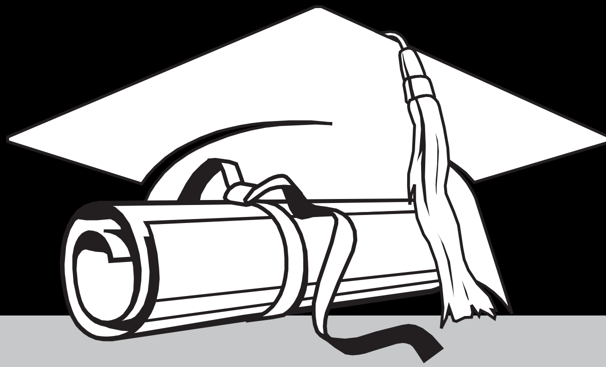
EDUCATION



LAO

60 YEARS OF SERVICE

2005-06 Analysis

Major Issues

Education

☑ Proposition 98—Governor Proposes $2.9 Billion Increase

- The budget proposes to leave 2004-05 Proposition 98 appropriations at roughly the level provided in the *2004-05 Budget Act*. This proposal would create $2.3 billion in General Fund savings over the two years. While the Governor's 2005-06 spending plan for K-14 grows by $2.9 billion, it does not include funding to cover all K-14 operating expenses that districts would incur under the budget proposal.
- We recommend the Legislature build a base budget for 2005-06 that fully funds the current K-14 education program (see page E-13).

☑ State Teachers' Retirement System (STRS) Proposal Lacks Benefits

- The Governor proposes to shift financial responsibility from the state to K-14 education for $469 million in annual contributions to STRS. The proposal, however, may not achieve the intended short-term goal of budgetary savings and does not resolve the longer-term issues with the current plan (see page E-28).

☑ Some School Districts Face Difficult Fiscal Conditions

- Some school districts face huge fiscal liabilities to pay for retiree health benefits. It will be difficult for districts to deal with these obligations without a long-term strategy. We recommend the Legislature take various actions to start addressing this problem (see page E-47).

- Around 40 percent of school districts face declining enrollment. The state continues to have inequities in revenue limit (general purpose) funding across school districts. We recommend an approach to address both of the problems, allowing declining enrollment districts to increase their per pupil revenue limit until they reach the equalization target (see page E-53).

☑ **Legislature Should Reject "Autopilot" Budgeting in Higher Education**

- The Governor's budget for the University of California (UC) and the California State University (CSU) follows his "compact" that establishes annual funding targets for the segments through 2010-11. By mapping out these funding choices six years ahead of time, the Governor's compact would put these budgets on autopilot.
- We recommend the Legislature disregard the compact, and instead consider its various funding choices annually based on what is needed to achieve the state's higher education goals as expressed in the Master Plan (see page E-149).
- The Governor's budget does not account for anticipated revenue from planned fee increases at UC and CSU. We recommend the Legislature include this revenue in its budget plan. This approach would allow for budgets that fully fund anticipated growth and inflation-driven cost increases while freeing up some General Fund monies relative to the Governor's proposal (see page E-178).

☑ **Set Community College Fees to Maximize Federal Funding**

- We also recommend the Legislature increase community college fees from $26 per unit to $33 per unit. This would raise about $100 million in new fee revenue that could fund legislative priorities. It would also leverage about $50 million in federal funds to reimburse middle-income families for the higher fees. Financially needy students are exempt from paying fees at community colleges (see page E-195).

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OVERVIEW

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The Governor's budget includes a total of $58 billion in operational funding from state, local, and federal sources for K-12 schools for 2005-06. This is an increase of $1.6 billion, or 2.9 percent, from estimated appropriations in the current year. The budget also includes a total of $34.6 billion in state, local, and federal sources for higher education. This is an increase of $1.3 billion, or 4 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 almost $93 billion in 2005-06 from all sources (not including capital outlay-related spending).

Figure 1

K-12 and Higher Education Funding

(Dollars in Millions)

	Actual 2003-04	Estimated 2004-05	Proposed 2005-06	Change From 2004-05	
				Amount	Percent
K-12[a]	$54,673	$56,470	$58,123	$1,653	2.9%
Higher education[b]	32,016	33,232	34,567	1,335	4.0
Totals	**$86,688**	**$89,701**	**$92,689**	**$2,988**	**3.3%**

a Includes state, local, and federal funds. Excludes debt service for general obligation bonds and local debt service.

b Includes state, local, and federal funds and student fee revenue. Excludes debt service for general obligation bonds.

Funding Per Student

The Proposition 98 request for K-12 in 2005-06 represents $7,377 per student, as measured by average daily attendance (ADA). Proposed spending from all funding sources (excluding capital outlay and debt service) totals about $9,586 per ADA.

The Proposition 98 budget request for California Community Colleges (CCC) represents about $4,370 per full-time equivalent (FTE) student. When other state funds and student fee revenue are also considered, CCC will receive about $5,000 per FTE student. This compares to proposed total funding (General Fund and student fees) of $23,000 for each FTE student at the University of California (UC) and $11,500 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 deaf and blind individuals and the California Youth Authority. Proposition 98 funding constitutes over 70 percent 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 each 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.

Proposition 98 Allocations

Figure 3 (see page E-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 $47.1 billion, and increases funding to $50 billion for Proposition 98 in 2005-06 (an increase of $2.9 billion). The Governor does not provide the additional $1.1 billion in 2004-05 and $1.2 billion in 2005-06 that would have been needed to meet the funding target established in Chapter 213, Statutes of 2004 (SB 1101, Budget and Fiscal Review Committee). Under the Governor's budget, the General Fund cost of Proposition 98 is $2.4 billion more than the current year, but a portion of this higher cost ($675 million) is to backfill local property tax revenues that the state transferred to local government. Proposition 98 funding issues are discussed in more detail in the "Proposition 98 Budget 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 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.

ENROLLMENT FUNDING

The Governor's budget makes changes to enrollment funding levels for K-12 and higher education. The budget fully funds a 0.79 percent increase in K-12 enrollment, a level which is considerably lower than annual enrollment growth during the 1990s. 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 2005-06, which is about one and one-half times the expected rate of growth in the adult population. Consistent with the Governor's "compacts" with the public universities, the Governor's budget funds enrollment increases of 2.5 percent at UC and CSU.

Figure 3

Governor's Proposed Proposition 98 Funding

(Dollars in Millions)

	2004-05		2005-06	Change From 2004-05 Revised	
	Budget Act	Revised[a]	Proposed	Amount	Percent
K-12 Proposition 98					
General Fund	$30,874	$30,992	$33,117	$2,125	6.9%
Local property tax revenue	11,214	11,192	11,593	401	3.6
Subtotals[b]	($42,087)	($42,183)	($44,710)	($2,527)	(6.0%)
CCC Proposition 98					
General Fund	$3,035	$3,036	$3,321	$285	9.4%
Local property tax revenue	1,772	1,750	1,827	77	4.2
Subtotals[b]	($4,807)	($4,787)	($5,148)	($361)	(7.5%)
Total Proposition 98[c]					
General Fund	$34,003	$34,124	$36,532	$2,410	7.1%
Local property tax revenue	12,986	12,941	13,420	479	3.7
Totals[b]	**$46,989**	**$47,065**	**$49,953**	**$2,888**	**6.1%**

a These dollar amounts reflect appropriations made to date or proposed by the Governor in the current year. The revised spending level reflects a $3.1 billion suspension of the minimum guarantee.

b May not add due to rounding.

c Total Proposition 98 also includes around $95 million in funding that goes to other state agencies for educational purposes.

SETTING EDUCATION PRIORITIES FOR 2005-06

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 difficult fiscal environment that the state faces in 2005-06 makes it all the more important for the Legislature to reassess the effectiveness of current education policies and finance mechanisms. In both K-12 and higher education, we provide the Legislature with alternative approaches to the budget's proposal.

K-14 Priorities. An overriding issue for the Legislature in crafting the 2005-06 budget for K-12 education and CCC (both funded largely through Proposition 98 funds) is whether to maintain current-year spending at the level appropriated in the *2004-05 Budget Act*, augment current-year appropriations to the Chapter 213 target level ($2.3 billion more over the two years), or provide some funding level in between. In developing its 2005-06 Proposition 98 budget, we recommend the Legislature use a "current services" budget approach that fully funds the existing K-14 program. We identify some key areas of the K-14 budget where we recommend a different approach than that taken in the Governor's budget. These include State Teachers' Retirement System funding, mental health costs for special education students, and several of the Governor's other reform proposals. We also raise concerns about the current fiscal condition of school districts and the impact on districts of declining student enrollment.

Higher Education Priorities. For UC and CSU, the Governor's budget proposal largely follows the compacts he developed with the segments in spring 2004. Notwithstanding the compacts, the Governor's proposal offers little rationale for the proposed fee increases and growth funding for UC and CSU. We offer our own analysis of UC and CSU's funding needs, including recommendations with regard to student fees and enrollment growth.

For CCC, the Governor proposes a substantial increase for enrollment growth, but no new funding to advance the effort, begun in 2004-05, to equalize per student funding among community college districts. In the "California Community Colleges" section of this chapter, we assess the Governor's enrollment growth funding and accountability proposals. We also recommend increasing student fees at CCC to $33 per unit, which could increase total state funding on education by about $100 million, while leveraging about $50 million in federal financial aid. At the same time, it would add almost no new net costs for students with family incomes up to about $100,000.

CROSSCUTTING ISSUES

Education

PROPOSITION 98 BUDGET PRIORITIES

The Governor's budget proposes to leave 2004-05 Proposition 98 appropriations at roughly the level provided in the* 2004-05 Budget Act. *The proposal would create $2.3 billion in General Fund savings over two years. While the Governor's 2005-06 spending plan for K-14 grows by $2.9 billion, it does not include funding to cover all K-14 operating expenses that districts would incur under the budget proposal.

GOVERNOR'S MAJOR PROPOSALS

The Governor's budget proposes an increase in the Proposition 98 guarantee of $2.9 billion in 2005-06 compared to the revised 2004-05 spending level. This increase is sufficient to provide adjustments for K-14 growth in the student populations and the cost of living, a $329 million increase to K-12 school district revenue limits that partially restores reductions made during 2003-04, and $51 million for additional community college growth above the level suggested by demographic growth.

Budget Creates Costs Without Identifying Funding

The Governor's budget for K-14 education also includes several major policy issues that affect schools and community colleges. The budget, however, does not reflect the financial impact of these policy initiatives. Most importantly, the 2005-06 budget proposes to shift from the state to school districts and community colleges $469 million in annual State Teachers'

Retirement System (STRS) costs. The state has contributed this amount of non-Proposition 98 funds each year to pay for a portion of the system's costs. Beginning in 2005-06, the Governor's budget proposes that school and community college districts assume responsibility for these costs. No additional funds are proposed in the budget to help school districts pay for these new retirement costs.

The Governor also proposes to shift to school districts fiscal responsibility for mental health services needed by special education students. Under current law, these services are provided by county mental health agencies under a reimbursable state-mandated local program. Based on the most recent county claims, costs of this program totaled $143 million (non-Proposition 98 funds). By shifting responsibility for these services to school districts, the budget would also shift the cost of these mental health services to local education agencies. The special education budget includes $100 million that could be used to pay for these costs. No additional funds are proposed to cover the remaining $43 million of services.

Two other important proposals follow this same pattern. First, the budget includes a major vocational education initiative, requesting $20 million in one-time funds for the community colleges in support of the proposed reforms. Given the Governor's goal—to bring a "renewed emphasis" on vocational education in high school—it seems probable that the long-term cost of the plan would be much larger than the $20 million included in the proposal. Second, a pilot program is proposed to assess the impact of greater school-level control over the use of funding. No support, however, is requested for additional district costs associated with schoolsite budgeting or for the costs of an evaluation to determine whether the reforms increase student achievement.

Proposed Constitutional Amendments Affect K-14

The Governor also called a special session of the Legislature to address four major changes to the State Constitution that would affect school districts or community colleges. Specifically, the proposals:

- ***Proposition 98.*** Revamp the constitutional spending requirements of Proposition 98 as part of a larger reform of the state budget process. The measure would eliminate options for the state to reduce Proposition 98 funding levels during difficult budgetary times (Test 3 and suspension). Funding for K-14, however, would be subject to "across-the-board" reductions to the state budget that could occur under certain circumstances.
- ***Retirement.*** Prohibit all public agencies in California, including K-12 and community college districts, from enrolling new em-

ployees in a retirement plan that guarantees a specific benefit level upon retirement (known as a "defined benefit" plan). Instead, public agencies could only offer new employees (beginning July 1, 2007) "defined contribution" plans. These plans do not guarantee specific retirement benefits, but offer employers and employees certain other advantages.

- ***Merit Pay and Tenure.*** Alter existing regulation of local school district employee practices. The proposal would require districts to base employment decisions only on employee performance and the needs of the district and its students. The proposal also would extend from two years to ten years the amount of time teachers must perform satisfactorily before receiving employment protections known as "tenure."
- ***School Budget Reports.*** Require school districts to annually report to the public each school's revenues and expenditures.

CURRENT-YEAR GUARANTEE LEVEL IS PIVOTAL

A central issue facing the Legislature in developing the 2005-06 budget is the amount of Proposition 98 spending that ultimately is approved for 2004-05. As part of the *2004-05 Budget Act*, the state suspended the minimum Proposition 98 guarantee and set a target appropriation level that was $2 billion lower than the amount called for by the guarantee. The legislation authorizing the suspension—Chapter 213, Statutes of 2004 (SB 1101, Committee on Budget and Fiscal Review)—establishes a target funding level for K-14 education. The target suggests that higher General Fund revenues in 2004-05 would result in an increased funding level and lower revenues would reduce it.

The Governor's budget assumes that General Fund revenues in 2004-05 will be $2.2 billion higher than previously assumed. This would translate into an increase in the minimum guarantee of $1.1 billion in 2004-05. This higher current-year base also results in an increase in the guarantee of $1.2 billion in 2005-06. The budget, however, does not propose to appropriate these funds to schools and community colleges, only making technical adjustments to the current-year funding level. By leaving the level of Proposition 98 spending at roughly the level included in the *2004-05 Budget Act*, the Governor's budget frees about $2.3 billion over the two years to help address the state's budget problem.

What Level of Appropriation Is Required in 2004-05? Under the State Constitution, a suspension overrides all other Proposition 98 formulas (or tests) and establishes a new minimum guarantee based on the *amount* *appropriated* for K-14 education in that year. Suspension means that any changes to the economy or student population have no impact on the required level of spending. Instead, the guarantee for that year is defined by the amount actually appropriated for schools and community colleges. Because the requirements of Proposition 98 are suspended in 2004-05, the $2.2 billion increase in General Fund revenues has no direct impact on the amount the state must spend.

While Chapter 213 signals the intent of the Legislature to appropriate additional Proposition 98 funding if revenues increased, the statute does not contain appropriation authority. Because the statute does not provide this authority, we believe the Legislature would have to take positive action in the future to do so. Absent such action, the minimum guarantee would "default" to the current level of appropriations. Thus, in our view the Legislature could achieve the $2.3 billion savings simply by not making additional Proposition 98 appropriations in the current year. For transparency, however, we would suggest that the Legislature amend Chapter 213 to clarify that the suspension level for 2004-05 should depend on the amount appropriated, and not a specified amount below the Proposition 98 minimum guarantee. This would eliminate any ambiguity.

LAO Forecast—Higher Revenues, Lower Guarantee

Our updated economic and revenue forecasts indicate that General Fund revenues will be significantly higher in 2004-05 and modestly higher in 2005-06 compared to the administration's revenue forecast. While this is good news for the state's overall fiscal picture, our projected increases would actually result in a lower estimate of the minimum guarantee under Proposition 98 in 2005-06.

Cost of Reaching Chapter 213 Target Would Increase to $4 Billion. Specifically, our forecast projects General Fund revenues will be $1.4 billion higher in 2004-05 and $765 million higher in 2005-06 compared to the amounts assumed in the Governor's budget. Figure 1 shows the impact that these revenues would have on the Proposition 98 obligations relative to the Governor's proposal. First, in the current year, the higher revenues would have no impact on Proposition 98 obligations if the Legislature concurs with the Governor's plan to remain at the current-year funding level ($47.1 billion). If however, the Legislature wanted to meet the target of Chapter 213, the Legislature would need to provide an additional $1.9 billion in the current year (using our revenue estimates). This would lead to an increase in budget-year obligations of $2.1 billion, for a two-year impact of $4 billion in additional costs.

Figure 1

Proposition 98 Spending Under Different Revenue Scenarios

(In Billions)

	2004-05	2005-06	Change
Governor's Budget Revenues			
Chapter 213 target	$48.2	$51.2	$3.0
Revised 2004-05 budget	47.1	50.0	2.9
Additional cost to reach Chapter 213 target	$1.1	$1.2	$0.1
Two-Year Totals	**$2.3**		
LAO Revenues			
Chapter 213 target	$49.0	$51.7	$2.7
Revised 2004-05 budget	47.1	49.6	2.5
Additional cost to reach Chapter 213 target	$1.9	$2.1	$0.2
Two-Year Totals	**$4.0**		

More Revenues But Lower 2005-06 Guarantee? Our Proposition 98 forecast provides an unintuitive outcome. While we forecast *higher* revenues in both years, the growth rate in revenues between years actually generates a *lower* guarantee level in 2005-06 than assumed in the Governor's budget. As stated above, we project $1.4 billion higher revenues in 2004-05 and only $765 million in additional revenues in 2005-06. Thus, approximately one-half of the higher revenues are one-time in nature. Since Proposition 98 drives off of year-to-year growth in General Fund revenues, the one-time revenues in 2004-05 actually decrease the year-to-year growth in General Fund revenues between 2004-05 and 2005-06. As a result, the year-to-year growth in Proposition 98 is actually less under our revenue forecast compared to the Governor. Under our forecast, Proposition 98 would grow by $2.5 billion in 2005-06, roughly $420 million less than the Governor.

BALANCE STATE AND LOCAL FISCAL NEEDS

We recommend the Legislature base the 2005-06 Proposition 98 spending level on the amount schools and community colleges need to continue current programs.

Our recommendation on the appropriate level of Proposition 98 spending in both the current and budget years reflects our view that the state needs to resolve its structural budget problem by bringing revenues and expenditures into alignment. The Governor's proposal to leave the 2004-05 appropriation level essentially unchanged is a critical component of the budget's plan for closing the budget gap over the next two years. As a result, moderating increases in the minimum guarantee will greatly assist the Legislature in addressing the state's structural budget problem.

We are reluctant, however, to recommend that the Legislature reduce 2005-06 Proposition 98 spending consistent with our revenue forecast (that is, $420 million below the Governor's proposed level). Our lower estimate is an artifact of the Proposition 98 formulas and not caused by a worsening in the state's revenue situation. The May Revision will provide updated information on the overall General Fund condition and amount required under the minimum guarantee for the budget year. That will give the Legislature another opportunity to balance its spending priorities—including K-14 education—with the need to address the state's budget problem as it completes work on the 2005-06 budget.

To develop its Proposition 98 spending plan, we recommend the Legislature develop a budget for schools and community colleges that provides for adjustments in workload and other anticipated costs for 2005-06. This approach has a couple of advantages for the Legislature. First, it helps the Legislature create a funding base that would allow schools and community colleges to continue current programs under most circumstances. Second, developing a workload budget helps ensure that the spending plan adequately funds the workload and costs the budget would impose on schools and colleges.

A workload budget also would provide a base the Legislature could build on if it decides to appropriate a higher level of funds for Proposition 98. If the Legislature wants to follow this path, we recommend using any additional funds to begin reducing the education "credit card" debt—state obligations to schools and community colleges the state has failed to pay in past years. We discuss the credit card debt later in this section.

Building a Base Budget for 2005-06

Figure 2 displays the elements of a current services budget for K-14 in 2005-06. We made the following workload adjustments:

- ***Growth and Cost-of-Living Adjustments (COLAs).*** Updating the 2004-05 base for changes in K-14 enrollment and the cost of living adds $2.4 billion. Our estimate of the COLA is slightly higher than the figure used in the Governor's budget—4.1 percent compared to 3.93 percent—and adds $80 million in additional costs to the K-14 budget. Our higher estimate is based on data that were not available at the time the Governor's budget was developed.

- ***Ongoing Mandate Costs.*** We added $315 million to our workload budget for the ongoing cost of school district and community college mandates. The last time the state budget included ongoing funding for this constitutional obligation was 2001-02. The Governor's budget would continue the recent practice of deferring all Proposition 98 mandate costs in 2005-06—in effect, borrowing the funds from school districts. We recommend instead the Legislature include ongoing funding for this important state obligation.
- ***One-Time Funds.*** Another $185 million was added to restore to the ongoing budget program funding that was supported with one-time funds in 2004-05.

Figure 2

A Proposition 98 K-14 "Current Services" Budget

2005-06
(In Billions)

2004-05 base	$47.1
Growth	0.5
Cost of living	1.9
Restore base (one-time funds)	0.2
Ongoing cost of mandates	0.3
Total	**$50.0**
Amount above Governor's budget	—[a]
Amount above LAO guarantee	$0.5

[a] Less than $50 million.

Our current services budget exceeds slightly the amount of the minimum guarantee projected in the Governor's budget and in our alternate estimate of the minimum spending level. Specifically, the current services budget is $43 million higher than the level proposed in the Governor's budget for 2005-06 and $463 million higher than our estimate of the guarantee under our revenue assumptions.

Align Budget With Workload Priorities

We recommend the Legislature delete $382 million for revenue limit deficit reduction and higher community college growth because the proposals represent increases that are not needed to maintain existing programs. In addition, we recommend the Legislature add $315 million for K-14 mandates.

Our current services budget highlights the fact that the proposed budget provides approximately the amount of funds needed to fund a current services budget. The budget contains two main proposals that exceed a current services level of funding—$329 million to restore cuts in K-12 revenue limits and $51 million for "excess growth" in community colleges (that is, above growth in adult population). The savings our budget achieves by excluding these discretionary increases are more than offset by increases for mandate costs and our higher COLA.

Our workload budget also shows that the proposed budget does not fully fund all K-14 costs it would create. Most significantly, the Governor's budget does not fund the ongoing costs of K-14 mandates. In our view, providing a funding source for ongoing K-14 mandates in the base budget constitutes a higher priority than discretionary increases for revenue limits or community college growth.

Therefore, we recommend the Legislature align the budget bill with the spending priorities of our K-14 workload budget. This would require the following specific changes:

- Delete $381 million in discretionary increases—$329 million for deficit factor reduction and $51 million for excess growth in community colleges.
- Restore annual ongoing funding for K-14 mandates ($315 million).

STRS Proposal Lacks Benefits

The Governor's budget also proposes to shift financial responsibility from the state to K-14 education for $469 million in annual contributions to STRS. Later in this section, we discuss this proposal and conclude that the Governor's plan fails to create short- or long-term benefits for the state. In the short run, the proposed shift is intended to save $469 million by requiring K-14 education to absorb these retirement costs. In our view, the proposal may not save the state any funds because we believe the Legislature could have to "rebench" the Proposition 98 guarantee and appropriate the $469 million to schools and community colleges to pay for the increased local retirement contributions.

In the long run, the Governor's proposal does not offer the state, districts, or local employees any significant advantages. For the state, the proposal misses an opportunity to clarify the state's responsibility for long-term retirement fund liabilities. For districts and local employees, the proposal fails to offer additional flexibility over retirement benefits. For these reasons, we conclude that there is no strong rationale to support the STRS proposal. (Please see our discussion of the proposal in the "Crosscutting Issues" section of this chapter.)

K-14 Priorities Under a Higher Guarantee

If the Legislature chooses to provide a higher level of funding than suggested by our workload budget, additional funds would help the Legislature address a number of borrowing issues that have resulted from the lingering budget crisis. We have referred to this as the education credit card to reflect the amounts the state has borrowed from schools and community colleges. Figure 3 displays the "charges" on the education credit card.

Figure 3

Status of the Education Credit Card Debt

(In Millions)

One-time (Through 2004-05)		Ongoing (2005-06)	
Unpaid K-12 mandate payments	$1,400[a]	Ongoing K-14 mandate payments to budget	$315[a]
CCC and K-12 deferrals	1,271	Revenue limit reductions made in 2003-04	646
Total	**$2,667**	**Total**	**$961**
Grand Total		**$3,628**	

[a] Includes funding for the Standardized Testing and Reporting mandate, which is under review by the Commission on State Mandates.

The figure shows that our estimate of the credit card debt totals $3.6 billion. The largest charge results from unpaid school district claims for the cost of state-mandated local programs. Funding for mandates in the annual budget act ceased after 2001-02. We estimate that the ongoing cost of mandated programs totals $315 million in 2005-06. The backlog in payments through 2004-05 totals $1.4 billion.

The second largest major contributor to the credit card is $1.3 billion in program deferrals. The deferrals created one-time savings by shifting costs from one fiscal year to the next. For instance, the budget shifts the June payment for school district general purpose funds (revenue limits) to July 1, thereby paying this obligation with funds from the succeeding year's Proposition 98 funds. Until the state pays the $1.3 billion one-time cost to retire this "loan," the state will need to extend this deferral each year if it does not want to negatively impact education programs.

The third element of the credit card is $646 million in revenue limit "deficit factor"—funds saved each year by the state resulting from past reductions in general purpose funding. While past-year savings from these cuts do not have to be repaid, restoring them would build these additional costs into the K-12 base budget. Repaying deficit factor, therefore, requires the Legislature to use ongoing funds. The 2005-06 budget proposes to spend $329 million to partially restore school district and county office revenue limits. If the Legislature wants to provide additional funding to K-14 education in either the current or budget years, we would suggest that it dedicate funds to reduce the outstanding obligations on the education credit card.

GOVERNOR'S VOCATIONAL EDUCATION REFORM

The 2005-06 budget proposes $20 million in support of a broad-based reform of vocational education in K-12 education. We believe the Governor's proposal addresses a significant problem, but lacks the level of detail necessary for the Legislature to fully evaluate it. We therefore recommend the Legislature direct the Department of Finance to provide to the budget subcommittees prior to budget hearings (1) the details of the proposed plan and (2) responses to our initial concerns about the proposal.

The *2005-06 Governor's Budget* proposes to strengthen vocational education in high schools to ensure "that all students have educational opportunities that lead to successful employment." According to the administration, the proposal builds on successful programs that are currently in place to create a "renewed emphasis" on vocational education in high schools.

The administration's reform package has two key elements. First, the proposal would dedicate $20 million in one-time Proposition 98 Reversion Account funds to encourage high schools to work with local California Community Colleges (CCC) to expand and improve vocational courses available to high school students. The plan seeks to build on successful "2+2" programs, in which students take two years of high school vocational courses that lead into a two-year CCC vocational credential or diploma program. Funds could be used for a wide variety of local activities, including curriculum development and equipment purchases.

Second, the plan calls for all middle school students to take a new vocational awareness class. The administration proposes to mandate middle school introductory vocational courses to (1) help students consider their long-term career goals and (2) provide information about available vocational options. According to the administration, the new course would replace an existing elective course.

The reform plan includes several other supporting changes, including:

- ***Increasing K-12 Accountability.*** The proposal would add to the existing School Accountability Report Card (SARC) new indicators that measure the success of schools in offering vocational courses and in helping students who take vocational education courses.
- ***Supporting Local Efforts to Expand Options.*** The reform proposal also would (1) revise K-12 and teacher credential requirements to help schools and colleges hire teachers who are familiar with the current skill needs of business and (2) allow CCC to increase the proportion of part-time faculty (above the existing 25 percent target) as needed to meet demand for vocational education courses.

Proposal Addresses an Important Problem

We think the Governor's budget has identified an important problem. In a forthcoming report (expected later this year), we discuss how a strong secondary vocational education system can mitigate several major problems in high schools.

May Help Reduce Dropouts. By giving students a greater range of choices in high school, improving vocational education could help address the state's high dropout rates. About 30 percent of students who begin ninth grade drop out before finishing high school. Low academic achievement is a major factor in dropping out. Convinced that academic success is unlikely, many low-performing students see little reason to stay in school. A range of academic and vocational choices could help keep students in school by giving them greater control over what they study and help them use high school to achieve their postgraduation goals.

Increase Financial Returns to Students. Successfully restructuring vocational programs into sequences of high-level courses would increase the value of these courses to students. Research suggests that most existing high school vocational courses deliver students few benefits (such as higher wages or higher rates of employment). This is because the courses taken by students do not build on each other. Research shows that sequences of high-level secondary or community college courses lead to higher-level occupational skills, which in turn can generate significant payoffs for students.

Create Better Alternatives to a College Diploma. Vocational sequences that prepare students for high-level jobs may encourage students to pursue more realistic postgraduation goals. Perhaps because high school vocational programs have low returns, high school students see college as virtually the only road to success. Surveys show that 56 percent of California's tenth graders want to attend a four-year university and 22 percent plan on attending a two-year college after graduating from high school. Only about 10 percent of students plan on going directly into the workforce.

Data show a disconnect between these aspirations and actual experience. Less than one-half of those tenth graders attend university or college in the two years after graduating, and fewer than one in five earn a university or college degree. Most students who go to CCC drop out before receiving a diploma or transferring to a four-year institution.

When students fail to complete a rigorous academic or vocational program in high school or college, they enter the labor market with fewer saleable occupational skills. Strong secondary vocational programs expand the number of attractive options available to high school students. This can help students enter the labor market as adults with skills that improve their long-term job prospects.

Proposal Not Fully Developed

At the time this analysis was prepared, few details on the proposed changes were available. From the information that was available, the plan appears to address many of the critical areas that we see as problems for vocational education in high schools. The proposal, for instance, promotes an early focus on careers and the options available to high school students who are interested in specific occupation areas. The eighth grade "exploratory" class would help students (and their parents) develop a plan for taking the courses needed to achieve the students' postgraduation goals. We also think increasing the number of students involved in CCC vocational programs is a worthy goal—research shows very high wage returns to students who graduate from community college vocational programs. Finally, by adding data on the quality of school vocational programs into SARC, the proposal addresses the need to increase local accountability.

In concept, therefore, we think the proposed plan is headed in the right direction. We have several areas of concern with the reform plan, however, that warrant further legislative discussion.

The Eighth Grade Career Exploratory Course Would Create a Reimbursable State-Mandated Local Program. The Governor's plan would require districts to provide a middle school vocational course, which likely would result in a new state-mandated local program. In general, we advise against creating new programs through state mandates for two reasons. First, under the state mandate reimbursement process, it takes several years before the state begins to reimburse district costs. Second, the state has little control over the cost of new mandates, and our review of district mandate claims shows that local per pupil costs vary tremendously.

In addition, the Governor's proposal does not include an estimate of the likely costs of the new middle school course. An existing mandate that accomplished a similar goal—altering the courses needed to graduate from high school—costs about $13.5 million annually. There also may be additional one-time district costs to create a syllabus for the new exploratory course, obtain needed materials or textbooks, and train teachers.

We think the Legislature needs additional information on why the administration proposes to implement the middle school exploratory course through a state-mandated local program. In addition, the Legislature needs better information on the projected costs—one-time and ongoing—of the new course requirement.

Uses for CCC Funding Should Be Specified. As noted earlier, the Governor's proposal would provide $20 million to CCC for aligning vocational curricula between K-12 schools and community colleges' economic development programs. While we recognize the need for better alignment between vocational offerings in these two systems, we cannot determine the extent to which this funding would advance that goal. The administration could not provide us with many specifics about what kinds of activities would be funded with this money, on what basis it would be distributed, and what accountability provisions, if any, would be implemented. As a result, the administration could not explain why $20 million is the correct amount of funding to provide at this time.

The administration also proposes budget bill language that would make the allocation of the $20 million by CCC dependent on the submission of an expenditure plan that would be approved by the Department of Finance (DOF). In other the words, the Governor is asking the Legislature to approve the $20 million without knowing how the money will be spent. From our perspective, the budget process should allow the Legislature to review the administration's expenditure plan and include its own priorities for the use of the state's money. We believe a sufficiently detailed expenditure plan can be developed and reviewed within normal budget process timeframes.

The Legislature needs the details of how the $20 million fits into the overall reform plan. Without an expenditure plan that includes details on the proposed uses of the new funds, we would recommend the Legislature delete the $20 million appropriation.

Regional Occupational Programs and Centers (ROC/Ps) Have No Explicit Role in the Reform Program. About 40 percent of vocational courses taken by high school students are provided through ROC/Ps. These agencies provide regional support for vocational education. Most ROC/Ps are operated by county offices of education.

The Governor's proposal makes no mention of the role of ROC/Ps. From our perspective, ROC/Ps would contribute significantly to a strengthened system of secondary vocational education. Several changes to the mission of these agencies may be necessary, however. Switching the focus of ROC/Ps from administering individual low-level training classes to participating in sequences that result in two- and four-year skill certificates would align the goals of these regional agencies with the proposed reforms.

Reducing the number of adults served by ROC/Ps also would increase the amount of vocational resources available to high schools. In 2002-03, about one-third of ROC/P students were adults. Bringing all ROC/P resources to support vocational options for high school students would strengthen the proposed reform plan significantly. For these reasons, we think the Legislature needs more information on the role of ROC/Ps in the Governor's reform plan.

Students Need Better Information About the Likelihood of Success in College. As noted above, most high school students see college as virtually the only road to success in life. Research shows many high school graduates enroll in CCC without the academic skills needed to do college-level work. These students assume they are ready for college because they received reasonably good grades in high school. When they arrive at college, however, many students are required to retake courses they took in high school. Not surprisingly, perhaps, these students are less likely to earn a CCC degree or transfer to a four-year institution.

These findings indicate that students need early and ongoing information about whether they are "on track" for gaining the academic skills needed for college. Students and parents need data *other than grades* (which follow no statewide standard) with which to evaluate a student's likelihood of success in an academic college or university program. In addition, the information would help students and parents assess the academic requirements of the different vocational choices available at a high school.

Legislature Needs Details

While we think the broad outlines of the proposal hold promise, key details of the plan are unavailable. Therefore, we recommend the Legislature direct DOF to provide prior to budget hearings the specifics of the proposals contained in the proposed reform package, including responses to the specific concerns raised in this analysis.

STATE TEACHERS' RETIREMENT SYSTEM (1920)

The Governor's budget proposes shifting the state's contribution for basic teacher retirement to schools. (This includes K-12 school districts, county offices of education, and community colleges.) The budget assumes $469 million in General Fund savings from this reduction in state contributions to the State Teachers' Retirement System (STRS).

In this piece, we:

- Describe the retirement plan for teachers, its funding, and its unfunded liability.
- Lay out criteria for increasing local control, flexibility, and responsibility for a teacher retirement system.
- Describe and evaluate the Governor's proposal to shift contributions to school districts in the context of these goals.

BACKGROUND

The Basics of the STRS Plan

Defined Benefit Pays 2 Percent at 60. All K-12 and community college teachers in public schools who work at least half-time are required to participate in the state-sponsored retirement plan administered by STRS. This is a "defined benefit" program, which guarantees a certain lifetime monthly pension benefit based on salary, age, and years of service at retirement. The basic defined benefit pension for retired teachers pays 2 percent of salary for each year of service at age 60.

Recent Benefit Enhancements. Beginning in the late 1990s, when STRS investment returns had resulted in full plan funding, the state approved a series of benefit enhancements. Effective in 1999, the state approved higher percent-of-salary formulas to calculate pension benefits for teachers who are above 60 years of age and/or have 30 years of service.

Effective in 2001, the state again enhanced benefits as investments continued to surge. These changes instituted the following:

- Highest one-year salary (rather than the standard three-year period) to calculate pensions for teachers with 25 or more years of service.
- Additional dollar amounts per month for teachers who retire by the end of 2010 with 30 or more years of service.
- Diversion of 25 percent of teacher contributions—2 percent of the total 8 percent—to a new defined benefit supplement (DBS) program. This program includes individual accounts designed to provide extra retirement income above the defined benefit pension. This diversion is in effect through 2010.
- The STRS payment of Medicare Part A (hospitalization insurance) premiums for retiring teachers who did not pay Medicare taxes (hired before April 1986) and must, therefore, pay the full Part A premium to participate in the federal program.

In addition, the state also approved:

- Allowing retirement credit for accumulated sick leave.
- Increasing the inflation protection benefit from 75 percent up to 80 percent. This benefit increases retirees' pensions when inflation erodes their initial allowances to below 80 percent of their original purchasing power.

Three Contribution Sources Finance Benefits. Contributions to STRS are fixed in statute. Teachers contribute 8 percent of salary to STRS, while school districts contribute 8.25 percent. Figure 1 (see next page) compares employee and employer contribution rates for STRS and related or comparable Public Employees' Retirement System (PERS) plans.

In addition to the teacher and school contributions, the state contributes 4.517 percent of teacher payroll to STRS (calculated on payroll data from two fiscal years ago). The state contribution includes:

- 2.017 percent for the enhanced defined benefit program. This payment would be $469 million in 2005-06, if not for the Governor's proposal to shift the payment to school districts.
- 2.5 percent to finance purchasing power protection at 80 percent. This payment will contribute $581 million in 2005-06.

Figure 1

STRS Retirement Contributions Less Than Average PERS Contributions

	STRS	PERS Miscellaneous Tier 1	PERS School Employees
Employees			
Pension	8.0%	5.0%[a]	7.0%
Social Security	—	6.2	6.2
Totals	**8.0%**	**11.2%**	**13.2%**
Employers			
Pension	8.25%	12.4%[b]	7.6%[b]
Social Security	—	6.2	6.2
Totals	**8.25%**	**18.6%**	**13.8%**

a On amount of monthly salary in excess of $513.

b Varies annually for State Miscellaneous Tier 1 and noncertificated school employees. Amount shown is the 25-year average contribution rate.

Unlike typical defined benefit programs such as those administered by PERS, neither the STRS employer nor the state contribution rate varies annually to make up funding shortfalls or assess credits for actuarial surpluses.

Surcharge Triggered for First Time. The state also pays a surcharge when the teacher and school district contributions noted above are not sufficient to fully fund the pre-enhancement benefits within a 30-year period. Because of the downturn in the stock market, an actuarial valuation as of June 30, 2003 showed a $118 million shortfall in these baseline benefits—one-tenth of 1 percent of accrued liability. Consequently, this surcharge kicked in for the first time in the current year at 0.524 percent for three quarterly payments. This amounts to an additional $92 million from the General Fund in 2004-05.

The Governor's budget assumes this surcharge is discontinued in 2005-06 based on greater-than-assumed investment returns for 2003-04. It will not be known, however, whether the surcharge will continue until a new valuation becomes available in the spring. If it does continue, the 2005-06 General Fund cost for a full year would be between an estimated $120 million and $170 million.

Actuarial Valuation Finds Funding Shortfall

In addition to the small shortfall in pre-enhancement benefits (triggering the current-year surcharge), the recent valuation also showed a substantial $23 billion unfunded liability for the entire system, including enhanced benefits. That is, existing contributions from teachers, school districts, and the state are not sufficient to fully fund retirement benefits. As a result, STRS has just 82 percent of the assets necessary to pay accrued benefits.

As noted above, the pre-enhancement benefit structure has just a fractional shortfall. Consequently, the large systemwide unfunded liability results from the recent benefit enhancements. As described in the nearby box, STRS is currently reviewing options to address this shortfall.

LOCAL PROGRAM HAS NO LOCAL CONTROL OR RESPONSIBILITY

System Problems

We believe there are three main problems with the current method of providing teacher retirement benefits.

Passive State Role in Teacher Compensation, Except for Retirement. As described above, the state is extensively involved in providing teacher retirement benefits and designating funding for this local program. This active role is contrary to the state's passive role in other forms of teacher compensation. The most significant form of compensation—teacher salaries—is left to local school districts and their employees to determine through collective bargaining. Moreover, because the state contributes to the retirement system, local districts do not bear the full costs of retirement plans, unlike teacher salaries.

No Plan Flexibility. In addition, the state-run system limits the choices of both school districts and teachers. With a single benefit structure and required contributions spelled out in statute, districts and teachers have no choices about how best to meet their pension needs. For example, some districts might prefer to use retirement contributions to finance other pension plans that better meet their overall funding needs. Similarly, teacher retirement needs may vary dramatically. Some teachers may prefer to weight their compensation toward present needs. Other teachers may want to forego some current salary for an even more generous retirement allowance than that provided through the STRS program.

State Viewed as Funder of Last Resort. As noted above, all contributing parties—teachers, school districts, and the state—have fixed contributions in statute. Thus, there is no designated responsibility for long-term funding shortfalls, such as the current $23 billion gap. In fact, because the state requires school district participation and designates the rates paid by teachers and school districts, the Legislature may feel compelled to pick up some or all of the unfunded liability despite the local nature of the program. In this way, the current system prevents funding decisions from being viewed as a local responsibility.

Long-Term Solutions

In our view, the long-term solution to these issues is to put decision making and responsibility for school retirement (including nonteaching or noncertificated employees) at the local level with employers (school districts) and employees (teachers). In other words, treat teacher retirement the same as other local government retirement programs. This would include:

- Having all costs borne by school districts and/or teachers, rather than the state being responsible for some share of costs.

Larger State Teachers' Retirement System (STRS) Funding Issue Looms

Shortfall Amounts to an Extra $1 Billion in Annual Contributions. The Governor's cost-shift proposal comes at a time when STRS faces another significant funding issue—the $23 billion unfunded liability noted in the main text. The STRS estimates that the retirement fund needs the equivalent of an additional 4.438 percent of salary over a 30-year period to retire the unfunded liability. This amounts to additional contributions exceeding $1 billion annually.

Options for Closing the Gap. The STRS has developed a dozen options for the board to consider to address the identified shortfall. Most of these options would require legislative action. The options can be grouped into three categories:

- ***Rescinding Recent Benefit Increases.*** The majority of the options would roll back benefits provided to teachers in recent years. In most cases, these changes could only be implemented for teachers who begin working after the new changes take effect. (Courts have considered pension plans to be part of the employment contract. Once a teacher begins working, therefore, the pension is not changeable without some offsetting benefit.)

Continued

- Allowing local flexibility for schools to choose different retirement plans—for teachers and noncertificated staff—that best meet local needs. This could be through STRS, PERS, or other venues such as joint powers authorities.
- Assuring fiscal soundness in that all potential costs are designated to be covered by employers and employees without the necessity of future statutory changes.

It is these criteria that we use to evaluate the long-term impact of the Governor's proposal for teacher retirement. In addition, there are short-term issues the proposal raises as a 2005-06 budget balancing solution.

GOVERNOR PROPOSES COST SHIFT TO SCHOOL DISTRICTS

Proposal

The budget proposes shifting the state's benefits contribution to school districts. (The state would continue annually paying 2.5 percent of payroll

- ***Additional Contributions.*** The state could increase contributions for teachers, school districts, and/or the state to cover the liability. As with reductions in benefits, the state generally would not be able to increase current teachers' contribution rates.
- ***Refinancing the Unfunded Liability.*** The STRS typically amortizes unfunded liabilities over a 30-year period. One refinancing option developed by STRS would stretch these payments over 40 years. (This time period would exceed the bounds of what is allowed for private pensions and is outside the norm for the state's practice.) Another option would be the issuance of a pension obligation bond. By issuing a bond at a lower interest rate than STRS' assumed rate of return (currently 8 percent), the state could reduce its interest payments over time. The Legislature would have to determine who is responsible for providing the resources to pay off the bond.

STRS Board Will Weigh Options This Spring. The STRS board has asked constituent groups for their comments, preferences, and recommendations on these options. The board has also requested an updated actuarial valuation as of June 30, 2004, which will be available in the spring. After this process, the board plans to bring proposals to the Legislature to address the unfunded liability.

to the inflation protection account.) The proposal would increase districts' contributions by 2 percent of payroll, resulting in a total district payment of 10.25 percent. (The state's contribution of 2.017 percent of payroll from two years ago is equivalent to a district payment of 2 percent at current payroll.) This amounts to roughly $500 million in additional contributions. The Governor's proposal would allow school districts to pass through to employees this additional contribution through collective bargaining. Consequently, teachers could contribute as much as 10 percent of their wages toward retirement.

To maintain take-home pay, however, teachers would also have the option of ending the equivalent diversion—2 percent—of the employee contribution to DBS (described previously). This component of the Governor's proposal is not contingent on school districts passing through the shifted responsibility for the 2 percent benefits contribution. Teachers could elect to stop contributing to DBS and receive that compensation in take-home pay regardless of whether districts or teachers pay the benefits contribution.

The administration proposal to shift the state's benefits contribution to school districts also includes eliminating the statutory provision for the surcharge when there is an unfunded liability in the pre-enhancement benefits.

Administration Asserts State Commitment Fulfilled. The administration asserts that the state fulfilled its 1971 promise—included in Chapter 1305, Statutes of 1971 (AB 543, Barnes)—to contribute a fixed dollar amount to the system for 30 years. This period would have ended in 2001-02, four years after the STRS program reached 100 percent funding.

Short Term: Does the Governor's Proposal Work As a 2005-06 Budget Solution?

We find that the Governor's proposal to shift the state benefits contribution to school districts likely would not achieve the intended savings under current law.

The Governor's proposed budget solution assumes the shift of STRS costs would provide ongoing General Fund relief. As we discuss below, however, these savings may not be achievable.

Shift Could Require Proposition 98 "Rebenching." Retirement contributions for school teachers and administrators are an operating cost schools face, like salaries and other benefits. When the state was implementing Proposition 98, however, it decided which programs to include within the minimum guarantee. At that time, the state decided to keep its STRS contributions outside of the guarantee. While the state can move a funding responsibility from outside of Proposition 98 into the guarantee, state law requires that the minimum guarantee be rebenched to reflect this added responsibility. Thus, the Governor's proposal would likely require a $469 million upward rebenching of the minimum guarantee. If so, the proposal would not result in any General Fund savings.

Long Term: Does the Proposal Move Toward the Goals of Local Control and Responsibility?

The Governor's proposal would not fundamentally reform the State Teachers' Retirement System. To move towards a retirement system that emphasizes local control and responsibility, the Legislature would need to focus on a new approach for new teachers.

Shortcomings in System Would Remain. On a long-term basis, the Governor's proposal would not bring the state significantly closer to a teachers' retirement system which reflects local control and responsibility.

- ***Local Control.*** The Governor's proposal would shift the costs of a local program to the local level. Yet, the proposal would not fundamentally change the state's role with regard to STRS. First, the state would continue to have an active role in the costs of the program—by contributing to the purchasing protection program. Second, the state would remain actively involved in determining future benefit changes.
- ***Local Flexibility.*** The Governor's proposal also would not increase flexibility for school districts or teachers. Every school district would continue to offer the same retirement plan for teachers, regardless of local circumstances.
- ***Designated Funding Responsibility.*** Finally, the proposal would not designate which entity would be responsible for any financial shortfalls. Consequently, the state could continue to be viewed as the funder of last resort, reducing local responsibility for the program.

Limitations on Changing System for Existing Teachers. For these reasons, the Governor's proposed cost shift would not fundamentally reform the existing STRS system. For existing teachers, the Legislature may find it difficult to reach the long-term goals of local control, flexibility, and designated funding responsibility with any proposal. Once in place, retirement systems are difficult to alter. By viewing a retirement program as part of the employer-employee contract, the courts have placed significant limits on the types of changes that can be made to a current employee's retirement program. Additionally, the state will be required to designate a source of funding to pay off the current STRS unfunded liability.

Proposals Regarding New Teachers. For new teachers, however, the Legislature would have significantly more flexibility in designing a system that focused on local control and responsibility. The Governor, for example, has proposed requiring all new state, local government, and school employees in California to participate in defined contribution retirement plans. We discuss his proposal in detail—as well as alternatives—in "Part V" of *The 2005-06 Budget: Perspectives and Issues*.

INTRODUCTION

K-12 Education

The budget proposes to provide a $2.5 billion (6 percent) increase in K-12 Proposition 98 funding from the 2004-05 level. Most of the new funding is used to fully fund attendance growth, and provide a cost-of-living adjustment (COLA) plus an additional $329 million to restore part of a prior-year COLA. Adjusting for deferrals funding, schools would receive $7,377 per pupil, or 5.2 percent, more than revised per pupil expenditures in the current year. The Governor proposes not to fund a $1.1 billion increase in funding in the current year that would be needed to meet the targeted funding level in the bill suspending Proposition 98 for 2004-05. The two-year savings from this proposal is $2.3 billion. The Governor proposes to transfer from the state to school districts and community colleges a $469 million State Teachers' Retirement System cost obligation (the K-12 share is $433 million).

Overview of K-12 Education Spending

Figure 1(see next page) displays all significant sources for K-12 education for the budget year and two previous years. As the figure shows, Proposition 98 funding constitutes over 70 percent of overall K-12 funding. Proposition 98 funding for K-12 increases $2.5 billion (6 percent) from the 2004-05 level. However, other funding for K-12 falls by a combined $723 million (see Figure 1).

Local Government Deals Require Higher General Fund Support for Proposition 98. The $2.5 billion increase in K-12 Proposition 98 funding is supported mainly by the General Fund ($2.1 billion). Since 2003-04 the K-12 share of Proposition 98 supported by the General Fund has increased from 67 percent in 2003-04 to 74 percent in the proposed budget. The main cause of the increased General Fund share of Proposition 98 is transfers of local property tax revenues from schools to local government to meet the requirements of the vehicle license fee (VLF) "swap" and the "triple flip" payment mechanism for the deficit reduction bond passed by the voters in March 2004. The Department of Finance (DOF) forecasted that underlying local property tax revenues would grow by 9 percent, which would have provided almost $1.1 billion in year-to-year growth. However, technical adjustments to the VLF swap and triple flip amounts require an additional $675 million to be transferred from schools to local government. Thus, the growth in local property tax revenues in 2005-06 is only $401 million (3.6 percent).

Figure 1

K-12 Education Budget Summary

(Dollars in Millions)

	Actual 2003-04	Revised 2004-05	Proposed 2005-06	Change From 2004-05	
				Amount	Percent
K-12 Proposition 98					
State General Fund	$28,154	$30,992	$33,117	$2,125	6.9%
Local property tax revenue	13,656	11,192	11,593	401	3.6
Subtotals, Proposition 98	($41,810)	($42,183)	($44,710)	($2,527)	(6.0%)
Other Funds					
General Fund					
Teacher retirement	$469	$1,050	$502	-$549	-$52.3%
Bond payments	890	1,674	1,825	151	9.0
Other programs	254	720	441	-280	-38.8
State lottery funds	873	810	810	—	—
Other state programs	112	110	105	-5	-4.5
Federal funds	7,154	7,584	7,533	-51	-0.7
Other local funds	5,195	5,206	5,217	10	0.2
Subtotals, other funds	($14,948)	($17,155)	($16,433)	(-$723)	(-4.2%)
Totals	**$56,758**	**$59,339**	**$61,143**	**$1,804**	**3.0%**
K-12 Proposition 98					
Average daily attendance (ADA)	5,958,356	6,015,984	6,063,491	47,507	0.8%
Budgeted amount per ADA	$7,017	$7,012	$7,374	$362	5.2

Totals may not add due to rounding.

Proposed Reductions in Non-Proposition 98 Spending. The budget proposes to decrease non-Proposition 98 funding for K-12 by a net of $723 million in 2005-06. The key changes include:

- ***Shifting the Responsibility for the State Teachers' Retirement System (STRS) Contributions From State to School Districts—Decrease of $433 Million.*** The state's General Fund currently contributes roughly 2 percent of teacher payroll annually for the STRS base program. The budget proposes to shift this payment to school districts and/or teachers. This would result in 2005-06 General Fund savings of $469 million ($433 million of this is costs shifted to school districts and the remainder is shifted to the community colleges).

- ***One-Time STRS Surcharge Triggers Off—Decrease of $94 Million.*** In the current year, a funding shortfall in the STRS base program triggered a 0.524 percent General Fund surcharge for three-quarters of the year. This amounts to $94 million. The administration assumes that this surcharge will not continue in 2005-06 (at a full year cost of at least $122 million) because greater-than-assumed investment returns in 2003-04 may have erased the small shortfall that triggered the surcharge. It is our understanding that the statutory provision for a surcharge would be eliminated as part of the administration's proposed benefits funding shift.

- ***School Bond Debt Service—Increase of $151 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) and Proposition 47 (2002).

- ***Proposition 98 Reversion Account Reductions—Decrease of $203 Million.*** Most of the decrease in "General Fund—Other programs" in Figure 1 results from a $203 million reduction in funds available in the Proposition 98 Reversion Account. The Reversion Account reappropriates funds that were appropriated to Proposition 98 in the past, but were not used. The Reversion Account balances are projected to be less for 2005-06 largely because the state has reduced funding for many of the programs that have historically generated reversion funding. Starting in 2005-06, one-half of the funds in the Reversion Account are transferred to an emergency fund for facilities as part of the *Williams v. California* lawsuit settlement.

- ***Federal Funding Reductions Reflect Conservative Estimate—Decrease of $51 Million.*** The Governor's budget makes conservative assumptions about the availability of federal funding in 2005-06 because the federal budget was passed too late to incorporate into the budget. We now have early estimates of the year-to-year change in federal funding. The federal Department of Education estimates that federal funding for California education will increase around $75 million in 2005-06. Thus, the Governor has underbudgeted federal funds by around $125 million. The DOF informs us that they will reflect additional federal funds in the May Revision.

Per Pupil Spending Grows by $362 in 2005-06

The Governor's budget provides an additional $362 per pupil, a 5.2 percent increase from the current year. Figure 2 shows per pupil spending in actual dollars over the last decade. The figure shows two distinct trends—a fast growth period in the late 1990s, and a slow growth period between 2000-01 and 2004-05. Spending per pupil increased in each year of this period. However, these spending levels do not take into account the effects of inflation. Figure 3 adjusts per pupil spending for inflation. K-12 spending since 2000-01 has not kept pace with rising costs, declining 1.3 percent per year, on average, between 2000-01 and 2004-05. Looking at changes over the last decade, spending (in inflation-adjusted terms) has increased by approximately $930 per pupil (14 percent). The Governor's proposal would end the recent trend of reduction, growing per pupil spending 2.3 percent after adjusting for the effect of inflation.

Figure 2

K-12 Per Pupil Spending

(Nominal Dollars)

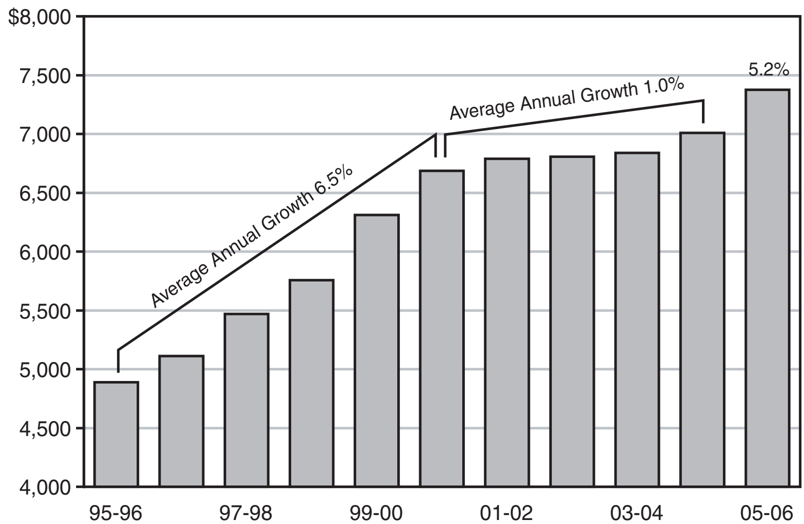
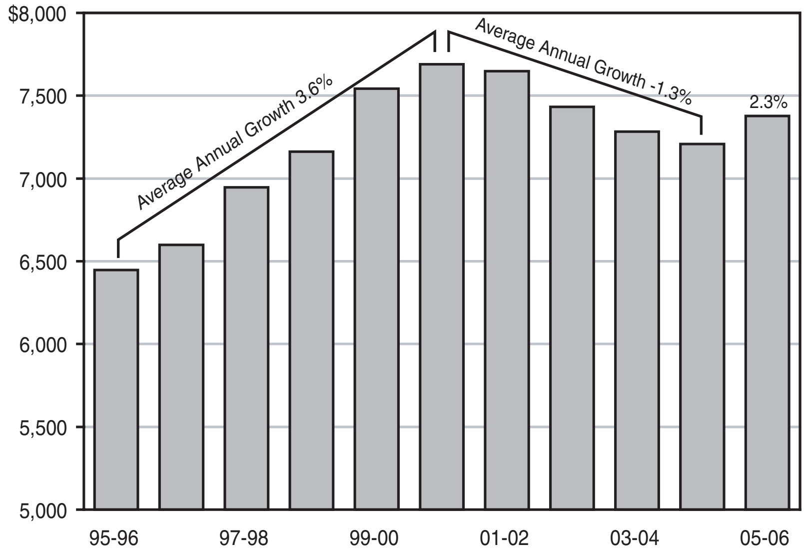


Figure 3

K-12 Per Pupil Spending Adusted for Inflation



Major K-12 Funding Changes

Figure 4 (see next page) displays the major K-12 funding changes from the *2004-05 Budget Act*. In the current year, the Governor's budget reflects a net $89 million increase resulting mainly from higher-than-expected attendance. In 2005-06, the Governor's budget proposes about $2.5 billion in new K-12 expenditures for the following purposes.

- ***Revenue Limit Growth and COLAs—$1.5 Billion.*** The Governor fully funds 0.79 percent growth in revenue limits ($234.7 million), and a 3.93 percent COLA ($1.2 billion).
- ***Deficit Factor Reduction—$329 Million.*** In 2003-04, the state did not provide a COLA (1.8 percent), and reduced revenue limits by 1.2 percent. At that time, the state created an obligation to restore the reductions at some point in the future. That obligation is referred to as the "deficit factor." The budget provides $329 million to reduce the deficit factor from around 2.1 percent to 1.1 percent.
- ***Categorical Growth and COLAs—$588 Million.*** The Governor fully funds growth and COLAs for categorical programs including $427.6 million for COLAs and $160 million for growth.

- ***Restoration of Categorical Funding.*** To help balance the 2004-05 budget, the state used one-time funds to support ongoing education programs. The Governor provides ongoing funding for these programs starting in 2005-06.

Figure 4

Major K-12 Proposition 98 Changes

(In Millions)	
2004-05 Budget Act	**$42,087.3**
Additional K-12 revenue limit	$93.2
Other	-4.7
2004-05 Revised K-12 Spending Level	**$42,183.3**
Revenue Limit	
Cost-of-living adjustments (COLAs)	$1,222.1
Growth	234.7
Deficit factor reduction	329.3
Subtotal	($1,786.1)
Categorical Programs	
COLAs	$427.6
Growth	160.0
Restore categoricals funded with one-time funds	146.5
Other	6.5
Subtotal	($740.6)
Total Changes	**$2,526.7**
2005-06 Proposed	**$44,710.0**
Change From Revised 2004-05	
Amount	$2,526.7
Percent	6%

Proposition 98 Spending by Major Program

Figure 5 shows Proposition 98 spending for major K-12 programs adjusted for funding deferrals. The budget provides almost $33 billion for revenue limits, $3.2 billion for special education, and almost $1.7 billion for K-3 class size reduction (CSR).

Figure 5

Major K-12 Education Programs Funded by Proposition 98

(Dollars in Millions)

	Revised 2004-05[a]	Proposed 2005-06[a]	Change	
			Amount	Percent
Revenue Limits				
General Fund	$19,513.2	$20,912.8	$1,399.7	7.2%
Local property tax	10,859.1	11,245.3	386.2	3.6
Subtotals	($30,372.3)	($32,158.2)	($1,785.8)	(5.9%)
Categorical Programs				
Special education[b]	$3,051.2	$3,239.2	$188.0	6.2%
K-3 class size reduction	1,651.8	1,671.6	19.8	1.2
Child development and care	1,097.4	1,177.9	80.5	7.3
Targeted Instructional Improvement Block Grant[c]	930.2	974.4	44.2	4.8
Adult education	606.5	646.1	39.6	6.5
Economic Impact Aid	536.2	585.2	48.9	9.1
Regional Occupation Centers and Programs	393.3	419.5	26.2	6.7
Instructional Materials Block Grant	363.0	380.2	17.2	4.8
Public School Accountability Act	249.2	249.2	—	—
Deferred maintenance	250.4	267.4	17.0	6.8
Home-to-school transportation	541.9	567.7	25.8	4.8
School and Library Improvement Block Grant[c]	402.5	421.6	19.1	4.8
Professional Development Block Grant[c]	239.1	248.6	9.5	4.0
Pupil Retention Block Grant[c]	164.3	174.1	9.8	6.0
Mandated supplemental instruction (summer school)	281.3	293.5	12.2	4.3
Other	1,161.7	1,255.0	93.3	7.9
Deferrals and other adjustments	-111.2	-19.3	91.9	-82.6
Subtotals	($11,810.7)	($12,551.9)	($741.2)	(6.3%)
Totals	**$42,183.0**	**$44,710.1**	**$2,527.0**	**6.0%**

a 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.

b Special education includes both General Fund and local property tax revenues.

c Chapter 871, Statutes of 2004 (AB 825, Firebaugh), created these new categorical block grants. The 2004-05 amounts include funding provided for the predecessor programs.

Enrollment Trends

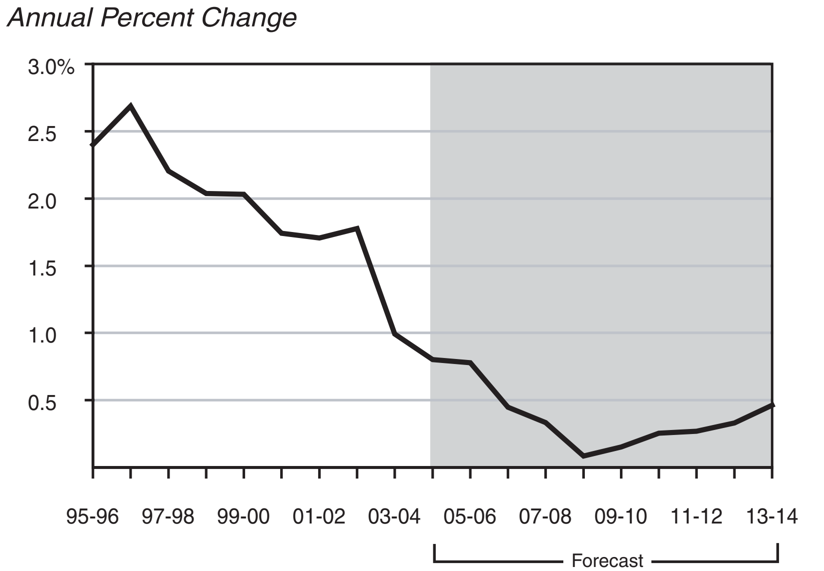
Enrollment growth significantly shapes the Legislature's annual K-12 budget and policy decisions. When enrollment grows slowly, for example, fewer resources are needed to meet statutory funding obligations for revenue limits and K-12 education categorical programs. This leaves more General Fund resources 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.

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 0.8 percent in 2005-06, bringing total enrollment to about 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 2008-09, when it will turn upward.

Figure 6

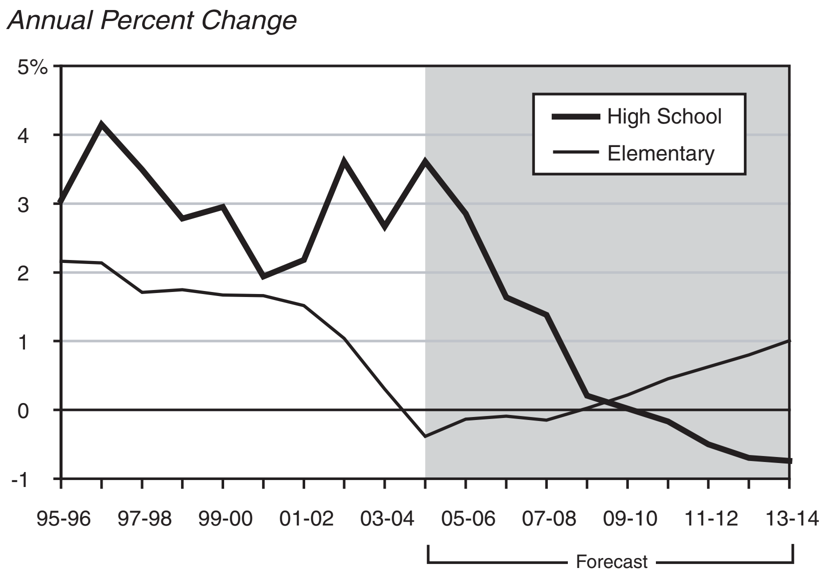
K-12 Enrollment Growth



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 gradually slowed since 1995-96. This enrollment is expected to decline annually between 2004-05 and 2008-09. In contrast, high school enrollment growth has been growing rapidly, with a 3.6 percent increase in 2004-05. Beginning in the budget year, growth is expected to slow sharply, becoming negative in 2010-11. Expected growth from the current year to 2007-08 is approximately 115,000 pupils (6 percent). Between 2007-08 and 2013-14, however, enrollment will fall by almost 40,000 students.

Figure 7

Elementary and High School Enrollment Growth



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:

- A 1 percent increase in K-12 enrollment requires an increase of approximately $450 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.
- Despite the general downward trend in enrollment growth, significant variation is expected to occur across counties. For example, between 2004-05 and 2013-14, Los Angeles' enrollment is expected to decline almost 120,000 students (a 7 percent decline), whereas Riverside's enrollment is expected to increase by over 90,000 students (a 25 percent increase).
- 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. The state will need to increase its focus on the language development skills of the state's English learner population.

Budget Issues

K-12 Education

School District Financial Condition

School districts face a number of difficult financial challenges in 2005-06 and beyond, including falling revenues due to declining enrollment and long-term costs for retiree benefits.

School districts have not been immune to budget cuts during this current fiscal crisis. Midyear cuts reduced funding for categorical programs and mandates in 2002-03. In 2003-04, no cost-of-living adjustments (COLAs) were provided and the state actually reduced district general purpose funding by a small amount. In 2004-05, schools received a COLA and a partial repayment of the cut in general purpose funds. The 2005-06 proposed budget promises another COLA and partial general purpose funding restoration.

During this time, a significant number of districts also began losing students due to demographic changes in the K-12 population. As enrollment fell several years in a row, so did state funding for these districts. Recent data suggest that 40 percent of districts statewide experienced declining enrollment for both 2002-03 and 2003-04. The decline in district enrollments combined with modest increases in state funding over this period translated into flat or declining revenues for many districts.

Looking to 2005-06, school districts face a number of revenue and cost pressures (see Figure 1, next page). Declining enrollment will continue to affect many districts. In fact, our projection of K-12 enrollments shows very little growth during the next five years. These losses reduce district revenues, requiring budget cuts at the local level.

The figure also lists three other types of financial pressures facing districts. Districts must restore, beginning in 2005-06, unrestricted reserves and maintenance spending to levels required by the state. As part of the 2003-04 budget plan, the state allowed districts to reduce general purpose reserve levels, cut spending on maintenance, and transfer available categorical fund balances at the end of 2002-03 into the districts' general fund. In 2005-06, districts must restore reserve levels and maintenance spending to the state-required levels. For districts that used the full flexibility afforded by the state, the cost of restoring reserves and maintenance spending equals about 2.5 percent of local budgets.

Figure 1

Financial Pressures Facing School Districts

2005-06

✓ **Adjust to Lower Revenues From Declining Enrollment**

✓ **Restore State-Required Funding Levels**
- Unrestricted reserves.
- Long-term maintenance.

✓ **Restore Operating Budget Balance**
- Borrowing from self-insurance reserves.
- Using one-time funds for ongoing expenses.

✓ **Absorb Higher Costs**
- Liability for retiree health benefits.
- Health insurance premiums.
- Employee wage increases.

Based on our discussions with district and county fiscal officers, districts also are under pressure to get their operating budgets back in balance. In many cases, they have taken one-time actions to help finance spending that is above ongoing revenues. The figure shows some of the more common practices, including borrowing from other district funds (such as self-insurance funds) and using one-time funds for ongoing expenses. All of these practices can be justified as reasonable short-term actions if they are accompanied by a plan for ending the practice. Failure to end them—

that is, by aligning ongoing revenues and expenditures and repaying internal borrowing—often results in a bigger problem as time goes on.

Districts also face several significant cost increases in the budget year. Health insurance costs have been increasing at annual rates above 10 percent over the past several years, affecting the cost of current employees and retirees whose health benefits are covered by districts. Salary costs are also a concern; since employee salaries comprise the largest component of local budgets, any increase in wages has a major impact on district finances.

Districts With Financial Problems Increasing. Preliminary information for 2004-05 suggests an increasing number of districts need to take steps to remain financially healthy. The state maintains a fiscal oversight process (known as the AB 1200 process) that makes county offices of education (COEs) responsible for reviewing school district budgets and assisting districts that are experiencing financial difficulties. Twice each year, COEs certify the fiscal condition of districts—that is, they report the likelihood that each district will be able to meet its financial obligations over the next three fiscal years. The first 2004-05 reports were due to the State Department of Education (SDE) on December 15, 2004.

While these first 2004-05 reports were not available at the time this analysis was written, the Fiscal Crisis and Management Assistance Team (FCMAT) projects an increase in the number of districts given a "qualified" or "negative" certification. This team is established in state law to provide fiscal and management assistance to school districts and COEs. A qualified rating means the district may not be able to meet its financial obligations. A negative certification means the district will not be able to meet its obligations in the current or subsequent fiscal year. A negative or qualified certification initiates the development of a plan for addressing the causes of the district's financial instability.

The FCMAT projects the number of negative or qualified districts will increase in 2004-05. It expects 11 districts to receive a negative certification, up from 9 last spring. In addition, it expects 44 districts to receive a qualified certification, an increase from 36 in spring 2004. In addition to these districts, we know of several districts that made midyear reductions in order to avoid a negative or qualified certification. While the number of districts with a negative or qualified certification is still relatively small, the increase reflects the fiscal pressures districts face. We think the pressure is likely to mount in spring 2005, when districts begin their budget planning for next year in earnest.

In the following sections, we recommend the Legislature address two financial pressures faced by districts. The first is the problem of long-term retiree health benefits. Many districts face large liabilities for future retiree health care costs. We think the state needs to begin a process for recognizing these costs and requiring districts to develop plans for addressing long-term liabilities for these benefits.

The second issue is declining enrollment. Because statewide growth in the K-12 population is likely to be stagnant for the next five years, declining enrollment is likely to affect the majority of districts in the state. We suggest the Legislature consider an alternate declining enrollment funding formula that would give districts more time to adjust to the financial impact of fewer students.

RETIREE BENEFITS POSE LONG-TERM CHALLENGE

We recommend the Legislature require county offices of education and school districts to take steps addressing districts' long-term retiree health benefit liabilities.

In 2004, the Governmental Accounting Standards Board (GASB) issued a new policy describing how state and local governments (including schools and community colleges) must account for nonpension retirement benefits such as health insurance. For K-12 and community college districts, the GASB policy requires each district to include its long-term liabilities for post-retirement benefits in its annual financial statement. One component of this new liability statement is an identification of the amount that, if paid on an ongoing basis, would provide sufficient funds to pay for benefits as they come due.

In other words, GASB requires districts to account for health and other retirement benefits similarly to the way they account for pension costs. For retirement, an amount is contributed to a fund each year for each employee. Over the years, these payments are set at a level sufficient to pay for the full cost of retirement benefits for the average employee. In effect, the retirement benefits are "prefunded"—that is, their costs are provided for over the working life of the employee. (Also, contributions are set aside in a special "trust" fund so they cannot be used for any other purpose.) The new GASB policy encourages districts to pay for retiree health benefits in the same way, thereby avoiding the accumulation of large unfunded liabilities for future benefits. The GASB policy, however, does not require such annual payments or public agencies to act on any past liabilities—it only requires the reporting of such liabilities. We are not aware of any school district that has prefunded its retiree health benefits. Instead, these costs are paid out of districts' operating budgets as they are incurred by retirees.

Some District Liabilities Are Huge

The liabilities some districts face are very large—so large they potentially threaten the district's ability to operate in the future. For instance, Los Angeles Unified School District (LAUSD) estimates its current "actuarial liability" for retiree health benefits at $5 billion. This figure is the amount the district would need to place in an interest-bearing account in 2005 to pay for these benefits over time. To provide a sense of the size of this liability, the $5 billion estimate for LAUSD is the equivalent of about 80 percent of the district's general purpose annual operating budget. Other districts face a similar problem. Fresno Unified estimates its liability at $1.1 billion—almost twice its annual budget. The cost for both districts is very high because each provides lifetime health benefits to retirees.

While these costs are not yet at a stage that will seriously erode the district's ability to function, both districts are experiencing rapidly increasing annual costs for these benefits. In Los Angeles, for instance, the district budget includes about $170 million for retiree health benefits in 2004-05. The district estimates the annual cost of these benefits will grow to about $265 million by 2010 and $360 million by 2015. The district would have to add $500 million to the budget—about 8 percent of its overall budget—starting next year and continuing for the next 30 years to pay off its unfunded liabilities and prefund future retiree health benefits.

Weak District Incentives to Face Liabilities. Districts do not have much incentive to address this problem. In the short run, the need to set aside funds for this obligation would only complicate budgeting as it would reduce funding available for other local priorities. Furthermore, any financial crisis resulting from these liabilities may be years or decades away. For these reasons—and especially given the number of financial pressures districts currently face—districts will be reluctant to take the needed steps to address this problem. There is one way, however, that the new GASB policy may prod districts to address these liabilities. Large liabilities could affect a district's bond rating and increase the costs of borrowing. Pressure from credit agencies, therefore, represents one of the few short-term incentives for addressing retiree costs that will result from the new policy.

Liabilities Could Be Even Larger. Districts may also have an incentive to understate their actual liabilities. The GASB policy left many details of the actuarial calculation of liabilities to local agencies. While this makes sense given the range of state and local agencies affected by this policy, it also allows local agencies the ability to make assumptions that minimize their apparent liability. Small changes in the underlying assumptions used in these studies have a major impact on the results. For instance, the LAUSD's actuarial study determined a $5 billion actuarial liability using "best estimate" assumptions. This figure increased to $7 billion if all current and retired employees were included in the calculation instead of retirees plus those employees whose health retirement benefits are vested. Moreover, the figure grew to $11 billion if the long-term interest rate the district would earn on its annual contributions was reduced from 6 percent to 4 percent. Thus, we think it is in the state's interest to ensure districts use reasonable assumptions in their actuarial studies.

Require District Plans for Addressing Liabilities

The size of retiree health benefit liabilities is so large that unless steps are soon taken to address the issue, it seems likely that districts will eventually seek financial assistance from the state. As a first step, we think the Legislature needs to establish a process for ensuring that districts identify and address the liabilities created by post-retirement benefits. Currently, there is no state or local process for collecting information on the financial liabilities districts presently face or whether districts have a plan for addressing these liabilities. In addition, the long-term liabilities of retiree benefits are not part of the AB 1200 district fiscal review process. As a result, COEs are not always aware of which districts provide retiree benefits or the magnitude of the costs for those benefits.

About 150 districts present the most serious problem. Of these, 70 districts provide lifetime health benefits to retirees and represent the districts that probably have the most serious fiscal problem. Another 80 districts provide health benefits from the time an employee retirees to a specific age—most commonly age 70. These districts also may face significant fiscal challenges.

To address this problem we recommend the Legislature enact legislation to achieve the following:

Require districts to provide COEs by October 1, 2005, with a copy of any actuarial study of its retiree benefits liability. Until the GASB issued its new policy, the state required districts to assess their outstanding liabilities for certain post-retirement benefits every three years. The COEs should receive a copy of these studies so they are informed of the size of any existing liabilities.

Require districts to provide COEs by June 30, 2006, with a plan for addressing retiree benefits liabilities. The GASB policy requires large local agencies to make public data on retiree benefit liabilities beginning in 2007. Because of the prior state requirement and the new GASB policy, most districts with significant liabilities are aware of the problem. We think encouraging districts to develop a plan for addressing these long-term liabilities as soon as possible is in the districts' and state's interest. These plans could address district liabilities in several ways including prefunding benefits, restructuring or eliminating benefits for new employees, and partial prefunding that protects districts during years when benefit costs are high.

Modify AB 1200 to require COEs to review whether districts' funding of long-term liabilities adequately cover likely costs. This change would have two elements. First, COEs would assess whether districts are following their plan for addressing the long-term liabilities for retiree benefits. This review would occur each time districts revise their actuarial estimate of liability. Second, SDE would add to existing AB 1200 regulations new guidelines for the development of future actuarial studies of retiree benefits. This would ensure that district studies used reasonable assumptions in their assessment of local liability.

Require SDE to report to the fiscal committees by December 15, 2005 on the size of retiree health liabilities in the 150 districts that provide the most extensive benefits. This would inform the Legislature's discussion about any future steps that may be needed to deal with this problem.

CREATE A NEW DECLINING ENROLLMENT OPTION

We recommend the Legislature adopt legislation to establish an alternate declining enrollment formula that would give districts more time to adjust to the financial impact of fewer students. Our recommendation would create no additional state costs in 2005-06 but would probably result in a 2006-07 cost of $80 million to $100 million. This cost would grow modestly over time until districts reach their equalization targets.

Each district is assigned a unique revenue limit, or per-pupil funding rate. Revenue limits are comprised of two main parts. First, each district receives a *base* revenue limit, which accounts for 95 percent of the amount of revenue limit funds provided to districts. Base revenue limits are determined largely by historical factors, including a district's spending levels at the time Proposition 13 was approved by voters in 1978. Since then, the Legislature has added "equalization" funding to revenue limits several times to reduce differences among districts in base revenue limits.

Second, the other 5 percent of revenue limit funding is for ten "add-on" programs. These add-ons, for instance, include funding for minimum teacher salary incentive programs, the Unemployment Insurance program, and longer school day and year incentives. Since districts receive significantly different amounts from these adjustments, the add-on programs introduce a second factor contributing to differences in district revenue limits among districts.

In our past reports on K-12 finance, we have recommended the Legislature address these two problems. In our view, most of the differences in revenue limit funding levels among districts have no analytical basis. Instead, most of the variation stems from decisions made during the 1970s and 1980s that have little policy relevance today. To correct these problems, we have recommended the Legislature make progress in equalizing revenue limits. We have also recommended consolidating most of the add-on funding into base revenue limits so that the Legislature could equalize the amount of general purpose funds districts actually receive, not just the amounts represented by base revenue limits.

Recently, the Legislature made revenue limit equalization a funding priority. The *2004-05 Budget Act* provides $110 million for this purpose, setting the goal of equalization at the 90th percentile of all districts within each size and type. The 2005-06 budget proposal does not include any new funds to continue progress towards more uniform base funding levels.

Declining Enrollment Affects Many Districts

Another feature of the revenue limit system is known as the "declining enrollment adjustment." This adjustment gives districts a one-year reprieve from funding reductions caused by declining attendance. Technically, the adjustment allows districts to claim the higher of the current or prior year's average daily attendance (ADA). Since, in declining enrollment districts, the prior-year total exceeds the current-year ADA, the adjustment maintains a district's previous year's funding level (increased by a COLA).

A fall in the number of elementary school age students in California is creating declining enrollment in many school districts. In 2003-04, elementary and unified districts reported that 13,800 fewer students were enrolled in grades K-6 than in the previous year. This *net* decline is relatively small—only a 0.4 percent reduction in enrollment. However, the net figure masks the fact that the losses are not uniform across the state.

Forty Percent of Districts Are Declining. The most recent data available show that 412 districts (or 42 percent) experienced declining enrollments in 2003-04. The data suggest that attendance in most of these districts fell in both 2002-03 and 2003-04. The declining enrollment adjustment cost the state about $130 million in 2003-04.

The typical declining enrollment district lost 1.7 percent of its previous year's ADA. About one-fifth of districts reporting declines, however, lost more than 5 percent of their students. Districts of all sizes are experiencing falling enrollment. Most are small—about half enroll fewer than 1,000 students. Thirty-nine of the declining districts, however, are large, enrolling more than 10,000 students.

Declining revenues associated with falling enrollments create difficult fiscal issues for districts. Falling enrollments mean that districts need fewer teachers. As districts stop hiring new teachers, the average teacher salary grows (simply because districts have more experienced, higher wage staff whose salaries are not offset by newer, lower-wage staff), which requires additional cost reductions. If the decline is large or continues over an extended period of time, districts typically need to close schools.

School fiscal experts advise that districts should accommodate declining enrollment by making cost adjustments *before* the decline actually occurs. Often, enrollment trends are known in advance. In some cases, however, falling enrollments can occur relatively quickly. Enrollment increases in one year may be followed by sharp declines in the next—with no transition year in between. In these instances, or when districts fail to adequately plan for sustained reductions in enrollment, the financial consequences can be severe.

Our fall 2004 estimate of future K-12 attendance growth projected a continuing decline in the growth rate of the student population. By 2008-09, we estimate no growth in ADA statewide. As a result, we expect declining enrollment will play an important role in district finance for several years. Many districts that are currently declining will continue to lose students. A portion of districts that are still growing will become declining enrollment districts in the near future.

Option: Permanently Increase Revenue Limits

For districts that face significant long-term reductions in ADA, the existing declining enrollment adjustment may not provide a sufficient amount of time for districts to adjust to the fiscal consequences of falling enrollments. In the first year of decline, the adjustment maintains the prior-year funding level (plus a COLA). Beginning in the second year of ADA reductions, however, districts lose revenue limit funding commensurate with the size of the ADA decline in the previous year. While the declining enrollment adjustment actually provides a series of one-time financial benefits to districts in this situation, the current formula still requires districts to ratchet down their annual spending as enrollment falls.

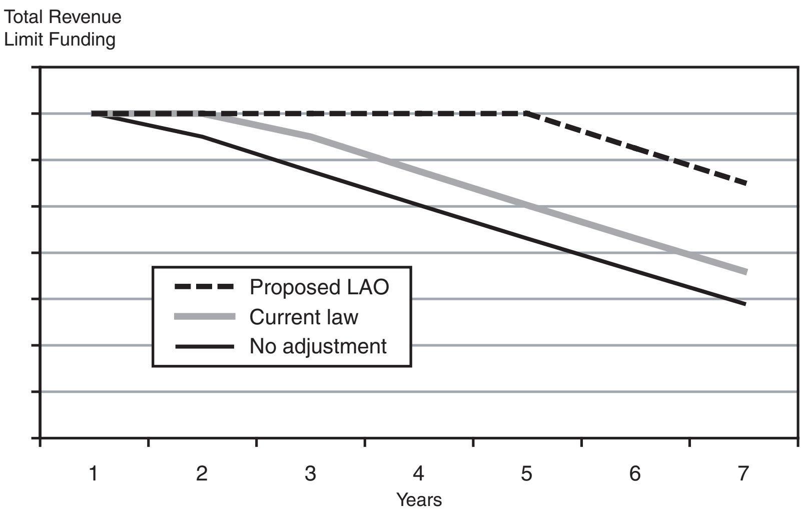
There are two basic ways the Legislature could help districts facing multiyear enrollment declines. First, it could expand the existing temporary protection, such as extending the funding adjustment to two years. This would provide districts with an additional year of constant funding before the impact of falling attendance reduced total revenue limit funding.

The second way is to provide a more lasting adjustment. We propose an option that increases revenue limits by an amount sufficient to offset the enrollment decline. This option would allow a district to maintain its prior-year level of funding over time. By allowing this option to be used only by districts which are *below* the state's equalization target, it would have the dual benefit of helping the state make progress toward its equalization goal.

How Would This Option Work? Figure 2 illustrates the difference in the impact of the current adjustment and our alternative adjustment in a hypothetical district that experiences falling attendance over many years. The dark line shows how total revenue limit funding would decline without *any* funding adjustment; revenues would fall with enrollment. The existing declining enrollment adjustment is shown as a parallel line to the "no adjustment" scenario. The current adjustment delays the revenue reduction of falling attendance by one year. As a result, after one year of holding the district harmless from the effect of falling enrollment, the district experiences annual cuts in revenues equal to the previous year's reduction in attendance.

Figure 2

Funding Options for Districts With Declining Enrollment[a]



[a]Assumes district experiences declining enrollment each year, beginning in year 2.

Our proposed declining enrollment adjustment would operate quite differently. As the figure illustrates, total revenues for the hypothetical district would stay constant for several years. During this time, the district's per-pupil revenue limit would be increased annually to offset the fall in attendance and keep total funding constant. In year five, however, the revenue limit increases cause the district to reach the state's equalization target. After that point, the district no longer qualifies for our proposed adjustment, and further enrollment declines reduce district revenues.

Proposal Helps Districts, Makes Progress Towards Equal Funding. Our proposed revenue limit increase has two main advantages over the current declining enrollment formula. First, it provides a higher level of funding protection for most districts that are losing students. This increase in a district's per-pupil revenue limit would be permanent—it would not revert back to its previous level the next year as the current ADA adjustment does. Per-pupil revenue limit adjustments would continue only until the district reaches the state's equalization target. Since almost all districts are within about 10 percent of the state's equalization target, districts experiencing significant, sustained, declines would reach the 90^{th} percentile funding level relatively quickly.

The second advantage of our proposal is that increasing district revenue limits to the state's equalization target makes progress on another state priority—a system of uniform revenue limits. Currently, districts are required to reduce spending due to declining enrollment regardless of whether they receive less per pupil than other similar districts. By holding total funding constant from year to year, the state can make progress towards its goal of reducing these differences.

Another advantage of our proposal is that the revenue limit adjustment would occur automatically. Like the existing adjustment, our proposal would automatically increase district revenue limits to compensate for declining enrollments. The Legislature would not be required to make a specific appropriation in the budget. Funds would flow to districts as part of the existing statutory appropriation. In this way, the state would make annual progress towards a more equal system of revenue limits.

It is important to recognize our alternate adjustment has a long-term cost. Since our proposal would generate the same amount of revenue limit funding to districts in the first year as the existing adjustment, our formula would not create any additional cost in 2005-06. Beginning in 2006-07, however, our formula would provide these districts a higher level of funding. Data are not available to allow us to make a precise estimate of the cost of this formula. Depending on the number of districts in decline and the size of the declines, the cost could total between $80 million and $100 million in 2006-07. This cost probably would increase modestly each year until districts reach their equalization targets. The total possible cost of the formula, however, cannot exceed the amount of funds needed to equalize revenue limits to the 90^{th} percentile for all districts. We calculate this amount to be about $300 million.

Add a Declining Enrollment Revenue Limit Adjustment

We recommend the Legislature adopt legislation to create a new declining enrollment revenue limit adjustment that would begin in 2005-06. As discussed earlier in this section, we are concerned by the size and number of financial pressures districts currently face. We also see enrollment declines as a statewide problem that probably will continue for some time. Based on our K-12 enrollment projections, the financial pressures associated with declining enrollment will continue for at least the next five years. Our proposal is not intended to prevent declining districts from making cost reductions warranted by a long-term fall in ADA. Instead, our formula would give districts a longer period for adjusting to the financial pressures created by falling attendance.

Our analysis also suggests another way the Legislature could help declining enrollment districts and make progress towards a more uniform funding system—providing additional equalization funding for all districts. Equalization funding would help both declining and growing districts with revenue limits below the state's equalization targets.

We also recommend two additional steps that we think should accompany this new formula, as follows.

Limit Increases to 5 Percent. As discussed above, about one-fifth of the current declining enrollment districts experienced reductions of more than 5 percent in 2002-03. Districts that sustain such large declines in student attendance need to make immediate efforts to bring costs into line with revenues. Therefore, we recommend the Legislature limit annual revenue limit increases to 5 percent. Under our proposal, a district that lost 10 percent of its ADA would be able to choose between our formula (which would provide an ongoing 5 percent increase) and the existing adjustment (which would provide a one-time 10 percent increase).

Consolidate "Add-On" Funding Into Revenue Limits. The state's equalization targets focus on differences in district base revenue limits. As noted above, however, the revenue limit add-on funds alter the distribution of revenue limit funding. As a consequence, successfully bringing all district base revenue limits to the state's equalization targets would not eliminate funding disparities introduced by the add-ons. As part of our alternate declining enrollment formula, therefore, we recommend the Legislature merge most of the add-on funds into base revenue limits and reset the equalization targets based on the consolidated amounts.

CATEGORICAL REFORM

Recent categorical reform enacted through Chapter 871, Statutes of 2004 (AB 825, Firebaugh), consolidates 26 existing programs into six block grants to take effect in 2005-06. It requires that districts and county offices of education (COEs) use the consolidated funding for the purpose of the programs subsumed in each block grant. Figure 1 (see next page) shows the programs included in the six block grants.

Chapter 871 contains several provisions pertaining to flexibility over the use of the block grant monies. The law, for instance, allows districts and COEs to transfer annually up to 15 percent of funding from four of the block grants into the other block grants or into other categorical programs. No funds, however, may be transferred out of the Pupil Retention and Teacher Credentialing block grants. The total funding a district or COE may expend for a program to which funds are transferred may not exceed 120 percent of the amount apportioned for that program in that fiscal year.

We have particular concerns about the Pupil Retention Block Grant (PRBG) and the two teacher training block grants. In the sections that follow, we discuss these concerns.

CATEGORICAL REFORM AND SUPPLEMENTAL INSTRUCTION

We recommend the Legislature adopt trailer bill language adding two supplemental instruction programs to the new Pupil Retention Block Grant along with a requirement specifying that "first call" on funds in the block grant must be for these supplemental instruction program costs.

The PRBG, one of the six block grants created by Chapter 871, consolidates 11 programs that support supplementary instruction and services for students at risk of academic failure. The budget includes $173 million for this block grant and will provide an additional $26.7 million of deferred amounts in a trailer bill.

Figure 1

Six New Block Grants

Pupil Retention Block Grant—$172.9 Million

- "Core" programs supplemental instruction.
- Continuation high schools.
- Drop Out Prevention and Recovery.
- Reading, writing, math supplemental instruction.
- Tenth Grade Counseling.
- High-Risk Youth Education and Public Safety.
- Opportunity Programs.
- Los Angeles Unified At-Risk Youth Program.
- Intensive reading supplemental instruction.[a]
- Algebra academies supplemental instruction.[a]
- Early Intervention for School Success.[a]

School Safety Consolidated Competitive Grant—$16.3 Million

- Safe school planning and partnership mini-grants.
- School community policing.
- Gang Risk Intervention Program.
- Safety plans for new schools.
- School community violence prevention.
- Conflict resolution.

Teacher Credentialing Block Grant—$83.9 Million

- Beginning Teacher Support and Assessment program.

Professional Development Block Grant—$248.6 Million

- Staff Development Buyout Days.
- Comprehensive Teacher Education Institutes.
- College Readiness Program.
- Teaching as a Priority Block Grant.[b]

Targeted Instructional Improvement Block Grant—$874.5 Million

- Targeted Instructional Improvement Grant Program.
- Supplemental Grants.

School and Library Improvement Block Grant—$421.6—Million

- School library materials.
- School Improvement Program.

a These programs were not funded in 2004-05, but school districts are allowed to use new block grant monies for their purposes.

b Program defunded as of 2003-04, but school districts are allowed to use new block grant monies for its purposes (teacher recruitment and retention).

Figure 2 shows the programs that are consolidated in the block grant. More than one-half of the funding comes from the "core" supplemental instruction program. Other programs included in the block grant support various other supplemental instruction programs and interventions for at-risk youth. Three programs, intensive reading supplemental instruction, algebra academies supplemental instruction, and Early Intervention for School Success, were not funded in 2004-05 and therefore do not add to the total amount in the block grant for 2005-06.

Figure 2

Programs in the Pupil Retention Block Grant

2005-06
(In Millions)

Program	Services	Amount[a]
"Core" programs supplemental instruction	Supplemental instruction in core academic areas for K-12 education.	$93.2
Continuation high schools	Extra funding for new continuation high schools.	35.1
Drop Out Prevention and Recovery	Services to reduce dropout rates.	23.7
Reading, writing, and math supplemental instruction	Supplemental instruction for students falling behind in reading, writing, and math for grades 2 through 6.	19.8
Tenth Grade Counseling	Support for completing high school and pursuing educational opportunities.	12.4
High-Risk Youth Education and Public Safety	Prevention program for high-risk youth.	11.9
Opportunity Programs	Classes for pupils who are truant or insubordinate.	2.8
Los Angeles Unified At-Risk Youth Program	Intensive program for at-risk youth with school-based and residency component.	0.6
Intensive reading supplemental instruction	Reading instruction for grades 1 through 4.	—[b]
Algebra academies supplemental instruction	Intensive algebra instruction for grades 7 through 8.	—[b]
Early Intervention for School Success	Staff development in reading instruction.	—[b]
Subtotal		($199.6)
Less deferrals[c]		-26.7
Total Block Grant Amount		**$172.9**

a Amount added to block grant based on prior-year funding.

b Not funded in 2004-05.

c Deferred amounts will be provided in a separate trailer bill.

Complex "Holdback" for At-Risk Instructional Programs

Chapter 871 also creates a unique funding interaction between the PRBG and two programs for supplemental instruction that are *not* included in the block grant. These two programs provide extra help to students in grades 7 through 12 who are at risk of failing the California High School Exit Exam and students in grades 2 through 9 who have been recommended for retention. The 2005-06 budget proposes $165 million for the grades 7 through 12 program and $40 million for the grades 2 through 9 program. State law, however, entitles districts to full reimbursement for the number of instructional hours provided for at-risk students through the two supplemental instruction programs.

Chapter 871 establishes the following process to create a funding set aside for any unfunded costs of the two supplemental instruction programs:

- The act directs the State Department of Education (SDE) to allocate 75 percent of the block grant to districts.
- The other 25 percent will be held back until the required supplemental instruction has been fully funded.
- If the 25 percent holdback proves insufficient to cover the remaining costs of the additional supplemental instruction programs, the State Controller will transfer any amounts necessary from the current budget or subsequent budgets for the PRBG to cover the deficits.
- Any remaining block grant funds left from the 25 percent holdback will be distributed to districts.

Mandate Ruling Creates Another Cost Pressure

Recent action by the Commission on State Mandates (CSM) will increase the cost of the supplemental instruction program for students in grades 2 through 9. Current law requires districts to develop policies for retaining low-achieving students in grade. Students who are identified for retention under this policy must be offered supplemental instruction. The CSM found this state law to constitute a reimbursable state-mandated program.

The commission's findings are likely to substantially increase the cost of the grades 2 through 9 supplemental instruction program. In adopting the reimbursement methodology for the mandate (through the "parameters and guidelines"), CSM provided districts substantial latitude in determining the level of activities and services to comply with the state's mandate for the program. For example, the parameters and guidelines do not stipulate the allowed teacher-pupil ratios, number of hours of supplemental instruction, length of intervention, or proportions of the districts' students eligible to receive these services. While CSM's current estimate of the mandate's cost is low, districts are likely to adapt their service models to provide more costly instruction to take advantage of the uncapped funding. As a result, we think the cost is likely to grow substantially in the future—possibly into the tens of millions of dollars annually.

Block Grant Faces Implementation Problems

While the intent behind the holdback—to contain the statewide costs of the two supplemental instruction programs—has merit, it renders the PRBG unworkable from a district perspective. In addition, the holdback does nothing to alter district incentives that could significantly increase the cost of the required supplemental instruction. We describe these potential problems below.

Block Grant Robs Peter to Pay Paul. As currently structured, the holdback provision of the block grant does not encourage districts to contain the costs of the two supplemental instruction programs. Instead, Chapter 871 would pay for increased district costs for supplemental instruction by redirecting block grant funds away from other districts. As a result, districts have little incentive to contain the costs of the supplemental instruction programs.

Timing Problems Create Budget Uncertainties for Districts. Districts' efforts to plan and implement programs using the new block grant will be constrained by the timing of the 25 percent holdback provision. Current apportionment practices at SDE suggest that the department will not allocate the 25 percent holdback for at least two years after the close of the fiscal year in order to tally the final cost of the two instructional programs. As a result, districts will either have to fund programs before they know whether state dollars will be provided or reduce services to students.

Funding Inequities Among Districts May Result. Claims for the supplemental instruction programs are currently concentrated in relatively few districts. Our review shows that only 92 districts have filed any claims for the two instructional programs. As a result, these districts would likely receive funding for supplemental instruction through the holdback provision of Chapter 871. Districts that do not submit claims for the two programs may be disadvantaged, as their 25 percent holdbacks are used to fund the other districts' mandate claims. As a result, the holdback provision may increase funding inequities among districts.

Add the Required Supplemental Instruction Programs To the Block Grant

As described above, the holdback provision results in many problems. To address these concerns, we recommend the Legislature revise the structure of the PRBG to take advantage of the strengths of a block grant in encouraging districts to control the cost of the supplemental instruction programs. The current structure creates the wrong incentives for districts and makes administration of the fund problematic. Instead, we recommend the Legislature give districts freedom over the use of a fixed level of funding for *all* pupil retention and promotion programs. With this change, the state would create strong local incentives to promote the efficient and locally appropriate use of those funds.

Specifically, we recommend the Legislature:

- Adopt trailer bill language to eliminate the holdback provisions from the PRBG.
- Consolidate the two supplemental instruction programs into the new block grant. This would increase the amount in the block grant by $205 million in 2005-06 (plus $63 million in deferred payments).
- Add language in the budget bill and trailer bill to require that first call on the PRBG funds must be for all costs—including any mandated costs—of the two instructional programs. We also recommend the Legislature add trailer bill language that limits the hourly reimbursement rate under the grades 2 through 9 instructional program to the amount provided in the annual budget act. Together, these two changes would significantly reduce the likelihood of any additional district claims for the two programs.

By including the required programs in the block grant, our recommendation would require districts to determine how best to use funds in the PRBG. Consequently, districts would allocate the block grant resources among the various intervention programs. We think this would greatly strengthen local incentives for cost containment because any "excess" costs for the two programs would reduce the amount of block grant funds available for other programs funded from the grant. It also would eliminate the problem of the two-year delay in knowing the amount of block grant funds available to each districts.

LINKING TEACHING WITH LEARNING

For the last several years, we have expressed concern with the state's approach toward K-12 professional development—funding dozens of different programs that ostensibly serve the same general purpose, though they are not well coordinated and entail considerable state and local administrative burden. We also have had an overriding concern with the state's incapacity to determine the value of its various professional development investments. This incapacity is due largely to the lack of a

state-level database that tracks program outcomes. Thus, we continue to recommend that the state build a teacher database that can be linked with its student database.

Below, we review recent developments relating to the state's teacher training programs. We then describe the Governor's budget-year teacher training block grant proposal and recommend specific changes to it. Most importantly, as a condition of receiving block grant monies, we recommend participating districts be required to supply the state with the data needed to do meaningful program evaluations.

Recent Developments Enhance Flexibility, Ignore Accountability

Chapter 871 established six block grants, including two teacher training block grants—the Teacher Credentialing Block Grant and the Professional Development Block Grant—that would take effect in 2005-06 (see Figure 3 next page). The Governor's budget proposal would add three programs to the Professional Development Block Grant. The 2005-06 budget also includes trailer bill language that would nominally merge the two block grants into a new "Professional Development and Teacher Credentialing Block Grant," though the teacher credentialing component, for all practical purposes, would be preserved as a distinct program—having a separate appropriation, funding mechanism, and expenditure requirements.

Chapter 871 Provides Small Increase in Flexibility. As established by Chapter 871, the Professional Development Block Grant consolidates funding for the sizeable Staff Development Buyout Day program and two small intersegmental programs. The Professional Development Block Grant provides some additional flexibility by allowing districts to use block grant monies for teacher recruitment and retention (such as offering signing bonuses and housing subsidies) as well as professional development. It somewhat reduces this flexibility, however, by requiring districts to provide all K-6 teachers with professional development in reading language arts. The credentialing block grant is itself a misnomer. It contains only one existing program (Beginning Teacher Support and Assessment [BTSA]) and makes no changes to the associated spending requirements, thereby offering no additional flexibility.

Governor's Budget Proposal Would Provide Another Small Increase in Flexibility. As shown in Figure 1, the administration proposes to add three programs to the newly created Professional Development Block Grant—the most notable being the Peer Assistance and Review program. It also would slightly increase local flexibility by allowing block grant monies to be used for teacher training relating to the Advancement Via Individual Determination program. The block grant would not include the Mathemat-

Figure 3

Summary of Teacher Training Block Grants

(In Millions)

	2005-06 Proposed
Teacher Credentialing Block Grant	
Beginning Teacher Support and Assessment	**$83.9**
Professional Development Block Grant	
Chapter 871 Consolidated:	
Staff Development Buyout Days	
Comprehensive Teacher Education Institutes	$248.6
College Readiness Program	
Governor's Budget Proposal Adds:	
Peer Assistance and Review	$27.3
Bilingual Teacher Training	1.9
Teacher Dismissal Apportionments	—[a]
Total, Professional Development Block Grant	**$277.9**
Grand Total, Teacher Training Block Grants	**$361.8**

[a] The Governor's budget includes $43,000 for this program.

ics and Reading Professional Development (MRPD) program—despite it being the state's largest existing professional development program.

Neither Chapter 871 Nor Governor's Proposal Enhances Accountability. Chapter 871 is clear in its intent to: (1) "refocus attention . . . on pupil learning rather than on state spending and compliance with operational rules for categorical programs" and (2) "provide schools increased flexibility in the use of available funds in exchange for accountability." The teacher training block grants, however, neither focus directly on student learning nor enhance accountability. Similarly, the Governor's proposal contains no link between teacher training and student learning, no data requirements, and no accountability provisions. It would provide $362 million for teacher training without any meaningful mechanism for assessing whether the state investment was worthwhile and cost-effective compared to other education programs.

Enhance Flexibility and Strengthen Accountability

We recommend the Legislature approve the Governor's proposed additions to the Professional Development Block Grant with three modifications. Unlike the Governor's budget proposal, we recommend including the Mathematics and Reading Professional Development program in the block grant and excluding Teacher Dismissal Apportionments. Additionally, we recommend the Legislature require school districts, as a condition of receiving block grant monies, to provide the State Department of Education with specific teacher-level data that can be linked with student-level Standardized Testing and Reporting data.

In general, we recommend approval of the Governor's proposal to merge additional teacher training programs into the Professional Development Block Grant. We think, however, that increased local flexibility should be accompanied by enhanced accountability—particularly by strengthening the state's capacity to conduct comparative program evaluations. Below, we discuss our specific recommendations for changes to the Governor's budget proposal.

Include the MRPD Program. Established in 2001, the MRPD program provides teachers with 120 hours of highly structured, standards-aligned training—including 40 hours of initial intensive training and 80 hours of onsite follow-up support and coaching. School districts receive $2,500 per participating teacher and are required to use state-approved professional development providers. The Governor's proposal excludes this program because it "provide[s] specific training to teachers . . . during a limited time period." All professional development programs presumably provide some type of training to teachers, so it is unclear why this would be a criterion for exclusion from a teacher training block grant. Moreover, the MRPD program is to sunset on January 1, 2007, but it has been funded with ongoing Proposition 98 monies ever since its inception—indicating an intent to use the funds for an ongoing education purpose, such as professional development. Furthermore, the MRPD program is the state's largest remaining professional development program; excluding it would undermine one of the major advantages of block granting—increased flexibility. Finally, the Governor's proposal includes new budget bill language that would require *all* professional development activities to be aligned with the state's academic content standards and curriculum frameworks—what some believed to be the unique advantage of the MRPD program. For these reasons, we recommend including it in the Professional Development Block Grant.

Exclude Teacher Dismissal Monies. The administration proposes to include Teacher Dismissal Apportionments—a tiny budget item ($43,000) unrelated to professional development. As its name suggests, the program relates to teacher dismissal and suspension. If a governing school board seeks to dismiss or suspend a permanent employee of the district, the employee may request a hearing. The board and employee each select an individual to sit on a review panel (accompanied by an administrative law judge). If the panel members need to conduct the employee review during the summer or vacation period and they determine the employee should be dismissed or suspended, then the state (rather than the school district) reimburses them for their time (at their regular rate). It is unclear why the state would fold this item into a virtually unrelated block grant. Therefore, we recommend it be excluded.

Integrated Data System Essential for Meaningful State-Level Program Evaluations and Local-Level Accountability. If the state is setting aside monies specifically for a teacher training block grant to improve teacher quality, then it needs data on teachers' professional development activities and the effect of these activities on student learning. Under the current system (with a few exceptions), school districts fill out applications, the state gives them money, and the cycle begins anew. The state, however, does not know if programs meet their objective, if teaching and learning actually are improved, if any particular program achieves better results at a lower cost, or if certain program components are especially effective in helping schools with disadvantaged students. Without this type of information, the state will not be able to determine what types of professional development enhance student learning. With this information, professional development programs can be compared, their cost-effectiveness assessed, and budget decisions refined. This is why, for the last two years, we have recommended the state establish an integrated teacher-student data system. (Please see "Enhance State's Teacher Information System," *2003-04 Analysis of the Budget Bill* [pages E-158 to E-161], and "Enhance Accountability for Improving Teacher Quality, *2004-05 Analysis of the Budget Bill* [pages E-62 to E-64].) We would also note that many education groups have expressed interest in such systems (see nearby box).

To help the state collect the data needed for program evaluation, we recommend the Legislature require school districts, as a condition of receiving Teacher Credentialing or Professional Development Block Grant monies, to provide SDE with specific teacher-level data linked with students' Standardized Testing and Reporting (STAR) scores. Specifically, participating school districts should be required to:

- Identify the type of professional development undertaken and completed by each teacher, using a unique teacher identifier.
- Complete the currently optional STAR item identifying a student's teacher, using the same unique teacher identifier that is used to track professional development activities.

As a condition of receiving Teacher Credentialing Block Grant monies, we recommend participating BTSA programs be required to:

- Share with SDE teacher-level demographic, retention, and assessment information that it already collects, using the same unique teacher identifier. (The BTSA program currently uses a consent form to collect participating teachers' social security numbers, demographic information, teaching assignments, and education backgrounds.)

In conclusion, we recommend the Legislature establish an integrated teacher-student data system that would both promote meaningful state-level program evaluations and help hold districts accountable for using block grant monies in ways that actually improve teacher quality. Importantly, this state-level system would not be intended to replace existing processes for local teacher evaluations (some of which, however, already use locally integrated teacher-student systems). It would be intended to maximize the benefits of any potential categorical reform of K-12 professional development programs.

Nine Groups Come Together to Support Statewide Teacher Data System

In September 2004, nine groups in California came together to express their interest in developing a reliable, comprehensive teacher data system. The Teacher Information System Working Group includes representatives from teacher groups (California Federation of Teachers and California Teachers Association), school administrators (Association of California School Administrators and California County Superintendents Educational Services Association), various state agencies (State Department of Education, Commission on Teacher Credentialing, California State University, and California School Information Services), and a research center (Center for the Future of Teaching and Learning). The group believes that "gaps in the collection, use, and availability of data seriously compromise efforts to plan and monitor the teacher workforce at both the state and local level." The group already has compiled a master list of teacher data currently collected by state agencies. It continues to seek opportunities and funding for making system improvements that would maximize the usefulness and reliability of teacher data.

Assure Block Grant Monies Are Tied to Need

We recommend the Legislature adopt trailer bill language to change the funding mechanism for both the Teacher Credentialing and Professional Development block grants to ensure they remain responsive to changes in districts' needs. Specifically, we recommend Teacher Credentialing block grant allocations be determined annually based on the number of first-year and second-year teachers in the district. We recommend Professional Development Block Grant allocations be determined annually based on the number of teachers in the district with three or more years of experience.

In developing the new teacher training block grants, Chapter 871 changed the existing funding mechanisms from being dynamic and need-based to locking in the current funding distribution into perpetuity. Prior to Chapter 871, BTSA monies were allocated based on the number of participating first- and second-year teachers. Thus, it targeted funds to hard-to-staff schools with high teacher turnover as well as to growing schools with large numbers of first- and second-year teachers. Moreover, it annually adjusted districts' allocations in response to changes in staffing needs. Although less need-based, the Staff Development Buyout Day program was linked to the number of teachers attending professional development workshops. It too adjusted districts' allocations annually based on changes in the number of teachers receiving training.

Chapter 871 Severs Link to Need. By comparison, both of the new block grants lock in place the 2005-06 funding distributions and thereafter adjust them for inflation and growth in average daily attendance. Funding, therefore, will no longer be responsive to districts' staffing needs. Instead, they will create new funding inequities. Those areas most needing additional funding—those serving additional beginning teachers and those fastest growing—virtually are assured of *not* receiving it.

Re-Establish Link Between Funding and Need. We recommend re-establishing the link between districts' funding allocations and their staffing needs. Specifically, we recommend that districts' allocations for the credential and professional development block grants be made annually based on the number of beginning and veteran teachers, respectively. This will ensure that funding allocations remain dynamic and responsive to changing needs—providing more funding to those districts that most need it.

SPECIAL EDUCATION

In 2003-04, 682,000 students age 22 and under were enrolled in special education programs in California, accounting for about 11 percent of all K-12 students. Special education is administered through a regional planning system consisting of Special Education Local Plan Areas (SELPAs). In 2003-04, there were 116 SELPAs.

Figure 1 displays the amounts proposed for special education in 2004-05 and 2005-06. The Governor's budget proposes total expenditures of $4.4 billion for special education in 2005-06, an increase of $215 million, or 5.1 percent. Under this proposal, General Fund support for special education would increase by $135 million or 4.9 percent. The budget proposes sufficient funding to accommodate a projected 0.79 percent increase in the number of students in the state, a 3.93 percent cost-of-living adjustment (COLA), and an augmentation of $25 million to base SELPA funding levels.

Figure 1

Special Education Funding

(Dollars in Millions)

			Change	
	2004-05	**2005-06**	**Amount**	**Percent**
General Fund	$2,756.7	$2,891.3	$134.6	4.9%
Local property taxes	332.6	347.9	15.3	4.6
Federal funds	1,046.2	1,110.9	64.7	6.2
Totals	**$4,135.5**	**$4,350.1**	**$214.6**	**5.1%**

Our review of the 2005-06 proposed budget identifies several major issues:

- ***Technical Budgeting Issues.*** There are two significant technical issues with the proposed special education budget. Addressing these issues would increase the Legislature's fiscal flexibility in the budget year.

- ***Mental Health Services.*** The Governor's proposal does not provide a long-term solution regarding the provision of mental health services for special education students.
- ***Incidence Adjustment.*** The budget includes no proposal for updating the special education incidence adjustment, despite the fact the adjustments are based on data that is now eight years old.

We discuss these issues in detail below.

TECHNICAL ISSUES OFFER SAVINGS

The state's special education budget is supported from three sources: local property tax collections, federal special education funds, and the state General Fund. Together, the state uses these three sources to maintain a system of relatively uniform per-pupil SELPA funding levels.

The Department of Finance (DOF) developed the 2005-06 special education budget by adding funding for the anticipated level of growth in the student population in 2005-06, a COLA, and other adjustments to the 2004-05 special education budget. As part of that process, DOF revised the 2003-04 and 2004-05 figures to reflect more recent estimates of program expenditures and growth in the student population. These base adjustments are important, as they can have a significant effect on the 2005-06 budget proposal.

We have identified two major technical budgeting issues with the 2005-06 special education budget that could reduce program costs by $61 million. First, we propose an alternative method for calculating the amount of federal funds that can be counted as an offset to the General Fund. Second, we identify technical problems in the special education budget that would, if corrected, generate significant General Fund savings.

Revise Federal Supplanting Calculation

We recommend the Legislature adopt an alternative calculation for complying with new federal supplanting rules. This recommendation would reduce General Fund special education costs in 2005-06 by $9.9 million.

Congress reauthorized the federal special education law in 2004. One new provision in the act prohibits states from using federal funds to pay for "state-law mandated funding obligations to local educational agencies, including funding based on student attendance or enrollment, or inflation." It appears the new language is designed to prohibit states from using federal funds to supplant state funds for normal budget increases such as growth and COLA.

California has used federal special education funds in ways that the new federal law appears to prohibit. The *2004-05 Budget Act,* for instance, used $124 million in new federal funds to pay for growth and COLA for the entire special education budget—including the state's share. Using federal funds in this way reduced the state's cost of special education. It appears, however, that the new federal law prohibits this from occurring in the future.

The budget proposes to comply with the new federal restriction, proposing to use $38.1 million of the increase in federal funds to offset growth and COLA and $24.8 million to augment the base program. We think the budget's new supplanting calculation would not work, for two reasons. First, despite the administration's intent to comply with the new federal law, the proposal uses a portion of the federal funds to pay for state growth adjustments—something specifically prohibited by the new federal rule. Of the $38.1 million in new federal funds the budget would use to pay for prior-year adjustments, we identified $5 million in budget increases that fall into the category of "state-law mandated funding obligations." Second, we think the calculation would disadvantage the state in 2006-07 and beyond. The budget's proposed new supplanting formula works for only one year—in future years the state likely would have to pass through to SELPAs all new federal funds in the form of program augmentations.

We think there are simpler options for complying with the new federal supplanting rules that would continue to allow the state to satisfy the new law but also not disadvantage the state over the longer run. Our proposal accomplishes this goal by separating the state and federal funding for budgeting purposes. The state would be responsible for providing growth and COLA adjustments on the portion of special education funds supported by state and property tax funds. The federal government would provide funding for growth and COLA increases on the portion support by federal funds. Any increase in federal funds above the level needed for growth and COLA would be used for statewide program augmentations. Any federal increase below that level would mean that SELPAs would not be fully compensated for the effects of growth and inflation. Under this proposal, only $14.9 million must be passed through to increase special education funding—$9.9 million less than proposed in the Governor's budget.

In sum, we recommend the Legislature adopt our alternative methodology for budgeting special education federal funds at the state level. Our proposal provides a simpler, more straightforward way to comply with the intent of the new federal law than the calculation proposed in the budget.

In addition, our methodology would generate $10 million in General Fund savings. The purpose of our proposal, however, is to comply with the new federal law while protecting the state's system of local grants—not to generate short-term savings. Below, we discuss our proposal for the use of the $9.9 million and the $14.9 million in "pass-through" funds.

Significant Technical Problems With Budget Proposal

We recommend the Legislature make two technical corrections in the proposed special education budget that will free more than $36 million in funds for other special education and Proposition 98 programs.

As noted above, the DOF revised the 2003-04 and 2004-05 estimates of special education spending in the development of the 2005-06 proposed budget. Our review found two major technical problems with the adjustments to the 2003-04 and 2004-05 budgets:

- ***Lower Estimated 2003-04 Growth.*** The Governor's budget fails to recognize $16.1 million in savings resulting from the revised estimate of student growth in 2003-04, which is significantly lower than assumed in the *2003-04 Budget Act*. Because of federal "maintenance of effort" rules, these funds must be spent on special education.
- ***Overbudgeting the New Licensed Children's Institution (LCI) Formula.*** The 2005-06 budget inadvertently assumes a $19.2 million increase in 2004-05 special education costs of students residing in LCIs compared to the level included in the *2004-05 Budget Act*. This technical error results in overbudgeting the LCI formula by $20.2 million in the 2005-06 budget.

We recommend the Legislature correct these technical errors, for a total savings of $36.3 million.

Use Funds to Meet Special Education and Other Priorities

We recommend the Legislature spend $61 million resulting from our recommendations for various special education programs in 2004-05 and 2005-06.

Figure 2 summarizes the impact of the technical budgeting recommendations made above. The figure includes the $24.8 million in funds discussed in our recommendation for an alternative supplanting calculation. It also contains the $36.3 million in savings from our recommendation to correct two technical errors in the special education budget. This brings total funds available from our recommendations to $61.1 million.

Figure 2

LAO Savings and Spending Recommendations Special Education

2005-06
(In Millions)

Sources	Total
Augmentation to the LCI[a] formula	$20.2
Lower 2003-04 growth in K-12 ADA[b]	16.1
LAO supplanting proposal	24.8
Total	**$61.1**
Uses	
Mental health shift	$42.8
LCI[a] formula correction	4.4
One-time block grant	13.9
Total	**$61.1**

[a] Licensed children's institutions.
[b] Average daily attendance.

Figure 2 also shows our suggested uses of the $61 million. The 2003-04 savings are one-time in nature and, therefore, should be spent on one-time activities. The remaining funds represent 2005-06 funds that may be used for any special education purpose. Our proposal also is shaped by issues raised by the Governor's proposed special education budget for 2005-06. Specifically, we recommend the Legislature use the savings as follows:

- $42.8 million to increase support for mental health services for special education students. This would use most of the ongoing funding that is available from our savings recommendations. We discuss this issue further below.

- $4.4 million ($2.2 million in 2004-05 and $2.2 million in 2005-06) to add to the LCI formula a class of group homes that was inadvertently excluded by the enabling legislation. We discuss this issue further below.

- $13.9 million in 2003-04 funds would be distributed to SELPAs in a per-pupil block grant that could be used for any local purpose. Federal MOE rules require the state to spend these funds for special education. By using the funds as a one-time block grant, the Legislature would honor the federal rules but not permanently increase special education funding.

MAKE MENTAL HEALTH SHIFT PERMANENT

We recommend the Legislature eliminate two county mental health mandates. We further recommend the Legislature provide a total of $143 million in state and federal funds to support Special Education Local Plan Areas costs of providing mental health services to special education students.

Federal law requires schools to provide mental health services to help special education students benefit from educational services. In practice, mental health services for this population range from short-term counseling on an outpatient basis to long-term psychiatric therapy for students in residential care facilities.

In the early 1980s, the state shifted responsibility for providing more intensive mental health services from school districts to county mental health agencies. This shift created a reimbursable state-mandated program that, by 2002-03, resulted in annual county claims of $123 million. This mandated program is often referred to as the "AB 3632" program, in reference to its enabling legislation. In 1996, the state also shifted responsibility for mental health services of students placed in out-of-state residential facilities to county mental health agencies. Claims for these out-of-state students totaled $22 million in 2002-03, resulting in total claims for the two mandates of $145 million.

As with most other education mandates, the state deferred payment of the two mandates in the *2004-05 Budget Act*—that is, the mandate was kept in place but no direct county reimbursement was provided in the Department of Mental Health's budget. To help pay for these mental health services, however, the special education budget included $69 million in federal funds for distribution to county mental health agencies. These funds provide partial state reimbursement for county AB 3632 costs. An additional $31 million from the General Fund was appropriated to support mental health services provided by SELPAs.

Budget Would Suspend Mandates

The Governor's budget proposes to suspend the two mandates in 2005-06. The passage of Proposition 1A in fall 2004 requires the state to either fund or suspend local government mandates each year. Suspending the mandate frees local government from the service requirement for 2005-06.

The budget proposes no county funding for AB 3632 or out-of-state students. Because state law would not require county mental health agencies to provide services to special education students in 2005-06, responsibility for services would fall to SELPAs and school districts. (This is because federal law requires these services to be provided to special education students.) The special education budget proposes to continue the 2004-05 funding set-asides for mental health services ($69 million in federal funds for counties and $31 million from the General Fund for SELPAs). The administration has not stated its long-term intent for funding the two mental health mandates.

We recommend the Legislature permanently assign this program responsibility to SELPAs, for several reasons. A one-year suspension, as proposed in the Governor's budget, would place SELPAs in a form of limbo: Does the proposal represent a permanent shift of responsibilities to education or would the mandates be funded in the future (thereby shifting program responsibility back to county mental health agencies)? A one-year suspension, therefore, would inhibit SELPAs from making the significant local administrative changes they would need to make if the shift in responsibilities is intended to be permanent.

In addition, the proposal muddies what have been clear lines of local responsibility. By continuing to funnel $69 million in special education funding to county mental health agencies, for instance, the budget proposal gives SELPAs financial responsibility for services, but does not give them administrative or policy control related to the services provided.

Finally, we recommend the Legislature make the shift of responsibility permanent because we are convinced that, by assigning full responsibility for these services to education, the state would foster a more efficient and effective service delivery system of mental health services to students. We discuss these issues further below.

Education Would Have Incentives to Provide Services Efficiently. In our view, the shift in responsibilities would result in a more efficient system primarily because educators would have strong incentives to be a "prudent purchaser" of services. Under the existing reimbursement system, educators and county mental health agencies have incentives to *increase* the state's mandated costs. Educators have the incentive to shift all mental health costs to the county agencies—including the cost of services that remained education's responsibility after the passage of AB 3632. County mental health agencies have the incentive to include all mental health services needed by students under the mandate—even if they are not required under federal law. In addition, by reimbursing 100 percent of a county's program costs, the system also reduces pressure on county agencies to limit the unit cost of services.

Recent audits by the State Controller's Office (SCO) confirms our view that the mandate reimbursement system encourages counties to inflate the actual cost of providing required mental health services to special education students. For instance, an audit of Los Angeles County's AB 3632 claim for services provided from 1998 through 2001 disallowed 21 percent, or $8.8 million, of the county's charges. These costs were disallowed because the county charged the state for (1) services that were not covered by the mandate, (2) services that were funded by other programs, (3) offsetting funding that was not identified, and (4) costs associated with overbilling and data entry errors. The county concurred with the SCO findings. Audits of other county AB 3632 claims show similar problems.

Placing SELPAs in charge of mental health services would strengthen local incentives for the efficient use of state mental health funds. By adding funding for these services into base special education grants, SELPAs would have the resources needed to provide mental health services directly or through county mental health agencies or other contracting entities. The SELPAs, however, would have the incentive to keep these costs to a minimum—any funds not needed for mental health services could be used to pay for other special education services. As a result, by giving SELPAs a reasonable amount of funds to pay for mental health services, we think the state would establish the incentives needed for a more efficient program structure.

Shift Could Improve Effectiveness of Services to Students. Returning responsibility for mental health services to SELPAs also would result in a more effective delivery system if it encouraged educators to increase the use of less-intensive preventive mental health services. As noted above, one consequence of AB 3632 is that the program creates an incentive for educators to shift as many mental health costs to county agencies as possible. In legislative discussions on AB 3632 last spring, county mental health agency staff expressed the belief that many schools fail to provide the early intervention services that remained the responsibility of education even after AB 3632 was enacted. To address this concern, the Legislature included $31 million in the 2004-05 special education budget to *require* SELPAs to provide more early intervention services.

Placing SELPAs in charge of mental health services, however, would encourage schools to recreate the capacity to provide these intervention services. Early intervention often is more cost effective. The proposal to shift responsibility back to education, therefore, may encourage educators to intervene earlier when behavioral problems can be treated with less intensive services. This would be good for students (avoiding the need for more intensive services) and it would represent another way that changing the local incentives for mental health services would benefit the state.

For the above reasons, we recommend that the Legislature eliminate the existing mental health mandates on counties. Federal law requires school districts provide these services. By eliminating the state mandate on counties, our recommendation has the effect of returning these responsibilities to school districts.

We also recommend the Legislature revise the proposed Budget Bill language and add the full $100 million earmarked for mental health services into the base special education funding formula. In addition, we recommend the Legislature redirect $42.8 million more in funding to SELPAs for mental health services (we discussed the source of these funds earlier in this section). This would provide a total of $142.8 million to SELPAs for mental health services in 2005-06. Based on past claims (and the magnitude of disallowed county costs), we believe our proposal provides a reasonable amount to allow SELPAs to pay for the needed mental health services.

OTHER ISSUES

Cleanup Needed on New Formula

We recommend the Legislature adopt trailer bill language to recognize the special education costs for residents of a class of licensed children's institutions that was inadvertently excluded from last year's trailer legislation. Fixing this error would cost $2.2 million in both 2004-05 and 2005-06.

As part of the *2004-05 Budget Act*, the Legislature revamped the funding formula for the support of special education students who reside in an LCI. In 2002-03, more than 50,000 K-12 students lived in an LCI (including foster family homes or group homes) because the youth's family was unable to provide needed care. The Department of Social Services licenses group homes based on the services needed by youth living in each home.

Since the enactment of the new formula, however, the State Department of Education (SDE) discovered that the trailer legislation inadvertently omitted a class of group homes from the formula. Specifically, the formula failed to include 129 community care facilities that serve disabled youth who are referred by regional centers for the disabled. Adding these group homes to the new LCI model increases costs by $2.2 million in both 2004-05 and 2005-06.

To correct for this oversight, we recommend the Legislature adopt trailer bill language that adds the community care facilities to the list of group homes used to distribute special education funds. We also recommend the Legislature add $4.4 million ($2.2 million in one-time funds that must be spent on special education programs for the 2004-05 costs and $2.2 million in ongoing 2005-06 funds) to the special education budget to pay for costs associated with the additional facilities.

Incidence Factor Remains Outdated

We recommend the State Department of Education report to the budget subcommittees before March 1 on the feasibility of assuming responsibility for calculating the special education "incidence" adjustment.

The 2005-06 budget proposes $84 million to pay for the special education "incidence" adjustment in 2005-06. State law calls for these supplements to local apportionments as a way of acknowledging that, for a variety of factors, some SELPAs experience higher costs than the typical SELPA. The current adjustments were calculated in 1998 using 1996-97 cost data. Since the factors underlying local cost profiles change over time, the existing adjustments likely no longer reflect actual SELPA costs.

To update the adjustments, the Legislature required SDE to contract for a study in 2002-03. This study was completed in the fall of 2003. Despite significant data problems, the study recommended a new set of incidence adjustments. The data problems, however, were so severe that they clouded the legitimacy of these new adjustments in the eyes of many SELPA administrators. The credibility of the incidence adjustments is very important, as the adjustments are designed to increase the fairness of the state's system of uniform base special education grants.

The study identified data quality as a prime concern. The SDE maintains a comprehensive special education database that provided the data for the 1998 and 2003 incidence factor studies. According to SDE, changes to the database made in 2001-02 resulted in local coding errors that reduced the accuracy of the data. The department believes these problems have been corrected with the 2002-03 data.

The study also suggested that the state update the incidence adjustments annually in order to avoid "radical changes in funding for some SELPAs" that may occur if the adjustments are reassessed only every five years. Indeed, changes to the adjustments identified in the 2003 study were so large that the study recommended a phased approach to implementing the new adjustments. The study suggests that a more frequent calculation of the adjustments would ease transition problems.

In our view, the problems with the 2001-02 data require updating the incidence adjustments. This would be no small task, however. The study presents a series of technical and policy issues that have to be resolved each time the adjustment is recalculated. In our discussion on this issue, we asked SDE to assess the feasibility and cost of assuming responsibility for this task. At the time this analysis was written, the department was in the process of determining what resources would be needed to replicate the study.

In our view, the long-term viability of the incidence factor rides on the department's capacity to update the adjustment. The current reliance on the 1998 adjustments can no longer be defended given the many changes to SELPA costs that have occurred over the past eight years. In addition, the use of outside contractors to recalculate the adjustment is expensive and time-consuming—particularly if the Legislature would like to update the adjustment more often than every five years. If the department does not believe it can reasonably develop the capacity to assume this responsibility, the Legislature will need to either (1) consider eliminating the adjustment or (2) spend about $150,000 each year or two to update the adjustment.

To assist the Legislature in assessing its options for the long-term viability of the incidence adjustment, we recommend SDE report to the budget subcommittees on the costs and feasibility of the department assuming responsibility for calculating the special education incidence adjustment.

CHARTER SCHOOLS

Ever since it was first implemented in 1999-00, we have had concerns with the calculation of the charter school categorical block grant funding level. The basic area of disagreement has revolved around which programs are in and out of the block grant. The Governor's budget addresses these existing disagreements in one way by "delinking" the charter school categorical block grant from any set of underlying categorical programs. This delinking approach, however, undermines the purpose of the block grant and is very likely to be unworkable. We recommend the Legislature pursue an alternative reform strategy based upon a new control section in the annual budget act that would provide charter schools a share of categorical funding that is equivalent to the proportion of K-12 students they serve. This alternative approach would be simple, workable, and consistent with the original intent of the block grant.

Below, we identify the basic problems with the existing charter school block grant funding model. These problems became so significant in 2004-05 that the budget act essentially suspended the existing model and authorized a working group to try to improve it. We summarize the progress the working group made toward developing a new model. We then describe the Governor's budget proposal to reform the model, discuss our concerns with the proposal, and recommend an alternative reform approach. We conclude this section with a brief discussion of a related budget proposal that would allow colleges and universities to authorize charter schools. As we recommended last year, we think a system of multiple charter authorizers, with certain accompanying safeguards, could enhance charter school oversight and accountability.

Existing Block Grant Funding Model Has Become Virtually Unworkable

The charter school block grant was established in 1999 to provide charter schools with categorical program funding similar to public schools serving similar student populations. The block grant currently suffers from two basic problems. The primary problem is a lack of consensus regarding which programs are in and out of the block grant. A secondary problem is the funding formula used to calculate the block grant funding level is overly complex.

Categorical Confusion. Since its inception, our office and the Department of Education (SDE) have interpreted statute to include several programs in the charter school block grant that the Department of Finance (DOF) has excluded when determining the block grant funding level. Several of the programs at the center of contention are large programs with large fiscal implications for charter schools—Targeted Instructional Improvement, Regional Occupation Centers and Programs, Teaching as a Priority, Library Materials, Deferred Maintenance, and Mandates. In addition, statute is ambiguous as to whether county-administered programs, such as the California Technology Assistance Project, County Office Fiscal Oversight, California Student Information System, and the K-12 High Speed Network, are to be in or out of the block grant. A new area of ambiguity involves the block grants created by Chapter 871, Statutes of 2004 (AB 825, Firebaugh). Four of the six new block grants consolidate programs that are in the charter school block grant with programs that charter schools formerly had to apply for separately. It is unclear whether these block grants are to be subsumed into the charter school block grant, whether charter schools now have to apply separately for all six block grants, or whether all the pre-existing programs need to be tracked separately just for charter school funding purposes.

Methodological Madness. A secondary problem with the block grant is its overly complex funding formula. The formula uses 1998-99 as a base year and measures all changes from this year. Locking in 1998-99 as a base year has led to accidental funding errors (when the base year was not correctly updated to reflect budget-year adjustments). The base year also has become increasingly obsolete, with few of the categorical programs in the original block grant still remaining and many new categorical programs since created. These changes have made the formula increasingly difficult to use and have called into question the validity of the formula to account accurately for current categorical funding. In addition, the formula is sensitive to changes in revenue limits—changes that occur throughout the year and for which information is not generally available.

Working Group Makes Some Progress Toward New Model

As of a result of these problems, the *2004-05 Budget Act* contained language directing the Legislative Analyst's Office and DOF to coordinate a working group to "develop a simpler and clearer method for calculating the charter school block grant appropriation in future years." The working group, which held three meetings during fall 2004, included representatives from SDE, the Office of the Secretary for Education, the California Charter School Association, the Charter School Development Center, EdVoice, the Association of California School Administrators, the California School Boards Association, the California Teachers Association, the California County Superintendents Educational Services Association, and legislative staff. Although the group did not ultimately agree as to exactly which programs should be in and out of the block grant or on all aspects of a new block grant method, it did achieve notable consensus in important areas.

Agreed on Purpose of Block Grant. The group generally agreed that existing statute provided sufficient guidance as to the basic intent of the charter school funding system. Existing statute states, "It is the intent of the Legislature that each charter school be provided with operational funding that is equal to the total funding that would be available to a similar school district serving a similar pupil population." Moreover, the group generally agreed that the specific purpose of the block grant was to provide charter schools with funding in lieu of categorical programs.

Agreed on Principles to Guide Development of New Block Grant Model. The group generally agreed that the following principles should guide development of a new model.

- The block grant calculation should be simple.
- The calculation and its outcome should be transparent.
- The calculation should entail as little administrative burden as practicable at the local level as well as the state level.
- The calculation should result in comparable funding rates for similarly situated charter schools and other public schools.
- The calculation should not require the state to overappropriate the Proposition 98 minimum guarantee.
- Charter schools should retain existing flexibility to use block grant funds for general education purposes.

Agreed on Some Methodological Changes. The group agreed the model should no longer rely on a base year. It also preferred having one budget section govern the block grant appropriation rather than having charter provisions embedded within the budget items for every associated categorical program. It also agreed changes should be made to clarify which programs did not apply to charter schools as well as which programs charter schools were to apply for separately. However, the working group did not achieve consensus on all aspects of a new block grant model.

Governor's Proposal Is Not Viable Reform Option

The Governor's budget contains a charter finance reform proposal that attempts to address the difficulties with the current system. The Governor's funding proposal provides $68 million for the charter school block grant—a $10 million augmentation over the current year. As Figure 1 shows, this augmentation funds anticipated growth in charter average daily attendance (ADA), a cost-of-living adjustment, and a $2.9 million base augmentation. The DOF states the base augmentation is provided in recognition of charter schools' low participation in certain categorical programs and inability to access funding for other categorical programs.

Figure 1

Governor's Budget Proposal
Charter School Categorical Block Grant

(In Millions)

2004-05 Funding Level	**$58.1[a]**
Change From Current Year	
Average daily attendance growth (8 percent)	$4.6
Cost-of-living adjustment (3.93 percent)	2.5
Base augmentation	2.9
Total augmentation	$10.0
2005-06 Funding Level	**$68.1[b]**

a Of this amount, $5.3 million is deferred until 2005-06.

b Of this amount, $5.9 million is deferred until 2006-07.

The funding proposal is associated with accompanying trailer bill language that would significantly change the charter school categorical block grant by delinking it from any underlying set of categorical programs. That is, the block grant funding level would no longer represent in-lieu funding for a set of specified categorical programs. Under the proposal, once the 2005-06 funding level has been set, the block grant funding level would be adjusted in future years for growth in ADA and inflation. The block grant funding level would be reviewed every three years, beginning in 2008-09, to determine how its growth compared with growth in K-12 categorical funding generally, less a small set of special categorical programs.

Proposal Undermines Purpose of Charter School Block Grant. Despite controversy regarding exactly which programs are in and out of the block grant, the general purpose of the block grant, as indicated above, has rarely been questioned and remains quite clear—the block grant is to provide charter schools with in-lieu categorical funding. When originally established, the block grant provided charter schools with in-lieu funding for 33 categorical programs. By disconnecting it from categorical programs, the Governor's proposal undermines the policy basis of the block grant.

Proposal Very Likely to Be Unworkable. Under the Governor's proposal, it is unclear how charter schools, the Legislature, and state agencies would know which programs charter schools could apply for separately. The DOF suggests charter schools could apply separately only for those programs for which they currently can apply separately. Given the existing disagreement over which programs charter schools can apply for separately, this new statutory ambiguity is likely to generate even greater confusion over which programs are in and out of the block grant. Moreover, despite DOF's intention, the proposed language would seem to allow charter schools to apply separately for all categorical programs except Economic Impact Act. Having to apply separately for virtually every categorical program undermines one of the primary legislative purposes of charter schools, which was to offer schools greater fiscal autonomy in exchange for performance-based accountability. Nonetheless, if charter schools actually did apply separately for all categorical programs, then their categorical block grant appropriation would represent a windfall—providing charter schools with almost $300 more per ADA than noncharter schools.

Alternative Approach Could Achieve Simplicity, Clarity, and Comparability

We recommend the Legislature repeal the existing block grant model, reject the Governor's reform proposal, and adopt an alternative reform approach. The alternative approach we recommend would link charter schools' share of categorical funding with the share of K-12 students they serve. The resulting block grant amount then would be distributed among charter schools using a simple conversation factor to ensure more per pupil funding was provided for disadvantaged students. This approach is simple to understand, yields comparable charter and noncharter categorical funding rates, protects against an unintentional Proposition 98 overappropriation, remains dynamic such that it can respond to a changing array of categorical programs, and might become so automated and uncontroversial that the Legislature would not need to address the charter school finance system every year.

As with the Governor's reform proposal, we recommend the Legislature repeal the existing code sections that detail the charter school categorical block grant and its funding formula (Education Code Section 47634 and Section 47634.5). In its place, we recommend the Legislature create a new in-lieu categorical funding system for charter schools. Below, we describe each component of this alternative reform approach.

Clarifies Programs for Which Charter Schools Are Not Eligible. To address existing statutory ambiguity regarding certain types of county-run programs, we recommend the Legislature adopt a new code section that would list the categorical programs for which charter schools are *not* eligible. For these programs, charter schools neither could apply nor receive direct or in-lieu funding. We recommend this list contain programs funded and administered directly by a select group of county offices for nonclassroom-based county-level activities. Figure 2 lists the programs we recommend including in this category.

Figure 2

Programs for Which Charter Schools Would Not Be Eligible[a]

2005-06
(In Millions)

Program	Proposed Funding Level
K-12 High Speed Network	$21.0
California Technology Assistance Project	16.0
County Offices of Education Fiscal Oversight	10.5
American Indian Education Centers	4.7
Center for Civic Education	0.3
California Association of Student Councils	—[b]
Total	**$52.8**

a As recommended by the Legislative Analyst's Office.

b The Governor's budget includes $33,000 for this program.

Clarifies Programs for Which Charter Schools Must Apply Separately. We also recommend a new code section to clarify exactly which categorical programs charter schools must apply for separately. This section would be intended to reduce potential controversy regarding which programs are out of the block grant. Figure 3 lists the Proposition 98 programs for which we recommend charter schools be required to apply. As the figure shows, we recommend charter schools continue to apply separately for testing and student-information monies (to ensure their performance can be tracked), special education, and programs intended for non-K-12 populations (adult education and child development). This list is almost identical with existing statute governing the block grant funding formula and is largely consistent with the Governor's proposed trailer bill language for reviewing the block grant funding level. It also tries to be as consistent as possible with statutory directives that the charter school funding model be simple and allow for fiscal autonomy. (Nonetheless, this list still includes ten programs representing almost $5 billion in categorical funding, or approximately 40 percent of all Proposition 98 categorical funding.)

Figure 3

Programs Charter Schools Would Have to Apply for Separately[a]

2005-06
(In Millions)

Program	Proposed Funding Level
Special Education	$2,891.3
Child Development	1,177.9
Adult Education	600.3
After School Education and Safety[b]	121.6
Pupil Testing	85.9
Adults in Correctional Facilities	15.3
California School Information Services	4.5
Pupil Residency Verification	0.2
Teacher Dismissal Apportionments	—[c]
Mandates	—[d]
Total	**$4,897.0**

a As recommended by the Legislative Analyst's Office.

b Proposition 49 requires charter schools to apply separately for this program.

c The Governor's budget includes $43,000 for this program.

d The Governor's budget includes $36,000 for mandates.

Automates Funding While Ensuring Parity and Protecting Against Overappropriations. Third, we recommend the Legislature adopt a new system for providing charter schools with in-lieu categorical funding. The system would be described in statute but implemented through an annual budget control section. For all remaining Proposition 98 categorical programs (those that do not fall into the two above categories), we recommend control language that would provide charter schools a share of funding equal to the share of K-12 students they serve. Specifically, as part of the annual May Revision, SDE would project charter school's share of ADA in the budget year. This estimate would be included in the control section, accompanied with language providing the same share of funding from these remaining categorical programs to charter schools. This approach would allow SDE to distribute categorical funds immediately following enactment of the budget.

This approach eliminates the need for a base year, is not sensitive to changes in revenue limits, contains all relevant funding information in a single place, is dynamic such that it can reflect ongoing changes to the categorical landscape, and establishes a funding process that automatically produces parity. Thus, if any midyear adjustments, year-end pro-rata adjustments, or deferrals are made to any of these categorical programs, charter schools are automatically affected to the same degree as noncharter schools. Moreover, these adjustments are made without affecting overall Proposition 98 spending.

Simplifies Process, Strengthens Incentives to Serve Disadvantaged Students. Once charter schools' overall categorical funding level has been determined, we recommend a simple conversion factor be used to ensure charter schools receive more per pupil funding for the disadvantaged students they serve. Serving disadvantaged students is one of the legislative objectives of charter schools, and a supplemental disadvantaged-student funding rate is a core aspect of the existing charter school funding model. A conversion factor (for example, providing 25 percent more for every student eligible for free and reduced price meals) would be a simple means to generate incentives to serve disadvantaged students while ensuring the aggregate charter funding allocation is not exceeded.

Equalizes Funding Without Major Disruption. The model described above would provide charter schools with just over $200 million of in-lieu categorical funding in 2005-06. (This is based on DOF and SDE's assumption that charter schools will serve approximately 3 percent of all K-12 ADA in 2005-06 and on the Governor's proposed funding levels for categorical programs.) It is difficult to calculate how this compares to the amount charter schools currently are receiving. In a 2003 report, RAND found that, in California, charter schools received less categorical funding compared to noncharter public schools. If this is so, then our proposal, which provides similar funding for charter and noncharter schools, would likely result in charter schools receiving an increase in funding and noncharter public schools experiencing a slight decrease. Since the decrease would be spread over approximately 40 categorical programs, the impact on any district for any program would be minimal.

The reason that we are not able to quantify the exact impact on charter and noncharter schools is because we do not know precisely what share of categorical funding charter schools currently receive. For example, charter schools currently do apply separately for some programs (such as K-3 Class Size Reduction and English Language Learner Assistance) for which, under our alternative approach, they would receive direct in-lieu funding. To derive a precise estimate of "new" funding would require a comprehensive accounting of charter schools' existing categorical participation. Nonetheless, it is likely that charter schools with very high categorical participation and very few disadvantaged students would experience a slight reduction in funding. Similarly, noncharter schools with very high categorical participation rates would experience a slight reduction in categorical funding. In contrast, charter schools with low categorical participation and many disadvantaged students would experience an increase in funding. Noncharter schools with low categorical participation would be virtually unaffected by the new model. In short, the new system would involve some equalization and benefit charter schools with low categorical participation and many disadvantaged students.

Alternative Approach Creates Reform Structure. This alternative approach is not dependent upon any particular view of categorical programs. In other words, the Legislature might adopt the basic reform structure even if it decided to modify the list of programs for which charter schools would not be eligible or would have to apply for separately. Regardless of the treatment of specific categorical programs, we think the basic reform structure would simplify and clarify charter school finance.

In sum, we recommend the Legislature repeal the existing charter school block grant model, which has become virtually unworkable. We also recommend the Legislature reject the Governor's reform proposal, which too is very likely to be unworkable. Instead, we recommend the Legislature establish a simpler, more transparent model that results in more comparable charter and noncharter funding rates. A major advantage of the new model we describe is that it would be able to respond to an ever-changing categorical landscape—perhaps the greatest challenge confronting the existing system. The model would be directly linked to underlying categorical programs and automatically adjusted as funding for these programs changed. Indeed, it could operate so automatically that the Legislature would not need to review the charter school finance system every year. This would allow the Legislature to turn attention from the relatively technical issue of a funding formula to more meaningful issues of oversight and quality.

Alternative Authorizers Could Improve Quality

We recommend the Legislature adopt in concept the Governor's proposal to allow colleges and universities to authorize and oversee charter schools. We think a system of alternative authorizers has the potential to notably improve charter school development, oversight, and accountability. In establishing an alternative authorizer system, we recommend further attention be given both to the criteria an entity should meet prior to chartering schools and the conditions under which the state would revoke an entity's chartering authority.

The *Governor's Budget Summary* includes a proposal to allow alternative authorizers to charter K-12 schools. The proposal currently is not associated with a funding request. At the time of this writing, bill language had not yet been released, but the intent apparently is to allow colleges and universities, upon approval by the State Board of Education, to charter schools. In our January 2004 report, *Assessing California's Charter Schools*, we recommended a multiple authorizer system as one strategy for enhancing charter school development, oversight, and accountability. Below, we discuss our concerns with the existing authorizer system, explain how a multiple authorizer system might address these concerns, and highlight components of the Governor's proposal that require additional development.

Poor Incentives Embedded Within Existing System. Under the existing authorizer system, school districts are required to initially approve charter petitions that are adequately developed—even if the school districts are unlikely later to be able to conduct the oversight needed to ensure schools are honoring their charters. We have concerns with three particular types of school districts.

- ***Those Authorizing Few Charter Schools.*** RAND's 2002 charter authorizer survey found that slightly more than two-thirds of charter authorizers had authorized only one charter school. School districts authorizing only one charter school are likely to be unfamiliar and inexperienced with the petition review, oversight, evaluation, and renewal process.
- ***Those Experiencing Fiscal Difficulties.*** Some school districts are facing serious fiscal problems but nonetheless are required to authorize charter schools. We question whether these types of school districts can devote sufficient attention and resources to conducting rigorous charter oversight.

- ***Those Likely to Be Overly Receptive or Unreceptive to Charter Schools.*** School districts face various incentives stemming from their local environments that might contribute to lax or inappropriate oversight. For example, school districts experiencing facility problems or rapid growth might view charter schools as expedient solutions and be less likely to revoke charters. Conversely, school districts experiencing declining or shifting enrollment might be unreceptive to charter schools and conduct inappropriate oversight. In either case, the charter school accountability system is weakened.

Multiple Authorizers Could Improve Incentives and Constrain Costs. Allowing charter groups choice among potential authorizers might notably enhance the quality of charter development, oversight, and accountability. Charter groups might connect with authorizers who are familiar, experienced, and reputable at conducting high quality oversight and providing meaningful local assistance. They might bypass school districts that are distracted with serious fiscal problems or otherwise likely to be unable to provide adequate oversight and service. A multiple authorizer system also could have the ancillary benefit of constraining oversight costs, as schools might act as savvy consumers, selecting authorizers who provide the best service for the lowest price.

Certain Safeguards Likely to Be Needed. Although we think allowing colleges and universities to charter schools could potentially improve the charter school system, two components of the Governor's proposal require further development—the criteria entities must meet to be allowed initial chartering authority and the conditions under which this authority would be revoked. The state can provide some safeguard against errant authorizing by setting clear expectations as to the minimum qualifications expected of new authorizers. Minnesota, for example, recently began requiring initial training for new authorizers. (Minnesota has a relatively broad array of charter authorizers. Currently, the state department, 29 school districts, 20 postsecondary institutions, and 14 nonprofit organizations charter schools.) The state can provide further safeguard by setting clear expectations as to the conditions under which authorizing power would be revoked. For example, the state would want to retain power to revoke chartering authority from agencies that were negligent, mismanaged, or corrupt.

In sum, we think the Governor's proposal to allow colleges and universities to charter schools has the potential to notably improve charter schools generally, but we think some of the proposal's details require further development.

MANDATES

The Governor's budget recognizes 36 state-mandated local programs for K-12 education in 2005-06. These mandates require districts and county offices of education (COEs) to conduct a wide range of instructional, fiscal, and safety activities, and require districts to administer local processes designed to protect parent and student rights.

The State Constitution requires the state to reimburse local governments for the costs of complying with mandated local programs. The Commission on State Mandates (CSM) determines whether state laws or regulations create a mandated local program and whether the mandate requires reimbursing local governments for the costs of following the mandate. The CSM also develops claiming guidelines for the specific mandated activities that are eligible for reimbursement.

For several years, the state has not provided reimbursements to K-12 school districts for mandated programs. The *2001-02 Budget Act* was the last time the state made major appropriations for K-12 mandates. The state has instead "deferred" payments, which means that funds will be provided at some unspecified future time. Even though payments have been deferred, school districts are still required to perform the mandated services.

The budget again proposes basically no funding for K-12 mandates in 2005-06. The budget would defer payment for district and COE claims to future budgets due to the fiscal condition of the state. With this new proposed deferral (estimated at roughly $315 million), we estimate the state will owe about $1.7 billion in unpaid K-12 mandate claims by the end of the budget year. Proposition 1A, which requires the state to pay for mandates or relieve local government of the service requirements, does not apply to local education agencies. As a result, the state may continue deferring K-12 mandate costs. These deferred costs would be paid from future Proposition 98 funds.

Chapter 895, Statutes of 2004 (AB 2855, Laird), eliminated six state mandates affecting K-12 education beginning in 2005-06. Two other mandates that affected both K-12 education and other local government agencies also were eliminated. Based on 2002-03 final claims from districts and COEs, we estimate savings from eliminating the eight mandates totals more than $6 million annually. In addition, Chapter 895 directs CSM to review its decisions on the Standardized Testing and Reporting (STAR) program and the School Accountability Report Card mandates "in light of federal statutes enacted and state court decisions rendered since these statutes were enacted."

From our review of K-12 mandates, we have identified four issues:

- The budget should identify new mandates that have been approved by the Legislature.
- The State Department of Education (SDE) and the State Controller's Office (SCO) need to establish a process for sharing information on "offsetting revenues."
- The mandated cost of the new Comprehensive School Safety Plan mandate could be reduced by recognizing available revenues as offsets.
- Costs associated with the mandate to provide supplemental instruction to students in grades 2 through 9 could be reduced by limiting per pupil costs to the amount provided by the state for supplemental instruction programs.

We discuss the first three issues below. The fourth issue is discussed in the "Categorical Reform" section earlier in this chapter.

Newly Identified Mandate Review

We recommend the Legislature add eight new mandates to the budget bill in order to signal its recognition of the state's mandate liabilities.

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 eight new education mandates. Figure 1 displays the new mandates and the costs associated with each one. The CSM estimates total district costs of $77 million for the eight mandates through 2004-05. This estimate is based on actual district claims through 2002-03. In 2005-06, we estimate the new mandates will cost the state about $11.3 million.

Before the current budget crisis, the state maintained a process for including new mandates in the budget. Specifically, once CSM had completed its determination of a mandate's costs, an appropriation for the approved costs would be included in an annual "mandate claims bill."

The claims bill allowed the Legislature to review and approve the cost of new mandates—or direct CSM to reassess its approved costs based on specific issues identified during the deliberations on the bill.

Figure 1

New Mandates Approved by The Commission on State Mandates in 2004

(In Millions)

Mandate	Requirement	Accrued Costs Through 2004-05	Estimated Cost In 2005-06
Comprehensive School Safety Plan	Develop and annually update a comprehensive school safety plan.	$37.1	$5.5
Immunization Records: Hepatitis B	Ensure students have needed immunizations before entering school.	29.6	4.3
Pupil Promotion and Retention	Provide supplemental instruction to students at risk of academic failure.	9.0	1.4
Standards-Based Accountability	Provide specific accountability information (one-time).	0.6	—
Charter Schools II	Requires districts and counties to review charter petitions.	0.3	0.1
Criminal Background Check II	Requires background checks on employees and contractors.	0.3	0.1
School District Reorganization	Provide specific information on school district reorganization petitions.	—[a]	—
Attendance Accounting	Provide information for state change in attendance accounting (one-time).	—[a]	—
Totals		**$76.9**	**$11.3**

[a] Less than $50,000.

Because the state has ceased all education mandate payments, there has been no K-12 claims bill. This leaves the budget process as the primary vehicle for the Legislature's review of new mandates. The 2005-06 Governor's budget recognizes only one of the new K-12 mandates—the Comprehensive School Safety Plan. According to the Department of Finance, the commission's actions on the other K-12 mandates are still under review and may be included in an April budget revision letter or in the May Revision.

Our review of the CSM decisions on the new mandates did not identify any issues with the commission's determination of mandated costs. By adding the new mandates to the budget bill, the Legislature would signal its recognition of the state's mandate liabilities. For this reason, we recommend the Legislature amend the budget bill to include the eight mandates approved by CSM during 2004.

Offsetting Revenues Process Is Needed

We recommend the Legislature direct the State Department of Education and the State Controller's Office submit a joint plan to the budget subcommittees by April 1, 2005, outlining a process for sharing information needed to reduce the state cost of state-mandated local programs.

In past recommendations on state-mandated programs, we have discussed the problem that districts sometimes fail to recognize state funds that districts should have used as an offsetting revenue in their claims for reimbursement of mandated costs. For instance in our *Analysis of the 2004-05 Budget Bill* (please see page E-104), we noted that several district claims we reviewed for the STAR program did not recognize the annual apportionment for local program costs that is included in the budget each year. Statute directs local governments to recognize any such revenues as an offset that reduces their total claim for reimbursement.

The SCO processes school district claims for mandate reimbursement. While SCO reviews the claims for completeness and accuracy, it does not have access to data on the amount of state funds districts receive in programs that have been identified as offsetting revenues to specific mandates. Without that information, the SCO review cannot assess whether a district claim appropriately identified the availability of such revenues.

The state would benefit from ongoing exchange of information on state mandates between SCO and SDE. The SDE maintains data on the amount provided to each district in K-12 categorical program funding. If SDE supplied SCO with district allocations for specific programs, the Controller would be able to double check that districts were identifying offsetting revenues for specific mandates. Because district claims appear to be weak in this area, giving the Controller apportionment data could save the state a significant amount of funds.

The SCO also has information that would be useful to SDE. Specifically, SCO could provide feedback to SDE on current issues with specific mandates. For instance, SCO could inform the department when claims for specific mandates increase significantly. Since SCO also audits district mandate claims, it could discuss problems with specific mandates that are discovered through the audit process, such as offsetting revenues, that significantly increase state costs. With this information, SDE could advise the Legislature about statutory or budget changes to address these issues.

While sharing information seems like a simple task with significant benefits, it does not routinely occur. Therefore, we recommend the budget subcommittees direct SDE and SCO to jointly develop a plan for sharing data needed by both agencies. To give the subcommittees time to review the plan, we recommend the subcommittees require the agencies to submit the report by April 1, 2005.

Strengthen Language on Offsetting Revenues

We recommend the Legislature add budget bill and trailer bill language to ensure that districts use available funds to pay for local costs of the new Comprehensive School Safety Plan mandate.

The Comprehensive School Safety Plan mandate requires each K-12 school to develop and annually update a school safety plan. The plan must identify "strategies and programs that will provide or maintain a high level of school safety." The planning requirements are quite specific. For instance, the law requires schools to consult with local law enforcement in the writing of the school plan. The plan also requires schools to include in the plan (1) procedures for child abuse reporting; (2) the definition of "gang-related apparel;" and (3) other existing policies on sexual harassment, emergency disasters, and school discipline. We estimate the costs of the mandated planning process in 2005-06 at about $5.5 million. Since only about one-third of districts submitted a claim for this mandate, the long-term cost could be considerably higher.

The statute requiring the safety plans expresses the Legislature's intent that districts use existing funds to pay for the costs of developing the plans. The language, however, does not specifically identify any existing program that the Legislature intended districts to use for the planning process. The commission identified at least two possible funding programs that could support the mandated activities. Without an explicit requirement in law, however, CSM could not identify these programs as a required offsetting revenue. In this case, unless *districts* identify the funding sources as an offset, the state cannot require districts to use the funds to pay for the mandated planning process.

The two programs identified by CSM include a grant program for new school safety plans and the Carl Washington School Safety and Violence Prevention Act. In 2004-05, the budget act contains $1 million for the new school safety planning grants program. The program was merged into the School Safety Consolidated Competitive Grant program by Chapter 871, Statutes of 2004 (AB 825, Firebaugh), beginning in 2005-06. The Carl Washington program supports local activities to improve middle and high school safety programs. The budget proposes $91 million for this program in 2005-06.

Budget Proposes New Provisional Language. The proposed budget bill contains provisional language placing "first call" on funds in these two programs for any local costs of the Comprehensive School Safety Plan mandate. This language would require districts to first use funds to pay for the costs of the planning mandate. This language is appropriate because it would induce districts to use these school safety funds as offsets to any subsequent district claim for costs associated with this mandate. We think, however, a couple of other changes are necessary. First, we suggest adding a *statutory* first call provision to both programs, which would reinforce the priority of the programs' funds for mandated planning costs. Second, we have identified several technical issues that need to be corrected with the new language.

We also have identified an appropriate fund source for the cost of planning in elementary schools—the School Improvement Program (SIP). The SIP supports a wide range of school site activities, guided by a parent-teacher school site council. Since the Comprehensive School Safety Plan mandate directs site councils to develop the safety plan, we think the Legislature should require districts to use SIP funds to pay for the mandated school plans. Virtually all elementary schools receive significant annual funding under SIP.

As part of Chapter 871, the Legislature consolidated SIP into a new School and Library Improvement Block Grant. The budget proposes $419 million for the block grant in 2005-06—virtually all of these funds are currently part of the 2004-05 SIP appropriation. Thus, adding both budget and statutory direction for districts to use funds in the School and Library Improvement Block Grant would recognize that, in creating the Comprehensive School Safety Plan mandate, the Legislature added another duty to school site councils that should be paid from funds provided to the council.

AFTER SCHOOL PROGRAMS AND PROPOSITION 49

21ST CENTURY COMMUNITY LEARNING CENTERS NOT SPENDING FEDERAL GRANTS

The state has had problems in taking full advantage of federal funds for the 21st Century Community Learning Centers Program (21st Century program). By the end of 2004-05, the state could have up to $100 million in carryover funds. We suggest various steps the Legislature could take to reduce the carryover problems over the next several years.

Below, we first describe the purpose and structure of the 21st Century program and compare it to the state's After School Education and Safety (ASES) Program. In the following section, we describe the problems with unspent funds and discuss possible causes. We then provide several recommendations to begin reducing the level of unspent funds.

Background

The 21st Century program is a federally funded before and after school program that provides disadvantaged K-12 students with academic enrichment opportunities and supportive services to help the students meet state and local standards in core academic content areas. In the past, the federal Department of Education (DOE) awarded three-year competitive grants for these centers directly to school districts. In 2001, the reauthorized Elementary and Secondary Education Act converted the 21st Century program to a state formula program. Starting in 2002, DOE began phasing out the direct federal grants and began transitioning the program to a state-administered one.

The federal grant to California, which was $41.3 million in 2002-03, has steadily increased since then. In 2005-06 the federal grant amount is $136 million. The state has 27 months from the date the state appropriates funding in the annual budget act to spend these 21st Century program funds. Unspent funds are returned to DOE.

State Law Restricts 21st Century Program. The state implemented the 21st Century program at the elementary and middle school levels generally to parallel the state ASES program:

- ***Maximum Grants.*** Grant levels are capped at $75,000 for elementary schools with 600 or fewer students, $100,000 for middle schools with 900 or fewer students, and $250,000 for high schools. For larger schools, a per pupil funding formula allows higher maximum grant amounts.
- ***Per Pupil Reimbursement Rates.*** The elementary and middle school programs are reimbursed at a rate of $5 per student per day. (The state program, however, requires a 50 percent local match, increasing the total spending level to $7.50 per student per day. Federal law prohibits a local match on the 21st Century program.)

Small portions of the federal funds are used for high school grants, "equitable access," and support of family literacy programs.

Funds Are Consistently Underutilized

Since the inception of the state-administered 21st Century program, the State Department of Education (SDE) has experienced problems using these funds to serve eligible schools and students. Each year, SDE has carried over a substantial portion of appropriated funds into the following budget year. Figure 1 shows the state appropriations for the three years of the state-administered program and the amounts and proportions of funds that are expected to be spent by specified dates. For example, only 42 percent of the 2002-03 appropriation and 55 percent of the 2003-04 appropriation has been spent to date. The SDE has estimated that $119 million of the current year's appropriation (74 percent) will be spent. We think that this estimate is overly optimistic, given past experience, and would expect that much less will actually be spent.

Figure 1

21st Century Program Spending Lags Appropriations

(Dollars in Millions)

	2002-03	2003-04	2004-05
State appropriation	$40.9	$75.5	$162.8
Spending (estimate)	17.1	41.3	119.8
Percent spent	42%	55%	74%

Spending Roadblocks. The SDE and school districts are both responsible for these funds not being used to serve more students. Most of the problems are concentrated with the elementary and middle school grantees. Two primary issues appear to account for this:

- ***SDE Slow in Awarding Grants.*** First, SDE has not provided grant funds to grantees until the fiscal year is well underway in most years. For example, in 2002-03, grant award letters were not sent until April 2003, and in 2003-04, award letters for new grantees were not sent until July 2004—after the close of the fiscal year. For 2004-05, award letters were mailed in the late fall; however because of the paperwork requirements, funds were not disbursed until January 2005. When grantees do not know whether or when they will receive their grants, their efforts at program planning can be significantly hampered. For example, the new cohort of schools funded in 2003-04 only spent 15 percent of their funds in the fiscal year.
- ***Schools Do Not Fill All of Their Slots.*** The SDE grants a maximum dollar amount to a school—for example, $75,000 for an elementary school. The elementary and middle schools then must earn the grant at a rate of $5 per student per day (except for in the first year of the grant, when up to 15 percent can be used for start-up costs). Most schools are not able to earn their grant and must return funds to the state at the end of the fiscal year. Based on the short history of the program, schools on average have only earned about one-half of their grants, returning funds to the state at the end of the year.

Reversions of Federal Dollars a Threat by End of the Budget Year. The state avoided returning any 2002-03 federal monies (which had to be fully spent by September 2004) and it may spend enough by September 2005 to avoid reverting 2003-04 federal funds. However, available data from SDE suggest that $100 million of the 2004-05 federal funds will not be spent in the current year. As a result, these unspent funds could revert to DOE in September 2006 unless the Legislature takes action to change key aspects of the state's approach to disbursing 21st Century program funds.

One-Time Grants a Bad Strategy. Late in spring 2004, SDE notified the Legislature of the large carryover balances in this program, leaving the Legislature little time to develop a longer-term strategy. So, the state gave providers one-time grants totaling $25 million on a statewide basis from these carryover funds. Because these funds must be used for one-time purposes, it is not likely that they were used to serve additional students—the goal of the program. A better approach for taking full advantage of these funds is to restructure the program. We discuss such an approach to serve more kids below.

Restructure Program and Serve More Kids

We recommend the Legislature pass legislation creating a new group of grantees to begin in late summer 2005. In addition, we recommend the Legislature increase reimbursement rates, annual grant caps, and start-up funding for the elementary and middle school programs in their first year.

We believe that the Legislature needs to take action immediately to restructure this program. We recommend a series of measures aimed at increasing the possibility that grantees will be able to earn their grants within the budget year. Our recommendations will establish funding rate parity between the 21st Century program and ASES, provide grantees with the ability to establish program infrastructure prior to enrolling students, and enable grantees to start programs at the beginning of the fiscal year.

Create New Cohort. We recommend the Legislature pass urgency legislation this spring to appropriate funding for a new cohort of schools. This accelerated timeline would allow SDE to issue grants in summer 2005, and provide an opportunity for new grant recipients to earn a larger share of their grants in the first year by beginning the program with the school year.

Increase Elementary and Middle School Daily Reimbursement Rate and Increase Grant Caps. We recommend increasing the reimbursement rate for elementary and middle schools to $7.50 per student per day and increasing the statutory spending caps for the elementary and middle school programs. The current reimbursement rate for the elementary and middle school programs of $5 per pupil per day is less than the state rate of $7.50 per pupil per day (including the state required local match). Since the federal government prohibits a local match, the rate increase is a way to equalize funding between the state and federal programs.

If the Legislature acts to increase the reimbursement rate, we recommend it also increase the statutory schoolwide spending caps. The combination of the current $75,000 cap for an elementary school with 600 or fewer students and a $7.50 reimbursement rate would mean that elementary schools could serve a maximum of only 55 students per year. In a school with 600 students, 55 students would represent only 9 percent of the student body. We recommend the Legislature increase the school grant caps to $150,000 for elementary schools and $200,000 for middle schools.

Provide Larger Start-Up Grants for Elementary and Middle Schools. Currently, the elementary and middle school grantees must earn their grants by documenting student attendance. However, any program has start-up costs and fixed operating expenses that are required for any level of service. Currently, SDE provides 15 percent of the first-year grant amount that grantees do not have to "earn" with student attendance. Given the significant start-up investments that programs must make in order to attract and enroll students, 15 percent may be inadequate. We propose the Legislature amend state law to increase the first-year start-up amount that does not need to be earned with attendance to 25 percent of the total grant amount. This would allow schools to address some of the facility, staff, equipment, and materials costs that are part of starting up a new program. From the state level, it would also help to ensure that a larger portion of first-year grants are actually used.

We believe that this three-pronged approach of a new cohort, higher reimbursement rates, and larger start-up grants would help the state to begin reducing the level of unspent funds and serve more children.

PROPOSITION 49: AFTER SCHOOL EDUCATION AND SAFETY PROGRAM

We 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.

As approved by voters in 2002, Proposition 49 requires the state to provide substantially more funding for the ASES program beginning some time between 2005-06 and 2007-08. When certain conditions are met (please see nearby box next page), the proposition triggers an automatic increase in state funding for the program—from the $122 million provided in 2003-04 to $550 million (a $428 million increase). Importantly, when these additional funds are provided for the program, they will be "on top of" the state's Proposition 98 minimum funding guarantee (referred to as an "overappropriation"). Proposition 49 also converted after school funding to a "continuous appropriation" (that is, no annual legislative action is needed to appropriate funds).

We have serious concerns with the proposition, which we discuss in detail below.

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. Whether Proposition 49 triggers in the budget year or as late as 2007-08, the state is likely still to be facing a significant budget problem. Moreover, the autopilot formula that triggers Proposition 49 creates additional spending obligations without the Legislature and Governor being able to assess

Disagreements Linger Over Proposition 49 "Trigger"

Proposition 49 requires the state to provide additional funding for after school programs when General Fund spending reaches a certain level. Specifically, the Proposition 49 trigger is calculated by (1) determining, for 2000-01 through 2003-04, when the level of "nonguaranteed" General Fund appropriations was at its highest level and (2) adding $1.5 billion to that base-year funding level. Two technical issues complicate the calculation of the trigger.

- *What Are Nonguaranteed Appropriations?* The definition of this term is open to interpretation. We think the term refers to non-Proposition 98 General Fund appropriations plus any overappropriations of the Proposition 98 minimum guarantee. Others believe Proposition 98 overappropriations are guaranteed. Under the latter view, Proposition 49 triggers sooner.

- *Treatment of Vehicle License Fee (VLF) "Swap."* The state's actions in the current year to meet local government VLF obligations with property tax revenues instead of General Fund payments (the VLF swap) essentially converted $4.8 billion of General Fund monies from nonguaranteed to guaranteed appropriations. The statutory language in Proposition 49 is unclear as to whether the base-year General Fund nonguaranteed spending should be adjusted (or rebenched) downward to account for this type of action. If rebenched, Proposition 49 would trigger sooner.

The figure below shows the uncertainty these two technical issues cause for determining when the Proposition 49 funding requirement is triggered. Depending upon how overappropriations and the VLF swap are treated, the trigger could be as soon as the budget year or as late as 2007-08. Since the trigger would likely require the entire $428 million augmentation be provided all at once, this uncertainty is a significant budget risk.

When Does Proposition 49 Trigger? Assumptions Matter

	Rebench for VLF[a] Swap	
Proposition 98 Overappropriations	**Yes**	**No**
Treat as nonguaranteed	2006-07	2007-08
Treat as guaranteed	2005-06	2007-08

[a] Vehicle license fee.

the merits of the augmentation. The additional spending also likely would require the state either to raise additional General Fund revenues and/or make program cuts in other areas.

Lower K-12 Education Priority. In previous sections, we have discussed the fiscal problems that school districts will 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. If the state were planning to overappropriate Proposition 98, we think providing the funding to address the $3.6 billion on the education credit card (discussed in the "Proposition 98 Budget Priorities" write-up in the "Crosscutting Issues" section of this chapter) would be a better strategy for helping districts address some of their current fiscal challenges.

Proposition 49 Funding Not Likely to Be Spent in a Timely Manner. As discussed above, the state is having a difficult time spending its relatively small increases in federal after school funding in a timely fashion. Since 2002-03, federal after school funding has grown to an annual level of $136 million, yet the state has been spending only about one-half its federal allotment and is now at risk of reverting federal monies. Since the late 1990s, the state also has had difficulty expending its state-funded ASES program. The program continues to revert funding annually, spending around 80 percent of the grant annually.

Given that the trigger mechanism likely would provide a $428 million augmentation all in one year, schools also are not likely to be able to spend much of the new funding in the near term. As with any new grant program, the state typically has a difficult time spending the allotted funds in the first couple of years. Given the size of the augmentation, as well as the poor track record of getting additional after school funding to schools, the state is likely to have hundreds of millions of dollars revert annually in the initial years of 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 recommend the Legislature enact legislation placing before the voters a repeal of Proposition 49.

CHILD CARE

California's subsidized child care system is primarily administered through the State Department of Education (SDE) 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 Governor's 2005-06 budget.

As the figure shows, the budget proposes about $2.6 billion ($1.3 billion General Fund) for the state's child care programs. This is an increase of about $33 million from the estimated current-year level of funding for these programs. About $1.2 billion (46 percent) of total child care funding is estimated to be spent on child care for current or former California Work Opportunity and Responsibility to Kids (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 488,700 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 SDE.

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.

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

Figure 1

California Child Care Programs

2005-06
(Dollars in Millions)

Program	State Control[a]	Estimated Enrollment	Governor's Budget
CalWORKs[b]			
Stage 1[c]	DSS	98,000	$498.8
Stage 2[c]	SDE	94,000	575.4
Community colleges (Stage 2)	CCC	3,000	15.0
Stage 3[d]	SDE	14,500	87.6
Subtotals		(209,900)	($1,167.8)
Non-CalWORKs[b,e]			
General child care	SDE	88,000	$632.1
Alternative Payment programs	SDE	71,000	430.0
Preschool	SDE	101,000	325.4
Other	SDE	18,700	54.2
Subtotals		(278,800)	($1,441.6)
Totals—All Programs		**488,700**	**$2,609.4**

a Department of Social Services, State Department of Education, and California Community Colleges.
b California Work Opportunity and Responsibility to Kids.
c Includes holdback of reserve funding which will be allocated during 2005-06 based on actual need.
d Significantly reduced due to Governor's reform proposal to move current Stage 3 recipients to general child care.
e Does not include after school care, which has a budget of $250 million and is estimated to provide care for 249,500 school-aged children.

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 SDE 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 SDE) 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.

GOVERNOR'S CHILD CARE REFORM PROPOSALS

Figure 2 shows the child care reforms proposed by the Governor and their fiscal impact. The Governor's reforms fall into two broad categories: (1) eligibility for child care services and (2) provider reimbursement rates. The changes to eligibility feature a redistribution of child care slots to promote greater equity in child care access between CalWORKs recipients and the working poor. At the center of the rate reforms is a quality-driven tiered reimbursement rate structure. Most of the reforms would only affect the voucher program, leaving the SDE contracted programs basically unaltered.

Figure 2

Administration's Child Care Proposals

2005-06
(In Millions)

Reform	Cost/ Savings
Eligibility	
Moving Stage 3 Child Care Permanently expand the general Alternative Payment (AP) program by shifting all current CalWORKs Stage 3 child care recipients, and the associated funding, to the AP program, limiting guaranteed child care to a maximum of eight years and limiting Stage 3 to one year.	**—**
Creating Centralized Waiting Lists Require counties to create a two-tiered waiting list for all subsidized child care: the first tier for families below 138 percent of the federal poverty level (FPL) and the second tier for families above that level.	**$7.9**
Rebenching Child Care Eligibility Shift eligibility determination to FPL measures rather than the current State Department of Education state median income calculations.	**—**
After School Care for 11- and 12-Year-Olds Designate after school care as the default placement and require parents to submit a reason in writing that they cannot use the available after school program.	**-$23.8**
Reimbursement Rates	
Tiered Reimbursement Rates Reduce the amount the state is willing to pay license-exempt providers. Further, create fiscal incentives for all providers to raise the quality of the care they provide and encouraging additional training.	**-$140.1**
Equitable Provider Rates Adopt regulations establishing an alternative rate setting mechanism for providers that only serve subsidized families. These regulations have been suspended for the last two years.	**-$8.2**

ELIGIBILITY REFORMS

Shifting CalWORKs Families to AP Programs

The Governor proposes to shift Stage 3 California Work Opportunity and Responsibility to Kids (CalWORKs) child care to the State Department of Education's Alternative Payment (AP) program, in addition to creating centralized county waiting lists for subsidized child care. Timing problems under the Governor's proposal may disadvantage current CalWORKs recipients' attempts to receive long-term subsidized child care. To address this issue, we recommend delaying the shift of the Stage 3 program to the AP program until counties have created centralized waiting lists. We also recommend placing current CalWORKs participants on the waiting lists based upon the date that they first had earned income in the program.

Eliminating the Long-Term CalWORKs Child Care Guarantee

Under current law, current and former CalWORKs families are guaranteed child care as long as they meet eligibility requirements and have a need for child care. The Governor proposes shifting all current CalWORKs Stage 3 families (former CalWORKs recipients) into the AP program along with the associated funding and ending the child care guarantee for CalWORKs families. In other words, all families who are receiving Stage 3 child care as of June 30, 2005 would in the future be served by the non-CalWORKs AP voucher program. (Local AP providers assist families in locating child care and distribute vouchers to those families.) This shift would permanently expand the AP program. There would be no impact on families currently receiving service as their child care guarantee would not change. However, any families coming into Stage 3 CalWORKs after this point would be limited to one or two years.

Under this proposal, families who leave CalWORKs after June 30, 2005 would be allowed two years of transitional child care in Stages 1 and 2, and one year in Stage 3. In other words, they would be guaranteed child care for three years after leaving aid. If a family is currently off aid and in Stage 1 or Stage 2, the family would receive two years of Stage 3 child care while they are on the waiting list for a child care slot in the AP child care program. These families' child care guarantee would be for a maximum of four years after leaving aid, depending on the time they have left in Stage 2. Figure 3 shows the guaranteed time in child care for current and former CalWORKs families under current law and under the Governor's proposed reform.

Figure 3

CalWORKs[a] Child Care
Current Law and Governor's Proposal

	CalWORKs Child Care Guarantee		
Family Status	**Current Law[b]**	**Governor's Proposal**	**Centralized Waiting List**
Aided family with earnings	Until family's income exceeds 75 percent of SMI[c] or children age out.	Remaining time in CalWORKs plus three years. Same age/income limits.	As soon as list is created.
Aided family without earnings	Same as above.	Same as above.	When parents become employed.
Formerly aided family in Stage 2	Same as above.	Up to two years in Stage 2 and two years in Stage 3.	As soon as list is created.
Formerly aided family in Stage 3	Same as above.	Until family's income exceeds 75 percent of SMI[c] or children age out.	Child care guaranteed. No waiting list.

a California Work Opportunity and Responsibility to Kids.

b Current practice has been to fully fund Stage 3 child care, which allows all former CalWORKs families to be served. However, Stage 3 is not an entitlement and is therefore subject to the appropriation of adequate funding.

c State median income.

This proposal allows all CalWORKs families to place their names on the waiting list as soon as they have earned income. Therefore, CalWORKs families would not have to wait until leaving aid before they can compete for SDE's subsidized child care. However, they would need to wait until they have earned income, which would be problematic for the families nearing their CalWORKs time limits who have been participating in welfare-to-work activities other than employment (such as community service or vocational education). Adults in CalWORKs have a five-year time limit.

We note that in contrast to last year, this proposal preserves the child care guarantee for families already in Stage 3 and allows aided families to place their names on centralized waiting lists as soon as they have earned income. These changes address the major concerns we raised in the *Analysis of the 2004-05 Budget Bill*.

Two-Tiered Waiting Lists

In addition to the changes in Stage 3, the Governor has proposed creating centralized county waiting lists for SDE subsidized child care.

Current Waiting Lists for Subsidized Child Care. There is not enough funding available to serve all of the working poor non-CalWORKs families who qualify for subsidized child care. Therefore, providers create waiting lists for those families seeking subsidized child care. Families place their names on waiting lists in the hopes of receiving assistance with the cost of child care. While there is currently no information on the number of families on waiting lists or the amount of duplication among the lists, it is commonly believed that families place their names on multiple lists in order to increase their chances of receiving subsidized child care. When a provider has a space for a subsidized family, that provider is required to serve the family on their list with the lowest income first, unless the family is referred by child protective services, in which case they receive priority.

Centralized List. The Governor proposes eliminating provider waiting lists and requiring each county to develop a centralized waiting list for all subsidized non-CalWORKs child care. The budget includes $7.9 million (General Fund) for this purpose. County waiting lists would be split into two different tiers, while maintaining the existing priority for families referred by child protective services. Families earning less than $2,168 per month (for a family of four) would be placed in the first tier of the waiting list and would be provided with child care on a first-come, first-served basis. This would include all CalWORKs families with earned income because under current law, a family of four is no longer eligible for CalWORKs once they have an income of $1,951 per month.

The second tier would be for families who have a monthly income above 138 percent of the federal poverty level (FPL), approximately $2,168 per month for a family of four. These families would be served only after all first-tier families have been served. From this list, families would be served based on income, with the lowest-income family served first.

Advantages to Governor's Proposal

Dismantling Stage 3 Helps Create Parity Among All Working Poor Families. Under the current system, families that receive child care through the CalWORKs system have traditionally been guaranteed subsidized child care until their incomes exceed eligibility limits or their children age out of the child care system. Conversely, working poor families that have not participated in the CalWORKs program must compete for the limited subsidized child care slots in their communities. The Governor's proposal permanently expands non-CalWORKs subsidized child care and effectively limits Stage 3 CalWORKs child care to one year. While the total number of child care slots would not change, this would provide greater access to child care for working poor non-CalWORKs families. Some of these working poor families may have family income significantly below many of the Stage 3 CalWORKs families.

Centralized Waiting Lists Would Provide Critical Information for Policymakers. As mentioned previously, there are virtually no centralized waiting lists in counties and those counties with centralized waiting lists cannot require providers to participate. Consequently, the Legislature and the administration have no way of knowing how many families need subsidized child care and are not receiving it, or the length of time families remain on waiting lists without being served. Centralizing the waiting lists would allow counties to establish an accurate count of families in their communities that are eligible and waiting for subsidized child care, and would allow them to clean up waiting lists by removing duplicate names or families that are no longer eligible for child care. They would also be able to determine the average length of time a family remains on the waiting lists. Having data provides the Legislature with the information it needs to determine the adequacy of California's subsidized child care system.

Implementation Concerns

Centralized Waiting Lists Should Be Created First. The Governor's proposal moves all of the current Stage 3 child care cases as of June 30, 2005 to general AP child care upon passage of the budget. This shift would not impact the current families in Stage 3. However, families in Stage 2 that would be moving to Stage 3 within the next year or so could be adversely affected during the transition period. This is because it will take time for counties to collect and merge all of the existing provider waiting lists in each county and then to sort through duplicate entries and determine whether a family should be placed on the first tier or second tier of the waiting list and in what order. Until this process is completed, there will not be a centralized waiting list for CalWORKs families on which to place their names. Moreover, to the extent that families leave the general AP program before the lists are created, those child care slots may remain unused or will only be available to working poor families on current waiting lists. In order to avoid this confusion and the delay in families receiving subsidized child care, the centralized waiting lists should be created before Stage 3 child care is dismantled.

CalWORKs Recipients May Be Located at the Bottom of the Waiting Lists. According to the administration, the centralized waiting lists in each county will be established by merging all of the existing lists that subsidized child care providers now maintain. As these lists are merged, families will be placed in the higher second tier (above 138 percent of the FPL) in lowest-income-first order. The remaining families (at or below 138 percent of the FPL) will be placed in first-come, first-served order based upon the length of time they have been on their existing lists.

For the most part, the existing waiting lists do not contain the names of current and former CalWORKs families because those families have been served under the CalWORKs child care program. This means that all current or former CalWORKs families with earned income who need child care and are not currently in Stage 3 will have to place their names on the centralized county waiting lists. Most of them will be eligible for the lower first tier (below 138 percent of the FPL) of the waiting lists. Because the waiting lists would be created by merging existing lists that do not include these families, virtually all of the CalWORKs families will be placed at the bottom of the lists. Depending on the availability of subsidized child care and the length of the waiting lists in each county, CalWORKs families that have exhausted much of their five-year CalWORKs time limit will be at a disadvantage and are less likely to receive subsidized child care once their time in the CalWORKs child care program comes to an end.

In order to address this problem, during the initial development of the lists, CalWORKs families with earned income could be placed on the waiting list according to the date that they began working. Theoretically, non-CalWORKs working poor families placed their names on waiting lists when they had their first child and/or began working. Placing CalWORKs families in a similar position on the waiting lists by their work dates creates parity between the two groups. There may be some slight CalWORKs administrative costs associated with determining the appropriate dates for families. However, those costs should be minimal.

Funding May Grow Slightly Faster Under Governor's Proposal. We would note that funding for these former Stage 3 child care slots may grow faster under the Governor's proposal than under the current program. This is because the cost-of-living adjustments (COLAs) and growth adjustments used for subsidized child care are projected to increase at a greater rate than the caseload and COLAs used for CalWORKs child care.

LAO Recommendation

We believe there is considerable merit to the Governor's proposed changes to subsidized child care for CalWORKs families. Shifting CalWORKs Stage 3 child care to AP child care and creating centralized two-tiered waiting lists will allow more equitable access to subsidized child care for all families with very low incomes, whether they have participated in the CalWORKs program or not. However, in transitioning to this new system and essentially dismantling Stage 3 child care, it is important that current CalWORKs families not be disadvantaged. Accordingly, we recommend delaying the shift from Stage 3 to AP child care by six months, thereby allowing enough time for counties to develop centralized waiting lists that include CalWORKs families within that six-month period. Once a county has a functioning waiting list, it can then shift its child care program.

In order to avoid placing existing CalWORKs families at the bottom of the waiting lists, we recommend placing CalWORKs families on the waiting list based upon the date they first had earned income in the program. However, CalWORKs families will still be expected to take the initiative of signing up for AP child care. To avoid lingering administrative problems, we recommend that CalWORKs families only be given 120 days once the list is functioning to ask to be placed, based upon their employment date. Once the 120-day period is up, CalWORKs families would be placed on the centralized waiting lists on a first-come, first-served basis.

Making these two adjustments to the Governor's proposal will ensure that existing CalWORKs families will be given a level playing field to compete with other working poor families for subsidized child care.

Governor Proposes Further Reforms for 11- and 12-Year-Olds

The Legislature was concerned about the Governor's 2004-05 budget proposal to shift 11- and 12-year-old children to after school programs. Many working poor families, whether CalWORKs or non-CalWORKs, are employed in nontraditional jobs that require working evenings, nights, and weekends. For these families, after school care usually is not a realistic option for their children. Therefore, the Legislature modified the Governor's proposal to encourage, rather than mandate, after school placement. Specifically, families were not required to shift their children to after school care and the Legislature established a reserve to continue to fund child care for these families.

To further strengthen the after school reform from the prior year while recognizing the difficulties faced by some families, the Governor has proposed making after school care the default placement for 11- and 12-year-olds. However, to the extent that this type of care is not acceptable or practical for families, they may submit their reason in writing and receive an alternate form of child care for their children. The budget assumes that 25 percent of families with 11- and 12-year-olds will shift them from child care to after school care.

We believe this modification allows families to continue to have flexibility in their child care decisions and addresses the concerns expressed by the Legislature in the previous budget.

REIMBURSEMENT RATE REFORMS

The Governor's proposal includes two reforms related to provider rates. The first would create a new system of tiered provider reimbursement. The second would revise regulations for determining rates for providers who do not have private pay clients.

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 receive a voucher from CWD or AP. In addition, the state provides vouchers to working poor families through APs. The combined programs provide about 272,900 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 85th percentile of the rates charged by private market providers in the area offering the same type of child care. The 85th 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 (85th 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.

SDE Contracts Directly With Child Care and Preschool Centers. For child care and preschool, SDE contracts directly with 850 different agencies through approximately 2,100 different contracts. These providers are reimbursed with the Standard Reimbursement Rate, $28.82 per full day of enrollment. 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.

In the nearby box, we provide a list of the child care terms and corresponding definitions used throughout the remainder of this section.

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 childcare.
- ***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 centers.

State Department of Education (SDE) Contractors/Title 5 Providers. Providers who contract directly with SDE 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 SDE standards.
- ***Title 5 Centers, Including Preschool.*** Licensed centers that also meet SDE standards.

Other Terms

- ***Alternative Payment (AP) Program.*** The SDE-administered voucher program for non-CalWORKS working poor families.
- ***Standard Reimbursement Rate (SRR).*** The per child rate paid to Title 5 providers that contract with SDE.
- ***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^{th} percentile of the maximum rate paid to Title 22 FCCHs. Serves as the basis for the license-exempt care rates.

Figure 4 shows the major care types and associated regulations offered through voucher providers and SDE contractors for preschool-aged children. Moving from the left-hand side of Figure 4 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.

Figure 4

Subsidized Child Care Providers Safety and Educational Requirements

Current Law for Preschool-Aged Children

	Voucher Providers			SDE Contractors
	License-Exempt Providers	Title 22 FCCHs	Title 22 Centers	Title 5 Providers Including Preschool
Provider/teacher education and training	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).
Provider health and safety training	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.
Required ratios	None.	1:6 adult-child ratio.	1:12 teacher-child ratio or 1 teacher and 1 aide for 15 children.	1:24 teacher child ratio and 1:8 adult-child ratio.
Accountability, monitoring, and oversight	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.

FCCHs = family child care homes; SDE = State 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 SDE. 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 to adhere to adult-to-child ratios. 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.

Proposal Creates a Tiered Reimbursement Rate Structure for AP Providers

The Governor proposes to implement a tiered reimbursement rate structure for the voucher child care programs. Tiered reimbursement for child care provides differential reimbursement rates that encourage providers to improve program quality by obtaining additional training and education and improving outcomes as measured by independent standards of quality. We believe that the Legislature should first consider whether tiered reimbursement is desirable, and then decide upon specific levels of reimbursement.

Below, we (1) describe the Governor's proposal, (2) examine the merits of tiered reimbursement, and (3) discuss the appropriate levels for the rates in tiered reimbursement.

Governor's Tiered Reimbursement Proposal

The Governor's proposal creates a five-tiered child care reimbursement rate structure that reimburses voucher providers from 55 percent to 100 percent of the current maximum rates, depending on independent quality ratings, licensing, accreditation, education, and health and safety training. The proposal is summarized in Figures 5 and 6 (see next page). The intent of the proposal is to provide higher reimbursement rates to providers that exhibit higher quality. Figures 5 and 6 show the reimbursement rates for three categories of care—license-exempt, family home care, and center-based care. The figures also show the education and training requirements for the various levels of rates under the Governor's proposal. For license-exempt care, there are two levels: license-exempt and license-exempt plus. The FCCHs and centers are rated according to a three-star system whereby the highest quality providers receive three stars and the lowest one star. Please note that Figure 6 uses the term "environmental rating scale," which is explained below.

Figure 5

Governor's Tiered Reimbursement Proposal For License-Exempt Providers

	Percent of FCCH[a] Maximum	Additional Requirements
License-exempt	55 percent	None.
License-exempt plus	60 percent	License-exempt training, assistant teacher permit, or heath and safety training.

a Family child care homes.

Figure 6

Governor's Tiered Reimbursement Proposal For Licensed Providers

Star Rating	Maximum Rate	Additional Requirements	
		FCCHs[a]	Centers
*	75 percent of the 85th percentile RMR.[b]	None.	None.
**	85 percent of the 85th percentile RMR.[b]	Environmental rating scale average of 4 or associate teacher permit.	Environmental rating scale average of 4 or all teachers have teacher permit.
***	85th percentile RMR.[b]	Environmental rating scale average of 5.5, teacher permit, associates degree, or accreditation.	Environmental rating scale average of 5.5, all teachers have bachelor's degree, or accreditation.

a Family child care homes.

b Regional Market Rate (RMR) survey of providers in the area offering the same type of child care. The RMR will vary by care type.

License-Exempt Rate Reduction of $140 Million. The Governor's entire 2005-06 savings estimate for the tiered reimbursement proposal is based on reductions to license-exempt care rates for the voucher program (CalWORKs Stages 1, 2, and 3 and AP). Under the proposal, the rates of license-exempt care providers with no training would be cut to 60 percent of the 85th percentile. This reduction would take effect on July 1, 2005. These providers would then have 90 days to obtain the specified training for the second reimbursement tier, license-exempt plus, or their rates will be further cut to 55 percent of the 85th percentile. Figure 7 shows how the changes would affect license-exempt provider rates in a sample of counties in various geographic regions throughout the state. In these counties, license-exempt providers' rates would be reduced by between $182 and $303 per child per month.

Figure 7

Monthly Child Care Maximum Reimbursement Rates

License-Exempt Providers

Percent of FCCH[a] Maximum	Sacramento	San Francisco	Los Angeles	Contra Costa	Fresno	Shasta
90 percent[b]	$526	$780	$585	$624	$488	$468
60 percent[c]	351	520	390	416	325	312
55 percent[d]	321	476	357	381	298	286
Potential Reduction	**-$205**	**-$303**	**-$227**	**-$242**	**-$190**	**-$182**

a Family child care homes.

b Current license-exempt rate limits are based on 90 percent of the FCCH rate maximum (85th percentile) for full-time monthly care for a child age two through five.

c Reflects the maximum reimbursement rates if exempts are limited to 60 percent of the 85th percentile of the FCCH rate maximum.

d Reflects the maximum reimbursement rates if exempts are limited to 55 percent of the 85th percentile of the FCCH rate maximum.

License-exempt providers also would have the option to become licensed as FCCHs. If current license-exempt providers obtain the 15-hour health and safety training in order to meet the license-exempt plus rating, they will have completed the educational and training component of the FCCH licensing requirements. If licensed, providers would have their rates increased significantly, as shown in Figure 6.

Reimbursement Reforms for FCCH and Center-Based Providers Would Not Affect Rates for Two Years. Currently, FCCHs and centers are reimbursed up to the 85th percentile of the RMR. Under the Governor's proposal, providers' rates would be reduced starting in 2007-08 unless the providers demonstrated high program quality through (1) educational attainment, (2) program quality review, or (3) accreditation. Available data suggest that most providers would need to make significant investments to attain either a two-star or three-star rating.

Educational Attainment Options for Providers. The FCCH providers could achieve a three-star rating (highest rating) by completing 24 units in Early Childhood Education or Child Development, or obtaining a child care teacher permit (which requires 24 units). A two-star rating would require an associate teacher permit. For centers, the education requirements are more stringent. Teachers must have permits (24 units) for a two-star rating center or bachelor's degrees for a three-star rating.

Program Quality Review Options. The FCCH and center providers could agree to an independent assessment of their program through an environmental rating scale system. (See nearby box for a description of environmental rating scales.) Providers would need to score an average of 4 out of 7 on all the subscales for two stars or an average of 5.5 for three stars. The feasibility of meeting rating scale standards is difficult to assess since currently there is no system for independent assessments using environmental rating scales in California.

Program Accreditation. To receive three stars, the FCCHs also could become accredited through the National Association for Family Child Care, and centers could become accredited through either the National Association for the Education of Young Children or the National After School Association. Accreditation can be an arduous and costly process. Currently,

Environmental Rating Scales

Environmental rating scales are used to assess the quality of child care programs. There are numerous such assessments specific to the different ages of children served and the type of care provided. The Early Childhood Environmental Rating Scale (ECERS) has been designed for use in preschool, kindergarten, and child care classrooms which serve children ages two and one-half through five. The ECERS evaluates 43 specific items in seven main categories related to the quality of care: physical environment, basic care, schedule structure, program structure, curriculum, interaction, parenting classes, and staff education. For each of the 43 items, centers are rated on a 7-point scale ranging from inadequate (1) to excellent (7).

Assessment of a single classroom by an experienced rater requires approximately three hours. Generally, anyone can receive training to become a rater. Raters typically are evaluated on a regular basis to calibrate their scoring against standard benchmarks and against scores given by other raters.

less than 1 percent of the FCCH and less than 5 percent of the center-based programs in California are accredited.

The Governor's proposal does not include any savings estimates for the proposed changes to FCCH and center reimbursement maximum rates because they will not take effect for two years. At that point, savings could reach tens of millions of dollars annually.

Proposal to Create Incentives for Quality Makes Sense

We recommend the Legislature consider the Governor's tiered reimbursement proposal in two parts. First, the Legislature should determine if a tiered reimbursement rate structure that provides incentives for quality makes sense. Then the Legislature should determine the appropriate rates for the tiers.

The policy of tying reimbursement rates to a provider's level of training, education, and other factors has merit in that it (1) attempts to promote what research suggests are the characteristics of high quality care; (2) better reflects the cost of providing care; and (3) creates a rating system that is transparent, allowing parents and other stakeholders to easily identify quality options.

Reform Could Promote Child Development

The number of families utilizing nonparental child care has increased significantly in part due to enactment of the 1996 federal welfare reforms and the expansion of federal child care vouchers for low-income families. One federal study in 2000 suggested that the number of families receiving public child care support has increased by over one million nationwide since the 1996 reforms. The voucher system that has emerged in this context reflects an attempt to respond to increasing demand by offering parents choice and flexibility so that they can transition off cash aid and/or maintain employment.

The effort to provide parents with a variety of child care options, however, 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. While the child care system should strive to meet the needs of poor and working parents, it should also take into consideration the important early learning and development needs of their children.

Research Suggests Quality Differences by Care Type. Several small demonstration programs, such as the Perry Preschool Project and the Chicago Parent-Child Centers, have established a positive relationship between enrollment in the center-based preschool programs and children's cognitive development. While these studies provide preliminary evidence of the benefits of high quality preschool programs, it is difficult to generalize their findings to the larger child care and preschool market because of their unique qualities as demonstration programs. However, recent academic studies investigating the relative benefits of different child care types in existing settings have provided 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 (including provider turnover). 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.

One-Half of Children in Lowest Quality Care. As shown in Figure 8, in California'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 SDE 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. (Data showing the Stage 1 distribution by care type of children in licensed care were not available from DSS.)

Incentives Weighted Toward Lowest Quality Care. As discussed above, Title 5 providers have the highest standards. Yet, in some counties, providers with the lowest standards (license-exempt) are paid at a higher reimbursement rate than the Title 5 providers. Figure 9 compares child care reimbursement rates for the voucher system with the state contracted system. While statewide average rates are similar across care types, in some high-cost counties voucher providers can receive significantly higher reimbursements than the Title 5 contract providers.

Figure 8

Proportion of Children Served in Each Care Type by Program

Care Type	CalWORKs[a] Stage 1	CalWORKs Stage 2	CalWORKs Stage 3	Alternative Payment	Totals
License-exempt	60%	50%	47%	28%	48%
FCCHs	]—40[b]	29	27	39	]—52%[b]
Centers		21	26	33	
Totals	**100%**	**100%**	**100%**	**100%**	**100%**

a California Work Opportunity and Responsibility to Kids.

b Family child care homes. The Stage 1 distribution between centers and FCCHs was not available from the Department of Social Services.

Figure 9

Regional Reimbursement Rates for Voucher and Title 5 Providers

Dollars Per Month for Full Day Care

	Vouchers			
	License-Exempt Rate	**Family Care Maximum Rate**	**Center Maximum Rate**	**Title 5 Providers**
High-cost county	$780	$866	$988	$586
Low-cost county	384	427	355	586
Average statewide	505	561	556	586

In fact, in eight Bay Area counties, the current reimbursement rate for license-exempt care providers is greater than the rate for the Title 5 providers. In 21 counties, the rate maximum for Title 22 centers is higher than the rate for Title 5 providers.

These rate differentials are particularly prevalent in some of the most populous regions in the state, thus affecting a disproportionately large number of children. Fifteen percent of children in license-exempt care are cared for by providers who are reimbursed at rates higher than

Title 5 providers. Similarly, more than one-half of the children cared for in Title 22 centers and FCCHs have rate maximums that are higher than the Title 5 reimbursement rate. Under current law, most FCCHs only serve subsidized children, and are thus reimbursed at the maximum rate (please see discussion on the "Pick-Five" regulations below). Data are not available showing the actual rates that Title 22 centers receive, only that the rate maximum exceeds the Title 5 rate for two-thirds of the kids. Given the higher program requirements of Title 5 providers (as discussed in Figure 4), it seems counterintuitive that their reimbursement rates would be lower than the voucher programs.

Tiered System Would Reflect Real Cost of Service Differences

Tiered reimbursement would reflect the differences in the costs associated with providing care and the providers' differential investments of time and money for required training and education. As noted, license-exempt providers' investments and costs, particularly in terms of education and training, are minimal. In contrast, Title 22 centers have to maintain a facility and materials as well as a qualified staff. Title 5 providers not only have significant overhead and operating costs but also have the additional responsibility for student learning and development outcomes through SDE's Desired Results System. The Desired Results System is an evaluation and accountability system to measure the achievement of identified results for children and families.

A Star Rating System Would Make Quality Differences Transparent

The APs and Resource and Referral Networks (R&Rs)—local agencies that help parents place their children in child care settings—currently do not have the authority to recommend one provider over another because of the subjective assessment that such recommendations would involve. A rating system similar to that proposed by the Governor would create a set of transparent and objective criteria that APs and R&Rs could provide to parents attempting to find the best settings for their children. The simplicity of the star-rating system would enhance parents' ability to distinguish between different child care options and give the public at large access to information about the quality of child care offerings.

A Tiered Reimbursement Could Address Significant Problems in the Current System

The current system of reimbursements creates the wrong incentives for providers. Not only is lower quality care often reimbursed at higher rates than higher quality care, these rate differentials can reach in excess of

$200 per child per month. Moreover, the current system only creates a limited impetus for child care providers to seek the higher levels of training and education that research suggests can promote cognitive development in young children. Also, the state does not differentiate the reimbursement rate provided to those with higher educational/quality attainment, and therefore the nonsubsidized public may have a difficult time measuring the quality of a program.

Rate tiers would create a way to address these problems by providing reimbursements that better reflect differences in the cost of care and provide incentives for providers to seek higher levels of education and training. In doing so, tiered reimbursement would also create transparency in the child care system by giving stakeholders an objective basis for making child care placements and holding providers accountable for the quality of the care they offer. Finally, if California adopts a tiered system, it would be following in the footsteps of many other states that have adopted such reforms. According to a national clearinghouse for child care information, 34 states had implemented a tiered rating system for improving child care quality as of 2002. Almost all of them provide financial incentives for higher levels of quality. For these reasons, we recommend that the Legislature transform the current reimbursement rate structure into a tiered reimbursement structure.

Transition Title 5 Provider Reimbursement to RMRs

We recommend the Legislature transition reimbursement rates for Title 5 providers to be based on the rate provided to voucher providers.

As discussed above, Title 5 providers have the highest expectations of the state's subsidized child care programs. However, in some counties the Title 5 reimbursement rates are substantially lower than the market rates. This makes it difficult for Title 5 providers in these areas to compete for qualified teachers and to maintain the quality care that is expected of them. In many counties, these centers would be better off if they became Title 22 centers with lower quality expectations and potentially higher reimbursement rates. In other counties (primarily rural ones), Title 5 providers are reimbursed at rates that are substantially above local market rates. To address this differential treatment of Title 5 providers, we recommend the Legislature transition Title 5 providers to the RMR structure and that they receive the maximum RMR for their region. These changes to the Title 5 provider rates would promote parity with the voucher providers' rates and would help ensure that Title 5 provider rates better reflect regional cost variations. Under this system, many Title 5 providers' rates would increase, while some may decrease.

Reimbursement Rates Should Reflect a Systematic Approach to Improving Quality in Child Care

We recommend the Legislature consider an approach to reimbursement rates that promotes quality and child development while preserving family choice.

As the Legislature considers child care reimbursement rate options, we recommend weighing the Governor's rate reductions and corresponding savings against the potential benefits of alternative approaches to reimbursement rates. We suggest a structure that adheres to the following guiding principles:

- ***Promote Quality and Child Development.*** Reimbursement rate structures should promote quality child care through a system of tiered reimbursements that rewards providers with more advanced training and education, accreditation, and/or higher independent ratings of quality within and across care types. This approach should specifically incorporate SDE contracted Title 5 providers.
- ***Maintain Choice.*** Any modifications to current rates should aim to preserve families' ability to choose from a variety of child care options. Families opt for different child care settings for a variety of reasons and rates should be sufficient to preserve the current range of options, including exempt care.

The first principle appears to generally undergird the Governor's proposal. However, as noted above, the proposal does not address inequities between the Title 5 and the voucher providers.

With regard to the second guiding principle, it is unclear how the Governor's proposal would affect families' choices. Specifically, we are unable to predict how the Governor's proposal would influence child care supply because we do not know how the proposed license-exempt rate reductions would affect license-exempt providers' decisions to leave the child care market, continue providing care at lower rates, or seek licensure as a means to access higher rates. However, we suggest that the Legislature devote attention to these issues as it balances any reductions in child care spending against other K-12 priorities.

There are many different possibilities for rate reforms that could incorporate these guiding principles and also meet other objectives—such as generating savings or maintaining current child care funding levels. If the Legislature wants to implement a reform that is cost neutral, it could pursue a strategy that would implement the proposed five-tiered system while modifying the proposed rates. Such an approach could preserve current reimbursement rates for FCCH and center-based providers who meet two-star standards and enhance funding for those that attain three-star quality. Reductions in the current license-exempt care rates and one-star providers could offset the increased costs of funding enhancements for the three-star providers. This approach would ensure that centers and FCCHs are able to maintain current levels of service and at the same time offer incentives for improving quality. Under this rate structure, license-exempt care providers could choose to pursue advanced training to enhance their rates as exempt providers or obtain FCCH licensure.

The practices of other states suggest that lowering the license-exempt care reimbursement maximum rate is a reasonable mechanism for generating savings to offset increased rates for higher quality providers. Several other large states reimburse license-exempt care providers at lower rates than California does currently. Most reimburse license-exempt providers between 50 percent and 80 percent of the licensed FCCH rate.

"Pick-Five" Regulations Would Enhance Rate Equity

We recommend the Legislature adopt the Governor's proposal to implement regulations for an alternative rate setting methodology for subsidized child care provider reimbursements when they serve no private pay customers.

Statute requires the state to provide reimbursement rates for voucher programs that do not exceed the local market rates for a provider's community. Also, providers cannot charge the state more than they charge a private paying customer. For providers that serve no private pay customers, it is difficult for the state to determine an appropriate reimbursement rate level. Under current practice, the state reimburses providers without private pay customers at the RMR's maximum rate. This approach likely overpays many providers, especially FCCH providers, and creates negative incentives to serve private pay customers.

Because of these factors, statute directed SDE to develop regulations to determine an alternative reimbursement approach. The State Board of Education adopted regulations for the 2003-04 fiscal year. These regulations, commonly referred to as the Pick-Five regulations, determine the rate for a provider with no private pay customers based on the rates charged by five randomly selected providers in the same or comparable zip codes that have private pay customers. Nevertheless, the Legislature enacted legislation to suspend implementation of these regulations. We believe, however, that the regulations have merit in creating rates for providers without private pay clients. Below, we explain the rationale for the regulations.

There are some communities where it would be difficult for providers to find private paying customers. At the same time, there are many communities where providers could enroll private pay customers, but choose not to because the state will reimburse them at higher-than-market rates if they do not serve private pay customers. This practice appears common in the FCCH environment. Under these circumstances, the state is providing a reimbursement rate that exceeds local market rates. While the Pick-Five regulations do not provide a perfect estimate of the local market costs, they do provide a reasonable proxy. We believe that the Pick-Five system is an improvement on current practice because it does not overpay providers and eliminates the incentive to discourage private pay customers. Accordingly, we recommend that the Legislature permit the existing suspension to expire on June 30, 2005, thus allowing the Pick-Five regulations to be implemented in the budget year. The Department of Finance (DOF) estimates that these regulations would save $8.2 million annually.

New RMR Survey Methodology Shows Promise

We recommend the Legislature require the State Department of Education to report at hearings on the new Regional Market Rate methodology, including how the new survey may improve the accuracy of the Pick-Five regulations.

The SDE has contracted with an independent research firm for a new RMR survey methodology. The new methodology would address problems in the current RMR survey. By reducing nonresponse rates and using a sophisticated new method of grouping providers based on demographic variables, the approach is expected to increase the accuracy of the estimates of market costs of child care in particular communities. The SDE is currently in the process of final reviews and adjustments to the methodology and aims to secure the required approval for adoption from DSS and DOF during the current tear. The SDE is planning to implement the new RMR survey in 2005-06.

In setting reimbursement rates for child care, the Legislature should strive to use the most accurate data possible. It appears that the new methodology may offer some distinct advantages over the previous survey approach. We recommend that the Legislature request a complete report on the new RMR survey methodology at hearings. While we support the new methodology in concept, we believe it requires substantial review because it is likely to significantly affect reimbursement rates providers receive in the budget year. We also think that this new methodology may improve the quality of the information used to meet the Pick-Five regulations, especially in communities with limited numbers of providers serving private pay customers. For these communities, the new methodology may be able to use information on provider rates in demographically similar communities in other parts of the state.

COMMISSION ON TEACHER CREDENTIALING (6360)

The Commission on Teacher Credentialing (CTC) was created in 1970 to establish and maintain high standards for the preparation and licensing of public school teachers and administrators. The CTC issues permits and credentials to classroom teachers, student services specialists, school administrators, and child care instructors and administrators. In total, it issues almost 200 different types of documents. In addition to setting teaching standards and processing credentials, the commission (1) performs accreditation reviews of teacher preparation programs; (2) develops, monitors, and administers licensure exams; and (3) investigates allegations of wrongdoing made against credential holders. The CTC also administers two local assistance activities—the Internship and Paraprofessional Teacher Training programs.

The CTC receives revenue from two primary sources—credential application fees and teacher examination fees. Application fee revenue is deposited into the Teacher Credential Fund (TCF) and examination fee revenue is deposited into a subaccount within the TCF, the Test Development and Administration Account (TDAA). These revenues support CTC's operations. The General Fund supports CTC's two local assistance programs.

Below, we discuss concerns we have with CTC's TCF and TDAA fund conditions for 2004-05 and 2005-06. We first discuss discrepancies in the current-year TDAA fund condition. We then discuss the Governor's budget proposal, under which both the TCF and TDAA would end 2005-06 without a prudent reserve.

Revised TDAA Fund Condition Requires Additional Explanation

We recommend the Legislature direct the Commission on Teacher Credentialing to explain during budget hearings why its 2004-05 beginning balance and revenue assumptions have changed so significantly within such a short amount of time.

Figure 1 compares the 2004-05 TDAA fund condition as estimated in January 2004 and November 2004. The January fund statement is critical because it was presented to the Legislature as part of the 2004-05 proposed budget, and its revenue and expenditure estimates form the basis of the *2004-05 Budget Act*. The November fund statement revises the 2004-05 budget and establishes a base for the Governor's 2005-06 budget proposal.

As Figure 1 shows, there are large differences between the original and revised TDAA fund condition for 2004-05. In every respect, the revised fund condition is troubling. The CTC now expects to have a 2004-05 beginning balance only one-half of what it had originally estimated. In addition, its revenue estimate is down by $4.1 million. This represents a substantial decline (41 percent) even though the TDAA revenue stream tends to be rather stable. Whereas revenues are now expected to be much lower than originally anticipated, expenditures have increased slightly. The result of all these revisions is that CTC now expects to end the current year with a reserve of $2.3 million rather than the $9.3 million assumed in the *2004-05 Budget Act*.

Figure 1

Large Current-Year Fund Changes Require Additional Explanation

Test Development and Administration Account (In Millions)

	2004-05	
	January 2004	**November 2004**
Revenues		
Beginning balances	$5.1	$2.5
Revenues	13.9	9.8
Subtotals	($19.0)	($12.3)
Expenditures/ Transfers		
Expenditures	$9.7	$9.7[a]
Transfers to TCF[b]	—	0.3
Subtotals	($9.7)	($10.0)
Ending Balances	**$9.3**	**$2.3**

a Expenditures have increased by $56,000.

b Teacher Credential Fund.

In response to our inquiries, CTC was not able to provide clear answers as to why its current-year budget had experienced such unforeseen changes. It asserts that the changes are due to a transition it currently is undergoing with its test contractors. Rather than test fees being funneled through CTC, test fees are now to flow directly from test takers to test contractors. Changing its relationship with its test contractors in this way would reduce the amount of test revenue it reflects in its fund condition, but it also would reduce, dollar-for-dollar, its expenditures. Thus, it seems very unlikely that this transition is explaining the large discrepancies noted above in the TDAA fund balance.

The Legislature needs an accurate current-year fund statement both to ensure CTC has proper fiscal management and to make well-informed budget-year decisions. One of the reasons the Legislature did not raise the credential application fee in 2004-05 was because the TDAA was projected to end the year with a substantial reserve. Without confidence in the fund statements, the Legislature is likely to have difficulty deciding how to proceed in the budget year, and it might be placed in the awkward position of increasing the credential application fee unnecessarily or having CTC run a deficit without a reserve to cover it. For these reasons, we recommend the Legislature direct CTC to explain (1) why such large changes to its TDAA fund statement have occurred in such a short amount of time and (2) if other revisions are expected.

If Fund Statements Reliable, Action Should Be Taken to Keep CTC Solvent

If the Commission on Teacher Credentialing (CTC) can show that it will not have a prudent reserve at the end of 2005-06, then we recommend the Legislature consider various options for maintaining CTC's solvency.

One of the reasons the current-year TDAA fund balance is so critical is because, under the Governor's budget proposal, both the TCF and TDAA would end 2005-06 with no reserve. Figure 2 shows the TCF and TDAA fund balances for the prior year, current year, and budget year.

If CTC can provide clear and accurate fund statements that show it would end 2005-06 without a prudent reserve, then we recommend the Legislature consider the following options for maintaining CTC's solvency.

Increase the Credential Application Fee. Every $5 increase in the application fee generates an estimated $1.1 million. This amount equates to a TCF reserve of 7 percent, which typically would be deemed a modest reserve for a small state agency. (Given the TDAA also is to end the budget year without a prudent reserve, the Legislature might want to consider a slightly larger fee increase in 2005-06 or 2006-07.)

Figure 2

If Fund Statements Reliable, CTC Would End 2005-06 With No Reserve

(Dollars in Millions)

	2003-04 Actual	2004-05 Estimated	2005-06 Budgeted
Teacher Credential Fund (TCF)			
Revenues/Transfers			
Beginning balances	$0.4	$1.3	—
Revenues	13.2	13.2	$13.2
Transfers from TDAA	3.0	0.3	1.9
Subtotals	($16.6)	($14.8)	($15.1)
Expenditures	$15.4	$14.8	$15.1
Ending Balances:			
Amount	$1.3	—	—
Percent of expenditures	8%	—	—
Test Development and Administration Account (TDAA)			
Revenues			
Beginning balances	$4.9	$2.5	$2.3
Revenues	11.5	9.8	9.8
Subtotals	($16.3)	($12.3)	($12.1)
Expenditures/Transfers			
Expenditures	$10.9	$9.7	$10.2
Transfers to TCF	3.0	0.3	1.9
Subtotals	($13.8)	($10.0)	($12.1)
Ending Balances:			
Amount	$2.5	$2.3	—
Percent of expenditures	23%	23%	—

Automate or Devolve Credentialing Authority. The Governor's budget includes a proposal that would entrust accredited university-run teacher preparation programs with essentially preapproving the credential applications they submit to CTC, and CTC in turn would grant the official credential without further review. As CTC currently evaluates more than 50,000 applications submitted from universities, this would notably reduce CTC's workload. Given it represents a reasonable and feasible option for achieving greater efficiencies, the Legislature may want to approve this proposal.

The Legislature also may want to consider related options that might achieve even more substantial efficiencies. It could consider authorizing a similar preapproval process for district-run teacher preparation programs and community college child development programs. (In addition to the credential applications noted above, CTC currently reviews approximately 10,000 child development permits.)

Alternatively, the Legislature could consider establishing a pilot program that would devolve issuance authority to teacher preparation and child development programs. These programs already hire their own credential/permit analysts, already review their students' applications, and already recommend approved candidates to the CTC. A pilot program would entrust these campuses with actually issuing the credential/permit to the applicants, thereby eliminating CTC's cursory review process altogether. Participating campuses could be required to issue their credentials/permits prior to the beginning of the school year. This in turn would reduce county workload because county offices of education must issue temporary county certificates to credential applicants who, prior to the beginning of the school year, have not yet received their official CTC document.

Pursue Additional Efficiencies. The *2004-05 Budget Act* included budget bill language requiring CTC to submit a report to the Legislature and the Department of Finance that identified "at least three feasible options to further reduce processing time that could be implemented in 2005-06." The CTC submitted its report, which contains five efficiency options. (The commission is in the process of implementing some of these options.) Among the options is a proposal to conduct a public relations campaign to encourage more teachers to renew their credentials online and two proposals to eliminate hard copies of documents and instead provide only online access. Several of these proposals hold promise. The public relations campaign, for instance, could yield considerable long-term pay-off (as only 36 percent of eligible applicants currently renew online). The two online proposals also would reduce workload and postage costs. The Legislature may want CTC to provide periodic updates on its implementation of these efficiency initiatives.

In sum, the Legislature has a number of options for addressing a funding shortfall. Unless CTC can provide more reliable fund statements, it will however have difficulty knowing whether CTC is actually likely to experience a shortfall. If CTC can provide clear and accurate fund statements that show a likely budget-year shortfall, then it should offer the Legislature viable alternatives for addressing it. Ideally, CTC would submit a proposal that contains revenue options (for example, an increase in the credential application fee) and expenditure options (for example, an estimate of personnel savings under various efficiency options). We recommend the Legislature direct CTC both to provide more reliable fund statements and present various options for addressing a potential shortfall.

OTHER ISSUES

Few Details on Other Proposals

We recommend the Legislature reject several new initiatives proposed in the budget unless the administration makes available complete proposals including a narrative that explains their rationale.

The Governor's budget for K-12 education contains a number of other proposals for which few details were available at the time this analysis was prepared. A complete budget proposal generally includes a narrative explaining the need for the program and the rationale for the approach proposed, a detailed description of the fiscal structure of the new program, and proposed budget or statutory language needed to implement the proposal. The budget provides none of this supporting material for the proposals discussed below. In several cases, the budget proposal also fails to identify how the new activities would be funded in the budget year.

The Legislature's budget process is designed to ensure that the state's fiscal plan targets funds to the state's highest priorities. Without a thorough understanding of the recommended changes, the Legislature is unable to evaluate the costs and benefits of the Governor's proposals. Therefore, unless the administration provides the Legislature with a complete package of supporting material for these proposals, we recommend the Legislature reject them.

This would be unfortunate because, in most cases, the concepts forwarded in the Governor's budget for K-12 appear to have merit. Below, we describe each proposal for which we received no supporting material and discuss our initial reaction to it.

Accelerated English Language Acquisition Program (ELAP). The budget would redirect $57.6 million in funds for ELAP and use the funds to provide staff development in teaching instruction to English learner (EL) students. Currently, ELAP funds are distributed to districts for services to EL students in grades 4 through 8. The new staff development program would serve teachers in these grades with services modeled on the existing Reading First staff development program. Reading First is a federally funded program that provides districts with a minimum of $6,500 per K-3 teacher for reading professional development.

The most recent evaluation of ELAP suggests the current program has little impact on student learning. For this reason, we would support proposals that use these funds more effectively. In addition, we also believe that helping EL students learn English quickly is a critical task for the state's education system. The proposal raises several issues, however. Dedicating $50 million for a yet-unproven staff development program appears to be going too far, too fast. Moreover, no justification has been given why the Reading First model would be an effective approach for helping teachers meet the needs of EL students. Finally, given that English language development for most EL students in California begins in kindergarten, it is not evident why focusing on teachers in grades 4 through 8 is the most effective approach to helping this group of students.

Intervention in Low-Performing Schools. The budget proposes to convert failing schools into charter schools or assume management of the schools through a School Recovery Team. The budget proposal would place an unknown number of schools that are failing to meet state or federal performance goals into this intervention program.

Most critically, the budget does not identify how the administration proposes to support the new program. The budget is silent on the cost of the intervention, the length of time state teams would manage the schools, and what happens to the schools after the state leaves. We also note the budget proposal continues the past focus of intervention on individual schools. We think the state should concentrate most of its efforts on improving low-performing *districts* rather than schools. Since districts affect so many elements of school success—including teacher assignment, curriculum and instructional development, and resource decisions—we think a focus on improving districts has more promise than a state takeover of schools.

Delegating Budget Decisions to the School Site. The Governor's budget proposes a pilot program for determining the costs and benefits of school site budgeting and decision making. The pilot would test the concept in a small number of districts that volunteer for the program. As part of the pilot, schools would be given more flexibility over the use of state categorical program funds in order to help the sites use funds most effectively to meet student needs.

Districts in California and in other states currently are devolving a greater amount of budget discretion to school sites. Decentralization appears sufficiently promising that a study of the costs and benefits of the approach has merit. Details of the proposal, however, were not available at the time this analysis was prepared. How the proposal would extend greater flexibility over categorical program resources to participating schools constitutes a critical detail. The proposal also failed to clearly specify the goals of the pilot and the criteria that would be used to measure its success. In addition, the Governor's proposal does not provide any resources to districts for planning or for the evaluation of the pilot.

Fitness and Nutrition Initiative. The budget proposes an initiative to prevent child obesity. According to the budget document, the initiative includes several school-based efforts such as improving the nutritional quality of food and beverages, increasing opportunities for physical activities, and making fresh fruit and vegetables more available. The budget includes $6 million in the Department of Health Services (DHS) budget for a series of obesity reforms, but provides no funding in the K-12 portion of the budget.

Data provided in the budget document indicate that the number of overweight children has grown significantly over the last two decades. The proposal, however, provides no specific details about how the school-based initiatives would be funded or implemented. Funding proposed in the DHS budget could support some of the proposed activities in schools. For example, the proposal provides $3 million for grants to community organizations to implement projects involving schools and other local agencies. No information was available on whether the DHS program was intended to support the K-12 activities or whether the administration expects to identify another funding source for the education component of the program. (Please see our analysis of the DHS proposal in the "Health and Social Services" chapter.)

INTRODUCTION

Higher Education

The Governor's budget proposes a $663 million augmentation in General Fund expenditures for higher education in 2005-06. This represents a 7.5 percent increase from the revised 2004-05 amount. The Governor's proposal also assumes the enactment of student fee increases which, when coupled with changes in all other revenue sources, would increase total higher education funding by $1.3 billion, or 4 percent. 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 2005-06 budget proposal provides a total of $34.6 billion from all sources for higher education. This amount is $1.3 billion, or 4 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), California Community Colleges (CCC), Hastings College of the Law, the Student Aid Commission (SAC), 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 technical adjustments.

Major Funding Sources

The 2005-06 budget proposal provides $9.5 billion in General Fund appropriations for higher education. This amount is $663 million, or 7.5 percent, more than proposed current-year funding. The budget also projects that local property taxes will contribute $1.8 billion for CCC in 2005-06, which reflects an increase of $77 million, or 4.4 percent, from the revised current-year amount.

Figure 1

Governor's 2005-06 Higher Education Budget Proposal

(Dollars in Millions)

	2004-05	2005-06	Change Amount	Change Percent
UC				
General Fund	$2,708.8	$2,806.3	$97.5	3.6%
Fee revenue	1,800.0	1,949.9	149.9	8.3
Subtotals	($4,508.8)	($4,756.2)	($247.4)	(5.5%)
All other funds	$14,162.5	$14,637.3	$474.9	3.4%
Totals	**$18,671.3**	**$19,393.5**	**$722.2**	**3.9%**
CSU				
General Fund	$2,496.7	$2,607.2	$110.5	4.4%
Fee revenue	1,111.3	1,212.5	101.2	9.1
Subtotals	($3,608.0)	($3,819.7)	($211.7)	(5.9%)
All other funds	$2,222.1	$2,197.5	-$24.5	-1.1%
Totals	**$5,830.1**	**$6,017.3**	**$187.2**	**3.2%**
CCC				
General Fund	$3,050.6	$3,349.7	$299.1	9.8%
Local property tax	1,750.4	1,827.0	76.7	4.4
Fee revenue	357.5	368.2	10.7	3.0
Subtotals	($5,158.5)	($5,545.0)	($386.5)	(7.5%)
All other funds	$2,168.2	$2,165.0	-$3.3	-0.2%
Totals	**$7,326.7**	**$7,709.9**	**$383.2**	**5.2%**
SAC				
General Fund	$589.4	$745.5	$156.1	26.5%
All other funds	758.6	646.9	-111.7	-14.7
Totals	**$1,348.0**	**$1,392.4**	**$44.4**	**3.3%**
Other				
General Fund	$10.2	$10.4	$0.2	2.4%
Fee revenue	25.5	26.2	0.7	2.8
All other funds	20.1	16.8	-3.2	-16.2
Totals	**$55.7**	**$53.4**	**-$2.3**	**-4.1%**
Grand Totals	**$33,231.7**	**$34,566.5**	**$1,334.7**	**4.0%**
General Fund	$8,855.7	$9,519.1	$663.4	7.5%
Fee revenue	3,294.3	3,556.8	262.5	8.0
Local property tax	1,750.4	1,827.0	76.7	4.4
All other funds	19,331.4	19,663.5	332.1	1.7

[a] Excludes payments on general obligation bonds.

In addition, student fee revenue at all the public higher education segments account for $3.6 billion of proposed expenditures. This is $263 million, or 8 percent, greater than student fee revenue in the current year. This increase is primarily due to planned fee increases at UC and CSU. (The Governor does not propose any fee increase for CCC.) The budget also includes $968 million in other state funds (such as lottery and tobacco funds), reflecting a decrease of $143 million, or 12.9 percent.

Finally, the budget includes $18.7 billion in nonstate revenue—including federal funding, private contributions to the universities, and other revenue. This amount is $475 million, or 2.6 percent, more than the revised current-year level. The amounts in Figure 1 do not include capital outlay expenditures or the General Fund costs associated with paying off general obligation bonds. These costs are discussed in the "Capital Outlay" chapter of this *Analysis*.

Funding by Segment

For UC, the budget proposal provides General Fund appropriations of $2.8 billion, which is a net $97.5 million, or 3.6 percent, more than the proposed current-year estimate. The Governor's budget also anticipates that, largely as a result of planned fee increases, student fee revenue will increase by $150 million. When General Fund and fee revenue are combined, UC's budget would increase by 5.5 percent.

For CSU, the budget proposes $2.6 billion in General Fund support, which is a net increase of $111 million, or 4.4 percent, from the revised current-year level. With proposed fee increases, student fee revenue would increase by $101 million. Total General Fund and fee revenue combined would increase by 5.9 percent.

For CCC, the Governor's budget proposes $3.4 billion in General Fund support, which is $299 million, or 9.8 percent, above the current-year amount. Local property tax revenue (the second largest source of CCC funding) would increase by 4.4 percent, to $1.8 billion. The Governor's budget does not propose an increase in student fee levels at CCC. Combined, these three sources of district apportionments (General Fund support, property taxes, and fee revenue) would amount to $5.5 billion, which reflects an increase of $387 million, or 7.5 percent.

Major Cost Drivers for Higher Education

Year-to-year changes in higher education costs are influenced by three main factors: (1) enrollment, (2) inflation, and (3) student fee levels.

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 CCC, although there are technical differences in how funding is calculated. (We discuss marginal cost funding in some detail in an intersegmental issue later in 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, price inflation creates pressure to provide cost-of-living adjustments to maintain the buying power of faculty and staff salaries.

Student Fees. Student fees and General Fund support are the two primary funding sources for the segments' instructional programs. The Legislature generally considers fee increases either to (1) *maintain the share* of costs supported by fees as the segments' budgets increase yearly, or (2) *increase the share* of total costs supported by fees.

Major Budget Changes

The Governor's higher education budget proposal results primarily from base increases (essentially to compensate for 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 of 2.5 percent at UC and CSU, and 3 percent at CCC. Figure 3 (see page E-146) shows enrollment changes at the three segments. We discuss proposed enrollment levels in more detail later in this chapter.

Student Fees. For UC and CSU, the Governor proposes fee increases of 8 percent for undergraduate students and teacher credential students, and 10 percent for graduate students. The Governor's budget does not account for the continued phase-in of higher fees for students taking "excess" course units. That fee phase-in was proposed by the Governor in the 2004-05 budget, and accepted by the Legislature. For 2005-06, the excess course unit policy is to generate $25.5 million in General Fund savings. Once fully implemented over five years, the excess course unit policy would raise student fees to the full marginal cost of education for students taking more than 110 percent of the credit units required for graduation.

Figure 2

Higher Education
Proposed Major General Fund Changes

University of California	**Requested:**	**$2.8 billion**
	Increase:	**$97.5 million (+3.6%)**

Base Augmentation: Provides $76.1 million for a 3 percent base funding increase.

Enrollment Growth: Provides $37.9 million for 2.5 percent enrollment growth, which is sufficient to fund 5,000 additional full-time equivalent (FTE) students.

Budget Reductions: Eliminates $3.8 million for Labor Institutes, and makes a $17.3 million reduction to enrollment and/or outreach. (The university would decide how to allocate this reduction between these two activities.)

California State University	**Requested:**	**$2.6 billion**
	Increase:	**$111 million (+4.4%)**

Base Augmentations: Provides $71.1 million for a 3 percent base funding increase, and $44.4 million for increased retirement costs.

Enrollment Growth: Provides $50.8 million for 2.5 percent enrollment growth, which is sufficient to fund 8,100 additional FTE students.

Budget Reduction: Includes a $7 million reduction to enrollment and/or outreach. (The university would decide how to allocate this reduction between these two activities.)

California Community Colleges	**Requested:**	**$3.3 billion**
	Increase:	**$299 million (+9.8%)**

Cost-of-Living Adjustments (COLAs): Provides $196 million for a COLA of 3.93 percent for apportionments and selected categorical programs.

Enrollment Growth: Provides $142 million for 3 percent enrollment growth (to fund about 34,000 additional FTE students).

Other Augmentations: Includes $20 million one-time funding to create new vocational curricula that link K-12 and community college classroom work. Also, sets aside an additional $31.4 million that would be added to general apportionments, contingent on the Board of Governors' adequately responding to legislation requiring the development of a district-level accountability proposal.

Technical Reductions: Reduction of $90.1 million which adjusts for increased fee and property tax estimates.

Figure 3

Higher Education Enrollment

Full-Time Equivalent Students

	Actual 2003-04	Budgeted 2004-05	Proposed 2005-06	Change	
				Amount	Percent
University of California					
Undergraduate	155,754	155,647	159,730	4,083	2.6%
Graduate	32,874	32,963	33,860	897	2.7
Health sciences	13,268	12,366	12,386	20	0.2
UC Totals	**201,896**	**200,976**	**205,976**	**5,000**	**2.5%**
California State University					
Undergraduate	278,774	272,419	279,207	6,788	2.5%
Graduate/postbacalaurate	52,931	51,701	53,016	1,315	2.5
CSU Totals	**331,705**	**324,120**	**332,223**	**8,103**	**2.5%**
California Community Colleges	1,108,348	1,142,987	1,177,276	34,289	3.0%
Hastings College of the Law	1,261	1,250	1,250	—	—
Grand Totals	**1,643,210**	**1,669,333**	**1,716,725**	**47,392**	**2.8%**

For CCC, the Governor proposes no increase in student fees. Resident students at CCC would continue to pay $26 per unit—the lowest fee in the country. Proposed student fees are shown in Figure 4, and are discussed in more detail later in this chapter.

Student Financial Aid. The Governor's budget provides $746 million in General Fund support for SAC, primarily for the Cal Grant programs. This reflects an increase of $156 million from the revised current-year level. About two-thirds of this increase would be used to backfill a reduction in funding from the Student Loan Operating Fund (SLOF). About $147 million in surplus funding in the SLOF was used on a one-time basis in the current year to achieve General Fund savings. For 2005-06, the Governor proposes a smaller one-time shift of $35 million from the SLOF. The remaining increase in General Fund support for SAC is largely due to higher fees at UC and CSU (which are covered by Cal Grants) and a projected increase in the number of Cal Grant awards.

Figure 4

Annual Education Fees for Full-Time Resident Students[a]

	Actual 2003-04	Actual 2004-05	Proposed 2005-06	Change From 2004-05	
				Amount	Percent
University of California					
Undergraduate	$4,984	$5,684	$6,141	$457	8%
Graduate	5,219	6,269	6,897	628	10
Select professional programs[b]					
Nursing	8,389	8,389	9,105	716	9
Pharmacy	10,339	14,139	15,027	888	6
Medicine	14,013	18,513	19,532	1,019	6
Business	14,824	19,324	20,368	1,044	5
Hastings College of the Law	$13,735	$18,750	$19,725	$975	5%
California State University					
Undergraduate	$2,046	$2,334	$2,520	$186	8%
Teacher education	2,256	2,706	2,922	216	8
Graduate	2,256	2,820	3,102	282	10
California Community Colleges	$540	$780	$780	—	—

a Fees shown do not include campus-based fees.

b The University of California currently charges special fee rates for nine professional programs—including the four shown. The Governor's budget proposes to charge a special rate ($10,897) for three additional programs—Public Health, Public Policy, and International Relations and Pacific Studies.

BUDGET ISSUES

Higher Education

INTERSEGMENTAL: HIGHER EDUCATION "COMPACT"

The Governor's 2005-06 budget proposal generally follows a "compact" between the Governor and the University of California (UC) and the California State University (CSU), agreed to in spring 2004. In return for specific funding commitments over the next six years, UC and CSU have agreed to meet various performance expectations negotiated with the Governor. Below, we explain our concerns with the Governor's compact and advise the Legislature to disregard it for budgeting purposes. Instead, we recommend the Legislature continue to use the annual budget process as a mechanism to fund its priorities and to hold the segments accountable for fulfilling the mission assigned to them by the **Master Plan for Higher Education.**

Background

In 1960, the state adopted a fiscal and programmatic roadmap for higher education in the form of the *Master Plan for Higher Education*. This document defines California's higher education goals and outlines strategies for achieving them. The guiding principle expressed in the Master Plan is that all qualified Californians should have the opportunity to enroll in high quality, affordable institutions of higher education. To achieve this goal, the Master Plan addresses various overarching matters, including governance structures and mission differentiation. It also establishes guidelines for eligibility pools, transfer policies, enrollment planning, facility utilization, financial aid, and other policy areas. The Master Plan has proven to be a remarkably enduring planning document, enjoying bipartisan support since its adoption. Starting in the mid-1990s, the state's public universities have entered into a series of nonbinding funding compacts to try to gain greater fiscal and programmatic stability.

Previous Higher Education Funding Agreements. In 1995, UC and CSU entered a four-year compact with the Wilson Administration following several years of fiscal uncertainty caused in large part by the state's economic recession. Under the agreement, the Governor committed to request at least a specified level of General Fund revenue in his annual budget proposals to support base budget increases, enrollment growth, and other priorities. In return, UC and CSU agreed to meet certain program objectives. Desiring to extend this arrangement, UC and CSU negotiated a new agreement with the Davis Administration in 1999. This agreement, known as the "Partnership," contained many of the same provisions of the previous compact. The Partnership agreement lasted from 1999 through 2003.

Previous Agreements Did Not Deliver Expected Funding. The Partnership agreement included provisions for a 5 percent annual base increase for UC and CSU. However, the state experienced a pronounced fiscal deterioration, caused by significantly lower-than-expected revenues. As a result, the Governor proposed in the May Revision to his 2001-02 budget to provide UC and CSU with a 2 percent base increase instead of the 5 percent called for under the Partnership. The following year he proposed a 1.5 percent base increase—again, less than outlined in the agreement. As shown by these and other experiences, the provisions of the segments' funding agreements are primarily expressions of intent at a point in time. They have not and cannot guarantee budgetary predictability to the public universities.

Development of the Current Agreement. In developing his budget proposal for 2004-05, the Schwarzenegger Administration confronted an estimated $17 billion General Fund shortfall. The Governor proposed to make up for some of this with General Fund reductions for UC and CSU, much of which was "backfilled" with revenue from student fee increases. While this budget proposal was being deliberated in the Legislature, the Governor developed a new compact with UC and CSU to provide annual budget increases beginning in 2005-06. The 2004-05 budget adopted by the Legislature approved some of the Governor's proposals for reductions at UC and CSU and significantly modified a few of them. The enacted budget made no reference to the compact.

Major Terms of the Current Agreement. The current compact would guide the Governor's budget proposals for the public universities through 2010-11. As Figure 1 shows, the compact establishes annual funding targets, including base increases of 3 percent (increasing to 4 percent in 2007-08 and 5 percent in 2008-09), 2.5 percent annual increases in enrollment funding, and annual fee increases that would generate additional funding to be used at the segments' discretion. As part of the compact, the segments agree to meet various programmatic expectations and to provide annual reports with specified information. (These are outlined in Figure 2 (see next page) and discussed in further detail later in this section.)

Figure 1

Major Funding Provisions of the Governor's Compact With UC and CSU

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
General Fund Augmentations						
Base increase	3.0%	3.0%	4.0%	5.0%	5.0%	5.0%
Enrollment growth	2.5	2.5	2.5	2.5	2.5	2.5
Student Fee Increases						
Undergraduate fees	8.0%	8.0%	—[a]	—[a]	—[a]	—[a]
Graduate fees (minimum increase)	10.0	10.0	—[b]	—[b]	—[b]	—[b]

Other Provisions

Phase in excess course unit fee (over five-year period ending in 2008-09).

Full funding of lease-revenue debt service, annuitant health benefits, and other expenses.

General obligation bond support of $345 million per segment, per year, for capital outlay.

[a] Starting in 2007-08, undergraduate fees are to change at the same rate as per capita personal income. The compact permits fees to increase further—up to 10 percent—if required by "fiscal circumstances."

[b] Graduate student fees are dependent on the development of a fee policy in which graduate fees gradually increase to 150 percent of undergraduate fees.

Concerns With the Compact

The Governor's budget proposal for higher education largely is guided by his compact. Below, we identify several concerns with it.

Compact's Funding Targets Are Disconnected From Master Plan

The compact's funding expectations for enrollment growth, base increases, and student fees have no direct link to funding needs derived from the Master Plan.

No Link Between Master Plan and Compact's Enrollment Targets. The Master Plan provides guidance on eligibility criteria for each of the higher education segments. Specifically, UC is directed to accept students from the top one-eighth (12.5 percent) of high school graduates, CSU from the top one-third (33.3 percent) of high school graduates, and community colleges are to accept all applicants 18 years of age and older who can benefit from attendance. A recent report by the California Postsecondary Education Commission (CPEC) showed that in 2003, UC and CSU's eligibility criteria were not aligned with the eligibility targets outlined in the Master Plan. According to CPEC's analysis, UC drew its students from the top 14.4 percent of high school graduates (exceeding its 12.5 percent target by about one-seventh) and CSU drew its students from the top 28.8 percent of high school graduates (falling short of its 33.3 percent target by a similar proportion).

Figure 2

Major Accountability Provisions of the Governor's Compact With UC and CSU

- ✓ Meet Master Plan eligibility targets.
- ✓ Complete lower division major preparation agreements by the end of 2005-06.
- ✓ Provide summer instruction to at least 40 percent of the average fall/winter/spring enrollment by 2010-11.
- ✓ Improve student persistence and graduation rates.
- ✓ Improve supply of science and mathematics teachers.
- ✓ Approve college preparatory courses that integrate academics with technical content.
- ✓ Strengthen community service programs.
- ✓ Provide accountability report on various performance measures annually to the Legislature and Governor.

The annual increases in enrollment called for in the compact show no obvious link to the Master Plan's eligibility targets. They appear neither to address the mismatch between the Master Plan eligibility targets and current practice nor to mesh with projected growth in the college-age population over the next few years. Instead, the compact would provide UC and CSU identical fixed levels of annual enrollment growth for the term of the agreement. In contrast, we believe the Legislature should make enrollment funding decisions annually to provide the segments with the resources necessary to meet their Master Plan eligibility targets.

No Link Between Master Plan and Compact's Base Increases. The state's public universities, like other institutions, experience increases in their program costs due to inflation. In order to maintain the Master Plan's commitment to support quality academic programs, therefore, the Legislature periodically increases the segments' base budgets. To maintain the same purchasing power, these base increases would generally track an inflationary index such as the state and local deflator. The Governor's agreement with the segments, however, prescribes specific base increases through 2010-11, irrespective of the rates of inflation the segments will actually experience. Under the Governor's agreement with UC and CSU, the proposed base increases might match, exceed, or fall behind the annual rate of inflation.

We believe the Legislature should consider increasing the public universities' base budgets to adjust for the effects of inflation during annual budget hearings. Such consideration should weigh providing these increases against competing budget priorities. In this way, the Legislature maintains flexibility in the allocation of budget resources.

Compact's Fee Targets Are Arbitrary. The State Constitution confers on the Board of Regents the power to set student fee levels for UC, and the Legislature statutorily confers on the Board of Trustees the power to set fee levels for CSU. Both universities in recent years have determined fee levels as a response to the state's fiscal situation. For example, in the late 1990s, the public universities reduced fees—despite a strong economy and burgeoning financial aid opportunities—because state General Fund revenue was available to substitute for some fee revenue. Over the last couple of years, UC and CSU have raised student fees significantly to compensate for General Fund reductions. The Governor's agreement with the segments prescribes annual fee increases through 2010-11. Specifically, the compact proposes 8 percent fee increases in undergraduate fees in 2005-06 and 2006-07, with subsequent increases based on the change in per capita personal income. Graduate fees would increase by at least 10 percent in 2005-06 and 2006-07, with the segments committing to "make progress" in subsequent years toward the goal of raising graduate fees to 150 percent of undergraduate fees. This policy would ensure that fee increases are relatively moderate and predictable, but it does not provide an underlying policy rationale for the actual fee levels.

We believe the Legislature should instead adopt a long-term fee policy that results in students paying a fixed percentage of their total education costs each year. The size of the students' share would be a policy choice for the Legislature to make. This policy would provide an underlying rationale for fee levels, ensure moderate and gradual fee increases, and reflect underlying costs.

Compact Would Place Higher Education Funding on "Autopilot"

Compact Seeks Routine Increases. Rather than allowing for an annual review to reassess budget assumptions, the Governor's compact seeks automatic spending increases for UC and CSU. By prescribing specific targets for enrollment growth and base budget increases, the compact attempts to lock into place specific funding levels, thereby putting higher education on autopilot. As shown in Figure 3, by the final year of the compact, UC and CSU's General Fund support is projected to increase by about $2 billion from the 2004-05 level. When combined with student fee revenue, total resources for UC and CSU would increase by more than more $3.2 billion. In contrast, our projections of population growth and inflation suggest that UC and CSU would require an additional $1.8 billion in 2010-11, or about 60 percent of the increase called for by the compact. (Note: These figures do not include other increases that would be provided under the compact—such as funding for annuitant health benefits and capital outlay-related expenses.)

Figure 3

Funding Expectations Under Governor's Compact[a]

Additional Funding Above 2004-05 Level (In Millions)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Additional General Fund support	$208	$439	$739	$1,119	$1,551	$2,013
Additional student fee revenue	251	504	658	829	1,005	1,205
Totals	**$459**	**$943**	**$1,397**	**$1,948**	**$2,556**	**$3,218**

[a] Base increases, fee increases, and enrollment growth only. The compact calls for undefined levels of additional General Fund support to cover other cost increases.

Budget Process Should Be Followed. The Legislature makes budget decisions within a context of changing fiscal, economic, and policy conditions. Unanticipated challenges, including natural disasters and economic downturns, require annual reassessments of funding needs as part of the budget process. To better accommodate these unexpected situations, as well as any policy changes the Legislature may want to implement, we believe the Legislature should reject the compact's autopilot approach and continue to use the annual budgetary process to allocate resources to the segments.

Compact's Accountability Provisions Are Inadequate

While we agree that accountability is an important issue directly connected with budgeting, we believe the accountability provisions referenced in the Governor's compact are inadequate for several reasons.

Compact's Accountability Lacks Explicit Goals and Measures. The Governor's agreement with the public universities includes performance measures as a means to monitor UC and CSU's progress toward meeting certain goals. Program goals and performance measures are important components of any successful accountability system. However, to be effective, goals should describe the desired outcomes or impact. Similarly, measures should directly relate to a specific goal, be quantifiable, and focus on results.

Although the compact makes an effort to measure various activities and outputs, it does not provide enough detail in the goals it hopes to achieve or in the measures it suggests to determine performance. For example, the compact lists a goal of "utilization of systemwide resources." Proposed measures of this goal include "faculty honors and awards," "information on technology transfer," and "instructional activities per faculty member." Using the criteria mentioned above, the proposed goal of utilization of systemwide services does not provide enough clarity about expected results. The lack of clarity, in turn, precludes the development of measures that accurately gauge progress toward the goal.

Compact's Accountability Not Focused on Outcomes. The Governor's agreement with the public universities includes *output* measures, which are concerned with the number of goods produced, rather than *outcome* measures, which focus on program results and impact on society. For example, the segments are expected to report the number of degrees awarded and instructional activities per faculty member. Although *outputs* are important, ultimately it is *outcomes* that provide insight into how well a program meets its mission.

Conclusion

The *Master Plan for Higher Education* serves as the state's framework for higher education. Since 1960, the Legislature, Governor, and public education segments have looked to the Master Plan for guidance on the operation and support of the state's public institutions of higher education. The Governor's budget proposal is based on an agreement he made with UC and CSU. The funding targets of this compact have no explicit link to the objectives outlined in the Master Plan. We recommend the Legislature continue to use the annual budget process as a mechanism to fund its priorities and to hold the segments accountable for fulfilling the mission assigned to them by the *Master Plan for Higher Education*.

INTERSEGMENTAL: HIGHER EDUCATION ENROLLMENT GROWTH AND FUNDING

The Governor's budget proposes $88.7 million to fund 2.5 percent enrollment growth at the University of California (UC) and the California State University (CSU). This amount would provide $7,588 in General Fund support for each additional student at UC and $6,270 for each additional student at CSU. The proposed budget also provides $142 million for a 3 percent increase of enrollment at California Community Colleges. In this section, we (1) review current-year enrollment levels at UC and CSU, (2) analyze the Governor's proposed enrollment growth and funding rates for 2005-06, and (3) recommend alternatives to those funding rates.

HIGHER EDUCATION ENROLLMENT TRENDS

In 2003, approximately 2.2 million students (headcount) were enrolled either full-time or part-time at the University of California (UC), the California State University (CSU), and California Community Colleges (CCC). This is equal to roughly 1.7 million full-time equivalent (FTE) students. (We describe the differences between *headcount* and *FTE* in the accompanying text box.) Figure 1 (see next page) displays actual headcount enrollment for the state's public colleges and universities for the past 40 years. The figure shows that enrollment grew rapidly through 1975 and then fluctuated over the next two decades. Since 1995, enrollment grew steadily until a slight decline in 2003. As we discuss in the "California Community Colleges" section of this chapter, this decline was largely made up of part-time community college students who were taking relatively few courses. Despite this drop in *headcount*, there was a much smaller decline in community college *FTE* enrollment from 2002 to 2003.

Figure 1

California Public Higher Education Enrollment[a]

Headcount (In Millions)

[a] Includes the University of California, the California State University, and the California Community Colleges.

Full-Time Equivalent (FTE) Versus Headcount Enrollment

In this analysis, we generally refer to FTE students, rather than headcount enrollment. Headcount refers to the number of individual students attending college, whether they attend on a part-time or full-time basis. In contrast, the FTE measure converts part-time student attendance into the equivalent full-time basis. For example, two half-time students would be represented as one FTE student. In 2003-04, on average, one headcount enrollment equaled 0.88 FTE at the University of California, 0.75 FTE at the California State University, and 0.68 FTE at California Community Colleges.

Headcount measures are typically used to reflect the number of individuals participating in higher education. On the other hand, FTE measures better reflect the costs of serving students (that is, the number of course units taken) and is the preferred measure for state budgeting purposes.

Enrollment Down in 2004-05, But Master Plan Intact

As a reference point to guide legislative and executive decisions, the *Master Plan for Higher Education* (adopted by the Legislature in 1960 and periodically reassessed) established admission guidelines that remain the state's official policy today. Each year, UC and CSU typically accommodate all eligible freshman applicants. In enacting the 2004-05 budget, the Legislature rejected the Governor's proposal *not* to admit some eligible freshmen, and instead required that UC and CSU accommodate all eligible students as called for in the Master Plan. (See accompanying box for further information about this proposal.)

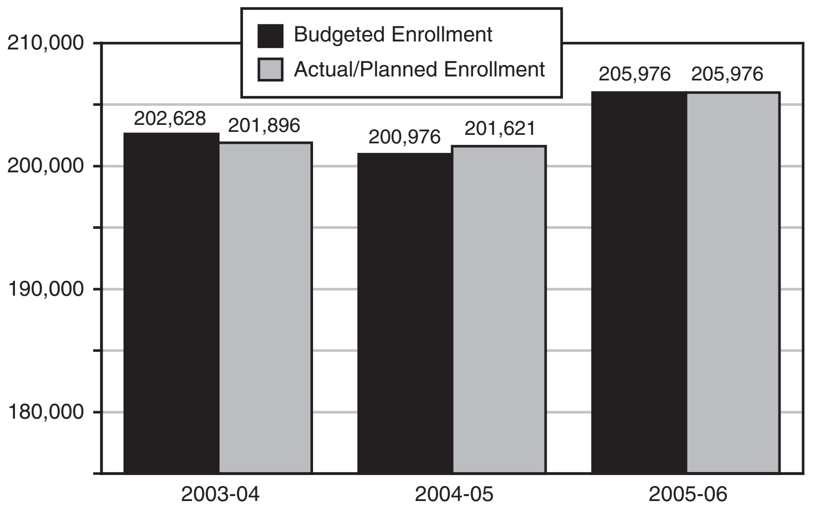
The *2004-05 Budget Act* nevertheless included reductions to budgeted enrollment levels at both UC and CSU.

- For UC, the budget established a total enrollment target of 200,976 FTE students. However, as indicated in Figure 2, this amount is about 900 students *fewer* than the number of students actually served in the prior year.

Figure 2

UC Enrollment Trends

Full-Time Equivalent Students



Redirection of UC Freshmen to Community Colleges

In his January budget proposal for 2004-05, the Governor proposed to reduce new freshman enrollment at the University of California (UC) and the California State University (CSU) in order to achieve General Fund savings. Under this proposal, these freshmen would have been redirected to the lower-cost community colleges, with those students being promised eventual admission to a UC or CSU campus after completing a transfer program. In recognition of the Governor's proposal, UC redirected about 5,700 eligible freshman applicants to the community colleges in the spring of 2004. In contrast to UC, CSU did not at any time redirect eligible freshman applicants to the community colleges.

In enacting the 2004-05 budget, the Legislature rejected the Governor's proposal to require the redirection of freshman enrollment, insisting instead that UC and CSU accommodate all eligible students. Accordingly, UC subsequently offered freshman admission to the 5,700 (formerly) redirected students. Students were admitted to one of UC's campuses (which might not be a campus to which a student had applied). All these students were still provided the option to first attend a community college as part of a *voluntary* redirection program established by Chapter 213, Statutes of 2004 (SB 1108, Committee on Budget and Fiscal Review). Of the 5,700 redirected students, about 1,500 decided to enroll at UC as freshmen, and about 500 students chose to participate in the voluntary redirection program. All students participating in the program in 2004-05 will have their fees waived during their first two years at a community college. After 2004-05, only financially needy students will have their community college fees waived.

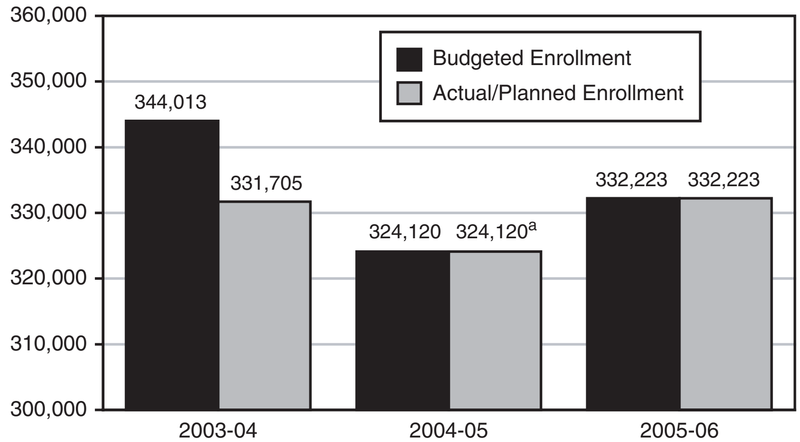
- For CSU, the budget established a total enrollment target of 324,120 FTE students. However, as indicated in Figure 3, this amount is about 7,600 FTE students *fewer* than the number of students actually served in the prior year.

Despite the above reductions to budgeted enrollment levels at UC and CSU, the state has been able to maintain the Master Plan's commitment to college access. Specifically, the segments indicate that no eligible applicants were denied admission to the universities as a whole in 2004-05. (We recognize, however, that some eligible applicants were not admitted to their preferred campus as happens every year.)

Figure 3

CSU Enrollment Trends

2003-04 Through 2005-06
Full-Time Equivalent Students



[a] This represents the number of students CSU plans to enroll in the current year. Unlike UC, CSU could not provide an estimate on the number of students actually enrolled at this point in time.

Disconnect Between Enrollment Funding and Actual Enrollment

The budgeted enrollment levels funded in each year's budget are targets for which funding is provided. Because the number of eligible students enrolling at the segments cannot be predicted with complete accuracy, in any given year UC and CSU typically serve slightly more or less FTE students than budgeted. Recently, however, actual enrollment has deviated more significantly from funded levels. As we discussed in our *Analysis of the 2004-05 Budget Bill* (page E-182), for example, CSU enrolled significantly *fewer* students than it was funded for in 2003-04. This was because the university redirected a significant amount of enrollment funding to essentially "backfill" budget reductions in other program areas. Although not in the same magnitude, UC also redirected some enrollment funding to other purposes in 2003-04.

In recognition of the above 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 *2004-05 Budget Act* to ensure that UC and CSU use enrollment funding for enrollment. Specifically, the 2004-05 budget required that UC and CSU report to the Legislature by March 15, 2005, on whether they met their current-year enrollment targets (200,976 FTE students for UC and 324,120 FTE student for CSU). If the segments do not meet these goals, the Director of the Department of Finance (DOF) is to revert to the General Fund the total amount of enrollment funding associated with the share of the enrollment goal that was not met.

At the time of this writing, UC is projected to exceed its budgeted enrollment target by roughly 600 FTE students, for a total of 201,621 FTE students. The CSU was unable to provide an estimate of the actual number of students currently enrolled at the university. However, the university tells us it expects to meet its current-year enrollment target.

GOVERNOR'S BUDGET PROPOSAL

The budget requests a total of $225.4 million in General Fund support to increase enrollment at UC , CSU, and CCC. The $225.4 million total consists of:

- $37.9 million to UC for 2.5 percent enrollment growth (or 5,000 FTE students) above current-year budgeted enrollment, which is based on a marginal General Fund cost of $7,588 per additional student. (This amount includes funding for 1,000 new FTE students at the Merced campus, which will open in fall 2005.)
- $50.8 million to CSU for 2.5 percent enrollment growth (or 8,103 FTE students) above current-year budgeted enrollment, which is based on a marginal General Fund cost of $6,270 per additional student.
- $142 million (Proposition 98) to CCC for 3 percent enrollment growth (or 34,000 FTE students) above current-year budgeted enrollment, which is considerably higher than the statutory growth rate of 1.89 percent. (We further discuss enrollment at CCC in the "California Community Colleges" section of this chapter.)

DETERMINING ENROLLMENT GROWTH FUNDING FOR 2005-06

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 in the annual budget act to support a specific level of enrollment growth at the state's public higher education segments. The total amount of enrollment growth funding provided each year is based upon a per-student funding rate multiplied by the number of additional FTE students. For example, the Governor's budget proposes a per-student funding rate of $6,270 for 8,103 additional students at CSU, for a total of $50.8 million.

As earlier noted, the proposed budget includes a total of $88.7 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 2005-06?
- 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. Although the Master Plan sets eligibility targets, it is often difficult to accurately predict factors that affect the level of demand for higher education. As a result, most enrollment projections have had limited success as predictors of actual enrollment demand.

In general, 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," which for the rest of this decade is expected to range from a little more than 1 percent to about 2.5 percent annually.
- ***Participation Rates.*** For any subgroup of the general population, the percentage of individuals who enroll in college is that subgroup's college participate rate. California's participation rates are among the highest in the nation. Specifically, California currently ranks fourth (tied with four other states) in college enrollment among 18- to 24-year-olds, and first among 25- to 49-year-olds. However, predicting future changes to participation rates is

difficult because students' interest in attending college is influenced by a number 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 reduce the Governor's proposal for budgeted enrollment growth for the University of California and the California State University from 2.5 percent to 2 percent. Our proposal should easily allow the segments to 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 roughly 1.5 percent from 2004-05 to 2005-06. (See accompanying text box for a description of the demographics-based methodology we developed to estimate future higher education enrollment levels.) Since this projection is driven solely by projected population growth, it should serve as a starting point for considering how much enrollment to fund in 2005-06. In other words, the Legislature can evaluate how various related budget and policy choices could change enrollment compared to this baseline. We note that over the years the Legislature has taken deliberate policy actions (such as funding student outreach programs and expanding the availability of financial aid) 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 one-third higher than our estimate of population-driven enrollment growth, and therefore should easily allow the segments to accommodate enrollment growth next year due to increases in population, as well as modest increases in college participation. More importantly, our recommended 2 percent growth rate helps preserve the Legislature's priority that UC and CSU accommodate all eligible students (as called for in the Master Plan).

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 estimated a distinct growth rate for Asian females between 18 and 24 years of age, and calculated 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 2 percent from 2005-06 through 2009-10. In terms of the budget year (2005-06), we project enrollment growth of roughly 1.5 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 students and their families' financial situations. 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. Our projections merely provide a baseline reflecting underlying population trends. We believe that our enrollment projections are valuable not as a prediction of what will happen, but as a starting point for considering higher education funding.

Ensuring That Enrollment Targets Are Met

We recommend the Legislature adopt budget bill language specifying enrollment targets for both the University of California and the California State University, in order to protect its priority to increase higher education enrollment.

Although the Governor's budget would increase funded enrollment by 2.5 percent at UC and CSU, the total number of students the segments in fact would serve in 2005-06 is not clear. This is because the proposed budget bill departs from recent practice and does not hold the segments accountable for meeting a specific budgeted enrollment target.

We believe that the Legislature, the Governor, and the public should have a clear understanding of how many students are funded at UC and CSU in the annual budget act. Additionally, the segments should be expected to use enrollment funding provided by the state for that purpose and be held accountable for meeting their annual enrollment targets as adopted by the Legislature. If UC or CSU does not meet its goal, the amount of enrollment funding associated with the enrollment shortfall should return to the state's General Fund. However, under the Governor's proposal, the segments would have the flexibility to reduce enrollments at their discretion regardless of the Legislature's priority to increase enrollment. As previously discussed, there has been a disconnect in recent years between funded and actual enrollment. This is because the segments have redirected enrollment funding away from serving additional students essentially to maintain services in other program areas.

For the above reasons, we recommend the Legislature establish specific enrollment targets (based on our recommended 2 percent enrollment growth) and accountability provisions for UC and CSU. We propose language for 2005-06 that is similar to what was adopted in 2004-05. First, we propose the Legislature add the following provision to Item 6440-001-0001:

> The amount appropriated in Schedule (1) includes funding for the University of California to enroll 204,996 full-time equivalent (FTE) students. The Legislature expects the university to enroll this number of FTE students during the 2005-06 academic year. The university shall report to the Legislature by March 15, 2006, on whether it has met the 2005-06 enrollment goal. If the university does not meet this goal, the Director of the Department of Finance shall revert to the General Fund the total amount of enrollment funding associated with the share of the enrollment goal that was not met.

Similarly, we also recommend adding the following provision to Item 6610-001-0001:

> The amount appropriated in Schedule (1) includes funding for the California State University to enroll 330,602 full-time equivalent (FTE) students. The Legislature expects the university to enroll this number of FTE students during the 2005-06 academic year. The university shall report to the Legislature by March 15, 2006, on whether it has met the 2005-06 enrollment goal. If the university does not meet this goal, the Director of the Department of Finance shall revert to the General Fund 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 2005-06, the Legislature must also determine the *amount* of funding to provide for each additional FTE student at UC and CSU. Given recent 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, certain fixed costs (such as for 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.)

The current practice has been for the state to provide a separate funding rate for each higher education segment. In other words, the state uses a model of differential funding—providing separate funding rates for distinct categories of students—based on which higher education segment the student attends. (As we discuss below, the state in the past has provided separate funding rates based on education level and type of instruction.) As discussed above, the Governor's budget for 2005-06 proposes to provide $7,588 in General Fund support for each additional student at UC and $6,270 for each additional student at CSU.

Background on the Development of the 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. In general, the state has sought to simplify the way it funds enrollment growth. 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 systems.

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 formulas before 1992 did not account for costs related to student services and institutional support. The state made funding adjustments to these budget areas independent of enrollment funding decisions.

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 only 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 at the time). 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. Specifically, the language required representatives from UC, CSU, DOF, and our office to review the 1991-92 marginal cost formulas and propose improvements that could be used in developing the 1996-97 budget. The working group had two primary goals: (1) updating the calculations to more accurately reflect actual costs and (2) establishing more consistency between segments in the methods used to fund enrollment growth. This work coincided with CSU's efforts to simplify the university's budget development process, streamline budget formulas, and increase the system's budget discretion.

After a series of negotiations in 1995, the four agencies developed a new methodology for estimating the amount of funding needed to support each additional FTE student. The new methodology was first implemented in 1996-97 and has generally been used to calculate enrollment funding ever since. 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 fixed student-faculty ratio (as adopted in the budget act) 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. (See nearby text box for a review of the different types of differential funding and their potential benefits and drawbacks.)
- ***Marginal Cost for Additional Program Areas.*** The working group concluded that the marginal cost formula should include additional cost components beyond salaries for faculty, teaching assistants, 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 suggested that both the General Fund and student fee revenue should contribute toward the total marginal cost. This is because fee revenue is unrestricted, and is thus used for general purposes the same as General Fund revenue. It also reflects the state's policy that students and the state should share in the cost of education. 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.

Instituting a More Differential Funding System

Our office recently examined various options to modify California's existing higher education funding practices in a way that differentiates funding in other ways than just by segment. (Currently, the state also provides different funding rates for credit and noncredit courses at the community colleges.) The most common factors other states use to differentiate among enrollments are as follows:

- ***Differential Funding by Education Level.*** The most common practice among states is to provide a different funding rate for lower division students, upper division students, and graduate students. Funding rates generally increase as students advance to higher education levels, reflecting the higher costs typically incurred at those levels.

- ***Differential Funding by Academic Program.*** Another common method is to distinguish funding based upon a program's cost. This means providing higher funding rates for more costly programs (such as nursing).

- ***Differential Funding by Mode of Instructional Delivery.*** Some states provide different funding rates for lecture and laboratory courses. Because they often require expensive equipment and materials, as well as a lower student-faculty ratio, laboratory courses typically are much more costly than lecture courses and therefore are associated with higher funding rates.

The different forms of differential funding are not mutually exclusive. That is, California could redesign its enrollment funding system around any combination of the above factors. For example, it might retain its existing distinctions and incorporate new funding rates for undergraduate and graduate students enrolled in lecture and laboratory courses. A myriad of other combinations are possible.

Potential Advantages and Disadvantages. Differentiated funding systems more accurately account for specific differences in education costs. They can also increase transparency, strengthen accountability, and ensure comparable funding for comparable services. Despite these benefits, more differentiated funding systems can also have potential drawbacks. Depending upon how they are designed, some systems may create more complexity without improving the budget process. In particular, too many enrollment categories can limit flexibility and increase administrative burden.

Recent Departure From the 1995 Marginal Cost Methodology

After the above marginal cost methodology was developed in 1995, UC and CSU used it every fall to estimate the amount of funding they would require for each additional FTE student enrolled in the coming year. (If necessary, the estimate is later updated to reflect revised current-year expenditures.) From 1996-97 through 2003-04, these amounts were in turn used in the annual budget act to fund enrollment growth at UC and CSU. However, the budgets adopted for the current year (2004-05) and proposed for the budget year (2005-06) depart from this practice and rely on a slightly different methodology used by DOF.

Different Methodology Used for CSU in 2004-05 Budget. The *2004-05 Budget Act* included new enrollment funding for CSU based on DOF's calculation of a marginal General Fund cost of $5,662 per additional FTE student. According to CSU, however, the 1995 methodology would have called for $5,773 in General Fund support per student. (This is the rate approved by the CSU Board of Trustees as part of its budget request to the Governor.) The DOF's calculation departs from the 1995 methodology in that it is based on funding and enrollment levels proposed for 2004-05, rather than as budgeted in 2003-04.

Unexplainable Methodology Proposed for UC in Governor's 2005-06 Budget. For 2005-06, the Governor proposes to provide $7,588 in General Fund support for each additional student at UC. However, it is unclear how the administration calculated this per-student funding rate. At the time of this analysis, DOF staff could neither substantiate nor explain the methodology it used to derive the $7,588 proposed marginal cost. In a departure from past practices, DOF staff declined to provide the specific formulas and data supporting its proposal. Thus, we are unable to conclude whether the administration is proposing an entirely new methodology for UC in the budget year. As we discuss below, UC calculated a different marginal cost rate as part of its 2005-06 budget request.

LAO Recommendations Based on 1995 Methodology

Using our marginal cost estimates for enrollment growth based on the agreed-upon 1995 methodology and our proposed 2 percent enrollment growth, we recommend deleting $21.3 million from the combined $88.7 million requested in the budget for enrollment growth. Our proposal would leave sufficient funding to provide $7,180 for each additional University of California student and $5,999 for each additional California State University student. (Reduce Item 6440-001-0001 by $9.4 million and Item 6610-001-0001 by $11.9 million.)

Until the Legislature approves a new marginal cost methodology, we believe that it should fund enrollment growth at UC and CSU in the 2005-06 budget that is aligned with the 1995 methodology. Using our marginal cost estimates for enrollment growth based on the agreed-upon 1995 methodology, we recommend alternatives to the Governor's proposed funding rates.

Provide $7,108 in General Fund Support for Each Additional UC Student. As discussed above, it is unclear how the administration calculated its proposed marginal General Fund cost of $7,588 for each additional student at UC. More importantly, as we discuss below, this rate is considerably different from our estimate of what would be called for under the marginal cost methodology developed in 1995. As part of its 2005-06 budget request to the Governor this past fall, the UC Board of Regents approved a marginal General Fund cost of $7,528 per FTE student that is based on the 1995 marginal cost methodology (see Figure 4).

Figure 4

University of California (UC)
2005-06 Marginal Cost Calculation

(As Requested by UC[a])

Basic Cost Components (Based on Initial 2004-05 Costs)	Average Cost Per FTE[b]	Discount Factor	Marginal Cost Per FTE[b]
Faculty salary	$2,876[c]	—	$2,876
Faculty benefits	619	—	619
Teaching assistants salary	653	—	653
Instructional equipment	266	—	266
Instructional support	3,903	10%	3,512
Academic support	1,102	35	716
Student services	1,079	20	863
Institutional support	1,896	50	948
Totals	**$9,425**	—	**$10,454**
Less student fee revenue	—	—	-$2,926[d]
State Funding Per Student	—	—	**$7,528**

[a] The Governor's budget proposes a different marginal General Fund cost for UC ($7,588). At the time of this analysis, the administration was unable to explain its cost calculations.

[b] Full-time equivalent.

[c] Based on an annual salary of $53,780 (Assistant Professor, Step 3) and a student-faculty ratio of 18.7:1.

[d] Based on a percentage of the total marginal cost per FTE student that equals the percentage of UC's operating budget that is funded from student fee revenue.

However, since UC calculated this rate several months ago, it does not reflect current legislative policies and expenditure data. For example, as part of the 2004-05 budget package, the Legislature approved the Governor's proposal to increase the student-faculty ratio at UC from 19.7:1 to 20.7:1 in order to achieve ongoing General Fund savings. As noted in Figure 4, however, the faculty salary and benefits included in the university's own marginal cost calculation is based on a student-faculty ratio of 18.7:1. In addition, the average cost per FTE student for instructional support, academic support, and institutional support reflect initial planning estimates for the current year. (The Governor's budget for 2005-06 displays revised funding data for 2004-05.) After making the above adjustments, we calculate a marginal General Fund cost at UC of $7,108 based on the 1995 methodology.

Provide $5,999 in General Fund Support for Each Additional CSU Student. Figure 5 displays a simplified version of the marginal cost calculations used by CSU to estimate the $6,270 per FTE student funding rate proposed in the Governor's budget for 2005-06. As noted in the figure, the

Figure 5

California State University (CSU) 2005-06 Marginal Cost Calculation

(As Requested by CSU and Funded in Governor's Budget)

Basic Cost Components (Based on 2004-05 Costs)	Average Cost Per FTE[a]	Discount Factor	Marginal Cost Per FTE[a]
Faculty salary	$3,079[b]	—	$3,079
Faculty benefits	1,114	—	1,114
Teaching assistants salary	358	—	358
Instructional equipment	142	—	142
Instructional support	799	10%	719
Academic support	1,360	15	1,156
Student services	1,066	20	853
Institutional support	1,507	35	980
Totals	**$9,425**	—	**$8,401**
Less student fee revenue	—	—	-$2,131[c]
State Funding Per Student	—	—	**$6,270**

a Full-time equivalent.

b Based on an annual salary of $58,196 (Associate Professor, between Steps 7 and 8) and a student-faculty ratio of 18.9:1.

c Based on a percentage of the total marginal cost per FTE student that equals the percentage of CSU's operating budget that is funded from student fee revenue.

identified costs associated with faculty salary and benefits assume a student-faculty ratio of 18.9:1. However, as was done for UC, the Legislature in the last two budget acts increased the student-faculty ratio at CSU as a cost-cutting measure. Specifically, the *2004-05 Budget Act* assumed $53.5 million in General Fund savings from increasing the student-faculty ratio by 5 percent (from 19.9:1 to 20.9:1). In effect, this higher ratio means that fewer new faculty positions are necessary to teach a cohort of additional students than otherwise would be needed with a lower ratio. Thus, an increase in the student-faculty ratio effectively reduces the marginal cost per additional FTE student. We estimate that a student-faculty ratio of 20.9:1 results in a marginal General Fund cost of $5,999 for CSU.

In view of the above technical adjustments, we recommend the Legislature provide $7,180 in General Fund support for each additional student at UC and $5,999 for each additional student at CSU. (See Figure 6 for a detailed description of our marginal cost calculations.) Given our earlier proposal to fund enrollment growth at a rate of 2 percent at both UC and CSU,

Figure 6

LAO Marginal Cost Recommendations

(Based on 1995 Marginal Cost Methodology)

	Marginal Cost Per FTE[a]	
Basic Cost Components	**UC**	**CSU**
Faculty salary[b]	$2,598	$2,784
Faculty benefits[b]	559	1,008
Teaching assistants salary	653	358
Instructional equipment	266	142
Instructional support	3,578	719
Academic support	596	1,156
Student services	863	853
Institutional support	758	980
Totals	**$9,871**	**$7,999**
Less student fee revenue	-$2,763	-$2,000
State Funding Per Student	**$7,108**	**$5,999**

[a] Full-time equivalent.

[b] Based on a student-faculty ratio of 20.7:1 at the University of California (UC) and 20.9:1 at the California State University (CSU). Also based on costs for an Assistant Professor (Step 3) at UC and an Associate Professor (between Steps 7 and 8) at CSU, as called for in the 1995 methodology.

we therefore recommend reducing the proposed General Fund augmentation for enrollment growth by a total of $21.3 million, including $9.4 million from UC and $11.9 million from CSU. Under our proposal, the segments would still receive sufficient funding to cover the estimated costs of enrollment growth due to increases in population and college participation.

Legislative Review of Marginal Cost Methodology Needed

We believe the Legislature should revisit and reassess the marginal cost methodology. Specifically, we recommend the Legislature direct our office, in consultation with representatives from the Department of Finance, the University of California, and the California State University, to review the current system of funding new enrollment and propose modifications for use in the development of future budgets.

The Legislature's most recent review of the Master Plan (in 2002) called for an assessment of the existing marginal cost formula. According to the 2002 Joint Committee to Develop a Master Plan for Education, "The State should analyze the appropriateness of modifying the current marginal cost approach for funding all additional enrollments in public colleges and universities, to account for contemporary costs of operations, differing missions and functions, and differential student characteristics that affect costs in each sector." Such a review is particularly important at this time because the Governor in his budget proposal is already deviating from the 1995 marginal cost methodology for UC. We also note that the segments themselves have expressed concern in the past about the adequacy of the existing marginal cost methodology.

Obviously, there are many ways to calculate the marginal General Fund cost for each additional student at UC and CSU. Based on our assessment of the current marginal cost methodology (as developed in 1995), we have developed a series of principles to guide the Legislature in determining how to more effectively fund the increased costs associated with enrollment growth. Figure 7 (see next page) outlines the principles, which we discuss in further detail below.

Comparable Formulas for UC and CSU. We recognize that there are instances where it is reasonable to have different formulas for the segments, particularly in recognition of their differing missions and costs. However, under the current methodology, there is an unexplainable difference between the segments regarding the formulas used to adjust for fixed costs in two program areas (academic support and institutional support). For example, CSU's methodology includes a higher percentage of institutional support costs. (Institutional support primarily includes funding for the central administration offices of university presidents and chancellors.) Based on our conversations with the segments, we find no analytic reason why cost increases for institutional support would be different at the two segments.

Include Only Program Costs Linked to Enrollment Growth. The marginal cost formula should include only program costs that tie directly to enrollment growth. For example, the marginal cost should include funding to purchase instructional equipment for the additional students, but not to replace or upgrade existing equipment for use by existing students. Legislative decisions regarding funding for such nonenrollment-growth-related costs should be made independent of marginal cost funding. Moreover, there also may be some costs not included in the current marginal cost formula which increase when a university enrolls an additional student. Such costs (for instance, related to operation and maintenance services) might appropriately be added to the marginal cost methodology.

Figure 7

Guiding Principles for Marginal Cost Funding

- ✓ ***Comparable Formulas for the University of California (UC) and the California State University (CSU).*** To the extent possible, the calculation of the different variable costs (such as for institutional support) should be consistent across the two university systems.
- ✓ ***Include Only Program Costs Linked to Enrollment Growth.*** Since marginal cost funding is intended to support the various costs that UC and CSU will incur in enrolling one additional full-time equivalent (FTE) student, the marginal cost formula should include only program costs that increase with enrollment growth.
- ✓ ***Input Data Should Reflect Actual Costs.*** In order to appropriately budget for enrollment growth, the expenditure and enrollment data used to calculate the marginal cost for UC and CSU should reflect actual costs.
- ✓ ***Accurately Account for Available Student Fee Revenue.*** In order to determine how much General Fund support is needed from the state for each additional FTE student, the marginal cost formula should "back out" the fee revenue that UC and CSU anticipate collecting from each student.

Input Data Should Reflect Actual Costs. The expenditure and enrollment data used to calculate the marginal cost at UC and CSU should appropriately reflect actual costs. For example, the costs for additional faculty and TAs should be determined based on current data regarding the salaries and benefits of existing personnel. We note that a 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 annual salary. For 2005-06, this translates to an estimated annual TA salary of about $38,000. According to the CSU Chancellor's Office, however, the average annual salary for a TA is currently only $7,180 (about 12 percent of an entering faculty member's salary). This means that the state is currently overbudgeting the marginal cost of hiring additional TAs. Conversely, there may be certain program costs that are not fully funded under the existing marginal cost formula.

Accurately Account for Available Student Fee Revenue. In order to determine how much General Fund support is needed from the state 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 40 percent of UC's budget for 2004-05, then fee revenue would be deemed to support 40 percent of the total marginal cost for 2005-06. The remaining 60 percent would be funded by the state's General Fund. A different approach could simply be to adjust the marginal cost based on the fee revenue collected for each FTE student (regardless of education level).

Moreover, the total amount of fee revenue collected by the segments is not always accounted for in the current methodology. For example, UC does not include the revenue collected from nonresident tuition when adjusting for fee revenues. Since the different program costs are based on expenditures from all fund sources (including nonresident tuition), then the marginal cost formula should include the supplemental fee paid by nonresident students in order to accurately determine the state's share of the total marginal cost. (An alternative approach would be to exclude nonresident tuition altogether from the marginal cost calculations.)

In conclusion, we recommend the Legislature direct our office, in consultation with DOF, UC, and CSU to review the current process of determining the amount of funding to provide for each additional FTE student and propose any modifications for use in the development of future budgets.

INTERSEGMENTAL: STUDENT FEES

Currently, the state has no student fee policy. Instead of making fee decisions based upon an explicit agreement as to share of cost or an assessment of other specified factors (such as fee levels at similar institutions), the state has made fee decisions based almost entirely on the state's fiscal situation—raising fees in bad fiscal times and lowering them in good fiscal times. Given the recent volatility in fee levels and disparity in cost burden among student groups over time, both the Governor and Legislature worked in 2004-05 to develop a state fee policy. Despite these efforts, fee legislation was not enacted. We continue to recommend the state adopt a fee policy that designates explicit share-of-cost targets. This policy then could be used to guide annual fee decisions.

Below, we describe the Governor's fee agreements with the University of California (UC) and the California State University (CSU), identify our concerns with them, and list the Governor's specific budget-year fee proposals. We then describe a share-of-cost fee policy and illustrate how the Legislature could use this policy to make its budget-year fee decisions. Next, we discuss the Governor's treatment of new fee revenue—treatment that is inconsistent with general budgeting standards—and highlight a technical budgeting error related to excess-unit fee revenue. We conclude with a discussion of community college fees.

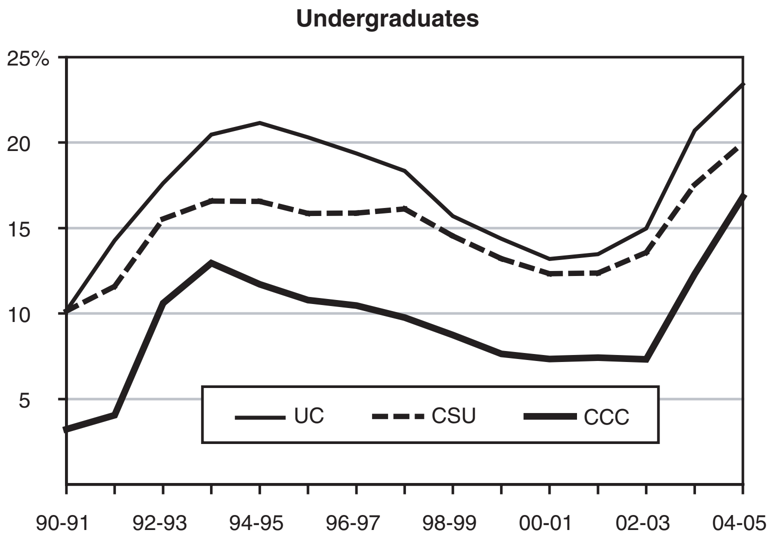
Lack of Fee Policy Has Resulted in Volatility and Disparity

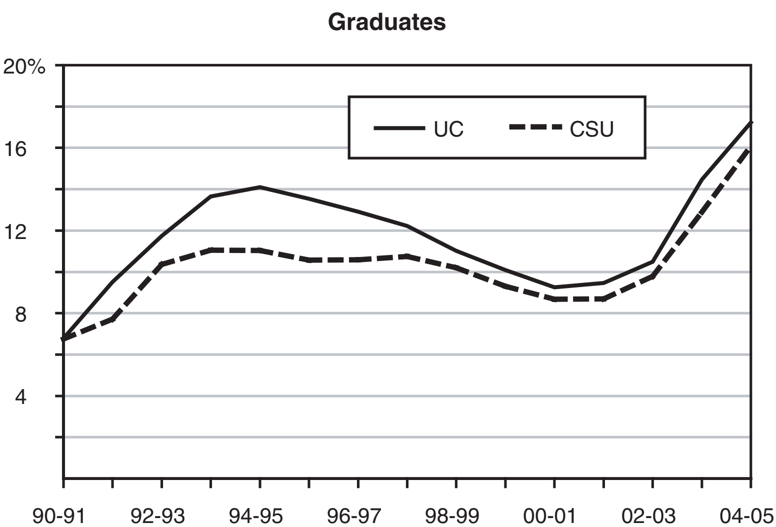
Figure 1 shows, in inflation-adjusted dollars, student fees as a share of total education support costs. During the early 1990s recession, students' average share of cost increased notably—peaking between 1993 and 1995. Undergraduates at UC, for example, were paying 21 percent of their total education costs in 1994-95 compared to 10 percent in 1990-91. Similarly, California Community College (CCC) students were paying 13 percent of their total education costs in 1993-94 compared to 3 percent three years earlier.

Figure 1

Lack of Fee Policy Has Resulted in Volatility and Disparity

2004-05 Inflation-Adjusted Dollars





Students' average share of cost declined for the next six to seven years. For example, CSU undergraduates' share of cost fell from 17 percent in 1994-95 to 12 percent in 2001-02. Students' share of cost, as well as fee levels themselves, declined despite increases in education costs, burgeoning financial aid opportunities, a strong economy, and a nationwide trend toward higher fees. Fees declined despite California's public institutions charging much less than similar public institutions. At the same time, California was the only state in the country that was not maximizing its receipt of federal Pell Grant monies and one of few states not maximizing federal tax credit benefits.

Since 2001-02, students' share of cost for both undergraduates and graduate students has increased at all three segments. Despite these increases, students' share of cost remains small, fee levels still are low compared to similar institutions, and California continues not to maximize its receipt of federal financial aid funding.

Partly because of this recent volatility in fees, the Legislature passed a major fee bill in 2004 (AB 2710, Liu). Though the bill was vetoed, it represented a significant step toward developing a state fee policy. (Please see the nearby gray box for a summary of the bill.)

Governor Makes Agreement With UC and CSU on Student Fees

The Governor's compact with UC and CSU, which is not binding on the Legislature but which he nonetheless uses for budgeting purposes, contains the following components.

- ***Undergraduate Fees to Increase on Annual Basis.*** After increasing 14 percent in the current year, undergraduate fees would increase by 8 percent in 2005-06 and 8 percent in 2006-07. Annually thereafter, undergraduate fees would increase consistent with the change in California per capita income. Use of this index, however, could be suspended during difficult fiscal times and fees allowed to increase by as much as 10 percent.
- ***Graduate and Professional School Fees to Increase Annually Based Upon Multiple Factors.*** Graduate fee decisions would be determined annually after considering the average fee charged at comparison institutions, students' share of cost, the total cost of attendance, the need to preserve or enhance the quality of certain graduate programs, and the state's need for additional workers in particular occupations. Overlaying these factors is a target that graduate academic fees be 50 percent more than undergraduate fees. This differential, developed with the segments' input, is to account for the higher costs of providing graduate education.

- ***Segments to Determine Institutional Aid Set Aside.*** For undergraduates, the budget would assume between 20 percent and 33 percent of new fee revenue is set aside for financial aid. For graduate students, the segments apparently would have complete discretion to set aside for financial aid any amount of their choosing.
- ***New Fee Revenue Not Accounted for in Budget.*** New fee revenue essentially would be unbudgeted. That is, the segments would be allowed full discretion in deciding how to spend additional fee revenue. They would not be required to use any new fee monies for state-identified priorities.

Legislature Tried to Enact Fee Policy During Last Session

In the 2004 session, the Legislature passed a fee policy, AB 2710 (Liu), which the Governor vetoed. Assembly Bill 2710 included three primary policy guidelines, which, in many respects, echoed former state fee policies.

- ***Cost to Be Shared.*** The bill declared that the total cost of education should be a shared responsibility of students and the state, with the state bearing the preponderance of the cost.
- ***Changes to Be Gradual, Moderate, and Predictable.*** The bill emphasized that fee increases should take place gradually, be moderate in magnitude, and clearly anticipated, with students given sufficient advance notice.
- ***Fee Levels to Be Based on Share of Cost and Related Factors.*** The bill also specified that the total cost of education, students' share of cost, and families' ability to pay should be considered when setting fee levels.

Assembly Bill 2710 was distinct from earlier state fee policies in that it suggested share-of-cost targets. Undergraduate fees were not to exceed 40 percent of overall education costs at the University of California (UC) and 30 percent of overall costs at the California State University (CSU). To this end, students' share of cost was to be calculated annually and presumably incorporated into fee-setting discussions. The Governor vetoed the bill because he felt it was "inconsistent" with the provisions of his compact with UC and CSU.

Governor's Agreement Has Serious Shortcomings

We have three major concerns with the Governors' fee agreements with UC and CSU.

No Rational Basis for Determining UC and CSU Undergraduate Fees. The Governor's agreement assumes the 2003-04 fee was the "right" fee for UC and CSU and hereafter merely needs to be adjusted annually consistent with families' ability to pay. Given UC and CSU's 2003-04 undergraduate fee levels were (1) the lowest of all their public comparison institutions, (2) substantially beneath the comparison-institution average (20 percent lower at UC and 51 percent lower at CSU), and (3) represented a small share of total education cost (26 percent of total education costs at UC and 21 percent at CSU), it is unclear why the state would want to essentially lock them in place.

No Rational Institutional Aid Policy. The Governor's agreement allows the segments broad discretion to budget for institutional aid without any associated expectation that they justify their decisions. That is, the Governor's agreement does not require the segments to document their need and identify the amount required to cover it—seemingly disregarding even the most basic budgeting standards. Moreover, the segments are effectively granted authority to augment their institutional aid programs without the typical state-level discussion of competing priorities (whether it be the Cal Grant program, other higher education priorities, or other state priorities). Please see the nearby box for a more detailed discussion of our concerns with the segments' institutional aid set aside.

Treatment of New Fee Revenue Translates Into Autopilot Budgeting. Perhaps the most significant problem with the Governor's compact is its treatment of new fee revenue. In contrast to past practice, the Governor's budget proposal does not consider new fee revenue as available to meet needs identified in the state budget. Instead, the Governor's compact would fund all identified budgetary needs entirely with General Fund support, allowing the segments to use all their new fee revenue for whatever additional purposes they deemed worthwhile. This approach allows the segments routinely to receive significantly more total revenue than is needed to cover the normal cost increases resulting from enrollment growth and inflation.

Fee Agreement Used to Justify All Budget-Year Fee Proposals

The Governor's budget contains several fee proposals. The justification given for these proposals is that they are consistent with his compact with UC and CSU. The major fee proposals are to increase:

- Resident undergraduate fees at UC and CSU by 8 percent.

- Resident graduate fees at UC and CSU by 10 percent.
- Resident professional schools at UC and Hastings College of the Law from 5 percent to 9 percent, depending on the program. Addi-

Institutional Aid Decisions Need Better Justification

As we have discussed in previous years, we do not think the state (or the segments) should budget for institutional financial aid by setting aside an arbitrary percentage of new fee revenue. This set-aside approach has no rational policy basis and has resulted in funding levels that are disconnected from identified needs. For example, between 2002-03 and 2003-04, the state augmented the Cal Grant Entitlement program by $88 million (or 37 percent) to cover enrollment growth and undergraduate fee increases at the University of California (UC) and the California State University (CSU). Despite providing financial aid increases sufficient to offset costs through the Cal Grant program, UC and CSU's own undergraduate institutional aid budgets increased $130 million (or 54 percent) due to set asides from fee increases. It is unclear what financial aid purposes were served by the set-aside funds that were not explicitly addressed by the Legislature through its Cal Grant funding decisions.

The fee set-aside approach also disregards basic budgeting standards for accountability and hinders legislative oversight. For example, when asked for information about the institutional aid set aside, the segments could estimate neither the number of need-based institutional aid recipients nor the average institutional aid award for the prior, current, or budget years. In lieu of this approach, we continue to recommend the elimination of fixed percentage fee set asides. Instead, the segments should be required to provide the Legislature with evidence of their student aid needs and justification for any requested augmentation. In the absence of better information or more sophisticated forecasting tools, we recommend the Legislature address any shortfalls in undergraduate financial aid by augmenting the Cal Grant program (sufficient to cover enrollment growth and fee increases, as is longstanding practice). Since the Cal Grant program does not address *graduate* financial need, it would be appropriate for the Legislature to consider providing additional resources to the segments in this area, given growth in graduate students and proposed graduate fee increases. (For additional detail about the segments' institutional aid programs and the set-aside approach, please see "The Institutional Aid Set Aside," *2004-05 Analysis of the Budget Bill*, pages E-228 to E-233.)

tionally, three programs—Public Health, Public Policy, and International Relations and Pacific Studies—would begin charging supplemental professional school fees for the first time, resulting in much higher year-to-year percent increases (61 percent) for these programs.

Total nonresident charges at UC and CSU would increase due to these proposed increases in resident fees, which essentially represent base charges for nonresident students. In addition, for UC undergraduates, the budget assumes nonresident tuition (which essentially represents a supplemental charge) would increase by 5 percent. Figure 2 compares 2004-05 undergraduate and graduate fee levels with the proposed 2005-06 levels, and Figure 3 (see page E-186) provides comparable information for professional school fees.

Adopt Share-of-Cost Fee Policy

We recommend the state adopt a fee policy for the University of California, California State University, and California Community Colleges that sets certain targets for the share of education cost to be paid by students.

To address the problems with the state's existing fee-setting practices and the Governor's fee agreements with the segments, we recommend the state adopt a share-of-cost fee policy. Most importantly, a share-of-cost fee policy would provide both an underlying rationale for fee levels and a mechanism for annually assessing these levels. In doing so, it would promote clear expectations about fee levels and consistent treatment of student cohorts over time. It also would create incentives for students to hold the segments accountable for keeping costs low and quality high, and it would formally recognize the private as well as public benefits of higher education.

Promotes Clear Expectations and Consistent Treatment. A share-of-cost fee policy would make explicit the share of total education costs that nonfinancially needy students would be expected to bear. (Financially needy students meeting certain academic and age criteria would continue to receive aid sufficient to cover education fees.) Once the share-of-cost target was achieved, it would be maintained over time. For example, if nonneedy UC undergraduates were expected to pay 40 percent of their total education costs, fees would be adjusted annually such that students continued to pay 40 percent of total costs (without the need to rely upon any specific inflationary index). The central advantages of this approach are that nonneedy students would have clear expectations about the share of cost they would be expected to bear and student cohorts would be treated consistently over time.

Figure 2

Summary of Governor's Undergraduate and Graduate Fee Proposals

(Systemwide Charges for Full-Time Students[a])

	2004-05 Actual	2005-06 Proposed	Change	
			Amount	Percent
University of California				
Resident Charge				
Undergraduates	$5,684	$6,141	$457	8%
Graduates	6,269	6,897	628	10
Nonresident Charge				
Undergraduates	$22,640	$23,961	$1,321	6%
Graduates	21,208	21,858	650	3
California State University				
Resident Charge				
Undergraduates	$2,334	$2,520	$186	8%
Teacher education students	2,706	2,922	216	8
Graduates	2,820	3,102	282	10
Nonresident Charge				
Undergraduates	$12,504	$12,690	$186	1%
Graduates	12,990	13,272	282	2
California Community Colleges				
Resident charge[b]	$780	$780	—	—
Nonresident charge[c]	4,470	4,530	$60	1%

a Reflects only systemwide charges. Does not include campus-based fees.

b Reflects $26 per unit charge.

c Nonresident students are charged on a per-unit basis (as are resident students). In 2004-05, the nonresident per-unit rate was $149. This rate is projected to increase to $151 in 2005-06.

Strengthens Accountability. A share-of-cost fee policy would link fee levels to total education costs. As costs increased, fees would increase along with them. In other words, a portion of any increase in the cost of education would be automatically passed on to nonneedy students in the form of higher fees. Students and their families, therefore, would have a much greater incentive to hold their campuses accountable for keeping costs low and quality high.

Figure 3

Summary of Governor's Professional School Fee Proposals

(Systemwide Charges for Full-Time Students[a])

	2004-05 Budget Act	2005-06 Proposed	Change Amount	Change Percent
University of California				
Resident Charge				
Business/management	$19,324	$20,368	$1,044	5%
Law	19,113	20,150	1,037	5
Medicine	18,513	19,532	1,019	6
Dentistry	18,024	19,029	1,005	6
Veterinary medicine	16,029	16,974	945	6
Optometry	14,139	15,027	888	6
Pharmacy	14,139	15,027	888	6
Theater, film, and television	11,249	12,051	802	7
Nursing	8,389	9,105	716	9
Public health	6,269	10,092	3,823	61
New programs[b]	6,269	10,092	3,823	61
Nonresident Charge				
Business/management	$31,569	$32,613	$1,044	3%
Law	31,358	32,395	1,037	3
Medicine	30,758	31,777	1,019	3
Dentistry	30,269	31,274	1,005	3
Veterinary medicine	28,274	29,219	945	3
Optometry	26,384	27,272	888	3
Pharmacy	26,384	27,272	888	3
Theater, film, and television	23,494	24,296	802	3
Public health	20,963	22,337	1,374	7
New programs[b]	20,963	22,337	1,374	7
Nursing	20,634	21,350	716	3
Hastings College of the Law				
Resident charge	$18,750	$19,725	$975	5%
Nonresident charge	30,950	30,950	—	—

a Reflects only systemwide charges. Does not include campus-based fees. In 2004-05, average campus-based fees ranged from $1,199 in public health programs to $4,101 in the veterinary medicine program.

b Public health, public policy, and international relations and pacific studies.

Formally Recognizes That Higher Education Is Shared Responsibility With Shared Benefits. The fee policies the state adopted in 1985 and 1990 both indicated that higher education should be a shared responsibility among students and the state. A share-of-cost fee policy explicitly recognizes the private returns of higher education by asking nonneedy students to contribute some portion toward their education costs. Clearly, individuals receive significant private benefits from higher education. Although establishing causality is difficult, a high correlation exists between level of education and personal earnings. For example, compared to those with only a high school education, the median earnings for adults with an associate degree is 22 percent higher. The median earnings for adults with a baccalaureate degree is 62 percent higher, and the median earnings of professional degree-holders is more than 200 percent greater. Unsurprisingly, higher education institutions across the country commonly use potential earnings (one key measure of private benefits) to determine appropriate cost-sharing arrangements.

Other Factors Might Be Considered to Provide Fuller Context. Although we think an explicit share-of-cost target would be the simplest, most consistent, and most defensible factor to use in setting and adjusting fees, the Legislature might want periodically to consider fee levels in the context of other factors—including fees at comparison institutions, the quality of specific education programs, the need for additional workers in particular occupations, and federal financial aid policies. This periodic review would help the Legislature better assess how well the share-of-cost fee policy was meeting various policy objectives.

Use Share-of-Cost Approach to Assess Budget-Year Fee Levels

We recommend the Legislature assess the Governor's budget-year fee proposals in light of their effect on students' share of cost. In most cases, the proposals would make at least some progress toward the share-of-cost targets specified in AB 2710 (Liu).

Below, we assess each of the Governor's fee proposals.

Increasing Resident Undergraduate Fees by 8 Percent Progresses Toward AB 2710 Share-of-Cost Targets. Figure 4 (see next page) shows resident fees as a percent of total operating costs for each of the three segments. As the figure shows, UC and CSU's proposed fee increases for resident undergraduates would increase students' share of total cost slightly. While the share of cost at UC and CSU would remain below the targets specified in AB 2710, some progress would be made toward eventually reaching them.

Figure 4

Resident Fees as a Share of Total Education Costs At California's Public Colleges and Universities

	2003-04 Actual	2004-05 Budgeted	2005-06 Proposed
Undergraduates			
University of California (UC)			
Cost of education	$19,144	$19,859	$20,087
Resident fees	4,984	5,684	6,141
Fee as a percent of cost	26.0%	29.0%	31.0%
California State University (CSU)			
Cost of education	$9,699	$10,312	$10,601
Resident fees	2,046	2,334	2,520
Fee as a percent of cost	21.0%	23.0%	24.0%
California Community Colleges			
Cost of education	$4,343	$4,698	$4,883
Resident fees	540	780	780
Fee as a percent of cost	12.4%	16.6%	16.0%
Graduates			
UC			
Cost of education	$28,716	$29,788	$30,130
Resident fees	5,219	6,269	6,897
Fee as a percent of cost	18.0%	21.0%	23.0%
CSU			
Cost of education	$14,549	$15,468	$15,902
Resident fees	2,256	2,820	3,102
Fee as a percent of cost	16.0%	18.0%	20.0%

Undergraduate Fees Would Remain Low Relative to Comparison Institutions. The proposed resident undergraduate fee increases likely would not affect UC and CSU's ranking compared to similar institutions. As Figure 5 shows, of UC's four public comparison institutions, only the State University of New York, Buffalo campus had a lower fee level in 2004-05. The UC undergraduate rate was more than $1,000 below the average of its public comparison institutions. Assuming fees at the comparison institutions increase in 2005-06 at the same average rate they increased last year, the UC undergraduate rate would remain more than $1,000 below the comparison-institution average. At CSU, even with the proposed 8 percent fee increase, its fee would very likely remain the lowest of all its public comparison institutions and only about one-half of the average of these comparison institutions.

Figure 5

UC and CSU's Resident Undergraduate Fees Low Relative to Comparison Institutions

	2004-05 Actual	2005-06 Proposed/ Projected[a]
UC and Its Public Comparison Institutions		
University of Michigan	$8,722	$9,323
University of Illinois	7,944	8,491
Average	*7,341*	*7,846*
University of Virginia	6,790	7,258
UC	**6,312**	**6,769**
State University of New York	5,907	6,314
CSU and Its Public Comparison Institutions		
Rutgers University	$8,869	$9,652
University of Maryland, Baltimore	8,020	8,728
University of Connecticut	7,490	8,151
Cleveland State University	6,618	7,202
State University of New York, Albany	6,383	6,946
University of Wisconsin, Milwaukee	5,835	6,350
Wayne State University	5,819	6,333
Average	*5,656*	*6,155*
Illinois State University	5,588	6,081
George Mason University	5,448	5,929
University of Texas, Arlington	5,093	5,543
North Carolina State University	4,260	4,636
University of Colorado, Denver	4,160	4,527
Georgia State University	4,154	4,521
Arizona State University	4,066	4,425
University of Nevada, Reno	3,034	3,302
CSU	**2,916**	**3,102**

a Reflects Governor's budget proposals for UC and CSU. For comparison institutions, adjusts 2004-05 fee levels by the average prior-year growth rate (6.9 percent for UC's comparison institutions and 8.8 percent for CSU's comparison institutions).

Increasing Graduate Fees by 10 Percent Makes Slight Progress Toward Target Differential. As shown in Figure 4, the graduate fee proposal would result in slight increases in graduate students' share of cost. These shares, however, would remain quite low. For example, even with a 10 percent fee increase, nonneedy graduate students at CSU would be bearing only one-fifth of their total support costs. Moreover, graduate students' share of cost would remain below that of undergraduates. It is unclear why the state would ask nonneedy undergraduates to bear a larger share of their education cost than nonneedy graduate students.

Graduate Fees Likely to Remain Lowest of Comparison Institutions. In addition, UC and CSU's graduate fees are even further below their comparison institutions (in both dollar and percentage terms) than undergraduate fees. The CSU 2004-05 rate, for example, is approximately $600 lower than the next lowest comparison institution and $4,300 less than the average of the comparison institutions. As Figure 6 shows, UC and CSU's graduate fees currently are the lowest of all their comparison institutions, and, even with the proposed 2005-06 fee increases, would very likely remain the lowest.

Over Next Several Years, Slightly Larger Graduate Fee Increases Would Help Address Existing Disparities. In short, graduate fees represent an even smaller share of cost than undergraduate fees, and, relative to undergraduate fees, are even further below their comparison institutions. Moreover, graduate fees are not yet 50 percent higher than undergraduate fees, a target agreed upon by the segments. To address these existing disparities, the Legislature may want to institute slightly higher graduate fee increases over the next several years.

Inconsistent Treatment of Nonresident Students. Figure 7 (see page E-192) summarizes the fees paid by nonresident students at the three segments. As the figure shows, nonresident undergraduates at UC and CSU currently are paying substantially more than full cost, and nonresident students at CCC (largely because of statutory requirements) are paying just about full cost. By comparison, nonresident graduate students at UC and CSU are paying considerably less than full cost.

Over Next Several Years, Larger Nonresident Graduate Fee Increases Would Help Align With Full Cost. It is unclear why the state currently is providing a substantial subsidy to nonresident graduate students. A share-of-cost fee policy might have all nonresident students pay full cost. If this were to be the state's policy, then the Legislature would want to increase nonresident graduate tuition more quickly over the next several years while holding nonresident undergraduate tuition steady. Both actions would help align nonresident charges with full cost.

Figure 6

UC and CSU'S Resident Graduate Fees Lowest of Comparison Institutions

	2004-05 Actual	2005-06 Proposed/ Projected[a]
UC and Its Public Comparison Institutions		
University of Michigan	$13,585	$15,204
Average	*10,138*	*11,346*
State University of New York	9,455	10,582
University of Virginia	9,200	10,296
University of Illinois	8,310	9,300
UC	**7,928**	**8,556**
CSU and Its Public Comparison Institutions		
University of Maryland, Baltimore	$13,500	$15,466
Rutgers University	10,846	12,425
Wayne State University	9,978	11,431
Cleveland State University	9,308	10,663
State University of New York, Albany	8,949	10,252
University of Connecticut	8,476	9,710
University of Wisconsin, Milwaukee	8,131	9,315
George Mason University	7,830	8,970
Average	*7,663*	*8,779*
University of Colorado, Denver	6,918	7,925
University of Texas, Arlington	6,740	7,721
Illinois State University	5,646	6,468
Arizona State University	5,310	6,083
Georgia State University	4,830	5,533
North Carolina State University	4,479	5,131
University of Nevada, Reno	4,009	4,593
CSU	**3,402**	**3,684**

a Reflects Governor's budget proposals for UC and CSU. For comparison institutions, adjusts 2004-05 fee levels by the average prior-year growth rate (11.9 percent for UC's comparison institutions and 14.6 percent for CSU's comparison institutions).

Figure 7

Nonresident Fees as a Share of Total Education Costs At California's Public Colleges and Universities

	2003-04	2004-05	2005-06
Undergraduates			
University of California (UC)			
Cost of education	$19,144	$19,859	$20,087
Nonresident fees	19,194	22,640	23,961
Fee as a percent of cost	100%	114%	119%
California State University (CSU)			
Cost of education	$9,699	$10,312	$10,601
Nonresident fees	10,506	12,504	12,690
Fee as a percent of cost	108%	121%	120%
California Community Colleges			
Cost of education	$4,343	$4,698	$4,883
Nonresident fees	4,470	4,470	4,530
Fee as a percent of cost	103%	95%	93%
Graduates			
UC			
Cost of education	$28,716	$29,788	$30,130
Nonresident fees	17,708	21,208	21,858
Fee as a percent of cost	62%	71%	73%
CSU			
Cost of education	$14,549	$15,468	$15,902
Nonresident fees	10,716	12,990	13,272
Fee as a percent of cost	74%	84%	83%

Legislature Should Budget New Fee Revenue

We recommend the Legislature reject the Governor's proposal to let the segments decide how to spend fee increase revenues. We recommend instead the Legislature follow standard budget practices and assess the segments' needs, decide what to fund, and then apply the segment's new fee revenue toward the identified costs.

As described earlier, one of the primary problems with the Governor's budget proposal is that it treats new fee revenue as unavailable to meet legislatively determined needs of the segments. Instead, the segments could use new fee revenue for whatever they deemed worthwhile. This translates into a highly unusual form of budgeting, whereby the segments raise and spend revenue outside of the regular legislative review process. It also is a departure from longstanding policy that fee revenues are an important funding source for the segments' basic instructional programs.

Focus on Needs, Apply Fee Revenue to Them. We recommend the Legislature follow common budgeting practices and begin by identifying the segments' needs and debating the advantages and disadvantages of specific funding requests. For example, the Legislature might choose to fund enrollment growth and a cost-of-living adjustment for each segment. It also might choose to provide the segments additional support for graduate financial aid. Each action obviously would entail related costs. As a result of the Governor's proposed fee increases, UC and CSU have $114 million and $76 million, respectively, in new revenue from the fee increases that can be used to cover all or a portion of these costs. If fee revenue is inadequate to meet all identified needs, then, as is typically the case, the General Fund would be applied toward the remaining costs.

In sum, rather than following the Governor's approach, which would result in inadequate oversight of the segments' budgets, we recommend the Legislature carefully consider each of the segments' requests and determine which ones should be funded. In doing so, the Legislature should consider new fee revenue as available to help meet identified needs.

Score Fee Revenue From Second-Year Phase In Of Excess-Unit Fee Initiative

We recommend the Legislature score $25.5 million in additional fee revenue associated with the second-year phase in of the excess-unit fee policy and capture a like amount of General Fund savings ($1.1 million for the University of California and $24.4 million for the California State University).

Adopted in the current year, the excess-unit fee policy is to charge undergraduate students full cost for units taken in excess of 110 percent of the units needed to obtain their degree. The policy is to be phased in over a five-year period—capturing only one-fifth of the potential excess-unit fee revenue in 2004-05, two-fifths of potential excess-unit fee revenue in 2005-06, and, so forth, until all excess-unit fee revenue is scored in 2008-09. This extended implementation period was designed to give the segments considerable flexibility in implementing the new policy and determining who should be assessed the higher fee.

UC and CSU Have Been Developing Segmental Policies. The UC Board of Regents plans to adopt a detailed policy at its upcoming March meeting. It tentatively has decided to define "full" cost as the full marginal cost (which is used for the state's enrollment growth funding practices), and it is likely to provide special treatment for students with a double major or high-unit major. The CSU indicates it is making progress on developing its policy, but, at the time of this writing, could provide no detail.

Second-Year Phase In to Yield $25.5 Million in Additional Fee Revenue. Despite being the second-year phase in of the excess-unit fee policy adopted by the Legislature and reflected in the Governor's higher education compact, the 2005-06 budget proposal does not reflect any associated fee revenue. The second-year phase in is to yield $25.5 million in additional fee revenue consistent with the savings scored in 2004-05. We recommend the Legislature score these revenues in 2005-06, resulting in a comparable amount of General Fund savings.

State Lacks CCC Fee Policy

The state currently does not have a policy for setting CCC fees. The Governor's fee agreements do not encompass CCC fees, nor did AB 2710 address CCC fees. Yet, without a fee policy, students have no clear expectation as to what they will need to pay for a CCC education, and the public has no clear understanding of its expected contribution. Currently, the CCC fee is the lowest of any state in the country. In 2004-05, annual community college fees for a full-time student were $780. The national average was about three times this amount ($2,324).

Existing Fee Level Has Unintended Consequence—State Loses Federal Funds, CCC Loses Revenue. Although keeping fees low might seem like a reasonable strategy for maintaining access, it has an unintended effect—the state loses substantial revenue from middle-income and wealthy students—many of whom would receive substantial, if not full, fee refunds from the federal government. California is one of the few states that does not take full advantage of these federal funds (that come back to fee-paying students in the form of tax credits and tax deductions). Moreover, if California's fee waiver program works as intended, a fee increase would have no effect on financially needy students' access to community colleges—as all students with any financial need would receive full fee coverage. Thus, a low fee policy actually works to the disadvantage of the state.

Federal Tax Benefits Result in Fee Refunds for Middle- and Upper Middle-Income Students. Figure 8 provides basic information about the federal Hope tax credit, Lifetime Learning tax credit, and tuition and fee tax deduction. As the figure indicates, the Hope tax credit is designed for middle-income students with family incomes up to $105,000. Through the Hope tax credit, the federal government reimburses these middle-income students for the first $1,000 they pay in education fees. For students with family incomes between $105,000 and $160,000, the federal government provides a tax deduction on the first $2,000 they pay in education fees.

Almost Every Other State in the Nation Maximizes Federal Aid. Currently, only California and some community colleges in New Mexico charge less than $1,000. Only 16 states charge less than $2,000. California, therefore, is one of few states currently not maximizing Hope tax credits for higher education. Put another way, CCC is not collecting from middle- and upper middle-income students fee revenue that, if collected, would be significantly offset with federal tax credits back to these same students. In effect, the state is paying for costs that the federal government would otherwise pay.

Figure 8

Federal Tax Benefits Applied Toward Higher Education Fees

Hope Credit	Lifetime Learning Credit	Tuition and Fee Deduction
• Directly reduces tax bill.	• Directly reduces tax bill.	• Reduces taxable income.
• Covers 100 percent of first $1,000 in fee payments. Covers 50 percent of second $1,000 (for maximum tax credit of $1,500).	• Covers 20 percent of first $10,000 in fee payments.	• Deducts up to $2,000 in fee payments.
• Designed for middle-income students who are: —In first or second year of college. —Attend at least half time.	• Designed for any middle-income student beyond first two years of college.	• Designed for any upper middle-income student not qualifying for a tax credit.
• Phases out entirely at adjusted income of $52,000 for single filers and $105,000 for married filers.	• Phases out entirely at adjusted income of $52,000 for single filers and $105,000 for married filers.	• Capped at adjusted income of $65,000 for single filers and $160,000 for married filers.

Increasing CCC Fee Shifts Costs to Federal Government Without Hurting Students

We recommend the Legislature increase the per unit fee at California Community Colleges (CCC) from $26 to $33. This higher fee, to be charged only to middle-income and wealthy students, would generate about $100 million in additional revenue for CCC. The federal government, in turn, would fully reimburse those fee-paying students with family incomes up to $105,000 (unless they do not have sufficient tax liability) and partially reimburse those fee-paying students with family incomes up to

$160,000. Financially needy students, on the other hand, are entitled to have their fees entirely waived (through a state aid program) and thus should pay nothing even with fees being increased. Given the Governor's budget continues to provide CCC with $37 million for financial aid outreach and counseling, CCC has resources to ensure that all eligible students receive available aid.

The existing $26 per unit fee, which only nonnneedy students are required to pay, represents 17 percent of total education costs. If raised to $33 per unit, nonneedy students' share of cost would increase to 20 percent. We believe it is reasonable for the state to ask nonneedy students (those who demonstrate no financial need using the standard federal means-tested methodology) to pay one-fifth of their total education costs. Raising the fee also would have substantial benefits—increasing CCC revenue and federal aid without restricting access for financially needy students.

Generates More Than $100 Million in State Revenue. Charging nonneedy students an additional $7 per unit would generate about $100 million in additional fee revenue for the community colleges. Of the nonneedy students paying the higher fee, those with family incomes up to $105,000 would qualify for a full fee refund in the form of a Hope tax credit. (This assumes that the family had a tax liability at least equal to the fee payment, which would usually be the case.) Others with family incomes up to $160,000 would qualify for a partial fee refund in the form of a Lifetime Learning tax credit or tax deduction. Based on data in the 2003 Student Expenses and Resource Survey, more than 90 percent of CCC students having to pay the higher fee would receive some offsetting federal tax benefit. In total, we estimate about one-half of the higher fees paid would be offset by these federal tax benefits.

Raising the fee also might result in a small additional Pell benefit (of several million dollars) to the financially neediest students attending some community colleges. That is, raising the fee to $33 per unit would ensure that the financially neediest students at all community colleges, even those with low average full-time workloads, would be able to obtain the maximum federal Pell Grant.

Fee Waiver Designed to Insulate Financially Needy Students From Effect of Any Fee Increase. The fee increase should not affect financially needy students. This is because the Board of Governors' fee waiver program waives fees for all students who demonstrate financial need. The program, which functions as an entitlement, is a generous needs-based program—requiring students to demonstrate only $1 of need to receive full fee coverage. Moreover, it helps financially needy students of all kinds—young and old; entering college for the first time or returning as an adult; seeking an associate degree, vocational degree, certificate, or license; seeking to transfer; already possessing a baccalaureate degree; seeking to prepare for a new career or advance in an existing career; and taking any number of classes.

The program also has relatively high income cut-offs. For example, a community college student living at home, with a younger sibling and married parents, could have a family income up to roughly $62,000 and still qualify for a fee waiver. The income cut-off would increase to roughly $75,000 if this same student was living away from home and would increase to $110,000 if two children were attending community college simultaneously. An older, independent student living alone could have an income up to roughly $40,000 and a student with a one child could have an income up to roughly $76,000 and still qualify for fee waivers.

Outreach Funding Helps Educate About Federal Aid Opportunities. In 2003-04 and 2004-05, in conjunction with the enacted CCC fee increases, the state provided CCC with significant new outreach funding to help educate students about federal and state financial aid opportunities. The Governor's 2005-06 budget proposal maintains this outreach funding at its current-year level of $37 million. These funds are to be used explicitly for individual financial aid counseling and a statewide media campaign that focuses on educating students about state and federal financial aid opportunities. This funding is in addition to the approximately $18 million the Student Aid Commission spends annually on financial aid outreach and counseling. (Even if fees are unchanged, the Governor's budget assumes both CCC and the commission will continue these outreach efforts.)

For all these reasons, we recommend raising the CCC fee, which only nonneedy students are required to pay, from $26 to $33 per unit. This would generate about $100 million in additional fee revenue for community colleges. Significantly, the state could realize these revenues without any effect on financially needy students (who are eligible for full fee waivers) and very little impact on middle-income students (whose fees would be offset by comparable increases in federal tax benefits).

UNIVERSITY OF CALIFORNIA
(6440)

The University of California (UC) consists of eight general campuses and one health science campus. The university is developing a tenth campus in Merced, which is scheduled to open in fall 2005. The Governor's budget proposal includes about $19.4 billion for UC from all fund sources—including state General Fund, student fee revenue, federal funds, and other funds. This is an increase of $722 million, or 3.9 percent, from the revised current-year amount. The budget proposes General Fund spending of $2.8 billion for the segment in 2005-06. This is an increase of $97.5 million, or 3.6 percent, from the proposed revision of the 2004-05 budget.

For the current year, the Governor proposes a net General Fund reduction of $12.2 million to account for (1) Public Employees' Retirement System rate adjustments and (2) an unexpended balance from lease-revenue bond proceeds. For the budget year, the Governor proposes $128.1 million in General Fund augmentations, $21.1 million in General Fund reductions, and a $9.5 million net decrease for baseline and technical adjustments. Figure 1 summarizes the Governor's proposed General Fund changes for the current year and the budget year.

Proposed Augmentations. The budget provides UC with a 3 percent General Fund base increase of $76.1 million that is not restricted for specific purposes. The UC indicates that it would apply most of these funds towards various salary increases. The Governor's budget also includes a $37.9 million General Fund augmentation for enrollment growth at UC. This would increase the university's budgeted enrollment by 5,000 full-time equivalent (FTE) students, or 2.5 percent, above the current-year level. In addition, the budget proposes a $14 million one-time augmentation for the UC campus in Merced, which is scheduled to open this fall.

Proposed Reductions. While the Governor's budget proposes a total of $128.1 million in General Fund augmentations, it also proposes $21.1 million in General Fund reductions. Specifically, the budget includes a $17.3 million reduction to outreach programs (also known as academic preparation programs) and enrollment. Proposed budget bill language directs UC to apply this reduction to any combination of outreach programs and student enrollment that it chooses. The Governor's budget also eliminates all General Fund support for the labor research institute, for savings of $3.8 million. Both of the above proposals would reduce specific augmentations approved by the Legislature last year in its adoption of the 2004-05 budget.

Figure 1

University of California (UC) General Fund Budget Proposal

(Dollars in Millions)

	General Fund
2004-05 Budget Act	**$2,721.0**
Baseline adjustments	-$12.2
2004-05 Revised Budget	**$2,708.8**
Baseline and Technical Adjustments	-$9.5
Proposed Increases	
Base budget increase (3 percent)	$76.1
Enrollment growth (2.5 percent)	37.9
One-time augmentation for UC Merced	14.0
Subtotal	($128.1)
Proposed Reductions	
Reduce funding for enrollment and outreach	-$17.3
Eliminate labor research institute	-3.8
Subtotal	(-$21.1)
2005-06 Proposed Budget	**$2,806.3**
Change From 2004-05 Revised Budget	
Amount	$97.5
Percent	3.6%

Student Fee Increases

The Governor's budget assumes that the university will receive $144.6 million in new student fee revenue—$30.6 million associated with 2.5 percent enrollment growth and $114 million from fee increases recently approved by the UC Board of Regents for undergraduate, graduate, professional school, and nonresident students. Below, we review the proposed fee levels. (For a detailed discussion about the need for a long-term fee policy and how fees interact with General Fund revenue, please see the "Student Fees" write-up earlier in this chapter.)

Undergraduate and Graduate Systemwide Fees. Figure 2 summarizes the planned increases in undergraduate and graduate systemwide fees. As the figure shows, the budget assumes a planned increase of 8 percent in the systemwide fee for undergraduate students. The budget also assumes a 10 percent increase in the systemwide fee for graduate students. When combined with campus-based fees, the total student fee for a resident full-time student in 2005-06 would be $6,769 for undergraduates and $8,556 for graduates. In addition to paying the systemwide and campus-based fees, professional school students and nonresident students also pay special supplementary fees, as we discuss below.

Figure 2

UC Systemwide Fees[a]
Resident Full-Time Students

			Change From 2004-05	
	2004-05	2005-06	Amount	Percent
Undergraduates	$5,684	$6,141	$457	8%
Graduates	6,269	6,897	628	10

[a] Amounts do not include campus-based fees.

Professional School Fees. The Governor's budget assumes $7.3 million in additional revenue from a planned 3 percent average increase in professional school fees. The budget also proposes extending a supplementary fee to professional programs in public health, public policy, and pacific international affairs. Currently, professional school fees vary by program. For 2005-06, the professional school fee is planned to range from a low of $3,013 for students in nursing programs to a high of $14,276 for business/management school students.

Nonresident Tuition. The proposed budget also assumes a planned 5 percent increase in the tuition surcharge imposed on nonresident students. Specifically, this surcharge would increase from $16,476 to $17,304. The increase in nonresident tuition is expected to provide about $6 million in additional fee revenue in the budget year.

Intersegmental Issues Involving UC

In 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.

Evaluate Higher Education Funding Needs Based on Master Plan, Not Governor's "Compact." The General Fund support and student fee increases proposed for 2005-06 are consistent with the compact that the Governor developed with UC and the California State University last spring. This compact specifies targets for the Governor's budget requests through 2010-11. Notwithstanding the Governor's compact, we advise the Legislature to enact a budget for higher education as it normally does, by examining each of the Governor's proposals on its own merits. Specifically, the Legislature should evaluate funding for higher education based on its *Master Plan for Higher Education* and not the Governor's compact.

Fund Enrollment Growth Consistent With Demographic Projections and Agreed-Upon Funding Practices. The Governor's budget provides $37.9 million to fund 2.5 percent enrollment growth at a marginal General Fund cost of $7,588 per additional FTE student. We recommend the Legislature instead provide funding for enrollment growth at a rate of 2 percent, which better matches anticipated need under the Master Plan. We also recommend adopting budget bill language specifying an enrollment target of 204,996 FTE students for UC. Moreover, using our marginal cost estimate based on the agreed-upon 1995 methodology, we recommend reducing the Governor's proposed per student funding rate for UC from $7,588 to $7,108. Accordingly, we recommend a General Fund reduction of $9.4 million for UC. In the "Enrollment Growth and Funding" write-up in this chapter, we also propose that the Legislature revisit and assess how the state determines the amount of funding to provide UC for each additional FTE student in future budget years.

Align Student Fee Increases to Share of Education Costs. The proposed budget assumes an additional $114 million in student fee revenue from various fee increases recently approved by the UC Regents. However, the Governor's budget does not account for this revenue, ceding to UC full discretion in deciding how to spend the additional revenue. We recommend that the Legislature consider this revenue as part of the base support for UC's programs, as it always has. In the "Student Fees" section, we also propose the Legislature adopt a long-term fee policy that sets fees at a fixed percentage of students' total education costs. Moreover, we recommend the Legislature reduce UC's General Fund appropriation to reflect $1.1 million in new revenue and savings associated with the second-year phase-in of the excess-unit fee policy that was adopted as part of the 2004-05 budget.

Impact of LAO Recommendations

Adopting all the above recommendations would result in a much different approach to UC's budget than that taken by the administration. In our view, the Legislature should approach UC's budget as it traditionally has: (1) assessing the cost of funding the programmatic objectives the Legislature has identified and (2) directing available funding—including both General Fund support and student fee revenue—to cover those costs. Figure 3 shows how UC's budget would be affected if the Legislature adopted our recommendations under this approach. Specifically, it shows the additional expenditures and resources above 2004-05 levels.

Figure 3

LAO Alternative 2005-06 Budget Plan for UC

Increases Over 2004-05

	In Millions
Expenditures	
Base budget increase (3 percent)[a]	$122.2
Enrollment growth (2 percent)	28.5
Adjustments for Merced and annuitant health and dental benefits[b]	4.5
Total	**$155.2**
Resources	
Additional revenue from student fee increase[c]	$113.4
Additional revenue from excess course unit charge	1.1
Governor's proposed General Fund increase	97.5
Total	**$212.0**
Freed Up General Fund Resources	**$56.8**

a Based on total state General Fund and student fee revenue.

b As proposed in the Governor's budget.

c Assumes 2 percent enrollment growth.

Expenditures. Figure 3 first shows new spending components:

- *Base Increase.* As discussed earlier, the Governor proposes a 3 percent base increase for UC. Given that we project inflation in 2005-06 will roughly match this percentage, we do not take issue with it.

However, the Governor applies the 3 percent increase only to the portion of UC's budget funded from the General Fund. We believe that a base increase should be applied to all of UC's base budget, including that portion which is funded with student fee revenue. As a result, under our approach, a 3 percent base increase would cost $122.2 million.

- ***Enrollment Growth.*** As discussed earlier, we recommend the Legislature fund a 2 percent increase in enrollment for UC. This would cost $28.5 million.
- ***Other Adjustments.*** The Governor proposes a net increase of $4.5 million to accommodate the costs of opening UC Merced in fall 2005 and various health and benefits costs. We have included these costs in Figure 3. We have not, however, included the Governor's proposed $17.3 million reduction to outreach and enrollment funding, which grants to UC the authority to decide where the cuts would be made. We believe the Legislature should specifically designate any areas for reduction so that it knows what it is buying in the budget.

Resources. Figure 3 displays two sources of new revenue:

- ***Fee Revenue.*** We estimate that the planned fee increases for the budget year will provide UC with $114.5 million in new student fee revenue. This amount assumes additional revenue from the university's excess course unit policy and our proposed 2 percent enrollment growth.
- ***General Fund Support.*** As discussed earlier in this analysis, the Governor's budget proposes to increase General Fund support for UC by $97.5 million from the revised 2004-05 budget (see Figure 1). As a starting point, therefore, these funds are available to fund the additional costs identified above.

Uncommitted Resources. As shown in Figure 3, the Legislature could (1) fully fund enrollment growth and a cost-of-living adjustment for UC and (2) reject the Governor's proposed $17.3 million reduction to UC's outreach programs and enrollment funding, all at a lower General Fund cost than proposed by the Governor. In fact, under our proposal the Legislature would free up almost $57 million in General Fund support (from the level in the Governor's budget proposal) to address other priorities.

As discussed earlier, the Legislature may wish to use some of this amount to provide increased financial aid for UC graduate students, given that these students, unlike needy UC undergraduates, are not protected from fee increases by the Cal Grant entitlement program. Our identified General Fund savings could also be used to fund legislative priorities in other areas, including addressing the state's budget problem.

CALIFORNIA STATE UNIVERSITY (6610)

The California State University (CSU) consists of 23 campuses. The Governor's budget includes about $6 billion for CSU from all fund sources—including General Fund, student fee revenue, federal funds, and other funds. This is an increase of $187 million, or 3.2 percent, from the revised current-year amount. Of that increase, $101 million will be generated from student fees. The budget proposes General Fund spending of $2.6 billion for the system in 2005-06. This is an increase of $111 million, or 4.4 percent, from the revised 2004-05 budget. Figure 1 (see next page) summarizes changes from the enacted 2004-05 budget to the Governor's 2005-06 proposal.

Proposed Augmentations. The proposed budget provides CSU with $122.5 million in General Fund augmentations to fulfill an agreement the Governor made with CSU. Specifically, the budget provides $71.7 million for a 3 percent base budget increase and $50.8 million to accommodate a 2.5 percent enrollment increase (to serve an additional 8,100 full-time equivalent [FTE] students).

Proposed Reductions. The budget also proposes $12 million in General Fund reductions. These changes include a $7 million reduction to enrollment growth and outreach, which would be allocated between the two areas at CSU's discretion.

Student Fee Increases

For 2005-06, the Governor's budget assumes increases in the systemwide fee for undergraduate and graduate students and nonresident tuition. These increases have already been approved by the Board of Trustees. The fee increases are expected to provide an additional $76 million in new student fee revenue. The Governor's proposal assumes the additional student fee revenue will *not* be offset by a reduction in CSU's General Fund support. (For a detailed description about the need for a long-term fee policy and how fees represent another source of funding for the university's operations, please see the "Student Fees" write-up earlier in this chapter.)

Figure 1

California State University General Fund Budget Proposal

(Dollars in Millions)

	General Fund
2004-05 Budget Act	**$2,448.0**
Baseline and Technical Adjustments	
Public Employees' Retirement System rate increase	$44.4
Carryover/reappropriation	4.4
Lease-revenue bond payment adjustment	-0.1
Revised 2004-05 Budget	**$2,496.7**
Proposed Increases	
Base increase (3 percent)	$71.7
Enrollment growth (2.5 percent)	50.8
Subtotal	($122.5)
Proposed Reductions	
Reduce funding for enrollment or outreach	-$7.0
Technical adjustments	-5.0
Subtotal	(-$12.0)
2005-06 Proposed Budget	**$2,607.2**
Change From 2004-05 Revised Budget	
Amount	$110.5
Percent	4.4%

Undergraduate and Graduate Systemwide Fees. As Figure 2 shows, the Governor's budget assumes an increase from 2004-05 of 8 percent, or $186, in the systemwide fee for undergraduate students. The proposed budget also assumes a 10 percent increase, or $282, in the graduate student systemwide fee.

Nonresident Fees. At CSU, nonresident students also pay a supplementary fee in the form of nonresident tuition. The budget assumes this supplementary fee will remain at the current level of $10,170.

Figure 2

CSU Systemwide Fees[a]
Resident Full-Time Students

			Change From 2004-05	
	2004-05	2005-06	Amount	Percent
Undergraduates	$2,334	$2,520	$186	8%
Graduates	2,820	3,102	282	10

[a] Amounts do not include campus-based fees.

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.

Evaluate Higher Education Funding Needs Based on Master Plan, Not Governor's "Compact." The General Fund support and student fee increases proposed for 2005-06 are consistent with the compact that the Governor developed with CSU and the University of California (UC) last spring. This compact specifies targets for the Governor's budget requests through 2010-11. Notwithstanding the Governor's compact, we advise the Legislature to enact a budget for higher education as it normally does, by examining each of the Governor's proposals on its own merits. Specifically, the Legislature should evaluate funding for higher education based on its *Master Plan for Higher Education* and not the Governor's compact.

Fund Enrollment Growth Consistent With Demographic Projections and Agreed-Upon Funding Practices. The Governor's budget provides $50.8 million to fund 2.5 percent enrollment growth at a marginal General Fund cost of $6,270 per additional FTE student. We recommend the Legislature instead provide funding for enrollment growth at a rate of 2 percent, which better matches anticipated need under the Master Plan. We also recommend adopting budget bill language specifying an enrollment target of 330,602 FTE students for CSU. Moreover, using our marginal cost estimate based on the agreed-upon 1995 methodology, we recommend reducing the Governor's proposed per student funding rate for CSU from $6,270 to $5,999. Accordingly, we recommend a General Fund reduction of $11.9 million for CSU. In the "Enrollment Growth and Funding" write-up of this chapter, we also propose that the Legislature revisit and assess how the state determines the amount of funding to provide CSU for each additional FTE student in future budget years.

Align Student Fee Increases to Share of Education Costs. The proposed budget assumes an additional $101 million in student fee revenue largely due to various fee increases recently approved by the CSU Board of Trustees. However, the Governor's budget does not account for this revenue, ceding to CSU full discretion in deciding how to spend the additional funds. We recommend that the Legislature consider this revenue as part of the base support for CSU's programs, as it always has. In the "Student Fees" write-up, we also propose the Legislature adopt a long-term fee policy that sets fees at a fixed percentage of students' total education costs. Moreover, we recommend the Legislature reduce CSU's General Fund appropriation to reflect $24.4 million in new revenue and savings associated with the second-year phase in of the excess unit fee policy that was adopted as part of the 2004-05 budget.

Impact of LAO Recommendations

Adopting all the above recommendations would result in a much different approach to CSU's budget than that taken by the administration. In our view, the Legislature should approach CSU's budget as it traditionally has: (1) assessing the cost of funding the programmatic objectives the Legislature has identified and (2) directing available funding—including both General Fund support and student fee revenue—to cover those costs. Figure 3 shows how CSU's budget would be affected if the Legislature adopted our recommendations under this approach. Specifically, it shows the additional expenditures and resources above 2004-05 levels.

Expenditures. Figure 3 first shows new spending components:

- ***Base Increase.*** As discussed earlier, the Governor proposes a 3 percent base increase for CSU. Given that we project inflation in 2005-06 will roughly match this percentage, we do not take issue with it. However, the Governor applies the 3 percent increase only to the portion of CSU's budget funded from the General Fund. We believe that a base increase should be applied to all of CSU's base budget, including that portion which is funded with student fee revenue. As a result, under our approach, a 3 percent base increase would cost $105 million.

- ***Enrollment Growth.*** As discussed earlier, we recommend the Legislature fund a 2 percent increase in enrollment for CSU. This would cost $38.9 million.

Figure 3

LAO Alternative Budget Plan for CSU

Increases Over 2004-05	In Millions
Expenditures	
Base budget increase (3 percent)[a]	$105.0
Enrollment growth (2 percent)	38.9
Technical adjustments[b]	-5.0
Total	**$138.9**
Resources	
Governor's proposed General Fund increase	$110.5
Additional revenue from student fee increases[c]	75.5
Additional revenue from excess course unit charge	24.4
Total	**$210.4**
Freed Up General Fund Resources	**$71.5**

a Based on total state General Fund and student fee revenue.

b As proposed by Governor.

c Assumes 2 percent enrollment growth.

- ***Other Adjustments.*** The Governor's budget includes a net $5 million reduction to CSU's base budget. This includes accounting for the one-time effect of a carryover appropriation and other technical adjustments.

Resources. Figure 3 displays two sources of new revenue:

- ***Fee Revenue.*** We estimate that the planned fee increases for the budget year will provide CSU with $75.5 million in new student fee revenue. This amount assumes additional revenue from the university's excess course unit policy and our proposed 2 percent enrollment growth.

- ***General Fund Support.*** As discussed earlier in this analysis, the Governor's budget proposes to increase General Fund support for CSU by $110.5 million from the revised 2004-05 budget (see Figure 1). As a starting point, therefore, these funds are available to fund the additional costs identified above.

Uncommitted Resources. As shown in Figure 3, the Legislature could (1) fully fund enrollment growth and a cost-of-living adjustment for CSU and (2) reject the Governor's proposed $7 million reduction to CSU's outreach programs and enrollment funding, all at a lower General Fund cost than proposed by the Governor. In fact, under our proposal the Legislature would free up over $71 million in General Fund support (from the level in the Governor's budget proposal) to address other priorities.

As discussed earlier, the Legislature may wish to use some of this amount to provide increased financial aid for CSU graduate students, given that these students, unlike needy UC undergraduates, are not protected from fee increases by the Cal Grant entitlement program. Our identified General Fund savings could also be used to fund legislative priorities in other areas, including addressing the state's budget problem.

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 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 (see next page), the Governor's proposal would increase total Proposition 98 funding for CCC by $361 million, or 7.5 percent. This increase funds a cost-of-living adjustment (COLA) of 3.93 percent, and enrollment growth of 3 percent. When all fund sources—including student fee revenue and federal and local funds—are considered, CCC's budget would total almost $8 billion.

CCC's Share of Proposition 98 Funding. As shown in Figure 1, the Governor's budget includes $5.1 billion in Proposition 98 funding for CCC in 2005-06. This is about two-thirds of total community college funding. Overall, Proposition 98 provides funding of approximately $50 billion in support of K-12 education, CCC, and several other state agencies. As proposed by the Governor, CCC would receive about 10.3 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 budget proposal would again suspend this provision.

Figure 1

Community College Budget Summary

(Dollars in Millions)

	Actual 2003-04	Estimated 2004-05	Proposed 2005-06	Change From 2004-05	
				Amount	Percent
Community College Proposition 98					
General Fund	$2,272.5	$3,036.3	$3,320.9	$284.6	9.4%
Local property tax	2,102.1	1,750.4	1,827.0	76.7	4.4
Subtotals, Proposition 98	($4,374.6)	($4,786.7)	($5,147.9)	($361.3)	(7.5%)
Other Funds					
General Fund	($132.4)	($247.7)	($259.9)	($12.2)	(4.9%)
Proposition 98 Reversion Account	0.1	5.4	20.0	14.6	271.5
State operations	8.6	8.9	8.8	-0.1	-1.2
Teachers' retirement	40.3	98.3	79.8	-18.5	-18.8
Bond payments	83.3	135.1	151.3	16.2	12.0
State lottery funds	120.8	143.3	139.9	-3.4	-2.4
Other state funds	8.6	8.8	9.1	0.3	2.9
Student fees	243.3	357.5	368.2	10.7	3.0
Federal funds	249.2	277.1	277.1	—	—
Other local funds	1,563.8	1,738.9	1,738.8	-0.1	—
Subtotals, other funds	($2,318.1)	($2,773.4)	($2,793.1)	($19.7)	(0.7%)
Grand Totals	**$6,692.7**	**$7,560.1**	**$7,941.0**	**$380.9**	**5.0%**

Major Budget Changes

Figure 2 shows the changes proposed for community college Proposition 98 spending in the current and budget years. Major base increases include $142 million for enrollment growth of 3 percent and $196 million for a COLA of 3.93 percent. (This is based on an estimate of inflation that will not be finalized until April.) The Governor also "sets aside" $31.4 million for a potential restoration of funding he vetoed in 2004-05. (We describe this set-aside later in this piece.) In addition to the new Proposition 98 spending shown in Figure 2, the Governor proposes $20 million in one-time Proposition 98 Reversion Account funds for aligning K-12 and CCC vocational curricula. (We discuss this proposal in the "Crosscutting Issues" section of this chapter.)

Figure 2

California Community Colleges Governor's Budget Proposal

Proposition 98 Spending[a] (In Millions)

2004-05 (Enacted)	**$4,808.0**
Local property tax shortfall	-$21.5
Lease-revenue augmentation per Section 4.30	0.1
2004-05 (Estimated)	**$4,786.7**
Property tax base adjustment	$21.5
Proposed Budget-Year Augmentations	
Cost-of-living adjustment of 3.93 percent	$195.5
Enrollment growth of 3 percent	141.9
Set-aside for restoration of 2004-05 vetoed funds	31.4
Lease-revenue payments	4.0
Permanently shift funding for Foster Parent Training Program to Proposition 98	3.0
Subtotal	($375.9)
Proposed Budget-Year Reductions	
Adjustment for increased estimate of fee revenue	-$34.9
Technical adjustments	-1.3
Subtotal	(-$36.1)
2005-06 (Proposed)	**$5,147.9**
Change From 2004-05 (Estimated)	
Amount	$361.3
Percent	7.5%

a Numbers may not add due to rounding.

Proposition 98 Spending by Major Program

Figure 3 (see next page) shows Proposition 98 expenditures for various community college programs. As shown in the figure, apportionment funding (available to districts to spend on general purposes) accounts for $4.6 billion in 2005-06, an increase of about $312 million, or 7.3 percent, from the current year. Apportionment funding in the budget year accounts for about 89 percent of CCC's total Proposition 98 expenditures.

Figure 3

Major Community College Programs Funded by Proposition 98

(Dollars in Millions)

	Estimated 2004-05	Proposed 2005-06	Change	
			Amount	Percent
Apportionments				
State General Fund	$2,507.8	$2,742.8	$235.0	9.4%
Local property tax revenue	1,750.4	1,827.0	76.7	4.4
Subtotals	($4,258.1)	(4,569.8)	($311.7)	(7.3%)
Categorical Programs				
Extended Opportunity Programs and Services	$98.8	$104.6	$5.8	5.9%
Disabled students	86.0	91.0	5.1	5.9
Matriculation	62.5	66.2	3.7	5.9
Services for CalWORKs[a] 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[b]	35.8	35.8	—	—
Telecommunications and technology services	23.4	23.4	—	—
Basic skills and apprenticeships	41.7	43.4	1.7	4.1
Financial aid/outreach	47.3	46.2	-1.1	-2.4
Foster Parent Training Program	1.8	4.8	3.0[c]	171.0
Fund for Student Success	6.2	6.2	—	—
Other programs	4.2	4.2	—	—
Subtotals	($528.6)	($546.7)	($18.2)	(3.4%)
Other Appropriations				
Set-aside for possible veto restoration	—	$31.4	—	—
Totals	**$4,786.7**	**$5,147.9**	**$361.3**	**7.5%**

a California Work Opportunity and Responsibility to Kids.

b For 2005-06, the Governor's budget also includes $20 million from the Proposition 98 Reversion Account to align career-technical education curricula between K-12 and California Community Colleges.

c Replaces $3 million previously provided by the Foster Children and Parents Training Fund.

Categorical programs (whose funding is earmarked for specified purposes) are also 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 5.9 percent for the three largest categorical programs (to fund a COLA and enrollment growth), but for most other programs he proposes no changes. In addition, the Foster Parent Training Program would be funded entirely from Proposition 98 General Fund support, replacing $3 million previously provided by the Foster Children and Parents Training Fund.

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 4.6 percent of total CCC funding. (In the "Student Fees" intersegmental piece earlier in this chapter, we recommend raising the CCC fee to $33 per unit. This would increase total revenue available to the state, and maximize federal reimbursements for students paying the fee.)

ENROLLMENT GROWTH

Enrollment Changes Over Time

The CCC is the nation's largest system of higher education, enrolling about 1.6 million students in fall 2004. As shown in Figure 4, enrollment has gradually increased over the past two decades by about 420,000 students, although it has fluctuated on a year-to-year basis.

Figure 4

CCC Enrollment

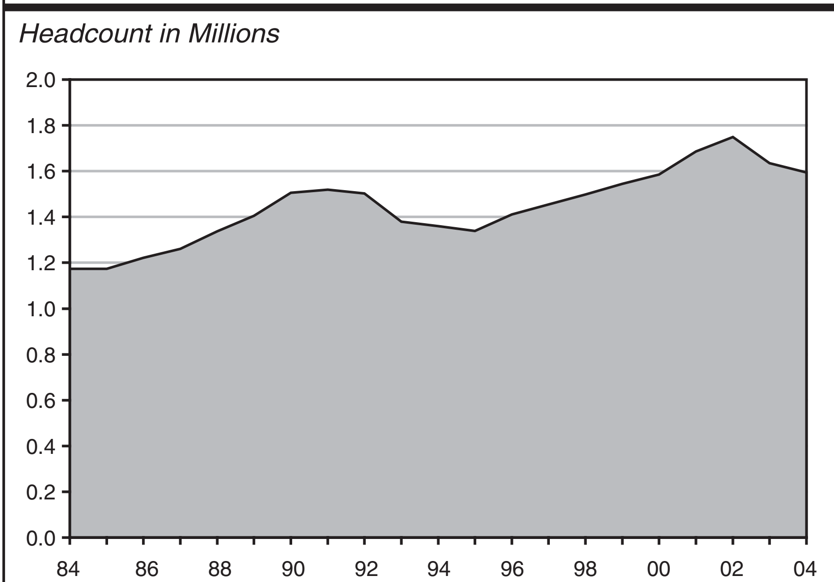


Figure 5 compares the cumulative change in enrollment over the past two decades with the cumulative change in the adult population, as well as the cumulative change in the traditional college-age population (18- to 24-year-olds). As the figure shows, CCC's enrollment has far outpaced the college-age population, and has generally matched growth in the adult population.

Figure 5

CCC Enrollment Versus State Population Growth

Cumulative Percent Change From 1984

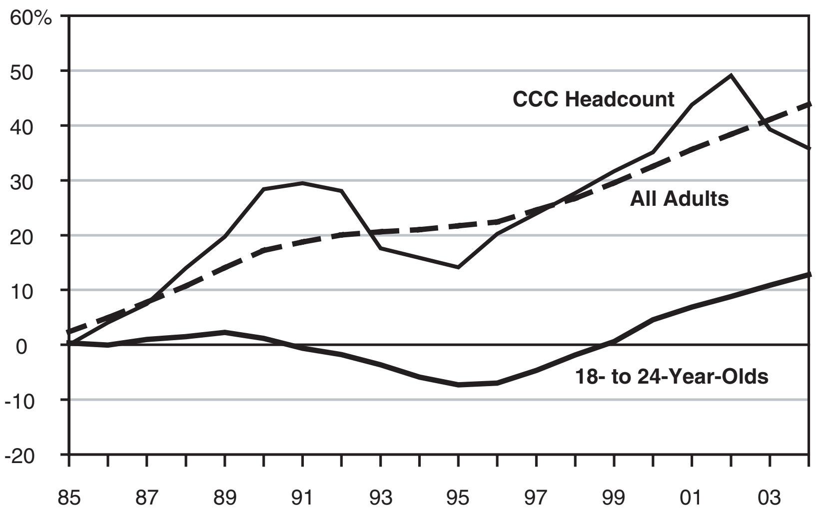


Figure 5 suggests that CCC's adult participation rate has generally remained constant, with temporary ups and downs, over the past two decades. Although participation rates can provide a rough sense of whether "access" to CCC is increasing or decreasing, it does not provide any obvious guidance as to what the participation rate "should" be. Based on comparisons with other states, however, California's college participation levels stand out. For example, the National Center for Public Policy and Higher Education recently found that California has some of the highest participation rates in the nation. Specifically, the National Center determined that California ranks fourth (tied with four other states) in college enrollment among 18- to 24-year olds, and that it ranks first in college enrollment among 25- to 49-year-olds.

Recent Slight Decline in CCC Enrollment— The Story Behind the Numbers

Over time, CCC's enrollment has fluctuated. These fluctuations respond to changes in a variety of factors, including the size and age distribution of the underlying population, cost factors (such as fees and the availability of financial aid), convenience of course schedules, and so on. As observed in Figure 4, CCC's enrollment increased through the late 1980s, declined in the early 1990s, and then rose significantly through the second half of the 1990s until 2003. In that year, CCC's enrollment dropped by about 115,000 students, or about 6.6 percent. What accounts for this enrollment decline?

Some Enrollment Decline Explained by Concurrent Enrollment Change. Some of the decline in enrollment was an intended result of statutory and budget changes to address a problem. Beginning in 2002, the Legislature and Governor both became concerned that a number of districts were inappropriately, and in some cases illegally, claiming state funding for a rapidly increasing number of high school students who were "concurrently enrolled" in CCC. While statute does make provision for some such enrollment, it was generally found that this provision was being abused. In response, the Chancellor called on districts to rein in these practices, and for 2003-04 the Legislature reduced funding for concurrent enrollment by $25 million and tightened related statutory provisions. As a result, high school students concurrently enrolled in community college courses dropped from a peak of about 94,000 in fall 2001 to about 80,000 in fall 2002 and 49,000 in fall 2003. Thus, more than one-quarter of the system's overall headcount drop between fall 2002 and fall 2003 can be explained by the drop in these high school students.

Cause of Remainder of Decline Unclear. The *2003-04 Budget Act* required the Chancellor's Office to report on changes in CCC enrollment for the 2003-04 academic year. Although a final report was due September 1, 2004, at the time this analysis was prepared (early February 2005), CCC could only provide preliminary data and draft reports. Available information suggests two main causes for the remaining enrollment decline (that is, not explained by the tightening of concurrent enrollment regulations):

- ***Reduced Course Offerings.*** The CCC suggests that districts reduced course offerings in spring 2003 in anticipation of possible budget reductions that had been included in the Governor's budget proposal for 2003-04. Although these proposed reductions were largely excluded from the enacted budget, the Chancellor's Office suggests that districts had already prepared for the reductions by hiring fewer part-time faculty and taking other steps to reduce costs. With fewer course offerings, some potential students found there was no space in courses they needed and thus did not enroll.

- ***Increased Fees.*** The Legislature raised student fees at CCC from $11 per unit to $18 per unit starting in fall 2003. Some students likely chose not to enroll at CCC at this higher cost. As noted in the nearby box, available data appear to indicate that the fee increase had no disproportionate impact on student racial and gender groups between fall 2002 and fall 2003.

Little Enrollment Decline Using Full-Time Equivalent (FTE) Measure. While headcount is a useful indicator of "access" in that it measures the number of individuals receiving instruction, it does not accurately reflect the amount of instruction being provided. This is because headcount measures do not distinguish between a full-time student taking 30 units per year and a part-time student taking, say, 6 units per year. For instance, although student headcount dropped about 6.6 percent between fall 2002

Fee Increase Had No Disproportionate Impact on Students

Budget bill language in the 2003-04 and 2004-05 budget acts requires the Chancellor's Office to provide data and analysis on the effect of recent fee increases upon student enrollment. The Chancellor's Office had only been able to provide preliminary information at the time this analysis was prepared. Based on this information, we offer the following conclusions about the changes to the makeup of the student population.

No Disproportionate Effect on Racial and Gender Groups. As shown in the figure, based on available information the recent small decline in enrollment in 2003-04 had no disproportionate effect on racial groups over the one-year period. Similarly, there was no change in the proportion of female and male students.

Small Effects on Age and Income Groups. The only significant change in the makeup of the student population in 2003-04 compared to the prior year relates to age. As shown in the figure, the percentage of CCC students under 18-years-old declined by more than one-quarter (largely reflecting the intended decline in concurrently enrolled students). Students between ages 18 and 29 somewhat increased their share of the student population, while those age 30 and above declined slightly.

The CCC's data show no evidence of disproportionate impact on income groups *as a result of the fee increase*. This likely reflects the fact that needy students are not required to pay fees. (The CCC's preliminary information does suggest there was a "modest" correlation between students' income and their likelihood to be affected by the reduction in course sections in spring 2003.)

(Continued)

and fall 2003, the number of total course "slots" that were taught declined by less than 2 percent. This suggests that, on average, the individual students making up the 6.6 percent headcount decline had been part-time students taking fewer than the average number of units. Indeed, anecdotal evidence suggests that many of these students were taking only one or two courses per semester.

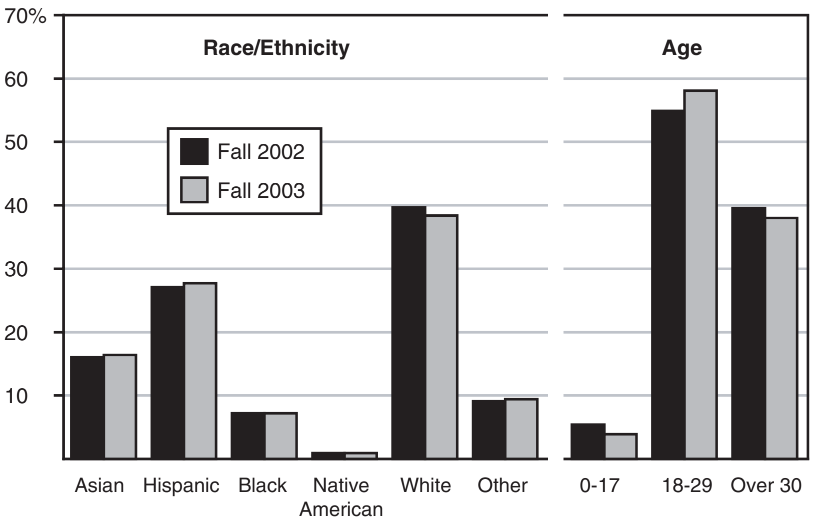
Enrollment Funding

The Governor's budget proposes an augmentation of $141.9 million to fund 3 percent enrollment growth at California Community Colleges. This is about one and one-half times the projected amount of enrollment growth due to underlying population increases. We recommend the Legislature fund this projected level of enrollment (1.9 percent), and redirect the remaining proposed growth funding to other K-14 priorities.

Report Overdue on Student Enrollment in 2004-05. For 2004-05, student fees increased again, from $18 per unit to $26 per unit. The *2004-05 Budget Act* required CCC to provide a report assessing the effect of this fee increase on enrollment by November 15, 2004. As of mid-February 2005, CCC had not yet provided that report.

Student Demographic Change

Percent of Total Headcount Enrollment



State law calls for CCC's annual budget request to include funding for enrollment growth that is at least the rate of increase in the adult population, as determined by the Department of Finance (DOF). For 2005-06, DOF projects that California's adult population will increase by 1.9 percent. This growth rate would translate into about 22,000 additional (FTE) students, at a cost of $91.3 million. The Governor's budget proposes to fund enrollment of about one and one-half times this amount: a 3 percent increase in FTE enrollment, which would fund 34,000 additional students at a cost of $141.9 million.

Recommend 1.9 Percent Enrollment Growth Funding. For 2005-06, we recommend the Legislature provide funding for 1.9 percent enrollment growth. The Master Plan calls on CCC to be open to all adults who can benefit from instruction, and DOF estimates that this eligibility pool will grow by 1.9 percent. Other things being equal, an increase in the eligibility pool should translate into a proportionate increase in enrollment. (We independently estimated the increase in CCC's enrollment based on various demographic factors, and arrived at a similar growth projection of 1.8 percent.)

As noted earlier, enrollment growth at the community colleges has been slowing in recent years, and California's college participation rates are among the highest in the country. In fact, preliminary data and anecdotal evidence suggest that many community college districts will serve fewer FTE students than they are funded to serve in 2004-05. For these reasons, we believe aligning enrollment growth funding with population growth for 2005-06 is a reasonable approach.

Funding Growth at 1.9 Percent Would Free Up Proposition 98 Resources for Other Priorities. The Governor's budget for CCC dedicates new Proposition 98 funding for two main purposes: enrollment growth and a COLA. If the amount of funding for growth were reduced to our recommended level of $91.3 million (to fund an enrollment increase of 1.9 percent), $50.6 million would be freed up for other K-14 priorities.

Reduce Enrollment Funding by $50.6 Million. We therefore recommend the Legislature reduce enrollment funding by $50.6 million, leaving $91.3 million to fund enrollment growth of 1.9 percent. We believe that this amount would be sufficient to fund increased enrollment demand at the community colleges.

STATE'S EFFORT TO EQUALIZE DISTRICT FUNDING SHOULD REMAIN A HIGH PRIORITY

We recommend the Legislature continue to support equalization of community college funding. The Legislature and Governor have already

established that this is an important goal, towards which they committed about one-third of necessary funding in the current year.

As a result of tax base differences that predate Proposition 13 in 1978, coupled with somewhat complex district allocation formulas, community college districts receive different amounts of funding for their students. In 2003-04, average funding per FTE student ranged from about $3,500 to about $8,200, although most districts have levels within a few hundred dollars of the state median of about $4,000. Small funding differences may be acceptable or even desirable (if they reflect real cost differences encountered by different districts). However, the funding differences currently experienced by community college districts have little correlation to underlying costs.

Numerous reports and hearings in recent years have recognized this disparity and have called for efforts to "equalize" funding among districts. In general, equalization can foster:

- ***Increased Fairness.*** 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 *Master Plan for Higher Education* and state law assign to community colleges a number of educational missions. The state has also 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.

2004-05 Budget Act *Initiated Multiyear Equalization Effort.* The *2004-05 Budget Act* included $80 million toward the goal of equalizing community college district funding over three years. The Legislature also enacted Chapter 216, Statutes of 2004 (AB 1108, Committee on Budget and Fiscal Review), which describes the goal of having at least 90 percent of statewide CCC enrollment eventually receive the same level of funding per FTE student, and specifies how the $80 million should be allocated toward that goal. We estimate that the $80 million moves the state about one-third of the way towards its equalization goal.

The Governor proposed the 90th percentile goal for equalization in his budget proposal last year, and called equalizing CCC and K-12 funding "foremost" among various education provisions enacted with the 2004-05 budget. He does not, however, propose that the state continue to move forward on its CCC equalization goal as part of the 2005-06 budget. We believe it is important to continue the state's commitment toward equalizing community college funding for the reasons mentioned above. It is especially important in light of the state's concern with CCC accountability. (We discuss recently enacted legislation concerning CCC accountability below.)

Consider Additional Funds for Equalization. We recommend, therefore, the Legislature consider allocating additional Proposition 98 funding to equalization, to be allocated in a manner consistent with Chapter 216. While we advise first funding workload increases (such as enrollment growth and cost-of-living increases), we recommend the next priority for additional ongoing Proposition 98 funding go to equalization. We think a target of $80 million—matching the current-year commitment—would make sense, to the extent that funding is available.

GREATER ACCOUNTABILITY NEEDED

With over a million and a half students spread across 109 campuses, the CCC system is large and decentralized. It also has a budget of almost $8 billion in public funds. For these reasons, oversight and accountability measures are critical for ensuring that public resources are being effectively used toward the various missions assigned to CCC by the Master Plan and by statute. The Chancellor's Office is generally charged with some oversight responsibilities. At the same time, the Legislature and Governor also have sought more formalized oversight and accountability provisions in statute. In recent years, evidence of fiscal mismanagement, inappropriately claimed reimbursements for nonexistent courses, and other improprieties by some districts have heightened the state's concern with CCC accountability.

"Partnership for Excellence" Has Expired

In 1998, the Legislature and Governor established the Partnership for Excellence (PFE) program through Chapter 330 (SB 1564, Schiff). In general, the PFE provided additional funding to community colleges in exchange for the commitment to improve their performance in five specified areas, such as the percentage of students who complete courses. A key accountability provision of the PFE called for district- and system-level performance in these specified areas to be reported annually. This information would be available to inform state-level budgeting, and could be used (if the CCC's Board of Governors [BOG] so chose) to influence the allocation of funding among districts. The BOG chose not to pursue this linking of funding to performance. The system made some very modest gains in some of the specified areas, such as workforce development, although towards the end of the program, performance again declined and most of those gains were lost. With the PFE sunsetting in December 2004, the Legislature moved the program's funding ($225 million) into districts' base apportionments. This funding thus remains in district budgets beyond the expiration of the program. (The Governor vetoed $31.4 million of this funding when he signed the *2004-05 Budget Act*, although as we explain below, he has set aside this amount for a possible restoration in the 2005-06 budget.)

District-Level Accountability to Be Developed

CCC Required to Develop New Accountability Measures. The PFE sunsetted on January 1, 2005. As imperfect as the PFE was as an accountability mechanism, the state now has no comprehensive mechanism for monitoring CCC's performance in various critical areas. Recognizing this, the Legislature and Governor enacted Chapter 581 (AB 1417, Pacheco) as part of the 2004-05 budget package. Among other things, Chapter 581 requires the 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. The BOG is to provide its recommended evaluation structure to the Legislature and Governor by March 25, 2005.

Consistent with Chapter 581, the BOG has consulted with our office, DOF, and various other higher education experts and interested parties as it has been developing its district-level accountability structure. We will advise the Legislature on the BOG's final proposal once it is completed and made public. In general, the Legislature should determine if the accountability mechanism:

- Uses meaningful indicators which measure both CCC's success in meeting minimum standards, and the degree of improvement achieved (or "value added") when students take CCC courses.
- Measures how well both the overall CCC system, and the individual districts, are fulfilling the missions assigned to them by the state.
- Recognizes the differing local needs that are encountered by districts.
- Is useful to the Chancellor's Office for the purpose of ensuring adequate district performance, and to the state for the purpose of monitoring the system's fulfillment of the mission assigned to it by the Master Plan.

Governor's Budget Proposal Makes Restoration of Vetoed Funds Contingent on CCC's Accountability Mechanism. The Governor vetoed $31.4 million of CCC's apportionment funding when he signed the *2004-05 Budget Act*. In his veto message, the Governor indicated that he was willing to restore this funding, which originally had been used to fund PFE-related improvements, if "district-level goals and performance evaluations are incorporated into the accountability structure" called for in the *2004-05 Budget Act* and Chapter 581. Accordingly, in his budget proposal for 2005-06, the Governor sets aside $31.4 million in new Proposition 98 support for possible appropriation through separate legislation "pending the outcome" of the BOG's proposed accountability mechanism.

We think it is reasonable to link a portion of the funding originally provided for one accountability-related program (the PFE) to a successor accountability program (the district-level accountability system called for in Chapter 581). However, we are concerned that provisional language in the Governor's proposal purports to express the *Legislature's* intent that DOF solely judge the adequacy CCC's proposed accountability program and, by extension, decide whether to restore the $31.4 million. We recommend this language be deleted, as outlined below:

> 4. As a condition of receiving funds appropriated in Schedule (1), the Board of Governors shall continue to assess and report to the Legislature, on or before April 15, data measures required by the current Partnership for Excellence program, scheduled to sunset January 1, 2005. It is the intent of the Legislature that these measures be replaced for reporting and assessment purposes, by district-specific outcome measures being developed by an accountability workgroup established by Chapter 581, Statutes of 2004. ~~It is also the intent of the Legislature that the final accountability measures produced by the workgroup, as approved by Department of Finance, result in the restoration of $31,409,000 to community college apportionments.~~

We plan to advise the Legislature on the bulk of the $31.4 million potential restoration once the BOG provides its proposal. Later in this section we recommend a small amount (about $1.25 million) of this funding set-aside be appropriated for expanding a performance-measurement data-sharing system that promises to be useful in helping districts make improvements in the areas of state concern expressed by Chapter 581.

Local Autonomy in Course Offerings Should Be Balanced With State Oversight

Course Offerings Should Emphasize State Priorities. Community college districts (which are governed by locally elected boards of trustees) have considerable autonomy in choosing which courses to offer in any given term. In fact, state regulations empower local districts to undertake any activity or initiate any program that is not in conflict with other laws and not inconsistent with CCC's broad mission. For example, a district could emphasize courses that are transferable to public universities and offer relatively few remedial courses. Another district could offer a much larger share of its courses in vocational fields and offer relatively few physical education courses.

At the same time, the Legislature has established various priorities for community colleges. Recognizing that existing statutes and regulations do not clearly prioritize the various components of CCC's mission, the Legislature and Governor in recent years have emphasized three state priority areas for CCC course offerings: student transfer to four-year colleges and universities, basic skills, and vocational/workforce training. Toward that end, the 2003-04 and 2004-05 budget acts have included provisions to help ensure that CCC districts in fact observe these priorities.

Criteria for Allocating Apportionment Funding. The *2003-04 Budget Act* included a provision requiring the BOG to adopt criteria for allocating apportionment funding to ensure that courses related to the three state priorities "are provided to the maximum extent possible within budgeted funds." In response, the Chancellor's Office developed a "cap" of 2 percent on the amount of funded credit FTE students that a district could provide outside of the three priority areas. Under the policy, the Chancellor's Office would monitor compliance and work with districts that exceeded the cap to either (1) identify an acceptable reason for exceeding the cap or (2) develop a plan to redirect the district's activity into compliance.

Methodology for Identifying Priority Courses. Concerns were expressed during budget hearings in 2004-05 about how CCC's policy defined and measured (and thus promoted) priority courses. For example, if the criteria for defining a course as meeting the state's priorities were vague or overbroad, the 2 percent cap could become meaningless. To address this concern, the *2004-05 Budget Act* included a provision requiring the BOG to adopt a clear methodology for determining which courses address any of the three priority areas. In response, the BOG defined as meeting state priorities all credit courses that are classified into any of five categories:

- "Transferable" to the University of California and/or the California State University.
- "Basic skills."
- "Occupational."
- Applicable towards any degree.
- English as a Second Language.

While the names of some of these categories appear to correspond to state priority areas, we remain concerned that, as a classification scheme, they are very broadly drawn. Indeed, it is unclear which types of credit courses, if any, are *not* included somewhere in these five categories.

Of greater concern, CCC's methodology excludes all noncredit courses, which make up about 9 percent of funded FTE students. Regulations require only that noncredit courses "meet the needs of" the students who take them. With such vague standards, the Legislature can have no assurance that noncredit courses focus on the state's stated priorities.

Recommend Clearer, More Inclusive Methodology. The CCC's limit on nonpriority courses provides little assurance that transfer, basic skills, and vocational education will in fact be accorded highest priority by districts. This is because the methodology for classifying courses as meeting the state's priorities is so expansive. We believe that the methodology should be refined to better identify courses that reasonably can be considered to address the state's three priority areas. At a minimum, noncredit courses as well as credit courses should be evaluated in determining the extent to which districts are advancing state priorities. We therefore recommend the Legislature amend budget bill language concerning these priorities so as to direct CCC to make these improvements.

> Item 6870-101-0001, Provision 9. Notwithstanding any other provision of law, funds appropriated in Schedule (3) of this item shall only be allocated for growth in full-time equivalent students (FTES) , on a district-by-district basis, as determined by the Chancellor of the California Community Colleges. The chancellor shall not include any FTES from concurrent enrollment in physical education, dance, recreation, study skills, and personal development courses and other courses in conflict with existing law for the purpose of calculating a district's three-year overcap adjustment. The board of governors shall implement ~~the~~ criteria required by provision 5(a) of the Budget Act of 2003 for the allocation of funds appropriated in Schedules (1) and (3), so as to assure that courses related to student needs for transfer, basic skills and vocational/workforce training are accorded the highest priority and are provided to the maximum extent possible within budgeted funds. <u>These criteria shall apply to both credit and noncredit courses. The Chancellor shall report to the Governor and Legislature by December 1, 2005, on the implementation of this provision.</u>

Cal-PASS Helps Districts to Improve Outcomes, Fosters Accountability

We recommend the Legislature allocate to the California Partnership for Achieving Student Success $1 million of the $31.4 million that is set aside for potential restoration. This funding would permit California Community Colleges to continue and expand a program that has been proven to promote better student outcomes and accountability.

In February 2003, the California Partnership for Achieving Student Success (Cal-PASS) was launched by 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 movement 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 critical. 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 700 institutions statewide. Our review has found numerous examples of improved outcomes, increased efficiencies, and cost savings as a result of the Cal-PASS program. Moreover, in 2003 Cal-PASS was endorsed by the Assembly higher education committee, the Senate subcommittee on higher education, and the Joint Committee to Develop an Education Master Plan.

Cal-PASS Can Help 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. The Cal-PASS already has shown its value in this regard in community college districts across the state and across disciplines.

- ***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. We note that some of the data elements available through Cal-PASS are directly related to elements in CCC's draft district accountability measures.

Recommend $1.5 Million Base Funding for Cal-PASS. Although Cal-PASS has expanded far beyond its original inception as a pilot program, its grant funding (from the state Chancellor's Office) has not increased and in fact will expire at the end of 2005-06. Based on our review of equipment, staffing, and other costs, we believe that a base budget of $1.5 million per year would ensure the continuation and further expansion of Cal-PASS.

Given that Cal-PASS still has access to about $500,000 in grant funds for 2005-06, we recommend an additional $1 million be directed to Cal-PASS. We recommend this funding be redirected from the $31.4 million that the Governor's budget has set aside pending CCC's response to the accountability requirements of Chapter 581. This would leave almost $30.4 million of the set-aside funds potentially to be restored to district base budgets. In effect, redirecting the $1 million to Cal-PASS would spread the cost of running the Cal-PASS system across all districts at an average cost of less than $1 per FTE student. We believe this is a reasonable cost for the benefits of Cal-PASS.

STUDENT AID COMMISSION
(7980)

The Student Aid Commission provides financial aid to students through a variety of grant and loan programs. The proposed 2005-06 budget for the commission includes state and federal funds totaling $1.4 billion. Of this amount, $746 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 first summarize the Governor's budget proposals for the Cal Grant program and the Assumption Program of Loans for Education (APLE). We have concerns with three of these proposals—the reduction to the private university Cal Grant, the "set aside" for the National Guard APLE program, and the size of EdFund's operating surplus (which partly supports the Cal Grant program). We discuss these issues later in this section.

Major Budget Proposals

Figure 1 (see next page) compares the commission's revised 2004-05 budget with the proposed 2005-06 budget. As the figure shows, financial aid expenditures would increase $44.6 million, or 6 percent, from the current year. Virtually all of this increase is due to additional Cal Grant costs ($37.3 million) and APLE costs ($6.9 million). As the figure also shows, in the budget year, General Fund support would increase considerably, in part to backfill a major reduction in support from the Student Loan Operating Fund (SLOF). Whereas $146.5 million in SLOF monies were used to support the Cal Grant program in 2004-05, the Governor's budget proposes to use $35 million in SLOF monies in 2005-06.

Cal Grant Program. Figure 2 (see page E-231) provides a more detailed breakdown of the four major budget proposals relating to the Cal Grant program. The Governor's budget assumes the commission will issue 3,345 additional Cal Grant awards. This represents a 1.3 percent increase from the current year in the total number of Cal Grant awards issued. The

Governor's budget also proposes to increase the value of Cal Grants for University of California (UC) and California State University (CSU) students (to compensate for the proposed undergraduate fee increases), but it would decrease Cal Grants for financially needy students attending private institutions by $873, or 10 percent. (Please see below for a more detailed discussion of the private university Cal Grant issue.)

Figure 1

Student Aid Commission Budget Summary[a]

(Dollars in Millions)

	2004-05 Revised	2005-06 Proposed	Change	
			Amount	Percent
Expenditures				
Cal Grant programs				
Entitlement	$551.0	$608.9	$57.9	11%
Competitive	116.2	124.9	8.7	7
Pre-Entitlement	37.2	7.4	-29.8	-80
Cal Grant C	9.7	10.3	0.6	6
Subtotals—Cal Grant[b]	($714.1)	($751.4)	($37.3)	(5%)
APLE[c]	$34.0	$40.9	$6.9	20%
Graduate APLE	0.2	0.4	0.2	75
National Guard APLE	—	0.2	0.2	—
Law enforcement scholarships	0.1	0.1	—	1
Totals	**$748.5**	**$793.1**	**$44.6**	**6%**
Funding Sources				
General Fund	$589.4	$745.5	$156.1	26%
Student Loan Operating Fund[d]	146.5	35.0	-111.5	-76
Federal Trust Fund[d]	12.6	12.6	—	—
Totals	**$748.5**	**$793.1**	**$44.6**	**6%**

a In addition to the programs listed, the commission administers the Byrd Scholarship and Child Development Teacher and Supervisor programs—both of which are supported entirely with federal funds. It also administers the Student Opportunity and Access program, an outreach program supported entirely with Student Loan Operating Fund monies.

b Includes $46,000 for the Cal Grant T program in 2004-05. The program has been phased out as of 2005-06.

c Assumption Program of Loans for Education.

d These monies pay for Cal Grant costs as well as support and administrative costs.

Figure 2

Major Cal Grant Budget Proposals

Governor's Budget Proposal	Cost (In Millions)
Increase in number of Cal Grant awards (3,345)	$21.6
Increase University of California Cal Grant by 8 percent (raising maximum award from $5,684 to $6,141)	15.3
Increase California State University Cal Grant by 8 percent (raising maximum award from $2,334 to $2,520)	7.9
Decrease private university Cal Grant by 10 percent (lowering maximum award from $8,322 to $7,449)	-7.5
Total	**$37.3**

Figure 3 (see next page) shows growth in the number of Cal Grant awards from 2003-04 (actual) to 2005-06 (projected). The budget assumes the commission will issue almost 260,000 Cal Grants in 2005-06. It assumes a modest increase (2.3 percent) in the number of new High School Entitlement awards, and no increase in the number of new Transfer Entitlement awards (though the commission indicates it currently is analyzing transfer patterns and might revise this estimate in the spring). Per statute, the budget assumes the commission will award 22,500 new Competitive Cal Grant awards and 7,761 new Cal Grant C awards. (The Competitive Cal Grant program is designed for older students whereas the Cal Grant C program is designed for students enrolled in short-term vocational programs.) The commission is in the midst of studying renewal patterns in the competitive program to determine if its associated budget-year projections need to be revised. The budget assumes only 1,660 pre-entitlement renewal awards—indicating that almost all pre-entitlement recipients already have completed college. In a couple of years, the program will be entirely phased out.

APLE Program. The Governor's budget includes a $6.9 million General Fund augmentation to cover loan-forgiveness costs associated with APLE warrants issued in previous years. The Governor's budget proposes to issue 7,700 new APLE warrants—the same level as in the current year. The Governor's budget also includes $200,000 to fund a maximum of 100 new National Guard APLE warrants. (Please see below for a more detailed discussion of this proposal.)

Figure 3

Growth in Cal Grant Participation

	2003-04 Actual	2004-05 Revised	2005-06 Projected	Change From 2004-05	
				Number	Percent
High School Entitlement					
New awards	60,359	63,000	64,449	1,449	2.3%
Renewal awards	82,486	106,960	114,371	7,411	6.9
Subtotals	(142,845)	(169,960)	(178,820)	(8,860)	(5.2%)
Transfer Entitlement					
New awards	2,270	4,300	4,300	—	—
Renewal awards	209	1,075	2,895	1,820	169.3%
Subtotals	(2,479)	(5,375)	(7,195)	(1,820)	(33.9%)
Competitive					
New awards	22,391	22,902	22,500	-402	-1.8%
Renewal awards	28,717	35,193	33,670	-1,523	-4.3
Subtotals	(51,108)	(58,095)	(56,170)	(-1,925)	(-3.3%)
Pre-Entitlement Renewal Awards	28,010	8,135	1,660	-6,475	-79.6%
Cal Grant C					
New awards	7,580	7,761	7,761	—	—
Renewal awards	6,500	6,884	7,964	1,080	15.7%
Subtotals	(14,080)	(14,645)	(15,725)	(1,080)	(7.4%)
Cal Grant T Renewal Awards	255	15	—	-15	-100.0%
Totals	**238,777**	**256,225**	**259,570**	**3,345**	**1.3%**

Private University Cal Grant

The Governor's budget proposes to reduce the maximum Cal Grant for students attending private colleges and universities by $873, or 10 percent—lowering the award from its current-year level of $8,322 to $7,449. This would be the second consecutive reduction. Between 2003-04 and 2004-05, the award was reduced by $1,386, or 14 percent. Approximately 12,100 financially needy students attending private universities likely would be affected by the proposal, which would be imposed only on new Cal Grant recipients. Of these students, approximately 8,500 would experience the reduction in the budget year whereas approximately 3,600 others would experience the reduction in 2006-07. (This delayed impact is due to a state policy that does not provide fee assistance to most first-year Cal Grant B recipients, even though they represent the financially neediest students served by the Cal Grant program.) Continuing students would retain the higher award rates they are receiving in the current year. The Governor's budget assumes the proposal would generate $7.5 million in General Fund savings. Below, we discuss our concerns with this proposal.

Create Parity for Financially Needy Students Attending Public and Private Universities

We recommend the Legislature establish in statute a policy and an associated award formula that would link the Cal Grant for financially needy students attending private universities to the General Fund subsidy the state provides for financially needy students attending public universities. Under our recommended formula, the private university Cal Grant would be $10,568 in 2005-06. Providing this higher award amount to new 2005-06 recipients would cost $26.6 million relative to the Governor's budget. We recommend the Legislature use additional Student Loan Operating Fund surplus monies to cover this cost (please see final write-up of this section).

Since 2001-02, the state has had neither an explicit nor an implicit policy for determining the private university Cal Grant. Without a policy, Cal Grant decisions can appear arbitrary, the program can become disconnected from its primary objective, and the program can be more difficult to oversee and evaluate. For these reasons, we recommend the Legislature establish a statutory private university Cal Grant policy that is linked with an associated award formula that can be used for budgeting purposes. We recommend a policy and related formula that would provide a simple means by which the state could ensure that it contributes about the same amount of support for all financially needy students.

Since 2000, State Has Not Had Private University Cal Grant Policy. When Chapter 403, Statutes of 2000 (SB 1644, Ortiz), created the new Cal Grant Entitlement program, the state's existing private university award policy was replaced with a new provision that linked the private university Cal Grant to whatever amount was specified in the annual budget act. For the next three consecutive years, the private university award was maintained at its 2000 level before being reduced in the current year.

Without a Policy, Funding Decisions Can Appear Arbitrary. Without an award policy, private university Cal Grant decisions can appear arbitrary. For example, in the current year, college costs (including fees and tuition) increased for public and private students alike. However, the Cal Grant award increased for public university students while the private university Cal Grant declined.

Without a Policy, Program Can Become Disconnected From Its Purpose. Without a policy to guide annual private university award decisions, the Cal Grant program can quickly become disconnected from its primary purpose. Although maintaining access and choice for all financially needy students is the primary goal of the Cal Grant program, the state's current-year action appeared to promote access to public institutions while dampening the potential for some financially needy students to attend private institutions. This is of particular concern because some private institutions are very specialized and essentially have no public university equivalent, yet they may best meet a financially needy student's educational objective. Access also is of particular concern because a significant proportion of financially needy, baccalaureate-seeking students attend *local* four-year private universities—living at home to substantially reduce overall college costs. For example, more than one-third of the financially neediest students (with family incomes less than $30,000) attending private four-year colleges live at home. Moreover, of the 25 private schools that enroll the greatest number of Cal Grant recipients (please see nearby box), all but a handful are relatively small regional universities with relatively small endowments. These institutions would not be as likely to backfill the proposed reduction in the state's award.

Without a Policy, Program Is Difficult to Evaluate. One of the primary benefits of any statutory policy is that it can clarify the objective of a program, thereby allowing the Legislature to monitor and track its performance. Without a policy, the Legislature cannot determine whether the private university award is fulfilling its objective. A statutory policy could establish criteria upon which to evaluate the private university award's success in promoting access, choice, and persistence among financially needy students as well as its success in expanding general higher education enrollment capacity.

State's Former Statutory Policy Sought Parity. Prior to 2000, the state had a longstanding statutory policy that guided private university Cal Grant decisions. Statute then specified, "The maximum award for students attending nonpublic institutions shall be set and maintained at the estimated average General Fund cost of educating a student at the public four-year institutions of higher education." Toward this end, statute included a formula that set the private university Cal Grant at 75 percent of the average General Fund cost per student at CSU plus the average of UC and CSU's student fees (both systemwide and campus-based).

Our Modified Formula Promotes Greater Parity. Our recommendation is consistent with the intent of the state's former statutory policy to provide comparable General Fund support for financially needy students attending public and private schools. We recommend modifying the previous formula to better meet this intent. The earlier formula was somewhat arbitrary in linking the award to "75 percent of the average General Fund cost per student at CSU." Our modified formula is based on the enrollment-weighted General Fund subsidy provided for students attending UC and CSU. We think this is a more accurate reflection of how much the state provides for an additional public university student. Second, our modified formula is based on the marginal cost rather than the average cost, as this too is a better reflection of the amount the state pays for each additional (rather than existing) student. Third, the earlier formula accounted for both systemwide and campus-based fees to reflect former Cal Grant policies. Our modified formula reflects current Cal Grant policies, which link awards only to systemwide fees. All three modifications establish a simple, ongoing means for equalizing what the state provides for financially needy students at public and private universities.

Figure 4 compares the support the state provides for different groups of financially needy students. As reflected in the figure, the Governor's proposed private university Cal Grant award would be 15 percent less

Figure 4

Comparing State Support for Financially Needy Students

	2005-06
University of California	
General subsidy	$7,588
Cal Grant	6,141
Total subsidy	$13,729
California State University	
General subsidy	$6,270
Cal Grant	2,520
Total subsidy	$8,790
Private University Cal Grant	
Proposed rate	$7,449
LAO-formula rate	10,568
Former statutory rate	10,694

than the level of General Fund support provided for financially needy students at CSU and 46 percent less than the level of General Fund support provided for financially needy students at UC. Also reflected in the figure, the budget-year private university rate generated by our recommended formula would be just slightly less than what the award would have been using the state's former statutory formula.

Fiscal Implication of New Parity Policy. Increasing the private university Cal Grant to $10,568 for new 2005-06 recipients would cost $26.6 million relative to the Governor's budget. (By comparison, the Governor's budget proposal includes a $23 million augmentation for UC and CSU Cal Grants in the budget year.) We recommend the Legislature use surplus SLOF monies to cover this budget-year cost. In 2006-07, the cost of the higher private university grant would increase by approximately $8.3 million as second-year Cal Grant B recipients began receiving a fee award (rather than only a subsistence award). The Legislature also may want to consider increasing the award for new Cal Grant recipients in the current year, who were subject to the 14 percent award reduction. We estimate providing the higher award of $10,568 for these students would cost an additional $25.5 million in 2005-06.

In sum, we recommend the Legislature adopt a policy that would seek parity between state support provided for financially needy students attending public and private universities. This policy could help guide annual private university Cal Grant decisions, thereby making them seem less arbitrary. It also would support the primary objective of the Cal Grant program—to promote access and choice for all financially needy students. Finally, having an explicit policy could enhance the Legislature's ability, on an ongoing basis, to assess the public benefit of the private university Cal Grant.

National Guard APLE Program

As established in 2003 and amended in 2004, the National Guard APLE program offers loan forgiveness as an incentive for more individuals to enlist or re-enlist in the National Guard, State Military Reserve, and Naval Militia. Specifically, qualifying members have a portion of their education loans forgiven after each year of military service—$2,000 after their first year of service and $3,000 after their second, third, and fourth years of service—for total loan forgiveness of $11,000. The annual budget act has not yet authorized the commission to issue any National Guard warrants.

Private University Cal Grant Helps Financially Needy Students Attending Diverse Set of Institutions

To help answer some private university Cal Grant questions that often arise, we list below the 25 private schools that enrolled the greatest number of Cal Grant recipients in 2004-05. Of the 25 schools, 23 are four-year institutions whereas 2 are two-year institutions. Seventeen are nonprofit institutions whereas eight are for-profit institutions. Two schools (Stanford and the University of Southern California) have endowments that exceed $1 billion, six schools have endowments that exceed $100 million, and the remaining nonprofit schools have relatively small endowments. These 25 schools enroll just about one-half of all private university Cal Grant recipients. In total, new Cal Grant recipients in 2004-05 are enrolled at 191 private institutions.

Private Institutions Enrolling the Greatest Number of Cal Grant Recipients

(2004-05)

Private Institution	Cal Grant Recipients	Private Institution	Cal Grant Recipients
University of Southern California	838	University of San Diego	231
University of Phoenix[a]	572	Saint Mary's College of California	215
Devry University, Pomona[a]	488	Westwood College of Technology[a]	199
Loyola Marymount University	392	University of Redlands	194
University of the Pacific	348	California Baptist University	194
Fashion Institute of Design[a,b]	334	The Art Institute of California, Los Angeles[a]	192
University of Laverne	306	Universal Technical Institute[a,b]	178
Azusa Pacific University	299	American Intercontinental University[a]	175
University of San Francisco	278	Santa Clara University	172
Mount St. Mary's College	264	La Sierra University	158
Stanford University	253	The Art Institute of California, San Francisco[a]	153
Chapman University	236	Fresno Pacific University	151
Biola University	232		

a For-profit institutions.

b Two-year institution.

New Warrants Have No Budget-Year Cost

Because no National Guard warrants have been issued to date, and individuals must complete one year of military service prior to receiving loan forgiveness, the commission will incur no associated program costs in 2005-06. Thus, the Governor's budget prematurely funds the program. We therefore recommend the Legislature capture the associated $200,000 as General Fund savings.

The Governor's budget proposes to authorize up to 100 new National Guard APLE warrants. It also includes $200,000 for the program, with accompanying budget bill language that "these funds shall remain available through 2006-07." Because warrant-holders must complete one year of military service before receiving loan forgiveness, the state would not begin incurring a cost for a new National Guard APLE warrant (as is the case with all APLE warrants) until at least one year after it is originally issued. Thus, no funding would be needed in the budget year. Moreover, the Governor's proposal to set aside 2005-06 monies that will not be needed until 2006-07 is inconsistent with existing APLE funding practices. Specifically, the state has a long history of funding APLE warrants only as payment on them becomes due. This helps ensure funds are provided when needed. We recommend the Legislature continue to adhere to its existing budget practice and pay for any new warrants when payment becomes due. Thus, we recommend the Legislature capture the unneeded $200,000 as General Fund savings.

EDFUND OPERATING SURPLUS

Chapter 961, Statutes of 1996 (AB 3133, Firestone), gave the commission the authority to establish an auxiliary organization for purposes of administrating the Federal Family Education Loan (FFEL) program. Toward this end, the commission created EdFund, which, consistent with statute, functions as a nonprofit public benefit corporation. Colleges and universities that are interested in participating in the FFEL program may choose to work with EdFund or one of several other independent guaranty agencies. Alternatively, colleges and universities may participate in the Federal Direct Student Loan program, in which case their student loans are guaranteed and administered directly by the federal government.

After Six Years of Increasingly Large Annual Surpluses, EdFund Had $267 Million Cumulative Surplus. From federal fiscal year (FFY) 1997-98 through FFY 2002-03, EdFund experienced increasingly large annual operating surpluses. In 2002-03, EdFund's annual surplus reached $108 million. EdFund's annual operating expenses that year were $118 million, so it was generating about twice as much revenue as it needed to cover its operating costs. By the close of 2002-03, EdFund was carrying a cumulative surplus of $267 million. EdFund attributes these surpluses to three primary factors—an increase in its loan volume as well as its success in default prevention and loan collections.

Current-Year "Swap" Works as Intended. In 2004-05, the state decided to use $146.5 million in SLOF monies to cover a portion of Cal Grant costs. The swap worked as intended—helping to maintain existing Cal Grant benefits for most students, reducing EdFund's surplus without threatening the viability of the agency, and relieving the General Fund. Even after accounting for this swap, EdFund has a cumulative surplus of $160 million (as of September 2004).

Use Larger Budget-Year Swap to Restore Cal Grant Benefits

We recommend the Legislature use an additional $26.6 million in Student Loan Operating Fund surplus monies to restore Cal Grant benefits for financially needy students attending private universities (thereby reducing the cumulative surplus to a more moderate level).

The Governor's budget proposes to use $35 million in SLOF surplus monies to support the Cal Grant program. In essence, it swaps $35 million in SLOF surplus monies for General Fund monies. We recommend the Legislature increase the swap by $26.6 million—for a total of $61.6 million—to restore the current-year and proposed reductions to the private university Cal Grant. If EdFund generated no additional operating surplus in FFY 2004-05, our recommendation would reduce EdFund's cumulative surplus from $160 million to $98 million. This equates to roughly a nine-month reserve. We think, for a nonprofit public agency, this is still a substantial reserve level—one that would not reduce EdFund's viability as a guaranty agency.

FINDINGS AND RECOMMENDATIONS

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Crosscutting Issues

Proposition 98 Priorities

E-13 ■ **Balance State and Local Fiscal Needs.** Recommend the Legislature base the 2005-06 Proposition 98 spending level on the amount schools and community colleges need to continue current programs under most circumstances.

E-20 ■ **Align Budget Bill With Workload Priorities.** Recommend the Legislature delete $382 million for revenue limit deficit reduction and higher community college growth because the proposals represent discretionary increases that are not needed to maintain existing programs. Instead, we recommend the Legislature add $315 million for K-14 mandates and fund higher estimated cost-of-living adjustments.

Vocational Education

E-23 ■ **Governor's Vocational Education Reform.** Recommend the Legislature direct the Department of Finance to provide specific information prior to budget hearings.

State Teachers' Retirement System

E-28 ■ **Does the Governor's Proposal Work as a 2005-06 Budget Solution?** We find that the Governor's proposal to shift the state benefits contribution to school districts likely would not achieve the intended savings under current law.

E-35 ■ **Long Term: Does the Proposal Move Toward the Goals of Local Control and Responsibility?** The Governor's proposal would not fundamentally reform the State Teachers' Retirement System. To move towards a retirement system that emphasizes local control and responsibility, the Legislature would need to focus on a new approach for new teachers.

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School District Financial Condition

E-50 ■ **Retiree Benefits Pose Long-Term Challenge.** Recommend the Legislature adopt statutory changes to require county offices of education to review whether districts' plan for funding of long-term retiree health benefit liabilities adequately cover likely costs.

E-53 ■ **Revise Declining Enrollment Options**. Recommend adopting legislation to create a new declining enrollment revenue limit adjustment that would begin in 2005-06.

Categorical Reform

E-59 ■ **Reform Supplemental Instruction.** Recommend the Legislature adopt trailer bill language adding two supplemental instruction programs to the new Pupil Retention Block Grant along with a requirement specifying that "first call" on funds in the block grant must be for these supplemental instruction program costs.

E-64 ■ **Increase Flexibility and Enhance Accountability of Teacher Training Block Grant Monies. Eliminate Item 6110-137-0001 and Shift $31.7 Million to Item 6110-245-0001.** Recommend including the Mathematics and Reading Professional Development program in the block grant and excluding Teacher Dismissal Apportionments. Also recommend requiring school districts, as a condition of receiving teacher training block grant monies, to provide the State Department of Education with teacher-level data linked with student-level Standardized Testing and Reporting data.

E-70 ■ **Adopt Trailer Bill Language Re-Establishing the Link Between Teacher Training Block Grant Monies and Districts' Staffing Needs.** Recommend school districts' allocations for the credential and professional development block grants be made annually based on the number of beginning and veteran teachers, respectively. This would ensure that funding allocations are responsive to changes in districts' staffing needs.

Special Education

E-72 ■ **Conform to New Federal Rules. Reduce Item 6110-161-001 by $9.9 million.** Recommend adopting a revised calculation of supplanting for federal special education funds, for a savings of $9.9 million from the General Fund.

E-74 ■ **Technical Problems Create Overbudgeting. Recognize Savings of $77 million.** Recommend correcting two technical budgeting problems for a savings of $36.3 million in Proposition 98 funds.

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E-74 ■ **Use Funds for Special Education Priorities.** Recommend spending $61 million for various special education programs in 2004-05 and 2005-06.

E-76 ■ **Make Mental Health Shift Permanent.** Recommend permanently shifting responsibility for mental health services to K-12 education. Recommend adding $43 million to the amount proposed in the budget to provide a total of $143 million for mental health services.

E-79 ■ **Cleanup Needed on New Formula**. Recommend adding a class of group homes to the formula for distributing special education funds for students who reside in licensed children's institutions. This recommendation would result in costs of $2.2 million (one-time) for 2004-05 and $2.2 million in 2005-06.

E-80 ■ **Incidence Factor Remains Outdated.** Recommend the State Department of Education report to the budget subcommittees on the feasibility of assuming responsibility for calculating the special education "incidence" adjustment.

Charter Schools

E-82 ■ **Reform Charter School Block Grant Funding Model.** Recommend the Legislature repeal the existing block grant funding model, reject the Governor's funding and reform proposal, and adopt an alternative reform approach. This alternative approach includes various statutory changes as well as a new budget control section that would link charter schools' share of categorical funding with the share of K-12 students they serve.

E-91 ■ **Alternative Authorizers Could Improve Quality.** Recommend the Legislature adopt in concept the Governor's proposal to allow colleges and universities to authorize and oversee charter schools but request further detail on certain currently underdeveloped aspects of the proposal.

Mandates

E-94 ■ **Recognize New Mandates.** Recommend adding the new mandates to the budget bill in order to signal the Legislature's recognition of their budgetary costs.

E-96 ■ **Ongoing "Offsetting Revenues" Process Is Needed.** Recommend the Legislature direct the State Department of Education and the State Controller's Office submit a joint plan to the budget subcommittees by April 1, 2005, outlining a process for sharing information needed to reduce the state cost of state-mandated local programs.

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E-97 ■ **Strengthen Language on Offsetting Revenues.** Recommend the Legislature add budget bill and trailer bill language to ensure that districts use available funds to pay for local costs of the new Comprehensive School Safety Plan mandate.

After School Programs and Proposition 49

E-99 ■ **21st Century Community Learning Centers Not Spending Federal Funds.** Recommend the Legislature pass legislation creating a new group of grantees to begin in late summer 2005. In addition, recommend the Legislature increase reimbursement rates, annual grant caps, and start-up funding for the elementary and middle school programs in their first year.

E-103 ■ **Repeal Proposition 49.** 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.

Child Care

E-110 ■ **Shifting California Work Opportunity and Responsibility to Kids (CalWORKs) Families to General Child Care.** Recommend delaying the shift of the Stage 3 program to Alternative Payment child care until counties have created centralized waiting lists. Further recommend placing current CalWORKs child care on the waiting lists based upon the date that they first had earned income in the program.

E-119 ■ **Proposal to Create Incentives for Quality Makes Sense.** Recommend the Legislature consider the Governor's tiered reimbursement proposal in two parts. First, the Legislature should determine if a tiered reimbursement rate structure that provides incentives for quality makes sense. Then the Legislature should determine the appropriate rates for the tiers. We recommend the Legislature revise reimbursement rates to promote quality and child development and preserve family choice.

E-127 ■ **State Department of Education (SDE) Contracted Transition Providers Reimbursement to Mirror Voucher Programs.** Recommend the Legislature transition reimbursement rates for SDE contracted providers to be based on the rate provided to voucher providers.

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E-129 ■ **"Pick-Five" Regulations Would Enhance Rate Equity.** Recommend the Legislature adopt the Governor's proposal to implement regulations for an alternative rate-setting methodology for subsidized child care provider reimbursements when they serve no private pay customers.

E-130 ■ **New Regional Market Rate (RMR) Survey Methodology Shows Promise.** Recommend the Legislature require SDE to report at hearings on the new RMR methodology, including how the new survey may improve the accuracy of the Pick-Five regulations.

Commission on Teacher Credentialing (CTC)

E-132 ■ **Large Differences Between Original and Revised Fund Condition.** Recommend CTC explain during budget hearings why its 2004-05 beginning balance and revenue assumptions for the Test Development and Administration Account have changed so significantly within such a short amount of time—leaving it with a $2.3 million reserve rather than the $9.3 million reserve assumed in the *2004-05 Budget Act*.

E-134 ■ **If Fund Statements Reliable, Action Should Be Taken to Keep CTC Solvent.** If CTC can show that it will not have a prudent reserve at the end of 2005-06, then we recommend it provide the Legislature with various options for maintaining its solvency.

Other Issues

E-138 ■ **Other Issues.** Recommend the Legislature reject several budget proposals unless more information is provided on the details of the proposed programs: the Accelerated English Language Assistance Program, alternatives for low-performing schools, school site budgeting and decision making, and the Governor's fitness and nutrition initiative.

Intersegmental

Higher Education "Compact"

E-149 ■ **Disregard Higher Education Compact.** Recommend the Legislature disregard the Governor's compact and instead continue to use the annual budget process as a mechanism to fund its priorities and to hold the segments accountable for fulfilling the mission assigned to them by the *Master Plan for Higher Education*.

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Higher Education Enrollment Growth and Funding

E-164 ■ **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 reduce the budgeted enrollment growth rate proposed by the Governor for UC and CSU from 2.5 percent to 2 percent.

E-165 ■ **Adopt Enrollment Targets in Budget Bill.** Recommend the Legislature adopt budget bill language specifying enrollment targets for both UC and CSU, in order to protect its priority to increase higher education enrollment.

E-171 ■ **Reduce Marginal Cost Funding Rates for UC and CSU. Reduce Item 6440-001-0001 by $9.4 Million and Item 6610-001-0001 by $11.9 Million.** Using our marginal cost estimates for enrollment growth based on the agreed-upon 1995 methodology, we recommend the Legislature reduce the Governor's proposed funding rates for each additional student at UC (from $7,588 to $7,108) and CSU (from $6,270 to $5,999).

E-175 ■ **Review Marginal Cost Methodology.** Recommend the Legislature revisit and reassess the marginal cost methodology. Further recommend the Legislature direct our office, in consultation with the Department of Finance, UC, and CSU, to review the current system of funding new enrollment and propose modifications for use in the development of future budgets.

Student Fees

E-184 ■ **Adopt Share-of-Cost Fee Policy.** A share-of-cost fee policy would help the Legislature annually assess fee levels and make fee decisions, and it would provide both students and the public with clear expectations about fee levels. It also would treat student cohorts consistently over time, and, as a portion of any cost increase is passed on automatically to nonneedy students, it would create incentives for students to hold the segments accountable for keeping costs low and quality high.

E-192 ■ **Treat $114 Million in New University of California (UC) Fee Revenue and $76 Million in New California State University (CSU) Fee Revenue as Available to Meet Identified Needs.** Recommend the Legislature reject the Governor's proposal to let the segments spend new fee revenue for whatever they deem worthwhile. Instead, recommend Legislature adhere to standard budget practices and apply fee-increase revenue toward segments' identified needs.

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E-193 ■ **Score $25.5 Million in Fee Revenue From Second-Year Phase In of Excess-Unit Fee Initiative ($1.1 Million for UC and $24.4 Million for CSU).** The excess-unit fee policy, initiated in the current year and being phased in over a five-year period, requires students (with certain exceptions) to pay full cost for excess units (more than 110 percent of that needed to obtain their degree). Despite being the second-year phase in of the excess-unit fee policy, the 2005-06 budget proposal does not reflect any associated increase in fee revenue. We recommend the Legislature score the revenue that is to be generated from the surcharge policy in the budget year ($25.5 million).

E-195 ■ **Increase California Community Colleges (CCC) Fee to $33 Per Unit. Score $101 Million in Additional CCC Fee Revenue**. This higher fee, to be charged only to middle-income and wealthy students, would generate about $100 million in additional revenue for CCC. The federal government, in turn, would fully reimburse those fee-paying students with family incomes up to $105,000 (if they had sufficient tax liability). It would partially reimburse those fee-paying students with family incomes up to $160,000. In total, these middle- and upper middle-income students would receive approximately $50 million in federal aid. Financially needy students, on the other hand, are entitled to have their fees waived (through a state aid program) and thus should pay nothing even with fees being increased.

University of California (UC)

E-202 ■ **Alternative Budget Proposal for UC.** Based on our review of the UC's funding needs for 2005-06, we recommend an alternative to the Governor's budget for the university. Our alternative would increase funding in the budget year to maintain the Master Plan's commitment to student access, while avoiding the programmatic reductions proposed by the Governor. At the same time, our proposal would free up $57 million in General Fund support to address other priorities.

California State University (CSU)

E-208 ■ **Adopt the Legislative Analyst's Office Alternative Budget for CSU.** Based on our review of CSU's funding needs for 2005-06, we recommend an alternative to the Governor's budget for the university. Our alternative would increase funding in the budget year to maintain the Master Plan's commitment to student access, while avoiding the programmatic reductions proposed by the Governor. At the same time, our proposal would free up $71.5 million in the General Fund to address other priorities.

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California Community Colleges (CCC)

E-219 ■ **Fund Enrollment Growth of 1.9 Percent.** The Governor proposes to fund enrollment growth of 3 percent. We recommend funding enrollment growth of 1.9 percent, which is the same rate as adult population is projected to grow. We recommend the associated savings ($50.6 million) be redirected to other K-14 priorities.

E-220 ■ **Continue to Advance Equalization Effort.** Recommend the Legislature continue the effort, begun in the current year, to equalize per-student funding among community college districts. We recommend equalization be made a funding priority for new Proposition 98 funding that is not needed to fund workload increases.

E-222 ■ **Clarify Accountability Expectations.** We recommend two changes to provisional language in the Governor's budget proposal in order to clarify the state's expectations about CCC's recent accountability efforts.

E-226 ■ **Fund the California Partnership for Achieving Student Success. Increase Item 6870-101-0001 by $1 Million.** Recommend the Legislature fund the continuation and expansion of an important and proven program that improves district performance and can assist in accountability efforts.

Student Aid Commission

E-233 ■ **Create Parity for Financially Needy Students Attending Public and Private Universities. Increase Item 7980-101-0001 by $26.6 Million.** Recommend the Legislature provide the same amount of support for financially needy students at public and private universities. This would help ensure that the Cal Grant program continued to promote access and choice for all financially needy students.

E-238 ■ **New National Guard Assumption Program of Loans for Education Warrants Have No Budget-Year Cost. Reduce Item 7980-101-001 by $200,000.** Given no National Guard warrants have been issued to date, and individuals must complete one year of military service prior to receiving state benefits, the state would incur no associated program cost until at least 2006-07. Rather than setting aside funds even though they would not be needed, recommend the Legislature capture $200,000 as General Fund savings.

E-239 ■ **Use Larger Budget-Year Swap to Restore Cal Grant Benefits. Increase Reimbursements to Item 7980-101-0001 by $26.6 Million.** Recommend the Legislature designate $61.6 million (or $26.6 million more than proposed in the Governor's budget) in Student Loan Operating Fund surplus monies to restore Cal Grant benefits for all financially needy students. This larger swap would reduce EdFund's cumulative surplus from $160 million to about $98 million. This equates to roughly a nine-month operating reserve—still a healthy reserve for the agency.