PREFACE

What a great time to be the Governor of California! We are sure Arnold Schwarzenegger reflects on that topic often. New expectations and new hopes abound, but so do the same old economics. We believe that the Budget is the single most important policy document provided by the Governor in that it is not only reflective of his priorities, but also shows the style with which he approaches problems and their solutions.

So, in his very first Budget, the Governor gets a major test of not only his financial skills, but also his ability to develop consensus and to build bridges to constituencies that will feel the sharp blade of the budget-cutter's ax. And many will feel that sting.

In his Budget proposal released on January 9, 2004, Governor Schwarzenegger treats community colleges in a very different light than did former Governor Gray Davis in his 2003-04 Budget proposal. You will recall that California community colleges started the 2003-04 year with a Budget proposal that amounted to $530 million in mid-year cuts. Governor Schwarzenegger does not include a COLA for community colleges, but does fund enrollment growth and equalization. In exchange, Proposition 98 would be "rebased" to allow the Administration to lower the guarantee by $2 billion. The lost revenues would be made up in some unspecified future year.

The list of cuts is long and painful. Public works, local government, and higher education (UC and CSU) all get less state assistance than they did in the previous year. But, contrary to popular thinking, Health and Human Services, Corrections, and state government all receive increases—some of them substantial.

We firmly believe that the K-12 education community's ability to reach an agreement to receive less than an unaltered Proposition 98 would have provided—but more than we were likely to get if there was a full suspension—serves to help California community colleges (although the system was not consulted in the deal). However, we do not view K-14 education as being treated like the favored child. Health and Human Services is getting a bigger increase than community colleges when measured either as a percentage or in raw dollars.

So, the commonly heard wail that we are "taking away old people's false teeth" to fund education is just not true. Still, California has many challenges and we would never suggest that other parts of the Budget are not deserving of funding. We do suggest that K-14 education has shouldered its share of the burden as well.

But beyond the numbers in the Budget are the underpinnings needed to support them. Four propositions will appear before the voters on the March 2nd ballot. Three of them—Propositions 55, 57, and 58—are essential to the fiscal solvency of the state. Proposition 55 continues the state's commitment to adequate facilities for our students. Proposition 57 provides a $15 billion dollar deficit reduction bond to help put the past behind us and allow us to look to the future. Proposition 58, which is double joined to Proposition 57, provides for a balanced budget and spending limits to help prevent a repeat of the current crisis.

Additionally, the new Governor has pinned his hopes for recovery on the creation of jobs and a more "business-friendly" climate. We think the repeal of SB 1419 (the anti-contracting out bill), further reform of a wasteful Workers' Compensation system, a revisiting of SB 2 (mandatory employer paid health benefits), and a more balanced approach in laws affecting the union/management relationship are essential to reaching that goal.

Finally, we have seen that the Governor can lead the people of California and that they welcome that leadership. But the Governor has not yet faced and passed a major test—proving he will be able to work with the Legislature and get a Budget plan enacted. Further, if the voters fail to approve his fiscal recovery plan (the $15 billion bond) on the March ballot, the May Revision will likely call for a total suspension of Proposition 98 and drastic cuts will ensue. Over the next few months, we will see the results of the Governor's leadership and ability to work with the Legislature—we need both to past the test. The people of California expect and deserve no less.

ARNOLD BRAY
Legislative Advocate

INTRODUCTION

California's Fiscal Challenge

Prior to taking office, Governor Schwarzenegger called for an independent audit of state government finances, detailing the size and scope of the fiscal crisis that the Governor and the Legislature must confront. Among the key findings of the first phase of the audit were:

- State revenues have increased by 25% over the past five years, while state expenditures have risen by 43%

- If state government had not spent the extraordinary tax revenues from the one-time surge in capital gains and stock options (during the late 1990s) on ongoing programs, the State Budget deficit would be significantly lower

- Program expansions occurred over the past five years without the necessary funding to support them; if programs had not been created or expanded, expenditures in the Budget would be lower than they are today

- State bureaucracy has grown and agencies have been allowed to consistently spend above their budget levels

As a result, the state of California has accumulated a debt of more than $22 billion, representing policy and budgetary decisions made by the Legislature and the prior Administration. In the absence of corrective actions to change these policies, the state will continue incurring operating deficits, estimated at $14 billion in fiscal year 2004-05. California also faces a potential cash crisis this year. In order for the state to meet its daily cash flow needs, the previous Administration borrowed a total of $14 billion using short-term notes. Those notes are due to be repaid in June 2004.

In addition, all three major credit rating agencies have lowered the state's credit rating this year. California's General Obligation Bond rating is "Triple B," which is barely above investment grade and is currently the lowest among all the states. Anything below "Triple B" is commonly known as a junk bond.

Total Inherited Debt

Accumulated Deficit Through 2002-031	$9.3 billion
Operating Deficit in 2003-04[1]	3.0 billion
Total Accumulated Deficit[1]	$12.3 billion
Effect of Prior Decisions After 2003-04	9.8 billion
Total Inherited Debt	$22.1 billion

[1] In November, the audit projected the accumulated deficit through 2002-03 at $10.6 billion, the operating deficit in 2003-04 at $4.3 billion, and total the accumulated deficit at $14.9 billion. Since then, natural revenue growth and expenditure decreases have exceeded expectations.

California's Recovery Plan

Faced with current and growing debt, the Governor is proposing a four-part economic recovery plan, which consists of:

- The Economic Recovery Bond Act to refinance a portion of the prior-year debt. This bond act, in the amount of $15 billion, is subject to voter approval at the March 2, 2004, statewide primary election. The repayment of the bond will be secured by a pledge of revenues from an increase in the state's share of the sales and use tax (one-quarter cent) starting in July 2004. The Administration intends to use the bond proceeds to refinance a portion of the $22 billion deficit.

- A budget for 2004-05 that moves toward structural balance. In January 2004, the Administration proposed reductions totaling $3.9 billion ($2.3 billion in 2003-04 and $1.6 billion in 2004-05). To close the remaining budget gap, additional solutions are included in the proposed Budget: $0.3 billion in 2003-04 and $12.8 billion in 2004-05, offset by a reduction of $0.8 billion in 2002-03. Overall solutions proposed exceed the projected budget gap by $635 million (the amount of the reserve).

- A Constitutional Amendment to require balanced budgets with prudent reserves in the future. Proposition 58 will be submitted to the voters on the March 2, 2004, ballot. The proposed amendment will ensure that the state enacts budgets that keep expenditures within available resources. It would also require the state to contribute to a special reserve of 1% of revenues in 2006-07, 2% in 2007-08, and 3% in subsequent years. This special reserve will be used to repay the Economic Recovery Bonds and provide a rainy day fund for future economic downturns or natural disasters. It would allow the Governor to declare a fiscal emergency whenever he or she determines that General Fund revenues will decline below budgeted expenditures, or that expenditures will increase substantially above available resources. Finally, it would require the Legislature to take action on legislation proposed by the Governor to address fiscal emergencies.

- Improving the business and job climate in order to revitalize the state's economy and improve revenue growth over time. While California's economic indicators suggest that modest reform is projected for 2004, job growth throughout the state maybe tempered due to the high cost of doing business in California. Some estimates conclude that business costs are 30% higher in California than in other western states—most note the highest Workers' Compensation rates in the nation as one of the largest components of the high cost.

Economic Outlook

The national and California economies strengthened in the second half of 2003. Increased business investment and job growth—the two missing pieces of a stronger, sustainable economic recovery—appeared to be in place as the year ended. Improved labor markets and stronger output growth are expected for both economies in 2004-05.

National economic output expanded at its fastest rate in nearly 20 years in the third quarter. While the first estimate of the fourth quarter is economic output will not be released until late January, monthly statistics from October and November depict an economy continuing to forge ahead.

California personal income increased for the sixth consecutive quarter in the second quarter of 2003. Also encouraging, exports of made-in-California merchandise began to increase again in the third quarter after falling for nearly three years, and taxable sales posted a fifth consecutive year-over-year gain. In addition, manufacturing activity expanded in the third quarter in the Inland Empire and Orange County, according to a local survey of purchasing managers. But California labor markets were not as strong as those in the rest of the nation, on average, near year-end. Southern California labor strikes played a role in that below-average performance.

Construction was up in the first ten months of 2003. Through October, home permits were on pace to hit 194,000 units for the year, roughly a 16% gain over 2002 and the highest level since 1989. Private sector nonresidential building, on the other hand, was grown in value, mostly because of a decline in new office building construction. Public works construction was up slightly, with a sizable gain in public building construction—such as K-12 schools and community colleges—more than offsetting a considerable decline in roads, bridges, and other heavy construction.

The outlook for California's economy in 2004 depends heavily on the fate of the national economy. The national economy grew at a breakneck pace in the third quarter of 2003. Most likely, the California economy did as well, but enough quarterly economic statistics on the state economy confirming that assertion will not be available, as previously mentioned, until at least the end of January 2004. By one important measure—job growth—the state economy underperformed the national economy in the second half of 2003. While strikes in Southern California were at least partially responsible, it will be important to see some job growth in the early months of 2004. Job growth is necessary for a stronger, sustainable recovery.

Low interest rates and a considerable amount of federal fiscal stimulus will boost the state and national economies in 2004. Cuts in expenditures to reduce state and local government budget deficits will be a drag on the state and national economies, however. On balance, the outlook for the California economy is for moderate growth in 2004 and even better growth in 2005. Unemployment will likely remain above 6% throughout the period. Personal income will grow by about 5.6% in 2004 and almost 6% in 2005, but not as quickly as in past recoveries. Consumers are the linchpins of this outlook. They have to continue to be optimistic that stronger labor markets lie just ahead.

Revenue Estimates

The long anticipated recovery of California revenues arrived in 2003, and the outlook for 2004 and 2005 is for continued, though moderate, growth. Therefore, the revenue outlook has improved from what was expected at the time the 2003-04 May Revision was prepared. Since enactment of the 2003 Budget Act, the General Fund revenue forecast for major taxes and licenses has increased by $1.7 billion for the past and current years combined. In addition, an increase of 4% in revenues, or $2.9 billion, is expected for 2004-05. This revenue increase includes significant gains in the three major taxes: personal income tax, sales tax, and corporation tax.

Improvement in the California economy began late in 2002, followed by taxable sales showing year-over-year growth beginning in the third quarter of 2003, after four consecutive quarters of negative growth. During 2003, personal income tax withholding also began to show year-over-year growth, after declining nearly every month since mid-2001. Finally, personal income tax estimated payments are expected to recover in the fourth quarter of 2003, after 11 consecutive months of negative growth.

As had been noted for some time, the state's remarkable revenue growth in the late 1990s was driven by stock market-related gains, while the fall-off from 2000 through 2002 largely reflected the market's decline. With regard to market-related income, growth is expected to resume in 2004 and should continue, albeit at more sustainable levels.

Despite the positive developments in the economic and revenue outlook, revenue growth alone will not solve the state's Budget problems. Because of the accumulated deficit balance and the ongoing structural deficit, the Governor's Budget includes major program reductions and restructuring.

The personal income tax, the state's largest revenue source, is expected to contribute 50% of all General Fund revenues and transfers in 2004-05. Personal income tax revenues are forecast to increase by 7.4% for 2003-04 and 8.3% for 2004-05.

Receipts from sales and use taxes—the state's second largest revenue source—are expected to contribute 33% of all General Fund revenues in 2004-05. Sales and use taxes are imposed on the retail sale or use of tangible personal property in California.

Corporation tax revenues are expected to contribute 10% of all General Fund revenues in 2004-05. These revenues are derived from five taxes: the franchise tax and the corporate income tax, which are levied at an 8.84% rate on profits; taxes from corporations that have a limited number of shareholders and meet other requirements to qualify for State Subchapter S status, which pay a 1.5% rate rather than the 8.84% rate imposed on other corporations; takes from banks and other financial corporations, which pay an additional 2% tax on their net income; the alternative minimum tax imposed at a rate of 6.65%, which ensures that high-income taxpayers do not make excessive use of deductions and exemptions to avoid paying a minimum level of tax; and a minimum franchise tax of $800, which is imposed on corporations subject to the franchise tax but not on those subject to the corporate income tax.

Highlights of the Proposed Community College Budget for 2004-05

What a difference a year makes. Last year at this time, former Governor Gray Davis was proposing a $530 million cut to California Community Colleges. As it turned out, the 2003-04 State Budget was Davis' last State Budget. Serving less than a year of his second term, he was recalled by the voters. Who could have predicted that movie star Arnold Schwarzenegger would become our Governor (the only California governor to graduate from one of our community colleges).

Governor Schwarzenegger's first Budget is a significant improvement over Gray Davis' last budget. The Governor's Budget, released on January 9, 2004, increases community college funding by $211 million, a 4.4% increase in funding. This amount continues the $200 million "deferral" of payments from June to July that was part of the 2003 Governor's Budget Act. As a result of the funding increases, the community college share of Proposition 98 funds increases from 9.51% (current year) to 10.04% in 2004-05.

The Budget, as proposed by the Governor, is a better starting point than last year. However, it will still present some challenges to the system. Student enrollment fees are significantly raised for the second year in a row, going from $18 to $26 per unit, a 44% increase. Also, the "differential fee" is back, a proposed $50 per unit fee for holders of baccalaureate and other advanced degrees. No COLA is provided and no funding is provided for local districts' increased costs due to the 12.2% PERS rate.

The Chancellor's Office, on behalf of the system, had requested a total of $512.5 million in augmentations for the 2004-05 fiscal year. The only augmentation requests that received any funding were growth at 3% ($125 million) and equalization aid at $80 million.

Other major elements of the Governor's Budget Proposal include:

Partnership for Excellence	$225,000,000
Matriculation	$54,307,000
Part-Time Faculty Compensation	$50,828,000
Part-Time Faculty Health Insurance	$1,000,000
Part-Time Faculty Office Hours	$7,172,000
Targeted Student Services	$101,050,000
Disabled Student Programs & Services	$82,583,000
Basic Skills and Apprenticeship	$40,552,000
Student Financial Aid Administration	$47,265,000
Special Services for CalWORKS Recipients	$34,580,000
Foster Care Education Program	$1,754,000
Academic Senate	$467,000
Economic Development	$35,790,000
Transfer Education and Articulation	$1,974,000

Faculty and Staff Diversity/EEO per SB 2028	$1,747,000
Physical Plan and Instructional Support[2]	$29,345,000
Telecommunications and Technology Services[3]	$10,897,000

Community college funding, from all sources, as proposed by the Governor would bring the system's funding for 2004-05 to $5,274,288,000. (See attached "California Community Colleges Local Assistance Budget)

K-12 "Agreement" Determines Community College Funding Levels

No single feature of the Governor Arnold Schwarzenegger's proposed budget for 2004-05 stands out more clearly than the state's need to adopt the Economic Recovery Act to refinance a portion of the state's debt. The $15 billion Bond Act, which will be submitted to the California electorate as Proposition 57 on March 2, 2004, is an essential underpinning to ensure that the state has the fiscal capability necessary to address 2004-05 fiscal issues. The bond will provide $9.3 billion to pay for the state budget deficit through 2002-03, will provide $1.9 billion for employee retirement costs (in lieu of the Pension Obligation Bond struck down by the courts), $188 million in other loan repayments and the balance to address issues of the State's Budget for 2004-05.

The State Budget is designed with the assumption that the electorate approves the Economic Recovery Bond Act on March 2. If it is not adopted, all of the following features for the education budget would need to be redesigned and recast in what is likely to be a much more difficult fiscal calamity for the state and, in turn, public education.

The K-12 Education "Agreement"

The Administration has reached agreement with statewide education associations (not including community colleges) to "rebase" Proposition 98 obligations for 2004-05, and to temporarily reduce the level of Prop 98 payments due to K-14 in 2004-05 by $2 billion. This limited suspension of Prop 98 is allowed by law, but requires a two-thirds vote of the Legislature. Proposition 98 growth in the budget year would increase by approximately $.8 billion rather than the $2.8 billion required by the Proposition's formulas. The $2 billion unpaid balance would be added to the "Maintenance Factor" and would be paid in subsequent years. How quickly this cut will be restored is unknown. The Administration estimates an average augmentation of $730 million per year starting in 2005-06, with $2 billion of the Maintenance Factor restored by 2007-08. But the Legislative Analyst's November 2003, forecast is much more conservative indicating only $500 million of the Maintenance Factor restoration funding by 2008-09.

The remaining Proposition 98 funding in 2004-05 would provide sufficient dollar amounts to cover K-14 growth and K-12 Cost of Living Adjustments. If the Proposition 98 guarantee

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[2] Scheduled Maintenance/Special Repairs/Instructional Equipment/Library Materials and Hazardous Substances.

[3] Of the total funding currently provided to the Telecommunications Program, $12.5 million is allocated to local districts for support functions. Under the new funding allocation, the funds would be shifted into the general apportionments, leaving the new combined program with approximately $10.9 million to support statewide centralized functions.

increases in 2004-05 so that additional dollars must be allocated to K-14 education in 2004-05 or in subsequent years, the $2 billion restoration would be distributed in the following sequence: (1) restore deficits in apportionments including cost-of-living adjustments from 2003-04, (2) fund "valid" mandate cost reimbursements, and (3) split the remaining balance 75%-25% between general purpose augmentations and other state funding priorities.

Property Tax Shifts

The Governor's Budget also proposes that $1.3 billion of local property tax collections of local government be shifted to K-14 districts, thus reducing state General Fund costs for apportionments for education by an equal amount. This shift will be administered as an additional amount in the Education Revenue Augmentation Fund (ERAF) of current law and will save the state General Fund $1.3 billion. Assuming the funds will be administered in the same manner as current law, there should be no direct adverse impact on public education. The dollar amount of the ERAF shift is almost equal to the property tax amount that education will be paid for the so called "triple flip," designed to create a dedicated sales tax stream to pay off the $15 billion deficit bond.

Another ERAF Shift Proposed

One of the solutions to the budget crisis of the early 1990s was the establishment of the Education Revenue Augmentation Fund (ERAF) and the shift of a portion of local governments' share of property tax to K-12 schools and community colleges. This shift was accomplished by the transfer of $3.9 billion from local governments to the counties' ERAF and the allocation of these funds from the ERAF to the K-12 schools and community colleges to offset state aid. This transfer benefited the state, local government lost, and schools broke even. The Governor's Budget for 2004-05 proposes to increase local governments' transfer of property taxes to the ERAF.

Specifically, for 2004-05, the Governor's Budget calls for an increase in local governments' property tax transfer to the ERAF of $1.3 billion. The budget indicates that the $1.3 billion ERAF shift is equivalent to the amount of revenues lost by local governments in the current year related to the VLF increase. Local governments suffered a VLF shortfall this year when the state terminated the VLF backfill commencing in July 2003, even though the higher payments from vehicle owners did not begin until October 2003. In the end, the Governor rescinded the rate increase on vehicle owners and restored the state backfill. However, the backfill amount was determined on the amount needed only for the nine months of the fiscal year beginning in October 2003. Local governments were thus shorted about $1.3 billion in VLF payments in the current year for the period from July 2003 through October 2003.

The Governor's ERAF proposal essentially makes permanent local governments' current year shortfall in the VLF—the $1.3 billion loss. Like the shift of the early 1990s, this proposal will save the state General Fund an amount equal to the increase in the ERAF. The ERAF shift, however, will have a different distributional impact on local government entities than the current year VLF shortfall, with cities bearing a smaller reduction and counties, special districts, and redevelopment agencies suffering a larger loss. For K-12 education and the community colleges, this proposal will have no budget impact—but we will likely be blamed . . . again.

The Triple Flip

A cornerstone of the 2003-04 State Budget was the borrowing of $10.7 billion to cover what would have otherwise been a negative ending balance for the state. Under the terms of the deal that was struck, the state would guarantee a revenue stream to repay this bond by dedicating a _-cent of the local government sales tax for this purpose, backfill local government with an equivalent shift of ERAF taxes, and then make schools whole by backfilling the loss of ERAF with state aid. While this $10.7 billion bond has been superceded by the $15 billion deficit bond on the March ballot, the repayment scheme is similar, except that the triple flip will involve only a _-cent sales tax shift, and about $1.2 billion in ERAF shifted from schools back to local governments.

Net Impact

The net impact of these two opposite changes in ERAF funds is, as indicated, almost a wash. Regardless of the level of ERAF funding, K-12 school district and county office revenue limits are protected by the continuous appropriation wherein the state must make up for any shortfall in property taxes. But community colleges do not have that same protection. Also, starting in 2002-03, more excess ERAF funds “spilled over” into K-12 special education, serving to reduce (or perhaps eliminate) what would otherwise have been about a $20 million special education deficit. Had only the triple flip occurred, ERAF funds would have been reduced, and this could have led to higher special education deficits (unless supplemental appropriations to cover the shortfall were made). But with both the triple flip and the offsetting ERAF shift, there should be no problem with either special education or community college property tax support in 2004-05.

Proposition 98 Funding

What a difference a year makes. In 2002-03, and also in 2001-02, state tax revenues fell far short of budget projections, and the Proposition 98 minimum funding level fell as well. In response, the state enacted mid-year cuts in both years to reduce the appropriations to schools that counted toward Proposition 98.

But in 2003-04, state tax revenues are coming in higher than the budget estimates. In turn, this triggers an increase in the Proposition 98 minimum funding level (estimated to be $448 million by the Department of Finance) under the Maintenance Factor formula that requires the state to restore prior reductions when state taxes grow faster than personal income. In addition, the Department of Finance reports that the state underfunded the 2002-03 Proposition 98 minimum funding level by $518 million, and that the state still owes $251 million corresponding to the underfunding of Proposition 98 in 1995-96 and 1996-97, bringing the total Proposition 98 “debt” to more than $1.2 billion. The Governor proposes to start paying off this debt in 2006-07, with the appropriations being made for one-time expenditures, such as instructional materials and deferred maintenance (but without any specific schedule of payments or proposed uses).

For 2004-05, the Proposition 98 minimum funding level is projected to grow significantly. After taking into account the $448 million increase to the 2003-04 Proposition 98 funding level and factoring in the 2004-05 adjustments estimated to be $1.5 billion for growth and inflation, plus another $0.8 billion under the Maintenance Factor formula, the Proposition 98 minimum funding level would jump by $2.8 billion over the current year funding level. But the Governor has called for "rebasing" Proposition 98 and reducing school funding by $2 billion below the minimum funding level in 2004-05, as well as delaying the 2003-04 "settle up" well past the date when it would normally be paid.

Rebasing is Like an Artificial "Test 3"

The "Test 3" calculation, which serves to reduce the minimum funding level when state taxes decline (or grow very slowly), was added in 1990 to the Proposition 98 calculations to protect the state during difficult fiscal times. While state taxes are projected to grow in 2004-05, the state is certainly facing difficult fiscal times, and the Governor's proposal is what one Administration official called an "artificial Test 3." Just like under "Test 3," the Governor is proposing to reduce the Proposition 98 funding to ease the state's budget shortfall. And, just like under "Test 3," the amount of the reduction is added to the Maintenance Factor—creating an obligation to prospectively restore this amount to Proposition 98 funding.

With this additional $2 billion cut, the Maintenance Factor would be just under $4 billion in 2004-05. Under the constitutional provision, the state must make restoration payments in those years in which state taxes grow faster than personal income. However, according to the Legislative Analyst's multi-year forecast issued in November 2003, growth in state tax revenues would only generate about $500 million in Maintenance Factor funding between 2005-06 and 2008-09.

The Administration indicates that the priorities for use of the Maintenance Factor restoration funding would be:

- First, to fund the K-12 revenue limit deficit (this would cost about $900 million)
- Second, to fund valid deferred mandated cost claims (with "valid" referring to claims that have passed an audit)
- Third, any remaining funds would be split, with 75% going to general purpose apportionments and the other 25% for other state funding priorities

But even with this $2 billion reduction, Proposition 98 funding will still grow by $0.8 billion in 2004-05. In addition, changes in the level of school apportionment deferrals serves to free up funding for schools. That is, the school apportionments that were deferred in 2003-04 and will be paid in 2004-05 are $610 million less than the amounts deferred in 2002-03 and paid in 2003-04. And since less is needed to pay the deferrals in 2004-05, $610 million more is available for expenditure. In total, this provides about $1.4 billion in new funding available for K-14 programs in 2004-05.

Summary

While we would never advocate for less money for public education, the Governor's proposal is certainly reasonable (except for the student fee increases)—and perhaps better than a deal that the Legislature may propose. To accomplish his proposed rebasing of Proposition 98, the Governor will need to have the Legislature enact a bill that will implement a limited suspension of Proposition 98—limited, that is, to a reduction of $2 billion. If the state's economy does better than currently expected and the Proposition 98 minimum funding level is higher, then we would receive that higher level—$2 billion is the maximum cut in school funding in 2004-05, under the Governor's proposal.

Equalization Aid

One of the surprise augmentations in the community college budget was the level of equalization funding provided to the system. The system's budget proposal requested $25 million for equalization aid, but the Governor's proposed State Budget includes $80 million for these purposes. The Governor's proposal is to equalize low-funded districts to the funding for districts at the 90th percentile. Since the cost of fully funding this process of equalization is somewhat more than $200 million, the Governor's proposal calls upon the Chancellor's Office to prorate the available funds according to each eligible district's entitlement. This funding is ongoing.

According to the Department of Finance (DOF) these funds ($80 million) shall not be allocated to districts until the Chancellor develops a plan that is approved by the DOF. The DOF shall not approve any plan prior to a 30-day review by the Joint Legislative Budget Committee and the respective committee of each house of the Legislature that considers the budget.

Further, according to the DOF, the plan shall conform to the following requirements:

- Shall provide that the districts be divided between two categories, representing large and small districts. A district shall be determined to be a small district if its total funded credit FTES, based on the 2003-04 second principal apportionment, does not exceed 4,000 FTES.

- Shall provide that the Chancellor shall compute an equalization adjustment for each applicable large community college district, so that no district's 2003-04 base funding per credit FTES is less than the 2003-04 base level of funding per credit FTES above which not less than 10% of the total statewide funded credit FTES for large districts falls.

- Shall provide that the Chancellor shall compute an equalization adjustment for each applicable small community college district, so that base funding per credit FTES is not less than the base funding per credit FTES equalization target determined for large districts multiplied by 1.10. This 10% adjustment for the small district equalization target is intended to recognize diseconomies of scale for small districts, and approximates the difference in targets utilized by the state for K-12 unified school district equalization purposes.

Categorical Reform

In order to provide additional flexibility to districts, the Governor's Budget proposal consolidates several groups of programs into fewer larger programs and increases available discretionary funding in exchange for maintaining accountability for state priority student outcomes, similar to the priorities associated with the sunsetting Partnership for Excellence program. These consolidations are based upon the programs currently having similar funding mechanisms or related purposes, and will allow each community college district to better address its own unique needs, student populations, job environments, and local expectations.

The programs proposed for consolidation include: Partnership for Excellence, Matriculation, and a portion of Telecommunication and Technology Infrastructure, and Part-Time Faculty Compensation, Office Hours, and Health Benefits. Current levels of funding for these programs would be folded into a district's base apportionment. Thus, the district would have the flexibility to decide on what level of funding would be appropriate for these programs, if any.

The Budget technically maintains these programs as separate line items, but only for the purpose of providing districts with guidance if they choose to implement the programs according to existing regulations.

Additionally, other programs such as: Extended Opportunity Programs and Services, Fund for Student Success, Scheduled Maintenance/Special Repairs, Instructional Equipment and Library Materials Replacement, Hazardous Substances, the balance of Telecommunications and Technology Infrastructure, and California Virtual University, are combined to reduce the overall number of programs.

Finally, two small programs, Teacher and Reading Development Partnerships and Fund for Instructional Improvement, are discontinued, and their funding ($4 million) is made available for growth in noncredit FTES.

PERS Rate

The Department of Finance estimates that the school employer rate for the Public Employees Retirement System (PERS) will be 12.2% for 2004-05, an increase over the current year rate of 10.4%.

The Chancellor's Office requested an augmentation of $67.5 million in the 2004-05 State Budget to cover the increased cost to community college employers. However, no funding for this is purpose was included in the Governor's Budget proposal.

Conversely, K-12 schools' increased PERS costs will be offset to some extent in the budget. Since the PERS Revenue Limit Reduction recaptures the savings from the decrease in the PERS rate compared with the 1981-82 rate of 13.02%, this means that the PERS Reduction recaptures the savings from only a .82% (est.) reduction in the PERS rate. In addition, under current law, the $35 million for K-12 schools appropriated in 2003-04 to buy out the PERS Reduction increases by COLA and growth to about $36 million in 2004-05. Given the very small amount being recaptured, it is estimated that this amount will be sufficient to buyout about 70% of the dollar amount of the 2004-05 PERS Reduction.

Funding PERS rate increases will be a priority for community colleges in this year's budget process.

Cost-Of-Living Adjustments

The Governor's Budget proposal did not provide a cost-of-living adjustment (COLA) for community college apportionments or programs. The system's budget proposal had requested a COLA of 2% for general apportionments and categorical programs.

Conversely, the Administration provided K-12 schools with a statutory COLA estimated to be at 1.84%. The Administration's rationale in providing a COLA to K-12 was based on current law that specifies a COLA to be provided to all statutorily required programs. Community Colleges do not have the same requirements in law. [The rationalization by the Administration is that]

It should be noted that K-12 discretionary programs did not receive a COLA.

A COLA for community colleges would have increased funding by approximately $80 million.

Child Care

The Governor's Budget proposes comprehensive reforms in the area of child care in an effort to contain costs of non-K-12 education child care (license-exempt providers) funded out of Proposition 98. The Budget proposal cites a 2001 report released by the State and Consumer Service Agency that found California has the most generous eligibility, subsidy, and co-payment policies of any other large state.

Out of the total $3 billion program administered by California Department of Education, Department of Social Services, and California Community Colleges, the budget proposal reflects a savings of $164.8 million resulting from proposed reforms, expenditures, and caseload changes.

The major savings would be generated by:

- Child Care Family Fees—Lowering the income thresholds with gradual fee increases to prepare families for when they are no longer eligible for subsidies.

- Child Care Reimbursement Rate Limits—Reforming reimbursement rate limits for license-exempt providers and at the same time providing incentives for those providers that demonstrate the integration of early childhood development principles

- Time Limit Changes to CalWORKs Stage 3—Providing that any CalWORKs Stage 3 family who has exceeded three years of transitional child care in 2004-05 to be granted one additional year to make other arrangements if they are not able to access a slot in the general child care program

Savings by program are as follows:

CalWORKs Stage 1	$41.8 million
CalWORKs Stage 2	$53.8 million
CalWORKs Stage 3	$32.5 million
General Child Care	$17.1 million
Alternative Payment Program	$16.3 million
Latchkey Program	$3.3 million
Total	$164.8 million

Capital Outlay Program

School facility needs continue to grow even in the face of the state's operating budget problems. Adequate facilities help to ensure that California's students have access to the same richness, quality, depth, and breadth of program choice that are available in other states. Failure to provide these facilities creates additional barriers that negatively affect student performance. These barriers also affect the ability of California's students to compete on an equitable basis for access to universities and colleges and to succeed in life's major endeavors. Good facilities don't guarantee a quality education, but the absence of those facilities may very well place a ceiling on student achievement.

State Bonds

The Governor's spending plan for facilities during 2004-05 is a marked improvement over the Budget adopted a year ago. The Governor emphasizes his commitment to passage of Proposition 55, the Kindergarten-University Public Education Facilities Bond Act of 2004 on the March ballot. Proposition 55 would provide $12.3 billion for K-14 facilities. Both Proposition 55 and its successful predecessor, Proposition 47 of 2002, were authorized by AB 16 of 2002. Proposition 47 continues to provide funding for eligible school projects, but will be exhausted later this year.

The Governor's Budget includes $618 million for 39 previously approved projects and 52 new projects. $576 million to be funded from proposed general obligation bonds. Proposition 55 provides that the $2.3 billion for higher education would be distributed in the following manner: $920 million for community colleges, and $690 million each for UC and CSU.

Successful passage of Proposition 55 would provide $12.3 billion for school facilities divided as follows:

	Balance (in millions)
Higher Education	$2,300.0
K-12:	
New Construction (up to $300 million may be allocated to charter schools)	$5,260.0
Hardship Applications	$2,250.0
Critically Overcrowded Schools	$2,440.0
Joint Use Projects	$50.0
Total	**$12,300.0**

This bond may have a tough time on the same ballot as Proposition 57, the deficit debt consolidation bond, but notwithstanding that—we need this bond!

Mandates

As identified in the prior year budget, the education mandates are proposed for continued deferral in 2004-05 with a few minor exceptions. School Bus Safety II and School Crimes Reporting I/II have been suspended since 2002 and are proposed for continued suspension for 2004-05. Two mandates are proposed for suspension or repeal—Law Enforcement Sexual Harassment Training and County Treasury Oversight Committee. Look for changes to statute in either subsequent legislation that would cause repeal, or in Budget language allowing suspension. The Budget does contain the $1,000 allocation for all of the other existing education mandates.

It is important to point out that this budget highlights that several mandates have either been repealed or sunset during the past fiscal year. The list includes the following mandates and the Budget shows no allocation for 2004-05:

- Chapter 172/86 Interdistrict Attendance Child Care (Sunset)
- Chapter 172/86 Interdistrict Attendance Parent’s Employment (Sunset)
- Chapter 783/95 Investment Reports (Repealed)

We believe that the framers of this section of the Governor’s Budget demonstrate a lack of sensitivity to the real purpose of mandate law. The permissive Education Code presumes that a high level of local control and accountability is desirable. But it also recognizes that there are times when the state might choose to impose a mandate—and if the state chooses to do so, it must pay the cost. If the state wishes to reduce costs, it can do so by repealing the imposition of the requirement. But is it very inconsistent and unfair to remove the funding but still require district to perform the mandated service.

Lottery

For the 2004-05 fiscal year, the Lottery Commission is projecting sales at approximately $2.8 billion and funds distributed to education at approximately $1 billion. These projections assume that both revenues and distributions to education are essentially flat.

The Governor's 2004-05 budget projects that the K-14 education share of the current fiscal year (2003-04) Lottery distributions will actually decline by $6.1 million, from the original budget of $799.4 million to $793.3 million. Then K-14 education revenues are projected to be flat in 2004-05 at $793.3 million level. Based on the Governor's projection, the current year total per ADA/FTES amount (including both Proposition 20 and unrestricted amounts) may decline by approximately $1, with the 2004-05 budget year amount either unchanged or possibly declining by another $1 per ADA/FTES depending on actual growth.

Based upon the Governor's projection, given minimal growth in ADA/FTES, schools would receive about $110.50 per ADA/FTES in unrestricted and $12.50 per ADA/FTES in Proposition 20 distributions. This total of $123 is the same amount as projected for the current year, but with a larger proportion allocated for Proposition 20.

The Non-Proposition 98 Budget

While this report focuses on the Proposition 98 side of the Budget, it is also useful to examine some of the other major proposals contained in the Governor's Budget. In total, the non-Proposition 98 side of the budget will account for almost $50 billion of the $79.1 billion in total General Fund spending. Some of the major non-Proposition 98 programs include Medi-Cal, Supplemental Security Income/State Supplementary Payment (SSI/SSP), CalWORKs, Corrections, and Higher Education.

The Governor has spread budget reductions through all areas of the State Budget, having identified a problem of $14.4 billion for next year. The Budget acknowledges that some of the Budget solutions will rely on one-time funds, such as issuing pension obligation bonds and using $3 billion from the proceeds of the Proposition 57 Economic Recovery Bond in the budget year. Other adjustments are presumably ongoing, but the Governor in his State-of-the-State speech, indicated that while the cuts would not be easy, "they would not be forever." It will remain to be seen whether any of these reductions, if adopted, are eventually restored.

Health and Human Services programs are proposed for major reductions from what would have been required to maintain current services. The Medi-Cal program accounts for reductions of $880 million. CalWORKs would be cut $787 million. SSI/SSP, which supports the aged, blind, and disabled, would be cut $135 million, and In-Home Supportive Services would be cut $127 million on top of a similar cut proposed for the current year.

The Administration's Medi-Cal proposals includes $680 million in mid-year reductions as of November 2003. The mid-year reductions included a 10% decrease in provider rates, elimination of supplemental payments to long-term care facilities offering higher salaries for caregivers, and capping enrollment for immigrants. (We would note that the courts have overturned a 5%

provider rate reduction for the current year, and the chance that an even larger 10% reduction would be sustained seems unlikely.) The Budget also proposes a number of reforms intended to cut costs and implement efficiencies. These proposals include a multi-tiered benefit package for various eligible populations, co-payments for selected services, and benefit reductions that conform to offerings of private health plans. The reform proposal also includes an expansion of managed care for the aged, blind, and disabled to achieve savings over the fee-for-service delivery model.

For CalWORKs, the state's low income assistance program, the budget proposes to eliminate the 2004-05 cost-of-living adjustment (COLA) and reduce the basic CalWORKs grant.

Local governments, which were elated that the Governor restored the VLF backfill in December, will experience cuts in 2004-05 nevertheless. Local governments would be subject to a loss of property tax revenues of $1.3 billion in the budget year as a result of an increase in the required shift to the Education Revenue Augmentation Fund (ERAF). The ERAF funds would then be allocated to K-14 education, which in turn allows the state to reduce support for public education by an equivalent amount. (This $1.3 billion reduction corresponds to the amount of VLF funding that cities and counties lost during the brief tenure of the tripled Vehicle License Fee.)

The University of California and the California State University are budgeted cuts totaling $729 million. The Budget proposes a fee increase of 10% for undergraduate students and 40% for graduate students. In addition, non-resident fees would increase 20%. The Budget continues to assume adoption of the November 2003 proposal to eliminate academic outreach programs. It also calls for an increase in the student/faculty ratio of 5% and a reduction in freshman enrollment of 10%.

The Budget also cuts student financial aid, reducing the maximum Cal Grant A and B award for private schools by 43% to $5,482, the undergraduate fee level for UC.

The Budget counts $1.3 billion in savings from the reduction in debt service payments relating to the substitution of the Proposition 57 bond—which will carry a 14-year term—for the $10.7 billion deficit bond assumed in the 2003 Budget Act, which would have carried a five-year term. The longer term of the Proposition 57 bond reduces annual debt service payments, which the Budget counts toward solving the $14.4 billion problem.

The Administration is also counting on $500 million from renegotiated agreements with Indian tribes offering gaming on reservation lands. This compares to $680 million assumed in the 2003 Budget Act for the current year, an amount that will not be realized.

Even though the Governor has criticized the previous Administration for its over reliance on one-time funds, the Governor's Budget continues to rely on one-time revenues to balance revenues against spending in 2004-05. The Budget identifies the use of $3 billion in proceeds from the Proposition 57 Economic Recovery Bonds to be made available in the budget year to assist in balancing the Budget. The Administration's spending proposal also relies on one-time funds from the suspension of Proposition 42, a measure which requires the transfer of General Fund revenues for transportation projects. This suspension is in place for the current year, and the

Governor's Budget proposes another suspension in 2004-05. The proposal makes available $947 million in the budget year.

Finally, the Budget assumes the issuance of bonds to avoid General Fund pension payments in the budget year, a strategy assumed in the current year budget and rejected by the courts.