To: Shap Smith, Speaker of the House
From: Education Finance Working Group (Mollie Burke, Chip Conquest, Bernie Juskiewicz, Bill Johnson, Mitzi Johnson, Neale Lunderville, Oliver Olsen, Dave Sharpe & Jeff Wilson)
Re: Final Report
Date: December 12, 2014

Over the past four months, the Working Group you established to reform Vermont's pre-K through 12 education finance system has worked in a highly collegial and conscientious manner to offer credible and constructive ideas that, we believe, merit consideration by the General Assembly in the 2015 session. There are no simple, painless remedies to address the challenges we face in this arena, but we recognize that most Vermonters have come to find the status-quo undesirable and are looking to state government to produce change. The suggestions we have pulled together represent alternative, and in some cases, new and creative approaches to reform. Moreover, we recognize that many of the options being put forward require additional vetting and deliberation, and not every member of the Working Group has embraced all aspects of the various ideas contained within this report. However, we do believe education finance must be a policy priority next session, and that our work represents a stimulating starting point for a thoughtful legislative conversation in 2015. With this as the context for our efforts, we have developed four general avenues for change that we believe worthy of consideration:

1. House Education Committee – Expand its responsibilities to include education finance;
2. Renovation Plan – Eight ideas to incrementally rework the current Act 60/68 system;
3. Variable Income Tax - A new approach to the funding side of the equation;
4. Regional Block Grant – A new system to replace Act 60/68.

Below, please find a more detailed discussion of these ideas:

Education Committee's Role

Traditionally, legislation entailing education finance reforms have been referred to the House Ways and Means Committee, with leadership of the House Education Committee often conferring informally with the leadership of Ways and Means concerning the merit of various initiatives. This process, at times, was less than optimal in trying to produce legislative outcomes that were both sound, from the perspective of education policy, and fiscally prudent. To better marry education policy and finance, it is recommended that the Speaker revise the charge of the House Education Committee, so that it becomes the first stop for all education finance-related legislation. This procedural change would more closely emulate the successful intertwined policy-finance scrutiny the House Transportation Committee pursues in its review of legislation pertaining to transportation income and expenditures. As with transportation finance questions, Ways and Means would still have its chance for consideration of any education revenue question, just not on a first-stop basis.

Renovation Plan

1. Excess Spending Surcharge: A new Excess Spending Surcharge, replacing the current Excess Spending Penalty, would be imposed as the primary education spending cost control lever. The surcharge would be structured to restrain per pupil expenditures (which drive property tax impacts), and inspire policy development and behavior at the school district and supervisory union levels in ways that would produce enhanced efforts at administrative and organizational efficiencies/decision-making.

   The new surcharge, if statutorily configured in the 2015 legislative session, could become effective in FY 17. The provisions of the surcharge are, as follows:

   - A Per Pupil Spending Target for FY 17 would be established by adding 3% to the median level of budgeted FY 15 per pupil school district spending ($14,571). In subsequent years (FY 18 and beyond) the Per Pupil Spending Target could be adjusted by indexing it to some recognized, published inflationary factor, or by anchoring it in some form to the previous year's median (e.g. previous year's median plus 3%);

   - Residential taxpayers in a School District that exceeds the Per Pupil Spending Target by more than 10% would be assessed a surcharge as set forth in the following schedule:

     - 10% tax rate surcharge in Districts that exceed the target by more than 10%;
     - 15% tax rate surcharge in Districts that exceed the target by more than 15%;
     - 20% tax rate surcharge in Districts that exceed the target by more than 20%;
     - 25% tax rate surcharge in Districts that exceed the target by more than 25%;
     - 30% tax rate surcharge in Districts that exceed the target by more than 30%.

   - The surcharge would be assessed on all residential taxpayers in excess spending districts, as follows:

     - The surcharge percentage would be calculated as a percentage of a District's "normal" equalized school tax (e.g. $1.60 x .10 = $0.16, and then adjusted by the CLA);
     - It would be billed based upon property value (the so-called "penny rate") on all residential taxpayers, whether income sensitized, or not;
     - It would be listed as a separate rate on the tax bill.

   - The amounts collected in surcharge assessments[1] would be transferred into a special State Property Tax Relief Fund that must be used to reduce the statewide property tax rate in the ensuing year;

2. Hold Harmless – "Phantom student" hold harmless provisions would be phased out.

[1] Based on a preliminary run on FY 15 per student spending by Brad James, it appears that such a surcharge, as structured in the proposal, would raise a little under $9 million for redistribution.

3. Small School Grants – This type of grant would be phased out for schools that are not deemed geographically isolated by the Agency of Education[2].

4. Students in Poverty – More resources would be directed to school districts with high school-based poverty levels.

5. Increase Incentives to form REDs – The financial incentive package for local districts to join a Regional Education District would be enhanced. Also, the Agency of Education would be fully resourced to provide in-depth technical assistance to districts that consider transitioning to a RED.

6. State Mandates – Require the General Fund to assume all costs associated with new state mandates imposed upon local school districts and supervisory unions.

7. Streamline Hiring Process – Make Principals responsible for hiring all staff, and give Superintendents the sole authority over hiring Principals. This would help to clearly define responsibilities, save valuable board time and make Principals and Superintendents exclusively accountable for the choices they make.

8. Teachers Contract – Have the Agency produce a model teachers' contract that districts could use during labor negotiations. Explore the idea that districts could opt-into a statewide contract.

Variable Income Tax Model

This document summarizes an alternative funding mechanism to Act 60/68, which would replace the current residential education property tax mechanism with a variable income tax and a much lower flat residential education property tax. This model would streamline and simplify the current funding structure, improve funding transparency, and ensure that nearly everyone eligible to vote on school budgets shares a proportional tax burden.

Two fundamental problems with Act 60/68 are the lack of transparency and accountability that stem from the inherent complexity of the system. Even legislators and school board members struggle to understand how the system works, say nothing of average citizens who are being asked to vote on school budgets.

Under the current education finance system, there are no less than six different types of voters who are impacted in different ways by the school spending decisions we ask them to make annually:

1. Voters who own their own home, but are ineligible for income sensitivity assistance - they pay the full residential property tax rate;

[2] As a subtext on the phase-out discussion, it was suggested that a district might be able to postpone the elimination of the grant temporarily, if the district made an ironclad commitment to joining a Regional Education District.

2. Voters who own their own home, and are eligible for income sensitivity assistance (i.e. those with household income up to $90,000) - in a roundabout, convoluted way, they pay a tax that is based on their household income;
3. Voters who own their own home, and are eligible for partial income sensitivity assistance, but are limited by a cap on income sensitivity payment (capped at $8,000), own more than 2 acres of land, earn more than a certain amount of income through interest and dividends, and/or have a home that is valued over $500,000 - these folks pay a hybrid property/income tax;
4. Voters who own their own home, but have less than $47,000 in household income - they are guaranteed to pay no more than 5% of their household income in education and municipal property taxes, regardless of local school and/or municipal spending decisions;
5. Voters who rent their home - they don't pay property taxes directly, and although their landlord pays property taxes, those taxes are at the fixed non-residential rate, which does not vary based on local school spending;
6. Voters who live rent-free in another person's home (e.g. parent, adult child, partner, etc.) - they don't pay property taxes.

This presents a challenge for school boards when posed with the obvious question on Town Meeting Day: "How will this budget affect my bottom line tax bill?"

Under the current system there is never a clear answer to this very straightforward question, since individual voters are paying different taxes in different ways in response to the same budget.

The variable income tax system would make the impact of school spending decisions much more transparent, so the voters have a clear understanding of how a proposed school budget will translate into their individual tax obligation.

Under the variable income tax system, the core financing structure underpinning Act 60/68 would remain in place. The education fund would continue to distribute funding in response to local budget decisions, the annual transfer from the general fund to the education fund would remain in place, and the non-residential property tax would be unchanged. The major change under this system would be to the residential property tax structure:

1. a substantially lower residential property tax that would be fixed at a uniform statewide rate;
2. the elimination of income sensitivity, property tax rebate, and renter rebate programs; and
3. an education income tax that would vary from community to community, based on local per pupil spending decisions.

Currently, about 64% of Vermont homeowners participate in the income sensitivity program; in a roundabout way, they are already paying an income tax based on their local school spending. However, this is far from evident to the average taxpayer - it involves a tax credit applied to a property tax bill based on the prior year's income and property tax liability. Under the variable income tax system, the complexity of this system would be eliminated, we would call it what it is – an income tax – and apply it to all residents, regardless of whether or not they own property. Everyone would have a stake in the financial impact of their vote on local school budgets.

Variable Income Tax: Key attributes

- Overall – Simplifies the funding system with a uniform tax structure where nearly all eligible voters would pay an education income tax that would vary based on local school spending decisions.
- Funding – A statewide education income tax and a relatively low residential property tax would replace the current variable homestead property tax.
- Spending – Existing Act 60/68 distribution mechanism and spending controls would remain in place, but could be modified with some or all components of the Renovation Plan.
- Outcomes – There would be no direct impact on student outcomes.
- Governance – There would be no change to existing governance structures.

Variable Income Tax: Key features

- *How the funding works*
    - Replace the current ***variable*** residential education property tax rate with a much lower ***fixed*** residential property tax rate that would be uniform across the state;
    - Allow residential rental units to be taxed at the lower residential property tax rate, rather than the non-residential tax rate (so renters would not be taxed twice);
    - Education income tax structure would vary according to local school spending;
    - Eliminate the income sensitivity, property tax rebate, and renter rebate programs (no longer necessary due to the lower residential property tax rate);
- *How the spending works*
    - There would be no change to the distribution of funding and how spending decisions are made – i.e. local budgeting process would remain the same.
    - Any spending controls designed for Act 60/68 could be applied to this model in the same manner.
- *How governance works*
    - By itself, this mechanism would leave existing governance structures in place
    - Other governance models, including the voluntary governance consolidation incentives already available, can be employed.

Variable Income Tax: Additional considerations and open questions

- How would the transition be handled?
    - Cash flow would be a challenge in the first year – would need to look at options to phase in without creating the illusion of double-taxation.
- Income tax could result in a much higher tax burden for residents with high incomes
    - Impact would be particularly pronounced with high-income residents living in residential property of modest value.
    - Need to consider reducing the marginal education income tax rate at higher income levels to ameliorate the more extreme impacts.
- How would renters be treated?
    - Rental property would be taxed at the lower residential tax rate, but an incentive would be needed to ensure that landlords pass the savings onto renters in the first year the

reduced tax rate takes effect – otherwise renters could end up being effectively taxed twice.

- Shifting to a more transparent education income tax could create additional spending capacity within municipal government and within the education system.
    - Lower residential property tax rate could open the door to increased municipal spending that would fill the void.
    - A high percentage of residents would pay their education income tax through payroll withholding – removing the "sticker shock" effect that comes with a property tax bill – this would make it easier to spend more on education.

    - A relatively low withholding rate could frame a dynamic where an income tax bill (vs. a refund) would come due around the same time education budgets are voted on, which could help moderate the growth of spending.

Regional Block Grant Model

The purpose of this document is to outline a new approach to K-12 education funding, spending, and governance based on a regional block grant model (RBGM). This new model emphasizes equity of opportunity with a focus on educational excellence for all students, and strengthens school board control between spending decisions and outcomes. The RBGM eliminates the complexity and confusion of the current Act 60/68 system while providing greater financial equity across all school districts. The new approach incorporates inherent cost control measures at both a statewide and regional level that will naturally moderate education spending and provide taxpayer relief.

RBGM: Key attributes

- Overall – Schools and school boards focused on classroom excellence and property tax payers get lower, more stable rates.
- Funding – The State assumes responsibility for K-12 education funding.
- Spending – School boards work with regional entities to set budgets that ensure equity of opportunity, but retain full control of spending decisions.
- Outcomes – School boards retain responsibility for education outcomes, plus policy and personnel decisions.
- Governance – No mandated consolidations at district level. Adds regional educational entities (REEs) to facilitate budgeting and shared services.

RBGM: Key features

- *How the funding works*
    - After a phase-in period, the education fund (EF) would be eliminated and State education funding would be appropriated as general fund (GF) expenditure to REEs responsible for ensuring equity of opportunity.
    - All previously earmarked revenue (education property taxes, 1/3 of purchase and use tax, etc.) would flow to the GF, and education funding would be weighed against all other state priorities. This provides a natural check on education spending growth.

- Working from a per-pupil spending recommendation by the Secretary of Education, the Governor would propose a total education appropriation as part of the annual recommended budget.
- The Legislature would set a statewide per-pupil spending amount and appropriate to REEs based on the number of students in a region. "Phantom students" will not be counted. [The number of students may be weighted based on grade level with weighting determined annually by the State Board of Education.]
- For example, if the State sets per-pupil spending at $15,000, then a region of 1,000 students would receive: $15,000 x 1,000 students = $15,000,000 annual regional block grant.
- The State *residential* education property tax rate would be significantly lowered and fixed, and income sensitivity would be eliminated. The State *non-residential* education property tax rate would remain at current levels. The difference in collected revenue would be made up in other GF taxes (income tax, sales tax, etc.) or found by offsetting budget priorities.
- Only the State would set education property tax rates and those rates would be the same for all taxpayers. Local adjustments would not be needed or allowed.

- *How the spending works*
  - Local school boards and voters would develop school budgets based on per-pupil spending guidelines. Those budgets would be submitted to REEs for review.
  - Based on the State appropriation for education, REEs would assess submitted budgets and work collaboratively with local districts to make adjustments to ensure equity of opportunity across all districts within the region. Districts would have the right to appeal regional budgeting decisions to the State Board of Education.
  - Local school boards would retain complete control of spending, policy, curricula, and personnel decisions within the budget approved by the regional entity.
  - REEs may elect to establish a general services model for bulk purchasing and specialized services to create efficiencies of scale and cost savings. General services may include: special academic offerings, e.g., foreign languages, advanced math, remedial education; information technology management; building maintenance and grounds keeping; energy procurement and delivery; and food services.
  - REEs may also elect to use innovative approaches for academic opportunities and non-core services and assets, including: full school choice across the region; new school construction via lease deals with private developers; and public-private partnerships with education innovators.
  - This approach to spending encourages informed, holistic decision-making that spurs all types of innovation both administratively and in the classroom.

- *How governance works*
  - There would be no mandated consolidation of local school districts.
  - Local school districts would elect to join with other districts to create a REE that would facilitate allocation of the State block grant, annual budgeting to ensure equity of opportunity, and allow for regional shared services.
  - A regional board would govern the REE and be elected from the participating districts, to include both at-large members and district representatives.

    - The decision to join a REE would be voluntary during the initial phases of the RBGM, with the greatest incentive accruing to early adopters. In latter phases, the State Board of Education will have the authority to place "orphaned" districts with existing REEs to make the system complete.

<u>RBGM: Additional considerations and open questions</u>

- In the voluntary approach, what will be the initial regional block grant amount?
    - There are both pros and cons to the statewide average or a most recent spending approach.
- What is the best approach to phasing-in the RBGM?
    - Could voluntary approach be accomplished with an annual "open season" that is managed by the State Board of Education?
    - What happens when benefits accruing to early adopters are weighing too heavily on non-adopters? Is there a trigger for the State Board to mandate REEs for non-adopters?
    - Is there merit for the "big bang" approach where the State specifies a one year window for new REEs and then makes BRAC-like decisions based on applications?
- Should the State set the per-pupil spending amount a year ahead for school budgeting purposes?
    - Will this create an unfair advantage for the education appropriation, as it would not be subject to the same annual pressures as other programs?

As the committee wrapped up its work a number of other ideas surfaced that the committee members did not have time to discuss. This is a testament to the process that the Speaker has initiated in selecting this working group. We invite much further discussion of the ideas presented here. We also hope this will be a jumping off point for other proposals. We need the participation of all Vermont citizens to help envision great opportunities for our Vermont students with a funding system that is equitable and sustainable.