

***State of New York
Office of the State Comptroller
Division of Management Audit
and State Financial Services***

STATE EDUCATION DEPARTMENT

**THE STATE AID ESTIMATING
PROCESS**

REPORT 96-S-90



H. Carl McCall

Comptroller



State of New York Office of the State Comptroller

Division of Management Audit and State Financial Services

Report 96-S-90

Mr. Carl T. Hayden
Chancellor
The University of the State of New York
State Education Building
Albany, New York 12234

Dear Mr. Hayden:

The following is our report on the process for estimating State Aid due to school districts. We did this audit according to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution and Section 8, Article 2 of the State Finance Law. We list major contributors to this report in Appendix A.

*Office of the State Comptroller
Division of Management Audit
and State Financial Services*

April 21, 1998

Executive Summary

State Education Department The State Aid Estimating Process

Scope of Audit

New York State provides annual aid to local school districts for public elementary, middle and secondary education. The Legislature appropriated more than \$10 billion in State Aid for the 1996-97 school year. This appropriation was based on estimates prepared by the State Education Department (Department) from data submitted by school districts. There are more than 40 State Aid and grant categories used to calculate State Aid due school districts. Districts amend their State Aid claims over time as claim data becomes more certain.

State Division of the Budget officials and Legislators have expressed concern about the accuracy of the Department's State Aid estimates. Actual school aid liabilities have consistently exceeded Department estimates and legislative appropriations. Since State Aid is an entitlement, appropriations limit payments in any fiscal year, but not the State's overall liability. The difference between the State Aid appropriation and the ultimate aid liability is commonly called the "bump."

Our audit addressed the following questions about the Department's State Aid estimating process for school years 1990-91 through 1996-97:

- Why do significant variances occur between State Aid estimates and total State Aid liability?
- Could Department and school district managers more accurately project State Aid needs?

Audit Observations and Conclusions

The State Aid "bump" occurs for a variety of reasons, including the complexity of the State Aid process and its formulas, the lack of certain data for calculating future aid needs and delays in submitting and recording claims adjustments. We encourage the Department to pursue legislative action to address some of these issues. We also believe that Department managers can help to reduce variances by recording adjustments and performing desk audits of claims timely, and by ensuring school districts, especially New York City, submit claim data promptly.

Appropriations for school years 1990-91 through 1995-96 have been between \$87 million and \$306 million less than the actual State Aid liability. The State Aid shortfall has ranged from .9 to 3.7 percent of State Aid appropriations annually. These recurring "bumps" have a significant impact on the State's annual financial plan and have resulted in a growing long-term liability that causes financial problems for the

districts and the State. We recommended legislative changes to simplify and improve the State Aid process should be considered. For example, the use of a block grant approach for distributing State Aid. (See pp. 5-7, 23-24)

We identified several factors that cause the State Aid shortfall. Appropriations have historically been based on estimated rather than actual data. In fact, many data elements used in the State Aid formulas must be estimated at the time school districts are required to submit initial claims. However, the Aid school districts receive and the State's Aid liability are based on actual spending and attendance data. Department officials stated that tax certiorari cases (legal challenges to property value assessments) have also resulted in unbudgeted increases in districts' Aid claims. (See pp. 9-12)

As of May 1997, State Aid "bumps" have resulted in an unfunded school aid liability that has grown to more than \$689 million (\$175 million in Department-approved claims and \$514 million in claims that had not yet been approved). However, many affected districts will have to wait for years to receive payments of these claims. Over the past few years, the Legislature has appropriated \$21.8 million annually to pay for prior years' claims. Based on this appropriation level, the Department will be unable to pay the approved portion of New York City's prior years' claim adjustments until the 2009-10 year or completely pay other districts until the 2003-04 year. (See pp. 13-15)

Twenty-seven districts were owed amounts of \$500,000 or more for prior years' claim adjustments as of May 1997. New York City was owed \$100 million for its approved claims. Another 130 districts were owed amounts between \$100,000 and \$500,000. Some school districts have had to raise property taxes because their claims have not been paid. The Department will not be able to pay timely the State's obligations for districts' adjusted claims unless the Governor's Office and the Legislature authorize sufficient appropriations to pay these claims. State leaders should ensure that sufficient appropriations are made available for the State to meet its obligations to the districts timely. (See pp. 15-17)

In 1996, the Legislature made several changes to State Aid formulas to reduce the "bump" liability. These changes included: a statute of limitations for filing claims; changes to base year data used in the State Aid formulas; and the use of more certain data to calculate State Aid. While these changes may help to alleviate annual variations, we believe more substantial changes, such as those noted in this report, are needed to completely eliminate the State Aid "bump." (See pp. 19-22)

Comments of Department Officials

We provided Department officials with draft copies of this report for their review and formal comment. Department officials generally agreed with our recommendations and indicated that actions have been or will be taken to implement them.

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Introduction

Background

New York State provides aid to local school districts for public elementary, middle and secondary education. The State Legislature appropriates funds for school aid at the beginning of each State fiscal year. Appropriations are based on estimates prepared by the State Education Department (Department) from data submitted by school districts. The legislative appropriation generally includes 70 percent of the estimated aid needed for the upcoming school year (which begins July 1) plus the unpaid portion of the actual aid claimed for the current school year. The Legislature appropriated more than \$10 billion in aid for the 1996-97 school year.

School districts make adjustments to their State Aid claims throughout the school year as claim data becomes more certain. Adjustments that are submitted during the school year are considered current year adjustments. State Aid payments to school districts are amended for current year adjustments. Adjustments to State Aid claims that are submitted after the school year has ended are considered prior years' adjustments and are paid as funds become available.

There are currently more than 40 State Aid and grant categories. A separate formula is used to calculate the aid due school districts for each category. The largest aid categories include:

- Basic Operating Aid to help meet expenditures for general operations and maintenance;
 - Private and Public Excess Cost Aid to help pay for the cost of special education programs for students with disabilities;
 - Transportation Aid to help school districts pay for the cost of transporting pupils;
 - Building Aid for expenses resulting from the construction of new buildings, additions, alterations or modernization;
 - Tax Adjustment Aids to help certain school districts and taxpayers burdened with exceptionally high tax rates;
 - Growth Aid to compensate school districts for the assumed increase in expenditures resulting from attendance increases; and
 - Extraordinary Needs Aid to meet needs associated with educating concentrations of students living in poverty, students with limited English proficiency or students in sparsely populated school districts.
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There are several problems with the current State Aid system. First, legislative appropriations for State Aid are largely based on estimated rather than certain data. Over the past several years, State Division of the Budget officials and Legislators have expressed concern about the accuracy of the Department's State Aid estimates. Actual school aid liabilities have been consistently higher than the Department's estimates and legislative appropriations. In addition, the current State Aid system is extremely complex, administratively cumbersome and inflexible. The current system may also encourage higher spending since school districts generally receive more State Aid as their expenditures increase.

In 1996, the Legislature passed several laws to address some of these problems. For example, the Legislature enacted a statute of limitations for filing or amending State Aid claims, limited school districts' current year aid payments to their original estimates (with excess payments deferred to the subsequent school year) and established minimum terms for repaying obligations related to school construction projects. We discuss the effects of these changes in subsequent sections of this report.

Audit Scope, Objectives and Methodology

We audited the Department's process for estimating school district State Aid needs for school fiscal years 1990-91 through 1996-97. The primary objectives of our performance audit were (1) to determine why significant variances occur between State Aid estimates and total State Aid liability and (2) to determine how Department and school district managers could more accurately project State Aid needs.

To accomplish our objectives, we reviewed and analyzed relevant Department records and documentation. We also interviewed appropriate Department managers and staff as well as school district and Division of the Budget officials.

We did our audit according to generally accepted government auditing standards. Such standards require that we plan and do our audit to adequately assess those Department procedures and operations included within the audit scope. Further, these standards require that we understand the Department's internal control system and compliance with those laws, rules and regulations that are relevant to the Department's procedures and operations that are included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on those procedures and operations that we have identified through a preliminary survey as having the greatest probability of needing improvement. Consequently, by design, we use our finite audit resources to identify where and how improvements can be made. Thus, we devote little audit effort to reviewing procedures and operations that may be relatively efficient or effective. As a result, our reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

Comments of Department Officials

We provided draft copies of this report to Department officials for their review and formal comment. We have considered the comments of Department officials in preparing this report and have included their comments as Appendix B. Department officials generally agreed with our recommendations and indicated that actions have been or will be taken to implement them.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of Education shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

State Aid Estimates

Over the past several years, annual State Aid appropriations have been less than the actual school aid liability. The difference between the State Aid appropriation and the eventual aid liability is commonly called the State Aid "bump." The following chart shows that legislative appropriations for school years 1990-91 through 1995-96 have been between \$87 million and \$306 million less than the actual State Aid liability.

School Year	Original Appropriation (in Billions)	Liability as of 5/97 (in Billions)	Shortfall (in Billions)	Percent Difference
90 - 91	\$ 8.85	\$ 8.96	\$.11	1.2%
91 - 92	8.33	8.63	.30	3.7%
92 - 93	8.55	8.81	.26	3.1%
93 - 94	9.02	9.15	.13	1.4%
94 - 95	9.68	9.93	.25	2.5%
95 - 96	9.89	9.98	.09	.9%
96 - 97*	10.21	10.27	.06	.6%

*Further increases in the 1996-97 liability, and therefore the shortfall, are likely as school districts submit amended claims.

Although school aid appropriations have generally increased from year to year, the State's annual school aid liability has consistently exceeded Department estimates and the appropriations. We reviewed State Aid appropriations and liabilities over the last several years to see if specific aid categories or school districts were causing the bumps. We found that generally different aid categories caused the bumps and the same school districts did not contribute to the bump in each year reviewed.

Analysis of Aid Categories

As the chart above shows, the annual State Aid bump has resulted in school aid expenditures that have significantly exceeded the Legislature's appropriations in terms of dollars. On a percentage basis, however, the increase in total State Aid liability has not been significant. From school year 1990-91 through 1995-96, the bump has ranged from .9 to 3.7 percent of the amounts appropriated annually. The \$87 million to \$306 million a year by which school aid costs exceeded appropriations has had

a significant impact on the State's annual financial plan. More importantly, it has resulted in a growing long-term liability that causes serious financial problems for some school districts and the State.

Department officials told us that they believe different State Aid categories have caused the bump in each year. Our review of data for school years 1993-94 through 1995-96 (as of May 1997) showed this was generally true, except for Public Excess Cost Aid. Most aid categories did not consistently contribute to the bump for the three school years we reviewed. For example:

- Building Aid was a significant cause of the bump in both 1993-94 and 1994-95 but not in 1995-96. Actual Building Aid was \$57.9 million (12.5 percent) higher than projected in 1993-94 and about \$63 million (11.9 percent) higher in 1994-95. However, in 1995-96, Building Aid was \$15 million (3 percent) less than estimated.
- Extraordinary Needs Aid in 1993-94 was \$37.3 million (11.1 percent) higher than estimated. However, this aid category did not significantly contribute to the bump in the two subsequent fiscal years. In 1994-95, actual aid was \$3.9 million (.9 percent) higher than estimated. In 1995-96, it was \$3.4 million (.8 percent) higher.
- Private Excess Cost Aid in 1993-94 was \$15.2 million (19.5 percent) higher than originally estimated. In 1994-95, actual aid was only \$90,000 (.1 percent) higher than estimated. In 1995-96, it was \$14.2 million (12.4 percent) lower than estimated.
- Claims for Current Year Growth Aid were \$6.1 million (23.6 percent) lower than estimated in 1993-94. In 1994-95, claims were \$28.5 million (55.3 percent) higher than the original aid estimate. For 1995-96, claims were \$2.9 million (6.2 percent) lower than estimated.

However, claims for Public Excess Cost Aid (Special Education) were a significant factor in the bumps for each of the three school years reviewed. Actual claims exceeded estimates by \$73.7 million, \$73 million and \$48.2 million for the 1993-94 through 1995-96 school years, respectively. This is an aid program that has experienced significant growth over the past several years. We believe it is likely that program growth caused the bumps as much as poor estimates.

Analysis of School District Estimates

We analyzed school district data to determine whether they have submitted State Aid data that causes Department managers to underestimate State Aid needs. We found most school districts did not submit data that caused Department managers to significantly underestimate State Aid needs. School districts that materially underestimated aid needs for a given year did not underestimate aid needs in subsequent years.

Twenty-eight percent (194) of all school districts underestimated their State Aid needs by more than 5 percent for school year 1994-95. At the same time, 27 percent (184) of the school districts actually overestimated their needs. The remaining 351 (45 percent) districts did not underestimate their State Aid needs or underestimated them by 5 percent or less.

We identified and analyzed 60 of the school districts that significantly underestimated State Aid needs for at least one year in a three-year period (1994-95 through 1996-97). Our analysis showed that these districts did not underestimate their total State Aid needs in the other years in this period. For example, in 1994-95 the Albany City school district underestimated aid by \$1.6 million or 11 percent. In 1995-96 and 1996-97, district officials overestimated aid by about \$410,000 (2.4 percent) and \$1.2 million (6.6 percent), respectively. The Troy City school district underestimated 1994-95 aid by \$2.9 million (11.6 percent). However, Troy district officials overestimated aid by \$382,000 in 1995-96, and by \$117,000 in 1996-97. The Middle Country Central School District underestimated aid by \$13.5 million (31.5 percent) in 1994-95. Although district officials did underestimate aid in 1995-96 by \$436,000 (.8 percent), they overestimated aid by \$75,000 (.1 percent) in 1996-97.

It is important to note that until recently, the New York City Board of Education had not submitted accurate, complete and timely State Aid claim data. As a result, the Department regularly paid aid to New York City based on its own estimates. Those estimates were not accurate since Department managers now conclude they owe New York City about \$615 million for adjusted State Aid claims dating from the 1988-89 school year.

Based on this data, we conclude that the majority of school districts are not routinely underestimating State Aid needs. We found no pattern of consistent underestimation by school districts in the period that we reviewed. We also found that the majority of districts (72 percent) underestimated their State Aid needs by less than five percent.

Causes of State Aid Bumps

Many factors cause the Department's State Aid estimates to consistently understate actual claims submitted by school districts. Until recently, laws governing the State Aid process have made it extremely difficult for Department staff to predict annual State Aid needs accurately. Other factors, such as the late submission of claim data by school districts and the Department not completing desk audits in a timely manner, have also had a negative effect on the accuracy of State Aid estimates. In 1996, the State Legislature enacted several changes to State Aid formulas intended to address some of these problems. Since most of these changes became effective for the 1996-97 school year, we were not able to assess their impact.

Use of Estimated Data

State Aid appropriations have historically been based on estimated rather than known data. For example, school districts submitted initial State Aid claim data for the 1996-97 school year in August and September 1995, before the 1995-96 school year began. Estimating future needs without having certain data available can present a problem for school districts.

The calculation for Basic Operating Aid illustrates this problem. The Basic Operating Aid formula for 1996-97 uses past attendance data, assessed property values and adjusted gross income for district residents to establish a school district's aid allocation. Attendance data from the 1995-96 school year is used as the base year to estimate 1996-97 aid. However, when school districts submitted their initial 1996-97 State Aid estimate, the 1995-96 school year had not yet begun. Department officials also told us that property value and adjusted gross income data required by the formula are not finalized until after districts submit estimated State Aid needs to the Division of the Budget in November.

Compounding this problem is the fact that State Aid is an entitlement. School districts receive State Aid based on actual spending and attendance. If actual attendance is higher than estimated, then the district's aid will most likely be higher. Likewise, if property value or gross income is lower than estimated, State Aid will be higher. However, the State Aid formulas establish the State's liability for school aid, not the initial estimates or legislative appropriations. Appropriation levels limit school aid payments in any fiscal year, but the State's liability is not limited. The Department must eventually pay any additional State Aid liability in future years.

The complexity of the current school aid process also contributes to the inability to predict State Aid needs precisely. In 1974-75, there were three major State Aid categories. Today, there are more than 40 separate State Aid categories and grant programs. Most of these aid categories have formulas that contain several data elements. Actual State Aid for each category changes each time these numbers are amended. In addition, several State Aid formulas are interrelated. For example, the results of the Basic Operating Aid formula are used to calculate the following aid categories: Tax Equalization, Limited English Proficiency, Reorganization Incentive Operating and Growth.

As discussed subsequently in this report, the Legislature has amended some State Aid formulas so that more certain data is used to calculate annual school aid needs. We believe that Department managers should continue to assess State Aid formulas and identify instances where more certain — rather than estimated — data can be used to project State Aid needs. We understand that Department managers need to weigh the benefits of using more certain data against the potential costs to school districts for increasing the lag between district expenditures and State Aid reimbursement.

Valuation (Tax Certiorari) Claims

Tax certiorari cases are legal challenges to property value assessments. Court ordered changes in property valuations result in the school district's property valuation base being reduced. School districts must then repay property owners for the portion of taxes overpaid in prior years.

Several State Aid formulas use property value data to calculate State Aid. These include Basic Operating Aid, Building Aid, Reorganization Operating Aid, Transportation Aid, Excess Cost Aid, Growth Aid and the Transition Adjustment. Therefore, the reduction of a school district's property value entitles that district to a higher share of State Aid for the years affected. School districts may amend State Aid claims for any year affected by a tax certiorari case. Valuation claims contribute to the bump because they result in unbudgeted increases in school district State Aid claims for the current and prior years.

Department officials believe that valuation claims are a major contributor to the annual State Aid bump. However, the complexity of State Aid formulas and the degree to which they are interrelated makes it difficult to establish the true effect of valuation claims on prior year adjustments.

Our review showed that as of March 1997, Department staff had approved \$31 million in valuation claims for payment. However, the Department has not recorded all valuation claims received. Department staff have not audited or recorded on the computer system any of the 116 valuation claims received since January 1996 that affect prior years. This has not been done because the State Aid Unit is implementing a new computer system. Further, current appropriations are not available to pay any of these claims.

The Department's State Aid Unit has not done any analyses of valuation claims to determine whether specific areas or counties account for most of the valuation claims. Department officials believe that most of the valuation claims come from five counties: Nassau, Westchester, Rockland, Suffolk and Putnam. They believe this occurs because properties in these counties have largely gone without reassessment. We reviewed the 116 valuation claims that have not been entered into the Department's computer system. They are mainly from Nassau (45 claims) and Suffolk (37 claims) Counties. Department managers have not estimated the potential liability resulting from these claims.

Our analysis of approved tax valuation claims shows that five school districts accounted for \$24 million of the \$31 approved valuation claims. These school districts included: Troy City, (Rensselaer County); Port Jefferson Union Free, South Country Central, and Three Village Central (Suffolk County); and Yonkers City (Westchester County).

In their response to the draft report, Department officials indicated that they would take steps to review and record valuation claims in a timely fashion, as the Department reaches its goals for timely desk audits. Officials also stated that they anticipate that the number of valuation changes will decrease substantially once various changes in State law take effect.

Late Filed Claims

Late filed claims also hinder the Department's ability to accurately estimate State Aid requirements. Some school districts have not submitted required aid claims and other data timely. For example, 37 districts had not submitted required 1997-98 school aid claim data by November 1996. Department officials needed this data to prepare State Aid estimates for the 1997-98 fiscal year. In such cases, Department staff must use prior years' data to estimate aid for those districts that did not supply required data. Until recently, the New York City school district regularly submitted its State Aid claim data well after the required submission dates. For example, as of May 1995, New York City had not submitted Public

Excess Cost Aid claims for the 1993-94 and 1994-95 school year. This has also contributed to State Aid estimating problems.

In their response to the draft report, Department officials stated that the Department has recommended revisions to the Education Law regarding the due dates for State Aid claim forms and penalties for late filing. According to officials, these recommendations have resulted in the creation of realistic timelines for the submission of claim forms.

Desk Audits of State Aid Claims

The fact that the Department does not complete timely desk audits of State Aid claims also affects State Aid estimates. Department staff are currently a year or two behind in auditing claims. Several State Aid formulas use the prior year's aid amounts to calculate current year aid. As Department staff review these claims and the original data is corrected, future years' estimates and claim payment data will change. Not auditing claims in a timely manner can result in the need to adjust several years' claims if staff detect errors. We also noted that desk audits of New York City's claims have not been completed for the school years 1991-1992 to the present.

We previously reported on the backlog of unaudited claims in our audit of the Department's Oversight of School Districts' Non-Instructional Activities (Report 95-S-108, issued March 28, 1997). We recognize that Department officials are working to correct this problem.

In their response to the draft report, Department officials indicated that they were working with the State Comptroller's Aid Payment Unit to include triage procedures in the claims review process. The intent of the triage procedures is to quickly identify claim errors that have a meaningful impact on the aid payable, without delaying the processing of the other claims. Officials added that triage procedures used for reviews of attendance data have already greatly expedited the process. They anticipate similar gains as additional triage procedures are introduced into other major claim data areas.

Problems Resulting From Inaccurate State Aid Estimates

The inability to accurately predict State Aid needs results in annual legislative appropriations that are insufficient to cover school district needs. The current system creates additional unfunded State Aid liabilities each year. However, the State has elected to fund only a small portion of these liabilities each year. As a result, the aggregate liability has reached major proportions and continues to grow. Even though the State ended the 1996-97 fiscal year with a significant cash surplus, the Governor and the Legislature did not address this growing liability, to the detriment of school districts and local taxpayers.

As of May 1997, the State's cumulative unfunded school aid liability to school districts had grown to more than \$689 million with almost \$615 million owed to New York City. This comes at a time when the New York City Board of Education is faced with serious funding needs to effectively deal with a growing student population and deteriorating school facilities. Additionally, the State owed \$473 million to counties for unpaid preschool handicapped education aid. School districts and local taxpayers have been negatively affected because they must wait long periods for reimbursement for large portions of their costs.

Prior Years' Adjustments to State Aid Claims

While school district and Department estimates are the basis for legislative appropriations, the State's liability generally depends on actual school district expenditures and attendance. When school districts find that additional State Aid is due, they submit adjusted claims.

School district State Aid claims received after the original claim year has been closed are considered prior years' adjustments. Before June 1996, school districts had no specific deadline for submitting State Aid claim revisions. The Department considered adjusted claims to be current if staff were still auditing the district's original claim year. If staff had completed the audit of the claim year, they would classify the revision as a prior year adjustment.

As of May 1997, Department officials estimated that they owed more than \$689 million to school districts for approved and unapproved prior year claims. However, the Department had not recorded all prior year claims because appropriations were not sufficient to pay them. Furthermore, Department staff had not audited or recorded on the computer system any

of the 328 Building and Transportation Aid claims received since August 1996.

In response to the draft report, Department officials indicated that to facilitate more timely entry of data, resulting from prior years' adjustments, that would not create a roll forward effect on the current year's aid payments, requires a new automated process. The process would also have to allow a roll forward impact, segregated from current aid payments, to be included in the projections of future State aid appropriation needs. Officials added that the Department's present automated systems cannot adequately accomplish this dual treatment of prior years' adjustments. They prefer changes in statute and current State policies instead of the large investment of time and resources that would be required to enable the Department's current automated systems to process prior years' adjustments without impacting current aid payments.

The following chart summarizes the estimated State Aid due to school districts resulting from prior years' claims.

	<u>New York City</u>	<u>All Other School Districts</u>	<u>Total</u>
Approved Claims (as of May 1997)	\$100,147,000	\$74,934,000	\$175,081,000
Unapproved Claims (as of May 1997)	<u>\$514,598,000</u>	_____	<u>\$514,598,000</u>
Total	<u>\$614,745,000</u>	<u>\$ 74,934,000</u>	<u>\$689,679,000</u>

Over the last several fiscal years, the Legislature has appropriated about \$21.8 million annually to pay for prior years' claims. For fiscal year 1997-98, the Legislature authorized an additional \$18 million for adjustments to claims for the 1995-96 year, which will be available for payment to the districts in June 1998. However, based on the usual annual appropriation of \$21.8 million, the Department cannot pay the approved portion of New York City's prior years' adjustments until the 2009-10 school year. Also, the Department will not be able to completely pay other school districts until the 2003-04 school year. Moreover, prior years' claims continue to be submitted by school districts and the amount of these claims has been greater than legislative appropriations. Therefore, the amount owed to school districts for prior years' claims continues to grow.

Before 1995, the State Division of the Budget allowed the Department to use recoveries of prior years' State Aid overpayments to offset any increased State Aid liability resulting from prior year adjustments. Since 1995, however, the Division of the Budget has directed that such overpayments be returned to the General Fund rather than used to help pay for prior years' adjustments. This has contributed to the delay in State Aid payments to some school districts while increasing the State's unfunded school aid liability.

In their response to the draft report, Department officials indicated that they have requested permission from the Division of the Budget, in the past, to use recoveries of prior years' State Aid overpayments to offset increased aid liabilities resulting from prior years' adjustments. Officials added that they will continue to seek such permission in the future.

The Effect of Unpaid State Aid

We analyzed the \$175 million of approved claims for prior years' State Aid. The Department owes some State Aid from prior years to more than 500 school districts. Twenty-seven school districts are owed more than \$500,000. These include:

<u>School District</u>	<u>County</u>	<u>Amount Owed</u>
New York City		\$100,147,430
Port Jefferson Union Free	Suffolk	5,387,124
South Country Central	Suffolk	5,207,609
Yonkers City (Note 1)	Westchester	4,988,184
Three Village Central	Suffolk	3,343,617
Syracuse City	Onondaga	2,528,593
Troy City	Rensselaer	1,814,164
Buffalo City	Erie	1,407,309
Broadalbin-Perth Central	Fulton	1,038,989
Uniondale Union Free	Nassau	976,108
Connetquot Central	Suffolk	899,935
Monticello Central	Sullivan	888,826
Bethlehem Central	Albany	780,541
East Meadow Union Free	Nassau	780,280
Brentwood Union Free	Suffolk	770,902
Sachem Central	Suffolk	757,657
Jordan-Elbridge Central	Onondaga	722,475
Wyandanch Union Free	Suffolk	684,319
		<u>Amount Owed</u>
<u>School District</u>	<u>County</u>	<u>Owed</u>

Fallsburgh Central	Sullivan	\$675,121
Brighton Central	Monroe	652,997
Jamestown City	Chautauqua	636,275
East Irondequoit Central	Monroe	613,307
Hempstead Union Free	Nassau	550,670
Bellmore-Merrick Central High	Nassau	526,890
Ellenville Central	Ulster	526,828
Freeport Union Free (Note 1)	Nassau	516,998
Utica City	Oneida	511,882

Note 1 - School district or municipality that has been authorized to issue bonds to finance a deficit.

In addition, a total of 130 school districts are owed amounts between \$100,000 and \$500,000, and 373 districts are owed amounts less than \$100,000.

The current practice of appropriating \$21.8 million per year for unpaid State Aid results in school districts waiting many years to receive full aid reimbursement. Some school districts are experiencing cash flow problems and have been forced to raise property taxes to make up for State Aid owed to them.

For example, officials at one school district that owed more than \$1 million, told us that the district had to raise property taxes by 8 percent in 1996-97 and 10 percent in 1997-98. They believe these increases would not have been necessary if they were paid for prior years' claims adjustments.

At a second school district, district officials told us they have had fiscal problems for several years due to \$5 million in unpaid State Aid. District administrators believe they could institute a property tax reduction if the Department were to pay them for prior years' State Aid claims.

However, the Department will not be able to pay the State's obligations for districts' adjusted claims in a timely fashion unless the Governor's Office and the Legislature authorize sufficient appropriations to fund claim payments. We believe that State leaders should ensure that sufficient appropriations are made available for the State to meet its legal and moral obligations to the districts timely.

In response to the draft report, Department officials acknowledged that recent appropriations for prior years' adjustments have been inadequate to allow full payment of approved prior years' claims. Officials added that

they will continue to forward current information regarding prior years' claims to the Division of the Budget and the Legislature for their action.

Changing the State Aid System

In 1996, the Legislature made several changes to State Aid formulas to reduce the variation between initial estimates and the ultimate aid liability. Because these changes are so recent, we were not able to assess their full impact at the time of our audit. We believe that the recent changes to the State Aid process will help reduce some of the variances between estimated and actual amounts. However, these changes come at a price to school districts and, to some degree, variances will continue unless there is fundamental change to the system. We believe it will be necessary to carry out more substantial changes to bring about a real solution to what has become a chronic problem, for both school districts and the State. Some of the changes initiated in 1996 are noted below.

- A Statute of Limitations for Filing Claims. A statute of limitations for filing State Aid claims gradually reduces the period in which school districts can submit or amend claims. School districts have been allowed up to three years after the 1993-94 school year to submit or amend claims affecting that year. By school year 1997-98, however, districts will have one year from the end of the school year to submit or amend claims. The intent of this change is to reduce the effect of prior years' revisions.
- Changes to Base Year Data. 1996 legislation placed a freeze on base year data. Data used in aid formulas for the 1992-93 school year was frozen as of July 1, 1996. By the 1999-2000 school year, there will be a one-year open period before the base data is frozen. This change will help reduce the ripple effect of prior years' adjustments to State Aid claims.
- Use of More Certain Data to Calculate Aid. The Legislature also changed the base year data used to calculate many State Aid formulas. For instance, attendance, property value and district income data used in several formulas has been moved back an additional year. This means that the 1997-98 estimate will be based on 1995-96 attendance data rather than 1996-97 data. Department officials expect this change will allow school districts and the Department to more accurately predict aid needs.
- Limiting Claim Payments to the Lower of Estimated or Actual. Current year State Aid payments will be limited to the lesser of 100 percent of a district's estimated or actual claims. The Department will defer any additional or excess claim payments

until the following September. This helps reduce the bump for the current year by deferring aid increases to the next year. However, this change will not reduce or eliminate the State's liability to pay for school aid increases.

- Building Aid. Legislation now requires that school districts notify the Department of building projects by November 15 to be eligible for State Aid reimbursement in the current year. Also, school districts can no longer receive aid for the payment of principal to liquidate Bond Anticipation Notes (BANs) during the first 23 months following the BANs date of issue. If school districts pay the outstanding principal on a BAN with monies that they have not borrowed, they will receive Building Aid based on an assumed amortization of principal over 10 years for reconstruction projects and 15 years for new construction.

If school districts amortize obligations over at least 10 years for reconstruction projects or 15 years for new construction, the Department will pay aid on the annual amortized debt. Even if school districts repay obligations in less than the 10 or 15 year minimum, the Department will continue to pay aid based on an assumed 10 or 15 year amortization. For New York City construction projects, aid is based on an assumed amortization period of 30 years. School districts will still receive current year State Aid reimbursement for building projects if they are financed from capital reserves or current operating funds.

The Legislature implemented these changes to eliminate the wide variations in State Building Aid from year to year. Before these changes, school districts could obligate the State for their share of building costs in any year by paying all principal and interest that was due. The resulting unexpected costs contributed greatly to the annual State Aid bump. We believe that these changes will help to eliminate part of the bump. However, we also recognize that these changes encourage school districts to use and maintain long term debt rather than repay obligations over a shorter period. The impact of these changes on overall construction financing costs will depend on future interest rates and other economic factors.

The changes discussed above will help the State by making the annual State Aid needs more predictable. However, these changes will have a fiscal impact on school districts. These changes will delay payments for amended claims to future years, limit flexibility for funding building

projects and increase the lag between school district expenditures and State Aid reimbursement.

These changes do not address several existing problems with the current State Aid system. For example, none of the changes affect the complexity of the State Aid formulas or the fact that many of the formulas are expenditure driven. In addition, these changes do not address the inflexibility inherent in the current system since the number of aid categories has not been reduced. The large number of aid categories limits how school districts can use their State Aid. School districts are required to allocate resources to specific areas in order to obtain aid.

In October 1996, the State Comptroller's Office issued an Agenda For Equitable and Cost-Effective School Finance Reform which addressed some of the problems associated with the current State Aid system. Included within this agenda was a proposal that a block grant approach be used to distribute State Aid. A block grant approach could help resolve many of the short-comings of the current system.

For example, a block grant approach would provide aid through a formula that would not vary with specific local expenditures. Once the aid calculation was performed, funds would go to school districts in a set amount. No variations in aid would result from subsequent changes in school district expenditures or other estimates. State aid for each year would be set prospectively, rather than continuing to vary with estimate revisions, years after the fact. Although a formula would be used to calculate the amount of aid due each district, an open entitlement would not exist.

This approach would also simplify the State Aid system. Some of the current State Aid categories and associated formulas could be eliminated. Aid provided under this approach would not reimburse school districts for expenditures as the current system does. Therefore, there would likely be a greater incentive for school districts to hold down costs and accomplish efficiencies. Any savings from efficiencies would accrue to school districts since there would be no reduction in State Aid resulting from accrued expenditures. This would also give school districts greater flexibility to allocate resources.

Department officials stated that any process for distributing State Aid should adequately address the equalization of aid distribution in terms of each district's own financial resources, the needs of the students and the relative cost of services. We agree that funding equity, student needs and cost of living factors should be considered in any method of State Aid

distribution, including block grants. We believe the block grant approach simplifies the current formulas. More relevant, from a State Aid estimating perspective, is that once the aid level is established for the school year it would not be subject to fluctuations during the year.

In response to the draft report, Department officials agreed with our recommendation to consider legislative changes to simplify and improve the State Aid process, including the use of block grants. Officials added that simplification of the formulas and process is included in the Regents' State Aid Proposal.

Conclusions and Recommendations

The current complex system of school aid formulas needs substantial redesign. While recent changes may help resolve some problems, more substantial changes are needed. Therefore, we recommend the following steps be taken, as appropriate.

Recommendations

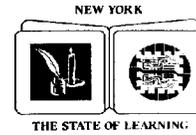
1. Consider legislative changes to simplify and improve the State Aid process, such as:
 - Using block grants;
 - Changing the State Aid formulas that will allow the use of more certain data; and
 - Making changes that will simplify the process and the formulas to make the State's aid liability more predictable.
2. Analyze future variances in estimated and actual aid amounts to determine the causes and appropriate corrective action.
3. Ensure that school districts submit State Aid claim data timely.
4. Complete desk audits timely.
5. Review valuation claims and record them on the State Aid computer system timely. Maintain current estimates of the State's liability for unpaid valuation claims.
6. Ensure that prior years' adjustment claims are recorded on the State Aid computer system timely. Maintain updated records of the State's total liability for unpaid State Aid claims.
7. Request approval from the Governor's Office to offset State Aid overpayment recoveries against prior years' State Aid claims.

Recommendations (continued)

8. Work with the Governor's Office and the Legislature to help ensure that sufficient appropriations are made available for the State to meet its legal and moral obligations to the districts on a timely basis for Department-approved prior years' claims.
9. Determine whether the recent changes to State Aid formulas have been effective in reducing the State Aid bump.
10. Determine whether the recent changes to Building Aid reimbursement are cost effective.

Major Contributors to This Report

William Challice
David R. Hancox
Carmen Maldonado
Robert Lindholm
Brian Mason
Jack Dougherty
Dianne Hart
Naomi Hoffman
Lei Zhang
Nancy Varley



THE STATE EDUCATION DEPARTMENT / THE UNIVERSITY OF THE STATE OF NEW YORK / ALBANY, NY 12234

CHIEF OPERATING OFFICER
Tel. (518) 474-2547
Fax (518) 473-2827
E-mail: rcate@mail.nysed.gov

March 11, 1998

Ms. Carmen Maldonado
Audit Director
Office of the State Comptroller
Division of Management Audit and
State Financial Services
270 Broadway, 19th Floor
New York, New York 10007

Dear Ms. Maldonado:

Thank you for sharing the *revised* draft report "State Education Department – The State Aid Estimating Process," (Report 96-S-90) which was sent to Chancellor Hayden on February 6. The following are the State Education Department's responses to the recommendations of the report.

1. **Consider legislative changes to simplify and improve the State Aid process, such as:**
 - **Using block grants.**
 - **Changing the State Aid formulas that will allow the use of more certain data.**
 - **Making changes that will simplify the process and the formulas to make the State's aid liability more predictable.**

We agree with the recommendation. Simplification of the formulas and process has been proposed in the Regents State Aid Proposal.

2. **Analyze future variances in estimated and actual aid amounts to determine the causes and appropriate corrective action.**

We agree with the recommendation. As part of our annual data collection planning process we assess the data elements, directions, discrepancies and variances in order to improve our processes for the future year. In addition we have regional discussions with school district business officials to solicit their input into this analysis.

3. **Ensure that school districts submit State Aid claim data timely.**

We agree with the recommendation. The Department has taken the lead in recommending revisions to Section 3601 of the Education Law regarding due dates for State Aid claim forms and penalties for late filing. These recommendations have resulted in the creation of realistic timelines for submittal of claims and projections so that data are available for State planning purposes in early November each year.

4. **Complete desk audits timely.**

We agree with the recommendation. We are working with staff of the Comptroller's State Aid Payments Unit to introduce triage procedures in the claims review process. These triage measures allow us to quickly identify those claim errors that have a meaningful impact on the aids payable, without delaying the processing of other claims. The triage procedures have already been used by the Department and OSC for attendance data review and have greatly expedited this process. We anticipate similar gains as additional triage procedures are introduced in the other major claim data areas. Unfortunately, none of these expedited procedures apply to prior years' claims still pending final review. The status of such claims is as follows:

- A. The following school districts, other than New York City, have original claims still pending final review for the 1995-96 aid year and earlier as of 3/3/98:

<u>Aid Year</u>	<u>Districts with Original Claims Pending Review</u>
1993-94	Syracuse
1994-95	Syracuse and Rochester
1995-96	16 districts (Weedsport, Buffalo, Batavia, Oneida, Rochester, Rush Henricetta, Hempstead, North Syracuse, Syracuse, Clarkstown, East Ramapo, Watertown, Longwood, Smithtown, Owego Appalachin, Yonkers)

- B. Status of 1996-97 claims for school districts, other than New York City, as of 3/3/98:

684 Attendance Reviews Completed
 587 Building Aid Reviews Completed
 476 Transportation Aid Reviews Completed
 68 Whole Claims Reviews Final

- C. Status of New York City claims as of 3/3/98:

<u>Aid Year</u>	<u>Status</u>
1980-81 to Present	Transportation Claims Pending
1980-81 to 1990-91	All Portions of Claims, other than Transportation, are Final
1991-92	All Portions of Claims, other than Transportation, have been Reviewed and Submitted to Comptroller for Confirmation
1992-93 to Present	All Portions of Claims will be Reviewed as Comptroller Confirms Prior Year's Findings

5. **Review valuation claims and record them on the State Aid computer system timely. Maintain current estimates of the State's liability for unpaid valuation claims.**

We agree with the recommendation. We anticipate that as we reach our goal of timely desk audits, we will once again review and record valuation claims in a timely fashion. We also anticipate that the number of valuation changes will decrease substantially once the various legislative changes related to submission of revised claims take effect. The

processing of valuation changes has been made more complex, however, by revisions to Section 3604(5) of the Education Law enacted by Chapter 436 of the Laws of 1997 which require that each valuation change and its potential aid impact first be compared to the value of one percent of the school district's total revenues from State sources, and, if the change is not greater than such value, it must be rejected.

6. **Ensure that prior years' adjustment claims are recorded on the State Aid computer system timely. Maintain updated records of the State's total liability for unpaid State Aid Claims.**

We agree in part with the recommendation.

In order to record prior year adjustments to the State Aid computer system on a timely basis under existing statute and policies, a process is required that would allow entry of the revised data resulting from the prior year adjustments, including tax certiorari revisions, without creating a roll forward effect upon subsequent, current year aid payments. Such a process is needed since any roll forward impact of the change is also considered a prior year adjustment under existing statute and policies. However, the required process should also allow a roll forward impact, segregated from the current aid payment process, so that the impact is included in current and future projections of state appropriation needs in support of public schools. The technology of existing computer files for processing state aid claims is inadequate to accomplish such a dual treatment of prior year adjustments, and the investment of time and other resources required to design a system that would allow such a dual treatment is significant enough to suggest that a change in statute and in current policies to allow a more timely payment of prior year adjustments, at least in terms of their impact on current year aid payments, is more appropriate. The Education Department will continue to advocate for changes in statute and policy that would allow for such timely payments within the constraints of state fiscal resources.

7. **Request approval from the Governor's Office to offset State Aid overpayment recoveries against prior years' State Aid claims.**

We agree with the recommendation. The request has been made in the past and we will continue to make such requests in the future.

8. **Work with the Governor's Office and the Legislature to help ensure that sufficient appropriations are made available for the State to meet its legal and moral obligations to the districts on a timely basis for Department-approved prior years' claims.**

We agree in part with the recommendation. Recent appropriations for prior year adjustments are inadequate to allow full payment of prior year approved claims. The Department will continue to forward the current prior year claims information to the Division of the Budget and the Legislature.

9. **Determine whether the recent changes to State Aid formulas have been effective in reducing the State Aid bump.**

We agree with the recommendation. The effects of these changes should be carefully analyzed once they have been fully implemented. As stated above, the evaluation of these changes should be completed before additional analysis is conducted or new legislation proposed.

10. **Determine whether the recent changes to Building Aid reimbursement are cost effective.**

This recommendation has, for the most part, already been implemented. Analysis has been done, and is conducted on an ongoing basis by State Aid Unit staff at the request of the Division of the Budget. Results have been shared with the Division of the Budget and others, and are available upon request.

Sincerely,



Richard H. Cate