



MEMORANDUM

To: Dave Nelson

From: Larry Picus

RE: External Cost Adjustment Options for Wyoming

Date: October 10, 2006

One of the issues you have asked us to consider is how to help the Legislature determine the most appropriate External Cost Adjustment (ECA) for the Wyoming School Funding Model in the years between model recalibration. This memo provides background on the ECA issue and describes the differences among potential measures that can be used to establish the ECA for the 2007-08 school year.

BACKGROUND

In its ruling in *Campbell II*, the Wyoming Supreme Court Stated: "We ... hold that the model and statute must be adjusted for inflation/deflation every two years at a minimum."¹

An external cost adjustment can be used to meet this requirement. The purpose of the ECA adjustment is to maintain the adequacy of the funding model, without going through the burdensome task of recalibrating the system every year. Using an estimate of the general rise in prices of the goods and services purchased by school districts is the best way to maintain that adequacy.

There is no single measure of price fluctuation that exactly captures the mix of goods and services each school district purchases to provide educational services. Moreover, even if there were an index that attempted to estimate price fluctuations for educational organizations, it would not capture the exact mix of goods and services purchased by each of the 48 individual school districts in Wyoming. Moreover development of such an index for Wyoming would be prohibitively expensive and subject to the same type of measurement error all indexes of this sort experience. Consequently, our opinion is that use of an annual ECA as determined by the Legislature is the best way to meet the Court's requirement outlined above. This will ensure the model accurately and consistently funds the costs of providing education across Wyoming.

¹ *State v. Campbell County School District*. 19 P.3d 518



In our November 30, 2005 recalibration report², we recommended that the ECA adjustment be formally defined to facilitate future planning for both the state and local school districts. We argued that the importance of having a fixed measure that is established early in the process is important, and suggested use of the WCLI. We also used the WCLI to estimate price changes for resources in the model that needed to be estimated at 2005-06 levels for use in the distribution of 2006-07 funds. The following language is taken from the November 30, version of that report:

External cost adjustment recommendation. We recommend that the state use the Wyoming Cost of Living Index to adjust annually all dollar parameters and salary levels in the formula between the major recalibrations.

The Select Committee approved this recommendation at its August 23rd and October 31-November 1, 2005 meetings.

In running the cost model for those situations in which we needed to adjust the 2002 calibrated dollar figures to an appropriate 2004-2005 base, for use in simulating 2005-2006 aids, we used a cumulative WCLI cost adjustment of 14 percent.

In our conversations with the committee at that time, and in discussions that have taken place since, we have emphasized that more important than the particular index chosen, it is important that some adjustment be made to enable districts to accurately predict future revenues and thus plan for the instructional needs of their students more effectively.

In past years, the percentage change in the indexes from the end of the 2nd quarter in one year to the end of the second quarter in the next year was used to develop the ECA. This means that the percentage change in the indexes from June 30, 2005 to June 30, 2006 will be used to estimate the ECA for the 2007-08 school year.

It is our understanding that the JAC will make a recommendation to the Legislature before the end of 2006, which will enable districts to begin planning, with the recognition that the recommendation may or may not be fully accepted by the entire legislature when it convenes in 2007.

In the past, the Legislature has looked at a combination of indexes before establishing the ECA for the following year. This has generally included:

- The WCLI

² Odden, A.O., Picus, L.O. and others (2005). *An Evidence Based Approach to recalibrating the Wyoming Block Grant School Funding Formula*. State of Wyoming, Legislative Service Office. <http://legisweb.state.wy.us/2005/interim/schoolfinance/Recalibration>



- The CPI-U
- The Western States CPI-U
- The Midwest CPI-U of City Size D (less than 50,000)
- The Employment Cost Index

This memo describes each of these measures and indicates the percentage change in each from June 2005 to June 2006. Members of the JAC can use these figures, along with data on the appropriations for 2006-07 through the Wyoming School Finance Model, to estimate both the ECA and the impact of the ECA adjustment on anticipated appropriations for the 2007-08 school year.

Finally, members of the Legislature have expressed concern about the rapid increase in the price of utilities in recent months and have suggested that a separate index for utilities be considered as part of the overall ECA. This memo addresses that concern as well.

ALTERNATIVES FOR ESTIMATING THE ECA FOR WYOMING

One of the major steps forward in the development of the Wyoming Funding Model for the 2006-07 school year was our ability to use 2005-06 actual salary, education, experience, and responsibility data in the model. This makes much of the data in the model as current as possible improving the reliability of an ECA to reflect changes in the prices of educational goods and services to school districts. Below we outline the options available for estimating the ECA for the 2007-08 school year.

Wyoming Cost of Living Index (WCLI)

One index that has been used in the past to determine the ECA – as well as the Regional Cost Adjustment (RCA) used in the funding model – is the Wyoming Cost of Living Index (WCLI). In fact, the Wyoming Supreme Court stated:

“Given the acceptance of all parties of the validity of the WCLI, adjustments made consistent with that index will be presumed to be adequate. If other methods of adjustment are chosen by the legislature, they must be structured to assure quality of education remains adequate.”³

The Wyoming Economic Analysis Division estimates the percentage change in the WCLI from June 2005 to June 2006 was 5.6 percent. However, a recent report by Rob Godby⁴ suggests the WCLI may overstate the actual rate of inflation, so alternatives to the WCLI should also be considered.

³*State v. Campbell County School District*. 19 P.3d 518

⁴ Godby, R. (2005). *Measuring Price Level in Wyoming: Recommendations to Improve the WCLI*. Laramie, WY Department of Economics and Finance, University of Wyoming. December. (mimeo).



The Consumer Price Index (CPI)

An alternative index is the Consumer Price Index (CPI), either the CPI-U or the CPI-W. The CPI-U is the Consumer Price Index for all Urban Consumers, while the CPI-W is the Consumer Price Index for urban wage earners. We recommend use of the CPI-U as it is more commonly used for this purpose and it captures a basket of goods that is more similar to the mix of goods purchased by school districts.

The Bureau of Labor Statistics computes the CPI-U in the following categories:

U.S. City Average

Regional

Northwest

Midwest

South

West

Population Size Category

A – Greater than 1,500,000

B/C – Between 50,000 and 1,500,000

D – Less than 50,000

Wyoming has no large cities making population size category D the most appropriate for year-to-year estimates of inflation. Unfortunately the data for population size category D are not available in the West region (where Wyoming is located). It is, however, available for the Midwest (which Wyoming borders) and the South.

In reviewing CPI-U data for recent years, we found that Class B/C CPI data tend to exhibit a lower inflation rate over the year than both the all urban classification and the Class A size category. However, in the two areas where Class D data are available, the annual inflation rate is the highest in the areas with population below 50,000. This seems to be the population size category that is most relevant to Wyoming. Given the higher CPI increases in the smallest population size category, it is not surprising that the WCLI's inflation estimates tend to be higher than the general CPI-U estimates

The June 2005 to June 2006 increase in the various components of the CPI-U are as follows:

CPI-U – All items all cities: 4.3 percent

CPI-U – Western Region all cities: 3.6 percent

CPI-U – Midwest Region Size D (less than 50,000): 4.1 percent



The Employment Cost Index (ECI)

An alternative index that could also be considered is the Employment Cost Index (ECI). Like the CPU-U, it is estimated by the Bureau of Labor Statistics, however, the ECI estimates the total cost of all compensation for all employees and various categories of employees.

The June 2005 to June 2006 percentage increase in this measure is 2.8 percent for all private industry workers and 2.3 percent for all Management, business and Financial private industry workers. For education workers, the percentage increase was 3.8 percent.

Summary

There are several different indexes that the JAC can consider in determining the ECA. They are summarized in Table 1 below.

Table 1
Summary of Annual Percentage Change in
Alternative Price Indexes: June 2005 to June 2006

Index	Percentage Change June 2005 to June 2006
WCLI	5.6%
CPI-U	
All Urban Consumers	4.3%
Western Region, All Cities	3.6%
Midwest Region, Size D (less than 50,000)	4.1%
ECI	
All private industry workers	2.8%
All management, business and financial private industry workers	2.3%
Education Workers	3.8%



COMPUTATION OF A SEPARATE ADJUSTMENT FOR UTILITIES⁵

In our 2006 report, we recommended that utility costs be estimated by providing districts with their actual utility costs for 2004-05 inflated up to 2005-06, and that the funding for utilities in future years would simply increase by the amount of the ECA along with all other revenues. Our reasoning was that the indexes being considered – the CPI-U and the WCLI both include utilities as a component of the basket of goods for which prices are reviewed, and thus the impact of increased utility costs would automatically be included in the ECA over time.

Using the logic identified above that no index will perfectly capture the changes in all costs facing school districts, we believe it better to use a more general index that captures the mix of goods and services purchased by schools rather than relying on multiple, complex adjustments for small components of school district expenditures. There is no clear evidence that shows one method is more or less accurate than the other over time. Therefore we stand by our recommendation that utilities not be separated from the balance of the model in computing the ECA.

FINAL RECOMMENDATIONS

As stated above, it is important that the funding model be adjusted annually by an ECA. As the Wyoming Supreme Court recognized in *Campbell II*, absent such an adjustment, funding will not remain adequate over time. As to which index is best, there is no simple or straightforward answer. The WCLI appears to do a good job of estimating the year to year changes in the price of goods and services in Wyoming, but that is somewhat different from the “costs” of the items needed to provide an adequate education. The CPI-U similarly offers an estimate of the impact of inflation on operating costs. The ECI could also be used although perhaps only applied to the salary component of the model.

Our recommendation would be to settle on one method for computing the ECA and use it consistently for the next four years. That approach would make forecasts for school districts straightforward, and allow a choice of measures that enables the state to provide adequate funding opportunities for schools while recognizing the general uncertainty of the impact of inflation on individual schools and school districts.

⁵ Note that as used here, utilities do not include the cost of fuel for school busses as transportation in Wyoming is funded on a reimbursement basis and thus there is no need for an ECA for transportation services.