

The FISCAL REPORT *an informational update*

Copyright © 2017 School Services of California, Inc.

Volume 37

For Publication Date: May 19, 2017

No. 10

An Overview of the 2017-18 Governor's May Revision

Preface

The May Revision represents the final statutory opportunity for the Governor to update his economic projections prior to enactment of the State Budget in June. Factors such as tax revenues, population growth and competing state priorities are all detailed in the Governor's May Revision. As we have seen in the past, significant changes, both positive and negative, can surface in the May Revision.

This year, there was a mixture of hope and confusion in January when the Governor announced lower revenue projections and the Legislative Analyst's Office immediately announced higher projections. In the May Revision, the Administration's new forecast for 2017-18 splits the difference. The hoped-for higher revenues have not materialized in the current year. However, the Governor has increased the 2017-18 revenue forecast and reflected an increase in the Proposition 98 minimum guarantee. At the same time, the Governor also proposes modification to the provision of Test 3 to ensure that the state is not compelled to fund Proposition 98 above the minimum guarantee.

The Governor projects the 2017-18 Proposition 98 minimum guarantee from January to be up \$1.1 billion to \$74.6 billion, while the current-year minimum guarantee is calculated once again at the 2016-17 State Budget level of \$71.4 billion. This increase compared to January fully eliminates that current-year, one-time deferral that was proposed at the January State Budget.

Some educators worried that there might be a proposal for a restructuring of funding and delivery of special education services. The Governor has not made a proposal; however, he does suggest that further study is needed.

Overview of the Governor's May Revision

Governor Jerry Brown's May Revision paints a somewhat brighter fiscal picture than what he offered in his January Budget proposal. Throughout the current year, state revenues have been soft, falling below projections through April. However, even though the May Revision acknowledges a current-year shortfall of \$225 million, budget-year revenues are expected to exceed the January forecast by almost \$1.9 billion. This revenue gain allows for increased spending next year compared to what we were bracing for just four months ago.

In his May 11, 2017, press conference, the Governor returned to his theme of fiscal prudence. He noted that the state has increased spending by billions of dollars over the last several years, especially for education. He warned, however, that we're starting to press the envelope with regard to the length of our current economic recovery, noting that the longest recovery on record is ten years, and we're now in our eighth year of growth.

He stressed that he did not want to return to the practices of prior Administrations in which new programs

were added during the good times but have “the rug pulled out” from people receiving these services when the economy turned south. Without predicting such a recession, he stated that the Department of Finance (DOF) has forecast a \$55 billion revenue shortfall over three years even with a recession of “moderate intensity.”

Proposals outside of Proposition 98 include:

- A \$6 billion supplemental payment to the California Public Employees’ Retirement System (CalPERS) with a loan from the state’s Surplus Money Investment Fund
- A \$400 million increase to mitigate cost increases to counties related to realignment of the In-Home Supportive Services program
- Sequesters \$50 million from the University of California (UC) until State Auditor recommendations and other UC commitments are met

Finally, the Governor’s May Revision highlights a number of initiatives to assist those in poverty, including raising the minimum wage, expanding health care coverage and providing a cost-of-living increase to the Supplemental Security Income/State Supplementary Payment program.

The Economy and Revenues

Economic Outlook

The Governor’s May Revision continues the themes from the January Budget proposal, including continued emphasis on the risks posed by the all but inevitable eventual recession. The Governor was quick to point out that the current recovery is the third longest in the post-war period and if there is not a recession within the next two years it would be historical. He emphasized exercising fiscal restraint due to this looming recession and pressures from Washington D.C. He cautioned that if the American Health Care Act (“Trumpcare”), or a similar bill were to become law, it would cost California billions of dollars. While we concur with the Governor about the risks present, we believe that there is still room for optimism.

Federal tax and spending policies remain relatively constant compared to 2016, with modest economic growth continuing over the next few years. U.S. inflation is expected to rise from 1.3% in 2016 to over 2% in 2017 as housing, gas, and medical costs increase. The Federal Reserve is expected to continue steadily increasing interest rates after the March interest rate hike.

The national unemployment rate as of April 2017 is equal to the pre-recession low of 4.4%, while California’s unemployment rate fell to 4.9% in March 2017 and is expected to remain near that level throughout the forecast. The drop in the unemployment rate is leading to higher wage growth, which is shifting the source of personal income growth. Education has been a beneficiary of these good times, but as the Governor likes to remind us . . . The next recession is just around the corner.

State Revenues

While not at the level that education has experienced in the past, revenue projections are once again up as part of the May Revision compared to the Governor’s January Budget. Personal income tax and corporation tax revenues are up \$2.9 billion and \$400 million, respectively, while sales tax revenues are down \$1.2 billion due to weak cash receipts. These factors reduce the forecast for 2016-17 by \$225 million compared to the January Budget, but increase the 2017-18 forecast by \$1.9 billion. Total General Fund revenues are projected to be \$118.5 billion in 2016-17 and \$125.9 billion in 2017-18.

While the Governor continues to stress the likelihood of a recession in the near future, the forecast does not project a recession and in fact reflects continued growth over the next four years. The average year-over-year growth rate over these four years is projected at 3.7%, with total General Fund revenues increasing \$22.7 billion to \$136.8 billion in 2020-21.

Proposition 98

Proposition 98 sets in the State Constitution a series of complex formulas that establish the minimum funding level for K-12 education and 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 K-12 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 past few years, Proposition 98 has provided significant funding increases for schools, which have been used to restore cuts that were imposed during the Great Recession.

While Proposition 98 funding increases slightly over the January proposal, the Governor cautions that the major gains of the recent past have come to an end. The May Revision proposes a \$1.1 billion increase for 2017-18 from the January proposal in Proposition 98 funding to \$74.6 billion, while the current-year minimum guarantee is maintained at the 2016-17 State Budget level of \$71.4 billion. The May Revision also proposes to fully eliminate the current-year, one-time deferral of \$859 million that was proposed in January.

In order to increase Proposition 98 funding and eliminate the deferral in this economic climate, the Governor proposes to suspend the statutory Proposition 98 Test 3B supplemental appropriation in 2016-17, in addition to the 2018-19 through 2020-21 fiscal years. Although the summary asserts that funding reduced through this mechanism will be automatically added to the maintenance factor obligation, which ensures that school funding is restored in the long term, there are still some unanswered questions about this strategy and the future outlook of Proposition 98 funding.

Cost-of-Living Adjustment and Average Daily Attendance

The May Revision includes a 1.56% cost-of-living adjustment (COLA) for K-12 education programs. The statutory COLA for K-12 education is based on the annual average percentage change in value of the federally maintained Implicit Price Deflator for state and local governments, and is applied to the Local Control Funding Formula (LCFF) base grant targets, as well as other education programs that are funded outside of the LCFF. The estimated statutory COLA for K-12 education programs in the Governor's January Budget proposal for 2017-18 was 1.48%, but based on final data for the Implicit Price Deflator, the actual COLA is 1.56%.

During implementation of the LCFF, the COLA is a less significant factor for most K-12 local educational agencies (LEAs) in estimating revenue changes for the upcoming year than it was under revenue limits. The COLA will affect the per-pupil grants used to calculate the LCFF target, but does not directly impact the level of the appropriation for LCFF gap closure. Rather than the COLA, it is the appropriation and its corresponding gap closure percentage which determine revenue growth for most school districts and charter schools.

LEAs that are at their LCFF target (i.e., fully implemented) will see a slight increase in LCFF funding and funding for categorical programs from January. Those programs include Special Education, Child Nutrition, Foster Youth, Preschool, American Indian Education Centers, and American Indian Early Childhood Education, all of which will now receive the statutory COLA of 1.56%.

As a result of an increased May Revision estimate of 2016-17 and 2017-18 ADA, total funding for school districts, county offices of education (COEs), and charter schools under the LCFF will increase by \$26.2 million in 2016-17 and by \$74.1 million in 2017-18.

Local Control Funding Formula

The Governor's 2017-18 May Revision continues implementation of the LCFF with an increase of \$1.4 billion in additional Proposition 98 revenues, up \$661 million from the January State Budget proposal. The LCFF provides funding to transition all school districts 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 increase by the statutory COLA of 1.56%, a slight upward adjustment from January's 1.48% COLA estimate.

Grade Span	2016-17 Target Base Grant per ADA	1.56% COLA	2017-18 Target Base Grant per ADA
TK-3	\$7,083	\$110	\$7,193
4-6	\$7,189	\$112	\$7,301
7-8	\$7,403	\$115	\$7,518
9-12	\$8,578	\$134	\$8,712

The 2017-18 transitional kindergarten-3 grade span adjustment (GSA) for class-size reduction (CSR) is also 1.56% higher from 2016-17 at \$748 per ADA, as well as the grade 9-12 GSA at \$227 per ADA, in recognition of the need for career technical education (CTE) courses provided to students in the secondary grades.

In addition to the base grants, school districts and charter schools are entitled to supplemental increases equal to 20% of the adjusted base grant (which 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 (the unduplicated pupil percentage). An additional 50% per-pupil increase is provided as a concentration grant for the percentage of eligible students 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 a district's or charter school'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 May Revision proposal calls for a \$1.4 billion increase to LCFF allocations. According to our initial estimate, this will close 45% of the gap remaining to full implementation of the LCFF. The DOF has not yet released their calculation of the revised 2017-18 gap closure percentage.

Special Education

The Governor's May Revision does not include any measurable funding increase for special education programs. It does, however, include a summary of actions taken by the DOF as a result of the Governor's Budget and the Administration's desire to solicit stakeholder feedback on recent reports on special education finance in California. The May Revision states that, "given the scope of the feedback and the complexity of this program area, the Administration will spend additional time in the coming months examining these issues to chart a path forward that will maximize resources to serve students while increasing transparency and accountability."

Child Care and Preschool

In a significant shift from his January Budget, which proposed to suspend a 2016-17 Budget agreement with the Legislature for a three-year investment plan in child care and preschool, the May Revision now fully funds last year's deal by providing increases to provider reimbursement rates and additional state preschool slots. Specifically, the May Revision provides an additional \$67.6 million to fund a full 10% increase to the Standard Reimbursement Rate over the 2015-16 rate. It also increases the Regional Market Rate to the 75th percentile of the 2016 survey, beginning on January 1, 2018. With regard to increasing access to preschool and consistent with the 2016-17 agreement, the May Revision proposes to increase full-day preschool slots by 2,959. The Governor's January Budget also proposed no COLA for child care and preschool; however, the May Revision includes a COLA for both. The 2017-18 investment in rates, slots, and COLA amounts to a total of \$239.21 million (\$111.14 million from non-Proposition 98 funds, and \$127.85 million from Proposition 98 funds). Finally, the May Revision proposes reductions in California Work Opportunity and Responsibility to Kids Stages 2 and 3 of \$18.1 million and \$12.8 million, respectively, to reflect caseload adjustments.

Discretionary Funds

The Governor's May Revision proposes just over \$1 billion in one-time discretionary funds for school districts, COEs, and charter schools. This is an increase of just under \$750 million to the \$287 million proposed in January. Like prior years, these funds would be available for expenditure at the discretion of LEAs and would be used to offset LEAs' outstanding mandate reimbursement claims. In prior years, funding has been allocated on the basis of prior-year Second Principal Apportionment (P-2) ADA. The May Revision makes no mention of changing this policy. In addition, the May Revision proposes to disburse these funds in May 2019.

School Facilities and Proposition 39 (2012)

In his January Budget, Governor Brown offered his support for the sale of Proposition 51 bonds contingent upon increased transparency and accountability in the State School Facility Program. He proposed developing and implementing an up-front grant agreement and subsuming the audit of state-funded facilities projects into the annual K-12 independent audit process. The May Revision simply restates the Governor's January position. The State Allocation Board is scheduled to take action on the proposed grant agreement at

its May 2017 meeting.

The May Revision makes a modest reduction to the proposed appropriation to fund Proposition 39 school and community college district energy projects. The 2017-18 appropriation for K-12 energy projects is proposed to be \$376.2 million, while the community college appropriation is proposed at \$46.5 million, reductions of \$46.7 million and \$5.8 million respectively, from the January Budget.

Career Technical Education

The Governor's 2017-18 January Budget proposal included the final installment of \$200 million for the three-year Career Technical Education Incentive Grant program that began in 2015. The May Revision maintains this proposal and adds no additional funding.

Teacher Workforce

To help address California's teacher shortage, last year's Budget appropriated funds to recruit teachers and assist aspiring teachers in completing requirements to enter the profession. Building on last year's actions, the May Revision proposes to optimize federal funds to support these efforts. Without much detail, the Governor suggests that California can leverage the flexibility of the Every Student Succeeds Act to "direct additional federal resources" for teacher recruitment and retention efforts, with a particular focus on "high need" fields.

Federal Programs

Congress recently passed a federal spending package to complete fiscal year 2017 (through September 2017). Consequently, federal education funding for low-income, English learner, and special education students, along with funding to support educator preparedness and professional development, will be coming into clearer view when the California Department of Education completes its evaluation of how much California can expect to receive.

Apportionment Deferrals

Deferrals of \$859 million, as proposed in January, have been rescinded as a result of additional resources available from the 2015-16 and 2016-17 fiscal years. State aid payments in the month of June 2017 are back to their original schedule.

In Closing

Regardless of any one-year's budget decisions, California remains a very high-tax state but assigns a lower priority to education than other high-revenue states. The modest promise of the LCFF, restoration of the purchasing power level of 2007-08, will not be met because much of the restoration funding will go to increased contributions for the California State Teachers' System and CalPERS, not to educational programs. California is destined to remain lower than other states in funding for public education.

Volatility is also a significant problem in education funding in California. Reliance on the volatile income tax instead of the more stable property tax amplifies year-to-year swings in funding. Also, even during periods of tremendously high job growth, overreliance on the top 1% of earners ensures additional volatility. Successful states enjoy a high level of stable funding; we don't enjoy either.

While the Governor is quick to note that we are overdue for a recession, his forecasts do not include any

potential effects of the next recession. Make no mistake, modification of the Test 3 provisions of Proposition 98 is proposed in order to protect the state, not school districts.

All in all, the May Revision is better for public education than the January Budget. But only enough to offer slightly better prospects for maintaining programs. There is little room for growth in program costs or new programs.

The best education plans have always shared the characteristics of good reserves, conservative budgeting, and rigorous setting of priorities. That will continue to be true over the next few years under the Governor's plan.

—*SSC Staff*

posted 05/11/2017