC's student-TA ratio accounts only for undergraduate students, whereas the marginal cost funding rate is intended to fund all additional FTE students (regardless of education level). Based on recent

data the segments provided us on FTE students and full-time TAs, we calculate a student-TA ratio of 62:1 at UC and 608:1 at CSU. (The high student-TA ratio at CSU reflects the fact that, unlike UC, many courses at CSU do not include TA support.) We recommend that these ratios be used in determining the marginal cost of instruction.

***Include Costs for Operation and Maintenance.*** The current marginal cost methodology does not include costs for operation and maintenance. (Operation and maintenance primarily includes funding for the administration, supervision, maintenance, preservation, and protection of the university's physical plant.) As previously mentioned, the Governor proposes to include these costs in his calculation of the marginal cost. (We note that the segments also requested that the marginal cost account for such costs.) In including operation and maintenance costs, the Governor adjusts for (1) specific operation and maintenance services whose costs increase very little with additional students (such as physical plant administration) and (2) the maintenance costs for UC's research facilities. We have taken a similar approach in our proposed methodology.

***Change Definition of CSU Graduate FTE Student.*** We recommend that the current marginal cost methodology be changed to recognize a graduate FTE student unit load at CSU of 12 units per term, rather than 15 units (as requested by the university and proposed by the Governor). This would be consistent with how such a load is defined at UC and most other higher education institutions. The proposed change would be revenue neutral, simultaneously increasing the defined number of graduate students and decreasing the defined cost of a graduate student.

***Accurately Account for Available Student Fee Revenue.*** In order to determine how much state General Fund support is needed for each additional FTE student at UC and CSU, the marginal cost formula must back out the fee revenue that the segments anticipate collecting from each student. Under the current methodology, this is based on the percentage of the university's entire operating budget that is supported by student fee revenue. For example, if fee revenue makes up 30 percent of UC's budget for 2005-06, then new fee revenue would be deemed to support 30 percent of the total marginal cost for 2006-07. The remaining 70 percent would be funded by the state's General Fund. Based on the current methodology, the fee backout for the budget year (2006-07) would be \$3,336 for UC and \$1,966 for CSU.

In our review of the current marginal cost methodology, we found that the above approach underestimates the student fee revenue available to support enrollment growth. This is because the percentage share of fees is calculated based on the university's total operating budget, which includes program costs that are not supposed to be covered by fees (such

as research and UC's teaching hospitals). In other words, the "base" (or denominator) is larger than appropriate, which in turn depresses the percentage supported by fees. We recommend the total marginal cost be adjusted for the average systemwide fee revenue collected from each additional FTE student (regardless of education level). In order to calculate the average fee per FTE student at UC and CSU, total current-year mandatory systemwide fee revenue (registration and education fees for UC and state university fees for CSU) is divided by total current-year FTE students. This approach results in a fee backout for the budget year of \$6,211 for UC and \$2,949 for CSU. These amounts reflect the average fee amount that each additional student will pay towards their educational costs.

### **Fund Enrollment Growth Based on LAO's Revised Methodology**

*Using our revised methodology and our proposed 2 percent enrollment growth, we recommend deleting \$30.8 million from the \$110 million requested in the budget for enrollment growth at the University of California (UC) and the California State University (CSU). Our proposal would leave sufficient funding to provide \$8,574 for each additional UC student and \$6,407 for each additional CSU student. We further recommend the Legislature adopt (1) provisional language specifying the marginal cost funding rate for each segment and (2) supplemental report language specifying that enrollment growth funding provided in future budgets be based on our proposed methodology. (Reduce Item 6440-001-0001 by \$16.7 million and Item 6610-001-0001 by \$14.1 million.)*

Based on our above proposals to revise the current marginal cost methodology, we recommend the Legislature provide \$8,574 in General Fund support for each additional FTE student at UC and \$6,407 for each additional FTE student at CSU. (See Figure 6 for a detailed description of our marginal cost calculations.) Our proposed methodology would provide UC and CSU with more General Fund support than the current marginal cost methodology (\$8,087 per student at UC and \$5,597 per student at CSU). At the same time, our rates are lower than the Governor's proposed funding rates.

After incorporating our earlier proposal to fund enrollment growth at a rate of 2 percent at both UC and CSU, we therefore recommend reducing the Governor's proposed General Fund augmentation for enrollment growth by a total of \$30.8 million, including \$16.7 million from UC and \$14.1 million from CSU. Under our proposal, the segments would still receive sufficient funding to cover estimated costs of enrollment growth due to increases in population and college participation. At the same time, the Legislature could use our identified General Fund savings to address other priorities, including addressing the state's budget problem.

**Figure 6**  
**LAO Marginal Cost Recommendations**

2006-07

	Marginal Cost Per FTE <sup>a</sup> Student	
	UC	CSU
Faculty salary	\$3,721	\$3,083
Faculty benefits	714	1,133
Teaching Assistants	479	17
Instructional equipment replacement	461	126
Instructional support	4,310	783
Academic support	1,507	1,293
Student services	1,028	992
Institutional support	837	988
Operation and maintenance	1,729	942
<b>Totals</b>	<b>\$14,785</b>	<b>\$9,356</b>
Less student fee revenue	-\$6,211	-\$2,949
<b>LAO's Proposed State Funding Rate</b>	<b>\$8,574</b>	<b>\$6,407</b>
<b>Current Methodology</b>	<b>\$8,087</b>	<b>\$5,597</b>
<b>Governor's Proposed Methodology</b>	<b>\$10,103</b>	<b>\$6,792</b>

<sup>a</sup> Full-time equivalent.

We further recommend the Legislature adopt provisional language, for both UC and CSU, specifying the (1) amount of funding provided for enrollment growth, (2) estimated marginal cost funding rate, and (3) number of additional FTE students funded. This is because the Legislature, the Governor, and the public should have a clear understanding of how much enrollment growth is funded at UC and CSU in the annual budget act. Additionally, the segments should be expected to use enrollment growth funding provided by the state to serve additional students and not to supplement funding for existing students (such as those enrolled in non-state supported summer instruction programs). Moreover, we recommend the Legislature adopt supplemental report language specifying its intent that enrollment growth funding provided to UC and CSU in subsequent budgets be based on our proposed marginal cost methodology.

For the above reasons, we propose the Legislature add the following provision to Item 6440-001-0001:

Of the amount appropriated in Schedule (1), \$35,325,000 is to fund 2 percent enrollment growth (or 4,120 additional full-time equivalent students) at the University of California, based on a marginal General Fund cost of \$8,574 per additional student. This funding shall not be used to provide additional state support to students for which campuses only received state funding in 2005-06 to buy down their summer fees.

Similarly, we also recommend adding the following provision to Item 6610-001-0001:

Of the amount appropriated in Schedule (1), \$43,516,000 is to fund 2 percent enrollment growth (or 6,792 additional full-time equivalent students) at the California State University, based on a marginal General Fund cost of \$6,407 per additional student. This funding shall not be used to provide additional state support to students for which campuses only received state funding in 2005-06 to buy down their summer fees.



## INTERSEGMENTAL: YEAR-ROUND OPERATIONS AT UC AND CSU

*Operating University of California (UC) and California State University (CSU) campuses on a year-round schedule—which more fully utilizes the summer term—is an efficient strategy for serving additional students with existing facilities. In this write-up, we (1) review actions the state has taken to promote summer expansion, (2) provide an update on UC’s and CSU’s efforts to expand summer operations, and (3) identify issues for the Legislature to consider in regard to further summer expansion.*

Various state policies and statutes promote year-round operations in higher education. For example, the 1960 *Master Plan for Higher Education* recommended year-round operations at campuses and state support for summer sessions. More recently, the Legislature has strongly encouraged the University of California (UC) and the California State University (CSU) to serve more students during the summer term by implementing year-round operations. Expanding summer operations has the benefit of significantly increasing UC’s and CSU’s enrollment capacity while reducing out-year costs associated with constructing new classrooms and campuses. Additionally, it increases students’ access to high demand campuses and allows students to reduce their time to degree. It also offers faculty greater flexibility because they can select when to work among more terms without increasing their overall workload.

### KEY STATE ACTIONS TOWARD FULLY IMPLEMENTING YEAR-ROUND OPERATIONS

In a prior report, *Year-Round Operation in Higher Education* (February 1999), we discussed various state actions concerning the implementation of year-round operations. In recent years, the state has taken three major

steps toward the full implementation of year-round operations at UC and CSU. Figure 1 summarizes these steps, which we discuss in further detail below.

**Figure 1**

### **Recent Steps Toward Full Implementation of Year-Round Operations**

- ✓ **Established Consistent Funding Policy for Enrollment Growth**
  - In 1999-00, the Legislature and Governor agreed to provide “marginal cost” funding for *all* additional FTE students enrolled in *all* programs at UC and CSU regardless of whether they enrolled in fall, winter, spring, or summer.
- ✓ **Established Consistent Fee Policy and “Bought Down” Summer Fees**
  - Chapter 383, Statutes of 2000 (AB 2409, Migden), prohibited UC and CSU from charging students more in summer than in other terms.
  - The *2000-01 Budget Act* provided UC and CSU with General Fund support to make up for the reduced summer fee revenue.
- ✓ **Provided Supplemental Funding to “Fully Convert” Some Summer Sessions**
  - In 2001-02 and 2002-03, the state provided supplemental funding to enhance summer operations at specific UC and CSU campuses. (This action is typically referred to as “fully converting” a campus to year-round operations.)
  - This supplemental funding was separate from funding for enrollment growth to serve additional students at all campuses in all terms.
  - The state made the funding contingent on UC and CSU meeting minimum on levels of growth in summer enrollment growth.

*Established Consistent Funding Policy for Enrollment Growth.* Prior to 1998-99, the state provided General Fund support only for students enrolled in fall, winter, and spring terms. Summer-session costs were not directly supported by the state. Instead, they were “self-supported” by student fees, which were set higher than the other academic terms. In 1998-99 and 1999-00, the state made a series of decisions consistent with its intent to fund all enrollment growth, regardless of term, at the same funding rate. As we discussed earlier in this chapter, the state funds enrollment growth at UC and CSU based upon the “marginal cost” imposed by

each additional full-time equivalent (FTE) student for additional faculty, teaching assistants, equipment, and various support services.

***Established Consistent Fee Policy and “Bought Down” Summer Fees.*** The next action the state took to expand summer enrollment was to reduce the summer fee rate to the regular fee rate charged in other terms. Chapter 383, Statutes of 2000 (AB 2409, Migden), prohibited UC and CSU from charging students more in summer than in fall, winter, and spring. Prior to this action, UC campuses charged students approximately 15 percent more (on average) for courses in the summer. At CSU, campuses charged between 120 percent and 160 percent more for summer courses. Thus, Chapter 383 created a consistent, year-round fee policy at all UC and CSU campuses. The *2000-01 Budget Act* included a total of \$33.7 million in ongoing General Fund support—\$13.8 million for UC and \$19.9 million for CSU—to compensate the universities for revenue they would forgo by reducing summer fees at their campuses. Based on summer enrollments at that time, this gave (1) UC the equivalent of \$2,163 per student for 6,381 FTE students and (2) CSU \$2,417 per student for 8,232 FTE students. The *2002-03 Budget Act* provided an additional \$1 million to UC to buy down fees for additional enrollment in the university’s summer sessions.

***Provided Supplemental Funding to “Fully Convert” Some Summer Sessions.*** As a result of Chapter 383, UC and CSU campuses received state funding to “buy down” the fees of existing summer students. However, the resulting funding per student was still less than the marginal cost support provided for regular enrollment growth. The segments asserted that they needed the full marginal cost amount in order to enhance the quality of their summer terms to be comparable to other terms. Providing this additional summer funding to support existing summer students—meaning those students whose summer fees were bought down—at a particular campus is typically known as “fully converting” the campus to year-round operations.

In 2001-02, the state provided a total of \$33.1 million in supplemental funding—\$20.7 million to UC and \$12.4 million to CSU—to fully convert three UC campuses (Berkeley, Los Angeles, and Santa Barbara) and four CSU campuses (Fullerton, Long Beach, San Diego, and San Francisco). (As we discussed in our *Analysis of the 2002-03 Budget Bill* [page E-190], CSU decided to use fee-buydown monies provided in 2001-02 to fully convert five additional campuses—Dominguez Hills, San Bernardino, San Jose, San Marcos, and Stanislaus—and some existing students at the Sacramento campus.) The supplemental funding was provided in addition to a separate funding allocation provided by the state for enrollment growth (regardless of term) at all campuses. For example, the *2001-02 Budget Act* also included \$55.7 million in General Fund support for 3 percent enrollment growth at CSU.

In the following year (2002-03), the state provided another special allotment to fully convert additional university campuses to year-round operation. The *2002-03 Budget Act* included a total of \$8.6 million from the General Fund to support *existing* summer enrollments at UC Davis (\$7.4 million) and CSU Chico (\$1.2 million). As was the practice in the previous year, this funding was provided separately from enrollment growth funding to serve *additional* students at all campuses. Since 2002-03, the state has not provided funding to fully convert additional UC and CSU campuses to year-round operations.

Although supplemental funding for existing students is not strictly necessary for summer enrollments to grow, the state decided to provide it as an incentive to expand summer operations at UC and CSU as rapidly as possible. For example, the *2001-02 Budget Act* made the supplemental funding (of \$33.1 million) contingent on the campuses' meeting minimum summer 2001 growth targets (700 additional FTE students at UC and 400 additional FTE students at CSU). Failure to meet these targets would trigger the reversion of a proportionate share of the summer appropriations. The *2001-02 Budget Act* required the universities to report to the Legislature on whether they met their enrollment targets. The supplemental funding provided to UC and CSU in 2002-03 for summer operations was similarly linked to growth in summer enrollment.

## UPDATE ON SUMMER ENROLLMENT

### UC Summer Enrollment Has Increased

Figure 2 compares summer 2000 and summer 2005 FTE enrollment at eight general UC campuses (excluding the new campus in Merced). This includes both the four "full conversion" campuses (those that received full marginal cost support for summer enrollment) and the four "partial conversion" campuses (those that received state funding only for the fee buydown).

As Figure 2 shows, total summer enrollment at UC's four full conversion campuses doubled from summer 2000 to summer 2005, for an increase of almost 12,000 FTE students. Each of these campuses exceeded its respective summer enrollment target that was established when the state provided supplemental funding to the campus as an incentive to serve more students during the summer. Total summer enrollment at the four partial conversion campuses has also grown substantially (by 71 percent). In fact, all partial conversion campuses have increased summer enrollment by a greater percentage than one of the full conversion campuses (Berkeley).

**Figure 2**  
**UC Enrollment—Summer 2000 and 2005**

*(Full-Time Equivalent Students)*

	2000	2005	Change From 2000	
			Amount	Percent
<b>Full Conversion Campuses<sup>a</sup></b>				
Berkeley	2,780	3,900	1,120	40%
Davis	2,472	5,805	3,333	135
Los Angeles	3,666	7,500	3,834	105
Santa Barbara	2,562	6,150	3,588	140
Subtotals	(11,480)	(23,355)	(11,875)	(103%)
<b>Partial Conversion Campuses<sup>b</sup></b>				
Irvine	2,913	4,425	1,512	52%
Riverside	1,290	2,769	1,479	115
San Diego	2,325	3,735	1,410	61
Santa Cruz	1,053	2,052	999	95
Subtotals	(7,581)	(12,981)	(5,400)	(71%)
<b>Totals</b>	<b>19,061</b>	<b>36,336</b>	<b>17,275</b>	<b>91%</b>

<sup>a</sup> Full conversion campuses received full marginal cost support for summer enrollment.  
<sup>b</sup> Partial conversion campuses received state funding only to buy down summer fees.

Despite the above increases in summer enrollment at UC, the summer term still serves only a fraction of the fall enrollment level. Figure 3 compares the number of FTE students served in summer 2005 with the number served in fall 2005. As shown in Figure 3 (see next page), the summer term at UC serves one-fifth the number of students as the fall term. In other words, UC's campuses operate in summer at only 20 percent of their fall levels.

### CSU Summer Enrollment Has Declined

Figure 4 (see page 213) compares FTE enrollment in summer 2001 with summer 2004 at different campuses (excluding Channel Islands and Maritime Academy, which received no fee buydown funding and have no extensive summer program). (Unlike UC, CSU was unable at the time of this analysis to provide complete enrollment data for summer 2000 and summer 2005.) As shown in the figure, summer enrollment at the 15 campuses authorized to receive full funding has actually declined by 37 percent (or about 14,000 FTE students) from summer 2001 to sum-

mer 2004. (As we discussed in an earlier write-up, total state-supported enrollment for the entire academic year at CSU declined in 2004-05.) During the same period, however, summer enrollment at campuses which receive partial state funding—only to buy down fees—increased by 44 percent. Put another way, campuses that receive supplemental funding from the state as an incentive to serve more students in the summer are in fact serving fewer students. On the other hand, campuses that do not receive such funding for the summer are serving more students.

**Figure 3**

### University of California Percentage of Students Served in Summer Versus Fall

	Summer 2005 FTE <sup>a</sup> Students	Fall 2005 FTE Students	Summer as Percent of Fall
<b>Full Conversion Campuses<sup>b</sup></b>			
Berkeley	3,900	30,924	13%
Davis	5,805	25,765	23
Los Angeles	7,500	31,306	24
Santa Barbara	6,150	20,105	31
Subtotals	(23,355)	(108,100)	22%
<b>Partial Conversion Campuses<sup>c</sup></b>			
Irvine	4,425	22,974	19%
Riverside	2,769	15,547	18
San Diego	3,735	23,821	16
Santa Cruz	2,052	14,960	14
Subtotals	(12,981)	(77,302)	17%
<b>Totals</b>	<b>36,336</b>	<b>185,402</b>	<b>20%</b>

a Full-time equivalent.  
b Full conversion campuses received full marginal cost support for summer enrollment.  
c Partial conversion campuses received state funding only to buy down summer fees.

Figure 5 (see page 214) summarizes the number of FTE students at CSU served in summer 2004 and fall 2004. As indicated in the figure, the summer term at CSU serves only 9 percent of the number of students as the fall term. There are, however, two full conversion campuses (East Bay—previously known as Hayward—and Los Angeles) whose summer terms serve over two-fifths of the fall enrollment levels.

**Figure 4**  
**CSU Enrollment<sup>a</sup>—Summer 2001 and 2004**

*(Full-Time Equivalent Students)*

	2001	2004	Change From 2001	
			Amount	Percent
<b>Full Conversion Campuses<sup>b</sup></b>				
Chico	662	0	-662	-100%
Dominguez Hills	1,474	786	-688	-47
East Bay	4,583	4,466	-117	-3
Fullerton	2,980	0	-2,980	-100
Humboldt	653	0	-653	-100
Long Beach	3,208	2,796	-412	-13
Los Angeles	6,594	6,462	-132	-2
Pomona	4,644	3,678	-966	-21
San Bernardino	1,997	0	-1,997	-100
San Diego	2,659	2,939	280	11
San Francisco	3,138	2,739	-399	-13
San Jose	2,312	0	-2,312	-100
San Luis Obispo	2,364	412	-1,952	-83
San Marcos	452	0	-452	-100
Stanislaus	610	0	-610	-100
Subtotals	(38,330)	(24,278)	-(14,052)	(-37%)
<b>Partial Conversion Campuses<sup>c</sup></b>				
Bakersfield	312	391	79	25%
Fresno	878	804	-74	-8
Monterey Bay	144	191	47	33
Northridge	1521	2,263	742	49
Sacramento	640	1,430	790	123
Sonoma	321	430	109	34
Subtotals	(3,816)	(5,509)	(1,693)	(44%)
<b>Totals</b>	<b>42,146</b>	<b>29,787</b>	<b>-12,359</b>	<b>-29%</b>

<sup>a</sup> Excludes Channel Islands and Maritime Academy, which received no fee buydown funding and do not operate extensive summer sessions.

<sup>b</sup> Full conversion campuses received full marginal cost support for summer enrollment.

<sup>c</sup> Partial conversion campuses received state funding only to buy down summer fees.

**Figure 5****California State University  
Percentage of Students Served in Summer Versus Fall<sup>a</sup>**

	Summer 2004 FTE <sup>b</sup> Students	Fall 2004 FTE Students	Summer As Percent of Fall
<b>Full Conversion Campuses<sup>c</sup></b>			
Chico	—	14,214	—
Dominguez Hills	786	8,523	9%
East Bay	4,466	10,660	42
Fullerton	—	24,143	—
Humboldt	—	7,030	—
Long Beach	2,796	26,009	11
Los Angeles	6,462	15,457	42
Pomona	3,678	15,964	23
San Bernardino	—	13,100	—
San Diego	2,939	26,769	11
San Francisco	2,739	22,187	12
San Jose	—	21,554	—
San Luis Obispo	412	16,643	2
San Marcos	—	5,837	—
Stanislaus	—	5,779	—
Subtotals	(24,278)	(233,869)	(10%)
<b>Partial Conversion Campuses<sup>d</sup></b>			
Bakersfield	391	6,644	6%
Fresno	804	17,133	5
Monterey Bay	191	3,851	5
Northridge	2,263	23,205	10
Sacramento	1,430	22,091	6
Sonoma	430	6,958	6
Subtotals	(5,509)	(79,882)	(7%)
<b>Totals</b>	<b>29,787</b>	<b>313,751</b>	<b>9%</b>
<p><sup>a</sup> Excludes Channel Islands and Maritime Academy, which received no fee buydown funding and do not operate extensive summer sessions.</p> <p><sup>b</sup> Full-time equivalent.</p> <p><sup>c</sup> Full conversion campuses received full marginal cost support for summer enrollment.</p> <p><sup>d</sup> Partial conversion campuses received state funding only to buy down summer fees.</p>			

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## ISSUES FOR LEGISLATIVE CONSIDERATION

As we discussed earlier, the state has taken several critical steps toward implementing year-round operations at all UC and CSU campuses. Despite some of these efforts, summer enrollment at some campuses has not significantly increased. In fact, summer enrollment at most “fully converted” CSU campuses actually declined, with some no longer operating a summer session. At the same time, summer enrollment has increased at most CSU campuses that received no supplemental funding (nonfully converted campuses). In addition, the summer term at many UC and CSU campuses are operating far from full capacity.

In view of the above, we believe that it is an important time for the Legislature to consider whether (1) supplemental funding should be provided to fully convert additional campuses to year-round operations and (2) additional efforts should be made to encourage more students to enroll in the summer. This issue of summer capacity is particularly relevant as the Legislature deliberates the Governor’s education bond proposal to provide \$7.9 billion to UC and CSU over the next decade for capital projects.

### **Should the State Provide Funding to Fully Convert Additional Campuses?**

*In determining whether to provide additional funding to fully convert additional University of California (UC) and California State University (CSU) campuses to year-round operations, we believe the Legislature should consider (1) recent summer enrollment trends and (2) the effectiveness of earlier supplemental funding provided to UC and CSU in prior-year budgets.*

Currently, there are four UC campuses (Irvine, Riverside, San Diego, and Santa Cruz) and six CSU campuses (Bakersfield, Fresno, Monterey Bay, Northridge, Sacramento, and Sonoma) that are not fully converted to year-round operation. In general, full conversion has been interpreted as providing campuses with supplemental funding to enhance summer sessions (for example, hiring more full-time faculty and providing additional student services), with the objective of increasing summer enrollment. When the state fully converted specific UC and CSU campuses in the past, the supplemental amount made up the difference between the fee buydown amount and the full marginal cost rate for existing summer students.

As shown by the increase in summer enrollment at nonfully converted campuses, supplemental funding is not required for summer enrollment to grow. In other words, recent enrollment trends cast doubt on the effectiveness of such funding. However, past practice has been to provide the

supplemental funding to UC and CSU as an incentive for them to expand their summer sessions. We estimate the cost of converting the remaining campuses using the above methodology would be roughly \$20 million for UC and \$7 million for CSU.

However, summer enrollment data for 2004 suggests that CSU has roughly \$7 million in its base budget that the state provided specifically for summer operations that is not being used for that purpose. These funds should be considered available to support the conversion of the university's remaining nonfully converted campuses. Specifically, the state provided (1) about \$5 million in 2001-02 to expand summer enrollment at CSU Fullerton and (2) about \$2 million in 2002-03 to expand summer enrollment at CSU Chico, for a combined total of \$7 million. As shown earlier in Figure 4, however, neither campus served any students in a state-supported summer program in 2004. (As previously mentioned, at the time this *Analysis* was being prepared in early February, CSU was unable to provide enrollment data for summer 2005.) This suggests that CSU has sufficient funding in its base budget to fully convert all its campuses (excluding Channel Islands and Maritime Academy, which do not operate extensive summer sessions) and does not need additional funding for the conversion. In addition, we have identified General Fund savings throughout this chapter relative to the Governor's budget proposal that could also be redirected to support the expansion of year-round operations at the remaining UC campuses.

If the Legislature decides to provide supplemental funding to fully convert additional campuses to year-round operations, we recommend it adopt similar accountability provisions as in the past. Such provisions would protect the Legislature's priority to expand summer enrollments. For example, funding for any conversion should be provided separately from enrollment growth appropriations. We also recommend making summer-expansion funding contingent on campuses meeting minimum summer enrollment growth targets. Moreover, the existing summer FTE students at the campuses proposed for full conversion should not be counted towards meeting the segments' state-supported budgeted enrollment target. Rather, the enrollment targets should be "rebenched" to account for these students.

### **How to Encourage Better Utilization of the Summer Term?**

*We believe that the University of California and California State University should continue to take steps to increase enrollment during the summer term, including providing financial incentives to students and requiring some summer enrollment at high-demand campuses.*

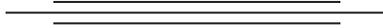
Given the large unused capacity at both UC and CSU during the summer term, we believe the Legislature and the segments should continue

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to explore ways to increase enrollment during the summer term. This is because better utilization of the summer term is a more cost-effective strategy for accommodating new enrollment growth than building new facilities. Below, we discuss steps that campuses could implement to encourage students to enroll during the summer:

- ***Offer Financial Incentives.*** Financial incentives can encourage students to enroll in the summer term. For example, campuses could charge *lower* fees for the summer term, which could be offset by somewhat *higher* fees for the other terms. Another incentive could be to cap summer fees at a particular number of units, thereby encouraging students to enroll in more units during the summer at no additional cost. In addition, campuses could offer fee rebates to seniors who graduate at the end of the summer rather than returning in the fall. The UC Berkeley campus did this in summer 2000.
- ***Require Some Summer Enrollment at High-Demand Campuses.*** As we discussed most recently in our report, *Promoting Access to Higher Education: A Review of the State's Transfer Process* (January 2006), some campuses do not have the capacity and resources to admit all eligible applicants that apply to them. For example, many UC campuses (such as Los Angeles and Berkeley) and some CSU campuses (such as San Luis Obispo) are unable to accept all eligible applicants. If such high-demand campuses required students to attend some summer terms, they could accommodate more students. Summer terms, then, would essentially “free up” more enrollment spaces and increase access to high-demand campuses.
- ***Increase Access to High-Demand Courses.*** According to UC, the primary reason why many students enroll in summer courses is to complete required courses that they were unable to enroll in during the fall, winter, or spring term due to limited space. Campuses should view the summer term as an opportunity to offer courses that typically fill up quickly during the other academic term. Increasing access in this way can reduce a student's time to degree.
- ***Offer Priority Housing and Registration.*** Some CSU campuses offer students priority housing and priority registration for the fall term if they enroll in the summer term. For example, CSU San Francisco, where housing facilities are in great demand, offers priority housing and priority registration to new students who start in the summer (rather than the fall).

In conclusion, we believe that the Legislature should continue to take steps to encourage UC and CSU to serve more students during the summer by implementing year-round operations. At the same time, the segments should be held accountable for increasing their summer enrollments as envisioned by the Legislature. More importantly, summer sessions should be maximized to full capacity before the authorization to construct new classrooms and teaching laboratories for the purpose of accommodating anticipated enrollment growth.



## INTERSEGMENTAL: STUDENT FEES

Currently, the state has no student fee policy for the University of California (UC), Hastings College of the Law (Hastings), California State University (CSU), or California Community Colleges (CCC). Lacking a long-term approach to setting fees, the state has tended to make fee decisions based almost entirely on its fiscal condition—raising fees in bad fiscal times and lowering them in good fiscal times. In an attempt to address this volatility, the administration established written agreements with the segments that called for modest fee increases annually through 2010-11. Consistent with these agreements, the UC Regents, Hastings Directors, and CSU Trustees approved fee increases for 2006-07 of 8 percent for undergraduates and 10 percent for graduate students. The administration now proposes that those fee increases be revoked and student fees be maintained at their current-year levels. (The administration also proposes that CCC fees remain unchanged.) In a related proposal, the Governor’s budget provides the higher education segments with an unallocated \$149 million General Fund augmentation intended to substitute for the foregone fee revenue. (Of this amount, \$75 million is provided to UC, \$1.4 million to Hastings, \$54 million to CSU, and \$19 million [Proposition 98] to CCC.) We have concerns with both the proposed fee levels and the proposed “fee buyout.”

Below, we first describe the problems associated with not having a fee policy, discuss the benefits of a share-of-cost fee policy, and explain our recommendation to hold students’ share of cost constant from 2005-06 to 2006-07. We then compare various 2006-07 fee proposals. Toward the end of the piece, we discuss the Governor’s proposed fee buyout.

### **Share-of-Cost Fee Policy Would Benefit Students and the State**

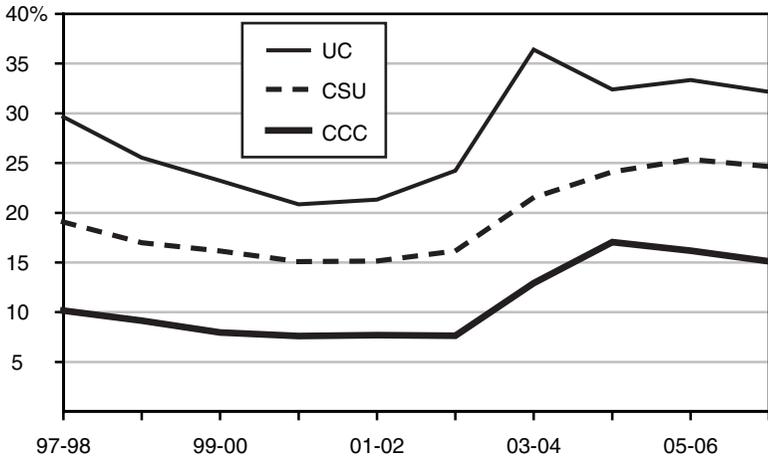
Over the last ten years, fee levels have fluctuated significantly, as have students’ expected contributions toward education costs. As shown in Figure 1 (see next page), UC undergraduates’ share of their education costs

Figure 1

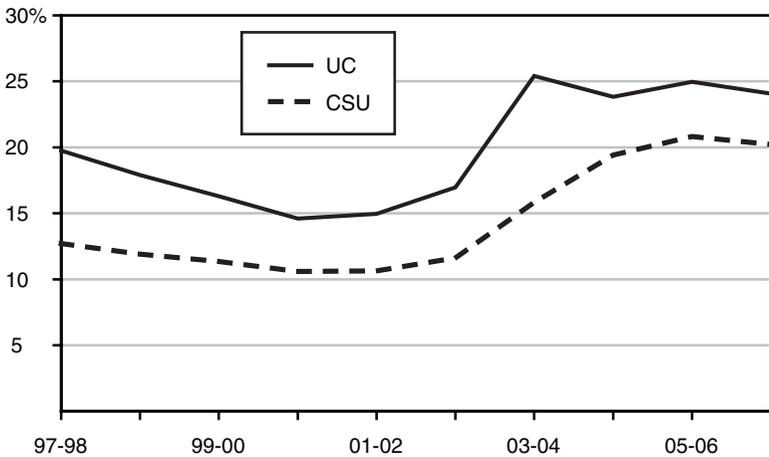
### Nonneedy Students' Share of Cost Fluctuates Significantly

Share of Cost

#### Undergraduates



#### Graduates



over this period has been as low as 21 percent and as high as 36 percent. Following the same trend, UC graduate students' share of cost has ranged from 15 percent to 25 percent. At CSU and CCC, students' share of cost has been equally volatile. Undergraduates' share of cost at CSU has ranged from 15 percent to 25 percent, and graduate students' share of cost has ranged from 11 percent to 21 percent. At CCC, students' share of cost has been as low as 8 percent and as high as 17 percent.

***Lack of Fee Policy Has Resulted in Inconsistent Treatment of Student Groups.*** In general, financially needy students of traditional college age are not required to pay education fees to attend public higher education in California. (These fees are covered through a variety of financial aid programs, which we briefly describe in the box (see next page). In that box, we also describe aid programs designed for students who are not of traditional college age.) Therefore, the state intends for only nonneedy students to pay a portion of their direct education costs. The lack of a fee policy generates considerable volatility and disparity among nonneedy students. As reflected in Figure 1, nonneedy student groups bear very different shares of cost depending on the state's fiscal fortunes during the years they attend college. The resulting annual changes in fee levels clearly are not gradual, moderate, or predictable—despite these principles being embedded in virtually every student fee policy the Legislature has considered over the last decade.

***Share-of-Cost Fee Policy Has Many Benefits.*** A share-of-cost fee policy provides both an underlying rationale for fee levels and a simple mechanism for annually adjusting them. In doing so, it provides clarity, ensures consistency, fosters shared responsibility, and strengthens accountability. It provides clarity by establishing an expected contribution from all nonneedy students, regardless of when they enter college. It promotes consistency by routinely adjusting fee levels such that nonneedy students pay the same share of cost over time. It also recognizes that college is a partnership between students and the general public—expecting both to contribute to its costs and intending for both to benefit from its activities. Lastly, a share-of-cost policy ensures that students and the university share the cost of any new program or program enhancement, thereby providing a strong incentive for students to hold their campuses accountable for making quality investments at reasonable cost.

## **Maintain Students' Share of Cost at Current-Year Level**

***For 2006-07, we recommend the Legislature at least maintain nonneedy students' share of cost at the current-year level. Holding this share constant would entail modest fee increases of 3.5 percent at the University of California (UC), 3.0 percent at the California***

*State University (CSU), and 7.0 percent at the California Community College (CCC). For a full-time undergraduate, this equates to an annual increase of \$215 at UC, \$76 at CSU, and \$55 at CCC. These increases would generate \$84 million in net new fee revenue. (Of this fee revenue, \$35 million is generated at UC, and \$1 million at Hastings, \$24 million at CSU, and \$24 million at CCC.)*

### **State Financial Aid Programs Intended to Ensure Access**

The Legislature has established a number of financial aid programs intended to ensure that the state's financially needy students have access to public higher education. Given these programs cover education fees for most financially needy students of traditional college age and many older students, the state's fee decisions largely affect only nonneedy students and the share of cost they bear.

For community college students, one of the major financial aid programs is the Board of Governors (BOG) fee waiver program. Under this program, all students who have even one dollar of financial need (as defined by federal guidelines) are eligible to have their fees entirely waived. There are no grade point average (GPA) or age requirements and family incomes can be relatively high. For example, a dependent student in a family of four with income as high as \$80,000 could still receive a fee waiver. Currently about 42 percent of all full-time equivalent students receive BOG waivers.

Financially needy undergraduate students at the University of California (UC) and the California State University (CSU) (as well as private colleges and California Community College) are generally eligible for a Cal Grant, which pays education fees and in some cases provides a living stipend. Students who have recently graduated from high school and young adults who are transferring from a community college to a four-year college generally are entitled to these grants (as long as they meet income and GPA requirements). Older students who are not eligible for entitlement awards compete for a fixed number of competitive Cal Grants. Currently, these older students are among the most likely not to be served by the state's financial aid programs. (The Cal Grant program is expressly designed to give priority to students of traditional college age.) Many students, however, who are not awarded a Cal Grant have been able to receive institutional aid at UC and CSU.

As indicated above, the Governor's budget proposes no fee increases for resident students attending UC, Hastings, CSU, and CCC. At the same time, the Governor's budget proposes various General Fund augmentations that would drive up the per student cost of education at all three segments and Hastings. Without fee increases, this results in nonneedy students' share of cost falling (and the general taxpayers' share increasing) between 2005-06 and 2006-07.

At a minimum, we recommend the Legislature maintain nonneedy students' share of cost at their current-year levels (shown in Figure 2). This would entail modest fee increases of 3.5 percent at UC, 4.5 percent at Hastings, 3.0 percent at CSU, and 7.0 percent at CCC. The fee increases reflect both the effect of inflation and additional spending on education proposed in the Governor's budget. Maintaining students' share of cost at their current-year levels both would promote consistency among student cohorts and adhere to the broadly agreed-upon principles that fee increases should be gradual, moderate, and predictable. It also would reduce the need for steep fee increases in the future.

**Figure 2**

**Nonneedy Students' Share of Cost  
Low at All Three Segments**

2005-06

	Average Cost of Education	Systemwide Education Fee	Fees as a Share of Cost
UC undergraduates	\$18,415	\$6,141	33%
UC graduate students	27,622	6,897	25
CSU undergraduates	9,932	2,520	25
CSU graduate students	14,899	3,102	21
CCC students	4,823	780	16

*Fees Would Be Lower Than Those Anticipated by Students and the Segments.* Figure 3 and Figure 4 (see pages 224 and 225) compare (1) the administration's 2006-07 fee proposals, (2) our fee recommendations, and (3) the fee levels adopted last fall by the segments' governing boards. The figures show that our recommended 2006-07 fee levels, while higher than those proposed by the Governor, are lower than those the segments have approved.

**Figure 3****Comparing 2006-07 Undergraduate and Graduate Fee Proposals***(Systemwide Education Fees for Full-Time Resident Students)*

	Governor <sup>a</sup>		LAO <sup>b</sup>		Regents/Trustees <sup>c</sup>	
	Fee	Fee	Percent Increase	Fee	Percent Increase	Fee
UC undergraduates	\$6,141	\$6,356	3.5%	\$6,633	8%	\$6,633
UC graduate students	6,897	7,138	3.5	7,587	10	7,587
CSU undergraduates	2,520	2,596	3.0	2,724	8	2,724
CSU graduate students	3,102	3,195	3.0	3,414	10	3,414
CCC students	780	835	7.0	—	—	—

<sup>a</sup> Maintains fees at 2005-06 levels.  
<sup>b</sup> Reflects our recommendation to maintain nonneedy students' share of cost at the current-year level.  
<sup>c</sup> Reflects fee levels adopted by the boards at their fall 2005 budget meetings.

***Fees Would Remain Very Low Compared to Similar Institutions.***

Even with the modest fee increases that we recommend, California's fees would remain relatively low. As Figure 5 (see page 226) shows, assuming a 3.5 percent fee increase at UC in 2006-07, resident undergraduate fees very likely would remain the second lowest of UC's public comparison institutions. Graduate fees very likely would remain the lowest. Assuming a 3 percent fee increase at CSU, resident undergraduate and graduate fees very likely would remain the lowest of CSU's public comparison institutions (as shown in Figure 6 and Figure 7 on pages 227 and 228). Similarly, assuming a 7 percent fee increase at CCC, fees very likely still would be by far the lowest in the nation and less than one-third the national average.

***Additional Fee Revenue Would Be Generated.*** By maintaining the relatively modest share of cost for nonneedy students at the three segments, fee revenue is generated from those with the ability to pay. Our recommended fee levels would generate \$103 million in gross new fee revenue.

***Financially Needy Students Would Be Protected From Fee Increases.***

The state has various financial aid programs that provide grants or waivers that cover education fees for financially needy students. Consistent with these practices, we recommend setting aside \$19 million from the new fee revenue to fully cover the fee increases for existing as well as new financially needy students. Consistent with historical practice, we recommend covering the fee increases for undergraduates via the Cal Grant program and, for graduate students, covering them via the segments' institutional aid programs (given the absence of a statewide program).

**Figure 4****Comparing 2006-07 Professional School Fee Proposals***(Systemwide Education Fees for Full-Time Resident Students)*

	Governor <sup>a</sup>		LAO <sup>b</sup>		Regents/ Directors <sup>c</sup>	
	Fee	Fee	Percent Increase	Fee	Percent Increase	Percent Increase
<b>University of California</b>						
Veterinary Medicine	\$18,024	\$18,655	3.5%	\$18,926	5.0%	
Dentistry <sup>d</sup>	21,949	22,717	3.5	23,048	5.0	
Business/Management <sup>d</sup>	22,966	23,769	3.5	24,509	6.7	
Law <sup>d</sup>	22,816	23,614	3.5	24,741	8.4	
Medicine	20,582	21,302	3.5	21,612	5.0	
Optometry	16,684	17,268	3.5	17,519	5.0	
Pharmacy	18,240	18,878	3.5	19,153	5.0	
Nursing	10,360	10,723	3.5	10,879	5.0	
Theater/Film	13,101	13,560	3.5	13,757	5.0	
Public Health	10,897	11,278	3.5	11,442	5.0	
Public Policy/International Relations	10,897	11,278	3.5	11,442	5.0	
<b>Hastings College of the Law</b>	19,725	20,613	4.5	21,303	8.0	

a Reflects 2005-06 fee levels.

b Reflects our recommendation to maintain nonneedy students' share of cost at the current-year level.

c Reflects fee levels adopted by the boards at their fall 2005 meetings.

d Reflects midpoint of fee levels, which vary by campus.

**Reject Concept of Fee Buyout**

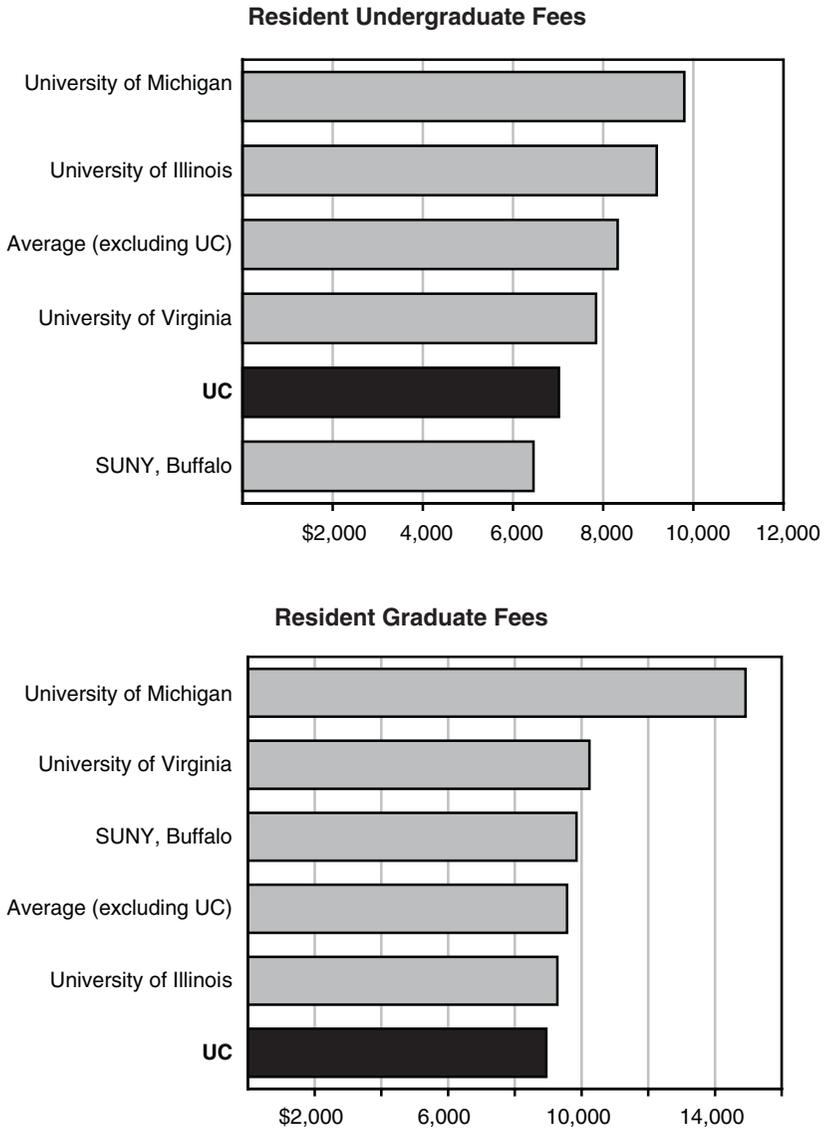
*We recommend the Legislature reject the Governor's "fee buyout" proposal because it distorts budgeting and creates the wrong incentives. Rather than provide a fee buyout, we recommend the Legislature provide the segments sufficient funding to meet identified needs.*

The Governor's budget provides the segments a large General Fund augmentation (\$149 million) linked to a "fee buyout." Specifically, \$75 million is provided to UC, \$1.4 million to Hastings, \$54 million to CSU, and \$19 million (Proposition 98) to CCC. In calculating the buyout, the Governor's budget assumes the segments would have raised fees between 5 percent (for community college students) and 10 percent (for graduate students). It then provides General Fund support to offset the hypothetically foregone fee revenue. We recommend rejecting this fee buyout proposal because it distorts budgeting and creates the wrong incentives.

**Figure 5**

**UC Fees Still Would Be Low  
Relative to Public Comparison Institutions<sup>a</sup>**

2006-07

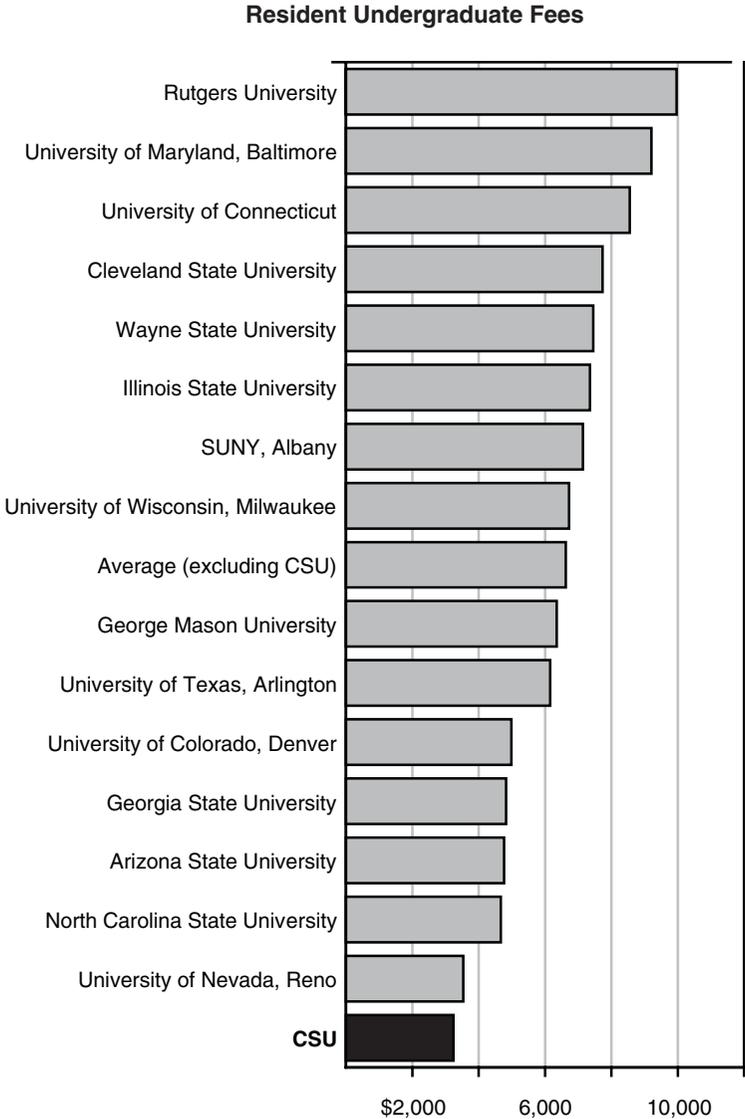


<sup>a</sup>Includes systemwide education fee and average campus-based fee. Reflects our share-of-cost recommendation. For comparison institutions, grows current-year fee levels by the average prior-year growth rate (6.4 percent for undergraduates and 4.5 percent for graduate students).

Figure 6

**CSU Undergraduate Fees Still Would Be Lowest of Public Comparison Institutions<sup>a</sup>**

2006-07



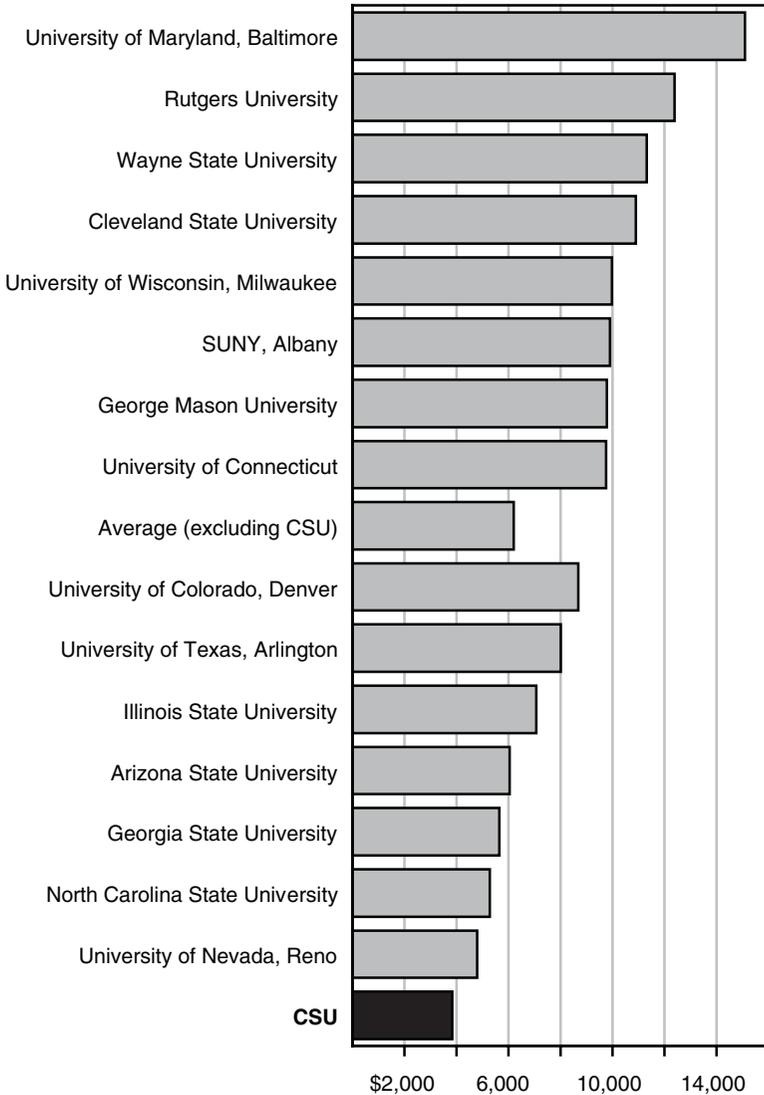
<sup>a</sup>Includes systemwide education fee and average campus-based fee. Reflects our share-of-cost recommendation. For comparison institutions, grows current-year fee levels by the average prior-year growth rate (8.1 percent).

**Figure 7**

**CSU Resident Graduate Fees Still Would Be Lowest Of Public Comparison Institutions<sup>a</sup>**

2006-07

**Resident Graduate Fees**



<sup>a</sup>Includes systemwide education fee and average campus-based fee. Reflects our share-of-cost recommendation. For comparison institutions, grows current-year fee levels by the average prior-year growth rate (8.7 percent).

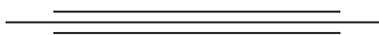
***Fee Buyout Distorts Budgeting.*** The Governor's budget bases a large General Fund augmentation on segment-approved fee increases. Linking the monies in this way tells the Legislature nothing about whether the funding is needed or how it will be spent. We believe the budget should be built in a more rational way. We recommend the Legislature first determine the segments' overall budget needs. For example, as we discuss earlier in the higher education priorities write-up, the Legislature should first consider basic cost increases and enrollment growth. Once budget needs have been identified, the Legislature then can decide how to share any new costs between the state and students. In the above section, we recommend at least maintaining students' share of cost at their current-year levels. To the extent the budget increases spending per student, maintaining students' share of cost would entail modest fee increases and an associated increase in student fee revenue as well as additional financial aid. With this type of process, there is never a need to consider fee buyouts.

***Fee Buyout Creates Wrong Incentives.*** Because the Governor's fee buyout approach begins with fee increases disconnected from budget needs, it creates perverse incentives for the segments to build inflated budgets. For example, under the Governor's approach, the segments could have proposed 30 percent fee increases (as occurred in 2003-04), which would have "required" a fee buyout of \$584 million. Under a buyout approach, the segments have reduced incentives to be realistic either about fee increases or budget needs.

***Rejecting a Fee Increase Does Not Require a "Buyout."*** After identifying the segments' budget needs, the Legislature could decide that it does not want fees raised. This would have the effect of increasing the state's share of cost and reducing the students' share. It should not, however, change the basic approach to building the segments' budgets, as discussed above.

## Conclusion

We continue to recommend the Legislature adopt a share-of-cost fee policy that would guide annual fee decisions. For 2006-07, we recommend the Legislature at least maintain nonneedy students' share of cost at their current-year levels. This would treat nonneedy students consistently year to year and generate \$84 million in net new fee revenue. Whether or not the Legislature decides to raise fees, we recommend it reject the Governor's proposed \$149 million fee buyout proposal because it distorts budgeting and creates the wrong incentives.



## UNIVERSITY OF CALIFORNIA (6440)

The University of California (UC) consists of nine general campuses and one health science campus. The Governor's budget includes about \$20 billion for UC from all fund sources—including the state General Fund, student fee revenue, federal funds, and other funds. This is an increase of about \$643 million, or 3.3 percent, from the revised current-year amount. The budget proposes General Fund spending of \$3 billion for the segment in 2006-07. This is an increase of \$206.7 million, or 7.3 percent, from the revised 2005-06 budget.

Figure 1 summarizes the Governor's proposed General Fund changes for the current year and the budget year. For 2006-07, the Governor proposes \$222.1 million in General Fund augmentations, a \$17.3 million General Fund reduction to outreach programs, and a \$2 million net increase for baseline and technical adjustments. We discuss the proposed augmentations in further detail below.

**Base Budget Increases.** The Governor's budget proposes two base increases to UC's General Fund budget totaling \$155.5 million that are not restricted for specific purposes. First, the budget provides UC with a 3 percent General Fund base increase of \$80.5 million intended to support salary and benefit increases for faculty and staff. The UC indicates that it would apply most of these funds towards various salary increases. The second base increase totals \$75 million and is provided to UC in lieu of additional student fee revenue that would have been generated by the fee increases recently approved by the UC Board of Regents for undergraduate, graduate, and professional school students. The Governor assumes that the Board of Regents will cancel these fee increases. According to UC, this additional revenue will be used to (1) provide further salary and benefit increases (for a total average increase of 4 percent), (2) reduce the university's current student-faculty ratio, and (3) fund costs increases for professional school programs. Because the funding provided in lieu of the fee increases is not intended for any particular program, it effectively increases UC's total, unrestricted base increase from 3 percent to 5.8 percent.

**Figure 1**  
**University of California (UC)**  
**General Fund Budget Proposal**

(Dollars in Millions)

<b>2005-06 Budget Act</b>	<b>\$2,843.2</b>
Entry-level nursing program <sup>a</sup>	\$1.7
Baseline adjustments	-2.5
<b>2005-06 Revised Budget</b>	<b>\$2,842.4</b>
<b>Baseline and Technical Adjustments</b>	<b>\$2.0</b>
<b>Proposed Increases</b>	
Base increase (3 percent)	\$80.5
Additional base increase in lieu of fee increase (2.8 percent)	75.0
Enrollment growth (2.5 percent)	52.0
One-time augmentation for UC Merced	14.0
Other increases	0.6
Subtotal	(\$222.1)
<b>Proposed Reductions</b>	
Eliminate General Fund support for outreach programs	-\$17.3
<b>2006-07 Proposed Budget</b>	<b>\$3,049.2</b>
<b>Change From 2005-06 Revised Budget</b>	
Amount	\$206.7
Percent	7.3%

<sup>a</sup> Per Chapter 592, Statutes of 2005 (SB 73, Committee on Budget and Fiscal Review).

*Enrollment Growth.* In addition to base increases, the Governor's budget includes a \$52 million General Fund augmentation for enrollment growth at UC. This would increase the university's budgeted enrollment by 5,149 full-time equivalent (FTE) students, or 2.5 percent, above the current-year level, which assumes a marginal General Fund cost of \$10,103 per additional student. The proposed enrollment growth funding reflects a new methodology proposed by the Governor for calculating the marginal cost of serving an additional student. In addition, the budget proposal assumes UC will enroll an additional 130 FTE students in its entry-level master's nursing program, as required under Chapter 592, Statutes of 2005 (SB 73, Committee on Budget and Fiscal Review).

**Other Proposed General Fund Augmentations.** The Governor's budget proposes a \$14 million one-time augmentation for start-up costs to support the UC campus in Merced, which opened in fall 2005. In addition, the budget provides UC \$375,000 in new funding for the expansion of the Governor's math and science teacher initiative, which is intended to increase the number of math and science teachers trained at UC and the California State University (CSU). The proposed budget also includes a \$180,000 augmentation to expand enrollment in UC's Program in Medical Education for the Latino Community (PRIME-LC).

## Student Fees

As discussed earlier, the Governor's budget assumes no fee increases in the systemwide fees for undergraduate, graduate, and professional school students at UC. The full-time resident systemwide fees would remain at \$6,141 for undergraduate students and \$6,897 for graduate students. These amounts do not include campus-based fees. When combined with campus-based fees, the total student fee for a resident full-time student in 2006-07 would be \$6,802 for undergraduates and \$8,708 for graduates. For 2006-07, the systemwide professional school fee is planned to range from a low of \$10,360 for students in nursing programs to a high of \$24,513 for business/management school students.

The proposed budget, however, does assume a planned 5 percent increase in the tuition surcharge imposed on nonresident undergraduate students, as recently approved by the UC Board of Regents. Specifically, this surcharge would increase from \$17,304 to \$18,168. This increase in nonresident tuition for undergraduates is expected to provide about \$7.5 million in additional fee revenue in the budget year. The budget also assumes that nonresident tuition for graduate students would remain at \$14,694, as recently approved by the Regents.

## INTERSEGMENTAL ISSUES INVOLVING UC

In the "Intersegmental" write-ups earlier in this chapter, we address several issues relating to UC. For each of these issues, we offer an alternative to the Governor's proposal. We summarize our main findings and recommendations below.

**Fund Enrollment Growth Consistent With Demographic Projections and Our Revised Marginal Cost Methodology.** The Governor's budget provides \$52 million to fund 2.5 percent enrollment growth at a marginal General Fund cost of \$10,103 per additional FTE student, based on his proposal for a new marginal cost methodology. In the "UC and CSU Enrollment Growth and Funding" write-up in this chapter, we

recommend, based on our demographic projections, the Legislature instead provide funding for enrollment growth at a rate of 2 percent. Our proposal would allow the university to accommodate enrollment growth next year due to increases in population, as well as modest increases in college participation rates.

Moreover, we recommend the Legislature reject the Governor's proposed marginal cost methodology. While we concur that the methodology is in need of revision, we propose an approach which more appropriately funds the increased costs associated with enrollment growth. Specifically, we propose (1) excluding unrelated costs, (2) better reflecting the actual costs of hiring entry-level faculty and teaching assistants, (3) including operation and maintenance costs, and (4) adjusting the total marginal cost by the average fee revenue collected per student. Using our revised methodology, we recommend reducing the Governor's proposed per student funding rate for UC from \$10,103 to \$8,574. (Our proposed rate is still higher than the level that would be generated under the current methodology.) Accordingly, we recommend a General Fund reduction of \$16.7 million for UC.

***Maintain Nonneedy Students' Share-of-Cost At Current-Year Levels.*** The proposed budget assumes no increases in the systemwide fees for undergraduate, graduate, and professional school students at UC. In the "Student Fees" write-up, we recommend the Legislature maintain nonneedy students' share-of-cost at their current-year levels. Because of various augmentations proposed for the budget year at UC, holding students' share-of-cost constant would entail a modest systemwide fee increase of 3.5 percent. For a full-time UC undergraduate, this equates to an annual increase of \$215. In addition, we recommend adjustments in Cal Grant award amounts sufficient to ensure that all eligible financially needy students receive grants that fully cover the fee increase.

***Facilitate Expansion of Summer Programs.*** In recent years, the Legislature has taken steps to encourage UC to serve more students during summer sessions (such as providing supplemental funding to enhance summer operations), thus reducing the need for adding new facilities to accommodate additional demand. Between summer 2000 and summer 2005, summer enrollment at UC campuses targeted for expansion doubled. Over the same time period, summer enrollment at campuses not targeted for expansion has also increased. Despite these increases, the summer term at UC is very far from operating at full capacity. In the "Year-Round Operations at UC and CSU" write-up in this chapter, we (1) provide an update on UC's efforts to expand summer operations, (2) examine whether the Legislature should provide funding to fully convert additional UC campuses to year-round operations, and (3) outline steps

that campuses could take to encourage more students to enroll during the summer term.

***Address Retiree Health Benefits.*** In “Part V” of the 2006-07 Budget: *Perspectives and Issues*, we discuss the increasing costs of providing health and dental benefits to retired public employees—including UC employees. With regard to UC, we recommend that the segment assess its retiree health benefit liabilities and propose a long-term plan to address these liabilities.

## **GENERAL FUND BASE INCREASE**

*Given our projection of inflation for 2006-07, we recommend the Legislature provide a 3.3 percent General Fund base increase to the University of California (UC). Since the Governor proposes funding for a 5.8 percent base increase, we recommend deleting \$67 million from the \$155.5 million General Fund base augmentation requested in the budget for UC. (Reduce Item 6440-001-0001 by \$67 million.)*

In order to offset the effects of inflation, which erode the purchasing power of a fixed appropriation over time, many state programs receive periodic base increases. The UC uses these increases to fund salary and wage increases for faculty and staff, as well as increased prices of goods and services. In other words, these cost-of-living adjustments are not intended to fund increased workload, but rather are meant to help the university’s campuses pay for existing workload whose cost has increased due to inflation.

For 2006-07, the Governor proposes two base increases: (1) \$80.5 million for a 3 percent operational base increase and (2) \$75 million for a 2.8 percent base increase provided in lieu of increased funding from student fees. However, we project inflation in 2006-07 to be 3.3 percent (based on our estimate of the change in the U.S. state and local deflator from 2005-06 to 2006-07), which would cost \$88.5 million. Thus, we recommend the Legislature reduce the Governor’s proposed base increase from \$155.5 million to \$88.5 million. Under our proposal, the university would receive sufficient funding to compensate for increased costs. At the same time, the Legislature could use our identified General Fund savings of \$67 million to address other priorities, including addressing the state’s budget problem.

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## OTHER ISSUES

### K-14 Outreach Programs

*We withhold recommendation on the proposed \$17.3 million General Fund reduction to the University of California's outreach programs, pending our review of an evaluation of the programs to be submitted in April.*

The UC currently administers over 15 different K-14 outreach programs (also known as academic preparation programs) that focus on preparing students from disadvantaged backgrounds for college. The 2005-06 *Budget Act* included a total of \$29.3 million for such programs. This amount consists of \$17.3 million from the General Fund and \$12 million in other funds. For 2006-07, the Governor's budget proposes a \$17.3 million General Fund reduction to UC's outreach programs, which would eliminate all their General Fund support. Under the Governor's proposal, UC would maintain \$12 million in other funds to allocate across its various outreach programs. In adopting the 2005-06 budget, the Legislature rejected a similar reduction proposed by the Governor last year.

As part of the 2005-06 *Budget Act*, the Legislature adopted provisional language to ensure oversight of the use of UC's outreach funds. Specifically, the 2005-06 budget required that UC report to the Legislature by April 1, 2006, on the outcomes and effectiveness of its outreach programs. We note that the Legislature has required the university to provide similar reports in the past. In fact, the university has been provided a combined total of about \$9 million since 1998-99 for the purpose of evaluating its outreach efforts. For example, the 2005-06 budget includes \$1.1 million for outreach program evaluation. However, as we discussed in our *Analysis of the 2004-05 Budget Bill*, UC's past outreach evaluations showed little conclusive evidence regarding program effectiveness. This is not to say that outreach programs are ineffective in helping disadvantaged students enroll in college. Rather, UC's data did not demonstrate whether students participating in outreach programs would have been eligible for or likely to attend college without these services. In addition, it was unclear whether the state's current outreach efforts are cost-effective in comparison to alternative approaches.

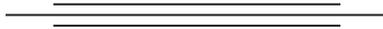
In April 2005, UC adopted a new accountability framework for assessing its outreach programs. For each program, the framework (1) specifies goals and target groups and (2) establishes performance measures and indicators in order to determine program effectiveness. The 2005-06 budget specifies that UC's evaluation report to the Legislature this spring shall be consistent with this accountability framework. We withhold recommen-

dition on the Governor's proposed \$17.3 million General Fund reduction, pending receipt and review of the required evaluation.

### **PRIME-LC**

*We withhold recommendation on the \$180,000 proposed augmentation for the University of California's Program in Medical Education for the Latino Community, pending further review of the basis of the proposed augmentation.*

The 2005-06 Budget Act included \$300,000 in General Fund support for 20 medical students in UC's PRIME-LC. The purpose of PRIME-LC is to train physicians specifically to serve in underrepresented communities. The Governor's budget proposes a \$180,000 General Fund augmentation for the program to enroll an additional 12 medical students. At the time this *Analysis* was being prepared in early February, both the university and the administration could not provide adequate information regarding the requested augmentation. As a result, we withhold recommendation on the proposed augmentation pending further review.



## CALIFORNIA STATE UNIVERSITY (6610)

The California State University (CSU) consists of 23 campuses. The Governor's budget includes about \$6.2 billion for CSU from all fund sources, including General Fund, student fee revenue, federal funds, and other funds. This is an increase of \$196 million, or 3.3 percent, from the revised current-year amount. Most of the increase comes from CSU's General Fund appropriations, which increase by \$178 million, or 6.9 percent, from the revised current-year level. These General Fund changes are summarized in Figure 1 (see next page) and detailed below. The CSU's other funds collectively experience a net reduction of \$8.4 million (0.4 percent).

### Proposed General Fund Changes

**Base Budget Increases.** The proposed budget provides two base increases to CSU's General Fund budget that are not restricted for specific purposes. The first totals \$75.8 million and reflects a 3 percent base increase intended to compensate for increased costs to the university (mainly faculty and staff compensation increases). The second base increase totals \$54.4 million and is provided to CSU in lieu of additional student fee revenue that would have been generated by a fee increase approved by the CSU Board of Trustees for 2006-07. The Governor expects that CSU will rescind the fee increase. According to CSU, this additional revenue will be used to (1) provide further salary and benefit increases beyond 3 percent, and (2) expand libraries, technology, and maintenance funding. Yet because the funding provided in lieu of the fee increase can be used by the segment for any purpose, it effectively increases CSU's total, unrestricted base increase from 3 percent to 5.2 percent.

**Enrollment Growth.** In addition to base increases, the Governor's budget also provides \$57.7 million for a 2.5 percent increase in budgeted enrollment. This would increase CSU's budgeted enrollment by 8,306 full-time equivalent (FTE) students. However, the Governor's budget also proposes to reduce the number of units that define an FTE graduate student from 15 units per semester to 12 units per semester. This would have the effect of increasing the calculated number of graduate FTE students at CSU.

**Figure 1**  
**California State University**  
**General Fund Budget Proposal**

*(Dollars in Millions)*

<b>2005-06 Budget Act</b>	<b>\$2,615.1</b>
Entry-level nursing program <sup>a</sup>	\$1.7
Carryover/reappropriation and other technical changes	3.1
Reduced cost of state retirement contributions	-22.5
<b>Revised 2005-06 Budget</b>	<b>\$2,597.5</b>
<b>Proposed Increases</b>	
Base increase (3 percent)	\$75.8
Additional base increase in lieu of fee increase (2.2 percent)	54.4
Enrollment growth (2.5 percent)	57.7
Other adjustments	2.4
Subtotal	(\$190.3)
<b>Proposed Reductions</b>	
Eliminate outreach funding	-\$7.0
Reflect General Fund interest loss from proposed shift of fee revenue to local trust funds	-5.0
Subtotal	(-\$12.0)
<b>2006-07 Proposed Budget</b>	<b>\$2,775.8</b>
<b>Change from 2005-06 Revised Budget</b>	
Amount	\$178.3
Percent	6.9%

<sup>a</sup> Per Chapter 592, Statutes of 2005 (SB 73, Committee on Budget and Fiscal Review).

The enrollment growth augmentation provides \$6,792 per additional FTE student. This reflects a proposed new formula for calculating the marginal cost of serving each additional student. In addition, the budget proposal assumes CSU will enroll an additional 163 FTE students in its entry-level master's nursing program, as required by Chapter 592, Statutes of 2005 (SB 73, Committee on Budget and Fiscal Review).

***Continuous Appropriation of Fee Revenue.*** The budget reduces CSU's General Fund support by \$5 million as a result of a proposed change to the treatment of student fee revenue. Up to now, CSU fee revenue has been collected by individual campuses but appropriated through the state bud-

get in a special account. This fee revenue has earned interest, which has accrued to the state General Fund. The Governor proposes that campuses shall instead deposit fee revenue into local trust funds, which would be continuously appropriated. The state would no longer appropriate the funding through the budget act, and the General Fund would no longer receive interest from those fees. The proposed \$5 million reduction in CSU's General Fund appropriation is intended to reflect the interest that otherwise would have accrued to the General Fund, but which instead will accrue to CSU campuses through their trust funds. (Later in this write-up we recommend that if the Legislature desires to approve this proposal, it amend the proposed trailer bill language to protect budgetary accountability.)

***Math and Science Initiative.*** The Governor's budget provides CSU \$1.1 million in new funding for the expansion of the Governor's math and science initiative, which is intended to increase the number of math and science teachers trained at CSU.

## **Student Fees**

As discussed earlier, the Governor's budget assumes no increase in student fee levels. Fees for resident full-time students would remain at \$2,520 for undergraduate students and \$3,102 for graduate students. These amounts do not include campus-based fees. When combined with the average of campus-based fees, the total student fee for a resident full-time student in 2006-07 would be \$3,164 for undergraduates and \$3,746 for graduate students. Total nonresident tuition and fees would remain unchanged at \$13,334 for undergraduates and \$13,916 for graduate students.

## **Intersegmental Issues Involving CSU**

In "Intersegmental" write-ups earlier in this chapter, we address several issues relating to CSU. For each of these issues, we offer an alternative to the Governor's proposal. We summarize our main findings and recommendations below.

***Fund Enrollment Growth Consistent With Demographic Projections and Our Revised Marginal Cost Methodology.*** The Governor's budget provides \$57.7 million to fund 2.5 percent enrollment growth at a marginal General Fund cost of \$6,792 per additional FTE student, based on a proposed new marginal cost methodology. In the "UC and CSU Enrollment Growth and Funding" section in this chapter, we recommend, based on our demographic projections, that the Legislature instead provide funding for enrollment growth at a rate of 2 percent. Our proposal would allow the university to accommodate enrollment growth next year due to increases in population, as well as modest increases in college participation rates.

Moreover, we recommend the Legislature reject the Governor's proposed marginal cost methodology. While we concur that the methodology is in need of revision, we propose an approach which more appropriately funds the increased costs associated with enrollment growth. Specifically, we propose (1) excluding unrelated costs, (2) better reflecting the actual costs of hiring entry-level faculty and teaching assistants, (3) including operation and maintenance costs, and (4) adjusting the total marginal cost by the average fee revenue collected per student. Using our revised methodology, we recommend reducing the Governor's proposed per student funding rate for CSU from \$6,792 to \$6,407. (Our proposed rate is still higher than the level that would be generated under the current methodology.) Accordingly, we recommend a General Fund reduction of \$14.1 million for CSU.

*Maintain Nonneedy Students' Share of Cost at Current-Year Levels.* The proposed budget assumes no fee increase in the systemwide fees paid by CSU students. In the "Student Fees" write-up, we recommend the Legislature maintain nonneedy students' share of cost at current-year levels. Because the cost of serving CSU is projected to increase, holding students' share of cost constant would entail a modest systemwide fee increase of 3 percent. For a full-time CSU undergraduate, this amounts to an annual increase of \$76. In addition, we recommend adjustments in Cal Grant award amounts sufficient to ensure that all eligible financially needy students receive grants that fully cover the fee increase.

*Facilitate Expansion of Summer Programs.* In recent years, the Legislature has taken steps to encourage CSU to serve more students during summer sessions (such as providing supplemental funding to enhance summer operations), thus reducing the need for adding new facilities to accommodate additional demand. The CSU's progress in this area is mixed. Between 2001 and 2004, summer enrollment at some CSU campuses grew while enrollment at campuses targeted for expansion *declined* by about 40 percent. Systemwide, summer sessions have enrollment levels that are less than 10 percent of fall sessions. In the "Year-Round Operations at UC and CSU" write-up in this chapter, we (1) provide an update on CSU's (and the University of California's) efforts to expand summer operations, (2) examine whether any additional funding would be needed to fully convert all CSU campuses to year-round operations, and (3) identify several ways that the Legislature could further facilitate the achievement of truly year-round operations at the state's universities.

## **General Fund Base Increase**

*We recommend the Legislature provide a 3.3 percent General Fund base increase to the California State University. This is consistent with our projection for inflation in the budget year. The Governor in effect*

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*proposes funding for a 5.2 percent base increase. We therefore recommend reducing the proposed increase of \$130 million by \$46.8 million. (Reduce Item 6610-001-0001 by \$46.8 million.)*

In order to compensate for the effects of inflation, which erode the purchasing power of a fixed appropriation over time, many state programs receive periodic base increases. The CSU uses these increases to fund salary and wage increases for faculty and staff, as well as increased prices of goods and services. In other words, these cost-of-living adjustments are not intended to fund increased workload, but rather are meant to help the university's campuses pay for existing workload whose cost has increased due to inflation.

For 2006-07, the Governor proposes two base increases: (1) \$75.8 million for a 3 percent base increase and (2) \$54.4 million for a 2.2 percent base increase provided in lieu of increased funding from student fees. We project inflation in 2006-07 to be 3.3 percent (based on our estimate of the change in the U.S. state and local deflator from 2005-06 to 2006-07), which would increase CSU's base costs by \$83.4 million. Thus, we recommend the Legislature reduce the Governor's proposed base increase from \$130.2 million to \$83.4 million. Under our proposal, the university would receive sufficient funding to compensate for increased costs. At the same time, the Legislature could use our identified General Fund savings of \$46.8 million to address other priorities, including addressing the state's budget problem.

### **K-14 Outreach Programs**

*We withhold recommendation on the proposed \$7 million General Fund reduction to CSU's outreach programs, pending our review of an evaluation of the programs to be submitted in April.*

The CSU currently administers a number of outreach programs (also known as academic preparation programs) that focus on preparing and encouraging students from disadvantaged backgrounds to attend college. These programs include the Early Academic Assessment Program, the Educational Opportunity Program, and campus-based outreach programs. The 2005-06 Budget Act included a total of \$52 million for such programs. This amount consists of \$7 million from the General Fund and \$45 million in other funds. For 2006-07, the Governor's budget proposes to eliminate the \$7 million in General Fund support from CSU's outreach funding. Under the Governor's proposal, CSU would maintain \$45 million in other funds to allocate to its outreach programs. In adopting the 2005-06 budget, the Legislature rejected a similar proposal made by the Governor last year.

As part of the *2005-06 Budget Act*, the Legislature adopted provisional language to ensure oversight of the use of CSU's outreach funds. Specifically, it required that CSU report to the Legislature by March 15, 2006, on the outcomes and effectiveness of the Early Academic Assessment Program. We withhold recommendation on the proposed reduction to CSU's outreach programs until we have had an opportunity to review this report.

### **Continuous Appropriation of Fee Revenue Could Reduce Accountability**

*If the Legislature wishes to continuously appropriate CSU's fee revenue, we would recommend the Legislature amend trailer bill language to facilitate continued accountability for these funds.*

Currently, student fee revenue collected by CSU campuses is placed in a special account and appropriated to CSU through the annual budget act. In the current year, \$1.2 billion in fee revenue is appropriated in this way. Accompanying budget bill language specifies that any fee revenue collected in excess of this amount is automatically appropriated as an augmentation to the specified appropriation. Because the fee revenue is held in a state account, the state earns interest on it. This interest is estimated to total \$4.5 million in the current year. For 2006-07, it is estimated to total \$5 million.

The Governor proposes (through trailer bill language) that CSU fee revenue no longer be deposited in state funds and appropriated to CSU through the annual budget act. Instead, he proposes that fee revenue be deposited in local trust accounts maintained by CSU campuses and continuously appropriated for CSU's general purposes. Existing state law would require that any interest received on these deposits be credited to the state General Fund. The CSU asserts that the proposed changes to the treatment of fee revenue would be more efficient because it would reduce the number of times this revenue would have to be recorded and reconciled. It also asserts that the proposal would be revenue-neutral for the state.

*Stronger Trailer Bill Language Needed to Preserve Accountability.* While this proposal would not appear to have any net fiscal impact on the state and may improve efficiency, it potentially could reduce accountability. If the Legislature wishes to continuously appropriate CSU's fee revenue for the purpose of increasing efficiency, we recommend the proposed trailer bill language be revised to ensure that fee revenue is accounted for in annual budgeting and routinely reported and clearly displayed in budget documents. At a minimum, we would recommend that language be added that (1) requires the Governor's annual budget proposal to include an estimate of the total fees to be collected in the current year and

budget year, as well as the actual amount collected in the prior year, and (2) expresses the Legislature's intent that the General Fund appropriation for CSU take into account estimated fee revenue.

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## CALIFORNIA COMMUNITY COLLEGES (6870)

California Community Colleges (CCC) provide instruction to about 1.6 million students at 109 campuses operated by 72 locally governed districts throughout the state. The system offers academic, occupational, and recreational programs at the lower division (freshman and sophomore) level. Based on agreements with local school districts, some college districts also offer a variety of adult education programs. In addition, pursuant to state law, many colleges have established programs intended to promote regional economic development.

***Funding Increases Proposed.*** The Governor's budget includes significant funding increases for CCC. As shown in Figure 1, the Governor's proposal would increase total Proposition 98 funding for CCC by \$606 million, or 11.6 percent. This augmentation funds a cost-of-living adjustment (COLA) of 5.18 percent, enrollment growth of 3 percent, and various expanded programs. Counting all fund sources—including student fee revenue and federal and local funds—CCC's budget would total \$8.6 billion.

***CCC's Share of Proposition 98 Funding.*** As shown in Figure 1, the Governor's budget includes \$5.8 billion in Proposition 98 funding for CCC in 2006-07. This is about two-thirds of total community college funding. Overall, Proposition 98 provides funding of approximately \$54 billion in support of K-12 education, CCC, and several other state agencies. As proposed by the Governor, CCC would receive about 10.8 percent of total Proposition 98 funding.

State law calls for CCC to receive approximately 10.9 percent of total Proposition 98 appropriations. However, in recent years, this provision has been suspended in the annual budget act and CCC's share of Proposition 98 funding has been lower than 10.9 percent. The Governor's proposed budget would again suspend this provision, although the share provided CCC would come close to what is called for in statute.

**Figure 1****Community College Budget Summary***(Dollars in Millions)*

	Actual 2004-05	Estimated 2005-06	Proposed 2006-07	Change From 2005-06	
				Amount	Percent
<b>Community College Proposition 98</b>					
General Fund	\$3,036.3	\$3,412.4	\$3,948.7	\$536.3	15.7%
Local property tax	1,755.7	1,829.7	1,899.3	69.6	3.8
Subtotals, Proposition 98	(\$4,792.0)	(\$5,242.1)	(\$5,848.1)	(\$606.0)	(11.6%)
<b>Other Funds</b>					
General Fund	(\$241.2)	(\$265.8)	(\$255.9)	(-\$10.0)	(-3.8%)
Proposition 98 Reversion Account	5.4	35.6	—	-35.6	-100.0
State operations	8.9	9.2	9.4	0.2	2.3
Teachers' retirement	98.3	82.2	83.2	1.0	1.2
Bond payments	128.6	138.9	163.3	24.4	17.6
State lottery funds	143.3	177.9	177.9	—	—
Other state funds	9.3	11.1	11.2	0.1	0.6
Student fees	334.7	347.9	358.4	10.4	3.0
Federal funds	244.1	268.5	268.5	—	—
Other local funds	1536.2	1691.9	1691.9	—	—
Subtotals, other funds	(\$2,508.8)	(\$2,763.2)	(\$2,763.7)	(\$0.5)	—
<b>Grand Totals</b>	<b>\$7,300.8</b>	<b>\$8,005.3</b>	<b>\$8,611.8</b>	<b>\$606.5</b>	<b>7.6%</b>

Detail may not total due to rounding.

**Major Budget Changes**

Figure 2 (see next page) shows the changes proposed for community college Proposition 98 spending in the current and budget years. Major base increases include \$149 million for enrollment growth of 3 percent and \$265 million for a COLA of 5.18 percent. (Following longstanding practice, the Governor proposes that CCC receive the same statutory COLA as K-12 schools. The statutory COLA is based on an estimate of inflation that will not be finalized until April.) In addition to these base adjustments, the Governor proposes program expansions of \$130 million in equalization funding and \$50 million in career technical education. (We discuss these issues further in this section.)

**Figure 2**  
**California Community Colleges**  
**Governor's Budget Proposal**

*Proposition 98 Spending*  
*(In Millions)*

<b>2005-06 (Enacted)</b>	<b>\$5,216.9</b>
Local property tax surplus	\$26.0
Lease-purchase payments reduction	-0.9
<b>2005-06 (Estimated)</b>	<b>\$5,242.1</b>
Property tax base adjustment	-\$26.0
<b>Proposed Budget-Year Augmentations</b>	
Cost-of-living adjustment (COLA) (5.18 percent) for apportionments	\$264.6
Enrollment growth for apportionments (3 percent)	148.8
COLA (3 percent) and enrollment growth (1.74 percent) for categorical programs	20.8
Equalization funding for credit instruction	130.0
Career technical education	50.0
Disabled Students Programs and Services	9.6
Child care funds for students	6.2
Lease-revenue payments	4.8
California Partnership for Achieving Student Success (Cal-PASS)	0.5
Baccalaureate Partnership Program	0.1
Technical adjustments	0.2
Subtotal	(\$609.6)
<b>Proposed Budget-Year Reductions</b>	
Adjustment for increased estimate of fee revenue	-\$3.1
Technical adjustments	-0.6
Subtotal	(-\$3.6)
<b>2006-07 (Proposed)</b>	<b>\$5,848.1</b>
<b>Change From 2005-06 (Estimated)</b>	
Amount	\$606.0
Percent	11.6%
Detail may not total due to rounding.	

## Proposition 98 Spending by Major Program

Figure 3 (see next page) shows Proposition 98 expenditures for community college programs. As shown in the figure, apportionment funding (available to districts to spend on general purposes) accounts for \$5.2 billion in 2006-07, an increase of \$519 million, or 11.1 percent, from the current year. Apportionment funding in the budget year accounts for about 89 percent of CCC's total Proposition 98 expenditures.

Categorical programs (whose funding is earmarked for specified purposes) also are shown in Figure 3. These programs support a wide range of activities—from services to disabled students to part-time faculty health insurance. The Governor's budget proposes increases of approximately 7 percent for certain categorical programs to fund a COLA and enrollment growth, but for most other programs it proposes no changes. In addition, the proposed budget provides a \$9.6 million augmentation for Disabled Students Programs and Services to fund additional sign language interpretative services and captioning equipment.

## Student Fees

The Governor proposes no change to the existing student fee level of \$26 per unit. Under the Governor's budget, student fee revenue would account for 4.2 percent of total CCC funding. As we discuss in the "Student Fees" intersegmental piece earlier in this chapter, the Governor's budget provides a 5.18 percent COLA to fund cost increases in apportionments. Because the proposed budget holds student fees constant, increased fee revenue is not helping to cover those higher apportionment costs. As such \$19 million in state General Fund revenue is compensating for keeping fees constant. In contrast to the Governor's proposal, we recommend raising the CCC fee by 7 percent, requiring full-time students to pay an annual fee of \$835. This would maintain the same share of cost that nonneedy students pay, and maximize federal reimbursements for students paying the fee.

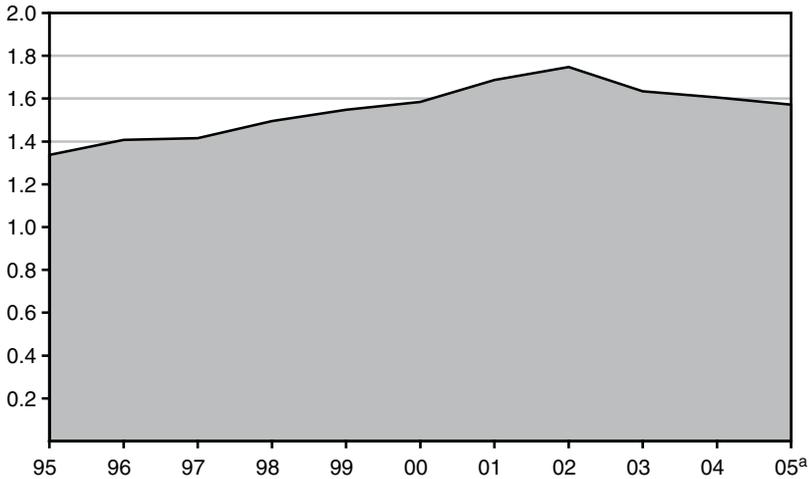
## ENROLLMENT

The CCC is the nation's largest system of higher education and enrolls three out of four public postsecondary students in the state. Over the last decade, enrollment increased by about 268,000 students or an average of 2.1 percent annually. As shown in Figure 4 (see page E-249), CCC's headcount enrollment peaked in fall 2002, but since then has been declining. Preliminary estimates indicate that CCC enrolled about 1.6 million students in the fall 2005 term. This would reflect a decline from the previous fall term of about 2 percent and represent the third consecutive year of decline. While enrollment may begin to rebound, we note that the Department of Finance's (DOF's) demographic research unit projects a modest decline in CCC headcount enrollment for 2006-07.

### Figure 3 Major Community College Programs Funded by Proposition 98

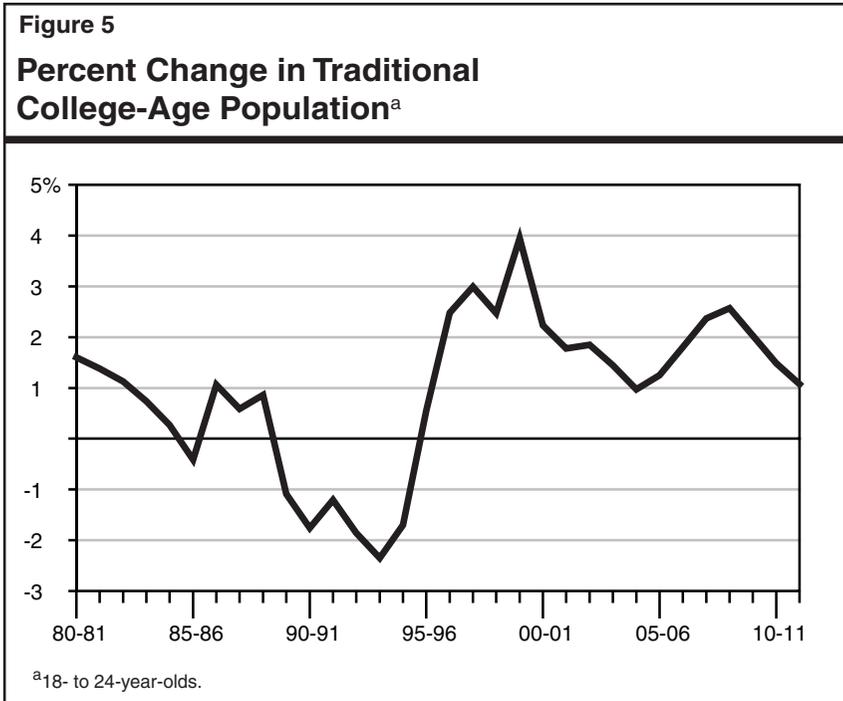
(Dollars in Millions)

	Estimated 2005-06	Proposed 2006-07	Change	
			Amount	Percent
<b>Apportionments</b>				
General Fund	\$2,858.8	\$3,308.2	\$449.4	15.7%
Local property tax revenue	1,829.7	1,899.3	69.6	3.8
Subtotals	(\$4,688.5)	(\$5,207.6)	(\$519.0)	(11.1%)
<b>Categorical Programs</b>				
Extended Opportunity and Special Services	\$104.8	\$112.1	\$7.3	7.0%
Disabled Students	91.2	107.2	16.0	17.5
Matriculation	66.3	71.0	4.7	7.0
Services for CalWORKs <sup>a</sup> recipients	34.6	34.6	—	—
Part-time faculty compensation	50.8	50.8	—	—
Part-time faculty office hours	7.2	7.2	—	—
Part-time faculty health insurance	1.0	1.0	—	—
Physical plant and instructional support	27.3	27.3	—	—
Economic development program	35.8	35.8	—	—
Career technical education	—	\$50.0	—	—
Telecommunications and technology services	24.4	24.9	0.5	2.0
Basic skills and apprenticeships	43.5	45.6	2.2	5.0
Financial aid/outreach	51.6	51.8	0.2	0.5
Child care funds for students	—	\$6.5	—	—
Foster Parent Training Program	4.8	4.8	—	—
Transfer education and articulation	2.0	1.4	-0.6	-27.9
Fund for Student Success	6.2	6.2	—	—
Baccalaureate Partnership Program	—	\$0.1	—	—
Other programs	2.2	2.2	—	—
Subtotals	(\$553.6)	(\$584.0)	(\$30.4)	(5.5%)
<b>Totals</b>	<b>\$5,242.1</b>	<b>\$5,848.1</b>	<b>\$606.0</b>	<b>11.6%</b>
Detail may not total due to rounding.				
<sup>a</sup> California Work Opportunity and Responsibility to Kids.				

**Figure 4****CCC Enrollment***Fall Headcount in Millions*<sup>a</sup>Preliminary estimate.**Modest Growth in College-Age Population Brings No Tidal Wave**

The decline in CCC's enrollment comes at a time when CCC anticipated record enrollment from an increase in the traditional college-age population. The expected increase in enrollment demand is sometimes referred to as "Tidal Wave II." California's population of 18- to 24-year olds increased from about 3 million in 1995 to nearly 3.7 million in 2005, an average annual growth rate of 2 percent. As shown in Figure 5 (see next page), the fastest period of growth of this population occurred in the late 1990s, followed by slower growth in recent years. Figure 5 also shows that the rate of growth of the college-age population is projected to increase through 2008-09, after which growth is expected to slow.

Since the late 1990s, many have speculated that this increase in the college-age population would lead to record numbers of students seeking admission to community colleges. Despite the expectation of a "tidal wave" of students, CCC enrollment growth over the last decade has been moderate. Indeed, recent system enrollment has been declining.



*What Influences Enrollment at CCC?* An increase in the state's college-age population is a major factor affecting enrollment levels, but it is not the only one. Fluctuations in participation rates affect enrollment at California's community colleges as well. Factors such as state and local education policies and personal choices of potential students determine participation rates and are much more difficult to predict. State policies affecting demand include fees and financial aid, eligibility requirements, and educational priorities, such as transfer preparation and vocational training. Additionally, factors such as the availability of certain classes, local economic conditions, and the perceived value of the education to potential students also affect participation rates.

### Why Has Enrollment Lagged Population Growth?

As discussed above, CCC's enrollment rose steadily through the second half of the 1990s, and then began declining in 2003. Although we are unable to isolate the precise causes of the recent decreases, several factors are likely to have contributed to the decline.

*Recent Improvements in the State's Economy.* The availability of jobs influences the decision adults make to attend college. After a recent peak in 2003, the state's unemployment rate has been steadily declining,

resulting from an expansion of various economic sectors. In some regions, for example, new housing developments have created greater demand for housing construction workers. Some community college districts, using local surveys of recent students, report that some of these students left college to take advantage of these types of higher-wage jobs available in local economies. Thus, some portion of the statewide enrollment decline resulted from students opting for the more immediate benefits of employment in an improving economy.

***Expected Reductions in Concurrent Enrollment.*** Beginning in 2002, the state took statutory and budgetary action to reduce concurrent enrollment levels after concerns were raised about a number of community college districts inappropriately claiming state funding for an increasing number of concurrently enrolled high school students. While state statute still permits districts to enroll some K-12 students, the Legislature and Governor adopted new restrictions on concurrent enrollment to prevent districts from abusing the provision. As a result, the number of K-12 students concurrently enrolled in CCC, predominantly high school students taking physical education courses, declined by more than 100,000.

***Reduced Course Offerings.*** The Chancellor's Office suggests some of the enrollment decline can be explained by districts having reduced the number of course offerings in spring 2003, in anticipation of the Governor's proposed budget reductions. Although the Legislature rejected most of these cuts in the enacted budget, some districts reportedly prepared for budget cuts by hiring fewer part-time faculty and reducing the number of course sections available to students. Community colleges reduced about 9,800 course sections systemwide between fall 2002 and fall 2003. However, by spring 2005, CCC had restored the sections. Despite the restoration of course sections, overall enrollment has continued to decline. As a result, the average class size has fallen.

***Impact of Fee Increases on Nonneedy Students.*** The Legislature raised fees in 2003-04 from \$11 to \$18 per credit unit and again in 2004-05 from \$18 to \$26 per credit unit. Community college student fees remain the lowest in the nation, and all financially needy students are eligible to receive a fee waiver. Nonetheless, some assert that the fee increases may have influenced demand.

Responding to such concerns about the impact of fees on enrollment, the Legislature took steps to ensure that needy students would still be able to attend CCC. As part of this effort, the Legislature appropriated \$38 million in the *2003-04 Budget Act* (\$37 million on an ongoing basis) to expand financial aid outreach, and continued to fully fund fee waivers for needy students. The Legislature also directed the Chancellor's Office to monitor the effect of the fee increase on enrollment and report its findings to the

Legislature. The Chancellor's Office reports reveal no direct effect of fee increases on student access. Instead, the reports assert that an unknown portion of the enrollment decline is due to the fee increases.

### **Effect of Decline on the Student Population Profile**

The CCC fee reports were able to measure whether the enrollment decline affected the segment's student population profile. It found the following:

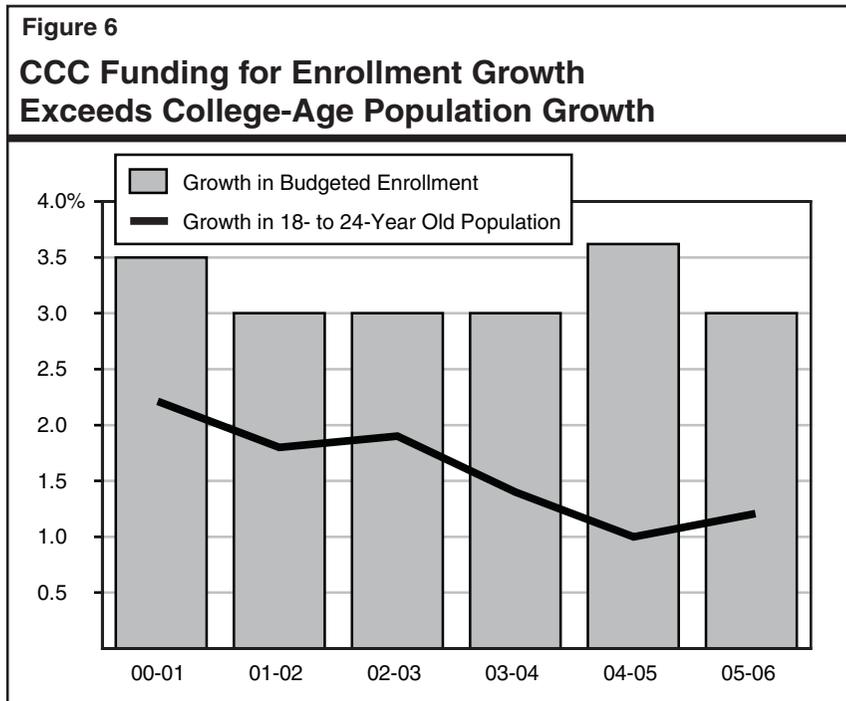
- ***Shift Toward Younger Students.*** The student population after the decline included a greater percentage of traditional college-age students and a reduced share of students age 30 and over.
- ***No Disproportionate Effect on Lower-Income Groups.*** The analysis showed that students residing in low-income areas were no more affected by the fee increases than students from higher-income areas. This likely reflects the fact that needy students are not required to pay fees.
- ***No Disproportionate Effect on Racial and Gender Groups.*** No racial or gender group's share of total enrollment declined, with the exception of a 3 percent decline in the percentage of white students during this period.
- ***Positive Effect on Student Educational Goals and Retention.*** The CCC reports show a significant rise in the percentage of students seeking a degree or certificate, or intending to transfer to a four-year institution. Specifically, about 43 percent of students enrolled in fall 2004, indicated upon enrollment that their educational goal included obtaining a degree or certificate, or seeking to transfer. This reflects an increase of 6 percent since fall 2002.
- ***Increased Course Retention Rate.*** The percentage of students completing a course increased to 83 percent in fall 2004, up more than one-half of a percentage point since fall 2002. However, this increase in retention rates was not associated with an increase in success rates. The CCC calculates course success rates as the percentage of students staying until the term's end and receiving a grade of C or better. During the same period, success rates declined more than one-half percentage point with about 67 percent of students successfully completing a course.

In summary, the CCC reports indicate that lower-income and historically under-represented groups do not disproportionately account for the recent declines in enrollment.

## Recent Enrollment Funding Trends

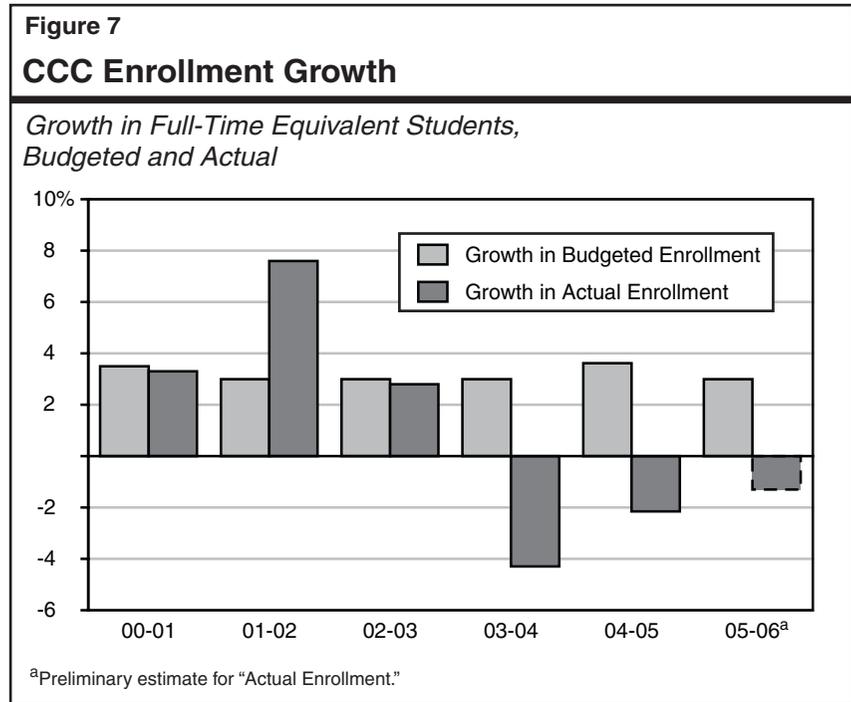
In recent years, the state budget has included funding for enrollment growth that is high by a number of standards. For the remainder of this section, we discuss enrollment as a measure of full-time equivalent (FTE) students.

**CCC Enrollment Funding Outpacing Population Growth.** Funding for student enrollment at CCC has grown faster than the percent change in the traditional college-age population of 18- to 24-year olds. Figure 6 compares changes in enrollment funding with the rate of change for the population of 18- to 24-year olds over the last six years. As the figure shows, funding for CCC enrollment growth has far outpaced the annual change in the college-age population. Since 2000-01, CCC has received annual augmentations for enrollment growth at or above 3 percent. Meanwhile, growth in the college-age population has slowed during this period.

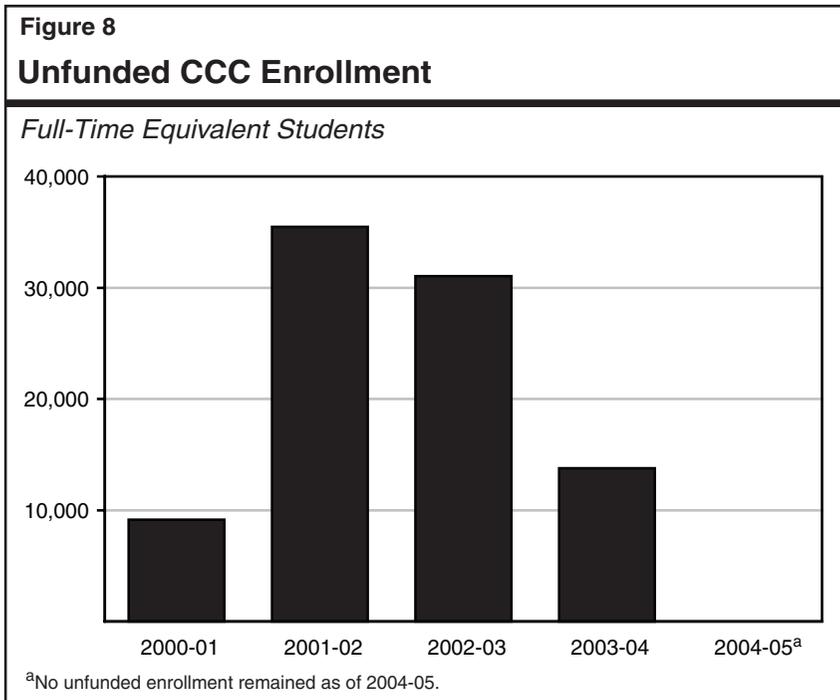


**CCC Enrollment Funding Outpacing Enrollment Growth.** In recent years, the state budget has provided CCC with more funding for enrollment growth than community colleges used to enroll additional students. As shown in Figure 7 (see next page), funding provided for budgeted enrollment growth has exceeded the percent change in FTE students actually

enrolled each year except for 2001-02. (Enrollment significantly exceeded funding in 2001-02 due in part to individuals choosing to attend college at the time of a tight job market.) In 2003-04, CCC's actual FTE enrollment declined about 4 percent. The following year, it declined by another 2 percent. As a result, CCC received more funding for enrollment growth than was required to fund its actual enrollment growth. Some of this excess growth funding went to districts that had "unfunded" enrollment.



**No Unfunded Enrollment Remains.** In allocating enrollment funding each year, the Chancellor's Office sets a limit or "cap" on the maximum number of FTE students each district will be funded to serve. A district enrolling students above this cap in a given year will not receive funding for the "overcap" students (with some exceptions). A district whose enrollment exceeds the level of enrollment allowed by the system is said to have unfunded enrollment. Figure 8 shows the level of unfunded students since 2000-01. As the figure indicates, unfunded enrollment, which peaked in 2001-02, declined rapidly thereafter as community colleges received growth funding in excess of actual enrollment. As of 2004-05, the community colleges had eliminated unfunded enrollment for all districts.



**2004-05 Growth Less Than Funded.** Data from CCC suggest that the community colleges served fewer FTE students than it was funded to serve in 2004-05. The *2004-05 Budget Act* included \$161 million to fund enrollment growth of 3.7 percent. According to the most recent available data, the community colleges fell about 13,000 students shy of its funded level. State law requires that any unused growth funding revert to the Proposition 98 Reversion Account. We expect to have a better estimate of the amount of unused 2004-05 enrollment growth funding by the Governor's May Revision.

**2005-06 Growth Also Likely Below Funded Level.** If enrollment continues to decline, CCC may not be able to use all the funding provided for enrollment growth in 2005-06. The *2005-06 Budget Act* provided an augmentation of about \$142 million to fund 3 percent enrollment growth, or an additional 34,000 FTE students. This amount is significantly above estimated adult population changes. Preliminary enrollment estimates indicate that CCC enrollment in 2005-06 could continue to decline or, at best, remain flat. The Chancellor's Office has not yet received the final fall 2005 term enrollment numbers but preliminary data based on an initial census of districts' enrollment of FTE students project a decline of as much as 1 percent compared to the fall 2004 term. These preliminary

projections cast significant doubt on whether the colleges will be able to use all of their budgeted growth funding in 2005-06. In the event that CCC has unused growth funding in 2005-06, this funding would be available to fund one-time K-14 priorities. Although unused enrollment growth funding would revert, going forward this level of funding remains in the base for the budget year.

## **2006-07 Enrollment Growth**

*The Governor's budget proposes an augmentation of \$149 million to fund 3 percent enrollment growth at California Community Colleges (CCC). This level of enrollment growth exceeds our projected increase in CCC enrollment of 1.75 percent. We recommend the Legislature fund 1.75 percent enrollment growth, thus reducing the Governor's proposed augmentation by \$62 million.*

The budget proposal provides an increase of \$149 million for enrollment growth in 2006-07 to fund about 35,000 additional FTE students (a 3 percent increase). With this augmentation, the Governor's budget proposes funding a total of 1.2 million FTE students in 2006-07.

State law requires the annual budget request for CCC to include funding for enrollment growth at least as large as the rate of increase in the adult population, as determined by DOF. The DOF projects that California's adult population rate will increase by 1.74 percent in 2006-07.

***Recommend 1.75 Percent Enrollment Growth Funding (Reduce Item 6870-101-0001 by \$62 Million)*** This is a particularly difficult time to project enrollment growth for CCC. The segment has been experiencing overall declines in recent years. While it appears that this decline may continue in the current year, more conclusive information will not be available for a few months.

While recent evidence would suggest that CCC as a system will experience little or no increase in total enrollment, we recommend the Legislature fund 1.75 percent growth for 2006-07. This is the level of additional students we forecast based on our demographically driven enrollment model. We think our recommended growth level, while potentially on the high side, would support the Legislature's goal of ensuring widespread access to the community colleges. At our recommended level, CCC's growth augmentation could be reduced by \$62 million compared to the Governor's budget.

***Additional Savings May Be Available.*** To the extent that CCC is not able to use all its enrollment growth funding in the current year, the segment would have unused 2005-06 growth funding in its 2006-07 *base* that could be applied toward its projected budget-year enrollment growth.

(This is in addition to one-time savings in 2005-06 from unused growth funding which would revert.) The availability of these funds would further reduce the amount of new enrollment growth funding CCC would require in 2006-07 compared to the Governor's budget, resulting in additional savings from what we identify above. We will update the Legislature on this matter at budget hearings as additional current-year enrollment information becomes available.

## EQUALIZATION

*The Governor's 2006-07 budget proposal includes \$130 million to equalize per-student funding among community college districts. To the extent the Legislature wishes to fund priorities beyond workload increases, we recommend that the Legislature approve an augmentation sufficient to finish funding equalization to the 90th percentile, as called for in statute. However, we recommend the Legislature fund equalization contingent upon enactment of legislation providing an allocation method that preserves its equalization investment.*

As a result of tax base differences that predate Proposition 13 in 1978, coupled with complex district allocation formulas, community college districts receive different amounts of funding to serve their students. Specifically, the amount of general purpose or "apportionment" funding the state provides for each FTE student varies by district. In 2003-04, when recent equalization efforts began, districts' funding per FTE student ranged from \$3,500 to \$8,200. Most districts, however, had levels within a few hundred dollars of \$3,800, the state median amount at the time. Funding differences may be acceptable if they are small or reflect real cost differences encountered by different districts. However, the funding differences that historically have existed among community college districts have little correlation to underlying costs.

### Equalization Makes Sense

Numerous reports and hearings in recent years have recognized these funding disparities and have called for efforts to "equalize" funding among districts. As we have noted in earlier publications (see our *Analysis of the 2004-05 Budget Bill*, page E-220), we think equalization makes sense as a public policy goal. In particular, equalization can foster:

- **Fairness to Students.** Providing all districts with similar levels of funding per FTE student helps to ensure that students in different parts of the state have access to similar levels of educational support, which can translate into similar levels of educational quality and student services.

- **Accountability.** The state's *Master Plan for Higher Education* and state law assign to community colleges a number of educational missions. The state also has called on the community colleges to meet performance expectations in a number of areas, including preparing students to transfer to a four-year institution, awarding degrees and certificates, and improving course completion rates. It is difficult to hold all districts accountable for these standards when the amount of funding provided per student varies from district to district. To the extent that equalization funding can help districts provide comparable levels of educational services, the community college system will be in a better position to evaluate district outcomes. (We discuss CCC accountability efforts in more detail later in this section.)

***Different Approaches to Equalization.*** There is no single way to equalize community college funding. Over the years, the Legislature has considered different methods to define and implement district equalization. In general, these methods take different approaches to account for fixed costs and set funding targets. Different districts will receive more funding under some equalization approaches compared to others. However, in virtually all the methods that have been proposed, no district would lose any funding in order to equalize funding statewide.

### **2004-05 Budget Act Initiated Multiyear Equalization Effort**

After considering these various ways to equalize, the Legislature enacted a method of equalizing district funding based on dollars per FTE student. Chapter 216, Statutes of 2004 (SB 1108, Committee on Budget and Fiscal Review), established the goal that up to 90 percent of statewide community college enrollment eventually receive the same level of funding per credit FTE student. (Noncredit enrollment and funding were excluded for purposes of equalization. Funding for noncredit students is not an equalization issue because all districts receive the same amount for each noncredit student.) Given that a few districts currently have unusually high levels of per-student funding, the Legislature concluded that it would be too costly to provide the highest rate to all districts and instead set the 90<sup>th</sup> percentile as its goal.

Chapter 216 directed the Chancellor's Office to classify districts as small, medium, or large, based on total number of credit FTE students funded in each district's 2003-04 base budget. The equalization targets for smaller districts would be slightly higher to account for their higher per-student fixed costs. Based on a statutory formula, the Chancellor's Office calculated the 90<sup>th</sup> percentile funding rate for large districts to be \$4,037 per credit FTE student. The target for medium-sized districts was

3 percent above this amount, or \$4,158. The target for small districts was 10 percent above the large districts' target, or \$4,441.

The *2004-05 Budget Act* provided \$80 million toward this equalization effort. At the time, we estimated that achieving the 90<sup>th</sup> percentile target would cost about \$240 million. The Chancellor's Office prorated the \$80 million to qualifying districts—57 districts received funding—as a first installment toward reaching their equalization targets.

The *2005-06 Budget Act* provided a second installment of equalization funding, totaling \$30 million. These funds brought the state's total investment under this equalization effort to \$110 million.

### **Equalization to Cost More Than Governor's Proposed \$130 Million**

The *2006-07 Governor's Budget* proposes \$130 million as the final installment to complete equalization under Chapter 216. Combined with the \$110 million the Legislature previously provided, the Governor's proposed funding would bring the total investment in equalization under Chapter 216 to \$240 million.

While the Governor intends for the proposed funding to equalize credit instruction rates per FTE student to the 90<sup>th</sup> percentile, it may not be sufficient to achieve that goal. Two developments have driven up the cost of equalizing to the 90<sup>th</sup> percentile: (1) since 2003 there has been an increase in the number of students to be equalized, and (2) the CCC's funding allocation method works at cross purposes with the Legislature's equalization efforts.

***More Students to Equalize.*** While overall enrollment has declined in the past several years, *funded* enrollment in some districts has increased. To the extent enrollment has increased in equalization districts, it now costs more than it did two years ago to equalize the enrollment in those districts.

***Program-Based Funding Works Against Equalization Goal.*** While the Legislature provided funds to equalize districts, it left in place a complex method of allocating apportionment funding to districts for enrollment growth and COLAs based on a program-based funding formula. This formula attempts to account for the different costs that different districts experience. Under program-based funding, districts do not receive equal funding rates on a per-FTE student basis. Instead, district allocations are influenced by headcount enrollment, total square footage of district facilities, and other factors. As such, program-based funding works at cross purposes from the goal of funding statutory equalization targets. Having both allocation methods operating at the same time is contrary to the Legislature's most recent intent to equalize per-student funding.

## Link Equalization Funding to New Apportionment Allocation Method

*Use Latest CCC Data to Measure Equalization.* The Legislature chose the 90<sup>th</sup> percentile as a reasonable point where disparities in revenues limits would be reduced to acceptable levels. We believe updated CCC data should be used to measure the 90<sup>th</sup> percentile target. Reaching the 90<sup>th</sup> percentile based on the latest CCC data would cost approximately \$150 million this year—according to preliminary estimates—rather than the \$130 million proposed by the Governor. Providing this higher amount would allow the Legislature to reach its goal of equalizing district funding disparities. If the Legislature decides to fund Proposition 98 expenditures at the level proposed in the 2006-07 budget, we believe equalization represents a good use of discretionary funds.

*Link Equalization Funding to Allocation Formula.* If the Legislature provides funding for equalization, we recommend it do so contingent on the enactment of legislation replacing program-based funding with an allocation method more consistent with its equalization goal. As discussed above, program-based funding allocates new apportionment funding to districts in a way that is inconsistent with the Legislature's equalization goal. To maintain equalization levels, we recommend that the Legislature amend statute to allocate new apportionment funding at the same amount per credit FTE student for all districts in similar size groupings. This way, as student enrollment increases, districts' level of funding per student would keep pace with other districts of similar size. This method would ensure future allocations of growth funding are applied consistently with the Legislature's equalization goals.

## CAREER TECHNICAL EDUCATION

*The 2006-07 budget proposes \$50 million for the Governor's Career Technical Education initiative to expand and improve the sequencing of vocational courses offered at high schools and California Community Colleges (CCC). This proposal augments the \$20 million in one-time funds the Legislature provided in the current year towards this effort. We recommend the Legislature not expand the program until CCC has evaluated the progress of the initial efforts and prepared a proposal for the new funds. (Reduce Item 6870-101-0001 by \$50 million)*

The 2005-06 Governor's Budget proposal included funding to encourage high schools and community colleges to work together to expand and improve vocational courses. The proposal was intended to build upon the existing "2+2" programs, in which students take two years of high school vocational courses that lead into a two-year CCC vocational credential or degree program.

The Governor's initial proposal was modified somewhat in budget hearings, and the Governor vetoed the funding included in the *2005-06 Budget Bill*. Ultimately, however, the Legislature enacted Chapter 352, Statutes of 2005 (SB 70, Scott), which provided \$20 million in one-time funds to CCC to award local assistance grants to a consortia of community colleges, and elementary and secondary schools. The legislation requires CCC to assist economic and workforce regional development centers and consortia—including middle schools, junior highs, or high schools, and regional occupational centers and programs—to improve connections between vocational programs. In response to legislative concerns, CCC has developed a spending plan for the 2005-06 funds. However, CCC has not yet awarded the grants. The Chancellor's Office tells us it expects to begin making awards later this spring.

The 2006-07 budget proposes increasing funding for this effort by \$50 million on an ongoing basis. We supported the initial grants as a starting point for addressing a significant problem in career technical education, but we note that the Governor's new proposal does not include a broad vision for revitalizing career technical education across the state. Furthermore, the CCC does not have a proposal for how it would spend this additional money. Finally, given that the initial grants have not yet been awarded, we believe that this proposed augmentation is premature. Consequently, we recommend the Legislature not fund an augmentation to the career technical education program at this time, for a savings of \$50 million.

## RETIREE HEALTH BENEFIT LIABILITIES

*We recommend the Legislature direct the California Community Colleges Chancellor's Office to provide an assessment at budget hearings regarding the extent of the retiree health benefit liabilities of the community colleges.*

In 2004, the national Governmental Accounting Standards Board (GASB) issued a new policy requiring local governments, including local educational agencies, to account for retiree health benefits in a manner similar to other pension costs. This new GASB policy requires community college districts to identify the total unfunded liability for retiree benefits that the districts have promised to current employees and retirees. (We discuss this overall issue in more detail in the K-12 "School District Financial Condition" section of this analysis and in "Retiree Health Care: A Growing Cost for Government," in "Part V" of *The 2006-07 Budget: Perspectives and Issues*.)

This policy presents a major new fiscal challenge for many community college districts. According to the Community College League of California, about 65 of the 72 community college districts pay some level of post-employment retiree health benefits. These districts have an estimated total liability of \$2.5 billion to \$3 billion and have reserved about 15 percent of this liability.

Seventeen of these districts formed a joint powers agency (JPA) to address the fiscal challenges of complying with this new accounting standard. This new JPA is providing participating districts with assistance such as actuarial services and a pooled investment program.

Districts have some incentives to address their retiree health benefit liabilities. For example, the existence of unfunded liabilities can reduce a district's bond rating, thereby increasing the cost of borrowing. Additionally, the Accrediting Commission for Community and Junior Colleges has cited these unfunded liabilities as a factor in evaluating an institution's financial stability and has required institutions make plans to identify and provide for these obligations.

The state, however, also has an incentive to encourage districts to focus on this problem because, at some point, districts may seek financial assistance for these costs from the state. The CCC currently has no comprehensive data on the extent of the problem. As such, we recommend the Legislature direct the Chancellor's Office to survey districts on their retiree health care liabilities and provide the Legislature with an assessment at the time of budget hearings.

## **CCC ACCOUNTABILITY UPDATE**

In recent years, the Legislature has become increasingly concerned with accountability in higher education. In legislation as well as the annual budget, the Legislature has sought assurances that state resources are being used effectively to advance the various missions assigned to the segments by the *Master Plan for Higher Education*. This issue became particularly important in relation to CCC last year, when accountability provisions related to the Partnership for Excellence (PFE) expired on January 1, 2005. (We discussed the approaching sunset of those PFE provisions in our *Analysis of the 2004-05 Budget Bill*, page E-256.)

### **New CCC Accountability System**

Anticipating the sunset of the PFE, the Legislature and Governor enacted Chapter 581, Statutes of 2004 (AB 1417, Pacheco), which required the CCC Board of Governors (BOG) to develop "a workable structure for

the annual evaluation of district-level performance in meeting statewide educational outcome priorities," including transfer, basic skills, and vocational education. Pursuant to statutory direction, the BOG consulted with our office, DOF, and various other higher education experts and interested parties as it developed its proposal. The proposal was presented to the Legislature and Governor last spring, and was adopted as part of the 2005-06 budget package in Chapter 73, Statutes of 2005 (SB 63, Committee on Budget and Fiscal Review). Chapter 73 requires community college districts to report specified data to the CCC Chancellor's Office, which in turn is to submit an annual report to the Legislature and Governor. The first preliminary report is due January 31, 2007. (Please see nearby box for a summary of the accountability measures.)

### **CCC District-Level Accountability Reporting**

Using data provided by community college districts, the Chancellor's Office is to provide annual reports to the Legislature that facilitate both internal and external assessment of districts' performance. Reports are due annually on March 31, beginning in 2007. In addition, beginning in the same year an annual preliminary report is due to the Legislative Analyst's Office and the Department of Finance by January 31. Reports shall include district- or college-level performance data concerning outcomes in the following categories:

- Degrees and certificates earned by the California Community College students, and student transfers to four-year institutions.
- Student progress and achievement in the areas of vocational, occupational, and workforce development.
- Pre-collegiate improvement, including basic skills and English as a second language.

Reports shall include the following data for each district (and each college, as warranted):

- Performance data for the immediately preceding fiscal year.
- A comparison of achievements with those of comparable "peer" districts and colleges.
- A comparison of achievements with the system as a whole.
- Summary background information on educational programs, missions, students, and service area demographics.

***Specific Performance Measures Being Developed.*** While Chapter 73 establishes several major types of outcomes to be measured (such as student transfers), it does not specify what specific data will be used to measure outcomes. For example, there are various ways to define transfer rates that use different definitions of the pool of potential transfer students. To resolve these kinds of measurement questions, the Chancellor's Office established a "Technical Advisory Workgroup." In addition to staff from the Chancellor's Office, the workgroup includes about a dozen research and analysis experts from community college districts and other agencies. The workgroup has been meeting regularly, and is expected to develop a final recommendation for approval by the Board of Governors this spring.

***Reports Should Facilitate Various Forms of Accountability.*** The CCC accountability reports should be helpful for a number of different purposes. For example, they can assist the Legislature in its oversight function, indicating overall system performance and effectiveness in carrying out CCC's educational mission. The reports should also help inform legislative budgeting and policy decisions, helping to identify issues that require attention. The reports should also help the Chancellor's Office in its role of monitoring the performance of individual districts and colleges, enabling it to respond to concerns as warranted. In addition, the reports should be helpful to local residents in holding their local community college governing boards accountable for district performance in relation to similar districts.

For all these reasons, we believe the emerging accountability system can be a useful tool for advancing CCC's mission. Once the working group completes its recommended accountability methodologies, we will advise the Legislature on further steps, if any, that we would recommend the Legislature take. We note that Chapter 73 expresses the Legislature's intent to specify performance measures and reporting requirements in the annual budget if warranted by changes in state needs, legislative priorities, or the availability of data.

## **Cal-PASS Funding a Good Investment**

In February 2003, the California Partnership for Achieving Student Success (Cal-PASS) was launched by the Grossmont-Cuyamaca Community College District using a grant from the Chancellor's Office. The Cal-PASS is a data-sharing system aimed at improving the transition of students from high schools to community colleges to universities.

Student transitions are critical to the success of the educational system. For community colleges they are especially crucial. The success of students at community colleges depends in part on how well the K-12 curriculum is aligned with community college courses. In addition, the success of

community college students wishing to eventually earn a four-year degree depends to a large extent on how well CCC's curriculum is aligned with that of the universities and colleges to which students transfer. The Cal-PASS collects information on students throughout the state regarding their performance and movement through these various segments. These data are used by faculty consortia, institutions, and researchers to identify potential obstacles to the successful and efficient movement of students between segments. For example, high remediation rates of students who take English at a particular high school and enroll at a particular college could point to a need to better align the English curriculum or standards between these two institutions. Similarly, data concerning course standards and content can help reduce the incidence of students taking unnecessary or inappropriate courses for transfer.

Participation in Cal-PASS by individual institutions is voluntary. Since its inception, the Cal-PASS network has grown from several colleges, universities, and high schools in the San Diego area to more than 1,000 institutions statewide.

***Cal-PASS Helps Address State's Accountability Concerns.*** We believe Cal-PASS promotes district-level and system accountability in two ways:

- ***Identifies Problems.*** The Cal-PASS helps districts identify problems in areas of particular concern to the state, including transfer and remediation. Identifying these problems is a first step toward improving performance.
- ***Monitors Progress.*** The Cal-PASS can measure changes in performance over time, thereby providing policymakers with information on how well districts and the system as a whole are responding to state concerns.

***Proposed Augmentation Would Expand Cal-PASS.*** The Governor's budget proposes to increase state support for Cal-PASS by \$500,000, for total funding of \$1.5 million in 2006-07. This augmentation would support the expansion of Cal-PASS by: (1) including more institutions, (2) creating additional faculty councils that use Cal-PASS data to align curricula, and (3) performing additional research on student transitions and outcomes. To the extent the Legislature wished to appropriate Proposition 98 funding for CCC above the amount required for workload-related increases, we would recommend approval of this augmentation as a good investment for monitoring and improving student transitions throughout the state's educational system.

## STUDENT AID COMMISSION (7980)

The California Student Aid Commission (CSAC) provides financial aid to students through a variety of grant and loan programs. The proposed 2006-07 budget for the commission includes state and federal funds totaling \$1.6 billion. Of this amount, \$862 million is General Fund support—all of which is used for direct student aid for higher education. A special fund covers the commission's operating costs.

Below, we summarize the Governor's major budget proposals. We then discuss the Governor's proposals to increase the private university Cal Grant award and designate 600 loan forgiveness warrants for participants in the Governor's Science and Math Teacher Initiative. We also reference a Cal Grant issue linked to our student fees write-up earlier in this chapter. Lastly, we examine the organizational relationship between CSAC and its auxiliary, EdFund, and recommend a significant organizational restructuring intended to improve state-level financial aid administration.

### Major Budget Proposals

Figure 1 compares the commission's revised 2005-06 budget with the proposed 2006-07 budget. As the figure shows, funding for state financial aid programs would increase by \$58 million, or 7.1 percent, from the current year. This increase is due to additional costs associated with the Cal Grant programs (\$51 million) and the Assumption Program of Loans for Education, or APLE program (\$6.8 million). As the figure also shows, in the budget year, General Fund support would increase considerably (by \$109 million, or 15 percent). This is due in part to a large General Fund backfill. Whereas \$51 million in Student Loan Operating Fund (Operating Fund) monies were used to support Cal Grant costs in the current year, the Governor's budget provides General Fund monies to backfill this amount in the budget year. Thus, no Operating Fund monies are proposed to be used for Cal Grant costs in 2006-07.

**Figure 1****Student Aid Commission Budget Summary<sup>a</sup>***(Dollars in Millions)*

	2005-06 Revised	2006-07 Proposed	Change	
			Amount	Percent
<b>Expenditures</b>				
Cal Grant programs				
Entitlement	\$645.0	\$697.2	\$52.2	8.1%
Competitive	115.5	118.2	2.7	2.4
Pre-Chapter 403	4.9	0.9	-4.0	-81.6
Cal Grant C	9.2	9.6	0.4	4.4
Subtotals—Cal Grant	(\$774.6)	(\$825.9)	(\$51.3)	(6.6%)
APLE <sup>b</sup>	\$40.9	\$47.7	\$6.8	16.7%
Graduate APLE	0.4	0.4	—	—
Law enforcement scholarships	0.1	0.1	—	—
<b>Totals</b>	<b>\$816.0</b>	<b>\$874.2</b>	<b>\$58.2</b>	<b>7.1%</b>
<b>Funding Sources</b>				
General Fund	\$752.4	\$861.6	\$109.2	14.5%
Student Loan Operating Fund <sup>c</sup>	51.0	—	-51.0	-100.0
Federal Trust Fund <sup>c</sup>	12.6	12.6	—	—
<sup>a</sup> In addition to the programs listed, the commission administers the Byrd Scholarship, Child Development Teacher and Supervisor Grant, and California Chafee programs—all of which are supported entirely with federal funds. It also administers the Student Opportunity and Access program, a state out-reach program supported entirely with Student Loan Operating Fund monies.				
<sup>b</sup> Assumption Program of Loans for Education.				
<sup>c</sup> These monies pay for Cal Grant costs.				

**Cal Grant Programs.** As Figure 1 shows, the Governor's budget would increase funding for the Cal Grant Entitlement programs by \$52 million (or 8.1 percent) and Cal Grant Competitive programs by \$2.7 million (or 2.4 percent). Figure 2 (see next page) provides a more detailed breakdown of these proposed augmentations.

The Governor's budget funds approximately 1,600 new High School Entitlement awards. This reflects growth of 3.4 percent, consistent with the projected growth in high school graduates for 2005-06. It also funds 2,700 new Transfer Entitlement awards, a 59 percent increase over the current year (consistent with the percent change from the prior year to the current year). The Governor's budget includes no additional funding for new Competitive awards because the commission already issues the maximum

number allowable under statute (22,500). For new Entitlement and Competitive recipients attending private institutions, the Governor's budget provides \$11.9 million to raise the maximum grant from its current-year level of \$8,322 to \$9,708. The Governor's budget also makes adjustments to account for expected changes in the costs of Cal Grant renewal awards.

<b>Figure 2</b>	
<b>Cal Grant Programs</b>	
<b>Budget Summary</b>	
<i>(In Millions)</i>	
	<b>Proposed Change</b>
<b>Entitlement Program</b>	
New High School awards	\$4.4
New CCC Transfer awards	13.6
Increasing private-institution award	8.8
Renewal awards	25.4
<b>Total</b>	<b>\$52.2</b>
<b>Competitive Program</b>	
New awards	-\$0.1
Increasing private-institution award	3.1
Renewal awards	-0.3
<b>Total</b>	<b>\$2.7</b>

*Loan Forgiveness Programs.* Additionally, the Governor's budget includes a \$6.8 million General Fund augmentation to cover loan-forgiveness costs associated with APLE warrants issued in previous years. The Governor's budget proposes to issue 8,000 new APLE warrants—the same level as in the current year. It also proposes to issue 100 new National Guard warrants. To date, the budget act has not authorized any National Guard warrants.

### **Promote Parity for Financially Needy Students Attending Public and Private Universities**

*We continue to recommend the Legislature adopt a policy linking the maximum Cal Grant for financially needy students attending private institutions to the General Fund subsidy the state provides to*

*financially needy students attending public institutions. The Governor's budget proposal to raise the maximum private-student award to \$9,708 would reduce (but not eliminate) the existing award disparity. Further award increases could be phased in gradually until parity between financially needy students attending public and private institutions was achieved.*

Prior to 2001-02, the state had a longstanding statutory policy that linked the maximum Cal Grant for financially needy students attending private institutions to the average General Fund cost of educating a financially needy student at the University of California (UC) and the California State University (CSU). When the Cal Grant Entitlement program was created in 2000, this policy was replaced with a new provision linking the maximum private-student Cal Grant award to whatever amount was specified in the annual budget act. As shown in Figure 3, the maximum award was maintained at its 2000 level (\$9,708) for three years and then reduced to \$8,322 in 2004. The Governor's budget provides \$11.9 million to restore the maximum award to \$9,708. The proposal would affect approximately 12,300 new Cal Grant recipients.

<b>Figure 3</b>		
<b>Maximum Cal Grant for Financially Needy Students Attending Private Institutions</b>		
	<b>Actual Amount</b>	<b>Parity-Based Formula Amount</b>
2001-02	9,708	\$9,470
2002-03	9,708	9,631
2003-04	9,708	10,575
2004-05	8,322	10,062
2005-06	8,322	10,568
2006-07	9,708 <sup>a</sup>	11,011

<sup>a</sup> Reflects Governor's budget proposal.

We recommend the Legislature restore the policy basis of the Cal Grant for financially needy students attending private institutions. Without a policy, annual Cal Grant decisions can appear arbitrary and unpredictable. These decisions also can be inconsistent and work at cross-purposes. For example, in recent years, benefits have been enhanced for some financially needy students while reduced for other needy students in similar financial

situations. To establish a rational policy basis and promote consistency among student groups (across the segments and over time), we recommend establishing a policy that would base the maximum Cal Grant for financially needy students attending private institutions on the average General Fund subsidy provided to financially needy students at UC and CSU (weighted for enrollment). Figure 3 shows what the maximum award would have been from 2001-02 through 2006-07 using this parity-based formula. As the figure shows, the formula would have generated a slightly lower rate than the actual rate provided in 2001-02 and 2002-03 and then trended upward gradually and moderately.

For 2006-07, the formula generates a maximum Cal Grant rate of \$11,011. (Providing this higher award to new recipients would cost \$11.1 million relative to the Governor's budget.) This rate is approximately \$1,300 higher than the private university award amount proposed in the Governor's budget. Having once restored the policy basis of the award, the Legislature could gradually phase in modest award increases until parity between financially needy students attending public and private institutions is achieved.

### **Avoid Complicating Existing, Well-Structured Program**

*We recommend the Legislature retain the existing structure of the Assumption Program of Loans for Education and reject proposed budget bill language to add various new, unneeded provisions.*

The Governor's budget authorizes 8,000 new APLE warrants. It also contains language that would allocate 600 of these new warrants to UC and CSU for students participating in the Governor's Science and Math Teacher Initiative. Because this program is not authorized in statute, various budget bill provisions are needed to implement the Governor's proposal. In the current year, the administration had proposed similar language, which the Legislature rejected. We recommend the Legislature also reject the proposed budget-year language. The Legislature can meet the administration's intended objective—encouraging and rewarding individuals to teach in high-need subject areas—simply by relying on the existing APLE program.

*Existing Program Already Creates Strong Incentives to Serve as Science and Math Teachers.* The existing APLE program is based on a tiered incentive system that links certain levels of loan forgiveness to certain behavior. Specifically, it provides up to \$11,000 in loan forgiveness for individuals who teach full time for at least four consecutive years in a high-need subject area (as determined by the Superintendent of Public Instruction) or high-need school (those that are low performing, serve a large population of low-income students, or have 20 percent or more uncredentialed teachers). Having already targeted these high-need areas,

the program then provides up to an additional \$4,000 in loan forgiveness if the individual teaches science, math, or special education and up to another \$4,000 in loan forgiveness if the individual teaches in one of these high-priority shortage areas *and* serves in a school ranked in the bottom two deciles of the Academic Performance Index. In short, the program encourages individuals to become math and science teachers by offering them significant additional benefits.

***Rather Than Adding Unneeded Complications, Simply Retain Existing Program.*** Given the APLE program already has these strong incentives encouraging individuals to serve as science and math teachers, we recommend the Legislature reject the Governor's new budget bill provisions. These new provisions actually create restrictions—reserving 600 new warrants only for certain UC and CSU students—that could make meeting the program's intent more difficult. Rather than add unneeded complications to an already well-structured program, we recommend allowing the existing program to serve all individuals that meet its high-need subject and school criteria.

### **Intersegmental Issue Involving CSAC**

In the student fees write-up in the intersegmental section of this chapter, we recommend maintaining nonneedy students' share of education costs at their current-year levels (33 percent at UC and 25 percent at CSU). Because the Governor's budget includes various augmentations that drive up per student costs at UC and CSU, holding students' share of cost constant would entail modest fee increases (3.5 percent at UC and 3 percent at CSU). In our fees write-up, we recommend a corresponding increase in Cal Grant award amounts sufficient to ensure that all eligible financially needy students receive grants that fully cover the fee increases. Based on the commission's projections of Cal Grant participation, we estimate the additional coverage would cost \$11.9 million (\$8.3 million for financially needy students at UC and \$3.6 million for financially needy students at CSU).

## **RESTRUCTURING HOW THE STATE ADMINISTERS GRANT AND LOAN FINANCIAL AID PROGRAMS**

Last year, members of the education policy and fiscal committees expressed concern with the organizational relationship between CSAC and EdFund. Responding to a legislative directive, our office released a report in January 2006 that examined this relationship and identified options for restructuring it (*California's Options for Administering the Federal Family*

*Education Loan Program*). Below, we summarize the organizational options the state has for administering grant and loan financial aid programs. We then identify the shortcomings both of the state's original single state-agency structure and its existing two-agency administrative structure. In the final section, we recommend the state restructure how it administers these financial aid programs.

## **Organizational Options**

As we discuss in more detail in our January 2006 report, the Legislature has five basic options for coordinating administration of state grant programs and federal student loan programs. As summarized in Figure 4, these options can be grouped into single-agency structures and two-agency structures. To simplify the discussion, we describe these options before applying them to California's experience in administering grant and loan programs.

***Single-Agency Options.*** Under a single-agency structure, the Legislature could: (1) entrust a state agency with administering both grant and loan programs or (2) establish a nonprofit public benefit corporation to administer them. Under a state-agency model, the Legislature would give responsibility for grant and loan program administration to CSAC or another state agency. This entity would be subject to all applicable state laws and regulations, including those relating to hiring, compensation, promotion, and procurement. Under this model, the state agency could provide all program services internally or contract for any or all services. Under a nonprofit public benefit corporation model, the primary difference is that the agency would be exempt from state employment and procurement practices, thereby afforded greater autonomy and flexibility in its daily operations.

***Two-Agency Options.*** Under a two-agency structure, the Legislature could: (3) retain the existing two-agency arrangement, (4) modify the existing two-agency arrangement, or (5) rely on a state agency to administer grant programs and an independent agency to administer federal loan programs. Maintaining the status quo obviously is the simplest option in that no statutory changes would be required. The Legislature, however, could modify the existing arrangement by making various statutory changes to clarify the roles and responsibilities of the grant agency vis-à-vis the loan agency. For example, the Legislature likely would want to clarify which agency had responsibility for budget development, resource allocation, policy leadership, and representation before the state and federal governments. Instead of using a loan agency that was an auxiliary of or otherwise dependent on the state, the Legislature could use an independent loan agency—either a reconstituted EdFund or another existing loan

agency. This latter option would be more involved in that it would entail selling EdFund’s existing loan portfolio and entering into a contractual agreement with some other existing loan agency (either a private corporation or another state’s loan agency).

<b>Figure 4</b>	
<b>Organizational Options</b>	
<b>Single Agency</b>	
<b>State Agency Model</b>	<b>Nonprofit Public Benefit Corporation Model</b>
Single state agency administers state grant programs and federal loan programs.	Single nonprofit public benefit corporation administers state grant programs and federal loan programs.
Agency subject to state employment and procurement laws and regulations.	Agency exempt from state employment and procurement laws and regulations.
<i>Options as Applied to California:</i>	
(1) California Student Aid Commission (CSAC) (or another state agency) administers both grant and loan programs.	(2) EdFund (or another nonprofit public benefit corporation) administers both grant and loan programs.
<b>Two Agencies</b>	
<b>State/Dependent Guarantor Model</b>	<b>State/Independent Guarantor Model</b>
A state agency administers state grant programs and a separate state-dependent or auxiliary agency administers federal loan programs.	A state agency administers state grant programs and an independent agency administers federal student loan programs.
State employment and procurement laws apply to state agency but not loan agency.	State employment and procurement laws apply to state agency but not loan agency.
<i>Options as Applied to California:</i>	
(3) Make no changes to existing CSAC/EdFund arrangement.	(5) Rely on CSAC (or another state agency) to administer state grant programs and an independent agency to administer federal loan programs.
(4) Modify CSAC and EdFund's roles and responsibilities.	

## Single State-Agency Structure Had Shortcomings

Of the five organizational options identified above, California relied on a single state-agency structure from 1979 to 1996. During this period, CSAC administered both grant and loan programs. By the mid-1990s, the state Legislature, federal government, and financial aid stakeholders expressed concern with this structure and specifically with CSAC's ability to administer the federal loan programs.

*Single State-Agency Model Deemed Too Rigid, Not Adequately Responsive.* To understand better the problems that spurred the initial creation of EdFund, we reviewed independent evaluations, state audits, and federal audits conducted in the early- and mid-1990s. We also conducted interviews with individuals familiar with CSAC operations during this period. The problems identified were far reaching—ranging from financial aid processing difficulties and accounting errors to staff inexperience and perceptions among colleges that CSAC was not adequately responsive or service-oriented.

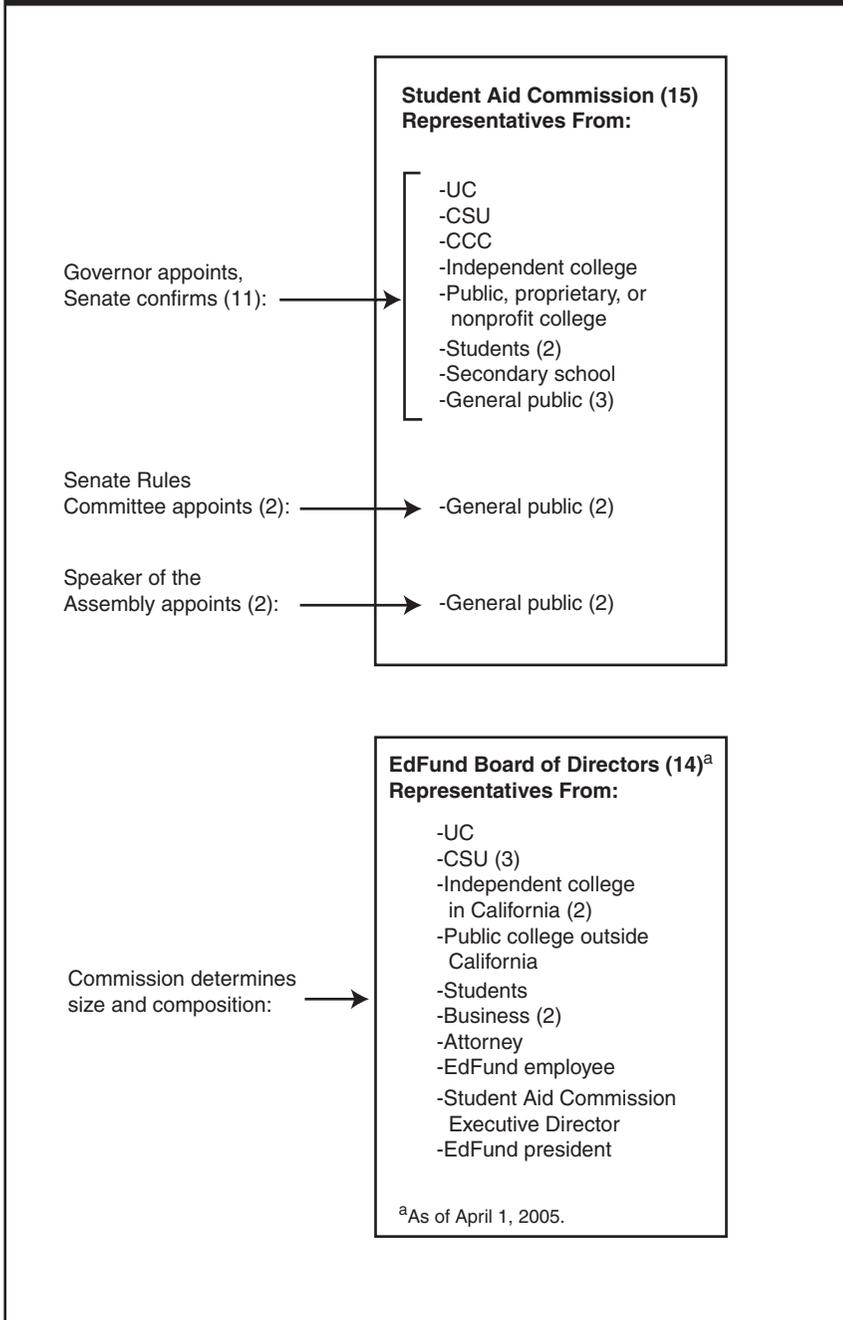
*EdFund Designed to Be More Responsive.* In 1996, the Legislature authorized CSAC to create an auxiliary agency for the purpose of administering federal student loan programs. As defined in statute, the auxiliary agency is a nonprofit public benefit corporation that is exempt from certain state employment and procurement laws. Individuals involved in developing the 1996 legislation state that these particular statutory provisions were viewed as critical changes designed to allow the auxiliary agency to respond more quickly and effectively to loan market dynamics, colleges, and students.

## Existing Two-Agency Structure Has Shortcomings

Since 1996, the state has relied on a two-agency structure—using CSAC to administer state grant programs and EdFund to administer federal loan programs. By 2005, the Legislature, as well as various stakeholders, was expressing growing concern with this two-agency, shared-control structure. We think much of this concern can be linked with three shortcomings of the existing organizational structure. (The Bureau of State Audits is currently reviewing EdFund's employment and procurement practices to determine if other problems exist. The auditor is expected to release its findings in spring 2006. Given the audit is still underway, we do not address these particular issues.)

*Separate Governing Bodies Has Led to Tension Among Organizational Leadership.* We think one of the major shortcomings of the existing organizational arrangement stems from its competing governing bodies. Figure 5 shows the composition of these governing bodies (as of April 2005). As reflected in the figure, state law specifies that CSAC is to be

**Figure 5**  
**Structure of Governing Bodies**



governed by a 15-member commission. The commission is responsible for appointing a board of directors for its auxiliary agency. The commission is given broad authority to determine both the size and composition of this board. Furthermore, EdFund's bylaws permit the commission to remove any individual serving on the board at any time, with or without cause. Despite being given no ultimate, independent authority, EdFund is delegated (both by law and its operating agreement) major operational responsibilities. Ever since the inception of EdFund, this disconnect between organizational authority and operational responsibility has created considerable tension between the two agencies.

This tension was evident in spring 2005 when the commission voted to dismantle the EdFund board. In the minutes from the April 2005 commission meeting, the commission indicated its action was motivated by concerns with governance as well as by a desire to ensure both agencies were working together toward a united set of goals. Many parties (including legislators, financial aid administrators, and lenders) expressed concern that the decision to dismantle the board threatened EdFund's stability and viability.

***State Law Lacks Clarity on Which Agency Is Responsible for Which Operational Functions.*** A second shortcoming of the existing organizational arrangement is the lack of clarity and agreement on which agency should be entrusted with which specific operational responsibilities. Silent on specific operational issues, state law calls for these responsibilities to be negotiated in a jointly developed annual operating agreement approved by the commission. In our discussions with CSAC and EdFund leadership, several areas of concern were raised about the existing ambiguity in law and resulting tension within the negotiation process. Most importantly, concerns revolved around determining who is responsible for developing EdFund's budget, designating the use of Operating Fund monies, representing EdFund's interests to the state Legislature, negotiating EdFund's working agreements with the federal government, and resolving grievances of EdFund's remaining civil service employees. This interagency tension continues to manifest itself in the currently unresolved discussion involving the agencies' roles. After several months of discussion and various draft proposals regarding these responsibilities, the issues remain unresolved.

***Incompatible Incentive Systems Detract From a Student Focus.*** Third, whereas CSAC is structured as a traditional state agency whose employees are subject to civil service laws, EdFund's status as a nonprofit corporation has fostered more market-driven practices. For example, EdFund uses variable compensation plans that offer incentive compensation to reward employees for providing high-quality service in their respective domain. These plans are notably different from the typical civil service

compensation plans based on routine step increases. Both CSAC and EdFund leadership expressed concern that these incompatible incentive systems have led to certain perceptions of unfairness among staff and directors. Equally important, the resulting interagency tension has detracted from a public focus on providing students with high-quality grant and loan services.

### **Recommend Single Agency With Flexibility in Daily Operations but Stronger Accountability Requirements**

*We recommend the Legislature enact legislation that would restructure how the state administers grant and loan programs. Specifically, we recommend the Legislature authorize a single agency, with a single board and Executive Director, to administer both state grant and federal loan programs. We recommend the agency be structured as a nonprofit public benefit corporation but subject to stronger accountability requirements.*

As described in more detail in our January 2006 report, we think any restructuring proposal should overcome both the original shortcomings that led to EdFund's creation and the shortcomings of the existing two-agency structure. In particular, we think an organizational solution should reduce tension among organizational leadership, clarify certain roles and responsibilities, and promote incentives that reward high-quality service to students. Given the unique intricacies of student financial aid and the unique aspects of the federal student loan programs, we think these objectives could best be met with a single nonprofit public benefit agency that has a unified leadership and an incentive system that rewards employees based on the quality of service they provide to students.

*This Option Most Likely to Overcome Existing Problems.* Compared to a two-agency, shared-control structure, a single-agency structure has certain inherent advantages. With a single agency, board structure, and Executive Director, tension is less likely among organizational leadership, and confusion about roles and responsibilities is likely to be more easily and quickly resolved. Moreover, as a nonprofit public benefit corporation, the agency would have more flexibility in its daily operations. This would allow the agency to adapt more quickly to changes in loan programs and loan competitors—changes that can have significant effects on agencies' market share and the benefits they are able to provide student borrowers. This structure also would allow the agency to reward all employees—in both the loan and grant divisions—for providing high-quality service to students.

*Greater Autonomy Should Be Coupled With Greater Accountability.* Increasing an agency's autonomy over its daily administrative activities

should be coupled with increased attention to accountability. Toward this end, the Legislature could establish accountability requirements to ensure the agency is meeting legislative intent and providing students with excellent service. Specifically, we recommend the Legislature require the agency to submit various budget documents, conduct annual audits, and report on program outcomes. (Additionally, depending on the findings of the pending state audit, the Legislature might want to establish other safeguards or limitations on the agency's operations.) Because the agency would be a statutory creation, the Legislature, as further protection, would retain ultimate authority over it.

***New Structure Could Accommodate Broader Reform.*** We think another distinct advantage of our recommendation is that it creates a structure within which other reforms could easily be accommodated. As a single agency, it would be better situated to integrate grant and loan information and services. As such, the Legislature could consider a variety of other reforms related to financial aid administration. For example, the new agency could assume responsibility for the state's savings and scholarship programs (currently administered by the Scholarshare Investment Board). This would unify all state-level financial aid administration in one umbrella agency and create a one-stop shop for state-level financial aid information.

## **Conclusion**

Over the last several decades, California has experimented with two organizational structures for administering state student grant programs and the federal student loan programs. It has tried both a single state-agency structure and a two-agency, shared-control structure. It has had notable problems with both structures. We recommend the Legislature establish a new structure. Specifically, given the unique intricacies of student financial aid, we recommend the Legislature authorize a single agency with a unified leadership to administer both grant and loan programs. Furthermore, given the unique market-oriented and competitive nature of the federal student loan programs, we recommend the Legislature structure this agency as a nonprofit public benefit corporation that would have greater flexibility over its daily operations, with the ultimate intent of increasing public accountability and providing the best possible services and benefits to students.

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# FINDINGS AND RECOMMENDATIONS

## *Education*

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#### Proposition 98 Update

- E-13 ■ **Updated Revenue Forecast Leads to Higher Proposition 98 Minimum Guarantees in Current and Budget Years.** Because of higher estimates for General Fund revenues, our forecast suggests the minimum guarantee is roughly \$200 million higher in 2005-06 and \$115 million higher in 2006-07, as compared to the administration's estimates.
- E-20 ■ **Rebench Proposition 98 Test 1 Factor.** Recommend the Legislature enact trailer bill language to clarify how the administration should rebench the Test 1 factor to reflect the effect of changes in the allocation of local property tax revenues.
- E-24 ■ **Budget-Year Cost-of-Living Adjustment (COLA) Expected to Be Higher Than Governor's Estimates.** Updated data suggests the K-12 COLA will be around 5.8 percent rather than 5.2 percent, which would lead to increased costs of around \$300 million.

#### Proposition 98 Priorities

- E-27 ■ **Proposition 98 Priorities.** The Governor's budget proposal to spend \$1.7 billion more than the Proposition 98 minimum guarantee would widen the state's structural spending gap in 2007-08 and raises the issue of whether the state would be able to sustain the proposed level of General Fund expenditures in the future.
- E-31 ■ **Minimize Impact of Proposition 98 on Structural Gap.** Recommend the Legislature reject all proposals for new K-14 programs and fund Proposition 98 at the level needed to fully fund base program costs in the budget year.
- E-34 ■ **Option 1: Supplement Base With One-Time Funds.** If the Legislature desires to provide K-14 resources at levels similar to the Governor's budget, recommend the Legislature spend \$1 billion on a *one-time* basis to reduce the state's K-14 "credit card" debt.

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- E-37 ■ **Option 2: Target New Funds at Highest Local Needs.** Recommend that, if the Legislature wants to provide a higher ongoing level of Proposition 98 expenditures similar to the amount proposed in the 2006-07 budget, the Legislature (1) eliminate new after school funding and repeal Proposition 49, (2) commit new K-12 discretionary funds for a fiscal solvency block grant, and (3) use community college funding to achieve the Legislature's equalization goal.

## Governor's New Categorical Programs

- E-51 ■ **Reject New Categorical Program Proposals. Reduce Items 6110-217-0001 by \$18.2 Million, 6110-244-0001 by \$65 Million, 6110-260-0001 by \$85 Million, 6110-262-0001 by \$100 Million, 6110-264-0001 by \$25 Million, and 6110-265-0001 by \$100 Million.** Recommend rejecting these new program proposals because they: (1) do not address the major fiscal issues facing the state or school districts; (2) take a step backwards for categorical reform; (3) have basic policy flaws; and (4) contain virtually no planning, reporting, evaluation, or accountability components.

## School District Financial Condition

- E-56 ■ **Address Retiree Health Benefit Liabilities.** Data on retiree health benefits suggest that a significant number of school districts and county offices have accumulated significant unfunded liabilities for future costs of retiree health benefits.
- E-61 ■ **Require Districts to Address Liabilities.** Recommend enactment of legislation to require county offices of education and school districts to develop a plan for addressing long-term liabilities for retiree health benefits.
- E-62 ■ **Negotiate a Plan to Use Federal Funds for Retiree Costs.** Recommend the Legislature enact trailer bill language to allow districts to use state categorical program funds as part of a comprehensive plan for addressing retiree health liabilities. Also recommend the Legislature direct CDE to work with the federal government to develop a template that would guide district development of comprehensive plans for addressing unfunded retiree health benefits.
- E-63 ■ **Create a Fiscal Solvency Block Grant.** Recommend the Legislature redirect \$393.5 million in Proposition 98 funds to a block grant that would provide districts and county offices with a source of funding to address the fiscal challenges they currently face.

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## Revenue Limits

- E-69 ■ **Redirect Funding for Deficit Factor Reduction to cost-of-living adjustment (COLA).** Recommend the Legislature redirect the proposed \$206 million for deficit factor reduction to pay for the increased costs of a higher COLA.
- E-70 ■ **Increase Funding for Declining Enrollment Adjustment.** Recommend the Legislature score an additional \$75 million to recognize the cost of fully funding the declining enrollment adjustment.
- E-73 ■ **Redirect Equalization Funding to Fiscal Solvency Block Grant.** Recommend the Legislature redirect the proposed \$200 million for equalization to address the serious fiscal solvency issues faced by many districts in the state. If the Legislature chooses to fund equalization, we recommend allocating the funds based on a new formula that consolidates “add-on” programs into base revenue limits.

## Mandates

- E-77 ■ **Newly Identified Mandate Review.** Recommend the Legislature approve four new K-12 mandates.
- E-78 ■ **Fully Fund Ongoing Mandate Costs.** Recommend augmenting the appropriation for mandates by \$28.2 million in order to fully fund these costs in the budget year. Also recommend amending the budget bill to list the specific mandates the appropriation is intended to cover.
- E-80 ■ **Create New Mandate Block Grant.** Recommend appropriating K-12 mandate funds in a per-pupil block grant to districts in order to streamline and simplify the K-12 mandate process.
- E-84 ■ **Revisit the STAR Mandate.** Recommend augmenting the Standardized Testing and Reporting (STAR) budget by \$11.2 million ongoing and earmarking \$104.5 million of the \$151 million in one-time funds for prior-year mandates to settle mandated costs for this program.
- E-88 ■ **Create a New Truancy Program.** Recommend adopting trailer bill language to eliminate two truancy mandates and redirecting the funds to create a new truancy categorical grant program in order to increase the effectiveness of these funds for their intended purpose.

## After School Programs (Proposition 49)

- E-94 ■ **Repeal Proposition 49.** Continue to recommend Legislature enact legislation placing before the voters a repeal of Proposition 49 because (1) it triggers an autopilot augmentation even though the state is facing a structural budget gap of billions of dollars, (2) the additional spending on after school programs is a lower budget priority than protecting

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districts' base education program, and (3) existing state and federal after school funds are going unused.

- E-96 ■ **Amending Proposition 49 After School Program May Require Voter Approval.** Recommend Legislature seek legal advice on the extent to which it can alter the provisions of Proposition 49.
- E-105 ■ **Amend Proposition 49 to Provide Districts Flexibility to Meet School Safety or Academic Goals.** If the Legislature decides not to repeal Proposition 49, recommend Legislature enact legislation placing before the voters a package that significantly revamps the after school program described in the initiative. Instead of uniform school grants, we recommend distributing the after school funds to districts based on a weighted pupil formula. This approach will reflect differential needs across districts, but will provide districts the flexibility to make the trade-offs between the number of students served, and the academic richness of the program.

**Child Care**

- E-116 ■ **Increase Funding for Higher Quality Programs.** Recommend Legislature increase the reimbursement rates for Title 5 providers in high-cost counties by redirecting savings from several policy changes recommended below.
- E-117 ■ **Redirect Child Care Growth Funding.** Recommend Legislature redirect \$14.8 million in child care growth funding to provide for a higher reimbursement rate for Title 5 providers in high-cost counties.
- E-117 ■ **Limit License-Exempt Reimbursement Rate.** Recommend limiting the license exempt reimbursement rate to the lesser of 90 percent of the regional market rate or 90 percent of the Title 5 reimbursement rate.
- E-117 ■ **Create a State Level Sibling Discount.** Recommend the Legislature require child care centers offering private pay customers a sibling discount to also offer that discount to the state for any family with more than one child in the same care center.
- E-118 ■ **Adopt a Sliding Scale COLA for General Child Care and State Preschool.** Recommend the Legislature distribute the cost-of-living adjustment (COLA) funds to provide an above average COLA to Title 5 providers in high-cost counties and a below average COLA in lower cost counties.
- E-119 ■ **New Regional Market Rate (RMR) Survey Provides Room for Compromise.** Recommend the Legislature direct the California Department of Education to use the new RMR survey results to develop a set of

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sub-regions within counties to balance the efficiency benefits of having multiple reimbursement rates in a county with the administrative burden that multiple rates create.

## Economic Impact Aid

- E-122 ■ **Revise the Economic Impact Aid (EIA) Formula.** Recommend the Legislature revise the EIA formula so that district allocations are predictable and meet local needs, and calculation is based on dependable data source. Recommend providing transitional funding to ease districts' transition to new formula.

## Special Education

- E-132 ■ **Fully Fund Base Program.** Recommend redirecting \$19.5 million from "one-time" discretionary grants to cover base special education costs in 2006-07.
- E-133 ■ **Fully Fund Growth and Inflation Adjustments.** Recommend redirecting \$38.6 million to provide a full increase for growth and inflation on the federally funded portion of the program.

## Facilities Emergency Repair Program

- E-136 ■ **Modify Emergency Repair Program (ERP) Funding Distribution System.** Recommend the Legislature grant the ERP funds directly to districts with low performing schools to address facility needs identified by the School Facilities Needs Assessment Program, while maintaining \$50 million at the state level for an emergency repair loan program.

## Federal Funds

- E-141 ■ **Reject All but One Component of Governor's Carryover Proposal. Eliminate Item 6110-135-0890 (\$82 Million). Create 6110-123-0890, Schedule 2 (\$16 Million), and Augment 6110-125-0890, Schedule 1 (\$19 Million) and 6110-136-0890, Schedule 3 (\$47 Million).** We recommend the Legislature reject the Governor's carryover proposals for the Migrant Education Program, Comprehensive School Reform Program, and Title I, Program Improvement. For the Title I, Basic Program carryover, we recommend the Legislature direct the California Department of Education to seek federal approval to transfer carryover funds to Title I, Program Improvement, thereby expanding funding for school and district assistance and interventions.

**Analysis****Page****Migrant Education**

- E-150 ■ **Revise Migrant Education Program (MEP) Funding Model.** Recommend the Legislature adopt a new district-based MEP service model by allocating 70 percent of the state's MEP grant directly to school districts, 15 percent to regional support centers, and 15 percent to the California Department of Education (CDE).
- E-153 ■ **Revise Per-Pupil Funding Formula for Districts.** Recommend the Legislature direct CDE to revise the district funding formula to emphasize federal and state priorities.
- E-154 ■ **Enhance Migrant Student Database.** Recommend the Legislature direct CDE to determine best approach for expanding database to include more data elements and provide district and school personnel access to the system.
- E-156 ■ **Use Carryover Funds to Build Better System.** Recommend the Legislature use: (1) up to \$4 million in MEP carryover funds to enhance migrant student database and (2) remaining funds to help transition to a district-based funding and service model.
- E-157 ■ **Allow 5 Percent Carryover at Local Level.** Recommend the Legislature adopt budget bill language to authorize up to 5 percent of MEP funds to carry over at the local level.
- E-158 ■ **Require Report to Legislature.** Recommend Legislature require CDE to report back by October 31, 2006 regarding progress in implementing program reforms.

**California High School Exit Examination (CAHSEE)**

- E-160 ■ **Test the Impact of a CAHSEE Block Grant.** Recommend the Legislature adopt trailer bill language that would allow up to ten districts to test comprehensive approaches to assisting students to pass CAHSEE

**Instructional Materials**

- E-xx ■ **Eliminate Instructional Materials Augmentation.** Recommend the Legislature eliminate a \$40 million proposed augmentation for instructional materials given recent large increases in funding provided from lottery revenues.

**Intersegmental: UC and CSU Enrollment Growth And Funding**

- E-186 ■ **Reduce Budgeted Enrollment Growth for the University of California (UC) and the California State University (CSU).** Based on our demographic projections, we recommend the Legislature fund budgeted enrollment growth of 2 percent for UC and CSU.

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- E-188 ■ **Adjust CSU's Base Budget to Reflect Actual Enrollment.** If CSU does not meet its current-year enrollment target, we recommend the Legislature remove the unused enrollment funding from CSU's base budget.
- E-188 ■ **Modify Enrollment Target Provisions in Budget Bill.** Recommend Legislature modify provisional language relating to enrollment targets for both UC and CSU, in order to protect its priority to increase state-supported higher education enrollment.
- E-200 ■ **Revise Marginal Cost Methodology.** Recommend Legislature revise the current marginal cost methodology, in order to more effectively fund the increased costs associated with enrollment growth. Specifically, recommend (1) excluding unrelated costs, (2) better reflecting the actual costs of hiring entry-level faculty and teaching assistants, (3) including operation and maintenance costs, (4) redefining a full-time equivalent CSU graduate student, and (5) adjusting the total marginal cost by the average fee revenue collected per student.
- E-204 ■ **Fund 2 Percent Enrollment Growth Based on Revised Marginal Cost Methodology. Reduce Item 6440-001-0001 by \$16.7 Million and Item 6610-001-0001 by \$14.1 Million.** Using our proposed marginal cost methodology and proposed 2 percent growth projection, we recommend reducing the Governor's proposed funding rates for each additional student at UC (from \$10,103 to \$8,574) and CSU (from \$6,792 to \$6,407). Further recommend Legislature adopt (1) provisional language specifying the marginal cost funding rate for each segment and (2) supplemental report language specifying that enrollment growth funding provided in future budgets be based on our proposed methodology.

## Year-Round Operations at UC and CSU

- E-207 ■ **Expanding Summer Enrollment.** We review actions the state has taken to promote full utilization of the summer term at the University of California (UC) and the California State University (CSU). We find that while UC's summer enrollment has increased, CSU's summer enrollment has declined. We also identify issues for the Legislature to consider in regards to funding further summer expansion.

## Student Fees

- E-221 ■ **Maintain Nonneediest Students' Share of Cost at Current-Year Levels. Score \$84 million in net new student fee revenue.** Recommend maintaining nonneediest students' share of cost at the current-year level. This would entail modest fee increases of 3.5 percent at University of

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California (UC), 3 percent at the California State University (CSU), and 7 percent at the California Community College (CCC). For a full-time undergraduate, this equates to an annual increase of \$215 at UC, \$76 at CSU, and \$55 at CCC. These increases would generate \$84 million in net new fee revenue.

- E-225 ■ **Reject Governor's Fee Buyout Proposal.** Recommend rejecting the Governor's fee buyout proposal because it distorts budgeting and creates wrong incentives.

**University of California**

- E-234 ■ **General Fund Base Increase. Reduce Item 6440-001-0001 by \$67 Million.** Based on our projection of inflation for 2006-07, we recommend the Legislature reduce the General Fund base increase proposed by the Governor for the University of California (UC) from 5.8 percent to 3.3 percent. Accordingly, we recommend deleting \$67 million from the \$155.5 million proposed General Fund augmentation.
- E-235 ■ **K-14 Outreach Programs.** Withhold recommendation on the proposed \$17.3 million General Fund reduction to UC's outreach programs, pending review of the university's evaluation report to be submitted in April.
- E-236 ■ **Program in Medical Education for the Latino Community (PRIME-LC).** Withhold recommendation on the \$180,000 proposed augmentation for UC's PRIME-LC, pending further review of the basis of the proposed augmentation.

**California State University**

- E-240 ■ **General Fund Base Increase. Reduce Item 6110-001-0001 by \$46.8 Million.** Recommend the Legislature reduce the General Fund base increase proposed by the Governor for the California State University (CSU) from 5.2 percent to 3.3 percent, which is our projection of inflation. Accordingly, we recommend deleting \$46.8 million from the proposed augmentation of \$130.2 million.
- E-241 ■ **K-14 Outreach Programs.** Withhold recommendation on the proposed \$7 million General Fund reduction to CSU's outreach programs, pending review of the university's evaluation report to be submitted in March.
- E-242 ■ **Continuous Appropriation of Fee Revenue.** If the Legislature wishes to approve the Governor's proposal to continuously appropriate CSU fee revenue, we would recommend it amend trailer bill language to facilitate accountability.

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## California Community Colleges (CCC)

- E-257 ■ **Fund 1.75 Percent Enrollment Growth. Reduce Item 6870-101-0001 by \$62 Million.** We project overall enrollment at CCC to increase by 1.75 percent in 2006-07. Funding at this level would save \$62 million relative to the Governor's proposal.
- E-260 ■ **Equalization Funding a High Priority, but Should Be Contingent on New Allocation Formula.** To the extent the Legislature wishes to provide augmentations above workload-related increases, we recommend providing a final installment of funding towards its equalization goals. The Governor proposes \$130 million for this purpose. However, because the existing formula for allocating funding to community colleges would erode the state's equalization gains over time, we recommend that additional funding be provided for equalization contingent on enactment of legislation providing an allocation mechanism that preserves its equalization goals.
- E-260 ■ **Reject \$50 Million Expansion of Career Technical Education Initiative. Reduce Item 6870-101-0001 by \$50 Million.** Because CCC will not distribute current-year money for this initiative until later this spring, we believe expanding the program at this time is premature. We recommend the Legislature not expand the program until the CCC has evaluated the progress of the initial effects and prepared a proposal for the new funds.
- E-261 ■ **Direct Chancellor's Office to Provide Update on Retiree Health Benefit Liabilities.** A new policy by the national Governmental Accounting Standards Board on retiree health benefits presents a major new fiscal challenge to community colleges. We recommend the Legislature direct the Chancellor's Office to provide an update on the magnitude of these liabilities and current efforts to address them.
- E-262 ■ **Accountability Update.** We provide an update on the implementation of a new district-level accountability system for CCC, as well as the planned expansion of the California Partnership for Achieving Student Success (Cal-PASS). To the extent the Legislature wishes to augment CCC's budget above workload increases, we think the Governor's proposed \$500,000 augmentation for Cal-PASS makes sense.

## Student Aid Commission

- E-268 ■ **Promote Parity for Financially Needy Students Attending Public and Private Universities.** We continue to recommend the Legislature adopt a policy linking the maximum Cal Grant for financially needy students attending private institutions to state support for financially needy students attending public institutions. Having restored its policy

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basis, the Legislature could gradually phase in award increases until parity for financially needy students attending public and private institutions was achieved.

- E-270 ■ **Avoid Complicating Well-Structured Assumption Program of Loans for Education (APLE).** We recommend the Legislature retain the existing structure of the APLE program and reject proposed budget bill language to add various new, unneeded provisions.
- E-277 ■ **Restructure How State Administers Student Grant and Loan Programs.** We recommend the Legislature enact legislation that would authorize a single agency, with one board and Executive Director, to administer both state grant and federal loan programs. We recommend the agency be structured as a nonprofit public benefit corporation but subject to stronger accountability requirements.