EdSource REPORT

Clarifying Complex Education Issues®

JANUARY 2011

School Finance Highlights 2010–11

As Gov. Jerry Brown prepares to release his budget proposal for the upcoming fiscal year, California must contend not only with a massive projected deficit for 2011–12, but also a sizable gap in the current $87 billion general fund budget. For both years combined, the state's budget deficit is about $28 billion.

California faces several financial challenges

Some of the methods that policymakers used to address budget deficits in the recent past are, or soon will be, unavailable. For example:

- All federal stimulus funds to help states with their budget problems have been distributed. Most of that funding must be spent by the end of September 2011, and "EduJobs" funding must be spent by the end of September 2012. (See page 2.)
- The state can no longer borrow from local governments as a result of Proposition 22, passed by California voters in November 2010.
- Temporary tax hikes enacted in 2008 are expiring, and many one-time revenue sources such as accelerated tax receipts have already been used.

The state will eventually have to cover other large payments:

- Unfunded liabilities of at least $100 billion in government employee pension funds.
- A $10 billion deficit in the Unemployment Insurance Fund.
- Repayment of $15 billion borrowed to close deficits in the recent past.

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The state entered 2010–11 with a long-standing imbalance between ongoing spending and income. Unrealistic assumptions—including, for example, banking on a large increase in federal funding that has not materialized—have helped create that ongoing gap. This pre-existing structural deficit makes it especially challenging to close the current shortfall.

In addition, many of the options used to address past deficits are now, or soon will be, closed off. And the budget deficit is not the state's only financial challenge. (See the box to the left.)

Leading up to the release of his 2011–12 budget proposal, Brown signaled an intention to get the state to face up to its dire fiscal situation. In December 2010, before being sworn into office, Brown sponsored two meetings designed to build a common understanding of the problem. At a forum with education leaders, Brown said "the day of reckoning is upon us." Regarding education specifically, he said, "I can't promise you there won't be more cuts because there will be."

The governor made these statements just two months after state policymakers suspended Proposition 98 as part of enacting a budget for 2010–11. It was only the second time state leaders had suspended the measure since voters passed it in 1988, establishing in the state constitution a minimum funding guarantee for K–12 schools and community colleges.

This EdSource report discusses that budgetary decision and others made in 2010–11 that will affect K–12 education this year and going forward. The current year situation provides important context for understanding Brown's budget proposal for the upcoming year and its potential impact on K–12 education.

Revenues for K-12 schools are down nearly 10% this year compared with 2007-08

The 2010–11 state budget was the third in a row with a substantially reduced funding level for K–12 education as compared with 2007–08, the year before the recent recession significantly impacted the budget. The drop-off has been most acute in the current year. According to data from the California Department of Education (CDE), the state's K–12 education system received a total of $71.1 billion in 2007–08 from all local, state, and federal sources and is receiving $64.4 billion in 2010–11.

A sizable portion of that total—about $7.8 billion in 2010–11—does not directly fund current operations of K–12 schools but rather goes to state agencies such as the CDE, debt service on local capital projects, and programs such as adult education and child care. Considering only the operating funds for K–12 schools, the total revenues are $62.9 billion for 2007–08 and $56.7 billion in 2010–11, a decrease of $6.2 billion or nearly 10%.

These funds come from five sources—monies from the state general fund and local property taxes that count toward the Proposition 98 minimum funding guarantee, federal dollars, miscellaneous funds that local school agencies raise, and lottery funding.

Figure 1 shows the amounts of K–12 education funding from those five sources and how they have changed during the past six years.

State funding has seen the greatest drop

Education revenues from the state's general fund and local property taxes have declined substantially since 2007–08. For example, state funding went from $37.8 billion in 2007–08 to $32.0 billion in 2010–11. In percentage terms, that 15.3% reduction is similar to the 16.2% decrease in total state general fund expenditures between those two years.

Along with revenue reductions, California's schools must contend with funding delays. A total of $7.3 billion for services provided in 2010–11 will not arrive until the early part of 2011–12. The amount of delayed funding represents 23% of the Proposition 98 general fund spending on K–12 education.

Local property taxes are collected by counties, but the state determines their distribution among local governments, including education agencies. The 8.4% decline in schools' property tax revenues was considerably smaller than the decrease in general fund revenues but still significant. Fortunately for schools, the state's education finance system requires the general fund to backfill any decrease in their property tax revenues.

Extra federal funding will soon be exhausted

Federal stimulus funding partially compensated for reductions in state general fund and local property tax revenues. Through the American Recovery and Reinvestment Act that Congress enacted in February 2009, California's K–12 education system received more than $6 billion. Those funds will soon be exhausted, and federal policymakers are not currently planning to provide another installment. However, they did pass an "education jobs" bill in August 2010, which provided California school agencies with an additional $1.2 billion for saving or creating positions. The EduJobs money must be spent in 2010–11 and 2011–12.

The remainder of federal funding comes from programs such as Child Nutrition, Special Education, and Title I of the Elementary and Secondary Education Act, which provides grants to school districts to support students from low-income families.

Other, smaller funding sources have remained relatively stable

Local miscellaneous sources provided 8.7% of total revenues in 2008–09 and 2009–10, a little more than is typical. This year, they are projected to provide 7.7%, a slightly reduced portion. Local miscellaneous funds include, for example, interest income; parcel taxes; lease and rental income; and donations from parents, foundations, and local companies.

One factor contributing to the predicted decline in local miscellaneous funding could be a decrease in interest income, in part due to districts spending down reserve funds that would otherwise earn interest. The statewide

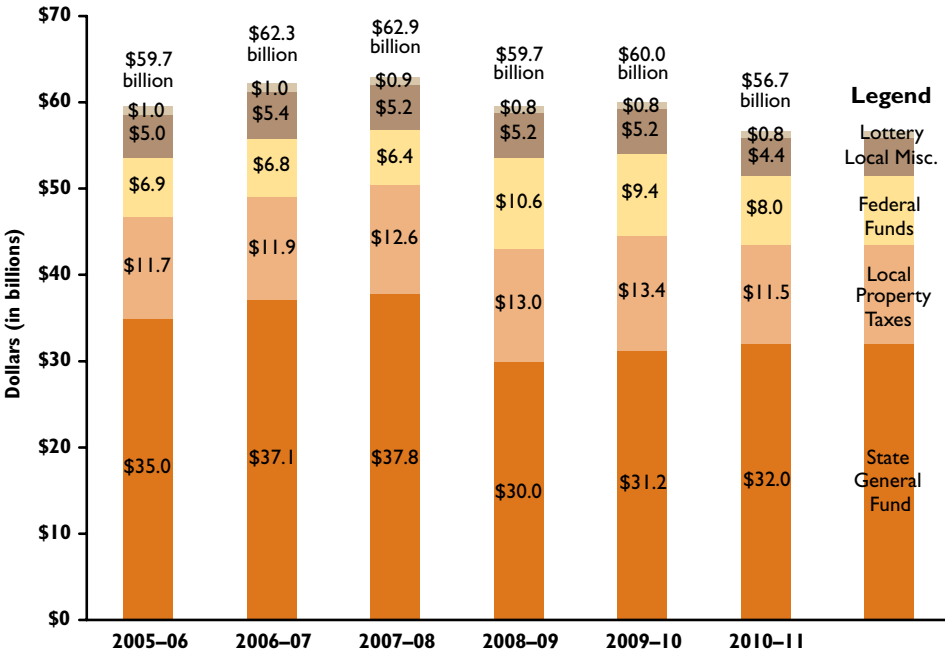
School districts receive funding in two forms

Funding comes to local education agencies—school districts, county offices of education, and charter schools—either as restricted or unrestricted.

Unrestricted revenues, which represent about 70% of the average district's funding, can be spent at the district's discretion. These monies are often referred to as general purpose funds. The primary source of unrestricted or general purpose monies is revenue limit funding, which some people refer to as "ADA funding" because it is based on a district's average daily attendance.

Restricted revenues are dedicated to a specific category of activities or type of students (e.g., English learners). Many of these latter funding sources are thus called "categorical" programs.

figure 1 | **K–12 education revenues from the state's general fund dropped dramatically in 2008–09**



Note: This does not reflect certain revenues for California's K-12 education system—namely, local debt service, contributions from the state general fund and local property taxes that do not count toward the Proposition 98 minimum funding guarantee, and other state funds. In 2010-11, those funds totaled about $7.8 billion. Those monies generally do not support current operations of K-12 schools.

Data: California Department of Education (CDE) EdSource 1/11

total of districts' interest income went from $469 million in 2007–08 to $268 million in 2008–09, according to the Education Data Partnership website. More recent data are not available, but anecdotal evidence suggests that spending of reserves has only increased since 2008–09.

The state lottery is projected to provide about $800 million—a smaller amount and percentage than it provided between 2005–06 and 2007–08. On a per-pupil basis, the lottery is expected to provide about $130 in 2010–11—$112.50 in unrestricted funds and $17.50 dedicated to instructional materials.

Proposition 98 offers limited protection to education funding

Proposition 98 provides a process for determining the minimum amount the state must spend on K–12 schools and community colleges each year. The complicated set of tests related to Proposition 98 also gives state leaders the ability to both adjust spending downward when state revenues are low and suspend the guarantee in a given year. But in both cases, the process also creates a promise that, over the long term, the funding levels are supposed to be restored to what is referred to as the long-term Test 2 level.

Understanding the three tests of Proposition 98

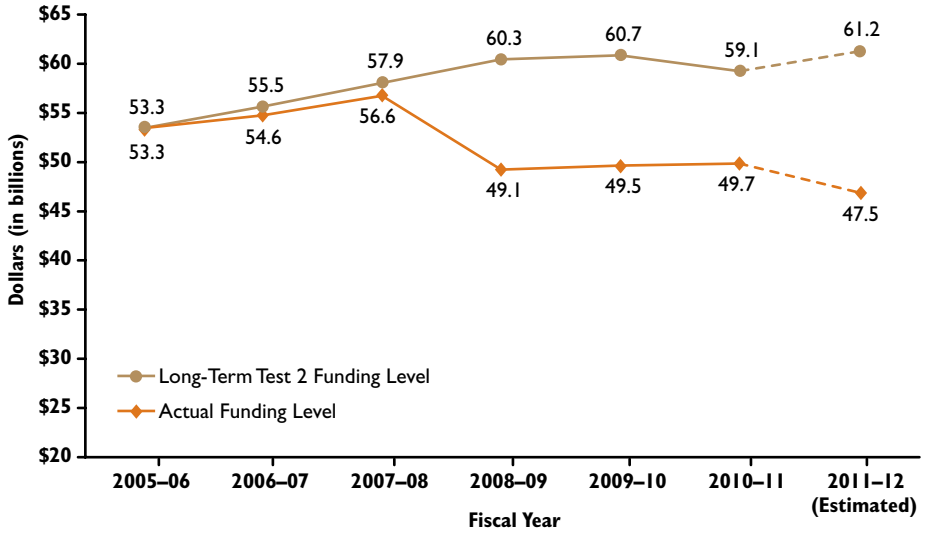
The minimum spending level under Proposition 98 is determined by one of three "tests" or formulas. Several factors influence which test is used to set the minimum guarantee, but the most important are the annual changes in statewide K-12 student attendance, per capita personal income, and per capita general fund revenues.

TEST 1 **Percentage of General Fund Revenues** Times used: 2	**Requirement** K-14 education must receive a minimum percentage of general fund revenues, currently about 40%. **When is it operative?** When it would provide more money than Test 2 or 3. It has been used in 1988-89 and 2009-10.
TEST 2 **Adjustment Based on Statewide Personal Income** Times used: 12	**Requirement** K-14 education must receive at least the same amount of state aid and local property tax dollars as received the prior year, adjusted for changes in attendance and per capita personal income. **When is it operative?** Generally, when state general fund revenues experience normal or strong growth over the prior year. (Specifically, it is used when the percentage growth in state per capita personal income is less than or equal to the percentage growth in per capita general fund revenues plus 0.5%.)
TEST 3 **Adjustment Based on Available Revenues** Times used: 7	**Requirement** K-14 education must receive at least the same amount of state aid and local property tax dollars as received in the prior year, adjusted for changes in attendance and per capita general fund revenues, plus 0.5% of the prior year Proposition 98 spending amount. **When is it operative?** Generally, when general fund revenues fall or grow slowly over the prior year. The intent is to allow, but not require, education funding to be responsive to the state's reduced revenue level. (Specifically, it is used when the percentage growth in statewide per capita personal income is greater than the percentage growth in per capita general fund revenues plus 0.5%.)
SUSPENSION Times used: 2, including in 2010-11	Proposition 98 can be suspended for a year with a two-thirds vote of the Legislature and concurrence of the governor. If suspended, policymakers have great discretion as to the level of funding they provide. Besides 2010-11, it was also used in 2004-05.
MAINTENANCE FACTOR	If Test 3 is used, or if Proposition 98 is suspended, the state keeps track of the amount that would have been provided if Test 2 had been in effect. Eventually, the state must bring spending up to what it would have been if Test 2 had consistently applied. Restoration is to begin in the next year in which the percentage growth in per capita general fund revenues exceeds the percentage growth in per capita personal income. (Specifically, the minimum amount that must be restored in a given year is one-half of the difference between those two percentages times the current-year level of general fund revenues.)
SETTLE UP	When state leaders craft a budget for the upcoming fiscal year, they must estimate what the minimum Proposition 98 spending level will be before the fiscal year starts. If, during the course of the fiscal year, the estimate turns out to be too low, the state must later make up the shortfall. The amount of the shortfall is often referred to as the "settle up" amount.

Proposition 98 funding has not been funded at the long-term Test 2 level for several years

Figure 2 indicates that the last year that the state funded schools and community colleges at the long-term Test 2 level was 2005–06. The gap between the "actual funding level" and the "long-term Test 2 funding level" represents education's call on state dollars in the future. When state revenue growth comes back to a healthy level, policymakers will have to get the K–14 education funding level back on track. This is not the same as paying back all the "lost" funding, but it does mean that the Test 2 funding level is the default minimum whenever the state can afford it and that some compensation is made when feasible. The restoration to the long-term Test 2 funding level does not have to occur all at once. In fact, in the past the restoration has been gradual.

figure 2 **K–14 Proposition 98 funding estimates, 2005–06 through 2011–12: In recent years, actual funding has been substantially lower than long-term Test 2 levels**



Data: Legislative Analyst's Office (LAO) EdSource 1/11

This year's K–14 Proposition 98 funding level is $49.7 billion

For 2010–11, the K–14 Proposition 98 minimum estimated at the time of budget adoption was $53.8 billion. (The minimum would have been based on Test 1, not the long-term Test 2 amount.) Providing that level of funding would have required more revenue increases or cuts to noneducation services than policymakers wanted to make. Instead, they suspended Proposition 98 and provided $49.7 billion. As Figure 2 shows, the Legislative Analyst's Office (LAO) estimates that the 2010–11 Proposition 98 actual funding level is more than $9 billion below the long-term Test 2 requirement.

The $49.7 billion provided in the 2010–11 budget act represents a slight increase from the $49.5 billion in Proposition 98 funding in 2009–10. However, now that 2009–10 is over and all of the state's revenues and expenditures have been accounted for, the Proposition 98 minimum funding level for 2009–10 should be adjusted to $51.4 billion, according to the Legislative Analyst's Office. The state must eventually settle up the difference between what was provided last year and that recalculated minimum.

Charter school funding reflects the changes that regular public school funding has undergone

California's method of funding charter schools and the amount they receive is derived from the general school funding system. Charters receive a general purpose block grant that is similar to districts' revenue limit funding in purpose and amount. In addition, charters automatically get categorical program dollars through a block grant and may apply for other categorical funding. Charters also receive a grant in lieu of Economic Impact Aid (EIA). Both the categorical block grant and "in lieu of EIA" grant are discretionary, meaning that the funding can be spent as charter schools choose. In addition, charter schools receive the same amount of lottery funding per pupil as districts get.

Charter schools' general purpose block grant amounts vary depending on the grade span they serve and are based on the average of what the state pays in revenue limit funding. The funding amounts for charter schools therefore reflect the recent decreases to revenue limit funding.

The categorical block grant is provided in place of a few dozen of the categorical programs for which districts receive funding. In 2010–11, charters are getting $410 per pupil through the categorical block grant. This amount is down from the $500 they began receiving in 2007–08, reflecting cuts to categorical programs that the K–12 education community as a whole has absorbed. Charters cannot apply separately for categorical programs included in the block grant (cannot be double funded). But they can apply for other programs—such as K–3 Class Size Reduction, subsidized meals, and other smaller programs—that are outside the block grant. Some charter schools also receive federal Title I funds to provide extra support to low-income students.

Charter schools that began operating in 2008–09 or later are also receiving a supplemental categorical block grant payment of $127 per pupil. This is to compensate for a design flaw in a policy enacted beginning two years ago. When lawmakers decided in February 2009 to reduce funding for about 40 categorical programs and make the funding discretionary, they specified that local school agencies would get the same percentage of the statewide total funding for those programs going forward as they did in a "base year" (generally 2008–09). For example, if a district or charter school received 1% of all

the funds allocated statewide for those programs in the base year, then it would receive 1% of the reduced amount in subsequent years. Because charter schools that began operating only recently did not have a well-established "base year" funding amount, they were precluded from receiving funding for the newly flexible categorical programs. The $127 per pupil is meant to compensate these new schools.

Figure 3 shows the funding rates for charter schools as estimated by the California Department of Education.

The extra general purpose money that some charters also receive in lieu of EIA funding is allocated based on the number of students at a school who are identified as low-income or English learners. It is estimated that charters will get $319 per eligible pupil in 2010–11. Students who are both low-income and English learners generate double the amount, similar to what happens with noncharter schools. A concentration bonus is provided if the majority of students in the school are eligible. A minimum per-school amount of EIA funding is granted to very small schools. If the number of eligible students exceeds state estimates, the actual amount per pupil would be reduced because the funding comes from a fixed appropriation.

Like noncharters, charter schools also receive Special Education funding and must use a portion of their general purpose funds to cover the costs of educating any special-needs students whom they serve when state and federal funds are inadequate to fully fund those costs.

Charter schools can receive funding for facilities or actual building space through three main avenues. First, they can access state bond funds for facilities construction. Second, if they are serving a primarily low-income population, they can receive rent or lease assistance. In 2009–10, the state began providing rent/lease-assistance as grants, rather than as reimbursements after the costs are incurred. However, funding for this program in 2010–11 must first be used to reimburse eligible charter schools for 2009–10 costs and then be used to fund schools that are eligible in 2010–11. Finally, Proposition 39, passed by the state's voters in November 2000, requires school districts to provide charters serving at least 80 students from the district with furnished and equipped facilities that are reasonably equivalent to other buildings in the district.

figure 3 | **Estimated 2010–11 funding rates for all charter schools**

	K–3	4–6	7–8	9–12
General Purpose Block Grant	$5,054	$5,128	$5,278	$6,142
Categorical Block Grant	$410	$410	$410	$410
Total	**$5,464**	**$5,538**	**$5,688**	**$6,552**

Data: California Department of Education (CDE) EdSource 1/11

The 2010–11 budget package contained important policy changes—most notably regarding mandates

Although the overall 2010–11 budget reflected some unrealistic assumptions, it also contained some important policy changes. The grim fiscal environment prompted lawmakers to modify state mandates on schools in order to reduce the state's liability for covering the cost of compliance. They also changed the way the state funds the K–3 Class Size Reduction program.

State provides $300 million for K–14 mandate reimbursements in 2010–11

When California voters approved Proposition 4 in 1979, they established in the state constitution a guarantee that the state would reimburse local governments—such as school districts—for the cost of implementing any new state-required program or higher level of service.

However, the state has come far short of fully reimbursing local school agencies during the past several years. In December 2008, a San Diego Superior Court ruled that this breach was illegal. But former Gov. Arnold Schwarzenegger's administration appealed that decision, and the governor and Legislature continued to require that many education mandates be followed, with virtually no funding appropriated for reimbursements. According to a February 2010 report by the LAO, the state owes $3.24 billion to K–12 schools and $383 million to community colleges for a huge backlog of reimbursements. And late payments must include interest.

In the 2010–11 budget, policymakers took some action on this issue. Specifically, they provided $90 million to partially cover the cost of mandates in 2010–11 ($80 million for K–12 and $10 million for community colleges) and $210 million to cover some of the unpaid K–14 claims from prior years. In addition, lawmakers:

- Modified the two most costly mandates—high school science graduation requirements and behavioral intervention plans for Special Education students—in an attempt to eliminate them.
- Reduced requirements and thus costs associated with three mandates.
- Suspended for the time being all or part of 13 mandates—eight that apply only to K–12 schools, two for community colleges only, and three that apply to both schools and community colleges.
- Authorized a working group to analyze the cost-effectiveness of the remaining mandates and recommend whether to keep, modify, or eliminate them. The working group must develop its recommendations by March 15, 2011.

For more information about changes to mandates, see: www.edsource.org/assets/files/misc/lawmakers-education-mandates-2010-11.pdf

A budgeting change reflects uncertainty in the amount needed to fund K–3 Class Size Reduction

Many school districts have taken advantage of recently granted flexibility regarding pupil/teacher ratio requirements of the K–3 Class Size Reduction (CSR) program, which

provides incentive funding to have 20 students per teacher in kindergarten through grade 3. These districts have increased class sizes in the early grades, foregoing a portion of the funding they receive for CSR but also saving money by laying off or reassigning their K–3 teachers. As a result, the amount set aside in the state budget for the program has exceeded the state's actual costs. The state has thus been able to recapture some CSR funding.

Due to uncertainties in the actual amount needed for the program going forward, the 2010–11 budget breaks from tradition and does not have a line item for K–3 CSR with a fixed dollar amount. This year, the superintendent of public instruction has been authorized to certify the amount needed for the program, and the state controller is to then apportion funding according to a specified schedule.

Schwarzenegger's line-item vetoes were controversial

In signing the 2010–11 budget, the former governor used his line-item veto authority to reduce or eliminate funding for a few education-related programs. Although these vetoes may have only short-lived impacts, they can also be seen as another salvo in the continuing battle between Republicans who want to hold the line on tax increases and Democrats who believe that state programs should not be cut further.

In two of the cases, the vetoes allowed Schwarzenegger to achieve some state savings that he had proposed in his May Revision but that the majority-Democrat Legislature did not approve. Those two vetoes illustrate the extremity of the state's financial situation as they affect the state's most vulnerable populations and edged close enough to legal constraints that both evoked court challenges.

Temporary funding provides a cushion for families affected by child care funding veto

In his May Revision, Schwarzenegger proposed eliminating all state funding for subsidized child care to save $1.2 billion in Proposition 98 funding and an additional $500 million for the state general fund. The Legislature did not adopt this proposal but attempted to realize savings by altering the administration of some of the child care programs.

When the budget came back to the former governor for his signature, he vetoed $256 million for one component of subsidized child care—California Work Opportunity and Responsibility to Kids (CalWORKs) Stage 3. CalWORKs provides temporary financial assistance plus help with training and employment to low-income families with children under 18. Stage 3 child care is for families who have completed the CalWORKs program and been off of cash aid for two years. The California Department of Education provides some of those child care services through contractors.

The governor maintained $129 million in federal funding to pay for Stage 3 child care services through Oct. 31, 2010, but services were to cease on Nov. 1. This was going to affect about 55,000 children.

In response, the Legislature allocated $40 million to sustain the programs temporarily. And opponents of the veto challenged it in court. In mid-November, a judge declared that funding must continue through the end of 2010 and that providers must notify families of any eligibility for other subsidized child care programs.

Courts will determine funding for mental health services for disabled students

Also in May, the former governor proposed suspending the mandate that county mental health departments provide mental health services to Special Education students. The bill that required such services was Assembly Bill 3632, enacted in 1984. Thus, the program is often called the AB 3632 mandate.

During its budget deliberations, the Legislature rejected Schwarzenegger's proposal and provided $133 million to reimburse local mental health departments for the cost of providing services in prior years. In addition, California legislators channeled additional federal Special Education funding to local education agencies to pass through to mental health departments, increasing funding from $69 million to $76 million.

When the governor signed the budget, he vetoed the $133 million in state funds, and he declared that the AB 3632 mandate was suspended. The governor's action, plus the recently passed Proposition 1A, which requires the state to either fully reimburse counties for fulfilling mandates or suspend them, prompted several county mental health agencies to stop accepting new students.

Three lawsuits, each on a different aspect of the situation, have been filed in response to the veto.

One suit maintains that mental health services for students are an entitlement under the federal Individuals with Disabilities Education Act (IDEA). Plaintiffs are seeking a temporary restraining order on the state and school agencies to maintain the status quo. The CDE has allocated the $76 million in federal funding, and four Los Angeles–area local agencies named in the suit have agreed to provide services. But the funds will run out very soon.

What other local agencies will do with their portion of the federal funds is unclear. However, more than 40 counties have banded together and filed suit in the Sacramento

A related EdSource publication discusses the local impact of state budget decisions

In December 2010, EdSource published a report documenting the extent to which California's state budget troubles, including this year's record delay in passing the state budget, have strained districts' ability to manage their budgets responsibly and have created financial uncertainty for them. It also looks forward, discussing challenges that schools may face in the near future, such as the expiration of flexibility with K-3 Class Size Reduction in 2011-12 and categorical funding in 2012-13. *Challenging Times: California Schools Cope with Adversity and the Imperative To Do More* is available at: www.edsource.org/pub10-challenging-times.html

County Superior Court against several state officials, asking the court to affirm that the requirement to provide mental health services to students has been suspended due to the lack of funding. As this report was being completed, the matter had not been resolved.

The third lawsuit, brought by the California School Boards Education Legal Alliance in the Court of Appeal in the Second Appellate District in Los Angeles County, questions the legality of the former governor's unilateral suspension of a mandate and asks that the state funding be restored. This suit was filed on Nov. 10, 2010, and oral arguments have been set for Feb. 8, 2011. Plaintiffs in this case asked the Sacramento County Superior Court to slow down the second case referred to above, but the judge allowed the counties' case to be heard on Jan. 7, 2011, as scheduled.

The state may soon make mid-year changes to the 2010–11 education budget

When policymakers in Sacramento enacted the 2010–11 budget, they knew it was based on some questionable assumptions, such as $4.1 billion in additional federal funding for health and welfare programs. Those federal funds have not materialized, which has contributed to the projected current year deficit of $6.1 billion. In addition, California's slow economic growth continues to spur demand for governmental services and hinder growth in state revenues. The special legislative session that Schwarzenegger called in early December failed to yield action on the current year gap. That leaves the new governor and Legislature needing to forge solutions to the current deficit at the same time that they plan for 2011–12.

Brown seems undaunted, however. At the December 2010 forum for educators referred to earlier, Brown said he would like to enact a budget "within 60 days" (presumably from the release of his budget plan in early January 2011). That timeline has caused some Capitol insiders to speculate that the governor will try to get measures on a statewide ballot in the spring or summer of 2011 to help with closing the deficit. Some believe that Brown will ask voters to approve an extension of recently raised tax rates on vehicles, sales, and income—as well as new taxing authority for local governments as part of a plan to increase local control.

However, the governor himself has made it clear that he does not intend to solve the deficit with new revenues alone. At the forum, Brown heard from union leaders, school district superintendents, advocacy group representatives, and other education stakeholders. Some asked the governor to continue—and even expand—funding flexibility granted for 2008–09 through 2012–13. Others urged the governor not to propose any further reductions in education spending. A sympathetic Brown did not respond directly to these recommendations and ultimately could not offer the audience encouragement.

He braced them for bad news by saying: "Please sit down if you're reading the stories on the budget on Jan. 10. If you're driving, fasten your seat belt because it's going to be a rough ride."

Thus, it appears that whatever relatively good news the 2010–11 state budget held for K–12 education—primarily money for mandate reimbursements and the slight increase in Proposition 98 funding over the prior year—may soon be a memory.

Acknowledgments

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Brian Edwards

With research support from:
Liz Terry

Edited by:
Mary Perry

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