La Follette Issues

THE TWO-THIRDS INITIATIVE

A Reform Opportunity Lost?

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The Two-Thirds Initiative

A Reform Opportunity Lost

Big changes do occur from time to time, even in public finance. In the spring of 1994 the Wisconsin legislature passed and the governor signed a bill which committed the state to pay two-thirds of the cost of primary and secondary education beginning in the 1996-97 school year. Until very recently, state assistance has accounted for only about 40 percent of total spending on public schools. This "two-thirds initiative" required the state to come up with more than $1 *billion* in additional state school aid (general purpose state revenues currently amount to about $7.5 billion) *and* mandated that, in the future, K-12 education would get first call on state revenues.

The legislature did not specify how the $1 billion was to be raised or distributed among school districts. In his 1995 Valentine's Day budget address, Governor Tommy Thompson filled in details. The governor's budget calls for raising $1.08 billion in additional school aid by wide-ranging restriction in growth of many state programs, absolute reduction for some, and elimination of others. The funds are to be distributed through a dramatic expansion of the state's current equalization aids formula, and property tax relief is to be assured through extension of "caps" on school district expenditure growth.

As is true elsewhere, in Wisconsin the property tax is not very popular, both because of its perceived inequities and because of the size of the typical homeowner's property tax bill. Since 55 percent of property taxes in Wisconsin go for financing public elementary and secondary education, dissatisfaction with the property tax is closely connected with dissatisfaction with the state's system for paying for schools and with the schools themselves. The property tax revolt that created the new legislation could provide the energy needed for both improving the property tax and reforming school finance. The environment is ripe for change; the real danger is that in the rush to quell the taxpayer rebellion, we will lose a rare opportunity to make fundamental improvements in both our tax system and in public education.

Summarized, our argument is that both the governor and the legislature have sought property tax *relief* and ignored both tax and school finance *reform*. The result will be continued problems both with the property tax and with school finance. It is still possible to alter the initiative and its implementation in ways that will accomplish reform and provide property tax relief. This paper reviews the background and substance of

the two-thirds initiative and the impetus for change. We then point out the flaws in the initiative and the governor's response. We close by suggesting an alternative.

How We Got Here, and Where We Are

Fever for property tax reform has long been one of the vital signs of Wisconsin's body politic. The particular paroxysm that produced the two-thirds commitment was stimulated by Governor Tommy Thompson's State of the State address in January 1993. In that speech, the governor committed his administration to significant property tax relief. The two-thirds initiative was the product of the subsequent struggle between Republicans and Democrats to capture the political benefits expected from maneuvering to the front of the tax relief movement.

The governor focused the effort on changing the state's system of school finance. The rationale for this approach is obvious. In fiscal year 1994, governments in the state levied more than $5.4 billion in property taxes. Fifty-five percent of property tax revenues go for financing public elementary and secondary education. Coincidentally, approximately 55 percent of total revenues for public education come from the property tax.

In his 1993 speech, the governor called for a freeze on property tax rates and committed his administration to finding ways to bring them down. In response, the legislature enacted as part of the 1993-95 biennial budget a cap on year-to-year increases in school revenues (and therefore expenditures) and made substantial changes in procedures for collective bargaining with teachers. In March 1994, after the Democratic Assembly leadership compromised with the Republican-controlled Senate, the legislature passed the two-thirds initiative (93 Wisconsin Act 437). The new law provided sufficient additional state equalization aid to school districts to guarantee that, with the revenue cap in place, total statewide property tax levies would be frozen for the next two school years. For the 1996-97 academic year and thereafter, the legislation committed the state to fund 66.7 percent of total public spending on K-12 education.[1] This provision not only required the state to come up with nearly $1 billion per year in additional state school aid, but it also gave the education commitment precedence over all other claims on state revenues. The legislation established a bipartisan commission made up of the governor, the superintendent of public instruction, and legislative leaders to propose both the source of new state funding for education and a mechanism for distributing the extra aid to local school districts.

The two-thirds initiative is very significant. By simultaneously increasing the state's share of school funding from 48.4 to 66.7 percent and restricting the rate of increase in school spending, the state will be able to guarantee that the average property taxpayer in the state will receive substantial property tax rate reductions. Early estimates by the Legislative Fiscal Bureau (1994) suggest that the school property tax rate will decline from $17.80 per $1000 of equalized value (the rate in 1993-94) to $10.80 by 1999-2000, a reduction of nearly 40 percent. Given that school property taxes are on average about 55 percent of total property taxes, property tax rates can be expected to decline by about 22 percent on average by the end of the century. The governor's budget summary promises a statewide average property tax reduction of 9.5 percent in 1996.

These are average results, and the experience of individual taxpayers is certain to differ. The amount by which property taxes will be reduced in any given school district depends in part on the operation of the revised equalization aids formula. Figuring out how things will change under a new proposal requires a clear picture of how things were when the governor called for reform. It is to this retrospective that we now turn.

The Impetus for Change

Two themes are common in the school finance reform debate in Wisconsin. One is that the property tax is inequitable and excessive. The other is that the system of state aids for schools, while generally cast as tax relief, leaves taxes high and makes inequities worse. In this section, we review these charges. We emphasize the second, for if the state is to assume two-thirds of the burden of school finance, the method of distribution of assistance across districts becomes very important. As important as distribution of state aid is, we also need to address the general criticism of the property tax, because the two-thirds initiative does not do away with it altogether. After all, a 9.5 percent reduction leaves 90.5 percent in place.

The Property Tax

In their latest annual survey of taxpayer attitudes towards various taxes, the U. S. Advisory Commission on Intergovernmental Relations finds that the largest number of survey respondents characterize the local property tax as the "worst" tax (1994). In Wisconsin, an article in the state's official digest of facts and statistics, the *Wisconsin Blue Book*, concluded that "despite enormous state spending and hundreds of changes to the property tax system, that system still lacks the equity its proponents and opponents have sought over the years" (Stark, 1991, 160).

We are not able to explain fully people's attitudes towards taxes and what would constitute an equitable distribution of the tax burden. However, four features of the property tax are regularly cited as problems. First, people think the property tax is a regressive tax that places high burdens (measured relative to annual income) on many low-income taxpayers. Two groups that are particularly critical of the property tax are the elderly and farmers. In both cases property value, and therefore property taxes, can

be high relative to current incomes. The elderly (and potential heirs, speaking on their behalf) claim that high property tax burdens threaten to "tax them out of their homes." Farmers claim that the property tax discriminates against them because of the inherently property-intensive nature of farming. Second, property tax liabilities may sometimes change substantially from year to year when property value assessments change. Again, in these instances the change in property value may be unrelated to changes in current income of owners, and as a result change in tax liabilities, even given the increase in the value of property, may create cash-flow problems. Third, even when property values remain stable, income may fluctuate, with the result that families experiencing unemployment or other reversals may see their income taxes fall, but their property tax liability remains unchanged. Finally, critics often argue that the process of assessing the value of property for tax purposes is highly inaccurate and inevitably leads to substantial differences in tax liabilities among taxpayers with similar properties. Although economists have suggested that these criticisms of the property tax are overstated, it appears that they are at the root of much of the popular discontent with the property tax.[2]

Equitably distributed or not, property taxes in Wisconsin are most frequently criticized simply for being too high. When compared to other states, Wisconsin property taxes are indeed high, and they have been high for some time. In fiscal year 1992 (the latest year for which these data are available), the ratio of property taxes collected in Wisconsin to personal income was 24 percent above the national average. In only twelve other states was the ratio higher. Property taxes have also been growing. Between 1982 and 1991, the property tax/personal income ratio grew by nearly 11 percent. Among the 15 states with the highest property tax to personal income ratios in 1982, only five other states had rates of growth higher than Wisconsin's.

The state has tried repeatedly to provide property tax relief. Between fiscal year 1983-84 and 1993-94, state aid to schools doubled, from $1.1 to $2.2 billion. But at the same time that state aid increased, so did overall school expenditures, with the result that the state's share of funding for education remains at virtually the same level as ten years ago. The increase in expenditures is *not* attributable to an increase in enrollment; overall school enrollment is up by only about 4 percent. As the governor's budget summary points out:

> Throughout the years, Wisconsin has tried a myriad of options to achieve property tax relief. Wisconsin uses every major strategy to try to relieve property taxes: state aids, direct credits, circuit breakers, partial exemptions, income tax credits, and assumption of local services. . . . Simply devoting large amounts of state revenue to local assistance programs, however, has not controlled property taxes. (Wisconsin Department of Administration, 1995a, 43)

In summary, at the advent of the two-thirds initiative, Wisconsin taxpayers were paying high property taxes. Extensive efforts by the legislature to reduce the burden by increasing school aids had failed. The legislature was ready, therefore, to take a much more radical approach, and the governor chose to follow suit.

State Aid to Schools

The public attitudes that precipitated the drive for property tax relief and the two-thirds initiative are reflected in a feature story on school finance broadcast two years ago by the state's flagship public education television station, Madison's WHA-TV. The commentary was illustrated with a poker game. The "players" were two Wisconsin school districts, Gibraltar and Mellen, and the chips were state school aids. The station's message was that the dispensing of school aids was a random process, and the outcomes weren't fair:

> The taxpayer in the Gibraltar district pays $6.09 per $1,000 [of assessed property value] in property tax, and the school district spends $8,659 per student. The Mellen taxpayer pays $31.56 per $1,000, and the state puts in $2,000,000 of equalization aid per year. Yet per pupil spending is $6,503 in the Mellen district.[3]

To station WHA and other media observers, the discovery of numbers like these was the public finance equivalent of finding rats in the vats of a sausage factory: Reform, it seemed obvious, was clearly, urgently, and immediately needed. In the aggregate, state governments financed about 47 percent of K-12 education spending, while in Wisconsin the state's share was only 39 percent (U. S. Advisory Commission on Intergovernmental Relations, 1992, 265). Most critics argued that the solution to Wisconsin's problem was an increase in the state's contribution to school spending, targeted to districts like Mellen.

Wisconsin's state constitution, adopted in 1848, requires that "the legislature shall provide by law for the establishment of district schools, which shall be as nearly uniform as practicable. . . ." While the appropriate interpretation of the phrase *as nearly uniform as practicable* is debatable, over the past 25 years it has generally been interpreted to require *taxpayer equity*. That is, if two districts choose the same property tax rate, an attempt is made to assure—insofar as "practicable"—that the allocation of state aid will compensate for interdistrict differences in tax base so that *expenditures per student* will also be equal. Despite WHA's Mellen/Gibraltar example, our analysis (presented below and in Reschovsky and Wiseman, 1994) and those of others suggest that the state's school finance system

has achieved a good deal of equalization. To understand how this was accomplished while at the same time leaving rats-in-the-vats problems like the Mellen/Gibraltar disparity, it is necessary to look a bit more closely at the system.

District Power Equalization, Wisconsin Style. Taxpayer equity is pursued in Wisconsin by district power equalization (DPE). Under DPE schemes, the yield to a school district from any given property tax rate is the revenue it would have received had the district's property tax base per pupil equaled a "guaranteed" level. The difference between this guaranteed yield and the district's actual revenue is made up, if positive, by state aid. During the 1994-95 academic year, the equalization formula provided the state's 370 K-12 districts with a guaranteed tax base (the "primary guarantee") of $357,837 (Wisconsin Legislative Fiscal Bureau, 1995).[4]

In textbook DPE schemes, rich districts (defined as those with per pupil tax bases larger than the guaranteed base) donate their property revenues generated from the value of their tax bases in excess of the guaranteed base to the state aid pool. However, in no state DPE scheme does this "donation"—called *recovery*—actually occur.[5] In practice what generally happens is that tax base guarantees are set to exceed the tax bases of most school districts, and those with tax bases above the guarantee receive no aid or some minimum amount. Of the 370 Wisconsin K-12 districts, only 28 had tax bases above the state guarantee in 1994-95. These districts receive no equalization aid, but are guaranteed a minimum aid payment of from $100 to $400 per pupil, with the actual amount dependent upon a district's household income and tax rate.[6] Nearly 85 percent of state aid is distributed through the DPE formula and minimum aids. Most of the remaining 15 percent of aid is distributed through 32 different categorical aid programs, the largest of which funds education for handicapped children.

District power equalization schemes create incentives for increased spending for districts with tax bases less than the guaranteed level. This incentive arises because DPE formulas lower the *tax price* of each additional dollar of spending per pupil. This occurs because DPE formulas provide more aid for each additional dollar of local spending (in the previous year), and thus each $1 of additional spending on education costs local taxpayers less than $1 in additional property taxes. The greater the gap between a district's actual tax base per pupil and the guaranteed tax base, the greater will be the price incentive to increase expenditures.[7]

The details of the operation of the DPE formula are complicated, and may in fact be irrelevant if, as suggested by the WHA commentary, the formula has failed to achieve its goal of taxpayer equity. A closer examination of the school finance system, however, will lead to a different conclusion.

How Well Has Wisconsin's School Finance System Worked? The governor's commitment to property tax relief in his 1993 State of the State address makes 1992-93 a good year for assessing the effectiveness of equalization efforts in Wisconsin. This is also the year for which the WHA numbers are reported. In earlier work (Reschovsky and Wiseman, 1994 and 1995), we show that a different, and much more favorable, impression of the success of the state's aids program in 1992-93 is gained from looking at all districts, instead of just two as WHA did.

In table 1, we provide the most recent available data on the characteristics and fiscal behavior of Wisconsin's 369 K-12 school districts.[8] For each variable, we report minimum, maximum, and average values across the districts as well as the variable value for the district that marked the tenth and the district that marked the ninetieth percentile level. For example, the first line in the table shows that during the 1994-95 school year the smallest K-12 district (Washington Island) in the state had only 110 students, the largest (Milwaukee) had over 98,000, and the average district had 2,187 students. Eighty percent of districts reported enrollments between 414 (the enrollment of the largest district in the first decile) and 3,549 (the enrollment in the school district that marked the top of the ninth decile).[9]

The top portion of table 1 lists what were, from the perspective of local school boards, matters beyond their control: school enrollment ("membership" in Wisconsin), the tax base per pupil, and average income per tax return within the district.[10] As in many other states, there is substantial variation on each of these dimensions. Looking beyond the question of *taxpayer* equity for a moment, we note that an important *student* equity issue is whether these differences in district circumstances translate into unacceptable disparities in the quality of public education.

While expenditures per student are an inadequate indicator of educational quality, it is a place to begin to look for disparities. Table 1 shows that while variations in expenditures per pupil across districts were much smaller in 1994-95 than the variation in district wealth (measured either by tax base per pupil or by income per return), substantial differences existed, with the highest-spending district spending almost twice as much per student as the lowest. These are extremes, especially on the high end; 80 percent of districts spent within the much narrower band of $6,021 to $8,044.

Table 1 also provides data on the distribution of school property tax rates in Wisconsin. For the 1994-95 school year, the average school district employed a property tax rate equal to about 1.7 percent of the equalized value of property (equivalent to 17 mills). The rates ranged from a low of 5.7 mills in Gibraltar (already familiar from the WHA-TV commentary quoted on page 9) to 29 mills in the Goodman-Armstrong school district. The Mellen school district mentioned by WHA-TV, while no longer dis-

Table 1

Wisconsin's 369 K-12 Districts

Variable	Minimum	10th Percentile	Average	90th Percentile	Maximum
Background					
Enrollment (1994-95)	110	414	2,187	3,549	98,022
Tax base/pupil (1994)	$75,588	$109,984	$197,925	$308,767	$1,352,952
Income/return (1993)	$12,524	$19,428	$26,816	$35,282	$65,187
Finances					
Total spending per pupil (1993-94)	$5,218	$6,021	$6,895	$8,044	$10,311
School tax rate (mills) (1994-95)	5.7	14.8	17.2	20.6	29.0
Spending-effort ratio (per-pupil spending/school mill rate)	$309	$353	$408	$447	$1,510

Source: Calculations by authors using data supplied by Wisconsin Department of Revenue.

tinguished as the district with the highest tax rate, still has the state's third highest rate. Table 1 also reveals something WHA failed to mention: Attention to the outliers may lead to exaggeration of tax rate disparity. Although the difference between the Mellen and Goodman-Armstrong between was about 23 mills, 80 percent of all districts utilized rates falling within a range of 5.8 mills.

Wisconsin's equalization formula is not designed strictly to achieve complete taxpayer equity, but it does weaken the link between school district property wealth and the ability to fund public education. A simple and direct measure of the system's effectiveness is provided by calculating the ratio of each district's per-pupil spending to its school property tax rate (in mills) and comparing distribution of these *spending-effort ratios*

across districts, both with and without the receipt of equalizing aid. In the sense the term was used above, full taxpayer equity is achieved when all districts have identical spending-effort ratios: that is, the same mill rate produces the same expenditures per student. In earlier work, Reschovsky (1994) calculates that equalization aid reduced the variation of spending-effort ratios by *half* for the 1992-93 school year compared to what would have been the case in the absence of school aids. We interpret this finding to mean that Wisconsin's DPE formula is in fact quite successful in achieving a substantial amount of taxpayer equity.[11]

Although we are not aware of comparable analyses for other states, the fact that Wisconsin's formula employs a high guaranteed tax base suggests that few, if any, other states achieve more taxpayer equity (as measured by the distribution of spending-effort ratios) than does Wisconsin.[12] When measured by the standard of spending equalization, Wisconsin has also been quite successful. Interdistrict variation in spending per pupil in Wisconsin declined by 46 percent between 1980-81 and 1992-93.[13] Bringing together the results from a number of other studies, Rossmiller (1992) finds that school district spending per pupil is more equal (as measured by coefficients of variation) in Wisconsin than in eight other states.[14] Similar results are reported by Odden, Busch, and Hertert (1994), who characterize the system "as having fiscal disparities less than those in most states and close to or better than normative standards of equity."[15]

Enduring Inequalities. But still, as the WHA commentary points out and table 1 confirms, substantial variation in spending-effort ratios and expenditures per student remain. What happened?

The persistence of interdistrict expenditure disparities despite power equalization can be traced to several factors: (1) categorical aids; (2) exemptions from the DPE system; (3) voter choice; and (4) and lags between district decisions to spend and changes in state aid. As already discussed, approximately 15 percent of aid is distributed through nonequalizing categorical aid programs, and the factors that lead to categorical assistance, such as the number of handicapped pupils or the number "children at risk," are not uniformly distributed across districts. A small number of districts have tax bases in excess of the guaranteed base. Thanks to a small enrollment and a large proportion of recreation-oriented property, the Gibraltar district had a tax base of about $1.35 million per pupil for the 1994-95 school year, over 3½ times the "primary guarantee." Yet under the equalization aids formula, the district still received minimum aids of $300 per pupil.

Evidence that voter preferences are at work in creating interdistrict differences in expenditures is provided by the fact that school property tax rates are substantially lower in low-spending than in high-spending districts. The average mill rate in the 10 percent of districts (that is, the lowest decile) that spend the least is 15.1, and mill rates rise to 19.8 in the

ninth decile, before declining slightly to 18.2 in the highest-spending decile. This suggests that the state has been successful in distributing aid in such a way that per-pupil spending is higher in districts that choose to tax themselves at higher rates.

District power equalization formulas are not designed explicitly to equalize per-pupil spending across districts. Nevertheless, they do provide larger reductions in tax prices to low-wealth districts than to high-wealth districts. This fact leads supporters of DPE systems of school finance to expect that once power equalization is introduced, per-pupil spending by low-wealth districts will increase relative to spending in high-wealth districts. Despite these expectations, the use of a DPE formula in Wisconsin has not eliminated low levels of per-pupil spending by some low-wealth districts.

There are several possible reasons for DPE formulas being less than fully effective mechanisms for raising per-pupil spending levels in low-wealth and low-spending districts. First, nothing in the current system of school finance *requires* a school district to increase its level of spending. The state aid formulas attempt to induce low-wealth and low-spending districts to increase their support for education by providing as much as seventy-five cents in additional aid for each dollar of additional spending. Local taxpayers, however, represented by their elected school board, may choose to ignore the incentives in the state aid formulas and to maintain relatively low levels of spending.

In practice, this year's aid is distributed on the basis of last year's tax rates and spending. The one-year lag between a decision by a local school to increase spending per pupil and the receipt of additional aid may well discourage low-spending districts from trying to catch up. Because of this one-year lag in aid, every dollar of an increase in expenditures (beyond previous levels of local funding and the formula-determined level of state aid) is obtained during the first year from the local tax base. Over time the aid system will catch up to such spending changes by rewarding low-spending, low-wealth districts and penalizing high-spending, high-wealth ones, but the effect is not immediately felt. In effect, a low-spending district must gamble by increasing outlays with the expected reward being an increase in state aids in subsequent years. Even when aid does catch up, what's lost by local taxpayers in the first year is never returned.[16] Moreover, the actual response of state aid to local expenditure changes cannot be predicted with precision and this, too, probably increases school board reluctance to undertake adjustment.

The tax-now-for-aid-next-year strategy may be particularly difficult when resources are scarce to begin with. This administrative lag may account for at least part of the persistent spending inequality. It is a significant factor behind the very high tax rate reported for the Mellen school district (the *cause célèbre* for the WHA-TV commentary). The Mellen school

district now has the state's second lowest tax base. In 1992-93 the district undertook a major investment in school rebuilding. The first step took major taxpayer effort. After two years the aids system has begun to catch up, and the tax rate fell from 31.6 to 25.6 mills. This rate is still high by state standards (see table 1), but at $8,902, so is the district's level of expenditures per student.

Inflationary Bias. Although Wisconsin's equalization aids program may have been more successful than most people realize at achieving taxpayer equity and reducing variation in per-pupil expenditures, we believe the system has also worked to thwart efforts at tax relief. Our argument is developed in detail in our paper in the third volume of the La Follette Institute's budget guide, *Dollars and Sense* (Reschovsky and Wiseman, 1994), so we will only summarize it here. The villain in our tale is the equalization aid formula itself. Over the past decade, the legislature has attempted to provide tax relief principally by providing school districts with more equalization aid. This has been accomplished by increasing the guaranteed tax base. Were districts to hold expenditures constant, this new state aid could have been used for tax relief. But by the very nature of the DPE formula, increases in the guaranteed tax base result in reductions in the tax-prices faced by most school districts. Lower tax-prices, by reducing the cost to local taxpayers of increasing spending, make it politically easier for local school boards to increase per-pupil spending. Although we do not know how important a role lower tax-prices had in stimulating spending, over the past two decades cheap (to local taxpayers) expenditures certainly did nothing to encourage fiscal discipline by local school boards.

Summary and a Note about Costs

The governor's decision to push the legislature for school finance reform was well justified, at least from the perspective of taxpayers. The distribution of property tax burdens under the current system may not be acceptable, and the share of property taxes in government finance in Wisconsin may be exceptionally large. The equalization aids formula leads to a substantial degree of taxpayer equity at any point in time, but some districts are clearly hard-pressed to meet immediate expenditure needs, and others enjoy an advantaged position which is enhanced by state minimum aids. Moreover, the existing aids system was creating incentives to raise expenditures rather than lower taxes, and every time the legislature attempted to bring about tax relief by manipulation of the aids system, the expenditure incentives offset the attempt. The question now to be addressed is whether the two-thirds initiative and the accompanying reforms will make the system better.

Before turning to the two-thirds initiative, we add one concern not typically addressed by critics. Most discussions of school finance, including our analysis of the data in table 1, make no adjustment for variation across school districts in the *cost* of providing education. Indeed, in most discussions of school finance issues in Wisconsin, the term "costs" is used as if it were synonymous with "expenditures." It is not. "Costs" refer to the amount of money a school district *must* spend to obtain a particular item (for example, an hour of a teacher's time), or to meet a particular educational goal (such as getting all students in a fourth grade class to read at the fourth grade level). "Expenditure" refers to the amount of money a district actually spends. Costs can go up without expenditures changing, and vice versa.

Some costs (for example, the wage paid for an hour of teacher's time) are to a significant extent within the control of local school boards. Other are much less so. For reasons outside the control of local school boards, it will take more resources to provide any given level of education to some students than to others. For example, children who are handicapped, require bilingual education, or come from single-parent, low-income families often require both special attention and additional resources. Also, costs are higher when children in sparsely populated areas must be bused long distances to school. For these reasons and others, costs do vary, and as a result equality in dollar expenditures may not indicate equality in real resources available for education. This issue has yet to surface in the debate over tax relief, because the participants in that debate tended to be preoccupied with nominal school spending. But the debate also involves education, and if one objective of school finance reform is to increase equity in student access to education, adjustments for costs must be incorporated. We return to this issue later.

The Legislature's Action

In response to the governor's request, the legislature enacted as part of the 1993-95 biennial budget a cap on year-to-year revenue increases and substantial changes in collective bargaining procedures for teachers. These changes were followed, in 1994, with the two-thirds initiative.

Revenues subject to the cap included property taxes plus state aids (equalization and minimum aid) but excluded most forms of categorical aid. Under the cap, a district is allowed to increase its revenues per pupil by a fixed dollar amount or by the previous year's rate of inflation, whichever is greater. The fixed dollar amount, which was set at $190 per pupil in 1993-94 and indexed for inflation thereafter, allows low-spending districts to increase revenues at a rate slightly in excess of the annual increase in the price level.[17] Furthermore, school districts wishing to increase spending by more than the permitted maximums were allowed to do so only if they obtain voter approval through a special referendum.[18] Experience in Massachusetts suggests that with the exception of small, high-income communities, the passage of referenda to increase spending above the caps will be very difficult (Bradbury, 1991). To date only a few districts have attempted to override the caps and fewer than half the districts that have tried have succeeded.

Prior to the passage of the 1993-95 budget, salary disputes between teachers and school boards were resolved through mediation and binding arbitration procedures. The 1993 budget bill repealed these procedures effective July 1, 1996. In the interim, only in cases when school boards fail to offer teachers "qualified economic offers" can economic issues be decided by binding arbitration. A qualified economic offer is defined as an offer of wage increases of at least 2.1 percent per year and of fringe benefit increases of at least 1.7 percent. Any increases in the cost of fringe benefits above the 1.7 percent limit are to be counted against the permissible wage increase limit. Unlike the revenue cap, these maximums are not linked to rates of inflation.

The revenue cap reduced the rate of increase in education spending in most school districts and produced rate reductions in some. Because the cap did not *guarantee* actual cuts in property tax levies, however, many policymakers in Wisconsin called for more drastic measures designed explicitly to reduce property taxes.

The drastic measure turned out to be the two-thirds initiative (93 Wisconsin Act 437). A special commission was established to recommend how the commitment was to be met. Eventually the governor proposed, in his Valentine's Day speech, both a procedure for raising the cash needed for meeting the two-thirds commitment and a procedure for distributing the funds.

The Governor's Approach

In his budget address the governor emphasized the link between school finance and the property tax. "My approach to this budget was very simple," he said, "our schools and our property taxpayers come first. Whatever is left goes to the rest of state and local government." "This funding is going to be *fair*," he went on to say. "It is going to be equitable. We are developing a new distribution formula that will make sure students—no matter where they live in the state—have equal opportunities for a quality education" (Thompson, 1995, p. 9). The approach referred to by the governor was to include shifting spending to public education and away from other state programs, small increases in taxes and fees, a revision of the state's DPE scheme, and a tightening of school district revenue caps.

The Source of Funds

The governor's budget defers a sizable portion of the impact of the two-thirds commitment to the 1997-99 biennium. For 1995-97, the necessary funds are raised from carry-over funds, expected increased tax collections, a reduction in the renter credit on the income tax, increases in departmental revenues and user fees, spending cuts in a wide range of state programs, and a onetime forward shift to the next biennial budget of an increase in the school levy credit. Aside from the increase in funds for schools and a major expansion of the corrections budget, most state expenditures will decline in absolute terms. The cuts are concentrated in fiscal year 1996-97. The Wisconsin Taxpayers Alliance estimates that the governor's plan will cause the state to begin the 1997-99 biennium with $460 million in unfunded obligations; this carry-over deficit amounts to about 5 percent of general fund appropriations for the 1996-97 fiscal year (Wisconsin Taxpayers Alliance, 1995).

The Distribution of State Assistance

The governor's plan meets the two-thirds commitment by increasing fiscal assistance to school districts by $1.21 *billion* between the current school year (1994-95) and the next (1996-97). As shown in table 2, total fiscal assistance to school districts will increase from $2.8 billion in 1994-95 to $4.0 billion in 1996-97. Most of this increase is attributable to a proposed increase of $1.1 billion in state equalization aid. Funding for most categorical aid programs is not scheduled to increase, while three categorical programs are targeted for elimination. The only significant increase in categorical programs is $4.1 million for a new grant program to support the purchase of "instructional technology" by school districts. Finally, the governor has proposed increasing the school levy credit by $150 million. While equalization and categorical aid provide direct aid to school districts, and subject to the constraints imposed by revenue caps, can be used to finance educational spending, the school levy credit is used to finance property tax rate reductions directly. Although the amount of school property tax levies are used to calculate the credit, state payments are made to municipal governments (in their role as the administrators of the property tax system) and are in turn distributed to all overlying units of governments, including school districts, county governments, VTAE districts, and other special purpose districts.

Expansion of the Revenue Caps

The governor's plan calls for not only making the current system of revenue caps permanent, but also for two adjustments to the caps that will make them more stringent. First, all districts will be limited to a revenue increase of $194 per year per student with no inflation adjustment. Second, the revenue limits are expanded to cover most funds received from the state through categorical grants, including grants for school lunches, handicapped education, and pupil transportation. Greater amounts may be spent if approved by voter referendum, but as we shall make clear below, proposed changes in the equalization aid formula will create a very strong incentive for many districts to turn down any referendum calling for additional spending. Finally, in response to concerns that the revenue caps would prevent low spending districts from "catching up" with other districts, the governor's proposal will allow school districts with capped revenues of less than $5,200 per student in the 1995-96 school year and $5,500 in each subsequent school year to increase revenues to these levels without a referendum.

The proposed revisions of the revenue caps make them considerably more restrictive, especially for school districts with above-average expenditures. Since $194 per student per year is only a 3.5 percent increase at the $5,500 expenditure level, any district with capped revenues above $5,500 will be forced to hold referendum elections simply to keep up with inflation, which has averaged 3.6 percent per year over the past 10 years.

Inclusion of categorical aids under the cap will create particular hardships for districts experiencing above-average increase in enrollment of

Table 2

Comparison of the Governor's Budget Recommendation for 1996-97 State Aid to School Districts and the School Levy Credit with Actual 1994-95 Spending on State Aid and the School Levy Credit

(in $ millions)

	1994-95	1996-97	Increase
General Aids (primarily equalization aid)	$2,093.7	$3,153.3	$1,059.6
Categorical Aids	370.7	372.7	2.0
Total Direct Aid	$2,464.4	$3,526.0	$1,061.6
School Levy Credit	319.3	469.3	150.0
Direct Aid and School Levy Credit	**$2,783.7**	**$3,995.3**	**$1,211.6**

Source: State of Wisconsin, 1995-97 *Biennial Budget*

children with special needs. Both federal and state laws require school districts to provide special education services to all mentally and physically handicapped students. Although handicapped aid now accounts for 75 percent of all categorical aid provided to school districts, it only provides enough resources to cover 45 percent of the cost of providing special education for handicapped children. Unless local taxpayers approve a referendum allowing spending at levels above the revenue caps, school districts will only be able to undertake the extra spending necessary to provide the mandated services for the handicapped by shifting resources away from programs for the non-handicapped. In effect, in the absence of a successful referendum, all additional categorical aid that is linked to the influx of special needs students will be used *de facto* for property tax relief. Thus the revenue caps will harm not only needy students, but the rest of the student body who must make do with reduced resources.

The New Equalization Aid Formula

The current equalization aids system features two levels of guaranteed tax base. The so-called primary level is applicable to expenditures up to a specified "primary ceiling"; the secondary guarantee is applicable to expenditures per pupil above the primary ceiling amount. A small number of districts with tax bases in excess of the primary guarantee are ineligible for equalization aid, but nevertheless receive "minimum aid" grants. The governor's plan eliminates explicit minimum aid grants, but guarantees that each district will receive some equalization aid by adding, in 1996-97, a new primary tax base guarantee of $2 *million* per student that is applicable to the first $1,000 of district expenditures per pupil.[19] All districts are guaranteed access to $515,000 in property value per student (the secondary guarantee) for the next approximately $4,900 in expenditures. For expenditures beyond $5,900 the (tertiary) guaranteed base is $220,000, the (estimated) average property value per student statewide.[20]

The State Budget Office estimates that if the new formula plus the two-thirds commitment been in effect for the 1994-95 school year, every district in the state would receive more aid (defined as the sum of general aid and school levy credit), with the increases averaging 36 percent (Wisconsin Department of Administration, State Budget Office, 1995). Among K-12 districts, the increases in aid would vary considerably, ranging from an 8 percent increase (in Mellen) to a 212 percent increase in Oconomowoc. In general, the largest percentage increases in aid are received by high property wealth districts. These districts, which receive minimum aids under the current system, benefit from both the new formula and from the increased funding for the school levy credit.[21] Irrespective of district property wealth, given the existence of the revenue caps, the major benefit to districts of the receipt of more aid is property tax relief for district residents, not more resources available to support the education of the district's children.

By increasing the (secondary) guaranteed tax base, the governor's new equalization formula will reduce the tax-price for education for districts with per-pupil tax bases below $515,000 and aided expenditures below approximately $5,900 (in 1996-97). For example, if the governor's proposal were in place for the current school year, the Rice Lake school district, with a per-pupil tax base of $146,474 and shared costs of $4,954, would receive 67 cents per pupil in additional equalization aid for each dollar of extra local spending. As we emphasized previously, the increase in aid occurs in the year following the increase in spending.

For districts with aided expenditures (referred to as *shared costs*) above the $5,900 primary ceiling and equalized values per student between the secondary and tertiary guaranteed tax base, the new equalization formula results in *less* aid for each dollar of extra spending. This *expenditure penalty* discourages school districts from raising spending within the constraints of the revenue caps, and provides voters with a very strong disincentive to approve referenda to increase education spending by amounts in excess of the caps.

The expenditure penalty implicit in the governor's plan may be illustrated by looking at the Madison school district. For the 1996-97 school year Madison's tax base is likely to be on the order of $350,000 per student, and aided expenditures are likely to be roughly $7,000 per student. Equalization aid will therefore be $825 for the first $1,000 in expenditures, $1,570 for the next $4,900, and *minus* $650 for the last $1,100. Total aid will be $1,745, or about a quarter of total aided school expenditures. *But every dollar of expenditures beyond $5,900 will cost Madison's property taxpayers $1.59 in extra local property taxes.* These high costs will probably doom any attempt to raise spending for education by more than the $194 per pupil amount allowed by the caps. For school districts with more property wealth per pupil than Madison, the incentives created by the formula to restrain spending are even stronger. For example, Gibraltar's aidable expenditure is certain to be at least $7,500 per student in the 1996-97 school year, and its tax base per student will be on the order of $1.3 million. Under the governor's plan, every dollar of extra spending per pupil above $5,900 will cost Gibraltar taxpayers $5.91 in local tax revenue.

This Isn't Property Tax Reform . . .

In his 1995 Valentine's Day address, Governor Thompson said that when he "sat down to work on this budget, [he] decided to see it as a one-billion dollar opportunity to improve education in this state." In our judgment, his budget proposal will fail to produce either property tax or school finance reform.

As we argued above, the recently enacted changes in the way public schools in Wisconsin are financed were motivated primarily by the desire on the part of the legislature to reduce property taxes. These changes will be a very ineffective mechanism for achieving property tax reform.

The legislature and the governor have chosen an indirect mechanism for reducing property tax burdens. By restricting increases in school district spending and simultaneously increasing state aid to school districts, local districts are left with no choice but to reduce school property tax levies. This form of property tax relief is completely untargeted. All taxpayers within a school district receive equal proportional reductions in their property taxes.[22] Thus a rich businessman, a poor widow, a national retail chain, a multinational manufacturing corporation, a local farmer, and an out-of-state owner of a vacation home all benefit from equal proportional property tax reductions.

While the reductions will be significant, it is not clear that the actual effect for most taxpayers will be commensurate with expectations generated by media coverage of the debate over property tax relief. As indicated earlier, estimates by the Legislative Fiscal Bureau (1994) suggest that the school property tax rate will decline by about 40 percent by the end of the decade. As school property taxes are on average about 55 percent of total property taxes, overall property tax rates will fall on average by about 22 percent. For taxpayers currently facing high burdens, a 22 percent reduction in property taxes over the next six years may seem like very modest property tax relief. Furthermore, for taxpayers who itemize deductions on their federal returns, any reduction in property tax liabilities will be partially offset by increasing federal income tax liabilities.

Although all taxpayers within a school district will benefit from equal tax rate reductions, there will be a wide range of rate reductions across school districts. In general, property tax reductions will be larger in rural communities, where school property taxes account for a much larger share of total property taxes, than in urban communities. The amount by which property taxes will be reduced in any school district also depends on the operation of the new equalization aids formula. Undoubtedly, some taxpayers currently facing high property tax burdens live in school districts like Shorewood, a suburb of Milwaukee, that will end up with relatively small aid allocations and very modest tax reductions, while some of the taxpayers who currently face low property tax burdens live in districts like Hayward Community that will benefit from relatively large tax reductions (attributable in part to large allocations in new state aid).

The recently enacted school finance reforms will do nothing to address directly the perceived problems with the property tax, namely, the perception that the tax is inequitable because some taxpayers, especially the elderly, the poor, and farmers, face very high tax burdens, the belief that property assessment procedures are unfair and result in arbitrarily

determined tax liability, and the possibility of sudden increase in property tax liabilities stemming from rapid increases in the assessed values.

Public policies could have been developed to ameliorate all the problems with the property tax. For example, the legislature could have targeted property tax relief to those facing especially high burdens.[23] For example, the state could have chosen to expand its circuit breaker-like Homestead and Farmland Tax Relief Credits.[24] Efforts could also have been taken to increase the quality of assessments or to phase in rapid increases in individual assessment over a period of several years. It is also likely that substantial property tax reforms along these lines could be achieved at a cost that would be considerably less than the more than $1 billion needed to finance the current approach to property tax relief.

The fact that none of these well-known policies was considered provides additional evidence that it was tax relief, and not property tax reform, that motivated the legislature and the governor. But the result is, as the *Blue Book* laments, that "the system still lacks the equity its proponents and opponents have sought over the years."

. . and It Isn't School Finance Reform, Either

From observing efforts to change state aid formulas in a number of states, we conclude that reform is highly unlikely unless every district can be guaranteed that it will not lose aid as a result of any legislative changes. This political imperative implies that true reform is possible only when the total aid budget increases substantially. The governor was therefore correct in declaring the legislature's mandate a "one billion dollar opportunity" to reform the current system of school finance in Wisconsin.

The problem is that the governor's initiative fails to take advantage of the opportunity, in four ways: (1) The aids system is likely to do little to increase spending in currently low-spending districts, and does nothing to guarantee that all districts actually provide their students with an adequate education; (2) the proposed system of grants exacerbates, rather than solves the special fiscal pressures faced by school districts with concentrations of poor and "special needs" students; (3) the system establishes a strong fiscal disincentive for districts with above average spending to increase spending by more than the revenue caps, with the consequence that over time per-pupil spending on education will *decline* in real terms; and (4) the revised aid system may well result in diminished public support for schools.

Guaranteeing All Students an Adequate Education

The price that school districts apparently must pay for increased state funding is the acceptance of a permanent revenue cap. The cap in turn has the effect, more or less, of freezing the current pattern of spending across

districts. The governor's proposal allows school boards in districts with base revenues per pupil below $5,500 in 1996 and thereafter the right to exceed the revenue cap without seeking voter approval. This provision will affect about forty school districts serving under 6 percent of Wisconsin's public school students.

There are three reasons why this provision is unlikely to result in a distribution of spending that will guarantee that all pupils receive an *adequate* education. First, because cost differences among districts are ignored, data on spending or revenues per pupil do not provide an appropriate measure of the distribution of educational resources. Districts in parts of the state with a relatively low cost of living and districts with few "special needs" students may be able to provide high quality education with a relatively low level of spending per pupil. Conversely, districts in parts of the state with high living costs must offer relatively high salaries to attract qualified teachers. If these districts also have a concentration of disadvantaged students, relatively high levels of spending may be inadequate to provide the same level of high quality education that some districts are able to provide at much lower levels of per pupil spending.

The second reason why the governor's school finance proposals are unlikely to result in adequate support of education for all children is that there is no requirement that districts that are currently providing inadequate support for education increase their spending on public education. Although the governor's proposals make it considerably more difficult for districts to increase spending on education, they include no provisions that require districts that are providing inadequate education to increase their level of support for education.

Finally, there is good reason to believe that most low-spending districts will not take advantage of the opportunity to increase per-pupil revenues by amounts in excess of the revenue cap. In the 1994-95 school year thirty-one K-12 districts have revenues below $5,000 per pupil.[25] Of these districts, twenty-four face tax-prices of less than 0.5, implying that for each dollar increase in spending per pupil this year, they will receive at least an extra 50 cents per pupil in state aid next year. Thus even though the state equalization aid formula already provides these districts with a very strong incentive to increase spending, the residents of these districts, through their elected school boards, have chosen to maintain relatively low levels of spending.

Providing Financial Assistance for Districts with Needy Pupils

The governor's proposal does not address the issue of interdistrict variation in costs *at all*. Like the current equalization aid formula, the proposed formula distributes money among districts on the basis of differences in per-pupil property wealth. Neither the old formula nor the governor's replacement takes into account the fact that some districts face harsher environments than others and must spend more money to provide any given level of education. The formulas fail to reflect the added costs of dealing with student bodies that include large concentrations of students who come from poor families, have limited proficiency in English, or are mentally or physically disabled.

The revenue cap also takes no account of these cost differences among districts. An increase of spending of $194 per pupil will be most restrictive in districts with high costs. The effect of the revenue caps is made even more pernicious than might otherwise be the case by inclusion of categorical aids. With spending increases limited, districts with growing concentrations of high cost and high need students will be forced to reallocate resources from average students or to shortchange just those students who are most in need of extra attention. This burden will grow over time: the governor's biennial budget proposals call for no increases in the funding for most categorical aid programs, plus the elimination of several grant programs that are targeted to children from low-income families.

Disincentives to Increased Spending

An obvious response to complaints about the restrictions on education spending imposed by the revenue caps is that the voters in any community are free to override the restrictions of the caps by approving referenda allowing additional spending. The problem with the referenda approach, however, is that for many school districts the system has been stacked against approval of referenda. Recall that in 1996-97, the equalization aid formula proposed by the governor includes an *expenditure penalty* for any district with expenditures above $5,900 and a moderate-size per pupil tax base.[26] For any district facing the expenditure penalty, the decision by voters to increase spending by an extra $1 per pupil will directly result in a *reduction* of state aid. Thus, in passing a spending referenda, local voters must agree to increase their property tax payments by more than one dollar per pupil for each dollar of their own taxes they wish to spend on educating their own children. It is thus clear that the proposed aid formula provides a very strong incentive for districts to turn down any spending increases in excess of the revenue caps. Data for the current year indicate that ninety-nine districts, representing nearly 24 percent of all public school students in Wisconsin, would face the *expenditure penalty* built into the proposed aid formulas.

It is apparent that the proposed formula has been designed, in concert with the revenue caps, to achieve a high degree of equalization of spending per pupil across districts. As we have argued in this paper, existing differences across districts in per pupil spending represent primarily dif-

ferences across districts in the *demand* for public education. Some communities are known for their high quality schools, and families who particularly value high quality education are drawn to these communities. The proposed system of school finance is designed to make it very hard for voters in these communities to get the education they want for their children.

Voters are left with few options. To the extent that differences in spending per pupil across communities are diminished, parents who are dissatisfied with the level of education provided in their community will gain little by moving elsewhere. If the public schools do not provide the education parents want, the best option for those who can afford it will be to enroll their children in private schools (Downes and Schoeman, 1993). Over time, the consequences of a movement to private schools are pernicious. Not only does such migration erode support for public education among the very citizens who were once the public schools' strongest supporters, it also removes highly motivated children from public classrooms. Their flight will diminish the quality of education for those forced to remain.

Declining Public Support for Education

By reducing the power of local school boards to determine the size of their local budgets, the revenue caps may well result in a reduction in the overall support for local public education. Although the evidence for this assertion is far from complete, the experience in California suggests that local control is necessary to sustain local commitment to public education. As a result of the well known Serrano decision, the state government in California not only took over most of the financing of public education, but restricted local spending by high wealth districts. In the years since the implementation of that decision, spending per pupil on public education went from 13 percent above the national average (in 1970) to 10 percent below the national average (in 1990). In a recent paper, Silva and Sonstelie (1994) attribute about half of this *decline* in spending to the court-mandated requirement to *equalize* spending.

In many ways the strategy taken in Wisconsin for reform of school finance seems out of step with general political developments nationally. Although interpretation of the results of the congressional elections of 1994 is controversial, most authorities—and certainly the Republican leadership of the U.S. House of Representatives—see in the elections a mandate for devolution of responsibility to lower and presumably more responsive units of government. Governors, including Governor Thompson, argue for elimination of federal restrictions—that is, mandates—in order to allow maximum discretion for state government. But in Wisconsin's case, the same governor and legislators who argue so effectively for minimization of control from Washington insist upon it for governments—school districts—that are even closer to the grass roots. We have yet to hear why school districts *can't* be trusted with state funds, but governors and legislators *can* be trusted with federal grants. After all, the imposition of a revenue cap is in effect a *mandate* on local school boards to limit their spending. And to our knowledge no one has been able to explain why it is that districts that choose to spend generously on education should see their state aid reduced.

We conclude that the quality of public education in Wisconsin will suffer if the legislature adopts the governor's plan. We conclude in addition that these reforms ignore some major problems with the current system of school finance in Wisconsin. We believe it is possible to achieve true school finance reform in Wisconsin while still guaranteeing property tax relief to Wisconsin residents. We think it is essential to attempt to do so in the context of the massive restructuring of finance the legislature has authorized.

An Alternative Strategy

A reasonable starting point for any effort to reform the system of school financing in Wisconsin is to redefine the way we think of the state's constitutional mandate to provide schools that are "as uniform as practicable . . . ." For the past several decades, uniform schooling has, at least implicitly, meant that equal tax rates guarantee equal spending. As long as the costs of providing education vary across districts for reasons that local school districts have no control over, this objective, whatever its merits, does not guarantee that equal tax rates will generate equal educational opportunities. For example, if as suggested by research in other states, there are extra costs involved in educating children from economically disadvantaged families, then districts with heavy concentration of these poor children will be less able to provide any given quality of education than districts with fewer economically disadvantaged children.

Furthermore, even if the state aid system guarantees that equal tax rates will generate equal levels of per-pupil spending, there is no reason to believe that actual per-pupil spending will be equal across districts. Data in Wisconsin and elsewhere indicate that spending per pupil in high-income school districts is generally higher than spending in low-income districts, despite the fact that low-income districts receive substantially more aid.[27]

In our view, a preferable way for the state to meet its obligation to provide uniform education is to mandate that every district spend enough money on the education of its pupils to guarantee that they are given an *adequate* education. To enable all school districts to fulfill this obligation at a reasonable tax rate, the state should guarantee that each district be provided with sufficient fiscal resources to achieve this goal. Thus uniformity

would be defined as a standard of quality education to which all Wisconsin children would be entitled. The fact that some school districts may choose to spend more does nothing to diminish the uniformity of the standard.

In order to achieve this goal, the state should establish a *foundation* formula with cost- and inflation-adjusted foundation levels. This is accomplished by defining a foundation level equal to the amount of spending the legislature determines is necessary to provide an adequate level of education in districts with average costs. Each district would be required to spend an amount per pupil that equaled its foundation level. Based on data on the characteristics of each school district, the state would develop a school cost index. A district with average per-pupil costs has an index value of one. A district in which, for reasons beyond the control of the local school board, it costs 18 percent more than average to provide an adequate education would have a cost index equal to 1.18. Likewise, the value of the cost index for a school district with costs that are 10 percent below average, would equal 0.9. Each school district's cost index would then be multiplied by the average foundation level in order to determine the foundation amount for each district.

State aid allocations to each district would be determined by calculating the difference between each district's foundation level and the amount of property tax revenue each district would raise by levying a required minimum property tax rate. Any districts in which the property tax revenue generated by the required mill rate exceeded that district's foundation level would receive no foundation aid.[28]

Under this type of foundation formula, state aid would be both a function of the size of the tax base and the costs of providing education in each school district. With the cost-adjusted foundation set at a level sufficient to provide an adequate level of education and with the required property tax rate set at a low level, it would be possible to achieve a substantial reduction in property tax rates in most communities. If it chooses, the state could commit itself to providing total aid equal to two-thirds (or more) of the cost of funding the foundation level of education for each child. This goal could be achieved by setting the required property tax rate equal to one-third of the rate necessary to finance the foundation level of education from the current statewide property tax base.

Local school districts will be free to supplement spending above the cost-adjusted foundation. The critical element is that the full cost of providing extra spending should be borne by local taxpayers. This will provide fiscal discipline and should retard the average growth of property taxes. At the same time, communities that want to increase spending on public education would be able to do so through their support of higher property tax rates. Thus a big advantage of a foundation formula is that it can be adopted without also adopting a revenue cap and without penalizing school districts that choose to spend at higher-than-average levels.

By committing itself to financing two-thirds of total educational spending, state government must also control local spending on public education if it wants to retain control over the growth of the state's aggregate budget. Thus the two-thirds commitment comes at the heavy cost of greatly diminishing the control local school districts have over educational spending. In our view, it is far preferable for the state to commit itself to fund the cost of a cost-adjusted and indexed foundation formula that will guarantee that all Wisconsin children receive an adequate quality education. As with the governor's proposal, this approach would guarantee that the share of education spending financed by the state would increase substantially, and the cost of the state's commitment would grow at approximately the rate of inflation. The big difference, however, is that each local school district will retain control over local spending decisions, and these decisions would reflect the true cost to local taxpayers of increasing spending.

The major (nonpolitical) impediment to adopting the type of foundation formula we propose is the difficulty of measuring costs and developing a cost index. Although the measurement problems are complex, several states have made reasonably successful efforts. The goal of any such effort is to measure only those costs that are attributable to characteristics of the local school district or the composition of students bodies that are beyond the control of local school officials. Recent studies have provided estimates of educational costs in Nebraska (Ratcliff, Riddle, and Yinger, 1990), Arizona (Downes and Pogue, 1994), New York (Duncombe, Ruggiero, and Yinger, 1995), and Michigan (Courant, Gramlich, and Loeb, 1994).[29] In each case, the authors found that costs varied substantially among districts. For example, Courant, Gramlich, and Loeb show that under Michigan's new system of school finance, the Detroit school district will spend an above average amount per pupil, when spending is measured in money terms. When spending is adjusted to reflect the cost differences among districts, Detroit's "real" per pupil spending falls below spending in the rest of Michigan's 523 school districts. We are confident that a similar approach can be used in Wisconsin to provide a reasonably accurate measure of the costs of education in each district.

The Crossroads

To conclude, we see the state at a crossroads. One direction involves rigid adherence to the two-thirds mandate and focus on tax relief. Under this alternative, property taxes will go down, and other taxes will go up or other government services will be contracted, but neither property tax reform nor school finance reform will be achieved. Both the expenditure penalties incorporated in the new aids formula and the permanent expenditure controls will serve to reduce the level of school expenditures over

time. The independence of the state's school districts will be substantially diminished. Despite all these changes, in the end—or even by the year 2000—most of the problems associated with the property tax will still be with us, and the quality of public education in Wisconsin will probably be reduced.

The alternative is for the legislature and the governor to recognize that property tax relief is not the state's only objective, and that the two-thirds initiative offers what may be the last opportunity in this century for meaningful reform of both the property tax and the state's system of finance. The state can finance two-thirds of the cost of an equal education guarantee for all students. Doing so may require more substantial structural reforms now, but we believe the payoff will be more lasting "relief" from the school finance debate and a better future for Wisconsin's children.

Endnotes

1. This percentage includes both direct state aid and school levy credits as a proportion of the sum of property taxes plus aid and credits. To be consistent with calculations of state shares in other states, property tax credits should be excluded from the calculations. Excluding levy credits, the state share mandated by the new legislation would increase from 39.0 percent in 1993-94 to 61.4 percent in 1996-97.

2. A number of studies by economists have found that the property tax is considerably less regressive than suggested by the simple analysis of annual property tax liabilities and incomes. Furthermore, there is little evidence that the property tax results in elderly homeowners being taxed out of their homes. Nevertheless, the conclusions of this literature have had little impact on the public perception of the fairness of the property tax. A prerequisite for new policies to alleviate inequities in Wisconsin's property tax system should be a detailed study of the distribution of actual property tax burdens in Wisconsin. The last such study was conducted nearly 25 years ago.

3. Wisconsin Public Broadcasting, Television Station WHA, "Weekend," February 12, 1993.

4. For this discussion we ignore unmerged school districts. In addition to the 370 K-12 districts, Wisconsin has 47 elementary districts and 10 high school only districts. State aids are distributed to the high school and elementary districts using a different formula from that applied to the K-12 districts (Wisconsin Department of Public Instruction, 1994, 96).

5. Recovery or "negative aid" was declared unconstitutional in Wisconsin in 1976 (*Buse v. Smith*). During the television special cited on page 9, WHA commentators argued that this court decision set back the state's system of school finance to its status in 1949, when the state first attempted to compensate for interdistrict variation in tax base with equalization aids. This claim is ludicrous given the small number of districts involved. Legally, this decision probably did imply a judicial consensus that achievement of complete taxpayer equity is not "practical" in the sense used by the constitutional requirement of "nearly uniform" district schools (see page 9).

6. The largest per pupil minimum aid payments go to districts with low household income and high tax rates and the smallest payments go to high wealth, high income districts with low tax rates. See Wisconsin Department of Public Instruction (1994), p. 61.

7. The actual formula used to distribute equalization aid in Wisconsin is more complicated than a standard DPE formula. Above a specified level of spending per pupil, called the "primary ceiling," the state share declines. For districts spending above the primary ceiling ($5,453 in 1993-94) and with property tax bases per pupil below the "primary guarantee" but above what is termed the "secondary guarantee" ($204,365 in 1993-94), each extra dollar of spending *reduces* total equalization aid. In consequence, a district's decision to raise expenditures by $1 per pupil beyond this level will cost *more* than $1 when both necessary local taxes and the resulting reduction in state aid are figured in.

8. There are actually 370 K-12 districts in Wisconsin. We follow the common practice and drop the Norris school district from our analysis. Due to an historical anomaly, Norris is officially a public school district, but it is in fact a private boys' reform school with an enrollment of 72 students and a per-pupil property tax base that is only 3½ percent of the state average.

9. The data in table 1 are organized by district, not by enrollment. Thus the bottom enrollment decile accounts for far fewer students than does the top. We utilize district rather than individual data because districts, not individuals, respond to the incentives created by the state's financing system.

10. Each year when Wisconsin's citizens file tax returns they are asked to report their school district. This information and reported taxpayer adjusted gross income is used to generate the average "income/return" data displayed in table 1. It is important to keep in mind that (a) taxpayers make errors, (b) some households do not file, and (c) adjusted gross income does not include nontaxable income. Despite these limitations, we believe that these data provide a good picture of the relative incomes of school district households.

11. More precisely, we measure interdistrict variation in spending-effort

ratios by the *coefficient of variation*, that is, the ratio of the standard deviation of spending effort to the mean. The coefficient of variation of spending-effort ratios for 1992-93 was 0.239. The reduction estimate reported in the text is based on the (admittedly unlikely) assumption that in the absence of equalization aids districts would have maintained their 1992-93 level of expenditures per pupil by raising local tax rates.

12. In contrast, Courant, Gramlich, and Loeb (1994, p. 5) report that in 1992-93 the guaranteed base in Michigan amounted to $192,520 (adjusted for assessment ratios) and more than one-third of all school districts had tax bases above this guarantee. Recall the Wisconsin "primary guarantee" was $310,726 in the same year.

13. Measured by the coefficient of variation in spending (see note 11). The value of the coefficient of variation in 1992-93 was .127. The coefficient of variation for 1980-81 is from Yoon (1991).

14. These states are Illinois, Indiana, Kansas, Michigan, North Dakota, Ohio, Pennsylvania, and Virginia.

15. "Normative standards of equity" in the literature on school finance are decidedly ad hoc. In this case the "standard" is that the coefficient of variation of expenditures per pupil is less than or equal to 10 percent (Odden, Busch, and Hertert, 1994, p. 7).

16. The problem of lags has another dimension. Lags in responding to changes in the equalization aid formula may result in our underestimating the equalizing impact of the grant system. Since we do not know how long it takes school districts to respond to changes in aid distribution formulas, we have no way of knowing whether the school finance system, as we observe it, is in equilibrium. In Wisconsin, the parameters of the grant system—the primary and secondary guarantees, and the "primary ceiling"—have changed almost every year. The available data provide a "snapshot" of patterns of spending and taxing in a single year. It is dangerous to interpret these data as representing the full response of local school districts to their constantly changing fiscal environments.

17. The revenue caps are also adjusted to account, with a one-year lag, for enrollment increases.

18. Any unauthorized spending above the caps would result in a reduction in state equalization aid by an amount equal to the revenues in excess of the cap.

19. Currently no district in the state has a tax base of $2 million per student, so all will fall under the equalization aids scheme.

20. The precise parameters will depend on the aid amounts required to assure that the two-thirds target is met.

21. The school levy credit is distributed in direct proportion to each community's school property tax levy. Thus, because high income districts generally have relatively high property tax levies per student, they are favored by the distribution of the school levy credits.

22. Economists disagree considerably about how much of the property tax levied on rental property is passed on to tenants in the form of higher rents. It is clear, however, that tenants will not immediately benefit from property tax reductions. Rents will be reduced to reflect the fall in property taxes only to the extent that the change in tax policy induces an increase in the supply of rental units, which in turn will place downward pressure on market rents.

23. Targeting of property tax relief to certain types of taxpayers will probably require the repeal of the "uniformity" clause of the state constitution.

24. For a description of the Homestead and Farmland Preservation Credits, see Wisconsin Department of Administration (1995), pp. 35-37. These provisions of current law substantially offset the impact of the property tax on farmers and low-income homeowners.

25. These revenues includes only those subject to the revenue cap.

26. Not all expenditures are subject to state aid. The $5,907 penalty level applies to "aided" expenditures.

27. Econometric evidence suggests that income elasticities of demand for public education are larger in absolute value than price elasticities (Bergstrom, Rubinfeld, and Shapiro, 1982). This finding helps explain the fact that high-income communities tend to spend more per pupil than low-income communities even in an environment where DPE school aid formulas achieve a substantial amount of taxpayer equity.

28. In algebraic terms the foundation formula can be written as:

$$G_{it} = \text{Maximum}\{ C_{it}F_t - t^*B_{it}, 0 \}$$

where G_t equals the foundation grant to school district i in year t, F_t equals the indexed foundation level in year t, indicating a level of per pupil spending that will provide what the state considers to be an adequate level of education in districts with average costs, C_{it} equals a cost index that indicates how much more or less it costs to provide an average quality education in school district i as compared to a district with average costs, t^* equals a minimum property tax rate that every school district is required to levy, and B_{it} equals the per pupil property tax base of district i in year t.

29. Downes and Pogue (1994) show that it is possible to estimate the costs of public school ing by directly estimating a cost function or indirectly by identifying the impact of various cost factors from an expenditure regression. The direct approach is complicated by the fact that in order to estimate a cost function one must explicitly measure public school output.

Downes and Pogue address this issue by using data on pupil test scores. Meyer (1994) has shown that an accurate measure of school output (at least as measured by increases in cognitive skills) requires repeated tests of the same students. Unfortunately, these data (in the form of standardized test scores) are not available in most states, including Wisconsin.

The alternative approach is to estimate a reduced form regression of per pupil expenditure on a set of demand and cost variables. Ideally the cost variables will reflect characteristics of the school districts, such as its physical size or the regional cost of living, and student characteristics related to costs, such as the number of students with handicaps or from economically disadvantaged families. In practice, some cost variables may at least in part reflect demand factors and may be correlated with the error term. As demonstrated by Bradbury et al. (1984), this regression-based approach to estimating costs is likely to provide an underestimate of the true cost differences among school districts if school boards in high-cost districts respond to these high costs by reducing their demand for education.

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