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Governor's Proposals for the 2017-18 State Budget and Education

Preface

Over the past four years, public education in California has enjoyed unprecedented growth in funding largely due to restoration of past reductions, growth in the economy, and passage of Proposition 30 in November of 2012. Within the first 30 seconds of his press conference on the 2017-18 State Budget, Governor Jerry Brown dashed hopes for any continuation of that trend.

In three of the past four years, actual revenue collections exceeded the Administration's forecasts by a substantial amount. However, even after the state lowered its revenue forecast for 2016-17, revenues are coming in below even the lowered estimates. As a result, the Governor has lowered revenue projections even more substantially. Additionally, the state now believes Proposition 98 was over appropriated in 2015-16 and 2016-17. As we explain below, the state intends to take full credit for the over appropriations moving forward. Just a year after paying back and reversing the last of the old cash deferrals, the Governor is proposing a new deferral as part of the correction of the Proposition 98 base.

The theme for the Budget is a broad recognition of the increased risk in the out years. The Governor referred to the fact that California has the most progressive tax structure and, therefore, the most unreliable revenues, in the nation. Our reliance on the top 1% of taxpayers gives us tremendous revenue volatility, both up and down. As a result, the Governor defended the creation of additional reserves at the state level to provide a layer of protection in uncertain times. We agree with the Governor and urge educational agencies to also shore up reserves.

For 2017-18, after the adjustments mentioned above and detailed below, the Governor is projecting barely enough growth in the Proposition 98 guarantee to fund the meager 1.48% cost-of-living adjustment (COLA) estimated for 2017-18. This leaves no room for additional gap closure, so the funded level of the Local Control Funding Formula (LCFF) would remain at 96% for 2017-18.

We have previously warned of the dangers of getting to a "COLA-only" scenario; for 2017-18, the Governor plans for that to be a reality. Remember, the COLA is applied to each local educational agency's (LEA's) unique LCFF calculation. Unlike the same percentage and flat dollar amount applied under the old revenue limits and charter school block grants, the funding increase will not be the same for all agencies.

The Governor mentioned a number of competing demands for funding. Maintaining health insurance coverage for those Californians newly provided benefits under the Affordable Care Act (ACA) is a concern and a risk to the Budget if the feds stop funding the current program. Affordable housing, transportation improvements, volatility of revenues, and other factors all create significant exposure for the state and risk to the Budget.

Overview of the Governor's Budget Proposals

Governor Brown unveiled his proposed State Budget for 2017-18 on Tuesday, January 10, 2017, making an energetic presentation to the assembled press corps and fielding questions at a press conference, which began just after 11:00 a.m.

The Governor began by noting that he was using some old, but updated, charts focusing on one that illustrated the deficits of the past and another, which showed that recent revenue forecasts have been lowered compared to one year ago. He also demonstrated the need for belt-tightening by using two charts instead of his usual five.

The Governor stressed the point that while California has the most progressive tax system in the United States, it is also one of the most "unreliable." Therefore, building and maintaining a big reserve is "a corollary of a progressive tax system."

Like prior years, the Governor reminded everyone that we will face a recession. It is just a matter of time. He noted that the current economic recovery is now the third longest on record, and the Department of Finance (DOF) had forecast deficits of $18 billion for three years if the state were to experience even a modest recession.

After this brief introduction, he took questions, which largely focused on California's response to federal fiscal policy changes that could affect the State Budget, such as Medi-Cal funding, the cap and trade program to reduce carbon emissions, collection of climate data, and the deportation of undocumented individuals. For the most part, the Governor offered a wait-and-see approach, declining to speculate on exactly what the Congress and the new president would enact.

On the specifics of the Budget, General Fund revenues and transfers are proposed at $124 billion (a 4.4% increase) compared to expenditures of $122.5 billion (a 0.2% decline). The state would end the 2017-18 fiscal year with a fund balance of $2.5 billion, plus $7.9 billion in the Rainy Day Fund. Compared to the revenue forecast accompanying the current-year Budget, however, state revenues are projected to be down $5.8 billion over the three-year period of 2015-16, 2016-17, and 2017-18.

The Governor's Budget proposes a combination of reductions and fund shifts totaling $3.2 billion to bring the Budget into balance. These proposals include (1) a $1.7 billion downward adjustment to Proposition 98, (2) $900 million in recaptured allocations for affordable housing and state office building modernizations, and (3) $600 million in expenditure reductions by suspending rate increases for child care, not providing middle class scholarships to new students, and rejecting Budget proposals from various state departments and agencies.

The Governor's Budget also holds tuition at the University of California and the California State University flat.

Finally, the Governor's Budget highlights the Administration's efforts to address poverty in the state. The Budget continues to fund the rise in the minimum wage for state workers, expanded health care coverage under the federal ACA, and a COLA for the Supplemental Security Income/State Supplementary Payment program.

The Economy and Revenues

Economic Outlook

The Governor's Budget takes a sharp turn from previous years. It recognizes that the economy, both locally and nationally, continues to recover from the recession and that this recovery is the third longest recovery in the post-war period. However, the clear message from the Governor's press conference continues to be the implementation of prudent fiscal practices that provide a balanced budget while continuing to plan and save for the future. California is still recovering and growing, however, monthly revenue estimates have fallen short five of the last seven months—supporting the Governor's calls for cautious budgeting and undertaking the difficult work necessary to deliver a balanced Budget.

History has shown that every balanced Budget is followed by large deficits that are significantly more pronounced than the preceding recovery, and the Governor's Budget proposal is aimed at putting a stop to that trend. Without taking action to curb expenses, the State Budget would experience a $1.6 billion deficit in 2017-18, with future deficits estimated at $1 to $2 billion. While the passage of Propositions 52 (hospital fee), Proposition 55 (income tax extension), Proposition 56 (tobacco tax), and Proposition 57 (prison reform) have mitigated deeper deficits and the state's Rainy Day Fund—anticipated to increase to $7.9 billion by the end of 2017-18—will assist in further addressing the consequences of the system's inherent volatility, action must be taken to keep the State Budget from falling into deficit as in prior years.

At the national level, the stock market continues to soar, over 12 million jobs have been added since the end of the recession, wages have picked up, and housing prices continue to rise. However, the Federal Reserve has raised interest rates and that might have a dampening effect on the housing market as mortgage rates rise in concert. There are still indications that the current economic growth the state is experiencing will continue in the near future. The unemployment rate for the country dipped below 5% to 4.6% in November 2016, and in the same month California's unemployment rate dropped to 5.3% further reducing the gap between the two. In addition, the country added 178,000 jobs in November 2016 and the Governor's Budget anticipates modest growth for the California economy.

State Revenues

The Governor's Budget presents a picture that we have seen before—though not in a number of years—and not a welcome one. While we have grown accustomed to seeing understated General Fund revenues when compared with receipts to date and projections, this year's Budget shows that revenues are lower than projections. The revenue forecast is $5.8 billion lower than expected and the state is experiencing a current-year shortfall in the Medi-Cal program, both which contribute to the lower than expected revenues as compared to the 2016 Budget Act adopted in June 2016.

To be clear, total state revenues are higher year-over-year, and the economy continues to grow, though modestly. The lowered expectations reflected in the Budget are a result of the difference in the revenue projections utilized by the DOF when building the 2016-17 Budget and actual revenues received year-to-date.

The Legislative Analyst's Office (LAO) forecast released in November 2016 notes that the condition of the Budget will depend heavily on numerous volatile and unpredictable economic conditions. However, in the near term, it anticipates increased reserves by the end of the 2017-18 fiscal year with no immediate downturn. The LAO provides two long-term estimates—one based on an economic growth scenario and another based on a mild recession scenario. Under the economic growth scenario, the Budget will retain a surplus, while the recession scenario reflects that the state's reserves will have to be utilized in order to cover operating deficits out through 2020-21.

Proposition 98

Adopted by state voters in 1988, 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 and (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. Over the last four years, Proposition 98 has provided significant gains to schools as funding cuts endured through the Great Recession are restored.

Current-Year Minimum Guarantee

For the current year, the Governor's Budget acknowledges that revenues are lower than projected in the adopted 2016-17 Budget Act, resulting in the lowering of the current-year minimum guarantee. For the current year, the Proposition 98 guarantee is now estimated at $71.4 billion, down $506 million from the enacted level. This decrease is based on lower than expected General Fund tax revenues on which the guarantee is funded, which have declined by $5.8 billion over the three-year budget period.

Proposition 98 also requires the state to account for state funding that falls below the long-term target established by Test 2 (i.e., adjustments required by annual changes in per capita personal income). This cumulative shortfall is termed Maintenance Factor. The Governor's Budget notes that as of the end of 2016-17 the Maintenance Factor will reach almost $1.4 billion, an increase of $864 million in the current year.

2017-18 Minimum Guarantee

For 2017-18, the Governor's Budget proposes a Proposition 98 guarantee of $73.5 billion, a decrease of $953 million, relative to the 2016-17 Budget Act. The guarantee is based on Test 3, the change in per capita General Fund revenues, plus 0.5%, and the change in K-12 ADA, which is expected to decline in the Budget year. The Governor's Budget notes that an additional $264 million in Maintenance Factor will be created—due to it being a Test 3 year—totaling just over $1.6 billion at the end of 2017-18.

Cost-of-Living Adjustment and Average Daily Attendance

The estimated statutory COLA for K-12 education programs in 2017-18 is 1.48%, and is applied to the LCFF base grant targets, as well as other education programs that are funded outside of the LCFF. Those programs include Special Education, Child Nutrition, Foster Youth, Preschool, American Indian Education Centers, and the American Indian Early Childhood Education program, all of which are proposed to receive the statutory COLA.

Statewide, ADA is expected to decrease only slightly in 2017-18, by 645 ADA from 2016-17 levels to an estimated ADA of 5,958,288.

Local Control Funding Formula

The Governor's 2017-18 Budget continues implementation of the LCFF with an infusion of $744 million, the amount needed to fund the statutory COLA. The LCFF provides funding to transition all LEAs toward target funding levels, and provides supplemental revenues through percentage weighting factors to increase or improve services for students who are not English language proficient, who are from low-income families, or who are in foster care.

LCFF Target Entitlements for School Districts and Charter Schools

The target base grants by grade span for 2017-18 are increased over 2016-17 by 1.48% to reflect the estimated statutory COLA:

Grade Span	2016-17 Target Base Grant Per ADA	1.48% COLA	2017-18 Target Base Grant Per ADA
TK-3	$7,083	$105	$7,188
4-6	$7,189	$106	$7,295
7-8	$7,403	$110	$7,513
9-12	$8,578	$127	$8,705

In addition, the 2017-18 Transitional Kindergarten (TK)-3 grant increase for the class-size reduction (CSR) grade span adjustment (GSA) is $748 per ADA, and the grade 9-12 base grant per ADA is increased by $226 in recognition of the need for career technical education (CTE) courses provided to students in the secondary grades.

School districts and charter schools are entitled to supplemental increases equal to 20% of the adjusted base grant (includes CSR and CTE funding) for the percentage of enrolled students who are English learners, eligible for the free and reduced-price meals program, or in foster care. An additional 50% per-pupil increase is provided as a concentration grant for each eligible student enrolled beyond 55% of total enrollment.

Bear in mind that the LCFF target entitlement is the full funding level for each LEA, in today’s dollars, that the state intends to provide at some point in the future under the formula. It is not the amount an LEA will receive in 2017-18, which is based on the difference, or “gap,” between the current-year LCFF funding level, the LEA’s target entitlement, and the proportion of the gap that can be funded with the LCFF increase.

LCFF Transition Entitlements and Gap Funding

The difference between an LEA’s current funding and its target entitlement is called the LCFF gap, and it is this gap that is funded with the additional dollars dedicated each year to implementation of the LCFF. For 2017-18, the Governor’s Budget proposes to spend $744 million to further close the LCFF funding gap.

The table below shows the DOF’s LCFF gap percentages through 2020-21:

District and Charter School LCFF Funding and Gap Closure Estimates (Dollars in Millions)							
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21

LCFF Funding	$4,722	$5,994	$2,942	$744	$1,904	$2,022	$2,294
Gap Closure %	30.16%	52.56%	55.28%	23.67%	53.85%	68.94%	100.00%
COLA	0.85%	1.02%	0.00%	1.48%	2.40%	2.53%	2.66%

Up through the 2016-17 fiscal year, the Administration has made significant strides to reach the full funding targets of the LCFF. With 2016-17's gap closure funding, the LCFF is now roughly 96% of the way towards full implementation. Although the Governor's 2017-18 Budget proposal makes no additional progress toward LCFF full funding, the proposal prevents erosion in LCFF implementation by proposing funding equal to the cost of the COLA increase on LCFF target rates. However, the proposed funding is significantly less than the $2.2 billion the Administration previously estimated would be provided for 2017-18.

Pupil transportation and Targeted Instructional Improvement Grants continue as separate add-ons to the LCFF allocations and do not receive a COLA.

Community-Funded School Districts

School districts with property tax revenues that exceed the formula funding levels will continue to retain their local tax growth, and will receive a minimum state-aid allocation that is reduced by the cuts incurred during the recession which, under the LCFF, are carried forward into future years for these districts.

County Offices of Education

County offices of education (COEs) receive funding under a similar formula, with funding provided in recognition of direct instructional services for pupils in juvenile court schools and community schools and an allocation for countywide services based on the number of school districts and total ADA within the county. As of 2014-15, the LCFF for COEs is fully implemented and, therefore, LCFF increases for COEs in 2017-18 are provided through the estimated COLA only, with COEs that are at their LCFF target receiving a 1.48% increase. COEs that are more than 1.48% above their LCFF target will receive no additional funding through the formula in the budget year.

COE funding for 2017-18 is increased under the Governor's Budget proposal by a net of $2.4 million to account for a COLA on LCFF entitlements and changes in ADA.

Special Education

Special education is one of the few programs proposed to receive a 1.48% COLA in the Governor's 2017-18 Budget proposal. The program is also called out for further review based on two reports that made recommendations to improve special education programs and finance, including increases in funding for special education equalization and preschool programs. The Governor indicates that his office will "engage stakeholders throughout the spring Budget process for feedback on the current special education funding system and the recommendations included in both of the reports, noting they must be made on principles that are consistent with the LCFF and apply to all students, including students with disabilities."

Child Care

Last year, the Legislature and Governor negotiated a three-year plan to increase state preschool slots and fund increases to provider reimbursement rates. To fully fund the 2016-17 obligations of the agreement reached with the Legislature, as well as workload adjustments to California Work Opportunity and Responsibility for Kids Stage 2 and 3, the Governor's 2017-18 Budget includes $87.9 million in non-Proposition 98 funds and $23.5 million in Proposition 98 funds. However, the Governor proposes to pause the agreement for the 2017-18 Budget, essentially extending the implementation plan by an additional year.

Specifically, the proposed appropriations fully funds increasing the Regional Market Rate to the 75th percentile of the 2014 regional market rate survey—and maintaining it at that level for 2017-18—and the planned increase of full-day state preschool slots by 2,959 (beginning April 1, 2017). The standard reimbursement rate is proposed to be maintained at the level funded by the 2016-17 Budget (an increase of 5% from 2015-16).

In addition to these fiscal provisions, the Governor's Budget contains several "streamlining" initiatives that allow for the better use of technology to expedite child care applications, address the continuing needs for children identified with exceptional needs when their families no longer meet the income eligibility requirements, and align facilities, staffing, and programmatic requirements between state preschool and transitional kindergarten.

Discretionary Funds

The Governor's Budget proposes $287 million in one-time Proposition 98 funds for school districts, charter schools, and COEs to use at the discretion of local governing boards. This equates to approximately $48 per ADA. These funds, like prior years, would be counted by the state as offsetting prior-year mandate reimbursement claims on a dollar-for-dollar basis. In contrast, the 2016-17 Budget Act appropriated $1.28 billion in one-time funds for the current year.

School Facilities

Proposition 51

The school facilities community has eagerly awaited Governor Brown's reaction to the passage of Proposition 51, which provides $9 billion in bond authority for K-12 and community college facilities. While the 2017-18 Budget recognizes the constraints that the initiative put on lawmakers to change the School Facility Program, the Administration does not believe that "the voters intended to forsake their right" to ensure that state bond dollars are used appropriately as emphasized by Finance Director Michael Cohen during the Budget press conference. Consequently, the Budget states the Administration's desire to revise regulations and policies to improve fiscal accountability, that include "front-end grant agreements that define basic terms, conditions, and accountability measures" among state bond applicants and recipients.

Further, the Administration is dusting off a proposal from prior streamlining recommendations to include facilities bond fund expenditures in the annual K-12 Audit Guide, making it part of the LEA's annual independent audit review. To answer the question of whether Governor Brown will authorize the sale of Proposition 51 bonds, the Budget states, "Once these measures are in place to verify taxpayers' dollars are appropriately used, the Administration will support the expenditure of Proposition 51 funds."

Proposition 39

Approved by voters in 2012, Proposition 39 requires the state to use half of the increased revenues from corporate taxes (not to exceed $550 million each year) for K-12 and community college energy efficiency projects. The state is obligated to do this through the end 2017-18; thus, this Budget contains what may be the last appropriation for this purpose. The Governor’s 2017-18 Budget includes $422.9 million to support school district and charter school energy projects and $3 million for community college energy projects.

Career Technical Education

The Governor’s 2017-18 Budget Proposal includes $200 million for CTE Incentive Grant funding, representing the final installment of the three-year grant program. Governor Brown notes, “Commencing with 2018-19, schools will support the full cost of these programs within their LCFF allocations.”

Federal Programs

There are significant funding unknowns facing K-14 education at the federal level resulting from the November 2016 election. In December, Congress approved House of Representatives (H.R.) 2028, a continuing resolution (CR), that will fund the federal government through April 28, 2017. The CR keeps the current budget cap level of $1.07 trillion put into place under the Budget Control Act of 2011. For K-14 education, the CR will maintain the same level of funding in 2017-18 as provided in 2016-17, that is, unless Congress and incoming President Donald Trump elects to increase or decrease funding after the CR expires. Additionally, the fate of some of the recently approved Every Student Succeeds Act regulations are now in flux due to legislation approved by Congress that would allow for the rescission of controversial regulations and with President-elect Trump’s vow to reduce regulations.

Other Categorical Programs

Two recent initiatives provide funding for school programs in a targeted, categorical style fashion.

Proposition 47 (2014) reduced the penalties for certain property and drug offenses and requires a portion of any resulting state savings to be invested into K-12 truancy and dropout prevention, victim services, and mental health and drug treatment. In this second year of funding, the Governor’s Budget provides $10.1 million for programs to improve outcomes for K-12 pupils by reducing truancy and supporting pupils who are at risk of dropping out of school or are victims of a crime.

Proposition 56 (2016) increases the cigarette tax by $2.00 per pack and requires a percentage of resulting revenues to be used for school programs that prevent and reduce the use of tobacco and nicotine products by young people. The Budget provides $29.9 million to support tobacco and nicotine prevention and reduction programs at K-12 schools.

Additionally, the Mandate Block Grant (MBG) continues to be funded outside the LCFF and will be increased by $8.5 million to reflect the addition of the Training for School Employee Mandated Reporters program. This translates to an estimated $1.40 per-ADA increase to the MBG.

K-3 Grade Span Adjustment

The requirements to receive the K-3 GSA are unchanged in the Governor’s Budget. Remember that school districts (excluding charter schools) will need to prepare to further reduce class sizes in grade levels transitional kindergarten through third grade by the Governor’s Budget proposed gap closure percentage using the difference between the 2016-17 calculated average class enrollment by school site and the average of 24 students per class per school site, rounded to the nearest half or whole integer, unless the collective bargaining exception applies to your district. Also, the Governor's Budget proposed gap closure percentage should be used for planning staff and class loading purposes, but ultimately districts will be required to make the progress of the gap percentage identified in the upcoming May Revision, which could change significantly.

Proposition 2 and Proposition 98 Reserves

Proposition 2, which revised the state's Rainy Day Fund (officially titled the Budget Stabilization Account), established a constitutional goal of setting aside 10% of tax revenues as protection against unforeseen Budget shortfalls. The Governor's Budget proposes to increase the amount in the Rainy Day Fund by $1.156 billion in 2017-18 to $7.869 billion. This would equal 63% of the constitutional target. Combined with $1.554 billion proposed for the Special Fund for Economic Uncertainties, the state would have $9.4 billion as a Budget cushion in 2017-18.

Proposition 2 also established a state reserve specifically for K-14 education. In the year following a contribution to the Proposition 98 reserve, state law imposes a cap on local school district reserves. Certain conditions must be met before the state could make a deposit into the Proposition 98 reserve, including:

- Extinguishing the existing Maintenance Factor
- Requiring that the Proposition 98 Minimum Guarantee be determined using Test 1
- Fully paying increases in student enrollment and funding the statutory COLA
- Capital gains tax revenues account for more than 8% of General Fund revenues

One year ago, the Governor's Budget assumed that the existing Maintenance Factor established prior to the enactment of Proposition 2 would be fully paid off. However, due to the revenue slowdown, $543 million of the original $6.2 billion remains unpaid. In addition, the Governor's Budget assumes that Proposition 98 will be funded based on Test 3, not Test 1.

The Governor's Budget does propose to fully fund student enrollment and provide funding for the statutory COLA of 1.48% (estimate).

Finally, capital gains revenue will account for 8.8% of General Fund revenues in 2017-18.

Therefore, according to the Governor's Budget, only two of the four criteria requiring a contribution to the Proposition 98 reserve will be met in 2017-18. Although the conditions for imposing the cap on district reserves will not be met next year, it continues to be an important issue for school districts statewide.

Apportionment Deferral

One year after eliminating the last of the cash deferrals, Governor Brown has proposed including a "one-time LCFF cost shift." This is the result of a decrease in the 2016-17 Proposition 98 minimum funding guarantee caused by lower-than-projected state revenues. Rather than adjusting the current-year apportionment schedule, the Governor is shifting $859.1 million in LCFF expenditures from June 2017 to July 2017, which will result in a decrease to June 2017 cash balances for LEAs across the state. It appears that, like the previous deferrals, this delay will be ongoing until such time as it is expressly reversed by the state.

In Closing

We want to remind readers that issuance of the Governor's Budget marks the beginning of the annual Budget process, not the end. Over the next several months, we expect that both the Administration and the

Legislature will weigh in on the proposals. In past years, proposals have been modified or fallen away with new ones rising to take their place in line.

So, rather than focus on the individual proposals, we think clear understanding of the premises behind them is important. Revenues growing at a lower rate, volatility in tax receipts, growing costs, and additional risks to the Budget are all at the forefront of the Governor's thinking. His proposals reflect the need to prepare for uncertain times.

We agree with the conservative stance taken by the Governor in these increasingly uncertain times. And further, we think you should too. Plan to spend conservatively, maintain adequate reserves, think long term, and be sure you have a good backup plan. These concepts have protected local school agencies, their employees, and their students through decades of uncertainty and a wide variety of economic conditions. Stay that course.

Each year all of us at School Services of California, Inc., work hard to provide early information that is accurate, timely, and relevant. We continue to refine that information as we prepare for our upcoming workshops. Even after the workshops, we will use our *Fiscal Report* to keep clients informed of clarifications and new information as it develops.

—SSC Staff

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