

# Grim Fiscal Forecast for CA K12 Education



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Ten years ago, California made a major change in how it distributes education resources when it adopted the Locally Controlled Funding Formula (LCFF). That change resulted in a more equitable distribution of resources, with additional funds flowing to the districts with more low-income students and English learners. That change has proven to be a positive development. We now know that the additional resources, particularly when made available to students who have greater needs, can lead to better learning outcomes (see, for example, [Johnson and Tanner, 2018](#); [LaFortune, 2021](#)).

LCFF represented a major overhaul in how the state distributes resources which had a positive impact. The passage of Proposition 13 (1978) altered the revenue side of the budget equation, but the consequences have been mostly negative. The overall impact has been to shift to relying on sales and income taxes to pay for most state programs, as well as a significant portion of K12 education. Forty-plus years later, state revenue has increased its dependence on personal income taxes, and in particular, the capital gains earned by the state's wealthiest residents. It has reached the point where just 0.5% of the state's taxpayers [accounted for 40% of total income tax collections](#).

On one hand, that shift set in motion by Prop. 13 has led to California having the most progressive tax structure of all of the states. On the other, it means California has one of the most volatile revenue systems, with total tax collections rising and falling dramatically from one year to the next.

Looking forward to the coming year, it is hard not to imagine a scenario where the impact of that volatility is felt, as a dramatic drop in revenue feels imminent. As has been the case in the past, when revenue falls, K12 education spending is cut. The other tactic is to delay the distribution of funds to schools. During the Great Recession, the state deferred a portion of funding. These deferrals were equivalent to an IOU, where the state gets a one-year loan for free while districts need to find a way to make ends meet. Of course, these cuts and disruptions hit low-income students and students of color **in the highest-poverty communities and school districts the hardest**. We know that because that is what has happened in the past. In fact, this pattern is incredibly, and frustratingly, predictable.

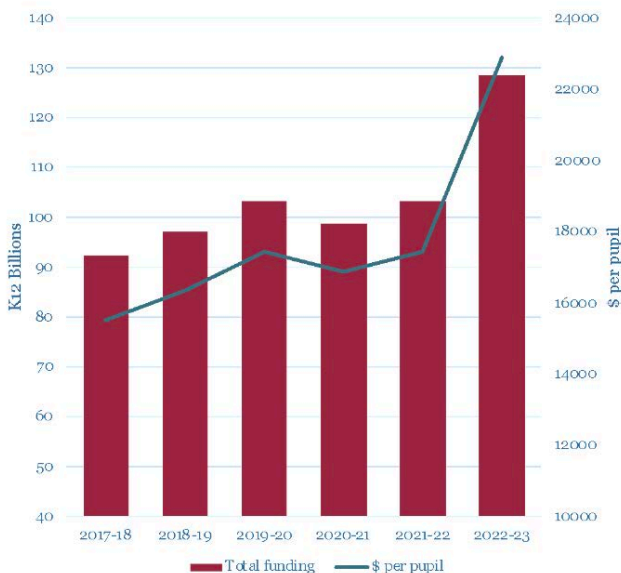
This paper lays out what is, unfortunately, a rather grim vision of the near-term future for education funding in California. It begins by describing how K12 spending is at an all-time high. It then outlines why we see revenues declining in the coming year and the impact on education funding. While the state's budget reserves are considerable, they likely will only be able to respond to the effects of a mild recession over a short timeline. The paper concludes by arguing it is time for researchers, policymakers, advocates, and funders to begin to invest in the work of developing policy alternatives to the state's current revenue structure, with a specific emphasis on reforming Proposition 13.



## Education funding at an all-time high

Resources for K12 education in California are at historically high levels. Total state spending is in excess of \$130 billion and that comes to more than \$22,000 per student – both state records in absolute terms (Figure 1).

Figure 1



These record funding levels have been driven by a combination of growing state revenues and an influx of federal dollars. A booming stock market fueled much of the increase in personal income tax collections and the different pandemic relief packages have been responsible for the sizable increase in federal money. Given the stock market losses over the last year and change and the shift in leadership in the U.S. House of Representatives, it is unlikely that either of these sources will grow, or even continue at their current levels. Therefore, a significant portion of this year's education budget should be thought of as "one-time money," funds that will not reoccur from one year to the next. The typical application of one-time money is to use it to address maintenance that was deferred in earlier years, purchase equipment that has long been on wish lists or, perhaps, build up local reserves in anticipation of the proverbial rainy day.

The challenges facing schools in the wake of the pandemic have been anything but typical. In this unique situation, some have argued that the best use of one-time money would be to invest in [strategies to address the learning gaps](#) that emerged in the wake of the pandemic. These approaches could include the hiring of tutors, expanding learning time, or developing customized or new learning models to address specific needs.

When you look at local district budgets, it is not clear this is [how the money was spent](#). And, many of them appear to be spending as if these good times are going to continue forever. Districts have [added staff](#), including teachers, counselors, and nurses, as well as committing to long-term salary increases. Although these additions may have been overdue, to maintain these spending levels in future years assumes that revenue will continue to grow. As we have noted, there are very good reasons to question that assumption.

And, even in this best of financial times, an increasing number of districts are showing signs of budgetary strain due to other issues such as persistent declining enrollment. Statewide, K12 students in California fell by over 110,000 (-1.8%) to start the 2022 school year. The drop hasn't been felt evenly, however, with large, urban school districts seeing the biggest declines. Los Angeles Unified, for example, saw enrollments fall by more than 22,000 students (-4.6%) while in San Diego the drop was -3.4% (more than 4,000) and in San Francisco it was -5.3% (3,100). Overall enrollment, of course, is a major factor in determining state funding. So, when the number of students fall, so do the dollars.

Other cost pressures also loom. These include the perennial threat of rising pension, health care, and special education spending. Inflation adds a new worry to the list, as school districts are not immune to its impact which can raise the price of everything from fuel for school buses to supplies for the classroom.

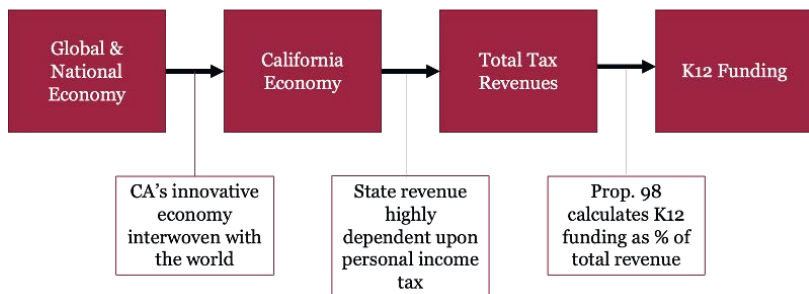
## Outlook for future revenue scary; K12 funding could be hit hard

To say that education funding in California is affected by the broader economic conditions is an understatement. Historically, total state revenue is extremely sensitive to the performance of the economy in general, and increasingly, to the performance of equity markets. This relationship is a function of California's dependence upon personal income taxes which accounted for [two-thirds of total general fund revenues](#) in the current year's budget. That dependence, combined with poorly distributed and highly progressive tax rates focused on the top 1% of taxpayers, creates a situation where total revenue can fluctuate significantly as a consequence of changes in non-wage income for the state's highest earners.

The relationship between total revenues and funding for education is even more direct. Proposition 98 (1988) amended the state's constitution to establish a minimum funding level for K12 schools and California's community colleges. This minimum level is determined by one of three tests that take into consideration the total amount of revenue collected by the state, the size of the student population, and changes in personal income in the state (Taylor, 2017). While Prop 98 was intended to set a floor for education funding, in practice, it also set a ceiling with total K12 funding rarely exceeding the Prop 98 calculation. And, lawmakers do have the ability to suspend Prop. 98 with a two-thirds majority in an emergency. A funding minimum for education, therefore, is not guaranteed.

**Figure 2**

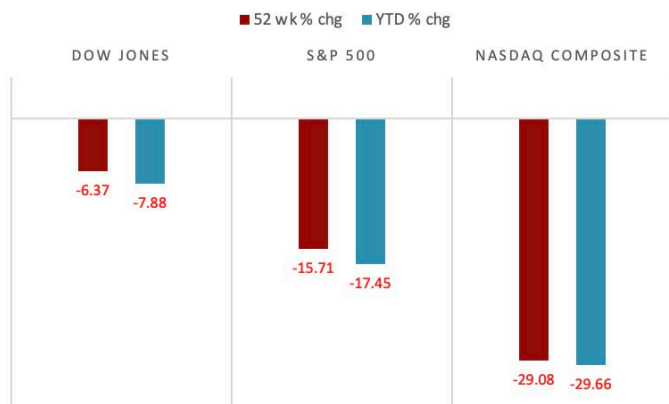
The relationship between the economy, state revenue, and K12 dollars



The bad news is that current indicators suggest that total state revenues are already falling short of expectations for the current year. All three of the major equity indices are down for the year -- the tech-heavy NASDAQ by almost 30 percent (see figure 3). The number of initial public offerings (IPOs), the source of considerable capital gains for many California taxpayers, is down over the prior year. As of December 12, 2022, [only 174 IPOs have launched](#), compared to 1001 on the same date in 2021, down over 80 percent.

**Figure 3**

Major equity market indices as of 12/09/22



Source: [countryeconomy.com](https://countryeconomy.com)

The Governor's Department of Finance reports revenue receipts on a monthly basis and keeps a running total of where things stand for the year. Already in this fiscal year (the one that began July 1, 2022), state tax collections are well below the budgeted levels. For the first quarter, total tax collections were almost \$5 billion below expectations. The report for October saw total receipts bounce back, but much of the jump was due to a one-time revenue gain from [lower-than-assumed personal income tax refunds](#) via pass-through entities.

Recently, the Legislative Analyst Office (LAO) released its annual [Fiscal Outlook](#) for the 2023-24 budget with an alarming message. The report was decidedly downbeat, projecting a \$24 billion budget problem for the coming year. It is also important to point out that this bleak picture is emerging before there has been any official declaration of a recession. The LAO notes that if a recession were to hit, "revenues could be \$30 billion to \$50 billion below our revenue outlook in the budget window."

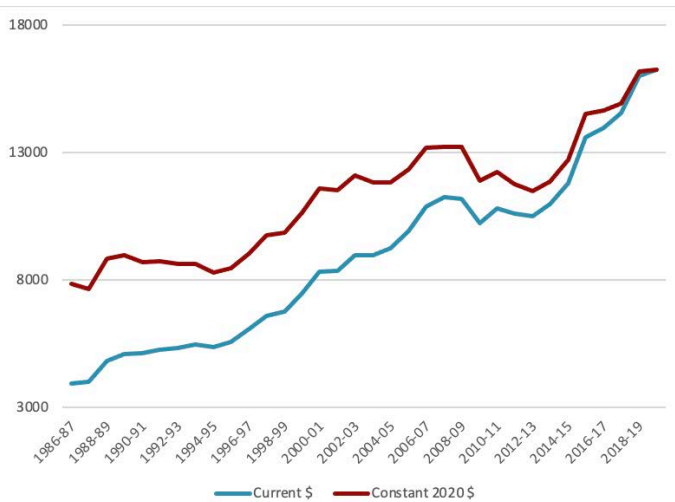
Economies do not perform well in uncertain times and the current situation is, if nothing else, the epitome of uncertainty. Inflation and interest rates have reached generational highs. Should inflation remain sticky, the Federal Reserve will be reluctant to drop interest rates and access to capital will remain tight. All of this would be happening while a land war rages in Europe, U.S./China relations remain tense, and climate change is forcing a re-ordering of priorities. It is not difficult to imagine a situation where the economy doesn't contract, but doesn't expand either. Even if there isn't an official recession, then, the current conditions don't favor California's globally-integrated economy and, as a consequence, the outlook for state revenues.

As revenues drop, the impact on K12 funding will be direct and severe. The fiscal impact of the Great Recession on education resources was particularly dramatic. Economic activity had come to a standstill, unemployment would eventually top 12%, and state revenues would fall almost 22% relative to the prior year. With education funding linked to total revenues, K12 spending dropped accordingly during the Great Recession. By 2012, per pupil education revenues fell 13 percent compared to the start of the recession and dropped below their 2000 level in inflation-adjusted dollars, (Figure 4).



**Figure 4**

California per pupil revenues fell dramatically during the Great Recession



Source: National Center for Education Statistics.

From a fiscal perspective, it took years for the state’s revenue picture to return to pre-recession levels. In terms of education spending specifically, per pupil spending didn’t bounce back for 7 years. And, of course, there aren’t metrics that account for the lost learning opportunities as class sizes grew and support services for vulnerable students disappeared.

## California’s reserves will only cover a short, mild recession

California enjoys record reserves at the moment. Surely, there is enough money “in the bank” to help the state weather the current economic downturn. Maybe.

Thanks to record-setting tax receipts and unprecedented levels of federal aid in response to the pandemic, the state has managed to set both spending and savings records. The enacted budget projects [reserves to total \\$27.7 billion](#) across three different accounts. Given general fund expenditures of over \$234 billion, reserves could theoretically cover about 1.5 months of spending in a given year. There are restrictions as to when and what share of total reserves can draw upon these savings, however.

Whether those savings levels are robust enough for the state to withstand the pending economic slowdown will depend on how much damage a future recession inflicts. Recessions are like hurricanes. We see them building on the horizon and when they hit, the damage that they inflict is a function of how much force they pack and how long they remain over a particular area.

Likewise, the damage caused by recessions can be measured along two dimensions: severity and length. In terms of severity, we can think of the economic depth of pain that the downturn causes. Pain can be measured by the effect on people, say in terms of rising unemployment or on government as indicated by falling revenue. Historically, the impact of these downturns has been more pronounced in California with the highs being higher and the lows lower.

The length of the recession can also vary. The most recent recession brought on by the global pandemic in 2020 only lasted two months ([NBER](#)). The Great Recession (2008), in contrast, officially lasted 18 months, with its impact on revenues stretching across multiple years ([Murphy, et al, 2019](#)). Combining these two dimensions produces four possible recession scenarios (Figure 5).

**Figure 5**

Recession vary in terms of length and severity

		Length	
		Short	Long
Depth of economic downturn	Severe	Pandemic 2020	Great Recession 2008-10
	Mild	Dot-com 1999	Double-dip oil shock 1980s



It is likely that the current level of state reserves would be sufficient to see cover the lost revenue associated with a mild, short recession. An assessment of [district-level reserves](#) reached a similar conclusion. If the downturn were to linger longer than a year – a plausible scenario if the Federal Reserve has to keep interest rates high – state revenues will be slow in bouncing back. And, even a short, steep drop in revenues could prove problematic for the state, despite its reserves. The dramatic increase in federal spending in the wake of the pandemic is a big reason why California can afford to spend on K12 education at these current levels. Should a 2023 recession emerge, is difficult to imagine the federal government stepping forward to help, given a divided Congress with very small majorities. Finally, it would be extremely difficult for the state to cope with the challenge presented by a long, deep recession, though such a scenario may be unlikely.

Regardless of length and depth, it is important to point out that the costs of an economic downturn are not borne equally by all California residents. Just as workers with lower incomes feel the impact of a downturn more acutely, students with greater needs are the first to feel the loss associated with resource cuts. Low-income school districts, which are more likely to also serve a larger share of communities of color, have [fewer options to fill gaps](#) in funding. When the state's allocation to the schools falls, there are few options at the district level except to cut services.

## The need to address California's structural fiscal problems

The reason California continues to ride the revenue roller coaster is that the state has never addressed its underlying fiscal problems. A number of fiscal decisions, many of them made decades ago, most of them decided at the ballot box, exacerbate the impact of recessions and limit what policymakers can do to address them. The genesis of most of these problems can be traced to Proposition 13.

[Work by our colleagues here at The Opportunity Institute and Pivot Learning](#) discussed the inequities that Prop 13 contributes to relative to home ownership in California. But, the 1978 ballot initiative did even more damage than that. By capping property tax rates and limiting assessments, it shifted state dependence to the more volatile personal income taxes and sales taxes. The proposition also severed the link between local government representation and taxing authority.

Prop 13 undermines the state's fiscal situation in a number of different ways and mitigating its impact will require a significant effort. But, until recently, there has been little effort – or interest – in exploring the range of policy alternatives that would retain the state's progressive tax structure while introducing more stable funding. The 2020 election presented one change – creating a split-roll where commercial property would be assessed at market rates – to voters. The [measure fell short](#) by 2 points. It represented the most significant challenge to Prop 13 in over four decades.

Taxing commercial property at market rates would have introduced more stability into the overall funding structure, but there are a number of other reforms that should be explored. For example, what would the impact be if Prop 13 protections were lifted for vacant land? It is possible that such a switch would both increase revenue as well as add to the supply of housing in the state.

Other possibilities include limiting the subsidy afforded by Prop 13 to only primary residences and assessing second homes at market rates. Or, in an effort to preserve local neighborhoods, one could argue that it is time to stop extending its benefits to homes owned by investment funds, properties owned by individuals residing beyond California's borders, or units used primarily as short-term rentals.

It is important to remember that how property is assessed is only one part of the equation. There are other policy levers associated with property taxes that Prop 13 froze in place, but warrant examination. For example, what would be the impact of moving the tax rate from 1.0% to 1.05%? What happens to affordability if there is an increase in the tax rate, combined with a change in the homeowners' exemption from its current \$7,000 to, say, \$250,000? Such a shift could benefit low-income California's by making the annual cost of homeownership lower. The additional costs would be borne by those with more expensive properties. These are just a few examples of the questions that need to be asked.

It is quite likely we are about to step off a fiscal cliff, again. Education funding will be cut, again. Low-income students and high-needs students will be hurt the most, again. It is unlikely that we will avoid such a situation in the coming year. Yes, there are some steps that the state can take in the short run to offset some of the impact, but at what point is there going to be a genuine discussion about structural cracks in the state's fiscal system?

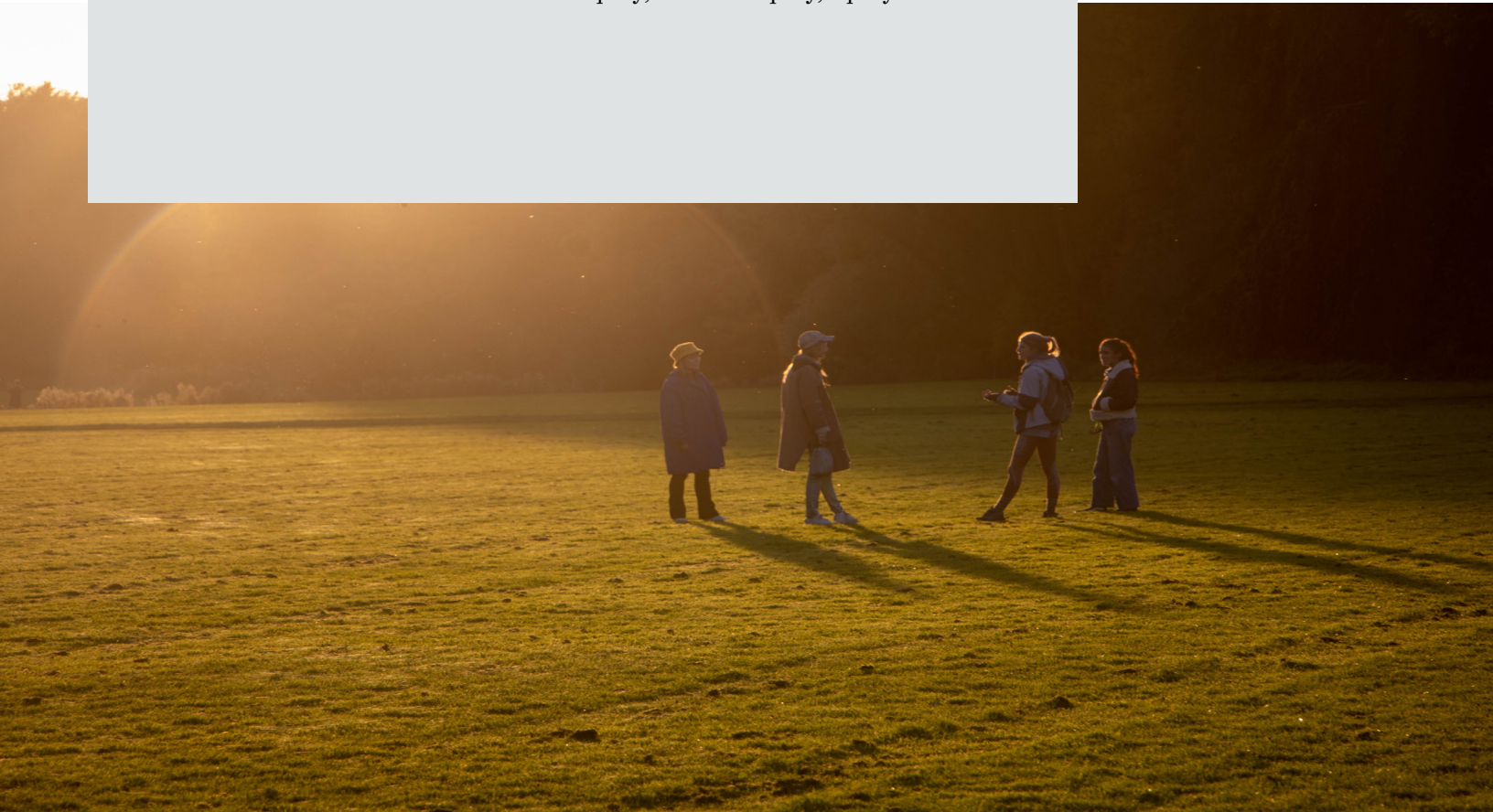
At the Opportunity Institute, we think it is time to have an honest conversation about the structural fiscal problems California faces. Such a discussion will need to be based upon a foundation of data and evidence. It also will be necessary to develop the right tools to analyze viable policy alternatives, with an explicit focus on their equity implications. We hope to begin the conversation by creating a network of interested parties among the advocacy, policy, research, and funding communities. It will be a big lift, but with strong, committed partners, we can begin to envision a fiscal future for California that is both sustainable and fair.





## About the Opportunity Institute

The Opportunity Institute (OI) is a national education policy organization that focuses broadly on cradle-to-career education policy, practice issues, and adjacent areas of social policy. Our work bridges the domains of policy, research, advocacy, and addresses equity in three main areas of work: “Whole Child” equity; resource equity; equity indicators.



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