

## The Texas School Finance Challenge and What to Do About It

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### Executive Summary

Education is the bedrock of an informed democracy and the bridge to lifelong opportunities. As a state, we rely on our public education system to develop a talented workforce and promote shared prosperity. But in order to fulfill our promise to the next generation of young Texans, we must first ensure that there is sufficient financial support for all kids to get a quality education, no matter where they live or what their background.

This policy brief provides context on why the current Texas school finance system is insufficient, changes the 2015 Legislature made to how we fund public education, and solutions for improving the school finance system for generations to come.

With a school finance ruling from the Supreme Court looming, the Legislature made only minor improvements to the school finance system. The Legislature:

- Raised the funding level for all districts by increasing the basic allotment, or the basic per student funding level, to \$5,140 from \$5,040, which was not enough to keep pace with inflation or the changing needs of students.
- Authorized \$100 million in funding for school facilities that had not received new state aid since 2010-11.
- Appropriated \$200 million for a technical adjustment to the tax rate for districts with a compressed tax rate below \$1.00.
- Passed \$3.8 billion in tax cuts, which hurt the state's ability to make future investments in public education or fund other budget priorities.

Our education system is like a valuable home that's in need of some repairs. When you remodel your home, you must do more than simply touch up the paint; you make substantial changes, keeping the previous shape of the house, but updating old parts and making the house more modern and efficient.

Education budget writers at the state Capitol decide not only how much money to direct to schools, but also the number of students per classroom and the amount of time each child gets with the teacher. The amount of resources allocated to our schools also determines access to science labs, computer courses, and art and music instruction—things that keep students engaged and eager to learn. Sufficient resources also allow for better training and less turnover for good teachers.

The Legislature's actions last session made some small and important updates, but they effectively produced little more than the equivalent of a fresh coat of paint. Much more work remains before we have a well-functioning school finance system that meets the needs of today's students and tomorrow's workforce. To effectively remodel and update our school finance system, the Legislature will need to:

- Commission an objective, third-party study on the level of funding required to meet the academic standards currently in place;
- Update several elements of the funding formulas, some of which haven't been adjusted for nearly three decades;
- Bring up funding levels for all districts by increasing the basic allotment; and
- Adjust the basic allotment for inflation and build in periodic reviews.

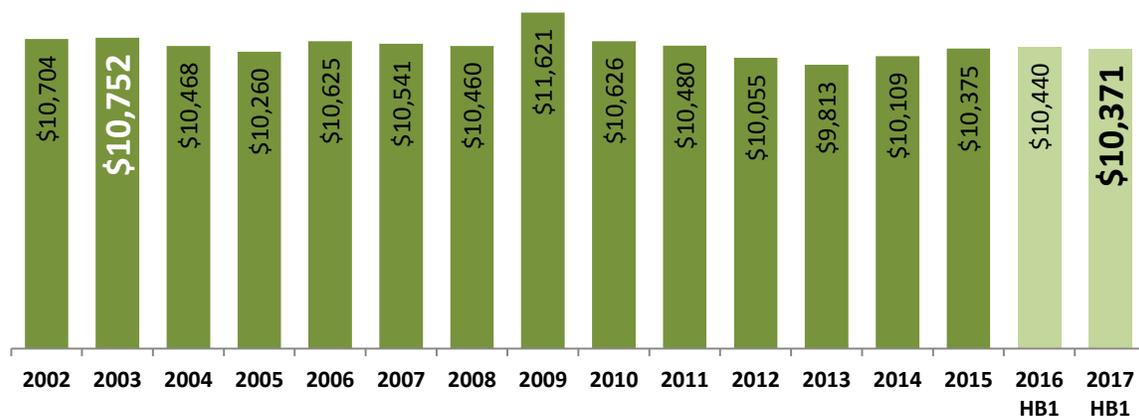
## The Texas School Finance System in Context

The right to an education is guaranteed by the Texas Constitution. But under our current system, it is increasingly difficult for schools to provide the resources needed for all students to be successful, no matter where they live or what their background.

The Foundation School Program is the state program that establishes, through a set of formulas and laws, the level of funding that public schools and charter schools receive for operations and facilities. Funding for the Foundation School Program comes from a combination of state revenue and local property taxes collected by school districts. Federal funding, grant programs (such as the High Quality Pre-K Grant Program), and local donations are not a part of the Foundation School Program. Fifty-seven percent of Foundation School Program funding comes from local property taxes and is not seen in the state budget. The other 43 percent comes from state revenue, and totaled \$42.3 billion for the 2016-17 biennium.

Even though state support for the public education system is the largest use of state revenue in the two-year state budget, our school finance system has been the frequent target of litigation over whether the state ensures access to a quality education for all Texas students. When adjusted for inflation, per student spending has remained relatively flat over the past 16 years.

### Spending per Student is Relatively Flat



*CPPP analysis of TEA and LBB data; state/local/federal spending per student, in 2015 \$*

Despite that relatively flat spending trend per student, Texas schools in 2017 will receive \$381 less per student than they did in 2003. To put that amount in context, a classroom of 30 students would have \$11,430 more per year if funded at the 2003 level. An average size district of 4,000 students would have an additional \$1.5 million to invest in smaller classroom sizes, enrichment activities, and professional development opportunities for their

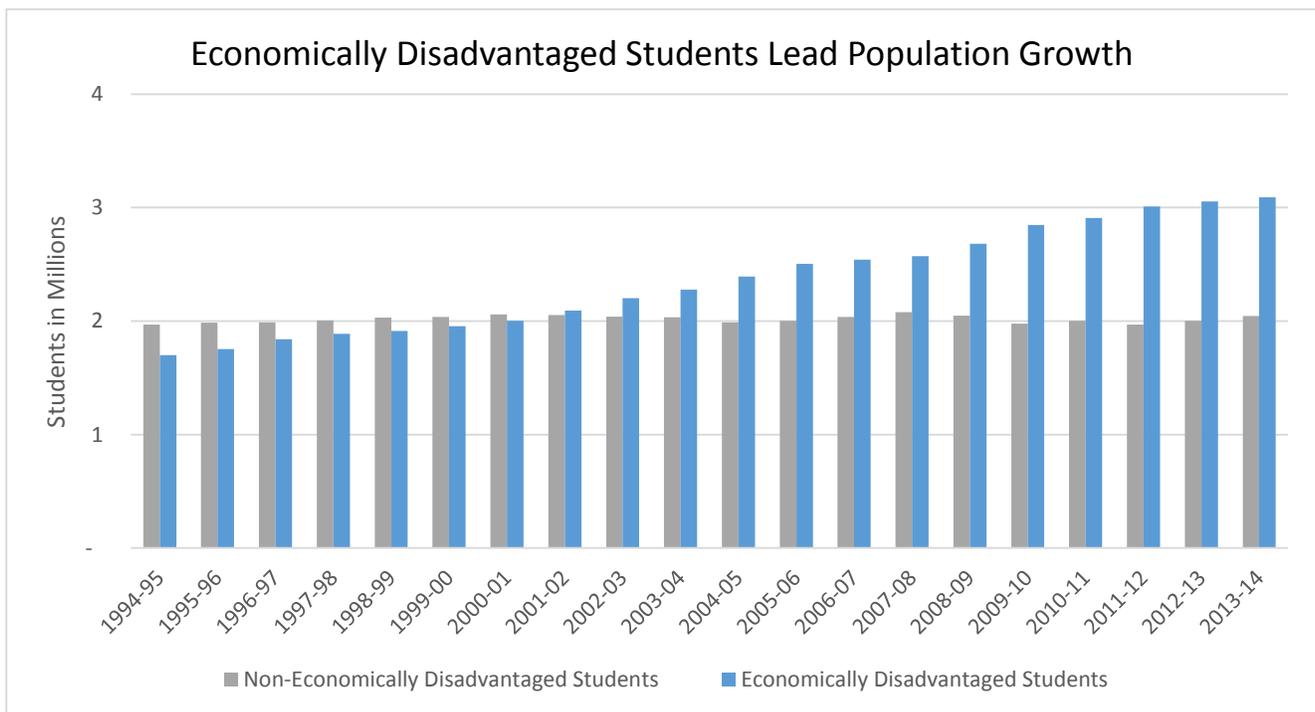
teachers. It would take an additional \$3.5 billion next biennium just to get our schools to where they were 14 years ago. In the meantime, state support for public schools continues to fall behind the cost of inflation, is not adjusted to account for changes in student needs or academic standards, and fails to distribute funds equitably between districts.

### Changing Student Demographics

Texas is experiencing dramatic student population growth driven almost entirely by economically disadvantaged students, meaning they qualify for the federal free or reduced price lunch program. While the overall student population has increased by 20 percent in the last 10 years, the economically disadvantaged student population grew by 40 percent.

As a result, 60 percent of students are economically disadvantaged today. Not all economically disadvantaged students struggle academically, however the number of students who qualify for free and reduced price lunch has long been used as a proxy for student need.

If our school finance system were responsive to the changing needs of our students, you would expect to see school funding increase in relation to the increase in economically disadvantaged students.



### Increasing Academic Standards

Since the first statewide assessments of student achievement were implemented in 1986, the academic standards and accountability system has continuously evolved and expanded our expectation for students. In just the last five years, the state has launched a new assessment tool with a deeper focus on a narrower set of skills and completely changed the pathway to high school graduation.

Despite these changes, 76 of percent eighth graders are unable to pass the STAAR reading test.<sup>i</sup> Only one in five students who began eighth grade in 2003 has completed a postsecondary certificate or a degree. That rate drops down to 10.4 percent for economically disadvantaged students and 13.2 percent for Hispanic students.<sup>ii</sup> Though our academic standards and expectations have become more rigorous, too many students struggle to fulfill our expectations and are in need of greater support.

Again, school districts have not received any substantial increase in funding to assist them in implementing the curriculum and accountability changes mandated by the state.

### An Unequitable Distribution of Limited School Funding

To complicate things even further, the scarce amount of funding that is available for public education is not distributed equitably between school districts. Over reliance on local property wealth has created a system where districts with low property wealth per student tax at a higher rate and receive less funding, all while having a greater share of economically disadvantaged and other students who are costlier to educate than property wealthy districts.

Because of these compounding challenges, the school finance system has been the target of years of litigation over whether it ensures all Texas students have access to a quality education. The latest lawsuits originated in 2011, after the Legislature slashed \$5.3 billion from public education spending. Prior to the beginning of the 2015 session, a state court found the entire school finance system unconstitutional because it fails to take into account increasing standards or the educational needs of our students. The state appealed this decision, and the State Supreme Court heard the case in fall 2015. A ruling is expected in spring 2016.

Just like a solid older home that needs remodeling to update the plumbing and electrical systems, the current school finance system has a solid foundation and structure that we want to keep. The system recognizes that different kids need different support and resources. It provides funding for early education for children in low-income families, and it alleviates some of the gross disparities across school districts that result from a reliance on property tax revenue. However, the system has largely been neglected for the past 30 years and is in need of considerable updates to be efficient.

## **Improvements in Foundation School Program Funding and Structure**

With the Texas Supreme Court decision forthcoming, the Legislature made minor improvements to the Foundation School Program funding and structure, but decided to wait for the Court's decision before addressing any large structural issues. Legislators approved a modest increase in the basic allotment to provide an additional \$100 per student, or \$1.2 billion in total, which was not enough to keep pace with inflation or the changing needs of students. Legislators also authorized \$100 million to restore facilities funding programs that have been dormant for five years, and appropriated \$200 million for a technical adjustment to reduce fractional funding among a handful of districts. Finally, the Legislature also passed \$3.8 billion in tax cuts, which hurt the state's ability to make future investments in public education or fund other budget priorities.

### Increase in the Basic Allotment

The Basic Allotment is the primary building block for the school finance formulas. Increasing the Basic Allotment improves every district's funding level by bringing more money into the system.

The Legislature allocated \$1.2 billion<sup>iii</sup> to increase the Basic Allotment to \$5,140 per student<sup>1</sup> in 2016 and 2017<sup>iv</sup> from \$5,040 in 2015. However, this \$100-per-student increase is not enough to counteract the effects of inflation over the next two years. After adjusting for inflation using the Consumer Price Index, by 2017 the \$5,140 Basic Allotment will only be worth \$4,964 per student in today's dollars.

Increasing the Basic Allotment is an important step in addressing the adequacy concerns in our school finance system, but this small increase is akin to patching a badly leaking roof. The repair will hold for a little while, but time quickly erodes the patch, creating a larger hole and requiring a more substantive repair.

#### Facilities Aid: Instructional Facilities Allotment and New Instructional Facilities Allotment

In Texas, nearly all funding for school facilities is raised on the local level with the state playing a very small role. Across the state, nearly 85,000 students are added to Texas public schools each year. Because facilities funding is raised locally, large inequities exist between what a property poor and property wealthy district can raise to meet a growing student population. The large public education cuts in 2011 left two of the three programs that assist districts with facilities funding dormant until the Legislature restored \$100 million in funding this past session.

The first is the Instructional Facilities Allotment (IFA), which directs state aid to property-poor districts to assist with debt repayment on qualifying bonds and lease-purchase agreements. The program began in 1997, and it allows districts to apply for funding from the Texas Education Agency to assist with the purchase, construction, renovation, and/or expansion of instructional facilities. Once a district receives approval for IFA funding, it continues to get IFA funding until the debt is repaid.<sup>v</sup> Lawmakers allocated \$55.5 million this session to reopen the program for another round of applications.<sup>vi</sup> The Legislature last opened up IFA funding to new applicants in 2010 with \$75 million of new money.

IFA funding priority is given to districts with the lowest property wealth. This means districts with the least ability to raise revenue locally, and which have gone five years without any state assistance to purchase, construct, renovate, or expand instructional facilities, now have access to state support to renovate or expand their operations.

The second program receiving new funding is the New Instructional Facilities Allotment (NIFA), which helps school districts and charter schools operate newly constructed campuses. The allotment provides \$250 per student in the first year the new campus is open and \$250 for each additional student in the second year.<sup>vii</sup>

Statute caps the NIFA at \$23.75 million for each fiscal year, and the Legislature appropriated the full amount for the 2016-17 budget.<sup>viii</sup> This is the first time the Legislature appropriated funds to the program since the 2011 cuts to public education. The funding is not retroactive, so districts that opened a new facility during the five years the program was not funded will not receive NIFA funding for those facilities. All districts with new facilities are eligible for NIFA funding, regardless of the districts' property wealth per student.

Thinking back to the old house that needs renovations, eliminating facilities support through the IFA and NIFA programs for the last five years has literally prevented schools from taking on the renovations and expansions needed to deliver a quality education in a safe and comfortable environment.

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<sup>1</sup> Schools are funded based on the average number of students in attendance. Average Daily Attendance or ADA is calculated by taking the sum of students in attendance each day throughout the year divided by the days of instruction.

## Technical Adjustment to Reduce Fractional Funding

The technical adjustment to reduce fractional funding approved by the Legislature is one of the more complicated aspects of school finance. But it is important to understand because it is a bi-product of the tax rate compression the Legislature established after the last court challenge to the school finance system, and it is likely to be ruled on again in the current court case. Fractional funding is also important because it exposes how preferential treatment for property wealthy districts is built into the school finance system.

In 2005, the Texas State Supreme Court ruled that the school finance system was imposing a *de facto* statewide property tax, because the majority of school districts were taxing at the maximum allowed rate and had lost the discretion to raise or lower property taxes locally. The court considered this lack of local discretion a statewide property tax, and the state Constitution prohibits a state property tax.

To try to remedy the state property tax issue, the Legislature compressed every school district's tax rate by one-third in 2006 and instituted a new local tax rate cap that allowed more room for districts to raise their local property tax rate. However, districts that had not yet reached the state cap in 2006 – predominantly wealthier districts – received a smaller, prorated portion of funding, called fractional funding.

The technical fix approved by the 2015 Legislature is an adjustment that provides some additional funding to these districts by reducing the effect of fractional funding. The Legislative Budget Board estimates a biennial cost of \$200 million for this technical adjustment that will impact about 270 districts.<sup>ix</sup> To put this amount in perspective, only \$118 million was appropriated to fund the new High Quality Pre-K Grant Program, an emergency item for the Governor.

For a more detailed look at the technical adjustment to reduce fractional funding, see the Technical Appendix.

## **Tax Cuts: Diverting General Revenue from Other Critical Public Services**

In addition to the \$1.5 billion in formula changes, the 2016-17 budget also contains a funding swap of \$3.8 billion in new General Revenue funds for the Foundation School Program. These funds are not an increase in public education funding. They merely replace lost funding due to the franchise tax cut and the increase in the homestead exemption that the 2015 Legislature and voters approved. But because the lost education revenue had to be replaced, the tax cuts ultimately hurt the state's ability to fund other budget priorities or make future investments in public education.

### Franchise Tax Cut

In 2006, the Legislature revised the franchise tax and planned to use the additional revenue generated to partially cover the cost of compressing school district tax rates. This revenue flows to schools through the Property Tax Relief Fund. The 2015 Legislature reduced franchise tax rates by 25 percent, at a cost of \$2.6 billion in lost revenue to the Property Tax Relief Fund.<sup>x</sup> An equivalent amount of General Revenue had to be used to make up for the franchise tax cut, or schools would have seen a cut in state aid.

### Increase in the Homestead Exemption

In November 2015, voters approved an amendment to the state Constitution that increases the local school property tax homestead exemption to \$25,000 from its previous level of \$15,000. The homestead exemption reduces the taxable value of property occupied by a homeowner. Increasing the homestead exemption

decreases school property tax collections, requiring a greater contribution from the state. The Legislative Budget Board estimates a two-year General Revenue cost of \$1.2 billion to cover the increase in the homestead exemption.<sup>xi</sup>

The franchise tax cut and the homestead exemption increase do not immediately affect education funding because General Revenue fills the gaps. However, directing more General Revenue to public education, while simultaneously diminishing the state's ability to generate revenue, has a long-term impact on the state's ability to fund necessary public services—including future investments in education.

For example, imagine that your house needs major renovations and that you may risk code violations, but instead of budgeting for those renovations and developing a plan to bring your home up to code you purposely cut your household income in half. As a result, you are left trying to convince code enforcement you cannot afford to make the needed renovations.

## Solutions

Our school finance system is facing big challenges, but they are not impossible to overcome. What our school finance system really needs is some updating and modernizing to bring it up to code and get it ready to educate future generations of Texans.

To effectively remodel and update our school finance system, the Legislature will need to:

- Commission an objective, third-party study on the level of funding required to meet the academic standards currently in place;
- Update several elements of the funding formulas, some of which haven't been adjusted for nearly three decades;
- Bring up funding levels for all districts by increasing the basic allotment; and
- Adjust the basic allotment for inflation and build in periodic reviews.

All good remodels have plans and goals. The Legislature has never taken a serious look at the resources needed to meet the academic standards we want students to achieve. Now is the time for the Legislature to commission an independent study that matches standards with resources.

Many of the funding elements in the formulas are severely outdated and need to be updated. These improvements can be thought of as tearing out all that old 80s wallpaper and patching holes in the dry wall.

We also need to reinforce the foundation of the system. The basic allotment is the per student funding level that works as the foundation of our school finance system, and it's the primary building block for all districts. Increasing the basic allotment brings funding levels up for all districts.

Part of having a strong foundation is developing a revenue system that meets today's needs and prepares Texas for future growth. There are several things the Legislature can do to strengthen the state's revenue system, such as scrubbing outdated exemptions from the tax code, ensuring commercial properties are appraised at market value, and accepting federal dollars when available.

Most importantly, we need to ensure we are not back in the exact same spot ten years from now. Adjusting the formulas for inflation will help our schools keep pace with rising costs. The Legislature should also build periodic reviews of the formulas into law so the funding elements do not quickly become outdated again.

To be competitive in the global economy, Texas must invest in our students and future workforce by updating and modernizing the school finance formulas. Just as a house needs ongoing maintenance and periodic updates to maintain its value, our school system needs some remodeling to stay current.

## **TECHNICAL APPENDIX**

### Technical Adjustment to Reduce Fractional Funding

The last court challenge of the school finance system, resolved in 2006, found that the state had a *de facto* statewide property tax, because the majority of school districts were taxing at the maximum allowed rate and had lost the discretion to raise or lower property taxes locally. The state Constitution prohibits a state property tax.

To remedy this situation, the Legislature compressed every school district's tax rate by one-third and instituted a new local tax rate cap of \$1.17 per \$100 of property value while promising that districts would not see a reduction in funding.

Since most districts were at the old \$1.50 tax cap, the one-third compression left most districts starting the new system taxing at \$1.00 per \$100 of property wealth with the option to raise its tax rate up to \$1.17. Districts that had not reached the \$1.50 cap had their tax rates compressed to less than one dollar and received a smaller, prorated portion of the Basic Allotment called fractional funding.

For example, if a district was taxing at \$1.30, its compressed tax rate would be \$0.88 and it would receive 88 percent of the Basic Allotment. This district can still raise its tax rate to \$1.17, but instead of having 17 additional pennies of tax available, this district has 29 pennies. Primarily it was property wealthy districts that were able to avoid hitting the cap because they could generate enough funding with lower property tax rates. However, a good number of districts were within five cents of the cap and also saw their funding prorated.

Who gets which penny when is important because school funding is broken into two tiers tied to tax rates. For most districts, the first dollar of tax goes toward funding the basic program, known as Tier I, which is tied to the Basic Allotment. Tier II is the enrichment tier, and it has two parts. The first six pennies after Tier I are called "Golden Pennies" because the state guarantees that districts will receive at least as much as Austin ISD (created when AISD was in the 95<sup>th</sup> wealth percentile), and these pennies are not subject to recapture. Recapture is the funding sent to the state from school districts categorized as property-wealthy under Chapter 41 of the education code. The last eleven pennies are called "Copper Pennies" because they have a lower guaranteed yield and are subject to recapture.

A district subject to fractional funding receives funding at the "Golden Penny" level for the first six pennies above its compressed Tier I tax rate and all the additional pennies up to the \$1.17 cap are funded at the lower "Copper Penny" level. Basically, these districts were allowed to jump directly to the pennies that carried the most value without earning the full Tier I funding as their tax rates increased.

Now that so many districts are struggling to provide a quality education with the funding available, even historically property wealthy districts are raising their tax rates. Many districts subjected to fractional funding in 2006 are now finding the only tax effort they have left is in the low-value "Copper Penny" segment. As a result, the Legislature is allowing districts that have increased their tax rates to more than six pennies above its compressed tax rate to swap low value "Copper Pennies" for higher value Tier I pennies while keeping all their

“Golden Pennies,” which hold the highest value. A district that goes through this tax rate conversion will still have its Basic Allotment prorated until it reaches a tax rate of \$1.00 per \$100 of property value in Tier I.

While this change is an overall positive for the system because it moves more districts toward being funded under the same rules, a more equitable approach would have been either to have districts earn the full Tier I funding before accessing “Golden Pennies” or to convert “Golden Pennies” to Tier I pennies first. “Golden Pennies” are a driver of inequity in the school finance system because there is no limit on the amount of funding a district can generate through these pennies.

The LBB assumes that 80 percent of the 341 districts with eligible pennies will choose to convert “Copper Pennies” to Tier I pennies in FY 2016. Of those, 58 percent were within five cents of the \$1.50 cap at the time of compression.<sup>xii</sup>

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<sup>i</sup> Texas Education Agency. State of Texas Assessments of Academic Readiness, Summary Report Grade 8 Reading. Date of Testing, June 2015.

<sup>ii</sup> Texas Tribune. Higher Ed Outcomes: Tracking Eighth-Graders’ Post-Secondary Success

<http://www.texastribune.org/education/public-education/8th-grade-cohorts/state/texas/>

<sup>iii</sup> Legislative Budget Board. Summary of Conference Committee Report for House Bill 1: Appropriations for the 2016-17 Biennium; May 2015

<sup>iv</sup> General Appropriations Act 2016-17. Article III – Texas Education Agency; rider 3.

<sup>v</sup> Texas Education Agency. Instructional Facilities Allotment (IFA) Program

[tea.texas.gov/Finance\\_and\\_Grants/State\\_Funding/Manuals/School\\_Finance\\_Topics\\_-\\_One\\_Page\\_Descriptions/](http://tea.texas.gov/Finance_and_Grants/State_Funding/Manuals/School_Finance_Topics_-_One_Page_Descriptions/)

<sup>vi</sup> General Appropriations Act 2016-17. Article III – Texas Education Agency; rider 3.

<sup>vii</sup> Texas Education Agency. New Instructional Facilities Allotment (NIFA) Program

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<sup>viii</sup> General Appropriations Act 2016-17. Article III – Texas Education Agency; rider 3.

<sup>ix</sup> Legislative Budget Board, Foundation School Program Estimates: 84<sup>th</sup> Legislature, Regular Session 2015.

<sup>x</sup> Legislative Budget Board, fiscal note for H.B. 32, May 25, 2015.

<sup>xi</sup> Legislative Budget Board, fiscal note for S.B. 1, May 29, 2015. The \$1.2 billion cost to increase the homestead exemption is for 2016-17; it rises to \$1.3 billion in 2018-19.

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