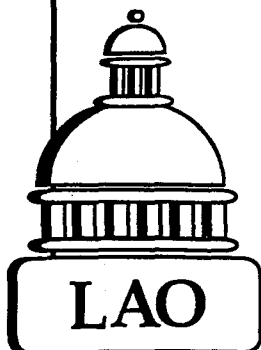


REPRINT

The 1991-92 Budget:
Perspectives and Issues

Proposition 98



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Proposition 98

How Is the Proposition 98 Minimum Funding Guarantee Determined, and What Are the Consequences of Suspending Proposition 98?

Summary

Proposition 98 provides K-12 schools and community colleges with a constitutionally guaranteed minimum level of funding in 1988-89 and thereafter. Under the provisions of this measure, funding requirements for K-14 education programs are determined using a series of complex calculations based on factors related to both workload-based needs and state revenue availability.

As part of its overall strategy for balancing the budget, the administration proposes to suspend Proposition 98 in 1991-92 and reduce funding for K-14 education programs by \$2 billion, relative to levels that would be required in the absence of suspension. One of the major decisions facing the Legislature, therefore, will be whether to suspend Proposition 98 (as proposed by the Governor's Budget).

Our review indicates that, if Proposition 98 is not suspended, the Legislature will have to cut funding for non-K-14 education programs by \$2 billion in addition to the significant reductions already proposed in the budget, raise an equivalent amount in new tax revenues, or use a combination of these two approaches.

If the Legislature suspends Proposition 98, on the other hand, it need not accept the administration's proposal to reduce funding for K-14 education by \$2 billion. Rather, the Legislature could determine the level of funding for K-14 education it deems appropriate. The Legislature would also have much greater flexibility in deciding how to distribute any new General Fund tax revenues in 1991-92.

In addressing the extremely complex problem of crafting a balanced budget for 1991-92, one of the Legislature's major decisions will be whether or not to suspend Proposition 98. In this piece, we describe the important fiscal provisions of this measure, how the Proposition 98 funding levels are determined in the current and budget years, and the consequences both of suspending and of not suspending Proposition 98 in 1991-92.

THE PROVISIONS OF PROPOSITION 98

Proposition 98, the "Classroom Instructional Accountability and Improvement Act of 1988," provides K-12 schools and community colleges with a constitutionally guaranteed minimum level of funding in 1988-89 and thereafter. As amended by Proposition 111 of 1989 and legislative statutes, the fiscal aspects of the measure consist of three major components:

- The minimum funding guarantee.
- Provisions relating to suspension and restoration.
- Provisions relating to the distribution of "excess" revenues (that is, revenues which exceed the state appropriations limit).

These components, described in more detail below, are summarized in Figure 1.

Minimum Funding Guarantee

The core of Proposition 98 is the minimum funding guarantee, which is based on one of three so-called "tests."

As originally enacted, Proposition 98 guaranteed K-14 education a level of funding based on the *greater* of:

- **Test 1--Percent of General Fund Revenues.** This is defined as the 1986-87 percentage of General Fund tax revenues provided K-14 education—about 40 percent.
- **Test 2--Maintenance of Prior-Year Service Levels.** This is defined as the prior-year level of total funding for K-14 education from state and local sources, adjusted for enrollment growth and for inflation.

Under the original provisions of Proposition 98, therefore, K-14 education was always guaranteed a level of funding at least as great as the amount received in the prior year, plus full adjustments for enrollment growth and inflation—irrespective of whether there were sufficient General Fund revenues available to support this level of funding.

Figure 1

Proposition 98 Major Fiscal Provisions

Minimum Funding Guarantee

In *normal or high revenue-growth* years, guarantee based on the greater of:

- **Test 1—Percent of General Fund Revenues.** 1986-87 percentage of General Fund tax revenues for K-14 education—about 40 percent—or
- **Test 2—Maintenance of Prior-Year Service Levels.** Prior-year total state and local funding level, adjusted for enrollment growth and growth in California per capita personal income.

In *low revenue-growth* years, guarantee based on:

- **Test 3—Adjustment Based on Available Revenues.** Prior-year total funding level, adjusted for enrollment growth and growth in General Fund revenues per capita, plus 0.5 percent of the prior-year level.

Suspension and Restoration

Minimum funding guarantee may be suspended for one year, *for any reason*, through urgency legislation other than the Budget Bill.

- Once guarantee has been suspended, the Legislature may appropriate *any level of funding* for K-14 education.

In years following either suspension or Test 3, the state may be required (depending upon the level of state revenues) to make minimum payments toward restoring K-14 education funding to the level that would have been required had funding not been reduced.

- These payments serve to restore K-14 education funding to pre-reduction levels (as adjusted to maintain service levels); ***there is no requirement that amounts that the state saves as a result of a reduction be repaid.***

"Excess" Revenues

In any year in which General Fund revenues exceed the state appropriations limit, K-14 education receives *one-half* of the excess amount, on a one-time basis (the other half must be returned to taxpayers).

- Unlike the minimum funding guarantee, the excess revenue provision may *not* be suspended.

Partially in response to concerns about this latter prospect, Proposition 111 of 1989 amended Proposition 98 to establish a third "test." Under this test, which is operative only in years in which General Fund revenue growth per capita is more than 0.5 percentage point *below* growth in per capita personal income, the minimum funding guarantee is based on:

- **Test 3—Adjustment Based on Available Revenues.** This is defined as the prior-year total level of funding for K-14 education from state and local sources, adjusted for enrollment growth and for growth in General Fund revenues per capita, *plus* 0.5 percent of the prior-year level.

Proposition 111 also added two other key provisions:

- It changed the inflation adjustment under Test 2 to growth in per capita personal income.
- It provides that in no event can Test 3 result in an increase in per-pupil funding that is less than the increase in per capita expenditures for all other General Fund-supported programs. This was intended to ensure that K-14 education is treated no worse, in years of low revenue growth, than are other segments of the state budget.

As the formula indicates, the calculation of the minimum funding guarantee under Test 3 is quite similar to that under Test 2--the only difference is in the inflation index used. Under Test 2, funding is increased based on growth in per capita personal income. Under Test 3, in contrast, funding is increased based on growth in General Fund revenues per capita (a measure of available budget resources), plus a 0.5 percent "bump" (which ensures a smooth transition between Test 2 and Test 3 as revenues decline).

"Spike" Protection. Proposition 111 also added another condition related to the calculation of the minimum funding guarantee: In any year in which the guarantee is determined by Test 1, and the Test 1 funding level exceeds the Test 2 level by more than 1.5 percent of General Fund revenues, the excess amount shall not be considered part of the "base," for purposes of calculating the following year's guarantee. This provision is intended to limit the extent to which a one-time "spike" in General Fund revenues may result in a permanent increase in the Proposition 98 "base."

Suspension and Restoration

Suspension. Proposition 98 provides that the minimum funding guarantee may be suspended for one year, through

urgency legislation, in a bill other than the Budget Bill. The measure gives no additional criteria on the decision to suspend. Consequently, the Legislature may suspend the minimum funding guarantee for *any reason* which meets the general criterion for urgency legislation specified in the California Constitution ("necessary for the immediate preservation of the public peace, health, or safety"). Once the minimum funding guarantee is suspended, which requires a two-thirds vote of each house, the Legislature may appropriate *any level of funding* for K-14 education.

Restoration. In years following a suspension or a Test 3-based reduction, however, the state may have to make specified minimum payments toward restoring K-14 education funding to the level that would have been required had funding not been reduced.

In practice, the process of suspension and restoration works as follows:

- **Creation of a "maintenance factor."** In any year in which funding for the minimum guarantee is reduced below the level that would otherwise have been required by either Test 1 or Test 2, a "maintenance factor" is created in an amount equal to the underfunding.
- **Computation of guarantee.** In the following year, the minimum funding guarantee is computed using Test 1, 2, or 3 (as appropriate), with the prior year's *actual* (reduced) level of funding as the new "base."
- **Computation of adjusted maintenance factor.** The amount of the maintenance factor is increased annually, using the adjustment factors specified in Test 2 (enrollment growth and growth in per capita personal income).
- **Minimum restoration payment.** In any year in which General Fund revenue growth per capita exceeds per capita personal income growth, the state must make a minimum restoration payment, equal to one-half of the difference in these growth rates, times total General Fund tax proceeds. In no case, however, is the restoration payment greater than the amount of maintenance factor outstanding. The restoration payment serves to reduce the amount of any maintenance factor outstanding.

It is important to emphasize that, because the restoration payments are on top of a minimum funding guarantee which in each year is based on the actual level of funding received in the prior year, they serve to restore K-14 education funding to a level equal to—but not greater than—the pre-reduction level (as ad-

justed for enrollment growth and inflation). As a result, amounts which the state saves due to a suspension or Test 3-based reduction *do not have to be repaid*.

"Excess" Revenues

Finally, Proposition 98 provides that, in any year in which General Fund revenues exceed the state appropriations limit, K-14 education shall receive one-half of the excess amount *on a one-time basis*. In other words, these funds do not get built into the "base," for purposes of computing the following year's minimum guarantee. The California Constitution requires that the remaining half of the "excess" revenues be returned to the taxpayers. Unlike the minimum funding guarantee, the excess revenue provision may not be suspended.

DETERMINATION OF PROPOSITION 98 FUNDING LEVELS

As the preceding discussion indicates, the computation of Proposition 98-required funding levels for K-14 education can be quite complex. In this section, we describe in more detail exactly how these funding levels are determined in 1990-91 and 1991-92 under the assumptions contained in the Governor's Budget.

Current-Year Funding Level

When the Legislature passed the 1990-91 budget last July, it approved a total level of state funding for Proposition 98 of \$17.1 billion. This amount was based on the assumption that the minimum funding guarantee would be determined by Test 2 (the maintenance of prior year's service levels test). The Governor's Budget indicates that, since that time, estimated 1990-91 General Fund tax revenues have decreased by \$2.4 billion. As a result, the basis for computing the minimum funding guarantee has shifted from Test 2 to Test 3.

Figure 2 shows how the decrease in General Fund tax revenues (horizontal axis) affects the determination of state aid requirements under the minimum funding guarantee (vertical axis). (The figure is based on the Governor's Budget estimates of General Fund tax revenues and the Proposition 98 guarantee.) As the figure shows, total General Fund tax revenues for 1990-91 were estimated last July to be \$41.4 billion, resulting in a Proposition 98 state aid requirement under Test 2 of \$17.1 billion (equal to 41.3 percent of General Fund tax revenues).

Figure 2 also shows that, since that time, the estimated level of current-year General Fund tax revenues has decreased by \$2.4 billion. As a result, the basis for computing the minimum funding

guarantee has shifted from Test 2 to Test 3, and the required level of state aid has decreased by approximately \$500 million. (Of this amount, the budget proposes to reduce approximately \$450 million from funds for K-12 education, and \$50 million from community colleges.) According to the budget estimates, the new level of the current-year guarantee is \$16.6 billion (equal to 42.6 percent of the revised estimate of General Fund tax revenues).

As these percentages confirm, in any year in which the Proposition 98 guarantee is determined by Test 2, the percentage of General Fund tax revenues represented by the 98 guarantee exceeds the 40 percent level required under Test 1. They also indicate, however, that the percentage represented by the minimum guarantee can exceed 40 percent *even in years in which the guarantee is determined by Test 3.*

Budget-Year Funding Level

For 1991-92, the administration proposes to suspend the Proposition 98 minimum funding guarantee, and reduce funding for K-14 education by \$2 billion below the level that would otherwise be required in the absence of suspension.

Figure 3 shows the level of funding proposed by the administration in relationship to the Proposition 98 funding guarantee and General Fund tax revenues. The figure shows that, under the Governor's Budget assumptions (including the administration's proposed reduction of 1990-91 Proposition 98 funding levels, as well as its revenue assumptions—see Part I of this document), the minimum funding guarantee would be determined by Test 2. Specifically, the Proposition 98 state aid requirement under Test 2 would be \$18.3 billion (equal to 40.8 percent of the total \$44.8 billion in General Fund tax revenues).

Figure 3 also shows that the level of funding proposed by the administration for Proposition 98-eligible programs is \$16.9 billion (equal to 37.6 percent of General Fund tax revenues) in 1991-92. As the figure shows, this amount is \$1.43 billion below the \$18.3 billion funding level that would otherwise be required by Test 2.

Finally, the figure shows that, in the absence of suspension, the state would also be required to fully restore \$550 million in maintenance factor outstanding (that is, the \$500 million current-year maintenance factor, as adjusted for enrollment growth and inflation) created by the shift to Test 3 in 1990-91. The combination of (1) the \$1.43 billion reduction below the Test 2 funding level and (2) the \$550 million restoration yields the \$2 billion total impact related to suspension noted above.

Figure 2

Proposition 98 Funding Guarantee

1990-91 (In billions)

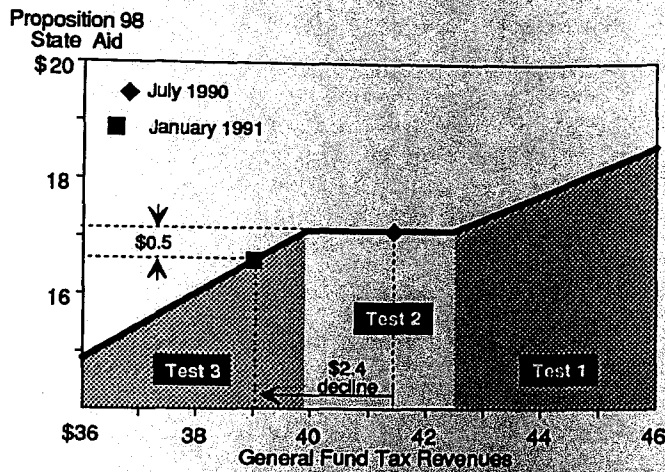
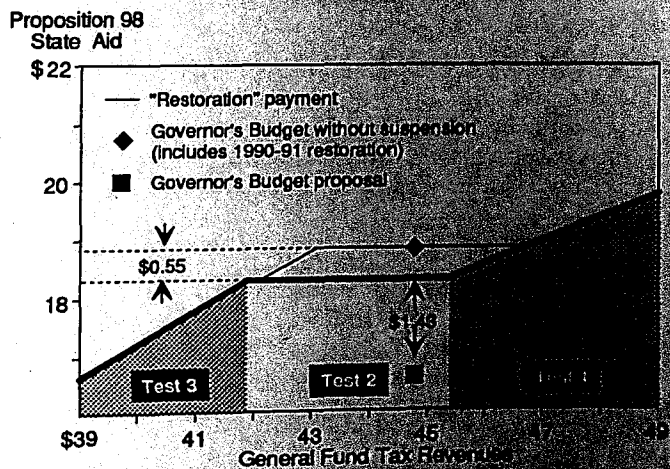


Figure 3

Proposition 98 Funding Guarantee

1991-92 (In billions)



Key Factors Affecting State Aid Requirements

As Figures 2 and 3 show, the level of state funding required for the Proposition 98 minimum funding guarantee can vary, depending upon the level of General Fund revenues. Changes in other factors may also affect the required level of state aid. These impacts are summarized in Figure 4, and are discussed in greater detail below.

Changes in General Fund Revenues. As noted, Figures 2 and 3 show how the required level of Proposition 98-related funding changes, as total General Fund tax revenues change. Specifically, the figures show that:

- **When the minimum funding guarantee is determined by Test 1,** K-14 education gains or loses approximately 40 cents for every dollar of tax revenues gained or lost by the General Fund. (This percentage reflects the share of General Fund spending for Proposition 98-eligible purposes in 1986-87—the Test 1 “base year”—and does not vary.)
- **When the minimum funding guarantee is determined by Test 2,** the level of Proposition 98 state aid is unaffected by changes in General Fund revenues.
- **When the minimum funding guarantee is determined by Test 3,** K-14 education gains or loses more than 40 cents for every dollar of tax revenues gained or lost by the General Fund. (The exact percentage is based on the ratio between total spending for Proposition 98 purposes from state and local funds in the prior year and total prior-year General Fund revenues. This ratio—which is 59 percent for 1991-92—varies from year to year.)

Changes in Other Factors. Figures 2 and 3 are only able to show the relationship between the Proposition 98 minimum funding guarantee and General Fund tax revenues, holding constant all other factors affecting the guarantee level. These other factors, shown in Figure 4, and their effects on the minimum funding guarantee are:

- **Local property tax revenues.** Increases in the level of local property taxes for schools or community colleges result in dollar-for-dollar *decreases* to the level of state funding required under Test 2 or Test 3. Changes in local property tax revenues have no effect on the level of state funding required under Test 1.
- **K-12 enrollment.** Increases in the rate of enrollment growth in K-12 schools result in *increases* in the level of

Figure 4

Impacts on State Aid Requirements of Changes in Key Factors Affecting Proposition 98

Increases in:	Impact on State Aid Requirements		
	Test 1	Test 2	Test 3
General Fund Revenues	↑	—	↑
Local Property Taxes	—	↓	↓
K-12 Enrollment	—	↑	↑
Per Capita Personal Income	—	↑	—

state funding required under Test 2 or Test 3 for both K-12 schools and community colleges. Changes in enrollment growth have no effect on the level of state funding required under Test 1.

- **Per capita personal income:** Increases in the rate of per capita personal income growth result in increases in the level of state funding required under Test 2. Changes in per capita personal income growth have no effect on the level of state funding required under Test 1 or Test 3.

Changes in Factors Unlikely to Solve Budget Problem.

Although changes in the factors noted above can reduce the level of Proposition 98-required state aid, our analysis indicates that—absent a major reduction in General Fund revenues below the level assumed in the Governor's Budget—such changes would not reduce the level of the Proposition 98 guarantee to the level of spending proposed by the administration in 1991-92.

We reach this conclusion for two reasons:

First, our analysis indicates that there is *no conceivable combination* of changes in these factors (other than a major reduction in General Fund revenues below the level assumed in the budget) that could cause a Test 3 reduction to occur in 1991-92.

Second, while changes in these factors could cause the guarantee under Test 1 or Test 2 to drop below the level assumed

in the Governor's Budget, it is unlikely that such a drop would significantly reduce the \$2.0 billion "gap" between the Proposition 98 "full funding" level and the budget proposal.

CONSEQUENCES OF SUSPENDING PROPOSITION 98

The decision of whether or not to suspend Proposition 98 has major implications for the Legislature's ability to find a solution to the enormous budget problem which it confronts in 1991-92. The decision also has major implications for the ability of school districts to balance their own budgets. In this section, we discuss several important considerations, summarized in Figure 5, which we believe the Legislature should bear in mind in deciding this issue.

What If the Legislature Chooses to Suspend?

As noted, once the minimum funding guarantee is suspended, the Legislature can appropriate funds for K-14 education *at any level*, not just the level proposed by the Governor. Suspension would give the Legislature the ability to distribute funds among all state programs, including K-14 education, *according to its own priorities*.

One-Time Suspension Can Yield Multi-Year Savings.

Figure 6 illustrates another important consideration--the *one-time* suspension of Proposition 98 in 1991-92 can yield major General Fund savings for *several years thereafter*. The figure presents our estimates of the level of Proposition 98 funding that would be required during 1991-92 through 1993-94 under the "full funding" (that is, no suspension) alternative (the top line in the figure) versus the Governor's Budget proposal to suspend (the lower, shaded portions of the bars).

Figure 6 also shows that, if the Legislature adopts the budget proposal, the state General Fund will save \$2.0 billion in 1991-92, relative to the K-14 education funding level that would be required in the absence of suspension. In 1992-93, we estimate that the minimum funding guarantee would be determined by Test 3. As a result, the General Fund would save an additional \$3.1 billion. (This amount is composed of the adjusted maintenance factor from 1991-92, plus an additional reduction in 1992-93 due to the shift to Test 3.) Finally, in 1993-94, we estimate that General Fund revenue growth would be sufficiently strong to require a restoration payment of \$1.2 billion. Relative to the funding level that would have been required had Proposition 98 not been suspended in 1991-92, however, the General Fund would save an additional \$2.2 billion.

Figure 5

Considerations Relative to Suspension of Proposition 98

IF MINIMUM FUNDING GUARANTEE IS SUSPENDED:

- ☒ Once the Proposition 98 minimum funding guarantee is suspended, the Legislature can appropriate funds for K-14 education *at any level*.
 - The Legislature is not bound by the Governor's proposal to reduce funding by \$2.0 billion below current-law requirements.
- ☒ One-time suspension not only yields major savings in 1991-92, but may also produce *major, multi-year savings* in future years, relative to funding levels that would have been required in the absence of suspension.
 - The amounts saved *do not have to be repaid*.
- ☒ Major reductions in funding will result in equivalent losses to school and community college districts, making it difficult for districts to balance their budgets.
 - Some districts may seek emergency loans; others may be forced into bankruptcy in order to break contractual agreements (such as multi-year collective bargaining agreements).

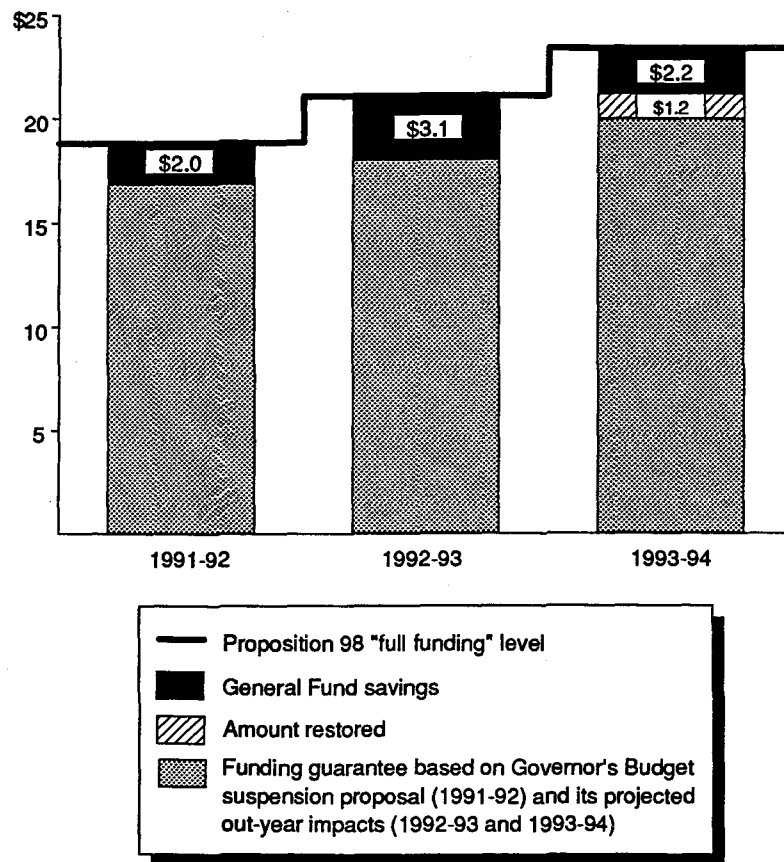
IF MINIMUM FUNDING GUARANTEE IS NOT SUSPENDED:

- ☒ The Legislature will need to appropriate an additional \$2.0 billion to K-14 education above amounts proposed in the Governor's Budget.
 - This amount consists of the \$1.43 billion reduction below the "Test 2" funding level, plus \$550 million to restore funding reduced due to the current-year shift to "Test 3."
- ☒ The Governor's Budget estimates that, with its spending and revenue proposals, there is only \$2.1 billion in additional "room" remaining under the state appropriations limit.
- ☒ Thus, if the Legislature chooses to address the budget problem by raising revenues, rather than by making further cuts in non-K-14 education programs, *100 percent* of the first \$2.0 billion in new revenues would have to be appropriated to K-14 education.
 - Of the next \$100 million, K-14 education would be entitled to roughly \$40 million (with \$60 million available for non-K-14 programs).
 - And, of any revenues raised in excess of \$2.1 billion, 50 percent would go to K-14 education and 50 percent would be rebated to taxpayers (with no additional funding available for non-K-14 programs).

Figure 6

**One-Time Proposition 98 Suspension
Can Yield Major Multi-Year Savings**

1991-92 through 1993-94 (In billions)



Source: Legislative Analyst's projections based on Governor's Budget proposal and LAO estimates of 1992-93 and 1993-94 revenues.

In total, therefore, our estimates of the future impact of the Governor's proposal imply that the one-time suspension of Proposition 98 would save the General Fund a total of **\$7.3 billion** over three years (\$2.0 billion in 1991-92, plus \$3.1 billion in 1992-93, plus \$2.2 billion in 1993-94).

State Savings Equal School District Losses. These state General Fund savings, of course, translate into equivalent losses to school and community college districts. Because personnel costs typically account for about 80 percent of district expenditures, losses of this magnitude would be difficult to accommodate under the best of circumstances. Such losses will be especially difficult to accommodate, however, for those districts which have entered into multi-year contractual arrangements (such as collective bargaining agreements) with no provisions allowing them to be renegotiated in the event of insufficient revenues. In these cases, major funding losses to school districts will undoubtedly generate pressure for emergency loans from the state and, in extreme cases, could force districts into bankruptcy. If the Legislature chooses to suspend Proposition 98, therefore, it will also need to consider these impacts in deciding on an appropriate level of funding to provide K-14 education.

What If the Legislature Chooses Not to Suspend?

If, on the other hand, the Legislature chooses not to suspend Proposition 98, it will need to appropriate an additional \$2 billion in funding to K-14 education above the amount contained in the Governor's Budget.

One option for fully funding Proposition 98 requirements would be to reduce funding for General Fund-supported programs other than K-14 education by an additional \$2 billion beyond the significant reductions already contained in the administration's budget proposal.

Another option would be to address the *overall* state budget problem by raising revenues. If this approach were taken:

- Of the first \$2 billion in new revenues, 100 percent would have to be appropriated to K-14 education.
 - Of the next \$100 million, K-14 education would be entitled to roughly 40 percent (because the guarantee at that revenue level would be based on Test 1)—with the remaining \$60 million available for non-K-14 education programs.
 - Of any revenues raised in excess of \$2.1 billion, 50 percent would go to K-14 education and the remaining 50 percent would have to be returned to taxpayers. This is because, at this amount of new revenues, the state would have reached its appropriations limit, which requires this distribution of "excess" revenues.
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A third option would be to raise the additional \$2 billion for K-14 education from some combination of revenue enhancements and additional spending cuts for non-K-14 education programs. Like the second option, however, this one would, in effect, require that 100 percent of any new revenues raised (up to \$2 billion) be devoted to K-14 education.

CONCLUSION

As the preceding analysis indicates, Proposition 98 is an extremely complex measure, under which funding requirements for K-14 education vary depending on a number of factors. The most immediate decision facing the Legislature regarding Proposition 98 is whether to suspend its minimum funding guarantee in 1991-92 in order to deal with the budget's overall funding gap.

Our review indicates that, if Proposition 98 is *not* suspended, the state would have to provide an additional \$2 billion in funding for K-14 education programs. This would require cutting funding for non-K-14 education programs by \$2 billion *on top of the reductions already proposed in the budget*, raising an equivalent amount in new tax revenues, or a combination of these two approaches.

If, on the other hand, the Legislature suspends Proposition 98, it need not accept the administration's proposal to reduce funding for K-14 education by \$2 billion. Rather, the Legislature could determine the level of funding for K-14 education it deems appropriate. The Legislature would also have much greater flexibility in deciding how to distribute any new General Fund tax revenues in 1991-92.

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