

Governor Unveils May Revision to 2017-18 State Budget
May 11, 2017
Updated May 15, 2017

This provides an update on the Governor's May Revision including insights from the Legislative Analyst Office (LAO). Since its May 11th release, Department of Finance released additional trailer bill language, the LAO issued its analysis of the May Revision Education Proposals and the Senate Budget Subcommittee held the first hearing on the May Revision. The Assembly Budget Subcommittee meets shortly.

On Thursday, May 11, 2017, the Governor announced that the May Revision would be similar to the January budget in terms of overall spending but that funding for K-12 education would increase. The May Revision increases funding for the Local Control Funding Formula (LCFF) for K-12, providing an increase of \$1.4 billion for LCFF targets in the coming fiscal year, and eliminates the "pause" on preschool and childcare increases. The Governor also proposes to shore up the California Public Employee Retirement System (CalPERS) with a \$6 billion supplemental payment that includes a loan from Surplus Money Investment Fund. In his press conference the Governor noted that California has spent a great deal to restore the services that were reduced in the Great Recession. "In 2017-18," he stated, "we will not be able to do that." Given the tightness of the overall revenue picture, the Governor's major focus is to eliminate some of the budget reduction strategies that had been proposed in the January Budget. To do this the Governor proposes to use a Prop 98 Test 3B suspension for three years. Overall, the May Revision is a small, a somewhat controversial, but important, restoration of revenues for K-14 education.

Since release of the revised budget proposal, the Administration has confirmed that it proposes to make allocation of one-time discretionary funding contingent upon a determination of the 2017-18 Prop 98 guarantee and to delay the appropriation until May 2019.

Economic Outlook

The Governor's May Revision maintains a cautious approach to the impacts of the economy and to the federal government's future budget actions on our state's revenues. In his press conference, the Governor emphasized that it will be critical for our state to be prepared for financial risks beyond the state's control. The Governor's budget continues to assume federal funds

and policies remain in place for the upcoming year, but highlights that should the repeal of the Affordable Care Act take effect, the state would lose about \$4.3 billion by 2020, which would increase to \$13 billion in 2027. Such a reduction in federal funding would necessitate a reduction in funding for core state programs, threatening access to healthcare services to 5 million Californians. Figure 6 on the charts below indicate the volatile nature of California's personal income taxes.

Proposition 98 Funding Levels

Last June, the 2016-17 Budget Act set Prop 98 funding at the minimum guarantee. Since that time, due to lower revenues, the funding level "over appropriates" the guarantee by \$432 million. This action also creates a higher funding base for Prop 98 going forward. In the January Budget, the Administration proposed to eliminate the "overappropriation" based on actual revenues received in 2015-16. This action reduced the Guarantee in 2016-17 and 2017-18. Additionally, the Governor proposed a deferral of \$859 million expenditure shift from 2016-17 to 2017-18.

For the May Revision, General Fund revenues that drive the calculation of the Guarantee are up by \$326 million in 2015-16, down by \$489 million in 2016-17, and up more than \$2.5 billion in 2017-18. In light of the increase, the May Revision proposes to not reduce funding for 2015-16, while generating savings similar to the January proposal over the long term.

Use of Test 3B – To achieve this savings, the Administration proposes to suspend the statutory Prop 98 Test 3B supplemental appropriation in 2016-17, as well as in 2018- 2019 through 2020-21. Under Test 3B, school funding grows at the same rate as the rest of the budget in years when the economic growth is slower. Funding reduced through this mechanism will be automatically added to the maintenance factor obligation which will restore Prop 98 funds over time.

- LAO analysis: The LAO notes that not providing the Test 3B supplemental appropriation provides the Legislature with more budget flexibility in future years. LAO also notes that this is not a suspension of the constitutional Prop 98 guarantee, but rather a suspension of a statutorily created supplemental appropriation. The state has provided this supplemental appropriation six times and has "notwithstanding" the statutory requirement as called for in the May Revision, once before, in 1993-94.

Increased Prop 98 Revenues in Budget Year – The adjustments outlined above, along with the additional \$2.5 billion from 2017-18 will increase Prop 98 funding by \$1.1 billion for 2017-18. This will provide a boost to the LCFF formula (getting districts to 97% of targets) and increases in one-time discretionary funds.

Maintenance Factor – The Administration indicates that primarily as a result of the increased revenues being provided in 2017-18, Prop 98 triggers a maintenance factor repayment of \$614 million in 2017-18 which reduces the outstanding maintenance factor balance to \$823 million.

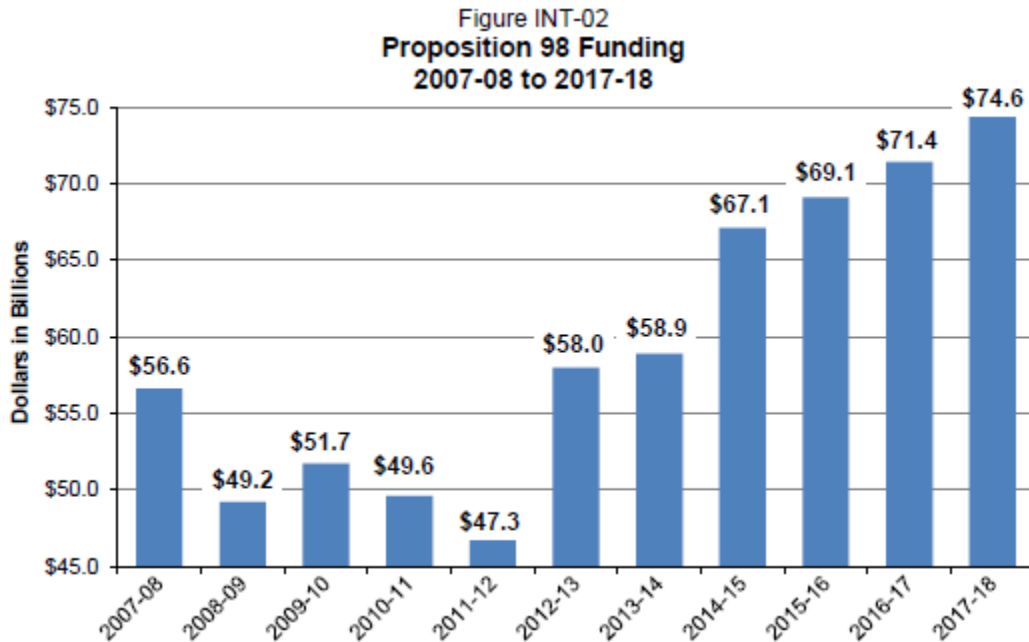
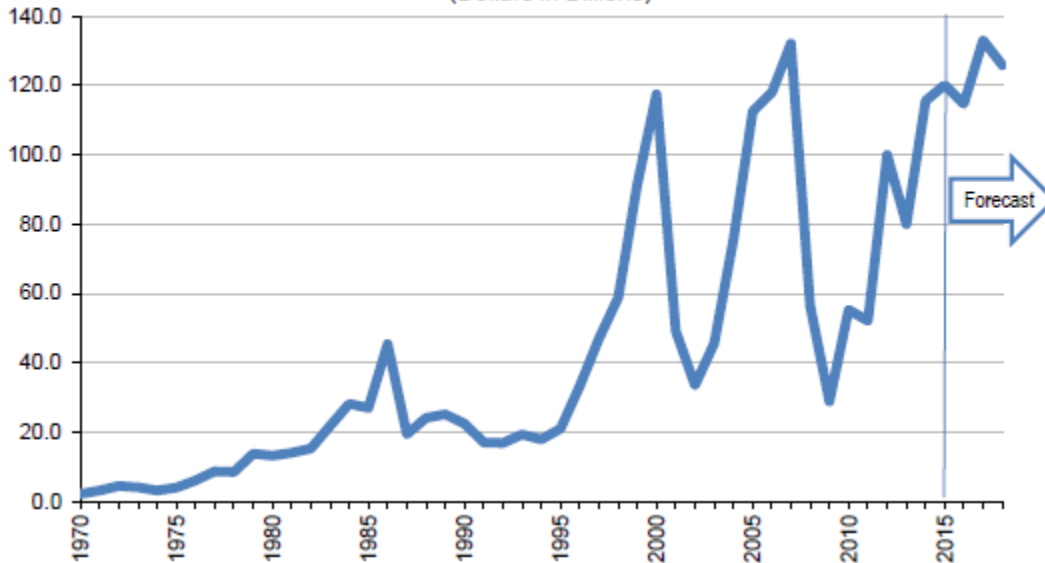


Figure INT-06
Volatile Capital Gains on the Rise
 (Dollars in Billions)



LAO analysis: Alternatives for Legislature to Consider

The LAO notes that there are alternatives the Legislature may want to consider in order to free up state funding for other non-education state priorities. In brief:

- Fund education at the minimum guarantee. This would provide about the same funding to education as in the January Budget proposal and would require some accounting changes such as using more of the Prop 98 settle-up funding and/or reinstating the deferral.
- Fund above the minimum but lower than the May Revision. This would require making a larger settle-up payment.
- LAO estimates that the state could use settle-up payments to free up as much as \$1 billion for its priorities and that about half of that would be one-time and half would be ongoing.

LCFF Payments – The May Revision proposes to use the increased revenue outlined above to continue to fund LCFF targets and increases the formula by an additional \$661 million. This is an increase over the \$770 million proposed in the January Budget. In total, there is \$1.4 billion proposed to increase the LCFF formula to 97% of full implementation. This LCFF funding will close approximately 43% of the remaining gap.

One-time Discretionary Funds – The January Budget proposed \$290 million in one-time funds for discretionary spending. The May Revision proposes an additional \$750 million. This total of a little over \$1 billion is described as being available for school districts, charter schools and county offices for a variety of priorities including further implementing state-adopted academic standards, making necessary investments in professional development, providing teacher induction, addressing infrastructure and deferred maintenance needs, and purchasing instructional materials and technology to “prepare both students and teachers for success.” As with past allocations of one-time funds, the state will reduce the outstanding mandate debt to local educational agencies (LEAs) by this amount. According to the Department of Finance, these funds will reduce the debt owed to LEAs by \$1.3 billion.

Update on delay of One-Time Discretionary Funds - What was not delineated in the May Revision Budget Summary was that these funds, which are based on the expected increase in personal income tax receipts expected to come in for 2017-18 will not be allocated in the regular manner. The Administration plans to release the funds in *May 2019* after making a determination of the final Prop 98 calculation for the 2017-18 fiscal year. If Prop 98 is "over appropriated" in the budget year, the amount of the reserved one-time funds will be reduced by that much to draw down to the minimum guarantee. Any remaining dollars would go out on an ADA approach in May of 2019. However, this \$1 billion will count toward the 2017-18 Prop 98 guarantee. On May 15, 2019, the director of the Department of Finance will certify whether the 2017-18 guarantee is greater, equal to or less than the amount in the 2017-18 Budget Act. If it is equal or greater, the dollars will be apportioned. If the guarantee is less, it will come out of the \$1 billion. Department of Finance released its trailer bill language on this contingency appropriation on May 15, 2017 and a copy is attached.

- LAO comments on the contingency appropriation of one-time funds: The LAO sees this as a reasonable planning option and one way the state can provide a cushion in event of an economic slowdown. The state could adjust reserved school funding without making reductions to LCFF or other ongoing school programs. The LAO does recommend a modification: to link additional one-time discretionary grants to a strategic plan to pay off remainder of K-12 mandates backlog.

K-12 Budget Adjustments

The significant adjustments to the January Budget include:

Local Property Tax Adjustments – An increase of \$188.7 million Prop 98 General Fund in 2016-17 and \$327.9 million for school districts, SELPAs and COEs as a result of lower offsetting property tax revenues.

Average Daily Attendance – An increase of \$26.2 million in 2016-17 and \$74.1 million in 2017-18 as a result of a smaller drop in ADA growth overall between these two years.

Prop 39 Energy – The May Revision decreases the funding by \$46.7 million for 2017-18 for a total of \$376.2 million.

Cost of Living Adjustment – The COLA is going up from 1.48% to 1.56%. The May Revision reflects an increase to \$3.2 million to cover this increase.

Update on COLA: The May Revision provides \$29 million for a 1.56 percent COLA to child care and preschool. The January Budget did not provide COLA for these programs.

Categorical Program Growth – The May Revision increases funding for the remaining state categorical programs by \$2.4 million to cover the growth of program ADA.

Educator Workforce Strategies

The Administration proposes to increase the efforts made in the prior year's budget to strengthen the educator workforce in California. The May Revision outlines funding in the 2016 Budget for the Commission on Teacher Credentialing that supports several programs:

- Forty-one grants have been awarded to 33 public and private post-secondary institutions to create or improve four-year programs that integrate a BA degree and a teacher preparation program. These grants will save new teachers approximately \$20,000 by eliminating the fifth year. These funds are from the Integrated Teacher Preparation program funded with \$10 million from 2016 legislation.
- A total of 24 grants have been awarded under the Classified School Employee Teacher Training Program passed by the legislature in 2016.

This will enable 960 classified employees to work toward earning a teaching credential.

- The Tulare County Office of Education has been awarded a five-year grant to create the California Center on Teaching Careers. The center will recruit candidates into the teaching profession by providing outreach and referral services both online and at regional centers.

The May Revision does not provide a specific funding increase to recruitment efforts but does propose to “leverage federal funds to attract and support the preparation and continued learning of committed teachers, principals and other school leaders.” The Administration proposes using flexibility under the federal Every Student Succeeds Act (ESSA) to direct “additional federal resources to state efforts to address recruitment and retention issues throughout the state, with particular focus on critical shortage areas and high need fields.”

Update on Educator Workforce Proposal

- In its letters to the Budget Committees, the Department of Finance outlines its proposal for \$11.3 million in federal Title II funds to be provided to the Commission on Teacher Credentialing (CTC) through an interagency agreement with California Department of Education and directs the CTC in conjunction with the California Center on Teaching Careers to develop a competitive grant program that assists LEAs in attracting and supporting the preparation and continued learning of teachers, principals and other school leaders in high need subjects and schools. More specifics are expected in trailer bill.

LAO analysis: The LAO recommends this proposal be modified to identify a specific policy problem and that it include clear objectives and ways to measure and monitor outcomes of the program.

Special Education

The Administration indicates it is still committed to the special education program reforms that were outlined in the January Budget. Noting the stakeholder sessions held in spring 2016 and “the scope of the feedback and complexity of this program area,” the Administration will continue working on these issues to “chart a path forward that will maximize resources to serve students while increasing transparency and accountability.”

K-12 School Facilities

The May Revision reiterates the Administration's desire to increase accountability and oversight of school facilities program expenditures, citing the 2016 audit as it did in the January Budget. The Administration continues to advance proposals for grant agreements that define basic terms, conditions and accountability measures and legislation to require facility bond expenditures to be included in the annual K-12 Audit Guide.

The write-up in the May Revision notes that the Office of Public School Construction (OPSC) has presented the draft grant agreement to the State Allocation Board and that "it is anticipated that the State Allocation Board will take action on a final grant agreement at its next meeting." (Update: The next meeting of the SAB is scheduled for June 2, 2017).

The Administration proposed revised trailer bill language on the K-12 Audit Guide in early April. It is available on the Department of Finance website at: http://dof.ca.gov/Budget/Trailer_Bill_Language/documents/300EducationOmnibusTrailerBill.pdf

The Administration restates its position that it will support expenditure of Proposition 51 funds when both the grant agreement and audit requirement are in place. The Coalition for Adequate School Housing (CASH), CASBO and other education organizations have previously weighed in with comments to OPSC and the Administration to voice concern should the language in either violate or constrain the school facilities program.

During a briefing on the May Revision, staff from the Department of Finance indicated they are looking at some of the concerns raised about the grant agreement and local audits. They did not commit to further changes but voiced optimism about moving these items forward. We've learned that CASH is preparing another letter on concerns. The OPSC has issued a notice that the May 24th meeting of the SAB has been rescheduled to June 2, 2017.

Preschool and Child Care

With the increase in state revenues, the May Revision brings a welcome proposal to meet the commitment in child care and preschool made as part of the 2016 budget agreement. The May Revision contains proposals for rate increases and additional preschool slots that the Governor's January Budget had "paused." The May Revision contains the following adjustments to the January Budget proposal:

Standard Reimbursement Rate Increases

- An increase in the reimbursement rate to reflect the full 10% increase that was made as part of the 2016 Budget Act: total increase of \$67.6 million (\$43.7 million Prop 98 and \$23.9 million in non-Prop 98).
- Additional 6% increase in the reimbursement rate to reflect the next phase of increases that were also part of the 2016 Budget Act: an increase of \$92.7 million (\$60.7 million Prop 98 and \$32 million non-Prop 98)

Regional Market Reimbursement Rate

An increase in the maximum reimbursement ceiling for voucher-based child care providers to the 75th percentile of the 2016 regional market survey, to begin January 1, 2018: increase of \$42.2 million in non-Prop 98.

Additional Full-Day Preschool Slots

Increase Full-Day State Preschool slots by 2,959: increase of \$7.9 million Prop 98.

Decrease in estimated caseload and cost per case for Cal WORKs Stage 2: decrease of \$18.1 million non-Prop 98 in 2017-18

Decrease in estimated case load and cost per case for CalWORKs Stage 3: decrease of \$12.8 million in non-98 in 2017-18

Update on COLA for child care and preschool programs: The May Revision provides \$29 million for a 1.56 percent COLA. The January Budget did not provide COLA.

Update on ECE policy proposals: The Administration proposes some modifications to the policy proposals to align Transitional Kindergarten (TK) and Preschool requirements:

- Clarify that part-day State Preschool programs can enroll 3- and 4-year old children with exceptional needs with family income above the income eligibility level only after all otherwise eligible children have been enrolled.
- Align the teacher education requirements with existing TK requirements (e.g., 24 units of ECE) for State Preschool programs that utilize the higher 1:12 adult children ratio.

- Specify that authorization of different lengths of school day for Kindergarten and TK may be at the same or different school sites.
- Provide CDE one year to implement any changes to licensing requirements for State Preschool programs operated by LEAs on school sites before exempting these programs from Title 22 health and safety regulations.

LAO analysis: The LAO recommends rejecting the policy proposals and instead taking a more comprehensive approach to aligning TK and Preschool.

Retirement – CalPERS Supplemental Payment

The May Revision includes a one-time \$6 billion supplemental payment to the California Public Employees Retirement System (CalPERS) to mitigate increasing pension contributions that are a result of the state’s large unfunded liabilities and the CalPERS Board’s recent action to lower its assumed investment rate of return from 7.5 percent to 7 percent. This payment will be a loan from the Surplus Money Investment Fund that will reduce unfunded liabilities and stabilize state contribution rates. Department of Finance believes that this will save \$11 billion over the next 20 years. The General Fund share of the repayment will come from Proposition 2 (Rainy Day Fund) revenues that are dedicated to reducing debts and long-term liabilities. It is not clear what impact this action will have on K-12 school employers with PERS employees. With this reduction of unfunded liability reduce payments for school districts? Not likely. Will this infusion of funds reduce the future payment of school employers? That is the biggest question that we will follow as this action is implemented. Finally, there does not seem to be any thought by the administration for a similar infusion of revenue into the STRS system.

Summary

Given that there was virtually no new funding in May than what was forecast in the January Budget, the May Revision is a very pleasant surprise. There are proposed revenue increases in both the LCFE revenues and in one-time funds of about \$2.5 billion. Additionally, the rate and slot increases to child care and preschool have been restored. However, the desire of the Governor to suspend Test 3B for three additional years and the manner in which the one-time discretionary funds will be delayed until May of 2019 are giving many education organizations legitimate concern. In spite of the Test 3B suspension and the proposed “deferral” of the one-time funding into

2019, schools will be viewed by the non-education sector as “getting all of the money.” Between now and the end of June, there will be negotiations, testiness and some battles to reset the funding priorities in the final budget. Legislators will seek to use funds for a variety of other programs.

Update from the May 15 legislation actions: The Senate Budget Subcommittee on Education was our first opportunity to hear questions from Legislators to the Department of Finance and the LAO. It was an overview of the Prop 98 proposals and no votes were taken. Both the Assembly and Senate will hold hearings throughout the week and we will get a much better idea when they vote to close out their respective budgets. By the end of the week we’ll get a better sense of priorities that each house, or both, will pursue. As always, we will monitor these actions and keep you informed.

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