COMMUNITY COLLEGE FUNDING FORMULA REVIEW

A Report Prepared for the

Legislative Finance Committee

By

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LFD

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INTRODUCTION

The current legislative funding formula for community colleges was revised in the 2007 legislative session, and is codified in Title 20, Chapter 15, Part 3 of the Montana Code Annotated.

This revision to the community college funding formula was the first change to the funding formula since 1981. The 1981 formula factors included an average cost of education (COE) per student that was established in 1981 and adjusted each biennium for cost increases, projected student enrollment, and the state percent share determined by the legislature each biennium.

While the legislature generally found the 1981 three-factor formula to be acceptable, there was enough legislative concern expressed in regard to the various means used to adjust the cost of education factor over two and one-half decades that the 2005 Legislature requested the Legislative Finance Committee to review the community college funding formula, specifically the methodology used to calculate the cost of education, and make recommendations for improvement, if any.

The Legislative Finance Committee (LFC) conducted its review during 2005 to 2006 and developed a new methodology for calculating the cost of education used as the basis for the state appropriation for the community colleges[1]. The new methodology to calculate the cost of education differed from the 1981 formula in two ways. First, the cost of education was proposed to be changed from an average cost per student to the sum of a fixed component that would include costs that are not influenced by student enrollment changes and a variable component that would include costs that are influenced by student enrollment changes. Second, the Legislative Finance Committee recommended that the cost of education be rebased each biennium, meaning that the cost of education component used in the formula would reflect actual expenditures in the budget base year, and that this rebasing would occur every two years to keep the cost of education relevant to actual costs incurred by the community colleges.

Two other formula components, enrollment and state percent share, essentially remained the same in the new formula as the 1981 formula.

The LFC review during 2005 to 2006 focused on the cost of education at the community colleges and the formula to calculate the state appropriation. The committee did not review non-state revenue supporting the community colleges.

The 2007 Legislature adopted the Legislative Finance Committee recommendations and passed SB 12 that included statutory changes necessary to implement the formula changes. This revised formula was used to calculate the state appropriation starting with FY 2008.

SCOPE AND PURPOSE OF CURRENT REVIEW

When the Legislative Finance Committee recommended changing the community college funding formula to the 2007 Legislature, it also charged its staff to review the formula after three biennia to determine if the cost of education calculation under the revised formula was still valid to use for the state appropriation calculation.

The review examined the following areas:

- Cost of Education (COE) – What is the cost of education, how has the COE changed since the inception of the revised community college formula, and what influences the cost of education?

[1] A workgroup comprised of the LFD, a representative from each community college, Office of the Commissioner of Higher Education, and the Governor's Office of Budget and Program Planning developed the new cost of education methodology that was adopted by the Legislative Finance Committee.

- Rebasing -- What is rebasing, why was this feature added when the formula was revised in 2007, and what has been the impact of rebasing?

- Allocation of Fixed and Variable Cost of Education Components – Is the current allocation of fixed and variable COE components (75% fixed/25% variable) still valid?

The purpose of this report is to inform the Legislative Finance Committee of the findings of the review and seek direction from the committee for two issues that were identified in the review.

SUMMARY OF FINDINGS AND ISSUES

- The cost of education at the community colleges has increased 44.40% from FY 2006 to 2011, higher than state government and the educational units of the Montana University System.

- Rebasing the COE each biennium has contributed towards significant overall budget increases at the community colleges.

- The design of the funding formula resulted in specific costs at the community colleges being funded twice – once through mandatory and/or permissive mill levies for a specific purpose (i.e. retirement levy), and an additional 50% (approximately) by the state appropriation. This has occurred since the implementation of the new formula and has resulted in an estimated cumulative $3.0 million of state general fund being appropriated for costs covered 100% by local levies.

    - Issue: Should the community college funding formula be amended to recognize that some costs are funded 100% from local levies (i.e. retirement and medical), and if so, how?

- Using the same cost category definitions as the 2005-2006 study, the FY 2011 cost of education expenditures for the three community colleges are, on average, 75% fixed and 25% variable. This is the same percentage allocation as the 2005-2006 study determined. While there are institutional variations, the community college funding formula is applied to all three colleges, so an overall average is used.

- Both Dawson Community College and Miles Community College are currently converting their accounting system to Banner. This effort started in FY 2010, but neither community college has yet to produce actual accounting data from the new system. Since the funding formula uses actual data to rebase the cost of education, lack of actual data will be an issue for budget development for the 2015 biennium.

    - Issue: Development of the 2015 biennium budget for the community colleges requires actual base year cost of education data for FY 2012. Since two of the three community colleges have not produced actual cost data since FY 2010, what should be the basis for estimating the state appropriation for the 2015 biennium?

CURRENT FUNDING FORMULA

The purpose of the community college funding formula is to provide a tool for the legislature to use to establish the state general fund appropriation for the community colleges each biennium.

The state appropriation for the community colleges is based upon a three-factor funding formula that includes a fixed and variable cost calculation defined by statute at 20-15-310, MCA. This formula and the formula factors are defined below:

(Projected Resident Student Enrollment x Variable Cost of Education per Student)

+ Fixed Cost of Education

= Total Cost of Education

X State Percent Share

= State General Fund Appropriation

Definitions

- Projected Resident Student Enrollment – the aggregated resident FTE count that the three colleges project for each year of the proposed biennial budget

- Variable Cost of Education per Student – the total variable costs for the base year divided by the actual FTE student enrollment for the base year (derived from base-year expenditure reports provided to the Board of Regents). The variable cost of education per student is an average cost for all three community colleges. The variable cost of education is currently based on 25% of the base year expenditures.

- Fixed Cost of Education – the total fixed costs for the base year (derived from base-year expenditure reports provided to the Board of Regents). The fixed cost of education is currently based on 75% of the base year expenditures.

- State Percent Share – the percent of the calculated fixed + variable cost calculation that the legislature decides to support with a state appropriation. The state percent share factor is the mechanism through which the legislature exercises public policy in this formula, as the percent level established is purely a matter of the public policy decision the legislature makes based upon available state revenue and the amount of funding the legislature determines that state government should support Montana resident students attending community colleges

The total cost of education is rebased each biennium from the actual base year expenditures reported by the community colleges in the annual operating budgets submitted to and approved by the Montana Board of Regents. These base expenditures are adjusted for one-time-only expenditures and anticipated reversion of state funds (if any).

FUNDING FORMULA REVIEW

The community college funding formula was evaluated using the most recent available information from the community colleges. As previously noted, Dawson and Miles Community Colleges have not produced actual expenditure data since FY 2010. Consequently the review utilized FY 2011 budgeted data for Dawson and Miles Community Colleges and actual FY 2011 data for Flathead Valley Community College.

COST OF EDUCATION

The cost of education component in the community college funding formula is derived from base-year actual expenditures reported to the Board of Regents in the annual operating budget. These base expenditures are adjusted for one-time-only expenditures and anticipated reversion of state funds (if any).

The overall growth in the cost of education was the first area examined. Figure 1 shows that the COE has increased 44.4% between FY 2006, the budget base year for the new formula revision, and FY 2011. By comparison, the overall growth in HB 2 expenditures for state government has increased 30.2% during the same time period, and the overall growth in the MUS educational units' actual expenditures increased 34.1% from FY 2006 through 2011.

Total student enrollment at the community colleges has increased 27.4% from FY 2006 through 2011. Because the cost of education is defined as being 75% fixed (not impacted by student enrollment) and 25% variable (impacted by student enrollment), the analysis sought to understand why the COE had increased at nearly twice the rate of student enrollment.

Figure 1
Montana Community Colleges Cost of Education and Funding Sources
FY 2006 and FY 2011 Comparison

Item	FY 2006 Actual[1]	FY 2011 Actual[2]	Change FY 2006 to FY 2011	% Change FY06-11
Cost of Education (CHE 201)	$17,374,178	$24,836,102	$7,461,924	
Less OTO expenditures/appropriations	0	0	0	
Less reversion placeholder	-179,270	0	179,270	
Net Cost of Education Expenditure Base	$17,194,908	$24,836,102	$7,641,194	44.4%
Funding Sources				
State Appropriation	7,295,101	10,117,852	2,822,751	38.7%
Tuition	3,478,171	6,785,187	3,307,016	95.1%
Mill Levys				
Mandatory General Levy	3,280,548	3,941,572	661,024	20.1%
Retirement Levy	1,163,584	1,595,029	431,445	37.1%
Audit Levy	6,520	0	(6,520)	-100.0%
Medical Levy	0	214,960	214,960	
Other	1,493,468	737,175	(756,293)	-50.6%
Scholarships & Fellowships	964,690	1,552,240	587,550	60.9%
Total Revenue	$17,682,082	$24,944,015	$7,261,933	41.1%
Total Student FTE Enrollment	2,337	2,977	640	27.4%
Cost of Education per Student FTE	7,358	8,343	985	13.4%

(1) Retirement costs and mill levy added at DCC in FY 2006 for consistency with FVCC and MCC

(2) FY 2011 Actual expenditure data for FVCC only; DCC and MCC reported FY 2011 budgeted data as FY 2011 actual data not yet available due to accounting software system conversion to Banner.

Figure 1 also shows the changes in revenues that support the community colleges, including state general fund, tuition, local mill levies, and other smaller revenue sources. As shown on the table, after state funding, the largest revenue source for the community colleges is student tuition. Tuition revenue has increased 95% between FY 2006 and 2011, due to student enrollment increases and tuition and fee rate increases that have averaged about 5% a year during this time period. This additional tuition revenue adds to the cost of education as it is revenue available for the community colleges to support its operating budget.

Local property tax mill levies have increased 29.2% between FY 2006 through 2011 due in part to implementation of the permissive medical levy (see 2-9-212, MCA) at two of the three colleges. This additional property tax revenue also adds to the cost of education as it is revenue available for the community colleges to support its operating budget.

REBASING EXPENDITURES

A significant change included in the 2007 revision of the community college funding formula is the biennial rebasing of the cost of education. Rebasing is the process of reestablishing the budget base that is used to determine the state appropriation for the ensuing biennium.

Why was Rebasing Added to the Formula?

The rebasing was a deliberate change to the formula as the legislature had lost confidence that the previous cost of education methodology accurately portrayed costs at the community colleges. A report from the Legislative Fiscal Division to the Legislative Finance Committee in March 2006 showed that increases to the cost of education factor used by the legislature in the previous funding formula lagged behind the consumer price index, Montana personal income growth, and other state economic indicators. By rebasing the cost of education every two years, the cost is kept more current and representative of actual expenditures at the community colleges.

What has been the Impact of Rebasing?

Rebasing has also contributed to the budget growth between FY 2006 through 2011 shown on Figure 1 because the increased non-state revenue, such as tuition and local mill levies, has increased the amount of revenue available to community colleges and are used to support expenditures that are higher than the base year budget used to set the state appropriation. The expenditures funded from the increased non-state revenue become part of the base year expenditures for the subsequent biennium, and approximately 50% (the state percent share) of the increase then becomes part of the state appropriation for the subsequent biennium.

Figure 2 illustrates a hypothetical example of how rebasing impacts the colleges' budget. The "Original COE" column represents the COE as estimated by the last legislature, along with the funding estimated at 50% from the state and 50% from non-state revenues.

The "Actual COE" column represents the actual base year expenditures and funding reported by the community colleges to the Board of Regents in the annual operating budget.

The "Rebased COE" column represents the rebased actual cost of education. In this hypothetical example, the state share remains at 50% and the dollar amount of the state share increases from $100 to $125 because the actual COE increased from $200 to $250. The entire non-state revenue stays with the community college and becomes part of the base year expenditures for subsequent biennia, thus increasing the total revenue in this example to $275.

The impact of rebasing upon state funds in this example is that the state picks up one-half of the increase in the non-state share. The impact to the community college budget is to increase spending by the additional state funds and the entire increase in non-state funds.

Note: There are other variables that impact the cost of education and community colleges' budgets. However, the hypothetical example was kept simple in order to convey the concept of rebasing.

Figure 2
Hypothetical Example of Rebasing
Community College Funding Formula

Funding	Original COE	Actual COE	Rebased COE
State Share 50%	$100	$100	$125
Non-State Share 50%	$100	$150	$150
Total	$200	$250	$275

Non-state revenue has increased by 42.7 % overall at the community colleges from FY 2006 to 2011.

In summary, rebasing has resulted in the cost of education staying "current" while contributing to significant budget increases in the community colleges.

State Funding Issue Identified

As noted, a major revenue source for the community colleges is local property tax levies required or allowed by law. The allowed levies are listed in Figure 3 on the next page, along with the statutory authorization, a brief description of how the levy revenue may be used, and the total mill levy revenue from FY 2008 through 2012.

Figure 3
Community College -- Local Mill Levies -- FY 2008 to FY 2012

Levy	MCA Authority	Type (Mandatory, Permissive, or Voted)	Purpose	FY 2008 Actual	FY 2009 Actual	FY 2010 Actual	FY 2011 Actual	FY 2012 Original Budget
Mandatory General Mill Levy	20-15-311	Mandatory	Education and general operating expenses of community college	$3,391,149	$3,461,577	$3,656,422	$3,720,649	$3,785,756
Retirement Mill Levy	20-9-501	Mandatory	Employer contribution for TRS, PERS, Social Security (if applicable), Unemployment Insurance	942,719 *(1)*	1,375,122	1,502,033	1,595,029	1,643,460
Audit Mill Levy	?	Mandatory	Non-state portion of biennial audit costs	12,875		14,787		22,500
Permissive Medical Mill Levy	2-9-212	Permissive	Employer contribution for insurance for the amount in excess of the base contribution as determined under 2-18-703	0	0	86,759	214,960	215,492
Community College Service Region	20-15-314	Permissive	To finance services offered by a community college district for the region	207,547	200,392	219,160	220,923	200,000
Debt Service Mill Levy	20-15-301	Mandatory	Principal and interest amount due during the fiscal year	1,443,929	1,441,627	1,411,585	1,391,569	1,289,000
Adult Education Mill Levy	20-15-305	Permissive	Support Adult Ed programs	270,528	287,878	299,176	312,499	324,500
Optional Voted Mill Levy	20-15-311 15-10-425	Voted	Education and general operating expenses of community college	144,000	144,000	144,000	144,000	144,000
			Total All Levies	$6,412,747	$6,910,596	$7,333,922	$7,599,629	$7,624,708

(1) DCC accounted for its retirement levy in the restricted fund until FY 2009

All of the levies listed on Figure 3, except for the debt service and adult education mill levies, are budgeted and accounted for in the current unrestricted operating fund when reported to the Board of Regents each year. This fund also accounts for the state appropriation and tuition and fees.

The retirement levy, audit levy, and medical levy generates revenue for the specific purpose noted on Figure 3 and provide 100% of the funding for the specific purpose. For example, the retirement levy provides 100% of the employer's contribution for the teachers' retirement system, public employees' retirement system, unemployment insurance, and social security. During this review, it was discovered that the formula for the state appropriation does not take into consideration that a portion of the cost of education is funded completely by local mill levies. The impact of not reflecting this local funding in the calculation of the state appropriation is that these expenditures are being funded once from local funds, and again from state funds (at the prevailing state % share rate). The cumulative amount of duplicated payment or overpayment of state appropriation since the formula was revised in 2007 is estimated to be over $3.0 million. Since the levies are required to be used for the specified purpose, this duplicated funding from the state appropriation becomes unrestricted revenue, is used for the general operations of the community college, and drives up the cost of education.

During this review, it was also discovered that state statute does not take into consideration that a portion of the cost of education is funded completely by local mill levies.

Section 20-15-310, MCA defines the cost of education component of the community college funding formula. This statute defines the COE as:

> "the actual costs incurred by the community colleges during the budget base fiscal year, as reported on the current unrestricted operating fund schedule that is statutorily required to be submitted to the commissioner of higher education, minus any reversion and one-time-only expenditures that are included."

In order to eliminate the duplicate funding that is occurring at the community colleges, state statute should be amended to require that the costs funded by the retirement and medical premium local mill levies be subtracted from the COE when the legislature calculates the state appropriation.

Issue: Does the Legislative Finance Committee wish to recommend statutory changes and adjustments to the community college funding formula calculations to recognize the costs that are funded 100% by local levies?

> Option 1 – Yes. Request a bill draft for the September 2012 Legislative Finance Committee meeting that will incorporate the statutory changes necessary to eliminate the duplicate funding at the community colleges.
>
> Option 2 – Yes. Recommend to the 2013 Legislature that the mill levy revenue from the retirement, audit, and medical mil levies in the FY 2012 COE base (and subsequent biennia) be recognized in the calculation of the state appropriation beginning with the 2015 biennium. All other factors being equal, this would result in approximately $1.8 million less general fund in the 2015 biennium for the three community colleges than if the costs funded from mill levy revenue were retained in the FY 2012 COE base.
>
> Option 3 – Yes, recommend that the mill levy revenue from the retirement, audit, and medical mill levies in the FY 2012 COE base be recognized, but recommend that the adjustment hold the community colleges harmless through FY 2012 – effectively allowing the duplicated payment that has already been included in the base remain in the base moving forward, but disallow all future increases in these levies beyond the FY 2012 actual levy amount. Holding the community colleges harmless could also be accomplished by adopting Option 2 and increasing the state % share rate.

Option 4—Accept options 1 and 2

Option 5 – Accept options 1 and 3

Option 6 -- No, take no action.

ALLOCATION OF FIXED AND VARIABLE COST OF EDUCATION COMPONENTS

The 2007 revision to the community college funding formula derives the cost of education from the sum of two components: a fixed portion, which is 75% of the base year actual COE expenditures and a variable portion, which uses the remaining 25% of the base year actual COE expenditures to derive a variable cost per student. The variable cost per student is multiplied by the projected student enrollment to calculate the variable component of the projected cost of education for the upcoming biennium.

This review examined the 75%/25% allocation of the cost of education components to determine if allocating the base year costs into 75% fixed and 25% variable remains valid. To determine this, the definitions of fixed and variable cost categories that were used in the 2007 formula revision were applied to the cost data submitted by the community colleges. Figure 4 below summarizes the fixed and variable costs of education for FY 2011 for each community college and the average for all three colleges.

Figure 4
Montana Community Colleges
Fixed and Variable Cost of Education Components, by College
FY 2011

College	Fixed	Variable	Total	% Fixed	% Variable	College % of Total
Dawson	$2,801,688	$1,033,360	$3,835,048	73.1%	26.9%	15.5%
Flathead	11,444,026	4,180,392	15,624,418	73.2%	26.8%	63.2%
Miles	4,367,875	886,297	5,254,172	83.1%	16.9%	21.3%
Total	$18,613,589	$6,100,049	$24,713,639	75.3%	24.7%	100.0%

As shown on the figure, the fixed and variable cost of education components, when averaged for the three community colleges, remains at 75% fixed and 25% variable. The individual campuses have some variation; most notably Miles Community College has higher fixed costs than either Dawson Community College or Flathead Valley Community College. The funding formula uses the average allocation.

2015 BIENNIUM BUDGET DEVELOPMENT

Actual base year cost of education data for FY 2012 will be necessary to develop the 2015 biennium budget. Dawson Community College and Miles Community College began the process of converting their accounting software to Banner in the second half of FY 2010 and neither college has produced actual accounting data from the new software at the time this report was written. Also, neither college reported FY 2011 actual expenditures to the Board of Regents in September 2011 (FY 2011 budgeted data was reported instead).

At this point in time, it is unknown when Dawson and Miles Community College will successfully produce actual cost of education data from the Banner software. Both colleges have reported they are working towards having FY 2012 data will be available by September 1, 2012.

Issue: If FY 2012 actual cost of education data is not available from Dawson and Miles Community College by September 1, 2012, how should the legislature proceed with estimating the state appropriation?

Option 1 – Use the FY 2011 cost of education data used in the Legislative Finance Committee review and reported in this document

Option 2 – Suspend use of the funding formula for the 2015 biennium and appropriate a sum that is deemed reasonable by the 2013 Legislature.