

# May Revision Changes to Proposition 98

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LEGISLATIVE ANALYST'S OFFICE

Presented To:  
Assembly Budget Subcommittee  
No. 2 on Education Finance





## How May Revision Allocates \$7.5 Billion in Additional Revenues Since January

*(In Billions)*

|  |              |
|--|--------------|
| <b>New Resources</b>                           |              |
| Revenue increase relative to January:          |              |
| 2005-06  | \$4.8        |
| 2006-07  | 2.7          |
| <b>Total, New Resources</b>                    | <b>\$7.5</b> |
| <b>New Uses</b>                                |              |
| <b>Spending on Current Programs</b>            |              |
| <b>Proposition 98</b>                          | <b>\$2.9</b> |
| Health care: disaster preparedness             | 0.4          |
| Other health and social services               | 0.1          |
| Corrections: inmate population and health care | 0.5          |
| Local government grants and reimbursements     | 0.1          |
| Flood control                                  | 0.5          |
| Other (net)                                    | -0.2         |
| Subtotal                                       | (\$4.3)      |
| <b>Prepayment of Budgetary Debt</b>            |              |
| Deficit financing bonds                        | \$1.0        |
| Special fund loans                             | 0.2          |
| <b>Proposition 98 settle-up payments</b>       | <b>0.2</b>   |
| Local flood control subventions                | 0.1          |
| Local mandates                                 | 0.1          |
| Subtotal                                       | (\$1.6)      |
| <b>Increased Reserve</b>                       | <b>\$1.6</b> |
| <b>Total, New Uses</b>                         | <b>\$7.5</b> |

- **Bottom Line**—Updated proposal has a number of positive features including its reliance on cautious revenue assumptions and its emphasis on debt prepayments, one-time spending, and the build-up of the reserve.
- **Continued Concerns**—The state will continue to face structural budget shortfalls in subsequent years, and faces several budgetary risks.
- **Schools See Large Funding Increases.** Schools receive an increase of \$2.9 billion from the January level, and a prepayment of a 2007-08 obligation of \$150 million.



## Governor's Budget General Fund Condition

*(In Millions)*

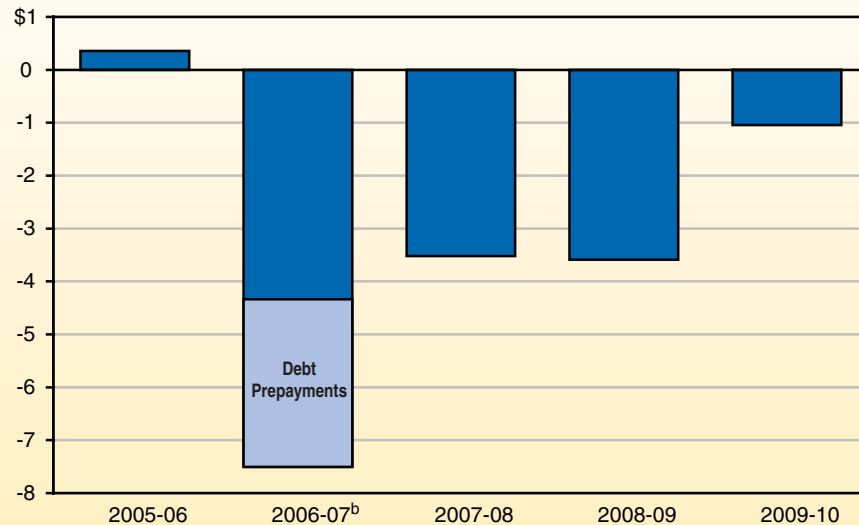
|                                    | 2005-06        | 2006-07        |
|------------------------------------|----------------|----------------|
| Prior-year fund balance            | \$9,507        | \$9,368        |
| Revenues and transfers             | 92,450         | 94,338         |
| Total resources available          | \$101,957      | \$103,706      |
| Expenditures                       | 92,589         | 100,985        |
| Ending fund balance                | \$9,368        | \$2,721        |
| Encumbrances                       | 521            | 521            |
| <b>Reserve</b>                     | <b>\$8,847</b> | <b>\$2,200</b> |
| Budget Stabilization Account       | —              | 472            |
| Reserve for Economic Uncertainties | 8,847          | 1,728          |

- The proposed 2006-07 budget spends \$6.7 billion more than General Fund revenues for 2006-07.
- Because of the additional May Revision General Fund revenues, the state is projected to end 2005-06 with a reserve of \$8.8 billion, allowing the state to spend above the 2006-07 revenues and still have a sizable reserve.
- The Governor increases the budget reserve by \$1.6 billion in the May Revision to \$2.2 billion. Given the risks discussed below, an even larger reserve may be necessary.



## Operating Deficits Persist Under May Revision

General Fund (In Billions)



<sup>a</sup>Annual revenues minus expenditures. Legislative Analyst's Office estimates of Governor's revenue and expenditure policies.

<sup>b</sup>2006-07 operating deficit includes \$3.2 billion in prepayments of budgetary debt plus numerous other one-time expenditures.

- Despite a \$17 billion improvement in the revenue outlook between June 2005 and May 2006, the state would continue to face out-year operating shortfalls in the range of \$3.5 billion a year. This level would continue until the deficit financing bond debt service payments drop off in 2009-10.
  
- In 2007-08, roughly one-half of the structural gap is the result of the Governor's proposed Chapter 213 settlement with the education community (discussed below).



## Budget Risks and Pressures

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### Lawsuits

- ***California Work Opportunity and Responsibility to Kids grants—Guillen case ( \$455 million).***
- ***State Teachers' Retirement System (STRS) (\$610 million to \$750 million).***
- ***Pension Obligation Bonds ( \$525 million).***



### Other Pressures

- ***Employee Compensation (unknown).*** Several bargaining units are currently negotiating with the administration.
- ***Unallocated Reductions (up to \$200 million risk).*** The May Revision continues to include \$222 million in unallocated savings (mostly one-time). Uncertain if these will occur.
- ***Corrections (unknown risks).*** Potential risk associated with federal receivership for inmate medical care.
- ***CalWORKs Work Participation—Potential Penalties (low hundreds of millions over several years).***
- ***Child Welfare Services and Foster Care—Potential Federal Penalties (unknown risk).***
- ***Real ID—Costs for Department of Motor Vehicles to collect additional information (unknown cost).***



### Longer-Term Pressures

- ***Health Care Retiree Benefits for Employees (\$40 to \$70 billion).*** Annual costs would be \$1 billion annually to pre-fund benefits going forward.
- ***STRS (\$20 billion total liability).*** Down slightly because of improved earnings. Annual costs of more than \$800 million to amortize over 30 years. These costs could be split amongst state, districts, and teachers.



## May Revision Changes to Proposition 98

*(In Millions)*

|   | 2005-06  | 2006-07  |
|---|----------|----------|
| <b>Total Proposition 98<sup>a</sup></b> |          |          |
| January budget                          | \$49,986 | \$54,318 |
| May Revision                            | 52,045   | 55,111   |
| Changes                                 | \$2,059  | \$793    |
| <b>K-12</b>                             |          |          |
| January budget                          | \$44,637 | \$48,366 |
| May Revision                            | 46,451   | 49,111   |
| Changes                                 | \$1,814  | \$745    |
| <b>Community Colleges</b>               |          |          |
| January budget                          | \$5,242  | \$5,848  |
| May Revision                            | 5,488    | 5,886    |
| Changes                                 | \$245    | \$38     |

<sup>a</sup> Includes Proposition 98 funding spent by other agencies including the Department of Corrections and Rehabilitation and state special schools.

- The May Revision increases Proposition 98 funding by \$2.1 billion in the current year and around \$800 million in the budget year over the levels proposed in the Governor's January budget.
- This includes an additional \$1.8 billion for the current year and \$745 million for the budget year to support K-12 schools.



## Year-to-Year Changes in Proposition 98 Funding

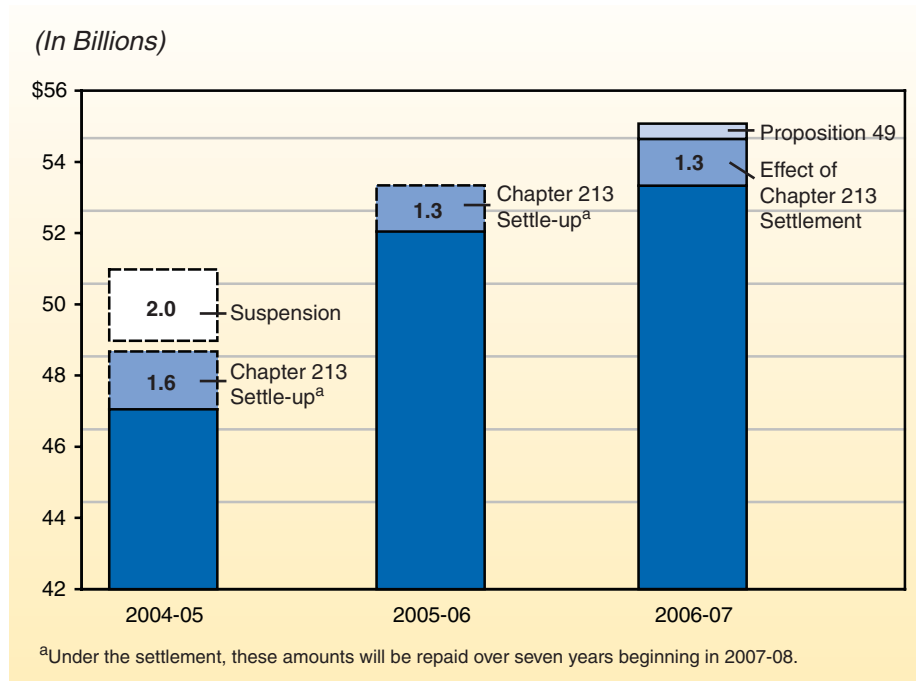
*(Dollars in Millions)*

|                         | <i>2005-06<br/>Budget Act</i> | 2006-07         | Change         |              |
|-------------------------|-------------------------------|-----------------|----------------|--------------|
|                         |                               |                 | Amount         | Percent      |
| K-12                    | \$44,644                      | \$49,111        | \$4,467        | 10.0%        |
| Community colleges      | 5,217                         | 5,886           | 669            | 12.8         |
| Other                   | 107                           | 114             | 7              | 6.5          |
| <b>Totals</b>           | <b>\$49,968</b>               | <b>\$55,111</b> | <b>\$5,143</b> | <b>10.3%</b> |
| General Fund            | \$36,591                      | \$41,295        | \$4,704        | 12.9%        |
| Local property tax      | 13,377                        | 13,817          | 440            | 3.2          |
| K-12 attendance         | 6,031,404                     | 5,957,368       | -74,036        | -1.2         |
| K-12 per-pupil spending | \$7,402                       | \$8,291         | \$889          | 12.0         |

- The May Revision proposes an overall Proposition 98 spending level of \$55.1 billion.
- This is an increase of \$5.1 billion, or 10.3 percent, over *2005-06 Budget Act* levels.
- This equates to an estimated \$8,291 per K-12 pupil—an increase of \$889, or 12 percent, over the *2005-06 Budget Act*.
- K-12 attendance is projected to decline by 1.2 percent in 2006-07 compared to the attendance level assumed in the *2005-06 Budget Act*.



## Impact of Chapter 213 Settlement on Proposition 98 Spending



**One-Time Payments to Be Paid Back in Installments.**

\$2.9 billion settlement will be paid over seven years beginning with \$300 million in 2007-08 and \$450 million each year thereafter until the obligation has been retired. The administration suggests that these funds be targeted at low performing schools for K-12, and nursing, career technical education and improving transfer rates for community colleges.



**Increase to Ongoing Base Funding Level.** Results in automatic increase to 2006-07 base of \$1.3 billion beyond what would have otherwise been required. Because of over-appropriation proposed in January, the actual increase in budget year spending is only \$800 million above the Governor's budget level.





## Total Proposition 98 Funding Increases in 2006-07

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*(In Billions)*

| Source   | Amount |
|--|--------|
| Ongoing  | \$5.1  |
| One-time <sup>a</sup>  | 2.6    |
| Settlement <sup>b</sup>  | 2.9    |
| <sup>a</sup> Includes increase to minimum guarantee for 2005-06, settle-up funds for various years, and reversion account funds.<br><sup>b</sup> Paid over approximately six years beginning in 2007-08. |        |



## LAO Guiding Principles for Spending New Funds

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- Strengthen Base Programs.** Prior to creating new programs, the Legislature should review existing core programs to determine whether the level of funding—and the distribution of funds to districts—adequately support program goals.
- Retire Outstanding Debts.** As of 2005-06, we estimate that about \$2.9 billion in various debts—funding deficits, unpaid mandate claims, and funding deferrals—have accumulated in K-14 education. With the significant amount of one-time funds available, the Legislature should place a high priority on retiring these debts.
- Improve Local Fiscal Health.** K-12 and community college districts face significant fiscal challenges. For K-12 districts, the effects of the fiscal crisis and declining enrollment create significant financial problems. In addition, both K-12 and community college districts have significant unfunded liabilities because of retiree health benefits. The Legislature should consider how to create incentives that encourage districts to address these short- and long-term fiscal threats.
- Use One-Time Funds for One-Time Purposes.** Using one-time funding for ongoing purposes would make developing future budgets difficult.



## Major K-12 Proposition 98 Changes

(In Millions)

| 2005-06 Revised K-12 Spending Level                                     |                   |                | \$44,637.2       |
|---|-------------------|----------------|------------------|
|   | Governor's Budget | May Revision   | Totals           |
| <b>Revenue Limit</b>  |                   |                |                  |
| COLA  | \$1,689.3         | \$225.3        | \$1,914.6        |
| Growth  | 54.3              | -323.1         | -268.9           |
| Declining enrollment adjustment   | 13.2              | 139.8          | 153.0            |
| PERS/UI <sup>a</sup>  | -136.0            | -1.9           | -137.9           |
| Deficit factor reduction (including basic aid)                          | 206.2             | 102.4          | 308.6            |
| Equalization  | 200.0             | 117.8          | 317.8            |
| Subtotals   | (\$2,027.0)       | (\$260.2)      | (\$2,287.2)      |
| <b>Categorical Programs</b>   |                   |                |                  |
| COLA  | \$594.1           | \$95.1         | \$689.2          |
| Growth  | 88.6              | -26.2          | 62.3             |
| Proposition 49 after school programs                                    | 426.2             | —              | 426.2            |
| High school counselors  | —                 | 200.0          | 200.0            |
| Mandates  | 133.4             | —              | 133.4            |
| Low performing schools block grant                                      | 100.0             | —              | 100.0            |
| Arts and music block grant  | 100.0             | 66.0           | 166.0            |
| Physical education  | 85.0              | —              | 85.0             |
| Preschool expansion   | —                 | 50.0           | 50.0             |
| CAHSEE supplemental assistance  | 20.0              | 30.5           | 50.5             |
| School meal rate increase   | —                 | 37.8           | 37.8             |
| Other new programs  | 90.0              | 31.3           | 121.3            |
| Other   | 63.7              | —              | 63.7             |
| Subtotals   | (\$1,700.9)       | (\$484.5)      | (\$2,185.4)      |
| <b>Total Changes</b>  | <b>\$3,727.9</b>  | <b>\$744.7</b> | <b>\$4,472.7</b> |
| 2006-07 Proposed  |                   |                | \$49,111.2       |
| Totals may not add due to rounding.                                     |                   |                |                  |
| <sup>a</sup> Public Employees Retirement System/Unemployment Insurance. |                   |                |                  |

- The cost of funding cost-of-living adjustment (COLA) increases by \$320 million above January estimates (\$225 million for revenue limits and \$95 million for categorical programs), reflecting a COLA rate of 5.92 percent. Estimates for funding the cost of the current law declining enrollment adjustment also increase by around \$140 million. These new costs are offset somewhat by around \$350 million in savings from lowered estimates for attendance.
- The May Revise reflects around \$1.6 billion in spending on new initiatives.



## Proposition 98 Ongoing Spending: Governor's New Initiatives

*(In Millions)*

|   | Governor         | LAO<br>Alternative   |
|---|------------------|----------------------|
| <b>K-12</b>                                       |                  |                      |
| Revenue limit equalization                        | \$317.8          | \$200.0 <sup>a</sup> |
| Revenue limit deficit-factor reduction            | 308.6            | 308.6                |
| Counselors  | 200.0            | 100.0 <sup>a</sup>   |
| Mandates  | 133.4            | 133.4                |
| Arts and music block grant                        | 166.0            | —                    |
| Teacher recruitment and retention                 | 100.0            | —                    |
| Physical education                                | 85.0             | —                    |
| Beginning teacher support                         | 65.0             | —                    |
| Preschool expansion                               | 50.0             | 50.0 <sup>a</sup>    |
| CAHSEE supplemental assistance                    | 50.5             | 50.5 <sup>a</sup>    |
| School meal increase                              | 37.8             | 37.8                 |
| Economic impact aid equalization and augmentation | —                | 415.0                |
| Special education equalization                    | —                | 150.0                |
| Special education mental health                   | —                | 30.0                 |
| Fully fund prorated programs                      | —                | 48.0                 |
| Other new programs                                | 74.5             | 65.3                 |
| Subtotals   | (\$1,588.6)      | (\$1,588.6)          |
| <b>California Community Colleges</b>              |                  |                      |
| Growth  | \$151.3          | \$88.0               |
| Equalization                                      | 130.0            | 160.0                |
| Career technical education                        | 50.0             | 22.0                 |
| Maintenance                                       | 29.5             | 69.6                 |
| Matriculation                                     | 24.0             | 30.0                 |
| Mandates  | 4.0              | 20.0                 |
| Other   | 40.4             | 39.6                 |
| Subtotals   | (\$429.2)        | (\$429.2)            |
| <b>Totals</b>                                     | <b>\$2,018.0</b> | <b>\$2,018.0</b>     |

<sup>a</sup> We recommend alternative implementation plans instead of the administration's proposals for these programs.



## LAO Recommendations for Ongoing Funds

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- Use Ongoing Resources to Restore and Enhance Base Program Instead of Creating New Initiatives.***
  
- Shift Focus From Low-Performing Schools to High-Priority Students.*** Provide additional resources for economically disadvantaged, English learners, and special education students.
  - Providing an additional \$415 million for economic impact aid program would increase implicit weight of “core” funding for targeted students from 1.09 to 1.12.
  
- Move Towards a More Transparent and Equal Funding System.*** Equalize per-pupil funding levels for revenue limits, economic impact aid, and special education.



## Ongoing Spending: “Other Programs”

(In Millions)

|   | Governor       | LAO               |
|---|----------------|-------------------|
| <b>K-12</b>   |                |                   |
| Digital classroom   | \$25.0         | —                 |
| Title V child care rate augmentation  | —              | \$20.0            |
| Teacher credentialing reforms   | 18.0           | 18.0 <sup>a</sup> |
| CalPADS—incentive grants  | —              | 15.0              |
| High speed network costs  | 8.6            | 4.0               |
| CAHSEE additional test administrations  | 7.7            | 7.7               |
| Fruits and vegetables   | 5.2            | —                 |
| National board fee subsidy  | 5.0            | —                 |
| Kindergarten oral health notification   | 4.4            | —                 |
| CSIS transition support   | 0.5            | 0.5               |
| STAR additional activities  | 0.1            | 0.1               |
| Subtotals   | (\$74.5)       | (\$65.3)          |
| <b>California Community College</b>   |                |                   |
| Economic development  | \$15.0         | \$15.0            |
| CAHSEE remediation  | 10.0           | 10.0              |
| Disabled student services   | 9.6            | 9.6               |
| Apprenticeship  | 2.5            | 2.5               |
| Nursing stipends  | 1.5            | 1.5               |
| Cal-PASS  | 1.0            | 1.0               |
| High speed network costs  | 0.8            | —                 |
| Subtotals   | (\$40.4)       | (\$39.6)          |
| <b>Totals</b>   | <b>\$104.9</b> | <b>\$104.9</b>    |
| <sup>a</sup> We recommend an alternative implementation plan instead of the administration's proposal for this program. |                |                   |



## LAO Recommendations for One-Time Funds

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*(In Millions)*

| Sources                          |                |
|----------------------------------|----------------|
| Additional 2005-06 obligation    | \$2,059        |
| Prior year settle-up             | 283            |
| Proposition 98 reversion account | 273            |
| <b>Total</b>                     | <b>\$2,615</b> |

- Help Retire Education Credit Card.** Pay down prior-year mandates and deferrals.
  
- Help Districts Address Fiscal Health as First Priority.** Provide “seed money” in fiscal solvency block grants to help districts address internal borrowing, retiree health liabilities, and challenges related to declining enrollment. Districts with no such issues can use funds at their discretion.



## Proposition 98 One-Time Spending

(In Millions)

|  | Governor       | LAO Alternative |
|--|----------------|-----------------|
| <b>K-12</b>  |                |                 |
| Mandates <sup>a</sup>  | \$959          | \$959           |
| Classroom supplies   | 400            | —               |
| Instructional materials  | 250            | 250             |
| Physical education equipment   | 250            | —               |
| Art and music equipment  | 250            | —               |
| Emergency repairs ( <i>Williams</i> settlement) <sup>b</sup>   | 137            | 137             |
| Library Materials  | 75             | —               |
| Preschool revolving loan fund  | 50             | 50              |
| K-12 deferrals   | —              | 718             |
| Fiscal solvency block grant  | —              | 300             |
| Other  | 138            | 96              |
| Baseline adjustments   | -247           | -247            |
| Subtotals  | (\$2,263)      | (\$2,263)       |
| <b>California Community College (CCC)</b>  |                |                 |
| General purpose block grant  | \$100          | —               |
| Deferred maintenance/instructional materials   | 100            | —               |
| Mandates <sup>a</sup>  | 38             | \$100           |
| CCC deferrals  | —              | 200             |
| Other  | 25             | —               |
| Subtotals  | (\$262)        | (\$300)         |
| K-12/CCC career technical equipment  | \$90           | \$52            |
| <b>Totals</b>  | <b>\$2,615</b> | <b>\$2,615</b>  |
| <p><sup>a</sup> Assuming that K-12 includes \$127.5 million and CCC includes \$22.5 million towards the cost of prior-year mandates as prepayment of \$150 million in settle-up payments originally scheduled for 2007-08 (85 percent to 15 percent shares, respectively). The administration has not yet provided detail on how these funds will be distributed.</p> <p><sup>b</sup> As described in our <i>Analysis of the 2006-07 Budget Bill</i>, we continue to recommend restructuring this program to distribute funds as grants to districts based on average daily attendance at their decile 1 through 3 schools, rather than on an application/reimbursement basis.</p> |                |                 |





## One-Time Spending: “Other Programs”

*(In Millions)*

|   | Governor        | LAO            |
|---|-----------------|----------------|
| <b>K-12</b>                                 |                 |                |
| Supplemental materials for English learners | \$30.0          | \$30.0         |
| School gardens                              | 30.0            | —              |
| CalPADS transition costs                    | 11.0            | 11.0           |
| Revenue limit adjustment (SB 319)           | 10.5            | 10.5           |
| School district fiscal solvency plans       | 10.0            | 10.0           |
| Healthy Start                               | 10.0            | 10.0           |
| Beginning teacher support                   | 9.6             | 9.6            |
| Charter school facilities                   | 9.0             | 9.0            |
| High speed network last mile connection     | 5.0             | —              |
| School breakfast start-up grants            | 3.0             | 3.0            |
| Teacher recruitment                         | 3.0             | —              |
| Teacher credentialing reforms (SB 1209)     | 2.0             | 2.0            |
| Principal training                          | 1.0             | —              |
| K-16 math partnership pilot                 | 1.8             | —              |
| Budget officer training                     | 1.1             | —              |
| CSIS transition support                     | 0.5             | 0.5            |
| Coaches training                            | 0.5             | —              |
| Attendance accounting mandate               | 0.04            | 0.04           |
| Subtotals                                   | (\$138.0)       | (\$95.6)       |
| <b>California Community College</b>         |                 |                |
| High speed network last mile connection     | \$0.5           | —              |
| Revise funding formula (SB 361)             | 23.6            | —              |
| Clinical nursing registry                   | 0.5             | —              |
| Subtotal                                    | (\$24.6)        | —              |
| <b>Totals</b>                               | <b>\$162.59</b> | <b>\$95.64</b> |



## Chapter 213 Settlement Provides Funds for Several Years

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- The Governor proposes using these funds for ongoing activities including targeting resources to low-performing schools. While we think this is an important policy goal to help close achievement gaps, we suggest using limited-term funds for limited-term activities, instead of the proposed ongoing activities.
  
- Above we proposed an alternative approach to low performing schools by proposing \$415 million ongoing funds for Economic Impact Aid to assist high-priority students. We think that targeting resources at students with additional needs instead of students attending low-performing schools ensures that the state does not reward failure.
  
- We recommend that these limited-term funds be used for a K-14 fiscal solvency block grant that would help school districts address internal borrowing, retiree health liabilities, and challenges related to declining enrollment.