

May Revision Changes to Proposition 98

LEGISLATIVE ANALYST'S OFFICE

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Major Sources and Uses of New Funds in the May Revision

Sources of New Funds (\$4.2 Billion)

Economics-Related Increase in State Revenues—\$4 Billion

- Prior-year balance—\$0.1 billion.
- 2004-05—\$2.7 billion.
- 2005-06—\$1.1 billion.

Amnesty-Related Increase in State Revenues (Net)—\$180 Million

Uses of New Funds (\$4.2 Billion)

Reduce Debt—\$2.5 Billion

- Eliminate planned 2005-06 sale of deficit-financing bonds—\$1.7 billion.
- Accelerate repayment of one-half of vehicle license fee "gap" loan—\$0.6 billion.
- Reduce size of pension obligation bond—\$0.2 billion.

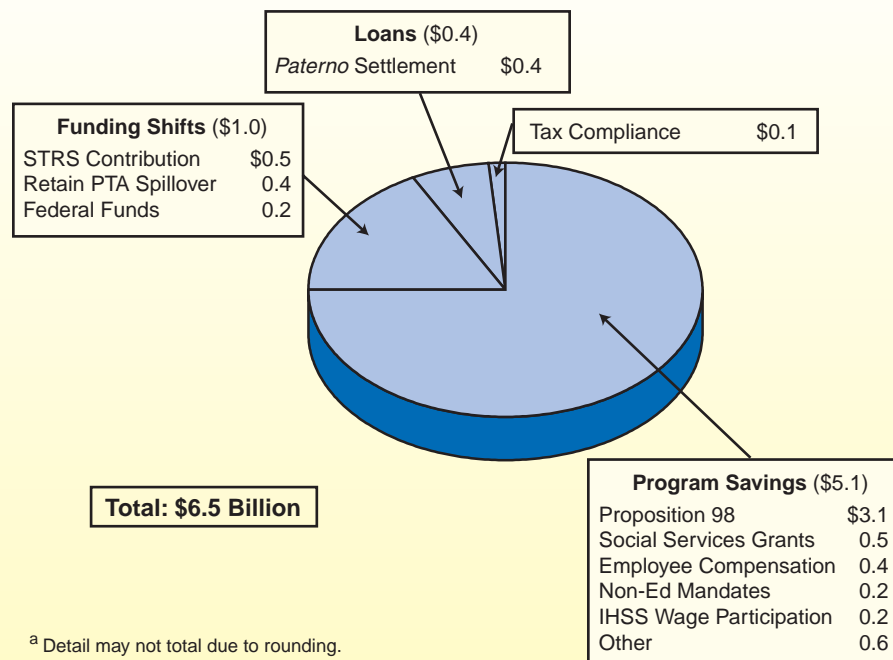
Restore/Augment Spending—\$1.7 Billion

- Proposition 42 transfer to transportation—\$1.3 billion.
- Proposition 98 settle-up payments—\$0.3 billion.
- Senior citizens' property tax and renters' assistance programs—\$0.1 billion.

Detail may not total due to rounding.

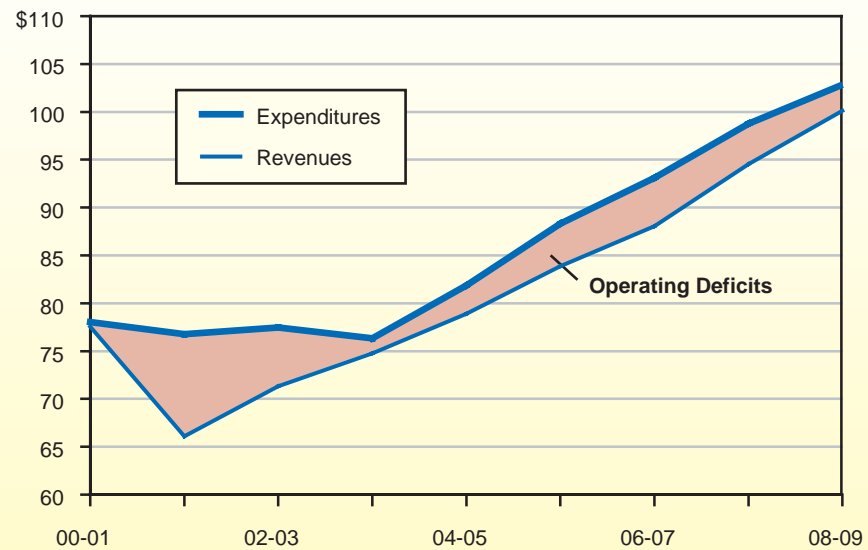


Proposed Two-Year Solutions in Governor's May Revision^a





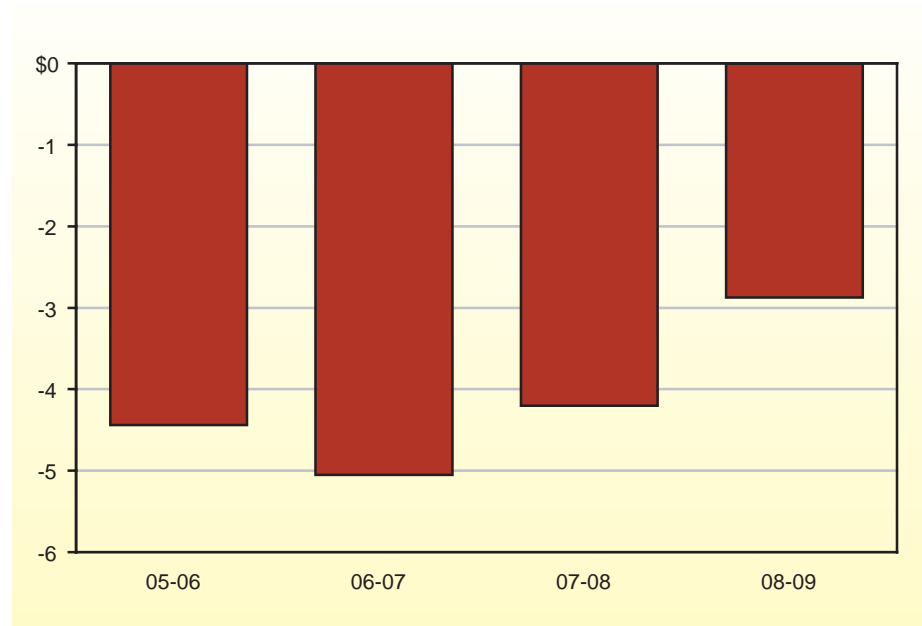
Structural Shortfall Remains^a



^a LAO estimates. Excludes deficit-financing bond proceeds.



Operating Shortfalls Under May Revision Plan





May Revision Changes to Proposition 98

	2003-04	2004-05	2005-06
January			
K-12	\$41,810	\$42,183	\$44,710
Community colleges	4,371	4,804	5,163
Other	95	96	95
Totals	\$46,276	\$47,083	\$49,968
May Revision			
K-12	\$41,824	\$42,070	\$44,644
Community colleges	4,373	4,775	5,216
Other	95	96	107
Totals	\$46,292	\$46,941	\$49,968
Difference			
K-12	\$14	-\$113	-\$66
Community colleges	2	29	54
Other	—	—	12
Totals	\$16	-\$142	—

- ☒ The May Revision maintains the same level of Proposition 98 spending for 2005-06 and reduces current-year spending by \$142 million because of lower attendance in K-12 and lower local property taxes for community colleges.
- ☒ The Governor proposes providing \$252 million in prior-year settle-up funds. Accounting for these funds, the Governor provides \$126 million more across all years than the January budget.
- ☒ Because of changes in year-to-year General Fund revenue growth, the Governor forecasts that 2005-06 will be a Test 3 year, and that maintaining the same funding level is now a \$509 million overappropriation of the guarantee.



Interaction of New Revenues And Proposition 98



The General Fund will receive an additional \$2.7 billion in 2004-05 and \$1.1 billion in 2005-06 compared to the January budget.



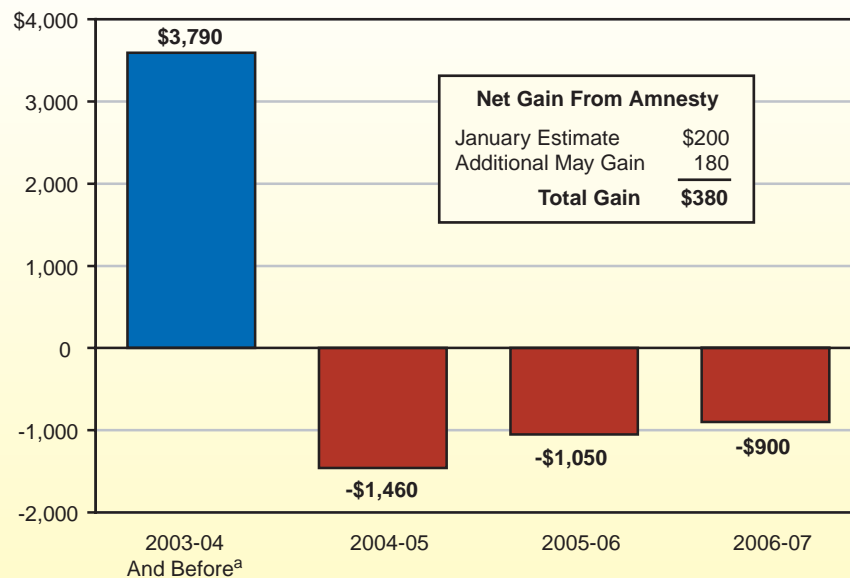
Current-Year Suspension Means Additional Revenues Have No Impact on Current-Year Proposition 98 Spending. In the current year, the additional revenues would have resulted in additional obligations for K-14 education if the minimum guarantee was not suspended. The additional revenues also increase the amount that would have to be provided to meet the current-year spending target established in Chapter 213, Statutes of 2004 (SB1101, Budget Committee). The Governor generally maintains the current-year spending, lowering it for K-12 attendance declines and local property tax adjustments.



Budget-Year Minimum Guarantee Falls by \$509 Million. Proposition 98 is affected by year-to-year changes in General Fund revenues. The administration is now projecting faster revenue growth in 2004-05 than 2005-06, which means that the year-to-year growth in General Fund revenues is less than it was in January. In fact, the growth rate falls enough for 2005-06 to result in a Test 3 year under the Department of Finance (DOF) assumed revenues.



Total Amnesty-Related Income Tax Impacts On General Fund Revenues



^a Shown for accounting purposes as increase in 2004-05 prior-year fund balance.



Interaction of Amnesty-Related Funds And Proposition 98

- ☒ The state has received \$3.8 billion in amnesty-related income tax payments related to past-year liabilities. Of this amount, approximately \$380 million is expected to be new revenues the state would not have received absent this program. The remainder, the state either would have received anyway or will have to return to taxpayers with interest.
- ☒ Because the \$3.8 billion in revenues is related to prior years, under DOF's accrual methodology, these funds are scored as an entering balance adjustment to 2004-05. Thus, these revenues have no Proposition 98 impact.
- ☒ However, the refunds and forgone future revenues will reduce General Fund revenues in 2004-05 through 2006-07 for Proposition 98 purposes. Because Proposition 98 formulas drive off of year-to-year changes in General Fund revenues, the impact on Proposition 98 will depend upon when these revenue impacts occur.
- ☒ Using the currently assumed timeline of refunds and lower payments, there would be a positive impact on Proposition 98 resulting in hundreds of millions of dollars in increases in the minimum guarantee obligations between 2005-06 and 2007-08.



LAO Proposition 98 Forecast



Less Current-Year Revenues Result in Higher Budget-Year Guarantee. We forecast around \$600 million less General Fund revenues in the current year, and roughly the same level of revenues for 2005-06. Because our assumptions result in a greater year-to-year increase in General Fund revenues, we forecast a higher minimum guarantee for 2005-06 than DOF.



LAO Forecasts Test 2 Year for 2005-06. Under our forecast, 2005-06 would barely be a Test 2 year with no maintenance factor restoration obligations. Our estimated minimum guarantee is \$216 million less than the Governor's spending level. Thus, under our estimated revenues the overappropriation would be \$216 million, instead of \$509 million under DOF's revenue assumption.



Still Investigating Administration's Local Property Tax Assumptions. In January, the administration estimated that the vehicle license fee (VLF) related property tax transfers to cities and counties as part of last year's local government deal would increase by \$675 million in 2005-06. At May Revision, the administration has increased the estimate of the transfer by an additional \$314 million. We are still investigating the technical justification for these increases. In the end, actual transfers will be adjusted based on the Department of Motor Vehicles' actual data on VLF obligations.



2005-06 K-14 Proposition 98 May Revision Changes From January Budget

(In Millions)

	Change
K-12 Revenue Limits	
Cost-of-living adjustment (COLA)	\$80
Growth	-191
Unemployment insurance	-51
Public Employees' Retirement System	-65
Subtotal	<u>(-\$227)</u>
K-12 Categorical Programs	
Class size reduction	\$123
Special education adjustments	9
Growth/COLA	29
Subtotal	<u>(\$161)</u>
Community Colleges	
Equalization	\$40
COLA	14
Subtotal	<u>(\$54)</u>
Other Agencies	\$12



Less K-12 Attendance Results in Savings. The Governor reduces revenue limits by \$307 million because of 32,000 less pupils, lower Public Employee's Retirement System costs, and lower unemployment insurance costs.



New Proposals and Higher Cost-of-Living Adjustments (COLAs). The May Revision provides \$128 million to fund a higher COLA (4.23 percent up from 3.93 percent). New proposals include class size reduction expansion for low-performing schools (\$123 million) and community college equalization.



LAO Proposition 98 Recommendations—Reductions

2005-06 Ongoing Funds (In Millions)

Program	Amount
Deficit factor reduction	\$231
Class size reduction expansion	123
High Speed Network	21
Total	\$375

- ☒ ***Reduce Revenue Limit Restoration by \$231 Million—Use Funds for Higher Priority Purposes.*** While the Legislature has committed to eliminating the deficit factor, we think other uses of these funds represent a higher priority (see next page). Our proposal leaves almost \$100 million for deficit reduction in 2005-06.

- ☒ ***Reject the Proposal to Expand Class Size Reduction, Saving \$123 Million.*** Little research on the effectiveness of reduced class sizes above grade 3. In addition, implementing the proposal would prove very difficult for districts.

- ☒ ***Eliminate \$21 Million for the High Speed Network and Require the Network to Use Internal “Savings” to Pay for Operations Costs in 2005-06.*** This would allow the network to operate in the budget year, while collecting more information on the costs and benefits of the network to K-12 education.



LAO Proposition 98 Recommendations—Increases

2005-06 Ongoing Funds (In Millions)

Program	Amount
Mandates	\$150
Declining enrollment—equalization	80
High School Exit Exam Block Grant	75
License-exempt child care	70
Total	\$375

- ☒ ***Provide \$150 Million for K-12 Mandate Costs, Thereby Partially Restoring Funding for Mandates to the Ongoing Budget.*** Excluding the Standardized Testing and Reporting mandate, we estimate ongoing mandate costs total about \$260 million.
- ☒ ***Earmark \$80 Million to Fund the LAO Declining Enrollment Proposal in 2005-06.*** This proposal would provide funding in the budget year for districts experiencing declining attendance and, at the same time, move the state further toward its goal of equalizing base revenue limits.
- ☒ ***Create a \$75 Million California High School Exit Exam Block Grant With Ongoing Funds (Rather Than One-Time Funds).*** This would provide about \$270 for each student who failed the exam as a tenth grader in 2004. Funds would be available for any supplemental purpose or program.
- ☒ ***Use \$70 Million to Partially Backfill Cuts Proposed in the Governor's Budget to Reduce Rates for License-Exempt Providers.*** Our proposal restores about one-half of the proposed cut, and would set rates for this group of providers at 70 percent (rather than 60 percent) of the regional market rate.



Proposition 98 Prior-Year Settle-Up Funds

(In Millions)

Program	Amount
High school supplemental instruction	\$58
Class size reduction	52
Teacher retention	50
Beginning Teacher Block Grant	30
Career technical education	30
Breakfast program—fruits and vegetables	18
Community colleges—nursing program	10
Others	4
Total	\$252



LAO Changes to the One-Time Proposition 98 Funding

(In Millions)

	Amount
Reductions	
High school supplemental instruction	\$57.5
Class size reduction	52.4
Teacher retention	49.5
Special education prior-year savings	30.7
Beginning Teacher Block Grant	30.0
Career technical seventh and eighth grade counseling	30.0
Breakfast program—fruits and vegetables	18.2
Principal training	10.0
School site budgeting	5.6
Physical education testing	2.2
Small learning environments	1.6
Charter school facilities	1.3
High school coaches	0.5
Total	\$289.4
Uses	
Mandates	\$289.4



LAO Proposition 98 Recommendations— Settle-Up Funds



Concerns

- ***The Governor Proposes to Use One-Time Funds for Ongoing Program Commitments.*** This would increase funding pressures in the 2006-07 Proposition 98 budget. Our projection for 2006-07 shows a limited amount of discretionary funds for Proposition 98.
- ***Many of the Proposals Need More Time for Districts to Implement the Proposed Programs.*** Expanding class size reduction, Beginning Teacher Support and Assistance, physical fitness testing, and creating a middle-career counseling class all take time to plan and implement. At this point in the school year, implementing these new programs would be quite difficult.
- ***The Proposal Would Recognize a Settle-Up Obligation That We Do Not Believe the State Is Obligated to Pay.*** The Governor proposes to recognize \$252 million in settle-up obligations from 1995-96 and 1996-97. This obligation results from a re-estimate of the state's population after the 2000 Census—not an underpayment of the state's obligations that were recognized at the time.



Recommendations

- ***Use the \$289.4 Million in One-Time Savings to Reduce the Amount Owed by the State for Past-Year Mandate Costs.*** This would provide \$42 per average daily attendance.
- ***Credit the \$251.8 Million in Settle-Up to Reducing the Outstanding Obligation for 2002-03.*** This would leave open the issue of the 1995-96 and 1996-97 obligation.