AUDIT AND BUDGET COMMITTEE AGENDA

Coast Community College District*

Special Meeting of the Audit and Budget Committee

Tuesday, November 22, 2022, at 1:00 p.m.

Zoom Meeting ID: 823 4798 8133

https://cccd-edu.zoom.us/j/82347988133

1. **Call to Order**

2. **Roll Call**

3. **Opportunity for Public Comment**

   Members of the public have the opportunity to address the Audit and Budget Committee on any item that has been described in this notice. Persons wishing to make comments will be recognized at this point in the meeting. Individuals will have up to five minutes per agenda item, and there is a 20-minutes total limit per item. These time limitations may be extended by the Committee.

   It is the intention of the Coast Community College District to comply with the Americans with Disabilities Act (ADA) in all respects. If, as an attendee or a participant at this meeting, you will need special assistance beyond what is normally provided, the Coast Community College District will attempt to accommodate you in every reasonable manner. Please contact the Secretary of the Board at jburton@cccd.edu as soon as possible to inform us of your particular needs so that appropriate accommodations may be made.

4. **Authorization under Brown Act, Government Code § 54953(e), for Conducting Meetings Remotely Due to the COVID-19 Emergency Because Meeting in Person Would Present Imminent Risks to the Health or Safety of Attendees**

5. **Approval of Minutes: Meeting of August 22, 2022** (Attachment #1)

6. **Review, Discuss, and Possible Action regarding Internal Audit Quarterly Update – Rachel Snell** (Attachment #2)

7. **Review, Discuss and Possible Action regarding State Legislative Budget Issues – Carly Shelby, Townsend Public Affairs** (Attachment #3)

8. **LAO Economic Outlook for 2023-24 – Marlene Drinkwine** (Attachment #4)

9. **Future Meeting Date**

10. **Future Agenda Items**

11. **Adjourn**

**The Committee may take action on any item listed on this agenda. Under the Brown Act, the Public has the right to receive copies of any non-exempt public documents relating to an agenda item that are distributed to the committee members. Please contact the Office of the Board of Trustees at jburton@cccd.edu prior to the meeting to facilitate the distribution of these documents.*

AUDIT AND BUDGET COMMITTEE MINUTES

Coast Community College District

Special Meeting of the Audit and Budget Committee

August 22, 2022

Zoom Conference Meeting

1. **Call to Order**

   The meeting was called to order at 2:00 p.m.

2. **Roll Call**

   Trustees Present: Trustee Jim Moreno and Trustee Mary Hornbuckle
   Trustees Absent: None

   In Attendance – Dr. John Weispfenning, Chancellor; Marlene Drinkwine, Vice Chancellor of Finance and Administrative Services; Dr. Andreea Serban, Vice Chancellor of Educational Services and Technology; Dr. Marco Baeza, Vice Chancellor, Human Resources; Dr. Vincent Rodriguez, President, Coastline; Tim McGrath, President GWC; Paul Wisner, GWC Director of Business Services; Daniela Thompson, Executive Director Fiscal Affairs; Tanya Tran, District Budget Manager; Rachel Kubik, OCC Director of Business Services; Erik Fallis, District Director, Public Affairs & Marketing; Janet Houlihan, Vice President, Administrative Services, GWC; Derek Bui, Director Business Services, Coastline; Julie Clevenger, Director Chancellor's Office Operations and Projects; Christine Nguyen, Vice President, Administrative Services, Coastline; Dr. Rich Pagel, OCC Vice President Administrative Services; Rick Garcia, OCC Director of Maintenance & Operations; Dana Swart, District Controller; Jose Fuentes-Perez, Student Trustee; Casey Elliott, Vice President, Townsend Public Affairs; Mary Grady Administrative Assistant, Board of Trustees; Jane Burton, Manager/Board Secretary

3. **Opportunity for Public Comment**

   Student Trustee, Jose Fuentes-Perez introduced himself to the Committee, and expressed his excitement at being selected as Student Trustee to the Coast District Board of Trustees. The Student Trustee email address for questions or comments was offered: strustee@cccd.edu.

4. **Authorization under Brown Act, Government Code § 54953(e), for Conducting Meetings Remotely Due to the COVID-19 Emergency Because Meeting in Person Would Present Imminent Risks to the Health or Safety of Attendees**

Attachment #1

Chancellor Weispfenning's recommendation was for this meeting to be held telephonically, and for the Committee to consider holding the next meeting in person.

On a motion by Trustee Hornbuckle, seconded by Trustee Moreno, the Committee voted to approve the Chancellor's recommendation.

Motion carried with the following vote:

Aye:	Trustee Hornbuckle and Trustee Moreno
No:	None
Absent:	None

5. Approval of Minutes: Meeting of May 24, 2022

On a motion by Trustee Hornbuckle, seconded by Trustee Moreno, the Committee voted to approve the minutes of the Special Meeting of May 24, 2022.

Motion carried with the following vote:

Aye:	Trustee Hornbuckle and Trustee Moreno
No:	None
Absent:	None

6. Review, Discuss, and Possible Action Regarding Internal Audit Quarterly Update

Rachell Snell, District Director of Internal Audit, could not be available for the meeting, however, she did send an update to the Committee in addition to the regular Internal Audit Quarterly Reports.

The prospect of developing a gift policy for Coast employees and Board of Trustees was discussed. Vice Chancellor Serban had already begun the process of reviewing CCLC templates and examples of gift policies from other community college districts and reported that a draft would be reviewed by the DCC BP/AP Sub-Committee and then eventually presented to the Board of Trustees for consideration and approval.

7. Review, Discuss and Possible Action Regarding State Legislature Budget Issues

Casey Elliott, Vice President, Townsend Public Affairs provided the Committee a brief update on current state legislative budget issues.

The May Governor's Revised Budget for FY 2022-23 was released by Governor Newsom. The main focus of the budget was one-time funding.

State revenues for the first month were about $1.5 billion below projections, although the year's budget for the state total reserve balance was just over $37 billion.

The Legislature was scheduled to adjourn the two-year Legislative session the following week, with at least one budget trailer bill expected to be approved before that time. He noted that he did not believe there was anything related to community colleges in that bill.

The State Chancellor's Office had begun to pull budgets together for the following year.

Trustee Moreno asked about the state surplus level. Casey Elliott noted that the carryover reserves ended up at approximately $37 billion. Surplus was in the low to mid $40 billion, with the overall budget up about 20%.

Both Trustee Moreno and Trustee Hornbuckle thanked Casey Elliott for his observations and direction.

8. Review, Discuss and Possible Action Regarding Budget FY 2022-2023

Vice Chancellor Marlene Drinkwine provided a presentation for the FY 2022-2023 Budget.

The regular state budget adoption procedure had changed due to the pandemic. A placeholder budget was put in place that allowed deadlines to be met with the release of funds. The placeholder budget would subsequently be revised, and this had been the new procedure for two years consecutively, including this year. This had caused the trailer bill phase to be extended.

All the data was not yet received for most of the large block grants and new funding, leaving uncertainty about program rates, expenditure guidelines, etc., and that was not typical for this point in August.

The Governor's Budget included good news with highlights covered including the fully funded 6.56% COLA, increases for the Student-Centered Funding Formula (SCFF) and specified categorical programs. Also, the ongoing extension of the Hold Harmless provision and a one-year extension of the Emergency Conditions Allowance, both critical to CCCD current and ongoing funding. Other items included one-time funding for maintenance, a discretionary block grant funding to address the impacts of the pandemic, and a host of augmentations for categorial programing - some ongoing and some one-time.

The State Chancellor's Office had expressed caution regarding the appropriation of funding for all college districts, as the State Chancellor's Office would need to determine if they had the full amount of funds needed. Last year a 1% funding deficit was projected, and then revised as it was determined more funds would be available to fully fund us. There was an improvement to the CCCD ending fund balance of $2 million.

The FY 2022-23 Budget Assumption Developments showed the 50% Law reserve requirements were met; however, we saw increases in CalPERS and CalSTRS and the rolling three-year average was declining, which would be a critical future consideration.

Projections for the Student-Centered Funding Formula, including the 6.56% COLA for FY 2022-23 of $218,829,580, would be a significant increase over FY 2021-22. Still funded at our Hold Harmless level, however, the Hold Harmless/Funding Floor decreased to $741,313. The FY 2022-23 projection was without benefit of the emergency conditions allowance. Within the enacted state budget funding floor budget for FY 2025-26 the recalculation would be $14,716.240 with no COLA.

Hold Harmless would be effective through FY 2024-25 and the Funding Floor would begin FY 2025-26 and would not be increased by COLA.

The state had declared a state of emergency due to the pandemic, and Districts were provided with emergency conditions allowances and could use the FY 2019-20 FTES instead of the current year FY 2021-22. That helped keep revenues high for the District. In addition to increases for the Student-Centered Funding Formula, other revenue was increased through the emergency conditions allowance including lottery revenue statewide.

Districts statewide had continued to experience declining enrollment. There was a surprise extension of the emergency conditions allowance into FY 2022-23. This extension had conditions attached to it, which included a Board approved emergency recovery plan (already approved) and several other requirements. Most critical was the requirement that the Board enact a reserve policy consistent with a new recommended reserve amount of two months of general fund operating expenditures, which equals 16.67%. That would be 6.67% over the current Board policy reserve funds of 10%.

The benefit of adhering to the conditions as mentioned above would bring an estimated return of approximately $4.5 million for FY 2022-23 and because of the three-year rolling average, it would bring another $4.5 million in FY 2023-24. It would be a combined $9 million in one-time funding that we could use to bolster our reserves.

The multi-year projections show budget year FY 2022-23 with deficit spending of $1.3 million, although this was expected to be resolved through salaries and benefits savings that would typically exceed that amount. Over the course of the next budget year, each quarterly update was expected to show improvements.

Although Projections showed 17.29% reserves in the budget year FY 2022-23, not all the ending balance was shown as available to meet reserves. The reason being some of the ending fund balances were already reserved. $5 million was in the college balances (typically not used to meet reserves), assigned reserves for multi purposes and not available to be included in the policy reserve funds. However, if we receive the emergency conditions allowance because we have adopted the higher reserve requirement, we will receive $9 million to bolster our reserves for the current and subsequent years.

The application for the FY 2022-23 Emergency Conditions Allowance was due September 1, 2022 and was already submitted. CCCD had already met a key condition to receive the emergency funds allowance for teaching colleges through the California mutual college open enrollment platform. With Dr. Serban's leadership, CCCD was the first district in the state to go live with online teaching for all three colleges, in October of 2020. Other districts would struggle with this condition, and CCCD was already ahead of the curve.

The new Board policy would need to be adopted by February 2023. If the State Chancellor's office determined the conditions were not met, the funds would need to be returned.

Although we would receive deferred maintenance and another Covid 19 block grant, it was less than proposed in May. The Capital Outlay funding for Orange Coast College Chemistry building was included in the FY 2021-22 budget and would remain available for that project.

Even though the GWC Fine Arts project had been included in the Board of Governors' proposed budget it was not included in the 2022-23 state budget. The State Chancellor's Office has assured us that they would again use it in their recommendation, and we would remain hopeful.

The Scheduled Maintenance and Instructional Equipment Block Grant final budget included $840.7 million in general fund dollars for community college deferred maintenance. Coast would see an estimated $18.8 million in one-time funding for this purpose. We should have four or five years to spend this money.

Student Housing AB 183, a higher education trailer bill, provided $1.23 billion in FY 2022-23 and included twelve eligible community college projects worth $542 million. An additional $2 billion in grant funding between now and 2024-25 for student housing projects and UC, CSU and CCC would bring the total program funding to $4 billion.

Developing concerns continued to be declining enrollment, the fiscal plateau beginning in FY 2025-26, increasing retirement systems employer contribution costs, and the absence of Federal emergency funding beginning FY 2022-23. The list continued with uncertain economic conditions resulting from the COVID-19 pandemic, labor market disruptions, global supply chain issues, inflation, and rising interest rates, highlighting the need for continued cost containment measures, e.g., salary cost savings. Vice Chancellor Drinkwine noted we were back over 90% on salaries and benefits.

The last area of importance was the System recommendation to adopt the Government Finance Officers Association (GFOA) recommendation of required reserves equal to a minimum of two months of total general fund operating expenditures, equivalent to 16.67% reserve.

Vice Chancellor added that our ending fund balance had improved over the course of the pandemic, largely due to HEERF, but reminded everyone that HEERF would go away at the end of the year.

The 2025-26 projection had been revised to reflect that it was no longer a fiscal cliff, rather a fiscal plateau, meaning we would have a few more years before we were in dire straits, but the value would decrease because it would not be increased by COLA.

We had received an excellent renewal on health benefits. One year retirement increases, however, were almost $4 million; an unavoidable ongoing increase in District costs.

In response to a question from Trustee Hornbuckle on Student Contact Hours/Full-Time Equivalent Faculty, Vice Chancellor Serban explained that the chart showed average class enrollment that had significantly declined for all three colleges. This was a reflection of the fact that over several years enrollment had declined and we were seeing lower average class enrollment overall.

The Trustees thanked Vice Chancellor Drinkwine for the in-depth presentation.

9. Future Meeting Date

The next meeting was previously scheduled for Tuesday, November 8, 2022, at 2:00 p.m.

10. Future Agenda Items

(a) Internal Quarterly Audit Update
(b) State Legislative Budget Update

11. Adjourn

The meeting was adjourned at 2:47 p.m.

Jane Burton
Secretary of the Board

Internal Audit

MEMORANDUM

Date: October 24, 2022

To: Dr. Whitney Yamamura, Chancellor
Dr. Angelica Suarez, OCC President
Dr. Madjid Niroumand, OCC Vice President Student Services

Cc: Kelly Daly, RN, OCC Health Center Director

From: Rachel Snell, Director Internal Audit

Re: OCC Health Center Revenue/Expense Review

OCC management requested Internal Audit review Health Center (Center) revenues and expenses and identify opportunities to increase revenues and/or lower expenses. To do this, Internal Audit reviewed the Center's Fiscal Year (FY) 2022-2023 budget, and met with staff from the Center, OCC Foundation, OCC Business Office, and District Grants.

Background Information

The Center offers basic health care, first aid, and mental services, in addition to some men's and women's health services, diagnostic lab tests, and COVID information. The Center refers students to local clinics and health facilities for care beyond what it can provide. A fee is charged to cover some costs, but occasions exist where either the student did not pay the health fee, or is not enrolled in courses as required, but receives care. A triage process confirms whether an urgent medical need exists; however, staff makes efforts to collect any fees at the time of service.

The Center Directors are both licensed in their respective fields, Nursing and Mental Health, and report to the Vice President of Student Services. There are three registered nurses, a medical assistant, and an administrative assistant, in addition to two professional experts (physician and nurse practitioner) who provide more advanced services. For mental health, there are four paid staff and eight unpaid interns.

Center revenues are primarily derived from the Student Health Fee, which is set by State law. Currently, the student health fee is $23 per semester and $20 for Summer Session. California Education Code Section 76355 limits the fee increase to the same percentage increase as the Implicit Price Deflator for State and Local Government Purchase of Goods and Services; however, the fee increase cannot exceed one dollar. The Center also receives funding from State grants, including a Mental Health grant. Most Center expenses are related to salaries for staff and professional experts, followed by medical supplies. For FY 2022-2023, budgeted revenue and expenses are $850,000. Anticipated actual revenue and expenses are estimated at $800,000 and $972,342 respectively, with a shortfall of approximately $172,342.

Attachment #2a

Results

Over the last few years, the Center's expenses exceeded revenue, since staff costs increase at a rate that exceeds all funding sources combined. Staff salaries are typically adjusted by the approved Cost of Living Adjustment (COLA), whereas the student health fee is not. The cost to provide health care is rising, and the Center is currently unable to generate enough revenue to meet its needs on a long-term basis. Due to funding limitations, the Center is unable to replace front-line staff, so the Center sometimes struggles to meet service demands. Since the Center supports two full-time managers and five full-time staff, the Center hires Professional Experts to cover most of its day-to-day medical and mental health services. Currently, OCC provided HEERF funding to cover the Center's budget needs. After this year, that funding will no longer be available.

To increase funding, the Center met with the OCC Foundation and District Grants Office, but the Center does not have certain data readily available to facilitate outreach efforts or research in these areas. Furthermore, the Center has not performed a detailed cost analysis to determine the true cost to provide care, which could inform decision making for the additional staff needed to meet demands. A cost analysis of the fee schedule could reveal whether fees are set at a minimum "break even" rate for those services.

Other Observations

<u>Cash Drawer:</u> The Center maintains a cash drawer, which is primarily used by one person. The Center rarely receives cash or checks. Almost all students pay via credit card or Apple Pay. The amount of transactions using cash is far less than the staff burden that would be necessary to implement proper internal controls over cash handling.

<u>Districtwide Health Center Operations:</u> Internal Audit did not review the Goldenwest College (GWC) Health Center. However, work at OCC revealed certain differences in the services provided to students. For example:

1. Students may receive services at OCC, regardless of whether the student paid the health fee, whereas at GWC, students may not receive services. In both cases however, there may be an initial assessment to determine medical need for care.
2. Fees related to services provided may not be the same at both Centers; however, the cost to provide those services also may not be the same at both colleges.
3. OCC offers more services than GWC, creating potential disparity between colleges.
4. CCC has a Memorandum of Understanding (MOU) with GWC and OCC to provide health services to its students. The MOU provides equal payment to both colleges, although more CCC students may select OCC as its primary provider than GWC.
5. While both Centers use the same software for health charts and other records, neither Center can access student records at the other Center.

In general, the colleges support obtaining more data to improve decision-making, but there is no consensus on sharing information across sites. There is also no consensus on making changes to Center operations that may cause one college to change in a manner that is inconsistent with how it would prefer to operate. GWC reported that it is currently operating with a positive budget balance, whereas OCC is not. However, OCC is reviewing its funding sources in order to balance its budget and is considering potentially expanding mental health services under its new Mental Health grant.

Recommendations

1. The Center should perform a cost analysis to determine the true cost of providing care, and use the results to determine the extent to which certain allowable fees can be increased.
2. The Center should gather detailed demographic and service data, and work with the Foundation and District Grants Office, to facilitate outreach to donors and granting entities with interests specific to the needs of the Center.
3. The Center should work with its college counterparts to review operations districtwide and service delivery to students, including but not limited to:
   a. Establishing similar services and fee schedules;
   b. Allowing each Center to access records in order to facilitate services to students; and
   c. Reviewing the MOU and determining whether more CCC students select one site over another for health care services and adjust the payment to that college accordingly.

OCC management generally agrees with the recommendations and will work towards gathering more data and reviewing that data in the context of making decisions related to operational improvements. OCC management also acknowledges the delicate need to balance the ability to provide services to students with the need to balance the budget and operate in a more financially viable manner. OCC management believes that health services are critical to students and despite funding gaps, should be funded with the General Fund to cover these gaps and should remain a college priority.

Audit and Budget Committee Meeting: 11/08/22

Projects—Completed

- Internal Audit Specialist Position: Maira de la Torre started 10/01/22.
- OCC Health Center: Review revenues and expenses (See Attached).
- Employee Relations—Confidential memo was issued to HR (Scheduled for release in December 2022).
- Waste of Public Funds/Conflict of Interest Allegations (1 complete—Scheduled for release in December 2022)

Other Projects—In Progress

- Risk Services: Business process improvement project.
- Cosmetology: To review processes for ensuring compliance with state licensing requirements (changed to follow up on prior audit recommendations and the Program Vitality Review).
- Waste of Public Funds/Conflict of Interest Allegations (1 in progress)
- External Audit Liaison: Ongoing
- General Counsel/Legal Fees
- Record Management—Internal Audit files

Other Services

- Retirement Board, Vice Chair
- DCC—BP/AP Subcommittee (Advisory)
- District Facilities Committee

Attachment #2b

TOWNSEND
PUBLIC AFFAIRS
EST TPA 1998

To: **Coast Community College District**
Audit and Budget Committee

From: **Townsend Public Affairs, Inc.**
Casey Elliott, Vice President

Date: **November 8, 2022**

Subject: **State Legislative Affairs Update**

The month of October included no legislative action in Sacramento as the Legislature has adjourned their session and the Governor has acted on all pending legislation. For the majority of October, legislators were focused on activities in their districts, leading up to the November General Election.

Below is an overview of relevant budget-related activities that transpired during the month of October.

California State Budget: Fiscal Outlook

In October, the Department of Finance released its monthly Finance Bulletin, which indicated that the state is experiencing a revenue shortfall of nearly $ 7 billion. Specifically, September cash receipts came in $2.8 billion below the month's projection and brings the state's expected revenue to $4.8 billion below projection for fiscal year to date. When combined with $2.2 billion shortfall ending in the last fiscal year, the State's total revenues are currently nearly $7 billion below most recent forecast. It should be noted that nearly all of the year-to-date revenue shortfall is due to lower-than-expected revenues from personal income taxes (lower withholdings, lower estimated payments, and higher refunds than expected).

The revenue numbers will continue to fluctuate over the course the next several months as additional returns data filters in throughout the tax season. It is possible that the lower personal income tax revenue early in the year will result in higher-than-expected personal income tax revenue later in the fiscal year, but this will not be know until the traditional income tax filings start to come into the state.

If the current trend holds, the state may have fewer resources available for the FY 2023-24 budget; however, responsible state budgeting throughout the past few gubernatorial administrations has resulted in a build up of over $23 billion in the state's rainy-day fund, strong budget reserves, and over $130 billion in cash on hand. The establishment, and funding, of the rainy-day fund will allow the Legislature and Administration to help mitigate the need for severe budget cuts, should revenues end up below projected levels. Additionally, a portion of the state's reserves are specifically earmarked for educational purposes, so K-14 education would not need to compete with other areas of the state budget for use of rainy-day funds.

Middle-Class Tax Refunds Enacted in Budget Agreement Distributed to Eligible Californians

Beginning on October 7th through October 25th, $9.5 billion in Middle Class Tax Refund payments was distributed to eligible Californians, with up to $1,050 for eligible families with dependents to help with rising prices caused by inflation. The three-tier program benefitted an estimated 23 million California taxpayers, including individual filers making as much as $250,000 and joint filers making as much as $500,000, with low- and middle-income households receiving incrementally more money. Households making as much as $75,000 for individuals or $150,000 for joint filers received $350 per taxpayer, plus an additional $350 if they have at least one dependent.

The distribution of payments marks the tangible benefits for Californians after months of legislative debates over how best to issue rebates to Californians in response to soaring inflation prices and a need to balance budget spending to circumvent issues related to the State Appropriations Limit (SAL). In the Governor's State of the State speech in March, he called for a plan to address soaring gas prices, which have since climbed into the $7 per gallon range, by sending $400 debit cards to every registered vehicle owner in the state. Legislative leaders firmly resisted that approach, which did not include an income limit, and could have left out the state's most needy – including those unable to afford to own vehicles. In response, Legislators countered with a separate plan to distribute $200 checks for each eligible taxpayer and their dependents living in households making less than $250,000 per year for a couple or $125,000 per year for an individual.

While inflation relief was a driving factor for the distribution of payments, so was the need to craft a budget spending plan that did not exceed the State Appropriations Limit (SAL). The SAL constrains how the Legislature can use revenues that exceed a specific threshold. Given recent revenue growth, the SAL has become an important consideration in the state budget process and will continue to constrain the Legislature's choices in next year's budget process. The limit is tied to California's 1978-79 spending level, adjusted for changes in population and per capita personal income. If the state exceeds its limit over a two-year period, the Legislature must spend the revenue over that limit in specific ways – providing funds to taxpayers via rebates and K-12 schools and community colleges.

Governor Calls Special Session to Address High Gas Prices

On October 4th, Governor Newsom announced he would call a special legislative session to consider a windfall profit tax on oil companies in response to the soaring price of gas in California. The Governor noted that the session would convene on December 5th, which is the same day that the new Legislature will be sworn into office and the 2023-24 Regular Legislative Session will commence.

Gas prices in California have soared to an average of nearly $7 per gallon, compared to a national average of $3.89 per gallon. Governor Newsom has pointed to the decreasing price of crude oil while the price of gasoline has increased, stating the discrepancy can be attributed to gas companies seeking profits. Critics have said that a windfall tax would only drive-up prices further because oil companies would pass on the cost to customers, and that the state should focus on suspending the gas tax instead. Legislative leaders Anthony Rendon and Toni Atkins released a joint statement stating they "look forward to examining the Governor's detailed proposal when they receive it."

Special sessions are those convened pursuant to a proclamation issued by a Governor. During special sessions, legislators may only legislate subjects specified in the proclamation but may consider budgetary or other matters incidental to the session subjects. While the proclamation will formally convene the Legislature, there is no constitutional requirement that any legislation be enacted.

While most bills enacted during the regular session take effect the following January, special session bills take effect on the 91st day after adjournment of the special session, which also means that, if the business before the special session has concluded, then the special session should cease so that the 90-day clock can begin running.

Over the past 28 years, there have been 34 different special sessions; however, this will be the first such special session in six years. Governor Brown called the Legislature into five special sessions during his second 8-year term; Governor Schwarzenegger called 18 special sessions during his 7 years in office; and Governor Davis convened 5 special sessions during his 5 years in office.

Looking Forward

As noted above, the Legislature will convene for the 2023-24 Regular Legislative Session on December 5th. While the Legislature will be sworn into office on this day, and will adopt the rules that will govern the Regular Session, after the day's activities have concluded, they will return to their districts until January. The Legislature will begin the new session, in earnest, the first week of January.

The California Constitution requires that the Governor issue his January Budget proposal no later than January 10th. It will be at this time that the Administration will put forth its preliminary revenue estimates for the upcoming fiscal year, as well as revise the revenues and expenditures for the remainder of the current budget year. Shortly after the Governor releases his January Budget proposal, the Legislature will begin conducting informational hearings of the Budget Committees and the Budget Subcommittees to receive more detailed information on the Governor's budget proposals.

As part of the January Budget proposal, the Governor may ask the Legislature to consider trailer bills to make modifications to current year budget proposals (which were adopted last year) in order to adjust to the actual revenues that are coming into the State. If the Governor asks the Legislature to consider additional budget year trailer bills, it would be expected that those proposals would be released as part of the larger January Budget proposal.

LAO

The 2023-24 Budget:

Fiscal Outlook for Schools and Community Colleges

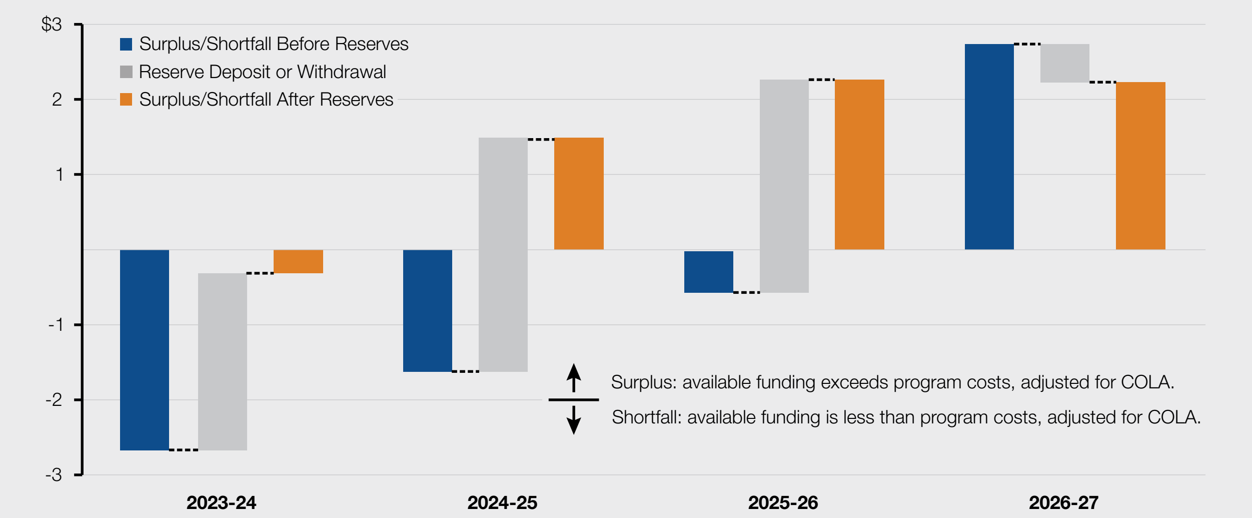
GABRIEL PETEK | LEGISLATIVE ANALYST | NOVEMBER 2022

SUMMARY

State Could Fund Increases for Existing Programs Despite Decline in Proposition 98 Guarantee. Each year, the state calculates a "minimum guarantee" for school and community college funding based upon a set of formulas established by Proposition 98 (1988). Based upon recent signs of weakness in the economy, we estimate the guarantee in 2023-24 is $2.2 billion (2 percent) below the 2022-23 enacted budget level. Despite this drop, $7.6 billion would be available to provide increases for school and community college programs. This funding is available due to three key adjustments—backing out one-time costs, reducing expenditures to reflect student attendance changes, and making a required withdrawal from the Proposition 98 Reserve. In 2023-24, the available funding could cover a cost-of-living adjustment (COLA) of up to 8.38 percent, which is slightly below our estimate of the statutory rate (8.73 percent). Over the next several years, growth in the guarantee and required reserve withdrawals would be just enough to cover the statutory COLA (see the figure below). Given this relatively precarious balance, we outline a few ways the Legislature could create a larger cushion to protect against revenue declines in the future.

Proposition 98 Reserve Compensates for Small Shortfalls Over the Next Few Years

(In Billions)



COLA = cost-of-living adjustment.

Attachment #4

INTRODUCTION

Report Provides Our Fiscal Outlook for Schools and Community Colleges. State budgeting for schools and the California Community Colleges is governed largely by Proposition 98. The measure establishes a minimum funding requirement for K-14 education commonly known as the minimum guarantee. This report provides our estimate of the minimum guarantee for the upcoming budget cycle. The report has four parts. First, we explain the formulas that determine the guarantee. Next, we explain how our estimates of the guarantee in 2021-22 and 2022-23 differ from the June 2022 estimates. Third, we estimate the guarantee over the 2023-24 through 2026-27 period under our economic forecast. Finally, we compare the funding available under the guarantee with the cost of existing educational programs and identify some issues for the Legislature to consider in the upcoming budget cycle. (*The 2023-24 Budget: California's Fiscal Outlook* contains an abbreviated version of this report, along with the outlook for other major programs in the state budget.)

BACKGROUND

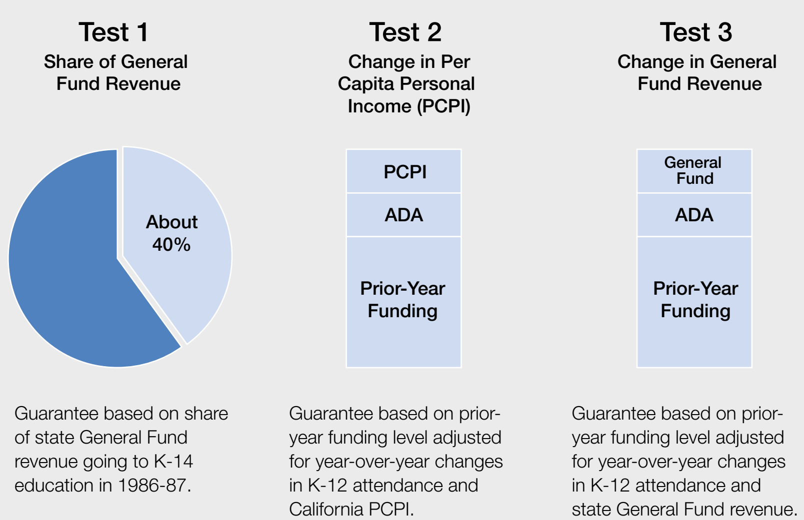
Minimum Guarantee Depends Upon Various Inputs and Formulas. The California Constitution sets forth three main tests for calculating the Proposition 98 minimum guarantee. Each test takes into account certain inputs, including General Fund revenue, per capita personal income, and student attendance (Figure 1). Whereas Test 2 and Test 3 build upon the amount of funding provided the previous year, Test 1 links school funding to a minimum share of General Fund revenue. The Constitution sets forth rules for comparing the tests, with one of the tests becoming operative and used for calculating the minimum guarantee that year. Although the state can provide more funding than required, it usually funds at or near the guarantee. With a two-thirds vote of each house of the Legislature, the state can suspend the guarantee and provide less funding than the formulas require that year. The guarantee consists of state General Fund and local property tax revenue.

Legislature Decides How to Allocate Proposition 98 Funding. Whereas Proposition 98 establishes a minimum funding level, the Legislature decides how to allocate this funding among school and community college programs. Since 2013-14, the Legislature has allocated most funding for schools through the Local Control Funding Formula (LCFF). A school district's allotment depends on its size (as measured by student attendance) and the share of its students who are low income or English learners. The Legislature allocates most community college funding through the Student Centered Funding Formula (SCFF). A college district's allotment depends on its enrollment, share of low-income students, and performance on certain outcome measures.

At Key Points, State Recalculates Minimum Guarantee and Certain Proposition 98 Costs. The guarantee typically changes from the level initially assumed in the enacted budget as the state updates the relevant Proposition 98 inputs.

Figure 1

Three Proposition 98 Tests



ADA = average daily attendance.

The state updates these inputs until May of the following fiscal year. The state also revises its estimates of certain school and community college costs. When student attendance changes, for example, the cost of LCFF tends to change in tandem. If the revised guarantee is above the revised cost of programs, the state makes a one-time payment to "settle up" for the difference. If program costs exceed the guarantee, the state can reduce spending if it chooses. After updating the guarantee and making any final spending adjustments, the state finalizes its Proposition 98 calculations through an annual process called "certification." Certification involves the publication of the underlying Proposition 98 inputs and a period of public review. The most recently certified year is 2020-21.

School and Community College Programs Typically Receive COLA. The state calculates a statutory cost-of-living adjustment (COLA) each year using a price index published by the federal government. This index reflects changes in the cost of goods and services purchased by state and local governments across the country. Costs for employee wages and benefits are the largest factor affecting the index. Other factors include costs for fuel, utilities, supplies, equipment, and facilities. The state finalizes the statutory COLA rate based upon the data available in May prior to the start of the fiscal year. State law automatically increases LCFF by the COLA unless the guarantee—as estimated in the enacted budget—is insufficient to cover the associated costs. In these cases, the state reduces the COLA for LCFF (and other K-12 programs) to fit within the guarantee. Though statute is silent on community college programs, the state typically aligns the COLA rate for these programs with the K-12 rate.

Proposition 98 Reserve Deposits and Withdrawals Required Under Certain Conditions. Proposition 2 (2014) created a state reserve specifically for schools and community colleges—the Public School System Stabilization Account (Proposition 98 Reserve). The Constitution requires the state to deposit Proposition 98 funding into this reserve when the state receives high levels of capital gains revenue and the minimum guarantee is growing relatively quickly (see the box on the next page). In tighter fiscal times, the Constitution requires the state to withdraw funding from the reserve. Unlike other state reserve accounts, the Proposition 98 Reserve is available only to supplement the funding schools and community colleges receive under Proposition 98.

Proposition 98 Reserve Linked With Cap on School Districts' Local Reserves. A state law enacted in 2014 and modified in 2017 caps school district reserves after the Proposition 98 Reserve reaches a certain threshold. Specifically, the cap applies if the funds in the Proposition 98 Reserve in the previous year exceeded 3 percent of the Proposition 98 funding allocated to schools that year. When the cap is operative, medium and large districts (those with more than 2,500 students) must limit their reserves to 10 percent of their annual expenditures. Smaller districts are exempt. The law also exempts reserves that are legally restricted to specific activities and reserves designated for specific purposes by a district's governing board. In addition, a district can receive an exemption from its county office of education for up to two consecutive years. The cap became operative for the first time in 2022-23.

2021-22 AND 2022-23 UPDATES

Weakening Economy Affecting State Revenue Estimates. Over the past year, high levels of inflation have led the Federal Reserve to raise interest rates significantly. Recent rate hikes already have led to weakness in certain parts of the economy, particularly housing and financial markets. Many economists expect this weakness to continue over the next year and have downgraded their outlook for the economy. State tax collections in recent months also have been weaker than the state estimated in June. Estimated income tax payments for 2022 so far have been notably weaker than 2021, likely due in part to falling stock prices. Consistent with this economic environment, our estimates of the General Fund revenues that affect the Proposition 98 guarantee are $15.1 billion below the June 2022 estimates across 2021-22 and 2022-23.

Overview of Proposition 98 Reserve

Deposits Predicated on Two Basic Conditions. To determine whether a deposit is required, the state estimates the amount of revenue it will receive from taxes on capital gains (a relatively volatile source of General Fund revenue). Deposits are required only when the state projects capital gains revenue will exceed 8 percent of total General Fund revenue. The state also identifies which of the three tests will determine the minimum guarantee. Deposits are required only when Test 1 is operative. (Test 1 years often are associated with relatively strong growth in the guarantee.)

Required Deposit Amount Depends on Formulas. After the state determines it meets the basic conditions, it performs additional calculations to determine the size of the deposit. Generally, the size of the deposit tends to increase when revenue from capital gains is relatively high and the guarantee is growing quickly relative to inflation. More specifically, the deposit equals the lowest of the following four amounts:

- ***Portion of the Guarantee Attributable to Above-Average Capital Gains.*** The state calculates what the Proposition 98 guarantee would have been if the state had not received any revenue from "excess" capital gains (the portion exceeding 8 percent of General Fund revenue). Deposits are capped at the difference between the actual guarantee and the hypothetical guarantee without the excess capital gains.
- ***Growth Relative to Prior-Year Base Level.*** The state calculates how much funding schools and community colleges would receive if it adjusted the previous year's funding level for changes in student attendance and inflation. For this calculation, the inflation factor is the higher of the statutory cost-of-living adjustment (COLA) or growth in per capita personal income. Deposits are capped at the difference between the Test 1 funding level and the prior-year adjusted level.
- ***Difference Between the Test 1 and Test 2 Levels***. Deposits are capped at the difference between the higher Test 1 and lower Test 2 funding levels. (The inflation factor for Test 2 is based upon per capita personal income, so in practice, this calculation tends to be less restrictive than the previous calculation.)
- ***Room Available Under a 10 Percent Cap.*** The Proposition 98 Reserve has a cap on required deposits equal to 10 percent of the funding allocated to schools and community colleges. Deposits are required only when the balance is below this level.

Withdrawals Required Under Certain Conditions. The Constitution requires the state to withdraw funds from the reserve if the guarantee is below the previous year's funding level, as adjusted for student attendance and inflation. The amount withdrawn equals the difference between the prior-year adjusted level and the actual guarantee, up to the full balance in the reserve. The Legislature can allocate withdrawals for any school or community college purpose. (The withdrawal may be more or less than the amount required to cover the COLA for school and community college programs because the calculation depends upon changes in the guarantee rather than changes in costs for those programs.)

Additional Withdrawals Possible if State Experiences a Budget Emergency. If the Governor declares a budget emergency (based upon a natural disaster or downturn in revenue growth), the Legislature may withdraw additional amounts from the reserve or suspend required deposits.

Proposition 98 Guarantee Revised Down in 2021-22 and 2022-23. Compared with the estimates made in June 2022, we estimate the guarantee is down $204 million in 2021-22 and $5.4 billion in 2022-23 (**Figure 2**). These declines are due to our lower General Fund revenue estimates. Test 1 remains operative in both years, with the decrease in the General Fund portion of the guarantee equating to nearly 40 percent of the revenue drop. Our estimates of local property tax revenue, by contrast, are up slightly in both years. (When Test 1 is operative, changes in local property tax revenue directly affect the Proposition 98 guarantee. They do not offset General Fund spending.)

Program Cost Estimates Down Over the Two Years. For 2021-22, the latest available data show that costs for LCFF are down $566 million compared with the June 2022 estimates (**Figure 3**). For 2022-23, we estimate LCFF costs are down $1.4 billion. Two factors account for most of this reduction: (1) the lower costs in 2021-22 carry forward, and (2) we make an additional downward adjustment of about 1 percent to account for the phaseout of a policy funding school districts according to the attendance they reported prior to the COVID-19 pandemic. We also assume somewhat fewer newly eligible students enroll in transitional kindergarten (based upon enrollment trends over the past few years) and reduce our cost estimates accordingly. For all other K-14 programs, our cost estimates are similar to the June estimates.

Figure 2

Updating Prior- and Current-Year Estimates of the Minimum Guarantee

(In Millions)

	2021-22			2022-23		
	June Budget Plan	November LAO Estimates	Change	June Budget Plan	November LAO Estimates	Change
Minimum Guarantee						
General Fund	$83,677	$83,306	-$371	$82,312	$76,811	-$5,501
Local property tax	26,560	26,727	167	28,042	28,112	70
Totals	**$110,237**	**$110,033**	**-$204**	**$110,354**	**$104,923**	**-$5,431**
General Fund tax revenue	$220,109	$219,134	-$975	$214,887	$200,767	-$14,120

Figure 3

Revised Spending Is Above the Guarantee in Prior and Current Year

(In Millions)

	2021-22			2022-23		
	June Budget Plan	November LAO Estimates	Change	June Budget Plan	November LAO Estimates	Change
Minimum Guarantee	**$110,237**	**$110,033**	**-$204**	**$110,354**	**$104,923**	**-$5,431**
Funding Allocations						
Local Control Funding Formula[a]	$68,249	$67,682	-$566	$77,476	$76,055	-$1,422
Other K-14 programs	38,000	37,995	-5	30,654	30,656	2
Proposition 98 Reserve deposit	3,988	4,976	988	2,224	14	-2,210
Totals	**$110,237**	**$110,653**	**$416**	**$110,354**	**$106,724**	**-$3,630**
Spending Above Guarantee	**—**	**$620**	**$620**	**—**	**$1,801**	**$1,801**

[a] Includes school districts, charter schools, and county offices of education.

Proposition 98 Reserve Deposit up in 2021-22 but Down in 2022-23. The June budget plan anticipated the state would make large reserve deposits in 2021-22 and 2022-23 due to strong revenue from capital gains. For 2021-22, we estimate the required deposit has increased from $4 billion to $5 billion. This increase reflects our estimate that capital gains revenue was higher than the June estimate even though overall state revenue is down slightly for the year. For 2022-23, we estimate that capital gains revenue will be significantly weaker and barely exceed the 8 percent threshold. Due to this lower estimate, the required deposit drops from $2.2 billion to $14 million. These two deposits—combined with deposits in previous years—would bring the total balance in the reserve to $8.3 billion. This reserve level represents 7.9 percent of our revised estimate of the guarantee in 2022-23.

School Spending Would Exceed the Guarantee in Both Years. After accounting for decreases in the minimum guarantee, lower program costs, and modified reserve deposits, school spending would be $620 million above the guarantee in 2021-22 and $1.8 billion above in 2022-23. If the Legislature chooses to reduce spending, it could do so in ways that would not disrupt ongoing programs. For example, it could reduce certain one-time grants the state has not yet allocated to schools or community colleges. The 2022-23 budget also funded several grants that will be allocated in installments over the next several years. The Legislature could reduce funding for future installments and cover those costs from future budgets instead.

MULTIYEAR OUTLOOK

In this section, we estimate the minimum guarantee for 2023-24 and the following three years under our economic forecast. We also examine how the Proposition 98 Reserve would change and the factors affecting costs for school and community college programs.

Economic Assumptions

Weak Economic Picture Weighs Down Revenue Estimates Over the Next Two Years. Current economic conditions point to an elevated risk of a recession starting next year. This risk weighs down our economic outlook and accounts for our estimate of flat General Fund revenues in 2023-24 and sluggish growth in 2024-25. Notably, however, our outlook does not specifically assume a recession occurs, which would result in more significant revenue declines. Our forecast also anticipates improvement in subsequent years, with revenue estimates reflecting normal levels of growth in 2025-26 and 2026-27.

The Minimum Guarantee

Guarantee Grows Slowly in 2023-24 but Remains Below Previously Enacted Budget Level. The minimum guarantee under our forecast is $108.2 billion in 2023-24 (**Figure 4**). Compared with our revised estimate of Proposition 98 funding in 2022-23, the guarantee is up $1.5 billion (1.4 percent). This increase is attributable to growth in local property tax revenue and partially offset by lower General Fund spending. Despite this increase, the guarantee in 2023-24 remains $2.2 billion below the enacted budget level for 2022-23 (**Figure 5**).

Growth in the Guarantee Accelerates After 2023-24. Increases in the guarantee become larger after 2023-24, with year-over-year growth of 4.9 percent in 2024-25, 5.6 percent in 2025-26, and 7.9 percent in 2026-27. By 2026-27, the guarantee would be $129.3 billion, an increase of $22.6 billion (21.1 percent) compared with the revised 2022-23 level. Of this increase, more than $16.7 billion is attributable to the General Fund portion of the guarantee and more than $5.8 billion is attributable to the local property tax portion. Test 1 is operative throughout the period, with the General Fund portion of the guarantee increasing about 40 cents for each dollar of additional revenue. Our estimates also account for two other adjustments. First, we assume the state continues to adjust the guarantee for the expansion of transitional kindergarten.

Figure 4

Proposition 98 Outlook

(Dollars in Millions)

	2022-23	2023-24	2024-25	2025-26	2026-27
Proposition 98 Funding					
General Fund[a]	$78,613[b]	$78,098	$81,829	$87,258	$95,354
Local property tax	28,112	30,077	31,627	32,573	33,927
Totals	**$106,724**	**$108,175**	**$113,456**	**$119,831**	**$129,281**
Change From Prior Year					
General Fund	-$5,313	-$515	$3,732	$5,429	$8,096
Percent change	-6.3%	-0.7%	4.8%	6.6%	9.3%
Local property tax	$1,385	$1,965	$1,550	$946	$1,354
Percent change	5.2%	7.0%	5.2%	3.0%	4.2%
Total funding	-$3,929	$1,451	$5,281	$6,375	$9,450
Percent change	-3.6%	1.4%	4.9%	5.6%	7.9%
General Fund Tax Revenue[c]	$200,767	$200,080	$207,884	$219,187	$239,523
Growth Rates					
K-12 average daily attendance[d]	3.1%	1.2%	1.4%	1.8%	0.7%
Per capita personal income (Test 2)	7.6	2.0	1.2	1.8	3.4
Per capita General Fund (Test 3)[e]	-8.7	1.4	2.8	3.2	7.4
Proposition 98 Reserve					
Deposit (+) or withdrawal (-)	$14	-$2,351	-$3,110	-$2,830	$510
Cumulative balance	8,292	5,941	2,830	—	510

[a] Beginning in 2023-24, General Fund estimates include an increase for Proposition 28.
[b] Includes $1.8 billion in funding above the minimum guarantee.
[c] Excludes non-tax revenues and transfers, which do not affect the calculation of the minimum guarantee.
[d] Estimates account for the expansion of transitional kindergarten eligibility.
[e] As set forth in the State Constitution, reflects change in per capita General Fund plus 0.5 percent.

Notes: Test 1 is operative throughout the period. No maintenance factor is created or paid.

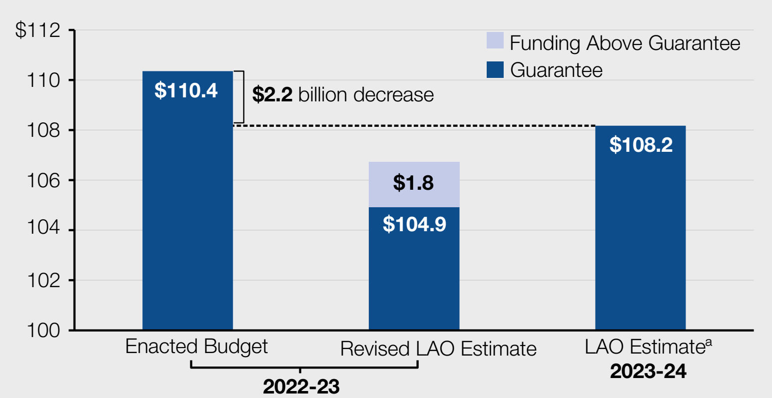
This adjustment increases required General Fund spending by approximately $2.6 billion by the end of the period. Second, we account for preliminary election results indicating the voters have approved Proposition 28. This proposition increases required General Fund spending by approximately $1 billion per year beginning in 2023-24 (as discussed later in the report).

Local Property Tax Estimates Reflect Trends in the Housing Market. Growth in property tax revenue is linked with growth in the housing market, but this growth typically lags the market by a few years. (This lag exists for three main reasons: (1) properties are not reassessed until sold, (2) new construction projects started

Figure 5

Proposition 98 Guarantee in 2023-24 Remains Below Previously Enacted Budget Level

(In Billions)



[a] Includes adjustment for Proposition 28 (2022).

in response to rising prices take time to complete, and (3) property tax bills are based on the assessed value of a property during the previous year.) Our forecast anticipates relatively large increases in property tax revenue of 7 percent in 2023-24 and 5.2 percent in 2024-25. These increases reflect the housing boom that began in the summer of 2020 and continued until early 2022. Our forecast anticipates weaker growth of 3 percent in 2025-26 and 4.2 percent in 2026-27. These slower increases account for cooling trends in the housing market that began in the spring of 2022.

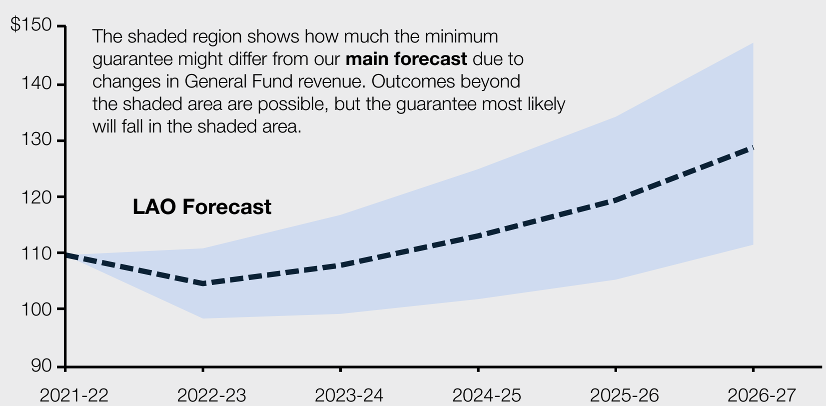
Guarantee Is Moderately Sensitive to Changes in General Fund Revenue. General Fund revenue tends to be the most volatile input in the calculation of the Proposition 98 guarantee. For any given year, the relationship between the guarantee and General Fund revenue generally depends on which Proposition 98 test is operative and whether another test could become operative with higher or lower revenue. Under our forecast, Test 1 remains operative throughout the period, meaning the guarantee would change about 40 cents for each dollar of higher or lower General Fund revenue. In 2022-23 and 2023-24, Test 1 is likely to remain operative even if General Fund revenue or other inputs vary significantly from our forecast.

Estimates of the Guarantee Become More Uncertain Over Time. Our forecast builds upon the revenue estimates we think are most likely, but these estimates in all likelihood will be wrong to some extent. For example, our forecast assumes a relatively smooth transition to faster revenue growth over the next four years. In practice, however, revenue tends to be volatile from year to year even if it follows a general upward trajectory over time. Figure 6 shows how far the minimum guarantee could differ from our forecast based upon swings in General Fund revenue. For this analysis, we examined the historical relationship between previous revenue estimates and actual revenue collections, and then calculated the minimum guarantee under the different revenue scenarios. (Technically, the bottom of the shaded area corresponds to the 10th percentile of potential scenarios and the top corresponds to the 90th percentile.) The uncertainty in our estimates increases significantly over the outlook period. For example, the range for the guarantee in 2026-27 is about twice as large as the range in 2023-24.

Figure 6

Estimates of the Proposition 98 Guarantee Become More Uncertain Over Time

(In Billions)



State and School Reserves

Proposition 98 Reserve Withdrawals Begin in 2023-24. Under our outlook, growth in the guarantee is somewhat slower than increases in student attendance and inflation for the next several years. This slower growth triggers reserve withdrawals of $2.4 billion in 2023-24, $3.1 billion in 2024-25, and $2.8 billion in 2025-26. The state would begin building back the reserve balance once the guarantee begins to grow more quickly. Under our outlook assumptions, the state makes a small deposit in 2026-27. Reserve deposits and withdrawals, however, are relatively sensitive to assumptions about revenue and inflation.

Proposition 98 Reserve Mitigates Some Volatility in the Guarantee. The reserve provides a modest cushion for school and community programs when the minimum guarantee changes. On the downside, a lower guarantee likely would lead to larger withdrawals. These withdrawals would reduce the likelihood of reductions to existing programs. This cushioning effect is relatively limited, however, because the reserve would be exhausted in 2025-26. If the guarantee were below our estimates in 2024-25, for example, the increase in withdrawals that year would come at the expense of withdrawals the following year. On the upside, if the guarantee were to exceed our forecast because of higher General Fund revenues, the required withdrawals likely would decrease.

Local Reserve Cap Remains Operative. Under our outlook, the school district reserve cap would remain in effect through 2024-25. In that year, the balance in the Proposition 98 reserve would drop below 3 percent of the Proposition 98 funding allocated to schools. The cap, in turn, would become inoperative in 2025-26. Although statewide data are not yet available, our understanding is that school district reserves currently are at relatively high levels despite the cap. County offices of education and other local experts indicate that most districts with reserves above the cap took board action to designate their reserves for specific future purposes (as the law allows), rather than spending them down immediately.

Program Costs

Very Large Statutory COLA Estimated for 2023-24. For 2023-24, we estimate the statutory COLA is 8.73 percent. This COLA rate—the highest since 1979-80—reflects the significant price inflation recorded in most parts of the economy over the past year. Costs for energy and other "nondurable goods" are the fastest growing component of the index. Available data show that in the third quarter of 2022, this component increased by 25 percent compared with the same quarter in 2021. By comparison, the other components of the price index grew by an average of 6.9 percent over that period. In making our estimate of the statutory COLA, we relied upon published federal data for six of the eight quarters that determine the COLA, and our own projections for the final two quarters. The federal government will publish data for these final two quarters at the end of January and the end of April, respectively.

Statutory COLA Would Remain High Over the Next Several Years. Although most economic forecasters expect price inflation to moderate by the end of 2022-23, evidence suggests there is a risk inflation could remain above the historical average for an extended period. Our corresponding COLA estimates are 5.3 percent in 2024-25, 4.5 percent in 2025-26, and 4.2 percent in 2026-27. By comparison, the average statutory COLA over the past 20 years has been 2.8 percent.

Partial Recovery in K-12 Attendance Assumed. Under our outlook, K-12 student attendance grows by an average of 1.6 percent per year from 2022-23 through 2026-27. This growth, however, follows a steep attendance decline in 2021-22. Data from the California Department of Education show that statewide average daily attendance totaled 5.35 million students in 2021-22—a drop of about 550,000 students (9.3 percent) compared with the levels reported in 2019-20 prior to the start of the COVID-19 pandemic. (The state did not collect attendance data in 2020-21.) Approximately three-quarters of this drop seems attributable to a surge in absenteeism. Whereas school attendance rates averaged about 95 percent of enrollment prior to the pandemic, they dropped to around 90 percent in 2021-22. We think much of this drop reflects the emergence of the Omicron variant of COVID-19 in the middle of the 2021-22 school year. Our outlook assumes districts recover about half this drop in 2022-23, with incremental improvements in subsequent years. The remaining quarter of the attendance drop appears attributable to students who left public schools entirely, including students who left the state, enrolled in private school or homeschool, or dropped out. Our outlook does not assume any of these students return to California public schools.

Transitional Kindergarten Expansion Also Affects Statewide Attendance Over the Next Few Years. Another factor affecting statewide attendance is the expansion of transitional kindergarten. State law began expanding eligibility for this program in 2022-23. All four-year olds will be eligible by 2025-26. Under our outlook, students newly eligible for this program account for slightly less than half of our estimated attendance growth over the period.

LCFF Costs Decrease as Pre-Pandemic Attendance Funding Phases Out. For the purpose of allocating LCFF funding in 2021-22, the state credited school districts and most charter schools with at least as much attendance as they reported in 2019-20. This policy insulated most schools from the fiscal effects of attendance declines. Beginning in 2022-23, the state will fund school districts according to their actual attendance in the current year, prior year, or average of the three prior years (whichever is highest). In practice, this new policy means districts' higher pre-pandemic attendance levels will phase-out over the 2022-23 through 2024-25 period. Our outlook accounts for these changes with a $1.6 billion (2.2 percent) downward adjustment to LCFF costs in 2023-24. This adjustment builds upon our lower revised estimate of LCFF costs in 2022-23. (For charter schools, the state is allocating funding according to current-year attendance only, beginning in 2022-23.)

Outlook Assumes New Funding for Arts Education. Preliminary results from the November 8 election indicate that the voters have approved Proposition 28. This proposition creates a new ongoing program to fund arts education beginning in 2023-24 (described in the nearby box). The measure also increases the minimum guarantee to cover the additional costs. Throughout this

Proposition 28 (2022)

Establishes New Program to Fund Arts Education. Proposition 28 establishes a program to provide additional funding for arts instruction and related activities in schools, beginning in 2023-24. The annual amount for the program equals 1 percent of the Proposition 98 funding allocated to schools in the previous year. For 2023-24, we estimate the program will receive an allocation of $941 million. Under our estimates of growth in K-12 funding, this amount would grow by approximately 4 percent per year over the next several years.

Provides Rules for Allocating and Using Funds. The measure allocates 70 percent of its funding to school districts, charter schools, and county offices of education through a formula based on prior-year enrollment of students in preschool, transitional kindergarten, kindergarten, and grade 1 through grade 12. The measure allocates the remaining 30 percent based upon the share of low-income students enrolled in those entities in the prior year. School principals are responsible for developing expenditure plans describing how they will use their share of the funds, subject to two requirements. First, the measure requires schools with at least 500 students to use their funds primarily to hire new arts staff. Second, schools must use their funds to supplement any existing funding they already provide for their arts education programs.

Adjusts the Proposition 98 Guarantee Upward. In addition to creating a new program funded within Proposition 98, the measure adjusts the minimum guarantee upward. This adjustment occurs in two steps. In 2023-24, the state adds the cost of the program to the minimum guarantee otherwise calculated for the year. The state then converts this amount to a percentage of General Fund revenue. Beginning in 2024-25, the state adds this percentage to the minimum percentage of General Fund revenue allocated to schools under Test 1. Under our outlook, the $941 million cost of the program in 2023-24 would result in an ongoing increase to the guarantee of 0.47 percent of General Fund revenue.

Legislature Can Reduce Funding if it Suspends the Guarantee. The measure allows the Legislature to reduce funding for arts education if it suspends the minimum guarantee. In this case, the percentage reduction for arts education cannot exceed the percentage reduction in overall funding for school and community college programs.

report, we account for Proposition 28 in our estimates of school spending and our estimates of the minimum guarantee.

KEY CONSIDERATIONS

In this part of the report, we highlight a few issues for the Legislature to consider as it prepares for the upcoming budget cycle. Specifically, we (1) compare the funding available under the minimum guarantee with the cost of existing school and community college programs, (2) provide context for the budget decisions the state will make in 2023-24, and (3) identify a few issues the Legislature may want to think about when planning for the upcoming budget cycle.

The Budget Picture in 2023-24 and Beyond

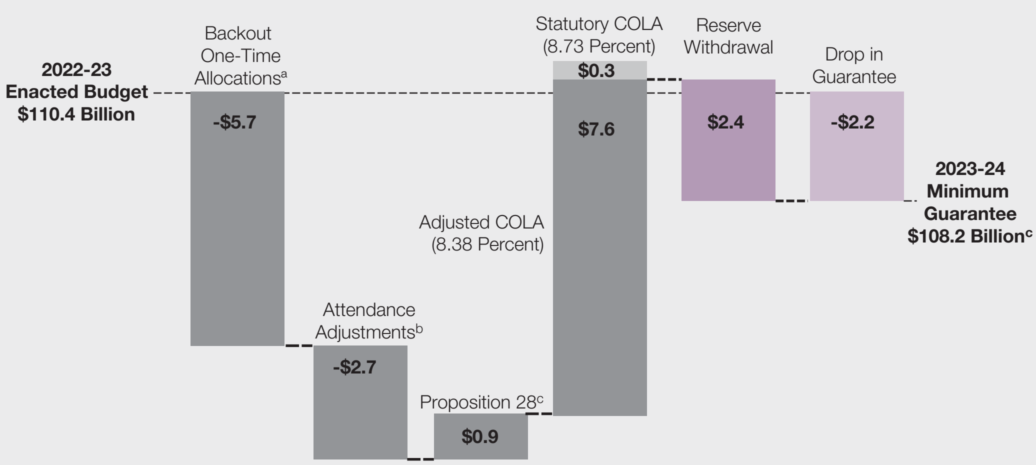
State Could Cover Existing Programs and Most of the Statutory COLA in 2023-24. Figure 7 shows our estimate of the changes in funding and costs relative to the 2022-23 enacted budget level. Although the minimum guarantee drops $2.2 billion, a few key adjustments free-up significant amounts of funding. Most notably, the 2022-23 budget allocated a significant amount of ongoing Proposition 98 funding for one-time activities. These activities expire in 2023-24, freeing-up the underlying funds. We also score savings from attendance-related changes to LCFF and account for the required reserve withdrawal. After making these adjustments, $7.6 billion in funding is available. Regarding cost increases, we estimate that covering the 8.73 percent statutory COLA would cost $7.9 billion. Consistent with current law, we assume the state reduces the COLA rate to 8.38 percent—lowering the cost by approximately $300 million—to fit within the $7.6 billion available.

Reserve Withdrawals Cover Gap Between Guarantee and Program Costs for the Next Few Years. Figure 8 on the next page shows how the funding available for school and community college programs changes over the period under our forecast. The blue bars represent the amount

Figure 7

State Could Cover Most of the Statutory COLA in 2023-24

Changes From 2022-23 Enacted Budget (In Billions)



[a] Consists primarily of the reserve deposit amount estimated in June and the portions of the K-12 Learning Recovery Emergency Block Grant, K-12 community schools grant, and community college maintenance and equipment funds attributed to 2022-23.

[b] Consists primarily of lower costs for the Local Control Funding Formula resulting from the phaseout of pre-pandemic attendance funding. Also reflects several smaller adjustments for other programs.

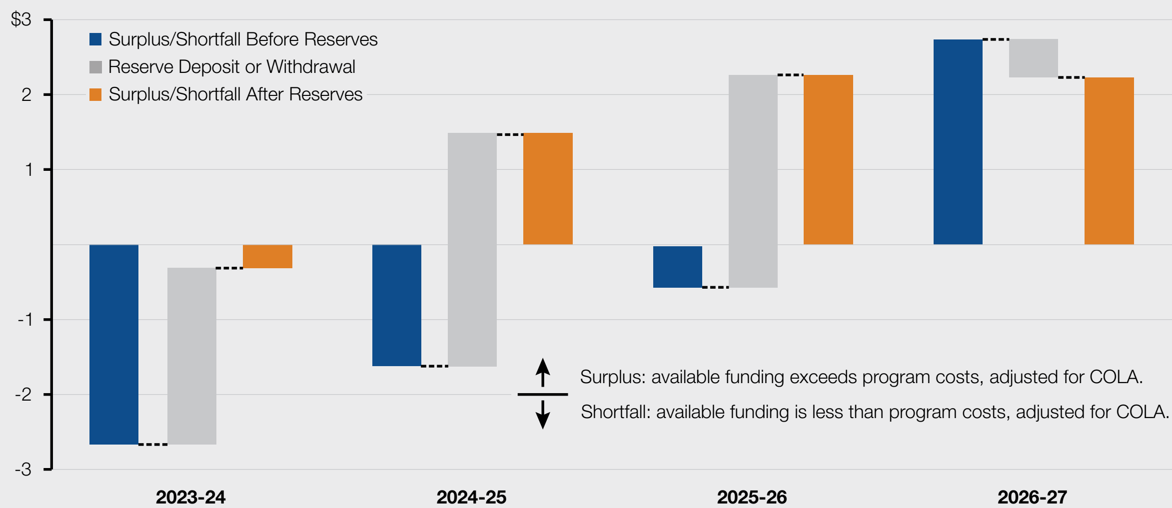
[c] Proposition 28 (2022) establishes a program funding arts education in schools. As required by the measure, the estimate of the guarantee in 2023-24 includes a $941 million increase to offset the cost of the program.

COLA = cost-of-living adjustment.

Figure 8

Proposition 98 Reserve Compensates for Small Shortfalls Over the Next Few Years

(In Billions)



COLA = cost-of-living adjustment.

by which the Proposition 98 guarantee is above or below the cost of covering existing programs as adjusted by the statutory COLA. Negative bars indicate a "shortfall" (the guarantee is insufficient to cover these costs) and positive bars indicate a "surplus" (the guarantee is more than sufficient). The gray bars account for required withdrawals and deposits from the Proposition 98 Reserve. The orange bars represent the surplus or shortfall after accounting for the reserve. As the figure shows, a small shortfall exists each year through 2025-26, but reserve withdrawals provide additional funding that reduces the shortfall in 2023-24 and more than offset the shortfalls in 2024-25 and 2025-26.

Budget Picture Stabilizes by the End of the Period, Assuming No New Ongoing Commitments. Under our forecast, the gap between the minimum guarantee and program costs shrinks over the period. In 2026-27, the guarantee is above the cost of existing programs and the state begins making reserve deposits rather than withdrawals. The picture could improve sooner if the economy grows more quickly than our forecast or the statutory COLA rate is smaller. Alternatively, it might improve after 2026-27 if the state experiences a recession during the forecast period. In making these estimates, we also assume the state makes no new ongoing commitments.

The Education Budget in Context

Tighter Outlook Follows Two Years of Extraordinary Growth. Although our outlook estimates a drop in the guarantee in 2022-23 and slow growth in 2023-24, these changes build upon two previous years of historic growth. Between 2019-20 and 2021-22, the minimum guarantee grew $31.3 billion (39.5 percent)—the fastest increase over any two-year period since the passage of Proposition 98 in 1988. The drop in 2022-23 erodes only a small portion of this gain. By historical standards, the school funding picture remains strong. Figure 9 illustrates this point by comparing our estimate of K-12 funding per student under our outlook with funding levels over the previous 25 years. After accounting for the effects of inflation and changes in student attendance, school funding would dip in 2022-23 and 2023-24 but remain relatively high over the remainder of the period.

Multiyear Block Grants Provide Further Support to Districts. The June 2022 budget plan funded two large block grants to address the effects of the COVID-19 pandemic on schools and community colleges. These grants are intended to support district activities over the next several years. For schools, the state provided $7.9 billion for the Learning Recovery Emergency Block Grant (averaging about $1,500 per student). Schools can use their funds broadly to support academic learning recovery, staff and student social and emotional well-being, and other costs attributable to the pandemic. For community colleges, the state provided $650 million (about $730 per student) to fund student support, reengagement strategies, professional development, technology, equipment, and other specified activities. Although both block grants are provided on a one-time basis, they represent an additional source of funding districts can use to supplement other funding over the next several years.

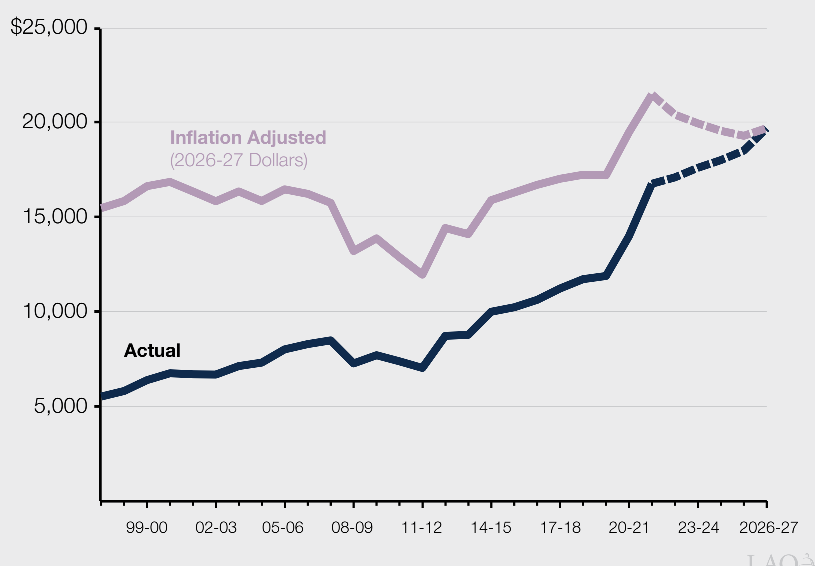
Previous Budget Actions Significantly Improve the Budget Picture in 2023-24. Our estimate of the funding available in 2023-24 highlights the importance of preparing for economic downturns during stronger fiscal times. The budget adopted by the Legislature in June contained two major components that improved budget resiliency. Specifically, the budget (1) set aside some ongoing funds for one-time activities and (2) made the Proposition 98 Reserve deposits required by Proposition 2. If the state had not set aside any ongoing funds and lacked the Proposition 98 Reserve, the budget picture in 2023-24 would look much different. Under that alternative scenario, we estimate that the available Proposition 98 funding would have been at least $8.3 billion—rather than about $300 million—below the level necessary to cover existing programs and the statutory COLA. Facing such a scenario, the state might have needed to eliminate the 2023-24 COLA or fund a much smaller COLA and take other actions to reduce spending.

Rest of the State Budget Faces Large Problem. The rest of the state budget—consisting of the programs not funded through Proposition 98—is in a difficult position under our outlook. Specifically, the rest of the budget faces a $25 billion problem in 2023-24. This shortfall represents the difference between available resources and the cost of currently authorized programs and services. The problem is due primarily to reductions in General Fund revenue, partially offset by (1) lower required spending to meet the Proposition 98 guarantee and (2) lower required deposits into the state's general-purpose reserve. Moreover, the rest of the budget faces an ongoing deficit over the next several years. Even with relatively strong revenue growth in 2025-26 and 2026-27, the resources available in those years are less than the estimated cost of current programs and services. Given these issues, the state would have difficulty funding school and community college programs beyond the amounts required to meet the guarantee.

Figure 9

K-12 Funding Dips When Adjusted for Inflation but Remains Relatively High

Funding Per Student



State Appropriations Limit Is Not a Significant Issue This Year... Proposition 4 (1979) places constraints on how the state can spend tax revenues that exceed a certain limit. Specifically, if the state collects revenue in excess of the limit, the Constitution allows the Legislature to respond by lowering tax revenues, increasing spending on activities excluded from the limit, or splitting the excess revenues equally between taxpayer refunds and one-time payments to schools and community colleges. Due primarily to our lower General Fund revenues, we estimate the state is below the limit in 2022-23 and 2023-24.

...But Would Affect State Budgeting in the Future. Assuming General Fund revenues follow the trajectory in our forecast, the state appropriations limit would begin to affect state budgeting in 2025-26. The main reason is that our estimates of General Fund revenue grow faster than the limit itself over the next several years. Our Proposition 98 outlook does not make any explicit adjustment for the appropriations limit, in part because the state must fund the minimum guarantee even if the limit requires reductions to other programs in the state budget. The state, however, could respond to future excess revenues in ways that would affect school funding. For example, it could reduce General Fund tax revenue, which also would lower the guarantee. Alternatively, it could split excess revenues between refunds and one-time payments, which would provide schools and community colleges with additional funding on top of the minimum guarantee. Estimates of the state appropriations limit also are subject to significant uncertainty beyond the budget year.

Planning for the Upcoming Year

Economic Uncertainty Abounds as Legislature Prepares for Upcoming Budget Cycle. The current economic environment poses a substantial risk to state revenues. In the past, economic conditions similar to the conditions we have observed over the past several months have typically resulted in subsequent revenue declines. On the other hand, we do not think a recession next year is inevitable. Even if a recession does occur, its exact timing and severity are uncertain. Our outlook takes a middle approach—assuming economic weakness but not a recession. For 2023-24, this uncertainty means the Proposition 98 guarantee could be billions of dollars above or below our current estimates. Although the state will have a better sense of revenues and the guarantee by June when it adopts the budget, the economic picture beyond 2023-24 remains murky.

Building a Larger Budget Cushion Would Mitigate Future Downside Risk. Our outlook makes spending estimates for school and community college programs based upon current laws and policies. Two important assumptions are embedded in this forecasting approach: (1) the state maintains existing programs at their current levels except for formula-driven adjustments, and (2) the state applies all available Proposition 98 funding (including reserve withdrawals) toward covering the statutory COLA. Using this approach to set ongoing spending levels in 2023-24, however, would leave the Proposition 98 budget precariously balanced over the coming years. For example, our estimate of the guarantee in 2024-25 is just large enough to cover existing programs and the statutory COLA after accounting for a reserve withdrawal. In approximately half of all the potential economic scenarios that could unfold that year, the guarantee ends up below our estimate. Although the Proposition 98 Reserve might cushion a minor decrease, a larger drop would pose risks to ongoing programs. To build up somewhat more protection against such downside risks, the Legislature could consider some adjustments next year to create a larger budget cushion. Specifically, it could reduce certain ongoing expenditures and increase one-time spending. Below, we outline a few options for reducing ongoing expenditures.

Consider Reductions to Expanded Learning Opportunities Program (ELOP). The state created ELOP in the 2021-22 budget to fund academic and enrichment activities for K-12 students outside of normal school hours. As part of the 2022-23 budget, the state increased ongoing funding for the program from $1 billion to $4 billion. The program allocates funding to districts based on their attendance in the elementary grades and share of low-income students and English learners. Although statewide data are not available, initial feedback from districts suggests not all low-income students and English learners are interested in the program. We think the state could improve the program and reduce costs by allocating funding based on actual participation instead of districtwide attendance. The state also could reduce ELOP allocations by accounting for other state and federal funds districts receive for before and after school programs. To achieve additional savings on a one-time basis, the state could further require districts to spend all their ELOP funding from 2021-22 and 2022-23 before they receive funding in 2023-24. Any of these actions could achieve savings without requiring districts to serve fewer students.

Consider Reductions to Community College Programs That Are Under Capacity or Lower Priority. Over the past few years, the state has provided some funding that may not be earned by colleges or may be a lower legislative priority. The 2021-22 budget, for example, provided a $24 million base augmentation to SCFF for enrollment growth. Based on preliminary data, only about $1 million of this funding will be earned by districts. The Legislature could revert any unearned funds—and reduce systemwide base funding by a like amount—once final data is reported by the Chancellor's Office in spring 2023. Similarly, this spring the Legislature could identify other community college programs that may be under capacity, such as the California Apprenticeship Initiative or other grant programs the Legislature has authorized in recent years. The Legislature also may want to target for reductions certain programs that may be a lower priority given the students served. For example, the 2022-23 budget provided $25 million ongoing Proposition 98 General Fund to expand eligibility for the California College Promise. This program allows colleges to waive enrollment fees for returning students enrolled full time who do not have financial need given their higher income level.

Consider Funding Smaller COLA. Another option would involve reducing the COLA rate below the 8.38 percent increase we estimate the state could fund in 2023-24. One reason the state might consider this option is that the surge in energy prices appears to be responsible for a notable portion (likely at least 2 percentage points) of the high COLA rate. Although district energy costs are likely up too, these costs typically account for a small share of district budgets. The Legislature could consider funding a COLA that is below the statutory rate but still large enough to allow schools and community colleges to address their cost pressures and local priorities. We estimate that each 1 percent reduction in the COLA rate equates to approximately $910 million in lower ongoing spending.

Legislature Could Advance Its Priorities Next Year Through Oversight. Over the past two years, the Legislature has allocated Proposition 98 funding to more than 50 new school and community college activities. Some of the largest allocations have involved learning loss recovery, community schools, the teaching workforce, infrastructure, and community college financial aid and student support services. The Legislature could use the upcoming budget cycle to conduct oversight of these activities. In particular, the Legislature might want to examine: (1) whether these activities are having their intended effects on students and programs, (2) how these activities fit with broader goals (such as reducing historical funding disparities among districts, improving student achievement, and closing achievement gaps), and (3) any challenges districts face implementing these activities. By conducting oversight and exploring changes in these areas, the Legislature could continue to advance its priorities despite the tighter budget picture we anticipate next year.

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