

designing options for California's young children

Financing Early Care and Education in California REVENUE OPTIONS



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KEY FINDINGS

- Roller-coaster funding for early-childhood programs persists. Spending has more than recovered from recession-era cuts, but the count of publicly financed slots has not.
- Both Prop 98 and the discretionary side of the budget have contributed to recent growth of state investment in young children.
- The Prop 98 set aside for pre-k to 12 education will be negatively effected by declining enrollment statewide.
- The governor could expand paid family leave by adjusting the existing payroll tax. The program might better serve poor and true middle-class families.
- Recovering corporate tax revenue, lost through the Trump tax cuts, might help finance early-childhood programs.
- Returning to a split-role property tax offers a potential long-term revenue source.
- Facilities support for pre-k in schools and community organizations could be included in a 2020 statewide and local bond measures.

How to finance early childhood and family initiatives?

California's new governor aims to support young families engaged in the essential human task of raising an infant or toddler, yet struggle to make ends meet. As mayor of San Francisco, Gavin Newsom widened access to pre-k options for 3 and 4-year-olds, while improving the quality of programs and carefully gauging the benefits experienced by young children.

Moving forward, how might the governor and legislative leaders identify revenue sources to strengthen the availability and quality of infant-toddler care, along with ensuring that preschool-age children gain access to quality pre-k? Awarding parents of newborns sufficient time at home is another piece of the family support puzzle. This brief begins to pinpoint sources of revenue that appear technically sound and may be politically possible.

We divide this analysis into three sections. First, we trace the state's progress in restoring funding for early care and education programs (ECE) since the Great Recession. Second, we discuss the projected decline in public school enrollments, which directly shapes K-12 spending levels tied to Proposition 98. Third, we examine pro's and con's of additional revenue sources that might help finance ECE efforts statewide.

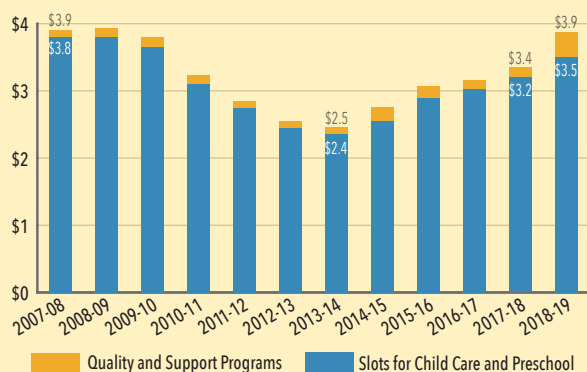


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ROLLER COASTER FUNDING FOR EARLY CARE AND EDUCATION

The Great Recession delivered a devastating blow to California's child care and preschool programs. Total state and federal spending on ECE programs collapsed, falling from \$3.9 billion in 2007-08, on the eve of the economic downturn, to \$2.5 billion in 2013-14.¹ But Gov. Jerry Brown and the legislature returned spending (in inflation adjusted dollars) to this pre-recession level when approving the state budget for 2018-19. Federal funding gains from the Child Development Block Grant have contributed to this rebound as well. Figure 1 illustrates the roller-coaster budget ride that has beset parents, along with early care and education providers.

FIGURE 1 Total funding for child care and pre-k bounces back post-recession

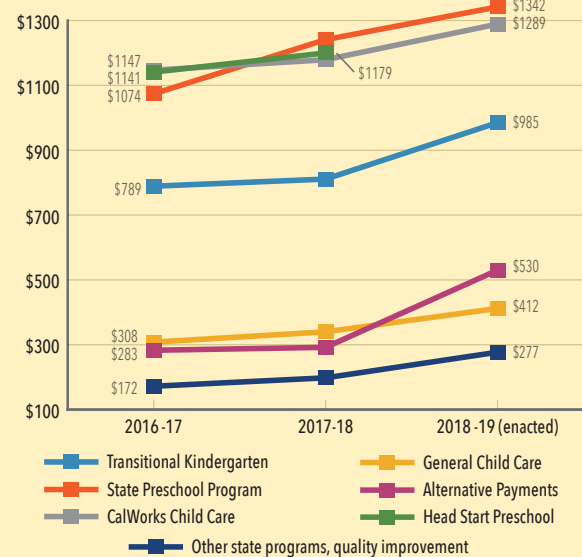


Note: Figures reflect the enacted budget each year except for 2008-09, which reflects the revised budget as of February 2009. Figures include federal and state funds for slots as well as for quality and support programs and are in 2018-19 dollars. Child care includes CalWORKs and non-CalWORKs programs. Preschool excludes Transitional Kindergarten. Source: California Department of Education and Department of Finance

After adding over \$900 million in support of Transitional Kindergarten (TK) created in 2010 and Head Start gains, California now invests just over \$5.9 billion in public funding for ECE programs from state and federal sources (2018-19), according to the legislature's budget analyst. This excludes nearly \$1 billion in paid family leave benefits (discussed below), child screening or information provided through pediatric services (reimbursable via Medicare), and the state's child-care tax credit (a \$380 million yearly tax expenditure).² Parents also pay an unknown level of fee-generated revenue for local ECE programs.

Alternative Payments (portable vouchers) for child care have grown 87% over the past three years, from \$283 million to \$530 million, as shown in Figure 2 (current dollars).³ State spending on TK, serving 4 year-olds near the age cutoff for entering kindergarten, has climbed 22% from \$789 million to \$965 million during the same period.

FIGURE 2 Recent growth in spending for young children by program (in millions of dollars)



Source: Source: Legislative Analyst's Office (2018). Child care and preschool: Early education budget. Sacramento, July. Head Start (2017). Head Start program facts, fiscal year 2017. Washington, DC.

These spending hikes have effectively boosted reimbursements to child-care providers, while the count of slots for lower-income families still lags behind pre-recession levels.

This recent growth is encouraging, made possible by California's strong economy and rising revenues coming into the state treasury. In fact, the Legislative Analyst is currently projecting nearly \$15 billion in available resources in the budget for 2019-20. Yet the persistent worry is that children's funding may nosedive again in the future whenever the nation's next recession appears on the horizon.

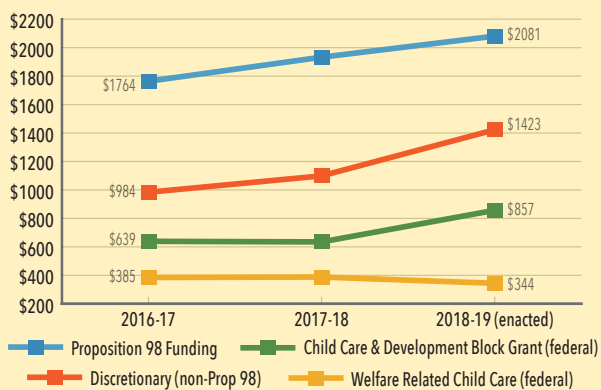
The ECE sector gains some protection from its partial financing under Prop 98. This earlier ballot measure, approved by voters in 1988, ensures that about 38% of the state's operating budget goes for pre-k-to-14 public education annually. However, even Prop 98 funding is subject to reductions during downturns. Prop 98 financing of ECE programs has crept upward slightly over the past three years, from \$1.8 billion to \$2.1 billion (Figure 3). Nearly half of this allocation supports TK, run by local school districts. TK is funded through the Local Control Funding Formula (LCFF) that's tied to average daily attendance (ADA) and demographic characteristics of students.

State support of ECE from the discretionary (non-Prop 98) side of the budget has climbed more quickly than from the Prop 98 side – making these recent gains quite vulnerable when the economy begins to cool down. This increase on

the discretionary side equals a 45% rise, from \$984 million in 2016-17 to \$1.4 billion in the current year. The federal child-care block grant jumped 35% this year, rising to \$857 million. Yet, Washington policy makers shaved back child-care dollars for parents making their way from welfare to work.

The state's economic recovery has fueled increases of over \$23 billion in additional yearly Prop 98 funding for local K-14 districts since 2011-12. The K-12 portion of this funding has been distributed primarily through LCFF, which more heavily funds school districts serving concentrations of students from low-income families. Some districts, including Long Beach Unified and Los Angeles Unified, have opted to use rising LCFF funding to expand their pre-k programs.

FIGURE 3 Rising Prop 98 and discretionary spending for young children



The Getting Down to Facts II study and others have noted that post-recession funding of California schools has grown higher than at any point since the onset of the recession.⁴ However, these funding levels, measured on a per-pupil basis, remain consistently below the national average and gauges of adequate education funding. In addition, these increases in funding, and concurrent structural changes in California school finance, have ignored sizeable increases on the cost side, particularly for pensions, special education, and facilities.

DECLINING SCHOOL ENROLLMENTS AND PROP 98 VULNERABILITY

The Prop 98 guarantee surpasses \$78 billion in the current 2018-19 fiscal year, over \$69 billion allocated to K-12 education. In the current year nearly \$61 billion of the \$69 billion is locked into LCFF (up from \$40 billion in 2013, the initial year of LCFF). The Legislative Analyst projects that the Prop 98 guarantee will continue to grow by \$2 to \$3 billion per year in the near term, assuming no recession and modest



declines in enrollment. But this increase may largely be used to fund a cost of living adjustment (COLA), as well as community college base funding. For example, a 3.1% COLA on existing programs under Prop 98, as forecast for the near-term by the Legislative Analyst,⁵ would expend about \$2.3 billion of any increase in Prop 98 funding.

Specifically, for 2019-20 the Legislative Analyst is projecting \$2.8 billion in additional K-14 funds (\$2.4 billion in Prop 98 growth, and the remainder in recaptured 2018-19 one-time funds). Yet, \$2.3 billion of that would be used to cover COLA on existing programs. Competition for the minimal amount of remaining Prop 98 funds from special education, career technical education, district fixed-cost needs (e.g., pension liabilities) and other K-12 interests will be intense.

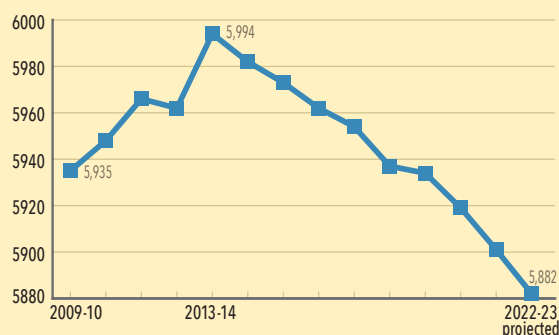
In fact, competition for new dollars in the state budget will be stiff, both inside and outside the education sector. Programs outside of Prop 98 have recovered from the recession more slowly than K-14 education. The state's additional contributions to pension funding will also draw on available increases in revenue. The press for affordable housing and additional support for mental health continues to grow, as do state obligations to cover health care costs. The continued uncertainty in Washington over funding of the Affordable Care Act will encourage proposals to ensure health care for all, and further boost competition for funding.

Another uncertainty facing the K-12 sector – now including Transitional Kindergarten – is the specter of declining school enrollment. The decline is well underway in urban parts of California. An earlier Berkeley Think Tank brief details how child populations, age 0-5 years, have been diminishing in recent years, while comparatively high fertility rates in Central Valley and rural counties will sustain growth of native-born children in coming decades.⁶

The Prop 98 guarantee in most years is adjusted when statewide K-12 enrollment (as measured by ADA) changes. A constitutional “hold-harmless” provision in Prop 98, however, guards against a downward adjustment in the guarantee unless ADA declines for three consecutive years. This provision assumes a declining need for state support as the count of students falls across local school districts.

Though the state hit a high point last year (2017-18) in terms of total enrollment, serving about 6,224,000 students, statewide ADA has been falling since 2014-15.⁷ These declines have led to downward adjustments on the guarantee. For example, a 0.3% decline in ADA, projected for the current year and for three of the four subsequent years, would lead to an annual downward adjustment in the hundreds of millions of dollars.⁸ The loss in the Prop 98 guarantee equals nearly one-half-billion dollars in the current fiscal year. Over the three-year period, 2017-18 to 2019-20, the total reduction associated with declining ADA equals about \$800 million, says the Legislative Analyst.⁹ Absent changes in policy, both the Department of Finance and the Legislative Analyst are projecting continuing decline into the future. An economic downturn could also accelerate this decline, given that families tend to leave California when the job market weakens.

FIGURE 4 Estimated decline in K-12 attendance (ADA) through 2023-24



Source: Legislative Analyst, November 2018. Numbers are projected estimates for 2018-19 and forward.

Overall, unless K-12 adds additional children (ADA), Prop 98 revenues will continue to experience these downward adjustments. In addition, differences across districts in the decline or expansion of ADA will lead to state education dollars being shifted from urban to Central Valley districts, along with fast-growing commuter centers on the edge of expensive cities.

One way to forestall this decline in enrollment and the subsequent downward adjustments to the Prop 98 guarantee would be to expand Transitional Kindergarten or pre-K

programs out to younger 4-year-olds, while counting those additional students towards ADA. In any year where sufficient students were added, the chain of three years of decline would be broken and the hold-harmless provision would be reset.

In this way, an influx of new students would eliminate any downward adjustment in the guarantee for three years, and retain funding for schools, rather than seeing it likely moved to the non-Prop 98 side of the budget. Phasing in additional 4-year-olds to TK over time could extend this “savings” effect over many years, even in the face of declines in the current student population. Moreover, any increase in the Prop 98 guarantee in one year adds to the base for calculating the guarantee in the following year.

One way to hedge against the cut to the Prop 98 guarantee, hypothetically, would be to add about 50,000 children, age 4, to Early Transitional Kindergarten, while enriching classroom staff. This level of expansion, plus adding a classroom aide (similar to the state preschool program), would cost about \$1.2 billion when fully implemented – more than recovering the \$800 million cut in K-12 spending that will otherwise result.

There are clearly capacity issues, mainly in terms of facilities and staffing, which would have to be addressed if an expansion of TK or a dedicated program for 4-year olds were to be implemented.

Adding younger 4-year-olds to the TK program as legislated in 2015, would be feasible under Prop 98. But adding new students to other pre-K programs and financing that through ADA-based apportionments to local districts would likely be seen as a new program under Prop 98.

The State has moved programs from outside of Prop 98 into the Prop 98 calculations and vice versa, or added new programs to Prop 98, quite often. When a program’s appropriation is shifted from outside into Prop 98 (and if the legislature is not willing to over-appropriate the guarantee), it crowds other potential K-14 appropriations. That is, it uses up the capacity under the guarantee that would have otherwise been used to fund some program already included in Prop 98.

Theoretically the state could avoid these effects by “rebenching” the Prop 98 guarantee. Rebenching would entail expanding the guarantee to account for the appropriations going to a new program moved into Prop 98 (avoiding the crowd out).

Despite the simplicity in theory, the state's track record on rebenching is mixed. The decision as to whether to rebench when changes are made has most often been determined on the basis of fiscal exigencies or political expediency. This has been particularly apparent in the treatment of funding changes related to ECE programs, which have led to controversy and litigation. That said, expanding ECE programs and rebenching Prop 98 to account for the required funding for that expansion would eliminate the crowding out effect that the expansion would have on funding for other K-14 educational programs.



Let's turn next to other revenue options that could help support ECE programs. We begin with paid family leave (PFL), California's effort that partially sustains family income after the birth of a child. We then assess the pro's and con's of restoring corporate tax rates, moving back to a split-roll property tax, and taxing services between business firms, recognizing the new realities of California's post-industrial economy. Finally, we accent how funding for ECE facilities will be required to expand child care and pre-k programs.

PAID FAMILY LEAVE – EXPANDING PARENT PARTICIPATION, DISTRIBUTING BENEFITS FAIRLY

Close and consistent ties between a parent and newborn yield important outcomes for infants and relieve stress for working parents, according to child-development researchers. Yet, many parents cannot afford to stop-out from work during their child's infancy. About 46% of eligible California mothers do participate in the state-run – yet worker financed – paid family leave (PFL) program, along with 9% of fathers.¹⁰

Lengthening the weeks of coverage or enrolling more parents would likely buoy the early growth of infants and toddlers. It also may prove to be a cost-effective policy strategy, compared with building formal centers for infants and toddlers. (The two approaches are not mutually exclusive.) Another strategy is to offer major employers tax incentives to encourage wider participation in PFL, partially financed privately.

PFL participants in California can draw up to six weeks of paid leave under the state program, equaling a share of one's existing wage, provided the applicant has been recently employed. This "replacement" of income equals 70% of current wages for low-wage workers, to 60% of higher earners (raised by the legislature in January 2018).

Take-up rates are higher for low and high-income parents, with middle-class participation falling lower. Pregnant women may draw an additional 10 weeks of paid leave, including four weeks prior to giving birth. The average weekly benefit is projected to be \$661 in 2018, and ranges up to \$1,216 weekly.¹¹

One shortcoming of the current PFL program is that it operates regressively, from the standpoint of who pays and who gains the lion's share of benefits. A one percent (1.0%) payroll tax – levied on taxable income up to \$114,967 – currently finances California's State Disability Insurance (SDI) fund. All wage-earners, no matter how rich or poor, pay the same rate. This is unlike the state income tax, which taxes wealthier Californians at a higher rate than low-income citizens.

In addition, the cap on income subject to the disability tax means that higher-income taxpayers pay a smaller fraction of their income, while reaping a large fraction of the payout – compared with true middle-class families who may the full 1.0%, but under-utilize the program. Overall, the PFL program pays out about \$1 billion annually to families with a newborn.

The additional worry – if the policy principle is to spread the tax burden and payout from PFL evenly across workers – is that high-earning men make-up a disproportionate share of the recent increase in beneficiaries. On the one hand, it's encouraging to observe the growing participation of fathers in child-rearing duties. At the same time, the amount of aggregate wages underwritten by PFL increasingly favors better-off parents. These trends are detailed in a research brief from the Berkeley Think Tank.¹²

The rate at which workers are taxed for the SDI fund has historically moved up and down, typically pegged to economic cycles and jobless rates, which shape incoming revenue streams. The payroll tax stood at 0.8% in 2008, just prior to the Great Recession, rising to 1.2% during the economic trough. The current 1.0% appears adequate to finance the modest expansion of PFL approved in January 2018. The executive branch can adjust the SDI tax rate up to 0.1% each year at its discretion, equaling about \$750 million in revenue. This has been done in

about 15 instances under various governors on a bipartisan basis since the late 1990s.

A modest increase in the payroll tax could support an additional 100,000 young parents, assuming current benefit levels. Or, incentives could be strengthened to more fairly involve lower-income families in the program. It might be adjusted to ensure that well-off Californians pay an equal share of their income into the SDI pool.



TRUMP'S CORPORATE TAX CUT – RETRIEVING LOST REVENUE

President Trump's tax cut, approved in December 2017, reduced the federal levy on corporate profits from 35 to 21 percent. This translates into about \$30 billion in annual tax saving for firms doing business in California. One revenue option is to raise the state corporate tax, now pegged at 8.8% of profits, to replace lost revenues. Current revenue stemming from all corporate taxes, not only income levies, still paid to the California treasury equals \$12.3 billion each year.¹³

To retrieve about one-half of the revenues lost to the Trump tax cut, a pair of legislators have proposed a state tax increase on firms earning at least \$1 million annually from business conducted in California (Assembly Constitutional Amendment 22). Such a bill requires a two-thirds vote in each legislative chamber, then a majority vote of the people. Under ACA 22, approximately 40% of the recovered revenue would go for child care, pre-k, and public schools. Such a proposed tax hike, if approved, would raise the state's corporate income tax rate to 18.8%, the highest level of any state in the nation.

Potential revenue estimates ultimately depend on the tax increase that may be pursued by the legislature. For a 10% increase, like that proposed in ACA 22, estimates range from \$14.4 to \$17.0 billion.¹⁴ Under this scenario, total state

revenue from corporate taxes would at least double, rising about \$26.7 billion.

California voters did not support the Trump tax bill. One poll, conducted in March 2018, showed that 58% of likely voters disapproved of the federal tax legislation, with just over one-third in support.¹⁵ Whether voters would see this tax hike as remediating Trump's earlier tax cut, debated two or three years later, remains unknown.

RETURNING TO A SPLIT-ROLL PROPERTY TAX

An alternate route for raising taxes on business interests would return California to a split-roll property tax, whereby levies on commercial property could rise independently of those raised on residential property. Housing California, a statewide nonprofit, has gathered sufficient signatures for a ballot proposition that would allow the state to raise taxes on industrial and business property, while retaining Prop 13 caps on levies applied to residential property.

Stepping back, Prop 13, approved by the voters in 1978, locked in property tax values at 1976 assessed values, then limited tax increases to no more than two-percent until the property is sold, or when more than half of the property's ownership changes at one time. Prop 13 replaced the previous practice of annually reassessing a property at market value using a system based on a property's cost at acquisition.

The requirement that at least 50% of a property's ownership must change before the property can be reassessed has opened a loophole for businesses that spread ownership among multiple owners or hold property ownership in a corporate name. So long as an ownership share to be sold is less than half (or the corporation never sells the property), the property can be transferred to a new owner (or corporate shares can change hands) and taxes stay the same. This has allowed large corporations, like Disneyland, to still pay taxes at pre-1978 levels, while the average home owner may pay upwards of eight-times that hike since their home is reassessed to full market value each time it is sold.

One way to address this inequity, is using the so-called "split roll," the concept of taxing business and industrial property at higher rates than residential properties. Altering Prop 13 requires a voter-approved constitutional amendment. The Housing California proposal would require that commercial and industrial properties be reassessed at market value. Officially titled, the California Schools and Local Communities Funding Act, has qualified to be placed on a future ballot, perhaps the presidential election, November 2020.¹⁶

The proposal would generate \$6 to \$10 billion in new state revenue, according to the Legislative Analyst, depending on the real estate market's strength downstream.¹⁷ Though increases in property taxes generally do not increase the Prop 98 guarantee, under this proposal two-fifths of the new revenue would go to public schools (outside the Prop 98 guarantee), the remaining three-fifths to local governments.

Business lobbies and taxpayer groups will predictably oppose the measure. At least one critic argues that split-roll could incent municipalities to enlarge commercial development, rather than foster growth of affordable housing.¹⁸ Voter support remains mixed when asked to alter Prop 13, including the split-roll proposal, according to one recent poll.¹⁹ Voters did reject a ballot measure in November 2018 that would have allowed well-off Californians to dodge property tax increases.

COMPREHENSIVE TAX REFORM – EQUAL LEVIES ON SERVICES

Proponents of a state levy on business services argue that California's current tax structure has failed to keep pace with the character of a post-industrial economy. They urge the legislature to adapt to the reality that consumers have shifted from spending on property and consumer goods, which are taxable, to less tangible goods and services, which are not. Many services are bought by corporations, including advertising, legal, accounting, and finance services – tax-free transactions. The estimated value of business-to-business services equals about \$644 billion in California annually, says the state Board of Equalization.²⁰



Opponents argue that service taxes stifle economic growth, disproportionately affect small business, and result in tax costs simply being passed onto customers through higher prices. Big corporations might bring these services into their own firms, while small business might inadvertently bear the brunt of a service tax.²¹

A bill introduced by Sen. Bob Hertzberg this past year would add a 3% tax on business services, balanced by a 2% reduction in state sales tax by 2022. The policy goal is to better align the tax structure with the distribution of transactions that reflect the state's new economy.

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In 2015, an omnibus service tax would have raised about \$122.6 billion in new revenues. About \$60.9 billion could go to the state, and another \$61.7 billion would accrue to local governments, according to the Board of Equalization. The Hertzberg bill is limited to service transactions among firms, not among individuals. His strategy engages wider tax reform, not only raising additional revenue for state operations.

A SCHOOL FACILITIES BOND – INCLUDING EARLY CARE AND EDUCATION

California's public schools are constructed and modernized through a statutory and regulatory scheme known as the School Facilities Program (SFP). The primary purpose of the SFP is to provide state matching funds—generated through general obligation bonds approved by voters—to local educational agencies (LEAs) to construct new facilities and modernize existing facilities.

The most recent statewide bond, Proposition 51, authorized \$7 billion total for K-12 facilities: \$3 billion for "new construction," \$3 billion for modernization, \$500 million for charter schools, and \$500 million for career technical education facilities. Proposition 51 also authorized \$2 billion for community college facilities.

Under existing law and Prop 51, state grants may not be used for ECE facilities, except for "qualifying individuals with exceptional needs." Likewise, ECE pupils do not generate additional SFP funding eligibility under current law, except for special needs pupils. Only Transitional Kindergarten through grade 12 students generate SFP funding eligibility. To construct or modernize ECE facilities, districts may use local bond funds or convert unused sites to house young children.

Local bond funds may be used for ECE purposes. But without a state match for pre-k children, local voters might worry that their school district will leave matching dollars on the table.

Members of the Berkeley Panel include Catherine Atkin, Erin Gabel, Angie Garling, Rebecca Gomez, Scott Moore, Kim Patillo Brownson, Karla Pleitez Howell, Patricia Lozano, Hanna Melnick, Sarah Neville-Morgan, Chris Steinhauer, Gerry Shelton, Deborah Stipek, Pete Weldy, and Lisa Wilkin. Members of the Berkeley panel have discussed and helped craft the ideas presented in this brief.

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To correct this eligibility problem, the SFP would need to be amended to specifically allow for (1) state matching funds to go towards ECE facilities, and (2) all ECE pupils would help generate LEA funding eligibility. The legislature cannot alter the allocation of Prop 51 funds through statute. But the next school bond could be written more flexibly.

Many observers expect SFP rules to change under a new statewide bond. This provides an opportunity for ECE advocates to argue for a slice of the pie, though this must be accomplished well in advance of any finalized measure being introduced. Even now, two years prior to a hypothetical November 2020 bond, myriad school and business interests are discussing the shape of the next facilities proposal.

**the passage of the next statewide bond
provides an opportunity for ECE advocates
to argue for a slice of the pie**

THE BERKELEY THINK TANK ON EARLY CHILDHOOD POLICY

Policy thinkers and seasoned practitioners have come together to delineate feasible policy options for equalizing access to quality child care and pre-k providers. Scholars at Berkeley's Institute of Human Development facilitate deliberations of the 17-member Think Tank Panel.

The panel aims to synthesize key pieces of evidence regarding demographic trends, enrollment in extant programs, and dimensions of quality that elevate children's early growth and learning. Then, we put forward realistic policy options, estimate costs, and focus on trade-offs – based on core principles and always thinking long term. Broad consensus among stakeholders is required to boldly move forward. Our North Star shines bright: seeking to build an easily accessed set of quality early-childhood options for California's families.

More information: b_fuller@berkeley.edu
and <https://choosechildren.org/>

ENDNOTES

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