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Jon Sonstelie, UC Santa Barbara and Public Policy Institute of California

California's school finance system is complex. State funds flow to school districts through many channels, each with its own rules and regulations. Although each channel has its rationale, the net effect is a system that is unnecessarily opaque and too restrictive.

A better system is easy to visualize. It would start with the basic question of what resources a typical school needs to achieve the outcomes expected by the state, would determine the cost of those resources, and then allocate funds to school districts according to those costs. Districts would be free to make their own resource choices, taking advantage of local knowledge. The state would monitor outcomes, not input choices.

This system would be flexible and transparent. School districts could employ funds as they saw fit, and the system would be clearly based on the resources a school needs to achieve specified outcomes. There would be a vigorous debate about resource needs and about how those needs vary with the characteristics of schools and their students. That debate would surely produce a complicated formula for allocating funds. It is hard to imagine, however, that the formula would be more complicated than the current system.

Although California could do better, it is not clear that it will. The legislative body that would need to enact a new system is the same body that created the current one. Why would it do anything differently? This question points to a deeper line of inquiry--why did California end up with the system it has? Are there fundamental forces that drove the system to its current state? If so, it might be more productive to focus efforts on those forces, to cure the disease instead of treating the symptoms.

These are not questions to which much objective evidence can be brought, but they are questions that we should consider. I would answer them in the following way: The root of the system's problems is that California has centralized finance and decentralized governance—state finance and local governance. The two systems do not mesh, and the state needs to either centralize governance or decentralize finance. In particular, California needs to either re-establish a significant source of discretionary local revenue for school districts or eliminate local school districts.

California has local governance in the sense that voters in each school district elect school board members who approve district budgets and hire key personnel. California has state finance in the sense that the Legislature determines the funds every school district receives. Although the property tax is collected locally, the state determines the property tax rate and the allocation of property tax revenue.

State finance is incompatible with local governance for a simple reason. Because the Legislature determines school district funds, it has a natural interest in how those funds are spent. But local school boards decide school district budgets. The Legislature is then left with the difficult task of indirectly influencing those decisions by the way it allocates funds to districts. The result is usually a complicated categorical program delineating how a certain sum of money can be spent. The program allocates funds to over 900 school districts, each with its own unique environment. Inevitably, in some districts it provides funds for resources that the district views as low priority, and the district sees the program as restrictive and wasteful. Some of these cases may come down to a disagreement about values, the Legislature valuing some uses differently than the local school board. But in many others, it is likely to come down to knowledge about local conditions. The value of a particular use of funds depends on the environment in which it is applied, and local school boards may know more about the environment in their districts than does the Legislature. Even though a school board may share the Legislature's values, its local knowledge may lead it to employ resources differently than would the Legislature.

A good example is California's K-3 class size reduction program. In 2006-07, the program provided districts $1,024 for each K-3 student in a classroom with 20 or fewer students. Some districts would have chosen K-3 class sizes close to 20 students without the program, so the 20 student requirement is not particularly restrictive. Other districts would have chosen larger class sizes, however, and the reward for reducing class sizes barely covers the cost. Can it be that the former districts have little need for state direction, but the latter do? Perhaps, but it seems unlikely that 20 students is an essential class size that should be achieved regardless of its cost.

Described that way, the K-3 class size reduction program perfectly illustrates the inefficiency of state categorical programs, a one-size-fits-all approach that ignores differences among districts. The program's history illustrates another point, however. The program was initiated in 1996-97. The first half of the 1990s were not good times for California public schools. The recession of the early 1990s adversely affected state revenues and thus the funds allocated to public schools. From 1989-90 to 1994-95, real spending per pupil in California fell by 10 percent. The number of teachers per student fell by 5 percent, and real teacher compensation also fell by 5 percent. The economy began to rebound in 1995, and state revenues improved. Proposition 98 dictated a significant increase in public school spending, approximately $2 billion. Governor Pete Wilson proposed that about half that increase be allocated to reducing class sizes. In a few short months, the K-3 class size reduction program was proposed and enacted by the Legislature.

As a result of that program and subsequent actions, the number of teachers per pupil increased dramatically in the last half of the 1990s. By 1999-2000, the ratio of teachers to pupils was 10 percent higher than in 1989-90. The dramatic increase in the number of teachers did not leave much money for increasing teacher salaries. Real teacher salaries were higher in 1999-2000 than in 1994-95, but they were still below the level of 1989-90.[1] If the Proposition 98 increase had been allocated entirely to increasing the unrestricted funds of districts, a larger portion of it would have surely gone to increasing teacher salaries and less would have gone to increasing the number of teachers. Indirectly, therefore, K-3 class size reduction was a bit of high-level collective bargaining by the state. It imposed on school districts a different allocation of funds than they would have chosen through their own collective bargaining processes. From that perspective, the program may be seen as resulting from a difference in values between the state and local school districts.

California may witness another conflict in values as the Legislature grapples with the resource implications of the state's new standards for student achievement. The standards are high, and the same standards apply to every school. Student achievement, however, is strongly correlated with family income, suggesting that schools serving low-

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[1] For details, see Rose, Sonstelie, Reinhard, and Heng, *High Expectations, Modest Means: The Challenge Facing California's Public Schools*, Public Policy Institute of California, 2003, Chapter 6.

income communities may need additional resources. The logical response is to direct more funding to school districts with high proportions of low-income students, expecting that districts would allocate these funds to schools serving low-income communities. But school board members represent many constituencies and favoring low-income schools over other schools is a difficult political proposition. Recognizing those political pressures, the Legislature is likely to mandate that the additional funds be spent on low-income schools, which would require an elaborate accounting exercise and elicit more complaints from school districts about restrictive categorical programs.

An alternative approach is to allocate funds to districts and hold them accountable for the outcomes. That is, allocate additional funds to school districts for the low-income students they serve, allow districts to use those funds as they see fit, but hold them accountable for student achievement in all schools, including those serving low-income communities. This approach may be good in theory, but how exactly does the state hold districts accountable? The obvious answer is to reward administrators who are successful in meeting state expectations and to dismiss those who are not. Provided with those incentives, administrators would direct resources to the schools in greatest need of improvement. But the hiring, compensation, and dismissal of school district administrators is the province of local school boards, and they may be more interested in the equitable distribution of resources across schools in their districts than in concentrating resources in areas of greatest need.

The difficulty the state now has in holding districts accountable for outcomes points to one way in which finance and governance could be aligned: Centralize governance by eliminating local school boards and school districts. Under centralized governance, the public school system would be one large department of state government. Schools scattered throughout the state would be organized into regions. Regional headquarters would provide many of the services currently provided by school districts, such as transportation, maintenance, and personnel that require a large scale to be efficient. Most importantly, regional managers would hire, promote, and dismiss school administrators and allocate their budgets among schools in their regions. In turn, the regional mangers would report to the Superintendent of Public Instruction, who would hire, promote and fire regional managers and allocate the state budget among regions. In this system, resource choices would be decentralized and the allocation of funds among schools would be flexible. At each stage of the budget allocation process, the manager in charge could take account of the unique situations of lower units. Information about resource needs would flow up the chain of command, and funds would flow down in response. There would be no need to write complicated rules about the allocation of funds as in the current system. Rules would be replaced by discretion, and decision makers would be accountable for outcomes. Under centralized governance, collective bargaining would be centralized, obviating the rationale for the type of indirect collective bargaining exemplified by K-3 class size reduction.

While centralized governance has certain advantages over the current situation, it flies in the face of a cherished notion: public schools as our most local form of government. In most parts of the country, residents still vote on the property tax rate their school districts levy. While school districts still receive significant support from the state, the school finance systems in other states tend to be simpler and more coherent than California's. Their school finance systems tend to be aimed more at balancing the fiscal playing field across districts than at dictating how public schools spend their money. Could that work in California? If local school districts had more authority to raise tax revenue, would the Legislature be less inclined to dictate how public schools spend their funds?

The main argument for an affirmative answer is that a discretionary source of local revenue removes some pressure on the Legislature to address every need of local school districts. As the system currently exists, the only real source of additional funds is the Legislature. School districts argue for more funds by identifying an “important need”. The Legislature responds by creating a program to address that need, and another restrictive categorical program is created. If instead, local school districts had a discretionary source of revenue, they would tend to turn to local taxpayers for additional funds. Needs would differ from district to district, and voters could judge those needs on a case-by-case basis. Voters would have more interest in school board elections, and school board members would face more scrutiny about the wise use of funds.

These arguments for local finance are well known. But could California re-institute local finance given the constraints of Proposition 13 and *Serrano v. Priest*? One possibility turns the current system on its head. Under the current system, all property in California is taxed at 1 percent of assessed value, the Proposition 13 limit. The revenue from each parcel flows to the local governments serving that parcel in accordance to a formula established by the Legislature. In the case of school districts, the state then supplements that property tax revenue with unrestricted state aid so that every school district receives about the same per-pupil allocation of unrestricted funds (property taxes plus unrestricted state aid). Because the property tax rate and allocation are fixed in advance, the discretionary funds come from the state. Suppose California were to turn that system around so that the state provided the fixed amount and local school districts provided the discretionary funds? The state would allocate a certain base grant to every school district, perhaps $4,000 per pupil. School districts could then supplement that grant with property tax revenue. The 1-percent tax rate limit under Proposition 13 would be split into two parts: one limit for school districts and one limit for other local governments. School districts could levy a rate of up to, perhaps 0.5 percent, and other local governments could levy a rate of up to 0.5 percent. School district levies would be subject to regular referenda.[2]

This system would not satisfy the ruling of the California Supreme Court in *Serrano v. Priest*. To satisfy the Court, the Legislature would also have to neutralize the fiscal playing field among school districts. It would have to ensure that the same property tax rate would yield approximately the same revenue per student in different school districts. It could do this with a guaranteed base program that would match the property tax revenue in districts with low assessed value per pupil.

The Legislature would still face pressure to increase the base grant, but it would also have a good indication of the willingness of taxpayers to spend tax dollars on public schools. If almost all school districts pass tax rates at or near their upper limit, the Legislature would have a clear signal of the willingness of taxpayers to support their schools, a signal to which it could respond by increasing its base grant. On the other hand, if few districts were taxing at their upper limit, the Legislature would have a ready response to those seeking to increase state funds for public schools.

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[2] This system is described in more detail in "Is There a Better Response to Serrano," *School Finance and California's Master Plan for Education*, Public Policy Institute of California, 2001.