State Education Funding Keeps Pressure on Many School Districts

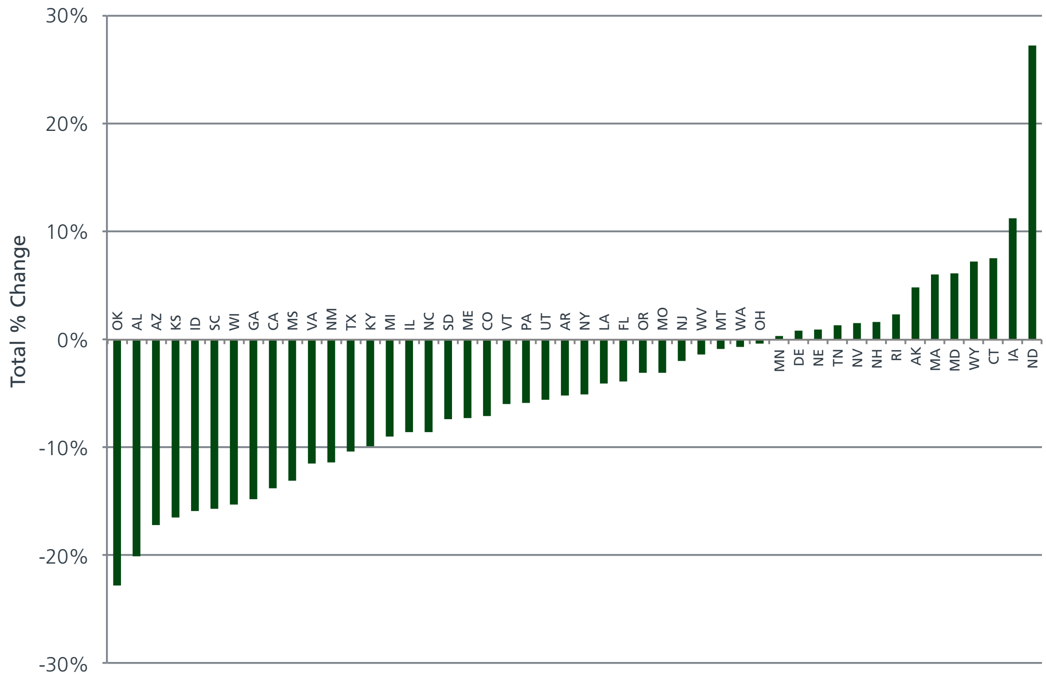
Local school districts are funded primarily from two sources, local property taxes and state aid payments, with some additional funding from federal and state programs and other local sources. Local property taxes have historically been a relatively stable revenue base that provided a great deal of budget stability for districts. When real estate market values in most areas declined from 2007 through 2011, local tax revenues dropped substantially in many districts as the decline in housing prices hit local tax bases. Even so, in most areas those drops were manageable and have begun stabilizing or reversing. In contrast, state education funding remains a source of significant budget pressure for many local school districts.

A new report from the Center on Budget and Policy Priorities finds that the level of state funding for kindergarten through 12th grade in most states in the current fiscal year (FY2013-2014) remains below the pre-recession funding levels of FY2007-2008. On a per-pupil basis, many states are allocating substantially less for K-12 education than in the past. Furthermore, 15 states' budgets included additional K-12 funding decreases (per-pupil) for the current fiscal year, placing even more pressure on local school districts to balance tight budgets. Even though the national economy technically emerged from recession in June 2009, the subsequent (and continuing) period of slow growth hampered revenue growth in most states until 2011 or later.

According to the Center's statistics, overall state tax revenues as of March 2013 remained 2.8% below peak 2008 levels, when adjusted for inflation. States have been forced to cut spending heavily to balance their own budgets and education funding is one of the largest components of overall spending in most states. Consequently, many states were forced to make significant cuts to total education spending to manage their own budget crises, pushing the pain down onto the local level.

Changes in Per-Student Education Spending by State

% Change, FY2008 to FY2014

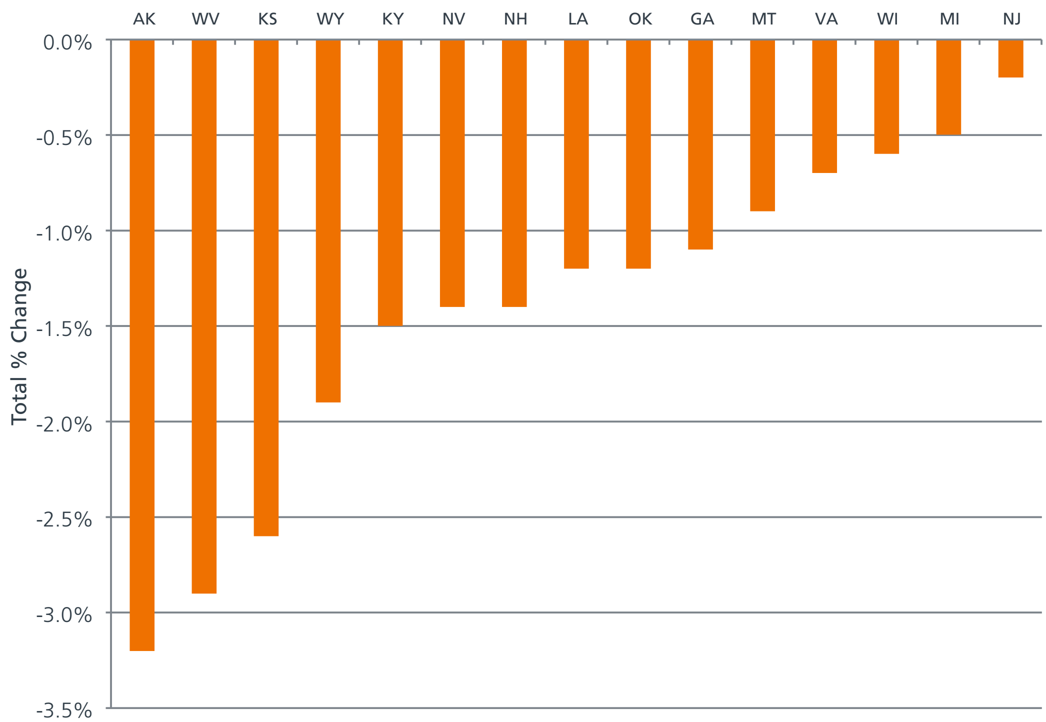


Notes: Figures are adjusted for inflation. Hawaii and Indiana are not included due to the difficulty of comparing annual funding data as reported.
Sources: The Centre on Budget and Policy Priorities; Ascent Investment Partners

State education funding cuts can place significant downward pressure on local school district bond ratings. State per-pupil educational aid accounts for approximately 44% of all spending on K-12 education, according to the Center's report. However, that aggregate number does not reflect the relative importance of state education funding for many local school districts. Some districts, typically wealthy districts with high-value tax bases, receive 10% or less of annual funding from the state. In contrast, many districts rely on state funding for 75% or more of annual operating funds, with some districts' state share of revenues topping 90%. For these districts, even small cuts in state aid have very significant impacts on budgets. For growing districts, per-pupil state aid cuts may be muted by overall revenue growth from an increasing student population. For districts with shrinking enrollment, the combination of lower enrollment and fewer dollars per student can rapidly create severe budget pressure.

FY 2014 State Per-Student Education Spending Cuts

% Change from FY2013



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Likewise, changes in the timing of state payments to local districts can also have a significant impact on local school districts' credit health, even when total receipts don't decline. In Minnesota, for example, the state delayed some payments to local school districts until after June 30, pushing the expenditure into the following fiscal year to close current-year budget gaps on the state level. On the local level, this creates a revenue shortfall in the current year that is impossible to replace. Districts must turn to mid-year expenditure cuts, reserve draws or short-term funding to manage their own cash flow needs.

Local school bonds are typically general obligation bonds secured by an unlimited property tax pledge. They are approved by local voters and allow the district to levy property taxes at whatever level necessary to ensure that sufficient funds are received to pay the general obligation bond interest and principal when due. On the surface, changes in state-level payments to the district don't have a direct impact on the revenues flowing into the district that are dedicated to make debt payments. Credit ratings, though, reflect the overall creditworthiness of an issuer, including their financial health, the strength of their economic and tax base, and many other factors. While some districts have been able to manage expenditures through staff reductions, program elimination and other means, many have also dipped into reserves or even been forced to borrow funds to close budget gaps.

For bondholders, it is important to understand the financial and economic foundation underpinning the credit quality of local school bond holdings. Factors that Ascent considers prior to purchasing any local school bond issue include:

- The state education funding environment;
- The district's mix of revenues from federal, state and local sources;
- Population and enrollment trends;
- The district's economic and demographic fundamentals;
- Financial performance through the recent recession and recovery, and the district's approach to budget management;
- Direct and overlapping debt measures and the district's capacity under any operating or debt millage limits;
- Pension and other retiree costs that could impact long-term budget flexibility; and
- The presence of state enhancement programs.

Ascent remains an active buyer of local school district bonds, including in states like Kansas, Oklahoma and Texas where school funding has been hit relatively hard. We are, however, extremely selective in choosing the districts we buy to ensure that the district exhibits the credit strengths to weather the current education funding cycle and offer the yield value to reward investors. Although the state-level funding environment may be difficult, local credits will be impacted to different degrees and will react in a variety of different ways. These local variations make all the difference in selecting and holding local school bonds over time.

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