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A contentious issue . . . is the call for an 'urban factor' in the funding formula.

#### Reward-for-Effort

In 1993, the Indiana General Assembly sought to address these concerns by adopting a new concept to guide state aid to K-12 schools and state control of school general fund tax rates. This new approach allocates state aid, and prescribes school corporation general fund tax rates, in an effort to weaken the strong positive link between non-categorical revenue and property values described in *Lake Central*. Instead, the state is implementing a reward-for-effort—or guaranteed tax base—approach that attempts to establish a strong positive link between a school corporation's per pupil non-categorical revenue and its general fund tax rate. The formula requires those school corporations who receive higher revenue amounts to levy higher general fund tax rates than those school corporations who receive lower revenue amounts.

# Indiana's Reward-for-Effort School Funding Formula: Issues and Options

Neil D. Theobald  
Barry Bull  
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The reward-for-effort approach guarantees a unique assessed valuation amount per pupil for each per pupil revenue level (i.e., the formula assigns each per pupil revenue amount a given per pupil assessed value amount). As the per pupil revenue amount increases above \$3,755, the guaranteed assessed value decreases from its peak of \$147,200. For example, in 1997, the state allows a school corporation with non-categorical revenue of \$4,000 per pupil to use an assessed valuation of \$142,756 per pupil in calculating its target general fund tax rate. This generates a tax rate of approximately \$2.80 (\$4,000 divided by \$142,756 = \$2.8020 per \$100 AV). A school corporation with non-categorical revenue of \$5,000 per pupil will use an assessed valuation of only \$126,663 per pupil in calculating its target general fund tax rate (see Figure 1). This generates a tax rate of nearly \$3.95 (\$5,000 divided by \$126,663 = \$3.9475 per \$100 AV). Allowing a school corporation with \$4,000 per pupil in revenue to use a higher assessed valuation than does a school corporation with \$5,000 per pupil will lower the tax rate charged in the former corporation in comparison to the rate charged in the latter corporation.

Indiana is in the fourth year of a scheduled six year phase-in of its guaranteed yield reward-for-effort school funding formula. The goal of the formula is to ensure that school corporations receiving equal reward (i.e., generating equal amounts of per pupil non-categorical revenue<sup>1</sup>) also make equal effort (i.e., levy equal general fund property tax rates).<sup>2</sup> Previous work (Theobald, Vesper, & Bull, 1995) suggests that the state has made significant progress in meeting its goal of equal reward-for-effort across Indiana school corporations.

This paper will first briefly describe how Indiana funds K-12 education. It will then review current school funding issues faced by the state and discuss possible courses of action available to the Indiana General Assembly. The intent is to provide policy makers, both inside and outside Indiana, with an overview of how the state will distribute nearly \$2.3 billion in non-categorical aid in 1997 and the challenges the 1997 General Assembly faces in devising the 1998 and 1999 school formula.

The reward-for-effort formula sets each school corporation's per pupil non-categorical revenue, its general fund property tax rate, and its percentage of state aid. Each year, the formula first adjusts a school corporation's prior year revenue amount to provide larger funding increases for school corporations with lower revenues. Once these variable grants and minimum guarantees are in place, though, the formula "adjusts the school corporation's regular tuition support downward when enrollment has declined for two consecutive years" (Mills, 1995, p. 3). This provision, known as the "deghoster", is not allowed to decrease per pupil revenue below \$3,715, the minimum guaranteed in 1997.

## How Schools Are Funded in Indiana

The Indiana school funding formula was developed in response to a lawsuit that challenged the constitutionality of the state's previous school funding system (*Lake Central et al. v. State of Indiana et al.*, 1987). The plaintiffs in the *Lake Central* lawsuit charged that since the previous modified foundation formula allowed property-rich school corporations to generate more revenue than property-poor school corporations, it violated the equal protection clause of the state constitution (Article I, Section 23) and that the state was out of compliance with Article VIII, Section 1, which provides "for a general and uniform system of common schools." Other critics charged that the formula was "a twenty-year ad hoc accumulation of frequently conflicting and inconsistent policies" (Johnson, 1993).

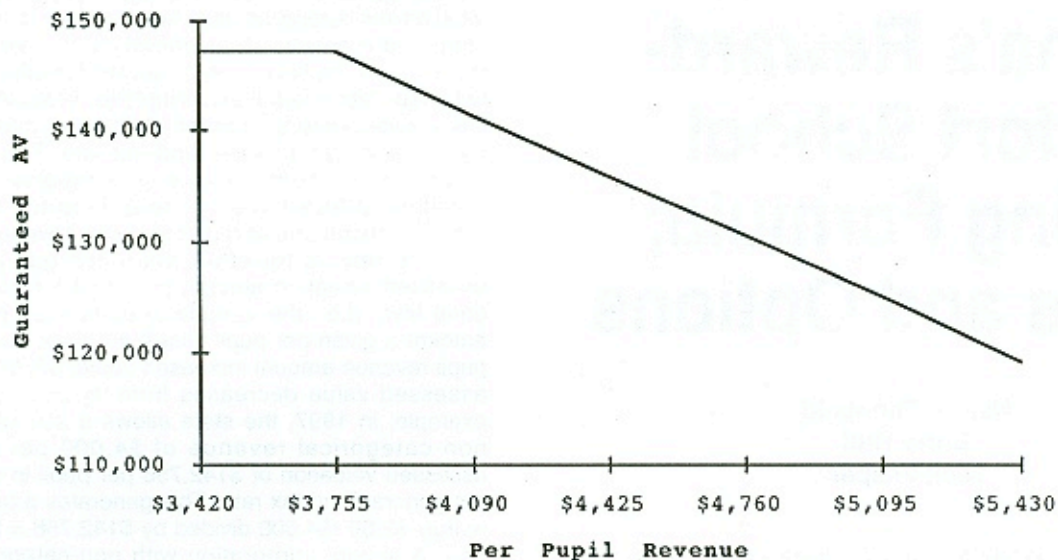
For each per-pupil revenue amount, the school formula prescribes a unique "target" general fund tax rate. For 123 school corporations, this 1997 target rate is within 5¢ of their 1996 general fund tax rate. These corporations are described as "corresponding" (i.e., the corporation's tax rate "corresponds" to its per pupil revenue) or "on-chart". They use the 1997 target rate as their 1997 general fund property tax rate. The remaining 171 school corporations (those whose 1997 target rate is more than 5¢ above or below their 1996 general fund tax rate) are described as "non-corresponding" or "off-chart". These corporations determine their 1997 general fund property tax rate by increasing or decreasing their 1996 general fund rate by 5¢ (whichever moves the corporation toward its target tax rate).

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## Non-Categorical State Aid

While school corporations use a guaranteed assessed valuation to calculate target revenues and tax rates, they use their actual per pupil assessed value to calculate the percentage of non-categorical revenue that the state will provide. The percentage of a school corporation's non-categorical revenue pro-

**Figure 1**  
**1997 Guaranteed Assessed Valuation at**  
**Each Per Pupil Revenue Level**



vided through state aid is determined by the extent to which a school corporation's actual assessed valuation per pupil falls short of the guaranteed assessed valuation per pupil.

In 1997, the mean per pupil non-categorical revenue in Indiana is \$3,823, while the mean assessed valuation per pupil is \$48,713. According to the 1997 funding formula, a per pupil revenue amount of \$3,823 would allow a school corporation to assume a guaranteed assessed valuation of \$145,909 per pupil. Since the guaranteed assessed valuation is about three times the local tax base, a school corporation with average per pupil revenue and average assessed valuation will receive approximately three times the revenue generated solely by their local assessed valuation. Thus, state aid accounts for about two-thirds of an average school corporation's non-categorical revenue.

The percentage of non-categorical state aid received by a school corporation varies inversely with revenue and with assessed valuation. The percentage of state aid increases for school corporations with below-average revenues or below average assessed valuations and falls as revenues or assessed valuations increase across school corporations. At the extreme, the most property-rich school corporation in the state receives no state aid, but is allowed to levy a slightly lower general fund tax rate to keep the non-categorical revenue it collects from being greater than its targeted amount.

#### *Categorical State Aid*

Along with the non-categorical revenue generated through the reward-for-effort formula, the state apportionment formula provides additional grants for (a) enrollment growth, (b) at-risk programs, (c) K-3 class size reduction, (d) special education, and (e) vocational education.

1. To qualify for the enrollment growth grant, a school corporation must enroll 250 more students than in the prior school year. For these school corporations, the state provides an additional four months of revenue (to cover expenses for September-to-December of the prior fiscal year) for each added student.

2. To qualify for an at-risk program grant, a school corporation must be among the 234 school corporations in the state with the highest "at-risk indexes" as measured by a state formula. The formula uses percentages of (i) adults without high school degrees, (ii) children living in single-parent homes, and (iii) children living in poverty as proxies for social conditions that create unique and significant expenses for school corporations.
3. To qualify for a K-3 class size reduction incentive (i.e., PRIMETIME) grant, a school corporation must either reduce pupil-to-adult ratios in grades K-3 in the current year or maintain the grade level ratios prescribed for a particular grade (18-to-1 in kindergarten and first grade; 20-to-1 in second and third grades). An instructional assistant is counted as one-third FTE for purposes of calculating this ratio. In 1997, school corporations receive \$25,000 for each FTE added to the ratio in the current year or needed to maintain the ratio below the grade level threshold.
4. Special education grants are based on the number of children identified in three categories. In 1997, students in the severe category generate \$7,000 per pupil, those in the mild and moderate category generate \$1,900 per pupil, and those in the communication and homebound category generate \$450 per pupil.
5. Vocational education grants are based on an additional pupil count (APC) matrix that has remained unchanged since 1979. Each of 11 vocational programs is weighted to provide an additional pupil count that generates \$1,540 per APC in 1997.

#### **Current School Funding Issues in Indiana**

The remainder of this paper highlights three current school funding issues faced by Indiana and discusses possible courses of action available to the General Assembly. The first two—property taxes and urban school funding—are enduring issues that will require efforts across several sessions. The last

issue—alternative schools—is narrow with objectives that are reachable in a single session. This section presents each issue, followed by a discussion of pertinent data and, when appropriate, recommends an option to the 1997 Indiana General Assembly in addressing the issue.

#### Issue #1

- The new formula generates higher average general fund property tax rates. This trend compounds a widespread perception that property taxes are increasing too fast in Indiana.

In 1993, school corporations in Indiana levied general fund property tax rates that averaged \$2.92 per \$100 of assessed valuation. In 1996, all property in Indiana was reassessed. Due to this reassessment, the charged rate fell to slightly less than \$2.73 per \$100 of reassessed property in 1997. Without this reassessment, though, school corporations in Indiana would have levied general fund property tax rates that averaged \$3.10 per \$100 of assessed valuation. Thus, over the first four years of the phase-in, general fund tax rates have increased by 18¢, or 6.3%.

This tax increase, though, has begun to address the taxpayer inequity that lay at the heart of *Lake Central*. In 1993, taxpayers in the 30 school corporations with the highest general fund tax rates paid more than double the tax rate paid by the taxpayers in the 30 school corporations with the lowest general fund tax rates (see Figure 2). The 40% of school corporations with general fund property tax rates above the state average paid nearly \$1.00 per \$100 of assessed valuation more in taxes than did lower tax rate school corporations (\$3.49 per \$100 for high tax rate school corporations; \$2.54 per \$100 for low rate corporations).

As shown in Figure 3, the new formula has increased tax rates for low rate corporations by an average of nearly 10%, while higher rate school corporations have increased by less than 3%. It could be argued, therefore, that the property tax rate increase created by the new formula resulted not from a flaw in the formula, but instead as a necessary by-product of the very low property tax rates prevailing in a large number of Indiana school corporations.

One of the anomalies of the current formula is that the 90 lowest revenue school corporations in Indiana are all classified by the formula as "low-tax-high spend" (i.e., the corporation's general fund tax rate is too low given its per pupil revenue). These school corporations have low per pupil revenue, but they have very low general fund property tax rates. To rectify the taxpayer inequity described in *Lake Central*, the new formula must bring tax rates in these very low rate school corporations closer to those prevailing in the rest of the state.

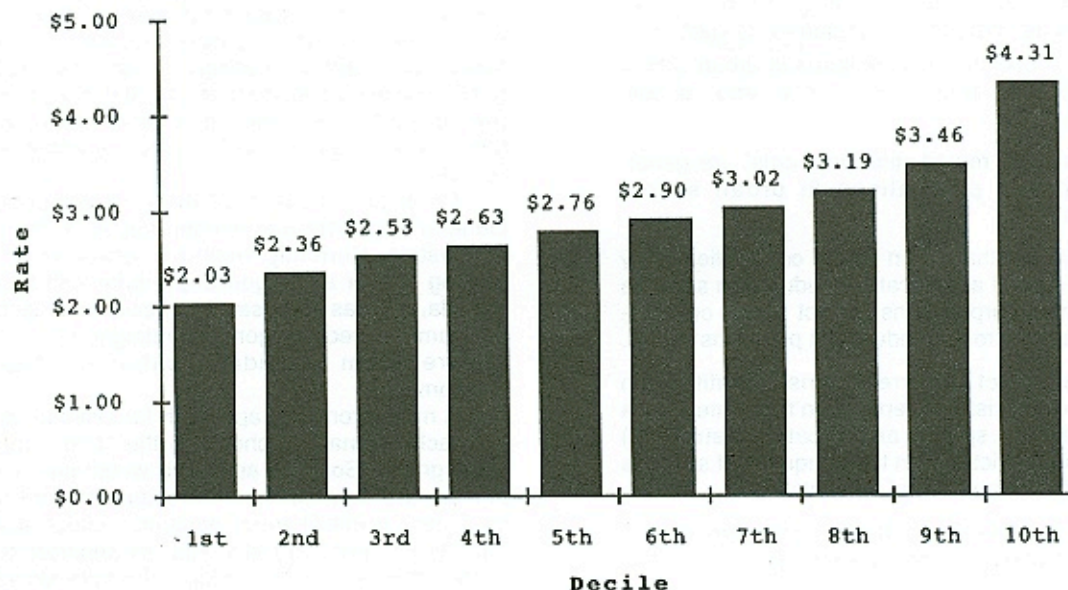
Thus, an immediate course of action for the 1997 General Assembly seems uncertain. Although the previous court order to rebuild Indiana's property assessment system has been vacated, the 1997 General Assembly will be under increasing pressure to find alternatives to the current dependence on property taxes to fund public schools. This pressure, though, seems to be, at least in part, in reaction to efforts to improve taxpayer equity. One course of action the 1997 General Assembly might consider is establishing an interim committee to study the Indiana tax system as it relates to public schools. Such a study could include exploration of alternative sources of revenues for public education, but should also address how proposed changes would affect the fairness of the tax system across Indiana's school corporations.

#### Issue #2

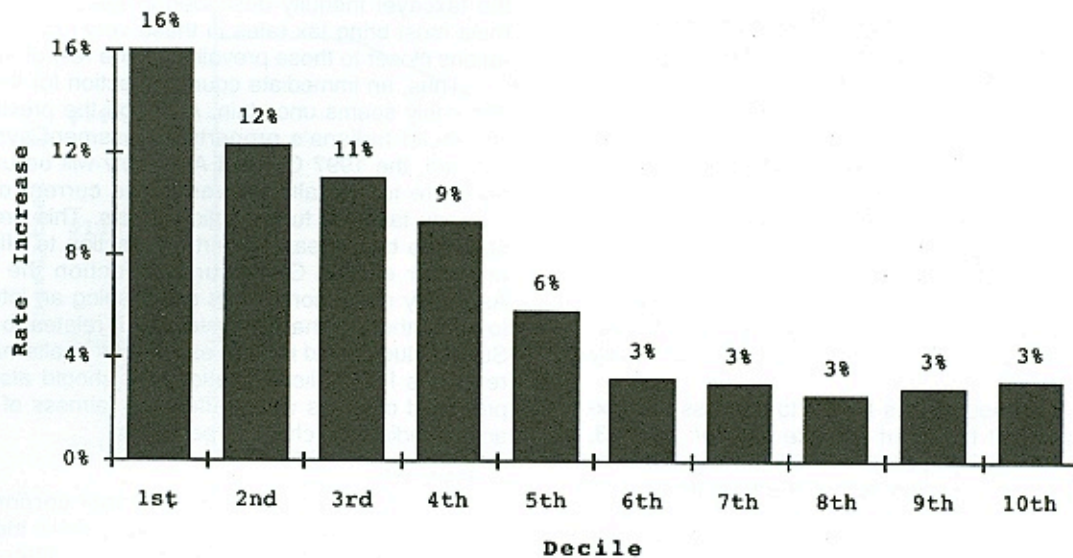
- An increasing number of school corporations, and especially those in urban areas, believe the funding formula should better recognize real differences in the cost of education across the varied school corporations in the state.

Currently, urban school corporations receive an average of about \$400 more per-pupil revenue than other Indiana school corporations (Theobald, Bull, & Vesper, in press). These corporations have come to increasingly question the extent to which this additional revenue sufficiently reimburses them for the expenses generated by the special populations they serve (Indiana Urban Schools Association (IUSA, 1997). For example, students in Indiana's urban school corporations are three times more likely to live in poverty, twice as likely to require remediation for the statewide academic exam, and are

**Figure 2**  
General Fund Property Tax Rates in 1993, by Decile



**Figure 3**  
**General Fund Property Tax Rate Increase**  
**from 1993-1997, by Decile**  
**(Rates Adjusted for 1996 Reassessment)**



more than twice as likely to live in a single-parent home than are students in non-urban districts (Theobald, Vesper, & Bull, 1995).

As a result, urban school corporations have approached the 1997 General Assembly with requests that the school funding formula be revised to provide additional revenue for expenditures (i.e., security, English as a second language, free textbooks for students living in poverty) that they believe heavily impact urban schools. According to these corporations, without support for these kinds of expenditures, urban corporations are left with relatively less to spend on instruction.

In response, the 1997 General Assembly might consider establishing an interim committee to study cost factors that affect urban schools uniquely. The increasing diversity in our urban centers is well documented. What has not been documented is the way in which these factors constrain the ability of urban schools to meet their constitutional charge to "provide a free and appropriate education" for all children. An interim study committee could address itself to questions such as:

- How do distributions of expenditures in urban school corporations differ from those in non-urban school corporations?
- What needs (e.g., remediation programs) are generated by special populations in urban school corporations?
- How does the role that urban school corporations play in providing special and vocational education services to other school corporations impact urban corporations' spending for regular education programs?
- What is the impact of current at-risk identification practices (i.e., at-risk students aren't "counted" in a manner similar to special and vocational students) and spending restrictions on the adequacy of services provided to this population of students?
- How well do graduates of urban school corporations perform in college and in the labor market?

#### Issue #3

- Increasing numbers of policy makers and educators are calling for state funding for alternative education.

Alternative schools were championed by a number of candidates in the 1996 election, most prominently the incoming governor, as one means of providing better educational opportunity for students exhibiting behavior problems and showing an inability to function in the traditional school setting. In addition, alternative schools are seen as leading to greater overall achievement by students in the traditional setting whose educations are currently being negatively affected by chronically disruptive students.

The 1997 General Assembly might consider developing a formula to provide funding for the excess costs involved in developing and operating alternative schools (primarily staff training, facility upgrades, and student transportation). An initial step will be defining the purposes and means of alternative education that would be supported by state funds. One option is to define alternative education as instructional and pupil personnel programs, in settings outside the regular school program, that are designed to enhance the likelihood that students placed in them will attain the performance levels established by the state testing (i.e., ISTEP) program and graduate from high school.

Clear specification of the problem should provide the General Assembly with needed guidance in designing a funding system. Currently, most proposals for alternative school funding call for a categorical program with a separate funding formula, such as that used for special education. Unfortunately, program-focused categorical funding formulas have historically suffered from over-identification of students for these programs.

A more promising approach for distributing funds might be to attach alternative schools to the state's current at-risk program grants. Such an approach would see alternative education as the solution for addressing the problem of "at-risk students". If the General Assembly chose instead to specify "chronically disruptive students" as separate from "at-risk students", then it might develop a formula similar to the at-risk

index. Such a formula could base a school corporation's alternative school funding on indicators of chronic disruption such as reported incidents of disorderly conduct or drug incidents. Tying alternative school funding to students and their circumstances—as could be accomplished through either the current at-risk formula or through a new alternative school formula—effectively targets funds without providing incentives to over-qualify students.

### Conclusion

Before the implementation of the new guaranteed yield reward-for-effort school funding formula, differences in property values were more important than differences in tax rates in explaining why some school corporations had access to more revenue than did other school corporations. Currently, differences among school corporations in local property tax rates are eight times more important than differences in property tax wealth in explaining why school corporations generate differing amounts of revenue (Theobald, Vesper, & Bull, 1995). Thus, the new funding formula is dramatically succeeding in moving toward its goal of providing higher revenue amounts to school corporations with higher tax rates.

However, the 1997 General Assembly still faces a number of difficult challenges as it attempts to continue this progress in 1998 and 1999. The current formula has increased general fund property tax rates by 6.3% in an environment in which property taxes—and their use to fund public schools—are coming under keen scrutiny. This increase in property taxes is far from uniform, though, and it could be argued that the tax rates in a large number of very low rate school corporations need to be brought closer to those prevailing in the rest of the state if the formula is to rectify the taxpayer inequity described in Lake Central.

Another contentious issue facing the 1997 General Assembly is the call for an "urban factor" in the funding formula that would reflect differences in the cost of education across the varied school corporations in the state. Urban school corporations believe that they "have expenditures which are unique to the nature of the communities in which they are located" (IUSA, p. 4).

This paper recommends establishing interim committees to study both (a) the Indiana tax system as it relates to the state's public schools, and (b) cost factors that affect urban schools uniquely. Each of these issues has wide-ranging financial and legal ramifications. Detailed analysis of current and alternative practices would provide future legislative sessions with extremely valuable guidance on these enduring school finance issues.

The other major challenge facing the 1997 General Assembly—funding of alternative school programs—is nar-

rower in scope and seems amenable to more straight-forward legislative action. Students in an alternative setting are almost necessarily more expensive to educate than children in a traditional setting. Additional staff training and lower class sizes produce higher operating expenses, while the development of segregated settings may require additional on-going transportation expenses. This paper recommends that General Assembly not develop a separate categorical funding formula for students placed in alternative education settings. Instead, the General Assembly should either build a factor into the state's current at-risk formula to trigger funding for alternative settings or establish a new alternative school formula that ties funding to students and their circumstances as is the case with the at-risk index. Such an approach will allocate alternative program funding across school corporations without providing an incentive to over-identify students for such programs.

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### Endnotes

1. Per pupil non-categorical revenue is the sum of a school corporation's (a) state tuition support, (b) state at-risk grant, (c) maximum local levy, (d) vehicle excise and financial institutions taxes, and (e) state share of Social Security employer contribution, divided by the school corporation's average daily membership.
2. General fund property tax rates are the general fund dollars raised per \$100 of assessed valuation of real property in the school corporation.