

Dollars Diverted: Taking a Hard Look at Education Finance Reform in New Hampshire

By Brian Gottlob and Daphne Kenyon

Prepared for

THE COMMITTEE FOR
Sensible School Funding



www.nhcommonsense.com

January 2005

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EXECUTIVE SUMMARY

Most of the new state general education aid dollars since 1999 have been channeled to non-educational purposes or to middle and high-income towns. In light of the projected state budget deficit, policymakers need to seriously consider how our education aid dollars are used and where they are needed most. Increasing state general education aid without fixing the education aid system will only waste scarce state revenues.

The Study

It has been over five years since New Hampshire's landmark education funding law was enacted, leading to the biggest tax increase in the state's history. This study focuses on state general education aid provided by the state to local governments.

In 1999, state education aid quadrupled from \$97 million to \$407 million, and increased almost every year thereafter. State education aid was not even cut in the wake of the 2001-02 national recession and resulting decline in state revenues. State education aid is scheduled to increase 12 percent next fiscal year to a total of \$508 million.

Five years of data are now available from the New Hampshire Department of Revenue Administration to analyze:

- How did the new state education aid money affect local budgets?
- Which towns benefited from the increase in state education aid?

The Findings

Less Than 40% of New State Education Aid Was Used to Educate NH Students. Over the five-year period from FY99-00 to FY03-04, the state sent \$1.65 billion to local governments in additional state education aid. Only 39 percent of these funds were used to increase education spending. The remainder of the additional funding spurred additional municipal or county spending or tax relief. Over the five-year period, state education aid used for municipal spending increased the fastest while state education aid used for tax relief declined to nearly zero.

In FY03-04 Nearly \$150 Million of State Education Aid Was Used on Municipal or County Spending. In the latest year for which data are available, nearly \$150 million of the new state education aid dollars were used for additional municipal or county spending, with municipal spending accounting for \$111 million of the total. This means that over a two-year period, the amount of state education aid used for non-education purposes is around \$300 million – the size of the projected state budget deficit.

Before Claremont, Education Aid Was Highly Targeted to Low-Income Towns.

Before the new education funding law was enacted, low-income towns, accounting for 15 percent of the state's K-12 public school students, received 37 percent of state general education aid.¹

After Claremont, Middle and High-Income Towns Received the Largest Percentage Increases in State Education Aid. Middle and high-income towns received the highest percentage increases in state education aid under the new law while low-income towns received the lowest. State education aid for low-income towns increased from \$36.1 million in FY98-99 to \$98.5 million in FY03-04; for middle-income towns the increase was from \$57.7 million to \$322.5 million; for high-income towns the increase was from \$3.2 million to \$30.5 million. In FY03-04, low-income towns received only 22 percent of the total state general education aid, compared with 37 percent before Claremont.

¹ For the purposes of this study, low-income towns are towns in which personal income per capita of residents is at least 20 percent below the state average. High-income towns are towns in which personal income per capita is at least 20 percent higher than state average. The rest of the towns are considered middle-income towns.

Dollars Diverted: Taking a Hard Look at Education Finance Reform in New Hampshire

In response to the New Hampshire Supreme Court's *Claremont* rulings, the state enacted a new system of state general education aid (state aid or state education aid) in 1999, and the amount of state aid to local governments increased dramatically. This new education aid program prompted the largest state tax increase in New Hampshire history.²

Five years later, it is sensible to ask: What has been the impact of this major new state expenditure? It is beyond the scope of this project to determine whether more New Hampshire children receive an adequate education under the new system of "adequate education grants."³ But we address an important related question: How much additional local spending on education has taken place? This research also examines how much state education aid was increased and which communities have benefited most financially from the state aid program. Finally, the research examines whether low, middle, or high-income communities increased education spending in response to the new state education aid program. As explained below, statewide property taxes retained locally are not considered in this report; the focus is on direct state general education aid to local governments.

State Education Aid Quadrupled in 1999

Although the amount of state general education aid increased dramatically in FY99-00, the true increase is less than the reported increase. In FY98-99, the state sent \$97.1 million in general education aid to New Hampshire's communities.⁴ In FY99-00, the state's required financial contribution to K-12 education for all public school children was estimated

² This was calculated from U.S. Census data, with two adjustments. First, the 2000 conversion of local property taxes to statewide property taxes retained locally was not counted as a state tax increase. Second, the 1992 change in the Medicaid hospital tax from a voluntary tax to part of rooms and meals tax was not counted as a state tax increase.

³ State law refers to these grants as "adequate education grants."

⁴ Education aid for particular uses, such as building aid, is ignored throughout this report.

to be \$824.8 million.⁵ Instead of using state taxes to fund the entire \$824.8 million, the state converted \$6.60/\$1,000 of local property taxes into a statewide property tax. Towns receiving the new adequate education grants levied, collected, and spent the same \$6.60/\$1,000 in property taxes they always had, but on the taxpayer's bill it was now labeled as a state tax. Local property taxes were, in essence, renamed as state property taxes. (Only in the case of donor towns did some portion of the statewide property tax represent new state funds.)⁶

Since renaming property taxes should not properly be considered an increase in state aid to education, state property taxes retained locally must be subtracted from the \$824.8 million in order to determine the true amount of state education aid.⁷ When this adjustment is made, we find that state general education aid increased from \$97.1 million to \$406.8 million, or more than quadrupled, from FY98-99 to FY99-00.⁸

State Education Aid Continued to Increase Since 1999

State aid for education has increased in all but one year since the new aid program was enacted as shown in Chart 1. Adequate education grants increased by 0.6 percent to 4.8 percent per year, or an average of 2 percent per year, every year except the second year of the program. State aid to education even increased during the recent recession when fiscal difficulties led many states to cut their education aid programs. State education aid is scheduled to increase 12 percent next fiscal year to a total of \$508 million.

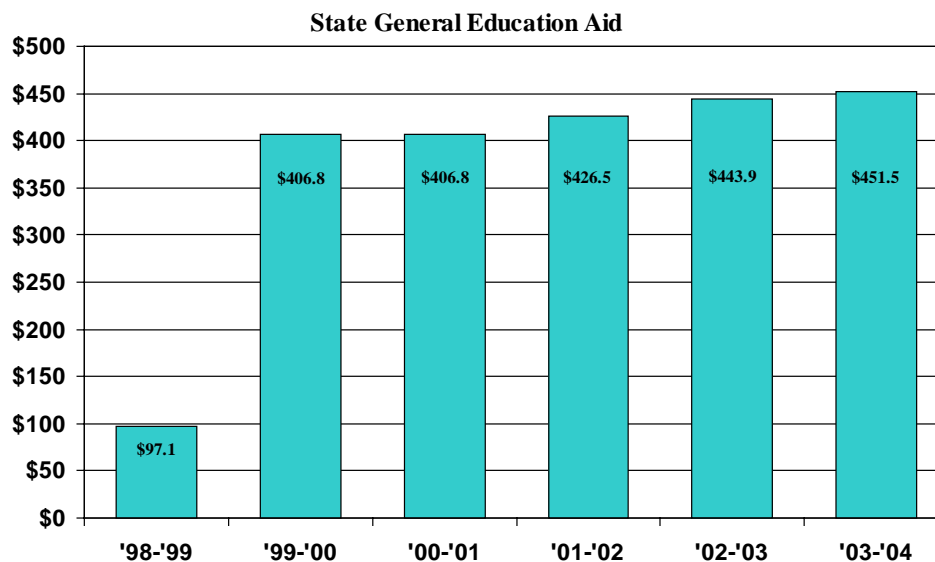
⁵ State law refers to this as the "cost of an adequate education."

⁶ In the case of donor towns, some portion of the \$6.60/\$1,000 in property taxes was sent to the state to be used as part of the education trust fund. The total amount contributed by donor towns in FY99-00 was \$24.1 million. The amount of the statewide property tax retained locally by all NH towns was \$418 million.

⁷ The U.S. Census classifies the statewide property tax that Kansas imposed in response to a school funding lawsuit as a local tax. In addition, as part of their foundation aid programs about 22 states mandate that local governments levy a minimum property tax rate. Those mandated minimum local property tax rates function very much like New Hampshire's state property tax. (See Daphne A. Kenyon, "Are State Governments Encroaching on the Local Property Tax?" *State Tax Notes*, June 30, 2003.)

⁸ The net increase in state education aid further depends upon how one treats the excess education tax payments of the donor communities. One has the option of either counting them as tax payments or as negative aid. If they are counted as tax payments, state general education grants in FY99-00 total \$406.8 million as noted in the text above. If they are treated as negative aid payments, total net grants in FY99-00 become \$382.7 million (\$406.8 million minus \$24.1 million in excess education tax payments). Because the \$24.1 million is a small amount relative to total grants, treating these donor community taxes as negative grants changes the general conclusion only slightly: state general aid to education approximately quadrupled from FY98-99 to FY99-00.

Chart 1
State Education Aid Quadrupled in 1999,
Then Continued To Increase



Overall Impact of Additional State Education Aid

This report asks whether additional state education aid led to additional education spending. First, we summarize the major finding of our research. Later, we explain the methodology and provide additional detail on our estimated impact of state aid on local government budgets.

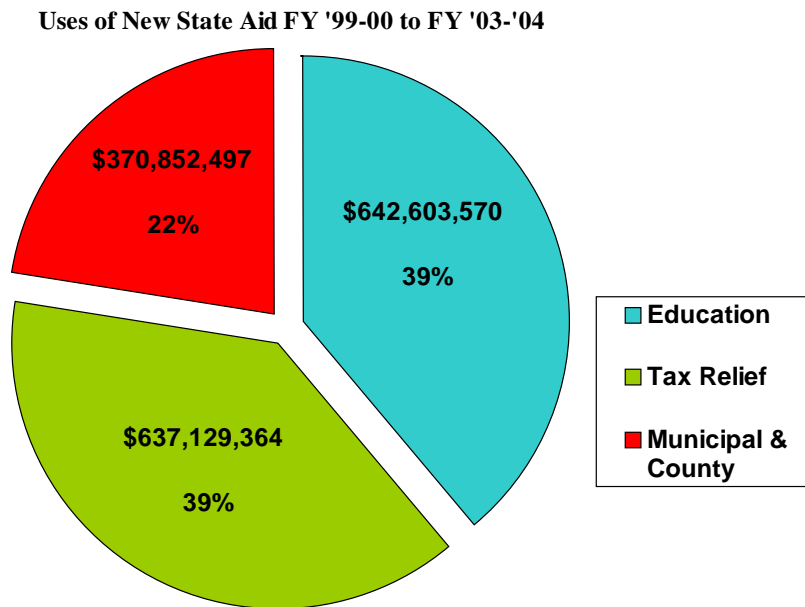
Less Than 40 Percent of New State Education Aid Was Used for Education.

Over the five-year period from FY99-00 to FY03-04, the state sent \$1.65 billion to local governments in additional state education aid.⁹ As shown in Chart 2 below, local governments used only 39 percent of this state education aid to increase education spending. The remainder of the additional state education aid spurred additional municipal or county spending or tax relief.

⁹ The amount the state spends annually on additional education aid is approximately equal to what the state pays for its entire annual Medicaid budget.

Over the five-year period from FY99-00 to FY03-04, state education aid used for municipal spending increased the fastest while state education aid used for tax relief declined to nearly zero (See Chart 3).

Chart 2
Less Than 40% of New State Aid Used for Education



Explanation of Methodology. How do we determine how much state education aid was used for education? It is important to note that the estimates presented here do not refer to the state legal requirement that local governments spend education aid on education.

The legal requirement is simple to meet. A town can meet the legal requirement to spend state aid on education without impacting its local education budget. The town simply needs to move the same number of local tax dollars out of the school budget as the number of state dollars it moves into the school budget. A town reducing local education spending by \$1 million at the same time as it accepts an additional \$1 million in state grant money has complied with the legal requirement to “spend” state education aid on education.

Consider a community with a \$20 million school district budget that receives \$1 million in additional state grant money. This community can spend the \$1 million on education while using \$1 million in local funds it would have spent on education for municipal projects or initiatives. The community's school budget is still \$20 million, while the municipal budget is \$1 million higher. The methodology used in this report will classify the \$1 million in state aid as being used for municipal spending.¹⁰

Use of State Education Aid by Year. Chart 3 and Chart 4 present additional detail on the estimated impact of the new system of state education aid on local budgets.

Chart 3 presents the estimated impact of the post-Claremont system of state education aid on local budgets for each of the five years for which we have data, FY99-00 through FY03-04. This chart divides the total amount of new state education aid dollars among the potential uses: education spending, municipal or county spending, and tax relief. For the last year shown, FY03-04, nearly \$150 million of state education aid was used for additional municipal or county spending, with municipal spending accounting for \$111 million of the total.

¹⁰ Because this report examines a five-year period over which local government spending is expected to grow due to population increases, inflation and other budgetary demands, the methodology used is actually somewhat more complicated than explained in the text. The following dynamic example explains how growth over time has been taken into account. Imagine a town with education spending of \$500,000 and municipal spending of \$500,000 in Year 1 (assume that county spending is zero to make this example simpler). Assume past annual increases in both education and municipal spending average 10 percent per year. Suppose this town received a \$100,000 increase in state education aid. Growth in education and municipal spending that differs from initial expectations will be attributed to the change in aid. Suppose education spending in Year 2 was \$600,000 (\$50,000 more than expected), but municipal spending was \$550,000 (exactly as expected). The accounting methodology would estimate that every extra dollar of adequate education aid increased education spending by 50 cents (\$50,000/\$100,000), had no effect on municipal spending (\$0/\$100,000), and led to an extra 50 cents in tax relief (\$50,000/\$100,000). The portion of the \$100,000 not attributed to greater spending (\$50,000) is attributed to tax relief.

Chart 3
 Nearly \$150 Million of State Education Aid Used for
 Non-Education Spending in FY03-04

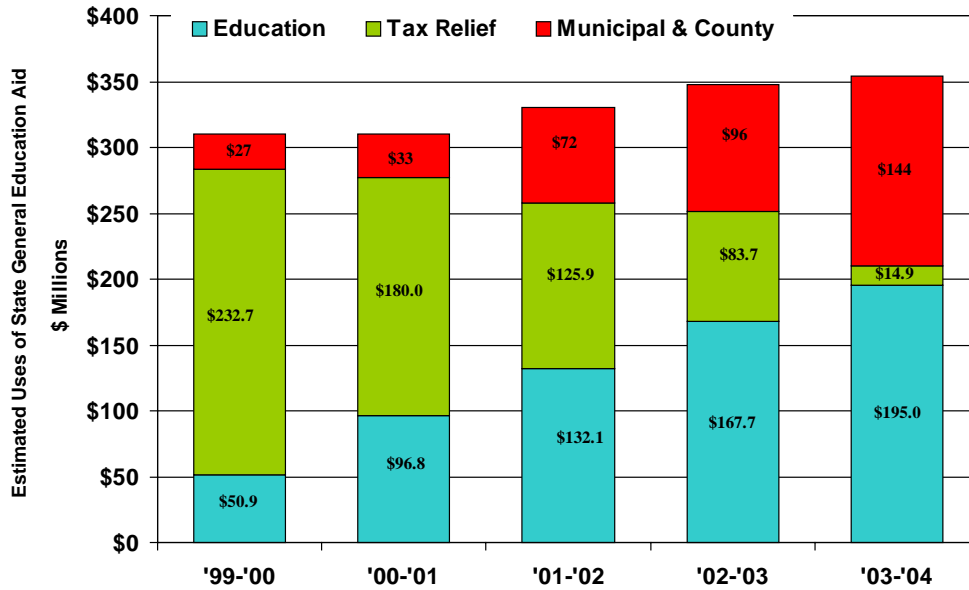


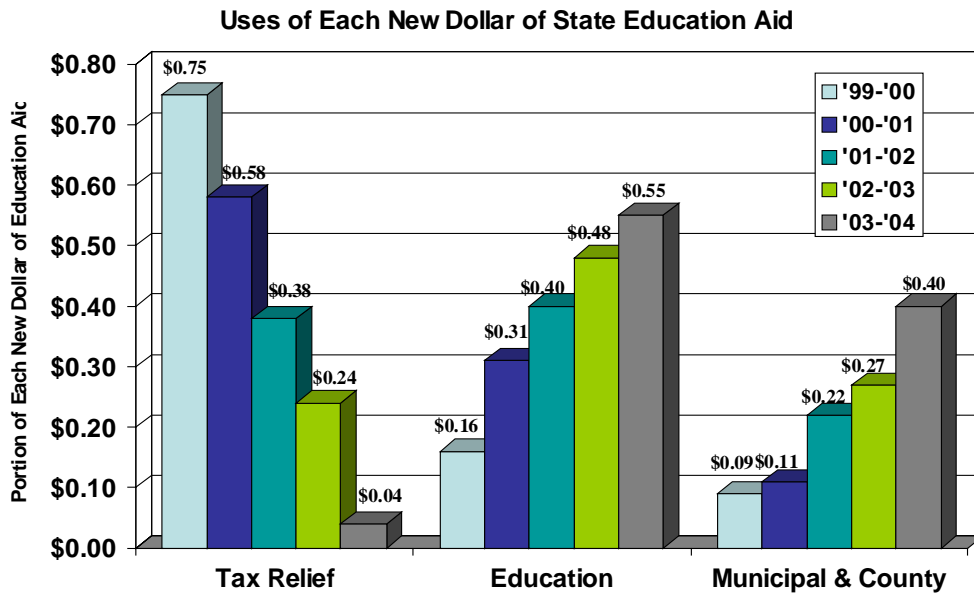
Chart 4 shows how each new dollar of state education aid was used. It shows that the first year of the new system of state education aid led to very little additional education spending. Each extra dollar of state aid led to only 16 cents in additional education spending. The impact of state aid on education spending has increased over time, so that in FY03-04, each extra dollar of state aid is estimated to increase school spending by 55 cents.

In contrast, much of the additional funding was apparently used for tax relief in the first year of the new education aid program. In FY99-00 it is estimated that every extra dollar of state education aid led to an additional 75 cents in tax relief. The impact of state education aid on tax relief has decreased over time, so that in FY03-04, each extra dollar of state aid is estimated to contribute only 4 cents in tax relief. In part, these results reflect that in the first year of the new state education aid system, many, if not most, of the towns receiving additional state aid had already set their school and town budgets by the time they

received confirmation of the amount of increased state aid they would receive. In subsequent years, towns were able to incorporate the new state aid figures into their budget decisions.

The impact of state education aid on municipal and county spending has increased over time.¹¹ In the first year, state education aid led to 9 cents, or about \$27 million, of additional municipal or county spending, but by FY03-04, every new dollar in state aid contributed an additional 40 cents, or approximately \$144 million, in municipal or county spending (31 cents can be attributed to municipal spending and 9 cents to county spending). The amount of state education aid used to increase county spending equals almost exactly the aggregate deficit of revenues over expenditures of county run nursing homes.¹²

Chart 4
New State Aid Used For Municipal & County Spending Has Increased Fastest



¹¹ There was a 288 percent increase in the portion of each new dollar of education aid used for municipal spending from FY00-01 to FY03-04. The corresponding percentage growth rates for the other categories were 93 percent decline for tax relief, 77 percent increase for education spending and 200 percent increase for county spending.

¹² Local governments have discretion over the amount of municipal spending they choose, but not over their county tax payments. One way to think about the use of education aid for county spending is that without higher county taxes, local governments would have been able to use those new education aid dollars for education spending, municipal spending or tax relief.

Adequate Education Grants are a Form of Revenue Sharing.

Another way to view the impact of the new system of state education aid is as a form of general revenue sharing.¹³ As previously explained, communities that receive state education aid can easily fulfill the legal requirement to spend the state aid money on education without changing the amount that they would have otherwise spent on education. The additional funds can be diverted to pay for additional municipal or county spending or for tax relief. Because communities are not required to increase education spending by the amount of the new grant, the grants operate like a form of revenue sharing, whereby the state shares some of its revenue with local governments, to use as they see fit.

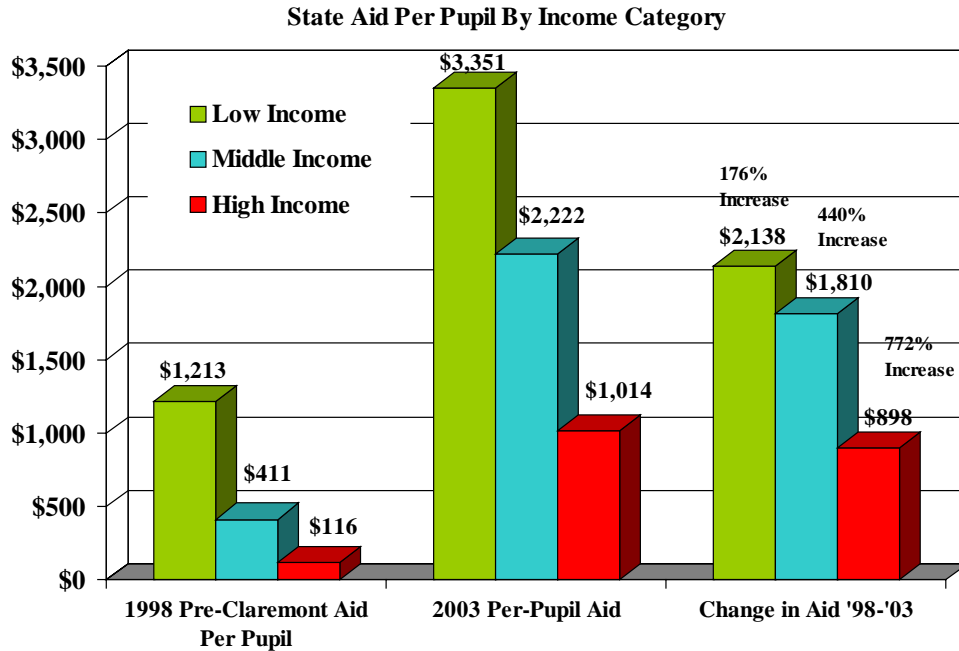
Distribution of New State Education Aid Dollars Among Towns

Before the new system of education aid was enacted, the state sent very little education aid to middle or high-income towns.¹⁴ In 1998, high-income towns received \$116 per pupil in state education aid and middle-income towns received \$411 per pupil, while low-income towns received \$1,213 per pupil. As Chart 5 shows, after the new state education aid system was enacted low-income towns received a 176 percent increase in state education aid per pupil while high-income towns received a 772 percent increase and middle-income towns a 440 percent increase. In total dollars, state education aid for low-income towns increased from \$36.1 million in FY98-99 to \$98.5 million in FY03-04; for high-income towns the increase was from \$3.2 million to \$30.5 million, and for middle-income towns the increase was from \$57.7 million to \$322.6 million.

¹³ This point was first made by Brian Gottlob in "The Results of the New Hampshire Education Funding Reform," The Josiah Bartlett Center for Public Policy, June 2003.

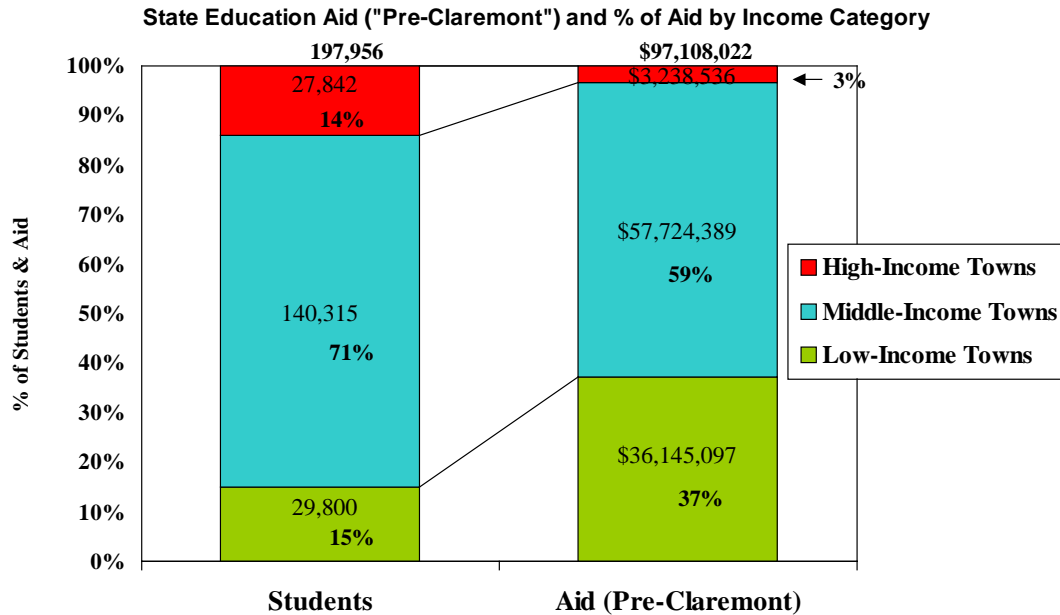
¹⁴ For the purposes of this study, high-income towns are towns in which personal income per capita is at least 20 percent higher than state average. Low-income towns are towns in which personal income per capita of residents is at least 20 percent below state average. All other towns are considered middle-income towns.

Chart 5
Since 1998 High-Income Towns Received
Largest Percentage Increase in Aid



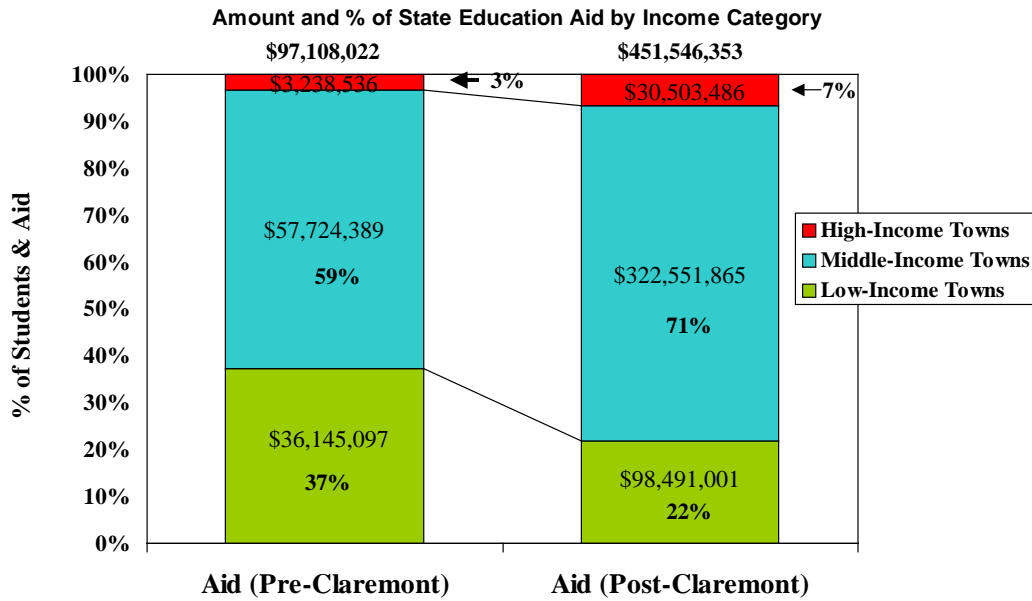
Another way to look at the distribution of state education aid under the new system is to compare the degree of targeting to low-income towns under the old and new systems of state aid. Chart 6 shows state education aid was highly targeted to low-income towns before 1999. Fifteen percent of the state’s K-12 students lived in low-income towns, but they received 37 percent of the state education aid (about twice their “share” if every student were to receive an equal amount of state aid). In contrast, while 14 percent of the state’s public K-12 students lived in high-income towns, they received only 3 percent of the state education aid, and while 71 percent of the students lived in middle-income towns, they received only 59 percent of the state education aid.

Chart 6
Before 1999 Education Aid Was Highly Targeted
to Low-Income Towns



Post-Claremont, state education aid was targeted to low-income towns to a much lesser degree, as shown in Chart 7 below. Low-income towns now receive 22 percent of total state education aid, down from 37 percent before the reforms. High-income towns receive 7 percent of state education aid, up from 3 percent pre-Claremont and middle-income towns receive 71 percent of the state aid, up from 59 percent pre-Claremont. In total dollars, high-income towns received \$3.2 million in state education aid pre-Claremont, but \$30.5 million in FY2003-04, with middle-income towns receiving \$57.7 million in state education aid pre-Claremont and \$322.6 million in FY2003-04.

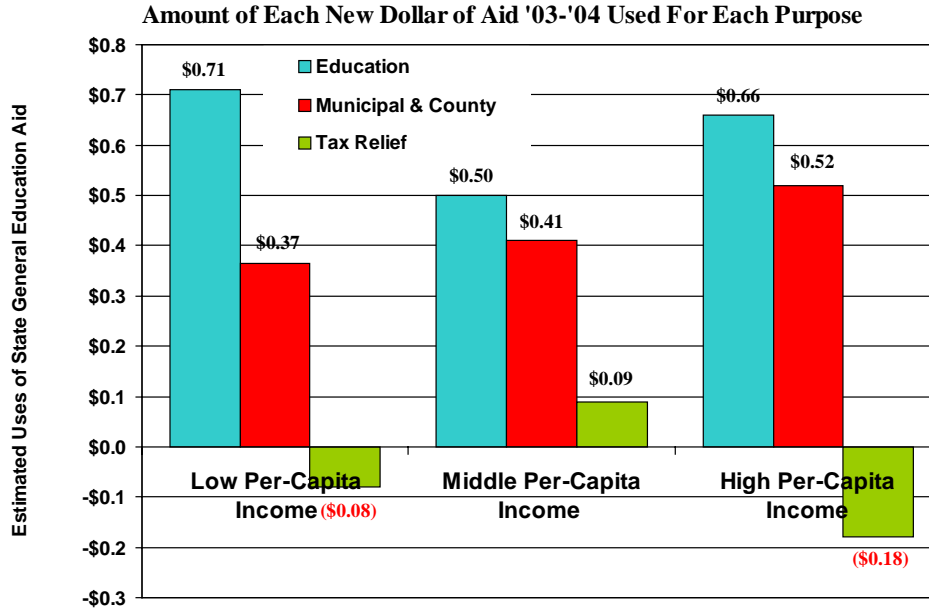
Chart 7
 Large Proportion of New State Aid Sent to
 Middle and High-Income Towns



Which Towns Increased Education Spending the Most?

Finally, it is important to note which towns increased education spending the most given their increase in state education aid. Chart 8 shows that in FY03-04 low-income towns used 71 cents of every extra dollar for education spending, compared with 50 cents for middle-income towns and 66 cents for high-income towns. Low-income towns used 37 cents of every extra dollar for municipal or county spending, middle-income towns used 41 cents, and high-income towns used 52 cents. In dollar terms, low-income towns used \$23 million of additional state education aid for municipal or county spending in FY03-04, while middle and high-income towns used about \$123 million for municipal or county spending in that year.

Chart 8
Low Income Towns Use Higher Percentage of
New Education Aid For Education



Conclusion

It has been over five years since New Hampshire’s landmark education funding law was enacted, leading to the biggest tax increase in the state’s history. In 1999, state general education aid quadrupled from \$97 million to \$407 million, and it has increased almost every year thereafter. State aid was not even cut in the wake of the 2001-02 national recession.

This study estimates the impact of the \$1.65 billion in additional state general education aid from FY99-00 to FY03-04 on local government budgets. In the first year of the new state aid program, towns channeled most of the additional funding into tax relief, but this did not last. Over time, towns channeled a greater proportion of the additional state education aid into education spending, but even in FY03-04 only 55 cents of every additional dollar of aid was contributed to education spending. In total, over the five years, only 39

percent of the additional state aid (\$642.6 million) was used to increase education spending while over \$1 billion was used for municipal and county spending, and tax relief.

High and middle-income towns received a much greater percentage increase in state education aid than did low-income towns. Although low-income towns receive a larger share of state aid than would be expected based on their school enrollment both before and after the post-Claremont reforms, the system before 1999 was more targeted to low-income towns. Low-income towns used more of the state education aid for education than did middle and high-income towns. Conversely, middle and high-income towns used a greater portion of state aid for municipal and county spending than did low-income towns. In dollar terms, low-income towns used \$23 million of additional state education aid for municipal or county spending in FY03-04, while middle and high-income towns used about \$123 million for municipal or county spending.

APPENDIX

Dollars Diverted:

LIST OF TOWNS BY PER CAPITA INCOME

Low-income towns are towns in which personal income per capita of residents is at least 20 percent below the New Hampshire state average of \$23,844 (based on the 2000 Census). High-income towns are towns in which per capita income is at least 20 percent higher than the New Hampshire average. All other towns are classified as middle-income towns. This is a list of all New Hampshire towns, including donor towns that do not receive state general education aid.

Low-Income Towns

ACWORTH	LINCOLN
ALLENSTOWN	LISBON
ANTRIM	LITTLETON
ASHLAND	MARLOW
BATH	MIDDLETON
BENTON	MILTON
BERLIN	NEWPORT
BOSCAWEN	NORTHFIELD
CARROLL	NORTHUMBERLAND
CHARLESTOWN	ORANGE
CHATHAM	OSSIPEE
CLARKSVILLE	PITTSBURG
COLEBROOK	PLYMOUTH
COLUMBIA	RAYMOND
DALTON	RINDGE
DANBURY	ROCHESTER
DORCHESTER	RUMNEY
DUMMER	STARK
DURHAM	STEWARTSTOWN
EFFINGHAM	STRATFORD
FARMINGTON	TAMWORTH
FRANKLIN	THORNTON
GORHAM	TROY
GRAFTON	UNITY
GREENVILLE	WARREN
GROTON	WENTWORTH
HAVERHILL	WHITEFIELD
HINSDALE	WINCHESTER
LANDAFF	WINDSOR

Middle-Income Towns

ALBANY	FREMONT	NORTHWOOD
ALEXANDRIA	GILMANTON	NOTTINGHAM
ALSTEAD	GILSUM	ORFORD
ALTON	GOFFSTOWN	PELHAM
ANDOVER	GOSHEN	PEMBROKE
AUBURN	GREENFIELD	PETERBOROUGH
BARNSTEAD	HARRISVILLE	PIERMONT
BARRINGTON	HENNIKER	PITTSFIELD
BARTLETT	HILL	PLAINFIELD
BELMONT	HILLSBORO	PLAISTOW
BENNINGTON	HOLDERNESS	PORTSMOUTH
BETHLEHEM	HOOKSETT	RANDOLPH
BRADFORD	HUDSON	RICHMOND
BRENTWOOD	JACKSON	ROLLINSFORD
BRIDGEWATER	JAFFREY	ROXBURY
BRISTOL	JEFFERSON	SALEM
BROOKFIELD	KEENE	SALISBURY
CAMPTON	LACONIA	SANBORNTON
CANAAN	LANCASTER	SANDOWN
CANDIA	LANGDON	SANDWICH
CANTERBURY	LEBANON	SEABROOK
CHESTER	LEE	SHELBURNE
CHESTERFIELD	LEMPSTER	SOMERSWORTH
CHICHESTER	LITCHFIELD	SOUTH HAMPTON
CLAREMONT	LONDONDERRY	SPRINGFIELD
CONCORD	LOUDON	STODDARD
CONWAY	LYMAN	STRAFFORD
CORNISH	LYNDEBORO	SULLIVAN
CROYDON	MADBURY	SURRY
DANVILLE	MADISON	SUTTON
DEERFIELD	MANCHESTER	SWANZEY
DEERING	MARLBORO	TEMPLE
DERRY	MASON	TILTON
DOVER	MEREDITH	TUFTONBORO
DUBLIN	MERRIMACK	WAKEFIELD
DUNBARTON	MILAN	WALPOLE
EATON	MILFORD	WARNER
ELLSWORTH	MONROE	WASHINGTON
ENFIELD	MONT VERNON	WATERVILLE VALLEY
EPPING	NASHUA	WEARE
EPSOM	NEW BOSTON	WEBSTER
ERROL	NEW DURHAM	WESTMORELAND
EXETER	NEW HAMPTON	WILMOT
FITZWILLIAM	NEW IPSWICH	WILTON
FRANCONIA	NEWMARKET	WOLFEBORO
FREEDOM	NEWTON	WOODSTOCK

High-Income Towns

AMHERST
ATKINSON
BEDFORD
BOW
BROOKLINE
EAST KINGSTON
EASTON
FRANCESTOWN
GILFORD
GRANTHAM
GREENLAND
HAMPSTEAD
HAMPTON
HAMPTON FALLS
HANCOCK
HANOVER
HEBRON
HOLLIS
HOPKINTON

KENSINGTON
KINGSTON
LYME
MOULTONBORO
NELSON
NEW CASTLE
NEW LONDON
NEWBURY
NEWFIELDS
NEWINGTON
NORTH HAMPTON
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