

Proposition 98—How Does It Work?

Background

Proposition 98 changed the California constitution in 1988 and was modified by Proposition 111 in 1990. It establishes a minimum annual funding guarantee for kindergarten through community colleges or K-14 education. Over 40% of the State budget is spent on Proposition 98. And, about 75% of total K-14 funding comes from Proposition 98. Federal funds, special funds (such as lottery revenues), fee revenue (such as student enrollment fees), and non-Proposition 98 state General Fund dollars (which are largely dedicated to debt service on school facilities and costs for teacher retirement) make up the remainder.

As stated above, Proposition 98 funds both K-12 and community colleges. Currently, about 88% of the Proposition 98 pot goes to K-12 with 12% going to the community colleges. The division between K-12 and community colleges is commonly called “**The Split.**” It is not addressed in the constitution and, thus, becomes much of the focus of the Proposition 98 budget battle.

In normal years, the growth in Proposition 98 provides enough funding to cover the cost of COLA and growth in student attendance or what is called base apportionment. Any reform measures or special program funding comes on top of this base and only occurs in years with a very positive increase in revenues.

Because of the size of the Proposition 98 pot—the largest in the State budget—and because voters consider education important, Proposition 98 always has a special place in budget negotiations.

Determining the Funding Level

Each year the State calculates the minimum Proposition 98 funding requirement—commonly called “**The Minimum Guarantee**”. This minimum guarantee is determined by one of three “tests”. The tests are mathematical formulas and are based on five major factors: (1) General Fund revenues, (2) state population, (3) personal income, (4) local property taxes, and (5) K-12 average daily attendance (ADA).

The Proposition 98 tests or formulas require that two conditions are met. The first is that at least 40% of the General Fund revenue is spent on K-14 education. The second condition is that Proposition 98 grows at least as fast as the economy, as measured by increases in per capita income.

As stated above, there are three tests which are used to determine the minimum level of Proposition 98 funding:

Test 1—Share of General Fund--simply calculates 40% of the general fund revenue and establishes that as the minimum guarantee or the funding floor for Proposition 98. It produces the lowest level of funding and has not been used to determine the level of Proposition 98 funding since 1988-89.

Test 2—Growth in Per Capita Personal Income--calculates the growth in K-12 attendance and multiplies it by the change in *per capita* personal income and uses the result to once again determine the Proposition 98 minimum guarantee. Generally, this test is operative in years with normal to strong General Fund revenue growth. This test has been used the most frequently.

So, how does the State determine which level of funding or which test is operative in a given year? The State must pick the higher of the two amounts calculated. However, in 1990 Proposition 111 was passed to provide relief from the requirements of Test 2 when the economy is growing more slowly than growth in personal income and Test 3 was established.

Test 3—Growth in General Fund Revenues increases prior-year funding by multiplying changes in K-12 attendance times growth in *per capita* General Fund revenues. Generally, this test is operative when General Fund revenues fall or grow slowly. Test 3 cannot be used to provide less money than would be provided under Test 1, however, it does provide for a lower funding level than Test 2. The gap between the levels of funding that would have been produced under Test 2 and the funding level established in a Test 3 year is called “**The Maintenance Factor**” and is discussed below.

Which test is used in a given year is determined by the provisions in the constitution. The Legislature **does not** get to decide which test is used to determine the minimum guarantee. Usually, the minimum guarantee is based on changes in ADA and per capita personal income (Test 2) or per capita General Fund revenues (Test 3). Notice that changes in community college FTES (Full Time Student Equivalent) do not affect the tests.

The Legislature **does** have the authority to determine the funding level by either spending less than the guarantee--suspension of Proposition 98--or spending more—over appropriating Proposition 98. Both options have major considerations. **Suspension** requires a two-thirds vote and creates a mandate to repay the money that would have been spent if Proposition 98 had not been suspended. **Spending above the minimum guarantee** in one year creates a higher floor in the next year. Most policymakers do not want to vote to cut education spending; it has only occurred once in 2004-2005. In good years, Proposition 98 has received additional funding.

State Sources of Revenues ant the Role of Forecasting

Although the budget is enacted appropriating specific amounts to K-12 and community colleges, Proposition 98 funding changes throughout the budget year as the underlying factors—**General Fund revenues, local property taxes, and K-12 attendance**—continue to change even after the close of the fiscal year. The Legislature passes the budget based on **estimates** of revenues, property tax, income, K-12 attendance, and

population. All of these can change over time and can affect which test will be finally used to determine funding.

General Fund Revenues

General Fund revenues are comprised of personal income tax, sales and use taxes, insurance, bank, and corporate taxes, and other taxes and fees. Because 56% of General Fund revenues come from personal income tax, a very volatile source of fiscal resources partly because slightly more than one-fourth comes from capital gains and stock options which vary tremendously from year to year, California revenues fluctuate widely from year to year. In fact, General Fund revenues almost parallel changes in capital gains and stock options which reflect the performance of the stock market.

Property Tax Revenues

Another source of revenue, property taxes, are a relatively stable source of revenue, however, lack of a perfect prediction of the amount of revenue they generate leads to problems for the community colleges. This is because final calculations of property tax revenues come late in the fiscal year, usually around the end of Spring semester, after most of the educational program has already been offered and funds spent accordingly. While K-12 receives an **automatic** backfill of any property tax shortfall, community colleges do not. Although the Legislature frequently backfills this shortfall for community colleges, in very bad economic times such as we are facing now, either no property tax backfill or an incomplete backfill is provided. This means the colleges have to take a late budget reduction either from their reserves or summer school. Community colleges have tried to find legislative solutions to this issue for many years with no success.

K-12 Attendance

Proposition 98 only takes growth in K-12 students into account; demand for classes at community colleges is not taken into account when determining the minimum level of Proposition 98 funding. Changes in K-12 attendance are usually fairly predictable and are the basis for Tests 2 and 3. However, demand for community college classes and growth in K-12 attendance do not run in tandem. Need for a community college education increases dramatically in hard economic times, just when State revenues decline and there are budget cuts rather than increases to cover the additional classes needed to serve the students. Community colleges have frequently stepped up to the plate and kept the door open to all students despite lack of funding leading to what is called “unfunded FTES.”

What if the Forecasts are Wrong?

It is important to note that if forecasts underestimate the minimum guarantee level of Proposition 98 funding, the State must provide additional revenues to K-14 to fund the higher amount. This amount is called “**settle up**” funds. This is automatic and does not require the Legislature to take action, i.e. vote on whether to provide these additional dollars or not.

If, however, the forecasts overestimate the amount of Proposition 98 funding, the Legislature has to take action to lower the Proposition 98 appropriation. When revenues come in significantly lower than projected and the Legislature decides to act, it leads to mid-year cuts. These are especially hard for the educational community to absorb because the educational year has already been planned and students have frequently enrolled for the Spring semester prior to the mid-year cuts which can include student fee increases as a source of revenue for additional dollars to the colleges.

What is the Maintenance Factor?

The “Maintenance Factor”

The intent of Proposition 98 is to provide the highest minimum guarantee allowed under the three tests discussed above. The goal is to have the budget grow K-14 funding to accommodate more students and increased costs, paralleling increases in revenue. When the State provides less money than would be provided in a Test 2 year, a funding gap is created. This is called “**The Maintenance Factor**”, in other words, the State is required to bring Proposition 98 back to the level of funding it would have received under Test 2 in future years. How long it takes to pay back this money depends on the overall health of the economy. The goal is to grow Proposition 98 funding faster than the economy is growing in bad economic times. The impact is to save the State money until the economy is better and K-14 is all paid back.

Does the State Restore the Maintenance Factor?

The maintenance factor is the long-term target and paid back when the economy is good. When the economy is booming, the state restores the Maintenance Factor by allocating about fifty-five percent of the new General Fund revenues to Proposition 98. For example, in the early nineties, a stalled economy meant that Proposition 98 was funded under Test 3 for many years. By 1993-1994, the maintenance factor was \$2.2 billion. By 1997-1998 the entire \$2.2 billion had been paid back to Proposition 98. However, the economic downturn in this century has been persistent. Proposition 98 has been suspended and funded under Test 3, yet there has not been enough growth in the General Fund revenue to restore Proposition 98 to full funding.

The Big Policy Question: Does a Test 1 Year Produce a Maintenance Factor?

At the time the 2009-2010 budgets was enacted, there was agreement that 2008-2009 would not become a Test 1 year. Therefore, the July agreement for the 2009-2010 budget currently includes a \$1.1 billion maintenance factor repayment with the rest of the maintenance factor to begin to be repaid in 2012-2013.

However, the Governor’s January budget proposal asserts that 2008-2009 has become a Test 1 year because of falling revenues due to the decline in property values. While he takes no money out of Proposition 98 for 2008-2009, he retires the \$1.3 billion maintenance factor from prior years. Additionally, while he acknowledges an obligation, no maintenance factor payments are made until 2012-13.

What Is the Discussion?

Because of the poor condition of the budget, many policy analysts thought Proposition 98 might be funded under Test 1. During that discussion, questions arose regarding the payment of lost funds. In other words, if Proposition 98 is funded using Test 1, and the state spends roughly 40 percent of General Fund revenues on K-14 education, is the state required to bring spending back to the amount that would have been mandated to have been spent on K-14 education if Test 2 had been used.

Other than the first year under Proposition 98 in 1988-89, the state has always provided more for K-14 education than Test 1 required and has calculated the minimum guarantee using either the “Test 2” or “Test 3.” If there is a Test 1 year, the debate will heat up over how Test 1 works. According to the Legislative Analyst, the debate tends to hinge on whether the constitutional provisions are read literally (sometimes leading to odd outcomes) or in a way that avoids strange outcomes (but conflicts with the literal language). There was an attempt to resolve the issue in Proposition 1B in the May 2009 election, but it failed.

What Are the Exact Concerns About a Test 1 Year?

The concern is how “maintenance factor” is treated under Test 1. There are two questions:

- 1) Does the state need to establish a maintenance factor?
- 2) Is the maintenance factor on top of the Test 2 level?

Issue number one questions whether the gap between what would have been allocated to Proposition 98 under Test 2 versus Test 1 becomes a maintenance factor that needs to be paid back in out years. Historically, Test 3 years have produced a maintenance factor to establish the amount of money schools are due which is the difference between the higher Test 2 level which is owed and the lower Test 3 level which was paid. There is a difference of opinion on whether the same would happen in a Test 1 year.

The second issue questions whether maintenance factor payments will be made on top of the Test 2 or Test 1 levels. California Federation of Teachers has filed a lawsuit to determine what the law is for a Test 1 year regarding the treatment of the “maintenance factor.”

How the Maintenance Factor Dollars Are Currently Allocated

The maintenance factor created in 2008-2009 gives only 8% to the community colleges. The historical share of Proposition 98 has usually ranged from 10 to 11%. This share is based on the amount of workload, full-time equivalent students, generated by K-12 versus community colleges as measured at the time of implementation of Proposition 98. The community colleges share of the workload has grown over time to the current level of roughly 17% or 18%. The community colleges have spent a lot of their advocacy on finding a permanent solution to this annual issue. The most recent effort was Proposition 92 which would have separated the community college portion of Proposition 98 from the K-12 portion. However, that effort failed and thus the battle over the Proposition 98 “split” continues. Needless to say, the community colleges will be focused on getting the

colleges and their students a fair share of the Proposition 98 and any associated maintenance factor dollars.

Additionally, the budget gave half of the maintenance factor dollars allocated to the community colleges to backfill cuts to base apportionment and half would go to expand the Career Technical Education as defined under SB 70.

The community colleges go through a lengthy consultation process on developing budget priorities. Budget priorities always focus on backfilling any holes in the base. Additionally, there has been a substantial loss in buying power of a community college dollar because there has been no money to fund COLAs. When per student funding is lowered, there is no question it negatively impacts the quality of a community college educational experience as seen in longer lines, larger class sizes, fewer course offerings, and less services provided, for example. Additionally, employees have taken substantial hits to their paychecks, been furloughed, and jobs have been lost. In other words, there is a very large pent up demand to get back the lost COLAs and restore purchasing power to the community college dollar. Finally, the cuts to categorical programs have been devastating as have fee increases. There is concern among the community college community regarding both the Split and where the money is targeted to be allocated. The community colleges will have to develop and implement an effective advocacy campaign in order to achieve an appropriate level of resources.

Conclusion

Other Budget Priorities

Finally, all discussions regarding Proposition 98 do not occur in a vacuum rather how the budget affects all other areas of State government are considered during deliberations. For example, 2004-2005 the State should have spent an addition \$3.1 billion on Proposition 98. However, this would have cut other non-98 programs even further. Thus, the State chose to suspend Proposition 98 creating a maintenance factor, but preserving other services including other institutions of public higher education, i.e. UC and CSU.

Additionally, in 2011-2012 the increased tax revenues passed in February 2009 sunset taking \$10.9 billion in resources out of the General Fund, creating another hole in the California budget that needs to be filled either by increased revenues or further cuts to programs. As stated above, paying back the maintenance factor is slated to begin in 2012-2013. Additionally, Proposition 98 will be increasing faster than growth and COLA. However, the structural problems in the overall budget will continue to persist unless new sources of revenue are found. There will be pressure to increase student fees.

Californians are very supportive of California community colleges. Community colleges will continue to need their support to bring the needed revenue to fund our high quality programs. And, Californians need community colleges more each day whether it is to prepare for transfer to a 4-year university, earn a career technical certificate to enter the job market, retrain to change jobs, build basic skills, or any of a multitude of goals that

make the people of California better prepared for this millennium and California's economy strong, vital, and growing.