

SCRIPT FOR:

***THE BASICS OF PROPOSITION 98,
A TUTORIAL FOR STATE POLICYMAKERS***

1. Introduction.

Welcome to *The Basics of Proposition 98, A Tutorial for State Policymakers* from the Legislative Analyst's Office.

2. Overview of Presentation.

This presentation is intended to cover the basics of Proposition 98 at a very high level, and will last about 20 minutes. This tutorial is designed specifically for state-level policymakers, and information is provided through the lens of what a policymaker needs to know. The presentation is broken into three distinct sections: (a) a high-level overview of background and general information, (b) an introduction to the mechanics of Proposition 98, with a review of its formulas and vocabulary, and (c) finally a discussion of the major budget decisions that policymakers face each year related to Proposition 98.

3. Why Should Policymakers Care About Understanding Proposition 98 Basics?

Before you dive into this exercise, you might ask yourself, why should I bother to learn about Proposition 98? Here are a few reasons. To start with, it is the largest area of the state budget, and accounts for over 40 percent of annual state General Fund spending. It is a key factor in annual budget decisions and negotiations. In addition, public opinion polls consistently rank education as a foremost area of interest for the California public. The Proposition 98 formulas drive off of how much revenue the state takes in, so proposals that change revenues, for example by raising or lowering taxes, can change the Proposition 98 requirements. When considering budget proposals or legislation that have revenue impacts, it is helpful to understand how these interactions might work. Finally, because education is such a key area of interest and a large share of the budget, and because Proposition 98 plays such a key role in education funding decisions, Proposition 98 is a frequently mentioned topic in the Capitol, by members, staffers, media, and constituent groups. It is helpful to have some context of what everyone is talking about.

4. Part I—Background Questions.

In this first section of the presentation, we will cover some general background information about Proposition 98.

5. When Was Proposition 98 Enacted?

Voters approved Proposition 98 in 1988 as an amendment to the State's Constitution. Two years later, in 1990, the Legislature placed Proposition 111 on the ballot, through which voters approved some modifications to the original initiative.

6. What is Proposition 98?

When people discuss Proposition 98, it is sometimes difficult to know exactly what it is they are talking about. Basically, Proposition 98 established a set of mathematical formulas in the Constitution. Each year, the state must use these formulas to calculate a funding amount. This funding amount is the minimum level the state is required to spend on schools and community colleges in that year.

7. Why Proposition 98?

It seems Proposition 98 has three main goals. First, by establishing a funding requirement, education funding now receives special status in annual budget negotiations. Second, it ensures that the state dedicates a certain proportion of state funding to education and makes sure it remains the largest priority-funding item. Finally, the formulas are designed to keep education funding growing along with the economy.

8. What Sources Fund Proposition 98?

The Proposition 98 requirement is funded by a combination of local property tax revenue and state General Fund dollars. As shown in the pie chart, local property tax revenues generally make up about one-quarter of total funding, while state General Fund makes up the remaining three-quarters.

9. Where do Proposition 98 Funds Go?

Proposition 98 funding is provided primarily to K-12 public schools—including charter schools—and the California Community Colleges. Because of this, we sometimes refer to Proposition 98 as funding K-14 education. Proposition 98 funding is also provided for other state entities that provide public education in nontraditional venues, such as state mental hospitals or detention centers for juvenile offenders. Some funding is also provided for state-run preschool and child care services. There is no Proposition 98 funding, however, provided for the University of California or California State University. As with most other areas of state spending, funding levels for these entities are determined as part of annual budget process.

10. How Much Funding Does Proposition 98 Provide?

As you can see in the pie chart, Proposition 98 funding for the 2008-09 fiscal year, as amended in February 2009, provided a total of \$51 billion to K-14 education. Forty-five billion, or about 88 percent of the Proposition 98 funds, were provided for K-12 education. Six billion, or 12 percent, was provided for community colleges.

11. Proposition 98 Is Primary Source of Funding for K-14 Education.

Both K-12 schools and community colleges receive funding from other sources, but they primarily rely on Proposition 98 funds for their operations. As you can see in the figure, Proposition 98 funds make up around 75 percent of total funding for K-14 education. K-12 schools and community colleges also receive significant levels of funding from the federal government and from other local sources. These each total about 10 percent of funding for K-14 education.

12. What Does Proposition 98 Fund?

The Proposition 98 formulas calculate a required amount the state must spend on K-14 education, but they are silent as to *how* those funds can be spent. The Legislature has the discretion to determine how the funds will be used. Currently, about two-thirds of Proposition 98 funds are sent to local districts and colleges as general purpose funds to support most personnel and operations costs. A portion of the remaining funds are targeted by the Legislature for specific purposes such as special education, services for disadvantaged students, and after school programs. In most (but not all) years, the formulas result in sufficient year-to-year growth in Proposition 98 funding to provide enrollment and cost-of-living adjustments to schools and colleges.

13. Part II—Proposition 98 Mechanics.

In this second section of the presentation, we provide an introduction to the Proposition 98 formulas and define some of the terminology often used in Proposition 98 discussions. Specialized Proposition 98 vocabulary will appear in green font.

14. Minimum Guarantee.

Each year, the state calculates the required funding level for K-14 education. The requirement is known as the minimum guarantee. The calculation is done using the constitutional formulas put in place by Proposition 98. These formulas are known as Tests. Each year, one of three formulas, or Tests, applies.

15. Proposition 98 Formulas.

The Proposition 98 formulas require that two basic conditions are met. The first condition is that a certain percentage of General Fund revenues must be spent for K-14 education—specifically, at least 40 percent. This is known as Test 1. The second condition is that funding for K-14 education must grow at least as fast as the economy, as measured by percapita personal income, and growth in numbers of students. This is known as Test 2. Each year the minimum funding requirement is based on whichever formula results in the higher, more generous level.

16. Proposition 98 Formulas—The Relief Valve.

Proposition 98 was amended in 1990 to allow for a “relief valve” from the Test 2 requirement in years when the state’s General Fund is experiencing slow growth. Specifically, if the General Fund is growing more slowly than personal income, suggesting a tough year for the General Fund, the state may grow prior year funding at the same rate as General Fund growth, rather than growth in the economy. This is known as Test 3, and results in a lower funding requirement than Test 2. While this relief can be helpful in difficult years, it cannot bring total K-14 spending below the Test 1 minimum requirement of roughly 40 percent of all General Fund spending. In most years the General Fund grows more quickly than personal income, so historically since 1988, in most years the requirement has been that funding grow with the economy, or Test 2.

17. Proposition 98 Formulas Apply Automatically.

Which formula is used to determine the funding requirement—Test 1, 2, or 3—is triggered automatically depending on how the economy and General Fund are growing from year to year. It is not up to the Legislature to decide which test it wants to apply or what it wants the resulting requirement to be. Also, the requirement does not “lock in” when the budget is enacted, but can change as underlying factors like General Fund revenues change. Although the formulas apply automatically and the Legislature cannot choose what the *requirement* will be, it can waive the formulas and choose what *funding level* to provide, either more or less than formulas call for. Providing less than the minimum guarantee is known as suspension, because the Legislature suspends the requirement. These options are discussed later in the presentation.

18. Catching Up to the Long-Term Funding Target.

In years where the General Fund is growing slowly and Test 3 applies, Proposition 98 requires that we figure out what the funding level would have been had Proposition 98 funding grown with the economy (Test 2). This hypothetical funding level becomes the long-term funding target. The technical term for the gap between the long-term target and the amount actually provided when Test 3 applies is known as maintenance factor. In future years, the state must provide additional funding for Proposition 98 to “catch-up” to that long-term target level. A similar process exists if the Legislature decides to suspend Proposition 98 and provide less than the minimum funding requirement.

19. Catching Up to the Long-Term Funding Target.

This graphic illustrates how maintenance factor works in a Test 3 year. In this hypothetical example, the dark blue bars represent funding that was actually provided. As shown in the year 1 column, in a Test 3 year the Proposition 98 funding level is below what it would have been had the Test 2 “grow with the economy” formula been used. The difference between the two, which is colored light blue, is the maintenance factor. This reflects the amount of savings the state experiences by taking advantage of the Test 3 relief valve. The Test 2 funding level is established as a long-term target. Over the course of the next several years, the Proposition 98 formulas require that K-14 funding grow at an expedited rate, such that the long-term target is reached and the maintenance factor gap is eliminated. In this way, K-14 funding gets “back on track” to where it otherwise would have been if it had never dipped below Test 2. However, in the interim years when the state General Fund may be growing relatively slowly, the state does experience savings, and it never has to “pay back” the funds that schools did not receive in those years. The amount of time it takes to build back up to the long term target depends on the size of the maintenance factor and on state General Fund revenue growth. It could happen in a few years, as in this example, or take a longer period of time. Again, a similar catch up process takes place in years following a legislative decision to suspend Proposition 98 and provide less than the formulas require.

20. Results of Formulas Not Always Intuitive.

To wrap up this section on Proposition 98 mechanics, we think it is important to emphasize that the formulas may not always lead to the types of results you might expect. The formulas incorporate changes in revenues and personal income, and are intended to track with the overall economy and the state's General Fund resources. However, because they focus only on the year-to-year changes in these factors—not the state's overall fiscal condition or the amount of General Fund resources the state actually has available—sometimes the results are not always intuitive, and the requirements may not track exactly with the amount of resources the state has available to spend. Proposition 98 requirements may seem particularly confusing in years following large spikes or dips in state revenues, when intuitively it may seem like the state should be spending more or less on education than the formulas require.

21. Part III—Major Proposition 98-Related Budget Decisions.

In this final section of the presentation, we take a step back from the technical formulas and talk about how Proposition 98 actually affects budget decisions. Specifically, we will review four key Proposition 98-related decisions policymakers can face. While the Proposition 98 formulas operate automatically, there *are* ways in which the Legislature's budgetary decisions affect K-14 spending. The first decision is whether the Legislature even opts to follow the formulas. Next, we will discuss two ways in which the Legislature can change the Proposition 98 requirement by lowering the prior-year funding base or altering General Fund revenues. The final decision deals not with the total amount of Proposition 98 funding, but with how to spend the education dollars.

22. Proposition 98 Requirement Often Is Moving Target.

Each year policymakers put the budget together based on a forecast of what revenues the state will receive in the coming year. Similarly, at the time of the budget act, the Legislature funds Proposition 98 based on an estimate of what the requirement, or minimum guarantee, will be in the coming year. Over the course of the year, actual revenues may come in higher or lower than originally forecast. K-12 attendance, another factor in the formula, can also change from original estimates. Correspondingly, the actual Proposition 98 requirement may end up higher or lower than what was originally forecast. In this way, the Proposition 98 requirement is often a moving target throughout the year.

23. Reconciling Proposition 98 Spending for Updated Revenues.

Though the actual requirement may be a moving target that does not lock in until revenues are finalized up to a year and a half later, the Legislature must still make a Proposition 98 appropriation at the time of the budget enactment. What happens if the initial estimate ends up being too high or too low? If higher revenues lead to a higher requirement than what was initially funded at the budget act, the Legislature must makeup the difference and provide the additional funding. This is referred to as "settle-up." This is not a choice, it is required by the constitutional formulas. If lower revenues lead to a lower requirement than the budget act funding level, the Legislature has the

option to reduce funding to the lower, revised minimum guarantee. This reduction does not happen on the natural—it takes legislative action to amend the budget Act and reduce the funding amount.

24. (1) Legislature Can Override Proposition 98 Requirement.

This leads us to the first key Proposition 98 related budget decision for the Legislature—whether to fund at the Proposition 98 minimum guarantee. As discussed earlier, policymakers always have the option to fund at a higher or lower level than what the formulas would otherwise require. However, overriding the formulas is not without challenges. Providing more is often referred to as an overappropriation, because it is appropriating over the requirement. While this has taken place a number of times in the past, the Legislature is often cautious about taking this approach because it can raise the Proposition 98 spending requirement in future years. This is because the prior year’s funding level is one factor that affects the next year’s requirement. Thus, whenever the Legislature chooses to raise the funding level, that higher base can carry forward into subsequent years. The Legislature can also provide less than formulas require, but only by voting to suspend the Proposition 98 requirement. This takes a two-thirds vote, and can be politically difficult to do. The Legislature has only taken that two-thirds vote to suspend the Proposition 98 requirement once, in 2004-05.

25. (2) If Revenues Drop, Legislature Can:

As noted earlier, in many years revenues decline from initial forecasts and the Proposition 98 requirement drops after the budget act. In this case, the Legislature can decide whether to reduce Proposition 98 spending to the newly lowered minimum guarantee. While the constitutional formulas allow this flexibility, it can be very difficult, both logistically and politically, to cut school spending in the middle of the year, in large part because schools are already running programs and have hired staff for the year. Therefore, such reductions have usually been targeted where funds are not likely to be spent. However, leaving the Proposition 98 spending level at the budget act level means spending more than what is actually required, which can have both short- and long-term consequences. If the state does not make the midyear reduction to education, it could mean making deeper cuts in other areas of the budget, or drawing down the state’s reserve. As discussed, this decision would also affect the budget in subsequent years, because spending in one year becomes the funding base for the next year. So, if the state does not reduce spending down to the requirement, it can carry that higher base into the next year as well. In the past when revenues have dropped midyear the Legislature has often looked for creative solutions, such as using one-time funds, delaying implementation of new programs, or funding deferrals to protect schools from inconvenient midyear cuts while reducing Proposition 98 spending to realize some savings at the state level. In other years, the Legislature has just left funding overappropriated at the budget act level.

26. (3) Tax Revenues Affect Proposition 98 Requirement.

Another budget decision that policymakers face each year is whether to modify the state’s tax policy and change the amount of revenues flowing into the General Fund.

This can have implications for Proposition 98. Specifically, increasing tax revenue can increase the Proposition 98 requirement. Conversely, decreasing revenues can lower the requirement. The exact effect of revenue increases or decreases on the Proposition 98 requirement can vary depending on a number of factors, but a rough rule of thumb that has applied in recent years is that the Proposition 98 effect is about half of every dollar increase or decrease. For example, if the Legislature decides to raise the sales tax and generate \$1 billion in new General Fund revenues, in some cases the Proposition 98 requirement will increase by about \$500 million. Put another way, about half of the new revenue must be spent on Proposition 98. This interaction is important to keep in mind if policymakers are attempting to generate revenues to use for another, noneducation purpose—it could be that only half of the new revenue may be available for that other purpose.

27. (4) Legislature Chooses How to Spend Funds.

Now, we have spent a lot of time talking about formulas and ways the Legislature can influence the Proposition 98 funding *amount*. But once a Proposition 98 spending level has been determined, each year the Legislature faces the important task of deciding what that funding will be spent *on*. As noted, Proposition 98 is silent on this point—it is completely up to the Legislature to decide how to allocate the funds. Existing statute says that about 11 percent of Proposition 98 funds should be used for community colleges, with the remainder left for K-12 education. While this statute is waived in some years, the Legislature has tended to split Proposition 98 funding in roughly these proportions. In addition to the ongoing Proposition 98 funding, the Legislature typically faces annual decisions about how to allocate one-time funds for K-14 education. These are usually unspent Proposition 98 funds from prior years, which often have totaled several hundred million dollars annually.

28. Congratulations!

Congratulations! You have made it through an introductory tour of Proposition 98. For additional information, please see our Web site, which includes a *Proposition 98 Primer* written in 2005, as well as recent handouts and publications on current education budget proposals. Please call the staff of our education section if you have any further questions.