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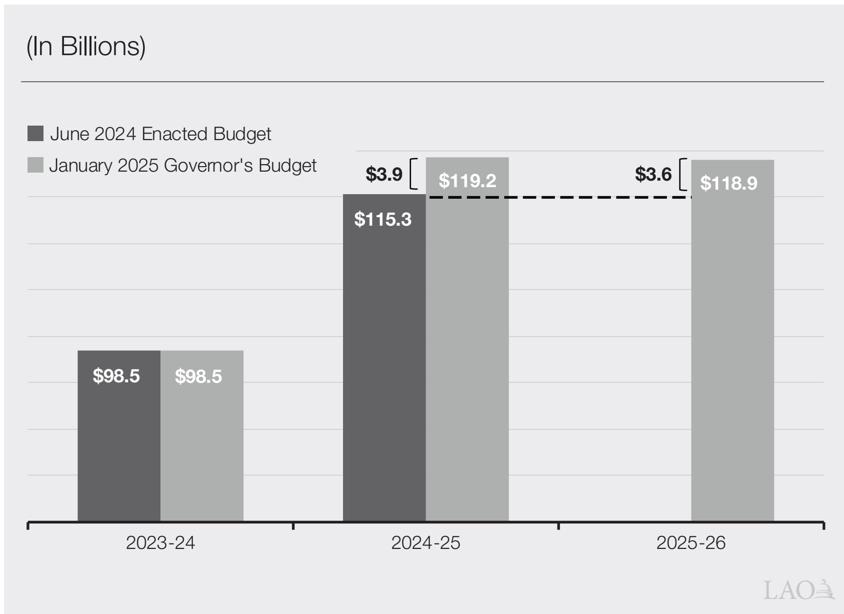
The 2025-26 Budget: Proposition 98 Guarantee and K-12 Spending Plan

PRESENTED TO:

Assembly Budget Subcommittee No. 3 on Education Finance
Hon. David A. Alvarez, Chair

LEGISLATIVE ANALYST'S OFFICE

Governor's Budget Estimate of the Proposition 98 Guarantee



Proposition 98 Guarantee Revised Up $7.5 Billion Across 2024-25 and 2025-26

- Relative to the 2024-25 enacted budget, the guarantee is up $3.9 billion (3.4 percent) in 2024-25 and $3.6 billion (3.2 percent) in 2025-26.
- "Test 1" remains operative for calculating the guarantee in both years.

Increase in 2024-25 Guarantee Driven by Higher General Fund Revenue Estimates

Increase in 2025-26 Guarantee Driven by Three Factors:

- Growth in General Fund revenues (year-over-year increase of 3.5 percent).
- Growth in local property tax revenue (year-over-year increase of 5.5 percent).
- Upward adjustment for transitional kindergarten (nearly $900 million).

General Fund Revenue Estimates and the Guarantee

The Revenue Estimates in the Governor's Budget Are Reasonable—but Depend on a Volatile Stock Market

- State tax receipts have been strong since June 2024. Most notably, personal income tax withholding has been growing at an annual rate of about 10 percent.
- These revenue gains build upon a run-up in the stock market and exceptional stock performance among a few California tech companies.
- The broader state economy remains lackluster—job growth outside the healthcare and government sectors has been limited, and consumer spending has been weak.

Guarantee Is Extremely Sensitive to Revenue Changes in 2024-25

- For every dollar of higher or lower revenue, the guarantee would change by about 95 cents (holding other factors constant).
- This high sensitivity is related to a relatively unusual configuration of the Proposition 98 formulas—Test 1 is operative and the state is paying maintenance factor (an obligation it created last year when it suspended the guarantee).

Guarantee Is Moderately Sensitive to Revenue Changes in 2025-26

- For every dollar of higher or lower revenue, the guarantee would change by nearly 40 cents (holding other factors constant).
- The state is unlikely to pay any maintenance factor in 2025-26. Growth in per capita personal income has been strong, and maintenance factor payments are required only when General Fund revenues are outpacing this growth.

Governor's Budget Has $7.8 Billion in School Spending Proposals

(In Millions)	
Ongoing	
LCFF COLA (2.43 percent)	$1,858
Transitional kindergarten expansion	1,065
Transitional kindergarten lower student-to-adult ratios	746
Expanded Learning Opportunities Program	435
COLA for select categorical programs (2.43 percent)	206
Universal school meals	84
Statewide System of Support: literacy	5
K-12 High Speed Network	4
California College Guidance Initiative	3
Homeless education technical assistance centers	2
FCMAT salary adjustment	1
Subtotal	($4,408)
One Time	
Discretionary block grant	$1,776
Literacy and math coaches	500
Learning Recovery Emergency Block Grant	379
Pay down LCFF deferral	247
Teacher recruitment incentive grant	150
Kitchen infrastructure and training	150
National Board Certified Teacher Certification Incentive Program	100
Training for literacy screenings	40
Transitional kindergarten English language proficiency screeners	10
Statewide System of Support: literacy	5
IEP template digitization and translation	2
Evaluation of standards and materials adoption process	1
Subtotal	($3,359)
Total	**$7,768**

LCFF = Local Control Funding Formula; COLA = cost-of-living adjustment; FCMAT = Fiscal Crisis and Management Assistance Team; and IEP = Individualized Education Program.

Most Targeted Proposals Focus on Four Areas

- (1) Transitional kindergarten (TK), (2) literacy and math initiatives, (3) teacher training and recruitment, and (4) expanded learning (after school programs and summer programs).

Most Proposals Expand Existing Programs or Support One-Time Activities the State Funded in Previous Budgets

Strengths of the Governor's School Spending Plan

Has a Reasonable Mix of One-Time and Ongoing Spending

- Of the new spending, the budget dedicates $4.4 billion for ongoing augmentations and $3.4 billion for one-time activities.
- The ongoing spending increases would help districts address longer-term challenges and cover ongoing cost pressures. Conversely, one-time funds would help districts fund short-term activities and cover one-time costs.

Contains a Budget Cushion to Protect Ongoing Programs

- Of the one-time school spending, $1.4 billion is attributable to 2025-26. In combination with a deposit into the Proposition 98 Reserve ($376 million) and one-time community college spending ($331 million), the budget has $2.1 billion in ongoing Proposition 98 funds dedicated to one-time purposes.
- This budgeting approach creates a cushion that would help accommodate future drops in the guarantee without program reductions or payment deferrals.

Has a Reasonable Mix of Flexible Funding and Targeted Proposals

- The Governor's budget allocates $4 billion for proposals that would provide districts with flexible funding, including a cost-of-living adjustment (COLA). It allocates $3.5 billion for proposals with specific requirements or spending restrictions. It also provides $247 million to eliminate a payment deferral.
- The mix of proposals could allow districts to address their cost pressures and a few core state priorities without being overwhelmed by new requirements.

Recommend Building Budget That Retains These Structural Features

Addressing Proposition 98 Volatility in 2024-25

Governor Proposes to Delay $1.6 Billion "Settle-Up" Payment

- The Governor's budget provides $117.6 billion in funding for schools and community colleges in 2024-25—$1.6 billion less than the revised estimate of the Proposition 98 guarantee that year. This proposal would create a $1.6 billion settle-up obligation the state would address in next year's budget.
- The proposal is intended to mitigate the risk that state revenues and the guarantee fall short of the Governor's budget estimates for 2024-25. It also allows more spending on nonschool programs this year by delaying costs into the future.

Governor's Concern About Volatility Is Well Founded

- The recent stock market boom could reverse quickly and without warning.
- Tax extensions in Los Angeles County add uncertainty to state revenue estimates.
- The Proposition 98 guarantee is highly sensitive to revenue changes in 2024-25.

Legislature Has a Few Alternative Options to Address Volatility

- Alternative 1: Make a discretionary deposit into the Proposition 98 Reserve this year and reverse the deposit next year if revenues fall short.
- Alternative 2: Make an appropriation for school and community college programs this year but delay disbursing the funds until June 2026. Make the appropriation contingent on revenues meeting expectations.
- Alternative 3: Suspend the Proposition 98 guarantee. Suspension would allow the state to fund schools at any level this year but requires faster funding increases in the future.

Addressing Proposition 98 Volatility in 2024-25

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Differences Among the Options Mainly Involve Timing

- All options assume the state eventually funds the Proposition 98 requirement.
- Some options would require the state to cover the cost of the higher guarantee immediately, whereas others would delay costs further into the future.

Option	Helps Balance the Budget This Year?	Increases Future State Costs?	When Would State Decide How to Allocate the Funding?[a]
Governor's settle-up proposal	Yes	Yes	June 2026 budget
Discretionary reserve deposit	No	No	Future year(s) whenever funds are withdrawn
Appropriation with delayed disbursement	No	No	June 2025 budget
Suspending the guarantee	Yes	Yes	Future year(s) based on maintenance factor formulas

[a] Assuming revenue estimates for 2024-25 meet the projections in the Governor's budget.

Recommend Legislature Address Volatility Proactively

- The Governor's plan is viable, but we think the discretionary reserve deposit is a more compelling approach to addressing volatility.
  - The main advantage of the discretionary deposit is that it reduces state costs in 2026-27 (when the state is likely to face a large budget deficit). It also could be reversed easily without affecting local district budgeting.
  - The main disadvantage is that it involves higher costs this year, potentially meaning additional reductions to nonschool programs.
- In selecting among the various options, the Legislature will need to consider its plan for balancing the state budget now and in the future.

Payment Deferrals

Schools and Community Colleges Ordinarily Receive State Payments in Monthly Installments

The June 2024 Budget Deferred $490 Million in School and Community College Payments

- The June budget deferred nearly $247 million in school payments and $244 million in community college payments. The state adopted the deferrals to help address a significant reduction in Proposition 98 funding.
- The budget implemented the deferrals by moving a portion of the payment schools and community colleges normally receive in June to July.

The Governor Proposes to Eliminate the Payment Deferrals

- The budget provides $490 million (one time) to eliminate the deferrals and restore the regular payment schedule beginning in 2025-26.
- The deferral scheduled for June 2025 would still occur.

Proposal Is Prudent, Recommend Adopting

- Eliminating the deferral would align the ongoing cost of school programs with the ongoing funding necessary to support those programs. It also would improve local cash flow and simplify state and school accounting.
- The Legislature could consider eliminating the deferral a year earlier (avoiding the June 2025 deferral). This accelerated approach would reduce state and local workload, but require the Legislature to act by early April.

Update on the Public School System Stabilization Account (PSSSA)

Proposition 2 (2014) Established a Proposition 98 Reserve Known as the PSSSA

- The California 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 quickly relative to inflation. It also requires the state to withdraw funding when the guarantee is growing slowly relative to inflation.
- Unlike other state reserve accounts, the Proposition 98 Reserve is earmarked exclusively for school and community college programs.
- The June 2024 budget withdrew the entire balance of the reserve—$8.4 billion—to address a significant funding drop in 2023-24.

State Would Deposit $1.5 Billion Under the Governor's Budget

- The budget includes a $1.2 billion required deposit in 2024-25, replacing a previous $1.1 billion discretionary deposit.
- The budget also includes a $376 million deposit in 2025-26. (The budget originally estimated this deposit would be mandatory, but the Department of Finance recently updated its calculation and determined the deposit is optional.)

Assessment of Reserve Deposit Estimates

- The required deposit in 2024-25 is highly sensitive to capital gains estimates, and the estimate will likely change in coming months.
- The two deposits would help the state begin to rebuild the balance in the reserve and prepare schools for the next economic downturn.

Discretionary Block Grant Proposal

Governor Proposes $1.8 Billion to Create the Student Support and Professional Development Discretionary Block Grant

- Trailer language would make the funding available to "address rising costs" and fund activities in four main areas: (1) teacher professional development, (2) teacher recruitment and retention, (3) career pathways, and (4) dual enrollment programs.
- The state would distribute funding to districts based on their average daily attendance ($323 per student based on current estimates).

Proposal Is Reasonable

- Districts received significant federal funding in recent years and used this funding to hire staff and expand programs. The discretionary block grant could allow districts to sustain their most promising programs for another few years.
- Districts could use the discretionary grant to cover various one-time costs, including (1) technology replacements and upgrades, (2) facility updates, (3) insurance-related increases and special assessments, and (4) retirement liabilities.

Recommend Adopting Proposal With Three Refinements:

- Explicitly allow districts to spend their grants on local costs and priorities.
- Call out fiscal liabilities and temporary costs in the intent language related to rising costs.
- Specify that the funds a district receives count toward any unpaid mandate claims. (A few districts still have unpaid claims, generally predating the creation of the mandates block grant in 2012-13. The state has adopted similar offset language for previous discretionary block grants to help address this backlog.)

Los Angeles Wildfires and School Funding

The January Fires in Los Angeles Were Exceptionally Destructive

- The Eaton Fire and Palisades Fire together burned more than 37,000 acres and killed at least 29 people.
- The fires damaged or destroyed thousands of homes, businesses, and other structures. We estimate the fires will reduce assessed property values by $10 billion to $20 billion.
- Most of the physical damage occurred in the boundaries of three school districts: Los Angeles Unified, Pasadena Unified, and Santa Monica Malibu Unified.
- The fires destroyed or severely damaged at least eight school district and charter school facilities as well as several private schools.

State Law Mitigates Loss of Operational Funding for Affected School Districts

- A waiver process allows districts to avoid penalties if fires force them to shorten the school year or reduce instructional time. The waiver also allows districts to receive credit for average daily attendance lost due to the fires.
- If a district experiences an ongoing attendance reduction, it will receive funding based on its average attendance over the three previous years. This policy provides time for the district to adjust its budget. This policy does not apply to charter schools.
- Most districts receive an automatic General Fund backfill to offset reductions in property tax revenue. (Backfills for “basic aid” districts have a separate process.)

Los Angeles Wildfires and School Funding

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State Law Helps Districts Rebuild Facilities

- State law requires districts to carry fire insurance. Payouts on these policies help districts rebuild.
- Districts with damaged buildings may qualify for the Facility Hardship Program. This program waives the typical eligibility requirements for the School Facility Program and provides priority for application processing and funding.

Fiscal Mitigation Measures Cannot Address All Impacts of the Fires

- Fires can cause stress and trauma for students and their families.
- Fires can cause higher absences among teachers and staff.

Effect of Los Angeles Fires on Proposition 98 Guarantee

- The Los Angeles fires will likely reduce school and community college property tax revenues by $30 million to $60 million in 2025-26. Some effect in 2024-25 also is likely, particularly in districts affected by property tax payment extensions.
- The lower revenues will reduce the Proposition 98 guarantee by a corresponding amount. This reduction is relatively modest compared with school property tax estimates statewide ($34.3 billion under the Governor's budget for 2025-26).
- The reduction will fade over time as debris is cleared and homes are rebuilt.