# A SUMMARY OF THE OCTOBER 2015 SPECIAL LEGISLATIVE SESSION ON EDUCATION FINANCE

## A Report from the Office of the University Economist

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**SUMMARY OF SPECIAL LEGISLATIVE SESSION ON EDUCATION FINANCE**

- The entire education finance package is conditional, subject to voter approval in a special election on May 17, 2016.
- The package will last 10 years, from fiscal years 2016 through 2025.
- The estimated additional funding for elementary and secondary (K-12) education increases from $298.8 million in fiscal year (FY) 2016 to $400.3 million in FY 2025.
  - Of the $298.8 million increase for FY 2016, $74.4 million was already appropriated. Assuming that the $74.4 million would have continued in succeeding years and been adjusted for inflation, "new" funding from the package rises from $224.4 million in FY 2016 to $314.5 million in FY 2025.
- Most of the additional funding is due to a reset of the base level to $3,600 (per weighted student count) in FY 2016. In addition, supplemental funding (not incorporated in the base) will be $50 million per year for FYs 2016 through 2020 and $75 million per year for FYs 2021 through 2025.
- Most of the new funding will come from the permanent fund (land trust) — the new funding from this source is projected to rise from $172.1 million in FY 2016 to $216.1 million in FY 2021, then drop slightly. The balance of the new funding will come from the general fund, with the amount varying by year. The FY 2016 figure is $52.4 million; the range is from $31.5 million in FY 2019 to $106.5 million in FY 2025.
  - The distribution from the land trust will increase from the current 2.5% per year to 6.9% for FYs 2016 through 2025. The distribution reverts to 2.5% in FY 2026.
- Each school district has the option of using the additional funding for maintenance and operations or for capital outlays.
- Several "triggers" could reduce the amount of funding provided to K-12 education.
  - The base level inflation adjustment — which currently is the lesser of 2% or the inflation rate — will be suspended if economic growth slows beyond a certain rate. Economic growth is defined as (1) nominal growth in transaction privilege tax (TPT) revenues distributed to the general fund, measured as the calendar year total for the latest year, and (2) the December-to-December percent change in total nonfarm employment (seasonally adjusted).
    - If both TPT growth and employment growth slow to between 1-and-2%, the Legislature is given the discretion to suspend inflation funding.
    - If both TPT growth and employment growth slow to less than 1%, the inflation funding will be suspended.
    - Even if the inflation funding is suspended, the base level for the next year still will rise according to the formula.
  - A second trigger is activated if the balance in the land trust drops, as measured as the latest five-year calendar year average compared to the prior five-year average. If this trigger is activated, the Legislature may select a distribution of between 2.5% and 6.9%.
  - After FY 2025, a third trigger is a possibility.
    - If K-12 appropriations reach 49% of total general fund appropriations, the Legislature may suspend the annual inflation funding and may reduce K-12 funding by the amount of the prior year's inflationary adjustment.

- If K-12 appropriations reach 50% of total general fund appropriations, the Legislature may suspend the annual inflation funding and may reduce K-12 funding by twice the amount of the prior year's inflationary adjustment.

## Discussion

**Amount of Increase in K-12 Funding**

The new K-12 funding of $224.4 million in FY 2016 represents an increase of only 4% from the total of appropriated plus not-appropriated funding specified in the FY 2016 Appropriations Report.

For a perspective on how Arizona with the additional funding will compare on K-12 funding to other states, the latest K-12 finance data from the Census Bureau is used. In FY 2013, per pupil state and local government revenue for K-12 education was 42% less in Arizona than the national average and ranked 49th among the 50 states and the District of Columbia. Per student expenditures for current operations were 41% below average and ranked 50th.

Some argue that the per student measure is inappropriate since the "ability to pay" is so much lower than average in Arizona. For example, per capita personal income in Arizona in FY 2013 was 17 percent less than the national average. The ability to pay can be considered by measuring K-12 revenues and expenditures per student per $1,000 of per capita personal income. On this basis, Arizona's state and local government revenues for K-12 education were not as far below the national average in FY 2013, but Arizona had the lowest figure in the nation at 30 percent below the U.S. average. Current operations spending per student per $1,000 of per capita personal income in Arizona in FY 2013 was 29 percent below average and ranked 49th.

Even if funding in FY 2013 had been $400 million higher (the reported total effect of the education funding package in FY 2025), Arizona's K-12 funding relative to the nation and other states would have hardly changed, as seen in the following table.

**ELEMENTARY AND SECONDARY EDUCATION FINANCE IN ARIZONA, FISCAL YEAR 2013**

| | Per Student | | Per Student Per $1,000 of Per Capita Personal Income | |
|---|---|---|---|---|
| | Rank* | Difference From U.S. Average | Rank* | Difference From U.S. Average |
| State and Local Government Revenue | | | | |
| Actual | 49 | -41.8% | 51 | -29.6% |
| With Addition of $400 Million | 49 | -38.5 | 49 | -25.6 |
| Current Operations Expenditures | | | | |
| Actual | 50 | -41.1 | 49 | -28.8 |
| With Addition of $400 Million | 49 | -37.7 | 49 | -24.7 |

* Among 50 states and the District of Columbia, with the highest figure given a rank of 1.

Source: U.S. Department of Commerce, Census Bureau, Public Elementary–Secondary Education Finance, http://www.census.gov/govs/school/.

For Arizona to have matched the U.S. average on the per student per $1,000 of per capita personal income measure in FY 2013, an increase of $2.97 billion (43%) would have been needed based on state and local government revenue; based on expenditures for current operations, an increase of $2.81 billion (41%) would have been needed. For Arizona to have matched the U.S. average on the per student measure after adjusting for Arizona's lower cost of living (2.6 percent below the national average in FY 2013), an increase of $4.77 billion (69 percent) would have been needed based on state and local government revenue. The needed increase based on expenditures for current operations was $4.57 billion (67%).

**Triggers**

The inclusion of the triggers in the education finance package mean that K-12 funding from FYs 2016 through 2025 could be lower than projected. The trigger related to economic growth likely will be activated during the next recession. A historical analysis going back to the mid-1980s indicates that had this trigger been in place it would have been activated on a discretionary basis in FY 2003 — calendar year 2002 gains in both TPT revenue and employment were between 1-and-2%.[1] During the last downturn, a mandatory suspension of the inflation adjustment would have occurred in each fiscal year from 2008 through 2011 — the growth in each economic measure was less than 1% in four consecutive calendar years.

The probability of the trigger related to the land trust becoming effective is difficult to assess, being dependent on investment earnings and trust fund revenues in coming years. Since most of the new funding in the package comes from the land trust, activation of this trigger could result in a substantial reduction in K-12 funding.

According to the JLBC's baseline spending projections, K-12's share of general fund appropriations is unlikely to be close to activating the third trigger. The share would be lower if discretionary spending increases occur in other programs. On the other hand, if the Legislature were to pass significant additional tax cuts (for example, under a policy to eliminate the income tax), or if the next recession is deeper than expected, significant reductions in funding for other programs could occur over the next decade, raising the K-12 share high enough to activate the trigger.

**Future Decreases in Funding**

Without additional action being taken by the Legislature or by the electorate, two decreases in K-12 education funding will occur during the next decade. The first will occur in FY 2022 — the 0.6% sales tax dedicated to education that was passed by voters in 2000 expires in FY 2021. This is projected to result in a loss of $650 million for K-12 education. Even with the projected $372 million in additional spending resulting from the recent special session, the net loss in funding is projected to be $278 million in FY 2022. Then, when the funding package expires at the end of FY 2025, a loss of $400 million is projected.

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[1] The sum of retail sales and restaurant and bar sales was used as a proxy for calendar year TPT distributions to the general fund.