OHIO LEGISLATIVE SERVICE COMMISSION

Revised

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Fiscal Note & Local Impact Statement

Bill: H.B. 102 of the 132nd G.A.

Status: As Introduced

Sponsor: Rep. Brenner

Local Impact Statement Procedure Required: Yes

Subject: Revises the K-12 education funding system

State & Local Fiscal Highlights

- The bill provides a framework to replace the current state-local school funding system with a new state-funded system, provided that voters approve both (1) a constitutional amendment authorizing the state to issue obligations to refund outstanding school district bond debt (H.J.R. 3 of the 132nd General Assembly proposes such an amendment) and (2) a statewide ballot issue levying a new state property tax and simultaneously prohibiting school district tax levies.

State education aid formula and debt service costs

- Under the bill's framework, the state provides state education formula aid through a modified formula beginning in FY 2021. These formula payments may be used for both operating and capital expenses. In general, the proposed formula increases the per-pupil formula amount from $6,010 currently to $8,720, based on an analysis of FY 2017 state and local school funding sources and student enrollment, and distributes state funds on a per-pupil basis to the public or chartered nonpublic school that each student attends, with no local contribution.
- The modified state education aid formula is estimated to cost about $19.31 billion annually, based on FY 2018 student enrollment data. Due to the assumed influx of chartered nonpublic school students into the state funding system, the bill shifts a significant portion of formula funding from traditional and joint vocational school districts to chartered nonpublic schools.
- The framework also pays off outstanding school district bond debt using proceeds from general obligation bonds, maturing over 20 years, that the state will issue and service. GRF debt service costs on these bonds are estimated to be about $889 million annually.
- Combined, estimated state education formula aid and debt service on the school district debt refunding bonds totals $20.19 billion, based on FY 2018 data. This amount is about $721 million less than the FY 2018 sources of funding the bill replaces or modifies.

Revenue sources supporting the funding model

- The bill's framework prohibits all school district property and income tax levies beginning in tax year (TY) 2020 and supports the state's formula costs through a new state property tax, a dedicated state sales and use tax rate increase, existing lottery profits, and transfers of GRF funds.
- The new state property tax, levied at a gross rate of 20 mills, will generate an estimated $5.08 billion, based on TY 2016 statewide property values. Receipts from the state property tax will be deposited into the State Education Fund, which the bill creates to fund state education aid formula payments.
- The bill increases the state sales and use tax rate from 5.75% to 7.35% in 2021 and earmarks 21.8% of state sales and use tax receipts to the State Education Fund, with the remainder deposited to the GRF. Sales tax revenue to the State Education Fund is estimated to be $2.80 billion annually, based on FY 2018 data.
- The bill requires GRF transfers to support any remaining state education aid formula obligations each year after taking into account lottery profits appropriated for formula costs. If the system had been in place in FY 2018, the GRF would have needed to provide an additional $2.64 billion over current GRF and commercial activity tax (CAT) receipts dedicated to applicable school funding purposes to fully support the state education aid formula and debt service on the school district refunding bonds.
- The increase in the sales tax rate is assumed to lower the tax base and thus decrease sales tax revenue not credited to the State Education Fund by $153 million annually. This revenue loss would be shared by the GRF (96.68%), the Local Government Fund (1.66%), and the Public Library Fund (1.66%).
- Revenue from local permissive county and transit authority sales taxes, which share the state sales tax base, would decrease by $37 million annually.

School facilities projects

- The bill prohibits any additional school building project from being approved for state funding under any of the Ohio Facilities Construction Commission's school facilities assistance programs, effective January 1, 2021. Without a dedicated funding stream, the completion of many school building projects will likely be delayed.
- Presumably, the state would also cease issuing common schools general obligation bonds to finance the state share of school facilities projects. GRF-funded debt service costs on those bonds will decrease over time as current obligations are satisfied.

State assessments

- The bill requires all chartered nonpublic school students to take all state tests that are required for public school students under current law, beginning July 1, 2021. This provision may increase state testing system costs by up to $2.4 million per year. State tests are primarily supported by the GRF.

Detailed Fiscal Analysis

Overview of the bill

Under current law, the operating and capital costs of public K-12 schools are funded primarily with a mix of state revenues and revenues raised at the school district level. The state uses a foundation funding formula to distribute the bulk of its contribution. The bill provides the framework to replace the current state-local school funding system with a state-funded system in which the state provides most nonfederal school district funding through a modified state education aid formula starting in FY 2021. These formula payments may be used for both operating and capital expenses and are distributed on a per-pupil basis to the public or chartered nonpublic school that each student attends, with no local contribution. In turn, the bill's framework prohibits all school district property and income tax levies beginning in tax year (TY) 2020 and supports the state's formula costs through (1) a new state property tax, (2) a dedicated state sales tax rate increase, (3) existing lottery profits, and (4) transfers of GRF funds to support any remaining formula costs not funded by the previous three dedicated sources. In addition, the bill's framework pays off the outstanding bond debt of school districts using proceeds from general obligation bonds issued and serviced by the state.

However, the bill's provisions will not take effect unless Ohio voters approve two issues at the November 2019 general election: the creation of the state property tax and a constitutional amendment (proposed by H.J.R. 3 of the 132nd General Assembly) authorizing the state to issue bonds that would pay off outstanding school district bond debt. If the voters reject either the state property tax or the constitutional amendment, the current school funding system remains in effect. The following provides an overview of Ohio's current school funding sources and school district bond debt as well as the fiscal implications of the bill's school funding framework and other major provisions. The Fiscal Note generally uses FY 2018 data to illustrate the bill's potential effects on tax revenues and K-12 education funding.

Overview of current school funding sources

The operating and capital needs of Ohio's schools are financed by a variety of major state and local revenue sources, including local property and income taxes, state foundation aid (a portion of which is supported by lottery profits), and state school facilities assistance programs, among a number of others. The bill's financing mechanism would replace or significantly modify these sources, which total to an estimated $20.92 billion in FY 2018. Table 1 below illustrates the composition of these funds. Overall, state sources comprise $10.22 billion (48.9%). Of this amount, state foundation aid provides $8.23 billion (80.6%) for school districts, community and science, technology, engineering and mathematics (STEM) schools, and scholarships financed by transfers from the student's resident district. Most of the remainder is designated for property tax relief ($1.18 billion, 11.5%), school facilities ($337.5 million, 3.3%), property tax reimbursements for TPP tax losses ($201.1 million, 2.0%), and funding for chartered nonpublic school auxiliary services ($148.0 million, 1.4%). Local revenues produce $10.70 billion (51.1%). Local revenues are primarily comprised of property taxes (95.1%, excluding the portion of property taxes paid by the state) and school district income taxes (4.0%).

Table 1. Major State and Local Sources for K-12 Education Funding, FY 2018		
Source Components	**Amount (in millions)**	**Percentage of Source**
State Sources		
Foundation formula	$8,231.7	80.6%
Property tax relief	$1,180.1	11.5%
School facilities assistance (capital)*	$337.5	3.3%
Direct reimbursements for TPP tax losses	$201.1	2.0%
Auxiliary services for chartered nonpublic schools	$148.0	1.4%
Directly funded scholarships	$82.4	0.8%
Half-mill maintenance equalization	$18.7	0.2%
Community school facilities	$16.8	0.2%
Community school performance bonuses	$1.8	< 0.1%
TOTAL: State Sources	**$10,218.2**	**100.0%**
Local Sources		
Property taxes	$10,175.1	95.1%
Income taxes (FY 2017)	$426.0	4.0%
Payments in lieu of taxes (FY 2016)	$95.7	0.9%
TOTAL: Local Sources	**$10,696.9**	**100.0%**
TOTAL: All Sources	**$20,915.1**	

*School facilities assistance represents one-half of the applicable capital appropriations for the FY 2017-FY 2018 capital biennium.

Table 2 below displays current school district property tax collections in more detail. As the table shows, traditional and joint vocational school districts levied a total $11.36 billion in property taxes for TY 2016, which, due to the different calendars for tax years and state fiscal years, generally corresponds to the state's FY 2018. Most of these taxes, $9.96 billion (87.7%), were levied for operating purposes. The remainder was levied primarily to pay the debt service on outstanding school district bonds. Of the total amount levied, the state will pay an estimated $1.18 billion in FY 2018 to provide property tax relief under the 10% and 2.5% property tax "rollbacks" and the Homestead Exemption Program for the elderly and disabled.

Table 2. Traditional and Joint Vocational School District Property Taxes by Levy Purpose, FY 2018		
Levy Purpose	**Amount (in millions)**	**Percentage of Source**
Current expense (operating)	$9,955.5	87.7%
Debt service	$1,028.1	9.1%
Permanent improvements	$364.4	3.2%
Other	$7.2	0.1%
Property tax subtotal	**$11,355.2**	**100.0%**
State-paid property taxes	$1,180.1	
Locally paid property taxes	**$10,175.1**	

School district bond debt

Under the bill's school funding framework, the state will issue general obligation bonds to refund the outstanding bond debt of school districts. School districts owed $11.30 billion as of the end of FY 2015, the latest available data.[1] This amount is projected to grow to $13.23 billion by the end of FY 2018 based on a trend analysis of the outstanding debt reported each year from FY 2011 through FY 2015. If H.J.R. 3 is enacted and the constitutional amendment is approved by voters, the Treasurer of State must issue general obligation bonds, maturing over 20 years, to refund any school district bond debt outstanding as of the date of the 2019 general election. The annual GRF-funded debt service on the state bonds is estimated at $888.7 million based upon the national average 20-year municipal bond rate for AAA-rated municipal bonds, as of December 8, 2017, plus 1%, for a total of 3.60%.[2]

Analysis of proposed K-12 state education aid distribution formula

Overview of formula changes

The bill creates a new system of distributing state education formula aid to schools, effective January 1, 2021, where the state pays a specified amount per student that each student may use to attend the public or chartered nonpublic school of the student's choice, without the requirement of a local contribution. The bill repeals a current law requirement that formula aid only be used for operating expenses, meaning that such payments could also be used for capital expenses. Among the major formula changes, the bill:

- Increases the per-pupil formula amount from the current FY 2018 level of $6,010 to $8,720;
- Eliminates the state share index, a current formula component used to equalize payments based upon district capacity to raise local revenues;
- Eliminates targeted assistance and capacity aid, two other formula components tied to the variation in school district capacity;
- Excludes any funding guarantees or payment cap limitations;
- Replaces district-operated pupil transportation systems with countywide pupil transportation systems overseen by educational service centers (ESCs);

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[1] U.S. Census Bureau, 2015 Survey of School System Finances, Table 10. Indebtedness and Debt Transactions of Public Elementary-Secondary School Systems by State, accessible online at https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=SSF_2015_00A10&prodType=table.

[2] https://www.fmsbonds.com/market-yields/. One percent was added to the December 8, 2017 rate to ensure sufficient resources are available to pay the debt service should municipal bond rates rise in the future.

- Funds community and STEM schools directly rather than through transfers of state aid from the students' resident districts;
- Limits the opportunity grant payment for an e-school student to 70% of the per-pupil formula amount;
- Permits community and STEM schools (both site-based and e-schools) to receive gifted identification and unit funding and e-schools to receive per-pupil categorical funding for students who are limited English proficient, economically disadvantaged, and in grades K-3 (current law excludes such schools from these funding components); and
- Eliminates open enrollment, all state scholarship programs, and auxiliary services payments for chartered nonpublic schools.

Effective dates

The bill's effective date for its funding provisions is January 1, 2021. While it falls in the middle of FY 2021, it resolves timing issues created by the different calendars used for tax years and state and school fiscal years. Tax years are generally from January 1 to December 31, whereas state and school fiscal years are from July 1 to June 30. If the funding provisions became effective July 1, 2021 (the start of FY 2022), school districts would forego six months of local property tax revenue before the new funding system begins. A January 1, 2021 effective date implements the new funding system as local property tax collections cease.

The provisions eliminating open enrollment, all state scholarship programs, and other state funding for chartered nonpublic schools are delayed until July 1, 2021 to avoid disruption in the middle of the 2020-2021 school year.

Admission priority for resident district students

The bill generally permits each student to attend the public or chartered nonpublic school of the student's choice, with state education formula aid following the student. However, the bill requires a school district to maintain the necessary capacity to admit resident students. It also requires a school district to give first priority for admission to students who are residents of the district before admitting students who are residents of other districts.

Student transportation

The bill replaces district-operated pupil transportation systems with countywide pupil transportation systems overseen by ESCs, effective January 1, 2021. The bill pays the pupil transportation amounts calculated for school districts under the existing transportation formula, without the state share index applied, to the ESC that serves the county in which a majority of the district is located. Thus, we assume, in both current law and the bill, total transportation funding to be equal to the formula-calculated costs for Type I (board-owned and operated school buses) and Type II (contractor-owned and operated school buses) transportation plus formula costs for other types of transportation, payments to community schools transporting their own students, and the current formula's transportation supplement. These amounts total to $892.1 million in FY 2018.

Comparison of funding in aggregate

LSC simulated the effects of the bill on FY 2018 to compare its distribution with current law, controlling for the transfers of traditional school district state aid for community and STEM schools and scholarship programs. We assume current public and chartered nonpublic students remain in their educating districts or schools since we are uncertain about where students will attend school under the bill. Actual results may vary significantly as students and parents make use of the bill's expanded school choice provisions. Table 3 below compares our simulation of the bill to estimated K-12 education funding for FY 2018 under current law.

Table 3. K-12 Education Funding, Current Law vs. Bill, FY 2018 ($ in millions)				
School Type/Category	**Current Law**	**Proposed**	**$ Change**	**% Change**
Traditional districts (less transportation and debt service)	$16,894.2	$15,312.5	-$1,581.7	-9.4%
Joint vocational school districts	$685.3	$539.9	-$145.3	-21.2%
Community and STEM schools	$930.8	$1,080.1	$149.3	16.0%
Chartered nonpublic schools	$484.7	$1,480.9	$996.2	205.6%
Transportation	$892.1	$892.1	$0	0.0%
Debt service on school district bonds	$1,028.1	$888.7	-$139.3	-13.6%
TOTAL	**$20,915.1**	**$20,194.2**	**-$720.9**	**-3.4%**

As Table 3 shows, the bill's framework, including debt service, would cost an estimated $20.19 billion statewide if it was in place in FY 2018, an amount that is about $721 million less than applicable current sources. One factor to consider is that the bill's formula amount was determined based on an analysis of state and local school funding sources and student enrollment in FY 2017, the goal of which was to generate approximately the same total amount of state education formula aid as was received from the state and local sources the bill is replacing or modifying. However, overall state and local funding for schools is estimated to increase in FY 2018 while student enrollment is projected to fall somewhat, both of which combine to produce the overall imbalance indicated in the table.

Even so, Table 3 also shows that the bill shifts a significant portion of funding from traditional and joint vocational school districts to chartered nonpublic schools. Funding for chartered nonpublic students amounts to $1.48 billion under the bill, assuming all 170,000 or so students currently attending a chartered nonpublic school will be introduced into the state funding system. This amount likely understates state payments for these students, as, due to data limitations, it is based only on the funding generated by the per-pupil formula amount. Actual funding may be greater because such students will be supported by additional per-pupil amounts if they are identified as disabled, economically disadvantaged, limited English proficient, in grades K-3, and so on. Nevertheless, the projected funding for chartered nonpublic students represents an increase of $996 million from applicable state funding of $485 million for FY 2018.

On the other hand, public district funding decreases substantially. After controlling for transportation and debt service, proposed traditional school district funding is $1.58 billion (9.4%) less than current law, mainly because of the influx of new nonpublic students into the state funding system. Likewise, funding for joint vocational school districts decreases $145.3 million (21.2%).

Analysis of proposed K-12 education funding sources

State property tax

If the statewide ballot issue included in the bill is approved by Ohio voters, all school district property and income tax levies will cease in TY 2020[3] and, at the same time, a state property tax will begin to be levied at a gross rate of 20 mills to fund primary and secondary education.[4] When applied to TY 2016 statewide total taxable value of $254.04 billion, a tax rate of 20 mills raises $5.08 billion. The bill creates the State Education Fund to receive the proceeds of the state property tax and other dedicated sources of funding for the state education aid formula.

State property tax revenue will likely grow in future years, but not at the same rate as property values grow. The state property tax is subject to tax reduction factors, a tax policy enshrined in the Ohio Constitution that limits tax revenue growth on existing real property. When the value of existing real property increases, tax reduction factors reduce the effective tax rate so tax revenue on that property remains the same. However, tax reduction factors do not apply to new construction and tangible property; taxes on these two types of property will grow at the same rate property values grow. Thus, a 5.0% increase in real property value will generally lead to a smaller increase (1.0%, for example) in real property tax revenue for the state. Note that, unlike current law with respect to certain school district property tax levies, the state effective tax rate may fall below 20 mills. The bill, in prohibiting school district property taxes, eliminates the "20-mill floor" without enacting a similar provision for the state property tax.[5]

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[3] The bill continues to allow a school district to serve as the taxing authority for a "school district public library," a type of public library that shares the territory of the school district in which it is located. No public library system has the independent power to levy taxes. Their source of local tax funding is the taxing authority of a political subdivision. In this case, a school district board levies the tax on the taxable property of the district. However, the proceeds are paid to the treasurer of the board of library trustees.

[4] The bill's framework would prohibit school districts from levying both voted and unvoted ("inside") mills. The bill prohibits inside millage currently allotted to school districts from being allotted to any other subdivision or taxing unit even if the total of the minimum levies is less than otherwise allowed under the ten-mill limitation.

[5] The 20-mill floor refers to a provision of current law that prohibits a school district's combined real property millage from current expense levies and inside mills for operating expenses from falling below 20 effective mills. Once the combined real property millage falls to 20 effective mills, tax reduction factors no longer apply. Real property taxes based on these 20 mills will grow at the same rate as real property values grow.

State sales and use tax increase

The bill increases the state sales and use tax rates on January 1, 2021, from the current 5.75% to 7.35% and earmarks 21.8% (that is, the percentage point increase divided by the new rate, or 1.6% / 7.35%) of the revenue generated from the tax to the State Education Fund. The bill credits the remainder of state sales and use tax receipts (78.2%) to the GRF, which currently receives 100% of such tax proceeds.

The sales tax rate increase is estimated to provide the State Education Fund with $2.80 billion annually, based on FY 2018 data. LSC assumes the increase in the state sales and use tax rate will decrease the tax base somewhat, leading to a decrease in the portion of state sales tax revenues not credited to the State Education Fund of $153 million. Ultimately, the GRF would bear 96.68% of this revenue loss from the state sales and use tax, while the Local Government Fund (LGF) and the Public Library Fund (PLF) would each bear 1.66%; funds in the LGF and PLF are for distribution to counties, municipalities, townships, and public libraries. Thus, sales tax revenue to the GRF would decline by up to $148 million annually, and distributions to the LGF and PLF would be reduced by a total of about $5 million annually.

The bill will also reduce the tax base for permissive county and transit authority sales taxes. Those local taxes share the state sales and use tax base. The potential revenue loss to local governments from local sales taxes would be up to $37 million annually, again based on FY 2018 data. Thus, total tax annual revenue losses for local governments, including reduced LGF and PLF distributions, may be up to $42 million.

Lottery profits and GRF resources

The bill continues to use lottery profits to support a portion of state education aid formula costs. Based on FY 2018 lottery-supported foundation formula and community schools facilities appropriations, lottery profits contribute $1.10 billion to the plan. If the total amount in the State Education Fund, when combined with lottery profits, is insufficient to make the payments required for the state education aid formula, the bill requires transfers from the GRF to make up the difference. Based on FY 2018 data, the GRF's share of the $20.19 billion in estimated state education formula aid and debt service costs would be $11.21 billion, as shown in Table 4 below. In FY 2018, the GRF and commercial activity tax (CAT) receipts dedicated to school district TPP direct reimbursements[6] combine to fund $8.57 billion of the $20.92 billion described in Table 1 above. Therefore, an additional $2.64 billion from the GRF would need to be allocated to K-12 education to fully fund the bill's framework.

[6] The bill redirects to the GRF the portion of CAT receipts dedicated to funding the reimbursements.

Table 4. Proposed State Education Formula Aid and Debt Service Sources (FY 2018)		
Levy Purpose	Amount (in millions)	Percentage of Source
State property tax @ 20 mills	$5,080.8	25.2%
State sales tax increase	$2,800.0	13.9%
Lottery profits	$1,102.9	5.5%
Dedicated sources subtotal	**$8,983.7**	**44.5%**
Remainder – GRF	$11,210.5	55.5%
TOTAL	**$20,194.2**	**100.0%**

School facilities projects

The state currently provides capital funding for school facilities assistance through a variety of programs. Most such funding for school districts is provided through the Classroom Facilities Assistance Program (CFAP). CFAP funding is based on each district's relative wealth. Lower wealth districts are funded before higher wealth districts and receive a larger percentage of their total project funding from the state. As of the end of FY 2017, 137 districts (21%) had not yet been offered funding and another 131 (20%) had been offered funding but had not yet accepted it.[7]

The bill prohibits any additional school building project from being approved for state funding under any of the school facilities assistance programs overseen by the Ohio Facilities Construction Commission (OFCC), effective January 1, 2021.[8] Projects in progress at that time will continue to receive state funding. Without a separate funding stream for school facilities assistance, it appears that school districts will need to pay for future capital needs out of the resources distributed through the state education aid formula, likely delaying the completion of many school building projects.

State costs for school facilities assistance are primarily supported by the issuance of common schools general obligation (GO) bonds, the debt service for which is paid by the GRF. It appears that the state would cease issuing GO bonds for this purpose in future years as a result of the bill. Thus, the debt service costs on those bonds would decrease over time as current obligations are satisfied. As a point of reference, the Treasurer of State reports that the state's outstanding principal on common schools GO bond debt totaled $2.57 billion as of December 31, 2016. If no further bonds are issued, these obligations would be fully retired by the end of FY 2035. H.B. 49 of the 132nd General Assembly appropriates $376.1 million from the GRF in FY 2018 for debt service on the bonds.

[7] Districts must raise the local share of their project costs before accepting the state funding offer.

[8] The bill abolishes the School Facilities Commission (SFC) and transfers its powers, duties, and staff, with respect to in-progress, state-funded school building projects, to OFCC. However, the bill was introduced prior to the enactment of H.B. 49 of the 132nd General Assembly, which abolished the SFC and transferred its responsibilities to OFCC.

State achievement tests

Beginning July 1, 2021, the bill requires all chartered nonpublic school students to take all state achievement tests that are required for public school students under current law. This will increase state testing system costs, which are primarily funded by the GRF. Subject to certain exceptions, high school students attending chartered nonpublic schools must already take state tests that comprise a portion of the high school testing system, including a national college admissions test (either the ACT or SAT) and seven end-of-course exams. Therefore, the primary cost of this provision is likely to be the administration of the state tests to elementary students at chartered nonpublic schools. Based on a headcount of chartered nonpublic students in grades three to eight in attendance during the first full week of classes in October 2016 and the state's current cost per content test of $13, this provision may increase state testing costs by up to $2.4 million annually. However, the cost could be less depending on the number of students in grades three to eight and attending a chartered nonpublic school through a state scholarship program, who generally must take all state tests under current law.

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