Options for Reducing State Funding of Alaska's Schools

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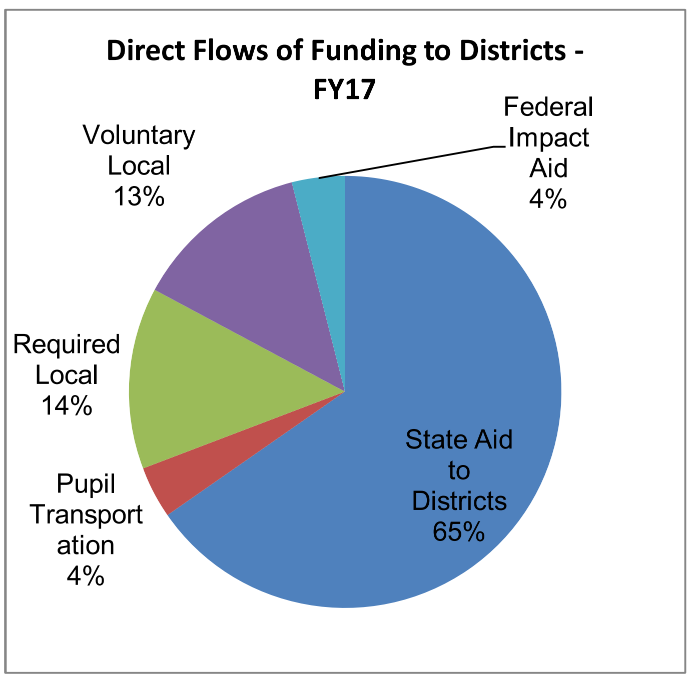
The State of Alaska funds school districts both directly and indirectly. Counting direct costs only, Alaska ranks second in the nation for the State share of K-12 spending per student. Because there are multiple flows of funding, there are numerous levers the State could pull to reduce its spending on K-12 education. Each has a different impact, and each has pros and cons.

Direct Flows of Funding to Districts

Foundation Formula

The largest source of funding to Alaska's school districts is the state's foundation formula. This formula sets a Base Student Allocation (BSA) in statute, and multiplies the BSA by a variety of statutory factors—including student count—to arrive at Basic Need. Basic Need refers to total statutory funding and is paid via several sources:

1. **The Required Local Contribution**, which for most districts is set at 2.65 mills on real property value – this is estimated to be $252.0 million in FY18;[1]
2. **Deductible Federal Impact Aid**, which is the portion of federal impact aid to districts that the State is allowed to deduct from its share of the formula (see more discussion of this topic in a subsequent section) – this is estimated to be $73.6 million in FY18; and
3. **State Aid**, which pays the rest and is estimated to be $1,217.3 million in FY18.



The legislature can alter funding to districts—both total funding and the amount allocated to various districts—

[1] Some districts are capped at 45% of Basic Need for the preceding year because of unusually high property values relative to population. This currently applies to districts in the North Slope, Skagway, and Valdez.

by passing legislation that changes:

1. the BSA,
2. the factors in the formula, or
3. the required level of local contributions. (Note that State aid decreases one dollar for every additional dollar of required local contributions.)

The legislature can also simply under-fund the foundation formula, which results in the shortfall being pro-rated to districts according to basic need.

Voluntary Local Contributions

In addition to required local contributions, municipal governments can contribute an additional amount of up to 23% of basic need.[2] Few local governments contribute up to the cap, but nearly every organized community pays more than the required local contribution. In FY17, districts are budgeting $245.7 million of voluntary contributions.

Pupil Transportation

Most districts receive additional funding from the State that is designated for pupil transportation.[3] This is a statutory formula, but is subject to appropriation. In FY18, this formula is estimated to pay $79.0 million.

Indirect Flows of Funding to Districts (Excluded from National Rankings)

Teachers Retirement System (TRS) Payments on Behalf of Districts

TRS, like Alaska's other public pension plans, has an unfunded liability that pushes employer contribution rates up substantially. The State capped school districts' contributions to TRS at 12.56% of TRS payroll, which is less than half of the total rate required to adequately fund the retirement system. Everything above the cap is paid by the State. In FY18, the State will contribute about $111.8 million to TRS on behalf of school districts.

If the legislature raised the cap on TRS employer contributions, costs would be shifted from the State to school districts.

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[2] The districts with the alternate funding cap also have an alternate voluntary local cap of 2 mills.

[3] Districts that do not operate systems of pupil transportation do not qualify. In FY18, 48 of Alaska's 53 districts will receive pupil transportation funding. Districts may use foundation formula funding to pay for pupil transportation, or may use transportation funding in the classroom.

School Debt Reimbursement

Statutes call for the State to reimburse municipal governments for up to 90% of their debt service for school construction and major maintenance, subject to appropriation. This program is currently closed to new projects through FY21. In FY18, the State's portion of municipal debt service is expected to be about $116.0 million.

If the State reimbursed less than the statutory amount, municipal governments could either absorb the cost increases or pass the costs on to school districts by reducing voluntary local contributions.

Regional Education Attendance Area (REAA) Fund

As part of the *Kasayulie* settlement, the State capitalizes the REAA fund at a percentage of what is spent on School Debt Reimbursement. The REAA fund is then spent on school construction and major maintenance in unincorporated areas. In FY18, the State's deposit to the fund is expected to be $40.6 million.

Options for Reducing State Funding

The principal options to reduce State costs associated with K-12 schools are:

1. Reducing the statutory BSA;
2. Underfunding the foundation formula, causing a one-time reduction to be spread in proportion to Basic Need;
3. Increasing the TRS contribution rate cap;
4. Increasing the Required Local Contribution, either by eliminating required property tax exemptions or by raising the rate above 2.65 mills;
5. Reducing appropriations for school debt reimbursement; or
6. Reducing factors that are multiplied by the BSA to arrive at Basic Need.

Option 6 would require extensive research to avoid creating unintended consequences. This paper addresses options 1-5.

Options 1 and 2 (Formula Funding)

Reducing the BSA and underfunding the Foundation Formula produce nearly identical results in a single year. The main difference is that reducing the BSA requires a statutory change, and would reduce the funding baseline going forward. Underfunding the formula could be done through the budget process, but it would have only a one-time impact; continuing to reduce funding would require continually underfunding the statutory formula.

Reducing the BSA would directly reduce State aid to schools. It would also reduce the maximum amount that communities could voluntarily contribute to schools by the same percentage as the reduction to the BSA. Options 1 and 2 would likely reduce voluntary local contributions from some communities that fund near the cap. In FY17, five districts fund within 5% of the cap: Anchorage, Denali Borough, Kenai Peninsula Borough, Unalaska and Yakutat.[4] If the BSA is reduced, these districts could lose local contributions in addition to losing State aid.[5]

Reducing the BSA or pro-rating the foundation formula would affect all districts. Generally, rural districts (which rely more heavily on State funds) would be the hardest hit, while urban districts (which generally receive more money from local governments) would see a smaller relative impact.

Regarding the BSA's indirect impact on voluntary local contributions, the impact would be limited to the five communities that contribute at or near the cap. The bulk of the impact would be in Anchorage, which is not only the largest district, but also funds to the cap. A formula reduction that reduced State aid to Anchorage schools by $20.2 million could cost the school district an additional $4.6 million in local contributions.

Option 3 (TRS Funding)

Increasing the TRS rate would require a statutory change. Generally, urban districts spend a larger percentage of their budgets on employee salaries so would see a larger percentage cost impact than rural districts.

Basic need—and the cap on local contributions—would not be affected by a change in TRS contribution rates, making this the least complicated of the options. Impacts would be limited to the school districts and the State: for every dollar increase in district costs, the State would save a dollar of retirement payments on behalf of school districts.

Option 4 (Local Contributions)

There are two ways to increase required local effort:

1. mandated property tax exemptions could be made optional or
2. the mill rate could be increased from 2.65.

This may be the most complicated of the options. Increasing contributions required from local governments would definitely reduce State costs, but the impact on local governments, local tax payers and school districts is unpredictable:

[4] Excluding the districts with the alternate funding cap, which are unaffected by this provision.
[5] Whether the voluntary cap would be affected if the formula were under-funded is a subject of debate. Legislative Legal and the Department of Law have issued contradictory opinions on the matter.

1. A community could retain property tax exemptions and reduce voluntary contributions to offset the increase in required contributions, thereby shifting the impact to the school district.
2. A community could choose to tax all or a portion of newly taxable property, potentially increasing revenue and increasing voluntary contributions to schools.
3. An increase in required local contributions could reduce voluntary local contributions, thereby shifting the impact to the school district.

Option 4 would not affect the twenty REAAs; only communities with taxing power would be affected.

Currently, local governments are mandated by the State to exempt (from property tax) the first $150,000 of residential property owned by seniors and disabled veterans. Some communities exempt higher values. The mill rate for schools is applied only to taxable property, so removing the mandated exemption would increase required local effort (and reduce State aid by the same amount). In FY15, removing the mandated exemption could have increased the local share of school costs by $13 million.

Increasing the mill rate would shift $9.5 million in support costs from the State to local governments for each 10 point increase in the mill rate. Two facts put the State/local share of costs in perspective:

1. Alaska ranks fifth among states in the share of education funding from State versus local sources. Alaska pays about 76% of combined state and local K-12 costs and the national median share is 56%.
2. Until FY02, the mandatory local contribution rate was 4 mills. Returning to the "traditional" 4 mill local contribution would shift $128.4 million in K-12 costs from the State to local governments.

Raising the required local contribution to 4 mills would move Alaska from fifth place to seventh place—with a 71% State share of education funding (assuming no change in voluntary local contributions). To reach the median share, Alaska would have to shift about $450 million to local governments. That would require a mandatory local tax rate of about 7.6 mills for education.

Option 5 (School Debt Reimbursement)

Reducing reimbursement for municipal school debt would not directly affect school districts—municipalities are responsible for debt service. However, municipalities faced with higher payments for school debt may opt to reduce voluntary contributions to school districts.

School debt is linked (by a statutory formula) to State spending on construction of schools in the REAAs. If debt reimbursement is reduced, statute indicates that the deposit to the REAA fund should be reduced as well.

Comparison of Impacts on Select Districts

The spreadsheet below shows the impact of reducing State funding by $50 million via a

1. $50 million reduction via a BSA cut,
2. TRS employer rate increase shifting $50 million from the State to school districts, and
3. required local contribution increase of $50 million.

District	**Options 1 & 2** (BSA/PEF Reduction)	% of Basic Need	**Option 3** (TRS Rate Increase)	% of Basic Need	**Option 4** (Increase Required Local Effort)	% of Basic Need	**Option 5** (Reduce Debt Reimburse-ment)	% of Basic Need
Anchorage	$14,541,861	3.3%	$17,269,404	3.9%	$21,385,370	4.9%	$19,132,480	4.3%
Mat-Su	$6,570,009	3.3%	$6,287,312	3.2%	$5,777,146	2.9%	$10,081,893	5.1%
Fairbanks	$5,054,350	3.3%	$5,041,161	3.3%	$5,866,614	3.8%	$5,150,321	3.4%
Kenai Peninsula	$3,504,323	3.3%	$3,373,679	3.2%	$5,323,057	5.0%	$1,177,697	1.1%
Juneau	$1,712,810	3.3%	$1,817,743	3.5%	$2,736,262	5.3%	$4,820,182	9.3%
Bering Strait	$1,402,586	3.3%	$918,227	2.2%	$0	0.0%	$0	0.0%
Iditarod	$217,361	3.3%	$142,780	2.2%	$0	0.0%	$0	0.0%
Craig	$173,039	3.3%	$141,870	2.7%	$85,042	1.6%	$0	0.0%
Saint Mary’s	$120,057	3.3%	$65,166	1.8%	$17,069	0.5%	$0	0.0%

Disparity and Federal Impact Aid

One complicating factor for any change to school funding is the federal disparity test. The federal government allows the State to deduct 90% of allowable impact aid from the amount the foundation formula allocates to school districts.[6] This reduces the State’s cost by $73 million per year. However, the State is allowed to deduct federal impact aid only if it has an equalized formula in accordance with federal law. Impact aid is paid to districts based on federal property or Alaska Native lands that are exempt from property tax. The amounts vary widely between districts: in the Mat-Su, no impact aid is deducted, but in Lower Kuskokwim, $14.9 million is deducted.

[6] The state may not deduct impact aid given for children with disabilities, construction funding, and heavily impacted districts (which in Alaska is only the Annette Islands School District). It also cannot deduct 1/5 of funding given for children on Indian lands. Of the remaining amount, impact aid for municipal school districts is multiplied by the percentage of required local contributions divided by actual local contributions (this step is not done for REAAs because they have no local effort). The state may then deduct 90% of that amount.

Each year, the Department of Education performs the Disparity Test, which compares high- and low-funded districts to each other. If the funding differential is less than 25% per student (based on adjusted average daily membership), the formula is considered equal and the State is allowed to deduct the $73 million. This is the reason for the 23% cap on voluntary local effort–it is intended to ensure disparity does not exceed 25%.

If the State fails the disparity test, the formula would not be considered equalized, the State would owe districts $73 million, and Alaska could not deduct federal impact aid again until the State's education funding system is re-certified by the federal government. Since the disparity test is performed after the fiscal year is over, this would mean that the State would owe that $73 million for several years. For example, if the State failed for FY18, the results would be determined in FY19, and the State could not get recertified until at least FY21. In that case, failing the disparity test would cost the State at least $220 million.

Despite the 23% cap, the State is constantly at the risk of failing the disparity test because some of the funding that goes to districts is not accounted for by the cap (such as federal e-rate funding and earnings on investments). Changes to state funding or federal e-rate awards could cause the state to fail the test.