

# Oregon School Finance:

*A Review of System  
Stability, Adequacy, Equity  
and Transparency*

Prepared for  
The Chalkboard Project

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# Table of Contents

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<b>CHAPTER 1</b>	<b>INTRODUCTION</b>	
	Purpose of the Report.....	1-1
	Organization of the Report.....	1-1
<b>CHAPTER 2</b>	<b>STABILITY</b>	
	Introduction .....	2-1
	Policy Alternatives.....	2-3
	Summary of Policy Options.....	2-17
<b>CHAPTER 3</b>	<b>ADEQUACY</b>	
	Introduction .....	3-1
	Recent Trends in K-12 Spending .....	3-2
	Evidence on Spending and K-12 Outcomes.....	3-3
	Cost-out Models .....	3-4
	Local Revenue Options.....	3-9
	Conclusion and Policy Options.....	3-16
<b>CHAPTER 4</b>	<b>EQUITY</b>	
	Introduction .....	4-1
	Equity in Oregon.....	4-2
	Outstanding Issues Related to Equity .....	4-6
	Conclusion and Policy Options.....	4-14
<b>CHAPTER 5</b>	<b>TRANSPARENT BUDGETING</b>	
	Introduction .....	5-1
	The Case for a New K-12 Budget Format .....	5-3
	What a transparent budget could show .....	5-4
	Looking Forward: How policymakers could use transparent budgeting in the future .....	5-7
	Conclusion and Policy Options.....	5-10
<b>CHAPTER 6</b>	<b>PROGRAM EFFICIENCIES</b>	
	Introduction .....	6-1
	Policy Options .....	6-1
<b>CHAPTER 7</b>	<b>CONCLUSION</b>	
	Conclusion.....	7-1



## PURPOSE OF THE REPORT

This report is the third in a series of research reports produced for *The Chalkboard Project*, an effort sponsored by five Oregon foundations to share best practices, broaden perspectives, and unite the citizens of Oregon in the goal of a superior public education system. The first report in the Chalkboard series, entitled *The Condition of Oregon K-12 Education*, described the existing conditions of Oregon's K-12 system and stopped short of offering solutions. The second report, *Improving Quality and Strengthening Accountability in Oregon's Schools: A Broad Review of Promising Practices and Policy Options*, reviewed national and international education practices and advanced a broad list of policy options that showed strong potential to improve student achievement.

This third and final report turns to the topic of school finance. No feature of the Oregon K-12 system has captured more stakeholder and media interest in recent years. The increased focus is due, in part, to the centralized nature of the finance decision, which today rests primarily with the state legislature. During this most recent economic downturn, Oregonians twice rejected statewide efforts—Measures 28 (2003) and Measure 30 (2004)—aimed at stabilizing spending in K-12 and other public service areas. The rejection of the measures, particularly Measure 28, attracted significant national media attention. Given that context, it should come as no surprise that a recent statewide poll found funding issues topped Oregonians' concerns about the K-12 system.

With no statewide solution, a number of school districts relied on a patchwork of local approaches to mitigate declines in spending per student during the recent state fiscal crisis. While some school districts employed the property tax-based local option process, others turned to transfers from local cities. Meanwhile, voters in Multnomah County departed from traditional revenue sources and created the state's first county income tax.

These uncoordinated approaches to securing school funding place the state's school finance system at a crossroads. In recent months, policymakers and state officials have considered and debated a wide array of finance-related policy options. The purpose of this report is to assemble evidence on policies that show potential to strengthen the state's method of funding its schools.

## ORGANIZATION OF THE REPORT

The report contains five topical chapters and a conclusion.

- **Chapter 2 Stability.** Oregon's recent economic downturn and the accompanying fiscal crisis exposed a flaw in the state's revenue system. This chapter discusses the causes of the recent revenue swings and offers policy options that, if implemented, could stabilize K-12 spending during future recessions.
- **Chapter 3 Adequacy.** While Oregonians tend to agree that funding is important, they disagree on whether the system has adequate resources to deliver a quality product. With a goal of clarifying the adequacy discussion, this chapter explores recent spending trends, examines spending proposed through the state's Quality Education Model, and considers a reformed local option process.
- **Chapter 4 Equity.** During the 1990s, Oregon shifted primary responsibility for funding K-12 activities from localities to the state. Concurrent with the shift in responsibility came an explicit goal to equalize the resources available to students across the state. With resource equity at the district level largely achieved, this chapter explores *intra*-district budgeting practices that potentially undermine equity goals and then turns to a concept of outcome-equity, which has implications for the state's funding formula.
- **Chapter 5 Transparent Budgeting.** Relative to other government programs like Medicaid or higher education, fiscal reporting in K-12 is robust. In the late 1980s the National Center for Education Statistics worked with states to ensure competent and thorough reporting of education expenditures. In short, all the pieces are in place to support strong fiscal accountability. Despite good availability, Oregon has not used its data very intensively and budgets have not been transparent. This chapter explores recent K-12 spending trends and offers recommendations for an improved budget process built on open and clear budgeting practices.
- **Chapter 6 Program Efficiencies.** The recent sharp declines in spending per student have caused local districts across the state, and the nation, to do more with less. School officials are on a constant lookout for more efficient ways to do business. This chapter reviews a range of strategies that local districts and the state could employ to bolster program efficiencies.

## INTRODUCTION

Like businesses, schools need to plan for the implementation of their education services. Oregonians may differ about how they should deliver educational services and how much they should spend to do it, but once they agree on an amount and an approach, few should disagree the agreed-upon resources should be relatively stable from year to year.

Since the passage of property tax limitations during 1990s, Oregon has gradually shifted responsibility for K-12 education funding from the local to state level. With this transfer of funding authority, the state legislature essentially determines the overall level of resources available to school districts and ultimately to children across the state. The transfer in primary funding authority from localities to the state also implied an increasing reliance on the personal and corporate income taxes, which compose the majority of the state's general fund.

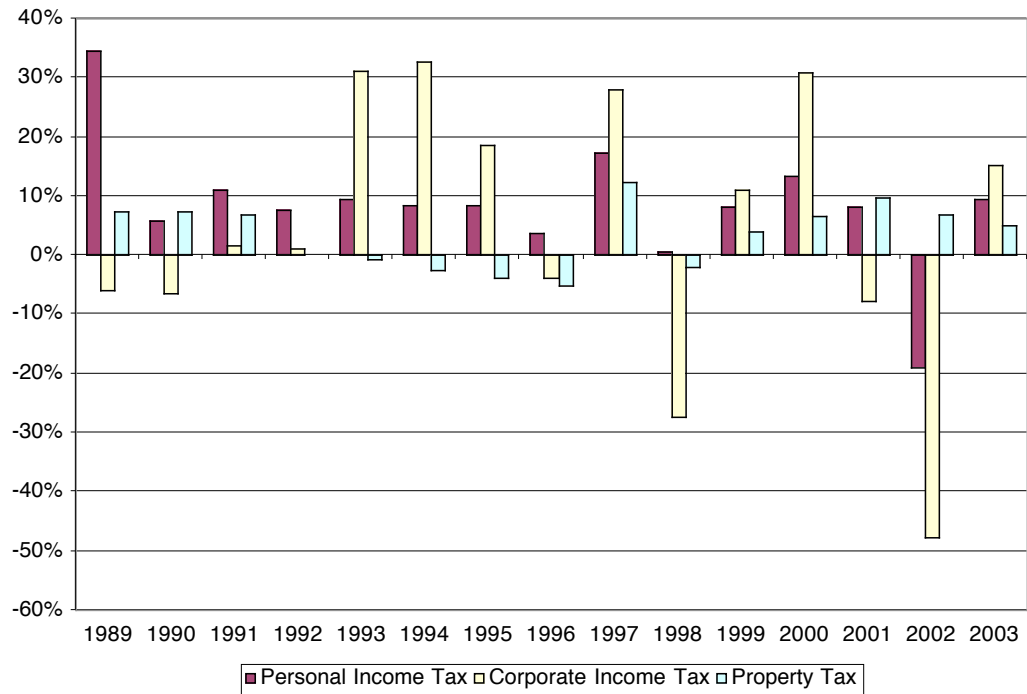
Figure 2-1 illustrates the relative stability of Oregon personal income, corporate income, and property taxes during 1989-2003. Property taxes, which served as the primary revenue source for schools before 1990, show annual changes between -10 and +15 percent, with the majority of years falling between -5 and +5 percent. The implementation of Measures 5 and 50 explain the declining property tax revenues during the mid-1990s.

Personal and corporate income taxes are tied closely to economic activity and, consequently, are more volatile. Personal income tax revenue increased by 34 percent in 1989 and exhibited positive year-to-year gains throughout—by varying amounts—throughout the 1990s. However, between fiscal years 2001 and 2002, personal income tax revenues fell by 19 percent. Oregon's relatively high reliance on capital gains income contributes to the instability of personal income taxes.

Corporate income taxes, which compose a much smaller share of the General Fund, are considerably more volatile. As expected, they grow during economic expansions and fall during and after recessions.

Table 2-1 shows the contribution of a state's *largest* revenue source as a share of all the revenues raised at the state level. Compared with its Western peers, Oregon has an unusually high dependence on a single tax (income).

**Figure 2-1 Annual Percentage Changes in Oregon Personal Income Taxes, Corporate Income Taxes and Property, 1989-2003 State Fiscal Years**



Source: Oregon State Legislative Revenue Office

**Table 2-1: Largest Revenue Source Expressed as a Share of All State-Level Revenue, Selected Western States, Fiscal Year 2002**

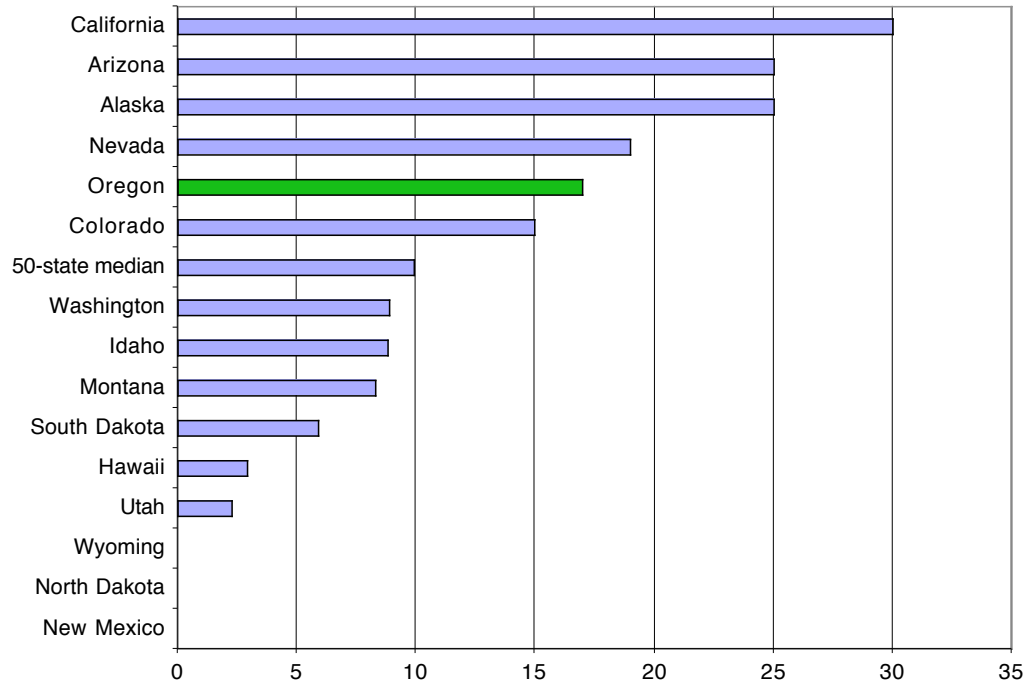
State	Largest State Revenue Source	Share of State-Level Revenue
Oregon	Income (Personal and Corporate)	75.3
Washington	Sales	62.6
Nevada	Sales	52.5
Arizona	Sales	50.6
California	Income (Personal and Corporate)	49.4
Utah	Income (Personal and Corporate)	43.7
Idaho	Income (Personal and Corporate)	40.5

Source: Oregon State Legislative Revenue Office

Oregon’s reliance on highly volatile income taxes—coupled with the absence of a stabilization or “rainy day” fund—produced the state’s well-documented fiscal crisis during the recent economic downturn. Figure 2-2

shows Oregon faced a budget gap of 17 percent in fiscal year 2004 compared to a 50-state median of 9.9 percent. Despite the relatively high deficit, Oregon voters twice rejected statewide efforts to mitigate the state's fiscal crisis through increased taxes.

**Figure 2-2: State Government Budget Gaps Expressed as a Percent of State Budget (Before Gap-Closing Actions), Selected Western States and US Median, FY 2004**



Source: State Budget Update: April 2004, National Conference of State Legislatures; Center on Budget and Policy Priorities

The state's fiscal crisis, in turn, produced instability in K-12 funding. Current expenditures per student for public Kindergarten-12<sup>th</sup> grade (K-12) schools fell by an estimated 6.1 percent between the 2002 and 2003 school years—from \$7,713 to \$7,242. The decline was not only the largest annual decline measured by any state between 2002-2003; it was the second largest year-to-year decline measured by any state or jurisdiction since the 1989-90 school year<sup>1</sup>.

## POLICY ALTERNATIVES

The most recent economic downturn exposed a structural weakness in Oregon's public finance system. Technically, achieving stability in a volatile revenue system is straightforward. Fiscal experts have devised a variety of methods to smooth the severity of revenue peaks and troughs.

<sup>1</sup> The District of Columbia registered the largest year-to-year percent decline (-6.25 percent) between the 1993-94 and 1994-95 school years.

However, the move from volatility to stability involves significant challenges, which could include forgoing spending on essential services in the short-term to build reserves in a rainy day fund or introducing less volatile revenue sources like consumption taxes.

In a general sense, Oregon's options to improve funding stability fall into three broad categories.

- **Create minimum K-12 spending guarantees.** Through this approach, the state could leave the basic structure of the General Fund untouched but require that the state spend a certain share of General Fund resources on K-12 activities or, alternatively, guarantee an annual increase in per student spending.
- **Stabilize the state general fund with no change to the key revenue sources.** Income taxes would continue to compose the majority of the general fund but the state would create stabilizing features (e.g., rainy day fund, required ending balances).
- **Stabilize the state general fund by changing the key revenue sources.** Policymakers could stabilize the general fund by altering its portfolio of revenue sources.

These three general options are not mutually exclusive, and policymakers could implement policies in one or more of these categories simultaneously. For example, policymakers could couple the implementation of a rainy day fund with a K-12 spending guarantee or create a new consumption-based tax, while requiring a projected ending balance. Below, we discuss each policy category in more detail.

## MANDATING K-12 SPENDING GUARANTEES

A number of states have implemented policies that—to some extent—drive or guarantee certain spending or service levels. In Oregon, the closest example of state-mandated service levels was implemented through Ballot Measure 11, which enacted minimum prison sentencing guidelines and has resulted in larger prison populations and, consequently, public safety budgets.

In the K-12 area, California and Colorado have enacted policies that guarantee certain levels of per student spending from year to year. In both states, these policies conflict—to some degree—with competing policies that limit overall government revenues: Proposition 13 in California and the Taxpayer's Bill of Rights (TABOR) in Colorado. In the following sections, we discuss the spending guarantees and the consequences for education and other public services.

## CALIFORNIA'S PROPOSITION 98<sup>2</sup>

Californians approved Proposition 98, as an amendment to the state constitution in 1988. The amendment guarantees K-14 (elementary through community college) a minimum amount of state and local revenue based on the condition of the state's fiscal position and economic health. The funding guarantee is tied to three principles:

1. In years of normal state revenue growth, K-14 education receives at least the same amount as the previous year, adjusted for changes in enrollment and per capita personal income<sup>3</sup>.
2. When revenue growth from one year to the next is particularly bad, K-14 education participates in the state's losses according to a specified fair share formula.
3. Following a fair share reduction that causes the Proposition 98 guarantee to lag behind normal growth, the state is obligated to eventually restore K-14 funding to what it would have been if no reduction had occurred.

During California's strong economic growth of the 1990s, the guarantee resulted in K-14 receiving an allocation equal to the previous fiscal year *plus* enrollment growth and an inflation adjustment equal to the change in per capita personal income.

Beginning in 2000, revenues from the state's personal and corporate income taxes have been highly volatile, and by 2004, California led the nation with an estimated 30 percent shortfall in its state general fund. During the 2001-02 and 2002-03 state budget cycles, the legislature cut K-14 allocations and provided \$966 million less than the minimum guarantee. Then, in his 2003-04 budget, Governor Schwarzenegger proposed a suspension to the Proposition 98 guarantee, advancing a \$46.7 billion budget that was \$2 billion below the guaranteed levels.

By falling short of the guarantees, the state has essentially established an obligation and must eventually restore funding to the previously determined growth path (as determined by long-run trends in enrollment and per capita personal income growth). As California moves into the "funding restoration" period, the state will calculate the difference between 1) actual spending and 2) an alternative path that would have occurred if per student spending had

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<sup>2</sup> This section's description of Proposition 98 draws heavily from Ed Source. April 2004. *Proposition 98 guarantees a minimum level of funding for public schools*. Palo Alto, CA

<sup>3</sup> The enrollment plus per capita income growth is the most common driver of the annual guaranteed amounts. However, the state formally calculates the guarantee through a three-part test: Test 1: K-14 spending is equal to at least 34.6 percent of state General Fund revenues; Test 2: K-14 spending is the same amount as the previous year, plus enrollment growth and inflation adjustment based on growth in per capita personal income; Test 3: same as Test 2 except the inflation adjustment is the annual change (increase or decrease) in per capita General Fund revenues plus 0.5 percent.

kept pace with personal income growth. This difference is called the “maintenance factor” and it is restored in one of two ways:

1. When General Fund revenues grow faster than personal income, the state must reduce the maintenance factor by providing additional growth funding
2. The Legislature can opt to provide funding above the minimum guarantee—restoring the maintenance factor faster than required under law.

In practice, the Proposition 98 rules allow funding restoration over the number of years, and the state’s Legislative Analyst’s Office predicts the so-called “maintenance factor” generated by the suspension will persist through the 2008-09 fiscal year.

Despite the recent suspension, critics of Proposition 98 argue the spending guarantee—coupled with California’s long-standing property tax limitations (Proposition 13)—place considerable fiscal pressure on government programs that lack constitutional spending guarantees. In California, local governments, which compete with schools for property tax revenues, are frequently cited as victims of combined effects of Propositions 13 and 98<sup>4</sup>.

## **COLORADO’S AMENDMENT 23<sup>5</sup>**

In 2000, Colorado adopted Amendment 23, which like California’s Proposition 98, guarantees a minimum level of K-12 spending. Amendment 23 guarantees per student spending increases at the rate of inflation plus one percentage point from 2001-2011. After 2011, the annual guarantee is equal to the rate of inflation. Colorado’s Legislative Council Staff estimates that Amendment 23’s first provision will increase K-12 spending by \$1.4 billion during its first seven years, providing an additional \$44.1 million in fiscal year 2002 and a projected \$371.8 million in fiscal year 2008.

Unlike California, the Colorado K-12 *spending guarantee* coexists with a state revenue *limit*. Colorado’s Taxpayer’s Bill of Rights (TABOR) limits annual growth in state revenue to rate of growth in inflation plus population. Revenue collected in excess of the TABOR limits creates surpluses that are returned to taxpayers in the form of refunds.

The interaction between the Amendment 23 guarantees, TABOR rules, and weak economy have generated unanticipated fiscal consequences in the State’s General Fund.

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<sup>4</sup> See, for example, Walters, Dan October 12, 2004. *Protections may cause problems for California’s local governments*. Sacramento Bee. Scripps Howard Inc.

<sup>5</sup> This section draws from Colorado Legislative Council Staff. September 2003. *House Joint Resolution 03-1033 Study: TABOR, Amendment 23, the Gallagher Amendment, and Other Fiscal Issues*. Publication No. 518.

When Colorado adopted Amendment 23, the state was in a strong economic position. In fiscal year 2001, the state collected \$927 million in income taxes in excess of TABOR revenue limits. Through a provision in Amendment 23, the state could tap TABOR surpluses to pay for the K-12 spending guarantees. As long as the TABOR surpluses continued, the state could avoid tapping the General Fund to support the K-12 spending mandate. In other words, by tapping TABOR surpluses (essentially reducing taxpayer refunds), policymakers could hold the General Fund—and the non-K12 programs it supports—harmless.

However, in fiscal year 2002, Colorado's income tax revenues fell 19 percent, instantly erasing the TABOR surpluses and refunds. Consequently, beginning in fiscal 2002 and thereafter, the state began financing Amendment 23 spending guarantee with General Fund appropriations, which exacerbated the state's already weak fiscal position. The state's Legislative Council staff forecasts—that if the Amendment 23 guarantee remains in place—the state will continue to draw resources from General Fund through fiscal year 2008.

Fiscal observers point to TABOR and Amendment 23, with their competing goals, as determinants of \$215 million fiscal year 2004 budget shortfall, which may result in cuts to non-K-12 programs. Cuts under consideration include moving some elderly patients out of state-funded nursing homes, closing state parks, and increasing tuition at state universities and colleges.

Colorado's experience provides important lessons for Oregon as it considers overall spending limits and possible reforms to its education finance system. In short, if Oregon adopts a TABOR-style spending limit, the Legislature must take particular care in the design of any accompanying spending guarantees—for education or any other program.

## **STABILIZE THE STATE GENERAL FUND WITH NO CHANGE TO THE KEY REVENUE SOURCES**

A second alternative to promote revenue stability in the state General Fund would involve creating budgetary mechanisms that would require the state to save resources during strong revenue periods (stabilization or “rainy day” fund) or require a specified ending General Fund balance. The two strategies could be implemented separately or together. The goals and purposes of each approach are different, as discussed in more detail below.

### **STABILIZATION FUNDS<sup>6</sup>**

Stabilization funds are fiscal tools through which governments save revenues during strong economic times. The funds have the explicit goal of

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<sup>6</sup> This section draws heavily on State of Oregon Legislative Revenue Office. August 2004. *The Education Stability Fund*. Salem OR.

stabilizing General Fund expenditures in both good and bad economic times. The state would mitigate budget shortfalls by drawing on fund resources during economic downturns. Conversely, the state would curb expenditures during economic expansions by requiring deposits into the fund.

Policymakers must consider four factors in developing a stabilization fund.

1. **Revenue source.** Policymakers must identify the stream of revenues that support the fund during periods of strong economic growth. Any number of options are possible, including broad appropriations of general fund revenues or specifically earmarked revenue sources.
2. **Withdrawal triggers.** Formal stabilization funds typically contain economic, fiscal, and political triggers that specify precise rules as to how and when policymakers can access fund resources. Economic triggers may tie fund withdrawals to recessionary periods. Fiscal triggers may tie withdrawals to net reductions in General Fund resources from one period to the next. Finally, political triggers specify voting criteria and other actions by the legislative and executive branches required to access fund resources.
3. **Use of funds.** Rules specify whether accessed funds can be used broadly for all or a specific subset of services.
4. **Size of fund.** Rules dictate how large a fund can grow relative to the overall size of the state's General Fund or comparable measure.

In the years leading up to the most recent economic downturn, Oregon was one of only five states without a formal stabilization fund as part of its General Fund<sup>7</sup>. In 2002, Oregon voters established an Education Stability Fund, which used as its foundation a predecessor fund: Education Endowment Fund. The Legislature created the Education Endowment Fund in 1995 and earmarked 15 percent of Lottery earnings to it. Like its predecessor fund, resources from the Education Stability Fund can be spent on only public education, which is defined broadly to include pre-Kindergarten through higher education as well as continuing education and workforce training. The key differences between the Education Stability Fund and its predecessor are twofold:

1. Under the newly created Education Stability Fund, lawmakers could authorize the spending of fund *principal*; The Endowment Fund allowed the spending of only fund *earnings*;

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<sup>7</sup> See Oregon State Legislative Revenue Office. March 8, 2002. *Education Stability Fund*.

2. The Education Stability Fund receives a higher share of Lottery earnings than its predecessor: 18 percent versus 15 percent.

Use of the fund's principal is limited to periods of economic recession and additionally require supermajority (60 percent) approval of each chamber in the Legislature. Fund principal can also be spent if the Governor declares an emergency and each legislative chamber approves, again through a supermajority. Finally, the Fund is capped at 5 percent of the General Fund<sup>8</sup>.

Figure 2-3 shows the ending year balances for the related funds since 1998. Given prior law forbade spending the Education Endowment Fund's principal, ending year balances grew from \$45.8 million in 1998 to \$222.2 million in 2002. Since May 2003, under the framework of the new fund rules, the Legislature has transferred \$384.7 million to the State School Fund. Given the transfers, the fund has a projected ending balance of \$33.6 million at the end of fiscal year 2005, which is equal to 0.3 percent of the 2003-05 General Fund. Assuming Lottery earnings under current law, the Fund is expected to grow to almost \$500 million by 2011, which will still be well below the 5 percent General Fund cap.

The Education Stability Fund explicitly supports only a subset of General Fund programs. Unlike stabilizing funds in many other states, the resources cannot *directly* support health, human services, or public safety programs. Despite the explicit earmark of resources to educational activities, the existence of the Fund, when at the capped 5 percent level, would *indirectly* provide a stabilizing benefit for all programs in the General Fund.

The 5 percent cap, given that it is the only stabilization fund associated with the General Fund, is well below levels recommended by the nonpartisan Government Finance Officers Association (GFOA). The GFOA recommends stabilization funds equal 5 to 15 percent of the General Fund, with the upper end reserved for states like Oregon with undiversified and highly volatile tax portfolios<sup>9</sup>.

Regardless of the specific approach, experts view stabilization funds as a critical aspect of state fiscal structures as states become increasingly dependent on income taxes and spending pressures mount. In recommending a variety of proposals for school finance reform, the national Committee for Economic Development, which is composed of corporate executives of top US companies, called on states to bolster their reserves<sup>10</sup>:

*“While many states set aside “rainy day funds” during the 1990s, these reserve accounts have not proven large enough to protect states from the*

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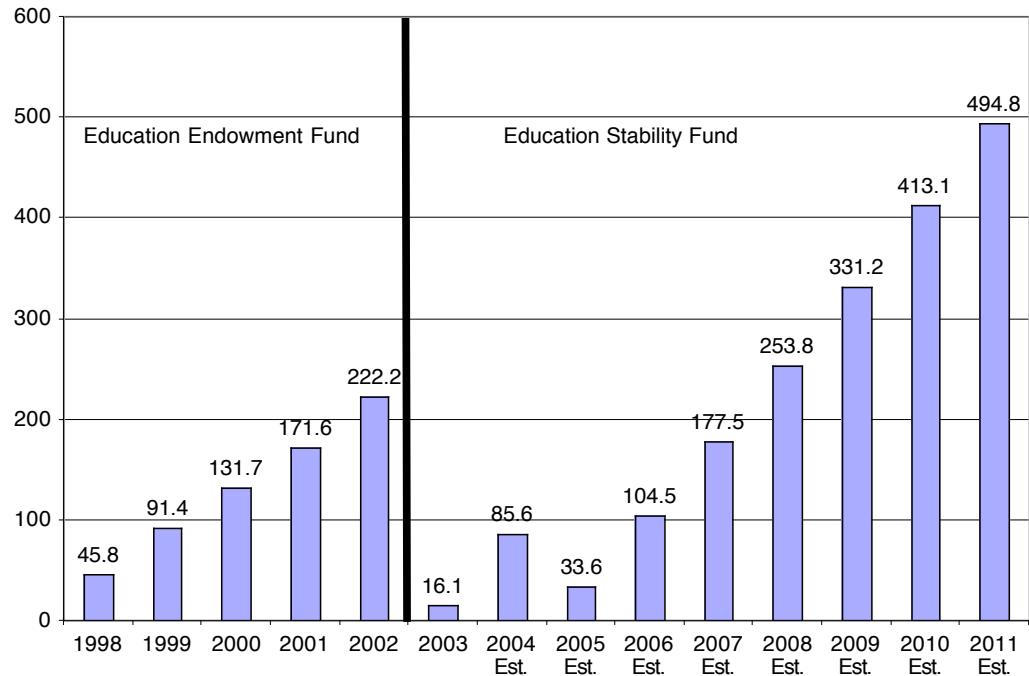
<sup>8</sup> If the cap is met, draws on Lottery earnings fall to 15 percent and accrue in School Capital Matching subaccount.

<sup>9</sup> See Government Finance Officers Association. 2002. *Appropriate Level of Unreserved Fund Balance in the General Fund*. Accessed on November 5<sup>th</sup> 2004 from <http://www.gfoa.org/services/rp/budget.shtml>

<sup>10</sup> See Committee for Economic Development. 2004. *Investing in Learning: School Funding Policies to Foster High Performance*. Page 44. Washington DC.

*need to raise taxes or cut expenditures in the current downturn. Healthy reserves are increasingly important, however, as states depend more heavily on income taxes, because these tax revenues are more sensitive to economic downturns than other important state taxes like sales and excise taxes. Shortcomings in current “rainy day fund” policies highlight the need to begin thinking now about changes that can help such funds do a better job of protecting state programs in future fiscal crises.”*

**Figure 2-3: Actual and Projected Ending Balances in Oregon’s Education Endowment/Stability Funds in Millions, 1998-2011**



Source: Oregon State Legislative Revenue Office

## REQUIRED PROJECTED ENDING BALANCE

Under current budgeting rules, the Legislature can appropriate 100 percent of projected General Fund resources in a given biennium—leaving no projected ending balance. If, as happened multiple times during the recent economic downturn, actual revenues fall short of projections, the Legislature has to cut previously approved program expenditures.

By requiring a 5 or 10 percent projected ending balance in the General Fund, the Legislature would appropriate fewer resources to programs in the first instance. If by the end of the biennium, the original revenue projections prove accurate, the Legislature could 1) supplement spending in the current biennium, 2) roll the ending balance into the subsequent biennium, and/or 3) deposit some or all of the balance into a stabilization fund. If the original projections proved overestimates, the Legislature could avoid program cuts but, depending on the magnitude of the over-projection, may still have

resources to supplement current spending or transfer for uses in future biennia.

## **STABILIZE THE STATE GENERAL FUND BY CHANGING THE KEY REVENUE SOURCES**

With or without a stabilization fund or required ending balance, policymakers could stabilize the General Fund by altering its revenue portfolio. Oregon's high reliance on volatile revenue was well known prior to the most recent economic downturn. A number of commissions and agencies have examined in detail the advantages and disadvantages of a range of comprehensive tax reform proposals. In this section, we introduce the key principles of tax policy and then highlight advantages and disadvantages of tax alternatives.

### **EVALUATING MAJOR TAX ALTERNATIVES**

When considering tax alternatives, analysts typically review a tax performance on five performance criteria:

1. **Size (or adequacy).** Is the tax base sufficiently large to generate revenues of sufficient size to fund desired public services?
2. **Stability.** By how much do revenues vary during strong and weak economic periods?
3. **Equity.** Are similarly situated individuals or businesses treated similarly (so-called horizontal equity)? How do different groups of taxpayers (high income, low income) bear the tax burden (so-called vertical equity)?
4. **Administrability.** How easy (or hard) is the tax to administer?
5. **Economic distortion.** By how much does a tax change economic activity by individuals or businesses.

Figure 2-4 briefly evaluates income, sales, and property taxes using evaluative criteria. Each tax has advantages and disadvantages.

### **Income taxes**

From the fiscal perspective, a key advantage to income taxes are attractive because they grow as fast—and at times faster—than the overall economy. Given their growth potential, most fiscal experts see income taxes as better able to keep pace with public service demands over the next decade than traditional retail sales taxes<sup>11</sup>. States can easily design income taxes to

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<sup>11</sup> See for example, Committee for Economic Development. 2004. *Investing in Learning: School Funding Policies to Foster High Performance*. Page 44. Washington DC. And Boyd (2003).

be progressive, which appeals to the desires of some policymakers who would like the tax burden to fall disproportionately on those most able to pay.

On the downside, income taxes discourage income-producing activities and, as has been discussed previously, are volatile.

## Sales taxes

Sales taxes are generally more stable than income taxes and encourage savings. However, the foundation of traditional sales taxes, which have been levied on retail items, is eroding as economic activity has shifted from manufacturing to the service sectors, which have proven more difficult to tax. Moreover, individual states have lost tax revenues through expansions of Internet and direct mail sales. Because of these two effects, Western states are projected to lose up to 5.5 percent of their state and local sales tax revenues during 2001-2006 (see Figure 2-5). Given the projected slow growth, fiscal observers predict states that are dependent on traditional retail sales taxes will likely run structural deficits through the end of the decade<sup>12</sup>. In addition, to an eroding revenue base, traditional sales taxes tend to be regressive (that is, low-income households pay a higher percentage of their incomes on the tax than high-income households). While the degree of regressivity can be mitigated through low-income credits, such programs increase the tax's administrative burden.

Oregon could mitigate some of the concerns just discussed by expanding the tax base and capturing sales in the service sector. Washington's gross receipts tax—as the name suggests—assess a tax based on the gross receipts of businesses across a wide range of industries. Alternatively, Oregon could consider so-called value-added taxes, which tax the incremental value added at each stage of the production process. Michigan and New Hampshire are the only two states with value-added taxes, which are much more popular outside the United States.

## Property taxes

Property taxes are appealing to governments that service small geographic areas (local governments), because property—unlike income and consumer purchases—cannot be easily moved or hidden. Relative to incomes and consumption behavior, property values tend to be stable. Economists generally believe those who own land *at the time a property tax is imposed* absorb the cost of the tax through a reduction in the value of the property. That reduction can be offset, in part or in whole, by the value of the public services financed through the property tax revenues. Finally, property taxes increase the cost of capital, so localities with relatively high property taxes likely see a reduction in capital-intensive economic activities (e.g., manufacturing)—all other things being equal.

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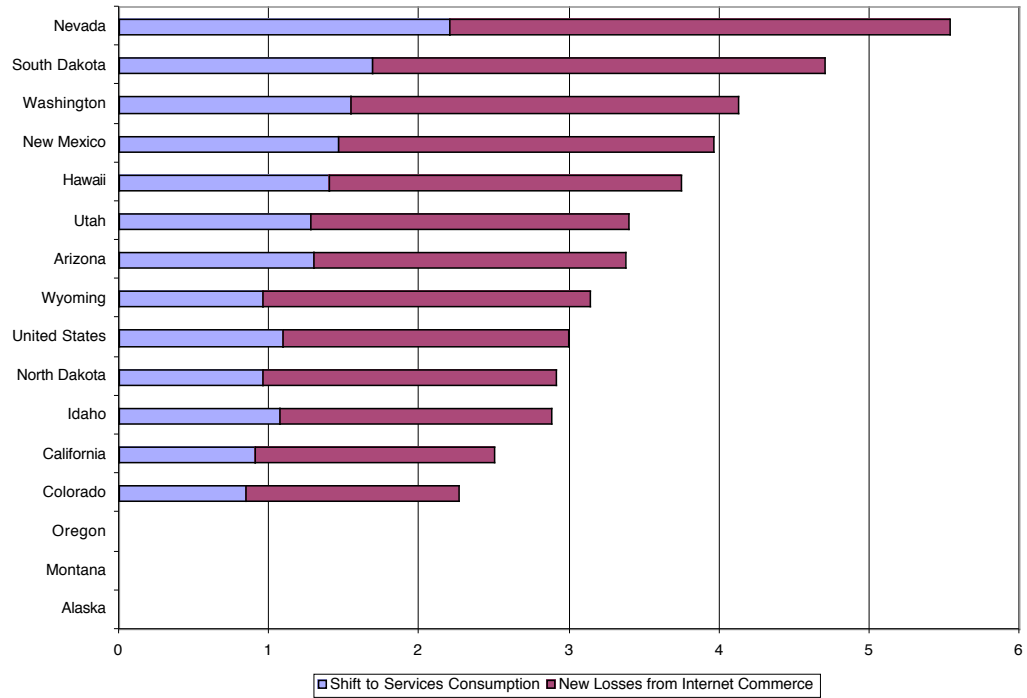
<sup>12</sup> A structural deficit occurs when a state's projected service demands, at constant levels of service, outpace projected revenue growth.

**Figure 2-4: Characteristics of Key Taxes on Public Finance Evaluative Criteria**

	Size	Stability	Equity	Administrability	Economic Distortion
Income	Rates and base determine revenue size; Typically, grows faster than the economy	Highly volatile, particularly in recessions	Tax as share of income usually rises as income rises (progressive)	Easy to administer at the state level; Difficult to administer at the local level	Discourages income producing activities; Can be structured with broad base (allowing lower rates and less economic distortion)
Sales	Can keep pace with economy but has leakages (Internet, mail order); Economy is transitioning to hard-to-tax services	Less volatile than income taxes during recessions	Tax as share of income rises as income falls (regressive); Efforts to lessen regressivity (credits) add to administrative complexity	Easier to administer in small areas than an income tax but still problematic (especially in relation to Internet sales)	Can be structured with broad base, low rates; Encourages savings
Property	Tax rate and assessment rules determine revenue size	Stable	Effectively paid by owner of property at time the tax is assessed	Easily administered in small geographic areas	Can be highly distorting

Source: Adapted from Boyd, Donald. 2003. *Are Western States' Tax Structures Adequate?*

**Figure 2-5: Projected Percentage Erosion of State and Local Sales Taxes Between 2001 and 2006**



Throughout the state's recent fiscal crisis, legislative committees, individual state policymakers, and non-profit think tanks have advanced a

host of tax reform proposals that range from incremental to comprehensive. The following sections briefly describe the key reforms advanced to date that would increase the stability of the state's General Fund without significantly increasing or decreasing the total revenue raised:

- Reduce volatility of the income tax
- Add a broad-based consumption-based tax to the General Fund's portfolio

These general approaches are not mutually exclusive and could be implemented together.

## REDUCE VOLATILITY OF THE INCOME TAX

Oregon residents and nonresidents earning income in Oregon pay the state's personal income tax. The state taxes personal income at rates between 5 and 9 percent. The state phases in the higher tax rates at low levels of taxable income, which yields a tax structure that is essentially flat with most tax units paying at the 9 percent rate on their taxable income<sup>13</sup>. Taxable income is equal to total income less exclusions and either the standard or itemized deductions. The state could reduce the volatility of the tax by broadening its base and reducing the rate at which the income is taxed.

The state could broaden its income-tax base by reducing so-called *tax expenditures*, which are tax revenue foregone through allowed deductions and exemptions. For example, the state could eliminate or modify key deductions allowed through the federal tax code, such as the mortgage interest and expanded medical deductions. The state could also eliminate or modify state-specific credits including the personal exemption credit, the political contribution credit, and the pollution control credit. Revenue gained through the reduction in exemptions would then be used to finance lowering personal income tax rates.

Table 2-2 offers detail on the magnitude of selected tax expenditures. The Legislative Revenue Office estimates that income deductions carried over from federal rules reduced state income tax revenue by \$1.766 billion in the 2003-05 biennium. In addition, Oregon-specific credits and subtractions from income reduced revenues by \$172.1 million and \$705.8 respectively<sup>14</sup>. In total, the deductions and credits considered in the LRO analysis reduced income tax revenues by \$2.644 billion in the 2003-05 biennium.

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<sup>13</sup> Specifically, on single returns, the 9 percent rate is assessed on taxable income above \$6,350. For joint returns, the 9 percent rate is assessed for taxable income above \$12,700.

<sup>14</sup> LRO analysis exempted a number of federal and state deductions and credits in its analysis, including deductions and subtractions for income from Social Security, federal pensions, federal securities, lottery prizes, certified pollution control credits, insurance offsets, IRA/Keogh plan deductions, earned income credit, and Oregon's working family credit.

Legislative policymakers have considered reducing the deductions and credits *proportionately*. For example, an across the board 25 percent reduction in the selected credits would have generated \$660.9 million in revenue during the 2003-05 biennium.

A *revenue-neutral*, base-broadening package could link the 25 percent reduction in deduction and credits with a 0.5 percentage point reduction in income tax rates (that is, lowering rates to 4.5 – 6.5 – 8.5 percent).

**Table 2-2. Estimated Tax Expenditures Associated with Selected Federal and State Deductions, Credits, and Subtractions, 2003-05 Biennium**

Tax Expenditure Category	2003-05 Biennial Revenue (in Millions)
<b>Selected Personal Deductions and Credits</b>	
Federal Deductions	1,765.7
Oregon Credits	172.1
Oregon Subtractions	705.8
<b>TOTAL</b>	<b>2,643.6</b>
<b>25% Proportional Reduction</b>	<b>660.9</b>

Source: Legislative Revenue Office

## **ADD CONSUMPTION BASED TAXES TO THE GENERAL FUND'S PORTFOLIO**

Oregon is one of only five states without a retail sales tax, and voters have rejected the tax nine times. Recently, some business and legislative leaders have revived the call for adoption of the sales tax in combination with other consumption taxes and a reduction in income taxes.

The most thoroughly developed proposal in the 2003 legislative session was so-called "Group Plan A". The tax package called for a broad based 5-percent tax levied on goods and services, which LRO estimated would generate \$6.1 billion in revenue in the 2005-07 biennium. The package would also included a reduction in personal income taxes by 3 percentage points (top rate falls from 9 to 6 percent), a reduction in the capital gains tax (from 9 to 4 percent), and an expansion in the state Earned Income Tax Credit. The package also included property tax relief.

The LRO estimated the package would generate modest net revenues relative to the current system and would shift some of the tax burden from households to businesses (see Table 2-3).

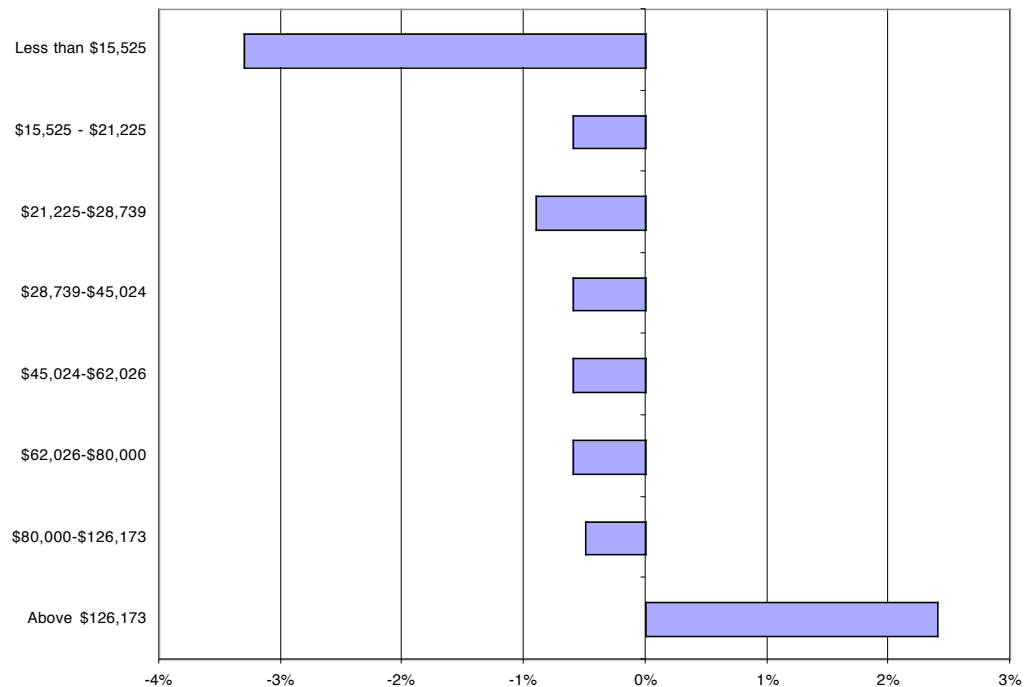
**Table 2-3. Household and Business Share of State and Local Taxes Under Current Law and Proposed “Group A Plan, Estimates for Fiscal Year 2000 (in Millions)**

	Personal Income Tax	Property Tax	Sales Tax	Tourist Taxes	Excise Taxes	SEV	Unemployment Compensation	Total
<b>Current Law Tax Regime</b>								
Businesses	799	1,050	0	23	363	37	483	2,755
Households	3,750	1,643	0	23	521	0	0	5,937
Total	4,549	2,693	0	46	884	37	483	8,692
Household Share of Total	82%	61%	0%	50%	59%	0%	0%	68%
<b>Proposed "Group A" Tax Regime</b>								
Businesses	641	1,050	831	23	363	37	483	3,428
Households	2,302	1,347	1,604	23	521	0	0	5,797
Total	2,943	2,397	2,435	46	884	37	483	9,225
Household Share of Total	78%	56%	66%	50%	59%	0%	0%	63%

Source: Oregon State Legislative Revenue Office

The plan’s architects attempted to mitigate the regressive features of proposal by exempting food, shelter, and utilities from the sales tax and adding an expansion to the state earned income tax credit and target property tax relief. Figure 2-6 reports the LRO estimated change in household income, by income level. As would be expected with the adoption of a sales tax, very low income households (household income less than \$15,525) would experience slight decrease in income (-3.3 percent) while upper income households (above \$126, 173) would see an increase (+2.4 percent). All households between the two extremes would see small decreases (-0.6 percent or less).

**Figure 2-6. Group Plan A Effects on Household Income, by Income Groups**



Source: Oregon State Legislative Revenue Office calculated using the OTIM model

# SUMMARY OF POLICY OPTIONS

As outlined earlier, state policymakers have three general options available to them to stabilize K-12 funding: 1) establishing spending guarantees, 2) stabilizing state General Fund revenues without altering the tax system, or 3) altering the mix of taxes. Again, policymakers could combine features from more than one category.

In this section, we revisit each area, formulate a policy option, and highlight a number of implementation details.

- **Link annual increases in K-12 funding to growth in the number of students and average wages.** Short of altering the tax system, the state could establish annual expenditure targets for the K-12 budget as has been done in California (Proposition 98) and Colorado. Through such a process, policymakers would select a beginning per student spending level and establish annual growth based on projections of two factors: 1) average daily attendance (ADA) and 2) average wages of all Oregon workers. The system would use average wages, rather than a consumer price index, because education is a highly labor intensive enterprise. Historically, average wages in Oregon have increased at about 0.5 to 1.0 percentage points higher than the consumer price index.

In times of fiscal crisis, the legislature could fund the system at levels below those called for by the student-wage index. However, as the state's fiscal position recovers, the legislature would have to return per-student spending to its previously projected path.

Ideally, this system would be implemented in concert with one of the policy options below. If not, the K-12 budget would be given preferential treatment within a volatile general fund, which would put non-protected services (for example, higher education, senior and disabled services) at a disadvantage.

- **Establish a required projected ending balance in the state's general fund.** While two key revenue sources (property taxes and lottery) for the K-12 system are relatively stable, income taxes, which flow through the state's general fund, are not. The late 1990s boom and subsequent collapse of income tax receipts exposed a serious flaw in the state's public finance system.

To stabilize the budget process without the creation of a new fund or new revenue sources, policymakers could limit biennial expenditures to 90 percent of projected revenues and hold the remaining 10 percent in an ending balance. The projected ending balance would essentially serve as insurance in biennia with unanticipated revenue shortfalls. The first-time establishment of an ending balance would require the state to forego services, but once established, the year-to-year expenditures would be largely unaffected.

- **Create a broader rainy day fund that serves all general fund programs.** Oregon's existing Education Stability Fund has all the features of a general rainy day fund but is too limited in scope and in the short-run is too small to protect education programs from the potential instability. With the current funding framework, the Education Stability Fund will remain well below 5 percent of General Fund resources through fiscal year 2011. Oregon policymakers could expand the scope of the fund to protect all General Fund programs and increase the limit on fund levels to somewhere between 10 and 15 percent of General Fund revenues. In addition, policymakers could examine methods of accelerating payments to fund during the current economic expansion. Options include establishing a projected ending balance (as discussed in the preceding proposal), and assuming projections hold, transferring the ending balance to the stabilization fund at the close of the biennium.

**Adding Predictability to the Budget Process: Altering the State Legislature's meeting schedule.**

The legislature's traditional meeting schedule (first two calendar quarters of odd numbered years) was developed long before the state played a major role in K-12 finance. Since the establishment of local property tax limitations through the enactment of Measures 5 and 50, state policymakers set the total non-federal spending for the K-12 system; now, K-12 spending is the single largest general fund category, representing more than 40 percent of expenditures. The legislature's biennial meeting schedule overlaps with school budget planning processes in odd numbered years. Consequently, every other year, local districts establish budgets without full knowledge of available state resources.

Given the state's recently acquired role of chief K-12 financier, policymakers should consider altering the timing of their sessions to better serve local schools. A transition to convening in the third and fourth calendar quarters of odd-number years would increase the likelihood that the legislature will have approved state spending levels in advance of school budget processes.

- **Broaden the income tax base by reducing tax expenditures and income tax rates.** Revenue stability would improve through a proportional reduction in federal and state deductions, credits, and subtractions from personal and business income. Reductions in these so-called tax expenditures could be coupled with a lower income tax rate in a revenue neutral proposal.
- **Reduce the general fund's reliance on income taxes; expand use of consumption taxes.** Oregon's degree of dependence on a single tax (income taxes at the state-level) is second only to Alaska. The recent instability in the state's fiscal position has led to a variety of proposals to alter the revenue sources that compose the general fund. Income taxes are the most volatile revenue source followed by sales and property taxes. Generally, as a system's reliance on income taxes falls, revenue stability improves. The state could craft any number of alternative tax packages that would

improve the system's stability. In selecting a package, however, policymakers would have to balance the goal of stability with other tax principles: equity, ease of administration, interaction with the federal tax code, and economic impacts. During the last legislative session, the most thoroughly researched alternative would have reduced tax rates on personal income and capital gains and created a broad based goods and services sales tax. The overall package was designed to be roughly revenue neutral.



## INTRODUCTION

During the past 15 to 20 years, many of those advocating for K-12 budgets have called for *stable* and *adequate* funding. The concept of stability is relatively straightforward. Once taxpayers determine how much they are willing to spend per student—and for students of different characteristics—the amount should be consistent from year to year.

Adequacy raises a considerably more subjective question. Namely, given the standards policymakers have set for students, teachers, and administrators, do our schools have sufficient resources to meet those standards?

The modern adequacy movement can be traced to a Kentucky Supreme Court decision in *Rose vs. Council of Education*<sup>1</sup>. In that decision, Kentucky's Supreme Court ruled the state's entire education system as unconstitutional. Kentucky's Supreme Court not only set education goals for the system but additionally required the legislature to provide enough funding for students to meet those goals.

In the wake of the Kentucky and other state rulings, a number of researchers have developed so-called *cost-out models* that estimate how much it would cost to meet the state's educational goals given the characteristics of its students. Models relying on a variety of methods exist in Oregon, Alaska, Illinois, Ohio, Maryland, New Hampshire, Wisconsin, and Wyoming. A number of states have estimated how much the adoption of such a model would cost if implemented statewide. In fact, some policymakers in states where such models exist have proposed tying K-12 funding levels—constitutionally or statutorily—to cover the costs estimated through the models' method.

Critics of cost-out models contend that K-12 spending per student has increased sharply for many decades with no corresponding improvement in student achievement. Moreover, they argue that cost-out models assume no change to the fundamental K-12 delivery structure and that by strengthening internal incentives (through market-based reforms), the system could improve performance with little or no increase in spending.

Oregon's cost-out model—the Quality Education Model—called for a \$1.3 billion spending increase in the 2003-05 biennium. However, Oregonians themselves are split on the adequacy question. In the Chalkboard Project's recent statewide poll, 52 percent of Oregonians believed the schools were underfunded while 40 percent believed they were not. Despite the slim

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<sup>1</sup> Case description drawn from <http://www.ncsl.org/programs/educ/PubsAdequacy.htm>

majority that consider the system underfunded, Oregon voters rejected two statewide efforts to temporarily raise revenues for the K-12 system and other public programs.

The balance of this chapter addresses the notion of adequacy by reviewing Oregon's recent spending trends, describing the range of methods used to develop cost-out models, and analyzing Oregon's version of a cost-out model: the Quality Education Model.

## RECENT TRENDS IN K-12 SPENDING

A predecessor report entitled *The Condition of Oregon K-12 Education* identified a number of key trends in K-12 spending. In general, the report found that—through a combination of property tax limitations and the recent state fiscal crisis—Oregon's spending per student is much closer to the national average than it was in 1990. Oregon's K-12 system stands out as having relatively fewer staff (teachers, administrators, support staff) per student than other states, but districts compensate staff better than average. Salaries per full-time equivalent staff member ranked 14<sup>th</sup> nationally in 2001-02 school year; benefit spending per staff member ranked 1<sup>st</sup>. Overall, spending on total compensation per staff member ranked 8<sup>th</sup> nationally. We outline our detailed findings below.

- **Oregon's K-12 spending as a percent of total personal income declined throughout the 1990s and fell below the U.S. average in 2002-03.** In the 1989-90 school year, Oregonians spent 4.8 percent of their total personal incomes on current K-12 expenditures—compared to the U.S. average of 4.1 percent. Since then Oregon's K-12 spending did not keep pace with personal income growth and, by 2002-03, K-12 spending equaled 4.0 percent of personal income—below the U.S. average (4.2 percent).
- **Oregon salaries and benefits measured on a *per student* basis are close to the national average; Salaries and benefits measured *per full-time equivalent staff member* are high relative to other states.** In school year 2001-02, Oregon spent \$2.44 billion and \$1.02 billion on benefits for all staff in the K-12 system. Measured on a per student basis, Oregon spent \$6,267 per student on salaries and benefits, almost identical to the national average of \$6,272. However, as discussed previously, Oregon employs relatively few staff, which implies salaries and benefits per staff member are above average. Oregon's salaries average \$42,453 per full-time staff member, which ranked 14<sup>th</sup> nationally. Benefit expenditures total \$17,684 per full-time staff member, which ranked 1<sup>st</sup> nationally and is 11 percent higher than second-place Wisconsin. Taken together, expenditures on the total compensation package average \$60,137 per full-time employee, which ranked 8<sup>th</sup> nationally.

- **Spending per student on instruction is slightly below the national average.** In 2001-02, Oregon spent \$4,490 per student or \$265 less than the national average.
- **Spending per student on “other support services” is well above the national average.** Oregon spent \$467 per student on other support services in 2001-02, which is well above the national average (\$264 per student). Other support services include expenses for the business support staff, payroll, financial accounting, internal auditing, purchasing, and warehousing. The Oregon Secretary of State recently audited spending behavior in a number of districts across the state and recommended a variety of cost-cutting strategies including bulk purchasing, seeking in-kind contributions and donations, and sharing the cost of certain specialized staff.

## EVIDENCE ON SPENDING AND K-12 OUTCOMES

The basic hypothesis underlying the adequacy movement, and associated cost-out models, is that a relationship exists between spending and student achievement. The academic literature attempting to link spending and student achievement is sizable. Economists and other academics have conducted dozens of studies with the goal of isolating the relationship between per student spending and a variety of measures of achievement. In a 1997 study, Stanford University economist Eric Hanushek reviewed 41 studies that contained 163 separate estimates of the relationship between spending per student and student achievement<sup>2</sup>. He concluded that only 27 percent of the 163 estimates showed a positive (and statistically significant) relationship to achievement while 7 percent of the estimates suggested a negative relationship. The balance of the estimates (two-thirds) found no statistically significant relationship—positive or negative—to achievement (see Table 3-1, Column 1). From his review, Hanushek concluded that the findings on spending per student are cloudy at best.

Princeton University’s Alan Krueger recently reanalyzed Hanushek’s review and concluded that Hanushek’s method of weighting findings misrepresented the literature<sup>3</sup>. Put simply, Krueger argued that Hanushek’s “*one vote per estimate*” method had no statistical basis and that alternative methods suggested per student spending, on balance, yielded positive impacts on student achievement. Krueger advanced three alternative methods of summarizing the findings from the 41 studies. The first method gave the findings of each study equal weight—regardless of the number of individual estimates it reported (that is, “*one vote per study*”). Krueger’s second method weighted studies according to the number of times they were cited in the academic literature assuming that academics would cite higher quality

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<sup>2</sup> See Hanushek, Eric A. 1997. “Assessing the Effects of School Resources on Student Performance: An Update.” *Educational Evaluation and Policy Analysis* 19(2): 141-64.

<sup>3</sup> See Mishel and Rothstein (ibid) pages 19-21.

studies more often. Finally, in a third approach, Krueger developed a statistical model to estimate an “average” finding from each study (that is, Krueger’s so-called Selection-Adjusted weighting) and then assigned each study one vote. Within individual studies, this third method gives more value to estimates based on a full sample of students than estimates based on sub-samples or sub-populations, which are inherently more uncertain.

Columns 2 through 4 in Table 3-1 report the findings from Krueger’s reanalysis of Hanushek’s 1997 work. In short, each of his alternative weighting methods suggests that per student spending, on balance, show considerably more positive impacts than negative. The simplest method—one study, one vote—suggests 38 percent of studies show a positive impact, 6 percent a negative impact, and 56 percent no distinguishable impact at all. Krueger’s alternative weighting methods provide more support for spending but—even these alternative schemes—show up to one-half of studies that fail to establish a relationship between spending per student and achievement.

**Table 3-1: Findings from Competing Reviews of 41 Studies Per Student Spending**

Effect of Spending per Student on Student Achievement	Hanushek weights (1)	Krueger alternative weights		
		Equally weighted studies (2)	Weighted by number of citations (3)	Selection adjusted weighted studies (4)
Positive	27%	38%	34%	51%
Negative	7%	6%	3%	6%
Statistically insignificant	66%	56%	64%	44%

Source: Adapted from Table 1-4 (page 20) in Mishel and Rothstein (2002)

The two reviews have essentially bounded the evidence on per student spending. At worst, according to Hanushek, spending per student has a weak link to student achievement. At best, according to Krueger, per student may produce positive outcomes, but they are equally likely to produce no measurable improvement at all. In short, the literature suggests that if policymakers increase spending per student significantly, they should do so wisely with a full understanding that the empirical evidence offers no iron-clad guarantee of achievement gains.

## COST-OUT MODELS

As discussed in the introduction, a number of states, including Oregon, have developed so-called cost-out models that estimate that cost of meeting the state’s educational goals. In this section, we describe the variety of methods used to develop cost-out models and then turn to a detailed description of Oregon’s version: the Quality Education Model.

## METHODS FOR DETERMINING ADEQUACY

Researchers have relied on four methods to develop cost-out (or, adequate funding) models:

1. **Advanced statistical method.** The most complex of the cost-out methods, the advanced statistical approach applies rigorous statistical techniques to determine the relationship between student characteristics, expenditures, and key educational inputs on student achievement. Once the model has identified independent relationships between the key factors and achievement, the researcher can estimate the cost of achieving specified achievement goals for a specific school with specific student characteristics. The method's complexity makes it inaccessible to most policymakers and assumes the current delivery system is essentially sound.
2. **Evidence based method.** This approach estimates the cost of practices identified by research as most effective in student learning. While the method is supported by a research base, critics argue that the approach can lead to a "one size fits all" recommendation. They caution that some educational practices—even if supported in research—can prove cost-inefficient to implement or may not fit with the culture and needs of a particular state or locality.
3. **Successful schools method.** This method looks at spending in the schools (and districts) within a state that are meeting or exceeding proficiency standards. The basic notion is that "any district should be able to accomplish what some districts do accomplish". Critics argue that schools used for the model are often atypical or "outliers": small, suburban or rural and idiosyncratic in nature. Moreover, the model does little to address differences in student characteristics, and therefore assumes that, *given comparable resources*, a school with a high share of at-risk students can perform at the same level as a school with a low share of at-risk students.
4. **Professional judgment model.** This model relies on the expert judgment of educators and administrators to identify the key educational inputs that drive student achievement. The models are easy to understand and consist of recommendations for class size reductions and recommended staffing levels for special education and support positions.

Table 3-2 reports the method, or methods, used to estimate K-12 adequate funding in nine selected states. In most cases, the models call for sizable increases in funding relative to current levels, with most reported here recommending increases in the 25 to 40 percent range.

**Table 3-2: Methods Used for Determining Adequacy and Estimated Increase Needed Above Current Spending Levels, Selected States**

State	Adequacy Method(s) Used	Percent Increase (or Range of Increase) over Current Funding
Indiana	Evidence based	31
Maryland	Professional judgment and successful schools	34 to 49
Montana	Professional judgment	34 to 80
Nebraska	Professional judgment	45
New York	Professional judgment and cost function	16 to 60
South Carolina	Professional judgment	24 to 84
Texas	Cost function	35
Washington	Professional judgment	31
Wisconsin	Evidence based	35

Source: Adapted from Conley, David T. *Surveying the Landscape of Adequacy Funding: What States are Doing*. Accessed on November 9, 2004 from [www.sbe.wa.gov/.../Landscape%20of%20Adequacy%20Funding/WSLFA%20Funding%20Summit.David%20Conley.ppt](http://www.sbe.wa.gov/.../Landscape%20of%20Adequacy%20Funding/WSLFA%20Funding%20Summit.David%20Conley.ppt)

## OREGON'S QUALITY EDUCATION MODEL

In Oregon, the state's cost-out model—known as the Quality Education Model (QEM)—is maintained by the state's Quality Education Commission. The model's development was motivated by a state constitutional amendment, which required Oregon's legislature to identify an amount of money need to fund education adequately, as well as the consequences of not doing so.

The QEM relies on the professional judgment and effective schools methods. Through the QEM development process, education experts identified the characteristics of so-called prototype schools—with separate prototypes at the elementary, middle, and high school levels. The prototypes, designed to be easily understood by the public and policymakers, outline recommended school sizes (e.g., number of students per school), class sizes by grade-level cluster, required support staff levels, textbook, computer, and other material needs, and host of other education inputs. The model then allows an administrator of a particular school to compare her staffing and resource levels to those of prototype. With additional analysis, the QEM accommodates comparisons between actual and QEM-prototypical spending at the district and state levels.

The model's developers point to two important purposes. Specifically, the model:

- Defines a clear vision of three school prototypes (at the elementary, middle, high school levels) designed to enable a large majority of Oregon children to meet state educational standards,

- Serves as a tool for the development of education budgets.

When Oregon's Quality Education Commission was released in June 1999, the sponsors estimated that full implementation of the model's recommendations would cost \$1.2 billion more per biennium than the Governor's proposed K-12 budget. The models prescribed class sizes (20:1 at the elementary level and 29:1 for core academic courses at the middle and high school levels) are key underlying drivers of the QEM's costs.

Table 3-3 reports the estimated cost of adopting QEM's full-implementation prototype in the 2003-05 biennium. Full implementation across all of the educational categories would cost \$1.381 billion, which would represent a 28 percent in the K-12 General Fund appropriation<sup>4</sup>. The largest single policy category—class size reduction strategies—contains 42 percent of the estimated cost increase.

## CRITIQUES OF COST-OUT MODELS

Cost-out models are relatively new, and their methods are still evolving. Critiques of the models range from mild to severe. Generally, proponents of the methods view the exercises as important but concede the methods are in their infancy and require considerably more work before they can be widely accepted and understood<sup>5</sup>. In its recent report on school finance, the business-backed Committee for Economic Development recognized the shortcomings of existing models but urged states to build analytic methods for determining the costs of meeting standards<sup>6</sup>.

Opponents of the cost-out approach, which include Stanford's Eric Hanushek, contend that little or no historic evidence existing linking across-the-board spending increases to improved student achievement. Moreover, they argue the detailed proposals that compose the models—most notably, class size reductions—also lack evidence of success<sup>7</sup>. Finally, critics believe cost-out models rely exclusively on the status quo delivery structure, which lacks incentives for superior performance. In their view, more radical reforms to the K-12 delivery system—open enrollment, targeted vouchers, charter schools—would yield improved outcomes at no additional cost.

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<sup>4</sup> The 2003-05 Legislatively Approved General Fund Budget for K-12 through the April 2004 E-Board total \$4.905 billion.

<sup>5</sup> See Augenblick, John. July 2001. *Education Finance in the States: Its Past, Present, and Future: The Status of School Finance Today*. Education Commission of the States Issue Paper. ECS. Denver, CO. Page 5.

<sup>6</sup> See Committee for Economic Development. 2004. *Investing in Learning: School Funding Policies to Foster High Performance*. CED: Washington DC. Page 42.

<sup>7</sup> See Hanushek, Eric A. July 2002. *The Failure of Input-based Schooling Policies*.

**Table 3-3: Constituent Policies and Estimated Costs of Oregon's Quality Education Model, 2003-05 Biennium**

<b>Program/Strategy</b>	<b>Biennial Cost of Full Implementation Prototype</b>
<b>Class Size Reduction Strategies</b>	
Kindergarten Class Size*	30,504,618
Grade 1-3 Class Size	153,612,539
Grade 4-5 Class Size	0
Staffing in Core Classes at Middle and High Schools	54,518,659
Subject Area Specialists (e.g., reading, math)	342,266,450
<b>SUBTOTAL</b>	<b>580,902,265</b>
<b>Program Delivery</b>	
All-Day Kindergarten	87,156,050
Summer School (weeks)	67,873,942
Tutoring and After-School Programs	73,906,088
<b>SUBTOTAL</b>	<b>228,936,080</b>
<b>Special Instruction</b>	
Low-incidence, High-Cost Special Education	66,000,000
Centralized Special Education	9,572,617
Special Education Licensed Staff	51,204,180
English as a Second Language Licensed Staff	60,114,621
<b>SUBTOTAL</b>	<b>186,891,417</b>
<b>Specialized Staff</b>	
Counselors	41,516,035
Co-Curricular Activities Directors	22,972,845
Instructional Improvement Staff	109,022,105
Classified Staff	33,854,503
Consultants	1,584,571
Extracurricular Activities Sponsors	5,563,877
<b>SUBTOTAL</b>	<b>214,513,937</b>
<b>Staff Development</b>	
Teacher Professional Development	65,682,440
Administrator Leadership Development	4,790,699
<b>SUBTOTAL</b>	<b>70,473,139</b>
<b>Technology, Supplies, and Other</b>	
Software (share of computers upgraded each year)	10,398,882
Networks	15,880,256
Texts, Consumables, Classroom Sets (\$ per student)	21,333,503
Supplies and Materials (\$ per student)	56,751,693
Food Service Costs per Student (Net of Revenue)	-4,699,366
<b>SUBTOTAL</b>	<b>99,664,968</b>
<b>GRAND TOTAL</b>	<b>1,381,381,806</b>

\*Assuming All Day Kindergarten

Source: ECONorthwest calculated using Oregon Department of Education data.

# LOCAL REVENUE OPTIONS

## OREGON'S SCHOOL LOCAL OPTION PROPERTY TAX

In Oregon, a review of adequacy must also include a discussion of the relative abilities of local school districts to raise revenues above levels appropriated by the legislature through the State School Fund. As discussed in the Chapter 4, concurrent with the implementation of property tax limitations, Oregon enacted a policy that—over time—essentially equalized the level of resources available for K-12 students across the state. During 1991-1998, local districts had no formal method to supplement the state-distributed revenues with their own resources.

In 1999, the Legislature created the existing School Local Option Property Tax, which allows local school districts to raise revenue above the amounts distributed by the state subject to certain restrictions. The local option process implicitly recognizes that local communities have different opinions about the adequacy of state-distributed funding, and the effectiveness of additional school spending. In the ideal system, those communities that see value in adding resources to the system could, while those that do not would not. The local option process creates a tension between the concepts of adequacy and equity. In districts that persuade voters to spend more on schools advance their own adequacy goals, they simultaneously increase inequities in per student spending. The more certain localities rise above the state-distributed amounts, the greater is the tension between adequacy and equity.

## CALCULATING AMOUNTS AVAILABLE TO LOCAL SCHOOL DISTRICTS

Calculating amounts available to local districts through Oregon's local option process is complex and consists of three steps:

1. **Estimating the so-called Measure 5/Measure 50 tax gap**, the gap largely determines the potential for local revenue generation.
2. **Applying limits to local option revenue per student.** Regardless of the size of the district's tax gap, a district can collect no more than \$750 per student or 15 percent of state-distributed revenue, whichever is less.
3. **Calculating the amount of state equalization grants.** Supplemental amounts paid to districts with weak property tax bases.

Below we describe each of these steps in more detail and then show the amount of local option revenue generated by districts during 2003-04.

## ESTIMATING THE MEASURE 5/MEASURE 50 TAX GAP

The local option process is linked closely to property tax limits enacted through both Measures 5 and 50.

- **Measure 5** established a limit on permanent property tax rates for schools—local K-12 school districts, education service districts, and community colleges—of \$5 per \$1,000 of *real market value*.
- **Measure 50** did not replace Measure 5 but established a second set of limits. The measure established permanent tax rates for each taxing district and introduced the concept of *assessed value*. In 1997-98, a property's maximum *assessed value* was set to 90 percent of its 1995-96 *real market value*. Measure 50 limited growth of assessed values at 3 percent per year<sup>8</sup>.

Amounts available for local school options are created by a *gap* between the Measure 5 and 50 property tax limits. The gap is equal to the difference between \$5 per \$1,000 real market value (Measure 5 limit) and the sum of the permanent rates for schools, education service districts, and community colleges times assessed value (Measure 50 limit).

Table 3-4 calculates the gap for a hypothetical property in the Portland area. The property has a real market value of \$196,280. Measure 5 limits property taxes for education-related services at \$5 per \$1,000 RMV. For this property, the Measure 5 limit equals \$981.40.

Measure 50 uses the property's assessed value (\$124,310). The Measure 50 limit equals the sum of the permanent property tax rates (\$5.51) multiplied by the assessed value. For this property, the Measure 50 limit equals \$685.53.

The property's tax gap is equal to the Measure 5 limit minus the Measure 50 limit, or \$295.87<sup>9</sup>.

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<sup>8</sup> Plus any new construction,

<sup>9</sup> This amount would be reduced by any gap bond tax rates levied on the property.

**Table 3-4: Illustrative Tax Gap Calculation for a Portland Area Property\***

<b>Measure 5 Calculation</b>		
a	Real Market Value (RMV) <i>in Thousands</i>	\$196.28
b	Measure 5 Education Limit (per \$1,000 RMV)	\$5.00
c	Measure 5 Limit (a times b)	\$981.40
<b>Measure 50 Calculation</b>		
d	Assessed Value (AV) <i>in Thousands</i>	\$124.31
	<i>Permanent Rates per \$1,000 AV</i>	
	Portland SD 1J	\$4.77
	Multnomah Education Service District	\$0.46
	Portland Community College	\$0.28
e	Total Permanent Rates for Education	\$5.51
f	Measure 50 Limit (c times d)	\$685.53
<b>Tax Gap (c minus f)</b>		\$295.87

\*Assumes no gap bond tax rates

Source: ECONorthwest

Every *property* within a school district's jurisdiction has its own tax gap. The factors that determine the size of an *individual property's* tax gap include:

- **Level of permanent tax rates for K-12 and other educational institutions.** If the combined K-12 school district, Educational Service District, and community college *permanent* rates are relatively high (above \$5), then the tax gap for properties in that area will be smaller than those for properties in areas with lower permanent tax rates. For example, a property owner in Northeast Portland pays a permanent rate of \$5.51 per \$1,000 assessed value to support educational institutions while a property owner in Riverdale pays \$4.56 per \$1,000 assessed value.<sup>10</sup>
- **Rapid growth in real market value.** If a property's real market value has increased at more than 3 percent annually, the Measure 5 limits (*based on real market value*) will gradually separate from the Measure 50 limits (*based on assessed values and capped at 3 percent annual growth*). Therefore, holding other factors constant, properties in high demand areas of the state will have larger tax gaps than properties in low demand areas.

<sup>10</sup> The Northeast Portland property owner pays \$4.77 per \$1,000 AV for the Portland School District 1J; \$0.29 per \$1,000 AV for Portland Community College; and \$0.46 per \$1,000 AV for the Multnomah Education Service District. The Riverdale property owner pays \$3.81 per \$1,000 AV for the Riverdale School District and the same rates as the Northeast Portland property owner for Portland Community College and the Multnomah Education Service District.

- **Type of property.** Certain types of industrial and utility properties with depreciable assets have assessed values that are close, or equal to, their real market values, and therefore, have small tax gaps.

For any given school district, the first step of the local option calculation involves adding up the gaps for all of the individual properties in its jurisdiction and comparing the resulting total to student enrollment. *Column A* of Table 3-5 shows a wide variation in tax gaps for 17 districts that used the local option in the 2003-04 school year. Specifically, Column A reports a *district's* tax gap (that is, the sum of gaps for all the properties in its jurisdiction) divided by the district's number of "weighted" students (or Weighted Average Daily Membership-ADMw) before any adjustments<sup>11</sup>.

As just discussed, permanent tax rates, growth in real market values, and existence of industrial/utility property drive the variation in district-level tax gaps. For example, a hot real estate market, low permanent tax rates, and a low share of industrial/utility properties explain Riverdale's relatively high tax gap per ADMw. Conversely, Helix's high concentration of utility property (about two-thirds of Helix's property value is utility related) and a soft real estate market explain its low tax gap per ADMw.

**Table 3-5: Calculation of School Local Property Tax Option for 17 Districts with Local Option Levies, 2003-04**

School District	[A] Unadjusted Gap per ADMw	[B] Maximum Allowed Local Option Revenue per ADMw	[C] Maximum State Equalization Grant per ADMw	[D] = [B]+[C] Maximum Allowed Local Option + Maximum State Equalization Grant per ADMw	[E] 2003-04 Actual Local Option Imposed per ADMw	[F] 2003-04 Actual State Equalization Grant per ADMw	[G] = [E]+[F] 2003-04 Total Revenue per ADMw Related to Local Option
Sisters 6	1,590.73	750.00	0.00	750.00	593.38	0.00	593.38
Lake Oswego 7j	925.43	745.59	0.00	745.59	516.59	0.00	516.59
Riverdale 51j	1,644.19	750.00	0.00	750.00	476.71	0.00	476.71
Beaverton 48j	561.16	561.16	0.00	561.16	470.10	0.00	470.10
West Linn 3j	451.15	451.15	0.00	451.15	387.78	0.00	387.78
Joseph 6	694.55	694.55	0.00	694.55	346.63	0.00	346.63
Tigard-Tualatin SD 23J	589.61	589.61	0.00	589.61	346.10	0.00	346.10
Portland 1j	969.24	733.44	0.00	733.44	296.49	0.00	296.49
Eugene 4j	339.36	339.36	0.00	339.36	290.07	0.00	290.07
Condon 25j	327.26	327.26	0.00	327.26	276.03	0.00	276.03
Crow-Applegate-Lorane 66	222.39	222.39	0.00	222.39	219.98	0.00	219.98
Corvallis 509j	446.03	446.03	0.00	446.03	161.73	0.00	161.73
Colton 53	159.50	159.50	68.57	228.08	96.14	41.33	137.47
Pendleton 16	216.67	216.67	104.67	321.34	77.04	37.21	114.25
Oakland 1	112.61	112.61	33.48	146.09	53.29	15.84	69.14
Sherman 1	113.03	113.03	2.09	115.11	27.36	0.51	27.86
Helix 1	47.36	47.36	0.00	47.36	8.95	0.00	8.95

Source: ECONorthwest calculated using Oregon Department of Education data

<sup>11</sup> See Chapter 4 for a description of weighted students.

## APPLYING LIMITS TO LOCAL OPTION REVENUE PER STUDENT

With the goal of maintaining spending equity, State law limits the amount of revenue raised through the local option. Once the district determines its tax gap, local option rules permit districts to collect the *lesser* of:

- The district's actual tax gap per ADMw
- \$750 per ADMw
- 15 percent of school distribution formula revenue (state and local)

Column B in Table 3-5 shows the maximum amount of local option funding per ADMw available for each district with the restrictions in place. Column B shows Sisters and Riverdale restricted by the \$750 per ADMw limit. The 15 percent of formula revenue cap affected Lake Oswego and Portland. The actual tax gaps limited the remaining 14 districts.

## EQUALIZING LOCAL OPTION REVENUE

In 2001, the Legislature created an equalization grant to supplement local option revenues for districts with sub-par property tax bases. Specifically, the Legislature used a process through which the revenue generating “power” of a property-poor district is equated to that of a so-called “target” district.

The first step involves identifying the target district. To do so, the Oregon Department of Education calculates each district's tax ability. Specifically, ODE calculates the total assessed value of properties in the district for every student (ADMw). ODE then orders the districts from smallest AV/ADMw to largest and then identifies the district at the 75<sup>th</sup> percentile—the level identified in State law<sup>12</sup>

With the 75th percentile set as the target, 75 percent of districts, or the 148 districts below the target district on the list, are potentially eligible for equalization grants (if they levy a local option). In ODE's 2003-04 calculations, the AV/ADMw ratios ranged from \$78,836 to \$1,053,629. The target district's AV/ADMw ratio equaled \$331,505. Property-poor districts at the bottom of the list are potentially eligible for sizable grants; districts just below the target district are eligible for tiny grants.

To calculate the potential grant for a particular district, ODE compares the grantee district's AV/ADMw ratio to the target district's AV/ADMw ratio. To illustrate the calculation, we will use the Pendleton School District as an example. Pendleton's AV/ADMw ratio equaled \$223,527 while the target district's ratio was \$331,505—48 percent higher.

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<sup>12</sup> With 199 districts, the target district was the 149th district starting from the bottom the list.

In Pendleton's case, the state funded equalization grant boosts their maximum local option revenue per ADMw (Table 3-5 Column B) by 48 percent. If Pendleton had levied their full local option in 2003-04 they would have generate \$216.67 per ADMw from their own tax base and received an equalization grant of \$104.67 per ADMw from the State (Table 3-5, Column C). Of the 17 districts that levied local option taxes in 2003-04, only four (Colton, Oakland, Pendleton, and Sherman) were eligible for equalization grants.

## **ACTUAL LOCAL OPTIONS LEVIES AND EQUALIZATION GRANTS**

To this point, we have discussed only the *potential* amounts that *could* be raised through the local option. While some local option potential exists for most districts, actual use of local option has been relatively limited. Since adoption of the process, 51 school districts have voted on 64 local option levies and passed 21<sup>13</sup>. Columns E through G in Table 3-5 report the amounts of own-source local option revenue and related equalization grants for each of the 17 districts that levied the local option in 2003-04.

## **EQUITY ISSUES AND THE EXISTING LOCAL OPTION**

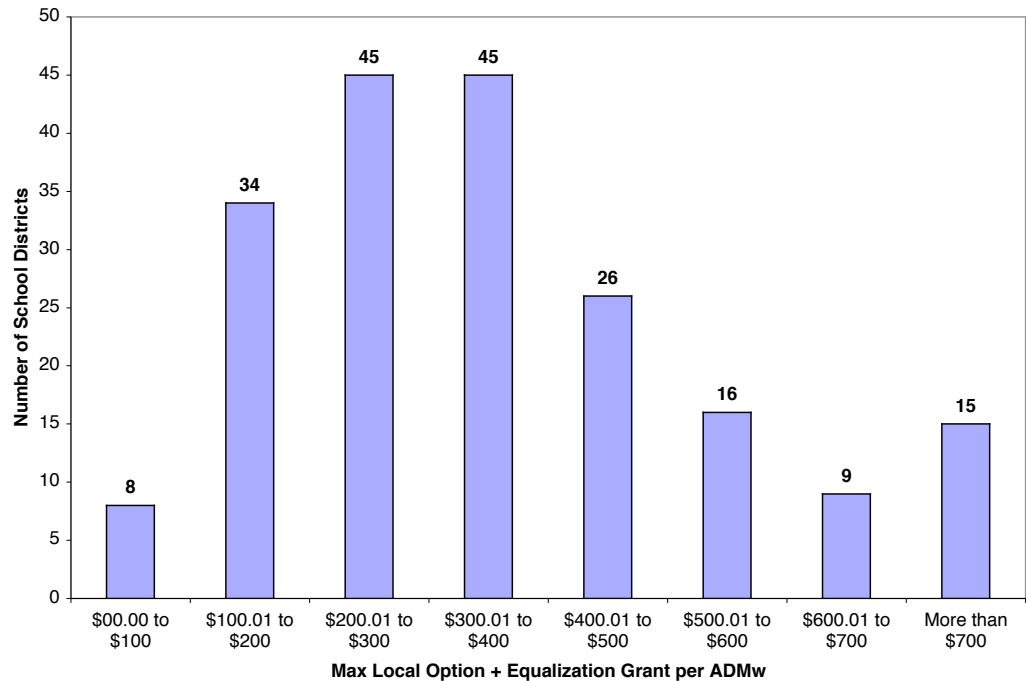
The complex nature of the Measure 5 and 50 limits yields a local option system that provides considerably more local revenue capacity for some districts than others. Figure 3-1 shows how the revenue potential of the local option process varies across districts. The figure reports the total revenue per ADMw districts could generate if they levied the full amount of their local option, including revenue from state equalization grants. Most districts are eligible for less than \$400 per ADMw. Fifteen districts, most located in areas with strong property value growth, could generate more than \$700 per ADMw.

As discussed previously, the Measure 5/50 tax gap is the key determinant of a district's local option capacity. The size of the gap is almost entirely outside a school district's control. A district is responsible for its own permanent tax rate, other factors that affect the gap—permanent rates for other educational institutions, growth in real property values, existence of local utilities or industrial areas—are all outside the district's control.

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<sup>13</sup> See Oregon State Legislative Revenue Office. August 2004. *School Local Option Property Tax: Legislation and Utilization*. Salem OR, Page 1

**Figure 3-1: Distribution of 198 School Districts by the Maximum Revenue Potential of the Local Option per Weighted Student (Own Source Revenue plus State Equalization Grants), 2003-04**



Source: ECONorthwest calculated using Oregon Department of Education data

Adding to the inequity of the formal local option process are other efforts to raise local revenue. During the recent state fiscal crisis, school districts relied on a patchwork of approaches to mitigate declines in spending per student. These included transfers from local cities, and for eight school districts located in Multnomah County, the creation of state’s first county income tax.

## LOCAL OPTION ALTERNATIVES

In a search for alternatives to the recently uncoordinated local efforts, Oregon’s policymakers would have to 1) select a revenue source and 2) determine how local option resources would be equalized across districts.

For revenue sources, the most straightforward approach would involve a statewide property tax that allowed localities, with voter approval, to increase rates up to \$2 per \$1,000 of *real market value*. The local option system would operate *outside* the Measure 5 and 50 framework and would require a change to the Oregon Constitution. If the constitutional barrier proved insurmountable, the state could simply set a per student spending limit on local options and allow localities to raise resources through a variety of predefined sources, including local income and sales taxes.

With the development of the local option system, the policymakers will have to decide if, and how, to equalize resources across districts that

participate in the system. With no equalization, localities would raise \$1 in taxes to receive a \$1 in school funding. Under an equalized option, property-wealthy districts would pay a \$1 in taxes to receive a \$1 in school funding, and state aid would subsidize property-poor districts so they would spend well under \$1 in local property taxes to receive a \$1 in school funding. Another model would involve property wealthy districts paying *more than* \$1 in taxes to receive a \$1 in school revenue and using the surplus tax revenue to subsidize the property poor districts.

Any reform of the local option process immediately raises equity concerns. The intensity of those concerns will depend on whether Oregonians believe the state's foundation support (currently financed through the State School Fund) is adequate to provide a quality education. In short, the more Oregonians who are convinced the State School Fund provides adequate funding, the fewer who will be concerned if some localities supplement that funding through a local option.

## CONCLUSION AND POLICY OPTIONS

Scanning across the public finance goals (adequacy, stability, and equity), adequacy is the clearly the most subjective and subject to controversy. Attempts to measure adequacy through cost-out models are still in their infancy—even by the accounts of their creators and proponents. Five years after the release of the QEM, Oregonians have differing opinions about the adequacy of K-12 revenues with only a slim majority believing schools are underfunded.

A reformed local option system would provide Oregonians some flexibility in defining what adequate funding means for the own schools. If the state moves forward with local option reform, policymakers should keep in mind that as that the capacity of a local option process system increases, funding equity—another stated goal—weakens.

Policy options in the adequacy area are:

- **Quality Education Commission (QEC) should rank the 29 constituent reforms that compose the full implementation Quality Education Model based on the rigor of the research that underlies the proposed reform and the likelihood that implementation would cost-effectively improve student achievement or attainment.** The Quality Education Model's full implementation prototype essentially called for a 28 percent increase in the state's K-12 General Fund appropriation in the 2003-05 biennium. The QEM was not designed for immediate implementation, and California's disappointing experience its with class size reduction policy points to the downside of hastily enacted spending increases. To date, the QEC has not offered a detailed discussion of the relative importance of its constituent recommendations. References have been made to funding shares of

the QEM (e.g., 80 percent) but it is unclear whether that implies districts would (or should) partially implement parts of all the reforms or would selectively adopt some reforms for early implementation.

The value of the QEM would improve with a thorough discussion of the relative costs and benefits associated with each its 29 reforms. Specifically, the QEC should rank reforms based on the degree to which rigorous research has demonstrated a link between the reform and change in student achievement.

- **Establish a statewide, uniform revenue source that school districts could tap to augment local per student spending.** As outlined above, the local option process in Oregon is complex and inequitable. A statewide property tax that allowed localities, with local voter approval, to increase property taxes based on *real market value* could strengthen the current system. Such a change would require an amendment to the Oregon Constitution. Support for such a change will hinge on Oregonians' perspectives of the adequacy of the state's basic (foundation) support of its schools—currently provided through the State School Fund. If Oregonians are generally convinced today's level of funding is adequate, then the move to increased local flexibility is less likely to trigger equity concerns. However, if Oregonians are generally unsatisfied with K-12 's foundation funding, then voters are likely to view a reformed local option as method that allows wealthy districts to approach adequacy while poorer districts settle for a substandard funding.



## INTRODUCTION

The administration and funding of elementary and secondary schools has had a long history of local control in the United States. Historically, school districts were generally free to request any amount of resources that local taxpayers were willing to pay. Therefore, for much of the history of school finance, spending per student depended on two factors: 1) the property wealth within the school district's boundaries and 2) the taxpayers willingness to tax that wealth to fund public services. High wealth districts with a high willingness and desire to fund education generated high spending per student levels. Low property wealth districts—*often regardless of their willingness to fund schools*—had relatively low spending per student levels. In some states it was not uncommon for property-wealthy districts to spend twice as much per student as the property-poor districts<sup>1</sup>.

Per student funding inequities in schools began to change in 1971 when several California school districts sued the state in *Serrano v. Priest*. Under the state's funding system, the low-wealth districts did not receive comparable resources to high-wealth districts. The California court determined the school funding process violated the state's equal protection clause.

In 1973, the US Supreme Court ruled that unequal spending per student did not violate the US Constitution (*San Antonio Independent School District v. Rodriguez*) but also indicated the matter was not a federal issue. With the issue left to the states, school finance equity lawsuits were filed in more than 43 states; and in 19 states, the courts ruled their state's method of school finance unconstitutional. In defining equity, the courts have generally *not* called on for "perfect equity" (an identical per student spending level across districts) but rather "relative equity" (districts' per student spending levels fall within an acceptable range).

Unlike many education reforms that are hotly debated but scarcely implemented, funding equity has affected almost every school district in the United States. The processes by which states equalize per student funding can be quite complex; and depending on their designs, can affect the overall level of resources provided to schools.

In the balance of this chapter, we discuss how Oregon has implemented its version of equitable per student spending during the 1990s and then turn

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<sup>1</sup> See Education Commission of the States: Equity Brief accessed on November 16<sup>th</sup>, 2004 from <http://www.ecs.org/html/issue.asp?issueid=48&subIssueID=40>.

to a number of outstanding issues related to equity that policymakers should consider and possibly address.

## EQUITY IN OREGON<sup>2</sup>

Oregon's move to equitable per student spending is associated with two property tax limitations adopted during the 1990s. With the implementation of Measures 5 and 50, the primary responsibility for K-12 funding shifted from local school districts to the state. State-level funding, which stood at less than 30 percent of the State School Fund in 1990-91, increased to about 70 percent in 1999-00. In 2004, state funding composes just less than 70 percent of the State School Fund.

Along with majority state funding came a policy decision to provide a comparable level of resources to students across the state. In short, policymakers decided that—given the majority of K-12 resources came from the state-level—a rational and equitable method of distributing those resources should exist. With the goal of equitable per student funding in mind, the state created a funding formula based on four principles:

1. Most school funding sources are shared statewide;
2. Local school districts decide how to spend their K-12 allocation (that is, the formula distributes aid as a lump sum rather than categorical grants);
3. Per student funding differences would be permitted for only factors outside the abilities of local districts to control (for example, the socio-economic profile of their student populations);
4. Minimize incentives—in the formula—that would allow districts to increase their allocation for avoidable differences in costs.

Described simply, so-called “foundation” funding for Oregon's schools works as follows. The state combines locally collected property taxes and a share of the state's General Fund (income tax and lottery resources) into the State School Fund. The state then distributes the Fund's resources to school districts—providing an equal amount of spending per *weighted* student. The student weighting method, described below, accounts for special student needs.

The equalization process, implemented through the state's funding formula, created winners and losers over the decade of the 1990s. Districts with historically weak local property tax bases benefited from the process, saw spending per student increase above the rate of inflation, and added

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<sup>2</sup> This section draws from Oregon State Legislative Revenue Committee. July 2004. *K-12 and ESD School Finance: State School Fund Distribution*. Research Report #03-04. Salem, OR.

programs and services they had never offered previously. By contrast, historically well-funded districts saw revenue growth slow and eliminated, or scaled back a number of programs over the decade.

Table 4-1 reports how income taxes flowed in and out of the State School Fund in the 2000-01 school year. For example, Washington County—a high income and property wealth area—contributed an estimated \$417.4 million in income taxes to the State School Fund. In the same year, school districts located in Washington County received \$270.2 million in State School Fund resources to supplement their locally collected property taxes. Consequently, in school year 2000-01, Washington County taxpayers were *net donors* with their contributions exceeding revenue receipts by \$147.2 million. At the other end of the scale are *net recipient* counties like Wheeler County, which paid an estimated \$431 thousand into the State School Fund and received \$2.4 million in school resources.

**Table 4.1: Estimated Income Taxes Paid To and Received From the State School Fund, 2000-01**

County	Estimated Taxes Paid into State School Fund 2000-01*	Estimated Revenues Received from the State School Fund 2000-01*	Taxes Paid as a Percentage of Revenue Received
Washington	\$417,383,068	\$270,223,664	154%
Multnomah	\$529,180,980	\$352,685,875	150%
Benton	\$50,674,145	\$35,841,774	141%
Clackamas	\$296,617,282	\$212,197,806	140%
Tillamook	\$10,652,398	\$8,134,304	131%
Clatsop	\$15,608,702	\$13,621,349	115%
Deschutes	\$76,200,895	\$68,547,539	111%
Polk	\$31,603,359	\$29,818,031	106%
Lincoln	\$18,816,783	\$18,764,966	100%
Lane	\$176,235,342	\$194,420,239	91%
Columbia	\$25,855,024	\$32,814,054	79%
Jackson	\$90,647,763	\$123,686,199	73%
Curry	\$9,041,588	\$12,420,132	73%
Linn	\$52,460,296	\$74,003,198	71%
Yamhill	\$49,128,211	\$69,364,682	71%
Wallowa	\$3,029,807	\$4,815,027	63%
Marion	\$151,359,316	\$241,249,198	63%
Wasco	\$10,242,901	\$16,481,013	62%
Douglas	\$44,091,038	\$73,496,648	60%
Coos	\$26,087,218	\$44,671,455	58%
Crook	\$8,017,457	\$13,848,352	58%
Josephine	\$29,078,281	\$50,946,692	57%
Hood River	\$9,584,206	\$18,046,362	53%
Union	\$10,682,409	\$21,549,608	50%
Klamath	\$24,816,474	\$52,260,805	47%
Umatilla	\$27,448,320	\$65,408,027	42%
Baker	\$5,944,762	\$14,309,179	42%
Morrow	\$3,683,211	\$10,207,665	36%
Gilliam	\$928,540	\$2,594,868	36%
Grant	\$2,915,815	\$8,708,087	33%
Lake	\$2,323,034	\$7,358,352	32%
Sherman	\$869,777	\$2,781,364	31%
Jefferson	\$5,698,401	\$19,109,866	30%
Harney	\$2,428,881	\$8,258,107	29%
Malheur	\$8,355,296	\$33,092,175	25%
Wheeler	\$431,416	\$2,385,738	18%
<b>TOTAL</b>	<b>\$2,228,122,397</b>	<b>\$2,228,122,397</b>	<b>100%</b>

Source: Oregon Department of Education

The state distributes funding based on largely on a unique student definition known as “Average Daily Membership-Weighted” or ADMw.

ADMw is the year-to-date average of daily student enrollment for students residing within the district as of June 30 adjusted to reflect students with special needs. Under the funding formula, the state counts kindergarten students as half-time students and credits districts with additional ADM “weights” for the following factors.

Special Education	1.00	December Count of IEP's
English Language Learners	.50	Year-to-date average - 6/30
Pregnant & Parenting	1.00	Year-to-date average - 6/30
Poverty Factor	.25	Census data –adjusted
Foster Care/Neglected and Delinquent	.25	Dept. of Human Resources count

The ADMw measure is unique to Oregon. Proponents of the ADMw advocate its use because it explicitly accounts for changes in the nature of the student body (that is, the unavoidable costs discussed above), and the relative ease or difficulty in providing educational services, in addition to tracking the number of children served. Of course, this assumes the weighting convention described accurately captures the relative cost impacts of the student categories.

Table 4-2, which reports a measure of funding equity developed by *Education Week* magazine, suggests that—by 2002—Oregon had gone a long way in achieving its goal of providing comparable resources to students across the state. The indicator, which is based on a number of complex measures that account for the variance in spending per student within states, awards a higher percentage to states with more equity—and less variance—in spending per student.

**Table 4-2: Education Week’s Funding Equity Score, 2002**

Rank	State	Funding Equity Score
1	HI	98%
2	VT	88%
3	AR	86%
4	DE	86%
5	MN	84%
7	Oregon	80%

Source: Education Week

While the equity goal, as envisioned by policymakers in the mid-1990s, has been largely achieved, several important equity-related issues remain in Oregon.

- **A statewide funding framework implies that communities with diverse expectations about K-12 purposes and goals have to make funding decisions together.** Through implementation of the state funding formula, local school districts ceded much of their ability to control revenue and expenditure levels. Consequently, in order to increase resources for a local district, local taxpayers must hope voters across the state agree with their decision to increase taxes. Conversely, taxpayers who are satisfied with the quality of education in their district can nonetheless be required to invest additional resources in their schools if state voters approve a tax increase and boost the K-12 budget.
- **Taxpayers face different prices to get an additional dollar of K-12 resources.** As described above, the equalization process, by its very nature, requires sizable inter-district transfers that are not well understood by the public. Generally, resources flow from districts with high property tax bases and incomes to districts with low property wealth and incomes. In short, on statewide funding votes—like the recent Measures 28 and 30—the price of securing an additional dollar of K-12 resources is considerably higher than a dollar for taxpayers in Metropolitan Portland and considerably less than a dollar in Eastern Oregon counties. As discussed in the next section, this type of equalization framework can affect the statewide average spending per student
- **Limited local option financing exists but the process is in need of reform.** State law does allow local school districts to raise additional resources outside of the state-equalized framework. As discussed in detail in Chapter 3, the complex intersection of tax limitation rules in Measures 5 and 50 make state’s formal local option process more feasible in some districts than others. Moreover, localities can depart from traditional financing methods altogether as Multnomah County did by creating the state’s first-ever county-level income tax in 2003. Multnomah County does not share the revenue with school districts outside its borders.
- **Equitable resources do not guarantee equal opportunity to meet state standards.** Some experts contend that, while policymakers have made considerable progress in equating resources per student, they have yet to provide an equal opportunity to meet the state’s education standards. Oregon’s student weighting system attempts to do just that by providing additional resources to students with special needs. Some finance observers believe it is time to review the formula’s weights.

# OUTSTANDING ISSUES RELATED TO EQUITY

This section reviews three equity issues worthy of in-depth consideration should the state embark on school finance reform. First, we consider common tradeoff between funding adequacy and equity, by reviewing estimated changes in spending per student associated with the implementation of equalization policies. Second, we introduce the concept of outcome- or performance-equity in which the equity goal would be gauged by educational outcomes across districts rather than by the amount of resources provided per student. Finally, we discuss how transparent budget accounting can support the equity goal by insuring that parents and taxpayers are fully aware of actual spending at their local schools.

## EQUITY/ADEQUACY TRADEOFF

Throughout the 1970s and 1980s, states implemented a wide variation of policies under the similar goals of equalizing resources per student. State courts and legal staff frequently designed equity policies, without a full understanding of the associated economic and tax incentives. Hoxby (2001)<sup>3</sup> conducted a comprehensive review of state equalization policies implemented during 1970 to 1990. Depending on how they were designed, the analysis found that an equalization policy could either increase (or, “*level up*”) or depress (“*level down*”) the overall average spending per student in the state.

The study considered a number of features of state equalization policies and then estimated effects of each on

- the degree to which equalization was achieved and
- the impact on overall per student spending in the state.

Table 4-3 shows Hoxby’s detailed results for 47 states<sup>4</sup>. Column A reports the degree to which the equalization process achieved its goal of resource equity. Specifically, Hoxby measures success by calculating the spending gap between high (90<sup>th</sup> percentile) and low (10<sup>th</sup> percentile) spending districts before and after implementation of the equalization policy. The Column A results show that all states achieved some degree of equalization with the gaps between high and low spending districts declining by 6 to 20 percent.

Column B turns to the estimated effects of equalization policies on the statewide average spending per student. Thirty-nine states *level down*, or spend less on per student on average *due to the implementation of equalization* while nine states *level up*.

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<sup>3</sup> Hoxby, Caroline. November 2001. “All School Finance Equalizations are not Created Equal”. *The Quarterly Journal of Economics*.

<sup>4</sup> The results measure conditions circa 1990—which predates Oregon’s major move toward equalization.

Leveling down states include Arizona (10.1 percent lower), California (15.0 percent lower), New Mexico (13.3 percent lower), Oklahoma (9.6 percent lower), and Utah (10.4 percent lower). Leveling up states include New Jersey (7.2 percent higher), New York (6.8 percent higher), and Pennsylvania (7.7 percent higher).

Hoxby deemed two characteristics important in determining how overall spending per student changed:

- **Structure of power equalization or guaranteed tax revenue (GTR) schemes.** These mechanisms attempt to make an identical tax rate—levied in different districts—generate the same revenue per student. The policies come in many forms, and states can design GTR schemes to *encourage* or *discourage* spending.

To encourage spending, a state may guarantee that every district in the state gets the same revenue per student that the wealthiest district generates at a given tax rate. Under this system, the wealthiest district would tax and keep its revenue while every other district would levy taxes and then receive a state subsidy that raises its revenue per student to the level obtained by the wealthy district.

GTR policies can also discourage spending. For example, the state could establish a “revenue per student limit”. Wealthy districts could keep revenues generated up to the limit but would send any amounts over the limit to a state fund. In this way, a GTR program a wealthy district may receive, for example, only \$.50 for every \$1 in taxes generated, which implicitly increases the cost of education, and therefore, discourages spending.

Columns C and D summarize the structure of state GTR policies as they existed in 1990. Column C reports how much revenue a wealthy district would keep for every \$1 of taxes raised while Column D reports how much a poor district would receive for every \$1 of taxes raised. In many states, equalization policies allowed districts to retain taxes they raised, and therefore, Column C and D both report \$1. States that show amounts other than a dollar in Columns C or D were operating a GTR system that implicitly encouraged spending, discouraged spending, or both.

California operated an extreme GTR program that set \$10/\$1,000 as a minimum *and* maximum tax rate, so wealthy districts were essentially prohibited from raising taxes and generating more spending per student. Likewise, New Mexico GTR policy strongly discouraged local districts from raising taxes with an additional \$1 in taxes generating \$0.05 in revenue.

By contrast, New Jersey allowed high property wealth districts to raise (and keep local revenues) and subsidized the poorest districts by

essentially providing \$1.50 revenue for every \$1.00 in local property taxes raised.

- **Change in the local property tax levy to support “foundation” aid.** As part of the equalization policy, a number of states set a statewide minimum property tax to support the basic (or, foundation) operations of K-12 schools. After controlling for other factors, Hoxby found that states that implemented a large increase in property taxes to achieve equity saw average spending per student fall. For example, Arizona and Utah, which each raised local property tax rates by more than \$30/\$1,000 (see Column E) saw spending per student fall.

Leveling down is a more common outcome of equalization than leveling up because of the cost to achieve each. California and New Mexico—two leveling down states—promoted equity by simply forbidding districts from generating additional revenues. The policy cost those states nothing. By contrast, New Jersey and New York—leveling up states—equalized spending by coaxing (heavily subsidizing) poor districts into spending more.

In addition to tracking impacts on spending, the study highlights a number of unintended consequences and related effects of equalization policies. For example,

- **If poorly designed, equalization policies can leave low spending districts worse off.** Leveling down in California and New Mexico was so severe that the intended beneficiaries of equalization—low spending districts (those at the 20<sup>th</sup> percentile in spending)—actually spent less under their states’ equalization policies than they would have without them.
- **Implementation of equalization policies coincided with an increase in private school enrollments.** The study estimates that equalization generated an increase in private school enrollments in high property wealth districts.
- **Equalization lowered dropout rates in districts with new (higher) spending floors.** Districts increased spending per student through the creation of spending floors saw some decrease in dropout rates on average.

**Table 4-3: The Effect of State Equalization Policies on Spending Equity and Average Spending Per Student, Estimates Based on Programs and Spending in 1990**

	(A)	(B)	(C)	(D)	(E)
State	Estimated Reduction in Per Student Spending Inequity Between 90th and 10th Percentile Spending Districts	Estimated Change in Average Spending per Student due to State Equalization	Minimum Revenue Generated for \$1 Tax Raised Under Equalization	Maximum Revenue Generated for \$1 Tax Raised Under Equalization	Change in Foundation Tax Rate (Expressed in Dollars per Thousands)
Alabama	-15%	-5%	\$1.00	\$1.00	0.0
Arizona	-13%	-10%	\$1.00	\$1.00	34.0
Arkansas	-15%	-5%	\$1.00	\$1.00	10.0
California	-19%	-15%	\$0.00	\$0.00	0.0
Connecticut	-16%	4%	\$0.53	\$1.87	0.0
Delaware	-13%	0%	\$1.00	\$1.00	0.0
Florida	-12%	-1%	\$1.00	\$1.00	1.3
Georgia	-14%	-8%	\$0.78	\$1.93	3.0
Idaho	-15%	-5%	\$1.00	\$1.00	20.0
Illinois	-17%	-5%	\$1.00	\$1.00	22.6
Indiana	-15%	-4%	\$1.00	\$1.00	2.5
Iowa	-11%	0%	\$1.00	\$1.00	0.0
Kansas	-13%	0%	\$0.57	\$1.96	12.0
Kentucky	-13%	-2%	\$1.00	\$1.00	4.0
Louisiana	-13%	-4%	\$1.00	\$1.00	0.0
Maine	-12%	-1%	\$1.00	\$1.00	-0.8
Maryland	-11%	0%	\$1.00	\$1.00	-2.7
Massachusetts	-15%	0%	\$1.00	\$1.00	0.0
Michigan	-12%	0%	\$0.85	\$1.62	12.0
Minnesota	-17%	-5%	\$1.00	\$1.00	3.0
Mississippi	-8%	0%	\$1.00	\$1.00	0.0
Missouri	-11%	-1%	\$1.00	\$1.00	-1.0
Montana	-16%	-6%	\$1.00	\$1.00	13.0
Nebraska	-10%	-1%	\$1.00	\$1.00	1.0
Nevada	-10%	-2%	\$1.00	\$1.00	0.5
New Hampshire	-13%	-3%	\$1.00	\$1.00	5.0
New Jersey	-11%	7%	\$1.00	\$1.50	0.0
New Mexico	-20%	-13%	\$0.05	\$0.05	-1.0
New York	-10%	7%	\$1.00	\$1.46	-6.0
North Carolina	-6%	1%	\$1.00	\$1.00	-18.0
North Dakota	-15%	-4%	\$1.00	\$1.00	0.0
Ohio	-15%	-4%	\$1.00	\$1.00	10.7
Oklahoma	-14%	-10%	\$0.15	\$0.96	-2.0
Oregon	-11%	-2%	\$1.00	\$1.00	-1.7
Pennsylvania	-11%	8%	\$1.00	\$1.54	-15.9
Rhode Island	-13%	-2%	\$1.00	\$1.00	9.0
South Carolina	-12%	-1%	\$1.00	\$1.00	-12.0
South Dakota	-19%	-8%	\$1.00	\$1.00	24.0
Tennessee	-10%	0%	\$1.00	\$1.00	-11.8
Texas	-15%	-7%	\$1.00	\$1.00	-3.0
Utah	-18%	-10%	\$1.00	\$1.00	31.0
Vermont	-13%	-2%	\$1.00	\$1.00	9.0
Virginia	-14%	1%	\$1.00	\$1.00	-21.0
Washington	-14%	1%	\$1.00	\$1.00	-18.4
West Virginia	-14%	0%	\$1.00	\$1.00	0.3
Wisconsin	-13%	-5%	\$1.00	\$1.00	9.0
Wyoming	-16%	-5%	\$1.00	\$1.00	3.0

Source: Adapted from Hoxby (2001) Tables I and III

An attempt to relate Hoxby's findings to Oregon's experience underscores just how complicated equalization policies can be. Oregon's current system can encourage or discourage school spending depending on who is attempting to raise the resources and how they are attempting to raise them. Consider the following three ways localities can attempt to raise K-12 revenue.

- **State income taxes.** If Oregonians attempt to raise income taxes to support statewide increases in K-12 spending, wealthy districts would receive less than they pay in taxes and poor districts would receive more. So, in this context, the price of an additional dollar of K-12 services is higher than a dollar in Metropolitan Portland and less than a dollar in Eastern Oregon.
- **Local option property taxes.** If a gap exists between the Measure 5 and 50 limits, a local district can raise \$1 and keep it. Moreover, the state supplements local option revenue for property-poor districts—essentially encouraging those districts to use the option.
- **Ad hoc revenue approaches.** State law allows localities to raise revenue outside the equalization process. Most notably, voters in Multnomah County recently approved the state’s first-ever county-level income tax. Because the tax was not anticipated the in equalization rules, Multnomah County taxpayers keep the full amount of revenue they raise for schools.

As Oregon policymakers consider changes to the school finance system, they should be aware that equalization sets in motion an array of interrelated economic incentives. Equalization not only redistributes resources from people with a greater ability to pay to people with lower ability to pay taxes, the policy can also redistribute from people with a greater taste for education services to people with a lower taste for education services.

## RESOURCE VERSUS OUTCOME EQUITY

Much of the focus of early equalization policy was on *resource equity*, which involves equating spending per student across districts. Indeed, all of the current equity benchmarks still compare simple variations in spending between high and low spending districts. As discussed previously, Oregon has largely achieved resource equity through its statewide funding framework.

Syracuse University’s John Yinger and others argue that district *outcomes*—rather than *resources*—should be the focus of equity debates<sup>5</sup>. Table 4-4 offers one approach to measuring outcome equity. The table reports a distribution of school districts by the percent of their students that met the state benchmark scores in math and reading. The first data column shows that 20 percent of districts can claim more than 90 percent of their students met the 3<sup>rd</sup> grade reading benchmark. Another 54 percent of districts report more than 80 percent of their students met the benchmarks. *Relative to the other assessments reported in the table*, one could argue the 3<sup>rd</sup> grade reading scores are approaching equity.

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<sup>5</sup> See Yinger, John. 2004. *Helping Children Left Behind: State Aid and the Pursuit of Educational Equity*. MIT Press. Cambridge, MA. Pages 8 and 9.

By contrast, the remaining assessments show much wider ranges in outcomes across districts. In 5<sup>th</sup> grade math, some districts have more than 90 percent of students meeting the state benchmark while others have less than 30 percent.

**Table 4-4: Distribution of School Districts by Percent of Students Meeting Benchmarks, 2000-01**

Percent of Students Meeting Benchmark	Percent of Districts							
	3rd Grade		5th Grade		8th Grade		10th Grade	
	Reading	Math	Reading	Math	Reading	Math	Reading	Math
Less than 30 Percent	0%	1%	0%	1%	1%	5%	6%	20%
30 to 39 Percent	0%	2%	2%	3%	4%	12%	10%	35%
40 to 49 Percent	0%	2%	2%	2%	15%	26%	29%	21%
50 to 59 Percent	2%	10%	4%	11%	31%	28%	32%	17%
60 to 69 Percent	6%	19%	18%	22%	31%	21%	15%	6%
70 to 79 Percent	18%	36%	37%	40%	12%	7%	6%	2%
80 to 89 Percent	54%	23%	29%	15%	4%	2%	3%	1%
90 Percent or more	20%	7%	8%	5%	1%	1%	0%	0%
Totals	100%	100%	100%	100%	100%	100%	100%	100%

Source: Oregon Department of Education. *An Evaluation of Education Service District and School District Services in Oregon*. Final Report to the Interim Legislative Committees on Revenue.

Proponents of outcome-based approach would argue that policymakers concerned with equity should keep track of trends in Table 4-4 rather than relatively simple measures of spending per student. Proponents of outcome equity contend that equating resources across districts was an important first step but fails to recognize that districts face substantially different costs in their attempts to meet educational standards. Yinger summarizes his concerns as follows:

*“Programs that set high student performance standards without giving high-cost, low-wealth districts the resources they need to meet these standards are a recipe for these districts to fail.”<sup>6</sup>*

Oregon’s weighting scheme for students with special needs (funding by Average Daily Membership-Weighted) is an explicit recognition that students face different challenges in reaching benchmarks and require different levels of resources. The state developed the per student weights in the mid-1990s. A number of state finance experts, including those involved in the original development of the formula, believe it is time to revisit the literature and state expenditures and conduct a thorough review of it weights<sup>7</sup>

In conducting its review, the state could draw on a comprehensive analysis of New York state’s schools that estimated the additional cost of serving students with special needs *while holding constant other*

<sup>6</sup> Yinger (2004), Page 48.

<sup>7</sup> See Oregon Department of Education. October 25, 2002. *An Evaluation of Education Service District and School District Services in Oregon*. Final Report to the Interim Legislative Committees on Revenue. Salem OR. Pages 1-2.

*environmental factors, the school's performance on key educational outcomes, and the relative efficiency of the school's operations*<sup>8</sup>.

## EQUITY AND INTRA-DISTRICT BUDGETING

Equity in Oregon—and most other states—is measured at the school district level. Recently researchers have uncovered that common intra-district accounting practices may deprive schools in low-income, hard to serve areas of resources and overstate the degree to which resource equity has been achieved.

Specifically, Roza and Hill (2003)<sup>9</sup> found that districts commonly cost-out school spending by using district-wide *average* teacher salaries rather than *actual* teacher salaries. Using average instead of actual salaries distorts the reported resources devoted to each school because senior, highly paid teachers are not distributed evenly across schools, even within the same district. Roza and Hill identify several forces that lead to an imbalance of teachers:

*Teaching jobs vary considerably from school to school. A high performing school in a wealthy suburb offers a very different work environment than a chronically low performing inner-city, high-poverty school. In the former, a teacher may be more likely to have parents that read to children at night, emphasize education, enforce homework completion, and come to parent nights. In the latter, a teacher may experience a student population with greater health needs, increased student mobility, behavioral problems, heavy scrutiny from the district central office, and increased staff turnover. Certainly, these kinds of schools create more difficult jobs for teachers.*

Consistent with their data from a number of urban school districts, Roza and Hill conclude that high performing districts receive more applicants for any given opening, including teachers with seniority rights, and, therefore have more flexibility to choose teachers who fit their needs. As a consequence, they find a disproportionate share of senior teachers in better performing schools within a given district.

Given the uneven distribution of senior teachers, the use of average teacher salaries in district budgeting masks per student spending inequities. To illustrate the point, the authors analyzed the budgets in four large urban school districts (Baltimore City, Baltimore County, Cincinnati, and Seattle). In Baltimore City, the district-wide average salary equaled \$47,178; but school-level averages ranged from \$37,618 to \$57,000. Similar patterns existed in Baltimore County, Cincinnati, and Seattle.

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<sup>8</sup> See Duncombe, William and John Yinger. June 1998. "School Finance Reform: Aid Formulas and Equity Objectives". *National Tax Journal*. Volume 51. no 2. pp. 2239-62.

<sup>9</sup> Roza, Marguerite and Paul Hill. May 2003. "How Within-District Spending Inequities Help Some Schools to Fail" (a draft conference paper for the Brookings Conference on *The Teachers We Need*)

Having calculated the range in *actual* salaries, the researchers then calculated how much a typical school's budget would rise or fall *if the school paid the district-wide average to each of its teachers*. Put differently, the analysis showed how much spending would rise in a school with low salaried teachers if the school paid those teachers the higher district average. Similarly, the analysis shows how much spending would fall in schools with high-paid, senior teachers if the schools paid no more than the average salary.

Table 4-5 shows that schools in Baltimore City would gain or lose an average \$101,786 if they actually paid the district-wide average, which translates to a per student increase/decrease of \$246 per student. The average school budget would change by 5.9 percent; however, at the extremes, the analysis indicates spending in the school with the lowest paid teachers would have increased by more than 21 percent while spending in the school with the highest paid teachers would fall by roughly the same magnitude. The analysis found similar—albeit less pronounced—impacts in the other three districts.

**Table 4-5: Impact of Teacher Salary Averaging in Four Districts**

	Baltimore City	Baltimore County	Cincinnati	Seattle
Average gain or loss in school budget if actual rather than average salaries had been used to calculate school budget	(+/-) \$101,786	(+/-) \$120,612	(+/-) \$106,974	(+/-) \$72,576
Average gain or loss per student	(+/-) \$246	(+/-) \$232	(+/-) \$189	(+/-) \$144
Average percent impact on each school's budget	5.9%	6.5%	5.9%	4.9%
Maximum benefit as percent of the school's budget	21.8%	17.7%	15.6%	11.0%
Maximum loss as percent of school's budget	-20.8%	-18.4%	-19.2%	-21.8%

Source: Roza, Marguerite and Paul Hill. May 2003. "How Within-District Spending Inequities Help Some Schools to Fail" (a draft conference paper for the Brookings Conference on *The Teachers We Need*).

The Roza-Hill analysis has led the Committee on Economic Development<sup>10</sup> and others to urge school districts to end the practice. At a minimum, Roza and Hill recommend that school boards to implement transparent budgets that track real dollar spending on a per student basis using actual rather than average salaries. At the state level, policymakers could require that salary and benefit agreements hold students harmless against distortions in spending.

Roza and Hill also urge states to experiment with *school-level* funding. To date, only a handful of districts across the country have devolved spending authority to the school level. Notable experiments with school-level finance

<sup>10</sup> See Committee for Economic Development. 2004. *Investing in Learning: School Funding Policies to Foster High Performance*. Washington, DC. Page 12.

exist in Cincinnati, Houston, Milwaukee, Sacramento, and Seattle. In Canada, the Edmonton, Alberta schools initiated a decentralized finance system in 1973 and now more than 90 percent of school budgets are under their principals' control

With the money in the education system tied to the student and essentially coming “from the bottom up,” advocates of the approach believe schools could help districts refine their service provision by offering to pay more or less for the central services schools see as more or less beneficial to improving student outcomes. Moreover, such a change could work in tandem with the rise of state-level accountability and student performance benchmarks. As the standards movement more clearly defines the goals for student achievement, proponents of school-level funding believe individual schools need to have the authority to align their resources with the pursuit of achieving those goals. Pairing finance reforms to increases in school autonomy could have a powerful effect to encourage innovation and the discovery of best practices. Decentralization of spending authority could not be achieved overnight and must allow principals and teachers to adapt to new responsibilities regarding how to allocate their resources.

## CONCLUSION AND POLICY OPTIONS

With the implementation of local property tax limitations during early to mid-1990s, the primary responsibility for K-12 funding shifted from the local to the state level. Along with majority state funding came a policy decision to provide a comparable level of resources to students across the state. By 2002, Oregon had largely achieved that goal.

Despite the achievement, a number of important equity-issues remain in Oregon. Directions for future policy include:

- **Reform the local option process with an eye on equity.** As the state considers reform of its local option process (discussed fully in the Adequacy chapter), policymakers will have to tackle the inherent tradeoffs between adequacy and equity. Specifically, policymakers and their constituents will have to determine the extent to which districts should be able to add to the state's basic K-12 (foundation) spending and how (or whether) the state subsidizes spending in low property wealth/income areas.
- **Clarify outcome-based equity as a goal and determine whether existing student weights support it.** First, policymakers must clarify that outcome-equity is an explicit goal of the state's education system. For the most part, the Federal *No Child Left Behind Act* has required outcome equity; however if the state is going to tie finance to the concept, the state will need to develop a measure to gauge its success in achieving it. Once a goal is clarified, the state should reconsider the funding formula weights for children with special needs. The state developed the weights with

little empirical data on the relative cost of serving students with different needs.

- **Audit district accounting practices and prohibit methods that assign average teacher salaries rather than actual teacher salaries to individual schools.** High-poverty, low-achieving schools are hurt by accounting practices that assign average teacher salaries to each teaching position. Such schools may save a district money by hiring less experienced teachers but do not realize the savings in their budgets because of the accounting technique. The Oregon Department of Education should review district and school payroll records, eliminate the accounting practice, and encourage transparent budgeting.
- **Pilot school-level funding.** A number of finance experts point to decentralized, school-level funding as key to meaningful education reform. To date, only a handful of districts across the country have devolved spending authority to the school level. Notable experiments with school-level finance exist in Cincinnati, Houston, Milwaukee, Sacramento, and Seattle. In Canada, the Edmonton, Alberta schools initiated a decentralized finance system in 1973 and now more than 90 percent of school budgets are under their principals' control.

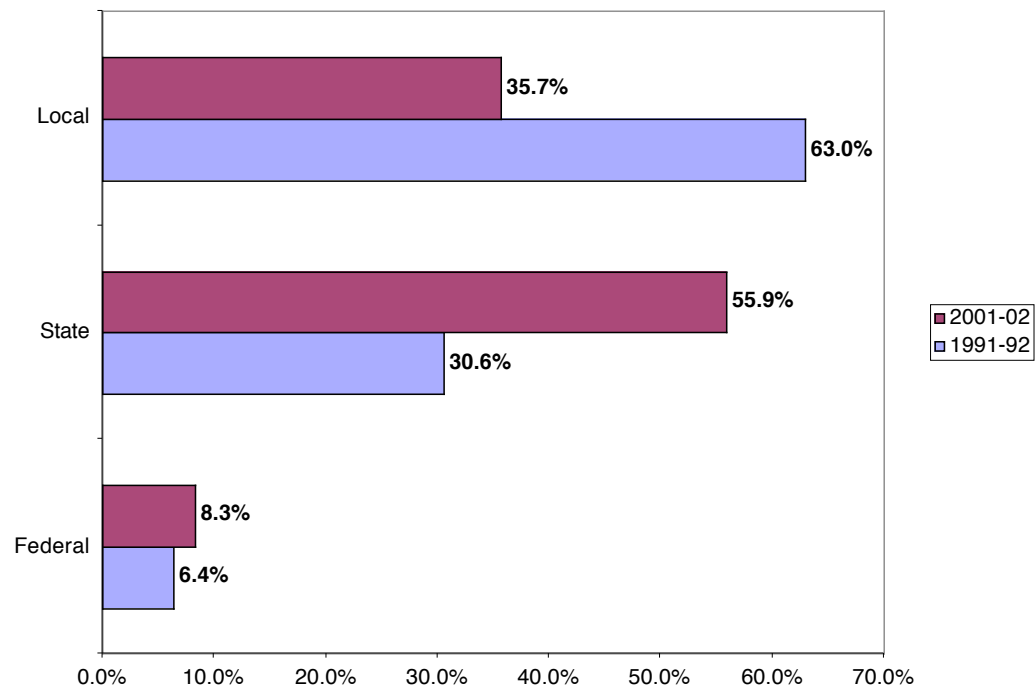
With the money in the education system now coming “from the bottom up,” schools might be able to help districts refine their service provision by offering to pay more or less for the central services schools see as more or less beneficial to improving student outcomes. Moreover, such a change would work in tandem with the rise of state-level accountability and student performance benchmarks. As the standards movement more clearly defines the goals for student achievement, proponents of school-level funding believe individual schools need to have the authority to align their resources with the pursuit of achieving those goals. Pairing finance reforms to increases in school autonomy could have a powerful effect to encourage innovation and the discovery of best practices. Decentralization of spending authority cannot be achieved overnight and must allow principals and teachers to adapt to new responsibilities regarding how to allocate their resources.



## INTRODUCTION

Since the passage of property tax limitations during 1990s, Oregon has gradually shifted responsibility for K-12 education funding from the local to state level. From the 1991-92 school year to the 2001-02 school year, the State's share of K-12 revenues increased from 30.6 percent to 55.9 percent (see Figure 5-1). With this transfer of funding authority, the state legislature essentially determines the overall level of resources available to school districts and ultimately to children across the state. Unlike local school boards—formerly the strongest influence on resource levels—state-level policymakers work with highly aggregated budgets.

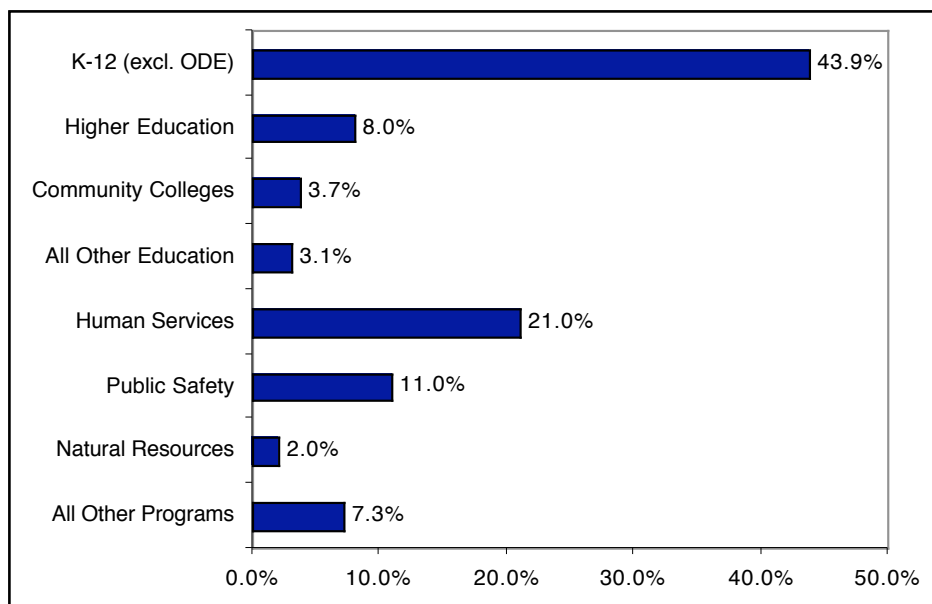
**Figure 5.1: Share of Revenues for Oregon Public Elementary and Secondary Schools by Source, School Years 1993-94 and 2000-01**



Source: ECONorthwest calculations based on U.S. Department of Education, National Center for Education Statistics: "National Public Education Financial Survey."

As the 2003-05 K-12 budget developed, legislative debate revolved around a single, large appropriation: some leaders argued for \$4.9 billion and the Governor suggested \$5.2 billion. With spending of this magnitude, the K-12 share of the general fund dwarfs all other spending categories (see Figure 5-2). The K-12 line item is more than twice as large as the second largest category (Human Services) and more than 20 times state spending on Natural Resources.

**Figure 5-2: Shares of Oregon's 2003-05 Legislatively Approved Discretionary Budget\***



Source: ECONorthwest calculations based on *LFO 2003-05 Budget Highlights UPDATE*.  
\*Budget as of April 2004 E-Board

As currently presented, the K-12 budget offers policymakers only a limited perspective on a complex system. The typical state policymaker may be vaguely aware that overall spending per student outpaced inflation during the 1990s. They attempt to reconcile that understanding with testimony from superintendents and local school board members who often sight increasing pressure to increase class sizes and eliminate popular programs in the arts, music, and athletics.

Essentially, an aggregated budget fails to recognize that the K-12 system delivers a number of distinct services with goals that differ from the system's overall mission. For example, spending on classroom instruction is clearly intended to increase student achievement. Meanwhile, spending on the physical plant and student transportation—while less directly linked to student achievement—nonetheless remains an essential system input. In addition to their distinct purposes, a variety of factors drive different aspects of the K-12 budgets. For example, salary schedules, teacher experience, retirement rates, and class sizes drive instructional expenditures while fuel and utility prices determine transportation and facility costs. Immigration policy drives the cost of ESL programs.

In the remainder of this chapter, we consider an alternative, more in-depth presentation of the K-12 budget that would educate policymakers about important K-12 inputs and changes in spending on these services over time. After illustrating the new budget format, we discuss how state and local officials might use the more detailed information.

# THE CASE FOR A NEW K-12 BUDGET FORMAT

Education finance experts have long recognized the need to provide policymakers with more detailed K-12 budget information<sup>1</sup>. While Oregon's policymakers are generally aware that K-12 spending per student increased during the 1990s, most can not describe the magnitude of the new spending (net of inflation) or identify the program areas that received increased funds. A reformatted budget focused on a number of distinct K-12 services would:

- **Isolate distinct inputs to the K-12 production function and identify the goals of each.** Under current practice, policymakers approve spending for the entire system and evaluate impacts using high-level performance indicators. *With a more detailed budget, policymakers could better understand where local schools have made major investments and where they might anticipate changed outcomes.* Traditionally, policymakers have assumed all school spending serves a single outcome goal—improved academic achievement of regular students. However, schools strive for a variety of other outcomes as well: student health and nutrition, vocational education, student safety, assimilation of non-English speaking students, training students with mental and physical disabilities. Test scores alone are insufficient measures to determine whether these goals are being met. A detailed budget would allow policymakers to link a detailed investment to better-defined outcomes.
- **Allow policymakers to gauge whether legislative funding intent translates into local expenditures.** Under the current budget process, state policymakers have no clear way to measure a policy's funding intent against its realized spending impact for the targeted program. For example, the state's existing funding formula implicitly directs additional resources to certain types of students, but only a disaggregated budget can illustrate if and how those policies translate into local expenditures.
- **Enlighten discussions about resource adequacy and program efficiencies.** The current budget configuration does not lend itself to meaningful debates about resource adequacy or program efficiency. In Salem, most policymakers work with a single K-12 number, and measure funding adequacy relative to comparable spending in other states or the Quality Education Model. A number of distinct spending categories would stimulate vigorous and enlightened debates about the policies underlying a service category and the efficiency with which localities deliver the service. After all, the policies and practices associated with K-12 student transportation have little to do with the policies and practices of

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<sup>1</sup> See Rothstein, Richard and Karen Hawley Miles. 1995. *Where Has the Money Gone? Changes in the Level and Composition of Education Spending*. Economic Policy Institute. Washington, DC.

elementary instruction. Likewise, the practice of delivering English as a Second Language differs dramatically from delivery of regular mathematics and reading instruction. A detailed evaluation of spending on a manageable number of distinct services will inspire discussion about the purpose and goals of each service and its supporting policies.

- **Strengthen spending projections.** As discussed previously, different service categories have distinct “cost drivers”. Demographers can forecast the relative numbers of children that will flow through the elementary, middle, and high school levels, and policymakers could anticipate the changing need for resources at each level. Similarly, if forecasters anticipate a continued in-migration of foreign-born students, policymakers could anticipate an upward trend on ESL spending. If local school districts embark on a policy to build small schools, student transportation costs should fall.

## WHAT A TRANSPARENT BUDGET COULD SHOW

K-12 finance debates often revolve around statewide average spending per student, measured across all students regardless of type. For example, data from the National Center on Education Statistics indicate that Oregon spent about \$7,642 per student on on-going operations and maintenance in the 2001-02 school year, which is slightly below the national average of \$7,734 per student. The simple statewide average misses the fact that the K-12 system consists of a variety of programs with different price tags. The cost to serve any particular students depends on the type of program they access.

Table 5-1 moves away from the single statewide average and reports per student spending across a number of program types for the 2002-03 school year. The programs fall into three major categories:

- **Regular education** includes regular elementary, middle, and high school programs designed to prepare students for activities as citizens, workers, students in higher education, and family members.
- **Supplements to regular education.** Programs designed to serve students with mental, physical, emotional, or social disabilities, English language learners, economically disadvantaged students, students at-risk of dropping out of school, and the talented and gifted. *Students in supplemental programs also receive regular education services.*
- **Programs outside regular education.** Programs operated wholly outside the regular education setting that offer intensive special education for students with mental and physical disabilities, alternative private and public programs (including charter schools), early intervention services for children aged 0-5, and pre-kindergarten.

In 2002-03, Oregon spent \$3.9 billion on regular education and served 538,949 students. The totals include operations, maintenance and capital expenditures. Per student spending was highest at the high school level and lowest at the middle school level. State and local revenues supported between 84 and 87 percent of regular education expenditures. Charges are higher at the high school level where student fees support key extracurricular activities.

Oregon spent \$361 million on special education for 63,010 mentally and physically disabled children who remain in regular classrooms. Given that these students remain in regular classrooms, their \$5,737 per student cost *supplements* their regular education services. Therefore, a special education student who attends a regular elementary school program costs roughly \$12,860 annually (or, \$7,123 plus \$5,737). Supplemental expenditures for English language learners average \$1,440 per student; Title I and At-Risk spending, which is targeted to the economically disadvantaged and students at-risk of dropping out of school, averages \$682 per student; supplements for TAG students average \$185 per student. Within this category, state and local revenues dominate except for the Title I At Risk program, which is funded primarily by the federal government.

Finally, for programs outside regular education, special education for students in separate educational settings accounts for about half of the category's total. School districts spend an average \$21,670 per student. Services include instruction but also extend to health and psychological services and special-needs transportation. Spending per student for the remaining three programs all fall in the \$7,000 to \$8,000 range.

**Table 5-1: Oregon K-12 Spending per Student by Program Type and Source of Revenue, 2002-03 School Year**

Program Type	Number of Students	Per Student Spending	Total Expenditures	Revenue Source			
				State and Local	Federal	Charges	Misc.
<b>Regular Education</b>							
Elementary	241,344	7,123	1,719,002,353	88%	5%	4%	4%
Middle School	131,443	6,853	900,815,162	87%	5%	4%	3%
High School	166,162	7,561	1,256,401,844	84%	6%	7%	3%
Regular Education Subtotal			3,876,219,359				
<b>Supplements to Regular Education</b>							
Special Ed in Regular Classrooms	63,010	5,737	361,489,114	82%	15%	1%	1%
English as a Second Language	49,580	1,440	71,391,954	91%	7%	1%	2%
Title I, At-Risk	211,501	682	144,290,996	21%	79%	0%	0%
Talented and Gifted	42,376	185	7,823,604	96%	1%	1%	2%
			584,995,668				
<b>Programs Outside Regular Education</b>							
Special Ed in Separate Classrooms	8,862	21,670	192,041,562	77%	20%	1%	2%
Alternative Schools	7,363	7,276	53,573,290	78%	19%	1%	1%
Early Intervention	7,158	7,407	53,016,415	86%	14%	0%	0%
Pre-Kindergarten	10,026	7,971	79,914,320	41%	59%	0%	0%
			378,545,587				
<b>GRAND TOTAL</b>	<b>572,358</b>	<b>8,456</b>	<b>4,839,760,614</b>	<b>83%</b>	<b>10%</b>	<b>4%</b>	<b>3%</b>

Source: ECONorthwest calculated using Oregon Department of Education data.

Reporting per student spending in more transparent ways achieves multiple goals. First, the format emphasizes that no two students are alike, and that with each student comes different needs. Second, the reporting

would force policymakers and budget analysts to anticipate how different student populations have grown and will grow. During the 1990s, for example, growth in the two categories of special education students (regular and separate classrooms) outpaced the growth of regular enrollment and put pressure on school district budgets. Absent transparent budgets, principals, administrators, and policymakers were aware of the general trend but had little precise data to anticipate how the growth would impact their other educational programs. The data exist to support transparent budgets, but to date, policymakers have not used the rich information contained in school budgets intensively.

## LOOKING FORWARD: HOW POLICYMAKERS COULD USE TRANSPARENT BUDGETING IN THE FUTURE

### FORECAST DEVELOPMENT

In this section, we illustrate how a budget forecast could work with transparent per student spending information. First, analysts could predict per student spending using a similar level of programmatic detail outlined in the previous section (so-called program functions). By disaggregating the budget in this way, analysts would be required to consider different cost drivers for each program category. For example, predicted class sizes, teacher salary schedules, benefit trends, and the experience profile of the teaching corps would drive instruction costs. Different salary policies for administrators and support staff would—as well as support staff to student ratios—would drive administrative costs. Fuel and maintenance costs would be key considerations in the physical plant and transportation areas. Each forecast could be accompanied with the trends leading up to the current year, so policymakers could see if how the forecasts differ from recent history.

**Table 5-2 Hypothetical Budget Forecast for Regular Education, Illustrative Student and Spending Levels by Function**

School Year	Fall Enrollment	Regular Instruction	School Level Admin	Central Admin	Physical Plant	Transprt	Other	Total per Fall Enrollee	Total Expenditures (In Millions)
Year 1	550,532	3,041	858	399	619	260	170	5,346	2,943
Year 2	547,958	3,132	884	411	638	267	175	5,506	3,017
Year 3	543,145	3,226	910	423	657	275	180	5,672	3,080
Year 4	539,059	3,323	938	436	676	284	186	5,842	3,149
Year 5	536,624	3,422	966	449	697	292	191	6,017	3,229
Year 6	533,955	3,525	995	462	718	301	197	6,197	3,309
Annual Growth	-1%	3%	3%	3%	3%	3%	3%	3%	2%

Source: ECONorthwest illustrative student and spending forecasts

Budget analysts would not want to stop with Table 5-2. For any program, they could—and should express and forecast the data in a different way—namely by spending object (those are, salaries, retirement benefits, healthcare benefits, and other expenditures). In short, the analyst would be expressing the identical spending totals through a different budgetary lens (*Note that in these hypothetical forecasts total expenditures and total per fall enrollee are equal in Tables 5-2 and 5-3*).

By reviewing and forecasting spending by objects, policymakers could keep better tabs on two important recent drivers of K-12 spending: retirement and healthcare costs. A predecessor report, entitled *The Condition of K-12 Education in Oregon*, showed Oregon's per staff spending on benefits ranked 1<sup>st</sup> nationally, and expected increased costs associated with state's retirement system will continue to put upward pressure on benefit spending.

**Table 5-3: Hypothetical Budget Forecast for Regular Education, Illustrative Student and Spending Levels by Object**

School Year	Fall Enrollment	Salaries	Retirement	Health	Other	Total per Fall Enrollee	Total Expenditures (In Millions)
Year 1	550,532	3,184	666	666	830	5,346	2,943
Year 2	547,958	3,280	686	686	855	5,506	3,017
Year 3	543,145	3,378	707	707	880	5,672	3,080
Year 4	539,059	3,479	728	728	907	5,842	3,149
Year 5	536,624	3,584	750	750	934	6,017	3,229
Year 6	533,955	3,691	772	772	962	6,197	3,309
Annual Growth	-1%	3%	3%	3%	3%	3%	2%

Source: ECONorthwest illustrative student and spending forecasts

Ideally, analysts would develop separate forecasts for special education, English as a Second Language, and other programs that serve well-defined student populations. Table 5-4 illustrates a hypothetical budget that forecasts per student special education spending by program function.

**Table 5-4: Hypothetical Budget Forecast for Special Education, Illustrative Student and Spending Levels by Function**

School Year	Special Ed. Enrollment	Instruction	Health and Psyc. Services	Transprtn	Total Per Special Ed. Student	Total Expenditures (in Millions)
Year 1	73,405	4,975	989	611	6,575	483
Year 2	74,662	5,127	1,032	638	6,797	507
Year 3	75,767	5,286	1,077	666	7,029	533
Year 4	76,799	5,451	1,124	695	7,270	558
Year 5	77,498	5,623	1,173	725	7,522	583
Year 6	78,279	5,803	1,225	757	7,785	609

Source: ECONorthwest illustrative student and spending forecasts

## PUTTING THE FORECAST TO WORK

A detailed budget proves useful only if policymakers use the data to make more informed decisions. State policymakers considering a number of component budgets rather than an aggregate allotment would engage in a considerably different debate: their overall funding decisions and policy directives already drive tradeoffs across the system's variety of services, but a redesigned budget format would significantly improve the clarity of these tradeoffs.

During most of the 1990s, policymakers oversaw real annual increases in per student spending on special education while per student spending on regular education either kept pace with inflation (elementary school), outpaced inflation (middle school), or declined in real terms (high school),

While there may have been solid policy reasons for each of these trends, the policy changes were not vigorously debated—for the most part, state-level policymakers were unaware of the shifts.

Taken alone, a redesigned budget presentation would educate policymakers about the uses of dominant K-12 budget components. However, a move to transparent, component budgets should further support a process by which the improved information supports a more rigorous analysis of the system's productivity. We describe below how an improved budget development process might work.

## STATE-LEVEL BUDGET DEVELOPMENT PROCESS

The K-12 service categories facilitate an independent examination of underlying policies and anticipated outcomes. The Governor and legislative leaders could convene distinct K-12 budget *advisory councils* that would review policy and recommend a budget for each of the programmatic areas discussed above. The councils could be composed of superintendents, school board members, business leaders, academics, and other community leaders. The Governor would charge each council to review national best practices in their respective areas, analyze conditions in Oregon, and advance a spending proposals and forecasts.

Council membership would not be limited to experts in the education field. For example, health professionals might be better positioned to assess whether schools are efficiently delivering health and psychological services. Executives from high-technology firms would have useful insights on how the system could better manage its information and data systems. Business leaders could identify procurement efficiencies that would further shrink general administrative costs. As part of their overall spending recommendations, the councils would identify any strategic investments that demonstrate a high likelihood for positive impacts.

Beyond spending recommendations, the councils would also identify the outcomes that policymakers should expect from investments in the area. Under the unified budget, we generally look for a higher rate of achievement and attainment, but we should have different expectations when examining individual budget categories. For example, increased spending on transportation may support student safety and school attendance but should have only an indirect effect on achievement. Investments in special education should strengthen achievement but only for a select set students.

At the state-level, the redesigned budget process would culminate in the legislative adoption of multiple K-12 service budgets. The Governor, legislative leaders, and the public would be better informed about the investments they are making and the outcomes they can anticipate.

## REVENUE DISTRIBUTION AND LOCAL SPENDING DIRECTIVES

Having approved multiple budgets, the state would arrive at a total K-12 spending level. At that point, the state could distribute the resources in a number of different ways:

- **Aggregate the separate service budgets and distribute a total K-12 package through the current funding formula.** Through this approach, the state would aggregate the spending proposals from each of the service areas and distribute the total resources through the same process they do today. While the budget would have been developed and debated in a more rational, educated fashion, much of the new process' value would be lost. Moreover, because the existing funding formula has explicit weights associated with certain types of students and activities (e.g., special education, at-risk students, transportation), the priorities implicit in the existing formula would become misaligned with the priorities advanced through the new budget-making process. For example, if policymakers deemed an even larger investment in special education worthwhile, the weights in the existing funding formula may no longer be appropriate.
- **Distribute budgets for each service category independently through unique formulas but do not dictate how local school districts spend their resources.** Alternatively, the state could develop unique methods to distribute each of the independent service budgets based on service-specific measures of need. Through such a process, spending on regular instruction and special education would be distributed separately through distinct formulas. The formula for regular education spending could be based on a simple unweighted count of school district enrollment or attendance. Likewise, resources for special education would be distributed on some measure of district need<sup>2</sup>. The state could distribute revenues for transportation and technology services through distinct methods. Under this approach, local school districts would receive resources by category but would be free to spend their resulting total in any way they saw fit. Therefore, if a local district proved exceptionally efficient in one service category, they could liberate resources and spend them in other areas.
- **Distribute budgets for each service category independently and require local districts to earmark revenues to those categories.** In this final approach, the state could distribute resources separately and call on local districts to maintain spending in those specific categories. This model maximizes the state's control over spending but takes a major step away from local control and limits experimentation.

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<sup>2</sup> The state would probably want to depart from the current process by which the state provides resources for each student identified by the district up to a capped threshold.

Of the three options outlined above, the second approach shows the most promise. By distributing resources for distinct services, state policymakers can send clear signals about priorities. However, a more flexible distribution of revenues would allow school districts to implement innovative educational practices and explore program efficiencies.

In the end, policymakers would need to balance the need for fiscal accountability with the need for district flexibility. Any move toward earmarked or categorical funding would work against Oregonians' long-standing preference for local control of educational services.

## CONCLUSION AND POLICY OPTIONS

Relative to other government programs like Medicaid or higher education, fiscal reporting in K-12 is robust. In the late 1980s the National Center for Education Statistics worked with states to ensure competent and thorough reporting of education expenditures. In short, all the pieces are in place to support good fiscal accountability.

Despite good availability, Oregon has not used its data very intensively and budgets have not been transparent. The Legislature, which essentially sets the overall spending level, debates funding at a very abstract level (for example, \$4.9 billion or \$5.4 billion). Few state-level policymakers dig into the trends to see what is driving costs.

The following policy options, if adopted, could improve policymakers' understanding on the K-12 and strengthen fiscal accountability.

- **Overhaul the K-12 budget process and track per student spending for distinct services delivered by the system.**

Education finance experts have long recognized the need to provide policymakers with more detailed K-12 budget information. While policymakers are generally aware that K-12 spending per student increased during the 1990s, most cannot describe the magnitude of the new spending or identify the service areas that received increased funds.

A reformatted budget focused on a number of distinct K-12 services would 1) isolate distinct inputs to the K-12 production function, 2) allow policymakers to determine whether funding intent translated into local expenditures, 3) enlighten debates about resource adequacy and 4) improve spending projections

- **Explore a separate budgeting process for retirement and health benefits.** Oregon's spending per K-12 staff member on benefits ranks first nationally, and forecasts suggest spending on retirement and health benefits are likely to increase during the next decade. Even if the Oregon Supreme Court rules in favor of the state's recent retirement reforms, the cost of the system to local school districts will continue to increase throughout the next decade.

Health insurance benefits will also put upward pressure on spending as medical inflation is expected to outpace growth in incomes.

A separate appropriation process would highlight trends in these critical and growing components of the K-12 budget. The process would also allow state lawmakers to provide non-binding policy guidance to local districts. For example, state lawmakers could establish an initial appropriation for health benefits that assumed all districts had the *median* benefit package offered by school districts or, alternatively, a package comparable those offered to other state employees. Once set, the appropriation would then grow at a defined rate. Rather than using medical premium inflation, the state could tie the future appropriation levels to state revenue forecasts. If medical inflation continues to outpace general economic growth (and the state's general fund), local districts would either scale back benefit packages or hold benefit packages in place at the expense of other K-12 services.



## INTRODUCTION

The recent sharp declines in spending per student have caused local districts across the state, and the nation, to do more with less. School officials are on a constant lookout for untapped revenue sources and more efficient ways to do business. While tight fiscal times have forced Oregon's superintendents, business managers, and principals to implement an array of cost cutting measures, some innovative reforms, implemented outside Oregon, have not been tried here.

*The Chalkboard Project* requested a broad review of short- and long-term policy options that have the potential to improve the efficiency with which local districts and the state spend scarce K-12 resources. To assemble the list of proposals, the research team interviewed a number of current and former officials with the Oregon Department of Education, Department of Administrative Services, Legislative Revenue Office, and the Board of Education. In addition, the team reviewed documents assembled by the National Conference of State Legislatures (NCSL) and other organizations that survey cost cutting efforts implemented by school districts throughout the country.

## POLICY OPTIONS

This section reports the policy options identified through these combined interview and data assembly efforts. The policy options show potential to improve efficiency in the K-12 delivery system. While we outline a number of proposals that show potential to support a more efficient system and generate savings, we do not specify how local districts or the state should use those savings. Options include reinvesting the efficiency savings in programs they view as cost-beneficial or simply allow spending per student to fall and, in essence, provide a similar level of service at a lower cost.

- **Policy Option #1: Critically assess the efficiency of Oregon's Education Service Districts (ESD) and consider methods to increase school district participation in the development of ESD services.** Oregon has 21 ESDs that receive about 5 percent of K-12 resources. While ESD services can be diverse, they are generally concentrated in the areas of special education, centralized procurement, and data systems.

In 2002, the Interim Legislative Committee of Revenue directed the Oregon Department of Education (ODE) to evaluate possible ESD-service deficiencies. The resulting report noted that the state's school funding formula—which largely eliminated per student funding inequities at the *district* level by 2002—had yet to equalize per student spending across

ESDs. The report concluded that a revised ESD funding formula (scheduled for full implementation by 2005-06) should “virtually eliminate the variation in ESD funding [per student]” and eliminate relative ESD service deficiencies.

In addition to commenting on short-term ESD funding inequities, ODE surveyed local districts to assess their overall satisfaction with ESD services. The report concluded that “districts generally are satisfied with the services they are receiving from their ESDs, but some districts would like more influence over the menu of services offered by their ESD.”

Through our interviews, observers generally believed the value of ESDs to the local school districts they serve varied across the state. In some areas, ESDs provide special education at an economic scale that could not be delivered at equal cost by the individual districts they serve. Similarly, a number of ESDs serve as, or participate in, purchasing cooperatives, thus effectively exploiting economies of scale in the procurement of instructional supplies.

In other areas, however, interviewees argued ESDs provide services that duplicate those of their constituent districts or simply provide inefficient service. Given that the value of these agencies to their local districts varies across the state, most observers argued that no single, statewide policy prescription—status quo or complete termination of the ESDs—made sense.

Most observers saw the need for ODE to extend its 2002 work and more critically assess the value to local districts of the ESD special education, procurement, and technology services. Moreover, most respondents recognized the need to increase district participation in ESD service delivery decisions. The most aggressive way to increase district input into ESD service delivery would involve fully redirecting the state’s ESD funding to local school districts and allowing the districts to purchase only those services of highest value to them. The practical effect of this market-based approach would be a consolidation in the number of the ESDs and perhaps a change in boundaries for the ESDs.

- **Policy Option #2: Eliminate transportation-matching funds and distribute a fixed block grant based on program efficiency.** Under current law, the state reimburses local districts for 70 to 90 percent of their approved transportation expenditures, which are specified in state law. The existing matching grant provides little incentive to operate an efficient system or otherwise contain costs. Fiscal incentives could improve if the state transitioned to a block grant program that distributed a fixed level of resources based on the efficiency of the district’s transportation program. North Carolina has operated such a model since 1980 and evaluates district efficiency based on the average distance of students to a school, the number of students transported per mile of road, elevation, and the number and types of special education students served. Districts with higher levels of estimated efficiency receive a higher share

of their costs reimbursed. A cursory analysis suggests the North Carolina program is working as the state spends \$223 per student on transportation compared to Oregon's \$319 and a US average of \$298.

- **Policy Option #3: Consolidate individual district payroll and student tracking systems into a single statewide system.** School districts and ESDs currently operate hundreds of different data systems to process their payrolls and track student attendance and achievement levels. A number of larger districts have selected common student tracking systems, and now, systems that contain data on more than half the students in the state are compatible. On the other hand, payroll and purchasing systems still number in the hundreds with many districts operating and maintaining unique software. The existing system is the equivalent of a large chain of grocery stores allowing each of its stores to process payroll separately. Full consolidation of payroll and student tracking systems into a single statewide system would require an upfront capital investment but, if implemented efficiently, would generate long-run capital, operational, and maintenance savings for individual districts. Moreover, a consolidated system would greatly improve tracking of students who move across districts and similarly could facilitate the transfer of financial information for teachers and staff who change district employers.
- **Policy Option #4: Expand federal Medicaid reimbursements for services to special education students.** A range of the services provided by schools to special education students are medically related and qualify as expenditures under the federal Medicaid program. The share of special education funding that qualifies for federal Medicaid matching dollars varies from 1 percent in Idaho to 9 percent in New York. Oregon did not participate in the fiscal survey, which makes it impossible to determine the potential of the Medicaid funding source.

As a preliminary step, the state should create, or update, its estimate of the share of total special education expenditures financed through the Medicaid program. If the share is below 5 percent, the state should consider a variety of methods to overhaul the Medicaid reimbursement process. First, the Department of Human Services and Department of Education should jointly review the state's Medicaid contract with the federal government to ensure that all Medicaid eligible special education services are listed. Second, the agencies could develop an easily accessible statewide database of Medicaid eligible students that could be accessed by local district personnel. Finally, the state should consider consolidating Medicaid claims processing into a centralized state (or regional) office or outsourcing the activity to a private firm. If the state takes the latter approach, policymakers should first test the cost effectiveness of outsourcing on a demonstration basis.

- **Policy Option #5: Consider an increase in the use of student fees for non-core services as an alternative revenue source.** The use of student fees to fund non-core academic programs has risen consistently

over the past decade. As school spending continues to outpace educational resources, districts have sought alternative means of raising revenue to provide extracurricular opportunities for their students. More than 20 states charge fees to students participating in school clubs and interscholastic sports. Some have gone even further, requiring fees for instructional but non-core classes like keyboarding, art, business classes, SAT workshops, industrial arts, and driver education. Many other schools generate revenue by charging for locks and ID's, instituting "materials fees," and requiring upper-secondary students to purchase parking permits to park on school grounds. Student fees can be governed by school board policies, and waived for indigent families where appropriate. In states employing student fees, the amount can vary widely depending on the service, from \$1 for locks, \$20 for class materials, to over \$250 for behind-the-wheel driver education. Oregon schools can focus taxpayer dollars on core academic instruction by charging student fees for optional extracurricular activities and student services.

- **Policy Option #6: Experiment with centralized online purchasing and/or purchasing cooperatives for school supplies and materials.** Districts in many states are finding that they can take advantage of scale economies by cooperatively purchasing essential school materials. Information technology has played a large role in making schools more efficient by streamlining the purchasing process. School districts in Ohio employ online, centralized textbook purchasing for their schools; they report dramatic savings in materials, shipping, inventory, and labor costs as a result of adopting more efficient purchasing practices. Groups of Los Angeles-area schools recently banded together to cooperatively purchase recycled paper to receive a better price. Cooperative bulk purchasing, combined with improved online inventory-tracking technology, is a promising avenue for reducing costs and freeing existing educational resources for core academic instruction.
- **Policy Option #7: Address the findings of the Secretary of State's Audit Report that Oregon has above-average spending on "support services."** Support services are "services provided to facilitate and enhance instruction," such as transportation, instructional staff support, school and district level administration, operation and maintenance, student support services (student counseling), and business and other support services as well. The Secretary of State found that if Oregon school districts had spent the average amount on support services in 2000-01, then schools would have had an additional \$162 million to redirect into instructional activities. To address districts' above-average spending, the audit report recommends many of the previously mentioned techniques to produce savings, like cooperative purchasing to enjoy economies of scale and finding new revenue sources. Additionally, the report recommends Oregon school districts examine some promising practices from other states, such as district-level sharing of specialized personnel, increasing the quality and uniformity of expenditure information across schools to enhance the district's ability to recognize

overspending, and fostering communication between schools to discover and proliferate best practices.

- **Policy Option #8: Investigate innovative new energy purchasing practices.** In addition to installing energy-saving equipment, some school districts are beginning to experiment with innovative energy-purchasing strategies to save on energy costs. The Missouri School Board Association formed a consortium to collectively purchase natural gas for its schools at an estimated 30 percent total savings. Some districts in Ohio are exploring an even more pioneering practice: school districts are buying energy futures to purchase natural gas when prices are low for delivery for in the peak winter season when prices are typically much higher. Some districts estimate their overall energy savings at 25 percent. Exploring the features of Oregon schools' energy expenditures may expose savings opportunities through employing these, or other, new and creative energy purchasing practices.
- **Policy Option #9: Mandate that local districts strike early retirement programs from their labor contracts.** Historically, local districts have sought means to encourage the early retirement of experienced teachers, who, under traditional step-based scales, earn the highest salaries. Under these programs, districts offer to pay for health insurance between the ages the 58 and 65 for the early retiree. In the past, the cost of the health insurance was typically more than offset by the savings associated with the corresponding reduction in salary as the district replaced the retiree with a younger counterpart. Two recent developments have made these programs less cost-effective. First, Oregon's public retirement benefits—even as amended by the 2003 legislature—are high expressed as a share of an employee's wages. Consequently, the existing retirement package already provides a strong incentive for early retirement. Second, health care inflation has put upward pressure on the cost of these early retirement packages, rendering most—if not all—of these local programs cost-ineffective.
- **Policy Option #10: Transfer funding for remote schools to the economic development department.** Maintaining very small schools in remote areas of the state may serve economic development goals of the communities they serve, but the additional spending for those schools cannot be supported from an educational perspective. To better align resources with the true goals of the program, the state's economic development department should govern funding for small, remote schools.

Remote school funding is a weight in the state school formula. It began as a weight to add funding for "necessary" small schools. These were schools that had to be small because the local population was so sparse that students would have to travel long distances to attend a larger, more economic school. In recent years, the weight was expanded to include other small schools that were not remote, because, although there was another reasonably nearby school in a neighboring district, combining the

schools would close a school that was important to the identity and development of a small town.

In short, the current weight has mixed goals. If the funding is shifted, these goals should be re-separated.

Oregon's system of school finance—and public finance in general—is at the crossroads. The system's weak design was exposed during the recent economic downturn resulted in high budget shortfalls and ultimately led to abrupt declines in K-12 spending per student. The estimated 6.1 percent decline in per student spending between 2002-2003 was not only the highest decline recorded by a state between those years, it also represented the second highest annual decline for any state since 1990.

Voters considered and rejected statewide efforts to mitigate the shortfalls through temporary tax increases. Absent a statewide solution, school districts turned to an uncoordinated patchwork of local strategies. Some looked to the state's K-12 local option property tax; however, given its complex limits, the mechanism has proved a more feasible solution in some districts than others. Districts that deemed the traditional local option infeasible considered transfers from nearby local governments. And in Multnomah County, voters circumvented traditional school finance approaches altogether and established the state's first-ever local income tax to support spending in the county's eight school districts. By establishing a tax that—up to that point—had never existed, the county's taxpayers also circumvented sharing the resulting revenues with poor districts.

Oregon's system of school finance appears ripe for change. While Oregonians, and the policymakers who serve them, may disagree on the scope and details of the needed overhaul—the growing number of legislative, stakeholder, and citizen volunteer committees looking into school finance, and public finance generally, suggests Oregonians are calling for some action. *The Chalkboard Project's* civic engagement process stands ready to assemble and clarify their views. In support of that process, this report advanced a number of policy options, which we summarize below.

## STABILITY

As the state's economy continues its recovery, its finance system remains unstable. The creation of the Education Stability Fund fostered future stability, but the Fund's cap—at 5 percent of the General Fund is low and for the time being its resources are depleted. Solutions to the instability problem abound and barriers to their adoption are less technical than they are political. Incremental approaches would leave the state's income tax in place but establish budgetary mechanisms to smooth revenue peaks and troughs in good and bad economic times. An expanded rainy day fund, a required General Fund ending balance, or a combination of both would support the stability goal. A rainy day fund is useful only to the extent it has resources when the next downturn hits. In the short term, finding those resources would require sacrifices in the form of foregone spending or tax increases.

Spending guarantees also have potential to stabilize K-12 budgets. However, as demonstrated in California and Colorado, when a state mixes spending *guarantees* with overall spending or revenue *limits*, something has to give. In Colorado's case, the unanticipated consequences of competing policy goals (TABOR's spending limits v. Amendment 23's guarantees) pit school budgets against other programs funded through the state's General Fund (e.g., public safety and medical assistance). In California, spending guarantees essentially give K-12 preferential access to property tax revenues, which are limited by Proposition 13. There, local governments, which also rely on property taxes, perceive themselves as losing resources to the schools. If Oregon pursues spending guarantees, it should do so carefully, learn from the experiences of Colorado and California, and be exceedingly clear about how any guarantees would interact with existing or proposed revenue or spending limits.

#### **Stability Policy Options:**

- *Link annual increases in K-12 funding to growth in the number of students and average wages.*
- *Establish a required projected ending balance in the state's general fund.*
- *Create a broader rainy day fund that serves all general fund programs.*
- *Broaden the income tax base by reducing tax expenditures and income tax rates.*
- *Reduce the general fund's reliance on income taxes; expand use of consumption taxes.*

Stability could also be achieved through comprehensive tax reform. Policymakers could devise any number of packages that improve stability with or without increasing total revenues to the state. The most common proposals advanced recently involve either the creation of a good and services sales tax or the retention of the income tax but with a broader base and lower rates. Any significant tax reform creates winners and losers, which is why it is so uncommon.

## **ADEQUACY**

The question of resource adequacy is inherently subjective and depends, in part, on how Oregonians believe the system is managing the resources it already has. Fifty two percent of Oregonians believed "public schools just do not have enough money" while 40 percent believed schools "did not have funding problem. Those who perceive funding shortage are more likely to believe that waste and inefficiency has been rung from the system and that additional resources would directly and immediately benefit the system's achievement and attainment outcomes. Their critics counter that the structure of Oregon's K-12 delivery system fosters waste and inefficiency by limiting competition and entrepreneurial innovation. Consequently, they believe a system—reformed through market-based principles—could produce

dramatically better outcomes with the same level of resources—or even less than they have now.

Perspectives on adequacy also turn on Oregonians' expectations for their K-12 system. A system geared to produce students competent in core mathematics, reading, writing, and science skills probably requires a different level of funding than a system that aims to produce citizens with good basic skills and competency in the arts, music, and foreign languages. In short, determining whether Oregon spends too much or too little on K-12 education depends, in part, on Oregonian's goals for the system.

#### **Adequacy Policy Options:**

- *Quality Education Commission (QEC) should rank the 29 constituent reforms that compose the full implementation Quality Education Model based on the rigor of the research that underlies the proposed reform and the likelihood that implementation would cost-effectively improve student achievement or attainment.*
- *Establish a statewide, uniform revenue source that school districts could tap to augment local per student spending.*

By moving to majority state-level finance, Oregon has dramatically broadened the pool of taxpayers who together must decide what is adequate. The old local-level finance model depended on modest-sized electorates of relatively like-minds. By contrast, today a philosophically and politically diverse statewide electorate jointly makes the funding call with often widely different perceptions and expectations of the K-12 system.

A reformed local option process could ease the tensions caused by the electorate's diversity. Local option reform would support the goals of adequacy and likely result in an overall increase in spending per student however—as just described—it quickly runs into conflicts with equity goals.

Those looking to this report for the definitive answer on adequacy will be disappointed. Such an answer may be premature given the lack of understanding Oregonians, and many of their policymakers, have about school spending and its associated goals. Arming Oregonians with better information through its broad civic engagement process is a key goal of *The Chalkboard Project*.

## **EQUITY**

Oregon's move to majority state-level finance and a system of rational *resource-based* equity is largely complete. Today, students across the state have access to a roughly comparable level of resources. Moreover, a funding weighting scheme provides additional resources to students with special needs, which is an implicit attempt to provide equal opportunity to outcomes.

Despite this accomplishment, Oregonians and their policymakers will continue to face equity issues. The state's local option process provides unequal access to supplemental property tax revenues across school districts. Any reform of the process immediately raises equity concerns. The intensity of those concerns will depend on whether Oregonians believe the state's foundation support (currently financed through the State School Fund) is adequate to support a quality education. In short, the more Oregonians who are convinced the State School Fund provides adequate foundation funding, the fewer who will be concerned if some localities supplement that funding through a local option.

**Equity Policy Options:**

- *Reform the local option process with an eye on equity.*
- *Clarify outcome-based equity as a goal and determine whether existing student weights support it.*
- *Audit district accounting practices and prohibit methods that assign average teacher salaries rather than actual teacher salaries to individual schools.*
- *Pilot school-level funding.*

Other policies and practices warrant review for impacts on equity. The formula weights for students with special needs are dated—and even by the account of those who helped create them—are in need of a thorough review. Also recent findings on *intra*-district budgeting practices in other states have uncovered sizable funding disparities between schools in high and low-income areas. The Oregon Department of Education should review Oregon practices to determine whether comparable accounting practices weaken resource equity at the school level.

## TRANSPARENT BUDGETING

Relative to other major public programs, K-12 accounting is robust. At the state level, where overall spending levels are set, the rich data have not been used intensively. As a consequence, policymakers and taxpayers cannot reconcile how overall spending per student can keep pace with inflation while simultaneously district managers call for cuts in arts, music, and physical education programs that were once taken for granted.

Transparent budgets—at the state and local levels—could track K-12 spending by its key functions (e.g., regular and special instruction, administration, physical plant) and objects (e.g., salaries, retirement benefits, health benefits, materials). Looking at the budget through both lenses would identify the key

**Budget Policy Options:**

- *Overhaul the K-12 budget process and track per student spending for distinct services delivered by the system.*
- *Explore a separate budgeting process for retirement and health benefits.*

cost drivers—both avoidable and unavoidable. With transparent budgets, the Legislature could depart from its cursory debate over the total level of the State School Fund and engage in far more relevant debates about goals of important components of the K-12 enterprise and what it costs to achieve them.

## PROGRAM EFFICIENCIES

Fiscal crises, like those just faced in Oregon and elsewhere, focus the attention of superintendents, business managers, principals and others on ways to do more with less. This report benefited from the insights of a host of finance experts, both inside and outside the state. Key recommendations include the creation of a unified K-12 payroll system, an overhaul of student transportation finance, and a more rational and organized approach to seeking federal Medicaid reimbursements for expenditures for special education students. In addition, we recommend a review of the state's 21 Education Service Districts and recommend that state consider funding the ESDs indirectly through their constituent school districts.

The program efficiencies listed here are constrained by an implicit assumption that the existing K-12 delivery structure remains largely in place. Some will argue that a more appropriate way to foster program

### Efficiency Policy Options:

- *Critically assess the efficiency of Oregon's Education Service Districts (ESD) and consider methods to increase school district participation in the development of ESD services.*
- *Eliminate transportation-matching funds and distribute a fixed block grant based on program efficiency.*
- *Consolidate individual district payroll and student tracking systems into a single statewide system.*
- *Expand federal Medicaid reimbursements for services to special education students.*
- *Consider an increase in the use of student fees for non-core services as an alternative revenue source.*
- *Experiment with centralized online purchasing and/or purchasing cooperatives for school supplies and materials.*
- *Address the findings of the Secretary of State's Audit Report that Oregon has above-average spending on "support services."*
- *Investigate innovative new energy purchasing practices.*
- *Mandate that local districts strike early retirement programs from their labor contracts.*
- *Transfer funding for remote schools to the economic development department.*

efficiency is through the creation of incentives that expose the system and its actors to more competition. A full discussion of policy options in those areas is found in Chapter 11 of a predecessor report—entitled *Improving Quality and Strengthening Accountability in Oregon’s Schools: A Broad Review of Promising Practices and Policy Options*.