Policy Analysis for California Education (PACE)

POLICY BRIEF

No. 1 January 1992

THE EFFECTS OF STATE CONTROL ON SCHOOL FINANCE IN CALIFORNIA

Across the United States, funding for education has shown tremendous growth since World War II. After taking inflation and student enrollment increases into account, spending for our nation's schools increased by 67 percent in the 1960s, 35 percent in the 1970s, and 30 percent in the 1980s. In California, real spending per pupil for education grew 13 percent between 1980–81 and 1990–91.

Why, in the wealthiest state in the nation, has the growth in spending for schools lagged behind other states? There are a number of plausible explanations, including the taxpayer revolt of the late 1970s, the fierce competition for funds to pay for a variety of public services across the state, the changing demographics of the state's population, particularly its children, and voter preferences for other services. One Sacramento lobbyist says that "at one time, Californians had a Cadillac school system and drove Chevrolets, but today have elected to drive Cadillacs and accept a Chevrolet school system."

Although the reasons for California's inability to keep up with national spending trends are deep and complex, many of the causes are rooted in the design of the state tax system and the resulting school finance structure. The purpose of this policy brief is to describe the forces that have conspired to retard the growth in spending for California's schools over the last two decades.

The current status of California school finance can be traced to three watershed events of the last twenty years:

1. The *Serrano v. Priest* legal challenge to California's school finance system,
2. Passage of Proposition 13's property tax limitation, and
3. Voter approval of Proposition 98's minimum funding guarantee for education.

The primary effect of these events has been a dramatic shift in the control of California school finance away from local districts and to the state. In 1991–92, California will spend over $27 billion on K–12 education. Approximately 85 percent of that money will either come directly from the state (64%), or through property taxes which are directly controlled by the state (20.6%).

How did this reliance develop and what are the consequences of these events for the future of school funding in California?

CALIFORNIA SCHOOL FINANCE: STATEHOOD TO *SERRANO*

California's first school governance and finance act was passed in 1851 in response to the original 1849 state constitution's requirement for "a system of common schools, by which a school shall be kept up and supported in each district at least three months in every year." This measure called upon each district to raise at least one-third of the operating budget for its schools from local property taxation, voluntary subscription, or other means as a condition for receiving state aid.

By the early 1900s, property assessment practices varied considerably among California counties. In recommending the separation of state and local revenue sources, with local governments taxing property and the state taxing inheritances, banks and corporations, public utilities, and insurance, as well as levying a poll tax and motor vehicle registration fees, the 1905 Commission on Revenue and Taxation stated that the school finance system "puts a penalty on honesty and pays high premiums for dishonesty."

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The commission's recommendations were implemented in 1910. However, state funding for education did not keep pace with the total costs of education, placing a greater burden on local property taxes. A constitutional initiative passed in 1920 increased local school property taxes to a minimum of $30 per Average Daily Attendance (ADA) (up from an average of $21), and guaranteed state-funded basic aid of another $30 per ADA, up from $17.50. This action was the first of many cycles in which the state increased its funding commitment, then watched as, over time, its share of total funding for schools declined and local property taxes increased. State aid was increased substantially in 1933, 1946, and again in 1952. The 1952 amendment to the California Constitution, still in effect today, increased state aid to $120 per ADA or a minimum of $2,400 per district, whichever was greater.

In 1947, the state introduced a statutory foundation program to equalize differences in local district revenue-raising capabilities and to establish a minimum level of support for schools. Although the foundation program theoretically provided equalization among school districts, by 1970 it represented a mere 50 percent of funds being expended for schools, limiting its effectiveness. As a result of the substantial inequities among local school districts, the *Serrano v. Priest* legal challenge to the California school finance system was filed in 1968.

SERRANO TO PROPOSITION 13

The Legal Challenge

On August 30, 1971, the California Supreme Court handed down a ruling in the *Serrano v. Priest* case, which has affected every major change in California's school finance structure since then. The suit alleged that there were "substantial disparities" in per-pupil spending among the school districts in California, and that "therefore substantial disparities in the quality and extent . . . of educational opportunities . . . are perpetuated among the several school districts of the state." The plaintiffs argued that education was a fundamental interest of the state, and therefore was subject to strict judicial scrutiny. "Strict scrutiny" prohibits states from making distinctions among citizens on the basis of a "suspect classification" in the exercise of a fundamental right or the provision of a fundamental interest.

Plaintiffs argued that California's school finance laws resulted in higher spending in school districts with higher property tax bases and lower spending in school districts with lower property tax bases, making students living in poor districts a "suspect classification" entitled to court protection in securing the right of equal educational opportunity. They claimed that this situation violated the equal protection provision of both the California and United States Constitutions.

Although initially dismissed by the superior court, the case was appealed to the California Supreme Court which ruled that the state's finance system "invidiously discriminates against the poor because it makes the quality of a child's education a function of the wealth of his parents and neighbors." The court remanded the case back to superior court for trial.

The Response

Although superior court Judge Bernard S. Jefferson did not issue his ruling until 1974, state policymakers generally considered the *Serrano I* ruling of the supreme court to be a sign that the California finance system did not meet the requirements of the state constitution. While awaiting Jefferson's ruling, the legislature enacted Senate Bill 90, the first of many laws intended to meet the *Serrano* requirements.

In addition to increasing foundation-level support, SB 90 introduced revenue limits to California school finance. Revenue limits changed the basis of future growth in the system away from being a function of the increases in assessed value, and turned the power to control district spending growth over to the legislature. The initial revenue limits place a variable ceiling on the rate of growth of district expenditures. Thus, if a district's assessed valuation grew at a faster rate than its revenue limit, its tax rate was reduced accordingly. The variable growth in revenue limits was designed as a "squeeze" factor. Districts with revenues below the foundation program amount were allowed to increase their revenue limit up to 15 percent per year, while districts at the foundation level were granted a 6-percent-per-pupil inflation factor. Districts above the foundation level were squeezed by limiting growth in revenues to a factor of less than 6 percent per pupil per year.

SB 90 ended local authority to seek locally approved property tax overrides without a vote, and limited the conditions under which school districts could seek voter support for such overrides. The bill also appropriated funds for a number of categorical programs. These appropriations marked the beginning of nearly twenty years of continual growth in state-supported categorical programs.

When Judge Jefferson issued his *Serrano* decision in 1974, he ruled that the legislature's first attempt to deal with the issues brought up in *Serrano* was inadequate. His opinion required that wealth-related revenue disparities among districts in spending for basic educational services be reduced to "amounts considerably less than $100 per pupil," regardless of the district's property wealth. He did not, however, mandate specific reforms to reach this goal. Jefferson's decision was upheld by the California Supreme Court in a 4–3 vote in 1976.

During the 1970s there were a number of legislative attempts to improve the equity of the school finance system. Designing a system that would meet constitutional muster proved difficult. In what turned out to be their final attempt to meet these requirements, the legislature passed Assembly Bill 65 in 1977. AB 65 would have substantially increased the foundation program, applied a uniform minimum tax rate in all school districts, expanded property-tax power equalization to all local voter-approved override taxes, and continued the differential in annual revenue limit increases to speed the convergence of spending differentials. AB 65 was to take effect in 1978–79, but before it could be implemented, California's voters intervened by passing Proposition 13. Overnight, Proposition 13 reduced local property taxes by some 60 percent, and, with the passage of bailout legislation, created a *de facto* state property tax system. AB 65's complex distributional formulas and tax levy schema became obsolete.

PROPOSITION 13 AND ITS EFFECTS

On June 6, 1978, California voters approved the Jarvis-Gann tax limitation initiative, Proposition 13. An amendment to the state constitution, Proposition 13's major provisions include:

1. Taxes on residential, commercial, and business property are limited to one percent of 1975–76 assessed market value.

2. Property tax assessment increases are limited to no more than two percent a year.

3. Property can be reappraised at current market value when it is sold, when ownership is transferred, or when it is newly constructed.

4. State or local governments are prohibited from passing new property taxes.

5. A two-thirds vote of the people residing in a jurisdiction is required for imposition of special taxes.

6. A two-thirds vote of the legislature is required for changes in state taxes.

The Bailout

The immediate effect of Proposition 13 was to reduce total property tax collections by some $7 billion beginning on July 1, 1978, a scant three weeks from the date the constitutional amendment took effect. To replace local property tax losses, the legislature enacted SB 154, popularly known as the "bailout bill." SB 154 allocated the $4.4 billion in property taxes that were still to be collected with the one-percent levy, and appropriated $4.1 billion from the state budget surplus to replace just over 60 percent of the local revenue lost. This assured school districts of between 85 and 91 percent of the total revenue-limit funding they would have received under AB 65.

It also heralded a new era for school finance in California. For the first time, the burden of financing education was placed on the state. Local residents and school boards could no longer decide how much to spend on education (unless they desired further spending reductions). At the same time, the state faced a new situation. It was no longer possible for state planners to count on growth in assessed values to fund local services. Education had to compete with other services for a share of the state's general fund resources.

A Long-Term Solution

The immediate crisis over, the legislature turned to a long-term solution to the post-Proposition 13 funding situation when it started its new session in January 1979. The result of the legislature's deliberations was Assembly Bill 8. The basic financial framework established by AB 8 is still in use today, although there have been some modifications over time. Five factors that influence the level of funding available to schools since AB 8's passage are:

1. A large portion of the substantial increase in state funds provided to local school districts was used to offset local property tax decreases. Although state aid increased by $4.1 billion between 1978 and 1980, property taxes declined by $3.1 billion, resulting in a net increase to local schools of only $1 billion.

2. School district revenue limits are increased by the allowable state-determined Cost of Living Adjustment (COLA) each year. As a result, if local property tax collections are higher than expected, the additional funds are used to reduce the state revenue needed to reach a district's revenue limit. Over the eight-year period

immediately following the passage of Proposition 13, nearly 40 percent of state revenue increases for education were simply replacement dollars for lost local property tax revenues. Much of the political effort exerted for school funding therefore benefited property taxpayers, not the education system.

3. Because school funding depends much more heavily on the health of the state's economy than it did previously, when the economy experiences a downturn, funding for education suffers. In the past, local property taxes provided a buffer from fluctuations in state revenue. The 1990–91 $14.3 billion-plus deficit offers a dramatic example of the dangers of heavy reliance on state resources to finance schools.

4. By reducing the number of governmental bodies that are involved in allocating revenues for education from over one thousand to only one, California reduced, if not eliminated, competition among districts that in the past helped provide increases in the level of funding for schools. The only other state that has virtually eliminated the role of local districts in school funding—Washington—has also seen a marked decline in the rate of funding increases for elementary and secondary schools.

Funding Issues in the 1980s

Real spending per pupil in California increased 13.07 percent between 1980–81 and 1990–91. Although this represents a substantial increase in resources devoted to education, it is substantially less than the 30 percent real increase in spending observed nationally during the same time period.

California's per-pupil expenditures for education compared to the national average for the last twenty-two years, as well as California's ranking among the fifty states, has shown a general decline. In 1967–68, per-pupil spending in California ranked 12th in the nation. The state's ranking declined to a low of 42nd at the end of the 1981–82 recession. By 1990–91, California ranked 25th in per-pupil spending—still considerably below the 1967–68 ranking of 12th.

Two factors combined to make the first years of the 1980s difficult for school finance in California. Proposition 13 reduced available funding for all government services in California beginning in 1978–79. Meanwhile, the national recession at the beginning of the decade, combined with the schools' heavier financial reliance on the state, led to a decline in available revenue.

Senate Bill 813. The funding picture improved somewhat beginning in 1982–83, and continued after the 1983 passage of SB 813, California's omnibus education reform act. Among SB 813's many provisions was a commitment to increase funding for education by $1 billion a year in each of four years. This promise of additional money was made contingent on the implementation of a number of reform measures, including increased high school graduation requirements, longer school days and years, and increases in minimum teacher salaries.

Senate Bill 813 was a dramatic example of the new power the state had acquired over local school district decisions. For the first time, bargaining for new funds, which now occurred almost entirely at the state level rather than at the local level, included issues of school performance, accountability, and reform. The message from Sacramento was that districts could no longer expect to receive large increases in funding without showing that the funds were being spent wisely, or at least in a manner deemed wise by state policymakers. SB 813 demonstrated, for the first time, how control had shifted to the state.

Revenue Limits. A district's basic revenue is still determined by its revenue limit. The revenue limit calculation begins with the previous year's revenue limit, which is then adjusted for inflation and increases in enrollment. Once a district's revenue limit is determined, its general aid from the state amounts to the difference between its revenue limit and the property taxes collected.

The Lottery. The funding picture for schools was expected to improve in November 1984 with voter approval of a state lottery. The voter initiative creating it specified that at least 34 percent of the revenues from the lottery games be used for education. Included in the definition of education were K–12 schools, the community colleges, the state university system, and the University of California. Proceeds from the lottery are distributed quarterly to schools on a per-pupil basis. The first distribution took place during the 1985–86 fiscal year, following the November 1985 introduction of lottery games across the state.

Although the lottery has never provided more than 4 percent of K–12 revenues, its impact on education has been considerable. Districts were cautioned that lottery revenues could fluctuate widely and therefore should not be used to pay for continuing expenditures such as salary increases. However, many districts have, over the past five years, begun using lottery funds for these purposes.

The Growth of Categorical Programs. California's response to *Serrano* assumed that the court required the elimination of wealth-related differences in spending across school districts. Although Proposition 13 eliminated the option of increasing local tax effort, neither it nor *Serrano* dealt with the issue of differing student needs. Recognizing that districts are not affected uniformly by the distribution of students with special needs (i.e., handicapped, limited-English-proficient, or economically disadvantaged), California has long maintained a large number of categorical funding programs. Budgeted at over $5 billion from all sources for 1991–92, these programs represent nearly one-fifth of total educational expenditures.

Data prepared by the legislative analyst indicate that funding for these categorical programs has grown faster than funding for revenue limits or general aid. The areas in which this effect is most notable are special education, school facilities, and desegregation. It appears that in the 1980s, districts with a high incidence of special-needs children succeeded in shifting resources away from general aid and into programs that were more favorable to their interests.

This success may have been short-lived, however. As part of the legislation implementing Proposition 98, the legislature enacted a program known as "supplemental grants." Supplemental grants are categorical funds allocated to school districts in inverse relation to districts' receipt of other categorical funds. Thus, districts with high categorical program receipts, such as the large urban districts in the state, do not qualify for supplemental grants, while suburban and rural districts that have not benefited from past categorical programs receive additional money under this program.

Gann Limits. In 1979, the voters passed a second constitutional amendment aimed at limiting state expenditures. Proposition 4, known popularly as the Gann limitation, restricts the growth of state spending. Specifically, growth in state spending is limited to the amount expended in the previous year, adjusted for the growth in population and inflation. Revenues exceeding the state's Gann spending limitation must be returned to the taxpayers. Since its enactment, state revenues have exceeded the Gann limitation only once, in 1986. That year, after considerable debate between the legislature and the governor, approximately $1.1 billion was returned to the state's income taxpayers. In all previous years, state revenues have been below the Gann limits.

PROPOSITION 98 AND THE CURRENT STATUS OF SCHOOL FINANCE IN CALIFORNIA

As the 1980s drew to a close, the dominance of state politics over funding for education was clear. Prior to the passage of Proposition 13, local funds accounted for at least half of all school district revenues. Since Proposition 13, the state has become the largest source of funding for schools. As a result, school district revenues have been determined almost entirely in Sacramento. In annual budget deliberations, the schools face stiff competition from other state services, including transportation, health care, and prisons.

Moreover, by the end of the 1980s, there was a growing belief among the public that the lottery was providing adequate funds for schools. However, lottery revenues never amounted to more than 4 percent of total K–12 educational expenditures. More importantly, even though lottery money was supposed to supplement and not replace legislative appropriations for education, appropriations for schools as a percentage of the state's general fund budget had declined since institution of the lottery, implying that funds were being diverted to other state services.

Convinced that education's share of the state budget was declining, Superintendent of Public Instruction Bill Honig and members of education interest groups across the state succeeded in placing a school funding initiative measure on the ballot and convinced the state's voters to approve it. Known as Proposition 98, this measure provided a number of important funding guarantees for education. It was believed these guarantees would help resolve some of the funding problems schools were facing. Proposition 98 contained three major provisions:

1. A minimum funding guarantee for schools

2. Allocation of funds when state revenues exceed the Gann spending limit

3. School accountability report cards

The first two of these are described below. The third, school accountability report cards, is a requirement that each school submit annually a report documenting its performance in thirteen different categories. Although an important part of Proposition 98, the school accountability report cards do not relate specifically to the funding of California schools, and are not discussed here.

The Minimum Funding Guarantee

The core of Proposition 98 is the minimum funding guarantee that is determined on the basis of one of three tests. As originally passed, funding for K–14 (K–12 and the community colleges) was based on the greater of:

Test 1. The percentage of state general fund tax revenues devoted to education in 1986–87, which amounts to about 40 percent of the general fund.

Test 2. The amount of revenue devoted to K–14 education the previous year adjusted for growth in enrollment and the growth in California per-capita personal income.

Proposition 111, passed in 1990, added a third test to the determination of revenue of K–14 education:

Test 3. Test 3 becomes active when state revenue growth is very low. Basically, this test replaces the growth in statewide personal income with the growth rate in general fund revenues plus 0.5 percent. It also requires that K–14 education be treated no worse than any other general fund-supported program. Finally, Test 3 also requires that a "maintenance factor" be established so that the reduction created by using Test 3 is returned to the schools in future years.

The following generalizations can be made about the operation of Proposition 98's funding guarantees:

1. When the minimum funding guarantee is determined by Test 1, K–14 education gains or loses approximately 40 cents for every dollar change in general fund revenues.
2. When the minimum funding guarantee is determined by Test 2, the level of state aid is not altered by changes in state general fund revenues.
3. When Test 3 is operative, K–14 education gains or loses more than 40 cents for every dollar change in state general fund revenues.

Excess Revenue Distribution

The second major provision of Proposition 98 has to do with the Gann spending limitation. In any year in which general fund revenues exceed this limit, one-half of the "excess" amount must be used for education on a one-time basis. The other half must still be returned to the taxpayers. These "excess" funds are treated as a one-time revenue for schools so that they will not affect computation of Test 2, which could result in the "ratcheting up" of the percentage of the general fund budget devoted to K–14 education.

The Future: What Next?

One of the unintended consequences of Proposition 98's funding guarantees is that the legislature has treated it as both a floor and a ceiling. Consequently, legislators have been unwilling to give the schools any more money than required by Proposition 98. To ensure that the schools do not receive additional funds, the legislature establishes an annual Proposition 98 reserve fund. If state revenues decline, the state will not be committed to distribute funds to the schools beyond the minimum guarantee, and the money in the reserve fund can be used for other purposes. This factor alone should work to suppress available funding for education in the future.

Conclusion

The role of the state in California school finance has grown steadily since statehood. In the early years, both the state and local school districts used the property tax to fund their shares of education. Over time, the local share grew in relation to the state share. At the turn of the century, constitutional changes were enacted to boost the state's share of educational expenditures. Until the 1970s, the state share of school revenue showed something of a roller coaster pattern, dropping as a percent of total expenditures until a new revenue measure or constitutional amendment was enacted, increasing state funds for education.

Each time the state offered more money, it took a little more control over the finance system. Whether additional funds were provided at the same time as property assessment practices were cleaned up, or additional funds were distributed through a foundation program to equalize spending across districts, the state slowly increased its control over local revenue-generating capacity.

This trend of increasing state control did not become significant until the 1970s when, in response to the *Serrano* court rulings, the legislature began enacting programs designed to actually control local school district revenues. Senate Bill 90's revenue limits marked the first time that the future growth of a school district's revenues was decided by the state and not by the locally elected school board and/or the voters of the district. Even then, a number of local voter overrides were permitted, weakening the equalization component of major school finance reform measures.

In 1978, California voters further restricted local district flexibility when they passed Proposition 13, limiting property tax rates to one percent of market value statewide. This action gave almost complete control over school district revenues to the state. Not only did the legislature now decide what school district revenue limits would be, it also determined how property taxes would be distributed among local jurisdictions. Since the state funded the difference between a district's property tax collections and its revenue limit, the legislature effectively controlled over 90 percent of local district revenue.

At the same time, the voters approved a strict constitutional spending limit for the state, making large increases in spending on education even more difficult. Even if strong political support for raising taxes were available, the Gann spending limitation restricted how much could be spent. As a result, school districts, which once needed only the approval of their local voters to increase taxes, now had to compete with all other state programs for the money that was available.

Proposition 98 was passed in 1988. Designed to ensure that schools received their fair share of state funds, this measure guaranteed school districts 40 percent of the state's general fund budget. Although educational interest groups thought this measure would solve the schools' financial difficulties, the legislature treated this requirement not only as a spending floor, but also as a ceiling, deciding that the remaining 60 percent of the general fund would go to all other services.

There are some positive effects from increased state control over education funding. Equalization has improved dramatically across the state. As a result of Proposition 13, differences in tax effort across districts have been eliminated. Moreover, spending differences across districts have been reduced dramatically. According to the legislative analyst, more than 95 percent of the students in the state attend school in districts with revenue limits within the *Serrano* inflation-adjusted spending band of $268 per ADA. More importantly, of the 5 percent of the students who are not in districts inside the band, the legislative analyst estimates that all are in districts whose revenue limit is above the band.

Thus, many of the state's tax and spending goals have been achieved under the system that has developed. But at what price? Spending per pupil in California ranks 25th in the nation. Although teacher salaries are relatively high, the average class size is larger than every state except Utah. Considering that California has over five million school-age children, many of whom live in poverty, speak little or no English, and have other learning disabilities, available funds for schools are stretched thin. The problems are worse if one considers the need for capital spending on schools in the next ten years. The California Department of Education estimates that over the next decade, more than $11 billion will be needed to meet the demand for new schools and to make needed repairs and renovations to existing schools.

Meanwhile, the schools are completely dependent on the state for their revenue. Even property tax revenues are controlled from Sacramento. Unfortunately, the state entered the 1990s with a $14.3 billion deficit. Although legislation was enacted to increase taxes by over $7 billion, the deep cuts needed to close the budget gap will leave scars on California's fiscal landscape for years to come. The likelihood of increased educational expenditures in the next few years appears slim.

Not only do the schools have to compete with other state programs and services; in recent years, they have competed among themselves in determining how revenues should be distributed. The rapid growth in categorical programs in the state is evidence of districts banding together around a mutual interest to garner additional state funds to finance their particular needs. This is most clearly evidenced by the supplemental grant program which provides districts categorical funds in inverse proportion to the amount of other categorical grants received. The rural and suburban school districts which viewed the distribution of categorical funds as favoring urban districts across the state banded together and convinced the legislature to set aside $180 million for this program.

California has achieved a system that largely equalizes expenditure disparities and has eliminated differences in tax effort across districts. The price of this achievement has been increased state control over the level of revenue available to school districts. Even the education community's efforts to garner a fixed percentage of the state budget for schools has failed to provide substantial growth in education funding. As a result, California lags behind most of the industrialized states in the country in educational expenditures per pupil.

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