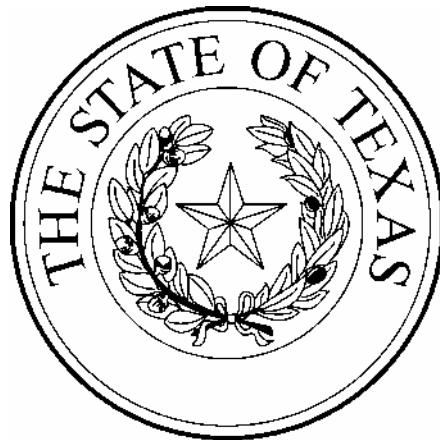


JOINT SELECT COMMITTEE ON PUBLIC SCHOOL FINANCE



Report to the Legislature

March 2004

***Co-Chairs:** Senator Florence Shapiro and Representative Kent Grusendorf
Members: Senator Eddie Lucio, Senator Steve Ogden, Senator Todd Staples, Senator Leticia Van de Putte,
Representative Talmadge Heflin, Representative Fred Hill, Representative Vilma Luna, Representative Ken
Marchant, Representative Ron Wilson, Carolyn Bacon, Caroline Hoxby, Jack Ladd, Don McAdams*



JOINT SELECT COMMITTEE ON PUBLIC SCHOOL FINANCE



78th Legislature

Sen. Florence Shapiro
Co-Chair
Sen. Teel Bivins
Sen. Eddie Lucio
Sen. Steve Ogden
Sen. Todd Staples
Sen. Leticia Van de Putte

Public Members
Carolyn Bacon
Caroline Hoxby
Jack Ladd
Don McAdams

Rep. Kent Grusendorf
Co-Chair
Rep. Talmadge Heflin
Rep. Fred Hill
Rep. Vilma Luna
Rep. Ken Marchant
Rep. Ron Wilson

March 15, 2004

The Honorable Rick Perry
Governor of the State of Texas
P.O. Box 12428
Austin, Texas 78711

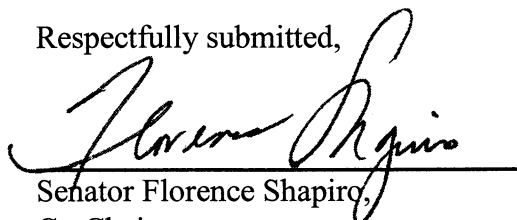
The Honorable David Dewhurst
Lieutenant Governor of the State of Texas
P.O. Box 12068
Austin, Texas 78711

The Honorable Tom Craddick
Speaker of the House of the State of Texas
P.O. Box 2910
Austin, Texas 78768

Dear Governor Perry, Lieutenant Governor Dewhurst and Speaker Craddick:

The Joint Select Committee on Public School Finance is pleased to submit its final interim report for consideration.

Respectfully submitted,

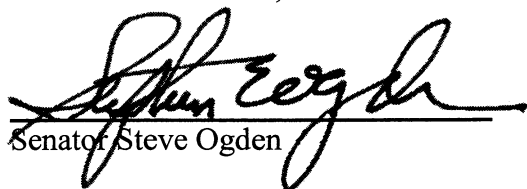


Senator Florence Shapiro,
Co-Chair



Representative Kent Grusendorf,
Co-Chair

Senator Eddie Lucio, Jr.



Senator Steve Ogden

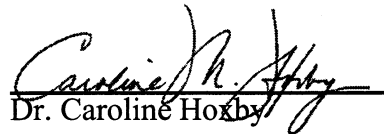
Representative Ron Wilson

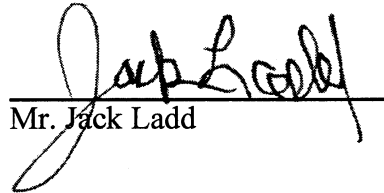


Representative Talmadge Heflin

Senator Leticia Van de Putte


Senator Todd Staples

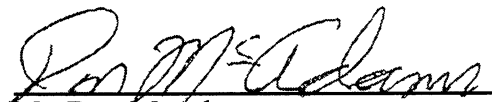

Dr. Caroline Hoxby


Mr. Jack Ladd


Representative Ken Marchant


Representative Fred Hill

Representative Vilma Luna


Mr. Don McAdams



Ms. Carolyn Bacon

TABLE OF CONTENTS

Charges to the Joint Select Committee on Public School Finance	1
Executive Summary	2
Committee Recommendations	3
Summary of Current Property Taxes	8
Summary of Current Weights and Allotments.....	11
Executive Summaries of Research Findings.....	26

CHARGES TO THE JOINT SELECT COMMITTEE ON PUBLIC SCHOOL FINANCE

(a) The committee shall conduct a study of issues affecting the duty of the legislature to establish and make suitable provision for the support and maintenance of an efficient system of public free schools.

(b) The study shall include:

- 1) a review of the state's revenue system as it relates to the legislature's ability to provide for a constitutional school finance system;
- 2) an assessment of funding options that will sustain Texas schools for the long term and that will substantially increase the state's share of public school funding;
- 3) a determination of appropriate funding levels to enable high academic performance;
- 4) an analysis of legitimate student and school district cost differences;
- 5) a review of the appropriate role of the state in the provision of school facilities;
- 6) an examination of strategies and practices that contribute to high academic performance in schools; and
- 7) a review of possible incentives for improved student performance and cost-effective operation.

EXECUTIVE SUMMARY

Goals

- Drive student success through the efficient use of resources and innovative use of funds.
- Provide significant property tax relief – minimum \$0.50 to \$0.75 property tax reduction while achieving fairness and balance in the overall tax structure.
- Create a simplified school finance and tax system that people can understand.
- Create a tax system that is stable, predictable, and broadly based.
- Replace current Robin Hood system with equitable and constitutionally sound system for financing all Texas public schools.
- Create a system of financing schools which grows with the economy.
- Stimulate the economy and create new jobs.

Rationale

SCHOOL FINANCE REFORM

- Drives academic performance.
- Current school finance system is too complex; making it virtually impossible for the average taxpayer to understand.
- Creates a more transparent system while preserving cost adjustments necessary for a fair and balanced funding system.
- Changes the current over-reliance on property taxes and increases the state share of education funding.
- Creates greater efficiency and accountability.

EDUCATIONAL ACCOUNTABILITY AND SCHOOL EFFICIENCY

- Drives student success by creating a system that focuses on outputs versus inputs.
- Modernizes our assessment system to give teachers and school districts the tools they need to track and analyze student progress.
- Provides mandate relief and administrative flexibility to school districts.

EDUCATIONAL EXCELLENCE FUND

- Creates an incentive that will reward the best teachers based on performance and value added.
- Changes the culture in education by encouraging a results-oriented model, rather than a one-size-fits-all model.
- Creates an incentive for the most effective teachers to teach at the most challenging schools.
- Creates campus based incentives based on value-added student performance.

SCHOOL FINANCE REFORM

ACCREDITATION ALLOTMENT

- Create an Accreditation Allotment in lieu of a Basic Allotment.
- Review the following potential changes:
 - Funding secondary schools at a higher level than elementary schools, creating an incentive for high school completion.
 - Reflecting cost adjustments for student characteristics in dollar amounts.
 - Distributing funding on a more transparent per-pupil basis.

SIZE

- Adopt rational adjustments that reflect variations in size and sparsity.

COST OF EDUCATION INDEX

- Implement in statute and regularly update the Cost of Education Index.

LOCAL ENRICHMENT / TAXPAYER PROTECTION

- Provide for meaningful local enrichment with voter approval for revenue increases.

RECAPTURE

- Eliminate.

HOLD HARMLESS PROVISIONS

- Roll all existing provisions into one.
- Guarantee all districts same level of funding at the 2005 levels.
- Phase-out over time.

FACILITIES

- Maintain current system.
- Restrict state support to those facilities that are to be used for instructional purposes only.
- Eliminate prevailing wage requirement.
- The state should consider establishing criteria for new facilities or renovations to qualify for Instructional Facilities Allotment (IFA) funding.
- Provide relief for fast-growth districts.
- Allow fast-growth districts to assess impact fees with voter approval.

REVENUE OPTIONS

AVAILABLE OPTIONS FOR PROPERTY TAX REDUCTION

- Increase sales tax rate.
- Expand the base of the sales tax to include items currently exempted or excluded from the sales tax.
- Create a modified business activity tax spread over a broad spectrum at a nominal rate.

AVAILABLE OPTIONS FOR RESTRUCTURING THE CURRENT SYSTEM

- Statewide property tax
- Split tax roll

AVAILABLE SOURCES OF ADDITIONAL REVENUE FOR EDUCATION

- Authorize video lottery terminals by implementing devices at a limited number of locations.
- Increase the cigarette tax and/or other “sin” taxes.

EDUCATIONAL ACCOUNTABILITY

IMPROVE STUDENT ASSESSMENT SYSTEM

- Include end-of-course exams as necessary for core courses.
- Require ACT or SAT administration, fully funded by the state, to ensure college-readiness and provide for student comparisons on a nationally norm-referenced test.
- Direct TEA to move forward on the use of on-line assessment using both computer-adaptive and computer-based tests.

BENEFITS AND COMPENSATION

- Simplify the existing teacher salary schedule to provide for greater flexibility.
- Fully fund liability insurance for teachers.
- Maintain health reimbursement accounts.

IMPROVE FINANCIAL EVALUATION OF SCHOOL DISTRICTS

- Standardize instructional and accountability tracking capabilities.
- Revise **FIRST** [Financial Integrity Rating System of Texas].
- Account for federal funding.

IMPROVE PUBLIC EDUCATION INFORMATION MANAGEMENT SYSTEM

- Provide real-time data and accountability tracking capabilities.
- Make data useful for schools and educators when computing value-added.
- Improve data accessibility for educators, parents, and taxpayers.
- Link all data to student performance.

SCHOOL EFFICIENCY

MANDATE RELIEF & EFFICIENCY

- Move notice of non-renewal date to occur after end of school year.
- Make it less costly and time consuming to dismiss teachers with history of low performance.
- Provide voluntary incentives for cooperative efforts between school districts to consolidate services such as transportation, special education, personnel and human resources, food services, and business management.
- Provide districts more flexibility to convert to a campus charter model.
- Convert current class size limits to district-wide averages for grades K-4 to allow districts to better meet student needs.
- Encourage administrative cost reductions and greater efficiency while increasing student performance.
- Authorize the LBB School Performance Review to review districts with a focus on mandate relief, administrative savings, and operational efficiency.

EDUCATIONAL EXCELLENCE FUND

Require the education commissioner to implement a value-added component that would include TAKS, but also include other measures as data allows.

INDIVIDUAL TEACHER PERFORMANCE INCENTIVES

- Voluntary participation by district and individual teacher.
- Locally implemented with an objective evaluation tied to value-added student achievement with input from principals and parents.
- Must be in the top 15% of eligible teachers in the district.
- \$10,000 for top 5% in each district, \$5,000 for next 10% in each district.

CAMPUS PERFORMANCE INCENTIVES

- Voluntary participation by district.
- Campuses will be identified by ranking based on value-added growth.
- Largest bonuses go to highest-rated campuses that comprise 20% of the state's students.
- \$3,000 to \$5,000 bonuses will be awarded to each teacher on the campus.
- Smaller bonuses go to the next 20%, \$1,000 to \$2,000.
- Qualifying campuses will be determined by the state.
- Bonuses for principals at \$10,000 for top 20% and \$5,000 for the next 20%.
- Upon recommendation of the site-based decision making committee, the principal would determine specific bonuses for other eligible professional staff.

CLOSING THE ACHIEVEMENT GAP

- Provide a significant incentive to bring the most effective teachers into the most challenging schools.
- Improve accountability and funding measures for bilingual education programs focused on progress toward proficiency in English.

OTHER INCENTIVES

- Maintain and expand AP and algebra incentives.
- Provide financial incentives for schools whose students complete more rigorous graduation requirements.
- Design formulas to encourage high school completion.

SUMMARY OF CURRENT PROPERTY TAXES

Prepared by the Legislative Budget Board

Property Tax Reduction Estimated Impact Under Current Law

The table below reflects the assumptions contained in the Legislative Budget Board's current law model. Student populations grow by 1.6% in 2006 and 2% in 2007 and local property values are estimated to grow by 4.75% in 2006 but are held flat in 2007. Tax effort is held flat throughout the period.

The current law model serves two purposes. It is used to estimate the effects of changes to the school finance formulas—comparing formula changes to current law—and it is also used as a tool in the budget development process prior to each regular Legislative session.

The figures in the table below should not be used to estimate the potential cost to the state of the current law school finance system for the 2006-07 biennium. Those costs will be largely dependent on estimates, available in October of each even numbered year, of Average Daily Attendance and of District Property Values, estimated by law by the Texas Education Agency and the Comptroller of Public Accounts, respectively. The cost of 2006-07 to the state will also be largely dependent on final 2004-05 Foundation School Program expenditures.

The average M&O tax rate under current law is \$1.48, and the local revenue under current law reflected in the table (i.e., \$15.9 billion in 2005) for each year assumes that rate. It does not assume the \$1.50 current law cap.

A general rule of thumb is that each penny of local property tax reduction represents approximately \$100 million. The first incremental reduction shown in the table reflects a reduction of \$0.23 (\$1.25 cap) yielding \$13.3 in local revenue and an associated revenue reduction of \$2.6 billion. The residential and commercial portions of the overall reduction are extrapolations based on the current split of ~52% residential and 48% commercial.

Property Tax Reduction Estimated Impact Under Current Law

Tax Cap	Total M&O Revenue <i>Current Law</i>	Local M&O Revenue <i>Current Law</i>	Local Revenue	Revenue Reduction
<i>all numbers in billions</i>				
2005				
	\$25.5	\$15.9		
\$1.25			\$13.3	\$2.6
\$1.00			\$10.7	\$5.3
\$0.90			\$9.6	\$6.3
\$0.80			\$8.5	\$7.4
\$0.75			\$8.0	\$7.9
\$0.50			\$5.3	\$10.6
\$0.25			\$2.7	\$13.2
2006				
	\$26.2	\$16.7		
\$1.25			\$14.0	\$2.7
\$1.00			\$11.2	\$5.5
\$0.90			\$10.0	\$6.6
\$0.80			\$8.9	\$7.7
\$0.75			\$8.4	\$8.3
\$0.50			\$5.6	\$11.1
\$0.25			\$2.8	\$13.9
2007				
	\$26.6	\$16.7		
\$1.25			\$14.0	\$2.7
\$1.00			\$11.2	\$5.5
\$0.90			\$10.0	\$6.6
\$0.80			\$8.9	\$7.7
\$0.75			\$8.4	\$8.3
\$0.50			\$5.6	\$11.1
\$0.25			\$2.8	\$13.9

**SUMMARY OF CURRENT WEIGHTS AND ALLOTMENTS
AND HISTORY OF CHANGES**

Provided by the Texas Education Agency

Special Education Weighted Funding

- Purpose:** Allocate funding related to distinct instructional arrangements to support services to students with disabilities
- Created:** 1984
- Cost:** \$1.2 billion in Tier 1 (allotment totals to nearly \$1.7 billion, but about \$500 million would still occur as regular program funding if the weights were removed)
- Population:** 169,600 FTEs, 68,500 mainstream ADA; 502,700 individuals in 2003
- Chapter 41?:** Applies through WADA calculation
- Current Law :** Funding is based on full-time equivalents for all but the mainstream arrangement.

Instructional Arrangement	Weight	Equivalent Dollar Amount per FTE*	Minimum # of Students per FTE
Homebound	5.0	\$12,685	6
Hospital Class	3.0	\$7,611	1.333
Speech Therapy	5.0	\$12,685	24
Resource Room	3.0	\$7,611	2.099
Self-contained Mild and Moderate	3.0	\$7,611	2.099
Self-contained, Severe	3.0	\$7,611	2.099
Off Home Campus	2.7	\$6,850	1.412
Nonpublic Day School	1.7	\$3,313	1
Vocational Adjustment Class	2.3	\$5,835	1.091
Residential Treatment	4.0	\$10,148	1,091
State Schools	2.8	\$7,104	1.091
Mainstream	1.1 (non-FTE)	\$2,791	1

- These amounts reflect the application of the weight to the basic allotment, prior to any adjustment for small district or cost of education adjustments. The amounts are stated per FTE, and it typically requires more than one student with perfect attendance to generate one FTE of contact time, depending on the instructional arrangement.

History of Changes:

1995 - 2003	No change																								
1993	<table> <thead> <tr> <th>Weight Changes:</th> <th>New</th> </tr> </thead> <tbody> <tr> <td>Hospital Class</td> <td>3.0</td> </tr> <tr> <td>Speech Therapy</td> <td>5.0</td> </tr> <tr> <td>Resource Room</td> <td>3.0</td> </tr> <tr> <td>Self-contained Mild and Moderate</td> <td>3.0</td> </tr> <tr> <td>Self-contained, Severe</td> <td>3.0</td> </tr> <tr> <td>Multi-district</td> <td>2.7</td> </tr> <tr> <td>Nonpublic Day School</td> <td>1.7</td> </tr> <tr> <td>Community Class</td> <td>2.7</td> </tr> <tr> <td>Residential Placement</td> <td>4.0</td> </tr> <tr> <td>State Schools</td> <td>2.8</td> </tr> <tr> <td>Mainstream</td> <td>1.1</td> </tr> </tbody> </table> <p>Combined “self-contained severe,” “multi-district class,” and “community class into one arrangement, “off home campus”, effective in 1995-96. Also required that “resource room,” “self-contained, mild and moderate,” and “self-contained, severe” arrangements have the same number of contact hours, effective with 1995-96.</p>	Weight Changes:	New	Hospital Class	3.0	Speech Therapy	5.0	Resource Room	3.0	Self-contained Mild and Moderate	3.0	Self-contained, Severe	3.0	Multi-district	2.7	Nonpublic Day School	1.7	Community Class	2.7	Residential Placement	4.0	State Schools	2.8	Mainstream	1.1
Weight Changes:	New																								
Hospital Class	3.0																								
Speech Therapy	5.0																								
Resource Room	3.0																								
Self-contained Mild and Moderate	3.0																								
Self-contained, Severe	3.0																								
Multi-district	2.7																								
Nonpublic Day School	1.7																								
Community Class	2.7																								
Residential Placement	4.0																								
State Schools	2.8																								
Mainstream	1.1																								
1991	No change																								
1989	Lowered speech therapy weight to 7.11. Moved pregnant student weight to compensatory education. Mainstream weight created at 0.25.																								
1987	No change																								
1985	1984 special session created weighted funding structure. Prior law allocated one special education personnel unit for each 100 students up to 6,000 students, then 0.85 unit for each additional 100 students.																								

Compensatory Education Weighted Funding

- Purpose:** Fund supplemental programs and services designed to eliminate disparities in performance of students identified as at risk. Also a source of most set-aside program funding.
- Created:** 1984
- Cost:** \$1.2 billion in Tier 1
- Population:** 2,168,000 students for regular funding, 1,604 FTEs for pregnant student component, 1,710,000 at risk students served in 2003
- Chapter 41?:** Applies through WADA calculation
- Current Law:** 0.20 for each average student eligible for free or reduced lunch program in previous year, or non-disabled student in a residential placement facility in a district in which the student's parents do not reside; equivalent to \$507 per student funded
- 2.41 for each FTE student in a remedial and support program because the student is pregnant; equivalent to \$6,114 per FTE

History of Changes

1991 - 2003	No change
1989	Pregnant student weight moved from special education
1987	Added non-disabled students in residential placement facility
1985	1984 special session created weighted funding structure. Prior law allocated \$44 for each educationally disadvantaged student.

Bilingual Education Weighted Funding

- Purpose:** Fund incremental costs of bilingual education or special language programs
- Created:** 1984
- Cost:** \$150 million
- Population:** 528,000 ADA; 573,000 individuals served out of 631,000 LEP students identified
- Chapter 41?:** Applies through WADA calculation
- Current Law:** 0.10 for each student in average daily attendance in the program; equivalent to \$254 per student funded

History of Changes

1987 - 2003	No change
1985	1984 special session created weighted funding structure. Prior law allocated \$50 for each student in a bilingual class and \$12.50 for each student in an English as second language class

Career and Technology Education Weighted Funding

- Purpose:** Allocate funding for career and technology courses
- Created:** 1984
- Cost:** \$190 million (allotment totals to nearly \$700 million, but over \$500 million would still occur as regular program funding if the weight were removed)
- Population:** 177,000 FTEs; 842,000 individuals in 2003
- Chapter 41?:** Applies through WADA calculation
- Current Law:** 1.35 for each full-time equivalent student in the program; equivalent to \$3,425 per FTE

History of Changes

2003	Weight reduced to 1.35 and commissioner directed to identify courses that should not receive weighted funding
1991 - 2001	No change
1989	Weight reduced to 1.37
1987	No change
1985	1984 special session created weighted funding structure with a weight of 1.45. Prior law allocated personnel units and supported extra equipment needs with \$400 per unit for supplies and equipment.

Gifted and Talented Weighted Funding

- Purpose:** Allocate funding for services to gifted and talented students
- Created:** 1984
- Cost:** \$68 million
- Population:** 198,000 ADA funded; 333,000 individuals identified in 2003
- Chapter 41?:** Applies through WADA calculation
- Current Law:** 0.12 for each student identified and served in the program, up to a maximum of 5% of total average daily attendance; equivalent to \$304 per student funded

History of Changes

1991 - 2003	No change
1989	Weight of .047 for 1990, .12 for 1991
1987	Weight of .039 for 1988, .043 for 1989.
1985	Weighted funding structure with an initial weight of 0.032 with annual escalation scheduled. Weight of 0.035 for FY 1987. Prior law allocated \$150 for each student served up to 5% of students, not to exceed \$100,000 total.

Transportation Funding

- Purpose:** Provide funding for efficient systems of school transportation
- Created:** Predates 1984
- Cost:** \$340 million
- Chapter 41?:** Chapter 41 districts effectively do not receive credit for the allotment, although law does allow them to be funded. Transportation is specifically excluded in the WADA calculation

Current Law:

Transportation funding operates on a mileage reimbursement rate for different linear density groupings. Linear density is determined by dividing the average number of students transported each day by the daily route miles traveled. For regular transportation, the rates are as follows, not to exceed actual cost:

Linear Density Grouping	Mileage Reimbursement Rate
2.40 and above	\$1.43
1.65 to 2.40	\$1.25
1.15 to 1.65	\$1.11
.90 to 1.15	\$0.97
.65 to .90	\$0.88
.40 to .65	\$0.79
Up to .40	\$0.68

Separate funding rates exist for certain other categories. Special education is limited to \$1.08 per mile. Private transportation is reimbursed \$0.25 per mile, not to exceed \$816 per pupil. Career and Technology transportation is not limited by rate, but reimbursed at actual cost.

History of Changes

There have been no changes in the groupings or the reimbursement rates since fiscal 1984. Rates immediately prior to that year were approximately 30% lower.

New Instructional Facilities Allotment

- Purpose:** Reimbursement of costs associated with opening a new school
- Created:** 1999
- Cost:** \$25 million per year (capped by statute)
- Chapter 41?:** Applies outside WADA calculation as a credit against recapture costs
- Current Law:** \$250 for each student in average daily attendance at a new school in the first year of operation and an additional \$250 for each additional student in the second year.

History of Changes

There have been no changes to this allotment since its creation.

Cost of Education Adjustment

- Purpose:** Reflect geographic variation in known resource costs and costs of education beyond the control of school districts through an adjustment to the basic allotment
- Created:** 1984 (as “Price Differential Index”)
- Cost:** \$1.1 billion per year
- Population:** All school district have a cost of education index value greater than 1.00.
- Chapter 41?:** Applies through WADA calculation; only 50% of cost added by the adjustment is considered in calculating WADA for both Chapter 41 and Chapter 42 purposes
- Current Law:** Current index is based on a statistical analysis performed in 1990 based on 1989 data and adopted by the Foundation School Fund Budget Committee. The primary factors in the index computation are competitive salaries paid in the area, size of district, location in rural areas or counties with low population, and the proportion of student population that comes from low income families.

History of Changes

1993-2003	No change
1991	Foundation School Fund Budget Committee adopted rules based on research coordinated by the Legislative Education Board and the Legislative Budget Board.
1989	Study of index moved to Legislative Education Board and Legislative Budget Board
1987	Index updated under SBOE rules
1985	1984 special session created Price Differential Index. No similar adjustment in prior law. Index reflected salaries in competing districts in the county and surrounding counties, plus an adjustment for the percentage of low income students in the district. State Board of Education directed to determine a replacement for temporary index.

Small and Mid-Size Adjustments

- Purpose:** Reflect the diseconomies of scale in smaller districts through an adjustment to the basic allotment
- Created:** 1984
- Cost:** \$330 million per year for the small district adjustments
\$91 million per year for the mid-size adjustment
- Population:** 480 districts receive small district adjustment for those less than 300 square miles; 175 districts receive the small district adjustment for those with more than 300 square miles; 220 districts receive the mid-size adjustment; 27 districts would receive the mid-size adjustment but do not because of property wealth; 135 districts are too large to receive any adjustment
- Chapter 41?:** Small district adjustments apply through WADA calculation; mid-size statutorily does not apply to districts subject to Chapter 41
- Current Law:** For districts with fewer than 1600 regular program students in average daily attendance, one of two adjustments apply. For districts with fewer than 5,000 students, districts are eligible for the greater adjustment from the mid-size adjustment or the applicable small district adjustment.

Small, less than 300 square miles	$(1 + ((1600 - ADA) \times 0.00025) \times \text{Adjusted Basic Allotment})$
Small, more than 300 square miles	$(1 + ((1600 - ADA) \times 0.0004) \times \text{Adjusted Basic Allotment})$
Mid-Size	$(1 + ((5000 - ADA) \times 0.000025) \times \text{Adjusted Basic Allotment})$

History of Changes

1997 - 2003	No change
1995	Mid-size adjustment added with a five-year phase-in beginning with fiscal 1997
1987 - 1993	No change
1985	Current small district adjustments adopted. Prior law contained similar adjustments for districts with less than 1,000 students, but applied them to the allocation of personnel units.

Sparsity Adjustment

Purpose: Provides a minimum level of attendance for funding purposes for certain small districts

Created: 1984

Cost: About \$6 million per year

Population: 46 school districts receive the adjustment

Chapter 41?: Applies through WADA calculation

Current Law:

For districts with fewer than 130 students in ADA, offering kindergarten through grade 12 instruction, that had prior year attendance of at least 90 students or is more than 30 miles from the nearest high school, 130 total ADA will be used to calculate funding.

For districts with fewer than 75 students in ADA, offering kindergarten through grade 8 instruction, that had prior year attendance of at least 50 students or is more than 30 miles from the nearest high school, 75 total ADA will be used to calculate funding.

For districts with fewer than 60 students in ADA, offering kindergarten through grade 6 instruction, that had prior year attendance of at least 40 students or is more than 30 miles from the nearest high school, 60 total ADA will be used to calculate funding.

History of Changes

1987 - 2003	No change
1985	1984 special session created adjustment structure. Prior law allocated a minimum number of personnel units to smaller districts, which had a similar effect.

Rapid Property Value Decline Adjustment

- Purpose:** Provide some financial relief to districts that experience rapid declines in local tax base beyond the control of the district.
- Created:** 1984
- Cost:** \$26 million per year ceiling set by rider in the general appropriations act
- Population:** 142 school districts had eligible declines in 2003
- Chapter 41?:** Applies to any district
- Current Law:** A district with declines in taxable value that exceed 4% may have the excess decline deducted from the prior year property value to the extent that funds are available. Historically funded only when surplus funds available.

History of Changes

2001-2003	No change
1999	Chapter 41 standard changed to 4%
1997	No change
1995	Standard for Chapter 42 changed to 4%
1993	Chapter 41 (then Chapter 36) created with a threshold of 0%.
1985	Eight percent threshold established for recognition of declines in taxable value. Prior law contained no similar provision.

Optional Homestead Exemption Adjustment

- Purpose:** Adjustment to tax base used for funding for those districts that provide a local option homestead exemption
- Created:** 1999
- Cost:** \$140 million per year if funds are available
- Chapter 41?:** Applies to all districts
- Current Law:** If funding is available, prior year property values are reduced by 50% of the value of the optional homestead exemption. Approximately 250 school districts receive some adjustment. Because of funding mechanism, has only been applied in fiscal 2001 and 2003.

History of Changes

No changes since created in 1999.

Adjusted Property Value for Districts not Offering All Grade Levels

- Purpose:** Adjusts the property value used for calculating state aid or recapture payments for those districts that pay tuition to educate their above-grade students
- Created:** 1999
- Cost:** \$3 million per year
- Population:** 17 districts received this adjustment in 2003
- Chapter 41?:** Applies to values used for all districts
- Current Law:** An amount is subtracted from the property value used for state aid that is the tuition divided by 0.015, the equivalent of a tax rate of \$1.50. The effect is for the state aid of the school district to be comparably adjusted upward so that the state provides additional state aid equivalent to the amount of tuition paid by the district. Tuition paid in such an arrangement is limited by commissioner's rule

History of Changes

No changes since created in 1999.

**EXECUTIVE SUMMARIES
OF RESEARCH FINDINGS FOR
THE JOINT SELECT COMMITTEE
ON PUBLIC SCHOOL FINANCE**

Full reports are available at: <http://www.capitol.state.tx.us/psf/reports.htm>

MEASURING EDUCATIONAL ADEQUACY IN PUBLIC SCHOOLS

EXECUTIVE SUMMARY

Bruce D. Baker
University of Kansas

Lori L. Taylor
Arnold Vedlitz
Texas A&M University

States, interest groups and independent researchers throughout the nation are engaging in studies to help identify resources needed to provide an “adequate” public education for their children. The goal of this report is to provide a concise, thorough, and balanced review of methodologies employed in such studies and to highlight implications for Texas.

An Overview of Adequacy Studies 1993-2003

Over the last decade, educational adequacy studies have been conducted in many states. Such studies can be grouped into three broad categories: average expenditure studies, resource cost studies, and statistical modeling studies.

- Average Expenditure Studies look at the average or median level of school expenditures. “Successful Schools” studies use data on outcome measures such as attendance rates and student test scores to identify that set of schools or districts in a state that meet a chosen standard of success. “Modified Successful Schools” analyses include some consideration of how schools use their resources.
- Resource Cost Studies look at the resources (people, time, space, equipment) needed to provide a given set of services and then determine the cost to provide these resources. In “Professional Judgment” studies, focus groups of educators and policymakers are typically convened to prescribe the resources required for providing an adequate education. In “Evidence-Based” studies, resources needs are derived from “proven effective” school reform models.
- Statistical Modeling Studies use “Cost Functions” and other statistical methods to estimate the cost of achieving a designated set of outcomes, in different districts, serving different student populations.

Since the various methodologies are aimed at the same target—identifying the costs of an adequate education—they should lead to similar predictions about costs, all other things being equal. Ideally, well-informed professionals advising districts on how to meet a specific performance goal would prescribe the same mix of resources as would economists optimizing an educational production function, and that mix, when evaluated at market prices, would cost exactly as much as predicted by a cost function.

However, different cost estimates arise when all other things are not equal. Adjusted for inflation and regional price variations—but not for differences in the definition of “adequate”—the estimated per-pupil cost of an adequate education ranges from \$3,675 to \$8,674 (in 2000 dollars). Successful Schools methods have produced the lowest estimates of the cost of an adequate education. Resource-oriented methods like Professional Judgment and Evidence-Based methods produced consistently higher results, as did Statistical Modeling methods. The Successful Schools approach may (by design) estimate the cost associated with a lower performance standard than the other methodologies, but whenever the same researchers applied alternative methods to the same state in the same year they found that Professional Judgment analyses generated higher cost estimates than other approaches.

In addition to basic costs, many adequacy studies have attempted to estimate the variations in costs associated with district characteristics, like size and student population characteristics. Findings from recent Professional Judgment analyses vary widely. For example, in Nebraska, a district with 400 pupils had costs 40 percent above the minimum, but in Missouri a district with 364 pupils had costs only nine percent above the minimum. Findings from Cost Function analyses appear somewhat more consistent. Evidence-Based and Successful Schools studies have not included attempts to estimate costs associated with economies of scale.

What Lessons Can Be Learned?

Each approach has strengths and weaknesses in giving decision makers the definitive information they need to set appropriate funding levels.

Resource-Oriented Strengths

- The methods are relatively simple and transparent and produce easily understood results.
- There is no need to define or measure an adequate performance level.

Resource-Oriented Weaknesses

- The link between costs and student outcomes can be uncomfortably loose.
- For practical reasons, resource-oriented analyses rely on a limited set of prototypical districts, which can lead to problems when actual school districts differ from the prototypes.
- Evidence regarding the effectiveness and the cost effectiveness of comprehensive school reforms is mixed at best.

Performance-Oriented Strengths

- Performance-oriented methods provide direct evidence about linkages between costs and outcomes.
- Cost estimates are based on actual data about student performance and school district expenditures so there is no question that the analysis is applicable.
- Cost Function analysis generates direct estimates of the differences in costs associated with differences in school district characteristics like size and student need.

Performance-Oriented Weaknesses

- Performance standards must be measurable.
- The approaches are data intensive, requiring high quality measures of school district performance and expenditures.
- Statistical analyses can be difficult to understand and difficult to communicate to constituents.
- By design, statistical models describe relationships within the experience of the data. It can be problematic to extrapolate beyond that experience.
- Statistical modeling inherently involves errors of estimation and modeling.
- Performance-oriented methods may provide little insights into how districts should internally organize their resources to effectively and efficiently produce outcomes.

Implications for Texas

Texas has enormous variation in the characteristics of the students served by the public school system. There are large differences in school district size, and there are large variations in the price Texas school districts must pay to hire a comparable staff. Therefore, evaluating the cost of providing an adequate education will require methods that can be used to estimate, with the greatest available precision, the uncontrollable costs associated with geographic price variations, economies of scale, and variations in student need.

Perhaps the strongest arguments favoring resource-oriented methods like Professional Judgment are (a) that they can be conducted in the absence of detailed student outcome data; and (b) that prototypical sets of schooling inputs are both conceptually and methodologically easy for policymakers to understand. The availability of detailed, student level outcome data in Texas limits the importance of the first advantage. Texas collects and audits student performance data for each of the four million students in its public school system and tracks student improvements. These data give Texas access to much better measures of school outcomes than are available in other states. While few would argue that standardized tests represent the sum total of expectations about schools, the State of Texas has a history of using such indicators to drive funding decisions and school policy. On the second point, it is difficult to conceive just how many prototypes would be required to sufficiently characterize the diversity of Texas school districts.

The logistics of implementing Successful Schools analysis would be far easier to overcome in Texas. However, in order to produce valid estimates of basic costs and cost variations across Texas districts, such an approach must be heavily modified to accommodate regional variations in input prices and student characteristics. With enough modifications, Successful Schools analysis morphs into a limited, special case of a Cost Function analysis.

An educational Cost Function uses regression analysis to measure the systematic relationship between current operating expenditures and educational outcomes given input price differentials and technological factors like student characteristics and school district size. Such an analysis appears feasible and is the most obvious fit to the

challenges of educational cost analysis in Texas. As discussed previously, there are drawbacks to the Cost Function approach, ranging from problems with measurement error that may lead to difficulties in sorting out precise differences in district efficiency to difficulties in crafting the ideal statistical model for estimating costs. However, it is likely the best available method for estimating costs of achieving desired outcomes in Texas and how those costs vary across Texas's diverse schools and districts.

KEY FINDINGS

School Outcomes and School Costs: The Cost Function Approach and Adjusting for Geographic Variations in Teacher Compensation: Updating the Texas Cost-of-Education Index

An educational cost function is an advanced statistical approach that uses data on school district expenditures and outcomes to estimate the costs of achieving a desired set of results, taking account of uncontrollable cost variations due to the characteristics of communities, school districts, and students. This type of analysis can be used to predict the average cost of achieving certain outcomes in a school district of average characteristics serving a student population of average characteristics. It can also be used to estimate the degree to which the cost of providing public educational services varies according to differences in school district size and student need. Most states lack the rich data on the financing and performance of their public schools required to conduct this sort of analysis, however.

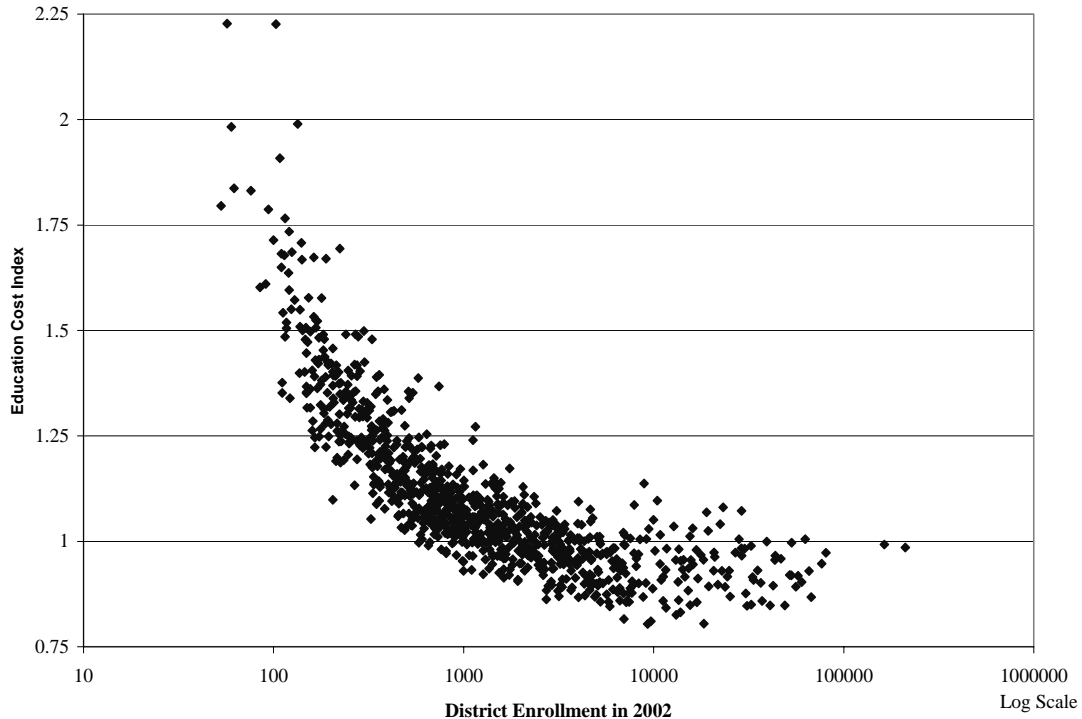
A cost function analysis is feasible for Texas because of the state's unusually rich educational data system. This approach may also be more appropriate than the alternatives because of the unusual diversity in the characteristics of Texas school districts. Simpler approaches based on stereotypical schools or districts may be appropriate for states with less variation among districts. Texas school districts serve a wide range of populations in an unusual variety of circumstances, however, which suggests that analyses of the costs of education in Texas should estimate with the greatest available precision the uncontrollable costs associated with geographic price variations, economies of scale and variations in student need. A cost function analysis is designed to capture these cost variations. Furthermore, Texas has been at the forefront of the transition from "process" or input-based evaluation to "outcome" or performance-based evaluation of schools. Unlike "adequacy studies" conducted in other states, a cost function analysis can be used to examine the relative efficiency of school districts, which researchers and policymakers can in turn use as the basis for a study of cost-effective school district "best practices." Thus, it is fitting that Texas is the first state to commission a cost function analysis to inform its policy deliberations about how to align its school finance system with the state's educational goals. Key findings are outlined below.

1. There appears to be a fundamental economic relationship among input prices, educational outcomes, and cost in Texas public schools. Other things being equal, the analyses suggest that it costs more to produce higher levels of educational outcomes. Nevertheless, the average minimum funding level per pupil of meeting state performance standards is estimated to be between \$6,172 and \$6,271 (in 2004 dollars), which is slightly lower than the current average budgeted expenditure level of \$6,503. Depending on assumptions concerning natural improvements as students and teachers adjust to new tests, changes in required passing scores on state tests, expectations with regard to the efficiency of school district operations, and inflation, however, the analyses suggest that

some Texas school districts will require additional annual funding of between \$226M and \$408M (in 2004 dollars). These estimates are based on analyses that consider all federal, state, and local dollars for district operations—excepting revenue for debt service, transportation, and food—and are based on the best available data regarding requirements for compliance with *No Child Left Behind* and the state accountability system. They also assume that school districts receiving additional funding would operate with at least average levels of efficiency.

- As in other studies of the effects of scale on educational costs, the analyses indicate that the cost of educational services in Texas is strongly influenced by school district size and geographic isolation. In particular, costs increase substantially for districts serving less than 500 students. The relative effects of scale on district costs is illustrated in Figure 1.

Figure 1: Education Cost Index from Cost Function Analysis Versus Scale



As Figure 1 illustrates, on a per student basis the estimated cost of operating a district with 75 students is nearly twice the cost of operating a district with 7,500 students. Most economies of scale are realized at approximately 25,000 students. The analyses did not find evidence of diseconomies of scale for large urban districts, however.

- Just as other industries experience variations in the costs of hiring comparable employees in different labor markets across Texas, there are substantial regional variations in the costs of public education, particularly with regard to the costs of hiring “highly qualified” teachers. According to the most conservative

estimate, a Texas school district in the highest-cost urban area would be expected to have to pay approximately 29 percent more than school districts in the lowest cost rural area to hire a classroom teacher with comparable qualifications. This estimate is derived from analyses of a three-year average of data on school districts, communities, and teachers, including data on teacher salary and benefits, certification status, and time spent teaching in-field.

4. There are significant cost differentials associated with student need. Relatively high concentrations of students who are economically disadvantaged, have limited proficiency in English, are in special education programs, or are enrolled in high school can substantially increase school district costs. For example, a district that educates *more* students who are eligible for free lunch than the state average of 39.5 percent would be projected to need to spend more to achieve comparable outcomes, other things being equal. Conversely, a district that educates *fewer* students eligible for free lunch than the average would be projected to require less funding.
5. On average, unexplained variations in school district expenditures due to the production of unmeasured outcomes or inefficiency are moderate. The average level of inefficiency in school districts is estimated to be 7 percent. There is a substantial range among estimates of district inefficiency, however, from less than 2 percent in some districts to as much as 28 percent. This finding suggests that some Texas school districts are remarkably efficient in transforming resources into measured educational outcomes that reflect the core educational goals of the state; other districts appear to be substantially less efficient. It is important to note, however, that this type of analysis cannot distinguish between school districts that appear inefficient simply because of poor management and districts that appear relatively inefficient because they are focused on producing different kinds of outcomes. For example, the analysis cannot distinguish between excessive spending on administration and relatively high spending on music, athletics, or mathematics programs. This issue suggests that Texas policymakers should take up the question of how much local school districts should be allowed to choose the outcomes they aspire to produce, along with issues concerning state sanctions or incentives to promote cost-effective operation.

These findings are instructive for the construction of new Texas school finance formulas that contain appropriate adjustments for scale, regional price variations, and student need. It is important to note, however, that the analyses described above are focused on the issues of appropriate "foundation" or base levels of funding and cost adjustments for school district operations. The analyses do not directly address issues concerning facilities funding or "enrichment" levels of funding for supplemental programs beyond those that districts are able to provide within the 7 percent range of average unexplained school district expenditures. The facilities issue will be addressed in analyses to be released later. The enrichment issue, which speaks to the core issue of which educational outcomes are included in the constitutional standard of a General Diffusion of Knowledge, is properly left to the Legislature.

ADJUSTING FOR GEOGRAPHIC VARIATIONS IN TEACHER COMPENSATION: UPDATING THE TEXAS CEI

Lori L. Taylor
Texas A&M University

Executive Summary

Educational dollars don't go quite as far in some parts of Texas as they do in others. Because any such inequalities in purchasing power undermine the equity and adequacy of the school finance system, the Joint Select Committee on Public School Finance commissioned this study of uncontrollable variations in the price of a school district's most important resource—teachers. Analysis demonstrates both that there is considerable need for cost of education adjustments in Texas and that there is a need to update the Texas Cost of Education Index (CEI).

The Existing CEI

The CEI is the mechanism that Texas uses to adjust its school finance formula to compensate for variations in labor costs that are beyond the control of school districts. As implemented, the CEI increases the amount of state aid received by school districts in high cost areas and reduces the amount of local revenue redistributed among districts through a process known formally as recapture and informally as Robin Hood. However, the existing CEI has not been updated since its adoption in 1991, which means that the annual distribution of approximately \$1.34 billion rests on teacher compensation patterns and school district characteristics from 1989.

The 2000 Study by the Charles A. Dana Center

This study extends prior analysis which was conducted on behalf of the 76th Texas Legislature by the Charles A. Dana Center at the University of Texas, Texas A&M University, the Texas Education Agency, and the Texas Comptroller of Public Accounts.

The 2000 Dana Center study explored three different strategies for measuring labor cost: a faithful replication of the existing CEI using new data on district characteristics and teacher compensation; a new model of teacher compensation which incorporates additional information unavailable in 1990; and a study of cost of living, as revealed by systematic variations in the salaries of non-educators. The Dana Center Study demonstrated that there are substantial cost differentials outside of school district control, and presented a strong case for updating the CEI.

The 2004 Study for the Joint Select Committee

This analysis for the Joint Select Committee follows the general structure of the original Dana Center report, but focuses exclusively on the new compensation models and an alternative version of the comparable wage model. The primary contributions of this analysis arise from the incorporation of revised and newly available data—in particular data from the 2000 Census and from the 2001, 2002 and 2003 school years.

Models of Teacher Compensation

The wealth of data on teacher compensation in Texas supports a wide variety of possible models. The report develops twelve: a year by year analysis of teacher salaries for each of the five years from 1999 through 2003; a parallel set of models analyzing salaries and benefits; a multi-year model of salary and benefits that pools the information from 2000-2003; and a multi-year model of salary and benefits that uses the teacher-fixed-effects methodology to ensure that researchers can construct a cost index that is not influenced by district choices about the people they hire.

All of the teacher compensation models rely on the same set of uncontrollable cost factors:

- Average daily attendance
- Distance to nearest teacher certifying institution
- Distance to the center of the nearest metropolitan area
- Percent of students who were
 - Limited English proficient
 - Immigrants
- Average house price
- Climate
- Unemployment rate
- Population density

For each of the twelve models, a cost index was constructed by predicting the compensation (either salary or salary and benefits) that would be demanded from each district by the typical Texas teacher, if that teacher were fully certified in the subjects he or she was teaching. Predicted salaries below the state minimum were assigned the state minimum. A district's index value is the district's predicted salary divided by the minimum predicted salary in the state

The resulting index values are highly correlated with one another and tell generally consistent stories about the pattern of cost variation.

Pooling the data—with or without teacher fixed effects—reduces the risks associated with year-specific measurement errors or incomplete survey coverage. It also generates index values that reflect only persistent relationships between compensation and cost factors. For these reasons, a multi-year model of salary and benefits would seem most the most appropriate model of teacher compensation.

A Census-based Measure of Comparable Wages

Both the Pooled Salary and Benefits index and the Teacher Fixed Effects Salary and Benefits index use the pattern of teacher compensation to identify uncontrollable variations in labor costs. A Comparable-Wage model uses the pattern of non-educator salaries to accomplish the same goal.

The 2000 Census provides just the sort of data needed for a comparable wage analysis. Regression analysis yields an estimate of the local wage level in each employment area, controlling for the age, gender, ethnicity, educational attainment, amount of time worked, and occupation of each of the 65,656 employed, college-educated Texans in the sample. Dividing the local wage level by the lowest reliably estimated wage level yields a Census-based Comparable Wage index. The Census-based Comparable Wage index ranges from 1.00 in much of rural Texas to 1.36 in the Dallas metropolitan area, implying that wages in Dallas are 36 percent higher than wages in the least-cost parts of the state.

Major Points of Comparison

- All three indexes cover a comparable range.
 - The Teacher Fixed Effects Salary and Benefits Index ranges from 1.00 to 1.29.
 - The Pooled Salary and Benefits Index ranges from 1.00 to 1.30.
 - The Comparable Wage Index ranges from 1.00 to 1.36.
- The Comparable Wage Index is clearly outside of school district control.
- The Teacher Fixed Effects Salary and Benefits Index is also independent of district hiring decisions.
- The Pooled Salary and Benefits Index could still confuse high spending districts with high cost districts, but the risk is small given the wide array of individual characteristics included in the compensation model.
- The Comparable Wage Index is essentially a cost-of-living index.
 - As such, it is the index that is most like the approaches used in other states to adjust the school finance formula for geographic variations in price.
 - Differences in the cost of living may be only part of the differences in the cost of hiring.
 - The Comparable Wage Index assigns the same index value to all districts in a labor market. Thus, all districts in the Dallas metropolitan area have an index value of 1.36.
 - The Comparable Wage Index does not reflect any changes in the relative cost of living since the 2000 Census.
- The indexes that are based on an analysis of teacher compensation (the Teacher Fixed Effects Salary and Benefits Index and the Pooled Salary and Benefits Index):
 - use district-specific characteristics to generate different index values for each district.

- are based on models that explain more than 90 percent of the variation in teacher compensation and are consistent with reasonable expectations about teacher compensation. For example, all other things being equal, costs are higher in areas where housing costs are higher and in sparsely populated areas.
- The statistical process for making sure that Teacher Fixed Effects Salary and Benefits Index is independent of district hiring decisions may also unduly limit the influence of persistent district characteristics like remoteness or climate.
- The Teacher Fixed Effects Salary and Benefits Index is very highly correlated with the Pooled Salary and Benefits Index. However, the Pooled Salary and Benefits Index is somewhat higher than the Teacher Fixed Effects Salary and Benefits Index in major urban areas, and substantially higher in Brownsville, Laredo and McAllen.

Conclusions

Our analysis of educator and non-educator wages in Texas strongly suggests that school districts face substantial and uncontrollable differences in teacher compensation. By the most conservative estimate, the highest-cost district must pay 29 percent more than the lowest cost districts to hire a comparable individual. In contrast, a Census-based Comparable Wage index data suggest that all districts in the Dallas metropolitan area must pay 36 percent more than the lowest cost districts in the state. The Census-based index implies that variations in the price of teachers are double those reflected in the existing CEI and the Texas school finance formula.

Not only have uncontrollable price variations grown larger in the dozen years since the CEI was first adopted, but the pattern of cost has shifted. Hiring costs have risen much more rapidly in some areas than in others, changing the relative index values of school districts. Where cost increases have been unusually large, updating revises index values upward; where cost increases have been relatively modest, updating revises index values downward. Regardless of the strategy chosen by the Legislature, updating would substantially increase the index values for major urban areas, while generally reducing the index values for rural areas.

Much has changed in Texas since 1989. As a result, the existing CEI has become badly outdated. Accurately reflecting uncontrollable variations in the cost of education requires adoption of a new CEI.

AN ECONOMIC EVALUATION OF ALTERNATIVE SOURCES OF TAX REVENUE FOR THE STATE OF TEXAS

George R. Zodrow
Rice University

Executive Summary

The State of Texas is contemplating sweeping changes in its revenue structure as part of a reform of the system of K-12 school finance in the state, with the main goal being elimination of the existing “Robin Hood” plan under which property tax revenues raised in school districts that are relatively “property rich” are transferred to districts that are “property poor.” Although these reform plans differ considerably in emphasis and detail, all of them would significantly increase the state share of K-12 school finance by replacing some local property tax revenues with additional state-level support of education. Moreover, some of the proposals under discussion would increase the overall funding level of education, with the additional revenues also being generated at the state level. Thus, all of the plans under consideration would require significant additional sources of state revenue.

There are, of course, many options for obtaining such extra revenue. They range from moderate adjustments of the existing state tax system focused on rate increases or modest base broadening, to sweeping overhauls of the existing system, to the introduction of new forms of taxation. The debate over which of these alternative revenue sources should be utilized will be lengthy and contentious. The goal of this paper, which builds on the earlier analysis in George Zodrow (1999), is to contribute to the debate, not by formulating specific recommendations but by providing a framework for evaluating the relative advantages and disadvantages of the main potential approaches currently under active consideration in Texas. For the more sweeping reforms—fundamental changes in the structure of existing taxes or the introduction of new taxes—the analysis will assume

that, in addition to raising additional state revenue, improving the tax system in Texas by creating a tax climate that is more conducive to economic growth and the efficient allocation of the state's resources is a primary goal of the tax reform effort.

After providing a brief description of the existing Texas state tax system, the report turns to an economic evaluation of the various alternative sources of additional state tax revenues. The evaluation utilizes the three primary criteria typically used by public finance economists to evaluate alternative tax systems: efficiency in resource allocation, the equity or fairness of the tax system, and simplicity of compliance and administration. In addition, it considers the supplementary criteria of revenue stability, both with respect to economic growth and over the business cycle, and deductibility against federal personal income tax liability.

The report argues that an application of these criteria suggests that the following four general directions for reform of the Texas state tax system are desirable:

- To the maximum extent possible, additional revenue should be raised with expanded use of benefit taxes, including those assessed on businesses. Benefit taxes have the considerable advantage of improving the efficiency of resource allocation while simultaneously raising revenue.
- Mobility considerations, coupled with historical opposition in Texas to progressive taxes, suggest that any progressivity of the state tax system should be limited to adjustment for the fact that federal income tax deductibility is worth more to high-income individuals. In addition, longstanding practice in Texas suggests that the tax system should minimize the tax burden on very low-income individuals.
- The fact that Texas businesses must compete in a national and global economy implies that non-benefit related taxation of businesses should generally be minimized. In particular, to the extent that capital is perfectly mobile, source-based taxation of business income is largely counterproductive

for the residents of the state, who ultimately bear both the direct tax burden and the efficiency costs associated with taxing mobile capital.

- Texas should avoid taxes on gross receipts and taxes that have economic effects similar to those of gross receipts taxes. The tax cascading caused by such taxes distorts business decisions regarding inputs and vertical integration, consumer decisions regarding consumption choices, impairs the efficiency of the political process by financing public services with a “hidden” tax, and creates a significant tax bias against small firms.

Given these general directions for reform, as well as the criteria for evaluating tax systems outlined previously, the analysis turns to an examination of various alternative sources of tax revenue for the state. Three types of reforms are considered: incremental reforms of the existing system, more fundamental reforms of the existing tax system, and the introduction of new taxes.

Consider first potential reforms that involve relatively moderate changes of the existing sales tax, excise taxes, franchise tax, and lottery. The analysis draws the following conclusions:

- Broadening the sales tax base to include a wider variety of consumer goods and services is generally desirable. Concerns about the distributional effects of reducing or eliminating sales tax exemptions and goods consumed disproportionately by the poor could be addressed by introducing a highly targeted means-tested sales tax rebate, perhaps involving expanded utilization of the Lone Star Card program.
- The case for expanding the base of the sales tax to include a wide variety of business services, however, is much weaker. Such an expansion would increase the extent to which the sales tax functions as an undesirable gross receipts tax, and would introduce significant administrative problems.

- Some revenues could be raised by increasing excise tax rates (such as the tax rates on motor fuels, cigarettes, or alcohol) to levels comparable to those in states that are fairly aggressive in using these tax instruments. The primary problem with this approach is that it is regressive, at least for some taxes, even if one adopts the lifetime view of tax incidence used in the report.
- The “small open economy” argument utilized in the paper implies that the franchise tax is one of the most inefficient taxes utilized by the state. Thus, reduction or elimination of the state franchise tax on Texas businesses would be desirable. However, if this is unattainable, the tax should be applied to all forms of business, subject to a small firm exemption, and serious consideration should be given to various measures to reduce opportunities for tax avoidance, including changing nexus rules and imposing consolidation requirements.
- Expansion of the existing lottery by adding video lottery terminals could provide some additional revenues without increasing the already relatively high level of taxation of existing lottery games. Since the incidence of the lottery tax is quite regressive, its expansion should arguably be accompanied by other tax changes that offset its regressive impact.

Texas may also wish to consider more fundamental reform of its existing tax system, especially the current sales tax.

- Fundamental reform of the sales tax system would include all of the sales tax reforms described above, coupled with a concerted effort to eliminate business inputs from the sales tax base. Such an approach would insure that Texas would receive the economic benefits of a true tax on consumption, uniformly applied to all consumption goods and services to the extent politically and administratively feasible.

- The franchise tax would best be replaced by an alternative more neutral, more comprehensive business tax based on valued added that would minimize source-based income taxation of highly mobile capital.

Finally, additional revenues could be raised with entirely new forms of state-level taxation. There are three obvious options: a personal income tax, statewide taxation of nonresidential property, and some form of value-added taxation.

- Although most Texans abhor a personal state income tax, such a reform has the advantage of simplicity (at the state level) and deductibility against individual federal tax liability. Although an income tax exacerbates the distortion of saving decisions associated with the federal income tax and creates a tax incentive for high-income taxpayers to leave the state, it would avoid the differential taxation of business inputs that characterizes the current system and result in fewer distortions of consumption decisions. An income tax would also be more progressive than the sales tax (at least with respect to annual income), and would provide a simple way of exempting the poor from tax.
- Statewide taxation of nonresidential property would also be a dramatic reform. Although non-benefit property taxation of nonresidential property is generally undesirable, a state level tax would at least be somewhat less inefficient than the local tax. The distributional effects of such a reform would be small on average, but could potentially involve significant, difficult-to-predict redistributions of wealth across Texas jurisdictions.
- Finally, a strong case can be made for a consumption-based value-added tax (VAT) that has desirable efficiency properties, is relatively simple, and avoids source-based taxation of mobile capital and thus spurs investment. Consideration could also be given to the Simplified Alternative Tax version of

the VAT, which allows businesses a deduction for wages and then taxes wage income at the individual level, subject to a standard deduction and personal exemptions to exempt the poor from tax. However, all of these VAT options would add a new layer of complexity to administration and compliance, and would introduce a variety of new problems not shared by the existing tax system.

LETTERS FROM MEMBERS

CAROLINE M. HOXBY
MEMBER, JOINT SELECT COMMITTEE ON SCHOOL FINANCE
PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS
HARVARD UNIVERSITY, CAMBRIDGE, MA 02138

March 10 2004

The Honorable Florence Shapiro and The Honorable Kent Grusendorf
Co-Chairs, The Joint Select Committee on School Finance
The Capitol
Austin, Texas 78711

Dear Chairwoman Shapiro and Chairman Grusendorf,

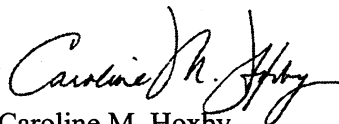
I am writing to express a few thoughts about the Draft version of the Executive Summary from the Joint Select Committee on School Finance (dated March 10). I realize that it is only a draft and that it proposes options, not a set of policies that are fixed.

Nevertheless, it is my view that if Texas were to enact policies like those outlined in the Draft Executive Summary, its education system would become the most ambitious, growth-oriented system among U.S. states'.

There are several good things about the reforms described in the Draft Executive Summary. First, the reforms are likely to succeed because they are well thought out. They are creative, but they also reflect the lessons of hard experience. Second, they are consistent. There are themes that run throughout: accountability, transparency, and significant rewards for people who get young Texans to achieve, either through school leadership or classroom teaching. Finally, the Draft Executive Summary package of reforms is forward-looking. It is a plan for immediate reforms, yes, but it is also a guide for future reform.

Texas is important not only because of its immense size, but also because it is a bellwether in the United States. Its population and student trends lead those of other states. With astute reforms like those in the Draft Executive Summary, Texas can make itself the state to match in achievement growth.

Sincerely,



Caroline M. Hoxby
Member, Joint Select Committee on School Finance

The Senate of The State of Texas

STATE CAPITOL, ROOM E1.708
P.O. Box 12068
AUSTIN, TEXAS 78711
(512) 463-0103
FAX (512) 463-1526
DIAL 711 FOR RELAY CALLS



504 E. HODGES
PALESTINE, TEXAS 75801
903-729-7717
FAX: 903-723-0408

COMMITTEES:
STATE AFFAIRS, VICE-CHAIR
EDUCATION
FINANCE
NATURAL RESOURCES
SUBCOMMITTEE ON HIGHER EDUCATION

TODD STAPLES

March 15, 2004

The Honorable Florence Shapiro
The Honorable Kent Grusendorf
Co-Chairs
Joint Select Committee on Public School Finance
Texas Legislature
Austin, Texas 78711

Dear Chairwoman Shapiro and Chairman Grusendorf:

Thank you for taking my input on the draft of the Executive Summary for the Final Report from the Joint Select Committee on Public School Finance. I appreciate your leadership, and I wholeheartedly agree that attaining high educational goals is of utmost importance to our state.

I applaud many of the changes incorporated into the draft report. However, the report could be sufficiently enhanced if it would clearly articulate what I believe is a critical element of our current work: *to make progress in closing the gap between the state's wealthiest and poorest schools, after adjusting for inherent differences in student and district costs.*

The Goals of the Executive Summary state, "Replace current system of recapture with *equitable* and *constitutionally* sound system for financing all Texas public schools, ensuring a fair and balanced tax burden shared by all Texans." Equity can be defined in a multitude of ways, and some might argue that ensuring an "adequate" education for all children is "equitable."

However, the courts have repeatedly opined on the issue of the funding gap between our schools. Therefore, our report should reflect the committee's goals and rationale to minimize the difference in the funding levels, yet no where can this be clearly found in the draft committee report.



The Honorable Shapiro and Grusendorf

Page 2

March 15, 2004

I have 88 school districts in my senatorial district. Ensuring five school districts (Chapter 41 districts in SD3) excel while 83 cannot make the grade is not victory. Every child must have access to a quality education, and quality must not be dependent on their zip code.

This goal can be made clear in the reforms targeted for hold-harmless provisions as well. By guaranteeing all districts the same level of funding at the 2005 levels and phasing-out hold harmless over time, we must ensure the goal is to not bring the top down, but to bring the bottom up to a comparable level. We agree dollars alone cannot solve our education problems; however, providing a truly equitable funding system will send the right message that Texans value every child and that we are committed to providing the opportunity for excellence.

As we seek to decide the best revenue options for restructuring the manner in which we finance our public schools, I feel it important to recognize the Available Sources of Additional Revenue for Education be consistently noted as "Options." The committee recommendations do not clearly reflect that video lottery terminals, cigarette taxes and/or other "sin" taxes are merely *options* before the legislature. Further, there is not a consensus these are the only or appropriate options.

In closing, our goals are the same: to ensure each Texas student has access to the best education we can provide. However, we must provide more clarity on the critical issue of equity. If our state is going to provide education to our children, each must have access to the same level of adjusted funding.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Todd Staples", written in a cursive style.

Todd Staples

TS/SLJ/slj