Exhibit 27

MEMORANDUM

TO: Representative Joyce Elliott, Chair
House Interim Committee on Education

Senator Jim Argue, Chair
Senate Interim Committee on Education

FROM: Timothy G. Gauger, Deputy Attorney General

CC: Mark Hudson, Legislative Analyst

DATE: February 21, 2006

RE: Legal Precedent in Arkansas Regarding Funding Phantom Students

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This memorandum was prepared in response to Mr. Mark Hudson's letter to me, dated January 25, 2006, requesting a presentation on the above-referenced subject at the February 22, 2006 meeting of the House and Senate Interim Committees on Education. This memo outlines my anticipated presentation concerning legal precedent in Arkansas regarding the funding of "phantom students."

To understand this issue one must first have an understanding of what the phrase "phantom students" means. The phrase is not used in any published Arkansas judicial decision dealing with public school finance, but rather has become a convenient short-hand to refer to the practice, in a school funding formula that distributes funds to school districts on a per-student basis, of distributing funds to districts for more students than a district is currently responsible for educating.

The assertion that the funding of "phantom students" is constitutionally problematic usually stems from the Arkansas Supreme Court's decision in *DuPree v. Alma School District No. 30 of Crawford County*, 279 Ark. 340, 651 S.W.2d 90 (1983). In *DuPree*, several school districts challenged the then-existing school funding system as violating the "equality" provisions of the Arkansas Constitution. The trial court found that the system was unconstitutional, and on appeal the Arkansas Supreme Court affirmed. In its majority opinion, the Supreme Court described the gravamen of the districts' claims as follows:

> The appellees' basic contention is the great disparity in funds available for education to school districts throughout the state is due primarily to the fact that the major determinative of revenue for school districts is the local tax base, a basis unrelated to the educational needs of any given district; that the current state financing system is inadequate to rectify the inequalities inherent in a financing system based on widely varying local tax bases, and actually widens the gap

> between the property poor and property wealthy districts in providing educational opportunities.

Id., 279 Ark. at 342.

The Court then described how the school funding system operated at the time, and the results of the funding system, as follows:

> The funding for Arkansas schools comes from three sources: state revenues provide 51.6%, local revenues 38.1%, and federal revenues 10.3%. The majority of state aid is distributed under the Minimum Foundation Program (MFP). In 1978-79 MFP constituted 77.1% of all state aid. Act 1100 of 1979, the current MFP program, is similar to prior MFP programs and consists of two major elements: base aid and equalization aid. The base aid program originated under the Minimum School Budget Law of 1951. The formula was based on a calculation of teacher and student population per district. *The base aid program contained a "hold-harmless" provision which guaranteed that no district would receive less aid in any year than it received the previous year. As a result, a district with declining enrollment would over the years get continually higher aid per pupil. While Act 1100 eliminates the district "hold-harmless" provision, it still contains a pupil "hold-harmless" provision which has no bearing on educational needs or property wealth; the base aid year is permanently held at the 1978-79 level, and the inequities resulting from thirty years of the district "hold-harmless" provision are being carried forward without compensating adjustments.*
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> The funds remaining after allocation for base aid are distributed under "equalization aid". Under this section of the act, *half* of the remaining funds are distributed under a flat grant on a per pupil basis. Districts receive the same amount of aid under this provision irrespective of local property wealth and revenue raised. The remaining funds under the equalization provision are then distributed under a formula directed at equalizing the disparity between the poor and wealthy districts. Of the total allocated under this program in 1979-80, this accounted for only 6.8% of MFP aid.
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> Against this backdrop of funding is the undisputed evidence that there are sharp disparities among school districts in the expenditures per pupil and the education opportunities available as reflected by staff, class size, curriculum, remedial services, facilities, materials and equipment. In dollar terms the highest and lowest revenues per pupil in 1978-79 respectively were $2,378 and $873. Disregarding the extremes, the difference at the 95th and 5th percentiles was

> $1,576 and $937. It is also undisputed that there is a substantial variation in property wealth among districts. The distribution of property wealth, measured as equalized assessed valuation per pupil in average daily attendance (ADA) in 1978-79, ranged from $73,773 to $1,853. These wealth disparities are prevalent among both large and small districts. As the system is currently operating, the major determinative of local revenues is district property wealth and the amount a school district can raise is directly related to its property wealth.
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> The range in revenues among school districts in Arkansas is not limited to the extremes. There are a substantial number of children affected by the revenue disparities. In 1978-79, only 7% of the pupils resided in school districts with over $1,500 per pupil in state-local revenues, while over 21% resided in districts with less than $1000 in state-local revenues, and 55% of the districts were below the state mean. This great disparity among the districts' property wealth and the current state funding system as it is now applied does not equalize the educational revenues available to the school districts, but only widens the gap.

Id., 279 Ark. at 343-44 (emphasis added). Based upon this record, the Supreme Court in *DuPree* upheld the trial court's finding that the funding system was unconstitutional.

From the above-quoted portions of the *DuPree* opinion it has been argued that any funding formula that distributes funds to school districts for "phantom students," i.e., for students the district is not currently responsible for educating, is constitutionally suspect. Those who make the argument point to the fact that, in discussing the "inequitable" results produced by the then-existing funding system, the majority in *DuPree* noted and emphasized the effect of the "hold harmless" provisions of the base aid formula on school districts with declining enrollment. Those hold-harmless provisions could be viewed as the funding of "phantom students" because for school districts with declining enrollment, base aid was "frozen" at a level that did not correspond to the district's actual needs based upon the number of students it was currently responsible for educating. As is discussed below, however, I do not believe that the *DuPree* decision stands for the proposition that "phantom student" funding is per se unconstitutional. Furthermore, I believe that such an argument is further undermined by the Arkansas Supreme Court's subsequent decisions in the *Lake View* case.

It is important to keep in mind that, unlike the post-2000 "adequacy" decisions in the *Lake View* case, the *DuPree* case was a so-called "equity" case. In other words, while the post-2000 *Lake View* opinions examined whether the funding system provided sufficient funding to enable school districts to deliver an "adequate" education, the *DuPree* decision was almost exclusively concerned with the issue of whether disparities in funding and expenditures (and hence educational opportunity) between "poor" and "wealthy" school districts were constitutionally tolerable. From an "equity" perspective, any "hold harmless" or "phantom student" aspect of a funding formula, over time, can contribute to inequality of funding and expenditures per student between districts. However, it is important to note that the "hold

harmless" aspect of the funding formula examined in *DuPree* was but one of several characteristics of the funding system that contributed to the ultimate funding and expenditure disparities that were found to be unconstitutional. The disparities were also attributable, in part, to the system's relatively heavy reliance upon local property taxes, the disparities in assessed property values between districts, and the relatively low percentage of state aid distributed in an effort to alleviate the funding disparities attributable to local wealth per student. Thus, *DuPree* cannot be read as holding that *any* funding of "phantom students" is *per se* unconstitutional – rather, it is best understood as standing for the proposition that, in an "equity" case, hold-harmless provisions (or funding for "phantom students") can be one of several factors that lead to constitutionally intolerable funding and expenditure disparities between districts.

Subsequent decisions of the Supreme Court in the *Lake View* case make it clear that there is no *per se* prohibition of the funding of "phantom students." As an initial matter, I note that the adoption of Amendment 74 and the Supreme Court's 2002 and 2004 *Lake View* decisions appear to have changed the legal standard for evaluating the "equity" of the school funding system. Language in the Court's 2002 *Lake View* opinion made it clear that the State had a duty to ensure that all children, regardless of residence, had a substantially equal opportunity to receive an "adequate" education. In its 2004 Supplemental Opinion, *Lake View School Dist. No. 25 v. Huckabee* ("*Lake View 2004*"), 358 Ark. 137, ___ S.W.3d ___ (2004) (Supplemental Opinion), the Court clarified what it meant in *Lake View 2002* when it made reference to "substantial equality" of educational opportunity:

> One issue raised in the Masters' Report is whether this court's term "substantial equality" in *Lake View [2002]* means a basic level of adequate education for all or whether it means identical education assets for all.
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> We said in *Lake View [2002]* that "[i]t is the State's responsibility, first and foremost, to develop forthwith what constitutes an adequate education [.]" *Lake View III*, 351 Ark at ----, 91 S.W.3d at 500. We went on to say that it is the State's responsibility to afford a substantially equal educational opportunity to all school children, based on what comprises an adequate education. *See id.*
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> An adequate educational opportunity must be afforded on a substantially equal basis to all the school children of this state. This does not mean that if certain school districts provide *more than* an adequate education, all school districts must provide *more than* an adequate education with identical curricula, facilities, and equipment. Amendment 74 to the Arkansas Constitution allows for variances in school district revenues *above* the base millage rate of 25 mills, which may lead to enhanced curricula, facilities, and equipment which are superior to what is deemed to be adequate by the State. Nevertheless, the over arching constitutional principle is that an adequate education must be provided to all school children on a substantially equal basis with regard to curricula, facilities, and equipment. Identical curricula, facilities, and equipment in all school districts across the state

is not what is required.

Lake View 2004, 358 Ark. at ___. Thus, after *Lake View 2004*, it is clear that the Constitution no longer requires that school districts have identical or nearly identical revenue or expenditures per student. While the *DuPree* decision might be read to suggest that disparities in funding attributable to local wealth and varying levels of local taxation can violate the Constitution, it is plain after *Lake View 2004* that such disparities are constitutionally tolerable so long as all school districts have sufficient resources to provide an "adequate" education as defined by the State. Enhancements to educational programs funded by local millages adopted pursuant to subsection (c) of Amendment 74 cannot form the basis for a finding that the system is constitutionally inequitable.

More specifically, it does not appear that aspects of the present funding formula that can be characterized as the funding "phantom students" are of concern to the Court. For example, the present funding formula distributes Foundation Aid in the current school year based upon a school district's Average Daily Membership for the previous school year. In theory, for a district with declining enrollment, this means that the district receives funding based upon a number of students that is greater than the number of students the district currently is responsible for educating. Yet that one-year "hold harmless" or "phantom student" aspect of the formula was not called into question or otherwise criticized by either the Special Masters or the Supreme Court during their proceedings in 2004 or 2005. To the contrary, the Court's willingness to tolerate limited "hold harmless" or "phantom student" aspects of a funding formula can be inferred from the Court's comments concerning the needs of school districts with declining enrollments. In its 2005 opinion, under the heading "Other Deficiencies," the Supreme Court noted that it adopted the Special Masters' Report "as it pertains to findings of other deficiencies directly related to the constitutionality of Arkansas' school funding system." *Lake View School District No. 25 v. Huckabee*, ___ S.W.3d ___, 2005 WL 3436660 (Dec. 15, 2005). One of those "deficiencies' was summarized by the Court as follows:

> 5. The Masters found other examples of unintended consequences that further affect the economic stability and adequacy of school districts. They underscored that when a school district loses students, its foundation funding is decreased for the following year though salary costs and personnel costs remain unchanged and are ongoing for the following year.

Id. Certainly if the above-described phenomenon is found to be a valid concern with regard to some school districts, some form of a limited "hold harmless" or "phantom student" funding might be one of several options for the legislature to consider by way of a solution.