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Impact of Governor's Spending Cap Proposal On Proposition 98

L E G I S L A T I V E   A N A L Y S T ' S   O F F I C E

Presented To:

Senate Budget and Fiscal Review Committee and
Senate Appropriations Committee

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Highlights of Spending Cap and Proposition 98 Interactions

☑ ***Up to $2 Billion Less "Maintenance Factor" Restoration.*** Generally, the minimum guarantee calculation would not require the restoration of the existing maintenance factor after 2004-05. We estimate that this would reduce Proposition 98 spending by hundreds of millions annually in the first couple of years, and by around $2 billion annually in the long run absent overappropriations of the minimum guarantee.

☑ ***Could Provide Greater Stability in Minimum Guarantee.*** By placing "excess revenues" in the Budget Stabilization Fund in Test 2 years, and then returning funds to the General Fund in Test 3 years, this proposal could reduce volatility in minimum guarantee funding.

☑ ***Proposition 98 Not Likely to "Crowd Out" Other General Fund Expenditures.*** The minimum guarantee is not likely to crowd out non-Proposition 98 programs within the spending cap in the foreseeable future because (1) student attendance is growing at a slower rate than the general population and (2) local property tax revenues are forecast to grow at a faster rate than General Fund revenues.

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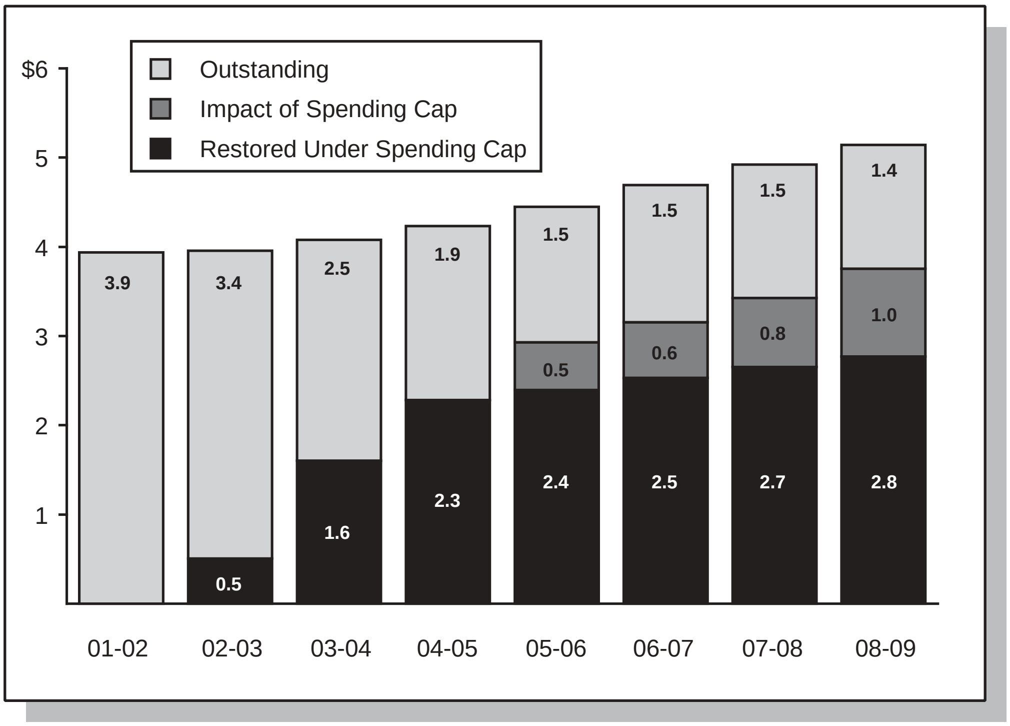
Impact on Maintenance Factor Restoration Of Governor's Proposed Spending Cap

(Dollars in Billions)



- ☑ Under current law, maintenance factor is only required to be restored when General Fund revenues grow faster than personal income (Test 2 years). Since the spending cap would constrain General Fund revenues to grow only as fast as personal income, generally no maintenance factor restorations would be made.

- ☑ Generally, the minimum guarantee calculation would no longer restore outstanding maintenance factor after 2004-05. We estimate that this would reduce Proposition 98 spending by hundreds of millions annually in the first couple of years, and by around $2 billion annually in the long run absent overappropriations of the minimum guarantee.

Measure Could Insulate Proposition 98 From General Fund Fluctuations

☑ Test 2 Years

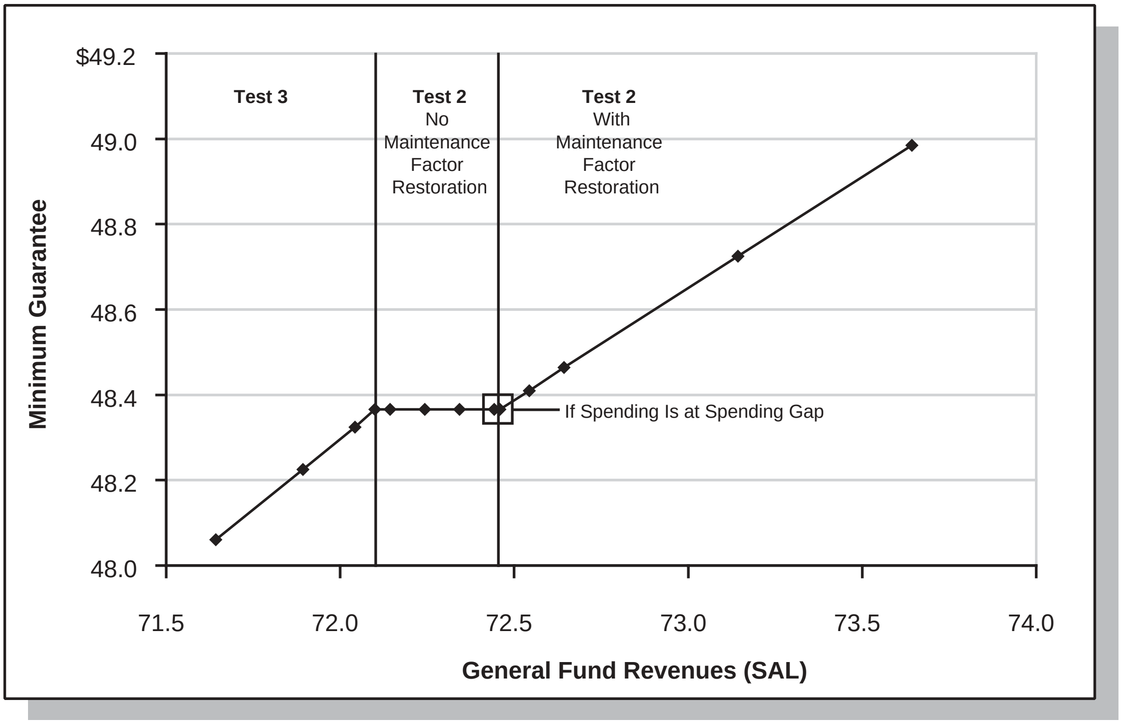
- If in 2005-06 General Fund revenues grow faster than population growth and per capita personal income, revenues would be transferred to the Budget Stabilization Fund.
- This would result in no maintenance factor being restored.

☑ Test 3 Years (Two Possible Scenarios)

- If funds are available in the stabilization account, the Legislature could transfer the funds back to the General Fund, increasing General Fund revenues, thereby increasing the Proposition 98 minimum guarantee. This could continue until either the stabilization account ran out of funds, or Proposition 98 was returned to a Test 2 scenario.
- If the stabilization account had insufficient funds, then Test 3 would remain in operation, and additional maintenance factor would be created. This additional maintenance factor could be restored in future years if General Fund revenues returned to the spending cap level.

Relationship Between General Fund Revenues And the Minimum Guarantee

(In Billions)



- ☑ If General Fund revenues would have required maintenance factor restoration (absent the Governor's proposal), then the Governor's proposal would require revenues to be transferred into the Budget Stabilization Fund until General Fund revenues were reduced to the level where no maintenance factor is required to be restored.

- ☑ If in Test 3 years funds are transferred from the Budget Stabilization Fund back to the General Fund to allow the state to remain at the spending cap, the transfer of funds would move the minimum guarantee back to the Test 2 level.

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Would Proposition 98 Spending Crowd Out Non-Proposition 98 Programs?

☑ Proposition 98 spending at the minimum guarantee would not likely crowd out non-Proposition 98 programs in the foreseeable future. This is due to two major factors:

- ***Slower Student Attendance Growth.*** The growth in the number of students attending K-12 schools (one of the main factors of the minimum guarantee growth) will be slower than the growth in state population. Since the spending cap would grow based on the state population, we would expect Proposition 98 to take up a smaller share of total General Fund spending over time.
- ***Fast Growing Local Property Tax Revenues.*** Proposition 98 is funded with a mixture of General Fund and local property tax revenues. We forecast local property taxes growing faster than the General Fund. So over time, a higher proportion of Proposition 98 would be supported by local property taxes. Again, this would lead to Proposition 98 using a smaller share of General Fund revenues.

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Proposition 98 Overview

Funding "Tests"

Proposition 98 mandates that a minimum amount of funding be guaranteed for K-14 school agencies equal to the greater of:

- A specified percent of the state's General Fund revenues (Test 1).
- The amount provided in the prior year, adjusted for growth in students and inflation (Tests 2 and 3).

Test 1—Percent of General Fund Revenues

Approximately 34.5 percent of General Fund plus local property taxes.

Requires that K-12 schools and the California Community Colleges (CCC) receive at least the same share of state General Fund tax revenues as in 1986-87. This percentage was originally calculated to be slightly greater than 40 percent. In recognition of shifts in property taxes to K-14 schools from cities, counties, and special districts, the current rate is approximately 34.5 percent.

Test 2—Adjustments Based on Statewide Income

Prior-year funding adjusted by growth in per capita personal income.

Requires that K-12 schools and CCC receive at least the same amount of combined state aid and local tax dollars as was received in the prior year, adjusted for statewide growth in average daily attendance and inflation (annual change in per capita personal income).

Test 3—Adjustment Based on Available Revenues

Prior-year funding adjusted by growth in per capita General Fund.

Same as Test 2 except the inflation factor is equal to the annual change in per capita state General Fund revenues plus 0.5 percent. Test 3 is used only when it calculates a guarantee amount less than the Test 2 amount.

- **Test 3B Supplement.** Statute requires that, in Test 3 years, K-14 Proposition 98 funding per student grow at least as fast as per capita General Fund spending on non-Proposition 98 programs. This can require that a supplemental amount be added to the minimum guarantee.

Other Major Funding Provisions

Suspension

Proposition 98 also includes a provision allowing the state to suspend the minimum funding level for one year through urgency legislation other than the budget bill.

Restoration ("Maintenance Factor")

Following a suspension or Test 3 year, the Legislature must increase funding over time until the base is fully restored. The overall dollar amount that needs to be restored is referred to as the maintenance factor.

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How the Maintenance Factor Works

- ☑ ***What Is a Maintenance Factor?*** Over the long run, the Proposition 98 minimum guarantee is determined by the growth in K-12 attendance and growth in per capita personal income (referred to as long-term Test 2 level). The Constitution allows the Legislature to appropriate less for K-14 education than this long-term Test 2 level (1) under a suspension or (2) if per capita General Fund revenues grow slower than per capita personal income (known as a Test 3 level). The Constitution requires the state to restore in future years the difference between the actual level of spending and the long-term Test 2 level of spending. This difference is known as the maintenance factor.

- ☑ ***Maintenance Factor Restored in Test 2 Years***. When the General Fund grows faster than personal income, the Constitution requires a portion of the maintenance factor to be restored.

- ☑ ***$3.9 Billion Maintenance Factor Created in 2001-02.*** In 2001-02, when General Fund revenues fell by more than 17 percent (a Test 3 year), the Legislature appropriated $3.9 billion less than would have been required if Test 2 were operative. This created a $3.9 billion maintenance factor. While we forecast that portions of this maintenance factor would be paid off by 2004-05, we estimate that around $2 billion in maintenance factor would still be outstanding.