

# **TO EDUCATE A NATION**

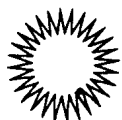
**Federal and National Strategies of  
School Reform**

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Foreword by

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## **4. Challenges in Redistributing Resources across Local School Districts**

### **Evidence from Title I and State School Finance Equalizations**

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Both control and financing of elementary and secondary education in the United States historically have been the domain of local governments. Correspondingly, education funding levels, services, and outcomes vary widely across school districts, both across and within states. This chapter focuses on federal and state efforts to change the level and distribution of local educational expenditures *through inter-governmental grants to local school districts*. Federal and state governments affect local education services through regulation as well as through financing; other chapters in this volume detail the nature and effects of regulatory efforts such as the federal No Child Left Behind Act (NCLB) (Clarke) and state laws on accountability (McDermott).

NCLB is the latest in a long line of omnibus education bills that began with the Elementary and Secondary Education Act (ESEA) of 1965. All of these bills have contained a section called Title I, which provides funds for the basic skills education of children in schools with relatively high rates of family poverty. One basic assumption of Title I is that if the federal government provides substantial funds for basic education to school districts with high rates of family poverty, and if it holds school districts accountable, students' skills will improve in those districts. Leaving aside the question of whether increased funding leads to more effective learning, this chapter casts doubt on another major assumption behind Title I: that providing districts with more funds for certain educational activities will lead to increased expenditures on those activities. As it turns out, giving districts more revenue does not ensure increased educational spending, so hopes for improved student outcomes may be misplaced.

This chapter emphasizes three themes. First, the almost purely local system of education finance that initially developed in the United States possessed both

advantages and disadvantages. Second, in the context of socioeconomic residential segregation, taxation by higher levels of government and intergovernmental grants are necessary mechanisms for redistribution in a locally based system. Third, designing and evaluating the effects of these grants are challenging tasks. I will first discuss these themes in a general context and then illustrate the last point with specific policy examples from federal and state grant programs. For the remainder of this chapter, all discussion of centralization versus local control refers specifically to the *financing* of elementary and secondary education, and not to other aspects of the system.

The rest of the chapter proceeds as follows: I begin by describing the evolution of the federalist nature of elementary and secondary school finance in the United States. Next, I explain how economic theory reveals advantages and disadvantages of local systems of financing public schooling, and how it predicts some difficulty in transferring revenues from one level of government to another. I then present a brief summary of empirical evidence on how successful higher-level jurisdictions have been in supplementing spending by lower-level jurisdictions in targeted program areas outside of education.

Finally, I present my own research findings on the distributional impacts of two intergovernmental education grant programs: the federal Title I program and the broad array of court-ordered state school finance equalizations (SFEs). These are two of the most important intergovernmental grant efforts under way in elementary and secondary education. Title I is the U.S. Department of Education's largest elementary and secondary education program, and state supreme courts have played influential roles in determining how progressive and how centralized education finance systems are since California's landmark *Serrano v. Priest* ruling (1971). Title I and court-ordered SFEs both have unintended effects that prevent them from redistributing as much money as originally intended. Specifically, one source of revenue may "crowd out" another; revenue generated locally to pay for particular programs may decline if local policy makers view incoming state and/or federal grants as full or partial replacement for it. In such situations, total revenue increases by less than the full amount of the new grant(s). Theory predicts that this outcome is difficult to avoid in a system that is still fundamentally local; these offsetting responses may prove a necessary cost of redistribution.

#### HISTORICAL TRENDS IN THE CENTRALIZATION OF U.S. SCHOOL FINANCE

Public elementary and secondary school finance in the United States has grown increasingly centralized over time. Initially, fiscal responsibility for elementary and

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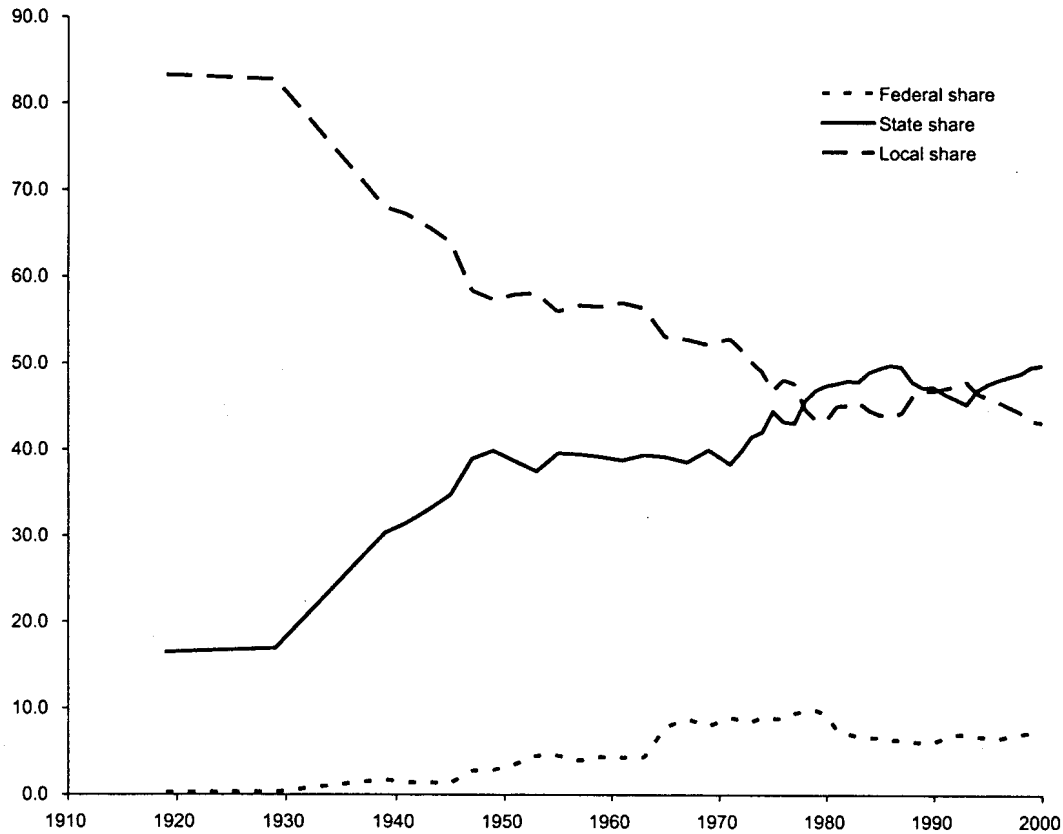
secondary education was entirely private, but some towns chose to organize support for schools through public financing; in 1648, Dedham, Massachusetts, levied the first recorded local property tax designed to support schools.<sup>1</sup> Individual states eventually *required* towns to undertake such efforts, and for at least the next 200 years, most states required local school districts to raise all desired revenue locally.<sup>2</sup> This trend began to change in the early 1800s, when states began to intervene with school finance by offering relatively small lump-sum grants to districts.<sup>3</sup> Not until the early 1920s, however, did states initiate widespread efforts to use intergovernmental grants to reduce inequality in school spending across districts, which typically was caused by disparities in property wealth.<sup>4</sup> Such equalization efforts intensified in the late 1960s and continue through the present day.<sup>5</sup>

Prior to 1965, the federal role in elementary and secondary education finance was inconsequential in magnitude, and much of it was not explicitly redistributive in intent. Most federal elementary and secondary education aid before 1965 focused on math and science education, school lunch programs, aiding federally affected districts, and vocational education. The passage of ESEA in 1965 was therefore a watershed event in the history of federal funding for education.<sup>6</sup> The largest component of ESEA was Title I, designed to assist school districts in providing programs for poor, "educationally disadvantaged" children. Title I dramatically affected federal school funding almost immediately: during the fall of 1965, Congress doubled federal expenditure on education when it appropriated almost \$1 billion for the new program.<sup>7</sup> For decades, Title I has remained the cornerstone of federal education policy.

One way of summarizing these changes is by looking at local, state, and federal revenues distinctly as shares of elementary and secondary school spending. Figure 4.1 shows quite an evolution over time. In the 1920s, local government revenue accounted for 83 percent of elementary and secondary expenditures; this percentage had decreased to just under 50 percent by 1974. Currently, local revenue accounts for about 43 percent of the funds raised for public elementary and secondary schools.

Declines in local revenue shares have occurred because states have shouldered increasing amounts of responsibility for elementary and secondary education. In the 1920s, the states financed about 16 percent of elementary and secondary education costs, increasing to 30 percent by 1939, up to 40 percent by 1949, and reaching almost half of all school revenue by the mid- to late 1980s. Similarly, federal revenue for elementary and secondary education has grown substantially. Although federal monies funded only 7.3 percent of spending in 2000, this number marked a huge increase over the federal government's share of 0.3 percent in 1919. The importance of ESEA is highlighted in the chronology in Figure 4.1.

Figure 4.2 highlights another important contributor to the increased centralization of U.S. elementary and secondary education over the twentieth century:

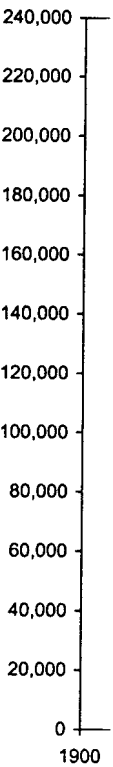


Source: NCES, Digest of Education Statistics 2003, Table 156.

**Figure 4.1. Local, State, and Federal Revenue for Elementary and Secondary Education, 1919–2000**

school district consolidation. Consolidation refers to the process by which two or more local school districts merge. The newly merged district may adopt a new name, or it may retain the name of one of the original districts (typically the larger one). Consolidated districts are decentralized in the sense that they are still controlled at the local level; that said, the process of serving the same geographic area and population via fewer (consolidated) districts is inherently more centralized than doing so with more districts. In 1937, there were 119,001 districts in the United States, and the mean district served 211 enrolled students. By 2000, there were a total of 14,859 districts, and the mean district served 3,177 enrolled students.

Discussion of aggregate U.S. trends masks the fact that individual states' experiences with school finance centralization and consolidation of local districts have varied greatly. The state systems historically have had different levels of centralization. (To cite an extreme example, Hawaii has administered a state-level system without any local school districts since it achieved statehood, whereas Illinois initially had over 12,000 local districts.) Even today, states have widely varying levels



Source: NCES

**Figure 4.2. 1939–2000**

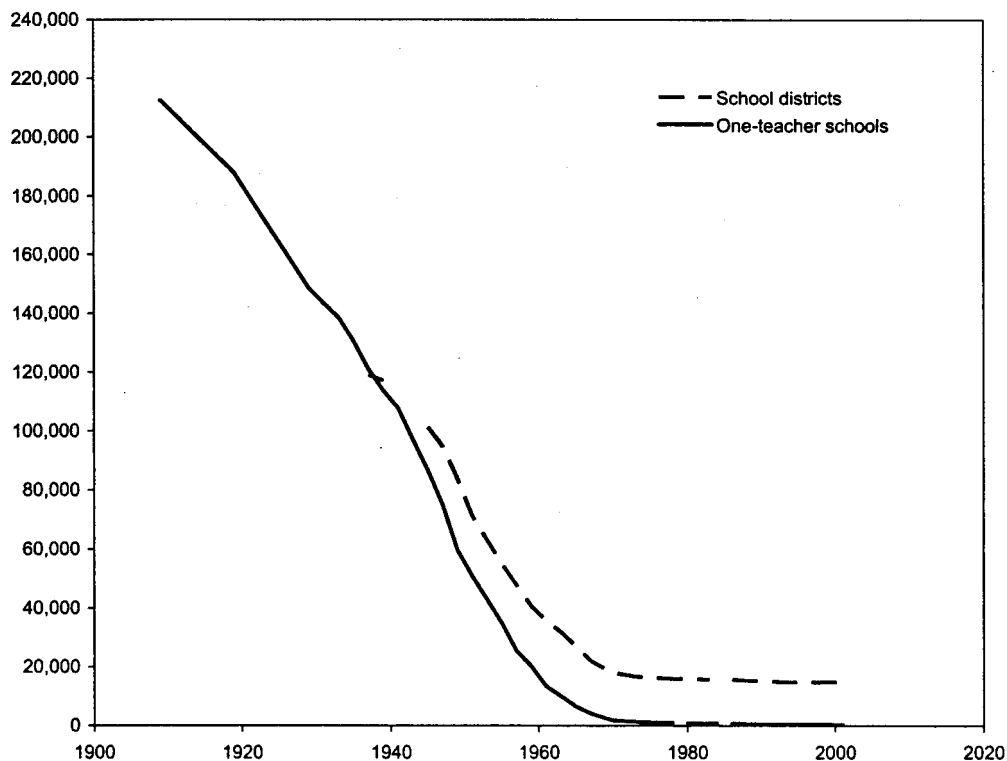
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Source: NCES, Digest of Education Statistics 2003.

**Figure 4.2. School Districts and One-Teacher Schools in the United States, 1939–2000**

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of centralization; only 13 percent of all elementary and secondary revenue in New Mexico was raised locally in 2000, while 63 percent of Nevada's revenue was.

At the state level, transitions from historical structures to the present ones have occurred along different paths. Although aggregate U.S. trends have been relatively smooth, school finance structures in individual states typically have changed abruptly rather than gradually, often because of enactment of SFE reforms brought on by legal challenges. In certain instances, school finance reforms have served as powerful motivators for school district consolidation.<sup>8</sup>

Beginning with the landmark *Serrano v. Priest* case in California in 1971, states have moved toward increasingly redistributive school finance policies. In the last twenty-five years, twenty-two states have been ordered by their supreme courts to redistribute funds to lower-income school districts. Because states see SFEs as vehicles for increasing the resources available to students in poor school districts, many have adopted them voluntarily as well as under court order. All in all, states exhibit wide variation in the structure and details of their SFEs, and empirical and theoretical work has shown that these different ways of distributing state revenue

to districts have significantly different effects on local responses and thus on school spending at the district level.<sup>9</sup>

A large body of research, which I can touch on only briefly here, explores how SFEs have affected the amount and distribution of education spending. The primary finding from this literature is that SFEs do in fact change the amount of state aid to school districts sufficiently to alter both the distribution and mean level of local education spending. Such alterations result from changes in how states distribute aid as well as from changes in the overall amounts states spend on education. Sheila Murray, William Evans, and Robert Schwab<sup>10</sup> found that court-ordered SFEs reduced inequality in local education spending within states by up to one-third between 1972 and 1992. David Card and A. Abigail Payne<sup>11</sup> found that court-ordered SFEs increased the progressivity of state education aid to school districts from 1977 to 1992. After studying a particularly severe SFE, William Fischel<sup>12</sup> found that California's *Serrano* decision—which equalized school spending—led to property tax limitations in Proposition 13 and, subsequently, to declines in education spending.

In summary, the U.S. system of elementary and secondary education finance is a complex web of time-varying local, state, and federal roles, in which the definition of local and state roles varies across states as well as over time.

#### PERSPECTIVES ON REDISTRIBUTION ACROSS JURISDICTIONS WITHIN A FEDERALIST SYSTEM

Is the U.S. school finance system a desirable one? I will examine this question from an economic perspective, noting the advantages and disadvantages of local finance of elementary and secondary education. For the purposes of the following theoretical discussion of local public goods, the early twentieth-century U.S. system of public education—which witnessed little redistribution by state or federal agencies—serves as a good proxy for a purely local system. Once I have established this purely local system's tradeoffs (as implied by economic theory), I will introduce intergovernmental grants into the model so that it more closely reflects the current school finance climate in the United States.

In public finance, much literature is concerned with the problem that when public expenditure programs apply to large populations, such as an entire country, relying on voluntary contributions to fund these programs results in inefficiently low levels of spending. This is the result of what is known as *free-riding*. Put simply, individuals contribute less for a good when they know that others will contribute to it as well, so they will voluntarily contribute an amount that will buy less of the shared good than they want to consume, whereas they would spend more

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if they were the sole contributor toward the good. This insight is well established in both the theoretical<sup>13</sup> and experimental<sup>14</sup> literatures.

Because of the free-riding problem, governments cannot rely on voluntary contributions toward public goods, and instead must collect fees or taxes to fund public expenditures. If individual payments are linked to an individual's stated preference for a certain public spending program (say, schools), that individual is likely to *understate* his or her preference for public schooling in order to avoid higher fees. This "preference revelation problem" is the subject of an extensive theoretical mechanism design literature that aims to develop joint methods of voting and financing that offer individuals incentives to tell the truth about their desired level of public spending.<sup>15</sup>

Charles Tiebout argued that when expenditures are determined within local jurisdictions rather than at a larger central level, people can sort themselves into different, heterogeneous jurisdictions with different levels of public spending (and, correspondingly, different levels of taxation with which to finance that spending).<sup>16</sup> In the Tiebout model, individuals reveal their preferences for public spending through residential location choice. They no longer have incentives to understate these preferences, since doing so would force them to live in jurisdictions with lower-than-desired spending levels. Because locally based systems of public spending are able to reduce free-riding and get people to report truthfully their desired public spending, local systems achieve greater economic efficiency than systems in which only one centralized jurisdiction provides relevant public goods or services. Additional efficiency improvements are derived from the fact that local jurisdictions compete with one another to recruit residents; in efforts to make themselves attractive to potential dwellers, they seek to provide public services more cost effectively.

In a theoretical Tiebout world, education is underprovided at the central level but efficiently provided at a local level. This world relies on a number of restrictive assumptions that are unlikely to hold in reality, including but not limited to the idea that there are no educational spillovers across jurisdictions (I will explain this assumption in detail), the notion that residential mobility is costless, and the assumption that a sufficiently varied array of local communities always exists to meet heterogeneous demands for education and other locally provided goods and services.

There are two main economic arguments against a purely local system of education finance, one from an efficiency standpoint, the other from a distributive standpoint. The efficiency argument challenges Tiebout's assumption that there will be no "spillover" effects across local jurisdictions. For example, the fact that a central city school district spends "too little" on education could negatively affect the well-being of residents of surrounding school districts as well. If other

communities benefit from the education spending in the central city, it would make sense—for the overall group of communities—if the central city would spend more on schooling; if, however, the residents of the central city care only about their own welfare, they will not do so. The implication here is that each district chooses a level of education spending based upon marginal costs and benefits *to its own residents*, ignoring those “spillover” costs or benefits that accrue to people who live and vote outside of the local jurisdiction. In the case of education, these spillovers are quite likely to exist and be substantial through channels such as worker productivity,<sup>17</sup> crime,<sup>18</sup> and civic participation.<sup>19</sup>

The redistributive argument against a purely local school finance system relates to the private benefits of education: that is, the benefits each *individual* accrues as a result of investing in education, as opposed to benefits *society* gains from investing in a given individual’s education. Simply put, because the education of poor children is paid for primarily through taxes on those economically better off, this system of school finance is progressive in nature. The role of education in social mobility makes education a particularly apt channel for this type of redistribution.

In the extreme Tiebout model, each locality is homogeneous, so within-locality redistribution is meaningless. However, in the current system of school finance, local districts are semiautonomous and very heterogeneous; thus redistribution across localities must be the task of higher levels of government, such as states and the federal government. Higher-level jurisdictions can choose among several types of grant structures in their attempts to redistribute education spending. For simplicity, the following discussion will refer to districts as the receiving jurisdictions and states as the jurisdictions making the redistributive grants targeted to elementary and secondary education.

*Block grants* transfer funds from the state to the district. A *conditional block grant* requires that the district spend at least the grant amount on education. (The federal Title I program is a conditional block grant.) This will bind in some cases, but not others. For example, imagine Lakeview School District spends \$7,000 annually per pupil. Under a new state redistribution scheme, it receives a grant from the state for \$100 per pupil. The district then spends \$7,050 per pupil on education, lowers taxes by \$50 per pupil, and argues that it spent the entire \$100 per pupil on instruction while simultaneously cutting \$50 from some *other* budget line item. This fungibility of grant income (and all other income), and the lack of a clear counterfactual—perfect knowledge of what a district would do without the grant at the time—make it difficult to force local districts to increase spending by the full amount of even *conditional* block grants.

Conditional block grants only bind if the receiving jurisdiction had been spending less than the grant amount before the implementation of the grant program. For example, if the state granted Lakeview \$8,000 per student per year, the condi-

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tional nature of the grant would force Lakeview to increase its spending by at least \$1,000 per student per year.

States can support local education spending through *matching grants* in which they match district-level contributions toward education at a set rate of the state's choosing. These rates may vary: a closed-end matching grant, for example, will match local contributions at a set rate up to a certain level of local contributions, but not match contributions above that level. More complex matching-grant regimes could offer differing match rates for different levels of local contributions. Matching grants differ from block grants because they fundamentally change incentives for spending on education; they make education spending "cheaper" than other types of spending. Initial state support for local schools usually took the form of block grants, but current state school finance regimes in the United States combine aspects of block and matching grants.

#### Evidence on Intergovernmental Grants outside of Education

The question of how to redistribute government spending among local jurisdictions is not specific to education. A long-standing question in public finance concerns how intergovernmental grants affect the spending decisions of recipient jurisdictions, and whether such grants reduce previously existing support for the targeted services. This question is highly relevant in the United States, where funding of education, welfare, transportation, and health services (such as Medicaid) relies heavily on intergovernmental grants. Economic theory predicts that a jurisdiction receiving an intergovernmental lump-sum grant will view the grant as income and spend it as such, with a fraction going to the targeted service and the remainder going to other projects or to tax reduction. Many empirical studies, however, have observed that the marginal propensity to spend an intergovernmental grant on the targeted government service is higher than the marginal propensity to spend other income on that service. Arthur Okun called this empirical regularity the "flypaper effect" because money "sticks where it hits." A strong flypaper effect would be revealed in a case where total spending increased by the full amount of a new intergovernmental grant; such a "full" flypaper effect requires no crowding out of existing revenue sources.

Given the current and historical prevalence of such grants, it is not surprising that a well-developed body of literature tackles questions of whether they ultimately supplement, or "stick to," local spending. James Hines and Richard Thaler provide an excellent review of this literature,<sup>20</sup> and Ronald Fisher and Leslie Papke<sup>21</sup> review education-specific flypaper research. Studies included in these reviews typically find that an additional dollar of intergovernmental funding *does* increase expenditures on the targeted program—and usually by a much greater amount than the



## TWO CASE STUDIES IN THE PITFALLS OF INTERGOVERNMENTAL REDISTRIBUTION FOR EDUCATION SPENDING

In this section I present evidence on the impacts of two different attempts to redistribute money through intergovernmental grants: the federal Title I program and assorted state SFE regimes, considered collectively. The Title I program is a conditional block grant, and the SFEs are similar to complex matching grants in which match rates vary by level of expenditure and property wealth. These two cases illustrate the difficulty of reallocating income targeted toward education across jurisdictions.

### Case 1: Title I and the Flypaper Effect

Title I is widely recognized as the federal government's single most important education program.<sup>25</sup> It attempts to increase the resources of school districts that serve economically disadvantaged children, and it cost \$12.7 billion in 2006. It thus represents one-third of the U.S. Department of Education's elementary and secondary budget. The program makes nonmatching grants to school districts based upon the number of poor children they serve, and it specifies that the grants be used to provide educationally disadvantaged children with compensatory education, such as small group instruction outside the classroom.<sup>26</sup> Title I traditionally has been the federal government's main vehicle for directly aiding poor local schools. Among the 10 percent of school districts that rely most heavily on the program, Title I accounts for between 5 and 10 percent of total spending. Under the No Child Left Behind Act (NCLB) of 2001, the Title I program has adopted new accountability standards: schools designated in need of improvement may lose Title I funds.<sup>27</sup>

If other revenue sources to school districts systematically offset gains from Title I, the program will have less than its intended effect on the schooling experienced by poor children. School districts' budgets are determined by as many as three levels of government in addition to the federal government: states, local parent governments such as counties and municipalities, and school districts. Any of these other levels of government may potentially offset Title I revenue. Where this is the case, federal dollars are subsidizing other levels of government rather than supplementing instructional resources for poor children. To address this problem, I have estimated the effect of Title I on school spending, and I then examine how local and state governments respond to changes in the federal program.

Assessing the impact of Title I has been a challenge for previous empirical studies. This is because a district's poverty determines its Title I allocation, but poverty

also affects a district through other channels. In particular, poverty affects a district's ability to raise revenue from its own residents, simply because their ability to pay is a continuous function of their incomes. State aid to school districts also is based partly on local poverty rates, although states generally use measures of economic need based on a district's property wealth per pupil rather than poverty. In my work on this topic I use an innovative identification strategy that exploits a key difference between Title I and state and local funds. State and local revenue both depend on a district's *current* ability to pay.<sup>28</sup> They change annually as the district's ability to pay changes. In contrast, Title I traditionally has depended on child poverty counts from the decennial U.S. Census of Population, and these counts are updated only at ten-year intervals.<sup>29</sup> Thus, Title I allocations jump every ten years, whereas poverty (and the state and local revenues that depend on poverty) change continually. Moreover, decennial census counts are first used in Title I allocations approximately three years *after* the information is gathered, so census-based changes in poverty do not even include *current* changes in poverty, which affect state and local revenue.

Knowing how much Title I affects school spending is quite relevant given the current accountability policy environment. Ultimately, Title I aims not merely to provide supplemental educational spending and services to poor children but to improve educational outcomes for these disadvantaged children. As a rule, the Title I evaluation literature looks for achievement to change as a direct result of Title I revenue, ignoring the possibility that some or all Title I-funded services might have been provided in the program's absence.<sup>30</sup> To the extent that state or local governments offset Title I by lowering their own spending on services to poor students, Title I will have diminished impact on students' educational experiences, and a finding of an insignificant treatment effect (as shown in the congressionally mandated national *Prospects* study, and more recent studies by Wilbert van der Klaauw<sup>31</sup> and Jordan Matsudaira, Adrienne Hosek, and Elias Walsh<sup>32</sup> on a large urban school district in the Northeast) should be no surprise. Indeed, the common finding that Title I students exhibit no relative improvement could be entirely because of their having experienced few additional resources. The impact of a classroom aide, for example, should be the same regardless of whether her salary comes from Title I revenue or local revenue. Given legislatures' current push for accountability in schools, it is important to understand whether the services funded by Title I are ineffective because they are poorly designed or because they do not represent net service increases.

In an article entitled "Do Federal Funds Boost School Spending?" I exploited the large and discrete effects of the decennial updating of child poverty data on Title I grants to estimate the effects of the grants on current total school spending. The data for this study are from the Census of Governments Elementary-Secondary

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School District Financial Data. These data, collected annually for the years of this study, describe school district revenues and expenditures as well as enrollment. The main methodology is estimation of school district-level regressions of the general specification in equation [1]:

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All variables in equation [1] are in per-pupil terms, adjusted for inflation. Because the variables of interest are within-district changes, this specification controls for all district characteristics that remain fixed over time. Changes in per-pupil state and local revenue from 1986 to 1991 (which together compose the bulk of total revenue and spending) were included as independent variables to allow districts to be on different fiscal trajectories; the change in enrollment over the relevant period (above, 1992 to 1993) was included to control for any changes in per-pupil fiscal variables that may have been driven by changes in enrollment rather than changes in spending or revenue. I estimated equation [1] for each of the following dependent variables: total current spending, spending on instruction, spending on services, local revenue, state revenue, and total revenue.<sup>33</sup> Because the data are available annually, I was able to estimate effects over one-year periods (as denoted by the 1992–1993 subscripts in equation [1]) and also over two- and three-year periods (from the 1992–1993 school year to the 1994–1995 and 1995–1996 school years respectively).

Table 4.1 summarizes my findings. Changes in grants were reflected nearly fully in the first year after the shock; but three years later it was possible that instructional spending was unchanged by the grant.<sup>34</sup> Although these estimates reflect how school districts responded to a discretely defined and relatively exogenous change in their Title I grants, it is important to note that the changes were small relative to the overall size of the program. These estimates therefore do not sufficiently inform us as to how much school districts would spend in the complete absence of Title I programs—a question of great interest given the potential for districts to lose Title I funding under NCLB provisions.

If we are interested only in how an intergovernmental grant affects spending on education, then this type of analysis is sufficient. We can see that it does not increase education spending by the full amount of the grant, and in fact it is possible that it has no effect on education spending at all. If we are interested in the greater welfare implications of the grant, however, it is essential to know for which funds Title I serves as a substitute. If receiving Title I funds prompts school districts to raise less money themselves, then residents of those districts will pay lower taxes and have more disposable income with which to purchase other goods. If federal Title I funds prompt state governments to give local districts less aid, we must

**Table 4.1. Instrumental Variable Estimates of Effects of Change in Title I Funds per Pupil on Changes in Revenue and Expenditures per Pupil**

	One-year change, 1992–1993 (1)	Two-year change, 1992–1994 (2)	Three-year change, 1992–1995 (3)
<b>Revenue</b>			
Total revenue	0.981** (0.406)	0.538 (0.485)	-0.036 (0.469)
State revenue	0.348 (0.308)	0.465 (0.487)	0.251 (0.396)
Local revenue	-0.199 (0.337)	-0.952** (0.452)	-1.215*** (0.338)
<b>Expenditures</b>			
Instructional spending	1.401** (0.551)	0.960* (0.509)	0.119 (0.501)
Support services	-0.425* (0.241)	-0.028 (0.264)	-0.293 (0.208)

*Note:* \*\*\*, \*\*, and \* indicate statistical significance at the 0.01, 0.05, and 0.10 levels, respectively. Each cell in the table represents its own regression. Simulated changes in Title I hold poverty constant at 1980 levels, and instrument for actual changes in Title I. All regressions are weighted by district enrollment in 1992, and control for district-level changes in state and local revenue per pupil from 1986 to 1991 and for relevant changes in enrollment (1992–1993, 1993–1994, 1994–1995). Robust standard errors are in parentheses. All amounts are in real 1992 school year dollars. Two- and three-year changes exclude Michigan, which had a major school finance reform during that period.

know what the state government does instead with those funds; possibilities include funding other programs more or lowering statewide taxes.

This raises the following question: if the Title I funds do not fully supplement education spending, where do they go? The funds are disbursed to school districts, which spend only on education, rather than to other local governments with more varied fiscal responsibility. Since the district cannot divert the funds to noneducation programs, the easiest way to use the funds as a substitute for other resources is to reduce other revenue sources. The other revenue sources of interest are state and local; I estimate that the main force behind Title I's limited effect on spending is a reduction in *local* (rather than state) revenues—specifically those raised through property taxes.<sup>35</sup>

What might the implications of reduced local revenues be? As stated above, they give local residents more disposable income with which to purchase other goods. These goods might be private goods or public expenditures financed through taxes

levied by localities, and grant-indeed answer to the SFE reform

### Case 2: The on the District Governme

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levied by local governments other than the school district, such as municipalities, cities, and counties. The distributive and aggregate welfare implications of the grant-induced reduction in school district tax revenue critically depend on the answer to this question. The next case study explores exactly this issue, using state SFE reforms as a shock to state revenue flowing to school districts.

**Case 2: The Impact of State School Finance Equalizations on the Distribution of Education and Other Local Government Expenditures**

Many states are under court order to reduce local disparities in education spending.<sup>36</sup> Although a substantial body of literature suggests that these orders and the resulting SFEs have increased the amount and progressivity of state education spending, there is little evidence on the broader effects of such measures (e.g., how they change the resources available to different localities). When states spend more on education through transfers to local school districts, both state and local budget constraints are affected. State and local decisions about how much revenue to raise and how much to spend on a variety of programs, including those other than education, may respond to the new school finance regimes. These responses are interesting because they have the potential fully or partially to undo the increased levels of government spending on the poor that SFEs are designed to promote. I looked at this topic in my joint work with Katherine Baicker.<sup>37</sup>

We examined how state education aid to local school districts affected the total resources available to school districts and other local governments; we chronicled how much money those local governments spent on programs, both education and noneducation. Court-ordered finance equalizations are widely utilized policy instruments of independent interest, and here they provided us with a source of externally imposed variation in how states transfer funds to local school districts. Such variation is critical to identifying how the receipt of more (or less) state education aid affects other state aid received, local revenue generated, and education and noneducation program expenditures. For example, poorer areas within a state may simultaneously (1) receive more state education aid, (2) receive more state aid through other income-based progressive programs, and (3) raise less revenue themselves through income taxes—all because these poor areas have lower per capita income, not because any one of these developments causes the others. In order to uncover a causal relationship between state education aid and other local fiscal variables, we need to use a source of exogenous variation in the amount of state education aid each locality receives that is unrelated to that locality's desire to spend on other programs. Previous research suggests that court-ordered SFEs provide just such a shock to state education grants to school districts.

School districts are distinct governmental units, and state education aid typically flows directly to them rather than through other local governments.<sup>38</sup> Because school districts by definition spend only on education, we must look to the local governments with which they are geographically coterminous if we wish to identify the effects of SFEs on revenues and expenditures *not* related to education. Therefore, some type of link between school districts and local governments is necessary for investigating the effects of state education aid on intergovernmental revenues for noneducation programs.

The mapping of school districts to other local governments varies both across and within states: school districts may share full or partial boundaries with counties or municipalities. Some school districts contain multiple municipalities, and some cities contain multiple school districts. Additionally, the degree to which different types of local governments (for example, counties versus cities) take responsibility for noneducation expenditures differs by state. For these reasons, using the Census of Government Finances county area unit of observation is helpful because it aggregates revenues and expenditures for all governments within a given county. The county area unit typically includes the county government itself,<sup>39</sup> all municipal and/or township governments located within the county, all school districts in the county, and any special districts in the county.<sup>40</sup> This unit of observation therefore suits our needs because it links school district finances to the finances of other geographically coterminous local governments. It also provides a unit of observation that is consistent across states despite state-level variation in the responsibilities of different levels of local governments. Data aggregated to this county area unit are available from the Census of Government Finances collected by the U.S. Bureau of the Census.

Using the county area as our unit of analysis, we estimated the effect of education revenue from the state to the county area on other county area revenues and expenditures. Formally, in the regression specified by equation [3] we instrument for actual state education revenue to the county area with the state education revenue predicted by equation [2]. In both equations,  $i$  indexes the county area and  $t$  indexes the year. The county area data are available every five years, and we used data for 1982 through 1997. We thus focused specifically on the variation in state education revenue levels attributable to state SFEs, ignoring other changes such as those resulting from changes in county area characteristics with their own independent effects on other fiscal outcomes.

$$\text{educ rev from state}_{it} = \alpha_i + \beta_i + X_{it}\Gamma + \delta_i \text{SFE}_{st} + \varepsilon_{it} \quad [2]$$

Equation [2], the first stage, estimates education revenue to a county area from the state in a given year, controlling for county and year fixed effects, a variety of

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time-varying local demographics ( $X$ , which includes county-level population, employment/population ratio, median family income relative to the state average, percent black, percent Hispanic, percent poor, and percent urban), and the SFE variable, which is equal to one if there has been a school finance equalization in that year or any previous year and zero otherwise. We obtained these variables from the Area Resource File and the U.S. Census Bureau.

In equation [3], we estimated the effects of state education revenue on county area spending and other revenue sources. Again, we used the predicted value from equation [2] as an instrument for actual state education revenue. All of the same controls are included in this specification.

$$\text{revenue or expenditure}_{it} = \alpha_i + \beta_i + X_{it}\Gamma + \delta \text{educ revenue from state}_{it} + \epsilon_{it} \quad [3]$$

Table 4.2 describes our main results, corresponding to the coefficients and standard errors on the  $\delta$  term in equation [3] with column headings describing the dependent variable.<sup>41</sup>

In summary, we find that states *did* change their spending patterns in a way that partially offset the mandated increase in their education spending (although not in a way that diminished their progressivity). Each dollar of increased education funding a locality received from the state resulted in an average decline of about 20¢ in state funds they received for other purposes. Hospitals, highways, and welfare were most affected by these cutbacks, but localities also made significant cuts in spending on police, public health, fire protection, and public buildings. Thus, although mandated increases in state education aid did increase total spending on education, they did so at the expense of drawing resources away from spending on other programs.

Researchers need to incorporate the effect of these offsetting responses when they analyze the effects of mandated education spending changes on student outcomes such as achievement test scores, high school drop-out rates, and college attendance. Changes in these outcomes reflect not only changes in education spending but also changes in *other* resources that are inputs into those same student outcomes. If, for example, high school drop-out rates do not change in the face of increased spending from SFEs, a naïve interpretation would suggest that “money doesn’t matter” for education. But perhaps students simultaneously experienced a decline in programs such as community policing, summer camps, and vaccination campaigns. Where this is the case, an increase in educational resources and a decline in other resources *both* may have affected student outcomes.

Broadly construed, these results have strong implications for redistribution policy in a federal system—both across programs and between localities. The effectiveness of redistribution through specific programs is limited by the ability of

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**Table 4.2. Instrumental Variable Estimates of County Responses  
Instrument is Presence of Court-Ordered School Finance Equalization**

		County-area intergovernmental revenues from the state				
	Total	Total non-education	Highways	Public welfare	Health and hospitals	
State intergovernmental revenues to county-area	0.779 (.080)	-0.221 (.080)	-0.080 (.041)	-0.071 (.022)	-0.043 (.018)	
Observations	12133	12133	12009	11862	11807	

		County-area direct expenditures						
	Education	Public welfare	Hospitals	Health	Highways	Police	Fire protection	Public bldgs
State intergovernmental revenues to county-area	0.860 (.119)	-0.069 (.038)	-0.486 (.136)	-0.097 (.033)	-0.288 (.070)	-0.042 (.020)	-0.045 (.012)	-0.055 (.037)
Observations	12135	11734	11977	11882	12110	12124	11992	11938

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intervening levels of government to "undo" redistribution and to redirect funds for other purposes. In response to mandated changes in spending on certain programs or to certain jurisdictions, state governments may change the composition of funding that localities receive as well as the division of resources *between* localities. Local jurisdictions, in turn, may also change the level and composition of their own spending. In the face of these complexities, policy makers must decide whether their goal is to change the level, distribution, or composition of public spending, and then anticipate the potentially offsetting reactions of intervening levels of government.

#### CONCLUSION

Evidence from Title I's targeted lump-sum transfers from the federal government to local school districts and from the experiences of states rewriting their school finance laws following court orders support the suggestion from economic theory that it is difficult to redistribute money across local jurisdictions. State and federal financial contributions toward (and regulatory power over) elementary and secondary education in the United States have increased in recent years, but it is unlikely that the fundamentally local nature of the U.S. education system will change in the near future, suggesting that policy makers will continue to grapple with the challenges of intergovernmental transfers. Research can aid this process by identifying financing regimes in which targeting is more or less effective<sup>42</sup> and by continuing to study the effects these regimes have on educational spending, inputs, outcomes, and on social welfare overall. Furthermore, responses to grants may vary greatly with local characteristics, so it can be dangerous to take results from one particular policy situation and make predictions outside of the sample treated.

That said, there *is* one clear policy approach that limits a grant recipient government's ability to use money it receives as a substitute for revenue it otherwise would have to raise itself. This approach is to restrict the use of intergovernmental transfers to extremely specific and verifiable areas in which receiving governments had been spending *less* than the grant amount before they began receiving the grant. For example, if a state government knew that school districts typically bought only one new book per pupil per year, and if that state wanted to ensure that school districts buy three new books per pupil each year, it could offer a grant stipulating that the grant money be used for that explicit purpose. The state government could then easily observe book spending at the district level before and after reception of the grant money, and thereby judge the receiving jurisdictions' compliance. Though this approach limits the capacity for crowding out, in many cases it is an unattractive policy option in a system based on local control. Local districts wish to maintain control over their resources, and if they have better information about what

they need than the granting jurisdiction, letting them make decisions themselves will be more efficient.

At the other end of the policy spectrum, governments wishing to redistribute to lower-level jurisdictions could choose to do so in more flexible ways (e.g., through the tax system). A progressive state income tax system redistributes resources from richer to poorer taxpayers, who tend to be geographically segregated. This approach is satisfying if policy makers seek to provide cash resources to poor households rather than to bolster specific programs targeted at poor communities. If the goal is to improve school quality and not simply to redistribute money, this would be an inefficient transfer mechanism.

Given that the need to redistribute across localities is unlikely to change, and that the desire to do so in relatively unrestricted ways is warranted, our best hope is for continued research on how to design these transfers optimally. Although the federalist system results in a complicated array of fiscal regimes across state and local jurisdictions, it also has the benefit of providing ample variation with which to perform such research and identify the most promising forms of redistribution.

## NOTES

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22. When state tax bases increase, government spending is estimated to rise by about 5 to 10 percent of the additional potential revenue; see 218. Legislators almost certainly would be disappointed if total education expenditures rose by only 5 to 10 percent of the increase in the Title I grant amount, but the maintenance-of-effort clause would not be violated in most cases.
23. Brian Knight, "Endogenous Federal Grants and Crowd-out of State Government Spending: Theory and Evidence from the Federal Highway Aid Program," *American Economic Review* 92, no. 1 (March 2002): 71-92.
24. Katherine Baicker and Douglas Staiger, "Fiscal Shenanigans, Targeted Federal Health Care Funds, and Patient Mortality," NBER Working Paper No. W10440 (April 2004).
25. Much of the text in this section is drawn verbatim from Nora Gordon, "Do Federal Funds Boost School Spending? Evidence from Title I," *Journal of Public Economics* 88, nos. 9-10 (August 2004): 1771-1792.
26. Within districts, Title I is allocated to a subset of schools based on school-level measures of economic disadvantage; within schools, Title I services (with the exception of supplemental educational services) are allocated to individual students based on educational rather than economic need. Federal allocations to districts, however, rely on district-level child poverty counts and state-level educational spending.
27. NCLB requires states to set subject- and grade-specific academic standards and to assess students in relation to these standards. The law has several accountability provisions specifying penalties for schools that fail to make sufficient progress in meeting these standards. After two years of failing to make "adequate yearly progress," schools must reserve up to 20 percent of Title I Part A funds for transporting students to schools that are not designated as in need of improvement. They also must reserve 10 percent of Title I Part A funds for educators' professional development. After three years, schools must allow students essentially to cash out their Title I benefits and purchase supplemental instructional services from a private provider.

28. Gordon, "Do Federal Funds Boost School Spending?" 1771-1792.

29. The U.S. Census Bureau began using administrative data to project district-level child poverty counts for the Title I allocation process for the 1997-1998 school year. I consider only years using the decennial data in this chapter.

30. Geoffrey D. Borman and Jerome V. D'Agostino, "Title I and Student Achievement: A Meta-Analysis of Federal Evaluation Results," *Educational Evaluation and Policy Analysis* 18, no. 4 (Winter 1996): 309-326; Brent D. Mast, "Title I and Academic Achievement: Evidence from the State NAEP," American Enterprise Institute, July 2001, mimeo; Michael J. Puma et al., *Prospects*, the congressionally mandated study of educational growth and opportunity (the interim report) (Washington, D.C.: U.S. Department of Education, 1993).

31. Wilbert van der Klaauw, "Breaking the Link between Poverty and Low Student Achievement: An Evaluation of Title I," mimeo, University of North Carolina, Chapel Hill, 2005.

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33. Title I grants are determined by district-level child poverty and by lagged state-level average education spending. Because I am interested in how states respond to Title I grants, I estimate an instrument variables specification of equation [1] in which the change in Title I predicted by changes in child poverty alone, holding lagged state average education spending constant, instruments for actual changes in Title I. In both the OLS estimation as summarized by equation [1] and its instrumental variable counterpart, the identification strategy relies on the decennial poverty updating.

34. Gordon, "Do Federal Funds Boost School Spending?" 1771.

35. Gordon, "Following Federal Education Dollars to Their Local Destinations: Effects of Title I Revenue on Taxes and Local Public Goods," National Tax Association Proceedings, 2003.

36. Much of the text in this section is drawn verbatim from Katherine Baicker and Nora Gordon, "The Effect of Mandated State Education Spending on Total Local Resources," NBER Working Paper No. W10701 (August 2004).

37. Baicker and Gordon, "The Effect of Mandated State Education Spending on Total Local Resources"; see also Katherine Baicker and Nora Gordon, "The Effect of State Education Reform on Total Local Resources," *Journal of Public Economics* 90, nos. 8-9 (January 2006): 1519-1534. The latter estimates the reduced form of the SFE impact and the former uses an instrumental variable strategy.

38. This is true for independent school districts, which comprise about 90 percent of the districts in the United States. Dependent school districts do not collect revenue themselves and instead rely on local governments for their financial support. Our county area aggregation approach allows consistent treatment of both types of districts.

39. Connecticut and Rhode Island do not have county governments recognized by the Census of Government Finances. Because their noncounty local government finances can still be aggregated up to the county level, they are included in our data.

40. Special districts are districts formed for special purposes, independent of other local governments. The most common functions of special districts relate to natural resource management, fire protection, water supply, housing, community development, and sewerage.

41. All revenue and expenditure variables are in thousands per capita, real year 2000 dollars. Standard errors are in parentheses.

42. Hoxby, "All School Finance Equalizations Are Not Created Equal" is a good example of such work.

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