

RESTRUCTURING PUBLIC SCHOOL FINANCE

How Can the Legislature Increase Local Control Over and Accountability for K-12 General Education Spending?

Summary

California provides K-12 general education programs to its children through a partnership between the state and about 1,000 local school districts. About three-fourths of the proposed \$22 billion in K-12 education funding from the state General Fund and local property tax sources supports general-purpose spending by school districts. Although the state determines the level of general-purpose funding that districts receive, districts have significant discretion in how funds are used.

This separation of state control over the level of general-purpose funding and district control over local spending has had positive and negative consequences. On the positive side, state control over the level of revenues has achieved substantial interdistrict equalization of general-purpose funding per pupil. On the negative side, restricted local ability to control revenue levels has hampered the ability of districts to meet local preferences for educational services, and to work with other local agencies to craft innovative responses to local needs. In addition, the separation between revenue control and spending control allows local decision-makers to disclaim accountability for outcomes. This becomes a particular concern in those situations where school district spending commitments exceed available resources.

We suggest an approach to K-12 education funding that would increase local control over the level of general-purpose education revenues and local accountability for outcomes, without compromising the state's fundamental interest in ensuring an adequate education for all. Specifically, while we believe that the state should continue to provide the substantial majority of school funding, we recommend a local option property tax that (1) raises a meaningful incremental amount of general education revenues and (2) is implemented in such a way as to give districts equal ability to generate revenues regardless of property tax wealth. Together with reforms of K-12 categorical programs that we have proposed elsewhere, this approach would give school districts added flexibility in developing creative responses to local educational needs at a time when such responsiveness appears to be much in demand.

INTRODUCTION

Over the past three years, we have conducted a major review of California's system of state and local government that provides services to the state's citizens. We have concluded that this system is dysfunctional—characterized by state and local agencies working at cross-purposes, counterproductive fiscal incentives, lack of accountability for program outcomes, and erosion of local control over the levels and mix of services, among other problems. Accordingly, in our analysis of last year's budget, we recommended ways the Legislature could reorganize state and local government program responsibilities. We offered a general model of a more rational system of government for the state—a plan for “making government make sense”—and recommended that the Legislature proceed to implement this plan.

This section applies the principles of the model to the education of California's children. Specifically, it examines the history and problems of the state/school district partnership in financing K-12 general purpose education programs, and suggests a plan for improving the relationship. In other recent reports, we have discussed reform of special purpose—“categorical”—K-12 programs, vocational education programs, and California's educational outcomes in comparison to other states.

FUNDING K-12 GENERAL EDUCATION: DYNAMICS AND PROBLEMS OF THE STATE/LOCAL PARTNERSHIP

In the current system of financing K-12 general education programs, funding responsibility and spending control reside at different levels of government. The state determines the level of funding and the broad framework of educational policy, while local school districts, governed by boards of education, make the policy and spending decisions that determine the specific shape of local education programs. County Offices of Education occupy an intermediate place between the state and school districts. They provide business and curriculum services to school districts, provide some specialized instructional programs, and oversee school district financial performance on behalf of the state. County offices and school districts together are called local education agencies (LEAs).

A positive result of state control over LEA revenues has been substantial interdistrict equalization of general-purpose spending per pupil. The separation of control over funding levels and control over spending, however, has also resulted in erosion of local fiscal accountability, a diffusion of accountability for program outcomes, and erosion of local control over the level and type of education services offered.

State Determines the Level of General-Purpose Funding

General-purpose funding for school districts supports the core educational programs provided at the local level. This funding totals about \$16.4 billion from state and local sources in 1993-94. State aid, generally called “apportionments,” supports about 56 percent of the total, and local property tax revenues support the rest (the mix of state and local revenues varies widely from district to district). The state, however, funds virtually all of any increase in spending. This is because of requirements for interdistrict equalization of general-purpose funding, Proposition 13 constraints on *ad valorem* property tax revenues, and the absence of significant local revenue alternatives to the *ad valorem* property tax.

Equalization Requirements

The maximum amount of general-purpose revenue that a school district may receive in any year is determined by a revenue limit. A district's revenue limit generally is the amount of funding per pupil that the district received in the prior year from unrestricted state aid (apportionments) and local property tax revenues, adjusted for inflation. Revenue limits originated in response to the California Supreme Court's ruling in *Serrano v. Priest*, which found that interdistrict differences in general-purpose spending were so dependent upon local property tax wealth as to infringe upon the constitutional rights of pupils in low property wealth districts. The court determined that the state's school finance system should be structured so as to reduce wealth-related spending disparities between districts to amounts less than \$100 per pupil. This \$100 band has subsequently been adjusted for inflation.

Through several legislative measures that limited the annual inflation increases permitted for districts with above-average revenue limits, and about \$1.4 billion in equalization aid to “level up” school districts with below-average revenue limits, the state has made substantial progress in equalizing general-purpose spending. In 1974-75, when *Serrano* was originally decided, 51 percent of pupils were within the specified \$100 per pupil band. In 1991-92, 96 percent of pupils fell within the specified band (about \$300 per pupil after adjustment for inflation). Virtually all of the pupils outside the range are in districts with revenue limits that are *above* the band. In its most recent review of *Serrano* (1986), the California Supreme Court let stand an appellate court ruling that the state had fully complied with the requirement to reduce wealth-related disparities in per-pupil spending to insignificant differences.

Proposition 13

Proposition 13, adopted by state voters in 1978, capped local *ad valorem* property tax rates at 1 percent of assessed value and capped growth in assessed value at 2 percent per year. This reduced by about 54 percent the amount of property

taxes available to fund services provided by cities, counties, school districts, and other governmental agencies. An *ad valorem* property tax is levied on the assessed value of real property, as distinguished from a property tax that levies a fixed dollar charge per parcel or square foot, regardless of property value (commonly referred to as “parcel taxes”). Reliance on parcel taxes, although growing, is limited.

Following adoption of Proposition 13, the Legislature took a number of actions to specify how the remaining local property tax revenues should be allocated and to provide state funding for services that had previously been supported by local property tax revenues.

These actions had two significant effects on general-purpose funding for school districts. First, by reducing local property tax revenues for the schools, they significantly increased the role of the state in supporting school district general-purpose funding. The state share increased from one-fourth of general-purpose funding prior to enactment of Proposition 13 to about two-thirds in the year after enactment.

Second, these actions eliminated local discretion over general-purpose funding levels. Prior to Proposition 13, a district's revenue limit effectively capped property tax revenues for support of K-12 schools. Because revenues for most districts were below the cap, any change in funding from year to year was a subject of local discretion.

Since Proposition 13, each school district has received its share of the 1 percent local property tax based on allocation formulas fixed in state statutory law. A district's entitlement to state aid has become the difference between its revenue limit and its allocation of local property tax revenues. This means that changes in general-purpose funding—such as cost-of-living adjustments—are at the discretion of the state, and are determined as part of the state's budget process. (There are a very few districts—“basic aid” districts—in which the allocated level of local property taxes exceed the revenue limit. In these districts, the spending level is not determined by the state—they receive only the constitutionally required minimum state funds of \$120 per pupil—but is instead determined by growth in the assessed value of property.)

Limited Local Revenue Alternatives

While school districts now have no control over the amount of revenues they receive from *ad valorem* property taxes, they do have some limited local options for raising general-purpose revenues. These options, however, have not generated significant additional local revenues for most school districts. This is because they generally require approval by a two-thirds majority of voters, or because they have very limited revenue-raising potential. Existing local revenue options primarily include parcel or square footage taxes and a county-wide sales tax.

- **Parcel Taxes.** Upon approval by a two-thirds majority of voters, a school district may impose a flat tax per parcel or square foot of real property (the tax is not based on the assessed value of property). Since 1984, 41 districts

have had successful parcel tax elections. About 37 percent of all parcel tax elections by school districts have been successful. In 1991-92, parcel taxes generated about \$46 million for school districts statewide. Legislation (SB 1, Hart) that would permit imposition of parcel taxes on approval by a simple majority of voters was approved by the Legislature in 1993 but vetoed by the Governor.

- **Local Option Sales Tax.** Chapter 14X, Statutes of 1991 (AB 17X, Willie Brown), permits formation of a local finance authority that, upon agreement of 50 percent of the school districts in a county, can call for an election to authorize a county-wide one-half cent sales tax to benefit public education and various county programs. Imposition of the tax requires approval by a simple majority of county voters. This tax has the potential to raise significant revenues for schools—as much as \$1.4 billion statewide, if approved in all counties. Recent court decisions, however, call into question the constitutionality of levying this tax without approval by a two-thirds majority of voters. The City and County of San Francisco is thus far the only county to impose such a tax—it did so with a greater than two-thirds margin.

Existing System Does Not Encourage Local Control or Local Accountability

From a state fiscal perspective, the separation of funding responsibility and spending control causes two problems. First, it allows local boards to disclaim responsibility for outcomes, by blaming problems on the level of funding provided by the state. The state is held accountable for local spending decisions and, in effect, accountability for local spending decisions is diffused among voters statewide. Moreover, since the level of local taxes is not at stake in determining the level of school funding, schools are not fiscally accountable in any direct sense to local voters, and local voters are insulated from the full fiscal consequences of failures by elected school board officials or their appointees.

Second, this gap becomes a concern in those situations where school district spending commitments exceed available resources. Although the vast majority of school districts have budgeted responsibly, even in the recent period of declining “real” (inflation-adjusted) revenues per pupil, the state has paid out over \$75 million in emergency loans over the past ten years to ensure that classrooms stay open and staffed in some districts. This is because the California Supreme Court has held that the state bears the ultimate responsibility for basic equality of educational opportunity in California. As affirmed recently in regard to the Richmond Unified School District in *Thomas K. Butt v. State of California*, the state is required to step in when a school district's financial problems threaten to close its schools and thereby deny its students educational opportunity on par with their peers in other districts.

From a local perspective, restricted ability to control revenue levels may hamper school districts' ability to meet local preferences for educational services, and to work with other local agencies to craft innovative responses to local needs. For example, local control of spending levels would give school districts more flexibil-

ity to get involved in identifying and working with children in need of community-based services. Local discretion in determining school revenue levels is certainly not the only issue to be addressed in efforts to improve school-community linkages. The lack of it, however, deprives local school officials, their counterparts in other local governments, and voters of an important incentive to exchange views over and build consensus about educational programs, community priorities, and desired outcomes.

RESTRUCTURING PROPOSAL

Principles for Reform

The approach we offer to address the issues of accountability and local control discussed above maintains the state's predominant role in public school finance, but allows for some significant local flexibility to raise revenues at the margin and thus locally determine revenue levels for general education programs. It is consistent with the general model of state/local government relationships we discussed last year in *Making Government Make Sense*.

In Figure 9, we summarize the principles that form the basis for our recommendations about education finance. The first two principles—align funding responsibility with spending control and provide local control over local revenue levels—come directly from *Making Government Make Sense*. The third principle—local option revenues should be wealth-neutral—is unique to education. We then identify (1) our major conclusions from *Making Government Make Sense* about the structure of state/local relationships and (2) implications for school finance reform.

Proposed Funding Model

The thrust of the model we propose is to provide the existing level of general-purpose spending primarily through state aid, with local authority to raise limited additional local revenues. Essentially, base funding levels would be the same as under current law, but districts would have significantly more ability to raise local revenues and thereby control local funding levels. The model is summarized in Figure 10.

“Foundation” Spending Supported by State. In the proposed funding model, the state would continue to guarantee a district's current level of general-purpose spending per pupil with inflation adjustments, as it does under existing law. Funding for this “foundation” level of spending would come primarily from state aid, offset to a limited extent by whatever local property tax revenues remain with the district after most are reallocated to cities and counties.

Local Option Taxes. School districts would be permitted to increase their general-purpose spending beyond their revenue limit up to a specified target level per pupil through a voter-approved increase in the *ad valorem* property tax rate. Specification of an expenditure cap serves to limit (1) the potential local tax

burden, (2) state equalization expenditures as explained below, and (3) the disequalizing potential of the local revenue option.

Figure 9

Framework for Reform of School Finance

Principle: State and local government duties must be clearly defined through appropriate alignment of control and funding responsibilities

Conclusions in *Making Government Make Sense*

- To ensure maximum responsiveness to local needs and preferences, local agencies should be responsible for both control and funding of most local services.
- However, due to the state's interest in ensuring an adequate education for all, the state should have primary responsibility for K-12 funding.

Implications for school finance reform

- School districts should continue to have primary responsibility for operating education programs.
- County offices should be continued and strengthened as the fiscal oversight arm of the state.

Principle: Local communities should control local revenues necessary to fund local service preferences

Conclusions in *Making Government Make Sense*

- State Constitution should be modified to allow simple majority of voters to alter existing 1 percent limit on local property tax rates.
- State and local appropriation limits in the State Constitution should be repealed.
- After reallocation of property tax revenues, revenue growth should be allocated to school districts and local governments where growth occurs.

Implications for school finance reform

- School districts should have enhanced local revenue-raising capability to promote local program control and accountability.
- Local revenue option could be based on local property tax.
- Local property tax revenues should be spent where they are raised.

Principle: Local option revenues for education must be wealth-neutral

Implication for school finance reform

- State must ensure that interdistrict variations in level of locally generated revenues do not depend on local tax base wealth.

Figure 10**Elements of Proposed Model****State Funds "Foundation" Level of Spending**

- Existing revenue limit funding formulas, with cost-of-living adjustments.
- Primarily from state aid, with some local property tax revenue.

School Districts Provide Added Funding Through Local Option Taxes

- Additional funding limited by state-specified expenditure cap.
- Voter approval required—simple majority vote.
- State guarantees equal revenue for equal tax effort through matching grants.

Equalize Revenues Based on Tax Effort. In order to satisfy the requirements of *Serrano*, the state would have to take steps to ensure that the amount of revenue raised for any given level of tax effort was similar among districts. This is because a low property tax wealth district (relatively low assessed value per pupil) requires a higher tax rate to generate a given level of spending per pupil than does a high property tax wealth district. In *Serrano*, the court ruled that such differences are unacceptable to the extent that they result in significant disparities in per-pupil spending between districts.

The state could approach this equalization objective in a number of different ways. All involve some level of state-funded match, or “reward” for school district tax effort in order to guarantee that a district receives a given level of revenue if it levies a specified local property tax rate. In the next section, we discuss options for designing such a system, generally referred to as a “guaranteed yield program.”

Guaranteed yield programs of the type illustrated below appear to offer the best hope of ensuring that a local revenue option for school funding does not generate wealth-related disparities in per-pupil spending levels among districts. They do not guarantee a wealth-neutral outcome, however. For example, even though all districts are guaranteed equal revenue for equal tax effort, it may turn out that high property tax wealth districts are consistently more likely to make the effort or make a higher level of effort than other districts. To the extent that such differences significantly exceed the level tolerated by the *Serrano* decisions—currently about \$300 per pupil—a guaranteed yield approach to school funding could be vulnerable to legal challenge. The state could mitigate this risk by capping the total amount of revenue that may be generated.

Equalization Program Examples

Below we discuss three examples of guaranteed yield programs. These examples are intended to be illustrative, not exhaustive. Actual selection of an approach would involve extensive district by district modeling of several different approaches, an effort that is beyond the scope of this report. Selection of an approach would most importantly strike a balance between two concerns: (1) level of state equalization costs and (2) extent to which the likely distribution of per-pupil spending among districts is acceptable under *Serrano*.

In each example below, the state subsidizes districts with lower assessed value per pupil in order to reduce the level of local property tax effort required to obtain a given amount of revenue—\$300 per pupil. Also in all examples, the state imposes a limit on the maximum amount a district can raise through a guaranteed yield program—no district may end up spending more than 110 percent of the statewide average revenue limit for districts of its size and type.

We use \$300 per pupil as the target level of additional revenue because it is about 10 percent of average revenue-limit spending per pupil for districts in California. Thus, under a 110 percent spending cap, the average district participating in a guaranteed yield program could raise up to \$300 per pupil. Finally, all three examples include four districts with assessed value (AV) per pupil ranging from \$200,000 to \$1 million, with an AV per pupil of \$315,000 in the average district. This AV profile corresponds roughly to the AV profile of unified school districts in California.

Example 1: Full Equalization

In this example, a district that wants to generate a target level of funding per pupil would be required to levy a set tax rate. This tax rate would be the rate required to generate the target level of funding per pupil in the district with the *greatest* assessed value (AV) per pupil.

Part A of Figure 11 illustrates the results of this approach for four hypothetical school districts, each of which elects to raise \$300 per pupil. The district with the greatest AV per pupil (\$1 million per pupil) would be required to raise property taxes by 3 cents per \$100 of AV to obtain \$300 per pupil. To raise the same \$300 per pupil, other districts would also be required to levy the same 3-cent property tax rate. In these districts, however, this level of tax effort would generate less than \$300 per pupil in property tax revenues. The state would fund the difference. For example, a tax of 3 cents per \$100 of AV in the average property tax wealth district would yield \$95 per pupil in property tax revenues. The state would therefore provide a matching grant of \$205 per pupil. The lower a district's AV per pupil, the greater the amount of state aid supplied as a match for local effort. From the state's standpoint, this would be the most expensive possible matching grant approach to equalization.

Figure 11

Guaranteed Yield Illustrations State Match Necessary to Deliver \$300 per Pupil

School District	Assessed Value (AV) Pupil	Required Tax Rate (Per \$100 AV)	Local Revenue Raised per Pupil	State Match per Pupil	Total Revenue to District
A. Example 1: Full Equalization					
High wealth	\$1,000,000	0.03	\$300	—	\$300
Average wealth	315,000	0.03	95	\$205	300
Low wealth	275,000	0.03	83	217	300
Low wealth	200,000	0.03	60	240	300
B. Example 2: Low-Wealth Equalization					
High wealth	\$1,000,000	0.03	\$300	—	\$300
Average wealth	315,000	0.10	300	—	300
Low wealth	275,000	0.10	262	\$38	300
Low wealth	200,000	0.10	190	110	300
C. Example 3: Power Equalization					
High wealth	\$1,000,000	0.10	\$1,000	-\$700	\$300
Average wealth	315,000	0.10	300	—	300
Low wealth	275,000	0.10	262	38	300
Low wealth	200,000	0.10	190	110	300

Example 2: Low-Wealth Equalization

In this example, the tax rate required to raise a given level of revenue would be the rate necessary in an *average-wealth* district. Part B of Figure 11 illustrates the result of this approach for the same four hypothetical school districts. The district with the average AV per pupil (\$315,000 per pupil) would be required to raise property taxes by about 10 cents per \$100 of AV to obtain \$300 per pupil. To raise the same \$300 per pupil, below-average wealth districts would be required to levy the same 10-cent tax rate, and the state would fund the difference between the resulting property tax revenues and the target revenue level. For example, a 10-cent tax rate in the district with below-average AV of \$275,000 per pupil would generate \$262 per pupil in local property tax revenues. The state would therefore provide a matching grant of \$38 per pupil. Above-average wealth districts would get no state match.

We developed cost and revenue estimates based on this example because it is in the middle of the three examples with respect to state cost. If implemented in California, we estimate that this approach could, at a maximum, yield up to \$1.3 billion in additional local property tax revenues for schools and require up to \$300 million annually in state matching grants. This estimate assumes that all districts with revenue limits below the cap levy a tax rate sufficient to reach the cap.

While this approach to equalization would cost the state less than the approach outlined in Example 1, it would not fully equalize the amount of additional revenue received for any given level of tax effort. Districts with above-average AV per pupil would find it easier than others to raise a given amount of revenue. Consequently, this approach could be more vulnerable to a *Serrano*-based legal challenge.

Example 3: Power Equalization

An alternative approach that would also limit the state's cost but more fully equalize the return of revenue to tax effort is commonly referred to as district power equalizing (DPE). Under this approach, the state would proceed as in Example 2, but also require districts with *above-average* AV per pupil to levy the tax rate required in the average AV per pupil district to achieve the target expenditure level. This rate would actually raise more revenue than necessary to achieve the target level of expenditure in those districts. The state would recover the excess funds and redistribute them to participating districts with below average AV per pupil, thus offsetting some of its costs for matching grants.

Part C of Figure 11 illustrates this approach for the four hypothetical school districts. A DPE approach would fully equalize the level of tax effort needed to achieve a given level of revenue. If high-wealth districts participated, this would be the least costly equalization approach for the state.

Prior to enactment of Proposition 13, the Legislature approved a DPE-based reform of school finance (Ch 894/77, AB 65, Leroy Greene). The reform package was never implemented because the Proposition 13 statewide cap on property tax rates made this reform moot.

IMPLEMENTATION ISSUES

Alternatives to the *Ad Valorem* Property Tax

The proposed reform uses the *ad valorem* property tax as a local option revenue vehicle for several reasons:

- It is relatively easy to administer compared to other taxes (the administrative infrastructure is already in place to implement it at the school district level).
- It is historically the primary local funding vehicle for education in California.
- It is easy to levy in such a way as to minimize wealth-related differences.

We recognize, however, that implementation of our suggested *ad valorem* property tax option would require significant changes in the State Constitution.

Alternatives to the *ad valorem* property tax have advantages and disadvantages of their own, but generally appear to be less desirable options. They include local sales taxes, parcel taxes, and local income taxes.

Local Sales Tax. Sales taxes generally fall more heavily on lower income groups, and therefore raise tax burden issues. Moreover, a sales tax that could be levied on a district-by-district basis at a rate that could vary from district to district would significantly increase the cost of business transactions in California. This would go contrary to various initiatives undertaken by the Legislature in the past year to make it easier to do business in the state. The existing option for a county-wide sales tax to benefit schools avoids this issue, but does not meet the objective of giving individual school districts more control over revenue levels. Moreover, it is not clear that a tax levied under the existing option may be considered a general-purpose tax for purposes of Proposition 13. If determined to be a special tax, it could not be implemented upon approval by a simple majority of voters without a constitutional amendment to modify provisions of Proposition 13.

Parcel Tax. The parcel tax is much like the *ad valorem* property tax in ease of implementation and administration. In the long run, a local revenue option based primarily on the parcel tax could be vulnerable to a *Serrano*-related challenge if higher-wealth districts consistently use the tax to achieve higher levels of spending per pupil than lower-wealth districts.

Local Income Tax. A few states permit school districts and other local government entities to levy a local income tax. California does not have a local income tax. Consequently, implementation of such a tax on a district-by-district basis would involve significant administrative costs to the state. This tax would also impose significant administrative burdens on businesses, because they would be required to withhold income taxes at different rates, depending on employees' school district of residence. Implementation of a local income tax on a county-wide basis would mitigate some of these administrative problems, but would not meet the objective of giving school districts more control over their revenue levels.

Proposition 98

In *Making Government Make Sense*, we recommended elimination of the Proposition 98 minimum funding guarantee. This is primarily because the earmarking of specific portions of state-level resources is fundamentally inconsistent with our proposed model for state-local relations. In recommending its elimination, we did not anticipate lowering funding levels for schools.

The specific model of general-purpose funding suggested here would work equally well with or without Proposition 98. If implemented under Proposition 98, we would propose that property tax revenues raised through the local option tax and any state matching grants not count as revenues under Proposition 98. This is because they would be used to increase a district's level of general-purpose spending beyond its revenue limit.

School District Financial Accountability

Our proposed local revenue option for school districts can be expected to improve the accountability of schools to local voters. It would do so by linking voter expectations of school programs with school district planning through voter control over the level of school spending. It cannot, however, be expected to relieve the state, which will still supply the vast majority of funds for schools, from being the financial backstop for irresponsibly managed districts. Consequently, it will be important for the state to find ways to strengthen and more clearly define the fiscal oversight role of the County Superintendents of Education, continuing the process begun by the Legislature in Ch 1213/91 (AB 1200, Eastin).

CONCLUSION

The reform of K-12 general education funding we have outlined above would provide a measure of local control over levels of education spending. As a result, it would increase the accountability of public schools to local voters for financial and program outcomes. Together with reforms of K-12 categorical programs that we have proposed elsewhere, it would give school districts added flexibility in developing creative responses to local educational needs at a time when such responsiveness appears to be much in demand. Accordingly, we recommend that the Legislature take steps to include a local option tax capable of raising significant general education revenues in its ongoing efforts to help schools better respond to local priorities.
