

K-12 CATEGORICAL REFORM

The state administers K-12 funding through more than 100 individual funding streams. Reform of the funding system would have several local benefits, including greater flexibility to use funds to support high-priority district programs.

The 2007-08 Budget Act devotes \$14.9 billion in General Fund support for 62 K-12 categorical programs. These programs fund a broad array of program activities. Among the largest are K-3 class-size reduction (\$1.8 billion), child development (\$1.8 billion), and Economic Impact Aid (\$994 million). Many programs, however, are relatively small—30 of the 62 programs received an appropriation of less than \$50 million in the current year. Many of these programs also are comprised of several separate subprograms. The child development program, for example, has eight individual subprograms that serve different subgroups of infants and toddlers using different payment mechanisms. Similarly, the special education program is comprised of more than 15 individual subprograms.

In addition to categorical programs, the K-12 school finance system contains a significant number of other funding programs. The state is obligated, for example, to pay for 38 mandated local programs in K-12 districts. As we discuss elsewhere in this chapter, district costs of administering these mandated programs totals about \$180 million in 2008-09. Additionally, nine “add-on” categorical programs are funded as additions to district base revenue limits. These revenue limit add-ons total about \$1.5 billion to school districts in the budget year.

REFORM WOULD HELP DISTRICTS AND SCHOOLS

The *Getting Down to Facts* studies, published by Stanford University in 2007, strongly criticize the state’s K-12 funding system, finding it “broken,” and the system of categorical programs “especially troublesome.” Specifically, researchers found that the restrictions created by the reliance on categorical funding “impose meaningful compliance costs and make

it difficult for local actors to respond to incentives embedded in the accountability system.”

Since the early 1990s, we have recommended the Legislature consolidate and rationalize the school finance system. Our recommendations include creating a simple base grant that combines existing revenue limit funds and most of the revenue limit add-ons. We also have called for consolidating categorical funds into block grants that would provide districts greater flexibility over the use of funds.

Reforming the system of categorical programs would have several very important benefits for schools and districts, including:

- ***Flexibility to Use Funds to Meet Local Priorities.*** Since student and school needs can vary substantially among districts, funding should allow schools and districts the latitude to identify and resolve the most pressing local problems.
- ***Ability to Find Local Solutions to Problems.*** Allowing teachers and administrators to develop solutions to local issues helps build school-site problem-solving capacity and a shared commitment to the improvement process.
- ***Increased Focus on Outcomes.*** The push for greater student success requires adaptation and change at the local level. Increasing local flexibility helps educators to feel safe about trying new things rather than focusing on complying with state rules and regulations.
- ***Increased Understanding of Available Resources and Options.*** Increasing the transparency of the finance system reduces confusion among parents, teachers, and administrators about the level of resources provided by the state and how those funds may be used.

Some Categorical Programs May Be Necessary

Categorical funding, however, may serve legitimate state purposes. In general, categorical funding streams represent a tool used by the state to correct negative local incentives—forces that encourage districts and schools to engage in behavior that is not in the best interests of students. District incentive problems include:

- ***Weak Subgroup Accountability.*** Local accountability for outcomes may not be sufficiently strong for some subgroups of students. Accountability for foster children, for instance, is weak because (1) there are relatively few foster children in each school and (2) some groups of foster children change placements frequently.

- **Strong District Spending Incentives.** District behavior may be skewed by local factors that favor spending for specific inputs. Categorical programs, for instance, shield state funding from the employee union bargaining process.
- **Lack of Uniformity.** Some state policies require uniform application across the state as a critical condition for program success. The most important example of this is statewide testing, which requires all students in a grade (or subject) take the same test.
- **Cost Shifting.** Local incentives exist for schools and other local governments to shift costs to each other. For instance, failure of county mental health agencies to provide mental health services to students may result in school costs due to a greater number of “problem” students. Similarly, failure to address student academic and social needs can result in higher dropout rates, with the accompanying costs for local government in the form of higher crime and welfare costs.

MANY OPTIONS FOR IMPROVING SYSTEM

Over the years, several options for reforming the system of categorical programs have been discussed. The options offer different strengths and weaknesses. We discuss three general options below.

Pupil-Weighted Formula

Many states distribute funds to schools or districts based on the number and types of students in attendance. The formulas begin with a base grant that supports the basic cost of education for each student. Added to the base grant are weights that reflect the higher cost of educating specific groups of students. The pupil weights add a percentage of the base grant for each type of targeted student.

For instance, imagine the state wants to provide districts with a base grant of \$5,000, \$500 (an additional 10 percent) for each student whose primary language is not English, and \$1,000 (and a weight of 20 percent) for each low-income student. If all students in a district were English Learners (EL) and low-income, the district would receive \$6,500 per student from the formula. For a district with no low-income or EL students, the state funding entitlement would remain at \$5,000 per student.

Most states use these weighted formulas to provide *general purpose* funding to districts. The formula compensates districts for students who need additional services to be successful (such as EL or low-income students) through the use of student weights. The funds, however, generally

can be used for any local purpose. Because the formula does not contain the “strings” or restrictions that are common to categorical programs, a weighted formula promotes significantly greater district flexibility.

The formula also increases transparency of the funding system and helps ensure a fair distribution of funding among districts. The weighted formula is a simple mechanism for distributing funds to districts, which makes it easy to understand for local educators, parents, and community members. The transparency of a weighted formula also helps to ensure that similar districts receive a similar amount of state funding.

A weighted student formula works best in distributing general purpose funds to districts. While restrictions and requirements may be attached to a weighted formula, the greater the restrictions, the more the funding takes on the characteristics of a categorical program. Pupil formulas, therefore, tend to be used when district accountability for student outcomes is strong and effective.

Block Grants

Block grants provide an effective way to distribute state funds for activities where the state seeks special restrictions on the use of funds to counteract negative local incentives but where flexibility, transparency, and fairness are desired. The difference between a categorical block grant and a categorical program is in the scope of activities funded and flexibility in the use of funds. A block grant generally covers an entire category of local program activity (staff development) rather than one particular element within it (mathematics training). Block grants usually also provide districts with flexibility in determining which specific activities to fund and the way to deliver services.

Block grants, therefore, can have many of the positive attributes of a pupil-weighted formula while also restricting the use of funds to a broad category of activities. They can distribute funds based on pupil counts or other district data, thereby providing transparency and fairness. Block grants also can provide considerable flexibility over the local use of funds—although not as much as a pupil weighted formula.

By restricting the use of funds, block grants can counteract local incentives that cause districts to underinvest in specific activities. In California, categorical funds have been used to prevent funding from being subject to local collective bargaining agreements. In many districts, local bargaining agreements contain provisions that trigger increases in local salary schedules when state general purpose funding increases. Since salaries and benefits account for about 85 percent of district operational spending, these contract provisions mean a significant proportion of whatever new

general purpose funds are provided through the budget will automatically be used to increase employee salaries. Given this connection, the state has sometimes restricted new funds in categorical programs to “keep the funds off the bargaining table.”

Program Clusters

The significant number of categorical programs in some policy areas offers the Legislature a third option for reform—clustering programs together. Program clusters allow the state to consolidate similar programs into one larger grant while retaining the individual programs within the single grant. The state could, for instance, group the nine existing staff development programs into such a cluster. This would allow districts to move funds among the programs within the cluster, and use available staff development funding for the programs that best match local needs.

Clusters represent a limited step towards the types of funding mechanisms that would be most helpful to districts. Flexibility over the use of funds is only as broad as the range of programs included in the cluster. Similarly, district authority over program design remains limited by the specific restrictions on programs within the cluster. In general, we do not recommend using the cluster concept as the gains from clustering are too limited. Clusters, however, may be an attractive option in those areas where the Legislature desires to expand local flexibility in very small steps.

SIMPLIFY STATE FUNDING SYSTEM

We recommend the Legislature consolidate 43 individual K-12 funding streams totaling \$42 billion (Proposition 98) into a base funding grant and three block grants.

Our evaluation of the options suggests that the state could streamline the K-12 fiscal system by consolidating a large number of categorical programs into three block grants. In addition, we suggest the Legislature create a new base grant by consolidating base revenue limits with selected add-on and categorical programs. Figure 1 (see next page) summarizes our recommendations for the reform of the K-12 fiscal system.

We propose to consolidate 43 categorical funding streams into four new grants. The “base” grant is largest of our proposed grants, at almost \$35 billion. The new grant would include existing revenue limit funding and seven other individual funding programs. The special education grant would consolidate seven existing special education programs into the existing per pupil special education funding grant that was created by Chapter 854, Statutes of 1997 (AB 602, Poochigian and Davis), for a total

new grant that provides \$3.2 billion. The proposed Opportunity to Learn grant would provide \$3.1 billion in state funds by merging 11 existing programs that are targeted to meet the needs of students who need additional services to succeed in school. The school improvement block grant would consolidate 16 existing programs in these areas in order to provide greater local flexibility over the uses of \$1.3 billion in state funds.

All told, our recommendations include about 80 percent of all Proposition 98 K-12 funds. The remaining 20 percent of funds are allocated through remaining categorical programs—such as child development, adult education, and necessary small school funding. While many of these funding streams could be improved or consolidated, these programs present different issues from the programs we include in our four new grants.

Figure 1	
LAO Proposed K-12 Finance Reform	
Proposed New Grants	
<i>(In Billions)</i>	
	2007-08 Amounts
Base	\$34.8
Special education	3.2
Opportunity to learn	3.1
Instructional improvement	1.2
Total	\$42.3

Below, we briefly outline our recommendations. For each new grant, we describe the purpose of the grant and any restrictions on the use of funds in the proposed grant that we believe are needed. In addition, we discuss data that districts would be required to collect and report to the state. The data creates an additional level of accountability for funds and provides feedback on district success in using the grant funds for the intended purposes.

Our proposal also has two important design features that apply to all four grants. First, our proposal would not alter the distribution of funding that is currently provided by the individual programs that we consolidate into block grants. Districts would continue to receive the same amount as in the past. In the future, grants would be equalized based on the formulas contained in each block grant. Second, the underlying requirements of the programs that are merged into the block grants would be eliminated as

part of the reform. That is, the programs would cease to exist when the new grants are implemented. This, in our view, is a critical step to foster autonomy and flexibility at the local level.

Create a New Base Grant

The first step in our proposal is to simplify and consolidate existing base funding streams. Figure 2 displays the programs and amounts that we would consolidate in our proposed base grant. The current base revenue limit represents the single largest source of funds to schools—\$31 billion in state funds and local property taxes—and is designed to pay for the basic cost of education for students. To this amount, we added seven categorical funding streams that we believe are general purpose in nature or provide basic support for the operation of classrooms.

Figure 2	
LAO Proposed K-12 Base Grant	
<i>(In Billions)</i>	
Current Program	2007-08 Amounts
Base revenue limits	\$31.4
K-3 class size reduction	1.8
SB 813 incentives	1.4
Meals for needy pupils	0.2
9 th grade class size reduction	0.1
Minimum teacher salary	0.1
Unemployment insurance ^a	—
PERS ^b reduction	-0.2
Total	\$34.8

^a Less than \$100 million.
^b PERS = Public Employees' Retirement System

Five of the eight programs—Meals for Needy Pupils, SB 813 incentive programs, minimum teacher salary incentive, unemployment insurance, and the Public Employees' Retirement System reduction—are known as revenue limit add-ons because they are calculated and apportioned to districts as part of the revenue limit formula. As we discuss in our 2004 report *The Distribution of K-12 General Purpose Funds*, the add-ons provide widely differing per pupil amounts to districts based primarily on histori-

cal factors. Consolidating these adjustments into a new base grant would reduce district paperwork, clarify district funding levels, and ensure future equalization adjustments reflect the base amounts that are actually provided to districts.

We also include class size reduction (CSR) funds in our base grant. We have recommended several times in the past to loosen the restrictions on CSR funds that make the program unnecessarily expensive to administer. In addition, evaluations of smaller class sizes show small learning gains despite the significant investment associated with CSR. As a result, the program's focus on a 20 to 1 student-teacher ratio precludes districts from using the funds for other supplemental classroom services that could have a larger impact on student achievement.

As a result, CSR fits the description of a state categorical program that unduly restricts local practice in using funds most efficiently. For these reasons, we include K-3 and 9th grade CSR funds in our base grant. Rather than spread the CSR funds across all grades, however, we recommend the Legislature adopt specific *grade-span* base grants that reflect the higher funding levels for K-3 and 9th grade CSR. Similar to the base grants provided to charter schools, our proposal would establish specific perpupil funding rates for grades K-3, 4-6, 7-8, and 9-12.

By including the K-3 CSR funds into the K-3 grade span rate, districts would be required to spend the funds on services for students in the primary grades. Districts could determine the best mix of smaller classes and other supplemental instructional services to address student needs. In addition, greater flexibility over the use of CSR funds would provide another resource to assist districts in focusing on effective primary grades instructional programs that help all students to achieve at state standards in mathematics and reading by the end of third grade.

We do not recommend requiring districts to provide any additional accountability data as part of the new base grant. State and federal accountability programs provide sufficient information on the academic progress of students.

Consolidate Special Education Funding

Similar to our new base grant, we also propose a consolidated special education grant. The grant would merge funding from seven existing programs into the existing perpupil funding formula. Figure 3 illustrates the programs we would consolidate into the new grant. As the figure shows, our recommendations would create a \$3.2 billion state grant for special education.

Figure 3	
LAO Consolidated Special Education Grant	
<i>(In Millions)</i>	
Program	2007-08 Amounts
Attendance-based apportionment	\$ 3,021.5
SELPA ^a base funding	88.1
Workability	39.6
Vocational education	5.3
Small SELPA base funding	2.6
Personnel development	2.5
Low incidence services	1.7
Necessary small SELPA	0.2
Total	\$ 3,165.5

^a Special Education Local Plan Area.

The purpose of consolidating these special education funding sources is no different than for the previous grants—to provide additional flexibility in the use of funds. In addition, while most of the funding streams that would be merged into the formula are small, the multiple sources of money obscure the amounts individual Special Education Local Plan Areas (SELPA) receive from the state for special education. By consolidating funding sources, therefore, the Legislature also could clarify actual funding levels and set the stage for future equalization efforts.

In identifying the programs to consolidate, we focused on programs that distribute funds to most of the SELPAs or support core special education activities. Federal law, for instance, requires that the individual education plan (IEP) for each special education student in high school contain a transition plan that outlines the classes or other services a student needs for a successful transition to adult life. The Workability program and vocational education funds in our block grant help SELPAs pay for services identified in the student transition plans. Since the underlying activities are required by student IEPs, merging these funds into the base per pupil allocation would give SELPAs more options for the use of these funds without affecting student IEPs.

Because our proposal primarily would simplify the special education funding system, we think additional accountability provisions

are unnecessary. We would recommend, however, that the Legislature require California Department of Education (CDE) to submit an annual performance report on the progress of special education students using data from Standardized Testing and Reporting (STAR) and California High School Exit Examination (CAHSEE). This report would highlight for policymakers the academic status of the special education population and identify districts with especially effective or ineffective special education programs.

An Opportunity to Learn Grant

Our third grant is called the Opportunity to Learn (OTL) grant. This grant would merge 11 different programs aimed at students who need additional services to succeed in school. As shown in Figure 4, this new grant would provide \$3.1 billion in funds to districts. The new grant is split into two parts: an academic support grant would provide compensatory instructional services to disadvantaged students and a student support grant would fund other types of services or activities that promote learning in schools.

As the figure suggests, our new grant would consolidate existing programs that target disadvantaged students. The academic support grant includes the Targeted Instructional Improvement grants, Economic Impact Aid and English Learner Assistance program, which are the primary source of *additional* classroom services to students who need additional help to succeed. We also included supplemental instruction funding and the High School Exit Examination supplemental instruction funds, which pay for *remedial* classes after school or during the summer for students who are struggling to meet state standards.

Ending the categorical nature of the supplemental instruction funds represents a significant policy shift. By including these funds in our grant, our proposal makes districts responsible for determining the mix of additional classroom services and remedial services, and whether those services are delivered during or after the regular school day.

Similarly, we believe that the After School Education and Safety (ASES) program also in an ideal candidate for inclusion in the support component of the OTL grant. Unfortunately, however, the requirements of Proposition 49 do not allow the kind of flexibility that would justify including these funds in our block grant. (For more information on ASES, please see the “After School Programs” section of this chapter.) Should the rules for this program become more flexible, we would recommend its inclusion in the OTL grant.

Figure 4	
LAO Proposed Opportunity to Learn Grant	
<i>(In Millions)</i>	
	2007-08 Amounts
Academic Support	
Targeted Instructional Improvement	\$1,075.7
Economic Impact Aid	994.3
Supplemental Instruction	420.8
CAHSEE ^a Supplemental Instruction	72.8
English Learner Assistance	63.6
Advanced Placement Fee Waivers	3.1
Subtotal	(\$2,630.3)
Student Support	
Grade 7-12 Counseling	\$209.1
School safety	100.6
Pupil retention	97.5
Community English Tutoring	50.0
AVID ^b	9.0
Subtotal	(\$457.2)
Total	\$3,087.5
^a California High School Exit Examination.	
^b Advancement Via Individual Determination.	

Our proposal also emphasizes the importance of an *effective* program of additional class room services. Districts sometimes complain that the state provides too little remedial support. Need for remediation, however, reflects a district's problems in providing the regular classroom services students need to learn the required material. Thus, the state's current remedial funding approach lets districts "off the hook" for ineffective instructional programs. By combining the many funding sources targeted at disadvantaged and struggling students, therefore, the Legislature would also make districts more accountable for the quality of classroom instruction.

The student support grant aggregates \$457 million in funds that the state currently dedicates to six programs, including student safety and counseling programs. As with our other grants, our proposal would increase local flexibility over the use of these funds while reserving their use for nonacademic support to students and their parents. These sup-

port activities would include counseling, outreach to parents, and school safety activities.

The OTL grant funds would be distributed based on the number of disadvantaged students in each district. Specifically, grants would be based on a count of the number of EL students and students with at least one parent who had not graduated from high school. This formula is based on our analysis that parent graduation is a more accurate indicator of need for funding than available measures of family income.

We recommend giving districts some flexibility to move money from one grant to the other. This would ensure district funding was not “locked in” to the amounts for instruction and support that are currently provided by the state. We also suggest continuing the requirements that districts provide counseling and remedial instruction to students who fail or are likely to fail CAHSEE.

Similar to our recommendation for special education, we also suggest monitoring district performance on the OTL grants. As we discussed in our 2005 report *Improving High School: A Strategic Approach*, research shows that very low academic progress is a major factor in the decision of students to drop out of high school. Research also indicates that student academic problems usually are evident in elementary and middle school. A focus on giving all students an opportunity to learn, therefore, means giving students a good education in every grade and ensuring that schools assist students when their performance begins to falter.

Based on this finding, we suggest monitoring performance in several critical areas. For instance, district performance on the grant could be assessed by the (1) proportion of students in grades 3, 6, and 9 scoring “below basic” on the STAR program mathematics and language arts test, (2) the proportion of ninth grade students who fail to graduate within four years, and (3) the proportion of ninth grade students who, by the end of 12th grade have not prepared for life after high school by taking all of the “A through G” courses that are required for admission into the University of California and California State University or earned an employer-certified vocational certificate. As supplemental information on the effectiveness of the student support grant in improving campus safety, we also would suggest the report include data on the number of student suspensions and expulsions and the number of incidents of on-campus violence.

Finally, we recommend the Legislature require CDE to submit an annual performance report on the progress of disadvantaged students using the program data discussed above. This report would highlight for policymakers the academic status of the at-risk population and districts that make below- and above-average progress. The report would help the Legislature provide oversight on districts’ performance in serving at-risk students.

An Expanded School Improvement Grant

The final grant we recommend is a new school improvement grant. As shown in Figure 5, we would merge the funding currently provided by 16 programs to provide \$1.2 billion for the new grant. As the figure also shows, the new grant is comprised of two parts, one targeted at instructional improvement and the second focused on staff development.

As suggested by its name, the purpose of the grant is to ensure a flexible source of funding for school improvement activities. The two-part nature of our grant reflects the fact that school improvement often requires a focus on a coordinated instructional approach and the development of teacher and administrator capacity.

Figure 5	
LAO Proposed School Improvement Grant	
<i>(In Millions)</i>	
	2007-08 Amounts
Instructional Improvement	
School & Library Improvement	\$465.5
Arts and Music	109.8
Gifted and Talented	51.3
Partnership Academies	23.5
Education Technology	17.7
Specialized Secondary Program	6.2
Civic Education	0.3
Subtotal	(\$674.3)
Staff Development	
Professional Development	\$274.7
Teacher Credentialing	128.7
Mathematics and Reading Professional Development	56.7
Staff Development	32.7
Alternative Certification (Intern)	31.7
Certificated Staff Mentoring	11.7
Paraprofessional Teacher Training	7.9
Teacher Incentives National Board	6.0
Principal Training	5.0
Subtotal	(\$555.1)
Total	\$1,229.4

As with the other grants, our school improvement grant consolidates existing programs that provide district support for instructional improvements and staff development. As a result, the grant would free districts from the specifics of the existing grants but would still require districts to use the funds to improve student achievement through better instructional approaches and training. We propose distributing funding for the two grants based on average daily attendance.

We also recommend several restrictions on the use of funds. While the division of funds between the two types of activities mirrors the existing division of funding, we would suggest providing significant district flexibility to transfer funds between the two grants. As with special education, we do not propose additional accountability measures for the block grant. We think school accountability under existing state and federal law is sufficient.

Conclusion

Our recommendations would significantly reduce the number of categorical funding streams—consolidating 43 current programs into four new grants. The significant reduction in the number of programs would greatly simplify the K-12 finance system, reduce district paperwork, clarify the amounts districts actually receive from the state, focus districts on program outcomes rather than state rules and regulations, and provide greater district flexibility over the uses of state funds.

As dramatic as our proposals may seem, they are rather modest compared to reform models that are under discussion as part of the school reform efforts linked to the *Getting Down to Facts* studies. One proposal, for instance, would consolidate all K-12 funding into one of three state formulas. These formulas would distribute funding based on the number and type of students in each district, regional cost factors, and the population density of each district.

According to the authors, however, this model assumes that state and federal school and district accountability are sufficiently strong and fine-tuned that no categorical programs are needed. In other words, the model assumes that all major local incentive problems have been addressed. While we think school and district accountability has increased the local focus on student achievement, we do not think these programs are sufficiently strong to counteract all significant local incentive problems, such as weak subgroup accountability or local spending pressures.

Therefore, we suggest a middle road between total reform and the status quo. Our proposal would increase local flexibility and responsibility while also shedding more light on the impact of supplemental funds on

student achievement. In the current tight fiscal environment, the additional flexibility would prove especially helpful to districts as they look to support high-priority services within the district. Our proposal also offers the Legislature a way to monitor the impact of funds on student achievement that we think would be much more effective than the current system. Overall, therefore, we think the benefits of K-12 finance reform warrants the Legislature's consideration as part of the 2008-09 budget.
