

Overview

California's economy continued to perform strongly into 2006. This economic strength, coupled with a surge in revenues tied to corporate taxes, capital gains, and stock options, has resulted in an increase in projected state revenues—when compared to the Governor's January Budget—of \$4.8 billion in the current year and \$2.7 billion in the budget year, for a two-year increase of \$7.5 billion.

Given the volatility of California's revenues, it is imperative to view these gains with caution. Precise data on the components of the new revenue growth will not be available for several months. Therefore, fiscal prudence dictates that most of the current-year gain be viewed as one time in nature, which is why the budget-year revenue projection is significantly less than the current-year gain would seem to suggest. In light of this, the May Revision proposes a total reserve of \$2.2 billion, by far the largest May Revision reserve since the enactment of Proposition 13.

Political and Economic Realities

What a difference this May Revision Budget is compared with other recent State Budgets—the COLA is increased and fully funded, there are no major budget cuts, there is dramatically increased funding for mandates both past and present, there are significant dollars—mostly one-time for programs, the Proposition 98 lawsuit has been settled, and there is real growth in education funding. There is no argument—the May Revision is a very good budget for K-14 education.

This reflects the premise that the Governor's ability to say "yes" rises and falls with state economics. For 2006-07, the positive economic outlook means that the Governor can address many issues, which has not been true of the past several years. The economics this year are extraordinarily positive, which happens to coincide with an election year.

The California economy continues to expand:

- Job creation in 2005 reached a five-year high, with 255,000 jobs added
- California's personal income growth rate exceeded the national average
- California's exports grew 6.2% in 2005

This economic activity generated billions more in tax revenue. General Fund revenues for 2005-06 are up \$4.8 billion from the January forecast—a 12.5% revenue increase over 2004-05. Much of this results from personal income tax growth related to capital gains and stock options, similar to that of the years 1999 and 2000.

Most of this revenue gain, however, is believed to be one-time and will not carry forward into 2006-07. The May Revision outlook for next year shows a slowing economy, due to higher energy prices, slowing residential construction, and rising interest rates. The revenue outlook reflects

this slowdown and the loss of 2005-06 one-time funds. General Fund revenues are forecast to increase only 1.5% in 2006-07.

How the Legislature deals with the May Revise remains to be seen. However, the legislative action on the infrastructure bond package points to hopeful May Revise negotiations. The differences between the Democrats and Republicans were ironed out, even though the overall amount of borrowing was considerably less than the Governor's January plan for \$68 billion. This success may lead to promising negotiations on the State Budget.

Settlement Agreement (California Teachers Association, et al. v. Arnold Schwarzenegger, et al.)

An agreement was reached between K-12 education advocates and Governor Schwarzenegger to settle a lawsuit against the Governor over prior-year funding of the Proposition 98 guarantee. The lawsuit was filed last summer, arguing that the Governor did not fully fund Proposition 98 in accordance with an agreement made with the education community in 2004. At issue was whether education was entitled to increases in General Fund revenues beyond what was assumed in the 2004 Budget Act.

The settlement provides for added Proposition 98 funding that was due for the 2004-05 and 2005-06 fiscal years. The Governor's May Revision contains approximately \$2 billion, plus Budget language that calls for an additional \$3 billion to be paid in annual installments.

The parties agree that the outstanding balance of the minimum funding obligation for 2004-05 and 2005-06 shall be paid as follows: \$300 million in fiscal year 2007-08 and \$450 million in fiscal year 2008-09 and in each succeeding fiscal year until the entire minimum funding obligation for fiscal years 2004-05 and 2005-06 is paid. Under this schedule, it is anticipated that the state will complete payment of the balance of the minimum funding obligation for fiscal years 2004-05 and 2005-06 in fiscal year 2013-14.

Community College Budget

The May Revision provided a major increase in funding for the California Community Colleges. A significant increase in state revenues and the settlement of the CTA lawsuit against the Governor contributed to the increase in funding for community colleges. K-14 education benefits from the increase in Proposition 98 funding in the following manner: (1) an increase in one-time funds for fiscal year 2005-06 of approximately \$2.1 billion, (2) an increase in the 2006-07 Proposition 98 base of approximately \$800 million, and (3) a "settle-up" agreement over a seven-year period starting in 2007-08, paid in installments that add up to approximately \$3 billion.

The System's share of Proposition 98 funds is reported to be 10.70% for the 2006-07 fiscal year. This is slightly less than the 10.79% calculated in the Governor's January Budget.

The May Revision reflects the change in cost-of-living adjustment (COLA) that was estimated at 5.18% in January and is now funded at 5.92%. This modification of the COLA represents an increase of approximately \$38 million more for community colleges over the \$264.6 million included in the January Budget.

For now, the May Revision maintained growth funding at the amount included in the January Budget—3% (\$148.8 million). However, due to data received from local districts regarding their growth numbers, all of the 3% in growth funds will not be used in 2005-06. Thus, there may be a “re-benching” of current-year growth dollars to some extent before the Budget is finalized.

Attachment A is a summary of the Governor’s May Revision for California Community Colleges.

Lottery

The 2005-06 year was good for the Lottery, with total estimated revenues of \$3.6 billion. Approximately \$1.25 billion of this amount goes to K-14 education, which results in a total of \$151 per FTES, an upward revision from the January projections by \$10 per FTES. The estimated funding rates for each portion of Lottery funding are:

- \$125 per FTES unrestricted
- \$26 per FTES restricted for instructional materials (Proposition 20)

For 2006-07, the Lottery Commission projects a slight decline because of lower-than-expected MEGA Millions sales. The estimated revenues for 2006-07 for school agencies are:

- \$123 per FTES unrestricted
- \$25 per FTES restricted for instructional materials

Mandated Cost Reimbursements

There is general agreement that the current mandate reimbursement process is broken. The deferred reimbursement for prior-year mandates for K-14 education exceeds \$1 billion. Long delays exist between the imposition of a new mandate and ultimate reimbursement, and there are unclear or nonexistent audit standards that result in too many disallowed claims.

The legislative reform effort underway is represented by AB 2846 (Daucher, R-Brea), which would allow districts to receive 80% funding for prior-year claims not subject to audit, and require a multi-agency working group to develop a unit rate reimbursement system.

The May Revision does provide \$270,000 to facilitate a collaborative reform process for the Commission on State Mandates with state and local officials. In addition, the May Revision provides a significant increase in funds for mandate reimbursements:

