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Fitch Ratings: Texas HB3 Boosts State K-12 Funding, Reduces Local Tax Rates

Fitch Ratings-Austin-19 June 2019: The recent increase in state aid to Texas school districts will provide a short-term boost to district revenue growth, but Fitch Ratings is concerned about the sustainability of the higher funding level over time. Fitch does not expect the funding changes to trigger immediate rating changes for Texas school districts.

Texas Governor Gregg Abbott last week signed into law House Bill 3 (HB3), which materially boosts state K-12 funding for the next biennium and shifts more of the funding responsibility to the state from local tax bases, reducing somewhat funding and operational pressures on local school districts. However, if the funding increase is not sustained following this biennium it could be disruptive to districts as they work the increased funding into new or enhanced programs.

Unless state aid continues to grow over time from the now elevated base it is unlikely to affect Fitch's assessment of long-term revenue growth prospects, a component of Fitch's U.S. Public Finance Tax-Supported Rating Criteria. The additional funding also has the potential to bolster local districts' operating profiles, a development that will vary by district and will likewise depend on the sustainability of the increased funding levels. Operating performance for the vast majority of Fitch-rated Texas school districts is already assessed at 'aaa', so sustained improvement would have the potential to affect only a few ratings.

HB3 provides for an $11.6 billion (roughly 20%) increase in K-12 funding. The increase includes $6.5 billion in additional aid for educational programs, primarily through an increase in the per student basic allotment to $6,160 from $5,140 previously (also a 20% increase). The bill requires districts to apply 30% of annual increased funding to full-time employee compensation increases (75% of which would go to teachers, counselors, nurses and librarians).

The increased funding also includes $5.1 billion to lower local school district property tax rates. For the vast majority of districts, maintenance and operations (M&O) tax rates will be compressed from $1.04 per $100 of taxable assessed valuation (TAV) to roughly $0.97 in 2020, the first year of implementation. It also requires districts to limit annual operating tax revenue increases to 2.5% (by requiring a reduction in the M&O rate if TAV increases by more than 2.5%), beginning in 2021. These tax rate-related changes will not affect Fitch's current assessment of Texas districts' legal ability to increase revenues, which is uniformly at the 'bb' level given their inability to increase M&O tax rates without voter approval. The legislation also revises the equalization formula, the goal of which has been to reduce the calculated wealth level of property-wealthy school districts to an equalized level; most districts accomplish this by either paying property tax revenues to the state or directly to less wealthy districts (recapture). The formula change is expected to reduce recapture payments made by property-wealthy districts by $1.6 billion in fiscal 2020 and $1.9 billion in fiscal 2021.

The boost in state aid under HB3 allows for a number of changes and reforms to the Texas K-12 educational system. These changes include full day pre-K for eligible children, increased funding for low-income student education, incentives for districts to offer dual language programs, and money for districts to develop merit pay programs for teachers.

Separate legislation (Senate Bill 12) increases state, district and employee contributions to the Teachers Retirement System of Texas (TRS), a state-sponsored pension plan. State contributions are increasing from 6.8% of salary currently to 8.25% by 2024, employee contributions are increasing from 7.7% currently to 8.25% by 2024, and district contributions will ramp up from 1.5% currently to 2.0% by 2025 (increasing .1% annually). The contribution increases are expected to keep the scheduled amortization of the plan at around 31 years, consistent with the projected amortization period that was in place prior to TRS board action in July 2018 that reduced the assumed investment/discount rated from 8.0% to 7.25%; this change increased the unfunded liability of $35 billion by $10 billion and extended the amortization period to 86 years. Fitch has previously noted the possibility of increased district contributions to TRS, but believes the increase from 1.5% of salary to 2.0% should not apply material pressure to districts' operations–particularly in light of the boost in basic allotment funding. However, additional increases of any magnitude could alter our assessment of this district obligation.

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