HOW STATES PROTECT FUNDING FOR K-12 PUBLIC SCHOOLS

A primer on funding protection policies

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EdCHOICE

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INTRODUCTION

Public education funding is a complex matter. It is widely understood that dollars for public schools come from federal, state, and local sources, but the revenue stream from each source is calculated in complex formulas and criteria that can make it hard for anyone to understand the system fully. Take local revenue, for instance. At the most basic level, it is easy to understand that local dollars are raised via local levies on property. If a school district has more local property wealth, it will receive more local education funding. Yet, determining local revenue can be quite difficult. Consider the matter of assessing property values. A piece of real property may be assessed at different rates depending on whether it is zoned for agricultural, commercial, or residential use.[1] There are, furthermore, variations within each of these broad categories. In Missouri, for example, the state tax commission assigns eight different grades to farmland and assesses the land based on those grades.[2] The point is that no two states are identical on even this single portion of the school funding system.

School funding systems are no less complicated on the receiving end and, importantly, each decision about funding involves trade-offs. When a state chooses to determine the amount of aid in one way and not another, it may favor some schools or localities over others. Or, to put it another way, a funding formula may choose to incentivize some policies or actions and not others. One prime example is whether an official aid formula is based on a district's average daily attendance or its enrollment.

Calculating aid based on some measure of the number of students that a school district serves is the primary modus operandi by state education departments. Some states determine aid based on average daily attendance, and others use enrollment counts. Each approach has trade-offs. By using daily attendance, a state will provide less funding to school districts in disadvantaged communities because attendance there is, on average, lower than in more affluent communities. On the other hand, choosing to ignore attendance and focus only on enrollment counts fails to incentivize student attendance.

These are policy trade-offs, and they are the subject of this primer. Specifically, we focus on various school funding protections (also known as "hold harmless" provisions) that states take. We will explain this term in more detail later, but for now, it is enough to say it means limits on financial aid reductions when a school district has fewer students in its classrooms. Our goal here is simple—to explain a complex subject. We hope that after reading this primer, you will understand better the various types of funding protections and the trade-offs they present to policymakers and citizens.

What Are Funding Protections? Definition and Rationale

Some use the term "hold harmless" to refer to any kind of funding protection. For instance, Robert Toutkoushian and Robert Michael define hold harmless provisions as those "meant to restrict declines in revenues for districts."[3] Throughout this paper, we refer to any provision that protects a district from declining revenue as a form of funding protection. We refer to "hold harmless" provisions as a specific form of funding protection which we describe below. There are, of course, many ways to protect school districts from declining revenue, and it is important to understand the relative merits and trade-offs of these policy decisions.

There are two main categories of funding protections. The first category is the *declining enrollment* provision. This is just what it sounds like: Education funding is tied to the number of students a district serves, so districts stand to lose funds as they lose students. Because some education costs are fixed, this may strain district finances.[4] Declining enrollment provisions are meant to protect school districts from these losses.

The second category of funding protections is the *funding guarantee*, which is commonly called "hold harmless." A funding guarantee promises that districts will receive a specific level of aid. The amount could be a total level of state aid or a per pupil amount. Funding guarantees are often inserted into state law by legislators when the state changes its funding formula.

Any change to the funding formula will create winners and losers. Some districts will receive more state aid, and others will receive less. Funding guarantees ensure there are no losers from creating a new or altered formula.

The declining enrollment provision is meant to give districts stability, even as they face natural changes from year to year. It is thus a management-friendly tool. The second type of funding protection, which we refer to throughout this paper as the funding guarantee or traditional "hold harmless" provision, has a twofold purpose. First, as Gerald Bass wrote in 1987, "Transition formulas, also known as 'hold-harmless' provisions, are used to ease the budgetary and political impact of fundamental changes in state funding for public education."[5] These transition formulas protect districts from unexpected changes in revenue due to government action. Funding guarantees have another purely political purpose. They may be seen as a bargaining chip to gain the support of legislators from districts that may stand to lose revenue from a change in the state's aid formula.

Overview of Paper

In the next two sections of the paper, we will discuss each type of funding protection provision in detail, along with their trade-offs. First, we will examine declining enrollment provisions and their trade-offs. Then, we will do the same for funding guarantees. We follow up that discussion with suggestions for using either policy more effectively.

DECLINING ENROLLMENT PROVISIONS

If your income were to suddenly decline, you could find ways to cut your expenses immediately. You might eat spaghetti without those expensive meatballs, or you might switch from a name brand product to a less expensive generic one. A purchase that you can modify or eliminate immediately represents a variable cost. But there are other things you could not cut in the short run, such as your rent or mortgage payment. These are known as fixed costs.

Discussions of school finance policy are often grounded in the claim that many educational expenses are fixed costs. If a school district loses ten pupils and those pupils each generate $15,000 for the district, the district's revenue would decrease by $150,000. District officials, under this thinking, would have a hard time adjusting to a declining enrollment by making corresponding budget cuts. If those ten students were spread across different grades and different schools, the district would not be able to save any funds by reducing the teaching staff or cutting building costs. Furthermore, public school districts employ tenured teachers on essentially permanent contracts. Thus, making significant changes to staffing is difficult in the short run. A similar argument can be made for facilities. School districts cannot change their overhead costs significantly in the short run.[6]

A fundamental economic principle holds that all costs are variable in the long run. The person who suddenly cannot make a mortgage payment could sell the house and find a less expensive place to live, perhaps only after some significant effort. Similarly, school districts can make staffing changes and adjustments to facility budgets in the long run.

Declining enrollment provisions give school officials more time to adjust to a shrinking enrollment. The idea of a declining enrollment provision is clear, but the means of enacting it varies across states and even within states. A state may allow a school district to choose the way it measures its student load: current year enrollment, prior enrollment, or average daily attendance counts. A school district with a declining enrollment might not feel the effects in lost revenue for one or two years, depending on the number of years it can go back. A district also may be able to use enrollment averaging. Here, it averages current and prior-year enrollments, lessening the impact of any given year's enrollment decline.

The Benefits of Declining Enrollment Provisions

Declining enrollment provisions give revenue stability to school districts with declining or fluctuating enrollment. They allow for a lag between when enrollment declines occur and when school districts feel their effects. School districts often hire in the spring and summer for the upcoming school year, and enrollment counts are typically conducted only after the school year starts. This means that unexpected drops in enrollment may cause significant financial strain. Delaying the revenue changes, then, delays the impact of the enrollment drop to the next hiring-and-staffing cycle.

It is easy to see why a declining enrollment provision appeals to school districts. Instead of losing a substantial amount of revenue at once–often after they make spending commitments for the year–they have extra time to revise budgets and make necessary changes.

The Downside of Declining Enrollment Provisions

The downside of declining enrollment provisions is obvious: They increase the cost of K-12 public education to taxpayers. When enrollments drop, the state continues to fund students who are no longer present in the district. Some scholars call these children ″ghost" students. In essence, the state pays a district to educate a student who, like a ghost, is present only in memory. In some cases, the ghost student may have moved to another district, where his or her presence increases the enrollment. In such cases, the state would be providing funding to both the district the student left and the student's new district.

Declining enrollment provisions are especially problematic when there are many school choice options or where student mobility is high. For instance, let's assume there is a new private school choice program, and students who switch can take some portion of state funds their school district received and use them at a private school. Declining enrollment provisions would increase the state's costs by requiring it to fund the school district the students left, provided the district's enrollment went down, and to fund the students in the new private school choice program. To make matters worse, the more prior years a state allows school districts to use in these calculations, the greater the cost to taxpayers.

Suggestions for Declining Enrollment Provisions

In managing any business, being able to forecast and know what your future budget may look like helps you plan accordingly, and being able to plan is better than not being able to plan. So, a limited declining enrollment provision, such as a two-year averaging, makes sense. Such a short-term funding protection minimizes the financial harm caused by declining enrollment and makes management easier. The short-term nature also recognizes that school districts should not continue to receive aid for years for students they are no longer educating.

But there are always trade-offs. When states provide additional aid to school districts via extensive declining enrollment provisions, the aid cannot be used elsewhere. This is a classic case of what Frédéric Bastiat called "that which is seen, and that which is not seen." When states provide additional funds for declining enrollment provisions, we can see where that aid is going: It protects jobs and limits budgetary impacts on school districts. We do not, however, see where the money may have been spent elsewhere: It may have been appropriated to additional K-12 support programs, allocated to higher education, or used in any number of other ways. Given these facts, states must balance the desire to smooth the funding declines school districts face with the desire to be wise stewards of taxpayer funds.

FUNDING GUARANTEES OR TRADITIONAL HOLD HARMLESS PROVISIONS

Funding guarantees typically promise school districts a specific level of state funding or a specific level of per pupil funding. These guarantees are often created when states move to new funding formulas. States do not often make major overhauls to their funding systems, but when they do, those changes can have dramatic effects on some districts' revenue. When this occurs, lawmakers who represent districts that will lose revenue often advocate for some form of transition or hold harmless provision. This is a very common practice. As Parker and Pingleton noted in a report for the Oklahoma School Boards Association in 1981, "Every school finance reform proposal contains [a hold-harmless] provision because it would be poor policy to force districts, however wealthy, to suddenly curtail programs and services without warning and without opportunity to make adjustments over a period of time."[7]

While it may be a "poor policy" to dramatically cut funding to school districts without giving administrators proper time to make budgetary adjustments, hold harmless decisions are inevitably political.[8] As Bass noted, "Obviously, when school districts stand to gain or lose…the administrators, school board members, and other interested parties become politically active in order to maintain or eliminate such a provision in the statutes."[9] State lawmakers represent their local interests. Any lawmaker whose constituents will lose some revenue under a new funding formula has a vested interest in securing a hold harmless provision.

Funding guarantees, one type of school funding protection, can be designed in different ways. In some cases, there is no timeline for when the guarantee ends, meaning they are not, as some scholars call them, transitional funds. When they are permanent, they do not in any way facilitate a transition to the new funding formula. Instead, they create a system where some districts receive aid based on the new formula and others receive state aid based on the guarantee.

A transitional hold harmless provision would have this goal in mind: It would move districts, over time, from the old formula funding system to the new. Bass provides an example in which "a district might be guaranteed only 75 percent of the difference for the first year, 50 percent for the second, 25 percent for the third, and only the amount determined by the formula for the fourth and succeeding years."[10]

A state may choose to guarantee a specific level of funding, which is essentially a minimum amount of state aid a district will receive, regardless of the new formula. The state may also choose to provide a guarantee on a per pupil basis. In this case, the state promises that the district's per pupil funding will not decline, regardless of how its demographics change. Truly, there are myriad ways a state could structure a funding guarantee. As William Fox, Matthew Murray, and Patricia Price note in the *Journal of Education Finance:*

> *A hold-harmless provision prevents each Local Education Agency's formula- based revenues from declining below a certain level, regardless of how the factors are changing. Normally, hold-harmless provisions prevent the revenues provided to an LEA from falling below the amount received in the previous year, but other thresholds could be established. For example, the hold-harmless provision could say that revenues cannot fall by more than 1.0 percent from the previous year. Alternatively, a more complicated hold-harmless provision could be developed, such as one that says revenues cannot decline by more than 1.0 percent or by more than the percentage decline in Average Daily Membership (ADM), whichever is greater.*[11]

To summarize, there are practical and political reasons that funding guarantees exist, and these guarantees may be structured in a variety of ways. In the next two sections, we examine some trade-offs of various approaches.

The Benefits of Funding Guarantees

Changes to funding systems may lead to dramatic funding changes for school districts, often without giving districts enough time to adjust. Faced with funding cliffs, districts may resort to inopportune decisions. For instance, they may have to reduce their workforce. In many instances, teachers' contracts are governed by collective bargaining agreements with protections for veteran employees. This may lead to a "last-in, first-out" reduction scheme whereby the most novice teachers are more likely to be laid off. Research has shown that a last-in, first-out policy, rather than a deliberative one that considers teacher quality, can have a negative effect on student achievement.[12] Without lead time, districts may have little ability to negotiate with unions or to create more effective procedures for trimming the workforce.

There is also an obvious benefit to local school districts to have funding guarantees. As Fox, Murray, and Price put it, "The major advantage of a hold-harmless provision is that LEAs can know there will be no significant year-to-year decline in state revenues (or no decline at all, depending on the provision), regardless of changes in LEA attributes."[13]

As student enrollment or the composition of students changes under normal circumstances, school districts must adjust. This may mean tightening budgets, or it may mean increasing local property tax levies when possible. When a state's hold harmless provision is permanent, the district shoulders almost no concern about how local changes may impact state revenues. While this may be a net positive for the local district, it also has its downside.

The Downside of Funding Guarantees

Once again, the obvious trade-off of funding guarantees is that they can be costly for taxpayers and school districts. Money sent to hold harmless districts could have been distributed elsewhere. That is not the only problem, though, and these issues are particularly problematic when the guarantees essentially become permanent fixtures of the funding system, as they often do. While declining enrollment provisions are temporary guarantees of revenue based on some calculation of prior enrollment, funding guarantees consider more than just enrollment and provide a perpetual source of funding.

Whereas declining enrollment provisions only protect school districts when their financial circumstances are getting worse (they are losing students and state aid), funding guarantees may also protect school districts where their financial circumstances are improving, even though they may receive less state aid. Many factors may lead to a school district being provided less aid via a state's funding formula. For example, a new commercial real estate development may generate more local dollars for a particular district, which might receive less state aid as a result. Similarly, an increase in family incomes in an area could mean a district receives less state aid that is targeted for students living in poverty.

In either of these cases, a funding guarantee would protect the school district from losing state funds as a result of recalculating the funding formula, even though the district's financial situation is improving. Most states have some form of progressive state aid, where school districts with greater need receive more funds from the state than school districts with lesser need. In both cases mentioned above, the state aid would have declined because progressive state aid formulas are designed to give less state aid to school districts with higher local wealth.

When states offer funding guarantees to school districts that have high amounts of local wealth or are increasing their local wealth, they undermine any effort to increase fiscal equity among school districts. As Albert Cortez put it in his analysis of Texas' school funding, "Perpetual hold harmless has no place in an equalized system."[14]

These two notions—funding guarantees and funding equity—are in direct conflict with one another: "It is not possible to have both a hold harmless-based system and a property wealth-based system working simultaneously, since each is designed to achieve conflicting results."[15]

This finding both makes sense and is borne out in the literature. Intuitively, we can surmise that school districts receive less state aid when their student demographics become generally "easier" to educate. That is, they have fewer students living in poverty, fewer English language learners, and fewer students with special needs. School districts also tend to receive less state aid as their local wealth increases. Thus, school districts that experience economic growth may start both to lose state aid and to qualify for the state's funding guarantee. Toutkoushian and Michael find this very thing in an analysis of Indiana's hold harmless provisions, which they call "overlay provisions." They write, "Our results show that across multiple measures of horizontal and vertical equity, the [overlay provisions] used by Indiana created inequity in both horizontal and vertical dimensions."[16] That is, students with the same needs do not have access to the same resources, and students with greater needs do not have access to greater resources.

Permanent funding guarantees also might thwart the efforts of the state legislature to remake the funding system. In essence, they remove any qualifying districts from participation in the newer funding system. In this way, funding guarantees "perpetuate past aid distributions."[17]

Finally, funding guarantees reduce the impact of market pressures that arise in a system of student choice. Without guarantees, a district will feel some financial pain when students leave. As such, it is in the district's best interest to serve students well and work to retain as many as possible. When the state guarantees a specific level of funding, it weakens this incentive. The state financial system then is less efficient and less responsive to the needs of students.

Suggestions for Funding Guarantees

When states make significant changes to funding formulas that will harm some school districts' budgets, it makes sense to provide some form of support—as long as it is temporary. When state policymakers write a new funding plan, they should put a transition plan in the new formula or a sunset for funding guarantees. They should remember that the longer the guarantees, the greater the harm to funding equity. Bass outlines three useful rules policymakers should keep in mind when considering this type of hold harmless aid. First, this aid should be temporary and transitional, with the express purpose of weaning school districts off excess state support.

Second, the funding guarantees should be on a per pupil basis. Funding guarantees that are not tied to the number of students generate distorted incentives. Funding guarantees offered on a per pupil basis, in contrast, keep the incentives embedded in per student funding intact. This kind of guarantee protects the school district from changes caused by the formula, but it does not protect the district from changes that naturally occur, such as enrollment fluctuations.

Third, Bass argues, the dollars districts lose as a state changes its school funding system should be put back into the formula. Lawmakers rarely change the funding formula because they want to decrease funding to schools. Rather, their goal is to increase aid, increase adequacy, or increase equity. As school districts lose funding while moving off funding guarantees, Bass argues those funds should not simply be removed but should be reinvested.

These are three good principles to keep in mind. Of course, states could do away with funding guarantees altogether by allowing greater time between a bill's passage and the time school districts realize the loss.

In this case, the state could build in time for districts to adjust their budgets and reallocate resources. The idea here is to remove the element of surprise. In doing so, part, but not all, of the motivation for funding guarantees may be removed.

CONCLUSION

Funding protections, whether they come in declining enrollment provisions or funding guarantees, distort the education market. They provide additional funds to school districts that otherwise would not have received them. Declining enrollment provisions provide school districts funds to educate students they do not have. The same thing can happen when the state guarantees a district's total revenue. Funding guarantees can also increase inequities by giving extra funds to wealthier school districts that would otherwise not receive them in the new formula.

We have repeatedly shown that school funding policy is about trade-offs. The money policymakers devote to funding protections cannot be spent elsewhere, and they must come from somewhere. The funds could have been used elsewhere, including in other policy areas, or on districts that do not receive funding protections.[18] Elsewhere, we have described the principles policy-makers should use when they adjust state funding formulas. We wrote, "Equity, efficiency, and educational opportunity are three guiding principles that state lawmakers should consider as they develop or change state funding systems in order to pursue ideal education finance systems."[19] Funding protection provisions run afoul of each of these principles.

Funding guarantees undermine equity by providing additional funds to wealthy school districts that would have otherwise received less in state aid. They are inefficient because they allow districts to receive funds for students they are not educating. Finally, they undermine efforts to increase educational opportunity by separating funding decisions from students. For all these reasons, policymakers should be very judicious as they use funding guarantees. These provisions, meant to protect districts from dramatic changes that may occur through no fault of their own, should be used sparingly and on a temporary rather than permanent basis.

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