GOVERNOR KASICH'S EXECUTIVE BUDGET RECOMMENDATIONS
FOR FISCAL YEARS 2016 AND 2017 – EDUCATION FUNDING FORMULA

TESTIMONY BY DIRECTOR TIMOTHY S. KEEN,
OFFICE OF BUDGET AND MANAGEMENT

SENATE FINANCE COMMITTEE – EDUCATION SUBCOMMITTEE
APRIL 29, 2015

Chairman Hite, Vice Chairman Sawyer and members of the Education Subcommittee, my name is Tim Keen, and I am Director of the Office of Budget and Management. I am pleased to be with you today to testify on Governor Kasich's Executive Budget Recommendations for fiscal years 2016 and 2017, in particular regarding proposals for the education funding formula.

I would like to begin by restating relevant portions of budget testimony I gave to the full Senate Finance Committee on April 21, then conclude with some additional remarks about changes the House of Representatives made to the governor's education proposals in its recently passed version of House Bill 64.

As I testified before the Senate Finance Committee last week:

Recommended GRF and lottery appropriations for the Department of Education total their largest amounts ever, at $8.7 billion in FY 2016 and $9.1 billion in FY 2017. This represents growth of $410.1 million, or 4.9%, in FY 2016, and another $345.8 million, or 4.0%, in FY 2017. The GRF portion of these appropriations is $7.7 billion in FY 2016 and $8.0 billion in FY 2017, representing growth of $441.2 million, or 6.1%, in FY 2016, and another $344.4 million, or

4.5%, in FY 2017. Lottery appropriations equal slightly more than $1.0 billion in both fiscal years. State education appropriations represent the largest commitment of state General Revenue Fund appropriations contained in the budget.

Foundation Formula

Total state resources allocated to the Foundation formula total $7.4 billion in FY 2016 and $7.7 billion in 2017. Of this amount, $877.7 million comes from the lottery. This includes an additional $700 million over the biennium in new state aid distributed to school districts and community schools through the formula.

The Executive Budget largely maintains the basic structure of the school funding formula enacted two years ago. We retain the nine primary aid categories: the core opportunity grant, targeted assistance, K-3 literacy funds, economically disadvantaged aid, limited English proficiency funding, gifted funding, transportation aid, special education aid, and career-technical education funding. Our commitment to ensuring that state aid is most effectively targeted to districts with the least capacity to generate local revenue compelled us to make several notable modifications, including the following:

- increasing the core opportunity grant per pupil amount to $5,900 in FY 2016 and $6,000 in FY 2017,
- increasing annual funding amounts for primary aid categories of assistance within the formula (2% increase for special education aid; 4% increase for career-technical education aid; 5% increase for K-3 literacy aid),
- updating various data elements to the most recently available data.

As the Administration began development of the education budget for the FY 2016-17, it was our intention to work within the framework of the funding formula adopted two years ago. As noted earlier, in large part we have done so. However, we identified three areas where we felt modifications were necessary to achieve the objectives of efficiently and effectively distributing resources through the formula to the districts with less capacity to raise revenues locally.

Calculating State Share

The school funding formula adopted in 2013 attempted to incorporate income into the calculation of the state share for districts where the income index was lower than the property index for that district. After almost two years of experience implementing the current school funding formula, we have determined that the manner in which the income adjustment is constructed does not appropriately incorporate income into the formula for lower property-wealth districts. In fact, the current construction of the income adjustment does very little to account for income levels for lower-wealth and is more likely to benefit higher-valuation districts. Clearly, if our theory is that we should be allocating our limited state resources to districts with the least capacity to generate local revenue, this outcome is not acceptable and cannot be continued.

Accordingly, the Governor's school funding proposal includes a modification to the current wealth index (which we propose to call the capacity measure) and the state share index (which we propose to call the state share percentage). Our proposed changes are designed to more appropriately incorporate income as a factor into the distribution of state resources, allowing the formula to more effectively target state aid to districts with a lesser capacity to generate local revenue. In order to accomplish this, the proposal compares each district's income to the statewide median income. Districts that cluster around the median income do not receive an income-based adjustment. But for districts where income varies meaningfully from the median, the income index is used to adjust the state and local share contribution for both higher and lower income districts.

Under this approach, there are 321 districts whose income clusters around the median income (within 0.5 standard deviation) who receive no income adjustment to their capacity. There are 176 districts whose lower income levels result in an increase in the amount of aid that comes from the state. Conversely, there are 114 districts whose higher income results in a greater share of their aid being delivered from local contributions. The calculation that incorporates the income adjustment for lower wealth districts will be implemented immediately beginning in FY 2016. The calculation for higher wealth districts will be phased-in gradually over a five-year period. Our analysis indicates that this approach is very effective at driving resources to districts with less capacity to generate local revenue and is a significant improvement over the income adjustment in current law.

<u>Transportation</u>

Under current law, each school district receives transportation funding based on either a cost-per-rider or cost-per-mile calculation. After a school district's transportation funding is calculated, as with other components of the formula, the greater of either the district's state share percentage or minimum state share of 60% is applied. However, if there are insufficient appropriations to pay the calculated amounts, the distributed amounts are prorated to fit within the appropriation. In the event of proration, a special set-aside for low density/low-mileage districts is relied upon to partially offset the reduction in formulaic amounts.

In our analysis of the transportation component, we noted several areas of concern. First, prorating the transportation funding to fit within the appropriation level adversely effects lower wealth districts by preventing school districts from receiving the full amount of transportation funding as calculated by the formula. Second, the use of a minimum state share of 60% disproportionally benefits wealthier districts, as any district with a state share percentage between 5% and 59% receives an upward adjustment to the minimum state share percentage factor for their transportation funding calculation.

As we set out to construct our transportation proposal, our primary objective was to fully fund the formula. This budget accomplishes that objective through a series of rational policy choices designed to most efficiently direct resources to districts with less capacity to generate local revenue. First, we determined that it was necessary to commit additional funding to the transportation component. Second, we propose reducing the minimum state percentage for all districts from 60% to 50%. By reducing the state minimum share, funds that would have previously gone to wealthier districts in order to provide them with a 60% share of transportation funding will be available for distribution to lower wealth districts.

Fully funding the formula and reducing the minimum state share within the formula eliminates the need to continue funding the low density/low mileage set-aside within the appropriation. These changes allowed us to accomplish our objective of fully funding the formula, thereby eliminating the need to prorate the appropriation in the Executive Budget, as introduced.

Transitional Aid

Transitional aid (or the "guarantee" as it is commonly referred to), has long been an element of the state's school funding formula. Most often, the guarantee in law has prevented a district's state aid from falling below the previous year's amount. However, because guarantees have been in place without interruption for many years, the guarantee is not necessarily to last year's amount, but perhaps to a formula calculation from a number of years prior. This means that the factors used to calculate guaranteed state aid levels are often the result of student population and/or property values that are dramatically different from what currently exists. The purpose of the school funding formula is to efficiently allocate state resources to school districts based on current local capacity. The guarantee short-circuits the formula and continues to direct limited state resources without regard to changing district circumstances.

The Executive Budget proposes to replace the 100% guarantee. This does not mean completely eliminating the guarantee, because we recognize that dramatic shifts in state aid could be disruptive to school programs. Instead, we propose a very modest reduction in state aid if factors indicate that a district's aid amount should be less than currently received. Under our proposal, a school district's state aid would not be allowed to fall by an amount that is greater than 1% of the district's combined state and local resources. It is our belief that this proposal better fits the concept of "transitional" aid, buffering districts from adverse funding consequences in the short run.

Cap

The current formula contains a feature known as the cap that withholds calculated aid above a specified annual percentage growth rate. Like a guarantee, but with the opposite effect, the cap short-circuits the formula, in this case withholding earned formula aid.

The executive budget maintains a cap at 10.0% annual growth in each year. However, our formula development choices will reduce the number of districts on the cap and the amount of money withheld by the cap, and should position us to eliminate the cap in the next budget.

Tangible Personal Property (TPP) Tax and Utility Deregulation Replacement Payments

I would now like to briefly discuss another proposal that impacts state distributions to some school districts: the phase-out of temporary replacement payments. State subsidy payments to some school districts will be reduced as a result of the proposal to phase out temporary replacement payments made under current law. These temporary payments were put into law as a result of the electric and gas deregulation changes to local property taxes on utility property in 1999-2000 and the gradual repeal of local property taxes on general business property that began in 2005.

The Executive Budget proposes to reduce reimbursement payments for fixed-rate operating levies by no more than 2% of the calculated total state and local resources per year over the next two years, and each year annually thereafter. You may recall that this process was actually begun in HB 153, for the FY 2012-2013 biennium, but the phase-out was suspended after FY 2013.

Actually the proposed phase-out is more nuanced than the original HB 153 phase-out proposal. In keeping with the philosophy that drove the Administration's K-12 education funding proposal, i.e. driving available state resources toward lower capacity districts, this proposal would reduce TPP and utility deregulation by only 1% of calculated resources annually for the lowest capacity districts, those in the first (poorest) quintile. Only those districts in the fifth (wealthiest) quintile would face an annual reduction of 2% of resources. For those districts in quintiles 2, 3, and 4 the phase-out percentages would be 1.25%, 1.50%, and 1.75% respectively.

Fixed-rate non-operating levies would be reimbursed at half the FY 2015 amounts in FY 2016, and then not be reimbursed in FY 2017 or thereafter. Emergency levy reimbursement, which under current law is scheduled to face total elimination in FY 2017 or 2018 (depending on whether it is for TPP or utility property tax) will instead be phased out gradually over FY 2017-2022.

This TPP/deregulation phase-out also impacts local governments, with a phase-out schedule that reduces payments by no more than 2% of state and local resources each year.

As a reminder, temporary TPP reimbursement first was put in place in 2005, with payments beginning in FY 2007, to help districts adjust to the loss of local valuation and revenue that occurred as a result of tax reform that eliminated the taxation of TPP. Utility deregulation reimbursement was put in place in 2001, following the passage of electric and gas deregulation laws in 1999-2000.

TPP reimbursement was held constant for five years, followed by seven years of reduced payments, until payments fall to zero in FY 2019. In 2011, the Administration, through HB 153, replaced this original phase-out schedule with a mechanism that reduced payments based on a district's measured reliance on the payments. Reliance was, and under the proposal will again be, measured as the reimbursement payments as a percentage of state and local resources.

As a result of the reductions in FY 2012-2013, only 260 school districts are still receiving fixed-rate operating levy reimbursement, while 352 districts have already seen their payments eliminated. There are 460 districts that are still receiving reimbursement for non-operating levies, but those amounts are very small. Total estimated reimbursement in FY 2015 for those non-operating levies is only $13.4 million, or about $29,000 per district.

The proposed phase-out of TPP and deregulation payments would actually re-conform the law to the original intent of these payments in the wake of utility deregulation and tax reform, namely to provide temporary state subsidies that would give districts time to adjust their finances under the new tax laws. These reimbursements to school districts and local governments were never intended to be permanent. It does not make sense to continue to pay state compensation for local tax revenues received from a long-ago tax system based on economic conditions that in many if not most places are much different than conditions today.

Furthermore, with regard to schools, the continued use of state revenues to make TPP reimbursement payments is not consistent with the philosophy of targeting limited state resources to districts with a lesser local capacity to raise revenue. State TPP payments to schools are significantly tilted to districts with a higher local capacity.

The Administration proposal recognizes that it has taken and will take districts time to adjust to changing circumstances. That is why the phase-out for districts with high reliance on these TPP and deregulation payments will actually extend out beyond the original elimination date of FY 2019. It is why the emergency levy reimbursements, rather than disappearing all at once as they are scheduled to do under current law, will be gradually reduced until they are eliminated in FY 2022. It is why no reduction is made to bond levy reimbursements until the levy is expired or the debt is retired. However, providing for an easier transition for school districts should not be confused with simply continuing these payments indefinitely. Eventually everyone, school districts, local governments, taxpayers, and the state must adapt to the new economic and legal realities.

<u>House-passed Changes to Executive Budget Recommendations</u>

Mr. Chairman, that concludes relevant portions of my earlier budget testimony on recommendations for the education funding formula in Governor Kasich's Executive Budget proposal.

Before concluding my testimony today, I would like to spend a few minutes discussing the school funding-related changes the House made to Governor Kasich's budget. While I will discuss seven specific House changes, I would like to begin by offering my general observations in order to add context to my remarks:

- As I have discussed, Governor Kasich's proposal builds on the current funding formula adopted two years ago by making modifications that further target resources efficiently and effectively to those districts with the least capacity to fund an appropriate educational program. To the greatest extent practical, the proposal allows the formula's calculations to determine district funding levels. Reliance on guarantees is reduced, allowing modest declines in funding when warranted by changing circumstances within districts, such as having fewer students to educate in areas of declining enrollment. The impact of caps is diminished, as policy choices are intended to steadily reduce the number of districts on the cap and the amount of funds withheld by the cap.

- In contrast, the House proposal makes a number of significant changes to the funding formula adopted two years ago, which appear to be intended to achieve two primary objectives: first, to increase funding to small districts, which are predominantly rural, but not through a mechanism primarily determined by district capacity; and second, to ensure that no district loses funding regardless of changes in districts' circumstances.

That said, I want to draw your particular attention to seven specific changes contained in the House proposal:

- Replacing the capacity measure used to determine the state share of formula aid with a 20-mill charge-off against total district valuation that is adjusted for median income.

- Utilizing a six-year rather than a three-year average of property valuation for districts where agricultural property makes up more than 20% of their total valuation.

- Phasing in a 20% minimum of the per-pupil Opportunity Grant amount for all school districts.

- Establishing a new category of aid called capacity aid, which is distributed based on how much a district can raise with one mill of local property tax effort.

- Reinstating the concept of a 100% guarantee within the formula, thereby preventing districts from receiving less state aid than they received in FY15, regardless of changing district circumstances or current local capacity.

- Reducing the maximum annual district growth rate (the cap) from 10% to 7.5%. More importantly, making a series of policy changes that more than double the number of districts subject to the cap as compared to the governor's proposal and that result in withholding more than $1.75 billion in calculated aid from school districts over the biennium.

- Providing a supplemental Tangible Personal Property Tax (TPP) guarantee to shelter districts from receiving less funding in each fiscal year than their combined funding from foundation aid and tangible personal property payments.

Mr. Chairman, members of the subcommittee, I appreciate having this opportunity to testify on the education funding aspects of Governor Kasich's Executive Budget and to point out some of my significant concerns about changes made by the House of Representatives. I am happy to answer any questions you may have.