Foundation School Program
Fiscal and Policy Studies

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FISCAL NEUTRALITY

Fiscal neutrality, commonly referred to as "equity," entails a public school finance system that provides "for substantially equal access to similar revenue per student at similar tax effort, considering all state and local tax revenues of districts after acknowledging all legitimate student and district cost differences." (Texas Education Code, Section 42.001(b)).

This statutory language derives from Texas Supreme Court rulings on the constitutional requirement that Texas operate a system of free public schools that is "efficient," in the sense that limited resources must be distributed across school districts in such a way as to achieve a general diffusion of knowledge. The Texas Supreme Court, in its 2005 West-Orange Cove decision, held that the state's school finance system did not violate the constitutional requirement of efficiency. That decision was based on the school finance system as it operated in the 2003–04 school year.

In the West-Orange Cove ruling that upheld the equity of Texas school finance, the court also found the system unconstitutional in that it did not provide school districts with meaningful discretion in setting tax rates, and directed the Texas Legislature to provide a remedy. In 2006, the Seventy-ninth Legislature, Third Called Session, responded by enacting House Bill 1 (HB1), which was implemented in the 2006–07 school year. This legislation significantly altered school finance by reducing school district property tax rates by one-third, linking formula yields to the eighty-eighth percentile of wealth, establishing a total revenue target for each district, providing hold harmless funds if local and state formula revenue did not generate the target, and creating a $0.17 enrichment tier.

As a significant piece of public school finance legislation, HB1 had a substantial impact on the equity of the system. The following analysis presents data to assess the system's equity, from the years before House Bill 1 beginning with the 2003–04 school year, to current law projections for the school years of the 2010–11 biennium.

SIGNIFICANT FINDINGS

- Concepts previously central to the measurement of the equity of a school finance system in Texas, such as an "equalized system," are no longer easily defined under the revenue target mechanism established by the Seventy-ninth Legislature, Third Called Session, 2006.

- The equity of the public school finance system, as measured by the analysis presented here, has declined since the implementation of the related statutory provisions of the 2006 legislation.

RECOMMENDATIONS

- Fund a school finance system with levels of equity comparable to that of the system in place for the 2003–04 school year, the year that the Texas Supreme Court judged the system to be constitutionally equitable.

- Establish a target revenue floor per WADA per penny to deliver additional state funds to districts with lower revenue. This would reduce the revenue gap and bring districts closer to the statewide average revenue. Alternately, modify the funding formulas of the basic allotment to increase the guaranteed yield. This would free the resulting revenue from constrictions of the current target revenue mechanism.

DISCUSSION

If one views the traditional funding formulas of the school finance system—the Tier 1 basic allotment and the Tier 2 guaranteed yield—in isolation, HB1 substantially increased their level of equity. The dollar amounts at which those yields were statutorily set under the previous finance system would have approached the seventy-fifth percentile of wealth in the 2006–07 school year. HB1 increased the yields to the eighty-eighth percentile, and indexed them to that percentile so that the yields would increase with property value growth.

With the HB1 system, the increased formula yields flow additional state funds that replace a portion of local revenue lost due to tax relief. However, to ensure no loss of total revenue, HB1 also guaranteed that districts would receive the total revenue per student in weighted average daily attendance (WADA) received in either the 2005–06 or 2006–07 school years. If the formulas did not deliver sufficient revenue to meet that target, the system would provide "hold harmless" funding up to the target amount.

The effect of the base-year revenue target, and the hold harmless funds that flowed from it, was to override the equity gain in the formula structure and lock in the inequities that existed in the system in those base years. Some of those existing inequities are relatively small; for example, there are 34 wealthy districts that, due to a Chapter 41 hold harmless provision, were allowed to retain some revenue above the equalized wealth level.

Other inequities have a larger impact. The prime example is the Available School Fund per capita apportionment; an annual distribution that, for less wealthy districts subject to Chapter 42, serves a method of financing their entitlement, but for wealthy Chapter 41 districts is in addition to the local revenue they retain. This amount has averaged approximately $305 per student in average daily attendance (ADA) over the last 10 years; on a WADA basis, roughly $230 per WADA on average. Although this distribution has been partially offset since fiscal year 2004 by a per WADA distribution made through the General Appropriations Act, it remains a significant benefit to Chapter 41 districts. Furthermore, in the 2006–07 school year, one of the years of which a district could base its revenue target, the per capita apportionment reached a high water mark of $394 per ADA. This is likely one reason, among several, why more than 85 percent of Chapter 41 districts have their revenue target based on the 2006–07 school year.

In addition to perpetuating existing inequities in the system, the revenue target mechanism added an additional inequity. Under the previous funding system, state aid or recapture payments were not adjusted to reflect local revenue growth until the following year. However, under the total revenue target mechanism of HB1, any district that had a year of strong growth in local property tax collections, perhaps due to strong property value growth, in the 2005–06 or 2006–07 school years received a higher revenue target as a result. As it happened, in the 2006–07 school year, the year which most districts based their revenue target, wealthier districts on average experienced significantly higher property value and resulting collections growth than poorer districts.

While one can predict the impact that the revenue target mechanism of HB1 has on equity, the effect of the enrichment tier is less clear. The enrichment tier comprises the $0.17 above the statewide maximum compressed tax rate of $1.00 This tier consists of two levels:
- the "golden pennies," which apply to the first $0.06 levied above a district's compressed rate, are equalized at the yield generated by the Austin Independent

School District (ISD), and on which there is no recapture, and

- the "copper pennies," which are the pennies remaining above a district's compressed rate plus the $0.06 (golden pennies), are equalized at $31.95 per penny per WADA, and on which revenue generated above this yield are recaptured.

In terms of equity, each of these enrichment levels has countervailing factors. For the golden pennies, the guaranteed yield is highly equalized at approximately the ninety-sixth percentile of wealth, but the 111 or so districts generating revenue above that level retain everything they collect. For the copper pennies, on a per penny basis they are equalized at $31.95 per WADA with full recapture above that level. However, districts with compressed rates below $1.00 have access to more copper pennies than do districts compressed to $1.00 and, on average, districts at the top end of the wealth spectrum have lower compressed rates than less wealthy districts.

EQUITY ANALYSIS

This analysis applies a set of standard equity measures to the school finance system as captured by the Legislative Budget Board final models for school years 2003–04 to 2007–08, and by projections from current law models for school years 2008–09 to 2010–11. As noted previously, the Texas Supreme Court judged the school finance system to be efficient based on data from the 2003–04 school year. Using this year as a benchmark does not imply that a less equalized system would be unconstitutional; rather, the analysis presents the 2003–04 school year as a possible target should the state want to maintain a school finance system with a level of equity that is arguably comparable to the one found constitutional by the Texas Supreme Court.

The analysis reflects the following methodology:
- **Use a per WADA basis.** Analysis is done on a revenue–per-weighted student basis (WADA), thus incorporating student and district cost differences expressed by those weights. As a result, the analysis presumes that the array of weights, allotments, and other cost adjustments in the current system are, by the terms of the Texas Education Code Section 42.001(b), "legitimate"; that is, appropriate and representative of true cost differences between student groups and district types.

- **Include enrichment.** In West-Orange Cove, the court noted that revenues generated above an adequate level needed for the general diffusion of knowledge are supplemental and therefore exempt from a consideration of equity. Some may argue that the enrichment tier established by HB1 should be considered as such, and only the school finance system under districts' compressed tax rates should be examined. However, since the 2006–07 school year, the revenue capacity of this "compressed tier" has only increased to the degree population has, and there is evidence that districts have faced significant inflationary costs beyond student growth during this period. As a result, for the purposes of this equity analysis, the enrichment tier is included.

- **Assume the maximum tax rate.** Districts, and their voters, have discretion over the number of pennies of enrichment tax effort they wish to levy. Consequently, an analysis based on actual district revenue amounts per WADA will be affected by individual district decisions on tax effort, which could obscure the equity of the school finance system. To remove the effects of variable tax effort across districts, amounts shown are based on what district revenues would be at the maximum maintenance and operations (M&O) tax rates of $1.50 in school years 2003–04 to 2006–07, and $1.17 in 2008 and beyond.

MEASURES OF EQUITY

Prior to HB1, the three measures used to determine equity were:

- the percentage of students within the equalized funding system;

- the percentage of total Foundation School Program (FSP) revenue within the equalized funding system; and

- the gap in total revenue between districts at the top of the wealth spectrum, and those below the guaranteed yield level.

In the school finance system established by HB1, the "equalized funding system" used by the first two equity measures is difficult to specify. First, as discussed previously, each district has a unique total revenue target, based on the best of three calculations from two different funding years. Equalized formula levels within the system are effectively superseded by "hold harmless" state aid, which funds a significant portion of many districts' entitlements; statewide, this hold harmless funding is estimated to represent approximately one-third of total state aid for M&O.

Given the uncertainty regarding the definition of an equalized funding system, this analysis begins with a calculation of the remaining equity measure from the previous funding system—the "revenue gap."

Consistent with the methodology employed by prior fiscal studies, the revenue gap compares the total M&O revenue per WADA, on a weighted average basis, in districts with property wealth below the Tier 2 guaranteed yield threshold with that of districts with property wealth equal to or greater than the equalized wealth level. As discussed above, this analysis is calculated assuming all districts are taxing at the maximum allowable rate.

There are two caveats to note regarding the revenue gap analysis. First, for school years 2003–04 to 2005–06, there was a gap between the Tier 2 guaranteed yield level of $27.14 per penny/WADA and the equalized wealth level of $305,000 ($30.50 on a per penny/WADA basis); districts with yields in this gap are excluded from the analysis. For each of these years, at least one of the two largest districts in the state (Houston ISD and Dallas ISD) fell into this gap. The second caveat is that for school years 2006–07 to 2008–09, this analysis determines the eighty-eighth percentile yields calculated with latest available property values and weighted student counts. The actual implementation of the school finance system for the 2008–09 biennium required the establishment of the eighty-eighth percentile at set dollar amounts in the General Appropriations Act (2008–09 biennium) which, due to property value growth and student counts that diverged from what was projected, are lower than current data indicate.

These caveats are important because they suggest weaknesses in the revenue gap as an equity measure. First, the exclusion of the districts between the guaranteed yield and the equalized wealth level entails ignoring the equity impact of the school finance system on a sizeable portion of the student population—over 12 percent in certain years. Additionally, even after the 2005–06 school year when HB1 eliminated the gap between formula yields and the equalized wealth level, a small change in the wealth level of one of the larger districts could push it from Chapter 42 status to Chapter 41 status (or vice versa). This could potentially alter the average revenue per WADA of both groups in a way that does not reflect the change in the equity of the system as a whole.

Lastly, a comparison of the weighted average revenue of these two groups can mask substantial variations within each group. To address these shortcomings, this analysis computes the coefficient of variation, which is an additional measure of equity.

The coefficient of variation measure begins with the standard deviation for total revenue per WADA for each district, weighted for the size of the district's student population. The standard deviation is a measure of how widely spread districts are across the spectrum of total revenue per WADA, with a smaller number indicating more districts are grouped more closely to the average total revenue, and a larger number indicating that more districts have total revenue amounts farther from the average. Assuming a fairly normal distribution of districts around the statewide average revenue, approximately 68 percent of students will fall within plus or minus one standard deviation of the average, and about 95 percent will be within plus or minus two standard deviations of the average.

The coefficient of variation is simply this measure of dispersion divided by the statewide weighted average total revenue per WADA, which gives a comparable calculation across years. A smaller coefficient indicates a higher level of equity.

ANALYSIS RESULTS

Figure 1 shows the trend in average total revenue per WADA across all districts. First, it should be noted that HB1 markedly increased the overall capacity of the school finance system, increasing maximum average revenues per WADA

under $4,800 in the 2005–06 school year to just under $5,900 in the 2007–08 school year, the first full year of implementation. This capacity has a bearing on the equity question in that comparisons of revenue gaps and measures of dispersion across school years should be viewed proportionally to the size of the system.

Figure 2 shows the first measure, the revenue gap, increasing from school years 2005–06 to 2006–07, the first year of HB1 implementation. Analysis of district revenue targets suggests that this is due primarily to the dis-equalizing effects of the revenue target calculation mentioned above. This gap increases slightly from 2007 to 2008, perhaps due to a property value growth-driven jump in the number of effective pennies on which the yield is paid. The model estimates another small increase to the gap in fiscal year 2009 as the golden pennies are expanded to six, but a moderation of the gap thereafter as effective tax rates in the enrichment tier decrease with slowing property value growth. The revenue gap as a proportion of the average total revenue per WADA for Chapter 42 districts, after its initial jump from the pre-HB1 to the post-HB1 system, stays relatively stable thereafter.

Similarly, Figure 3 shows an increase in the coefficient of variation between pre-HB1 and post-HB1 school years, and then a steady equity level thereafter. One may expect this level of equity to continue in the out years; the only factor that can substantially affect the system's revenue distribution (at the maximum tax rate) under current law are fluctuations in effective tax rates in the enrichment tier, and the increase of the golden penny yield, set to Austin ISD's yield, relative
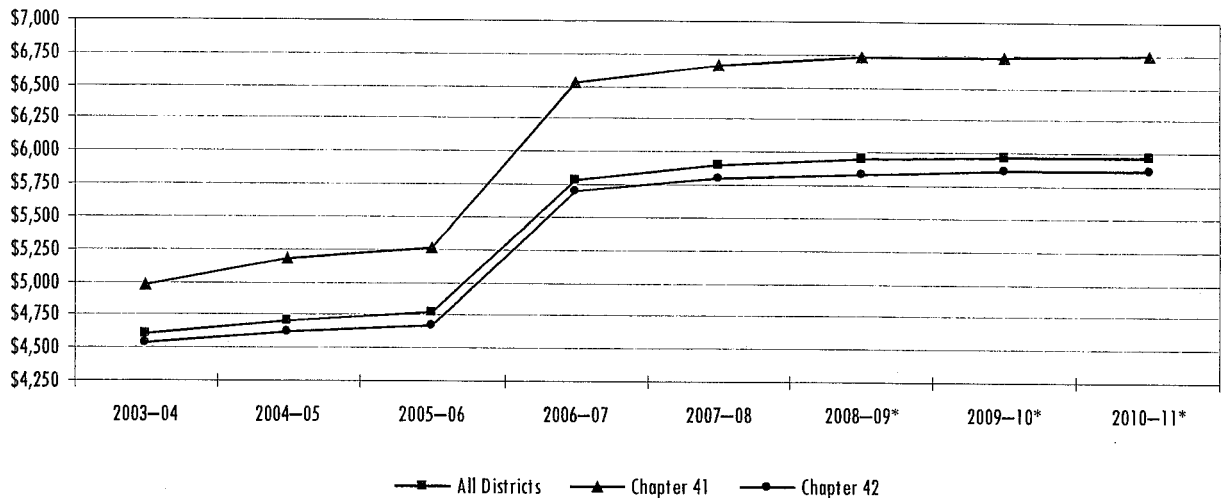
FIGURE 1
EQUITY ANALYSIS OF MAXIMUM M&O TAX EFFORT (INCLUDING ENRICHMENT), FISCAL YEARS 2004 TO 2011

	2004	2005	2006	2007	2008	2009*	2010*	2011*
Average Total Revenue per WADA (All Districts)	$4,609	$4,710	$4,779	$5,793	5,898	$5,948	$5,965	$5,969
Average Total Revenue per WADA (Chapter 42)	$4,532	$4,621	$4,668	$5,698	$5,795	$5,841	$5,868	$5,873
Average Total Revenue per WADA (Chapter 41)	$4,970	$5,183	$5,263	$6,527	$6,655	$6,730	$6,736	$6,746
Revenue Gap between Chapter 41 and Chapter 42 Districts	$438	$562	$596	$829	$860	$889	$868	$873
Revenue Gap as Percentage of Chapter 42 Revenue	9.7%	12.2%	12.8%	14.6%	14.8%	15.2%	14.8%	14.8%
Standard Deviation	$336	$325	$348	$493	$504	$513	$516	$510
Coefficient of Variation	7.3%	6.9%	7.3%	8.5%	8.5%	8.6%	8.6%	8.5%

*Projected.
Source: Legislative Budget Board.

FIGURE 2
AVERAGE TOTAL REVENUE PER WADA, CHAPTER 41, CHAPTER 42, AND ALL DISTRICTS,
SCHOOL YEARS 2003–04 TO 2010–11

—■— All Districts —▲— Chapter 41 —●— Chapter 42

*Projected.
SOURCE: Legislative Budget Board.

FIGURE 3
COEFFICIENT OF VARIATION IN AVERAGE REVENUE PER WADA, SCHOOL YEARS 2003–04 TO 2010–11

*Projected
SOURCE: Legislative Budget Board.

to the yields of those districts above Austin ISD. These represent a very small share of total revenue in the system.

It is interesting to note that the enrichment tier, specifically the copper pennies, increases the level of equity in the school finance system. The six golden pennies have a negligible effect on the overall equity of the system, as measured by the coefficient of variation. It appears that the positive equity impact of the high Austin ISD yield largely negates the negative equity effect of the additional local revenue kept by districts above that yield, at least relative to the rest of the school finance system. That un-recaptured

revenue is about 6 percent of the approximately $2.1 billion in potential total revenue the golden pennies are projected to generate in the 2009–10 school year.

Conversely, including the copper pennies reduces the coefficient of variation by approximately 0.4 percent. The fact that, on average, wealthier districts have approximately two additional copper pennies compared to the statewide average is more than offset by full equalization at $31.95 per WADA per penny. In the 2009–10 school year, the copper pennies are projected to generate a maximum amount of approximately $2.3 billion in total revenue.

RECOMMENDATION

The Legislature should make changes to the public school finance system to restore its equity to the level it exhibited in the year the system was last deemed constitutionally efficient by the Texas Supreme Court. Proposals to achieve this goal could be analyzed in terms of their coefficients of variation in total revenue per weighted student, and those coefficients could be compared to that of the system as it operated in the 2003–04 school year.

School finance changes that enhance the equity of the system could operate within the target revenue mechanism or could supersede it. For example, the Legislature could establish a target revenue floor per WADA per penny. This method would deliver additional state aid to districts at the lowest end of the revenue spectrum, shrinking the revenue gap and pulling districts more tightly around the statewide average revenue. Alternatively, the current law mechanisms of the basic allotment and/or guaranteed yield could be significantly increased, and revenue delivered through those formulas could be freed from constrictions of the target revenue mechanism.