

COMMISSION ON CALIFORNIA STATE GOVERNMENT ORGANIZATION AND ECONOMY

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Dear Governor and Members of the Legislature:

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On May 21, 1986, the Commission on California State Government Organization and Economy, also known as the Little Hoover Commission, conducted a public hearing on the use of lottery funds in the State's kindergarten through grade 12 (K-12) public school system. The hearing focused on determining if the State has established a sound system to allocate, use and account for lottery funds distributed to education. It also reviewed the processes used by school districts to develop priorities for spending lottery funds and the expenditures that school districts have made with these funds. This letter presents a report of our findings and recommendations on issues and problems associated with the State's current system for expending lottery funds for K-12 public education.

The Commission has had a strong and continuing interest in the overall financial accountability and responsibility of school districts in California during recent years. While the lottery funds represent a relatively small portion of the monies received by school districts, it is a new and highly discretionary revenue source. Therefore, the Commission believes it is important that the problems that are occurring in the administration and use of these funds be addressed immediately.

The Commission is extremely concerned with the lack of parameters for school districts' expenditure of lottery funds and the general lack of assurance that these funds are being used for instructional activities. Although the Commission respects the right of local boards of education to decide how lottery funds are spent, our review showed that the processes used by some school districts to determine spending priorities for lottery funds do not provide for full participation by all interested groups. Moreover, since lottery funds are among the least restricted funds that school districts receive, we believe that it is imperative that the State have an adequate system of financial accountability and control in place to ensure that the public has

confidence that lottery funds are being well-spent. Specifically, our review identified the following problems:

- o School districts are using inconsistent and sometimes inadequate processes for determining priorities for spending lottery funds;
- o School districts are confused regarding the allowable uses of lottery funds;
- o Some school districts are not making prudent use of lottery funds;
- o The State has not established sufficient accounting and reporting for lottery funds; and
- o The State should include certain educational programs in the calculation and allocation of lottery funds.

To help solve these problems, the Commission believes that the Governor and the Legislature should require that guidelines be developed for local boards of education to use in determining spending priorities for lottery funds. In addition, the Legislature needs to further define allowable uses of lottery funds and urge local boards of education to use lottery funds for non-recurring expenditures. The Legislature also needs to strengthen reporting and auditing requirements for lottery funds. Finally, the Legislature should make some minor adjustments in the method used to allocate lottery funds to school districts to ensure the equitable distribution of funds.

The remaining sections in this letter present background information pertaining to our review, a discussion of each of our major findings, and the Commission's recommendations for addressing the problems identified during the study.

BACKGROUND

The California State Lottery (Lottery) was approved by the voters of California with the passage of Proposition 37 in November 1984. The purpose and intent of the Lottery, as defined in the Lottery Act, are support for the preservation of the rights, liberties, and welfare of the people by providing additional monies to benefit education without the imposition of additional or increased taxes. Moreover, the Lottery Act also stated that the net revenues of the Lottery shall not be used as substitute funds, but rather shall supplement the total amount of money allocated for public education in California.

The Lottery Act established a formula for allocating lottery funds for public education. It requires that 50% of the total annual revenues shall be returned to the public in the form of prizes. In addition, it states that at least 34% of the total annual revenues shall be allocated to the benefit of public education, and that no more than 16% shall be allocated for payment of the Lottery's expenses.

Based upon the requirements in the Lottery Act, the State has established a process for allocating funds for education. The current process, as it relates to K-12 public education involves five major steps. First, all lottery revenues are deposited in the State Lottery Fund. Second, on a quarterly basis, the Lottery calculates 34% of all revenues received by the State Lottery Fund, which represents the amount of revenues earmarked for public education. The State Controller's Office then sees that these funds are transferred to the California State Lottery Education Fund. Third, the State Department of Education provides the State Controller's Office with average daily attendance (ADA) information for each of the 1028 school districts in California. The State Controller's Office then determines the allocation of lottery funds to school districts on a "per capita" basis by dividing the total lottery education funds by the total statewide ADA. This "per capita" amount is then multiplied by the number of students in a school district to determine the amount of funds a district will receive.

Once the amount of funds each school district should receive is determined, the fourth step in the process occurs. The State Controller's Office issues a warrant to each County Treasurer for all school districts in a county. The warrant is accompanied by a memo that identifies each district's allocation. Finally, step five involves a County Treasurer depositing the warrant for a county in a special account for lottery funds that each county has established for use by school districts. Each district may then withdraw funds from the account to its allocation limit.

The Lottery Act stipulates that all funds allocated from the California State Lottery Education Fund shall be used exclusively for the education of pupils and students and no funds shall be spent for acquisition of real property, construction of facilities, financing of research or any other non-instructional purpose. In addition, the Lottery Act states that the State Controller's Office shall conduct quarterly and annual post-audits of all accounts and transactions of the State Lottery Commission and other special post-audits as the State Controller's Office deems necessary.

SCHOOL DISTRICTS ARE USING INCONSISTENT AND SOMETIMES INADEQUATE PROCESSES FOR DETERMINING PRIORITIES FOR SPENDING LOTTERY FUNDS

The testimony at the Commission's public hearing revealed that the processes used by school districts to determine how they will spend their lottery funds differ considerably and may not be adequate in some instances to ensure that the funds are being well spent. Due to the lack of sufficient processes for determining spending priorities, certain concerned groups may not have the opportunity to participate in the determination of how their school district identifies and assigns priorities to its needs, and in how their district eventually spends its lottery monies. Moreover, the lack of well-defined and open processes in school districts for determining how to use lottery funds can undermine the public's confidence in the use of these funds.

While existing law permits school districts to spend lottery funds within certain broad parameters, there is no provision in State law governing the process that school districts should use to determine how to

spend lottery money. In addition, although the State Department of Education has issued guidelines to school districts relating to various concerns pertaining to the use of lottery funds, it has not issued guidelines to school districts regarding how districts should establish a process for determining how lottery funds should be spent. This has resulted in a wide range of different types of processes being developed and used in school districts.

Some processes are well-defined, thorough, and allow for public comment, while other processes are poorly defined, vague, and do not rely on much, if any, public input. For example, our public hearing showed that the San Juan Unified School District and the San Diego Unified School District have established extensive processes for determining how to spend lottery funds. On the other hand, the Los Angeles Unified School District, the Oakland Unified School District, and the Sacramento City Unified School District have not utilized processes that are as extensive.

The San Juan Unified School District's process for determining district priorities and how lottery funds would be spent spanned eight months and included the use of parents and administrative staff on advisory groups for kindergarten through grade 6, grade 7 and 8, grades 9 through 12, and special education. These groups developed requests for lottery funds which were then discussed with other parent/administrative groups, councils (administrative meetings with principals/vice principals) and teacher groups (elementary teacher advisory groups, grade 7-12 teacher groups, department representatives and curriculum groups). A package of lottery requests were then presented to the Board of Education which held a series of public hearings on these requests. The District staff then assigned priorities to the requests for lottery funds. These requests were reviewed at a public hearing which included more than three hours of public comment and then voted on by the Board of Education.

The San Diego Unified School District developed a different, but a similarly extensive process, for determining how it would establish priorities for and spend its lottery funds. The District's plan for using lottery funds allocated approximately one-third of the funds to teachers for either salaries or class-size reductions, one-third for school site discretionary uses, and one-third for district-wide program and equipment needs. The plan for one-third of the funds to be earmarked for teachers' salaries or class-size reductions resulted from negotiations with the District's teacher bargaining unit. A joint committee of teachers and managers will make recommendations to the Board of Education on how the class-size reductions should be implemented. School site committees, made up of staff and parents, will determine critical needs for school site allocation spending. Finally, a district level committee comprised of the heads of each district division will make recommendations for district-wide projects.

Conversely, the Los Angeles Unified School District's Board of Education had not allocated any of its lottery funds at the time of our public hearing. Instead, it placed the lottery funds in a separate interest-bearing account pending the outcome of legislation it is sponsoring to allow lottery funds to be spent for capital outlay, which it is currently precluded by law from doing. While the Los Angeles Board of

Education has not made any specific allocation of lottery funds, it has taken a position in determining priorities for the use of funds. Specifically, its position is that the District's highest priority is to relieve the shortage of classroom facilities and overcrowding. Once the legislative issue relating to the use of lottery funds is decided, the Board of Education is planning to determine what percentage of lottery funds will be applied to relieve overcrowding, and what percentage will go towards other needs.

The Oakland Unified School District used approximately half of the lottery funds it expects to receive for fiscal year 1985-86 to negotiate a strike settlement with its teachers. The District plans to spend its remaining lottery funds for this fiscal year on textbooks, deferred maintenance, and other miscellaneous areas as determined by the Board of Education.

The Sacramento City Unified School District surveyed district administrators to solicit input for potential uses of lottery monies. The methods used by individual school site administrators and central office administrators in obtaining information from other staff members varied throughout the District. Once administrators determined potential uses of lottery funds, the District's Executive Staff submitted a report to the Board of Education. However, the Board of Education decided to place a major portion of its first lottery income, approximately 83 percent, in an unrestricted reserve so that the lottery money could be considered with the District's overall needs and priorities for the fiscal year 1986-87.

The testimony that the Commission received at its public hearing and the research conducted by the Commission regarding the processes used by school districts to allocate lottery funds identified three major weaknesses in some school districts, including:

- o The lack of an adequately defined process for allocating lottery funds that allows groups participating in the process to understand how the process works;
- o The lack of a sufficiently open process to determine district priorities and how funds would be spent. This includes allowing for participation by all major groups potentially effected by the process, including administrators, teachers, classified employees, parents, students, and other members of the community; and
- o The lack of a well-advertised process to ensure public review and comment on the spending priorities and the actual use of funds.

Due to the considerable variation in the processes being used by school districts to allocate lottery funds and the lack of statewide guidelines in this area, the Commission believes that these concerns must be addressed in order to ensure that the public has confidence that lottery funds are well-spent by school districts.

SCHOOL DISTRICTS ARE CONFUSED REGARDING THE ALLOWABLE USES OF LOTTERY FUNDS

Since the initial disbursement of \$272 million of lottery funds for public education was made by the State Controller's Office in February 1986, approximately 90 percent of which went to K-12 public education, school districts throughout the State have expressed concern and confusion regarding what expenditures can be made with these funds. This uncertainty has occurred because the Lottery Act is vague regarding what expenditures are permissible with lottery funds and no parameters have been established for school districts regarding the use of such funds. As a result, the Commission found that some school districts are making highly questionable uses of lottery funds. Although the uses are allowable under State law, they are not consistent with the expressed intent of the Lottery Act, which is to augment funds already allocated to public education and to spend lottery funds exclusively for instructional purposes.

The declared purpose of the Lottery Act was to provide additional monies to benefit education without the imposition of additional or increased taxes. The Lottery Act also specifies that the net revenues of the California State Lottery shall not be used as substitute funds but rather shall supplement the total amount of money allocated for public education in California (Section 8880.1, Government Code). The Lottery Act also states that it is the intent of the Act that all funds allocated from the California State Lottery Education Fund shall be used exclusively for the education of pupils and students and no funds shall be spent for acquisition of real property, construction of facilities, financing of research or any other non-instructional purpose (Section 8880.5(d) Government Code).

The California Education Code does not define instructional purposes. However, a recent court decision, Hartzell v. Connell, 35 Cal. 3d 899, in which the State Supreme Court considered the constitutionality of district imposed fees for participation in "extra-curricular" programs, such as athletics and cheerleading, held that activities which form an integral part of education in the broad sense of the term are a part of the "free school" guarantee of the California Constitution, Article IX, Section 5.

Counsel opinions which have been received by school districts regarding the use of lottery funds suggest that it might be appropriate to equate the word "instructional" with the word "educational"-- a broader term. Therefore, other than the uses of funds which are clearly proscribed in the Lottery Act, including the purchase of school sites, the construction of facilities, and the financing of research or any other non-instructional purpose, school activities that fall within the "free school" guarantee of the California Constitution are permissible uses of lottery funds. More recently, Chapters 872 and 1052, Statutes of 1985, specifically provided for the expenditure of lottery revenues free of state control and at the discretion of the local school boards.

In response to questions and concerns raised by school districts regarding the allowable uses of lottery funds, Superintendent Honig issued a letter to County and District Superintendents on November 1, 1985. This letter emphasized that it is important for school districts to utilize

lottery funds for visible, high-impact activities in order to maintain public support for lottery revenues as a supplement to general education funding. In the letter, Superintendent Honig recommended that lottery funds be considered for items such as additional textbooks or supplementary materials, refurbishing of science laboratories, restocking of school libraries and special teacher training programs. He also stressed that local communities be aware of what the school districts are using the funds for and what impact expenditures are having.

The testimony that the Commission received at its public hearing indicated that school districts are spending lottery funds for a wide variety of uses. Some of the uses of lottery funds are extremely imaginative, creative and have a direct relationship to classroom instruction, while other uses appear to be questionable and not directly related to instructional purposes.

Among the uses of lottery funds that the Commission found to be directly related to classroom instruction were the following:

- o San Diego Unified School District -- the purchase of instructional supplies, textbooks, equipment; supplies for implementing and upgrading an Advanced Placement Program; and class size reductions;
- o San Jose Unified School District -- the purchase of equipment and materials for media centers and libraries; expository writing awards for students; and the development of a sequential curriculum for the various specialty areas covered by special education; and
- o Cupertino Union School District -- the establishment of a voluntary extended teacher work year for site instructional planning; a program to build decision-making skills in students regarding drugs, alcohol, and other social problems; and after-school sports.

While the above mentioned uses of lottery funds by school districts have a strong relationship to instructional or educational purposes, the Commission identified other uses of lottery funds that were not as directly related to instructional purposes. For example, the Commission identified the following uses, or planned uses, of lottery funds:

- o Sacramento City Unified School District -- the allocation of \$1,917,300 out of \$2,270,000, or 83 percent, of its initial payment of lottery funds to an undistributed reserve account for future use;
- o Oakland Unified School District -- the use of \$2.5 million of the estimated \$5.5 million, or 45 percent, of lottery funds to be received in fiscal year 1985-86 for the settlement of a teachers strike;
- o Los Angeles Unified School District -- the placement of all funds received for fiscal year 1985-86, approximately \$65 million, in a separate interest-bearing account to be used largely for the construction of new facilities, if legislation allowing such construction is enacted by the Legislature;

- o San Diego Unified School District -- the planned use of \$1.8 million of the estimated \$14 million the district will receive in fiscal year 1986-87 for liability insurance. In addition, the planned use of \$1.9 million for deferred maintenance matching funds and \$8.1 million for a reserve to cover certain economic uncertainties, including revenue deficits, integration programs, unresolved cost of living allowance issues, and impact aid funding.

The Commission is extremely concerned with the essentially unlimited definition of instructional, or educational purposes. While the Commission respects the authority of local boards of education to determine the use of lottery funds, the Commission believes that this authority should be exercised within certain broad parameters or guidelines. Among the questionable areas which the Commission is concerned that lottery funds are being used for are the following:

- o Deferred maintenance -- includes the provision of new lighting, roofing repairs, ground repairs, and plumbing repairs;
- o Regular maintenance -- includes the routine cleaning, painting, or janitorial service for buildings and grounds;
- o Transportation -- includes the purchase and maintenance of school busses or other vehicles;
- o Equipment and fixtures -- includes the purchase of new furbishings for facilities, such as air conditioners and carpets, and other related items and services, such as wall coverings;

While the Commission realizes that these are necessary and useful expenditures for school districts to make, the Commission believes that such expenditures are questionable uses of lottery funds in that the expenditures are not being made to augment funds already allocated to public education and are not being used exclusively for instructional purposes.

SOME SCHOOL DISTRICTS ARE NOT MAKING PRUDENT USE OF LOTTERY FUNDS

Our public hearing revealed that some school districts are using lottery funds for on-going expenses, such as funding permanent increases in teacher salary schedules. While the use of lottery funds for on-going expenses is not precluded by State law, the Commission does not believe that using lottery funds for on-going expenses is a prudent business practice because lottery funds have historically declined in other states after the first year and therefore are not guaranteed at any level. As a result, school districts could be faced with unfunded liabilities in the future if lottery funds decrease.

As previously mentioned, school districts have considerable discretion in how they make use of lottery funds. Generally speaking, school districts can use lottery funds for any instructional or educational use, except those uses that are specifically proscribed in the Lottery Act, including; the purchase of school sites, the construction of facilities; and the financing of research or any other non-instructional purpose.

Superintendent Honig, in his November 1, 1985 letter to school district superintendents regarding the use of lottery funds, urged school districts to use the bulk of lottery funds for non-recurring expenses, due to the fluctuating nature of lottery revenues provided to school districts from year to year. Thus, the Superintendent has warned districts to avoid making long-term funding commitments with lottery funds. Furthermore, the California School Boards Association has adopted a policy statement that "strongly urges all members to restrict the use of lottery funds to supplemental non-recurring expenses."

The Commission has determined that some school districts have not heeded these warnings and are making long-term funding commitments with lottery funds. For example, the Oakland Unified School District committed \$2.5 million of its estimated \$5.5 million in fiscal year 1985-86 lottery revenues to negotiate salary settlements during its recent teachers strike. Similarly, the San Diego Unified School District plans to commit \$3.5 million of its estimated \$9.5 million in lottery revenues this fiscal year for teachers salaries, benefits, and class-size reductions.

A recent survey by the California School Boards Association showed that 20 out of 114 school districts responding, or 18%, are committing a portion of their lottery funds to salary compensation. This does not include districts that are committing lottery funds to one-time salary bonuses; instead, it identifies districts that are using lottery funds to make long-term recurring commitments.

The Commission also found that school districts are using lottery funds for other long-term recurring commitments, including maintenance, custodial and clerical services. While the Commission recognizes these services and teacher salary commitments as being vital to school districts, the Commission does not believe these expenditures represent prudent uses of lottery funds. Because lottery funding can potentially fluctuate considerably from year to year, the Commission believes that school districts use of lottery funds for long-term recurring expenditures could result in school districts making financial commitments that they would be unable to meet in future years if lottery funding is reduced.

THE STATE HAS NOT ESTABLISHED SUFFICIENT ACCOUNTING AND REPORTING FOR LOTTERY FUNDS

The Lottery Act and subsequent legislation provide that lottery funds should be used at the discretion of local boards of education with only few limitations. Lottery funds are among the least restricted source of funds that school districts receive and, as evidenced by our study, are used for a wide variety of purposes. Although some reporting and accounting mechanisms have been established, the Commission found that the financial accountability for lottery funds is insufficient to ensure that the funds are used in accordance with State law.

The Lottery Act and subsequent related legislation, including Chapters 872 and 1052, have provided that school districts may spend lottery funds at their discretion within certain broad limitations. As previously discussed, lottery funds cannot be used for the acquisition of real property, construction of facilities, financing or research or any other

non-instructional purpose. In addition, the Lottery Act stated that lottery funds shall supplement the total amount of money allocated for public education in California.

As a precondition of receiving lottery monies, each County Treasurer was required to certify to the State Controller's Office that each school district for which it acted as the Treasurer had established a separate lottery education account as required by State law. The State Controller's Office also has the responsibility for preparing the audit manual that is used by certified public accounting firms to audit school districts. The State Controller's Office has modified the audit manual to require some audit coverage of lottery funds.

The State Department of Education also has provided guidance to school districts on accounting for and reporting on the use of lottery funds. The State Department of Education has issued two Fiscal Management Advisory Memos to school districts and has documented the Annual Financial and Budget Report with an element on accounting and reporting for lottery funds use. In addition, the State Department of Education, in accordance with supplemental language to the Budget Act of 1985, is required to compile information and report to the Legislature by October 1, 1986 on how much lottery funds each school district received, its use of these funds, and its proposed expenditures for fiscal year 1986-87.

Although the State Controller's Office and the State Department of Education have taken steps to provide accountability and reporting for lottery funds, the Commission's public hearing and research indicate that the actions that have been taken are insufficient to ensure that lottery funds are spent appropriately. For example, the audit manual developed by the State Controller's Office includes an audit step for ensuring that a separate lottery education account has been established by each school district. However, even though school districts have considerably more discretion for spending lottery funds, no special audit routines have been developed to review the use of these funds. Moreover, since lottery funds represent only about three percent of the funds received by K-12 public education in California, these funds will receive only minimal scrutiny during the annual independent audit performed in school districts.

Similarly, the accounting and reporting on the use of lottery funds on the Annual Financial and Budget Report, and also on the special report being prepared this year by the State Department of Education in response to the Budget Act of 1985, are being performed at a very high level of analysis and do not provide detailed information on expenditures.

As a result, the existing accounting and reporting requirements for lottery funds are not sufficiently detailed to determine how lottery funds are actually being used by school districts and whether or not these funds are being spent in accordance with State law. In addition, the accounting and reporting requirements that have been developed are not commensurate with the degree of discretion exercised by school districts in spending lottery funds and are not adequate to ensure accountability and financial control.

THE STATE SHOULD INCLUDE CERTAIN EDUCATIONAL PROGRAMS IN THE ALLOCATION OF LOTTERY FUNDS

Under the current process for allocating lottery funds to K-12 public education programs, certain deserving programs, including state-funded summer school, apprenticeship, and state special schools programs, are not recognized in the calculations used to distribute lottery funds. As a result, these programs do not share in the receipt of lottery funds.

The State Department of Education provides the State Controller's Office with information regarding the total average daily attendance that is eligible for lottery funds from each school district. The State Controller's Office then uses this ADA information as the basis of determining a statewide "per capita" amount of lottery funds available for each unit of ADA. Then, the State Controller's Office makes a determination of the allocation for each school district by multiplying the "per capita" amount times the number of eligible ADA in a school district.

The State Controller's Office has specified that the ADA included as the basis for lottery revenue distribution includes all regular school ADA, special education ADA, adult ADA for state-mandated classes including pupil counts above the capped growth level, ROC/P ADA including pupil counts above the capped growth level, and state hospital students in special day classes.

Due to the way the State Controller's Office has determined the ADA that is eligible for lottery funds, the ADA equivalent of certain deserving programs operated by school districts are not included in the calculation of the distribution of lottery funds. These include the ADA equivalent of state-funded summer school, apprenticeship, and state special schools programs which represent an estimated 43,000 ADA statewide. As a result, school districts operating these programs do not receive lottery funds for the ADA equivalent of the students in these programs.

RECOMMENDATIONS

To improve the system that the State has established to allocate, use, and account for lottery funds distributed to K-12 public education, the Commission recommends the following actions:

- (1) The Legislature should require the State Department of Education, in cooperation with a task force of school district representatives, to develop guidelines for local boards of education to use in developing advisory processes for determining spending priorities for lottery funds. At a minimum, these guidelines should address the following:
 - o Defining the major steps in the advisory process for determining priorities;
 - o Ensuring an opportunity for maximum participation in the process by effected groups, including: administrators, teachers, parents, students, classified employees, students, and other interested groups; and

- o Allowing for adequate public notice of the process and for review and comment on priorities.

Moreover, the advisory process for lottery fund expenditures should compliment the annual budgetary process presently used by school districts.

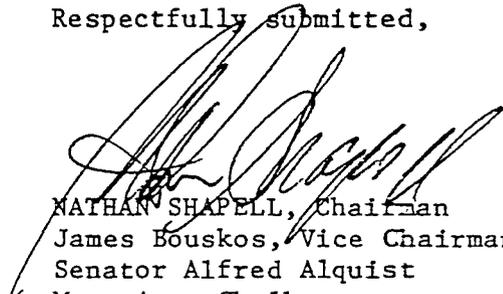
- (2) The Legislature should enact legislation that generally defines instructional and non-instructional purposes. To do this, the Legislature should first require the State Department of Education, in cooperation with a task force of representatives of school districts, to develop definitions of instructional and non-instructional purposes.
- (3) The Legislature should enact legislation that strongly urges local boards of education to use lottery funds for supplemental non-recurring expenses.
- (4) The Legislature should require the State Controller's Office, in cooperation with the State Department of Education, to develop more specific audit requirements relating to the use of lottery funds to be included in the audit manual used by certified public accountants to perform the annual audit of school districts. Specifically, these requirements should include audit tests relating to the appropriate use of lottery funds.
- (5) The State Department of Education should review and improve its current forms for collecting information from school districts on the use of lottery funds. Specifically, the Department should require school districts to provide more detailed information on the use of lottery funds by type of expenditure on the Annual Financial and Budget Report.
- (6) The Legislature should enact legislation that provides for the ADA equivalent of state-funded summer school, apprenticeship, and state special schools programs to be recognized and included in the distribution of lottery funds.

* * * * *

Based on our review of the initial allocation of lottery funds to school districts, it is apparent that the actions outlined in our recommendations are warranted and necessary to ensure that the State has established a sound and complete system to ensure the proper use, allocation, and accounting for lottery funds in its K-12 public school system. The Commission is extremely concerned with the lack of assurance that lottery funds are being used for classroom-related activities. In addition, the Commission believes that some school districts are being very short-sighted by using lottery funds for recurring expenditures, which, if lottery funds decrease in coming years, could result in deficit situations in these districts.

The Commission believes that the Governor and the Legislature should adopt the measures outlined in this report so that the public will have confidence that lottery funds are being well-spent by school districts. These measures will strengthen the financial accountability for lottery funds without undermining local control.

Respectfully submitted,



NATHAN SHAPELL, Chairman
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