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COMMUNITY COLLEGE UPDATE

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Proposition 98—The Road Ahead

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More and more we hear about how unique this pandemic-induced recession is when compared to recessions of the past. Recent unemployment data, the stock market, and industry-specific gross domestic product suggest that the COVID-19 recession and the recovery are uneven at best, and at worst could economically disenfranchise millions of Americans, dividing largely on socioeconomic and racial/ethnic lines, as well as by levels of educational attainment. The recent UCLA Anderson Forecast (see "Recovery Not Cut-and-Dried According to UCLA Forecasters" in the current issue of the *Community College Update*) highlights these recessionary disparities, along with recent articles in the Washington Post and Wall Street Journal, suggesting that not only has the recession and recovery been uneven but that the recovery itself may resemble more of a K-shape rather than the V or L that many economists discussed.

But what does all of this mean for California and specifically for the State Budget and Proposition 98 for next year? How do educational leaders plan given the levels of uncertainty and the risks involved in any forecast that necessarily assume certain conditions? We hope that this article will detangle what could feel like a complicated web so that you, along with your community partners, can develop sound budget strategies.

Sizing the Divide

Similar to budget practices at the local level, the Enacted State Budget for 2020–21 was predicated on its own assumptions. The largest assumptions, and most significant source of state General Fund revenues, are the "Big Three" state taxes—personal income, sales and use, and corporation taxes. The state assumed that personal income tax and sales and use tax would decrease by nearly 20% from the revised 2019–20 projections. This was a product of expected unemployment rates exceeding 20%, and the S&P 500 index declining from its all-time high of 3,373 on February 20, 2020, to a protracted level of approximately 2,200.

Because funding for K–14 education in California is calculated based on Proposition 98, and the operative test is currently Test 1 for 2020–21 and the foreseeable future, any decrease in state General Fund revenues will directly impact funding for schools. Generally speaking, education is appropriated 38.5 cents of every General Fund dollar under Test 1 of Proposition 98.

The impact on funding for K–14 education is significant. Projected funding for K–14 education in 2020–21 dropped nearly $7 billion from the revised 2019–20 funding levels to $70.9 billion. This is $700 million less than what K–14 education received in 2016–17. K–12 funding escaped real dollar cuts in 2020–21 as the Enacted Budget included more than $12 billion in budget deferrals.

The impact of implementing more than $12 billion of budget deferrals is that program expenses for K–14 in 2020–21 are maintained at their 2019–20 level of $80.9 billion, but the state accounts for the budget deferrals in the 2021–22 State Budget.

In September 2020, the Legislative Analyst's Office (LAO)—using assumptions from the Enacted State Budget—estimated that funding under Proposition 98 will grow to $74.7 billion in 2021–22. Because the spending level is maintained at $80.9 billion, this results in a shortfall between current program spending levels and Proposition 98 funding of $6.2 billion. We underscore that these figures are based on the Enacted State Budget assumptions.
The chart below illustrates the projected shortfalls for the prior, current and budget year.

	2019–20	**2020–21**	**2021–22**
Current Program	$80.9	$80.9	$80.9
Proposition 98 Funding	$77.7	$70.9	$74.7
Projected Shortfall	$3.2	$10.0	$6.2
Note: Dollar amounts are in billions			

What We Know Now

When we overlay the Enacted Budget assumptions with recent data from economic indicators, the analysis suggests that earlier assumptions may have been overly conservative. The Department of Finance's September Finance Bulletin showed the state's unemployment rate fell to 11.4% in August, after reaching an average of 15.9% in the second quarter of the 2020 calendar year. Additionally, the S&P 500 sank all the way down to 2,237 on March 23, 2020, but the index has been north of 3,000 since May 27, 2020. The index reached an all-time high of 3,580 on September 2, 2020.

The resulting economic impact is that the "Big Three" tax revenues are ahead of Enacted State Budget projections by $4.6 billion through the first two months of the fiscal year. Together, these taxes generate over 75% of state revenue, with personal income taxes alone generating over two-thirds of it. This is key when you consider California's tax structure where the state's top 1% of income earners (those earning $500,000 or more annually) yield roughly 50% of personal income tax revenues. This is to say that California's tax policies may be cushioning the state General Fund from the COVID-19 recession as few, if any, of its highest earners who contribute a sizable share of its revenue have been impacted by it. This is perhaps most evident with the current stock market that is outperforming earlier expectations.

The overperformance of General Fund revenues to date, and the S&P 500, portend well for the 2021–22 General Fund projections as compared to the 2020–21 Enacted State Budget. However, the $6.2 billion shortfall that was based on the assumptions in the Enacted State Budget is a tall hill to climb, especially when layered with continuing budget deferrals that exceed $12 billion.

Unanswered Questions

Although unemployment is faring better than expected, questions remain about the impact protracted unemployment can have on the overall recovery, and the dimming prospect of additional federal stimulus. Also, the pace of tax collections over the last two months may be unsustainable, but where will the dust settle?

Time is our greatest ally when it comes to assurances on actual funding levels. However, time works against us when it comes to preparing budgets and multi-year projections in the face of uncertainty. The good news, in the short-term, is that the assumptions used by the state lag behind current economic indicators, but how that translates in the Governor's State Budget Proposal in January . . . only time will tell.