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The 2012-13 Budget:

Proposition 98 Education Analysis

CONTENTS

EXECUTIVE SUMMARY

This report analyzes the Governor's 2012-13 Proposition 98 budget package. The report provides detailed assessments of the Governor's: (1) basic budget plan (which assumes passage of his November 2012 ballot measure to raise certain taxes temporarily), (2) major policy proposals, (3) multiyear plan to retire existing education obligations, and (4) back-up budget plan (in the event his ballot measure fails).

Governor's Basic Budget Plan

Paying Down Deferrals Makes Sense. The largest component of the Governor's basic plan is to pay down $2.4 billion in K-14 payment deferrals. If the state has additional Proposition 98 resources to spend in 2012-13, we think paying down these deferrals is reasonable. This would not only help reduce the significant cash management challenges now facing districts but also would be less disruptive than programmatic cuts were the tax measure to fail.

Major Policy Proposals

Recommend Replacing Seriously Flawed Mandate System With Block Grant. The Governor's budget proposes to eliminate more than half of education mandates and fund remaining mandated activities within a $200 million discretionary block grant. The state's existing mandate system has serious flaws, and we think a block grant approach would help overcome many of them. We recommend the Legislature adopt the block grant approach and create a working group to address implementation details over the next few months.

Recommend Fundamental Restructuring of State's K-12 Funding Model. The Governor proposes major changes to the way the state allocates funding to districts. Because the state's current K-12 funding system is complex and inequitable, we recommend the Legislature adopt some version of the Governor's proposal. While we think his specific proposal for a weighted student formula has many strengths, we believe the Legislature should consider some modifications to ensure fundamental state priorities are preserved. Most importantly, we recommend the Legislature preserve some assurances that districts dedicate additional resources toward their disadvantaged students.

Recommend Expanding Categorical Flexibility for Community Colleges. The Governor proposes to consolidate all funding for community college categorical programs into one discretionary "flex item." We agree that community colleges would benefit from more categorical flexibility but offer two alternative approaches for the Legislature to consider—a somewhat more limited version of the Governor's flex item or combining categorical programs into two block grants. Either of these alternatives would enhance local flexibility while still ensuring that the funds continue to be spent on support services for students and faculty.

Recommend Package of Changes to Transitional Kindergarten (TK) and Preschool Programs. The Governor proposes canceling initiation of a new TK program. He also proposes to notably reduce funding and slots in the state's preschool program. Because some of the affected populations would be the same, we believe the Legislature may want to consider these proposals in tandem. We recommend the Legislature focus limited resources on serving the four-year olds who could most benefit from a state-subsidized preschool program. This includes immediately adopting the Governor's proposal not to initiate the TK program, but preserving—to the degree budgetary resources allow—the state's current investment in providing preschool services.

Multiyear Plan to Retire Education "Wall of Debt"

Governor's Plan Is Solid Starting Point. The Governor's package contains a multiyear plan for retiring certain education obligations. We think building such a plan is a prudent practice. We recommend, however, the Legislature consider extending the payment period, scheduling out payments more evenly, designating settle-up funds be used for mandates or deferrals, and redirecting Quality Education Investment Act program savings (with first call to retire Emergency Repair Program obligations). Although the Legislature will need to modify this plan if conditions change, having a plan in place is critical to ensure progress in retiring such large outstanding obligations.

Back-Up Budget Plan

Two Notable Concerns With Governor's Back-up Plan. If the Governor's tax measure is not approved by voters, the Governor proposes $5.4 billion in midyear trigger cuts. Of this amount, $4.8 billion, or 90 percent, would come from Proposition 98 cuts. To achieve these savings, the Governor begins funding K-14 debt service payments within Proposition 98. We have serious policy concerns with this proposal. Because debt service payments are volatile, the proposal would result in notably greater volatility for education programs. Absent a clear, compelling policy rationale, we question why the state would want to change its longstanding facility funding practices, particularly when the change results in a significant cut in programmatic funding. The Governor's back-up plan also excludes the 2011-realignment related sales tax revenue from the Proposition 98 calculations. We believe such treatment is risky. If the realignment revenues were to count toward the guarantee, the guarantee would increase roughly by $1.7 billion. As a result, the Governor's back-up plan would need to be modified—either by suspending the guarantee or by funding the higher guarantee and implementing $1.7 billion in reductions in other areas of the budget.

Consider Several Factors When Developing Back-up Plan. Most districts likely will base their local budgets on the state's back-up plan. Given this, the Legislature needs to be very deliberate in developing such a plan. If the Legislature decided to enact midyear cuts, it would need to identify a target level of savings, decide how best to allocate cuts among education and non-education programs, determine the specific K-14 cuts to impose, and design tools to help districts respond. Alternatively, the Legislature could adopt a plan that made cuts up front and then provided midyear spending increases if the tax measure passed. It could designate the new revenues for one-time investments in 2012-13 and then build them into the base budget in 2013-14.

Provide Districts More Flexibility Given All the Uncertainty They Face in 2012-13. We recommend the Legislature give districts some flexibility tools (effective July 1) for the coming year. We offer a number of options, including removing additional categorical and mandate requirements, shortening the school year, suspending the number of full-time faculty that community colleges must employ, and allowing for a special post-election layoff window.

INTRODUCTION

Proposition 98 monies support K-12 education, the California Community Colleges (CCC), preschool, and various other state education programs. In this report, we analyze the Governor's Proposition 98 budget package. The report begins with an overview of the Governor's basic Proposition 98 budget plan, which assumes passage of his November 2012 ballot measure to raise certain taxes temporarily. This is followed by a retrospective on per-student funding over the last several years. We then have a section focusing on the various adjustments the Governor would make to the Proposition 98 minimum guarantee under his basic plan. The next five main sections of the report analyze specific Governor's proposals (relating to deferrals, mandates, restructuring of the K-12 funding model, CCC categorical flexibility, and transitional kindergarten/preschool). We then turn to our assessment of the Governor's multiyear plan to retire the "wall of debt" relating to existing education funding obligations, followed by our analysis of the Governor's Proposition 98 back-up plan were his tax measure to fail. The last section contains a summary table listing all the recommendations we make throughout the report.

OVERVIEW

Proposes $4.9 Billion Increase in Proposition 98 Funding. The Governor's basic budget plan increases total Proposition 98 funding by $4.9 billion, or 10 percent, between the current year and the budget year. As shown in Figure 1, the year-over-year increases in Proposition 98 General Fund for schools and community colleges are larger—15 percent and 14 percent, respectively—with local property tax revenues estimated to be virtually flat. The funding levels reflected in Figure 1 assume voters approve the Governor's November 2012 ballot measure to raise sales and

Figure 1

Proposition 98 Funding

(Dollars in Millions)

	2011-12 Revised	2012-13 Proposed	Change From 2011-12 Amount	Change From 2011-12 Percent
K-12 Education				
General Fund	$29,329	$33,755	$4,426	15%
Local property tax revenue	12,891	12,908	17	—
Subtotals	($42,220)	($46,663)	($4,443)	(11%)
California Community Colleges				
General Fund	$3,217	$3,683	$465	14%
Local property tax revenue	2,107	2,101	-6	—
Subtotals	($5,324)	($5,784)	($459)	(9%)
Other Agencies	$83	$80	-$2	-3%
Totals, Proposition 98	**$47,627**	**$52,527**	**$4,900**	10%
General Fund	$32,629	$37,518	$4,889	15%
Local property tax revenue	14,998	15,009	11	—

income tax rates temporarily, with a portion of the associated revenue increase benefiting K-14 education.

Major Spending Proposals. As shown in Figure 2, the year-to-year funding increase under the Governor's plan would be dedicated primarily to backfilling one-time solutions from last year and paying down existing K-14 deferrals. The plan provides no cost-of-living adjustment (COLA) for any K-14 education program. (Providing the projected 3.17 percent COLA for K-14 programs would cost $1.8 billion.) It funds a slight increase in the projected overall K-12 student population (0.35 percent) for revenue limits and special education, a more sizable increase in the projected charter student population (15 percent), and a slight increase in preschool slots (0.16 percent). It funds no enrollment growth at the community colleges. The Governor's basic spending plan contains a few program reductions and eliminations, including reductions in preschool funding, savings from choosing not to initiate the Transitional Kindergarten (TK) program, and the elimination of the Early Mental Health Initiative.

Figure 2

Proposition 98 Spending Changes

(In Millions)

2011-12 Budget Act Spending	**$48,651**
Revenue limit adjustments	-$588
Home-to-School Transportation trigger reduction	-248
CCC trigger reductions	-102
K-12 revenue limit trigger reductions	-80
Preschool trigger reductions	-6
Other technical adjustments	-1
Total Changes	**-$1,024**
2011-12 Revised Spending	**$47,627**
Technical Changes	
Backill one-time actions	$2,440
Make revenue limit technical adjustments	162
Fund revenue limit growth	158
Backfill Proposition 63 mental health funding	99
Adjust for revised CCC fee revenue estimate	97
Make other technical adjustments	-182
Subtotal	($2,775)
Policy Changes	
Pay down K-12 deferrals	$2,151
Pay down CCC deferrals	218
Create K-12 mandate block grant	98
Create CCC mandate block grant	12
Do not initiate Transitional Kindergarten program	-224
Reduce preschool funding	-58
Swap one-time funds	-57
Eliminate Early Mental Health Initiative	-15
Subtotal	($2,125)
Total Changes	**$4,900**
2012-13 Proposed Spending	**$52,527**

Major Policy Proposals. The Governor's Proposition 98 budget package also contains a set of major proposals to restructure how the state allocates certain education funding. Most significantly, the Governor proposes to replace the state's existing K-12 funding system with a weighted student formula. The Governor also proposes to remove the specific requirements associated with most remaining stand-alone CCC categorical programs. Additionally, for both schools and community colleges, the Governor proposes to replace the state's existing mandate reimbursement system with a discretionary block grant.

RETROSPECTIVE

In this section, we recap the major budget developments affecting school districts and community colleges over the last five years, identify the impact on per-student programmatic funding, and discuss the implications for school and college operations. We use 2007-08 as the base year because it marks the year immediately preceding the significant downturn in state revenues and reflects the last year in which the state funded COLAs and enrollment growth for K-12 and CCC programs. We extend comparisons through 2012-13 to show how the Governor's most recent budget proposal would affect education funding.

Rather than focusing solely on Proposition 98 funding, we also include any extraordinary funding used to support Proposition 98 programs. Most significantly, in addition to ongoing Proposition 98 funding, we include Quality Education Investment Act (QEIA) funding, federal one-time education funding, community college student fee revenue, and special funds used to support education programs. (We exclude ongoing federal funds, lottery funds, and various other local funds.) We focus on "programmatic" funding in that we make various adjustments to reflect when education programs are authorized and operated rather than the year in which the state makes cash payments for them. The numbers in this section do not reflect inflationary adjustments. General inflation over the period has been low and, given the particularly soft employment situation, the cost to provide districts' main operating expense—teacher wages—has been relatively flat over the period. Still, the reductions in spending are somewhat understated because of these inflationary factors.

School Districts

Several Actions Taken by State and Federal Governments to Help School Districts Through Great Recession. As shown in the top part of Figure 3, the state and federal governments have

Figure 3

K-12 "Programmatic" Funding

	2007-08 Final	2008-09 Final	2009-10 Final	2010-11 Final	2011-12 Revised	2012-13 Proposed	2012-13 With Trigger
Total Programmatic Funding (In Millions)							
K-12 ongoing funding	$48,883	$43,215	$40,717	$43,017	$42,254	$46,755	$42,390
Payment deferrals	—	2,904	1,679	1,719	2,064	-2,151	—
Settle-up payments	—	1,101	—	267	—	—	—
Public Transportation Account	99	619	—	—	—	—	—
Freed-up restricted reserves[a]	—	1,100	1,100	—	—	—	—
Federal ARRA funding[a]	—	1,192	3,575	1,192	—	—	—
Federal education jobs funding[a]	—	—	—	421	781	—	—
Totals	**$48,982**	**$50,130**	**$47,070**	**$46,616**	**$45,099**	**$44,604**	**$42,390**
Per-Pupil Programmatic Funding (In Dollars)							
K-12 attendance	5,947,758	5,957,111	5,933,761	5,953,259	5,947,368	5,950,041	5,950,041
Per-Pupil Funding	**$8,235**	**$8,415**	**$7,933**	**$7,830**	**$7,583**	**$7,496**	**$7,124**
Year-to-year percent change	—	2.2%	-5.7%	-1.3%	-3.2%	-1.1%	-6.0%
Percent change from 2007-08	—	2.2	-3.7	-4.9	-7.9	-9.0	-13.5

[a] Reflects LAO estimates of funds spent in each year.
ARRA = American Recovery and Reinvestment Act.

taken various actions over the last five years to mitigate reductions in school district funding. (We discuss these changes in more detail in *Update on School District Finance in California*, 2011.)

- ***Deferrals.*** Since the beginning of the recession, the state has relied heavily on payment deferrals (discussed in more detail later in this report). Essentially, the state has avoided deeper programmatic cuts by authorizing school districts to support operations through short-term borrowing. The state then has made late payments to school districts using funding from the next fiscal year. The state has increased its reliance on such borrowing over the last four years, with 22 percent of K-12 Proposition 98 payments (and 30 percent of K-12 Proposition 98 General Fund payments) now paid late.

- ***One-Time Federal Aid.*** The federal government provided states with two major sources of one-time aid to mitigate reductions in school funding. The federal government provided California with $6 billion in American Recovery and Reinvestment Act (ARRA) funding (that could be used in 2008-09 through 2010-11) and $1.2 billion in Federal Education Jobs and Medicaid Act funding (that could be used in 2010-11 and 2011-12). Both allocations were intended to allow school districts to retain school personnel, avoid teacher layoffs, and support school operations that otherwise might be cut.

- ***Fund Swaps and Other Actions.*** The state has taken a variety of other actions over the last few years to help school districts through the recession, including using certain special funding sources to support school operations, freeing up school districts' restricted reserves to be used for any educational purpose, and removing ongoing programmatic requirements associated with many state-funded categorical programs.

Despite These Efforts, Per-Pupil Funding Has Dropped. Despite these efforts, school districts' programmatic per-pupil funding is lower today than five years ago. As shown in the bottom part of Figure 3, per-pupil funding in 2011-12 was $7,583—lower than the 2007-08 level of $8,235. Under the Governor's 2012-13 budget proposal, per-pupil funding would drop further. Assuming the Governor's tax measure passes, per-pupil funding would drop slightly from the current year (1.1 percent). If the tax measure fails, per-pupil funding under the Governor's trigger plan would drop 6 percent from the current year, with per-pupil funding more than $1,100 lower than the 2007-08 level.

School Operations Have Been Affected in Notable Ways. These drops in per-pupil funding have affected school operations in several ways. The size of the teacher workforce has fallen from 306,000 full-time equivalent (FTE) teachers in 2007-08 to 272,000 FTE teachers in 2010-11—a drop of 34,000 FTE teachers (11 percent). Because student attendance has been virtually flat over this period, the student/teacher ratio has climbed from 19.4 to 21.9. The number of instructional days also has been affected. In 2007-08, virtually all school districts provided 180 instructional days whereas in 2010-11 one-third of districts provided less than 180 instructional days. In addition, many school districts have redirected funds away from specialized programs and support services to general operations. In particular, many school districts report shifting funds away from "flexed" categorical programs (including professional development, summer school, adult education, art and music programs, facility maintenance, school libraries, and high school class size reduction). Teacher salaries have been affected less than other aspects of school operations, with average teacher salaries increasing from $65,800 in 2007-08 to $67,900 in 2010-11.

Community Colleges

Efforts Also Made to Mitigate Programmatic Reductions at Community Colleges. Over the last five years, programmatic reductions at the community colleges have been mitigated primarily by payment deferrals, one-time federal aid, and increases in student fees. (We discuss these developments in more detail in *The 2010-11 Budget: Higher Education,* pages 12 to 13, and *The Budget Package: 2011-12 California Spending Plan,* pages 29 to 30.)

- ***Deferrals.*** As with school districts, the state has relied heavily on deferring payments to community colleges as a way of avoiding deeper programmatic cuts. The state has relied on additional CCC deferrals in each of the last four years, with 17 percent of CCC Proposition 98 payments (and 27 percent of CCC Proposition 98 General Fund payments) now paid late.

- ***One-Time Federal Aid.*** Community colleges also benefitted from one-time federal aid—receiving a total of $39 million in ARRA funding.

- ***Additional Student Fee Revenue.*** The state has relied on increases in CCC student fees as another way to mitigate reductions in state funding. The state raised student fees from $20 per unit to $26 per unit in 2009-10, to $36 per unit in 2011-12, and to $46 per unit effective summer 2012. (Though the additional revenue raised from recent fee increases has mitigated programmatic reductions, fee revenues have been falling short of budgeted expectations—$14 million short in 2009-10 and an estimated $100 million short in 2011-12. These shortfalls appear primarily due to a significant increase in the number of students receiving fee waivers.)

Total Programmatic Funding Has Dropped Over Period. As shown in the top part of Figure 4 (see next page), community colleges are operating with $650 million less total programmatic support in 2011-12 than in 2007-08. Of this reduction, about $350 million reflects cuts in apportionment funding (general purpose monies used to fund enrollment and other campus costs), with the remaining $300 million reflecting cuts in categorical funding (funding earmarked for specified purposes, such as student support services).

CCC Receiving Less Funding Per Student, and Fewer Students Are Being Funded. The bottom part of Figure 4 shows that budgeted funding per full-time equivalent student (FTES) in 2011-12 was $5,260—lower than the 2007-08 level of $5,570. This reduction would have been even greater had it not been for the Legislature's decision in both 2009-10 and 2011-12 to reduce colleges' enrollment targets. In the current year, community colleges are funded to serve just over 1.1 million FTES—about 75,000 FTES less than their funded level in 2010-11. Under the Governor's proposal for 2012-13, the number of funded FTES would remain flat compared with the current year, with per-FTES funding increasing 2 percent (to $5,366).

Community College Operations Have Been Affected in Notable Ways. Since the first round of cuts was imposed on CCC in 2009-10, campuses have reduced considerably the level of services and programs they provide. Most notably, community

Figure 4

California Community College (CCC) Programmatic Funding

	2007-08 Final	2008-09 Final	2009-10 Final	2010-11 Revised	2011-12 Revised	2012-13 Proposed	2012-13 With Triggers
Total Programmatic Funding (In Millions)							
CCC ongoing funding	$6,145	$5,995	$5,714	$5,892	$5,372	$5,832	$5,321
Payment deferrals	—	340	163	129	129	-218	—
Settle-up payments	—	—	—	32	—	—	—
Federal ARRA funding	—	—	35	4	—	—	—
Student fees	291	303	354	317	354	359	359
One-time backfills[a]	69	—	—	—	—	—	—
Oil and mineral revenues	9	9	7	8	8	8	8
Totals	**$6,514**	**$6,647**	**$6,273**	**$6,382**	**$5,864**	**$5,981**	**$5,688**
Per-FTES Programmatic Funding (In Dollars)							
CCC funded enrollment	1,169,606	1,205,741	1,168,364	1,190,221	1,114,654	1,114,654	1,049,654[b]
Per-FTES Funding	**$5,570**	**$5,513**	**$5,369**	**$5,362**	**$5,260**	**$5,366**	**$5,419**
Year-to-year percent change	—	-1.0%	-2.6%	-0.1%	-1.9%	2.0%	3.0%
Percent change from 2007-08	—	-1.0	-3.6	-3.7	-5.6	-3.7	-2.7

[a] Various funds designated to partially backfill local property tax shortfall in 2007-08.

[b] The adminstration has not indicated whether base cuts would be accompanied by a proportional reduction in CCC's funded enrollment level. Consistent with the Legislature's past actions, we assume a corresponding reduction in CCC's enrollment target. If enrollment were not reduced, per-FTES funding would drop to $5,103.

ARRA = American Recovery and Reinvestment Act and FTES = Full-Time Equivalent Student.

colleges offered almost 59,000 (14 percent) fewer course sections in 2010-11 compared with 2008-09. Based on preliminary information, we estimate an additional 20,000 (5 percent) fewer course sections are being offered in 2011-12 compared with 2010-11. Our review of systemwide CCC data finds that virtually all types of instruction and academic programs have been affected over the last few years, with noncredit instruction and courses that are primarily recreational in nature (such as physical education and ceramics) receiving a disproportionate share of cuts.

ADJUSTMENTS TO THE MINIMUM GUARANTEE

Figure 5 describes all of the major changes to the Proposition 98 minimum guarantee under the Governor's 2012-13 budget proposal. In addition to typical baseline adjustments (including changes in General Fund revenues, per capita personal income, and average daily attendance), the Governor's budget makes adjustments for a proposed change to the methodology used to "rebench" the Proposition 98 minimum guarantee, a recent court ruling on redevelopment agencies, and his proposed tax measure. (The specific value of each of these adjustments is affected by a number of factors, including the order in which changes are implemented. Because we sequence some of the changes differently, our numbers differ somewhat from the Governor's estimates.)

Governor's Proposed Modifications to Proposition 98 Calculation

The Governor's budget includes several changes that would modify the way the Proposition 98 minimum guarantee is calculated. These modifications, commonly known as rebenchings, have been adopted in prior years to prevent certain state actions from having unintended consequences on the Proposition 98 minimum guarantee. For example, in 1993-94, the state required cities and counties to shift $2.6 billion in property tax revenues to schools and community colleges to achieve state General Fund savings. To ensure that the shift in revenue provided state savings, the state rebenched the Proposition 98 calculation so the additional property tax revenue would not increase the minimum guarantee. Conversely, the state rebenched the Proposition 98 calculation in 2004-05 such that various shifts of property tax revenues from schools to counties did not result in a reduction in total school funding. The Governor's budget: (1) changes the methodology for certain rebenchings made in 2011-12, (2) eliminates one rebenching, and (3) modifies an anticipated second-year adjustment associated with the recent shift of student mental health responsibilities from counties to schools. We discuss each of these proposed changes below. (In addition to the modifications discussed in this section, the Governor proposes another modification to the Proposition 98 calculation if his proposed ballot measure were to be rejected by voters. This modification is discussed later in this report.)

The "1986-87 Rebenching Approach." Prior to 2011-12, the state had rebenched for a number of local property shifts using a methodology known as the 1986-87 approach. Under this approach, when shifting property taxes to or away from schools, the state rebenches the Proposition 98 calculation by determining the percent change in school property tax revenues due to the shift and then applying that same percent change back to school property tax revenues in 1986-87. This rebenching approach increases or decreases the state's General Fund obligation in response to the property tax change assuming the shift had been implemented the year prior to the enactment of Proposition 98. While the local and state shares of Proposition 98 funding are affected, the intent of the rebenching is to leave the minimum guarantee itself unaffected. This approach better reflects the effect of a policy change had it been implemented prior to the inception of Proposition 98, but it often results in unexpected fiscal effects. Using this approach, a $2 billion shift in property tax revenues to schools, for example, might only provide $1.5 billion General Fund savings. This is because the share of the Proposition 98 obligation covered by local

Figure 5

Major Adjustments to Proposition 98 Minimum Guarantee

(In Millions)

2011-12 Budget Act	**$48,651**
Update for changes in baseline revenues	-$883
Update for changes in other Proposition 98 factors[a]	-131
Change child care rebenching	298
Change redevelopment agencies rebenching	267
Change AB 3632 rebenching	-197
Eliminate gas tax rebenching	-596
Add Governor's new revenues accrued to 2011-12	879
2011-12 Revised	**$48,288[b]**
Add Governor's new revenues attributed to 2012-13	$2,444
Baseline growth	1,790
Additional AB 3632 rebenching	5
2012-13 Proposed	**$52,527**

[a] Includes updated estimates for revenues from local property taxes, redevelopment agencies, and the sales tax on gasoline.

[b] If the Governor's tax measure were to fail, the 2011-12 minimum guarantee would drop to $47.4 billion. The state therefore would owe no settle-up for 2011-12 (spending would be $218 million above the revised minimum guarantee).

property taxes has changed over time. In 1986-87, local property tax revenues represented a smaller share of Proposition 98 funding than today. When the shift is applied to property tax revenues in 1986-87, the shift therefore reduces the General Fund obligation by a smaller amount than one might expect.

The "Current-Year Rebenching Approach." In 2011-12, the state used a different rebenching approach. Under this approach, the state rebenched for the current value of the shift, thereby ensuring that it achieved an associated dollar-for-dollar impact. This new approach was used to rebench for one property tax shift and two program shifts. Specifically, it was used for the shift in property tax revenues from redevelopment agencies to school districts and community colleges (resulting in $1.7 billion General Fund savings but no effect on the minimum guarantee), the removal of child care programs from the Proposition 98 calculation (resulting in a $1.1 billion reduction in the guarantee), and the shift of responsibility for student mental health services from counties to school districts (resulting in a $222 million increase in the guarantee).

Proposes to Change Rebenching Methodology. The Governor proposes to recalculate these 2011-12 adjustments using the 1986-87 approach. For the two program shifts, the Governor would estimate the value of programs in 1986-87 as a proportion of total Proposition 98 funding that year and adjust the minimum guarantee by the same proportion in 2011-12. As Figure 5 shows, applying this method to the child care and redevelopment rebenchings would increase the Proposition 98 minimum guarantee by $298 million and $267 million, respectively, whereas applying it to the shift of student mental health services would reduce the minimum guarantee by $197 million.

Eliminates Rebenching for Gas Tax Swap. In addition, the Governor proposes to eliminate existing provisions that require the state to rebench for the "gas tax swap" adopted by the Legislature in 2011, reducing the minimum guarantee by $596 million. The gas tax swap eliminated the sales tax on gasoline (previously included in the Proposition 98 calculation) and replaced it with an increase in the excise tax on gasoline (excluded from the Proposition 98 calculation). Absent a rebenching, the minimum guarantee would have decreased due to the loss of gas tax revenues.

Completes Implementation of Student Mental Health Services Shift. The Governor's proposal also includes rebenching in 2012-13 to account for additional Proposition 98 funding being provided for student mental health services. In 2012-13, the Governor rebenches by $5 million to account for the completion of the student mental health services shift to schools.

Recommend Consistency in Rebenching Approach. We have no major concerns with the Governor's proposal to eliminate the rebenching for the gas tax swap. Given the state has not historically made adjustments to the minimum guarantee for increases or decreases in existing tax rates, we do not think a compelling reason exists for making an adjustment for this one specific tax change. Regarding the Governor's other rebenching proposals, we are concerned by the lack of consistency in the rebenching approach across years. In particular, we are concerned that frequent changes in the approach can result in arbitrary changes to the Proposition 98 minimum guarantee from year to year and allow otherwise technical calculations to be used as a way to meet other objectives.

Changes Due to Recent Court Ruling on Redevelopment Agencies

Two Major Current-Year Actions Affecting Redevelopment Agencies and Schools. The 2011-12 budget package included two bills related to redevelopment agencies. The first bill eliminated the statutory authority for redevelopment agencies to exist. Under this bill, successor agencies were established for the purpose of paying off any existing redevelopment debt with local property tax revenues that otherwise would have gone to the redevelopment agencies. Any revenue in excess of what is required to pay off these debts is to be distributed to schools, community colleges, and other local governments (cities, counties, and special districts) pursuant to existing property tax allocation laws. The second bill would have permitted a city or county that has a redevelopment agency to prevent that agency's elimination by making a remittance payment to the schools, fire protection districts, and transit districts that overlap with the redevelopment agency's project areas. The remittance payments and property taxes redirected from dissolved redevelopment agencies were estimated to provide a total of $1.7 billion to schools in 2011-12 and $400 million each year thereafter. The state rebenched the Proposition 98 calculation to achieve $1.7 billion in state General Fund savings from the remittance payments in 2011-12, with schools receiving no increase in their total Proposition 98 funding. Moving forward, the $400 million was to have been in addition to Proposition 98 appropriations (no rebenching was to occur).

Court Ruling Changes State Actions. Shortly after the state enacted these bills, the California Redevelopment Association filed a lawsuit against it, claiming that the bills violated the State Constitution. On December 29, 2011, the California Supreme Court found the first bill (which eliminated redevelopment agencies) constitutional but declared the second bill (which authorized the return of a redevelopment agency contingent upon a remittance payment) unconstitutional. As a result of the court rulings, all redevelopment agencies statewide were eliminated and no remittance payments will flow to schools. School districts and community colleges will receive additional property tax revenues as a result of the ruling, however, since revenues in excess of what is required to pay off redevelopment agency debts will be distributed pursuant to existing property tax allocation laws. The administration currently estimates that school districts and community colleges will receive $1.1 billion annually in 2011-12 and 2012-13 as a result of the elimination of redevelopment agencies.

Governor Proposes Permanent Rebenching. Consistent with the treatment of the $1.7 billion in remittance payments that were adopted in the budget plan, the Governor proposes to rebench the Proposition 98 minimum guarantee for the shift of $1.1 billion in property tax revenues to schools and community colleges in 2011-12, providing state General Fund savings. The Governor, however, also proposes to rebench the minimum guarantee for these revenues in 2012-13 and the next several years (as redevelopment-agency debt is retired), ensuring ongoing General Fund savings as a result of the elimination of redevelopment agencies.

Governor's Tax Proposal

Revenues Increase Minimum Guarantee $3.2 Billion Over Two Years. The Governor's Budget includes $6.9 billion in new revenues from his ballot-measure proposal to increase income taxes on high-income earners and the sales tax rate by a half cent. Of the revenues coming from his proposed tax increases, the Governor proposes to accrue $2.2 billion to 2011-12 and attribute $4.7 billion to 2012-13. As Figure 5 shows, the new revenues increase the minimum guarantee by almost $900 million, to $48.3 billion, in 2011-12. (The Governor's plan does not provide sufficient funding to meet the higher 2011-12 Proposition 98 obligation. Instead, he creates a $661 million settle-up obligation, which would be paid in future years.) In 2012-13, the Governor's proposed revenues increase the minimum guarantee by $2.4 billion.

Revenue Assumptions Have Significant Effect on Minimum Guarantee. As discussed in our recent *Overview of the Governor's Budget*, the administration's revenue estimates differ from our office's November forecast. For 2012-13, our baseline General Fund revenue forecast is $3.2 billion lower than the administration's forecast. In addition, our estimate of the increase in General Fund revenues under the Governor's tax proposal is $2.1 billion lower than the administration's estimate. If actual revenues were closer to our office's estimates, the minimum guarantee would be lower than the Governor's estimates. Using our revenue estimates, the minimum guarantee would be $1.9 billion lower in 2012-13 ($50.7 billion rather than $52.5 billion). Given the significant effect that revised revenues could have on the Proposition 98 minimum guarantee, most major Proposition 98 decisions likely cannot be finalized until updated May revenue estimates are available.

PAYMENT DEFERRALS

The Governor's largest spending proposal is to retire some existing K-14 payment deferrals, which have grown significantly in recent years. If the state has additional Proposition 98 resources to spend in 2012-13, we think the Governor's prioritization of retiring some existing K-14 payment deferrals rather than providing K-14 program augmentations is reasonable.

Background

Increased Reliance on Deferrals. The state has relied heavily on deferring Proposition 98 payments as a way to achieve budgetary savings in difficult fiscal times. The first Proposition 98 deferrals were adopted in the middle of 2001-02, when $1.1 billion in K-12 payments were deferred from late June 2002 to early July 2002. This delay, while only a few weeks, allowed the state to achieve one-time savings by reducing Proposition 98 General Fund spending in 2001-02 without making programmatic reductions. Schools continued to operate a larger program using cash reserves. In 2008-09, facing an even larger budgetary shortfall, the state delayed $3.2 billion in Proposition 98 payments to achieve one-time General Fund savings. (To address the 2008-09 budget shortfall, the state also made $2 billion in midyear Proposition 98 programmatic reductions.) The state adopted additional deferrals in 2009-10 ($1.8 billion), 2010-11 ($1.8 billion), and 2011-12 ($2.2 billion) to achieve one-time savings and avoid further programmatic reductions. In the current year, a total of $10.4 billion in Proposition 98 payments are being paid late (roughly 21 percent of total Proposition 98 support).

Length of Deferrals Has Correspondingly Increased. As the state has continued its reliance on payment deferrals, the length of deferrals also has increased. Although the initial deferrals were only a few weeks, the state now defers payments as long as nine months (with the longest deferral stretched from January to October). These delays place a larger cash management burden on school districts. To access cash, districts can use existing budget reserves or special funds (although drawing down reserves also results in a loss of earned interest). If internal resources are insufficient, districts can try to borrow from private lenders, their County Office of Education (COE), or their County Treasurer. If districts borrow from other agencies, they are responsible for covering all transaction and interest costs.

Governor's Proposal

Reduces Outstanding Deferrals by $2.4 Billion. The Governor's budget uses virtually all of the Proposition 98 funding available for augmentations to retire $2.4 billion in existing K-14 payment deferrals ($2.2 billion in K-12 payments, $218 million in CCC payments). As Figure 6 shows, these payments would reduce the state's total Proposition 98 late payments from $10.4 billion to $8.1 billion. Just as implementing payment deferrals provide the state with one-time General Fund savings, retiring payment deferrals results in a one-time General Fund cost. That is, the "room" within total Proposition 98 spending used for retiring deferrals would be available in subsequent years for other educational purposes (such as ongoing program augmentation or payments to retire additional deferrals).

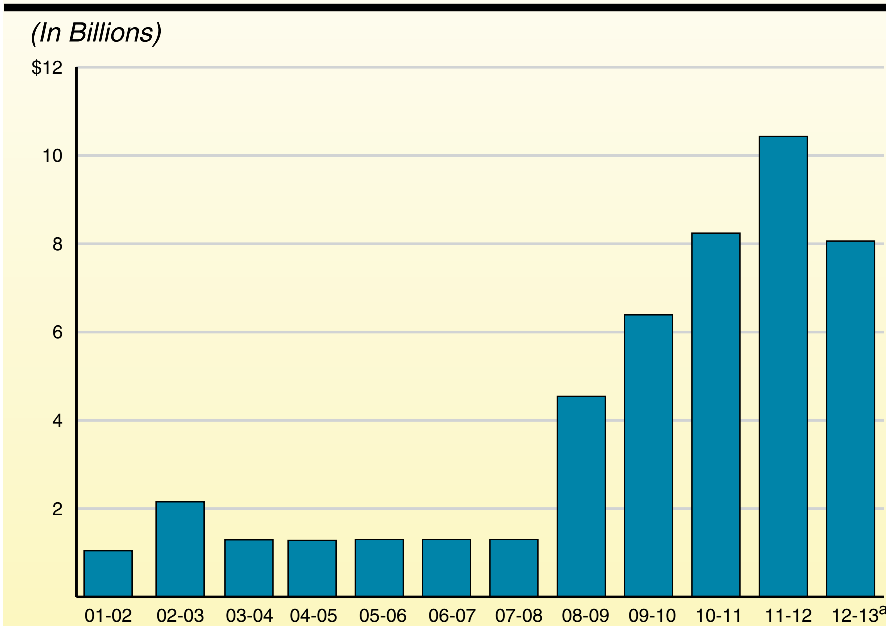
Reduces Deferrals in Most Cash-Strapped Months. For schools, the Governor proposes to pay down $1 billion in February deferrals currently paid in July and $1.2 billion in April and May deferrals currently paid in August. For community colleges, the proposal reduces deferrals each month of the January through June period, with somewhat larger paydowns in April and June. As Figure 7 shows (see next page), the proposal generally reduces late payments in the months that currently have the largest share of payments deferred, thereby providing roughly the same amount of state funding each month from February through June. (The administration also assumes the state will need to rely once again on intra-year deferrals to achieve savings in certain months when the state is cash poor, including the start of the fiscal year.)

Recommend Adopting Deferral Approach

Prioritizing Deferral Pay Downs Reasonable, Particularly Given Uncertainty of Revenues. If the state has additional Proposition 98 resources to spend in 2012-13, we recommend the Legislature take the Governor's approach and retire some existing K-14 payment deferrals rather than provide K-14 program augmentations. This would help mitigate the existing cash management problems that many school districts and community colleges face as a result of the state's late payments. In addition, given the uncertainty of the Governor's revenue proposals, setting aside additional Proposition 98 funding from the ballot measure for paying down deferrals could be less disruptive to districts than earmarking the monies for programmatic funding increases. That is, if the Governor's proposed ballot measure is rejected by voters, it will be easier for school districts and community colleges to retain existing short-term borrowing options than to make midyear programmatic reductions.

Figure 6

Proposition 98 Deferrals by Fiscal Year



[a] Reflects level of deferrals under Governor's proposal.

EDUCATION MANDATES

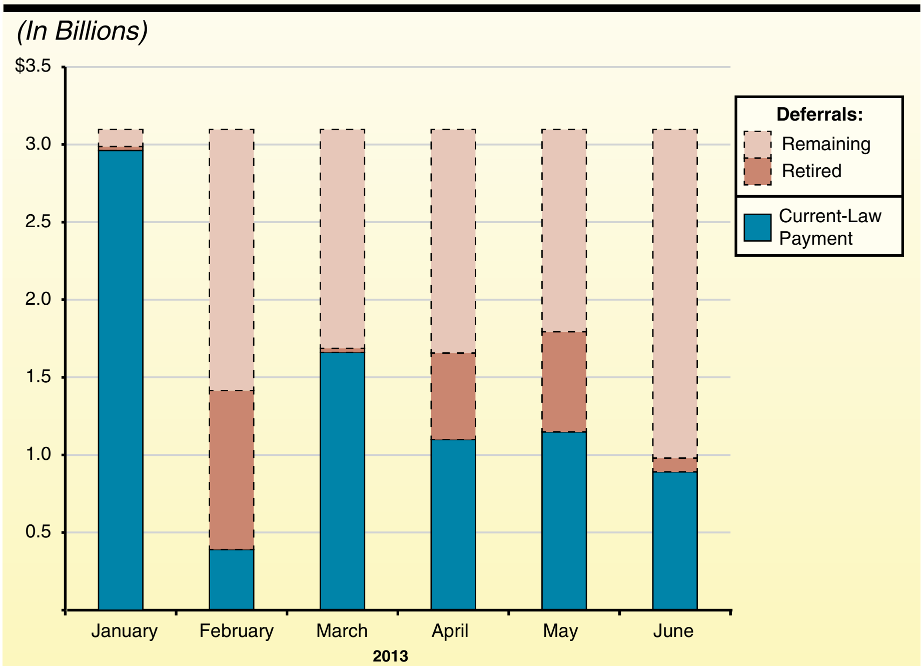
The Governor's budget includes a two-part proposal to simplify the education mandate reimbursement process. First, he proposes to eliminate more than half of education mandates. Second, the activities required by the remaining mandates would be included in a new discretionary block grant. The budget provides $200 million for the block grant. Given the significant costs and inefficiencies associated with the current mandate process, we think the Governor's proposal would be a significant improvement—greatly simplifying the existing system and overcoming many of its shortcomings. For these reasons, we recommend the Legislature adopt the Governor's approach and create a working group to address certain implementation details over the next few months.

Background

State Required to Reimburse School and Community College Districts for Mandated Activities. In 1979, voters passed Proposition 4, which added a requirement to the California Constitution that local governments be reimbursed for new programs or higher levels of service the state imposes on them. Currently, the state has about 50 K-14 education mandates, with each mandate requiring school districts and/or community colleges to perform as many as a dozen specific activities. The 2011-12 budget included $90 million for these claims. The state went seven consecutive years (2003-04 through 2009-10) making only negligible mandate payments. As a result, a backlog of unpaid claims has developed that now totals an estimated $3.6 billion. The state has a constitutional obligation to pay off this backlog. Moreover, in December 2008, a superior court found the state's practice of deferring education mandate payments unconstitutional and ordered the state to fully fund mandated programs "in the future." While constitutional separation of powers means the court cannot force the Legislature to make appropriations for past mandate costs, its decision increases pressure on the state to pay its mandate obligations.

Figure 7

Governor Proposes to Retire $2.4 Billion in Late Proposition 98 Payments



Existing Mandate System Has Serious Flaws. As we discussed in our publication *Education Mandates: Overhauling a Broken System* (2010), California has an elaborate system overseen by the Commission on State Mandates (CSM) for determining both whether new local requirements constitute mandates and how much to reimburse local agencies for those mandates. Over the last several years, we have highlighted serious flaws with this system:

- Many mandates do not serve a compelling statewide purpose, such as preserving public health and safety.
- Even if some activities serve compelling purposes, districts might have strong existing local incentives to undertake the associated activities, such that the state receives little extra benefit from mandating the activity.
- Mandate costs can be much higher than anticipated since the Legislature does not know what costs CSM will deem reimbursable until after new legislation takes effect and districts file claims.
- The reimbursement rate for a particular mandate can vary significantly among districts due in large part to differences in record keeping and claim filing practices.
- Since districts are reimbursed based on their actual costs, they have limited incentives to perform mandated activities as efficiently as possible.
- Districts are reimbursed for mandated activities regardless of how well they perform the activity or whether they are meeting its underlying policy objectives.

Several Recent Efforts Taken to Reduce K-14 Mandate Costs. Given concerns with the cost of mandates, the Legislature has taken action in recent years to reduce these costs. These actions include suspending about a dozen education mandates. Additionally, as part of the 2010-11 budget package, the Legislature adopted statutory changes to reduce the costs of the high school science graduation mandate and behavioral intervention plans mandate (two of the costliest mandates), as well as two truancy-related mandates. The Legislature also requested that CSM reconsider the collective bargaining mandate since many associated requirements now also apply to private employers, meaning that they possibly could be no longer considered a higher level of service required of governmental agencies.

Governor's Proposal

Replace Existing K-14 Mandate System With Block Grant. The Governor's budget proposes two significant changes for K-14 mandates. First, the proposal would eliminate more than half of K-14 mandates, as shown in the top part of Figure 8 (see next page). The mandates proposed for elimination include a number that already have been suspended in recent years, such as physical education reporting and pupil residency verification. Second, the proposal would suspend nearly all of the remaining K-14 mandates and then place them into a new, discretionary "mandate block grant." (The Governor proposes to retain three community college mandates and offset their costs with categorical "flex" funds.) The budget provides $200 million ($178 million for schools, $22 million for community colleges) for the block grant. Charter schools (which currently are ineligible for mandate reimbursements) would be allowed to participate in the block grant. School districts, charter schools, and community colleges that choose to receive block grant funding would receive a uniform per-student allocation. (We estimate that this rate would be roughly $30 for schools and $20 for community colleges.) As a condition of receiving block grant funding, recipients would be required to complete all applicable activities included in the block grant. The administration indicates it will establish some auditing and/or compliance monitoring process to ensure grant recipients undertake the required activities.

Proposed Approach Addresses Many Problems With Current Mandate System

Most Mandates Proposed for Elimination Do Not Serve Compelling Purpose. We generally agree that the mandates the Governor proposes to eliminate do not serve a compelling, statewide purpose. In fact, most of the mandates that the proposal would eliminate are mandates that our office has recommended eliminating in the past. In most cases, these mandates are not related to public health, safety, or accountability. Moreover, even though some of these mandates could arguably relate to one of these purposes, the specific mandated activity often may not further statewide goals. For example, while the mandate requiring school districts to perform physical performance tests on students in certain grades may be related to the important goal of improving students' physical activity, these tests do not supplement state physical

Figure 8

Governor's Mandate Proposal

Mandates Eliminated	
Active	**Suspended**
Absentee Ballots[a]	Grand Jury Proceedings[a]
Agency Fee Arrangements[a]	Health Benefits for Survivors of Peace Officers and Firefighters[a]
Mandate Reimbursement Process[a]	Law Enforcement Sexual Harassment Training[a]
Threats Against Peace Officers[a]	Integrated Waste Management[b]
Health Fees/Services[b]	Law Enforcement Jurisdiction Agreements[b]
Reporting Improper Governmental Activities[b]	Sexual Assault Response Procedures[b]
Caregiver Affidavits	Student Records[b]
Financial and Compliance Audits	County Treasury Withdrawals
Habitual Truants	Physical Education Reports
Law Enforcement Agency Notifications	Pupil Residency Verification
Missing Children Reports	Removal of Chemicals
Notification of Truancy	School Bus Safety I and II
Notification to Teachers: Pupil Discipline Records	Scoliosis Screening
Notification to Teachers: Pupil Suspension or Expulsion I and II	**Pending Cost Estimate/Under Litigation**
Physical Performance Tests	Behavioral Intervention Plans
Pupil Suspensions, Expulsions, Expulsion Appeals	Graduation Requirements

Mandates in Block Grant	
California State Teachers Retirement System Services Credit[a]	Differential Pay and Reemployment
Collective Bargaining[a]	Immunization Records I and II
Open Meetings/Brown Act[a]	Intradistrict Attendance
Prevailing Wage[a]	Juvenile Court Notices II
Sex Offenders: Disclosure Requirements[b]	Pupil Health Screenings
AIDS Instruction and AIDS Prevention Instruction	Pupil Promotion and Retention
Annual Parent Notification	Pupil Safety Notices
California High School Exit Exam	School Accountability Report Cards II and III
Charter Schools I, II, and III	School District Fiscal Accountability Reporting
Comprehensive School Safety Plans	School District Reorganization
County Office of Education Fiscal Accountability Reporting	The Stull Act
Criminal Background Checks I and II	

[a] Applies to both school districts and community colleges.

[b] Applies only to community colleges. Unless otherwise indicated, remaining mandates apply only to school districts.

education requirements in any substantive way nor are the test results used to improve physical education practices. In addition, we find that some of the mandates proposed for elimination overlap with requirements in federal law or are in districts' self-interest to perform. In these cases, even though the official mandates would be eliminated under the Governor's proposal, districts would likely still perform the activities.

Block Grant Approach Would Promote Efficiency for Both the State and Districts. One of the major benefits of the Governor's approach to changing the current mandate system is that it would provide opportunities for both the state and districts to improve their operations and become more efficient. For the state, a uniform per-pupil funding rate would address the uncertainty regarding how much mandates will cost each year and simplify the budgeting process for these costs. It could also free up staff time and resources at the CSM and the State Controller's Office (which is responsible for processing and auditing mandate claims). For the districts, a standardized rate would also help them plan their budgets. More importantly, though, it would provide an incentive for districts to perform the activities in the block grant more efficiently. This is because a district will want to reduce its costs to at or below the rate provided, given any unneeded dollar can be redirected to other educational purposes within the district.

Proposed Funding Level Could Provide Strong Incentive for Districts to Participate . . . Given that under the Governor's proposal districts would have the option of whether to participate in the block grant program and perform the associated high-priority activities, it would be important to provide them with a strong incentive to do so. While it is difficult for a variety of reasons to determine precisely the "right" amount of funding for the block grant, the amount proposed by the Governor appears to provide reasonably strong incentives for districts to participate. For example, we estimate claims will total roughly $102 million for the activities included in the block grant—roughly half the amount proposed by the Governor. This amount, however, could understate the actual cost of performing these activities since many districts do not bother to submit claims for many activities since the reimbursement process can be so administratively burdensome for them. Conversely, this could overstate the actual cost since currently little incentive exists for districts to perform the activities as efficiently as possible. On balance, the $200 million proposed by the Governor likely would be more than sufficient to cover on a statewide basis the cost of the activities being performed.

. . . But Fiscal Incentives Could Vary Somewhat by District. Although the proposed funding level would likely exceed statewide costs, the fiscal effect for individual districts could vary somewhat. This is the case not only because districts may have different administrative and program cost structures but also because some of the activities included in the block grant do not apply to all districts. For instance, the block grant requirement to review petitions and renewals for charter schools would only apply to districts that actually have charter schools in them—roughly one-quarter of all school districts. This means that the uniform per-pupil block grant rate could provide "too much" funding for some districts and "too little" funding for other districts. The administration, however, indicates that it does not intend to modify its proposal to address this issue. According to the administration, one of the main motivations for the proposal is to simplify the process used to pay for these activities and setting different rates for different districts would complicate it, thereby undermining the intent of having a simplified new payment process. While we acknowledge that some districts could fare differently as a result of the uniform rate proposed by the Governor, we agree with the administration that keeping the block grant simple, straightforward, and transparent would be a significant improvement over the current mandate system.

Implementation Details on Funding and Accountability Mechanisms Still Need to Be Addressed. Although the administration has provided certain details on how it envisions the proposal working, at the time this analysis was prepared it had not yet submitted to the Legislature its proposed trailer bill language to make the necessary statutory changes to implement the plan. Therefore, there are still a number of unanswered questions regarding the plan, such as:

- What would happen if the number of pupils changes compared to what is budgeted? Would any resulting savings be "swept" if enrollment were lower than expected? Would additional funding be provided to address a deficiency if enrollment were higher? Alternatively, would pro-rata increases or decreases be implemented if actual enrollment varied from budgeted enrollment?

- For the community college block grant, would funding be provided to districts based on the number of students funded in the state budget or the number of students actually served by the district?

- How would funding levels be determined in the out-years? Would the per-pupil rate be set in statute or would it vary from year to year? Or, would the entire block grant amount grow by a COLA? Would new mandates change the block grant amount? What if some activities were removed from the block grant (for example, if they were to be required in the future by the federal government)?

- What accountability measures would be implemented to ensure that districts are performing the required activities? Are there existing school compliance mechanisms that could be used? Or would conducting random audits be the most efficient way to hold districts accountable without replicating the administrative burdens involved in the current mandate process?

Although the administration has yet to address these issues in its proposal, these are relatively minor details that the Legislature could address during the coming months.

Recommend Adopting Overall Approach But Some Refinements Needed

Overall, we find that the Governor's proposal offers an attractive alternative to the current inefficient and burdensome mandate process. We therefore recommend that the Legislature adopt the Governor's proposed concept (including setting a uniform per-pupil funding rate and allowing charter schools to participate), but also (1) review the list of mandates to be eliminated or folded into the block grant to make sure that its highest priorities are preserved, and (2) convene a working group over the next few months to address some of the details that the administration has not yet answered about funding and accountability mechanisms.

RESTRUCTURING K-12 FUNDING SYSTEM

The Governor proposes major changes to the way the state allocates funding to school districts and charter schools. (It is still unclear exactly how this proposal would apply to COEs.) These changes would begin in 2012-13 and be phased in over a five-year period. Because the state's current K-12 funding system is complex, inequitable, and inefficient, we recommend the Legislature adopt some version of the Governor's proposal. While we think his specific proposal for a weighted student formula has many strengths, we believe the Legislature should consider some important modifications to ensure fundamental state priorities are preserved. Below, we offer our assessment of the Governor's proposal, as well as some potential modifications and alternatives the Legislature could consider.

Governor's Proposals

Would Expand Flexibility by Eliminating Several Remaining Categorical Programs. In February 2009, the Legislature temporarily removed programmatic and spending requirements for about 40 categorical programs and an associated $4.7 billion. This flexibility, currently scheduled to expire in 2014-15, allows districts to use funding originally restricted for these programs for any purpose. For 2012-13, the Governor proposes to extend this flexibility to an additional seven programs and an associated $2.3 billion for which funds have thus far remained restricted to their original purpose. The Governor proposes to make these changes permanent, eventually repealing all programmatic statutes and budget provisions associated with these programs. Under his plan, the state would maintain existing categorical requirements for 13 other programs and an associated $4.9 billion. Figure 9 (see next page) lists how individual K-12 categorical programs would be treated under the Governor's proposal.

Would Shift Funding Model to Weighted Student Formula. The Governor's elimination of certain categorical program requirements is just the first step of a larger plan to restructure the way the state allocates funding to local educational agencies (LEAs). In lieu of the current revenue limit and categorical program model, the Governor proposes that all LEAs receive an equal base per-pupil amount, plus additional general purpose funding intended to serve disadvantaged students. Specifically, for every dollar LEAs would receive for a student, they would get an additional 37 cents if the student were poor and/or an English Learner (EL). (They would not receive double allotments for students who meet both criteria.) Moreover, any LEA with a large concentration of low-income and EL students—at least half of its overall enrollment—would receive additional funding, with funding rates increasing as the concentration of these students increases. We estimate that about 60 percent of K-12 students are EL and/or receive free or reduced price meals (the Governor's proposed measure for economic disadvantage) and roughly 60 percent of LEAs have large concentrations of disadvantaged students.

Formula Would Be Phased In Over Five Years. The Governor proposes to transition to the weighted student formula over five years, beginning in the budget year. In 2012-13, 20 percent of applicable K-12 funding would be allocated via the new formula and 80 percent via the existing revenue limit and categorical formulas. In 2013-14, the proportions would shift to 40 percent new formula and 60 percent old formulas, and so on, until all affected K-12 funding is distributed via the weighted student methodology in 2016-17.

In Future, Would Include Fiscal Incentives for Strong Performance. The Governor indicates that he has plans to add a performance component to the weighted student formula, perhaps as soon as 2013-14. While the administration is still developing the details of this plan, the intent is to provide fiscal incentives for districts that improve or sustain high academic performance. Districts would be evaluated based on statewide tests, locally developed assessments, and potentially some qualitative measures.

Approach to Restructuring Moves in the Right Direction

Current K-12 Funding System Deeply Flawed. As our office has discussed numerous times in prior years, the state's categorical program structure, as well as its broader K-12 funding system, has major shortcomings. First, little evidence exists that the vast majority of categorical programs

Figure 9

How Existing Categorical Programs Are Treated Under Governor's Proposal

Programs That Would Merge Into Weighted Student Formula	
Currently Flexible ($4.7 Billion)	
Adult education	Oral health assessments
Advanced placement grant programs	Peer Assistance and Review
Alternative credentialing/internship program	Physical Education Block Grant
Arts and Music Block Grant	Principal training
Bilingual teacher training assistance program	Professional Development Block Grant
California High School Exit Exam supplemental instruction	Professional development for math and English
California School Age Families	Pupil Retention Block Grant
California Technology Assistance Projects	Reader services for blind teachers
Certificated Staff Mentoring	Regional Occupational Centers and Programs
Charter Schools Categorical Block Grant	School and Library Improvement Block Grant
Civic Education	School Safety Block Grant
Community Based English Tutoring	School Safety Competetive Grant
Community Day School (extra hours)	Specialized secondary program grants
Deferred maintenance	Student leadership
Gifted and Talented Education	Summer school programs
Grade 7-12 counseling	Targeted Instructional Improvement Block Grant
Instructional Materials Block Grant	Teacher Credentialing Block Grant
National Board certification incentive grants	Teacher dismissal apportionment
Ninth-Grade Class Size Reduction	
Newly Flexible as of 2012-13 ($2.3 Billion)	
Adults in correctional facilities	Foster youth programs
Agricultural vocational education	K-3 Class Size Reduction
Apprentice programs	Partnership Academies
Economic Impact Aid	
Programs That Would Remain Restricted	
After School Education and Safety Program	County Office fiscal oversight
American Indian Early Education Programs[a]	County Office oversight (*Williams* lawsuit)[a]
American Indian Education Centers[a]	K-12 Internet Access
Assessments	Special education
Charter school facility grants	State Preschool
Child nutrition	Quality Education Investment Act
Community Day School	

[a] These programs currently are subject to limited-term flexibility, but the Governor's proposal would reinstate categorical restrictions.

are achieving their intended purposes. This is in part because programs are so rarely evaluated. In addition, separate categorical programs often contain both overlapping and unique requirements. This magnifies the difficulty that districts have in offering cohesive services to students. It also blurs accountability and increases administrative burden. Moreover, having so many different categorical programs with somewhat different requirements creates a compliance-oriented system rather than a student-oriented system. In California, these problems are further exacerbated by categorical programs that have antiquated funding formulas that over time have become increasingly disconnected from local needs. For all these reasons, several research groups over the last decade have concluded that California's K-12 finance system is overly complex, irrational, inequitable, inefficient, and highly centralized. Though the state's current categorical flexibility provisions have temporarily decentralized some decision making, the provisions have done little to make the K-12 funding system more rational, equitable, or efficient.

Governor's Restructuring Plan Has Several Strong Components . . . We credit the Governor for offering a comprehensive solution to the state's problematic K-12 funding system. As highlighted in Figure 10, we believe the Governor's plan has several strengths. First and foremost, it replaces the complexities and inequities of the current system with a formula that is straightforward, rational, and linked to student need. The formula is designed

Figure 10

Strengths and Weaknesses of Governor's Restructuring Approach

Strengths

- ✓ ***Implements System That Is Simple, Transparent, and Rational.*** Lawmakers, districts, and the public would be able to understand and explain why a particular district receives a particular level of funding.
- ✓ ***Provides Additional Funding for Districts to Serve Needy Students.*** Acknowledges that many English Learner and low-income students require additional educational services.
- ✓ ***Provides Immediate Increase in Local Flexibility to Focus on Local Priorities.*** Provides districts latitude to develop educational approaches and activities based on local circumstances. Immediate suspension of categorical requirements assists districts in accommodating tight budgets and begins transition to new system.
- ✓ ***Offers Reasonable Phase-In Period.*** Five-year phase in provides districts time to adjust to potential change in resources but achieves full implementation of new formula without extensive delay.
- ✓ ***Accomplishes Restructuring Within Existing Resources.*** Builds new system using current funding (unlike many reform proposals that are predicated on adding billions of dollars in new revenues).

Weaknesses

- ✓ ***Important State Priorities May Not Be Accomplished.*** Legislature may have important statewide policy goals that local districts decide not to pursue.
- ✓ ***Does Not Ensure Additional Funding Will Translate to Additional Services for Disadvantaged Students.*** No requirement that districts spend extra funds on English Learners or low-income students.
- ✓ ***Overestimates Power of Existing Accountability System.*** Depends upon system that lacks sufficient nuance or sanctions to guide districts in improving student outcomes.

to treat similar students similarly, eliminating unfounded funding advantages and disadvantages. By removing more categorical restrictions, the new system also would provide districts with greater latitude to tailor program services to best meet local needs. Moreover, in contrast with many funding reform proposals that are predicated on a prolonged implementation period and the addition of substantial additional revenue, the Governor's proposal uses existing resources to begin restructuring immediately and achieve full implementation without extensive delay. By beginning implementation immediately, existing funding inequities are addressed right away rather than being allowed to persist many years into the future.

. . . But Devolving Virtually All Decision Making to Local Level Has Some Drawbacks. Figure 10 also notes some of the concerns we have with the Governor's restructuring proposal. While shifting spending decisions from the state to the local level has many benefits, we believe the Governor's proposal may go too far. One of the primary reasons the state establishes categorical programs is that it believes districts may underinvest in certain services or student populations unless the state guarantees those priorities through a dedicated source of funding. Because all funding distributed under the Governor's weighted student formula would be general purpose funds, the state would no longer be able to ensure that important state priorities would be accomplished. We are particularly concerned that districts would not be required to spend the additional funding generated by their disadvantaged student populations on services that benefit those students. A district could, for example, choose to spend that additional funding on providing an across-the-board increase to teacher salaries rather than on supplemental services for EL and low-income students. Other specific activities and student groups that have traditionally been high priorities for the Legislature also no longer would be assured funding under the Governor's plan.

Current Accountability System Not Strong Enough to Ensure Desired Outcomes. The Governor asserts that because districts are now outcome-oriented, categorical programs are no longer necessary. That is, he believes sufficient accountability now exists for districts to conduct all of the activities needed to produce positive student outcomes. According to this argument, all spending decisions can therefore be made at the local level. While we agree that stronger accountability systems could allow for more local flexibility, we are concerned the Governor is overestimating the power of the existing accountability system. The existing K-12 accountability framework is not nuanced enough to help districts clearly determine how they need to improve or help the state clearly identify which school districts need intervention. For example, aggregate comparisons of how a district's EL "subgroup" performs from one year to the next are not particularly meaningful because the students classified as EL change every year due to immigration and redesignation—typically with the lower performers entering and the higher performers transitioning out. Furthermore, we are not convinced the sanctions included in the current K-12 intervention system are strong enough to force struggling districts to significantly change their practices. While the Governor is considering introducing new fiscal incentives to reward school performance, he is not proposing to address the shortcomings of the existing accountability system.

Recommend Adopting Modified Version of Governor's Proposal

We believe the Governor's restructuring proposal offers a positive first step towards improving the state's problematic school funding system. As such, we recommend the Legislature adopt some version of his proposed changes, with modifications to ensure legislative priorities are met. Most importantly, we recommend the Legislature preserve some assurances that districts dedicate additional resources towards addressing the additional needs of their disadvantaged students. We also offer some other options the Legislature may want to consider in designing a new system for allocating K-12 funding.

Recommend Maintaining Spending Requirements for Disadvantaged Pupils Until State Has More Robust Accountability System. Even if the Legislature were to adopt the Governor's proposed approach to *distributing* K-12 funding, it could still retain or impose some requirements on how districts *spend* those funds. At the very least, we recommend the Legislature require that districts spend the supplemental "weighted" portion of their allocations to provide supplemental services to the disadvantaged students who generate the additional funds. We believe these requirements are needed to protect services for disadvantaged students, at least until the state has developed a more robust accountability system that can both guide districts and provide reliable information to the state. (This would include improvements such as vertically scaled assessments, value-added performance measures based on student-level data, and meaningful performance targets and sanctions.) These spending requirements could be very broad—similar to those of the existing federal Title I and Title III programs and state Economic Impact Aid program which contain general requirements that funding and services for targeted student populations supplement and not supplant the basic educational program the district provides to all students. As with those programs, the state could monitor compliance with these requirements. Additionally, compliance reviews from the California Department of Education (CDE) and/or COEs could provide programmatic assistance for how districts might spend these additional resources most effectively to improve student outcomes.

Legislature Could Further Modify Proposal to Preserve Other Important Priorities. The Legislature may wish to make additional modifications to the Governor's proposal to adjust the weighting factors, preserve other Legislative priorities, or mitigate the transition to the new formula. Below, we describe four options the Legislature could consider as it explores how best to restructure the current system.

- ***Consider Adopting Different Weights for Disadvantaged Students.*** The Governor's proposal provides notably more funding for districts that serve disadvantaged students—particularly those containing high concentrations of EL or low-income students. While we believe this is a strength of the proposal, the Legislature could change the weight for disadvantaged students slightly and dedicate a bit more or a bit less funding towards the "base" per pupil amount.

- ***Consider Additional Weighting Factors.*** The Legislature also could consider establishing additional funding weights to account for other cost drivers. For example, the formula could account for grade-span cost differences by providing a higher weight for high school students (who tend to be more expensive to educate than elementary students). The formula also could be adjusted to account for regional cost differences. Adding new weighting factors, however, would increase the complexity of the new system.

- ***Consider Block Grant Approach in Lieu of Weighted Student Formula.*** If the Legislature is concerned that by providing virtually all monies to districts as general purpose funds some districts might opt not to address essential state priorities, it could take a different approach to restructuring. Our office has long recommended distributing funding via a few block grants. These funding "pots" could have broad thematic objectives and requirements that provide districts with direction but also latitude as to how specifically to structure local services. For example, the Legislature could design an "Instructional Support Block Grant" reserved for activities such as purchasing instructional materials, offering professional development, providing student enrichment courses, and other similar services. The Legislature also could design a block grant with funding reserved for providing supplemental services to disadvantaged students.

- ***Consider Extending Timeline for Phasing In New Formula.*** While we believe the Governor's five-year timeframe is a reasonable period for transitioning to the new formula, the Legislature could extend this by a couple of additional years to provide districts more time to adjust to potential changes in resources resulting from the new allocation methodology.

Fiscal Effect of New Formula on Individual School Districts Would Vary

New Formula Begins Redistributing Funds Beginning in 2012-13. The administration has yet to release its estimates for how much individual districts would receive under its proposed new formula. Undoubtedly, *any* new allocation methodology will result in funding changes for some districts—in some cases resulting in more revenue, in others less revenue. Under the Governor's proposal, districts with high populations of EL and low-income students likely would benefit from the new formula. However, districts that receive especially high allocations of categorical funds under the existing system—either because of high participation rates or other historical factors—could lose some of those fiscal benefits under an updated formula. Two of the options we offer above (changing the weighting factor used for the supplemental grants and extending the implementation timeline) could help moderate some of the effects of these changes for districts. However, the Legislature must weigh the trade-offs of protecting historical advantages for certain districts against the benefits of allocating resources based on the needs and characteristics of *current* student populations.

CCC CATEGORICAL FLEXIBILITY

The Governor proposes to consolidate funding for all CCC categorical programs into one "flex item." With few exceptions, districts would have broad discretion in how they spend flex funding. Under the Governor's plan, this new flexibility is intended to be permanent, with implementation beginning in 2012-13. We agree that districts would benefit from more categorical flexibility. We have concerns, however, that the Governor's approach could result in local decisions that undermine the Legislature's original intent for these funds. We offer two alternative approaches for the Legislature to consider—both of which would enhance local flexibility while still ensuring that categorical funds continue to be spent on support services to students and faculty.

Background

The state provides two primary types of funding to the CCC system: (1) apportionments, which are intended to fund community colleges' basic operating costs (such as employee compensation, utilities, and supplies); and (2) categorical programs, which collectively support a wide range of supplemental activities—from child care to support services for underprepared students to financial aid advising. In 2011-12, the community colleges are receiving about $5.4 billion in apportionment funding and $397 million in categorical funding.

Funding for Categorical Programs Cut in 2009-10. The *2009-10 Budget Act* reduced ongoing Proposition 98 General Fund support for categorical programs by $263 million (about 37 percent) compared with 2008-09. One of CCC's 21 categorical programs was entirely defunded, 9 programs received a base cut of about 50 percent, and 8 programs were cut between 30 percent and roughly 40 percent (with three categorical programs subject to no reduction).

2009-10 Reductions Accompanied by Some Flexibility. In 2009-10, to help districts better accommodate these reductions, the state combined over half of CCC's categorical programs into a flex item (see Figure 11). Through 2014-15, districts are permitted to use funds from categorical programs in the flex item for any categorical purpose. (Such decisions must be made by local governing boards at publicly held meetings.) By contrast, funding for categorical programs that are excluded from the flex item must continue to be spent on specific associated statutory and regulatory requirements. For example, funds in the Economic and Workforce Development program (within the flex item) may instead be spent on the Basic Skills Initiative (outside the flex item), though Basic Skills Initiative funds can only be spent for that initiative.

Governor's Proposal

Significantly Expands Flexibility Over Use of Categorical Funds. As part of his emphasis on flexibility, the Governor proposes to place all 21 categorical programs into the flex item (see Figure 11). Funding in the flex item would total $412 million. (This is the sum of current-year funding for each categorical program, plus a proposed $14 million budget-year workload adjustment.) In contrast to current law, districts would not be restricted to spending these monies on existing categorical purposes. Instead, according

Figure 11

CCC Categorical Flexibility

Programs Currently Included in "Flex Item" ($113 Million)	
Academic Senate	Part-Time Faculty Compensation
Apprenticeship	Part-Time Faculty Health Insurance
Campus child care support	Part-Time Faculty Office Hours
Economic and Workforce Development	Physical Plant and Instructional Support
Equal Employment Opportunity	Transfer Education and Articulation
Matriculation	
Programs That Would Be Added to "Flex Item" ($298 Million)	
Basic skills initiative	Financial Aid Administration
CalWORKs student services	Foster Care Education Program[a]
Career Technical Education Pathways	Fund for Student Success
Disabled Students Program[b]	Nursing grants
Extended Opportunity Programs and Services	Telecommunications and Technology Services[a]

[a] Governor proposes to restrict all funding for these categorical programs.
[b] Governor proposes to partially protect funding for this categorical program.

to the administration, districts would have broad discretion to spend these monies on whatever they deem to be their local priorities.

Some Flex-Item Funding Would Remain Restricted. Though they would be in the flex item, three programs would effectively remain restricted. Specifically, the Governor proposes provisional language that would fully protect funding for the Foster Care Education Program ($5.3 million) and Telecommunications and Technology Services ($15.3 million). In addition, $12.6 million would continue to be appropriated for specified purposes in the Disabled Students Program. (A total of $69 million was appropriated for the program in the current year.)

Governor's Plan Moves in Right Direction

Current Categorical System Has Notable Drawbacks . . . Categorical programs are designed to ensure that districts address specific education priorities the state views as critical. However, CCC's categorical programs—like those of other state agencies—have notable drawbacks. As we have pointed out in past *Analyses*, community college categorical programs tend to be highly prescriptive in terms of how funds can be spent. Yet, California's 112 colleges have different student populations and local resources, and thus the needs of students vary. By requiring districts to spend funds for a specific purpose, categorical programs limit local flexibility to direct and combine funding in ways that address student needs most effectively and efficiently. Categorical funds are also costly for districts and the CCC Chancellor's Office to administer. Districts must apply for, track, and monitor the appropriate use of categorical funds, and the Chancellor's Office must oversee districts' compliance with numerous statutory and regulatory requirements. For all these reasons, we agree with the Governor that additional categorical reform is needed.

. . . But Governor's Plan Provides Less Assurance Statewide Priorities Will Be Met. We have concerns, however, that the Governor's proposal would provide the state with too little assurance that student and faculty support services would continue to be provided at the local level. The Legislature originally created CCC categorical programs to ensure that certain statewide priorities—most notably, direct support services to students—are addressed. Yet, under the Governor's proposal, the Legislature would no longer have such an assurance. That is, categorical funds (with the exception of appropriations for the three programs noted above) would, in effect, become general purpose monies. Though some districts might continue to spend flexed monies for existing categorical program purposes, such as counseling and tutoring, other districts could choose to repurpose the funds in ways that would not necessarily benefit students, such as providing a general salary increase to faculty and staff. To the extent some districts made such decisions, legislative intent in creating categorical programs could be undercut.

Recommend Enhancing Flexibility While Still Preserving Legislative Priorities

Rather than providing sweeping spending authority to districts, we recommend the Legislature consider two alternative models of categorical flexibility.

Expand Flex Item, but Retain Focus on Support Services. One option would be for the Legislature to add the Governor's proposed categorical programs to the flex item, but include statutory language that limits spending to *existing categorical program purposes* (as is the case with the 11 categorical programs already in the CCC flex item). This would strike a better balance between allowing districts to select for themselves the best strategies for achieving results, while also providing the Legislature some assurance that its educational priorities are addressed.

Consider Block Grants. Another restructuring approach our office has recommended in the past is to consolidate categorical programs into broad thematic block grants. Block grants ensure that districts continue to invest in high educational priorities, while providing flexibility to districts to structure their programs in pursuit of those goals. For community colleges, the Legislature could create two block grants—one centered around student success and one around faculty support (see Figure 12). These block grants would consolidate 15 programs and $294 million in associated funding, which is more than two-thirds of all CCC categorical programs and funding. (Because the remaining six existing categorical programs, including the three the Governor proposes to protect, serve various unrelated and specialized purposes, we recommend that they remain stand-alone programs.)

- ***Student Success Block Grant.*** As shown in Figure 12, the Legislature could consolidate ten programs and $264 million into a new Student Success block grant. By combining funding for these programs into one block grant, community colleges would be able to allocate student service funding in a way that best meets the needs of their students without being bound to specific existing programmatic requirements. With this funding, for example, districts could provide "wraparound" services such as assessment, orientation, counseling (academic and financial aid), tutoring, child care, and other activities designed to improve student completion.

- ***Faculty Support Block Grant.*** Also shown in Figure 12, the Legislature could consolidate five programs and $30 million into a new Faculty Support block grant. Under the block grant approach, districts would have flexibility to allocate faculty resources to meet local campus needs also without being bound by existing programmatic requirements. For example, districts could undertake professional development

Figure 12

LAO Alternative: Two CCC Block Grants

(In Millions)

	2011-12 Funding Level
Student Success Block Grant	
Expanded Opportunity Programs and Services	$73.6
Financial Aid Administration	56.7
Matriculation	49.2
CalWORKs	26.7
Economic and Workforce Development	22.9
Basic skills initiative	20.0
Apprenticeship	7.2
Fund for Student Success	3.8
Campus child care support	3.4
Transfer Education and Articulation	0.7
Total	**$264.2**
Faculty Support Block Grant	
Part-Time Faculty Compensation	$24.9
Part-Time Faculty Office Hours	3.5
Equal Employment Opportunity	0.8
Part-Time Faculty Health Insurance	0.5
Academic Senate	0.3
Total	**$30.0**

activities for instructors or offer faculty-leave time to develop new program curricula.

Allocating Block Grant Funding. Were the Legislature to decide to adopt the block grant approach, districts could retain the same amount of categorical funding in 2012-13 as they would have received absent a consolidation. Moving forward, we recommend that funds provided for these block grants be allocated to districts primarily on a per-student basis (with some allowance potentially made for districts with high percentages of financial aid recipients).

TRANSITIONAL KINDERGARTEN AND PRESCHOOL

The Governor has three separate proposals affecting children who are four years of age: (1) canceling initiation of a new TK program for children affected by the forthcoming change in the age cutoff for kindergarten; (2) reducing provider rates, family income eligibility thresholds, and child slots in the state preschool program; and (3) beginning in 2013-14, notably diminishing the state's center-based preschool services. Because some of the affected populations would be the same, we believe the Legislature may want to consider these proposals in tandem. Specifically, we recommend the Legislature target and preserve pre-kindergarten services for the state's most needy three- and four-year olds.

Transitional Kindergarten

Changes to Kindergarten Cutoff Date and Creation of New Program Scheduled to Take Effect in 2012-13. In response to concerns that California was encouraging children to start attending school before they were developmentally ready, the Legislature recently passed legislation prohibiting children under five years of age from enrolling in kindergarten unless a parental waiver was obtained. The change is phased in, moving the birthday cutoff back from December 2 to September 1, by one month at a time over three years, beginning with the shift to November 1 in 2012-13. This change will reduce the kindergarten population by about 40,000 students and yield estimated revenue limit savings of $224 million in 2012-13. The Legislature, however, redirected these savings to fund a new TK program, which will offer an additional year of public school to the children who will just miss the new kindergarten cutoff. This program also is phased in over three years, beginning in 2012-13 for those children turning age five between November 1 and December 2. By the time the program is fully implemented in 2014-15, it would cost roughly $675 million, making it among the most costly of the state's school programs.

Governor Would Not Initiate New TK Program, Saving $224 Million in 2012-13. The Governor proposes not to initiate the new TK program. Because he would maintain the date change for kindergarten eligibility, this proposal would save an estimated $224 million in 2012-13 from districts enrolling a smaller cohort of kindergarteners—that is, not enrolling children who will turn five after November 1. (The state would need to make a corresponding change to the "declining enrollment" adjustment in the state revenue limit formula to capture these savings in 2012-13.) The Governor's plan redirects these savings to fund other existing K-12 activities. The savings would grow to roughly $675 million annually by 2014-15, when the TK program otherwise would have been fully implemented. Presumably, the Legislature would decide how to redirect these additional savings towards other Proposition 98 priorities in future years.

Governor Would Make Slight Modification to Existing Waiver Process for Underage Kindergarteners. As under current law, parents of children born after the cutoff could request a waiver to have their children begin kindergarten early. The Governor is proposing to modify current law, however, so these children could begin kindergarten at the beginning of the school year, rather than waiting to enter in the middle of the year after they turn five. The administration clarifies that as under current law, the waiver option would continue to pertain to early admittance to *traditional* kindergarten programs, as TK programs would no longer be funded. Districts could choose to admit four-year old children to kindergarten early on a case-by-case basis if they believed it was in the best interest of the child. To the extent many parents request and districts grant these waivers, it would increase the 2012-13 kindergarten cohort, thereby reducing the amount of savings generated by the change in cutoff date.

Governor's Proposal Not to Initiate New TK Program Is Reasonable for Budgetary Reasons . . . Given the major funding and programmatic reductions school districts have experienced in recent years—and the potential for additional reductions if the November election does not result in new state revenue—we agree with the Governor's assessment that now is not the time to initiate major new programs. Budget reductions and unfunded COLAs mean districts currently are increasing class sizes, shortening the school year, and cutting many activities that have long been part of the school program. We do not believe offering a 14th year of public education to a limited pool of children—and dedicating resources to develop new curricula and train teachers—at the expense of funding existing K-12 services makes sense.

. . . And for Policy Reasons. We also have fundamental policy concerns with the design of the TK program. While receiving an additional year of public school likely would benefit many four-year olds born between September and December, we question why these children are more deserving of this benefit than children born in the other nine months of the year. This preferential treatment is particularly questionable since the eligibility date change will render children born between September and December the oldest of their kindergarten cohorts, arguably an advantage over their peers. Moreover, the TK program would provide an additional year of public school to age-eligible children regardless of need. This includes children from high and middle-income families who already benefit from well-educated parents and high-quality preschool programs. We believe focusing resources on providing preschool services for low-income four-year olds—regardless of their exact birth month—likely would have a greater effect on improving school readiness and reducing the achievement gap.

State Preschool

California State Preschool Program (CSPP) Currently Supported by Two Separate Budget Items. In 2011-12, the state budgeted $368 million in Proposition 98 funding to provide part-day/part-year center-based preschool services to low-income children. The state also budgeted $675 million for the General Child Care (GCC) program, to provide center-based child care services to low-income children from working families ages birth to 12. (Beginning in 2011-12, the Legislature shifted the funding source for GCC—and all child care programs other than part-day preschool—from Proposition 98 to non-Proposition 98 state General Fund.) Providers for both part-day preschool and GCC receive funding through direct contracts with CDE.

Chapter 308, Statutes of 2008 (AB 2759, Jones), allows local providers to merge monies from these two contracts to offer part-day/part-year preschool programs *or* full-day/full-year preschool programs for three- and four-year olds to best serve the needs of working families and local communities.

Treated Separately at State Level but One Program at Local Level. While still budgeted as two programs and funded by two sources at the state level, these services are thought of as one CSPP program at the local level. Data from CDE suggest that in 2011-12, local providers blended the Proposition 98 funds with about $400 million from the GCC program (or about 60 percent of total GCC funding) to offer CSPP services to approximately 145,000 low-income preschool-age children. Of these, two-thirds were served in part-day programs and one-third in full-day programs.

Governor Would Reduce Proposition 98 Funding for Preschool by $58 Million. For 2012-13, the Governor proposes to reduce funding for the Proposition 98 portion of the CSPP by $58 million, or 16 percent. These savings would be achieved through two changes that mirror proposals for other subsidized child care programs—which will be discussed in our office's forthcoming California Work Opportunity and Responsibility to Kids (CalWORKs)/Child Care budget report. (Comparable changes to the GCC program would yield an additional $89 million in non-Proposition 98 General Fund savings.)

- ***Provider Rate Reduction.*** The state would pay preschool providers 10 percent less, for Proposition 98 savings of $34 million. The part-day per-child Standard Reimbursement Rate (SRR) would drop from $21.22 to $19.10, and the full-day per-child SRR would drop from $34.38 to $30.94.
- ***Family Income Eligibility Criteria.*** The state would reduce program eligibility criteria by lowering the amount a family can earn and still participate in the program. Specifically, the maximum monthly income threshold would drop from 70 percent of the state median income (SMI)—$3,518 per month for a family of three—to 200 percent of the federal poverty level (about 62 percent of SMI, or $3,090 per month). The Governor would achieve $24 million in Proposition 98 savings from this change by defunding the estimated number of part-day preschool slots currently associated with children from families that exceed the new eligibility threshold—about 7,300 slots.

Governor's Proposed Preschool Rate Reduction Is Problematic. We have concerns that many preschool providers have few options for absorbing the Governor's proposed 10 percent reduction to the SRR and might close or drop out of the state program as a result. State mandated adult-to-child ratios and instructional day requirements, combined with local collective bargaining agreements—which frequently are embedded within larger K-12 school district contract agreements—mean that providers have limited flexibility to generate local savings. Moreover, the state rate for these centers is already somewhat low—in several areas in the state, the SRR currently is lower than the rates charged by the majority of other preschool providers in the county.

In 2013-14, Governor Proposes to Revert to Part-Day/Part-Year Preschool Program. As part of his proposed changes for non-Proposition 98 funded child care, beginning in 2013-14 the Governor would eliminate the existing GCC program and shift the associated funding to a child care voucher system to be administered by county welfare departments. This would abolish the blended CSPP and revert the state's direct-funded center-based preschool program to only a Proposition 98 funded part-day/part-year program for about 91,000 children (a reduction of roughly 54,000 compared to how many children were served in CSPP in 2011-12). Preschool providers' ability to serve additional children or offer full-day/full-year services to meet the needs of working families would depend upon how many enrolled families could afford to pay out of pocket or obtain a state-subsidized voucher from the county welfare department. (Under the Governor's proposal, low-income families not receiving CalWORKs cash assistance would have more limited access to these vouchers.)

Governor's Proposal for 2013-14 Ignores Reality of State's Current Preschool Program. The Governor's proposal for 2013-14 treats the Proposition 98 preschool budget item and GCC budget item as two separate programs—preserving one and eliminating the other. However, in reality these funding sources have been supporting one uniform preschool program. By redirecting all GCC funding into vouchers, the Governor's proposal would reduce the existing state preschool program by roughly 40 percent. Moreover, the dismantling of the blended CSPP would notably limit local providers' ability to provide a full-day/full-year preschool program, which is often the only way children from working low-income families are able to access services.

Five Recommendations to Better Target Preschool Services

A wide body of research suggests that preschool educational experiences can be important factors in future school success, particularly for economically disadvantaged children. As such, we recommend the Legislature focus limited resources on serving the four-year olds who could most benefit from a state-subsidized education program before beginning kindergarten. This includes recognizing and preserving—to the degree budgetary resources allow—the state's current investment in providing preschool services. To this end, we offer five specific steps the Legislature could take to better target services for needy preschool-age children.

Immediately Adopt Governor's Proposal to Cancel Initiation of TK Program. We recommend the Legislature adopt the Governor's proposal not to initiate the new TK program. The program is both costly and poorly designed and does not target the children most in need of a school readiness program. We recommend the Legislature take this action immediately to provide more certainty to parents and districts as they plan for the coming school year. We also recommend adopting the Governor's proposed change to the kindergarten waiver process, allowing districts to offer a full year of kindergarten to children born just after the cutoff date in cases where it is in the best interest of the child.

Consider Prioritizing Preschool Access for Low-Income Children Affected by Kindergarten Date Change. The Legislature may have concerns that changing the kindergarten cutoff date without offering a TK program could disadvantage some November-born low-income four-year olds who do not currently have access to meaningful pre-kindergarten educational experiences. The Legislature could take steps to help at-risk children who—without TK—would suddenly have to wait an additional year before entering public school. Specifically, for the short term the Legislature could prioritize slots in the state preschool program for income-eligible children affected by the kindergarten change. We estimate approximately half of the children who will turn five this November would meet the current income thresholds for state preschool.

Reject Proposal to Reduce Preschool Provider Rates by 10 Percent. Because of concerns that a

10 percent cut to the SRR may be untenable for many providers, and because the state rate is already low compared to what other providers charge in many counties, we recommend the Legislature reject this proposed reduction. As we discuss below, we recommend pursuing other options if the Legislature needs to achieve Proposition 98 savings from the preschool program.

Fund Entire CSPP Program Within Proposition 98. We recommend the Legislature accurately reflect the existing CSPP budget and align all funding for the program within Proposition 98. (As part of the alignment, we recommend a comparable adjustment to the Proposition 98 minimum guarantee to avoid the need for a corresponding reduction to K-12 programs.) Specifically, we recommend the Legislature reduce non-Proposition 98 General Fund for GCC by $400 million (the amount of GCC funds spent for CSPP services in 2011-12) and increase Proposition 98 funding for preschool by a like amount. This would allow the state to make policy and budget decisions affecting preschool services for four-year olds based on *actual* programmatic funding and caseload counts. We also recommend the Legislature preserve the existing flexibility for CSPP providers to offer full-day services for working families who want to be able to send their children to preschool and still have their care needs met. (Because the Governor has a number of proposals to reduce GCC funding in 2012-13, taking this action will necessitate other reductions to achieve a like amount of budgetary savings.)

If Reductions Are Needed, Recommend Eliminating Preschool Slots. If the Legislature needs to achieve Proposition 98 savings from preschool, we recommend it reduce the number of funded preschool slots. Because priority for enrollment in the state preschool program is already reserved for the lowest income applicants, there is no need to adopt the Governor's proposal to lower the income eligibility threshold to achieve savings. That is, providers already are required to select first from the families furthest below the existing ceiling of 70 percent of the SMI, and reducing the number of available slots would necessarily focus eligibility on an even narrower group of families.

PAYING DOWN THE WALL OF DEBT

The Governor's budget package contains a multiyear plan for retiring certain school and community college obligations. We think building such a plan is prudent budgeting practice. Though we believe the Governor's multiyear proposal is a solid starting point, we lay out several factors for the Legislature to keep in mind as it considers how best to retire existing obligations. Below, we identify the state's outstanding K-14 funding obligations, describe the Governor's plan, and highlight various issues related to fine-tuning the payment plan.

Background

State Has Many Large Outstanding Obligations. The state currently has large outstanding funding obligations relating to schools and community colleges. Some obligations result from *constitutional* provisions whereas others are linked with *statutory* provisions. Some obligations are funded within the annual *Proposition 98* appropriation whereas others rely on separate *non-Proposition 98* General Fund appropriations. One type of obligation—maintenance factor—is unique in that it increases the base Proposition 98 appropriation moving forward. In some cases, the state can retire two or more obligations at the same time. For example, the state can retire maintenance factor obligations by spending the required extra monies on deferral, mandate, and revenue limit obligations. Settle-up obligations also can be retired at the same time as these three other obligations. Figure 13 (see next page) describes each existing type of obligation and identifies the corresponding amount the state owes. (As suggested by all the different types of obligations that exist, the amounts shown are not in all cases additive.)

Some Obligations One-Time in Nature. The top part of Figure 13 identifies the state's outstanding one-time obligations. The state typically retires one-time obligations by making a series of payments over a few years, with the payments not resulting in any ongoing base increase in Proposition 98 funding. (As indicated in the figure, we classify "settle-up" as a one-time obligation. A settle-up obligation results from an unanticipated midyear increase in the minimum guarantee. Because the associated base increase in the minimum guarantee is reflected in the subsequent year's Proposition 98 appropriation, the state is left only a one-time obligation to backfill the unanticipated current-year shortfall.) The first three obligations listed in this section essentially reflect types of budgetary borrowing, with the state choosing not to pay certain costs as they are incurred because of its fiscal condition. The last two obligations listed in this section are connected with lawsuits.

Various Other Types of Obligations. The bottom part of the figure shows various other outstanding obligations. Some of these obligations are very large. For example, the state is carrying more than $10 billion in outstanding Proposition 98 maintenance factor. (A constitutional formula is used to determine when and how much maintenance factor is to be paid.) The state also has accumulated large unfunded liabilities relating to pension benefits for school employees. These unfunded liabilities are somewhat akin to budgetary borrowing, with the state's fiscal condition affecting how much the state has chosen to dedicate to these costs. A different type of obligation relates to state financing of school facilities. This borrowing is approved by voters and the state is required to make associated annual debt service payments. Another somewhat unique type of obligation is known as the "K-12 revenue limit deficit factor." In years when the state has not provided a COLA and/or has made base reductions to revenue limits, it has kept track of an associated deficit factor. In tandem, it has made a statutory commitment to increase base revenue limit funding equivalent to the deficit factor at some point in the future using growth in Proposition 98 funding.

Governor's Proposal

Governor Proposes Multiyear Plan to Pay Off Certain Obligations. The Governor proposes to retire the state's five outstanding one-time school and community college obligations. As shown in Figure 14 (see page 37), the administration plans to retire some of the obligations using natural growth in the Proposition 98 minimum guarantee whereas the remaining obligations would require non-Proposition 98 General Fund monies to retire. The Governor's plan would pay off these obligations in installments over a four-year period, beginning in 2012-13. For most obligations, payments are not spread evenly over the period. For example, the Governor proposes making a very large (almost $5 billion) deferral pay down in 2014-15 and a very large (almost $3 billion) mandate payment in 2015-16. Nonetheless, if this plan were implemented, the state would have entirely paid off the five associated obligations by the end of the period.

Figure 13

State Has Many Outstanding School and Community College Obligations

Obligation / Description	Authority	Funding
One-Time Obligations		
"Settle-Up" State generates a settle-up obligation when K-12 attendance or General Fund revenues increase after the budget is enacted—resulting in a higher minimum guarantee. State estimated to owe $2.6 billion ($1.6 billion for 2009-10, $352 million for 2010-11, and $661 million for 2011-12).	Constitutional	Non-P 98
K-14 Mandates State must reimburse school and community college districts for performing certain state-mandated activities. State deferred payments for seven consecutive years (2003-04 through 2009-10). It currently has an estimated backlog of $3.6 billion in unpaid mandate claims.	Constitutional	P 98
K-14 Deferrals The state has deferred certain K-14 payments from one fiscal year to the subsequent fiscal year, thereby achieving one-time state savings. The state instituted various new deferrals across the 2001-02 through 2011-12 period. Outstanding deferrals currently total $10.4 billion.	Statutory	P 98
Quality Education Investment Act Associated with a Proposition 98 suspension in 2004-05, the state agreed to provide an additional $2.7 billion to schools and community colleges. Annual payments of $450 million are to be provided until obligation has been retired. State has made $1,650 million in payments, with $1,081 million still owed.	Statutory	Non-P 98
Emergency Repair Program As part of the *Williams* settlement, state agreed to provide certain schools with $800 million for emergency facility repairs. State has made $338 million in payments, with $462 million still owed.	Statutory	P 98
Other Obligations		
Maintenance Factor Proposition 98 allows the state to provide less funding in certain situations (typically when General Fund revenue is growing sluggishly or declining), but it creates an associated obligation to increase funding in the future such that total funding is restored to the level it otherwise would have been absent the earlier reduction. The state currently is carrying a maintenance factor of $10.6 billion.	Constitutional	P 98
CalSTRS Pension Benefits For benefits already earned by current and past teachers and administrators, an unfunded liability of over $56 billion was reported as of June 30, 2010. In 2012-13, the state is projected to contribute $1.4 billion to the system, with districts and teachers contributing billions of dollars more. To address the unfunded liability over the next 30 years, additional contributions of about $4 billion per year (in current dollars) will be needed from some source. If a lower investment return rate is assumed, costs would be higher.	Constitutional	Non-P 98
CalPERS Pension Benefits For classified employee benefits, the existing unfunded liability is estimated to be $17 billion. Districts currently contribute about 11 percent of classified employee payroll ($1.2 billion in 2011-12) to these benefits, with employees also making contributions. Over the next several decades, part of the annual payments will go to retire the unfunded liability. District contributions may increase or decrease annually in accordance with CalPERS annual investment returns and other actuarial factors. If a lower investment return rate is assumed, costs would be higher.	Constitutional	Non-P 98
Debt Service on State General Obligation Bonds for K-14 Facilities The state has approved $31.9 billion in K-14 obligation bond authority in the past ten years to fund the construction and modernization of school and community college facilities. Bonds are paid off over a 30-year period. In 2011-12, K-14 debt-service costs total $2.5 billion.	Constitutional	Non-P 98[a]
K-12 Revenue Limits When the state has not provided a cost-of-living adjustment and/or has made a base reduction to revenue limits, it has created a "deficit factor" to keep track of the foregone funding. The current deficit factor (associated with funding foregone in 2008-09 through 2011-12) is 21.6 percent, or about $9 billion.	Statutory	P 98

[a] The Governor proposes to pay K-14 debt-service costs within the annual Proposition 98 appropriation beginning 2012-13 if his tax measure is rejected by voters.
Non-P 98 = Non-Proposition 98; P 98 = Proposition 98; CalSTRS = California State Teachers' Retirement System; CalPERS = California Public Employees' Retirement System.

Governor's Plan Is Solid Starting Point But Several Key Factors to Consider

We commend the Governor for developing a plan to retire several of the state's existing school and community college funding obligations. Adopting the Governor's plan would put both districts and the state on a more solid fiscal footing—with state payments once again made on time, two constitutional obligations retired, and two litigation-related obligations paid off. Moreover, the Governor's plan implicitly dedicates most, if not all, of the growth in the annual Proposition 98 appropriation resulting from his tax measure for retiring existing obligations rather than making new ongoing commitments. This is significant given the temporary nature of his proposed tax increases. In most cases, the loss of revenue resulting from the expiration of the temporary tax increases will result in the Proposition 98 minimum guarantee dropping or growing by less than it otherwise would. To the extent the state has not built up Proposition 98 programmatic commitments that it cannot sustain when the tax increases expire, the subsequent impact on schools and community colleges would be less disruptive. For all these reasons, we believe the Governor's plan is a good starting point. We discuss several other factors, however, for the Legislature to keep in mind as it considers how best to retire existing obligations.

Extending Payment Period Makes Consistent Implementation More Likely. Given the state's large outstanding balance on these obligations, we recommend the Legislature schedule out payments over a somewhat longer time period. By extending the payment period just one year (through 2016-17), for instance, the Legislature could build a more realistic plan that more likely could be implemented on schedule. For example, if deferral payments were spread evenly over a five-year period (2012-13 through 2016-17), the state would be scheduled to pay $2 billion in 2014-15 rather than almost $5 billion scheduled for payment under the Governor's plan. Spreading out payments evenly

Figure 14

Governor's Multiyear Plan for Retiring Certain Existing Proposition 98 Obligations

(In Millions)

	Proposed Payments Under Governor's Plan:				
	2012-13	2013-14	2014-15	2015-16	Total Payments Over Period
Payments to Be Made *Within* Annual Proposition 98 Appropriation:					
K-14 deferrals	$2,369	$2,469	$4,998	$594	$10,430
K-14 mandates	—	318	318	2,940	3,576
Totals	**$2,369**	**$2,787**	**$5,316**	**$3,534**	**$14,006**
Payments to Be Made *on Top of* Annual Proposition 98 Appropriation:					
Proposition 98 "settle-up"[a]	—	$857	$856	$856	$2,569
Quality Education Investment Act	$450	450	181	—	1,081
Emergency Repair Program[b]	12	150	150	150	462
Totals	**$462**	**$1,457**	**$1,187**	**$1,006**	**$4,112**

[a] Settle-up payments may be used to retire other obligations, such as mandates. If this approach is used, total General Fund payments would be reduced accordingly.

[b] Statute designates that these payments be made using Proposition 98 Reversion Account funds.

over a longer time period would increase the likelihood the state could afford to make the annual associated payments.

Designate Settle-Up Funds for Mandates or Deferrals. Because the state may use settle-up payments for any one-time purpose, we recommend using them to help retire other outstanding Proposition 98 obligations, with the two best candidates being K-14 mandates and K-14 payment deferrals. In prior years, the state has used this approach—scheduling out settle-up payments over a number of years and using them to pay down the K-14 mandate backlog. Given the K-14 mandate backlog ($3.5 billion) exceeds the state's existing settle-up obligation ($2.5 billion), settle-up could be used solely for this purpose. The state, however, also could use the funds to pay down existing K-14 deferrals. Somewhat different districts would benefit from the two approaches. If used for mandates, the funds would be allocated to roughly one-third of districts—typically midsize to large districts. If used for deferrals, the funds would be allocated across most districts but would provide particular benefit to districts that rely heavily on state payments (often linked with lower property wealth districts).

Reduce State Costs by Recognizing and Redirecting Certain Program Savings. Because QEIA schools that fail to meet five program requirements are to have funding terminated beginning in 2012-13, program costs are likely to be considerably lower in the budget year (see nearby box for more detail on QEIA program requirements). Based upon preliminary information, program costs could be about $140 million less beginning in 2012-13. The state could use any freed-up QEIA funding to first retire Emergency Repair Program (ERP) costs, which are related to the *Williams* settlement. The QEIA and ERP programs are designed for similar types of schools (those performing low on the Academic Performance Index). Though the state has designated statutorily that Proposition 98 Reversion Account funding be used for ERP, a statutory change could be made to use the freed-up QEIA funds to accelerate ERP payments.

Weigh Trade-Offs—Retiring Existing Obligations Versus Making Programmatic

Quality Education Investment Act (QEIA) Schools to Meet Five Requirements

Under current law, QEIA schools were required to meet the following five conditions by the end of 2010-11: (1) have kept K-3 class sizes at 20:1 and reduced class size in grades 4-12 to 25:1 or by five students per class, whichever is less; (2) have a pupil: counselor ratio in high schools of no more than 300:1; (3) ensured that each teacher in the school is highly qualified as defined in federal law; (4) ensured that the average experience of classroom teachers in the school is equal to or higher than the average for the school district; and (5) exceeded the Academic Performance Index growth target for the school averaged over the 2008-09 through 2010-11 period. The Superintendent of Public Instruction is to terminate funding for the school if these requirements are not met by the end of 2011-12. Under current law, a school that loses its funding may appeal that action to the State Board of Education (SBE), with SBE required to reinstate funding if the school demonstrates that its program data was "in error and that the school in question can fully demonstrate its compliance with the applicable requirements." Preliminary information indicates that 140 (of 474) schools might not have met these requirements.

Restorations. The Legislature obviously will face difficult trade-offs in deciding how much funding to designate for retiring outstanding obligations versus restoring or augmenting programs. These trade-offs will take various forms. The Legislature will face difficult choices in setting Proposition 98 priorities. For example, using growth in Proposition 98 funding for paying down deferrals means less funding is available for restoring K-12 revenue limits. The Legislature also will face difficult choices in deciding whether to use non-Proposition 98 General Fund monies for education or other state purposes. For example, making settle-up or QEIA payments comes at the expense of additional funds for health, social service, and corrections programs. The Legislature also will need to prioritize among the many large outstanding education obligations. For example, a dollar spent on retiring the K-14 mandate backlog is a dollar unavailable for paying unfunded liabilities for school employee pension benefits.

Think About Possible Contingency Plans. The Governor's multiyear plan is built on certain assumptions, including solid baseline revenue growth and passage of his tax measure. The Legislature presumably will need to consider what could happen to its basic budget plan were baseline revenues to be weaker and/or the Governor's tax measure to fail. If either of these things happens, the state would need to revisit its multiyear payment plan. Under this scenario, we still recommend the Legislature have a multiyear payment plan, but, to ensure that the plan is realistic and reasonable, the Legislature would need to consider an even longer payment period and/or reconsider certain paydowns in light of the deeper programmatic reductions that might be necessitated. Despite needing to make these types of modifications to the plan, having a payment plan in place remains critical for ensuring that the state makes continued progress in retiring its existing, very sizable outstanding obligations.

GOVERNOR'S BACK-UP PLAN

The Governor's budget package includes a contingency plan that would be designed to go into effect automatically if the Governor's tax measure is not approved by voters in November 2012. If the ballot measure were to fail, the Governor proposes $5.4 billion in midyear trigger reductions. Of this amount, $4.8 billion, or 90 percent, would come from Proposition 98 reductions. Below, we describe the Governor's Proposition 98 back-up plan, highlight our concerns with the plan, and identify key issues for the Legislature to consider as it develops such a plan.

Governor's Proposals

As shown in the top part of Figure 15 (see next page), the Proposition 98 minimum guarantee would drop an estimated $2.4 billion if the Governor's ballot measure were to fail and his assumed revenues not to materialize. Under this scenario, the Governor proposes several specific Proposition 98 actions be taken.

Begins Counting Debt Service Payments to Proposition 98 Guarantee, Rebenches for Change. Historically, debt service payments for school and community college facilities have been made using non-Proposition 98 General Fund monies and have not counted toward meeting the Proposition 98 minimum guarantee. Under the back-up plan, the Governor proposes to change this longstanding practice and begin making these payments *within* the annual Proposition 98 appropriation. In 2012-13, the state is expecting to make $2.6 billion in associated debt service payments ($2.4 billion for schools, $262 million for community colleges). In tandem with this shift, the Governor rebenches the minimum guarantee using the 1986-87 rebenching method (discussed in detail earlier in this report). Because debt service payments in 1986-87 were relatively small, using this rebenching method results in a small increase in the 2012-13 minimum guarantee—$200 million.

Makes $4.8 Billion in Trigger Reductions. The combination of the drop in baseline revenues and the shift of debt service payments results in the Governor making $4.8 billion in 2012-13 Proposition 98 trigger reductions. As shown in the bottom part of Figure 15, the Governor's back-up plan would rescind his proposals to pay down existing school and community college payment deferrals. Rescinding these paydowns would have no programmatic effect but could affect district cash flow. That is, some districts could find that they need to initiate a new round of short-term borrowing to cover cash needs through the second half of the fiscal year (though many districts likely would maintain existing short-term borrowing levels and then pay them off more quickly if additional revenues were to materialize midyear). In addition to rescinding the deferral paydowns, the Governor proposes to cut general purpose funding for school districts and community colleges by $2.2 billion and $292 million, respectively. These actions would have a direct programmatic effect.

Assumes Realignment Sales Tax Revenue Excluded From Proposition 98 Calculations. The Governor's contingency package also assumes that the sales tax revenue connected with the 2011-related realignment would not count toward the Proposition 98 minimum guarantee.

Two Concerns With Governor's Back-Up Plan

Below, we discuss two major concerns we have with the Governor's back-up plan.

Serious Policy Concerns With Debt Service Proposal. From a policy perspective, counting debt service payments to the guarantee is problematic. This is because the size of annual debt service payments is significantly more volatile than the annual changes in the Proposition 98 minimum guarantee. Whereas debt service payments are linked with the timing of voter-approved bond measures and state bond sales, the minimum guarantee is linked with changes in student attendance and growth in the economy or state revenues. Since the enactment of Proposition 98 in 1988, had debt service payments been counted toward the minimum guarantee, they would have equated to as much as 5.1 percent and as little as 0.5 percent of Proposition 98 spending.

Figure 15

Proposition 98 Changes Under Back-Up Plan[a]

(In Millions)

Changes in Minimum Guarantee	
Revenue drop due to measure failing	-$2,444
Rebench for debt service payments	200
Total Changes	**-$2,244**
Changes in Spending	
Accommodate K-12 debt service payments	$2,331
Accommodate CCC debt service payments	262
Rescind K-12 deferral pay downs	-2,151
Rescind CCC deferral pay downs	-218
Reduce K-12 general purpose funding	-2,175
Reduce CCC general purpose funding	-292
Total Changes	**-$2,244**

[a] Minimum guarantee/Proposition 98 spending falls from $52,527 million to $50,283 million, a drop of $2,244 million.

That is, in some years, particularly after a new bond measure passed, debt service payments could increase notably, potentially requiring Proposition 98 programmatic cuts to make room for the higher payments. In other years, debt service payments could decrease notably, potentially resulting in the need to make big Proposition 98 programmatic increases. In both cases, what otherwise would have been relatively stable school and community college operations will be partly driven by bond-related factors rather than an assessment of operational needs. Absent a clear, compelling policy rationale, we question why the state would want to change its longstanding education facility funding practices, particularly when the change results in a significant reduction in funding for school and community college operations.

Treatment of Realignment Revenues Also Risky. Historically, the 2011 realignment-related sales tax revenues have counted toward the Proposition 98 minimum guarantee. The provisions of Chapter 43, Statutes of 2011 (AB 114, Committee on Budget), also appear to reinforce that these sales tax revenues count toward the guarantee unless the voters explicitly approve their exclusion and a like amount of revenue is raised that would count toward the guarantee. The issue is currently being litigated. If the revenues were to count toward the guarantee, the guarantee would increase roughly $1.7 billion (from $50.3 billion to $52 billion) and the Governor's contingency plan would need to be modified. This could be done by suspending the guarantee such that his proposed spending reductions still could be achieved. Alternatively, the state could fund the higher Proposition 98 minimum guarantee and implement $1.7 billion in trigger reductions in other areas of the state budget.

Key Issues in Crafting Back-Up Plan

Anticipate Impact on Districts—Most Likely to Budget Assuming Trigger Reductions. Though the Governor's tax measure would improve notably the outlook for schools and community colleges in the coming years, his 2012-13 budget approach has significant near-term consequences for them. Because districts know that the tax measure could fail and because making large midyear reductions is so problematic and disruptive for them, most districts likely are feeling compelled to craft their 2012-13 budgets based only on the revenues they believe are assured of materializing. Given this assumption, most districts likely will adopt budgets that already reflect any potential trigger reductions. That is, by adjusting budgets now, districts protect themselves against either having to make disruptive midyear cuts or finding themselves unable to make sizeable midyear cuts and facing serious corresponding cash management problems. If revenues ultimately were to materialize, these districts likely would restore reserve levels immediately but potentially not make major programmatic adjustments until the following school year. While districts could make relatively minor programmatic adjustments midyear (such as hiring additional instructional aides), more significant programmatic changes (such as reducing class size and hiring additional teachers) might not be undertaken. This is because even these enhancements can be disruptive if implemented midyear, resulting in the shuffling of students among classes and teachers.

Districts That Budget More Optimistically Could Face Very Difficult Midyear Situations. Though most school districts and community colleges likely will plan now for the 2012-13 midyear trigger reductions (akin to how they planned in 2011-12 for the possible midyear trigger reductions), a few districts could feel compelled to budget using more optimistic assumptions. Those districts that do not plan now for possible midyear reductions could face serious consequences if the trigger reductions end up being imposed. Given current statutory restrictions, districts cannot lay off teachers midyear. They also typically negotiate changes in the length of the work year with affected unions, with districts needing to follow certain typically lengthy legal procedures if they wish to declare impasse and impose changes to a contract. Moreover, districts with reserve levels at the state-allowed minimums would not have sufficient reserves to cover a reduction as large as the one proposed under the Governor's back-up plan. As a result of all these factors, some of these districts could run out of cash the last part of the school year, be unable to make payroll, and require an emergency state loan (for which the district pays all associated costs and loses local control for a period up to 20 years).

Be Deliberate in Building Any Back-Up Plan. Given most districts will feel compelled to assume trigger reductions when building their 2012-13 budgets, the Legislature needs to be very deliberate in structuring a trigger package—as it in essence would determine the size and quality of California's K-14 education program next academic year. If such a plan were pursued, the Legislature would need to identify a target level of state savings, decide how best to allocate trigger reductions among education and non-education programs, determine the specific K-14 reductions to impose, and design tools to help schools and community colleges respond. Compared to the Governor's plan, which imposes virtually all of the cuts on education programs, the Legislature could consider spreading cuts among more state programs or focusing cuts on programs and services most likely to be able to respond to midyear changes. Given the likely unintended consequences and the major disruptions caused by midyear reductions to schools and community colleges, the Legislature also could consider a contingency plan that included spending increases rather than spending reductions. That is, the Legislature could decide this spring what level of Proposition 98 funding it could afford despite the revenue uncertainties and build its budget accordingly. It then could designate that any ballot-measure revenue that materialized in 2012-13 be used as one-time investments to pay down existing Proposition 98 obligations, with base budget increases considered the following fiscal year.

Provide Districts With More Flexibility, Effective July 1. Given the potential for midyear trigger cuts and the high likelihood that districts are building budgets assuming the lower funding level, we recommend the Legislature give districts some tools to help mitigate the effect on education programs. We recommend these tools be part of the initial budget package and effective beginning July 1. For school districts, we recommend the Legislature consider: removing additional categorical and mandate requirements (beyond current-law requirements), allowing for a shorter school year, increasing maximum statutory class sizes or suspending the caps for one year, and potentially allowing for a special post-election layoff window. Without having these types of tools available, districts might see few options other than laying off staff *this spring*. For community colleges, we recommend the Legislature consider: removing additional categorical and mandate requirements (beyond current-law requirements), suspending the requirements on the number of full-time faculty that districts must employ, modifying the 50 percent law (which requires districts to spend at least 50 percent of their general operating budget on compensation for in-classroom faculty) to include expenditures on counselors and librarians or suspending the law for one year, and allowing for a special post-election layoff window. (Though the administration indicates it is willing to work with districts to provide more flexibility given the proposed trigger reductions, corresponding language containing specific flexibility tools had not yet been submitted at the time this report was prepared.)

SUMMARY

LAO Recommendations

- ✓ ***Rebenchings of Proposition 98 Minimum Guarantee.*** Adopt Governor's proposal to eliminate the rebenching for the "gas tax swap." For other rebenchings, recommend consistent year-to-year approach.
- ✓ ***Payment Deferrals.*** Adopt Governor's proposal to retire some existing K-14 payment deferrals rather than provide K-14 program augmentations if the state has additional Proposition 98 resources to spend in 2012-13.
- ✓ ***Mandates.*** Adopt Governor's proposed concept but (1) review list of mandates eliminated or made optional and (2) create a working group to address implementation details.
- ✓ ***K-12 Funding Restructuring.*** Adopt Governor's proposal to change the way the state allocates K-12 funding, with modifications to incorporate legislative priorities.
- ✓ ***CCC Categorical Flexibility.*** Modify Governor's proposal to require CCC to use categorical funds for existing categorical-program purposes. Alternatively, create two block grants around thematic areas of student success and faculty support.
- ✓ ***Transitional Kindergarten (TK).*** Immediately adopt Governor's proposal to cancel initiation of new TK program. Would result in revenue limit savings of up to $224 million.
- ✓ ***Preschool.*** Shift $400 million into Proposition 98 to accurately reflect the amount currently spent on California State Preschool Program. Consider prioritizing slots for low-income children affected by the change in kindergarten start date. Reject Governor's proposal to reduce the rate the state pays preschool providers. To the degree Proposition 98 savings are needed, eliminate preschool slots.
- ✓ ***"Wall of Debt" Payment Plan.*** Use Governor's plan as a starting point for developing a multiyear plan to retire existing education funding obligations. To increase likelihood plan is consistently implemented, consider extending the payment period, spreading payments more evenly over period, designating settle-up funds for paying down mandates or deferrals, redirecting QEIA program savings to other obligations, and weighing trade-offs of retiring existing obligations versus making programmatic restorations.
- ✓ ***Trigger Plan.*** Build contingency plan. If plan assumes midyear cuts, be deliberate in both setting the magnitude of the cuts and specifying the allocation of the cuts. Alternatively, if plan assumes midyear augmentations, use funds to retire existing education obligations (such as paying down deferrals).
- ✓ ***Trigger-Related Flexibility Options for School Districts.*** Provide one-time tools to help districts respond to potential trigger cuts. Effective July 1, could remove additional categorical and mandate requirements, allow for a shorter school year, increase maximum statutory class sizes or suspend the caps, and authorize a special post-election layoff window.
- ✓ ***Trigger-Related Flexibility Options for Community Colleges.*** Provide one-time tools to help districts respond to potential trigger cuts. Effective July 1, could remove additional categorical and mandate requirements, suspend the requirements on the number of full-time faculty that districts must employ, modify the 50 percent law (which requires districts to spend at least 50 percent of their general operating budget on compensation of in-classroom faculty) to include expenditures on counselors and librarians or suspend the law for one year, and authorize a special post-election layoff window.

QEIA = Quality Education Investment Act.

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