
The FISCAL REPORT *an informational update*

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Volume 31

For Publication Date: January 21, 2011

No. 2

A New Governor, New Approach, Same Old Economic Problems

Unlike the rest of the nation, California's economic woes did not begin with the recession of 2008 and subsequent meltdown of the real estate, financial services, automobile, and other industries. Indeed, California had still not recovered from the financial obligations undertaken during the "dot.com boom" that began more than a decade earlier. The "dot.com bust" in 2000 left the state with a permanent structural Budget deficit. For California, the recession was simply yet another knock-down punch that left the State's Budget writhing on the canvas.

Despite the efforts of past Administrations, the state has not been able to gain acceptance of the fact that the Budget problem is broad, deep and, at least for the foreseeable future, permanent. Past efforts to find one-time patches and short-term fixes have simply not worked and the problem has continued to grow. Residents continue to demand the same service levels that were possible during better days, but without stepping up to pay for the cost of those services. It is clearly time to recognize the new reality, put the past behind us, and move forward.

The Governor's Approach

We were very pleased to see that the Governor has acknowledged that the only major portion of the State Budget that has been reduced significantly since 2007-08 is K-14 education. Re-reading the January Budget Proposals for those years and comparing those proposals to the actual Budgets enacted months later verifies that while Budgets have been created with cuts to most agencies, when the dust settles, cuts to K-14 education have stuck where others have not. This at a time when per-student K-12 spending in particular remains among the lowest in the nation and has fallen even further. We, therefore, believe that it is totally appropriate for the Governor to propose maintaining 2010-11 education spending at the level of the 2010-11 Enacted Budget and flat funding for K-12 education in 2011-12. We are disappointed that community colleges will take yet another cut under the Governor's plan.

We do caution that "flat funding" will not feel very flat to school districts. The loss of federal funds; changes in enrollment; and increased costs for seniority, step and column increases, and health benefits will all cause a continued need for Budget reductions. We expect that most districts will need to seek a continuation of concessions from employees and that, again this March, there will be a sea of pink slips to deal with. However, there is no question that during a time when the state's structural Budget deficit is real and growing, our new Governor is truly trying to protect K-12 education—relative to other segments of the Budget.

But in this environment, there is no such thing as perfect protection. We will not get relief from the substantial cuts we have already taken. It is also not clear as to whether we will benefit from what may be an improving economy, particularly for 2011-12. Extension of temporary taxes (i.e., a 0.25% surcharge on the income tax, a 1¢ increase in the sales tax, a 0.5% increase in the vehicle license fee, and a reduction in the dependent deduction) provides nearly a third of the Governor's Budget solutions and that extension would be put to voters in a June 2011 special election.

Education will continue to do more than its share in providing Budget relief to the state in both 2010-11 and 2011-12 even with the "flat funding" proposed by the Governor. For that reason, we strongly believe that the state should guarantee education at least flat funding for 2011-12, whether the continuation of the temporary

taxes is approved by voters or not. The Governor has given education proponents a good reason to support extension of the temporary taxes.

The proposal for community colleges is a net reduction of almost \$300 million accompanied by an increase in the enrollment fee of \$10—from \$26 to \$36 per unit. While the Governor points out that this would remain the lowest per unit cost in the nation, we view community colleges, Regional Occupational Centers and Programs (ROC/Ps), Adult Education, and Career Technical Education as pathways to the future. Further reducing opportunities in these already hard-hit areas creates a barrier to recovery. We are eating the seed corn.

Longer Term Prospects

Over the longer term, it is clear that Californians have some difficult choices ahead. The cost of providing services is increasing and revenues are just not keeping up. The choice between higher taxes or lower service levels is particularly difficult because the people who pay the most taxes enjoy relatively few government services. Given that the top 1% of taxpayers continue to pay half the state income tax and that the next 49% pay the other half, these taxpayers have been hardest hit by tax increases. The 50% of Californians who pay no income taxes have generally been more likely to be tax receivers and disproportionate beneficiaries of state services. The disconnect between who pays and who receives has grown, as the top 1% owe far less in taxes because they have experienced large reductions in income as the recession has wiped out the construction, real estate, natural resources, and financial services industries.

Long standing entitlement programs that cause California to spend more than other states for health, welfare, prisons, and other social services compete with education for fewer dollars now and into the future. The choice is clear: more taxes or fewer services. But the answer to that question is one of the most complex facing the state.

It is abundantly clear that California's most valuable asset, now and forever, is its educated workforce. Strong economic, political, and social growth all depend upon strong educational programs. We cannot tolerate a system where only the children of the rich and privileged are prepared to take our state forward. Our K-14 educational programs allowed our state to become the 7th largest economy in the world. If we want more taxpayers and fewer tax receivers in the future, education is how we achieve that goal.

Summary

California's chronic Budget problem can be compared to an individual resident who once had a good high-paying job and lost it. Initially, the individual believes that he will regain the high-paying job soon, but accepts a much lower paying "temporary" job. He reduces his expenditures a bit, but uses savings and borrowing to maintain his lifestyle. Then one morning, he wakes up and realizes that the high-paying job is not coming back any time soon and that the low-paying job is his new reality. He also realizes that he is out of savings and heavily in debt. Welcome back Governor Brown!

The Economy and Revenues

The Economy

While the 18-month "Great Recession" was declared over as of June 2009, most people remain unconvinced that a rebound is underway. The national unemployment rate stands at 9.4% as of December 2010, with only minor job gains registered thus far. Federal efforts to spur the economy have had mixed results, with stimulus funds being used to avoid further layoffs. Permanent job creation, however, remains elusive. The Governor's Budget does not anticipate a "double dip" recession, but acknowledges that the overall pace of recovery will be slow.

The Governor's Budget acknowledges this broad weakness in the California economy as well. California

suffers from an even worse job market than the nation as a whole, with the unemployment rate at 12.4%, the third highest in the nation. The Governor's Budget notes that the economy appeared to be on the mend in spring 2010, but stalled out as problems in Europe spread fear and anxiety throughout the globe. California's economy in particular is greatly influenced by international developments since a significant portion of its business activity is tied to international trade.

The outlook for California is similar to that of the U.S., with a slow recovery predicted. New home construction suffered a three-year decline beginning in 2006, but a glimmer of hope is emerging as new home permits are up 18% for the first ten months of 2010 compared to 2009—admittedly, a very low base year. Personal income, the broadest measure of economic activity statewide, fell in 2009 for the first time since 1938, but is projected to increase 3.8% in 2011 and 4% in 2012. These increases, however, are relatively weak compared to the average growth rate in personal income of 5.1% between 1989 and 2009. Taxable sales are forecast to show stronger increases of 7.1% in 2011 and 8.6% in 2012. Unfortunately, even with these positive economic activities, the unemployment rate is expected to exceed 11% through 2012 and it will not be until 2016 when payroll employment in the state reaches the pre-recession peak. And all of the improvement relies on *forecast* improvement; therefore, actual data does not reflect that degree of improvement.

State Revenues

Baseline revenues are projected to grow slowly, in line with the tepid pace of the economic recovery. However, overall revenues are bolstered as a result of policy changes that retain certain temporary taxes that are set to expire this year and through other changes in tax law that will generate new revenues.

The Department of Finance (DOF) projects underlying revenue growth to provide an additional \$2.3 billion in 2011-12, but the expiration of temporary taxes (i.e., a 0.25% surcharge on the income tax, a 1¢ increase in the sales tax, a 0.5% increase in the vehicle license fee, and a reduction in the dependent deduction) results in a loss of about \$8.8 billion in revenues, or about 7.9% from the baseline level.

In order to address this revenue loss, the Governor's Budget proposes a five-year extension of the temporary taxes, along with other changes to the corporation tax and tax shelter amnesty. These changes raise General Fund revenues by \$9.6 billion over 2010-11 and 2011-12 combined compared to the baseline projections without these policy changes.

Under the Governor's proposal, General Fund revenues are boosted over the baseline estimate, but nevertheless decline on a year-over-year basis. The Governor's Budget displays a drop in revenues of \$4.5 billion in 2011-12, or 4.8%, to \$89.7 billion.

More importantly, the Governor has indicated that his revenue proposals must be approved by state voters in order to be enacted. Two years ago the Legislature, through a two-thirds vote, approved the package of temporary taxes. While the Legislature has the authority to extend these taxes, the Governor instead wants to have the voters decide their fate. Thus, we will not know whether these revenues are part of the Budget solution until after a special election scheduled for this June.

Proposition 98

Proposition 98 sets, in the State Constitution, a series of complex formulas that establish the minimum funding level for K-12 education and the community colleges from one year to the next. This target level is determined by prior-year appropriations that count toward the guarantee, plus (1) workload changes as measured by the change in average daily attendance (ADA) and (2) inflation adjustments as measured by the change in either per capita personal income or per capita state General Fund revenues, whichever is less. Under certain circumstances, which are projected to be the case in 2011-12, the minimum level is set by a fixed percentage of General Fund revenues.

The Governor's Budget projects that the Proposition 98 guarantee for 2011-12 will be \$49.3 billion, slightly

less than the \$49.7 billion included in the 2010-11 Budget Act. The Governor's Budget proposal is dependent on voters taking action to extend for five additional years, approximately \$8.8 billion in temporary taxes due to expire at the end of 2010-11. Of this amount, around \$5 billion would be counted as General Fund revenue towards the Proposition 98 calculation. As a result, absent an extension in these taxes, the Governor's Budget estimates that the Proposition 98 guarantee, and level of funding the Governor proposes to provide, would drop by \$2.3 billion.

For the Budget year, the minimum guarantee is determined by Test 1—a fixed share of General Fund revenues—which is set at 41.2%. As a result, if state revenues grow to exceed current projections, the minimum guarantee would rise proportionally, or if they miss expectations funding could be lower.

Although it is expected to be a Test 1 year, it appears that the Proposition 98 Maintenance Factor may grow, adding several hundred million dollars to the \$9.7 billion anticipated for 2010-11. Based on the Proposition 98 formula, repayment of the Maintenance Factor would begin when state revenues recover.

For 2010-11, the Proposition 98 guarantee was not a factor because Proposition 98 was suspended. However, for 2011-12, the Governor has given a strong indication that he will fund the minimum guarantee. There are two possible avenues for improvement of the guarantee: (1) continuation of the temporary taxes or (2) improved economic growth. We need at least one, if not both, of these factors to come to pass to avoid funding cuts in 2011-12.

Revenue Limits

Revenue limits provide about two-thirds of school districts' revenues and the vast majority of general purpose funding. For the current year, the Governor's Budget proposes no change in revenue limit funding. Many educators have worried that the state's Budget problems would result in midyear cuts for 2010-11. The Governor has proposed no midyear reductions for K-12 education revenue limits.

For 2011-12, the Governor's Budget projects the statutory cost-of-living adjustment (COLA) at 1.67%, but proposes to not "fund" the COLA by increasing the K-12 Deficit Factor to 19.608%. For the Budget year, we estimate the positive COLAs to be \$102 per ADA for elementary districts, \$123 per ADA for high school districts, and \$107 per ADA for unified districts (see table below).

	2010-11	2011-12
Statutory COLA	-0.39%	1.67%
COLA Amounts		
Elementary	-\$24.00	\$102.00
High School	-\$29.00	\$123.00
Unified	-\$25.00	\$107.00
Deficit Factor	17.963%	19.608%

The estimated deficit factor of 19.608% calculated by the DOF is somewhat higher than that calculated by School Services of California Inc., (SSC). We estimate the deficit factor necessary to eliminate the COLA to be about 0.3% lower. We continue to work with the DOF to reconcile the factors used in the calculation and will reflect our calculation on the revised SSC Dartboard later this week.

Special Education

For special education, the Governor purports to fund the program generally at the 2010-11 level and provides a small federal increase (approximately \$3.38 per ADA) as a supplement to the base. The Budget proposal includes \$7.4 million to fund special education enrollment growth, roughly \$465 per-ADA, and, similar to revenue limits, does not fund the statutory 1.67% COLA. The Governor also proposes that Assembly Bill (AB) 3632 services provided to county mental health agencies be paid out of Proposition 63 funds in 2011-12

and commencing in 2012-13 out of the dedicated revenue source he proposes is created as part of his proposed realignment plan. The proposal includes a restoration of the \$70 million in the Department of Social Services budget to fund residential placements for youth accessing services through the AB 3632 program in the current year. The Budget documents refer to providing \$98.6 million for prior-year costs and we are seeking clarification on which years the funding will cover.

The Governor's proposal must be approved by the Legislature; however, if adopted, would resolve the chaos that has ensued as a result of former Governor Schwarzenegger's veto of \$133 million for AB 3632-related mental health services to students with disabilities and declaration that the mandate is suspended. That action resulted in major lawsuits that are beginning to wind their way through the courts and will hopefully reach a resolution in the near future.

Categorical Programs

There is no funding for categorical program growth, with the exception of special education, nor the estimated 1.67% COLA. The Governor continues to fund all categorical programs at the level provided in 2010-11 including, but not limited to, the Quality Education Investment Act (QEIA) and After School Education and Safety Program (Proposition 49).

The Governor proposes extending flexibility measures introduced in 2008-09 by an additional two years. This includes Tier III programs, reduction to the required routine maintenance contributions (3% to 1%), eliminating Deferred Maintenance program matching requirements, delaying instructional materials adoption timelines, and continuing the more relaxed K-3 Class-Size Reduction (CSR) program penalty structure, among others. In addition, the Governor proposes to continue to authorize districts to reduce their minimum budget reserves.

Extension of categorical flexibility provides welcome relief; the multiyear projections (MYPs) to be provided with 2011-12 district budgets in June 2011 will show large gaps if flexibility is not extended.

Child Care

The Governor's Budget proposes significant reductions to health and human services programs, including California Work Opportunity and Responsibility to Kids (CalWORKs) and related child care programs. Specifically the Governor's Budget proposes to decrease Proposition 98 funding for child care by \$716 million in 2011-12. This reduction would result in more stringent eligibility restrictions including eliminating children ages 11 and 12 from receiving services, along with any families that are above 60%, rather than the current 75%, of the State Median Income, putting the income threshold for a family of four at approximately \$45,450. Offsetting the reduction in funding is additional local flexibility that would allow copayments made to providers to be retained by local agencies. That would in part increase the latitude local agencies have to determine how to structure the fees and delivery of services to meet local needs.

Child Nutrition

The Governor's Budget includes increases in federal funding for child nutrition to support program growth and additional funding for the Fresh Fruits and Vegetable Program. A total of \$36.1 million in federal funding is proposed for program growth, along with \$12.0 million to expand the Fresh Fruits and Vegetable Program, which provides additional free fresh fruit and vegetable snacks to students during the school day.

Charter Schools

The Governor's proposal includes an increase of \$16.1 million for charter school funding—General Purpose Block Grant and Categorical Block Grant—due to growth in ADA. The table below reflects estimated 2011-12 charter school funding rates.

The General Purpose Rates are based on statewide average revenue limits—and thus reflect the 1.67% COLA that is then reduced in total by the adjusted deficit factor of 19.608%. The rates also reflect changes in the statewide cost of the revenue limit adjustments for unemployment insurance and the Public Employees' Retirement System (PERS) Reduction. These rates will be recalculated by the California Department of Education (CDE) at each apportionment during 2011-12 and can fluctuate up or down by more than \$20 per ADA.

2011-12 Estimated Charter School Rates				
	K-3	4-6	7-8	9-12
General Purpose Block Grant	\$5,030	\$5,106	\$5,252	\$6,097
Categorical Block Grant	410	410	410	410
Total	\$5,440	\$5,516	\$5,662	\$6,507

Source: Department of Finance
 Caution: The General Purpose Rates are rough estimates; actual rates may change considerably

Mandate Reimbursements

Under current statutory and constitutional law, the state may direct local agencies to provide new services to the public, but must also reimburse those agencies for costs incurred in providing those services. Over the years, the state generally honored this pact until it faced a Budget gap commencing in 2001-02. In that year—and in every year since, with the exception of 2006-07—the state has elected to sidestep its obligation to reimburse local agencies for mandated costs and instead has deferred payments to some unspecified future fiscal year. During this period, school districts were not freed of the obligation to provide the mandated service, but instead were required to maintain services and fund them from existing resources. The 2010 Budget Act reversed four years of deferred payments for state mandates by providing \$300 million to reimburse local educational agencies (LEAs) and community college districts for prior-year mandate claims that have gone unpaid (\$210 million), as well as recent claims filed for 2009-10 (\$90 million).

In 2011-12, the Governor's Budget proposes ongoing funding of \$89.9 million for K-14 mandates to provide level funding, relative to 2010-11, for reimbursement of state-mandated local costs. The proposal continues suspension of nine education mandates included in the 2010-11 Enacted Budget:

Proposed Ongoing Suspension of Mandates	
Removal of Chemicals	Health Benefits for Survivors of Peace Officers and Firefighters
Pupil Residency Verification and Appeals	Law Enforcement Sexual Harassment Training
School Bus Safety I and II	County Treasury Withdrawals
Physical Education Reports	Grand Jury Proceedings
Scoliosis Screening	

It appears the Governor recognizes that state mandated programs must be fully funded and is not considering budgeting "placeholders" to defer reimbursements, as was the practice for many years.

School Facilities

While the Governor's Budget focuses primarily on the operating budget for 2011-12, capital budgets are also affected. While the district operating budget benefits from continuation of flexibility in deferred maintenance and routine restricted maintenance, the capital budget suffers to an equal degree. Flexibility, once envisioned as temporary, would be extended to a term of seven years under the Governor's plan. Facility planners know that, even though the dollars may be desperately needed on the operating budget side, seven years of minimal maintenance expenditures will most certainly lead to big repair bills later. Coupled with absence of a new

statewide school facilities bond, facilities funding is minimal indeed. Thus, in the context of protecting programs for students now, we support continuation of this flexibility. However, this is not a cost-free option; there will be a piper to be paid.

Deferred Maintenance

The Governor's Budget proposal extends Deferred Maintenance flexibility for two additional years, with the state funding its contribution with \$250.8 million in the 2011-12 State Budget. LEAs would not be required to make the match to receive the funds through 2014-15.

Routine Restricted Maintenance Account

LEAs continue to have the ability to reduce the amount they must deposit into a routine restricted maintenance account for two additional years. The flexibility was allowed beginning with the 2008-09 fiscal year through 2012-13. The Governor's Budget proposal extends the flexibility through 2014-15.

The exemption allows a district to reduce its contribution from 3% of General Fund expenditures to 1%; however, if the school district maintains its facilities in good repair, as defined in Education Code Section (E.C.) 17002, it shall be exempt from this 1% requirement.

As with all flexibility, agencies must review their options locally and utilize the flexibility provisions as reasonable and applicable.

Lottery Funding

The California Lottery has transferred more than \$1 billion to LEAs annually for each of the past ten plus years. Lottery funding continues to be a welcome source of revenue for school agencies. The 2009-10 fiscal year ended with a 2% increase in Lottery funding for LEAs followed by a projected 1% increase for the 2010-11 fiscal year. No adjustments have been made to the original Budget adopted by the Lottery Commission in June 2010.

In the first quarter of 2010-11, the per-ADA amount distributed to LEAs by the State Controller's Office was approximately 12.5% lower than the first quarter apportionment of 2009-10. The 2009-10 first quarter Lottery payment was \$29.52 per ADA (unrestricted), which was a decrease of \$4.22 per ADA. Despite the lower per-ADA amounts in the first quarter, the Lottery Commission expects to make its sales goal for 2010-11 by the end of the fiscal year, which should mean funding increases to anticipated levels.

Based on the Lottery Commission forecast, we are projecting revenues for the 2011-12 fiscal year at \$111 per Annual ADA (unrestricted) and \$18.50 per Annual ADA (restricted), a decrease of 1% from the projected 2010-11 level.

Federal Programs

In the fall of 2010, Congress approved a multibillion dollar "Jobs Funding" bill to support education programs and related services for early childhood, elementary and secondary education, and other public sector services. California's share of the one-time funding was \$1.2 billion and is required to be used for salaries and benefits and other expenses associated with rehiring staff, retaining existing employees (avoiding lay offs), and hiring new staff to provide educationally related services and expenses incurred as of, but not prior to, August 10, 2010. The deadline for these one-time funds to be spent by school agencies is September 30, 2012.

Stimulus and Jobs Bill

Federal funds have been used to back fill losses from state-level funding cuts. There are no active bills at the

federal level to provide another round of one-time funding. Thus, in 2011-12, the loss of these important funds will be absorbed by districts. It will feel a lot like a budget cut.

Normal ongoing federal funding is anticipated to remain relatively unchanged in 2011-12, but there is a possibility that this could change with the pending reauthorization of the Elementary and Secondary Education Act and action to approve a 2011 Federal Budget. Before the end of the last session of Congress, a temporary extension of the current federal spending plan was approved.

Special Election

The proposed Governor's Budget assumes that all statutory changes necessary to implement programmatic reductions in the proposed budget are proposed to be in place within 60 days. The Governor also presumes that the proposed five-year extension of the temporary taxes will be placed on a June special election ballot with a two-thirds vote of the Legislature. Governor Brown indicated that he envisions that his proposed reductions would go into effect, regardless of the outcome of the special election so that voters can clearly see what they are voting on and the choices that they are making.

The actual State Budget would be voted on by the Legislature after the outcome of the special election is known.

Realignment

One of the hallmarks of the Governor's proposed 2011-12 State Budget calls for a shift of government services so that services are provided by the level of government that can best and most cost-effectively do so. The proposal also includes a permanent funding source which must be approved by voters as part of the special election in June. The proposal envisions shifting the following programs to the local level:

- Fire and Emergency Response
- Court Security
- Public Safety Programs supported by Vehicle License Fees
- Lower-Level offenders and Parole Violators
- Adult Parole
- Juvenile Justice Programs that haven't already been shifted to counties
- Mental Health Services (including AB 3632)
- Substance Abuse Treatment
- Foster Care and Child Welfare Services
- Adult Protective Services

Implementation will be phased in, with the first phase proposed to be funded with \$5.9 billion in revenue generated by extending the current tax rates on the Vehicle License Fee and by extending the 1% increase in sales tax. Mental health services, including AB 3632 services, are proposed to be shifted in 2012-13 and will be funded with dedicated revenues.

Deferrals

In order to accommodate the flat funding level proposed by the Governor, the Budget contains an additional deferral of \$2.1 billion from the 2011-12 K-12 revenue limit funding to 2012-13. This is in addition to the \$7.8 billion in deferrals that currently exist in statute. This will bring the deferrals to more than \$10 billion for K-14 education. The detail regarding the timing of receipt of cash from the additional deferral has yet to be determined.

—SSC Staff

posted 01/10/2011