BERKELEY INSTITUTE FOR YOUNG AMERICANS

Evaluating the Stability of Education Finance for California's Future

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This issue brief series is part of the California 100 initiative. The purpose of this brief is to foster conversations about the future of education in California. You may [read the full report here](#).

Overview

While there has been much focus on the role of adequacy and equity in the education finance literature, the stability of funding—a particularly salient aspect of education finance in California—is often overlooked. In this issue brief, we describe two factors that have made state revenue in California particularly unstable that have led to funding issues across the early Care and Education (ECE) and K-16 systems: 1) A state revenue base that is highly volatile and results in large fluctuations during economic upswings and downturns; and 2) A state budget with a large number of "restricted costs" that limit the ability of policymakers to smooth spending cuts during recessions. We then describe how the stability of funding is an important element for policymakers to consider when designing an education finance system for California's future.

Summary of Findings

- The state has large and growing fixed costs in its budget that are difficult to cut when lawmakers need to close a budget gap; at the same time, education spending at the preschool, K-12, and higher education levels is more flexible, with much of the spending either discretionary or having some flexibility with the action of state lawmakers.
- Funding for education in California is largely reliant on the performance of the state's general fund, which follows the boom and bust cycles of the economy. The general fund's combination of revenue volatility and high fixed costs makes funding for education at every level especially unpredictable.

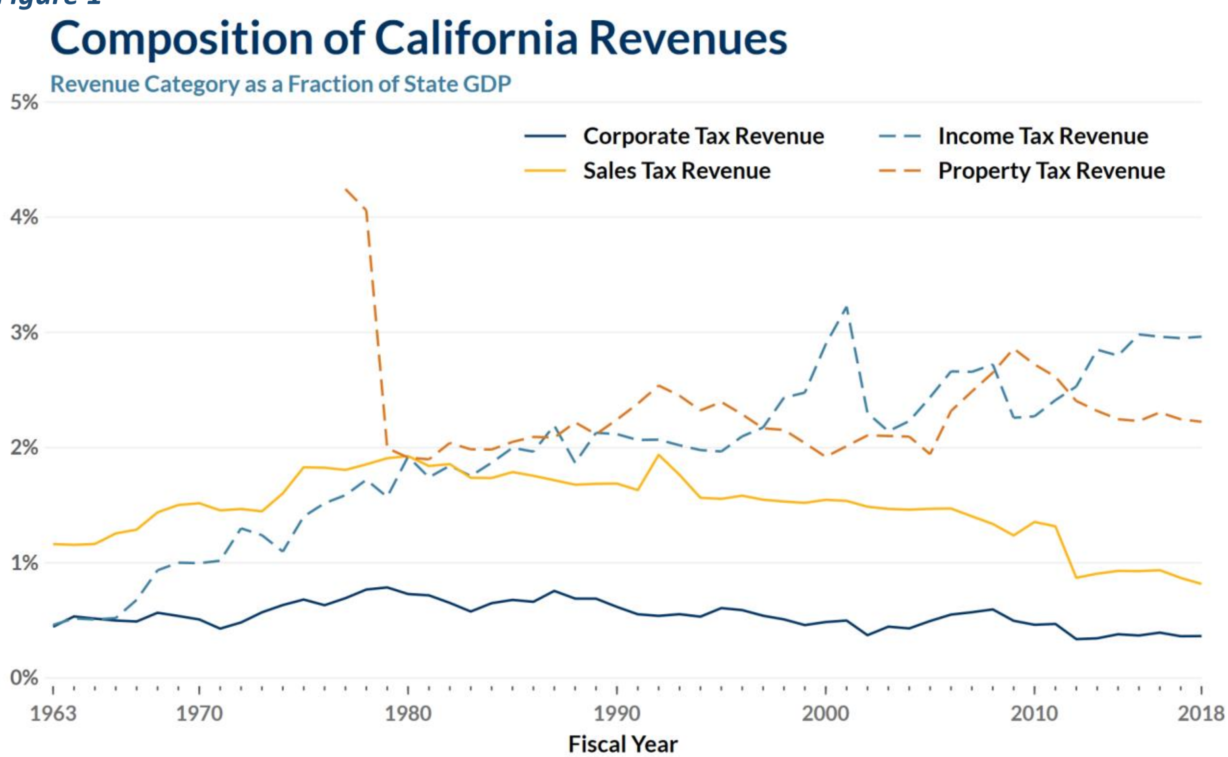
The bottom line: The state needs a long-term and substantial fix to its revenue system in order to stabilize school funding so that early childhood programs, schools, and universities have predictable and reliable funding.

A Highly Volatile Revenue Base

Funding for education in California is largely reliant on the performance of the state's general fund. In general, across the US, tax revenues have become more sensitive to business cycle fluctuations in recent decades leading to greater volatility in general fund revenue collections for most states. This is especially the case in California: research looking at the standard deviation in the annual percentage change in general fund revenue from 2006 to 2015 finds that the state has among the most volatile revenue of any state (Murphy, Paluch, & Mehlotra, 2019; Randall & Rueben, 2017). Additionally, across all states since 1977, the personal income tax (PIT), a particularly volatile revenue source, grew from 25 to 36 percent of total state revenues (Rueben, Randall, & Boddupalli, 2018).

In California today the PIT represents more than two thirds of state revenue; the state has come to rely more heavily on the PIT as a revenue source following the decision by California voters to significantly limit property taxes. As seen in Figure 1, there was a significant drop in the proportion of state revenue coming from property taxes in 1978 following the passage of Proposition 13. Following this initial drop, the share of property tax revenue has modestly increased with a steady growth of revenue coming from the PIT; revenue from other sources such as the sales and use tax and corporate tax have declined.

Figure 1



Source: Legislative Analyst's Office, Department of Finance, and US Census Bureau (compiled by the Urban Institute).
Sample: Property tax data unavailable prior to 1977.
Notes: Due to a break in the GDP series in 1997, we adjust pre-1997 SIC series values by the relative difference between the NAICS and SIC series in 1997. Property tax revenue combines state and local sources of property taxes.

Beyond wages and salaries, business income, and retirement income, the state has chosen to include other types of income in the personal income tax base such as income from capital gains and other dividends, interest, and rent, which are highly volatile (Miller & Chu, 2018). The upside is that the state has a highly progressive PIT —high-income earners pay much higher tax rates than lower income earners, with marginal tax rates as high as 13.3 percent (Miller & Chu, 2018). The state's top one percent of earners typically make up between 40-50 percent of the state's PIT revenue. When the economy is performing well, state revenue collections soar as top earners produce strong tax returns, but when there is an economic downturn, top earners tend to lose income and capital gains, leading to declines in PIT revenue (Miller & Chu, 2018). For a full explanation of California's composition of revenues and the General Fund, see the California 100 *Fiscal Reform* issue area.

Restricted Spending

In most states, constitutional and statutory budget formulas, federal grant requirements, initiatives and referenda, and court cases limit or lock in spending decisions; this type of restricted spending requires lawmakers to take measures beyond the normal appropriations process to make budgetary changes. Research from the Urban Institute, which attempts to measure the share of overall state expenditures that are restricted, finds that at the lower end of their estimates at least 40 percent of California's spending is restricted (Gordon, Randall, Steuerle, & Boddupalli, 2019). This represents spending that lawmakers have the least flexibility to change, which includes the state's pension obligations and other retirement benefits, debt service, and Medi-Cal. These are particularly inflexible expenditures as issues like health care and retirement benefits are often tied to collective bargaining agreements, and the state is also constitutionally required to make the annual actuarially required contributions to the largest public employee pension system in California - CalPERS.

Likewise, debt service payments for things like state bonds are contractual obligations and are unlikely to go unpaid. Technically states may opt out of Medicaid, though this would be politically unlikely and administratively costly. While California is not required by federal law to participate in Medicaid, there is a fiscal incentive for the state to participate in order to receive federal matching funds; in 2015, for example, California spent $87.2 billion on Medi-Cal (California's version of Medicaid), including $53.6 billion in federally financed spending. Factors largely beyond the state's control like price inflation, caseloads, and a growing number of new drugs and procedures have all led to increases in California's Medi-Cal spending, which means that Medi-Cal has been a large, growing, and highly inflexible expenditure in the state budget.

Considering a broader definition of restricted spending, the Urban Institute finds that as much as 86 percent of California's budget could be considered fixed (Gordon, Randall, Steuerle, & Boddupalli, 2019). In this case, the researchers include all potentially restricted spending in the state budget including the minimum K-14 education funding guarantees from Proposition 98, dedicated transportation spending, and deposits into the Budget Stabilization Account (one of the state's reserve funds), among others. As discussed previously, Proposition 98 creates a legal floor, but an informal ceiling, for K-14 education spending in the state. Though this spending minimum is constitutionally mandated, it is unique in that it is *both binding and flexible*. The state has the ability to modify Proposition 98 requirements each year (Proposition 111, which was passed shortly after Proposition 98, allows lawmakers to waive the Proposition 98 guarantee during economic downturns), which gives lawmakers the ability to cut education spending during times of fiscal stress, though ultimately any short-term cuts will have to be made up for by larger future maintenance payments. In this way, Proposition 98 is unique in that funding is guaranteed in 'good times' only--the state has constitutional authority to cut spending when necessary, making education funding unlike other restricted, fixed costs. Likewise, the state also earmarks funds for transportation or other issues that create additional inflexibility in the state budget. Lastly, recent constitutional amendments, like Proposition 2, require annual payments toward the state's reserves, which further restrict spending (see discussion of Proposition 2 below).

California's unique combination of particularly volatile tax revenue, together with relatively high restricted costs in its budget, means that the state's finances, and consequently its funding for education, are susceptible to boom and bust budgetary cycles (Petek, 2016). This means that during economic downturns, P-16 education spending can be particularly vulnerable to cuts because portions of education spending are discretionary (in particular higher education and some ECE programs) or can be discretionary if lawmakers invoke their constitutional authority to cut spending (specifically Proposition 98-funded portions of ECE, K-12, and community colleges).

Funding cuts for education during the Great Recession

During the 2008 Great Recession, California's state budget had an unprecedented multi-billion-dollar shortfall (Hollingshead & Barkman, 2018). The state was home to a booming construction and housing industry, and the California economy was hit particularly hard during the mortgage crisis (Bardhan & Walker, 2010). To balance the budget, legislators made drastic cuts to state programs over three years that relied on Proposition 98 funding (Hollingshead & Barkman, 2018).

Early Care and Education programs were cut by about $1 billion, or the equivalent of about 25 percent of the state's child care slots (Melnick et al., 2017). At the same time, according to the Legislative Analyst's Office, the state contribution to K-12 education (after adjusting for inflation) was cut so severely that per pupil spending during the Great Recession was even lower than 1988-89 inflation adjusted funding levels. By 2012-2013, the recession's impact on the state's K-12 education budget had reached its trough, with district spending down by about $2,100 per student due to state cuts, and California quickly fell to the bottom of state rankings in per pupil spending (Lafortune, Mehlotra, & Paluch, 2020; Shambaugh, Kitmitto, Parrish, Arellanes, & Nakashima, 2011). For the UCs and CSUs there were also deep cuts during this same period; cuts to the both systems ranged from 9 percent to 25 percent (Murphy, Paluch, & Mehlotra, 2019).

The return on pension investments during the Great Recession also reached historic lows, further stressing the state General Fund and school budgets; both CalPERS and CalSTRS had returns 30 percent lower than expected--yet because pensions are a fixed cost guaranteed to be paid out by the state, funding the shortfall became a state priority and shrunk the revenue pie for the state's education systems (Lin, 2018).

Budget-balancing approaches

Given the combination of revenue volatility and restricted costs discussed above, during recessions, California lawmakers often have to deal with significant budget shortfalls. To stave off more significant cuts to spending, policymakers may take other budget-balancing steps to help close the budget gap.

New revenue - While spending cuts in California may be difficult due to statutory, constitutional, or legal constraints, raising new revenue to help balance the budget during recessions can be challenging due to political constraints. Typically, it may be difficult to persuade voters and lawmakers to increase taxes during a recession if individuals and businesses are already struggling. Despite this challenge, California has a few recent examples of being able to pass *temporary* revenues during recessions. During the Great Recession lawmakers successfully passed temporary increases in the personal income tax and sales tax, as well as the vehicle license fees to help balance the state budget (Murphy, Paluch, & Mehlotra, 2019). And later on, as schools were still struggling during the recovery from the recession in 2012, voters passed Proposition 30, which enacted a temporary income and sales tax increase to stem further cuts to K-14 education. In 2016, the income tax increases were extended temporarily through 2030 with Proposition 55.

Budget maneuvers - As a best practice, states should pay for current year expenditures using recurring revenues earned during the same year. However, during times of fiscal distress states will often delay expenditures to future fiscal years or bring expected revenues from future years into the current fiscal year. Despite this, California has used such maneuvers during previous recessions, at times with a significant impact on education funding. For example, during the Great Recession, California delayed billions of dollars in payments to K-12 districts in order to prioritize balancing the state's General Fund (Shambaugh et al., 2011), causing school districts to dip into reserves, transfer funds between different accounts (Lafortune, Mehlotra, & Paluch, 2020), and in some cases, engage in borrowing from tax and revenue anticipation notes (TRAN's) and bond proceeds (Campbell & Herrera, 2019). Other state budget maneuvers included eliminating Cost of Living Adjustments (COLAs) for teachers and school staff, giving districts more flexibility to spend money allocated for categorical programs, and shifting funding between districts and redevelopment agencies (Lafortune, Mehlotra, & Paluch, 2020).

Federal intervention - During recessions, it is now commonplace for the federal government to supplement state General Fund losses with stimulus aid--this occurred during the 2008 Great Recession and again during the most recent COVID recession in 2020. During the COVID recession, California spent down several billions in reserves and immediately delayed $11 billion in funding to K-12 schools, but was 'lucky' in that the federal government invested in massive stimulus packages that included aid for states. At the same time, the Federal Reserve's macroeconomic policy interventions helped stabilize the stock market, business behavior, and asset prices, creating favorable economic conditions for the state's General Fund with far better returns than expected (Petrou, 2021). However, the COVID recession initially left California in a vulnerable financial situation with the fate of funding for the state's schools and higher education organizations, alongside other programs and services, reliant on the political environment of Washington, D.C. Whether or not the state will be able to rely on the federal government for this kind of budgetary relief in the future is uncertain and adds another dimension of uncertainty to the state's ability to plan for and withstand cuts to education budgets during future recessions.

- **New ideas:** California should consider ways to diversify its revenue base to improve volatility. The clearest way to diversify revenue, though hardly a new idea, would be to repeal all or part of Proposition 13 in order to give local governments greater leeway to raise new revenue. Likewise, the state could revisit broadening the base for consumption taxes, which it has experimented with in the past.

Short-term strategies vs. long-term resiliency

California lacks a strategic, long-term approach for managing high fixed costs in the General Fund and its exposure to revenue volatility during economic downturns. In recent years, California has relied on a short-term, “bandage” approach, building up its reserves and chipping away at its debt during economic booms in the hope this will help the state weather the storm during recessions. This was a strategy implemented by former Governor Jerry Brown following the Great Recession, as he prioritized paying down the state’s “wall of debt,” eliminating nearly $30 billion in debt between 2011 and 2017 (Petek, 2019). He also focused on building up the state’s reserves with the passage of Proposition 2, which created new constitutional rules for allocating revenue from the General Fund and from capital gains to the one of the state’s reserves (the Budget Stabilization Account) and mandated that a certain portion be dedicated to paying down outstanding debt (Hollingshead, 2021). While this approach of paying down debt and building up reserves may help somewhat in the future during mild or moderate economic downturns, the latest research indicates that this strategy may not be adequate during any future severe recession (Lafortune, Mehlotra, & Paluch, 2020).

California also lacks a long-term plan to stabilize education funding. Proposition 2 established a separate reserve account for K-12 schools; however the rules for how and when the state must contribute to the account are more restrictive, so the state did not make a contribution to the account until 2019, five years after it had been established. Even then, the amount deposited was less than one percent of annual state spending on schools in that year (Legislative Analyst’s Office, 2020).