CALIFORNIA BUDGET PROJECT

BUDGET BACKGROUNDER

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MAKING DOLLARS MAKE SENSE

SCHOOL FINANCE IN CALIFORNIA AND THE PROPOSITION 98 GUARANTEE

Introduction

Proposition 98, passed by California voters in November 1988, constitutionally guarantees a minimum level of funding for K-12 education, community colleges, and related child development, mental health, and developmental service programs. The guaranteed amount is calculated each year using one of three "tests" that apply under varying fiscal and economic conditions. Current budget debates over Proposition 98 spending have largely centered around the 2004-05 suspension of the Proposition 98 guarantee, subsequent funding levels for Proposition 98, and the Governor's proposed education budget for 2006-07. These debates raise the question of whether the minimum funding level is sufficient to meet the needs of California's public schools. Indeed, California currently lags the nation as a whole with respect to per pupil spending, teacher-pupil ratios, and education spending as a percentage of personal income.

This paper examines the history of school finance prior to Proposition 98, the provisions of Proposition 98, the law's implementation and impact on school finance, current budget debates regarding education finance, and how California's school spending compares to other states.

Education Finance Before Proposition 98

Prior to 1973, K-12 schools were financed largely with property tax revenues imposed by local school districts. Variations in the value of taxable property between districts resulted in significant disparities in per pupil property tax revenues. A school district with very high property values could raise more revenue per pupil with a low property tax rate, while a district with low property values could raise less with a much higher property tax rate. The state attempted to reduce these disparities by providing more state aid to low-property wealth districts. Despite this effort, the combination of state and local revenues per pupil varied considerably.[1] In fiscal year 1968-69, for example, per pupil expenditures ranged from $577 in Baldwin Park to $1,232 in Beverly Hills.[2]

The inequalities in district funding led John Serrano, a parent in East Los Angeles, to file a lawsuit against California State Treasurer Ivy Baker Priest in 1968. Eight years later, the California Supreme Court ruled in favor of Serrano on the grounds that pupils in low-property wealth districts were denied access to educational opportunities equal to those in high-property wealth districts. The Court found that:

> "Substantial disparities in expenditures per pupil among school districts cause and perpetuate substantial disparities in the quality and extent of availability of educational opportunities. For this reason the school financing system before the court fails to provide equality of treatment to all the pupils in the state. Although an equal expenditure level per pupil in every district is not educationally sound or desirable because of differing educational needs, equality of educational opportunity requires that all school districts possess an equal ability in terms of revenue to provide students with substantially equal opportunities for learning. The system before the court fails in this respect, for it gives high-wealth districts a substantial advantage in obtaining higher quality staff, program expansion and variety, beneficial teacher-pupil ratios and class sizes, modern equipment and materials, and high-quality buildings.
>
> There is a distinct relationship between cost and the quality of educational opportunities afforded. Quality

cannot be defined wholly in terms of performance on statewide achievement tests because such tests do not measure all the benefits and detriments that a child may receive from his educational experience. However, even using pupil output as a measure of the quality of a district's educational program, differences in dollars do produce differences in pupil achievement."[3]

In response to the *Serrano v. Priest* decision, the state enacted AB 65 (Greene, Chapter 894 of 1977). AB 65 attempted to equalize district revenues over time by creating an annual inflation-adjustment scale based on a district's level of revenues. Districts with low revenues would receive larger inflation increases in order to "level up" funding, while districts with high revenues would receive smaller or no adjustments in order to "level down" funding.[4]

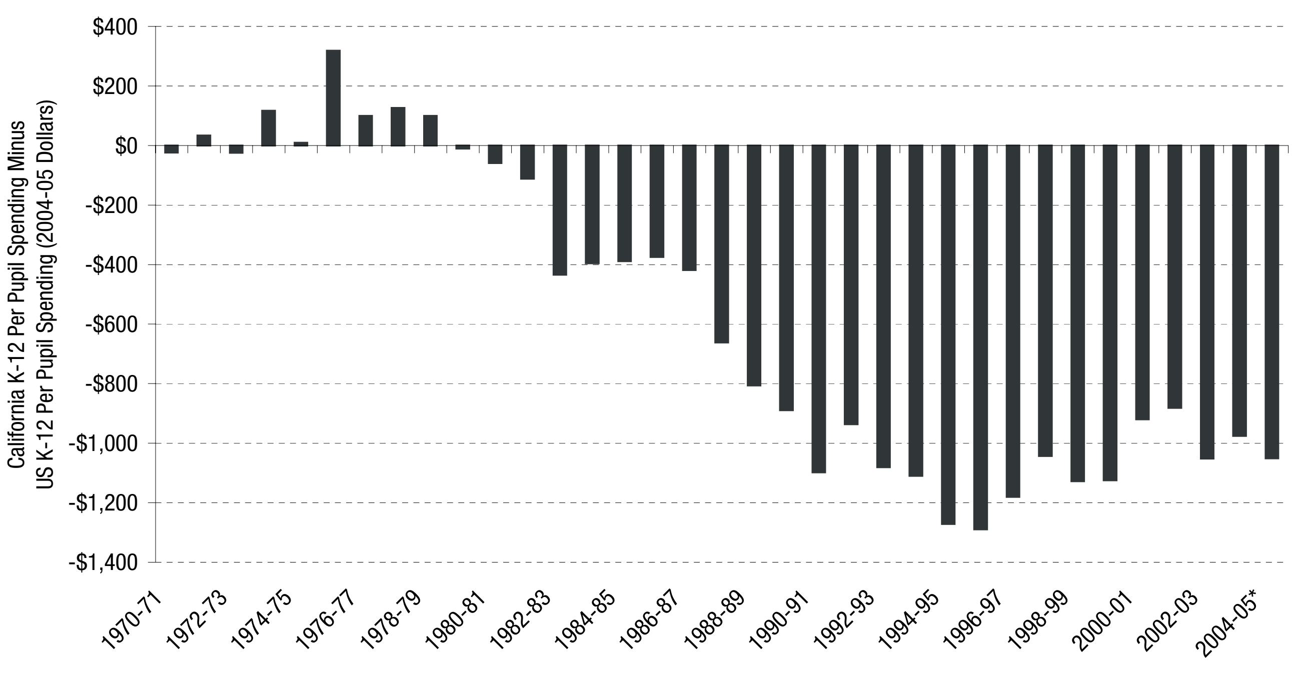
Before AB 65 went into effect, however, voters approved Proposition 13 in June 1978. The new law limited property tax rates to 1 percent of a property's assessed value at the time of acquisition. Proposition 13 reduced property tax revenues available for local governments and school districts. In an attempt to cushion the impact of Proposition 13 on local governments, the legislature passed AB 8 (Greene, Chapter 282 of 1979). AB 8 reallocated approximately $2.7 billion in property tax revenues from schools to cities, counties, and special districts. This transaction reduced schools' reliance on property tax revenues and increased the state's share of responsibility for school finance.[5]

Proposition 98 of 1988

During the decade prior to the passage of Proposition 13, California's per pupil spending was close to or modestly higher than that for the US as a whole. After 1979-80, however, California's per pupil spending fell below that for the nation as a whole and has remained below the US level since then. In 1986-87, California's per pupil spending was $419 below the level for the nation as a whole (Figure 1). Prompted by concerns over stagnating funding for schools, the California Teachers Association, the California State PTA, and the Association of California School Administrators sponsored Proposition 98 of 1988, approved by 50.7 percent of the voters.[6]

Proposition 98 establishes a minimum funding level for K-14 education each fiscal year. The Proposition 98 guarantee consists of three "tests" that apply under varying economic and fiscal conditions. Proposition 98 states that K-12 education and community colleges shall receive the greater of a fixed percentage of state General Fund revenues (Test 1) or the amount they received in the prior year, adjusted for enrollment and inflation (Tests 2 and 3).

Figure 1: California's K-12 Per Pupil Spending Has Lagged That of the US as a Whole Since 1979-80



* 2003-04 and 2004-05 are estimated.
Note: US includes District of Columbia. Per Pupil Spending is spending per unit of Average Daily Attendance (ADA).
Source: National Center for Education Statistics (1970-71 to 2002-03) and National Education Association (2003-04 to 2004-05)

Test 1 guarantees schools a percentage of General Fund revenues equal to the percentage of General Fund revenues appropriated for K-14 education in 1986-87, approximately 40 percent.[7]

Test 2 requires that schools receive at least as much as they received from state and local sources in the prior year, adjusted for enrollment growth and inflation as measured by the percentage change in state per capita personal income for the preceding year.[8] Test 2 is used in years in which 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 percent.[9] Test 2 has been the most frequently applied test under Proposition 98.[10]

Test 3 is similar to Test 2 except the inflation factor is equal to the annual change in per capita state General Fund revenues plus 0.5 percent. Test 3 is used in fiscal years in which state per capita personal income growth **exceeds** per capita General Fund revenues plus 0.5 percent.[11] Proposition 111 of 1990 added Test 3 to Proposition 98. Test 3 has been used in four years. Generally, Test 3 reduces the pressure of Proposition 98 on the General Fund in years when the state faces difficult budgets.[12]

The final guarantee is determined after the end of the fiscal year, since some of the information needed to calculate the guarantee, including actual average daily attendance and per capita personal income, is not available until after the close of the year. The process of reconciling the actual and estimated guarantee is known as "settle-up."

The legislature can suspend Proposition 98 for a single year by a two-thirds vote. Following suspension of the guarantee or a Test 3 year, the legislature must increase funding over time until funding returns to where it would have been under Test 2 absent a suspension or the use of Test 3.[13] The overall dollar amount needed to return funding to this level is called the "maintenance factor."[14] Restoration occurs in years when the percentage growth in per capita General Fund revenues exceeds the percentage growth in state per capita personal income. Maintenance factor payments become part of the base used to calculate subsequent years' funding guarantee.[15] The state's current maintenance factor obligation is at $3.7 billion, created as a result of the Proposition 98 suspension and unanticipated revenue growth in 2004-05. The Governor proposes to allocate $2.4 billion toward the state's maintenance factor obligation in his 2006-07 budget, leaving a remaining obligation of $1.3 billion.[16]

Proposition 49 and the Proposition 98 Guarantee

Proposition 49, approved by voters in November 2002, requires the state to provide up to $550 million per year for the After School Education and Safety Program (ASES) once General Fund spending reaches a certain level.[19] The spending level in the Governor's 2006-07 Proposed Budget would trigger Proposition 49 funding, requiring an increase of $428 million in funds for ASES, up from the $122 million provided in 2003-04. Proposition 49 states that additional funds for after-school programs shall be "in addition to the sums required by" the Proposition 98 guarantee. In future years, ASES funding would be included as part of the Proposition 98 base. ASES funding would not be reduced unless the Proposition 98 guarantee is suspended. If suspended, ASES funding would be reduced by the same percentage that Proposition 98 funding is reduced.

Proposition 49 was the first measure to earmark funds within the Proposition 98 guarantee. If demand for ASES decreases or more effective programs are identified, the legislature cannot reduce funding for ASES. This could make other programs funded by the guarantee more vulnerable to competition for remaining Proposition 98 resources during difficult budget years.[20]

Proposition 98 in Practice

Proposition 98 establishes an overall funding level, not an entitlement for individual programs. Proposition 98 establishes a required funding level for programs falling under the guarantee as a whole. It does not create an "entitlement" to funds for any particular program. The legislature has the authority to allocate funding to individual programs through the budget.[17] In other words, if the legislature allocates $100 million for instructional materials in one year, the same amount is not guaranteed in the following year. More specifically, Proposition 98 does not protect individual programs from reduction or elimination.

Proposition 98 covers more than just K-12 education. The Proposition 98 guarantee applies to spending for K-12 education, community colleges, county offices of education, and state agencies providing direct K-12 educational services, such as the State Special Schools, the Department of Youth Authority, and the Department of Mental Health. In 2005-06, K-12 education (including child development) accounted for 89.3 percent of Proposition 98 spending, community colleges accounted for 10.5 percent, and all other agencies accounted for less than 1 percent.[18]

Proposition 98 does not specify percentage shares for K-12 schools and community colleges. The result has been continued disagreement over how much should be allocated to each segment. In 1989, the legislature established a target for allocating funds among school districts, community colleges, and direct educational services provided by the state. In recent years, community colleges have received as much as 10.6 percent in 2002-03 and as little as 9.4 percent in 2003-04. The Governor's 2006-07 Proposed Budget allocates 10.8 percent of Proposition 98 funds to community colleges.

Spending above the Proposition 98 minimum can lead to a higher required minimum for future years. Proposition 98 requires under Tests 2 and 3 that schools receive at least as much as they received from the prior year with adjustments for enrollment growth and inflation. Hence, if the legislature allocates more than the minimum level of funding in a particular year, the increase becomes part of the base that is used to calculate future years' guarantees.

Current School Funding Policy Debates

Current budget debates over Proposition 98 funding levels have centered around the state's suspension of the Proposition 98 guarantee in 2004-05, the Proposition 98 funding target established in the 2004-05 budget agreement, subsequent Proposition 98 funding levels, and the Governor's proposed 2006-07 maintenance factor payment.

The 2004-05 budget agreement suspended the Proposition 98 guarantee and established a target funding level for K-14 education that was $2 billion below the level required under the minimum guarantee. Education advocates argue that the agreement suspending Proposition 98 guaranteed a level of funding that was $2 billion below the level determined by Proposition 98, not the level appropriated in the 2004-05 Budget Act. This is significant since the level of the Proposition 98 guarantee can change over the course of the fiscal year based on changes in estimated revenues, enrollment, or per capita personal income. In 2004-05, General Fund revenues increased to a higher than anticipated level, resulting in an increase in the minimum guarantee.[21]

The legislature maintained the spending level provided in the 2004-05 Budget Act. That spending level produced savings of $3.7 billion: $2 billion attributable to the initial suspension and $1.7 billion due to the increase in the guarantee over the course of the fiscal year. The 2005-06 budget agreement used the funding level in the 2004-05 Budget Act as the basis for 2005-06 Proposition 98 spending. Based on the Governor's January 2006 revenue estimates, the difference between holding Proposition 98 at the 2004-05 Budget Act level and the target assumed in the 2004-05 budget agreement over the two-year period is $3.2 billion.

The suspension led to the state's current maintenance factor obligation of $3.7 billion. In his 2006-07 Budget, the Governor proposes to pay $2.4 billion toward the state's maintenance factor obligation, including $426 million in appropriations for Proposition 49. This would leave a remaining maintenance factor obligation of $1.3 billion.[22] Education advocates contend that the Proposition 49 allocations should not count toward the maintenance factor obligation but in addition to the obligation, instead. Education advocates also argue that the Governor's proposal fails to meet the funding target suggested in the 2004-05 budget agreement for fiscal years 2004-05 and 2005-06, and that $3.2 billion in Proposition 98 funds are still owed to schools for those two years.

The Future of the Proposition 98 Guarantee

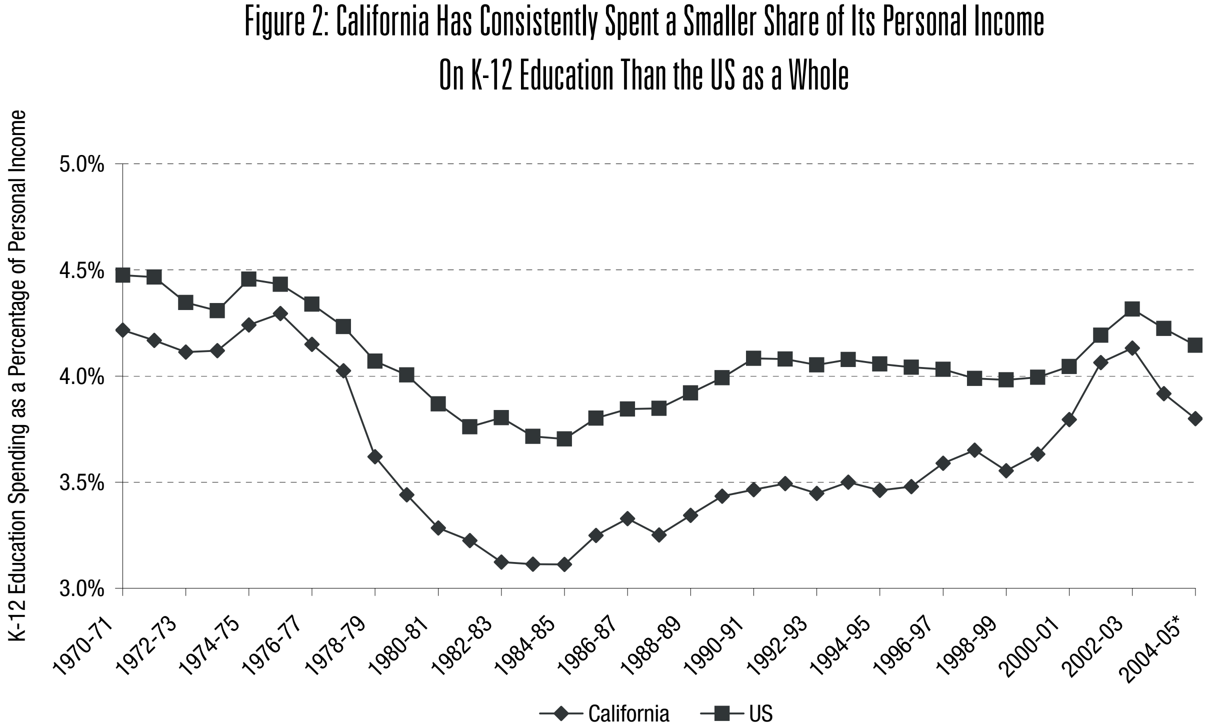
Test 2 has been the most frequently applied test under Proposition 98. However, Test 1 is expected to become the operative test in the near future due to a number of factors. The Legislative Analyst's Office (LAO) projects that over the next several years, strong growth in property tax revenues will influence K-14 education funding. The additional property tax revenues are expected to reduce the share of state General Fund monies spent on Proposition 98 under Test 2. In addition, slower K-12 attendance growth and the 2004-05 suspension of Proposition 98 had the effect of lowering the General Fund's Proposition 98 obligation under Test 2 in recent years. Collectively, these factors could lead to a transition from the use of the Test 2 formula to Test 1 in 2008-09. The LAO also projects that Test 1 likely will remain as the operative test for the near future once it is triggered.[23]

Education Spending in California

Recent policy debates on education raise the question of whether the current approach to education funding provides sufficient resources for California's schools to meet the state's academic standards and provide a quality education to California's students.

California's spending per pupil lags that of the US as a whole (Figure 1). In 2004-05, the most recent year for which data are available, California ranked 35th among the 50 states and the District of Columbia in K-12 per pupil spending. To reach the level of US per pupil spending, California would have had to spend an additional $6.4 billion on K-12 education. As a percentage of personal income – a measure of the size of the state's economy – California has consistently spent less on education than the US as a whole over the past decade (Figure 2). California ranked 38th in terms of K-12 education spending as a percentage of personal income in 2004-05. To reach the US level of spending, California would have had to spend an additional $4.5 billion on K-12 education. California also had the fourth highest number of K-12 students per teacher in 2004-05, with 19.3 students per teacher, as compared to 14.7 for the US as a whole in 2004-05.[24]

In contrast, experts have lauded the state for its high academic standards. A recent study, for example, ranked California's



* 2003-04 and 2004-05 are estimated.
Note: US includes District of Columbia.
Source: National Center for Education Statistics (1970-71 to 2002-03), National Education Association (2003-04 to 2004-05), and Bureau of Economic Analysis

reading standards as second in the country, while the state's math standards ranked first. The report also noted a disparity between California's high standards and its low performance on the National Assessment of Educational Progress (NAEP).[25]

To align instruction with standards, some states have conducted studies to determine the level of funding needed for students to meet the state's academic standards. In California, the legislature established the Quality Education Commission in 2002 to conduct such a study.[26] However, Governor Schwarzenegger has not appointed members to the Commission. Instead, the Governor appointed 16 members to the Governor's Advisory Committee on Education Excellence, a substitute for the Quality Education Commission that is not required by law to assess the adequacy of school funding levels. The Governor directed his Advisory Committee to deliver recommendations on various issues, including adequacy of school funding, in the near future. The Committee has not announced a timeline for presentation of these recommendations.

The current budget debate provides an opportunity for the state to look beyond what is minimally guaranteed and assess what resources are necessary to provide a quality education. By doing so, the state can move towards a system of providing an adequate level of funding to ensure a quality education for all California children.

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ENDNOTES

1 Paul M. Goldfinger and Bob Blattner, *Revenues and Limits* (Sacramento: School Services of California, Inc., 2002), p. 3.

2 California Supreme Court, *Serrano v. Priest*, 18 Cal.3d 728 (1976), downloaded from http://login.findlaw.com/scripts/callaw?dest=ca/cal3d/18/728.html on April 8, 2005.

3 California Supreme Court, *Serrano v. Priest*, 18 Cal.3d 728 (1976), downloaded from http://login.findlaw.com/scripts/callaw?dest=ca/cal3d/18/728.html on April 8, 2005.

4 EdSource, Selected School Finance Laws and Policies, downloaded from http://www.edsource.org/edu_fin_law.cfm on November 24, 2004.

5 California Budget Project, *Proposition 13: Its Impact on California and Implications for State and Local Finances* (April 1997), p. 2.

6 California Ballot Propositions Database, downloaded from http://holmes.uchastings.edu/cgi-bin/starfinder/2139/calprop.txt on October 5, 2004.

7 This percentage has been adjusted in statute in recognition of shifts in property tax revenues from local governments to schools.

8 Proposition 98 originally used the Consumer Price Index to adjust for inflation. However, Proposition 111 of 1990 changed the inflation factor, to the percentage change in state per capita personal income.

9 California Constitution, Article XVI, Section 8.

10 Legislative Analyst's Office, *Proposition 98 Primer* (February 2005), p. 5.

11 California Constitution, Article XVI, Section 8.

12 Legislative Analyst's Office, *Proposition 98 Primer* (February 2005), p. 5.

13 In the year following a suspension, guarantee calculations are based on the funding actually received in the suspended year.

14 The maintenance factor is adjusted annually for changes in enrollment and per capita personal income growth.

15 Legislative Analyst's Office, *Proposition 98 Primer* (February 2005), p. 13.

16 The Legislative Analyst's Office (LAO) projects a slightly higher minimum guarantee in 2006-07, and an additional $200 million in maintenance factor payments in 2005-06 due to the LAO's higher revenue estimate. This would leave a maintenance factor obligation of $1.2 billion. In addition, education advocates argue that $426 million in Proposition 49 funds should not count towards the maintenance factor (see below).

17 Paul M. Goldfinger and Bob Blattner, *Revenues and Limits* (Sacramento: School Services of California, Inc., 2002), p. 31-32.

18 Department of Finance, *Governor's Budget Summary 2006-07*, p. 86.

19 The funding level needed to trigger Proposition 49 is determined by establishing a base year between 2000-01 and 2003-04 in which General Fund non-Proposition 98 appropriations were at the highest level and adding $1.5 billion to that base year funding level.

20 See California Budget Project, *What Would Proposition 49, The After School Education and Safety Program Act, Mean for California?* (July 2002), for a more comprehensive discussion of Proposition 49.

21 Legislative Analyst's Office, *Analysis of the 2006-07 Budget Bill* (February 2006), p. E-19.

22 Legislative Analyst's Office, *Analysis of the 2006-07 Budget Bill* (February 2006), p. E-19.

23 Legislative Analyst's Office, *California's Fiscal Outlook: LAO Projections, 2005-06 Through 2010-11* (November 2005), p. 31.

24 CBP analysis of National Education Association data.

25 Sandra Stotsky, *The State of State English Standards* (Fordham Foundation: 2005) p. 7.

26 AB 2217 (Strom-Martin, Chapter 1026 of 2002).