



# The 2012-13 Budget: Proposition 98 Maintenance Factor: An Analysis of the Governor's Treatment

MAC TAYLOR • LEGISLATIVE ANALYST • MAY 31, 2012

The Governor's Proposition 98 budget package is built on two main assumptions regarding the creation and payment of "maintenance factor." These two assumptions produce unreasonable outcomes for schools and the rest of the state budget both in the near term and over the long term. In particular, the Governor's approach would ratchet down the Proposition 98 base in some years, ratchet up the base in other years, and, in some cases, lead to schools receiving almost exclusive benefit from any growth in state revenues. In these cases, the Governor's maintenance factor treatment can produce not only impractical but nonsensical results. For example, under the Governor's treatment, for every \$1 in revenue raised beyond \$10 billion in 2012-13, \$1.02 would need to be allocated to schools. This implies that the rest of the state budget—which would have received little benefit from the first \$10 billion in new state revenues—would need to begin making cuts to accommodate the larger school payment. It is unclear to us why the Governor would interpret associated constitutional school funding provisions such that they yield these types of outcomes—outcomes that would undermine the intent of the measures establishing the school funding formulas.

We recommend the Legislature reject the Governor's approach and adopt a budget package based upon a more reasonable approach. As discussed in this brief, we believe our recommended approach has a clear, compelling underlying rationale that keeps the creation and payment of maintenance factor linked. Specifically, under our recommended approach, maintenance factor is created any time school funding falls below the level otherwise needed to keep pace with growth in the economy, and maintenance factor is paid such that school funding is built up to the level it otherwise would have been absent the earlier shortfalls. We believe such an approach goes furthest in honoring the intent of Proposition 98 and Proposition 111.

**Introduction**

The Governor’s Proposition 98 budget package is built on two main assumptions regarding the creation and payment of maintenance factor. These two assumptions have significant implications for both school and non-school funding over both the near term and the long term. The first part of this brief provides background on: (1) the ballot measures that established the state’s minimum funding requirement for schools, (2) the formulas that underlie the calculation of this funding requirement, and (3) the maintenance factor. The second part of the brief explains the Governor’s assumptions for creating and paying maintenance factor, raises major concerns with his treatment of maintenance factor, and discusses an alternative maintenance factor approach. The brief is a companion piece to our *Overview of the May Revision* (May 2012), which provides a more comprehensive analysis of the Governor’s Proposition 98 package.

**The Ballot Measures**

**Proposition 98 Enacted in November 1988.** Approved by 50.7 percent of voters, Proposition 98 amended Section 8 of Article XVI of the California Constitution by establishing a minimum annual funding level for school districts and community colleges (hereafter referenced as schools). This minimum funding level is commonly called the “minimum guarantee.” The measure allows the state to provide less than the minimum guarantee in a particular year only by suspending the related provisions for that year with a two-thirds vote of each house of the Legislature.

**Two Years Later, Proposition 111 Makes Significant Changes to Proposition 98.** In June 1990 (as the state was entering an economic downturn), the Legislature placed Proposition 111 on the ballot. Approved by 52.4 percent of voters, Proposition 111 was a broad measure

**Figure 1**

**Three Tests Used to Determine the Minimum Funding Guarantee**

Test	Description	Rule	Established by	Comment
1	An amount derived by applying the same percentage of General Fund revenues appropriated to schools and community colleges in 1986-87 to current-year General Fund revenues.	Applicable if higher than other tests.	Proposition 98	The effective Test 1 percentage has ranged from 35 percent to 41 percent of General Fund revenues. (It has been modified over time due to various “Test 1 rebenchings.” These rebenchings lower or raise the General Fund obligation in response to shifts of local property taxes or programs to or from schools.)
2	Prior-year funding level for schools and community colleges adjusted by change in California per capita personal income and K-12 average daily attendance (ADA).	Applicable if higher than Test 1 and lower than Test 3.	Proposition 98, modified by Proposition 111	Under the Proposition 98 provisions, the prior-year funding level under Test 2 was adjusted for the lower of the United States Consumer Price Index and California per capita personal income. Proposition 111 required the Test 2 calculation be based on per capita personal income. Under Proposition 98, enrollment was not specifically defined, but implementing legislation defined it as K-12 ADA. (Proposition 111 made no change to this definition.)
3	Prior-year funding level for schools and community colleges adjusted by change in per capita General Fund revenues and K-12 ADA.	Applicable if higher than Test 1 and lower than Test 2.	Proposition 111	Enrollment is defined as K-12 ADA (same definition as used for Test 2 calculations).

that modified the state appropriations limit and established additional education funding formulas (as well as created a statewide traffic congestion relief program). Regarding education funding, Proposition 111 amended the Constitution by adding certain rules to the calculation of the minimum guarantee. Most importantly, the measure allows for a lower minimum guarantee when state General Fund revenues are relatively weak but then requires growth in funding for schools to be accelerated when General Fund revenues revive.

**The “Tests”**

**Three Tests Underlie Calculation of the Minimum Guarantee.** As set forth in subdivision (b) of Section 8 of Article XVI of the Constitution, the minimum guarantee is determined by one of three formulas, commonly called tests. Proposition 98 created two tests (commonly called Test 1 and Test 2). The measure required the state to provide about 40 percent of General Fund revenues to schools (Test 1) or last year’s funding amount adjusted for changes in student enrollment and inflation (Test 2), whichever yielded the higher amount for schools. Proposition 111 provided an additional a test (commonly called Test 3). Proposition 111 allows the state to provide less to schools when General Fund revenues are relatively weak (Test 3). Figure 1 provides some basic information relating to each of the three tests.

**Certain Rules for Determining Which Test Is Operative.** In determining which test to use in calculating the minimum guarantee, the constitutional provisions essentially set forth two comparisons. Test 2 and Test 3 are to be compared and the test providing the *lower* amount of funding is selected. Whichever of these tests is selected is then compared to Test 1, with the test providing the *higher* amount of funding used for determining the minimum guarantee. Figure 2 shows the years in which each test has been operative. Test 2 has been operative most frequently (13 of the last 24 years). Test 1 has been operative the fewest times (only twice).

**The Maintenance Factor**

**Maintenance Factor Designed to Help State in Tight Times . . .** Proposition 111 not only created Test 3 but also added maintenance factor provisions to the Constitution. As set forth in subdivision (d) of Section 8 of Article XVI of the Constitution, maintenance factor is created when Test 3 is below

**Figure 2**  
**The Years When Each Test Has Been Operative**

Test 1	Test 2	Test 3	Suspended
1988-89	1989-90 <sup>a</sup>	1990-91	2004-05
2011-12	1991-92	1992-93 <sup>b</sup>	2010-11
	1994-95	1993-94 <sup>a</sup>	
	1995-96	2001-02	
	1996-97	2006-07	
	1997-98	2007-08	
	1998-99	2008-09	
	1999-00		
	2000-01		
	2002-03		
	2003-04		
	2005-06		
	2009-10		

<sup>a</sup> In 1989-90 and 1993-94, the state adopted language suspending Proposition 98 “to the extent its provisions conflict” with state actions to raise revenue for certain purposes and not count those revenues toward the minimum guarantee. Whether these years are more appropriately classified as “suspended” is disputable.

<sup>b</sup> In 1992-93, the state adopted language suspending Proposition 98 in the event an appellate court determined that a \$1.1 billion prepayment was “unconstitutional, unenforceable, or otherwise invalid.” The state settled with the California Teachers Association as the ruling was being considered by an appellate court. Whether this year is more appropriately classified as “suspended” also is disputable.

Test 2 or the minimum guarantee is suspended. In the case of Test 3 being operative, the maintenance factor is equal to the difference between the amount of General Fund monies that would have been appropriated pursuant to Test 2 and the amount of General Fund monies actually provided to schools. In the case of suspension, the maintenance factor is equal to the difference between the amount of General Fund monies that would have been appropriated absent the suspension and the amount of General Fund monies actually provided to schools. (In both cases, the minimum guarantee is not necessarily lower than the prior-year guarantee. For example, when the minimum guarantee was suspended in 2004-05, the amount of funding provided to schools still was somewhat higher than in 2003-04.)

**... But Not Hurt Schools Over Long Run.**

Subdivision (e) of Section 8 of Article XVI of the Constitution (also added by Proposition 111) specifies that maintenance factor obligations are

to be adjusted annually for changes in enrollment and cost of living (the same adjustments apply to Test 2). This subdivision also establishes a formula for retiring maintenance factor obligations—a formula closely linked to the health of state revenues. If a maintenance factor obligation exists, strong General Fund revenue growth typically results in a large corresponding maintenance factor payment. As described in our voter guide analysis for Proposition 111, the maintenance factor “requires that the funding base be restored in future years so that education eventually receives the same annual amount that it would have received if no reduction had occurred.”

**Creating a Maintenance Factor Obligation.**

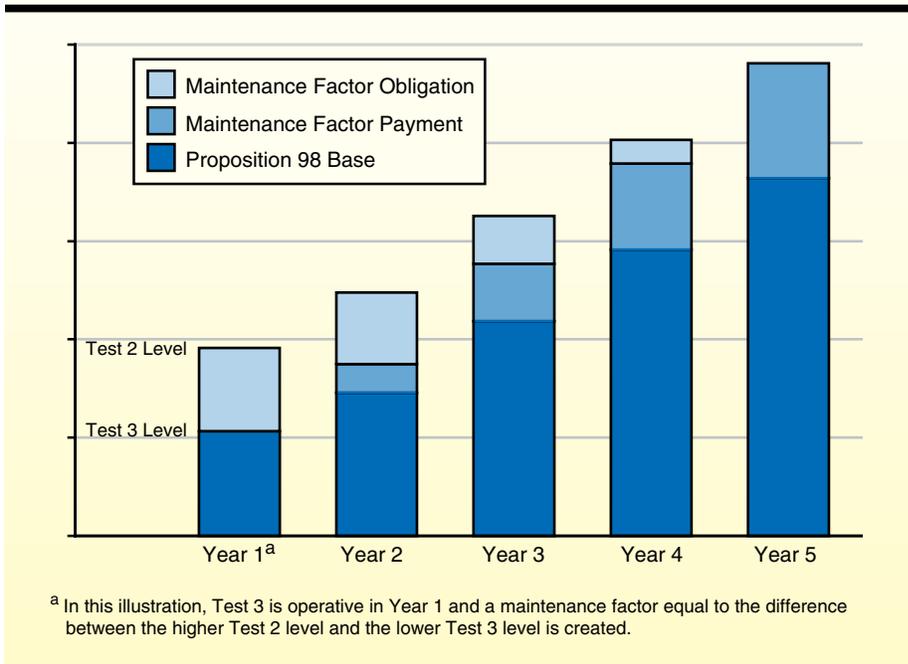
Figure 3 provides an illustration of how maintenance factor works. In this illustration, Test 3 is operative in Year 1 (that is, the Test 3 funding level is lower than Test 2 level but higher than the Test 1 level). In this case, a maintenance factor equal to the difference between the higher Test 2 level

and the lower Test 3 level is created. This maintenance factor essentially reflects state savings resulting from a minimum guarantee that is lower than the Test 2 level.

**Paying a Maintenance Factor Obligation.**

Under this illustration, state revenues improve in Year 2 and the state begins to retire the maintenance factor obligation. A portion of the obligation is retired each year over the next few years,

**Figure 3**  
**Illustration of How a Maintenance Factor Is Created and Paid**



with the obligation fully retired by the end of the period. From Year 2 through Year 4, the state continues to generate some savings by providing less than it would have provided had it funded at the Test 2 level in Year 1. Though the state achieves savings across these interim years, funding for schools by the end of the period is at the same level it otherwise would have been at absent the suspension.

***In Concept, Maintenance Factor Akin to a Deferred Salary Increase.*** Conceptually, a maintenance factor often has been considered analogous to a deferred salary increase, such as one that a school district and local teachers union might negotiate. For example, a district and union might agree to forego a salary increase for teachers in Year 1 on the condition that salary increases in Year 2 and Year 3 are somewhat higher than routine cost-of-living adjustments. In this example, the district avoids some costs in Year 1 but teachers' salaries by Year 3 are as high as they would have been absent the Year 1 salary freeze.

***Tracking***

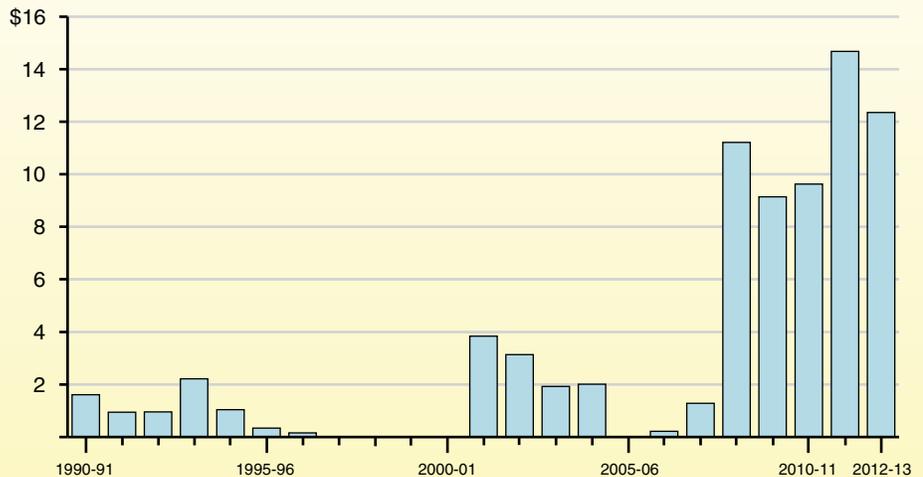
***Maintenance Factor Over Time.*** Figure 4 shows the state's total outstanding maintenance factor obligation each year since the maintenance factor provisions were established. The state typically is carrying some amount of maintenance factor. Over the applicable 23-year period, a maintenance factor obligation existed 18 years. Of these 18 years, the total

outstanding obligation has been as low as \$200 million and as high as \$11.2 billion. The largest new maintenance factor ever created in a single year was \$9.9 billion in 2008-09. The largest maintenance factor amount ever retired in a single year is likely to be 2012-13 (with a projected maintenance factor payment of \$2.9 billion). Prior to 2012-13, the largest maintenance factor payment had been \$2.1 billion (made in 2009-10).

**Disagreements Over Maintenance Factor Begin in 2008-09**

***Disagreement Involves When Maintenance Factor Is Created . . .*** In 2008-09, disagreement began to emerge regarding how to apply maintenance factor when Test 1 is operative. During the development of the 2008-09 budget, Test 1 appeared to be slightly *higher* than Test 3, but both Test 1 and Test 3 were significantly *lower* than the Test 2 level. In response to the issue, the state adopted Chapter X4 3, Statutes of 2009 (AB X4 3, Evans), and declared that maintenance factor

**Figure 4**  
**Total Outstanding Maintenance Factor Obligation**  
(In Billions)



Note: Beginning in 2010-11, LAO and Department of Finance numbers diverge due to differences in maintenance factor application. LAO number shown for 2010-11. The amounts reflected for 2011-12 and 2012-13 are LAO estimates.

was created—establishing a new corresponding maintenance factor obligation of \$9.9 billion, together with an existing maintenance factor obligation of \$1.3 billion, for a total obligation specified in statute of \$11.2 billion. (Once all the inputs underlying the minimum guarantee were finalized, Test 3 ultimately was operative for 2008-09, with the Test 3 funding level \$1.4 billion higher than the Test 1 level.) In 2011-12, the state is facing an essentially identical situation, with Test 1 currently estimated to be \$1 billion *higher* than Test 3 but \$4.7 billion *lower* than Test 2.

*. . . And How Maintenance Factor Is Paid.*

Disagreement regarding whether to create maintenance factor when Test 1 is operative became linked with a disagreement regarding how to pay maintenance factor when Test 1 is operative. In response to this issue, Chapter X4 3, added a statutory provision declaring that the calculations of the tests underlying the minimum guarantee “shall be performed prior to, and

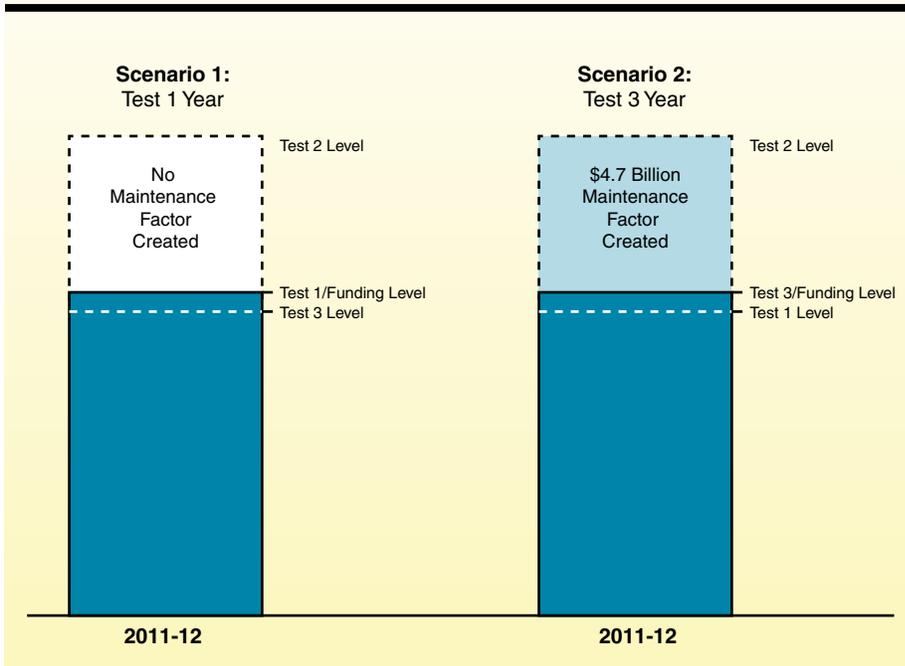
separately from” the calculation of the maintenance factor payment associated with the \$11.2 billion obligation established by the legislation. In 2009-10, the state made a \$2.1 billion payment toward this maintenance factor obligation. (Because Test 2 was operative in 2009-10, no concern has been raised regarding how the state made this particular maintenance factor payment.) In 2012-13, the state is estimated to make a \$2.9 billion payment. Because Test 1 is likely to be operative in 2012-13, an issue has emerged regarding how to make this payment.

**Governor’s Maintenance Factor Treatment Unreasonable**

The Governor’s Proposition 98 budget package contains underlying assumptions that involve both of these areas of disagreement. Regarding the creation of maintenance factor, the Governor assumes that no maintenance factor is created in 2011-12 if Test 1 is operative. Regarding

the payment of maintenance factor, the Governor assumes that payments be in addition to the Test 1 level if Test 1 is operative. By virtue of basing his package on these two assumptions, the Governor fundamentally delinks the underlying rationale for why maintenance factor is created and how it is paid. As discussed below, we have major concerns with the Governor’s treatment of maintenance factor.

**Figure 5**  
**Under Governor's Approach, a \$1 Change in State Revenues Can Result in Huge Changes in School Funding Obligations**



(In the subsequent section, we lay out what we believe to be a more reasonable approach to the creation and payment of maintenance factor.)

**Produces Unreasonable Outcomes Regarding Maintenance Factor Creation.** The Governor’s Proposition 98 budget package does not recognize any new maintenance factor created in 2011-12 if Test 1 is operative. If the Governor’s package were adopted, this would be the first time since the inception of Proposition 111 that the state has not created maintenance factor when the funding provided for schools was less than the Test 2 funding level. In this case, a \$4.7 billion maintenance factor obligation would not be created. This would have the effect of ratcheting down the Proposition 98 base on an ongoing basis. If Test 3, however, ultimately is operative based upon finalized state revenue collections for 2011-12, the Governor would create maintenance factor. Figure 5 shows the 2011-12 effect of using the Governor’s approach, with slight changes in state revenues

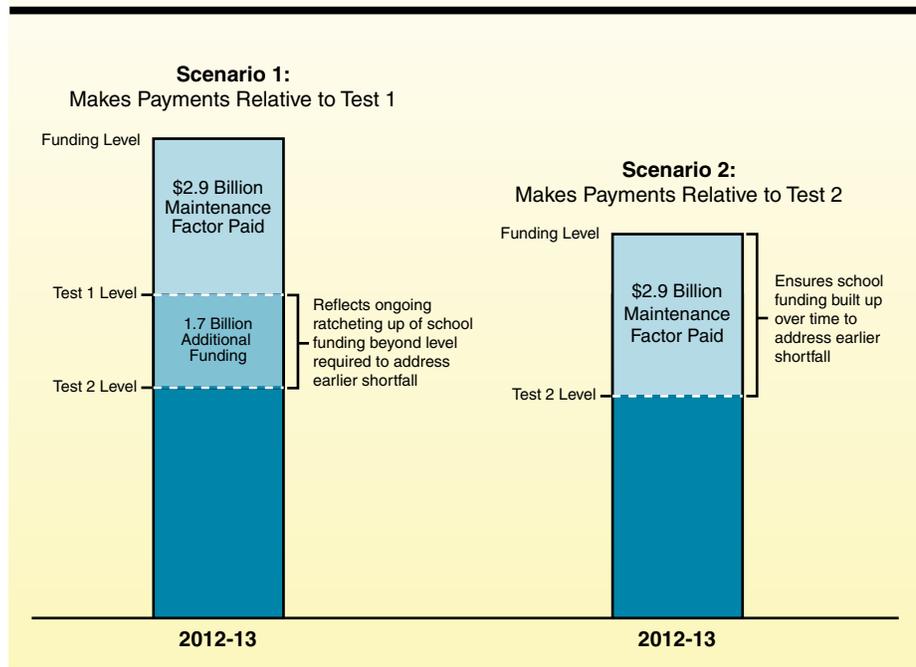
potentially resulting in huge changes in school funding obligations. As shown in Scenario 1, the Test 1 level is slightly above the Test 3 level and no maintenance factor is created. By comparison, as shown in Scenario 2, Test 3 is slightly above Test 1 and a new \$4.7 billion maintenance factor is created. The Governor provides no clear fiscal or policy rationale for why such small changes in state revenues should have such large effects

on schools. Neither does the Governor explain why a maintenance factor should be created in only some instances when school funding is less than it would have been had it grown with the economy (as measured by change in per capita personal income).

**Produces Unreasonable Outcomes Regarding Maintenance Factor Payments.** The Governor’s Proposition 98 budget package pays maintenance factor relative to the Test 1 level. If the Governor’s package were adopted, this would be the first time since the passage of Proposition 111 that the state has paid maintenance factor relative to that level rather than the Test 2 level. By making these payments relative to the Test 1 level, the Governor decouples the creation and payment of maintenance factor. As a result, maintenance factor payments are not used to build up school funding such that it is unaffected over the long run by earlier reductions. Instead, as reflected in Figure 6, school funding can be ratcheted up to a much higher level than presumably intended

Figure 6

**Governor's Method for Paying Maintenance Factor Lacks Fiscal/Policy Rationale**



by Proposition 111. The Governor provides no explanation for what is intended by his treatment of maintenance factor payments.

***Produces Unreasonable Outcomes for State Budget in Short Term.*** By treating the creation and payment of maintenance factor as if they are completely disconnected, the Governor puts the state budget in a very precarious position, as school funding can crowd out funding for other state programs. The Governor’s approach does this in three ways in 2012-13:

- ***Ratchets Up Base Funding.*** The Governor’s method of paying maintenance factor ratchets up the school funding base by \$1.7 billion relative to the conventional payment method, thereby crowding out \$1.7 billion in funding for other state programs.
- ***Requires Almost All New Revenues Be Allocated to Schools.*** The Governor’s method of paying maintenance factor also requires a much greater share of growth in state revenues be allocated to schools.

As shown in Figure 7, of the incremental \$500 million increase in revenues from \$501 million to \$1 billion, 53 cents of every dollar would be allocated to schools under both the Governor’s method (which makes payments relative to the Test 1 level) and the conventional method (which makes payments relative to the Test 2 level). By comparison, of the incremental \$250 million increase from \$1 billion to \$1.25 billion, 87 cents of every dollar would be allocated to schools under the Governor’s method compared to 53 cents of every dollar under the conventional method. Whereas the conventional method requires gradually increasing shares of new revenues be allocated to schools yet still ensures a considerable amount of growth funding remains available for the rest of the state budget, the Governor’s approach results in almost any new revenues going exclusively to schools.

- ***Produces Certain Nonsensical Results.***

Given the Governor’s method completely delinks maintenance factor creation and payment, his method can produce not only impractical but also nonsensical results. For example, for every \$1 in revenue raised beyond \$10 billion in 2012-13, \$1.02 would need to be allocated to schools. This implies that the rest of the budget—having received little benefit from the first \$10 billion in new state revenues—would need

**Figure 7**

**Under Governor’s Treatment, Most New Revenues in 2012-13 Allocated Almost Exclusively to Schools**

*(Dollars in Millions)*

Increase From Baseline Revenues <sup>a</sup>	Incremental Increase Under:	
	Governor’s Method	Conventional Method
\$501 - 1,000	53%	53%
1,001 - 1,250	87	53
1,251 - 1,500	93	54
1,501 - 3,000	94	55
3,001 - 4,000	95	56
4,001 - 5,000	96	57
5,001 - 6,000	97	58
6,001 - 7,000	99	60
7,001 - 8,000	100	60
8,001 - 9,000	101	62
9,001 - 10,000	102	63

<sup>a</sup> Baseline revenues in Governor’s workload budget are \$86.7 billion. Governor’s May Revision assumes \$5.3 billion in new revenues from ballot measure in 2012-13.

to begin making cuts to accommodate the larger school payment.

***Produces Unreasonable Outcomes for State Budget in Long Term.*** The Governor’s treatment of maintenance factor produces unreasonable budget outcomes not only in 2012-13 but also moving forward. Under the Governor’s approach, Proposition 98 funding would be ratcheted up again only a couple years later. Under both the administration’s and our forecast, Proposition 98 funding would increase significantly in 2014-15. Under the Governor’s forecast, however, Test 1 is operative and his payment method results in Proposition 98 funding rising by \$7 billion (compared to \$4 billion under our forecast), with all of the administration’s projected revenue growth above our projections being allocated to schools. As a result of the Governor’s maintenance factor treatment, school funding grows from 38 percent of the state General Fund budget in 2011-12 to 44 percent in 2014-15, with a matching decrease in the share of the budget available for other state programs. Due to the Governor’s treatment, legislators would become significantly constrained—even in years of strong revenue growth—in funding other state programs, balancing the budget, and increasing reserves.

### **Recommend Different Maintenance Factor Approach**

It is unclear to us why constitutional school funding provisions would be interpreted, as under the Governor’s treatment, to yield such unreasonable outcomes—particularly outcomes that seem to work contrary to the structure and purpose of Proposition 98 and Proposition 111. Under our maintenance factor approach, maintenance factor is created any time school funding falls below the level otherwise needed to keep pace with growth in the economy, and maintenance factor is paid such that school funding

is built up to the level it otherwise would have been absent the earlier shortfalls. Such an interpretation has been widely held over the last two decades.

***Our Recommended Approach to Maintenance Factor Creation.*** We recommend the Legislature continue to create maintenance factor any time school funding falls short of the Test 2 level (school funding grown with the economy). We believe this approach honors the intent of both Proposition 98 and Proposition 111. It honors the intent of Proposition 111 by creating maintenance factor when the state is facing a relatively difficult fiscal situation and school funding is depressed below the Test 2 level. It honors the intent of Proposition 98 by requiring the state to fund at the higher of the remaining tests (Test 1 and Test 3), thereby ensuring schools receive at least 40 percent of the state General Fund budget despite the difficult fiscal situation. In contrast, the Governor’s interpretation violates the intent of Proposition 111 by not creating maintenance factor when school funding is depressed below the Test 2 level.

***Our Recommended Approach to Maintenance Factor Payment.*** We recommend the Legislature continue to pay maintenance factor relative to the Test 2 level. We believe this approach also honors the intent of both Proposition 98 and Proposition 111. It honors the intent of Proposition 111 by using maintenance factor payments to build up the base such that school funding is not affected by earlier shortfalls (that is, pays from the Test 2 level—the level from which maintenance factor was created). It honors the intent of Proposition 98 by requiring the state to provide at the higher of the Test 1 and Test 2 levels. In contrast, the Governor’s interpretation violates the intent of Proposition 111 by not making maintenance factor payments relative to the Test 2 level. Our recommended approach also is the only approach that accelerates funding for schools during good economic times but does not produce

impractical or nonsensical results such that schools benefit almost exclusively from good economic times, with the rest of the state budget potentially remaining in difficult straits despite the growth in state revenues.

**Conclusion**

The Governor’s Proposition 98 budget package is built upon two highly questionable maintenance factor assumptions that produce unreasonable outcomes for schools and the rest of the state budget—the effects of which would be felt not only in 2012-13 but would persist moving forward. In

particular, the Governor’s approach would ratchet down the Proposition 98 base in some years, ratchet up the base in other years, and, in some cases, lead to schools receiving almost exclusive benefit from any growth in state revenues. Some of the outcomes of the Governor’s maintenance factor treatment are so unreasonable that the state theoretically would need to cut the rest of the budget severely to accommodate school funding requirements. Unlike the Governor’s approach, we believe our recommended approach has a clear, compelling underlying rationale that keeps the creation and payment of maintenance factor linked.

2012-13 BUDGET

### **LAO Publications**

---

This brief was prepared by Jennifer Kuhn, with assistance from Edgar Cabral. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

To request publications call (916) 445-4656. This brief and others, as well as an e-mail subscription service, are available on the LAO's website at [www.lao.ca.gov](http://www.lao.ca.gov). The LAO is located at 925 L Street, Suite 1000, Sacramento, CA 95814.