

DISCUSSION DRAFT – DO NOT DISTRIBUTE – DISCUSSION DRAFT

Proposition 1B: Education Finance

**Board Action:**

**OPPOSE**

**Rationale:**

Although passage of Proposition 1A will increase the General Fund reserve target, this measure will funnel a significant percentage of those reserves to K-14 education. As well, there is debate regarding the amount owed to education due to past suspensions of Proposition 98. This discrepancy could potentially save or cost the state close to \$8 billion. Legal actions would only delay this decision as well as cost the state more money in legal fees. Finally, not only are the payments from the Budget Stabilization Fund to the Supplemental Education Account guaranteed, the payment is included when calculating next year's education obligation. This payment artificially inflates the funding requirement on a yearly basis, despite potentially weak revenue growth that will ultimately be insufficient to cover these obligations.

**Background<sup>1</sup>:**

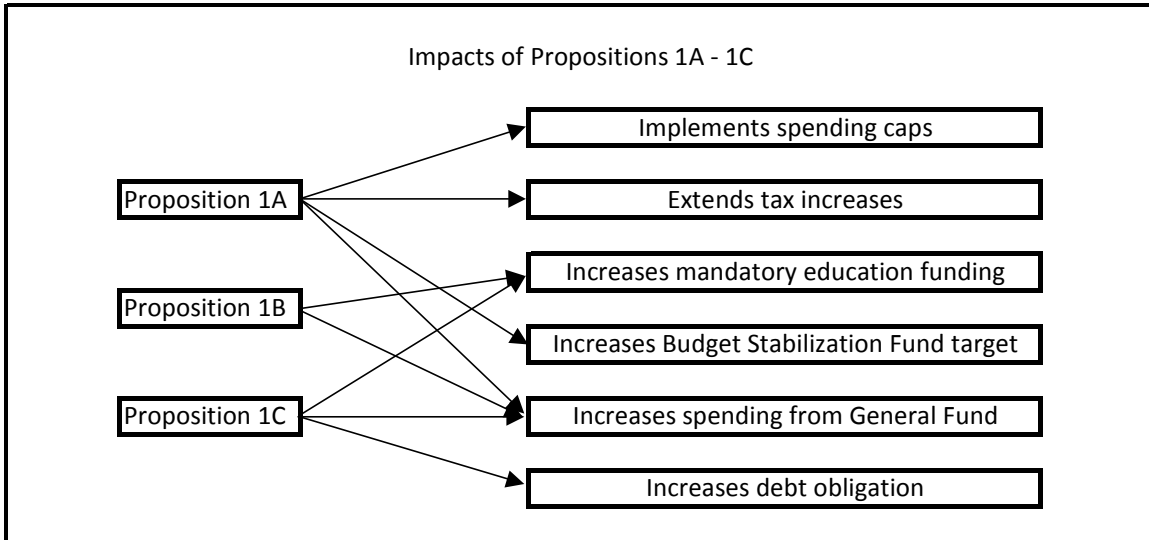
In January 2009, it was projected that the state would face a \$40 billion shortfall over fiscal years 2008-09 and 2009-10 if no corrective actions were taken. In February, the Governor and the Legislature agreed on a package to balance the current years and FY09-10 budget. This package is anticipated to generate \$98 billion in revenue and spend approximately \$92 billion. The remaining \$6 billion will cover the FY08-09 deficit and build up reserves.

As part of the budget package, six propositions were placed on a special election ballot to be held on May 19<sup>th</sup>. The FY09-10 budget depends on access to \$6 billion outlined within these measures. If voters approve all of the measures, it is expected that the state will still face multi-billion-dollar budget shortfalls in the coming years.

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<sup>1</sup> Overview of the State Budget. California Legislative Analyst's Office. February 25, 2009.

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*Education Funding*

Proposition 98 requires the state to provide a minimum funding level each year for K-12 education and community colleges. The minimum funding level is determined by one of three “funding formulas”. The General Fund and local property tax revenues pay for the funding requirements each year. The fiscal year 2009 budget includes \$51 billion in Proposition 98 funding; \$35 billion from the General Fund and \$16 billion from property tax revenues.

*Maintenance Factor*

The maintenance factor is a future funding obligation that results from a suspension or under-funding of the Proposition 98 annual requirement. As of the end of fiscal year 2008, the state has an outstanding maintenance factor obligation of \$1.4 billion. Proposition 98 requires the state to provide additional payments in future years until the maintenance factor has been closed. The minimum payback amount required varies from year to year as it is based on revenue growth. High revenue growth will lead to a higher maintenance factor payment for that year. It is important to note these payments are included as part of the base for the subsequent year’s minimum guarantee.

**Proposal:**

The Proposition 1B ballot label will read:

**EDUCATION FUNDING. PAYMENT PLAN.** Requires supplemental payments to local school districts and community colleges to address recent budget cuts. Fiscal Impact: Potential state savings of up to several billion dollars in 2009-10 and 2010-11. Potential state costs of billions of dollars annually thereafter.

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*Supplemental Education Obligation*

The California Legislative Analyst’s Office (LAO) has outlined potential ambiguity regarding calculating the state’s maintenance factor obligation. Different scenarios could result in an obligation of \$1.4 billion (as previously outlined) or \$9.3 billion. Proposition 1B requires supplemental payments totaling \$9.3 billion. This measure gives discretion to the Legislature and the Governor regarding how these payments would be distributed between K-12 education and community colleges.

*Dependency on Proposition 1A*

The funding mechanism for this passage is dependent on voter approval of Proposition 1A. Proposition 1A extends the recently approved tax increases and creates a “Supplemental Education Payment Account” (SEPA) and transfers 1.5% of General Fund revenues previously dedicated to the Budget Stabilization Fund (BSF) into this account. This transfer will continue until the \$9.3 billion obligation is repaid. If Proposition 1A fails, the provisions of this measure would be null.

**Fiscal Impact:**

If Proposition 1A is approved by voters, the state will see savings for the next two fiscal years due to the deferral of maintenance factor payments until fiscal year 2012. Beginning that year, the state will transfer 1.5% of BSF funds into the SEPA account annually until the total \$9.3 billion balance is paid. The 1.5% percent currently totals approximately \$1.5 billion. Assuming this amount holds constant, it will take between 5 to 6 years to pay the balance of the maintenance factor obligation.

Furthermore, once repayments of the maintenance factor begin, those amounts will be included within the base for the subsequent year’s required payment. The Governor or the Legislature cannot suspend these payments, even during years of declining revenues. The Constitution requires accelerated funding in future years until funding is back to where it would have been absent any suspensions.<sup>2</sup> If the state fails to generate sufficient revenues to meet the required education funding payments, the maintenance factor will continue increase and require higher future payments.

*Possible Court Action*

As mentioned, there is discrepancy as to how much funding is required through the maintenance factor obligation. The constitution does not specifically outline when the maintenance factor is applied in years of “Test 1” funding. Furthermore, if the factor does apply to “Test 1” years, there is question as to how these payments are to be made. Interpretations of these two issues can result in either a saving or obligation of \$7.9 billion. Passage of this measure could result in a lawsuit to determine the extent of the obligation.

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<sup>2</sup> California LAO 2009-10 Budget Analysis Series: Proposition 98 Education Programs

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*Impact on General Fund*

While the measure would limit spending based on a 10-year average and increase transfers to the BSF, there will undoubtedly be negative impacts that will affect future General Fund spending, as passage of Proposition 1A and Proposition 1B will increase annual Proposition 98 funding requirements. This is because the annual maintenance factor payment from the BSF will be included within baseline for the subsequent year's requirement. These payments, which cannot be suspended by the Governor or Legislature, will begin in FY2012 and will no longer be proportional to state revenues. This obligation is in addition to the mandated General Fund payments outlined within Proposition 1C.

*Increase in Education Funding*

Propositions 1A through 1C have a direct impact on state education funding. In each instance, passage of the measure will require the state to allocate more funding to K-14 education in future years. Proposition 1A will create a new account within the Budget Stabilization Fund that will direct 1.5% of General Fund revenues to K-14 education beginning in FY2012, and prohibit the suspension of these funds by the Governor and Legislature. Passage of Proposition 1B will enable these funds to be transferred each year until the \$9.3 billion outlined within the measure is reached. Finally, Proposition 1C transfers education funding responsibilities from the lottery to be placed upon the General Fund beginning in FY2010. FY2009 lottery numbers will be used as a base for the FY2010 funding requirement, and cannot be suspended by the Governor or the Legislature. This funding cannot be used to supplant Proposition 98 funding.

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### Proposed Education Funding

<u>FY2010</u>	<u>FY2011</u>	<u>FY2012</u>
		Proposition 1B (1.5% of General Fund Revenues COLA)
	Proposition 1C/Lottery Funds + COLA*	Proposition 1C/Lottery Funds + COLA*
Proposition 98	Proposition 98 (including enrollment growth & COLA*)	Proposition 98 (including enrollment growth & COLA*)
Proposition 1C (Based on FY09 Lottery payments plus enrollment growth & COLA*)		

\*COLA is tied to gross domestic product price deflator for purchases of goods and services by state and local governments (GDPSL)