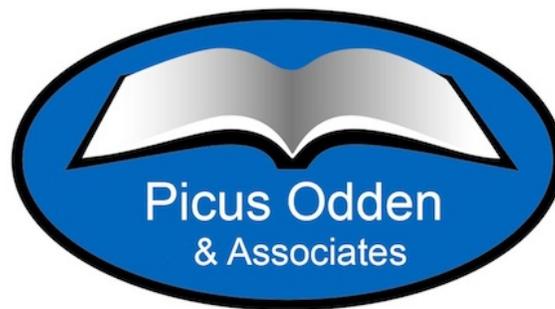


**FUNDING VERMONT'S SCHOOLS FOR THE FUTURE:  
A POLICY BRIEF**

**Prepared for  
The Shumlin Administration and the  
Vermont General Assembly**



**Prepared by  
Lawrence O. Picus  
Picus Odden and Associates  
February 4, 2014**

# **FUNDING VERMONT'S SCHOOLS FOR THE FUTURE: A POLICY BRIEF**

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As the 2014 legislative session develops, one of the key issues that the Vermont Legislature is reviewing is whether modifications to the state's school finance system are needed. Although it is arguably one of the best public school funding systems in the United States today, recent voter approved spending increases for schools, combined with declines in property values have led to increased homestead and non-residential property tax rates and growing questions about the system's sustainability. For the 2014-15 fiscal year, the Vermont Tax Commissioner has estimated that the base rate for education property taxes will increase by seven cents to \$1.01 (following a five cent increase for the current fiscal year) and the base income tax rate will increase from 1.80 percent to 1.84 percent. (The base income tax rate did not increase from 1.80% for this year as that figure represents the statutorily established floor). The Tax Commissioner also predicts a significant increase in total education property taxes and income tax rates. These tax increases have increased concerns that spending for Vermont's schools continues to grow despite enrollment declines that have seen the state's school population drop from over 104,000 students to approximately 88,000 students since the 1999-2000 school year.

This policy brief was prepared by Lawrence O. Picus of Picus Odden and Associates to help the Legislature and the administration consider the issues and potential options available to them should they decide to modify the school finance system. The basis for this policy brief is a framing paper prepared by Lawrence O. Picus and discussed at a daylong school finance symposium on January 14, 2014 at St. Michaels College in Colchester, Vermont. At that symposium, six national and Vermont experts met with over 100 education stakeholders and legislators to discuss the issues facing Vermont's school finance system and to consider possible modifications to that system.

The discussion at the January 14 symposium was wide ranging and covered a number of important areas. In introductory remarks by the State's leaders, as well as during the initial panel discussion by six finance experts, there was a general sense that overall, Vermont's funding system has accomplished a great deal and that the system is not "broken" but may be in need of some adjustments and fine tuning.

Governor Shumlin asked how the state could take its highly equitable system and make sure it is not too expensive, while Senate President Pro Tem Campbell expressed concern that increases in property tax rates for schools will lead to growing dissatisfaction with Acts 60 and 68. House Speaker Smith indicated that it is critical to define the problem that needs to be solved. There was agreement among the panel of experts that there is no silver bullet that will "fix" the funding system, or is there likely to be a solution that makes everyone better off without hurting any of the system players. Finally, throughout

the day, there were calls for increased transparency to enhance voter and taxpayer understanding of how Vermont's schools are funded.

The day long discussions identified a diversity of ideas about how the system operates and what changes would make school funding better serve the needs of the state's school children and taxpayers. From the discussions that took place, four major issues were identified:

1. Is current per pupil spending too high?
2. Are existing revenue sources appropriate for funding Vermont's schools? And is the burden of those taxes shared fairly?
3. Are there unintended consequences resulting from the operation of the current system and if so, how do they impact revenue and tax burdens?
4. Should anything be done at the present time?

The balance of this policy brief describes further the thoughts and recommendations surrounding these four areas and ends with some broad conclusions about potential areas for future consideration by the Legislature.

### **Is Current Per Pupil Spending Too High?**

At the core of the symposium discussions was the issue of whether spending was too high, and how either overall spending or the rate of growth in spending could be reduced in the future. The Governor made the point that despite substantial declines in school enrollments in the last 18 years, spending (and associated numbers of educational staff) have continued to increase. Concern was also expressed over the opportunity costs of high spending for education on other state services – does high spending on education put downward pressure on spending by other municipal agencies and on the state itself?

Important questions that were posed included:

1. What is the cause of spending increases and high spending?
2. What solutions exist to reduce spending or the rate of growth in spending?

Identifying the cause of high spending included many suggestions, but they clustered around issues of school/district size (economies of scale), the funding formula itself, continuing enrollment declines, and voter preferences for more spending. More detailed suggestions from the symposium on the cause of high spending using the framework of these three categories are summarized below:

#### *Causes of High Spending*

1. Economies of Scale
  - a. Vermont has the smallest average size school district in the country – average enrollment is under 300 students per district
  - b. A 'U' shaped cost curve

Under these circumstances the costs facing school districts in the provision of educational services are subject to dis-economies of scale leading to higher per pupil costs at the low and high ends of enrollment. Given that the largest district in Vermont is relatively small by national standards (approximately 4,000 students in Burlington), it is likely this is only an issue for the small districts, where spending generally appears to be high – recognizing the higher costs per pupil associated with that small size.

- c. Expensive school structure, spending on structure, not children
  - d. A system with small classes, high performance and small schools/districts is “doomed” to be expensive
  - e. The continuing decline in enrollment results in substantial increases in per pupil spending
2. Funding Formula
- a. Low tax price for many taxpayers/voters (see the next section of this document for more details on how this impacts spending and distribution of resources)
  - b. The high spending threshold in the formula has not been effective in holding down spending
  - c. Complexity of the formula obscures true costs and the impact on property tax rates
3. Voter Preferences
- a. Problem of the commons – voters pass higher budgets to keep up with and compete with neighbor districts

A related problem is the likely feeling in some districts that they might as well spend at higher levels because their neighbors are doing so and passing along the costs to them. Thus, the decision to spend more is partly a defensive posture to not being taken advantage of by other districts. With everyone feeling this way, the upward pressure on spending could be pretty strong.

- b. Approval of school district budgets takes place at the town or district level, which often keeps officials from considering the impact of small size on costs
- c. Taxpayers face varying costs for budget increases depending on their household income (the “skin in the game” argument)
- d. Voter desire for small schools

### *Suggested Solutions for Reducing Spending or the Growth in Spending*

Some participants argued that spending is not too high, and there is no need to restrain spending or its growth. They suggested that local voter control is the best arbitrator for

determining spending. Others felt the school finance formula requires some modification to reign in the growing costs of K-12 education. Ideas focused on incentives or actual actions to reduce or restrain spending, forms of school/district consolidation, and identifying efficiencies in school operations. The suggestions for holding back on spending are summarized below:

1. Restraining Spending
  - a. Impose spending caps
  - b. Eliminate or phase out the small school grants
  - c. Reduce the high spending threshold
  - d. Modify the high spending threshold
    - i. Multiple points where higher rates kick in
    - ii. Establish a “hard cap” on the high spending threshold
    - iii. Tie the threshold to a measure of inflation rather than a percentage of previous year’s spending
    - iv. Tie the threshold to individual district’s prior spending rather than the state average
    - v. Use of stiffer penalties
  - e. Develop a *minimum* class size

This would be a highly unusual step. To date there are no other states that dictate how small average class size can be. The debate is generally around the maximum class size to allow, and how to measure that across a school. Vermont presents a different situation as data provided by the Secretary of Education shows that 19 percent of elementary and elementary-middle schools have class sizes of three to nine students in the four core areas of math, science, language arts and social studies.

- f. Develop incentives for “appropriate class and school size – these might take the form of reduced state aid for class sizes that are too large or too small
  - g. Establish more state oversight to limit spending
  - h. Eliminate or phase out the hold harmless that does not count enrollment declines that exceed 3.5% of previous year enrollment
2. Consolidation
  - a. Shared Services through Supervisory Unions or similar organizations
  - b. Mandate what services Supervisory Unions provide
  - c. Create incentives for providing more cost effective services through Supervisory Unions – i.e. letting the district keep part of the savings for its own use
  - d. Creating larger taxing districts so that tax rates are approved regionally such as through the Supervisory Union
  - e. Do all budgeting and resource allocation at the Supervisory Union level – or create Supervisory “districts” that include the cluster of districts currently participating in the Supervisory Union
  - f. Only consolidate at the high school level

- g. Budget in 15 entities based on the state’s technical school boundaries
  - h. Move to regional or state-wide contracts for teachers and other personnel
  - i. Modify the law on district consolidation to enhance what appear to be insufficient incentives in the current law
3. Efficiencies
- a. Greater reliance on technology instead of personnel to deliver instruction and to provide the services children need
  - b. Adequacy study which would help identify an appropriate level for the base amount, and set targets for appropriate spending levels
  - c. Change the operation of the formula so that tax rates are set before budgets are established and restrict spending by forcing districts to live with the tax revenue constraints established through the tax rate
  - d. Make the funding system more transparent and understandable
  - e. Establish system timing so that the link between tax rates, budgets and income sensitivity are more clear to voters
  - f. Ensure Legislative committees with responsibility for portions of the education system hold occasional joint meetings to coordinate their work
  - g. Regionalize appraisal to minimize tax collection and appraisal costs as well as reduce confusion over the Common Level of Appraisal (CLA)
  - h. Eliminate unfunded mandates
  - i. Establish incentives for retirement without hiring replacement personnel

This discussion makes it clear that there are many competing views regarding both the cause of Vermont’s high spending level, and the range of suggestions about how spending can be reduced or the growth in spending slowed. The list of recommendations above offers an insight into the diversity of thinking about both what the cause of the problem might be as well as how the problem of high spending, if it is a problem, might be mitigated.

**Are Sources of Revenue Appropriate? And is the Burden Shared Fairly?**

In addition to consideration of spending levels, much of the discussion at the symposium considered the sources of revenue and how the burden of education taxation was shared. This is a critical question because Vermont has devoted considerable time and effort to establishing a highly equitable system that places responsibility for education funding squarely on the wealth of the state and not on the ability of individual school districts to raise property taxes for their schools. Because spending levels above the base amount are funded by tax rates levied on all districts in the state, the equalization, or sharing of tax revenues across districts is controversial. Considerable concern was expressed that many local voters approve large education spending increases because the cost they bear is substantially lower than the revenues they receive. This occurs either because of the equalization in the overall system, or because the income sensitivity component of the funding formula reduces the “tax price” they face when voting – meaning it costs them less than a dollar to increase spending by a dollar.

As one of the experts pointed out at the beginning of the symposium, changes in how funds are raised and distributed to school districts is certain to leave some individuals better off than at present and others worse off – determining the best combination of taxes is a complex undertaking.

While there was no agreement as to whether the relative share of income and property taxes was ideal, there were suggestions about how the relative shares might be modified if that were a desired policy outcome. The State could reduce reliance on property taxes by increasing the state general fund transfer to education. By relying on state sources of income (income taxes, sales taxes, etc.) more of the burden of funding schools could be shifted to these sources and property taxes reduced. If the general fund transfer were substantially increased, the base property tax rate and base income tax rates in the funding system could be reduced. While this would address the current concern over higher base rates for property and income taxes, it does not address the issue of spending levels, which are not necessarily reduced when the source of revenue shifts. Using such changes in the source of revenue to reduce spending or the growth in spending would also require limiting local districts' ability to increase spending independently of decisions made at the State level. Thus absent a continued commitment to strategies that would minimize education spending growth, this strategy would not, by itself, help reduce spending levels. It is also important to point out that shifting to a system that is more dependent on State sources of income is likely to be more sensitive to economic fluctuations than at present.

One problem with this approach is identifying sources of State revenue to fund the general fund transfer that don't result in the same high tax concerns motivating this discussion. Moreover, it is important to point out that the anticipated base property tax rate of \$1.01 and the base income tax rate of 1.84% remain below the initial rates established by Act 60 in 1997. Those rates were \$1.10 for the base property tax rate and 2.0% for the base income tax rate. Over time the growth in property values has led to reductions in those rates. It is possible that in the next few years, property values will begin to increase and that future property tax rate increases will not be needed or will not be as large. While increases in property values would alleviate concerns over increasing tax rates, it would not change the discussion about overall spending levels.

Property tax assessment remains a concern as well. There is some confusion over the CLA, confusion that could be reduced if larger taxing regions such as Supervisory Unions or even larger regions were used for taxation. Another concern has to do with the non-residential portion of the property taxes. Intended as a way to capture revenue from out of state residents and owners of second homes, the tax also places a burden on local merchants and manufacturing plants. One proposed solution is to further divide the grand list into additional classifications so there would be, for example, residential or homestead property, non-residential housing property, commercial property and industrial property. Each could theoretically be taxed at different rates, although some concern was expressed that this would violate Vermont's constitution by treating property owners differently.

## **Unintended Consequences of Current System**

One possible reason for high spending is that the income sensitive component of the tax system makes it possible for voters to raise spending by a dollar, yet pay substantially less than a dollar in increased taxes. Like other states, districts with relatively low property wealth per pupil are equalized by districts in other parts of the state who contribute more to the system than remains in their district. While this could lead to voters in low wealth districts deciding to take advantage of the system and vote large increases in spending that would be funded in part by taxes levied in towns with more wealth, there is little evidence in Vermont, or nationally, that low wealth districts that were low spending prior to school finance reforms (in Vermont Acts 60 and 68) choose to become high spending districts – instead they increase spending modestly and take advantage of lower property taxes.

The income sensitivity of Vermont’s funding system leads to a problem identified at the symposium as many voters not having “skin in the game.” The operation of Vermont’s circuit breaker for property taxes, along with the income sensitivity component of the funding system results in some taxpayers facing little or no increase in their own taxes even if they vote for higher education spending.

Taxpayers eligible for the circuit breaker (those with incomes below \$47,000 and property values high enough to fully qualify) would not see an increase in their own property tax bill if school taxes increase. Taxpayers who do not receive full circuit breaker relief or are eligible for income sensitive payments (household incomes between \$47,001 and 90,000 with sensitivity declining through approximately \$104,000) would only pay a portion of the additional taxes approved by voters, with the amount dependent on both their income and the percent of income necessary to fund the approved spending level.

These income sensitized voters essentially face a lower “tax price” for education spending because they are able to raise a dollar of additional spending at a cost to themselves of less than a dollar. The lower tax prices result in only modestly higher spending, not enough to turn low wealth districts into the highest spending districts, as the price elasticity is low. The Lawrence O. Picus and Associates report did find that those districts who experienced the larger tax price declines increased their education spending to a greater extent than districts with smaller tax price changes.

Changing the income sensitivity component of the model to slow the growth in education spending could be accomplished by increasing the percentage of income used to cap homestead property taxes, and then allowing it to increase from the base proportionally to increases in spending. It is also possible to have the income tax rate increase at a faster rate than the property tax rate increases with spending decisions, increasing the “tax price” income sensitized voters face.

Another alternative is to lower the high spending threshold– something that is already happening. This would cause the tax price to increase more quickly, potentially slowing

the growth in spending. Some participants at the symposium also suggested multiple thresholds or points where the property tax/income tax rate increased faster as higher expenditures were approved. For example rather than one high spending threshold at the current 123% of average spending, there could be one threshold at 110% of average spending beyond which the increase in rates was 1.5 times faster than the proportional increase; a second threshold at 120% of average spending where the rates double; and a third threshold at 130% of average spending where the rates increased at 2.5 times the proportional rate. Other suggestions related to the high spending threshold included only allowing it to increase by some rate of inflation rather than by the average of the previous year's spending.

Finally, the state could simply mandate maximum allowable increases in spending for districts. While this would slow spending if the mandate were lower than what the voters of each town would otherwise approve, the mandate would dramatically shift power from local towns to the state and is likely a hard sell in face of Vermont's local control traditions. Moreover, it is possible that by establishing a ceiling for spending, some low spending districts might use that as a floor and increase spending faster than otherwise – which may or may not be a desired policy outcome.

The issues described here go beyond ways to limit school district spending and instead focus on the revenue available to school districts. In considering alternatives to the current system, it is important to remember that the current system provides high levels of equity – as required by *Brigham*, and is steeped in the state's tradition of local control, so changing the level of voter control over school spending decisions may not be particularly popular.

### **Should Anything Be Done?**

Any consideration of policy should include the option of no change. There is ample evidence that Vermont's current school funding system is working well. As reported in a January 2012 report to the Legislature, Lawrence O. Picus and Associates, following a comprehensive review and evaluation of the state's school finance formula, concluded that the system developed through Acts 60 and 68 appeared to be operating well. The report found that per pupil spending levels were among the highest in the United States and that there was a high degree of equity in spending levels across the 233 school districts. The report noted that when measured as a percent of personal income, Vermonters work harder than any other state to provide funding for K-12 schools. The report noted that while test scores on the NAEP and NECAP were reasonably high, given the high levels of spending, the appropriate focus in the future should be on helping all schools improve so all Vermont school children have the opportunity to perform at high levels and graduate high school prepared for college and the work force.

Among the positive features of the system identified by symposium participants are:

1. The high level of equalization in the system

2. Vermont successfully weathered the recession and although property values declined during that time, they appear on the rebound in which case the high tax rate problem likely would disappear
3. The system has good economic properties in that it is not particularly regressive and provides a predictable and stable source of revenue for schools

Several questions pertaining to the issue of whether changes are necessary emerged from the discussions as well. They include:

1. Are we spending too much? How do we know? And what benchmarks are we comparing ourselves to?
2. Is the current level of spending sustainable, and what do we mean by sustainable?
3. Will changes, particularly reductions in spending or the growth rate of spending have a negative impact on student outcomes?
4. What are the tradeoffs between spending for education and other municipal services and does education “crowd out” spending on other important services?

While there was no clear consensus that nothing should be done, there was a strong general sense that if policy changes are made, they should be modifications to the existing structure and there was no need to throw the system out and start over. Additionally the current law conforms to the requirements of the *Brigham* decision for equity and the state’s desire for strong local control, both of which constrain policy changes moving forward.

## **Conclusion**

The January 14 education finance symposium identified a number of important issues facing Vermont as it considers options for its school finance system. As noted by many of the experts and participants at the symposium, the first step in this process is to determine what problem needs to be solved. Once identified, the range of potential actions is reduced and discussion and analysis about the impact of alternatives can be more tightly focused. For example, resolving issues of high property taxes may be possible by shifting sources of revenue, whereas reducing spending (or the rate of growth in spending requires different policy tools which may also lower property taxes. It is important to keep the focus on solutions that address the issue the state wants to address.

## APPENDIX

### AUTHOR AND EXPERT REVIEWER BIOGRAPHIES

**Lawrence O. Picus** is a principal partner in Picus Odden and Associates and Professor of Education Finance and Policy in the USC Rossier School of Education. His current research interests focus on adequacy and equity in school finance as well as efficiency and productivity in the provision of educational programs for PreK-12 school children. He consults widely with states on the design and implementation of school finance systems and is an expert in school finance adequacy. Picus is past-president of the Association for Education Finance and Policy, and is the president of [EdSource](#) where he has been a member of the board of directors for 14 years.

**Thomas A. Downes** is Associate Professor of Economics at Tufts University. His research focuses in part on the evaluation and construction of state and local policies to improve the delivery of publicly-provided goods and to reduce inequities in the delivery of these services, with particular attention paid to public education. Another portion of his research considers the roles of the public and private sectors in the provision of education, with the eventual goal of providing improved information on the potential outcomes of broadened school choice. He is currently the co-editor of *Education Finance and Policy*.

**Kieran M. Killeen** is Associate Professor in the College of Education at the University of Vermont. He is a former special education teacher from Louisiana and participant in the Teach For America national teacher corps. His current research interests focus on highly transient or mobile school children, with research projects underway in Minnesota, New York State and Vermont.

**Daphne A. Kenyon** is a visiting fellow at the Lincoln Institute of Land Policy, and heads D. A. Kenyon & Associates, a public policy consulting firm in Windham, New Hampshire. She also served on the New Hampshire State Board of Education, to which she was appointed by Governor John Lynch (D) in 2006. Kenyon's research and consulting have focused on state and local public finance, education policy, health care policy, fiscal federalism, and taxation.

**David H. Monk** is Professor of Educational Administration and Dean of the College of Education at The Pennsylvania State University. He served as the inaugural co-editor (2005-2010) and continues to serve as an Editorial Board member for *Education Finance and Policy* - The Journal of the Association for Education Finance and Policy (MIT Press). He consults widely on matters related to educational productivity and the organizational structuring of schools and school districts and is a Past President of the Association for Education Finance and Policy.

**Patrick Walsh** is Associate Professor of Economics at St. Michaels College in Vermont. His research focuses on the economics of education, competition in education, sorting among schools and peer externalities. He also conducts research on occupational choice and occupational switching.

**Michael Wolkoff** is Senior Lecturer in Economics and public Policy in the Department of Economics at the University of Rochester. His research focuses on public school finance, economic development policy, school performance and housing prices and state and local budgeting.