LAO

The 2025-26 Budget:

Child Care and State Preschool

GABRIEL PETEK | LEGISLATIVE ANALYST | MARCH 2025

SUMMARY

In this brief, we analyze the Governor's child care and State Preschool budget proposals and provide associated recommendations. Also, in light of the significant changes to the programs that have been made in recent years, we recommend the Legislature revisit three policies related to child care and State Preschool that might no longer align with its key priorities.

Consider Developing a Child Care Budget Plan in Case Legislature Does Not Receive Key Information Prior to Budget Deadline. The administration is currently developing a new reimbursement rate structure for subsidized child care providers. Statute requires the state to set reimbursement rates using the new rate structure by July 1, 2025. It is possible the Legislature will have little or no time to review the details of the new rate structure prior to the June 15 deadline to pass a budget. The Legislature could consider planning for costs associated with the new rates in 2025-26. The Legislature could also consider developing its own specific transition plan for non-represented child care centers if the timeline for implementing the alternative methodology by July 1 is not feasible.

Recommend Reducing State Preschool Funding to Align With Contracted Costs. Under the Governor's proposal, State Preschool funding would exceed projected costs in 2025-26—consistent with a trend over the last few years where the budgeted amount has exceeded actual costs. We recommend reducing ongoing State Preschool funding by $355 million Proposition 98 General Fund and $71 million non-Proposition 98 General Fund to better align funding with anticipated costs.

Recommend Revisiting Three Other Policies. We recommend the Legislature revisit three policies that may no longer align with the Legislature's key priorities given recent changes in child care and State Preschool funding.

- We recommend repealing a statutory cost-of-living adjustment (COLA) that only applies to certain providers who are funded on the Standard Reimbursement Rate (SRR). The current policy effectively prioritizes additional funding for providers already receiving rates that are relatively high compared to the private market in their county.
- We recommend the Legislature consider modifying the statutory COLA for voucher-based child care programs to better align funding with program costs. The state's current approach applies a COLA to total program costs, including the portion of funding that covers child care provider payments. However, funding for provider payments is typically adjusted through other mechanisms in the state budget. The Legislature could continue providing an annual COLA only for operational costs, in recognition of some of the inflationary cost pressures that these agencies likely face, but no longer apply the COLA to the portion of funding related to provider payments.
- During the pandemic, the state began allowing direct contract providers to receive their pre-pandemic contract amount, regardless of child attendance. We recommend allowing this reimbursement flexibility to expire June 30, 2025. Although this flexibility provided a great degree of fiscal stability for providers during the pandemic, maintaining the policy disconnects program funding from the number of children providers currently serve.

BACKGROUND

State Subsidizes Child Care, Primarily for Low-Income Families. As shown in **Figure 1**, the state administers various child care and development programs. Most of the state's subsidized child care is administered by the Department of Social Services (DSS) through three programs: (1) California Work Opportunity and Responsibility to Kids (CalWORKs) child care, (2) the California Alternative Payment Program (CAPP), and (3) the General Child Care program. CalWORKs child care programs focus on families enrolled in or transitioning out of CalWORKs welfare-to-work activities. The remaining programs are primarily designed for low-income, working families that have not participated in CalWORKs. Families are generally eligible for subsidized child care if they have a family income of less than 85 percent of the state median income ($89,659 annual income for a family of three).

Figure 1

Overview of Child Care Programs

Program	Description[a]
CalWORKs Child Care	Provides subsidized child care services to current and former CalWORKs families. Slots are available for all eligible families.
California Alternative Payment Program	Provides subsidized child care vouchers to eligible working families. Slots are limited by budget appropriation.
General Child Care and Development	Directly contracts with center-based and licensed family child care providers to serve working families eligible for subsidized care. Slots are limited by budget appropriation.
Family Child Care	Directly contracts with consortia of licensed family child care providers to serve working families eligible for subsidized care. Slots are limited by budget appropriation.
Migrant Child Care	Provides subsidized child care services to migrant families working in agriculturally related industries.[b] Services are provided throughout the Central Valley. Slots are limited by budget appropriation.
Care for Children With Severe Disabilities	Provides additional access to child care services for children under the age of 21 and with exceptional needs.[c] Program is located in the San Francisco Bay Area. Slots are limited by budget appropriation.
Emergency Child Care Bridge	Provides temporary child care services to children in foster care system and under age 13. Child care services are temporary until family finds longer-term child care solution.[d]

[a] Unless otherwise specified, child must be under age 13 and families must earn at or below 85 percent of the state median income to be eligible for subsidized child care programs. For example, a family of three must earn less than $89,659 annually in 2024-25 to be eligible for programs.

[b] Family earned at least 50 percent of their total gross income from employment in fishing, agriculture, or agriculturally related work during the 12 months immediately preceding the date of application for services.

[c] Child must have an individualized education program or an individualized family service plan issued through a special education program.

[d] Child care services provided up to 12 months, but may be extended for a compelling reason.

State Also Provides State Preschool for Certain Children. State Preschool is administered by the California Department of Education (CDE) and provided by a variety of local agencies and community-based organizations. Three- and four-year old children are generally eligible for State Preschool if their family earns at or below the state median income ($105,482 for a family of three). State law includes various enrollment flexibilities that allow providers to serve families with higher incomes, and some providers may choose to serve eligible two-year olds. Based on preliminary numbers from October 2024, the state serves 101,000 children in State Preschool.

Child Care and State Preschool Programs Supported With Multiple Funding Sources. The 2024-25 budget package provided $7 billion in funding for the state's subsidized child care programs. The majority of funding ($4 billion) was from non-Proposition 98 General Fund. The state also uses a total of roughly $2 billion in federal funding to partially cover program costs. In addition, the state partially covers program costs with funding from the Proposition 64 Youth Account, which is funded by the cannabis retail excise tax established in 2016. State Preschool programs are funded entirely with General Fund. State Preschool programs offered by local education agencies (LEAs)—school districts, county offices of education, community college districts, and certain charter schools—are funded with Proposition 98 General Fund. Those programs offered by non-LEA providers (community-based organizations, county welfare departments, and cities) are funded with non-Proposition 98 General Fund.

2021-22 Budget Agreement Included Multiyear Child Care Slot Expansion Plan. The 2021-22 budget agreement intended to add 206,800 child care slots over a multiyear period. This expansion built upon the approximately 100,000 non-CalWORKs slots the state already funded. The bulk of the expansion was planned through two programs—CAPP (143,000 slots) and General Child Care (62,000 slots). A smaller portion of the expansion was set aside for Migrant Alternative Payment (1,300 slots) and Emergency Child Care Bridge (500 slots). The 2023-24 and 2024-25 budgets subsequently made various changes to delay implementation of the of the slot expansion. Figure 2 shows the current multiyear expansion plan, as outlined in the 2024-25 budget agreement.

Some Child Care Providers Collectively Bargain With the State. Chapter 385 of 2019 (AB 379, Limón) established collective bargaining for licensed family child care homes and license-exempt family, friend, and neighbor providers. These providers are represented in collective bargaining by Child Care Providers United (CCPU). Under Chapter 385, the scope of collective bargaining includes 14 different topics, including reimbursement rates, payment procedures, and professional development and training for providers. The details of a collective bargaining agreement, as well as the associated funding, must be approved by the Legislature via statute. The current memorandum of understanding (MOU) between the state and these child care providers expires June 30, 2025.

Rates for Other Providers Are Determined by the Legislature. In contrast to licensed family homes and license-exempt providers, licensed child care centers do not collectively bargain. Instead, rates and policies are determined by the Legislature through the annual budget process. The Legislature typically has provided "parity" for centers by applying funding rates and policies similar to those that were included in the MOU for represented providers.

Child Care Providers Reimbursed Using Two Different Rate Structures. The state has historically used two different reimbursement rates for child care providers—the SRR and the Regional Market Rate (RMR). The SRR is a statewide rate (currently set at $54.93 per child, per day) that historically was used for direct contract providers. Most of these direct contract providers are funded through either General Child Care or State Preschool. Other providers are reimbursed using the RMR. The RMR is based on surveys of the cost of child care and varies by county. The RMR is currently set at the 75th percentile of market rates for child care that were identified in the 2018 regional market survey. (The state last conducted a market rate survey in 2021, but has not updated

Figure 2

State's Multiyear Child Care Expansion Plan

Number of New Child Care Slots by Year

Program	2021-22 Through 2024-25	2025-26	2026-27	2027-28	Totals
General Child Care	33,000	—	12,000	17,000	62,000
Alternative Payment	95,000	—	32,000	16,000	143,000
Migrant Alternative Payment	1,300	—	—	—	1,300
Emergency Child Care Bridge	500	—	—	—	500
Totals	**129,800**	—	**44,000**	**33,000**	**206,800**

the RMR to reflect this data. The RMR is adjusted at the Legislature's discretion.) In 2021-22, the state shifted direct contract providers from the SRR to the RMR to the extent the RMR was higher.

State Developing Alternative Reimbursement Rate Structure. In 2021, the state began the process of developing a single child care reimbursement rate structure, in partnership with the CCPU. This new alternative methodology is to be based on estimates of child care provider costs, not market rates. DSS is in the process of developing this alternative methodology, in collaboration with CDE. Components of the alternative methodology that relate to reimbursement rates for licensed family child care homes and license-exempt providers must be collectively bargained. Chapter 73 of 2024 (SB 163, Committee on Budget and Fiscal Review) requires reimbursement rates to be set using the alternative methodology by July 1 2025. If the rates based on the alternative methodology do not take effect by this date, DSS must provide the Legislature with a time line for transitioning to the new rates. As a condition of receiving federal funding for child care, the state must obtain federal approval for its alternative methodology. The state received federal approval for the structure of the alternative methodology on November 8, 2024.

2023-24 Budget Funded Temporary Rate Increases as Transition to Alternative Methodology. The 2023-24 budget package adopted a two-year collectively bargained early education and parity agreement estimated to cost $2 billion across 2023-24 and 2024-25. The agreement was funded with a variety of one-time funds, as well as foregone statutory COLAs for child care programs. The largest component of the agreement was monthly cost of care plus payments scheduled to be made January 1, 2024 through June 30, 2025. These temporary monthly per-child payments were intended to increase rates above the current SRR and RMR levels while the alternative methodology was being developed. The cost of care plus payments range from $140 to $211 per month, per child for licensed providers, depending on the county in which the provider is located.

2024-25 Budget Set "Floor" for 2025-26 Funding Levels. Chapter 73 requires 2025-26 rates to be no less than the rates that were in effect on June 30, 2024. This includes the rates providers receive under either the SRR or RMR, as well as the monthly cost of care plus payments providers are currently receiving.

CHILD CARE AND STATE PRESCHOOL PROPOSALS

Governor's Budget

Governor Proposes $7.1 Billion for Child Care Programs in 2025-26. As shown in Figure 3, the Governor's budget includes $7.1 billion for child care programs in 2025-26—a decrease of $207 million relative to the revised 2024-25 levels. This change includes a $420 million increase in non-Proposition 98 General fund, which is more than offset by a $440 million decrease in Proposition 64 funds and a $186 million decrease in federal funding. The latter reductions are primarily due to the use of one-time carryover funds in 2024-25.

Largest Spending Increase Associated With Monthly Cost of Care Plus Payments for Child Care Providers. Figure 4 shows the Governor's proposed changes in child care spending. The largest year-over-year increase in spending is $698 million non-Proposition 98 General Fund that is effectively a placeholder funding amount intended to meet the statutory requirement that 2025-26 rates be no less than the reimbursement rates that were in effect on June 30, 2024. This placeholder amount is equivalent to the value of the monthly cost of care plus payments for child care providers. The specific methodology for allocating these funds would be established as part of the budget process, and would be subject

Figure 3

Child Care Budget

(Dollars in Millions)

	2023-24 Revised[a]	2024-25 Revised[b]	2025-26 Proposed[b]	Change From 2024-25	
				Amount	Percent
Expenditures					
CalWORKs Child Care					
Stage 1	$550	$588	$602	$14	2%
Stage 2[c]	420	546	599	53	10
Stage 3	559	541	524	-17	-3
Subtotals	($1,530)	($1,675)	($1,725)	($51)	(3%)
Non-CalWORKs Child Care					
Alternative Payment Program	$2,028	$1,990	$2,052	$61	3%
General Child Care[d]	1,255	1,495	1,594	99	7
Bridge program for foster children	94	107	94	-14	-13
Migrant Child Care	70	79	80	2	2
Care for Children With Severe Disabilities	2	2	2	—	6
Subtotals	($3,449)	($3,673)	($3,822)	($149)	(4%)
Support Programs	$1,578[e]	$1,929[f]	$1,523[g]	-$407	-21%
Totals	**$6,557**	**$7,276**	**$7,070**	**-$207**	**-3%**
Funding					
Proposition 98 General Fund[h]	$3	$2	$1	-$1	-37%
Non-Proposition 98 General Fund	3,173	4189	4,609	420	10
Proposition 64 Special Fund	270	642	202	-440	-69
Federal	3,111	2,443	2,257	-186	-8

[a] Reflects 2024-25 May Revision estimates with LAO adjustments.
[b] Reflects 2025-26 Governor's budget.
[c] Does not include $11.2 million provided to community colleges for certain child care services.
[d] Includes funding for family child care home education networks.
[e] Includes cost estimates for quality programs, child care infrastructure, Child and Adult Care Food Program, Child Care Providers United Retirement Benefit Trust, accounts payable, Whole Child Community Equity, court cases, and costs associated with 2023-24 memorandum of understanding (MOU) and parity agreement.
[f] Includes cost estimates for quality programs, Child and Adult Care Food Program, accounts payable, Whole Child Community Equity, and costs associated with 2023-24 MOU and parity agreement.
[g] Includes cost estimates for quality programs, Child and Adult Care Food Program, accounts payable, and Whole Child Community Equity.
[h] Reflects Proposition 98 funds for Child and Adult Care Food Program.

Figure 4

Changes in Child Care Spending

(In Millions)

	General Fund				
	Prop. 98	Non-Prop. 98	Prop. 64	Federal	Total
Monthly cost of care plus payments	—	$698	—	—	$698
Annualization of General Child Care slot increases	—	76	—	—	76
COLA for child care programs	—	59	—	—	59
CalWORKs caseload and cost of care	—	108	—	-$57	51
Child and Adult Care Food Program caseload and COLA	-$0.7	0.2	—	16	16
COLA (2.43 percent) for Resource and Referral and LPCs	—	1	—	—	1
Technical adjustments	—	48	-$32	-109	-86
One-time adjustments[a]	—	-572	-409	-35	-1,016
Totals	**-$0.7**	**$420**	**-$440**	**-$186**	**-$207**

[a] Includes prior-year, one-time costs associated with quality carryover, SB 140 carryover, child care infrastructure program, court cases, temporary family fee waiver, and initial CCPU retirement fund deposit.

COLA = cost-of-living adjustment; LPCs = Local Planning Councils; and CCPU = Child Care Providers United.

to collective bargaining for family child care homes and license-exempt providers. The largest year-over-year decrease reflects $1 billion of several one-time and carryover funds that are expected to be spent in 2024-25.

Provides $2.9 Billion for State Preschool. Of this amount, $1.9 billion is Proposition 98 General Fund for programs offered by LEAs and $1 billion is for programs offered by non-LEAs. Overall, as Figure 5 shows, the Governor's budget increases State Preschool funding by $684 million compared to 2024-25. The largest year-over-year change comes from restoring a $673 million reduction made in 2024-25 to reflect the amount of funds that would otherwise have gone unused. The budget also includes $29 million to provide a 2.43 percent COLA to certain providers (those funded on the SRR). These increases are partially offset by an $18 million decrease related to one-time spending provided 2024-25.

Assessment

Governor's Child Care Budget Complies With Funding Requirement Adopted in 2024-25 Budget. As mentioned above, the Governor's budget creates a placeholder ensuring sufficient funding to comply with the statutory requirement that 2025-26 rates be no less than the rates as of June 30, 2024. The specific rates providers receive in 2025-26—as well as the overall amount of funding needed to support these rates—will depend on the collective bargaining process, decisions regarding the alternative reimbursement rate structure, and actions by the Legislature. As a result, it is possible that the amount set aside would not be sufficient to cover all additional costs in 2025-26.

Legislature May Not Have Time to Review Alternative Methodology Details Before Passing Budget. Although DSS is required to set rates based on the alternative methodology by July 1, 2025, the department's time line for sharing the details with the Legislature is unclear at this time. It is possible that the Legislature will not have any information regarding the overall costs or key details of the alternative reimbursement rates prior to the constitutional deadline to pass a budget by June 15. Furthermore, even if the information is released around the time of the May Revision or later, the Legislature would have only limited time to review the details of the alternative methodology and consider whether it would like to make changes to the structure for non-represented child care centers.

Funding for State Preschool Exceeds Amount Necessary to Cover Costs. In 2021-22, the state increased State Preschool rates by shifting providers from the SRR to the RMR, if the RMR was higher. The cost of these rate increases came in lower than budgeted, but the state has not made ongoing downward adjustments to align the budgeted amount with the anticipated ongoing costs. As such, according to CDE estimates, the overall amount budgeted for State Preschool exceeds the estimated costs by $426 million, including $355 million Proposition 98 General Fund and $71 million non-Proposition 98 General Fund.

Recommendations

Consider Developing a Child Care Budget Plan in Case Legislature Does Not Receive Key Information Prior to June 15. Given the alternative methodology and a new collective bargaining agreement may not be finalized prior to the June 15 deadline to pass a budget, the Legislature may want to plan for costs associated with the new rates in 2025-26. Budgeting for some costs would provide the Legislature with a cushion to the extent that the new agreements have notable costs. The Legislature could also consider developing its own specific transition plan for 2025-26 rates if the time line for

Figure 5

2025-26 Changes in State Preschool Funding

(In Millions)

Change	General Fund: Prop. 98	General Fund: Non-Prop. 98	Total
Restoration of one-time reduction	$519	$153	$673
Cost-of-living adjustment (2.43 percent)	19	10	29
Removal of one-time 2024-25 spending	—	-18	-18
Totals	**$539**	**$145**	**$684**

implementing the alternative methodology by July 1 is not feasible. A transition plan for represented family child care homes and license-exempt providers would need to be collectively bargained. However, the Legislature could establish transition rates for child care centers. This could help provide centers clarity regarding what their reimbursement rates would be for 2025-26.

Reduce State Preschool Funding to Align With Contracted Costs. To align funding with anticipated costs, we recommend reducing ongoing State Preschool funding by $355 million Proposition 98 General Fund and $71 million non-Proposition 98 General Fund. Under our recommendation, the budget would still provide a total of $1.6 billion Proposition 98 General Fund and $939 million non-Proposition 98 General Fund for State Preschool—enough to cover estimated contracted costs and provide funding equivalent to the monthly cost of care plus payments.

REVISITING VARIOUS CHILD CARE AND STATE PRESCHOOL FUNDING POLICIES

As we discuss in our recent post, *The 2025-26 Budget: Undertaking Fiscal Oversight*, we advise the Legislature to use the 2025-26 budget process to conduct robust fiscal oversight of state programs. Oversight of programs allows the state to determine whether existing programs are well-designed to address their key goals, as well as help inform legislative actions that might be needed to help balance the state budget over the next few years.

Consistent with this guidance, in this section, we describe three policies related to child care and State Preschool that we recommend the Legislature revisit. These policies may no longer align with the Legislature's key priorities given recent changes in child care and State Preschool funding. Our review focuses on aspects of child care and State Preschool funding that are not within the scope of collective bargaining because the Legislature has more flexibility to make changes in these areas. The Legislature could consider these changes as part of the 2025-26 budget process, but also could take action next year, when the Legislature has more details related to the alternative reimbursement rate structure.

STANDARD REIMBURSEMENT RATE COLA

Background

State Historically Used SRR for Direct Contract Providers. The state funds subsidized child care and preschool programs through either vouchers or direct contracts. The majority of direct contract providers are licensed centers funded through General Child Care and State Preschool. Prior to 2021-22, direct contract providers were funded based on the SRR. The SRR is a fixed statewide rate (currently $54.93 per day for child care programs and $55.27 for State Preschool) that is adjusted by length of care and age of child.

In 2021-22, Most Direct Contract Providers Shifted to RMR. In 2021-22, the state began funding most direct contract providers based on the RMR—the rate used for voucher-based providers—which reflects the 75th percentile of a county's market rates for child care identified in the 2018 survey. One goal of the change was to address concerns that—because the SRR is not adjusted by region—direct contract providers in many high-cost counties received lower rates than voucher-based providers funded through the RMR. The 2021-22 budget also included a hold harmless provision that funded direct contract providers based on the SRR if it was higher than the RMR in their county. In 2024-25, providers in 42 counties (representing about one-third of the state's population) continue to be funded based on the SRR. These counties to tend to be located outside of the most expensive regions of the state. In these areas, the SRR reimbursement rate is higher than the RMR rate.

Current Law Requires Annual COLA for SRR. The state provides a statutorily required annual COLA—the same rate provided to K-12 education programs—to the SRR. (The RMR does not have a statutory COLA and is adjusted at the Legislature's discretion.) After the COLA is applied, the state determines whether direct contract providers will be funded based on the SRR or the RMR. As part of the 2023 collectively bargained early education and parity agreement, the state did not apply the COLAs for 2023-24 and 2024-25. Instead, the amount that would have been required to fund the 2023-24 COLA over the next two years was used to fund the agreement.

Governor's Budget Includes $37.9 Million for 2.43 Percent COLA to SRR. Of this amount, $19.3 million is Proposition 98 General Fund and $18.6 million is non-Proposition 98 General Fund. After applying the COLA, the administration projects that providers in three additional counties would be funded based on the SRR, resulting in a total of 45 counties funded based on the SRR.

LAO Comments

COLA Policy Effectively Prioritizes Rate Increases for Lower-Cost Counties. Prior to 2021-22, when the SRR was the only reimbursement structure for direct contract providers, providing a COLA was a reasonable way to adjust rates to ensure the state was adequately covering provider costs. However, under the state's current approach—where direct contractors get the higher of SRR or RMR rates—the only providers that receive an annual COLA are those with rates that are higher than the 75th percentile of what private child care providers in their county charge based on the 2018 market survey. For example, in 30 of the 42 counties where direct contractors are currently funded on the SRR and receive an annual COLA, the SRR is higher than the 90th percentile of the regional market rate for four-year olds in full-time care.

Recommend Repealing COLA. In our view, there is no compelling policy reason for prioritizing funding for providers that already receive rates that are relatively high compared to the private market in their county. As a result, we recommend the Legislature repeal the required COLA for the SRR. This would free up $37.9 million ($19.3 million Proposition 98 General Fund and $18.6 million non-Proposition 98 General Fund) in 2025-26 that could be directed to other legislative priorities. Moving forward, the rates for these providers would be set at the discretion of the Legislature, similar to all other direct contract providers.

COLA FOR VOUCHER-BASED PROGRAMS

Background

Alternative Payment (AP) Agencies Administer Most Voucher-Based Programs. The state tasks AP agencies with administering most voucher-based child care programs, including CalWORKs Stage 2 and Stage 3, CAPP, and California Migrant Alternative Payment (CMAP). (County welfare departments are responsible for administering CalWORKs Stage 1, although most counties contract with an AP agency to administer the program.) Most AP agencies are community-based organizations, but in some regions the AP agency is a local governmental agency, such as a county office of education, county welfare department, or school district.

AP Agencies' Operational Funding Based on Proportion of Budget Appropriation. AP agencies' primary voucher-related responsibilities are to determine a family's eligibility for child care, make payments to the child care provider of a family's choice, and ensure families and providers are complying with state rules and regulations. Funding to cover these activities is based on a proportion of total program funding. AP agencies generally are authorized to spend up to 17.5 percent of total program funding on operational costs. (The remaining funding is to cover payments to child care providers.) For CAPP and CMAP, annual funding is limited by the amount appropriated in the annual budget. If the AP agency does not have sufficient funding to serve all eligible families, it may place families on a waiting list. For CalWORKs child care, the administration has authority to increase funding midyear if the amount of funding is not sufficient to cover all eligible families.

State Applies a Statutory COLA to Total CAPP and CMAP Funding. Typically, the total amount of state funding provided to AP agencies is based on the amount they received in the previous year, adjusted for any changes in reimbursement rates or slots specified in the most recent state budget. For CAPP and CMAP, the state then increases total funding based on the statutory COLA. (AP agencies do not receive a similar COLA for CalWORKs child care.) As part of the 2023 collectively bargained early education and parity agreement, the state did not apply the COLAs for 2023-24 and 2024-25. Instead, the amount that would have been required to fund the 2023-24 COLA over the next two years was used to fund the agreement.

Governor's Budget Provides $49.6 Million for COLA. The Governor's 2025-26 budget provides $49.6 million non-Proposition 98 General Fund to fund a 2.43 percent statutory COLA. Of this amount, $48.7 million is for CAPP and $904,000 is for CMAP.

LAO Comments

COLA Approach for Voucher-Based Programs Not Well-Targeted to Program Cost Pressures. In our view, providing a statutory COLA to AP agencies' operational costs is reasonable, as these agencies face inflationary cost pressures in administering voucher-based child care programs. However, there is no clear rationale for applying a COLA to the portion of funding that covers child care provider payments as these payment amounts are typically adjusted through other mechanisms in the state budget. For example, rates are set in statute and, when the Legislature has increased rates in the past, it has provided associated increases in funding to address the higher costs. Also, payments are adjusted when the state provides additional funding for new child care slots as part of the annual budget. As a result, under the current COLA structure—where it is applied to the entire AP agency allocation, rather than only the portion related to operational costs—the amount of COLA funding likely exceeds the amount that is needed to cover inflationary cost increases.

Consider Modifying COLA. Given the COLA is not targeted to AP agency operational costs (the component of these programs that faces inflationary costs), the Legislature may want to consider modifying the statutory COLA to better align funding with costs. The Legislature could choose to continue providing an annual COLA only for AP agency operational costs, in recognition of some of the inflationary cost pressures that these agencies likely face. More broadly, the Legislature might also want to consider changes to how AP agencies are funded. In a previous analysis of AP agency funding, we make several recommendations that would better align funding for AP agencies with the costs to administer voucher-based programs.

REIMBURSEMENT FLEXIBILITY FOR DIRECT CONTRACT PROVIDERS

Background

Prior to Pandemic, Funding for Direct Contract Providers Based Partly on Attendance. The state directly contracts with some providers for subsidized child care and preschool, primarily through State Preschool and General Child Care. The state sets an annual maximum reimbursable amount that each contractor can receive. Prior to the pandemic, the specific amount that a contractor would be reimbursed was based on the lesser of (1) the maximum reimbursable amount; (2) the contractor's reimbursable program costs; or (3) the contract rate per child day of enrollment, multiplied by the attendance rate of its children. Under this approach, providers had to have a specified amount of attendance to fully earn their contract. Any unearned funds would be returned to the state and could be redistributed to other providers that had capacity to serve more children.

Since the Pandemic, the State Has Provided Direct Contractors With Reimbursement Flexibility. Since 2020-21, the state has provided reimbursement flexibility for child care and State Preschool direct contractors. This flexibility was initially intended to minimize the fiscal effects of pandemic-related attendance declines and temporary requirements for smaller group sizes. Under this policy, providers receive the lesser of their reimbursable program costs or the maximum reimbursable amount. This allows providers to receive their full contract amount regardless of child attendance in the program.

Reimbursement Flexibility Set to Expire June 30, 2025. Although the state initially enacted this reimbursement flexibility during the pandemic, the policy was later extended. Most recently, the 2023-24 budget extended the flexibilities until June 30, 2025.

LAO Comments

Direct Contractor Reimbursement Flexibility Disconnects Funding From Current Program Attendance. During the pandemic, reimbursement flexibility provided a great degree of fiscal stability for providers, particularly given the uncertainty regarding enrollment and attendance rates in child care and preschool programs. However, by maintaining this policy for several years, the amount of funding direct contractors receive is not closely connected to their current program attendance. The disconnect between funding and program attendance is likely larger in State Preschool. Although annual statewide attendance is not publicly reported, statewide enrollment for State Preschool is currently 30 percent below pre-pandemic levels.

Recommend Allowing Direct Contract Flexibility to Expire. We recommend allowing the reimbursement flexibility provisions for direct contract providers to expire. This would ensure that funding levels for direct contractors are more closely aligned with the number of children they serve. If a contractor's attendance remains below pre-pandemic levels, they likely would see reductions in the amount of funding they receive. Over time, CDE and DSS could determine whether some contracts should be reduced and funds should be allocated to other providers that could serve additional children. The state would see General Fund savings to the extent that overall attendance does not return to pre-pandemic levels.

LAO PUBLICATIONS

This report was prepared by Dylan Hawksworth-Lutzow and Sara Cortez, and reviewed by Edgar Cabral and Ross Brown. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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