the Southwest ECONOMY

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School Finance Reform in Texas

"We hold that the state's school financing system is neither financially efficient nor efficient in the sense of providing for a 'general diffusion of knowledge' statewide, and therefore that it violates article VII, section 1 of the Texas Constitution."

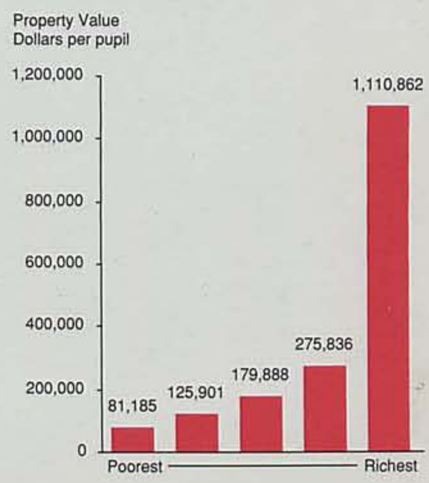
The Supreme Court of Texas
Edgewood Independent School District v. Kirby
777 S.W. 2d 391 (Texas 1989, p. 397)

With these words, Texas' highest court ruled the state's school finance system unconstitutional and ordered reform by May 1, 1990. The court found that disparities in local property values led to unacceptable differences in revenues derived from property taxes (*Chart 1*). For example, in 1985 Highland Park Independent School District (ISD) raised 38 percent more revenue per pupil with a property tax rate one-third that of Wilmer–Hutchins ISD. In a system acceptable to the court "districts must have substantially equal access to similar revenues per pupil at similar levels of tax effort" (*Edgewood*, p. 396).

In addition to requiring state monies, reforming educational funding has the potential to change the face of primary and secondary education in Texas. In Texas, like in many other states, control of primary and secondary education has been left largely in the hands of local school districts. Increased state funding could reduce local school district control. In choosing the vehicle for reforming educational funding, the state legislature will determine how much control local school districts will retain.

The state legislature, in two special sessions this spring, is examining options for reform. The legislature has several strategies to consider—full state funding, foundation programs or guarantee programs. In the 1970s and early 1980s, the highest courts of six states—Arkansas, California, Connecticut, New Jersey, Washington and Wyoming—required their respective states to make

Chart 1
Disparities of School District Values, 1985
(Property Value Per Pupil by School Districts by Quintile)



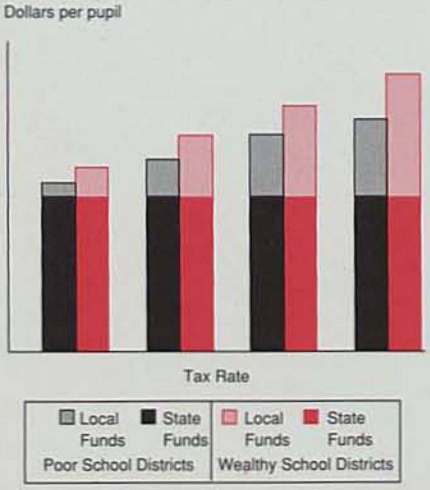
school finance more fair. Today, California and Washington rely on full state funding, Arkansas and Wyoming finance their schools with foundation programs, and Connecticut and New Jersey use guarantee programs.[1]

School Finance Strategies

Full State Funding. Under full state funding, the state collects the school taxes and then redistributes them to the school districts. The state may assume complete financing responsibility for the schools, or it may take responsibility for a basic program and leave enrichment activities to local school districts. The state may or may not direct the way in which school districts use state funds. Chart 2 illustrates school district revenues per pupil under a full state funding program that allows for local enrichment.

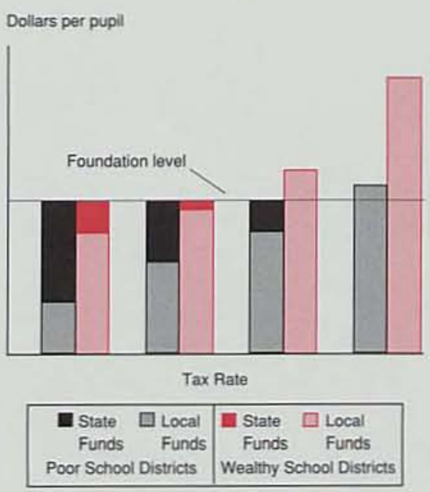
Foundation Programs. A foundation program sets a minimum standard for per-pupil expenditures in the state. If a school district's revenues are less than the standard, the state makes up the difference—even if the school district is using the lowest possible tax rate. If a school district's revenues exceed the standard, the state takes no action. When the standard is set high enough, expenditures become roughly equal across the state because only a few wealthy school districts choose to spend more than the foundation level (*Chart 3*).

Chart 2
School Financing
under Full State Funding with Enrichment



Under a foundation program, much of the cost of education can fall on the state government because the program assures school districts a specific level of funding regardless of their tax rates. That gives the school districts incentive to choose the lowest possible tax rate. In some states, the legislature established minimum local tax rates to prevent local school districts from shifting responsibility for funding to the state government.

Chart 3
School Financing
under a Foundation Program



Guarantee Programs. A guarantee program sets a guaranteed level of funding for each tax rate that the local school district chooses. Under a guarantee program (sometimes known as a guaranteed tax base), the state constructs a hypothetical tax base for each school district based on the number of students in the district. Tax rates are decided by local school districts. In the case where a district's actual tax base is lower than the hypothetical base, the state makes up the difference between actual tax revenues and tax revenue that the district would receive if it had the hypothetical tax base (*Chart 4*). States often set upper limits on the revenue they will guarantee. In the case where a district's actual tax base is greater than the hypothetical tax base, the state might take no action, or, in a process known as *recapture*, the state might claim the difference between actual tax revenues and tax revenue that the district would receive if it had the hypothetical tax base.

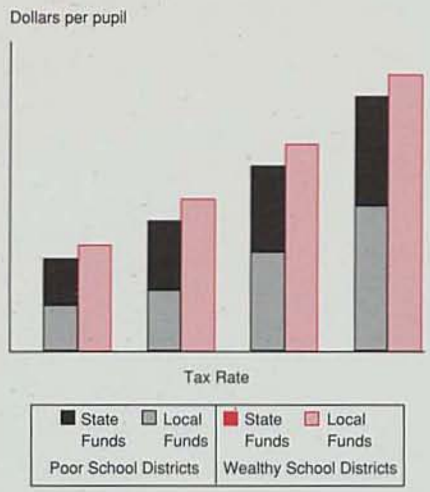
Choosing a School Finance Strategy

In choosing their strategy, Texas legislators will consider several criteria. They must satisfy the court. They will also consider how their program affects the quality of primary and secondary education in Texas, how much it costs the taxpayers and its effect on local school district control.

Satisfying the Court. The Texas Supreme Court set broad guidelines for satisfactory reform. The public school system must efficiently provide a basic program that leads to a general diffusion of knowledge. The court found that meeting this criterion requires a financing system in which there is "a direct and close correlation between a district's tax effort and the educational resources available to it" (*Edgewood*, p. 396). Nonetheless, satisfying the court does not require equal expenditure per pupil. The court specifically allows communities to supplement the efficient system with enrichment funds if those funds are derived solely from local tax revenues.[2]

With sufficient funding, all three of the financing strategies probably would satisfy the court. Full state funding would satisfy the court's requirements if the basic program provided by state funding leads to a general diffusion of knowledge and any enrichment funds

Chart 4
School Financing under Guarantee Program without Recapture



come from local tax revenues. Similarly, a foundation or guarantee program would satisfy the court if the minimum level of funding or the guarantee was set high enough to provide the basic program acceptable to the court. If the guarantee is set high enough to discourage most school districts from spending more than the maximum guaranteed amount, the legislature also might avoid the problem of defining a general diffusion of knowledge.

Costs. All of the programs are likely to increase both state funding and total spending on education. Full state funding that provides at least $3,500 per student for basic programs each year could cost Texas taxpayers an estimated $11 billion annually, all of which would be funded through the state government. A similar foundation program would cost Texas taxpayers $11 billion annually with at least $6 billion funded through the state government. A similar guarantee program without recapture would cost Texas taxpayers somewhat less than $11 billion annually with about $5.5 billion funded through the state government. Enrichment programs would add to local expenditures.

Including enrichments, total spending on primary and secondary education in Texas is likely to be greater with full state funding of the basic program than with a foundation program because full state funding is likely to lead to greater enrichment spending than a foundation program. With full state funding, local school districts need not fund the basic program locally before they can offer enrichment programs, whereas they must with a foundation program.

Full state funding is also likely to be more costly than a guarantee program. With full state funding, school districts would have no incentives to hold their costs below the state-funded level—even if they could meet their goals with less money. Under the guarantee program, school districts will have an incentive to hold their costs down. The guarantee program preserves a closer relationship between district costs and local taxes.

A foundation program is likely to be more costly than a guarantee program as well. Under the foundation program, some school districts are likely to receive more funding than necessary to support their basic programs. These excess funds could not be used on supplemental enrichment programs because the funds would not be derived from local tax effort as the court requires. Although the guarantee could encourage some property-poor school districts to spend heavily on education, other school districts probably would spend less money than the guarantee.

With recapture, a guarantee program might require little or no state funding, but recapture seems politically infeasible in Texas because it would require a transfer of funds from taxpayers in school districts with high property values. Even without recapture, a guarantee program is likely to require less state funding than a foundation program. School districts have an incentive to shift the burden of school finance to the state under a foundation program, but a guarantee program does not have such an incentive.

Full state funding requires more state funds than either a foundation or guarantee program. With either of the latter programs, local funds contribute to the basic program.

The most expensive program may not be the best. Research shows that the connection between educational expenditures and student achievement is weak (*See the box titled "More Money May Not Mean Better Education"*).

Local Control, Incentives and Quality. State funding could shift the control of primary and secondary education in Texas from local school districts toward the state government. Greater state control could enhance or lessen educational quality in the state. In Minnesota, state funding has been used to foster competition between school districts with the hope of improving quality. Parents are given a choice of schools in competing districts.[3]

Without a similar open enrollment program in Texas, maintaining some degree of control at the local school district would be desirable. Economists have found that public spending is best handled at the level of government where the primary benefits are received.[4] Although the benefits of primary and secondary education spill across school district lines, they are primarily local. Local control allows school districts to meet local needs and gives each community a greater voice in the kind of education it will provide.

Full state funding of basic programs would greatly reduce local school district control over the size of the school budget. Local school districts would be limited to determining the level of their enrichment programs.

Full state funding could also reduce local control over the distribution of resources within a school district. Once the legislature sets the level of funding for basic programs, it is likely to direct how those funds must be spent. In doing so, the legislature may mandate programs that do not meet the needs of individual school districts.

Compared to full state funding, a foundation program could more severely limit a local school district's control over the size of its budget. A foundation program would inhibit enrichment spending in all but the wealthiest school districts. A district that raises enough funds to offer enrichments would lose its state funding. To raise funds for its enrichment programs, a district also would have to raise sufficient funds from local taxes to cover the basic education.

A guarantee program would preserve control for local school districts. Under guarantee programs, individual school districts would choose the level of funding consistent with the educational objectives that meet their own community standards.

Conclusions

All three finance strategies—full state funding, a foundation program and a guarantee program—could be modified to satisfy the court. All of the programs will increase total spending on primary and secondary education in Texas. Nonetheless, the programs differ in costs and the degree of local control that they allow.

Full state funding is the most costly and could severely limit local school district control over the size and distribution of educational funds. A foundation program that is likely to satisfy the court would limit local control to enrichment spending and would discourage school districts from offering enrichments. A guarantee program that would satisfy the court would be the least costly and would preserve local school district control over the size and distribution of the school budget.

—Lori L. Taylor

More Money May Not Mean Better Education

Underlying the court's displeasure with school finance in Texas is the notion that a general diffusion of knowledge requires a general diffusion of money. Many economists strongly disagree. Professor Eric Hanushek of the University of Rochester analyzed 65 studies that examined the relationship between expenditures per pupil and student achievement. After adjusting for family characteristics, only 13 of the 65 studies indicated that increasing expenditures significantly increases student achievement. Surprisingly, three of the 65 studies indicated that increasing expenditures significantly decreases student achievement. The remaining studies found no relationship between expenditures and achievement.[1]

Increasing expenditures has the potential to increase achievement if funds are allocated effectively, but many popular strategies for improving the schools are generally ineffective. Professor Hanushek's analysis also demonstrates that the programs school districts tend to fund with additional school money—smaller class sizes, higher teacher salaries, more experienced teachers, or more teachers with advanced degrees—have no systematic effect on student achievement. The research does not imply that teachers are unimportant to student achievement. Instead, it indicates that current measures of teacher quality—their experience and education—seldom differentiate good teachers from bad ones. Increasing the number of teachers or the salaries of current teachers would be ineffective in a system that relied on these poor measures of quality when making decisions about hiring, firing and promotions.

[1] Hanushek, Eric A. (1986), "The Economics of Schooling: Production and Efficiency in Public Schools," *Journal of Economic Literature* Vol. 24, No. 3, pp. 1141–77.

[1] See Richard G. Salmon, Christina Dawson, Stephen B. Lawton, and Thomas L. Johns, compilers and editors, *Public School Finance Programs of the United States and Canada, 1986–87*, Blacksburg, Va.: American Education Finance Association and Virginia Polytechnic Institute and State University, 1988, p. 4.

[2] The court did not define the terms *basic* or *enrichment* programs. A basic program provides education in the fundamental subjects essential for a general diffusion of knowledge. An enrichment program provides funds for athletics and instruction in supplementary subjects.

[3] Similar programs are possible without state funding if the parents' choices are limited to schools within their school district.

[4] See Wallace E. Oates, *Fiscal Federalism*, New York: Harcourt Brace Jovanovich, Inc., 1972.

Economic Commentary

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Challenges for Southwestern Financial Institutions: Resolution and Beyond

During the past decade the financial industry in the Southwest has undergone a dramatic restructuring. This restructuring results in part from the broad-based changes in market conditions, technology and the regulatory structure that have had an impact on financial institutions nationwide. Beyond these changes, the last four years brought the financial industry in the Southwest the most severe financial losses since the Great Depression.

A new financial landscape is emerging as the process of resolving these troubled financial institutions continues. The combined effect of the many failures, liquidations and assisted and unassisted mergers that have occurred at banks and thrifts throughout the region has resulted in large-scale industry consolidation. This consolidation may benefit the surviving institutions, particularly in lowered operating costs. The recapitalization, using both public and private funds, has improved the overall capacity of the Southwestern financial industry to finance economic activity in the region, which will benefit the Southwest economy.

Despite these improvements, the magnitude of the recent banking and thrift difficulties raised several complications that will influence the near-term operations of financial institutions. First, concerns persist that the large inventory of nonperforming real estate assets at the insolvent thrifts and elsewhere will reduce the asset values of the solvent competitors of these institutions. The high concentration of problem assets and uncertainty regarding the timing and method of their sale may be depressing underlying real estate values. Second, troubled real estate assets also complicate the resolution process because regulatory efforts to resolve the problem assets at the troubled institutions can place the unassisted institutions at a competitive disadvantage relative to the newly recapitalized firms. The negotiated assistance packages tend to include provisions that remove the negative impact on earnings from troubled assets, whereas unassisted competitors of these assisted firms must continue to finance their nonperforming assets or independently raise sufficient capital to cover markdowns.

These issues are particularly troublesome for the Southwest, which has many financial institutions with high concentrations of troubled real estate assets and many troubled financial institutions that will require resolution. Nearly 50 percent of the thrifts in Texas and Arizona are insolvent, and thus will require some form of resolution during the next few years. In addition, many banks that have already been resolved in the region can have an impact on the operations of those unassisted institutions. Despite these problems, efforts to resolve problem institutions must continue. Delays would only increase the ultimate cost of resolution.

The sweeping changes currently reshaping the financial landscape will challenge both financial institutions and policymakers as we proceed with the resolution process and move forward in the changing financial structure. These unique and changing times increase the need to stay abreast of market developments and regulatory changes.

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In an effort to address the issues that confront financial institutions, the Federal Reserve Bank of Dallas and Southern Methodist University are sponsoring an open-forum discussion. The one-day conference, "Southwestern Banking in the 1990s: Resolution and Beyond," is scheduled for May 16. Sessions will feature presentations from banking leaders, real estate experts and regulatory representatives, along with audience participation. Main topics include managing through the resolution, the regulatory framework for the 1990s and market strategies beyond the resolution. Participants can expect a rigorous and informative discussion of the new opportunities and potential pitfalls facing the Southwestern financial industry.

China in Texas' Top 10 Export Markets

Despite U.S. trade embargoes imposed in the wake of the Tiananmen Square massacre, China continues to open its economy to foreign trade and to show great interest in purchasing Texas-made goods. China is one of Texas' top 10 export markets. In 1988, trade with China contributed $659 million to the state economy.

Chinese imports from Texas comprise only 2.4 percent of the total value of Texas exports, compared with 3.3 percent for Taiwan and 30 percent for Mexico. China tends to rely on Texas-made goods when its production requires levels of technology and capital intensity that China lacks. That is, China imports high-capital, high-skill production from Texas and makes low-capital, low-skill products for itself. Chinese purchases from Texas consist primarily of chemicals and allied products, but the country also is a major market for Texas agricultural products and industrial computer machinery.

Overall, chemicals rank third in Chinese import volume. Chemicals have long been Texas' principal world export product, accounting for about 27 percent of Texas' world exports in 1988. China uses Texas chemicals to produce agricultural and manufactured goods, as the country attempts to increase its agricultural production by adding chemical nutrients to the soil.

China is also expanding its output of consumer goods. China is the world's largest importer of polyolefin, often used in making artificial fibers, and Texas is China's primary source of this chemical. Because of Texas' role in chemical production, the Chinese have moved their petrochemical buying office from Beijing to Houston. In 1988, Texas exported nearly $337 million of chemicals to China, representing about 5 percent of the state's total chemical exports.

So far, however, China's attempts to use Texas-made chemicals in crop production have not made it agriculturally self-sufficient. The country sometimes relies heavily on food imports, many of which come from Texas. For example, 1988 brought large increases in the country's need for cereal grains. In 1988, Texas exported $182 million in agricultural production from Texas to China, compared with only $17 million the year before. Texas' agricultural exports to China in 1988 represented about 9 percent of its total agricultural exports.

China's third major interest in Texas products, industrial machinery and equipment, occupies a far smaller share of the state's exports of such products than chemicals do. In 1988, China's attempts to introduce more efficient productive processes included the purchase of more than $77 million of industrial and computer machinery that was exported from Texas. Chinese purchases represent about 1.7 percent of the state's total exports of these products. Texas also sent China $19 million in measuring, analyzing and control instruments, and $6 million in noncomputing electric and electronic equipment.

In sum, Texas' productive capacity and China's product needs make trade beneficial for both parties. Texas has technology and capital-intensive productive capacity. China not only lacks them, but also is likely to lack them for some time.

—David Hanna

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SOUTHWESTERN BANKING

in the 1990s:

RESOLUTION & BEYOND