The 2022-23 Budget:

Fiscal Outlook for Schools and Community Colleges

SUMMARY

Surge in School and Community College Funding Projected in Upcoming Budget Cycle. Each year, the state calculates a "minimum guarantee" for school and community college funding based upon a set of formulas established by Proposition 98 (1988). Based upon revenue projections that are significantly above the June 2021 estimates, we estimate the guarantee in 2022-23 is $11.6 billion (12.4 percent) above the 2021-22 enacted budget level. After accounting for various adjustments—backing out one-time expenditures, funding a 5.35 percent cost-of-living adjustment, and making required reserve deposits—we estimate that $9.5 billion is available for new commitments. In addition, we estimate that $10.2 billion in one-time funding is available due to increases in the guarantee in 2020-21 and 2021-22. In total, we estimate nearly $20 billion is available to allocate in the upcoming budget cycle. To help the Legislature prepare to allocate this funding, we outline several options that would build upon existing programs, expand services in targeted ways, and address future costs and uncertainties.

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NOVEMBER 2021

INTRODUCTION

Report Provides Our Fiscal Outlook for Schools and Community Colleges. State budgeting for schools and the California Community Colleges is governed largely by Proposition 98. The measure establishes a minimum funding requirement for K-14 education commonly known as the minimum guarantee. This report provides our estimate of the minimum guarantee for the upcoming budget cycle. The report has four parts. First, we explain the formulas that determine the minimum guarantee. Next, we explain how our estimates of the guarantee in 2020-21 and 2021-22 differ from the June 2021 estimates. Third, we estimate the guarantee over the 2022-23 through 2025-26 period under our main economic forecast. Finally, we identify the amount of funding that would be available for new commitments in the upcoming year and describe some issues and options for the Legislature to consider as it prepares to allocate this funding. (*The 2022-23 Budget: California's Fiscal Outlook* contains an abbreviated version of this report, along with the outlook for other major programs in the state budget.)

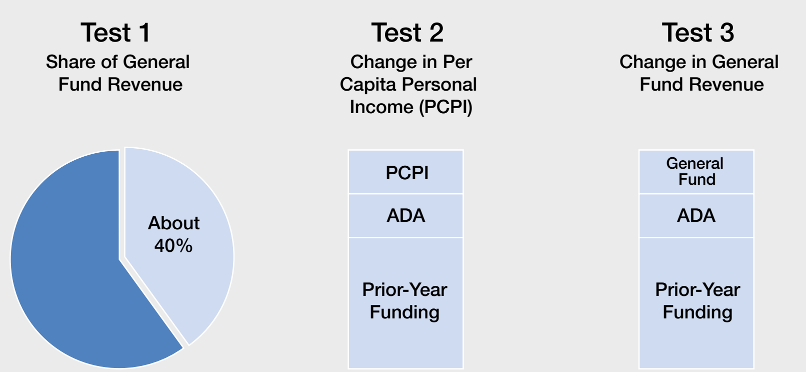
BACKGROUND

Minimum Guarantee Depends Upon Various Inputs and Formulas. The California Constitution sets forth three main tests for calculating the Proposition 98 minimum guarantee. Each test takes into account certain inputs, including General Fund revenue, per capita personal income, and student attendance (**Figure 1**). Whereas Test 2 and Test 3 build upon the amount of funding provided the previous year, Test 1 links school funding to a minimum share of General Fund revenue. The Constitution sets forth rules for comparing the tests, with one of the tests becoming operative and used for calculating the minimum guarantee that year. Although the state can provide more funding than required, in practice it usually funds at or near the guarantee. With a two-thirds vote of each house of the Legislature, the state can suspend the guarantee and provide less funding than the formulas require that year. The state meets the guarantee through a combination of General Fund and local property tax revenue.

Legislature Decides How to Allocate Proposition 98 Funding. Whereas Proposition 98 establishes a minimum funding level, the Legislature decides how to allocate this funding among school and community college programs. Since 2013-14, the Legislature has allocated most funding for schools through the Local Control Funding Formula (LCFF). A school district's allotment depends on its

Figure 1

Three Proposition 98 Tests



Guarantee based on share of state General Fund revenue going to K-14 education in 1986-87.

Guarantee based on prior-year funding level adjusted for year-over-year changes in K-12 attendance and California PCPI.

Guarantee based on prior-year funding level adjusted for year-over-year changes in K-12 attendance and state General Fund revenue.

ADA = average daily attendance.

size (as measured by student attendance) and the share of its students who are low income or English learners. The Legislature allocates most community college funding through the Student Centered Funding Formula (SCFF). A college district's allotment depends on its enrollment, share of low-income students, and performance on certain outcome measures.

At Key Points, State Recalculates Minimum Guarantee and Certain Proposition 98 Costs. The guarantee typically changes from the level initially assumed in the budget act as the state updates the relevant Proposition 98 inputs. The state updates these inputs until May of the following fiscal year. The state also revises its estimates of certain school and community college costs after it adopts the budget. When student attendance changes, for example, the cost of LCFF tends to change in tandem. The state finalizes its calculations through "certification," a process involving the publication of the underlying inputs and a period of public review. The most recently certified year is 2019-20.

School and Community College Programs Typically Receive COLA. The cost-of-living adjustment (COLA) rate is based on a price index published by the federal government. This index reflects changes in the cost of goods and services purchased by state and local governments across the country. State law provides an automatic COLA for LCFF unless the guarantee—as estimated in the enacted budget—is insufficient to cover the associated costs. In these cases, the law reduces the COLA for LCFF (and other K-12 programs) to fit within the guarantee. Though statute is silent on community college programs, the state generally aligns the COLA rate for these programs with the K-12 rate.

Proposition 98 Reserve Deposits Required Under Certain Conditions. Proposition 2 (2014) created a state reserve specifically for schools and community colleges—the Public School System Stabilization Account (Proposition 98 Reserve). The Constitution requires the state to make deposits into this reserve when the state receives above average revenue from capital gains and the minimum guarantee meets certain conditions (see the box on the next page).

Proposition 98 Reserve Linked With Cap on School Districts' Local Reserves. A state law enacted in 2014 and modified in 2017 sets a cap on school district reserves after the Proposition 98 Reserve reaches a certain threshold. Specifically, the cap applies if the balance in the reserve during the previous year exceeded 3 percent of the Proposition 98 funding allocated for K-12 schools that year. Once the cap becomes operative, medium and large districts (those with more than 2,500 students) must limit their reserves to 10 percent of their annual expenditures. Smaller districts are exempt. The law also exempts reserves that are legally restricted to specific activities and reserves set aside by a district's governing board for specific purposes. In addition, a district facing "extraordinary fiscal circumstances" can apply for an exemption from its county office of education for up to two consecutive years.

2020-21 AND 2021-22 UPDATES

State Revenues Have Been Surging. State tax collections have grown rapidly in recent months (Figure 2 on page 5). For example, September 2021 collections from the three largest taxes (personal income, sales, and corporation taxes) were 40 percent higher than September 2020 and almost 60 percent higher than September 2019. These increases build upon extraordinary growth in several measures of economic activity. Retail sales, for example, have posted double digit growth in 2021. Stock prices have doubled from their pandemic low in the spring of 2020. Several major firms have posted historically high earnings. Consistent with these developments, General Fund revenues under our outlook are more than $28 billion above the June 2021 estimates across 2020-21 and 2021-22.

Proposition 98 Guarantee Revised Up Significantly Across 2020-21 and 2021-22. Compared with the estimates included in the

Key Rules Governing the Proposition 98 Reserve

Deposits Predicated on Two Basic Conditions. To determine whether a deposit is required, the state estimates the amount of revenue it will receive from taxes on capital gains (a relatively volatile source of General Fund revenue). Deposits are required only when the state expects to receive an above-average amount of capital gains revenue. The state also identifies which of the three tests will determine the minimum guarantee. Deposits are required only when Test 1 is operative. (Test 1 years typically are associated with relatively strong growth in the guarantee.)

Required Deposit Amount Depends on Formulas. After the state determines it meets the basic conditions, it performs additional calculations to determine the size of the deposit. Generally, the size of the deposit tends to increase when revenue from capital gains is relatively high and the guarantee is growing quickly relative to inflation. More specifically, the deposit equals the lowest of the following four amounts:

- ***Portion of the Guarantee Attributable to Above-Average Capital Gains.*** The state calculates what the Proposition 98 guarantee would have been if the state had not received any revenue from "excess" capital gains (the portion exceeding the historical average). Deposits are capped at the difference between the actual guarantee and the hypothetical guarantee without the excess capital gains.
- ***Difference Between the Test 1 and Test 2 Levels.*** Deposits are capped at the difference between the higher Test 1 and lower Test 2 funding levels.
- ***Growth Relative to the Prior Year.*** The state calculates how much funding schools and community colleges would receive if it adjusted the previous year's funding level for changes in student attendance and inflation. (The inflation factor is the higher of the statutory cost-of-living adjustment or growth in per capita personal income.) Deposits are capped at the difference between the Test 1 funding level and the prior-year adjusted level.
- ***Room Available Under a 10 Percent Cap.*** The Proposition 98 Reserve has a cap on required deposits equal to 10 percent of the funding allocated to schools and community colleges. Deposits are only required to the extent the balance is below this threshold.

Legislature Has Some Control Over Deposit Amounts. Although the constitutional formulas generally control the size of the deposits, the Legislature can make different decisions in certain circumstances. In tight fiscal times, the Legislature can reduce or cancel a deposit if the Governor declares a budget emergency (based on a natural disaster or slowdown in state revenues). In addition, any required reserve deposit is canceled if the Legislature votes to suspend the minimum guarantee. In stronger fiscal times, the Constitution does not prevent the Legislature from making deposits above the required amount. (Since 2014, the state has made several optional deposits into the Budget Stabilization Account—the other reserve account established by Proposition 2.)

Withdrawals Also Linked With Formulas. The Constitution requires the state to withdraw previously required deposits from the Proposition 98 Reserve if the minimum guarantee is not growing quickly enough to support the prior-year funding level, as adjusted for student attendance and inflation. The Legislature can allocate withdrawals for any school or community college programs.

June 2021 budget plan, we estimate the minimum guarantee is up $1.8 billion in 2020-21 and $8.9 billion in 2021-22 (**Figure 3**). These upward revisions are due almost entirely to our higher General Fund revenue estimates. Test 1 remains operative in both years, with the increase in the General Fund portion of the guarantee equating to nearly 40 percent of the additional revenue. Our estimates of local property tax revenue, by comparison, are up slightly in 2020-21 and down slightly in 2021-22. (When Test 1 is operative, changes in local property tax revenue directly affect the Proposition 98 guarantee. They do not offset General Fund spending.)

Program Costs Down Slightly Over the Two Years. For 2020-21, the latest available data show that costs of LCFF and other Proposition 98 programs are essentially unchanged from June 2021 estimates (**Figure 4** on the next page). For 2021-22, we estimate costs are down $101 million. This drop mainly relates to our estimate that LCFF costs are likely to grow slightly less quickly than the state previously assumed.

Higher Proposition 98 Reserve Deposit Over the Two Years. Compared with June 2021 estimates, the reserve deposits under our outlook are down $231 million in 2020-21 and up $871 million in 2021-22. These changes are due to our revised estimates of capital gains, which are down slightly in 2020-21 and up in 2021-22.

State Required to Provide $10.2 Billion in Additional One-Time Funding. After accounting for increases in the minimum guarantee, lower program costs, and the higher reserve deposit, we estimate that spending is nearly $2.1 billion below the guarantee in 2020-21 and nearly $8.2 billion below the guarantee in 2021-22. Across the two years, the state would be required to make one-time payments totaling $10.2 billion to "settle up" for the difference. The Legislature could allocate these payments for any school or community college programs.

Figure 2

Rapid Rise in Revenue Collections in Recent Months

Rolling 12-Month Total Collections From Income, Sales, and Corporation Taxes

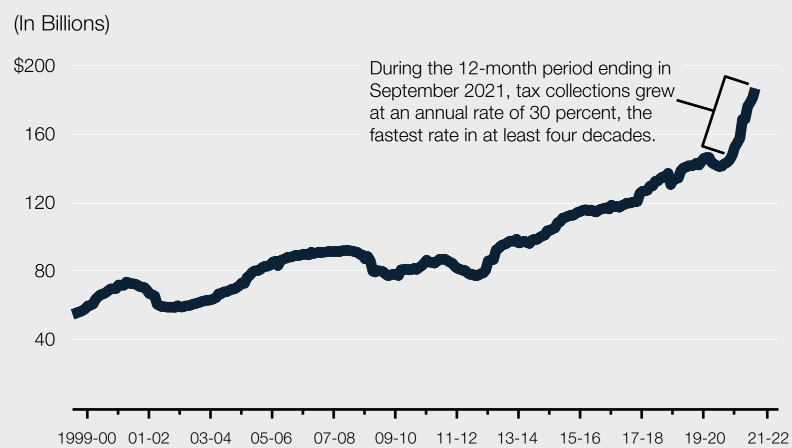


Figure 3

Updating Prior-and Current-Year Estimates of the Minimum Guarantee

(In Millions)

	2020-21			2021-22		
	June Budget Plan	November LAO Estimates	Change	June Budget Plan	November LAO Estimates	Change
Minimum Guarantee						
General Fund	$67,685	$69,449	$1,764	$66,374	$75,399	$9,024
Local property tax	25,745	25,814	69	27,365	27,279	-85
Totals	**$93,430**	**$95,263**	**$1,833**	**$93,739**	**$102,678**	**$8,939**
General Fund tax revenue	$178,080	$182,722	$4,642	$174,610	$198,365	$23,755

Figure 4

Additional Spending Required to Meet Guarantee in Prior and Current Year

(In Millions)

	2020-21			2021-22		
	June Budget Plan	November LAO Estimates	Change	June Budget Plan	November LAO Estimates	Change
Minimum Guarantee	**$93,430**	**$95,263**	**$1,833**	**$93,739**	**$102,678**	**$8,939**
Funding Allocations						
Local Control Funding Formula	$62,342	$62,354	$12	$66,710	$66,584	-$126
Other K-14 programs	29,198	29,191	-7	24,412	24,437	25
Proposition 98 Reserve deposit	1,889	1,658	-231	2,617	3,488	871
Totals	**$93,430**	**$93,204**	**-$226**	**$93,739**	**$94,509**	**$770**
Settle-Up Payment	**—**	**$2,059**	**$2,059**	**—**	**$8,169**	**$8,169**

MULTIYEAR OUTLOOK

In this section, we estimate the minimum guarantee for 2022-23 and the following three years under our main economic forecast. We also examine how the Proposition 98 Reserve would change and the factors affecting state costs for school and community college programs.

Economic Assumptions

Main Forecast Anticipates Moderate Growth. Our main forecast anticipates that the rapid pace of revenue growth will moderate significantly over the coming months. Whereas we forecast revenue will grow 8 percent in 2021-22, we anticipate growth will be about 2 percent in 2022-23, remain relatively flat in 2023-24, and return to historical norms of 5 percent to 6 percent annually thereafter. In developing these estimates, we accounted for the unprecedented nature of economic growth over the past year and assumed that only a portion of that growth would be sustained.

The Minimum Guarantee

Guarantee Grows Throughout the Outlook Period. The minimum guarantee under our main forecast is $105.3 billion in 2022-23. Relative to the 2021-22 enacted budget level, this increase is substantial—$11.6 billion (12.4 percent). Compared with our revised estimate of 2021-22, however, the increase is more modest—$2.6 billion (2.6 percent) (Figure 5). The guarantee continues to grow over the remaining years of the period, increasing modestly in 2023-24 and accelerating in 2024-25 and 2025-26.

Three Factors Account for Growth in the Guarantee. Under our main forecast, the guarantee grows to $121.3 billion in 2025-26, an increase of $18.6 billion compared with the revised 2021-22 level (Figure 6 on page 8). The average annual growth is $4.7 billion (4.3 percent). The largest factor contributing to this growth is the increase in General Fund revenue. Test 1 is operative throughout period, with the General Fund portion of the guarantee increasing about 40 cents for each dollar of additional revenue. Growth in local property tax revenue also accounts for a significant portion of the increase. Our property tax estimates primarily reflect growth in assessed property values, which ranges from 5.6 percent to 6 percent annually. Finally, the guarantee increases because of the planned expansion of Transitional Kindergarten. As we discuss later in this report, the Legislature and Governor have agreed to increase the General Fund portion of the guarantee to cover the cost of this expansion.

Guarantee Is Moderately Sensitive to Changes in Revenue Estimates. General Fund revenue tends to be the most volatile input in the calculation of the Proposition 98 guarantee. For any given year, the relationship between the guarantee and General Fund revenue generally depends on which Proposition 98 test is operative and whether another test could become operative with higher or lower revenue. Test 1 is likely to remain operative over the period even if revenues differ from our main forecast, meaning the guarantee would change about 40 cents for each dollar of higher or lower General Fund revenue.

Estimates of the Guarantee Become More Uncertain Over Time. We also examined the range of potential variation in General Fund revenue estimates relative to our main forecast. For this analysis, we looked at how much revenue forecasts tended to differ from actual revenues over the last 50 years. We then used this historical relationship to determine the likely range of revenues over the next several years. We also identified the subset of this range likely to be associated with a recession. Figure 7 on the next page displays our estimates of the guarantee under the various revenue ranges. The uncertainty in our estimates increases significantly over the outlook period. For example, the reasonable range for the guarantee in 2022-23 (barring a recession) is about half as large as the range by 2025-26. The figure also shows that in most scenarios, the guarantee is above our 2021-22 estimates by the end of the period. Local property tax revenue contributes significantly to this trend, because it tends to increase even when General Fund revenue is sluggish or declining

State and School District Reserves

Proposition 98 Reserve Deposits Required in 2022-23 and 2023-24. Under our main forecast, the state would make a $3.1 billion deposit into the Proposition 98 Reserve in 2022-23 and a $1.1 billion deposit in 2023-24. Combined with previous deposits, these two deposits would bring the total balance in the reserve to $9.4 billion (nearly 9 percent of the estimated guarantee in 2023-24). In the following two years, the state would not make any deposits or withdrawals. These estimates mainly reflect our assumptions about capital gains revenue. Under our outlook, capital gains revenue is

Figure 5

Proposition 98 Outlook Under Main Forecast

(Dollars in Millions)

	2021-22	2022-23	2023-24	2024-25	2025-26
Minimum Guarantee					
General Fund[a]	$75,399	$76,660	$77,146	$81,644	$87,777
Local property tax	27,279	28,661	30,188	31,838	33,524
Totals	**$102,678**	**$105,321**	**$107,334**	**$113,482**	**$121,302**
Change From Prior Year					
General Fund	$5,950	$1,261	$486	$4,499	$6,133
Percent change	8.6%	1.7%	0.6%	5.8%	7.5%
Local property tax	$1,465	$1,382	$1,527	$1,650	$1,686
Percent change	5.7%	5.1%	5.3%	5.5%	5.3%
Total guarantee	$7,415	$2,643	$2,013	$6,148	$7,819
Percent change	7.8%	2.6%	1.9%	5.7%	6.9%
General Fund Tax Revenue[b]	$198,365	$200,575	$200,290	$210,272	$223,301
Growth Rates					
K-12 average daily attendance[a]	-2.5%	1.1%	1.1%	0.9%	0.3%
Per capita personal income (Test 2)	5.7	5.1	4.1	3.2	3.3
Per capita General Fund (Test 3)[c]	9.6	1.6	0.0	4.9	6.1
Proposition 98 Reserve					
Deposit (+) or withdrawal (-)	$3,488	$3,123	$1,145	—	—
Cumulative balance	5,147	8,270	9,415	$9,415	$9,415

[a] Estimates account for the expansion of Transitional Kindergarten eligibility over the 2022-23 through 2025-26 period.
[b] Excludes non-tax revenues and transfers, which do not affect the calculation of the minimum guarantee.
[c] As set forth in the State Constitution, reflects change in per capita General Fund plus 0.5 percent.

Notes: Test 1 is operative throughout the period. No maintenance factor is created or paid.

strong in 2022-23, but fades to below average levels by the end of the outlook period. Reserve deposits, however, are sensitive to these assumptions. Deposits could increase if capital gains revenue were stronger over the period, potentially reaching the 10 percent limit. Conversely, the state could make no deposits if capital gains were weak over the period.

Proposition 98 Reserve Helps Mitigate Volatility in the Guarantee. Reserve deposits and withdrawals provide a cushion for school and community programs when the minimum guarantee changes. If the guarantee were to exceed our main forecast because of higher General Fund revenues, the state likely would be required to make a larger deposit. The higher deposit would limit the amount available for expanding school and community college programs. On the downside, a lower guarantee likely would reduce or eliminate any required deposits. Moreover, if the guarantee were below the previous year's level (adjusted for inflation), the state could make reserve withdrawals. These actions would reduce the size of potential reductions to school and community college programs. The cushioning effect of the reserve, however, is relatively modest. If the state were to experience a significant upward or downward swing in the guarantee, the funding available for programs could still change significantly.

Local Reserve Cap Would Remain Operative Over the Period. The June 2021 budget plan estimated that the Proposition 98 Reserve balance would exceed 3 percent of the Proposition 98 funding allocated for schools in 2021-22, triggering the reserve cap in 2022-23. Under our main forecast, the balance remains above this threshold and the reserve cap is operative throughout the period. The latest available data show that as of June 30, 2020, 265 out of 350 medium and large districts subject to the cap held reserves exceeding 10 percent of their expenditures. The total amount above the cap was $4.6 billion—approximately half of the reserves held by these districts. Districts affected by the cap could designate their reserves for specific purposes, seek temporary exemptions from their county offices of education, or spend down their reserves.

Figure 6

Growth in the Proposition 98 Guarantee From 2021-22 to 2025-26[a]

Main Forecast (Dollars in Billions)

	Increase Over Four-Year Period	Average Annual Increase	
		Amount	Percent
General Fund:			
Increases due to higher revenues	$9,518	$2,380	3.0%
TK adjustment	2,861	715	—
Subtotal (General Fund)	($12,379)	($3,095)	(3.9%)
Local property tax increases	$6,245	$1,561	5.3%
Total Guarantee	**$18,624**	**$4,656**	**4.3%**

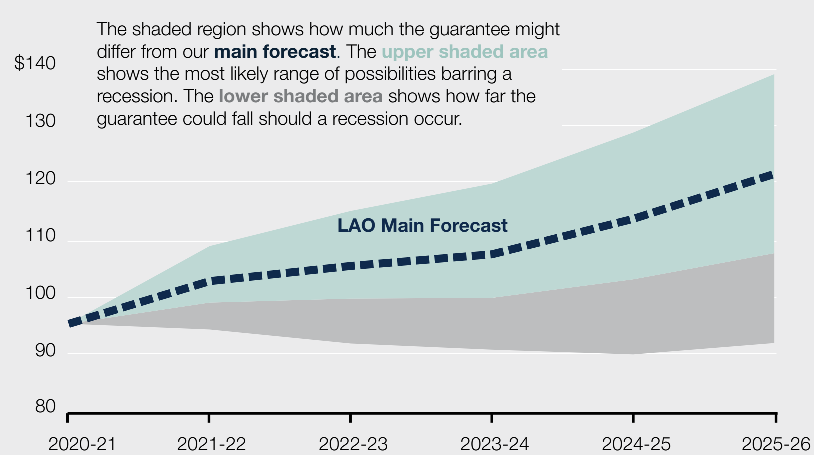
[a] Relative to 2021-22 revised estimate of the guarantee.

TK = Transitional Kindergarten.

Figure 7

Proposition 98 Estimates Become More Uncertain Over Time

Minimum Guarantee (In Billions)



Program Costs

Large Statutory COLA Projected in 2022-23, Followed by COLAs Around the Historical Average. For 2022-23, we estimate the statutory COLA is 5.35 percent. This COLA rate—the highest in 15 years—reflects above average growth in prices for many goods and services over the past several months. We estimate the cost of providing this COLA for school and community college programs is $4.4 billion. Moving forward, most economic forecasters expect price inflation to moderate sometime next year. Consistent with this assumption, our main forecast estimates the COLA rate at 3.5 percent in 2023-24, 3 percent in 2024-25, and 3 percent in 2025-26. These rates are somewhat above the annual average of 2.6 percent over the past three decades. We estimate the associated costs are roughly $3 billion per year. (Our outlook also reflects a new methodology for estimating the COLA rate, which we think better aligns with our overall economic assumptions. Whereas we previously relied on consensus estimates from Moody's Analytics, this year we developed our own estimates based on the consensus of economists in the Blue Chip Economic Indicators survey.)

Higher COLA Rates and Costs if Inflation Persists. Although many economists expect inflation to moderate, an alternative possibility is that higher inflation persists for at least the next several years. (Underscoring this possibility, data released after the development of our main forecast showed higher-than-expected inflation in October.) Based on our analysis of previous deviations from the economic consensus, a scenario in which inflation runs closer to 5 percent per year seems plausible. If the statutory COLA rate were 5 percent annually over the 2023-24 through 2025-26 period, the annual cost increases would be roughly $4.5 billion per year. (The 2022-23 COLA rate is unlikely to change significantly because it reflects changes in the price index during the previous year. The federal government has already published most of the data that will determine the 2022-23 COLA.)

Several Previous Commitments Increase Costs Over the Period. The June 2021 budget plan created five commitments that increase costs for various school programs over the next several years. Relative to the funding included in the 2021-22 budget, we estimate these commitments will increase costs by $2.3 billion in 2022-23 and $8.2 billion by 2025-26 (**Figure 8** on the next page). One of these commitments involves the expansion of Transitional Kindergarten, a program that is currently available to four-year olds born between September 2 and December 2. Trailer legislation begins expanding eligibility for this program in 2022-23 and opens the program to all four-year olds by 2025-26. The Legislature and Governor also have agreed to adjust the minimum guarantee upward by the cost of this expansion (which we estimate at $421 million in 2022-23 and $2.9 billion in 2025-26). For the other four commitments—related to the Expanded Learning Opportunities Program, Transitional Kindergarten staffing, school meal reimbursements, and special education—the state will not adjust the guarantee.

K-12 Attendance Projected to Drop in 2021-22, Rise Over the Following Four Years. The state did not collect school attendance data in 2020-21 due to the pandemic and the temporary switch to remote learning. For 2021-22, our outlook assumes average daily attendance will be down about 170,000 students (3 percent) relative to the pre-pandemic level of 5,897,000. Over the following four years, our outlook accounts for three trends affecting attendance. First, we expect an additional reduction of about 170,000 students by 2025-26 due to declines in the school age population. This drop primarily reflects declining births in California—a trend that began more than a decade ago and has continued through the pandemic. Second, we expect the expansion of Transitional Kindergarten to add nearly 230,000 students by 2025-26. Finally, we assume districts' attendance eventually recovers by the equivalent of about 140,000 students relative to the drop in 2021-22. Accounting for all these estimates and assumptions, statewide attendance would be approximately 5,925,000 students in 2025-26—slightly above the pre-pandemic level.

Figure 8

Estimated Cost Increases for Previous Commitments

(In Billions)

		Additional State Costs[a]	
Program/Issue	**New Requirement(s)**	**2022-23**	**2025-26**
Expanded Learning Opportunities Program	Districts must offer before/after school programs and summer programs to low-income students and English learners in Transitional Kindergarten through grade 6 in 2021-22. Beginning in 2022-23, districts with the highest concentrations of low-income students and English learners (80 percent or above) must serve all interested Transitional Kindergarten through grade 6 students.	$1.0[b]	$4.0[b]
Transitional Kindergarten eligibility	Districts must begin expanding eligibility for Transitional Kindergarten in 2022-23 and enroll all interested four-year olds by 2025-26.	0.4	2.9
School meal reimbursements	Districts must provide two free meals per school day for any student requesting a meal beginning in 2022-23.	0.7	0.7
Transitional Kindergarten staffing ratios	Districts must maintain a 12:1 ratio of students to adults in 2022-23 and a 10:1 ratio beginning in 2023-24.	—	0.4
Special education	Beginning in 2022-23, the state must backfill one-time funds provided in 2021-22 that count toward the federal maintenance of effort requirement.	0.2[c]	0.2[c]
Totals		**$2.3**	**$8.2**

[a] Estimate of the additional costs relative to the 2021-22 budget level.

[b] The 2021-22 budget provided $1 billion in ongoing funds and $750 million in one-time funds. Increases are relative to the ongoing amount provided in 2021-22.

[c] Excludes the portion of this requirement that is satisfied by funding growth and the cost-of-living adjustment in 2022-23. The state could allocate the backfill for any special education purpose.

KEY CONSIDERATIONS

In this part of the report, we highlight a few issues for the Legislature to consider as it begins planning for the upcoming budget cycle. Specifically, we (1) analyze the amount of new funding available for school and community college programs, (2) describe a few notable issues affecting district budgets, and (3) comment on the options for allocating the available one-time and ongoing funding.

Ongoing Funds for New Commitments

Nearly $10 Billion in New Ongoing Funds Available in 2022-23. Figure 9 shows our estimate of the changes in funding and costs relative to the 2021-22 enacted budget level. Regarding the downward cost adjustments, the 2021-22 budget plan allocated $5.9 billion for one-time activities, including funds to pay down deferrals and cover the reserve deposit required in 2021-22. These allocations expire in 2022-23, freeing-up the underlying funds. An additional $1.8 billion is available from reductions in costs due to lower attendance. Regarding cost increases, we account for previous commitments, the required reserve deposit, and the 5.35 percent COLA. After adjusting for these issues and the growth in the minimum guarantee, we estimate the Legislature has $9.5 billion in ongoing funds available in 2022-23. (Our estimates do not account for potential interactions with the state appropriations limit. The box on page 12 explains how the limit could affect school funding.)

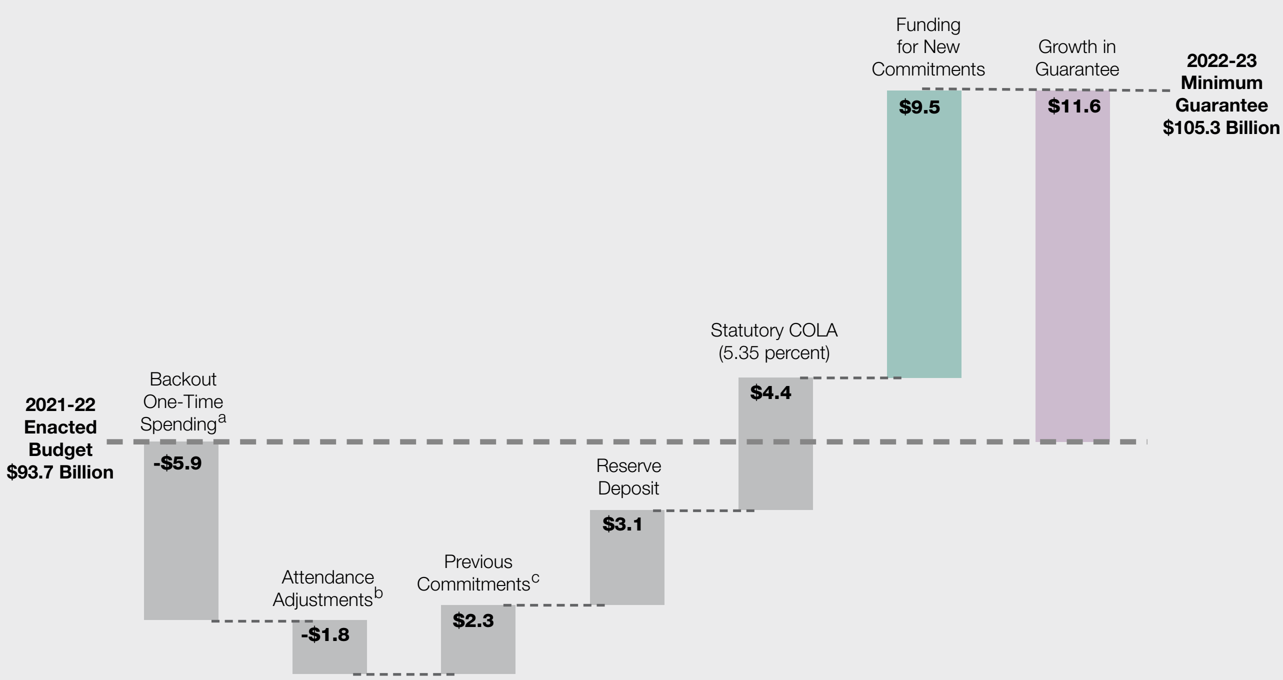
Under Main Forecast, Funding for New Commitments Dips in 2023-24, Then Grows. The top of Figure 10 on page 13 shows how funding and costs change over the period under our main forecast. The lighter shaded area represents the amount available for new commitments, assuming no changes to current law or policy. More specifically, it represents the difference between the Proposition 98 guarantee and baseline costs, which include the cost of providing the statutory COLA for existing programs and the cost increases related to previous commitments. Under our main forecast, the amount of funding available dips from $9.5 billion in 2022-23 to $8.4 billion in 2023-24, then grows over the rest of the period. To the extent the state adopts new ongoing commitments in 2022-23, the amount of funding available in each subsequent year would be lower by a corresponding amount. We also explored a variant of our main forecast in which the minimum guarantee is unchanged but the statutory COLA is 5 percent per year from 2023-24 through 2025-26. Baseline costs grow more quickly in this scenario, reducing the amount available for new commitments to about $7 billion in 2023-24 and about $9 billion in 2025-26.

Under Mild Economic Downturn, State Could Cover Existing Commitments Only. We examined how funding for schools and community colleges would change under a mild economic downturn (bottom of Figure 10). For this analysis, we assumed that instead of growing throughout the period, General Fund revenues would experience a year-over-year decline of $20 billion (10 percent) in 2023-24, then grow slowly over the following two years. In this scenario, the state would have enough funding cover the statutory COLA and the cost of its previous commitments, but would be unable to cover significant new commitments. The state, however, also could make withdrawals from the Proposition 98 Reserve in this situation. If the state had made any new ongoing commitments in 2022-23, these withdrawals would mitigate the need to make immediate reductions to those commitments in 2023-24.

Figure 9

Significant Funding Available for New Commitments in 2022-23

Changes From 2021-22 Enacted Budget (In Billions)



[a] Consists primarily of deferral paydowns and the 2021-22 reserve deposit.
[b] Consists primarily of lower LCFF costs due to attendance reductions in the previous year and the expiration of the hold harmless provision in 2022-23.
[c] Includes increases related to the Expanded Learning Opportunities Program, school meal reimbursements, Transitional Kindergarten, and special education.

COLA = cost-of-living adjustment and LCFF = Local Control Funding Formula.

District Budget Issues

Attendance Declines Likely to Affect School District LCFF Funding in 2022-23. Several large school districts have recently reported attendance levels that are well below their pre-pandemic levels. Districts indicate these drops reflect a combination of fewer students enrolling and higher rates of absenteeism for those who do enroll. A state law mitigates the effects of this decrease in 2021-22 by crediting districts with their pre-pandemic attendance levels for the purpose of LCFF. In 2022-23, however, the state is scheduled to return to its longstanding policy and will credit districts with the higher of their attendance in 2021-22 or 2022-23. This policy means that districts could experience funding declines based on lower attendance in 2021-22, but only to the extent those reductions continue in 2022-23. Our outlook assumes an attendance-related drop in LCFF of about $1.8 billion (2.5 percent) in 2022-23. Attendance-related drops, however, do not translate into less overall funding for schools statewide because the state must allocate the same total amount to meet the minimum guarantee. (Any funds freed-up from lower LCFF costs could be allocated for other school priorities—including LCFF augmentations.) Many community colleges also report enrollment declines relative to their pre-pandemic levels. Although these reductions eventually could translate into lower SCFF funding levels, the state has several "hold harmless" provisions to maintain funding in 2022-23.

The State Appropriations Limit and School Funding

Constitution Establishes State Appropriations Limit (SAL). Proposition 4 (1979) established an appropriations limit for the state (and most types of local governments). Under the measure, the state must compare its limit to the appropriations subject to the limit each year. Appropriations subject to the limit are determined by taking all proceeds of taxes and subtracting excluded spending, such as spending on capital outlay and certain subventions to local governments. If appropriations subject to the limit exceed the limit (on net) over any two-year period, the state has excess revenues. The Legislature can respond to excess revenues by (1) lowering tax revenues, (2) splitting the excess between taxpayer rebates and one-time payments to school and community college districts, or (3) appropriating more money for purposes excluded from the limit.

Under Our Revenue Estimates, SAL Has Significant Budget Implications. Our outlook anticipates the state will have a $31 billion General Fund surplus (outside of the Proposition 98 budget) to allocate in the upcoming budget process. Under our estimates of revenues and spending under current law and policy, the state would need to allocate $14 billion to meet the constitutional requirements under SAL across 2020-21 and 2021-22. Moreover, while there is significant uncertainty in these figures, we estimate the state could have $12 billion in *additional* SAL requirements to meet in 2022-23. This means that, under our revenue estimates, the Legislature likely would need to use a significant share of the surplus to meet its SAL requirements.

Potential Effects on School and Community College Funding. The effects on schools and community colleges depend on how the state responds to the limit. For example, the Legislature could split the excess revenues between taxpayer rebates and additional school and community college spending. In this scenario, schools and community colleges would receive funding (allocated on a per-pupil basis) to supplement the Proposition 98 guarantee. Alternatively, the Legislature could reduce General Fund taxes. Under this scenario, the guarantee would decrease about 40 cents for each dollar of lower revenue. Depending on the nature of those revenue reductions, the decrease in the guarantee could be temporary or ongoing.

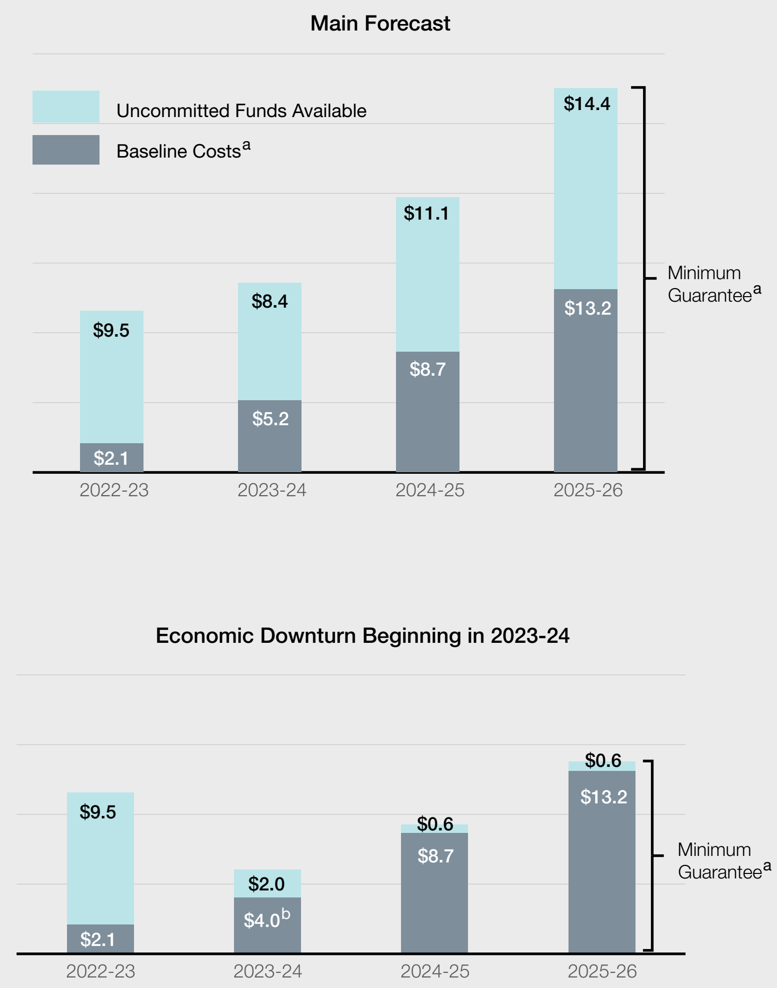
Pension Costs Increasing for School and Community College Districts. Districts make annual contributions to the California State Teachers' Retirement System (CalSTRS) for teachers, faculty, and administrators, as well as to the California Public Employees' Retirement System (CalPERS) for their other employees. To mitigate increases in district contributions, the state allocated more than $3 billion non-Proposition 98 General Fund for district cost relief over the 2019-20 through 2021-22 period. As this relief expires, district contributions are expected to grow significantly. For employees covered by CalSTRS, district costs currently are expected to increase about $1 billion (2.2 percent of pay) in 2022-23. For employees covered by CalPERS, the increase is about $600 million (3.2 percent). Although CalSTRS recently reported investment returns far above its long-term target, these returns are unlikely to reduce required district contributions. Under the funding plan the Legislature adopted in 2013-14, the state General Fund is responsible for most of the volatility in CalSTRS' investment returns. In other words, the General Fund receives the benefit when returns are strong and bears the costs when returns are weak. To the extent that projected district contributions to CalSTRS change in the coming months, they are likely to be somewhat *higher* than current estimates (as we explain in a separate post).

Districts Have Significant Amounts of Unspent One-Time Funds. Since March 2020, the federal government has provided California more than $23 billion in one-time funding for K-12 schools to address learning loss, reopen schools, and cover other pandemic-related costs. These funds have various spending deadlines, but the majority must be spent by September 2024. As of September 2021, California schools reported spending less than 15 percent of available federal funds. Moreover, in March 2021, the state provided an additional $4.6 billion in one-time Proposition 98

Figure 10

Proposition 98 Funding and Costs Under Main Forecast and Downturn Scenario

(In Billions)



[a] Increases in the minimum guarantee and baseline costs are relative to the 2021-22 enacted budget level. Baseline costs include statutory cost-of-living adjustments, costs of previously approved commitments, attendance changes, and required reserve deposits.

[b] Decrease relative to main forecast is due to elimination of required reserve deposit.

funds for similar purposes. (Community colleges have also received a large amount of one-time federal and state funding, and a significant portion remains unspent.)

LAO Comments

Outlook for School and Community College Funding Is Highly Positive. The projected growth in the guarantee under our outlook is extraordinary by several measures. For the upcoming budget cycle, the Legislature has nearly $20 billion to allocate for new commitments, including $10.2 billion in one-time funds related to 2020-21 and 2021-22 and $9.5 billion in ongoing funds related to 2022-23. This estimate of available funding exceeds the amount of new funding in any previous outlook report our office has produced. The pace at which this funding has emerged also is remarkable. Our estimate of the 2021-22 guarantee, for example, is up more than $24 billion (30 percent) compared with the guarantee three years ago. These funding increases provide a significant opportunity for the Legislature to make progress on its school and community college priorities. In the remainder of this section, we outline some considerations and options for allocating this funding.

Setting Aside Some 2022-23 Funds for One-Time Activities Would Mitigate Downside Risk. One preliminary decision for the Legislature involves the overall mix of one-time and ongoing activities to fund using the $9.5 billion available in 2022-23. (The increases associated with 2020-21 and 2021-22 are available only for one-time activities.) If the state were to allocate all $9.5 billion for new ongoing commitments, it could face difficulty maintaining those commitments in 2023-24 unless economic growth exceeds our main forecast. Under our main forecast, the amount available for new commitments in 2023-24 dips by about $1 billion. Under a scenario where the statutory COLA remains at 5 percent, the dip would be closer to $2.5 billion. Although the Legislature could go about determining its mix of one-time and ongoing funding in various ways based on its risk tolerance and spending priorities, one approach would be to set aside at least $2.5 billion for one-time activities to mitigate the risk from the higher inflation scenario. This approach would leave as much as $7 billion in funding available for new ongoing commitments. Setting aside even more one-time funding would provide protection against a larger array of negative scenarios, though the Legislature would have less funding available to allocate for new ongoing commitments. After deciding upon its overall mix of one-time and ongoing spending, the Legislature could then turn to decisions about funding specific school and community college programs.

Options for Allocating Additional Funds to Schools. For K-12 schools, the Legislature could consider allocating additional funding in ways that would build upon existing initiatives, improve services in targeted ways, and/or address historical funding disparities. Below, we outline a few promising options.

- ***Accelerate Expanded Learning Opportunities Program (ELO-P).*** The state created ELO-P in the 2021-22 budget to fund before/after school programs and summer programs for students in Transitional Kindergarten through grade 6. The Legislature and Governor previously agreed to ramp up ongoing funding over the next four years—from $1 billion in 2021-22 to about $5 billion by 2025-26. The state could accelerate this schedule, which would give districts more certainty about their funding levels and potentially improve local planning for these programs.
- ***Equalize LCFF Add-Ons.*** School districts receive $1.4 billion annually from various add-ons to the LCFF, largely based on the size of certain programs they were operating decades ago. The state could use some of the available ongoing funds to equalize these add-ons—for example, ensuring all districts receive a minimum amount per student, regardless of their previous allocations. Equalization would increase general purpose funding and reduce historical disparities in LCFF.
- ***Fund Implementation of Special Education Reforms.*** In recent years, the state has commissioned several studies examining

the delivery of special education to students with disabilities. Their purpose is to make recommendations for improvement in a variety of areas ranging from governance and accountability to coordination of services during important transitions. The state could use one-time or ongoing funds to implement the most promising recommendations.

Options for Allocating Additional Funds to Community Colleges. The Legislature could increase funding for the community colleges by providing more unrestricted funding, more restricted funding for specified purposes, or more support directly to students to address living costs. Below, we provide potential augmentations for each category.

- ***Augment Core Funding for SCFF.*** The SCFF is the primary source of general purpose funding for community college districts. The state could augment core funding for SCFF (beyond the statutory COLA) to help districts cover fixed and other general operating costs and increase overall funding per student. Each 1 percent increase in the base funding for SCFF would cost about $75 million ongoing.
- ***Provide Funding for Facility Maintenance.*** One notable funding need is for renewal of districts' physical infrastructure. Even after receiving a sizeable amount of one-time funds for facilities maintenance in the 2021-22 budget, districts continue to have a large deferred maintenance backlog (likely more than $600 million). The state could provide additional one-time or ongoing funds for deferred or scheduled (on time) maintenance projects.
- ***Provide More Direct Student Support.*** Over the past several years, the state has increased funding for community college students through increased financial aid, food pantries, rapid rehousing programs for homeless students, and student mental health services. To address high living costs for students, the state could increase ongoing funding for financial aid (such as by augmenting funding for the Student Success Completion Grant, which supports eligible low-income students attending college full time) or provide one-time or ongoing funds to support food and housing insecure students. The state also could provide additional funding to further support the mental health needs of community college students.

Crosscutting Options for Allocating Additional Funds. The Legislature could allocate some of the additional funding to address issues facing both schools and community colleges. We provide a few examples below, focusing on options that could mitigate future risks, costs, and uncertainties.

- ***Address Pension Liabilities and Costs.*** The state has a number of options for allocating funds that would improve the funding status of the pension systems and/or provide cost relief for districts. For example, the state could use one-time funds to pay down pension liabilities more quickly, which would also tend to lower district costs over the next several decades. Another approach could focus on smoothing future growth in pension costs, such as by setting aside funds districts would receive if their annual pension costs were to increase by more than a certain amount.
- ***Improve Climate Resiliency and Emergency Preparedness.*** Our office has released several reports examining the effects of climate change, including sea level rise, increasing temperatures, and more frequent and severe wildfires. School and community college districts own and operate more than 10,000 facilities across the state that could be affected. The state could explore providing grants for districts to assess their vulnerability, conduct emergency response planning, purchase emergency equipment, and retrofit buildings to improve their resiliency to these trends.
- ***Make Optional Proposition 98 Reserve Deposit.*** An additional one-time deposit into the Proposition 98 Reserve would increase the protection for ongoing programs in the event of an economic downturn, reducing the likelihood of cuts or deferrals. It also could allow the Legislature to set aside funds temporarily for programs it intends to identify or develop in the future.

LAO PUBLICATIONS

This report was prepared by Kenneth Kapphahn, and reviewed by Edgar Cabral and Anthony Simbol. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.

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