MEMORANDUM

TO: REPRESENTATIVE MITZI JOHNSON, SPEAKER OF THE HOUSE  
SENATOR TIM ASHE, PRESIDENT PRO TEM

CC: SENATOR JANE KITCHEL, CHAIR, SENATE COMMITTEE ON APPROPRIATIONS  
SENATOR COMMITTEE ON APPROPRIATIONS,  
SENATOR ANN CUMMINGS, CHAIR, SENATE COMMITTEE ON FINANCE  
SENATOR PHILIP BARUTH, CHAIR, SENATE COMMITTEE ON EDUCATION  
REPRESENTATIVE CATHERINE TOLL, CHAIR, HOUSE COMMITTEE ON APPROPRIATIONS  
REPRESENTATIVE JANET ANCEL, CHAIR, HOUSE COMMITTEE ON WAYS AND MEANS  
REPRESENTATIVE DAVID SHARPE, CHAIR, HOUSE COMMITTEE ON EDUCATION

FROM: GOVERNOR PHIL SCOTT

SUBJECT: 5-YEAR EDUCATION REVITALIZATION, TAX STABILIZATION & INVESTMENT PLAN

DATE: MAY 1, 2018

Purpose of this Memo
This memo lays out a comprehensive 5-year plan, built on the many ideas and concepts that have been presented though this biennium, both by the Legislature and my Administration, that will do the following:

- Close the FY19 Education Fund gap and prevent future deficits;
- Stabilize statewide property tax rates for five years;
- Fully fund the school budgets local voters have approved for next year;
- Generate almost $300 million in total savings over five years that can be reinvested in more and better early education, K-12 education, technical education, higher education opportunities and lower tax rates.
- Allow education spending to grow sustainably each year based on the average projected increase in grand list value of 3.25% each year\(^1\); and

\(^1\) [http://www.leg.state.vt.us/jfo/education/2017-Equalized%20Education%20Grand%20List.pdf](http://www.leg.state.vt.us/jfo/education/2017-Equalized%20Education%20Grand%20List.pdf)
• Set Vermont on a stable and predictable 5-year trajectory allowing local school districts to take full advantage of the governance changes made under Act 46.

Introduction
Thank you for your April 25, 2018 letter offering to work with my Administration to build a bipartisan consensus plan to address Vermont’s education fund deficit, maximize savings and maintain high quality education. This proposal is a good-faith effort to achieve those results.

Vermont currently enjoys the highest credit rating in New England. The rating agencies consistently note Vermont’s “strong budgetary management framework;”2 its “conservative fiscal management, including prompt action to address projected budget gaps as they emerge;”3 and its “conservative fiscal management and healthy financial reserves”4 as its greatest strengths. It is time to apply these strengths to management of the State Education Fund, which, at about $1.7 billion is the state’s largest expenditure.

As you know, the fund is on track to experience a $58 million deficit in fiscal year 2019 (FY19). This deficit can be addressed just like previous deficits in the Education Fund, with property tax rate increases year-after-year and onetime appropriations made with no offsetting structural reform. In my view this will continue to slowly erode quality and efforts to expand educational opportunities in many areas of the state – particularly in the many communities where school boards are already responding to pressure from taxpayers and declining enrollment.

Some Key Facts
For context, here are some key facts informing this proposal (there are more contained further into this memo):

First, our education system is built for a much larger student population. Twenty years ago, we were educating over 100,000 kids. Today it’s 76,000. Nearly 27,000 less. In that same period, the staff to student ratio has become four students for every staff member. There are schools all around the state -- many of them just 5, 10 or 15 miles from others in the same predicament -- operating class rooms that are much smaller than they were 20 years ago. And declining enrollment is projected to continue well into the foreseeable future.

Second, education is the single largest expenditure in state government. We currently spend about $1.7 billion to educate 76,000 students. Growth in education spending has outpaced growth in wages. It is even outpacing growth in healthcare costs – and this is particularly problematic when you consider we’re experiencing increasing utilization of our healthcare system as our population ages, while the number of students in the education system steadily declines. Continuously raising taxes, be they property, income or others, to address these unsustainable increases will also undermine our ability to make Vermont economically vibrant by keeping Vermonters here and attracting more working age families to live and work here.

Third, these cost increases aren’t translating to better outcomes or more equality. If anything, the status quo is exacerbating inequality. We have some schools offering a wide range of foreign languages, cutting-edge science, technology and engineering classes. Not to mention, sports, drama and music programs. And we have other schools that can’t offer any of these opportunities. We have districts that can afford tax hikes and others that have repeatedly trimmed programs for kids to restrain budget growth, only to learn their tax rates are going up because other schools have increased their spending dramatically.

In addition, looking at the “National Assessment of Educational Progress” – which is one of the few ways to compare performance in Vermont to national averages – our students perform about two percentage points better than the national average. Yet per-pupil spending is double the national average.5

Finally, while we pride ourselves on local governance, our statewide funding formula and a single state Education Fund make it hard to deny that Montpelier inserted itself into local education decisions when Act 60 passed in the 90’s.

Here’s the bottom line: I believe we must take steps now on a multi-year consensus plan to eliminate the current and future deficits, stabilize property taxes, establish a predictable growth rate and create investment opportunities through savings to improve the quality of education.

**Overview of the Plan**
The core mission of our public education system is to provide every family with access to a high-quality education at costs taxpayers can afford. As you know, I’ve called for a cradle-to-career education system that offers more choices, more opportunities and is the very best in the nation.

This education system can be Vermont’s greatest economic development tool and contribute more to this plan by helping to retain and recruit the working families who buy homes in our communities and put children in our schools.

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Vermont’s financial commitment to education is among the highest in the country. In the 2015-2016 school year, Vermont’s per pupil expenditure was $23,557, over $2,000 more per pupil than New York who spent the second most. This compares to a national average of $11,787 per pupil. Our class sizes are the smallest in the country and, relatedly, our schools have the lowest student-to-staff ratios in the country. This goal – having the nation’s best cradle-to-career education system – is attainable within the roughly $1.7 billion we currently spend on preK-12 education, and the growth in our economy and grand list value, but only if we continue to better align the structure of our system with the number of students we’re serving.

Over the last two decades, the total number of students declined by about 1,000 each year -- an average of about 3 kids per day. The U.S. Department of Education projects Vermont enrollment will decrease by another 7,000 students by 2026 -- 25% fewer students than we had 20 years ago. Every dollar spent maintaining an outdated and inefficient system is a dollar not invested in improving the quality of education for our children.

Increasing, only slightly, the student to staff ratio by relying on the natural rate of attrition (retirements and departures) will substantially improve the operational efficiency of the system and the educational quality in schools. As my Administration has pointed out, adjusting our student-to-staff ratio closer to peer state averages, which are still quite low nationally, would immediately generate well over $30 million in savings a year and grow to over $70 million per year by 2024. These savings could be reinvested in better educational opportunities and outcomes, and/or lower taxes.

As noted above, this plan is a 5-year, comprehensive approach drawn from, and expanding upon, ideas put forth by my Administration in its letter dated January 18, 2018 (the Administration’s letter); the work completed by the Legislature on special education and its continuing work on a statewide health plan; and some changes to the current income sensitivity components passed by the House in H.911.

This plan will maximize the value of investments we make in education, while ensuring they do not exceed what Vermonters can afford. In fact, over the 5-year period, not only will we stabilize statewide property tax rates, we will increase our investments in education each year and generate nearly $300 million in total savings that can be invested in lower tax rates, early care and learning, career and technical education, and higher education to achieve a quality and affordable cradle to career education system for Vermont children.

6 http://www.nea.org/home/70716.htm
This plan also complements the work a previous Legislature enacted under Act 46 – work that is essential to establishing the capacity we need to make Vermont’s education system the very best in the nation and directs more of every dollar we spend to our kids.

A summary of the plan is attached. Thank you in advance for your willingness to consider this proposal.

###
5-Year Education Revitalization, Tax Stabilization & Investment Plan Summary

At the outset, the Administration’s goals for this 5-year plan were to build a bipartisan consensus plan that would eliminate the projected FY19 Education Fund deficit and future deficits without raising taxes; provide a more affordable and sustainable way to fund our schools into the future; and ensure districts have flexibility to save money while maintaining quality and expanding opportunities for our children. These goals were set out in the Administration’s January 18, 2018 letter to Senator Jane Kitchel, Chair, Senate Committee on Appropriation (the Administration Letter), shared with Legislators at the start of the session, in which 18 ideas for further study and consideration were offered.

To ensure the plan is received in the bipartisan way it is intended, this comprehensive 5-year approach incorporates work already in progress in the Legislature and sets a course that, if passed, will provide continued property tax relief, maximize the value of investments we make in education, and once again put our strong fiscal management reputation to work.

In fact, as noted, over the 5-year period statewide property tax rates will remain stable, investments in education will continue to increase at sustainable levels, and approximately $300 million in savings could be invested in lower taxes, early care and learning, career and technical education, and higher education to achieve a quality cradle to career education system for Vermont children.

**Eliminating the FY19 Deficit:**
The FY19 Education Fund deficit is approximately $58 million, $9.5 million of this is the shortfall in the Education Fund Budget Stabilization Reserves and $48.6 million is the current FY19 operating deficit. If raised through property taxes (which the Governor will not support) the statewide property tax rate would increase by about seven cents to cover this deficit. Put another way, statewide property tax rates would be growing more than twice the average increase in wages.

By using available one-time funding within our current budgetary capacity, coupled with an interfund cash transfer between the General Fund and the Education Fund of $27 million, we will eliminate the FY19 deficit, pay off the General Fund loan established in Act 179 of 2015 by the Treasurer and Legislature for the Teacher’s Other Post-Employment Benefits Fund (OPEB), fully fund the Education Budget Stabilization Reserves in FY18 and FY19 to its statutory 5% threshold and generate almost $300 million in Education Fund savings before the end of FY24.

- $58 million in one-time funds available from various sources (see below)
- $27 million interfund cash transfer from General Fund to Education Fund
- $27 million to pay off existing General Fund Loan for Teacher’s OPEB
- $8.6 million to fully fund the FY18 Ed Fund Budget Stabilization Reserves
- $0.9 million to fully fund the FY19 Ed Fund Budget Stabilization Reserves
-$48.6 million to fully fund the FY19 Education Fund operating deficit

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Source of Funds

- $19 million from the $34 million received in tobacco settlement funds ($14 million from this settlement remains earmarked for opioid programs)
- $8.6 million in FY18 General Fund surplus revenues (as suggested in Senate waterfall language for FY18 Education Fund Budget Stabilization Reserve)
- $11.4 million in FY18 General Fund Surplus revenues
- $7 million from the General Fund Balance Reserve
- $4 million in direct applications from special funds
- $2 million in direct application from the Department of Financial Regulation non-smoothing
- $2 million reversion from Pay Act and reclassifications appropriations
- $2 million in expected Education Fund carryforwards
- $2 million in savings from changes to our method of calculating property tax adjustments, as proposed in H.911.

The budget currently under consideration by the Senate anticipates $24 million in surplus at the close of the current fiscal year (FY18) (H. 924, section C. 1000). The Administration agrees that surplus one-time revenue will be available and agrees with the Senate proposal to fully fund the FY18 Education Fund Budget Stabilization Reserve to its 5% statutory maximum.

The first $20 million of the FY18 General Fund surplus will be transferred to the Education Fund and used in the following order: the first $8.6 million will be used to bring the FY18 Education Budget Stabilization Reserve to the 5% statutory maximum. The remaining $11.4 will be applied to the FY19 operating deficit and to the Education Fund Budget Stabilization Reserve.

The Administration’s plan immediately retires the existing $27 million balance on the inter-fund loan between the General Fund and the OPEB Fund (as established in Act 179 of 2015) and referenced in Treasurer Pearce’s April 20, 2018 letter to leadership as a long-term financial remedy that was in the best interest of teachers and taxpayers. The version of the budget currently under consideration by the Senate retires the Treasurer’s loan in FY19 using money that may be available should the state’s consensus revenue forecast for FY19 be upgraded. The Administration’s plan assures full retirement of this obligation this fiscal year and allows us to start funding our long-term liabilities sooner, resulting in significant long-term savings. Our current, long term unfunded liability for teachers’ health care is $900+ million.

Much like the $30 million OPEB long-term financial remedy allowed the State Treasurer to leverage our state cash position to jump start funding retired teachers’ healthcare costs, retiring that debt allows us to leverage state cash to seed our 5-year education tax stabilization plan by transferring $27
million to the Education Fund with a plan to transfer the full amount back to the General Fund by 2024.

With this funding plan, we can fully fund all school budgets passed by voters on Town Meeting Day – and we can do it without raising property tax rates. But that’s only a small part of the challenge. The fact that we need an extra $58 million to fund education without raising taxes indicates we have a serious and ongoing structural problem that requires a smart, multi-year strategy.

Policymakers must implement a plan that recognizes the continued decline in student enrollment, takes full advantage of existing tools and allows school districts the fiscal stability and predictability necessary to continue the work of Act 46.

**Reform School Employees’ Health Plans the Right Way:**
As we are seeing presently, negotiating benefits on over sixty different fronts, which has the potential to create thousands of different cost-sharing permutations, has produced a level of administrative complexity that has put school employees’ health care coverage at risk. These challenges and uncertainty for employees, undoubtedly, could have been avoided had we been able to implement a statewide construct for negotiations last year. Nonetheless, the Administration remains committed to working with all stakeholders to move toward a statewide arrangement under which representation for employees and employers bargain over how much each pays for health care benefits.

There are currently a few different proposals under consideration in the Legislature and one commonality is a statewide, bargained framework. Clearly, perspectives have evolved quickly on this key issue, which is a positive development for Vermonters. We feel the most succinct path to the outcome we all want to reach is to build on the infrastructure and relationships already in place.

The Vermont Education Health Initiative (VEHI) has operated as a high-performing and responsible risk bearing entity for school districts and employees over two decades. Going forward, VEHI should continue to function as an intermunicipal health care trust. Alongside VEHI, we recommend creating a benefits advisory group comprised of employees and other stakeholders to provide input to VEHI on plan design and to address some of the concerns raised by the Vermont NEA.

Additionally, with nearly all employee contracts reopening in the summer of 2019, the Administration recommends establishing statutory boundaries on health care benefits for calendar year 2020 and 2021. The boundaries should align with the constraints recently expressed by the new, third-party administrator of school district’s employees’ health benefits.
Finally, by deferring action on a statewide health benefit last year, negotiated agreements resulted in $4.29 million higher costs for Health Reimbursement Accounts (HRAs) alone last year than they would have under the Act 85 recommended arrangements. The new terms, in many cases, do not have the HRA roll over to the employee in subsequent year. While the dollar amount negotiated at the local level last year exceeded targets, the out-of-pocket arrangements many districts decided on compounded future premium costs to taxpayers and employees due to how these arrangements interface with utilization.

The first sign of this unsustainable trajectory came last fall when VEHI requested a 16.8 percent rate increase for FY19 through the Department of Financial Regulation. For this reason, on all applicable plans, we must use Health Savings Accounts for calendar years 2020 and 2021.

While putting the cost-share arrangements in statute would correct the course of health care spending in education budgets, it is not a long-term solution and we should go back to a bargained arrangement in which school employees negotiate the terms of these benefits with employers. As an interim step, we should establish a commission to develop a statewide bargaining framework with equal representation from employees and employers. This commission shall consider issues of representation, timing, impasse procedures, incorporation into agreements, ratification and a process to adjudicate complaints of unfair labor practices.

This framework builds on the decades long relationships between school districts, school employees and VEHI.

**Improving Efficiency and Value with Better Staff-to-Student Ratios:**

The Education Fund can achieve substantial savings over the long term and simultaneously shift the focus from the cost of education to the quality of education – if we make changes now.

Increasing, only slightly, the student/staff ratio by relying on the natural rate of attrition (retirements and departures) will substantially improve the operational efficiency of the system and educational quality in schools.

Excluding certain employee categories, some of which are federally mandated (special educators) and others of which may be contracted out (e.g., bus drivers, food service), Vermont schools have on average 1 employee for every 5.15 students. Without these exclusions, our schools average 1 employee for every 4 students.

This plan proposes to achieve higher ratios over 5-years with the identified exclusions (such as special education), beginning in FY20 that will move staff-to-student ratios from 1-to-5.15 to 1-to-5.75 through FY24. Again, this would rely on the natural rate of attrition.
Working with the education community, as reflected in the 2017-18 Vermont School Boards Association Cost Containment Resolution, a task force will be convened to identify how different categories of schools and different district/SU configurations can best strategize to achieve higher ratios. The focus of this work, to be conducted this coming summer, will be on helping local school boards plan for and strategize in the coming five-year period. We feel this approach is critical, as it is the local education agencies that can best decide what strategies will work for them. This task force should also consider whether aspects of the regulatory environment, such as increasing flexibility in mandatory staffing requirements, could contribute to lower student-to-staff ratios. This plan assumes that in FY20, a ratio of 1-to-5.40 will be achieved, saving $32m in that year alone.

A recent VT-NEA Economic Analysis projected attrition of approximately 1,000 Teachers and Educational Support Professionals (ESP) per year. The Administration plan estimates vacancy savings from less than half that number. Further, the attrition proposal reflects a statewide aggregate ratio, begins in FY20, and convenes a task force that will address the very legitimate “one size does not fit all” concerns sometimes offered as a blanket reason why achieving a more rational ratio (which would remain among the lowest in the nation) cannot be done.

**Phase Down the Excess-Spending Threshold to 110 percent Over 5-Years:**

H.911 introduced a major change to the funding formula (how a budget becomes a local tax rate), with a goal of making high spending districts pay a higher price for additional dollars spent. The House proposal is such a dramatic shift it would require $60 million of additional funding, raised through a surcharge on the existing personal income tax.

Furthermore, rather than constraining spending as intended, the tax capacity created by H.911 is likely to induce additional spending, as all increases in tax capacity have demonstrated (see also: Act 68). The Administration does not support an income tax in the House passed version of H.911. Instead, the Administration plan changes the excess spending threshold beginning in FY20.

Currently, the excess spending threshold (EST) double counts the portion of per pupil spending more than 121% of the statewide average when computing district tax rates. The EST is very effective at constraining spending and encouraging innovation and, in some areas, is helping to advance consolidations that increase the capacity of districts to make more investments in education quality. Many districts spend just under the threshold, and very few spend more than the threshold.

This proposal will gradually reduce the EST over 5 years from 121% to 110%, allowing time for schools to adjust their budgets in concert with the attrition-driven student to staff ratio goals detailed above. It also reduces allowed aggregated exclusions in the calculation to 50%. Using the current law formula, reducing EST over 5 years from 121% to 110% will save $3 million in FY20 and almost $10 million in year 5.
Transition to New Special Education Payment Model:
One contributing factor to excess staffing in schools is our special education funding formula. We have long known our special education funding model needs repair, and we commend the House and Senate Education Committees for the good work they have done on H.897.

The state match rate for special education is 60/40, meaning state funds pick up 60% of the cost of special education, and this rate rises to 90/10 over a $50,000 threshold spending level (which hasn’t been adjusted in over 20 years). This funding method is a factor in Vermont’s unusually high ratio of special education to general education students.

A UVM study, called for in Act 148 of 2016, concluded that switching to a census-based funding model for special education would provide better outcomes at reduced cost. The approach would be phased in over a 5-year period but ultimately would produce almost $35 million in savings annually. Importantly, savings do not result from reduced spending on special education but rather from managing resources at their current levels. Again, the Administration appreciates the work done by the House and Senate in this area and have included it in this plan.

Focusing our Property Tax Adjustment System:
Seventy percent of Vermonters do not pay their full property tax bill under current law because of a reduction based on income (known as “income sensitivity”). The total cost of the program ($170+M) contributes over 20 cents, or 13%, to the average education property tax bill. To qualify for the reduction, a taxpayer must make less than $147,500, an income level that encompasses over 90% of Vermonters. The maximum house value eligible for relief is $500,000 and provides a housing subsidy to Vermonters living in homes valued at well over twice the median Vermont home value.

The program is an effective way to increase the affordability of housing for many deserving Vermonters. However, the original program has expanded to insulate many who do not have an affordability challenge, and in speaking with local clerks, treasurers, assessors and listers it is clear credibility and faith in the system has been compromised.

Voters consistently rate property taxes as a top concern, yet statewide town meeting day voter turnout is just over 20% (vs. 60+% in November elections.) This is not surprising with so many Vermonters being partially or fully insulated from the municipal and school budget decisions, where they cannot reasonably be expected to compute the net tax impact of the budgets they are voting on. Transparency, simplicity and connecting voters to budgets are all principles not met with a system so convoluted, which has lost its focus on assisting the economically vulnerable.

The House recognized these concerns in H.911, which reduced the maximum eligible house-site value from $500K to $400K effective in FY19. Net savings from this provision are $2M in FY19.
The Administration plan calls for reforms to the eligibility criteria for property tax adjustments that will focus the benefit on vulnerable Vermonters and, importantly, have no effect on current recipients. This proposal will gradually bring new homeowners into a more rational system that is simpler, more transparent and increase their connection to local budgets thereby improving local control. A critical element of the proposed changes is that they apply only to new homesteads established after July 1, 2018, so that no existing Vermont homeowners receiving property tax adjustments are affected.

The plan includes the following changes effective July 1, 2018:

- The maximum house site value used in the income sensitivity calculation will change to $250,000 minus the applicant's household income.
- When computing Household Income, a deduction of approximately $4,000 is allowed for each household member consistent with exemptions taken on the tax return. This provides a more robust benefit for a family of 5 making $50,000 compared to a single homeowner of the same income, recognizing that the discretionary income and ability to pay of a larger household with the same total income is very different. The result of this change means a low to middle income family of 4 living in a modest Vermont home could be eligible for more relief than under current law.
- Shifts the system to one educational property tax income rate, and one additional 3% cap (municipal circuit breaker) for those under $47,000, greatly improving the opportunity for Vermonters to understand how their adjustment is calculated. Under current law, there are two sets of criteria and rates that apply, (depending on income levels) that complicate the system and provide little or no transparency for Vermonters struggling to understand how their tax bill is computed. Savings to the Education Fund of these changes for new homesteads starting in July 1, 2018 start out at about $1 million and rise over time as homes change ownership and the new system ultimately becomes the norm.

An additional summary presentation is attached for your information.

###
FY19 - FY23 Education Spending and Enrollment Projections

Enrollment projection is Consensus JFO and Administration Forecast through FY20, then grown by CAGR blended with VTNEA Economic Analysis CAGR. Education spending projection is FY19 "Education Payment" line from EF Outlook grown by FY15-FY19 CAGR (2.238%)
Projected Education Fund Money Available for Investment after Administration Cost-Saving Initiatives

- Available for Investment
- Savings from Admin Initiatives
- FY19 GF->EF transfer with FY21-FY23 Payback
- One Time Transfers (payback FY23 & FY24)
- Transfer (to)/from Stabilization Reserve
- EF Operating Deficit

Millions of Dollars

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## Education Fund Savings Proposals

(in $millions)

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<th>Background/Source of Proposal</th>
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<td><strong>Increase student/staff ratio</strong>&lt;br&gt;Administration letter (January 18, 2018), VSBA Resolution, VTNEA projection</td>
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<td><strong>Transitions to statewide healthcare bargaining</strong>&lt;br&gt;2017 Governor Scott Proposal/VEHBC Recommendation, H.858</td>
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<td><strong>Property Tax Adjustments changes to new homesteads established after July 1, 2018</strong>&lt;br&gt;Administration letter (January 18, 2018) discussed income sensitivity reform, including housesite value</td>
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<td><strong>Reduce excess spending threshold gradually over 5 years (beginning in FY20)</strong>&lt;br&gt;Administration letter (January 18, 2018) advanced a similar reduction in the threshold</td>
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<td><strong>House site value from $500k to $400k (H.911)</strong>&lt;br&gt;H.911 - House passed</td>
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* Current student to staff approx. 5.15, increase to 5.75 by FY2024