InDepth

Understanding Texas School Finance

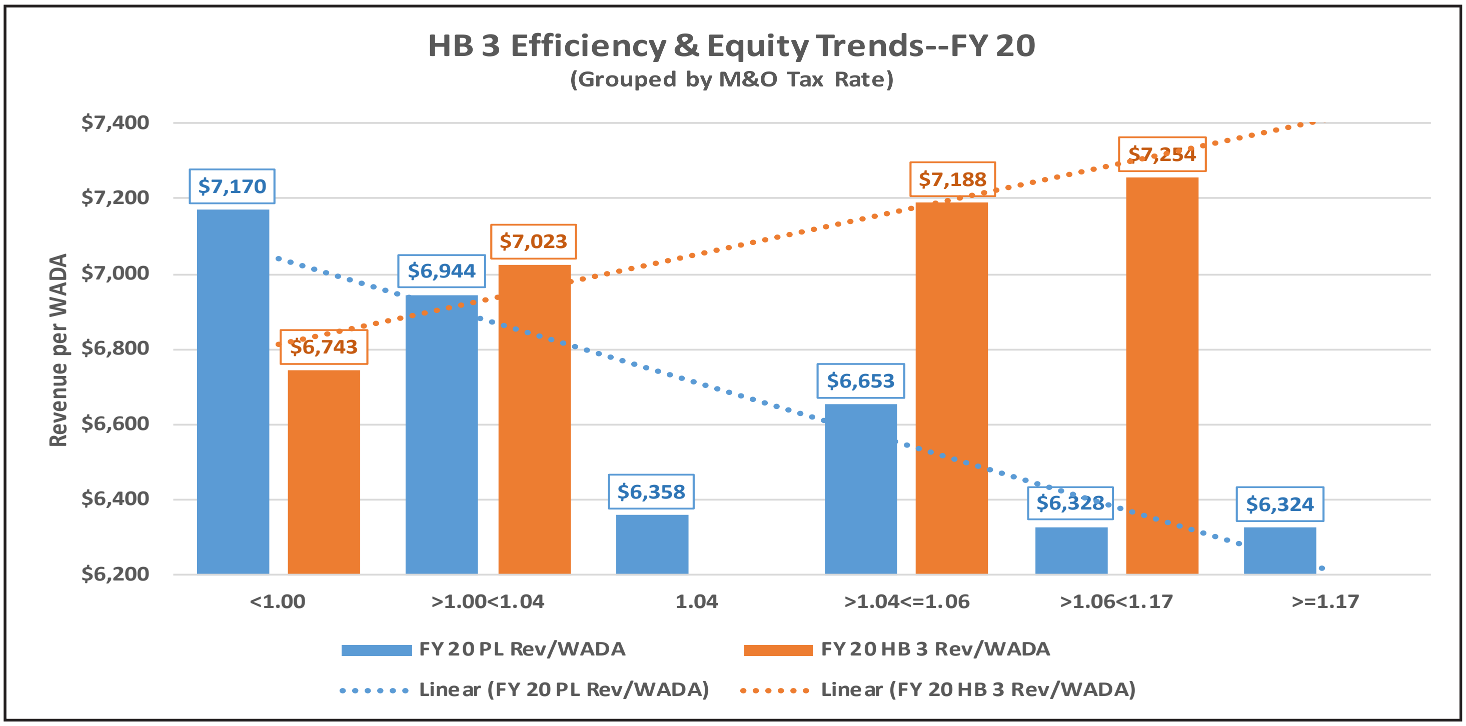
HB 3: Equity & Efficiency in a New School Finance Plan

As a general rule, the political system in our country/state doesn't necessarily work to produce legislation that is perfect or even that always benefits the majority of citizens. That said, occasionally (every 40 or 50 years or so) it seems the stars align with revenue available and the legislative personalities in place with the political will and desire to do the right thing. In the 86th legislative session, the conditions for public school finance were so iniquitous that political opportunity demanded legislative action, dramatically changing the landscape. HB 3 of the 86th Texas Legislature joins the ranks as one of most transformative and substantive rewrites of our school finance system in Texas history.

**The data in the following charts is compiled from projected data used by the legislature to determine the fiscal impact of the changes put forth in HB 3 on school funding in Texas.* While we will not know the exact district by district impact until later in the school year, the nature of the majority of the changes in HB 3 are so substantive in terms of efficiency and equity as to make the general trends in the following charts accurate reflections of HB 3's progress towards those goals.

Efficiency and Equity

An efficient and equitable funding system should be one that reflects higher levels of funding per weighted student (WADA) for greater tax effort, thereby adhering to the Edgewood school finance lawsuit's standard of similar revenue for similar students at similar local tax effort. In the chart below, the trend towards more efficiency and equity resulting from the changes made by HB 3 becomes readily apparent. *Chart explanation on page 2*



September 2019
Vol. 9, Issue 3

Equity Center

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HB 3: Equity & Efficiency... continued

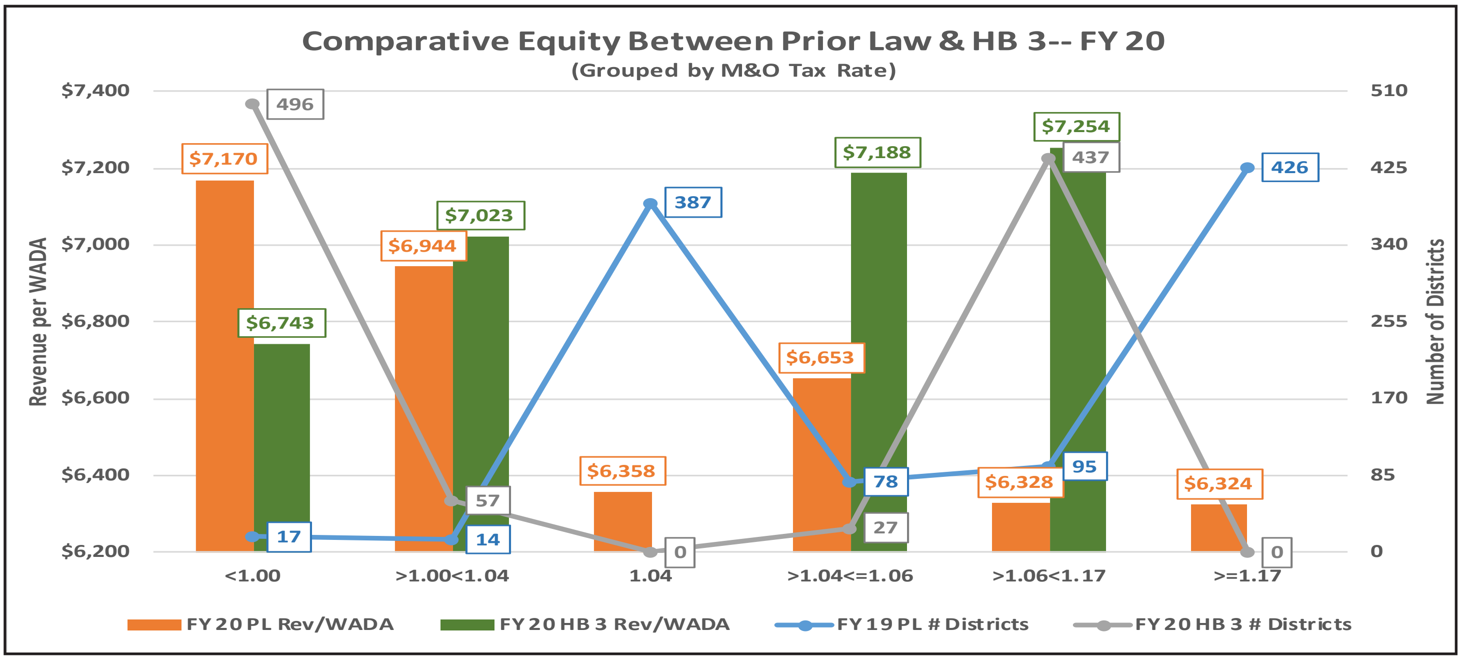
The blue columns and trend line reflect Texas' school finance system before HB 3. The trend clearly shows a system that clearly moved in the opposite direction of efficiency and equity rewarding the average district with a maintenance and operations (M&O) tax rate below a dollar with average funding per weighted student (WADA) of over $7,100 and the average district with M&O tax rates of $1.17 or higher with funding per WADA of less than $6,400. Nearly an $850 advantage per WADA for almost 20% less effort. Hardly reflective of anything resembling an efficient or equitable system of funding.

Conversely, the orange columns and trend line reflect a funding system moving in an efficient and equitable direction as the result of the substantive systemic changes brought about by HB 3. Because HB 3 moves toward a more cost based formula driven system based on entitlements determined by student costs and weights, not district wealth, average student funding per WADA is lower or higher based on the local district's tax effort.

This is reflected by the facts that under HB 3, the average district with less than a $1.00 M&O tax rate will have funding per WADA of just over $6,700 and the average district with funding over $1.06 will have funding per WADA of about $7,250. Clearly exhibiting a trend line reflective of an efficient and equitable funding system.

Comparative Equity by the Numbers

One of the major areas of change in HB 3 is the required M&O tax rate compression resulting from the bill. A further



examination of the data reflects those major shifts in the chart above. This chart reflects the same columns and averages of funding per WADA for the M&O tax rate groupings as the first chart. However the blue and gray lines in this chart reflect the changes in the number of districts in each of the tax rate groupings for both HB 3 and Prior Law (FY 2019). Again, the first column (orange) demonstrates funding under the old school finance system. The Second column (green) reflects HB 3 funding levels per WADA.

The blue line shows the number of districts under prior law taxing within each of the six tax rate groupings. The gray lines reflects the impact of the tax compression resulting from HB 3. Notice that while under prior law 17 districts had M&O tax rates below $1.00 and average funding per WADA of $7,120, with the changes brought about by HB 3, nearly 500 districts will now have M&O tax rates below $1.00 and average funding per WADA of nearly $6,750.

At the same time, under old law (the blue line) 426 districts (over 40% the districts in the state) had M&O tax rates at or above $1.17 and per WADA funding of $6,324. Under HB 3 those districts—and a few others—will average over $7,250 funding per WADA and have M&O tax rates of just over $1.06. Again, this is reflective of trend towards much greater efficiency and equity under HB 3. Additionally, this reflects the move in HB 3 for the state to pick up a substantially greater share of the cost of education. As local and statewide property value growth are used to further compression of M&O tax rates, the state's share (percentage of the total cost of the foundation school program) will continue to rise.

HB 3: Equity & Efficiency... continued

Impact of District Wealth on Funding per WADA

One of most important and transformational changes occurring from HB 3 is the move in tier 1 to eliminate the impact of district wealth on the guaranteed funding level per WADA and make that uniform for all districts, based on tax effort.

Prior law used prior year property values (ignoring the impact of growth/decline in local property values in funding available to local districts), funded districts under two different chapters based solely on local district wealth per WADA, and a variety of hold-harmlesses and non-cost based funding mechanisms within the formula to fund Texas' school finance system. This created a system that delivered a different level funding per WADA for each district, based upon the wealth of the district. That system became too heavily dependent on local property tax collections.

Because the wealth per WADA of school districts vary so greatly across the state (see the table below), prior law essentially established a system of funding that rewarded high local district wealth and low tax effort while punishing districts with lower wealth and higher tax effort - an inefficient, inequitable and inadequate funding system.

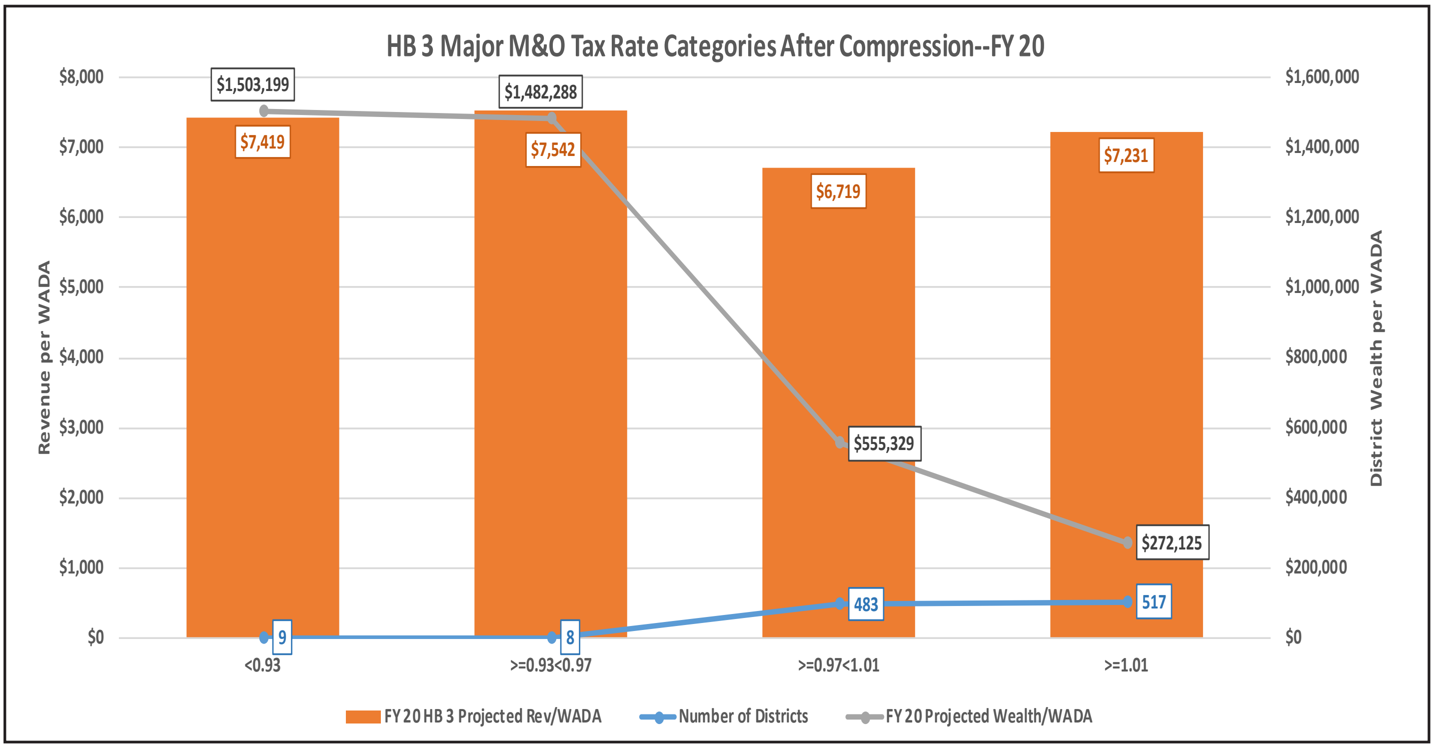
FY 19 Variation in Levels of Wealth per WADA Among Texas School Districts			
	Wealth per WADA	Wealth per WADA Gap	Wealth per WADA Ratio, Highest to Lowest
Wealthiest District	$5,778,730	-$5,760,324	314:1
Poorest District	$18,406		

HB 3 moved to correct most of the inefficiencies in Tier 1 by making these major changes:

- Moving to the use of current year values,
- Eliminating or phasing out the hold-harmlesses and non-cost based elements in prior law,
- Compressing Tier 1 M&O Tax rates statewide, and
- Funding all districts under the same formula in the same chapter, thereby guaranteeing the same level of Tier 1 funding per WADA for all districts that tax at the Tier 1 M&O tax rate.

Tax Compression Impact

As mentioned earlier, Tier 1 tax rate compression helps to create a system that maintains efficiency and state share of the overall funding system. As shown in the following chart, it also has the impact of moving overall tax rates and per WADA funding in a more equitable direction. *Chart explanation on page 4*



HB 3: Equity & Efficiency... continued

The four orange bars in the chart reflect the major M&O taxing groups after HB 3 compression. The gray line reflects the average property wealth per WADA of the districts in each taxing group. The blue line reflects the number of districts in each taxing group. The overall efficiency and equity achieved in HB 3 is readily apparent in the two taxing groups on the right of the chart. The districts with higher tax effort have higher revenues per WADA, regardless of district wealth. Additionally, the tax rate compression of HB 3 reduces the tax rate gap for those groupings to about 10 cents. This is partially created by the increase in yield and the accompanying compression of the Tier 2 copper pennies.

Additionally, notice that almost all districts (1,000) fall in those two groupings. The anomaly occurs for the remaining districts that fall in the lower tax groupings. As seen on the chart, those districts are among the wealthiest in the state and they maintain on average, higher per WADA funding levels than the rest of the state.

This is the result of transition and hold-harmless aid rolled forward for five years in HB 3. It will be imperative that the five year mandatory end of these transitions is maintained for HB 3 to become as efficient and equitable as designed and intended. Once again, this graphically demonstrates the constant fact that non-cost based funding elements intended to help or protect funding for a special or particular group of districts always results in the inefficient and inequitable use of state resources. Anytime that occurs, it is detrimental to all other districts because it eats up valuable resources that otherwise, would have been available to increase funding elements for all districts.

<u>Political Solutions Seem Never to be Perfect</u>
As pointed out at the start, political solutions are political. HB 3, while making great progress in moving our funding system in the proper direction, is not perfect. As discussed in the other articles in this issue of the InDepth, there are still things we need to work on to make our new funding system better.

That is where we go from here!

New Tax Rate Calculations Explained

Major changes to tax rates came with HB 3. Rollback rates became voter approval rates, and the calculations for these tax rates changed completely. Compression was added for the Tier 1 and Tier 2 Level 2 rates. One positive change was that the voter approval rate (the old rollback rate) calculation became much simpler. For FY20, it is the Tier 1 rate of 0.93 plus the maximum of 0.04 or the number of the prior year enrichment pennies (after copper penny compression). For FY21 and beyond, it is the district's Tier 1 rate (explained below) plus the maximum of 0.05 or the number of the prior year enrichment pennies.

Tier 1 Rate

Calculation of a district's Tier 1 rate in FY20 is the minimum of 0.93 or 93% of the prior year adopted tax rate. For FY21 and beyond, a statewide compression percentage has to be calculated first. This is based on the prior year state compression percentage and the estimated percentage change in total taxable property value based on the estimate submitted to the legislature for the appropriations bill. The formula is:

SCP = PYCP X 1.025 / (1 + ECPV)
SCP = 0.93 X 1.025 / (1 + 0.0401)
SCP = 0.916498

In the above formula, SCP is the state compression percentage, PYCP is the prior year compression percentage and ECPV is the estimated change in property value. Using an estimated increase of 4.01% for Tax Year 2020 and 0.93 for the prior year compression percentage, we can calculate the state compression percentage of 0.916498. Since this is lower than the prior year compression percentage of 0.93, this is the new state compression percentage, meaning no district's Tier 1 rate can be higher than this, but it can be lower.

The formula to calculate a district's maximum compressed rate is the minimum of the statewide compression percentage or, if the current year property value exceeds the prior year property value by 2.5% or more, the value from:

MCR = (1.025 ((PYDPV + E) X PYMCR)) / DPV
MCR = (1.025 ((110,302,808,080 + 0) X 0.93)) / 121,722,822,653
MCR = 0.863816

In the above formula, MCR is the district's maximum compressed rate, PYDPV is the prior year property value, E is any property value that was subject to a limitation under Chapter 311 or 313 in the prior year and is no longer excluded, PYMCR is the prior year maximum compressed rate, and DPV is the current year property value. There is a low limit that a district's maximum compressed rate cannot be below of 90% of the statewide compression percentage, or 0.824849 for FY21, which our example above is not below.

Tier 2 Rates and Copper Penny Compression

The next 8 pennies are the golden pennies. There is no compression on these. The remaining 9 are copper pennies and are compressed in any year that the basic allotment is increased. The equalized level, or the amount per penny per WADA, is a factor of the basic allotment, specifically the BA x 0.008. To calculate the compression in a year that the BA is increased, you use this formula:

CYCoP = PYCoP X (PYEL / CYEL)
CYCoP = 9 X (31.95 / 49.28)
CYCoP = 5.835

In the above formula, CYCoP is current year copper pennies, PYCoP is prior year copper pennies, PYEL is prior year equalized level and CYEL is current year equalized level. Using FY20 and 9 copper pennies as an example, copper pennies are compressed to 5.835. In years with compression, a district cannot increase the number of copper pennies that it is compressed down to.

As the property value in our state increases throughout the years, the state compression percentage will drop, lowering all districts' tax rates. This will not decrease entitlement, rather it will change the source of funding from local to state.

Ray & Wood

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For over a decade, Ray & Wood has successfully represented over 100 school districts in the administrative process leading up to the State Comptroller's Property Tax Division's (PTD) final determination of estimated property values. We offer our school district clients an unparalleled combination of legal, professional and technical expertise in the area of property value studies-and we get results. We help school districts maximize their state aid or minimize their local tax revenue recapture through our Local Tax Roll Quality Assurance Program. We also offer our school districts comprehensive administrative, and if necessary, judicial appeal representation.

Randall Buck Wood
Partner and Co-Founder

Doug W. Ray
Partner

The Ignored Cost of Facilities - An Interim EC Study

Let's begin with **10 Shocking Facts** regarding Texas funding for school facilities:

1. The State of Texas covered less than 6% of the cost of bond payments in 2018-19.

2. According to the Texas Education Agency's Summary of Finance (SoF), state spending under the Existing Debt Allotment (EDA) and the Instructional Facilities Allotment (IFA) peaked in fiscal year 2002 at just under $800 million (combined).

a. TEA's SoF for FY20 shows the funding level will drop to just over $340 million - and, that's in actual dollars, not inflation adjusted, which understates the true drop.

b. Interest & Sinking (I&S) tax collections for the same year are estimated at $7.3 billion.

c. That drops the state share to 4.4%!

3. Between FY2002 and FY2019, state EDA and IFA funding dropped by half even though student enrollment increased by more than 1,270,000 (30.5%), and

4. EDA and IFA were first implemented in the 1999-00 school year with 91% of the State's students in average daily attendance (ADA) in eligible districts. Twenty years later (in FY19), that percentage has fallen to only 25% of ADA in districts eligible to receive state funding.

5. The State's FY 2019 guaranteed yield (originally $35 per ADA) for:

a. Existing Debt Allotment has increased only $1.65 in the 20 years since the EDA's inception (only 8.25 cents (0.2%) per year on average), and only then because the Legislature was instituting new facilities funding for Charter Schools.

b. Instructional Facilities Allotment has not increased at all in 20 years.

6. The I&S tax rate for 118 districts exceeded $0.40 in 2018-19. Only 8 districts taxed that high in FY2000.

7. Many property-poor districts struggle to pay for necessary instructional facilities, but receive no state assistance and must rely 100% on local property taxpayers.

8. The State has ignored the marked increase in the cost of construction of educational facilities.

9. Fast-growth districts, which are in continuous need for new and ever-costly facilities, suffer the most from the State's lack of an adequate facilities funding program.

10. Since there is no recapture provision for I&S tax collections, very wealthy districts are able to use short-term bonds to circumvent recapture and supplement Maintenance & Operations revenue, creating a stealth inequity above the inequities that already exist on the M&O side.

Want to help rewrite Facilities Funding?

Contact us today to participate in the Equity Center Interim Facilities Funding Study!

In spite of these undeniable and serious facts, the State has never conducted a study to actually determine an appropriate funding level and to develop a funding system that fairly and adequately met those real, inescapable costs. For that reason and in conformity with its guiding principle of advocating for the fair treatment of all Texas school children and taxpayers, the Equity Center is committed to conducting an interim study on facilities funding. For that purpose, we have asked school finance expert, Dr. Wayne Pierce to find a solution to these problems with the active participation of school superintendents, chief financial officers, and other appropriate school officials in Equity Center districts to organize, direct, and conduct the study, which will begin in the fall.

Initial goals (subject to change by participants):

1. Determine the actual costs (and their growth) associated with new facilities and maintenance of existing ones, taking into account geographic factors, where possible;

2. Identify hidden "gotchas" in current law;

3. Develop data to demonstrate the relative I&S tax effort among districts and its impact on other aspects of the total funding system;

4. Create a new state facilities funding system that fairly and adequately funds both construction and maintenance of school facilities; and to

5. Determine strategies to engage district personnel in other districts so they can become acquainted with and actively support the improved system.

The completed study will be presented by study participants to the Equity Center Board of Directors, for inclusion in the Equity Center's Legislative Agenda for the regular session in 2021. ***Want to participate? If you are interested and will be able to devote the necessary time in this exciting endeavor, contact us TODAY! (512-478-7313) or email us:*** info@equitycenter.org ***- please note Facilities Study in subject line.***

Looking Ahead to the 87th

The philosopher John Rawls made popular a long-held concept when he suggested applying the "veil of ignorance" experiment to political philosophy. After being involved in the development of House Bill 3, this idea seems particularly relevant and I would suggest this exercise is useful and necessary as we continue working on perfecting school finance policy. The idea goes something like this: You are king for a day, and for the purposes of school finance discussions, you develop a statewide school finance system from the ground up, exactly as you would like it in every way. The catch is that you do not know where in the state, in which district, that you, your children and/or grandchildren will end up.

Do you develop a system that gives clear and distinct advantages to some students and taxpayers, or does the system reflect the idea of "similar revenue per similar student at similar tax effort?" Would funding be distributed differently in every district depending not only on that district's property values, but also on variations in each district's property values from year to year, regardless of what actual costs are? We believe that given this opportunity, each of us would choose the standard of fairness and neutrality that our existing statutes call for but on the whole have failed to deliver for far too long.

House Bill 3 was monumental, structural reform from a statewide perspective; however, for all of the progress made in HB 3, there are still key issues to address. Now, with some of the core problems resolved, it allows us to focus on what is still impacting our system of distributing the state's resources.

<u>Facilities</u>

Facilities funding is perhaps the biggest issue to draw attention to, and was not addressed in HB 3. State assistance for Interest and Sinking (I&S) funding has been nearly stagnant since the Instructional Facilities Allotment (IFA) and Existing Debt Allotment (EDA) were created in 1997 and 1999. The yields on facilities funding remained unchanged until HB 21 (2017) added $60 million to the EDA, effectively increasing the yield by less than $2 per penny of tax effort. Texas enjoys a booming economy and growing state population; however, with this growth comes the need for new and updated facilities... and new and updated facilities funding.

Recommendation: Substantially increase state assistance for facilities funding to drive up and move the yield for I&S programmatic funding towards the 1999 standard of 91% of students in districts that qualify for state assistance for I&S. Eliminate the 29 cent limit on EDA assistance. Determine the best use of state funds to identify and support fast growth school districts.

<u>Collections versus Values</u>

The school finance formulas exist for a reason - to identify the legitimate costs schools face in providing a quality education to every student as determined by the state's standards, and to fund those costs accordingly. Through the old system of using prior year values to determine state funding, actual formula funding was never delivered. Districts were subject to the whims of property valuations from year to year. HB 3 moved the system to current year values - a significant improvement in stabilizing funding. Using current year values ensures that property value fluctuations do not result in windfalls or deficits in revenue for districts, and creates more equity within the school finance system.

Recommendation: Further refine the system and move to current year <u>collections</u>/guaranteed allotment for all districts to reflect the actual revenue school districts collect, rather than the proxy reflected by property valuations.

<u>LOHE</u>

Mandatory state-subsidized funding for Tier 1 recapture districts opting to offer lower effective tax rates to their homeowners began in 2017, when the Texas Education Agency announced the reinterpretation of an existing rule. The change provided funding for 50 percent of a recaptured district's local option homestead exemption (LOHE). HB 3 eliminated Chapters 41 and 42 of the Education Code and put all schools into Chapter 48 to signify that all districts would be funded similarly under the same laws, with one exception: schools subject to recapture (now referred to as revenue in excess of entitlement) will have up to 100 percent of their LOHE paid for by the state (through credits to ensure their entitlement is met). Because of the most-recent interpretation (summer 2019), this same standard is not applied to non-recaptured districts.

Recommendation: Follow the spirit of HB 3: treat all school districts equally as it pertains to the recognition of local option homestead exemptions. As made clear in HB 3 discussions, the state should provide funding for this purpose for <u>all or none</u>.

Looking Ahead to the 87th... continued

Tier II

The policy rationale behind having three separate yields on pennies of tax effort has never been explained, we believe there is no solid reason for these funding differences. Last session, the legislature made several changes to Tier II funding, some welcomed and some harmful, involving both golden and copper pennies. One of the unwelcomed changes was to further exacerbate inequities in enrichment funding by increasing the number of unrecaptured golden pennies to eight. Additionally, HB 3 reduced the yield on those pennies from the Austin ISD level (which represents approximately the 99th percentile of wealth - $126.88 in 2020), to the greater of the 96th percentile of wealth or 160 percent of the Basic Allotment ($98.56). On the positive side, the copper penny yield was increased for the first time since they were created in 2006.

Recommendation: There are still remaining, unnecessary complexities in the system. Move to a single tier yield that treats every penny of M&O tax effort the same.

Identifying Costs: Small and Midsize Adjustment and the Cost of Education Index

The elimination of the Cost of Education Index (CEI) caused major funding problems for many school districts and will continue to as long as there is no recognition of costs that vary from one market and region to the next. The varying costs recognized through the CEI do not cease to exist simply because the CEI has been eliminated. To the legislature's credit, they did not entirely abandon the notion that these variations in costs exist and included in HB 3 the requirement for TEA to conduct a study on variations in geographic costs and transportation. Similarly, HB 3 changes to the Small and Midsize adjustments negatively affect more than half the districts in the state and fail to recognize economies of scale costs for certain student populations.

Recommendation: Include extensive research through the upcoming study on geographic variations in costs and implement the study's findings. Include automatic updates in the data utilized for the new index to ensure data does not become outdated, as was the case with the CEI. Reinstate the Small and Midsize adjustments as district adjustments that reflect all student populations.

If there is a better way to fund our childrens' educations, then we should continue to aspire toward it. We should continue to work for it, to demand it. This is why you are members of the Equity Center; this is our mission.

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