

Proposition 98: How California Funds K-14 Education

LEGISLATIVE ANALYST'S OFFICE

Presented To:
Sacramento Economics Roundtable

April 21, 2005



How Has Proposition 98 Worked So Far?



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.** Which test depends on how the economy and General Fund revenues grow from year to year.
 - **Test 1—Share of General Fund.** Provides 39 percent of General Fund revenues. This test has not been used since 1988-89.
 - **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.



What Have Been the Operative Tests?

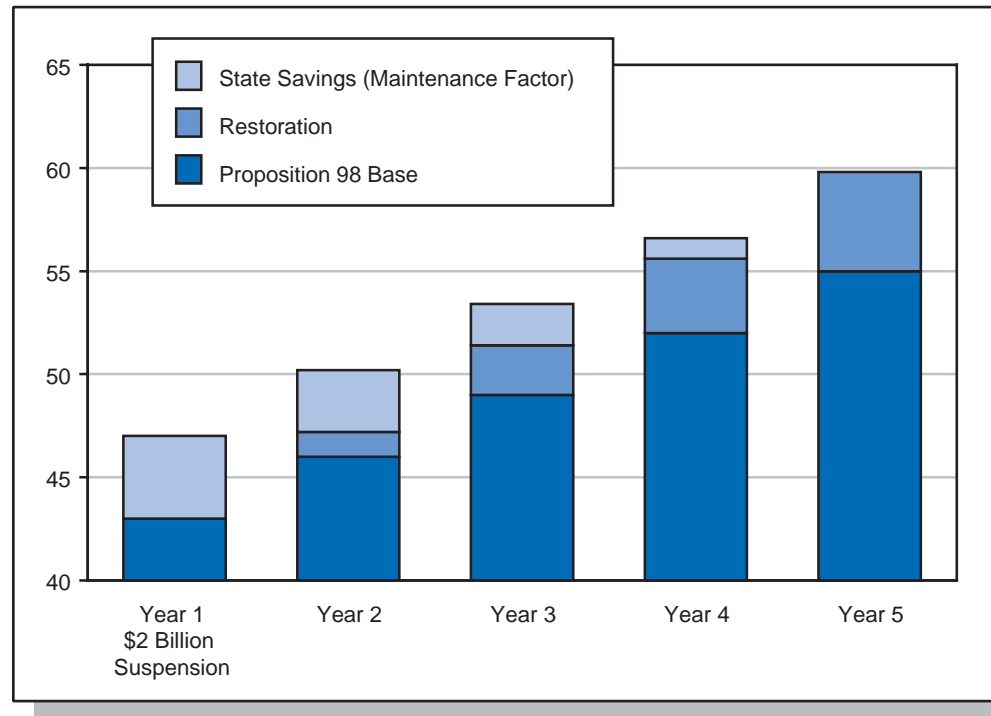
Year	Operative Test	Growth Factor Per Capita	
		Personal Income	General Fund
1998-89	1	3.9%	— ^a
1989-90	2	5.0	— ^a
1990-91	3	4.2	-4.0%
1991-92	2	4.1	8.0
1992-93	3	-0.6	-4.4
1993-94	3	2.7	-3.4
1994-95	2	0.7	6.6
1995-96	2	3.4	8.1
1996-97	2	4.7	5.6
1997-98	2	4.7	10.7
1998-99	2	4.2	6.5
1999-00	2	4.5	18.3
2000-01	2	4.9	6.9
2001-02	3	7.8	-18.6
2002-03	2	-1.3	1.0
2003-04	2	2.3	5.9
2004-05	Suspended	3.3	7.2
2005-06 ^b	2	4.5	5.7

^a Test 3 was added to Proposition 98 in 1990 by Proposition 111. Thus, per capita General Fund revenues were not part of the calculation in these years.

^b Based on 2005-06 Governor's Budget.



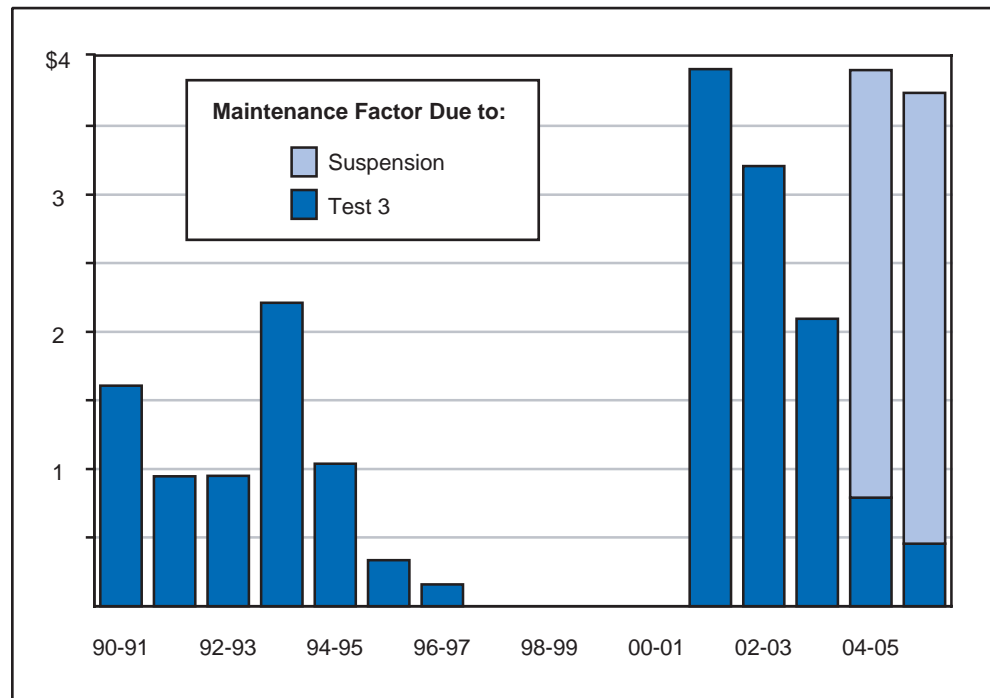
How a Maintenance Factor Is Created and Restored





Proposition 98 Outstanding Maintenance Factor

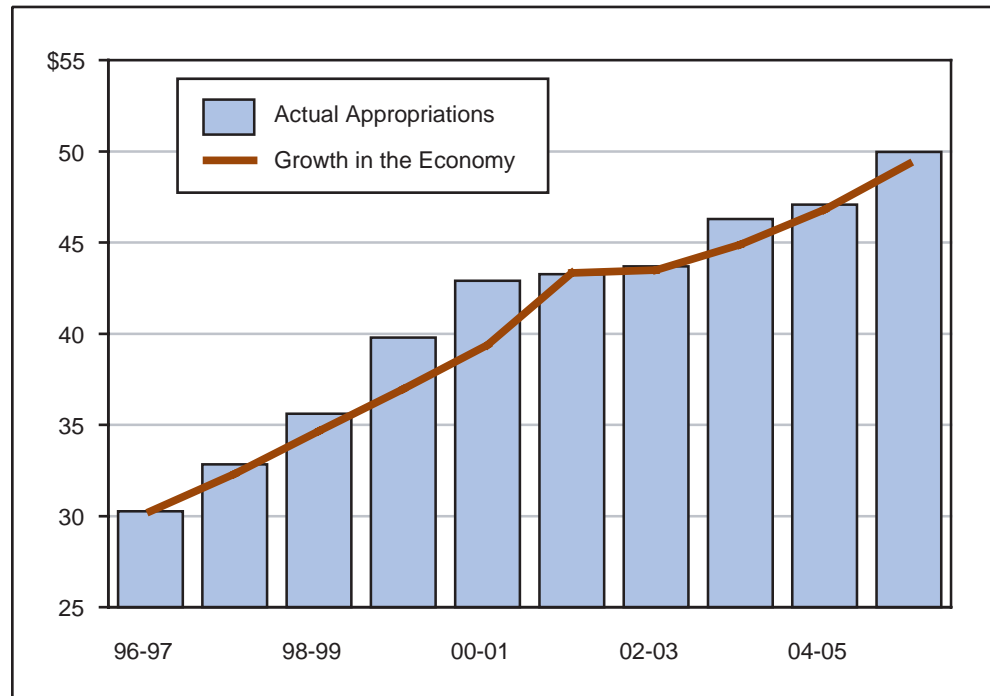
(In Billions)





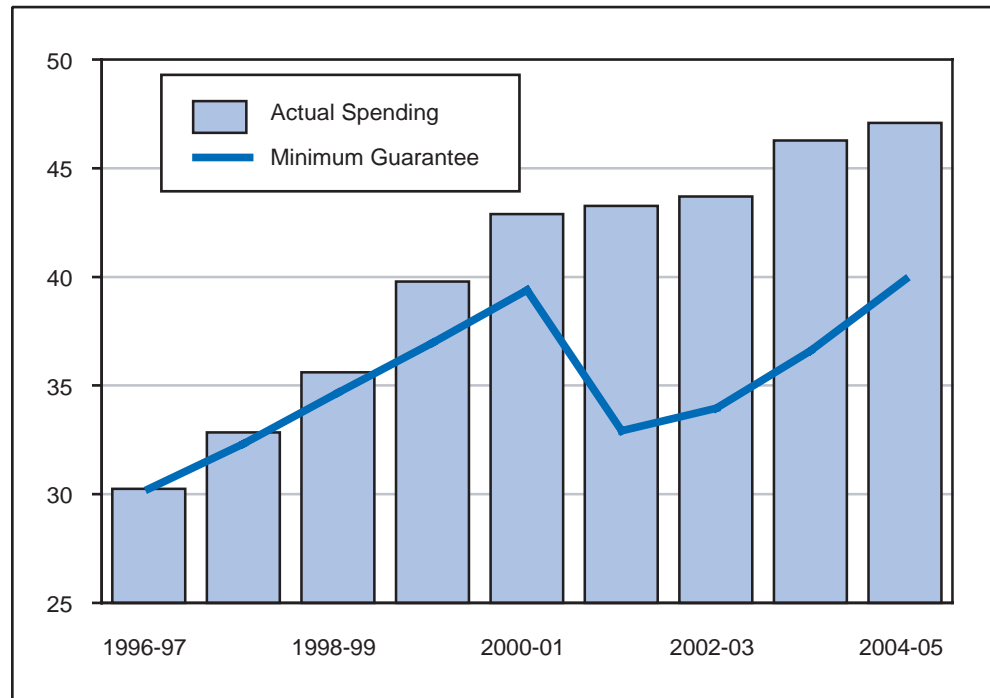
Growth in Proposition 98 Compared to Growth in the Economy

(In Billions)





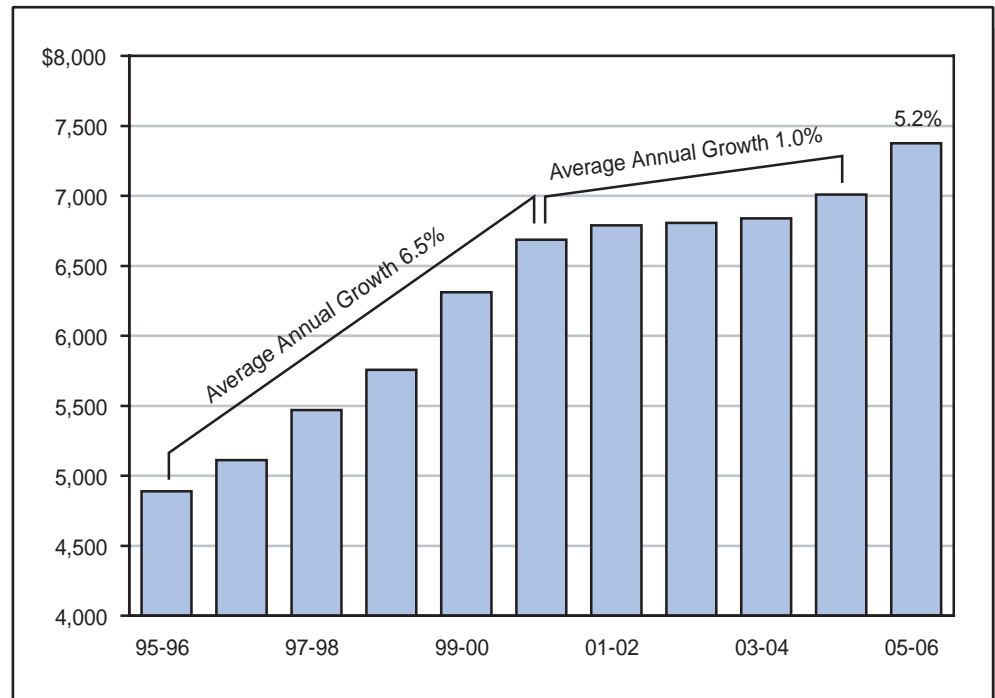
Proposition 98—If Legislature Had Appropriated at the Minimum Guarantee





K-12 Per Pupil Spending

Nominal Dollars

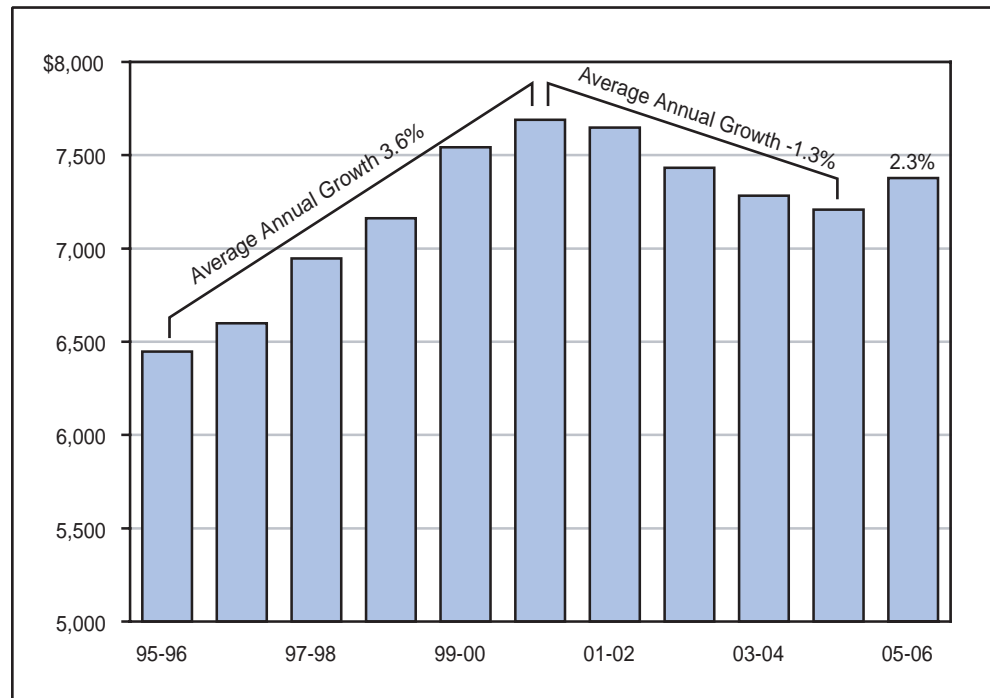




K-12 Per Pupil Spending

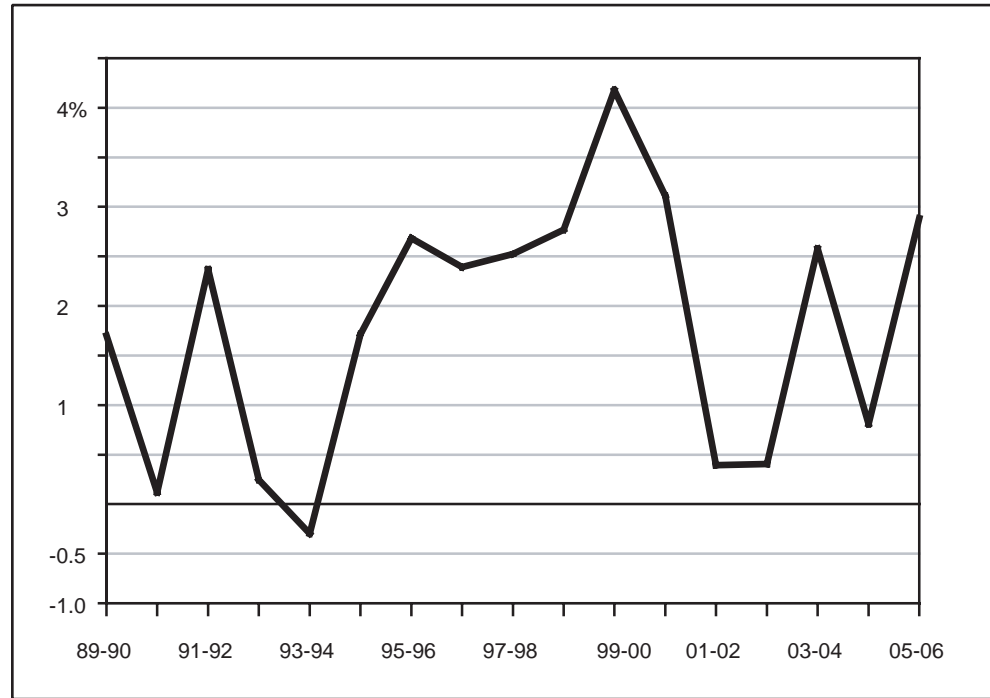
(Continued)

Adjusted for Inflation





Year-to-Year Growth Proposition 98



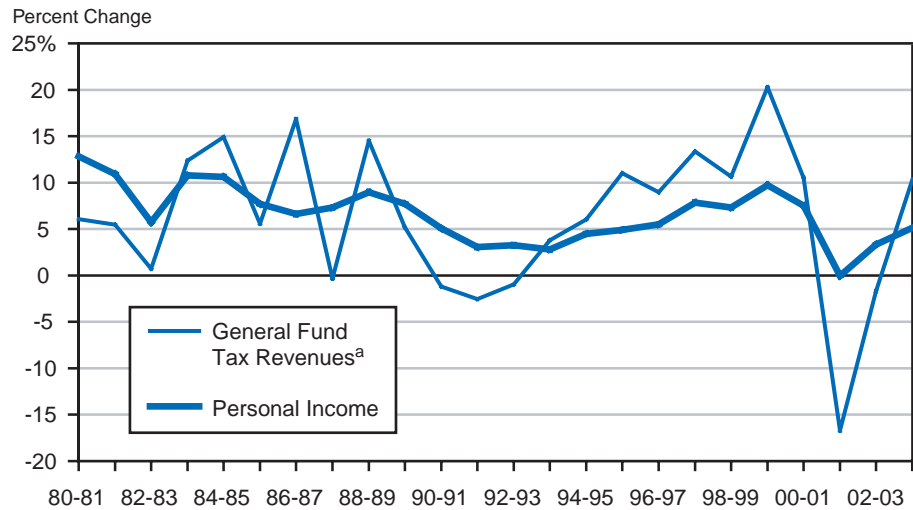
Year-to-year growth in Proposition 98 revenues is volatile. This volatility results from the dependence of Proposition 98 on General Fund revenues and the fact that General Fund revenues are volatile.

General Fund Volatility Major Factor in Proposition 98 Volatility

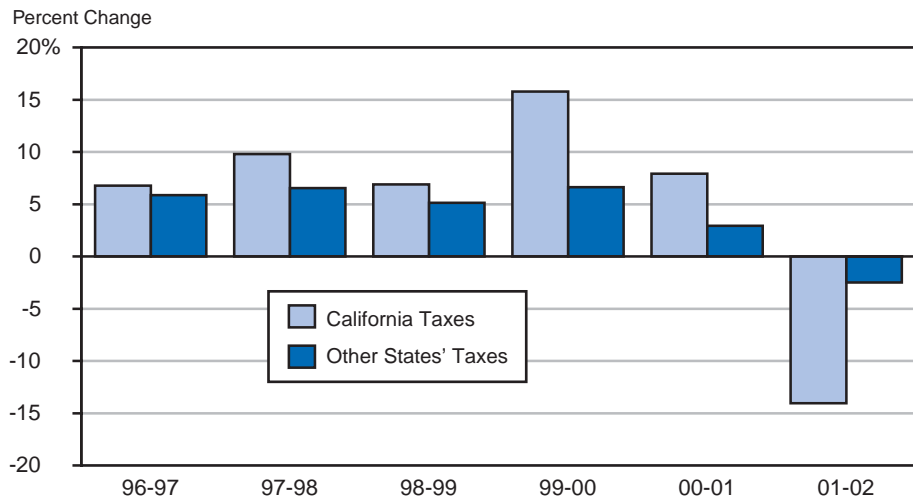


Recent History of California's Revenue Fluctuations

California's Tax Revenues Have Been More Volatile Than the State's Economy



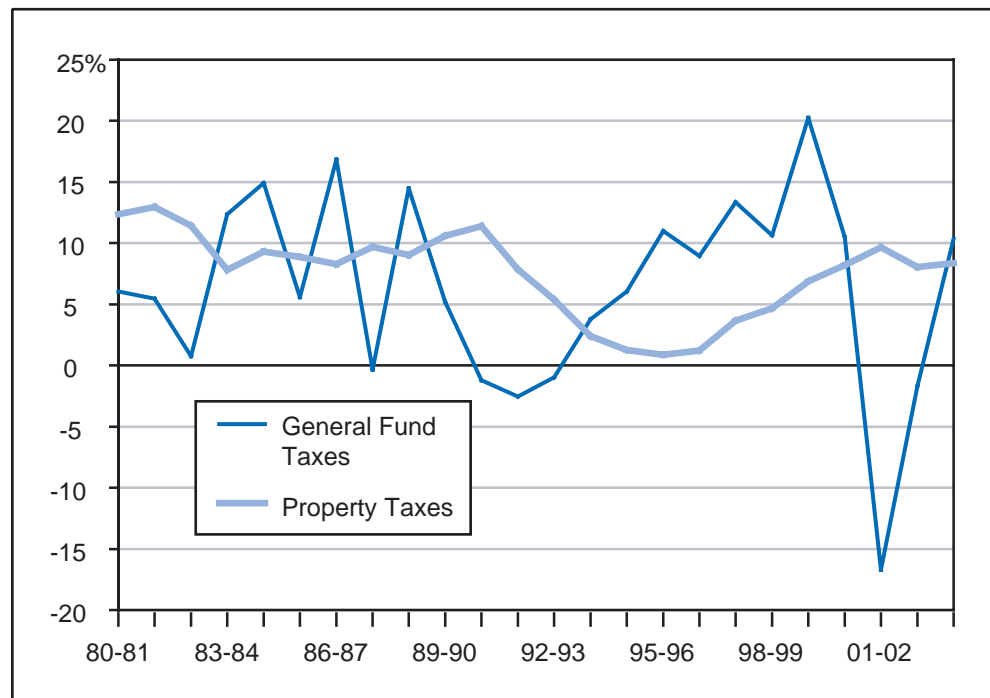
California's Revenue Volatility Has Also Exceeded That for Other States^a





California's Property Tax Has Been More Stable Than General Fund Tax Revenues

(Percent Change)





Historical Effects of Economic Cycles On General Fund Revenues

	Effects of a 1 Percent Change in Personal Income On Percent Changes in Revenues ^a		
	1979-80 Through 2003-04	1979-80 Through 1990-91	1991-92 Through 2003-04
Personal Income Tax	2.94%	1.09%	6.24%
Sales and Use Tax	1.19	1.33	1.44
Corporation Tax	1.70	2.57	3.33
Totals, All Revenues	2.05%	1.39%	3.51%

^a Based on short-term elasticity calculations.



Key Factors Contributing to California's Above-Average Revenue Volatility



Dynamic State Economy

- Has large cyclical industries like high technology and housing
- Has large fluctuations in domestic in-migration



Characteristics of the Tax Structure

- Largest tax, the PIT, is highly volatile
 - Progressive rate structure magnifies income fluctuations.
 - Volatile capital gains are fully taxed.
- Next largest tax, the SUT, is relatively stable but could be more so
 - Consists of more volatile types of spending, such as sales of building materials, autos, and business equipment.
- Third largest tax, the CT, is very volatile
 - Corporate profits fluctuate in such cyclical industries as high technology, finance, and construction.



Options for Changing the Tax System To Deal With Volatility

Option	Reduction in Volatility ^a	Key Policy Trade-Offs
1. Reduce personal income tax (PIT) rates on capital gains and stock options	Moderate to substantial reduction.	<ul style="list-style-type: none"> • Shift in tax burdens, either among income groups or among taxpayers with different forms of income.
2. Use income averaging for capital gains	Moderate reduction.	<ul style="list-style-type: none"> • Would not conform to federal law.
3. Reduce progressivity of the PIT rate structure	Potentially substantial reduction.	<ul style="list-style-type: none"> • Shift in tax burdens among income groups. • Reduction in revenue growth.
4. Rebalance mix of taxes away from PIT	Modest reduction.	<ul style="list-style-type: none"> • Some shift in tax burdens among income groups. • Some reduction in revenue growth.
5. Modify the corporation tax	Probably modest reduction.	<ul style="list-style-type: none"> • Shift in tax burdens among corporations. • Would reduce conformity with other states.
^a For purposes of this figure, "substantial" implies more than 20 percent, "moderate" implies between 10 percent and 20 percent, and "modest" implies less than 10 percent.		

Concerns With Governor's Proposition 98 Reform



Governor's Structural Budget Reform Proposal

Proposition 98
<ul style="list-style-type: none"> • Eliminates ability to suspend minimum guarantee. • Eliminates "Test 3" and maintenance factor. • Overappropriations not counted in Proposition 98 base.
Budget Process
<ul style="list-style-type: none"> • Late budget. <ul style="list-style-type: none"> — Prior year's appropriations continued. • Across-the-board cuts following Governor's proclamation of shortfall. <ul style="list-style-type: none"> — Late budget—if no legislative solution within 30 days. — Midyear—if no legislative solution within 45 days.
Proposition 42 Transportation Funding
<ul style="list-style-type: none"> • Eliminates ability to suspend transfer after 2006-07.
Special Funds
<ul style="list-style-type: none"> • No borrowing from special funds after 2006-07.
Consolidation and Repayment of Obligations Within 15 Years
<ul style="list-style-type: none"> • Existing Proposition 98 settle up and maintenance factor. • Proposition 42 suspended amounts (no less than one-fifteenth per year). • Mandate claim balances. • Loan balances from special funds.

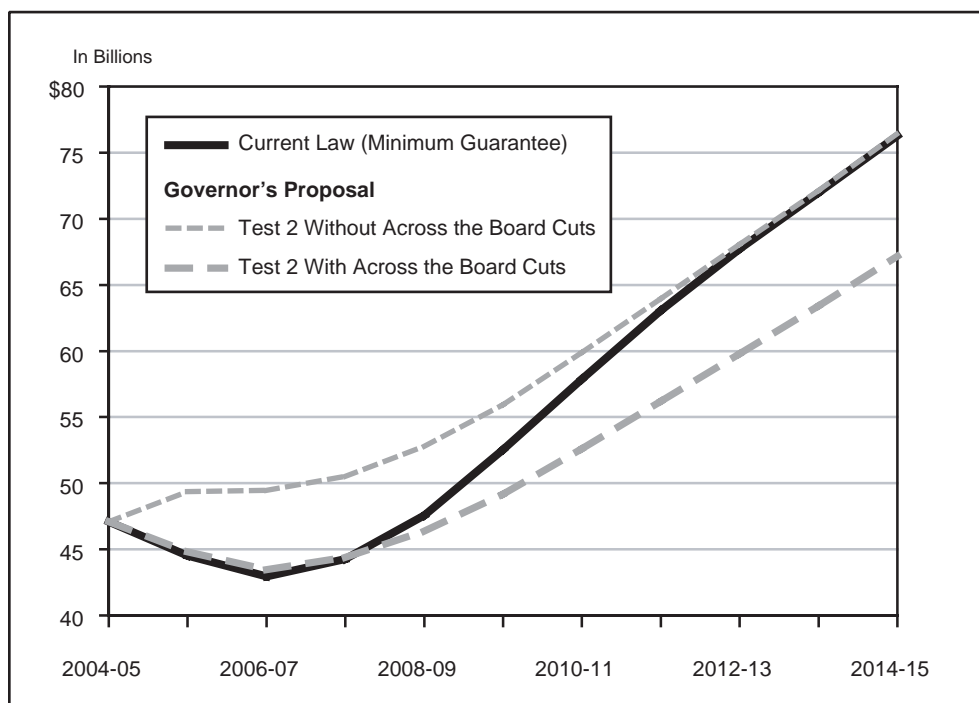


Major Concerns Raised by Governor's Proposal

- ✓ **Proposition 98 Changes Would Seriously Limit Legislative Flexibility**
 - Suspension and Test 3 have been effective tools.
 - Their elimination would leave 45 percent of the budget off limits.
 - The limited flexibility could drive the state to across-the-board reductions.
- ✓ **Across-the-Board Reductions—A Blunt Tool**
 - Result in unpredictable and uneven impacts on programs.
 - Represent major delegation of legislative powers.
 - Fail to distinguish between high- and low-priority programs.



Impact of Governor's Proposal Under a Bust-Boom Forecast



If revenues fell dramatically in the near term, the Governor's proposal would provide higher Proposition 98 spending than current law. The difference would decline in the out-years as the economy recovered.



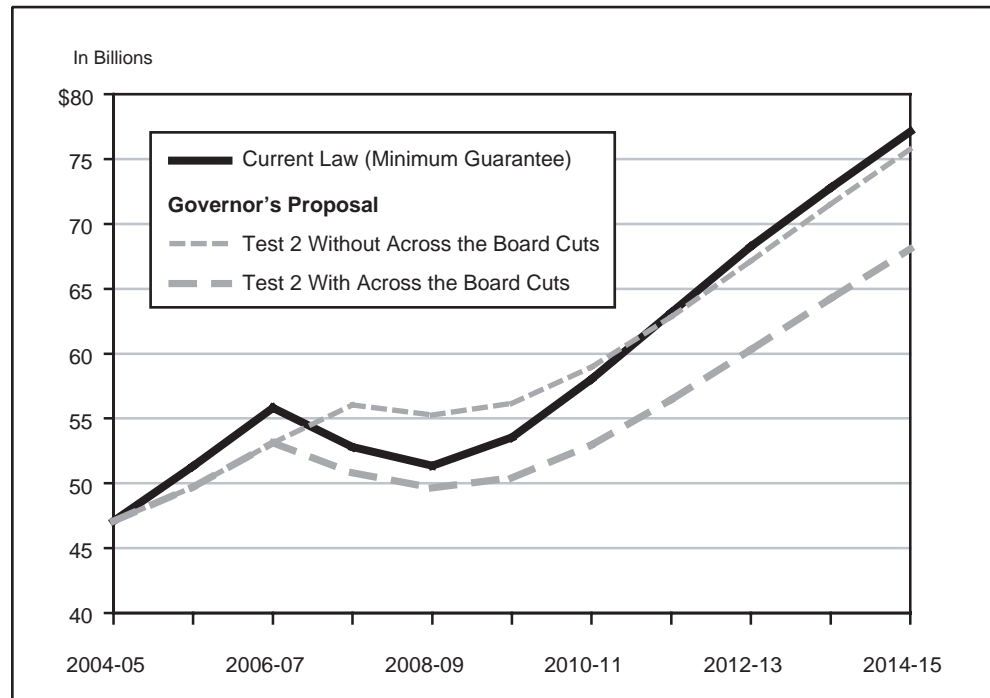
If the state needed to use across-the-board reductions to balance the budget, then education's guaranteed share of the budget would be permanently reduced. The state could provide funds above the guarantee to maintain education's share of the budget.



Without across-the-board reductions, the percentage reduction in non-Proposition 98 programs would have to be nearly double the fall in General Fund revenues.



Impact of Governor's Proposal Under a Boom-Bust Forecast



The Governor's proposal would provide lower funding during the initial boom, but higher funding during the bust years.



If across-the-board reductions were needed to balance the budget, then education's guaranteed share of the state budget would be permanently reduced.