Proposition 1B
Education Finance.

Background

This measure contains provisions relating to Proposition 98 "tests," the "maintenance factor," and K-12 "revenue limits." We provide basic information on each of these issues below.

Proposition 98 Tests

Proposition 98 Establishes Minimum Funding Level. Proposition 98, passed by voters in 1988 and modified in 1990, requires the state to provide a minimum level of funding each year for kindergarten through twelfth grade (K–12) education and community colleges. Together, these schools and colleges are commonly referred to as K-14 education. The Proposition 98 requirement is met using both state General Fund and local property tax revenues. In 2008-09, the state budget includes $51 billion in Proposition 98 funding. Of this total, about $35 billion is from the state's General Fund, with the other $16 billion from local property tax revenues.

"Minimum Guarantee" Determined by One of Three Tests. The minimum funding level—commonly known as the minimum guarantee—is determined by one of three funding formulas. The first formula, known as "Test 1," requires the state to provide roughly 40 percent of General Fund revenues for K-14 education. This test has been applied only once (1988-89). To date, the most common funding formula has been "Test 2" (applied 13 of the last 20 years). Under Test 2, the prior-year Proposition 98 funding level is adjusted based on changes in school attendance and the state's economy (as measured by per capita personal income). The final formula, known as "Test 3," adjusts prior-year Proposition 98 funding based on changes in attendance and the state's tax revenues. It has been applied in 6 of the last 20 years—generally in years when the state is experiencing slow growth or a decline in revenues. Test 3 permits the state to provide less Proposition 98 funding than required under Test 2.

Legislature Can Override Tests. The test that applies in any particular year depends upon a number of factors. The Legislature and the Governor, however, can override these tests and provide *less* than otherwise required. They can do so by suspending Proposition 98, which requires a two-thirds vote of each house of the Legislature and the approval of the Governor. As part of the regular state budget process, the Legislature and the Governor also can provide *more* than otherwise required.

Maintenance Factor

A Future Funding Obligation Is Created in Certain Proposition 98 Situations. Historically, Proposition 98 has created a future funding obligation—commonly called a maintenance factor—in two specific situations. It has created a maintenance factor when (1) the minimum guarantee is determined under Test 3 or (2) Proposition 98 has been suspended. In both cases, the state keeps track of the difference between the higher Proposition 98 amount that otherwise could have been required and the amount of funding actually provided to K-14 education in that year. As of the end of 2007-08, the state has an outstanding maintenance factor obligation of $1.4 billion.

Maintenance Factor Payments Based on Growth in General Fund Revenues. Proposition 98 requires the state to provide additional payments in future years until the maintenance factor (or funding gap) has been closed. Historically, education funding has been built up in future years to the level it would have otherwise reached (absent the previous decisions to spend below the Test 2 level or suspend). The minimum amount of maintenance factor that must be paid in one year depends on how quickly state revenues grow. When state revenues grow quickly, larger payments are made, and the obligation is paid off in a shorter period of time. These maintenance factor payments become part of the base for calculating the next year's Proposition 98 minimum guarantee.

Different Interpretations of Test 1 Years. Based on revenue estimates at the time this analysis was prepared, the minimum guarantee would be determined by Test 1 in 2008–09 and 2009–10. Other than the first year under Proposition 98 (1988–89), the state has always calculated the minimum guarantee using either Test 2 or Test 3. Two issues have arisen over how the maintenance factor is supposed to work under Test 1 years. These issues are described in more detail in the nearby box. Much disagreement exists over these issues, with different interpretations potentially resulting in very different Proposition 98 funding requirements.

Unclear How the Constitution Would Be Interpreted

Two issues have arisen over how the maintenance factor is supposed to work in Test 1 years—how it is created and how it is paid back.

Maintenance Factor Obligation in 2008-09 Is Unknown. The first issue relates to whether the state creates a maintenance factor obligation in a year when Test 1 is applied. Historically, a maintenance factor obligation generally has been created when *Test 3* applies. It is unclear whether a maintenance factor is created when *Test 1* applies and is lower than Test 2. Some believe a maintenance factor is created in this situation. If so, this could result in an additional maintenance factor obligation of $7.9 billion being created in 2008-09 (for a total outstanding maintenance factor obligation of $9.3 billion). Others believe that no maintenance factor is generated under this situation.

Method of Paying Maintenance Factor Also Unclear. The second issue relates to how the maintenance factor (from previous years) is paid in a Test 1 year. One interpretation is that maintenance factor payments are to be made on top of the Test 1 level. A second interpretation is that maintenance factor payments are to be made on top of the Test 2 level. Because the Test 1 level is expected to be significantly higher than the Test 2 level in 2009-10, the first interpretation could result in a significantly higher minimum guarantee in 2009-10.

K-12 Revenue Limits

Revenue Limits Provide Per-Pupil Funding for General Education Purposes. Approximately two-thirds of Proposition 98 funding for school districts is used for K-12 revenue limits. Revenue limits provide funding for general education purposes—that is, few requirements are attached to this funding. Districts decide how specifically to use the funds. School districts receive a funding amount per student (as measured by average daily attendance). Revenue limit amounts were initially based on each district's per-pupil funding level in the 1970s, which varied significantly among districts. Since then, the Legislature has provided additional revenue limit funding specifically for the purpose of "equalization." This funding has gone to those districts with the lowest per-pupil revenue limit amounts in order to reduce funding differences among school districts.

Proposal

Proposition 1B amends the California Constitution related to Proposition 98, as described below.

Creates $9.3 Billion "Supplemental Education" Obligation. This measure requires the state to make a total of $9.3 billion in supplemental payments to K-14 education. The payments would be made in annual installments, beginning in 2011-12. They would become part of the base budget when calculating the following year's Proposition 98 minimum guarantee.

Supplemental Payments in Place of Maintenance Factor Payments. These payments would replace any payments that the state would otherwise be required to make under current law for maintenance factor obligations created in 2007-08 and 2008-09. The measure, however, does not clarify the uncertainty regarding maintenance factor in Test 1 years for the future.

Distribution of Funds. The measure gives discretion to the Legislature and the Governor regarding how these payments would be distributed between K-12 education and community colleges. For any funds provided to K-12 education, the measure requires that the payments be made for revenue limits. Of the 2011-12 payment, up to $200 million can be provided to school districts with low per-pupil revenue limit amounts to equalize revenue limit payments among districts. All other K-12 payments would be distributed based on districts' per-pupil revenue limit rates. The measure makes no specific requirements on how any money provided to community colleges is to be used.

Measure Linked to Proposition 1A. The funding mechanism for making the supplemental payments established in this measure is provided in Proposition 1A, also on this ballot. That measure establishes a Supplemental Education Payment Account and requires the state to annually deposit 1.5 percent of General Fund revenues into the account, beginning in 2011-12. These funds would be put into the account annually until the entire $9.3 billion in supplemental payments had been provided. If Proposition 1A is not approved by the voters, the provisions of this measure would not go into effect, and there would be no obligation to make $9.3 billion in supplemental payments.

Fiscal Effects

This measure's fiscal effect would depend on a number of key factors, including:

- ***Interpretation of Current Law.*** Because there is uncertainty over how the Constitution would be interpreted in its current form, it is unknown how Proposition 98 funding would work in the future under current law. As a result, it is difficult to know how this measure would change the state's finances.
- ***Economic and Revenue Outlook.*** The Proposition 98 minimum guarantee changes each year in large part due to changes in the state's economy and

revenues. Thus, shifts in the economy and revenues can change the minimum guarantee by billions of dollars.

- ***Passage of Proposition 1A.*** If Proposition 1A is not approved by the state's voters, this measure would have no fiscal effect. Funding for Proposition 98 would be determined by interpreting the Constitution in its current form.

While these factors are uncertain, we describe below the likely effects of this measure for both the near- and the longer-term, assuming that Proposition 1A also passes.

Savings in Near Term. In 2009-10 and 2010-11, the measure could result in annual savings. This is because the measure could postpone maintenance factor payments that otherwise would have been made in these years. Any such savings could be up to several billion dollars each year. Under other interpretations of current law, however, this measure would result in no savings in 2009-10 and/or 2010-11.

Costs in Long Term. In 2011-12, the state would begin making supplemental payments. The $9.3 billion in payments likely would be paid over a five-to-six year period. As noted above, the long-term effect of these payments is subject to considerable uncertainty. Under most situations, however, costs for K-14 education likely would be higher than under current law—potentially by billions of dollars each year.